Tea Leaf

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Your guide to understanding today's economy and financial markets

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"…flation"

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Inflation?…Disinflation?…Deflation?

All of the above are currently newsworthy…

The story of much of the past two years has been a sharp rise in inflationary pressures, with consumer prices (the Consumer Price Index) registering some of the largest gains since the early '90s. The CPI rose 4.1% in 2007, the largest annual gain in 16 years. As recently as August of this year, the CPI had jumped 5.6% from the prior year.

The prior spike in energy and commodity prices obviously contributed to the surge in inflation. The subsequent sharp decline in such prices will dismantle recent inflation anxiety.

Consumer prices fell 1.0% in October (compared with the previous month), the largest monthly decline in 61 years of recordkeeping. The CPI rose 3.7% in the 12 months ending in October. Given the continuing decline in energy prices, as well as high monthly inflation data that falls out of the 12-month measure during the next two months, the CPI rise for 2008 could ultimately be around 2.0%…and probably less. The three national forecasting panels I serve on expect the CPI to rise between 1.5% and 2.0% in 2009.

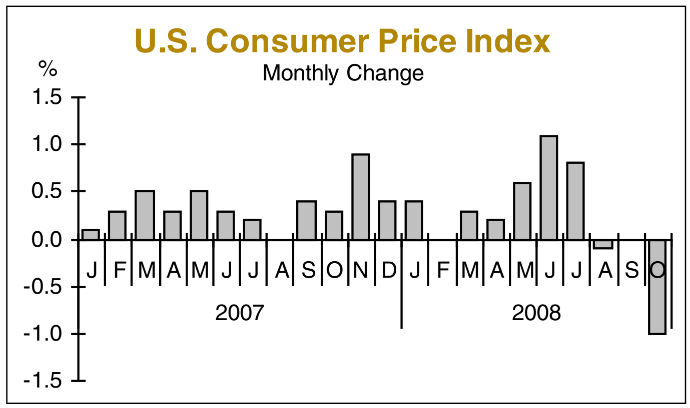
The Producer Price Index (a measure of prices at the wholesale level) also nosedived, with such prices down 2.8% in October, the largest one-month decline in more than 60 years. Such prices are now up 5.6% from a year ago, a 12-month measure that reached 9.8% as recently as July.

Dis… or De…?

The enormous unwinding of inflation pressures is good news, although too much of a good thing can be harmful. Economists refer to the sharp inflation decline as disinflation. The fear of many politicians, Federal Reserve officials, and market forecasters is that disinflation could turn into deflation.

Deflation, or a period of sustained falling prices, may sound like a good thing as it temporarily stretches consumer dollars. However, an extended period of falling prices is typically associated with declining economic growth. Such a period typically also includes declining employment and, eventually, falling wages…

…just ask the Japanese about their recent 8-year period of deflation, the only major nation to have suffered this phenomenon in modern times *(Bloomberg.com)*.



Divergent Views

One could point to the sharp decline in energy, commodity, and home prices as evidence of a deflationary trend already underway. Others might call such moves a return to more realistic valuations for such assets, with stability in such prices emerging sooner rather than later.

Others would point to the Federal Reserve as having "lost its mind" in recent months, with massive amounts of new "money" created to help stabilize financial markets. Such inflation-wary folks see inflation pressures moving dramatically higher in coming years.

Others would point to current yields (investment returns) on 10-year U.S. Treasury notes at a near all-time low of 2.98%, along with 30-year U.S. Treasury bonds at 3.52%, as signs that inflation will stay very low in coming years….

…pick yer' poison

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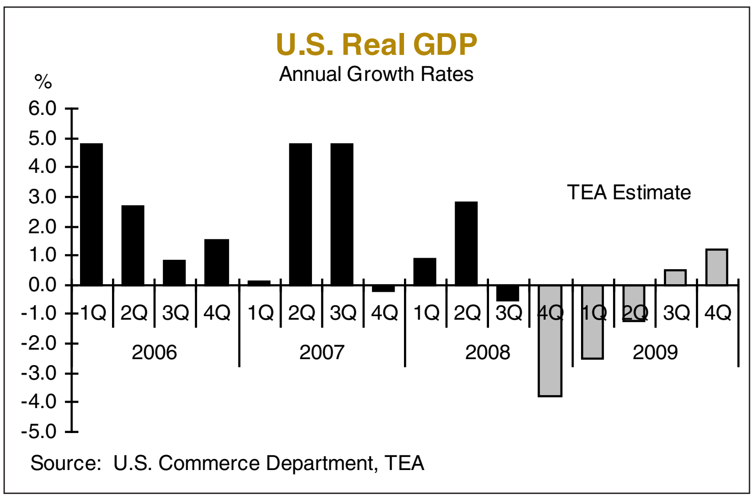
This Recession

American economic performance in 2008's third quarter was very weak. The current quarter will be even worse…

U.S. GDP (gross domestic product, the sum total of goods produced and services provided across the nation…and the most inclusive of various measures of economic output) declined at a 0.5% real (inflation adjusted) annual rate during the July-September quarter. The revision…the second of at least three…largely matched economists' forecasts.

The U.S. Commerce Department's first estimate a month ago was a 0.3% real annual rate of decline. The third quarter decline marks two of the past four quarters with negative economic growth rates.



Source: U.S. Commerce Department, TEA

Really Ugly

The fourth quarter will be substantially worse and is (currently) expected to be the worst quarter during the recession. Estimates range from a 2.5% to a 5.0% real annual rate of contraction, likely the worst quarter since the painful recession of the early 1980s.

Most forecasters see a painful, but lesser rate of decline during 2009's first quarter, with lesser pain, but still slightly negative performance, during the following quarter. The consensus of forecasting economists still sees weak, but at least positive, U.S economic growth during 2009's second half. Some suggest a return to positive growth will have to wait until 2010…

…ouch

The third quarter decline was the weakest quarterly performance in seven years. American consumers, weighed down by declining home values, plunging stock prices, tight credit availability, rising unemployment and constant media negativity, spent nearly $80 billion less than during the prior quarter. This 3.7% decline in spending was the largest percentage drop in 28 years. Consumer spending, which represents nearly 70% of total economic performance, will remain weak in coming quarters.

Scorekeeper

The National Bureau of Economic Research (NBER) *Business Cycle Dating Committee* (that group which "officially" decides when U.S. recessions begin and end) has not formally announced that we are in recession…

…but there is no doubt

I continue to expect an announcement any day that a U.S. recession began around the beginning of 2008, give or take a month or two

New Housing Efforts

Mortgage interest rates plunged yesterday on news that the Federal Reserve will buy up to $600 billion of mortgage-related securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae, three different government agencies. One major frustration of Washington policymakers in recent months has been the stubborn refusal of mortgage rates to decline, even as short-term interest rates fell to a 50-year low.

Bankrate Inc. noted that 30-year fixed-rate mortgages ended Tuesday around 5.50%, after starting the day near 6.38%. Anything that contributes to stabilization in home prices in coming quarters is very favorable news…

…lower mortgage rates are part of the solution

Jeff

"TEA"sers

Hillbilly medical terms…

Pelvis…second cousin to Elvis

Impotent…distinguished, well known

Barium…what doctors do when patients die

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