Inflation Illusions

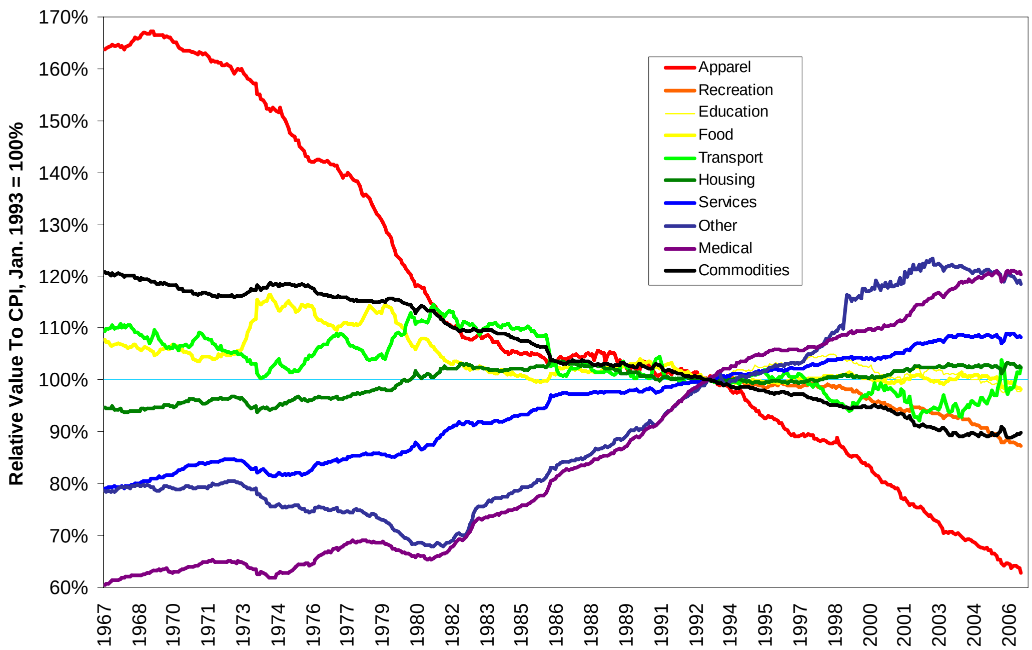
Consider the following soliloquy delivered by an irritated Edward G. Robinson in the 1944 film noir classic *Double Indemnity*:

> Come on, you never read an actuarial table in your life. I've got ten volumes on suicide alone. Suicide by race, by color, by occupation, by sex, by seasons of the year, by time of day. Suicide, how committed: by poisons, by fire-arms, by drowning, by leaps. Suicide by poison, subdivided by types of poison, such as corrosive, irritant, systemic, gaseous, narcotic, alkaloid, protein, and so forth. Suicide by leaps, subdivided by leaps from high places, under wheels of trains, under wheels of trucks, under the feet of horses, from steamboats.

There is no evidence director Billy Wilder and Raymond Chandler, who shared the screenplay credits, ever worked at the Bureau of Labor Statistics as compilers of the consumer price index, but given the large number of sub-indices in the CPI, they certainly shared a kindred spirit with this sharp-penciled crowd.

Chandler wrote some of the most famous detective stories of all time. How he would have gone about solving the chart below is a mystery. If we normalize some of the CPI sub-indices against the entire CPI itself with the January 1993 introduction of the recreation and education indices as the base, we find a very wide disparity between relative inflation rates. Apparel prices, heavily dampened by imports, have grown far more slowly than the CPI itself, as have the price indices for food, recreation and commodities. Transportation, which includes motor fuels, housing, services, medical and "other," which includes tobacco, have grown in price far more rapidly.

Relative Growth of CPI Sub-Indices



Let's focus both on the price indices for selected sectors and, more importantly, on the size of their claim on household budgets.

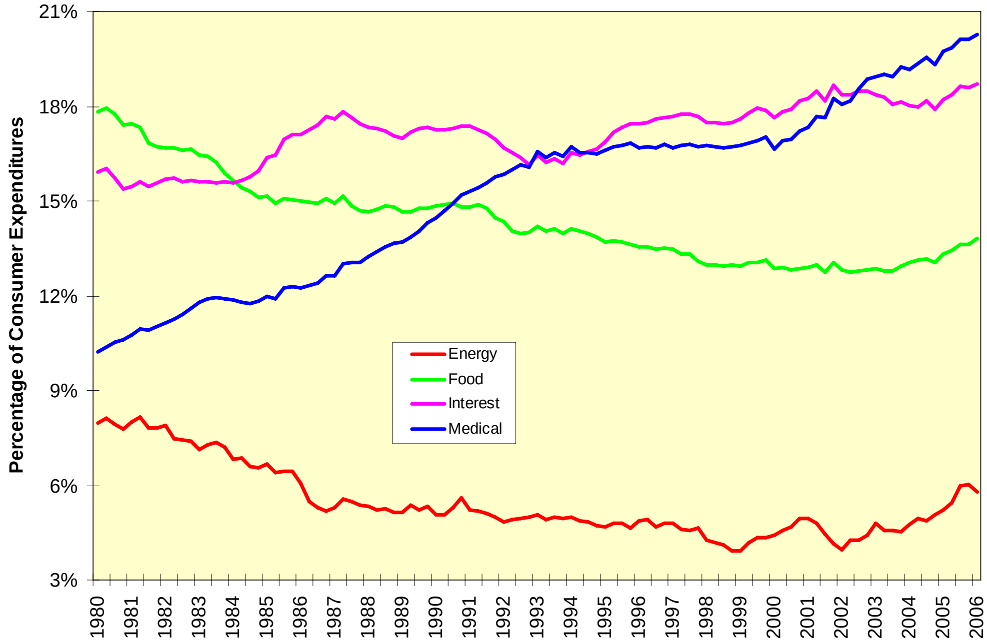
Price And Quantity

First, rest assured this is not one more black helicopter screed about how the CPI numbers are cooked. There is plenty of that to go around; rather it is to demonstrate how the burden of rising prices on consumer budgets are affected as much by the quantity of the goods and services consumed in that category as by their price. This may explain some of the unease all of us must feel whenever they talk about hedonic adjustments for personal computers and the like. Yes, computer prices have plunged, but you buy food and energy constantly and computers only occasionally.

Everyone's household budget is different. For years, the largest single category in mine has been taxes. I never recalled having voted for anyone who said, "I'm going to raise your taxes," and only Walter Mondale in 1984 even made that pitch, yet this category seems to rise without pause. Is it included in the CPI? No, it is not.

Let's take four broad categories of expenditure, food, energy, medical expenses and interest expenses and match them up against total expenditures. These four categories combine for more than 58% of household expenses. How have their percentages changed since 1980? Energy expenditures, for all of the screaming headlines and wide-eyed moments next to the self-service pump, actually take a smaller bite today than they did during the waning days of the Carter administration. They have, of course, increased rather significantly since the "Mission Accomplished" banner was unfurled across the bridge of the *USS Abraham Lincoln* in May 2003.

Growth In Selected Consumer Expenditures By Sector



Food expenses, the fellow exclusion in what is considered "core" as opposed to "headline" inflation, have declined as a share of expenditures as well over the past quarter-century. Interest expenditures have gained, which is one more piece of evidence that total expense, not just price, matters. Even though interest rates in 1980 were well into double-digit levels depending on maturity, Americans' total debt was less and therefore their debt service costs accounted for a lower percentage of household budgets.

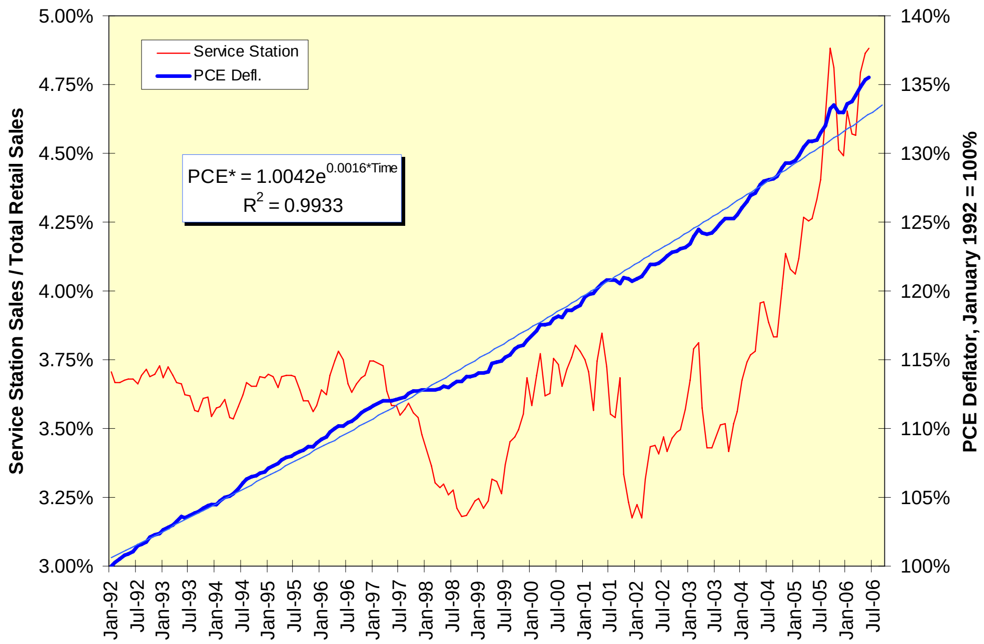
That leaves medical expenses as the outlier amongst the four categories. They have risen steadily, doubling as a percentage of expenditures between 1980 and 2006. This category likely will continue its ascent: Not only is the Baby Boomer entering their peak years of health care consumption, but government interference in the healthcare marketplace will push costs higher as well. The more money thrown into various subsidies and money-pits like Medicare Part D, the prescription drug plan, the more costs will rise to capture these distortions.

Alternative Energy

Let's take another view of energy expenses, one confined to the money spent at service stations. For the sake of completeness, let's recognize less than 100% of the money spent at service stations is spent on gasoline, but let's assume they sell more unleaded than they do Slim-Jims.

If we plot the share of national retail sales spent at service stations against the personal consumption expenditure deflator, we see how the PCE deflator has risen steadily over the available data sample. An exponential trend curve fitted to the PCE deflator show just how steady it has grown regardless of all the day-to-day hysterics seen in financial markets about whether inflation is too high or too low for someone's arbitrary taste.

Paying At The Pump



Even though service stations' share of retail sales have been rising steadily since May 2003, the PCE remained under its trend rate of growth until the beginning of 2005. In other words, those $50 fill-ups, with or without the Slim-Jims, did not push this measure of consumer inflation significantly higher until well after gasoline prices began to surge higher.

Yes, rising energy prices are a concern and have dampened household budgets to a noticeable degree. Statistically, Wal-Mart's claims their customers are pinched appear valid. But lost in the swirl of the news headlines is a different reality: Interest rate costs and total medical expenses are exerting a far greater impact each and every year.