

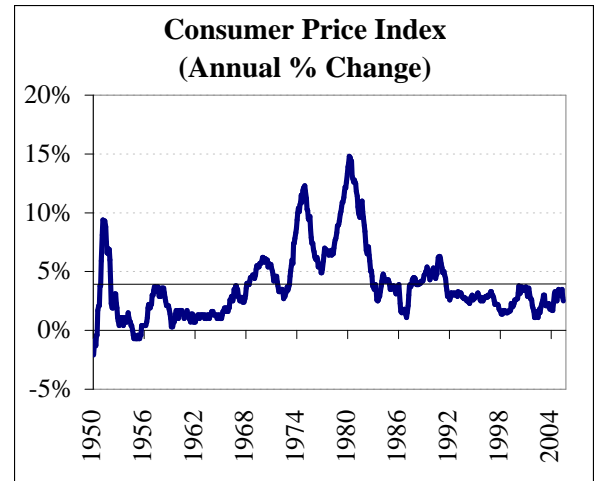
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## The Calm Surface of Low Inflation Hides a Wave of Change

The Consumer Price Index, or “CPI”, represents a basket of typical consumer goods, including housing, food, medical care, apparel, and more.

According to this index, inflation looks well controlled and below average.

However, the low and stable inflation that we enjoy today hides a more interesting story beneath the surface: prices are only stable for imports.

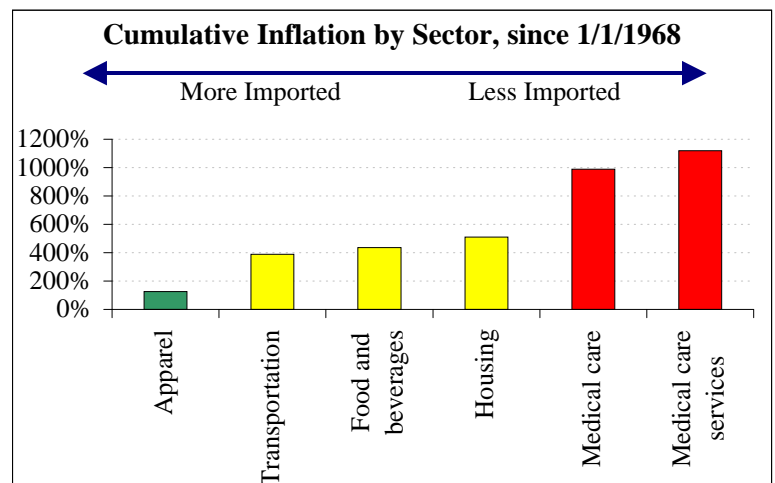


*Prices are only stable for imports.*

The advantages of world trade are driving down prices. Lower costs of labor and raw materials enter the US in the form of lower prices through imports and outsourcing. This pattern is likely to continue for several decades, although the pace may slow.

### Long-Term Evidence that Trade Lowers Prices

Data for some major CPI components are available from the Department of Labor since January 1968. Upon inspection, the components of CPI have a clear pattern: price growth is lower for goods that can be imported. This makes sense because imports often have a price advantage. Apparel may be the easiest good to import, and that sector has



*The US imports a low inflation rate.*

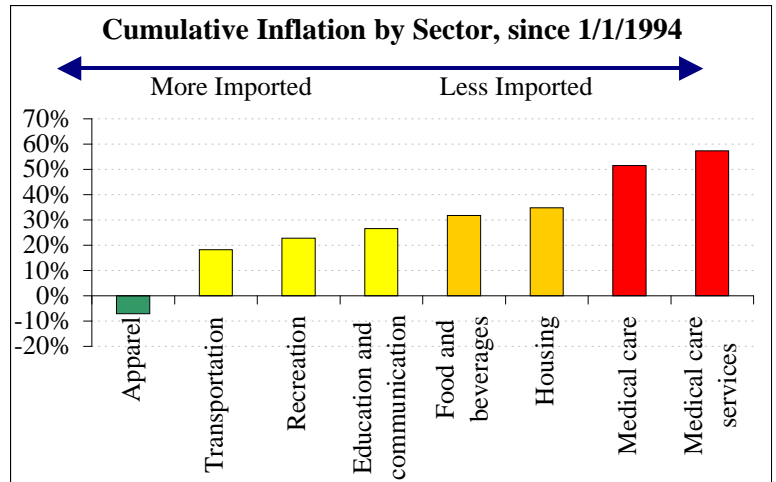
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risen far less than the other sectors in the CPI. The Medical Care Services sector may be the most difficult to import, and it has undergone the most inflation. Housing can benefit from unskilled labor and international materials, but it relies on US land and at least some US labor.

### Short-Term Confirmation

The impact of imports has been even more dramatic when we look at more recent data. Imports have actually caused *deflation* in apparel. Beginning in 1994, inflation data is available for the recreation and education/communication sectors. These sectors combine imported products such as cell phones and games with US labor such as teachers and entertainers.

Despite widespread talk of a housing bubble, the price index for housing, while high, is not as high as the price indexes for Medical Care or Medical Care Services. Housing, in other words, appears to be in line with other prices in the CPI, given its difficulty to import.



### Implications for the U.S. Economy

Imports are having a very favorable impact on inflation. Without the price pressure from imports, inflation would almost certainly be higher. But with imports, prices remain stable and the Fed can keep interest rates low. Low interest rates allow the economy to invest more and grow faster. In turn, this higher rate of investment and faster growth keeps more people employed and leads to higher levels of production throughout the world.

A strong US dollar means that imports are cheaper, further pushing down inflation. So the strengthening US dollar in recent months should give the Fed additional reason to stop tightening. A quarter-point increase on December 13<sup>th</sup> may mark the end of this cycle. Expect a rapid short-term rise in stock prices if the Fed changes its “measured pace” language on or before that day, and again if Greenspan gives us a parting gift—announcing a “neutral” rate on his last day, January 31<sup>st</sup>.

In the United States and other wealthy countries, manufacturing companies will need to innovate very rapidly if they are going to stay ahead of low-priced imports. Otherwise, manufacturing profit margins and wages will continue to fall. Many of the most reliable dividend-paying stocks may find their business models failing. The bankruptcy of Delphi and the suffering of GM are directly related to this long-term trend. There is little relief in sight for these companies, and there is little standing in the way of their foreign low-price competitors.

While the US imports a low inflation rate, more purchasing power, and a faster-growing economy, foreign countries are importing productivity, stability, and a faster-growing economy. The pieces are in place for long-term growth in global stock markets—but avoid the victims of foreign competition.