Inflation & Your Money

"If the current annual inflation rate is 3 percent, why do my bills seem like they're 10 percent higher than last year?"[1]

Many of us ask ourselves that question, and it illustrates the importance of understanding how inflation is reported and how it can affect investments.

What Is Inflation?

Inflation is defined as an upward movement in the average level of prices. Each month, the Bureau of Labor Statistics releases a report called the Consumer Price Index (CPI) to track these fluctuations. It was developed from detailed expenditure information provided by families and individuals on purchases made in the following categories: food and beverages, housing, apparel, transportation, medical care, recreation, education and communication, and other groups and services.[2]

How Applicable Is the CPI?

While it's the commonly used indicator of inflation, the CPI has come under scrutiny. For example, the CPI rose 2.4 percent for the 12 months ending in September 2024. However, a closer look at the report shows movement in prices on a more detailed level. Transportation services prices, for example, rose 8.5 percent during those 12 months. CPI is a basket of goods, and your basket of goods may not reflect the basket of goods represented by the CPI.[1]

Are Investments Affected by Inflation?

They sure are. As inflation rises and falls, three notable effects are observed.

First, inflation reduces the real rate of return on investments. So, if an investment earned 6 percent for a 12-month period and inflation averaged 1.5 percent over that time, the investment's real rate of return would have been 4.5 percent. If taxes are considered, the real rate of return may be reduced even further.[3]

Second, inflation puts purchasing power at risk. When prices rise, a fixed amount of money has the power to purchase fewer and fewer goods.

Third, inflation can influence the actions of the Federal Reserve. If the Fed wants to control inflation, it has various methods for reducing the amount of money in circulation. Hypothetically, a smaller supply of money would lead to less spending, which may lead to lower prices and lower inflation.

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When inflation is low, it's easy to overlook how rising prices are affecting a household budget. On the other hand, when inflation is high, it may be tempting to make more sweeping changes in response to increasing prices. The best approach may be to reach out to your financial professional to help you develop a sound investment strategy that takes both possible scenarios into account.

1. USInflationCalculator.com, 2024. As of October 2024.
2. BLS.gov, 2024
3. This is a hypothetical example used for illustrative purposes only. It is not representative of any specific investment or combination of investments. Past performance does not guarantee future results.

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