



Inflation Observatory

April 15th, 2009

Core inflation remains low but positive

- Falling energy prices led the decline of headline consumer prices
- Core components experienced mixed results
- Downside risks remain due to economic slack

Headline inflation fell for the first time in 2009

March's change in headline consumer prices came in below our expectations at -0.1%. After rising for the first two months of 2009, March's headline inflation was dragged down by a 3.0% drop in energy prices. The 4.0% drop in gasoline prices led the decline, bringing headline CPI down by 0.2pp. In addition, a 1.78% fall in home fuel prices subtracted another 0.1% from the overall index. Food prices dropped for the second consecutive month by 0.1%, but they had a negligible effect on the overall index. The 0.1% increase in food away from home was more than compensated by the 0.3% decrease in food at home. Looking forward, April's headline inflation could see a neutral influence of energy prices because both gasoline and natural gas have remained fairly stable.

Core consumer prices, on the other hand, exceeded our expectations by coming in at 0.2%, compared to our 0.1% forecast. Core commodities increased 0.4%, largely influenced by an 11% increase in prices of tobacco and smoking products along with a modest 0.3% increase in household furnishings. However, apparel prices decreased after rising for the previous two months, which could reflect discounts offered at retailers in response to the decline in demand. In addition, after increasing last month, prices of new and used automobiles remained unchanged. Core services increased 0.1% due to modest increases in education and communication and medical care. Shelter prices did not change for the second month in a row, because the increase in rent and owners equivalent rent was again offset by the continued decline in lodging away from home.

The results are in line with our baseline scenario

Excluding the surprise from tobacco, the core CPI figures are consistent with our baseline scenario of positive but low core inflation for 2009. Nevertheless, downside risks remain. March's core PPI data reflected no change in producer prices and continued year-over-year price decreases in intermediate and crude materials. Holding this information in tandem with today's core CPI results, it is evident that the ongoing economic slack is putting downward pressure on prices. However, due to the expected increases in government spending, the Fed's expansionary monetary policy and increasing labor costs, we maintain our expectations of low but positive core inflation in 2009. Therefore, we anticipate that the Federal Reserve will keep the Fed Funds rate at a low level for a prolonged period of time.

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