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# “Is inflation my friend or foe?”

By Brian D. Holmes

**Inflation is once again in the financial headlines, even though just two years ago the consumer price index was negative for the first time in 55 years.** Ever since the 1970s, when the CPI rose an alarming 47 percent over a six-year period, the Federal Reserve has used monetary policy to combat inflation. Yet today it is doing the opposite.

The CPI is the most commonly used measure of inflation. As defined by the Bureau of Labor Statistics, the CPI is “a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.” The income of more than 80 million Americans is tied to the CPI, as can be rents, royalties, child support and income taxes.

With costs at the pump and the grocery market surging, how can inflation be reported so low: 1.6 percent in 2010? The answer lies in the weighting components of the CPI. Housing accounts for 42 percent of the index, while food/beverage and energy/transportation account for only 14.8 percent and 16.7 percent,

respectively. The negative 12-month changes in housing is artificially holding down the CPI.

The weighting of the CPI has been used as a political tool in past administrations. Changes in the calculations began in the Reagan administration and continued during the Clinton years. In 1983, during the Reagan administration, rapidly rising real estate costs were causing the CPI to be overstated. Consequently, the cost of buying a home was substituted for an “owner equivalent” measurement of renting. This dramatically lowered the reported CPI later in the '80s.

During the G.H.W. Bush administration it was argued that by reducing the CPI rate, entitlements such as Social Security would be reduced, thereby reducing the federal deficit. This could be accomplished by altering the weightings from arithmetic to geometric calculation. The benefit was a lower weighting to CPI components rising in price and a higher weighting to those items dropping. The Clinton administration later adopted these changes along with two other adjustments.

Federal Reserve Chairman—then governor—Ben Bernanke stated that “sustained deflation can be highly destructive to a modern economy and should be strongly resisted.”


After the financial crisis and recession of 2008–2009, Bernanke, true to his word, began a five-step playbook to combat deflation:

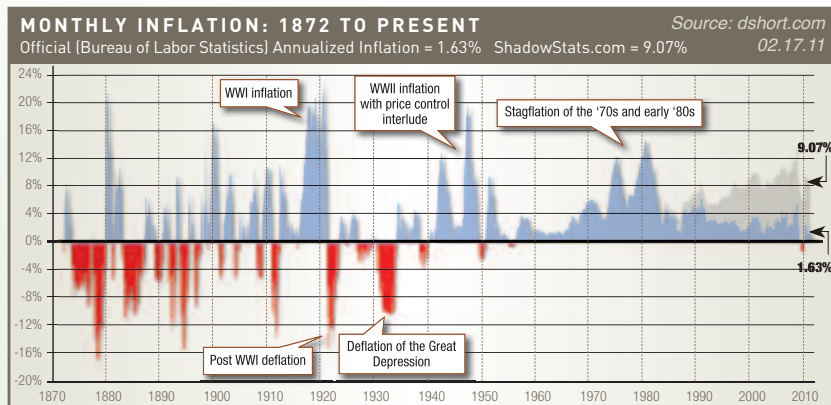
- Provide liquidity to the banking system
- Aggressively cut short-term interest rates
- Increase dollars in circulation (i.e., print money)
- Purchase mortgages and other long-term debt
- Devalue the dollar and inflate the economy

We are now in the throes of the final stage of his playbook, namely inflating the economy.

In the past 20 years, inflation has increased over the previous year eight times. In seven of those eight years, commodities outperformed both stocks and bonds.

Recently the prices of basic commodities have risen sharply, signaling inflation is on the horizon. Dozens of commodity ETFs and mutual funds are available to assist investors in protecting their portfolios from inflation.

The changes in how the CPI is measured have systematically understated inflation. Many studies suggest that Social Security benefits would be 70 to 100 percent higher today if the 1980 method of calculation were used. This understatement has led to the current disconnect of reality between government and Main Street. It is clear we have inflation, and more is on the way with Bernanke's inflationary policies. 



The **Blue Chart** shows inflation based on the Bureau of Labor Statistics CPI. The method for calculating inflation was slightly adjusted in the early '80s and more dramatically in the mid '90s. The **Gray Chart** shows inflation calculated consistently with the pre-1982 method. The source for this alternate CPI is ShadowStats.com.



**“With costs at the pump and the grocery market surging, how can inflation be reported so low: 1.6 percent in 2010?”**

– Brian D. Holmes



### How to reach Brian D. Holmes

*I encourage a short initial conference call and then an in-person complimentary consultation in one of SEIA's four offices. I can be reached at 310.712.2323 or at bholmes@seia.com.*

### WHAT'S ON MY DESK...

*John Wooden's Pyramid of Success*

### I NEVER LEAVE HOME WITHOUT...

*Kissing my wife and children good-bye*

### IF I WEREN'T A WEALTH ADVISOR, I'D BE...

*A university professor*

### About Brian D. Holmes

Brian D. Holmes, MS, CFP, CMFC, is the president and CEO of Signature Estate & Investment Advisors LLC. For four consecutive years (2007, 2008, 2009 and 2010), Mr. Holmes has ranked in the top 25 in *Barron's* annual list of the top 100 independent financial advisors. He has been in the securities and insurance business since 1984 and is the managing partner of the Century City branch of the John Hancock Financial Network. Mr. Holmes is a past member of the Schwab Institutional Advisory Board and the UCLA Department of Economics Board of Visitors. He received his bachelor of science degree from the University of California, Los Angeles. A longtime resident of Malibu, Calif., he is involved with numerous charities throughout Southern California.

Assets Under Management  
**\$2 billion (firm)**

Minimum Fee for Initial Meeting  
**None required**

Minimum Net Worth Requirement  
**\$4 million (planning services);  
\$1 million (investment services)**

Largest Client Net Worth  
**Confidential**

Financial Services Experience  
**27 years**

Compensation Method **Asset-based fees**

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Professional Services Provided  
**Planning, investment advisory, money management and private client  
wealth management services; estate planning**

Association Memberships **Investment Advisor Association, Financial Planning  
Association, UCLA Department of Economics Board of Visitors, Financial  
Services Institute, National Association of Insurance and Financial Advisors**

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