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(Some) Inflation Is Good

We know that third quarter economic growth will be good to very good, in spite of the credit crunch. Why? Prices are still rising at a healthy rate. And some inflation is good for economic growth, contrary to what the Federal Reserve may say.

The September Producer Price index for wholesale goods and services rose 1.1 percent, but most of the increase was in food and energy—no surprise in a growing economy. The so-called core rate without food and energy prices rose just 0.1 percent and is up just 2 percent in 12 months. This means that the extreme fluctuations in energy and food prices (due to seasonal demand factors) are not being passed on to other goods and services. What would happen if prices actually began to fall? That is one of the official definitions of a recession!

Here are some reasons we will see good growth for the rest of this year. The September employment report showed 110,000 jobs added to private and government payrolls, while another 118,000 jobs were added in revisions to prior months' estimated job growth by the Labor Dept. The 4.7 percent unemployment rate means the U.S. economy is still at full employment.

Then retail sales, the main indicator of consumer spending, continue to be healthy. Overall consumer spending is averaging 3 percent and retail sales, its main component, soared 5 percent annualized in September, the strongest showing in at least 2 years. The biggest spending was in health care, as well as catalogs and online sales, each up 1 percent.

In spite of this, growth could be slowing in Q4. Third quarter job growth was half that of 2006, and private sector payrolls are growing at slowest pace in three and one-half years. This alone should keep another interest rate cut on the table at the Fed's October meeting, says CBS Marketwatch economist Irwin Kellner.

Interest rates have barely budged since the Fed's September rate cut. ARM indexes, such as the Cost of Funds, or Treasury, or LIBOR indexes are still hovering around 5 percent, which means it could be months before holders of adjustable rate mortgage will see any payment relief. Why? Investors are asking for higher returns until the extent of ARM defaults is known. Most of the negatively amortized Option ARMs were issued in the past 2 years, and so they won't reach their full payment for at least another year. It is that uncertainty that is keeping short-term interest rates high.

How do we know when property valuations return to more normal levels? A measure of housing value used by economist Robert Shiller of Irrational Exuberance fame, is the growth of median incomes. Housing prices over the long term tend to approximate the average increase in household incomes. No surprise, since that is what determines affordability.

Household incomes have increased 5.6 percent per year over the past 35 years.

Yet average home prices have risen more than 50 percent just over the past 6 years, according to the National Association of Realtors. This means housing values have risen 15-20 percent over the historical norm in those years, and so must fall by that amount to return to the historical norms.