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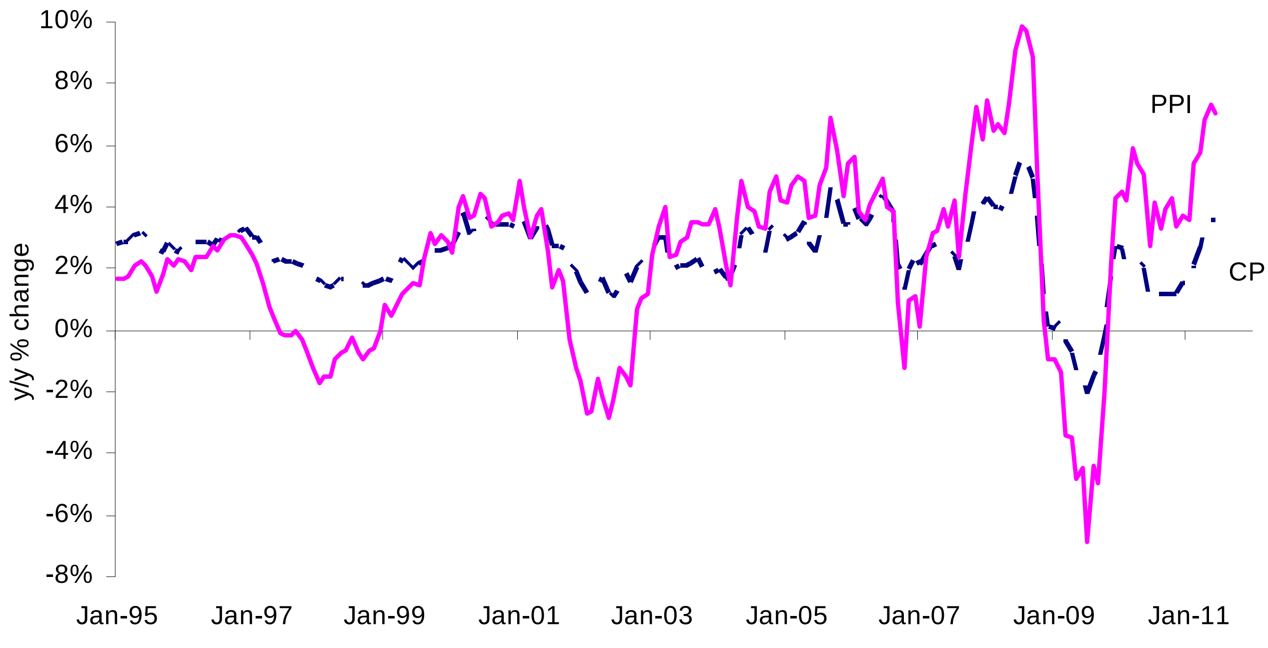
Inflation Should Fall, Then Rise Over Longer Term

CPI inflation held at 3.6% year-over-year in June, which is likely the peak for at least a year and a half as the 2010-2011 gasoline price bulge (one of several damaging costs from QE2) drops out of the year-over-year calculation.

- CPI inflation is likely to decline for the rest of this year, falling below 3% by December. The decline in gasoline prices caused a 0.2% CPI decline in June from May and will have a strong influence on the ups and downs in headline CPI. With the dollar weak and gold prices at a new record, we expect renewed gains in oil and gasoline when growth picks up in the second half and into 2012, but probably not enough to push CPI back above 3.6% again until late 2012.

- The producer price index rose 7.0% year-over-year, after the 7.3% peak in May.

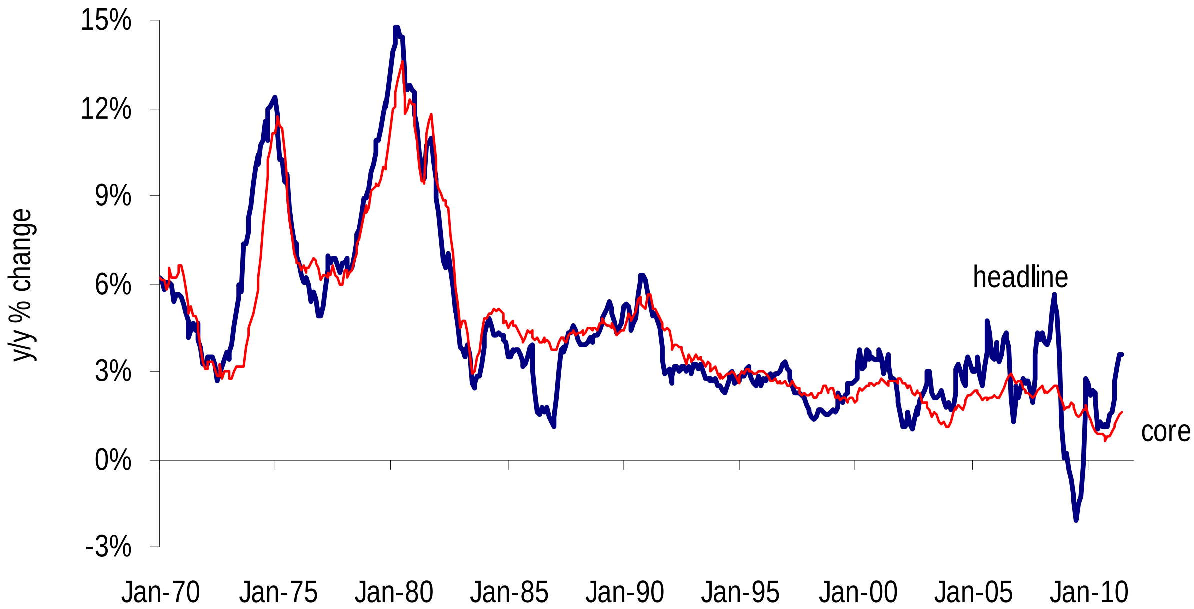
PPI and CPI Y/Y (last obs. June 2011)



Source: Bureau of Labor Statistics; Encima Global

- Excluding food and energy, core CPI rose 0.3% in June to 1.6% year-over-year and will likely top 2% by year-end despite the Federal Reserve's continued policy focus on deflation risks. Core PPI also rose 0.3% in June, reaching 2.4% year-over-year, the highest in two years.

CPI and Core CPI Y/Y (last obs. June 2011)

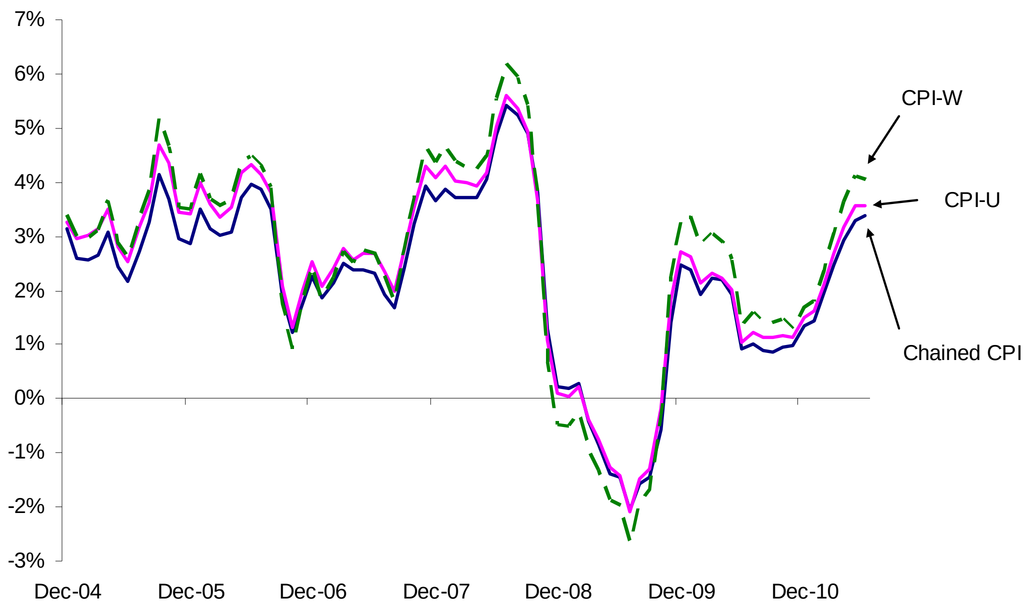


Source: Bureau of Labor Statistics; Encima Global

- Social security recipients will get a cost of living adjustment beginning in December (the SSI increase begins in January). The increases are normally announced in mid-October based on year-over-year CPI inflation for urban wage earners in the third quarter. In 2009 and 2010, this calculation led to no COLA because inflation had gone negative after the oil price crash in the second half of 2008. As a result, this year's COLA will be based on the three-year cumulative inflation from Q3 2008 through Q3 2011. By our estimate, this will create a COLA of 2.6% starting in January using CPI-W. Under the chain-weighted CPI, the COLA would be 1.8%.

- CPI-W, the inflation measure for Urban Wage Earners and Clerical Workers, is the basis for social security's COLA calculation. It was up 4.1% year-over-year through June. It tends to be more volatile than the headline figures. The debt limit discussions have considered switching the social security COLA (and also the bracket creep problem in the income tax system) to the chained CPI. It is up 3.4% year-over-year.

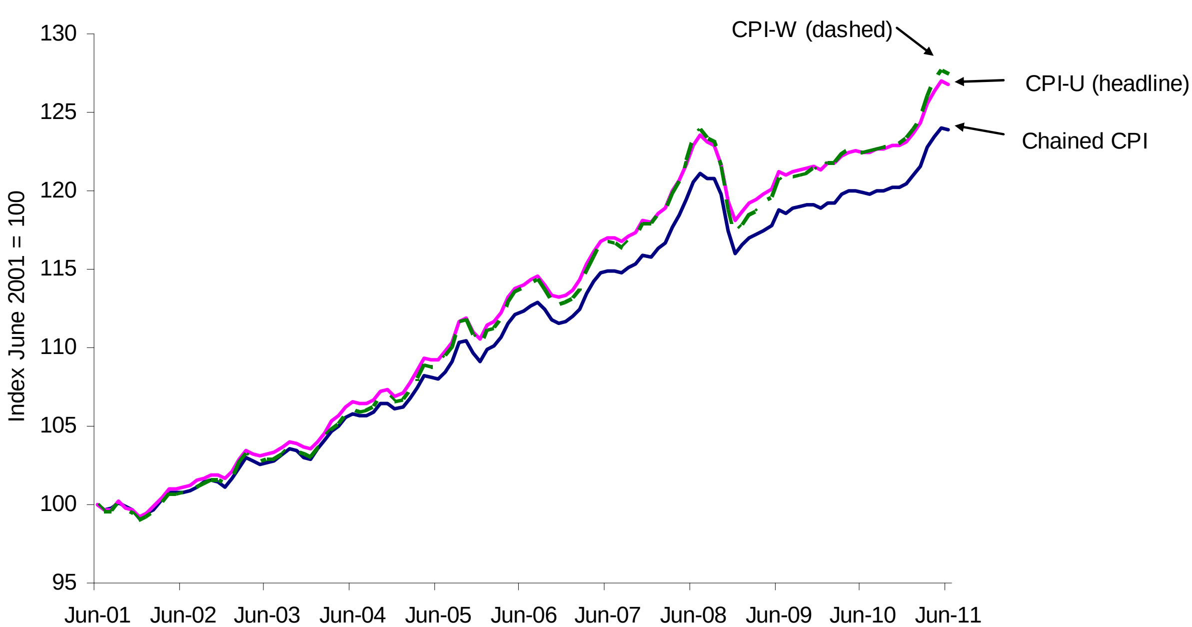
CPI Variations Y/Y (last obs. June 2011)



Source: Bureau of Labor Statistics; Encima Global

- Over the last ten years, the chained CPI index grew about 2.8% less than the current CPI-W social security COLA measure. The headline inflation index (CPI-U) grew 0.5% less than CPI-W.

CPI Variations (last obs. June 2011)

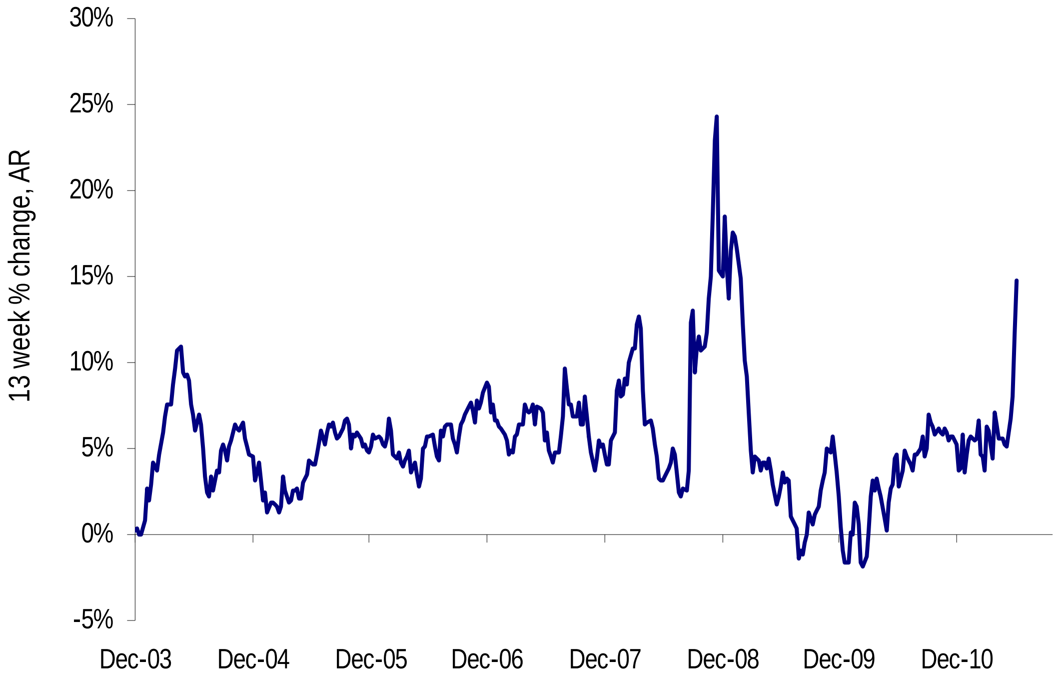


Source: Bureau of Labor Statistics; Encima Global

Looking longer-term, there's substantial uncertainty in the inflation outlook for at least three reasons:

- The U.S. has converted from a monetary policy based on the Fed funds rate to a credit rationing policy through regulators. We don't have any experience with this approach. Banks hold excess reserves, blocking the normal transmission mechanism from the expansion in the Fed's balance sheet to increased bank lending. Private sector credit didn't rise during QE2, but could rise rapidly if regulators allow some banks to add leverage. Europe's huge policy rift over bank stress tests and what qualifies as core capital bears on the question of whether the enormous cash balances at banks will be mobilized in a way that accelerates nominal GDP growth and inflation. We note the recent pickup in M2 money supply growth (up at a 14.8% annual rate in the last 13 weeks.

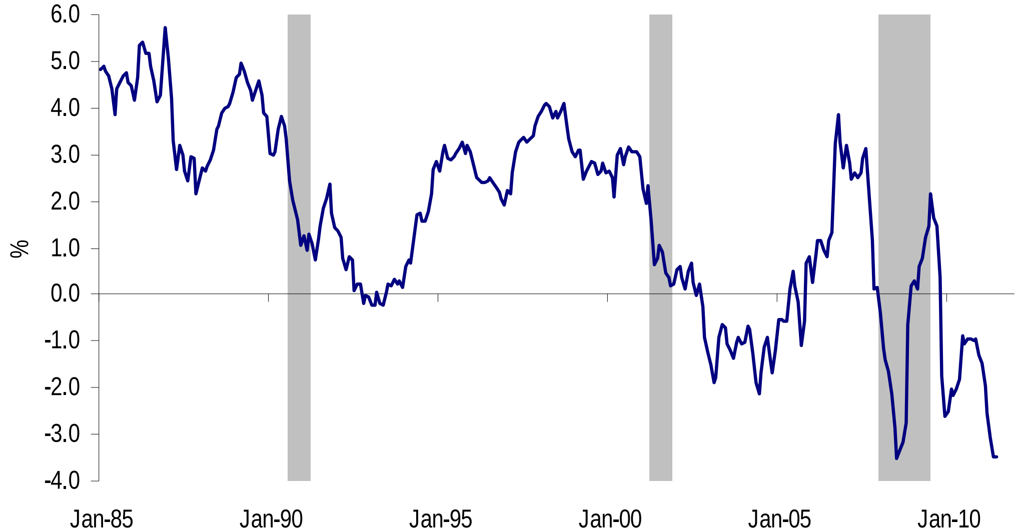
M2 13 week annualized growth (last obs. July 4, 2011)



Source: Federal Reserve; Encima Global

- The real Fed funds rate is even more deeply negative than in the over-flowing punchbowl policy in the previous decade. Many countries piggy-back on U.S. monetary policy but without the same regulatory control over their banks, creating an uncertainty in both the U.S. and global inflation outlook.

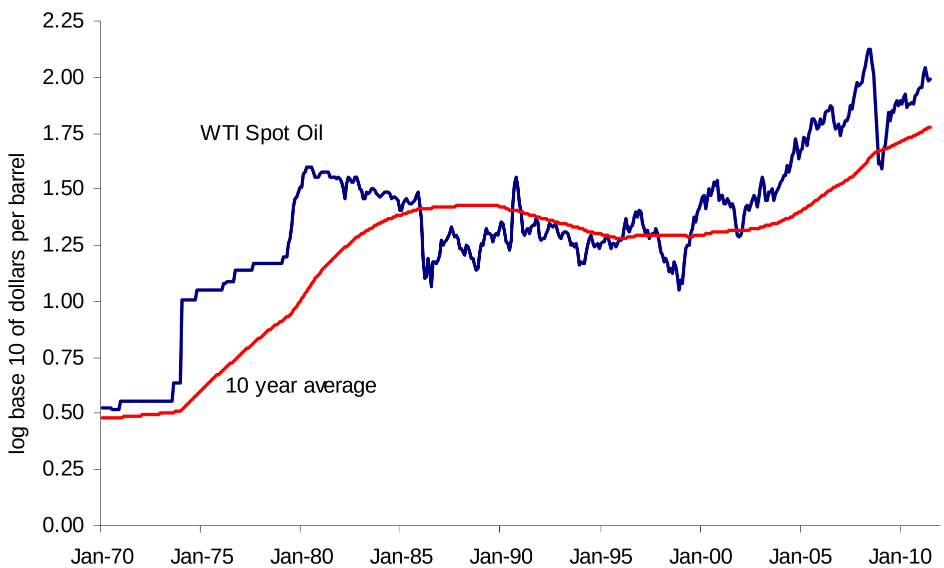
Real Fed Funds Rate (using headline CPI, last obs. June 2011)



Source: Federal Reserve; Bureau of Labor Statistics; Encima Global

- The weak-dollar policy is deeply harmful to the economy and jobs and could be reversed at any time, changing gold and commodity prices substantially and changing the long-term inflation trend. With the dollar weakening and gold rising, we think oil prices are still in an uptrend that may not fully stop until the U.S. changes monetary policy (see Volcker's impact on oil prices in 1979 and 1980.)

Crude Oil Price in Log Scale (last obs. July 15, 2011)



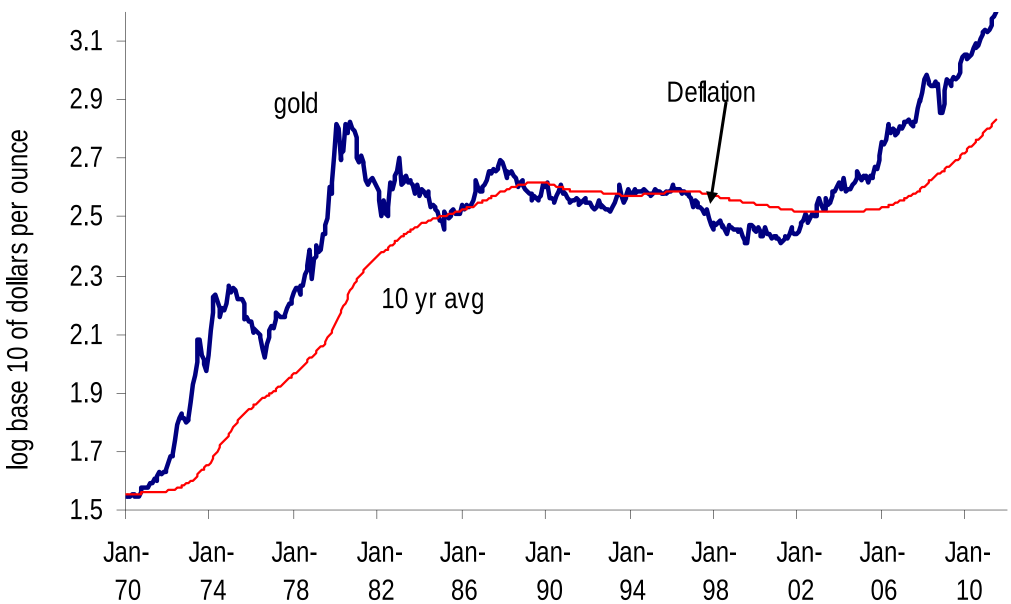
Source: Wall Street Journal; Encima Global

Our longer-term inflation view is that U.S. headline and core inflation trends will accelerate over the next ten years as the general price level adjusts to the devaluation of the dollar over the last decade and to the application of a near-zero Fed funds rate well into the expansion.

- We disagree with the view that QE2 was money printing and highly inflationary. Since the excess reserves were not lent, the inflationary impact of QE2 will depend on future regulatory policy and whether banks are allowed to increase their lending. (We criticized QE2 for other reasons – an expansion of the Fed's power, a harmful shortening of the maturity of Treasury debt, a permanent new tool the Fed will be expected to use whenever growth slows, a harmful distortion of short-term and long-term credit markets.)

- As a measure of dollar weakness, we note high and rising gold and commodity prices. There's a very long lag before dollar weakness passes through core inflation because many goods and services take years before prices are increased (for example, bus fares, electricity prices, long-term leases, Chinese pricing models, etc.) The uptrend in core inflation rates will accelerate if house prices stabilize and begin to rise in 2012 (as we expect), since housing-related prices is a 41% component of core CPI.

Gold Price in Log Scale (last obs. July 15, 2011)



Source: Wall Street Journal; Encima Global