

Financial Planning
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Inflation

Many of us have heard the practical definitions for Inflation as being “too many dollars chasing too few goods” or possibly “rising prices, across the board”. To understand inflation in more detail let’s start by discussing the difference between “Headline Inflation” and “Core Inflation”.

Headline Inflation (a.k.a. Consumer Price Index Inflation)

Refers to the rate of change in the overall CPI and aims to capture changes in people’s cost of living based on the movements of the average price of a specified basket of commodities and services consumed by a typical household.

Core Inflation

In contrast to Headline Inflation, Core Inflation excludes certain items in the overall CPI index whose price movements are characterized by short-term volatile movements. Core Inflation represents the long-term trend of inflation. To estimate Core Inflation, most countries exclude components of the CPI Index that manifest short-term volatility such as food and energy.

History

For much of human history inflation has not been an important part of economic life. Before 1930, prices were as likely to fall as rise during any given year, and in the long run these ups and downs usually cancelled each other out. By contrast, by the end of the 20th century, 60-year-old Americans had seen prices rise by over 1,000% during their lifetime. The most spectacular period of inflation in industrialized countries took place during the 1970s, partly as a result of sharp increases in oil prices implemented by the OPEC cartel without early enough response by the Federal Reserve to act to contain it. Throughout the 1990’s, most countries adopted a Core Inflation target of between 1 – 2.5%. (This equates to a 3.0% - 3.5% Headline Inflation. The average Headline Inflation for the U.S. over the last 75 years has been 3.5%). This has been found to be a healthy level for most developed economies because it allows for moderate inflation. (Most worrisome is deflation because there is negative economic growth, job losses and stagnation. Next most worrisome is hyper-inflation. Moderate inflation is the best balance between the two extremes.)

Higher Inflation?

It is a very thin line that the Federal Reserve must walk between raising short-term interest rates to contain inflation and the possibility of raising too high and thereby killing economic growth and heading into a recession. This is the current challenge. I don’t claim to know with certainty how inflation will behave. However, the primary inflationary factor currently seems to be energy prices. We do not really have “too many dollars chasing too few goods”. What’s deceiving about energy prices is that, yes, the increased costs of fuel permeate through our transportation system, which, in turn, effect the cost of most goods transported across the U.S. That is potentially inflationary. However, the higher gasoline prices also take those dollars from most families that

would normally be spent as “discretionary”, (on travel, entertainment, clothing, jewelry, etc.) and force those families to spend those dollars on gasoline. This is deflationary.

There is another factor to consider. The cost of labor is a high percentage of the CPI Index. Therefore, if we really want to monitor inflation, we must monitor the increases in wages. If we are getting substantial annual increases in labor rates, rest assured we are witnessing excess inflation. Over the last four years, our salaries and labor rates have been losing ground, even to our modest inflation for those years.

Federal Government Spending

We are all familiar with the current high federal government budget deficits caused by the spending in Iraq combined with tax cuts. Now we are on the cusp of huge additional expenditures to re-build from the damage of the hurricanes, projected at approximately \$72.6 billion of just federal government expenses. It is not under the purview of the Fed to control government spending. That is left to Congress. And, as we all know, the current administration has recently set spending records of the sort we would prefer never to see. This, in itself, creates upward pressure on inflation, and therefore forces continued action by the Fed.

Inflation Psychology

Are inflation expectations out of control? The University of Michigan has just completed a study of what consumers expect of inflation. The public expectation is that Headline Inflation will go from 3.0% to 4.3% before the end of 2006. This “Inflation Expectation” is what the Federal Reserve really wants to control. Why? Because if you as the consumer expect higher prices tomorrow, then you are going to make your purchases today, at the lower price. This then becomes a self-fulfilling prophecy of creating too many dollars chasing too few goods and in itself creates inflation. This is why the Federal Reserve has been so consistent with it’s last 11 short-term interest rate increases. It wants to stop the psychology in it’s tracks. However, it obviously has more work to do, which means we can probably expect even more interest rate increases.

The most important factors moving forward will be the continued softening of energy prices combined with steady growth in the GDP, hopefully resulting in a reduction in the level of projected federal deficits. These factors, combined with higher interest rates, may just allow for a continued stable Core Inflation rate and what is called a “soft landing”.

If you are interested in following inflation, track the Core Inflation rate, not the Headline Inflation rate. It is the long-term trend that counts. Month-to-month fluctuations are as misleading in predicting inflation as they are in predicting the stock market.

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