



Lombard Street Research

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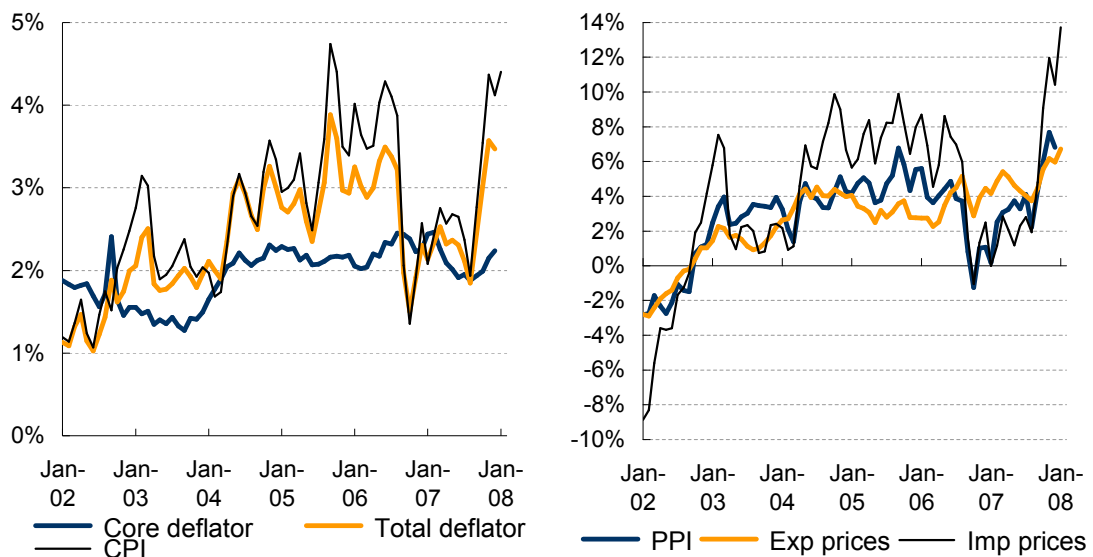
US CPI, housing => real GDP down in Q1

WE SUGGEST: Stock bear still in the ascendant

SUMMARY: Mr Bernanke's policy for reducing real US debt burdens – devaluation and inflation – is reducing real incomes as the CPI rose 4.4% in the 12 months to January and could accelerate in coming months. Housing remains in free fall. The stock market has to be hurt by stagflation.

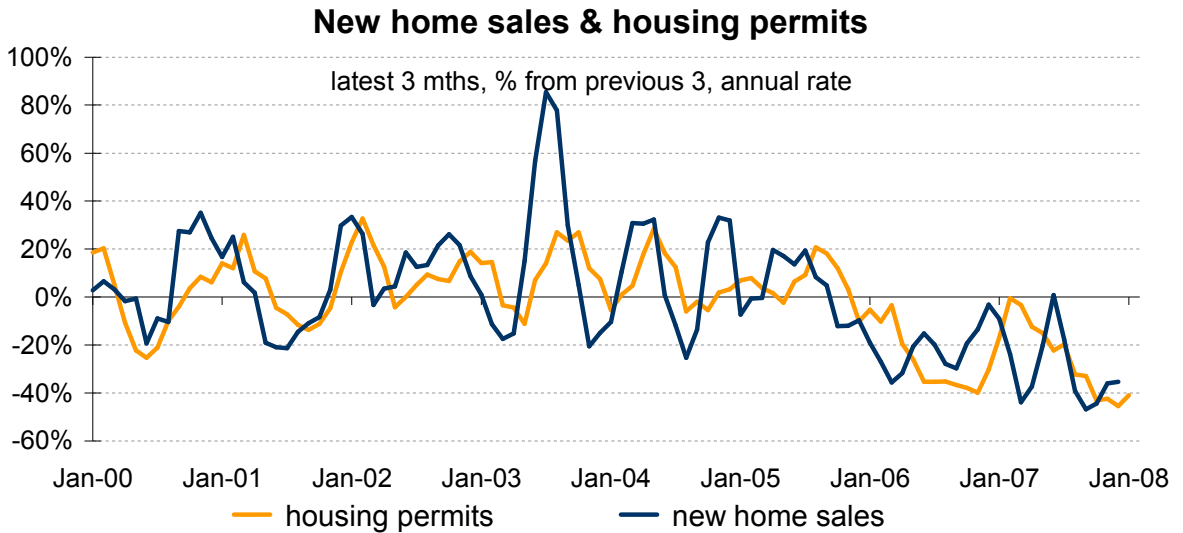
So much for the “good” January retail sales number last week: plus 0.3%. At the time our guess was that goods price inflation was at least 0.3% for the month. Today's CPI shows it to have been 0.5%. So real retail sales were down, as we suggested. With a much larger real decline in December giving strong downward momentum to the Q1/Q4 calculation, real goods consumption is could be heavily down – especially in view of oil and gasoline prices continuing strong. Meanwhile, the pace of housing decline has eased, but the Q4 pace of house-building decline, 24%, could be replicated in Q1.

Bernanke's Achilles heel – inflation on the up



Fed Chairman Bernanke continues to imagine he is operating in early 1930. He ignores the likelihood that it is more like 1974. Even his favourite measure, so-called “core” inflation – excluding food and energy – is lurching upward. At the level of consumer spending deflator this reached 2.2% in December, and for the CPI it was 2.5% in January (from 2.4%) – and shorter-period calculations suggest further acceleration in coming months. But those of us neither working at the Fed nor whistling Dixie on Wall Street know that even in

America people do eat and drive – even if these are not their “core” activities. For the total CPI the 12-month rate is back up to 4.4%, and going higher in coming months too. With nominal income growth almost certainly below 4% and perhaps as little as 3%, real income is falling. If the house price slump and household debt mountain are finally combining to drive up the savings rate, the cut in real consumer spending could be severe. With housing still in free fall, and business cap-ex on the cusp, the jump in government spending and/or net exports to prevent a Q1 GDP decline would have to be huge.



The normal lead of new home sales over housing permits, followed by starts, means the rate of decline of house-building may be bottoming out. But the likely negative 25% rate of change in Q1 will still by itself contribute minus 1% to GDP growth. This negative contribution should ease off quite rapidly from Q2, if only because the rate of permits and starts is now so low, but will probably remain below zero all year.

The latest upswing of oil prices, with West Texas Intermediate just topping \$100 again yesterday, may prove ephemeral, but should be enough to hold gasoline prices above the \$3 level that is relatively punitive in US conditions. With food prices rising at a 5% annual rate, people are having to run faster and faster just to stand still.

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