New Indicator: Underlying Inflation Gauge

***e*Research Corporation** is pleased to provide an article by Jill Mislinski of Advisor Perspectives.

Ms. Mislinski looks at the NY Federal Reserve Bank's newly-created inflation monitor.

The article is reproduced below, on the following page, but it also can be sourced at the following link:
https://www.advisorperspectives.com/dshort/updates/2018/01/16/new-indicator-underlying-inflation-gauge

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New Indicator: Underlying Inflation Gauge

January 16, 2018
By: Jill Mislinski

Economists at the NY Federal Reserve Bank introduced a new measure of trend inflation in September 2017, the Underlying Inflation Gauge (UIG), meant to complement the current standard measures. Investors and policymakers alike have an interest in the behavior of inflation over longer time periods.

The trend component of inflation is not an observed measure and a proxy measure is required to calculate it. To calculate trend inflation, transitory changes in inflation must be removed, such as volatile components or specific items. Core CPI, which is the most widely used and accepted form of estimating trend inflation, only focuses on price components.

The UIG derives trend inflation from a large set of data that extends beyond price variables. Additionally, it has shown higher forecast accuracy than traditional core inflation measures.

Here is what the NY Fed says about the UIG:

> "…the design of the UIG is based on the premise that movements in trend inflation are accompanied by related changes in the trend behavior of other economic and financial series. Consequently, we examine a large data-set to identify the common component of other economic and financial series and then focus on the persistent part of the common component."

The UIG uses a dynamic factor model for large data sets and uses two different sets for calculations. The first is a disaggregated price data series in the CPI, called "prices only" and the second is the CPI disaggregated price series plus a wide range of macroeconomic and financial data, called the "full set".

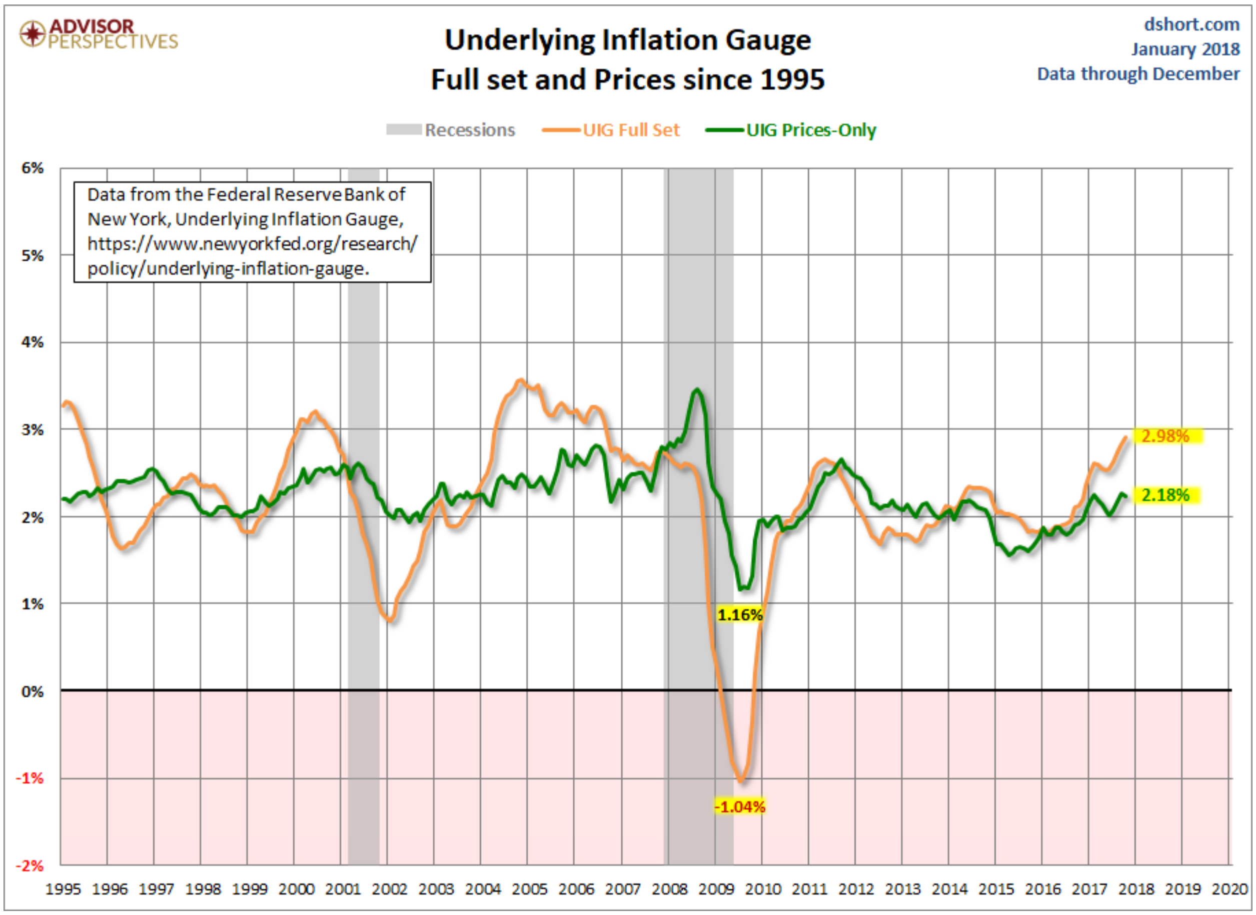
The major difference between say, Core CPI data, and the UIG data is that the UIG *adds* instead of removes information that signal changes in trend inflation.

The latest full set UIG for November is at 2.98% while the prices-only measure is 2.18%. Current Headline CPI is now 2.12% and Core CPI is 1.77%.

<continued>

UIG data goes back to 1995 and includes two recessions.

Here is a chart of both the full set and prices-only series. You will notice the difference between the full and prices-only sets, especially during recessions, which is a result of the additional information included in the full set, like macro-economic factors.



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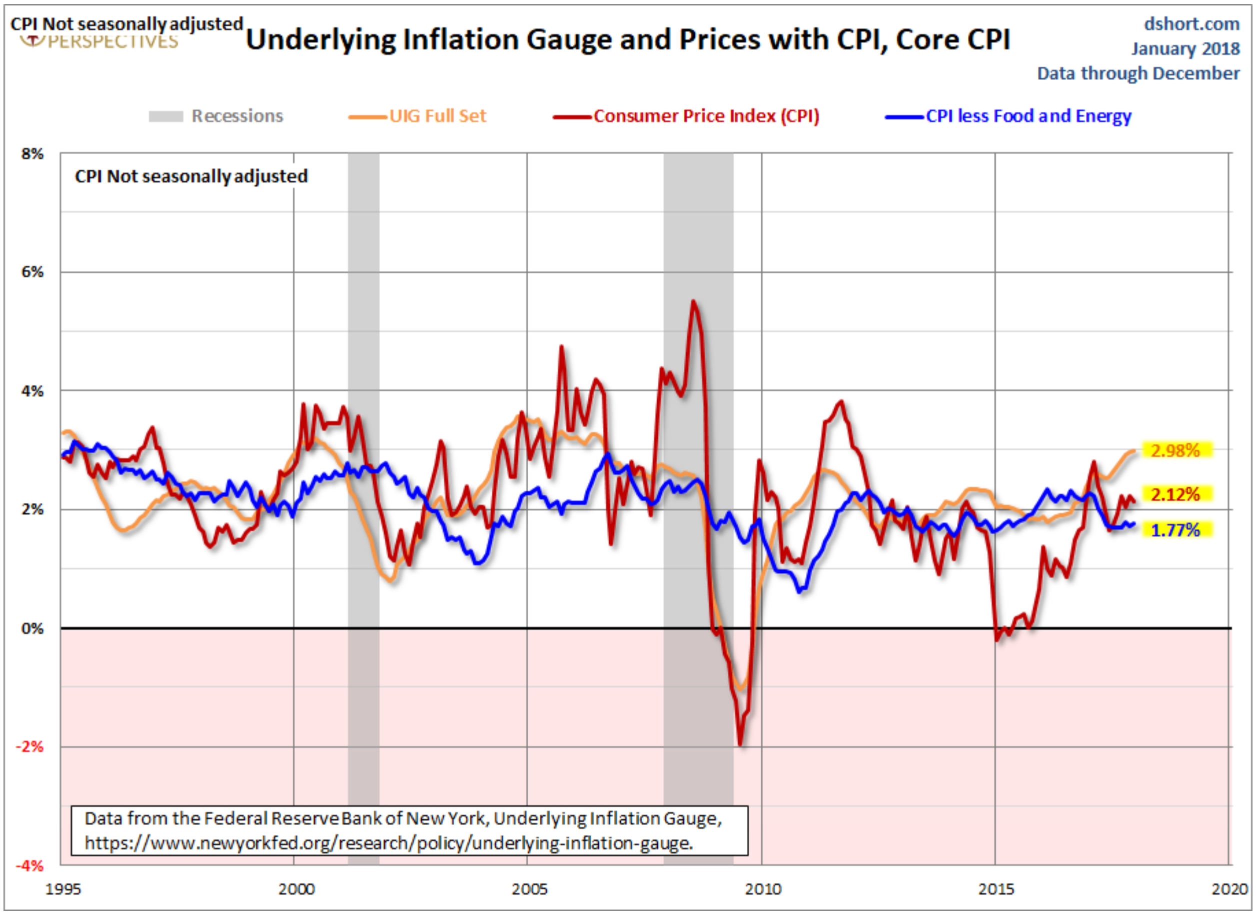
Here are the two UIG series compared with Core CPI. The full set diverges from Core CPI often and there are periods where UIG movements lead those in Core CPI.



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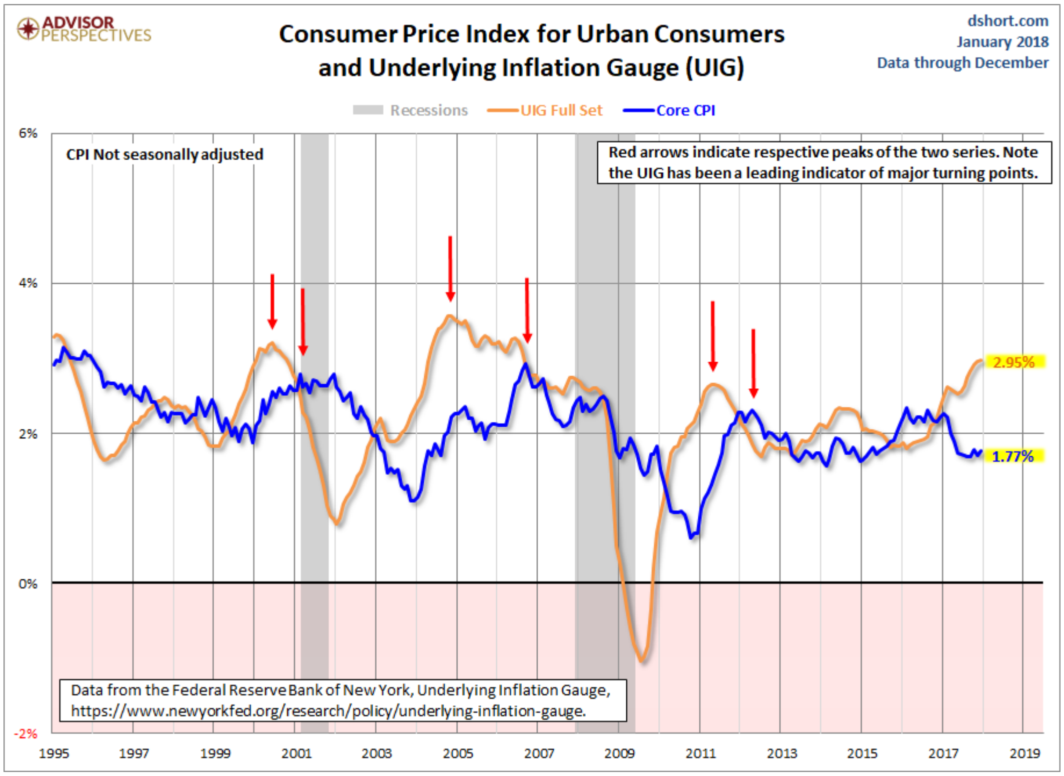
Let us take a closer look at UIG and Core CPI. Note the divergent periods - the red arrows indicate the respective peaks of the two series. The UIG has led major turning points in the CPI.



The UIG can be a useful complement to the traditional core inflation measures. While the NY Fed economists caution placing too much emphasis on UIG as a forecasting tool, the UIG still offers meaningful information not provided in Core CPI.

The next release of the UIG is scheduled for February 14th.

BW: Information on the Author is provided below.

Jill Mislinski works for Advisor Perspectives, a leading interactive publisher for Registered Investment Advisors, as Research Director. She analyzes economic and market data for the "dshort" portion of its website, concentrating on short-term and long-term trends. She is a CFA candidate.

BW: Information on Doug Short, dshort.com, and Advisor Perspectives is provided on the following pages.

ABOUT THE AUTHOR AND DSHORT.COM

My original dshort.com website was launched in February 2005 using a domain name based on my real name, Doug Short. I'm a first wave boomer with a Ph.D. in English from Duke and a lifelong interest in economics and finance. In 2011 my website was acquired by Advisor Perspectives.

My first career was a faculty position at North Carolina State University, where I achieved the rank of Full Professor in 1983. During the early '80s I got hooked on academic uses of microcomputers for research and instruction. In 1983, I co-directed the Sixth International Conference on Computers and the Humanities. An IBM executive who attended the conference made me a job offer I couldn't refuse.

Thus began my new career as a Higher Education Consultant for IBM — an ambassador for Information Technology to major universities around the country. After 12 years with Big Blue, I grew tired of the constant travel and left for a series of IT management positions in the Research Triangle area of North Carolina. I concluded my IT career managing the group responsible for email and research databases at GlaxoSmithKline. In mid-2006 economic analysis became my full-time occupation.

My interest in economics and financial planning was triggered by the bear market of 1973-74. My wife and I bought our first home in August 1973, a month after our second child was born. Two months later, the Oil Embargo tripled gas prices, and I began commuting to work on a bicycle. During the decade of stagflation, I became fascinated with economics, finance, and market behavior (my wife claims it's an addiction).

Charting financial data is something I've been doing for over thirty years. I was an early user of first-generation spreadsheet software (VisiCalc, SuperCalc, and Lotus 1-2-3), and I participated in the beta program for the original release of both Excel and Quicken.

I use the word "chart" for my visualizations of data rather than "graph", which has always struck me as a bit pretentious. I suppose my language preference was conditioned decades ago by the terminology used in spreadsheet software.

Contrary to what many visitors assume based on my last name, I'm not a bearish short seller. It's true that some of my content has occasionally been a bit pessimistic in recent years. But I believe this is a result of economic realities and not a personal bias. For the record, my efforts to educate others about bear markets date from November 2007, as this Motley Fool article attests.

Unless I've been coerced into a vacation to a remote location without Internet access, I'm usually at home in North Carolina watching the economy and markets on my handy Ultrabook or iPad.

Doug Short, Ph.D.
Advisor Perspectives

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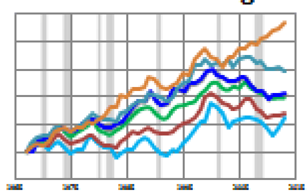

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