INVESTMENT FUNDAMENTALS

What is Inflation?

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Snapshot

- Inflation measures the price change of a basket of goods and services over time.
- Rising prices can erode consumer purchasing power, so investors should account for inflation in their plans.
- Central banks seek to target low-expected inflation by adjusting benchmark interest rates.

Inflation is a measurement that tracks the change in prices of goods and services over a set time period. In the U.S., inflation is often measured by the Consumer Price Index (CPI) or the Personal Consumption Expenditures Price Index (PCE). These indexes measure costs from a basket, or representative sample, of items across major categories including food and beverages, housing, apparel, transportation, medical care, recreation, education, communication and elsewhere. The CPI is calculated by the Bureau of Labor Statics (BLS) and is used by many government agencies to make changes to benefit payments such as social security cost-of-living adjustments. Meanwhile, the PCE is calculated by the Bureau of Economic Analysis (BEA) and is the Federal Reserve's (Fed) preferred method of calculating inflation.

Over time, the CPI shows a slightly higher rate of inflation than the PCE. Within the PCE, expenditure weights can change as consumers substitute goods. This can lead to a reading that more accurately mirrors real world behavior. Food purchases provide a good example—shoppers tend to buy less beef when prices rise, instead purchasing less expensive chicken.

Inflation in Practice

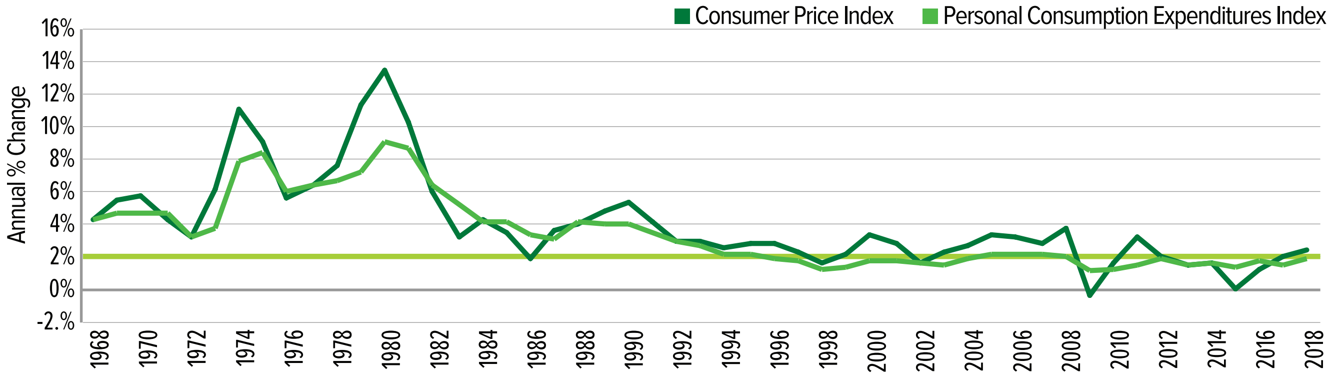
Rising inflation means the average cost of goods and services is increasing. For example, if you paid $100 for your basket of items last year and inflation is currently measured at 2%, then those items can be reasonably expected to cost $102 today. This does not mean the prices of all items will increase by 2%—some will rise more, others less, and some may even fall. You probably noticed that healthcare costs have increased much faster than 2% in recent years, while the cost of a high-definition television has fallen.

Persistent price increases show how inflation can diminish the purchasing power of consumers over time. With this in mind, investors need to consider the impact of inflation on their portfolios. A well-diversified mix of stocks and bonds may be expected to return 8% in a given year. However, the real expected return would only be 6% based on a 2% inflation estimate. The real return adjusts for inflation, given the erosive impact that rising prices can have on savings. A thoughtful investment approach will account for, and plan to manage inflation.

Managing Inflation

The 2% PCE rate used in the previous example is actually consistent with the Fed's long-term target. Believe it or not, a little inflation is actually a good thing, especially when it's expected. The Fed's 2% PCE target inflation rate is considered the sweet spot between higher-trend price increases, which could be detrimental to consumer purchasing power, and lower-trend increases or even stagnant prices, which could potentially lead to deflation, or falling prices (Exhibit 1). The CPI reading, as noted earlier, can be slightly higher.

Exhibit 1: Two Percent Target



Source: Bureau of Labor Statistics, Federal Reserve Bank of St. Louis, SEI
Data as of 3/31/2018

Deflation occurs amid poor economic conditions and becomes problematic as wages begin to fall in conjunction with prices. This can lead to even less demand for goods and further economic weakness, resulting in a deflationary downward spiral that can be difficult to reverse.

Central banks, like the Fed, often try to manage inflation through interest-rate policy, which means they will consider adjusting benchmark interest rates higher or lower when inflation is off-target. The Fed controls the rate at which major banks borrow and lend with each other, which serves as the basis for most other banking decisions throughout the U.S. economy.

Higher interest rates mean money is more expensive to borrow, which serves as an impediment to economic growth and thus helps keep inflation low. Conversely, lower interest rates promote borrowing and economic growth, thus encouraging higher rates of inflation.

As an investor, you can't attempt to manage inflation through interest-rate policy, but you can invest in inflation-sensitive assets. Examples include commodities, commodity-related equities, credit, Treasury inflation-protected securities and real-estate investment trusts. Or, rather than invest directly in these types of securities, investors may choose to purchase a mutual fund that offers professional management of inflation-sensitive securities.

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