The debt situation currently facing the U.S. is not unique. Historically, other countries have followed two paths to deal with an overwhelming debt burden: suffer the distasteful consequences of default or monetize their debt and pay it off with devalued money.

Both paths are painful for investors. Either way, the value of the dollar will erode, and investors will be left to grapple with the inflationary consequences. As I will show, recent policies suggest steep inflation may be just around the corner.

Fortunately, investors have some options to bolster their portfolios against the threat of inflation, as I describe below.

**The drivers of inflation**

Before we look at investment strategies, let’s review the underlying causes of inflation today.

The monetization of debt refers to using inflation (which reduces the value of each dollar) to pay off the national debt. Paying off the debt with somewhat worthless dollars can be politically expedient. That said, inflation leads to many problems for investors holding investments in cash or investments denominated in dollars.

Theoretically, under normal circumstances, a country wants to keep its money supply under control, which should keep inflation under control.

Where does the U.S. stand with the money supply?

One measure of money supply is the monetary base. The monetary base is highly liquid money that consists of coins and paper currency circulating in the public or in banks and commercial banks’ reserves with the central bank.

The monetary base is also called “high-powered money,” because a given increase in the monetary base can cause an even larger expansion in the supply of money, an effect often referred to as the money multiplier. An increase of one billion currency units in the monetary base will typically result in an increase of many more billions in the money supply, as banks use leverage to supply credit to their customers.
The number of newly printed U.S. dollars currently flooding the U.S. and world economies is unprecedented. In January 2008, the monetary base was $848 billion, and today the monetary base has more than doubled to $2.035 trillion. That is an increase in the monetary base of $1.2 trillion in just two and one half years.

The growth in the monetary base indicates the Federal Reserve has printed an unprecedented number of new dollars. What will happen when the money multiplier effect inflates the money supply?

Growth in the money supply is a function of the multiplier effect, which picks up as banks begin to lend money. Right now bankers will tell you that low interest rates do not allow enough profit to justify the risk of loans. But artificially low interest rates will end, as the federal government needs to sell ever more Treasury bonds to fund deficit spending. They’ll need to increase interest rates on those Treasury bonds to make them attractive enough to sell. Higher interest rates will accelerate the multiplier effect as banks again find the risk/return relationship satisfactory to allow them to initiate more loans. More bank loans increases velocity. With the large numbers of dollars already in circulation, increased velocity will cause the money supply to grow rapidly.

It is politically impossible for the new money to be somehow withdrawn from the economy before it causes inflation. Doing so would put us back into another recession. As inflation takes hold, the dollar will be devalued relative to other currencies. The higher cost of imports will add to the inflation we are likely to see in earnest soon.
Inflation will have a dramatic affect on investors, acting as an insidious tax, particularly for individuals living on a fixed income and for bond investors. They will lose purchasing power as inflation increases, which is often unnoticed until it is too late.

**Protecting your portfolio from inflation**

How can you protect your portfolio from inflation? Exchange-traded funds (ETFs) are a great place to start.

Less liquid real assets, such as real estate, timber, gold and silver coins and art, are appropriate for some investors, but these investments take time to locate and require careful research. Only buy these types of assets if you can afford to hold them indefinitely. You will likely lose money on this type of asset if you are forced to sell.

For most individuals, this less-liquid strategy is not an option, since they lack the specialized knowledge, wealth, and/or time to accumulate those assets. Therefore, liquid inflation hedges are more appropriate. The rise of ETFs enables investors to quickly and easily access investments to help protect a portfolio from inflation and a falling dollar, while providing liquidity, transparency and low cost.

Below are some ETFs with important inflation-protecting properties:

1. **Inflation-protected bonds**: These provide investors with income and some protection against inflation. We prefer the shorter-term PIMCO 1-5 Year U.S. TIPS Index Fund (NYSE Arca:STPZ) because we expect interest rates to rise as the U.S. is forced to sell more T-bonds to finance ever-increasing deficits. If interest rates go up, bond prices go down and long-term bonds, or long TIP, will go down more than short-term TIPS. Despite the fact that both long and short TIPS protect against inflation, short TIPS also protect against higher interest rates. The two ETFs with intermediate-term U.S. TIPS include: iShares Barclays TIPS Bond Fund (NYSEArca:TIP) and the SPDR Barclays Capital TIPS ETF (NYSEArca:IPE). For international government bonds with inflation protection look for the SPDR DB International Government Inflation-Protected Bond (NYSEArca: WIP).

2. **Non-dollar denominated bonds**: Owning bonds denominated in currencies other than the dollar offers a hedge against declines in the value of the dollar. They can provide income and also add diversification. This can be a good hedge on the premise that U.S. inflation causes a devaluation of the dollar. Good choices here are the Spiders- SPDR Barclays International Treasury Bond Index ETF (NYSEArca: BWX) and/or the PowerShares Emerging Markets Sovereign Debt - Exchange Traded Fund (NYSEArca: PCY). You may prefer these ETFs because they hold sovereign debt and, even though the sovereign emerging market debt has some low bond ratings, sovereign debt still reduces default risk somewhat.

3. **Currencies**: The idea of currency carry trading is to borrow funds in a currency with low interest expense and invest the funds in a currency paying high interest. The difference between the interest income and interest expense is the investor’s return. Prior to the advent of ETFs and ETNs, this relatively sophisticated strategy was unavailable to individual
investors. The Barclays iPath Optimized Currency Carry Index ETN, (NYSEArca: ICI) offers access to carry trading. This ETF looks at the G-10 currencies and borrows the three currencies with the lowest interest rates and purchases the three currencies paying the highest interest rates. They profit from the difference in what they earn versus what interest they pay. In addition to getting relatively safe income and low correlation to other investments, you hedge against the devaluation of the dollar to the extent that this ETF holds currencies other than the dollar.

4. **Real estate:** Because of its limited supply, real estate retains its value through 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. These are simply two good examples; there are many other U.S. and international REITs available. We’d suggest staying with ETFs rather than mutual funds because of the lower costs associated with ETFs.

5. **Commodities:** Commodities are generally considered an inflation hedge. A good idea for a broad-based, non-leveraged, long-only commodity fund is iShares iPath Dow Jones AIG Commodity Index, an ETN (NYSEArca: DJP). Another ETN, representing an index put together by the famous investor Jim Rogers 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.

6. **Master Limited Partnerships:** MLPs own domestic infrastructure assets that are used in the gathering, processing, transportation, storage, refining and distribution of energy-related assets like gas and oil pipelines. The yield comes from the lease income they receive for the use of these pipelines, among other sources. 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) that gives access to a real asset. MLPs own giant oil storage tanks, refining structures and pipelines. Kayne Anderson has an impeccable record of managing MLPs.

7. **Alternative energy:** As inflation increases and the value of the dollar decreases, energy prices quoted in dollars increase dramatically. This increases interest in, and the value of, alternative energy. A convenient way to own a global index of alternative energy investments is through Market Vectors Global Alternative Energy ETF (NYSEArca--GEX).

8. **Bet against the dollar:** A good way to hedge your dollar-based holdings is by purchasing PowerShares DB US Bearish Dollar Index (NYSEArca: UDN). This investment seeks to track the Deutsche Bank Short US Dollar Futures Index, which is designed to replicate the performance of being short the U.S. Dollar against the Euro, Japanese Yen, British Pound, Canadian Dollar, Swedish Kronor and Swiss Franc.

9. **Precious Metals:** Their weight and value makes precious metals cumbersome to safely store or move, but investors can use ETFs such as GLD and IAU to gain access to gold bullion, while a silver bullion ETF is SLV and an ETN is SIVR. An effective ETF for owning
a portfolio of large-company gold stocks is GDX and GDXJ for junior gold mining companies. Gold equities can leverage the move up or down in the price of gold bullion.

10. **Long/Short commodities**: An inflation hedge that can improve returns while reducing risk with its low correlation to other asset classes is the Rydex Long/Short Commodities Fund – Strategy H (RYLFX). This index measures trends in the commodity futures markets on a daily basis and enables investors to capture both upside and downside price movement in commodities. The fund shorts those commodities that drop below their 200-day moving average and goes long those commodities that are trading above their 200-day moving average. It tends to be a lower-risk commodity investment.

Advisors and their investors can effectively and easily purchase these investments and hold a diversified basket of inflation-protected securities that are inexpensive, liquid and fully transparent.

Inflation will be a byproduct of the massive expansion of the monetary base, and it will arrive much earlier than anyone expects. Investors must consider protecting their portfolios now before it is too late.

_Vern Sumnicht is President of iSectors and 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._

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