



Inflation Observatory

March 18th, 2009

Downward pressure remains contained

- Energy prices drove the increase in headline inflation
- Price increases were widespread across core components
- Downside risks due to increasing economic slack

Core CPI increased for the second straight month

February's headline consumer prices exceeded our expectations by coming in at 0.4%, compared to our forecast of 0.3%. This is the second month in a row of positive headline inflation after falling in the last three months of 2008. The index was boosted predominately by a 3.3% increase in energy prices, which added 0.3pp to inflation. Even though electricity and natural gas prices exhibited no change, gasoline prices greatly impacted headline inflation by soaring 8.3%. On the contrary, a 0.1% decline in food prices subtracted 0.1pp from the overall index. The increase in food away from home was more than compensated by the decrease in food at home. Looking forward, energy prices may have a negative impact on March's headline CPI because, thus far, the average price of gasoline has remained relatively stable and the price of natural gas has fallen.

Core consumer prices, on the other hand, met our expectations by increasing steadily at 0.2%. In contrast to January when shelter prices largely influenced inflation, February felt no effect from that sector. The 0.1% rise in rent of primary residences and owner's equivalent rent was offset by a 1.8% fall in the cost of lodging away from home. In fact, this month's figures saw a widespread increase across all other sectors, but were mostly driven by a 2.2% rise in the cost of private transportation. This category was primarily influenced by a 0.8% increase in the price of new automobiles, which rose for the second month in a row after falling for five straight months.

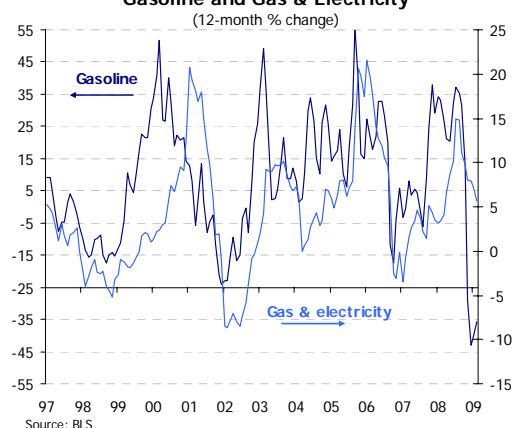
The results are in line with our baseline scenario

The core CPI figures are consistent with our baseline scenario of low but still positive core inflation for 2009. However, downside risks have intensified. For instance, February's PPI results highlight a downward trend in the core prices for intermediate goods and crude materials, suggesting that decreasing demand is exerting downward pressure on non-labor costs. Nonetheless, we do not expect the savings on inputs to be passed onto the consumer because wages, the primary production cost, are still increasing. In fact, wage growth has remained fairly steady over the past year at the average annual rate of 3.7%. This trend supports our view of that downward price pressure remains contained and that the Federal Reserve will keep the fed funds rate low for a prolonged period of time.

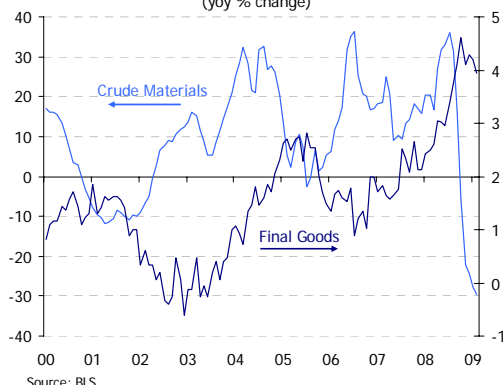
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Gasoline and Gas & Electricity



Core Producer Prices
(yoy % change)



Average Hourly Earnings
(yoy % change)

