

U.S.

Economic Watch

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Economic Research

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Inflation: May 2010

Consumer prices continue to decline

- **Falling energy prices keep headline inflation under control**
- **Downward trend in core inflation seems to be bottoming out**
- **Federal Reserve is likely to continue to keep its policy rates “low for an extended period of time”**

Consumer prices decreased for second straight month

In line with the consensus expectation, consumer prices declined 0.2% in May after falling 0.1% in April. This is the highest drop in headline inflation since December 2009 when it dropped 0.7%. The main driver of the decline is the falling energy prices. Energy prices decreased 2.9% from April to May. Although all major energy indices declined, gasoline prices had the most significant effect on overall prices. Gasoline prices dropped 5.2% in May. With this decrease, consumer prices increased 2.0% last year in spite of a 14% decrease in energy prices in the same period. Inflation has been decreasing since December 2009.

On the other hand, core prices, measured by consumer prices excluding energy and food prices, increased 0.1% in line with market and our expectations. This is the highest increase in core prices since October 2009. However, core inflation continued to decline on a YoY basis. Last year, core prices increased 0.9% which is the lowest level since 1963. Shelter, used cars and trucks, tobacco, apparel and medical care are some of the subcomponents of consumer price index that have a positive contribution to inflation. Shelter and medical care components increased 0.1% while apparel and education prices increased 0.2% and 0.3%, respectively.

Headline and core inflation are likely to be low but positive in 2010

Although core inflation continued to decrease, there are signs that the downward trend in core inflation is reaching an end. Shelter prices including owners' equivalent rent (OER) and rent components seem to break their negative trend. The rent component, for example, has been increasing for five months out of last six months. Change in their negative trends can be detected better from the perspective of a three-month period. With the recovery of all other housing components which constitute 42% percent of headline inflation, we are expecting core inflation to start increasing.

Along with the easing in shelter prices, high unemployment, and low capacity utilization, substantial economic slack will continue dampening inflation. Although we are expecting stronger growth in 2Q10 compared to 1Q10, it will take some time to wipe out the economic slack which makes a low but positive inflation scenario in 2010 more likely. Therefore, a decrease in YoY inflation in the last five months should be seen as a period of disinflation rather than deflation.

Low inflation will ensure low interest rate for an extended period of time

Both headline and core inflation are lower than Federal Reserve's target and give the Federal Reserve a relief for its loose monetary policy. Inflation expectations continue to be stable and remain well anchored. Economic growth is expected to be moderate and it is likely that the Fed will continue to keep interest rates low for extended period of time, at least until 1Q10. Therefore, we are expecting no rate changes in the FOMC meeting next week.

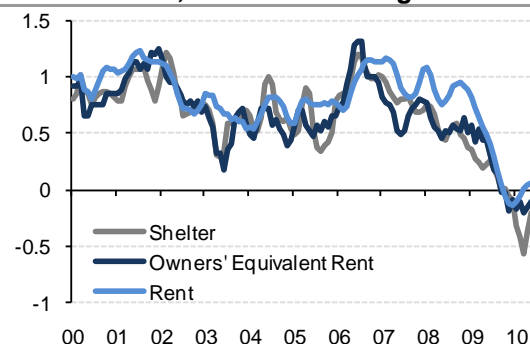
Table 1
CPI Forecasts

	Headline	Core
Date	yoy	yoy
Mar 10	2.3	1.1
April 10	2.2	0.9
May 10	2.0	0.9
June 10	1.9	1.1
July 10	1.9	1.2
August 10	1.9	1.4
2009	-0.3	1.7
2010	2.0	1.5

*Forecasts are in bold

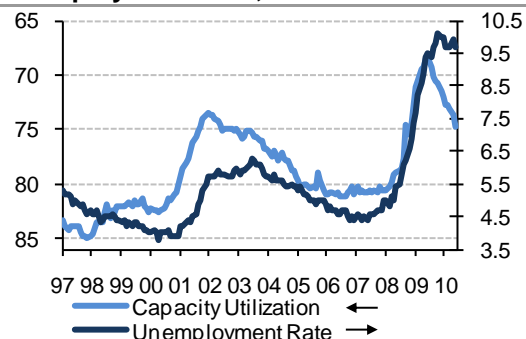
Source: BLS and BBVA Research

Graph 1
Shelter Prices, 3 month % change



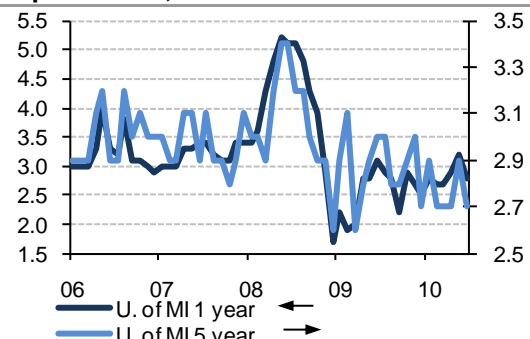
Source: BLS

Graph 2
Capacity Utilization (inverted scale) and Unemployment Rate, %



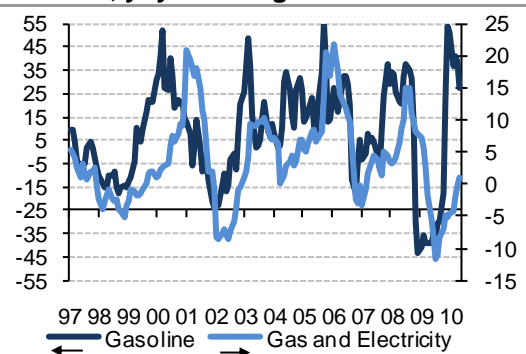
Source: BLS and Federal Reserve

Graph 3
University of Michigan Inflation Expectations, Index



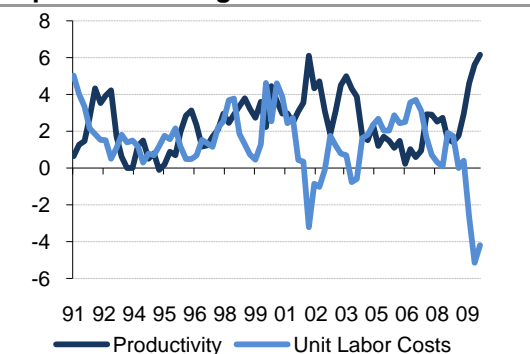
Source: University of Michigan

Graph 4
Gasoline, yoy % change



Source: BLS

Graph 5
Productivity and Labor Costs, non-farm, 4-quarter % change



Source: BEA

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