DAILY GLOBAL COMMENTARY

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Despite Soaring Current Inflation, the Fed Remains On Hold

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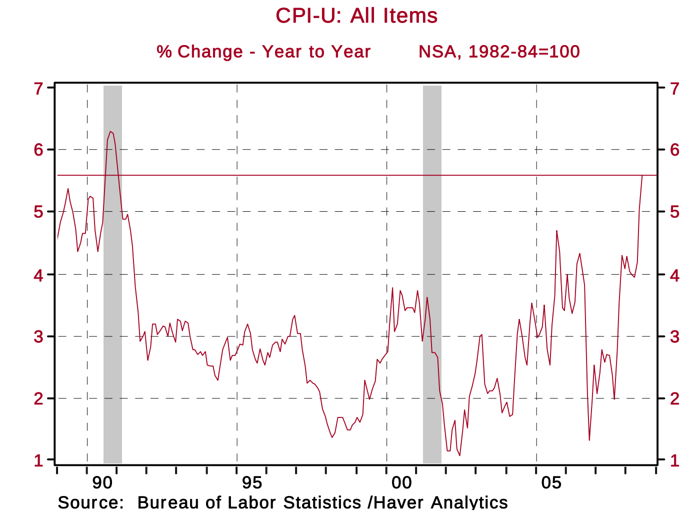
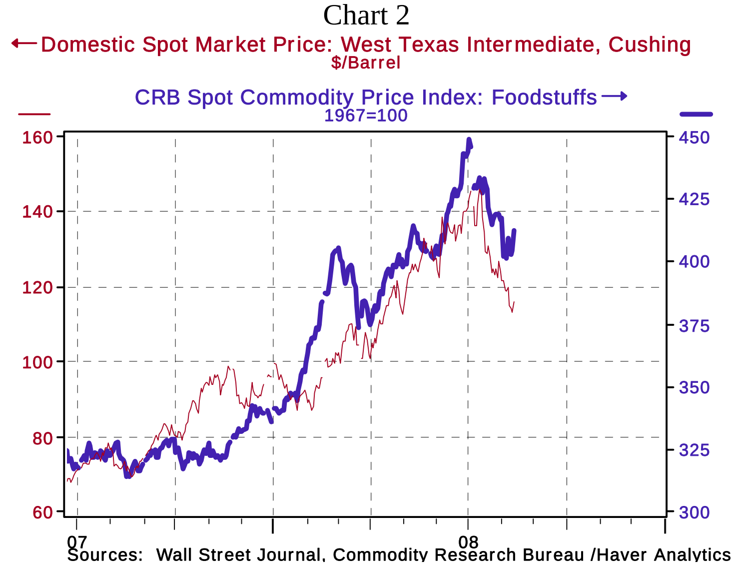
The Consumer Price Index (CPI) rose 0.8% in July after hefty increases of 0.6% and 1.1% in May and June, respectively. The Labor Department has indicated that the 4.0% increase in the energy price index accounted for half the gain in the overall CPI. The CPI rose 5.6% on a year-to-year basis in July, the largest jump since January 1991.

Chart 1



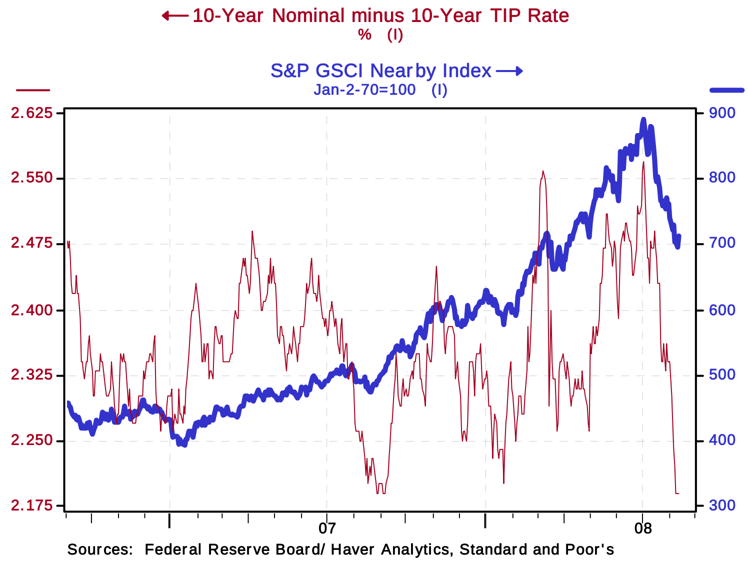
Energy prices have risen 33.1% in the first seven months of the year after a 17.4% increase in all of 2007. The food price index moved up 0.9% in July, putting the three-month annualized increase at 8.0%. In the January-July period, food prices have moved up at an annual rate of 7.6% vs. a 4.9% increase in all of 2007. The significant decline in energy and food prices in recent days suggests that the headline CPI index in August should be less alarming (see chart 2).

Chart 2



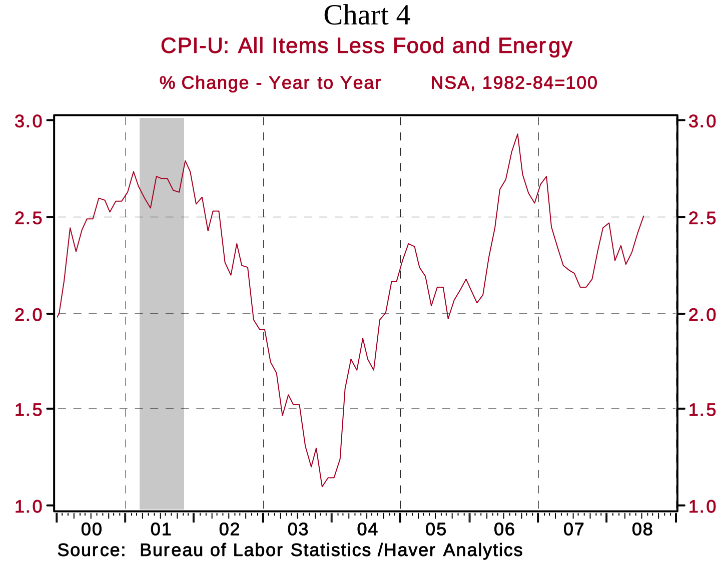
The recent sharp decline in commodity prices appears to have significantly lowered long-run market *expectations* of consumer inflation. Chart 3 shows that the yield spread between a 10-year nominal Treasury security and a 10-year inflation-protected Treasury security has fallen from a recent high of 256 basis points on June 30 to 219 basis points on August 13. If the market is less concerned about future inflation, so, too, is the Fed.

Chart 3



The core CPI, which excludes food and energy prices, increased 0.3% in July, matching the June gain. On a year-to-year basis, the core CPI is up 2.5% compared with a 2.4% increase in 2007. In July, there were widespread price increases for core items. Higher prices for air travel (+1.3%), apparel (+1.2%), recreation (+0.4%), education and communication (+0.5%) and more muted gains for shelter (+0.2%), new cars (+0.2%), and medical care (+0.1%) were highlights.

Chart 4



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Conclusion - The CPI's rapid ascent in the past three months undoubtedly remains near the top of the list of concerns of the FOMC. The recent decline in oil prices has reduced the anxiety about inflation somewhat. Although food prices are worrisome, the drop in these prices in recent weeks is reassuring. The grim reality is that the Fed and other central banks can only watch and wait for weakening economic conditions to translate into a moderation of inflation, which is entirely conceivable given the nature of incoming data (see chart 5). GDP in the Euro-area declined 0.2% in the second quarter, the first since record keeping for the Euro area commenced in 1995. Germany and France, the two largest economies of the group, recorded declines in real GDP of 0.5% and 0.3%, respectively, in the second quarter. Real GDP growth in Japan also fell 0.6% in the second quarter. Tax rebate dollars supported economic growth in the U.S. in the second quarter. By the next FOMC meeting on September 16, the FOMC will have another month's data for inflation, employment, and retail sales. Employment and retail sales should continue to show weakness and headline inflation will likely be considerably lower. Therefore, the Fed is firmly on hold.

Chart 5

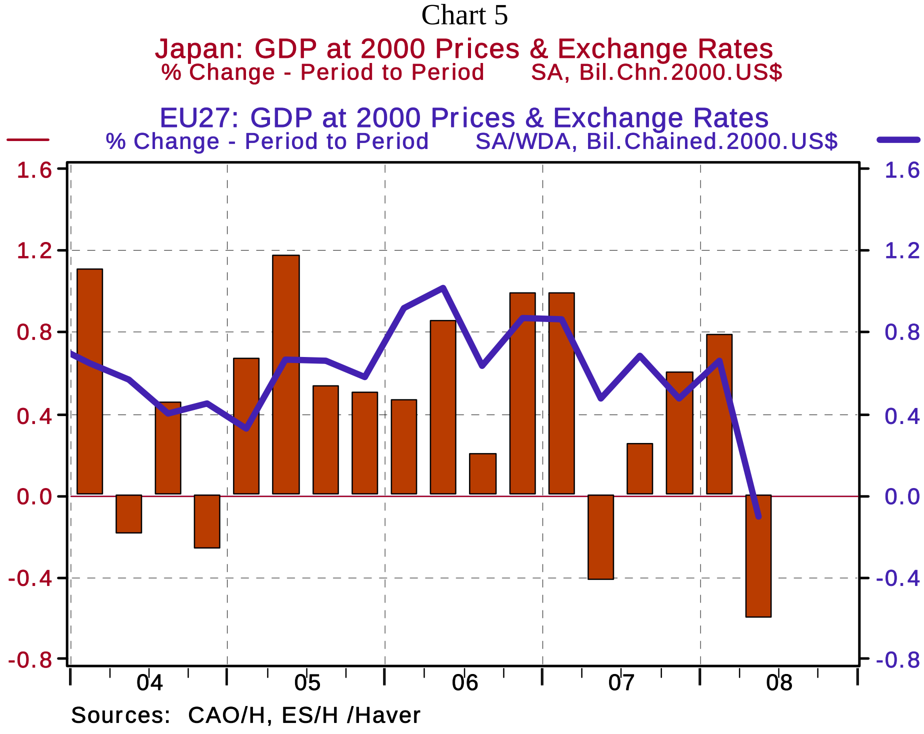
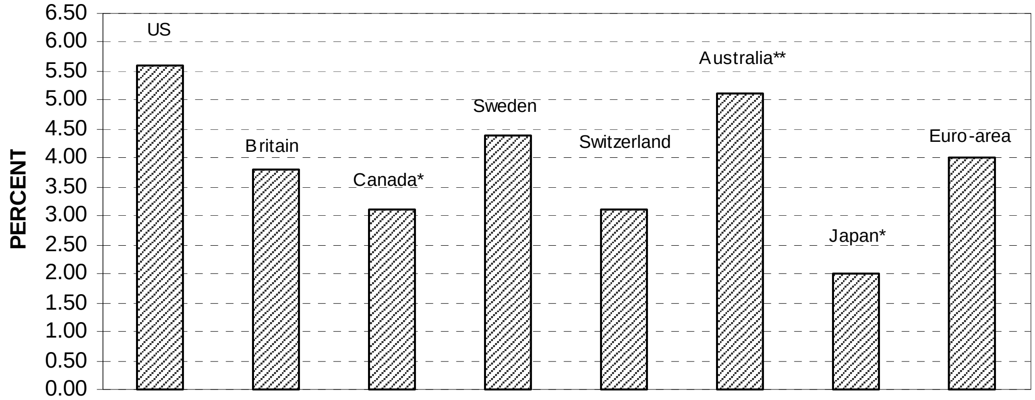


Chart 6
Change in Consumer Price Index in Major Developed Economies
(year-to-year percent change)



*- Japan and Canada yoy change of CPI in June.
** - Australia yoy change of CPI in 2008:Q2

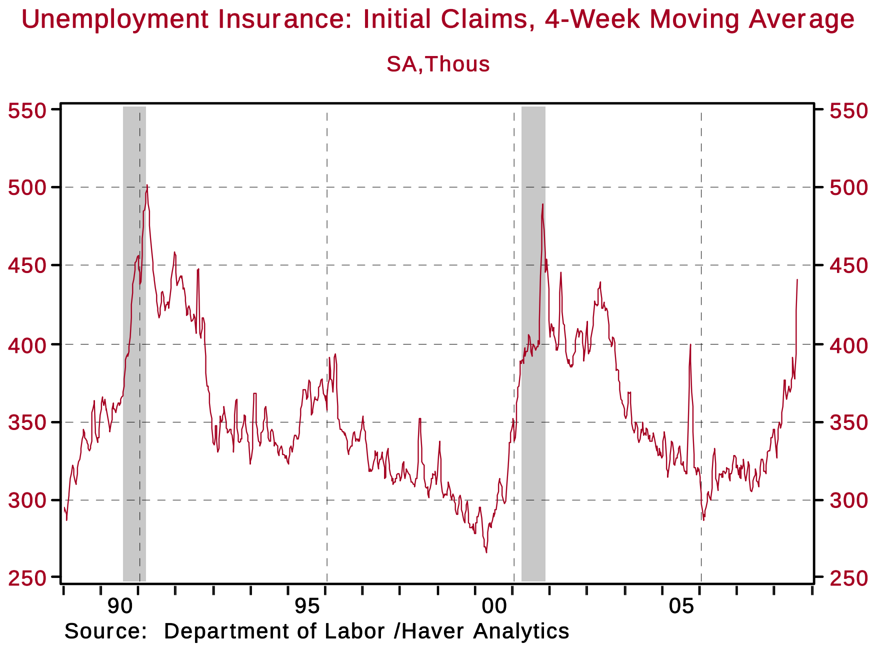
Highlights of the July 2008 Consumer Price Index

	% change	annualized % change			% change		
	prior month	year-to-date	3 mo. ago	6 mo. ago	Jul-08 yoy	Jul-07 yoy	Dec-07 yoy
CPI - ALL ITEMS	0.8	6.2	10.6	6.4	5.6	2.4	4.1
CORE - ALL ITEMS LESS FOOD & ENERGY (76.47)*	0.3	2.5	3.5	2.3	2.5	2.2	2.4
CPI ALL ITEMS LESS ENERGY (91.3)	0.4	3.3	4.2	3.1	3.0	2.5	2.8
FOOD (13.83)	0.9	7.6	8.4	7.4	6.0	4.2	4.9
ENERGY (9.69)	4.0	33.1	79.4	37.7	29.3	1.0	17.4
SHELTER (32.6)	0.2	2.2	2.9	1.9	2.5	3.6	3.1
COMMODITIES (41.27)	1.2	8.3	17.0	8.6	7.8	0.9	5.2
COMMODITIES LESS FOOD & ENERGY (21.6)	0.5	0.7	1.7	0.5	0.6	-0.6	0.1
SERVICES (58.7)	0.5	4.7	6.2	4.8	4.1	3.4	3.3
SERVICES LESS ENERGY SERVICES (54.87)	0.3	3.2	4.1	3.0	3.3	3.3	3.3
FRB CLEVELAND MEDIAN CPI	0.4	3.3	3.8	3.2	3.3	3.1	3.1

New High of Insured Unemployment Rate Raises More Concern About Labor Market

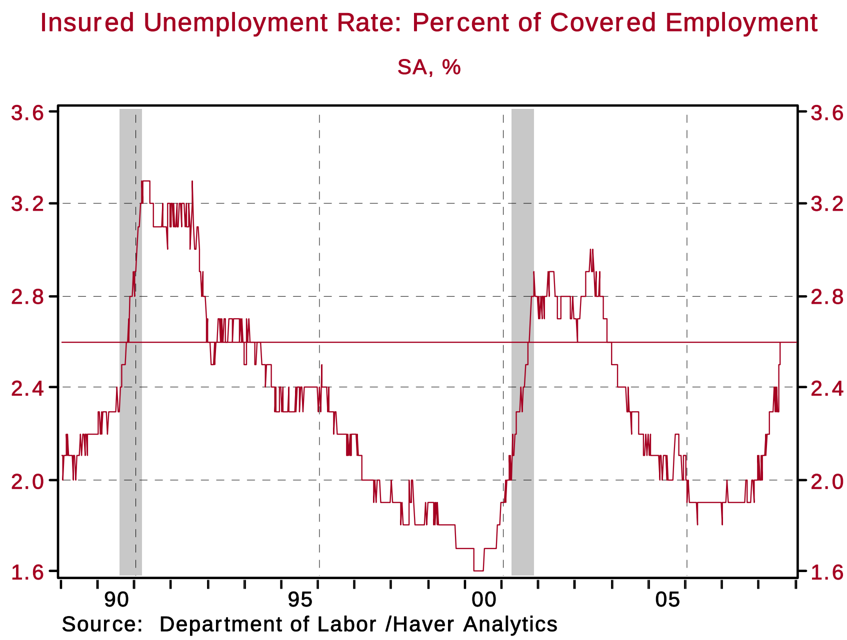
Initial jobless claims fell 10,000 to 450,000 in the week ended August 9. The four-week moving average is 440,500, even after discounting for the distortion from the extended unemployment benefits program, the underlying trend of initial jobless claims is consistent with recessionary periods.

Chart 7



Continuing claims, which lag initial claims by one week, rose 114,000 to 3.417 million. The insured unemployment rate moved up to 2.6%, like initial and continuing claims it now matches readings seen during recessions.

Chart 8



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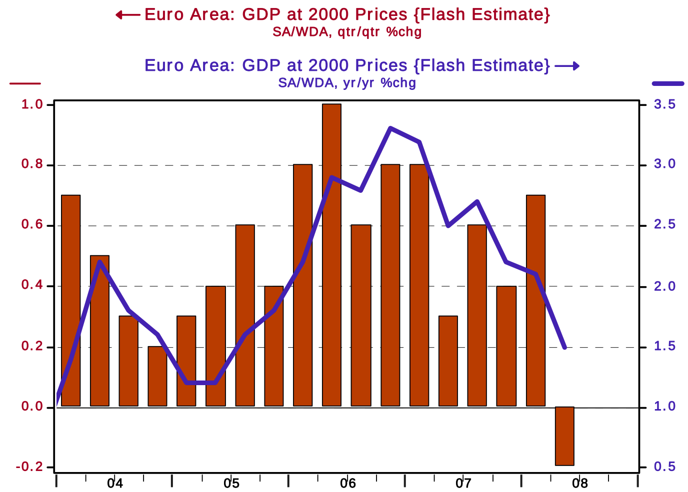
Euro-zone Economy Beat Expectations but Still Contracted in Q2

The Eurostat flash estimate for Euro-zone Q2 GDP was a mixed bag. The major economies did not suffer the drastic falls expected by most, but plenty of numbers were negative – including for the Euro-zone as a whole. What growth there was came from Spain, Portugal and Greece, all countries likely to slow further as the year progresses.

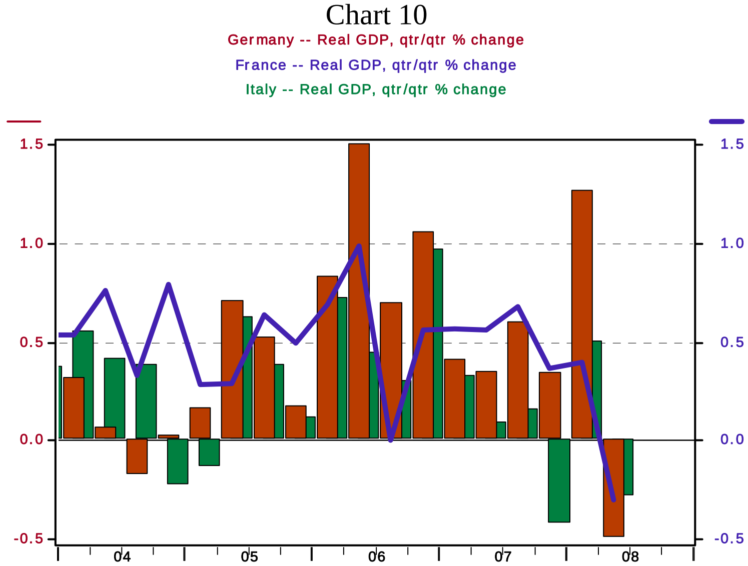
Chart 9



Source: Statistical Office of the European Communities /Haver Analytics

The three largest 'zone economies all contracted last quarter, with the largest (Germany) posting a drop of 0.5%, compared with 0.3% for France and Italy. Germany's abnormally-strong Q1 performance (+1.3% from Q4) raised concerns that the growth was largely borrowed from Q2, which would imply an even more precipitous fall, but for the most part this failed to emerge. Nevertheless, these powerhouse countries are now one quarter away from a technical recession, and likely to be followed by other 'zone members before long.

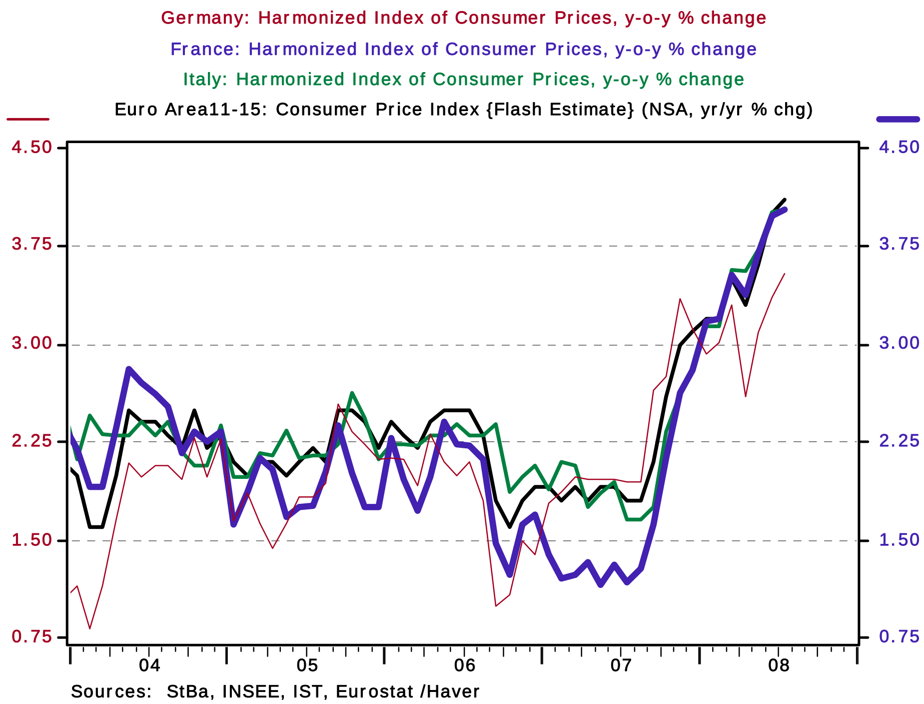
Chart 10



Sources: Bbk, INSEE, IST /Haver

Unfortunately, inflation remains just as much a problem as ever, with July inflation for the Euro-zone touching 4.1% last month and the main economies still exhibiting some price acceleration. This completes the stagflation scenario that the European Central Bank (ECB) has increasingly recognized over the past few months, and now the central bank is in a bind.

Chart 11



When the ECB raised its benchmark rate by 25 bps in early July, it was responding primarily to inflation but still acknowledging that growth was moderating throughout the ‘zone. Toward the end of that month, a wave of bearish indicators made it readily evident that the slowdown was more pronounced and more widespread than once thought, effectively shelving future rate hikes for this year in favor of possible rate cuts if the major economies went into a tailspin. Now, it appears that the slowdown is only occurring at a moderate pace, rather than the rapid collapse predicted by most analysts.

Today’s Eurostat report offers the ECB a chance to hold monetary policy for the near-term – recognizing that growth has slowed considerably but the slowdown appears contained given current interest rates. If the recent fall in oil prices translates into less-threatening CPI figures in the coming months, the ECB will have every justification in focusing its attention on the weak economy with an eye toward easing if necessary.