The Darnell Financial Planning Team

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Quarterly Insight

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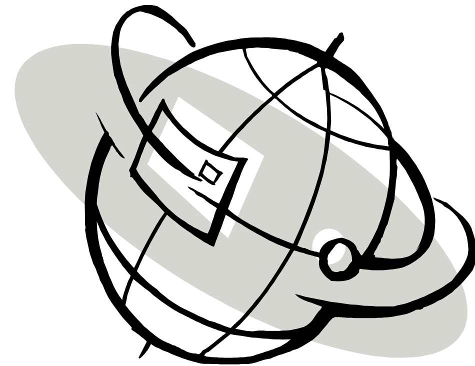
Is the U.S. economy heading into a period of higher inflation?

The answer may depend on whom you talk to, but regardless of the answer, one thing is certain: Inflation will leave a permanent mark on your finances. That is why it is important to understand what it is, how it affects you and what you can do to minimize its negative consequences.



The Basics

According to the U.S. Census Bureau in 1960 the average cost of a home in the United States was $11,900. In that same year a new car could be bought for $2,600 and it took 25 cents to purchase a gallon of gas. All of these prices may seem "cheap" when compared to today's standards, but the average family income in 1960 was $5,620 per year. After nearly 50 years, the equivalent items cannot be purchased for the same price because of inflation.

Very simply, inflation is the overall rate at which the prices of an economy's goods and services are increasing. As prices go up, your purchasing power goes down, since each dollar buys a smaller share of goods and services. At 3% inflation, for example, a bag of groceries bought for $100 today might cost you $103 next year. While inflation may seem insignificant on a shorter term basis, over the longer haul it can significantly impact your standard of living. Bottom line, if your income over that time period isn't keeping pace with prices, inflation can put your financial well-being in jeopardy.

Inflation may not seem all that problematic if salary increases allow your income to keep ahead of it, but consider the effects if you are living on a fixed income. Using an annual inflation rate of 3%, an individual who retires with a fixed pension of $40,000 per year would see their purchasing power cut by more than half in 25 years. Thus, that $40,000 pension would be worth about $19,000 in future dollars.

What causes prices to rise?

"…inflation can put your financial well-being at risk."

Inflationary spirals can be triggered by a variety of things. Among them are federal budget and current account deficits and oil or other commodity price shocks. What exactly is it that forces prices to go up? The first can be described as too much money chasing too few goods—or "demand-pull" inflation. The second scenario is called "cost-push" inflation. According to this theory, when companies experience an increase in their costs they attempt to maintain their profit margins by "pushing" those increases onto consumers in the form of higher prices.

Where interest rates come in

Because inflation can be the result of too many dollars chasing too few goods, one way to curb it is to tighten the supply of money circulating through the economy. To reduce the flow of money, the Federal Reserve ("Fed") employs several tools that impact short-term interest rates. By raising rates, the Fed increases the cost of borrowing and the number of loans taken generally declines. This, in turn, decreases the money in circulation, which lowers inflation. Conversely, by lowering rates, the Fed causes money to become "cheaper," enabling more people to borrow. When more people are borrowing, there is more money in the economy and prices tend to rise.

The sale or purchase of Treasury securities is one of the key methods the Fed uses to influence interest rates. As people and institutions buy the securities with dollars, the dollars available for consumption decrease and money becomes tighter or "more valuable." Hence, interest rates go up. The opposite occurs when the Fed buys back existing government bonds, infusing the economy with additional dollars. The Fed, acting as the nation's central bank, can also slow inflation by raising the discount rate, which is the interest rate it charges its member banks for overnight loans, or by requiring banks to hold more in reserves.

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Remember to "pay yourself first, because nobody else will."

Staying ahead of inflation

So how should you protect yourself from inflation's ability to erode the value of your assets? As simple as it sounds, the key is having clear investment goals and understanding your investment time horizon and risk tolerance. These three factors—not inflation, the business cycle or any other type of economic fluctuation—should be the real factors behind how you invest.

A well-diversified portfolio can provide a hedge against the risks imposed by inflation and rising interest rates. Remember, some inflation is healthy for the economy and financial markets. That said, you may periodically decide to make some adjustments to your portfolio in anticipation of changes in the economy. Here, briefly, are several investments that can offer added protection if inflation starts to climb.

- **Short- and intermediate-term bond funds****
- **Floating-rate funds****
- **High yield bond funds****
- **Treasury Inflation Protected Securities (TIPS)****
- **Real assets****

Again, the most prudent advice in any kind of economic environment is to avoid putting all your eggs in one basket and maintain a balanced, diversified approach to investing. This basic strategy, coupled with an ongoing review of your portfolio, may keep you ahead of inflation and headed toward achieving your goals.

*****Investors should carefully consider their investment objectives, risks, charges and expenses when considering a change of investment strategy. We encourage you to come in and discuss your portfolio with your financial advisor.***