TIGHTENING THE INFLATION VICE OR JUST BAD MATH

by Steve Brown

There is no doubt that a vice can hold things in place and be cranked down to apply enormous pressure. The question many ponder is whether or not the FOMC is doing the right thing in cranking down the inflation vice so much. After all, for years we have heard that CPI is a messed up way to measure inflation anyway. Consider our weekend ahead. After spending $100 to fill half a tank of gas on the SUV, we will go visit some open houses. Now we know our readers live all over the country, but in San Francisco, a nice 1,000 square foot house can be had for a mere $1.5mm (down from $2mm last year). Despite that fact, the business section of the paper howls about rising inflation pressure. This is understandable, particularly when one considers journalists have no idea about finance and that housing is the biggest component of CPI. The issue this measurement faces is that as the housing market rises, rents usually head lower. The theory goes that people will not rent when they can buy and own for the same price. The biggest problem with CPI is that rental prices also account for 30% of the number. Therefore, when housing markets are strong (as they have been over the past several years), CPI will fall and when housing is softening (as it is now), CPI will rise (as people stop buying homes and shift to rental units). Each month, the Bureau of Labor Statistics ("BLS") looks at monthly rents for detached single family homes and assumes everyone who owns a home rents it from themselves at the prevailing market rate. They do this because the BLS wants the CPI to measure the prices of "goods and services" but not "assets". The BLS has decided that homes are assets, not goods, so they look at rents, not prices. This means that real inflation Â– measured by actual declines in purchasing power can be higher or lower than CPI would indicate. As one considers the housing component of CPI, nothing is ever as simple as it first seems. Consider an area that has seen a lot of speculative activity. In these geographic areas, housing softness may not increase rents at all. Rather, because there could be a flood of homes that come onto the market all at once (either by speculators who can't sell fast enough, or eventually by the banks who now own these homes), prices of both homes and rental units may fall at the same time. Another example is equally thought provoking. Consider the person that sells their home and plows the money back into a mutual fund, bank or the stock market. These people (ala Baby Boomers) may be less interested in owning a house and are simply liquidating. Their action has little to do with inflation, but lots to do with life changes (i.e. travel, tired of cutting the grass, etc.). Finally, the data can also be skewed by the type of renter. For example, when housing markets are strong, high-end rentals go empty as this group shifts to home ownership, while low-end rentals are unaffected (i.e. cannot qualify for a loan). As CPI data collection indicates, each geographic area has its own unique characteristics. There is far more to this discussion (i.e. lagging effect of oil price impact, etc.), but suffice it to say this is one of many reasons the FOMC (even with the best data in the world), still struggles when trying to decide how many turns of the vice are needed to clamp down on inflation.

BANK NEWS

Acquisition

Barclays Bank will acquire the mortgage-servicing business of Wachovia in a transaction valued at nearly $469mm. The company is the last remnant of The Money Store which made home-equity loans in large volume.

Acquisition

U.S. Bank ($209B, MN) will acquire Schneider National Inc's payment service division for an unnamed sum.

Investing

Bank of America, Bear Stearns, Goldman and E-Trade will invest a total of $20mm in the Chicago Stock Exchange, giving them minority interest stakes.

Repaying Debt

Mexico said higher oil exports will allow the country to repay $7B in debts (to the World Bank and IADB) ahead of schedule.

Visa Breach

Visa announced some of their card numbers may have been compromised in a breach at a transaction processor. Further information has not been disclosed.

Interesting

Digital Federal Credit Union, the nation's 15th largest, has launched a program offering life insurance products to its members.

Thieves

A survey finds nearly 20% of workers say they have stolen office supplies from their company in the past year. While 25% of workers between the age of 18 and 29 admitted to raiding the supply cabinet, only 13% of those over age 50 admitted such actions.