Rates and Foreign Exchange Research

Global Macro Research and Strategy

United States Musings

TD Securities

June 10, 2010

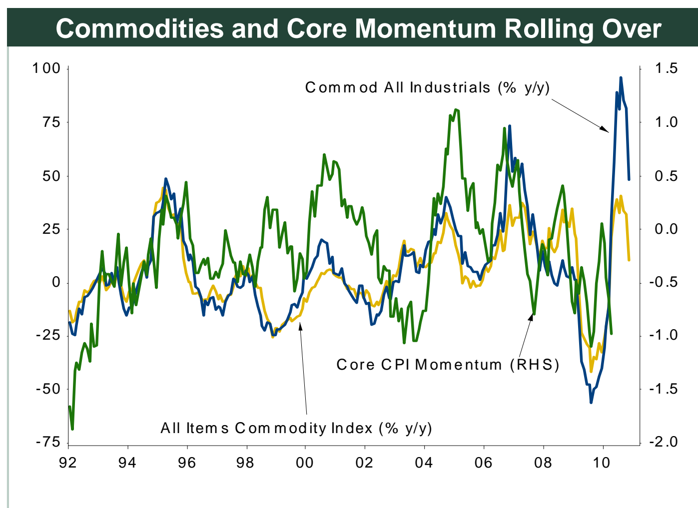
Disinflation: No Reprieve Yet

- Sell off in risk assets reflects a shift in inflation expectations as core prices plumb new lows.
- Cost-push and demand pull pressures remain absent and disinflation theme will persist over course of this year.
- Modest uptrend will take shape in 2011 as US avoids deflation opening door to higher policy rates next year.

Real Asset Returns & Deflation

Deflation Periods	Stocks	Property	Bonds	Cash
US 1930-1933	-6.5	0.0	10.8	7.6
Japan 1998-2003	0.7	-5.5	2.3	0.4
Average	-5.8	-5.5	6.6	4.0

Commodities and Core Momentum Rolling Over



Source:TD Securities

Subtle Shift in Inflation Calculus

A truism in the fixed income world is that Treasury bond prices should follow inflation. Over the course of the recent downturn and subsequent recovery, the inflation trend has been and remains very supportive to fixed income markets not just in the US but throughout the G-7. Indeed inflation has created more than the usual anxiety as some have feared the onset of deflation and others potential hyperinflation stemming from extraordinary accommodative policies from central banks, especially the Federal Reserve. Through the first year of the reflation trade economic momentum was rising providing. This provided a nice fillip for upward momentum in most risks assets such as equities and commodities. Core prices were drifting lower, but as long as economic growth was strong and output gaps closing, the balance of fear was tilted, however much at the margin, toward an eventual rebound toward higher inflation.

- The sell off in risk assets owing to events over the past several months in Euro land have tilted that calculus, at least for now.

We have argued that the knock-on effects to the US will not derail the recovery even if we believe it will take the edge off the growth profile to the tune of about 0.5% 2011, with only a marginally impact on domestic inflation. Nevertheless, perceptions drive market psychology and liquidity/solvency fears coupled with austerity measures and a bruised Euro land system, have been sufficient for markets to reassess inflation in a more nefarious light. As a result inflation expectations have fallen by almost 50bps over the past six weeks.

This re-pricing was simplified by a core inflation profile in the US that had already begun to accelerate to the downside. We do not ignore the secondary impact on economic growth from risk aversion, but also do not believe the US will fall into deflation. What is clear, however, is that disinflation will remain the persistent theme over the remainder of this year with core prices troughing around the 0.5% y/y mark by Q4 2010. As the accompanying table illustrates, the current inflation regime tends to favor cash and bonds over equities and real estate. In this regard, some retracement in risk assets is wholly rational.

Given the lags from growth to prices, most disinflation sets in through the course of the economic recovery rather than during the actual downturn. This cycle has been no different. The collapse in capacity utilization in labor, industry and housing has been extraordinary, and remains enormous by any metric. Cost-push pressures are virtually non-existent. Wage inflation is tepid and barely growing in real terms and the upward momentum in commodity prices has rolled over. The latest beige book indicated that input costs were higher in many districts owing primarily to the recent run-up in commodity prices, but without any pricing power those costs are readily absorbed by producers.

Small business price plans remain depressed, and the corporate price deflator amply demonstrates that falling unit

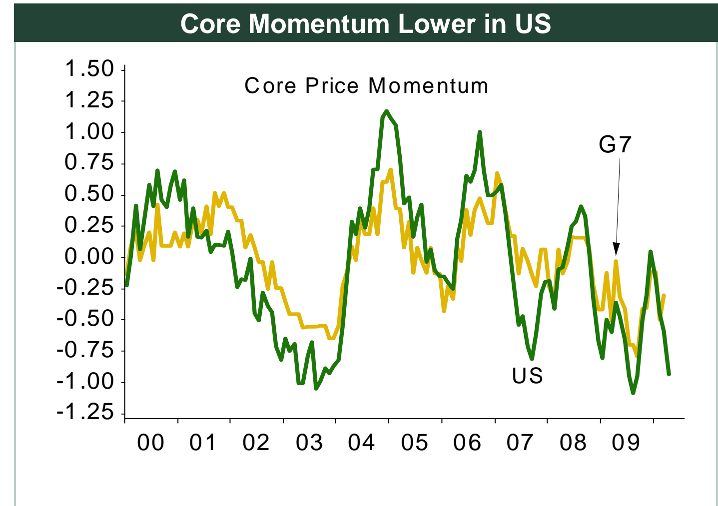
labor costs provide business tremendous latitude to absorb any additional input costs while still preserving profit growth, and market share. **This is why we argue that investor's should fade temporary spikes in ISM prices or Intermediate core PPI goods prices**. Demand-pull pressures are also notably absent. They are likely to remain so as private sector deleveraging extends and slack in labor demand persists.

No reprieve in downside price momentum is expected over the near term, or this year. Next week the markets have another US CPI report to digest. We expect core prices to remain broadly unchanged and headline inflation to decline by 0.2%, the second decline in as many months. Headline prices are poised to steadily dis-inflate from a recent high of 2.8% to 1.0% by year-end. We should note also that the balance of risks is tilted toward total prices being even lower by that time. Core prices will be rising close to 0.8% y/y after the May report, and over the past six months core inflation will have risen at only a 0.3% annual rate. That is substantially below the 1.5% rate at which the Fed usually gets nervous.

There is reason to believe, however, that prices will gain their footing and steadily rise in 2011. Output gaps remain large but are narrowing, housing rents which represent 40% of core prices are bottoming, and the Fed is committed to doing whatever is necessary to avoid even a temporary slip into core deflation. Moreover, inflation expectations remain well anchored. We would be more concerned if inflation expectations were falling off a cliff, but they are not. Breakeven inflation remains within a long term range and consumer 5 year price expectations have been very stable, and with a 1 year view have even moved higher of late.

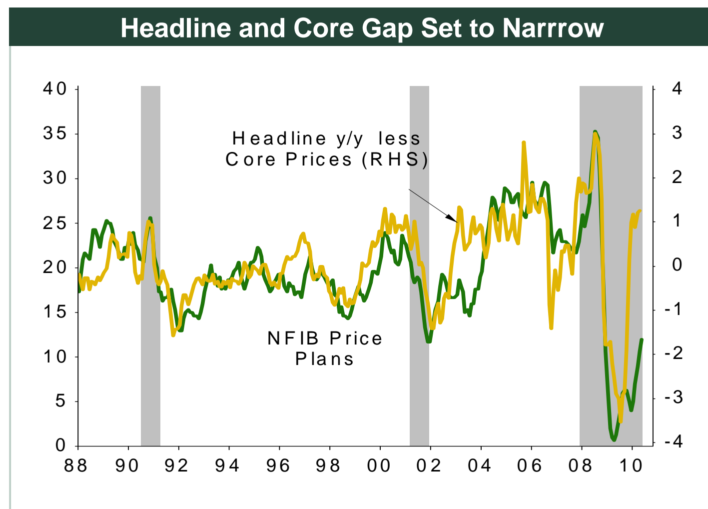
Nevertheless, a weak inflationary environment will remain supportive to fixed income assets through much of this year and the lower core inflation trends upside pressure on bond prices will endure. Our base case view remains, however, that this support will slowly give way by early 2011, and the Fed will then be inclined to final move policy accommodation off the zero-bound.

Core Momentum Lower in US



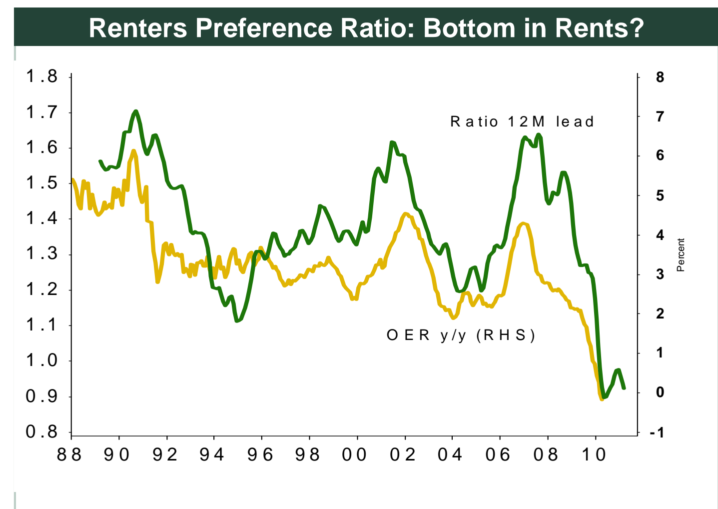
Source:TD Securities

Headline and Core Gap Set to Narrrow



Source:TD Securities

Renters Preference Ratio: Bottom in Rents?



Source:TD Securities

Eric Green, Chief US Rates Research and Strategy
eric.green@tdsecurities.com • +1 212 827 7156

This report has been prepared solely for informational purposes only and is not intended to provide financial, legal, accounting or tax advice and should not be relied upon in that regard. Information provided in this report is believed to be accurate and reliable, but we cannot guarantee it is accurate or complete or current at all times and no representation is made in this regard. Conclusions and opinions do not guarantee any future event or performance. Neither The Toronto-Dominion Bank nor any of its subsidiaries or affiliates are liable for any errors or omissions in the information or for any loss or damage suffered. Trade-mark of The Toronto-Dominion Bank. TD Securities Inc. is a licensed user. "TD Securities" is a trade-mark of The Toronto-Dominion Bank and represents TD Securities Inc., TD Securities (USA) LLC, TD Securities Ltd. and certain investment banking activities of The Toronto-Dominion Bank and its subsidiaries. Copyright 2010 The Toronto-Dominion Bank. All rights reserved.