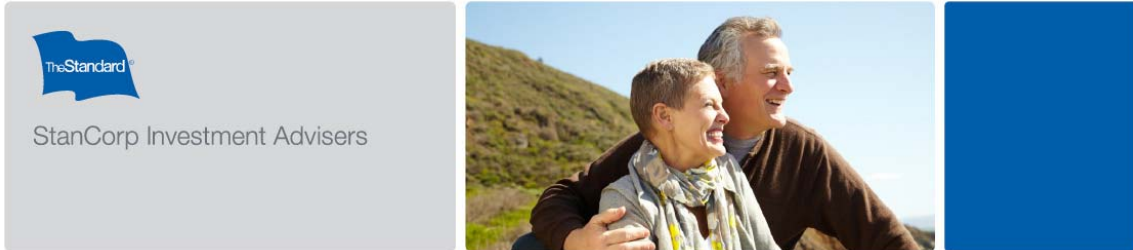


An Investor's Guide to Inflation

July 2011

www.StanCorpAdvisers.com
800.378.5742

Julie Grandstaff, CFA[®] and Don Yocham, CFA[®]



As you scan the financial press you are likely to hear emphatic assertions that “inflation is not a problem” alongside equally vocal statements calling for “runaway prices” and a “dollar collapse”. What is an investor to conclude in the face of such contradictory commentary? To answer this question, it is helpful to gain a better understanding of inflation and its sources.

Most definitions of inflation fall into one of two categories. The first category defines inflation as an increase in the supply of money, whereas the second one defines inflation as an increase in prices. The supply of money is measurable and driven solely by Federal Reserve (Fed) policies, however the cause of price increases is far less clear. Prices go up and down for a variety of reasons, such as supply and demand for a product or a change in the cost to produce a good due to productivity improvements and many other factors. In many cases, rising prices are not necessarily a sign of inflation, as in the case of supply and demand, which are transitory price increases. However when prices rise because there is “too much money chasing too few goods” that is truly inflation and is the result of an excess supply of money.

The Consumer Price Index (CPI) is one metric that Fed policy makers use to help determine whether they need to adjust the supply of money. The Bureau of Labor Statistics (BLS) calculates the CPI, which is the most widely recognized measure of prices. Its calculation methodology attempts to adjust for several factors that are not inflationary. The work is not perfect, and as a result, the CPI likely does not reflect what each of us experiences when we go to the store. The CPI identifies the price of a basket of goods that represents the buying habits of the average American. Periodically, the BLS readjusts the weightings to better

An Investor's Guide to Inflation

July 2011

www.StanCorpAdvisers.com
800.378.5742

Julie Grandstaff, CFA[®] and Don Yocham, CFA[®]

reflect changes in consumer buying patterns over time. Additionally, the BLS makes three other adjustments to the calculation.

- **Hedonic adjustments** adjust the price of a good based on changes in quality. For example, last year an iPad cost around \$500. This year, a new version was released that was twice as fast and half as heavy but still cost \$500. This increase in performance represents a discount to the actual price, and so an adjustment is made to reflect the improvement. In the CPI calculation the price of the iPad has declined.
- **Substitutions** come into play when the price of a good rises too much too fast. In these cases, it is assumed the consumer will substitute a cheaper but comparable product. For example, if the price of beef rises abruptly, it is assumed that consumers will buy more chicken instead.
- **Weighting adjustments** are similar to substitution adjustments. Instead of assuming consumers will switch to a different product in the face of rising prices, it is assumed that the consumer simply buys less of it. The BLS will assign the product a lower weighting and therefore it will have less of an impact on the overall price index.

These adjustments are designed to mitigate the various influences on price changes, in an effort to make the CPI a better measure of inflation, and subsequently a better tool for gauging the impact of the money supply on prices.

In addition to the CPI, you may often hear the core inflation rate reported. The CPI is referred to as headline inflation, which comprises the following major categories and weightings:

CPI - Category	Weighting
Food and Beverages	14.8%
Housing	41.5%
Apparel	3.6%
Transportation	17.3%
Medical Care	6.6%
Recreation	6.3%
Education and Communication	6.4%
Other Goods and Services	3.5%

Source: Bureau of Labor Statistics, May 2011

The sum of the weighted prices of goods in all categories is Headline CPI. However, food and energy prices (energy prices being components of the Housing and Transportation categories) can be volatile. In order to provide a more stable guide for monetary policy, food

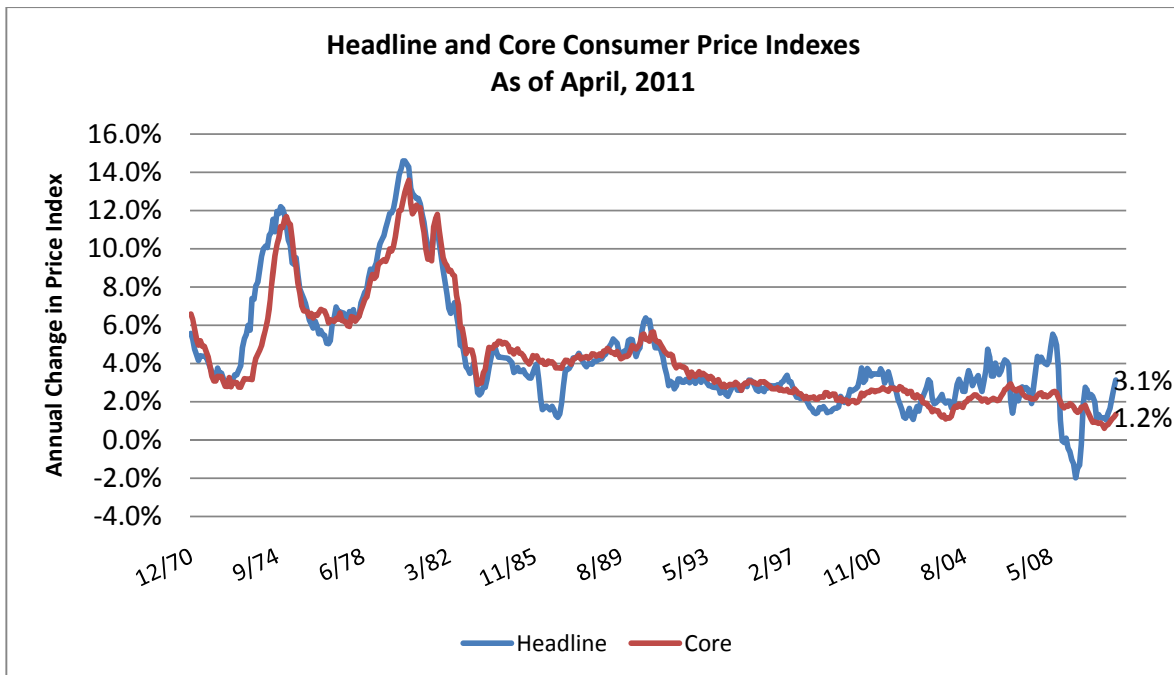
An Investor's Guide to Inflation

July 2011

www.StanCorpAdvisers.com
800.378.5742

Julie Grandstaff, CFA[®] and Don Yocham, CFA[®]

and energy prices are removed, to arrive at a measurement known as Core CPI. The chart below depicts both Headline and Core CPI, and shows how headline inflation fluctuates in the short-term but comes back in line with core inflation over time.



If an increase in the supply of money is the source of inflation, then what causes the supply of money to change? The Federal Reserve creates the money in the U.S. economy and so every dollar in circulation is a liability of the Fed. The Fed uses the money it creates to purchase assets in the banking system—effectively making loans. This is what is meant by money being lent into existence. If the Fed wants to increase the monetary base by \$1,000, they buy a \$1,000 bond from a bank. The act of purchasing bonds in exchange for money drives interest rates lower while simultaneously increasing the money supply. While traditionally the Fed focused on impacting short-term rates by buying short-term bonds, with the introduction of quantitative easing they now apply this same process to bonds of any maturity.

The Fed has injected \$1.8 trillion into the economy since the start of the recession in 2008, primarily through quantitative easing. The goal of these policies has been to reduce interest

An Investor's Guide to Inflation

July 2011

www.StanCorpAdvisers.com
800.378.5742

Julie Grandstaff, CFA[®] and Don Yocham, CFA[®]

rates. By driving down rates, consumers and businesses have more incentive to either increase spending or invest in risky assets. Spending and investment stimulates growth in the economy which in turn encourages businesses to hire. However, with such a large increase in the money supply, there is a risk of inflation.

While prices are higher, particularly for food and energy, these price increases are largely driven by commodity supply issues. To date we have yet to see an inflationary impact from the Fed's actions. There are two reasons for this. First, while the Fed has created the money to purchase large amounts of assets, the sellers of those assets (banks) have not invested the money in business or consumer loans. Not only is the monetary base lent into existence by the Fed, but the monetary base is again multiplied via the banking system through lending. Bank and corporate balance sheets currently have record amounts of cash. In order for the Fed's money to have a real impact on the economy it must ultimately be used to purchase goods or make investments. The rate at which the money is used is called velocity, and currently the velocity of money is near nil.

The second reason is that while the Fed has added a lot of money to the economy, the monetary base has not grown as much as one might expect. Over the last two decades, another multiplier emerged in the form of money market funds, government sponsored entities such as Ginnie Mae (which buys and guarantees mortgages), asset-backed bond issuers, other funding corporations, etc. These entities have been called the shadow banking system. The amount of money created by this system was massive and mostly backed by commercial real estate mortgages, home loans and unsecured lines of credit (e.g., credit cards). With the decline in the value of these assets during the financial crisis, the shadow banking system collapsed, taking a significant supply of money out of the economy.

While the Federal Reserve's actions through and since the financial crisis have created an unprecedented amount of money, the current outlook is for little to no inflation. The money is not being utilized in the economy as the Fed would have hoped, and despite the size of the effort, the new supply of money was essentially backfill for the collapsed shadow banking

An Investor's Guide to Inflation

July 2011

www.StanCorpAdvisers.com
800.378.5742

Julie Grandstaff, CFA[®] and Don Yocham, CFA[®]

system. The economic recovery must be more entrenched until we see this money move through the economy. There is opportunity for inflation to pick up in the future if the economy improves faster than expected. However at the moment it appears that the Fed has ample time to adjust its policies to contain future inflation.

About StanCorp Investment Advisers

One of your most important endeavors is to secure your financial future—and we're here to help. StanCorp Investment Advisers provides personal financial planning and investment management services to help you achieve financial security and independence. To learn more about our firm and our advisors, visit www.StanCorpAdvisers.com or call 800.378.5742.
