

US WEEKLY ECONOMIC UPDATE



June 29, 2007

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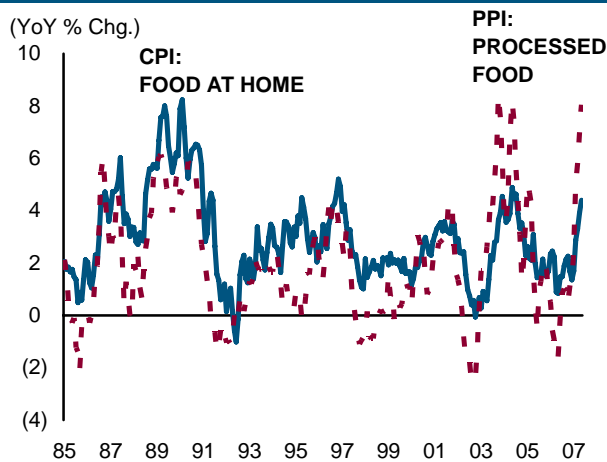
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US Economic and Investment Perspectives

Rising Food Prices Sour Inflation Outlook

Rising food prices are fueling an increase in inflation at a pace that hasn't been seen since the early 1990s. In the first five months of the year, food prices at the consumer level have increased at an annualized rate of 8.5%, exceeding the rate of both headline and core prices (**Display 1**).

Display 1: More Food Price Inflation Ahead? Food Price Trends



Source: Bureau of Labor Statistics and Haver Analytics

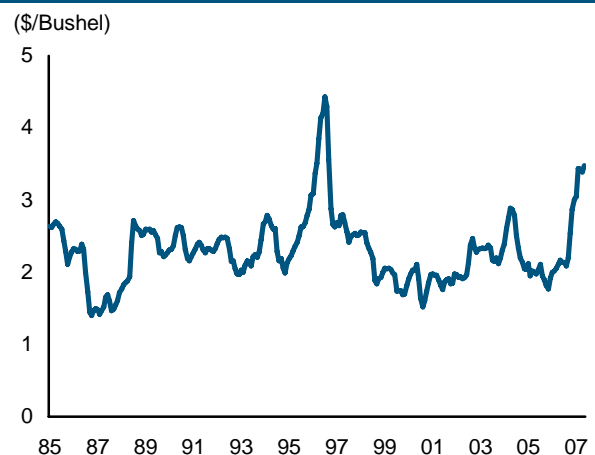
Although there have been a few spells of higher food prices in the past decade, the current cycle looks like it has staying power since it is driven by a rise in the price of food inputs. Food makes up roughly 14% of the consumer price index—four times the weight of gasoline—so a sustained increase in retail prices will keep headline inflation relatively high even if energy prices level off.

Several factors contribute to food inflation. The price of corn is one of the key food input costs, as it is the primary feed to produce protein, dairy and egg products. Moreover, corn and processed corn products are ingredients in hundreds of other items that appear on grocery store shelves. But the cost of energy is at least equally important, because it feeds

directly into food production, packaging and distribution.

Prices for both key inputs have been rising over the past few years. Corn prices have jumped sharply over the past year to the highest level since the drought of 1995 (**Display 2**). Overall energy costs for farmers have also leapt, and may even be pulled higher in coming months as crude oil has risen back to \$70 a barrel.

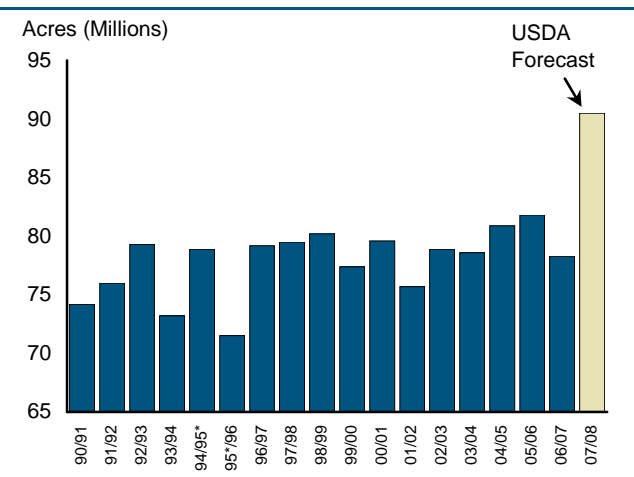
Display 2: Corn Is a Key Input to Food Prices Corn Prices



Source: US Department of Agriculture and Haver Analytics

Historically, retail food price inflation, driven by rising food input costs, has tended to be short-lived because farmers typically respond to higher prices by allocating more acres to corn production. According to the U.S. Department of Agriculture, farmers are expected to allocate 90.5 million acres for corn production this year, an increase of 15% over year-earlier levels and the largest acreage in use for corn since 1944 (**Display 3, next page**). Clearly, assuming good weather and normal yields, the sharp rise in acreage for corn production this year should alleviate some of the near-term pressures on corn prices.

Display 3: Sharply Higher 2007 Corn Acreage Should Provide Some Relief....

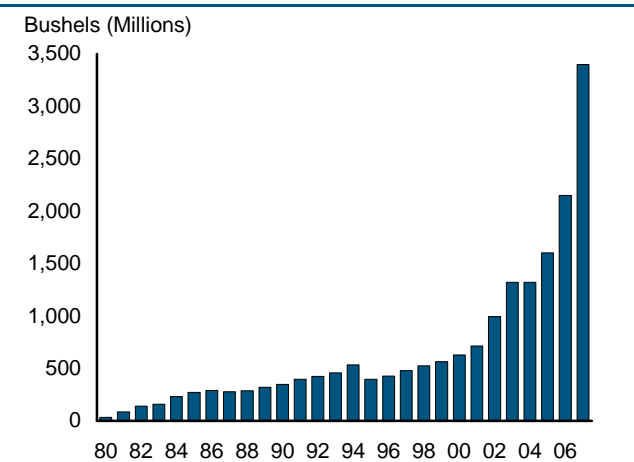


*Includes government set-asides

Source: US Department of Agriculture and Advanced Economic Solutions

Display 4: ...But Most of the Increase Will go to Ethanol

Corn Use for Ethanol Production



Source: US Department of Agriculture and Iowa Corn Promotion Board

But the relief might prove to be temporary. Unlike in prior cycles, an increasing proportion of the corn crop is used to produce fuel ethanol. According to USDA estimates, about 20% of overall corn output is being used for ethanol production, more than three times the figure only five years ago (**Display 4**). Government estimates also show that the ethanol industry’s consumption of corn could double again in the next two years.

Regardless of weather and yields over the summer, cost pressures in the pipeline appear to be mounting and will push food prices higher in coming months.

For example, one of the best indicators of retail food inflation is the movement in processed food prices at the producer level. Since the start of the year, processed food prices have increased 13.3%—well above the increase that has materialized at the retail level to date.

Retail prices will almost certainly catch up. Kroger, one of the nation’s largest supermarket chains, hinted this week that there will more food price increases down the road. Following the release of first-quarter earnings, Kroger’s Vice Chairman Rodney McMullen said on a conference call that the company “saw modest inflation in certain core grocery categories at a level we have not seen for several years.” He indicated that “such inflation will be eventually passed along to customers.” So far, Kroger has refrained from lifting prices due to competition—presumably from Wal-Mart. Nonetheless, grocery retailers will eventually be forced to pass-along the cost increases or face the prospect of lower margins, because a number of food manufacturers have announced price hikes as costs of corn, wheat and energy increase.

The Federal Reserve will pay close attention to these price movements at this critical juncture. Core inflation, which strips out volatile categories such as food and energy, has run above the Fed’s comfort zone of 1% to 2% over the past year and policymakers have indicated they are inclined to raise rates to stave off further inflation pressures. Yet, as they meet at mid-year, core inflation has fallen back to the upper end of that range. Under normal circumstances, we would expect this to lead the Fed to relax their language somewhat, and possibly even a shift to a balanced directive, indicating that are equally worried about growth being too slow or inflation too fast.

However, overall inflation is now running higher than core, and according to our estimates is likely to accelerate to 3% in 2007, in part because of rising food prices. That represents a big change from our view at the beginning of the year when we thought that headline would come in at about 2%. Accordingly, some Fed members might want to shift the focus to the headline measure and signal to the market that they are still worried about inflation trends and more likely to tighten down the road.

Importantly, the statement issued after the June FOMC did not suggest any shift in inflation gauges was imminent. But policymakers indicated that although core inflation has eased in recent months, the “moderation in inflation pressures has yet to be convincingly demonstrated.” As a result, the “predominant policy concern remains the risk of higher inflation,” which suggests that the Fed still is inclined to raise official rates further. In our view,

that would be a mistake. With growth expected to be around 2% this year, raising interest rates is a policy decision that we do not find very appetizing, no matter where food prices are headed over the intermediate term.

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Monetary Policy Decisions Should Be Based on Broad Inflation Perspective

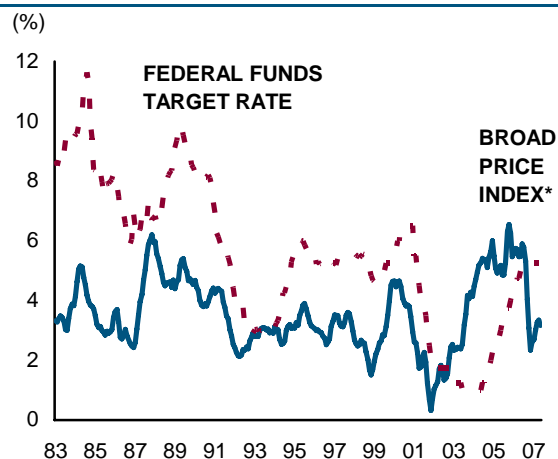
From our vantage point, future monetary policy decisions may center on relative risks in the outlook rather than potential outcomes. For example, the decision to raise official rates to restrain further headline inflation (perhaps due to rising food prices) and a corresponding rise in inflation expectations must be weighed against the effect of a rate hike on real asset prices, which are already being pulled lower by weak demand and record levels of inventory.

Importantly, rising prices in one category, or even in a single measure, should never be viewed in isolation. That’s because a rise in a single product price or a specific measure of prices (e.g. consumer prices) might be nothing more than a shift in relative prices rather than a shift up in overall inflation.

In order to avoid placing too much emphasis on one type of inflation over another we have always focused on the broad-based transaction-oriented price index—which includes consumer and producer prices along with real and financial asset prices. This index helps us distinguish between relative and absolute price changes. Our broad based price index currently shows an increase of around 3%, which is not too high or too low, suggesting that the uptick in consumer prices has been tempered to some extent with weakness in other prices, most recently by declines real asset prices.

Given how important asset price changes have become to the performance of the macro economy we think a different policy framework is needed to gauge underlying inflation pressures. Reliance on a single price measure is no longer sufficient, nor is a specific target. Indeed, policymakers must be mindful of inflation trends in all parts of the economy as falling real asset prices could easily do as much damage—or more—to the macro economy as a rise in food prices.

Broad Prices and Official Rates



*Three-month moving average; year-over-year percent change. The broad price index consists of consumer prices, all three stages of producer prices, new and existing home prices and stock prices. The consumer price index weight is 67%; producer prices 13%; house prices 15%; and stock prices 5%. All price series are indexed to 2000. Food and energy prices are excluded from the two lower stages of producer prices.

Source: Federal Reserve Board and AllianceBernstein