

What is the CPI Telling Us?

The CPI rose .4% in September as compared to a .1% change in August, and 2.6% (year-on-year) as compared to 2.7% in August. Remarkably, measured inflation declined only marginally. In a period of collapsing demand, why so little slowdown in inflation? One cause was that energy prices rose in the early part of the month while the fall in energy prices was delayed until the end of the month. This reflects the natural downward 'stickiness' in energy prices, particularly retail gasoline when the underlying crude price drops sharply in a brief period. With the more bearish economic statistics beginning to emerge, declining energy demands should continue to put downward pressure on retail prices of all transportation fuels.

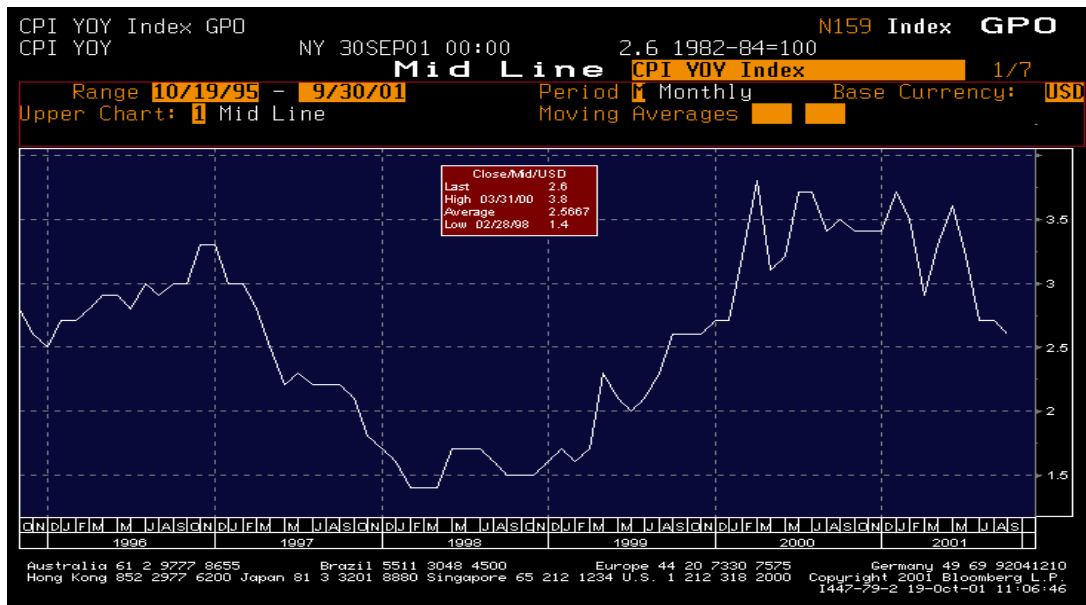


Figure 1: US CPI Year on Year Percentage Changes

A comparison of the percentage changes between the CPI and the core CPI (excluding food and energy) tells a familiar story of the overall index falling faster than the core index when commodity 'shocks' occur. We last saw this pattern during the Asian Crisis when the world economy had significant commodity price weakness. Top line inflation expanded at a significantly lower rate than core inflation. In mid 1996, crude oil (measured by WTI futures) was \$26-\$27 per barrel, but by late 1998, crude had fallen to below \$11 per barrel. By 1999 when the world economy was booming, core inflation expanded more slowly than top line inflation. Crude and petroleum product price increases had significant impacts on the top line inflation numbers.

The divergence between the two series this time will not entirely repeat the petroleum price collapse of 1997/1998. As a consequence we should expect top line inflation to decline more modestly. However, it seems clear that in a period of poor world demand growth for a wide variety of goods, inflation trends should continue to decline, giving scope for additional Central Bank easing. Falling inflation pressure also impacts household and firms differently.



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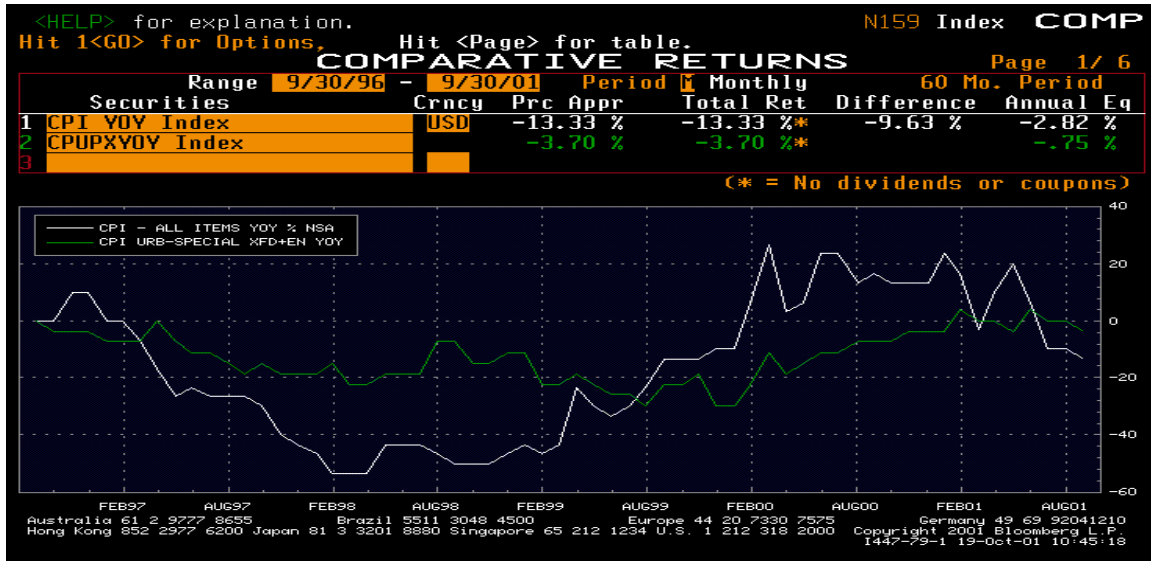


Figure 2: Top Line and Core CPI Comparison 09/30/96 to 09/30/01 (relative performance)

CPI YEAR on YEAR Changes

	Percentage change 12 months ended in December					9 mos. ended in Sep.		
	1994	1995	1996	1997	1998	1999	2000	2001
All items	2.7	2.5	3.3	1.7	1.6	2.7	3.4	2.8
Food and beverages	2.7	2.1	4.2	1.6	2.3	2.0	2.8	3.3
Housing	2.2	3.0	2.9	2.4	2.3	2.2	4.3	3.2
Apparel	-1.6	0.1	-0.2	1.0	-0.7	-.5	-1.8	-3.0
Transportation	3.8	1.5	4.4	-1.4	-1.7	5.4	4.1	.8
Medical care	4.9	3.9	3.0	2.8	3.4	3.7	4.2	4.8
Recreation	1.4	2.8	3.0	1.5	1.2	.8	1.7	1.8
Education and communication	3.3	4.0	3.4	3.0	0.7	1.6	1.3	3.2
Other goods and services	4.2	4.3	3.6	5.2	8.8	5.1	4.2	6.8
Special indexes								
Energy	2.2	-1.3	8.6	-3.4	-8.8	13.4	14.2	0.4
Energy commodities	5.2	-3.3	13.8	-6.9	-15.1	29.5	15.7	-1.7
Energy services	-.6	0.8	3.8	0.2	-3.3	1.2	12.7	2.6
All items less energy	2.6	2.9	2.9	2.1	2.4	2.0	2.6	2.8
Food	2.9	2.1	4.3	1.5	2.3	1.9	2.8	3.4
All items less food and energy	2.6	3.0	2.6	2.2	2.4	1.9	2.6	2.8

BLS data



The speed of wholesale to retail price changes, particularly in the decline phase of an oil cycle is limited by the need to purge inventories at the refinery and distribution levels as well as the time it takes for cheap imported fuels to enter the distribution channels in the U.S. Below, we have graphed a weekly series of retail gasoline prices. It is evident that major price breaks came after September 24th. We should expect to see a sharp change in top line CPI numbers next month.

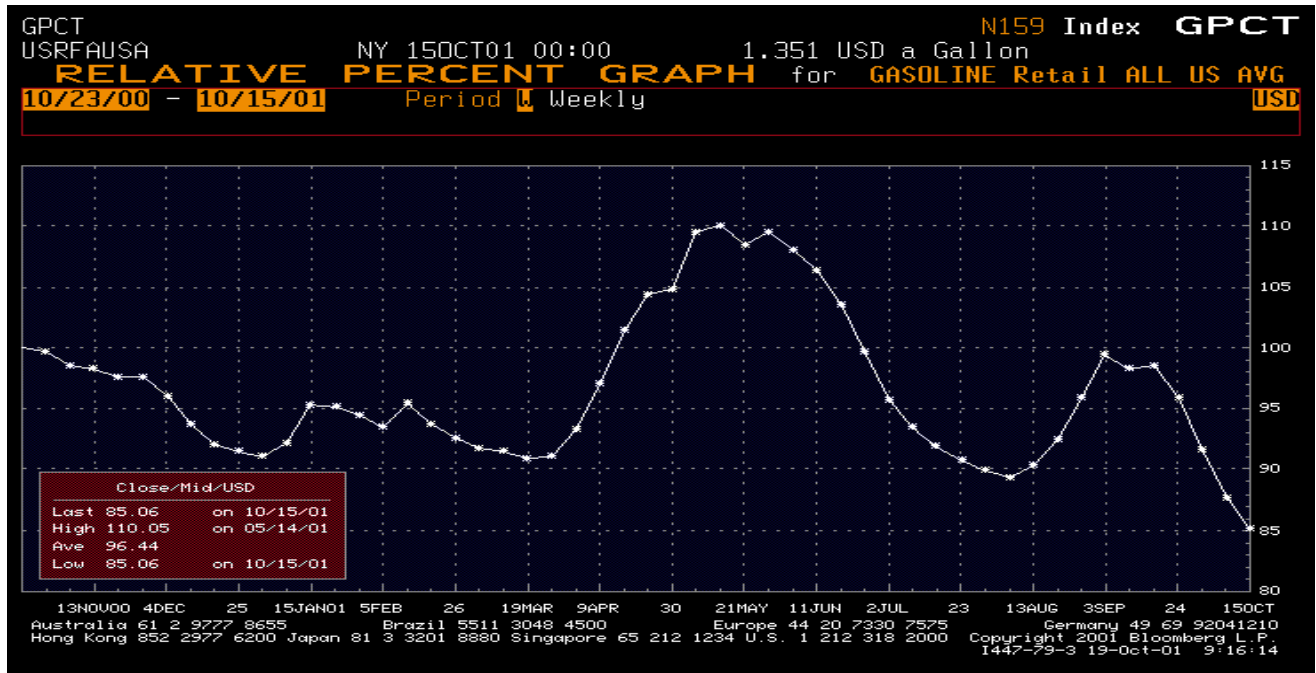


Figure 3: US AVERAGE RETAIL GASOLINE PRICES (% changes relative to w/e 10/23/00)

IMPLICATIONS: A major impact of a slowing rate of inflation will be on corporate sales and revenue growth. This in turn should negatively impact nominal cash flow and profits in the short run as inventory clearance continues. Reduced cash flow and profits work to deter a resumption of business investment. At the same time, a slower rate of inflation tends to retard the decline in living standards. For capital markets, the issue will be what a slowing rate of observed inflation will do to inflationary expectations. On the assumption that expectations of inflation fall when observed inflation falls, negative incentives are sent to households and firms with regard to capital asset acquisition.