Episode 19: Inflation & Your Investments with OJM Group's Andrew Taylor, CFP®

David Mandell:

Hello, David Mandell host of the podcast. Welcome to today's episode. On today's episode, we're handling a topic that I thought was timely. And I made the judgment that I wanted to get some content out on this to you folks so you could listen and, ideally, learn something. We're going to be talking about inflation, which has been a big topic in the financial news over the last couple of months. It'll probably be a little shorter than our normal time. I don't think any of you listeners will be complaining as I've gone over my targeted half hour timeframe on a number of the more recent podcasts.

Our guest today is my partner, Andy Taylor. Let me give you his brief bio and then we'll bring him on and we can talk about inflation.

Andy is a wealth advisor and a partner at OJM. He provides portfolio management and comprehensive financial planning services for high net worth clients and their families. He joined OJM group in 2012. Following more than 15 years in the financial services industry with Charles Schwab and company and Fidelity Investments. He's a contributing author of our books, Wealth Management Made Simple as well as the title of this podcast, our book, Wealth Planning for the Modern Physician. He also like many of us at OJM presents lectures and webcasts, podcasts on investing retirement planning and market analysis. He's a member of the Financial Planning Association of Southwestern Ohio. He's got a BS from University of Kentucky and as a certified financial planner. So with all that, Andy, welcome to the program.

Andrew Taylor:

Thank you for the intro David, excited to get started.

David Mandell:

Excellent. Okay, so let's start with the absolute basics… what is inflation?

Andrew Taylor:

Inflation is a term that describes a general increase in the cost of products and services as well as a decline in the purchasing value of money. So inflation occurs when demand exceeds supply in an economy. Common phrase used to describe inflation is too many dollars chasing too few goods.

David Mandell:

Thanks. Maybe none of us had the textbook definition as you've given us, but think most of our listeners probably have a pretty good sense that goods and services go up in price over time and so purchasing power, it needs to... and investments need to at least match that to have the same purchasing power. So I think most of us have that concept in mind.

One thing I've heard of, and I'm sure a lot of the folks here listening have heard of, is the term CPI as a measure of inflation, what does that mean?

Andrew Taylor:

So the full name for the CPI is the Consumer Price Index, but it's a measure used to examine the price of a basket of consumer goods and services, food, housing, transportation and medical care are a few of the components within the index.

David Mandell:

Got it. So CPI is kind of a standard measure on inflation. I'm sure people have read that the CPI is not that accurate or it's not representative, but it is generally, I guess, an accepted measure of inflation. It's at least where people start. I think you would probably agree with that.

So. All right. So what has been the inflation rate in the US over the past decade? And when was the inflation last a real problem here in the US?

Andrew Taylor:

Sure. Well, for measuring using the CPI, as most do, inflation's been at or below two and a half percent for most of the decade and has averaged 1.7% over the last 10 years. Now, the most recent report fell outside of that range. And we'll touch on this in a moment. As a matter of fact, inflation hasn't been a major issue on a broad scale in our country in 40 years.

Certainly we have had narrow pockets of inflation during that time-- college tuition, housing, and oil have all experienced boom and bust cycles over the last few decades, I'm referring to the type of broad-based inflation which has impacted everyone's life and has drastically changed spending habits.

Most recent example of excessive inflation in our country was in the 1970s when inflation average more than 7% annually. Our listeners over age 50, likely will remember when interest rates reached 16 to 17% for a brief period of time. And if you took out a mortgage during those days, you certainly will... as that has a lasting impact on you. It'd be very difficult to envision a similar scenario occurring today. I mean, in the 70s and early 1980s wages were sticky, retirees had healthy pensions and unions were very powerful , so it was difficult for companies to lay off employees. The country also experienced two different oil shocks during the decade, which played a key role in the rapidly rising prices.

David Mandell:

Yeah. I was 10 years old, so that did not really affect me, although maybe the price of a can of Coca-Cola or something like that, but I certainly understand taking out a mortgage and paying 12, 13% interest, that sounds crazy. And I think that the oil crisis was a big part of that. And obviously we're now a producer. So that's just one factor of how the world has changed. We're not relying on other countries that way.

Why are people talking about inflation now in the Spring here 2021 to make it a hot topic?

Andrew Taylor:

Yeah, David, it's a good question. It's the question that we're getting asked about most frequently now, in response to the COVID-19 pandemic, that Federal government's gone to great lengths to ignite the economy. We've had forgivable business loans. We've had multiple rounds of stimulus checks to individuals to put cash into the financial system. As of the time of this recording, negotiations are ongoing for infrastructure package, which may or may not ultimately be funded by tax increases. The Federal Reserve increased the money supply by purchasing treasury bonds and mortgage backed securities while lowering short-term interest rates to effectively zero. The Fed has also stated that they want inflation, specifically suggesting they're seeking a distinct period where inflation exceeds 2%. So the overriding point is that both the Federal Reserve and the Federal government are aggressively attempting to stimulate the economy.

We also had the April headline CPI number, which experienced a 4.2% year over year increase, which is the largest jump since September of 2008. Now this number appears shocking to many on the surface, but one needs to consider we're coming off a very low base. A year ago our country was on lockdown and it actually took a tremendous amount of effort to spend any money at all, savings rates skyrocketed, half the country didn't know if they'd have jobs to come back to when the economy reopened. So the 4.2% rate, I think is a little misleading when you hear that headline number.

The United States has experienced pockets of inflation recently, and most of that's due simply to disruption in the supply chain, but we've yet to experience broad-based inflation, which has been impacting all of goods and services. And this is very confusing to investors and rightfully so. They want to know why have we not had that broad level of inflation when we've seen the amount of money in the US economy. It's estimated to be roughly 20% higher than it was beginning of 2020, naturally you would expect inflation when the money supplies skyrockets. Well inflation hasn't taken off because we haven't experienced a change in the velocity of money, which is just as important as the money supply.

David Mandell:

That's a staggering stat, 20% more dollars in the economy. You think, okay wow, that's a lot more dollars. And some goods are even hard to get right now. So, I think it's a natural thing to be asking about inflation, but what is the velocity of money? You ended your explanation with that. So can you give us an example of what the velocity of money is?

Andrew Taylor:

Sure. So velocity is simply a measure how quickly cash is circulating in the economy. Simply put it's a measure of the businesses and individuals willingness to spend money. To understand the impact of the velocity of money, consider the following example-- say you had 10 individuals, each receive a million dollars and they're buried in their backyard. So the extra 10 million has no economic impact whatsoever and as a result, it has no impact on inflation.

On the other hand, if we consider the implications of each of those individuals spending the full 10 million, and let's say at two to three businesses. Now those businesses may need to hire more employees. They may need to replace inventory and that inventory could involve multiple suppliers.

Now, each supplier may need to manufacture more goods to re-establish their inventory. Now envision the cycle repeating itself thousands and thousands of times. And you can begin to understand why the velocity of money is such an important component of inflation.

David Mandell:

That makes sense. Tying it back to what you said, we just haven't been seeing that super increase in the velocity of money, even though all that cash was put in the system, people are investing it or sitting out it to some degree. I think savings rates have gone up. Is that anecdotally what you're saying?

Andrew Taylor:

Yes, exactly. Saving rates soared and they nearly doubled in 2020 and it's because some of the points I've mentioned earlier, consumers have been unable to travel. They haven't been able to dine or shop in stores to at least to the extent that they did during the pandemic. Now we're seeing the economy reopen, we're beginning to see the impact of pent up consumer demand and in turn, we're starting to see an increase in the velocity of money. So all this explains the spike in the April inflation report. Now much of this data is lagging. However, we can confidently say saving rates are beginning to decline as spending is increasing.

David Mandell:

That makes sense and I can say personally its true. I hadn't traveled at all until I was vaccinated. And so took my first trip in early May after 14 months of no travel, which is the first for me in 25 years, maybe ever, I can't even remember that long. In fact, it's recording this while I'm in Chicago. So I'm spending money for every meal, right? And everything I'm doing. So I'm part of that story.

As we sit here in May 2021, what's the common consensus in your research in the financial world about how inflation may impact people's savings.

Andrew Taylor:

Well, the consensus on Wall Street is that we will experience some form of a modest inflation this year. So we're seeing a growing concern that that inflation will quickly shoot past the Fed's target rate of 2% annually. Now, the difference of opinion that we're seeing today is whether or not that increase beyond 2% will be short term, or will it be sustained? So the Fed has expressed little concern that inflation will be a problem. The FOC members are saying that they have multiple tools at their disposal, which they will believe will successfully control the increasing costs. And some of those tools are bond purchases. They can actually turn that off. They can increase interest rates. There are a whole lot of tools in their toolbox, so to speak, that they can implement whether or not they want to heat up the economy or cool down the economy.

It's not really a concern in the eyes of the Fed. A segment of Wall Street is also claiming that, and then Fed would agree with this, that there's plenty of excess capacity in the economy that companies can quickly hire. They can ramp up production to keep up with the increasing demand. Now the concern of

those on the opposite side of the Fed is related to that belief in the ability of the economy to meet that kind of demand.

So it really comes down to a debate about excess capacity and concerns that the Fed will be too slow to react to inflationary pressure. And we've already seen some examples of supply disruption in the first half of the year. Lumber, if you're building a home, you certainly probably had sticker shock at the recent jump in lumber prices.

Yet that has pulled back over the course of the last three to four weeks, the semiconductor shortage has gotten plenty of media attention, especially as it relates to new automobiles and then shipping containers. We've heard about some of the disruptions in supply as a result, a lack in containers for the products that we're trying to send across the country. So we've had some of that disruption and in turn that is resulted in small pockets of inflation. So the question is, are we looking at something modest in that 2% range, or is the Fed going to understate and be a little slow to react. And are we going to see that numbers spike higher than what the Fed is suggesting the inflation rate would be.

David Mandell:

Got it. That makes sense. And this is something that we'll monitor for our OJM clients. People who get our newsletter, we'll be keeping on top of that.

Another related question is... What's the common consensus about, or how you're thinking about, how inflation will impact people's investments? So, I'm investing, I have my portfolio, you're my advisor on it, is it possible for inflation to have a positive impact on my investments or a client's investments? And how are you thinking about that?

Andrew Taylor:

Yes, it absolutely is. I mean first we would say that you always want to have a diversified portfolio. You don't want to make significant bets based upon a potential forecast, because again, there is a degree of speculation, but going back to your question on inflation, well, modest inflation has traditionally been actually very positive for stocks. So equities are a great hedge against the erosion of purchasing power, which essentially is what inflation is. Especially when you compare equities to fixed income or bond investments, as typically rising interest rates do follow inflation. Now they don't necessarily go hand in hand a 100% of the time, but that's typically that dynamic that we see regularly and rising rates can negatively impact the pricing of most traditional bonds.

That being said, the bonds remain a critical tool when managing investment risk. And we would caution investors from selling bonds solely due to the threat of inflation. I mean, as I mentioned, all in and all out strategies are extremely risky and rarely successful. There's no guarantee that we do experience inflation of any significant magnitude. In fact, you can find bond managers who have expressed some concern about deflation as well.

David Mandell:

Got it I think that fits with how we approach investments, as we try to look for fat pitches and sometimes we make some short-term tactical calls, but we're really more strategic. And most of our clients are fairly long term in their time horizon. So trying to make up a call on investments because of inflation and do some trading around that is always a suspect if it's too large a position given their overall allocation. But saying all that and putting that all out there, what is one asset class or one tactic that you, or that other listeners might look at, if inflation is a concern? How might you structure or do something within a portfolio? And what's an asset class you might look at?

Andrew Taylor:

Sure, that's a great question. And while we preach diversification we still do want to be active and make tactical changes that'll give our clients the best opportunity to outperform. So one option that we feel may be appropriate for the risk managed portion of an investor's portfolio. So this would be the bond segment of the portfolio, our Treasury Inflation Protected Securities, most commonly referred to as TIPS.

TIPS are bonds designed to protect investors from the risk of higher than anticipated inflation. The way that they work, they adjust their principle based upon changes in the CPI, and they pay out a fixed coupon rate on that principle. So as the size of the principal is adjusted, the coupon will also change and therefore will increase or decrease with changes in the CPI. So because of the structure of TIPS, they can be somewhat complicated. And we would recommend that our listeners contact a professional investment advisor, certainly your OJM advisor, if you're a client, to learn more about both the pros and cons of these investment vehicles.

David Mandell:

So TIPS are something to look into, obviously work with a professional, but that might be a particular tactical move if inflation is a concern, that's helpful.

Well, Andy, thanks for this again. I told the listeners that we would be precise and not too long. And I think this is helpful. It's been on the minds of a lot of clients, I think they have been asking you about this and others on our team, and certainly the media have been covering it. So I wanted to insert this into our schedule, thanks for making the time and to all the listeners, thanks for listening. And hopefully you learned a couple of things and look forward to having you listen to the next episode of the Wealth Planning for the Modern Physician podcast. Thank you. Thanks Andy.