TD Bank Financial Group

TD Economics

Special Report

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WHAT'S GOING ON WITH U.S. INFLATION?

Yesterday's U.S. CPI report for January was not what the doctor ordered for the ailing U.S. economy. The annual rate for core CPI edged up a notch to 2.5%, testing the upper bound of the Fed's implicit comfort level. To make matters worse, the three-month annualized trend accelerated to 3.1%, the highest level in over a year and a clear indication of percolating price pressures.

With the U.S. economy already in a state of stagnation that is expected to persist over the first half of the year, the ongoing build-up in economic slack limits the risk of a sharp intensification of price pressures. However, don't look for a meaningful drop either. Rather, core CPI could very well hover at or slightly above 2.5% for the remainder of this year and next, irrespective of whether the U.S. economy dips into a technical recession or not. That's because some of the key past downward influences on CPI have lost their influence in recent months.

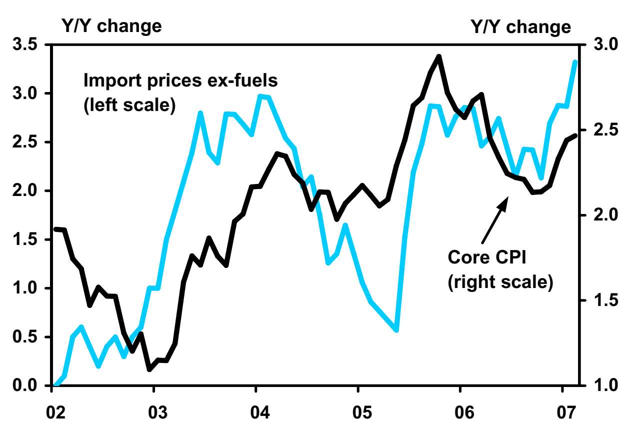
HIGHLIGHTS

- **U.S. core CPI will continue to test the Fed's implicit comfort level through 2008.**
- **Goods prices having less of a dampening influence than in the past, and this will likely continue to be the case going forward.**
- **Prices in the service sector proving to be sticky.**
- **Next Fed policy meeting on March 18th could mark the end of the easing cycle.**

Culprit #1 – higher goods prices

The decline in the U.S. dollar and tightening global capacity is translating into higher consumer prices for American goods, which are heavily imported. The graph below depicts the tight relationship between import prices (excluding fuels) and core CPI.

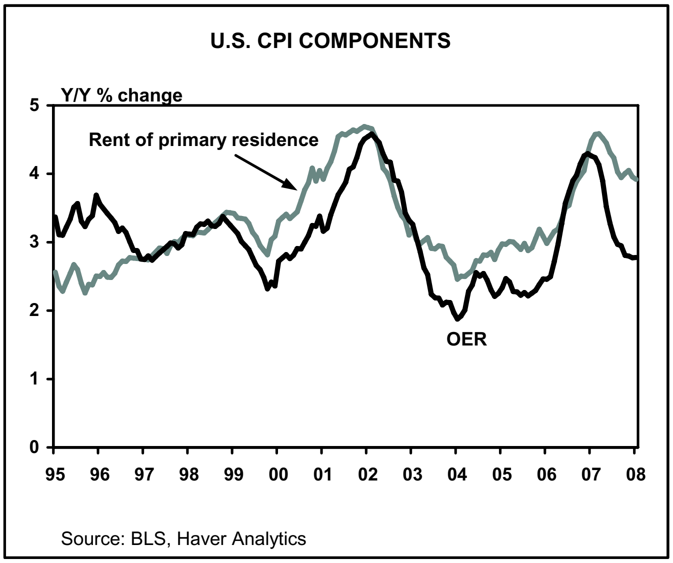
U.S. CORE CPI AND IMPORT PRICES



Source: Bureau of Labor Statistics and Haver Analytics

The three-month trend in prices for core goods (which excludes energy and food costs) trended up to 1.2% in January, the highest level since May 2006. Although this still-low level is hardly reason for alarm, it does mark a crucial reversal of fortunes. Prices for goods had been the one area that consistently weighed down the broader CPI index. Annual rates for this subcomponent held in negative territory for practically the whole of 2007, and pressures are now building to push the trend in the opposite direction.

For instance, the three-month annualized gain for apparel is at 4.6%, also the highest level since the spring of 2006. This component has posted five consecutive monthly gains, suggesting the hefty 0.4% gain in January cannot be dismissed as a statistical quirk. And, rising prices for clothing is not an isolated event. Medical products are also mirroring this trend with the 3-month annualized rate at a hefty 5.1% – the highest since January 2006.



Culprit #2 – sticky service prices

Sticky prices for services are the second influence preventing the CPI index from slipping back into tamer territory. The biggest component within the CPI index resides within the shelter subindex known as homeowner's equivalent rent (OER). This subcomponent represents about one-third of the CPI index and has always been a source of debate and confusion among market pundits. During the housing boom, there were heated discussions as to whether the OER index was underestimating price pressures in the economy. When home prices were rising at a double-digit annual pace, the OER component held steady at 2.3% from 2003-2005. Why? The OER does not reflect home prices; rather it is supposed to capture the user cost of capital, which means it approximates rent costs and not changes in the asset value. It is for this reason that even though annual growth in home prices for detached homes has been contracting for 17 straight months, the OER component in CPI is standing firm at +2.8%, which is where it has been for the past four months. Granted, this is a sharp deceleration from the 4.3% level registered one year ago, but it obviously does not compare to the carnage in the housing market.

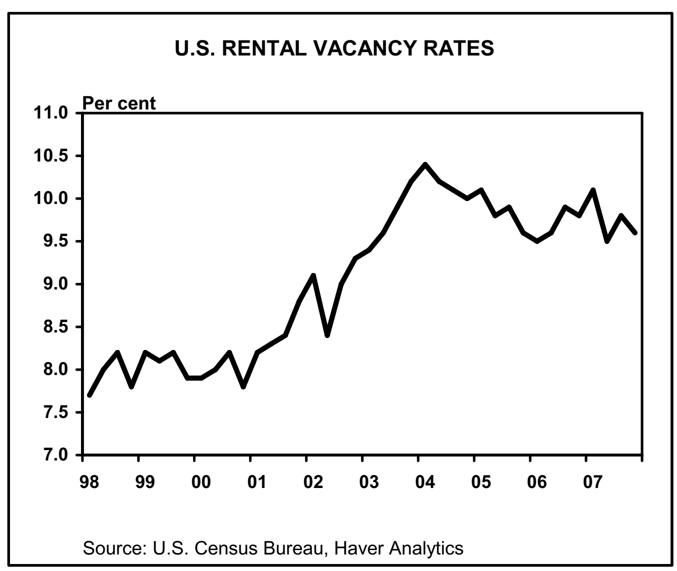
Because the OER component more closely tracks rental prices than home price movements, it may edge down over the course of the year at a rather slow rate. Rental vacancy rates are elevated but have been relatively stable over the past three years. In addition, homeownership rates have fallen back to levels seen in 2002, as eroded housing affordability squeezed people back into the renters market. And, even though prices are falling for homes and there is a high supply of vacant homes on the market, renters will probably be cautious in jumping into the housing market given the economic uncertainty that now permeates the landscape.

Although the OER price component is sticky by nature, it is not the only or even most powerful influence on core CPI at the moment. Excluding OER from core CPI reveals that the 3-month annualized trend remains unchanged at a 3.1% pace (compared to 1.4% a year ago). This is the highest level since 2005. Among some of the culprits, school tuitions and child care costs are running at a 6.7% annualized 3-month pace after four months of hefty gains, while medical services are holding at an elevated 5.1%.

Bottom line

The Federal Reserve has two legislated goals: price stability and full employment. With many of the economic risks stacked to the downside, the Fed appears to leaning more towards the second mandate by erring on the side of caution and cutting interest rates in order to prevent a deeper downturn. However, the Fed will be hard-pressed to ignore the stickiness that inflation is exhibiting. And, of course, the longer energy prices and other input costs remain elevated, the greater the chance that firms will have little choice but to pass those extra costs along to consumers.

From the Fed's perspective, it prefers the broader core PCE measure to gauge economy-wide price pressures than the core CPI measure. The former sat at a 2.2% annual rate at the end of 2007 and recent developments in the CPI measure are not good news for the PCE index. Within the latter, the shelter component carries a smaller weight



than the CPI index (15% vs. 33%), meaning that any cooling in the shelter CPI component won't have as big an impact on the core PCE measure. Meanwhile medical costs, which are on the upswing, carry a bigger weight in the PCE index (20% vs. 6.2%). Even the apparel component carries a larger weight (4.6% vs. 3.8%). Little surprise, then, that even though the Fed downgraded its estimate for 2008 GDP growth by half a percentage point in the FOMC January 29/30 minutes, it raised its estimate for core PCE to 2-2.2%. This is consistent with core CPI within a 2.5-2.7% range.

This is why the central bank is unlikely to cut rates drastically beyond current levels. Rather, we believe the next policy meeting on March 18th will mark the end of an easing cycle, with the Fed delivering a final 50 basis points in rate cuts. And, once the economy shows clear signs of recovery, the Fed will probably want to act quickly to remove some of the monetary stimulus that it has put in place in recent months.

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