



Inflation Observatory

September 16, 2009

The decline in headline inflation eased

- Energy prices boosted headline inflation in August
- Modest but widespread price increases keep core inflation stable
- Downward pressures on inflation persist

Core inflation is exhibiting a downward trend

August's headline inflation jumped up 0.4% after exhibiting no change in July. The index was boosted by a 4.6% increase in energy prices, driven by a 9.1% increase in gasoline prices that added 0.3pp to the total. Furthermore, household energy prices were boosted 0.2% by a 3.9% rise in fuel oil and other fuels, but due to the component's small contribution, the increase had a negligible effect on the total. In addition, food prices rose 0.1% for the first time since December 2008, driven by a 0.2% increase in food away from home. On a year-over-year (yoy) basis, the decline in headline prices eased to -1.5% from -2.1%, nevertheless headline inflation remains negative because energy prices are 23.2% below those of last year.

Excluding food and energy, core inflation was 0.1% in August. As in the previous month, modest rises across many components fueled the increase in core prices. Shelter rose 0.1% due to owners' equivalent rent and lodging away from home, but rent of primary residence remained unchanged. Although shelter prices are up 0.9% yoy, this component has been exhibiting a sharp downward trend since its peak in January 2007. Furthermore, increases were seen in prices of medical care (0.3%), recreation (0.1%), education (0.5%), personal care products (0.1%) and tobacco and smoking products (0.1%). On the other hand, prices dropped for new vehicles (-1.3%), communication (-0.2%) and apparel (-0.1%). Unlike headline prices, core prices remain 1.4% above those of last year. Nevertheless, they are exhibiting a downward trend. Average core inflation thus far in 2009 is 1.7%, which is in line with our baseline scenario of low but positive inflation.

Inflation is expected to remain low but positive

While the decline in headline inflation is the result of energy prices and is most likely transitory, core inflation over the past twelve months has been exhibiting a downward trend that is expected to continue because downside risks to inflation remain. The labor market is forecasted to deteriorate further, which will increase the unemployment rate and cause wages to continue to decline. Furthermore, the prices of producers' inputs remain well below those of last year, allowing producers to maintain profits without raising prices. This effect, along with steady inflation expectations will keep core inflation low and contain potential pressures that could arise from fiscal and monetary stimuli. As economic slack is expected to persist for some time, we maintain our expectation that the Fed will not raise interest rates for a prolonged period.

Kristin Lomicka

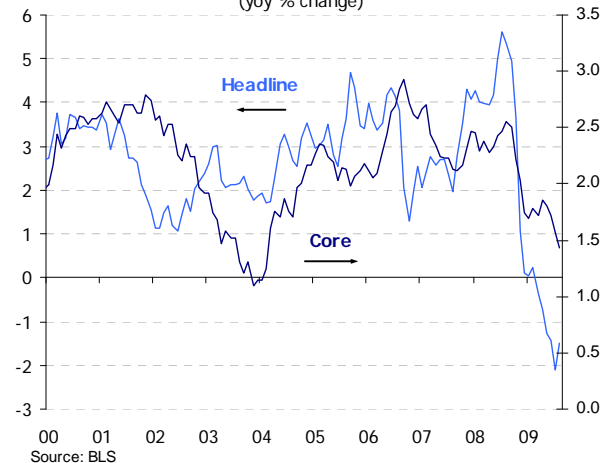
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CPI Forecasts

Date	Headline		Core	
	mom	yoy	mom	yoy
Jan 09	0.3	0.0	0.2	1.7
Feb 09	0.4	0.2	0.2	1.8
Mar 09	-0.1	-0.4	0.2	1.7
Apr 09	0.0	-0.7	0.3	1.9
May 09	0.1	-1.3	0.1	1.8
Jun 09	0.7	-1.4	0.2	1.7
Jul 09	0.0	-2.1	0.1	1.6
Aug 09	0.4	-1.5	0.1	1.4
Sep 09	0.1	-1.4	0.2	1.4
Oct 09	-0.3	-1.0	-0.1	1.4
Nov 09	-0.4	0.3	0.0	0.7
Dec 09	-0.2	0.9	-0.1	0.6
2008		3.8		2.3
2009		-0.7		1.5
2010		1.1		0.9

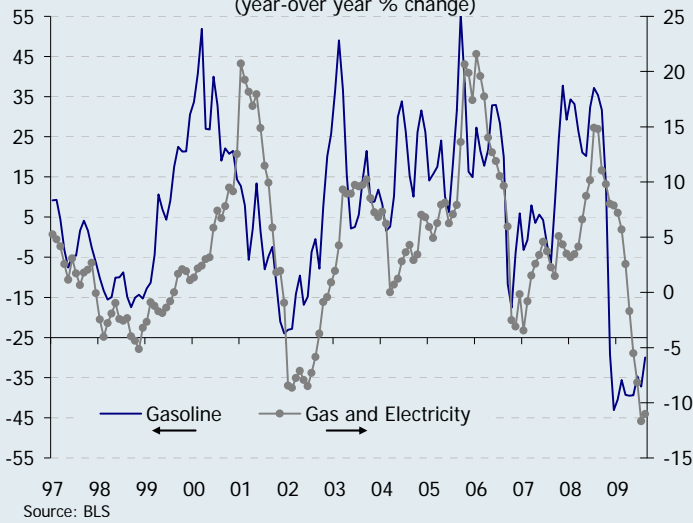
*Forecasts are in bold

Consumer Price Index
(yoy % change)



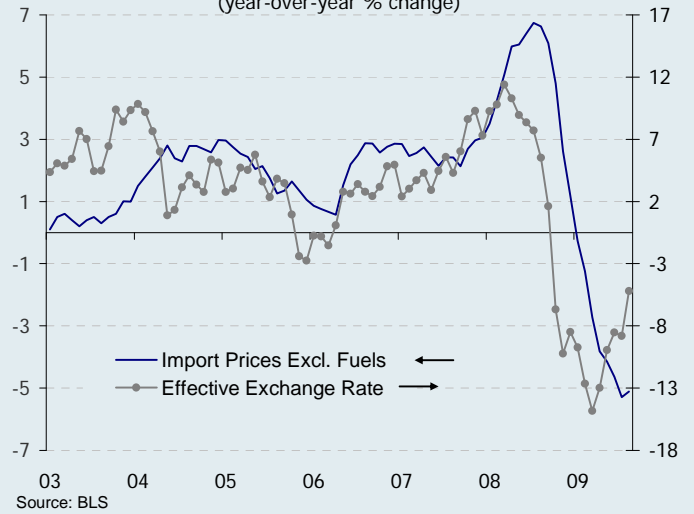
Extremely low energy prices compared to last year are dragging down headline inflation.

Gasoline and Gas & Electricity
(year-over-year % change)



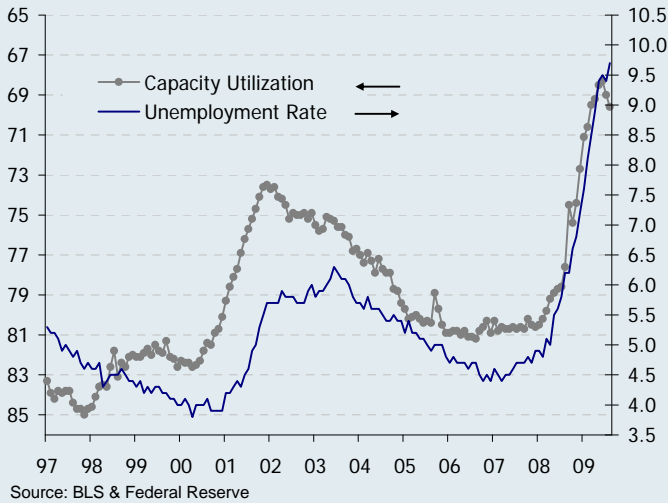
Improvement in the foreign exchange rate could stabilize import prices.

Import Prices & Effective Exchange Rate
(year-over-year % change)



Downward inflationary pressures remain due to abundant economic slack.

Capacity Utilization & Unemployment Rate
(inverted scale & %, %)



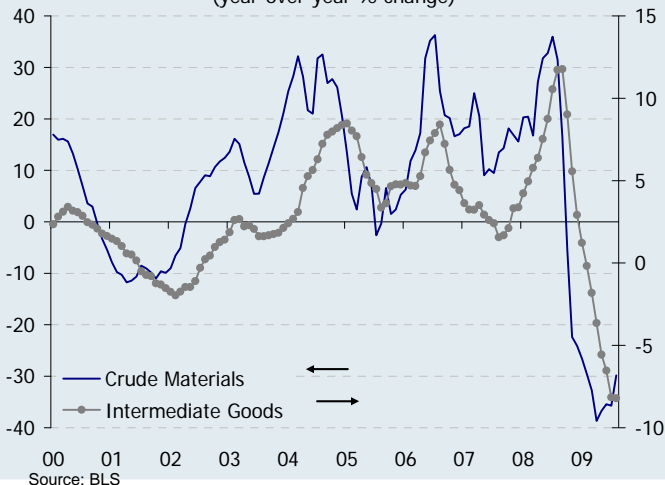
Labor costs are declining ...

Employee Compensation
(year-over-year % change)



... as are non-labor costs, which will allow producers to maintain profits without increasing prices.

Core Producer Price Indices
(year-over-year % change)



Nevertheless, stable inflation expectations are keeping the pressures in check.

University of Michigan Inflation Expectations
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