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INTELLECTUAL AMMUNITION

# Inflation: Disagreement Among Friends

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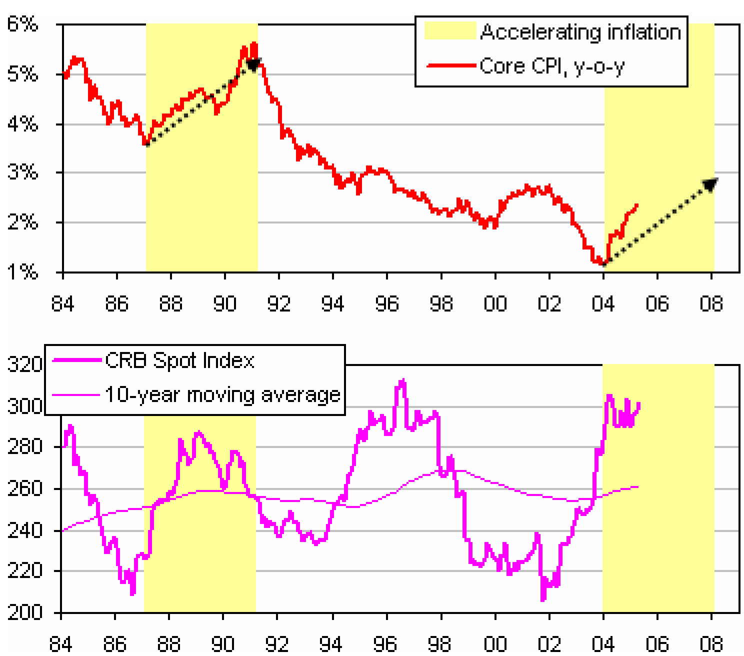
**Even economists who respect market-based price signals are missing the evidence of more inflation yet to come.**

Several clients have asked us explain our hawkish **inflation** outlook in light of the far more dovish views being espoused by commentators with whom we normally generally agree -- those who share are our grounding in classical (or so-called supply-side) economics. We see hard evidence based on market-based price signals that there are inflationary forces in play that have not yet been reflected in general prices, and we believe that **the Fed** should keep raising interest rates until those forces are neutralized. While respecting the importance of price signals just as we do, others read them differently -- some arguing that they are not currently signaling inflationary forces, and some arguing that it doesn't matter since we are still in the backwash of the monetary deflation of the early 2000s. Both therefore believe that the Fed should not raise interest rates.

**Wayne Angell**, a consistent proponent of market-based prices signals when he was a Fed board member, wrote in the ***Wall Street Journal*** last week that commodities prices are no longer signaling the threat of accelerating inflation. We fundamentally agree with Angell that inflation -- the increase in the general price level for goods and services that results from the oversupply of money liquidity -- shows up first in the prices of **commodities** that trade in spot markets. However we disagree with Angell that we should draw comfort from the fact that the year-over-year rate of change of an unweighted index of 21 commodities has decelerated to zero, having been rising at an unprecedented 40% in early 2003. It's a mistake to argue, simply because this commodities index has *stopped going up*, that the Fed's rate hikes so far have already been sufficient to snuff out the inflationary forces seen so clearly two years ago. Considering how far and how fast commodities prices have risen in the last four years, we believe we would have to see them *actually go down* from here before we would be willing to sound the all-clear on inflation.




Inflationary forces that show up first in spot commodity prices take years to feed through the economy's complex price system,

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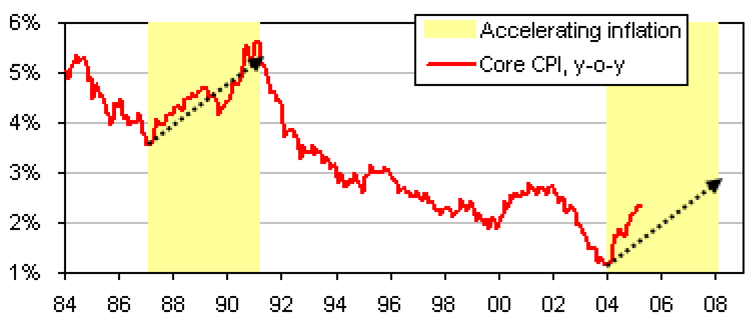
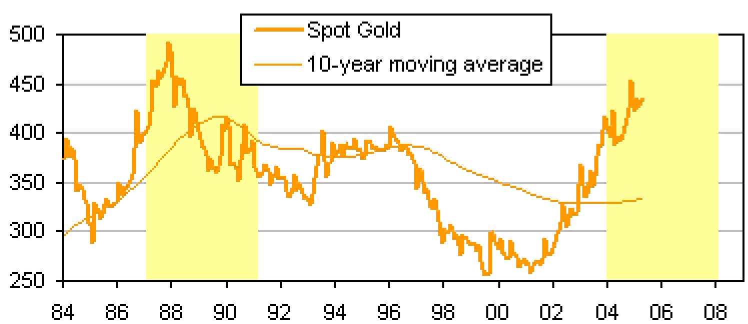
which contains many goods and services priced on long term contracts, both formal and informal. If the average maturity of outstanding debt in the US is any guide, the average contract duration in our economy could be as much as ten years. So as long as commodities are priced above their average price over the last decade, there are still inflationary adjustments that remain to be made as contracts mature and are renegotiated. If commodities prices stay just where they are for ten years, the ten-year moving average will, by definition, rise to meet them -- and so will general prices in the economy.

This view is borne out empirically. Since 1959, the difference between the **CRB Spot Index** and its ten-year moving average has shown an 81% positive correlation (an $r^2$ of 0.66) with the **core CPI** inflation rate in each following year. There's nothing special about exactly ten years, by the way -- the results are about the same for other similar long periods. But shorter periods are another matter. Year-over-year differences -- what Angell is looking at -- show only a 52% correlation (an $r^2$ of only 0.27). The CRB Spot Index today is 16% above its ten-year moving average. That suggests that there are still inflationary pressures that have not been reflected in the general price level. While we caution against reading too much into what is only a rough estimate, our regression equation interprets the CRB Index 16% above its ten-year average as indicating a core CPI inflation rate of 4.7% one year from today.

Further, Angell's choice of an unweighted index -- one that treats all commodities equally, without regard to either their monetary properties or their impact on the economy -- exacerbates the false impression that inflationary impulses are quiescent. Angell's unweighted index may be unchanged year-over-year, yet **crude oil** is up 50% year-over-year; **gold** is up 12% year-over-year; and the **US dollar** -- which renders its price signal in reverse -- is *down* 6% year-over-year versus the world's major currencies.




Another more dovish interpretation of market-based price signals has been expressed by **Lawrence Kudlow**. On his **CNBC** show two weeks ago, after I recited a list of sharp price increases over the last three years across a broad range of commodities (and real estate, too), Kudlow argued that much of that could be interpreted as a benign symptom of recovery from the monetary deflation of the early 2000s. In an important sense, Kudlow is perfectly correct. Gold's move from about $255 in 2000 to about $435 today began as a recovery to its ten-year moving average -- it reached it in late 2002 at $328. We argued right along with Kudlow then that gold's move to that point was not inflationary, but rather "disdeflationary" -- indeed, it happily signaled the end of the monetary deflation, ironically just when the Fed had finally admitted that deflation was a risk. At $328 -- the ten-year moving average -- gold was signaling that the general price level had no further adjustments to make, up or down, in relation to inflationary or deflationary forces then in play.

Where we disagree with Kudlow is with respect to the meaning of gold's subsequent large move *above* $328. There is a limit as to how much of today's market-based price signals can be explained by the recovery from deflation -- and that limit is probably pretty close to the ten-year moving average. Today, gold stands at about $435, 31% above its ten-year moving average now at $332. Thus gold is signaling the same thing as the CRB Spot Index (or for that matter, the dollar -- 13% *below* its ten-year moving average): the general price level has a long way to go before it fully reflects the inflationary forces still in play. Our regression equation for gold indicates a core CPI inflation rate of 4.3% one year from today.

**Bottom Line:** It's too late to write off high commodity prices as merely the salutary recovery from monetary deflation. And while the fact that commodity prices have stopped accelerating signals that the worst-case inflation scenario is off the table, it's too soon to say that the present inflationary acceleration has run its course. We'll be comforted when the Fed's increasing hawkishness reaches a point sufficient to drive the gold price and other commodity prices substantially lower (and the dollar higher). It's not too late for the Fed to achieve that with an orderly series of rate hikes that restore interest rates to normal, and need not do damage to the economy. But until that happens, the Fed remains too easy. We risk at some point crossing a line in the sand beyond which only shock treatment will be sufficient to reverse the inflationary threat. Beyond that line, all bets are off.