

The Green Eggs and Ham of the Consumer Price Index

During February, our local librarian decorates her bulletin board with Dr. Seuss book titles. Many parents trip their tongues over Seuss stories like Green Eggs and Ham. "Do you like green eggs and ham?/I do not like them, Sam-I-am./I do not like green eggs and ham", nor do I like the cost based on Consumer Price Index records.

Our son wields a wild spatula when making his April Fool's Day green eggs and ham. Sometimes his culinary skills warrant a cost per item analysis the same way the U.S. Department of Labor reports the Consumer Price Index (CPI).

CPI reports tell us what a "basket of goods and services" costs using a benchmark dating from 1982-1984. Importantly, the CPI becomes one of many components within inflation measurement models. The CPI "basket of goods" leaves out green eggs and ham, however, it includes breakfast cereal, milk, coffee, chicken, wine, full service meals and snacks. CPI reports account for 7 or 8 categories of goods and services in the U.S. economy. If you recall Psychology 101, each category coincides with Abraham Maslow's basic or physiological "Hierarchy of Needs".

When the U.S. Bureau of Statistics announces the CPI (most countries have a similar index), Wall Street listens because price increases suggest inflation concerns. When prices inflate, wallets deflate making consumers shy about spending. As you may observe, consumer spending drives worldwide economic productivity; for example, our spending habits account for nearly two-thirds of all U.S. economic activity.

Although statistical patterns for Internet spending seem scant, the effect appears the same. Mall shoppers and Internet surfers open or close their wallets based on value and price. Inflated costs suggest decreasing value for products or services. Likewise, inflation pushes credit card interest rates higher, thereby adding another burden to the consumer.

Inflation decreases the value of the dollar also. Ask your grandparents what they could purchase with a dollar compared with what that same service or product costs them today. Their experience explains inflation with more colorful expression than the CPI.

Investors become unnerved by inflation as evidenced by Wall Street sell-offs when CPI numbers go up. When interest rates increase, the cost to borrow increases making it more difficult for corporations to borrow for expansion, earnings decrease and stock prices stagnate.

Inflation numbers since 1926 average about 3.1%. In 1980, inflation peaked at 14%. High interest rates attract investors to bank certificates of deposit. However, investors often overlook and misunderstand "real rates of return". If a bank certificate of deposit earns 5% annually and the inflation index reads 2.5%, then your "real rate of return" becomes 2.5% (5%-2.5%). When bank certificate of deposits paid 16% in 1980, the real rate of return provided a measly 2% (16% - 14%), and then U.S. investors paid tax on that 2%. If you choose bonds or certificates of deposit as investments, consider laddering your maturities (e.g. with \$100,000 to invest have \$10,000 come due every year for ten years).

Stock or equity securities out perform bonds and certificates of deposit with returns exceeding inflation numbers. However, when inflation increases, stocks go down in value initially. Stock investing seeks long term returns which average about 11% since 1926. Since inflation averages about 3.0% during the same time period, stocks provide an 8% real and reasonable rate of return. Stocks, including stock mutual funds, confront investors with greater short term risk while offering higher real rates of return over long term time periods. This risk reward trade off allows you to purchase your green eggs and ham during any economic cycle.

"I learned there are troubles of more than one kind./Some come from ahead and some from behind." - Dr. Seuss

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