Point Of View

Income During Inflation

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Even as the Dow sits above 10,000, the public remains justifiably anxious about the state of the economy. The Federal Reserve has worked overtime to convince the public that it has saved the economy from a meltdown, but with unemployment at a 26-year high and the dollar tanking, it's a hard sell. What most people easily understand is that the Fed has produced a monetary time bomb. Since August 2008 the monetary base (bills in circulation plus bank credits at Federal Reserve banks) has increased by 137%. If not defused, this bomb will eventually explode into inflation. We are told by Fed Chairman Ben S. Bernanke and other members of the Fed's bomb squad not to worry. They assert that they know how and when to disarm the bomb.

Such assertions are a stretch. After all, it was the Fed's ultraloose monetary policy and disregard for the value of the greenback that fueled the asset bubbles that burst and set off the panic and subsequent destruction of jobs and wealth.

The time bomb hasn't exploded yet because, for now, the expansion in the monetary base has not given rise to a comparable expansion in a broader measure of the money supply called M2. That's the monetary base, plus demand deposits (commercial and individual) at banks, traveler's checks, savings accounts, time deposits and money market mutual funds.

The key here is something called the money multiplier, which is M2 divided by the monetary base. The multiplier measures, in a sense, the inflationary bang from every buck the Fed creates. In August 2008 the multiplier was 9.1. By December 2008 it had collapsed to 4.9 and since then has declined along an irregular path to 4.2. When the demand for the more narrowly defined kind of money goes down, as it eventually will, the money multiplier will move back into a normal range of 8 to 9. That is, the dollars manufactured by the Fed will give rise to more money (broadly defined) burning holes in people's pockets. An excess of money in spenders' hands is a recipe for inflation. This is when the Fed will need to shrink its balance sheet, but it will not be willing to do so because unemployment will probably still be elevated. In this scenario inflation expectations will become unhinged and inflation will accelerate.

With the Fed intent on keeping interest rates artificially low for an extended period of time, some of my previous recommendations should still work well. In September I recommended tapping into gold and commodities via the **SPDR Gold Shares (GLD), iShares S&P GSCI Commodity-Indexed Trust (GSG)** and **PowerShares DB Commodity Index Tracking Fund (DBC)**. Since then, these funds have appreciated by 13% to 15%, while the S&P 500 has notched a 9.2% gain. Retain these positions to protect your portfolio from the Fed.

With the inflationary wolf at the door, what's an income investor to do? Go for dividends.

Leggett & Platt (LEG, 20), a manufacturer with a product line that started out as bedsprings and veered off into things like parts for farm machinery and retail shelving, generates plenty of cash, even when sales slump. The dividend, which eats up 50% to 60% of earnings, was raised last year and now comes to an annual 5% of the share price. Management has also spent cash on stock buybacks, shrinking the number of shares outstanding by 15% over the past three years.

Philip Morris International (PM, 50) is the second-largest tobacco company in the world. PM claims almost 16% of the non-U.S. cigarette market, a big plus for dollar bears. The market is currently pricing in a revenue growth rate that is lower than what the company has enjoyed over the past five years. The yield is 4.56%.

With its acquisition this year of Alltel, **Verizon Communications (VZ, 30)** has a customer base equal to 30% of the U.S. population. Annual revenue growth over the past ten years has averaged 11.9%. But Verizon is not receiving much credit for its rapidly growing wireless business (it owns 55% of Verizon Wireless). This segment is growing at an annual rate of 17% and is now larger than the wire-line side of the business. The dividend yield is 6.4%.

Kellogg (K, 53) has a yield of only 2.8%, but its dividend is well covered (it uses up only 44% of earnings) and has enjoyed seven increases over the past ten years. The cold cereal company gets 34% of its revenue from outside North America. That portion will go up, so here is another hedge against a weak dollar, as earnings abroad get translated into EPS gains here. Wall Street is expecting mediocre growth--too pessimistic. Take a bite.

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