



PRATO CAPITAL

Thoughts about Inflation

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After being called “transitory” in 2021, inflation has proved to be more persistent in 2022. The impact of inflation and the rising interest rates used to control it can be significant.

Gregory Prato, the CEO and Chief Investment Officer of Prato Capital, recently had a great discussion about inflation with Apollo Lupescu, Vice President at Dimensional Fund Advisors. A recording can be found on YouTube, www.youtube.com/pratocapital, and on our website, <https://pratocapital.com/videos/>.

Inflation and the Federal Reserve

A recent Gallup poll highlights that most Americans feel their personal financial situation is getting worse and inflation was named the biggest concern¹. We have all seen the impact of inflation at the grocery store or when filling our tanks at the gas station. If we are still working, we have seen wages fall behind rising prices leaving less for discretionary spending or saving for future college costs, housing changes and upgrades, and retirement. For those already in retirement or on a fixed income, rising costs are especially worrisome.

The inflation rate has been relatively low since the early 1980s with most years seeing rates between 2% and 3%. According to the US Bureau of Labor Statistics, the Consumer Price Index rose 7.0% in 2021 which was the “the largest December to December percent change since 1981.”² According to the Federal Reserve Bank of Cleveland, a rate of 2% per year is “the right amount of inflation.”³

One of the ways the Federal Reserve controls inflation is with interest rates. When inflation becomes higher than the ‘right amount’, interest rates will rise in an effort to slow the economy. In March, the Federal Reserve started raising interest rates and many of the Fed Board of Governors have been quoted as seeing the need to continue raising rates for the foreseeable future. The financial media has focused on rising interest rates slowing the economy too much and the possibility of a recession in the United States over the next couple of years. Our [March blog](#) discussed this possibility and what we are recommending to investors and to our clients.

What can we do about inflation

Although the rates of inflation have increased since we have started publishing articles about the subject ([April 2021 newsletter](#)), our advice to investors and clients has not changed. Having a valid Financial Life Plan (FLP) that includes a disciplined investment strategy and regular updates will provide important insight about a client’s financial situation now and in the future.

The FLP at Prato Capital includes rates of inflation over the entire life of the plan and can provide a remarkably accurate view of the future. As inflation rates change, they can be changed in the FLP. This can eliminate surprises if inflation rates increase in the future and allow for the better preparation of 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.

A disciplined investment strategy is critical to the success of any FLP, and this includes during periods of inflation like we have seen recently. A balanced portfolio of stocks and bonds is one of the best ways to outpace inflation and it can make a FLP more reliable.

One of our investment partners, Dimensional Fund Advisors, released a very nice graphic illustrating how stock returns have outpaced inflation over the past 30 years, <https://www.dimensional.com/us-en/insights/will-inflation-hurt-stock-returns-not-necessarily>. Over that time period, S&P 500 returns were higher than inflation 23 times and the index averaged over an 8% return, all after adjusting for inflation.

Chart 1 below is updated from our April 2021 newsletter, and it shows how \$100 grew since 1981 (the difference from last year's chart is shown in the parentheses). Showing inflation is the CPI line where a basket of goods that cost \$100 in 1981 would now cost \$325 (+\$9). If \$100 was invested in the ICE BofA Corporate Bond Index, it would have grown to \$2472 (-\$109) and the same \$100 invested in the Willshire 5000 grew to \$8893 (+\$992). Again, staying invested with a portfolio of stocks and bonds has shown to greatly outpace inflation.

Chart 1: Inflation compared to stocks and bonds, 1981 – 2022⁴.



Conclusion

There is nothing Americans can do to change inflation rates. But planning and preparation through a FLP can lessen some of the long-term impacts from inflation. Maintaining a disciplined investment strategy that supports the long-term goals of the FLP is critical. This is how true wealth is built, especially in times of economic uncertainty like we see today.

We recommend everyone have a Financial Life Plan. It is one of the most important steps towards viewing and maintaining a positive view towards your financial situation.

Do you have a plan? If not, we can help.

"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair." – Sam Ewing, former baseball player.

¹ Jeffrey M. Jones, Gallup, Inc, <https://news.gallup.com/poll/392162/personal-finance-ratings-slide-amid-rising-prices.aspx>, April 28, 2022.

² US Bureau of Labor Statistics, <https://www.bls.gov/opub/ted/2022/consumer-price-index-2021-in-review.htm>, January 14, 2022.

³ Federal Reserve Bank of Cleveland, <https://www.clevelandfed.org/en/our-research/center-for-inflation-research/inflation-101/why-does-the-fed-care-get-started.aspx>, April 27, 2022.

⁴ 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>, April 28, 2022.

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>, April 28, 2022.

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>, April 28, 2022.