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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Where deflation rules

The Department of Labor will release the Consumer Price Index (C.P.I.) for the month of October on Wednesday morning. The report will probably continue to capture a reduction in price pressures in several key expenditure categories, extending a pattern that goes back to earlier in the year. Indeed, recent data actually suggest that some sectors of the economy are experiencing deflation, no doubt reflecting sluggish demand conditions as incomes erode and the nationwide unemployment rate sustains its upward trajectory. Whether the trend becomes more widespread is certainly open to debate and will undoubtedly be strongly affected by the performance of the job markets in the quarters to come.

The diminution in price pressures to some extent tracks the general weakness in the housing arena. Specifically, the owners' equivalent rent component, which comprises 24.4% of the overall Consumer Price Index, has gradually lost momentum throughout 2009. In the three months ending March, rents rose at a 2.5% annual rate. Over the April-June period, this component increased just 1.4% while in the three months that ended in September, prices contracted at a -0.4% annualized rate. The drop in this expense is a partial response by builders and landlords to the relatively high level of unoccupied properties throughout the country. With more than 17.0% of the workforce unemployed or underemployed, the demand for shelter has retreated thus requiring a more competitive pricing environment for rents and other housing related costs. Until a definitive turnaround in the job markets does develop, this heavily weighted component of the Consumer Price Index could continue to act as a drag on overall inflation.

Accelerated price discounting has been prevalent in other sectors as well this year, including information technology, recreation and motor vehicle equipment. In the technology segment, for example, prices were dropping at a -1.4% annual rate over the opening three months of 2009, but were tumbling by more than 10.0% in the quarter that ended in September. Similarly, audio and video services (recreation) were declining at a -4.2% annual rate in the third quarter, after being up 1.1% during the three months ending June. Despite a bounce back in automotive purchases during the summer months, prices on parts and equipment declined at a -2.5% annual rate, in dramatic contrast to the 4.3% increase registered during the first quarter.

Another surprising drag on the total cost-of-living so far in 2009 has been a persistent decline in food prices. According to the Department of Labor, the food and beverage category of the Consumer Price Index has contracted in every quarter this year. Price weakness has been measured for a broad array of products, paced by large declines for meat, dairy items and vegetables. With the food category representing 15.7% of the entire C.P.I., the reduced expense is a welcome relief for most household budgets.

Should retail inflation hold steady or move lower throughout 2010, the Federal Open Market Committee will have a powerful incentive to maintain an accommodative policy approach. In

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particular, central bank officials are apt to interpret changes in the Consumer Price Index as a barometer of prevailing demand conditions. If households remain cautious in regards to their personal spending, business firms will lack pricing power. As a result, companies will probably have to sustain a very competitive posture in the marketplace that is likely to result in a further erosion in the general cost-of-living. Conversely, should consumers feel more confident regarding job and income prospects in the year ahead, spending should reaccelerate on a more consistent basis. The firmer demand conditions could eliminate the need to discount prices and eventually an upward bias would be reestablished for the Consumer Price Index, especially in those areas that are now experiencing some outright deflation, such as rents.

In addition to impacting the Federal Reserve's decision-making process, the trend in inflation will have a huge impact on the yield curve as well. The surprising resilience in the Treasury securities market, despite record supplies and surging equity valuations, does appear to be related in part to the gradual diminution in non-energy price pressures this year. Effectively, real returns in the bond sector have been given a boost as the pace of inflation has lessened. Although nominal returns are low by historical standards, the purchasing power of that interest has been preserved to a large degree as inflationary pressures have diminished. Clearly, if demand conditions remain soft, there is an increased likelihood that the price discounting that has been evident this year will become deeper and more widespread during 2010, a situation that will certainly benefit U.S. Treasury securities.

Needless to say, the Fed would want to avoid a lengthy period of deflation as persistent price declines could have some serious consequences for the broad economy and the credit markets. If businesses remain under pressure to cut prices to move product and reduce inventory, corporate profitability will eventually lose momentum, thereby raising the probability of sharp pullback in the broad equity averages. Moreover, any erosion in earnings capability would translate to rising concerns regarding the creditworthiness of many bond issuers, particularly for those that are judged to be below investment grade.■

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