Email Body 5-25-2021

**Is Inflation as Scary as It Seems?**

It has been an interesting two weeks since I last wrote to you. While the financial markets have been volatile, they have pretty much ended up the same place they started. Lots of economic news caused some stir, most notably the April inflation report. Locally, San Diego County and California continue to improve our Covid-19 statistics, although no noticeable changes have occurred socially in our day-to-day lives. Apparently, CDC clearance to end mask mandates for at least the “inoculated” does not resonate with our governing officials who cannot quite seem to let go. Nevertheless, we move forward and look to the future with hope and assurance. Stay connected with family and friends and enjoy the upcoming summer months.

A lot has changed in the last two weeks for the better. San Diego County’s seven-day average daily virus case rate decreased from 204 daily cases to this week’s average of 81. Yesterday saw only 25 new cases in the County with over 6,000 tests performed. California saw its seven-day average virus case rate fall from 1,704 daily cases to 1,153, or a 32% decline. Covid-19 “associated” hospitalizations in San Diego County dropped from 150 to 127 while California hospitalizations dropped from 1,854 to 1,466, a record low. Almost 2.2 million San Diego County residents (about 66% of the County population) and 21.2 million California residents (about 53% of the state population) have received at least their first vaccine shot. The seven-day average rate of vaccination in San Diego County has remained relatively stable over the last two weeks at about 10,000 shots per day. California’s seven-day average rate of vaccination is a little more volatile over the last two weeks but is averaging about 90,000 shots a day. Nationally, 49.0% of the population has received at least one vaccine shot with 39% fully vaccinated. I believe it is safe to say that between vaccinated and previously infected and recovered individuals, we are essentially at herd immunity in San Diego County. California still has a little way to go before it reaches herd immunity.

As I said above, the financial markets have been volatile over the last two weeks, but overall did not move much. This volatility started with the release of the U.S. Labor Department’s April Consumer Price Index (CPI) report showing a year-over-year increase of 4.2% and a one-month increase of 0.8%. I believe what is happening is a “tug and pull” in the markets between those who believe inflation is returning (i.e., some believe with a vengeance while others think more moderately) and those who accept the Federal Reserve’s argument that the current outsized inflation figures are the result of structural issues/low base effect and are transitory as well as those who believe deflationary pressures will reassert themselves. So, the question on everyone’s mind is when will the Federal Reserve take away the proverbial punch bowl and begin increasing interest rates and reversing its $120 billion monthly purchases of U.S. bonds. No one knows the answer and even the Federal Reserve has stated it does not anticipate reversing its current policy until unemployment reaches pre-covid levels (i.e., 3.8%). That may change.

To understand where we are going it is important to understand how we got to where we are. You can break inflation down to two main components, goods inflation and services inflation. Goods are tangible items such as food, energy, cars, furniture, etc. Services include things like rent, healthcare, college, entertainment, etc. Over the last twenty years services inflation has averaged about 2.8% a year. Goods inflation on the other hand has been stable at about 0% and even at times, deflationary. Goods inflation at 0% is largely due to China’s entry onto the world trade scene in 2001 and globalization. Businesses seeking low-cost production combined with low energy prices resulted in a near perfect inflationary world for goods. Services however experienced an average annual inflation of 2.8%, largely because labor costs are the dominant cost component. Globalization was already on the downswing when Covid hit and this will be accelerated as supply chains are rebuilt nearer to their final markets. So, if services inflation remains steady at 2.8% and goods inflation picks up in excess of 0%, I do not see how we cannot experience over the next ten years higher inflation levels than we experienced in the last ten years.

Accordingly, my position is that in addition to April’s spike in CPI we may well see additional spikes in the next two-to three months due mostly to the low comparison reports to corresponding months in 2020 and then it will settle back down to between 2-3%. However, over the longer term (i.e. beginning in two or three years) I expect inflation and interest rates to trend up.

So how does this impact your portfolios. The key thing to remember is that the stock and bond markets can coexist with inflation, as long as inflation does not rise to far, too fast. The ability of the Federal Reserve to control these factors will be the determinant as to how much volatility the markets experience in the future. Real assets and stocks with growing earnings are excellent inflation hedges. A well-diversified portfolio that includes these types of assets and is actively managed will be able to weather a moderate inflationary environment. Our portfolio strategies exhibit these qualities and I expect them to perform accordingly. However, I will be watchful to see if the Federal Reserve Bank is able to do its part in this by managing inflation expectations. Time will tell.

Make sure your portfolio strategy is consistent with your cash flow needs. Assets significantly exposed to risk (i.e., the stock market) need at least a four-to-five-year time horizon to remain invested. Assets with a shorter time horizon should be exposed to less risk depending on your specific situation.

I have attached commentary by Brad McMillan, Commonwealth’s Chief Investment Officer this week. Brad and his cohort, Peter Essele, take a deeper dive into the Department of Labor’s April 2021 report of inflation.

I am always available to you via phone, zoom conference or in person. I encourage you to remain optimistic and to do what you can to contribute to growing the economy. I look forward to talking with you over the next few weeks. If you have any questions or if we can be of any help, please do not hesitate to contact Linda or me.

As always, stay safe and healthy!

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