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# US WEEKLY ECONOMIC UPDATE

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# US Economic and Investment Perspectives

## Inflation Poised to Rise in 2005

With the first stages of the inflationary cycle now firmly established, we expect to see both headline and core consumer inflation head higher in 2005. Overall consumer price inflation is likely to hit 3.5% next year, while core inflation could come in around 3%, the biggest annual increase since 1995.

Mounting price pressures have been evident at the lower stages of processing for many months, but only recently have we begun to see higher material and supply costs passed along (**Display 1**). Core crude-goods prices rose sharply in 2003, climbing 18%, and have accelerated this year, rising another 30%. This long sharp rise has slowly begun to work itself up the supply chain. Prices at the next level of processing, intermediate materials, turned higher early this year, and their pace has quickened in recent months. Through the end of October, intermediate material prices were up 7.8%, the fastest gain since 1995.

Not surprisingly, finished-goods prices at the producer and consumer level have begun to turn up, following the lead of rising prices at both the crude and intermediate stages of processing. For the first 10 months of the year, they are up 2.2% annualized at the producer level, excluding volatile food and energy prices. This may not sound very threatening, but it represents the largest increase in core producer prices since 1995. Following suit, consumer-goods prices are also rising for the first time in several years.

Industry price data tells a similar story. Each month the Bureau of Labor Statistics (BLS) provides net-output producer-price series for each industry, measuring the change in the price of all products in each. Observing price trends by industry, rather than by product or commodity, enables us to better determine the ability of companies and industries to raise prices.

Importantly, the October PPI showed positive overall pricing in 15 of the 20 manufacturing industries—the largest number this year. The industries were transportation, plastics, chemicals, fabricated and primary metals, furniture, paper, petroleum, apparel and leather, textile mills and products, and beverages and tobacco.

Since January, BLS has published producer price data for retail industries. A retail producer-price series measures the difference between the acquisition and selling prices of a good, capturing the retail markup and indicating how readily firms can raise prices when acquisition costs are rising. In the past few months, this series has shown positive pricing for clothing and general merchandise, motor vehicles and parts, sporting goods stores, and furniture stores.

Businesses across a range of sectors have succeeded in raising prices and a relatively high number plan to do so in coming months. The National Federation of Independent Business estimates that the percent of businesses planning to raise prices has been running at about 25% in 2004—the highest reading in more than a decade (**Display 2**). Price hikes were more frequent in manufacturing (26%) than in retail (20%), but both were well above year-ago levels.

Households are also beginning to expect more inflation. The rise in expectations, now above 3%, do not appear to be driven by transitory factors such as energy prices; they are roughly the same five years out as they are for the coming year.

How inflation expectations are formed is unclear, but they appear to be driven by an interplay between excessive liquidity, price trends and the general availability of goods and services. Analysts typically minimize the role of expectations in causing inflation, but history suggests they are important.

Easy money and credit conditions are important contributors because, at its root, inflation is a monetary phenomenon. Today, monetary policy remains very accommodative, evidenced by real short-term rates, which remain negative three years into the economic expansion. Policymakers, moreover, are removing monetary accommodation at a much slower pace than in the past. When price pressures at the intermediate and crude stages of processing first emerged in 1994, policymakers raised the federal funds rate by 300 basis points to 6% in just 12 months. That speedy response nipped inflation and prevented higher material prices from passing to the retail level. Today, policymakers are proving to be more measured in their inflation response. For instance, this year core consumer prices have risen in step with official rates (**Display 3**), meaning the Fed is following rather than preempting the inflation cycle.

That should result in a somewhat faster, longer inflation cycle, especially given that bank lending standards appear to be more lenient than at anytime since the mid-1990s (**Display 4**). A recent Federal Reserve survey of senior loan officers found that banks, while maintaining easy lending standards for consumers, are extending similarly relaxed standards to small and mid-sized businesses.

Together, a relaxed monetary policy and easy credit conditions are the fuel for tomorrow's inflation. Consumer prices are poised to rise faster in 2005, and that probably will surprise many when it happens.

*Joseph G. Carson*
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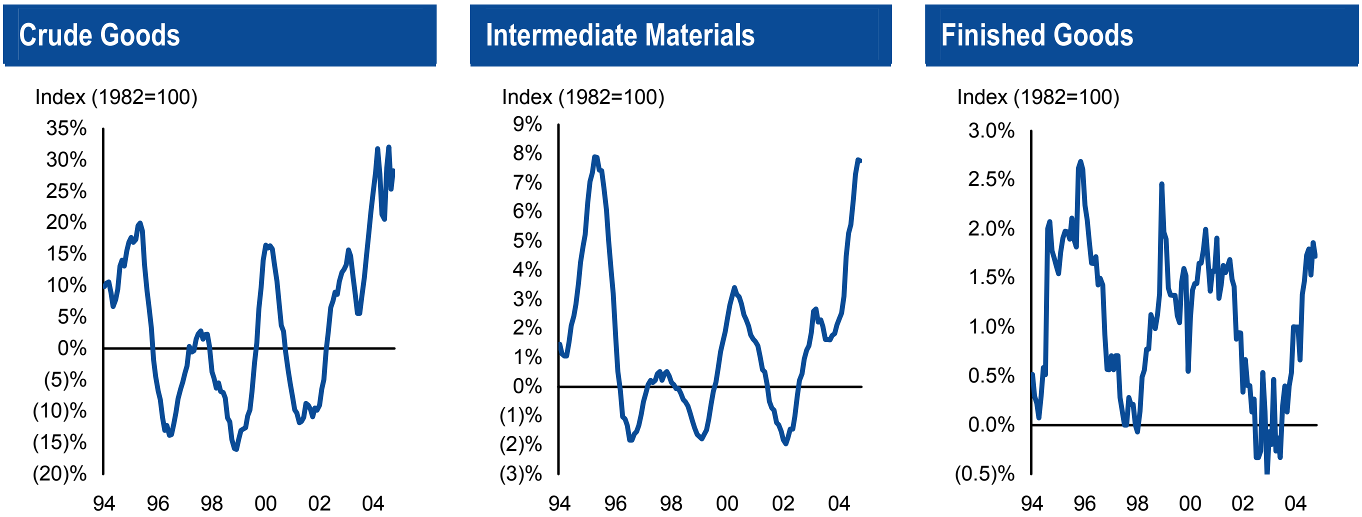
*November 19, 2004*

**Display 1: Price Increases Have Moved Up the Supply Chain**

Year-over-Year Growth in Producer-Price Index Processing Stages, Less Food And Energy

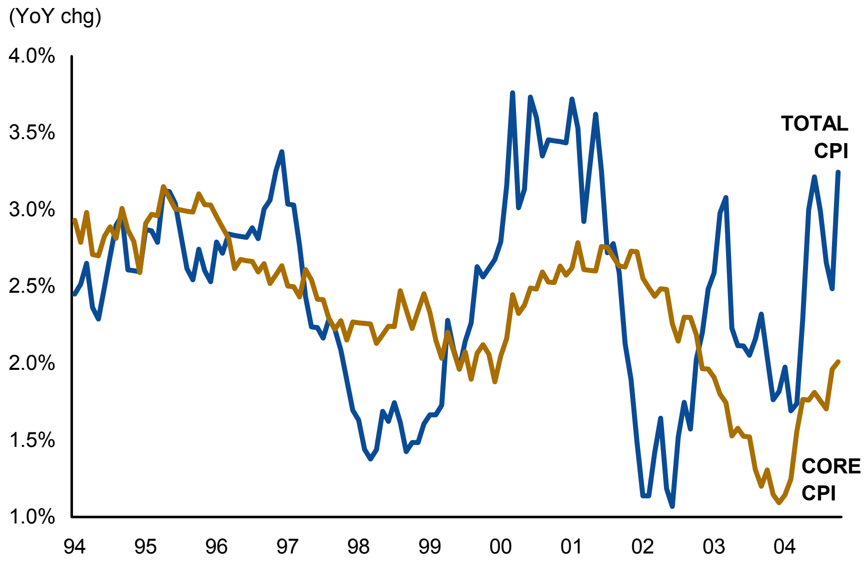



*Source: Bureau of Labor Statistics and Haver Analytics, November 19, 2004*

***Price increases have penetrated all levels of the supply chain. Since the beginning of 2003, prices of core crude goods have increased 45%. Consequently, prices of core intermediate materials rose sharply this year, and higher prices are now apparent at the finished-goods level.***

**Display 2: Consumer Prices Moving Higher**

Year-over-Year Percent Change in Total and Core Consumer Price Index

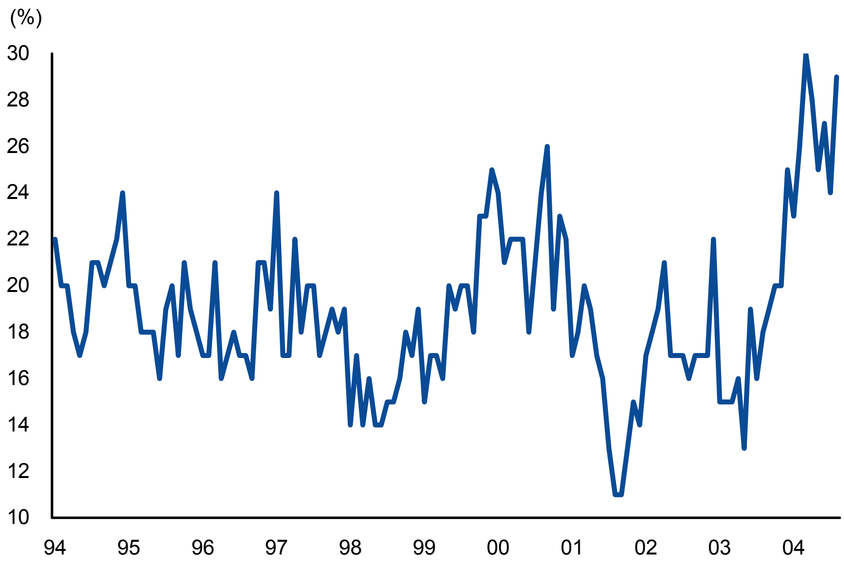



*Source: Bureau of Labor Statistics and Haver Analytics, November 19, 2004*

***At the consumer level, higher energy prices have pushed the headline CPI index up sharply during 2004. In recent months, core consumer prices have begun to move higher as well.***

**Display 3: A Growing Number of Companies Plan to Raise Prices**

NFIB Survey: Percent of Small Businesses Planning to Raise Average Selling Prices (three-Month Moving Average)



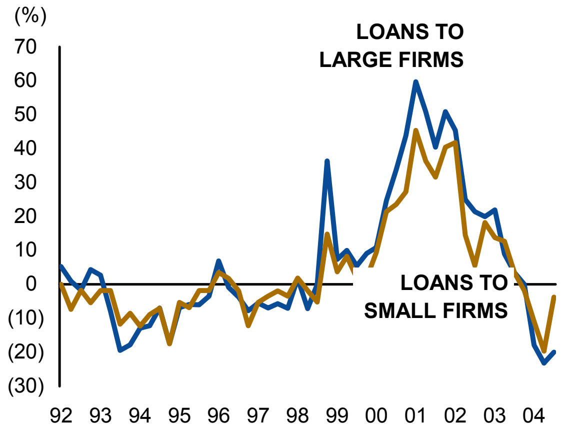

*Source: National Federation of Independent Business, Haver Analytics and Alliance Fixed Income, November 19, 2004*

***According to the National Federation of Independent Business, an association of roughly 600,000 small businesses, an increasing number of firms plan to raise prices over the next several months.***

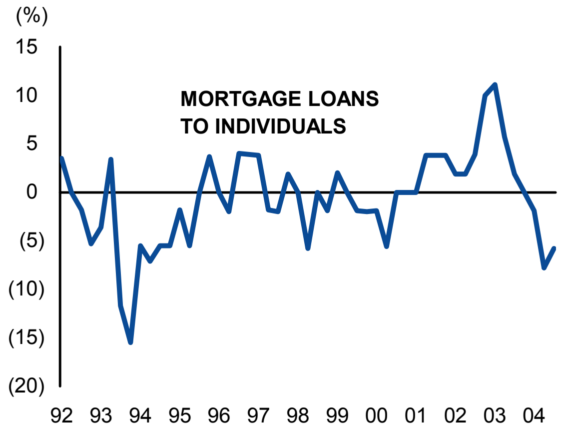
## Display 4: Banks Easing Lending Terms

Federal Reserve Survey of Senior Loan Officers

**Banks Tightening C&I Loans to Large and Small Firms**




**Banks Tightening Standards for Mortgages to Individuals**




*Source: Federal Reserve Board and Haver Analytics, November 19, 2004*

***According to a recent Federal Reserve survey of senior loan officers, banks are easing lending standards to businesses and maintaining easier standards for individuals.***