TD Economics

Special Report

November 17, 2006

FED CONUNDRUM WITH ELEVATED INFLATION TO PERSIST

HIGHLIGHTS

- **Core CPI inflation likely to stay above Fed comfort zone for several more months**
- **Services have been a critical source of upward pressure on consumer prices**
- **We cannot easily dismiss recent strength in largest service subindex -- owners equivalent rent (OER)**
- **But, there is no inherent conflict with continued elevated inflation readings and our expectation for interest rate cuts in 2007**
- **We still expect 75 basis points in cuts, with the first of three coming in March**

A subdued U.S. consumer price index (CPI) report on Thursday was welcome news to financial markets, but it may be some time yet before inflation returns back to the Fed's comfort zone. The U.S. economy is at a stage in the business cycle when financial markets could have some difficulty seeing the forest beyond the trees when it comes to the future path of monetary policy. Over the next 3-6 months, data on economic activity and inflation may appear to be at odds with each other. Inflation indicators are likely to remain elevated and outside the Fed's comfort zone, even as a crumbling housing market heightens the downside risks to consumer spending. This may cause financial markets to deliberate in terms of the direction of monetary policy. But, given the lagged impact of interest rate changes on the economy, if the Fed conducted monetary policy on the basis of near-term inflation data, it would always be one-to-two years behind the game. We believe the Fed will not wait to see a marked deceleration in inflation before cutting rates in March because the balance of risks will be decidedly tilted in favour of increasing economic slack.

Inflation data may prove deceptive

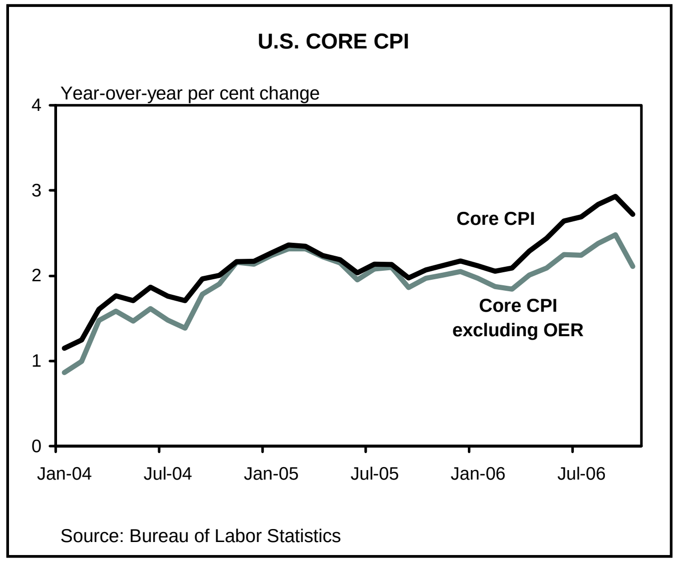
Even though there was some good news on the prices front on Thursday – when a modest 0.1% monthly gain in core CPI caused the annual rate to ease two notches to 2.7% – this does not put an end to the inflation debate. In fact, we would not be surprised to see the annual rate in core CPI hold stubbornly in the 2.6-2.8% range for the next 4-5 months, which is still above the Fed's implicit comfort level of 2-2.5%.

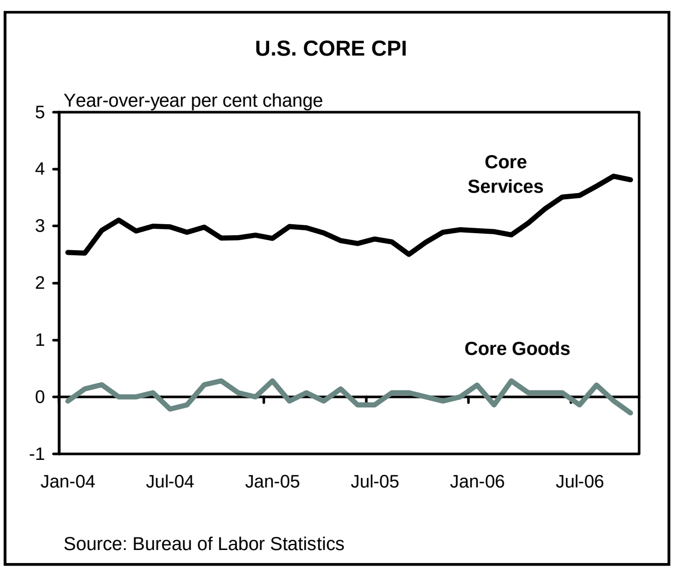
The subdued monthly performance in the CPI was solely due to a steep decline in goods prices, particularly clothing and automobiles. But there is nothing new about these prices having difficulty gaining traction. Core goods – excluding energy and food – were up a barely perceptible 0.2% in October, on a year-over-year basis. In the wake of intensified global competition, goods prices haven't cracked above the 1-per-cent mark in seven years! Plus, a 0.3% month-over-month retreat in core goods in October was the largest pullback in over a year, suggesting it is unlikely to be repeated in the coming months.

Conversely, services have been the critical source of upward pressure on consumer prices. This component makes up more than 50% of core CPI and is the reason why inflation is holding above the Fed's comfort zone. While the annual rate of growth for services like medical care and education is sitting in the 3-4% range, it is the owners equivalent rent (OER) category that has been a particular source of strain on the core measure this year, and there are no assurances that it will let up any time soon (see Box on page 3). This single component is rather important to the CPI outlook, because the OER has an outsized weight of nearly 30% in the core measure, so even when this subindex walks softly, it carries a big stick.

The 3-month annualized trend on the OER is running at 4%, after having averaged 2.2% in the prior three years. Part of the recent upward pressure on the OER annual rate is due to price behaviour a year ago, which economists refer to as base year effects. The subindex tracked a below-average monthly pace of 0.2% for much of 2005, and this is no longer the case. In fact, the OER is now tracking an above-average monthly pace of 0.4-0.6%. As a result, the subindex has been adding, on average, about half a percent to the overall annual growth rate in the core measure over the past four months, after having a negligible impact in 2005.

The seemingly sudden appearance of escalating price pressure in the OER may be the result of two sources. As home affordability collapsed in the U.S., rental vacancy rates started to tighten. And even though there has been some recent slackening, this may be adding upward price pressure to the OER measure. However, the bigger source of price pressure may be due to elevated energy costs in the past. Since residential leases often include utilities provided by the landlord, the Bureau of Labor Statistics subtracts these utility costs from rents when calculating OER. Therefore, during periods of rising energy prices, the growth in OER may be understated until these higher energy costs are reflected in higher rents. This may account for why the OER posted subdued gains last year in spite of a 17% spike in consumer energy costs. With the feed through operating under a lag, the OER has picked up steam in 2006, which could very well persist into early 2007 even with energy prices now easing back.





As we head into 2007, the CPI will likely continue to show the battle between goods and services. So, even though it's possible that the year-over-year change in the CPI has already crested, it doesn't look like it is set to ease by a significant degree over the next few months.

What's more, other inflation indicators may also stay on the high side over the near term. Take the Fed's preferred measure of inflation, the core personal consumption expenditure deflator (also known as core PCE). This index is running at a 2.4% annual rate. It is also above the Fed's comfort zone, which is believed to be in the 1.75-2% range. If the index were to post monthly gains of 0.15% – consistent with the median historical monthly pace, but below trends registered over the past year – the annual rate would still hold at about 2.3% for five more months, which is not the stuff that screams for rate cuts.

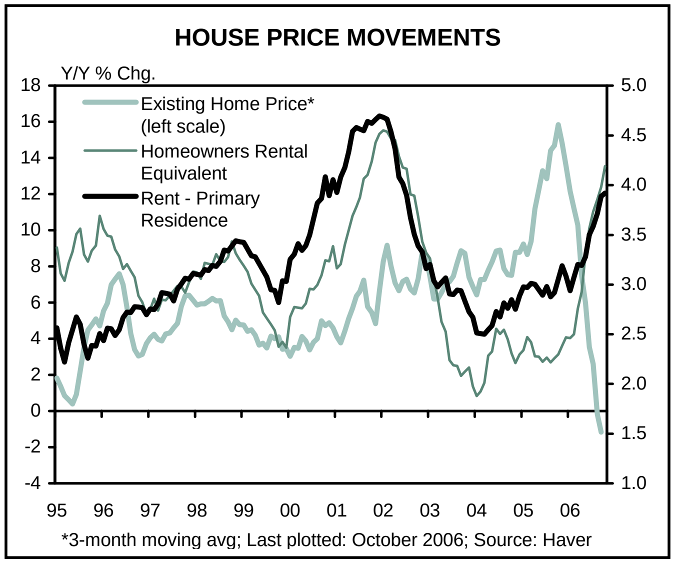
Likewise, wage pressures have also heated up lately. Business unit labour costs are running at a 5% annual clip, while average hourly earnings are clocking in at 4%.

Don't run for cover

Given recent inflation trends, it is understandable that fixed income futures are hesitant to price in Fed rate cuts. However, we still believe the Fed will cut rates by 75 basis points in 2007 (see Global Markets). Indeed, there is no inherent conflict with elevated near-term inflation observations and our expectation for interest rate cuts.

The CPI component of Owners Equivalent Rent (OER)

For those not familiar with the OER, it has always been a source of contention for market participants for two reasons. The OER is an imputed price measure that captures the amount a homeowner would pay to rent, or would earn from renting their home in a competitive market. Since the component relies on informal estimation judgments and requires some quality adjustment related to location and size, it can be prone to estimation errors. In addition, some analysts argue that this measure understates price pressures in the housing market since it does not directly include purchase prices. But the OER is not meant to capture appreciation of home values. Rather, the measure correctly attempts to remove price changes that are reflective of asset value and only account for the consumption aspect. In economic jargon this is the user cost of capital. It is for this reason that the OER more closely tracks rental prices than home prices.



When the Fed decided to stand pat with a 5.25% fed funds rate, it did so in a forward looking framework, by noting that "readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand." The time frame for the Fed is not the next 1-5 months, but rather 12-18 months due to the lags with which inflation and monetary policy feed through the economy.

In addition, we have yet to see the full feed through of a collapsing housing market on consumer spending, although some retailers are giving us a preview after having reported sagging sales for November, following unimpressive nationwide results in September and October. It is still our belief that real consumer spending will post sub-par 2% gains over the next couple of quarters. With the balance of risks expected to shift in favour of widening economic slack, we believe the Fed will remain forward looking and is unlikely to wait for disinflation to emerge before acting to cut rates.

And, there is historical precedence of this. January 2001 is a recent example when the Fed cut interest rates in advance of a deceleration in inflation, because the economic environment had soured beyond their expectations. At that time, real interest rates were over 3% and the economy was reeling from erosion on equity wealth and job losses in the wake of the tech implosion. This time we expect to see erosion in home wealth, but the economic backdrop is quite different. Nominal and real interest rates today are significantly less restrictive – a full percent lower – and the corporate restructuring that occurred at the start of the decade mitigates the risk of another round of mass job losses (see special report, The Decline and Fall of the U.S. Housing Market). As such, we believe some modest tweaking in interest rates is all that will be required in this economic cycle to shore up consumer spending and confidence.

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