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Feeling the Heat

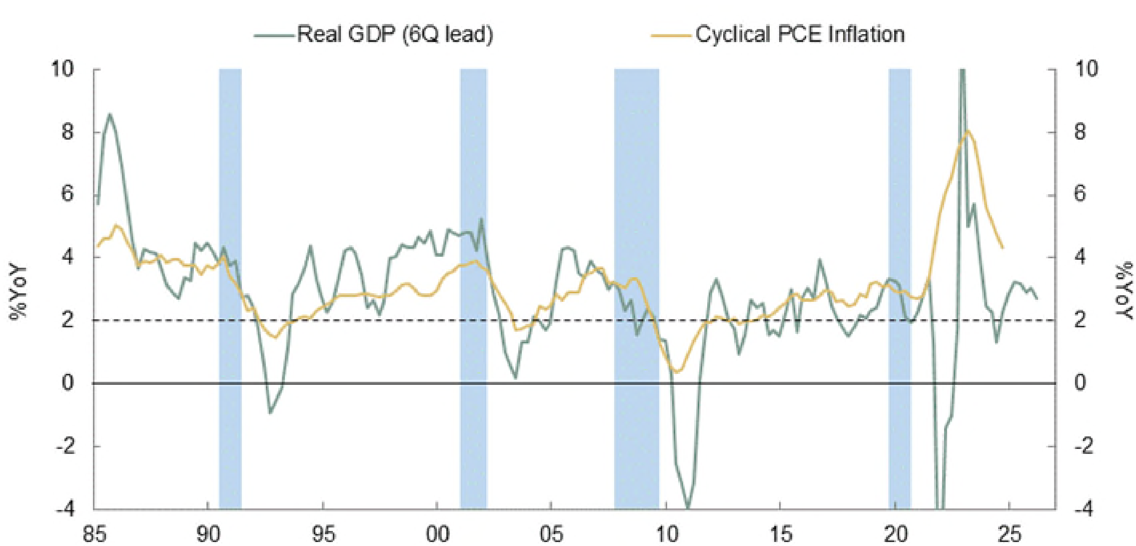
Investors were relieved this week when the December core consumer price index (CPI) rose "just" 0.225%. While this still annualizes to 2.7%, some were worried about an even higher print. Over the last three-, six- and 12 months annualized, the core CPI is still running well above target at 3.3%, 3.2% and 3.3%, respectively. However, the December CPI results suggest the core PCE deflator, the Fed's preferred metric, will come in at 0.2% or lower. Different statistical methodologies account for the discrepancy between the two series. Historically, the core PCE grows slower than the core CPI. But December's inflation results could only be a temporary respite.

The core PCE is comprised of 92 major components that fall into one of two buckets — one is acyclical and the other is cyclical. The former series is not correlated or influenced by the change in real GDP. Their movements have no relation to the economy's performance and include such categories as education and healthcare prices. This is not the case for cyclical prices which are highly correlated or influenced by the business cycle. Strong growth means higher prices and vice versa. This is clearly demonstrated in the chart below.

In terms of weighting, acyclical prices have a weight of 60% while cyclical prices have a weight of 40%. The former have risen 2.0% over the past year, which is right in line with the Fed's target. No problem there. However, cyclical prices are up by more than double at 4.2%. They continue to trend well above target. Outside of recession, the economy has not experienced a 2%-plus drop in PCE cyclical prices before.

Since these prices move with the direction of the economy, growth ostensibly would have to meaningfully slow in order to arrest excessive price appreciation. Real GDP growth is estimated to have grown around 3% last quarter and a similar pace is expected this quarter. **According to the National Federation of Independent Business, firms expecting the economy to improve rose to its third highest level recorded in December**. Data go back to the early 1970s. Under such a scenario, cyclical inflation does not slow unless aggregate demand also slows. But consider another scenario where another set of factors can dampen cyclical pricing pressures.

These developments include *increased energy production*, *permanence of full business expensing*, and *a slowdown in the rate of government spending*. All three measures will increase the economy's productive capacity by lowering the costs of production, increasing the economy's speed limit, and freeing up scarce resources thereby allowing cyclical inflation to slow organically.



Source: SFRB, BEA, Haver, SMBC Nikko

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