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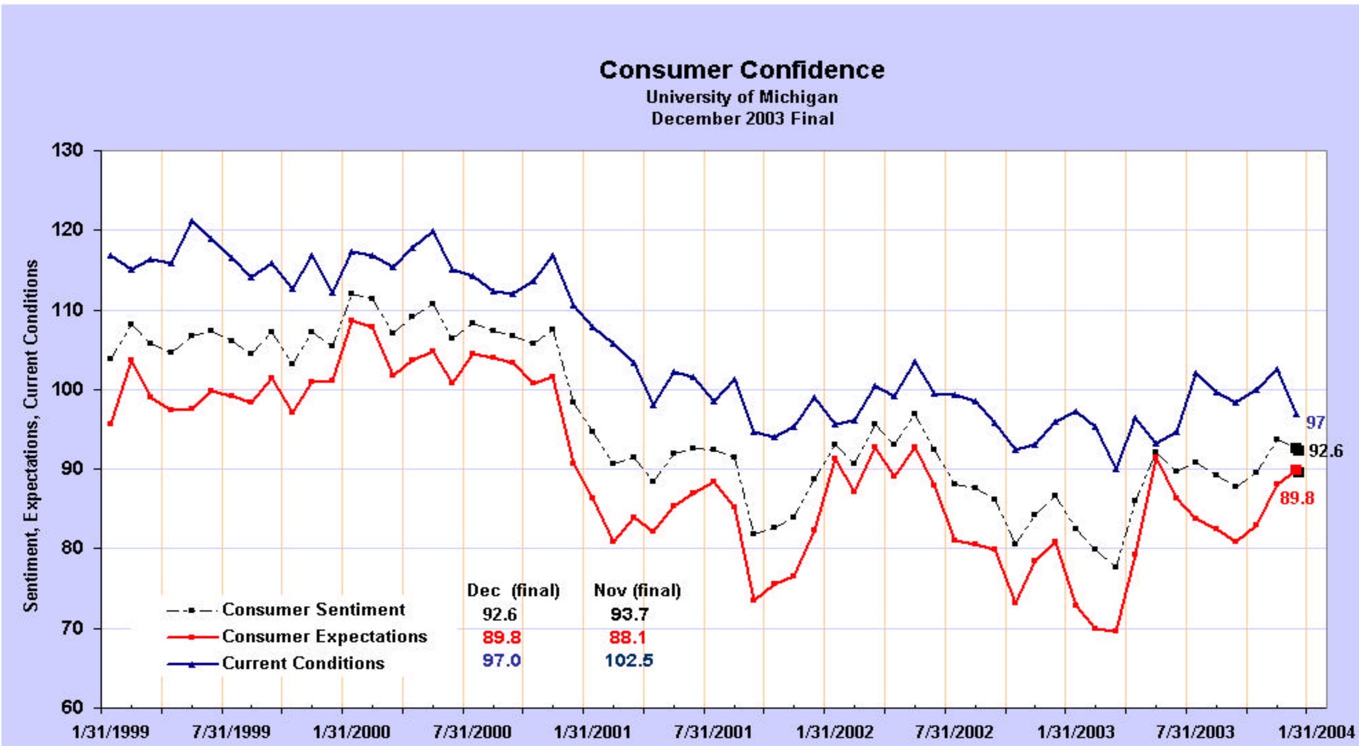
Have No Confidence in Consumer Confidence (surveys) but pay attention to Prices?

Consumer Sentiment (UMICH)



The UMICH final numbers are out for December. The current conditions fell to 97.0 from 102.5 (November final) and the **expectations** measure rose 89.8 from 88.1 (November final). The overall **sentiment** indicator fell to 92.6 down from 93.7 but better than the Bloomberg Consensus of 90.6. Investors might ask themselves, "Does it matter?" Probably to hungry analysts, but unlikely if you're trying to forecast the next squiggle in personal consumption. The standard deviations of sentiment, expectations and current conditions calculated from January 1999 are **9.7, 10.5** and **9.2**, respectively. Conventional statistical standards would seem to suggest that such squiggles are for graphs, not forecasts. It is probably more interesting to conjecture just what events are driving the squiggle this month? (The Saddam Effect, but then, why did the Current Conditions fall even more than the Sentiment indicator?)

Inflation-Deflation

The big shocker came from recent revisions to estimates of inflation. The core CPI seems to be falling and has fallen to 1.1% on a year over year basis. The Bond Market has interpreted that fall as another stay to the Fed's hand in reaching for the punch bowl. Nothing is quite what it seems, however, since there is a real question over measurements. What are the indices telling us? The core personal consumption

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expenditures deflator has gone through a recent revision that seems to show core PCE falling to 0.8% on a year over year basis. Since the core CPE is claimed to be the Fed's preferred measure of inflationary pressures, a natural question for Bond Junkies is if the Fed will see "deflation" as a Bogeyman again?

	PCE YoY		CPI YoY	PCE-CPI ?
	Revised	Original		Difference
JULY	1.3	1.4	1.5	-0.2
AUG	1.0	1.3	1.3	-0.3
SEP	0.8	1.2	1.2	-0.4
OCT	1.0	1.2	1.3	-0.3
NOV	0.8	NA	1.1	-0.3

One way to interpret the table above is to think of the PCE as having less of the Boskin Bias or putting it another way, that the PCE is said to account for more of the quality adjustment that has to be taken out of the CPI in order to compare 'like to like.' The Boskin estimate was often said to be on the order of 1%---yet that was in the days when we had 2-4% measured inflation (CPI basis). At lower rates of inflation, presumably the "bias" is smaller in absolute terms. The natural question is whether the **revised series** that now touches **0.8%** will lead the Fed not only to hold off raising rates, but actually to refill the punch bowl? If one takes the PCE data to be 0.8%, there is little margin of error on the road to deflation ----one could conceive of some claiming that **inflation has vanished entirely.**

More than likely, the FOMC will be looking at a broader array of indicators, not just the core PCE. There is said to be considerable slack, and employment, while rising, has still not picked up much of the job loss suffered during the downturn. Furthermore, it is not known yet by how much the rise in the Euro and/or other currencies that 'float' has impacted the prices of imports. Whatever one's predilection on these issues, clearly the FOMC has room to err on the downside. The question then becomes will the FOMC feel comfortable with an overshoot to the downside and a throttle back if it then seems it has gone too far?

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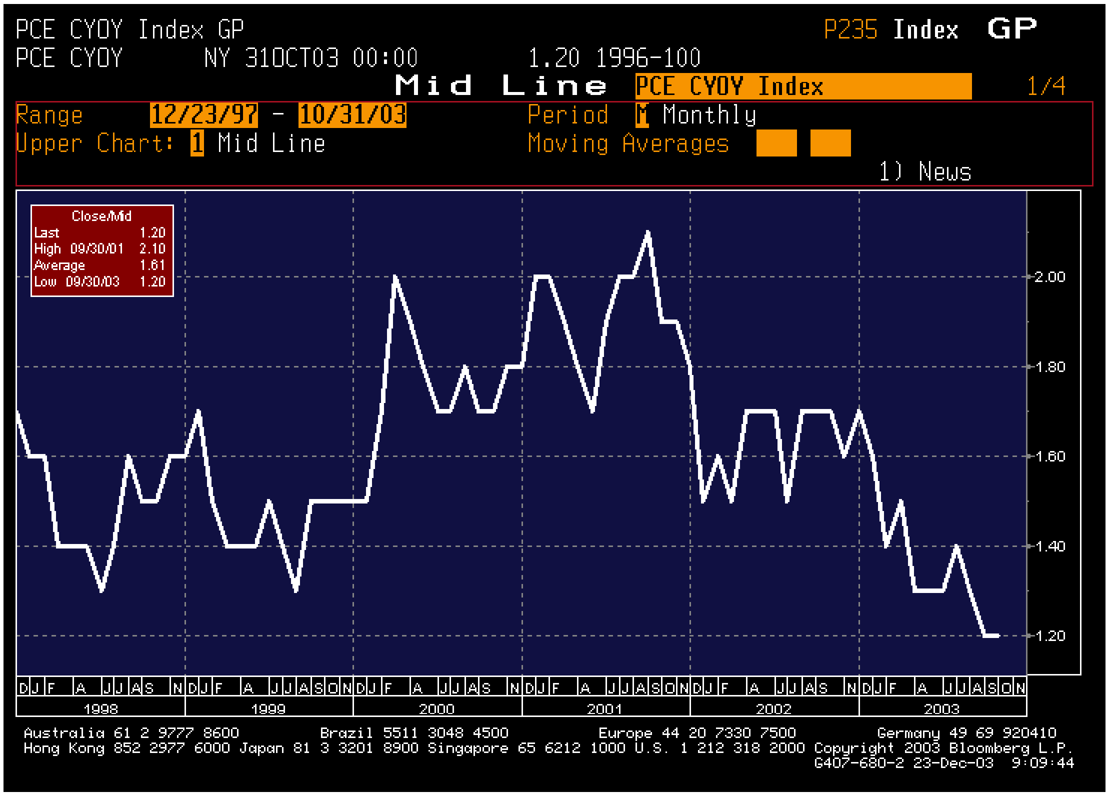
UNREVISED PCE YOY Through October 2003



The Bureau of Economic Analysis revealed some curiosa today on its website. One was the technical note that suggests that the largest upward revision in the PCE price index was due to service prices and among those service prices, the largest was the "implicit price of services furnished without payment by commercial banks."

> "The PCE price index was revised down; the revision was primarily accounted for by services prices. The largest contributor to the revision was the implicit price of services furnished without payment by commercial banks, reflecting newly available FDIC Call Report data and the definitional change to the measure of banking services introduced in the NIPA comprehensive revision. . The prices of business investment in equipment and software and of state and local government spending were revised up. "

The bottom line is that we do not know how to interpret these changes, and we are doubtful that the price shock that we have received is fully understood. The FOMC is likely to look at a much broader compendium of data before taking itself off the Neutral course even if the Bond Market has flattened the curve a bit. Wait 'til Next Year because interpreting the data is getting sticky!

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