HELM
INVESTMENT MANAGEMENT

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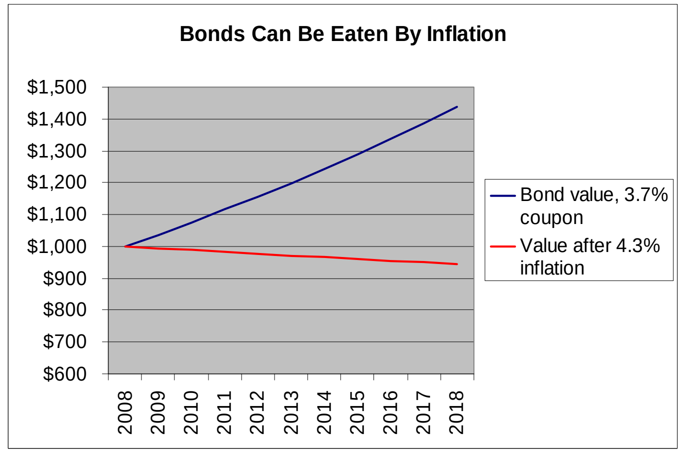

Feel like taking a hike? A mix of rising food and fuel prices and interest rate cuts by the Federal Reserve has the U.S. on the path towards increased inflation.

That's not all bad. The good:

- If your wages or other income rise in pace with inflation, some of your debts such as your mortgage will grow relatively smaller over time.
- This works for countries as well, which is why some governments encourage inflation to cut budget or trade deficits as a percentage of gross domestic product.
- The nominal interest you earn on fixed income usually heads up when investors expect inflation.

But the bad outweighs the good:

- The real return on fixed income (the stated return minus inflation) often heads to zero or worse. Investors in Treasury securities now earn yields of 2% on three-year notes. While they'll get their investment back, they won't be able to buy as much when they do if inflation holds at current levels of 4%. These investors are handing the U.S. government $1 now in return for 94 cents in three years.
- Inflation affects stock price-earnings ratios (P-Es). A key theory for valuing stocks sets a discount rate to price a company based on earnings, dividends, or cash flows. The risk-free rate (typically a Treasury rate) drives the formula. When inflation pushes Treasury rates up, the discount rate rises. That cuts the value of stocks and pushes P-Es down.
- Companies that face sudden shifts in the prices of the materials or labor needed to make their goods find it hard to plan when inflation is high. That means many companies will rein in some projects that might have led to higher growth. Other firms are squeezed between rising raw material prices and clients' resistance to paying higher prices.

In Germany, 1920s hyperinflation lingers in cultural memory. The European Central Bank hasn't budged rates in the face of the credit crunch. The Germans make sure it has one goal: Keep inflation below 2%. In the U.S., the Fed is charged both with watching inflation and ensuring economic growth. The Fed is walking a delicate path, deciding to first cut rates to help with the credit and mortgage crisis and to worry about rising inflation later.

How to react? Keep a global portfolio of stocks – other countries could have better growth and low inflation. Beware the safety of Agency and Treasury holdings: You'll get your money back but it won't buy as much when you do. Consider other fixed income, such as preferred stocks and Master Limited Partnerships.

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