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First Trust

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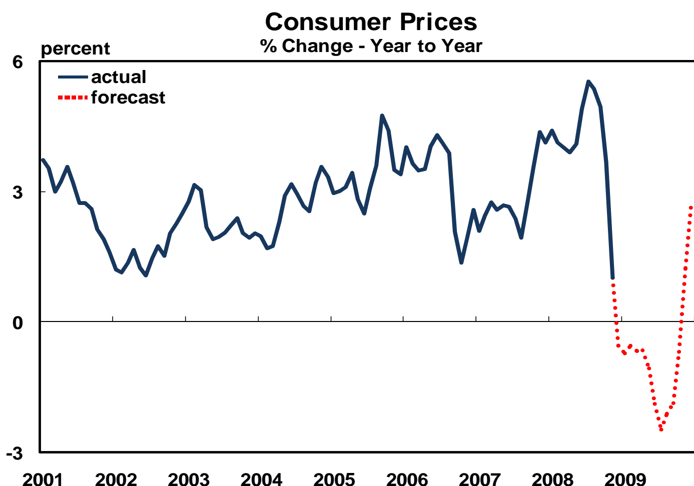
Economic Commentary

CPI Deflation On Tap – But It's Just Temporary

During the year ended July 2008, the consumer price index increased 5.6%, the fastest pace since 1990-91. Since then consumer prices have fallen rapidly, including consecutive drops of 1.0% in October and 1.7% in November – the steepest monthly declines since the 1930s.

One main factor explains the sudden drop in consumer prices – plummeting energy prices. Oil prices peaked at $145/barrel in July and fell as low as $34/barrel in December. Meanwhile, natural gas prices fell from a peak of $12.96 per million Btu in July to a December low of $5.38.



However, there is a second factor. Following the failure of Lehman Brothers, and the resulting panic by consumers and businesses, the economy suffered a huge decline in the velocity of money (the speed of money turnover). This drop in monetary velocity reduces nominal GDP, which in turn impacts both real economic growth and prices. While the velocity drop was manifested mainly in the energy market, the "core" CPI fell 0.1% in November.

Our calculations suggest consumer prices continued to decline in December, dropping about 1.2%. If this holds true, the CPI in December 2008 was 0.6% *below* where it was in December 2007, the first time the price level has declined over a twelve month period since the 1950s.

As we drop off the high monthly inflation readings from early 2008 (when oil prices were skyrocketing), the year-ago price comparisons will become even more negative early in 2009. Our models suggest monthly inflation readings averaging about 0.2% per month in 2009, but even with these increases, the year-over-year comparisons will fall even further into negative territory, pushing annual CPI deflation down to as low as -2.5%.

However, we do not expect deflation to become persistent. As we explained in December ("Fed Balance Sheet Expansion is Not Hyper-Inflationary," December 23, 2008), year-ago price comparisons are likely to show inflation re-appearing by late 2009 and intensifying in 2010.

As a result, the current period of an extremely rapid drop into deflation is likely to be followed by a period of extremely rapid re-acceleration of inflation (see chart to the left – forecast in red). Not only is the federal funds rate at rock-bottom low levels but currency in circulation as well as both the M1 and M2 measures of money supply have expanded rapidly in the past several months. We suspect the Federal Reserve will not take its foot off the monetary accelerator as quickly as it should when the economy begins the recover this spring. With a time lag, an inflation problem will be the inevitable result.

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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.