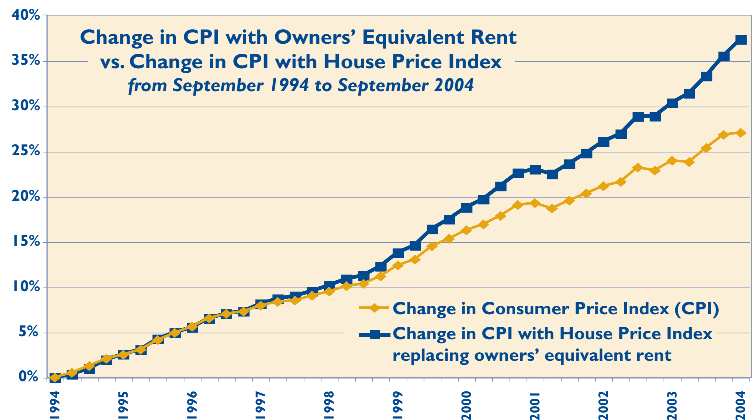
Thornburg Investment Management™

December 2004

What's your inflation rate?

by George Strickland
Municipal Portfolio Manager



Sources: Bureau of Labor Statistics, Office of Federal Housing Enterprise Oversight, Thornburg

The much expected bond market rout of 2004 was a bust. The U.S. economy is chugging along at a 3.9% growth rate, 198,000 new jobs are being created each month, the Fed Funds rate has doubled, but a 10-year treasury bond yields less today than it did at the beginning of 2004. What's going on here? Shouldn't bond yields be moving up?

Bond yields are not moving up because no one is afraid of the Big Bad Wolf. According to the Federal Reserve Release of November 10, 2004, "Inflation and longer-term inflation expectations remain well contained." As long as inflation stays under control, short-term rates can rise without affecting long-term rates.

While I agree with that premise, I am concerned that inflation is dangerously close to becoming uncontained. Furthermore, I believe that inflation is probably already understated by the Consumer Price Index (CPI).

As I write this, the debate over the use of "hedonic adjustments" in the CPI rages on. I don't want to add my wood to that fire. There are others that are much more versed in the subject than I am. I have chosen to focus on a simpler subject.

There is a data series embedded in the CPI called *owners' equivalent rent of primary residence.* At over 22% of the index, it is the largest single component of the CPI. The Bureau of Labor Statistics started using owners' equivalent rent in January 1983 because, in their words, "the asset price method can lead to inappropriate results for goods that are purchased largely for investment reasons."

So, rather than measure the price of homes being purchased, "rental equivalence measures the change in implicit rent, which is the amount a homeowner would pay to rent, or would earn from renting, his or her home in a competitive market." The Bureau acknowledges that "the rental value of owned homes is not an easily determined dollar amount, and housing survey analysts must spend considerable time and effort in estimating this value." However, the center of the analysis revolves around how the participants answer the following question:

"If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?"

Now, a lot can be done to objectify answers to that question, but it must still remain a very subjective process. For instance, I could answer that question for my own house, but I have little idea whether my answer would have any basis in reality. The problem of subjectivity leaves a lot of room for error, but the bigger problem is that the owners' equivalent rent is measuring the wrong thing.

The question asked of survey participants seeks to measure what one could rent one's house for, not what one could, would, or did pay for a house to live in. These are two very different things. First of all, most Americans would rather own their home than rent one – in essence making an owned home more valuable than a rented home. So, in asking someone what they would rent their home for, one would expect to get a value less than what they would be willing to pay to own the same home. Secondly, with low interest rates and more access to financing, home prices have been going up much faster than rental rates over the last few years. Are home buyers not paying higher prices because rental rates (and owners' equivalent rent) have been rising at a slower rate? Of course not! Housing price inflation is very real and it has been understated in the CPI through the use of owners' equivalent rent calculations.

Now, the harder question: how much has CPI been understated? I do not have the ultimate answer, I think that it will require a much more detailed study than I am able to undertake. However, I do have a very simple way of estimating the potential magnitude of the problem.

The Office of Federal Housing Enterprise Oversight (OFHEO), famous of late as a critic of accounting practices at Fannie Mae and Freddie Mac, maintains an index called the House Price Index (HPI). OFHEO uses data compiled from over 28 million repeat housing transactions to estimate changes in the HPI. It covers all areas of the country, and is considered by many to be the most accurate and comprehensive gauge of housing price changes.

If we strip out the owners' equivalent rent data from the CPI and replace it with data from the House Price Index, we end up with an approximation of what the CPI would look like if it measured real home prices rather than owners' equivalent rent. As you can see from the graph above, the HPI data does

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not change the CPI results very much from September 1994 through 1998. However, from 1999 through September 2004 the CPI rises much faster when the HPI is substituted for owners' equivalent rent.

In fact, over the five years ending September 2004, substituting HPI for owners' equivalent rent adds 1.36% to the average annual change in the CPI, taking it from a modest 2.48% to a somewhat alarming 3.84%. The one-year data are even more dramatic, where the use of HPI increases the change in CPI from 2.44% to 5.38%!

Talk about a paradigm shift. The real yield on the 10-year treasury just went from 1.72% to -1.17%! Of course, that won't really happen. There is way too much on the line, with Social Security and Treasury Inflation Protected Securities (TIPS) payments directly linked to CPI and virtually everything else indirectly linked. However, I do believe that wherever possible, index data should be based upon objective data rather than subjective judgment, and I am confident that virtually anyone who has bought a home in the last five years will agree that their inflation rate is significantly above 3%.

So, I advise you to be somewhat skeptical when viewing the recent CPI data. I am sure that the Bureau of Labor Statistics has good reasons for using owners' equivalent rent instead of real housing prices, but I am also sure that, by doing so, the Bureau is decreasing its relevance in reporting the true personal inflation rate for most Americans.

Furthermore, the use of owners' equivalent rent instead of real home prices has lowered the rate of change in reported CPI over the last five years by as much as 1.36%, thereby lowering the real rate on bonds of all types. Without the effect of owners' equivalent rent, U.S. Treasury bonds appear to be significantly overpriced.

We have always been mindful of the threat that inflation poses to fixed income portfolios. The defensive posture of Thornburg portfolios helps protect principal values, and our laddered maturity structure produces constant cash flow to reinvest if interest rates move higher. These measures enable Thornburg bond portfolios to benefit, over time, from a rising interest rate environment. We believe that such an environment may be closer at hand than many people think.

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Treasury Inflation Protected Securities (TIPS) are U.S. Treasury notes or bonds that offer protection from the effects of inflation. Using the Consumer Price Index as a guide, the value of the principal is adjusted to reflect the effects of inflation. A fixed interest rate is paid semi-annually on the adjusted amount. At maturity, if inflation has increased the value of the principal, the investor receives the higher value. If deflation has decreased the value, the investor receives the original face amount of the security.

The Fed Funds Rate is the interest rate at which point a depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight.

The Consumer Price Index (CPI) measures prices of a fixed basket of goods bought by a typical consumer, including food, transportation, shelter, utilities, clothing, medical care, entertainment and other items. The CPI, published by the Bureau of Labor Statistics in the Department of Labor, is based at 100 in 1982 and is released monthly. It is widely used as a cost-of-living benchmark to adjust Social Security payments and other payment schedules, union contracts and tax brackets. Also known as the cost-of-living index.

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