



# Economic Flash!

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## US CPI: Not a Bad Number If You Don't Drive

Percent Changes:	Seasonally		Adj.			Unadj.
	May	April	March	Feb	Jan	May08/07
All Items	0.6	0.2	0.3	UNCH	0.4	4.2
Excluding Food/Energy	0.2	0.1	0.2	UNCH	0.3	2.3
Energy	4.4	UNCH	1.9	-0.5	0.7	17.4
Food and Beverages	0.3	0.9	0.2	0.4	0.7	5.0
Food	0.3	0.9	0.2	0.4	0.7	5.1
Housing	0.5	0.3	0.4	0.2	0.2	3.3
Shelter	0.2	0.1	0.1	UNCH	0.3	2.6
Rent of Primary Residence	0.2	0.3	0.2	0.2	0.3	3.5
Owners' Equivalent Rent	0.1	0.2	0.2	0.1	0.3	2.6
Housing Fuels/Utilities	2.4	2.2	2.0	1.3	UNCH	10.7
Household Furn/Operations	0.2	-0.1	0.5	UNCH	0.1	0.2
Apparel	-0.3	0.5	-1.3	-0.3	0.4	-0.6
Transportation	2.0	-0.7	0.7	-0.7	0.5	8.1
New/Used Motor Vehicles	-0.1	-0.2	-0.1	-0.2	-0.1	-0.3
New Vehicles	-0.1	-0.2	-0.1	-0.3	-0.3	-1.2
Gasoline	5.7	-2.0	1.3	-2.0	1.2	20.8
Medical Care	0.2	0.2	0.1	0.1	0.5	4.1
Prescription drugs	-0.7	-0.2	0.4	0.1	0.7	2.8
Recreation	0.1	-0.1	0.3	0.1	0.2	1.2
Education/Communication	0.4	0.4	0.3	0.1	0.4	3.0
Tobacco	0.8	0.3	-0.1	0.4	1.1	5.7
Commodities	0.9	0.1	0.3	-0.2	0.5	5.1
Services	0.5	0.3	0.4	0.2	0.3	3.5
Airline Fares	3.2	-0.5	3.0	-0.3	0.8	14.4
CPI-urban & clerical	0.7	0.2	0.4	UNCH	0.4	4.5

- Although gasoline prices typically spike in advance of the summer driving season, May's unadjusted 8.9% m/m increase in fuel prices proved to be large even on a seasonally adjusted basis. This translated into a larger-than-consensus monthly gain of 0.6% in headline CPI, which worked out to a sizeable 4.2% increase on year-over-year basis. Core inflation was relatively tame at 0.2% m/m and 2.3% y/y, but is unlikely to remain so inured to rising commodity prices for too much longer.
- While it is true that both April and March's month-over-month headline CPI numbers were quite low despite surging oil prices, these results were really just a product of seasonality. As we see today, this statistical gift is both misleading and temporary in a world of consistently rising energy prices. The

stark reality is that despite monthly variations, both food and energy prices should remain on an upward trajectory which we do not expect to let up until well into 2009.

- With energy prices rising at over 17% a year, and food continuing to climb by over 5% over the last 12 months despite only rising by 0.3% m/m in May, there is a very real risk that these price gains will start to impact consumers' inflation expectations. This scenario is likely keeping Fed officials up at night, and is the reason why their public inflation rhetoric has been getting stronger.

## Implications & Actions

**Re: Economic Forecast** — Core inflation may be relatively tame for now, but today's spike in headline inflation will certainly make the already nervous Fed even more nervous. With crude oil pushing up against new highs, and gasoline prices following closely behind, inflation is proving to be a sustained and serious problem for policy makers on every continent. In the US year-over-year inflation has not moved below 3% since September 2007 and we see it touching 5% by the fall. All this means that the FOMC will have to kick off a prolonged tightening campaign as early as the fourth quarter, which will likely see the overnight rate rise by 200 bps before the end of 2009.

**Re: Markets** — May's bump up in headline inflation was certainly stronger than the consensus call, but did not make a terrible impact on the markets, which have spent the last few weeks girding themselves for a new round of Fed tightening. The fact that the bump-up in CPI was almost solely an energy story also had a calming effect on investors who were ready for something worse.

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