

# Investment Insights

## Inflation Checkpoint



**Elise Mordos**

Investment Strategies Analyst

### Highlights

- Amazon.com's competitive pricing strategies, along with technological advances and globalization, have had a deflationary effect on consumer goods.
- However, consumer goods represent a small component of the Consumer Price Index (CPI) relative to services, so the overall impact on inflation is subdued.
- At a higher level, through its business-to-business services, Amazon has been able to reduce costs for customers, furthering its multi-order effect on inflation.
- Bessemer's Price Index has slightly outpaced CPI over the past year, mainly driven by higher weightings in childcare and tuition.

### "Amazon Effect" and Deflation

Amazon.com's massive growth is impacting domestic inflation. Founded in 1994 as an online bookseller primarily competing against brick-and-mortar bookstores, Amazon now dominates the e-commerce market, generating around 50% of total e-commerce sales in the U.S. and offering an endless number of products and services — from Amazon Web Services (AWS) to grocery deliveries to original TV shows. The company has become such an integral part of our lives that it is hard to imagine a world without it. Where

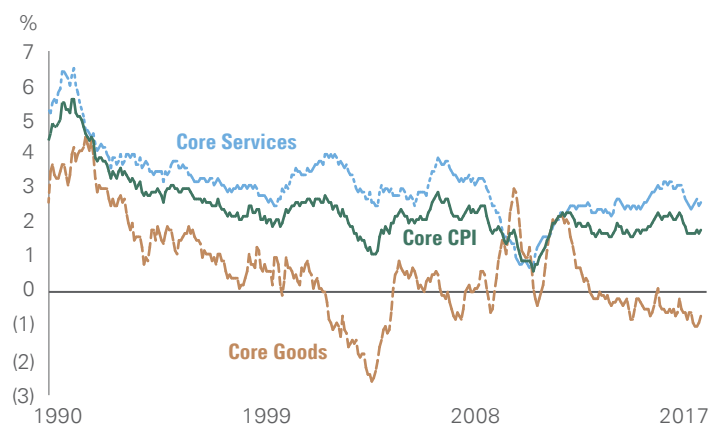
would kids buy textbooks? Where would we easily find a desk to perfectly fit in that alcove? How could we find the best price on wireless headphones?

### A Deeper Dive Into Core Goods

It is nearly impossible to find a single economic data point that is completely immune to Amazon's direct and indirect effects on society. Inflation is certainly not an exception. U.S. consumers have always been price conscious, and Amazon has made it easier than ever to do quick price comparisons for almost every consumer product. Brick-and-mortar and online retailers have been forced to compete with Amazon's competitive pricing strategy. This, in conjunction with technological advances and the effects of globalization, has had a deflationary effect on the cost of consumer products. While we primarily focus on Amazon's effect on inflation in this piece, other e-commerce companies, particularly eBay, and department store giants like Wal-Mart, Macy's, and Target have facilitated or use price-competitive strategies that have also had a deflationary impact on consumer products (Exhibit 1).

#### Exhibit 1: U.S. Core CPI Breakdown

##### Year-Over-Year



As of December 31, 2017. Core CPI (Consumer Price Index) excludes food and energy.

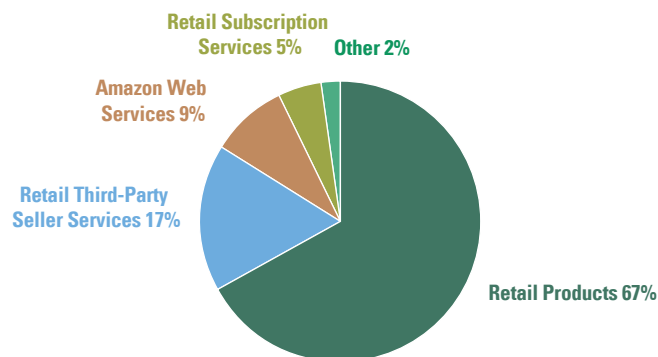
Source: Bloomberg, U.S. Bureau of Labor Statistics

## Inflation Checkpoint

While the “Amazon effect,” a term coined to describe the company’s impact on the retail space and beyond, is undeniable, the first-order effect of Amazon on inflation is likely relatively small. Amazon has been and continues to primarily offer consumer goods (Exhibit 2). Since the 1990s, consumer goods (excluding food and energy commodities) have made up less than 25% of the weight of the CPI and 35% of the core CPI, which excludes food and energy (Exhibit 3). As a result, the deflationary trend of core consumer goods depicted in Exhibit 1 has not had an overwhelming impact on the overall trend of core consumer prices. Services have been and continue to be the main driver of both headline and core inflation.

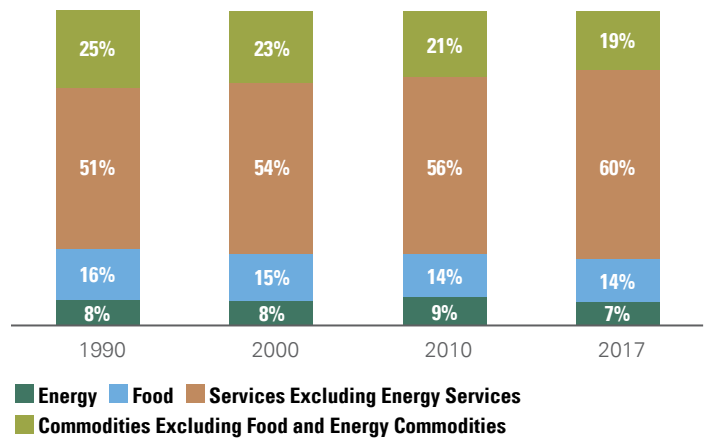
Moreover, the impact of Amazon is not uniform across all products within the core goods category. Specifically, many U.S. consumers still prefer to purchase their clothing and footwear in stores. Apparel makes up around 16% of core goods. Price competition for apparel products has been more heavily driven by globalization and technological innovation, such as the development of the modern factory, rather than the Amazon effect alone. Along a similar vein, other core consumer goods, like new vehicles (representing around 19% of core goods) and prescription drugs (7% of core goods) have been affected by Amazon in indirect ways. Some items, however, like books and electronics, including computers, are now mostly purchased online but together account for less than 15% of core consumer goods.

### Exhibit 2: Breakdown of Amazon Sales by Business Segment for Fiscal Year 2016



As of fiscal year 2016 dated April 12, 2017. Sales totaled \$136 billion in FY 2016.  
Source: FactSet

### Exhibit 3: Product Category Weightings of Consumer Goods and Services Within CPI for Selected Years



As of December 31, 2017.

Source: Bloomberg, U.S. Bureau of Labor Statistics

Amazon’s price-competitive behavior will likely continue to shape consumer behavior as its footprint expands, but its direct impact on inflation is likely to remain subdued. A study by Goldman Sachs found that online shopping is subtracting around 25 basis points from consumer goods inflation and one basis point for consumer services inflation measured using Personal Consumption Expenditure (PCE).

Additionally, as the Federal Reserve highlighted in its recent commentary, inflation has been relatively soft despite the U.S. being in the late stages of its current economic cycle and the labor market nearing or already at full employment. Core CPI and core PCE are both below the inflation target rate of 2%. While it might be easy to blame soft inflation on the deflationary trend of core consumer goods, the annual growth rate of these products is in line with pre-recession levels. Core services inflation, primarily medical care services, however, remains slightly below its pre-recession average.

Amazon’s impact on inflation and economic data, as a whole, goes beyond the first-order effect. More explicitly stated, by utilizing Amazon’s services, many companies have been able to keep costs lower. For instance, Amazon’s AWS is a cloud management solution used by many service-providing companies, including Netflix, Adobe, Airbnb, Discovery Communications, and

McDonald's, as well as goods-producing companies, like BMW, Ferrara Candy Company, and McCormick. AWS has helped reduce technology costs for these companies because a tremendous amount of time and energy goes into building systems similar to AWS that are necessary in today's tech-savvy business environment. In a similar vein, today's consumer wants a one-stop shop to find items online and looks for fast and cheap shipping options that can be very costly for some businesses to do on their own and, especially, on a large scale. For this reason, an increasing number of sellers are now using Amazon as their online selling platform rather than exclusively selling the product on their own websites and using Amazon's fulfillment centers to ship out their products.

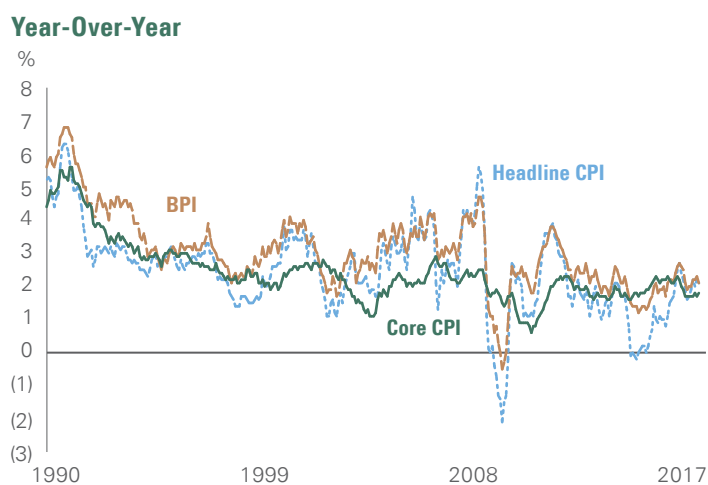
## Bessemer Price Inflation Index

The Bessemer Price Inflation Index (BPI) tracks the price of consumer goods with different weightings compared to the average CPI for all consumer items, not exclusively core goods and services (Exhibit 4), with the goal of better understanding the inflationary environment experienced by wealthier households. Like the traditional CPI measure, a very small weight of the index consists of items that Amazon has had a direct pricing impact on, like books and electronics. Second- and third-order effects of Amazon are, of course, felt in BPI much as they are in CPI.

Regarding BPI's recent trend versus headline CPI and core CPI, BPI's year-over-year percentage change has been slightly higher than CPI by an average of around 15 basis points over the past year. The higher weighting assigned to tuition and childcare (over 10% more weight is assigned to this category versus headline CPI) is a main driver behind BPI's slightly higher annual growth rate versus CPI because this product category's annual inflation rate is above average, increasing by a range of 2.2% to 2.6% over the past year.

Additionally, as mentioned in previous *Inflation Checkpoints*, the lesser weight assigned to the communications category, which has been deflationary over the past year, and the greater weight assigned to hospital services, which increased by an average annual rate of over 4% in 2017, contributed to BPI's slightly greater growth rate versus CPI in 2017.

## Exhibit 4: Bessemer Price Inflation Index versus Consumer Price Index



As of December 31, 2017. Core CPI excludes food and energy.

Source: Bessemer, Bloomberg, U.S. Bureau of Labor Statistics

Lastly, the greatest component of both BPI and CPI is owners' equivalent rent (around 26% of CPI and 13% of BPI), which has been providing a sizeable boost to overall inflation, increasing by over 3.5% year-over-year each month since June 2015.

Most recently, BPI increased by 2.1% year-over-year, which is in line with headline CPI and 0.2% higher than core CPI, as of December 2017.

## The Year Ahead

Looking forward to the year ahead, we expect inflation pressures to rise slightly and core inflation metrics to come closer to or meet the Federal Reserve's inflation objective rate of 2%. Additionally, the market's expectations of inflation have risen since December of last year, when tax reform became a reality, as evidenced by the 10-year Treasury yield's breakeven rate, currently at 2.1% versus a post-financial crisis low of 1.2% in February 2016 and post-2016 election low of 1.7% in June 2017. Moreover, we expect the Federal Reserve to continue tightening even if inflation remains relatively soft, though the number of future rate hikes will likely be fewer if core inflation metrics continue to be below 2%.

### Our Recent Insights

**Changing Contractual Relationships: The Tax Cuts and Jobs Act of 2017 – Investment Insights** (February 2018)

**Integrating Values and Your Investments: Sustainable Investing – A Closer Look** (January 2018, [Video Available](#))

**Q4 Earnings Season: What Lies Ahead – Investment Insights** (January 2018)

**The Tax Cuts and Jobs Act: What Does It Mean for You? – Wealth Planning Insights** (December 2017)

**Unwrapping Tax Reform: Implications for Markets – Investment Insights** (December 2017)

**Goldilocks or the Three Bears – Quarterly Investment Perspective** (First Quarter 2018, [Video Available](#))

**The Dollar Under President Trump Revisited** (December 2017)

**The Fed's Next Chapter – Investment Insights** (November 2017)

To view these and other recent insights, please visit [www.bessemer.com](http://www.bessemer.com).

### About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

Past performance is no guarantee of future results. This material is provided for your general information. It does not take into account the particular investment objectives, financial situations, or needs of individual clients. This material has been prepared based on information that Bessemer Trust believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. This presentation does not include a complete description of any portfolio mentioned herein and is not an offer to sell any securities. Investors should carefully consider the investment objectives, risks, charges, and expenses of each fund or portfolio before investing. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in economic growth, corporate profitability, geopolitical conditions, and inflation. The mention of a particular security is not intended to represent a stock-specific or other investment recommendation, and our view of these holdings may change at any time based on stock price movements, new research conclusions, or changes in risk preference. Index information is included herein to show the general trend in the securities markets during the periods indicated and is not intended to imply that any referenced portfolio is similar to the indices in either composition or volatility. Index returns are not an exact representation of any particular investment, as you cannot invest directly in an index.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH  
HOUSTON • LONDON • LOS ANGELES • MIAMI • NAPLES • NEW YORK • PALM BEACH • SAN FRANCISCO  
SEATTLE • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

Visit us at [bessemer.com](http://bessemer.com)