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WEEK OF FEBRUARY 19, 2007—THE INFLATION CONUNDRUM

We have another 'conundrum'. There was the interest rate conundrum pronounced by former Fed Chairman Alan Greenspan. Why were there incredibly low bond yields in the face of what, 17 consecutive Federal Reserve rate hikes amid high worldwide growth rates? Now we have the inflation conundrum, where the overall inflation rate has been falling in line with energy prices, but the core rate—without food and energy prices—has remained stubbornly high.

This has led some Fed officials to suggest rising short-term interest rates even higher to forestall possible future inflation, while others see falling inflation, and consumers don't seem to be bothered by any.

Fed Chairman Ben Bernanke is not so worried about inflation, predicting that even the core rate would fall below 2 percent by 2008 in congressional testimony. The core rate is currently in the 2.4-2.7 percent range, depending on the index. Chicago Fed President Michael Moskow, on the other hand, was concerned about a tight labor market and economy that continues "to operate at a high level relative to its potential, which could eventually lead to the emergence of higher inflation pressures."

Those who are happy with the status quo—i.e., no more rate hikes—seem to have stopped worrying about a housing catastrophe. San Francisco Fed President Jane Yellen says she is sleeping better these days on signs that the housing downturn may have bottomed, and is having "remarkably little effect on the rest of the economy", in a recent speech. She said the economy is in a sweet spot with inflation declining and good economic growth, so that rates are currently where they should be.

In fact, housing construction is still declining. January housing starts plunged 14 percent to a 10-year low. Starts were down 39 percent in a year, the biggest drop since 1991, during the last recession. Much of the current drop could be weather-related, however, since a warmer than normal Northeast showed a 9 percent increase in starts, while starts fell by 28 percent in the west.

Another optimist was Fed Governor Susan Bies, who claimed that the rise in sub-prime delinquencies was only 7-8 percent of outstanding mortgages. "I don't think there will be a large impact on the prime mortgage industry…I think it's really in the sub-prime ARM market, it's isolated at this point."

Many Fed officials believe that housing will not decline much more, in part based on the strengthening of mortgage volumes since last summer, first noted by Greenspan. Though purchase mortgage applications are still down 7 percent year-over-year in line with the drop in home purchases, refinance activity is 22 percent higher in 12 months.

In fact, the present direction of inflation is a conundrum. January's Producer Price Index (PPI) sank 0.6 percent, while the Consumer Price Index (CPI) rose 0.3 percent. But both core rates rose 0.2 percent, in line with expectations. The culprits were higher food, tobacco, and medical costs. The fear is that the volatility of energy prices has begun to creep into the rest of the market.

CPI—January consumer prices rose just 0.2 percent, but core prices rose 0.3 percent because medical costs are rising faster than the drop in retail energy prices, along with "other goods and services", such as tobacco.

LEI—The Conference Board's January Index of Leading Economic Indicators rose slightly, but only 4 of 10 components were positive. Its Current and Lagging indexes were higher indicating that current growth is good, but future economic growth uncertain. Manufacturing and housing permits continue to shrink, even though the money supply continues to grow. And wage earners incomes have begun rising after 4 years of wage stagnation. A rising money supply with rising wages could be why some Fed officials are still worried about future inflation.

We are really in a schizophrenic economy, where consumers are as confused as Fed officials. Average household incomes for those under 65 are still almost 6 percent below 2000 levels after inflation, in this the fifth year of recovery from the last very mild recession. Consumer confidence has also been declining of late, probably more due to the inclement weather in the midwest and east. But energy prices continue to bounce around, whether due to the weather or Middle Eastern uncertainty.

In fact, Fed officials seem to be talking consumers down to a soft landing with a slowing economy, fewer jobs, and a much weaker housing market. Keeping up morale might be helpful in the short term, but energy prices and interest rates have to decline in earnest before we are out of the woods.