

TRENDMACRO LIVE!

On November CPI

Friday, December 15, 2006
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Economic and financial nirvana must be at hand, as the excess dollar liquidity so clearly manifest in commodity prices, risk-based financial assets and foreign exchange is, at least for now, failing to show up in the official inflation data. But before joining in the celebration of this all-benefit/no-cost world of easy money, we would advise a modicum of caution. Today's flat reading for the November core CPI appears to have been significantly driven by factors that are not likely to be sustained longer-term.

No question, a second consecutive below-trend print on core inflation (October showed just a 0.1% increase) is not easily dismissed as challenge to our view that fundamental inflation trends continue to point higher. Obviously, we would be compelled to reassess our position should these soft readings continue. But today's release does not offer sufficient grounds for such a reassessment.

A 0.9% decline in transportation prices was the largest drag on the index, and here we find some quirky results that seem transitory in nature. For one, airline fares fell by 4.8%, which seems an obvious case of falling energy prices leaking into the core data. Also, new motor vehicle prices posted a 0.7% decline, which appears attributable to quality adjustments on the new model line. In addition, apparel prices fell by 0.3%, which may reflect retailer discounts occasioned by the unseasonably warm weather over much of the country last month. Meanwhile, the Cleveland Fed's median CPI, which endeavors to get at "true" underlying inflation fundamentals by correcting for the most volatile high and low components, was up 0.2% for the month, and has moved to new cycle highs on a year-over-year basis.

BOTTOM LINE: The key issue presented by today's inflation data is its impact on the policy outlook and what that is likely to mean for fixed income markets. 10-year Treasuries, after first rallying by nearly three-quarters of a point, dropping the yield by 8 basis points to 4.52%, by early afternoon had given back almost all of their gains, leaving the yield at 4.59%. While benign data for now provides the Fed some cover for keeping its hold on rates, the credit markets remain stretched, with bonds following tick-for-tick the trading in Eurodollar futures that are fully priced for one rate cut in the first half of next year, and more than two by year-end. Even were such benign readings to be sustained, which we doubt, the most it would mean for Fed policy is a reduced inclination to resume *raising* rates. Without a sharp reversal in currently solid growth prospects, the notion that the Fed is prepared to begin cutting rates in the short run remains far-fetched. **TM**

Update to strategic view

FED FUNDS: Today's benign core inflation data is based on a handful of unsustainable components, and is not confirmed by the more robust "median CPI" measure. Nevertheless, this relieves pressure on the Fed to raise interest rates -- but it does nothing to encourage the Fed to lower them.

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