

Economics Group

Special Commentary

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Inflation Chartbook: November 2009

Inflation Worries Appear Overblown, for Now

The Federal Reserve's massive quantitative easing program and efforts put in place by the Fed and Treasury to combat the financial crisis have raised fears that inflation will soon accelerate. While some fears are warranted, the near-term threat from inflation is likely overstated. Considerable excess capacity exists today and very few firms have any significant pricing power. Discounting remains rampant, rents are falling and wages and salaries are growing much slower.

While some fears are warranted, the near-term threat from inflation is likely overstated.

Rising commodity prices and the weaker dollar could pave the way to higher inflation down the road, but even here the threat appears to be far less than widely thought. Commodity prices make up only a tiny fraction of the final sales price of most goods and recent price gains follow the unusually sharp slide that accompanied the onset of the financial crisis. The falling dollar is likely producing more of an inflationary threat due to the pass-through to import prices, but evidence appears to be modest.¹ While these factors can still affect overall prices, they are being offset by moderating prices elsewhere.

Housing costs are another notable area of disinflation. With housing in obvious oversupply, rent and owners' equivalent rent should continue to moderate for a least another year. These two components account for 39 percent of the "core" CPI, which means the "core" CPI, which is currently up just 1.5 percent year to year, will likely continue to moderate through all of next year. We expect the year-to-year change in the "core" PCE deflator, the Fed's preferred inflation measure, to bottom at around 1.0 percent around the end of next year. This low rate of inflation will give the Fed flexibility to keep short-term interest rates low.

Figure 1

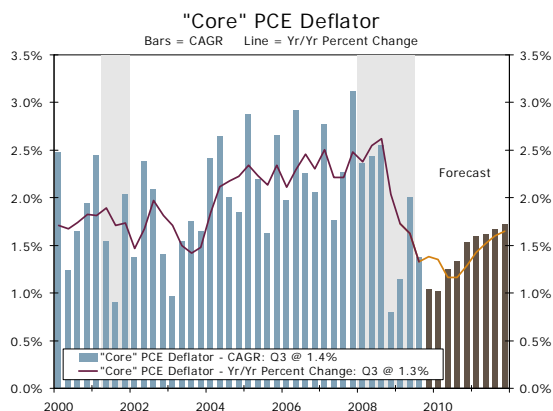
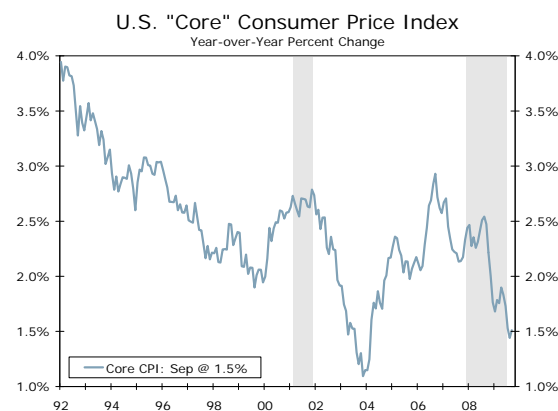


Figure 2



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

¹ Mishkin, Frederic S., Exchange Rate Pass-Through and Monetary Policy, At the Norges Bank Conference on Monetary Policy, Oslo, Norway (March 7, 2008)



Inflation Expectations Remain Contained

Despite all of the talk about rising inflation, actual measures of inflation expectations remain generally well-behaved. The spread between the Treasury’s 10-year note and the Treasury’s 10-year inflation-indexed note has remained between 2.0 and 2.5 percent for most of this year, which implies investors feel the risk of inflation is about the same as it was throughout much of the first half of the decade.

Consumers are a little less certain. Inflation expectations in the Conference Board’s Consumer Confidence Index have risen over the past few years and are currently around 5.3 percent. The Consumer Confidence Index has generally produced a higher estimate of future inflation than any other measure, however, and the current measure is only about a percentage point higher than it was during the earlier decade. Consumers are very sensitive to the price of gasoline, with notable spikes occurring following Hurricane Katrina and last fall. Gasoline prices are higher today than they were for much of the previous decade, which may explain the higher expectations reading.

Keeping inflation expectations contained is an important part of the Fed’s job in fighting actual inflation. If inflation expectations become unhinged, businesses and consumers might begin to behave in a way that reinforces inflationary pressures, making actual inflation more difficult to reverse. This is one reason why there is so much concern surrounding the Fed’s unprecedented quantitative easing program and why the Fed has taken great pains to explain its exit strategy. The Fed’s actions have dramatically increased the size of their balance sheet and monetary base. If banks were to lend out all the reserves that are currently available, this would lead to a colossal increase in the money supply and eventually boost inflation. Bank lending is still contracting, however, and if lending were to pick up, the Fed would know about it almost immediately, giving it plenty of opportunity to drain reserves out of the system.

While all of this sounds neat and relatively simple, there are a number of potential complications. To start off, there may not be as much slack present in the economy as widely thought. A great deal of the growth in the economy during the past expansion took place in industries tied to housing and consumer spending and this is where much of the excess capacity currently exists. If the recovery takes place in other areas, such as business fixed investment or export sensitive industries, there may not be as many idle resources present as widely thought, which could lead to a quicker pick-up in bank lending. Moreover, if that pick-up in bank lending occurs at a time when the unemployment rate is in double-digit territory, then the Fed may not have the political will to rein in the monetary base as quickly as it should. The upshot is that we expect inflation to remain well-contained over the next year to 18 months, but see a risk of higher inflation after that. We believe both headline and “core” measures will eventually rise above the Fed’s comfort zone, but do not look for a repeat of the late 1970s inflation experience.

The upshot is that we expect inflation to remain well-contained over the next year to 18 months but see a risk of higher inflation after that.

Figure 3

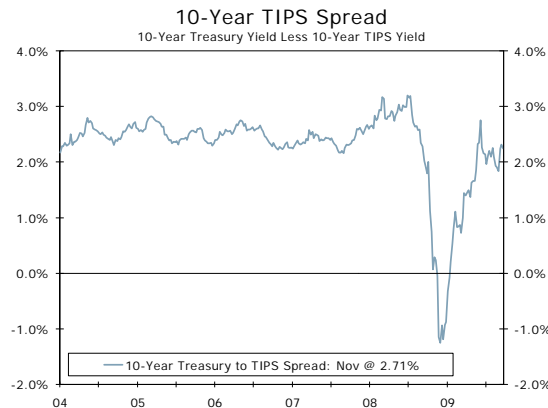
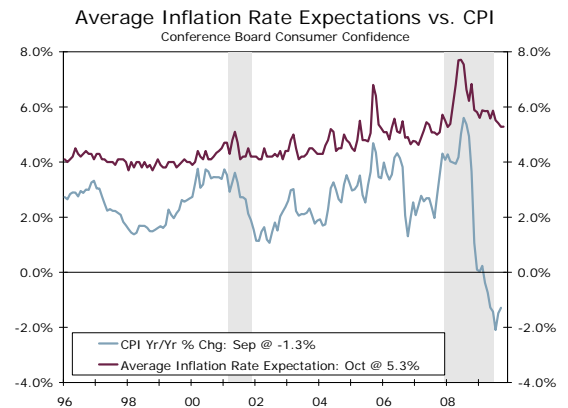


Figure 4



Source: The Conference Board, U.S. Department of Labor, Federal Reserve Board and Wells Fargo Securities, LLC

National Economic & Inflation Outlook

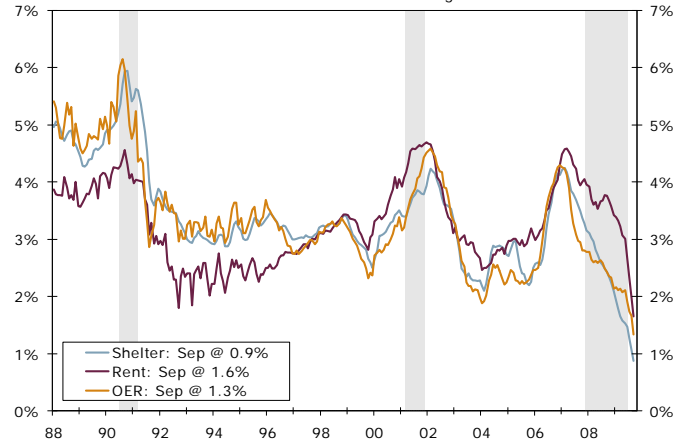
	2006			2007			2008			Forecast		
	2006	2007	2008	2009	2010	2011	2009	2010	2011	2009	2010	2011
Real GDP, compound annual growth rate	2.7	2.1	0.4	-2.5	2.4	2.3						
Nonfarm Employment, percent change	1.8	1.1	-0.4	-3.8	-1.5	0.9						
Unemployment Rate	4.6	4.6	5.8	9.2	10.4	9.9						
Consumer Price Index, percent change	3.2	2.9	3.8	-0.4	1.9	2.3						
CPI, excluding food & energy, percent change	2.5	2.3	2.3	1.6	1.3	1.6						
PCE Deflator, percent change	2.7	2.7	3.3	0.8	1.4	1.9						
PCE Deflator, excluding food & energy, percent change	2.3	2.4	2.4	1.5	1.2	1.5						
Producer Price Index, percent change	3.0	3.9	6.3	-3.0	1.4	1.6						
PPI, excluding food & energy, percent change	1.5	1.9	3.4	1.5	1.2	1.4						
Import Price Index, percent change	4.9	4.2	11.5	-4.2	1.5	1.8						
Export Price Index, percent change	3.6	4.9	6.0	-5.0	2.6	3.8						
Import Prices from Energy Products, percent change	20.6	11.6	37.7	-36.6	4.5	4.4						
Commodity Prices, Annual Average of Daily Close												
CRB Spot Index	335.9	405.8	412.5	357.0	388.0	402.0						
Crude Oil (West Texas Intermediate)	66.2	78.6	96.3	62.0	78.5	81.0						
Nonfarm Productivity	0.9	1.8	1.8	2.9	3.7	1.7						
Employment Cost Index, percent change	3.1	3.4	3.0	1.7	1.6	1.8						
Interest Rates - Annual Averages												
Federal Funds Target Rate	4.96	5.05	2.08	0.25	0.55	2.50						
10-Year Treasury Note	4.80	4.63	3.66	3.25	3.70	4.10						

Source: Federal Reserve Board, Bloomberg LP, U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

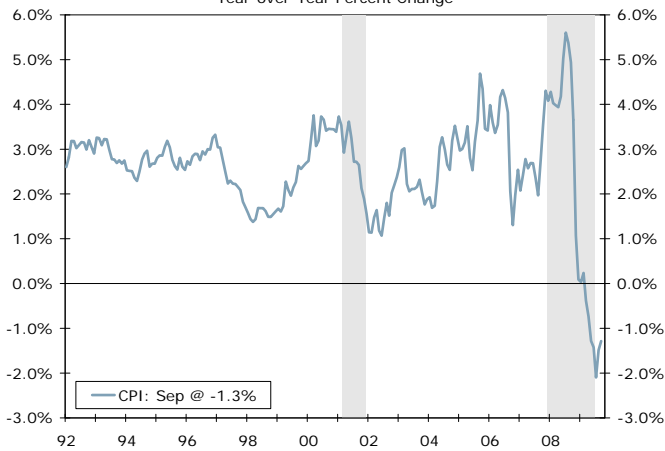
Consumer Price Index

- The Consumer Price Index rose modestly in September but remains down 1.3 percent over the past year. Energy prices are beginning to bounce back and oil prices will soon be above their year-earlier levels. Food prices continue to moderate, however, particularly at grocery stores. Price declines are helping undo the damage from last year, when higher diesel fuel prices pushed prices for field crops higher and the ethanol boom sent grain prices soaring.
- Excluding food and energy, consumer prices have moderated across a broad front and should decelerate even further. Housing remains in oversupply and this should put additional downward pressure on the rental components, which account for 42 percent of the “core” CPI.

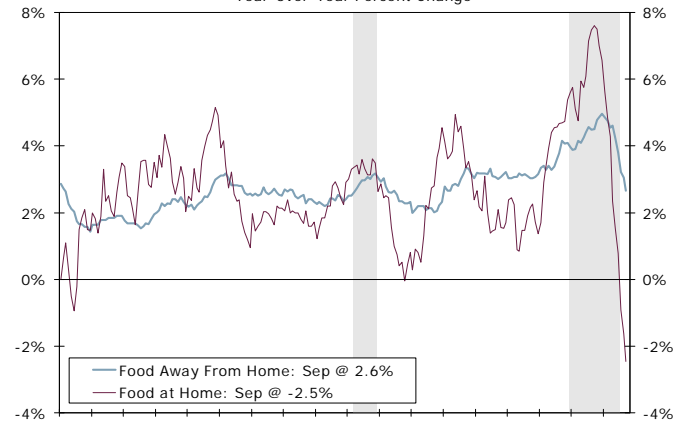
Shelter, OER & Rent Costs
 Year-over-Year Percent Change



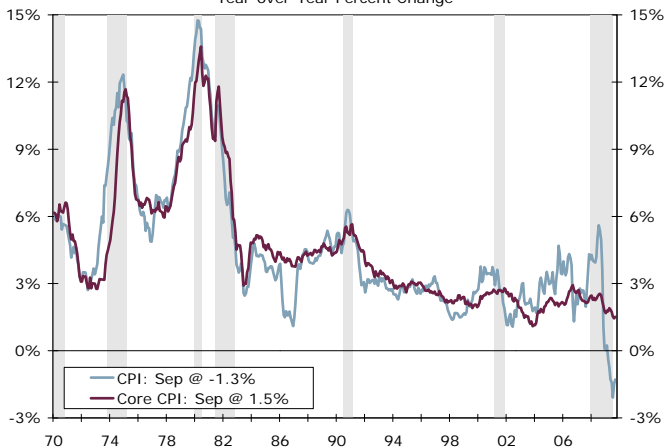
U.S. Consumer Price Index
 Year-over-Year Percent Change



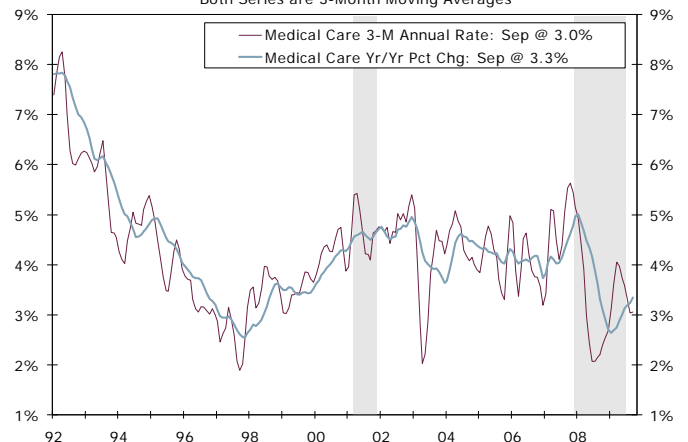
Food - At Home vs. Away from Home
 Year-over-Year Percent Change



CPI vs "Core" CPI
 Year-over-Year Percent Change



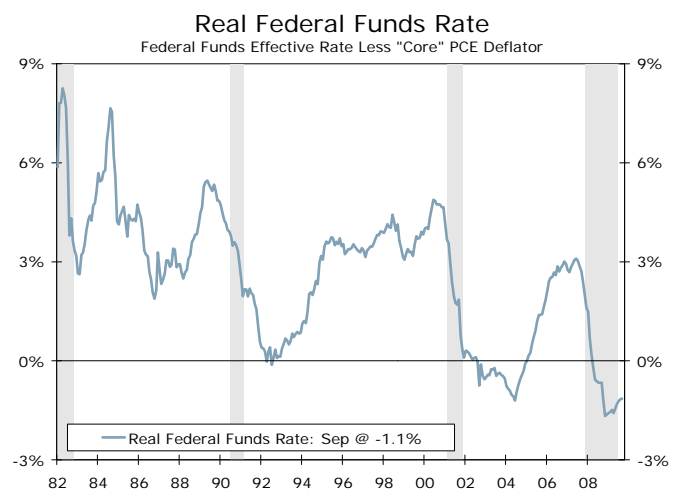
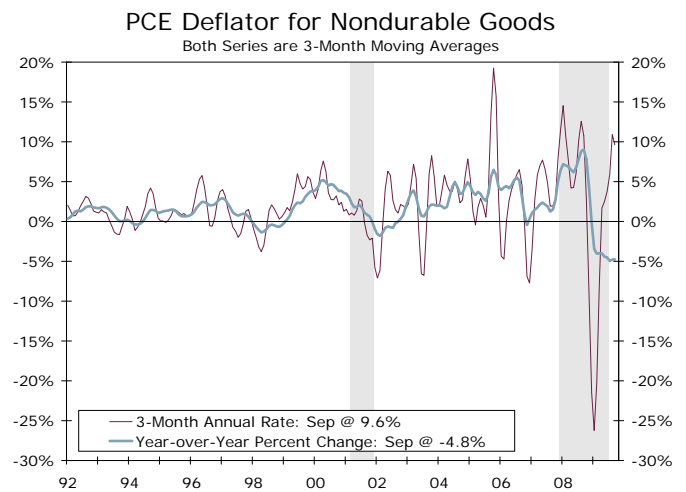
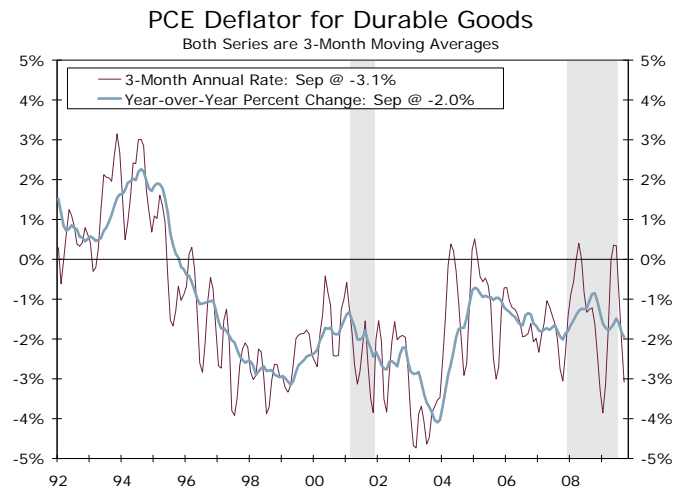
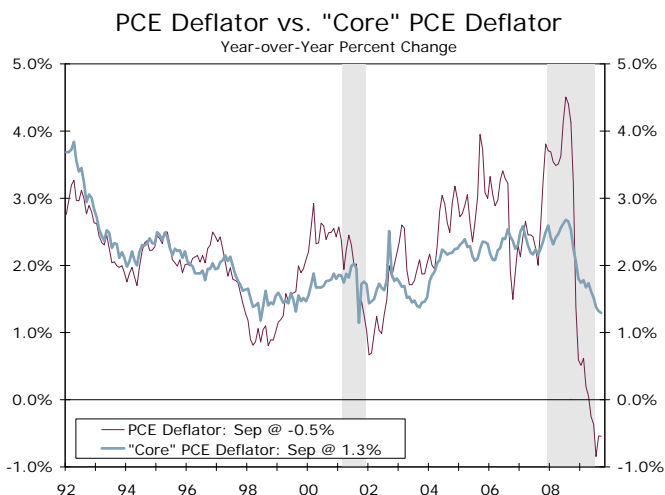
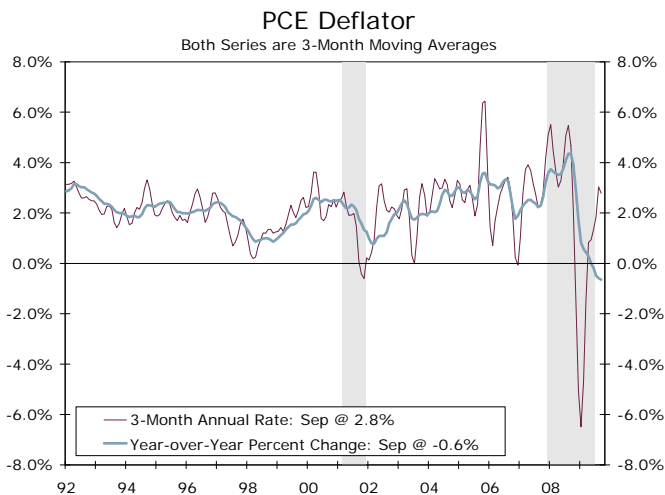
U.S. CPI - Medical Care
 Both Series are 3-Month Moving Averages



Source: U. S. Department of Labor and Wells Fargo Securities, LLC

PCE Deflator

- The PCE deflator continues to fall, but at a slower pace. Recent gains in energy prices will likely push the “headline” higher. The “core” PCE deflator has steadily fallen as housing, which accounts for 23 percent of the index, has continued to decline.
- The “core” PCE deflator, the Federal Reserve’s preferred inflation indicator, tends to decelerate into the second year of the recovery and will likely stay at low levels well into 2011.
- The “core” PCE deflator is up 1.3 percent year to year and remains within the Fed’s comfort zone. Low and moderating “core” inflation should allow the Fed to continue its extraordinary accommodative measures put in place to combat the financial crisis.

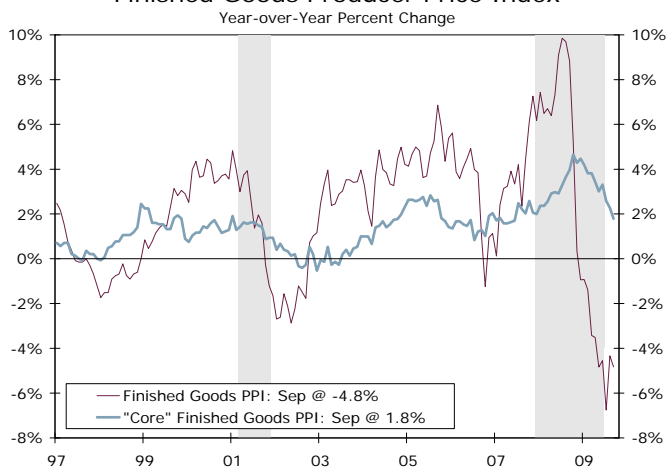


Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities, LLC

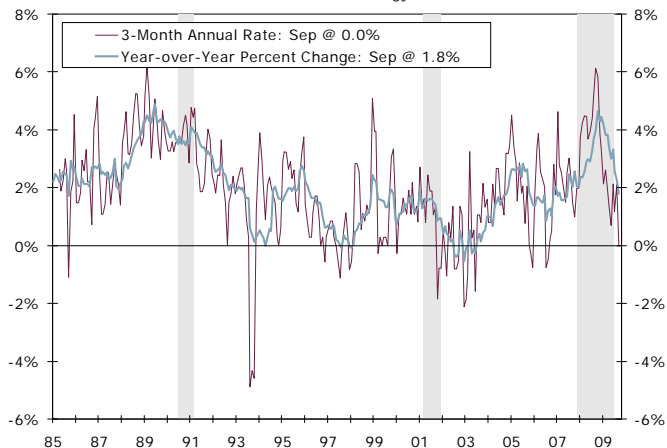
Producer Price Index

- Producer prices have declined steadily over the past year as gasoline and food prices moderated. More recently energy prices have rebounded.
- Further back in the pipeline, rising industrial commodity prices have pushed “core” intermediate goods prices higher. While part of the rise is due to stronger global economic growth, foreign investors are likely diversifying out of the dollar and buying hard assets. Weak final demand is, so far, preventing firms from passing higher prices to end consumers.
- The Philadelphia Fed’s Prices Received Index has risen modestly in recent months after declining for about a year, suggesting some of the deep discounting associated with inventory liquidations is coming to an end.

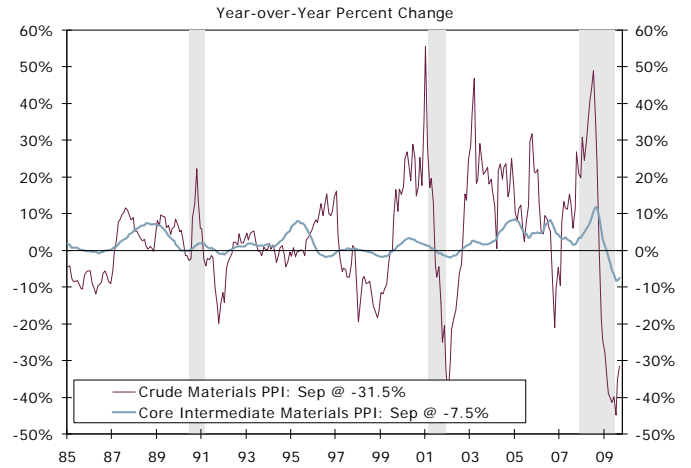
Finished Goods Producer Price Index



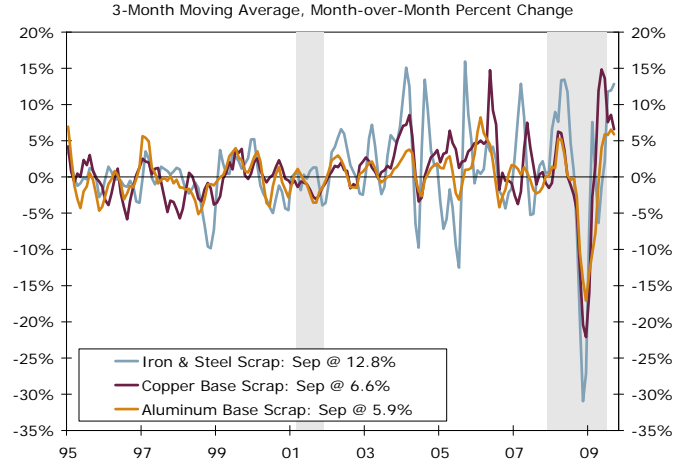
"Core" Finished Goods Producer Price Index
 Less Food & Energy



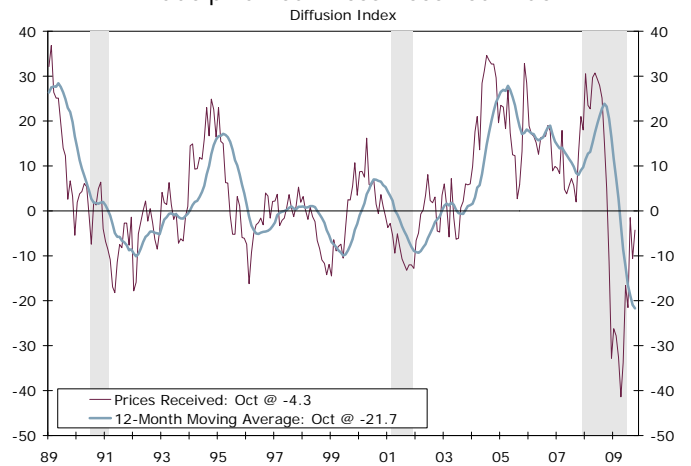
"Core" Intermediate & Crude Materials PPI



Iron and Steel, Copper & Aluminum Base Scrap



Philadelphia Fed Prices Received Index

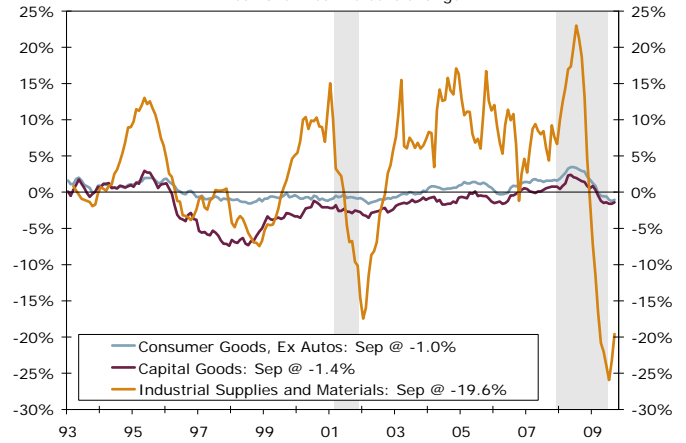


Source: Federal Reserve Bank of Philadelphia, U.S. Department of Labor and Wells Fargo Securities, LLC

Import Prices

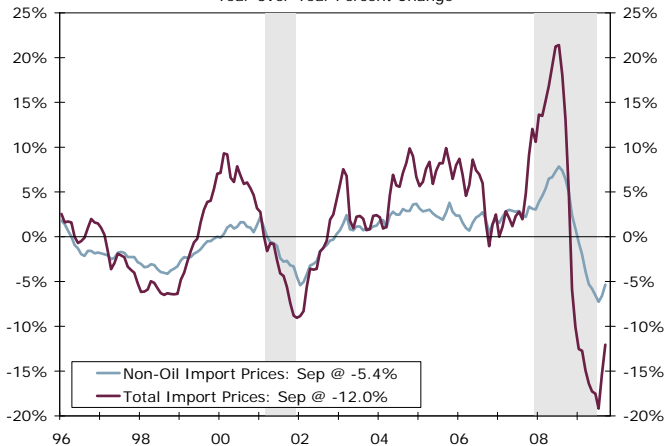
- “Headline” import prices have declined steadily from year-ago levels as oil prices fell sharply. Petroleum prices have been rising more recently, reflecting stronger global economic growth. The weaker dollar will also likely put upward pressure on prices of imported goods.
- Non-oil imports have risen two consecutive months but were down 5 percent from year-ago levels in September. The high correlation between non-oil import prices and producer prices suggests at least some modest inflationary pressures are building in this area.
- While import prices will likely rise further in coming months, the modest gains will be offset by disinflationary pressures elsewhere.

Import Prices By Sector
 Year-over-Year Percent Change



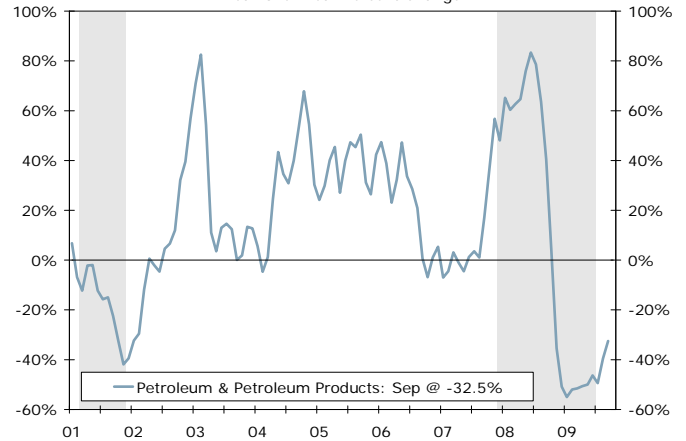
Import Prices

Year-over-Year Percent Change



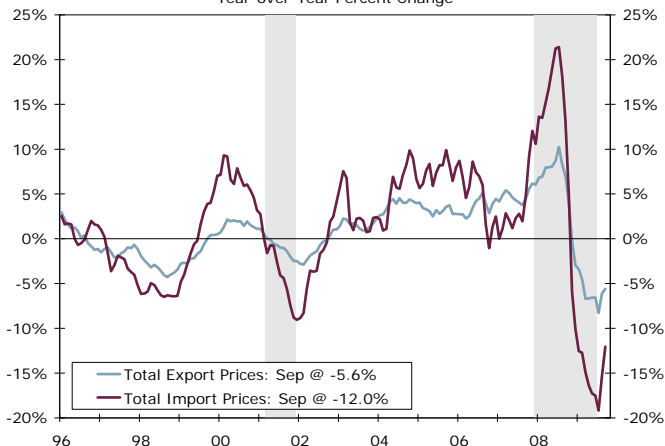
Import Prices For Energy Products

Year-over-Year Percent Change



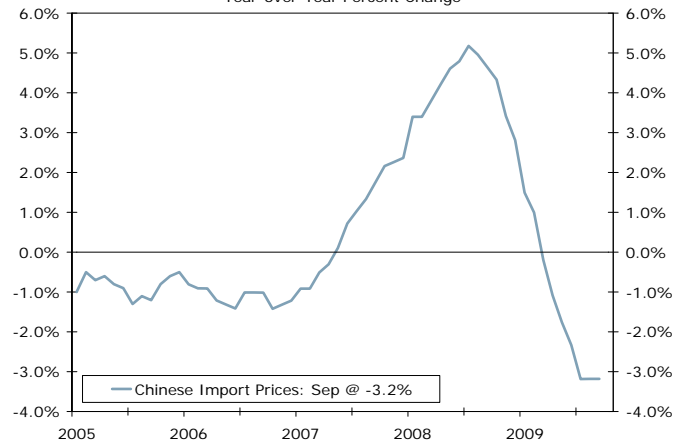
Import Prices vs Export Prices

Year-over-Year Percent Change



Chinese Import Prices

Year-over-Year Percent Change

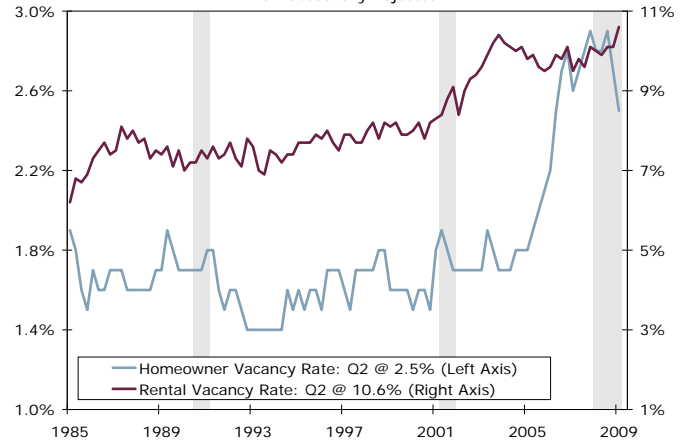


Source: U.S. Department of Labor and Wells Fargo Securities, LLC

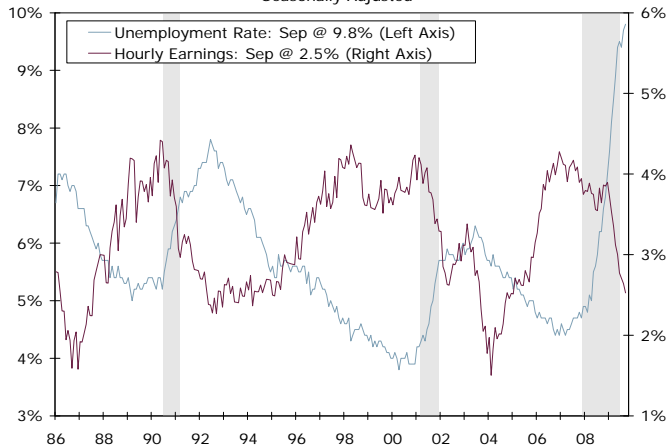
Measures of Slack

- Just about every measure of capacity suggests considerable slack exists throughout most areas of the economy and that disinflationary pressures should remain in place for some time.
- Labor market conditions remain exceptionally weak, suggesting compensation costs should remain contained over the next several quarters. Mandated compensation hikes, such as the recent hike in the minimum wage and pending healthcare legislation, may mitigate some of the market influences, however.
- Rebounding motor vehicle assemblies have lifted capacity utilization off its recent lows. Abundant capacity exists in industries tied to residential construction and consumer products, which should limit pricing power.

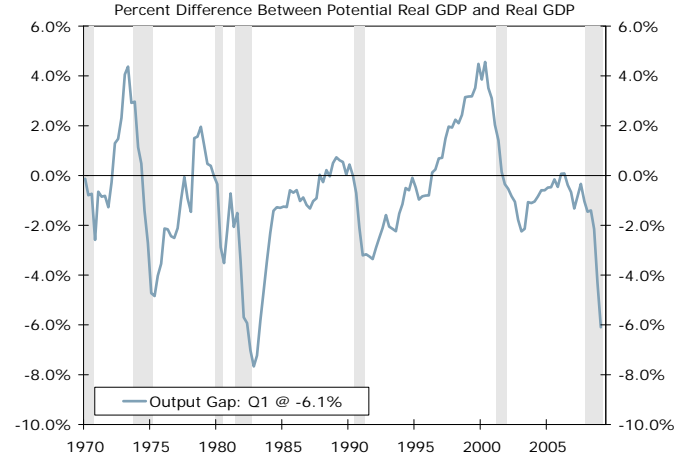
Residential Vacancy Rates
 Non-Seasonally Adjusted



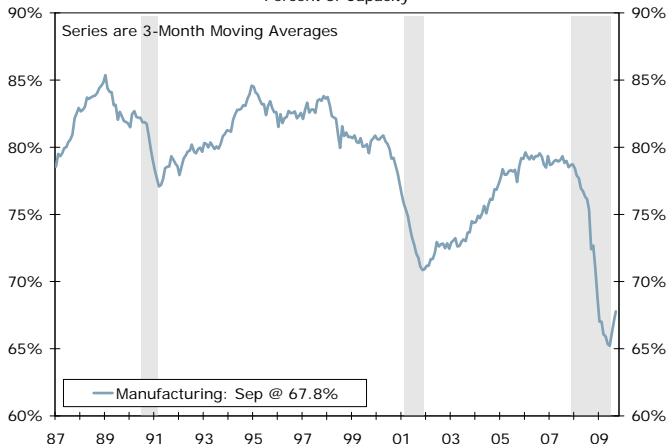
Unemployment and Wage Rates
 Seasonally Adjusted



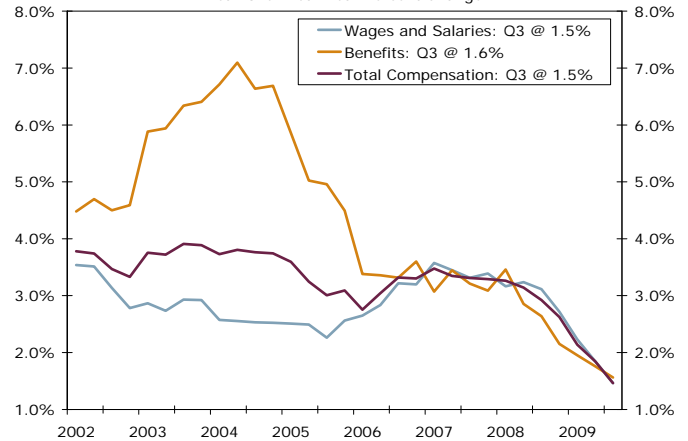
Output Gap
 Percent Difference Between Potential Real GDP and Real GDP



Manufacturing Capacity Utilization
 Percent of Capacity



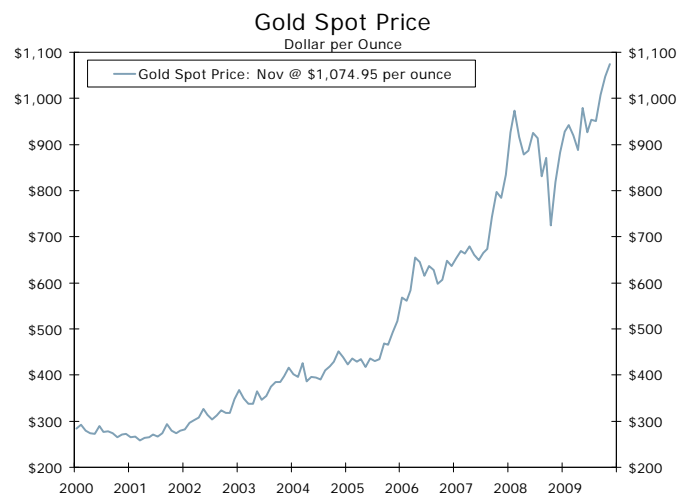
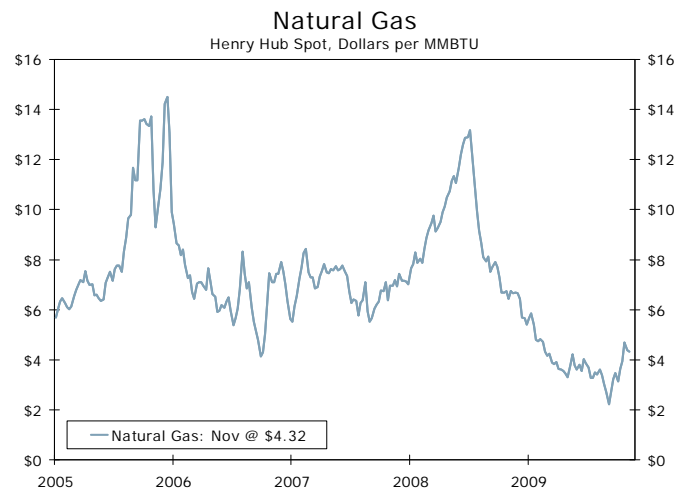
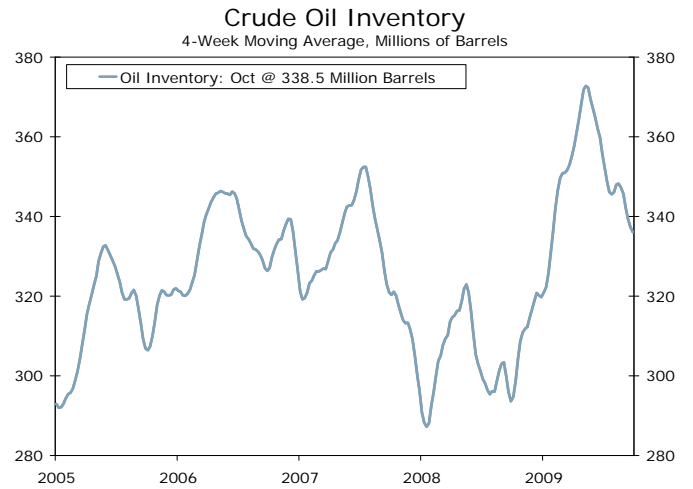
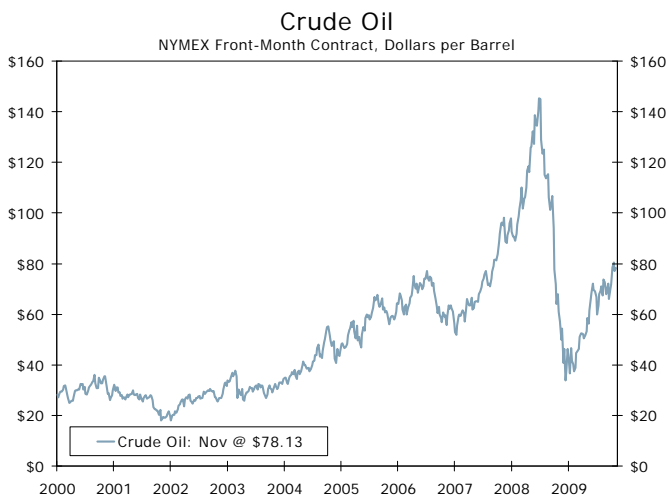
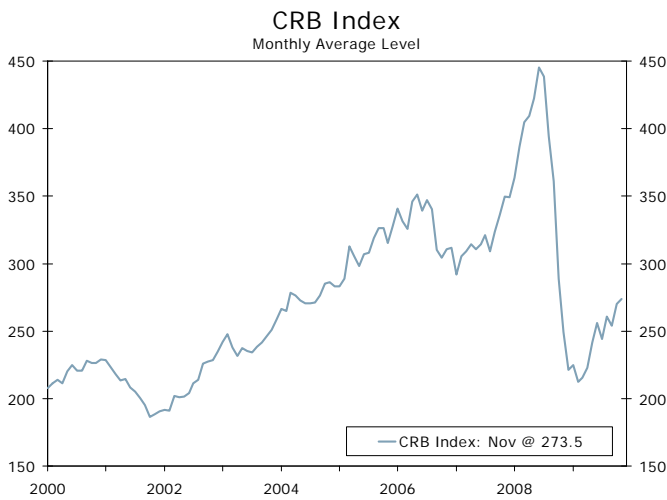
Employment Cost Index
 Year-over-Year Year Percent Change



Source: Congressional Budget Office, Federal Reserve Board, U.S. Department of Labor and Wells Fargo Securities, LLC

Commodity Prices

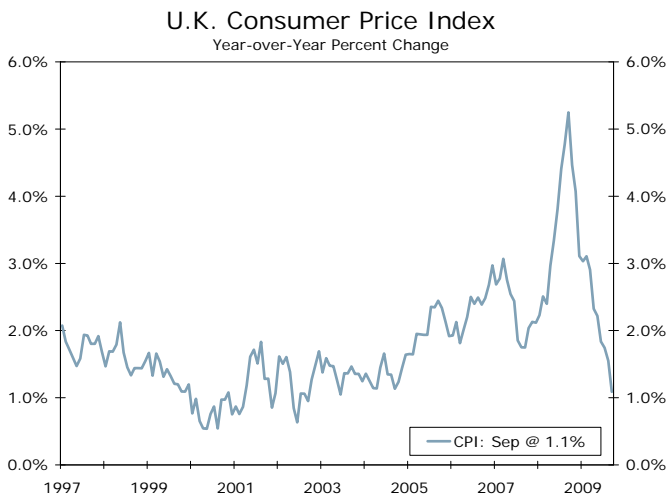
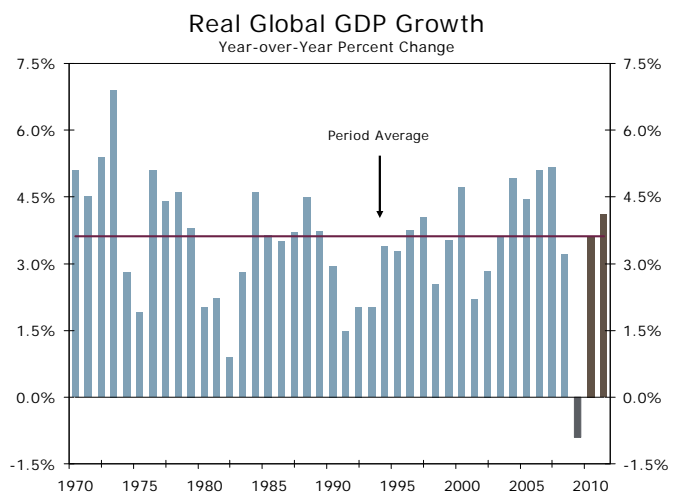
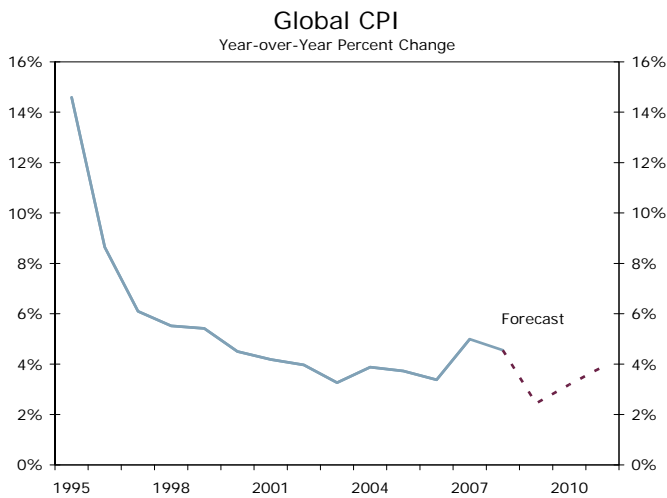
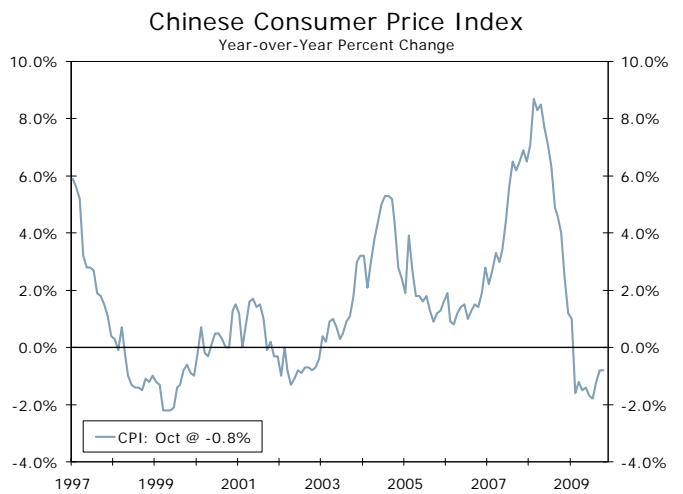
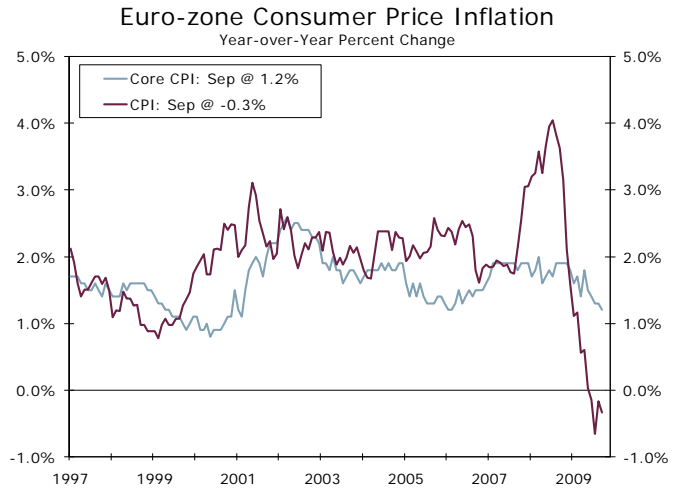
- Commodity prices have rebounded recently, reflecting stronger global economic growth and strategic stockpiling of some key raw materials.
- Stronger global growth and cooler weather in the United States are also boosting energy prices in recent months, such as for natural gas.
- Prices for gold, steel, aluminum, copper and sugar have surged in recent months. Part of the gain is due to an earlier and more robust recovery in global economic activity.
- Gold prices have risen dramatically in recent weeks. Central bank buying has picked up, as has speculative purchases. The run-up is not necessarily a harbinger of a problematic inflation and may simply reflect frustration over the limited available investment alternatives.



Source: Bloomberg LP and Wells Fargo Securities, LLC

Global Inflation

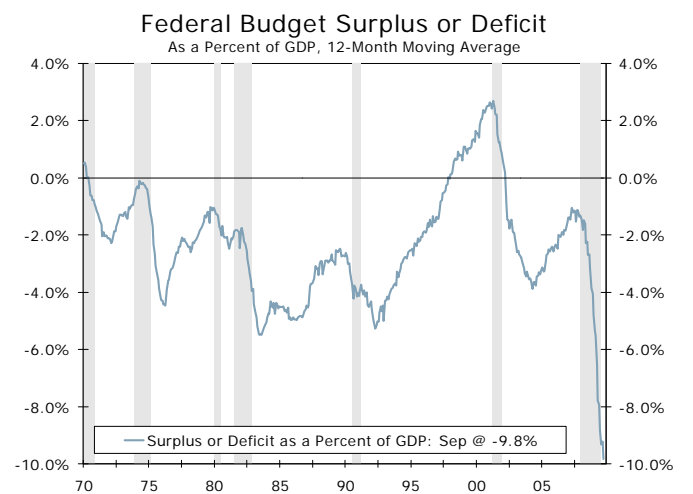
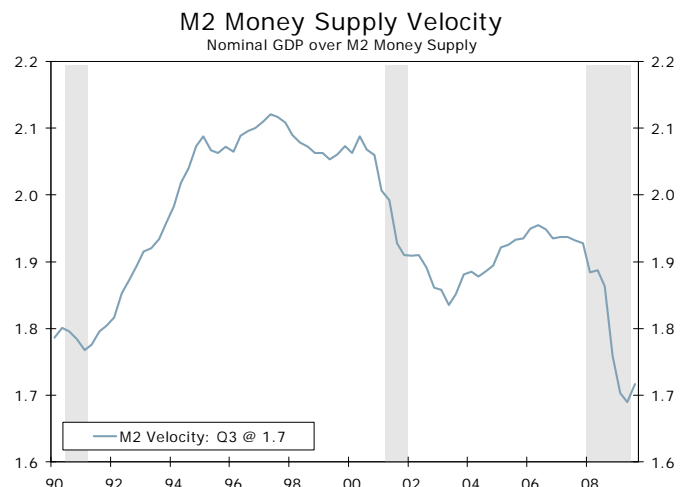
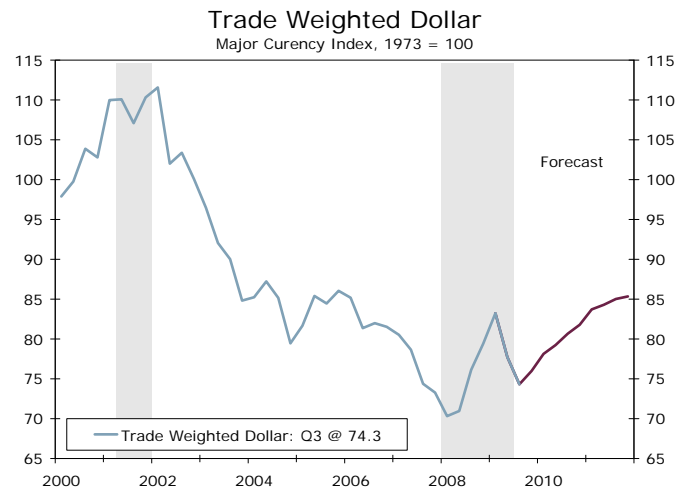
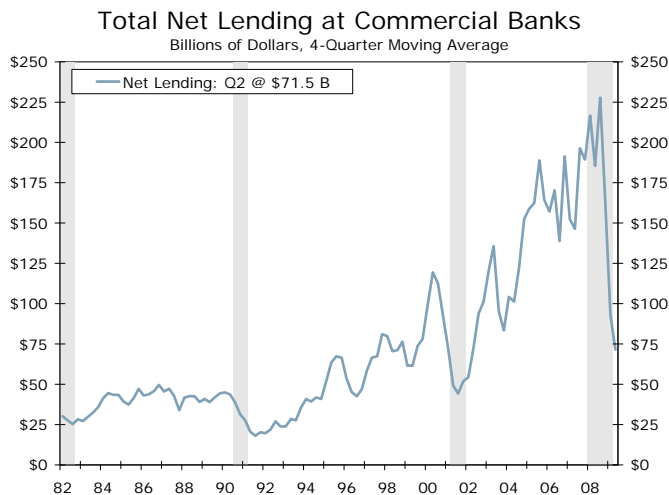
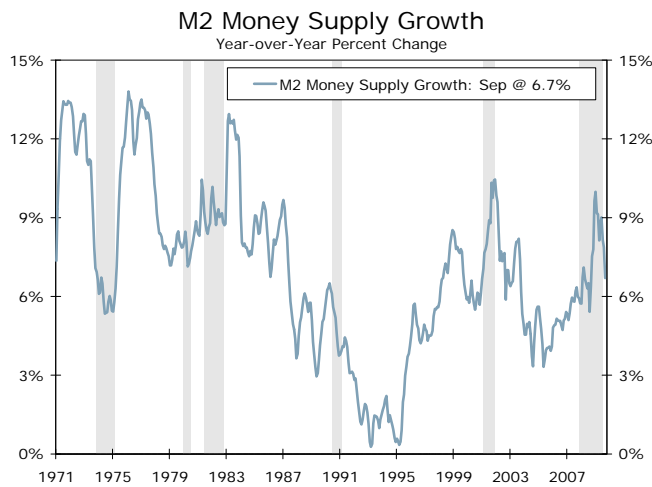
- The global economy fell into its deepest recession in decades with industrial production plunging at double-digit rates in most countries.
- Despite unprecedented amounts of monetary stimulus, inflation will likely remain benign across most developed nations. Most central banks will likely not rush to tighten policy and wait until there are more signs that an enduring recovery has indeed taken hold.
- The global recovery is being led by Asia where growth turned positive earlier this year. Asian financial systems were not nearly as levered as their western counterparts, so banks in the region were able to ramp up lending more quickly. Stimulus programs were also more successful at stimulating final demand.



Source: International Monetary Fund, U.S. Department of Labor and Wells Fargo Securities, LLC

Global Liquidity Measures

- Worries the Fed's aggressive quantitative easing program could set off some sort of horrendous inflation are, at the very least, premature and most likely considerably overblown. The monetary base has expanded substantially, but bank lending has not. Without an increase in bank lending, money growth is not likely to accelerate to the point that it threatens to unleash an inflationary spiral.
- The Fed is striving to revive bank lending but not by too much. It then needs to gradually throttle down the monetary stimulus. All of this is doable but will involve considerable skill and an iron political will. Given the heightened risks, there is little wonder that gold prices have shot higher, even in the absence of visible inflation.



Source: Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

Appendix

Consumer Price Index

The Consumer Price Index is the most widely used measure of inflation published by the Bureau of Labor Statistics and tracks the average price of a fixed basket of goods and services urban consumers regularly purchase in the United States. Urban consumers represent roughly 87 percent of consumers in the United States. The current basket of goods and services is based on the Consumer Expenditure Surveys of 2005 and 2006. Food and energy prices, which account for more than 20 percent of the index, often cause volatility in the short-term measurements of the CPI. Thus, many economists focus more on the “core” CPI, which excludes food and energy prices, to determine the underlying trend in the Consumer Price Index. A variation of the CPI, CPI for Urban Wage Earners and Clerical Workers (CPI-W) is used to make cost-of-living adjustments for Social Security benefit payments.

PCE Deflator

The PCE deflator is published by the Bureau of Economic Analysis along with the personal income and consumption release monthly. Prices are also reported excluding food and energy items, and the “core” PCE deflator has become once of the most closely watched inflation measures. The Federal Reserve has set an informal target of 1-2 percent year-to-year growth in the “core” PCE deflator as its comfort level of inflation. In contrast to the CPI, the PCE deflator is based on a survey of business sales and is a chain-weighted index instead of a fixed-weighted index. Because it is a chain-weighted index, the PCE deflator takes into account changing consumer consumption patterns, giving higher weight to items that consumers are purchasing more and less weight to items that consumers purchase less. Another major difference between the two indices is that shelter costs account for 32.4 percent of the CPI while the costs only account for about 15 percent of the PCE deflator. The PCE deflator has usually been about 0.25 to 0.50 percentage points lower than the CPI.

Producer Price Index

The Producer Price Index measures the average selling prices received by domestic producers of goods and some services. The PPI is published by the Bureau of Labor Statistics, and three main broad indexes are published monthly—finished goods, intermediate goods, supplies and components, and crude materials for further processing. The market pays the most attention to PPI for finished goods. The “core” reading of PPI is also calculated as food and energy prices are heavily weighted in the PPI for finished and intermediate goods. One of the most closely watched subindexes is “core” intermediate goods prices, which are sensitive to swings in industrial output and are thought to be a good leading indicator of future inflation trends.

Import Prices

Import and export price indexes are published by the Bureau of Labor Statistics and are used to deflate monthly merchandise trade figures. Given the volatile nature of petroleum prices, the markets tend to focus more on nonpetroleum import and export price indexes to see if import prices can influence domestic inflation, and if export prices can tell of the relative competitiveness of exported U.S.-produced goods. Price indexes are available for nearly all merchandise categories.

Reuters/Jefferies CRB index

The Reuters/Jefferies CRB index is published daily and is an arithmetic average of 19 commodity futures prices from six broad categories—grains, soft commodities, energy, industrials, precious metals and livestock. The large number of agricultural goods in the index means that it can be heavily influenced by the effects of weather or natural disasters on crop prices. Also, commodity prices tend to be highly volatile as they are extremely sensitive to small changes in supply and demand and represent prices at the earliest stage of production.

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