Will the Strong Inflation Trend Continue?

As the inflation chatter escalates we feel compelled to once again weigh-in and share our views on this development.

Looking back at 2007, there were countless forces at work driving the US economy to new heights. Tight labor markets, consumers' propensity to spend, rising home prices, easy credit, rising equity prices, and strong corporate profits, were just some of the dynamics bolstering our state of affairs. During the great expansion there were several episodes of inflation scares while inflation expectations remained remarkably subdued. Why then are inflation expectations surging as the financial system and the economy are faltering? It is our view that inflation is a lagging or late cycle phenomenon (as is employment) and a better measure of the strength of the previous cycle, not a precursor of lasting price increases.

For months, the echo effect of strong economic activity has been wreaking havoc in the food and energy markets. The boom in global growth fueled a commodity supply-to-demand imbalance serving to push their prices higher. Speculators and investors searching for higher returns then joined the party and jammed the level of these commodities to extremes. Parabolic is the only way to describe the dimension of the advance that we have witnessed in the pricing of these goods. It is always a good idea to take a step back and remember that we have seen episodes like this before. The NASDAQ, single-family housing market, and highly leveraged derivative securities certainly come to mind. Said another way, parabolic price moves inevitably assure dramatic reversals.

As always, many technicians and investors with ruler in hand will try to predict future levels of commodity prices. Lines will be drawn from the trough to peak, and the ensuing prognostication will call for a continuation of the powerful rally. While charting/technical analysis is often important, lines on a chart cannot serve to measure the growing angst and unrest amongst consumers as they are being squeezed between miniscule pay increases and rising prices.

We believe that for a sustainable inflation trend to emerge, workers must receive wage increases that are also outsized. The latest personal income data released last week however, evidence a continuing trend of modest pay increases. Although the April personal income figure was reported at +.2% (miniscule on its face), this figure included the tax rebate checks received by individuals. According to FTN Financial, if you exclude items that are not true salary components wages actually contracted by .2%.

If the current commodity inflation creates outsized wage demands, we could enter a period of embedded inflation. However, we believe that wage increases will remain well behind commodity inflation and therefore act as a deflationary force. Food and fuel are a microcosm of what we believe is at work. They elevate the current level of inflation while eventually crippling the ability of consumers to spend on discretionary items.   In our opinion, continuing to call for a higher inflation trend can only be based on an assumption that consumers still have sufficient levels of disposable income, access to credit, or remain confident about the future. The spending patterns of the past however, seem to be going by way of the dinosaur.

HSBC recently conducted a survey to anticipate the future spending habits of consumers. Two out of three intend to shrink their level of unnecessary spending in 2008, while four out of five plan to increase savings. When individuals were asked what they would do with the rebate tax checks that they were receiving from the government, they responded as follows: 40% of those quizzed in a Zogby survey said they will “pay down debt.” Another 20% intend to save it. Just 16% said they would spend the rebate on “something they consider necessary.” This is key as the combination of caution and an era of credit deflation should ultimately lead to price deflation.

Robert S. Waas
Managing Member