BURKE
FINANCIAL STRATEGIES
99 Wood Avenue South, Suite 102
Iselin, NJ 08830
(866) 603-3700
(732) 744-1240 Fax
john.b.burke@burkefinancialstrategies.com
steven.criscuolo@burkefinancialstrategies.com
christopher.trainor@burkefinancialstrategies.com
melissa.montalvo@burkefinancialstrategies.com


JOHN B. BURKE, MS, CFP®
Financial Advisor


STEVEN CRISCUOLO, CPA
Financial Advisor


CHRISTOPHER M. TRAINOR, CFP®
Financial Advisor


MELISSA MONTALVO, CFP®
Financial Advisor

financial $UCCESS

Securities offered through **Raymond James Financial Services, Inc.**
Member FINRA/SIPC

JUNE 2019

Why Inflation Can Be Good

Most people don't have a kind word to say about inflation, and those on fixed incomes hate it. It makes everything more expensive, and when you're living on an income that never rises, your standard of living suffers.

But ask most economists and they'll tell you that, within limits, inflation is good, and its opposite — deflation — is bad. How can that be? The broad definition of inflation is a general increase in prices. Deflation is the opposite — a general fall in prices.

When we say general, we're referring to the prices of most goods and services. This is an important distinction because prices of some things move in a different direction from most. For example, regardless of what's happening to the price of food or clothing, prices generally fall for new, high-technology items after a number of years. That's usually because manufacturers achieve economies of scale and are able to pass the associated savings along to consumers, and/or because they have invented new, less expensive ways to make the latest gadget. It also happens when more manufacturers come into the market and compete against established makers on the basis of price.

There can also be regional differences in the prices of some goods. An example is real estate, where prices may be falling in areas that are experiencing a high rate of job losses, while prices may be rising in areas where the job market is booming.

Three Measures of Inflation

1. The Consumer Price Index (CPI). This is the figure most Americans think of when they think about inflation. It's calculated monthly by

Continued on page 2

Why Isn't Inflation Zero Percent?

One of the main goals of the Federal Reserve is to maintain inflation at a reasonable rate, currently targeted at 2% annually. So, if the Fed is trying to control inflation, shouldn't they shoot for a zero percent inflation rate? The answer is probably no, for several reasons:

- ✔ Current measures of inflation are believed to overstate inflation, so low inflation rates may actually be close to zero percent.
- ✔ A reasonable level of inflation may help maintain employment, giving employers room to reduce labor costs when needed. While it is usually difficult for employers to lower wages, they can accomplish this by not increasing wages as much as inflation.
- ✔ Deflation is considered more costly than a reasonable level of inflation, so low inflation can help insure against falling prices.
- ✔ At low levels of inflation, nominal interest rates are close to zero percent. The preferred strategy used by the Federal Reserve to stimulate the economy is to lower short-term interest rates. Once short-term interest rates are at zero percent, the Fed must resort to other strategies to help stimulate the economy. Thus, the economy may be less stable when inflation is close to zero percent. ❍❍❍

FR2019-0118-0397

Why Inflation

Continued from page 1

the Bureau of Labor Statistics, based on the prices of a basket of some 80,000 different goods and services that most consumers buy in markets across the country.

The Bureau of Labor Statistics categorizes those goods and services as: food and beverages (including at-home and restaurant meals), housing (rent of a primary residence, owners' equivalent rent, furniture), clothing (including jewelry), transportation (new vehicles, airline fares, gasoline, motor vehicle insurance), medical care (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, hospital services), recreation (televisions, toys, pets and pet products, sports equipment, admissions), education and communication (college tuition, postage, telephone services, computer software and accessories), and other goods and services (tobacco and smoking products, haircuts, and other personal services). The CPI also includes sales and excise taxes, utility fees, and highway tolls. It excludes investments like stocks, bonds, and insurance, as well as income and Social Security taxes.

You'll sometimes hear about core inflation. This is a derivation of the CPI that excludes the goods that have volatile prices, like food and fuel. The idea is to avoid short-run price changes that mask longer-term trends.

2. GDP deflator. Based on changes in Gross Domestic Product (GDP), this is a broader measure than the CPI because it includes every kind of good and service the economy produces and delivers. For example, it includes raw materials and industrial goods, like steel, factory equipment, and investment services. It's expressed as a percentage that reduces the nominal new price of a good or service to reflect the quantity of goods.

The GDP deflator is regarded as a more accurate measure of price trends throughout the *entire* economy.

3. Producer Price Index (PPI). This measures changes in the wholesale prices of goods and services by manufacturers. It's often looked at as a leading indicator to estimate later changes in the CPI.

How Can Inflation Be a Good Thing?

Inflation is a by-product of economic growth, which is the means by which the standard of living rises. Think of it this way: prices are a function of supply and demand; if businesses post higher prices for their goods and services and they stick, it's because demand is willing and able to pay those prices. One of the ways that people can afford to pay more is if their incomes are rising, which is what happens when they are working for successful companies.

Higher prices are also supported when there is a continually growing number of people with jobs and money to spend.

Inflation can also stimulate growth by making existing debt cheaper. Think of homeowners who stretch their budgets to buy the nicest home they can afford. Over time, if the economy grows, so does their income. If they hold a fixed-rate mortgage, their monthly mortgage payment for principal and interest becomes a smaller and smaller percentage of their income.

As a result, they have an increasing amount of free cash flow to spend on other goods and services. And that, in turn, causes businesses to hire more people.

The Destructive Power of Deflation

Deflation is a general decline in prices — not to be confused with a decreasing rate of inflation — and is a destructive economic force. First, it's a sign that businesses can't pass along higher costs of production.

Second, it results in lower revenue and, if it lasts for several years, cutbacks in production and employment. When people lose their jobs, they spend less, have trouble keeping up with their bills, and even lose their homes.

Third, deflation makes debt more expensive. As incomes and business profits decline, fixed-rate loans become an increasingly larger percentage of cash flow. Banks foreclose on mortgages, increasing the supply of homes and driving down all home values, and some businesses go into bankruptcy. Banks lend fewer loans because fewer borrowers can qualify. People who still have jobs start paying off debt more aggressively.

This further reduces demand for goods and services, and the economy enters a negative feedback loop, feeding negative growth and higher unemployment.

Deflation is one of the major causes of economic depressions. In the 13 years from 1927 through 1939, the U.S. experienced CPI deflation in eight years, with prices falling 8.9% in 1931, 10.3% in 1932, and 5.0% in 1933.

By comparison, during the Great Recession, we experienced only one year of very slight deflation in 2009, when the CPI fell by 0.4%.

The Inflation Ideal: Low Single Digits

Is there an ideal rate of inflation? Economists suggest that a moderate rate of inflation — in the low-single digits — is optimal for sustained long-term growth. Indeed, the Federal Reserve Bank has said that an inflation rate of 2% is ideal.

Please call if you'd like to discuss this in more detail. ❍❍❍

Making Sense of the Federal Deficit

The federal deficit is often confused with federal debt, though the two are closely intertwined and impact the U.S. economy in several ways. A federal deficit is simply defined as the shortfall that remains when the government's expenditures exceed its revenue.

Imagine if, at the end of this month, your bills exceed your deposits. Just like Congress, you must find a way to fund this budget deficit to prevent any defaults. You might dip into your savings, apply the deficit to a credit card, or borrow money from a friend, family member, or lender. Essentially, this is no different than how Congress manages the federal deficit, except at the federal level, borrowing money means selling Treasury securities to the public. These owed funds become part of the national debt.

So who decides what is spent and what is collected as revenue? Each year, the annual federal budget is established by the president who submits a budget request each February for the upcoming fiscal year (beginning October 1) after consulting with federal agencies and the president's Office of Management and Budget. This budget request outlines three key factors: 1) the amount the government should spend on public services such as defense or education; 2) the tax revenues the government should collect; 3) the recommended annual deficit or surplus.

The federal government has consecutively reported a deficit since 2002. Last year alone, the Congressional Budget Office reported a deficit of $779 billion, putting the national debt at over $21 trillion at the fiscal end of 2018. Compared to recent years, this deficit was relatively low: in 2009, Congress reported a record-setting $1.41 trillion deficit, and over a trillion dollars each year thereafter until 2013. Historically, deficits are highest during times of war, with reported U.S. government deficits dating all the way to the aftermath of The American Revolutionary War. Deficits also spike during national emergencies, such as the subprime mortgage crisis.

What Do These Deficit Numbers Really Mean?

While it's difficult at best to absorb the enormity of these numbers, it's important to acknowledge that much of this debt is relative. Deficits and national debt should really be analyzed alongside the gross domestic product (GDP), taking the true size of our economy into context. The GDP is the total value of final goods and services produced within a country, generally measured on an annual basis.

If our GDP is growing at a higher rate than our national debt, there may be little cause for concern. The relationship between the two is measured by the ratio of national debt (in currency such as dollars) to the GDP. This debt-to-GDP ratio is a commonly used measure of a country's financial health, and the lower this ratio's percentage, the better. Countries wishing to join the European Union, for example, had to have a ratio under 60%. The U.S. Bureau of Public Debt reported a debt-to-GDP ratio of 105% in 2017, though this is still much lower than the highest reported U.S. debt ratio of 122% in 1946.

How Does the National Debt Impact Individuals?

High national debt can have several negative impacts on the economy, including the following:

Lower wages. Investing in government debt translates to money not being invested in companies, which can lead to stumped economic growth and wages.

Higher interest rates. With each new deficit, the government needs to sell more Treasury securities to finance the debt. In order to make these securities more attractive to foreign investors, banks, and the general public, the government will often increase interest rates. This can lead to higher interest rates in general.

Standard of living inequality for future generations. Lower wages, slower job growth, and higher interest rates all spell hardship for upcoming generations who may have to survive on less or prolong retirement dates.

Looming crises. If deficits and national debt growth go unchecked, U.S. debt investors could very well demand higher returns, ultimately leading to an unprecedented financial crisis.

The general consensus remains that both annual budget deficits and the national debt must be addressed in a way that strengthens the economy, though political parties will likely continue to disagree over tax hikes versus spending cuts.

Ironically, many people pay more attention to the federal budget and national debt than their own personal finances. It's important to understand that managing personal debt, coupled with a sound savings and investment plan, should be your highest priority. Please call to discuss your individual financial health. ❍❍❍

FR2019-0118-0397

Is Real Estate a Good Investment?

On March 12, 2007, the Wall Street Journal ran an article titled "Why your home isn't the investment you think it is." While it is self-serving for us to put down real estate as an investment (it competes with us for your investment dollars), here are some hard facts:

1) According to the article listed above (which used the Office of Federal Housing Enterprise Oversight as their source), U.S. home prices increased about 500% over the prior 30 years. Would that be the best investment you have ever made? That equates to an average return of 6.15%.

2) According to the National Association of Realtors (who would be a proponent of homes as an investment), over the last 20 years, the best housing market in the country was San Francisco. The average annual increase in value for that market for that period was 8.4%. The worst market was Dallas, Texas with average annual increases of 2.4%.

3) Returns are not even that good. Home owners are required to pay for local government (schools, police, firefighters) through real estate taxes. The average real estate taxes in the Tri-State area (NJ, NY, CT) take out just over 2% of the returns in owning your home.[1]

4) It gets worse. Home ownership requires upkeep. Average upkeep expenses are about 2.5% per year.[2]

Note that this argument is focused on residential real estate. Commercial real estate including apartments would be a different discussion as the economics are completely different. And, commercial real estate is something you can do through stocks as many commercial real estate companies have shares that trade on an exchange.

One may argue that you get to live in a home rent free. This is certainly true so add this benefit back in to get a true picture:

Average annual appreciation: 6.15% (from above)

Property taxes: 2%

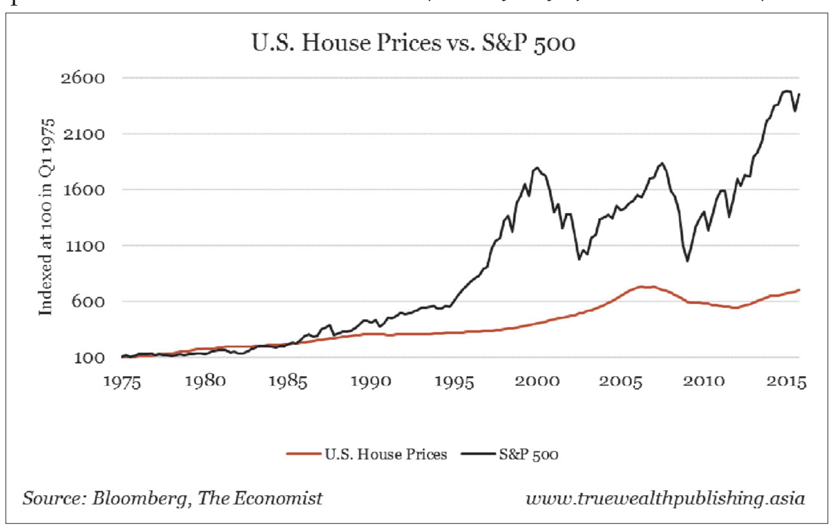
Upkeep: 2.5%

Rent savings: 4% (my own guess)

Total average return over the last 30 years: 5.65% with rental savings.

(This is a hypothetical example for illustration purposes only and does not represent an actual investment. Actual investor results will vary.)

The average return for the S&P 500 since it began in 1926 is approximately 10%.[3] Since 2000, stock market returns have been lower than that but so have real estate prices, so let's look at an apples to apples comparison in the chart below:



A final argument in favor of residential real estate as an investment is that the government subsidizes leverage (your mortgage) through a tax benefit (the deductibility of that mortgage). But the tax benefits of investing in real estate went down with the new tax law because of the $10,000 annual limit in deductions for local (state and property) taxes.

Stock market investments also have tax advantages that are underappreciated. Dividends are taxed at a lower rate. Plus, like real estate, capital gains can be deferred and even then, taxed also at a lower rate.

Finally, if you borrow or use margin, you can write off that expense against your gains.

We are not suggesting that you sell your home and invest in stocks. We are suggesting that real estate as an investment does not compare well versus stocks.

Sincerely,

John B. Burke

John B. Burke, MS, CFP®
Financial Advisor

[1]WalletHub
[2]Wall Street Journal, March 12, 2007, "Your House is Not a Great Investment."
[3] Investopedia