But Did Anyone Notice Inflation?

By Adrian Douglas

The mainstream media has been elated by early signs of economic activity picking up. In particular the Institute of Supply Management (ISM) issued their Purchasing Managers Index (PMI) on September 1:

http://www.reuters.com/article/pressRelease/idUS158400+01-Sep-2009+BW20090901

The index was reported at 52.9. This is the highest in two years and the first reading above 50 since the credit crisis began. A reading above 50 indicates expansion in manufacturing. The media was euphoric and investors have pushed the US stock indices to post recovery highs. What did not receive any attention was the prices paid component of the index. It increased to 65 from a reading of 55 in July. This is 18% increase in a single month! In May 2009 the index was at 43.5 which represents 49% increase in prices paid over 3 months. This is absolutely stunning. This is not a government massaged index; this is based on what purchasing managers are reporting they are paying. Only 8% of managers reported paying lower prices while 38% reported receiving higher prices.

This report was followed on September 3 by the Non-Manufacturing (Services) Index.

http://www.reuters.com/article/pressRelease/idUS173419+03-Sep-2009+BW20090903

It was reported at 48.4 and while this is still indicating contraction the index was 2 points higher than in July and 8 points higher than in March. Again the media were waxing lyrical about recovery. Again what was not mentioned was the prices paid component; it increased to 63.1 from 41.3 which is a simply shocking 52% jump in one month. It increased 34.5% from its May reading. Only 6% of managers reported paying lower prices while 23% reported paying higher prices.

On September 4 the Economic Cycle Research Institute's (ECRI) U.S. Future Inflation Gauge (USFIG) was released:

http://www.reuters.com/article/marketsNews/idUSNYS00538420090904

It was 89.6 in August compared to 84.6 in July. This is a 5.9% increase in one month. The August USFIG annualized growth rate, which smoothes out monthly fluctuations, rocketed to positive 6.5% from negative 8.8% in July! In other words the annualized indicator which smoothes out volatility went from a highly deflationary picture to one of rampant inflation in just a single month! The ECRI commented that the gauge was pushed higher by rising commodity prices. This dovetails with the picture we see from the reports of actual prices being paid as reported by the ISM.

The NY Federal Reserve Bank President, William Dudley, said on August 31st "My view is we have tools to manage our balance sheet so we're not going to have an inflation outcome, a bad inflation outcome"

http://www.americanbankingnews.com/2009/08/31/ny-federal-reserve-president-says-us-can-avoid-coming-inflation/

"I'm totally committed to taking away the punch bowl at the right time," he said during the same interview. "It is possible that inflation could decline for a while because of the slack in economy and the banking system will take time to heal itself", Dudley added.

Judging by the data I have presented it looks like Mr. Dudley only takes away the punch-bowl when his guests are rolling around on the floor incapable of drinking another drop!

Almost everyone has their eyes glued to the money supply data and the BLS CPI and PPI. Of course the government's proclivity to exclude everything that is rising in price from the PPI and CPI in their special brand of hedonics means that the last place to observe the affects of monetary inflation will be in these indices. John Williams at shadowstats.com reports that his reconstructed M3 is only growing at a rate of 6% annualized. I however question the accuracy of the input data. I don't think that all the actual monetary injections are being reported, which is probably one reason the FED does not want to be audited. Neil Barofsky, Inspector General of the TARP, recently testified before Congress that the total credit lines of the 50 or so stimulus programs totaled 23.7 Trillion dollars. A Treasury spokesman countered with a statement that only 2T$ had so far been spent. Where does that 2T$ appear in the M3 data? It doesn't! If government officials have the capacity to access 23.7T$ of credit who will bet me that they will not spend it? Clearly money is being pumped into the system which is bypassing the reporting system.

Furthermore the weakness of the US dollar means that foreign holdings of dollars will return to the domestic market as they are dumped.

A very important factor in the growing inflationary scenario is the monster derivatives market. The derivatives market provided massive leverage to mask inflation created in the Greenspan era. Greenspan massively increased the money supply from 4 T$ in 1995 to 12T$ by 2006. This would normally have created rampant general price inflation. The prices of commodities, which are the raw materials we use for manufacturing and for much of our food chain, were suppressed by the derivatives market creating phantom paper supply of commodities resulting in the apparent supply appearing many times bigger than the physical supply and so suppressed prices. This was the main purpose of the derivatives market and why 5 US Banks held 96% of all OTC derivatives and why Greenspan vehemently defended it not being regulated. The derivatives market grew to a staggering 1,200 Trillion dollars. How can a market that has a notional value of 20 times the size of the global economy not be regulated? How can this market be excluded from a discussion of whether we face inflation or deflation? This monster has now contracted to less than half its peak size and is continuing to shrink. As the phantom paper promises of commodities are removed from the market the previous suppressing effect is also removed and prices will rise. The 15 years of price suppression has prevented any meaningful expansion in the global production capacity of commodities. We will now see many commodities become in short supply and the consequent ramp up in prices.

Many analysts are waiting at the "front door" of the economy for signs of inflation, while inflation is flooding in through the back door. In my article "The Green Shoots of Hyperinflation"
http://www.marketforceanalysis.com/Published%20Articles_2009_assets/Green%20Shoots%20of%20Hyperinflation.pdf

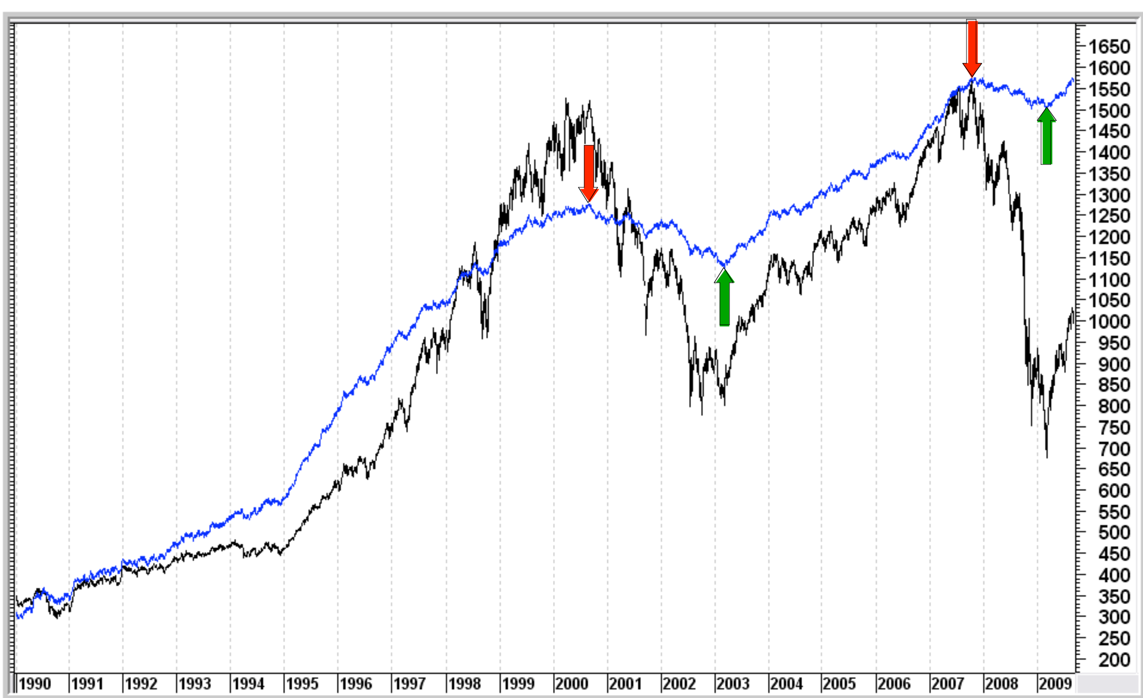

Figure 1: S&P 500 Potential Energy Chart (1990-2009)

I showed that the S&P500 has entered a new bull market trend. An updated version of the chart in that article is shown in Figure 1.
At Market Force Analysis we have developed a proprietary indicator which is called "Potential Energy" (PE) which uses the intraday data to determine whether buyers or sellers are more dominant. In figure 1 the S&P 500 is shown in black and the Potential Energy (PE) in blue. When the PE is rising the primary trend of the market is up and when it is falling the primary trend is down. It can be seen that this indicator is excellent at identifying a change in the primary trend. In the last 19 years only 4 turning points are identified as indicated by the arrows. The latest is a transition from bear to bull in March 2009. What is clear from PE is that the rise and fall cycles of the S&P500 in 2008 where the PE was falling are not the same as the rise we have seen since March 2009. The most recent rise is very similar to what was seen in 2003 when the market turned from Bear to Bull.

This is totally at odds with the fundamentals of the economy but this is another sign of inflation. As the dollar is debased money will flood into anything as a hedge against loss of purchasing power. The stock market will be such a hedge. It will rise in nominal terms but decline in real terms. This phenomenon was seen in Weimar Germany when its stock market made stellar nominal gains as the currency was debased and more recently in Zimbabwe the same phenomenon has been observed. The S&P500 will see pullbacks but it will not crash to new lows, below the March 2009 level of 676, as many expect.

I do not recommend buying general equities because investors will only gain in nominal terms while losing in real terms. The time tested hedge against inflation is precious metals and quality companies who explore for them and dig them out of the ground.

Real data is being reported, but ignored by the media and mainstream analysts, that reveal shocking increases in prices. There are still many who have their head stuck in the sands of deflation. Inflation and hyperinflation are baked in the cake by the promiscuous and unprecedented actions of the Federal Reserve and the unwinding of the massive derivatives commodity price suppression scheme.

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www.marketforceanalysis.com