



# Inflation Observatory

June 17th, 2009

## Core inflation is in line with our baseline scenario

- Rising energy prices offset falling food prices
- Core price increases were abundant across most components
- Core inflation is expected to remain low but positive

## Energy prices boosted May's headline inflation

May's headline consumer prices rose 0.1% after exhibiting no change in April. After falling for the previous two months, the energy index rose 0.2%. A 3.1% increase in gasoline prices offset the 1.8% decrease in household energy prices, a component that has been on the decline since August 2008. Food, on the other hand, maintained a four month path of falling prices by dropping 0.3%. The cost of food consumed at home dropped 0.5% for the sixth month in a row, whereas that of food away from home, a component that has been increasing since January 2003, did not change in May. On a year-over-year basis, headline inflation dropped 1.3%, the third consecutive negative monthly change.

Excluding food and energy, core consumer prices also increased by 0.1%, which is the smallest monthly change since December 2008. In the previous two months, core inflation was supported by large increases in the price of tobacco products, but that component dropped 0.3% in May. The shelter component rose 0.1%, exhibiting widespread increases across rent, lodging and owners equivalent rent. Prices of new and used automobiles also contributed positively by rising 0.5%, within which prices of used autos increased for the first time in fifteen months. Furthermore, the medical care and education and communication components both rose 0.3%, whereas apparel dropped 0.2%, led by decreases in prices of apparel for women, girls, infants and toddlers. On a year-over-year basis, core inflation rose 1.8% in May. In total, it has averaged a 1.8% yoy increase thus far for 2009, compared to a historical average of 2% yoy.

## Core inflation expected to remain low but positive

May's core CPI figures are in line with our baseline scenario of positive but low core inflation for 2009. Even though economic slack persists, with producer prices for core and intermediate goods on the decline, businesses may see higher margins and experience less pressure to lower prices in response to weak demand. Furthermore, rising inflation expectations, the anticipated increases in government spending, the Fed's expansionary monetary policy and increasing labor costs are expected to keep inflation positive. Consequentially, 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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