

## MONTHLY ECONOMIC COMMENTARY JANUARY 2008

### A WHIFF OF “STAGFLATION”

In the wake of ongoing financial market volatility, the U.S. economy did not do particularly well in January. During the month we saw retail sales rise only a small amount, after falling in December. In addition, manufacturing activity basically stagnated and non-manufacturing apparently contracted during the month. And, on the demand side we saw a continued deterioration in consumers' sentiment about current economic conditions and the future. So, it was not too surprising that payrolls contracted last month for the first time in years and the unemployment rate remained (at 4.9%) close to the December's elevated 5% rate. Therefore, the real economy slowed to a crawl during the month, and may even have contracted a bit.

Moreover, January saw another month of higher inflation. “Core” inflation continued to tick upwards, with the “core” (excluding food and energy) Consumer Price Index (CPI) rising 0.3% during the month and 2.5% versus January 2007. Also, the overall CPI rose at a fairly rapid clip of 0.4% month-to-month and 4.3% year-over-year. In total, these numbers represented a continuation in the rising inflation trend (especially with respect to “core” inflation) that has been in place since late last year.

With the economy stagnant and inflation higher, we probably got a whiff of “stagflation” in January.

Indeed, this situation puts the Fed somewhat in a bind. After easing so aggressively in recent months, should they continue to ease now that inflation continues to march higher? Should they switch gears and worry more about losing their grip on inflation than forestalling recession? Thus far, the answer seems to be that they are concentrating their efforts on avoiding recession rather than arresting inflation. So, we still look for the Fed to cut interest rates again by 50 basis points on March 18th, but not ease beyond that. To cut more beyond that point could seriously jeopardize the Fed's inflation fighting credentials.



Meanwhile in January, financial markets continued to reflect the economic stagnation so evident during the month and late last year. Equity markets continued to contract and high-yield bond spreads rose to recession-like heights as investors continued to lose their appetites for risk. Reflecting these diminished risk appetites, Treasuries continued to rally during the month with the average yield on 10-year notes falling to 3.74% from 4.10% in December.

In sum, the real side of the U.S. economy appeared stagnant last month and inflation continued to tick higher. We experienced a whiff of “stagflation” during January. Hopefully, the Fed’s monetary stimulus, largely already in place, will allow the economy to revive in coming months without sending inflation still higher. Only time will tell whether they can successfully navigate a course that results in an improved economy with well-contained inflation.

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