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MAJOR RISK FACTORS IN THE U. S. ECONOMY AND HOW INVESTORS CAN PREPARE FOR THEM

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The purpose of this paper is to assess the current state of the U. S. economy and formulate an investment policy appropriate to that assessment. Let us begin, however, with two premises that should probably be cornerstones of most investment policies most of the time.

The first premise is that the primary investment objective of most conservative investors should be "preservation of purchasing power," as opposed to "preservation of principal." If we have exactly the same number of dollars a decade from now as we have today, but each dollar will then buy only half as much, our investment program has not been a successful one.

The second premise is that, because the major forces that impact the securities markets tend to occur when least expected, it is wiser to "prepare" for them than try to "predict" them.

INFLATION & THE CONSUMER PRICE INDEX (CPI)

After spiraling upward to an annualized rate of 14.8% in 1980, the rise in the Consumer Price Index (CPI) slowed and remained relatively quiescent for about a quarter of a century. As anyone who drives a car, heats a home, or buys food knows, however, in recent months, the CPI has come to life again.

Chart #1 shows how the CPI, which had been rising at a rate of less than 2½% per year in the early months of 2007, has quickly climbed to about 4% per year today and seems headed higher still.*

THE PRODUCER PRICE INDEX (PPI)

The Producer Price Index (PPI), until 1978 known as the Wholesale Price Index (WPI), is published in three parts: the PPI for Crude Goods, the PPI for Intermediate Goods, and the PPI for Finished Goods. As an example, Crude Goods includes iron ore, Intermediate Goods includes the steel made from the iron ore, and Finished Goods includes automobiles made from the steel.

When the automobile is sold by the manufacturer to the automobile dealer its price is reflected in the PPI for Finished Goods; and, when the dealer sells the vehicle to a consumer, its price is reflected in the CPI. If, then, the manufacturer raises its price to the dealer, it is reasonable to expect this increase to be passed on to the consumer, with a delay equal to the time the automobile remains on the dealer's lot unsold.

And so, according to economic theory, price changes for crude goods get transmitted to intermediate goods, price changes in intermediate goods get transmitted to finished goods, and price changes in finished goods get transmitted to the CPI. If we want an idea as to which way the CPI might move in the months ahead, it is, then, customary, to take a look at the three components of the PPI. Let us begin with Chart #2, which shows how the PPI for Finished Goods has behaved since the beginning of 2007. Its rise has been even more dramatic than that of the CPI, and it is now rising at a rate of about 7% per year. It is, then, not unreasonable to fear the possibility of the CPI's rising at a rate of 7% per year in the not-to-distant future.

Chart #3 shows us that the PPI for Intermediate goods is now clipping along at a rate of over 10% per year. It is, then, not unreasonable to fear the possibility of the Finished Goods PPI's rising at a rate of 10% per year not too far down the road.

Chart #4 is the show-stopper. As can be seen, the PPI for Crude Goods has been ratcheting up at a rate of over 30% per year.

THE ROOT CAUSE

Chart #5 identifies the primary culprit. It is an index of the cost of imported petroleum products, and it has increased by a factor of nearly seven in as many years.

Chart #6 provides an index of the value of the dollar versus the currencies of our major trading partners. It is tantamount to an "inverted" CPI representing the cost to U. S. consumers of goods and services produced outside the United States.

It is useful to recognize that a weakening of the U. S. dollar exacerbates the inflation problem at home. On the one hand, to the extent to which foreign goods and services are purchased in the United States, they may become a part of the basket used to calculate the CPI. In addition, however, the growing export markets generated by the dollar's decline enable domestic producers to raise prices for domestic consumption even more than they could if the dollar were stable.

THE PROGNOSIS

Are we apt to have 7%, inflation, 10% inflation, 30% inflation, galloping inflation, runaway inflation, hyper inflation? Let us hope not but also be on guard for such possibilities. It is a part of the Federal Reserve Board's mandate to try to keep inflationary forces under control, and it will certainly do what it can to fulfill that obligation.

AS INVESTORS, HOW DO WE PREPARE FOR ACCELERATING INFLATION?

To the extent that we want to prepare for the possibility of a bad inflationary scenario, there are certain steps we probably should not take. We do not want to be lenders because, in such an environment, we would surely be paid back with dollars worth far less than those we loaned out. To the extent that we have our money in bonds, bank certificates of deposit, or even money market funds, we are lenders.

The alternative to being a "lender" is being an "owner." If we own something for which the replacement value goes up with inflation, we stand a good chance of maintaining our purchasing power. Owning our home is a good example of such an inflation hedge. In spite of the slide in home prices in recent months, the fact remains that, if inflation persists or grows worse, the replacement cost of our house will inevitably be higher a few years out than it is today.

The other major protection against inflation is common stocks. Because a common stock represents the ownership of such assets as buildings, machinery, equipment, fleets of vehicles, inventories, organizations of people, patents, trademarks, copyrights, corporate images, and reputations, the replacement costs of which rise with inflation, common stocks have historically been the other major hedge against inflation.

UNEMPLOYMENT

Inflation may not be the biggest economic problem that lies ahead of us. As seen in Chart #7, the unemployment rate appears to be rising rapidly. Admittedly, the unemployment rate is currently little more than half the 10.8% peak it reached in 1980 and a far cry from the 24.9% it reached in 1933, but it is the behavior of other economic measures that may lead to higher levels of unemployment that are of concern.

For example, Chart #8 shows how, after creating jobs at a declining rate for about two and one half years, the economy is now losing jobs at an increasing rate.

The primary culprit in the loss of jobs and the weakening economy has been the homebuilding industry. Chart #9, which tracks new home sales since 1963, puts the recent homebuilding bubble and its bursting in some historical perspective. For about three decades, in the sixties, seventies, and eighties, building cycle swings were of modest proportions, as compared to what we have experienced since the

early 1990s. As the chart indicates, since early 2006, new home sales have been in a free fall.

Just where the homebuilding industry is headed is very important. It is estimated that this industry and those industries directly related to, or heavily dependent upon it (major appliances, for example) account for 27% of the U. S. Gross Domestic Product (GDP). It is further generally accepted that it is impossible for the economy to right itself until the downward spiral in new home sales and new home prices is arrested.

New Home Construction

Just as the three components of the Producer Price Index may provide us with an indication of where the Consumer Price Index is headed, there are three measures tracked by the U. S. Census Bureau relating to New Home Construction that may give us a preview of where New Home Sales are headed. Going backward in time, they are New Home Completions (Chart #10), New Home Starts (Chart #11), and New Home Building Permits (Chart #12). Clearly, if new homes are not completed, they are not likely to be sold; if they are not started, they cannot be completed; and, in most jurisdictions, if a building permit is not issued, they cannot even be started.

In addition to the precipitous declines we see in all four of these indices, it is interesting to note that the rate of new home sales is significantly lower than the rate of new home completions, confirming the well-known fact that the inventory of unsold homes has been growing rapidly. The rate of new home starts is well below the rate of new home completions, and the rate at which new building permits are being issued is well below the rate of new home starts, which all seem to indicate that there is not yet any light at the end of the tunnel.

Home Prices

Chart #13 shows how, in 2004, 2005, and 2006, home prices were still rising, but at ever slowing rates and, then, how, in 2007 and 2008, home prices have been falling at an ever rising rate.

The decline in home prices inflicts a double-whammy on the economy. With the resale price of a new home less than its cost of construction, the home building industry is negatively impacted, as demonstrated in the foregoing charts. In addition, however, consumers had become acclimated to using the equity in their homes to finance current consumption and, so, now that source of spending is being dramatically curtailed as a source of economic growth.

Consumer Confidence

Not surprisingly, Chart #14 shows that the average consumer is less-than-sanguine about his economic future. Unfortunately, the consumer's state of mind can further compound the problem. To the extent that we start saving for a rainy day, pay down debt, and otherwise retrench on our spending, it becomes still more difficult for the economy to pull out of its slump.

Between a Rock and a Hard Place

So, are we in a recession or headed into one? If so, will it be a severe recession such as we had a generation ago or a depression such as we had two generations ago? Whatever it is, will it be global in nature and so even more intractable than in the past because of the increased interdependence of the world's economies?

In addition to its mandate to try to keep inflation in check, the Federal Reserve Board is supposed to do its best to keep the economy running at full employment. The great irony, however, is that the very steps required to tame inflation (which includes raising interest rates) can accelerate the deterioration of the economy, and the very steps required to stimulate the economy (which includes lowering interest rates) can accelerate the rate of inflation.

This is the problem with which the central bank was faced in the late 1970s and early 1980s when both the unemployment rate and the inflation rate got into

double digits and the prime interest rate ran up to 21.5%. This was what came to be known as a period of "stagflation," and surely one of the risks we now face is the possibility of experiencing another period of "stagflation" in the current decade, and possibly the next.

When confronted with a choice between a rising unemployment rate or a rising inflation rate, it would seem likely that the Fed would opt for the latter. When unemployment rises, the entire economic pie shrinks and so, collectively, we all have less. In contrast, when the rate of inflation rises, the total pie may actually expand, in which case, collectively, we are better off. It is just that the pie is shared in ways that were not previously intended. Lenders suffer, holders of physical assets prosper, and borrowers make out like bandits.

As Investors, How Do We Prepare for Both Accelerating Inflation and a Deteriorating Economy?

If we determine that we had better be in common stocks to protect ourselves against rampant inflation, it would seem to follow that, if we also want to prepare for the possibility of some sort of economic meltdown, those stocks in which we do entrust our financial future should be of extremely high quality.

About the simplest definition, and arguably the best definition, of a high quality common stock is one for which the underlying company has both a strong balance sheet and a healthy income statement.

We know from the history books of the carnage inflicted upon investors during the 1930s, and many of us were witness to the carnage inflicted upon investors during the 1970s and early 1980s. Not all common stocks proved disasters in those dire economic times, however. The common denominators of those companies that survived either period in tact were that they went into those periods with strong balance sheets and healthy income statements.

A few companies that fell into this latter category during both of these periods of severe economic stress, as testified to by their abilities to continue to pay cash dividends, without interruption, throughout both periods, appear in the table on the following page. In other words, history indicates that we should be able to provide ourselves with considerable protection against a calamitous economy, if we exercise discretion in the quality of the common stocks we own.

The most widely accepted way of measuring the quality of a common stock is by its Standard & Poor's quality ranking. Stocks with S&P rankings of A+, A, or A- are generally considered to be of high quality, while those with lower rankings are not.

Conclusion

In preparation for the possibility of rampant inflation, severe recession, or both, it is our suggestion that most investors keep their savings predominantly in high-quality common stocks, and that those investments that are not common stocks also be confined to issues of very high-quality.

For investors uncertain as to the underlying quality of their security holdings, we stand ready to provide such assessments at no cost or obligation.

COMPANIES PAYING CASH DIVIDENDS IN EVERY YEAR SINCE BEFORE THE GREAT DEPRESSION

COMPANY	CASH DIVIDENDS PAID IN EVERY YEAR SINCE
Abbott Laboratories	1926
Archer Daniels Midland	1927
Bank of New York	1785
Briggs & Stratton	1929
Bristol-Myers Squibb	1900
Campbell Soup	1902
Caterpillar Tractor	1914
Chevron (Standard Oil of California)	1912
CIGNA (Conn. General Insurance)	1867
Coca-Cola	1893
Colgate Palmolive	1895
Donnelley (R. R.)	1911
Eaton	1923
Exxon (Standard Oil of New Jersey)	1892
Gannett	1929
General Electric	1899
Heinz (H. J.)	1911
Honeywell International	1887
Hormel Foods	1928
Imperial Oil	1891
International Business Machines	1916
Johnson Controls	1887
Lilly (Eli)	1885
Minnesota Mining & Manufacturing	1916
Owens & Minor	1926
Penney (J. C.)	1922
Pfizer	1901
Proctor & Gamble	1891
Rohm & Haas	1927
Union Pacific	1900
Whirlpool	1929
Wiley (John) & Sons	1904

Though the above names provide examples of some better-known companies that weathered the last two economic storms well, not all of these companies are necessarily expected to weather the next such storm as well, should there be one.

* Because of the erratic nature and frequent subsequent revisions of the data used to construct the accompanying charts, moving averages are used in some instances to help highlight underlying trends.

This paper represents the general economic overviews of Clifford Dow, Dow Investment Group, LLC, and does not constitute investment advice, nor should it be considered predictive of any future market performance.

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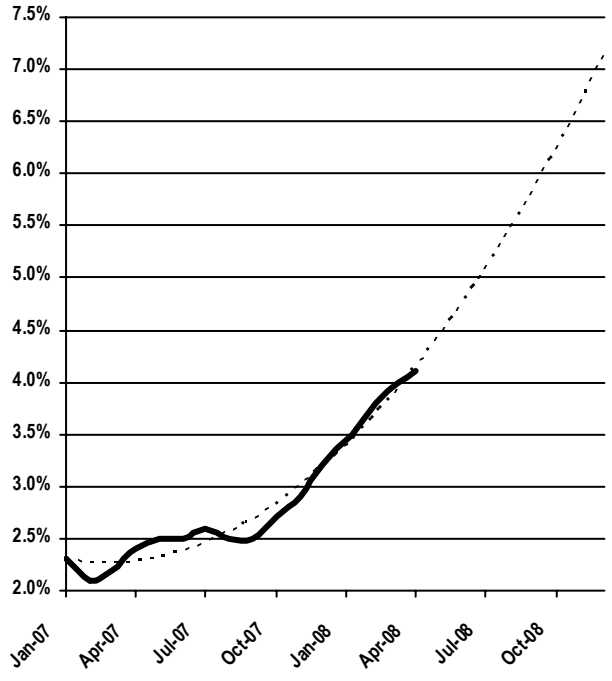
CHART #1

CONSUMER PRICE INDEX

% Changes in Year-to-Year 6-Month Moving Average

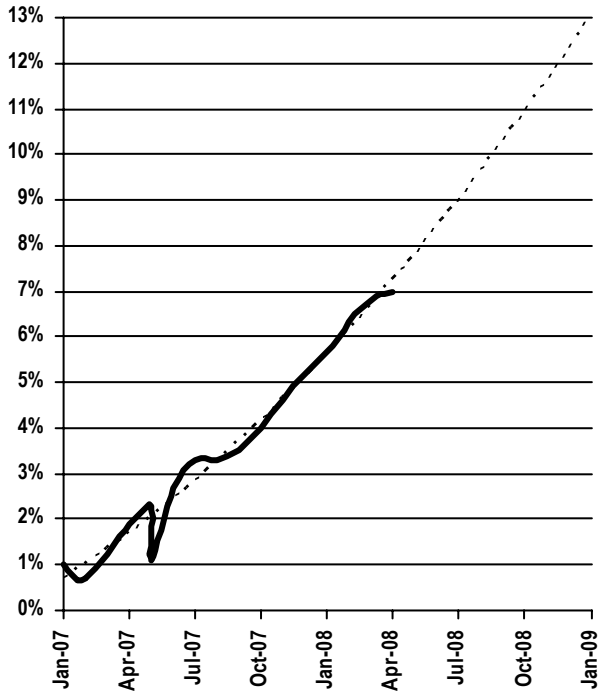


Source: US Bureau of Labor Statistics 5/14/08

CHART #2

PRODUCER PRICE INDEX - FINISHED GOODS

% Changes in Year-to-Year 6-Month Moving Average

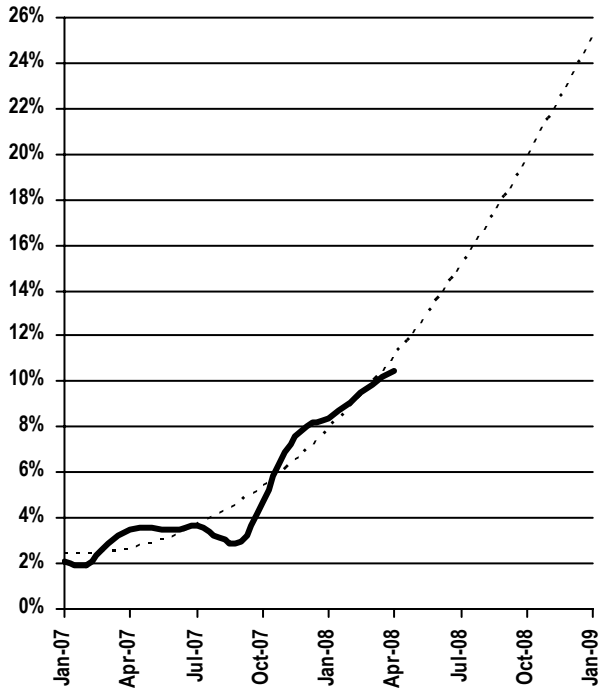


Source: US Bureau of Labor Statistics 5/20/08

CHART #3

PRODUCER PRICE INDEX - INTERMEDIATE GOODS

% Changes in Year-to-Year 2-Month Moving Average

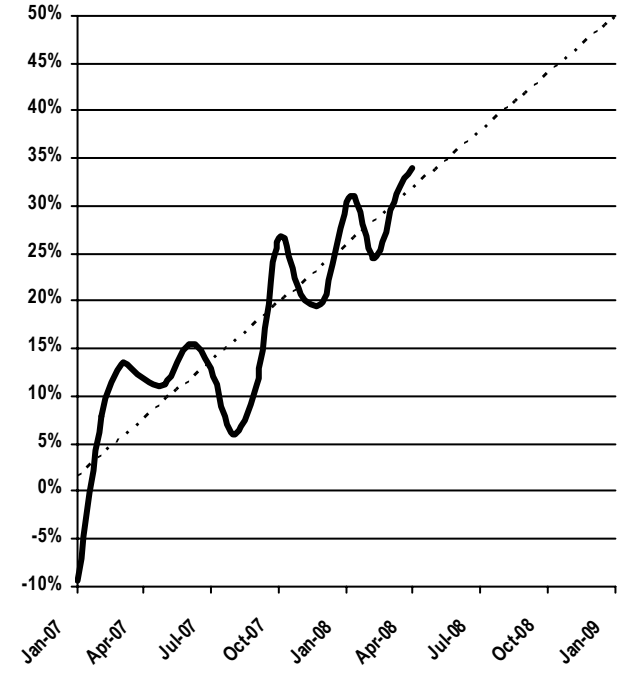


Source: US Bureau of Labor Statistics 5/20/08

CHART #4

PRODUCER PRICE INDEX - CRUDE GOODS

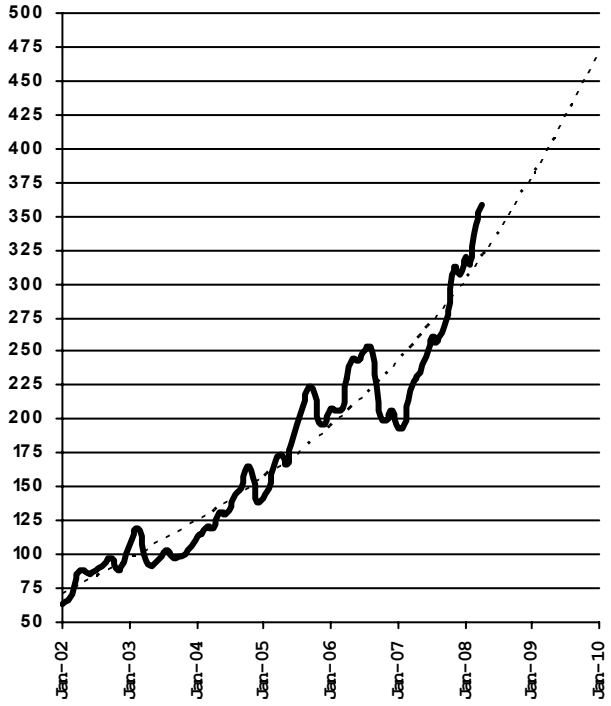
% Changes Year-to-Year



Source: US Bureau of Labor Statistics 5/20/08

CHART #5

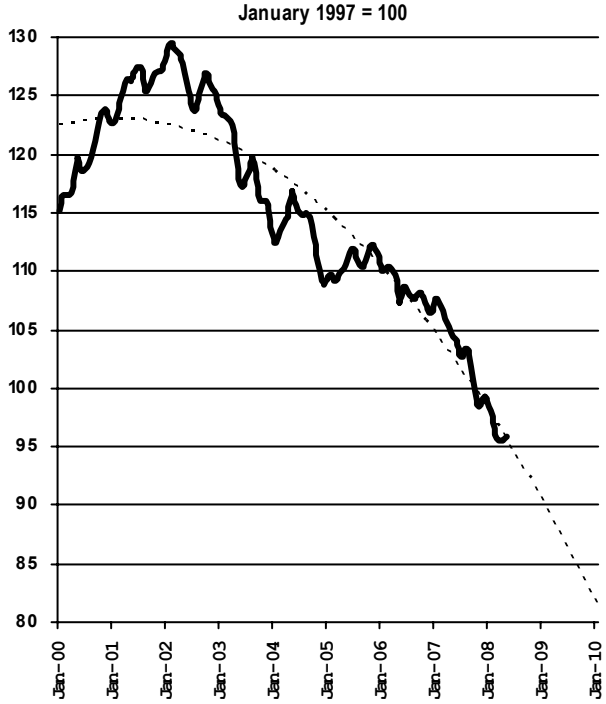
PETROLEUM PRODUCT IMPORTS
PRICE INDEX



Source: US Bureau of Labor Statistics 6/2/08

CHART #6

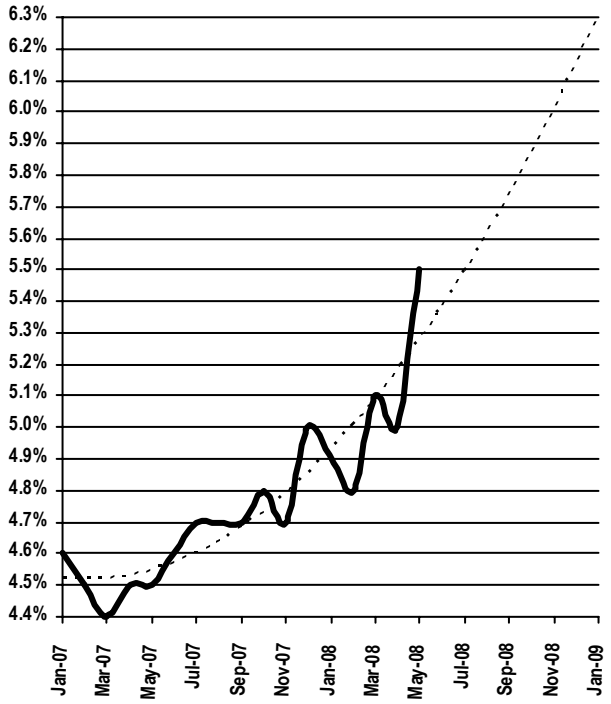
VALUE OF THE DOLLAR
vs. Major Trading Partners
January 1997 = 100



Source: Federal Reserve 6/2/08

CHART #7

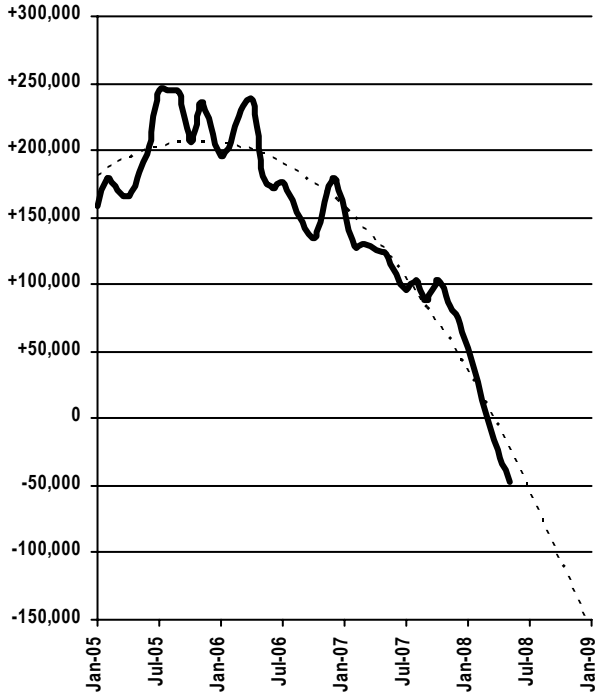
UNEMPLOYMENT RATE



Source: US Bureau of Labor Statistics 6/6/08

CHART #8

EMPLOYMENT (Jobs Gained or Lost)
6-Month Moving Average



Source: US Bureau of Labor Statistics 6/6/08

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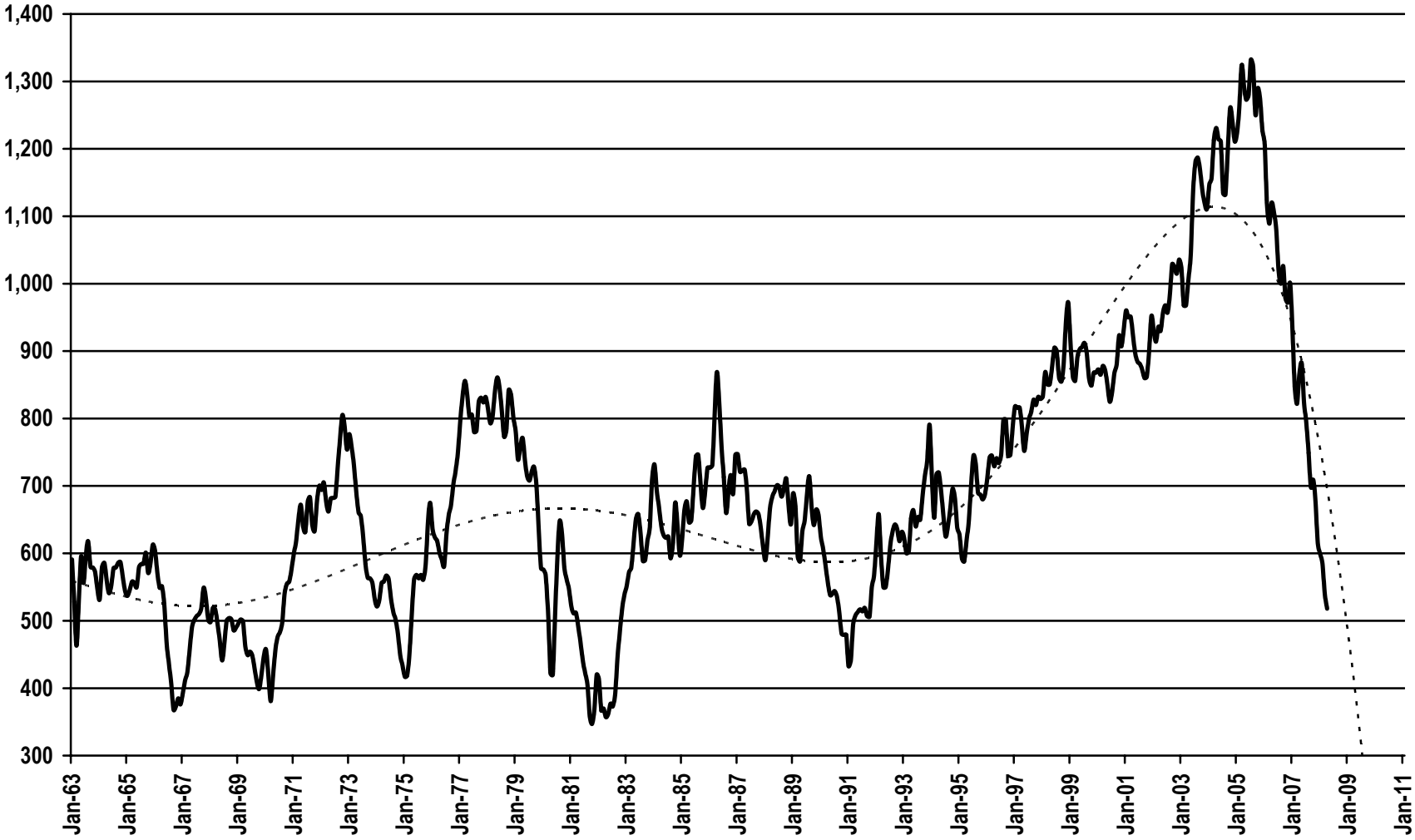
CHART #9

NEW HOME SALES

(privately owned single units, in thousands, seasonally adjusted, 2-month moving average))



Source: US Census Bureau 5/27/08

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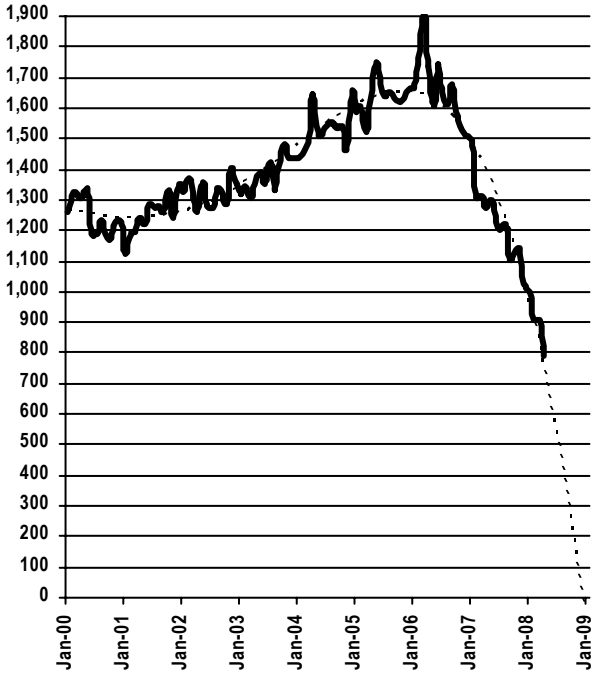
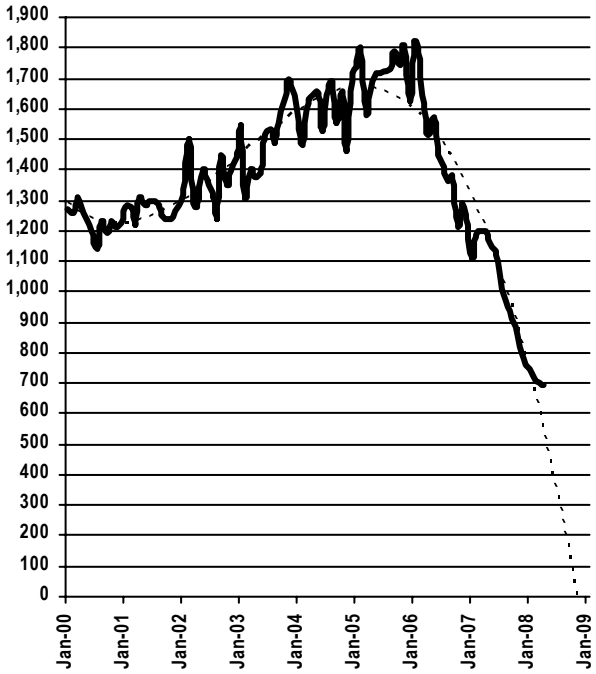
CHART #10
NEW HOME COMPLETIONS
(privately owned single units, in thousands, seasonally adjusted)



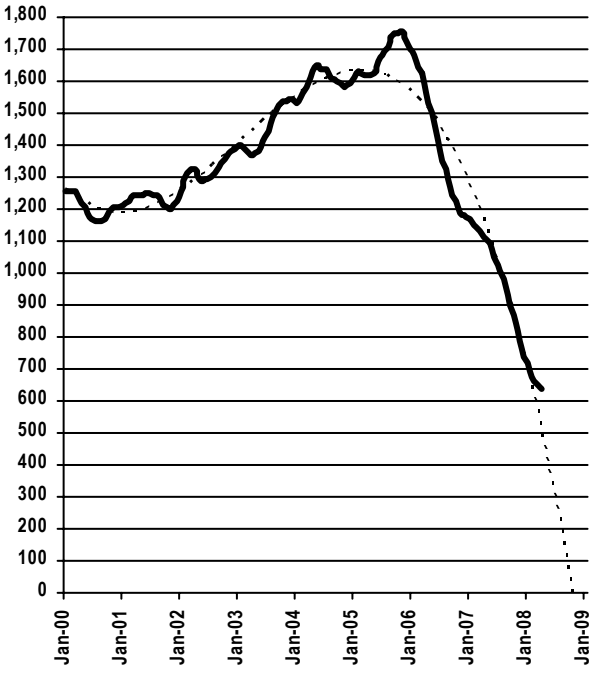
Source: US Census Bureau 5/27/08

CHART #11
NEW HOME STARTS
(privately owned single units, in thousands, seasonally adjusted)



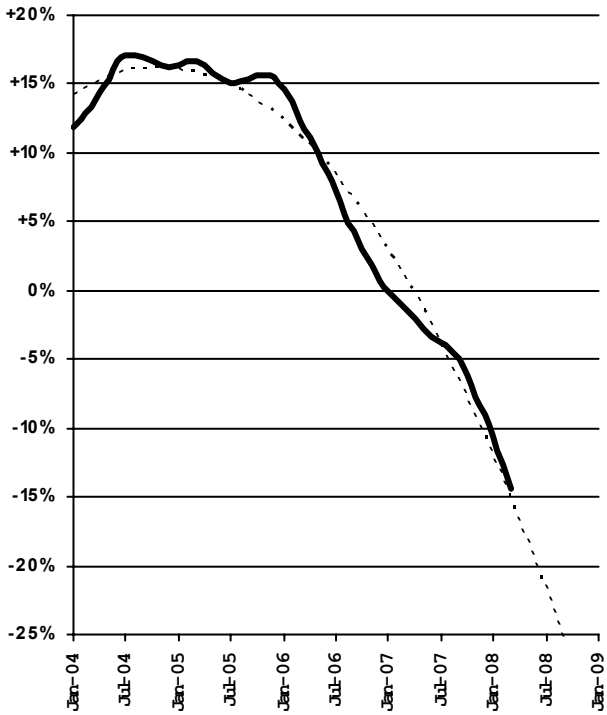
Source: US Census Bureau 5/27/08

CHART #12
NEW HOME BUILDING PERMITS
(private single units, thousands, seasonally adjusted, 3-mo. moving avg.)



Source: US Census Bureau 5/27/08

CHART #13
HOME PRICES
Year-to-Year % Change



Source: Standard & Poor's/ Case Shiller Index 5/27/08

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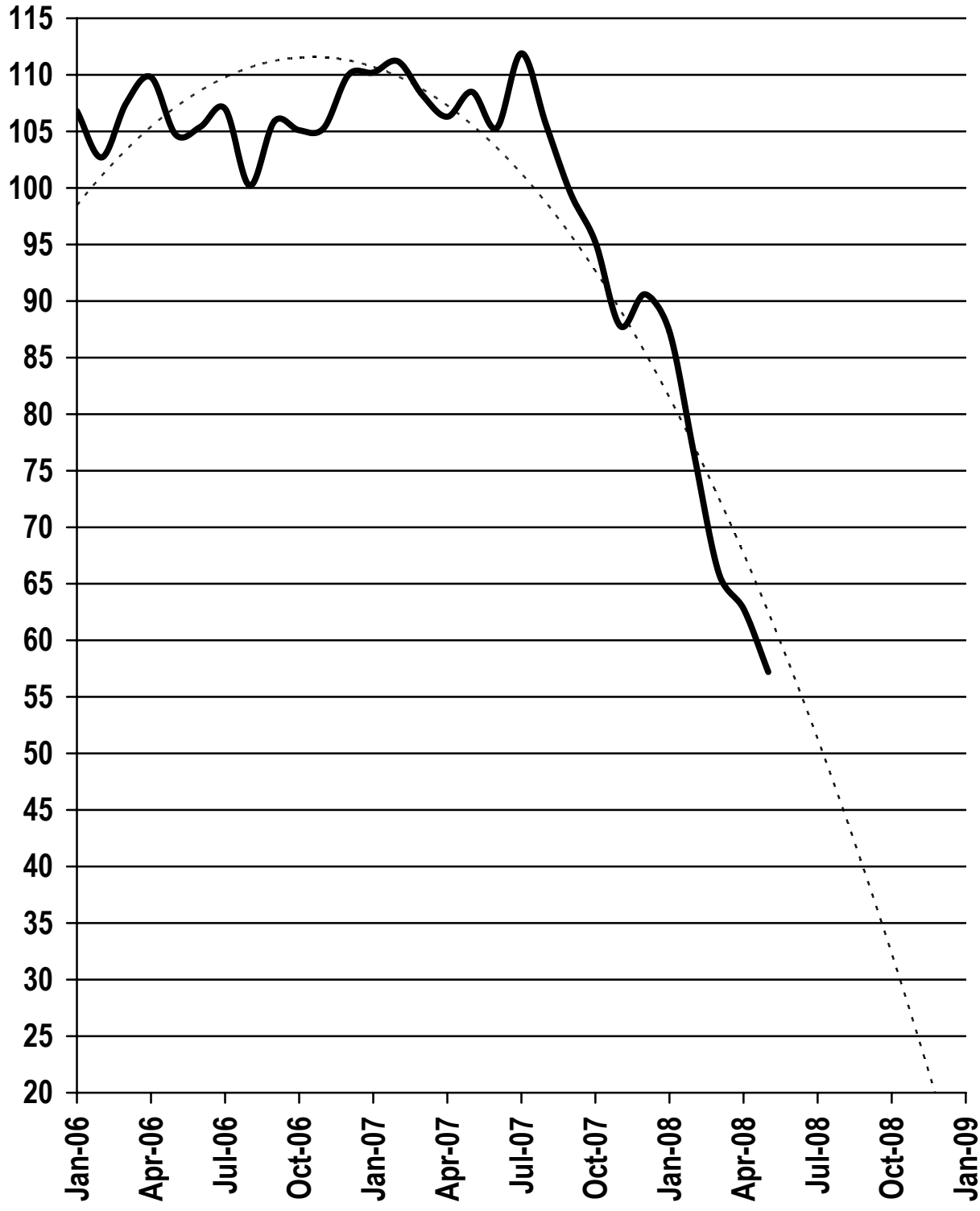
CHART #14

CONSUMER CONFIDENCE INDEX

1985 = 100



Source: Conference Board 5/27/08