



Much to nobody's surprise, inflation data reported today showed another slight increase. Two things are important to focus on: First, the CPI (Consumer Price Index) strips out the price of food and gas, which is where the greatest price hikes have resided. Secondly, the "slight increases" added together is becoming a rather large number; +4.2% since last summer.

We have spoken (and written) ad nauseam about inflation and "real inflation" as it applies to the US consumer, because there is such a disconnect from what the Federal Reserve watches and what we pay. The reason they do this is historically food and energy costs have been so volatile that they skewed the results. Regardless, it seems more logical to analyze the true impact rather than a select portion. Imagine being able to strip out Chemistry when calculating your GPA in school, or scraping that parked car when taking your drivers test. Personally, I wish I could have stripped out that second box of diapers from my grocery bill last week. According to the Bureau of Labor Statistics, the compounded rate of inflation for gasoline is 36.6% for the last 2 years. Utilities are +16.5%, Food +10.1% and Medical +8.6%. This is that "real inflation" that we have discussed.

For most of the decade, inflation has been low because we have been basically importing deflation from overseas; particularly China. Cheap labor reduces the cost of manufactured goods, and with the expansion of the "Big Box" stores like Wal-Mart, Costco and Target, etc, pricing power made virtually all retail products cheaper. However, with the rise in commodity prices and the growth in emerging markets, input costs have surged, and wages for workers have climbed too. And if you think inflation is becoming a problem here, China and India are both seeing an 8% rise, and it's 12% in Russia. This inherently is driving the prices of their exports. This issue is entirely out of the Federal Reserves control.

Interest rates, which are the real price of money, have been on the rise too. After 18 months of rate cuts, the Market has begun to price in its first hike as early as August. Our sense is that won't happen since the sluggish economy would be further damaged by an increase this early. In addition, it appears that Bernanke is anticipating the slowdown to reduce demand for finished goods as well as energy which will take inflation down with it.

The rise in interest rates has priced in a lot of the risk. Spreads over Treasuries are the widest we've seen in years, and Junk Bonds are finally trading like junk. Even higher quality Corporate Bonds have sold off, sending their interest rates higher, particularly with Financials as the need for capital has spiked and the perceived risk associated with it has risen too. This has forced the yield curve to steepen, which is generally a bullish sign. Lower oil and a stronger US Dollar will help support this trend. The Bond Market, which historically has been the best indicator of future returns is suggesting there is reason for optimism down the road. Unfortunately, getting there continues to be a chore. As our favorite linguist Yogi Berra said; "It's not too far, it just seems like it is", and "You've got to be careful if you don't know where you're going 'cause you might not get there."

INDEX	06.13.2008	12.31.2007	%Change
DOW JONES	12,307	13,265	- 7.22%
S&P 500	1,360	1,468	-7.36%
NASDAQ	2,454	2,652	-7.47%
Bond YIELD	4.26%	4.03%	5.71%*

Bond Prices



Bond Yield %



By Mike Frazier