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The Consumer Price Index and the Truth About Inflation

"By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens."
- John Maynard Keynes

Whether we're rich or poor, thrifty or overextended, inflation is as inevitable as death or taxes. But how high IS inflation? Is the Consumer Price Index a reliable guide? And what is the impact of underestimating inflation?

In an effort to gauge how much you need to save and how far your money will go in the future, most financial planners will run projections based on 3% or occasionally 3.5%, or even 2.5% annual inflation rates. However, as we'll see, this can put investors at serious risk.

The WORST kept secret behind inflation is that it is a lot steeper than we are led to believe.

There is a good reason why those 2 or 3% cost of living raises don't seem to keep pace with the economy... they're not.

You also need to understand there are different rates of inflation or cost of living in different parts of the country. For example, real estate is a lot more expensive in New York City then in Kansas City or going out for dinner or Auto Insurance. It is also different for "White Collar" executives versus "Blue Collar" workers.

Truth be told, inflation is a moving target. But that's not the only reason why our dollars seem to keep shrinking.

The Bureau of Labor and Statistics, or BLS, defines the Consumer Price Index (CPI). Measurement of the CPI is critical because it is the index used to regulate prices and to calculate changes in wages and pensions. Financial planners also use these indicators as a way to predict future costs.

The problem with this pricing methodology is that it paints an inaccurate portrait of inflation. The CPI measures inflation by how much the price of a “basket of goods and services” used by consumers changes over time. But the basket itself actually changes.

For example, if a family downgrades from beef to chicken because the price of beef has drastically increased, the comparison doesn’t reflect the true inflation rate. But when beef rises, the Consumer Price Index does just that, it changes the items that get measured, because that's what consumers do - they may substitute something lesser when prices rise.

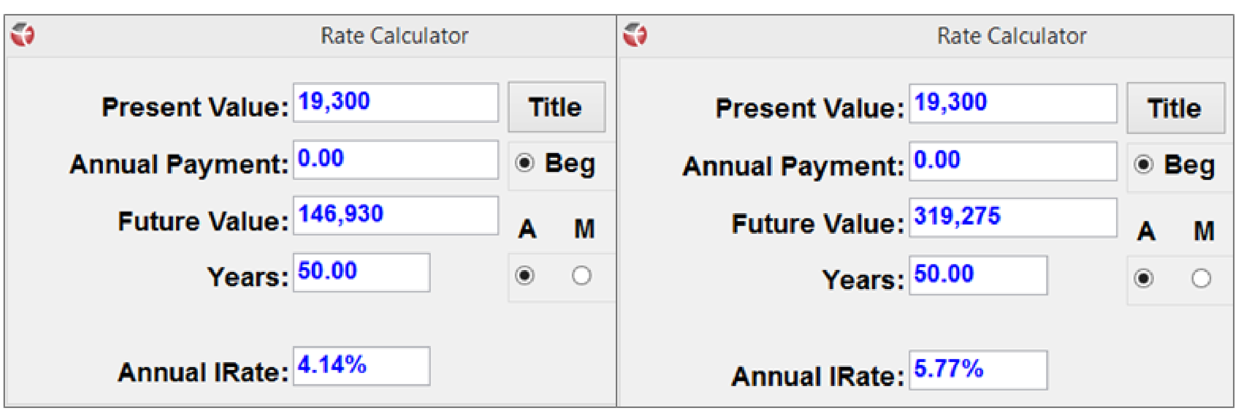
To quote Investopedia, “Substitution, the change in purchases by consumers in response to price changes, changes the relative weighing of the goods in the basket. The overall result tends to be a lower CPI.”

Not only that, but some important expenditures are left out. For instance, the actual price of purchasing a house is not factored in, only an estimate of what it might cost to rent that house. Since house prices rise in value faster that the CPI rates, the CPI can’t accurately reflect a true cost of living increase.

Statistics from the US Census Bureau show that average home prices rose by over 1600% between 1963 and 2013, from $19,300 to $319,275. However, by using the government’s CPI inflation calculator, $19,300 in 1963 adjusts upwards to only $146,930 in 2013 money. This is reflects less than HALF of the actual appreciated cost of a home over this period!

We can see on a (took out “Truth Concepts”) financial calculator that the actual difference in rate required to inflate a property to $319k instead of $147k was the difference between 4.14% to 5.77%.

In other words, a less than 40% increase in rate led to a 216% increase in prices over a 50 year period.



On their website, the Bureau of Labor and Statistics even owns up to the fact that the CPI doesn’t accurately reflect true cost of living increases:

> *"Both the CPI and a cost-of-living index would reflect changes in the prices of goods and services, such as food and clothing, that are directly purchased in the marketplace; but a complete cost-of-living index would go beyond this role to also take into account changes in other governmental or environmental factors that affect consumers’ well-being. It is very difficult to determine the proper treatment of public goods, such as safety and education, and other broad concerns, such as health, water quality, and crime, that would constitute a complete cost-of-living framework.”*

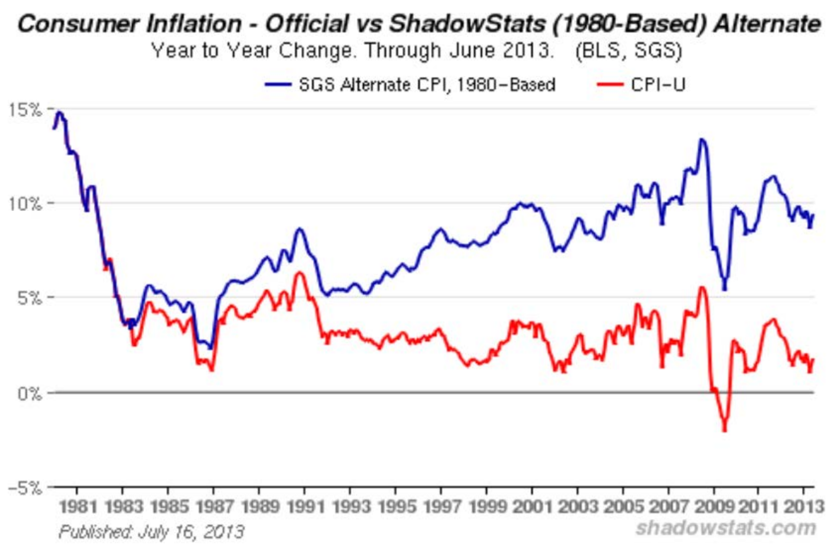
The bottom line? Critical cost of living increases aren't factored into the CPI.

One glaring omission is the cost of healthcare. Senior citizens spend a lot more on healthcare than younger consumers, often 20% of their income or more. By using the government figures, a financial planner might calculate that their client can live on less in their later years, but the number would ignore some costly realities.

Shadowstats.com, which measures and discusses the CPI at length, has drawn these conclusions:

- Since the early 1980s, the CPI has been recalculated repeatedly to underestimate the true rate of inflation.
- The CPI is not an accurate indicator of the cost of sustaining a consistent standard of living or total out-of-pocket expenses.
- By using a purely academic approach, politicians can manipulate the true rate of inflation so annual adjustments for programs like Social Security can be cut.
- The ability of seniors, wage-earners and investors to stay ahead of inflation is impeded by using CPI numbers.
- The illusion of economic recovery can be achieved when inflation-adjusted growth is calculated using a model of understated inflation.

The chart below from Shadowstats.com shows what the CPI might look like if the government hadn't changed their approach to measuring inflation in the early eighties:



The red line shows the CPI as reported, while the blue line indicates how it would read if the measurements weren't altered over time.

This creates a false sense of financial security and unprepared seniors who are simply unprepared for financial realities. The illusion of having enough money can cause us to set unrealistic goals, believing we have "plenty" of savings when we don't. Families find themselves using emergency tactics such as selling the mortgage-free family home to pay for Mom's $5000 a-month-fee in assisted living.

Is Money Worth the Paper It's Printed On?

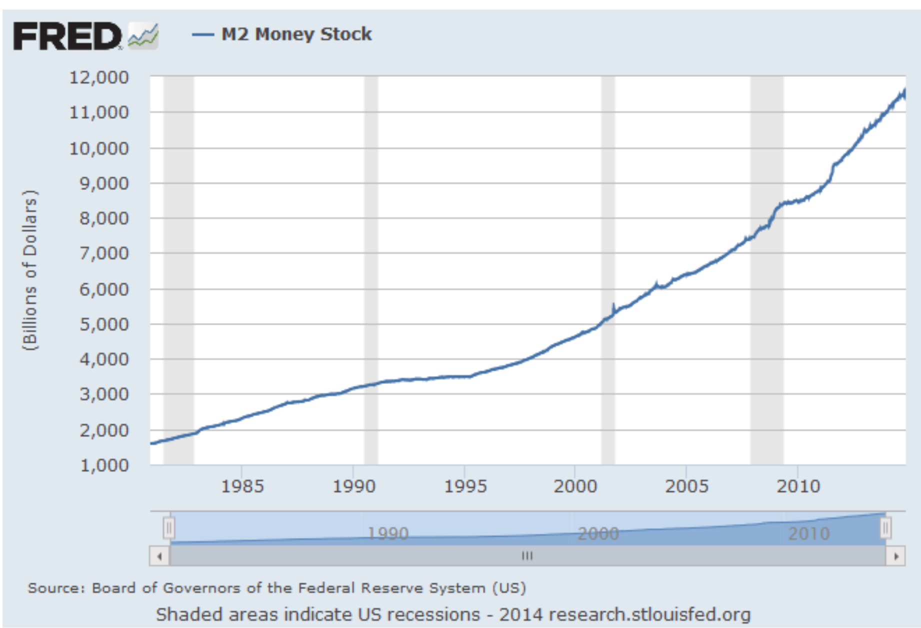
According to Forbes.com, http://www.forbes.com/sites/richardfinger/2013/09/20/the-federal-reserve-is-making-a-big-mistake/ "The Fed has no excess money or reserves…..so they simply fire up the printing presses and print out of thin air $85 billion of new money each and every month. This is money that goes directly into the money supply."

Printing more dollars may put more money into the money supply and ease short-term pain, but it drives the value of the dollar down. The temporary illusion of a robust economy is maintained, but in the long term, prices rise permanently.

In Legalizing Capitalism, Kel Kelley writes, "Historically, inflation was defined not as rising prices, but as an increase in the quantity of money in circulation. This definition has changed over time in such a way as to conceal the real source of the rising prices – credit creation and expansion."

As economist Milton Friedman put it, "Inflation is taxation without legislation." The government can print more money to spend, but this devalues the earnings of consumers who don't have the luxury of minting more money on an as-needed basis.

The chart below shows the increase of the money supply from 1980 to 2014:



How Can Investors Deal with Inflation?

There is no magic bullet, but three things that can help:

1. Estimate on the high side rather than the low side for inflation. We recommend using 4% at minimum, even though it may be discouraging to see how your dollars shrink.

2. Work longer and save more. As Kim Butler argues in *Busting the Retirement Lies*, the model of working until 65 and hoping you've saved enough to live on for another 25, 30, or more years is a simply a broken model that does not work for most Americans.

3. Make inflation work for you by owning *assets*, not just dollars. Use or leverage against the dollars you have saved to purchase income-producing assets such as rental properties or a cash-flowing business.

4. **Implement Whole Life** so that you have the **permission to spend principal and interest** of retirement savings during retirement knowing that the Death Benefit will be there to replace the principal spent.

This way, you'll at least be on the right side of the buyer-seller equation where inflation is concerned.

Need help keeping up with inflation?

We're here to help. Contact us today; we'd love to share some strategies to help you beat inflation and keep your dollars from shrinking!

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