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Why Inflation Can Be Good

Most people don't have a kind word to say about inflation, and those on fixed incomes hate it. It makes everything more expensive, and when you're living on an income that never rises, your standard of living suffers.

But ask most economists and they'll tell you that, within limits, inflation is good, and its opposite — deflation — is bad. How can that be? The broad definition of inflation is a general increase in prices. Deflation is the opposite — a general fall in prices.

When we say general, we're referring to the prices of most goods and services. This is an important distinction because prices of some things move in a different direction from most. For example, regardless of what's happening to the price of food or clothing, prices generally fall for new, high-technology items after a number of years. That's usually because manufacturers achieve economies of scale and are able to pass the associated savings along to consumers, and/or because they have invented new, less expensive ways to make the latest gadget. It also happens when more manufacturers come into the market and compete against established makers on the basis of price.

There can also be regional differences in the prices of some goods. An example is real estate, where prices may be falling in areas that are experiencing a high rate of job losses, while prices may be rising in areas where the job market is booming.

Three Measures of Inflation

1. The Consumer Price Index (CPI). This is the figure most Americans think of when they think about inflation. It's calculated monthly by

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Welcome Zane Schreiber

Abeles Flurie Wealth Management Group of Wells Fargo Advisors is excited to welcome Zane Schreiber to our practice effective October 1, 2019. Zane was a 2017 graduate of The George Washington University. He graduated with a double major and received his Bachelor of Science in Finance & Organizational Sciences. Also during his time at GW he pitched on the Baseball team for all four years.

Zane has been working closely with our practice for the past two years. As a Financial Advisor he will be managing clients, as well as, seeking to develop new wealth management relationships. Zane's claim to fame was he played a critical role on the Washington County Maryland, Federal Little League baseball team that went to the Little League World Series in 2008!

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Why Inflation

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the Bureau of Labor Statistics, based on the prices of a basket of some 80,000 different goods and services that most consumers buy in markets across the country.

The Bureau of Labor Statistics categorizes those goods and services as: food and beverages (including at-home and restaurant meals), housing (rent of a primary residence, owners' equivalent rent, furniture), clothing (including jewelry), transportation (new vehicles, airline fares, gasoline, motor vehicle insurance), medical care (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, hospital services), recreation (televisions, toys, pets and pet products, sports equipment, admissions), education and communication (college tuition, postage, telephone services, computer software and accessories), and other goods and services (tobacco and smoking products, haircuts, and other personal services). The CPI also includes sales and excise taxes, utility fees, and highway tolls. It excludes investments like stocks, bonds, and insurance, as well as income and Social Security taxes.

You'll sometimes hear about core inflation. This is a derivation of the CPI that excludes the goods that have volatile prices, like food and fuel. The idea is to avoid short-run price changes that mask longer-term trends.

2. GDP deflator. Based on changes in Gross Domestic Product (GDP), this is a broader measure than the CPI because it includes every kind of good and service the economy produces and delivers. For example, it includes raw materials and industrial goods, like steel, factory equipment, and investment services. It's expressed as a percentage that reduces the nominal new price of a good or service to reflect the quantity of goods.

The GDP deflator is regarded as a more accurate measure of price trends throughout the *entire* economy.

3. Producer Price Index (PPI). This measures changes in the wholesale prices of goods and services by manufacturers. It's often looked at as a leading indicator to estimate later changes in the CPI.

How Can Inflation Be a Good Thing?

Inflation is a by-product of economic growth, which is the means by which the standard of living rises. Think of it this way: prices are a function of supply and demand; if businesses post higher prices for their goods and services and they stick, it's because demand is willing and able to pay those prices. One of the ways that people can afford to pay more is if their incomes are rising, which is what happens when they are working for successful companies.

Higher prices are also supported when there is a continually growing number of people with jobs and money to spend.

Inflation can also stimulate growth by making existing debt cheaper. Think of homeowners who stretch their budgets to buy the nicest home they can afford. Over time, if the economy grows, so does their income. If they hold a fixed-rate mortgage, their monthly mortgage payment for principal and interest becomes a smaller and smaller percentage of their income.

As a result, they have an increasing amount of free cash flow to spend on other goods and services. And that, in turn, causes businesses to hire more people.

The Destructive Power of Deflation

Deflation is a general decline in prices — not to be confused with a decreasing rate of inflation — and is a destructive economic force. First, it's a sign that businesses can't pass along higher costs of production.

Second, it results in lower revenue and, if it lasts for several years, cutbacks in production and employment. When people lose their jobs, they spend less, have trouble keeping up with their bills, and even lose their homes.

Third, deflation makes debt more expensive. As incomes and business profits decline, fixed-rate loans become an increasingly larger percentage of cash flow. Banks foreclose on mortgages, increasing the supply of homes and driving down all home values, and some businesses go into bankruptcy. Banks lend fewer loans because fewer borrowers can qualify. People who still have jobs start paying off debt more aggressively.

This further reduces demand for goods and services, and the economy enters a negative feedback loop, feeding negative growth and higher unemployment.

Deflation is one of the major causes of economic depressions. In the 13 years from 1927 through 1939, the U.S. experienced CPI deflation in eight years, with prices falling 8.9% in 1931, 10.3% in 1932, and 5.0% in 1933.

By comparison, during the Great Recession, we experienced only one year of very slight deflation in 2009, when the CPI fell by 0.4%.

The Inflation Ideal: Low Single Digits

Is there an ideal rate of inflation? Economists suggest that a moderate rate of inflation — in the low-single digits — is optimal for sustained long-term growth. Indeed, the Federal Reserve Bank has said that an inflation rate of 2% is ideal.

Please call if you'd like to discuss this in more detail. ❍❍❍

Making Sense of the Federal Deficit

The federal deficit is often confused with federal debt, though the two are closely intertwined and impact the U.S. economy in several ways. A federal deficit is simply defined as the shortfall that remains when the government's expenditures exceed its revenue.

Imagine if, at the end of this month, your bills exceed your deposits. Just like Congress, you must find a way to fund this budget deficit to prevent any defaults. You might dip into your savings, apply the deficit to a credit card, or borrow money from a friend, family member, or lender. Essentially, this is no different than how Congress manages the federal deficit, except at the federal level, borrowing money means selling Treasury securities to the public. These owed funds become part of the national debt.

So who decides what is spent and what is collected as revenue? Each year, the annual federal budget is established by the president who submits a budget request each February for the upcoming fiscal year (beginning October 1) after consulting with federal agencies and the president's Office of Management and Budget. This budget request outlines three key factors: 1) the amount the government should spend on public services such as defense or education; 2) the tax revenues the government should collect; 3) the recommended annual deficit or surplus.

The federal government has consecutively reported a deficit since 2002. Last year alone, the Congressional Budget Office reported a deficit of $779 billion, putting the national debt at over $21 trillion at the fiscal end of 2018. Compared to recent years, this deficit was relatively low: in 2009, Congress reported a record-setting $1.41 trillion deficit, and over a trillion dollars each year thereafter until 2013. Historically, deficits are highest during times of war, with reported U.S. government deficits dating all the way to the aftermath of The American Revolutionary War. Deficits also spike during national emergencies, such as the subprime mortgage crisis.

What Do These Deficit Numbers Really Mean?

While it's difficult at best to absorb the enormity of these numbers, it's important to acknowledge that much of this debt is relative. Deficits and national debt should really be analyzed alongside the gross domestic product (GDP), taking the true size of our economy into context. The GDP is the total value of final goods and services produced within a country, generally measured on an annual basis.

If our GDP is growing at a higher rate than our national debt, there may be little cause for concern. The relationship between the two is measured by the ratio of national debt (in currency such as dollars) to the GDP. This debt-to-GDP ratio is a commonly used measure of a country's financial health, and the lower this ratio's percentage, the better. Countries wishing to join the European Union, for example, had to have a ratio under 60%. The U.S. Bureau of Public Debt reported a debt-to-GDP ratio of 105% in 2017, though this is still much lower than the highest reported U.S. debt ratio of 122% in 1946.

How Does the National Debt Impact Individuals?

High national debt can have several negative impacts on the economy, including the following:

Lower wages. Investing in government debt translates to money not being invested in companies, which can lead to stumped economic growth and wages.

Higher interest rates. With each new deficit, the government needs to sell more Treasury securities to finance the debt. In order to make these securities more attractive to foreign investors, banks, and the general public, the government will often increase interest rates. This can lead to higher interest rates in general.

Standard of living inequality for future generations. Lower wages, slower job growth, and higher interest rates all spell hardship for upcoming generations who may have to survive on less or prolong retirement dates.

Looming crises. If deficits and national debt growth go unchecked, U.S. debt investors could very well demand higher returns, ultimately leading to an unprecedented financial crisis.

The general consensus remains that both annual budget deficits and the national debt must be addressed in a way that strengthens the economy, though political parties will likely continue to disagree over tax hikes versus spending cuts.

Ironically, many people pay more attention to the federal budget and national debt than their own personal finances. It's important to understand that managing personal debt, coupled with a sound savings and investment plan, should be your highest priority. Please call to discuss your individual financial health. ❍❍❍

Is Your 401(k) Plan Enough?

In 2019, the maximum annual 401(k) contribution is $19,000, not including employer-matching contributions. If you are at least 50 years old, you can contribute an additional $6,000 in 2019, if permitted by the plan.

Here are five questions to help you decide whether your 401(k) plan is the only plan you'll need for retirement:

✔ **What kind of lifestyle do you want to fund in retirement?** You'll find general rules of thumb indicating you'll need anywhere from 70% to over 100% of your preretirement income during retirement. How much you'll need depends on your circumstances.

✔ **Can you count on Social Security?** Social Security benefits were never designed to be the sole source of retirement income, but are still a valuable source. Those with lower incomes will find that Social Security replaces a higher percentage of their preretirement income than those with higher incomes.

✔ **How much does your employer contribute to your 401(k) plan?** The $19,000 maximum contribution to your 401(k) plan does not include employer contributions. Employer-matching contributions vary by plan, but a typical match is 50 cents for every dollar contributed up to a maximum of 6% of your pay. However, many employers have recently reduced or eliminated matching contributions. If your employer offers a match, make sure you take full advantage of it. A generous matching contribution can contribute substantially toward your retirement.

✔ **What are average returns on your 401(k) investments?** You can only choose from the investments offered by your 401(k) plan. Within those parameters, select those that match the long-term nature of your investments.

✔ **What other sources of income can you count on?** If you already have other retirement assets, you might not need to count as heavily on your 401(k) plan. Other potential sources of retirement income might include a defined-benefit pension plan, individual retirement accounts (IRAs), an inheritance, or other investments.

If you contribute the maximum amount possible to your 401(k) plan and still aren't sure you'll have enough for retirement, please call for a review. ❍❍❍

Why Teach Children about Investing?

Not convinced your children need to know how investing works? Here are four good reasons.

Because someday they'll need to do it on their own — Once your children are on their own and have jobs, they'll have to make decisions about investing for retirement and other goals. If they are armed with good lessons from childhood, they're more likely to make smart decisions.

Because good money habits start early — Children's core money habits may be ingrained as early as seven years old. While it may not be reasonable to expect a second grader to understand the intricacies of derivatives and hedge funds, you can start to teach children about concepts related to investing, like the idea that wealth builds over time.

So they can make mistakes — By exposing your children to investing at a young age, they'll learn valuable lessons now, when losing money hurts less.

So they can start building wealth early — If your children start young, you'll be giving them an important leg up for their financial future. ❍❍❍

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