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Your guide to understanding today's economy and financial markets

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It's Always Somethin'

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If the policymakers at the Federal Reserve didn't have enough to worry about before...they do now

...inflation pressures were simply, unequivocally, and without question ugly, alarming, and downright uncomfortable in November, making the unenviable job of the Fed even more unpalatable in coming months

Quick History

The Federal Reserve cut its key short-term interest rate—the federal funds rate—three times in recent months. A 0.50% cut on September 18 was followed by 0.25% cuts on October 31 and on December 11. The rate is now at 4.25%, corresponding to a 7.25% prime lending rate.

(excluding food and energy prices) had been within or very close to the Fed's presumed target range of 1.0%-2.0%.

This is where the problem arises, as many inflation measures now exceed the Fed's target range. Such a reality will make it more difficult for the Fed to justify further cuts, unless market conditions deteriorate further. Having said that, we still expect the Fed to trim its key rate again on January 30.

Consumer Prices

The Consumer Price Index (CPI) jumped 0.8% during November, the largest monthly rise in two years. More ominously, the CPI has now risen 4.3% over the latest 12-month period, the largest annualized rise since mid-2006.

The core rate did not behave much better, with a 0.3% increase the largest in 10 months. The 2.3% rise of the past 12 months "violates" the Fed's desired target range.

As one would expect, energy prices were the culprit. The 5.7% rise in overall

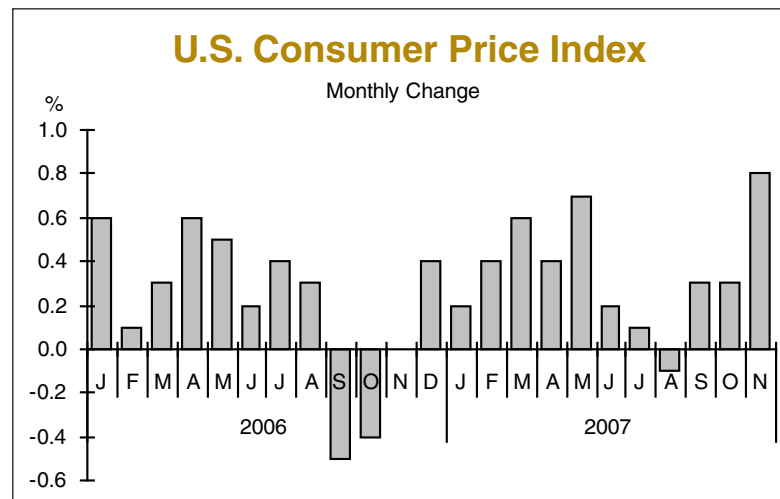
energy costs in November accounted for more than two-thirds of the 0.8% spike.

Producer Prices

If the CPI rise was ugly, it takes much stronger (or scarier) descriptors to describe the 3.2% rise during November in the Producer Price Index (PPI, a measure of wholesale prices). The 3.2% rise was the largest one-month increase since 1973, a period of 34 years.

Equally alarming was the 7.2% PPI rise of the past 12 months, an inflation rate which brings back painful memories of the late 1970s...

Yes, energy prices were again the culprit, with overall energy costs up 14.1%



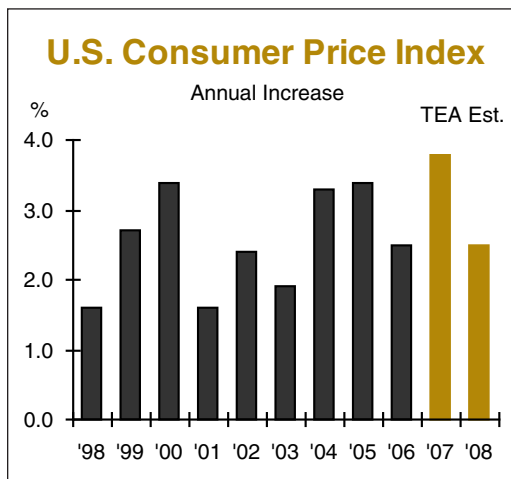
The Fed's rate cuts have been geared to minimizing some of the domestic and global paranoia that has engulfed financial markets and lending markets, primarily since August. The Fed's intention has *not* been to bail out homeowners, lenders, and investors who are players in the subprime lending mess, but to enhance overall financial market liquidity.

Too many lenders and investors remain uncomfortable in dealing with other lenders and investors around the world...

...not a good sign

The Fed had been able to cut its key interest rate in part because inflation pressures, especially at the core level

and gasoline prices soaring nearly 35%. Yes, the PPI tends to be a much more volatile inflation measure than is the CPI. Other news saw the core rate rise 0.4% in November, with a more palatable rise of 2.0% over the most recent 12 months.



Overall Versus Core Measures

The Fed has frequently drawn criticism because of its focus on core inflation rather than overall prices. The logic was that monthly inflation measures would be less volatile without the wide swings in food and energy costs. In addition, core prices over time largely matched the rise in overall or “headline” prices.

With the wide disparity during 2007 of the two measures, critics have suggested core inflation measurements were of value as long as one did not eat or drive...

...touché

Former Fed Chair Alan Greenspan recently joined the overall-versus-core debate, suggesting that core inflation should no longer be the preferred measure. He noted recently, “The notion of core pricing is fading in importance as: One, food prices driven by increased long-term demand for meat and milk rise with the growth of China and other developing countries, and: Two, global oil supply peaks lower and sooner than had been contemplated earlier.” (*The Wall Street Journal*)

Greenspan also noted in recent days that the challenge for his successor, Ben Bernanke, is greater than that faced by Greenspan during his 18+ years as Fed Chair. He stated, “This is a much tougher monetary policy environment than

anything I experienced.” He noted the Fed has less leeway to cut rates now than it did following the stock bust of 2001 because underlying inflation pressures are greater (*The Wall Street Journal*).

Personal Consumption Expenditures Index

The Fed doesn’t think much of the CPI as a measure of consumer inflation. The Fed much prefers the PCE Index, which it sees as a more up-to-date and responsive inflation measure. The 12-month core rate has been around 1.9% in recent months, within the Fed’s 1.0%-2.0% range. New data to be released at the end of December may not be so friendly.

Not Just a U.S. Disease

If misery loves company, the Fed has plenty. Inflation in the Eurozone reached 3.1% during the 12-month period ending in November, the highest level in more than six years. The European Central Bank (ECB) is much more focused on annual inflation targets, with the 1.0%-2.0% range almost gospel.

The reason? Two major hyper-inflations during the 20th Century in Germany following WWI and WWII have remained in Europe’s collective memory. The recent violation of the target band will keep the ECB talking tough, although it expects inflation pressures to subside in 2008.

Inflation in 2008?

It seems of only modest comfort today that the consensus view of economists for consumer prices in 2008 centers around a 2.5% increase, matching the 2006 rate. Many forecasters suggest that a flirt with, or fall into, recession will lessen inflation pressures.

Those economists who focus on the pace of money growth note that the essentially flat growth of M1 during the past three years strongly suggests low inflation in 2008 and 2009.

I see inflation pressures lower in 2008 as well...for a different reason. I expect oil prices to fall significantly during the next year, helping to unwind more recent inflation increases...

...stay tuned

“TEA”ser

A man who trims himself to suit everybody will soon whittle himself away.

—Charles Schwab

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