

Ben is Getting His Wish (and other things)

February 17, 2011

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2011 Outlook

GDP GROWTH:
3.2%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

Ben Bernanke fears deflation. We also fear this economic poison. Deflation (pressures that lower prices on a broad-based sense) is anathema to business and to economic growth. So too is rapidly rising inflation. Per our Fed Chair's view, the U.S. has several shortcomings in areas of the economy. One is too few jobs and too little economic growth. We also have too little inflationary pressure. The Fed believes "optimum," or target inflation (as measured by the "core" CPI), should be in the two percent range.

Historically, there has been a negative correlation between unemployment and inflation. According to Phillips Curve Theory, if inflation is lower, we should expect higher unemployment. If inflation is higher, we should expect job creation. This is partially due to the issue of nominal (not real) Gross Domestic Product (GDP). Nominal GDP is the raw growth rate in the economy, including inflation. The GDP data most of us study is "real" in nature – meaning, how rapidly the economy is growing after inflation. Additionally, corporate revenue generation historically tends to go hand-in-hand with rising employment. Makes sense? Thus, if corporate revenues are rising, companies are able to afford new workers to satisfy that rising revenue stream.

Corporate revenues are not reported on an "after inflation" basis. Historically, there is a strong positive correlation between corporate revenue growth and nominal GDP growth (both reflecting unit volume growth and inflation, or pricing flexibility). All of this is to say the Fed views a "managed" increase in inflationary pressure to be a good thing at this time. Therefore, to a certain degree, raising inflation is one of the main objectives of QE2. This is Ben's wish: to see rising inflation. Ben's wish should start to help ease bottlenecks in the employment picture.

Is it Working?

The quick answer is yes – it appears Ben is starting to get his wish. Is he going to continue getting his wish? It is probably too early to tell, but certain indications are showing he will, as inflation appears to be on the rise. Could this be temporary? Maybe. But from a worldwide standpoint, inflation is becoming a significant problem.

Now, don't get us wrong. We don't believe we are heading back to the hyper-inflation period of the 1970s and early 1980s. Today, the government released data pertaining to the Consumer Price Index (CPI) for the month of January. Yesterday, the Producer Price Index (PPI) came out, which reflects costs for the manufacturing segment of the economy. In summary, the CPI grew (all items) by 0.4 percent for the month of January. This equates to an annualized 4.9 percent rate of change. The "core" number (which once again, is the number on which Ben focuses) was 0.2 percent, or 2.1 percent on an annualized basis. ("Core" CPI does not include food or energy prices.)

Let's take a look at some "momentum" data pertaining to the CPI (all data released this week):

	<u>12-mo YOY</u>	<u>3-mo ANN</u>	<u>1-mo ANN</u>
CPI All Items	1.7%	3.9%	4.9%
CPI Core	0.9%	1.4%	2.1%
PPI (producer) All Items	3.7%	9.6%	9.5%
Intermediate Materials	5.9%	12.9%	14.2%
Crude Materials	10.3%	54.4%	47.7%

Interpreting the Data

First, let's discuss CPI. If inflation is the same for the next 11 months as we saw in January, the "all-in" inflation rate we as consumers should experience will be 4.9 percent for 2011. At the "core" level, inflationary pressure will rise to 2.1 percent. This compares to an inflation rate of 0.9 percent (core) we have seen over the last 12 months. Importantly for consumers, we have experienced 1.7 percent worth of "all-in" inflation over the last 12 months, which includes food and energy prices. As we can see, if inflation continues at its current pace, inflationary pressures are rising, and fairly quickly. So, it appears Ben is starting to get his wish.

Adding to our inflationary pressure conviction is information above regarding the PPI. All items for producers' show that at the current rate, inflation (or in many cases costs) are currently rising at a 9.5 percent annualized rate. This is up from a 3.7 percent rate of change over the last 12 months. Even the latest three-month rate of change (annualized) shows a 9.6 percent rising cost structure. This "all-item" data is further confirmed by trends in the intermediate materials data (costs earlier in the production chain), along with costs in the crude materials (commodities) data, which is currently rising at a 40+ percent rate of annualized change. (Note: this data is very volatile, so the reader needs to look at "trends" rather than one-month announcements.)

Final Word

We don't pretend to know where and how the market is going to trade. However, based on historical standards, risks appear to be rising for at least a temporary setback in stock prices to occur. We believe over the long-term; the market is driven by fundamentals – earnings, interest rates, political environment, etc. The majority of these fundamental trends are positive. However, over short periods of time, technical considerations need to be recognized.

Is the market setting itself up for a correction? Perhaps. At this time, if this comes to pass, we would treat weakness in the market as a short-term, but perhaps worrying trend.



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