

Why is U.S. Inflation Inevitable?

By Vernon C. Sumnicht, MBA, CFP®

To understand why inflation in the U.S. is inevitable, it's necessary to look at the numbers. The United States Government brought in (mostly from taxes) revenues for the 12 months ended August 31, 2009 of \$2.2 trillion (\$2,157,940,000,000). The U.S. Treasury reports that current outstanding debt as of August 31, 2009 is \$11.8 trillion (\$11,812,870,150,873.53).

Unfortunately, that isn't the entire story--the U.S. also has substantial unfunded financial obligations. The National Center for Policy Analysis (NCPA) estimates that the unfunded obligation to the U.S. Social Security program is currently \$17.5 trillion (\$17,500,000,000,000) as of June, 2009. The National Center for Policy Analysis also reports unfunded promises for Medicare of \$89.3 trillion (\$89,300,000,000,000).

What's our average annual interest rate on all that debt? The U.S. Treasury reports it is 3.36%. That means we're paying \$400 billion in interest on our \$11.8 trillion of debt. Okay, we can afford to pay the \$400 billion each year, but there isn't a chance we can pay the unfunded obligations from annual revenues. So what happens to interest payments if we borrow to pay the unfunded obligations?

We couldn't possibly pay the interest on debt of \$118 trillion. Even if we used all of our revenues to pay interest, we could only afford to borrow \$64.2 trillion ($\$2.157 \text{ trillion} \div 3.36\%$). This analysis doesn't include continued deficit spending or national health care. So what are the options when you can't pay your obligations with revenues or debt?

The U.S. could default on our obligations, but that would really cause problems--we need foreign participation in Treasury actions, trade, etc. Default would only crash the value of the dollar and lead to inflation anyway. Maybe we could sell assets, but I can't imagine the people of the United States selling off Yellowstone National Park. Even if we sold assets to foreign nations, if the outstanding debt was paid off with assets, the flood of money would lead to inflation.

The third option for the U.S. is to pay off the debt with worthless money (i.e. monetize the debt) by printing the dollars needed to pay off the debt. Another term for this approach is inflation. This has historically been the option of choice for other countries that have gotten themselves into this much debt. As you can see, inflation is ultimately the only way to resolve the U.S. debt problem. The only real question left is, will the Federal Reserve and Treasury be able to orchestrate a 6% - 8% inflation rate over the long-term (12 to 18) years, or will things get out of hand and lead to hyperinflation (triple-digit inflation)?

The possibility of price inflation turning into hyperinflation has been raised by Professor Peter Bernholz (Professor Emeritus of Economics in the Center for Economics and Business at the University of Basel, Switzerland). He concludes there have been 28 episodes of hyperinflation of national economies in the 20th century, with 20 occurring after 1980. In his most recent book, *Monetary Regimes and Inflation: History, Economic and Political Relationships*, Bernholz analyzes the 12 largest episodes of hyperinflations, all of which were caused by financing huge public budget deficits through money creation. His conclusion: “The tipping point for hyperinflation occurs when the government’s deficit exceeds 40% of its expenditures.” The U.S. hit the 40% mark in late 2009.

What are the signs of coming inflation?

Inflation can have many signals--it can show up in the form of interest rates that start to surge, exploding prices for oil, gold, silver, platinum and copper, all of which have just gone through the roof. In addition, a significant devaluation of the dollar which pushes import prices up. We’ve seen dollar devaluation and subsequent dollar revaluation as the Euro has been going through its own debt crisis.

There is no bell that will ring saying, “inflation is here.” In this current economic scenario, I’m watching the M2 money supply and interest rates. M2 and interest rates have been kept artificially low by the Federal Reserve.

I believe that as pressure continues to build for the U.S. to borrow more money (sell more Treasury securities), the U.S. will need to raise rates to attract buyers. As interest rates move higher, the banks will find it increasingly more attractive (profitable) to make new loans. This is exactly what we need to increase [the velocity of money](#), and as velocity picks up, the money supply numbers will begin to grow rapidly. Finally, as the supply of money in the economy increases, so does inflation. These are the signs that would convince me that Pandora’s Box of inflation horrors has been opened.

What should you do with your investments to protect them from inflation?

You should consider investing your savings into something other than potentially worthless paper money--for example, cash and equivalents, or fixed income investments (i.e. bonds). With bonds, especially long-term bonds, you risk losing principal as interest rates go higher and bond prices go lower (as I’d expect in an inflationary environment). If you decide to hold the bonds to maturity, you will lose purchasing power, because your principal will be repaid at maturity with dollars that won’t buy nearly as much as the dollars you used to purchase the bond.

What investment strategies can protect the purchasing power of your wealth from inflation? Gold and silver coins are excellent hedges against the dollar falling and inflation. As an example of how well gold holds purchasing power, I've read that when gold was \$35 dollars an ounce, you could buy one very nice men's suit for \$35 or an ounce of gold. Today, at over \$1,000 an ounce for gold, you can still buy one very nice men's suit for \$1,000 or one ounce of gold.

Real estate is another good example of something that can rise nicely in value during a period of inflation. There seems to be endless opportunities in real estate right now. Real estate has been significantly reduced in price today (as of January, 2010) and you can borrow for 30 years at around 5% annual interest. These rates are likely being kept artificially low by the Fed right now to stimulate the economy. However, you need to be able to hold onto your real estate for the long-term. You can borrow now to buy at these low rates and pay off the loan with worthless (i.e. highly inflated) dollars in the future. However, don't buy anything you can't really afford to hold onto longer term.

Historically, a long period of low inflation brings about opportunity in **colored gemstones (rubies, sapphires and emeralds)**. Remember, diamonds, gemstones and precious metals are crisis hedges. Stocks and bonds have a possibility of becoming worthless. This can't happen with something you can hold in your hand like gemstones or precious metals.

Many of these assets I've mentioned, including real estate, farmland, timberland, colored gems and others like diamonds, art, rare stamps, rare books, wine, Persian rugs or rare coins may be great real assets to purchase after long periods of low inflation or prior to periods of high inflation. However, you need to be very patient; these investments take time to locate and carefully research before buying or selling. They require that you develop a lot of specialized knowledge or engage someone who has the knowledge to determine the value of these assets. You should buy these assets only if you can afford to hold them indefinitely, if necessary. It is more likely than not that you'll lose money on this type of asset if you're ever forced to sell.

For many investors, without the specialized knowledge, wealth, and/or time to accumulate land, gems, rare art, etc., liquid inflation hedges may be more appropriate. Exchange-Traded Funds (ETFs) are investment vehicles that have been developed in the past few years that now provide investors with the ability to quickly and easily access instruments that can help protect a portfolio from inflation and a falling dollar. These ETFs offer daily liquidity, they require no or little minimum investment, no accreditation (like a net worth of \$1 million), they are all registered securities, and there are no performance-based fees or complicated tax issues. These investments allow you to buy or sell daily, or as you believe appropriate for your situation as things change.

If you're in a financial situation that dictates the investments you own need to provide you some income, consider inflation-protected bonds. The easiest way to purchase U.S. inflation-protected bonds is to purchase the Exchange-Traded Fund (ETF) **iShares Barclays inflation-protected bond index (NYSEArca--TIP)**. Similarly, for international bonds, there is an ETF called the Spiders – **SPDR DB International**

Government Inflation-Protected Bond Fund Index (NYSEArca--WIP). My personal choice would be **PIMCO 1-5 Year U.S. TIPS Index Fund (STPZ)**. These short-term bonds reduce the risk of interest rates going higher in an inflationary environment and bond prices, therefore, going lower.

An old favorite, when it comes to hedging inflation, is real estate, both here and abroad. As Will Rogers used to quip, “Buy real estate, they ain’t making any more of it.” The fact that there is a finite supply, unlike fiat currency, helps real estate retain its value throughout periods of inflation. Good options here may be domestic REITs, represented by the **iShares DJ Real Estate Index ETF (NYSEArca--IYR)** and/or international REITs such as the **SPDR Wilshire International REITs Index ETF (NYSEArca--RWX)**. REITs also provide healthy dividend payments.

Certainly, any “real asset” which includes most commodities would be considered an inflation hedge. A couple of good ideas for broad-based, non-leveraged, long-only commodity funds may include **iShares iPath Dow Jones AIG Commodity Index, an ETN (NYSEArca--DJP)**, and the index put together by the famous investor Jim Rogers. An ETN representing this index is available from **Elements** and is called the **Rogers International Commodity Index, (NYSEArca--RJI)**. Rogers uniquely weights the commodities in his index based on their use/demand throughout the world rather than by capitalization, which has historically been the most common approach.

When it comes to a commodity that everyone needs, there is nothing more fundamental than food. We are already seeing agricultural products around the world rising in price. Jim Rogers has also developed a broadly based agricultural index. An ETN representing this index is also available from **Elements** and is linked to the **Rogers International Commodity Index**, known as the [**RICI Agriculture Total Return Index \(NYSEArca--RJA\)**](#). Rogers also uniquely weights the agricultural commodities in his index based on their use/demand throughout the world.

Master Limited Partnerships (MLPs) are another real assets type of inflation hedge with a nice yield as well. MLPs own infrastructure like gas and oil pipelines. The yield comes from the lease income they receive from those who use the pipelines. A good way to invest in MLPs is by purchasing **Kayne Anderson MLP Investment Company. This is a non-diversified, closed-end management investment company (NYSE--KYN)**. The Company’s investment objective is to obtain a high after-tax total return by investing at least 85% of its total assets in energy-related Master Limited Partnerships (MLPs) and their affiliates, and in other companies that, as their principal business, operate assets used in the gathering, transporting, processing, storing, refining, distributing, mining or marketing of natural gas, natural gas liquids, crude oil, refined petroleum products or coal.

Timber is another commodity that can be purchased as an ETF. The **Claymore/Beacon Global Timber Index (NYSEArca--CUT)**, which represents the global timber market, seeks results that correspond generally to the performance of the Clear Global Timber Index. The fund normally invests at least 90% of total assets in common stock, American depositary receipts, and global depositary receipts that comprise the Clear Global Timber

Index. It seeks a correlation over time of 0.95 or better between its performance and the performance of the index.

An investor that intends to hedge against inflation would be well-advised to hold precious metals bullion. Unfortunately, because of their weight and value, precious metals are somewhat cumbersome to safely store or move. **Central Fund of Canada (AMEX--CEF)** is a closed-end mutual fund, trading like a stock on the exchange. Central Fund's purpose is to hold gold and silver bullion on a secure basis for the convenience of investors in the shares of Central Fund. At least 90% of Central's assets are gold and silver bullion at all times. Gold bullion ETFs include: **SPDR Gold Trust (NYSEArca: GLD)**, **iShares COMEX Gold Trust iShare (NYSEArca: IAU)** and **ETFS Gold Trust ETF (NYSEArca: SGOL)**. Silver bullion ETFs include: **ETFS Silver Trust (NYSEArca: SIVR)**, **iShares Silver Trust (NYSEArca: SLV)**. Platinum bullion ETFs include: **ETFS Physical Platinum Shares E (NYSEArca: PPLT)**. Palladium bullion ETFs include: **ETFS Physical Palladium Shares (NYSEArca: PALL)**.

For purposes of diversification and leverage, an ETF that owns gold mining stocks can also be an excellent precious metals hedge against inflation, such as the **Market Vectors Gold Miners ETF (NYSEArca--GDX)**. The investment seeks to replicate as closely as possible, before fees and expenses, the price and yield performance of the AMEX Gold Miners Index. The fund normally invests at least 80% of its total assets in common stocks and American depository receipts of large companies involved in the gold and silver mining industry. For additional potential growth, a more speculative ETF would be **Market Vectors Junior Gold Mine (NYSEArca: GDXJ)**. This ETF seeks replicating the price and yield performance of the Market Vectors Junior Gold Miners Index. The index tracks the overall performance of foreign and domestic publicly traded companies of small and medium capitalization that are involved primarily in mining gold and silver. The fact that gold only costs \$350 an ounce to mine, yet the market price of gold is about \$1,000 per ounce, is why owning the mining companies leverages the rising price of gold.

An inflation hedge that can improve returns, while reducing risk because of its low correlation to other asset classes, is the **Rydex Long/Short Commodities Fund – Strategy H (RYLFX)**. This is a relatively new fund; however, it is based on an index with a longer-term history that measures trends in the commodity futures markets on a daily basis. The fund invests substantially all of net assets in commodity-linked instruments whose performance seeks to provide investment results that match the daily performance of the JPMorgan Core Commodity-Investable Global Asset Rotator Sigma Long-Short Total Return Index.

The iSectors[®] Inflation Protection Allocation

In an effort to assist investors and their advisors in developing and managing a balanced allocation to protect their portfolios from inflation, iSectors[®] has developed an allocation called the iSectors[®] Inflation Protection Allocation. My team and I researched various

inflation-targeted securities (including many of those mentioned above) and, after running some optimization analyses, we created a unique allocation of liquid securities that offer inflation protection potential. This allocation allows advisors and their investors to simply and easily purchase and hold a diversified basket of inflation protection securities that is inexpensive, professionally managed, liquid and fully transparent.

Conclusion

The inflation scenario is a dynamic situation we face throughout the world today. It seems the news changes every day. In addition, new securities are being developed with new risks and new potentials. Staying aware and connected can mean these changes create new opportunities, not threats to your financial health.

As with any investment strategy, you should retain the services of a qualified, independent registered investment advisor to help you assess the appropriateness of any investment. An independent registered investment advisor can help you identify unique risks specific to your current financial situation and future financial needs to help ensure that your investments are appropriately allocated, and will help you reach your financial goals.

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Vern Sumnicht has 25 years experience as a successful financial planner and has been recognized for four consecutive years by "Worth Magazine" as one of the Nation's Top Wealth Advisors. Vern and his team, with more than 100 years of collective post-graduate education, certifications and experience, developed iSectors® diversified ETF allocation portfolios. For more information about iSectors® ETF allocation portfolios, visit www.iSectors.com, email Vern at vern@isectors.com, or call 1-800-iSectors.

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