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MACROCOSM

Deflation? Surely You're Joking

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Inflation pressures are still intense, despite falling commodities and slower growth.

With the government's official price indicators now running at rates not seen in many years, some are musing that the worst of the inflation uptrend is behind us. A prominent economist quoted yesterday in the *New York Times* offered that the reported 1.2% increase in producer prices last month -- putting the 12-month rate at nearly 10%, highest since 1981 -- was "old news." He maintained, "The cure for the inflation problem is a recession in the United States and Europe." A columnist on the *Barron's* website yesterday, as incredible as it might seem, even spotted signs of a "deflationary riptide dragging at the U.S. economy."

This line of reasoning is seriously flawed. The recent rollback of commodity prices and rebound of the dollar's forex value off record lows is providing superficial support for the notion that the inflation problem has been solved or, as the *Barron's* columnist imagines, is actually indicative of deflation's onset. This mode of analysis is closely tied to the proposition that economic weakness will, *ipso facto*, restrain inflationary pressures. Unfortunately, that's also the dominant view at the Fed, which remains content to sustain an exceptionally easy posture in the belief that the inflationary manifestations now increasingly evident will somehow retreat of their own accord.

Update to strategic view
US MACRO: The conventional wisdom errs in adopting the new narrative that inflation pressures are easing, due to the recent drop in commodity prices or a slowing global economy. In full context, commodity prices remain quite elevated -- and slow growth has no connection with inflation.
[see Investment Strategy Dashboard]

Not likely. The suggestion that the commodity price declines are indicative of the anti-inflationary effects of sluggish growth doesn't square with the fact that these prices had been rising steadily for most of the past year in the face of an economic slowdown. The much clearer relationships were seen in the correlations between the Fed becoming increasingly more accommodative, the dollar weakening, and commodities ramping higher.

That said, the Fed remains just as accommodative, but the past month has witnessed a notable pullback in commodity prices and a rally in the dollar. We have noted that exogenous trading events, such as the ECB's less hawkish than expected policy announcement earlier this month, have had at least a short-run effect in strengthening the dollar, which has rippled through the other markets (see "Dollar/Euro, Fed/ECB, Gold/Oil: Keeping It All Straight" August 11, 2008). Admittedly, we were taken aback by the steep correction in the price of gold, although it now

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appears to be consolidating more than $50 above its lows around $775 last week. At its highs above $1,000 in the immediate wake of the Bear Stearns calamity in March, this most monetary of all commodities was signaling the risks at hand were the Fed compelled to undertake an aggressive easing move in response. When the Fed instead decided to open a sterilized liquidity facility to provide discount window access to primary dealers, we predicted gold would drop, and indeed it fell back by some $150 over a number of weeks as the worst of the inflation risks were taken off the table (see "Inflation Inflection" March 25, 2008). Gold again rallied to just below $1,000 in the Fannie/Freddy panic last month in what could be seen as another test of the Fed's fortitude (see "Indecision and Inflation" July 22, 2008). When the crisis passed without precipitating an overt policy easing, gold fell back again. But considering that the Fed now seems hamstrung at a very easy 2% funds rate for as far as the eye can see, the fall in the gold price to near $775 seems very much overdone (see "Gold: Is Enough Enough?" August 13, 2008).

There should be no misunderstanding, though, that at above $800, gold continues to point unmistakably toward a sustained period of elevated inflation. In just the last year, the price has risen by nearly 30%, and it has nearly doubled in the last three years. Historical experience suggests that with the lags involved in these impulses feeding through the system, we're now only at the early stages of the price level adjustment that will ultimately be incurred, unless the Fed takes sufficient action to strengthen the dollar's real purchasing power and root out the inflation now embedded in the system.

It's a similar situation with the dollar. Although it has risen by some 7% since mid-July, it has lost some 17% of its value on a trade-weighted basis the past three years. Against the euro, the recent rally of more than 6% still pales against the depreciation of nearly 30% the last three years, fully 10% of which has come just in the past year. Seen in this wider perspective, the dollar's recent appreciation does not alter the fact that the currency remains extremely weak, and thus it is unlikely to do much to curb the inflation pressures which have become evident.

The oil price slide from its peak near $150 per barrel last month will have some moderating effect on headline inflation -- at least versus the eruption that would have occurred if oil had stayed at peak prices. But this will be more an appearance of slackening inflation pressure than a reflection of the underlying inflation reality. It's becoming increasingly clear that the inflation that first showed up in sensitive commodities such as gold and oil is spreading across the price universe. Non-energy CPI is up at an annual rate of 4.2% in the past three months, the highest in 17 years. The Cleveland Fed's trimmed-mean CPI, which filters out the most volatile 16% of the components of the index rather than arbitrarily excluding food and energy as is done with the conventional core index, is also running at a 17-year high of 3.6%.

BOTTOM LINE: A story-line developing among the keepers of the conventional wisdom is that the recent pullback in commodity prices is indicative of the slow growth affecting a good part of the global economy, so therefore the inflation problem is being solved by economic weakness. It's not going to be that easy. Commodity prices have been in a rip-roaring rally for most of the past year, a period which was already marked by significant slowing. Does slow growth explain commodity prices both rising *and* falling? Despite the recent declines in commodity prices, and appreciation of the dollar, these indicators remain at levels suggesting inflation will remain at elevated levels for the foreseeable future.