Interest Rates, Inflation, and Investment Strategy

AVERY WEALTH
OPTIMIZE YOUR FINANCIAL FUTURE

Interest Rates, Inflation, and Investment Strategy

At its March 15–16 Federal Open Market Committee (FOMC) meeting, the U.S. Federal Reserve raised its federal target funds rate by a quarter point. It was the first increase since December 2018, but it wasn't a huge surprise. Fed Chair Jerome Powell had already said we should expect as much, with the potential for additional hikes before year-end.

Along with interest rates, inflation remains a related topic of conversation … not to mention the economic toll and humanitarian tragedy being wrought by Russia's horrific warmongering.

To our distress, there is only so much we can do to alleviate the heartbreaking news coming out of Ukraine. But as a financial advisor, we can at least help you put these interrelated influences into thoughtful context. That's what we'll focus on in this three-part report. We'll start with interest rates, followed by inflation, and wrap by exploring what these influences mean to you and your investments.

To steal our own thunder, this report will reinforce the core principles we already incorporate as we help people navigate their financial interests across time and through various market conditions. The news may be new, but the timeless tenets driving our patient and personalized advice are enduring and, if anything, even more relevant during periods of increased uncertainty.

Part 1: Understanding Interest Rates

What's Up With the Fed Rate?

Almost everyone is familiar with interest rates. That said, far fewer know what to make of the Fed's target funds rate in particular. Everyone from economists, to politicians, to the financial press seems to always be talking about them. Markets rise or fall when the Fed comments on them. They're often treated as synonymous with interest rates in general. They must be important, right?

Well, yes, the target funds rate *is* important. But not in the way you might expect.

As the central bank for the United States, the Federal Reserve is tasked with setting monetary policy to promote "maximum employment, stable prices and moderate long-term interest rates … thereby supporting conditions for long-term economic growth." In this supporting role, the Fed uses its target funds rate as one of many "levers" to achieve its aims.

When the Fed increases or decreases the target funds rate by specific points—such as the recent 0.25% increase—it's actually establishing a range of rates. Current rates are thus 0.25%–0.50%, up a quarter-point from 0.00%–0.25%. Banks and similar institutions then target this range when they lend overnight money to one another. They use these hyper-short-term loans to collectively maintain their required cash reserves, or to otherwise raise immediate operational cash.

Keeping Time With the Fed

Think of the banking system as an intricate timepiece. Each bank operates independently. Each can choose when or if to lend to or borrow from other banks within the Fed's current target rate range. Each also sets its own, public-facing retail rates. When banks stay in synch with one another and the Fed, the economy will hopefully keep good time. But if even a few cogs get jammed, it can stymie the entire operation.

In our analogy, the Fed plays the role of a master timekeeper. Or at least it tries to.

When the Fed increases the target funds rate (as it just did): It's hoping to reduce the flow of excess cash or stimulus in the economy, which in turn can help temper inflation.

When the Fed lowers the target funds rate (as it did during the pandemic and the Great Recession): It's hoping to keep stimulating cash flowing through the economy … without letting inflation get out of hand.

Along with adjusting the target funds rate: The Fed also can inject or extract cash into or out of the system, in an effort to quicken or slow the wheels of commerce, increase or decrease inflation, ward off a recession, tamp down "irrational exuberance," and/or otherwise spur or check economic activities.

However, we must emphasize: No single entity can just flip a switch to power the economy off and on. The Fed is in a relatively strong position to **encourage** long-term economic growth through its actions. Often, its actions will trickle down to other types of loans and move them in a similar direction, for the same purpose. But not always, and rarely across the board. As in any complex system, any given move interacts with countless others, with varied results. This is especially so globally, as most countries have central banks and "timekeepers" of their own.

Which brings us to our next point.

The Fed Rate Isn't Every Rate

To review, the Fed's target funds rate is the rate range at which banks lend each other overnight cash. Rising rates are meant to help unwind earlier stimulus programs, and manage rising inflation by tinkering with the cash flow in our banking systems. But as an admittedly blunt tool, there is an even more tenuous connection between the Fed's rates and the interest rates you personally pay or receive.

For example, as described in this Wall Street Journal video, existing fixed-rate debt such as home and student loans may not be as immediately affected by rising rates, while free-floating credit card debt is more likely to creep quickly upward in tandem with the Fed's rates. It's generally wise to avoid credit card debt to begin with, given their persistently higher rates. It's even more critical as rates rise.

Similarly, you may or may not receive higher rates on interest-bearing instruments such as bonds, CDs, bank accounts, etc. That's because it's the banks and similar entities, not the Fed, who set these rates.

We'll discuss this further in part 3, when we explore the impact of interest rates and inflation on your investment strategies. But as another recent Wall Street Journal column described: "Interest rates are about to rise. Savers shouldn't get their hopes up. … Banks have little incentive to raise the interest they pay on deposits because they simply don't need the money."

Time will tell whether this or future Fed rate increases contribute to lower inflation and a healthy economy. Similar actions have been known to help in the past. But of course, each era comes with its own challenges and opportunities. Current events are certainly no exception to this rule! In particular, current global strife may well have a much larger influence on inflationary risk than what the Fed can and cannot do about interest rates. So, next up, let's talk about inflation, and how it factors into our conversation so far.

Part 2: Understanding Inflation

How Do We Measure Inflation?

Has rising inflation got you down? Inflation is the rate at which money loses its purchasing power over time. As you might guess, there are many ways to measure such a squishy figure. There are various economic sectors, such as energy, food, housing, and healthcare, which can complicate the equation by exhibiting wildly different inflation rates at different times. There is ongoing debate over which figures are most relevant under what conditions.

There also is today's inflation rate, versus the rate at which inflation has changed or is expected to change over time. For example:

- Measured by the U.S. Consumer Price Index, inflation stood at a February 2022 annual rate of **7.9%**, fueled significantly by increased energy prices.
- Measured by the Intercontinental Exchange (ICE) U.S. Dollar Inflation Expectations, 1 Year Expected Inflation was at **5.74%** on March 23, 2022.
- Measured by the Federal Reserve's 10 Year Break-Even Inflation Rate (the U.S. market's expected average annual inflation rate for the next 10 years), expected inflation was hovering at around **2.94%** on March 23, 2022.

While that's a wide range of numbers for seemingly the same figure, they all share one point in common: By nearly any measure, inflation is higher than it's been in quite a while. One need only visit the $1.25 Dollar Tree (or nearly anywhere else these days), to realize that $1 doesn't buy what it used to.

But what should we make of that information? As usual, it helps to consider current events in historical context to discover informative insights.

Inflationary Times: Past and Present

Unless you're at least in your 60s, you've probably never experienced steep inflation in your lifetime—at least not in the U.S., where the last time inflation was as high (and higher) was in the early 1980s. After years of high inflation that began in the late 1960s and peaked at a feverish 14.8% in 1980, Americans were literally marching in the streets over the price of groceries, waving protest signs such as, "50¢ worth of chuck shouldn't cost us a buck."

During his 1979–1987 tenure, Federal Reserve chair Paul Volcker is credited with routing the runaway inflation by ratcheting up the Federal target funds rate to a peak of 20% by 1980. (Compare that to the recent increase to 0.05% as discussed in our last piece.) Aimed at reducing the feverish spending and lending that had become the status quo, Volcker's strategies apparently effected a cure, or at least contributed to one. By 1983, inflation had dropped considerably closer to its cooler target rate of 2%, around which it has mostly hovered ever since. Until now.

The Inflationary Past Is Not Always Prelude

Why not just ratchet up the Fed's target rates as Volcker did? Unfortunately, it's not that simple.

First, as described in this commentary, "Should We Be Scared of Inflation?" there are several broad categories—such as supply and demand, rising labor and production costs, and a nation's monetary policies—each of which can contribute to inflation individually or in combination. This means each inflationary period is borne of unique circumstances. So, even if a "treatment" seems relatively reliable, you never know for sure how each "patient," or economy, will respond.

Second, even if an inflation-busting action does work, it's not unlike treating cancer through aggressive chemotherapy. Left unchecked, the side-effects can be worse than the disease.

Volcker's actions are a case in point. The higher target rates not only tamed inflation, they weakened the economy significantly, leading to an early 1980s "double dip" recession and high unemployment. Overall unemployment hovered above 7% for several years, with some sectors such as the construction and automotive industries experiencing double-digit figures. Even if the outcome was worth the pain involved, it's not a course one embraces with enthusiasm.

"If/Then" Stage Two Thinking

Are we doomed to reach double-digit levels of inflation this time, face another painful recession, or both? As always, time will tell. However, in the face of today's challenges, we choose judicious optimism over paralyzing fear. This is not because we're naïve or blind to the facts, but because we are guided by an economic principle known as stage two thinking.

Economist Thomas Sowell has described staged thinking in his pivotal book, "Applied Economics: Thinking Beyond Stage One." Basically, before acting on any event's initial impact, it's best to engage in stage two thinking, by repeatedly asking a very simple question:

"And then what will happen?"

By applying stage two thinking to inflation, we can accept that, yes, inflation has become uncomfortably high. Labor costs, supply constraints, low interest rates, and high spending have all likely contributed to inflated costs, which can then twirl around and further aggravate these same influencers. In the resulting tango, inflation could spin out of control.

But **then** what will happen? In reality, next-step responses are already taking place. The Fed has raised interest rates once, and hopes to continue raising them throughout 2022. Likewise, businesses are revisiting their growth plans, and consumers are thinking twice about their purchases, especially in markets where inflation is having its greatest impact.

It probably won't happen overnight, but these next steps should chip away at inflation. True, this could lead to a recession … or not. We hope not. Either way, **then** what will happen? Once again, governments, businesses, and individuals will likely adjust their behaviors and expectations in response. And so on.

Investing in Inflationary Times

Even if odds are heavily stacked in favor of our taming inflation over time, this is not to suggest it will be easy. And even if we "win" in the end, it's unlikely it will be obvious until we are able to look back at the events in hindsight. As such, as we press forward, you may repeatedly question what these influences mean today to you and your investments. We'll explore that next.

Part 3: Investing in Uncertain Times

After taking a closer look at interest rates and inflation, we come to the heart of the matter:

When interest rates, inflation, or both are on the rise, what's an investor to do?

Big picture, we are continuing to deploy the same core principles we use to help people invest across time and through various market conditions. These include:

- Building and maintaining personalized investment portfolios of stocks, bonds, select alternative investments, and cash reserves
- Minimizing exposure to concentrated investment risks through global diversification
- Reducing the impulse to act on fear, excitement, and similar reactions to unfolding news
- Keeping an eye on tax ramifications and other costs

If anything, adhering to these timeless tenets becomes even more important during increased geopolitical uncertainty and economic stress—to guide you past any bouts of doubt.

Future Uncertainty

With so much going on, there's been no lack of analyses of what to expect across various markets, and what investment actions you should take based on these forecasts.

The trouble is, it's as devilishly difficult as ever to predict the future. For example, your psychic talents are far better than ours if you can predict exactly how Putin's war is going to play out, let alone how its effects will converge with myriad others to drive future market pricing.

Moreover, those best positioned to offer the most informed insights about the future may be the voices you're least likely to hear. Wharton Professor Phil Tetlock has dedicated much of his career to studying the efficacy of expert forecasters, and his research suggests as follows:

> "People who generate better sound bites generate better media ratings, and that is what gets people promoted in the media business. So there is a bit of a perverse inverse relationship between having the skills that go into being a good forecaster and having the skills that go into being an effective media presence."

Historic Insights

If we look to the past, we can find ample evidence of just how hard it is to reliably anticipate various markets' reactions to current events. Following are some relevant examples:

Global investing and inflation: In their 2021 analysis, "US Inflation and Global Asset Returns," Wei Dai and Mamdouh Medhat of Dimensional Fund Advisors studied how bonds, stocks, industry portfolios, factor premiums, commodities, and REITs performed during periods of high and low U.S. inflation from 1927–2020. They found that "most assets had positive average real returns in both low- and high-inflation years."

Bond investing and interest rates: In "All Eyes on the Fed?" Dimensional Fund Advisors also examined whether Federal target funds rate changes have influenced either global government bond returns, or longer- vs. shorter-duration bond returns. They concluded: "Our analysis of global government bond data from 1984–2021 shows no reliable relation between past changes in the federal funds rate and either future bond excess return over cash or future term premiums."

Bond investing and interest rates (again): You may recall, interest rates did tick upward in 2017–2018, creating concerns similar to those we're hearing today. At the time, financial author Larry Swedroe published an ETF.com piece, "Rising Rates Increase Worries," in which he illustrated why it's best to disregard breaking news about rising rates (emphasis ours):

> "As in 2018, we entered 2017 with the market anticipating several increases in the federal funds rate. … Despite that, the Vanguard Long-Term Treasury Index ETF (VGLT) returned 8.6% in 2017, outperforming the Vanguard Intermediate-Term Treasury Index ETF (VGIT), which returned 1.7% and the Vanguard Short-Term Treasury Index ETF (VGSH), which returned 0.0%. **Investors scared off by the likelihood of rising rates suffered for betting against the collective wisdom of the market."**

Factor investing and economic cycles: One of our timeless investment strategies is to allocate our portfolios across various market "factors," or sources of expected return, in pursuit of particular long-term outcomes. In an Alpha Architect guest post, "Factor Investing Premiums and the Economic Cycle," Swedroe also examined whether it had made good historical sense to shift those allocations in response to economic cycles. Bottom line, it had not. Compiling the findings from a number of academic studies, he concludes: "Although a factor's return changes throughout the business cycle, the ability to predict economic regimes and alter factor allocations accordingly produces less successful results despite being intuitively pleasing."

Global investing and geopolitics: Even if we can't peer into the future, we can already see for ourselves the horrific toll Putin's war is wreaking. Shouldn't that translate into predictable "winning" and "losing" investments? Once again, the practical answer is no. In his recent work, "Chaos is a friend of mine," financial columnist Bob Seawright points to a range of historical events demonstrating why complex adaptive systems like financial markets are essentially unpredictable. That's thanks in large part to chaos theory (aka, "the butterfly effect"):

> "Financial markets exhibit the kinds of behaviors that might be predicted by chaos theory … [E]ven tiny differences in initial conditions or infinitesimal changes to current, seemingly stable conditions, can result in monumentally different outcomes."

In other words, news from the front lines may seem tremendous or trivial, awful or inspiring, or even everything at once. But avoid letting any of it heavily influence your actionable investment insights; the world is just too chaotic for that.

Layers of Protection

By now, we hope we've described what NOT to do in response to current events: Across stock and bond assets alike, it remains as ill-advised as ever to chase or flee individual positions, markets, or economic cycles.

If your investment portfolio is already well-structured, you should already be well-positioned to capture appropriate measures of expected investment premiums over time, while defending against inflation and other risk/reward tradeoffs. It may not feel like it right now, while we're enduring the rising risks. And unfortunately, even a best-laid plan doesn't guarantee success. But if you weigh the odds, your best course by far is probably the one you've already got.

At the same time, it's worth reviewing what you are seeking to achieve as an investor, by deploying two broad strategies for protecting against inflation:

Hedging against inflation: To preserve the spending power of upcoming cash flows out of your portfolio (such as in retirement), you can hedge some of your assets against rising inflation.

For example, you can allocate more of your fixed income to assets that tend to move in tandem with inflation, such as Treasury Inflation-Protected Securities (TIPS) versus "regular" Treasury bonds. Neither is ideal across all conditions. But if you hold some of both, they can complement each other over time and across various inflationary rates.

We do **not** suggest piling into assets that may be periodically inflation-sensitive, but also exhibit heightened volatility—such as energy stocks, gold, and other commodities. Who needs a different sort of excess uncertainty as part of your hedging safety net? (The aforementioned report, "US Inflation and Global Asset Returns," explores this point further.)

Outperforming inflation: At the same time, your longer-term financial goals typically require a portion of your portfolio to **outperform inflation** over the long haul. For that, you need to stay invested in various markets. As Dimensional's Dai and Medhat concluded in a recent report, "Overall, outpacing inflation over the long term has been the rule rather than the exception among the assets we study."

- **Stocks:** Equities in general, and especially stock factors such as the value premium, have handily outpaced inflation over time.
- **Bonds:** Investing in bonds that offer the highest yield for the least amount of term, credit, and call risk is also expected to help a portfolio stay ahead of inflation over time. (A timely tip: As in any other market, avoid trying to time the bond market in response to breaking news.)
- **Alternative investments:** As costs and complexities are coming down among certain alternative investment solutions, you may consider allocating a modest portion of your portfolio to alternative markets such as reinsurance or alternative lending; this may help lower your portfolio's overall volatility without sacrificing expected returns.

Most investors require elements of both hedging and outperforming inflation, calling for portfolios that are constructed accordingly. Additional defenses against inflation can include: (1) using relatively realistic inflation estimates in your financial and retirement planning; and (2) delaying taking Social Security when possible, to maximize the power of the COLA (cost of living adjustments) on higher monthly payments.

United We Stand

This brings our report to a wrap. We've thrown a lot at you in a short space, so please consider this material as more of a conversation-starter than a comprehensive guide. Most important, the decisions you make moving forward should be grounded in your own circumstances rather than general rules of thumb. For that, the best way to move forward is together. Please be in touch if we can assist.