NPF INVESTMENT ADVISORS

Much Ado About Inflation

Given the level of concern we've heard from clients on this topic, we'd like to address some of the key questions on inflation:

Is inflation truly as high as the headlines proclaim?

In theory, yes. But this is based on government math using a basket of goods and services. What you spend your money on could be quite a bit different, so your personal inflation rate will vary (see more on the next question).

What's driving inflation?

Economic wonks will use the term "Base Effects." This just means that inflation is justifiably high because we had a low comparison point from the prior year when the world was in an economic free-fall. Essentially, it's just the math of going from 0 to 60 in a relatively short period of time.

But there are other things at play, namely an almost "perfect storm" of problems: **1)** automobiles are in short supply due to microchip shortages, thus driving up prices; **2)** lumber prices were up almost 6x (albeit cooling now); **3)** labor shortages are occurring in the service sector as supply can't keep up with demand post-reopening; **4)** we're seeing strong "pent-up" demand in leisure and hospitality (i.e. airfare and hotel prices); and several other factors mostly driven by the stimulus money and reopening activities.

Is this just temporary?

Probably. Given that many of the variables behind the high inflation appear to be transitory issues related to the economic reopening, it would seem so. The old adage is: "the cure for high prices is high prices," so we are starting to see people make decisions that could ease the current pricing pain (i.e. forgo buying a new house or car if it isn't absolutely needed right now).

However, it does seem likely that we'll see higher inflation in the coming years versus what we've seen over the past few decades. The Fed has made it known they are comfortable with inflation **above** their 2% target, due to the number of years inflation fell **below** the 2% target, particularly after the 2008/2009 Global Financial Crisis.

Are we going to see "hyper-inflation" like we experienced in the 1970s?

Probably not. Many of you remember how awful that was, though. However, there were different circumstances then, and we're not convinced we're moving into an inflationary spiral with the current backdrop.

One thing that doesn't get enough attention is *deflation* risk – much of this tied to our aging demographics and high level of sovereign debt (especially after the multiple rounds of pandemic stimulus). Academics have been debating this for some time, and it's important to remember examples of deflationary cycles (such as Japan, Europe) as much as the inflationary cycle experienced in the US during the '70s. No doubt, this all warrants attention, but we are not sold that hyper-inflation is the most likely scenario – as mentioned earlier, slightly above-average inflation for several years ahead seems more realistic (we assume 3% in financial plans, to be conservative).

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What can I do to protect my wealth against inflation?

It's true that inflation is a pernicious tax on your wealth over time – eating into your purchasing power bit-by-bit each year. Let's face it, your dollar doesn't get you as much today as it did 10-20 years ago, and it likely won't go as far in the next 10-20 years.

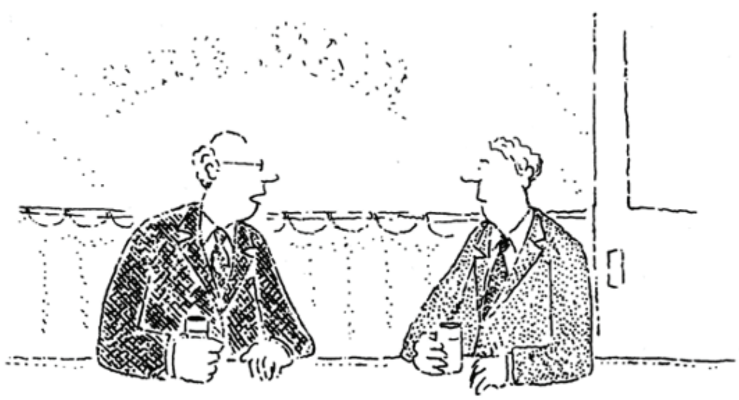
So, it's important to consider inflation in your overall financial plan and to have an investment strategy that aligns with your need to preserve purchasing power (i.e., the ability to buy the same amount with your wealth in the future as you can today).

Regarding investments, gold is frequently recommended for inflation protection. It might work if you know when inflation is going to pop up, but the evidence isn't clear if owning it in your portfolio over the long haul really generates sufficient "real" return. (In other words, it feels good to see it go up during inflationary periods, but in the long run, you might be disappointed since it doesn't actually "produce" investment income).

The better defense is owning good-quality businesses (namely, stocks), particularly those with strong pricing power (that is, the ability to pass on input price increases to customers because demand is "sticky"). If these stocks continue to generate long-term positive returns due to earnings growth and dividend payments while giving you a "raise" when you need it during the inflationary years, then you should do all right over time.

We also believe fixed income investments (bonds or "debt") are important for your long-term asset mix. Bonds are generally not as defensive in inflationary environments, so it's important to have a good investment manager for your fixed income allocation as there are things that can be done to mitigate the impact of inflation on this asset class.

The bottom line here is that we constantly go through cycles of greed to fear and back again. But your best strategy is to **build a solid plan, avoid the noise and stick to it!**



"I've hedged against inflation and I've hedged against deflation, but price stability could knock me for a loop."

Source: CartoonStock.com

Sincerely,

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