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ADVANCE CAPITAL MANAGEMENT

FINANCIAL LIVING

volume Q4 2021

A QUARTERLY NEWSLETTER FOR THE CLIENTS AND FRIENDS OF ADVANCE CAPITAL MANAGEMENT

The Inflation Conundrum

"Inflation is caused by too much money chasing too few goods." -Milton Friedman

Inflation is likely a foreign concept to many people, unless they are old enough to recall the high inflation of the late 1970's and early 1980's. Back then, a toxic combination of easy money policies by the Federal Reserve, along with massive deficit spending and large social programs, started the inflation bug. Then our country experienced an oil embargo, price and wage controls, and the elimination of the gold window. The result was one of the worst bouts of inflation our country has ever experienced.

Today, with inflation spiking in the aftermath of the pandemic, it is natural to wonder whether we are headed for a 1970's style inflation redux, particularly since several of the economic characteristics appear eerily similar. The Federal Reserve and the federal government have unleashed unprecedented liquidity, inflating the nation's budget deficit. Oil prices have shot up 70 percent this year. Food prices are up more than 10 percent, and the prices for many everyday purchases are noticeably higher. Further complicating the equation is massive global supply bottlenecks, a lack of qualified workers, and higher consumer demand for products and services. It appears this is a classic supply and demand mismatch that has resulted in higher inflation.

The biggest questions for investors are: How high might inflation go and how long will it last? Is it transitory or the new normal? Let's try to put it into some historical perspective and attempt to predict where inflation might be headed in the future. Today's inflation gauge, as measured by the Consumer Price Index (CPI), hit 5.4 percent over the past 12 months through September. The last time it hit this level was June 1990. Relative to a staggering 15 percent in 1980, the current growth in CPI is not too problematic at this point. On the other hand, the Producer Price Index (PPI) just topped its highest yearly increase since 1980. This index measures the price increases received by those companies that produce goods and services. In short, demand has increased in the wake of the pandemic lockdowns and consumers are flush with cash from all the government assistance. At the same time, availability of products across many sectors of the economy are severely constrained from a combination of a labor shortage, Covid restrictions and supply-chain issues. Demand is high, supply is low. Hence, higher inflation.

Will it last?

The short answer is some of it probably will. The supply and demand imbalance throughout the economy will take time to "normalize." West Coast ports are jammed with products waiting to be unloaded, transportation companies are struggling to find workers and wages are rising. Yet, many of the more sensitive categories like food, energy and car prices, which

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Market Insights: Q3 2021

"New beginnings are often disguised as painful endings," is a famous and appropriate quote relevant to today's economic and social environment. Although we desperately try to move on from the pandemic, we are constantly reminded of its grip on our lives. Still, the economy has roared back to life, with tremendous help from the government and Federal Reserve.

Collectively, we are settling into our new reality with a bit more clarity and appreciation for what lies ahead. Our world has been forever altered because of this experience. Hopefully, for the better. Already these changes have had a profound impact on our lives, including how we work, shop, learn and use technology. Dramatic changes in life tend come with newfound opportunities, and we are starting to witness this in both the economy and capital markets.

ECONOMY GRAPPLES WITH HIGH DEMAND AND LOW SUPPLY

On the economic front, the major trends continue to point to robust growth with strong end-user demand for both products and services. The recent manufacturing industry report showed growth in 15 of 18 sectors with broad production gains, an increase in new orders and higher backlogs. Yet, the industry continues to struggle with a combination of global supply-chain slowdowns, higher input costs and trouble hiring qualified workers. These and other persistent problems are expected to last well into 2022. The services part of the economy has also benefitted from a surge in demand as consumers attempt to return to normal activities. However, the lack of workers along with higher commodity prices and increased regulations has pressured profit margins and left many businesses struggling to keep afloat.

The housing market remains another bright spot in the economy. The number of single-family houses under construction rose to 689,000, the most since 2007. Further, annual housing starts are expected to hit 1.6 million, a pace last witnessed nearly 15 years ago, as demand is expected to remain elevated. Still, as homebuilders grapple with limited availability of land, labor and materials, home prices are expected to rise modestly in the years ahead.

FEDERAL RESERVE CONSIDERS TAKING ITS FOOT OFF THE GAS

While still unprecedented in modern history, the tremendous financial support by the Federal Reserve and the U.S. government is expected to wane a bit in the months ahead. Already, the government has ended both the additional unemployment payments to individuals and the eviction moratorium. However, new benefits have started, such as the child tax credit payments, which should help buoy the finances of many families. At the same time, the Federal Reserve has indicated that its massive monetary support to the credit markets throughout the crisis is not infinite. In the recent commentary by the committee, it started the process of discussing a timeline to reduce asset purchases and return to a more normal operational environment at some point. While this could ultimately take years to accomplish, it is difficult to determine how disruptive these actions by the government and Federal Reserve could be on the financial markets.

MARKETS STRUGGLE WITH LATEST COVID SURGE

During the quarter, investors struggled with a rise in Covid cases, even as vaccine rates increased, and concerns that waning support by the Federal Reserve would negatively impact the economy and capital markets. Still, corporate earnings grew about 90 percent for S&P 500 companies in the latest quarter and are expected to top 20 percent over the next few quarters. Higher earnings should bolster stocks, even as overall valuations remain high. For the quarter, the S&P 500 Index returned 0.58%, while mid- and small-cap stocks declined -1.76% and -2.85%, respectively. Growth stocks came roaring back, relative to value, as investors cooled a bit on the reopening story. In bonds, interest rates declined modestly, which helped produce slightly positive results for most areas of the bond market.

OUR MARKET OUTLOOK

Looking ahead, the economy and financial markets face several obstacles that could either help or hinder growth and market returns. The recent surge of economic activity brought along higher inflation, supply bottlenecks and a lack of qualified workers. These conditions are not easily resolved and could restrain economic activity over the next few years. Further, investor expectations of unlimited support by the Federal Reserve will be tested over the next few years.

Finally, although massive deficit spending by the U.S. government helps support growth in the short-term, the long-term ramifications of this high debt load is likely to hinder growth. While we expect some additional volatility in the capital markets

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It is not possible to invest directly into an index. The indices mentioned in this article are unmanaged and are not affiliated with Advance Capital Companies.

What to Do If You Have Too Much Cash

You should save a certain amount of cash that is easily accessible to help cover financial emergencies or immediate financial goals. But, with interest rates so low, you practically earn nothing on your cash when it is saved in a bank account.

So, how much is too much, and what should you do with your excess cash?

How Much Cash to Keep on Hand

Again, liquid cash is a necessity. The point of that money isn't to earn a nice return, but rather to just be there when you need it most. For that purpose though, the amount of cash to have is not unlimited.

You may have heard recommendations to set aside 6 or even 12 months' worth of living expenses in cash. While that provides a wide financial safety net, it could be almost too safe. For a couple who has $7,000 in monthly expenses, as an example, that rule of thumb equates to saving $42,000 to $84,000. That is potentially a lot of money simply sitting there; hopefully, in a bank account and not stuffed under a mattress.

Instead, it can make more sense to keep a lower amount of cash on hand – say, 1 to 3 months' worth of living expenses – and then invest the excess amount.

Let's explore why.

The Adverse Impact of Inflation on Cash

The biggest risk of having too much cash isn't the missed opportunity of growth, it is the loss of purchasing power over time. That is the adverse effect of inflation, the rise in price of goods and services.

When you combine near-zero interest rates with rising inflation, you can expect your money's value to gradually decline. Historically, the rate of inflation has been around 3%. But even if we consider a 2% inflation rate, reflecting low inflation in recent times, it still has a significantly negative effect on your purchasing power.

Here is the impact of 2% inflation on $100,000 saved in an account earning 0% interest:

Assuming 2% Inflation

Year	0% Interest Earned
Today	$100,000
10	$82,034
20	$67,296
30	$55,206
40	$45,290

After 40 years, you would still have $100,000 saved in your bank account. Except you would only be able to buy around $45,000 worth of stuff.

Investing Excess Cash

Keeping the value of your money above the rate of inflation is a major reason for investing money. Therefore, you should consider investing your excess cash – as long as you have a fully funded emergency fund.

To better illustrate why, let's say you took the $100,000 from the example above and instead invested it, earning an annual return of 5%.

Here is a comparison of $100,000 earning a 5% return versus a 0% return, assuming a 2% inflation rate (see next page):

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The Inflation Conundrum *(Continued from page 1)*

have spiked higher in price recently, can also move lower over time. Consequently, many economists estimate inflation will remain above its long-term average of 3 percent for at least another year or two. However, the red-hot level of inflation we are currently experiencing should cool a bit in the coming quarters.

What to do?

From an investment perspective, inflation can severely hinder returns in bonds, while certain sectors of the stock market should hold up reasonably well. For instance, the 10-year U.S. Treasury bond is currently yielding about 1.6 percent, while inflation is 5.4 percent. In essence, investing in Treasury bonds is a losing proposition relative to inflation. However, holding some Treasury Inflation Protected Securities (TIPS) will help buffer some of the inflationary pressures in bonds. Conversely, many economic sensitive sectors of the stock market benefit from higher inflation, such as commodities, banks, industrial and consumer staples. Referred to as "value" stocks, these companies have more flexibility and pricing power in an inflationary environment. But, before making wholesale changes to your portfolio, remember that sustained periods of elevated inflation are rare in U.S. history. Over the past 100 years, inflation has stayed below 5 percent most of the time. In the aftermath of the 2007-2009 global financial crisis, inflation struggled to hit 2 percent on a sustained basis, despite unprecedented government stimulus. Some inflation can be a good thing for both the economy and the financial markets. Even during times of higher inflation, stocks and bonds have generally provided reasonable returns.

In short, while the current inflationary environment is unnerving, it is not that abnormal given the unprecedented demand and monetary stimulus in the wake of the pandemic crisis, which was mostly self-induced. Still, the lingering effects of inflation are likely to continue for at least the next year before subsiding once the monetary stimulus is removed, supply-chain disruptions are resolved, and demand declines. While some inflation is healthy, too much can wreak havoc on the economy and financial assets. For now, it appears like a mismatch in supply and demand, and only time will tell how much of it is temporary or permanent. ■

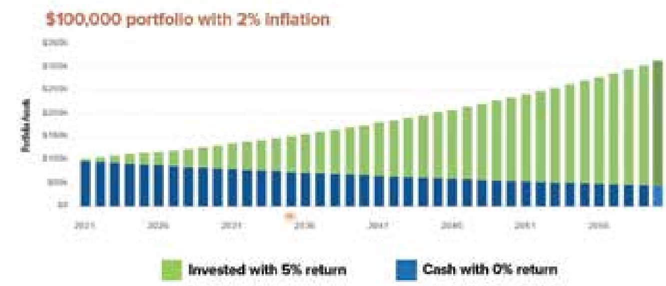
Year-End Finance Steps

As tax season revs up in January, the end of the year is the perfect time for some financial housekeeping. Here are some steps to take that'll help make 2022 a financial success:

- If working, try to maximize contributions to your retirement savings accounts.
- Check your tax withholding.
- Schedule a meeting with your adviser for a portfolio review.
- Update your beneficiaries.
- Review your budget.
- Check your credit reports.
- Shop around for more favorable insurance rates.
- Consider charitable giving.

As always, your adviser is available to further discuss these steps with you! ■

Too Much Cash *(Continued from page 3)*



The money that is invested steadily grows over time. Whereas, the money sitting in cash gradually goes in the opposite direction.

Investing your excess cash doesn't mean putting it in a retirement account. Rather, you can invest your excess cash in a non-qualified investment account. It is essentially like a savings account within which you can invest. You can put as much money into it that you want, and then withdraw that money whenever you want (though you would owe taxes on any capital gains).

As with any investment account, you can set it up and manage it with the help of your financial adviser.

The Emotional Benefits of Saving Cash

Advance Capital Management is all about looking at the whole picture. We know that one factor of your financial life that deserves as much consideration as what the data say is what your emotions say.

Therefore, there are always good exceptions to what makes the most sense from a purely financial perspective.

For example, the Employee Benefit Research Institute's (EBRI) Spending in Retirement Survey evaluated the spending habits and well-being of 2,000 Americans ages 62 to 75. The majority of respondents (57%) wanted to spend down only a small portion of assets, spend none at all, or grow their assets.

When asked about the rationale for not spending down their assets, more than a third (31%) said they "simply feel better when account balances remain high." A surprising 64% of survey respondents agreed that saving as much as they can makes them feel happy and fulfilled.

Peace of mind is important. Whatever helps you sleep at night should not be underestimated.

At the same time, giving in to your emotions should not come at the expense of living out your financial goals – which is the point of accumulating this money in the first place! Ultimately, the ideal amount of cash to keep on hand and what you should do with any excess cash is a personal decision, one that you should consider talking over with your financial adviser. ■

Market Insights *(Continued from page 2)*

as we work through these issues, we suspect corporate earnings growth will remain strong, which should bring down currently lofty valuations, and interest rates should remain historically low. With stocks up substantially already for the year, we expect more muted returns over the next few quarters. In bonds, higher consumer inflation and better economic growth will likely hinder returns. We continue to work diligently to analyze the environment and make strategic investment moves in client accounts as appropriate.

As always, investing in capital markets comes with some risk and uncertainty. We thank you for your continued support of our investment process as we work hard to deliver positive risk-adjusted portfolio returns to our clients. Should you have any questions, please do not hesitate to reach out to your financial adviser. ■

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