INFLATION: AN UNFORTUNATE SYMPTOM OF A GROWING ECONOMY

Overview

Even though COVID-19 remains a part of our lives and will likely be here for quite some time, many Americans have learned to live with the virus, and the economy has experienced a faster-than-expected recovery. While economists expect the U.S. to have setbacks when new, more virulent variants of the coronavirus surface, we now have systems in place to modify and distribute vaccines quickly, and companies have learned how to shift operations when necessary in order to create a safer environment for employees and customers.

Today, monetary policy is accommodative, corporations are investing, and both employment levels and wages are increasing. All of these positive factors can lead to rising prices.

Inflation During Economic Growth

Within this new normal landscape, the economy is thriving. However, there are always trade-offs to economic growth, and one of those is rising inflation. Inflation is simply a reflection of the rising cost of living.

Inflation occurs when consumers are flush with cash. When interest rates are low, it's cheap to borrow money, and when the employment rate is high, consumers are more apt to buy goods. This higher demand for products can reduce inventories faster than companies can produce the goods. When this happens, companies will raise prices to stem demand while earning the same level of revenues.

Inflation During an Economic Decline

Eventually, rising prices curb spending and company revenues drop, and that can lead to lower employment. Once consumers stop buying as much, inventories typically rise again amid reduced demand — and prices will likely drop again. That's the natural ebb and flow of inflation. However, when things don't work quite that smoothly, when the cost of goods or the unemployment rate increases too fast or lasts too long, the government has ways of intervening. The Federal Reserve is charged with monitoring inflation and employment levels. It can adjust monetary policy by raising or lowering interest rates or purchasing assets to infuse more money into the economy.

By raising interest rates, the Federal Reserve can reduce available funding, which, in turn, will slow down the economy. Less spending can lead to lower company revenues, which may lead to layoffs, so unemployment will begin to rise. When workers are desperate to cling to their jobs, they no longer have the bargaining power to negotiate higher wages. With less money available, inflation subsides as companies reduce prices to encourage spending.

"Supply chains were not prepared for the economic rebound to be as quick as it has been. Couple that with the global cut in oil production that cannot come back online fast enough, and you get a supply-side shock."[1]

Inflation During the Pandemic

With all that said, inflation is working a little differently these days due to the pandemic. The U.S. rebounded more quickly than expected because it was able to develop and distribute vaccines fast enough to safely reopen its economy. However, that has not been the case throughout the rest of the world. And because we have all been participating in a global economy since the turn of the century, there has been a marked shortage of supplies that we usually purchase from other countries.

Major suppliers such as China and India have not recovered as quickly. Their manufacturing capabilities have been suppressed, creating a bottleneck in the supply chain for raw materials. As a result, Americans have experienced shortages of goods ranging from toilet paper to microchips for new cars — driving up the costs of these goods. And, what goods are produced are not getting distributed quickly due to disruptions in shipping and transportation. Shortages in the labor market further exacerbate these problems. Workers are insisting on higher wages now that the bargaining chips are in their corner. Furthermore, the worker pool has shrunk following a wave of older workers who retired during the pandemic.

Yet despite these problems, America is still undergoing an economic boom, and that has led to higher inflation. In October, the U.S. Department of Labor reported a 0.9% increase in goods across the board, as measured by the consumer price index (CPI). This means a product that cost $10 in September would have increased to $10.09 in October. However, the 12-month inflation rate increased by 6.2%, while wages increased by only 5.8%. So while wages are increasing, they're not quite on par with the pace of inflation. A product that cost $10 in October of 2020 would have increased to $10.62 by October of 2021.[2]

Other Factors

Some products tend to fall outside the mainstream of rising prices because they are subject to other factors. One of those is the price of gas. The principles are the same — when demand falls, so do prices. When demand increases, prices rise. That's because the oil industry reduces oil production based on demand, which tends to be driven by seasonal changes. For example, people travel more in warmer months, so oil companies ramp up production to meet demand. They travel less in cold months, so oil companies produce less product.

The pandemic reduced demand for a sustained period, so when the U.S. economy recovered quickly, supplies were low and, therefore, prices increased. Moving forward, however, the U.S. Energy Information Administration (EIA) expects prices to begin dropping again during the winter months and then average about $2.88 a gallon in 2022 as demand levels normalize.[3]

It is also worth noting that the unknowable impacts of increased extreme weather events due to climate change may impact inflation. For example, rising temperatures and more-frequent droughts can affect agriculture crops here and in other countries we rely on for food.[4] Many factors can create shortages of goods, which would then increase prices. Bear in mind that there is only so much the Federal Reserve can do to mitigate inflation — it cannot produce drought-resistant crops.

According to recent remarks by a member of the Board of Governors of the Federal Reserve, the U.S. has recovered its fundamental production capacity to engage in a robust economy as it existed before the pandemic. In other words, fluctuating prices driven by supply and demand can be reconciled by the normal principles of capitalism. However, other transitory factors (e.g., a global pandemic, the ravages of climate change) pose challenges that fiscal and monetary policies may not be able to adequately address.[5]

What to Expect Moving Ahead

The pandemic created a new dynamic. We can no longer rely on the standard principles of inflation correcting itself because it's not being caused by the normal cyclical nature of the economy. Worse yet, the economy is being driven by a virus that we currently seem unable to contain. This means our economy will likely continue to fluctuate based on the severity of new strains as they develop, as well as our ability to respond in kind.

It is also important to recognize that the U.S. is not alone in this quandary. Even if we could control the virus within our own borders, we rely on the rest of the world for much of our economic viability. This encompasses import and export shipping and the influx of business travelers from all over the globe — who can carry the virus here as easily as we can spread it to other countries.

Nor is rising inflation exclusive to the U.S. Countries worldwide are experiencing some of the highest inflation rates in recent years, and in many cases, people are struggling to buy food or fuel their cars. With another surge of infections during the winter season, we may see more countries close or tighten their borders, further hampering global economic recovery. As supply chains get cut off, we can expect higher inflation here in the U.S.[6]

Historically, when prices rose too quickly or were sustained too long, the Federal Reserve would raise interest rates — and it may still. However, the Fed is powerless to address global supply shortages, shipping disruptions and an unhappy labor force that refuses to work for wages misaligned with the cost of living. These are issues that may need to be addressed through a combination of government policy and foreign diplomacy, reallocated resources and the private sector reconciling company balance sheets to accommodate the demands of their workforce.

Invest To Keep Up With Inflation

The value of an uninvested dollar today will not buy the same amount of goods 25 years from now. Therefore, your investment portfolio should be allocated in a way that helps enable it to exceed inevitable increases in long-term inflation. According to the U.S. Bank Asset Management Group, there has been a positive correlation between inflation and the stocks of large companies over the past three decades. In other words, rising prices help bolster the balance sheets of many public companies, which in turn yield higher returns for investors who own their stock.

The accompanying table shows the correlation between rising inflation and various investment asset classes between 1990 and 2020.[7]

	Asset class	Relationship
Stocks	- U.S. large-cap stocks - Developed foreign stocks - Emerging market stocks	- Positive - Strong negative - Strong negative
Bonds	- Investment-grade bonds - Treasury inflation-protected securities (TIPS)	- Strong negative - Positive
Real Assets	- Real estate stocks - Commodities	- Strong positive - Strong positive

Final Thoughts

Clearly, not everything associated with inflation is bad. It is often an indicator that the economy is growing, and while rising prices may hurt consumers, they can benefit investors.

The negative aspect of inflation is that it can erode your purchasing power — both today and in the future. Long-term inflation presents a risk that the money you save for retirement won't buy as much as it does today, so you have to plan for that cost-of-living increase. This usually means allocating a portion of your investment portfolio to stocks, which over time are typically best positioned to keep pace with inflation.[8]

However, your retirement may last two or three decades, and advisors generally recommend that you reduce investment risk as you get older. In the latter stages of retirement, you may not want to put any assets at risk that you need for income purposes. It may be prudent to consider inflation-adjusted guaranteed income options offered via an insurance-backed annuity. Consult with your financial professional to determine the appropriate income solution to meet your needs and the long-term impact of inflation.

[1] *Christopher Gilchrist. Forrester. Oct. 13, 2021. "Build Contingencies To Prepare For Inflation That May Not Be Transitory." https://www.forrester.com/blogs/build-contingencies-to-prepare-for-inflation-that-may-not-be-transitory/. Accessed Dec. 7, 2021.*
[2] *U.S. Bureau of Labor Statistics. Nov. 10, 2021. "Consumer Price Index Summary." https://www.bls.gov/news.release/cpi.nr0.htm. Accessed Dec. 7, 2021.*
[3] *U.S. Energy Information Administration. Dec. 7, 2021. "Short-Term Energy Outlook." https://www.eia.gov/outlooks/steo/. Accessed Dec. 7, 2021.*
[4] *Osman Ouattara. The Conversation. Nov. 3, 2021. "Why climate change poses a threat to central banks." https://theconversation.com/why-climate-change-poses-a-threat-to-central-banks-168668. Accessed Dec. 14, 2021.*
[5] *Randal K. Quarles. The Federal Reserve. Oct. 20, 2021. "How Long is Too Long? How High is Too High? Managing Recent Inflation Developments within the FOMC's Monetary Policy Framework." https://www.federalreserve.gov/newsevents/speech/files/quarles20211020a.pdf. Accessed Dec. 7, 2021.*
[6] *Justin Spike, Paul Wiseman and Vanessa Gera. AP News. Nov. 29, 2021. "Food, gas prices pinch families as inflation surges globally." https://apnews.com/article/coronavirus-pandemic-lifestyle-health-business-poland-f559465c6a822d12b2dd513f122d5a31. Accessed Dec. 7, 2021.*
[7] *US Bank. Aug. 6, 2021. "Effects of inflation on investments." https://www.usbank.com/financialiq/invest-your-money/investment-strategies/effects-of-inflation-on-investments.html. Accessed Dec. 7, 2021.*
[8] *Poonkulali Thangavelu. Investopedia. June 20, 2021. "How Inflation Impacts Your Savings." https://www.investopedia.com/articles/investing/090715/how-inflation-affects-your-cash-savings.asp. Accessed Dec. 7, 2021.*

12/21-1952317