VLF*Alert*

ValueLine*funds*

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Dear Fellow Shareholder,

Thank you for choosing Value Line Funds as a part of your diversified investment portfolio. For over half a century, Value Line Funds has championed sound investment principles and helped thousands of investors accomplish their financial goals with our actively managed family of mutual funds.

We hope you enjoy this edition of the VLFAlert and thank you for your continued support.

What Does Inflation Really Mean…and Why Does It Matter

Most people think that inflation simply means rising prices. But for economists, and perhaps more importantly, for the Federal Reserve (Fed), inflation means much more than that. Here's an explanation of what the most popular measures of inflation—CPI and PCE and the core versions of each—are and how they might impact interest rates and you.

The two primary measures of inflation today are the Consumer Price Index (CPI) and the Personal Consumption Expenditures Index (PCE).

- CPI, released by the Bureau of Labor Statistics, tracks the change in the weighted average of prices for a fixed basket of consumer goods and services. "Headline" CPI, or the one you read about most commonly, is really a measure for urban households only, though this does account for approximately 89% of the U.S. population. CPI measures prices for transportation, food, medical care, housing, apparel, medical care, energy, recreation and education. Core CPI is a similar measure but excludes food and energy prices.
- PCE, issued by the Bureau of Economic Analysis, tracks the change in expenditures on goods and services by all households, including those paid for on a consumer's behalf, such as employer-sponsored health benefits. Here, too, core PCE excludes food and energy expenditures.

Both are important. The federal government uses the CPI to make inflation adjustments to certain kinds of benefits, such as Social Security. The Fed used to rely on core CPI as its primary inflation gauge in determining monetary policy but switched in 2000 to the lesser-known core PCE. Why? Because of its different scope, weightings and formula, the CPI tends to report somewhat higher inflation.

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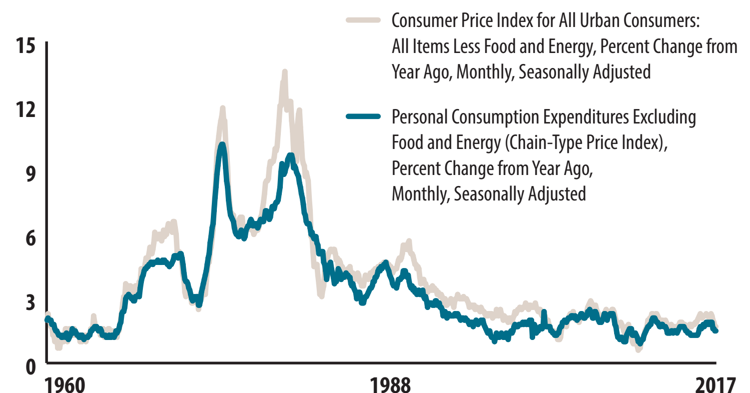
PCE and CPI Percent Change from a Year Ago



Source: Federal Reserve Economic Data (FRED).

How low inflation has impacted millions lately: The core CPI has increased to no more than 2%—the Fed's stated inflation target for the U.S. economy—since November 2015. And the core PCE has not yet reached that level (as of June 2017). This has had an impact on millions of Americans whose wages or Social Security benefits have seen no or minimal cost-of-living adjustments in 2016 and 2017. It's also been a reason why the Fed has been slow and gradual in its hiking of short-term interest rates so far.

However, should the economy continue to strengthen, then demand for employees should increase, putting workers in a

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better position to get higher wages and creating competition among employers for the best employees. If higher wages filter through the entire economy, then inflation could rise again.

Why inflation is so important to the Fed: For economists, and for the Fed, inflation indices measure not only changes in prices but the overall stability and growth rate of the U.S. economy. While we may think of inflation as a negative—after all, it means more money out of our pockets, to the Fed, even a small amount of inflation is regarded as an indication of a growing and healthy economy. When the cost of goods and services rise too slowly, the economy could be at risk of recession. If they rise too quickly, the economy could be heading to hyper, or out of control, inflation.

Sometimes, inflation or the lack thereof can be driven purely by expectations about inflation, set by central banks themselves and based on the credibility these venerable institutions have garnered. But actual inflation is caused by four primary drivers.

- **Market power,** or the ability of companies or organizations (think OPEC) to minimize competitive pressures and raise prices.
- **A rise in demand relative to supply,** or what we all learned in Economics 101.
- **A supply shock,** particularly seen within the commodities markets.
- **An asset market boom.** The connection between the prices of goods and services and those of financial assets is sometimes non-existent. When stock prices rose significantly in the 1990s, there was little movement in the CPI. However, inflationary pressure was a component in driving stock markets to poor performance in the 1970s and early 1980s. Or, in reverse, a stock market rally like that seen in the last year or so can translate to more optimistic businesses and consumers, which, in turn, can mean more spending. A boost to the economy and profits, yes, but also the potential for demand outstripping supply.

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Good news for equity investors: If inflation were to accelerate too quickly, the Fed might feel compelled to hike interest rates faster, possibly stalling the second-longest bull market in U.S. history. The good news for equity investors is that many companies have the pricing power to pass through cost increases to customers. Inflation also spurs corporate customers to find ways to cut costs and that can help those companies that provide more efficient solutions. Other companies that offer better prices may benefit from the search for value. What may be most important to keep in mind is that, historically, U.S. equities can actually give investors at least some protection against inflation that bonds and many other investments lack.

As we look to the end of this calendar year and watch carefully to see how much more the Fed may raise interest rates in 2018, it's important to keep inflation in perspective. Like so much else in life, inflation in moderation is a good thing. Inflation might be subdued for now, but you should still remain diligent in tracking both the CPI and PCE. Even though it's been a long time since high inflation impacted the U.S. economy, those who remember its effects know all too well why it matters.

Check out our News & Updates at vlfunds.com for the latest on the Value Line Funds.

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