

## >: 3 Ways to Profit from Inflation

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It's hard to talk about inflation with a straight face during the midst of one of the worst recessions since the 1930's.

After all, most bouts of inflation are driven by red-hot economic growth. So how could inflation even be on anyone's radar?

What exactly is inflation anyway? Inflation is a decline in the purchasing power of a nation's medium of exchange (money). In 1987 you could buy a pack of cigarettes in New York City for \$1.35. Today that same pack will cost you \$11.50. That's inflation at work; over time, currencies' buying power decline.

Most of the time inflation occurs when an economy is growing at a very rapid rate. During economic good times you hear a lot about wage inflation. This happens when the demand for workers becomes so great that companies have to hike wages in order to attract more talent. As more workers receive more money, they buy more stuff. This buying can lead then lead to higher prices for goods and services as greater demand pushes prices higher. The net effect of all of this is that the purchasing power of the country's dollars declines.

But we're not experiencing strong economic growth ... so how could inflation become an issue now?

Now, more than ever, we live in a globally linked economy. With the industrialization of China and India there is now a new demand for raw materials that has never existed before. As those countries' economies grow and their populations get richer, they will seek to buy more 'stuff' and that buying could lead to higher prices, aka inflation.

The other inflation specter out there is the US Dollar. Because most commodities are priced in US Dollars (regardless of where you live most commodities are quoted, bought and sold in American dollars), as the Dollar weakens commodity prices rise to account for the dollar's weakness.

The reason is that, as the US Dollar goes down, other currencies are strengthening against the dollar which means that foreigners can buy more dollars for their rubles, pounds, Yen what have you. This means that they can buy more dollar-denominated commodities using less of their home currency.

To show you how important US Dollar stability is to commodity prices, check out the action in oil. From 2002 until 2008 the US Dollar index declined approximately 50%. As the US Dollar went down, crude oil prices went from \$20 a barrel to \$147 a barrel. A 50% drop in the value of the dollar led to a 600% increase in the price of oil!

Here is the flip side: spot oil prices peaked at \$147 in July of 2008 just as the US Dollar was bottoming. The US Dollar index then rallied 25% and we saw crude oil prices drop an astounding 76% to \$36 a barrel!

As we can clearly see, the strength or weakness of the US dollar has a huge impact on how much we pay for oil as well as all of the other dollar-denominated commodities.

If the dollar goes into freefall, US consumers will get hammered by sky-rocketing commodity prices; that's your oil, your sugar, wheat, corn, metals ... everything we buy and use will go up in price. The worst part of this is that we could see big price hikes and no compensating economic growth.

This is the "earn less but pay more for everything" economy that many folks dealt with in the 1970's.

*The good news is that there are certain steps you can take to help insulate yourself from a potential inflation shock, especially one created by a cratering US D*

### **Gold**

The grand pappy of all inflation hedges has served as a storehouse of purchasing power for more than 5,000 years. When all else fails, the shiny stuff is the last man standing.

During inflationary times, savvy investors are looking for ways to preserve their buying power, which is why gold prices generally rise during inflationary periods. Gold is especially sensitive to fluctuations in the US dollar. As the Dollar goes down gold goes up, and as the Dollar goes up gold goes down.

The biggest gold ETF is the SPDR Gold Trust ETF, ticker symbol GLD. Each share represents 1/10th of an ounce of gold. If you believe that the US Dollar has a lot lower to go, GLD is one way to profit from it. However, keep in mind that when the US Dollar dropped from 2002 to 2008, gold only rose 233% vs. oil's 600% rise.

you believe the US Dollar is set to become the US Peso.

One of the best ETFs for exposure to crude is the Power Shares DB Oil Fund, ticker symbol DBO.

I prefer DBO over the more well known USO because the guys at Power Shares do a better job hedging for contango risks that can sometimes lead to big disparities between oil ETFs' performance and actual spot oil performance.

Aside from being an inflation hedge, owning oil is a great play on the growth in India and China and looks to be a trend with many years left in it.

## Interest Rates

Central bankers' paranoia and fear over inflation is legendary. Inflation is the monster that lurks under every central banker's bed. Out of control inflation can destroy a nation's paper wealth and topple its government. When and if inflation sets in, the only real "big gun" that the Fed has is its control over interest rates.

To fight inflation the Fed jacks up interest rates. What they try to do is restrict the availability of credit in an attempt to slow down economic growth and thereby slow demand for all items. Lower demand equals lower prices -- at least that's the way it's supposed to work. So if you believe that inflation is coming and that the Fed will have to raise rates to combat it, there are several potential ways to profit from it.

As interest rates go up and down, so do the prices of government bonds. Savvy investors use the government bond market all the time to play interest rate moves. With the advent of ETFs, regular investors can now participate in the same way.

Aside from trading interest-rate futures, there are a few Exchange-Traded Funds (ETFs) that allow you to profit from government debt interest-rate fluctuations. One particular ETF for the long bond is the Lehman Brothers 20 Year Treasury Index (Symbol: TLT). If you think rates are going up, you can short the TLT. If interest rates rise, the price of TLT will go down. The opposite is also true: if interest rates drop, the TLT will rise in price.

Just remember, if you short TLT, you are on the hook for the interest-rate payments the same way that you have to cover the dividend payments when you short a stock.

A way to mitigate that risk is to trade put options instead of short-selling. A put option will go up in price as TLT goes down in price. It has the added benefit of having no requirement to cover the interest payments that you would have to pay if you shorted TLT directly. Another advantage with using put options is that you can't lose more than you "put" into the position -- the amount you spend to buy the puts is your maximum dollar amount at risk.

If you don't want to short TLT and you don't want to buy options, there is another way that you can play rising rates. ProFunds has two leveraged ETF products, one that tracks the TLT and another that tracks the 7-10 Year Treasury index. They are the ProShares UltraShort Lehman 7-10 Year Treasury ETF (Symbol: PST) and the ProShares UltraShort Lehman 20 Year Treasury ETF (Symbol: TBT).

These two "UltraShort" ETFs are what are known as "inverse" ETFs, which means that they go up in value as the index they track goes down in price. There is one big difference, though -- that term "Ultra" means that you get leverage of 2-to-1. So, for every 1% the index goes down, the Ultra ETF will go up by 2%.

Remember that leverage works both ways. If the index goes up 1%, the Ultra ETF will go down 2%. If you wanted to leverage your position further, you could use options. Both of these ETFs have both puts and calls available to trade. Because the Ultra ETFs go up when the index goes down, you could substitute call options instead of directly buying the ETFs.

Inverse ETFs are terrific for investors who are unable or unwilling to trade on margin. All short sales require a margin account. This means that inverse ETFs can be bought in a non-margin account such as an IRA.

If you really want to put on your cowboy hat and go "buck wild," there is a product for you. Direxion -- a name you might have heard as a way to play the bank-industry woes, via the Direxion Daily Financial Bear 3x Shares (Symbol: FAZ) -- has set up four separate triple-leverage interest-rate ETFs:

- ? Direxion Daily 10-Year Treasury Bull 3x (Symbol: TYD)
- ? Direxion Daily 30-Year Treasury Bull 3x (Symbol: TMF)
- ? Direxion Daily 10-Year Treasury Bear 3x (Symbol: TYO)
- ? Direxion Daily 30-Year Treasury Bear 3x (Symbol: TMV)

Each of these ETFs will give you triple the return of the daily move of the underlying index that they track. They provide a bullish and bearish ETF for both the 10-year Treasury note and the 30-year Treasury note. Each of these ETFs also trade options.

A word of warning on the Direxion products: They are really geared toward daytraders and are not appropriate for long-term holds. The reason is

that, over time, the relationship of the ETF pricing and the underlying index degrades. If you are going to play the triple-leverage ETFs, make sure that you have a tight stop-loss in place and recognize that these instruments are designed for daytraders, not longer-term investors.

The long and the short of it is that there is always a way to make money no matter what the economy brings. Whether inflation, deflation or stagflation we at *The Tycoon Report* are going to help you find a way to make money!



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