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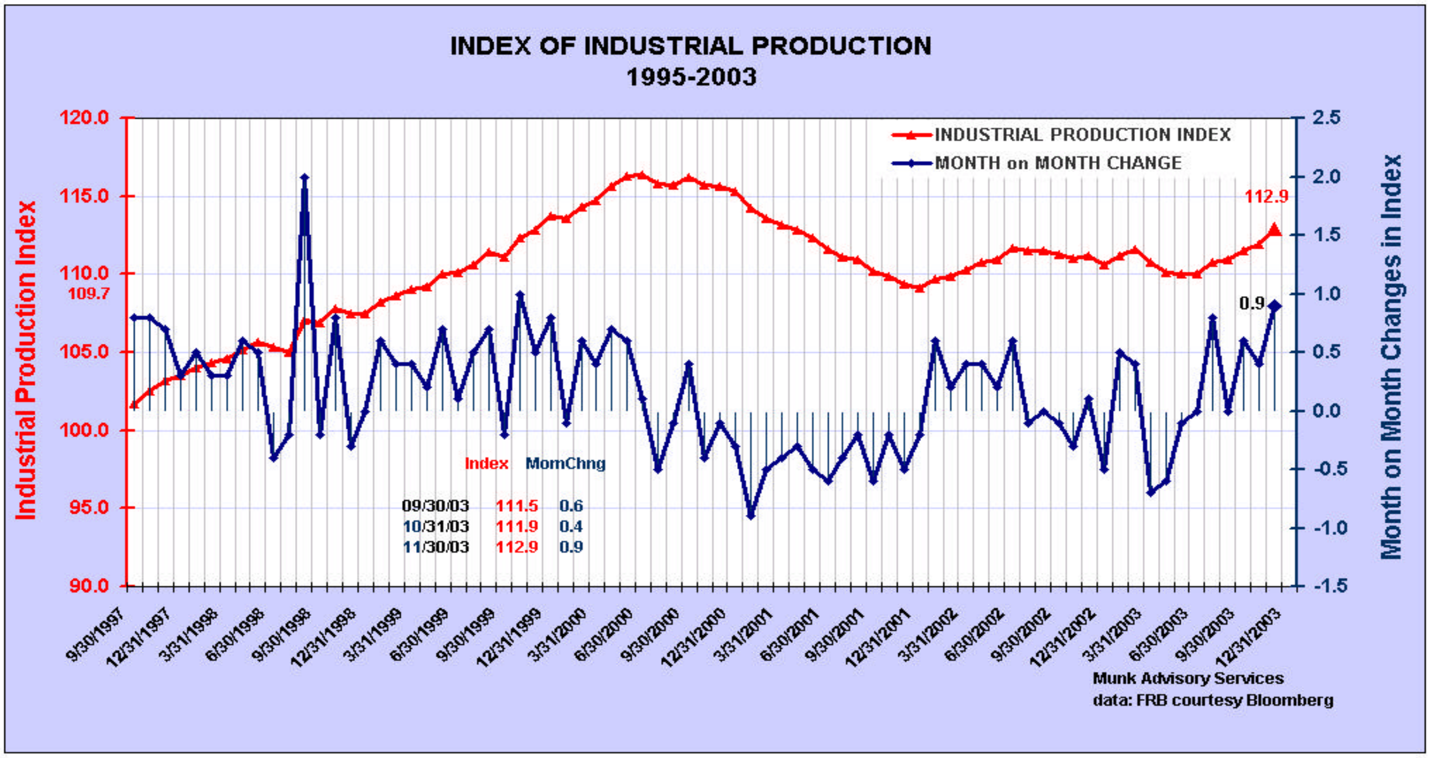
Industrial Production Increases with Consumer Price Quiescence



If one single statement characterizes this recovery, it is "sputtering." The recovery observed in the data during 2003 is highlighted by different data series showing not entirely acceleration or deceleration at different points in time. In other words, analysts who looked for 'consistency' in the data, were often misled and some concluded, incorrectly, that recovery was going to abort. This is a recovery that can be seen by carefully parsing various bits of data that illuminate its course provided one was not dominated by the need to find a simultaneous recovery in all the series. Industrial Production is a wonderful example because its torpid character over the bust-recovery phase frequently alarmed analysts, particularly those that worried if jobs would ever grow again! It certainly alarmed the business community that was notably the most pessimistic sector of the economy. The slow growth of inventories (which now seem to be building) reflected that pessimism.

The Industrial Production data for November, together with the revisions to prior months, now exhibit a more **consistent pattern of increase**, after the "trough" of early summer 2003 (April-June). This was the period where the 'deflation' scare received its widest attention at the "highest levels." Remember that it was on June 25th that the Fed cut its Federal Funds rate to 1.00% largely to offset this fear and to calm the bond market. Since that time, however, IP has steadily increased with a very large month-over-month 0.9% increase this past month. While the increased production has resulted in strikingly large job increases, it would appear that the worst is also over on the labor front, particularly since there is still no indication of a heavy inventory overhang. For this reason, increased sales will force further production in order to allow some inventory build in the next few months.

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The “big tickets” in these data are manufacturing output and business equipment, which jumped 1.7%. This is consistent with other indicators of stronger business investment and taken with the lesser increase in consumer goods output (0.4%), a shift to the “back end” of the economy is being signaled.

Consumer Price Quiescence

The CPI data today suggest that consumer price inflation is still a long way from alerting the Fed to a need to tighten. Both the core and topline measures fell, pushing year-on-year price changes to the very low level of 1.8% top line and 1.1% ex food and energy. Cheaper air transport, clothing and lodging were the drivers for this first decline in 21 years. However, price behavior at the wholesale or producer level in the economy shows a pattern of stronger commodity and material goods prices. How long can this dive rgence between intermediate and final goods price behavior last? Probably not nearly as long as the Fed’s “considerable period” doctrine would imply. One interpretation is that soon there will be a squeeze on some corporate profit margins due to higher material costs and an inability to ‘recover’ those costs in a soft-pricing power environment. But, recent profit indications belie that interpretation. We may be at the end of the best part of the “deflation,” but the current ‘stasis’ could last long enough to make QI2004 better than current forecasts. Stay tuned!

Core CPI Year-on-Year