NORTHSTAR FINANCIAL PLANNERS INC.

DECEMBER 2023

FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

IN THIS ISSUE:

UNPACKING THE 2% TARGET: THE FED'S INFLATION BALANCING ACT

Inflation is a bit like seasoning in cooking—just the right amount can perfectly enhance a dish, but too much or too little can ruin it. In the world of economics, the Federal Reserve (Fed) strives to find that perfect seasoning level for the economy, and they've pegged it at a 2% inflation rate. This article covers why there's a target inflation rate, its potential pros and cons, and steps you can take to help mitigate inflation over the long term.

THE ORIGINS OF THE 2% INFLATION TARGET

The tale of the 2% target begins in a place quite far from the U.S.—New Zealand. In 1990, the Reserve Bank of New Zealand was the first central bank to adopt an explicit inflation-targeting policy.

The goal? To bring down the high levels of inflation that had plagued the economy in the 1970s and 1980s, causing uncertainty and hindering economic growth.

New Zealand's success with inflation targeting soon became a model for other countries, including Canada, the United Kingdom, and eventually, the United States.

INFLATION AND DEFLATION: A DUAL THREAT

Before delving into why the Fed focuses on this target rate, let's clarify what inflation and deflation mean. Inflation is the rate at which the general level of prices for goods and services rises and, subsequently, purchasing power falls.

On the flip side, deflation is the decrease in the general price level of goods and services. A reduction might sound like a good thing, but it can lead to falling production, layoffs, and a slowdown in economic growth.

Inflation and deflation are pervasive forces that can erode or inflate the value of money to consumers' detriment. A stable, predictable inflation rate allows people to make long-term financial plans without worrying that their money's value will rollercoaster unexpectedly.

WHY THE FED TARGETS 2%

The Fed focuses on a target inflation rate for several reasons:

1. **Predictability:** A target helps businesses and consumers know what to expect regarding price changes, aiding in long-term planning and decision-making.
2. **Debt management:** Moderate inflation can help debtors, as it erodes the real value of debt over time—an essential aspect considering the significant amounts of public and private debt.
3. **Avoiding deflation:** The target also serves as a buffer against deflation, which can be a more severe problem than moderate inflation.
4. **Economic activity:** Some inflation can encourage spending and investment, as consumers and businesses are motivated to transact before prices increase.

THE PROS AND CONS OF INFLATION TARGETING

Like any policy, inflation targeting has its pros and cons.

Pros:

- **Transparency:** It offers clear guidance on what the central bank aims to achieve.
- **Accountability:** It provides a benchmark against which the Fed's performance can be measured.
- **Stability:** It reduces the volatility of inflation and, by extension, the economy.

Cons:

- **Rigidity:** It might limit the Fed's flexibility in responding to unexpected economic changes.
- **Narrow focus:** The target may lead the Fed to focus too much on inflation at the expense of other economic issues.
- **Asset bubbles:** Persistently low rates can lead to excessive risk-taking and the formation of speculative bubbles in asset markets.

NAVIGATING INFLATION IN PERSONAL FINANCE

Understanding the implications of the Fed's 2% inflation target is crucial. Here are some financial tips for dealing with inflation:

- **Diversify investments:** Diversification can help reduce short-term effects like inflation and help increase your ability to achieve the long-term returns you need for your goals.
- **Take inflation into account:** Factor in inflation when planning for retirement to help maintain your purchasing power.
- **Inflation-protected securities:** Look into assets such as Treasury inflation-protected securities (TIPS), which are designed to increase in value along with the inflation rate.
- **Talk with your financial advisor:** We're here to help you create a financial plan that takes inflation into account.

FINAL THOUGHTS

The 2% target isn't just an abstract number; it's a critical benchmark for economic health and individual financial well-being. At Northstar Financial Planners, we provide fiduciary financial planning and investment management that helps account for factors like inflation.

The 2% inflation target is a cornerstone of modern monetary policy. It's a figure that impacts everyone, from policymakers to businesses to individuals planning their financial futures.

As with any economic policy, it has its strengths and weaknesses, but understanding it is the first step toward making informed decisions that align with your financial goals.

— Northstar Financial Planners

COUNTRY DEBT AND STOCK RETURNS

U.S. government debt reached 121% of the value of the country's gross domestic product (GDP) last year.[1] Many investors have expressed concern over the impact that servicing this level of debt could have on the stock market. But the historical data show little relation between the two.

Since 1975, there have been 153 observations of a country exceeding 100% debt/GDP for a year. Stocks were up for that country/year in 104 of the 153, or about two-thirds of the time.

There are numerous examples of countries carrying high debt for extended periods. Italy and Belgium have both been over 100% debt/GDP in more than 30 of the past 48 years.

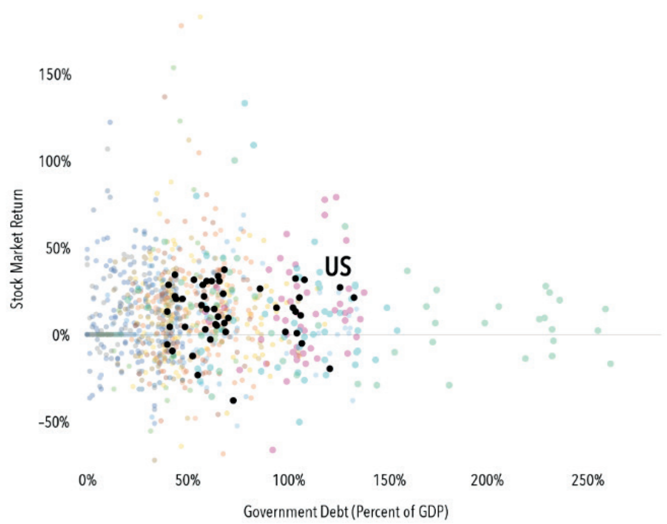
Meanwhile, their stock markets have returned an average of 10.8% and 12.0% per year, respectively. Japan has been over 200% since 2010 while its market averaged close to 6% per year over that period.

Stock markets set prices to the point where investors have a positive expected return given current information. Country debt is a slow-moving variable, so it's sensible that current prices reflect expectations about the effect of government debt. And it's unsurprising to see stock performance has generally been positive even amid high-debt conditions.

EXHIBIT 1

Indebted

General government debt, percent of GDP vs. stock market return for developed markets, 1975–2022



Past performance is not a guarantee of future results.

Debt figures are based on General Government Debt data from the Global Debt Database published by the International Monetary Fund. MSCI index returns are net dividends, in USD. MSCI data © MSCI 2023, all rights reserved.

— Wes Crill, PhD, Senior Investment Director and Vice President, Dimensional Fund Advisors

Footnotes

1 "General Government Debt," Global Debt Database, International Monetary Fund, September 2023.

WHO WE ARE

ALLEN P. GIESE, ChFC®, CLU®, ChSNC®
President, CEO, Senior Financial Advisor

STEVE TEPPER, CFP®, MBA
Vice President, Chief Operations Officer, Chief Compliance Officer, Senior Financial Advisor

GARY S. GLANZ
Director of Business Development, Investment Advisor Representative

CHARLES THOMAS, MBA
Lead Advisor

GARY C. GONZALEZ
Investment Advisor Representative

STACY SAAVEDRA
Director of Client Services

RICHARD LOTTIER III
Client Service Specialist

NORTHSTAR
FINANCIAL PLANNERS INC.

(954) 693-0030
1250 S. Pine Island Road, Suite 275
Plantation, FL 33324

northstarplanners.com
info@northstarplanners.com