

Fixed-Income Watch

Prepare for inflation

Richard Lehmann, 03.25.09, 06:00 PM EDT
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These days everyone is worrying about deflation. However, I think all the deflation talk is deflecting our attention from the equally scary possibility of inflation. That's what typically happens when governments vigorously stoke the money supply. What will inflationary days mean?

--People will spend now on things like cars rather than later when they'll cost more.

--The yield curve will steepen, which will mainly benefit banks.

--Investors will sell financial assets in order to buy real assets such as houses.

--Homeowners will be motivated to hold on to their homes or, if they can't cover the payments, sell them before the bank forecloses. There will be fewer mortgage defaults.

--Debtors like Uncle Sam and mortgagors will do well. Savers--mortgage holders, bank account holders and China--will suffer.

--The balance of trade will improve as the dollar weakens.

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--Tax collections will increase.

--There will be pressure for wage increases, and unions will gain power.

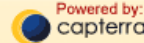
After reading this list, you might wonder why the Obama Administration isn't more enthusiastic about pumping up inflation. Of course, its actions speak louder than its rhetoric. After all, governments don't overtly promote inflation for fear that it will spin out of control. But they do tolerate it, and the people in both the White House and the Federal Reserve seem very tolerant of a rising money supply.

While inflation can provide short-term relief, it's harmful in the long run because it stifles real growth, hurts productivity and hurts savers. Unfortunately, short-term thinking goes hand in hand with Washington politics. Presidential cycles last only four years.

So what should you do to protect your capital? Gold is an obvious answer and so are supersafe tips, or Treasury Inflation-Protected Securities. tips currently pay 1.95% plus a quarterly value adjustment based on the change in the CPI. These securities have unquestionable credit protection but

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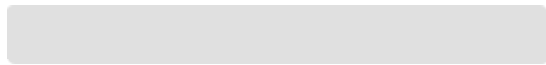
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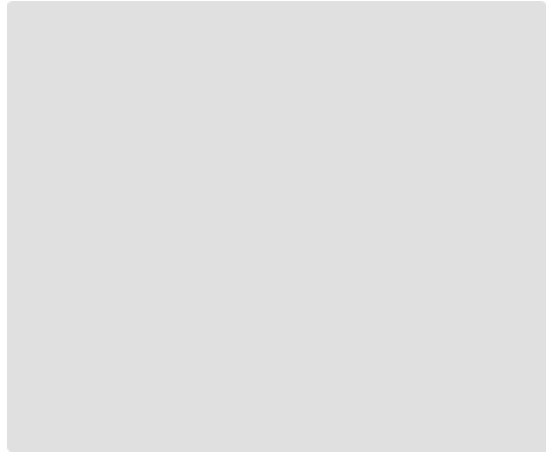


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David R. Henderson

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suffer from the fact that the CPI adjustment is taxable. If inflation and taxes go up, you could easily wind up with a negative real return from a 2% tips.

In my Mar. 2 column I recommended **Morgan Stanley (nyse: MS - news - people)'s senior floating rate notes due 2018** that are adjustable monthly for the CPI change. Total return since then: 9.7%. I would still be a buyer of these bonds, currently priced at 73. There are numerous such bonds and notes issued by various banks, and you should ask your broker to search for them. Their attraction today is that they sell at significant discounts from par value. Bear in mind that the CPI adjustment gets figured on the par value, not on the market price, and gets paid to you in cash each month. The CPI adjustment does not go below zero. If the issuer does not go the way of **Lehman Brothers (nyse: LEHMQ - news - people)**, you will enjoy a handsome capital gain.

There are other variable rate bonds tied to Libor or U.S. Treasurys. When shopping for these bonds, pay attention to the spread over the index (Libor plus 20 basis points is typical for an AA-rated bond), the bond's reset frequency and floor interest rate. Look for discounted bonds unlikely to be called. One that I like is an **AA-rated Wells Fargo (nyse: WFC - news - people) bond** pegged at Libor plus 19 basis points. The current yield is 1.85%, but at a price of 75.5, the bond has a yield to maturity in 2013 of 8.72%.

Canadian oil and gas trusts, which I have been recommending here since September 2004, are a good defense against inflation. These operating trusts trade at prices well below the value of their proven reserves and offer monthly dividends with annual yields in the double-digit range. My favorites are **Enerplus Resources (17, ERF)** and **Penn West Energy Trust (nyse: PWE - news - people) (10, PWE)** for conservative investors, and **Advantage Energy Income Fund (nyse: AAV - news - people) (2.4, AAV)** and **Provident Energy Trust (nyse: PVX - news - people) (3.8, PVX)** for those willing to take on more risk.

The most important question is when inflation will begin. My guess is that the current deflation, driven by inventory liquidations, will be over by year-end. If inflation returns in 2010, as I expect, the time to buy defensive securities is not then but now. By the time inflation is here, it may be too late.

So what should you do to protect your capital? Gold is an obvious answer. Holding a 5% to 10% of your portfolio in gold through an ETF is the way to go. I would buy SPDR's Gold Trust (94, GLD). It's very liquid and low cost way to hedge rather than than owning more volatile mining stocks. Share of this exchange traded security are backed by 25 lb bars of gold held in the London vault of **HSBC (nyse: HBC - news - people) Bank**.

Supersafe tips or Treasury Inflation-Protected Securities are another option. tips currently pay 1.95% plus a quarterly value adjustment based on the change in the CPI. These securities have unquestionable credit protection but suffer from the fact that the CPI adjustment is taxable. If inflation and taxes go up, you could easily wind up with a negative real return from a 2% tips.

Richard Lehmann is editor of the *Forbes/Lehmann Income Securities Investor*. Visit his homepage at

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