

Most consumers didn't need the government to tell them inflation was up in May—all they needed was to buy a tank of gas or food for a week. With the Bureau of Labor Statistics reporting that in May the consumer price index (CPI) took its biggest jump in six months (up 0.6 percent, seasonally adjusted), and with gasoline prices up 5.7 percent, some people are beginning to think seriously about what it means to live with inflation.

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For those who were around in the 1970s, contemplating inflation is a trip down memory lane. But the U.S. last experienced double-digit inflation in 1981—far enough in the past that many people have forgotten what it was like and others are left to imagine. And with lifestyle and business changes that have grown up around low monthly CPI increases, the subject is worth exploring with modern times in mind. Here are a few things to think about.



The CPI is up 4 percent as of June 2008 and will likely rise further

Make sure it's in the budget

For most of the last 15 years, with inflation down in the 1 percent to 3 percent range, it wasn't hard to absorb increases in consumer prices, especially when wage increases outpaced price increases. But so far in 2008, the CPI is up 4 percent (annualized), and the full effect of the oil price surge hasn't worked its way into the economy yet. It will likely be higher by the end of the year.

Most financial planners recommend baseline inflation factors for household budgets as a starting point for next year, and planners are beginning to advise clients to factor in a higher escalator. While economists are not predicting a return to the hyperinflationary economy of the 1970s and early 1980s, those who haven't included inflation in the budget could feel the pinch if they don't get in the habit of doing so.

Because most people don't live in the "average American household," some will need to make further inflation adjustments. People who shouldn't rely on a baseline adjustment include those who do a lot of driving and those with lots of mouths to feed. (This includes canine and feline mouths—one analyst predicts that pet food prices will be up in the high single digits by the end of the year.)

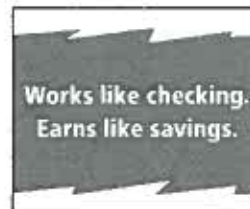
Consider this: Fuel and food went up more than other components of the CPI. Yet, some economists and analysts allow their inflation fears to be assuaged by the fact that "core" inflation, which doesn't include energy and food, was up a mere 0.2 percent in May.

Inflate savings, too

It's not only in the budget—retirement and financial planners routinely use inflation factors when figuring clients' future cash needs. It's time to update those plans.

The time-value-of-money principle plays in here—whatever the intended purchase, it will likely cost more in the future. Those who are saving for big expenditures, including retirement, need to save even more than they were planning.

Homeowners planning big expenditures in the next year or two might consider locking in home equity lines by converting them to loans before the rates go up. Parking the proceeds in CDs, money funds or high-interest savings accounts will defray the loan interest costs, though investors should take into consideration that any investments must have interest rates higher than the rate of inflation if they want to do more than simply break even.



Lisa Kirchenbauer, a certified financial planner and registered life planner in Arlington, Va., is addressing inflation in regular trimester meetings with clients by increasing the inflation rate in planning scenarios to at least 4 percent. Previously, Kirchenbauer was recommending 3 percent to 3.5 percent inflation rates.

"The minute you change the inflation rate, even by half a percentage point, it can take a plan from 'looking good' to 'failing.' And for a client who's more conservative, we're going to make it even higher," she said.

Investment considerations

In the face of higher inflation, Kirchenbauer also recommends that investors be more cautious in general. "The market isn't real excited about the effects of inflation, so we are taking a more moderate approach right now," she said.

One effect of this caution is to use a more moderate asset allocation, or even letting a portfolio drift past the lower end of the equity range. For example, Kirchenbauer said, an investor might decide to leave a portfolio with 62 percent equities rather than rebalancing to bring it into the 65 percent to 70 percent range set in the plan.

In addition to Kirchenbauer's suggestions, investors may also want to consider alternative investments and self-directed IRAs.

She said she is now recommending that retirement plans include inflation-oriented investments, such as Treasury Inflation-Protected Securities or funds that invest in them. In addition, she said, commodities provide a hedge to protect investors on the downside and should be part of any well-diversified portfolio.

While advocating caution and moderation, Kirchenbauer said investors should not shy away from buying in the face of inflation. "If we know we need to make a change, this is the time to do it," she said. Generally, purchases cost less now than they will, so "why not be investing now?"

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