AIER

08|13 INFLATION REPORT

Retail, Wholesale Prices Trend Up

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Three months of changes point to a possible turning point in the currently tame inflationary climate

With an increase of 1.8 percent year-to-year, the U.S. Bureau of Labor Statistics' most recent Consumer Price Index paints a picture of tame inflation. But that is more about where we've been than where we are going.

Beneath the surface, inflationary pressures continue to mount as they have for months. These pressures are coming closer to breaking out into the wider economy. All of the important inflation measures at the retail and wholesale levels are up. These increases are the continuation of three-month trends that may signal a turning point in the economy.

Over the three months ending in June (the most recent date for which data is available), the CPI All Items Index went from -0.4 percent in April to 0.5 percent in June. During the same three months, the CPI Gasoline Price Index swung from -8.1 percent in April to 6.3 percent in June.

Increased upward pressure on gasoline prices is normal for the vacation months, but the magnitudes of these seasonally adjusted rates imply increased volatility. This is consistent with a rising inflation scenario. (See July 2013, *Inflation Report*, "Volatility Signals Inflation Risk.")

The most recent Producer Price Indexes confirm a scenario of rising inflation. These indexes provide insight into the wholesale prices that underlie retail prices. Monthly seasonally adjusted percent changes in the PPI for Finished Goods went from -0.7 percent in April, to 0.5 percent in May, and 0.8 percent in June. Intermediate wholesale goods followed similarly.

Food and energy were major drivers, but rising prices were not limited to these categories. The Core PPI (excluding food and energy) rose 0.2 percent in June, the eighth consecutive monthly increase.

Other factors also point to a changing inflationary climate. The Federal Reserve continues its easy-money policy, with adjusted bank reserves increasing about 48 percent since mid-May. GDP grew 1.7 percent in the second quarter—not great, but well ahead of the most pessimistic estimates. Disposable personal incomes increased by 3.4 percent after falling 8.2 percent in the first quarter, fueling a 1.8 percent growth in consumer spending. Consumer confidence is strong and business decision makers have improved their outlooks. All of this confirms the picture that has been shaping up since the beginning of the year: Moderately higher inflation is on the way.

All the important measures on the retail and wholesale levels are up.

CONSUMER PRICES

Both the broader, seasonally adjusted CPI and AIER's proprietary Everyday Price Index (EPI) rose 0.5 percent in June, more than a 6 percent annualized rate. This is in line with the 3.2 percent increase in the EPI for the first half of the year.

Energy was a major source of the increase. Seasonally adjusted, the CPI Energy Index rose 3.4 percent and the CPI Gasoline Index rose 6.3 percent in a single month.

But a number of other areas saw abnormally high price changes. Household fuel, utilities, and supplies rose 2.3 percent, the largest monthly increase in five years. The prices for household furnishings and operations, personal care products, and tobacco all increased. Apparel prices rose 0.9 percent in June, the biggest increase in two years. Medical care commodities rose 0.5 percent, and medical care services rose 0.4 percent—the largest increase in this category since last July.

Food prices overall rose an unalarming 0.2 percent after seasonal adjustment, but this is misleading. While the indexes for fruits and vegetables and for dairy and related products both declined slightly in response to better than average output of these products, four of the six major grocery store food group indexes posted increases. The index for cereals and bakery products and the index for meats, poultry, fish, and eggs, for example, both rose 0.4 percent—roughly 5 percent annualized.

Besides energy, a number of other areas saw abnormally high price changes.

ENERGY DRIVES RETAIL INCREASES

	MONTHLY RATE %	COMPOUNDED ANNUAL RATE %
June Seasonally Adjusted		
↑ CPI	0.5	5.9
↑ CPI Gasoline	6.3	108.8
↑ CPI Core	0.2	1.9
Not Seasonally Adjusted		
↑ CPI Core	0.1	0.9
↑ EPI	0.5	5.9

Rounding may cause apparent inconsistencies. Source: Bureau of Labor Statistics, Bloomberg, calculated by author.

WHOLESALE PRICES

Prices for wholesale goods often lead consumer prices, and prices at the wholesale level also continue to firm up. The seasonally adjusted Producer Price Index for Finished Goods rose 0.8 percent, around 10 percent on an annualized basis.

In looking at this index, many focus on its relatively low 12-month growth. Without seasonal adjustment, the index rose 2.5 percent in the 12 months ending in June. That isn't high, but it was also the largest 12-month rise since March 2012. The trend is up.

The PPI Index for Finished Goods less Food and Energy, or PPI Core, rose 0.2 percent—its eighth consecutive advance. The most notable factors in PPI Core were the prices of passenger cars—up 0.8 percent—and light trucks.

Over 80 percent of the 0.5 percent June increase in intermediate goods prices came from intermediate energy goods—up 2.0 percent. At the wholesale finished goods level, energy prices were also a major factor, rising 2.9 percent in June. This is the largest increase since February, and was driven by gasoline—up 7.2 percent—heating oil, and diesel fuel.

Finished food prices rose 0.2 percent in June after rising 0.6 percent in May. As we predicted in the July *Inflation Report,* an important factor was meat prices, which rose 4.2 percent in June. This is related to rising feed prices during last year's drought. Intermediate feed prices rose 8.3 percent in June year-to-year, unadjusted.

Wholesale prices at every level point in the same direction. Higher prices appear to be on the horizon.

MOST PRODUCER PRICES RISE

	MONTHLY RATE %	COMPOUNDED ANNUAL RATE %
June Seasonally Adjusted		
↑ PPI Crude	0.0	0.5
↑ PPI Crude Energy	0.3	3.1
↓ PPI Crude Food	-0.3	-3.5
↑ PPI Crude Nonfood less Energy	0.1	1.0
↑ PPI Intermediate	0.5	6.2
↑ PPI Finished	0.8	9.6
↑ PPI Finished Energy	2.9	40.7
↑ PPI Food	0.2	2.4
↑ PPI Core	0.2	2.0

Rounding may cause apparent inconsistencies. Source: Bureau of Labor Statistics, Bloomberg, calculated by author.

DEMAND

Recent softening of demand and persistently high unemployment have helped keep inflation contained. But this may be changing.

Newly released, revised GDP estimates for the second quarter evidence an economy growing at an annual rate of 1.7 percent. This was quite a bit higher than the consensus forecast of economists of 1 percent reported by Thomson-Reuters.

Disposable personal income expanded 3.4 percent, versus an 8.2 percent decline in the first quarter. This should provide the buying power to continue the growth of consumer spending at the second quarter's inflation-adjusted rate of 1.8 percent or higher.

Consumers have the means, but do they have the will to buy? Apparently so. According to the index compiled by Thomson-Reuters and the University of Michigan, consumer optimism has increased to 85.1, the highest level since July 2007.

And jobs are slowly returning.

BUYING POWER EXPANDS

	PERIOD CHANGE%	ANNUAL RATE %
Second Quarter		
↑ Real GDP	•	1.7
↑ Real Disposable Personal Income	•	3.4
↑ Real Consumer Spending	•	1.8
↑ Real Consumer Spending - Durables	•	6.5

Rounding may cause apparent inconsistencies. Source: Bureau of Economic Analysis, calculated by author.

> Consumer optimism has increased to the highest level since July 2007.

In June, nonfarm payroll employment rose in 37 states, and fell in 12. Incomes come back with jobs. This adds to buying power, consumer spending, and house buying, and creates upward pressure on prices.

This is not to say this is a runaway expansion. Unemployment in Nevada is 9.6 percent, in Illinois it is 9.2 percent, and in Mississippi it is 9 percent. But we should look for stronger growth in the second half and more potential for inflation.

SUPPLY

Supply growth is healthy, but because of considerable unused capacity, manufacturing growth is unlikely to have much impact on prices.

The Index of Industrial Production rose 0.3 percent in June, compared with flat growth in May. The production of consumer goods and of business equipment both grew by 0.5 percent. Every major component of consumer durables increased or was flat, with automotive products and home electronics posting the largest gains—1.4 percent and 2.2 percent, respectively.

At the same time, businesses were able to use 77.8 percent of their production capacity. But significant inflation pressures will not emerge until businesses operate at more than 80 percent of capacity.

UNUSED CAPACITY BLUNTS INFLATION

	PERIOD CHANGE%	ANNUAL RATE %
June		
↑ Industrial Production	0.3	3.8
↑ Capacity Utilization Rate	•	77.8 (+0.13)
First Quarter		
↑ Industrial Production	0.1	0.6

Rounding may cause apparent inconsistencies. Source: Federal Reserve Bank of St. Louis, Bloomberg, calculated by author.

INTERNATIONAL

Rising imports reflect rising domestic incomes and demand. In the second quarter, imports expanded by 9.5 percent, after rising only 0.6 percent in the first quarter. Imports also reduce the need to produce domestically, dampening growth in jobs and incomes. This helps restrain inflation, although it is not the best news for domestic employment.

Import prices also affect domestic prices directly, and import prices have been falling. Prices fell 0.2 percent in June after falling 0.7 percent in May. Import

IMPORTS RESTRAIN DOMESTIC PRICES

	MONTHLY RATE %	COMPOUNDED ANNUAL RATE %
June		
Not Seasonally Adjusted		
↓ Trade-weighted Dollar	-0.9	-10.3
↓ Import Price Index	-0.2	-2.4

Rounding may cause apparent inconsistencies. Trade weighted dollar is against major currencies.Source: Federal Reserve, Bloomberg, calculated by author.

prices are often dominated by oil and oil-related products, but for the last two months the drop in nonfuel prices more than offset increasing fuel prices. Cheap imports make it difficult for domestic producers to raise prices and intensify the dampening effect of imports on prices. This check on domestic inflation will not last forever. As the world economies strengthen, so will demand in foreign countries. This will raise the prices of the goods these countries produce for themselves and for the American market.

Right now, the American export market shows that demand is picking up in the foreign economies, but not as fast as it is in the U.S. American exports rose by 5.4 percent, after rising 1.3 percent in the first quarter.

Exports add to GDP. Imports subtract. For now, the unfavorable U.S. trade balance is also helping keep inflation in check. ■

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