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Financial Briefs

MAY/JUNE 2019

Why Inflation Can Be Good

Most people don't have a kind word to say about inflation, and those on fixed incomes hate it. It makes everything more expensive; and when you're living on an income that never rises, your standard of living suffers.

But ask most economists and they'll tell you that, within limits, inflation is good, and its opposite — deflation — is bad. How can that be?

The broad definition of inflation is a general increase in prices. Deflation is the opposite — a general fall in prices.

When we say general, we're referring to the prices of most goods and services. This is an important distinction because prices of some things move in a different direction from most.

For example, regardless of what's happening to the price of food or clothing, prices generally fall for new, high-technology items after a number of years. That's usually because manufacturers achieve economies of scale and are able to pass the associated savings along to consumers, and/or because they have invented new, less expensive ways to make the latest gadget. It also happens when more manufacturers come into the market and compete against established makers on the basis of price.

There can also be regional differences in the prices of some goods. An example is real estate, where prices may be falling in areas that are experiencing a high rate of job losses, while prices may be rising in

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Making Sense of the Federal Deficit

The federal deficit is often confused with federal debt, though the two are closely intertwined and impact the U.S. economy in several ways. A federal deficit is simply defined as the shortfall that remains when the government's expenditures exceed its revenue.

Imagine if, at the end of this month, your bills exceed your deposits. You might dip into your savings, apply the deficit to a credit card, or borrow money from a friend, family member, or lender. Essentially, this is no different than how Congress manages the federal deficit, except at the federal level, borrowing money means selling Treasury securities to the public. These owed funds become part of the national debt.

So who decides what is spent and what is collected as revenue? Each year, the annual federal budget is established by the president, who submits a budget request each February for the upcoming fiscal year (beginning October 1) after consulting with federal agencies and the president's Office of Management and Budget.

The federal government has consecutively reported a deficit since 2002. Last year alone, the Congressional Budget Office reported a deficit of $779 billion, putting the national debt at over $21 trillion at the fiscal end of 2018. Compared to recent years, this deficit was relatively low: in 2009, Congress reported a record-setting $1.41 trillion deficit, and over a trillion dollars each year thereafter until 2013.

Deficits and national debt should really be analyzed alongside the gross domestic product (GDP), taking the true size of our economy into context. The GDP is the total value of final goods and services produced within a country, generally measured on an annual basis. If our GDP is growing at a higher rate than our national debt, there may be little cause for concern. The relationship between the two is measured by the ratio of national debt (in currency such as dollars) to the GDP. This debt-to-GDP ratio is a commonly used measure of a country's

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Why Inflation

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areas where the job market is booming.

Three Measures of Inflation

1. The Consumer Price Index (CPI). This is the figure most Americans think of when they think about inflation. It's calculated monthly by the Bureau of Labor Statistics, based on the prices of a basket of some 80,000 different goods and services that most consumers buy in markets all across the country.

The Bureau of Labor Statistics categorizes those goods and services as:

- Food and beverages (including at-home and restaurant meals)
- Housing (rent of primary residence, owners' equivalent rent, furniture)
- Clothing (including jewelry)
- Transportation (new vehicles, airline fares, gasoline, motor vehicle insurance)
- Medical care (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, hospital services)
- Recreation (televisions, toys, pets and pet products, sports equipment, admissions)
- Education and communication (college tuition, postage, telephone services, computer software and accessories)
- Other goods and services (tobacco and smoking products, haircuts, and other personal services)

The CPI also includes sales and excise taxes, utility fees, and highway tolls. It excludes investments like stocks, bonds, and insurance, as well as income and Social Security taxes.

You'll sometimes hear about core inflation. This is a derivation of the CPI that excludes the goods that have volatile prices, like food and fuel. The idea is to avoid outlying, short-run price changes that mask longer-term trends.

2. GDP deflator. Based on changes in Gross Domestic Product (GDP), this is a broader measure than the CPI because it includes every kind of good and service the economy produces and delivers. For example, it includes raw materials and industrial goods, like steel, factory equipment, and investment services. It's expressed as a percentage that reduces the nominal new price of a good or service to reflect the quantity of goods.

The GDP deflator is regarded as a more accurate measure of price trends throughout the *entire* economy.

3. Producer Price Index (PPI). This measures changes in the wholesale prices of goods and services by manufacturers. It's often looked at as a leading indicator to estimate later changes in the CPI.

How Can Inflation Be a Good Thing?

Inflation is a by-product of economic growth, which is the means by which the standard of living rises.

Think of it this way: prices are a function of supply and demand; if businesses post higher prices for their goods and services and they stick, it's because demand is willing and able to pay those prices. One of the ways that people can afford to pay more is if their incomes are rising, which is what happens when they are working for successful companies.

Higher prices are also supported when there is a continually growing number of people with jobs and money to spend.

Inflation can also stimulate growth by making existing debt cheaper.

Think of homeowners who stretch their budgets to buy the nicest home they can afford. Over time, if the economy grows, so does their income. If they hold a fixed-rate mortgage, their monthly mortgage payment for principal and interest becomes a smaller and smaller percentage of their income.

As a result, they have an increasing amount of free cash flow to spend on other goods and services. And that, in turn, causes businesses to hire more people.

The Destructive Power of Deflation

Deflation is a general decline in prices — not to be confused with a decreasing rate of inflation — and is a destructive economic force. First, it's a sign that businesses can't pass along higher costs of production.

Second, it results in lower revenue and, if it lasts for several years, cutbacks in production and employment. When people lose their jobs, they spend less, have trouble keeping up with their bills, and even lose their homes.

Third, deflation makes debt more expensive. As incomes and business profits decline, fixed-rate loans become an increasingly larger percentage of cash flow. Banks foreclose on mortgages, increasing the supply of homes and driving down all home values, and some businesses go into bankruptcy. Banks lend fewer loans because fewer borrowers can qualify. People who still have jobs start paying off debt more aggressively.

This further reduces demand for goods and services, and the economy enters a negative feedback loop, feeding negative growth and higher unemployment.

Deflation is one of the major causes of economic depressions. In the 13 years from 1927 through 1939, the U.S. experienced CPI deflation in eight years, with prices falling 8.9% in 1931, 10.3% in 1932, and 5.0% in 1933.

By comparison, during the Great Recession, we experienced only one year of very slight deflation, in 2009, when the CPI fell by 0.4%.

The Inflation Ideal: Low Single Digits

Is there an ideal rate of inflation? Economists suggest that a moderate rate of inflation — in the low-single digits — is optimal for sustained long-term growth. Indeed, the Federal Reserve Bank has said that an inflation rate of 2% is ideal.

Please call if you'd like to discuss this in more detail.

Federal Deficit

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financial health, and the lower this ratio's percentage, the better. Countries wishing to join the European Union, for example, had to have a ratio under 60%. The U.S. Bureau of Public Debt reported a debt-to-GDP ratio of 105% in 2017, though this is still much lower than the highest reported U.S. debt ratio of 122% in 1946.

How Does the National Debt Impact Individuals?

High national debt can have several negative impacts on the economy, including the following:

Lower wages. Investing in government debt translates to money not being invested in companies, which can lead to stumped economic growth and wages.

Higher interest rates. With each new deficit, the government needs to sell more Treasury securities to finance the debt. In order to make these securities more attractive to foreign investors, banks, and the general public, the government will often increase interest rates.

Standard of living inequality for future generations. Lower wages, slower job growth, and higher interest rates all spell hardship for upcoming generations who may have to survive on less or prolong retirement dates.

Looming crises. If deficits and national debt growth go unchecked, U.S. debt investors could very well demand higher returns, ultimately leading to an unprecedented financial crisis.

Ironically, many people pay more attention to the federal budget and national debt than they do their own personal finances. When scrutinizing deficits and debt at an individual level, it's important to understand that managing personal debt, coupled with a sound savings and investment plan, should be your highest priority. Please call to discuss your individual financial health.

Don't Underestimate Inflation in Retirement

Inflation has been tame for so long that it's easy to ignore when planning for retirement. However, even inflation of 2% or 3% per year, over a period of many years, can seriously erode the purchasing power of your funds. At 2.5% inflation, $1 today will be worth 78 cents in 10 years, 61 cents in 20 years, and 48 cents in 30 years. That can have a major impact on those entering retirement for several reasons:

- New retirees are less likely to have defined-benefit pensions. Thus, they must rely more on Social Security benefits and personal savings.
- While Social Security benefits are still adjusted for inflation based on the Consumer Price Index (CPI), the methodology for calculating the CPI changed dramatically in 1999, reducing increases in the CPI.
- Retirees are living longer. As life expectancies increase, retirees are spending more years in retirement, so their retirement savings are subject to the impact of inflation over a longer time period.
- Healthcare costs are becoming more of a burden to retirees. More and more companies are reducing benefits or eliminating healthcare insurance for retirees, and healthcare costs tend to increase faster than overall inflation.

To combat the effects of inflation on your retirement income, consider these tips:

- **Use a conservative inflation rate for planning purposes.** Since your retirement is likely to span decades, consider inflation over long time periods.
- **Consider investment alternatives likely to stay ahead of inflation.** Thus, a significant portion of your portfolio would probably be invested in stocks.
- **Invest in tax-advantaged investment vehicles.** Look into 401(k) plans, individual retirement accounts, and other retirement vehicles. While each has different rules for taxing contributions and earnings, all provide some tax-free or tax-deferred benefits. Since you aren't paying income taxes on earnings throughout the years, that typically means you'll have a larger balance at retirement than if you were paying taxes throughout the years. Thus, you'll start out with a larger retirement base to help combat inflation's effects.
- **Keep fixed expenses as low as possible.** Try to enter retirement with as little debt as possible. If you aren't using a significant portion of your income to pay a mortgage, car payment, or credit card debts, you'll have more flexibility to deal with higher prices.
- **Decide how you will deal with healthcare costs.** While Medicare will help once you turn age 65, it still does not cover many healthcare costs. Look into Medigap policies and prescription coverage to help with those non-covered expenditures, especially if your employer does not provide health insurance after retirement.
- **Minimize withdrawals from your retirement assets, especially during the early years of retirement.** To counter inflation, you need to withdraw larger and larger sums just to maintain the same purchasing power. To make sure you don't run out of funds late in life, keep withdrawals during the early years to a minimum.
- **Be prepared for change.** After retirement, keep a close eye on your investments. If inflation increases and you are concerned that increasing withdrawals may deplete your investments, you may want to look for ways to reduce your living expenses or go back to work at least part-time.

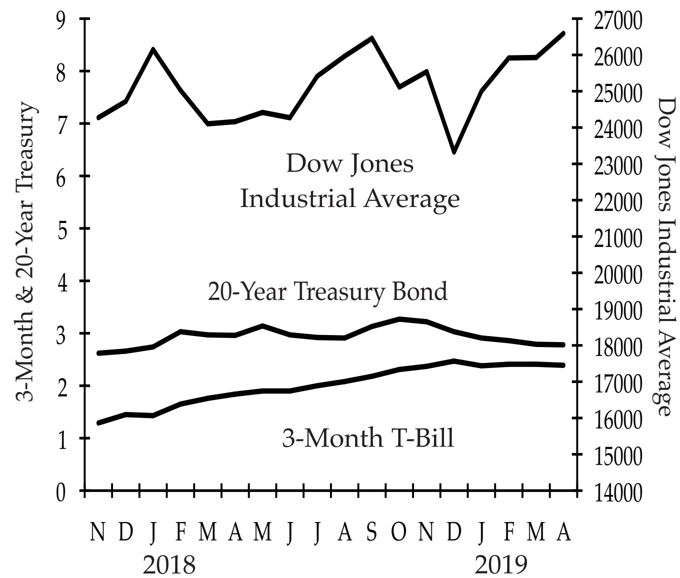
Business Data

Indicator	Feb-19	Mar-19	Apr-19	Dec-18	Apr-18
	Month-end				
Prime rate	5.50	5.50	5.50	5.50	4.75
3-month T-bill yield	2.41	2.41	2.39	2.47	1.84
10-year T-note yield	2.66	2.55	2.55	2.89	2.88
20-year T-bond yield	2.86	2.79	2.78	3.03	2.96
Dow Jones Corp.	4.08	3.74	3.74	4.40	3.88
GDP (adj. annual rate)#	+3.40	+2.20	+3.20	+2.20	+2.20

Indicator	Month-end			% Change	
	Feb-19	Mar-19	Apr-19	YTD	12-Mon.
Dow Jones Industrials	25916.00	25928.68	26592.91	14.0%	10.1%
Standard & Poor's 500	2784.49	2834.40	2945.83	17.5%	11.2%
Nasdaq Composite	7532.53	7729.32	8095.39	22.0%	14.6%
Gold	1319.15	1295.15	1282.30	0.1%	-2.4%
Unemployment rate@	4.00	3.80	3.80	2.7%	-7.3%
Consumer price index@	251.71	252.78	254.20	0.9%	1.8%

— 3rd, 4th, 1st quarter @ — Jan, Feb, Mar Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield
November 2017 to April 2019



News and Announcements

Why Isn't Inflation Zero Percent?

One of the main goals of the Federal Reserve is to maintain inflation at a reasonable rate, currently targeted at 2% annually. Inflation is costly, causing the economy to operate less efficiently, hampering economic growth, and reducing the standard of living. So, if the Fed is trying to control inflation, shouldn't they shoot for a zero percent inflation rate? The answer is probably no, for a number of reasons:

- Current measures of inflation are believed to overstate inflation, so low inflation rates may actually be close to zero percent.
- A reasonable level of inflation may help maintain employment, giving employers room to reduce labor costs when needed. While it is usually difficult for employers to lower wages, they can accomplish the same result by not increasing wages as much as inflation.
- Deflation is considered more costly than a reasonable level of inflation, so low levels of inflation can help insure against falling prices. One of the main costs of deflation is increased debt-servicing costs. Debtors must make debt-service payments with dollars that are increasing in value, making it more difficult to make payments.
- At low levels of inflation, nominal interest rates are close to zero percent. The preferred strategy used by the Federal Reserve to stimulate the economy is to lower short-term interest rates. Once short-term interest rates are at zero percent, the Fed must resort to other strategies to help stimulate the economy. Thus, the economy may be less stable when inflation rates are close to zero percent.

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