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First Trust

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Monday Morning Outlook

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Keep Your Eye on "Cash Inflation"

Investors are increasingly concerned about inflation, and for good reason. Gold – a traditional hedge against inflation – is at a record high of about $1,125 per ounce.

Meanwhile, according to the Federal Reserve Board, the five year forward inflation rate implied by Treasury securities is running at 3.2%, up from roughly 2% late last year. This is the annualized inflation rate Treasury investors expect for the five-year period starting five years from now. This measure is useful because, by focusing on a period that starts five years away, it should eliminate the short-term vagaries of monetary policy and focus on how well the Federal Reserve will achieve price stability over the long term.

Although consumer prices are still below where they were a year ago, this is due to the steep declines of late last year, during the post-Lehman Brothers panic. So far this year, consumer prices are up at a 2.7% annual rate.

Due to extremely loose monetary policy and a continued revival in the velocity of money, we anticipate that next year consumer prices will rise in the 3.5% to 4% range, with steeper gains in 2011. However, we also expect that as higher inflation grabs more headlines next year, a vocal contingent of naysayers will deny there's an inflation problem.

The naysayers will likely argue that "core" inflation – which excludes food and energy – is what matters and if this measure is only growing at about a 2.5% rate or less, then there's no reason to worry. Any near-term escalation in inflation will be fleeting, they will say, unless accompanied by a more significant rise in the supposedly all-important core CPI.

As we have pointed out in the past, though, food and energy prices should not be excluded in knee-jerk fashion. They make up about 22% of consumer spending and have a direct impact on our cost of living. The effects on living costs are particularly important for the middle-class and below, who, relative to the upscale, spend a larger share of their incomes on these commodities.

In addition, the core CPI is likely to be held down next year by something called owners' equivalent rent (OER), the government's estimate of what a homeowner would charge if he rented-out his home rather than occupying it himself.

Keep in mind that OER makes up 30% of the core CPI and – unlike the other parts of the CPI – does not reflect any actual money changing hands. Whether OER is high or low, because no money changes hands, it does not directly reflect our cost of living.

Instead of watching the core CPI, we think analysts should watch what we call "cash inflation," which includes everything in the consumer price index *except for OER*. Very quietly, this measure has already moved upward at an uncomfortable annual pace of 3.7% over the past six months.

Ultimately, the inflation debate that will heat up next year is about whether the Federal Reserve will protect the buying power of the money we earn. Those who dwell on the core CPI are, in effect, giving the Fed an excuse to hold off on tightening monetary policy. Using a measure like "cash inflation" is our way of bringing attention back to the things Americans are buying and what they cost.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-16 / 7:30 am	Retail Sales - Oct	+0.9%	**+0.9%**	+1.4%	-1.5%
7:30 am	Retail Sales Ex-Autos - Oct	+0.4%	**+0.2%**	+0.2%	+0.5%
7:30 am	Empire State Mfg Index - Nov	30.0	**31.0**	23.5	34.6
7:30 am	Business Inventories - Sep	-0.7%	**-0.8%**	-0.4%	-1.5%
11-17 / 7:30 am	PPI – Oct	+0.5%	**+0.7%**		-0.6%
7:30 am	"Core" PPI – Oct	+0.1%	**+0.1%**		-0.1%
8:15 am	Industrial Production - Oct	+0.4%	**+0.5%**		+0.7%
8:15 am	Capacity Utilization - Oct	70.8%	**70.9%**		70.5%
11-18 / 7:30 am	CPI – Oct	+0.2%	**+0.2%**		+0.2%
7:30 am	"Core" CPI – Oct	+0.1%	**+0.1%**		+0.2%
7:30 am	Housing Starts – Oct	0.600 Mil	**0.630 Mil**		0.590 Mil
11-19 / 7:30 am	Initial Claims - Nov 14	504K	**504K**		502K
9:00 am	Philly Fed Survey - Nov	12.0	**11.0**		11.5
9:00 am	Leading Indicators - Oct	+0.4%	**+0.5%**		+1.0%