



Investment Perspective

Portfolio Preparedness for Looming Inflation

As the U.S. Treasury maintains a high rate of deficit spending and the U.S. Federal Reserve (the Fed) increases the money supply to address ongoing softness in the U.S. economy, investor unease about a potentially weakening U.S. dollar and systemic pricing pressures have led to concerns about protecting portfolios from long-term inflation. Historically, periods of rampant inflation - which erode corporate earnings, reduce buying power and pressure long-term interest rates higher - have proved to be poor environments for investing in stocks, bonds and cash. While debate persists about whether deflation or inflation poses the greater risk for investors today, investors who seek ways now to compensate for the possibility of an inflationary environment may potentially offset investment losses from traditional asset classes.

What is inflation?

Inflation is a rise in prices caused directly by an increase in the money supply. Simply stated, inflation is too much money chasing too few goods - it doesn't result from increased demand or decreased supply of a particular good. Unlike fluctuations in the price of goods caused by supply and demand, inflation is much harder to quell once it starts because fixed costs, rather than variable costs, are affected.

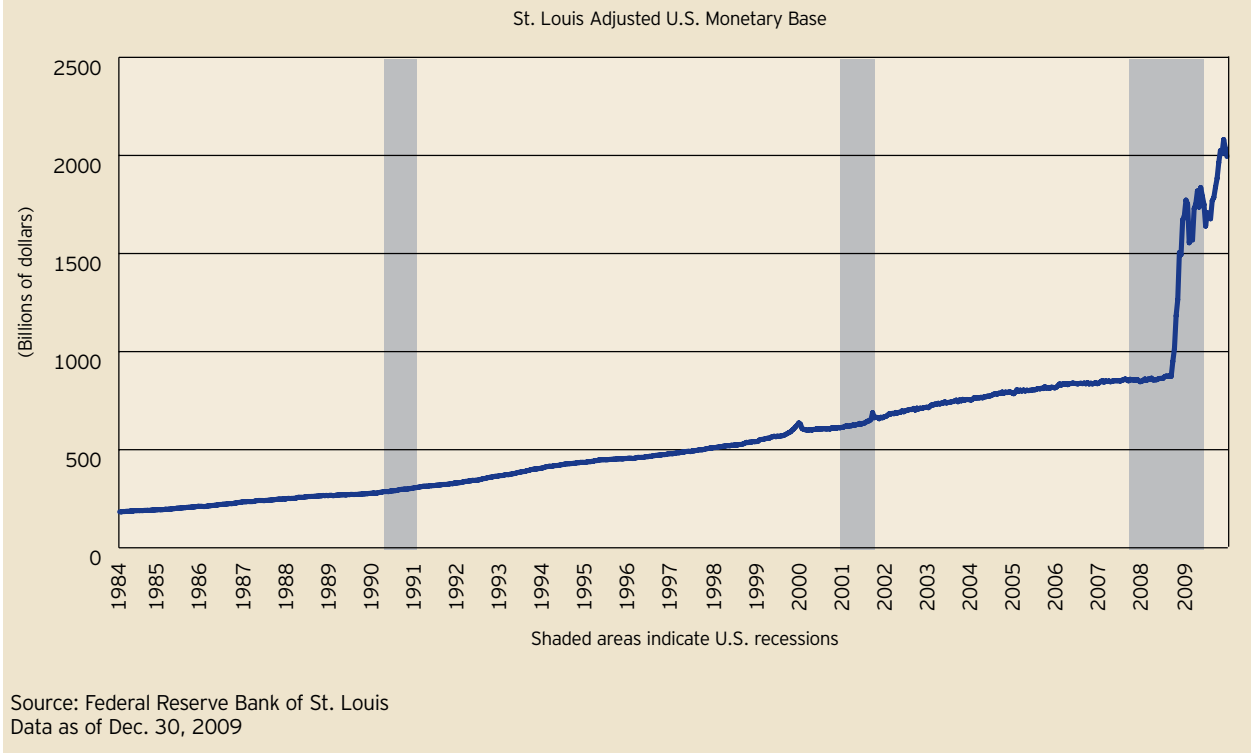
Setting the stage for inflation

Beginning in 2007, increasingly aggressive policy measures to dampen the effect of the global financial crisis have mandated direct monetary action by the Fed and record deficit spending and tax-rebate stimulus programs by the U.S. Treasury. From all indications, these policies will continue through 2010 and perhaps beyond.

While the efficacy and merits of each program are debated, investors should consider these facts when pondering the potential for inflation and a weakened U.S. dollar:

- The U.S. national debt and annual deficits have risen substantially.
- The Fed has taken a significant amount of risky assets, mortgages and U.S. Treasuries onto its balance sheet.
- The private banking system has seen an unprecedented inflow of government funds to increase stability and new lending.

Figure 1: Federal Reserve Monetary Base



Identifying assets that outperform in inflationary markets

Whether investors believe that inflation is a real threat or that it will be offset by continued recessionary or other market forces, investors should consider addressing inflationary risks today rather than waiting to see what happens.

Historically, inflation has had a negative effect on fixed income, equities and domestic currency.

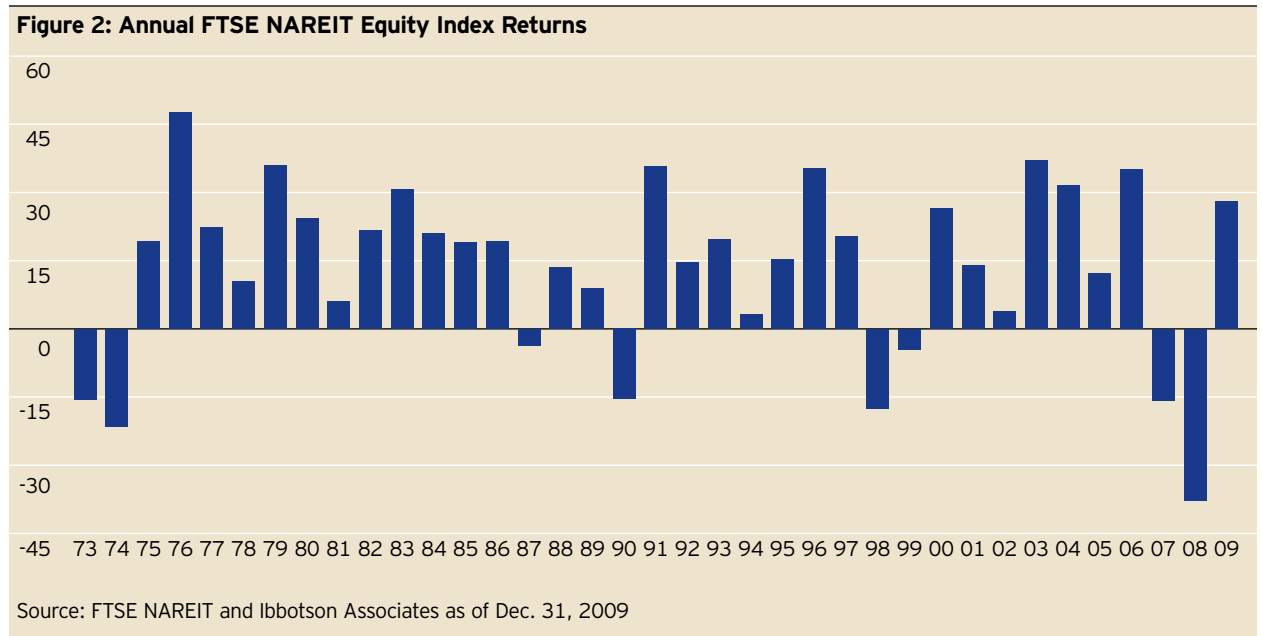
- Fixed-income investments have historically underperformed when interest rates rise. Bond investors - who lend money to companies or government entities - demand higher compensation for long-term contracts to offset inflation risk. Higher interest rates translate into lower bond prices.
- Equities have historically underperformed as a whole during periods of rising and/or high inflation, though not as definitively as bonds. In fact, rising interest rates can have two different effects on stocks. Generally, companies have a harder time passing rising fixed costs on to consumers when the economy is less than robust. In this case, stocks generally benefit from a rising-rate environment. However, inflation typically chokes off economic growth at some point as wage growth fails to keep pace with real inflation. Ultimately, stocks are pressured by high fixed costs, thus pressuring profit margins.
- Domestic currency is almost always a primary catalyst for inflation in the first place, as a declining currency due to supply/demand imbalances raises the effective price of everything. Once inflation takes hold, it can cause continued downward pressure on domestic currency as foreign investment wanes in favor of stronger global currencies.

But three investable assets may benefit from inflation - real estate, gold and commodities. Let's examine these assets as potential hedges against inflation.

Real estate: Inflation proof?

Real estate has a statistically moderate correlation to inflation due to conflicting forces in the economy. As a tangible asset, its intrinsic value naturally rises versus a declining currency. Moreover, rents typically rise in inflationary markets to pay for higher maintenance costs and rising wages. However, inflation also causes higher long-term interest rates, which deters borrowers and investors from creating new demand. While the correlation of real estate benchmarks has been moderate, periods of sustained inflation (such as the 1970s) have seen a remarkable increase in real estate values, both on a nominal and real basis.

Like residential real estate, commercial real estate can benefit from periods of inflation. When considering investments for a potentially inflationary environment, investors can examine real estate's performance in the U.S. during the 1970s and early 1980s*, a period characterized by double-digit inflation and a declining stock market in real-dollar value. As figure 2 below illustrates, U.S. REITs recorded relatively strong performance during these periods. Following the dismal recession during 1973 and 1974, the FTSE NAREIT Equity Index more than doubled over the next three years; similarly, the index surged following the recessions of 1981-1982, 1990-1991 and 2001-2002 (Source: FTSE NAREIT and Ibbotson Associates).



Gold: Commodity or currency?

Gold benefits from inflationary markets by virtue of its fixed value in relation to a declining currency. While generally considered part of the commodities universe, gold can better be characterized as a currency, both because of its characteristics as well as its lingering status as a retired, yet often cited, proxy for global currencies. The value of gold as a commodity stems from its physical properties - electrical and thermal conductivity, resistance to corrosion, malleability and ductility. But cheaper metals offer these properties. Clearly, gold is not priced as a commodity. If it were benchmarked against copper for its electrical properties in mass production, gold would be the most overpriced asset in the world at over \$15,000 per pound versus \$36 per pound for copper. Demand for gold goes beyond its intrinsic nature and inspires people to pay substantially more than its commodity value. Gold is money.

Commodities: Nature's inflation hedge

Because commodities prices usually rise with rising inflation, commodities can offer inflation protection. When the demand for goods and services raises prices, the prices of commodities used to produce those goods and services usually rise, too. Wheat, sugar, soy, copper, coffee, oranges, oil, natural gas and a host of other natural resources that we consume make up an important asset class that perhaps will be considered a traditional rather than alternative investment strategy.

What makes commodities durable through inflationary markets is their value as "hard assets" or at least tangible assets for more malleable items. Unlike buying the stock in a company dealing with higher fixed input costs, buying commodities directly allows investors to take advantage of the rise in those fixed costs and avoids company-related risks, such as poor management, that have nothing to do with commodities themselves.

*Past performance cannot guarantee comparable future results.

Investing in inflation-hedging strategies

What's the best way to invest in potentially inflation-resistant assets? Real estate investments are available through many types of investment vehicles, while commodities and precious metals can be purchased primarily through two channels - exchange-traded funds (ETFs) and futures.

- **ETFs.** In anticipation of a boom in commodities, a slew of ETF products have launched in the past few years to provide access to a predetermined basket of commodities and precious metals. While an ETF is one way to access this market without having to purchase the actual commodity itself, the weightings for the index an ETF is built to replicate can be arbitrary. Investors should carefully review the structure of the index for any ETF under consideration to ensure the weightings are in line with desired allocations.
- **Futures.** Active management through the purchase of futures contracts can provide an accurate proxy for the commodity itself, as well as an analytical approach to opportunities across the vast spectrum of commodities and gold. While futures may offer a purer exposure to the desired asset, ETFs are convenient and flexible. Investors should consider which structure better suits their investment needs.

The best defense: Portfolio preparation

With recessionary pressures apparently keeping inflation in check today, policy focus among most developed and many emerging market countries has clearly been geared toward fending off a deflationary spiral and revitalizing credit markets and consumer spending. Thus, the debate over whether inflation or deflation will hit the global economy next - or any other prognostication about economic and market conditions, for that matter - should focus less on guessing the correct answer and more on strategies for a well-diversified portfolio that balances risk and protects assets during various market conditions.

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