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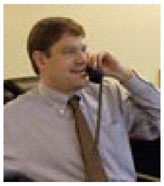

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Out with the Inflation Boogeyman, In with the Consumer Zombies

"Life imitates art..."
Oscar Wilde

September is early to be hauling out Halloween metaphors, but in the spirit of all things retail creeping ever forward on the calendar, I say *what the heck*, because this month I am talking about scary stuff: the cost of living, and how most Americans won't be able to sustain their spending habits at higher prices.

I have pointed out for a few years now how price hikes in energy (and lately food) were galloping ahead of core CPI (which excludes both, disingenuously, as "noncore") and I've surmised that those increases, combined with household overleverage, would ultimately clamp down on US consumers' ability to keep buying discretionary items such as second homes, third cars, overseas vacations for preschoolers, jewelry for the cat, personal espresso makers imposing as a Cray supercomputer (albeit with more nickel and brass, not to mention far neater *whooshing* noises) and the like. This year it has become part of the received wisdom that inflation lives and breathes, and breathes fiery at that. Not yet part of the consensus, however, is the profound implication of consumers finally hitting their limits.

Inflation actually alarms us less now than a year ago. Keep in mind, it's a lagging indicator: It follows in the business cycle's traces rather than crying its approach. We're *all* aware of the retrospective fact that prices are higher than before, but investment decisions must be guided by a *prospective* rationale.

Here's what informs ours.

First off, inflation won't run rampant without financing… and the financing mechanism is broken because collateral (real estate foremost) and financial accommodation (willingness and ability to make loans or support new security issuance) are reeling – asset <u>deflation</u> is real, pervasive, and worsening, and credit contraction promises no relent as we enter an era of deleveraging. Second, while the producer price index (PPI) has continued to rise at an alarming clip, changes in what you and I pay for stuff (CPI) have not kept pace; we read this as an aggregate lack of pricing power indicating that profit margin compression will concern us more as stock investors than will headline inflation alarm us as bond investors. Third, unit labor cost increases have decelerated over the last four quarters, while capacity utilization has edged down, unemployment has climbed to 5.7%, and payrolls have declined for seven months straight. Such an environment will be hostile to any wage-price spiraling.

So what do we make of the higher consumer prices in food and fuel, which, however retrospectively quantified, *are* real, *are* painful and *do* seem unlikely to retreat significantly? This: rather than spurring further and broad price increases, they will constrain them. When considered in combination with an environment of decelerating incomes, food and energy price hikes are tax-like insofar as they impose a largely inescapable burden which will displace spending on other things. The consequent shrinkage in aggregate demand will be inimical to broad inflation.

One question to ponder: How much of the 3.3% stirring in 2nd Quarter GDP was a retained reflex of consumers' former lives, of routines inculcated back when they actually had money, or at least access to affordable credit? How much of it was just a primitive spasm elicited by federal efforts at jumpstarting a corpse via one-off, bread-and-circuses tax rebates? As someone who squandered hours of his youth watching horror movies, I'm qualified to attest this much: when the zombies rise and walk the earth, the first place they head – and I'm not kidding – is for the shopping mall, where despite much lurching about, they don't actually buy anything. Is that what we can expect from late 2008 going into 2009, the living aping the undead aping the living? Scary stuff in a consumer economy… but then sometimes life imitates *bad* art.

William A. Harris, CFA