Investment Insights

Inflation Checkpoint

BESSEMER TRUST

Highlights

- The June reading for the Consumer Price Index (CPI) increased 1.0% year-over-year. Core prices (excluding food and energy) rose 2.3%. Bessemer's inflation index increased at a rate of 1.8%.
- Travel expenses are a key consideration for our clients, and Bessemer's index gives a higher weight to travel-related categories.
- Looking ahead, we expect headline CPI to head north of 2% by the end of 2016, as stable-to-rising oil prices put upward pressure on overall inflation.

At Bessemer, we take a holistic approach to analyzing inflation; this includes monitoring our proprietary price index, which is designed to reflect the inflationary experience felt by wealthier households. With the summer vacation season underway, travel plans are top of mind. In this *Inflation Checkpoint*, we examine how Bessemer's index accounts for travel-related inflation.

Measuring Travel-Related Inflation

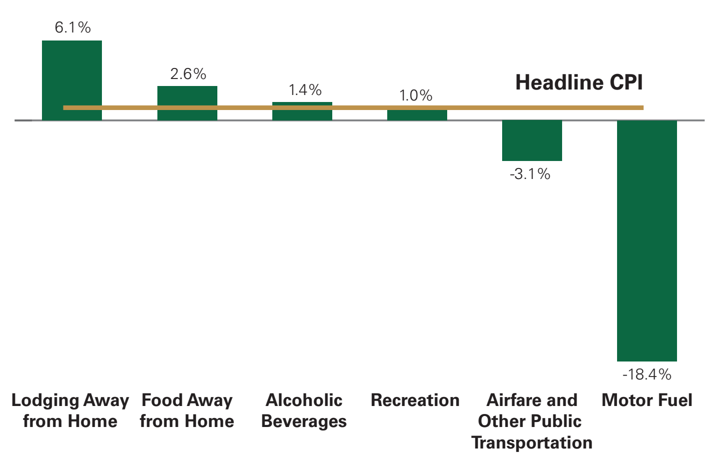
In the Bureau of Labor Statistics' measurement of inflation, the CPI, there is no designated category for travel. However, travel-related items are embedded within the CPI's main categories of food, housing, transportation, and recreation:

- Food away from home and alcohol — Meals from restaurants/vendors, drinks from stores or bars
- Lodging away from home — Includes hotel stays
- Gasoline and public transportation — Gasoline and fare changes for airlines/trains/buses
- Recreation — Includes, among other things, admission to shows and other events

Over the past year, as hotel and restaurant prices have increased 6% and 3%, respectively, the decline in the price of oil has dragged airfare down by over 3% (West Texas Intermediate crude is up over 30% through June but still down about 19% versus a year ago, Exhibit 1).

Exhibit 1: Travel Inflation by Category

Key Takeaway: Restaurant and hotel prices have been inflationary, while low oil prices have been a drag on gasoline and airfares.



As of June 30, 2016. Represents year-over-year inflation for each category related to travel.

Source: Bureau of Labor Statistics, FactSet

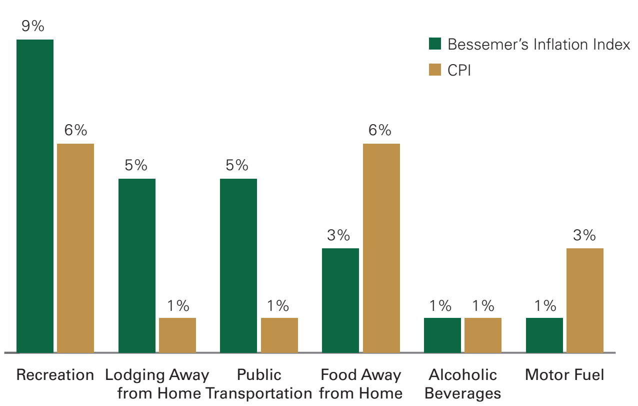
These categories are not limited to expenses for personal travel, but rolling them up using their respective weights in the CPI can give a rough proxy for travel-related inflation. According to this estimate, costs for travel decreased -1.9% in June compared to a year ago. Excluding gasoline, travel inflation increased by about 1.7%.

Bessemer's Approach

Bessemer's index reweights the individual categories of the CPI to be more consistent with the spending patterns of our clients. The travel-related items mentioned above make up about 19% of the CPI. According to our research, on average, wealthier households spend a larger proportion of overall spending on travel-related items with emphasis on different expense categories (Exhibit 2). As a result, Bessemer's inflation index allocates a slightly larger weight than the CPI to travel — around 24% — with the greatest relative importance to recreation, lodging away from home, and air and train fare but less importance to food away from home and gasoline. While travel-related items have not materially increased Bessemer's rate of inflation so far this year, particularly when compared to the CPI, we are monitoring the potential for stable-to-rising oil prices over coming months to place upward pressure on gasoline and airfare.

Exhibit 2: Comparing Weights of Bessemer's Index to Those of the CPI

Key Takeaway: Bessemer's index places a higher overall weight to travel-related categories than the CPI while emphasizing different areas.



As of June 30, 2016. Represents relative importance by category of Bessemer's index versus the CPI.

Source: Bureau of Labor Statistics, FactSet

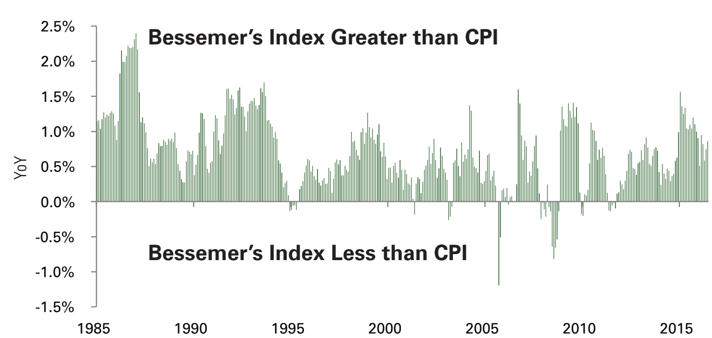
Currency is important for broader inflation trends (a weaker dollar tends to be correlated with higher rates of inflation, all else equal). Over the past year, the trade-weighted U.S. dollar has strengthened by about 5%, making traveling to places like the U.K. and Mexico, in particular, more affordable.

Looking Ahead

Since the middle of 2014, the CPI has been dominated by the precipitous fall in the price of oil, as about 10% of the overall index is devoted to gasoline and heating fuel. As we discussed in our January *Inflation Checkpoint*, Bessemer gives energy a weight of about half that, so oil has been less of a drag on our index. Other expense categories where we allocate a higher weight, including medical and education, have caused Bessemer's index to slightly outpace the CPI over the past year (Exhibit 3).

Exhibit 3: Bessemer's Index Minus CPI

Key Takeaway: Bessemer's inflation index continues to outpace CPI, driven primarily by the higher-weighted medical and education categories.



As of June 30, 2016. Represents the year-over-year rate of inflation for Bessemer's index minus that of the CPI each month.

Source: Bureau of Labor Statistics, FactSet

In our view, higher inflation by year end is a real possibility — and one that is currently getting very little attention. Year-over-year CPI could receive a tailwind if the trough in oil prices is behind us, which looks increasingly likely. In conjunction with already-building inflation pressures in services, it is not unreasonable to expect a headline CPI above 2% year-over-year by the end of 2016, from current levels of only 1.0%. The Federal Reserve is likely to continue to monitor various measures of inflation that look through oil price volatility. However, sustained inflation in excess of its 2% target combined with an unemployment rate below 5% could force the Fed to raise interest rates sooner than the market is expecting.

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