Inflation Checkpoint

Highlights

- The December reading for the Consumer Price Index (CPI) increased 0.7% year-over-year, a slight increase from last month but in line with estimates. Core prices (excluding the more volatile components of food and energy) increased 2.1% year-over-year (Exhibit 1).
- Key drivers of inflation over the period were energy, housing, and declining prices for imported goods — the latter dragged down in part by a stronger U.S. dollar. Bessemer's price index outpaced CPI by 0.9% year-over-year, a result of less weight to energy and increased exposure to medical care and education, which saw larger relative price increases.
- Looking ahead over the next few months, we expect headline CPI to remain depressed, but fading dollar and commodity headwinds could reduce the difference between the CPI and Bessemer's inflation index longer term.

Key Drivers of Inflation Trends

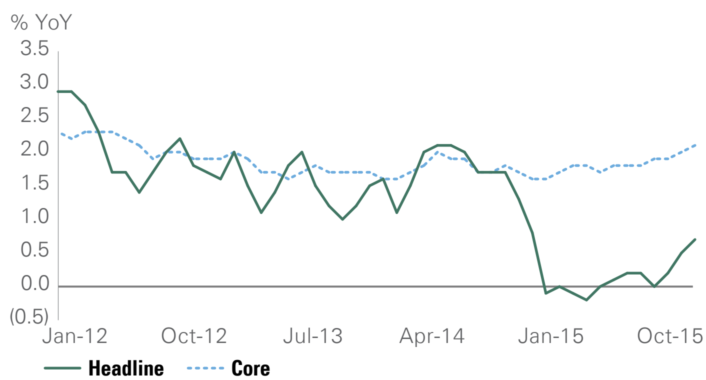
Falling energy prices. Energy prices — West Texas Intermediate oil, in particular — fell another 11% in December, bringing the annual percent change in oil for the 2015 calendar year to -30% (after an already massive drop of 46% in 2014). Energy manifests in the CPI through the housing and transportation categories (as heating fuel for the home and gasoline for automobiles) for a total weight of about 9% of the overall CPI. The average price for a gallon of gasoline is now below $2.00 — the lowest it has been in almost seven years. Even though energy's slice of the CPI pie is relatively small, volatile price swings can move the needle on headline CPI.

Increases in residential home prices. The rental market in the U.S. has steadily improved since the recession. Rental vacancy rates are down more than 30% from their 2009 peak, and median asking rents are up more than 11% during that same period. In December, the shelter component of the CPI, a subcategory that includes home rentals, ownership, insurance, and lodging away from home, increased 3.2% versus a year ago, counteracting some of oil's drag on the overall housing category.

U.S. dollar weighing on import prices. The U.S. dollar rose more than 10% in 2015 versus a trade-weighted basket of currencies, and, along with commodity prices, has weighed on the prices of imported goods. This has translated into deflation in apparel and the food at home category (e.g., groceries). The U.S. imports an estimated 50% of fresh fruits, 20% of fresh vegetables, and 80% of seafood, and a stronger dollar means foreign suppliers can charge less and still take home the same amount after adjusting for the currency.

Exhibit 1: Consumer Price Index

Key Takeaway: Inflation continues to run at a modest rate.



As of December 31, 2015.

Source: Bloomberg, Bureau of Labor Statistics

Bessemer's Price Index

Inflation is a very important topic for clients because it not only has a material impact on wealth accumulation over time but is also tangible and personal. Inflation is felt each day: at food stores, when consumers discover that the price of cereal has increased from a couple of months ago, or when comparing the tuition bill owed for the youngest child to that of an older sister four years prior. Over the past 30 years, U.S. inflation has eroded purchasing power by 54%; and that is despite a relatively benign average inflation rate of 2.7% per year and several periods of deflation.

In advising clients, we regularly receive questions about inflation — regardless of the economic environment. For example, when the rate of inflation is high, clients call to discuss what we are doing to protect their nest eggs against the long-term effects of inflation. When inflation is low, the focus shifts to whether published measures of inflation, such as the CPI released by the U.S. Bureau of Labor Statistics, are underrepresenting inflation broadly or, more specifically, to a particular demographic.

We have done extensive research into the components and drivers of inflation. An understanding of inflation as it pertains to our clients has led us to develop a proprietary price index that reweights the components of the CPI to provide real- time insight into the inflationary environment experienced by wealthier households.

Key Drivers of Bessemer's Price Index

In December, Bessemer's adjusted inflation index indicated an inflation rate of 1.6% year-over-year for wealthier households. This is approximately 0.9% higher than the CPI's rate of inflation. Over the last 30 years, Bessemer's price index has averaged 0.7% higher than the CPI — implying a meaningful difference in purchasing power. For the current 12-month period, we would highlight the following drivers of Bessemer's price index.

Collapse in the price of oil. In Bessemer's price index, energy components receive a lesser weight than in the CPI. This is because we find that on average wealthier households spend less as a percentage of their total annual spending heating their homes and filling up their gas tanks. When energy prices experience a large price drop, Bessemer's price index decreases less than the CPI.

Increasing medical costs. Medical expenses represent a larger weight in Bessemer's price index than in the CPI, so (all else equal) as medical costs rise, Bessemer's price index will outpace the CPI. Medicare payout rates and a shift to high-deductible plans seem to be slowing the rapid rise in healthcare costs, but hospital service prices still increased 4% in December compared to a year ago. (For reference, prices for overall medical care were increasing at a rate of 8% per year in the 1990s.)

Rapidly rising tuition rates. During the past 30 years, prices for tuition, including private grade schools and college education, have been one of the fastest-growing categories in the CPI. Bessemer's price index considers the large portion of our clients' expenses that go toward paying for private education and assigns a larger weight to the components of education than the CPI. In December, prices for education rose 3.7% year-over-year, increasing the overall rate of inflation for Bessemer's adjusted index versus the CPI.

Looking Ahead

Over the coming months, we expect headline inflation to remain depressed alongside oil and U.S. dollar pressures. It is hard to know when and at what price oil will find a bottom, but from an inflation standpoint, it is unlikely that the price of oil will increase enough in the next month or two to pull overall inflation higher. Base effects alone would require the price of oil to rise approximately 50% next month in order to be an inflationary force in the CPI. In other words, since inflation is usually discussed in year-over-year terms, oil prices have to rise significantly from current levels in order to reach a level where the current price of oil is higher than the price from a year ago. But looking further ahead, we expect that moderating commodity prices, easy money policies from global central banks, and an improvement in global demand from (among other things) lower gasoline prices could lead headline and, more importantly, core prices modestly higher.

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