BENOLD FINANCIAL PLANNING

Inflation or Deflation – Which Will It Be?

Many people are grateful that the Federal Reserve and the Treasury have provided trillions of dollars of aid to unemployed individuals, payroll support for small businesses and non-profit organizations. There is little doubt that the economic consequences of the Covid pandemic and the shelter in place regulations would have been much worse without this subsidy. Nevertheless, there is concern that "printing" 4 trillion dollars may likely cause not only inflation, but hyperinflation. Our historical experience of the 1920s in Germany and more recently in Zimbabwe has been that when a government pays its bills by simply printing money, hyperinflation is the result. A simple explanation of price inflation (a rise in the price of goods and services) is "too many dollars chasing too few goods and services".

However, it isn't the money creation that causes inflation, but the spending and investing of that money. This rate is called the velocity of money. The velocity of

money refers to the number of subsequent transactions that result from an initial expenditure. For example, if I purchase groceries, and the grocery store pays an employee with that money, and the grocery employee fills their car with gas etc. etc., each of these transactions with the same money adds to the velocity of money. If, in this same example, the grocery simply puts my money in a savings account, and the bank doesn't lend it to someone, then the velocity is low. What has happened over the past several years in America is that the money supply has increased markedly, but the velocity of money has dropped equally markedly, so the net effect is the very low rise in prices that we have seen.

Additionally, inflation seems to be a result of inflationary expectations, and now, inflation expectations are low. Particularly, the market for inflation-adjusted bonds (TIPS) shows an inflation expectation of less than 1%. Also, inflation usually occurs in a growing economy, and as debt rises, growth in the economy slows. This pattern has been clearly seen for nearly 40 years now in the US, Europe and Japan.

Interestingly, the more likely response of the economy to this massive "printing" of money will be either very little inflation, or even deflation. This pattern is well exemplified by the Japanese economy since 1989. After a severe recession, the Japanese government tried unsuccessfully over 30 years to revive the economy by infrastructure spending financed by debt. The Japanese national debt is now about 2.5 times ours on a per-capita basis, and is the highest in the world. This massive growth in debt has led to virtually no economic growth for 30 years, a zero rate of interest, and alternating very low inflation and actual deflation.

America and Japan both have an aging population, low immigration, low birthrates, and high social service spending financed by debt, which is then purchased by the central bank. They both have zero short term interest rates, very low inflation and slow economic growth. This "Japanification" of our economy may be more likely than significant inflation.

The Rise and Fall of 401(k)s

You are probably thinking "the fall of 401(k)s? Don't you mean pensions?" What I am conveying is the shift in how Americans retire. Since WWII, Americans have gone to work for a company and worked for that one company for 30 years. Next, they quit their job and start receiving a guaranteed pension income for the rest of their life. Additionally, they would get Social Security on top of the pension and sail quietly into retirement. However, this is not the case for Americans anymore.

A pension or defined benefit plan, is an income benefit from a company or government entity that will pay you a monthly income stream per number of years worked and gross salary earned. The employee does not pay into the plan like a 401(k). They earn it over the course of the years worked. Thus, there is not an incentive to switch companies. Also, the funds to be paid later are controlled and invested by the company itself. If that company does not invest well or does not meet the amount needed to pay retired workers in the future, their entity could be in default. As time went on, companies started to realize they did not want to be on the hook for paying retired ex employees. Enter the 401(k).

Starting in 1980, the 401(k) was invented as a way for employers to pay "pension" income to current employees only while they were working. The company would match a contribution from the employee into their individual 401(k) account that could be invested how the employee saw fit. This took the burden of having to invest the funds correctly and to have funds for all retired ex-employees in the future. Many companies started adopting this method and most have a similar type retirement program today. The power shifted away from companies and gave it to employees, so what's the problem?

The major problem with this transition away from pension retirement plans to 401(k) plans is employees now have to make investment decisions for their retirement without sufficient knowledge. Pension funds hire the top professionals to manage their fund to make sure they are invested correctly. Most employees do not know the different between an "international bond fund" and a "small cap stock fund." The importance of this investment as well as following capital markets are important for employees to know since their retirement depends on it. They will not receive a guaranteed pension income like the old days. What they invest in is what they will have in the future. Moreover, pension funds can not be invaded. 401(k)s can have loans taken out on them as well as money withdrawn to pay for other things like a down payment on a home or education for a child. Those are the penalty free versions of withdrawals. At the end of the day, if a person wanted to withdraw all of his/her 401(k) to buy a new car, they could and take a 10% penalty.

Once Generation X and millennials hit retirement age, they might not have enough to retire. This will cause them to work longer at jobs they do not enjoy. Or, they will be forced to go back to work. Also, these new retirees could be forced into taking social security earlier than needed which is detrimental to wealth creation. The bottom line is, a person cannot borrow for retirement and that should be the number one goal. Please max your 401(k) if you can as that is free money given to you. Also, when you leave a company, move the 401(k) funds to your individual IRA. There is no need to pay for bookkeeping fees (.2-.5%) at a company you no longer work for. Even though the pension is rarer today, a 401(k) is still a powerful tool towards your retirement.