

Thought for the Week: Monday, May 16th, 2011

Breaking Down Inflation

Seeking a Deeper Meaning

The mass media regularly presents financial and economic data as a single principle without explaining how the individual constituent components work. This can lead to **misunderstandings when trying to use the 'general' bulk data to predict** what may happen next.

As in many areas of science and technology, if you really want **to understand how a mechanism works, you should break it down and analyze its constituent components**. The bulk effect may be the result of one or two hidden components. As an investment team, dissecting data into its components is one of our major tasks. Looking on the surface of bulk data and assuming its constituents are homogenous is an anathema to us.

It is an accepted scientific principle that breaking things down into their constituent parts leads to a better understanding. An extreme example of this is the European CERN Particle Accelerator.

This device accelerates sub-atomic particles at close to the speed of light then smashes them into each other. The resultant collision causes the very small particles to break apart into even smaller particles which are photographed. By studying the new particles and forces which appear in the collision, scientists can gain a deeper insight into the workings of our universe; the universe which is made up of the sub-atomic particles.

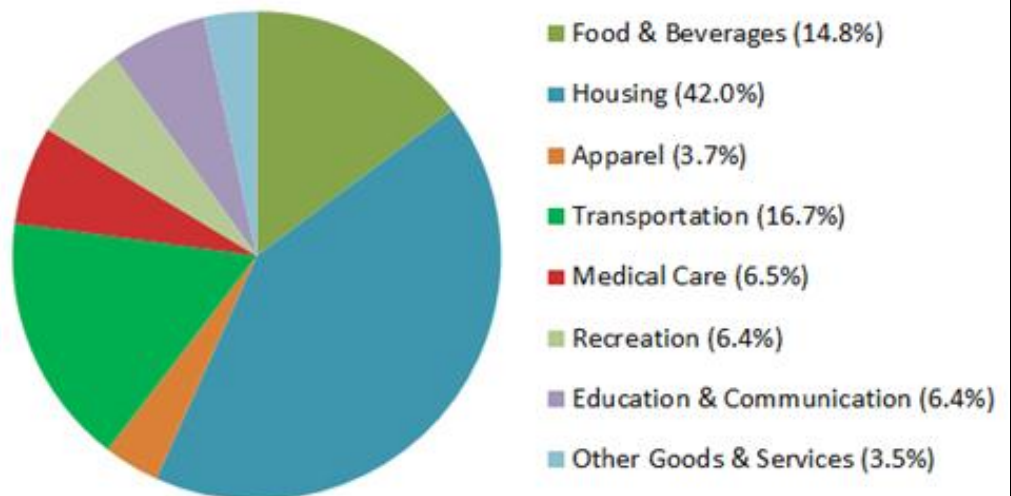
Understanding Inflation

To illustrate the above concept, let's start with the following bulk data: **"Inflation is very low and remains below the Government's acceptable limits"**.

The pie chart right breaks down the **components and weightings of the Consumer Price Index (CPI)**, a commonly used indicator of Inflation.

The Transportation slice includes gas prices.

Consumer Price Index Components





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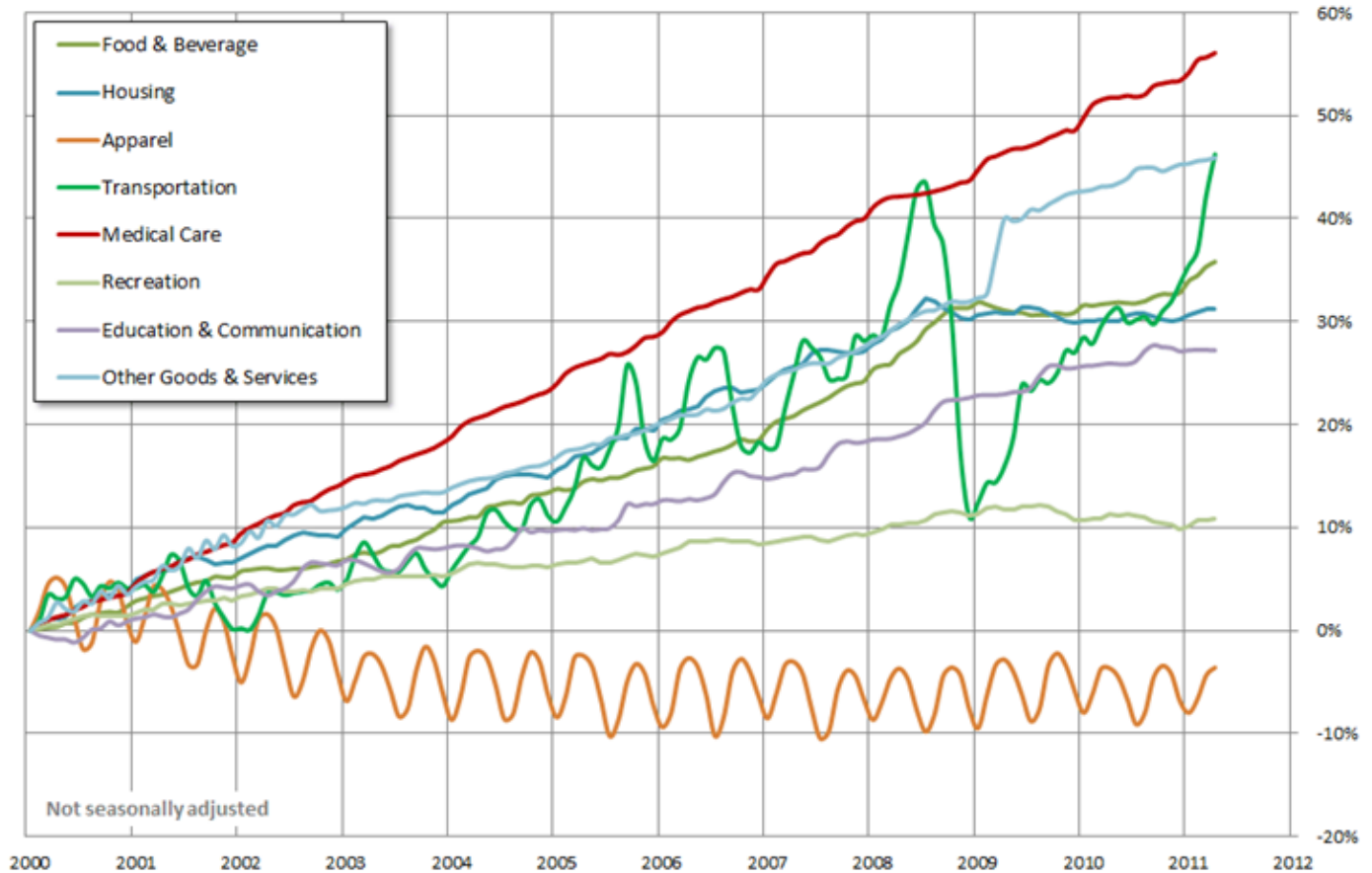
COMPREHENSIVE WEALTH MANAGEMENT

The chart below shows the **cumulative percent change in price for each of the eight CPI categories** since 2000. This illustrates the need to break things down before jumping to conclusions.

CPI Data Through
April 2011

Breaking Down the Consumer Price Index Percent Change in the Eight Subcomponents Since 2000

dshort.com
May 2011



Not surprisingly, **Medical Care has been the fastest growing category while Apparel has actually been deflating since 2000**. Another interesting feature of Apparel is the obvious seasonal volatility shown in the orange line above.

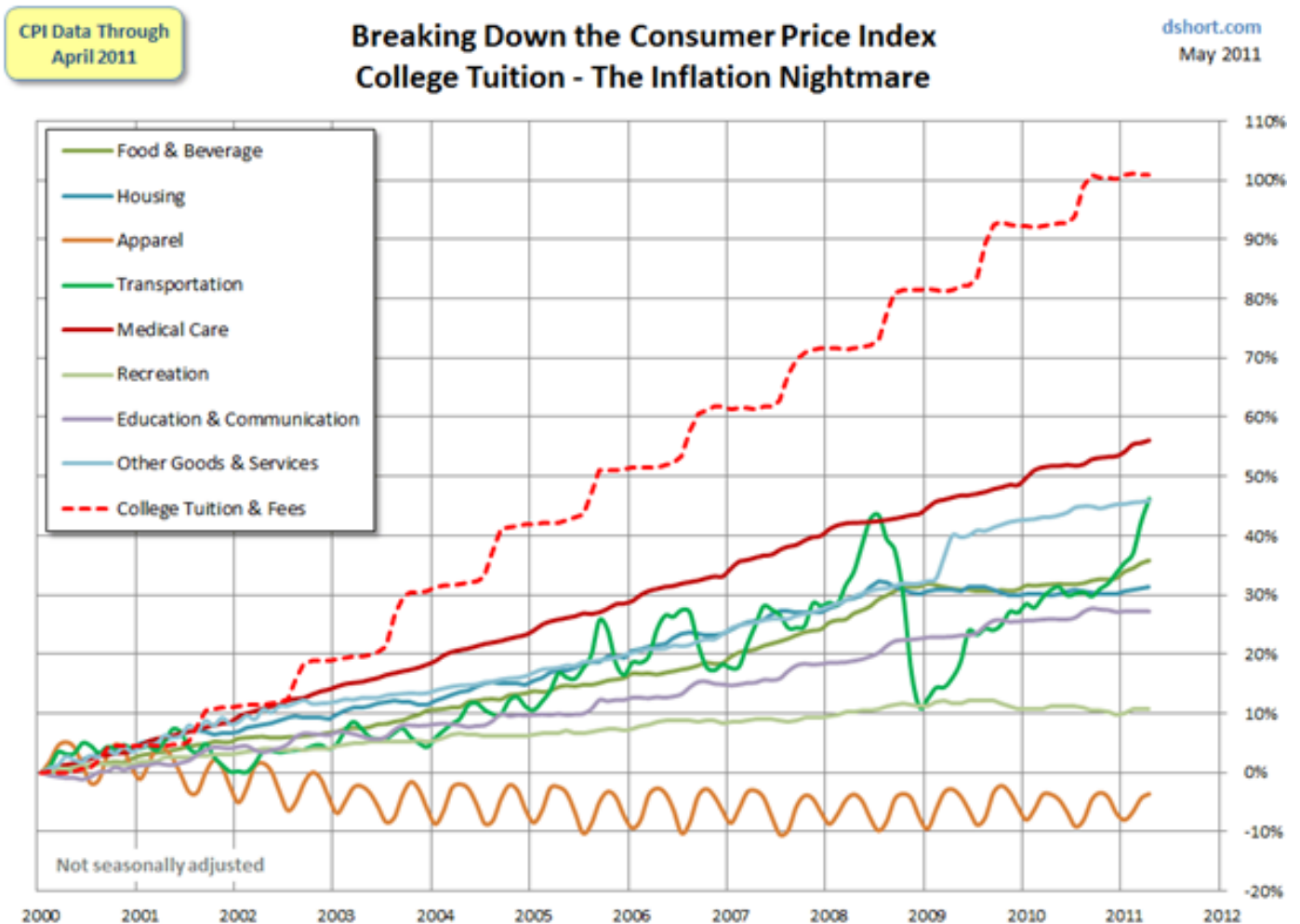
Transportation is the other category with high volatility — much more dramatic and irregular than the seasonality of Apparel. Transportation includes a wide range of subcategories but the volatility is largely driven by the Motor Fuel subcategory. For example, the spike in gasoline above \$4-a-gallon in 2008 is readily apparent in the chart. Also, energy costs are indirectly reflected in expenditure changes for goods and services which may vary to some degree based on energy cost variation, for example, those products whose prices include the cost of shipping and petrochemical raw materials.

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Clearly, **Transportation, Health Care and Other Goods** are rising fast, with a strong recent uptick in **Food & Beverage**. Prices in the other sectors are fairly flat.

To provide some perspective, the chart below shows the cumulative effect of College Tuition price inflation plotted alongside the CPI components:



One Final Word

Economists and policy makers, including the Federal Reserve, pay close attention to **Core Inflation**, which is the overall inflation rate **EXCLUDING Food and Energy**. This subtle distinction needs to be taken into account.

When you next see an announcement along the lines of “Core Inflation remains benign”, **be aware that Core Inflation is not the same as the Consumer Price Index (CPI)** outlined above and probably not representative of the price changes households are actually experiencing.

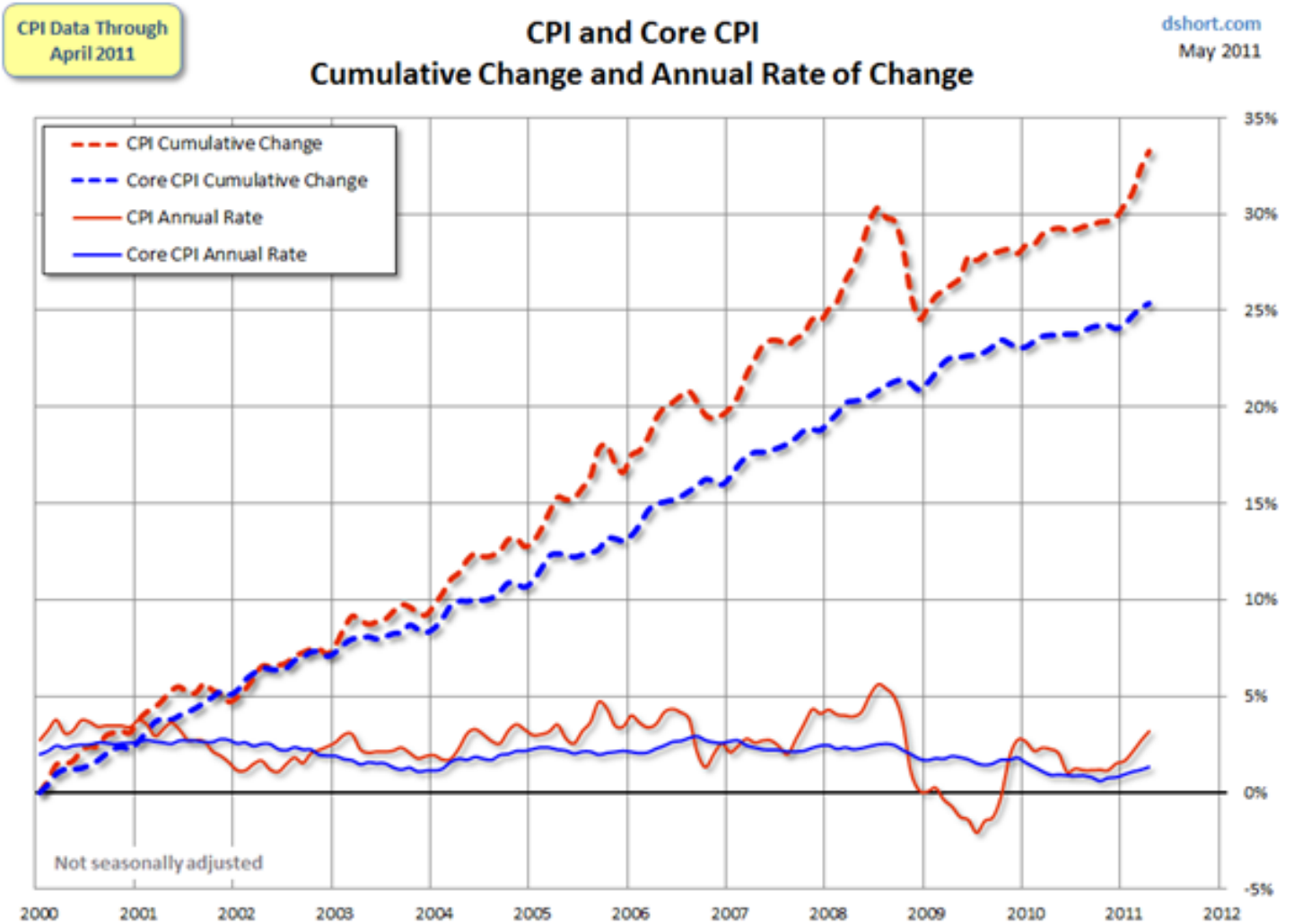


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COMPREHENSIVE WEALTH MANAGEMENT

The chart below compares CPI with Core Inflation by showing the annualized rate of change (solid lines) and the cumulative change (dotted lines) in CPI and Core CPI since 2000.

The difference between CPI and Core in 2008 and 2011 is significant.



Consumers, especially those who've managed expenses over several years, should **pay more attention to the top lines (pure CPI, not Core)** as the inflation story unfolds over the coming months and years.