Date March 07, 2011

QUESTION on the subject of Rampant Inflation: "I am concerned about what will happen to my fixed income investment portfolio when interest rates rise rapidly due to the coming rampant inflation. What are your thoughts?"

John

ANSWER:

John,

We weren't in line with you this weekend, but our cash supply is pretty skinny right now and I keep telling Iris to stop buying extra inventory, because we don't have any more shelf space (nor money, for that matter!)!!

On another matter for comment, my sense is that money flows will not change dramatically when the Fed ends its QE 2. This program was completed some time ago, in terms of total purchases, and now the Fed is merely replacing the assets that are running off - maturing. Though I haven't seen numbers on how much is rolling off, I presume that the roll-off will take many months, if not years, to complete, and that this will provide a graduated reduction in the Fed's action in the marketplace.

That being said, the Fed maintains a close watch on the money supply (M-1) and if lending does not begin to pick up at a level equal to the roll-off, the Fed can adjust its market actions to compensate for any slowing in the money supply growth. My guess is that private equity will continue to pick up the slack, as it has done over the past 3 years. If you check out M-2, you will find that it is increasing at about 4.5%. Take away inflation and you have the real GDP growth rate. Nominal GDP growth should follow pretty closely the M-2 growth rate.

The real concern - the one that will cause the bond market to "crash" - relates to expected (1)currency deflation and (2)economic inflation. You will see these changes take place in the long end of the bond yield curve. The spread between short maturities and long maturities (a steepening yield curve) will occur, causing the longer maturities to lose more money.

The best way to protect against inflation, as it affects a fixed income portfolio, is to ladder your maturities. When inflation is expected to occur, shorten your maturity ladder if you can. That being said, the best way to manage inflation's impact on a fixed income portfolio is to have about 10% to 20% of your portfolio mature every year. When this occurs, you are reinvesting every year at the longest maturity in the ladder (plus 1 year), while still having capital returned to your portfolio at par. During a period of inflation, you have cash coming into the portfolio if you need it, and you are increasing your average portfolio yield - because rates are rising - and you are investing at the long end of the yield curve - higher rates.

John, this last statement is important to understand. Through this management style, you are removing "Interest Rate Risk" from the spectrum of worries you must be concerned about. You can then concentrate on your equities investments.

Dick