WINTHROP WEALTH

JUNE 2021 CLIENT QUESTION OF THE MONTH: INFLATION

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As the United States begins to emerge from the pandemic and the economy (fueled by unprecedented amounts of monetary and fiscal stimulus) picks up speed, inflation has become top-of-mind for many investors. Inflation is defined as the rate at which prices increase over a period of time. There are several ways to measure inflation, including survey and market-based indicators. The most common indicators include, the Personal Consumption Expenditure (PCE) Index, Consumer Price Index (CPI), Producer Price Index (PPI), Average Hourly Earnings, and breakeven inflation rates. In our latest Client Question, we will examine the Fed's preferred measure, the Core Personal Consumption Expenditure Index, and the impact that inflation has on asset prices.

What is the Core Personal Consumption Expenditure Index?

The Core Personal Consumption Expenditure (PCE) Index measures the prices paid by consumers for goods and services based on surveys of what businesses are selling. Core means that the index excludes food and energy prices, which tend to be more volatile than other categories. You may have noticed prices going up at the grocery store or the gas station, but that is not reflected here. The Bureau of Economic Analysis calculates Core PCE data on a monthly basis as part of the Personal Income and Outlays report.

Core Personal Consumption Expenditure (PCE) Index			
Core Goods	**Weight**	**Core Services**	**Weight**
New Vehicles	3%	Housing	19%
Used Vehicles	1%	Ground Transportation	0%
Household Appliances	0%	Air Transportation	1%
Video, Audio, Computers	2%	Food Services	6%
Recreational Vehicles	1%	Financial Services & Insurance	10%
Jewlery & Watches	1%	Medical Services	19%
Clothing & Footwear	3%	Foreign Travel	0%
Pharma & Medical	5%	Residual Core Services	18%
Pet Products	1%	**Total**	**73%**
Expenditures Abroad	0%		
Residual Core Goods	10%		
Total	**27%**	**Grand Total**	**100%**

Source: Goldman Sachs

Why does the Fed prefer the Core Personal Consumption Expenditure index?

The Fed formally declared their preference for the Core PCE inflation measure in the February 2000 Monetary Policy Report to Congress. The Fed stated the index results in a more consistent measure over time based on its comprehensive methodology and flexibility to account for newly available information and improvements in measurement techniques. Of course, while PCE is the preferred measure, the Fed analyzes other information on prices and costs to assess the path of inflation.

Why does the Fed care about inflation?

The Fed acts is the central bank of the United States, while the Federal Open Market Committee (FOMC) is the governing body. The FOMC sets monetary policy to establish the financial conditions they believe will best achieve their three mandated goals established by congress: maximum employment, stable prices, and moderate long-term interest rates. As conditions in the economy change, the FOMC will adjust monetary policy accordingly. The Fed's most commonly used monetary policy tool is adjusting the federal funds rate. When the Fed is accommodative, they are trying to boost the economy and inflation by reducing or maintaining the federal funds rate at low levels. When the Fed is restrictive, they are trying to reduce inflation and the economy by raising or maintaining the federal funds rate at high levels.

At the August 2020 Jackson Hole Symposium, Chair Powell formally announced a change to the FOMC's Statement on Longer-Run Goals and Monetary Policy Strategy to reflect average inflation targeting. Historically, the Fed increased interest rates when inflation started to rise toward their old 2% objective. Under the new policy, the FOMC now "aims to achieve inflation moderately above 2% for some time so that inflation averages 2% over time and longer-term inflation expectations remain well anchored at 2%." This subtle change is very important for monetary policy going forward. Assuming the Fed sticks to this policy, they are willing to let inflation rise above 2% for some time before raising interest rates. Essentially, this means that interest rates are likely to stay lower for longer.

Please see our ***Client Question on The Fed*** which details the key entities, and the impact monetary policy has on the economy, interest rates, and stock prices.

Why does the Fed target inflation around 2%?
The Fed's stance on inflation, that 2% signifies "stable prices", can be confusing. The Fed prefers inflation around 2% for three main reasons:

1. **They have room to lower interest rates to boost the economy.** All interest rates include an estimate of future inflation. If you are lending money, you want to be compensated for future inflation. By targeting inflation around 2%, it means that interest rates should also around that level. When interest rates are above zero, the Fed has ammunition to lower them to boost the economy. When interest rates are near zero, the Fed must rely more heavily on nontraditional monetary policy.

2. **They are worried about deflation.** The Fed, and all central banks, worry about deflation due to the destructive force that it can have on an economy. Deflation is defined as a decrease in the price of goods or services. If you were thinking about making a major purchase, and you thought the price would be lower in 6-months, would you buy today? Of course not. Since about 70% of GDP is based on consumer spending, the economy can lock up when individuals expect deflation and stop making purchases. If you thought the price would be slightly higher in 6-months, you would probably purchase today. This is what keeps the economy going.

3. **Servicing debt becomes easier.** Inflation can be positive for borrowers, including both individuals and the government, assuming fixed payments. Since inflation causes the value of money to decrease over time, cash is worth more now than it will be later. Therefore, inflation lets borrowers pay their debts with cash that is worth less than when they originally borrowed it. Please see our ***Client Question on The Federal Debt***.

What are the latest inflation readings?
The latest Core PCE inflation reading increased by +1.8% year-over-year (Y/Y) in March. Most inflation readings have been below the Fed's +2% target for the last twenty years. The below chart shows that inflation has only been above 2% a handful of times over the last few decades. The 20-year average inflation rate is +1.7% Y/Y.

Source: Bloomberg 4/30/2021

Why has inflation remained low?
Inflation has been low for several decades low due to the deflationary forces of technological innovation, aging demographics, and globalization.

Why are inflation readings expected to increase?
To fight the pandemic, Congress and the Fed unveiled trillions in fiscal and monetary stimulus, thereby increasing the federal debt-to-GDP ratio to the highest level since World War II. Now the US is emerging from the pandemic and GDP is expected to increase at the highest rate since 1984. Simple inflation models suggest that prices should rise as fiscal and monetary stimulus increase the money supply and push demand above supply. *Note that these same models forecasted inflation, which never materialized, for the same reasons when the US was emerging from the financial crisis. However, the amount of stimulus during the pandemic was far greater than the financial crisis.*

Inflation will likely increase materially over the next several months on a year-over-year basis due to the deflationary forces that occurred during the first part of the pandemic last year. Inflation readings only averaged about 1% from April through June 2020 as large parts of the economy were shut down. The Fed insists that inflation increases in the Spring and Summer will be transitory and that they will focus more on the data in the latter half of 2021.

What are current inflation expectations?
The Fed expects that Core PCE inflation will increase to +2.2% Y/Y in 2021 before leveling off to about +2% over the next several years. While most FOMC participants do not expect to raise interest rates until at least 2024, you can bet that the Fed will adjust if inflation starts to run rampant.

We expect inflation readings to increase over the several months due the base effect of being compared to the early months of the pandemic. However, we also expect Core PCE inflation to level out around 2% to 2.5% due to the Fed's influence and the deflationary forces of technological innovation, aging demographics, and globalization.

How does inflation impact various asset classes?
Cash
Inflation has the most destructive impact on cash, especially in today's environment with interest rates on savings accounts near zero. Over time, a position in cash is eroded by inflation. Assume that a savings account yields zero while inflation is about 2% each year. This means that after one year, the savings account purchasing power is worth 2% less. Assuming the same variables, after ten years, the savings account purchasing power is worth about 22% less. We do not recommend holding large sums in cash unless it is to fund an upcoming expense.

Fixed Income (bonds)
Bonds are a loan to an entity (governments, corporations, municipalities, etc.) who promises to pay back the principal with interest. Bond holders do not have an ownership interest in the company, but they do have a higher priority than stocks in the event of bankruptcy. Fixed income investors typically prefer the relative safety of bonds and are looking for interest income. Investors often do not consider that inflation erodes the purchasing power of both interest and principal payments.

- **Interest:** When looking at bond yields, it is important to adjust for inflation. The real return of a bond is the nominal yield minus inflation. Assume a bond that is issued at par pays a 5% coupon while inflation is 2%. The nominal yield on the bond is 5% while the real yield is only 3% (real return = nominal – inflation).
- **Principal:** Assume an investor buys a $10,000 bond at par with ten years to maturity. The investor will lend the entity the funds today, receive coupon payments over the next ten years, and then receive their $10,000 back at maturity. The key point is that at maturity the purchasing power of the $10,000 principal is worth less than at issuance due to inflation.

Equities (stocks)

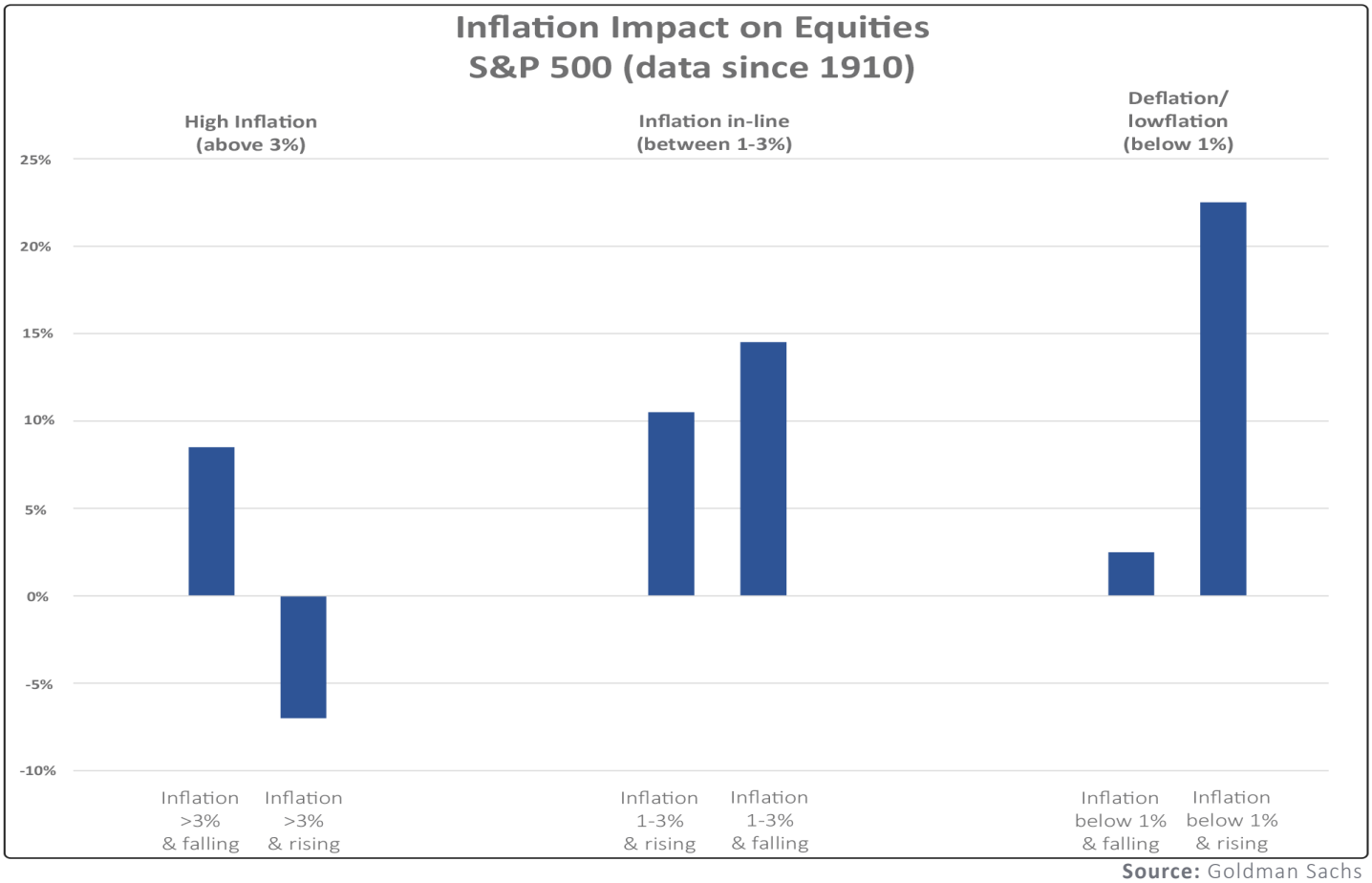
The impact of inflation on stock prices tends to vary based on the absolute level and rate of change.

When you buy a share of stock, you are purchasing an ownership stake in the underlying company. Your ownership stake represents a claim on the firm's cash flows, earnings (profits), and dividends. Stock prices reflect the present value of the company's expected future earnings.

Some inflation can benefit stock prices if companies can raise prices higher than costs, thereby increasing earnings. One of the major benefits of stocks over bonds, is that a company's earnings and dividends are not fixed.

If inflation runs rampant, the Fed responds by raising interest rates, thereby slowing the economy. Corporate cash flows expectedly decline during recessions and in higher interest rates environments. Please see our ***Client Question on Why Interest Rates Impact Stock Prices***.

The following chart illustrates how stocks have historically performed in various inflationary environments:



Source: Goldman Sachs

At Winthrop Wealth, we apply a total net worth approach to both comprehensive financial planning and investment management. Financial planning drives the investment strategy and provides a roadmap to each client's unique goals and objectives. The comprehensive financial plan defines cash flow needs, is stress tested for various market environments, optimizes account structures, considers tax minimization strategies, and continuously evaluates financial risks as circumstances and/or goals change. The investment management process is designed to provide well-diversified portfolios constructed with a methodology based on prudent risk management, asset allocation, and security selection.

DISCLOSURES:

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual.

The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Likewise, it is important to remember that no investment strategy assures success or protects against loss. Past performance is no guarantee of future results. Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.

Rebalancing a portfolio may cause you to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

All indexes mentioned are unmanaged indexes which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.