

Investment Outlook

РІМСО

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Con Job Redux

A man hears what he wants to hear and disregards the rest. – Paul Simon

Bloomberg's John Berry and the Fed's William Poole are well intentioned I'm sure but they have an agenda like we all do. As I told a client last week, my agenda is to promote the interests of bond holders and by osmosis PIMCO's and my own. Their agenda is to support the Federal Reserve, its strategies, and by osmosis the thinking of its chairman, Alan Greenspan. I was not surprised, therefore to read their criticism of my October Investment Outlook Haute Con Job, which called into question the validity of our government's inflation numbers. Berry and Poole read what they wanted to read and, as Paul Simon once suggested, disregarded the rest.

My point, however, was as follows. The CPI inaccurately calculates Americans' <u>cost</u> of living. Since Social Security and pension benefits, as well as the level of wage hikes are predicated upon the specific number and/or the perception of annual increases, Americans are being in effect conned by their government and falling behind the inflationary eight ball year after year. After slamming the concept of the core CPI, the primary culprits I cited were the government's use of hedonic and substitution adjustments to lower the CPI by as much as 1% in recent years. John Berry, the columnist, claimed my report was "inaccurate and flawed." William Poole, the Fed Governor, in effect said I didn't know what I was talking about. I think they read what they wanted to read, and I would hope that they would hear what <u>needs</u> to be heard.

I did not dispute the fact that the quality of goods and even services can improve and that the government shouldn't recognize that "hedonically." <u>I do disagree with those</u> adjustments being reflected in a CPI that is used to calculate the benefits of wage earners and retirees. The U.S. government has over 40 different CPI indices - there is not one sacred calculation. There is a CPI for medical care for instance, and a CPI for services, as well as a CPI for transportation. Take your pick. But in using for retirement benefits an hedonically adjusted CPI that lowers annual price increases by as much as 1%, they take money unjustly out of Americans' pockets. Peter Bernstein, in an article I cited in the Investment Outlook. suggested the same thing. He recommended the adoption of a new form of the CPI, which he dubbed the CPI/DX that excludes

all durable goods prices – the items most subject to hedonic calculations. He wrote that "what people <u>see</u> and <u>feel</u> as inflation is what they pay for services and nondurables" not hedonically adjusted durable goods such as computers and DVDs.

I would take that assertion one step further by using the following example that strikes to the heart of the hedonic debate. Say the only product that Americans purchase and consume are bags of gumdrops - 100 to a bag that cost \$1.00 per bag, with each citizen limited to 1 bag. Through the miracle of productivity, a way is found to fill each bag with 110 gumdrops that is now priced at \$1.10. The government's hedonic adjustments would now calculate that the bag really only costs \$1.00 and that the CPI has not gone up. After all, each gumdrop in the bag still only costs a penny does it not? It does. But here's the catch and the con. The price of a gumdrop hasn't gone up, but the cost of a bag of gumdrops has. Because Americans must buy 1 bag as opposed to individual candies, their cost of living has

increased by 10%. They must fork out an extra dime even though they're getting more for their money. Now turn the gumdrops into computers, cell phones, refrigerators, etc. and you see my point. We can't buy individual pieces of memory in a computer we have to buy the entire package. And the package costs more whether it's improved or not. The government's hedonic adjustments may accurately reflect productivity increases, but they should not be part of a CPI, which is intended to depict America's cost to live. In effect, that allows the benefits of productivity to accrue to businesses (which don't provide adequate raises) and government (which under-compensates Social Security recipients). Holders of TIPS who are hoping to keep up with the <u>cost</u> of living via their "inflation protection" are disadvantaged as well. It's a con – pure and very, very simple.

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