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Food prices leave bad taste on Fed policies

The agency thinks it's balanced inflation and economic risks, but rising costs could upset stability

SUMMING IT UP

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As the Fed keeps an eye on the economy, keep an eye on food for its effect on inflation and geopolitics. Stocks along the food chain may also provide an investment opportunity.

With its recent interest rate moves, the Fed balanced risks to further economic downturn against the risk of inflation.

Citing a slowing economy and strains in the financial markets, the Federal Reserve cut both the federal funds and discount rates by 25 basis points. And although the Fed noted the core inflation rate had improved modestly this year, it said there may be renewed risk of inflation. It promised to monitor the inflation rate closely.

In an Oct. 29 Wall Street Journal interview, I predicted the Fed would be forced to cut rates, even though it didn't want to, because of the rising risk of a recession. Even though third-quarter GDP came in at 3.9 percent – a solid performance – the Fed needed to look forward. Forecasters, such as Merrill Lynch chief economist David Rosenberg, say the odds of a recession lie "near" 50 percent. Supporting their case are the Conference Board's leading economic indicators, poor housing starts and consumer confidence numbers. The Chicago purchasing manager's index has fallen to 49.7 percent – a level that indicates an economy in contraction.

The downturn in housing, mortgage finance and retailing may not be contained, and it could affect the rest of the economy. The need to contain the problems in the credit markets caused the Fed to cut rates by 50 basis points in August. However, the Fed said strains in the financial markets have eased somewhat.

But the Fed has two historic roles. One is to let the economy grow at its natural rate; the other is to contain inflation. So the twin risk is not only to the economy but also to inflation.

Despite saying the readings on core inflation have improved modestly, the Fed recognizes upward pressure on food and commodity prices has heightened pressure.

Evidence of that inflationary pressure isn't hard to find. In previous columns, I noted the pressure on food prices both here and abroad. Globally, there is an increased demand for food, not only because of population growth but also because emerging countries have more money to spend and can thus demand a better diet. Coupled with this greater demand for food is a misguided U.S. energy policy that has pushed up the price of food all along the chain. And as a result of federal ethanol policies, corn and what prices have risen dramatically. So far this year, the prices of corn and soybeans are up 40 percent and 75 percent, respectively. Wheat is up 70 percent, to $9 a bushel, and a growing number of economists think these prices could last a decade or more. Since these grains are often feedstock for animals as well as humans, the price of meat is up at the butcher case. Anyone who shops knows prices are increasing.

And the price increases are global. For instance, food prices in China are up about 10 percent year-over-year. In Russia, where food prices have increased 8 percent, Soviet-style price controls have been put on basic food products. The rising prices have led to shortages. In China there's a shortage of pork, a staple in the Chinese diet, and a lack of refrigeration makes it impossible to safely move refrigerated food more than short distances.

In Japan, government figures show consumer prices have fallen for eight months in a row. The country appears stuck in a deflationary mode, yet price increases are stirring anger among consumers. And from butchers to bakers, a string of Japanese food producers have announced plans to increase prices. Both here and in Japan, there's a disconnect between official prices and prices in the marketplace.

Now there's concern that rising food prices will herald the first global food shortage since the 1970s. According to the Financial Times, finding food to feed the hungry of the world as the demand for food of all types grows is causing rich and poor nations to compete for food supplies. Food security is of growing concern, and can lead to domestic political instability and even international conflict.

So, as the Fed keeps an eye on the economy, keep an eye on food for its effect on inflation and geopolitics. Stocks along the food chain may also provide an investment opportunity.

A note: This column marks the one-year anniversary of my DJC column. I'd like to know how you like it, if you do. If you have comments, criticisms or kudos, call or e-mail with any suggestions. Thanks.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.