UNDERSTANDING INFLATION

And What It Means To You

Wealth Enhancement Group®

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WHAT IS INFLATION?

HOW CAN I MINIMIZE THE IMPACT OF INFLATION ON MY FINANCES?

WHAT IS INFLATION?

It’s no secret that the prices of goods and services have been rising over the years. We all remember those golden days back in 1980 when the average cost of a movie ticket was less than $3. But in 2019, the average price of a movie ticket more than tripled to just over $9.

And who could forget 1998, when the average price of gasoline in the U.S. was just barely over a dollar per gallon? Meanwhile, as of June 2022, the average price of a gallon of gas in the U.S. now costs around $5.

There are many factors affecting the price of gas in 2022. But something that affects the price of everything—from movie tickets to automobiles—is inflation.

Inflation is the ongoing increase in prices for all goods and services produced and consumed in the economy. Said another way, inflation is the decline of the dollar’s purchasing power. And although inflation isn’t a guarantee, it’s very likely to occur. There’s been at least some inflation in 94 of the 107 years between 1914 and 2021, so it’s something you should expect—and plan for.

Many of us are having to adjust our financial and personal lives as a result of inflation. We experience inflation in our daily lives as consumers, but its impact goes far beyond. Inflation also impacts your investments and your long-term financial plan.

WHAT CAUSES INFLATION?

There are a variety of causes for inflation. Big-picture, inflation is an increase in the money supply (i.e., U.S. Treasury prints more money and puts it into circulation). Its classic definition is “more money chasing fewer goods.” The impact of these dollars flooding the economy is to bid-up the price of goods.

However, there are some other different kinds of inflation based on what’s causing it, including:

DEMAND-PULL INFLATION	Not enough products or services being produced to keep up with demand
COST-PUSH INFLATION	Rising costs to produce products and services, forcing businesses to raise their prices
BUILT-IN INFLATION OR WAGE-PRICE SPIRAL	Workers demanding higher wages to keep up with rising living costs, as well as to fill millions of open jobs

HOW IS INFLATION MEASURED?

In the U.S., the monthly and annual inflation rate is tracked and reported by the U.S. Bureau of Labor Statistics (BLS) in the Consumer Price Index (CPI). The BLS calculates CPI using a basket of goods and services that’s adjusted for many factors, including geography and weather events.

Overall, CPI is a statistical estimate that, while useful as a measure of changing prices, does not completely reflect the lived experience of individual Americans. Additionally, CPI only reflects the broad spending patterns of American consumers—not the specific things you buy.

What Is the Difference Between "Headline" and "Core" Inflation?

It's helpful to understand what's included in the basket of goods and services driving inflation numbers. Notably, CPI includes two of the economy's most volatile sectors: energy and food costs.

However, most economists like to remove energy and food cost from CPI to get a clearer sense of where underlying inflation is headed. This less volatile measure is usually referred to as "core" inflation, while "headline" inflation includes energy and food.

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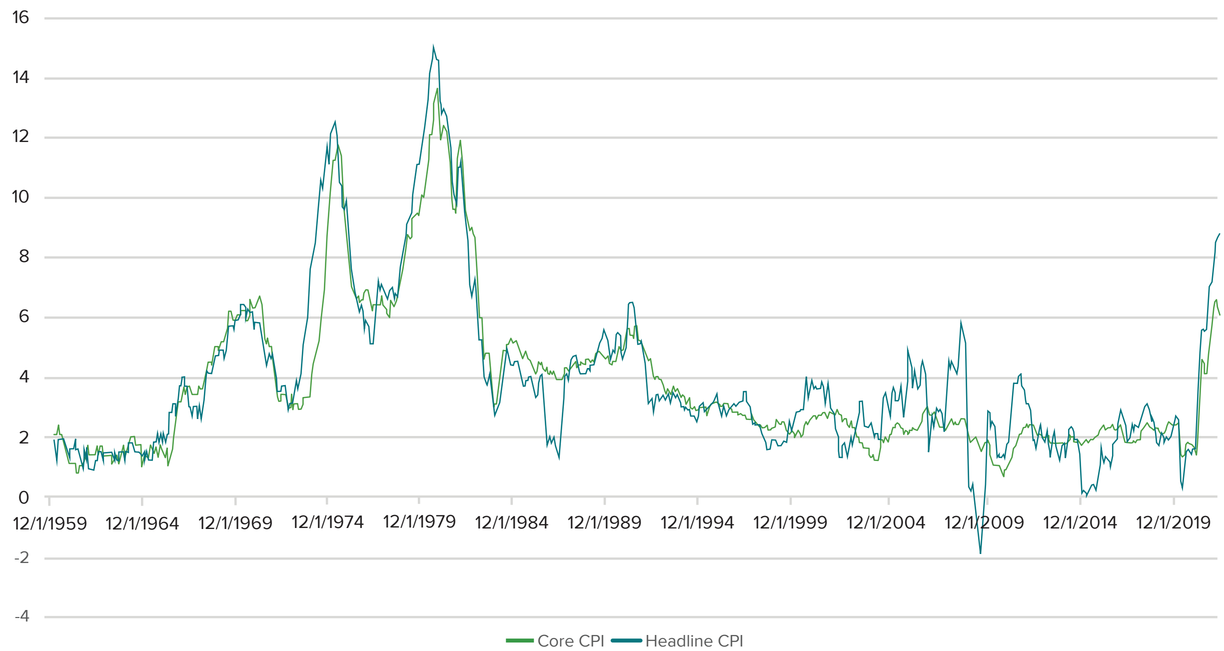
Figure 1. Headline vs. Core Inflation Since 1960



Source: Wealth Enhancement Advisory Services

WHAT INFLATION MEANS FOR YOU

Some inflation is normal—the Federal Reserve typically allows for around 2 or 3%—and can even be good in a growing economy. Modest levels of inflation can also be beneficial to people holding real assets such as real estate, gold, or commodities, as these assets tend to increase in value during inflationary periods.

However, inflation can also be potentially bad for some investors, such as those holding cash or bonds. What's more, too much or even too little inflation can spell economic trouble. And under certain conditions, its ripple effects can lead the economy into a recession.

Even when it's low, inflation can erode your savings. In the 20 years between 2001 and 2021, inflation averaged just 2.18% per year. That sounds low, but with the power of compounding, it can put a big dent in your purchasing power, as shown in Figure 2 below.

Figure 2. How Inflation Affects Your Purchasing Power

2.18%	**2001 TO 2021 AVERAGE INFLATION RATE (CPI)**
53.1%	**COMPOUNDED 20-YEAR INFLATION**
$15,309.04	**PRICE OF $10,000 IN GOODS AFTER 20 YEARS**

Source: http://www.usinflationcalculator.com/inflation/historical-inflation-rates/

To put the brakes on inflation, the Federal Reserve may increase the interest rate that banks are allowed to charge each other. These rate increases are intended to take money out of circulation and bring inflation closer in line with the Fed's policy target of 2% (it sets this target to pursue its statutory mandate of maximum employment, price stability, and moderate long-term interest rates). The trick is doing that without triggering a "hard landing" or recession.

DIFFERENT INFLATIONARY ENVIRONMENTS

Additionally, there are other inflationary environments that can occur within the economic cycle: hyperinflation, deflation, and stagflation.

Hyperinflation

Hyperinflation is used to describe a period of rapidly increasing inflation—typically at a rate of more than 50% each month for a given period of time. While extremely rare for developed countries, it can occur during wartime or periods of economic turmoil in less developed nations. In fact, the U.S. has never experienced a period of hyperinflation—though we came close twice: during the Revolutionary War and Civil War.

Deflation

As you may be able to guess from its name, deflation is basically the opposite of inflation—it's the general increase in the dollar's purchasing power, even if the prices of goods and services remain relatively unchanged. While on the surface this might seem like a good deal, it typically comes from central banks like the Federal Reserve decreasing the money supply, which can have catastrophic ripple effects on the economy. Usually, deflation occurs after long periods of artificial monetary expansion. The last time the U.S. experienced any sort of significant deflation was during the Great Depression.

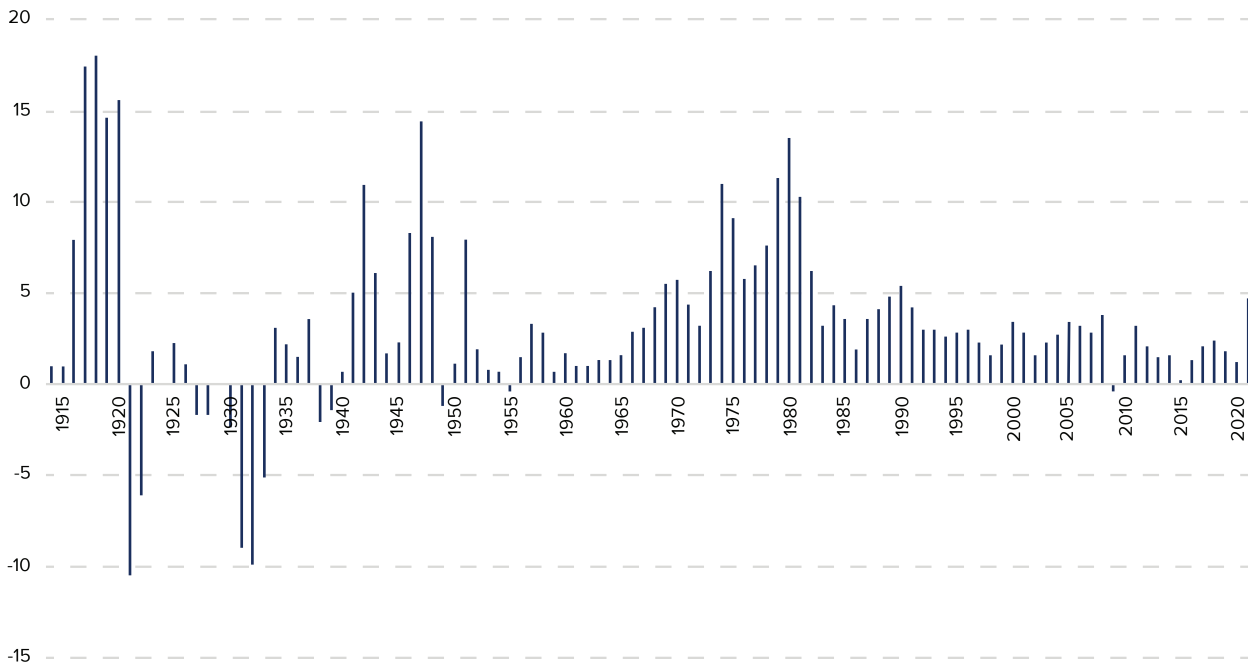
Stagflation

First recognized in the 1970s, stagflation is a relatively new phase in the economic cycle. This occurs when inflation increases but economic growth slows or stagnates. Essentially, stagflation occurs when an economy isn't functioning properly. It's what happens when inflation continues to soar, despite production decreasing and unemployment increasing. Most recently, the U.S. and many other developed countries experienced periods of stagflation as a result of the COVID-19 pandemic and the Russian invasion of Ukraine in early 2022—both of which caused supply chain disruptions, massive layoffs, and an overall decrease in production.

100 YEARS OF INFLATION

> *It can be helpful to understand inflation in context, over a far longer period than just a year or a decade. To get a better sense of the impact of inflation, let's look at it over the last 100 years.*

Figure 3. Percent Change in Annual Inflation from 1914 – 2021



Source: U.S. Bureau of Labor Statistics & New York Life Investments

1920s	1944	1971	1979	2021
Prices spiked dramatically during and immediately after WWI, but the Roaring '20s saw periods of deflation	The Bretton Woods system was established during WWII, which tied the U.S. Dollar to gold	With inflation rising, President Nixon abandoned the Bretton Woods system	Fed Chair Paul Volcker introduced drastic anti-inflationary action to combat inflation rising past 13% annually	After emerging from the COVID-19 pandemic, increased demand pushed prices higher

MINIMIZING INFLATION?

When economic shocks occur, it can be tempting for investors to do *something*—to adjust their asset allocation in a big way to lessen the potential negative impacts from those external events. Or worse, they decide to move a significant portion of their portfolios into cash.

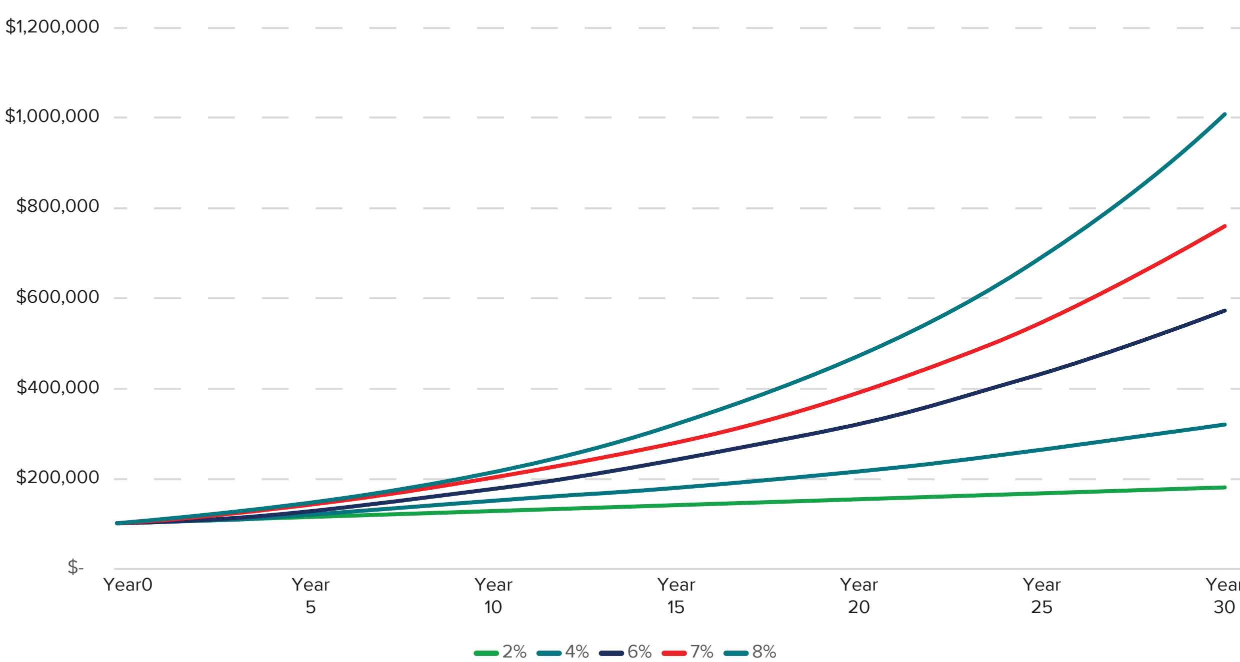
This is rarely the best course of action, in our view, as it constitutes a form of market timing, which is an extremely difficult strategy to execute. In nearly all situations when markets are stressed, we counsel clients who have a well-considered, well-diversified financial plan and investment portfolio already in place to stay the course.

One reason why we suggest staying invested is because stocks can be a powerful tool for taking on inflation.

HOW STOCKS CAN HELP

Figure 4 below illustrates the historic power of stocks to outpace inflation. Assuming you invested and held $100,000 in stocks over 30 years at an average return of 7% after inflation (with dividends reinvested), you'd have over $750,000, as shown by the red line on the chart.

Figure 4. Growth of $100,000 Over 30 Years

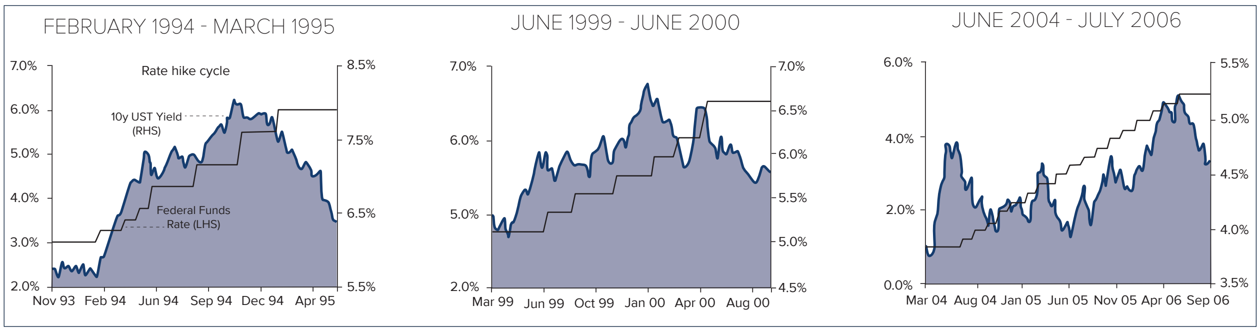


Source: Wealth Enhancement Advisory Services

While this type of outcome is hardly guaranteed, investing in assets that can potentially appreciate can help you keep pace with the rate of inflation—or even surpass it.

Additionally, when interest rates rise, investors are paid more to own bonds, which are typically less risky than holding stocks. Figure 5 below illustrates three different periods where the Fed raised interest rates, and in each period, U.S. Treasury bond yields ended up higher than when the cycle started.

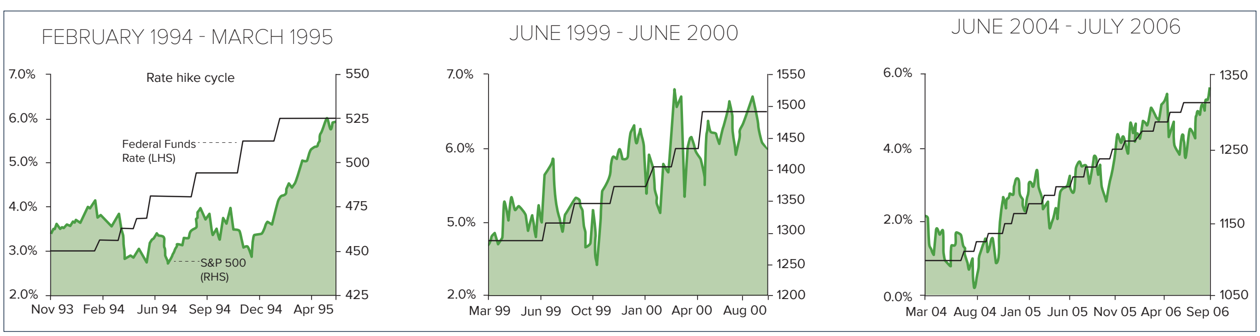
Figure 5. U.S. Treasury Bond Yields Over Three Different Rate-Hiking Cycles



Source: Standard & Poor's, J.P. Morgan Asset Management, Guide to the Markets – U.S. Data are as of September 20, 2015

But that doesn't mean you should run away from stocks. As you can see in Figure 6 , S&P performance was also up over those same periods. And despite there being periods of volatility, investors that stuck with it were rewarded.

Figure 6. S&P 500 Performance Over Three Different Rate-Hiking Cycles



Source: Standard & Poor's, J.P. Morgan Asset Management, Guide to the Markets – U.S. Data are as of September 20, 2015

Modest inflation by itself is not necessarily a bad thing, and higher interest rates could present attractive opportunities for long-term investors to acquire bonds at materially higher yields than we've seen in many years.

No one can predict the market. That's why we advise investors to create long-term financial plans that earmark certain funds for the short term, midterm and long term. That way, the money you need in the short term can be placed in asset classes that aren't as exposed to near-term market risks. And money that you won't need for 15 years or more can take on more risk, helping you stay ahead of inflation and preserving your long-term buying power.

ALTERNATIVE INVESTMENTS YOU MAY CONSIDER ADDING TO YOUR PORTFOLIO

There may be some additional moves you can make to position your portfolio to counteract negative effects on asset values from an extended period of inflation. Here are three alternative types of investments you may want to consider adding to your portfolio:

Commercial Real Estate

Commercial real estate has a been a resilient asset class during periods of inflation and rising interest rates. Since the early 1990s, annual increases in real estate net operating income (NOI) have exceeded CPI inflation by a sizeable margin—roughly 18%, according to Bureau of Labor Statistics (BLS) and National Council of Real Estate Investment Fiduciaries (NCREIF) data.

However, not all types of commercial real estate perform the same in an inflationary environment. Multifamily residential properties typically have annual lease structures that are pegged to an inflation adjustment. Because the new housing market has been underbuilt for the past 10 to 15 years, the rental market remains an attractive investment, particularly in sought-after suburban neighborhoods where there has been strong jobs growth.

Another attractive subsector is industrial warehouses, which have benefited from secular trends such as eCommerce and should continue to provide stable income, even with higher inflation in the near term. Private real estate funds may offer an attractive way to gain access to this durable sector without the volatility of publicly traded real estate investment trusts (REITs).

However, like all other types of investing, commercial real estate comes with its own set of risks. The greatest of these being the potential for falling property values, which can happen for a variety of reasons, including:

- Increasing vacancies or declining rents resulting from economic, legal, political or technological developments
- Lack of liquidity
- Limited diversification
- Sensitivity to certain economic factors such as interest rate changes and market recessions

Commodities

Commodities are often viewed as a hedge to inflation. They come in three broad categories: energy, agriculture, and metals. These are usually either essential to making everyday products (metals/oil) or necessary for survival (food/agriculture and energy). When inflation hits and purchasing power erodes, consumers will prioritize what they need to buy over all else. As a result, commodities prices tend to rise in an inflationary environment.

Some caution should be exercised when investing in commodities funds. Because certain commodities are perishable or can be expensive and cumbersome to store, most common investment vehicles gain exposure through the futures market rather than directly owning the actual commodities. Since futures represent a commitment to buy or sell at a future price, actual performance can sometimes deviate from the price movements of the underlying commodities. Thus, it is an area where active management should be given serious consideration.

Treasury Inflation-Protected Securities (TIPS)

TIPS could also be considered if you're looking to protect a portfolio against inflation. These are bonds that are backed by the U.S. government but are structured differently than conventional Treasury bonds. They are issued with a stated interest rate like other Treasury bonds. But what makes them attractive in an inflationary environment is that the bond value is periodically increased by any increase in the CPI.

It's important to note that this structure can cause TIPS to behave partially like traditional bonds and partially as inflation protectors. In an extended period of inflation, however, they should hold up much better than traditional Treasury bonds. I-bonds, or inflation-adjusted savings bonds, can address some of the limitations of TIPS, but individuals are generally limited to purchases of $10,000 per year.

PLANNING CONSIDERATIONS FOR PERIODS OF HIGH INFLATION

In periods of persistent and high levels of inflation, it's important for investors to pay attention to three big pieces of their financial pie: cash flow, taxes, and long-term inflation assumptions for retirement projections.

Cash Flow Outside Your Portfolio

Many investors limit their focus on how cash is allocated inside their portfolios. Given how low interest rates have been for so long, the goal of cash management is generally to hold as little cash in the portfolio as possible. But when the purchasing power of each dollar is being diminished by inflation, it's important for investors to consider how they manage cash outside of their portfolios—that is to say, how much to hold and where to hold it.

This is a good time to pay attention to the sources and uses of cash, depending on your individual needs and goals. These goals may include setting up an emergency fund, saving up for a down payment on a home, or a travel fund. As you create a budget for these items, recognize that the cost of living has gotten more expensive due to inflation.

Tax Planning

Many aspects of the federal tax system are linked to inflation, including tax brackets, the standard deduction, annual retirement contribution limits, and so on. As costs rise (including, in theory, what employers pay their employees), the amount of taxes paid as a percentage of income should remain on a relatively even keel. But in practice, this is not always the case.

> *For example, since the Tax Cuts and Jobs Act of 2017, the IRS now uses a calculation called the chained-CPI to calculate its annual inflation adjustments. Since chained-CPI typically rises more slowly than regular CPI, it's very possible that you could encounter "bracket creep"—meaning your income rises faster than the IRS's marginal tax rates—which could put your annual income into a higher tax bracket.*

There are steps you can take to lessen your risk of bracket creep, such as considering the benefits of selling a home, grouping charitable deductions into one year, or switching from Roth IRA contributions to Traditional 401(k) or IRA contributions. We advise working with an experienced and capable financial advisor to help you determine whether these moves would be helpful for your situation.

Long-Term Inflation Assumptions

Many financial planning projections are modeled with a long-term inflation assumption of between 2% and 3%, reflecting the past 20+ years of inflation history. Even a 1% pickup in the annual inflation rate could have a significant impact on your future purchasing power.

Since there are so many factors affecting inflation, it's impossible to say for certain where inflation will settle at any given time. However, you can improve financial outcomes by focusing on things you can control, such as saving regularly, controlling risk, and pursuing a disciplined investment strategy.

CALL US TODAY

1-888-229-7390

Schedule a free, no-obligation meeting to learn more about the recent tax policy changes and how you can take advantage of them.

(For best service, please call between 8:00 a.m. and 5:00 p.m. Central Time)

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