

What's in the Basket?

Understanding the Consumer Price Index

May 2004

Normally, we don't discuss seemingly dry, economic topics (instead we prefer dry, *financial planning* topics!). But interest rates and inflation are very relevant topics for many investors and consumers. The threat of inflation can impact both short and long-term interest rates and these rates dictate what we will pay for our mortgage and what banks and investors will pay us for use of our money. This month we will focus on one of the more widely used barometers of inflation - the Consumer Price Index ("CPI"). Nonetheless, a fresh cup of java is recommended for optimal comprehension as we attempt to cover what the CPI is and how it's used. Lastly, we will explain why we think the CPI is actually *understating* inflation.

What is the Consumer Price Index anyway?

The CPI represents changes in prices of all goods and services purchased for consumption by urban households. User fees (water and sewage service) and sales and excise taxes paid are also included. Prices for the goods and services used to calculate the CPI are collected in 87 urban areas throughout the country and from 23,000 retail and service establishments. Data on rents is sampled from 50,000 landlords and tenants. The weighting for an item is derived from reported expenditures for that item.¹

How the CPI affects you

As mentioned, the CPI is considered a leading economic indicator of inflation. Movements in the CPI dictate government economic policies and setting of short-term interest rates. The benchmark is also commonly referenced in documents ranging from bank loan agreements to social security benefits to the annual rent increase on your lease. The CPI is used as a deflator to compare price levels from various time periods.

The CPI is also used to adjust income payments. Union workers have their wages tied to the CPI. The index affects over 80 million citizens as a result of statutory action: 48 million social security beneficiaries, 4 million military/federal service retirees, and 23 million food stamp recipients. Additionally, the CPI affects the cost of lunches for 27 million children.

Is CPI understating inflation?

The "core" CPI index excludes energy and food. Yes, the \$50 it costs to fill up your SUV isn't considered. This is a bit misguided considering these 2 sectors comprise over 22% of CPI, if not your monthly expenditures. Further, the heaviest component in the CPI (40%) is housing.² Yet the housing element is calculated using rental equivalency measures – not home prices, real estate taxes, insurance etc. Because more than 70% of Americans own homes, this seems antiquated. The rental market is depressed while housing is booming, thanks to historically low mortgage rates and liberal real estate lending practices. That's why inflation reported is low while the cost of maintaining your same standard of living is rising.

The government has an interest in understating inflation: it minimizes the cost of living adjustments for Social Security and government retirement programs. It also keeps interest rates in check, which in turn reduces government borrowing costs and slows the deficit's growth.

In conclusion

At the risk of sounding like an Oliver Stone conspiracist, a deeper understanding of CPI leads to a better understanding of financial markets. The markets are hypersensitive to changes in inflation and interest rates. With the widening trade/budget deficits, higher commodity prices and a weak dollar, inflationary pressures are on the horizon. With that, expect gradual increases in both long and short-term interest rates. In fact, mortgage rates (which are long term rates) have already begun to head north.

For investment portfolio positioning strategies in this changing environment, please refer to our May 2003 Fiscal Fitness: "Up, Up and Away". Or call us. We'd like nothing better than to keep this lively discussion going.

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¹ US Department of Labor – October 2002

² Leuthold Weeden Capital Management