



March 5, 2008

Dow: 12,213

## ***STAGFLATION?***

Been there, done that. That was the scenario in the 1970s when most of today's investors were not yet born or were too young to understand what it was all about. That was a period of time when economic growth stalled and inflation ran rampant. By 1980 GDP (Gross Domestic Product) was advancing a mere 0.2% annually while inflation soared to 12% annually. Unemployment was 7% on its way to 9% and interest rates were above 20% (not a misprint). There was despair in the land as Americans did not feel too good about themselves or the direction of the country. Enter a new administration in 1981 and by 1989 inflation had dropped to 4%, interest rates to 9% and unemployment to 5%. How did this all come about? Supply side economics and understanding that increasing the economy's supply of goods and services leads to more jobs and lower prices. A total of 18 million jobs were created over this period. Believe it or not, our problems today are not as severe as they were in 1980. Today we have inflation running at a 4% annual rate, unemployment at 5% and interest rates at 3.5% (10 year treasury) and about to drop lower. It is not yet clear whether we are in a recession, but the Fed is better prepared to handle problems in the economy today. The major problem today is not sub-prime mortgage defaults (the media would have us think that every single mortgage in America will default), but rather the strange financial products that have been created over the last five years. These leveraged products have created the necessity of huge write-offs for many financial institutions and a subsequent decline in their share prices. This has caused pain and financial loss not only for these financial institutions, but for investors as well. Yes, we are still in the midst of a slowdown in the housing market both from a reduction in new construction and a drop in market prices of existing home sales, and yes, there will be more defaults, but this cycle will end and the uptrend in the housing cycle will resume as our population grows and more families enter the housing market. In the meantime, the Fed is doing its part by increasing the money supply to replace the money lost from the write-offs. We have talked in the past about the fact that increasing the money supply is a major cause of inflation. In this case, however, the Fed is just replacing money lost due to the write-offs. They are also reducing interest rates to help stimulate lending and investing.

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More importantly, there are several economic factors that can stave off a severe recession or an extended bout of stagflation. Number one would be to make the tax cuts permanent. Those cuts were the primary impetus for the last five years of economic growth that created over 22 million new jobs. We have mentioned in previous letters that the government should cut the corporate tax rate from its current level of 35% to at least 25%. The government could also eliminate ethanol subsidies as they are leading to higher food costs around the world. Continuing to pursue free trade deals around the world, contrary to what many think, would actually create more jobs. Congress passed a tariff act in 1930 to protect American jobs and it backfired famously as other countries did the same. Germany's economy actually boomed in the 1930s as they imposed their own tariffs and began spending on war materials. If we impose tariffs on Canada and Mexico, they would do likewise, and we would lose a major source of exports not to mention a major source of our oil.

Oil at \$100 a barrel, gold approaching \$1,000 an ounce, wheat trading at \$25 a bushel and base metals on a tear. Sure smells like inflation. On the other hand housing, autos and consumer electronics are holding overall inflation in check. Something must give. Commodities just might be the next bubble as speculators rush to invest (gamble) in this arena. That could turn out to be a good bubble as a blow off here would be a plus for consumer food prices. Meanwhile, China, India and other emerging countries still have an insatiable thirst for oil and base metals. A slowdown in the US economy could result in a drop in these prices as well.

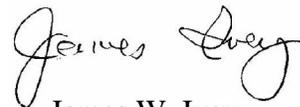
### **Random thought for March:**

“Despair is inappropriate for a culture as buoyant as our own”

William F. Buckley RIP



Michael L. Dana  
Chairman of the Board



James W. Ivey  
President

*Dana Investment Advisors welcomes any comments to their newsletter and is more than willing to discuss or explain any aspect of the letter. Feel free to call us at 262-782-3631.*

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