

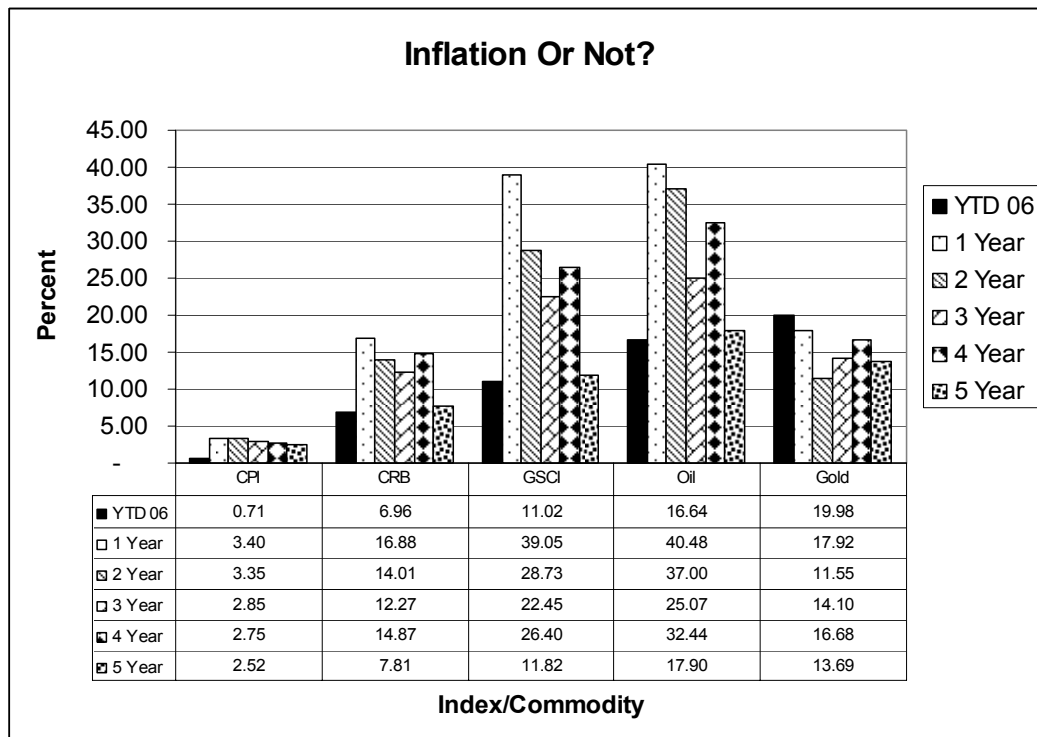
## Wants & Needs

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Inflation needs revisiting. In the first quarter of 2004, in an article entitled “Contrasts On Inflation” I raised the question of whether inflation was making a comeback, saying that “inflation...could return with a vengeance.” It hasn’t yet (according to the Fed), but at least the Fed is on-point, raising the discount rate every chance it gets and fiddling with the CPI calculations to make their life easier.

I pointed out at the time that for the 5 year period then ended, that the Commodities Research Bureau Index (CRB), the Goldman Sachs Commodity Index (GSCI), Oil, and Gold were up on an annualized basis by 8.14%, 12.86%, 16.58%, and 8.76%, respectively. Over the same five year period, the Consumer Price Index was only up an annualized 2.46%.

Let’s refresh the numbers from 2004 and look at them now.



The table above shows the year-to-date 2006 (YTD, through 4/18/06), and the 1, 2, 3, 4, and 5 year increases for the various commodities and indexes for the period ending 12/31/05. All percentages are annualized except the YTD figures.

Study this graph for a while. Keep looking at it. Don’t come back to the text yet. OK, now. Double digit inflation is rampant by every measure except one – the Consumer Price Index. Why? I’m not sure, but I did find out some interesting stuff.

I believe that CPI as a measure of inflation would have died years ago if it were not for COLA. Not Coca Cola, of course, but that annual Cost of Living Adjustment embedded in EVERYTHING the government does. At its most basic level, the COLA determines the annual increase in most, if not all, of the entitlement programs in our country.

The government has an inherently biased interest in keeping the reported CPI number manageable. Otherwise, the bond market goes in the tank, the currency spirals out of control, and entitlement programs drive this country bankrupt quicker than is now anticipated, but certainly within my lifetime. As Carl Pellegrini of Analytics, Inc. pointed out, "Citizens whose incomes are based on CPI adjustment escalation clauses are not receiving proper compensation and some smart lawyer will sooner or later have the basis for a great big class action suit." To say that the manipulation of CPI is criminal is an understatement.

Here's the stuff I discovered. Aluminum prices are through the roof, but nationwide registrations of motor homes fell by 26% in January 2006 from the year earlier period(1). The cost of money (interest rates) is creeping up – 30 year fixed mortgages are around 6.50% and according to RealtyTrac there was a 68% increase in mortgage loans in foreclosure in February 2006 versus last year(1). Oil is up almost 17% so far this year, while actual inventories are at an eight-year high(1). According to the Wall Street Journal (April 19, 2006, p. A12), "commodities across the board have been on a two-year price run not seen since the late 1970's." "...in our experience, no similar surge in global commodity prices has ever occurred without an accompanying rise in general inflation."

Digging deeper into the CPI I discovered that the largest component of the CPI is imputed rent – an estimate of the cost for those that own their own home. The fact that inflation of rental housing is increasing well in excess of the imputed estimate should cause one and all to question the ethics and agenda of these statistics (CPI)."

Oil, and thus gasoline, which is up almost 18% annually over the last five years and up another 17% so far this year, comprises less than 5% of CPI(1). And expensive televisions (yes, TV's) forget about them entirely. We have seen dramatic improvement in their quality, size, definition, flat-panel versus tube, etc. All this technology comes at a higher dollar cost. You might pay twice as much for a TV today as you did ten years ago, but the government, in its infinite wisdom, thinks the price of televisions is going down. According to Barron's(1), "but government statisticians, observing the same quality improvement that brings people to the stores, make adjustments and report that the price of TV sets is falling." According to the government, the price of televisions has fallen 59% in the last nine years(1). Go to Best Buy and see if you can confirm this for yourself.

According to Barron's, there is a current theme filtering through the market regarding "need" inflation versus "want" inflation. If you look at inflation closely, the things that we need, like gas, food, clothing, shelter, and medicine are inflating more rapidly than the things we want, like huge flat panel TV's, computers, cars, and such. At some point, this all has to come home to roost. The fact that the government is cooking the inflation books because they can't afford not to, combined with the fact that the price of our needs is going up dramatically will eventually be reflected in the economy. The fact that the consumer is massively leveraged, coupled with that fact that fully 43% of first-time home buyers made no down-payments on their home purchases in 2005 and 42% of loans last year were interest-only or ARM's(2) does not bode well. Can we work through these issues – yes; will it take some deft and skill – absolutely.

The silver lining in all this may be the continuing effect of productivity, globalization and quality improvements (think TV's and computers). Each has an apparently large offsetting influence to commodity price inflation, at least so far. Labor and capital move around the world nearly instantaneously to the highest level of efficiency. Over time, this can only serve to enhance worldwide living standards (China is in the early stages of this) and serve to inject growth into the world economy, including the U.S. Younger generations tend to embrace Western culture (maybe even values) when given even the briefest exposures to capitalism and democracy.

(1) Barron's, April 17, 2006.

(2) SAMCO Capital Markets, Bond Market Review, April 17, 2006.

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