THE NORTHERN TRUST INSTITUTE

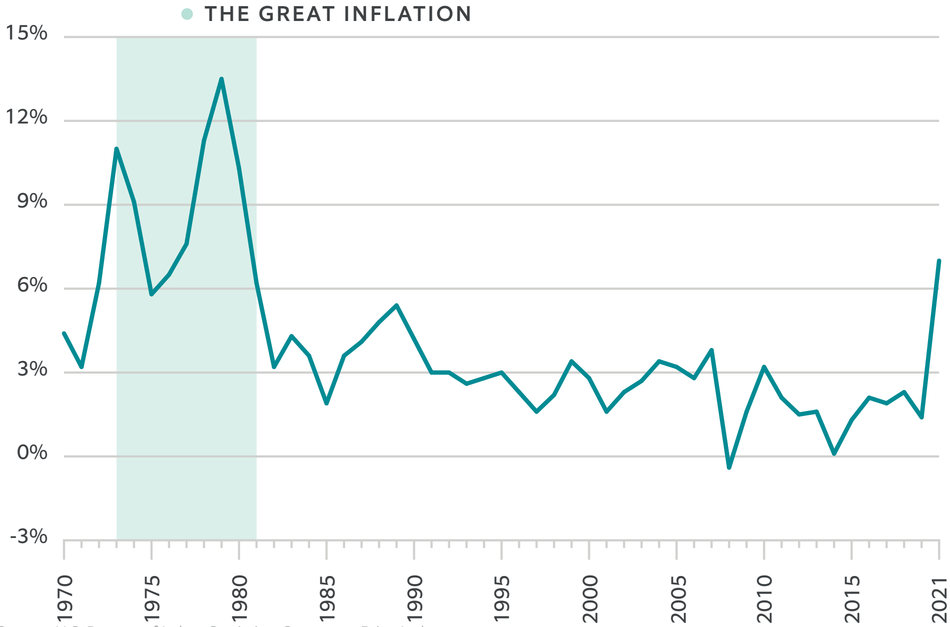
A CLOSER LOOK

PRICES, POLICY AND YOUR PORTFOLIO— YOUR INFLATION QUESTIONS ANSWERED

Though we believe the current excessive rate of inflation is unlikely to persist, investors should always consider inflation protection even in a more normalized inflation environment.

The highest rate of inflation in a generation has jolted investors, policymakers and markets alike. In 2021, consumer prices, as measured by headline Consumer Price Index (CPI), rose 7% year-over-year, the fastest pace since 1982, and significantly higher than the Federal Reserve's 2% target. This notable increase has sparked concerns around the effect of inflation on investors' portfolios, wealth plans and ability to fund goals.

ANNUAL AVERAGE CHANGE IN CONSUMER PRICE INDEX



Source: U.S. Bureau of Labor Statistics, Consumer Price Index

Though our forecast calls for the currently high rate of inflation to moderate over time, the outlook remains quite uncertain with many “known unknowns”:

- How quickly will supply chains recover?
- Will we see a decline in today’s high energy prices?
- Will upward pressure on wages continue?
- What will be the economic consequences of the Federal Reserve raising interest rates and potentially shrinking its balance sheet?

For investors, the best offense remains a good defense, and it is not too late to revisit your portfolio with an eye toward protection against the impact of inflation.

In the following report, we answer nine common questions from clients on the impact of inflation and how to fortify your portfolio and wealth plan in the face of uncertainty.

Q: How will inflation affect my portfolio returns?

We expect the rate of inflation to fall below 3% by the end of the year — still well above the pre-pandemic norm and the Federal Reserve's target. The risk remains that it may take longer for inflation to subside. Whether inflation remains stubbornly high or reverts to the Fed's target over a reasonable time frame, investors always need inflation protection. Inflation, even at a relatively low rate, diminishes purchasing power over time, and investors should always consider inflation protection in their overall investment strategy. The major detractors to net investment performance are fees, taxes and inflation. Two of those are controllable by the investor — fees and taxes — while one remains uncontrollable and hence needs to be hedged: inflation.

We fund goals with real returns, that is, nominal return adjusted for inflation. During periods of high inflation, real returns can be negative, even as nominal returns look high. From February 1973 to September 1981, a period known as the Great Inflation, nominal cumulative returns appeared fairly dazzling — ranging from 78% to 89% across investment objectives. But after adjusting for inflation, which ran 9.5% per year in that period, these portfolios would have lost purchasing power as real returns ranged from -14% to -19%.

Q: How can I protect my portfolio against inflation?

Each investor's individual goals should determine their portfolio allocation. However, our research into real assets' inflation-mitigation properties found that natural-resource equities and Treasury Inflation Protected Securities (TIPS) are most effective at protecting against inflation and, perhaps more importantly, unexpected increases in inflation.

Q: Should I increase my allocation to Treasury Inflation Protected Securities?

When funding longer-term goals in the face of rising inflation, it may be advantageous to allocate more to TIPS because of their reliability as an inflation mitigator. TIPS are structurally indexed to inflation, with their principal adjusting annually to correspond with changes in the Consumer Price Index. Our guidance for goals-based investors funding their high-priority lifestyle goal is a 20% allocation to TIPS in a Portfolio Reserve, a buffer of relatively stable assets designed to meet cash flow needs and fund lifestyle goals through periods of market distress.

When funding nearer-term lifestyle spending goals, we recommend a 20% allocation to TIPS within the larger risk-control allocation to mitigate the impact of inflation on goal funding. However, when future inflation is more uncertain and when funding long duration goals with risk-control assets, our research supports higher allocations to TIPS. Dive deeper with our research on "Risk-Free" Goal Funding and Securing High-Priority Goals.

Q: How do natural resource equities hedge inflation risk?

Natural resources and commodities are highly inflation sensitive, offering portfolios broad inflation protection. And while the inflation sensitivities of equity-based natural resources and futures-based commodities are similar, natural-resource equities are capital assets that have an expected return driven by the equity premium, so they can help fund long-term goals even after inflation normalizes.

These securities — including energy, metals and mining, and agricultural stocks — generated positive real returns during the Great Inflation of the 1970s, even as the broad equity market produced a negative real return. Natural-resource equities lack a structural inflation adjustment like TIPS, so they are not true inflation hedges, and there is no guarantee they will mitigate future inflation as well as they did in the past.

Q: Will rising inflation impact my tax bill?

Only some elements of individuals' taxes are routinely adjusted for inflation, but many remain unadjusted year-over-year. During periods of high inflation, this produces a so-called "hidden" tax. While the Internal Revenue Service boosts tax brackets, IRA contributions and annual gift tax exclusions, other taxes such as the Net Investment Income Tax (NIIT), capital loss offsets to ordinary income, and State and Local Tax (SALT) limitations remain fixed, potentially increasing what you owe. Additionally, almost half of U.S. states have at least one major unindexed tax provision, so your state tax bill may also increase.

ADJUSTED FOR INFLATION		NOT ADJUSTED FOR INFLATION	
TAX BRACKETS	DEDUCTIBLE IRA CONTRIBUTIONS	3.8% NIIT	EXEMPTION FOR PRIMARY RESIDENCE
ROTH IRA CONTRIBUTIONS	ESTATE EXEMPTION / ANNUAL GIFT EXCLUSION	IRA CATCH-UP CONTRIBUTIONS	HSA CATCH-UP CONTRIBUTIONS
FSA AND HSA CONTRIBUTIONS	SOCIAL SECURITY PAYMENTS	$10,000 SALT LIMITATION	$3,000 CAPITAL LOSS OFFSET TO ORDINARY INCOME
FOREIGN EARNED INCOME EXCLUSION	AMT EXEMPTION AND PHASEOUT	$250 RECEIPT FOR CHARITABLE CONTRIBUTIONS	RETIREMENT PLAN LOANS (EXCLUDING COVID-RELATED LOANS)
QUALIFIED TRANSPORTATION MONTHLY PRE-TAX LIMIT	STANDARD MILEAGE RATE	IMPUTED INTEREST FOR BELOW MARKET LOANS	STANDARD MILEAGE RATE

Q: Should I pay down debt before interest rates go even higher?

If you currently have a low interest loan, you are paying it off with money that is worth less than when you borrowed it. Rather than paying this debt down, you may consider holding the debt until inflation normalizes. However, with the possibility of several Fed rate hikes looming, borrowers with floating rate loans could experience a rapid increase in their interest expense. In this scenario, you may want to pay down revolving debt or lock in a fixed interest rate to maintain access to liquidity for other purposes.

Q: How could a policy misstep impact your outlook for inflation?

At the moment, the Fed is at risk for a policy misstep in either direction. Tightening too slowly risks lingering inflation, while tightening too quickly risks an economic slowdown. Our expectation is that inflation will settle a bit as we move through the course of 2022 as supply constraints ease, but monetary restraint will be needed to bring it back within a desirable range. We think that three to four rate increases over the next year is the most likely scenario and will be sufficient; anything less would lead us to revise our inflation forecast upward.

Q: What role do supply chain constraints play in increasing inflation?

Supply chain disruptions, the result of COVID-19 outbreaks and excess demand for goods, continue to plague the markets. We anticipate the logistical bottlenecks will abate, and we are already seeing signs of healing as we analyze the data from the ports of Los Angeles and Long Beach.

As the threat from — and related mitigation measures associated with — the pandemic recedes, it may also prompt a shift from goods consumption to services consumption. While this would help alleviate pressure on supply chains, the transition would also place renewed pressure on labor markets, which are becoming a more significant source of inflation. This is something we are monitoring closely.

Q: I'm worried about the impact of inflation on my retirement plans. Are there changes retirees should be considering in the current environment?

Retirees need to pay special attention to inflation, as they do not have the luxury of salary and other compensation that would likely adjust upward for inflation. What's more, retirees tend to have fixed costs, such as higher health care costs, that historically have been impacted broadly by inflation, a trend that is likely to continue. While social security and some taxes are adjusted for inflation, the calculations do not keep up with the real rate of inflation.

This is the time to revisit your plan to ensure you can fund your highest priority goals into retirement. For most investors, their highest priority goal is to fund lifestyle and cash flow needs. This goal tends to be highly sensitive to inflation, hence inflation protection — even in a lower inflation environment — is critical. Building inflation protection into your retirement plan is critical, including short duration TIPS and natural resource equity exposure.

INFLATION MITIGATION

Even as low bond-market yields suggest inflation could be quickly contained, the market has a poor track record of anticipating inflation, as we showed in Market Conditions and Predictions. The perennial risk of inflation is now dominating headlines and at the forefront of investor concerns. By incorporating well-researched inflation mitigation elements into your investment and wealth plan, you can protect your ability to fund both short- and long-term goals regardless of inflationary trends.

ABOUT THE NORTHERN TRUST INSTITUTE

The Northern Trust Institute is a research center dedicated to advising affluent families. More than 175 experts collaborate across 34 areas of expertise to analyze behavioral patterns and identify the strategies that have been most effective for our clients — bringing the breadth and depth of our firm to each unique situation. The resulting insights position you to take action with confidence and achieve optimal outcomes with your wealth.

ABOUT NORTHERN TRUST

Northern Trust collaborates with clients and their advisors to offer holistic wealth management services for individuals and families, privately held businesses, family offices, and foundations and endowments. We are recognized for innovative technology, service excellence and depth of expertise across all aspects of financial planning, including wealth transfer, banking, insurance, investments, tax management, philanthropy, family communication and more.

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