financial fitness

By Erik Ford

# It's Back

For a number of reasons, we have enjoyed a relatively long period of low-to-mild inflation. That has come to an abrupt halt of late and it is important to factor that into our planning.

While we enjoy and plan for low-to-mild inflation, we can make our future plans with a level of confidence. Things may cost more in nominal terms in the future, but the growth of future expenses with mild inflation is manageable and easy to comprehend. We have more confidence in our decisions. The economy is stable as businesses and investors feel more confident about the future and their own planning. Consumers benefit by not facing purchasing decisions with sharply rising prices outpacing income growth.

The consumer price index (CPI) hit an annual rate of 7% for the month of December 2021, having steadily risen through the year from a 1.4% reading in January 2021. The reading in December produced a year-over-year CPI of 4.8%, which will only increase if the high levels experienced in the last half of 2021 persist. For perspective, we have not seen a year-over-year CPI increase of more than 3.4% since 2008. Since then, we have experienced levels below 3% and extended periods below 2%. We have not seen monthly levels like late 2021 since 1990 and the fear of seeing double-digit inflation like the late '70s and early '80s is valid.

What does this mean for us and our planning? As we look at our financial future and retirement or education planning, we will have to buy things with future dollars. For example, at 2.0% inflation, it will require $74,300 to purchase in 20 years what we can buy for $50,000 today. At a 5% inflation rate, it will require $132,700 to buy today's $50,000 in 20 years. As you can see, that is a considerable difference in nominal dollars and can play havoc with our planning and investment decisions. We count on the power of compounding to increase the real value of our assets over time, but with high inflation, that same mathematical magic works against us.

How we arrived at our current level of inflation is a subject of debate, but enormous government spending funded by created money, supply chain disruptions and a sharp increase in energy costs are all candidates and likely all contributed to an extent (Fed-created money is my leading candidate). The outlook is difficult to predict. Whether we will return to lower levels soon or it takes a longer period to bring inflation down can make a big difference in the impact on our planning assumptions and investment strategy. Some of us are old enough to remember the sharp recession that was required to arrest the high inflation of the 1980s. We must hope this is not required this time around.

As you construct and review your financial plans in this uncertain environment, it is wise to look at more extreme assumptions than you may have previously. The planning needs to incorporate larger swings in inflation assumptions and make sure your investment return assumptions are consistent with your inflation and allocation assumptions. As the planning environment becomes more complex, working with an experienced planner can be helpful and reassuring. We should never take our planning lightly, but in a variable and uncertain environment, we should be even more focused.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. It is compiled by the U.S. Bureau of Labor Statistics.

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