Your 2021 Inflation Guide

October 20, 2021

The third quarter turned in our first disappointment since the pandemic lows about a year and a half ago. Despite declining 4.8% in September[1], the S&P 500 is still up handsomely on the year. This is amidst a seemingly endless onslaught of downright depressing news and current events. As I'm writing this, the government has managed to avoid a debt-ceiling disaster, which I'm sure eases a few worried minds. But of course, there are myriad other crises to be concerned with. It's like playing whack-a-mole. One mole that has popped back up a few times is inflation.

I thought about copying and pasting last quarter's commentary on inflation here as it's all still relevant today. But, I'll come up with some new material.

It's probably appropriate to say that inflation has in fact arrived. Three months ago, we had seen the one-month uptick, but that's now been sustained for the past three months. If it's any consolation, Social Security Benefits for 2022 will increase by 5.9%, the greatest single year adjustment in 40 years[2].
The chart below illustrates the rate of inflation (annualized) on a month-by-month basis.

Source: US Bureau of Labor Statistics, compiled data as of 9/1/2021.

Now, that line probably looks scary, but keep in mind we're looking at just four months-worth of ~5% inflation. As we discussed last quarter, our comparison point (what that 5% growth is *on*) is also clear on that graph where we experienced sub-1% inflation. Several months, or a year, or even a little bit longer than a year of elevated inflation probably won't be a big deal to most consumers. It's what we call

transitory inflation. This is different from sustained inflation that was experienced in the Great Depression and the 1970s.
So, the real concern is whether the spike we're seeing now is a transitory jump or the beginning of a sustained dark age.

I had originally written about guidance from both the Federal Reserve and the Biden Administration suggesting supply chain bottlenecks, a pandemic-recovery labor market tightening, and federal stimulus being the culprit for the uptick we've seen so far. All of which are likely to be temporary in nature. But those sources invite both partisanship and anti-Fed leanings that might color the acceptance of such rationales. However, there's a simpler and more impartial way we can get a sense of what long-term inflation might be.

We can instead use markets and their billions of global participants each effectively casting their cumulative expectations on inflation. By comparing regular Treasury bond yields with TIPS (Treasury Inflation Protected Securities) yields, we can see what the equilibrium inflation expectation is today. First, a quick primer on the difference between the two types of bonds. A regular Treasury note purchased with a face value of $10,000 will return to the investor $10,000 when it matures. A TIPS bond purchased with a face value of $10,000 will return some amount higher based on what inflation does over the course of the issuance. For example, if cumulative inflation over the life of a TIPS is 30%, then the bond would return the holder $13,000.

So, if we look at the difference in the yields on the two types of bonds for a given maturity date, we can see what the market, in aggregate, expects inflation to be over that period. As of the first week of October, the spread on the five-year bonds is 2.51% and the spread on the ten-year bonds is 2.38%3. What that tells us is that over the next 5-10 year period, the market expects inflation to be somewhere between 2.38 – 2.51%.

Now, this is merely a prediction. The actual inflation we will experience over the next 5-10 years will almost certainly be some amount higher or lower. But this is everyone's best guess based on all the information we know about the world and economy today. That information *includes* the spike in inflation we've already seen, as well as the forces exerting an influence on inflation like supply chain bottlenecks and "money printing". If it were obvious that inflation was set to be higher over the next 5-10 years, then there would be a tremendous, easy profit to be made by investing in TIPS. Smart, aggressive market participants would take advantage of that opportunity and drive up the price of TIPS, increasing the spread between TIPS and Treasuries, thereby giving us a higher expectation of inflation. But that isn't happening because the market has settled on that low-2% figure as being the *midpoint* expectation for the future.

As planners, we are acutely aware of the threat that inflation can have on the ability of our clients to accomplish their goals with a high degree of confidence. Generally, in our financial planning projections, we have used a long-term inflation expectation of 3% with selected increased carve-outs for things like healthcare and education. We believe that is a relatively conservative assumption when keeping in mind

that the Federal Reserve's long-term target for inflation is 2%4 and actual inflation since 1990 has been 2.4%5. Still, for clients that have expressed concerns over how inflation may affect their ability to accomplish goals, we have explored the effects of 3.5% inflation.

If the threat of inflation keeps you up at night, let's have a conversation and see what that may mean for you, specifically.

1 Source: Morningstar. Data as of 9/30/21.

2 Stein, Jeff. "Social Security benefits to rise 5.9 percent for roughly 70 million people in 2022." The Washington Post. 10/13/2021.

3 Source: Us Department of Treasury. Data as of 10/1/2021.

4 "Why does the Federal Reserve aim for inflation of 2 percent over the longer run?". US Federal Reserve. https://www.federalreserve.gov/faqs/economy_14400.htm. Accessed 10/11/2021.

5 Source: St. Louis Federal Reserve (FRED). Data as of 9/1/2021.

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