MENDOZA
PRIVATE WEALTH

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Inflation & Deflation

What is Inflation?

In simple terms, inflation means rising prices, whereas deflation means prices are falling. In order to gauge the overall direction of prices, investors often look at inflation indexes as a broad measure of general price trends. For example, consumer price indexes are calculated from a basket of goods and services based on general consumer spending patterns. Inflation and the business cycle are tied together in the sense that prices tend to rise in the late stages of the business cycle, leading to overall inflation. On the other hand, during recessions, or in the early stages of recovery, prices tend to fall potentially creating a period of deflation.

A period of prolonged elevated inflation can potentially cause detrimental effects to the economy. Consumers may fear that prices will rise even more in the future and accelerate purchases to try to avoid future increases. An outsized increase in short-term demand would most likely cause inflation to rise even higher, thus potentially causing an inflation spiral where prices become unanchored from sustainable levels. Central banks must try to avoid an inflation spiral at all costs.

Why is Inflation Bad?

The effects of inflation can be illustrated by way of example. Let us assume that a US consumer has a new $100 bill in their pocket on January 1st. If inflation is roughly around 3% for the year, then by December 31st, that hundred-dollar bill may appear to have the same value it did at the beginning of the year, but instead, in terms of its purchasing power, it's only worth $97. The loss of purchasing power can be especially acute if inflation remains high for a prolonged period. The effects of prolonged higher inflation would likely lead to changes in

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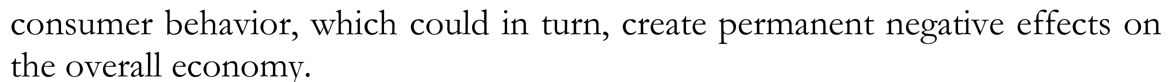

consumer behavior, which could in turn, create permanent negative effects on the overall economy.

This is why we often refer to inflation as the silent destroyer of wealth. We do not always perceive the effects of inflation because these effects are gradual and hardly noticeable in the short run. In the long run however, the reduction of our purchasing power can have a significant impact on our financial wellbeing, particularly for those on a fixed income.

To rein in inflation by increasing interest rates, the likely effects would include a higher interest cost when making large purchases. Rising borrowing costs means that the monthly payment calculated on that new home mortgage or that new auto loan would be higher than previously thought. The timing of which may be particularly challenging for those facing increasing prices in the grocery store and the gas pump. This financial stress would likely be accompanied by the overarching threat of layoffs and a rising unemployment rate.

Regardless of the temporary pain that tightening financial conditions may create, central bankers understand the need to take a more holistic view of the overall economy and realize that at times, it may be necessary to sacrifice some measure of job losses in order to protect the overall economy from runaway inflation. Businesses and consumers typically benefit from the environment in which future inflation expectations are anchored to an explicit target, thereby allowing decisions to be made without the influence of an inflationary or deflationary environment.

Investors should be aware of the eroding effects of inflation and if possible, position their assets in a way to help offset those effects over time. One of the best ways to do that is to have a properly diversified portfolio with multiple asset classes thoughtfully combined in a manner consistent with the overall risk tolerance, time horizon, and investment objectives of the investor.

Some asset classes perform better than others do during periods of higher, lower or stable inflation. During periods when inflation is either at or below expectations, equities historically do better than expected. During a period of higher-than-expected inflation, cash and real estate historically do better than expected. Finally, during periods of deflation, bonds historically do better than expected. We do not believe that investors should attempt to time their way in or out of asset classes based on their view on inflation. Instead, we believe investors should consider a diversified portfolio that addresses their needs through full market cycles. Even for the most seasoned market participants,

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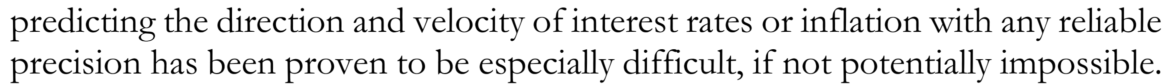
predicting the direction and velocity of interest rates or inflation with any reliable precision has been proven to be especially difficult, if not potentially impossible.

If you would like to learn more about how to prepare yourself for the long-term eroding effects of inflation, go to our website, send us a message via email, or give us a call at your convenience. We would be delighted to be of service.

Call/email me for additional insights or for more information.

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