



THE BACK BAY ADVISOR

745 Boylston Street, Suite 503 • Boston, MA 02116 • (617) 247-0518 • www.backbayfinancial.com

Will Low Inflation Continue?

Since the mid-1980s, inflation has been much lower and more stable than it was in the past. The high inflation rates of the 1970s detracted from the country's standard of living, hindered capital formation and economic growth, and it took the country many years to overcome the adverse effects. It is now generally believed that maintaining a low and stable inflation rate provides lasting benefits to the economy, which is why it is one of the Federal Reserve's primary monetary policy goals. As detailed in the 1977 amendment to the Federal Reserve Act of 1913, the Federal Reserve's goals when setting monetary policy are "to promote maximum sustainable output and employment and to promote stable prices."

In recent years, inflation has changed in a number of ways:

- Movements in inflation now convey less about future inflation. In the late 1970s and early 1980s, the most accurate forecast of future inflation was an average of inflation over the past few quarters. Sharp increases in inflation took a long time to reverse. Since the mid-1980s, shocks to inflation have not lasted long. Thus, the best estimate of future inflation is a very long average of past inflation.
- The correlation between inflation and unemployment has decreased. In the 1960s and 1970s,

inflation tended to rise in periods when unemployment was low, and vice versa. Starting in the 1980s, this correlation weakened substantially. Thus, a rapidly expanding economy will tend to generate a smaller increase in inflation. However, once inflation increases, it will be more difficult to get it under control, since the economy will have to slow more to reduce inflation.

- Changes in energy prices have less impact on inflation. In the 1970s, increases in energy prices

had a significant impact on core inflation, which is the change in consumer prices excluding food and energy. Since the early 1980s, energy price changes have had little impact on core inflation.

- Economic volatility has decreased significantly in the United States. Since the mid-1980s, output growth has been 50% less volatile, and employment growth has been two-thirds less volatile than the previous three decades

Continued on page 2

What Is Happening to Long-Term Interest Rates?

Typically, when the Federal Open Market Committee (FOMC) raises the federal funds rate, long-term interest rates react by increasing also. However, between June 2004 and July 2006, the FOMC raised rates 17 times in 1/4 percent increments, from 1% to 5.25%, and long-term rates barely moved.

In the past, a 1% increase in the fed funds rate produced a 0.3% increase in the 10-year Treasury yield (Source: *Economic Letter*, September 2006). Thus, with a 4.25% increase in the fed funds rate, you would expect the 10-year Treasury yield to increase by 1.3%, but it only increased 0.3%.

Similarly, since 1980, the difference between the yield on 3-month

Treasury bills and 10-year Treasury notes has averaged 1.79% (Source: The Federal Reserve Board, June 16, 2006). As recently as the end of 2006, the difference was less than 0.5%. Currently, the difference is still only 0.8% (Source: *Federal Reserve Statistical Release*, November 26, 2007).

Why haven't long-term interest rates increased as expected? Returns on bonds have two components — the real component, which compensates investors for the risk of loaning money, and the inflation component, which compensates investors for expected inflation over the bond's term. In recent years, both components have been

Continued on page 3

Low Inflation

Continued from page 1

(Source: *Business Review*, Quarter 1, 2007). Inflation's volatility has also fallen substantially.

Inflation expectations significantly influence actual inflation. Long-term inflation expectations vary over time, depending on economic developments and current and past monetary policy. U.S. monetary policy has become much more focused on low inflation, and the Federal Reserve has been strongly committed to keeping inflation under control. During the 1980s and 1990s, the Federal Reserve brought inflation down from double-digit levels to approximately 2%, a level that has been maintained for the past decade.

The Federal Reserve has done such a good job that expectations about future inflation have moderated significantly in recent years. Thus, when there is a shock to inflation, the public believes that the Federal Reserve will control the situation, so expectations about future inflation do not change much, keeping inflation under control. A recent example is the substantial increase in oil prices, which has not led to increased inflation or a recession, as it did in the 1970s.

Will low inflation persist for the foreseeable future? Like all questions about the future, this cannot be easily answered. Inflation now reacts less persistently to shocks, which is a result of better monetary policy and inflation expectations. Now that the public believes that the Federal Reserve will keep inflation under control, it acts in a manner that makes the economy more stable. Thus, it would seem that interest rate changes do not need to be as great to achieve stable inflation. But these circumstances will only last as long as monetary policy meets the public's expectations. Long-run inflation expectations must be monitored closely, and the Federal Reserve must respond aggressively to shocks that could have long-term impacts on inflation. ■■■

Narrowing the Wage Gap

For decades, we have heard that men earn more than women for the same type of work. While that is still true, the gap between wages for men and women has narrowed significantly. In the 1960s, women earned approximately 60 cents for every dollar men earned. By 2006, that amount had increased to 81 cents (Source: *Economic Letter*, May 2007). More sophisticated analysis that accounts for variables such as education, work experience, occupation, and family factors, however, show even greater progress in reducing the wage gap. For instance, one study found that women between the ages of 35 and 43 earn 97.5% of what men earn (Source: *Economic Letter*, May 2007).

While women still lag behind men in many job-related measures, they have made substantial progress over the past two generations in several areas:

- **Education** — Individuals with college degrees typically earn substantially more than workers without a college degree. College graduates now make up 30% of the U.S. population over age 25. In 1950, women obtained 24% of all bachelor's degrees, but that percentage rose to 57.5% by 2004. Women in the workplace are now more educated than men — approximately 19.8% of working women and 18.3% of working men are college graduates.
- **Higher-paying occupations** — Women have also shifted their job preferences to better paying jobs. For instance, 19% of women received bachelor's degrees in business in 2004, up from 2.9% in the early 1970s. The percentage of women obtaining degrees in education, on the other hand, decreased from 36.1% to 10.4%. Currently, women earn 3/4 of all veterinary medicine degrees, 2/3 of all

pharmacy degrees, 1/2 of all law degrees, 1/2 of all medical degrees, 40% of all MBAs, and 40% of all dentistry degrees. By 2004, 33% of women earned more than their husbands.

Despite these gains, a large number of women still obtain degrees in areas more compatible with family responsibilities that also tend to have lower pay. For instance, women received more than 60% of bachelor's degrees in health professions, social services, education, English, and foreign languages.

- **Less labor-intensive work** — Women have also benefited from the economy's transformation from manufacturing to services. Men are much more likely to work in manufacturing jobs. Women have moved into formerly male-dominated occupations that typically aren't physically demanding.
 - **Businesses** — Women have also increasingly become entrepreneurs. In 1972, women only owned 4.6% of U.S. businesses. By 2002, women owned at least a half interest in nearly 40% of all U.S. businesses. However, women-owned businesses tend to be small — 80% of women-owned businesses had \$50,000 or less in receipts and 85% employed fewer than 10 people in 2002.
 - **Corporate executives** — Women are increasingly taking on jobs as corporate executives. In 1972, 17.6% of management jobs were occupied by women, which increased to 37.2% by 2004.
- Over the past couple of decades, women have made choices that have prepared them well for the current job situation. While there is still a gap between wages earned by men and women, that gap has narrowed substantially.

■■■

Interest Rates

Continued from page 1

trending downward:

- **Real component** — The real component is also called the term premium, since historically, investors have received a premium for increasing the term the bond is held. Since the mid-1980s, economic growth has been less volatile, making investors more confident about future economic stability, so they require less return to hold longer-term bonds. It is also believed that demand for long-term bonds has increased, while supply has not kept pace, bringing down returns.
- **Inflation component** — Compared to a 5% inflation rate from 1980 to 1999, inflation in industrialized countries averaged 2% from 2000 to 2004 (Source: The Federal Reserve Board, June 16, 2006). Not only has inflation decreased, expectations for long-term inflation are in the 2% range. This has put significant downward pressure on long-term interest rates.

The behavior of long-term interest rates is not unique to the United States — other countries around the world have experienced similar declining patterns. The trend is so widespread that globalization of trade is suspected to be a major factor. Since goods, services, money, and ideas can cross borders so easily now, economies in different countries are tied together more closely. Excess demand in one part of the world can be filled by excess supply in another part of the world, evening out economic activity in individual countries.

This has major implications for monetary policy. Central bankers have control over short-term rates, which is the primary means of implementing monetary policy. Typically, when short-term rates are in-

creased, long-term rates follow. Higher long-term rates reduce consumption and investment, which helps contain inflation. Reducing short-term rates typically reduces

The State of Personal Savings

For years, we've heard our personal savings rate is dismally low — and declining. Several causes have been proposed for the significant decline in personal savings:

- Steep increases in many services, including medical care, education, recreation, and housing, have caused consumers to significantly increase their expenditures, leaving less available for saving.
- Government transfer payments, such as Social Security, Medicare, and Medicaid benefits, act as a disincentive for individuals to save. Realizing they can count on these benefits from the government, individuals feel less need to save on their own. Once they start receiving benefits, very little of those benefits is saved.
- The easy availability of credit has caused many consumers to borrow aggressively rather than save.
- The wealth effect may have caused consumers to increase consumption. Significant increases in stock and housing prices in the 1990s provided significant gains for many individuals. Since consumers base their ability to make purchases on income and wealth, those gains may have led them to increase purchases and decrease savings.

Whatever the cause, the long-term trend of lower savings is disturbing, since the baby-boomer generation is the first generation that will need to finance a signifi-

cant portion of its own retirement. Two major trends will require more in the way of personal savings from this generation:

- **Reduced benefits from third parties** — Generous pensions and Social Security benefits will probably not be as readily available to the baby boomer generation. While the Social Security system is expected to survive, changes are widely anticipated. Normal retirement age is already increasing gradually from age 65 to age 67, and benefit reductions of some form are considered likely in the future. The trend in company-sponsored pension plans has been a significant increase in defined contribution plans, where employees make contributions from their earnings with possible matching contributions from the employer, at the expense of defined-benefit plans, where the employer funds all benefits.
- **Increased longevity** — Not only are we now living much longer than in the past, but this trend is expected to accelerate in the future. It is not unrealistic to spend 25% to 30% of your life in retirement, a span of time requiring significant sums to finance.

While the debate over the significance of the declining personal savings rate will continue, on an individual level, it should serve as a wake-up call to assess your progress toward your retirement goals. Please call if you'd like help with this assessment. ■■■

long-term rates, which increases economic activity. If those relationships no longer hold, monetary policy will be significantly impacted. ■■■

In the News

The firm was featured in the 2007 Advisor Yearbook distributed by Schwab Institutional® and *Investment Advisor* magazine. The publication celebrates the progress of the registered independent advisor industry over the past two decades.



Client Services

Ed Childs joined the Process Improvement Committee. His involvement better integrates the investment operations function. He and **Joyce Alper** accelerated the delivery of investment reports.

Technology

Becky Martz spent the fall planning 2008 technology initiatives. **Ed Childs** is working with Becky on technology improvements for client report access and trading.

In preparation for the firm's 2008 technology upgrade, Becky enrolled in a class on Microsoft Office 2007.

All Work and No Play...

Fall was a popular season for sports fans at BBFG! As a season ticket holder, **Erik Gudim** enjoyed New York Giants football games, while **Mary Evans** traveled to Gillette Stadium to watch the New England Patriots take on the Buffalo Bills.

Bob Siefert, an avid supporter of the Boston College Women's Basketball Booster Club, reports this year's team is young and talented, and hopes everyone has the chance to take in a game this season.

Emily O'Hara celebrated an early birthday with her family and took in a Mariner's baseball game in Seattle.

The Red Sox fans in the office celebrated the World Series Championship, and thanks to a prime location on Boylston Street, were able to watch the parade.

Thanksgiving was a time for traveling for many staffers. **Phil Lee** traveled to New York, **Emily O'Hara** hopped a flight to California and **Susan Brown** celebrated with a family reunion in Long Island, N.Y.

This year, instead of traveling to the

annual Sellers' Thanksgiving dinner in North Carolina, **Francis Sellers** and his wife opted for a relaxing dinner at The Ocean House in Yarmouth, Mass.

For many, traveling wasn't only for the holidays! **Kevin Sweeney** and his wife recently traveled to Europe. The two spent five weeks in Italy. They stayed four weeks in Siena and made several short trips to Tuscany, Assisi and Cinque Terre.

Bob Siefert is currently enjoying an exotic trip to Australia, New Zealand and Maui, Hawaii. Bob and his wife spent years planning this trip and are traveling throughout January and February.

Becky Martz traveled to Arkansas where she saw Charlie Daniels perform "The Devil Went Down to Georgia."

Lindsay McDonald embarked on a trip to the West Coast with her boyfriend. The two visited Oregon and San Francisco. They drove through the Mt. Hood Pass and attempted (again) to see the parrots at Telegraph Hill.

Company News

In October BBFG hired new, part-time employee, **Rebecca Teeters**. Rebecca, a graduate student of the New England Conservatory, supports the office in administrative tasks and special projects.



Kevin Sweeney

After 21 years of practicing law, **Kevin Sweeney** joined the firm in December as a financial planning assistant. Kevin completed the Boston University financial planning program

John LeBlanc followed up a Las Vegas conference with a brief vacation to explore the Hoover Dam, Valley of Fire State Park and Death Valley National Park in California.

Staying close to home, **Erik Gudim** attended the annual Wellfleet OysterFest.

On the home-front, **Mandy Magee** is settling into her new house, and even has a new addition to the family—a dog named Yogi. **Phil Lee** recently signed a purchase and sale agreement for a new home in Marblehead, Mass.

Continuing Education

Jeanne Gibson Sullivan, **Phil Lee**, **Bob Siefert** and **Emily O'Hara** recently attended a Financial Planning

Association (FPA) national conference in Seattle. Topics included retirement and estate planning. **Jeanne** also participated in a Webinar discussing college financial aid.

As a member of the National Association of Personal Financial Advisors (NAPFA), **Phil Lee** attended a Massachusetts chapter meeting that covered annuities, universal life insurance and life planning. He and **John LeBlanc** also attended an estate and tax planning seminar discussing the unique needs of unmarried and same-sex couples.

At the NAPFA Northeast Regional Conference, **Susan Brown** presented a financial planning case study.

John LeBlanc attended Schwab's IMPACT conference in Las Vegas to celebrate Schwab's 20th anniversary of serving independent advisors. John also spent time in Nevada participating in an on-going study group, while **Bob Siefert** took part in a study group in Chicago.

in April and passed the Certified Financial Planning™ Certification Exam in July.

Meghan Sanders, long-time intern at BBFG, left the firm to participate in a program at the Defense Intelligence Agency in Washington D.C. Meghan was a valuable asset to the company and her talent will be missed.

In other company news: The staff enjoyed the annual holiday party at The Club at the Longwood Towers in Brookline, Mass. Music and vocals were provided by **Joyce Alper** and **Rebecca Teeters**.

Federal and Massachusetts estate tax returns were the focus of a trust and estate class attended by **Mary Evans**. **Mary**, **Emily O'Hara** and **John LeBlanc**, participated in a Webinar on the latest tax trends in charitable giving.

After completing a course at the College of Financial Planning, **Mandy Magee** is now a Registered Paraplanner.

Giving Back

This season, in an effort to reach out to those in need, BBFG "adopted" a family through the Massachusetts Department of Social Services. The firm contributed by donating a variety of requested items which were presented to the family as a gift.