PRATO CAPITAL

Inflation Concerns

April 2021

Reports in the media have highlighted concerns of inflation recently. What impact does inflation have on consumers and investors and what is driving these concerns now? A closer look at our current economic situation in the US may provide some guidance.

The Impact of Inflation

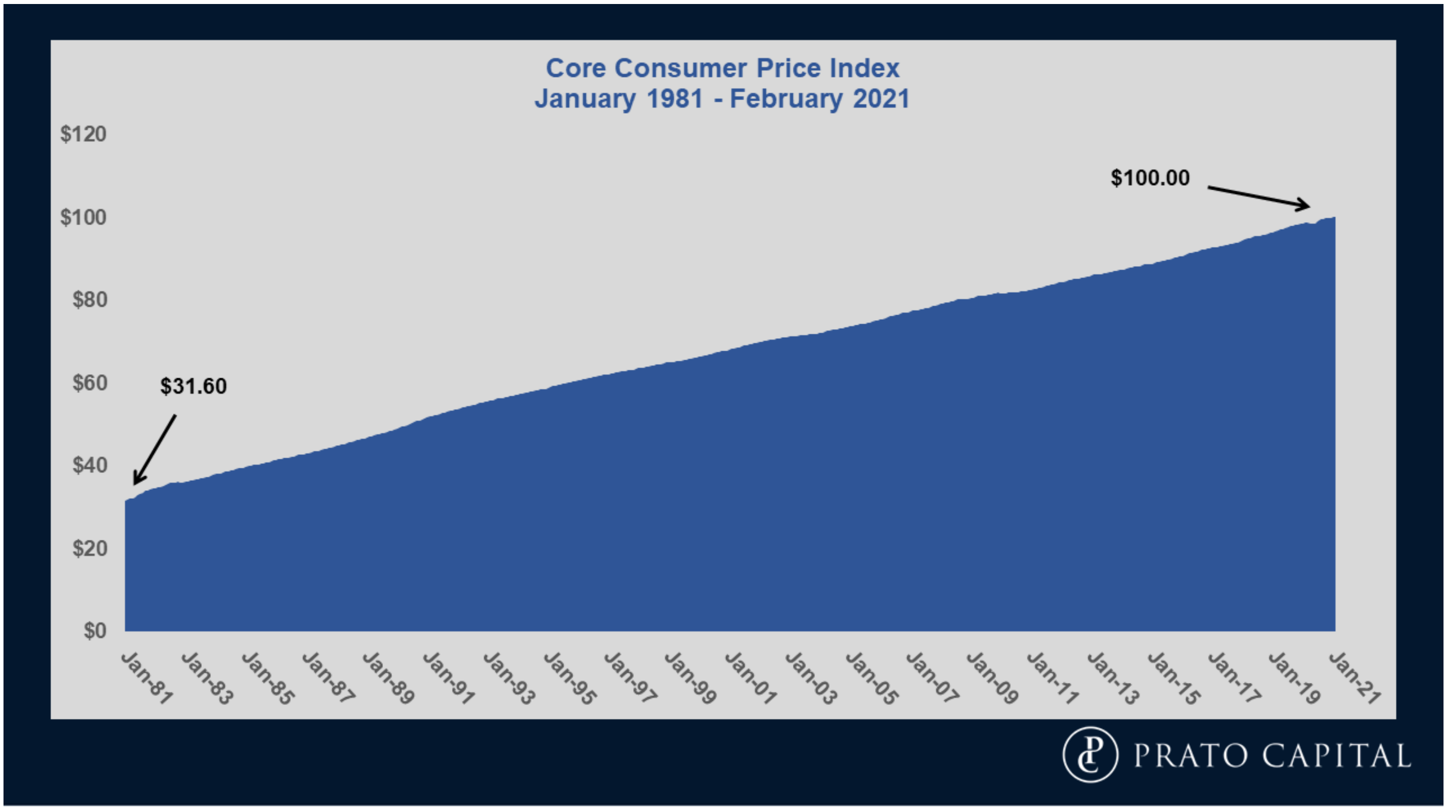
Inflation is the rate of change of prices for goods and services. Inflation can be thought of in 2 ways. First, it is the rising cost to purchase everyday items. Second, it is the reduced purchasing power of a fixed amount of money.

Many news reports include the rate of inflation associated with the Consumer Price Index (CPI). This is published monthly by the US Bureau of Labor Statistics and is defined as “the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.”[1] Most economists look to the Core CPI for a more accurate view of the real inflation rate in the US. The Core CPI excludes the price change of food and energy due to the possible short-term volatility associated with those two groups. Also, their price fluctuations cannot be changed with monetary policy. The unusually cold temperatures added to the ice and snowstorms across much of the US this February are examples of something that can have dramatic short-term effects on both food and energy prices.

Over the past 40 years, the Core CPI has increased a total of 216%, which is an average rate of 2.9% per year. Inflation is not just a simple average. Its effects compound over time and this is what makes the inflation rate so concerning. **Chart 1** below illustrates the cost of inflation since 1981. The same goods that cost less than $32 forty years ago now cost $100. This is not surprising for those of us approaching retirement age. Our paycheck does not last as long as it used to, and everything just seems to cost more than we remember.

[1] US Bureau of Labor Statistics. https://www.bls.gov/cpi/

<u>Chart 1:</u> Core Consumer Price Index, 1981 - 2021[2]



Inflation and Monetary Policy

As the US economy recovers from the impact of the pandemic and stimulus money is used to buy goods and services, there are concerns about an economy growing too fast and leading to possible increased inflation rates. There are many differing opinions from very high profile economists about future inflation, but most of the viewpoints focus on the two issues – changes in Federal Reserve policy and too much money in the economy.

The Federal Reserve has always had two goals to achieve through their monetary policy – maximum employment and price stability. Since the 1970s, the Federal Reserve has prioritized the policy of price stability to keep inflation low by raising the interest rates. In 2012, then Federal Reserve Chair Ben Bernanke set a 2% target inflation rate. This brought the US in line with most other central banks. As the CPI rate rose, the Federal Funds Rate would rise also with the intent to keep prices more stable. In August 2020, the Federal Reserve announced a subtle but important change to policy. Rather than maintaining a target level of 2% inflation, the new policy is an ‘average’ 2% inflation rate. This change means there is the potential for short-term inflation rates above 2%. With the US still at a 6.2% unemployment level with over 10 million unemployed, this change is a more accommodating approach for maximum employment.

[2] Data from U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average [CPILFESL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPILFESL, March 27, 2021.

The latest stimulus/recovery legislation may cause inflationary pressures according to some economists. Most notable is Larry Summers, former Treasury Secretary and White House Economic Advisor, who wrote an article in the Washington Post[3] describing his concerns about increasing money supply into an economy that is now expanding again. There are many economists that do not agree with this. It is important to note that Jerome Powell, Chairman of the Federal Reserve, sees only temporary increases in the inflation rates. St. Louis Fed President James Bullard recently noted he expected inflation to move up to 2.5%[4]

All economists quoted in the news today are expressing opinions about the future, and this includes the officials of the Federal Reserve. The future is notoriously difficult to predict for anyone, even for (especially for) those in economics and finance. Knowing how difficult the future is to predict, this does not stop many from getting in front of the microphone and the camera to offer their opinions.

What is the Investor to do?

It is probably not a surprise that if the cost of living increases by 1% or 2% more than expected, it will have a dramatic impact on those with a fixed income, which includes most in their retirement. Since the life expectancy has increased steadily over the years, it is common to be retired now for 30 or 40 years and see prices double once or twice during retirement. We will discuss two steps that everyone saving for retirement should take.

A valid and personalized financial plan can provide much information about future finances. At Prato Capital, the financial plans, or Financial Life Plans (FLP) as we call them, will include rates of inflation over the whole FLP for the individual to provide a remarkably accurate view of the future. The inflation rate can be changed as necessary if the rates are expected to increase or decrease. This can eliminate surprises in the future from rising inflation and allow for better preparation for financial goals like a comfortable retirement. And, small steps taken over a long period of time (additional savings or portfolio changes) can have a greater impact than trying to make up for unexpected shortfalls in the future.

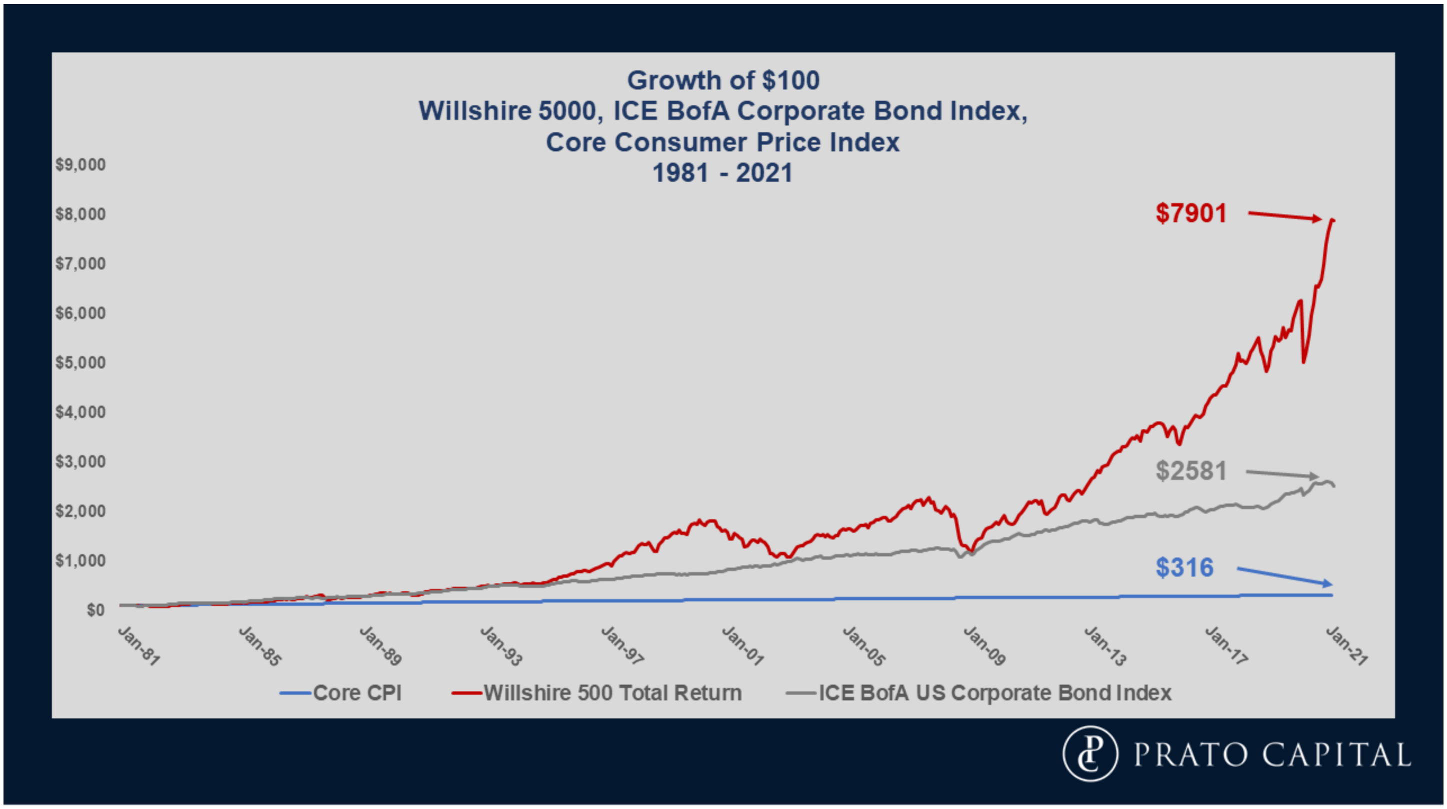
Savings and/or wages should increase at a rate greater than the CPI. **Chart 2** below shows how $100 grew since 1981. A basket of goods that cost $100 in 1981 would now cost $316. If $100 was invested in the ICE BofA Corporate Bond Index, it would have grown to $2581 and the same $100 in the Willshire 5000 to $7901.

Chart 2: Forty Years of Growth in Stocks and Bonds vs Core Inflation[5]

[3] "Opinion: The Biden stimulus is admirably ambitious. But it brings some big risks, too." Lawrence H. Summers. Washington Post, February 4, 2021. https://www.washingtonpost.com/opinions/2021/02/04/larry-summers-biden-covid-stimulus/

[4] "Bullard Discusses Economic Outlook, Federal Debt, Currency Competition in NABE Panel." March 23, 2021. https://www.stlouisfed.org/from-the-president/speeches-and-presentations/2021/bullard-economic-outlook-federal-debt-currency-competition-nabe.

[5] U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy in U.S. City Average [CPILFESL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPILFESL, March 27, 2021.
Wilshire Associates, Wilshire 5000 Total Market Full Cap Index [WILL5000INDFC], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WILL5000INDFC, March 27, 2021.
Ice Data Indices, LLC, ICE BofA US Corporate Index Total Return Index Value [BAMLCC0A0CMTRIV], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLCC0A0CMTRIV, March 27, 2021.



When we use history as a guide, we have seen stocks outperform bonds and both have returns greater than the rate of inflation over the long-term. The investor needs to stay invested with a balanced and diversified portfolio based on their financial goals and risk tolerance through the many market ups and downs. Staying invested is key and investing in that balanced and diversified portfolio does more than just build wealth, it keeps the investor ahead of the cost of inflation now and over the long-term.

Conclusion

There is nothing the average American can do to change the inflation rate. But, when we use history as a guide, we can see there are ways for everyone to lessen the impact of inflation. Planning and preparation with a Financial Life Plan can provide many insights for what the financial future may hold, including growth of a nest egg and the impact inflation may have on spending throughout retirement.

Over the years, inflation rates have gone both up and down. Having a Financial Life Plan is the best step to see how your financial goals will be impacted by inflation.

“If you don’t know where you are going, you’ll end up someplace else.” – Yogi Berra