Drilling Down on Inflation Numbers

March 18, 2024

We have written about our perspective on inflation in past Missives and Market Musings. Occasionally, we like to revisit our viewpoints. On the surface, official inflation data come from an arbitrary mix of price changes in a set of goods and services in the economy and how these prices have changed, rising, or falling. By monitoring these fluctuations, the Federal Reserve considers the strategy for monetary policy.

Remember that the government has developed these inputs, and they are accepted as a reasonable proxy for both estimating inflation and assessing the threat of rising prices that affect our standards of living. Our problem is that occasionally, we are bewildered by the value of these inputs. For example, the theory behind rising prices is that consumers suffer from having to pay more for goods and services. One such price increase in the consumer price index (CPI) is the cost of professional investment management services. The bean counters would have us believe that price increases for such services would add to the inflation equation. However, this expectation would be incorrect. The way the data are incorporated into the price index is based on the changes in the value of investors' portfolios, not the fees charged by investment managers. However, few investors' standards of living decline when the stock market goes up. Both the investors and the investment managers benefit as their pay is tied to the value of each client's portfolio. How does such a calculation contribute to inflation?

The Fed's use of price changes for goods and services in the economy to measure inflation seems to be counterintuitive. Virtually every financial textbook defines inflation as "too much money chasing too few goods" yet it is the Federal Reserve that controls the money supply. In the recent response to the pandemic, the government printed trillions of dollars that were given mostly to the private sector to avoid an economic meltdown. Given the fact that the pandemic caused bottlenecks that constrained the amount of goods available, a bout of high inflation was inevitable. Since the Fed cannot directly impact the supply of goods, the solution was to go for slowing or reducing the growth rate of the money supply. To reduce a surge in inflation, the Fed embarked on a historic policy of raising interest rates to slow the economy! Rather than getting a government commitment to increase the supply of goods and services, the Fed decided to reduce the money supply and raise interest rates higher to reduce demand. Historically such a policy slowed economic growth and increased unemployment. The recent strategy of rapidly rising interest rates fostered strains in both the commercial and residential mortgage markets.

Prices for goods and services across industries will always be determined by supply and demand. Pointing to one or two industries that raise prices as the culprit in the rise of inflation avoids concluding that the government plays an important role in contributing to inflation.