

# Weekly Economic Commentary

May 21, 2012



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### Highlights

Here in 2012, food and energy inflation is less of a concern for consumers.

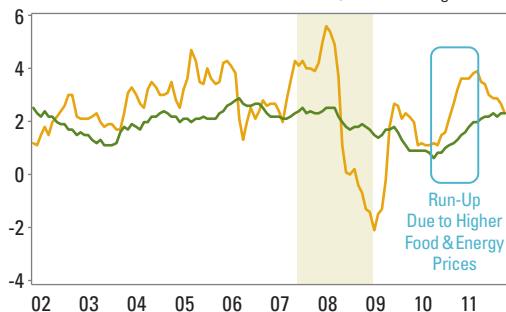
Rapidly rising consumer food prices in 2011 were largely due to a surge in prices for agricultural commodities in late 2010. That surge has dissipated, and food inflation is decelerating rapidly.

Consumer energy prices surged in early 2011, as the "Arab Spring" pushed up oil prices. Most geopolitical tensions have eased in 2012. Gasoline prices are under \$4 per gallon.

Please See the LPL Financial Research Weekly Calendar on page 3

### 1 Headline Inflation Accelerated Sharply in Early 2011, but Has Receded Recently

— CPI-U: All Items Less Food and Energy: 1982-84=100 Year/Year %Change  
— CPI-U: All Items: 1982-84=100 Year/Year %Change



Source: Bureau of Labor Statistics, Haver Analytics 05/21/12

Shaded areas indicate recession.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

## The Ebb of Energy & Eating Costs

In the spring of 2011, U.S. consumers were hit with high energy and food prices. This double whammy drove headline consumer prices, as measured by the Consumer Price Index (CPI), from a 1.1% year-over-year gain in late 2010 to nearly 4.0% by the fall of 2011. A rapid acceleration in food and energy prices accounted for most of the acceleration in overall inflation. Combined, these two components of the CPI account for less than 15% of the overall index. But because consumers make purchases of food (grocery stores) and energy (gas stations) quite often, rising prices in these two categories captured the public's (and the media's) attention.

### Pain at the Pump and in the Grocery Aisle

The sharp acceleration in food and energy prices made headlines nearly every day in the spring and summer of 2011; after all, many Americans make several visits to gasoline stations and grocery stores every week. Higher prices and more related media coverage were a large contributor to the slide in consumer sentiment over the spring and summer of 2011. However, the acrimonious debate in Washington over the debt ceiling and the volatility in financial markets due to the debt ceiling debate and the European sovereign debt problems were also to blame. Growth in real consumer spending (which accounts for two-thirds of economic activity) slowed sharply between late 2010 and the middle of 2011, from a 3.6% pace in late 2010 to under 1.0% in mid-2011, partly because consumers were diverting some of their discretionary incomes to purchase "must-have" items like groceries and gasoline.

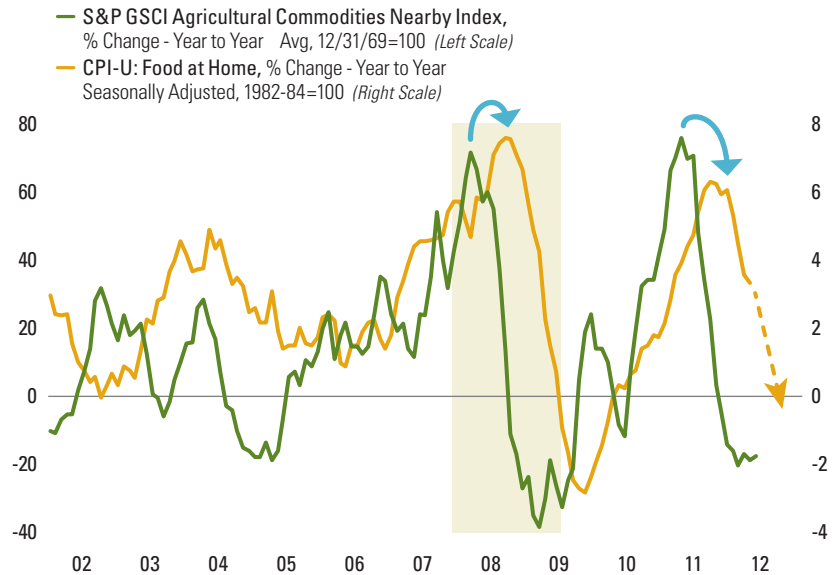
Just how rapid were the price increases in these categories? Energy prices in the CPI accelerated from 4.0% year-over-year in late 2010 to 22% year-over-year in mid-2011, as a gallon of gas increased from under \$2.75 in the fall of 2010 to nearly \$4.25 in the spring of 2011. The rise in gasoline prices, in turn, was driven largely by the Arab Spring uprisings that rolled across the Middle East in the winter and spring of 2011, driving oil prices from around \$70 per barrel in September 2010 to as high as \$114 per barrel in April 2011.

Food price inflation accelerated from under 1.0% year-over-year in the fall of 2010 to a 6.3% year-over-year gain in the fall of 2011. That rapid increase, which was accompanied by almost constant reinforcement from local and national media about rising prices for staples like bread and milk, was a result of a near-doubling of agricultural commodity prices between mid-2010 and early 2011. The rise in prices for agricultural commodities was largely the result of supply shocks caused by poor weather, reduced inventory



levels of key agricultural commodities, and a full resumption of economic activity in low and middle income countries around the world.

**2 Prices of Agricultural Commodities Lead Food Prices in the CPI by Approximately Seven Months**



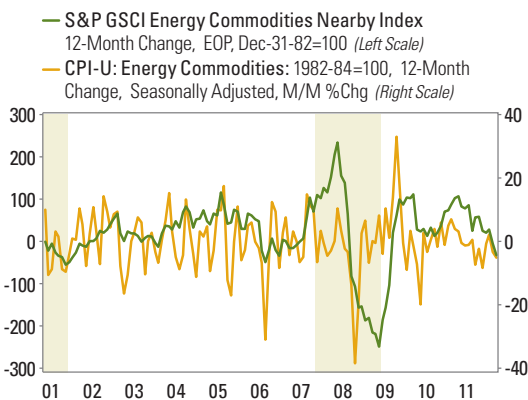
Source: S&P, Bureau of Labor Statistics, Haver Analytics 05/21/12

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The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

**3 Movement in CPI for Energy Are Closely Aligned With Changes in Oil Prices**



Source: S&P, Bureau of Labor Statistics, Haver Analytics 05/21/12

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**Fuel Fares**

This year, food and energy prices are more muted, and should head lower over the remainder of 2012, with food prices leading the charge lower.


Gasoline prices again reached \$4 per gallon this spring but have receded sharply since the early April peak in prices. Here again, gasoline prices are being driven by oil prices. Until recently this year, oil prices have held in a narrow range between \$95 and \$110 per barrel, hitting the high end of that range in late February 2012, amid concerns over an attack on Iran's nuclear facilities. Since early May 2012, oil prices have dipped to nearly \$90 per barrel amid concerns that global economic growth will slow as the European fiscal crisis flares up again. A spike higher in oil prices is possible later this year if: 1) there is more unrest in the Middle East; 2) there is an active Atlantic hurricane season; or 3) tensions around Iran's nuclear capabilities flare up again. However, oil prices are likely to remain near \$100 per barrel, which suggests that gasoline prices should remain under \$4 per gallon. Gasoline near or under \$4 over the remainder of the year would put little upward pressure on the CPI for energy products, and would help drive headline CPI back under 2.0% by the end of the year.



## LPL Financial Research Weekly Calendar

	 <b>U.S. Data</b>	 <b>Fed</b>	 <b>Global Notables</b>
2012			
21 May		 Lockhart *	<ul style="list-style-type: none"> <li>■ Belgium: Bond auction</li> <li>■ <b>China: Leading Indicators (Apr)</b></li> <li>■ <b>China: Commodity import/export data (Apr)</b></li> </ul>
22 May	<ul style="list-style-type: none"> <li>■ Existing Home Sales (Apr)</li> <li>■ <b>Richmond Fed Mfg. Index (May)</b></li> </ul>	 Lockhart *	<ul style="list-style-type: none"> <li>■ Netherlands: Bond auction</li> <li>■ OECD: Global Economic Outlook</li> <li>■ Eurozone: Consumer Confidence (May)</li> </ul>
23 May	<ul style="list-style-type: none"> <li>■ New Home Sales (Apr)</li> </ul>	 Kocherlakota	<ul style="list-style-type: none"> <li>■ Germany: Bond auction</li> <li>■ China: HSBC Manufacturing Index (May)</li> <li>■ Iran: Nuclear negotiations</li> <li>■ <b>Eurozone: Informal Leaders' Summit</b></li> </ul>
24 May	<ul style="list-style-type: none"> <li>■ Durable Goods Orders and Shipments (Apr)</li> <li>■ <b>Initial Claims (5/19)</b></li> <li>■ <b>Kansas City Fed Mfg. Index (May)</b></li> </ul>	 Dudley*	<ul style="list-style-type: none"> <li>■ South Africa: Central Bank meeting</li> <li>■ Germany: IFO (May)</li> </ul>
25 May	<ul style="list-style-type: none"> <li>■ Consumer Confidence (May)</li> </ul>	 Plosser	

 Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

 Doves: Fed officials who favor the full employment side of the Fed's dual mandate

\* Voting members of the Federal Open Market Committee (FOMC)

The surge in food and energy prices that drove headline inflation sharply higher in the spring and summer of 2011 has faded.

## Grocery Prices Going Down

The bigger driver of further deceleration in headline inflation, however, may be food prices. As shown in [Figure 2](#), changes in the price of agricultural commodities leads to changes in food prices, as measured in the CPI by around seven months. As noted above, prices of agricultural commodities surged in 2010 and early 2011, but have moderated since, turning negative on a year-over-year basis late in 2011. Prices of agricultural commodities have dropped by nearly 25% since peaking in early 2011, and are down 17% from a year ago. The drop in prices of agricultural commodities came as weather improved, inventories were built, and as some global trade policies normalized. If the traditional relationship holds between prices of agricultural commodities and the CPI for food, we could see food prices turn negative on a year-over-year basis by the fall of 2012. This would continue to push headline inflation below 2.0% (from the current 2.3% year-over year reading), providing the Federal Reserve with enough wiggle room to embark on another round of quantitative easing (QE3) if necessary later in the year.

On balance, the surge in food and energy prices that drove headline inflation sharply higher in the spring and summer of 2011, which weighed on consumer sentiment and sharply curtailed consumer spending in early to mid-2011, has faded. Prices of energy and agricultural commodities have been much better behaved in 2012, and point to decelerating headline inflation over the remainder of 2012. ■



### LPL Financial Research 2012 Forecasts

- GDP 2%\*
- Federal Funds Rate 0%^
- Private Payrolls +200K/mo.†

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.

#### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

\* Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:

- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

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The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity. This research material has been prepared by LPL Financial.

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