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S&P/ASX 200	AUD/USD		TOP GAINER GEM		TOP LOSER FMG								
+0.61%	-0.31%		+5.70%		-3.97%								
5968.4000	\$0.77		\$3.71		\$1.81								

When the prices are not right: is inflation really that low?

STIRLING LARKIN THE AUSTRALIAN APRIL 11, 2015 12:00AM



Alan Greenspan suggested that if the true inflation rate were calculated, it would be lower than the official figure. Source: AFP

In this current environment, when all natural market metrics fail to make sense, it becomes more important than ever before to solidify our world views and come to reassess the basic laws of the jungle.

The graph illustrates that year to date, the global sectors performing the best are those that defy all the classic presumptions of “markets microstructure” — the central science of how markets should behave — and there does not appear to be any fundamental patterns that can be confirmed.

This is not necessarily a bad thing. This reality does, though, shake the very bedrock of a vast majority of our investment portfolios; whether we are assertive active traders or uber conservative superannuation pension investors.

Australian Ultra High Net Worth (UHNW) investors, in particular, are put in an even more odd position because, due to the innate nature of those who asset allocate wealth that is dispersed across conservative and exploratory bounds, mixed outcomes are being seen, not always in the desired pairings.

In other words, Australian UHNW investors often hold both conservative and risky investments within their broader portfolios at the same time and sometimes in combinations that provide them the worst of both worlds.

Through all the insanity fit for an asylum, the rational among us can take a step back and remember what it was that motivated us to invest in the first place.

The Oxford Dictionary defines the word “investment” as: the action or process of investing money for profit. The operative word in that sentence is not “investing” nor “profit” but rather “money”.

This is because, over many years, the trickiest art within investing is the appreciation of what and how money actually works.

Money is far more complex than most realise.

Collectively recognised as “currency”, money, by its very nature, has behavioural traits that investors

often underestimate.

On this, most of us (hopefully) have come to grasp the concept of “inflation” and why one dollar today is not the same value as one dollar in 2020 or 2010.

In this contemporary era, we understand that inflation is a reflection of a general increase in prices, directly representing the purchasing value of money. What we still struggle with is how it should be measured.

The astute global investor knows that benchmarking investments — whether they be made domestically or abroad — against conventional “Consumer Price Index” (CPI) is a foolish path that only lemmings follow.

CPI was never meant to be used in the vast and wide ways that it is in today’s global economies.

To understand why, it is helpful to look to its genesis and ask why it was created in the first place.

In 1917 the US Bureau of Labour Statistics first set out to devise a measure of prices in order to learn what it cost an American family to meet its basic needs.

This meant more than simply sending surveyors across the country to record the cost of a specified basket of goods, as the bureau had previously done. It meant figuring out how prices shaped consumption and how new goods pushed out old ones.

Without that, as the economist Zachary Karabell highlights, the CPI used to measure inflation today might still include horsewhips and the IBM Selectric typewriter. It was never intended to be used as an investment benchmark, as “asset inflation” was a different kettle of fish already.

During the post war years (1945-1970), though, this is how it came to be employed. Until the 1970s, most were not particularly interested in inflationary measurements — with the exception of union members, whose leaders demanded that wage increases be pegged to inflation. In Australia, ACTU president Bob Hawke rose to power on the back of this issue.

But the so-called “Great Inflation” of the 1970s, when official inflation levels exceeded 10 per cent, saw the index propelled to the centre of public debate and, of equal importance, moved investment conversations away from prima facie results to ones where inflation adjustments were included. Today, we refer to this as real versus nominal returns — anyone with money in term deposits will know those terms well.

In 1977 in the US, insisting that the traditional methods of measurement were making things seem worse than they really were, government statisticians introduced the “core CPI”, which measures inflation without taking into account goods such as petrol and food, whose prices frequently change.

On this, Karabell argues that, of course, for most people, those are the goods that matter most, coupled with the fact that many of their investments had been made in industries and sectors directly confronting such inflation.

Regardless, the core CPI became the preferred gauge for policymakers around the developed world, precisely because it removed goods with volatile prices, which could easily skew perceptions.

In the 1990s, the question of whether official estimates overstated the inflation rate emerged once again.

The myopically sighted Alan Greenspan suggested that if the true rate were calculated, it would be lower than the official figure.

This was blatantly wrong.

Official inflation statistics remain a contentious topic and it falls upon the savvy global investor to seek out their own ways of gauging broader, consumer and asset inflation measures.

Within a year when fundamental market patterns make no discernible sense, boiling down investment decisions to their bones involves determining for oneself what is now considered “investing”, “profit” and, most importantly, “money”.

Abstracting the true nature of inflation today becomes paramount and, remembering that lemmings fall off cliffs, thinking for oneself also becomes the best investment one can make.

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