What is Canada's inflation rate? [1]

If you thought the answer to be around 2% then you, along with most Canadians, subscribe to the long-run targeted rate of inflation by the Bank of Canada. A more robust answer to this question is a measured one. This is because there is a myriad of ways inflation is measured, and the measure that matters depends on who is asking. The average Canadian is most concerned with the rise in their cost of living. On the other hand, the Bank of Canada is most concerned with identifying the average underlying trend in inflation that looks through temporary changes. Some observers even question the methodologies of measuring inflation, and have come up with several viable alternatives that give quite different results. While varied measures exist, inflation considerations are a basic starting point when constructing portfolios for the long-run.

The Consumer Price Index (CPI) tracks price changes in a sample of 600 consumer goods and services and assigns weights to each. This sample basket is designed to reflect the goods and services the average Canadian household buys. A glaring issue with this basket is that we don't all buy the same goods and services (or even the same goods and services in this representative basket) and we don't all buy them in the same proportion. Despite the short-comings of this measure it is the broadest measure available, and has served as an approximation of changes in the cost of living.

To look through temporary changes, the Bank of Canada focuses on "core" inflation, which drops eight historically volatile components from the calculation of the CPI: fruits, vegetables, gasoline, fuel oil, natural gas, mortgage interest, intercity transportation and tobacco products. Clearly, this measure removes significant components from the basket that the average Canadian cannot - nor can the consumer easily substitute these vital components. The Bank of Canada's focus on the underlying trend is important for setting monetary policy that aims to control the level and trend of inflation. It is intuitive to think that volatile components should be removed for the purpose of identifying the underlying trend in aggregate inflation; however the ability to change and modify the measurement leaves some to question the quality of the output.

Observers have questioned the numerous changes in methodologies of measuring inflation that have occurred over the past few decades. John Williams, an economic consultant in the U.S., noticed a dramatic shift since the early 1980's in the measures he tracks. He notes two factors were used to adjust the CPI lower during this time through a process called 'hedonic modelling' (a process also used in Canada) which are 1) the reduction to the inflation rate from improved product quality, and 2) substitution—the idea that consumers will switch to cheaper products in the face of higher prices on their preferred goods and services. He notes, "The US reports inflation around 1.5% per year right now, but if you look at the changes they've made in their methodologies compared with what was done in 1980, the CPI is being understated by about 7 percentage points each year." (See graph[3])

While this is the U.S experience, Canada's inflation rate has tracked the U.S. inflation rate quite closely[2] and uses similar calculation methodologies. Given the interconnectedness of our economies and shared practices, it stands to reason that underestimation is also occurring in Canada. The CPI in both Canada and the U.S. becomes the baseline for adjustments to various expenditures. This creates an environment for governments and other central bodies to be incentivized to keep reported inflation low, which in turn keeps expenditures low. For instance, the inflation rate calculation is also used in government employee compensation and pension escalators, so there is every incentive to low ball the official number. Meanwhile, Canadian consumers and businesses bear the full brunt of cost-volatility as a result of the removal of vital components from the "core" CPI measurement. This situation gives rise to many Canadians having the impression that their inflation experience is markedly different than the reported number.

For investors, and retirees, it's important to know that the official numbers are not necessarily representative of real life and have important implications for portfolio construction. Inflation is particularly detrimental to real (after inflation) returns to bond holders with no inflation protection, because their coupon payments are generally fixed. Stock investors are in a better position to maintain real returns as companies seek to pass through cost increases to consumers in the form of higher prices.

SEAMARK has long believed our bottom-up stock selection philosophy and acute awareness of risk (including the pervasive inflation risk) allows us to provide investors with the greatest opportunity for real wealth accumulation over the long-term.

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1. http://www.theglobeandmail.com/report-on-business/the-logic-and-lunacy-of-calculating-the-inflation-rate/article25008805/

2. (*Figure 3)* http://www.economics.utoronto.ca/jfloyd/modules/infl.html

3. http://www.shadowstats.com/alternate_data/inflation-charts