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Second Quarter 2021

Welcome to Hedonism

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Using sensationalist headlines is an editorial tactic that has proven extremely effective during the internet era. Spicy headlines excite potential readers to click through to see what lies behind the headline. More often than not, the body of the story doesn't live up to the sensationalist headline. Fortunately, that will not be the case this time. Our spicy headline is in reference to the Hedonic Quality Adjustment (HQA) of the Consumer Price Index (CPI). Now that we have you hooked……

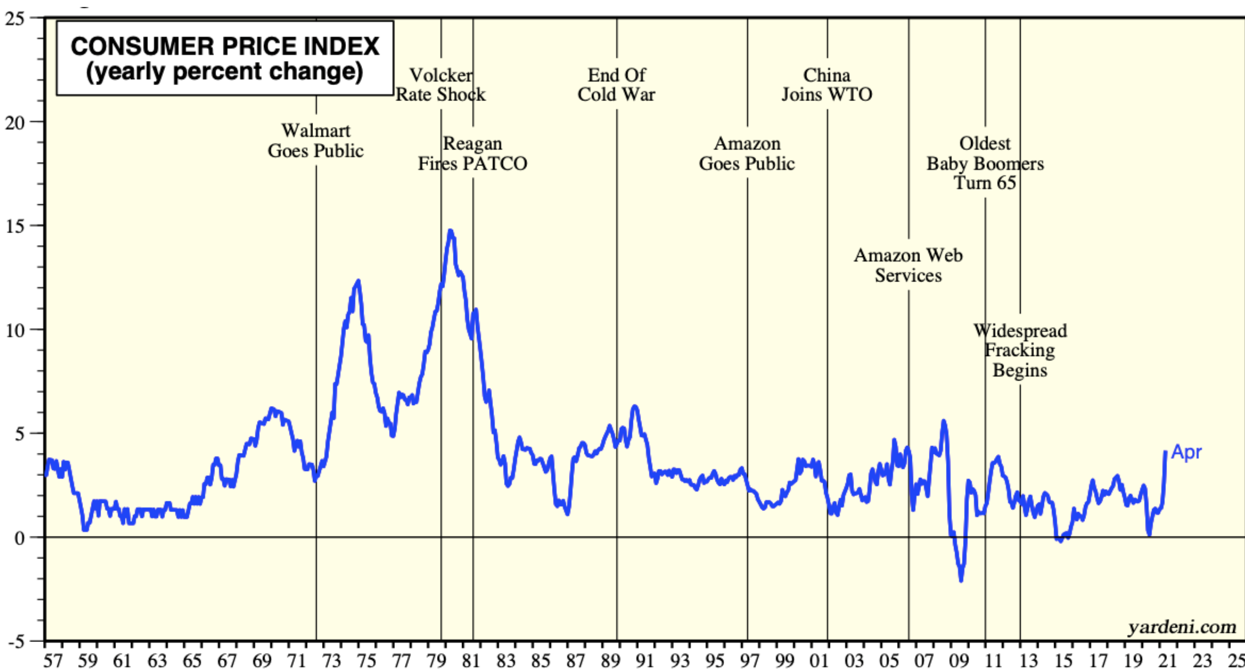
We continue to receive questions from our clients regarding inflation. By the way, we love hearing from you, please keep the questions coming. Oftentimes your questions make us think of a topic from a different perspective and we appreciate that. Many of your inflation questions have been anecdotal. The general gist is "how can there be no inflation when I use to pay X for my widget and now, I'm paying 2X"? Although it's counterintuitive, just because prices are higher doesn't necessarily mean inflation needs to be higher. The Bureau of Labor Statistics (BLS) performs a Hedonic Quality Adjustment to the basket of goods it uses to measure inflation. For example, if the price of a product doubled, but its *quality* also doubled, the Consumer Price Index (CPI) would measure zero inflation for that product.

The hedonic quality adjustment removes the component of price change in a product that is attributed to a change in the quality of the product. Innovation and technology have greatly improved the products we use in our everyday lives. Your dishwasher today is far superior and lasts longer than your dishwasher in the 70s'. Mercifully, it also isn't Avocado Green.

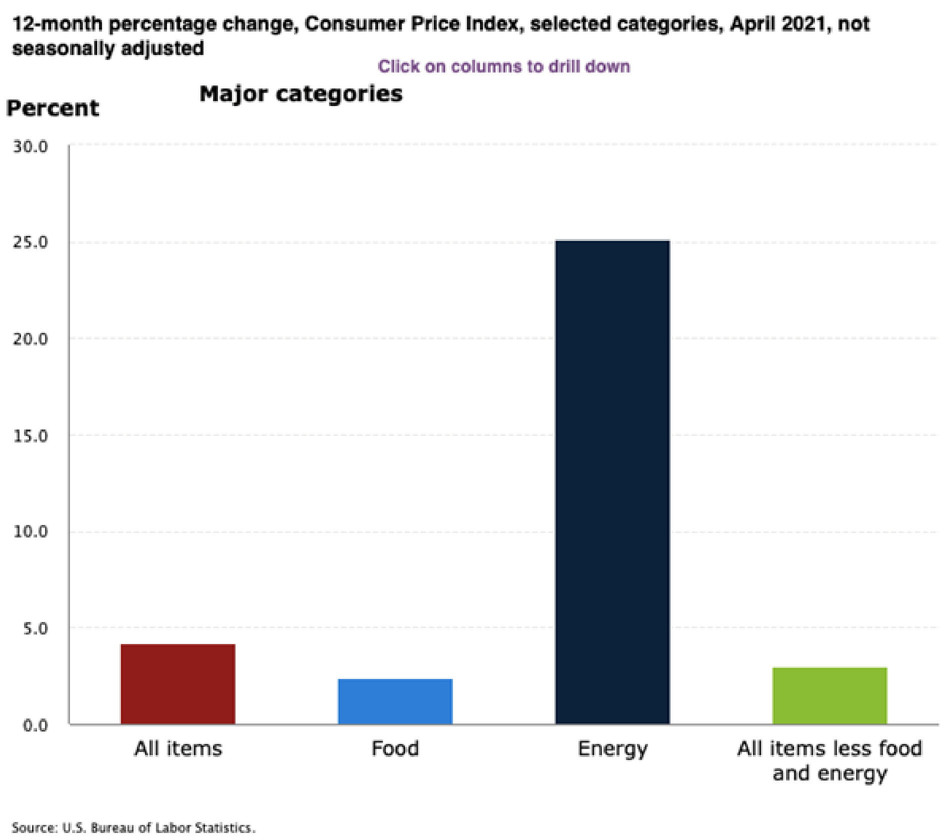
While definitionally the same, the word hedonic has a much different connotation when used by an economist. The Greek origin of hedonic is “relating to pleasure.” Economists equate pleasure and utility and consider these words synonyms – hedonic is the measure of satisfaction derived from consuming a good. Only an economist could make hedonism boring. Economists at the BLS use hedonic regression models to determine the extra utility derived from the improvement of a product. Inflation for the product is then adjusted lower to reflect this increase in utility.

The BLS provides the mind-numbing mathematics of their hedonic regression models on their website. In fairness, they also do their geeky best of providing a simplified example of how they adjust for innovation (improvement). They use television sets which are an excellent example. The third most expensive purchase for households from the 50s’ to the 80s’ was the television set, trailing only houses and cars. We used to pay a couple of hundred dollars for a 200lb CRT black and white screen measuring 13 inches on the diagonal. On a good day, your rabbit ears pulled in 3 different snowy channels. Today we pay about the same price for a 46-inch color LCD screen weighing 20 pounds that hangs on our wall. It’s not fair to simply say the price of television sets hasn’t changed over time. They’ve become dramatically cheaper when adjusted for quality. The increased longevity of cars and faster computer processing speeds are additional examples of how the HQA is used in recognition of improved quality.

The CPI tells us that that we have not had material inflation over the last 40 years. In 1980, Fed Chairman Paul Volcker broke the back of the inflationary 70s' by dramatically raising short-term interest rates and purposely putting the country into a deep recession. Over the decades that followed, globalization and technology have greatly increased supply, which is deflationary. We believe that's why despite all the deficit spending over the last several decades (increase in demand), prices have not materially increased.

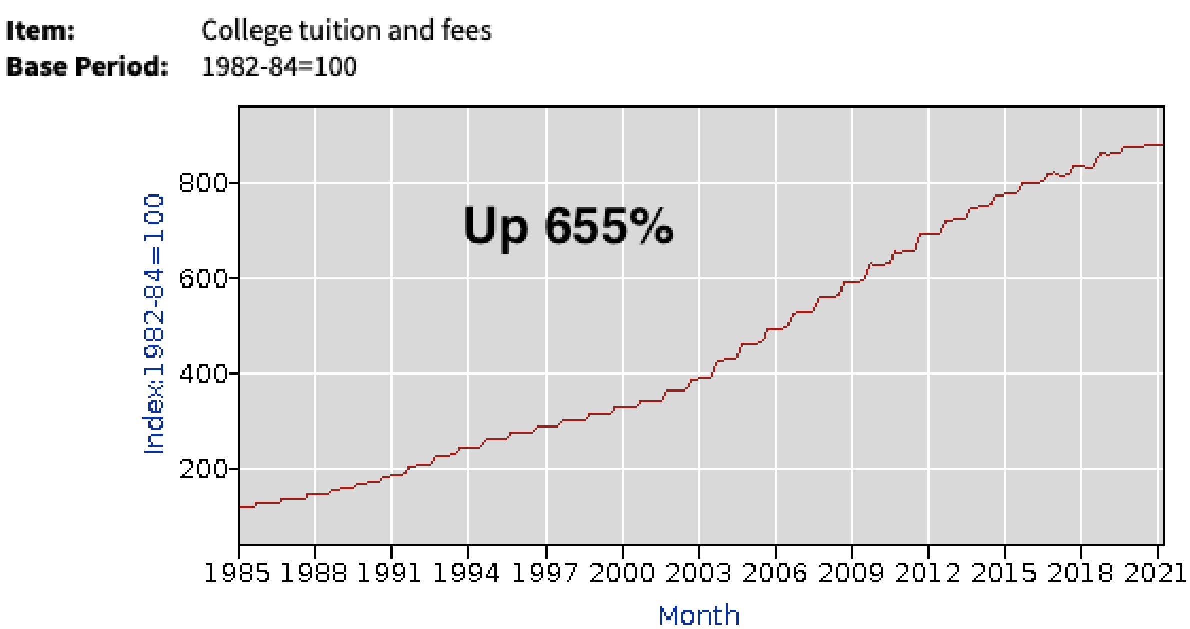


Needless to say, there is a subjective component to measuring inflation. We would also argue inflation is in the eyes of the beholder. If you've eliminated your commute and are working from home, inflation might seem quite tame. If you're an OTR trucker, inflation is ridiculously high and eroding your profit margin.



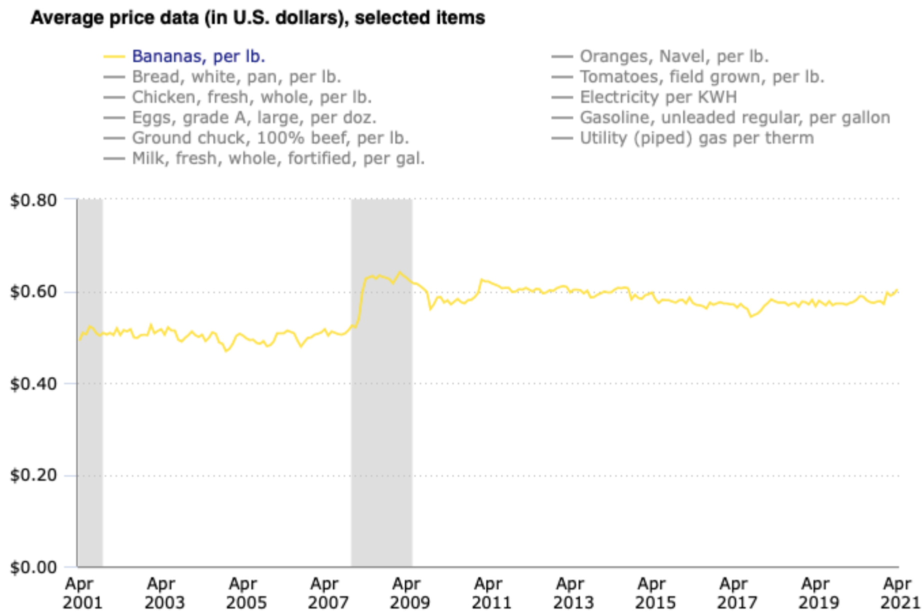
When referencing aggregate indicators like CPI, macroeconomists focus on the headline CPI number, not the components of CPI that make up the headline number. As we see above, these components can vary greatly. Economist humor is greatly underappreciated. Economists joke that if your feet are in the freezer and your head is in the oven, on average you are at the right temperature. While this is true at the aggregate level (macroeconomics), microeconomics which focuses on the individual, tells a very different story. As parents of college students, we were particularly sympathetic to one email bemoaning the rise in college tuition. "25 years ago I paid $17,000 a year to go to the same school my kid is now paying $72,000 a year to go to, and he's currently online!"

Now you've got us all riled up. Writing college tuition checks will do that to a person. Here's a recent article from Forbes Magazine that states, "*the average cost of attending a four-year college or university in the United States rose by 497% between the 1985-86 and 2017-18 academic years, more than twice the rate of inflation."* We decided to jump headfirst into the BLS website and get some answers. Sure enough, it confirms the findings of this article. According to the Bureau of Labor Statistics, if you graduated college in 1985 and now have a college student of your own, you are paying 655% more for your child's education than you paid for your own. That sure sounds like inflation to us!



Looking into the methodology the BLS uses to calculate *College Tuition and Fees* inflation was eye-opening to us. It shows just how subjective all inflation measurements can be. The BLS only counts students that aren't receiving any kind of financial aid; "The inclusion of financial aid has added to the complexity of pricing college tuition." They then adjust for "*a quality improvement (such as increased instructional time)".* The bottom line is this - your emails helped us to realize the silliness that goes into computing some of these numbers. Thank you for that.

The BLS website is a bit clunky but it allows you to drill down as deep as you want into each basket of goods so you can calculate and read the methodology and measurement of inflation at the most detailed level. For example, here is the inflation rate for bananas over the last 20 years.



As we mentioned earlier, inflation is in the eye of the beholder. If you feel like you are experiencing inflation, you likely are. You don't need an official number to confirm that. Due to base effects (pandemic lows were 1year ago), we are going to see some alarmingly high inflation numbers over the next few months. We believe these elevated numbers will prove to be transitory. That said, we are becoming modestly more concerned about inflation. More specifically, we are becoming concerned that the Fed may start to "taper" their ultra-easy monetary policies. More on that later.

Enjoy the warm weather,

The Mommaerts Mahaney Financial Team

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J. Matthew Tuccini, CFP®: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

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