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First Trust

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Monday Morning Outlook

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Inflation: Don't Forgetaboutit…It's Still A Huge Problem

Less than a year ago, inflation was a serious issue. Oil was trading at $145 per barrel and the consumer price index (CPI) was up 5.6% between July 2007 and July 2008 – the fastest inflation in 17 years. At the same time, producer prices were up 9.9%, with the "core" PPI up 4.6% at its peak

But in the second half of 2008, as velocity collapsed, inflation vanished into thin air. As oil prices plummeted, the CPI fell at a 12.4% annual rate in the last three months of 2008. And, as we drop off the big moves from last year, the CPI is on a rollercoaster ride, with year-over-year comparisons falling rapidly. Consumer prices are up just 0.2% versus last year while producer prices and import prices are down 1.3% and 1.9%, respectively.

And there is more to come. On a year-over-year basis, the CPI will turn negative this month and stay negative for many more months. As a result, those who fear deflation will have data to hang their hats on for much of 2009.

But, these deflation-istas will be looking in the rear view mirror. On a month-to-month basis, inflation is already starting to claw its way back. In the first two months of 2009, consumer prices are up at a 4.1% annual rate while producer prices are up at a 5.8% rate.

What's interesting about this return of inflation in the early part of 2009 is that it is being met with skepticism and denial. Conventional wisdom thinks that any increase in inflation is virtually impossible because the economy is in trouble and unemployment has been climbing.

Even the Federal Reserve, which has embarked on an unprecedented expansion of its balance sheet and is committed to keeping short-term interest rates at essentially zero for at least another year, is not worried about inflation. The Fed believes that it can reverse course on this stance before inflation becomes a serious issue.

Unfortunately, the Fed is paying too much attention to short-term developments. The reason commodity prices and overall inflation indices fell so rapidly last year (and will look low on year-over-year comparisons this year) is because monetary velocity collapsed. Even though the Fed was super easy, panic about the viability of the US banking system caused a steep drop in the turnover of money (velocity). From a monetary point of view, a drop in velocity offsets easy money.

Now that velocity is coming back, any further easing in monetary policy will be like throwing gasoline on the fire. This is exactly happened last week when the Fed announced a plan to print more than $1 trillion in new money, setting the stage for a sharp inflationary resurgence that is likely to catch many investors by surprise.

Gold fell to roughly $700 an ounce last year, but is now near $950. This is an early signal of excessive monetary ease. And oil is now above $53 a barrel after falling into the mid-$30/bbl. range last year. This is a sign of both easy money and a return in velocity.

While it takes a much longer time for inflation to appear than some fear, at present, the commodities market and the Treasury markets are not correctly pricing in the risk. Investors in inflation-adjusted Treasury securities seem to think CPI inflation will average about 1.25% for the next ten years. And commodity prices, after being overvalued last summer are undervalued today.

There is a saying: "if the Fed is not worried about inflation, investors should be." Today, it is clear the Fed is not worried and the political class is actively arguing for lower and lower rates and easier and easier money. A prudent investor will hedge his or her bets in this environment to protect against erosion in the value of the dollar.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-23 / 9:00 am	Existing Home Sales - Feb	4.45 Mil	**4.42 Mil**	4.72 Mil	4.49 Mil
3-25 / 7:30 am	Durable Goods - Feb	-2.5%	**-0.5%**		-5.2%
7:30 am	Durable Goods (Ex-Trans) - Feb	-2.0%	**-1.3%**		-2.5%
9:00 am	New Home Sales - Feb	0.300 Mil	**0.334 Mil**		0.309 Mil
3-26 / 7:30 am	Q4 GDP Final	-6.6%	**-6.7%**		-6.2%
7:30 am	Q4 GDP Chain Price Index	-4.4%	**0.5%**		0.5%
7:30 am	Initial Claims - Mar 21	650K	**640K**		646K
3-27 / 7:30 am	Personal Income - Feb	-0.1%	**-0.4%**		+0.4%
7:30 am	Personal Spending - Feb	+0.2%	**+0.5%**		+0.6%
8:45 am	U. Mich. Consumer Sentiment	56.8	**57.0**		56.6

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.