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Abstract: The article discusses how a lack of fear of inflation in the U.S. economy has led to less public visibility for Federal Reserve chairman Alan Greenspan. The Fed may be holding short-term interest rates at a mere 1%--the lowest level in 45 years--and the deficit may be exploding, reaching a projected $477 billion this year. But investors are behaving as though price stability were guaranteed. There's a bias toward inflation that is built into most economies. In the 19th century there were bursts of inflation above 6% a year, but those were offset by periods when prices fell 6% or more a year. The end of World War I ushered in inflation as high as 18%, followed almost immediately by a 10% price decline in 1921. Deflation is politically destabilizing because it takes such a heavy toll on working people, depressing wages and making debt more burdensome. Deflation reached crisis levels during the Great Depression, when prices sank, wages tumbled and unemployment soared. Some inflation investments could rack up big gains as well as protect your purchasing power. The T. Rowe Price New Era fund remains a top choice for inflation stocks, while the Vanguard Inflation-Protected Securities fund holds mostly inflation-indexed government bonds.

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BRACING FOR INFLATION

Rising prices may not be a problem right now, but they could be within the next few years. Here's how to protect your portfolio

Whatever happened to Alan Greenspan? It seems we haven't seen his face for a while. Not so long ago, the Federal Reserve chairman was constantly visible in the media, warning about irrational exuberance, deflation or some other seemingly dire threat. But now, nothing. It's as though the Fed has simply vanished.

Greenspan has disappeared off the radar screen for one reason: Scarcely anyone is afraid of inflation nowadays. The Fed may be holding short-term interest rates at a mere 1%--the lowest level in 45 years--and the deficit may be exploding, reaching a projected $477 billion this year. But investors are behaving as though price stability were guaranteed.

It isn't. Inflation may not be a problem for the next few years. But sooner or later, it will be back. In fact, there's a bias toward inflation that is built into most economies. Just consider the history of the denarius, the silver Roman coin stamped with the emperor's image that Jesus used for his "Render to Caesar" speech. Early in the first century, that coin was worth about $35, or a day's wages. By the 14th century, however, the coin had evolved into the French denier, still silver but worth only about $4, or what a successful Varlet of Hounds earned in just an hour. The coin survived into the 20th century as the penny in Great Britain, by that time made of copper, until the pound went decimal in 1971. If the descendant of the denarius still existed today, it would be worth less than one U.S. cent.

Over 2,000 years, such depreciation represents a compound inflation rate of less than 0.5% a year. That may not be high, but it does show that periods of inflation outweigh periods of deflation. And the bias toward inflation has become much greater in the U.S. since the 1930s.

ON THE GOLD STANDARD

In the 19th century there were bursts of inflation above 6% a year, but those were offset by periods when prices fell 6% or more a year. Prices declined slightly, on balance, because the U.S. was on a restrictive gold standard, and the amount of gold in circulation simply wasn't large enough to meet the needs of a booming economy.

The end of World War I ushered in inflation as high as 18%, followed almost immediately by a 10% price decline in 1921. You might think that alternating inflation and deflation would just cancel each other out. And they do, as far as price levels are concerned. But there's a problem. Deflation is politically destabilizing because it takes such a heavy toll on working people, depressing wages and making debt more burdensome.

Deflation reached crisis levels during the Great Depression, when prices sank, wages tumbled and unemployment soared. Franklin Roosevelt decided something had to be done to stop it, even if other economic distortions were the result. The New Deal built a much stronger inflationary bias into the economy. After 1933 there would never again be price declines large and persistent enough to cause serious economic disruption. But this relief came at a price: The inflation rate would periodically surge above 10%.

As you can see, we've had two major waves of inflation since 1933. Right now we're at a low point. But another bout is most likely on the way. The current political and economic environment bears a remarkable resemblance to the period right before the explosion of inflation in the late 1960s and '70s. Lyndon Johnson was fighting an expensive war at the same time that he was expanding social programs for the Great Society. And he refused to raise taxes to cover those costs.

Some farsighted investors saw the writing on the wall. In 1969, T. Rowe Price created the New Era mutual fund, which was designed to hedge against inflation. The phenomenal success of this fund when prices took off in the 1970s helped make T. Rowe Price the leading fund company it is today.

Do investors need similar inflation protection now? I'd say yes, because a price spiral could begin within three or four years. Just compare today's headlines with those of the 1960s. The war on terror will continue for some time. And Bush's compassionate conservatism philosophy seems to require potentially large--if selective--increases in social spending. Finally, the Bush administration is determined not to raise taxes.

10 TOP PICKS

Some inflation investments could rack up big gains as well as protect your purchasing power. But even so, you probably won't need to devote more than 15% of your portfolio to inflation hedges. The easiest way to go is through mutual funds. The T. Rowe Price New Era fund remains a top choice for inflation stocks, while the Vanguard Inflation-Protected Securities fund holds mostly inflation-indexed government bonds.

Gold, up from $320 an ounce last April to $410 recently, remains the most popular specific refuge for investors worried about inflation. Attractive gold index funds include Fidelity Select Gold and American Century Global Gold.

If you prefer to buy individual gold stocks, consider Newmont Mining and Barrick Gold.

Other mining and natural resources stocks can serve as inflation hedges too. Among them I like Alcoa, which meets the growth and financial strength tests for my list of 70 top growth stocks (for the latest statistics on the Sivy 70, go to money.com/commentary/sivy). Alcoa's earnings are projected to increase at a 12% compound annual rate. The stock offers a 1.7% yield and trades at 19 times earnings for 2004.

Land is a great natural inflation hedge, of course. I've recently been recommending St. Joe, a real estate company that owns enormous tracts of land, mostly near the Gulf Coast of the Florida panhandle.

Finally, energy is likely to be a strong sector over the long term as developing countries rapidly increase their consumption of fossil fuel, thereby driving up the global oil price. Anadarko Petroleum is a producer with three-quarters of its reserves in North America. The stock trades at only 11 times earnings for the coming year. ConocoPhillips, a much larger and less volatile integrated oil company, trades at a 12.5 P/E and offers a yield above 2.5%.

Inflation-busters

Putting up to 15% of your portfolio into mutual funds and stocks like the ones listed here can protect you against an unexpected upsurge in inflation.

FUND	% RETURN ONE YEAR	THREE YEARS	FIVE YEARS	EXPENSE RATIO	800 NUMBER
T. Rowe Price New Era	44.3	7.7	13.1	0.72%	638-5660
Vanguard Inflation-Protected Sec.	8.2	10.5	N.A.	0.22	851-4999

Fidelity Select Gold	20.7	38.5	18.7	1.18	343-3548
Amer. Century Global Gold	29.8	47.7	19.0	0.69	345-2021

STOCK (TICKER)	PRICE	52-WEEK RANGE	P/E RATIO	GROWTH RATE	YIELD
Newmont Mining (NEM)	$42.51	$24-$50	27.2	15%	0.5%
Barrick Gold (ABX)	20.44	$14-$24	45.4	10	1.1
Alcoa (AA)	35.26	$18-$39	19.2	12	1.7
St. Joe (JOE)	40.00	$26-$40	44.0	15	1.2
Anadarko Petroleum(APC)	50.76	$40-$53	11.0	10	1.1
ConocoPhillips (COP)	67.71	$45-$68	12.5	5	2.5

Notes: As of Jan. 27. All funds are no-load. Three- and five-year returns are annualized. P/Es are based on estimated 2004 earnings. Growth rate is projected compound annual rate over next five years. N.A.: Not applicable.

Sources: Lipper, Thomson/Baseline.

GRAPH: Rising prices: The New Deal nearly eliminated deflation. Since 1934, consumer prices have been rising steadily, with inflation sometimes topping 10%.

PHOTO (COLOR)

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