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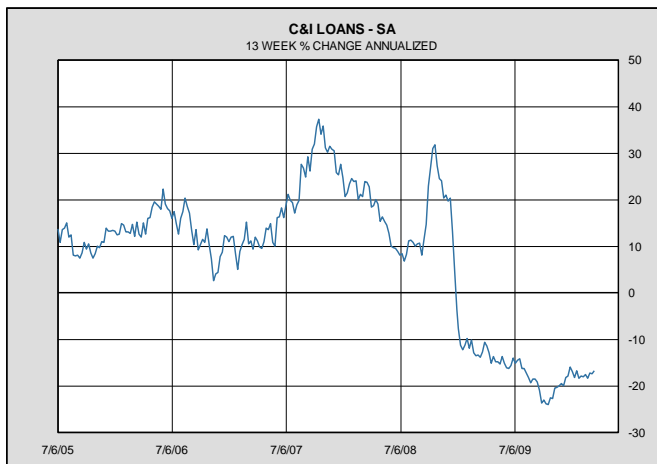
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Inflation Boogeyman at Bay

Back in 2008 I wrote that in spite of rising producer prices and high energy costs, we were actually entering an era of deleveraging which would cool inflation ([Out with the Inflation Boogeyman, In with the Consumer Zombies](#)). A few trillion dollars in Treasury debt issuance and Federal Reserve balance sheet expansion later, how about now? With bad debts still unwinding and weighing on non-federal outlays, we doubt that a monstrous inflation can pounce anytime soon:

Private Sector Still Deleveraging

Today's Fed report on consumer credit showed contraction at a -5.6% annualized rate, more than undoing January's brief glimmer of credit growth. Consumer credit has dropped in 15 of the last 17 months now. Similarly, as the chart below shows, commercial and industrial borrowing keeps falling at a double digit annualized rate:



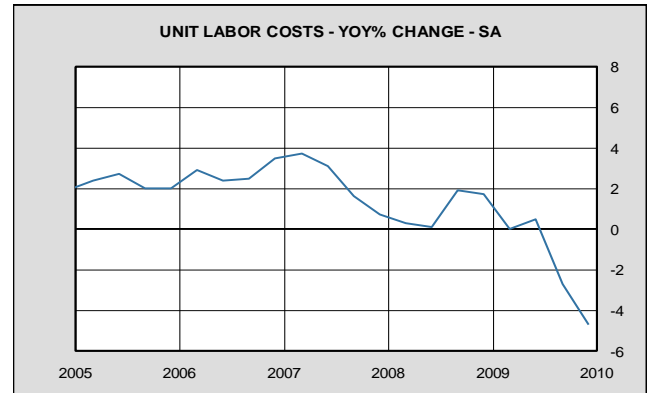
Source: Haver Analytics, Northern Trust.

Consider also a marginally shrinking M2 money supply, and there isn't enough financial liquidity on hand to fuel an inflationary fire just yet.

Soft Job Market, Good Productivity

The weak jobs picture is familiar to you all: a headline unemployment rate of 9.7%, and a more inclusive U-6 rate of 16.9% constituting a deep "shadow" surplus of available labor when hiring starts up. Then there's the poor character of wages – an hourly earnings growth rate whose year-over-

year descent has been steepening, which has helped unit labor costs fall below -4%:



Source: Bloomberg, Northern Trust.

Lower unit labor costs mean higher productivity – an unalloyed good from the perspective of profit margins – but combined with a pokey household income picture and sluggish aggregate demand suggest price hikes are neither necessary (margin-wise) nor even obtainable. With capacity utilization barely above 72%, there's slack aplenty to pull back on line before rising demand volumes can suck up capacity and buoy pricing power.

Tame Direct and Indirect Measures of Inflation

The Consumer Price Index (CPI) is up just 2.1% from early 2009's deepest despair – in spite of rising commodity prices – and the index of Core PCE (Personal Consumption Expenditures) has been bobbing along under 2%. As an indirect, market-based measure of prospective inflation over a ten-year horizon, the TIPS breakeven rate of 2.3% is hardly in nose-bleed territory.

Negative Stimulus at State and Local Levels

Unlike Congress, state legislatures and local governments don't have the power to persist for years in spending beyond their revenues. When revenues fall, projects get mothballed, services shrink, and payrolls suffer. While the Feds have eased municipal access to credit, they haven't stanch the bleeding from municipal budget cuts.

So have we "gone dovish" on you?

I don't think so. The potential for nasty inflation when the domestic credit pendulum swings back the other way concerns us. Even more, we worry the federal government will slip into thinking that the measures it took to quell the crisis can be modulated easily enough that they can be made permanent. But these threats lie beyond 2010. For now the Boogeyman holds at bay, and the skulking minions of debt deflation haunt day and night.