THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
WWW.ECONOMICOUTLOOKGROUP.COM

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

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A Benign Inflation Report. Congress Has a Seat on the FOMC.

CPI

Is inflation getting a little warmer? Yes. Should we worry about it? Absolutely not! In fact, rising prices at this stage of the business cycle is to be welcomed, not feared.

This may sound heretical to some. But given the near collapse of the economy a year ago and with the threat of deflation still looming overhead, a modest acceleration of inflation is a benign symptom of an economy that is recovering from a near-death spiral. Still, some analysts will cry out that the Federal Reserve is already behind the curve and thus must move quickly to cool inflation pressures. Those calling for higher rates should stop their fixation on monetarism and view the broader macroeconomic picture.

First, unemployment is still at double-digit levels and will likely remain so for much of 2010. Second, while the recovery has begun, it is tenuous and still completely dependent on fiscal and monetary stimulus. Without government assistance, a relapse into recession is a virtual certainty. Third, companies and banks are still deleveraging which means that demand will remain subpar. Fourth, real estate, the largest single asset category on the planet, continues to fall in price. That alone deprives consumers from tapping their home equity, a major source of funding in the past.
Fifth, there is still ample excess capacity in labor and industry, not just in the US but also around the world!

The sixth reason is our final Maginot line for inflation. It is **not possible** for consumer prices to become problematic so long as wages and salaries are falling!! Real disposable personal income has dropped 1.5% over the year!! Even if wages do begin to rise next year, it needs to increase at a pace faster than labor productivity to really aggravate inflation. We are still a galaxy distance away from that condition since productivity has been surging at a time when wages keep slipping. So let's stop the hand wringing over inflation.

Now for the CPI details. The headline data showed prices increased 0.4% in November, versus 0.3% the month before. Higher energy prices were the dominant factor pushing the CPI higher last month. For the past year, retail price inflation jumped by 1.8%, the most since October 2008. Take out food and energy, however, and the CPI showed no gain at all last month. Nada. Over the last 12 months, core CPI held steady at 1.7%. Again, there is nothing in the CPI report that warrants a change in monetary policy. In addition, energy prices have slipped this month so we expect headline CPI will ease back in December.

Housing Starts and Permits

On the housing front, we've been receiving mixed signals from builders. Yesterday, we got dismal news on homebuilder confidence. Today, we find out that new home construction surged 8.9% in November, to a rate of 574,000 homes. Permits jumped 6% to a 584,000 annual rate, the highest level in year.

What really raised eyebrows were permits for single-family home construction, which increased 5.4% in November to a 473,000 unit rate. That the highest pace we've seen since September 2005, a time that takes us back to the halcyon days of real estate construction.

These numbers stand in stark contrast to the abysmal level of confidence homebuilders recently expressed in their sentiment survey. Overall confidence in the Housing Market Index fell to 16, its lowest level since June. Remember, readings below 50 mean most respondents view conditions as poor. Traffic of prospective buyers into homebuilder showrooms held at a low 13. (It had managed to climb back to 17 in September.) Mind you, these homebuilders were polled between December 1st and the 10th, which means they offered their opinions on the housing market the same week the government surprised us with the better than expected job numbers. Yet, despite the fewer payroll losses in November and the decline in jobless rate from 10.2% to 10%, it was still not enough to turn homebuilder sentiment higher.

When faced with such a dichotomy, we have to place more weight on what homebuilders actually do, rather than how they "feel" at any particular point in time. As a result, we're downplaying the latest drop in sentiment and find the housing starts and permit numbers to be a better gauge of the optimism builders have of the future.

Federal Reserve Meets

With the recovery gathering more steam and inflation inching higher, all eyes will turn to the Federal Reserve this afternoon to detect any hint of a change in monetary policy that would lead to higher interest rates. No doubt we'll see numerous Talmudic interpretations of today's FOMC statement. Our expectation is that nothing meaningful will change mostly because the risks to the economy are still too high. But let's break down the reasons why fed funds will remain close to zero through the first half of next year.

- The unemployment rate will very likely edge back above 10% in 2010 as more Americans re-enter the force now that the economy is growing again.

- History has shown the Fed typically will not raise interest raise rates until the jobless rate has fallen by at least a full percentage point.

- On average, the Fed usually waits 6 months AFTER the jobless rate has peaked before tightening monetary policy.

- **There's one other important factor to mention. Congress, at least for now, has a seat on the FOMC. What we mean by that is that FOMC officials will be deliberating at a time when Congress is actively debating how much power to strip from the Fed. Any wording in the statement that contains even the slightest whiff of higher rates will raise the ire of Congressional leaders. We suspect no one on the FOMC wants to provoke Congress just when legislators are voting on reforms that would reduce the Fed's role in the economy.**

Bottom line:
Inflation, while edging higher, remains benign. The latest numbers on housing starts and permits corroborate virtually all other economic indicators in recent weeks that the recovery is real and, by all appearances, durable. Finally, so long as the shadow of Congress looms over the FOMC --- and with inflation still well behaved --we do not see any increase in the fed funds rate until the second half of 2010, at the earliest.