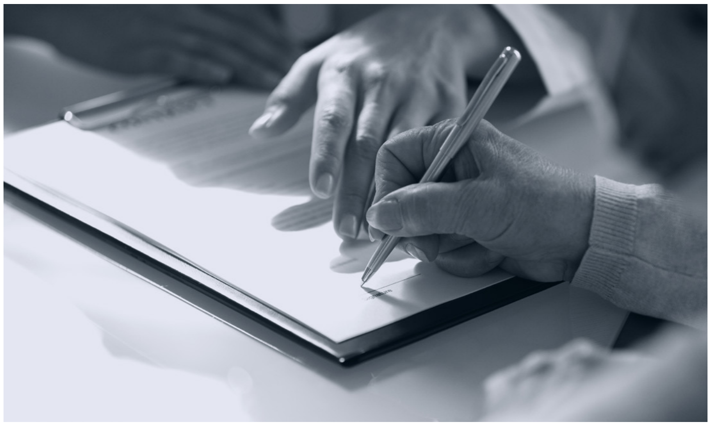
Retirement & Inflation

What To Know And How To Prepare

2024
Edition

In 2023, we saw a continuation of market turbulence, loosening of labor markets, and lighter inflation due to economic tightening from the Federal Reserve.[1] Compared to a couple of years ago, you may have noticed higher prices on the items you buy every week and may be wondering if we'll continue to see high inflation. Nobody can predict the future, so if you're nearing or in retirement, you should aim to protect yourself from the eroding effects of inflation. In this guide we'll look at:



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What Is Inflation?

Inflation signifies an increase in the cost of goods and services, which implies that the value of money decreases over time. This decrease in monetary value can be measured through the average surge in the prices of a chosen range of goods and services over a particular span of time. The escalating costs, usually represented as a percentage, indicate that a single unit of currency now buys less than it could in previous times. This phenomenon of inflation is the opposite of deflation, where the prices drop and purchasing power is enhanced.

The fundamental cause of inflation is a change in the amount of money circulating in an economy. This may manifest through various economic processes. Inflation can be induced by policy decisions made by monetary authorities such as central banks or by economic factors relating to the supply and demand of goods and services in an economy. Keep in mind that moderate inflation is commonly considered a sign of a stable, growing economy, and deflation may be a sign of overall stagnating growth. However, any large swings in inflation and deflation could be signs of economic instability.[2]

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The Effects Of Inflation In The Past

INFLATION IN THE PAST

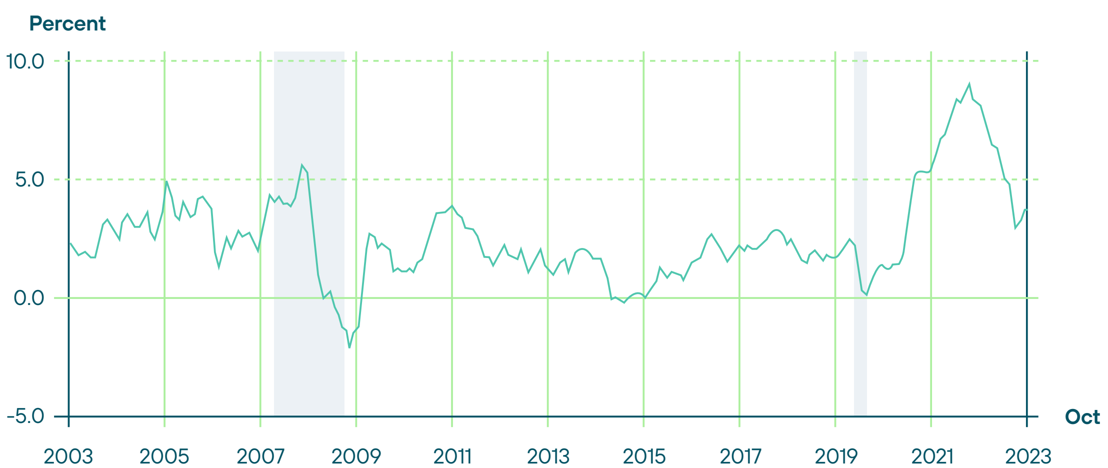
Americans saw double-digit inflation in the 1970s, leading to noticeable price increases. Since then, inflation remained low until it spiked in 2022 and came down slightly in 2023. Keep in mind that this doesn't mean prices came down; it simply means that the rate at which prices increased came down.[3]

COLAs can vary in size from year to year. 2024's COLA was 3.2%.[5] In 2021, the COLA was 1.3%, and the COLA adjustment has been as low as 0.3% for 2016 and even 0% for 2015. However, in 2023, the COLA was 8.7%.[6] Just as you should consider the long-term effects of inflation on your Social Security benefit, you should consider its effects on your other sources of retirement income and savings.

Consider this:
The Senior Citizens League estimates that the average Social Security benefit has lost just over a third of its buying power since 2000 because benefit increases have not kept up with the increasing cost of prescription drugs, food, and housing.[4] This is despite yearly Cost of Living Adjustments (COLAs) for Social Security benefits that are meant to help benefit amounts keep up with inflation.

Compare prices of common goods over the past 20 years:

12-month percentage change, Consumer Price Index, selected categories, not seasonally adjusted



Source: https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm

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How Inflation Is Managed By The Federal Reserve

HOW INFLATION IS MANAGED IN THE ECONOMY: AN OVERVIEW OF US FEDERAL RESERVE POLICY[8]

The Federal Reserve plays a major role in helping control inflation, but it's important to first understand how the Fed works and how it influences the economy.

The Federal Reserve's main goal is to balance the financial system that underpins our economy using a set of limited tools. These tools stimulate and contract the economy, helping keep it in balance.

- It can buy and sell securities from other banks to control the amount of money banks hold in reserve, influencing lending decisions made by those banks.
- It manages and oversees the production of money printed by the Treasury each year, directly influencing the money supply.
- It can share information, data, and—crucially for markets—forecasts with the public periodically.
- And most importantly, it can offer a unique type of loan with an interest rate, known as the discount rate, which is charged to banks for an ultra-short term to help them maintain liquidity levels overnight.[7]

Discount rate loans typically last no longer than 24 hours. Banks may lend to each other at rates of their choosing. Such rates are lower than the Fed's discount rate and are usually structured for longer periods. However, the Fed's discount rate is most accessible to banks during times of strife when liquidity is needed. This sets the tone for other lending activities as well. Discount rate loans are designed to be comprehensive loans to cover immediate liquidity requirements and last-resort loans to protect against insolvency.[9]

> **"The Federal Reserve's main goal is to balance the financial system that underpins our economy..."**

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All of these actions help control short-term interest rates charged or offered by banks, which in turn inform all rates on loans for different durations. You might see these rates on your mortgage or savings account, for example.

Because the Fed can see the full pipeline of effects they have on the economy, they set a target average rate for loans across the US economy, known as the Federal Funds Rate, which is what is commonly referred to when speaking about the general interest rate in the economy.

How Does This Help Control Inflation?

To understand how the Fed helps control inflation, it's important to first know what it really means to adjust the Federal Funds Rate and, thus, interest rates across the market.

- If the Fed raises rates, it increases the cost of borrowing, making both credit and investment loans more expensive.
  - This can be done to slow an overheated economy.
- If the Fed lowers rates, it makes borrowing cheaper, which encourages spending on credit and investment.
  - This can be done to help stimulate a stagnant economy.[7]

In recent history, inflation tends to occur when the economy is over-stimulated. In other cases, inflation may occur when there are supply shortages as well.[10] Therefore, given the information presented above, raising interest rates can help cool down price increases when the economy is over-stimulated. While this may dampen economic activity, it keeps economic changes more stable and predictable. Furthermore, it keeps people from having to greatly adjust their budgets each month to keep up with increasing prices. Price stability is important given that very high inflation could outpace wage growth quickly enough to cause people to struggle to cover their expenses.[11]

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The Current State Of Inflation

Increased spending from government economic policies, scarcity from supply chain disruptions raising the prices of goods, and oil price spikes due to the war in Ukraine are some of the many contributing factors to the inflation we've seen recently. However, a concept known as "inflation expectation" seems to be keeping the prices of certain goods and services elevated as well. The effect of inflation expectation simply means that such expectations are sometimes selffulfilling. When businesses know that consumers are expecting price increases and potentially budgeting for them, they may try to raise prices as high as possible and keep them that way, regardless of the internal costs of their business.[12] This can have varying levels of effectiveness for different products and industries.[13]

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The Current Federal Reserve Policy On Inflation

To counteract inflation, the Federal Reserve raised interest rates, making it more expensive to borrow money, tightening the economy, and, thus, introduced deflationary pressure on the dollar. As stated above, this fights inflation but at the risk of inducing an economic pullback[11, 3] Specifically, the Federal Reserve's target rate of inflation is 2%. So this means that they will continue to use the tools at their disposal, such as interest rate-increasing measures, to get average inflation down to 2%.[14]

Fears about high inflation could also cause volatility in the stock market, given that it indicates the health of the overall market and economy, as well as the effectiveness of measures used by the Fed to maintain a healthy economy. The triple threat of high inflation, increasing interest rates, and subsequent market volatility pose a particular set of threats to retirees aiming to protect their nest egg and make it last for the rest of their lives.

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How Could Inflation Affect You?

"After 10 years of 7% inflation, $1 million would be worth about half that amount: $508,350."

Many retirees cite inflation as a considerable fear in terms of their ability to cover their costs and achieve and maintain financial stability.[15] Simply put, inflation reduces the buying power of each dollar. We saw a 3.7% year-over-year inflation in August of 2023, a decrease from the 8.3% increase in August of 2022.[16]

To put this into perspective, let's say you're at a grocery store and you've purchased a carton of eggs for $1 in August of 2021. Then, you revisit that grocery store a year later in 2022. You'd find that a new carton of eggs would cost roughly $1.09, meaning your dollar won't stretch as far as it used to in covering your egg budget.

Now, let's say you come back to the store another year later in 2023. Prices have increased 3.7%—less than 8.3%, but still an increase. So, those eggs would now cost $1.13. Now, let's discuss an example that illustrates what inflation can do to a larger sum of money. After 10 years of 7% inflation, $1 million would be worth about half that amount: $508,350. After 20 years with a 2% inflation rate (the Fed's "target" interest rate), $1,000,000 would have the buying power of only $672,971.[14, 17]

Your retirement could last even longer than 20 years, so consider its cumulative effects on your nest egg!

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What Can You Do To Protect Yourself Against Inflation?

Recent economic and financial challenges might not be the last retirement roadblock you'll face. While inflation may be lower than last year, according to the data sourced, it's not impossible that inflation could return, especially if interest rates come down.[18] Remember, if rates remain relatively high, economic activity may stay relatively slower. As such, the overall stock market, as benchmarked by the S&P 500, may not see the level of returns it saw in the past decade or so. This could potentially have a direct impact on your financial situation.

Our goal is to help you find a balance and create an investment approach that fits your investment risk tolerance. This can include finding the right mix between stocks and bonds, exploring alternative investments, and quite possibly utilizing inflationprotected securities, such as:

- Inflation-Protected Annuities.
- Treasury Inflation-Protected Securities.
- Commodities and Precious Metals.
- High-Yield Savings Accounts & CDs.
- Blue Chip Equities and Bonds.

Understand that these are merely options one might consider, and the inclusion of these options is not intended as a suggestion to use any particular strategy or product mentioned.

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WHAT IS AN INFLATION-PROTECTED ANNUITY (IPA)?

An IPA is an annuity that offers a real rate of return at or above inflation.[19] In general, an annuity is an insurance-based financial product that accepts funds and then pays them back later in a stream of payments or a lump sum. An annuity can be thought of as the opposite of life insurance, which protects against the possibility of passing away too soon and leaving your loved ones to struggle financially. An annuity can help protect against outliving your money by providing guaranteed payments to you for life or a pre-determined amount of time. Deferred annuities include an accumulation phase in which the principal investment can earn interest before distributions begin.[20] There are many types of annuities that may be available to you, but they are complex products, and while they can be a perfect fit for one person, they may not be the right fit for everyone.

“An IPA is an annuity that offers a real rate of return at or above inflation.[19]”

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TREASURY INFLATION-PROTECTED SECURITIES (TIPS)

TIPS are treasury bonds with a unique structure to its interest return designed to factor in the rate of inflation. Treasury bonds (T-bonds) are government debt securities issued by the U.S. Federal government that have a maturity date. Until that maturity date, T-bonds earn periodic interest. At maturity, the owner of the bond is also paid back their principal investment. With TIPS, their interest rate matches the Consumer Price Index, which is the official indicator of inflation in the US. You may have access to these securities via mutual funds, through exchange-traded funds, or directly via the US Treasury.[21]

These securities are different from I Bonds, which have unique characteristics and limitations. Such limitations are that you may only purchase them directly from the US Treasury and may only purchase up to $10,000 worth of them. However, their inflation-protection function is the same; their rate tracks the CPI-reported inflation level.[22]

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COMMODITIES AND PRECIOUS METALS

Investments in commodities and precious metals have traditionally served as a hedge against inflation. Remember, inflation erodes the purchasing power of money, leading to an overall increase in the prices of goods and services. So, commodities such as water, oil, wheat, or other agricultural products tend to rise in value proportionately. So, instead of just being a buyer of these products, owning them as investments indirectly makes you an owner or potential seller of them as well. These assets may retain intrinsic value, unlike currency, and their price increases as the cost of production (labor, energy, etc.) rises with inflation. Access to these investments may be available through various funds.

Moreover, precious metals like gold and silver are often considered safe havens in turbulent economic times. During periods of inflation, investors may flock to these metals, driving up their prices. By investing in these assets, investors can potentially mitigate the impact of inflation on their portfolios. As the value of currency decreases, the relative worth of these tangible assets often increases, providing a protective buffer for investors.[23]

04

HIGH-YIELD SAVINGS ACCOUNTS & CDS

Investing in high-yield savings accounts can serve as an effective strategy to guard against the effects of inflation. These financial instruments have the potential to provide returns that outpace inflation, thus preserving the purchasing power of your savings. High-yield savings accounts offer an interest rate that is typically higher than that of regular savings accounts, which means your money grows at a faster rate. This higher interest rate can help offset the erosion of value that occurs due to inflation.[24]

CDs, on the other hand, offer a fixed interest rate over a specific duration, which can range from a few months to more than five years. The advantage of CDs is that they provide a guaranteed return, regardless of the fluctuations in the market. If rates are high to counter inflation, CDs may help protect against inflation. But because they are fixed return investment tools, if inflation and/or interest rates keep increasing, longer term CDs may lock in lower rates that don’t adequately fight inflation.[25]

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BLUE CHIPS EQUITIES AND BONDS

Blue-chip equities refer to shares in large, financially stable companies with a history of reliable performance. These organizations are typically leaders in their respective industries and have a track record of generating consistent revenue and profits. Although past performance doesn't indicate future results, due to their established position and robust financial health, blue-chip companies are often in a position to pass inflationary pressures onto their customers in the form of higher prices, thereby maintaining their profitability. In addition, these more stable companies could weather an economic pullback induced by inflation-fighting measures taken by the Fed. Furthermore, these companies often pay dividends to their shareholders, providing an additional source of income that can help counter the effects of inflation.[26]

As we've discussed, the Fed may raise interest rates during periods of high inflation. If that's the case, then bond rates will eventually rise along with all the other rates that the Fed aims to increase in order to combat inflation. From an investment perspective, that may mean that federal, municipal (state), and corporate bonds may start paying higher rates. This may be favorable, especially if increasing interest rates cause a pullback in economic activity and business growth, therefore dampening stock market returns.

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There's No One-Size-Fits-All Strategy For Protecting Against Inflation

We've only scratched the surface of what we could discuss regarding inflation, how it may affect you, and what strategies may be a part of your inflation-protection toolkit. The right strategy for outmaneuvering inflation depends on many factors and is unique to the individual, their market risk tolerance, income needs, and much more. There's no single, easy answer to how to beat inflation, but we can help you create a plan to help protect what you've earned and create reliable income in retirement. Schedule a complimentary meeting with the professionals at VestGen Wealth Partners to discuss your concerns and potential solutions.

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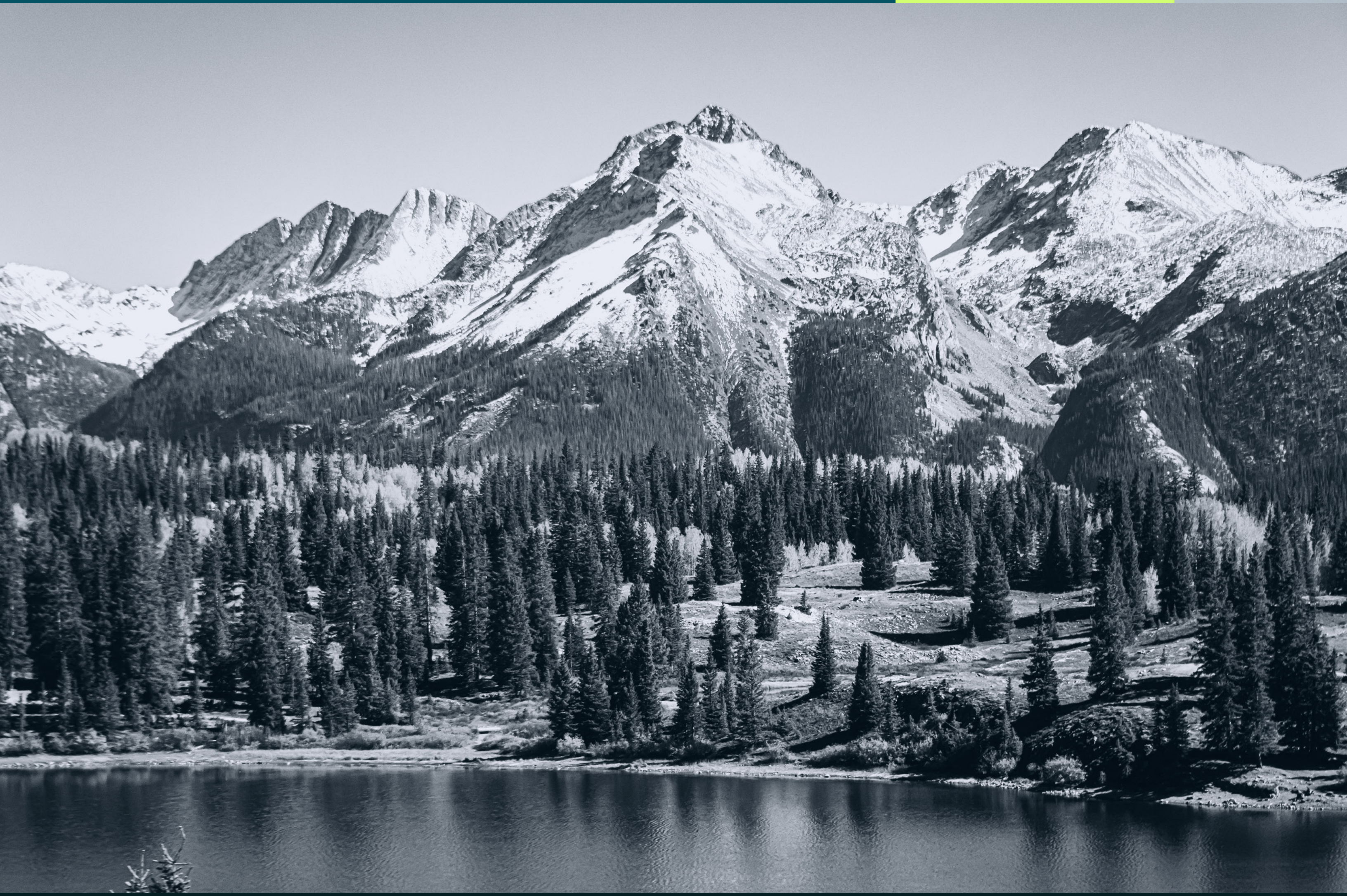

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