

DAILY GLOBAL COMMENTARY

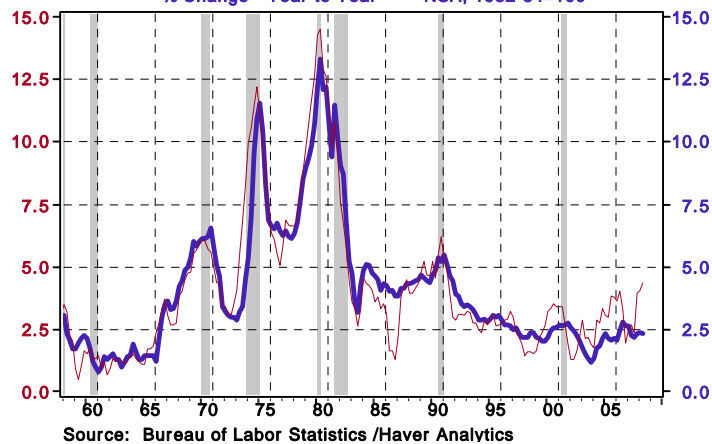
Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Asha G. Bangalore
Hagb3@ntrs.com

Stepping Back and Looking at the History of Core Inflation August 20, 2008

The July price reports – wholesale, retail, and import – have raised a number of questions about the underlying threat from inflation. Stepping back in time and looking at historical data should help us understand the big picture. Inflation is a lagging economic indicator which peaks after an economic downturn has commenced and establishes a trough several months after a recession has ended and the next recovery is underway (see chart 1).

Chart 1
CPI-U: All Items (Quarterly data ending 2008:Q2, total and core CPI)
% Change - Year to Year NSA, 1982-84=100
CPI-U: All Items Less Food and Energy
% Change - Year to Year NSA, 1982-84=100



Food and energy prices are out of the reach of monetary policy changes in the short-term, so I chose to focus on core price measures. Moreover, oil and other commodity prices have been trending down in recent days. Chart 2 plots a short history of the core consumer price index and core personal consumption expenditure price index. Both core price measures show a rising trend in the last few months and the latest year-to-year readings exceed the Fed's comfort level.

Chart 2
CPI-U: All Items Less Food and Energy
% Change - Year to Year NSA, 1982-84=100
PCE less Food & Energy: Chain Price Index
% Change - Year to Year SA, 2000=100



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Tables 1 and 2 present the behavior of core prices through business cycle since 1960. The main conclusion is that both core price measures – core CPI and core personal consumption expenditure price index – peak several months after the peak of the business cycle. In particular, the core CPI and core personal consumption expenditure price index peaked *eight* months after the peak of the last expansion in March 2001.

Table 1 Core Consumer Price Index

Business cycle peak to trough	Core CPI - Peak and Trough				Number of months	
	Date	Peak	Date	Trough	PP	TT
Apr. 1960 - Feb. 1961	Feb-60	2.3	Mar-61	0.7	-2	1
Dec. 1969 - Nov. 1970	Nov-70	6.6	Feb-73	2.8	11	27
Nov. 1973 - Mar 1975	Feb-75	11.7	Nov-77	5.9	15	32
Jan 1980 - Jul 1980	Jun-80	13.6	Jun-81	9.4	5	11
Jul 1981 - Nov 1982	Sep-81	11.8	Jun-83	2.9	2	7
Jul 1990 - Mar 1991	Feb-91	5.6	Dec-94	2.6	7	45
Mar 2001 - Nov 2001	Nov-01	2.8	Nov-03	1.1	8	24

Jul-08 yoy change in core CPI is 2.5%

Average 6.6 21.0
Median 7.0 24.0

Table 2 Personal Consumption Expenditure Price Index Excluding Food and Energy

Peak to Trough	Date	Peak	Date	Trough	Number of months	
					PP	TT
Apr. 1960 - Feb. 1961	May-60	1.94	Nov-61	0.90	1	9
Dec. 1969 - Nov. 1970	Jul-69	4.78	Jul-70	4.31	-5	-4
Nov. 1973 - Mar 1975	Feb-75	9.94	Jul-76	5.85	15	16
Jan 1980 - Jul 1980	Mar-80	9.18	May-80	8.66	2	-2
Jul 1981 - Nov 1982	Apr-81	9.13	Sep-84	3.71	-3	22
Jul 1990 - Mar 1991	Aug-90	4.64	May-94	1.99	1	38
Mar 2001 - Nov 2001	Nov-01	2.30	Sep-03	1.27	8	22

Jun-08 yoy change in core PCE is 2.31%

Average 2.7 14.4
Median 1.0 16.0

Note: Tables 1-2 – year-to-year changes in inflation measures are used

PP - number of months between peak of the inflation measure and peak of business cycle

TT - number of months between trough of the inflation measure and trough of business cycle

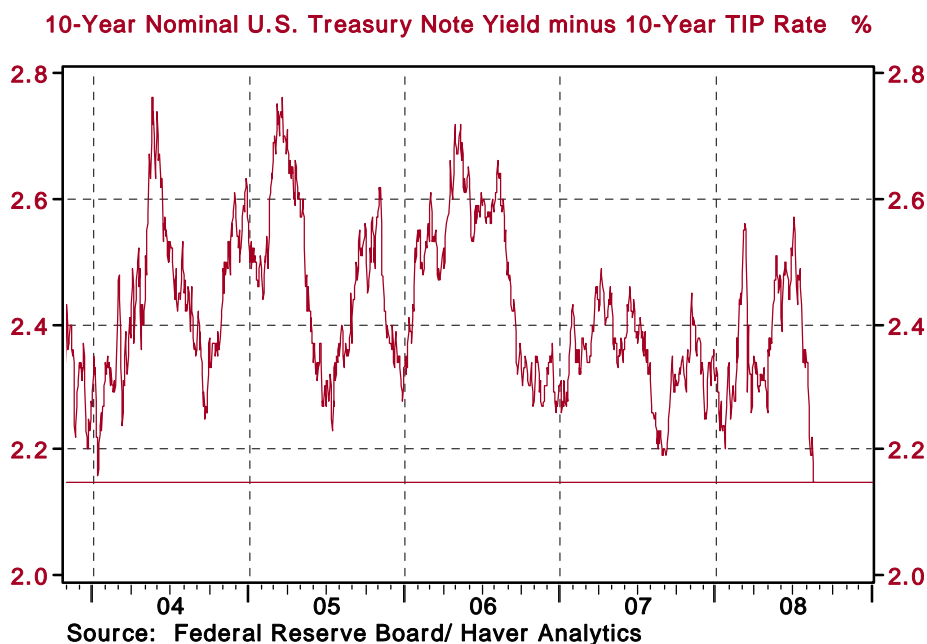
If the indicator peaks or establishes a trough before the business cycle peak or trough it is denoted with a minus sign

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Therefore, where is the U.S. economy at the moment? The NBER has yet to date the peak of the current business cycle. The four measures the agency uses to date business cycles have peaked. Our best guess is that the peak of the current cycle is December 2007/January 2008 or approximately around this time period. In other words, if history is a guide, the U.S. economy is probably at the brink of a turning point in inflation. This is entirely conceivable given the projection of weak economic conditions in the near term. Inflation expectations (as measured by the difference in nominal 10-year U.S Treasury note yield and the 10-year TIP yield) as of August 19 stood at 2.15%, down from 2.57% on July 3 (see chart 3).

Chart 3

Inflation Expectations



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