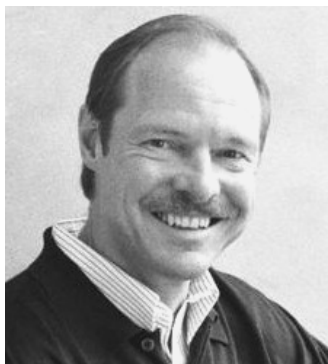


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Perspectives



Three Inflation Hedges That Will Protect You

The last thing you need at this time of the year is another 2004 forecast, so let me be brief in summing up what you'll have heard from almost everyone and then deal with the real issues.

As you no doubt know, the U.S. economy has taken off. The combination of tax cuts and low interest rates is keeping consumer spending at robust levels and corporate profitability increasingly reflects that. Companies have started rebuilding their diminished inventories and, in time, that should lead to employment growth and, finally, a revival of capital spending.

A while ago, when the Fed engineered its unprecedented monetary bailout, while the Bush administration initiated massive tax refunds, much of the world pooh-poohed the US action and predicted outright disaster. At that time, I quoted my old friend, Swiss-based money manager Dominique Dziurzynski, who stoically noted that "In risk-adverse Europe this would never be successful, but given America's can-do attitude, it may just work." And work it did, as we now know.

In America, It May Just Work

This is not to say that all will be well ever after. On the contrary, the monetary torrent unleashed by the Fed and the fiscally questionable Bush tax cut will usher in a whole new set of problems—problems that I've seen addressed in remarkably few year-end commentaries. I'd like to discuss them in some detail in this article.

The first consequence of the great US bailout is all-apparent: the dollar has experienced a major meltdown. That the greenback fell so rapidly despite the clear absence of good currency alternatives only accentuates the predicament. To be sure, in the next few months, the falling dollar may even help America's economy. US exports will be more competitive which, in turn, will help get the looming trade deficit under control.

But there's a hitch: US imports are becoming more expensive. Right now, manufacturers in many parts of the world are still saddled with excess capacity. That means they'll be careful to raise prices. But as the global manufacturing economy recovers--and there are growing signs that an improvement is underway--that will change. Prices will rise, especially for US consumers, who will have to pay in depreciated dollars.

The Fed's "No Crisis" Rhetoric

You wouldn't know any of this if you listened to various Fed officials giving their upbeat speeches. On the contrary, the rhetoric that's emanated from the Federal Reserve is such that you'd think interest rates will stay low forever and the dollar's descent, no matter how steep, should simply be shrugged off. The Treasury echoes such notions.

Let me tell you something: when the Federal Reserve and the Treasury blow into the same horn and they sound a bit shrill (as they've recently sounded on the topic of the dollar), watch out! I disagree with some of the doomsday scenarios, such as the one that the world will start to aggressively sell dollar denominated assets, but I stand by my prediction that inflation will become a problem. I first cautioned of the coming turnaround in interest rates and inflation pressures last summer, when the Fed was still worried about deflation (see "The Fed's Monetary Torrent: Sowing the Seeds of Inflation"—you can re-read it on www.cavelti.com). I'm now even more convinced of that outcome.

What does that mean for you, as an investor? In my opinion, two questions should dominate your strategic thinking: The first is whether you have sufficient inflation protection in your portfolio, the second whether you have exposure to the world's fastest growing economies.

What Inflation Risk?

When I recently recited these considerations to a client, he asked me, "What inflation risk are you talking about? I can get a car for less money than a few years ago, computer prices are crashing and every night I'm getting calls from people trying to hawk off cheap flights and holidays." It's a valid observation. So where exactly is the inflation risk?

One key area of price pressure is energy. Oil and natural gas prices have been higher than most analysts ever predicted. In 2002 we were told that the global economic slowdown would bring prices to their knees; in 2003 America's invasion of Iraq was going to cure the situation. Throughout, inventories stayed at the low end of historical norms and demand was surprisingly robust. Amazingly, there are still a considerable number of economists who miss what's so apparent. The energy industry has failed to make the investment necessary to keep ahead of increases in global demand. As third world consumption soars and the developed economies are turning stronger, energy prices are likely to stay high. Consequently, part of your inflation hedge should be shares in energy companies.

Luckily, energy prices are denominated in dollars. That means investors in dollar-linked economies won't have to worry too much about currency depreciation. But many consumer goods come from places like Europe and Japan. The lower the dollar sinks, the more expensive they will become. In other words, the sinking US currency poses another key inflation risk. What asset has the best negative correlation to the dollar? Gold! That's why I've recommended a core position in gold mining shares during the past two years. I don't know how long the dollar will continue to fall, but the odds are good that as long as it slides, gold bullion will rise. And the quality gold mining shares in our model portfolio appreciate at about three times the rate gold does. In a nutshell: gold stocks should form a key component of your inflation hedge.

Your third inflation hedge should be in equities of the world's fastest growing economies. For the next many years, I suspect that China and South East Asia will hold that distinction. One reason is that many Emerging Asian economies are on a dollar peg, which means that they'll become even more competitive as the US currency falls. Another reality is that in the increasingly inflationary world I foresee, only a handful of countries will be able to compensate through growth for the losses racked up by currency devaluation and price inflation. China and some of the Emerging Asian economies are likely to be among them. In short: make Emerging Asia another key inflation hedge.

When Should I Buy?

Longer term Perspectives readers already hold core holdings in all three areas, but if you've joined our service more recently, you'll probably wonder whether it's not too late to position yourself. Gold mining shares have gained the most since I formulated my three-pronged approach. One of our core holdings, Newmont Mining (NYSE:NEM), has appreciated more than 150% during the past two years (see chart below); the other, Dundee Precious Metals, is up 250%. Clearly, this is not the ideal time to initiate holdings in these stocks and the question of whether it's too late to buy these stocks is relevant.



Still, despite the substantial gains we've seen in the gold mining share sector, it's probably a good idea to buy into it on any meaningful setbacks.

Remember, gold bullion fell for 21 years, from \$855 in 1980 to just below \$260 in 2001. The two and a half years that gold's been rising is a very short time by comparison; or, expressed differently, the Midas metal is only in the fledgling stages of a new bull market.

The same can be said of the ascent of the Emerging Asian economies. The chart below shows you the rise of Scudder New Asia Fund (NYSE:SAF), one of our proxies for the sector. The gains here amount to 66% during the past two years. And as in the case of gold, there is good reason that the party will continue. A friend of mine asked me the other day why I preferred investing in places like China to putting my money to work in the US. The reason is simple. The United States, even though I like it a lot better than Europe or Japan, is a mature economy. Investing in China is like entering the US market in the early 1900s. Yes, the growth from an emerging economy to one of the world's juggernauts will be accompanied by periodic hiccups and crises. But I have no doubt that investors with a longer term horizon will be handsomely rewarded. In the case of Emerging Asia, my advice is this: if you haven't boarded the train yet, do so on setbacks.

When it comes to energy, the decision of when to buy is a bit easier. During the past two years, I have repeatedly pointed to improving energy fundamentals, but while the sector offered some good trading opportunities, it failed to post a convincing upward move—until just very recently. The chart of one of our core holdings, Devon Energy (NYSE:DVN) tells the story.

In short: energy is still an under-recognized story. Apart from their appeal as inflation hedges, stocks of quality integrated companies, producers and drillers are still attractively priced.

How Big an Inflation Hedge?

Which brings me to the final question: how much of an inflation hedge should you hold? When it comes to our model portfolio, I've been cautious on equities in general; at current market prices, total stock exposure amounts to only 33%. However, more than half of that (about 1/6 of overall investment holdings) is held in the Natural Resource and Emerging Asia sectors—i.e. the inflation hedges I've just talked about.

I know of people who are taking substantially bigger bets on energy, gold and the emerging markets. In my opinion, it's too early for that. I'm convinced that inflation will be back, but I don't yet know how the monetary authorities will react. Will the Fed, which routinely sets the tone for the world's central banks, be quick to raise interest rates, when evidence of nascent inflation first presents itself? Or will they stay behind the curve, as they did the last time they encountered a similar situation, in the 1970s? Another question is whether growing inflationary pressures will coincide with robust economic growth (in which case my approach will be the right one) or whether it will fall into a period of stagnant growth (in which case gold will do a lot better than energy). Such fine-tuning of your portfolio to ongoing developments will be a crucial step in keeping yourself protected. For now, the main thing is to recognize that the dangers of deflation are likely behind us and that the biggest risk to your assets comes from the forces that will trigger the next round of inflation: a vast monetary expansion, a dramatic decline in the dollar and spiraling energy prices! □

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