In the Spotlight

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Inflation 1-2-3-4

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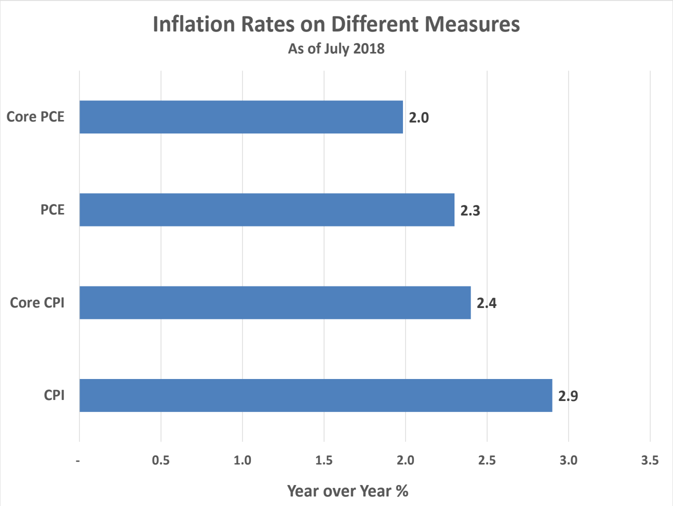
There are many measures of inflation. This Spotlight focuses on four:

1. The Consumer Price Index (CPI): The most commonly used measure of inflation. Social Security benefits, tax brackets and Treasury Inflation Protected Securities (TIPS) are all indexed in some form to CPI.
2. The core CPI (excludes the volatile food and energy components): Provides a more stable measure to assess underlying inflation trends.
3. The Personal Consumption Expenditures Price Index (PCE): The Fed states its long-term target for inflation (2%) in terms of the PCE.
4. The core PCE (excludes the volatile food and energy components): The Fed's preferred measure of inflation for setting policy.

Below are the inflation rates for the four measures as of July, which range from 2.0 to 2.9%. The range is driven by differences in the basket of goods used to calculate the price level. Sources of differences are as follows:

1. Weights: The CPI is based on household buying surveys. The PCE is based on surveys of what businesses are selling.
2. Scope: CPI only covers out of pocket spending. It excludes items that are indirectly paid including medical care paid by employer-provided insurance, Medicare, etc. PCE includes these items.
3. Formula: PCE tries to address substitution between goods as prices change. For example, if beef prices rise a lot, PCE adjusts the basket to account for people buying less beef. CPI does not.
4. Other: minor items like seasonal adjustments.



The biggest driver of variation tends to be the difference in the weights. An important note: the weights are survey-based averages. **Your** personal inflation rate depends on **your** specific consumption basket.

Over the next few years, **it is likely that the Fed's 2% inflation target may not be what many think it is, nor what they experience.** Why? It is a target, not an upper limit. Inflation above 2% is acceptable to the Fed so long as inflation averages out near 2% over time. PCE Inflation has averaged just 1.6% since the Fed formalized its 2% target in January of 2012. This implies that **inflation above 2% can persist** for some time**.** For example, if PCE inflation averages 2.5% for the next five years, the ten year average will still be near 2%.

Further, since 1960, the Fed's preferred inflation measure, the core PCE, has averaged about 0.50% per year lower than the core CPI. Therefore, if core PCE is running at 2.5% a year, core CPI can easily run at 3%. As such, it is reasonable to expect that **we will experience "consumer price inflation" of 2.5% to 3% or more,** assuming the Fed allows core PCE inflation to rise above 2% for a period of time. Based on Fed statements that the target is symmetric and that they have undershot it for a decade, it appears that they are telling us to expect them to overshoot the target for a while.

Email research@wealthcarecapital.com with questions, comments or requests. Sources include the Federal Reserve, Bloomberg, Reuters, Wealthcare.

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