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Monthly Insight

Inflation: Is It Time to Worry?

Since the 2008 financial crisis that led to the Great Recession, the US Federal Reserve has targeted a 2% annual rate of inflation as the “Goldilocks zone”: not too high, not too low—just right. Using the tools at their disposal—primarily, control over the money supply and short-term interest rates—the Fed has tried to calibrate the world’s largest economy in such a way that inflation, defined as an increase in the cost of goods and services and an inverse decrease in the purchasing power of the underlying currency, remains in a narrow range that the US central bank considers healthy.

Why would decreasing a currency's purchasing power be considered healthy? Well, according to most economists, it's because as long as inflation remains modest, it encourages consumers to spend their money today, when it buys more, rather than hoarding it, which could restrict the flow of money through the economy and have negative results. This also has implications for investors, especially those who are planning for long-term goals such as retirement. Over a long period of time, if inflation isn't taken into account, investors can find themselves holding dollars with much lower purchasing power than they need to meet their needs. This is why it's important to consider the anticipated growth rate of your portfolio; if the growth rate over time is insufficient to stay ahead of inflation, you're less likely to have the necessary resources in the future. For example, I have a friend who remembers buying gasoline in 1972 at 36 cents per gallon. How far do you think he could travel today if he still allocated his gasoline budget at 1972 levels?

Too much inflation, however, can be just as devastating for an economy as too little. This is because it drives the price of basic goods and services beyond the reach of businesses and individual consumers, which can cause an entire economy to crash. Many of us learned in history classes about the devastating effects of hyperinflation on the post-WWI German economy, including stories about needing a wheelbarrow full of currency to buy a loaf of bread. More recently, the economy of Venezuela fell apart because of an inflation rate of a million percent per month. Hordes of citizens fled the country, as basic daily living needs became impossible to meet. So, when inflation is perceived to be rising at a faster rate than desired, it is typically negative for stock prices, due to the implications for the economy.

These days, the stock market has generally been in an almost-unprecedented state of ascent since the pandemic lows of spring 2020. But recently investors have been noticing intermittent pullbacks, largely in response to the perception of increasing inflation in the US economy, combined with talk of Fed tightening (raising short-term

rates and decreasing money supply in an effort to curb inflationary tendencies). Keep in mind that the massive amounts of liquidity pumped into the economy by the Fed during the pandemic crisis was a large factor in the swift recovery of the markets after the economic shutdown in Spring 2020. Any reverses in the Fed's attitude toward that liquidity (i.e., tightening), will likely be interpreted by the financial markets as a response to inflation that is creeping out of the “Goldilocks zone,” and the market’s way of factoring in that possibility is a decrease in share prices. For example, the S&P 500 closed at 4,246 on June 15, 2021. The next day, after Fed officials signaled that they might begin raising short-term interest rates a bit sooner than many analysts had expected, the index closed at around 4,000, down 0.5%. Keep in mind that short-term rates have been hovering at barely above zero since March 2020. The Fed is talking about allowing rates to rise to perhaps 0.6% by the end of 2023. But because analysts were expecting rates to remain near current levels until sometime in 2024, the remarks from the Fed were interpreted as concern about inflation, with the associated effect on stock prices.

So, what does this mean for the average investor? Is inflation about to rage out of control? Should we all start buying gold? Fed Chairman Jerome Powell has stated that the US economic recovery remains strong, bolstered largely by the number of Americans who are now vaccinated and able to return to work with reduced fears of contracting COVID-19. “We are on a path to a very strong labor market here,” Powell stated, and the Fed believes unemployment will fall to a national rate of around 4.5% during 2021. Powell also mentioned that at some point, the Fed may slow its purchases of government-backed debt, thus tapping the brakes on the liquidity it has been pumping into the money supply.

But some analysts believe the Fed is operating “behind the curve.” Mohammed El-Erian, chief economic advisor for international financial service provider Allianz SE, stated in a recent Bloomberg column that he believes the Fed is placing too much confidence in the “transitory” nature of inflation presently, given the massive amounts of

liquidity it has injected into the economy—liquidity that is chasing relatively scarce goods and services. Remember, when goods and services are in shorter supply—and thus more valuable—than money, that is the definition of inflation.

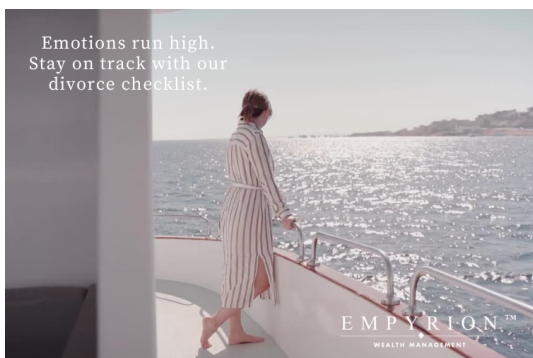
For investors who want to be proactive on inflation, it will be important to take measures to hedge their portfolios. These might include shortening the maturities on fixed-income holdings, moving from longer durations toward the 3–5-year range, or even the 1–3-year range, in order to take advantage of higher coupon rates when interest rates begin rising. [I also wrote recently](#) about the inflation protection provided by the US Treasury I-Series bonds, which re-adjust their interest rate every six months in step with the Consumer Price Index (CPI), a principal government measure of inflation. An example of a fund following this fixed-income strategy is the Short Duration Real Return ([DFAIX](#)) fund from Dimensional Funds. For equity holdings, mutual funds and exchange-traded funds (ETFs) that provide inflation protection, such as those invested in financial stocks, utilities, basic energy materials, and telecommunications (for example, ProShares Equities for Rising Rates ETF, [EQRR](#)) could become important for maintaining value and growth in the face of higher inflation.

Ultimately, history and research demonstrate that clients who maintain a well-diversified portfolio that conforms to their risk tolerance and investment goals, and who are disciplined about rebalancing the portfolio to stay within strategic guidelines, will do well over the long term. As a fiduciary financial advisor and wealth manager, my job is to put my clients' needs first in every recommendation and decision. To learn more about making smart investment decisions, click [here](#) to download my white paper, “The Informed Investor.”

Stay Diversified, Stay YOUR Course!

SOCIAL MEDIA DIGEST

In case you missed them, here is a roundup of my latest posts on social media:



When you are going through the wrenching emotions of a #divorce, it's hard to think straight about financial matters. But important steps should be followed before and after the divorce to ensure that the division of assets is fair to everyone. Take advantage of our #divorcechecklist to help stay on track.



Will you have to make a required minimum distribution this year? This week on KTXL FOX40 News, I discuss some of the rules and changes regarding RMDs. If you're 72 or about to turn 72, it's especially important for you to stay on top of these rules to avoid paying hefty penalties.

Planning a trip with your grandchildren can give you invaluable bonding time with these



precious youngsters. Today on the blog, I'm sharing tips and key considerations for grandparents taking their grandkids on vacation. #familytravel



In my guest article for Advisor Perspectives, I explain how harnessing the power of local recognition and brand awareness can lead to consumer acceptance. Here are several ways you can make yourself a household name in your area without throwing thousands of dollars at an advertising budget.



KIMBERLY FOSS

President, CFP[®], CPWA[®],
CFT-I[™] Candidate

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