Higher Interest Rates vs Inflation

SARASOTA, FL, UNITED STATES, November 11, 2022 / EINPresswire.com/ -- Higher rates may be good for conservative investors, but what about the impact of inflation? Jeff LaBelle, a Sarasota Florida financial advisor, published author and President of Gulf Coast Wealth Advisors, sees inflation dramatically impacting real rates of return.

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Most conservative investors have been hit hard if they were in the stock market this year. Not only because of following equity prices, but also following bond prices. Traditionally, when the stock market falls, bond prices would increase. This has historically been the correlation up until now. With the Federal Reserve tightening the money supply, and increasing short term rates, bond yields have been following this trend and increasing.

For investors looking for higher fixed rates such as certificates of deposit or fixed annuities, it is now common to lock in rates as high as 5%. For the conservative investor, this is very appealing since we haven’t had rates this high in decades. But in this economy, it comes with a price tag, inflation.

Let’s take a look at someone who is retired and depends on their investment income to help cover expenses. In these examples we compare real rates of return on fixed rates:

EXAMPLE #1
Two years ago an investor could put $100,000 in a 2% CD. Interest generated would've been $2000. Assuming an effective tax rate of 20% and an inflation rate of 3%, you would have a -1.6% real rate of return. After paying taxes you would net 1.4%. And with inflation at 3%, this would give you a negative real return of
-1.6%.

EXAMPLE #2
Today, investors can earn 5% on a $100,000 CD or fixed annuity. Interest generated would be $5000. Today's inflation rate is approximately 8%. This would give you a negative real return of -4%. After paying taxes of $1000, you would net $4000 or 4%. With the inflation rate of 8%, you have a negative real rate of return of -4%.

What we learn from these examples are simple. High inflation as we have today is devastating on fixed rate investments. Real rates of return will be negative until the inflation rate comes back to the norm of 3%. At that time, a 5% fixed rate becomes appealing.

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