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ISSUE 5 | VOLUME 13 | NOVEMBER 2024

Cadence clips

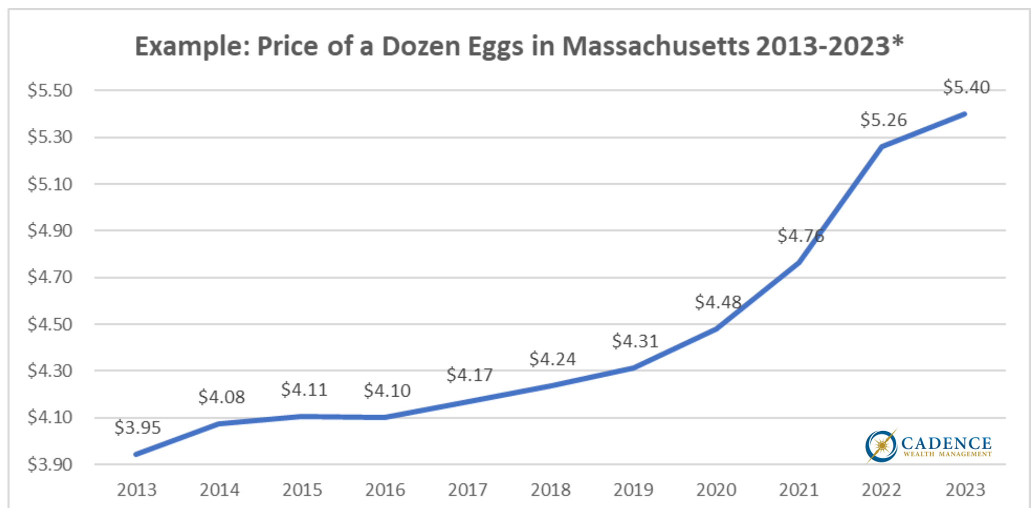
FOCUSED ON WHAT MATTERS MOST.

Inflation: What It Is and What It Isn't

By Steve DeBoth

Inflation is a simple concept that gets misrepresented in the press and by seemingly intelligent people all the time. A common definition of inflation is that it represents a general increase in prices. By that definition, inflation is a positive rate of change. Despite how uncomplicated that seems, people tend to misunderstand what "falling" inflation means. Falling inflation does not mean that prices are going down, because inflation is a positive rate of change. What falling inflation means, then, is a smaller amount of positive change. As a result, even when inflation is falling, prices are still increasing, just by less than before. A recent example of this is 2023's year-end inflation measurement of 3.4% after it was 6.5% in 2022. The rate at which prices increased was smaller in 2023 than in 2022, however prices still went up in 2023, just by less than in 2022.

Unfortunately, because inflation, even when it is falling, still represents an increase in the prices of goods and services, we do not really feel relief from falling inflation. It's better than rising inflation, to be sure, but there have been some instances where news articles have painted the recent falling inflation as something we should feel good about, forgetting or ignoring that because there were some periods of rising inflation preceding the fall, this recent falling inflation still hurts. With inflation as measured by the Consumer Price Index up 14% from the end of 2020 through 2022, adding 2023's 3.4% saw prices up nearly 18% in just three years. To illustrate this, consider the changing price of eggs in Massachusetts over the past 10 years using the overall U.S. food component of the CPI as the inflator.



* Based on the overall US food component of the Consumer Price Index as reported by the U.S. Bureau of Labor Statis-

Reliable data on the actual changing prices of eggs in Massachusetts has proven beyond my ability to find, so we will have to use the overall U.S. food component of the CPI and trust it to be a relatively close proxy. Based on this, a dozen eggs costing $3.95 in Massachusetts back in 2013 rose to $5.40 per dozen by the end of last year. That is around a 37% overall increase in 10 years, with an annualized increase of 3.2%. That's not really all that horrible, is it? Eggs only getting 3.2% more expensive every year? Well, yes and no. Yes, because a 3.2% increase is actually not all that big. No, because the inflation rate was even smaller than that the first 7 years, around 1.8%, but then jumped up in relative terms the final three years and we are still feeling that outsized recent price jump. It's a lot to ask people to feel good about a relatively small $0.14 increase in egg prices last year when prices still ended up being $0.92 more expensive than in 2020. If it were only eggs up 21% in three years, you may not really notice it, but when your entire cart full of food is up that much, a $15,600 annual grocery bill is now around $18,875.

A lowering rate of inflation, like what happened in the reported price of food from 2022 to 2023, is known as "disinflation". A negative rate of inflation, as in falling prices, is known as "deflation", like what the reported price of food did from 2015 to 2016, but only by -0.1%.

What Causes Inflation?

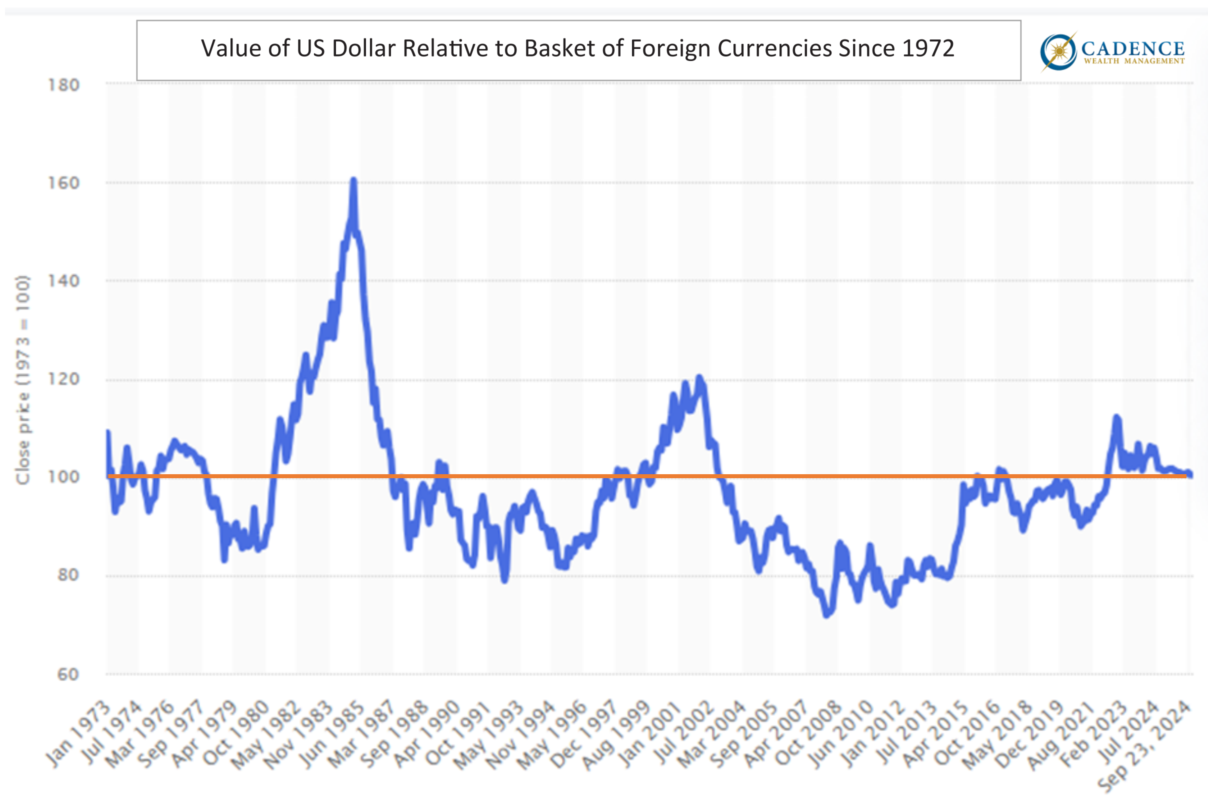
Quite a lot of things, actually. To generalize, we can group them like this:

1. Increased Money Supply. When the supply of money in the economy increases at the correct pace, interest rates tend to fall, it is then cheaper to borrow money to fuel production, and the supply of goods and services grows as a result. Growing supply will be able to accommodate growing demand. However, when the supply of money increases faster than the supply of product can keep up, that leads to inflation. Banks add to the money supply through the expansion of credit. Nearly every remaining item on this list is downstream of credit expansion, and therefore dependent upon the supply of money in the economy.

2. Demand. When more buyers want a product or service than the seller has available, that triggers inflation. The imbalance between demand and supply can happen on either end. When multiple buyers all want the same house, the seller cannot make another house to meet the demand. Therefore, the seller is able to raise the price. The seller of the house isn't intentionally only offering one house, however sometimes the seller of a product is able to artificially limit the supply to drive the price up, like when oil-producing countries intentionally reduce production and refinement. Frequently, and especially lately, the demand-supply imbalance has been caused by an increase in demand of goods and services beyond the amounts that are available.

3. Cost. If it costs producers more to make goods and services, they increase the price of the finished product to account for that. Raw materials are a cost that go into manufactured goods, energy prices affect companies' ability to pay for the power needed to run their production lines, and wages affect goods and service producers alike. Anything that increases the cost to produce a good or service has the potential to cause the seller to raise its price to make up for that.

4. Exchange Rates. For Americans, a strong U.S. dollar relative to other world currencies can be great. Without doing anything, the price of foreign-made goods seems to be going down, when it's really just that our dollars can buy more of those goods, and those savings get passed on to us consumers. Traveling overseas is great when the dollar is really strong. Since March of 2008, the value of the dollar relative to six other foreign currencies has been in an upswing, which has helped decrease the price of foreign goods and services the past 16 years.



The negative side to this, however, is that as foreign goods are cheaper for us, U.S. goods and services are more expensive in other countries, which hurts our exports and hurts our companies that produce goods and services sold overseas.

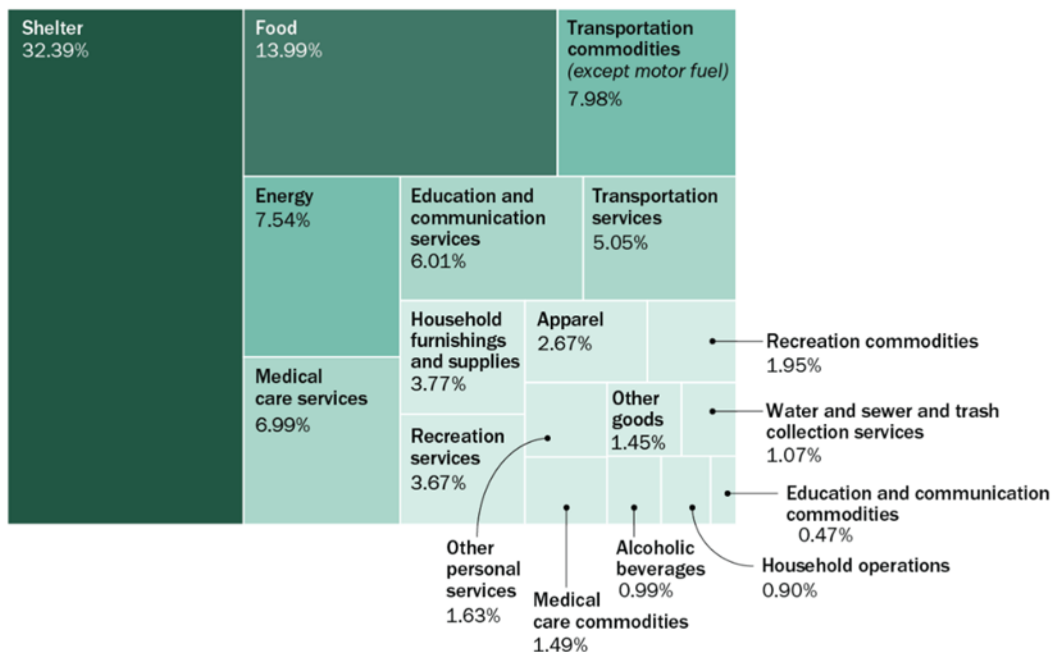
5. Rising Wages. When the economy is running hot and jobs are plentiful, there are fewer workers per job available. As a result, employers have to raise wages to attract talent. Likewise, they may need to raise wages to keep their talent as well, what with all those high paying available jobs out there. That increases costs, and producers have to raise prices to accommodate. Also, higher pay puts extra money in everyone's pockets, which affects the demand side of the equation as well. Rising wages, then, have the double impact of forcing producers to raise prices on the cost side, as well as putting more dollars in workers' pockets on the demand side. Prices in this instance are then both pushed and pulled upwards.

6. Monetary & Fiscal Policies. Central banks are responsible for maintaining monetary policy around the world. Our Federal Reserve's primary tools to keep inflation low are raising or lowering interest rates, bank reserve requirements, and the supply of government securities. Taxing and spending are the responsibilities of Congress and the Office of the President. Fiscal policies, like raising and lowering taxes, obviously affects where money gets spent and by whom, but pretty much every fiscal decision the government makes affects the flow of money to or from different parts of the economy. On top of that, the government is allowed to borrow money it can then funnel into the economy, which usually has an inflationary affect.

The Consumer Price Index Bugaboo

If you have read this far, I think you get a college credit. You now know what inflation is, and what falling inflation isn't. You know the general causes of inflation, but what you don't know, and none of us really do, is how much general price levels really move up or down each year, and that is because really good data is hard to find. Take the Consumer Price Index, which for the purposes of this discussion I have been forced to use as the government's reporting on the CPI is reliable to the extent it happens every month. The Consumer Price Index is a measure of the

average change over time in the prices paid by consumers for a representative basket of consumer goods and services. The CPI is reported to measure inflation as experienced by consumers in their day-to-day living expenses. The Bureau of Labor Statistics collects price data for hundreds of discrete goods and services – the so-called "market basket" – and puts them into dozens of categories and subcategories, and then assigns weights to each category. The changes in price month over month are then calculated via a variety of methods, added all together, and the overall change in the price of the total basket from the previous month is created and reported.



One simple problem using the CPI to inform on how you are being affected by changing prices over time is that these category weightings are almost definitely not identical to where your monthly expenses are going. Gasoline accounts for just 4% of the overall CPI, but depending on how much you drive, it may account for much more of yours. If you have a large family, your food bills may be a lot more than 14% of your monthly budget. The CPI, therefore, may not be an accurate measure of how inflation among the various categories is actually affecting you because your basket of goods and services has different weightings.

On top of that, the accuracy of the CPI cannot be fully trusted. For starters, nearly one third of the index is comprised of housing, but the index uses a methodology to impute the cost of home ownership from the cost of renting, and any time the cost of home ownership changes at a different rate then renting, it throws the CPI off. Another factor is that the effects government regulations have on product changes get taken into account, and if government statisticians believe a product has been improved enough, they may go so far as to say the price of the product has effectively fallen for the purposes of calculating the CPI even if the actual price to the consumer has risen. Lastly, health insurance makes up around 7% of the index, but the CPI imputes health insurance premiums from health insurers' profits. If profits decline due to health insurer costs increasing, this would register as a lowering of health insurance premiums and lead to a lower CPI, even if health insurance premiums had stayed the same or even risen.

These are just a few of the many problematic ways that the CPI gets calculated, and by some estimates the current rate of inflation that we are really facing could be twice as high as what is being reported. Additionally, and somewhat cynically, there is an incentive for any administration in power to under-represent the CPI. Firstly, because a high CPI makes you look bad, and secondly, because adjustments to social security and other government programs are based off the CPI, and a lower CPI helps to control the costs associated with these programs. So, inflation as measured by the CPI may not be the full story behind why you find things costing a fair bit more than they did a few years ago, as the prices you have been finding may have grown by more than the official numbers. This is a much-reported issue at the moment, but what is not as reported is that through unintentional and intentional means, calculating the Consumer Price Index is a murky and manipulatable process. Regardless of how inflation is calculated and reported, it has certainly plagued us recently to a degree not seen since the 1980's, and is much more complicated than any one thing can explain. Just remember, falling inflation is still an increase in prices, and therefore rarely something to celebrate, as much as it sounds like something we should.

Incentives, Conflicts, and Capture

By Casey Clarke

One of the reasons we formed Cadence back in 2010 was to rid ourselves of the embedded conflicts of interest that are inherent in large, profit-seeking public firms. I'm not suggesting that profit-seeking is bad, after all, it makes our economy go, jobs available, and is a genuinely positive aspect of the American way of life. But what we see every day working in financial markets is that there are immense pressures put on public companies by shareholders and Wall Street to increase profits quarter after quarter to fuel rising stock prices. Stock options within public companies, in many cases comprising a much larger form of compensation than salaries, provide additional motivation to maximize profit and keep share prices rising. One can commit any number of infractions and indiscretions when the largest part of his compensation depends on him doing so. On Wall Street, which is to say within large publicly traded companies, profit ultimately drives behavior. This incentive drives the potential for conflicts of interest with the consuming public, and the sheer scale and level of profits involved, which tends to correspond with the size of the Washington lobby for a particular business, fosters the potential for regulatory capture. Bank CEOs escaping jail time post Great Financial Crisis in 2007-2008? Big banks settling with the government on giant fraud charges for a fraction of their overall revenue? Big pharmaceutical companies repeatedly paying relatively small fines after harmful drugs are released to the public based on fraudulent trial data (Vioxx to name one of many)? This is capture at the tail end of consumer-damaging business practices that are driven by profit incentives and conflicts of interest.

As I mentioned, there is nothing inherently wrong with incentives that drive money-making activity. In fact, this is a key ingredient for a dynamic, innovative economic system. It is important, however, that the "system" or rules of the game align the success of the enterprise with that of the consumer. For example, banks shouldn't make loans embedded with clauses and features that they know customers have a good chance of defaulting on... without recourse. Auto manufacturers shouldn't be able to sell cars they know have potential warranty issues or faulty parts... without recourse. And drug companies should be responsible, in a big way, for knowingly manipulating trial data to make a harmful drug look good. When there are no consequences for bad behavior, we get moral hazard, and conflicts of interest almost every time. It's simply human nature.

The way we view the world of global finance here at Cadence is through this lens. In practice, we aim to minimize those conflicts, real or perceived, so that we are always in a position to view financial markets honestly and objec-

tively, formulate strategies according to that untainted view, and communicate them without fear of reprisal or recourse. This flexibility to look anywhere, and think anything, can sometimes lead to some uncomfortable findings. For example…

- Buying and holding doesn't always work. There have been times in history where investors had to wait much longer than 10 years to regain market losses.
- Stocks don't always return more than bonds.
- Lower interest rates don't necessarily lead to inflation.
- High interest rates don't always crush the economy and lead to disinflation.
- Deflation isn't bad like the government and its agencies and advocates tell us it is.
- The Fed doesn't control the economy nearly to the extent most think it does.
- Government bonds are not conservative investments.
- A typical diversified portfolio can lose much more money than most think.
- The U.S. government will not pay off its debt and this will have consequences.

These observations might not sound outlandish to our clients, since we talk about these things quite a bit, but to those watching a good amount of CNBC or working with a typical Wall Street firm, they'd probably border on heresy. We almost certainly would not be invited onto CNBC to opine on anything with these views. Why is that?

The answer to that question lies in the answers to the following:

- Who are the primary purveyors of financial information?
- How do they make money (financial incentives)?
- Who pays them (advertisers)?
- What are the financial incentives of those who pay them?
- Who are they regulated by?
- Do those regulators have relationships with those they regulate?
- Are there financial incentives in place that lead to conflicts of interest?

Let's dissect the common Wall Street guidance of buy and hold investing, and the tendency for the media to have a perpetually positive outlook for the stock market no matter the conditions. I always found it odd that you'd rarely see a guest on financial television or read an opinion piece in a prominent financial journal where the outlook was clearly negative for stocks. You'd also almost never hear a forecast for a negative performance year for the market from mutual fund companies or other investment firms we'd come into contact with. After experiencing two bear markets in the 2000s, it became crystal clear as to why. For the firms selling mutual funds and other investment products, there were strong financial incentives to make sure clients were always invested. For the financial media, a very large percentage of their advertising revenue came from investment product companies, so their messaging was effectively controlled by the financial interests of those advertisers. If they, or their guests were too honest about the risks they saw in financial markets, and it cost their advertisers fee revenue, then the threat of cancelling an advertising relationship loomed. Is this criminal? No. Does it lead to skewed messaging and a one-sided assessment of financial conditions and opinions? Yes, most definitely it does. These are all conflicts of interest that directly affect investors and support mantras like buy and hold investing.

And the regulators? Let's put it this way. If the financial firm is large enough, and offers ample incentive either now or in the future for a regulator not to regulate, then a lack of regulation is what we get. This is true across industries and is far more common than most think. We find former energy executives within the EPA, former pharmaceutical executives embedded within the FDA, former Goldman Sachs executives (like Hank Paulson) heading the Treasury. The same is true in reverse, with retiring public sector regulators and officials finding work with the very companies they were charged to regulate. Former Fed chairman, Ben Bernanke working with Citadel, one of the largest hedge funds in the world after wrapping up public service is a good example of this on the financial side. This cozy relationship between the public and private sector is simply a reality in our world and it makes folks all the wiser and keener once they know about it.

So What?

I share this because it's central to how we view the world and manage your money. We believe strongly that over time, the degree to which we successfully spot conflicts leading to bad behavior and business practices, and avoid them, can help us avoid unnecessary risks, and find more lasting opportunities. The more clearly we see the world and financial markets that power it, the better off our clients are. In addition, there's so much overlap between the things we need to research and fully understand in the world in order to invest client money wisely and the things that are affecting us daily in our personal lives. Where most people view an issue through the lens of politics, we tend to view it agnostically, through our human impulse lens of incentives, conflicts, and capture. The very nature of politics is to obscure the full context of an issue in order to appease a particular constituency while placing the blame on another. Thus, most issues that people view in a political way, sometimes emotionally, are actually being driven by big players with vested interests; by big money. When that happens, you get a narrative campaign lacking full information and context designed to leave you feeling one way. In my world, that's buy stocks and hold them despite the risk of doing so. In other industries, it can lead to far more emotional viewpoints and consequential outcomes. It's gross, and I'm confident everyone would agree that if the divisive rhetoric, finger pointing, and narrative-crafting completely abated tomorrow, we'd all be happier and much better off.

But it won't end tomorrow, and there's also a good chance that things get worse politically after November 5, despite which candidate comes out ahead. In anticipation of this - the prospect of vicious claims, accusations, and information campaigns to come - we could either just accept what comes at us as completely true or think about things more agnostically and dispassionately. Personally and professionally, we'll be keeping an eye on the money, whose interests are in play, and on a case-by-case basis, the embedded incentives, conflicts, and capture. This should continue to keep our goggles free of disorienting fog and serve us and our clients very well as we likely move into increasingly turbulent times in the weeks and months ahead.

End of the Student Loan "On-Ramp" *By Tom Shiffer*

A bit of background:

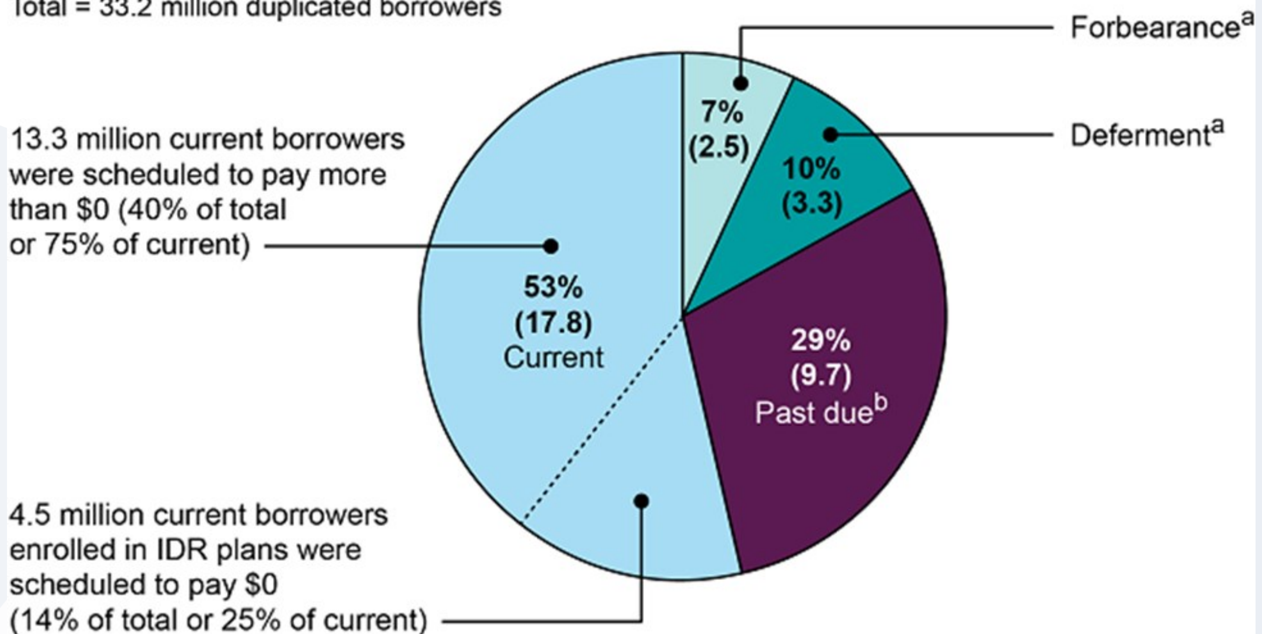
Due to the Covid-19 pandemic, Congress passed the CARES Act in March of 2020. That act, in combination with other administrative actions, paused the student loan program – meaning no payments were due and no interest would accrue. This 3 ½ year pause was extended several times until Congress passed the Fiscal Responsibility Act of 2023. As a result of the Fiscal Responsibility Act, interest began accruing in September of 2023, and monthly

payments started back up in October of 2023. However, in order to help borrowers begin making payments again after such a long pause, the Education Department (ED) created a temporary on-ramp period until September 30th, 2024, during which the ED would not report borrowers as delinquent for missing payments to credit scoring companies. Effective October 1st ,2024, that deliquent reporting pause has officially ended.

The Latest Impact Data:

According to the U.S. Government Accountability Office's (GAO) publicly released report on August 14, 2024, the most recent data as of January 31st, 2024 shows:

- 40% of borrowers were current on their loans
- 14% of borrowers were enrolled in income driven repayment (IDR) plans (including the new SAVE Plan) and had no payment
- 29% were past due
- 17% were in deferment (still in school) or forbearance (financial hardship)



According to https://educationdata.org:

- The average monthly student loan payment is $500/month
- The average borrower takes 20 years to repay their loans
- The average outstanding debt is $37,853
- 52.6% of borrowers owe $20,000 or less in federal student loans

Exceptions to the Re-Start:

As of January, 2024, nearly 25% of borrowers in repayment were enrolled in the Saving on a Valuable Education (SAVE) Plan, a new income-driven repayment plan. SAVE generally results in lower payments, though one may end up paying more in the long run due to more payments and accumulated interest.

The U.S. Court of Appeals for the Eighth Circuit in August granted a temporary stay prohibiting the ED from implementing the SAVE Plan, so those borrowers are currently in interest-free forbearance while the litigation plays out.

Here is a chart showing who is eligible for the new SAVE Plan:

Eligible Loans for the Saving on a Valuable Education Plan

Our New Income-Driven Repayment Plan

Eligible	Eligible if Consolidated Into a Direct Consolidation Loan	Ineligible
Direct Subsidized Loans	Subsidized Federal Stafford Loans (from the Federal Family Education Loan [FFEL] Program)	Direct PLUS Loans made to parents
Direct Unsubsidized Loans	Unsubsidized Federal Stafford Loans (from the FFEL Program)	Direct Consolidation Loans that repaid PLUS loans made to parents
Direct PLUS Loans made to graduate or professional students	FFEL PLUS Loans made to graduate or professional students	FFEL Program Loans (some types can become eligible if consolidated)
Direct Consolidation Loans that did not repay any PLUS loans made to parents	FFEL Consolidation Loans	Federal Perkins Loans (can become eligible if consolidated)
	Federal Perkins Loans	Any loan that is currently in default

Federal Student Aid

Student loans now account for $1.5 Trillion in federal loans for 43 million borrowers, and the resumption of these payments will have an impact on many people moving forward. Especially impacted are borrowers who have not been paying the last 4 ½ years and have adjusted to a lifestyle without that payment, as well as those students who now have to make payments for the first time since they were still in college when Covid began and they've never had a payment. What the larger social and economic impacts are remains to be seen. One thing is certain though, with all of the different rules and programs, the process of paying back student loans can be very confusing and prone to mistakes. Make sure you reach out to your financial professional for help!

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