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How Inflation Affects Asset Values

by James B. Twining, CFP®

In 1980, the inflation rate peaked at 13.5%; higher than it had been in 60 years. The miserable economic conditions of 1980 caused by inflation are lodged into the collective American memory, and we have heard admonitions ever since that excessive money printing would result in the return of hyper- inflation. Those warnings turned out to be incorrect- until now. The latest 12-month inflation rate stands at 8.3%, up from 1.7% just 16 months ago.*

Inflation is an increase in currency relative to goods and services. It can be caused by increased money supply, a decrease in goods and services, or both. The recent stimulus packages have caused a rapid increase in the money supply, while lockdowns and other factors caused a decrease in goods and services. The lifeblood of a modern economy is energy; the supply of which has also been severely restricted through government policy and supply issues throughout the pandemic.

The primary symptom of inflation is increased prices. The increase in price is not due to any real increase in value, but rather a reflection of a devaluated dollar. An analogy I often make is to imagine your house is worth $1 million. Overnight, the money supply is doubled. Your house is now theoretically "worth" $2 million. In real terms, there is no change in value, but in dollar terms it is worth twice as much.

This same concept can be applied to your equity securities. All else being equal, as the dollar is devalued due to inflation and following some lag-time, the price of your shares increases in dollar terms, compensating you for inflation.

Let's contrast this with the real return on bond and cash holdings such as bank accounts. Suppose you loan $1 million today. With the scenario above in which the money supply doubles overnight, will the borrower repay you $2 million tomorrow? Of course not, you will be repaid only the promised $1 million, which in real terms is now worth only $500,000.

Typically, interest rates compensate you for inflation while your money is outstanding. For example, in an 8% inflationary environment, a bond that pays 8% interest compensates you for the decreasing value of the dollar. Currently, this is not the case. Consider that the 3 -month treasury bill rate is below 1%, yet inflation is currently over 8%, resulting in an annualized real loss of over 7%.

In summary, when interest rates are below the inflation rate, bonds, cash securities, and bank accounts lose value in in real terms. It does not follow that you should dump your bonds and bank accounts; there are other factors to consider. If you would like clarification, your advisor is a great resource and will be able to tell you what makes the most sense for your individual plan.

*As of April 30, 2022