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FIRST Trust ADVISORS L.P.

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Monday Morning Outlook

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More Inflation: On Its Way

We can't explain it, but the bond market somehow ignored Friday's absolutely ugly data on import and export price inflation. With even more unpleasant reports due this week (for producer and consumer prices), we will see if the market can still keep its eyes closed tight.

Import prices increased 2.8% in March and are up 14.8% versus a year ago, the largest gain on record (data goes back to 1983). The jump in import prices is largely due to oil, which is up 60% versus a year ago. However, even after excluding oil, import prices were up 1.1% in March, the most on record, and are up 5.4% versus last year, the most since the late 1980s.

Our analysis shows import prices (ex-oil) tend to lead consumer prices (ex-energy) by about a year, meaning the underlying trend in consumer price inflation will continue to rise through at least mid-2009.

To make matters worse, inflation expectations are starting to become unhinged. Friday's University of Michigan consumer sentiment survey found that consumers expect inflation to be 4.8% in the next year – one of the highest inflation expectations on record since 1982. One reason this is significant is that Fed officials have repeatedly said inflation expectations remain contained. In fact, they argue that low expectations give them room to maintain a more accommodative policy. With expectations rising so sharply, the Fed's argument will now be tested.

Recent news stories show inflation is not just a domestic issue. Commodities (such as food, energy, metals) are acutely sensitive to monetary policy and commodity–based economies are suffering high inflation.

In the past year, consumer prices are up 12.7% in Russia, 8.7% in China, and 19.4% in Vietnam. The city-state of Singapore, where consumer inflation averaged 2% per year for 25 years, now has 6.5% inflation, the highest since the early 1980s. Some of these countries have begun to institute "price controls," a very dangerous development.

Although foreign central banks should be held accountable for their own mistakes, the Fed's looseness has made their jobs tougher. The Fed is not just the central bank for the US, it is the central bank for the "dollar world," which is everywhere that uses dollars or has a currency linked to the dollar (either directly, via a peg, or indirectly, because the foreign central bank uses exchange rates to guide local monetary policy).

If the US were the only country in the world then a loose Fed would quickly lead to higher inflation in the US. But with globalization, the production process is more diversified than it used to be, with more commodity-related production overseas. So when the Fed is too loose, inflation rises in the "dollar-world periphery" before heading home. The US bond market won't be able to ignore this forever.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-14 / 7:30 am	Retail Sales - Mar	+0.0%	**+0.4%**	0.2	-0.6%
7:30 am	"Core" Retail Sales - Mar	+0.2%	**+0.5%**	0.1	-0.2%
7:30 am	Business Inventories - Feb	+0.4%	**+0.5%**	0.6	+0.8%
4-15 / 7:30 am	PPI – Mar	+0.6%	**+1.0%**		+0.3%
7:30 am	"Core" PPI - Mar	+0.2%	**+0.1%**		+0.5%
7:30 am	Empire State Mfg Index - Apr	-17.0	**-15.6**		-22.2
4-16 / 7:30 am	CPI – Mar	+0.4%	**+0.4%**		0.0%
7:30 am	"Core" CPI - Mar	+0.2%	**+0.2%**		0.0%
7:30 am	Housing Starts - Mar	1.003 Mil	**1.005 Mil**		1.065 Mil
8:15 am	Industrial Production - Mar	-0.1%	**-0.2%**		-0.5%
8:15 am	Capacity Utilization - Mar	80.3%	**80.1%**		80.4%
4-17 / 7:30 am	Initial Claims - April 12	370K	**360K**		357K
9:00 am	Philly Fed Survey - Apr	-14.8	**-14.8**		-17.4
9:00 am	Leading Indicators - Mar	-0.1%	**+0.1%**		-0.3%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.