Market Insights with Bill Knapp of MainStay Investments

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Persistent Inflation May Cause Fed to Increase Rates by Year-End

Inflation in the U.S. vaults to a 17-year high as retail sales wane and the rest of the developed world stumbles into recessionary territory. With prices rampant, the Fed will pay more heed to FOMC inflation hawks.

The Department of Labor on Thursday reported higher-than-expected headline inflation for July with the Consumer Price Index up 0.8%. The year-over-year gain was 5.6%, the largest rise in 17 years. The three-month annualized rate of change was a daunting 10.6% increase.

Core inflation, which excludes food and energy, rose 0.3% with a year-on-year change of 2.5%. The three-month annualized change was 3.5%—showing clear acceleration in the change in core prices. Core inflation is well outside the Fed's stated comfort zone of 1% to 2%.

While the recent small pull-back in energy and other commodity prices will probably help the August statistics, year-on-year price levels are still troubling. From July 2007 to July 2008, energy prices are up 29.3%, food is up 6.0%, and transportation is up 13.4%.

Unless commodity prices, in particular energy prices, continue their downward trajectory, the Fed may have to consider raising rates before year end. At a minimum, with price levels so high, the Fed has no wiggle room to cut rates as the economy decelerates into the second half.

Reflecting waning economic activity, Retail Sales fell in July, down 0.1%, the first fall-off in five months, as reported by the Commerce Department on Wednesday. The main culprit for the decline was auto sales, excluding autos, sales rose 0.4% in July and are up 6% from a year ago.

Much of the gain, ex-autos though, came from a rise in gasoline sales – up 3%. Volume in gallons appears to have fallen though. The sales number was disappointing and reflects a quicker fall-off in tax rebate related activity than expected.

About a third of the rebate checks were sent in the 3rd quarter and a larger-than-expected portion of the rebate appears to have been saved by consumers receiving them in the 2nd quarter. At this point consumer spending looks to be at a sufficient level for the U.S. to dodge GDP contraction in the 3rd quarter, but does not bode well for the 4th quarter.

On the bright side, the U.S. trade deficit contracted in June—as reported by the Commerce Department Tuesday. The trade gap slimmed to $56.8 billion in June from $59.2 billion in May. Exports rose 4% while imports grew 1.8%, largely due to a $3.3 billion increase in crude-oil imports. The unexpected shrinkage in the trade gap for June means 2nd quarter U.S. GDP will be revised upwards of half to a full percentage point from the original 1.9% estimate.

GDP Declines Globally

Global economic news was disheartening as the Japanese government reported that economy contracted in the 2nd quarter by 0.6%, the largest quarterly decline in 7 years. The European Union, for the first time in its nearly ten year history also reported a decline in 2nd quarter growth of 0.2%. Given recent business survey data – both the EU and Japanese economies may contract again in the 3rd quarter, placing them into a recession.

The developing world is not immune to the global slowdown either, as India reported a 16-year high in inflation of 12.44 and a much larger-than-expected fall-off in industrial production. Production grew just 5.2% in the 2nd quarter—roughly half the rate from a year ago of 10.3% growth. Rampant inflation will likely lead to further rate increases from the Reserve Bank of India, as real rates remain significantly negative.

Looking Ahead…

I will be on vacation next week so there will be no report until the 28th.

William Knapp, PhD, is the investment strategist for MainStay Investments.

Previously, he served as chief investment officer of Personal Financial Services at the Northern Trust Company in Chicago, Illinois. Prior to Northern Trust, he was head of global investment strategy at Citigroup Asset Management/Citigroup Private Bank.

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