KEEL POINT

INVESTMENT BULLETIN

Volume III, No. 7
July 2014

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Choose Your Own Inflation Measure

Inflation is a tricky thing. Too much of it can spin an economy out of control while deflation spurs recession. The Federal Reserve has tested the balance between these two extremes as it has pumped trillions of dollars into the economy since the 2007-09 recession, but so far price levels in the United States have stayed relatively steady. In fact, the only significant inflation has been in markets for investment capital, most visibly the US stock market, and not in markets for consumer goods. Recent readings, however, have indicated prices for consumer goods are starting to trend upwards. In the space that follows, we cover a brief history of inflation in the United States and then offer a thought exercise designed to link inflation to your own investment goals and objectives.

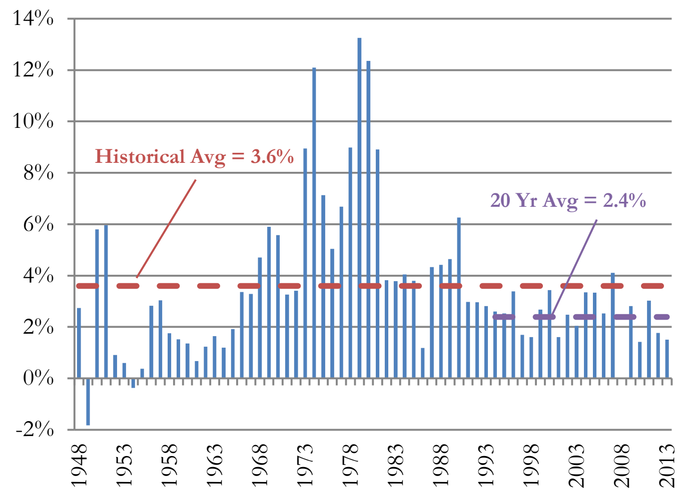
Where We've Been

The archives compiled by the Bureau of Labor Statistics (BLS) have data on the consumer price index (CPI) in the US going back to the 1940s. We've depicted the information in Figure 1. The qualitative summary of this time period is relatively straightforward: oil shocks in the 1970s sent consumer prices skyrocketing until the Federal Reserve under Chairman Volcker broke the spiral in the early 1980s. The historical inflation average over the entire time period has been 3.6%, but the last twenty years have only registered a 2.4% annual gain.

The credit for the calm period of the past twenty years has been generally attributed to central banker skill, globalization, or the oil producing countries. The first theory says that central bankers have demonstrated mastery of their inflation management toolbox. The consuming public has such faith in their skill that inflation expectations are reliably set at levels considered desirable by the central banks (such as 2.0% for the Fed). The globalization theory says prices have stayed low because of the unprecedented wave of cheap emerging market labor over the past few decades. Combined with productivity gains and lower costs to trade, cheap emerging market labor has dramatically slowed price increases for consumer goods. Finally, compared to the 1970s, oil supply imbalances have been better managed by oil producers so as to limit the shocks introduced to the cost of energy, a major input to many consumer goods.

If central bankers are the right group to thank that augurs well for the future. They have a very difficult strategy to execute – how to move back to normal monetary policy without upending growth or losing control of prices in the process. If they truly are masters then we can have confidence in moderate price inflation. However, if we owe the praise to the emerging market laborers, the outcome is likely different. The easy trick of repurposing labor from the fields to the factory is coming to an end. Prices for traded goods are likely to rise as pressure on labor costs in emerging market factories grows. Lastly, energy supply management is fraught with geopolitical peril, albeit aided by the enormous positive impact of technology providing new sources of oil and gas within US borders.

Figure 1: History of Inflation
Annual Change in CPI
Source: BLS

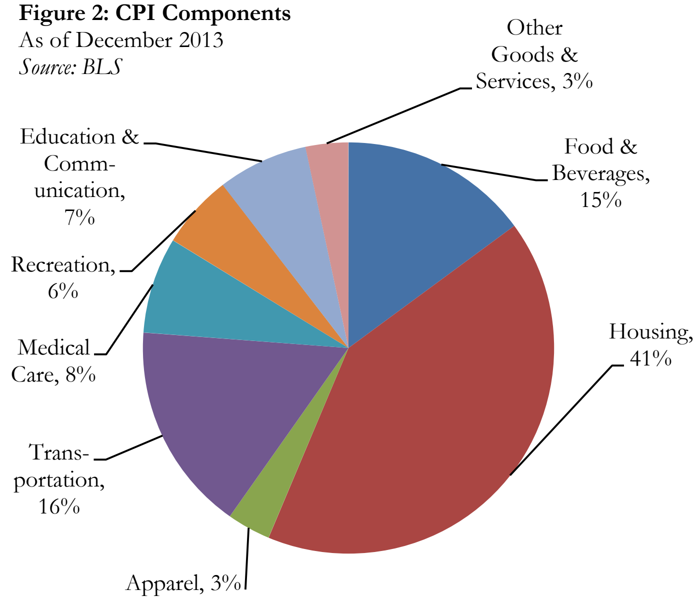


Where You're Going

One important, and probably obvious, point about the data presented in the first section is that it applies to the BLS' definition of the average American consumer. There is a good chance you do not resemble the average American consumer depicted in Figure 2 on the next page.

Figure 3 extends this breakout to show how prices have changed in the consumer's basket since 1993 (education/communication and recreation only go back this far) and 1967 (many other sectors drop off prior to this year). When thinking about how much your own basket of goods will cost in the future (this section is "Where You're Going" not "Where We're Going"), it is useful to consider this more granular historical perspective. It's also helpful to consider other sources for certain types of inflation if available. Finally, apply the globalization theory of moderating inflation to your basket of goods – we might be on the verge of rapid technological and productivity improvements in some sectors. Should new technologies work we could see a few points knocked off historical figures.

Figure 2: CPI Components
As of December 2013
Source: BLS

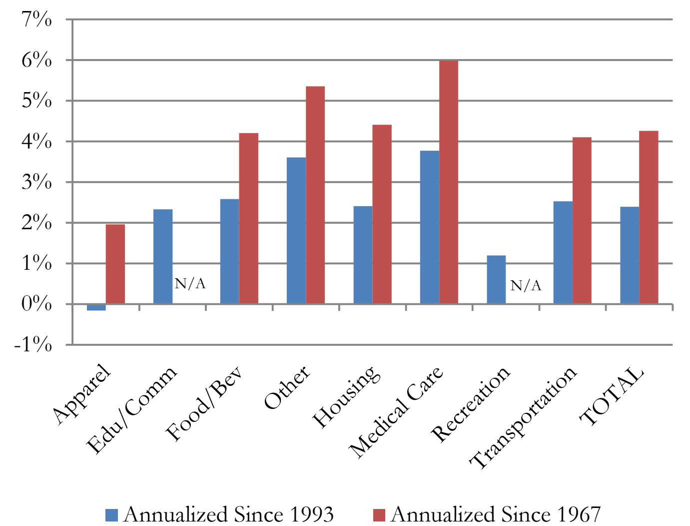


Let's review a few of the CPI components. Housing is perhaps the most controversial. Much of the slice is comprised of something called owner's equivalent rent. This is the BLS' way of treating housing as a consumption item, even though the majority of households own their home (in other words housing is an investment for them). In order to calculate owner's equivalent rent, the BLS asks sample homeowners: "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?" They attempt to work out the opportunity cost of owning your home – if you were to sell it to your neighbor how much would it cost you to rent it back? Your own goals may include the purchase of real estate, but local home price indices are likely a better guide than owner's equivalent rent.

You may have a goal of covering education expenses for your children and future generations. Per the CPI, those expenses have been growing at 2.3% per year since 1993. However, over the last decade, the College Board calculates the growth rate of all-in college costs at 2.1% *more* than the CPI for private universities and 3.2% *more* for publics. Going forward, though, the education sector does appear to be a candidate for the globalization story. Productivity gains may come from internet courses (rather than emerging market workshops) and might decelerate the rapid tuition price growth.

Medical care costs have risen the most over the periods shown in Figure 3. Demographics in much of the developed world suggest demand for medical care will go up as we age and its share in the consumption bucket will increase from 8%. Without the doctors and infrastructure to support these trends, prices will come under pressure. On the other hand, a wall of patent expirations may tame near-term prescription drug costs. And what role does technology play – will an emerging market doctor or perhaps a machine diagnosis your health concern? All told, it's harder to see reasons why this inflation measure will level off.

Figure 3: Component Inflation
Source: BLS



Charitable goals are subject to inflation too. It may be important to you that your foundation maintains the same charitable bang for its buck over time. You might make more impact per dollar given to medical research as indebted governments slim research & development budgets. Anti-poverty programs might see costs rise closely with the food & beverage series in Figure 3. Food inflation has been one of the leading causes of CPI increases. Demand for protein continues to increase as the emerging world climbs the income ladder – can we make the necessary productivity gains in this sector to keep up?

Most of us are planning to maintain our lifestyle, have a safe margin of reserves and pass something along to the next generations, through philanthropy or legacy giving. Inflation can have a big impact on achieving these goals so we are paying attention to it and finding suitable investment opportunities. □