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High Inflation: How Long Will It Last?

In March 2022, the Consumer Price Index for All Urban Consumers (CPI-U), the most common measure of inflation, rose at an annual rate of 8.5%, the highest level since December 1981.[1] It's not surprising that a Gallup poll at the end of March found that one out of six Americans considers inflation to be the most important problem facing the United States.[2]

When inflation began rising in the spring of 2021, many economists, including policymakers at the Federal Reserve, believed the increase would be transitory and subside over a period of months. One year later, inflation has proven to be more stubborn than expected. It may be helpful to look at some of the forces behind rising prices, the Fed's plan to combat them, and early signs that inflation may be easing.

Hot Economy Meets Russia and China

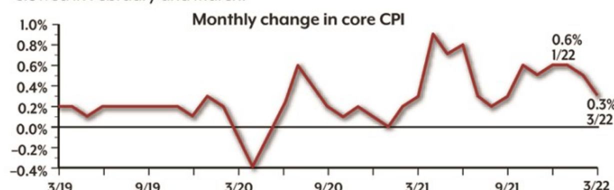
The fundamental cause of rising inflation continues to be the growing pains of a rapidly opening economy — a combination of pent-up consumer demand, supply-chain slowdowns, and not enough workers to fill open jobs. Loose Federal Reserve monetary policies and billions of dollars in government stimulus helped prevent a deeper recession but added fuel to the fire when the economy reopened.

More recently, the Russian invasion of Ukraine has placed upward pressure on already high global fuel and food prices.[3] At the same time, a COVID resurgence in China led to strict lockdowns that have closed factories and tightened already struggling supply chains for Chinese goods. The volume of cargo handled by the port of Shanghai, the world's busiest port, dropped by an estimated 40% in early April.[4]

Behind the Headlines

Although the 8.5% year-over-year "headline" inflation in March is a daunting number to consider, monthly numbers provide a clearer picture of the current trend. The month-over-month increase of 1.2% was extremely high, but more than half of it was due to gasoline prices, which rose 18.3% in March alone.[5] Despite the Russia-Ukraine conflict and increased seasonal demand, U.S. gas prices dropped in April, but the trend was moving upward by the end of the month.[6] The federal government's decision to release one million barrels of oil per day from the Strategic Petroleum Reserve for the next six months and allow summer sales of higher-ethanol gasoline may help moderate prices.[7]

Core inflation, which strips out volatile food and energy prices, rose 6.5% year-over-year in March, the highest rate since 1982. However, the month-over-month increase from February to March was just 0.3%, the slowest pace in six months. Another positive sign was the price of used cars and trucks, which rose more than 35% over the last 12 months (a prime driver of general inflation) but dropped 3.8% in March.[8]



Wages and Consumer Demand

For the 12 months ended in March, average hourly earnings increased 5.6% — not enough to keep up with inflation but enough to blunt some of the effects. Lower-paid service workers received higher increases, with wages jumping by almost 15% for nonmanagement employees in the leisure and hospitality industry. Although inflation has cut deeply into wage gains over the last year, wages have increased at about the same rate as inflation over the two-year period of the pandemic.[9]

One of the big questions going forward is whether rising wages will enable consumers to continue to pay higher prices, which can lead to an inflationary spiral of ever-increasing wages and prices. Recent signals are mixed. The official measure of consumer spending increased 1.1% in March, but an early April poll found that two out of three Americans had cut back on spending due to inflation.[10-11]

Soft or Hard Landing?

The Federal Open Market Committee (FOMC) of the Federal Reserve has laid out a plan to fight inflation by raising interest rates and tightening the money supply. After dropping the benchmark federal funds rate to near zero in order to stimulate the economy at the onset of the pandemic, the FOMC raised the rate by 0.25% at its March 2022 meeting and projected the equivalent of six more quarter-percent increases by the end of the year and three or four more in 2024.[12] This would bring the rate to around 2.75%, just above what the FOMC considers a "neutral rate" that will neither stimulate nor restrain the economy.[13]

These moves were projected to bring the Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE) Price Index, down to 4.3% by the end of 2022, 2.7% by the end of 2023, and 2.3% by the end of 2024.[14] PCE inflation — which was 6.6% in March — tends to run below CPI, so even if the Fed achieves these goals, CPI inflation will likely remain somewhat higher.[15]

Fed policymakers have signaled a willingness to be more aggressive, if necessary, and the FOMC raised the funds rate by 0.5% at its May meeting, as opposed to the more common 0.25% increase. This was the first half-percent increase since May 2000, and there may be more to come. The FOMC also began reducing the Fed's bond holdings to tighten the money supply. New projections to be released in June will provide an updated picture of the Fed's intentions for the federal funds rate.[16]

The question facing the FOMC is how fast it can raise interest rates and tighten the money supply while maintaining optimal employment and economic growth. The ideal is a "soft landing," similar to what occurred in the 1990s, when inflation was tamed without damaging the economy. At the other extreme is the "hard landing" of the early 1980s, when the Fed raised the funds rate to almost 20% in order to control runaway double-digit inflation, throwing the economy into a recession.[18]

Fed Chair Jerome Powell acknowledges that a soft landing will be difficult to achieve, but he believes the strong job market may help the economy withstand aggressive monetary policies. Supply chains are expected to improve over time, and workers who have not yet returned to the labor force might fill open jobs without increasing wage and price pressures.[19]

The next few months will be a key period to reveal the future direction of inflation and monetary policy. The hope is that March represented the peak and inflation will begin to trend downward. But even if that proves to be true, it could be a painfully slow descent.

Projections are based on current conditions, are subject to change, and may not come to pass.

1, 5, 8-9) U.S. Bureau of Labor Statistics, 2022

2) Gallup, March 29, 2022

3, 7) *The New York Times,* April 12, 2022

4) CNBC, April 7, 2022

6) AAA, April 25 & 29, 2022

10, 15) U.S. Bureau of Economic Analysis, 2022

11) CBS News, April 11, 2022

12, 14, 16) Federal Reserve, 2022

13, 17) *The Wall Street Journal,* April 18, 2022

18) *The New York Times,* March 21, 2022

What Do Rising Interest Rates Mean for Your Money?

Although rising interest rates make it more expensive for consumers and businesses to borrow, retirees and others who seek income could benefit from higher yields on savings accounts and CDs.

On March 16, 2022, the Federal Open Market Committee (FOMC) of the Federal Reserve raised the benchmark federal funds rate by 0.25% to a target range of 0.25% to 0.50%. This is the beginning of a series of increases that the FOMC expects to carry out over the next two years to combat high inflation.[1]

Along with announcing the current increase, the FOMC released economic projections that suggest the equivalent of six additional 0.25% increases in 2022, followed by three or four more increases in 2023.[2] Keep in mind that these are only projections, based on current conditions, and may not come to pass. However, they provide a helpful picture of the potential direction of U.S. interest rates.

What is the federal funds rate?

The federal funds rate is the interest rate at which banks lend funds to each other overnight to maintain legally required reserves within the Federal Reserve System. The FOMC sets a target range, usually a 0.25% spread, and then sets two specific rates that act as a floor and a ceiling to push the funds rate into that target range. The rate may vary slightly from day to day, but it generally stays within the target range.

Although the federal funds rate is an internal rate within the Federal Reserve System, it serves as a benchmark for many short-term rates set by banks and can influence longer-term rates as well.

Why does the Fed adjust the federal funds rate?

The Federal Reserve and the FOMC operate under a dual mandate to conduct monetary policies that foster maximum employment and price stability. Adjusting the federal funds rate is the Fed's primary tool to influence economic growth and inflation.

The FOMC lowers the federal funds rate to stimulate the economy by making it easier for businesses and consumers to borrow, and raises the rate to combat inflation by making borrowing more expensive. In March 2020, when the U.S. economy was devastated by the pandemic, the Committee quickly dropped the rate to its rock-bottom level of 0.00%–0.25% and has kept it there for two years as the economy recovered.

The FOMC has set a 2% annual inflation goal as consistent with healthy economic growth. The Committee considered it appropriate for inflation to run above 2% for some time in order to balance the extended period when it ran below 2% and give the economy more time to grow in a low-rate environment. However, the steadily increasing inflation levels over the last year — with no sign of easing — have forced the Fed to change course and tighten monetary policy.

How will consumer interest rates be affected?

The prime rate, which commercial banks charge their best customers, is tied directly to the federal funds rate and generally runs about 3% above it. Though actual rates can vary widely, small-business loans, adjustable-rate mortgages, home-equity lines of credit, auto loans, credit cards, and other forms of consumer credit are often linked to the prime rate, so the rates on these types of loans typically increase with the federal funds rate. Fed rate hikes might also put upward pressure on interest rates for new fixed-rate home mortgages, but these rates are not tied directly to the federal funds rate or the prime rate.

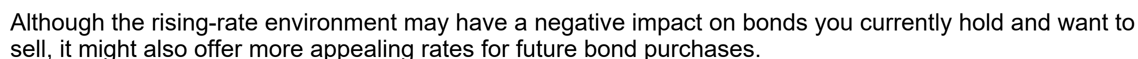
Although rising interest rates make it more expensive for consumers and businesses to borrow, retirees and others who seek income could eventually benefit from higher yields on savings accounts and certificates of deposit (CDs). Banks typically raise rates charged on loans more quickly than they raise rates paid on deposits, but an extended series of rate increases should filter down to savers over time.

What about bond investments?

Interest-rate changes can have a broad effect on investments, but the impact tends to be more pronounced in the short term as markets adjust to the new level.

When interest rates rise, the value of existing bonds typically falls. Put simply, investors would prefer a newer bond paying a higher interest rate than an existing bond paying a lower rate. Longer-term bonds tend to fluctuate more than those with shorter maturities because investors may be reluctant to tie up their money for an extended period if they anticipate higher yields in the future.

Bonds redeemed prior to maturity may be worth more or less than their original value, but when a bond is held to maturity, the bond owner would receive the face value and interest, unless the issuer defaults. Thus, rising interest rates should not affect the return on a bond you hold to maturity, but may affect the price of a bond you want to sell on the secondary market before it reaches maturity.



Although the rising-rate environment may have a negative impact on bonds you currently hold and want to sell, it might also offer more appealing rates for future bond purchases.

Bond funds are subject to the same inflation, interest rate, and credit risks associated with their underlying bonds. Thus, falling bond values due to rising rates can adversely affect a bond fund's performance. However, as underlying bonds mature and are replaced by higher-yielding bonds within a rising interest-rate environment, the fund's yield and/or share value could potentially increase over the long term.

How will the stock market react?

Equities may also be affected by rising rates, though not as directly as bonds. Stock prices are closely tied to earnings growth, so many corporations stand to benefit from a more robust economy, even with higher interest rates. On the other hand, companies that rely on heavy borrowing will likely face higher costs going forward, which could affect their bottom lines.

The stock market reacted positively to the initial rate hike and the projected path forward, but investors will be watching closely to see how the economy performs as interest rates adjust — and whether the increases are working to tame inflation.[3]

The market may continue to react, positively or negatively, to the government's inflation reports or the Fed's interest-rate decisions, but any reaction is typically temporary. As always, it's important to maintain a long-term perspective and make sound investment decisions based on your own financial goals, time horizon, and risk tolerance.

The FDIC insures CDs and bank savings accounts, which generally provide a fixed rate of return, up to $250,000 per depositor, per insured institution. The return and principal value of stocks and investment funds fluctuate with market conditions. Shares, when sold, may be worth more or less than their original cost. Investments offering the potential for higher rates of return also involve higher risk.

Investment funds are sold by prospectus. Please consider the fund's objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

1–2) Federal Reserve, March 16, 2022

3) *The Wall Street Journal,* March 17, 2022

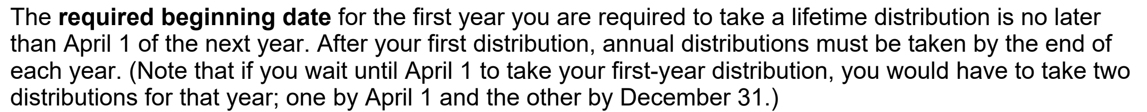
The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 changed the rules for taking distributions from retirement accounts inherited after 2019. The so-called 10-year rule generally requires inherited accounts to be emptied within 10 years of the original owner's death, with some exceptions. Where an exception applies, the entire account must generally be emptied within 10 years of the beneficiary's death, or within 10 years after a minor child beneficiary reaches age 21. This reduces the ability of most beneficiaries to spread out, or "stretch," distributions from an inherited defined contribution plan or an IRA.

The RMD 10-year rule substantially reduces the ability of most nonspouse beneficiaries to stretch distributions from an inherited defined contribution plan or IRA after the death of the original owner.

In February 2022, the IRS issued proposed regulations (generally applicable starting in 2022) that interpret the revised **required minimum distribution (RMD)** rules. Unless these proposals are amended, some beneficiaries could be subject to annual required distributions as well as a full distribution at the end of a 10-year period. Account owners and their beneficiaries may want to familiarize themselves with these new interpretations and how they might be affected by them.

RMD Basics

If you own a traditional IRA or participate in a retirement plan like a 401(k), you generally must start taking RMDs for the year you reach age 72 (age 70½ if you were born before July 1, 1949). If you're age 72 or older and still working for the employer that maintains the retirement plan, you may be able to wait until the year after retiring to start RMDs from that account. No RMDs are required from a Roth IRA during your lifetime (beneficiaries are subject to inherited retirement account rules). Failing to take an RMD can be costly: a 50% penalty generally applies to the extent an RMD is not made.



The **required beginning date** for the first year you are required to take a lifetime distribution is no later than April 1 of the next year. After your first distribution, annual distributions must be taken by the end of each year. (Note that if you wait until April 1 to take your first-year distribution, you would have to take two distributions for that year; one by April 1 and the other by December 31.)

When you die, the RMD rules also govern how quickly your retirement plan or IRA will need to be distributed to your beneficiaries. The rules are largely based on two factors: (1) the individuals you select as beneficiaries of your retirement plan, and (2) whether you pass away *before* or *on or after* your required beginning date. Because no lifetime RMDs are required from a Roth IRA, Roth IRA owners are always treated as dying before their required beginning date.

Who Is Subject to the 10-Year Rule?

The SECURE Act does still allow certain beneficiaries to continue to "stretch" distributions, at least to some extent. These **eligible designated beneficiaries (EDBs)** include your surviving spouse, your minor children, any individual not more than 10 years younger than you, and certain disabled or chronically ill individuals. Generally, EDBs are able to take annual required distributions based on remaining life expectancy. However, once an EDB dies, or once a minor child EDB reaches age 21, any remaining funds must be distributed within 10 years.

Significantly, though, the SECURE Act requires that if your designated beneficiary is not an EDB, the entire account must be fully distributed within 10 years after your death .

What If Your Designated Beneficiary Is Not an EDB?

If you die *before* your required beginning date, no distributions are required during the first nine years after your death, but the entire account must be distributed in the tenth year.

If you die *on or after* your required beginning date, annual distributions based on the designated beneficiary's remaining life expectancy are required in the first nine years after the year of your death, then the remainder of the account must be distributed in the tenth year.

What If Your Beneficiary Is a Nonspouse EDB?

After your death, annual distributions will be required based on remaining life expectancy. If you die *before* your required beginning date, required annual distributions will be based on the EDB's remaining life expectancy. If you die *on or after* your required beginning date, annual distributions after your death will be based on the greater of (a) what would have been your remaining life expectancy or (b) the beneficiary's remaining life expectancy. Also, if distributions are calculated each year based on what would have been your remaining life expectancy, the entire account must be distributed by the end of the calendar year in which the beneficiary's remaining life expectancy would have been reduced to one or less (if the beneficiary's remaining life expectancy had been used).

After your beneficiary dies or your beneficiary who is your minor child turns age 21, annual distributions based on remaining life expectancy must continue during the first nine years after the year of such an event. The entire account must be fully distributed in the tenth year.

What If Your Designated Beneficiary Is Your Spouse?

There are many special rules if your spouse is your designated beneficiary. The 10-year rule generally has no effect until after the death of your spouse, or possibly until after the death of your spouse's designated beneficiary.

What Life Expectancy Is Used to Determine RMDs After You Die?

Annual required distributions based on life expectancy are generally calculated each year by dividing the account balance as of December 31 of the previous year by the applicable denominator for the current year (but the RMD will never exceed the entire account balance on the date of the distribution).

When your life expectancy is used, the applicable denominator is your life expectancy in the calendar year of your death, reduced by one for each subsequent year. When the nonspouse beneficiary's life expectancy is used, the applicable denominator is that beneficiary's life expectancy in the year following the calendar year of your death, reduced by one for each subsequent year. (Note that if the applicable denominator is reduced to zero in any year using this "subtract one" method, the entire account would need to be distributed.) And at the end of the appropriate 10-year period, any remaining balance must be distributed.

The rules relating to required minimum distributions are complicated, and the consequences of making a mistake can be severe. Talk to a tax professional to understand how the rules, and the new proposed regulations, apply to your individual situation.

IMPORTANT DISCLOSURES

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