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Economics Group

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PPI: Mixed Results in February

The PPI for February showed a very strong increase in the finished goods index of 1.6 percent, but a more modest increase in the core PPI, which posted a more moderate 0.2 percent increase.

Strong PPI in February due to Food and Energy

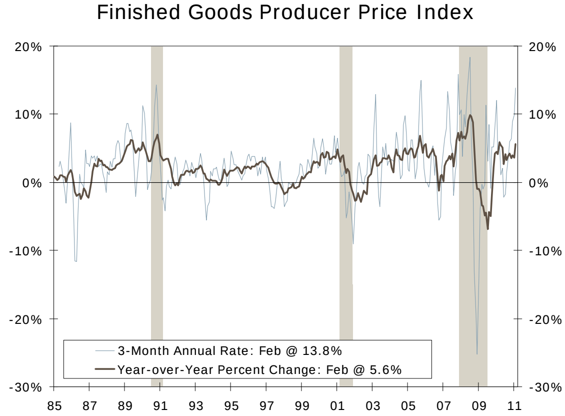
The good news for the Federal Reserve is that the producer price index for finished goods increased by 1.6 percent due to strong increases in food and energy prices, while the core index only increased by 0.2 percent, a slowdown compared to the 0.5 percent increase during the first month of the year. Prices for finished energy goods increased by 3.3 percent during the month, while prices for finished consumer foods increased by 3.9 percent. According to the report, the 3.9 percent spike in finished consumer foods was the largest monthly increase since November of 1974, when it posted a rate of 4.2 percent. This comparison should not be taken lightly.

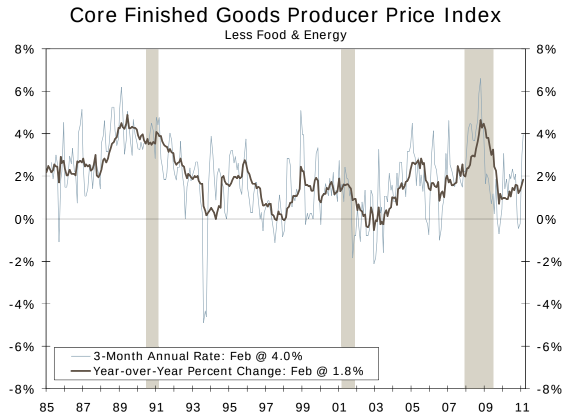
The comparison to 1974 is very telling because that was the year when the "stagflation" period started. Recall that stagflation is defined as a combination of economic stagnation and inflation. Having said this, it is still too early to try to make more analogies to the 1970s even though there are several characteristics that are very similar. While in 1974 the world was shocked by the first oil embargo, today's situation is void of an oil embargo but the same region of the world that declared the oil embargo is going through very difficult times and the end outcome could have similar effects on the petroleum market that the oil embargo had in 1974. Of course, this is only if the situation in the Middle East and North Africa continues to deteriorate and the crisis continues to spread to Saudi Arabia and other oil producing countries. Thus, this is the worst possible scenario, which, today, is not our base case, with our forecast of 2.7 percent GDP growth for 2011.

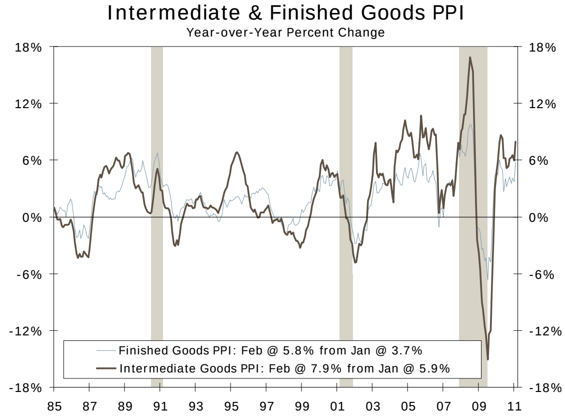
As the Economy Gains Momentum...

As the U.S. economy continues to gain momentum, higher prices at the producer price level will start to make inroads into consumer prices. While the economy still has some slack and employment is not growing as fast as in other recovery cycles, any addition to employment, any increase in income from new employment plus the extra monies from the decrease in payroll taxes will find its way into consumer prices. What is interesting here is that all this new money could end up being used by consumers to buy one type of good, that is, gasoline, which will keep the effects on core consumer prices muted and will prevent the Federal Reserve from reversing its more than accommodative monetary policy.

However, if there are signs that these increases in prices start to make their way to core prices, then the story will start to change, and the Federal Reserve will have to review its position. According to the latest Federal Reserve statement released yesterday, the story they are telling markets is the one with the "benign" ending, that is, where pricing pressures remain outside the core and everybody lives happily ever after. We will see.







Source: U.S. Department of Labor and Wells Fargo Securities, LLC

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