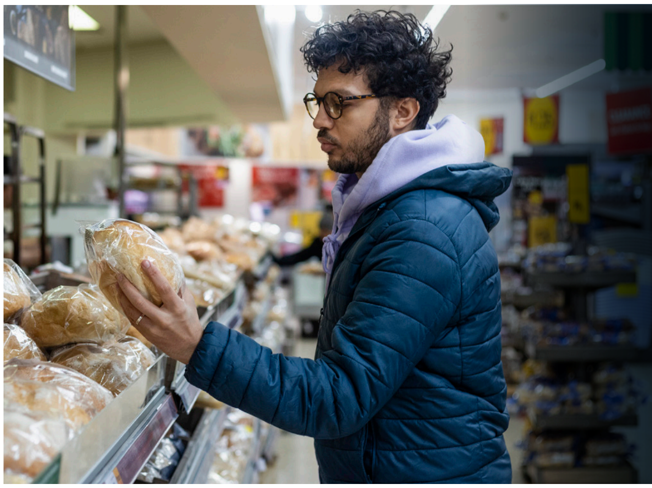
Risk & Insurance | Employee Benefits | Retirement & Private Wealth

Q&A: Gaining a Better Understanding of Inflation



Over the past year, price increases have grown out of pandemic-related shutdowns, supply chain disruptions, labor shortages, the war in Ukraine and a host of other influences. The Consumer Price Index (CPI), a key measure of inflation, reached a 40-year high in June of 2022, at 9.1%. The price of almost everything, including used cars, housing, gas and groceries have all been prominently affected.

The following are some general questions to help you better understand inflation, it's influence on the economy, and how it can affect your retirement planning efforts.

What is inflation?

Inflation is a loss of purchasing power over time. It means your dollar will not go as far tomorrow as it did today.

How is inflation measured?

There are several measures of inflation that investors can use to track inflation. In the U.S., the Consumer Price Index (CPI), which reflects retail prices of goods and services, including housing costs, transportation, and healthcare, is the most widely followed indicator.

What causes inflation?

There are many causes of inflation in our economy, but you should know two basic concepts. Cost-push inflation occurs when it costs a company more to provide a good or service – maybe due to an increase in the cost of raw materials – so they raise their prices to compensate. So higher costs push the price of the things we buy higher. Demand-pull inflation occurs when our desire to buy things — our demand — is greater than what companies can provide – their supply. Because something is in short supply, people are willing to pay more to get it. In this situation, we pull the price higher.

How does the government manage inflation?

At a high level, the Federal Reserve (the "Fed") can lower short-term rates, which encourages banks to borrow from a central bank and from each other, effectively increasing the money supply within the economy. Banks, in turn, make more loans to businesses and consumers, which stimulates spending and overall economic activity. As economic growth picks up, inflation generally increases. Raising short-term rates has the opposite effect: it discourages borrowing, decreases the money supply, slows economic activity and reduces inflation.

How can interest rate hikes affect my finances?

The Fed doesn't set interest rates on credit cards, mortgages, auto loans, and savings accounts, but its actions influence those rates. Here are three ways interest rate hikes can affect your finances and tips for managing it:

- **Credit Cards.** Most cards charge a variable rate that's tied to the bank's prime rate — the rate banks charge their best customers (many consumers pay an additional rate on top of prime, based on their credit profile.) Banks typically raise their prime rate quickly after the Fed boosts its key rate. Consider starting to pay down any balance before rates get much higher, focusing on the card with the highest rate first.
- **Mortgages.** If you have a fixed-rate mortgage, your monthly payments will stay the same. If you refinanced over the last few years and locked in a rate in the 2% to 3% range, that was really good timing. However, if you have an adjustable-rate mortgage (ARM), you may be faced with having to make larger payments, depending on the terms of your loan. If you have an ARM, budget for higher payments.
- **Auto Loans.** It's already more expensive to buy a new or used car, as their prices have increased dramatically over the last two years. This is due to a number of reasons that have resulted in supply not keeping up with demand. Unfortunately, if you're planning on financing the purchase of a vehicle in the near future, you'll need to add in the higher cost of borrowing. A sizable down payment will lower your monthly payments and could help secure a lower interest rate.

How does inflation affect my investments?

Your real rate of return is the return on your investment minus the inflation rate, and gives you a better sense of the purchasing power of the money you make from your investments. For example, if your investment portfolio earns an 8% rate of return in a particular year, and the inflation rate is currently 3%, your real rate of return is just 5%.

Equities have often been a good investment relative to inflation over the very long term, because companies can raise prices for their products when their costs increase in an inflationary environment. Higher prices may translate into higher earnings. When inflation rises suddenly or unexpectedly, it can heighten uncertainty about the economy, leading to lower earnings forecasts for companies and lower equity prices.

Conventional wisdom says you should consider keeping an appropriate amount of your retirement savings allocated to stock mutual funds to help offset inflation risk. Although past performance is no guarantee of future results, historical average stock returns have stayed ahead of inflation over the long term.

RPW-145-0722 (Exp. 07/24)