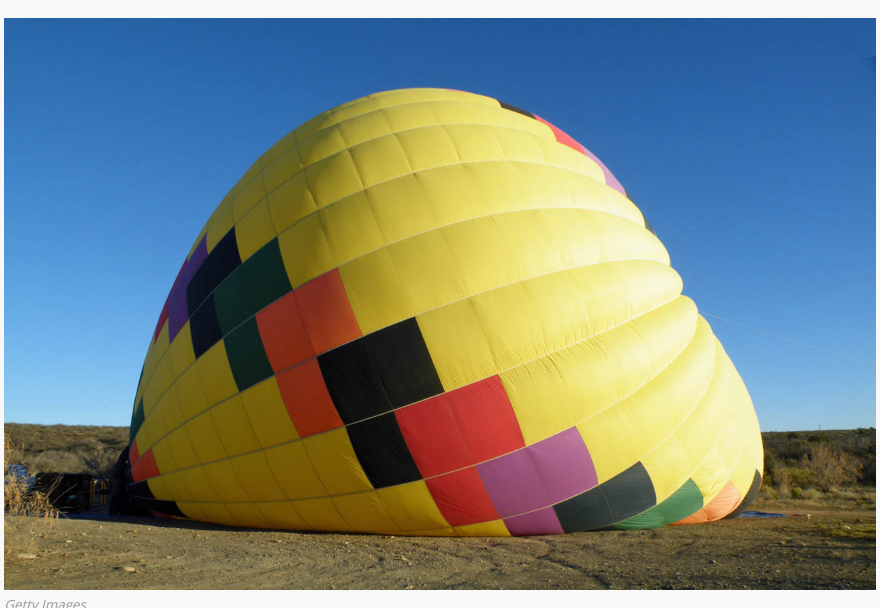
FUND WATCH

Why Inflation Is All But Dead

And why your portfolio should be protected against it anyway



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By JOHN WAGGONER, Contributing Writer
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Most people have a pet fear, whether it's being attacked by bees, bears or giant sandworms.

For retirees, one of the most common fears is inflation.

Rising prices can eat away the value of your savings and reduce your retirement plans to a mute pile of bones in the desert.

It's always best to face your fears, however. So let's examine those worries about inflation: where it is now, what could make it more of a problem in the future and how to combat it.

Inflation Has Been in a Deep Slumber …

Inflation simply means a period of rising prices. Today's crop of retirees probably remembers the soaring inflation from 1970 through 1980, when it averaged 7.7% annually. Inflation peaked in 1980 at 13.5%.

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In the past 20 years or so, however, inflation has been tamer than a 12-year-old cockapoo. The consumer price index, the government's main gauge of inflation, rose 1.7% the 12 months ended September. That's a whisper of its pace from the 1970s. But it's even low in comparison with the long-term inflation rate: The CPI has gained an average 2.88% a year since 1926, according to Morningstar Direct.

While inflation may not seem tame if you've taken your car to the garage lately, other measures corroborate today's current low inflation rate. For example, the core personal consumption expenditures (PCE) price index – the Federal Reserve's favorite inflation indicator – has gained 1.7% annually.

But CPI and PCE only show us where inflation has been. Where is it going?

A recent survey by the Philadelphia Federal Reserve Bank shows economists expect inflation to rise to 2.2% annually by the third quarter of 2021, and to average the same rate from 2019 through 2028.

But economists make predictions largely because people ask them to, and their prognostications tend to be about as accurate reading entrails.

If you want to know more about inflation expectations, peer into the Treasury market.

Consider the 30-year Treasury Inflation Protected Security, or TIPS. The government adds principal to the note's value as the CPI rises. The yield represents its return after inflation. The 30-year TIPS yield currently is 0.60%, meaning you'll get 0.60% above inflation for 30 years if you buy at current levels.

If you subtract the TIPS yield from the current 30-year Treasury rate (2.26%), you get 1.66%. In effect, that's what Wall Street expects the inflation rate to be for the next three decades. To make buying a 30-year TIPS worthwhile, you'd need to have an inflation rate of 1.66% or higher.

Now, are investors in 30-year T-bonds actually betting that inflation will run below 2.26% annually for the next three decades? Not really. Relatively few investors, aside from insurers, buy and hold 30-year Treasuries. But short-term bond traders seem to be betting that inflation will be muted for the foreseeable future.

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One reason is that the world's economy is weak, and a weak economy can result in a period of falling prices, rather than rising prices. Take the 10-year government bonds in Germany, France, the Netherlands, Switzerland and Japan: All of them have negative yields.

You'd only take a 10-year bond with a yield of -0.57% (as it is in Switzerland) if you expected prices to fall more than 0.57% a year for the next decade.

… But Don't Sleep on Inflation, Either

It's still reasonable to have *some* inflation protection in your portfolio.

For one thing, inflation is cumulative. A 2% inflation rate means that something that costs $10,000 now will cost $12,190 in a decade and $14,859 in two decades.

Kiplinger's expects the overall inflation rate to hit 2.1% by the end of the year and for the core rate – minus food and energy – to reach 2.5%. The two biggest culprits: higher costs for shelter and medical care.

Another reason to be wary of inflation: Bond traders and economists can be wrong – and sometimes are.

There are real arguments for a return to inflation, too. Although inflation in the 1970s was largely the result of the Arab oil embargo and spiraling energy prices, inflation typically is the byproduct of an overheated economy. As the unemployment rate dwindles, companies must lure workers with higher wages. And as wages rise, prices also rise, partly as a result of higher employment costs.

Also consider that the government is adding $1 trillion a year to the national debt, which currently totals $22.9 trillion.

Yes, a big debt doesn't guarantee higher inflation – Japan has a much more debt (compared to gross domestic product) than the U.S., and there is no Japanese inflation in sight. Nevertheless, reducing the deficit through inflation (tax revenues rise more than outlays) is probably the most tempting – and politically palatable – way to decrease our debt.

Protect Against Inflation With TIPS

Over the long term, stocks have proven to be far more effective in protecting yourself from inflation than most bond funds.

But it couldn't hurt to put at least some of your bond holdings in TIPS funds. Although TIPS funds are still bond funds, and therefore sensitive to changing interest rates (bond prices rise when interest rates fall, and vice-versa), they do benefit from the increase in principal value when inflation rears its ugly head.

Thanks to falling rates, TIPS funds have gained 6.8% this year, according to Morningstar. **Vanguard Inflation-Protected Securities Investor** (VIPSX, $13.22), which is entirely invested in TIPS, is one good choice; it charges 0.2% in annual fees and yields 0.2%. It's up 7.2% this year. **T. Rowe Price Inflation-Protected Bond** (PRIPX), which is 83% in TIPS but also holds sprinklings of corporate bonds, mortgage-backed securities and other debt, has gained 7.7%. It charges 0.41% in expenses.

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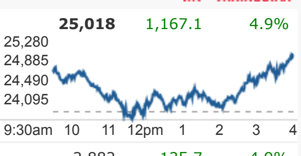

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S&P 500	2,882	135.7	4.9%
NASDAQ	8,344	393.6	5.0%

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