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RETURNS AT RISK FROM US INFLATION

With significant excess productive capacity in the US economy, inflation should be the last thing investors need to worry about.

However QIC research has revealed that an inflation spike could be on the horizon, with QIC advising superannuation funds to guard against a potential inflationary surge.

QIC Chief Economist Matthew Peter said the inflationary risk lay in the timing and implementation of the Federal Reserve's exit strategy which may lead to excess growth in the money supply and higher rates of inflation.

"The US Federal Reserve has pumped an enormous amount of cash into the US economy over the past 12 months to fight the global financial crisis," Matthew Peter said.

"Normally these funds would flow into the money supply, but they have been hoarded by US banks with limited credit being extended to households, businesses and investors.

"As confidence returns and banks expand credit, the money supply will increase with the inflationary impact depending on how the Federal Reserve responds once market conditions normalise.

"While investors believe the Fed will successfully exit from its extraordinary policy stance, the margin for error is extremely small.

"If they don't adequately drain excess reserves from the system when the economy recovers, there will be significant inflationary pressures and the potential for another asset price bubble.

"In a worst case scenario where the Fed allowed the money supply to increase by 40-80%, prices could rise between 8% and 14%.

"Even if the expansion of the money supply was limited to between 10% and 20%, we could expect a period where inflation averages between 3% and 5%, which is significantly higher than current market pricing of around 2%.

"Sharp and unanticipated rises in inflation have the potential to significantly erode investment returns.

"For example, the global inflation shock of the 1970's severely impacted economic growth and returns on assets.

"Prudent superannuation funds should be reviewing how they can protect their positions through instruments like inflation-linked bonds - an area QIC has vast experience after helping to establish the Australian inflation-linked swap market."

QIC has access to major global counterparties in the global inflation market through its Global Fixed Interest team.

Comprehensive research findings are contained in the QIC Red Paper *The Risk of Rising Inflation - Is Your Fund Prepared?* on the QIC website at www.qic.com.

QIC is one of Australia's largest institutional fund managers with \$65 billion¹ (US\$60 billion) under management. This includes more than US\$34 billion in global fixed interest for more than 60 clients.

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