Northern Trust

DAILY GLOBAL
COMMENTARY

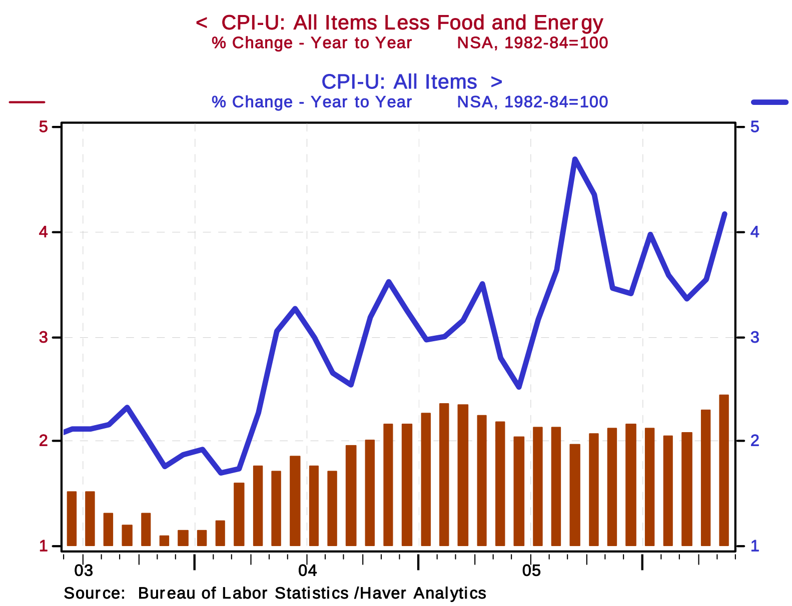
Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul Kasriel
plk1@ntrs.com

All Items or Core Inflation – You Can Tighten Now or Tighten Later

June 14, 2006

Do you know who popularized the concept of "core" inflation? Fed Chairman Arthur Burns. Back in the early 1970s, when both energy and food prices were soaring, Burns needed a lower measure of inflation so that he could justify not pushing interest rates as high as they should have been. (That was left for Volcker to do.) So Burns asked his staff: "Who among you can find a lower measure of inflation?" And core inflation was born. Similar to employer-subsidized medical care insurance, the core concept of inflation was an accident of history that has persisted. As the chart below shows, both all-items and core CPI inflation are re-accelerating on a year-over-year basis. But core CPI inflation set a new cyclical high in May at 2.44% while all-items CPI inflation has yet to take out its September 2005 peak of 4.69%. I think that 4.69% could very well remain the year-over-year percent change peak because the current level of energy prices is not much higher than it was in the fall of 2005 and are likely to be declining in the remainder of this year. But we may not have seen the peak in core inflation yet.



The core culprit is that hitherto obscure component – Owner's Equivalent Rent (OER). This is the implicit rent paid by the occupants of owner-occupied housing. This implicit rent is estimated by sampling the actual rents charged on comparable rental housing. Because the BLS accounts for gas and electricity prices elsewhere in the Shelter component of the CPI, it subtracts from its OER rent estimate the charges for utilities. So, price changes for gas and electricity are captured in the all-items CPI, but not in the core CPI. Changes in the OER are captured in both the core and all-items CPIs. OER is the highest-weighted single component in the CPI, accounting for 23.4% of the all-items CPI and 30.3% of the core CPI.

When the housing market was on fire and homeownership (a dubious term given the leverage in residential real estate today) in America was hitting record highs, rental units were going begging. This tended to hold down rent increases and thus the CPI heavyweight, OER. Also, when natural gas prices were soaring, these price increases were subtracted from rent increases, again holding down OER increases. Of course, rising natural gas prices were reflected in the accelerating all-items CPI inflation, but we have been trained to ignore all-items inflation, again thanks to Arthur Burns. So rising homeownership rates and rising natural gas prices had the effect of holding down the rate of increase in OER and thus core CPI inflation earlier in the cycle.

But now that the housing market is cooling off and the relative demand for rental units is rising, rents are increasing at a more rapid rate, which is putting upward pressure on OER. Moreover, natural gas prices are falling. Subtracting a negative, declining natural gas prices, from rents yields a positive increase in OER. The counterintuitive and countercyclical behavior of OER goes a long way in explaining why core consumer inflation is a *lagging* economic process.

Like Arthur Burns, will Ben Bernanke ask his staff to come up with a new and improved core measure of inflation? Core-plus, which excludes food prices, energy prices *and* OER? I doubt it. Bernanke strikes me as more of a straight shooter. Rather, he will bite the bullet and hike the funds rate on June 29 by 25 basis points and word the announcement in such a way to indicate that the FOMC is leaning toward yet another rate increase on August 8. This will help establish Bernanke's credentials as a hard money man with the influential editorial page writers of The Wall Street Journal. This will give Bernanke the flexibility to pause at the August 8 FOMC meeting when it will be apparent to all that real economic growth is in trouble (see section below on real retail sales).

It is somewhat ironic that the inflation in house prices abetted by the Fed's easy money policies indirectly held down core inflation earlier in the cycle and the moderation in house-price inflation is indirectly contributing to the acceleration in core inflation. In turn, this could force the Fed to tighten us into a recession. Boom-bust cycles are created by the Greenspan approach to monetary management. Ignore asset price inflation, which occurs early in a cycle, and respond to flawed measures of goods/services inflation, which occurs late in a cycle. Wouldn't it be better for the Fed to *not* target any prices – asset prices, goods/services prices, credit prices (interest rates) – but rather target the amount of credit it creates out of thin air so that there would be no *cumulative* increases in any prices as a result of Fed errors? The gory details of the CPI report are in the table below.

	% change		annualized change		% change	
	prior month	year-to-date	3 mo. ago	6 mo. ago	year ago	y-o-y '05**
CPI - ALL ITEMS	0.4	5.2	5.7	4.2	4.2	3.4
CORE - ALL ITEMS LESS FOOD & ENERGY (77.4)*	0.3	3.1	3.8	2.9	2.4	2.2
CPI ALL ITEMS LESS ENERGY (91.3)	0.3	2.9	3.2	2.8	2.4	2.2
FOOD (13.9)	0.1	1.8	0.6	1.7	1.9	2.3
ENERGY (8.69)	2.4	30.8	35.0	19.8	23.6	17.1
SHELTER (32.26)	0.4	4.1	5.0	4.0	3.2	2.6
COMMODITIES (40.79)	0.7	7.6	9.7	5.7	4.4	2.7
COMMODITIES LESS FOOD & ENERGY (22.31)	0.1	1.2	1.7	1.0	0.3	0.2
SERVICES (59.2)	0.3	3.5	3.1	3.2	3.9	3.8
SERVICES LESS ENERGY SERVICES (55.05)	0.4	3.8	4.4	3.7	3.3	2.9
FRB CLEVELAND MEDIAN CPI	0.4	3.7	4.2	3.6	3.0	2.5

Real Retail Sales On Track To Contract In Q2

Now that we have the May CPI data, we can adjust yesterday's anemic May nominal retail sales data for price increases. As you recall, nominal retail sales in May increased by just 0.1%. Today's CPI report shows the commodities (goods) component increasing 0.7% in May. Thus, CPI-adjusted May retail sales *fell* 0.6% month-to-month after a 0.3% *decline* in April. Even if June price-adjusted retail sales increase by 0.3%, real retail sales for Q2 are on track to *contract* at an annualized rate of about 3%. This compares with annualized growth of 13% in CPI-adjusted retail sales in the first quarter. Sure hope the economy is equipped with traction control! Tomorrow, the Fed will release complete monthly M2 data for May. The weekly data point to a monthly *decline* in nominal M2. With the 0.4% increase in the all-items CPI, real M2 will also be down for the month, which would mark the third consecutive month of declining

CPI-adjusted M2. But who wastes their time looking at real M2 growth? Only I and the Conference Board, the folks who put together the LEI, do.

Amanda Mason
am90@ntrs.com

Colombia: The Government's Risky Bet

On June 12th the Colombian stock market was closed after passing the closing threshold of a ten percent decline in one day (-11.44%). Following two years of record performance, the index has shown a marked uptick in volatility over the past month. Moderating commodity prices, concerns over the fate of the Andean Trade Block following Venezuela's withdrawal, and worries over the narrow composition of the index (approximately 64 percent of the index is made up of a group of Medellin-based companies, Grupo Antioquena, each with cross holdings in the others) have caused a rapid sell-off by small investors. Yesterday, the stock market took another serious hit, falling 8.73%, and the government eliminated a decree that required foreign capital portfolio investments to remain within Colombia for at least a year. Citing Colombia's economic fundamentals, high interest rates, and the newly attractive prices of liquid assets, the government believes the repeal will trigger investment inflows. But with the global risk appetite already shifting away from emerging markets, the risk of a massive unwinding of foreign investments occurring remains high. A sustained downturn in the Colombian stock market could potentially spark concerns over regional contagion.