630-322-7756
www.ftportfolios.com

Feb 25, 2008

Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

Inflation Denial

Despite a very clear set of data that show a sharp acceleration in inflationary pressures, there is a rampant denial that these pressures are worth worrying about.

Consumer prices, producer prices, and import prices are all signaling that American workers are having their purchasing power eroded. During the 12 months ending in January, consumer prices are up 4.3% - and 6.8% at an annual rate in the past three months, the fastest three-month increase since 1990 (excluding the immediate aftermath of Hurricanes Katrina and Rita).

The Federal Reserve Bank of Cleveland tracks something called "trimmed mean" inflation. This measure excludes the 8% of items that are rising the fastest *and* the 8% that are falling the fastest (or rising the slowest) to focus on the underlying inflation trend. Trimmed mean inflation is 3% for the past year, the highest since 1993.

On Tuesday, January producer prices are expected by the consensus to rise 0.3% (we forecast 0.5%). Assuming the consensus is right, that would bring the total increase versus last January to 7.7%, the largest increase in any twelve months since 1981.

Import prices are up 13.7% versus last year, the largest increase on record going back to the 1980s. Most of the increase is due to oil prices but even excluding petroleum, import prices are up 3.6% versus last year. This may not seem like much, but back in the late 1990s and early 2000s, non-oil import prices were falling, leading many people to talk about the US importing deflation from foreigners.

These statistics are ignored by many because home prices are falling. But this decline reflects a lower (or negative) rate of return on residential land and structures, not the rental cost of putting a roof over one's head. Although home prices have fallen in the past year, rents have continued to put upward pressure on the cost of living.

Meanwhile, the Federal Reserve has joined the ranks of those unconcerned about inflation. Despite the data, and significant interest rate cuts, the last two statements issued by the Fed to accompany their interest rate decisions have completely omitted "price stability" as a policy goal.

This is a reversal of the 1990s, when the Fed consistently argued that maximizing economic growth over the long-run required price stability. The idea was that if the Fed focused on price stability, both low inflation *and* higher long-term economic growth would be the result.

This stance reflected the lessons of the 1980s when Paul Volcker used Fed policy to fight inflation and Ronald Reagan cut tax rates in an effort to free the economy. These policies reversed those that created stagflation.

Unfortunately, in the US today, the Fed is cutting interest rates in an attempt to boost economic activity at the same time politicians are discussing how much to raise tax rates. And denial that inflation is on the rise does not help.

This was one of the key ingredients of bad policy in the 1970s – denial that there was a problem. But it can't last forever. Eventually, inflation won't be ignored and that time seems to be getting closer and closer.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-25 / 9:00 am	Existing Home Sales - Jan	4.890 Mil	**4.65 Mil**		4.890 Mil
2-26 / 7:30 am	PPI - Jan	+0.3%	**+0.5%**		-0.3%
7:30 am	"Core" PPI - Jan	+0.2%	**+0.2%**		+0.2%
2-27 / 7:30 am	Durable Goods - Jan	-4.0%	**-4.6%**		+5.0%
7:30 am	Durable Goods (Ex-Trans) - Jan	-1.4%	**-0.5%**		+2.3%
9:00 am	New Home Sales - Jan	0.600 Mil	**0.604 Mil**		0.604 Mil
2-28 / 7:30 am	Q4 GDP Preliminary	0.7%	**0.8%**		0.6%
7:30 am	Q4 GDP Chain Price Index	2.6%	**2.6%**		2.6%
7:30 am	Initial Claims - Feb 23	350 K	**350 K**		349 K
2-29 / 7:30 am	Personal Income - Jan	+0.2%	**+0.3%**		+0.5%
7:30 am	Personal Spending - Jan	+0.2%	**+0.4%**		+0.2%
9:00 am	Chicago PMI - Feb	50.0	**52.4**		51.5
8:45 am	U. Mich. Consumer Sentiment	70.0	**70.1**		69.6