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Your guide to understanding today's economy and financial markets

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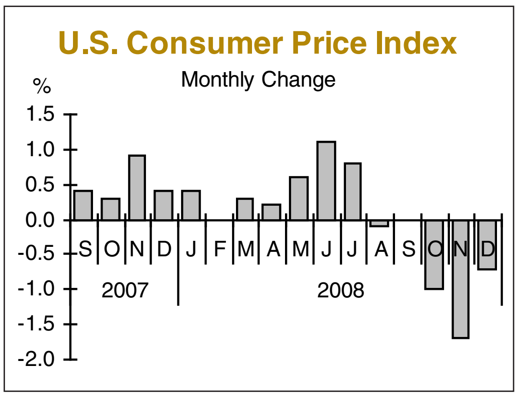
The enormous decline in consumer inflation pressures of the past six months continued unabated in December. The Consumer Price Index (the CPI) fell another 0.7% during the month, the third major decline in a row. November's larger 1.7% decline in consumer prices was the largest since monthly recordkeeping began in 1947.

The upward spike in energy and other commodity prices during 2007 and through July 2008 pushed inflation to painful levels. The CPI rose 4.1% during 2007, the largest annual rise in 16 years. As recently as six months ago, the year-over-year rise in consumer prices was approaching 6.0%.



As it turned out, the CPI rose just 0.1% during 2008, the smallest rise since 1954, a period of (you guessed it) 54 years. The CPI actually contracted at a 12.7% annual rate during 2008's final three months. Most forecasters see the CPI rising between 1.0% and 2.0% during 2009.

Inflation expectations during the next few years are all over the map. Some economists see the impact of massive U.S. Treasury spending and unprecedented monetary stimulus from the Federal Reserve leading to much higher levels of inflation in coming years. Other forecasters see deflation being the more likely scenario, tied to ongoing home price deflation, declining raw land prices, declining commercial real estate values, soft commodity prices, weak wage gains, and ongoing poor U.S. and global economic performance.

CPI Details

As noted, the plunge in energy costs led the way last year. Overall energy costs were down 21.3% during 2008, the largest decline since such recordkeeping began in 1958. Prices at the pump fell 43% last year, the largest decline since 1937.

Many other prices were soft as well. Average new car prices declined 3.2% last year, the largest drop since 1971. Food and beverage costs rose 5.8% last year, while apparel prices fell 1.0%. Medical care costs rose 2.6%.

The "core" CPI, which excludes volatile food and energy prices, was unchanged during December, matching November's result. Core prices rose 1.8% during 2008, the smallest rise since 2003.

Wholesale Prices

Of concern was the actual 0.9% decline in the Producer Price Index (a measure of wholesale prices) during 2008. Such prices declined at a 24.3% annual rate during 2008's fourth quarter. The decline followed a worrisome 6.2% rise in such prices during 2007.

What the Fed Wants

It might seem that the Federal Reserve would want consumer inflation, as well as broader inflationary measures, as close to zero as possible. Such is not necessarily the case.

The Fed's desired inflation target is typically around 1.5-2.0%. Such minimal levels of inflation allow for the needs of a rising population and allow modest price increases, and subsequent wage gains, to occur. As noted in recent days by Federal Reserve Bank of San Francisco President Janet Yellen, it is "not acceptable" for policymakers to allow inflation to fall "to levels that are unhealthy." *(Bloomberg.com)*

What the Fed Fears

Aggressive monetary stimulus from the Fed will continue under the new Administration. Fed Chair Bernanke is fearful that deflationary forces could become more pronounced this year and next. History tells us that dealing with inflation is a problem for consumers and businesses. However, dealing with deflation is worse… just ask the Japanese.

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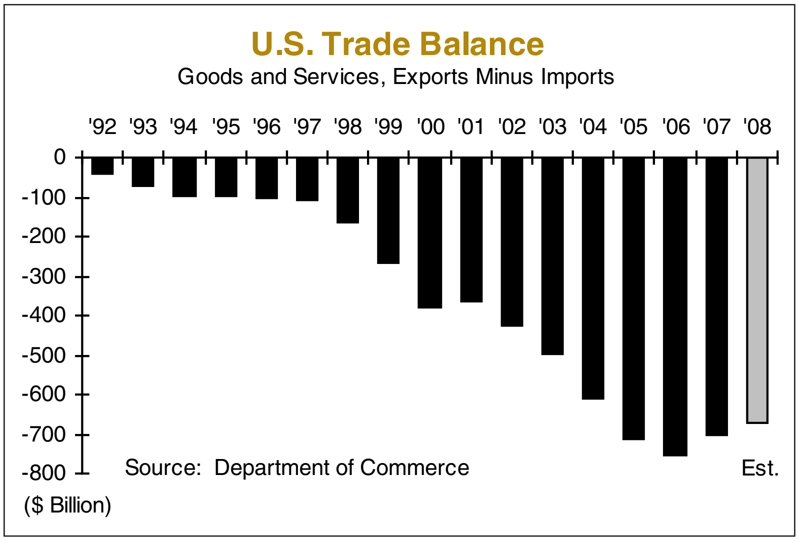
Drop Trade

A major surprise announced last week—one containing both good news and bad news—was the sharp decline in the nation's monthly trade imbalance with the rest of the global community. November's trade deficit…the net difference between what goods and services Americans buy from the world as compared to the goods and services we sell to the world…declined sharply to $40.4 billion, versus $56.7 billion in October. The latest deficit, down 29% from the prior month, was the smallest in five years.



During November, U.S exports of goods and services to the world declined by $8.7 billion (5.7%) to $142.8 billion, an ominous sign of a weak global economy. U.S. imports of goods and services fell by $25.0 billion, roughly 12%, to $183.2 billion, a sign of much lower oil costs and a weak U.S. economy.

The major contributor to the declining U.S. trade imbalance was the 27% decline in the average imported oil price to $66.72 per barrel. Current prices around $35-$45 suggest our oil import bill as reflected in upcoming monthly trade reports will continue to decline.

Not So Bad

One positive aspect of the smaller trade deficit is that the U.S. Commerce Department's first official estimate of fourth quarter U.S. economic weakness may not be as bad as feared. The estimate, to be released on January 30, may be closer to a 4.0%-5.0% real (inflation adjusted) annual rate of decline rather than some forecasts of GDP declining at a 6.0% or worse real annual rate. Most forecasters still expect the recession's worst quarter to be the one just ended.

Net imports from China fell sharply to $23.1 billion in November, versus $28.0 billion the prior month. This decline will temporarily reduce pressure on the new Obama Administration to pressure the Chinese to boost the value of their currency.

The smaller November trade imbalance will also lessen pressure on the new Administration to engage other nations in extensive trade discussions. For the moment, the U.S. and all other major nations have bigger fish to fry, i.e. economic and financial stabilization.

So Blue

Economists argue until blue in the face about the implications of large U.S. trade imbalances with the rest of the world. Critics of such imbalances note that as we obtain goods from the world we pay for them with dollars, which many other countries then send back to the U.S. to buy stocks, bonds, real estate, etc. These critics suggest that as Americans, we buy more foreign-made cars and TVs, assets that lose value over time. Other nations, on the other hand, obtain greater ownership of more critical U.S. assets.

The only thing that a room full of economists (heaven help us) will largely agree on is that promoting barriers against trade between nations is bad policy. Building bridges to trade is good policy. We will disagree on everything else.

Jeff

"TEA"sers

Who Thinks These Product Labels Up?

On a bar of Dove soap: Directions—Use like regular soap

On a Rowenta iron: Do not iron clothes on body

On an American Airlines packet of nuts: Directions—Open packet, eat nuts

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