

The Dirty Little Secret: Stealth Inflation

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Today, stock and bond markets appear to be booming and gold has fallen. This is based on a lowered geopolitical risk, lower oil prices and low inflation together with an expected fall in interest rates. The key is the outlook for inflation – but what is the real rate of inflation? You’ll be surprised!

When I filed my income tax return this year, I found that my deductible expenses had risen far faster than the 2.8% published Consumer Price Index (CPI) inflation rate. Unquestionably, many readers must have had a similar experience. The costs for transportation, housing, and commodities have risen across the board. So how can the published “official” CPI be so far below the “real” rate of inflation actually experienced by consumers?

Last month, FIR’s publisher Christopher Ruddy touched on the inflation matter. It is an important topic --- one of the most critical for investors, and we are exploring it once again this month.

The stock market is hoping for a downturn in economic growth, but only a downturn that helps bring interest rates down without hurting profitability.

It is a wonderful hope--- but likely illusory.

So great in this fascination with interest rates that we have recently seen the strange phenomenon of the “hope-inspired” stock market taking its lead from the more prudent bond market, as they keyed-in on the 10-year Treasury yield as a predictor of lower rates. The real Fed rate is at a historically low 2.45% (5.25% less core CPI inflation at 2.80%). Fed action on interest rates is dependent upon a subtle balance between inflation (headline, core and the true rate) and the outlook for economic growth, with a serious weakening in retail housing.

This is quite some balancing act!

At present the Fed is on “hold,” but what next?

On Oct. 12, *The Wall Street Journal* reported the U.S. budget deficit had shrunk by a whopping \$71 billion, based on lower tax rates yielding greater aggregate taxes.

This was a major event showing that lower tax rates do create enterprise, more jobs and more aggregate taxes.

However, the good news was offset by news that the U.S. trade deficit had ballooned 19%, compared with last year, to a gigantic \$69.9 billion for the month of August.

Furthermore, the published minutes of the September Federal Reserve Board meeting showed a worrying, long overdue, but little-noticed concern over inflation.

The minutes of the Fed showed that “members continue to see a substantial risk that inflation would not decline as anticipated by the committee” when they left rates on hold at 5.25%.

Apparently, several Fed members worried, “inflation expectations could rise and the Fed’s willingness to carry through on its intention to seek price stability could be called into question.”

We feel talk like this from members of the Fed should make the air feel decidedly thin at the present high levels reached by both the stock and long-bond markets.

Also reported by Bloomberg on Oct. 10 was a report that Warren Buffett had told his senior managers to resist the temptation to use “accounting gimmicks.”

We feel, in the long-term interests of all Americans, the Fed should be duty bound to consider the real rate of inflation, rather than the great “Inflation Lie” that FIR has long warned is published by the Bureau of Labor Statistics, which monitors inflation and publishes the CPI.

U.S. economic growth rates are relatively accurate and well known. Unfortunately the same is not true of inflation rates.

In April of last year, FIR alerted readers to “The Inflation Lie.”

In this article, we urge readers to look again and to beware of stealth inflation.

Why stealth inflation? Because it is being hidden from you by our government. Inflation is here, but we don’t see it.

In the fond belief in the low government inflation index, the financial markets have brought long-term bonds to yields below the rate for Fed funds and a Dow index that breaks new record highs.

We hope our readers will not get led along this road in a stampede towards financial vulnerability.

In this article, we aim to prepare our readers for the inflation shock that awaits the unwary.

Inflation --- The Big Lie!

We have bills for gasoline, heating oil, housing, and particularly prescription drugs and healthcare that have all increased substantially more than the 3% increase CPI claims for 2005.

So how is it possible that the core CPI, published as an official government statistic, is now a historically low 2.8%? Can it be true?

It cannot. It’s a gigantic con to keep us quiet. And judging by the money flowing from real estate and commodities into long bonds and stocks, it is working and working very well.

The trick is that by excluding such items as energy and health costs, and by including only the rental equivalent rather than the actual asset price of housing from the index, the core CPI is up only 2.8%.

With low inflation, government increases in payments to entitlement programs --- like Social Security and government employees raises --- are kept to a minimum.

At a time of low interest rates, who can justify a bid for higher wages?

Also, low “official” inflation has led to low interest rates (since the Fed says they look to inflation for seeing their rates) and a relatively low cost of government debt.

Today, investors and certain media pundits forecast a “Goldilocks” economy (not too hot, not too cold, but just right) if the Fed lowers rates in November. And of course, the lower our interest rates, the higher both bond and stock markets will roar.

Most of us are patriots and tend to believe official government statistics. But historically governments lie.

What we had felt to be a level of degraded honesty typical of continental European and Third World governments is now common currency amongst our own leaders in the U.S.

We urge you to beware of Stealth Inflation or risk severe losses on your stock and bond portfolios.

How did this debased deception of the people start?

It started way back in history, when even Roman leaders started to dilute the gold content of their coinage. Today, even our own penny piece contains less than 5% copper!

As we reported in FIR in April 2005, John Williams, head of the Shadow Government Statistics, explained:

1. The Kennedy administration redefined the unemployment rate to avoid political discouragement.
2. Lyndon Johnson insisted upon the redrafting of GNP figure until his Commerce Department, "got it right."
3. Carter was caught deliberately understating inflation.
4. Bush Senior began efforts to lower the reported CPI, systematically.
5. Clinton set the stage for the adoption of a new and lower-inflation CPI.
6. Our current President has expanded upon the expertise of Clinton.

So, shading the CPI inflation index is not new, just more refined and abused.

As stated in last year's FIR, Williams estimated the then-true CPI was closer to 6% rather than the stated 2%. He was supported by Agora Research who put the true CPI at between 7% and 8%.

That is two to nearly three times the published rate!

In a recent Barron's article, Rudolph-Riad Younes, co-manager of Julius Baer International Equity Fund (with an average growth of 17.55% for each of the past five years), arguably one of the best managed funds in the world, pointed out that even The Bank of England commented that the American CPI should include energy.

Younes went on to say that house asset values should be included rather than merely the rental equivalent (see more below).

Finally, Mr. Younes believes that if only housing were included in the make up of the true CPI the index would be between 7% and 10%.

At 10%, this is five times, or 500%, higher than Fed Chairman Mr. Bernanke has publicly expressed as the 2% upper limit of his "comfort zone" on inflation!

We are left only to wonder what the true level of inflation would be if it included not just house asset prices, but energy and healthcare. No doubt, it would be higher than 10%!

Why Are the Inflation Books Cooked?

High inflation is bad for business, particularly the business of politics. Increases in Social Security payments are fixed to inflation and would rise dramatically.

If the true inflation rate were declared, U.S. interest rates would have to rise sharply. The cost of government debt, including the hundreds of billions of U.S. Treasury debt held by China, would rise dramatically.

Increased interest rates would have a major depressing effect upon the U.S. economy and on stock and bond markets, risking a return of the stagflation that plagued western economies in the 1970s.

There are therefore pressing economic, financial, and electoral reasons for the government to maintain the illusion of low inflation.

The strongly adversarial party politics of today militate against the acceptance of risk, even in the national interest. So, expect the official rate of inflation to remain falsely low, until it explodes upon us. Then watch out!

In the meantime, be prepared.

How Are the Inflation Books Cooked?

Our readers may well wonder how such gross manipulation of a key published government statistic can be achieved, let alone be justified.

As FIR stated last year, there are several ways in which governments can hide information and keep the CPI artificially low. These include:

1. Geometric weighting. This allows for the lower weighting of any goods and services considered “too volatile” by the government. Their prices are considered as only temporary and therefore disruptive to the statistics. This all sounds great in theory, but it opens the door to statistical manipulation at the government’s whim.
2. Hedonic adjustments. This involves the reduction of the price increases of certain items by an arbitrary amount, reflecting an increase in “quality.” As we said last year, today’s Ford would scarcely have increased in price, officially, since the Model T Ford sold for \$300! Statistical manipulation?
3. Ignoring quality decreases and “on-sourcing.” In the old days, the post office provided four deliveries a day. Gas stations pumped gas, checked oil, and cleaned windshields. Today, these services have been reduced at the post office or at the gas station and “on-sourced” to the customer. But the higher effective cost relative to the reduced service is not reflected in the makeup of the CPI. Statistical manipulation?
4. Assumption that consumers will turn to cheaper alternatives. If the price of a meal at a restaurant went up, customers would move elsewhere, so it is not a “justifiable” increase. Statistical manipulation?
5. Exclusion of goods and services subsidized by the government. In this conjuring trick, the retail price is included, but *not* the actual cost, which contains the government subsidy. Items like airport security, public schooling, interstate highways, and housing for the poor, although provided at greatly increased prices, are largely excluded from the makeup of the CPI. Statistical manipulation? We think, definitely!

Consequences of Mass Deception on Inflation

Of course, the government has tried desperately to avert the economic depression that loomed after 9/11. Every financial spigot was opened at full force, in an unprecedented manner. Liquidity and credit were made available at record low rates of interest, sometimes even given away at negative real rates of interest. Government spending was unleashed on a massive scale.

Five years later, it has amazed us and many other observers that such actions did not unleash a major inflation wave.

Of course, there have been some legitimate factors holding inflation down. The Far East, particularly China, has exported deflation to the U.S. on a vast scale. Until 2004, even the fall in commodity prices was deflationary.

But the price of commodities turned around in a major way in 2005 and 2006. Indeed they went wild and yet inflation remained strangely benign. Why? Because of the “now you see it, now you don’t” cooked books!

Foreigners and currency traders have recognized the problem for some time, hence the fall of the dollar against the Swiss franc, gold, and even against other depreciating currencies such as the euro, sterling, and even the yen!

What is truly worrisome is though the Fed has moved to raise interest rates dramatically from a low of 1% to over 5%, the dollar has not strengthened but actually weakened. Any modern government faced by inflation and depression will accept inflation. Depression can be devastating, both economically and politically, taking many years to correct. So, we can understand a government decision to accept inflation, especially if they can distort the real figures in order to disguise inflation in the short to medium term! The downside of such a policy is that it can so easily lead to the onset of the stagflation that bedeviled western economies in the 1970s.

Last year FIR's Christopher Ruddy pointed to the depreciation of the U.S. dollar, caused by an inflation that has been hidden from the American people.

He wrote: "I have believed that for years the federal government has deliberately been understating inflation. I became suspicious of the CPI [inflation] rates when oil tripled in price in the late 1990's but had a negligible effect on inflation."

He continued: "There is evidence inflation statistics have been manipulated for about 10 years. If government understates inflation by just 2 percentage points a year, the cumulative effect over 10 years, is about 22% extra inflation --- almost *doubling* the 'official' rate over the same period."

Finally, he added prophetically: "This phenomenon of phony inflation provides an illusion for Fed policy makers, who can claim inflation is low. They in turn keep interest rates low. Then, low interest rates cause everyone --- from individuals to government --- to overspend, thanks to artificially low (and unsustainable) interest rates and easy credit." Well, what Christopher Ruddy predicted last year has become reality. The problem is when it unwinds. That will be the day of reckoning for government, consumers and markets alike.

On Sept. 16, the legendary inflation-busting former Fed Chairman, Paul Volcker, said he is, "worried about inflation and the [political] pressure [put] on the U.S. central bank to do nothing about it. This sounds similar to the political pressure put on American generals to say that they had enough to ensure victory in Iraq, and must raise alarm bells to any serious observer."

This important public statement was echoed by other influential financial practitioners who had a massive vested interest in not "spooking" the financial markets.

Gerald Corrigan, managing director of Goldman Sachs Group, was reported as saying, "...there is a small risk that the old inflation genie could sneak out of the bottle on us again. Once the genie is out of the bottle, it is very, very difficult and expensive to put it back in the bottle."

Chris Rupkey, senior financial economist of Tokyo-Mitsubishi UFJ in New York said: "...time will tell whether waiting [to continue raising interest rates, by the Fed] was the correct policy response." Then he added: "A warning on inflation-creep by the man [Paul Volcker] who tamed inflation could make some policy makers nervous."

Recently, Michael Moskow, president of the Chicago Fed, said, "the risk of inflation outweighs the risk of an economic slowdown right now ... Some additional firming

policy may yet be necessary to bring inflation back to a range consistent with price stability in a reasonable period of time ... By my standards, inflation has been too high.” All of these statements were based not upon the “real” rate of stealth inflation, but upon the cooked, official CPI.

What would they have said had they been speaking about the “true” inflation rate? Today, wage rates, unit labor costs, and consumer spending are rising fast. And yet inflation remains low at around 2.8%. Why so?

Well, after a very tight election, the government is desperate to keep mortgage rates down. This is particularly so in the states that are incidentally suffering the most in the housing correction --- Arizona, California, and Florida.

Mortgage rates are geared directly to interest rates. Interest rates are not geared but closely linked to the inflation rate --- the official inflation rate, that is. This is a dream world, where the 10-year Treasury is yielding 4.8% (as of Oct. 12), or just 2.0% in “real” money (above the official inflation rate).

The renowned international economist Lord John Maynard Keynes said, “It is the expectation of future interest rates that sets yields in today’s bond markets.”

A 7% inflation rate is more than two times the current 2.8% official core inflation rate --- a rate that already concerns Fed Chairman Ben Bernanke! He must also be more worried by the headline inflation rate of 3.8%.

In the meantime, it is understandable that U.S. stock and bond markets roar ahead. They expect today’s record corporate profitability to continue and are blind to stealth inflation. In their present irrational stampede, the U.S. stock markets are looking not for an *increase*, but for a *decrease* in U.S. interest rates.

Can you imagine what, in today’s markets, the realization of even a 7% inflation rate would do to the expectation of futures interest rates?

If the real inflation rate was to be exposed publicly at say just 7% (about what Williams and Agora felt, last year, would be the true rate if just partial reality were restored), what panic would ensue as the 10-year Treasury fell in price until it yielded 9%, just some 2% above inflation, without any expectation of future higher rates?

Stock markets would plummet as longer-term bond yields and the directly linked mortgage rates rose in even greater panic.

We believe you would not want to be in long-term investments, other than gold, during such a panic!

In short, a sudden rise in interest rates would lead to panic selling in the financial and real estate markets and panic buying of gold and commodities --- the exact reverse of what is happening today!

However, when the true inflation rate eventually leaks out, readers of FIR will not be those in a panic because they will have been forewarned!

Real Estate

With inventories of both new and existing houses at record levels, residential real estate prices look set for further declines.

We agree with Fed Chairman Bernanke that there is unlikely to be a soft landing for retail housing.

With the prospect of well over \$1.5 trillion worth of adjustable rate mortgages to be reset, we can expect foreclosures to rise.

It is uncertain yet what adverse effect a fall in residential real estate will have upon consumer spending, so long as after-tax money remains so cheap. But if the true rate of inflation leads to a large increase in interest rates, we feel both consumer sentiment and spending will fall, possibly dramatically, as the cost of consumer debt could rise alarmingly.

However, the commercial real estate sector continues to boom.

We believe considerable profits can still be made in astute investments in commercial real estate in areas of growing populations.

Bernanke:

No Soft Landing for Housing

Federal Reserve Chairman Ben Bernanke admits that the housing market is going through a “substantial correction” right now. That’s far from the tune the Fed was whistling earlier last year when it said a soft landing was probable.

“It seems pretty clear now that the U.S. housing market is cooling,” Bernanke said in May. “Our assessment at this point ... is that this looks to be a very orderly and moderate kind of cooling.”

Yesterday, though, Bernanke relented, calling the decline in housing “one of the major drags causing the economy to slow now” and that the slowdown could shave as much as 1% off the nation’s growth in the second half of 2006 and “probably” impact growth in 2007.

“I think I would estimate that slowing housing construction will probably take about a percentage point off growth in the second half of the year and probably something going into next year as well,” Bernanke said.

Bernanke made his remarks after a speech to the Economic Club of Washington in November. The speech focused on baby boomers and their impact on the economy. The Fed is monitoring the housing market to see if there is any spillover into other areas of the economy. “We’ll be watching to see what extent this decline in construction and moderation in housing prices affects consumer behavior and behavior in related industries ... that’s a key,” said Bernanke.

Bernanke believes that the healthy job market and low interest rates will help the real estate sector rebound. He also pointed out that strength in commercial real estate might help to offset the job losses in residential real estate.

“I think there are some strong fundamental underpinnings that should help the housing market over the medium term. These include a good job market, strong income growth, demographics, and continued low mortgage rates,” he said.

“Ultimately, the housing market is going to be supported by those factors,” he added. For now, both sellers and buyers are sitting on the sidelines, waiting for prices to stabilize.