

# It May Be Time to Think About Inflation Again

New signals suggest that inflation could reawaken as a financial concern.

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If you have not been factoring inflation potential into your financial strategy, now could be a good time to start. Inflation does remain low and inflation risk has been minimal for years. But there are signs that the inflation climate could be about to change. Among those signs was a recent shift in tone by the Federal Reserve's economic policy regulators.

## A Midsummer Night's Caution

When the Federal Reserve Open Market Committee last met at the end of July, there was what diplomats might call a frank and open discussion about the prospects for inflation. Fed policy makers ultimately agreed that there was no cause for immediate alarm, but they did say for the first time in recent memory that "... inflation has moved somewhat closer to the committee's longer-run objective."<sup>1</sup>

Specifically, the Fed seemed especially concerned that wages might be rising a little faster than they had previously predicted. Nobody on the committee was projecting a return to the conditions of the 1970s, when wages and prices kept pushing each other higher and annual inflation ran to double-digit percentages. But they did agree to watch the economy closely and consider raising interest rates if upward pressure on prices increases.

## Why Inflation Should Be a Concern for Long-Term Savers

Inflation risk is the possibility that your retirement fund may not have enough purchasing power to sustain the lifestyle you seek in retirement. It occurs because potential returns may not be great enough to replace the purchasing power that inflation may have taken over time.

Small amounts of inflation each year mount up, even at the 1% to 2% levels we've been seeing over the past several years. Keep in mind that during the recent past, inflation has been well below historical norms. Since the end of World War II, consumer prices have risen at an average of around 4% per year. While past performance cannot necessarily foretell future results, the erosive effects of continual inflation can disrupt an otherwise well-formed financial plan.

## Two Views of the Impact of Inflation



Assuming an annual inflation rate of 4%, you would need more than \$1 million in 25 years to have the same purchasing power as \$400,000 today. Alternatively, if your \$400,000 were to remain constant for 25 years, its purchasing power would have shrunk to the equivalent of just over \$150,000. Keep in mind that this is a purely hypothetical example and is presented for illustrative purposes only.

### Investing with Inflation in Mind

Arming your portfolio against the threat of inflation might begin with a review of the investments most likely to provide returns that outpace inflation.

- *Stocks*

Over the long run -- 10, 20, 30 years, or more -- stocks have tended to produce stronger returns than other asset classes. So while past performance is no guarantee of future results, stocks may offer strong potential for returns that exceed inflation.

Keep in mind that stocks do involve greater risk of short-term fluctuations than other asset classes. Shares of stock can rise or fall in value based on daily events in the stock market, trends in the economy, or problems at the issuing company. But if you have a long investment time frame and are willing to hold your ground during short-term ups and downs, you may find that stocks offer the best chance to beat inflation.

- *Bonds*

When held to maturity, bonds offer a predetermined rate of return. That allows bonds to serve as an important ingredient in plans to manage overall investment risk. But while the predictability and stability of fixed-income returns may be reassuring, there is a significant risk that those bond returns may not keep pace with inflation over time. As a result, investors should balance the benefits of investment risk management against the need for inflation risk management.

- *Treasury Inflation Protected Securities (TIPS)*

Treasury Inflation Protected Securities represent a unique category of fixed income investment. These are bonds issued by the U.S. Treasury whose

principal value is adjusted annually to reflect changes in the Consumer Price Index (CPI). With inflation (a rise in the CPI), TIPS' principal value increases. With deflation (a drop in the CPI), the principal decreases.

Ultimately, the key is to consider your time frame, your anticipated income needs, and how much volatility you are willing to accept, and then construct a portfolio with the mix of stocks and other investments with which you are comfortable. But even if you are approaching retirement, you may still need to maintain some growth-oriented investments as a hedge against inflation. After all, your retirement assets may need to last for 30 years or more, and inflation will continue to work against you throughout.

<sup>1</sup>[\*Minutes of the Federal Open Market Committee\*](#), meeting of July 29-30, 2014, released August 20, 2014.