PRIVATE ASSET MANAGEMENT, INC.
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This is the second part of our series. This month's Paradigm focuses on inflation. We believe there are two main takeaways. One, we found it interesting the lack of conviction by analysts as to why past inflation has been lower than expected, as well as when inflation may begin to increase. Two, regardless of this uncertainty, you still need to be aware that inflation impacts your financial future, and that you need to plan and execute accordingly.

The Federal Reserve Bank of Minneapolis estimates that inflation, as measured by the Consumer Price Index for Urban areas (CPI-U), for 2017 will be 1.8%. This will be the fifth straight year that inflation has been less than the Federal Reserve's long-term target of 2%. Using the 1.8% estimate for 2017's inflation, the average inflation rate for the past ten years has been 1.7% per year. Most current estimates peg inflation for the next ten years at roughly 2% per year.

Multiple factors have influenced inflation over the past five years, though the exact impact of each factor appears to be unquantifiable. Globalization, technology, disruptive business models, slack in manufacturing capacity, and slack in the labor market all get mentioned as factors. Here are several practical examples that relate to these factors.

Globalization can mean products being manufactured in lower cost areas of the world as well as the increased power of multinational firms who may hold prices down to gain market share.

Technology can be a catch-all phrase and can overlap with other factors like disruptive business models and globalization. For example, if an industrial company is working to improve the software component of its offerings, is that technology, a new business model, or the requirements of operating in a global economy? It is virtually impossible to dissect by cause and effect, but it is clearly a trend among industrial companies.

Recently, Amazon.com is the most used example for disruptive business models. Their business model affects retailing, cloud services, and video streaming as well as other industries. Amazon's business model seems to keep prices and inflation in check.

The talk about slack in manufacturing capacity, usually referred to as capacity utilization, is beginning to wane. After the Great Recession, it was unknown how much excess capacity there was and how much capacity had been taken out of productive use. Whatever level of excess capacity that existed over the past five years contributed to keeping inflation in check.

The slack labor market appears to be getting the most attention in recent months. This is likely to continue. The reason is that with reported unemployment below 4.5% most analysts and central bankers believe that wage growth should be picking up, leading to higher inflation. This hasn't happened as expected.

The best explanation for the lack in wage growth that we have read is that the low reported unemployment figure overstates the health of the economy. As the economy picks up, workers either re-enter the workforce, go from part time to full time, or aren't in a position to garner higher wages due to previously mentioned factors. Wage growth is likely to be the main factor to watch over the next few years.

We will close with two thoughts regarding the need for you to be aware how inflation might impact your financial future. We will keep this brief because it appears that rising inflation will play out over the coming years, not the coming months.

One, don't become complacent. The past five years of high returns and low inflation will not continue. Also, average inflation of 2% per year may be too low. The exact timing and magnitude of the change cannot be predicted. However, a 1% increase in inflation that remains permanent for 30 years can have a material impact on your financial health.

Two, don't make "big bets" in your planning based on permanently low inflation. Trends not only end, sometimes they end quickly. Commit to diversification and execution now. This is likely to reduce future mistakes that could materially impact your financial wellbeing.

Inflation has been muted. This will change. You should review how low inflation has aided you in the past and how higher inflation will impact you in the future. Let us help.

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