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Resolute Connections

First, the good news - in this month's newsletter, Social *Security Benefits Going Up* explains that next year's COLA is estimated to be 10.5%. This is great news for retirees. Now for the not-so-great news - *NOT-Transitory Inflation* discusses the assertion economists at the U.S. Federal Reserve Board made that the rampant inflation we were experiencing in the U.S. was 'transitory.' They were wrong, and increasingly so as time goes on.

The last two articles, *Unusual Downturn* and *Locking in 'Real' Losses*, touch on the unusual nature of the recession many think we are entering, and the role bonds still play in one's portfolio, even though the real return may be negligible.

If you have any questions about anything we have covered in the articles, or a specific situation please feel free to give us a call, or visit our website, www.ResoluteFinancial.com.

Social Security Benefits Going Up

We never know for sure until the announcement by the Social Security Administration each October, but it sure looks like people receiving benefits will get a big raise in 2023. Experts are predicting a 10.5% cost of living (COLA) adjustment, based on recent changes in the Consumer Price Index.

Taxwise, this could be a mixed blessing. More benefits will expose more Social Security income to federal income taxes; any joint return whose combined income (including Social Security income) exceeds $32,000 will trigger taxation of benefits, and higher income could also result in higher income-adjusted Medicare premiums. Those premiums are already becoming costlier; this year, Medicare Part B premiums rose 15.5%—higher than the Social Security cost of living adjustment. That means that Social Security recipients who had Medicare premiums automatically deducted actually saw their monthly checks go down, despite the reported upward adjustment in benefits. Another big increase this year will eat into the higher benefits—or potentially eliminate them completely.

The last time Social Security benefits rose by double digits was 1981, when recipients received an 11.2% raise. Back then, the standard Medicare premium was $89 a month.

NOT-Transitory Inflation

For much of last year, the economists at the U.S. Federal Reserve Board confidently told the public that the rampant inflation we were experiencing in the U.S. was 'transitory.'

They were wrong, and increasingly so as time goes on. This won't surprise anybody who has been shopping lately, but economists were shocked to discover that the inflation rate rose 9.1% annualized in the month of June. You would have to go back to 1981 to find a higher rate. And the usual culprits of the war in Ukraine—higher food and energy prices—were not the only reason for the cost-of-living increase. If you took out those two parts of the inflation calculation, the rate was still 5.9% overall. The Federal Reserve's 'target' is 2%.

So far, the U.S. Consumer Price Index measure of inflation is running around 8.6%—that is, it costs roughly 8.6% more to fund a normal lifestyle today than it did at this time last year. This is part of an international trend; the UK is looking at 11% overall price increases, and the Eurozone is experiencing an 8.6% inflation rate. South Korea's 6% annual inflation rate is the highest in 24 years, and even Japan, which has flirted with deflation for the past 30 years, is seeing prices rise 2.5%.

How long will this last? Nobody knows. The Fed seems committed to driving U.S. inflation down with a series of aggressive interest rate hikes, but with prices rising everywhere else, one wonders how effective this will be. But perhaps we can take comfort that our cost-of-living increases are markedly lower than what people are experiencing in Turkey (78% year-over-year), Argentina (60.7%) and Sri Lanka (54.6%).

Unusual Downturn

Are we in a recession today? That's one of the key questions that investors and economists are asking, and there is no easy answer.

A recession is a period of time when the economy stops its usual long-term growth pattern and starts shrinking. The technical definition is a drop in the value of goods and services produced (the gross domestic product) for two consecutive quarters. This is often associated with declining incomes, employment, industrial production and retail sales.

The U.S. experienced a shrinking GDP in the first three months of the year, down at an annual pace of 1.6%. But, unusual for a recession, employment was strong, incomes were rising and prices of goods and services were going up rather than down. Corporate profits are expected to rise for the remainder of the year. And that dismal first quarter follows a robust 6.9% increase in the previous quarter.

The conclusion is that if we are, indeed, experiencing a recession, it is an unusual one, triggered not by the typical decline in corporate activity and job losses, but by a unique combination of supply chain disruptions, a war in Europe, rising energy prices, and the persistence of Covid. In what other recession in history could we say (as we can today) that the economy added 390,000 new jobs in May, the 17th straight monthly gain, and the unemployment rate is at 3.6%—the lowest in a half century?

Unusual recessions are actually not that unusual. As recently as 2020, the U.S. economy experienced a sharp two-month downturn, the shortest ever. The Great Recession, on the other hand, lasted for 18 months, and was triggered not by the

usual economic factors, but by reckless Wall Street sales of sketchy bundles of mortgages with little underwriting—followed by a housing collapse.

Often, recessions are brought to heel by a Central Bank stimulus. In the case of the Great Recession and the more recent Covid downturn in 2020, the U.S. Fed flooded the economy with money at zero or near-zero interest rates, and made itself a significant buyer of government and mortgage bonds. Both times, the medicine worked. We cannot expect the Fed to ride to the rescue while the inflation rate is as high as it has been, but eventually an economic downturn will depress prices, and stimulus will once again be possible—assuming that an economy with robust employment and corporate profits will actually need it.

Locking in 'Real' Losses

You probably know that the 'real' returns of an investment are the gains and income you receive minus inflation and taxes. Most of us invest with the idea that, over time, we will experience positive real returns.

One would imagine that the cadres of bond investors have that same expectation, but the current situation is somewhat befuddling. Today, twelve-month Treasury bonds are yielding 3.10%. If you factor in the roughly 9% current inflation rate, that suggests that short-term bond holders are willing to experience 'real' returns of negative six percentage points over the coming year. Twelve-month Treasuries are actually generating a lower yield—currently 2.92%. Even if inflation comes down from its current rate over the next decade, it is not hard to project a negative 'real' return from that investment.

An investor in 1-year municipal bonds would currently receive, on average, a yield of 1.47%, which projects to an even greater negative yield.

What gives? There are a variety of factors at work here, including the fact that bonds tend to act as the portfolio's ballast during market downturns, which makes them valuable in unstable times. They provide a steady income and rarely fall to the same degree as more volatile assets do during bear markets. If you hold a bond to maturity,

you receive a predictable yield and, with high-quality bonds, you get your money back at the end. You won't get that kind of guarantee from stocks.

In addition, an allocation to bond or bond funds offers a pool of assets that could be used to buy stocks if/when prices become attractive—in the meantime collecting interest that can be used for the same purpose.

And for a person in or nearing retirement, having one to three years in a stable investment means that you will be able to meet your cost-of-living needs without having to sell stocks in the portfolio during a market downturn—which is one way of avoiding the danger of locking in losses and compromising the ability to sustain a retirement lifestyle going forward.

Institutions buy bonds for a different reason. Insurance companies have to ensure that they will have the assets to pay out projected death benefits, which means they tend to buy low-risk investments. The same is true of pension funds; buying bonds can allow them to match their future income with future payouts to beneficiaries.

So, yes, locking in a 'real' loss seems counterintuitive. Nobody would recommend that somebody do this with their entire retirement portfolio. But bonds will always, in every scenario, have a place in peoples' portfolios. And if history is any indication, eventually, one hopes sooner rather than later, bond yields will once again outpace inflation, and we can all get back to earning a 'real' return on that part of our investments.

Source:
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For more information on these topics or for a free consultation, contact Resolute Financial, LLC at (978) 463-8771 ext. 1003.

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