



Economics
& Strategy

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When, If Ever, Do Food & Energy Prices Count?

by Avery Shenfeld

We are what we eat, and even the greenest among us use some energy. But for financial markets and the US Federal Reserve, when it comes to thinking about inflation, food and energy prices are often overlooked. The custom isn't as ingrained in Europe, where the central bank focuses more on the total CPI. In other countries (Australia, Canada) foods other than fresh produce are included in the core measure.

The Fed's focus on core CPI or the core PCE price index made sense in a world in which gasoline or food prices went up and then came back down. The concept dates from a paper by the economist Robert Gordon in 1975, written just after a spectacular climb and subsequent cooling in both food and energy inflation measures.

But what if today's higher fuel costs simply give way to even higher prices in the future, or if global forces push food prices on a permanently faster trend? Since 2002, on a cumulative basis, headline CPI has outpaced core by roughly 4% (Chart 1), and more of the same is in store for 2008. Indeed, the upcoming headline CPI could be as high as 3.5% as we hit the one-year anniversary of a temporary dip in gasoline prices in 2006.

In that climate, as it fends off a growth slowdown, it will be even more convenient for the Fed to talk more about the core rate, and less about the overall CPI. But as the economy recovers in 2008, bond investors will be staring at a US CPI rate taking aim at 4% by next fall, making inflation-linked TIPS a better play.

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

Oil Inflation Served Four Ways

Global energy markets are fuelling US inflation in at least four ways. First, and most directly, rapid growth in oil demand from developing Asia, and from oil exporters that typically subsidize their domestic consumers, has crude prices on the rise. Global supply is still advancing, but all of the marginal barrels are coming from high cost unconventional sources—oil sands and deep water.

Moreover, creating room for developing country consumers and industry to elbow their way into the market requires ever-rising prices to induce the necessary conservation in the developed world, so that overall demand is held to the sluggish trend growth in supply. We will still be looking at US\$100/bbl oil in the fourth quarter of 2008, but a rebound from the unusually low crack spreads that prevailed in recent months will see gasoline prices top US\$3.50/gallon (Chart 2).

Chart 1
US Core CPI Understates Trend

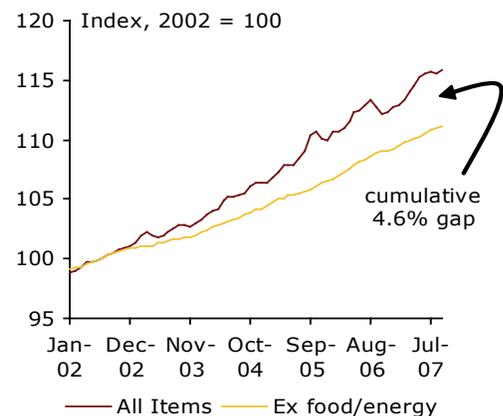


Chart 2
Further Pressures on Gasoline Prices

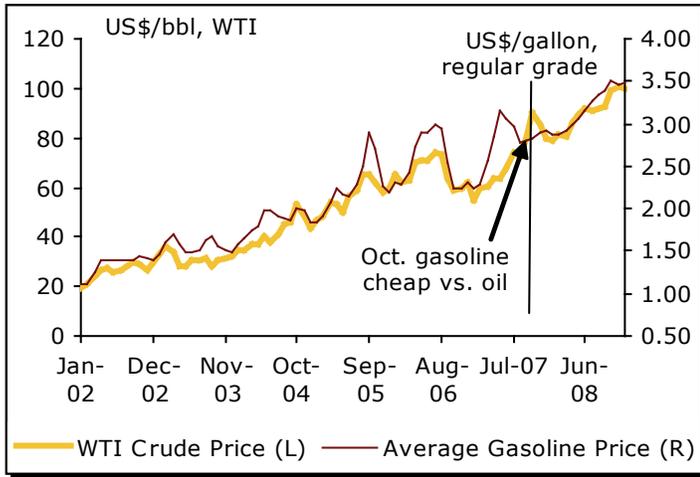
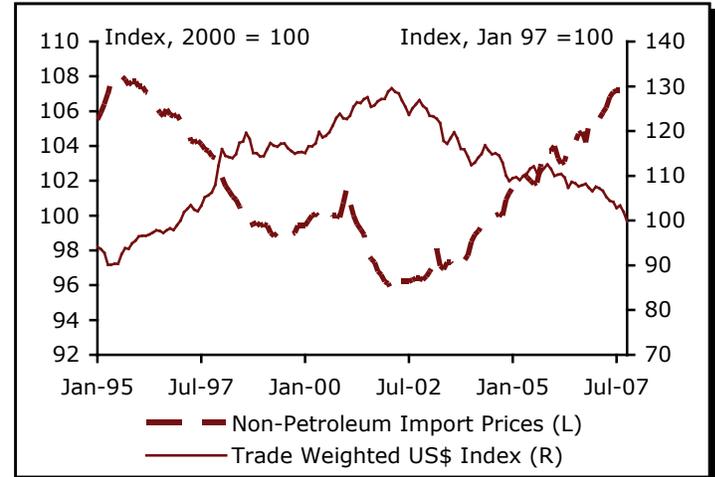


Chart 4
Sinking Dollar Boosting Import Prices



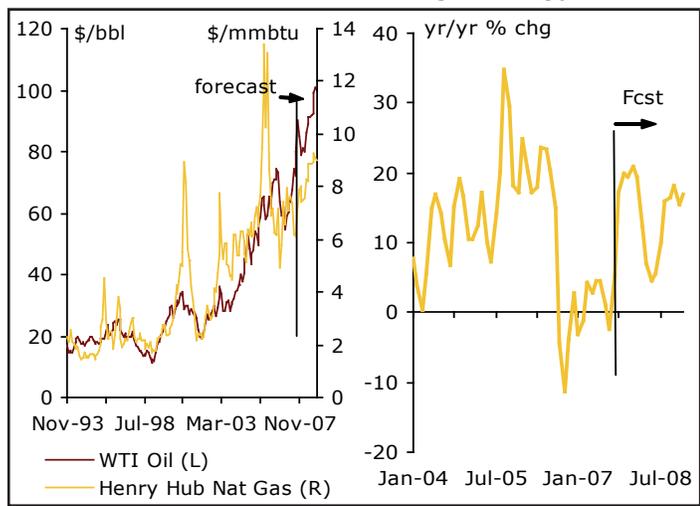
Natural gas has lagged well behind crude prices, but there is a longer term relationship linked to fuel substitution in some uses (Chart 3). Moreover, natural gas usage will be increased by ethanol production. If this winter is anything close to normal, US Henry Hub nat-gas should average US\$9/Mbtu next year. Add it all up, and the energy component of the CPI is projected to be running in double digits for much of the coming year.

Second, energy price hikes are playing an increasing role in America's current account and trade imbalance. While the weak dollar, and better demand growth overseas than at home, are shrinking the non-petroleum trade gap, a growing oil import bill is standing in the way of more dramatic overall progress. The resulting downward pressure on the US\$ is serving to raise prices for other US

imports (Chart 4), with more to come as China lets its currency appreciate at a faster pace. The lagged impacts of dollar depreciation will already tack on about 0.5%-points to next year's CPI, according to the Fed model's elasticities.

Third, energy costs show up in a number of core prices—airline tickets, goods moved by truck, and petrochemical products like plastics. Thus far, the damage to core prices has been contained as the necessary wage inflation hasn't been there, meaning that higher prices on some items simply depress household spending power, and thus price pressures, elsewhere. But that could prove to be a more meaningful threat when the economy eventually picks up.

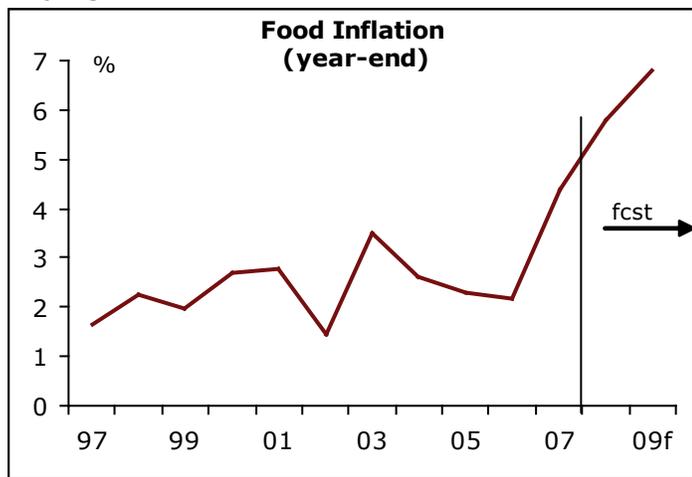
Chart 3
Nat Gas to Climb (L), Double-Digit Energy CPI (R)



Finally, one policy response to high oil prices, and associated fears of import dependency, has had much to do with the recent inflation climb in food prices. The combination of subsidies for ethanol, and tariff barriers on imported ethanol, has seen a rising share of US agricultural land shifted to corn grown for ethanol production (see CIBC World Markets, *StrategEcon* dated October 2007).

The resulting increases in feed grain prices have pushed up meat, dairy and egg prices, contributing to an escalation in food inflation to 4½%, and the further diversion of land for ethanol-based corn looks to boost food prices at a 5½% pace by the end of next year (Chart 5). Rising incomes in rapidly developing economies in Asia and Latin America are also increasing pressure on global meat and grain prices. Droughts in some growing areas are also not helping, and at least some view such arid conditions as

Chart 5
Paying to Eat: US Food Prices Climb

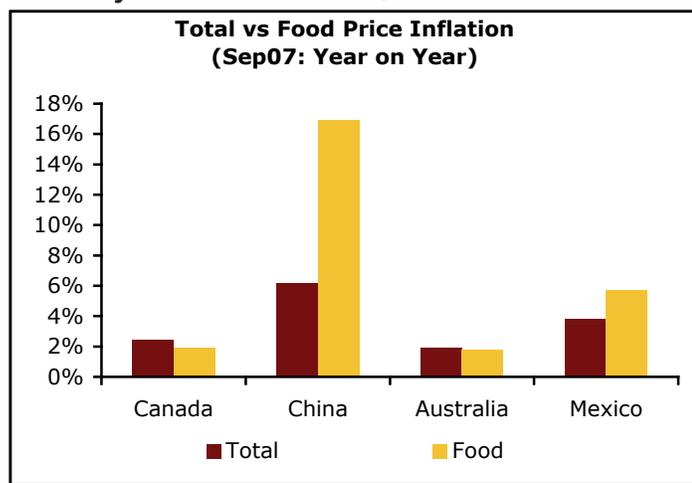


a lasting feature tied to global warming. Countries like Canada and Australia have been temporarily insulated from food inflation by sharply appreciating currencies. But food costs have become the issue for inflation in countries with lagging currencies, such as China and Mexico (Chart 6).

Cyclical Forces only a Temporary Respite

These secular inflation threats from food and energy will be set aside by the Fed, which will be clearly focused on the cyclical threat to growth from a collapsing housing sector. For now, the bond market has its eyes on that same story, taking Treasury yields sharply lower in anticipation of Fed rate cuts. The inflation numbers in the next few months will capture that split between the secular rise in food and energy, and a cyclical dampening on core inflation emanating from the US slowdown.

Chart 6
Currency Gains Shelter Cdn, Aussie Food Prices



Recessions typically leave a lower inflation path in their wake. But if, as we expect, this proves to be no worse than a mid-cycle slowdown, the economy won't open up enough slack to materially change the trajectory for inflation when better growth resumes in the second half of 2008. Indeed, in both 1987, and 1998, the last two times the Fed eased mid-cycle to counter a financial market shock, inflation accelerated in the subsequent six quarters (Chart 7). By fall of 2008, an economy that entered a slowdown with a headline inflation rate above 3% could be facing a headline rate taking aim at 4%.

A Hot TIP for Fixed Income

As a result, the Fed may be rushing to re-tighten before year-end 2008, as it did not long after the 1987 and 1998 rate cuts. Not only will Treasuries, and by extension, Canadian bonds, feel the heat of rising short rates, but there will be doubts about the efficacy of the renewed tightening in terms of its ability to quell more ingrained inflation pressures. Today's bond market rally will give way to a back-up in 10-year Treasuries towards 5%, sideswiping Canadian bonds in the process.

On a relative basis, inflation-linked bonds will be a more interesting play. Unlike the Fed's focus on core CPI or PCE, the payoff on US TIPS is tied to headline CPI. Right now, on a 10-year TIP, the implied inflation rate as measured by the spread to nominal Treasuries, is roughly 2½%. TIPS will outperform Treasuries to the extent that inflation exceeds that implicit projection over the life of the bond, or to the extent that the spread widens as inflation expectations change.

Chart 7
Inflation Experience After Mid-Cycle Fed Ease

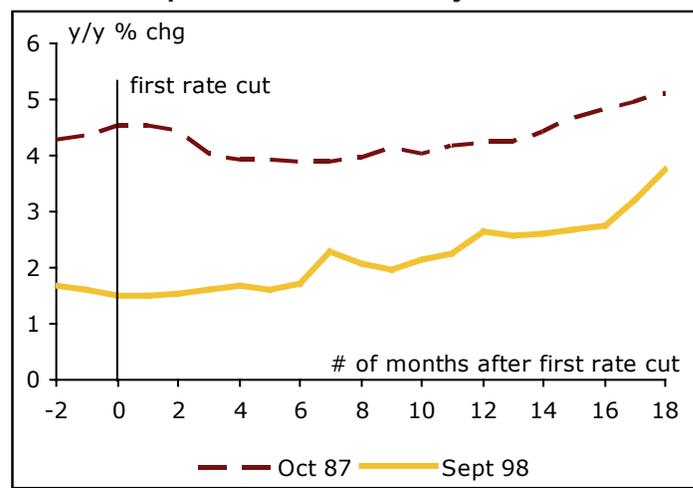
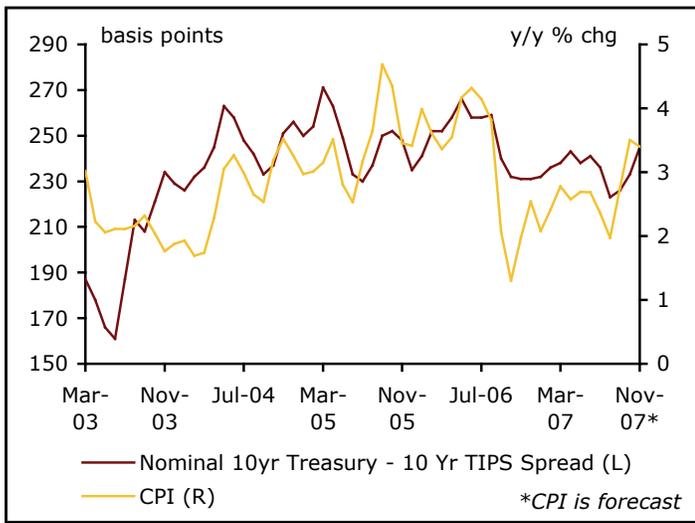


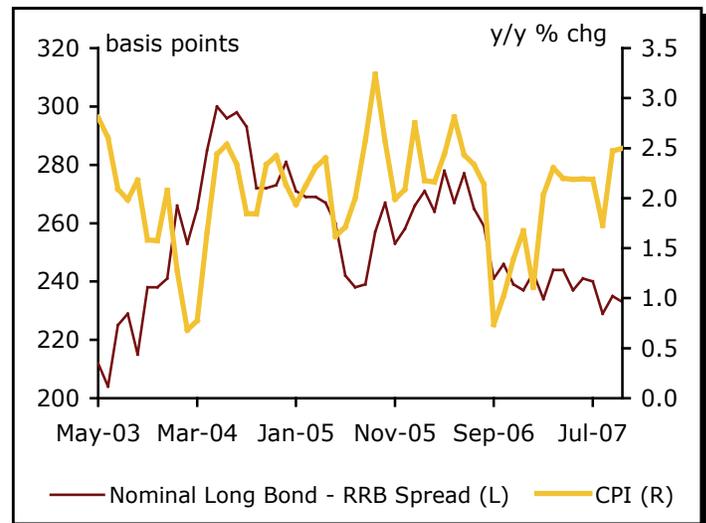
Chart 8
US CPI Drives TIPS Spread



History shows that while a number of factors likely drive the nominal bond-to-TIPS spread, actual headline inflation plays a role. Note that the implied inflation rate was higher at times in 2005-06, when inflation was also running at a hotter pace (Chart 8). If, as we expect, CPI inflation sees sustained periods above 3½% in the coming year on food and energy prices, TIPS will outperform as inflation expectations rise.

Canadian Real Return Bonds (RRBs) might get a similar benefit by late 2008, although one muted by the lagged impacts of a stronger currency in quelling import inflation. Add in a GST cut, and we can't see Canadian CPI topping 2½% at any time in 2008. As well, even if it watches only core inflation, by the Canadian definition, the Bank of

Chart 9
RRB Spread Less Tied to Canadian CPI



Canada will be taking meat, packaged foods and other such products into account. Finally, the implied inflation rate in RRBs has not been as well correlated with on-the-ground headline inflation (Chart 9). Still, with inflation fears in Canada likely to escalate as the US economy rebounds later in 2008, RRBs should still outperform a threatened nominal Government of Canada bond market.

At some point, if headline and core CPI continue to diverge, both the Fed and the Bank of Canada might have to take a harder look at the assumption that core is the better tracking measure. But in the interim, bond markets should expect a tolerance for headline price pressures that don't show up in the core.

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