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Inflation vs. The Fed

By Jon S.

Over the last year, the federal government has thrown trillions of dollars into the economy because of the pandemic. And during this time, Americans have squirreled away $1.6 trillion in savings. As the economy ramps up, there's a real concern of this surge of money coming into the system leading to higher prices. Too much money chasing too few goods and services—the definition of inflation—and you're already seeing it.

If you're selling a home today, there's a good chance you'll entertain multiple offers and sell above listing price. If you're building a new house, you're feeling the effects of higher lumber prices. Inflation giveth and inflation taketh away. What does all this inflation talk mean? The answer starts and ends with the Federal Reserve.

The Fed's role

The Federal Reserve has two prominent roles in the economy--a dual mandate of maintaining maximum employment (i.e., a low jobless rate) and stable prices (keeping inflation in check). They do this through monetary policy, and one of their most essential tools is setting a key interest rate known as the Federal Funds Rate.

If you're driving your car down the road and you want to go faster, you push on the gas pedal. If you need to slow down, you either take your foot off the gas or use the brake. The Fed helps drive the U.S. economy in a similar fashion by pumping money into the economy--giving it gas through lower interest rates and buying securities--when it needs a boost, and raising interest rates--pumping the brakes--when the economy runs too hot.

Low interest rates create a flurry of economic activity as homeowners refinance or trade up, businesses borrow to expand their product lines, and consumers do what they do best. Higher interest rates have the opposite effect, as consumers and businesses are less inclined to borrow, spend, and invest.

For the last decade-plus, the Fed had the pedal to the metal, trying to help the economy recover from the Financial Crisis (2008-09) and now again due to COVID-19. The Fed Funds Rate has been at or near zero for much of this period.

A one-time surge or persistent increase?

Even in the face of unprecedented amounts of stimulus and pent-up savings, current Fed Chairman Jerome Powell says he expects a "one-time surge in prices," but not ongoing and persistent inflation. Powell also says the Fed is content to let inflation run above 2% until the job market hits full employment. (For some context, since 1913, the average annual inflation rate is 3.1%.)

The Fed is walking a tightrope here. They don't want to pull the punch bowl away too soon and risk derailing a recovering economy, but they also don't want to let the party get out of hand. Many of you remember the late 1970s and early 80s when inflation skyrocketed. If you bought a house in 1981, your mortgage rate was in the neighborhood of 18%. That's 15% higher than today's rates. While this isn't the kind of inflation we ever want to see again, we need to point out that not all inflation is bad.

Thirty years ago, movie tickets cost $3 and a Runza meal was $3.50. Today, movies are $12, and the same Runza meal goes for nearly $8. This type of inflation is natural and healthy. Gradual rising prices allow businesses to raise wages, which workers put back into the economy through spending and investment.

So what's an investor to do?

Over the last 15 years, which encompasses the Financial Crisis and the pandemic, U.S. large company stocks made money in all but two years (2008 and 2018). On three other occasions (2007, 2011, and 2015), they returned less than their long-term average of roughly 10%. That means, in 10 of these 15 years, large cap stocks gained 10% or more annually.

One of the most significant factors driving stock prices higher over the last 10 years has been the low interest rates we mentioned earlier. Low rates made stocks an even more attractive investment than bonds. And low rates mean investors can purchase a company's future earnings more cheaply. Growth stocks have soared as a result.

The bond market is a different story. The 10-year U.S. Treasury bond began 2021 with a yield of 0.916%. As of this writing, the 10-year yields 1.70%, a near doubling in yield in three months. Clearly, bond investors are bracing for inflation and higher interest rates, even though the Fed says they don't anticipate raising rates until the end of 2023.

What does the future hold for the stock and bond markets, for inflation and interest rates? No one knows, not even the Fed. The "Goldilocks" scenario would be Powell's "one-time surge" in prices that settles down after the pandemic subsides and global supply chains readjust. Maybe the Fed raises rates a little, but there is no rampant and runaway inflation that leads to much higher interest rates.

As is always the case, the future is unknown and unpredictable. What I do know can be summed up by my favorite financial writer, Morgan Housel:

> *"All good investing comes down to surviving an inevitable chain of short-term setbacks and disappointments in order to enjoy long-term progress and compounding."*

Thanks for reading.

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