Inflation Observatory

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Inflationary pressures persist

- Headline consumer prices rose 5% on a year-to-year basis, the fastest rate of increase since May 1991
- Core inflation unexpectedly rose to 0.3% mom, offsetting positive readings in the previous months
- Economic slack and the absence of a wage spiral will help contain inflationary pressures from energy and food prices
- We maintain our forecast of a pause in monetary policy

Pressures to headline inflation intensified

Headline CPI rose 1.1% in June from 0.6% in May, the largest monthly change since September 2005, just in the aftermath of hurricane Katrina. Not surprisingly, the increase was driven by energy and food prices, which jumped 6.6 and 0.8% respectively. The CPI-Energy continued to experience the effect of elevated oil and gasoline prices. For instance, prices at the pump climbed 10.1% in the month, resulting in a 32.8% increase from the level of the previous year. On a three month basis, headline inflation rose at 7.9% annualized rate.

Core inflation increased, but remained under a relatively stable path

Core CPI came above expectations, rising 0.3% in June from 0.2% in May. Shelter picked up 0.3%, but rose 0.2% in May and 0.1% in April. Year-to-year, shelter increased by 2.6% for the third consecutive month, the lowest rate since March 2006. Core inflation doesn't seem to be escalating. In fact, June's acceleration came after two months of positive readings, particularly in April, when core inflation eased to an unusual 0.1%. In June, core prices rose by a 2.5% three-month annualized rate and 2.4% year-over-year, slightly above the average of 2007.

Inflation readings remain consistent with our forecast

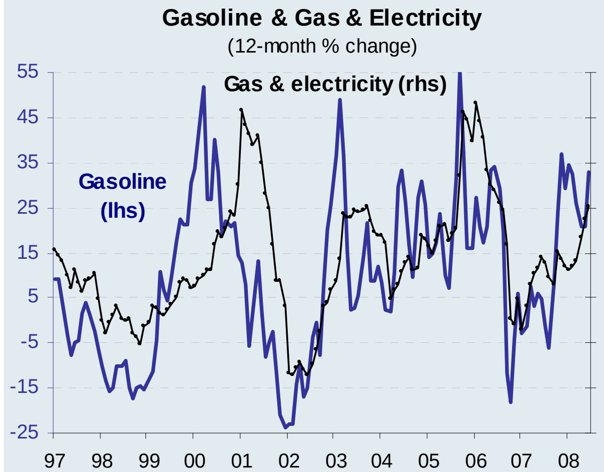
In line with our main scenario, headline inflation reached 5.0%, while core inflation, despite the slight increase, remained relatively contained. Pressures from energy, food, and short-term expectations continue to play against the inflation outlook. However, economic slack -the unemployment rate is already at 5.5% and could increase further- and the absence of a wages spiral will hopefully prevent core inflation from getting out of control. Through their communication, Fed officials have emphasized their increasing concern on the inflation outlook; however, inflationary risks are counterweighted by risks to economic growth. The balance of risks, makes an eventual rates hike less likely in the short-run. Therefore, we expect the FOMC to keep the Fed funds rate steady at 2.00% in the next meeting.

Consumer prices (sa, %)

	Jun	May	Apr	3-month change	12-month change
CPI	1.1	0.6	0.2	7.9	5.0
Core	0.3	0.2	0.1	2.5	2.4
Excl. shelter	0.3	0.2	0.1	2.7	2.3
Energy	6.6	4.4	0.0	53.6	24.7
Food	0.8	0.3	0.9	8.5	5.3
By expenditure					
Food & Beverages	0.7	0.3	0.9	8.1	5.2
Housing	0.5	0.5	0.3	5.2	3.5
Shelter	0.3	0.2	0.1	2.3	2.5
Rent of prim. resid.	0.4	0.2	0.3	3.5	3.7
Owners' eq. rent	0.3	0.1	0.2	2.2	2.6
Apparel	0.1	-0.3	0.5	1.0	-0.2
Transportation	3.8	2.0	-0.7	22.3	12.0
New vehicles	0.2	-0.1	-0.2	-0.1	-1.0
Gasoline	10.1	5.7	-2.0	69.1	32.8
Medical Care	0.2	0.2	0.2	2.1	4.0
Recreation	0.1	0.1	-0.1	0.6	1.3
Education & Comm.	0.5	0.4	0.5	5.2	3.8
Other Goods & Serv.	0.4	0.4	0.5	5.2	3.8
Commodities	1.9	0.9	0.1	12.0	6.9
Excl. food & energy	0.1	-0.1	0.0	-0.1	0.2
Services	0.5	0.5	0.3	5.1	3.7
Excl. energy	0.4	0.3	0.1	3.6	3.3

Trends

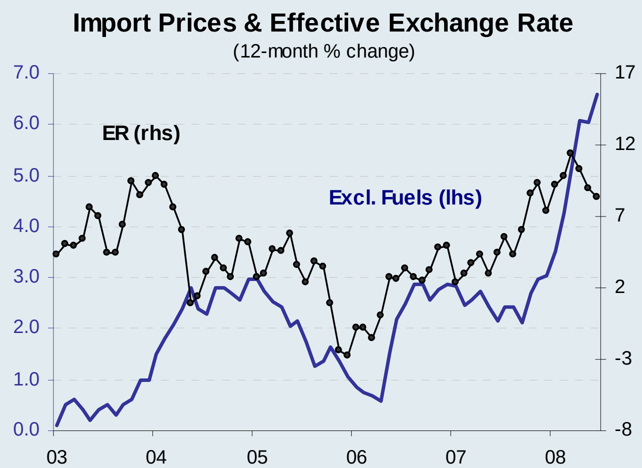
Energy Prices



Pass through from oil prices to gas

As stated by Fed Chairman Bernanke, oil prices continue to be the main source of current (and potentially future) headline inflation. Rising oil prices continue to be passed directly to consumers, who had seen how gas prices rose an additional 10% in June, after a 6% increase in May. With these numbers, gas prices have risen 33% in the last twelve months. On the other hand, the passthrough to other final goods remains contained thanks to a slowing aggregate demand. The Fed has heightened the inflationary risks to its outlook because of the growing uncertainty about future oil prices, and because of the growing risks of an abrupt passthrough to core goods' prices coming from the accumulated rises in (oil) costs.

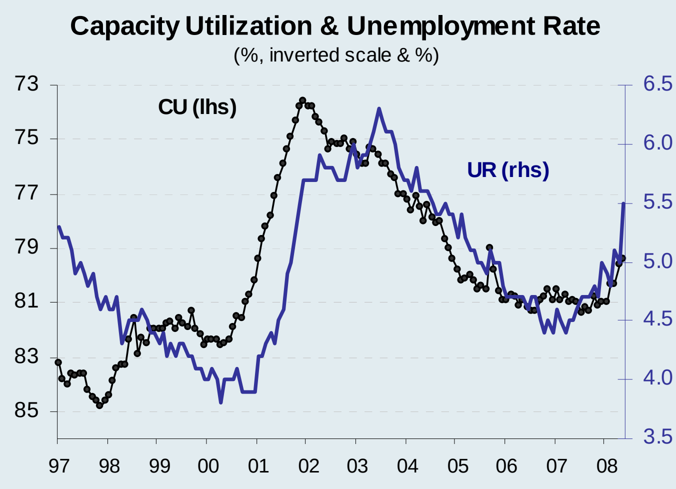
Import prices



Import prices remained on an upward trend

Chairman Bernanke acknowledged a potential relation between oil prices and dollar depreciation, but he remained skeptic of the size and significance of such effect. Nevertheless, the 8% dollar's depreciation accumulated in the last 12 months continues to inflate import prices. Although the dollar appreciated slightly in the last two months, import prices continued to accelerate. Excluding oil, June import prices grew at an annualized rate of 9.7% after a 5.3% annualized growth in May. Including the latest data, import prices have risen 6.6% in the last 12 months. This scenario is likely to continue in coming months as accumulated import inflation remains below the 12 months accumulated dollar's depreciation (8.9%). This in turn will continue to add pressure to domestic inflation.

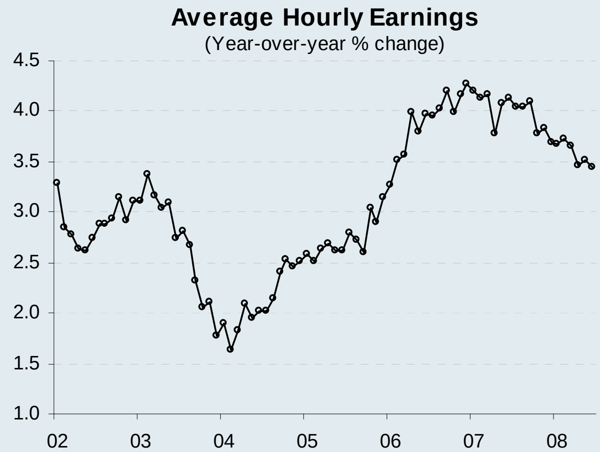
Economic Slack



More slack in the economy will help to contain inflationary pressures

The high level in the unemployment rate, coupled with the low level in capacity utilization, has persisted through June. After reaching 5.5% and 79.6% respectively, June's data signals that the real economy remains vulnerable despite higher than expected growth in the first half of the year. Bernanke recently heightened the risk of recession, thus keeping a very uncertain scenario in both inflation and growth fronts. As long as this is the case, the recessionary pressures will dampen potential inflationary pressures to core prices. Nonetheless, the Fed is aware that once inflationary pressures infect long term expectations, this recessionary pressures will not be enough to contain core prices.

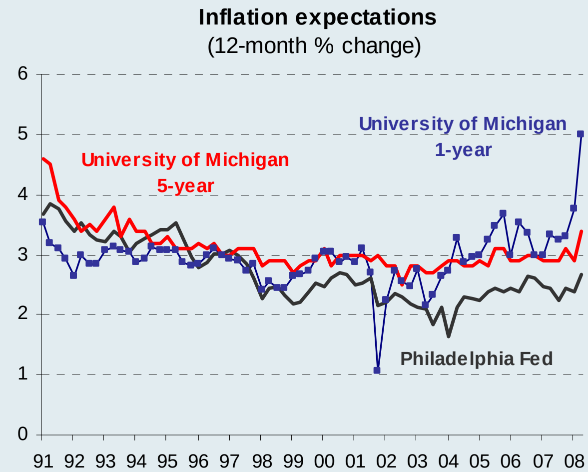
Labor Costs



Labor compensations continued to ease

Labor costs continue to offset inflationary pressure. Wage inflation seems to be stabilizing at an annualized inflation rate close to 4% (4.1% in past 5 months except for April). Although 4% is a high level, the good news is that wages have not accelerated. Low growth is clearly counterweighing inflationary pressures.

Inflation Expectations



Short-term inflation expectations have picked up significantly

Energy prices have boosted short-term inflation expectations in a way that could complicate the course of monetary policy, particularly in a context of slower economic growth. Nonetheless, long-term inflation expectations remain contained and should provide some support if the Fed maintains the pause.

Forecasts

CPI Forecasts

		CPI		Core	
		12-month	M/M*	12-month	M/M*
2007	Dec	4.1	0.4	2.5	0.2
2008	Jan	4.3	0.4	2.5	0.3
	Feb	4.0	0.0	2.3	0.0
	Mar	4.0	0.3	2.4	0.2
	Apr	3.9	0.2	2.3	0.1
	May	4.1	0.6	2.3	0.2
	Jun	5.0	1.1	2.4	0.3
	Jul	**5.4**	**0.7**	**2.4**	**0.2**
	Aug	**5.9**	**0.5**	**2.4**	**0.2**
	Sep	**6.0**	**0.4**	**2.4**	**0.2**
	Oct	**6.1**	**0.3**	**2.4**	**0.2**
	Nov	**5.4**	**0.3**	**2.4**	**0.2**
	Dec	**5.3**	**0.3**	**2.3**	**0.2**
2007		2.9		2.3	
2008		**5.0**		**2.4**	
2009		**3.9**		**2.4**	

* Seasonally-adjusted