**Explaining inflation**

**February 2023**

Even though the topic of inflation has been in the news for much of the last year or so, the levels of inflation we have recently seen isn’t something most current investors had previously experienced, so there is some continuing education we wanted to do as a short refresher on the subject.

Overall, inflation represents the rate of change in a consumer’s purchasing power, meaning simply that when inflation is positive, it means prices have gone up, so consumers can’t afford to purchase as much as before. For example, if your grocery budget is normally $100 a week, but in an inflationary environment the same basket of groceries might rise to $125 a week; which means the consumer will have to purchase fewer items in order to stay within their desired budget.

**Why do we have different ways to measure inflation?**

There are really several main calculations used to measure inflation, each with its own purpose.

The most common inflation measurement is the Consumer Price Index, or CPI. CPI is calculated by the Bureau of Labor Statistics (BLS) and it measures the rate of change in consumer prices using a basket of goods approach. The measurement of CPI is weighted based on several different categories of goods and services including housing (which is roughly 1/3 of the calculation), food, energy, health care, transportation, among others. While CPI is calculated monthly, it is most often shown as a year-over-year measurement. CPI’s calculation is also based on all urban households.

One noteworthy point about the use of year-over-year (YoY) inflation calculations, is that it doesn’t necessarily represent the most recent data or experience. For example, a YoY calculation as of December may be high because inflation was high in March, April, and May, even though it may have been modest in November or December. Therefore, if you really want to see what inflation looks like more recently, opt for a month-over-month observation.

Another measurement for inflation is known as Personal Consumption Expenditures (PCE). PCE is calculated by the Bureau of Economic Analysis (BEA) and is also calculated monthly, and most often presented using year-over-year measures. Different from CPI, PCE is a broader measure as it includes both urban and rural households, as well as nonprofit institutions serving households.

Both CPI and PCE are displayed with “headline” and “core” results. Headline results show the inflationary impact of the entire basket while in contrast, core inflation strips out the impact of the food and energy baskets, which tend to be quite volatile.

The Federal Open Market Committee (FOMC), who are the folks that set the Fed Funds rate and are focused on inflation as one of their key mandates, uses Core PCE as their preferred inflationary measure. For one, they like the fact that PCE is a broader measure vs. CPI. They also prefer looking at core over headline PCE because they feel that any rate changes they make have much less impact on food and energy, as those components are more commodity-like and tend to be driven by other external factors, including geopolitics, so stripping them out makes more sense for their purposes.

While CPI and PCE are focused on consumer prices, don’t forget about a third measure of inflation, the Producer Price Index, or PPI. Also calculated by the BLS monthly, PPI measures the average rate of change of prices for domestic producers.

**Is some inflation a good thing?**

Economists will tell you that having some inflation is a good thing, if it is low, stable, and somewhat predictable. In other words, “inflation” on its own is not necessarily a bad thing, but there are certainly times when it can be challenging, for example, when inflation rises too quickly or is higher than preferred. The fact that the Fed targets average annual inflation of 2% highlights that some inflation can indeed be a good thing and is expected.

**Can inflation be controlled?**

In the U.S., the FOMC has a dual mandate of stable prices and maximum employment, though truth be told they really don’t “control” either metric but instead have influence on both. Related to inflation, the FOMC will use the Fed Funds rate to impact inflationary trends, for example raising rates when inflation is thought to be too high, like they have been doing since early 2022. The idea is simply that higher rates will lead to reduced spending thereby lowering inflation. While central banks outside the U.S. may have different mandates, their use of raising rates to keep inflation in check is a common occurrence.

**What about all the other “-flations”?**

While we have been focusing on inflation to this point, there are other “-flations” that investors should also understand.

One of these other metrics is disinflation, which is the slowing of inflation. If you look at how the rate of inflation has slowed since the summer of 2022, this would be considered disinflation. In a disinflationary period, it is possible to have inflation that is higher than expected, but still be slowing in its year over year pace.

Another type of “flation” is deflation. Where inflation is too many dollars chasing too few goods, deflation is a decrease in prices of goods and services. Deflation can be very troubling from an economic perspective. Here is an example of why: if you are buying a car today that costs $25,000 but you expect that it will only cost $22,000 in a month, all else being equal you would wait the month to purchase the car at a lower price. Going one step further, if deflation were expected to continue, consumers might wait even longer to purchase goods in the expectation of an even lower price. If all consumers did this at the same time, this would be an obvious drag on growth.

Yet another metric is stagflation, which is a period represented by high inflation, high unemployment, and a stagnant economy (hence the term *stag*flation) all happening at the same time. Periods of stagflation have historically occurred during severe periods for the economy, which fortunately have been quite rare (the 1970’s and early 1980’s was the last time the U.S. experienced stagflation).

**Summary**

Over the last year we have been experiencing a period of higher than expected inflation, which brings a certain set of challenges to consumers. The FOMC for its part has been steadily increasing interest rates with the goal of slowing demand and spending, thereby lowering inflation. Inflation has certainly been decreasing since the summer months, but we are not necessarily out of the woods yet. As we know from history, the road from higher inflation to more expected levels of inflation is not a straight one. Plus, even though higher than expected inflation isn’t wonderful for the economy or consumers, economic cycles of deflation or stagflation aren’t exactly rainbows and roses either.

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