AIER

01 14 INFLATION REPORT

In The Shadows

By Luke F. Delorme, Research Fellow

Headline inflation figures remained flat for November. But price pressures lurk underneath, awaiting a trigger.

The headline data again suggest next to no change in prices. November actually saw declines across several measures of inflation. A strengthening economy coupled with a sustained influx of money from the Fed has economists shrugging their shoulders and squawking, "Where's the inflation?"

Retail prices as measured by the Consumer Price Index (CPI) remained flat for the month of November, while wholesale prices as measured by the Producer Price Index (PPI) decreased slightly. Both of these indices were driven largely by decreases in energy prices. The core measures, however, continued a gradual upward trend. Moreover, services prices continued their steady growth above a 2 percent annual rate. Durable goods prices maintained a flat to negative trajectory, held back by downward international pricing pressure and persistently low interest rates.

The demand for goods, as measured by consumer discretionary spending and retail sales, increased during November and continued its upward trend. Rising demand plus an increased money supply should lead to price inflation. However, suppressed prices endure as demand is fulfilled by increased supply (as measured by industrial production and capacity utilization). Whether supply can keep pace with demand remains a question. Some research suggests that utilization rates reach a bottleneck at a threshold near its current level.

All this adds up to a year-over-year inflation measure below the Fed's 2 percent annual inflation target. For inflation numbers to increase to the inflation target, it seems likely that durable goods will have to be the primary driver. This has not yet happened.

It appears that the Fed has been able to continue its stimulus programs without substantial measurable inflation because bank reserves are not moving into the economy. The zero interest rate policy, combined with restrictions on bank lending, has caused loan production to falter. Until the data show otherwise, the Fed will likely continue to focus its efforts on decreasing unemployment.

While the headline numbers have allowed the Fed to focus its efforts on jobs, a closer look at some of the numbers reveals the hidden inflation lurking in the shadows.

RETAIL PRICES

"Zero Point Zero." Like John Blutarsky's grade point average in Animal House, the broad CPI index was a 0.0 for November, unchanged from October.

The headline number was again driven by a 1 percent decrease in energy prices offset by core goods and foods. The year-over-year CPI is +1.2 percent, up slightly from October's 1 percent increase, but still below the Fed's 2 percent target. The

CPI exhibits levels above this target in services (less energy services), where a 2.4 percent year-over-year rate has been fairly consistent over the last 24 months.

The CPI indicates that inflationary concerns have yet to materialize, largely the result of flat to negative durable goods prices and negative energy prices. Several factors may be contributing to the downward pressure on durable goods prices including weaknesses in the European and Chinese economies, Japanese deflation and near-zero interest rates in the U.S. As these global trends begin to reverse in the long-term, we may start to see durable goods prices rise and the broader CPI increase to 2 percent or above.

These broader economic trends are highlighted by declining import prices, putting downward pressure on domestic prices. The year-over-year import price index was down 1.5 percent. Excluding food and fuels, the import price index was down 1.4 percent.

Energy prices are notoriously volatile, much more so than the broader index. As recently as 2011, year-over-year energy price increases ranged as high as 21 percent. Although daily price data do not suggest an immediate and severe increase in inflation, potential shifts in durable goods and energy prices are difficult to forecast and may be drivers of future inflation. In fact, data from the U.S. Energy Information Administration indicate that gas prices may have already been on the rise during December.

AIER's proprietary Everyday Price Index was also down for the month of November, led by a decrease in motor fuel costs. The EPI was up only 0.1 percent on a year-over-year basis. Services such as child care and personal services continued to see a rise, as reflected in the overall price gains in CPI services, whereas food and fuel prices fell. Again, prices in energy items such as motor fuel can fluctuate quickly. Nonetheless, this monthly decrease is encouraging for the American people especially during the holiday season.

WHOLESALE PRICES

The PPI confirms that inflationary concerns have not been realized. The PPI tracks how much producers receive for goods, which may offer a glimpse of future CPI.

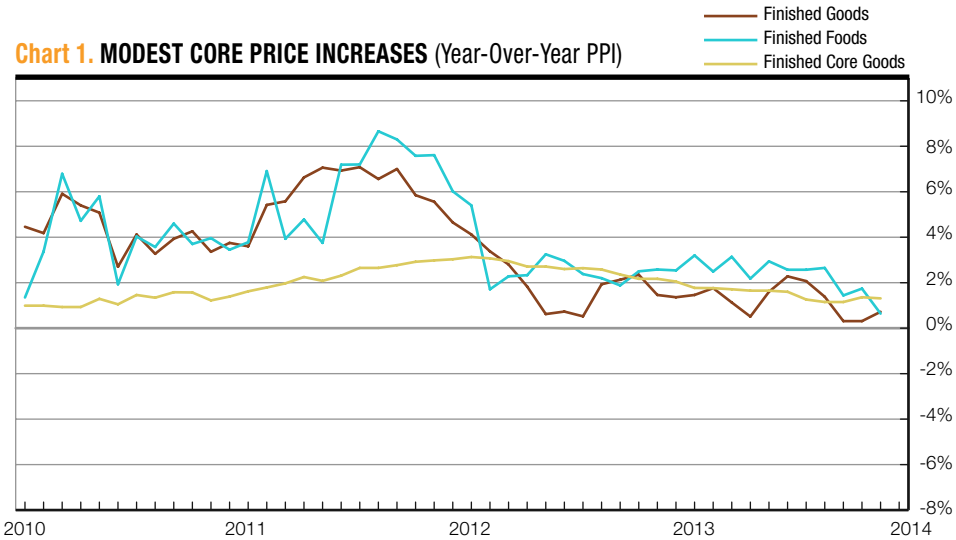
The November PPI for finished goods decreased by a seasonally adjusted 0.1 percent, the third straight month of minor downward pressure. For the 12 months ended November, the PPI was up a modest 0.7 percent. The year-over-year PPI has stayed within a range of 0.3 percent to 2.3 percent since April 2012, indicating slow and steady inflation. That is not to say that low inflation is benign, as any inflation above zero can hurt personal finances in a world with near-zero interest rates. Like the CPI, the monthly decrease can largely be

DURABLES AND ENERGY DRAG CPI

November	MONTHLY RATE % (Seasonally Adjusted)	YEAR-OVER-YEAR CHANGE %
↑ CPI	0.0	1.2
↑ CPI Food	0.1	1.2
↓ CPI Energy	-1.0	-2.4
↑ CPI Core (Less Food and Energy)	0.2	1.7
↑ CPI Services (Less Energy Services)	0.2	2.4
↓ CPI Durable Goods	-0.1	-0.7
↓ Import Prices Index	-0.6	-1.5
↓ Import Prices Core	0.1	-1.4

Source: Bureau of Labor Statistics, Haver Analytics. Calculated by author. Note: Rounding may cause apparent inconsistencies.

Chart 1. MODEST CORE PRICE INCREASES (Year-Over-Year PPI)



Source: Bureau of Labor Statistics, Haver Analytics.

attributed to a 0.4 percent decrease in prices for finished energy goods.

Contrary to the direction of the overall PPI, the index for finished core (less foods and energy) continued its steady rise by increasing 0.1 percent. This represented the 10th increase in finished core goods in the last 11 months. However, each increase has been a gradual 0.2 percent or less. Because it excludes widely fluctuating energy prices, the core PPI tends to be less volatile than the index overall.

The index for finished energy declined 0.4 percent in November, the second straight month of decline, primarily attributed to a decrease in gasoline prices. The nature of some of the more volatile prices can be found in November price changes for home heating oil (-5.7 percent), jet fuels (-6.8 percent), diesel fuel (-5.6 percent) and crude petroleum (-11.7 percent).

INFLATIONARY CONCERNS UNREALIZED

November	MONTHLY RATE % (Seasonally Adjusted)	YEAR-OVER-YEAR CHANGE %
↑ PPI Finished	-0.1	0.7
↓ PPI Finished Energy	-0.4	-0.6
↑ PPI Finished Food	0.0	0.6
↑ PPI Finished Core	0.1	1.3
↓ PPI Intermediate	-0.5	-0.5
↑ PPI Intermediate Core	-0.1	0.8
↓ PPI Crude	-2.6	-3.3
↓ PPI Crude Core	1.4	-5.2

Source: Bureau of Labor Statistics, Haver Analytics. Calculated by author. Note: Rounding may cause apparent inconsistencies.

DEMAND

Real earnings growth and consumer discretionary spending are strong indicators of the health of the U.S. economy. These figures are also often leading indicators of future inflation. From 2001 through 2007, consumer discretionary spending consistently rose at a 4-6 percent annual rate, which predicated a brief period of 4 percent to 5.5 percent inflation in late 2007 and 2008. This inflation quickly dissipated with the financial collapse in late 2008.

Since the economic recovery has taken hold in the last four years, consumer discretionary spending has risen by a fairly consistent 3-5 percent annual rate (2-3 percent real). This figure is in line with current GDP growth. While spending may suggest some increase in prices in the future, it does not seem to be moving prices upward at this point.

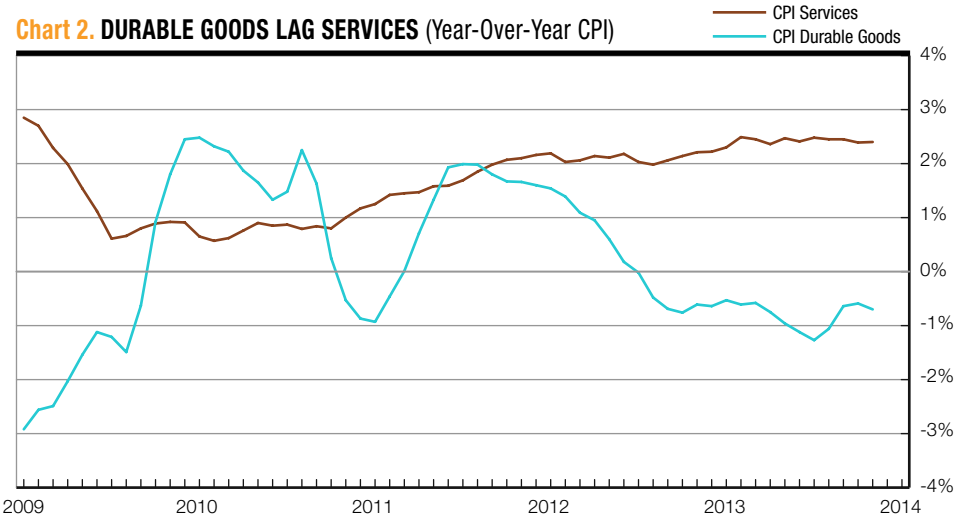
Incomes also continue to rise. In November, real average earnings rose by 0.2 percent on an hourly basis and 0.4 percent on a weekly basis, partially driven by an increase in the average workweek. Combined with the decreases in the EPI driven by lower fuel costs, the increase in earnings means that everyday people have more to spend.

Likewise, retail sales figures for November and the past year have been strong. The seasonally adjusted growth in retail sales was 0.6 percent in November. Adjusted for inflation, the year-over-year change in retail sales, including food services, was +3.4 percent. All indications point to strong demand for goods and services in the U.S. economy.

SUPPLY

As demand for goods increases, a subsequent increase in supply can help lessen inflationary pressures. The Industrial Production Index indicates that expanded production has increased supply measurably in November. The Index was up 1.1 percent in November, the largest increase since November 2012. Likewise, capacity utilization increased to

Chart 2. DURABLE GOODS LAG SERVICES (Year-Over-Year CPI)



Source: Bureau of Labor Statistics, Haver Analytics.

WAGES AND SPENDING ON THE RISE

	MONTHLY RATE % (Seasonally Adjusted)	YEAR-OVER-YEAR CHANGE %
November		
Average Hourly Earnings	0.2	0.9
Average Weekly Earnings	0.4	1.1
Retail Sales	0.6	4.6
Real Retail Sales and Food Services	0.6	3.4
October		
Consumer Discretionary Spending	0.4	3.5
Consumer Discretionary Spending (Real)	0.4	2.6

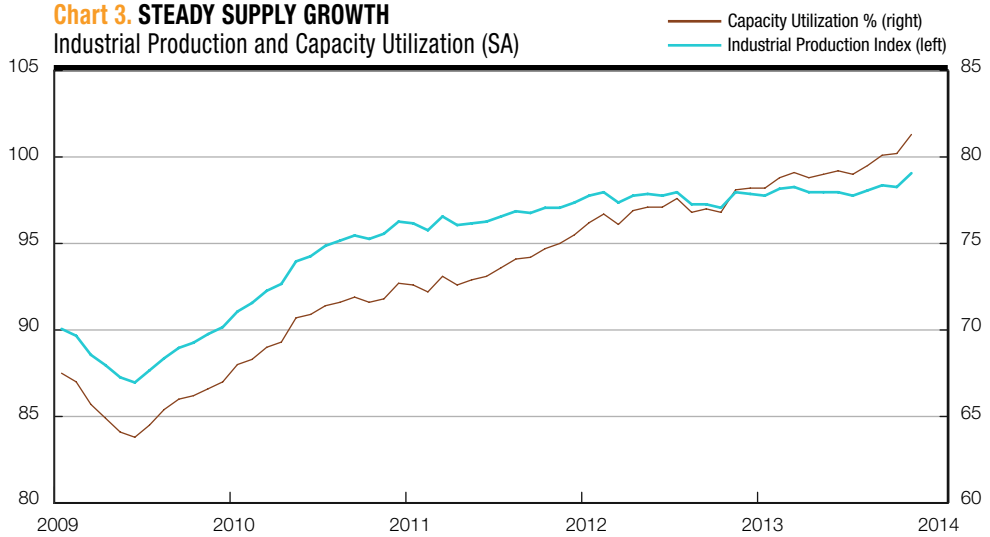
Rounding may cause apparent inconsistencies. Source: Bureau of Economic Analysis, calculated by author.

79.0 percent in November, the highest level since June 2008.

The year-over-year increase in the IPI was 3.3 percent, a fairly high level considering relative inaction during the summer months. The Index has now been expanding since mid-2009 and has reached an all-time high, helping to alleviate inflationary pressures over that time. Although advances were highest in utilities (+3.9 percent), gains were broad-based across final products (+0.9 percent), consumer goods (+1.5 percent), nonindustrial supplies (+0.9 percent) and materials (+1.4 percent).

Supply seems to have maintained pace with demand to this point, but capacity utilization has signaled supply bottlenecks near the 82 percent level. Currently at 79 percent, there is limited room for growth before the potential for supply to lag demand, which can lead to inflation. Moreover, year-over-year productivity is relatively flat, and unit labor costs may rise in the future. All this could amount to narrowing corporate margins, and ultimately, price increases passed on to the consumer.

Chart 3. STEADY SUPPLY GROWTH
Industrial Production and Capacity Utilization (SA)



Source: Federal Reserve Board, Haver Analytics.

BOTTOM LINE

Price inflation growth tends to be slow-moving, so it's not surprising that there hasn't been a lot of movement yet. This also means that once it arrives, it is also difficult to eradicate.

The current environment of little to no inflation seems persistent. But the key driver of the current headline numbers is energy prices, the most volatile component of inflation. There is some solace in the fact that the elements of core CPI tend to change slowly. At present, the slowest-moving inflation figures (CPI Core) tend to be mildly positive, while the volatile, and difficult to predict, energy prices tend to be negative. Given the huge overhang in the monetary base after three rounds of quantitative easing spanning the last five years, it is prudent to keep a keen eye on these underlying components of the price gauge. ■

SUPPLY MEETS DEMAND

	PERIOD CHANGE %	ANNUAL RATE %
November		
Industrial Production Index	1.1	3.3
Capacity Utilization	1.0	1.4

Source: Bureau of Labor Statistics, Haver Analytics. Calculated by author. Note: Rounding may cause apparent inconsistencies. Capacity utilization increased from 78.2% to 79.0%.

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American Institute for Economic Research
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