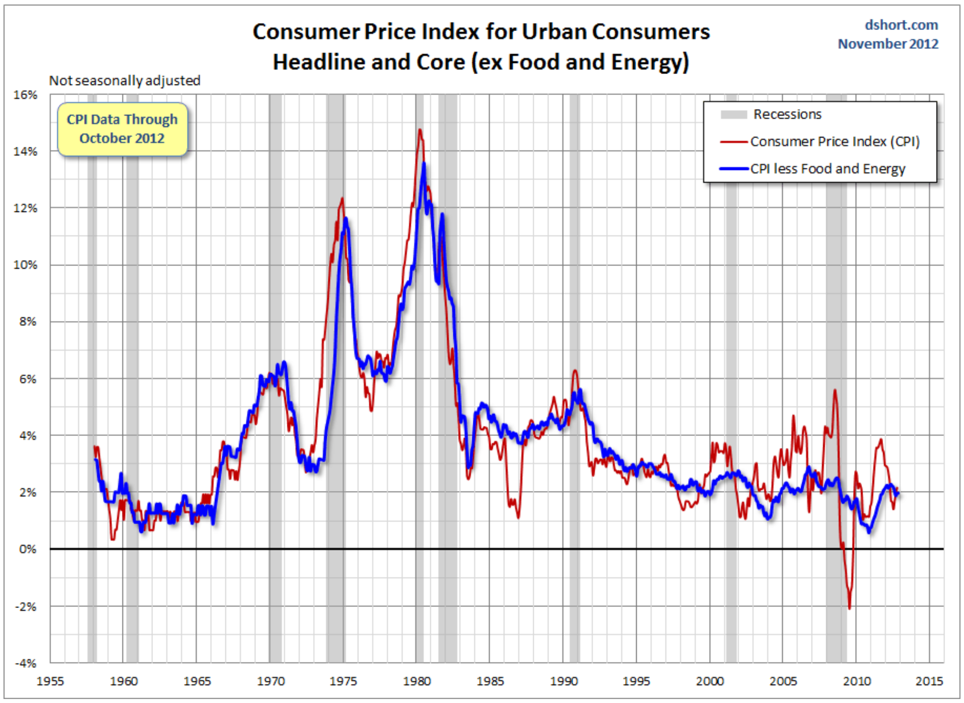
If you have been feeling the effects of 'Shrinkage', you're not alone...

Inflation:
Economist, Fed Officials, and Politicians have continually stated that inflation remains subdued and therefore allows the Fed plenty of latitude on easy monetary policy. The chart below shows the Consumer Price Index (CPI) since 1955.

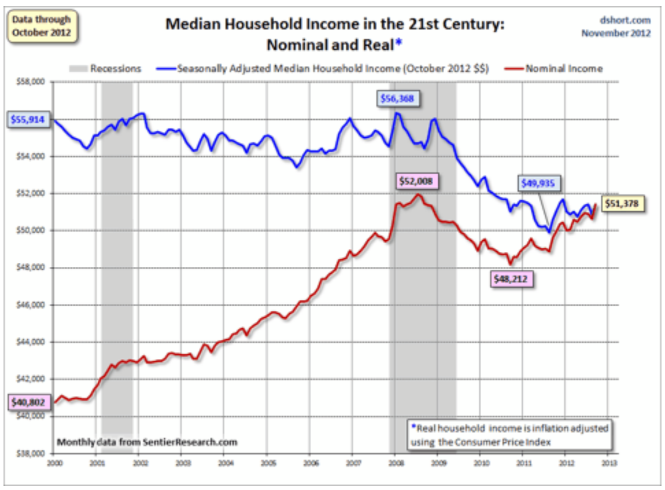


The blue line represents 'core' inflation (CPI less food and energy) has remained in a fairly subdued, around the 2% mark, for well over a decade. Thus, one could draw the conclusion that inflation really hasn't been an inhibitor to the recent recovery. Or has it?

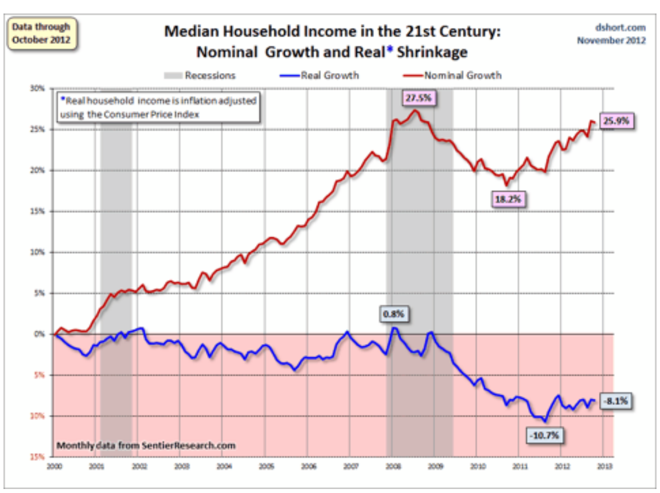
"Shrinkage" the REAL Income Story...
A good barometer of economic health and forward momentum is the level of 'REAL' Household Income. By 'REAL' I mean, income levels after inflation is factored in. Economist Doug Short has compiled two charts which summarize the shrinkage effect of inflation on income. They clearly show how REAL household income has struggling even before the Great Recession began and how income levels are in worse shape now than they were over a decade ago in 2000!

Let's take a look at the charts below.

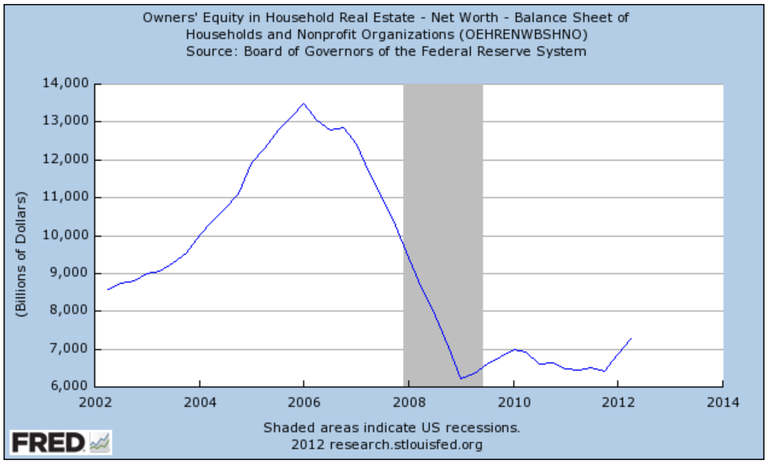
Household Income level: The first chart shows nominal and real household income levels since 2000. Notice how nominal income (red line) climbed steadily through 2008, and real income (blue line) hovered in a range. Then during the recession (shaded gray area), despite a drop in nominal income, real income actually remained near its high because inflation was indeed declining. But, since the end of the recession, real incomes have fallen dramatically due to rising inflation.



Household Income Growth: To put this in even better perspective, the chart on the next page shows <u>income growth</u> in both nominal (red) and real (blue) terms. Here we see nominal income rose steadily (+27.5%) thru 2008, took a dip and has now nearly recovered to its peak. However, **Real income spent most of the first nine years struggling to maintain the same purchasing power as it had in 2000. And since the recovery, Real Income has actually declined by over -8.1%. This is REAL Shrinkage!**



Household Equity: To be fair, Household Income is only part of the equation and other sources of wealth (like home equity) must be factored in. Rapid increase in housing prices (and phantom home equity) drove the US economy after the 2001 recession and then was quickly wiped out during the Great Recession of 2008/2009. The chart below shows the change in Owners equity since 2002. Though there is some improvement from the bottom, the level is far from where it was before the recession and has not offset the effect of Shrinkage of Household Income.



Capital preservation is one of the foundational goals of managing any investment portfolio. By definition, this means the goal is to prevent loss of principle. Some may assume that to achieve this goal means investments must be very conservative with low volatility. But *loss of principle can also come from erosion of principle through inflation*. Today, for example, thanks to the very aggressive action by the Federal Reserve to push interest rates down, 10yr US Government Bonds return 1.6% return, verses 2.2% inflation. Assuming inflation stays at this level for the next 10yrs, **this is a guaranteed negative -0.8% return. This is SHRINKAGE!**

<u>**Investment Strategy:**</u> The goal of every client portfolio is three fold:
-**Preserve Capital** which means keeping pace with inflation
-**Efficient Allocation of Risk** which means the return justifies the amount of risk assumed
-**Grow Wealth according to Client Goals**

These are <u>long term goals that are managed through many economic cycles</u>.

As always, please contact me with any questions or concerns.

Kind Regards,
Barbara