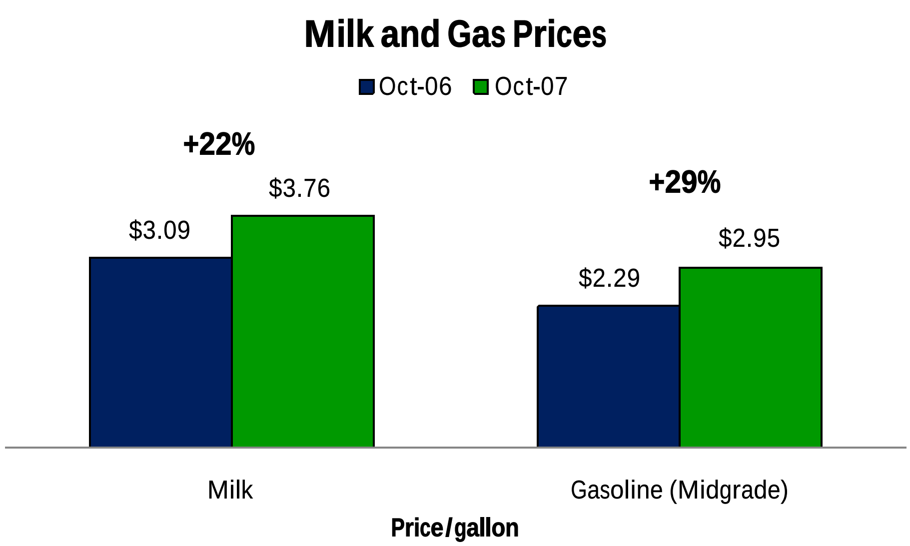
What's the Story With Inflation?

There are many ways to measure the change in the level of prices, and it seems that for every measure there is a different opinion as to where the rate of inflation is headed. Of the multitude of gauges, one of the best known is the Consumer Price Index (CPI) published by the U.S. Bureau of Labor Statistics. It measures the inflation experienced by urban consumers in their day-to-day living expenses, including both goods and services. The CPI is widely used by policy makers as an economic indicator, and therefore is a highly debated variable in forecasting the markets and the economy. Some commentators have asserted that the traditional CPI index is subject to undue volatility from highly variable energy and food prices, and as a result the *CPI Core* index, *which excludes energy and food prices*, has become a more popular indicator cited as the gauge of inflation, or should we say the lack of inflation.

Is the CPI Core Index the best current gauge of inflationary pressure in the U.S.?

In the past, the CPI Core index may have been a good proxy. We contend today, however, that any inflationary gauge that excludes food and energy prices is misleading and out of touch with the American consumer's day-to-day experience. In the past year, the prices of some of the most basic goods in these groups have not only risen sharply, they have soared. The table below shows the average cost of milk[1] and gasoline[2] across major metropolitan areas in the U.S.



In the twelve months from October 2006 to October 2007, the cost of a gallon of milk and the cost of a gallon of gasoline rose by 22% and 29%, respectively. Given the relatively-inelastic nature of demand for these necessities, we consider those large price increases as symptomatic of the underlying inflationary pressures on the budgets of average families. Moving beyond the direct costs to the consumer, there also are greater indirect costs generated by higher fuel prices for transporting goods to and from the marketplace. This is a reality that we will all feel this holiday season when we see the increased shipping costs of our many online purchases.

[1] Source: Average retail price for a gallon of milk in a selected group of metropolitan cities across the US. Federal milk order market administrators (MA's) collect retail milk price information by surveying one outlet each of the largest food store chain, the second largest food store chain, and the largest dairy/convenience store chain in the city or metropolitan area. The Agricultural Marketing Service (AMS) is part of the USDA. **http://www.ams.usda.gov/dyfmos/mib/rtl_milk_prices.htm**

[2] Source: Information Administration (EIA), Dept of Energy. Price per gallon of midgrade gasoline across the U.S. **http://www.eia.doe.gov/oil_gas/petroleum/data_publications/wrgp/mogas_history.html**

Even directionally, using the CPI Core inflation rate as a proxy for the inflation that consumers experience is no longer appropriate. In the last several years, the traditionally-correlated relationship between the CPI and CPI Core has broken down dramatically.

Correlations Between CPI and Component Indices

	CPI vs. CPI Core	CPI vs. Energy	CPI Core vs. Energy
Jan 1958 - Oct 2007	0.94	0.70	0.49
Jan 1970 - Oct 2007	0.93	0.70	0.46
Jan 1980 - Oct 2007	0.94	0.64	0.35
Jan 1990 - Oct 2007	0.69	0.58	-0.16
Jan 1997 - Dec 2006	0.15	0.91	-0.23
Jan 2000 - Dec 2006	0.19	0.89	-0.23
Jan 2006 - Oct 2007	**-0.19**	**0.98**	-0.32

Source: Bureau of Labor Statistics www.bls.gov

As shown in the "CPI vs. CPI Core" column above, the correlation between the two indices has fallen from close to 1 over the past 50 years to less than 0.20 in the last ten years, and has even turned negative in the last 22 months. The following two columns highlight how energy price inflation is increasingly moving with the broad inflation measure (a correlation of 0.98) and is clearly out of sync with the Core index (a negative correlation of -0.32).

The bottom line is that most American consumers are feeling a hit from rising food and energy prices, and any measure of inflation that does not take this into account is misleading. Many companies claim to have little or no pricing power due to increasing globalization and competition, and thus are unable to pass through price increases in raw materials to the end consumer. While this may be true, the data above show that there are more basic ways that inflation can feed through the economy and impact the average consumer.

As a result, we have and will continue to protect our clients' portfolios against this inflationary headwind. We continue to believe that holding positions in inflationary hedges like gold/commodities and Treasury Inflation Protected Securities (TIPS) is the best defense in this marketplace.

We hope everyone has a wonderful holiday season and we look forward to a healthy, happy and prosperous new year!

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Market Monitor – November 2007

The month of November was unkind to global equity markets, with most major indices declining in the range of –3% to –5%. The S&P 500 index fell more than –4% in the month, while International Developed markets performed somewhat better. The high-growth Opportunistic BRIC region (Brazil, Russia, India, China) fell slightly less than the broad Emerging Market index due to exposure to Russia, which managed a gain of nearly 2%. Within the U.S., Large-Cap stocks continued to outperform their Mid- and Small-Cap counterparts, and Growth once again bested Value in the style boxes.

U.S. fixed income provided some protection/diversification posting robustly positive returns. Treasury Inflation Protected Securities (TIPS) also were strong performers, with a gain of almost 4% for the U.S. TIPS index. Gold was down for the month, but less so than equity markets.

Relative Performance (+ to –)

BY ASSET CLASS
TIPS 3.97%
Bonds 1.80%
Cash 0.39%
Gold -1.33%
Equity -4.18%
Opportunistic -6.33%

TIPS = Lehman U.S. TIPS, Bonds = Lehman U.S. Aggregate
Cash = Lehman 1-3 Mo T-bill, Gold = DJAIG Gold subindex
Equity = S&P 500, Opportunistic = MSCI BRIC

EQUITIES

BY GEOGRAPHY	BY CAPITALIZATION	BY STYLE BOX
Int'l Developed -3.29%	Large -4.26%	Growth -3.68%
U.S. -4.18%	Mid -4.78%	Core -4.26%
Emerging -7.09%	Small -7.18%	Value -4.89%
Int'l Developed = MSCI EAFE	Large = Russell 1000® Index	Growth = Russell 1000® Growth
Emerging = MSCI Emg. Mkts.	Mid = Russell Mid Cap® Index	Core = Russell 1000® Index
U.S. = S&P 500	Small = Russell 2000® Index	Value = Russell 1000® Value

Source: Lehman Brothers, Dow Jones & Company, Standard & Poor's, MSCI Barra, Russell Investments