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# Inflation, Inflation, Inflation

The stock market is now in "bear" market territory having declined over 20% since last October.

In itself, that is bad news. However, beneath the surface, worse news seems to be percolating ever more vigorously.

On July 11, reports emerged that Fannie Mae and Freddie Mac, the giant home mortgage financiers, may need government bailouts. These two companies own or guarantee roughly half of the nation's $12 trillion mortgage market. On that news, the stock market fell more than 200 points. The credit crisis that began last summer continues to cause havoc with our economy.

Again, the market decline is unfortunate, but the decline is merely a symptom of a deeper concern.

Below are excerpts from a July 14 *Wall Street Journal* article on Fannie Mae and Freddie Mac:

> In a dramatic statement released Sunday, the White House and Federal Reserve moved to give the mortgage giants the capital they need to survive the depression in the housing market and turmoil in financial markets that had left them dangling over a cliff.
>
> Of most immediate importance, the Fed's board of governors voted to open up its emergency discount window to Fannie and Freddie.
>
> In addition, Treasury Secretary Henry Paulson announced that he will seek congressional authorization to buy stock in the two companies and increase the government's credit line.

Adding fuel to the fire, while July 11 began with speculative insolvency concerns on the East Coast, the day ended with an immediate crisis on the West Coast— the collapse of California-based IndyMac Bank, the second largest bank failure in U.S. history, with a projected cost to FDIC of $4 to $8 billion.

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As the government works to solve the year-old credit crisis, the primary tool has been to keep the economy's wheels greased with ever-increasing amounts of cash. If the financial markets seize up because of illiquidity, the economy could be in serious trouble—unemployment lines could grow long. By making liberal amounts of money available to the banking system, and encouraging those banks to make new loans, the economy may be able to swim out of the quicksand.

The question, then, is: *Where is this increasingly vast sum of money coming from?*

There are three possible sources. The government can borrow the money by selling bonds. It can raise taxes. Or it can effectively print new money. The most politically expedient approach seems to be the third option. The money supply has been growing rapidly.

If a bailout of these giant mortgage lenders is around the corner, the odds seem good that running the metaphoric printing presses may prove to be a large part of the solution. Unfortunately, printing money without commensurate economic growth drives monetary inflation. And monetary inflation powers price inflation. For investors, then, the government's medicine for addressing insolvencies and the broader credit crisis may be priming the economy for another debacle, but of a different stripe.

From the same *Wall Street Journal* article:

> Peter Schiff, president of Euro Pacific Capital, predicted that the package would put downside pressure on the dollar. He said letting the two firms collapse was preferable to a bailout and said the package announced amounted to sticking a finger into a leaking dam that was going to burst one way or another.
>
> Because of the plan, it would burst through a surge of inflation, he said.

Inflation, at many times in world history, has wiped out investors' savings. Inflation tends not to generate nearly as much media excitement as a 200-point stock market decline. Rather, escalating costs of living is rot that eats away at investors' portfolios 24 hours a day, 365 days a

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year. It is only when we look back over a period of time that we may comprehend—too late—just how much damage has been done.

Combating inflation in a portfolio is a challenge. There are clearly some measures that we would not want to take. Intermediate- and long-term bonds, for example, expose investors to considerable risk of losing their purchasing power irreversibly. Just like the myth formerly perpetuated by the real estate industry that real estate "always goes up," investors should not be deluded into believing that bonds are "safe." When owned at inopportune times, they may be responsible for unwinding a carefully crafted financial plan. Notable, also, "guaranteed" annuities that are not indexed to the CPI can leave their investors badly compromised.

Cash-like instruments have traditionally kept investors about even with inflation. At present, however, that clearly is not the case. Cash yields less than the current 4% inflation rate. Subtracting taxes paid on interest earned likely puts most such investors into the red. In other words, those who hold cash probably will be able to buy less on December 31, 2008 than they could at the start of this year.

Stock investors, however, have an advantage. Equity has traditionally been an effective hedge against rising prices. If we have inflation, the replacement costs of a company's factories, stores, patents, and other business infrastructures rise. Eventually, that tends to be reflected in higher stock valuations. As well, higher production costs are passed along to consumers in the form of higher fees and selling prices. The shareholder, then, has a built-in mechanism for protecting his purchasing power.

There is, of course, a price to be paid for the expected inflation protection afforded by equities. The stock owner does not know when he will be made whole after a period of inflation. The market might lag for years, or it might reflect intermittently the higher costs of living. Much of the bull market gains starting in 1982 merely reflected accrued inflation losses from the earlier decade.

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The choice, then, for investors confronting an environment of escalating inflation seems to be:

- Hold cash or bonds and likely accept a persistent erosion of purchasing power, or
- Hold high-quality stocks and tolerate market swings, with the expectation that, ultimately, we will be made whole again.

As painful as the volatility of stock investing has been—and surely will continue to be—that approach appears to give us the best chance for protecting a portfolio's long-term interests. Most simply, capitalism pays investors for enduring that discomfort.

Lastly, where will FDIC get the billions required to bail out IndyMac? Most of the Federal Deposit Insurance Corporation's $53 billion in assets are U.S. Treasury securities, not cash deposits. In other words, at the end of the day, FDIC premiums helped fund our public debt, and, long ago, Congress spent the money. If we trace through what happens when FDIC sells its Treasury securities, we see that bank bailouts ultimately fall on the taxpayer—an expense that we can finance, of course, with the printing press.

So the next time we pay a higher price for milk, just remember that this may be our way helping a hapless depositor at an underwater bank.

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