“Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hitman.”

- Ronald Reagan

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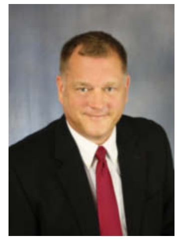

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Demystifying Inflation

"See this quarter?" asked Joe McGrath, the fictional general manager of the Charlestown Chiefs hockey team. "It used to be a nickel," he told Reggie Dunlop, the aging hockey player portrayed by Paul Newman in the movie Slap Shot. Indeed, when that movie came out in the mid-1970s inflation was so rampant the quarter in question probably was a nickel when the scene began. Inflation is basically measured by taking a basket of goods, and comparing the average prices at two intervals in time, while adjusting for changes made to those goods. Let's take a quick look at what some have labeled the "silent killer."

Five things you should know about Inflation:

1. When a dollar buys less of what you want, that doesn't mean it is inflation. There was a day when a dollar could buy nearly three gallons of gas. That was 1970 when a gallon took only 36¢ out of a motorist's pocket. Nowadays, a gallon of gas costs ten times as much. But is that because of inflation? Not necessarily. Items like food or energy products can experience sudden price fluctuations because they're commodities and, as such, their usefulness and value can change quickly for many reasons. What happens to orange juice prices whenever there's a frost in Florida? These event-driven price swings are why gas and food prices aren't included in the Federal Reserve's measure of inflation.

The price of just about everything is affected by the cost of fuel. After all, food and other goods have to be delivered to the end user and when it costs more for distributors to ship these goods, it costs more for a family to buy them. The Federal Reserve tracks their prices separately from core inflation.

2. Core inflation is the dollar eater. As mentioned, when the price of a good or service goes up for the end user it's called price inflation. Sudden increases and decreases in food and energy prices do not require a monetary policy response by the Fed. That's because a quick change in consumer habits can bring the cost of gas or orange juice or most anything else down in a hurry. What really costs American families, what really eats into their budgets, is the actual devaluation of the dollars in their pockets and in their bank accounts. That's core inflation. Core inflation is gauged by the Bureau of Labor Statistics (BLS) tracking about 10,000 different items every month —many of which are affected by food and energy prices. Core inflation includes things you need, but don't necessarily buy every day. Clothing, rent, recreation, medical care, bedroom furniture, college tuition, postage, telephone services, and consumer software are just some of the thousands of items the BLS uses to calculate the Consumer Price Index for all Urban consumers, or the CPI-U. When the average price of these items increases, we have core inflation as calculated by the BLS.

3. Isn't inflation too much money chasing too few goods and services? Yes, that's the academic definition. But perhaps it's more accurate to say that too much money spent chasing too few goods and services causes inflation, since only money spent can cause inflation. If money stays in banks or money market accounts, inflation may not occur.

4. That's where so much money is today. The Fed has been engaged for years in Quantitative Easing (i.e. the buying of government bonds), thereby adding to the money supply. However,

much of that money has not gone into circulation; it has stayed in the banks as they build up cash reserves in compliance with new federal laws and as a defensive move in case of another financial meltdown like we had in 2008. Therefore, that money hasn't been chasing goods and bidding up prices anywhere except, arguably, in the stock market. As such, core inflation has not risen substantially in recent years.

5. M0, M1, M2, M3, M4. These may sound like code names for spies, but they're really measures of the money supply in the United States. M0 and M1 are coins, bills and other money equivalents that are easily converted into cash. M2 includes the above plus short-term bank deposits and 24-hour money market funds. M3 includes M2 plus longer-term deposits and money market funds. M4 includes M3 plus other deposits. As there is more cash on hand in the economy, there is more of a chance that people will spend it on the things they want and need.

The key for a long-term investor is to always stay aware of inflation, even when it is not top of mind. When it comes to retirement planning in particular, inflation is likely to erode spending power.

1) 1970s Flashback, "1970 Economy / Prices," 2001. 2) Ludwig von Mises Institute, "Oil Prices Again," October 1990. 3)Bureau of Economic Analysis NIPA Handbook, "Chapter 5: Personal Consumption Expenditures," November 2012. 4) Federal Reserve Bank of San Francisco, "What is 'core inflation,' and why do economists use it instead of overall general inflation to track changes in the overall price level?" October 2004. 5) Inflation Data, "What is Core Inflation and Why Doesn't It Include Food and Energy," February 24, 2008. 6) Princeton University, "Demand-pull Inflation." 7) Financial Times Lexicon, "Definition of M0, M1, M2, M3, M4," 2014.