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The Rising Risk of Inflation

Since the financial meltdown in 2008, the Federal Reserve has been pumping an extraordinary amount of money into U.S. bank reserves in an effort to keep our economy from slipping into a deep depression.

Employing a monetary strategy called quantitative easing (QE), the Fed is increasing the money supply in an effort to spur economic growth - maintaining low interest rates, creating liquidity for the markets and providing consumers with extra money to spend freely. ¹

After four years of QE, some economists and strategists are sounding the warning that a massive spike in inflation is coming. ^{2,3,4} "Until the velocity of money accelerates, the vastly expanded money supply doesn't turn into inflation," explains Robert Arnott, chairman of Research Affiliates LLC. "So we've been protected by a sputtering economy."⁴

But signs indicate the economy is gaining traction and the money is beginning to move.⁵ Banks, initially reluctant to make the loans that would put their reserves into circulation, are picking up the pace of lending as the recovery progresses. To the extent that the reserves make it into the hands of businesses and consumers, the risk of inflation rises. ⁵

How Inflation Impacts the Consumer

When growth in the money supply outpaces economic growth, the value of currency falls, forcing prices of goods and services to rise. ⁵

The primary guide used to benchmark the cost of goods and services is the Consumer Price Index (CPI), produced by the Bureau of Labor. Using a "basket of goods approach," the CPI compares a consistent sampling of products from year to year that consumers buy and use on a daily basis. The price you pay for coffee, eggs, laundry detergent and a hair cut are captured and tracked closely in the CPI.⁶



The figures for 2012, just released January 16, show the CPI rose 1.7 percent in 2012, down from a 3.0 percent increase in 2011. But some economists argue that the CPI is not truly measuring day-to-day costs of consumers and understates the rate at which costs are rising.⁶

Looking historically at the CPI, in 2002, the cost of a loaf of bread was about \$1.00 and a gallon of milk was \$2.75. Today, that loaf of bread is \$1.40 and the gallon of milk is \$3.45. The increase may seem small, but when you take into account increased prices for food, clothes, utility and rent, inflation impacts how far your money will go and can significantly impact purchasing power.⁶

The Positive Side of Inflation

Yes, inflation pushes up the cost of goods and services. But it can also mean that homes, precious metals, stocks, bonds and other assets gain value too. For asset owners, inflation can have a wealth-building effect. Inflation can also result in higher wages for employees. If wages increase and keep pace with the cost of goods and services, then larger paychecks could help offset higher prices.

Inflation's Effect on Your Portfolio

Inflation may not impact your investments as quickly or dramatically as a stock market crash, but over time it can steadily and quietly chip away at the value of a portfolio.

Effects of inflation can include:⁷

- Reduction in purchasing power
- Disruption of stock and bond markets, causing volatility
- Devaluation of income on interest-bearing securities
- Squeezing of profit margins for certain types of stocks

From an investment standpoint, inflation is a risk that needs to be managed and balanced against other more evident forms of risk like market volatility and loss of principal.

Combat Inflation's Impact on Your Savings

- **Increase Savings Levels** - if you keep your contributions at the same level each year, without taking into account the rate of inflation, you are not really saving the same amount. Increase your savings by 3% each year to counteract inflation and preserve the value of your nest egg.
- **Adjust Projected Returns** - to account for inflation, subtract the inflation rate from the estimated rate of return on your investment. For example, if you anticipate an 8% return, by subtracting the inflation rate of 3%, your overall rate of return would be 5%. Factoring in inflation, you may need to save more in order to enjoy the standard of living you desire.
- **Diversify Against Inflation** - talk to your financial advisor about adding some inflation fighting investments to your portfolio.

Can I be of assistance? Let's keep your portfolio returns ahead of the rate of inflation to help sustain your purchasing power in retirement.

Sources: 1) Brad Plummer, "What is Quantitative Easing? And will it help the economy?" The Washington Post, September 13, 2012. 2) Lauren Lyster, "Peter Schiff doubles down on inflation prediction," Yahoo Business, January 10, 2013. 3) Sam Forgione, "PIMCO's Gross warns investors of looming inflation," Reuters, January 3, 2013. 4) Dan Jamieson, "Real story on inflation will soon be told: Arnott," Investment News, March 15, 2012. 5) Steven Cunningham, PhD, "The Inflation Risk Around the Corner," February 20, 2012. 6) Consumer Price Index (CPI), Bureau of Labor Statistics. 7) Richard Barrington, "Coping with Inflation Risk," Investopedia.

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