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ABOUT BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

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JVB FINANCIAL

Weekly Commentary

by Bill Sullivan, JVB Chief Economist

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Core inflation below one percent? It's possible!

An overlooked factor in the current environment is the progressive diminution in core inflationary pressures. Indeed, the cost-of-living for a broad array of non-food and non-energy products and services has been moving consistently lower for the last several quarters, no doubt reflecting the cautious approach to consumption that most households are pursuing. Although there could be shifts in underlying demand conditions in the period ahead, unless there is a substantial upturn in personal spending, the annualized core rate of inflation could easily drop to one percent or less before year end. Clearly, an inflation rate that low would have implications for Federal Reserve policy and could have a major impact on financial asset valuations as well.

The potential for a visibly lower core rate of inflation is of course partly related to the ongoing weakness in the nation's housing market. According to the Bureau of Labor Statistics, the non-food/non-energy component comprises 77.7% of the overall Consumer Price Index (CPI). Shelter related expenses, which include rents, make up 42.7% of the core measurement. As a result, the prevailing trend in housing costs can have an outsized impact on the rate of core inflation. To provide perspective, the non-food/non-energy component rose at a 2.3% annual rate during the six months that ended June, 2009. During the same time period, the rental equivalency category was rising at a 1.9% annualized pace, thus supporting the core rate of inflation. However, over the second half of calendar year 2009, rents actually fell at a -0.5% annual rate as landlords cut prices to fill vacant apartment units. The erosion in rental fees operated as a major drag on the non-food/non-energy component, with the core rate of inflation falling to just 1.3% during the six months that ended last December.

The prospect for a lower rate of core inflation as 2010 progresses is not exclusively a function of softness in the residential real estate markets. For sure, competitive pricing pressures are evident in many other areas with this competition likely to hold down core inflation for a while longer. As an example, apparel prices have drifted considerably lower over recent months as consumers have remained judicious in their spending habits. In the latest six months for which data are available, clothing prices are up just 0.6% annualized as compared to a +3.3% gain over the first half of 2009. With the dollar moving somewhat higher of late on world foreign exchange markets, prices of imported apparel could soften even further, adding an additional downward bias to core inflation this year. Another interesting development is the moderation in medical care prices. The pattern could be an attempt by drug manufacturers to adjust their pricing formularies as Congress debates health care reform, implying the trend could be subject to reversal. Nonetheless, in the second half of 2009, medical care costs rose at a 3.0% annual rate, down almost one full percent

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from the increase exhibited over the first six months of the calendar year. Other expenditure categories that have revealed pricing weakness and are thus placing downward pressure on core inflation readings include recreation, information technology and communication expenses.

There is even some evidence to suggest that the core rate of inflation has been overstated during recent quarters and just the removal of these temporary influences sets the stage for a further moderation in consumer prices, excluding food and energy. To provide perspective, the "cash for clunkers" program last summer obviously created some distortions in the automotive segment of the economy. Since trade-ins had to be junked, the net result of the Government's efforts was to create some spot shortages of used cars. The lack of supply gave a substantial lift to used car and truck prices, with this category rising at a hefty 25.0% annual rate during the second half of 2009, giving a definite boost to core inflation, accordingly. Once the shortage is relieved, used car prices should stabilize, if not move lower, removing this upward influence on the core rate. An additional support for the core measure has been sharp increases for tobacco and smoking products. Many state governments have lifted excise taxes on cigarettes in recent quarters in an attempt to bolster revenues and narrow prevailing budget deficits. Eventually, the upward bias on inflation from this source will dissipate, helping to place another downward influence on the core measure.

Should core inflationary pressures moderate during the year, the incentive for the Federal Open Market Committee to tighten policy will lessen. At a minimum, a move lower in core price pressures will certainly diminish the degree of tightening that could take place in 2010 and beyond. Needless to say, a further drop in core inflation would be a friendly development for the fixed income arena as real returns on bond investments would be given a lift by any downturn in cost-of-living pressures. Moreover, should core inflation edge downward, the pattern would reinforce the notion that, in a setting of historically high unemployment, there are no pass-through effects from higher energy or food prices, as may have been the case in past cycles. Of course, a further slippage in core inflation would be emblematic of many business firms lacking pricing power. Effectively, the diminution in prices would be a direct function of soft demand conditions that will ultimately curb top line revenue growth and corporate profitability. From that vantage point, lower inflation may not be as positive for the equity markets as many observers would normally assume. ■

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