A Goat's Head and Inflation

by Steve Brown

While happily riding the bicycle the other day, we rode across a goat's head on the bike trail. Not the head of a real goat, but the thorn variety, also known as Tribulus Terrestris or devil's thorn. This thorn is a longstanding nemesis of lion's paws, dog paws and bicycle tires. While the thorny seeds are about the size of a

big pencil eraser, they are potent enough to cause the immediate deflation of bike tires. As we spent a few minutes by the side of the trail reviewing tire changing skills and muttering, our minds wandered to the different meanings of inflation and deflation.

Economists and bond traders of all varieties spend a lot of time talking and thinking about inflation, in particular. There are plethoras of ways to measure inflation, including the Consumer Price Index and the Producer Price Index. The numbers are even adjusted to remove notoriously volatile food and energy components to get to core numbers.

The Bureau of Economic Analysis also provides investors with deflators (do they plant the goat heads?), the most important of which is the Personal Consumption Expenditure Price Index, also known as the PCE Deflator. The PCE measure is used for Gross Domestic Product (GDP) and is the primary number used by the FOMC in this area. It includes data on durable goods, non- durable goods and services.

There are also chain-weighted indices, which assume consumers switch products to avoid price increases and the Cleveland Fed gives us a couple of even more esoteric versions, such as median CPI and "16% trimmed-mean" CPI.

Do we really need any more measures to know whether or not we are paying more or less for all consumables? Well maybe so. New research by economists at the NY Fed takes a slightly different approach that looks quite interesting. At least at a glance the fundamentals seem logical and rather easily understood, unlike all the current data points. Economists break down price increases and decreases into goods and services, rather than at the producer or consumer level. There has been real divergence in goods and services prices since 2008, though they often moved in tandem prior to that time. Goods inflation has remained quite low for more than 10Ys, but was rising fairly sharply in the early years of this economic downturn. This was a time when China was digesting all the commodities in the world, so it makes sense goods prices jumped everywhere.

Services inflation, meanwhile, was tumbling at the same time because services inflation reflects something different. The price of services goes up when there aren't enough service people around to serve the same number of customers. In 2008 there were many unemployed people, so service prices tumbled. Services are about people, whereas goods are about global capacity. The upwards move in goods prices perhaps masked the drop in demand for services (people) and this at least to some extent added to the Fed's difficulties in measuring what as going on in the economy at the time.

Today, services inflation is moving upwards and it seems stabilized at a rate of about 2.3%. This is a large improvement from where it was before, but it is a far cry from the level before the recession and below the levels of the past 20Ys (which were consistently above 3%). While it is easy to pump air back into a bike tire and ride on, unemployment data still has more to go.

BANK NEWS

M&A

Southern Bank ($787mm, MO) has agreed to buy Bank of Thayer ($80mm, MO) for $6.2mm in cash or roughly 1.13x tangible book.

Competition

Wells Fargo said it will now offer text receipts as an option at its ATMs nationwide.

FOMC Projects

At the latest FOMC meeting, members modified GDP estimates to 2.45% for 2013 and 3.25% for 2014. They also projected the unemployment rate would decline to 7.25% by the end of this year and then drop down to 6.65% by the end of 2014. These forecasts imply the unemployment rate will hit the Fed's 6.5% threshold in the first half of 2015.

Shareholders

A reported 22 states now allow shareholders to cast votes remotely, including some that allow shareholders to do so through Webcasts.

Planning Ahead

n an effort to avoid tougher rules from Congress and in response to requests by regulators to hold a minimum level of long-term debt, the largest banks have reportedly submitted a plan to the Fed showing how they would pay for restructuring in the event of a future crisis. The plan reportedly indicates these large banks would be willing to hold more debt and equity at their holding company to support failed bank subsidiaries.

Stop Easing

The BIS issued a report warning central banks all over the world to withdraw accommodative easing, saying policies were less effective now and pointing out doing so was increasing the level of dangerous market imbalances.

Low IPO

Bloomberg reports IPOs by US corporations are down 31% to $19.9B, the lowest in 3Ys.

Consumers

A Cisco study of consumer preferences finds 77% want help to increase their savings, 69% want financial services that are easier to understand/use, 67% seek more financial education and 63% want to communicate with their bank using text, email or video.

Customers

An FIS study finds 55% of consumers want real time payments services from their primary checking account provider.