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First Trust

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Monday Morning Outlook

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Commodity Price Slide Not a Good Reason to Postpone Rate Hikes

Commodity prices have fallen dramatically in the past five weeks. As recently as mid-July, gold was trading at $975 per ounce. Now it's roughly $800, down about 18%. Meanwhile, oil has dropped from $145 per barrel to roughly $115, a decline of nearly 21%. As a result, many analysts are saying the Federal Reserve can be less concerned about inflation and can postpone raising interest rates.

We find this argument wrongheaded for two reasons. First, because inflation is running far above where the Fed ever should have let it go; second, because it contradicts the arguments about inflation and the Fed many of these same analysts have been making since last summer.

In the past twelve months, consumer prices are up 5.6% and producer prices are up 9.2%. The last time inflation was a bigger problem was when disco balls still hung in clubs throughout the US, and not because they were retro. Excluding the aftermath of Iraq's 1990 invasion of Kuwait, the last time consumer prices were up so much was 1982. The last time producer prices were up so much was 1981.

We believe the underlying trend in overall inflation has crept up to the 3.5% - 4% range, which is too high. In the past five years, consumer prices have risen at an average annual rate of 3.6%.

Some analysts trumpet the seemingly benign 2.5% increase in "core" consumer prices in the past year. However, this measure always excludes food and energy, artificially skewing the inflation results to the downside. A better measure of the underlying trend comes from the Cleveland Federal Reserve Bank, which calculates "trimmed-mean" inflation. This measure omits the prices of the items going up the fastest and also the prices of the items going up the slowest. That measure of inflation is 3.6% in the past year, the highest since 1991.

Even if it is reasonable to attribute some of the overall 5.6% rise in consumer prices in the past year to oil, the upward tilt in inflation's underlying trend is due to loose monetary policy, not oil.

The decline in oil prices may soon make headline inflation figures look lower than they have in recent months, but overall inflation is unlikely to drop to acceptable levels (around 2% or less) and the underlying trend will continue to rise because the Fed has yet to tighten monetary policy. Instead, we believe that as oil prices fall, consumers will have more money to spend on other goods and services, which should lift core measures of inflation.

The odd part of all this is that while commodities were soaring, many of the analysts who now say falling commodity prices are a reason to hold off on rate hikes were saying back then the Fed should ignore commodity prices. In other words, according to them, we should ignore commodity prices when they are rising but pay attention to them when they are falling. Moreover, despite recent declines, gold and oil are still up about 20% and 60%, respectively, versus the same time last year.

Rather than being a reason to delay rate hikes, the decline in commodity prices and potential boost this may provide US economic growth gives the Fed wiggle room to start rate hikes earlier.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-19 / 7:30 am	PPI - Jul	+0.6%	**+0.6%**		1.8%
7:30 am	"Core" PPI - Jul	+0.2%	**+0.2%**		+0.2%
7:30 am	Housing Starts -Jul	0.960 Mil	**0.964 Mil**		1.006 Mil
8-21 / 7:30 am	Initial Claims - Aug 16	440K	**443K**		450K
9:00 am	Philly Fed Survey - Aug	-13.8	**-15.3**		-16.3
9:00 am	Leading Indicators - Jul	-0.2%	**-0.1%**		-0.1%