Registered Investment Advisor Firm

©ISSUE VI, VOL. V – JUNE – 2016

Inflation Proof your Bonds

Inflation might not be as tame as many think it is. The Federal Reserve (FED) has signaled a willingness to tolerate inflation at a faster pace. This is just what could result if the FED gradually raises rates.

The FED monitors several inflation indexes, which vary according to what prices are included. Investors tend to follow the core consumer-price index (CPI) which rose 2.1% over the 12 months through April. This index excludes food and energy, *as if there is no inflation there.* The FED follows the core personal-consumption expenditures (CPE), which also excludes food and energy. It rose 1.6% over the same 12 months.

If the job market heats up, other prices keep rising and the FED tolerates more inflation, bondholders can expect some losses. Further increases in inflation could cause yields to rise as bond investors move to higher yields to stay ahead of inflation.

Bond yields move in the opposite direction as bond prices, so a rise, from inflation expectations, could cause many bonds to lose value. That could be a concern for retirees and investors using conservative asset allocations.

But there are actions investors can do to minimize inflation's impact and offer some protection. Here are 6 strategies:

Evaluate what you have: A well-diversified portfolio might already be protected. Savers in low-yield bank or money market accounts are averaging .11%, well below inflation. Investors in well-diversified intermediate-maturing bonds or bond funds can expect 2-3% yield, which should mostly offset inflation. Buying high quality bonds can offset current losses as the bonds approach their maturity.

Own more stocks, fewer bonds: Some advisors say bond funds no longer are a good tool for preserving capital. They not only lose value if rates rise, but yields of high-quality bonds scarcely compensate investors for inflation. Currently, 10-year Treasury's yield only 1.8%. Owning more stocks is one solution. Stocks would fare well if inflation averaged around 2%, but not as well if inflation rose significantly. The reasoning: as inflation rises more sharply, that tends to make it difficult for companies to raise prices rapidly enough to keep up with rising costs. This eats into profits.

Invest Globally: Global markets are moving in closer sync than ever, but some foreign economies aren't tracking the U.S. Economies in some countries are weak enough that their central banks might follow policies that will push down interest rate, offering capital appreciation opportunities. Many foreign stocks have higher yields than similar U.S. stocks. Foreign real-estate investment trusts (REITs) yield as much as 4.5% versus 3.5% for U.S. REITs.

Add inflation-linked bonds: The U.S. Treasury sells bonds indexed to changes in the CPI, known as Treasury inflation-protected securities (TIPS). These offer the purest form of inflation protection. For several years, TIPS have performed poorly because inflation has been maintaining a low rate. If inflation does edge above 2%, TIPS are likely to outperform Treasuries.

Corporate Credit: Bonds of U.S. companies pay a yield premium, or spread, over Treasuries to compensate for their lower credit. For a single-A rated bond that spread can be up to 3%. Higher-yield, or junk, bonds pay more than a 7% spread, but can lose a lot of value. Junk bonds have a 75% correlation to moves in stocks.

Bank Loan Funds: Bank loan funds, which feature floating rates, have a dual purpose in offering investors potential for both increasing yields and principal. These funds loan to companies with low credit ratings that pay higher yields. Rates float about 5% above a variable rate benchmark, such as the LIBOR. As the LIBOR rises, bank loan funds eventually pay higher yields, but, there could be a lag before this happens. Meanwhile, the value of the loan appreciates when yields rise, potentially giving investors an additional boost.

FED Watch
A 25% chance, and rising, of a rate increase in June.
Next meeting is June 14th and 15th.

Davis Investment Group

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

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