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CPI

CPI – the Consumer Price Index, aka inflation – has risen sharply, remains high and the trend ahead is uncertain. For consumers and investors alike, this has been an unwelcome and largely unexpected development. Whether at the gas pump or the grocery, prices are rising faster than incomes. Whether bonds or stocks, prices are lower in the year-to-date and higher inflation has been a factor. The CPI is the most frequently referenced measure of inflation. Some CPI relationships can provide perspective for investing ahead.

PERSPECTIVE

Until recently, a view that any rise in inflation would be "transitory" was widely held by many, including the Federal Reserve. Influencing this expectation in part was the prior experience of very low inflation over many years. Chart I shows consensus forecasts of and outcomes for the CPI. Just prior to the pandemic, the CPI had been around 2% and was forecasted to remain so. Well into the pandemic and following volatile swings in the CPI, the consensus forecast was for the CPI to return to 2%. Even with the more recent, sharp increases in the CPI, consensus forecasts have been for a relatively quick return to lower inflation. A less favorable outlook would bring more policy challenges if it resulted in changes in spending and investing behaviors.

Concern for persistent inflation rests in part on emergence of a so-called "wage-price spiral", i.e., higher prices lead to higher wages which lead to even higher prices and so on. Chart II shows the trends in the CPI and net employment cost. The all-in cost of employment offset by gains in productivity is a measure of wage pressure on inflation. Over most of the last two decades, net employment cost has run below the CPI. Both are now trending higher with employment cost pressure coming in part from the mismatch between job openings and available workers. The persistence of this mismatch could result either in a higher CPI, lower economic activity or both. The latter outcome, "stagflation", would challenge both consumers and investors.

As higher inflation reduces purchasing power, it is an important consideration when investing before and during retirement. The goal for many is to achieve a spending rate in retirement that neither falls short over time nor results in a reduced quality of life along the way. Table I shows the trade-offs between the rates of spending and inflation over 25-year horizons for a 60/40 portfolio allocation between stocks and bonds. An 80% probability of success is considered a safe harbor. Outcomes here are based on historical returns over many market cycles. An extended period of higher inflation and below average returns would reduce all safe-harbor spending rates.

CHART I

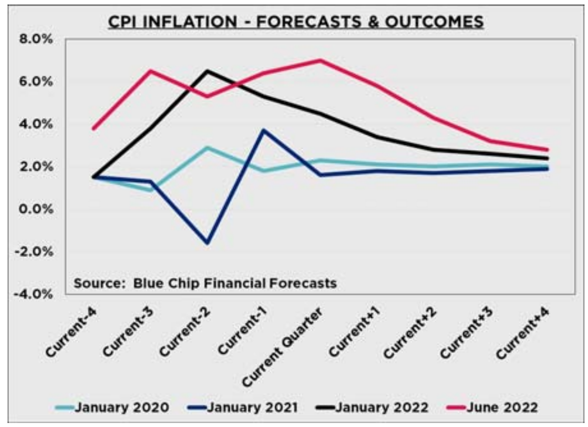

CHART II

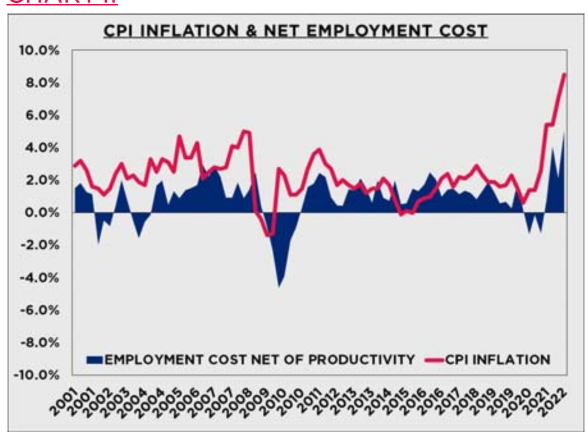

TABLE I

PROBABILITIES OF SUCCESS

25-YEAR HORIZON; 60/40 STOCK/BOND ALLOCATION

SPENDING RATE					
	6%	81%	64%	49%	31%
	5%	95%	91%	76%	60%
	4%	98%	96%	95%	91%
	3%	100%	100%	99%	97%
		3%	4%	5%	6%
		CPI INFLATION			

INVESTMENT IMPLICATIONS

The impact of a higher CPI can vary across households, but it remains a reasonable measure for assessing overall financial well-being. One strategy for addressing a higher CPI is raising portfolio risk levels in pursuit of higher returns. Such a strategy requires a clear understanding of the consequences from unfavorable outcomes. If the higher risk does not reward but the CPI remains high, success probabilities will contract. The significance of any contraction is dependent on individual goals, time horizons and risk tolerances.