JVB FINANCIAL

Economic Commentary

by Bill Sullivan, JVB Chief Economist

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 report on credit market trends and maintaining a regular schedule of economic broadcasts 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 Economic Broadcast, 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.

Prior to joining Morgan Stanley, he was affiliated with The Bank of New York, where he was a Senior Vice President in the Treasurer's Division.

Mr. Sullivan holds a Bachelor of Arts Degree in Economics from Fairfield University and an MBA in Investments from New York University.

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Deflation on the doorstep?

A recovery in U.S. business activity, stoked by Government programs and a historically accommodative monetary policy posture, appears underway. Indeed, some observers place the trough in the economy at June, 2009, or nearly one year ago. Notwithstanding the debate that surrounds the current cycle, it is very clear that the upturn has been associated with an unusual phenomenon: the progressive diminution in core inflationary pressures. The pattern of price weakness represents an interesting comment on the prevailing economic landscape. Clearly, the gradual trail-off in the cost-of-living would at a minimum seem to suggest that final demand conditions, despite recent improvements, remain soft and that retailers are in no position to raise prices for fear of losing market share. The trend also raises the prospect that should the economy begin to lose momentum in the quarters ahead, the potential for an episode of outright deflation is real, a development that would have a significant impact on financial asset valuations and the Federal Reserve's overall decision making process.

The downturn in core prices has not received a lot of attribution as the trend probably runs contrary to the widely-held thesis that a robust economic rebound is firmly entrenched. However, when reviewing the Consumer Price Index (CPI) excluding food and energy, the price weakness has been in place for a relatively long duration and has encompassed a fairly broad array of expenditure categories. To provide perspective, over the latest twelve months for which data are available, core prices have increased by just 1.1%. However, during the six months that ended in March, 2010, the annualized rate of core inflation had slipped to only 0.6% or about half the twelve month pace. Incredibly, during the first quarter, prices for non-food/ non energy items actually contracted at a 0.2% annualized rate. Effectively, the erosion in price pressures is becoming more pervasive, even as the economy emerges from the recession and interest rates are being held at all time lows.

Needless to say, the ongoing weakness in housing is contributing to the gradual slowdown in core inflation. Specifically, the owners' equivalent rent component, which comprises almost 24.0% of the entire C.P.I., was unchanged over the latest twelve months, dragging the aggregate core rate of inflation lower, accordingly. Against that backdrop, the downturn in core prices is oftentimes dismissed as being a true reflection of consumer price trends as the rental component is judged to be over weighted in the general index, thus exercising an excessive drag on the cost-of-living. While that argument may have some credibility, it should be noted that there were many years during the housing boom that core inflation was likely overstated on the upside as rental costs surged in response to the strong demand for shelter. As an example, during the twelve months that ended December, 2006, the rental equivalent component of the C.P.I. increased by a hefty 4.3%, contributing significantly to the 2.6% rise in core inflation over the same period. In that regard, the softness in rental costs in the current environment is a legitimate response to the sizeable gains that were evident during the up-cycle in housing during the previous decade.

Recognition has to also be given to the reality that other products and services beyond rents are revealing price weakness and in the process adding to the persistent erosion in core inflation over recent quarters. Apparel prices, for example, have fallen -0.4% over the last year and tumbled at a -4.5% annualized rate during the first three months of 2010, pointing towards a very competitive pricing atmosphere for clothing. Price cutting of late has also surfaced for household furnishings, new cars, recreation, telephone services, computers and personal care. The fact that a fairly extensive group of expenditure categories is displaying price softness lends a greater degree of

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permanency to the downward bias in core inflation.

The forces behind the pullback in core prices are numerous. The huge slack that is present in the American workforce has generated an erosion in unit labor costs that have helped to contain inflationary pressures. The high unemployment rate has held take home pay in check and in turn has prevented a resurgence in consumption that would support higher prices. Similarly, productivity improvements have been impressive over the recent past and have allowed businesses to bolster profit margins without resorting to price hikes on the products and services that these firms offer. A firmer dollar and international competition have undoubtedly bolstered the trend towards a lower core rate of inflation. These influences are likely to operate well into the future and, in response, core inflation could drift even lower through year-end and into 2011.

The economic consequences of a persistent contraction in non-food/non-energy prices are certainly open to debate. For sure, the inability to raise prices will eventually be a challenge for corporations to maintain the current pace of profit growth. Household expectations will shift as well as consumers may begin to defer purchases in hope of acquiring products and services at lower costs. Such deferrals would of course generate a major headwind for the economy's general momentum. Needless to say, should core prices work their way even lower in the months ahead, the policy debate among officials on the Federal Reserve Open Market Committee will have to be altered as well. If the cost-of-living in the U.S. were to edge downward on a consistent basis, the real cost of borrowing would move higher and could therefore provide a braking influence on business activity. Moreover, the Federal funds target in real terms would be providing more restraint on the system than the nominal rate per se would, creating the prospect that policy will be left on hold for an even lengthier period than otherwise would be the case. An outright trend of deflation would be a tremendous jolt to the bond market as many issuers could have increased difficulty in servicing their outstanding debt loads as the cost-of-living moves lower. Eventually, the multiples that are applied to corporate earnings would have to compress and would ultimately place some downward pressure on the broad equity averages. It would also seem difficult for many commodity prices to remain at elevated levels as the general cost-of-living recedes. While it may be premature to consider investment options in the context of core price deflation, the latest cost patterns do suggest that such an outcome is no longer an impossibility, especially if the economy retains a high volume of spare capacity. ■

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