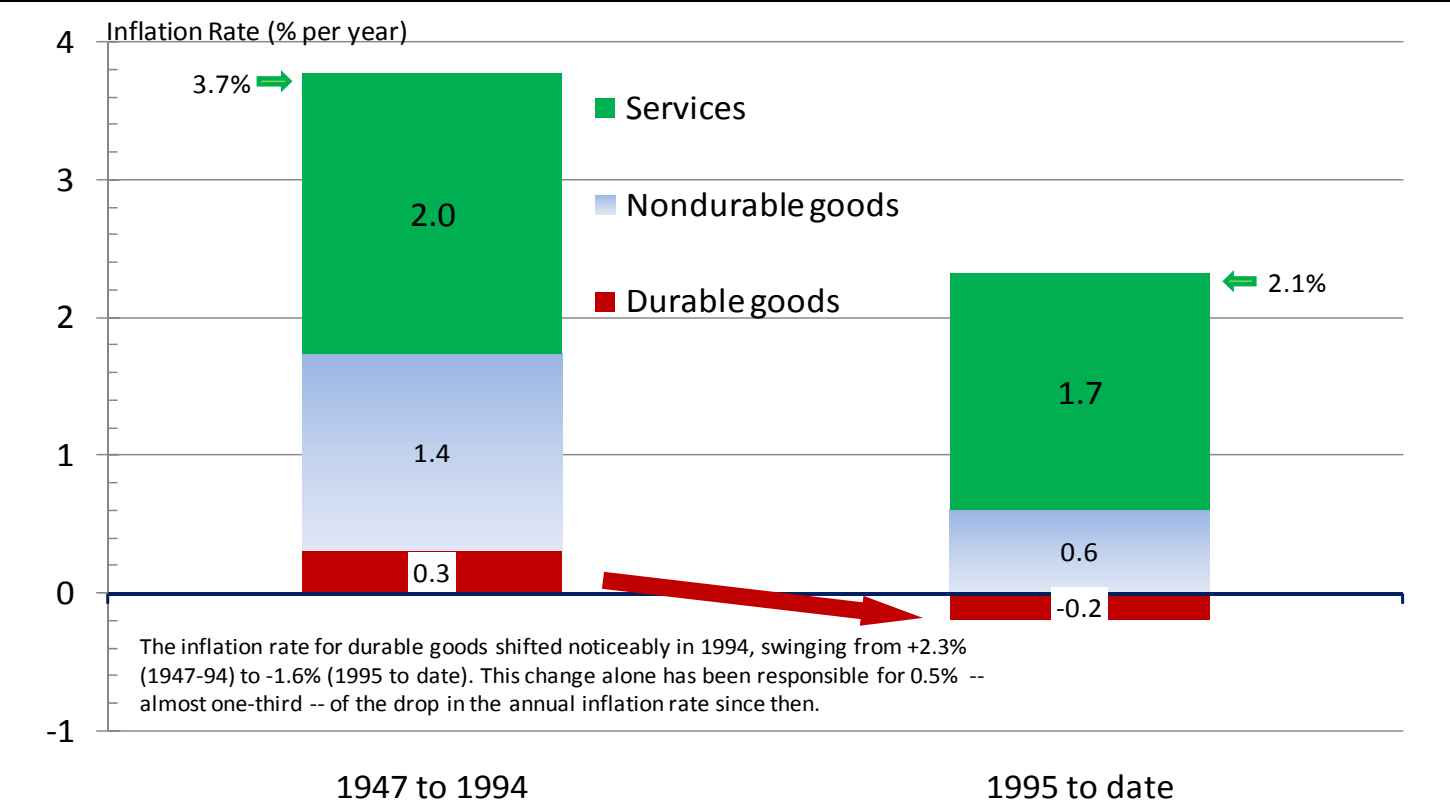


Gauging the Rate of Inflation is Critical to Investment Success

- Most investors seem to spend the bulk of their time focused on the asset side of their balance sheets. Perhaps they conclude that the best way to beat inflation and taxes is to maximize pre-tax returns and “hope for the best.” For some time, we have suggested that a hard look at one’s liabilities would be worthwhile. Given all that has happened in the past 2 years, our suggestion appears even more important now.
- We are not privy to President Obama’s plans eventually to offset some of the cost of the American Recovery and Reinvestment Act when the economy improves, but indications from the campaign were that tax rates on dividend income may rise and perhaps even on capital gains, too. One possible offset would be tax simplification — which we believe the market might celebrate, even if investors would have to pay higher rates. A reduction in the corporate income tax rate — or perhaps a shift to a corporate sales or value-added tax — might also help cushion the impact of higher taxes on investors, as it would likely boost job creation, and thus earnings growth.
- The outlook for inflation is more difficult to assess. The “problems” (the near-term effects of the housing and financial crisis) are exerting downward pressure on prices. But the “solutions” (the monetary, regulatory and fiscal responses to the crisis) are inherently inflationary, in our view. The risk to equity investors is two-sided. If the severe global downturn morphs into a “depression” or a global version of Japan’s “lost decade,” then deflationary pressures may grow stronger, in direct opposition to the Federal Reserve’s goals.
- But if we are correct in anticipating economic recovery to begin in the latter part of 2009 and continue into 2010, then downward price pressures should eventually reverse again to the upside. Given the immense size of fiscal stimulus programs in the U.S. and around the world, and the dramatic increase in the size of the Fed’s balance sheet, a recovery may stoke inflationary fears sooner — and perhaps with more vigor — than in prior cycles.
- In the near future, indications of consumer inflation are expected to remain under control, but the intermediate to longer-term trends are not as well-contained. Gasoline has already bounced off its lows, and the benefits of its drop have already passed through the system. Meanwhile, state and local tax rates are likely to rise meaningfully to offset revenue shortfalls and to help rebuild pension reserves. **We suggest that investors project long-term liabilities at an average inflation assumption of 2.5%, or even higher in some cases.**
- Investors should examine their own spending habits to determine what kind of “personal inflation rate” they might be subject to. More than 20 years ago, the Bureau of Labor Statistics began computing an experimental index called the “CPI-E” for “Consumer Price Index-Elderly” which uses the same prices as the standard CPI, but assumes a different spending pattern than for the population as a whole. Older investors have a greater exposure to health care costs (and other services), which have been rising significantly faster than the overall CPI. Over 25 years, the experimental index (for older consumers) rose about +0.2% faster per year.
- The U.K. government actually provides the public with an inflation calculator that anyone can try ... so even we Americans can use it to estimate our own personal inflation rates. As a starting point, consider that in the U.S., over the past 15 years, consumer inflation has been modest, averaging +2.1% per year. But the index hides an important divergence: inflation in the cost of services (about 60% of total personal expenditures) has risen much faster than the index, averaging +2.9%/yr., while nondurable goods (30% of spending) have risen in line with the index, climbing +2.3%/yr. Durable goods (only 10% of the total) have been exerting deflationary pressure on the index, falling almost -2%/yr. since 1994.

Falling Prices of Durable Goods Have Helped Pull Overall Consumer Inflation Lower Since '94
(Contribution of Major Classes of Consumer Spending to the Overall Inflation Rate)



Note: Inflation rates displayed are based on Personal Consumption Expenditures (not the Consumer Price Index). Source: Bureau of Economic Analysis.

Whether one regards inflation as the rate of increase of the total cost of a basket of goods and services — or as the rate at which one’s home currency is losing its purchasing power — inflation is an important process that investors and their advisors must monitor closely. Inflation is the ultimate benchmark, because the basic goal of every portfolio is to maintain (or perhaps to grow) purchasing power over time. The outlook for inflation (prospective inflation) is a critical variable in portfolio construction, as it helps determine the relative attractiveness of various asset classes under consideration.

A variety of different inflation indexes exist, but our main goal is to measure the effect on consumers’ pocketbooks. Whether one uses the Consumer Price index (the base for Social Security Cost of Living Adjustments) or the Personal Consumption Expenditures price index matters little. What matters most is the divergence in the components of the index.

Like any index, the components of inflation increase at different rates, and some components are more important than others. The chart above shows that inflation in services has become increasingly dominant, while goods inflation remains under control. Unfortunately for retirement savers, one cannot substitute cheap goods for critical services like health care.

Tom McManus

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The Standard & Poor’s indexes are unmanaged, weighted indexes of stocks providing a broad indicator of price movement. Individual investors cannot directly purchase an index.

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