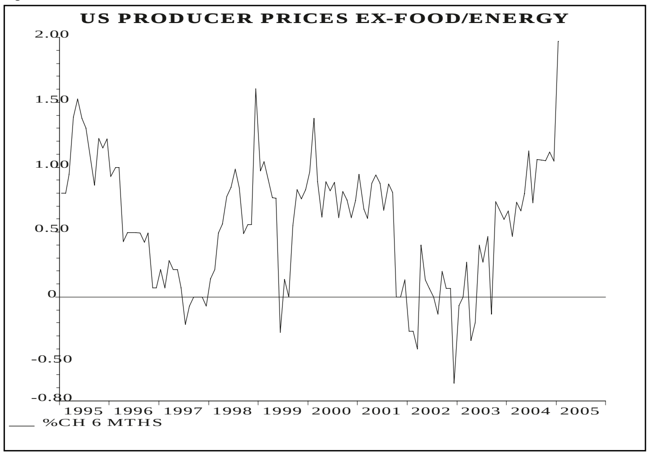
February 21st 2005

GFC ECONOMICS

DAILY COMMENTARY

US INFLATION PRESSURES RISE AGAIN

Mr Greenspan was quite sanguine about the longer-term inflation risks in the US when he made his semi-annual address to the Senate Banking Committee last Wednesday. The Fed Chairman devoted a significant part of his testimony to the question of productivity growth and globalisation, and the benign impact on pricing power. While the economy has performed well, "core inflation has remained low", he remarked. That may be true, but as last week showed, the short-term risks are building, and bonds are suffering. The PPI report was unwelcome, but unsurprising too given the strength of recent gains in raw material prices. More significantly, the rebound in some housing market indicators suggests the powerful boost to consumer spending from rising property values is unlikely to dissipate soon. Furthermore, the recent drop in jobless claims sends a strong signal that hiring may just be picking up after a recent lull. But ultimately, the housing bubble is inconsistent with the burgeoning current account deficit. Rates will have to go higher to brake credit growth and bring the deficit down to manageable levels. As we warned last week, the recent flattening of the yield curve may have run its course for now. But equally, the pressure for higher rates is manifesting itself further along the curve too. The case for a new *secular* low on Treasury yields 'remains', but the inflation numbers are likely to constitute a problem in the short run. The risks of a further significant spike up in yields cannot be ruled out.



The Shadow Of China's Boom

Given its relative detachment from the CPI reports over the past couple of years, the producer price numbers have not tended to elicit much of a response from the bond market. All that changed on Friday, when another 'inflationary' report sent Treasuries spinning lower. The 0.8% m/m jump in the core index may have been exaggerated by a 3.4% m/m and 2.8% m/m increase in the price of cigarettes and alcohol respectively. But car prices were up sharply, and durables inflation accelerated a touch to 5.9%. Pipeline price pressures remain intense. The 0.8% m/m rise in the core intermediate PPI pushed the annual rate up to 8.5%, its highest level since September 1981. It is not difficult to see where the rise in cost pressures is coming from. Industrial material prices less fuels were up 6.3% y/y, which was also the biggest gain since 1981.

The report was not all 'gloom and doom'. The 2.5% m/m drop in core crude material prices was quite striking, since there are signs that cost pressures at the earliest stage of the production process might be easing. The annual rate has dropped from a high of 32.0% in August to 13.1%, and the 3-month rate fell to -1.7%. However, base metal prices closed at a new high on Friday, and the Goldman Sachs non-energy commodity index is trending up again. The biggest threat to price stability in the US remains insatiable demand in China and the refusal of the Beijing authorities to countenance any revaluation of their currency. The status quo is inherently inflationary for the US economy in the short run, since inevitably, the US$ will have to go down - if not against the renminbi, then against the 'floaters'. That will compound the impact of rising raw material costs, and the Fed will continue to tighten. Logically, the absence of any change of policy in China suggests the US will be forced to bring its own housing boom under control, to secure some reduction in a current account deficit still heading inexorably up. In this sense, one should not get too excited about the modest drop in crude material prices. Geopolitical entrenchment - and the current willingness of the US authorities to tackle China over trade - dictates that the risks to raw material prices will not abate soon.

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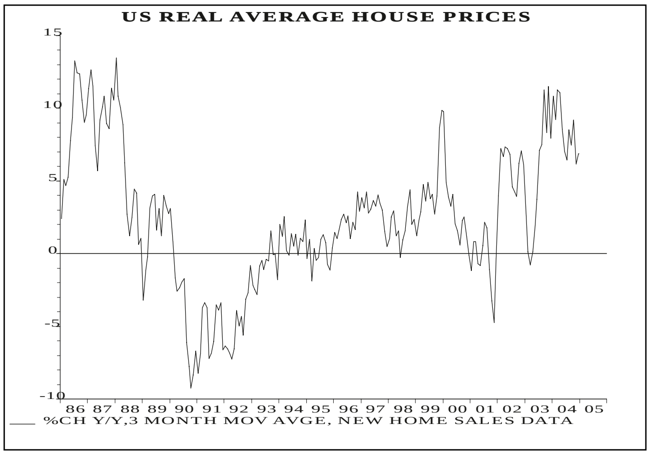
Just how far rates will have to rise depends in large part on the housing market. In this respect, last week's sharp jump in housing starts to a 20-year high was worrying. Inevitably, comparisons are being made between property prices and the dotcom bubble. Somewhat surprisingly, a recent study by the New York Federal Reserve ("Are Home Prices The Next “Bubble?”", December 2004) has cast doubt on the parallels. The analysis was remarkably circumscribed. The authors concluded that "house prices have essentially moved in line with nominal incomes and declines in mortgage interest rates", and to a large extent this is true. But that is only one side of the story. It was somewhat disingenuous to suggest that "as for the likelihood of a severe drop in home prices, our examination of historical national home prices finds no basis for concern". To the contrary, during the credit crunch of the early 1990s, average real house prices did fall sharply (see chart). The new home sales data shows that the average house price adjusted for the CPI fell by 22.8% between their peak in August 1989 and the trough in January 1993. The ensuing economic downturn was comparatively long and protracted, with the unemployment rate climbing from a low of 5.0% to a high of 7.8% in 1992.



Since then, the consumer debt to disposable income ratio has climbed significantly, rising from 82.9% in Q3 1989 to an all-time high of 119.3% 15 years later. Mr Greenspan has regularly sounded quite relaxed about the trend, arguing that financial sector innovation has played a part in driving a step-change in this debt burden. The latest Federal Reserve report is equally 'laid-back', arguing there cannot be a bubble since all of the rise in house prices can be traced to lower mortgage rates and rising nominal incomes. What seems to have been overlooked, is that similar arguments were being made with regards to technology share prices in the late-1990s. The stratospheric valuations were variously attributed to the rapid pace of innovation within the sector, the powerful impact of a falling inflation premium and the acceleration in profits growth. Higher P/E ratios could be justified simply because we were discounting a future income stream with permanently lower borrowing costs.

This 'theory' has been debased by events of the past five years, and eventually time will demolish any arguments that elevated house prices can be sustained just because nominal rates have fallen in recent years. The precise trigger for the sharp reversal in high-tech share prices during the spring of 2000 was the culmination of modest rate hikes, and a final realisation that many companies would be unable to deliver on somewhat fanciful profit estimates. A not too dissimilar scenario is now unfolding in the property market. The key driver is rising cost pressures, forcing the Fed to keep hiking. The immediate fundamental disequilibrium is the rising current account deficit and Chinese intransigence. For most of this year, the subsequent fallout on inflation has only been felt at the short end of the curve. But suddenly, the whole curve is selling off too. Intriguingly, the rally in longer-dated maturities this year has failed to trigger an upturn in mortgage demand *per se*, even if refinancings have improved a touch. The housing market may eventually slow without long-term rates having to rise quite so high as some fear. Similarly, the rise in short rates is having an impact on the growth in home equity loans. The 3-month annualised rate of change has dropped from a high of 50.7% last October to 18.3%. But these are merely indications that credit growth is proving sensitive to the rise in borrowing costs. They are a long way from suggesting that the housing market is slowing enough to resolve the net savings imbalance underpinning the record current account deficit. That may yet require several more rate hikes from the Fed.