

THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

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Asset Allocation

THE CPI: HOW - AND HOW WELL - IT WORKS AS A MEASURE OF INFLATION

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After the 2008 global financial crisis, the main concern of central banks was *deflation* - prices falling to such an extent that would push economies into depression. However, due to effects of the COVID-19 pandemic and subsequent actions taken by governments and central banks, the pendulum swung the other way. There has recently been a resurgence of inflation to levels not seen in over 40 years.

Inflation is defined as the rate of increase of prices and the subsequent loss in a currency's purchasing power. The measures of inflation quoted most often in the Canadian press are the Consumer Price Index (CPI), and the CPI-trim, which strips out the extreme price movements of the top and bottom 20% of the CPI basket.

Statistics Canada (Statcan) calculates both the CPI and CPI-trim. How? Statcan collects information on over 700 goods and services that Canadians typically buy each month. Statcan then adds up the total cost of this basket of goods to track the month-by-month changes. They weight the basket based on the combinations of goods bought across different geographical areas. For that reason, the spending habits of Ontarians have the largest impact on the CPI figures. Statcan updates and weights the consumer baskets every two years.

Like any type of index, the CPI operates with various assumptions and rules. These, in turn, govern how each basket is put together. People often differ on how relevant or accurate a basket is for their own individual circumstances. For example, the health and personal care portion of the basket might be larger for seniors. The shelter cost might be larger for those people with a mortgage or renting.

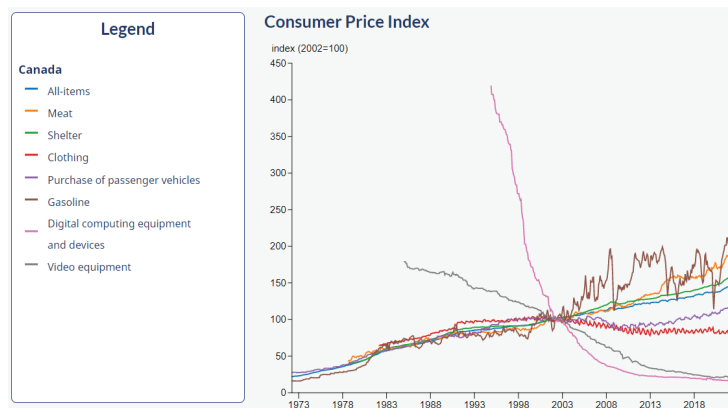
Another example: Just as many investors own a different basket of stocks and bonds at any one time, each consumer in the economy has different spending habits. Therefore, each has different opinions as to how relevant the CPI figure is.

Note that the CPI figure is meant to be a sample of the spending habits of the *average* of the population. Many people vary from the average, and like any sampling process CPI's is subject to sampling error and biases.

At right is the CPI composition in Canada as of April 2022.

	Relative Importance %	Current Level (2002=100)	Annualized Growth %	Apr. '21 - Apr. '22 %
All ITEMS	100.00	149.8	2.04	6.8
Food	16.24	169.0	2.66	8.8
Shelter	30.03	161.9	2.44	7.4
Household operations, furnishing & equipment	14.89	129.8	1.31	4.1
Clothing & footwear	3.99	95.1	-0.25	0.2
Transportation	15.96	166.3	2.58	11.2
Gasoline	3.57	251.7	4.72	36.3
Health & personal care	4.68	137.0	1.59	3.4
Recreation, education & reading	9.40	121.6	0.98	4.1
Alcohol, tobacco & recreational cannabis	4.80	179.8	2.98	3.1

Gasoline prices have gone up the most in the past 20 years. In the past two years, gas prices soared from a very low base. (Remember when oil briefly went below \$0 in April 2020?!) The cost of clothing and footwear has actually fallen in nominal terms. Both items still represent relatively small parts of the average consumer basket of goods. Shelter, household operations, furnishing and equipment, and food and transportation collectively represent just over 75% of the average consumer basket.



The main contributing factors to the recent surge in inflation have been increases in the larger components of CPI: food, shelter and transportation.

Some aspects of the sampling process have been shown to overestimate inflation, notably:

- **Lag time in adjusting the index:** Due to infrequent rebalancing, any new consumer goods or technologies that effectively lower prices for consumers are not instantly reflected in the CPI.
- **Substitution bias:** Say the price of beef goes up. As a result, the consumer eats more chicken. The CPI still assumes the same amount of beef is being eaten. In reality, differing items have different elasticities of demand, with some items being more easily substituted than others.

The Bank of Canada's interest rate policy often focuses on the CPI-trim, which strips out extreme components not viewed to be sustainable changes. Why? The sometimes highly volatile price changes in food and energy have not shown to persist over time. Not surprisingly, the Bank's approach has come under criticism. Food and

energy tend to make up a larger portion of some people's expenses as a proportion of their overall cost of living.

In our Personal Financial Plan process, we incorporate the CPI to reflect how your government and other pension benefits might grow. However, we also have the ability to separately define your own personal change in spending. This is important if you believe your spending changes might differ from the CPI now and into the future.



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