Money Matters: If inflation returns, are you ready?

By Rick Gross

Inflation is the normal state of affairs in the U.S. economy. Most economists consider an annual increase in the cost-of-living of 2 or 3 percent per year to be a manageable level of inflation. This increase usually is a good trend because it is an indication of a growing economy.

While inflation has not been a concern in recent decades, the 1970s and early 1980s are remembered as a time when inflation created major economic challenges. In some years during this timeframe, the cost-of-living (as measured by the Consumer Price Index or CPI) increased more than 10 percent per year.

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Signs of an inflation uptick

Through much of the current economic recovery, which began nine years ago, inflation has remained modest. Some economists and analysts believe this could change going forward. One key factor that could contribute to an accelerated inflation rate is the unemployment rate, which dipped to its lowest level in years. This may mean employers will have to start offering higher wages to attract and retain qualified staff, which could trigger higher inflation. Another contributing factor could be that most global economies are simultaneously

experiencing economic growth. This synchronized expansion may continue to stimulate demand for products and services, leading to faster price increases. Investors are also watching for the impact of the recent tax reform legislation, which could contribute to inflation should consumers spend more and prices rise.

Watch the Federal Reserve

One way to keep an eye on inflation risk is to follow actions taken by the Federal Reserve (the Fed). It targets an annual inflation rate of two percent, a goal it has had little difficulty maintaining in recent years. If the Fed begins lifting the short-term interest rates it controls more quickly than expected, it may be a sign that Fed policymakers are concerned that the threat of higher inflation is upon us. If the Fed raises rates quickly, consumers could see rising interest rates and a more volatile stock market. Your financial advisor can provide you more guidance as you prepare for changes that may lie ahead.

The potential impact on your bottom line

While no one can predict what will happen in the future, you should consider how to respond to a changing environment for living costs. If inflation increases rapidly, the impact can be dramatic for consumers. When prices of everyday items begin to noticeably increase, consumers could have, in effect, less disposable income. The greatest impact can often be on big-ticket items. For example, the price of houses or cars could begin to climb. In select housing markets, this has already happened even though the broader inflation rate has, at least until now, remained subdued.

Does that mean you should quickly adjust your spending? While it may seem prudent, you must be careful not to let short-term economic trends overly influence your long-term financial strategy. Being mindful about your spending and saving is a

helpful strategy no matter the economic backdrop.

Prepare your portfolio

Investors also need to be cognizant of the potential impact inflation can have on their portfolios. In what has generally been a period of low inflation (the 1980s through now), stocks and bonds have both performed consistently well. In the 1970s, when inflation was much higher, stocks lagged their historical averages and bonds were negatively affected by rapidly rising interest rates.

If inflation rises, interest rates historically have tended to follow that trend. If inflation should begin to accelerate, bond yields may as well. This could hurt bond investors; as existing bond holdings can lose value when yields rise in the broader bond market.

If you are concerned that inflation risks will become a greater concern, this may be a good time to review your portfolio. Consider taking steps to prepare for potential changes in the investment environment that could be caused, in part, by changes in the inflation scenario.

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