Food Price Herd On The Street

"The very rich are different from you and me." - F. Scott Fitzgerald
"Yes, they have more money." – Ernest Hemingway

These are not the easiest of times for those who find the modern incarnations of conspicuous consumption more than a little off-putting.   The garish competition to see who has the biggest yacht, the most expensive watch or the largest coterie of aging rock stars at their birthday party recalls Oscar Wilde's description of a fox hunt, "the unspeakable in full pursuit of the uneatable."

How much of this has been fueled by cheap credit, and how has it contributed to an inflationary psychology? The former definitely was on investors' minds last week during the Bear Stearns-induced subprime selloff; the latter question was on the minds of the central bankers in attendance at a recent Global Interdependence Center conference in Dublin where I spoke on the critical role of the yen carry trade. Their collective sense was the world's central banks were behind the curve in keeping inflation both inflation and inflationary expectations sufficiently low so that it would not matter in people's investment and spending decisions.

There was also the usual self-congratulation on how well inflation has been contained in recent years; at least one economist in attendance had the good grace not to note that the purchasing power of the dollar has declined more than 51% since the June 1983 birth of his eldest son. Why be a bubble in the bathtub of life?

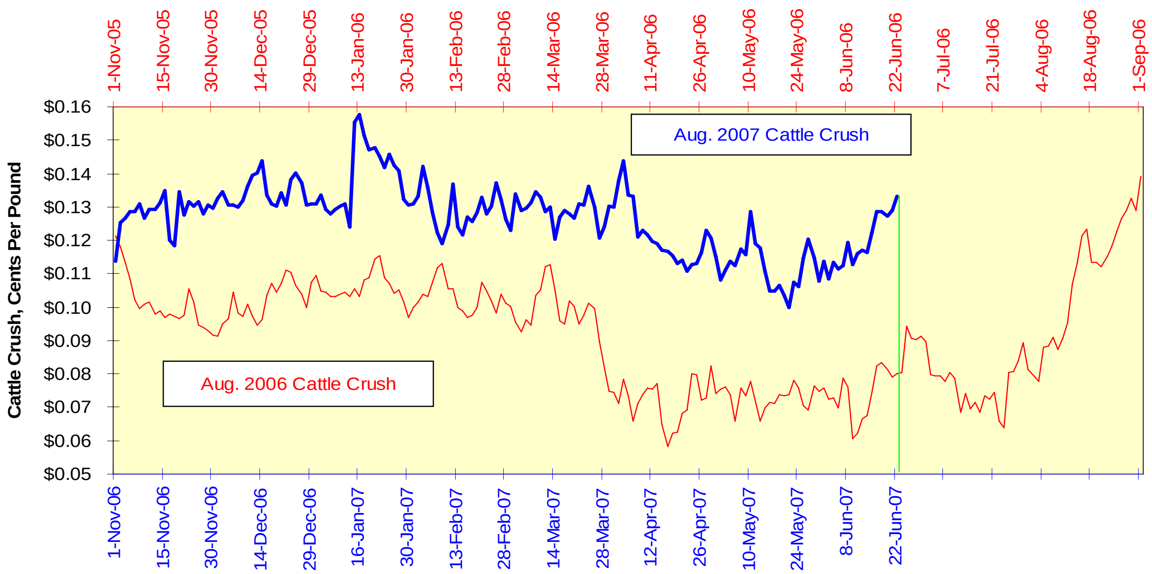
Food Price Inflation

If you do not have expectations of higher inflation already, a trip to the grocery store should persuade you to acquire them. Much of this can be attributed, as forecast here in January, to the ongoing ethanol boondoggle. Let's focus on the beef market, a topic last discussed here all the way back in November 2003. We have to put our sensibilities aside and focus on the economic role of livestock as processors of low-value corn into high-value meat; yes, commodities are not pretty. If the price of corn moves higher because we are distilling it into ethanol to keep the price of gasoline low – and how well is that one working? – we are making it more expensive to feed cattle.

The standard metric for this is called the "cattle crush" spread. The current front-month combination for this trade involves five August feeder cattle contracts, four September corn contracts and ten December live cattle contracts. In recipe form, add corn to younger cattle in a feedlot for four to five months and sell the cattle when finished.

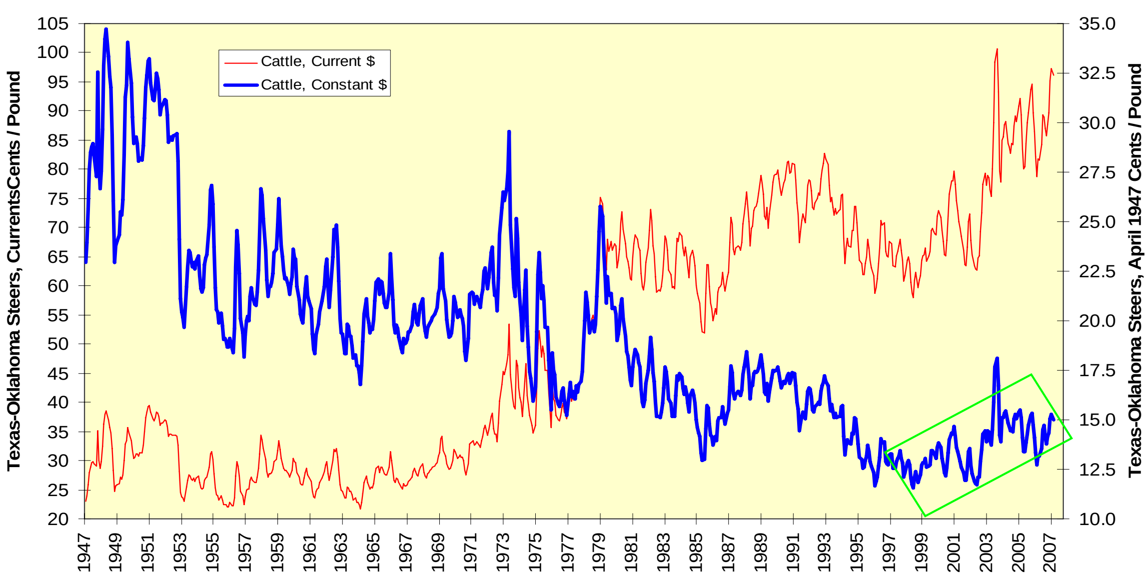
Let's compare this cattle crush combination for 2006 and 2007. The good news for feedlot operators is feeding margins in 2007 have been and continue to be well over 2006 levels. The bad news for consumers is this is because December live cattle prices are $0.94925 in 2007 as compared to $0.88875 in 2006, a 6.8% increase. The really bad news is there is no hedonic adjustment involved.

Current Cattle Feeding Margins Staying High



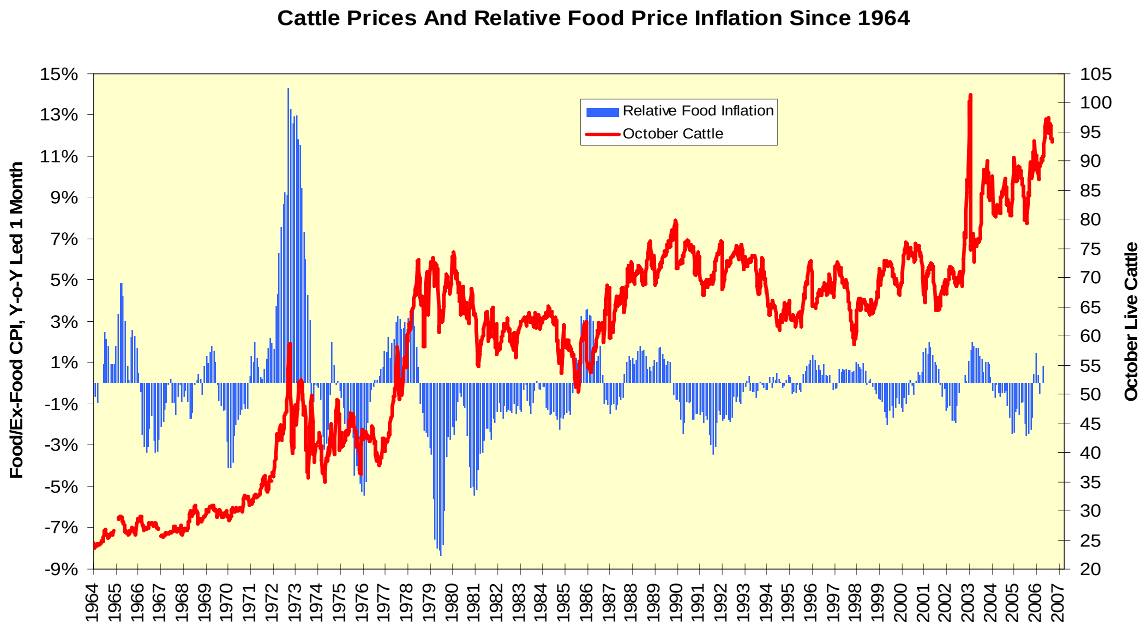
Let's take a trip down memory lane to the Truman administration and see how the nominal and PPI-adjusted prices for cash steers in the Texas-Oklahoma market have moved over the years. Nominal prices have increased at a 0.19% monthly rate; constant-dollar prices have declined at a 0.1% monthly rate. But take a look at the 1999-2007 period, highlighted on the chart: Real prices have been increasing at 0.16% average monthly rate. If prices of a basic and culturally iconic food rise at this rate, inflationary expectations are bound to rise as well.

The Real Trend In Cattle Starting To Rise



Relative Inflation

Thanks to our good friends at the Bureau of Labor Statistics, without whom we might think inflation has been rising at more than a 2.7% annual rate, we have price indices for food and for consumer prices ex-food. Let's compare their relative paths led one month going back to the start of cattle futures trading in 1964 and use a continuation series for the October contract to avoid the noise associated with intermonth contract rolls.



Two periods really stand out in this chart. The first is the 1971-1973 period when the Russians bought huge quantities of American grain – Soviet agriculture has been described as 70 years of bad weather – and when Richard Nixon imposed wage and price controls on the American economy. Food prices accelerated relative to non-food prices. The second prominent divergence occurred in the late 1970s and early 1980s, a period remembered for its double-digit inflation in most non-food categories.

But another observation is warranted: Once a relative trend gets going, it tends to persist for several years. We have just crossed the line from several years of relatively cheap food to faster growth in the food CPI. As the distortions of ethanol production only get bigger and as higher prices for natural gas-based fertilizers rise, we should expect to see higher food price inflation.

The monthly CPI report contains a "core" number, one that does not include food and energy prices; the theory is these prices are volatile and non-persistent. Oh; so you mean those high gasoline prices since 2000 have not persisted? My mistake. Now let's add several years of higher food prices to the mix and see what happens not only to inflationary expectations but to the credibility of those who argue food and energy prices do not matter to the measuring of inflation.

The trading recommendation here is buy expectations and sell credibility.