Against the Current:

Combatting Inflation's Erosive Impact

Cetera® Investment Management LLC

Each year, more than five million tourists visit the Grand Canyon in Arizona. One of the finest examples of erosion in the world, it's estimated to have taken over 70 million years for the powerful Colorado River to carve through the 277 miles and layers of rock, shaping the canyon into its current form. Inflation, like erosion, has a slow and residual impact. Rising prices erode purchasing power over time. The impact over a short period doesn't always seem apparent, but over the long run, rising prices have an increasing and substantial impact. There is little that can be done to slow the powerful forces of erosion, but there are things in our control that can slow, and even overcome, the impact of inflation. How? Let's head downstream to find out.

Inflation in the 2020s[1]

I Can't Believe It's Not Butter! The consumer price index (CPI) category with the highest inflation in the 2020s is margarine, with prices up a whopping 61%. Butter prices, on the other hand, are up 27% this decade, also outpacing the 19.7% CPI rise.

At Your Service. Demand for delivery service spiked during the pandemic. Many customers got accustomed to the convenience of dinner arriving at their doorstep. It's not cheap, however. Delivery service costs are up 30% in the 2020s.

A Dent in Your Savings. Motor vehicle repair costs are up 44% this decade. Car insurance naturally follows repair costs and the cost to insure a car is 39% more than the start of the decade.

Shrinkflation: Have you noticed your favorite products weighing a bit less? Your go-to cereal might have fewer calories in the box, but the price at the register is the same, or your potato chip craving has undergone portion control with more air and less chips in the bag. Shrinkflation is at play. Don't worry, they will tell you when they increase the amount again. There will be "30% more" listed on the packaging. They are awfully quiet when you get 30% less.

Less Formal. Working from home and hybrid work schedules are changing the way we dress. Our less formal attire pushed the price of men's suits down 1%, while women's dresses are 9% cheaper in the 2020s.

Petflation. Healthcare expenses have risen 10% in the 2020s, while veterinary services have witnessed a steeper 31% increase. Amid declining human birthrates and a rise in pet ownership, the escalating costs of veterinary care is taking a considerable nibble out of the wallets of devoted pet parents.

Why Inflation Matters

Prices for most consumer products and services tend to rise over time. This isn't a bad thing; moderate inflation is a sign of a healthy economy. The inverse is deflation, which is when prices decline, and is most common in times of economic turmoil. However, if inflation accelerates too quickly, it poses a threat to the economy because it can be challenging to slow the pace of price increases and they can spiral out of control. In these instances, central banks need to aggressively increase interest rates, which typically slows the economy and heightens the risk of recession.

The United States' central bank is the Federal Reserve (Fed). Its long-term inflation target rate is currently 2%, a healthy balance that isn't too hot or too cold. Note that the Fed's target rate is for the entire basket of goods and services in the U.S. economy. While some sectors, such as healthcare and college education, have seen costs increase faster than the overall inflation rate in the long run, others like home furnishings and clothing have lagged behind inflationary trends over time. Wage growth has outpaced inflation by 0.4%, annualized over the last 40 years. Wages don't rise faster than inflation in all years, as we experienced in 2021 and 2022, but wages typically keep up with or exceed inflation over the long term. In real time, inflation isn't always obvious when wages are also rising. It's future spending, rather than current spending, that is most impacted by inflation. To shield your finances from inflation, building a nest egg and safeguarding it is a crucial strategy.

Building a Nest Egg

It's hard to meet your financial goals without ample savings. The costs associated with education, a down payment for a home, health care, and retirement can be daunting. Inflation adds to this challenge of achieving milestone goals. A savings plan is where it all begins—consistently saving month after month and year after year. There isn't a golden rule for how much to save, as everyone's circumstances are different. That said, aiming to save 10% or more of your annual salary is a commendable starting point. Saving money isn't always easy, particularly in periods of high inflation. But it's the first and most important step to tackle the long-term effects of inflation. Savings alone won't conquer inflation, however. Safeguarding your nest requires an investment plan.

Safeguard Your Nest

Maintaining cash savings is prudent for emergencies and short-term savings goals. For long-term goals, however, investing is the best way to help safeguard your nest from the erosive force of inflation. Over the last 40 years (1984 to 2023), the S&P 500 increased at an annualized rate of 11.3% (including dividend reinvestment), turning a lump sum $1,000 investment that tracks the S&P 500 at the start of 1984 into $73,083 at the end of 2023 (see Figure 1). CPI, in contrast, saw an annualized increase of 2.8% from 1984 to 2023. The S&P 500 generated 8.3% inflation-adjusted returns over this 40-year period.

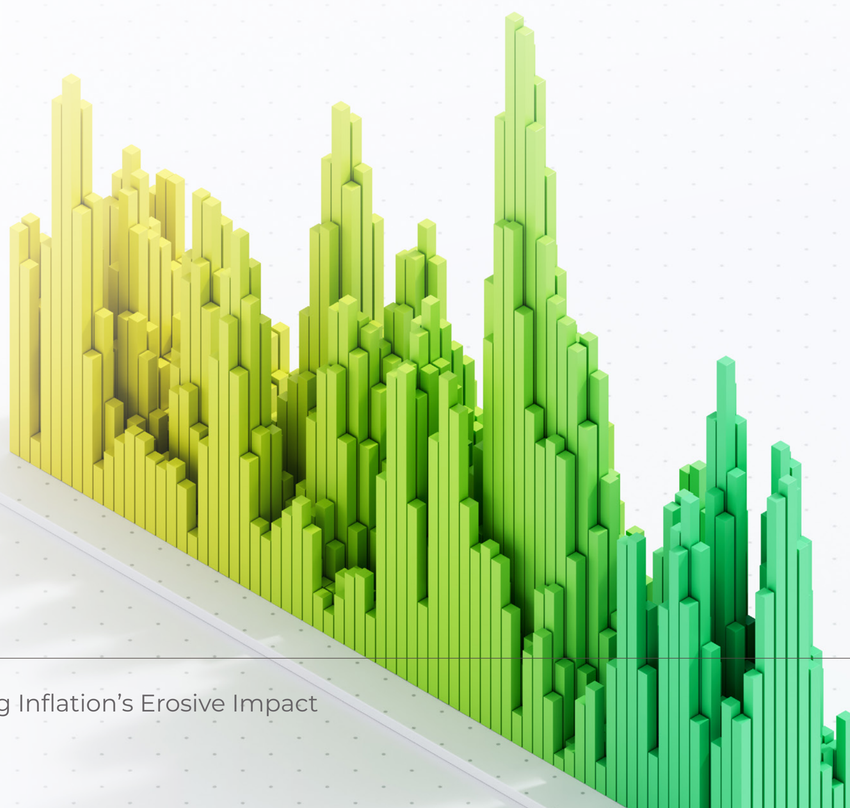
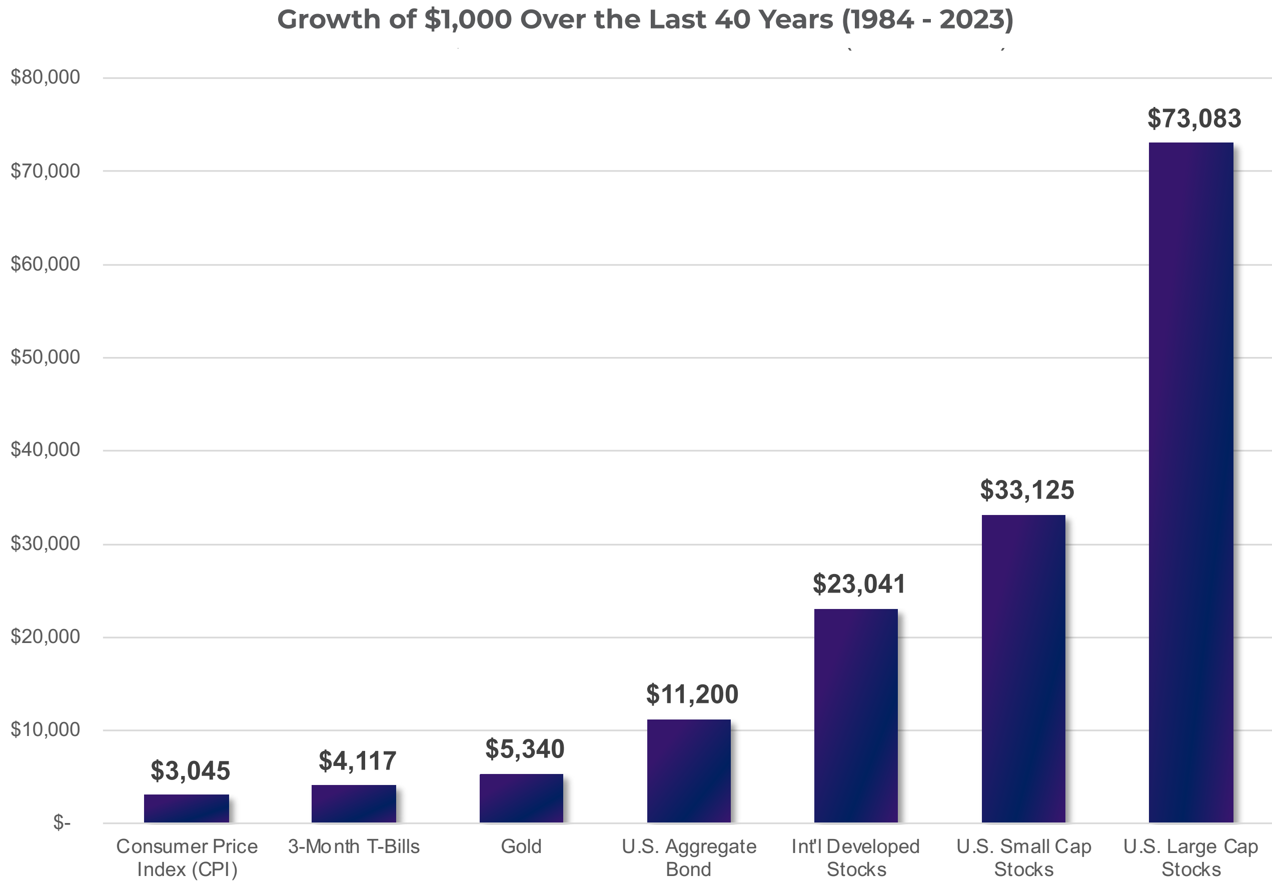


Figure 1: Growth of $1,000 Over the Last 40 Years (1984-2023)



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics, ICE BofA, Bloomberg, S&P Global, MSCI, Russell Investments. The data in this chart shows how much $1,000 grew from 1984 to 2023 if it tracked these asset classes. Indexes used: Inflation (Consumer Price Index), 3-Month Treasury Bills (ICE BofA U.S. 3-Month Treasuries), U.S. Intermediate Bonds (Bloomberg U.S. Aggregate Bond Index), Gold (S&P GSCI Gold), Int'l Developed Stocks (MSCI EAFE), U.S. Small Cap Stocks (Russell 2000), U.S. Large Cap Stocks (S&P 500). Total returns were used, which include dividend and interest reinvestment. Data is from 1/1/1984 to 12/31/2023.

There are inherent risks with stock market investing. The S&P 500 experienced six bear markets (20% or more decline) over this 40-year stretch, including two instances of 50% declines, along with several years with corrections of 10% or more. Investing is not just a balance between risk and reward, but also striking a balance between risk and your personal risk tolerance. While equities play a crucial role in asset allocation, it's essential for most investors to include conservative assets to help mitigate overall risk. Over this same 40-year period, bonds generated returns above inflation, albeit at a smaller margin compared to equities. The Bloomberg U.S. Aggregate Bond Index gained 6.2% annualized, translating to 3.3% inflation-adjusted. The fixed income market experienced lower volatility than equity indices, though. Even 3-month Treasury Bills managed to outpace inflation from 1984 to 2023, but the margin was more modest at 0.8% annualized.

Figure 2: Returns Over the Last 40 Years (1984-2023)

Category	Index	Annualized Return	Inflation-Adjusted Return
Inflation	Consumer Price Index (CPI)	2.8%	-
U.S. 3-Month T-Bills	ICE BofA U.S. 3-Month Treasuries	3.6%	0.8%
U.S. Intermediate Bonds	Bloomberg U.S. Aggregate Bond	6.2%	3.3%
Gold	S&P GSCI Gold	4.3%	1.4%
Int'l Developed Stocks	MSCI EAFE	8.2%	5.2%
U.S. Small Cap Stocks	Russell 2000	9.1%	6.1%
U.S. Large Cap Stocks	S&P 500	11.3%	8.3%

Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics, ICE BofA, Bloomberg, S&P Global, MSCI, Russell Investments. Total returns used, which include dividend and interest reinvestment. Data is from 1/1/1984 to 12/31/2023.

It's important to consider that these returns are reflective of a 40-year time frame, and there are shorter periods where returns may not keep pace with inflation. For instance, the S&P 500 faced a lost decade of negative returns from 2000 to 2009, with an annualized loss of 0.9%, magnified to -3.4% annualized when adjusted for inflation (Figure 3). Diversified investors, however, could have mitigated some of these declines by investing in other asset classes. The Russell 2000 index of small cap stocks gained 3.5% annualized from 2000 to 2009, or 0.9% adjusted for inflation. International equities (MSCI ACWI ex U.S.) gained 3.1% annualized (0.5% net of inflation), and the U.S. Aggregate Bond Index rose 6.3% annually (3.7% net of inflation) during this period.

Figure 3: Returns from 2000-2009

Category	Index	Annualized Return	Inflation-Adjusted Return
Inflation	Consumer Price Index (CPI)	2.6%	-
U.S. 3-Month T-Bills	ICE BofA U.S. 3-Month Treasuries	3.0%	0.4%
U.S. Intermediate Bonds	Bloomberg U.S. Aggregate Bond	6.3%	3.7%
Gold	S&P GSCI Gold	14.2%	11.4%
International Stocks	MSCI ACWI ex U.S.	3.1%	0.5%
U.S. Small Cap Stocks	Russell 2000	3.5%	0.9%
U.S. Large Cap Stocks	S&P 500	-0.9%	-3.4%

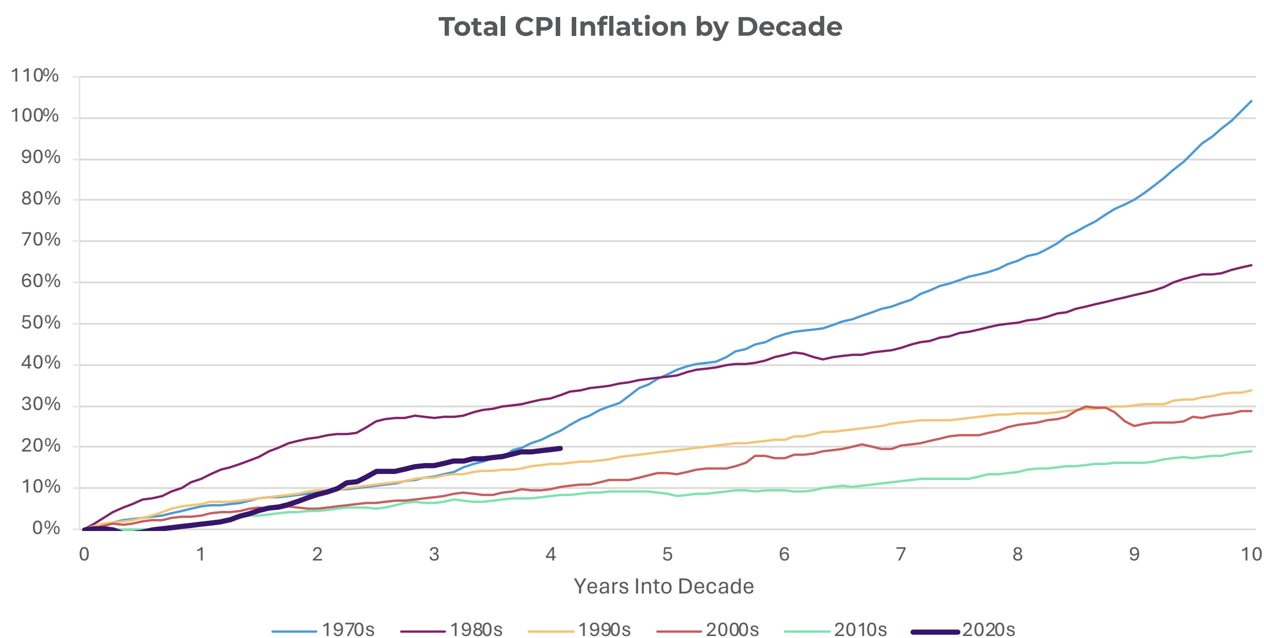
Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics, ICE BofA, Bloomberg, S&P Global, MSCI, Russell Investments. Total returns used, which include dividend and interest reinvestment. Data is from 1/1/2000 to 12/31/2009.

Over the past 10 years, the market environment has been less favorable for fixed income. Bonds failed to keep up with inflation during a 10-year stretch ending in December 2023, falling short by roughly 0.9% annualized. Conversely, the S&P 500 outpaced inflation by an impressive 9% annualized. This underscores the power of diversification. The allocation between stocks and bonds in a portfolio should align with an investor's timeframe and risk tolerance. Over time, this strategic mix, coupled with sector and global diversification, plays a critical role in smoothing out returns over time and reducing the risk of investments falling behind inflation. Just don't expect to outperform inflation every year. Moreover, what lags in one decade, may emerge as a leader in the next, and vice versa.

The Roaring 20s

Expect the unexpected in financial markets and the economy. Inflation in the 2010s was the weakest in the post-WWII era, with the consumer price index rising merely 19% for the entire decade, averaging 1.8% annually. The 2020s got off to a quiet inflationary start because of the pandemic, but quickly shifted gears. CPI inflation roared to a 41-year high of 9.1% year-over-year in the summer of 2022. Surprisingly, prices rose slightly more in the first four years of this decade (19.4%) than in the entire preceding decade (19.0%).

Figure 4: Inflation by Decade



Source: Cetera Investment Management, Federal Reserve Bank of St. Louis, U.S. Bureau of Labor Statistics. Data as of 1/31/2024.

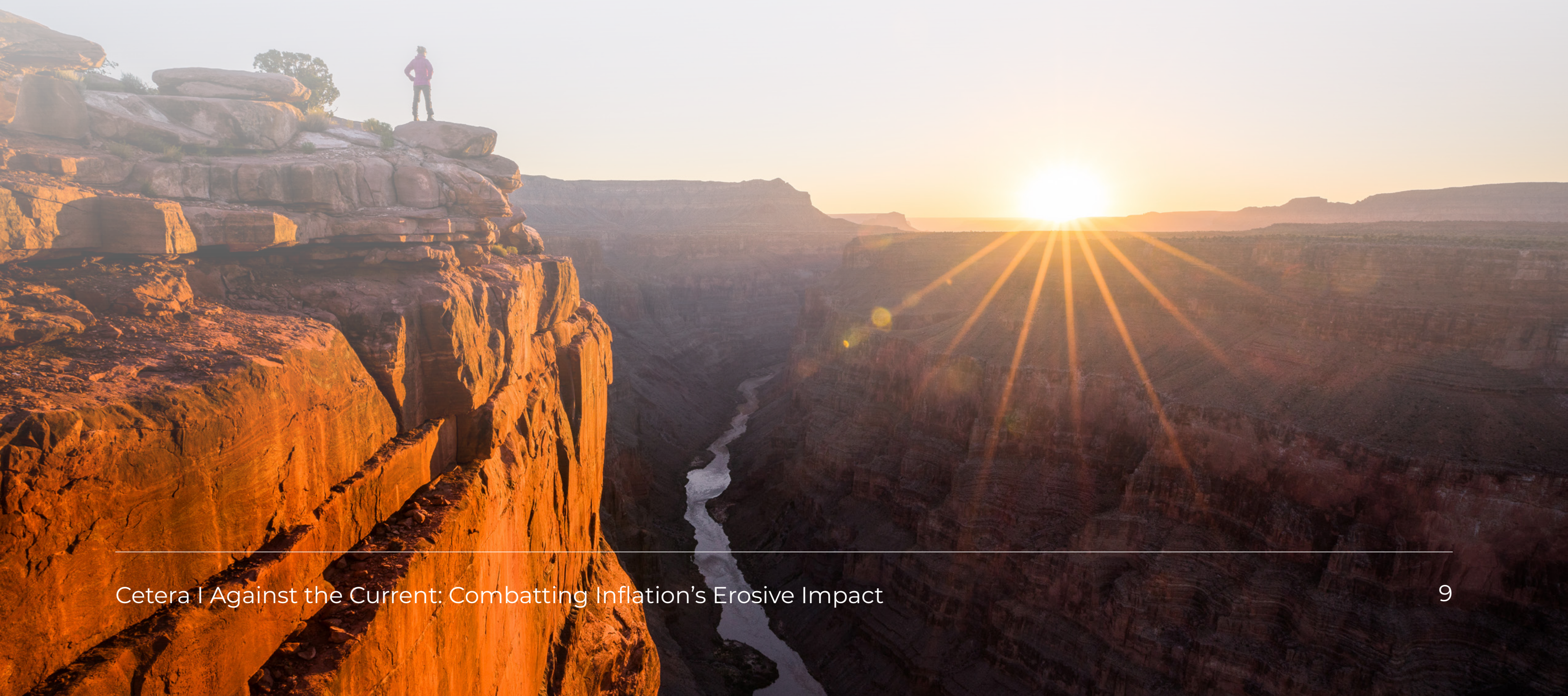
2022 was a year that provided a powerful illustration of the impact that accelerating inflation can have on returns in the short term. With the consumer price index surging that year, both stocks and bonds experienced large declines. The S&P 500 posted a total return of -18.1%, with the decline magnified to -23% when adjusted for inflation. The total return for the Bloomberg U.S. Aggregate Bond Index was -13%, deepening to -18.3% adjusted for inflation. That's nearly a fifth of the value lost in a single calendar year. 2022 marked the worst year for bonds on record, dating back to the inception of the U.S. Aggregate Bond Index in 1976. The index only had four annual losses prior to 2022, and the worst year was 1994 with a 2.9% decline. The inverse was 2023, with decelerating inflation and positive returns for both stocks and bonds. The S&P 500 had a standout year with a total return of 26.3%, while the U.S. Aggregate Bond Index finished the year with a respectable return of 5.3%.

Looking Ahead

Inflationary pressures are stabilizing. Headline CPI inflation slowed to 3.1% as of January 2024. However, there are lingering risks of inflation settling above the Fed's 2% target. Service inflation remains stubbornly high at 3.9% year-over-year. Inflation in the service economy is decelerating at a much slower pace than the goods sector, which has seen prices narrowly decline over the last year, after peaking at 10.6% year-over-year in 2022. There is a silver lining. Shelter inflation is the biggest reason why service inflation remains elevated. A leading indicator for shelter inflation is market rents. According to a few prominent national rent indexes, asking rents have slowed dramatically. There is a lag in the data, but slowing rental costs will likely lead to slower shelter inflation, and thus lower service inflation.

While the Fed is closely monitoring these signals, they are suggesting that rate cuts are coming this year if inflation data slows sustainably toward 2%. The Fed doesn't need to wait until inflation hits its target before considering interest rate cuts. Fed officials have expressed encouragement about inflation's progress. The Fed hiked interest rates this cycle at the fastest pace since the early 1980s, aiding inflation's slowdown. In our view, there are disinflationary forces that will dampen inflation further this year, including slowing rent growth, easing wage pressures, and rising productivity. As it stands today, it's not out of the question that we see three rate cuts in 2024. However, we likely need to wait until this summer before rate cuts commence.

The Fed faces a difficult challenge. Swift interest rate cuts in an environment of robust economic growth and a renewed bull market could reignite inflationary pressures. On the other hand, delaying rate cuts risks hurting the economy, which in turn increases recession risks. The pandemic and post-pandemic economic environments have been anything but normal. Even the Fed is surprised by the resiliency of the economy in this period of restrictive monetary policy that brought interest rates to a 23-year high. The unemployment rate has remained below 4% since the rate hike cycle began two years ago, marking the longest consecutive period under 4% since the late 1960s. The Fed doesn't want to jeopardize the economic expansion, preaching patience yet signaling that interest rates will be cut in 2024.



Conclusion

You will encounter a myriad of market environments throughout your investing journey, and periods of high inflation can be particularly challenging. The aim is to head downstream toward your financial goals, but the impact of inflation makes it feel like you are paddling against the current. Inflation has erosive effects on purchasing power and investment returns. Over the long run, however, the combination of a consistent savings plan and a diversified investment plan can help you overcome inflation and reach your financial goals. Collaborating closely with your financial professional on a personalized plan is critical to rising above the challenges posed by inflation.

[1] Data in this section is from the Consumer Price Index (U.S. Bureau of Labor Statistics), as of 1/31/2024.

Disclosures

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The **S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Bloomberg US Aggregate Bond** Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life of around 8.25 years. This total return index is unhedged and rebalances monthly.

The **Russell 2000 Index** is comprised of 2000 small-capitalization companies. It is made up of the bottom two-thirds in company size of the Russell 3000 index.

The **ICE BofA 3-Month U.S. Treasury Index** measures the performance of a single issue of outstanding Treasury Bill which matures closest to, but not beyond, three months from the rebalancing date. The issue is purchased at the beginning of the month and held for a full month; at the end of the month that issue is sold and rolled into a newly selected issue.

The **MSCI EAFE** is designed to measure large and mid cap equity market performance of 21 developed markets, including three regions (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted, covering 85% of the free float-adjusted market cap in each of the 21 countries.

The **S&P GSCI Gold Index,** a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark tracking the COMEX gold future. The more widely tracked S&P GSCI index is recognized as a leading measure of general price movements and inflation in the world economy. The index represents commodity market beta is world-production weighted and is designed to be investable by including the most liquid commodity futures.

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