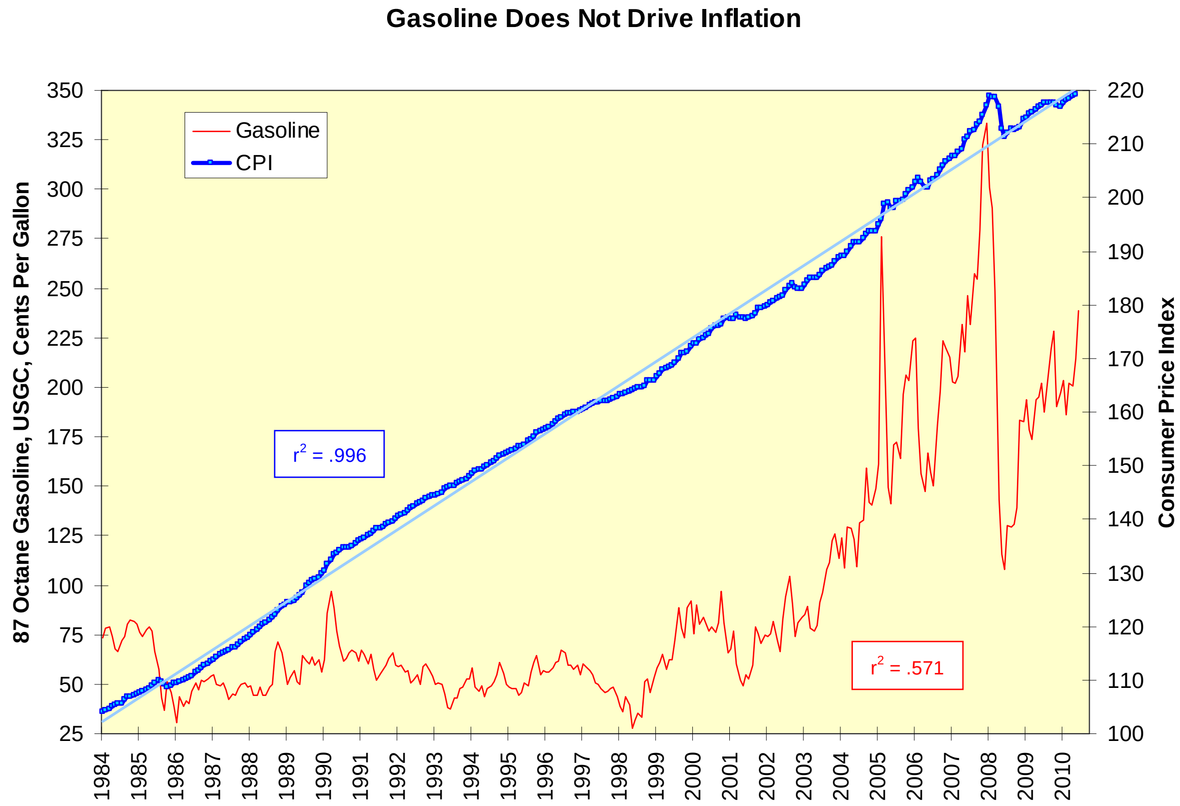
Gasoline Not A Concern Yet

Give half of Wall Street a ruler and they are only going to do one thing with it. An alternative use would be the construction of a descriptive model for the Consumer Price index that would beat the daylights out of 87-octane gasoline at the U.S. Gulf Coast.

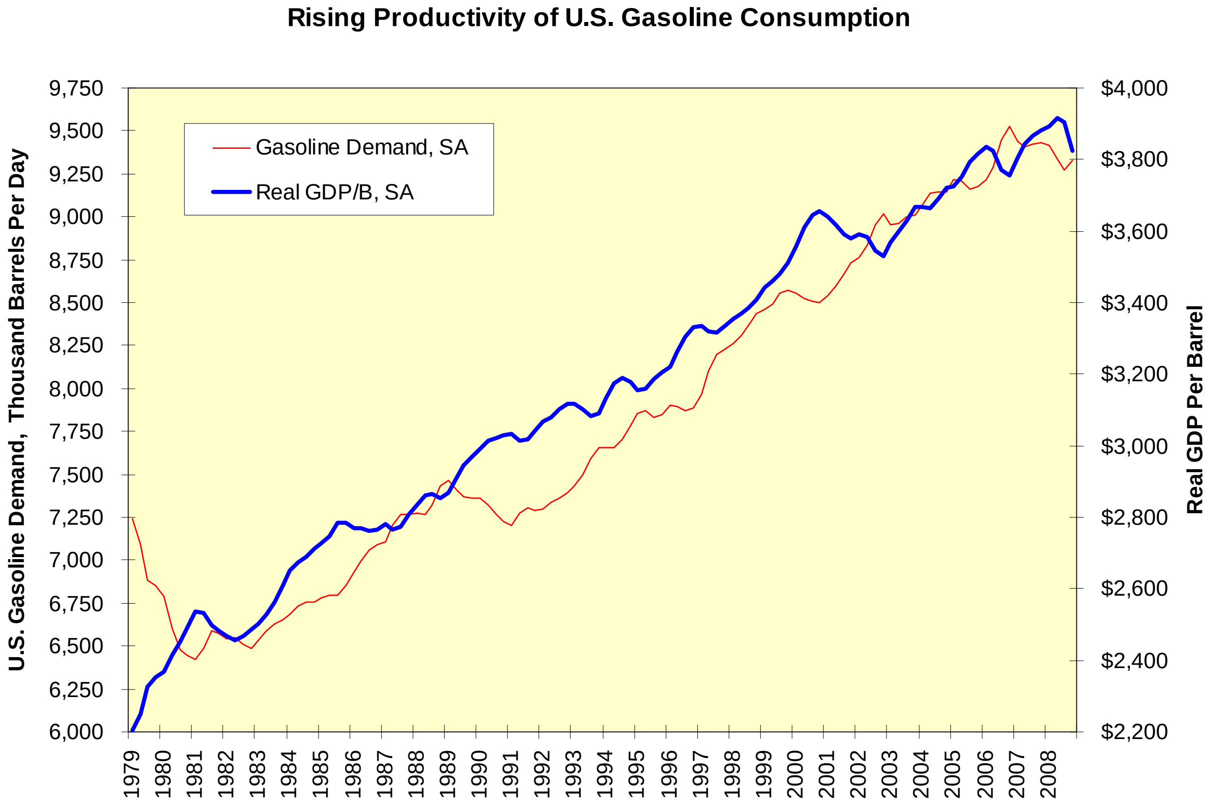
A straight linear regression of the CPI against time going back to July 1984 produces an r^2, or percentage of variance explained, of 0.996. The only significant residuals, or periods of unexplained variance, occurred during the CPI rise in 2007 and the first half of 2008 and its subsequent decline back to its long-term trend in late 2008 and early 2009. Thankfully, we had the money-printers at the Federal Reserve to rescue us from this "deflation."

What about gasoline as a descriptor of the CPI? That produces an r^2 of 0.571. We sniff. It is important to remember gasoline counts for only 4.337% of the CPI and is invisible to those who prefer to focus on "core" inflation, that measure excluding food and energy. As I noted earlier this week, food prices are going to rise, so Ben and his mangy menagerie of money-meisters, like Lucy Ricardo, will have some 'splainin' to do.



Productivity

Despite my observation from last April the S&P 500 was glancing nervously at higher crude oil prices, the economy as a whole is able to absorb higher prices for gasoline because of enormous productivity gains made over the past three decades in fuel consumption. If we map seasonally adjusted trendlines of U.S. gasoline demand against a similar measure of constant-dollar GDP per barrel of gasoline consumed, we see gasoline consumption has increased at an average annual rate of 0.8% since 1979 while the productivity of its consumption has increased at an average annual rate of 1.81%.



Implicit in this display is gasoline is nothing other than a process input in your life. Even when you are stuck in traffic, you are heading somewhere where you will be adding economic value. You, too, can take your talents to South Beach.

None of this should be surprising; it is how a market is supposed to work. I noted the same phenomenon with respect to labor and capital costs last October. Even Chairman Bernanke had to acknowledge in his Senate testimony last Friday employment growth was going to be slow; he could not acknowledge, however, his cheap money and ever-improving technology meant only a fool would hire more U.S. labor than necessary. You are not just importing cheap goods from China; you are importing cheap labor content, too.

Will there come a point when higher gasoline prices make consumers feel pinched? In the spirit of our times, you betcha. Complaining about gasoline is as American as driving everywhere. In a manner of poetic justice, however, the public's perennial equation of higher gasoline prices with higher inflation, the ruler notwithstanding, will lead to increased pressure for the Federal Reserve to start restraining credit.