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About a year ago, we started seeing news headlines about the future possibility of higher inflation. Now that we're in the future, almost all of us can confirm that we've experienced the effects of rapidly rising prices. Last month's consumer inflation rate reached the highest annual increase in forty years. In this Commentary, we'll take a look at how elevated inflation could impact your financial plan.(1)

We should start by pointing out that inflation's impact on your financial plan depends upon how long the current elevated inflation rates persist. One year ago, almost no one expected elevated inflation. Now, virtually the opposite is true. But if we were wrong about inflation's trajectory a year ago, we can be wrong today, and inflation can moderate more than common consensus expects. The four main drivers of the current elevated inflation are (1) trillions of dollars in U.S. government covid stimulus, (2) consumers spending more on goods rather than services (such as dining out and travel) during the pandemic, (3) manufacturing and supply chain disruptions as a result of workers finding other types of employment or being home sick with covid, and (4) commodity inflation driven by the Ukraine invasion. The first of these likely won't repeat, the second and third have started improving and are likely to continue doing so, and the fourth became a problem only recently and its resolution remains more uncertain.(2)

Inflation primarily impacts your financial plan in two ways: directly by increasing your cost of living, and indirectly through actions the Federal Reserve takes to try to reduce inflation.

With prices increasing at the highest rate in forty years, the first obvious impact to your financial plan is your money won't go as far as it used to. The various financial goals that we planned for in the future will take more dollars to fund. For those already retired, you're likely experiencing that first-hand right now. For those saving for retirement, you may need to increase your savings. That's the bad news. But there's also good news. First, inflation may soon peak. As we mentioned above, Americans have largely worked through spending their stimulus funds, and the government currently has no plans to provide additional stimulus. Americans have started spending more on services like travel and dining out, and less on goods, which helps ease inflation. Supply chain / manufacturing disruptions have shown signs of easing. The Russia / Ukraine conflict will resolve at some point, and that will likely ease commodity inflation. If some of these conditions continue to hold, it may mean we have seen the worst of the current inflation. The other positive is that inflation has only averaged about 3% a year since the government started recording data in 1913. Inflation will revert back to the average over time, and there's no reason to think that average inflation over the next twenty years will differ from the historic average of 3%. And finally, we've taken the historic inflation rate into account when we assembled your financial plan – and the historic inflation rate we used includes periods in the 1970s when inflation exceeded 10% a year. Yes, we have already planned for times like this when we projected out your future spending.(3)(4)(5)

So that's how elevated inflation will directly impact your financial plan through a higher cost of living. Elevated inflation can also indirectly impact your financial plan through the measures the Federal Reserve takes to reduce inflation. The primary way the Fed seeks to reduce inflation is by raising interest rates, which is a form of reducing economic stimulus. The Fed's actions to reduce inflation will have a less clear cut impact on your financial plan than the increased cost of living we described above. If we look back historically, we can find periods where rising interest rates led to declines in the value of stocks, bonds, and real estate, and we can find periods where asset values continued to rise. So far this year, rising interest rates have led to declines in both stock and bond prices. This likely has to do with the fact that interest rates were at zero, and the Fed has indicated they must increase them fairly aggressively in order to combat substantial inflation. How much of an impact the Fed's interest rate increases will have on stocks, bonds and real estate does depend on how much the Fed must increase interest rates. And that depends on whether the inflation rate starts to decline over time as a result of the four factors we mentioned above.(6)

Regardless of the exact path of interest rates and inflation, our Group does expect the economic climate over the next five to ten years to look quite different from the climate of the past five to ten years. We will probably experience a bumpy ride, with more volatility. For your financial plan, there are two key takeaways: The elevated inflation we're currently experiencing reinforces the need to allocate your assets to investments with a demonstrated track record of overcoming inflation over time. And the potential for rising interest rates emphasizes the need to allocate your assets to investments that have held up or done well during periods where the Federal Reserve increased interest rates.

As we've discussed before, stocks provide the best inflation protection compared to the other major asset classes. They have historically generated much higher returns than both bonds and real estate, and we expect that to continue in the future. Although times of volatility like the present are uncomfortable, this short-term pain is the price we pay for the strong long-term gains that stocks provide in excess of inflation.(7)(8)

What about periods of rising interest rates? As mentioned above, we can point to periods of rising interest rates where asset prices both increased and fell. Since no one has a problem with rising asset values, let's forget about those times and ask what happens if the current increase in interest rates leads to a worst-case scenario. The two most notorious examples of this in recent history are the two ten-year periods of 1972 to 1982 and 1999 to 2009. From 1972 to 1982, the Dow Jones stock index was flat. So stock prices as a whole did not go up for ten years. Yet investors who reinvested dividends earned a 69% return over those ten years. Similarly, most of us remember the bursting of the technology bubble in 1999 and then the housing bubble in 2008. Over the ten years 1999 to 2009, U.S. stocks as a whole fell 9% for the decade. Yet mundane industries that generated strong and stable cash flows generated good returns, with the consumer staples industry increasing 66%, health care stocks increasing 30%, and industrial stocks increasing 8%. The experience of 1972-1982 and 1999-2009 reflect what we've seen so far this year. Stable businesses paying strong cash flow to investors in the form of dividends have done relatively well. Meanwhile, some of the most popular investments of the past five to ten years, as well as speculative investments, have done poorly – many have crashed.(9)(10)

To conclude, we recognize that humans are terrible at predicting the future. While almost no one expected accelerated inflation a year ago, almost everyone now expects it. But our current expectations can prove wrong, just as they did a year ago. We think the most prudent approach for investors is to prepare themselves for a more challenging road over the next few years as financial plans confront the effects of elevated inflation and rising interest rates. We have positioned your assets to meet this moment, and we remain steadfastly confident in the ability of your investments to generate the results you depend upon over time.

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Sources:

(1) CNBC
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(9) Roger Thomas
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