

A person in a white shirt and tie is sitting at a desk, holding a pen over a document with financial charts. The image is partially covered by a green overlay.

McQueen
Financial Advisors

INFLATION IMPACT

4 Minute Read

Inflation Impact

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.

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**Higher deposit
costs are likely**

What is causing inflation?

The COVID-19 pandemic and supply chain shortages have contributed to the highest inflation rate since the late 1970s. For this discussion, we utilized CPI data for all consumers, as provided by the U.S. Bureau of Labor Statistics, one of the numerous inflation measures available. The annual inflation rate in 1979 was 13.3%, which was very high compared to the average inflation rate of just under 3% between 1981 and 2022. In both 2021 and 2022, the annual inflation rate was more than double the 40-year annualized rate. Supply chain shortages are only partially to blame for higher prices. Inflation was also 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. There remains some uncertainty about how the prolonged conflict will impact oil prices.

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. Future inflation expectations can become self-fulfilling. If businesses expect inflation to rise, they may increase prices, and if workers expect it, they may demand higher wages - both of which can lead to higher inflation.

Inflation Impact on Financial Institutions

As the Federal Reserve increases rates 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 funding costs are likely as depositors seek better returns. There remains considerable uncertainty about the timing and severity of Federal Reserve rate changes.

Inflation Impact

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 its target interest rate to a range of 0.00% to 0.25%, down from 1.75% at the 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 massive government response certainly contributed to the inflation problem. To fight inflation, the Federal Reserve began to raise interest rates, which can slow economic growth by making borrowing more expensive. There is a delicate balance between fighting inflation and causing economic slowdown, as raising rates too much or too quickly can stifle growth and potentially lead to a recession. The question of whether economic stimulus programs went too far is yet to be seen and a judgment call. A stronger economy is good, but higher inflation is one consequence of large government stimulus programs.

Federal Reserve Bank Inflation Response

In early March 2022, Chairman Powell 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.” Higher interest rates should slow the economy and bring inflation under control, but the timing and effectiveness these efforts can not be known for certain.

Inverted Yield Curve

A fully inverted yield curve refers to when long-term yields are lower than short their 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 a recession is imminent. Yield curve flattening, and then inversion, are characteristics of an economy shifting gears from mid-cycle to late-cycle. It is important to consider these large macro-trends. The slope and shape of the yield curve are important considerations that may impact budgets, growth plans, and rate-setting decisions.



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Action Items

Higher short-term interest rates, an inverted yield curve, and a potential economic slowdown are reasons for caution but not panic. Higher interest rates are generally favorable for financial institutions, but an inverted yield curve may result 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 initially grew during the pandemic. Many institutions elected to hold excess funds in overnight accounts, either waiting for higher rates or in anticipation of deposit run-off. Liquidity changed quickly when rates increased. It is now common for financial institutions to hold some investments with unrealized losses. We advocate for well structured ladders that ensure a steady stream of liquidity. A structured approach may offer ample flexibility to capitalize on market uncertainty and volatility. Trying to time the market is unwise, but now is as good a time as ever to review the investment portfolio. If an institution's liquidity remains ample, we recommend maintaining the current investment strategy. We consistently advise against wholesale changes to the balance sheet based solely on the yield curve or on speculative future events. It is important to continue to book assets in this higher rate environment. Smart investment decisions will lead to enhanced earnings. We encourage you to talk with us about how the yield shift volatile market may impact your institution and which bond sectors represent the best values.
- **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. With the significant increase in interest rates, the competition for accounts has become much more intense.

“ *Caution but not panic* ”

