

US WEEKLY ECONOMIC UPDATE



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US Economic and Investment Perspectives

Rising Inflation Tests Fed Strategy to Steer Through Slowdown

Inflation worries are escalating in the US and posing additional threats to the pace of real economic growth. Both consumer and producer prices posted relatively large gains in January, triggering the largest combined annual increase in years. Consumer prices rose 4.4% in the past year, while producer prices have climbed 7.7%.

Although food and energy are the main inflationary culprits, price increases have spread to a wide range of retail and manufactured products in recent months. Moreover, pressures are building in the pipeline, as prices at the lower stages of processing within the farm and manufacturing sectors are rising faster than finished product prices. Import prices are also on the rise, owing to the declining dollar and the fast pace of rising prices elsewhere in the world. Designing a strategy to confront this surge must be balanced by policymakers' concerns about reviving economic growth after GDP advanced just 0.6% in the fourth quarter.

A Temporary Phenomenon?

Much of the current run-up in inflation is demand-driven, emanating primarily from outside the US, and especially the emerging markets. This compounds the US economy's challenge to overcome rising prices because it resembles the effect of a supply shock, which reduces purchasing power in the process, especially for households. As a result, first quarter real consumer spending may struggle to reach our 1% estimate.

The Fed views this inflation environment as a temporary phenomenon that will probably turn around as the economy slows. Federal Reserve Vice Chairman Donald L. Kohn said this week that he expects the jump in headline inflation to be reversed and core inflation to head down over the next year or so. His forecast is based on the assumption that "greater slack in the economy should reduce

pressure on prices and wages," while data from the futures market suggest "energy and commodity prices will level out."

Kohn's position, however, is brimming with contradictions. He also expects economic activity to improve by mid-year as the lagged effects from official rate cuts kick in, tax rebates begin to flow to households in the spring and the rate of decline in housing eases. We don't disagree. These factors are likely to feed into economic growth as the year unfolds. However, this implies that improvements in the domestic economy will add to the demand pressures emanating from outside the US, perhaps prolonging the inflation cycle beyond expectations.

Rates Decline Despite Rising Commodity Prices

Many analysts are discounting the long-term inflationary consequences of commodity prices based on experiences of the last two business cycles. During the 1980s and 1990s, commodity price cycles were more muted and shorter than in the 1970s. In addition, the effect of commodity inflation on general inflation was greatly reduced as technological breakthroughs raised productivity while globalization proffered new capacity almost on demand.

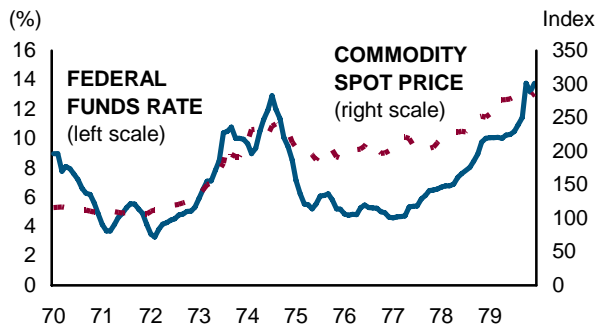
Yet, despite these disinflationary tendencies, the contour of official rates generally mimicked the cyclical pattern of commodity prices in the 1980s and 1990s, as policymakers tried to eliminate or curb imbalances that pushed inflation up (or in some cases down.) Changes in official rates were more proportional in the 1970s when the linkage from commodity prices to general inflation was more direct and concurrent (**Display 1, next page**).

Clearly, today's rapidly rising commodity prices amid an abrupt decline in official rates is markedly different from patterns of the 1980s and 1990s, and even somewhat different from the 1970s. First, in the 1980s and 1990s, commodities prices moved in a narrow band and never exceeded the highs of the

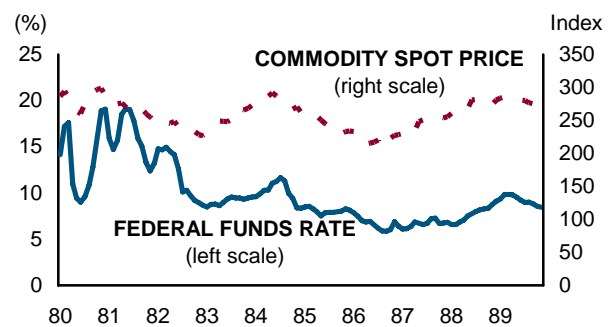
Display 1: Commodity Prices Follow a 1970s Trend, but US Rate Patterns Look Different

Four Decades of Fed Policy and Commodity Prices

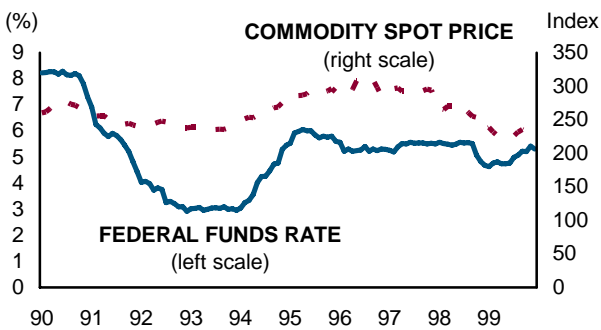
1970s



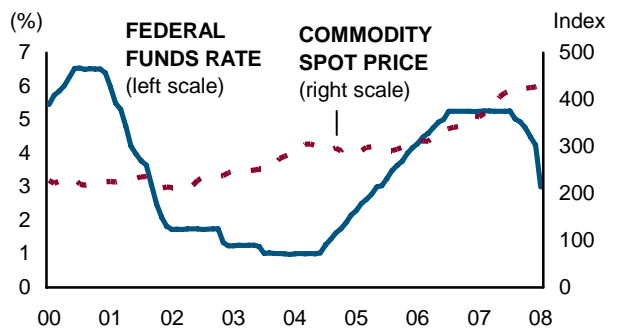
1980s



1990s



2000s



Source: Commodity Research Bureau, Federal Reserve Board and Haver Analytics

1970s. The current cycle resembles that of the 1970s, with price levels moving steadily higher to record levels. The current cycle is also unique because official rates have declined against the backdrop of fast increases in commodity prices.

The latter point should not be overlooked because our analysis shows that the fast rise in commodity prices is lifting the change in the aggregate price level in the economy. Our broad price index, which helps distinguish between relative and absolute price movements, and includes commodity prices (with a very low weight) along with consumer prices, finished producer prices and real and financial assets prices, has gained 3.5%—50 basis points over the target on the Fed funds rate.

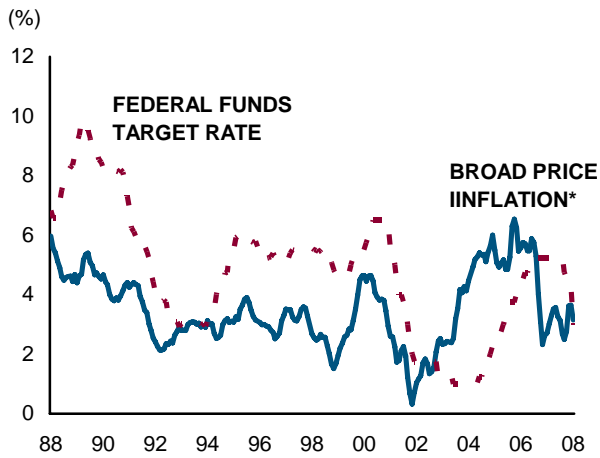
Only twice in the past 20 years (1993 and 2002) has the funds rate matched the rate of increase in the broad price index (**Display 2, next page**). In each case, two different policy responses prompted dramatically different outcomes. In 1994, the Fed

jacked up interest rates by 300 basis points over 12 months, staving off a cyclical rise in inflation in the process. But in 2002, the Fed left rates at unusually low levels and then cut rates again in 2003, which helped fuel an inflation cycle that was expressed mainly in an explosion in real asset prices.

History shows that inflation cycles can appear in products, services or commodities that consumers and business buy, or in other types of assets such as stocks, bonds or real estate. But every type of inflation cycle is rooted in an easy monetary policy.

In this week's testimony on monetary policy before the House Committee on Financial Services Federal Reserve, Chairman Ben S. Bernanke hinted that additional rate cuts may be in store to ward off further downside risks to growth. However, maintaining this type of accommodative policy increases the risk of generating an inflationary cycle on the other side of the slowdown. In the short run, we still expect financial markets to focus more on

Display 2: Fed's Quick Action Narrows Gap Broad Inflation and Interest Rates



*Year-on-year percent change, three-month moving average of Broad Price Index. The broad price index consists of consumer prices, all three stages of producer prices, new and existing home prices and stock prices. Food and energy prices are excluded from the two lower stages of producer prices.
Source: Federal Reserve Board and AllianceBernstein

the economy's growth performance than on inflation risks. But when economic growth is restored as we expect in the second half, inflation tendencies will probably move to front and center because the financial kindling being added today will help extend the current cycle of rising prices.

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