Is Inflation Really a Surprise?

Inflation is not fun. It seems, that everywhere you turn, everything costs more. If you are helping your child buy a first starter home or if you are trying to downsize to a smaller house in retirement, I am sure you have noticed, real estate is definitely higher. New cars cost more. Wow, even some used cars are also selling at top dollar. Every time you go the grocery store, you pay more, if you can find what you want! Air travel and hotels cost more. If it cost more to keep an employee, that cost will get passed on to the consumer. Energy prices have also risen. The price of oil has doubled in less than two years. If you recall my Summer 2020 newsletter, I mentioned that as of April 20, 2020, a barrel of oil could not be sold. There was such a glut at the time. The gluts have disappeared, and people are back to their previous driving ways and now paying for it. Higher energy prices are like a higher tax on individuals, corporations, and municipalities.

Is inflation really a surprise? I'm actually surprised its not a little bit worse. Still, the 7% recorded in December was a bit of a shocker. We have had unprecedented federal and state spending. There has been an avalanche of cash available to most eligible taxpayers from the IRS. There has also been a huge stimulus to businesses. The FED reserve took unprecedented actions to generate/ restart the economy after the huge layoffs in March and April of 2020. First, it moved the Federal Funds rate to almost zero. Mortgage rates followed suit, and again refinancing cranked up again. It also launched massive purchases of debt securities called QE or Quantitative Easing. All in all, the FED took more than a page from the '08-'09 Recession Playbook. Their actions were massive and touched almost all parts of the U.S. economy. Lastly, many individual and corporate balance sheets have done extremely well. When this happens, spending increases. When spending increases, and supply is tight, there is only one way for prices to go. The Fed believes the economy is now on stable ground. This is pretty amazing, considering what we have gone through after the COVID pandemic. Unemployment is low and the GDP (Gross Domestic Product) has recovered nicely. With positive economic news, the Fed will slowly start to raise interest rates. The Fed is also looking to trim their massive balance sheet.

What does all of this mean for the economy AND for the markets? The economy always slogs through, regardless of the circumstances, even with the current headwinds of inflation, higher interest rates, and major government expenditures. The economy during COVID showed us once again that it can navigate through anything. The economy will continue to perform. The markets are getting their first dose at the end of the prolonged easy money policy. This has presented challenges for both fixed income and for equities. Yes, bonds and stocks have had a tough start to year 2022. The good news is, we have seen this movie before. Regarding bond funds, the prices temporarily go lower, but eventually they rise as does the interest rates/yields of the underlying bonds. This helps in retirement to have a higher yield (income), yet it does not happen overnight, but it does happen. In equities, we have had a pretty healthy pullback. As investors, we can be accustomed to recent bias, and often get taken back when we see negative numbers. This is typical and perfectly normal to feel this way. This is another reason to keep a diversified portfolio. Different sectors move up and down, and this is why we do not get too excited and follow the herd in one particular investment. The number one performer one year, could easily become subpar the next year. It is too early to determine winners and losers for this year; for instance, Small Cap companies performed amazingly well during the first ten months of 2021, only to give a large portion back during the last 90 days. You always want to look at fundamentals and not what did well 'lately.' Investing is always a long-term commitment whether you have 30 years until retirement, or you are currently retired. The reason is even during retirement, you do not take all of your investments out at one time. A typical withdrawal rate should be in the range of 3 -5%. This percentage increases during down markets and reduces when markets are up. On the accumulation side of investing, if you are able to add funds during the ups and especially the down days, months, and, yes, even years, this is how wealth is created.

A stabilization factor is the use of COLA's. Higher inflation has also led to higher COLA increases from social security and those receiving pensions. Staying even is better than falling behind, hence that is the purpose of what a COLA increase is intended to do. There is a belief that inflation numbers will be reduced by the end of this year. Lower inflation will lead to lower annual raises for your fixed income.

So, yes, we are living with clear evidence of inflation; we see actions by governmental, financial institutions, and corporations. However, what it all means is to continue to apply the basic tenets of investing. Patience is probably the best course of action today. This applies to investing in the market or if you are in the need of an item that is in high demand. It may be worth waiting for, most things are😊

Sincerely,

Andrew D. Wade, CFP®
President