Episode 16: Inflation - How Did We Get Here and What is the Market Telling Us?

Bob French 00:00
The purpose of Retire with Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style and sign up to take the industry's first financial personality tool for retirement planning. So we're going to be talking about inflation, deflation, and stagflation. Where do I sign up?

Alex Murguia 00:48
Wade, why don't you do the intro this time? That since, mix it up.

Wade Pfau 00:55
Hey, everyone. Welcome to Retirement with Style. Welcome, everyone to Retire with Style. I'm Wade. And I'm joined today by Alex and our special guest today.

Bob French 01:14
Hey, everyone its Bob French again.

Wade Pfau 01:16
Yeah, welcome back to the second episode, we have so much to talk about on the previous episode, we focused more on what was going on with the financial markets more generally, but thinking more in terms of stock and bond returns. But Bob, we're happy to have you back for another episode where today, we want to focus more on the inflation environment. And really the fact that inflation is much higher than we're used to seeing in a very long time. And what to make of all that, in that regard, getting into this, you did start discussing this in our previous episodes. So maybe for those who want that full Bob experience, make sure you listen to what what were the issues that we were talking about last? Why is there higher inflation.

Alex Murguia 02:06
It's like double shot Tuesday, get the lead out.

Bob French 02:13
Yeah. Well, to bring this all back in here. You know, we talked about a number of things. And you know, a lot of, you know, the market stuff is really been driven by by inflation. So it's kind of good to dig in, to what's going on there. But the basic stories is largely going to be the same and largely kind of what we expected to a certain extent, I mean, effectively, I think it's fair to say the pandemic haitus screwed everything up, you know, screwed up, you know, all sorts of things, but from an economic and kind of

investment and or real economic standpoint, here, excuse me, you know, it screwed up the supply chains, just businesses, in general, we're seeing a lot higher labor costs. And, you know, that's kind of the supply side of the equation. On the demand side, people have been, you know, basically forced to save more, over the past few years, you know, we haven't been able to go out and do as much stuff. We haven't been traveling, we haven't been eating out as much. We haven't been just spending as much money.

Alex Murguia 03:24
But I do think that's been offset by the folks that needed to like, you know, the needed to have stimulus, you know, there were there are some folks that suffered.

Bob French 03:35
Yeah, and that that also plays in? Absolutely, yes, I do not want to minimize that in any fashion. What I'm looking at is simply from the straight economic perspective, you know, we have had saving rates just as a matter of fact, have been higher over the past, I guess, two years, than they have been historically in the US.

Wade Pfau 04:02
And it dropped dramatically during the pandemic,

Bob French 04:06
you know, for, well, for I was about to say, for a host of reasons, but really, for one big reason, you know, the pandemic, we haven't been able to safely go out and do as much and Alex is to your point that a lot of that pandemic money or the stimulus money from the pandemic, you know, that contributed to people being able to live in a lot of cases. But in a lot of other cases, it contributed to that savings that I'm talking about, you know, that money came in and you know, got put into the bank or put into their investment portfolio or wherever it went. But they didn't necessarily spend it at that point in time. And now that the economy and you know, the world is starting to open up again, people are looking to spend that money, you know, they are looking to go on that trip. Maybe Maybe it's domestic rather than international, maybe it's, you know, the next state over whatever it might be, but they're looking to do things, they're looking to get out and spend that money. So we're left in a situation where businesses haven't quite gotten back to where they need to be. So supply is down, demand is up. And that's what inflation is, there's more money chasing less goods. So the value of the dollar is both dropping. And that's what's going on here, in terms of why we're seeing what we are, and you can spin this out in any number of ways. But that's the underlying story.

Wade Pfau 05:41
And we're gonna be talking about like the role of the Federal Reserve in this process and what they're doing. But like one starting point, maybe it's a step back, that the Federal Reserve seems to target inflation around 2%. There. Yeah, somebody's echoing.

Bob French 06:03
Wade, I can still hear you.

Wade Pfau 06:05
Sorry about that. So the Fed seems to be targeting inflation, say at around 2%, rather than say, zero, why? Why are we simply not trying to have a 0% inflation rate? Why is some inflation potentially a good thing? Before we get into the conversation about when too much inflation?

Bob French 06:24
Yeah, so this is one that it's actually a really interesting kind of macro economic conversation, you know, effectively, we do as a general statement, actually want at least a little bit of inflation. You know, it's effectively an incentive to keep things moving, you know, if you can just sit on your money, you know, well, let's, let's actually take it the other way, you know, deflation, you know, when, you know, money becomes more valuable through time. You know, that's basically how you get some form of stagnation, when you have no incentive, or actually a disincentive to spend your money or do something with your money. You know, people don't, they sit on their money, and it kind of keeps things locked up. So some level of inflation is good for kind of making sure that doesn't happen and just generally keeping things moving. And

Alex Murguia 07:20
please, guys, just just in case for folks listening, inflation, we get it, can you just repeat the definition real quick, have stagflation of deflation and stagflation.

Bob French 07:32
So, deflation is the opposite of inflation. So deflation is when you know, inflation is is negative. So you know, $1 is worth more tomorrow than it is today or next year than it is today. You know, buys more stuff than it does today.

Wade Pfau 07:51
And this has happened historically, in the US Great Depression earlier, it's been an issue in Japan in recent years, where even just holding cash is gaining real purchasing power over time, if the price level is dropping, and it's happening

Bob French 08:06
It's happening in crypto, or was until recently anyway, so. But, you know, I mean, it's something that, you know, intuitively feels like, it should be a really cool thing, or a really great thing for people, you know, that their money just naturally is, you know, getting more valuable. Inflation is bad. So deflation must be good. Problem is, it's as some pretty nasty kind of economic consequences for, you know, the the quote, unquote, real economy, you know, people actually, you know, going out there and spending money and doing business with each other disincentivizes that,

Wade Pfau 08:44
and there's some interesting research to about like, businesses, inflation can provide flexibility because workers do not like to have their wages cut. With inflation, if I just keep paying the same wage, my my wages being cut, in real terms, it's losing purchasing power, but people don't usually think about that they're focused on their nominal wage. And so positive inflation provides some flexibility to firms to just not increase wages as quickly as a mechanism to help control costs in a way that if there's deflation,

they have to cut people's wages, or else they're because they're the goods that they can sell. They sell for less, they've got to cut wages, but that's going to really hurt morale at the firm. And so that's another reason that policymakers like to have some inflation to just create flexibility for businesses with responding to kind of the costs and so forth and business.

Alex Murguia 09:40
So it's, it's better to have a steady state of manageable inflation because it just helps and which is kind of the antithesis of of you're retired and you're holding cash.

Wade Pfau 09:53
Yep. And that's for for a long time. Now, it seemed like the Fed had beat the inflation and bug and long term market expectations where inflation of around 2% There's been points in recent history where we have worried a bit that maybe this inflation was going to turn into deflation. It didn't happen. Inflation tended to stay positive but low. But it's it's picking up now. And so what what's happening in terms of now we're seeing this high inflation, you've discussed why this is happening, this supply and demand issue. But what should we because inflation is now say, over the past year eight, even potentially 9%? Should we now build in an expectation that over the long term future at this point, we're going to be dealing with much higher inflation rates? Or how can we understand the future trajectory of inflation from this study?

Bob French 10:48
Yeah, yes, that actually opens up a lot of different cans of worms. So the first place I always want to start here is just acknowledging the fact that, you know, this level of higher inflation, you know, even over a relatively short period means that, well, we do have a lower spending power going for forward, and we have less money in real terms than we did a year ago, especially with what the market's been been doing. But that's a separate issue. That's, that's last week's issue. But, you know, the, the question is, what do we do from here? You know, if I've got my retirement plan, how do I adjust that? You know, do we just dump our inflation assumption up to 8%, and rerun it and see what happens? I mean, you can do that. And, you know, if it's, if everything's still kind of pencils out, when you're assuming 8%, inflation from here to forever, you're in a pretty good position. But, you know, probably most of us probably couldn't make that statement. So what's, what do we do going forward? How do we kind of estimate what we think inflation is going to look like going forward, and we actually have a really good way, or at least really good and maybe overstating it, but a reasonably decent way of estimating what that's going to look like, based on what the market is telling us. You know, we have some really, really interesting tools for doing this. And what we're, what we can do is we can actually look at the spread between kind of nominal treasury bonds are your normal treasury bonds, and tips, which are treasury inflation protected securities, which are treasury bonds, with inflation protection built in, so we can look at the price of both of those or the yield on both of those. And, you know, effectively, the only difference is that the Treasury is now saying, we're going to give you we're going to protect you on inflation, on tips. So the difference in yield there is what the market expects inflation to look like, over whatever the relevant time period is. So if I'm interested in what inflation is going to look like, over the next 20 years, I can look at the 20 year treasury bonds yield, and the yield on the 20 year tips. That difference is what the market expects inflation to be over the next 20 years. So that's a really, really powerful way of of kind of taking a look at how inflation is likely to kind of evolve through time. So

Wade Pfau 13:27
let's give an example because that this is an important point, it just makes sure it's clear what's going on. So approximately right now, the 30 year Treasury and the 30 year tips, I believe, like the 30 year Treasury will use hypothetical numbers since don't know when people are listening, but say 3%, for the 30 year treasury, a half a percent for the 30 year tips, that half a percent is the real interest rate. So whatever inflation will be ends up being added to that. And so the fact that a half a percent real 3% for the traditional Treasury implies that the market's best estimate is the lot the inflation over the next 30 years would be two and a half percent to two.

Alex Murguia 14:12
And when we when you said added to that that means added to the tips yield when they get your money,

Wade Pfau 14:17
yes, because if, if tips is yielding a half a percent, and inflation ends up being two and a half percent. My return is 3%. I add the inflation the government adjusted for you. Yes, and then if inflation ends up being higher than expected, tips would do better because if inflation ends up being 6%, I would get six and a half percent at my tips compared to 3% for the Treasury. But then if inflation only averaged 1%, I would be getting one and a half percent on the tips compared to 3% on the Treasury. And so people are going if I believe inflation will be higher than what the markets pricing in. I would buy more tips. If I believe that inflation will be lower. I More treasuries. If I'm a retiree whose expenses might grow with inflation, I might lean towards the tips as a way to help fund that liability in retirement that's going with inflation. Now, that's where the market lets us see what inflation expectations are.

Alex Murguia 15:17
I think this is an interesting point just as a general matter, as well, because we just spent the last episode talking about how we don't forecast. Right. And then we're making a statement that the market is telling us this. Is that a forecast? I mean, I know the answer, but I you know, is that a forecast or not?

Bob French 15:36
So you actually bring up an interesting philosophical question here. So I mean, in the strictest sense, it make a sound? Well, I don't know about the making a sound part only if you're there. So if you're not. But, you know, in the strictest sense, sure. That's the forecast. The difference is, you know, we're going in and we're using the available information, you know, we're looking at, we have a reasonable basis for saying, what's going to happen in that reasonable basis is we're just taking a look at the market returns, or what the market is telling us the market, the sum total of the knowledge of all of the market participants, everyone putting their money at risk is saying, you know, hey, I think, you know, the Treasury yield is here, the tips yield is there, we're just saying, This is what you would this is what everyone else is predicting.

Alex Murguia 16:33
Now, and this is different than looking at a historical average. And just saying this is so below historical averages, this is so above, it's going to regress towards the mean, this is really, you're having two sets

of information, and the difference between them can be explained by the expectation of what inflation will be. That's, that's a kind of a cool dynamic.

Wade Pfau 16:51
And it's not a one person forecasting that it's the aggregate interaction. Yeah, exactly. in that market.

Bob French 16:58
Yeah. And it's important to recognize that this is also something we need to take with a little bit of humility. You know, Alex, you made that point about humility. Last time round. This is something we got to take with with a grain of salt. You know, like a lot of these types of estimates from from other market data. You know, I would be willing to say that, you know, whatever number is predicted, whether it's way it's two and a half, or, you know, some other percent. We won't get that, you know, that number will be wrong. It will be higher or lower. But the thing is, I don't know which I don't know if it's going to be wrong, because you know, inflation was higher than expected or lower than expected. But, but given our currently available information, this is about where we think it'll be.

Alex Murguia 17:49
Yeah. And that's there's nothing wrong with that. I mean, it that's, that's what the market is right. Everything is priced. What you don't know is the unexpected piece. It's not like a year ago, the spread was 8%.

Bob French 17:59
Yep.

Wade Pfau 18:01
Yeah. So what is the market telling us right now, we've got this high inflation right now. But could you kind of let us know what the market thinks the average employee? Yeah, it'll be the next one. 520 30.

Alex Murguia 18:12
And real quick, I think the someone can say no, but I want it right now, three years or whatever. But the reality is, retirement income planning, you're making these 20 year projections, you're making these 30 year projections, I think it's good to match expectations that are of similar time horizon.

Bob French 18:30
Yeah. So, you know, Alex just called out how historical averages aren't that useful, but let's just talk about the historical average. And before we take a look at the the actual numbers to put this stuff, in context, so depending on exactly what time period you're looking at, inflation is average, call it two and a half to 3%. Historically, you know, as Wade's called out, you know, inflation depending on exactly which metric you're using, you know, over the past couple of years, beyond eight, nine ish percent. So crazy high, you know, not hyperinflation territory by any stretch of the imagination out there. So, you know, don't worry about those late night ads for boolean and stuff like that. But, you know, certainly higher than we would like to see. But thankfully, you know, taking the look at what the market is telling us, you know, over the next year, inflation will still be a little bit higher, you know, but we're looking at kind of, again, this has numbers based off, you know, relatively recent yields, but call it four and two

thirds percent over the coming year. And then kind of coming down from there, you know, the five year inflation assumption is just over 3%. You know, pushing out to kind of 20 and 30 year, tight timeframes, which is where we generally kind of will look for kind of long term retirement planning, you know, estimates kind of where we start from there because You know, that's a reasonable timeframe. You know, the 20 year is a little bit under 3%, the 30 year is a little bit over two and a half percent. So right in line with historical averages, so we're seeing higher inflation now. But the market is estimating, again, could be wrong. But our best information is suggesting that, you know, once we start getting out into longer time periods, it's going to come back to about normal back to where we've seen historically,

Alex Murguia 20:33
the I want to drive home the point that this answers that may not be to your liking, but it answers it relative to the information that's out there. Yeah, but And look, we this is a political as a political as it can be. And right now, by saying that I know Bob is holding his breath. But, but the reality is, this incorporates the Oh, but this current administration, that way we're going who knows what the heck's gonna happen? Or half of you are thinking, Oh, but we're suffering the ills of the previous administration. And that's going to take so long to unwind. Who knows what's going to happen? I get all of that. But the reality is, numbers are the numbers. And this is what we're seeing from a long term perspective, incorporating all those differing points of view? Yep, Bob, Wade do you want to maybe add to that?

Wade Pfau 21:27
Yeah, that's the point because it's the interaction of all the market players. And if you personally believe that over the next year, inflation will be more than that foreign two thirds percent. And or you're a retiree who's spending need is going to be hurt more by unexpectedly high inflation instead of lower than expected inflation, that might speak to you looking more towards the inflation adjusted bond, to give you that protection, but the interaction of all the market players is showing that there's this expectation that inflation will come down over time. And then it's ultimately that that forecast is wrong, but it's either gonna be too high or too low. And, and you can think about where you need to position yourself with respect to your retirement spending need.

Alex Murguia 22:14
So it doesn't matter if you watch Fox or MSNBC, it's, it's all incorporated.

Wade Pfau 22:20
Yes,

Bob French 22:22
both Fox and MSNBC watchers. So.... Let's take a moment to let the audience know that this show is sponsored by Retirement Researcher. You can learn more about Retirement Researcher at etirementresearcher.com And subscribe to our newsletter, where You'll receive weekly actionable information for your retirement planning benefit. Retirement Researcher is an online community devoted to helping you create the retirement income plan geared towards your goals.

Wade Pfau 22:52

Now, for a while, I had been personally like my long term inflation forecast was around 2%. Because for a long time, that's what the long term breakeven inflation rate that we're talking about between treasuries and tips was, it does look like that that number was below historical averages, as you noted, it does look like it makes sense for anyone who's making these long term forecasts to potentially be using two and a half to 3% as their long term inflation assumption, and

Bob French 23:25
call out that, you know, this is also something where you want to be thinking about where you get most comfortable with these types of assumptions. Because with all of our planning assumptions, you know, whether it's inflation, whether it's estimated stock returns, or bond returns, or whatever, we're wrong. You know, that's just something we got to accept when we put these things together. So we take this information into account, when we say, well, you know, the 30 year, you know, inflation rate is probably around two and a half percent. But think about how you've reacted to this past year, think about how you've reacted to relatively not relatively very high inflation rates. You know, is it something that really bothered you, and if it is, maybe push your assumptions up, and you're planning estimates, you know, to kind of account for that and give yourself a little bit of wiggle room, knowing that even in a higher interest rate environment, your plan will still work? So, you know, it's always important to recognize that there's push and pull on here, you know, we can tell you what the data is the data is, you know, the data. But there's always a bit of interpretation and how you implement that data.

Alex Murguia 24:46
You're absolutely right. I do have a question for ya here. Because what you got you got the talking and it sparked two questions for me way. Inflation assumptions, how you adjusted your inflation assumption based on the current environment right? A if you you are, if you are a total return person, remember, there's probably your probability base. But there's some optionality involved in that. So that means that you're willing to make changes to distribution levels, etc, etc, you know, according to the need, or desire, to some extent, the moment you change your inflation levels on your financial plan, that's gonna change the potential withdrawal rate that you could potentially take from a success rate standpoint, if you're on a financial planning, you do a Monte Carlo. And so, you know, if you're a total return person, you better you know, you're signing up for Yeah, I get it, stocks will go up over the long term. But if you have this inflation kicking in, in addition to messing around with the stock market, it's going to play around with your purchasing power. And so that will give you sort of a moment of reorganization around what distribution you're taking. And that's not good or bad. But that's just kind of what you signed up for. That's the first point we did. The second one I'd like to maybe have you comment on is, we get this question a lot, why aren't there annuities that are pegged to inflation? And the reality is, look how high inflation just went? The short answer is the way it would be priced, you wouldn't want to buy it, because the insurance company would have to protect themselves from this craziness. And so the reality is, you know, you get the best I could do as a cola, you know, on occasion. But I'll let Wade talk about if you mind just touching upon those two points and how they hit back on retirement income strategies.

Wade Pfau 26:34
Yeah, so the higher the inflation assumption, that's, that's a more conservative assumption, because it means all of your expenses will be growing at a faster clip, your Social Security will also grow faster as well. But usually you have less Inflation Protected income, then you have potentially expenses that

grow with inflation. So higher inflation, will put your financial plan in a worse position, it would lower your probability of success, unless you're just generally somehow assuming that market returns are going to grow in line with inflation, which you it's really the real, real rate of return for the financial plan that matters. And if you simply keep the same nominal investing, return assumption, but increase the inflation rate, then you are lowering your real return assumption. And therefore, you're going to have a lower probability of success, if that's the type of financial planning calculator you're using. Now, on the annuity question, it's right. There's no commercially available income annuity that grows with the Consumer Price Index there has been in the past. But it's hard for insurance companies to hedge that inflation risk, because it's they can up to 30 years, because the insurance company could use treasury inflation protected securities, but those only go out 30 years. And to the extent that they're going to have individuals in that risk pool who live more than 30 years, especially if we're talking about like a deferred income annuity or something like that. There's no way for them to safely hedge that inflation risk. And so then they would, that's they have to build in, if the market believes inflation is going to be 3%. Over the long term, they're going to have to work from the assumption that inflation will be, you know, four or 5%, just to help manage the risks they're taking. And then that does lead the pricing to not look as good, because then you could compare that while the market thinks inflation is going to be 3%. I could buy an income annuity with a 5% cola, it costs the same as the consumer price index version of the income annuity. And there just didn't seem to be a big enough market to support people wanting to use that it's more expensive, a CPI adjusted income annuities. So that's why we don't see those on the market today. But in that context, though, so how can we protect a financial plan from inflation? Like what are the the different options that we have? And Bob, we've been talking a lot about tips, so maybe we could

Bob French 29:16
start with the thing that's specifically designed to do that. Yeah, that's a good place.

Wade Pfau 29:20
Cause then. Can you also talk a little bit about the I bonds side?

Bob French 29:22
Yeah. Yeah, and if we didn't talk about either I bonds I know, from all you we would definitely hear about it is

Alex Murguia 29:31
right now not this is not an investment advice. caveat. It's, it's a good deal right now.

Bob French 29:37
Yeah, I definitely have some very attractive rates on them right about now. Yeah, obviously, just to touch to start with I bonds, you know, to go along with that really attractive set of rates on them. You know, there's also some pretty significant limitations on how much you can go out and buy you there's was a 10,000 per social security number, and then, you know, I guess we're after tax day right now. But you know, you can also get another 5000 from, you know, any refund you might have on your taxes. You know, I think theoretically, that number will adjust through time. But that's, that's where it is right now. So, you know, depending on what your portfolio looks like that, you know, 15,000, or 30,000, if

you're married might not get you all of the inflation protection you're looking for. But you know, over time, you can build that up pretty substantially. So that's a really, really great option. You know, it's one of those that, you know, the best time to start, that was five years ago, or today is the second best time. But moving back over to tips, you know.

Wade Pfau 30:53
Instead, the way they work is it's like a savings bond, and it's paying it is issued 0%, real interest rate plus inflation. So that's why with inflation being 8 or 9%, what you see in the news is, I bonds are currently returning 8 or 9%, because they'll continue to provide the real interest rate, which right now it'd be on currently issued one zero, plus the inflation experience, there is some liquidity constraints, if you do put your funds into those, you can't get them back for at least a year. For the first five years, there will be an interest penalty if you want to redeem them. But then they continue to pay interest for up to 30 years, and it's all tax deferred as well. And they stop paying interest after 30 years. So there's not much point in holding them beyond that. But they're that inflation protected asset is just the limitations on how much can go in. And also they don't have the interest rate risk. And like tips, if interest rates go up, and 20 years from now, you want to sell your I bonds, you don't have to worry about a capital loss. But that that's a great tool. But now Now let's get into this.

Bob French 31:59
Yeah, and actually Wade, since you brought up the the tax piece there. You know, one of the other advantages is that you will, it feels weird to describe this is an advantage, but you have to buy them in your taxable account. So now you've effectively moved some of that tax deferral out of your IRA into your taxable account, meaning that you have more tax deferral than you would have otherwise on an asset. That could theoretically have been some pretty gnarly from a tax perspective. Moving back to tips, actually, that isn't, this is the one that gets pretty gnarly from a tax perspective. But tips are treasury inflation protected securities, as we've been talking about, are things that are very specifically designed to well protect you from inflation, you know, they're treasury bonds, that are going to pay out effectively a real interest rate, they're going to be adjusting based on what happens with inflation. And they actually adjust the principles. So they keep a constant kind of coupon rate. But they adjust the principle based on, you know, if inflation goes up, your principal goes up, so that your coupon payment will kind of keep up with inflation, if you will. They're really, really great tools. And, you know, we mentioned I mentioned the kind of tax implications there ones, from an asset location standpoint, you really want to stick those in your tax deferred account as fast as you possibly can, you know, from from something called phantom income, where you get taxed on that principal adjustment in the year that happens irregardless of whether you sell it or not, that's just income to you, according to the IRS. So those are really, really great tools. And, you know, as I think it was Alex, he made this point, you know, even better than just dealing with the expected inflation tips allows you to protect yourself and I bonds as well, but tips allows you to protect yourself from that unexpected inflation. So Wade called out that, you know, last year, year and a half ago, or whenever you want to look, you know, the spread between nominal and tips, or nominal treasury bonds and tips was not 9%. You know, a good slug of this was kind of that unexpected part of inflation tips would have protected you from that, at least for the portion of your investment, or a portion of your money that is in tips. So those are really, really great tools from that angle. You know, I called out the expected inflation piece though, and there's a lot of other ways to deal with that. One of the classic ways is actually short term bonds. You know, if you're owning just

regular bonds, whether that's in an individual, just single bond or a bond fund, inflation assumptions are baked into that price. And one of the advantages of short term bonds is their cost. It'll be rolling over in a short term bond fund. So you're constantly bringing in that new information and protecting yourself from that expected level of inflation, not going to do anything about that unexpected inflation. But that expected inflation is built into the prices, they're saying we'll stop it.

Wade Pfau 35:18
I mean, it can take like if inflation is 8% right now and your short term bonds yielding 1%, you've got a negative 7%. Real return but at least when inflation picks up, we worry interest rates will go up. And as we were talking about in last week's episode, if you have longer term bonds and interest rates are going up, you have those capital losses that you avoid with the short term bonds. And then over time, your point of interest rates on the short term bonds will come up as well. Yeah, I

Alex Murguia 35:47
think big picture you have more reset opportunities. Yes. When you're with short term bonds, and this, I just did, because I don't think we described it enough. But it could because I'm thinking interest rates and short term bonds and what guides? What does the Fed set this? Or does the market kind of the Fed lead the market? Or does the market lead the Fed in terms of bond rates? Or what the Feds mandate? And I know we're kind of like doing what what what can you do to protect yourself? But I think it's important conversation. A quick minute, to maybe?

Bob French 36:20
Yeah, so the Fed, you know, it's a little bit chicken and egg. But I think it's probably more

Alex Murguia 36:30
who's the chicken?

Bob French 36:31
Right? So the Fed actually, you know, they don't set we talked about the Fed setting interest rates, what they set is basically the overnight rate that banks can lend to each other, you know, effectively, the the true risk free rate. And then, you know, everything gets layered on top of that. So, you know, if you're going out and buying, you know, money market fund, or just a general short term bond fund, that's purely market driven, layered on top of that really short, really safe, risk free rate. So the Fed has enormous influence, I don't want to kind of downplay that. But last time, as we talked about, as well, you know, they have the immediate influence, you know, when the Fed raises interest rates, when they raise their, their overnight rates that they they actually have some control over. And then they also have their open markets, they are in the are in the bond markets buying and selling stuff. But when they set their rates, you know, the market will move based off of that new information. But those moves don't have kind of longer term impacts, you know, knowing that the Fed raised interest rates last month, doesn't tell you what's going to happen in the markets next month. Or at least not any meaningful degree, I should say. So, you know, I mean, the Fed definitely does have an impact here. And, you know, the Fed. I think we haven't talked about them too much. But you know, they have kind of a dual mandate. You know, since we're talking about inflation, one of those mandates is, you know, to manage the level of inflation in the economy, others manage, or to keep unemployment relatively low,

or keep employment relatively high, whichever way you want to phrase that. And, you know, they can manage the level of inflation, to some degree through monetary policy, which is managing these these interest rates. And by raising interest rates, they're effectively taking money out of the economy, they're making it harder to borrow money harder to spend, you know, so the Fed, as we've seen, has been raising interest rates to combat this level of inflation. Yeah, and, you know, it's a question of whether they're going to continue, it looks like they are going to continue to raise inflation rates, so long as inflation stays relatively high. And, you know, that's going to have an impact here.

Wade Pfau 39:16
And then let's talk about stocks as well, and the role stocks play as an inflation hedge or if they play a role as an inflation hedge.

Bob French 39:25
Yeah, so they're a really good and massively noisy inflation hedge. So as we talked about last time, you know, stocks have relatively high levels of expected return to correspond with relatively high levels of risk. That's kind of the deal you're making when you're investing in stocks. And you know, part of that is that that their price will incorporate expectations about inflation. A lot along with everything else,

Alex Murguia 40:03
also pricing power,

Bob French 40:05
also exactly that sorry, I was going here. So, you know, they do have pricing power, they are going concerns, they're not just this set of contracts, like a bond is, you know, a bond, you know, absent outside stuff, you know, they're gonna give you this amount of money at this point in time, you know, on down the calendar, you know, a company is has Alex said that they have pricing power, they're going out and actually selling stuff. They're the ones you know, out there in the actual economy being the real players here. And, you know, that can come with all of that power to deal with inflation and, you know, kind of bring that back to you. Problem is it's incredibly noisy. So, you know, if you're saying, Well, you know, I can't, I don't want any changes in my purchasing power. In the short term, I want to always just know what I got, you know, for a whole host of reasons. Stocks are not not your solution. They're, you know, if you're saying over the course of my retirement, I want to be sure that I'm keeping track of inflation, or I'm keeping up with inflation, you know, a relatively high percentage of stocks in your portfolio will help you do that.

Wade Pfau 41:24
Historically, and,

Bob French 41:26
yeah. Under your

Alex Murguia 41:30
strategies, retirement strategies,

Wade Pfau 41:33
usually it works out, just to be clear, but But yeah, I guess one other thing that listeners might be thinking about is and you mentioned Boolean earlier in the conversation, commodities or cryptocurrencies. That's, yeah, it's,

Alex Murguia 41:48
that's, this is in that category of what is not? Yeah. Yeah. The stocks were noisy. This is like front row at a Metallica concert. Noisy.

Bob French 41:58
Yeah, yeah. So crypto. You know, I mean, whatever. Whatever I say about it, it's probably going to be, you know, the day before something different will happen in the crypto market is just pure and utter noise. That is actually, Alex, I'm sorry, go ahead.

Alex Murguia 42:16
No crypto right now, forget the whole it's another currency of this or that? I don't think we're there yet. It's right now it's just crypto is effectively for our purposes. High tech, high tech. Yeah. It's the high tech stocks within the high tech sector. But gold, silver, that stuff comes up quite a bit. Yeah. And this is where you're the app, but 2% of your portfolio and commodities and put 5% in your portfolio and commodities. And, you know, like, I like to say all the time, listen, you wouldn't put 50,500 you wouldn't put $10,000 in your kitchen table, put a light a match to it and watch it burn and then be had no, no worries, no big deal. You know? Yeah, so why the heck would you do this? You know, it's only 1% of my money. It's crazy.

Bob French 43:06
Yeah, no, I mean, it's, it's a more interesting story, because, you know, even more than bonds, commodities are just things, they're literally just things, it's, you know, a barrel of oil, it's, you know, an ounce of gold, it's whatever it might happen to be. And, you know, by and large, absent changes in actual practical use, the long term expected return of a commodity is actually inflation. You know, again, absent, you know, changes in, you know, extraction or use or anything like that. But theoretically, it's, it's inflation. The problem is that, and we've looked at this a bunch in the past, because it keeps coming up. Is that one, it's so incredibly noisy. So it's got, you know, inflation like expected return with stock like volatility, which is not a great combination.

Alex Murguia 44:10
So you just went from like, and to put that in context, stock, let's say, I don't know the actual historical number. But let's just annualized 10% Over the last 70 some odd years standard deviation of 17. That means it moves plus or minus 17 points on any given year, right. Yep. So now so bond like stock like volatility, is that Twitch when when Alex made that statement? Well, I'm just I'm sorry. probability based caveat. 100% Wade's correct. But I'm just trying to put weight behind statement in context here. I'm in a bubble. Okay. Wade, I'm in a bubble when I'm saying. You know, so why the heck would you buy something that returns inflate three percent long term with that same volatility of the stock market. And that's why it's noisy because the dispersion moves so much that you'll invariably find a time when it

moved along with inflation the way you want it to. But there'll be plenty of times where it doesn't. And the end, the round trip, a lot of calories for nothing.

Bob French 45:22
Absolutely, yeah. And that's exactly why inflation always comes up in these conversations, because it is just so noisy, that there are going to be periods where it is done insanely well. And those are the times when you hear about it, or immediately after is when you hear about Yeah,

Alex Murguia 45:41
exactly. But I think your point to Bob, it's very important, because he talked about stocks being a sliver of, you know, economic value this or that. And you said they're just things. And what that means is that they're just inputs. Yep. They're just things that are used to make. They don't create anything. Right? Yeah. Now you want to maybe talk about other than maybe timber, but as a side note, you want to maybe talk about, like, what I mean by that, in terms of like, it's not created, it just is it's used to make other things, those companies use them to their advantage. So this whole inflation thing, you it's just getting in stocks, you know, I mean, from that vantage point, if you're gonna go through that trouble, but you may want to, I mean, to talk about that a little better.

Bob French 46:26
Yeah, at least to a first approximation. You know, commodities are things that are bought by publicly traded companies, you know, they're things that go into publicly traded companies doing something with them, you know, that's not 100% True, there's a lot of kind of private companies that are doing it, people who are going outside companies, and you know, all that type of stuff. But to a first approximation anyway, it's good enough for what we're talking about here. All of that kind of commodity risk, is dispersed across the entire stock market across the entire world economy. So you know, if you're gonna go out and buy commodities in and of themselves, you have to recognize that you're doubling up on that risk. And you have to ask yourself, Why am I the natural holder of this commodity risk? Why do I want more commodity risk than the average person, I'm sure I can come up with some scenario where that would be true. But it's probably not as common as a lot of people seem to think it is apparently, or at least, not everyone who is going out there and buying it as part of their portfolio is necessarily one of the natural holders of commodity risk.

Alex Murguia 47:44
And Bob, since we're running on time, just okay, but it's not a I get all of that, Bob, I get all that. But you know, what, this is just another currency, it's a better currency than the dollar currency. You know, in I read the whole gold like that, because, you know, Nebuchadnezzar did the same. And, you know, I, you know, I

Bob French 48:06
went all the way back to Nebuchadnezzar, I don't know what to tell you at that point. But,

Alex Murguia 48:09
but, you know, I just, what's your answer?

Bob French 48:14
We're talking like, collapse of civilization type situation, you know, owning the gold ETF. It's not gonna do anything for you. You know, I mean, if you're worried about, you know, the gold held in New York, when you're in, you know, California or somewhere else, that ain't helping yet. But, you know, I mean, one of the things you can do is look at how these things correlate with with inflation, you know, assuming we're not talking about total civilizational collapse here, you know, in which case, I'd probably prefer the, the can of beans to bar a gold. But when you look at how commodities, you know, whether it's gold, whether it's oil, whether it's silver, whether it's whatever, you know, they don't tend to correlate well with inflation. So you don't tend to see, you know, high returns on commodities, when you have high levels of inflation, which is, if we're looking for kind of that direct hedge. That's what you would want to see. And we just don't see it. So, you know, if, you know, if you're looking at it, again, as that hedge for inflation, they're just like stocks, very noisy hedges for inflation. Again, the expected return is inflation. But the expected return is inflation. Well, we can get that same really noisy hedge with a much, much higher return. And, you know, with that opportunity said, I think I know where I'm gonna go.

Alex Murguia 49:48
Yeah, well, the only thing that's collapsing now is this podcast episode, right.

Bob French 49:56
I think that's a good way to call it

Wade Pfau 50:00
The current events angles. So thanks, Bob for these past two episodes walking us through what's going on because it's it's a different situation. Markets are down inflation is high and help. Thank you for helping us make context of everything going on.

Bob French 50:12
Well, thank you for having me. Absolutely.

Alex Murguia 50:15
All right. Finding the weight is I love the way Wade's addressing you. Uh, yeah. Yeah, we speak like every day. It's just it's Yeah.

Bob French 50:29
semi formal environment.

Alex Murguia 50:32
Thank you, Bob. Thank you for joining us a very special episode of blossom. Thank you, everyone.

Wade Pfau 50:41
Have a great week. See you next time on Retire with Style.

Bob French 50:47

If you're interested in learning more about inflation, how it will affect your retirement plan and how you can deal with it. I'll be hosting a webinar, Inflation and Your Retirement plan on Tuesday, June 7, at 2pm Eastern to sign up, go to retirement researcher.com/inflation That's retirement researcher.com/inflation. I'll see you there. Wade and Alex are both principals in McLean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tyson's, Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with the risk including risk of loss. Past performance does not guarantee future results.