

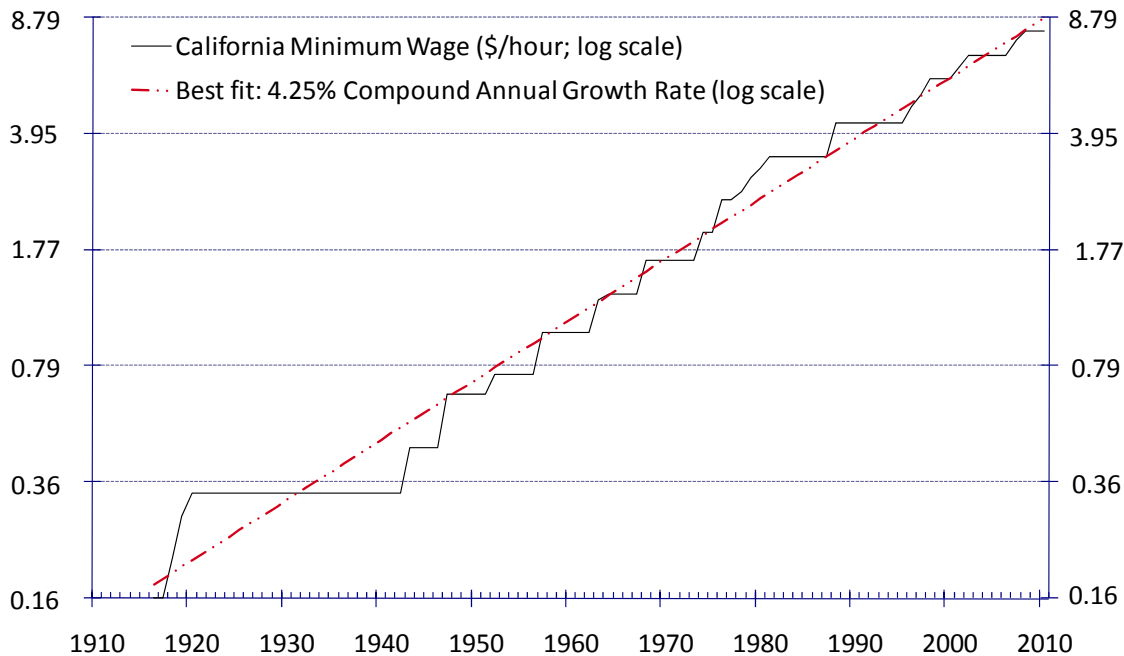
The Week

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Official Inflation Measures Leave Much to Be Desired

- Last week's release of official inflation figures — the Producer Price Index (PPI) on Tuesday and the Consumer Price Index (CPI) on Wednesday — showed only modest advances in May and early June, despite recent market concerns that a recovering economy might eventually trigger a wave of price hikes above the long-term trend.
- A number of reporters and observers of the economic scene commented on the tame inflation reports, pointing out that the 12-month change in the PPI and the CPI were both in negative territory, suggesting that *deflation* should be a bigger worry than *inflation*. Besides, the soft economy is not utilizing very much of the labor and other productive capital that is currently available, so the price of using more of these plentiful excess resources should remain low, at least for the near term.
- Looking beneath the surface, it is easy to see that the inflation process is continuing to reduce our purchasing power, admittedly at a slower pace than the average we have seen over the longer term. According to the Bureau of Labor Statistics (BLS), excluding food and energy prices (which were quite elevated a year ago), the PPI has risen +3.0% — and the CPI, +1.8% — in the past year.
- Of course, as with any index, some prices are rising more quickly than others, while some components of the index may actually be falling. The price changes are weighted to reflect their importance to the economy, but if a major component is moving in a different direction than the index, it can overwhelm the central tendency of the other components. The economists at the Cleveland Federal Reserve Bank publish a "median CPI" measure that is designed to reduce the impact of these divergences; it is indicating a +2.4% increase over the past year. This rate is not too different than what we have seen since 1998.
- Many economists seem to agree that inflation expectations play an important role in the process, and many point to the prices of Treasury Inflation Protected Securities (TIPS) as a reason to remain complacent about the prospects for inflation. In a recent article published in The New York Times, former Federal Reserve Vice-Chairman Alan Blinder says "As long as expected inflation doesn't rise much further, you should find something else to worry about."
- In a survey conducted early this month by the University of Michigan, consumers indicate that they perceive a higher rate of inflation over the next 12 months — a +3.1% gain, on average — than at any time since early October. But it seems clear that this result reflects the sharp increase in gasoline prices seen since the start of 2009; the nationwide average price of one gallon of regular unleaded gasoline is up \$1 to \$2.67 since January 1. Some of this increase is a seasonal effect, but it seems that the BLS is a little behind the curve in capturing the recent increases. According to a weekly survey of pump prices around the US, gas prices are currently within 5% of the average that consumers paid in 2007. By contrast, the CPI shows gasoline as nearly –20% lower than its 2007 average.

Inflation Trends Over Time: Many Goods and Services Rise in a Stairstep Pattern



Source: California Department of Industrial Relations.

Our chart displays an important characteristic of prices of goods and services in the real economy. Unlike the liquid capital and commodity markets — which normally provide a different indication every day and, now, even intra-day — prices move more slowly in the real economy. So, one often sees a “stair-step pattern” like the California minimum wage shown above. The prices of postage stamps, magazines, haircuts, subway rides and numerous other goods and services display a similar pattern. Sometimes prices may remain static for an extended period, and sometimes they rise more quickly. It is difficult to determine the underlying inflation rate without some perspective.

Last week, the Four Seasons restaurant in New York celebrated its 50th anniversary. Unlike some restaurateurs, Four Seasons management did not roll back its prices to those charged at its founding. But they did provide a peek at the lunch menu from 1959; a quick comparison of three items showed an average annual increase of +4.5% over 50 years. So in terms of fine dining, the dollar has lost almost –89% of its purchasing power over that time. For the CPI overall, the loss has been closer to –86%.

The lesson for investors is that one can never ignore inflation, and that markets will adjust as inflation expectations rise and fall ... one cannot wait until an inflation problem is unambiguous to protect one’s portfolio against its possible reemergence. Stock and bond markets performed much better than average for twenty years after inflation began falling in 1980 and valuations still appear to incorporate modest inflation expectations over the longer run. If inflation expectations continue to rise, the bond market will likely continue to struggle.

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