Inflation and the Consumer Price Index (CPI)

By Craig T. Callahan, DBA
Founder & President of ICON Advisers, Inc.

In the spring of 2009, many investors were anxious about the potential for increased inflation. Expecting stock prices to rise and wanting investors to participate, ICON published a report on June 9, 2009, showing how inflation has historically been docile following recessions. In retrospect, our 2009 inflation outlook proved accurate and equity prices have moved higher over the course of the last two years. We hope that report helped overcome the inflation objection to investing in equities.

Now, however, we see inflation concerns returning. While the Consumer Price Index (CPI) has been tame the last few years ($1.04 in May 2011 has the same buying power as $1.00 in June 2009), many investors allow these concerns to affect their investment decisions. They also express skepticism about the CPI and suggest it does not reflect the inflation they are personally experiencing. So let's look at the CPI.

The CPI is produced by the Bureau of Labor Statistics (referred to as "BLS" from here on) in three stages. First, the BLS surveys consumers to see what they are buying. Second, it surveys consumers to determine what proportion of their spending they are devoting to each item. This second factor helps determine how to weight each item in the "market basket" of goods and services. Third, and finally, the BLS surveys stores monthly to get the prices of those items in the market basket.

The BLS surveys one broad group (all urban consumers) and then surveys a narrower subset of that larger group (wage earners and clerical workers). As stated on the BLS website, the large group includes almost all residents of urban or metropolitan areas, including professionals, the self-employed, the poor, the unemployed, and retired people as well as urban wage earners and clerical workers. Not included in the CPI are the spending patterns of people living in rural nonmetropolitan areas, farm families, people in the Armed Forces, and those in institutions such as prisons and mental hospitals. Wage earners and clerical workers represent about 87% of the U.S. population.

The CPI market basket is developed from detailed expenditure information provided by families and individuals on what they actually bought. For the current (2011) CPI, this information was collected from the Consumer Expenditure Surveys for 2007 and 2008. In each of those years, about 7,000 families from around the country provided information each quarter on their spending habits in the interview survey. To collect information on frequently purchased items such as food and personal care products, another 7,000 families in each of these years kept diaries listing every thing they bought during a two-week period.

Over the two-year period, expenditure information came from approximately 28,000 weekly diaries and 60,000 quarterly interviews used to determine the importance, or weight, of the more than 200 item categories in the CPI structure.

The CPI represents all goods and services purchased for consumption by the reference population. BLS has classified all expenditure items into more than 200 categories, arranged into eight major groups. Major groups and examples of categories in each are as follows:

- **FOOD & BEVERAGES** (breakfast cereal, milk, coffee, chicken, wine, full-service meals, and snacks)
- **HOUSING** (rent of primary residence, owners' equivalent rent, fuel oil, and bedroom furniture)
- **APPAREL** (men's shirts and sweaters, women's dresses, and jewelry)
- **TRANSPORTATION** (new vehicles, airline fares, gasoline, and motor vehicle insurance)
- **MEDICAL CARE** (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, and hospital services)
- **RECREATION** (televisions, toys, pets and pet products, sports equipment, and admissions)
- **EDUCATION & COMMUNICATION** (college tuition, postage, telephone services, and computer software and accessories)
- **OTHER GOODS & SERVICES** (tobacco and smoking products, haircuts and other personal services, and funeral expenses)

In summary, the CPI has no party allegiance. It is neither republican nor democrat, and we do not believe it is readily influenced by the politicians in power at any given time. The CPI simply reflects the Bureau of Labor Statistics' detailed attempt to measure the prices of a market basket that consumers are actually purchasing. It would appear to be a better measure of inflation than the personal experience of certain investors who may focus on just one or two particular goods (such as gasoline or meat) over a short time period as a measure of inflation. We Americans seem to enjoy poking fun at our government and even criticizing its statistics at times, but its measure of inflation seems to be pretty sound.

At ICON, we do not expect rampant inflation over the next few years. Nonetheless, we recognize there could be some inflation with which to contend when investing. We favor stocks of high-quality companies that can be purchased at prices below our estimate of intrinsic value. For investors seeking income, we like high-quality, on-sale companies that also pay dividends, because there is the potential for dividend increases as earnings grow and also the potential for earnings to grow faster than inflation.

Past performance does not guarantee future results.

Opinions and forecasts are subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.

ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

The Consumer Price Index (CPI) is the primary indicator of U.S. inflation and is used to make cost-of-living adjustments to billions of dollars in benefit payments.

Please visit ICON online at www.iconadvisers.com or call 1-800-828-4881 for the most recent copy of ICON's Form ADV, Part 2.