ECRI
ECONOMIC CYCLE RESEARCH INSTITUTE

March 2005
Vol. X, No. 3
Founded by Geoffrey H. Moore

U.S. CYCLICAL OUTLOOK

INFLATION PRESSURES REMAIN ELEVATED

Simmering Inflation
Only a few weeks ago, inflation was widely considered to be low and under control. Today, it is the markets' key concern. Did economic conditions, in actual fact, change that abruptly?

As usual, it is not so much the underlying reality, but market perceptions, that have suddenly shifted. Indeed, it is quite telling that the spread between the yields on regular ten-year treasuries and ten-year treasury inflation-protected securities, which is a measure of the market's inflation expectations, spurted to a seven-and-a-half-year high after this week's Fed meeting.

The data have not changed quite as dramatically, but the cyclical upturn in inflation has become a little harder to ignore, with core PPI inflation surging to a 13-year high and core CPI inflation rising to a two-and-a-half-year high. In fact, by any measure, inflation has been in a cyclical upswing for the past year or so, as accurately anticipated by the relentless rise in ECRI's U.S. Future Inflation Gauge (USFIG) since late 2003 (page 6).

Although not imminent, a firming in economic growth is already in sight.

It is just that, until now, the markets had been able to turn a blind eye to the reality of steadily rising inflationary pressures. That position is no longer tenable given the shift in the Fed's stance.

The USFIG is still in a cyclical upswing, and underlying inflationary pressures remain elevated. As long as that remains the case, an easing in inflation will stay elusive. A gradual escalation in the USFIG from here would not imply a need for the Fed to step up the pace of rate hikes. However, a rapid rise in the USFIG could be more ominous.

Positive Longer-Term Growth Prospects
Notably, this rise in inflationary pressures took place mostly during the period of moderation in U.S. economic growth since last spring, as evident from the easing in the growth rate of ECRI's U.S. Coincident Index. This slowing was anticipated by growth rate downturns in ECRI's leading indexes (*U.S. Cyclical Outlook*, Vol. IX, No. 5, May 2004).

More recently, however, growth in the U.S. Long Leading Index (USLLI), which bottomed last September, has turned up (page 9), affirming that an end to the current moderation in growth is on the horizon. Growth in the Weekly Leading Index (WLI) has also been rising in the wake of the upturn in USLLI growth.

However, such an upturn is still tentative, at best, in the U.S. Short Leading Index growth rate (page 10). Thus, the firming in U.S. economic growth may not be immediately upon us.

Specifically, in the context of the global industrial slowdown, growth in the U.S. manufacturing sector has kept easing. Growth in the Leading Manufacturing Index also remains in a downturn (page 13). Thus, an upturn in manufacturing sector growth is still elusive.

The outlook for the service sector is more nuanced. Growth in the financial services sector appears to have turned up in the wake of a rise in the growth rate of the Leading Financial Services Index (page 12). However, for the much larger non-financial services sector, which by itself accounts for 61% of all U.S. jobs and half the national income, it is a different story.

As evident from the Leading Non-Financial Services Index, just introduced by ECRI (pages 3 to 4), growth in this huge sector of the economy is not about to pick up just yet. As a result, neither is growth in the overall service sector, according to the Leading Services Index (page 11). While growth in the Leading Construction Index bounced back in February (page 14), it is too soon to suggest that it is in a cyclical upturn.

These sectoral leading indexes tend to have shorter lead times, but their message is clear. For most of the economy, including manufacturing and non-financial services, a cyclical upturn in growth is not imminent. However, as suggested by

Continued...

IN THIS ISSUE

RISING OIL PRICES NOT YET A THREAT

Chart 1a: JoC-ECRI Industrial Price Index, Oil and Non-Oil Components, Growth Rates (%)

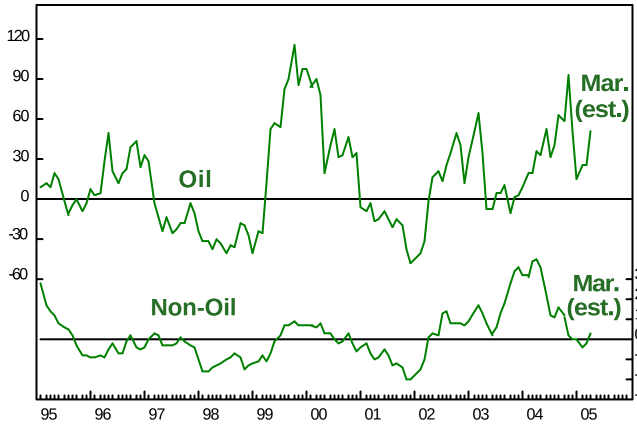
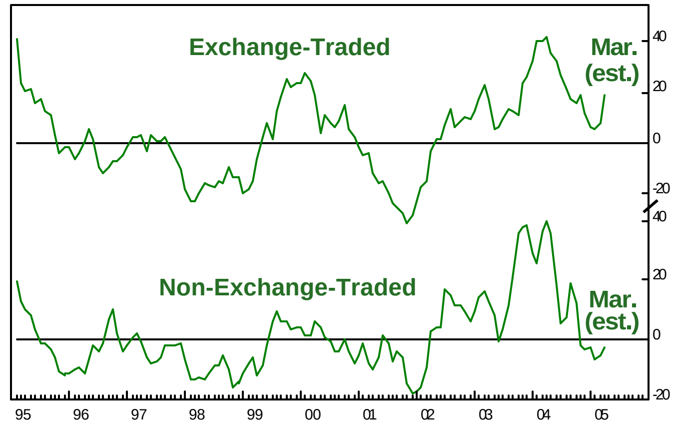


Chart 1b: JoC-ECRI Industrial Price Index, Exchange-Traded and Non-Exchange-Traded Components, Growth Rates (%)



...Continued from Page 1

the USLLI and WLI, which have longer lead times, a firming in overall economic growth in already on the horizon.

The Oil Slick

It is often observed that the U.S. economy is not as energy-intensive as it was in the 1970s, and that inflation-adjusted oil prices are still well below the highs reached at that time. That is true, but it does not explain why a rise in oil prices to $37 a barrel in the summer of 2000 helped to trigger a recession, but even with oil prices topping $57 a barrel this month, a recession is nowhere in sight. What is the difference?

The explanation is that the vulnerability of the economy to economic shocks varies over the business cycle. When the key leading indexes are falling in concert, the economy is in a window of vulnerability, and any significant shock could tip it into a recession. This is why, in September 2000, six months before the last recession officially began, we became cognizant of the risks posed by the oil price spike and warned of the recession danger in this publication (Vol. V, No. 9, September 2000). "Never in this expansion have the leading indicators been so close to forecasting a recession," we noted on that occasion.

The situation is quite different today. ECRI's key leading indexes are not falling – in fact, the most far-seeing among them are rising more rapidly. Until that situation changes, the economy is not in much danger from an oil price spike, even if oil prices hit new records.

Many explanations have been touted for the recent rise in oil prices. Until a few months ago, the "terror premium" and speculative excesses were popular explanations. More recently, the surge in Chinese oil demand has been mentioned more often as an explanation, and of course, we are in a synchronous, if slowing, global expansion. All of these explanations have some merit, but there is a more compelling reason for the fluctuations in oil prices.

Crude oil is, after all, an industrial commodity. Thus, its price is likely to be influenced by global industrial cycles, as in the case of other industrial raw materials. The JoC-ECRI Industrial Price Index is a composite index of the prices of 18 industrial commodities including crude oil, and is designed to be a leading indicator of inflation.

It is possible to extract from the JoC-ECRI Index a 17-commodity index that excludes crude oil prices in order to focus on the movements in the prices of the other industrial commodities. As Chart 1a shows, the growth rate of crude oil prices, i.e., oil price inflation, moves in cycles that are roughly in sync with cycles in that 17-commodity index excluding crude oil. While this is not a precise relationship, it is clear that the growth rates of both crude oil prices and the 17-commodity index have turned up lately, after a decline that corresponds to the global industrial slowdown. Such an upturn would be consistent with the earlier upswing in ECRI's Financial-Related Diffusion Index, which has a long lead over global industrial cycles (*International Cyclical Outlook*, Vol. X, No. 1, January 2005).

While those upturns are still quite tentative, they could well be harbingers of a future upturn in global industrial growth. While that could be good news, it would also boost inflationary pressures – possibly inducing the Fed to boost rates more than currently expected – while also stoking oil price inflation. If so, oil prices might rise much further, which could amount to a more severe oil shock.

Thus, it becomes important to ask whether the rise in oil prices as well as other commodity prices is just a result of speculative excesses in the commodity markets. One way to answer this question is to break up the JoC-ECRI Index into two separate indexes, one including only those of its components that are exchange-traded, and the other including the rest of its components, which are not exchange-traded. This is a major advantage of the JoC-ECRI index, in contrast with other commodity price indexes, which include only exchange-traded commodities, and are thus more subject to speculative excesses.

As Chart 1b shows, the rate of inflation in the prices of exchange-traded industrial commodities moves roughly in sync with that in the other commodities. That pattern has persisted in recent months. Thus, the recent rise in commodity prices cannot be blamed just on speculation. Notably, both indexes shown in Chart 1b have recently turned up, suggesting that, if these moves continue, they may well amount to cyclical upswings in commodity price inflation. In that case, if oil price inflation also rises, it could result in a more serious shock to the economy.

For the time being, the economy is not in a window of vulnerability. However, if and when ECRI's leading indexes turn down, any shock could have major, possibly recessionary, consequences. For those reasons, it would be very important in the coming months to keep an eye on both the JoC-ECRI index and ECRI's array of leading indexes of economic growth to assess whether a major threat to the economic expansion might be in the process of developing. For the time being, however, an oil shock does not pose a significant threat to the U.S. economy.