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A Commentary by Harley Bassman:

The Convexity Maven

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Value Concepts from the Credit Suisse Trading Desk
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"**Inflation: Making Sure it Happens Here**"

Paraphrased from Ben Bernanke, November 21, 2002

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The Gold Standard, backed by Eastern capitalists and despised by Western and Southern farmers burdened by debt, became a major political issue as the 1896 election approached. Two-term Nebraska congressman William Jennings Bryan mounted the Chicago convention podium and eloquently sent out the clarion call: *"…we will answer their demand for a Gold Standard by saying to them: You shall not press down upon the brow of labor this crown of thorns; you shall not crucify mankind upon a Cross of Gold !"*

Bryan was surely a man ahead of his time, at least judging by the concerted efforts the FED has made to insure inflation arrives soon to devalue our excessive Public and Private debt obligations. As noted in the past, there are only two ways to solve a debt crisis – default or inflate (noting that inflation is just a slow motion default). Today we would like to propose that not only does inflation serve the purposes of the political class, but also that inflation has already crept into the system on the Cat's Paws of Government obfuscation.

In 1995, the US Senate asked Michael Boskin to lead an "Advisory Commission to Study the Consumer Price Index". The premise was that CPI was overstating inflation. This was important since many Government programs escalated in tandem with the CPI. As such, a lower CPI would reduce the projected costs of these various entitlements. When the report was issued in December 1996, it was determined that indeed CPI overstated inflation by about 1.3%.

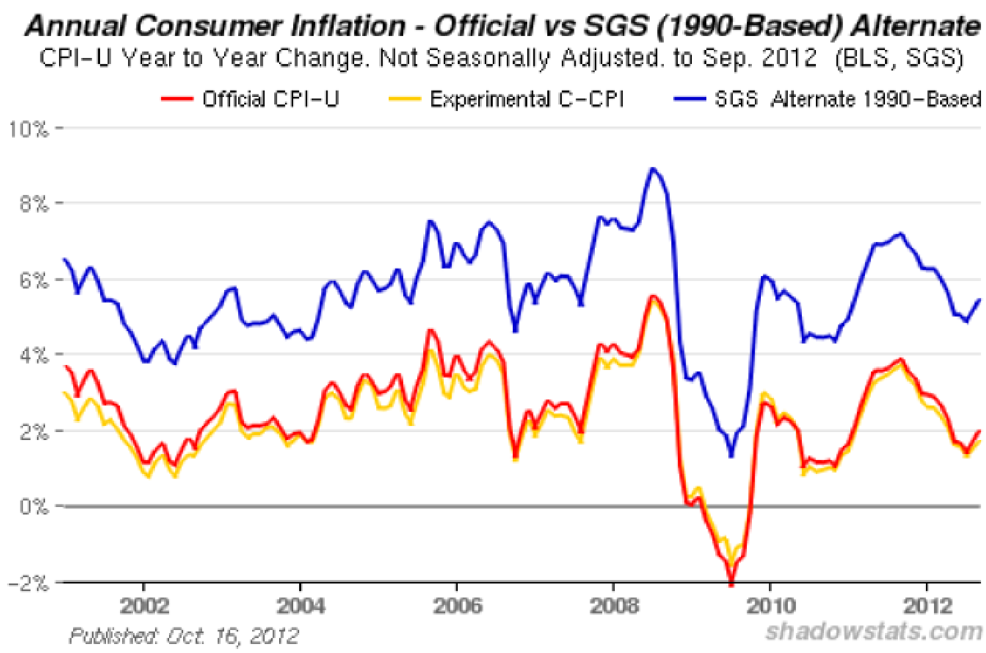
More than a dozen specific recommendations were presented to the Bureau of Labor Statistics (BLS); among these were the suggestions to recognize the "substitution effect" as well as to make "hedonic adjustments" for quality improvement over time.

The *substitution effect* focuses upon the notion that when prices rise, consumers may alter spending patterns to ameliorate the impact. The textbook example would cite that when faced with higher prices for steak, consumers would purchase chicken instead. While it is certainly true that families could receive similar nutrition at a lower cost by switching from red to white meat, the cold reality is that <u>product substitution is prima facie evidence of inflation</u>, not the contrary. The notion of a deflationary substitution process is simply an ex ante rationalization to modify the BLS shopping basket.

Hedonic adjustments focus upon the idea that as product quality rises, the effective cost of the item declines. Such is the case of the improved memory of a flash drive over the past decade with little change in the cost. As an absurd example, I will confess that I paid over $500 for a one gigabyte hard drive in the early 1990's (floppy disks were just not viable for the long-term storage of valuable records). Presently, one can buy a 16 GB flash for less than $11. Or consider that an early Apple computer with 128k of RAM and only a few megabytes of storage now costs the same as the current version with 10,000 times the power. Hedonics proposes that this is deflationary, but this is false since the minimum requirements floor has been raised. Microsoft Office requires three gigabytes of free disk space just to download, so buying that theoretically "cheaper" old computer is no longer a viable alternative, it is a false choice.

Using this flawed logic, a credit-impaired struggling homeowner should be considered wealthier than King Louis XIV at Versailles since at least the former has indoor plumbing, a microwave, and a mattress not made primarily of straw.

The various recommendations of the Boskin Commission were soon implemented with the desired effect. The –cardinal line- below is the official CPI rate as reported by the BLS. The –cobalt line- is an estimate for what CPI might be if the pre-Boskin metrics were used.



This 2% difference is not a trifle; lowering entitlement increases by a mere 2% over the course of little more than a generation will cut the growth of additional Government entitlement expenditures in half.

While the Boskin conclusions are of debatable economic merit, it is indisputable that it is a public policy winner; it is the silent tax on the middle class that can narrow the entitlement versus revenue gap – even Grover Norquist might approve.

Don’t Ignore Revenue Inflation

The Government employs a two-pronged strategy when it comes to the manipulation of Inflation. While under-reporting CPI can cut costs, the big money comes from revenue inflation. A stable two to three percent inflation rate is a magical elixir for career politicians. Over the long-haul, wages tend to keep pace with deliberate fiat currency devaluation. These steady nominal gains make their constituents feel good as the digits on their paychecks keep rising. However, since tax brackets are linked to the suppressed CPI, more quickly rising wages will push earners into an ever higher marginal rate thanks to our steeply progressive tax structure. So while wages rising faster than CPI can make headlines as an increase in "real income", progressive marginal rates will reduce a citizen's after-tax "real" take-home pay. Known as "bracket creep", this was one of the unsung heroes that helped close the budget deficit in the late 1990's. It is also why even Republicans do not cry too loudly about modifying the Alternative Minimum Tax (AMT). The AMT was originally designed in 1969 to prevent 155 individuals who earned more than $200,000 (including 20 millionaires), who had "tax preferred" income (such as municipal bonds), from paying no taxes. However, since this threshold was not properly indexed, the wide ATM net is now capturing huge schools of "the 99%".

Whom do you Believe: Statistics or your Lying Eyes ?

"Just because you are paranoid, does NOT mean they are not out to get you", or so the old saying goes. That said, Jack Welch was clearly out of bounds to accuse the BLS of cooking the books for the September 2012 unemployment rate. So let us delicately pirouette when it comes to our thoughts on how the BLS reports Inflation.

Annual Tuition Increases for some Manhattan Independent Schools

Year	Change
1996-97	6.5%
1997-98	4.1%
1998-99	5.7%
1999-00	6.2%
2000-01	6.1%
2001-02	5.5%
2002-03	5.7%
2003-04	10.8%
2004-05	4.9%
2005-06	8.0%
2006-07	6.6%
2007-08	6.6%
2008-09	6.0%
2009-10	2.1%
2010-11	4.8%
2011-12	4.6%
2012-13	5.8%

Source: Credit Suisse

The BLS is staffed by competent career public servants who execute their jobs as advertised. However CPI is defined, they produce that result, nothing more. My concern is that this result does not reflect the real cost of living.

As described above, various changes to the CPI calculation have reduced the reported number for well over a decade. Moreover, it is not lost on me that under-reporting CPI does benefit the Government. But pure paranoia is not a compelling argument. Let's consider some real life examples.

In the Table on the previous page, the –cerulean column- is a rough approximation of the annual change in tuition for some Manhattan independent schools. While some may dismiss this as a non-representative expense that is solely born by the over-pampered, consider what these schools must do:

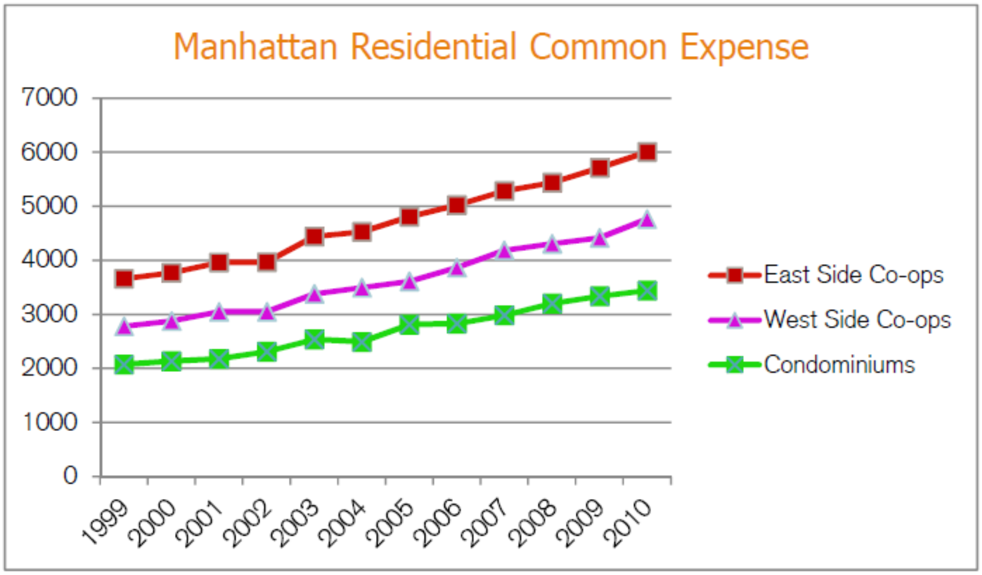
1. They must offer teachers a competitive **salary and benefits** package;
2. They pay large **energy and utility** costs to run the building;
3. They must pay market wages for **repairs and maintenance**;
4. They must maintain an inventory of **books and technology**;
5. They have a large **food** bill to maintain a full service cafeteria;
6. They do not make a profit (in fact, they generally run a 10% deficit).

In short, private schools operate in many respects like any small community exposed to all the various input costs that a "normal" family might experience. I presume all opportunities for "substitution" and "hedonic adjustments" are executed by management to optimize their cost structure. Nonetheless, as summarized by the –oxblood column-, over seventeen years tuition has rather smoothly followed about a 6% Compound Annual Growth Rate. Over the same time frame, the CPI has experienced a CAGR of a bit less than 2.5%.

So if private school tuition is a bit too hoity-toity, let's consider the all in cost of housing for a typical New York City resident, a surprisingly diverse and ordinary population once the tails of the distribution are flattened out.

Most residents of Manhattan live in some sort of multifamily residence, sometimes a condominium, but usually a co-operative (don't ask). Co-ops are mostly not for profit and tend to run a "zero budget". Since the residents of the Co-op are the owners, they are *severely conservative* (proper usage) when it comes to expenses. Similar to what a family in most locales might experience, Co-ops often pay union wages for services rendered. The Co-op must also pay for utilities, oil, supplies from the local hardware store, maintenance contracts as well as local property taxes and market interest rates. A Co-op is also faced with a steady stream of bills for legal, accounting, engineering and other professional services. In short, a Manhattan Co-op is similar to an ordinary family in that it has a diverse array of continuing expenses.

While we will stipulate that Manhattan will always cost more than most other cities, there is no reason to presuppose that its long-term rate of change should be any different than that of any other region of the country.



Source: Council of NY Co-ops and Condos

The graph above is taken from the Council of New York Cooperatives and Condominiums. Many Co-ops and Condos are members who submit their audited expenses to create this study and share information. These common charges include the cost of labor, physical maintenance, common utilities, professional fees, and in the case of Co-ops, local real estate taxes. East or West, Co-op or condo, they all own a cost structure that has risen at a CAGR of roughly 6.1%, over double that of the officially reported CPI.

While stipulated that living in NYC is more expensive than most other cities, the question one has to ask is whether its relative cost should be rising so quickly? According to the Council for Community and Economic Research, in 2010 it cost almost twice as much to live in Manhattan as it did to live in Minneapolis. Fine; but are we to suppose that in less than a dozen years the relative cost differential will be three to one? If this truly is the case, I guess this could be what underpins the increasing bifurcation of incomes in the US, known in the popular press as “income disparity”.

While certain aspects of NYC are unique within the US, such a persistent differential seems strange. More likely is the truth of our core proposition: **CPI does not accurately reflect the true cost of living in the United States**.

Using some gerrymandered rotating basket of goods purchased by residents who pay an Owner's Equivalent Rent for a compartment in *The Matrix* may be nice in theory, but where the rubber meets the road it is not accurate. Similar to the relative cost of NYC versus MPLS, we suspect that the price relationship between chicken and beef remains the same over ultra-long time horizons. As such, substitution only reduces the volatility of CPI, not its absolute level. When the kids eventually cry out for real hamburgers instead of Soy Steaks, do the denizens of the BLS make the proper adjustments and have the CPI catch up? Maybe, but if they do, what was the purpose of substitution to begin with?

At the end of the day, one pays for a "lifestyle" that includes all inputs and the cost of that lifestyle can be found at the bottom line of your checkbook on December 31st. How many total dollars one spent in a given year is the cost. Does it matter if my laptop now vibrates at 2.7 GHz, triple the rate of a few years ago? Not much if that is the lowest priced computer in the market. If a 1GHz computer is NOT available at half the price, one can never obtain the theoretical savings found on a BLS schedule. The cost is the cost no matter the speed, a computer costs "x"-dollars and I need to make a bank transfer of said dollars to own that computer. Only Brian Greene can live in that alternate Universe where one can pay for a lifestyle in "Hedonic" dollars. [See theory of the Multi-Verse.]

Ultimately this is a question of semantics: What is the notion of CPI measuring?

If it is the measure of how many nominal dollars it takes to purchase a static "Quality of Life", then CPI, as currently manufactured, is a reasonable data series. However, if it is meant to be a measure of the "Stored Purchasing Power" of money, i.e., how many dollars will buy a standard loaf of bread, then it is not so hot. Barely half of the US had indoor plumbing after WW2 while a Hershey Bar cost a mere nickel; CPI has been bludgeoned into a theoretical economist's reconciliation of these two facts – so explains my distaste for TIPs.

An ultra-low interest rate is NOT the FED's goal; it is a Means to an End: The End being Inflation. Hence, FED easy money policies have steadily debased our currency via new bubbles in gold, commodities, and financial assets.

Make investments to earn a "real return", read our Commentary – *"Holiday Stocking Stuffers"*, December 12, 2012, for our best investment ideas.

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