How Badly Does Inflation Affect Your Investments?

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The cost of living as measured by the Consumer Price Index is at its highest in forty years. The prospect of runaway inflation is on everyone's mind. How does inflation affect you and your family? How badly does inflation affect your investments? Inflation does not affect everyone the same. And inflation can have different effects depending on the mix of assets in your investment portfolio. Part of the puzzle has to do with which measure of inflation you use.

How Is Inflation Measured?

When you fill up your gas tank these days it costs about $4.27 a gallon and a year ago it cost about $2.95 a gallon. That is a little more than a 42% increase. So, is inflation 42% a year? The price of tomatoes is down from a year ago. Food prices are up about 7% from 2021 to 2022. The government measures inflation by comparing prices of 80,000 items from one month the next to come up with the Consumer Price Index (CPI) which is the most commonly referenced measure of inflation in the USA. Each item is weighted and the monthly price change times the weighting of the item is what goes into the index. The CPI is running at about 8% but is that an accurate measure for everyone? The government has more than just one measure of inflation.

The CPI-U compiled by the US Bureau of Labor Statistics measures prices of 80,000 each month in urban areas where 93% of people live. It measure prices but does not reflect the spending habits of any particular subgroup. For example, retirees are paying more for medications but typically not paying on their mortgage. Suburban workers are paying for gas to commute to work while workers within a city may take a bus or subway to work. Prices for citizens in rural areas may vary significantly from those in New York, San Francisco, or Miami. And a constant argument regarding the use of the CPI-U to adjust Social Security payments is that the consumer expenditure survey used to derive the CPI does not account for the differences in the mix of expenses for 70-year-old retirees versus young urban workers.

Total Versus Out of Pocket Expenditures

The US Bureau of Economic Analysis measures personal consumption expenditures (PCE). It covers payments by employers for insurance premiums, Medicaid, and Medicare as well as out of pocket payments at the doctor which is what the CPI measures. The PCE shows a faster increase in health care costs than does the CPI and may be a better measure for the older segment of the population. The Fed uses the PCE and not the CPI when setting inflation targets.

Adjustment of Tax Brackets for Inflation

Congress changed the law for adjusting tax brackets for inflation in 2017. Instead of using the CPI they use the

Chained Consumer Price Index for All Urban Consumers. This index is updated more frequently so that the weighting of items better reflects what goods and services people pay for in the real world. An example is the fact that fewer and fewer people have telephone land lines at home and use mobile devices like cell phones instead. The chained index picks up on these changes and provides a more accurate picture of inflation which is then used to adjust tax brackets.

Does Your Portfolio Stay Ahead of Inflation?

Interest bearing investments like CDs, Treasuries, and corporate bonds have always been part of a balanced investment portfolio. Unfortunately, these investments give you negative real interest rates when inflation is high. Investing in the stock market is often a better way to stay ahead of inflation but the k-shaped recovery from the pandemic has left many stocks behind. Gold was the preferred investment for beating inflation in the 1970s. While gold went from a low of $1,445 an ounce in 2019 to $2188 an ounce in 2020 it trades for $1,974 in April of 2022. In the last year when inflation gone up 8% gold has fallen nearly 10%. Bitcoin has also not shown itself to be a hedge against inflation as it fell by roughly half from November 2021 to April 2022. *US News* offers a list of 7 companies likely to beat inflation.

Here is their list.

Baker Hughes
BorgWarner
Newmont Corp.
Corning
American Tower Corp
KLA Corp
Eastman Chemical Co.

All of these companies are tied into the US economy, have the ability to raise prices as needed and use efficiencies to cut costs. The stock market has been the best investment vehicle over decades and well-chosen stocks are likely to be your best hedge against inflation no matter if you are following the CPI or PCE or simply noticing how much more you need to pay to fill up your tank with gasoline each week.

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