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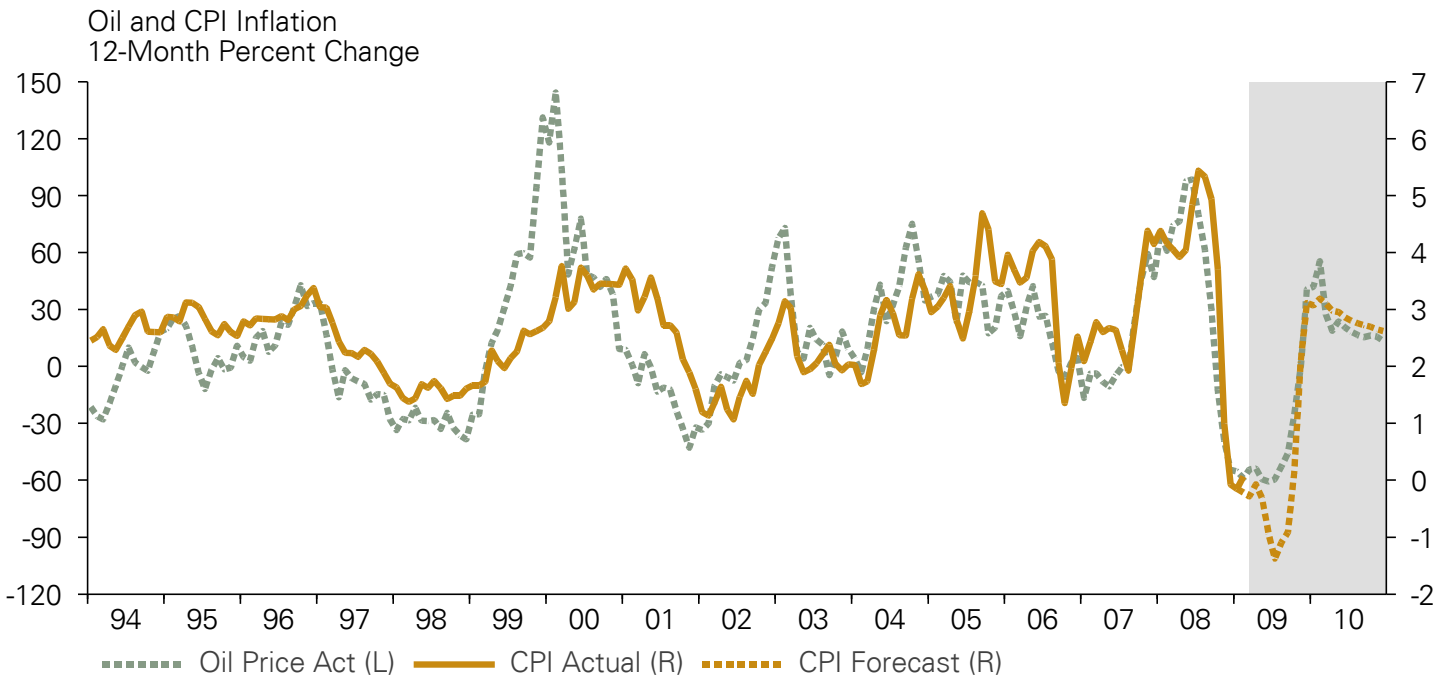
The unprecedented actions by the Federal Reserve to deal with the financial crisis and economic downturn have raised concerns about inflation. The substantial decreases in prices of houses and commodities amid widespread deleveraging smack of deflation. Our analysis indicates near-term deflation followed by a return to inflation.

Many years ago, as I pursued the Holy Grail of economic indicator forecasting, I was advised by one of the statisticians in Washington who helped compile the Consumer Price Index that the month to month fluctuations were random except for the influence of energy prices. The discussion led to a simple CPI forecasting equation that produces the results in the nearby graph, which shows the year-over-year percent changes in the monthly price of oil (dotted line; left axis) and the CPI (solid line; right axis).

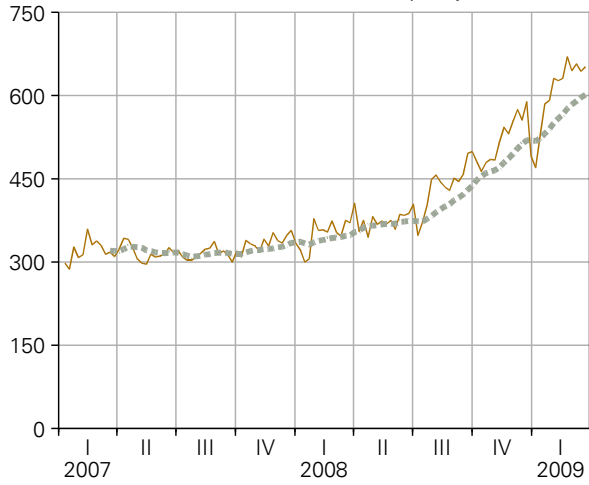
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The shaded area is the forecast period, which begins in March 2009. The forecast for the price of oil is from the futures market. The forecast for the CPI is from the forecasting equation. The equation has been very accurate in predicting the direction of inflation throughout the period shown. The equation accurately predicted a temporary spike in inflation in 2008 in real time, followed by a sharp reversal. Based on today's futures prices, the equation predicts year-over-year CPI deflation of 1% to 2% by mid-year, followed by a return to approximately 3% inflation by early 2010.

Jim Coons



Initial Claims for Unemployment Insurance
Thousands Per Week, Seasonally Adjusted



U. S. Dollar Exchange Rate
FRB Major Currency Index, 1973 = 100



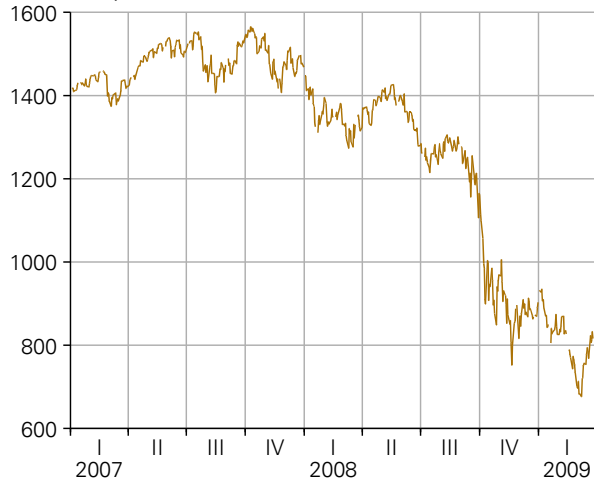
Price of Oil
West Texas Int, \$/bbl



Price of Gold
London PM Fixing, \$/oz



S&P 500 Stock Prices
Daily Close, Index 1941-43 = 10



Mortgage Loan Originations
MBA Purchase Index 3/16/90=100 SA

