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The long tentacles of inflation

Measuring the impact across your entire financial life

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Inflation is the topic du jour—and rightly so, considering the Consumer Price Index (CPI) surged to 7.5% year-over-year in January. It marked the most significant gain since the early 1980s.

Everyone has an opinion: every talking head on cable television, corporate executive and expert podcaster. And opinions vary from "transitory, just needing a few tweaks to the economy" to "a worse position than in 2008."

In the face of uncharted waters, the tendency is to revisit prior bouts of inflation to try to guess its behavior. But this is 2022—at the tail end of a pandemic with significant disruptions aided by break-speed technology—not 1982.

While there is merit to examining past patterns for general guidelines, they should be viewed through the lens of this unique time.

And although most people think of inflation in terms of rising food and gas prices, it makes sense to consider how it can impact all other aspects of your financial life.

Cost of living
Beyond food and gas, inflation starts affecting your cost of living when it also raises the price of energy, housing, healthcare and the rest of your nondiscretionary expenses. Such increases are felt most by those on fixed incomes or with jobs with nonnegotiable salaries.

And unless you can tap into savings or increase your income (whether earned or passive), you may have to make decisions that lower your usual standard of living. For example, if buying essentials takes up more of your income, there may be less room for the discretionary expenses that improve quality of life.

Short periods of high inflation may be absorbed without much impact. But, as it prolongs, it affects more and more facets of the population.

Salaries
Unless your paycheck increased by at least this year's inflation rate, you took a pay cut in 2021.

Average raises are expected to return to pre-pandemic levels sometime in 2022—particularly in light of labor shortages in so many service sectors where employers pay hiring bonuses and premium wages. However, the January 2022 inflation report of 7.5% year-over-year indicates that such raises will be outpaced by inflation.

In fact, an April/May 2021 survey by the Conference Board reported that the 2021 median total US salary increase budgets were 3%, in keeping with the prior decade. And projections for 2022 were about the same, across all categories, including nonexempt hourly, nonexempt salaried, exempt and executive.[1]

So, unless you have salary-negotiating power, a bright light might be to change jobs. As ADP reports,[2] job switchers have seen the healthiest wage growth as employers struggle to find available workers. Their wage growth averaged 7.5% in the fourth quarter of 2021, compared with 4.7% in early 2021.

Employment
Inflation can increase demand for goods and services as consumers have more money in their pockets, in which case businesses can hire more employees to meet the new demand. But inflation can also erode demand for goods and services once consumers can no longer afford to purchase at inflated prices. Eventually, as uncertainty makes it harder for businesses to plan, they may decrease business investment and trigger lower growth and lower employment in the long term.

However, all the possible effects of inflation on employment have been overshadowed by the impact of the pandemic. Shutdowns led to lost jobs and business closures. Rounds of pandemic-related stimulus payments put excess money in consumers' hands. Lockdowns led to shifts in spending from travel and experiences to food, home goods and online purchases of products. In turn, that strong consumer demand has helped drive product shortages as the economy deals with supply chain issues and not enough people willing to work.

But that doesn't mean that persistently high inflation couldn't absorb the excess liquidity and eventually lower both demand and businesses' willingness to invest and hire.

Government benefits

Inflation may not be detrimental to workers whose salaries keep up with inflation's rate, but it is harmful to those living on a fixed income, such as Social Security. The government provides a cost of living adjustment (COLA) most years, but it rarely—if ever—meets or exceeds the level of inflation.

Each year, the nearly 70 million Americans receiving benefits through programs under the Social Security Administration hold their breath as they await the small increase through COLA. Not only will it not make up for the actual increased cost of their nondiscretionary expenses, but the amount is further reduced by the accompanying increase in the Medicare Part B premium that all those over age 65 must pay.

Beneficiaries receiving average or smaller checks are most affected by this combination. Here's why:

COLA is based on the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). One complaint is that it is a lagging indicator of inflation. That means beneficiaries' check amounts are corrected once a year, but only after they were behind for an entire year. So, COLA never quite makes them whole.

What else? The COLA for 2021 was 1.3%, which represented a $20 increase for the average Social Security check.[3] The 5.9% COLA for 2022 was unusually high and resulted in an average increase of $92.[4] Part B premium increased by $9.10 in 2021 and $21.60 in 2022, representing 46% and 23% of the COLA increase, respectively.[5] A net $11 or $70 per month will do little to cover the increased cost of home heating or prescription drugs.

As a result, those relying heavily on Social Security to fund their retirement fall further behind each year. Even those who have other resources are aware of the diminishing contribution made by Social Security over the years.

Debt

Fixed-rate debt holders make up one segment of the population that benefits from inflation. As the dollar loses value to inflation, the dollars spent to pay off your debt have less purchasing power than when you first borrowed the money.

This holds for all forms of debt that do not adjust to reflect inflation. This is most evident to Americans repaying the mortgages on their homes. For example, the 3.2% interest rates on 30-year-fixed mortgages at Christmas 2021 were already hitting 4% two months later.[6] Regardless of how high rates go, for 30 years, mortgage holders will pay smaller and smaller percentages of their income each year for housing, while the bank makes less and less on its investment.

Adjustable-rate debt is another story. For example, with adjustable-rate mortgages, the interest rates tend to keep up with or surpass inflation. And repaying the mortgage can be doubly strained if your income does not increase faster than the inflation rate.

So, if you plan to take out a loan in the near term, the ideal time is as inflation is on its way up, as it is now.

Savings

Inflation may be good for borrowers, but it isn't good for savers, particularly those who keep any money in cash. Unfortunately, it is virtually impossible to find a safe place to park cash where interest rates are high enough to hold value against inflation.

With retirement savings, unless you are close to retirement and would not have time to recuperate any unexpected losses, the bulk should be invested in areas that let you grow your money faster than inflation can reduce its value.

But near-retirement savings and savings that need to be liquid (such as emergency funds) should be kept in low-risk investments such as money market accounts, certificates of deposit (CDs) or online banks that offer higher-yield savings accounts. While you may not keep up with inflation, you will preserve some of the value while keeping your savings safe and readily available. Your goal is to get the highest real rate possible—that is, the nominal interest rate minus the inflation rate.

But inflation can hurt your savings even before retirement. For example, if you're saving for a house down payment or your children's college, the purchasing power of your money can drop if interest rates are not greater than inflation.

Housing
Higher inflation has been pushing up housing prices, but the shortage of available housing inventory has compounded the inflationary pressure. (The housing shortage grew out of construction delays during the pandemic and people holding off selling and moving during the lockdowns.)

While this pressure might make it easier to sell, it will not make it easier if you're planning to buy. However, if it is true that prices may be reaching their peak, this could be an ideal time to sell—especially if you are in less of a hurry to buy.

What might diminish the pressure on the housing market? One tool used to bring inflation into line is for the Federal Open Market Committee (FOMC) to raise the federal funds rate, thus increasing the rate banks pay to borrow the money they lend to you. And fewer people will be looking to buy as mortgage rates rise.

But what if you are not buying or selling, but only figuring the cost of owning and maintaining your own home? Inflation can cause you to spend far more on property taxes and repairs than you planned for.

Investment
Of the two kinds of investments—debt and equity—we've already looked at debt and shown that debt investments are not a great choice in a high-inflation environment. While beneficial to borrowers, you don't want to be the lender receiving a fixed interest rate that is lower than inflation.

Bonds and Treasury notes are fixed-income assets that pay out the same amount year after year. Investors like the fixed returns and safety of such instruments, especially Treasuries that the US government guarantees. However, like other forms of lending, if inflation outstrips the return on such assets, they lose their value.

Equities are a far better choice, especially since inflation does not necessarily mean below-average or negative returns. Far more critical is identifying sectors that hold up best under inflationary conditions.

In addition to inflation, markets are facing several disruptions, including rampant technological change, de-globalization, geopolitical threats and increasing demand for wealth redistribution and environmental responsibility.

But the uncertainty brought on by disruptions also brings tremendous opportunities to those able to identify early entrants with solutions to those challenges. Moreover, capturing such growth can quickly reverse the negative impact of inflation.

Retirement planning
Inflation is always part of any retirement planning calculation. It can influence investment strategies during the "accumulation" phase. But it will undoubtedly be part of the "spending" phase calculations as you plan how to fund decades of successful retirement living.

What is more challenging is to determine what figures to use for inflation. Over the past few years, 2% would have been a fair guess. But the January 2022 report of 7.5% has added to the financial challenge pre-retirees and retirees face as they plan to finance 20 or 30 years of their desired lifestyle in retirement.

Inflation can create winners and losers depending on how retirement plans are designed. We've seen that investors, debtors and in-demand wage earners tend to benefit from it. Savers, creditors and those on fixed incomes do not. But what about pensions, insurances and other components of your plan? Are they fixed, or do they have inflation riders?

The planning process can be complex even without high inflation. But whether substantial inflation is with us for the short or long term, calling on expert advice for a review makes more sense than ever.

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[1] *https://www.conference-board.org/research/US-Salary-Increase-Budgets/US-salary-increase-budgets-2022.*
[2] *https://workforcereport.adp.com.*
[3] *https://www.ssa.gov/news/press/factsheets/colafacts2021.pdf.*
[4] *https://www.ssa.gov/news/press/factsheets/colafacts2022.pdf.*
[5] *https://www.cms.gov/newsroom/fact-sheets/2022-medicare-parts-b-premiums-and-deductibles2022-medicare-part-d-income-related-monthly-adjustment.*
[6] *https://www.bankrate.com/mortgages/30-year-mortgage-rates/?mortgageType=Purchase&purchaseLoanTerms=30yr.*

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