Inflation's Corps Of Discovery

Has it really been two hundred years since Lewis & Clark set out on their epic exploration of the Louisiana Purchase, the most striking example of after-the-fact due diligence in real estate history? At least no one can confuse the cast of characters involved with later real estate self-promoters and presidential memoir writers; thus we were spared the book *Jefferson And The Art Of The Deal*.

The expedition was given the collective name of The Corps of Discovery, which brings us to our topic for today, the homonymous core rate of inflation so central to last week's reports on both consumer and producer prices and the bond market's reactions thereto. We first must address whether anyone should make investment and trading decisions based on any of the price indices.

The Consumer Price Index, as has been discussed widely, is replete with various hedonic adjustments for technological improvements and, as the Federal Reserve Bank of Atlanta has noted, by distortions in the owner's implied rent and used car markets produced by the prolonged period of low interest rates. The Producer Price Index has been postponed so often in its release this year that even reasonable people not given to conspiracy theories now question its accuracy.

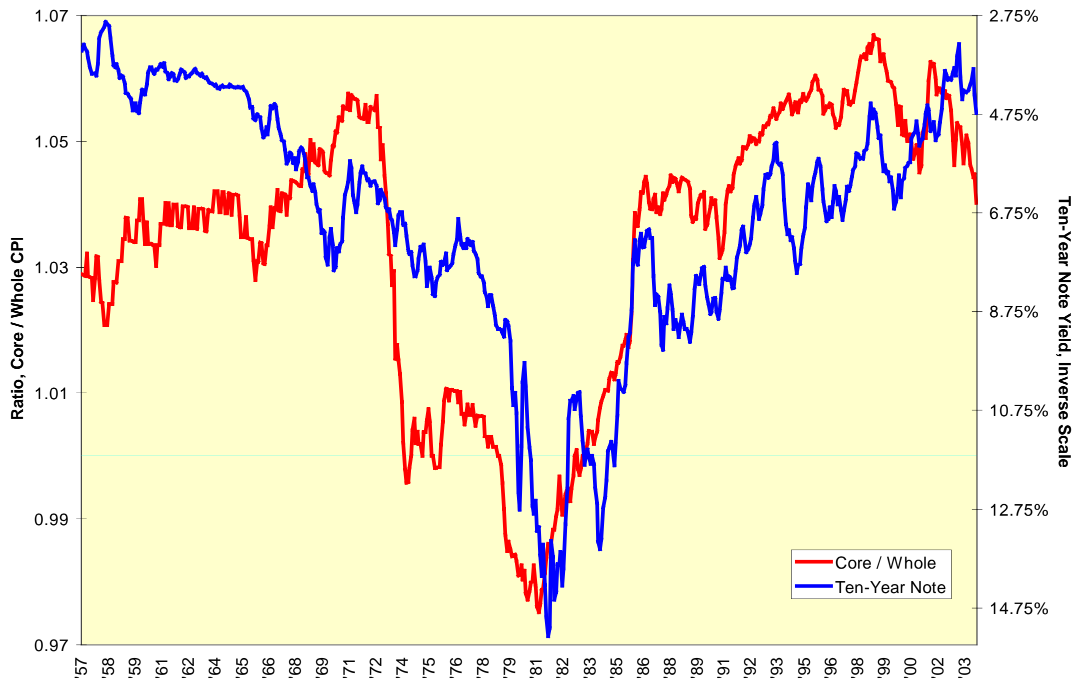
If markets are supposed to discount future developments rather than react to uncertain representations of past history, then we should treat these monthly releases as somewhat interesting factoids and not as tradable information. Failing that, which seems likely, we should at least examine the question of whether core inflation, the numbers left after food and energy prices are subtracted, is a better leading indicator of bond markets than are the whole indices.

Rotten To The Core Or Bad To The Bone?

Food and energy prices are often described as volatile, and that no doubt is true. Is this any reason to treat them separately in our analysis of price trends? Unlike many other goods, they are both produced and consumed continuously and are very price-inelastic in the short-term. Their prices often drop as precipitously as they rise, a characteristic not shared by most other goods.

However, every dollar you spend on gasoline or pizza is a dollar either unavailable for investment or expenditure elsewhere if you go on a cash basis, or one you have to borrow if you are part of America's consumer debt burden. In addition, higher energy prices constitute a tax as they contribute to our merchandise trade deficit. Offsetting this, the United States is a large net food exporter, which means higher food prices can reduce our trade deficit provided they do not price American exports out of the world market.

On balance, I instinctively lean toward counting food and energy prices in my assessment of inflation if for no other reason than they affect my own personal budget and my daily perceptions. More important, however, the data support this sentiment. The long-term relationship between the core CPI and the whole CPI confirms we ignore food and energy prices at our financial peril.



Our friends at the Bureau of Labor Statistics began recording the core rate in 1957; both indices have been re-indexed to 1982-1984 = 100, so the ratio of the core CPI to the whole CPI has a common basis. For much of the 1960s and up to the start of the large moves higher in food prices in 1972 and energy prices in 1973, the core rate understandably was rising faster than the whole rate. It then plunged relative to the whole CPI all the way to the nadir of the bond market in 1981. In other words, the period in which the whole CPI outpaced the gains in the core CPI corresponded to the worst prolonged bear market in bonds in American history.

The exact opposite occurred once the core rate of the CPI began to outpace the whole CPI. From 1981 up through the end of 1998, food and energy price growth slowed and in some periods was negative, and both the bond and stock markets enjoyed what we refer to now as secular bull markets.

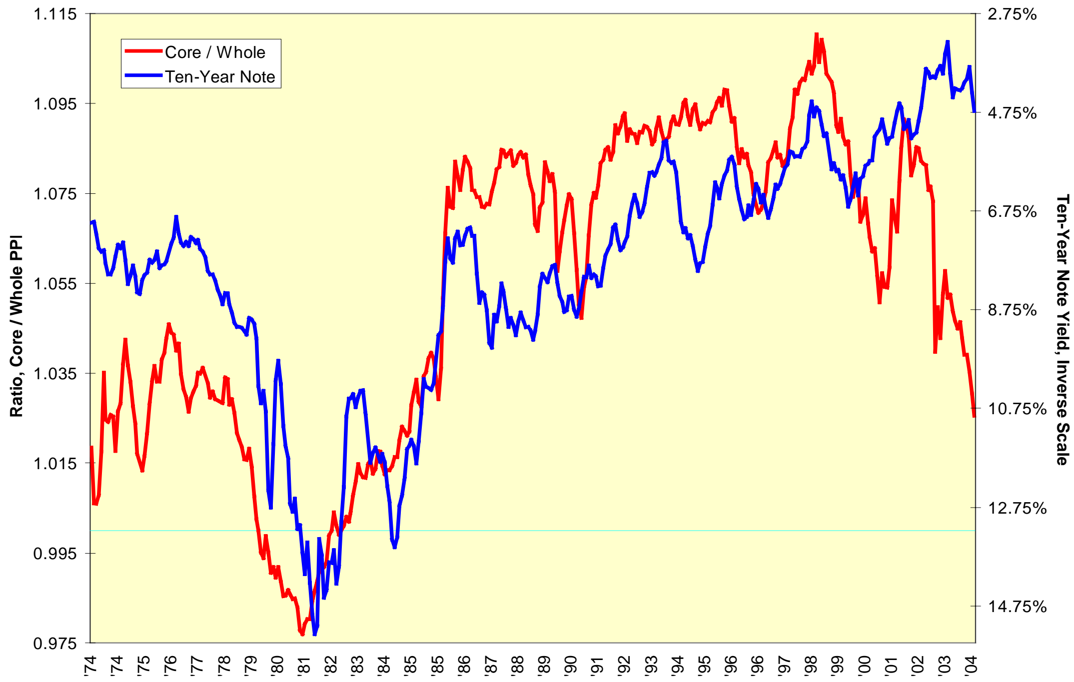
The reversal of the core/whole CPI relationship in early 1999 corresponded to the recovery in crude oil prices at the start of that year. The Federal Reserve simultaneously began to reverse its three post-Russian crisis / Long Term Capital Management rate cuts at the same time. Predictably, the combination of rising food and energy prices and a more hostile Fed led to a selloff in the bond market into the peak of the stock market's bubble in early 2000.

After this point, a number of special factors combined to distort the relationship between the core and whole CPI indices and ten-year note yields. These included the aftermath of September 11, the Fed's historic series of rate cuts, the aftermath of the equity bubble and the manic purchases of U.S. Treasuries by foreign central banks.

These special factors are over and done for the time being; the only exception I see on this horizon is the Fed's correct hesitancy to shock the economy by a too-rapid increase in short-term interest rates.

Producer Price Confirmation

The core Producer Price Index tells the same story. Its history begins later, in 1974, but we see the same trends and the same dislocation of pattern after 1998.



The historic record for both price indices suggests that the current increases in food and energy prices will contribute to higher bond yields as investors demand protection from inflation. The whole indices demonstrably matter more than do the core rates. We can only hope the bond market does not discover this the hard way.