TrendMacrolytics

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MACROCOSM

Inflation Flu

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While the bond market denies US inflation, for Thailand it's an all too familiar contagion.

Update to strategic view
US MACROECONOMY: Statistical evidence of inflation is being distorted by a market hooked on a too-dovish narrative. But Thailand's small fragile economy has been thrown into turmoil because of it, much as it was in the similarly misunderstood US deflation of the 1990s.
[see Investment Strategy Dashboard]

Last Friday, when the Consumer Price Index registered flat readings on both headline and core, the widely accepted takeaway was that the "inflation scare is over." But when earlier this week producer prices printed at multi-decade highs in both headline (up 2%) and core (1.3%), we were assured it was all about an anomalous surge in light truck prices. As far as the core Producer Price Index is concerned, according to the *Wall Street Journal,* other than light trucks "there was little evidence of broad price pressures." In reporting on the CPI last week, however, the *Journal* saw no need to mention that the core index was held down by a few volatile components, such as auto prices and airfare (see "On November CPI" December 15, 2006), while positing that "easing price pressures could encourage the Fed to focus less on inflation and more on economic growth."

The conventional wisdom that inflation is yesterday's news is so biasing the narrative that we saw no published report on the PPI this week pointing out that core consumer goods jumped 1.1% last month (light trucks are classified as capital equipment in the PPI), and are up an annualized 3.4% in the past three months. Nor, did the media see fit to note that crude materials surged by 15.7%. At the same time, falling 3-month measures have become a staple for dovishly biased reporting of CPI.

Though off its very highs of early this month, the bond market remains mostly impervious to what the clearly premature declarations of the death of inflation imply for the Fed policy outlook, content to ride this wave of good feeling for as long as it lasts. Following a knee-jerk quarter point sell off on the producer price release Tuesday, the 10-year Treasury quickly bounced back to unchanged, as the favored interpretation took hold that light truck prices explained the unexpected lurch higher. In fact, with today's rally on another soft-looking Philly Fed survey, the benchmark Treasury at 4.56% is back to pricing for some 60 bps in Fed rate cuts next year, an outcome we continue to consider highly implausible. It's far more likely we'll see at least 50 bps in rate *hikes,* which begins to outline the extent of the market's mispricing.

From our perspective, the government's official statistical price indexes represent only a deeply lagging, backward-looking accounting for earlier policy error, and tell us nothing about the going-forward outlook for inflation. That's why our analytical model focuses on sensitive market prices for commodities and foreign exchange, which have proven over time to provide reliable insights into the purchasing power of the currency, determinant of the future price level. We'd have much less concern about the current readings from the statistical indexes were these market price signals offering us assurance that the Fed has at least reached equilibrium and is no longer continuing to impart additional inflationary impulses into the system.

That's not the case, however, and an event this week represented a telling demonstration of the pressures being imposed on the international financial system by the Fed's still-loose policy stance. Thailand had seen the dollar weaken by nearly 15% this year against its currency, the baht. And with a world awash in dollar liquidity, small emerging markets like Thailand have become targets of speculative flows seeking to profit from the dollar's weakness. With their concerns growing about the competitive consequences of the baht's appreciation, and increasingly uneasy with the speculative buffeting they were enduring in the midst of it, the Thais made an aborted effort to impose capital controls on their markets this week. While the Thai authorities were roundly condemned on general free trade principles for their ham-handed intervention, little if any attention was paid to the actual specific source of the problem: the Fed's excess liquidity posture. There is a striking irony at work here, as it was also the Thais who first bore the brunt of the Fed's late-1990s deflationary error, forcing the devaluation in mid-1997 that initiated the currency crisis that we were the first to nickname the "Asian flu." This Thai episode underscores that in many ways, current conditions in world markets can be seen as equal and opposite of those set off by the dollar deflation that so paralyzed global finance less than10 years ago. At that time, the crisis was engendered by a too-tight Fed. Today, the risks roiling the markets are the product of a Fed that, despite much talk to the contrary, remains too easy.

BOTTOM LINE: Interpretations of the latest statistical inflation releases have managed to hew to the accepted wisdom that inflation is no longer an issue. In the case of producer prices, that was the product of shallow analyses suggesting that there was little evidence of price pressure other than in light trucks. The bond market continues to accept such superficialities unquestioningly, buying into the wishful thinking that the Fed's next move will be to ease. As the currency contretemps in Thailand helps illustrate, however, the Fed remains easy, and its next move will be higher, not lower. TM