The Importance of a Financial Plan

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In uncertain times like these, we believe it's particularly important that investors maintain an investment philosophy that ties their investments to their personal financial plan. We distinguish investment risks and opportunities by the time horizon associated with a client's goals. In the short term, the primary objective is preservation of capital. In the long term, the objective is to increase purchasing power, which requires attention to both growth potential and inflation risks. By minding valuations and performing scenario analysis for a range of potential growth and inflation outcomes, we construct portfolios to increase the probability of reaching inflation-adjusted return goals over specific time horizons. Sometimes the optimal portfolio can include a portion in gold, commodities or TIPS to protect against the potential for higher inflation. As economic conditions and government policies evolve, we believe time-based investing helps provide a clear process for balancing risk and return in an hever-uncertain environment.

The Importance of a Financial Plan

As hthe government has implemented public health measures to contain the coronavirus (COVID-19) pandemic, the resulting business disruption caused U.S. economic growth to decline -4.8% (annualized) last quarter compared with the fourth quarter of 2019. At the same time, after hitting 50-year lows before the pandemic, U.S. unemployment has risen sharply to 14.7%, with expectations for a continued increase over the next couple of months.

However, the U.S. government has acted swiftly and forcefully to contain the economic fallout through the Fed's policy easing and Congress's fiscal stimulus. These actions are warranted; without government support, it's likely the economy would experience a depression-like contraction with a self-reinforcing downward spiral of demand destruction and deflation. Policymakers fear deflation (a broad and prolonged decline in prices) because it's typically accompanied by a contraction in incomes, which can lead to a pickup in defaults. This vicious cycle is difficult to escape, so the government's response is welcome.

Since February, the Fed has reduced the federal funds rate by -1.5% to zero and announced aggressive asset purchase programs, which have caused the Fed's balance sheet to expand by $2.6 trillion, a 62% increase in just over two months. At the same time, Congress has responded to the crisis with $2.8 trillion of new deficit spending. Together, the government's policy efforts are intended to support the economy and markets until the public health crisis is resolved.

VIEWS ON GOVERNMENT INTERVENTION

While the current economic contraction clearly necessitates aggressive government stimulus to avoid a deflationary spiral, some observers fear that coordinated fiscal and monetary action could lead to inflation risks when the economy eventually recovers. A recent Fed survey clearly illustrates this tension between current deflationary forces and inflationary government policies. In April, consumer expectations about future inflation were the most varied since the survey began in 2013.

On one side, there is a small but growing contingent who embraces a continued increase in deficit spending and coordinated monetary policy to achieve economic and social objectives. On the other side, there is a fear that increased money printing and transfer payments (e.g., government payments to individuals) raise the risk of currency devaluation. While the future is always uncertain, we believe the current inflation outlook is particularly cloudy. Notwithstanding, in the near term we believe that the risk of deflation is greater than that of inflation. However, inflation could pose a risk if policy makers continue expansionary policies after the economy begins to rebound.

Important things to monitor include the magnitude, duration, and type of expansionary policy that is pursued. For example, after the economy regains its footing, the government could decide to continue making direct transfers to households and small businesses. Continued stimulus of this type could pose inflationary risks if not ended in a timely fashion. Other forms of stimulus such as productivity-enhancing investments in education, healthcare, and infrastructure would pose a lesser risk.