6 Important Questions to Understand Inflation

As the news media coverage of “meme stocks” and cryptocurrencies have waned, another story has inevitably taken its place. So, what is the financial story du jour?

It seems like *inflation* is grabbing many of the headlines these days. I want to share a few thoughts on inflation to help my readers digest information in the upcoming news cycle.

Q: What is inflation?

A: In its simplest form, inflation is the devaluation of purchasing power. That means the same amount of money buys less when inflation is present, over time.

How about an example…

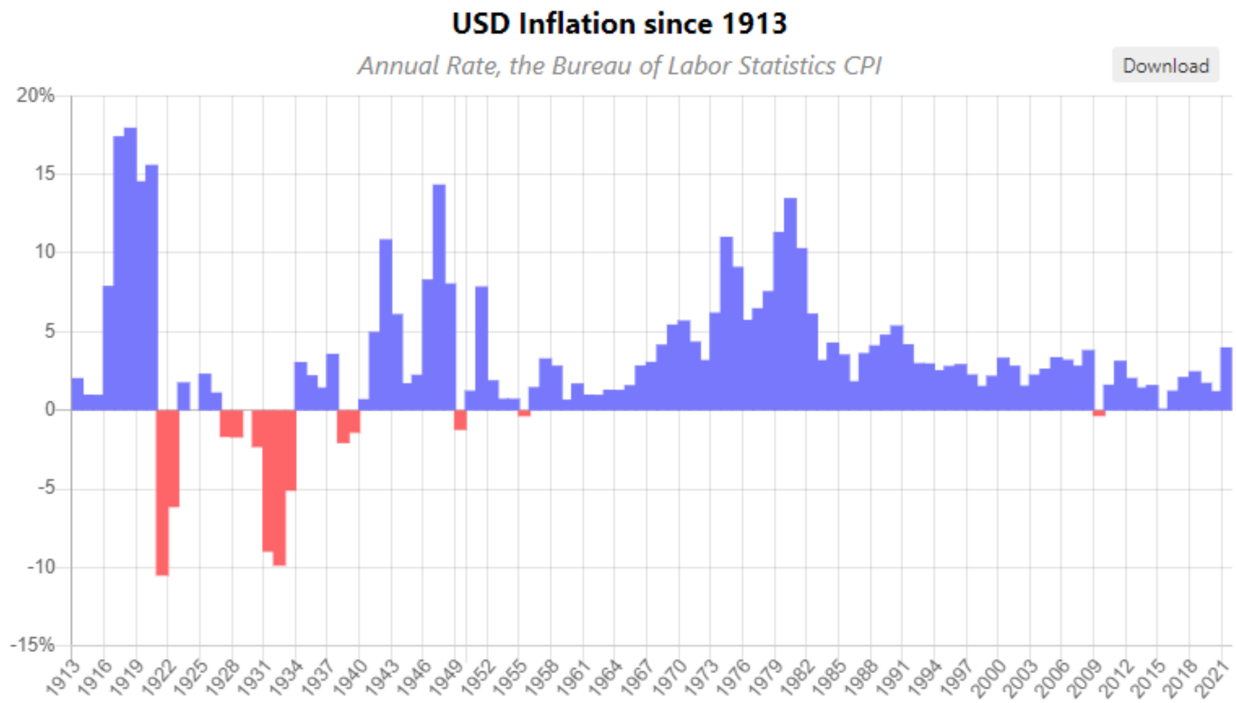
Cost of a Gallon of Milk

1961	You are 35 years old and for the first time you are able to save a little money. You have $0.36 that would buy you a gallon of milk but you put it under your mattress instead, in case you need to buy milk in the future.	$.36
1991	30 years later you retire at age 65 and decide to finally cash in your old milk money. You go to the store and find it will only buy you about 1/3rd of a gallon now. Frustrated, you put the $0.36 under your mattress for the future. Maybe prices will drop!	$1.05
2021	Now age 95, your health is starting to fade. Your grandkids come to visit and you ask them to go to the store to grab some milk. You take out the $0.36 and when they get to the store they realize it will only buy about 1/10th of a gallon!	$3.68

This is a prime example of why mattress money is eroded viciously by inflation. Inflation is one of the most constant headwinds faced by investors. Over time money buys less and the only way to keep pace is to grow your funds at a rate of inflation plus real (after inflation) growth requirements.

Q: What is normal inflation?

A: Inflation varies significantly over time but in the last 60 years it has averaged approximately 3.70% per year. Some years are much more inflationary than others.



https://www.officialdata.org/us/inflation/2019?endYear=1980&%2525252525252525253Bamount

Q: What is the worst-case scenario for inflation?

In 1980 the inflation rate was 13.50%, which was the highest since 1947. This was considered "runaway inflation" by many.

From the mid 70's until 1982 we had higher than normal inflation but by 1983 it dropped to 3.21% and never raised to higher than 5.4% since.

By international standard, even the '70's-80's in America were very tame. In 2021 Venezuela's inflation rate is 9,986%. The worst hyperinflation ever? Post-WWII Hungary. Prices doubled every 14.82 **HOURS.**

Q: How much is inflation in America now?

Since 2009 inflation has been very low. In fact, in 2009 we had "deflation" which is essentially the opposite of inflation. Without going into all the details, many economists view a modest amount of deflation as be more dangerous than a large amount of inflation. We definitely don't want that.

Current inflation expectations, according to the University of Michigan, is 4.60%. While this is higher than we have seen since 1990, it is still a long way from what is considered runaway inflation and nowhere near hyperinflation which requires a 50% monthly inflation rate.

Q: Will it get worse?

Maybe.

There are plenty of sources of inflationary pressure right now. Here are a few…

The "dovish" Fed is keen to keep interest rates low and has acknowledged publicly that it was OK with inflation if post-pandemic unemployment was improving. They have recently moved up their expectations for raising interest rates from 2024 to 2023 which is positive for anyone worried about inflation.

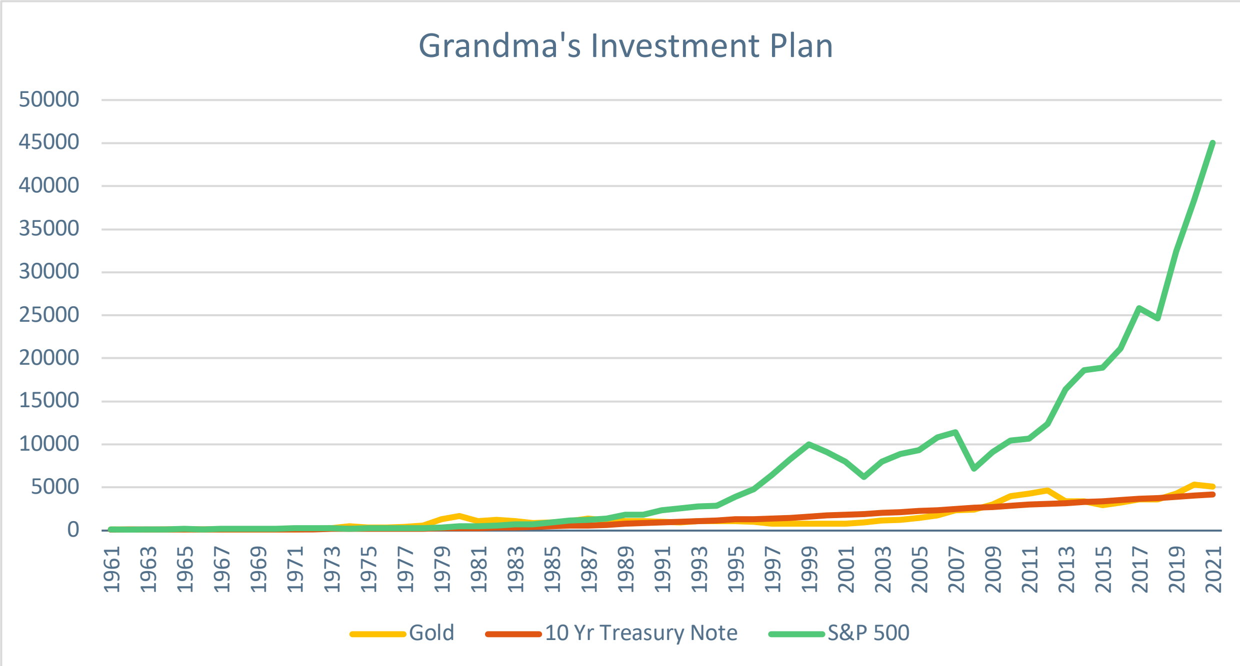
The federal government continues to print money. In fact, as I highlighted in the year-end wrap up Pathfinder newsletter, since January 1, 2020, our M2 money supply has increased by over 30%. In case you were wondering, this has occurred under both our current and previous Presidents. Economists say that this money has "low velocity" which essentially means it is sitting in banks rather than rippling through the economy. That is a good thing for inflation not taking off as long as it remains true.

Ultimately, no one (even economists) knows for sure. As always, panicking isn't the answer. We will likely see more inflation in the next 10 years than the last, but even that isn't a guarantee. It is much more likely that the media will sensationalize whatever inflation there is with warnings of it getting worse than it ever will. Thankfully, there are prudent solutions, and they are baked into normal portfolios.

Q: What can I do about inflation?

There are a few ways to protect against inflation. Some are more popular than others but that doesn't necessarily make them more effective.

Let's go back to 1961 and your VERY generous grandmother decided to gift you $300 ($2,700 in today's dollars, AKA after inflation). Your grandmother was smart and told you that you had to spread your money evenly across 3 different asset classes and you couldn't park it under your mattress. You decide to put $100 into the following investments. Gold, 10 Year Treasury Notes (with reinvested interest at initial rates, rolled at maturity) and the S&P500 with reinvested dividends. Now you are 95 and ready to make the same gift to your sole heir. How much do you give them?



2021 values based on $100 invested in 1961:

Gold: $5,100.30

10 Year Treasury Bonds: $4,193.70

S&P500: $45,031.00

In total, with Grandma's help you managed to turn $300 into **$54,325**. Put differently, you went from being able to buy 833 gallons of milk to 14,762 gallons.

Gold is normally one of the first places investors turn when they are afraid of inflation. In reality, over the long-term it performed virtually the same as bonds with much more risk. It reached a peak of $594.90 in 1980, as inflation concerns were getting off the ground and in the following year, with inflation still raging, it dropped to $400. It wouldn't return to the $594.90 value for 25 years. This means there is a very real possibility that someone that invested in gold and held it never got their value back. Not to mention the impact of inflation on that initial purchase.

There are occasional times where gold prices spike based on fear, but the timing can be exceptionally dangerous when the economic winds shift.

The clear winner for inflation protection over the long-term has been stocks, shown here as the S&P500. Therefore, investments in stocks are the cornerstone of investment portfolios for individuals and institutions. Buying and holding for decades has created a tremendous amount of value.

And you don't need to buy GameStop stock to achieve these long-term returns.

When you read about the impending inflation wave that is about to crash upon us, remember that you have been planning for this at least as long as you have been investing in stocks.