

## Common Cents

Economic and Market Perspective

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### Inflation

Interest rates are abnormally low and federal and state annual budget deficits are abnormally high. As a percentage of GDP, the national debt is returning to World War II levels. Global economies, particularly emerging markets, are showing signs of economic recovery and are again increasing their demand for energy and industrial materials. There is cause for concern. However, along with increased global demand there is increased global capacity to produce goods and services. That will have a tempering effect on the severity of inflation.

The Federal Reserve has the necessary tools to combat future inflation by decreasing money supply and increasing interest rates. It is difficult to get the timing right. Begin too soon and the fragile US economy will move back towards recession. Begin too late and inflation will get a foothold that will make it more difficult and painful to counteract in the future.

Unfortunately the difficulty of the Federal Reserve's mission to combat inflation is made even more difficult than just timing. The bigger challenge is politics. The Federal Reserve is theoretically insulated from politics but in democratic economies that is infeasible. It will be very difficult for the Federal Reserve to begin fighting inflation during a period of high unemployment. Growth in employment lags economic recovery so unemployment may remain abnormally high for a couple of years. It is likely that the Federal Reserve will be too slow to begin fighting inflation.

Near-term inflation is not a concern because of high unemployment, high U.S. household debt and excess global capacity. It is likely that an inflationary trend will begin within the next year. Because of supply side global capacity and global competition, it is unlikely that 1970's double digit inflation will return. Inflation in the five to seven percent range is possible driven by higher energy and industrial material prices.

Investing during inflationary periods is challenging - investing too conservatively in bonds, certificates of deposit and money markets results in after income tax investment returns below the rate of inflation. Although many investors are understandably disenchanted with stocks, it is stock investments that have the potential for positive returns after inflation and income taxes. That is particularly true of stocks that participate in inflation such as energy and industrial materials stocks. Investing in faster growing emerging economies has the potential to offset inflation too. Investing in US Treasury Inflation Protected bonds will help fight inflation with a more conservative investment. The overriding consideration for any investment portfolio is getting the mix of bonds and stocks in sync with the investors' profile and goals.

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