Whatâ??s so Bad about Inflation?

Meanwhile, the prices of stocks and real estate have risen to new heights, thanks to the Federal Reserveâ??s easy money policies and government stimulus checks. Interest rates have ticked up slightlyâ??from historical lowsâ??further adding to inflation anxiety.

Zero Sum

Inflation is a complicated thing and, like most things macroeconomic, tends to be a *zero-sum game* â??where one person wins only at the expense of causing someone else to lose.

Rising wages benefit workersâ??especially workers in industries hard hit by the pandemic and workers who have not seen meaningful wage increases in recent years. This, of course, means that consumers pay more for the goods and services they consume. Meanwhile, rising real estate prices are good for homeowners, but rising rents put pressure on rentersâ?? household budgets. And rising interest rates generate more interest income for savers, but borrowers pay more on their mortgages, credit cards, and car loans.

Whether inflation is a good thing or a bad thing for you really depends on your specific facts. And the complexity of the equation for your household makes it difficult to predict the impact.

Times They Are A-Changinâ??

Over the past decade, interest rates have been stuck at historically low levels. In fact, along the way, fears of deflation and negative interest rates repeatedly made the headlines, and policy makers wondered what it would take to get back to a healthy level of inflation.

Along the way, investors, including many nearing or in retirement, struggled to generate income from their portfolios. They were forced to accept lower returnsâ??at least on the fixed income portions of their portfoliosâ??or take more risk to achieve their goals. Thankfully, those who took more risk by investing in stocks were handsomely rewarded (despite a few white-knuckle moments along the way).

Further, while the low-rate environment created income challenges for retirees, they benefited from low inflation during this period. So, even as they shifted to stocks and other riskier investments that generated higher returns, the cost of living barely budged, allowing standards of living to rise. According to Morningstar, a simple portfolio of 45 percent U.S. stocks, 15 percent international stocks, and 40 percent bonds, rebalanced quarterly (fees and taxes aside), would have returned more than 8.8 percent over the decade from 2011 to 2020 while inflation ticked up at a mere 1.73 percent.

Now, it seems that we are entering a new chapter. As inflation and interest rates creep higher, bonds and other fixed-income investments may, at some point, become more appealing. (This, of course, assumes we donâ??t see a rapid rise or a dramatic spike in rates.) Thatâ??s certainly good news for investors, but they should be careful to consider their financial plans before they make any hasty moves.

Out of the Frying Pan

As we sit on the verge of a potentially new and higher inflation regime, itâ??s important to understand two cognitive biases that become more relevant.

Money illusion is the name for a bias that describes humansâ?? tendency to think about their wealth and income in nominal dollarsâ??todayâ??s valueâ??rather than real dollars that include the impact of inflation on tomorrowâ??s purchasing power. The money illusion anchors us to the value of money today and makes it hard for us to grasp, for example, what $100,000 of income will buy us in 10 years. At a 2 percent inflation rate that $100,000 will have only $83,400 of purchasing power in 2031. At 3 percent inflation, that number shrinks to $76,000.

*Exponential*â??*growth* bias is our tendency undervalue the effects of compound interest. For investments, this means we tend to underestimate future values. For inflation, it means that we overestimate the value of our purchasing power of our savings. Because we are very bad at these calculations, our errors can be massive, especially over long periods of time or at high rates. And, of course, a financial plan for a couple age 65 retiring today should anticipate 30 years of income in retirement. That qualifies as a long period of time.

While these two biases may sound similar, they are recognized as separate behaviors, and, unchecked, they could lead to a big underestimation of the savings needed to fund long-term goalsâ??or an overestimation of your future purchasing power.

One simple way to help overcome these biases and better understand inflationâ??s impact on your money is the *rule of 72*. Divide 72 by the annual inflation rate. The resulting number is how many

years it will take to cut your purchasing power in half. For example, at a 3 percent sustained inflation rate, your purchasing power will be cut in half in 24 years compared to 41 years based on the 1.73 percent average inflation rate we experienced during the 10 years before the COVID-19 pandemic. Thatâ??s a pretty dramatic change for a relatively small inflation uptick.

A Change (Would Do You Good)

Thankfully, the creeping nature of inflation means that you have time to address the risks and plan accordingly. Here are a few tips to help make sure that your financial plan remains on solid ground, whatever the future might hold for inflation.

- **Revisit your plan.** It is wise to update your financial plan every three to five yearsâ??or more often in the event of a significant change to your financial picture or the market environment. Should we determine that the recent surge of inflation will stick around, you should contact your advisor to update your financials and rerun your plan to help ensure that it still makes sense.
- **Do a shock test.** As boxer Mike Tyson famously said, â??Everyone has a plan until they get punched in the mouth.â?• Make sure your plan includes multiple scenarios, including extreme inflation scenarios, living to 100 (or older!), or a significant market sell-off during retirementâ??whatever you need to test to make sure youâ??re going to sleep at night.
- **Reserve the right to reassess.** Financial planning is not a set-it-and-forget-it endeavor. Itâ??s an iterative process, and you can adapt along the way, as needed. If you determine that rising inflation creates risk for your plan, you may decide to work a few more years, save a little more, spend a little less, or accept the risk, knowing that you can take another look in a year or two.

At present, it is difficult to know how the recent rise in inflation will play out. We may just be experiencing a short-term bout of inflation. Or this may be the beginning of something longer-term. Perhaps we will encounter a mixed scenario, where we see sustained price increases in some areas of the economy while others abate.

Regardless, with a solid plan in placeâ??and the ability to adjust, as needed, to conditionsâ??you will be well on the road toward your long-term financial goals.

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