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Why Core Inflation Data is Misleading Bond Investors

Core inflation is most often calculated by taking the Consumer Price Index (CPI) and excluding volatile cost components, such as; food and energy. The rationale of the Department of Labor excluding these important components is to eliminate prices that jump around for short periods, caused by weather and geopolitical uncertainties.

Despite these statistical merits, a reliance on core inflation among policy makers and investors ignore inflationary signals that may have lasting affects. Food and energy are frequent purchases among consumers and their prices tend to vary in the short term more than durable goods and services. Rising food prices have been a strong influence on perceptions of inflation and consumer behavior.

The core and variable components of inflation are not completely independent. Increases in food, gasoline, heating oil, and utilities does reduce consumer spending on other goods and services. The paradox is that this behavior can lead to depressed prices and artificially lowered core inflation.

Core inflation data places emphasis on supply-side disinflation, resulting from low cost products from places like China and India. The integration of these two countries into the global economy has brought down the costs of manufactured goods, but ignores the demand for commodities needed to build these economies. Since commodity-price-inflation (e.g. oil, gas, copper, steel, aluminum, corn, and soybean) has averaged more than 15% per year since 2003, true inflation has been under-stated. The cost of housing and commercial construction, which is determined by the land, materials, labor and insurance rates, is not included in core inflation.

While no inflation measure is perfect, the reliance upon the core method can be misleading to policy makers and investors. Cost of living adjustments are tied to the core inflation and clearly ignore the importance of the volatile cost components. The bank of England's governor recently referred to the practice of excluding price categories in the core number as "highly misleading."

