Inflation Impact

McQueen Financial Advisors

Inflation has moved from a mild concern and is now very real and hitting us all in the pocketbook. People aren't just feeling pain at the pump - they're feeling it all over. From gas to groceries, from cars to coffee, consumers are paying more for almost everything. A prolonged period of high inflation could have a major impact on consumers and financial institutions.

What is causing inflation?
The COVID-19 pandemic and supply chain shortages have contributed to the highest inflation rate since the 1980s. The inflation rate in 1980 was 13.5%, which was very high compared to the average inflation rate of just under 3% between 1980 and 2022. The annual inflation rate stands at 7.9% for the 12 months ended February 2022 although it doesn't appear that inflation will reach 1980s levels. Supply chain shortages are only partially to blame for higher prices. Inflation has also been driven higher by stimulus checks intended to boost the economy during the pandemic. The government response was massive and pumped trillions into the economy in order to prevent economic collapse. Government policies were very effective but also contributed to higher inflation. The price of oil soared in late February 2022 after Russia invaded Ukraine. While only about 8% of US oil imports are from Russia, global demand and uncertain supply pushed prices higher. Gasoline prices at the pump hit an all time high in March 2022. A prolonged high oil price may increase the risk of recession.

"Higher deposit costs are likely"

Inflation Impact on Consumers
Inflation often results in higher wages. Borrowers with existing low-rate loans may benefit from inflation because monthly payments will not change, but borrowers will have more money in their paychecks. In theory, inflation should cause greater demand for high-ticket items in the short term, because consumers are inclined to act on the idea that waiting will result in a higher price. Over the long term, the higher cost of living will have a larger impact on low-income borrowers. This may result in less money to satisfy debt payments and potentially higher delinquency and defaults. Higher interest rates may also cause some depositors to shop for the best available rate.

Inflation Impact on Financial Institutions
As the Federal Reserve increases rates in an effort to control inflation, variable rate loans will immediately reset higher. Average loan size may also increase as prices rise. Investment returns will trend higher, but the value of current holdings will drop in response to higher interest rates. For investors holding callable or amortizing bonds, return of principal may be delayed. Origination and gain on sale income from newly refinance activity will be significantly lower. Eventually, higher deposit costs are likely. However, most of our clients have an abundance of liquidity and won't need to increase deposit rates any time soon.

U.S. Pandemic Response
In March & April 2020, the U. S. Congress passed major stimulus packages as part of their determined effort to fight the pandemic and its impact on consumers. These actions pumped trillions of dollars into the economy. In March 2020, the Federal Reserve cut their target interest rate to a range of 0.00% to 0.25%, down from 1.75% at year-end 2019. The Fed also announced several quantitative easing programs in early 2020.

Did government programs go too far?
Stimulus payments are only partially responsible for higher inflation. At the onset, it was impossible to know the full economic impact of COVID-19. The question of whether economic stimulus programs went too far is a judgment call. A stronger economy is good, but higher inflation is one consequence of large government stimulus programs.

"Yield curve may invert again"

Federal Reserve Bank Inflation Response
In early March 2022, Chairman Powel described how raising interest rates will bring down inflation. "As we raise rates, that should gradually slow down demand for the interest sensitive parts of the economy. And so, what we would see is demand slowing down, but just enough so that it's better matched with supply. And that will bring inflation down over time. That's our plan." It is widely expected that the Fed will raise rates slowly so that the economy doesn't slow down quickly. The Fed's 25 basis point rate increase in March 2022 is the first of several rate hikes the central bank is likely to undertake this year. As part of their March statement, the Federal Reserve projected that the Fed Funds rate will end 2022 in the range of 1.90%.

Yield Curve
The yield curve has been flattening in anticipation of higher short-term rates. Compared to six months ago, short term rates are significantly higher and longer-term rates are modestly higher. If history repeats itself, the yield curve may invert again, just like it has three times since 2000. A fully inverted yield curve refers to when long term yields are lower than short them yields. This shows that investors have little confidence in the near-term economy. Deteriorating economic conditions often follow an inverted yield curve. However, an inverted yield curve is not a perfect recession indicator and doesn't mean that recession is imminent.

"Caution but not panic"

Action Items

Higher interest rates, talk of an inverted yield curve, and a potential economic slowdown are reasons for caution but not panic. Higher interest rates and a flat or inverted yield curve typically results in lower margins. To protect earnings, we suggest the following:

- **Raise Loan Rates:** Mortgage rates change quickly in response to higher benchmark U.S. Treasury rates, but the offering rate on most other loan types is largely based on competition. We suggest a frequent, thorough review of competitor rates. Consider being the first to raise rates in your market. Maybe others will follow.
- **Invest Excess Funds:** Deposit balances have grown substantially since the start of the pandemic. Loan balances have not kept pace, which means that most financial institutions are flush with liquidity. Many institutions have elected to hold excess funds in overnight accounts, either waiting for higher rates or in anticipation of deposit run-off. The rate earned on overnight cash is approximately 0.25%. Even though investment yields are expected to increase, there is a great cost of waiting for higher rates. Consider the comparison of holding funds in an overnight account for 2 years and the unlikely assumption that the rate earned will increase by 50 basis points every 3 months. The average rate of 2.17% is less than the rate currently available on 2-year U.S. Treasuries. Intermediate term investments will likely outperform a strategy of keeping a high cash position while waiting for higher rates.

Investment	Start Rate	Assumption	Ending Rate	Average Rate
Overnight Funds (held for 2 years)	0.25%	0.50% higher every 3 months	4.25% (not likely)	2.17%
2 Year U.S. Treasury	2.30%	Fixed Rate	2.30%	2.30%

This is just one small example to support our recommendation to invest excess funds. Depending on your ALM risk profile, liquidity & loan pipeline, we may recommend either shorter or longer investments. In some cases, longer investments are appropriate.

Raise Deposit Rates Slowly: Our recommendation here is nearly always the same. Raise rates in response to the need for funds, not solely based on competition. If a local competitor posts deposit specials, it could mean that their loan to deposit ratio is greater than yours. If so, discuss the competitive advantage that others may have and develop loan growth strategies.