



Daily Note: 16 January 2008

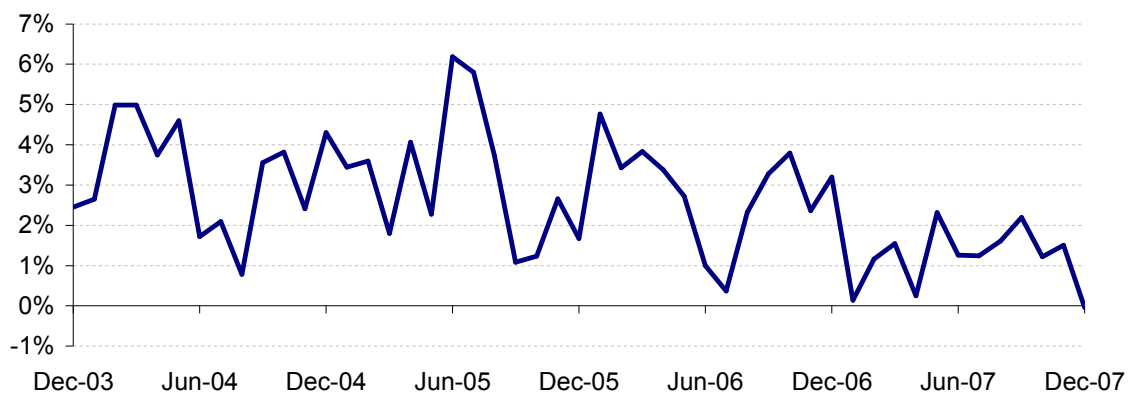
US stagflation approaches

WE SUGGEST: High US inflation won't stop Fed from cutting rates

SUMMARY: Recent US data has generally been bad. Both producer and consumer price inflation remain high in spite of easing in December. Real retail sales fell sharply in December and were almost flat in Q4. Industrial production fell in Q4. The Fed is all but certain to cut interest rates at the end of the month. At least during H1 2007, this will put the US economy into stagflation, possibly leading to elevated long-term bond yields.

US industrial production did not fall in December. That was the good news. The bad news is that inflation remains elevated, core inflation is picking up and retail sales were sharply down in real terms at the end of last year, bringing little Christmas cheer to retailers. Yesterday's retail sales figures for December were bad enough. A 0.4% fall in the headline figure, following a 1% rise in November but no change at all in October. In real terms, this translated into the series -0.3%, 0.3% and -0.6%, leaving the average for the quarter almost unchanged (up 0.1%) from Q3 – but the level for December was the lowest since July. On a twelve-month basis, retail sales were flat, taking us back to the kind of changes we saw around last winter – when GDP grew by less than ½%.

US retail sales, constant prices s/a, twelve-month change, %

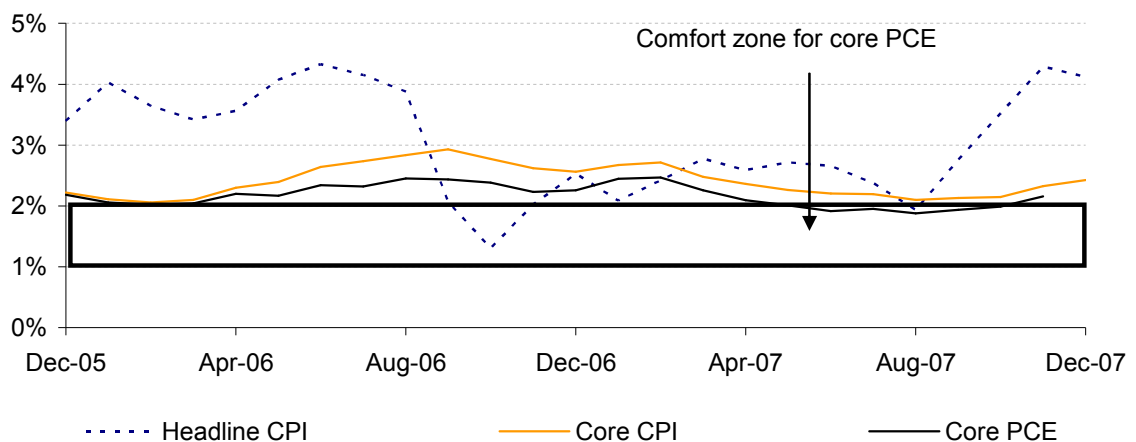


Add to this the fact that industrial production as noted above was flat in December, leaving Q4 0.7% down from the previous quarter and it does look as if the most pessimistic views of the US economy may also be the most realistic. In turn, the likelihood not only of a cut in the Fed Funds rate on 31st January, but a large (ie, 50bp) cut is also enhanced.

The Fed can, of course, do that because of its dual mandate – full employment and stable prices. For the one difference between now and a year ago is that inflation is

accelerating. In late 2006, inflation was on the way down, having been elevated during the summer. But, of course, at that time, the Fed policy of tightening had just peaked (and seemed likely to continue). Now we have accelerating inflation and an easing monetary policy. Today's CPI data show that consumer prices rose by 0.3% in December, lower than the 0.8% November rise, but still enough to keep the twelve-month rate above 4%. Meanwhile, the core rate rose by 0.2%, advancing the annual rate to 2.4%. Admittedly, import price inflation eased sharply in December. But the base effect will ensure that over coming months, imported inflation will remain high. Meanwhile, in contrast to earlier slowdowns and in spite of a rise in unemployment in December, the US labour market remains tight. It may therefore be difficult for the Fed to get inflation down from current levels.

US inflation, 12-month change, %



The dual mandate means that the Fed can for the moment ignore inflation, as it almost certainly will do. But, as pointed out in an earlier *Daily Note* (US stagflation rears its ugly head, 15th November 2007), this does run the risk of markets pushing up long-term interest rates and countering some of the effect of the lower Fed funds rate.

As it happens, stagflation is unlikely to last for very long. If a US slowdown is transmitted to the Far East, as seems likely, where it will coincide with Chinese attempts to cool an overheating economy, import price inflation is likely to abate rapidly, mainly because of lower demand for and hence weaker prices of commodities. Meanwhile, the US economy currently has a small negative output gap; below-trend growth will widen this in coming quarters, ensuring that domestic inflationary pressures subside. Nevertheless, for some months in H1 2008, the Fed will have to deal with the worst of both worlds.

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