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US Economic and Investment Perspectives

Odd Couple: Retail Prices Continue to Lag Producer Prices

In the past few years, there has been a slow but steady improvement in corporate pricing power. Core goods prices at the producer level have been running at an annualized rate of 2.5% to 2.75% in 2005, up from a little more than 2% in 2004 and 1% in 2003—the fastest gains since the early 1990s.

Oddly, very little of this increase has flowed through to core goods prices at the retail level, which have been running 0.5% to 0.75% annualized through the first eight months of 2005. While that is marginally faster than the price gains of 2004 and represents the fastest increase in five years, it is still substantially less than expected given the rise in core goods prices at the producer level. It's surprising because consumer-price increases are generally equal to or higher than producer-price increases.

As can be seen in **Display 1**, consumer prices have historically run close to or slightly faster than producer prices. That was true from the early 1980s all the way through the late 1990s. Over this period, core goods prices at the retail level ran 0.25% per year faster than goods prices at the producer level. Yet since 1999, the reverse has been true. Not only have producer prices of core goods consistently outpaced the gain in core goods at the retail level, but the margin has continually widened. In the past couple of years, the spread between the two price series has been the widest since 1975, the first year the government published the producer-price series.

If the data on prices is even approximately accurate, one would expect margins and profits in the retail-trade area to be dramatically depressed. But they are not. According to the Department of Commerce, retail-trade profits in early 2005 were at record levels, and many retail analysts that we have contacted indicated that several of the large retailers (not discounters) are operating close to, if not at, peak margins.

Why the Gap?

What, then, is driving this pricing gap? We think it might be a combination of fundamental and technical factors—though it is difficult to quantify the effects.

Retail Productivity: With labor costs constituting roughly three-fourths of retail costs, if not more, it would appear that productivity in the retail-trade sector has improved. One proxy for productivity—real retail sales per employee—does show a healthy rebound in recent years. But official data show that manufacturing productivity has been running in excess of 5% for several years, and core producer prices have still been on a steady climb. So it is hard to see how faster retail-sector productivity by itself explains the gap between producer and consumer core goods prices.

Imports: Import growth might be influencing the price imbalance, especially since producer prices only target prices of domestically produced goods while consumer prices capture both domestic and foreign goods. However, imports have been an important and growing part of the US economy for decades. It is, therefore, hard to see how, since the late 1990s, the flow of imports created a bigger wedge between domestic and foreign prices. If anything, one would think that greater connectivity (i.e., increased trade flows) between the developed and developing economies of the world would lead to a greater convergence in prices.

On the other hand, the growing flow of imported consumer goods does appear to have had an impact on lower-priced domestically produced goods. Perhaps this is because many lower-end priced goods are now produced offshore and the rate of price change (inflation being the measure of price change rather than price level) for these items is running less than that of the higher-end goods still produced in the US. There is some support for this argument because the operating margins of high-end retailers and department stores have improved in recent years, while those at discounters have declined **(Display 2)**.

Product Substitution: The introduction of product substitution at the consumer level but not at the producer level may also be an influence. The Bureau of Labor Statistics introduced product substitution in the CPI in 1999, exactly when there was a trend-shift between the two price series. Product substitution assumes that when the price of a product rises, consumers will shift to a different item. Importantly, substitution can take on many forms among brands, product sizes and outlets, and among different items within a category or different categories. It is hard to say how much of this measurement change is responsible for the gap between PPI and CPI core goods prices, but we think it would be no more than 0.5%.

In the final analysis, we are faced with analyzing and reacting to a shift in price trends that does not conform to historical experience. In the past, the rate of increase in core consumer goods prices was tied directly to the rate of price change in producer prices. Today, the price-through effect from producer prices to consumer prices is a lot smaller. Part of this might be tied to increased globalization and the fact that the prices of many low-end domestic goods, which are produced mainly offshore, are rising less quickly than those of domestically produced goods.

So far, this has been a net plus for the US because it has led to lower core inflation than what might otherwise be the case, which in turn has helped keep interest rates relatively low. But the price gap of the past few years also makes the US more susceptible to changes in global inflation trends, and that has possible ramifications for the US interest-rate cycle. For instance, given that global operating costs have risen on the back of higher energy costs, it is likely that US core prices will also rise. In the end, we still expect cyclical pressures to push core consumer inflation higher, but the process could be more extended given the various global influences at work today.

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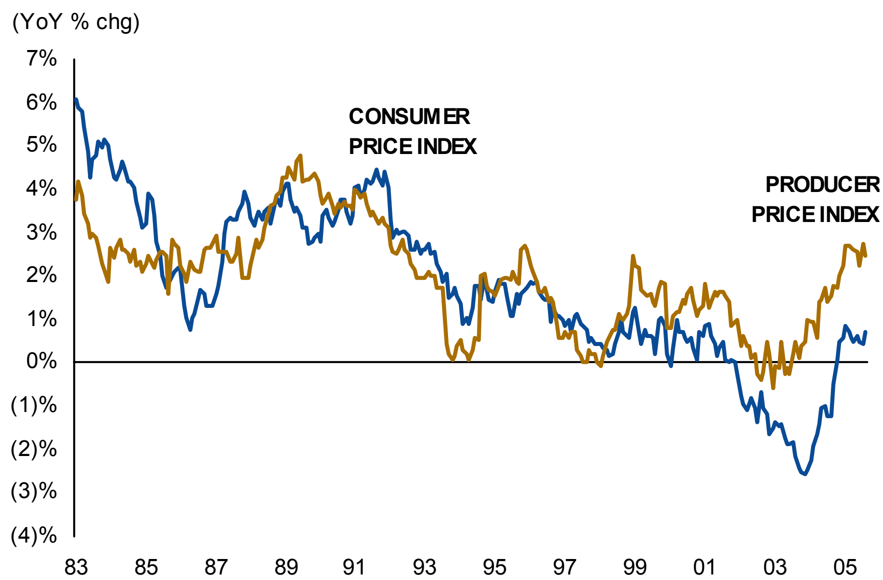
Display 1: Prices Rise Rapidly at the Producer Level, but Not at the Retail Level

Core Goods Prices at Producer and Retail Levels

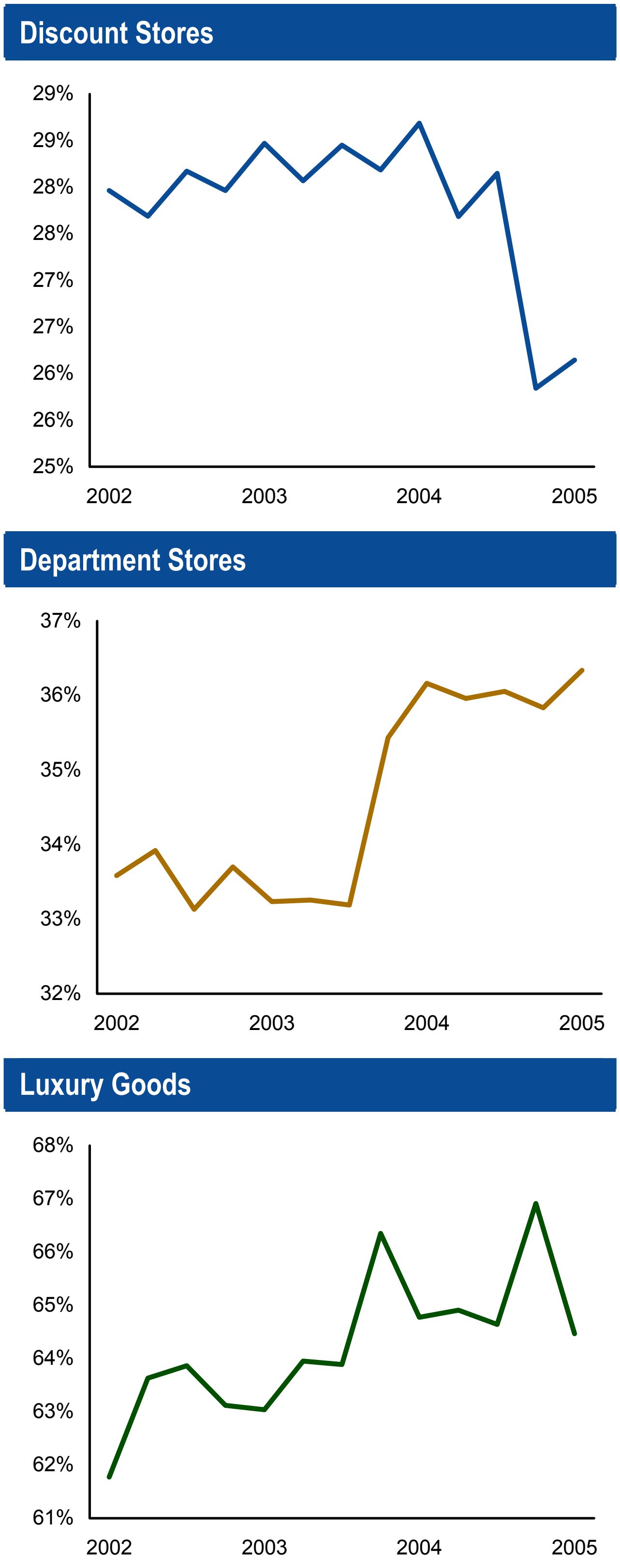


Source: Bureau of Labor Statistics and Haver Analytics; September 16, 2005

Historically, core goods price increases at the retail level followed price changes at the producer level. That relationship has changed over the last several years, and we think there are fundamental and technical reasons behind the shift…

Display 2: Weaker Margins at Discounters

Average Gross Margins at US Retailers



Source: Alliance Capital; September 16, 2005

We suspect the slower rate of retail price change captured by the consumer price index might have to do with the growing importance of imports, especially of lower-priced goods. Since the consumer price index includes both import and domestic prices while the producer price index only captures domestic goods prices, the rate of price change for lower-end goods (which are predominantly produced overseas), if slower as we suspect, may be dampening the faster rate of price change of higher-end goods still produced in the US.

The fact that operating margins of discounters have declined over the past few years while margins held reasonably steady (if not improved somewhat) at department stores supports this view.