

CHART OF THE DAY

The Canadian dollar



The surging Canadian dollar, hit parity with its U.S. counterpart for the first time since mid-2008 as rising commodity prices boosted the outlook for higher Canadian interest rates.

TODAY'S TOP NEWS

- Fed says "extended period" may last a long time
- Greece battered on markets, denies u-turn on IMF
- Bids for \$40 billion in three-year notes 'solid'
- Fed's Kocherlakota: U.S. recovery underway, challenges remain
- Yuan revaluation "China's choice"-Geithner
- U.S. Treasury expects GM, Chrysler to be profitable
- Pimco continues to snub UK gilts, U.S. bonds

ECON WATCH

FOR WEDNESDAY APRIL 7

ET	Indicators	Unit	Reuters	Prior
03:43	IT Markit/ADACI Serv. PMI	ind	51.5	50.8
03:48	FR Markit/CDAF Serv. PMI	ind	53.0	54.6
03:53	DE Markit Serv. PMI	ind	54.7	51.9
03:58	EZ Markit Serv. PMI	ind	53.7	51.8
03:58	EZ Markit-composite PMI	ind	55.5	53.7
04:28	GB CIPS/Markit Serv. PMI	ind	58.0	58.4
05:00	EZ GDP revised qq	%	0.1	0.4
05:00	EZ GDP revised yy	%	-2.1	-4.1
05:00	EZ Producer prices mm	%	0.1	0.7
05:00	EZ Producer prices yy	%	-0.4	-1.0
07:00	US Mortgage market index	ind	-	602.8
07:00	US Mortgage refi. index	ind	-	2707.8
08:30	CA Building permits mm	%	2.0	-4.9
10:00	CA Ivey PMI	ind	55.0	51.9
15:00	US Consumer credit	bln	0.50	4.96
-	JP BOJ rate decision	%	0.10	0.10
-	GB BoE starts 2-Day Monetary Policy Meeting .			

MARKETS TODAY

TODAY'S TOP STORY: The U.S. Federal Reserve could keep interest rates ultra-low for even longer than investors expect if the economic outlook worsens or inflation drops, minutes from the central bank's last meeting suggested. **For more please click here**

TREASURIES: U.S. Treasury prices rose as a recent spike in yields attracted bargain-minded investors and spurred bids at a \$40 billion three-year note auction.

- The rest of the week's note supply include a \$21 billion 10-yr note auction on Wednesday and a \$13 billion 30-yr bond sale on Thursday.
- 10-yr Treasury notes were up 8/32 to yield 3.96 pct from 3.99 pct on Monday. 10-yr yields have risen about 37 bps since the start of February, while 2-yr notes rose 3/32 yielding 1.14 pct from 1.18 pct.
- 30-yr bonds were down 1/32 yielding 4.84 pct.
- 2-10's part of the yield curve flattened more than 1 bps to 282 bps.

FOREX: The euro fell as reports that Greece wanted to amend a EU aid deal rekindled fear about its ability to resolve its debt crisis.

- Euro fell for a third straight day, dropping 0.59 pct to \$1.3402. It has fallen 6.5 pct so far this year against the dollar.
- The euro was down 1.26 pct at 125.59 yen while the dollar fell 0.66 pct to 93.72 yen.
- The dollar fell 0.06 pct to C\$1.0012 per U.S. dollar, breaking parity for the first time since July 2008.

CORPORATES: U.S. corporate bond yield spreads were little changed after tightening for seven weeks, but the tone was cautious on worries about potential ripples from sell-offs in government bond markets.

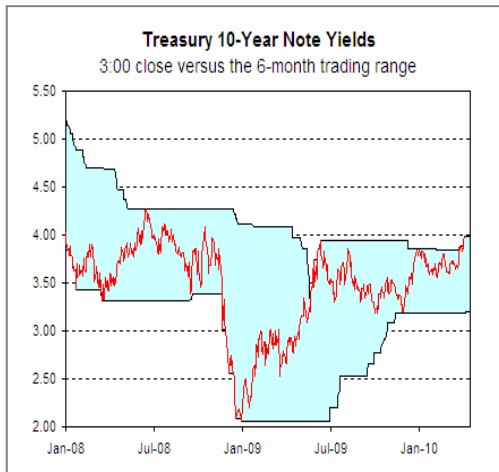
- The CDX.IG-14 index was unchanged at 84 bps.
- 5-yr CDS on Greek debt rose to 377.3 bps from 347 bps on April 2.
- Mexico launched \$1.0 bln worth of 40-yr bonds in a reopening of a 6.05 pct issue.
- Ford Motor Credit launched its \$1.75 bln five-yr note sale.

STOCKS: U.S. stocks gained as the financial sector got a lift from brokers' comments on banks, while minutes from the Federal Reserve's last meeting eased concerns over interest rates.

- Dow was down 0.03 pct at 10,969.99, S&P gained 0.17 pct to 1,189.44 and Nasdaq was up 0.3 pct to 2,436.81.
- Shares of Amazon.com rose 3.1 pct to \$135.56, Regions Financial rose 4.4 pct and Synovus Financial was up 6.16 pct.
- KB Home fell 2.83 pct to \$16.51 while Massey Energy was down 11.41 pct at \$48.45.
- KBW bank index was up 2.43 pct. S&P financials rose 1.05 pct.
- **C & E:** U.S. crude oil settled higher for a sixth consecutive session after a seesaw session as oil prices continued to be bolstered by optimism about economic recovery and demand going forward.
- U.S. crude oil rose 0.14 pct to \$86.74 per barrel.
- Gold gained 0.41 pct to \$1,134.30 an ounce.
- Reuters-Jefferies index slid 0.35 pct to 278.52.

- For MARKET SNAPSHOT click here
- For NEXT UP click here
- For DEEP DIVE click here

MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.170	0.14	0.172	-0.001
3-Mo Bill	0.170	0.160	0.172	0.005
6-Mo Bill	0.255	0.250	0.259	-0.006
1-Year	0.430	0.420	0.437	-0.007
2-Year	99.711	99.742	1.149	0.055
3-Year	99.016	99.047	1.720	0.078
5-Year	99.000	99.047	2.716	0.129
7-Year	98.938	98.984	3.422	0.211
10-Year	97.203	97.250	3.970	0.195
30-Year	96.531	96.594	4.846	-0.047

EQUITIES

	INDEX	CHANGE
DJIA	10979.21	5.66
NASDAQ	2441.23	11.70
S&P 500	1190.80	3.36

OIL

	PRICE	CHANGE
NYMEX	86.9	0.2
BRENT	86.1	0.3

EURODOLLAR FUTURES

	CLOSE	CHANGE
Apr-10	99.685	0.000
Jun-10	99.625	0.010
Sep-10	99.440	0.050
Dec-10	99.115	0.065

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.250	O/N	0.250
2-Week	0.250	2-Week	0.270
1-Month	0.260	1-Month	0.270
3-Month	0.290	3-Month	0.290
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.250	10:00 AM	0.190
2-Week	0.260	3:00 PM	0.189
1-Month	0.260		
3-Month	0.290		

IR SWAPS <19901>

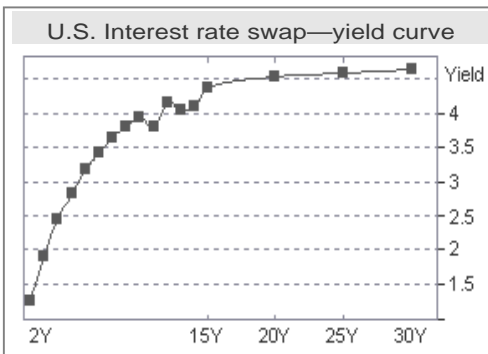
	SPREAD		RATE	
2-Year	11.75	15.75	1.26	1.28
3-Year	18.50	22.50	1.89	1.91
5-Year	14.25	18.25	2.85	2.85
7-Year	2.00	6.00	3.44	3.43
10-Year	-3.50	0.50	3.93	3.91
30-Year	-22.50	-18.50	4.62	4.59

FUTURES

	PRICE	CHANGE
CBOT 5 yr	114.12	0.17
CBOT 10 yr	115.73	0.42
CBOT 30 yr	115.28	-0.22

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.200	0.250	-	-
1-Month	0.220	0.300	0.200	0.210
3-Month	0.240	0.400	0.212	0.222
6-Month	0.350	0.450	0.245	0.255
12-Month	0.700	1.050	0.434	0.444



CURRENCIES

	BID	ASK
Euro	1.3396	1.3398
Sterling	1.5271	1.5276
JP Yen	93.82	93.84
Swiss Franc	1.0688	1.0690
Can Dollar	0.9999	1.0004
Mexico	12.2220	12.2254

FED FUNDS NYFRSM - 10AM

Open	0.2000	1m	0.2356
High	0.2300	3m	0.2919
Low	0.1800		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1	12/04/2012	11	10	1.26
3-Year	1.625	15/04/2013	18.5	17.5	1.91
5-Year	2.875	09/02/2015	18	17	2.9
7-Year	5.125	18/10/2016	20	13	3.63
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	38	0	5.2

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	-8	0	1.08
3-Year	1.75	07/05/2013	22.5	21.5	1.95
5-Year	2.625	20/11/2014	7.5	0	2.8
7-Year	5.25	15/09/2016	18	0	3.61
10-Year	3.75	27/03/2019	24	0	4.2
30-Year	6.25	15/07/2032	39	0	5.21

Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	4.0	100.2160	100.2220	3.815
FHLMC	4.0	100.2060	100.2120	3.801

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	4.5	99.0460	99.0520	4.652
FHLMC	4.5	99.0960	99.1020	4.621
GNMA	4.5	100.0860	100.0920	4.422

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

Fed says "extended period" may last a long time

The U.S. Federal Reserve could keep interest rates ultra-low for even longer than investors expect if the economic outlook worsens or inflation drops, minutes from the central bank's last meeting suggested.

The minutes of the Fed's March 16 gathering, showed lingering concern about the U.S. economy's prospects, with policymakers indicating they were in no hurry to raise interest rates.

"The duration of the extended period prior to policy firming might last for quite some time and could even increase if the economic outlook worsened appreciably or if trend inflation appeared to be declining further," the minutes said.

"Such forward guidance would not limit the committee's ability to commence monetary policy tightening promptly," they said.

Fed officials expressed concern about renewed weakness in housing and persistently high unemployment, saying the threat of a vicious cycle had not fully receded.

The U.S. Federal Reserve is considering allowing maturing Treasury bonds to roll off its portfolio as an alternative way to drain reserves from the banking system, according to minutes from its March meeting. The move would mark a shift from the current policy of reinvesting the proceeds from government debt into new Treasury bonds as the old ones come due.

This would serve as an additional tool for removing the extraordinary stimulus the Fed injected into the banking system in response to the worst financial crisis since the Great Depression.

Bids for \$40 billion in three-year notes 'solid'

Bidders came out in force to participate in the U.S. Treasury Department's \$40 billion auction of three-year notes.

The highest yield on the notes auctioned came in below the yield at which older three-year notes were trading in the market at the same time. The ratio of bids to securities offered in the auction was three-to-one.

Today's sale was the first coupon issuance of April, and the first since a series of poorly attended auctions of two-year, five-year and seven-year notes in late March. Those previous sales worried Treasury traders about continuing demand for U.S. government securities.

The three-year auction was the second out of four for the week, in which the Treasury will issue a total of \$82 billion in new debt.

Yuan revaluation "China's choice"-Geithner

China will ultimately decide more yuan flexibility would benefit it, U.S. Treasury Secretary Timothy Geithner said as Beijing defended its currency policy and said any changes would be on its own terms.

Geithner, who said global economic recovery "looks quite strong now," also said it was "China's choice" whether or not it revalues the yuan.

In Beijing, a Foreign Ministry spokeswoman and two government economists held out the prospect of the yuan being allowed to resume its rise after a 20-month pause but said at separate briefings that China would proceed with caution and on its own terms. A Chinese Foreign Ministry spokeswoman said China never manipulates the yuan and rejected the argument that a firmer yuan would reduce the U.S. trade deficit with China -- indicating that Geithner's decision may not have eased tensions over the issue.

Separately, the White House reiterated President Barack Obama's desire that China shift its yuan currency to a more market-based method of foreign exchange valuation and stressed this would be pursued through dialogue.

Greece battered on markets, denies u-turn on IMF

Markets pushed Greece's risk premium to a euro lifetime high amid growing doubts over the debt-laden country's capacity to resolve its debt crisis and fresh scepticism about an EU-IMF aid mechanism.

Returning to markets after a four-day Easter break, investors battered Greece over reports that the debt-laden country was seeking to amend an EU-IMF safety net despite Greek officials denying they intended to renegotiate the deal.

Markets ditched Greek assets, pushing Greek borrowing costs to a new euro life-time high with the premium investors demand to hold 10-year Greek government bonds rather than euro zone benchmark German Bunds rising to as much as 409 basis points. EU leaders agreed the aid mechanism. But the IMF still has not spelled out how it would cooperate, and every euro zone member state, including Germany, has a veto right, making it difficult to trigger the aid mechanism. The yield spread between 10-year Greek and German government bonds at one point exceeded 4 percentage points, the widest since the euro's launch. Separately, Greece will launch a multi-billion dollar bond in the United States this month, selling itself for the first time as an emerging market as demand for its debt dwindles in Europe, the Financial Times reported. Greece is seeking \$5 billion to \$10 billion from U.S. investors to help cover its May borrowing requirement of about 10 billion euros (\$13.5 billion) to roll over maturing debt and meet interest payments.

Fed's Kocherlakota: U.S. recovery underway, challenges remain

The U.S. economic recovery appears to be underway, but the housing sector will take a while to recover and the outlook for unemployment "is not promising", a top Federal Reserve official said.

Narayana Kocherlakota, the president of the Minneapolis Federal Reserve Bank, told the Minnesota Chamber of Commerce that he expects U.S. GDP growth of 3 percent per year over the next two years. Kocherlakota said he would be surprised if unemployment were below 8 percent by the end of 2011. Housing starts will likely remain low, possibly for several years, he said. Kocherlakota said he is "optimistic" the Fed will be able to get out of the mortgage business by 2020 and return to its pre-crisis monetary policy, but said it will need to slowly sell assets to do so. In a separate statement, he said, the prospect for economic recovery looks better in the United States than in Europe or Japan, but on jobs the United States is likely to lag.

U.S. Treasury expects GM, Chrysler to be profitable

General Motors Co and Chrysler Group LLC should be able to attract sufficient private investment and return to profitability, U.S. Treasury officials said in a government report released.

The GAO report on the automakers' pensions also said that it might be difficult for Treasury officials to make some decisions down the road since it oversees government equity in both companies as well as the agency that insures corporate pensions.

The GAO said uncertainty about the long-term viability of U.S. automakers and key suppliers pose significant risks to the health of the Pension Benefit Guaranty Corporation. GAO concluded that the ultimate impact of the federal investment on the future viability of GM and Chrysler is unclear due to the uncertain sales market and the struggling economy. Treasury officials told the GAO that they would consider "all commercial options" for disposing of government equity in automakers should they fail to become profitable -- including terminating pension plans.

TODAY'S TOP NEWS

Pimco continues to snub UK gilts, U.S. bonds

Pimco continues to avoid UK gilts and U.S. Treasury bonds because debt levels in the two countries pose a serious threat to investors' returns, Bill Gross, Pimco's co-chief investment officer, said yesterday.

Even though the UK and the United States are "decently positioned" to escape their individual debt crises, Gross said they are not good portfolio investments.

Gross helps oversee more than \$1 trillion at Newport Beach, California-based Pimco and manages the Pimco Total Return Fund, which has nearly \$220 billion in assets under management. He warned that the United States faces a growing debt burden because of unfunded commitments to entitlement programs, primarily Social Security and Medicare.

On the U.S. debt situation, Gross said the looming unfunded entitlements are in addition to a deficit equal to 10 percent of gross domestic product and a growing stock of outstanding debt.

Chicago Fed Midwest factory activity down in Feb

The Chicago Federal Reserve Bank said its Midwest manufacturing index slumped in February, largely on a reversal from January's robust growth in auto production.

The index fell 0.8 percent to a seasonally adjusted 82.6 from an upwardly revised 83.2 in January, which was originally reported at 83.1. Compared with a year earlier, Midwest output edged down 0.5 percent, significantly lower than the 2.0-percent national increase. Midwest auto sector production dropped by 2.8 percent in the month after January's steep 4.7 percent increase. Compared with a year earlier, the region's automotive output is up 10.0 percent, according to the report. The region's resource output is now up 3.0 percent compared to one year ago, but less than the national year-on-year increase of 3.9 percent.

Separately, Job openings slipped to 2.72 million from 2.85 million in January, the Labor Department said. The job openings rate dipped to 2.1 percent from 2.2 percent in January. Hirings fell to 3.96 million from 4.09 million, leaving the rate of hiring 3.1 percent from 3.2 percent in January.

US SEC mulls 5 pct risk retention in ABS-sources

U.S. regulators are considering a plan that would prevent banks and other sponsors from selling asset-backed securities without assuming any of the risks themselves, sources familiar with the Securities and Exchange Commission's approach said.

The SEC is mulling a proposal that would require asset-backed security sponsors to retain 5 percent of the credit risk of the security, said the sources, who requested anonymity because the plan is still in flux. The SEC proposal under consideration would also require banks and other ABS issuers to disclose in-depth information on every loan in a mortgage-backed security, the sources said. The SEC is considering requiring banks and issuers to disclose information on whether a home loan was underwritten with full documentation, for example, and where the home is located, the sources said.

Asset-backed securities linked to credit cards would not require information on every single credit card loan because of the sheer size of the pool, the sources said.

Iceland investment grade rating under review-Moody's

Iceland could lose its investment grade rating if it fails to resolve debt claims from Britain and the Netherlands, Moody's Investors Service said as it cut the country's credit outlook to negative.

The ratings agency warned the country might lose its Baa3 rating if it was forced to refinance upcoming eurobonds from its own funds.

Iceland has been trying for months to resolve the debt dispute with the two European Union states over failed online bank Icesave, and the delays have held up much-needed aid from the IMF and its Nordic neighbours.

Moody's said it was most likely Iceland would find a way of resolving the dispute, allowing foreign loan programmes to resume and enabling the country to retain its investment grade rating.

However the impasse with Britain and the Netherlands, over more than \$5 billion in debt incurred from Iceland's 2008 banking crisis, could potentially create refinancing problems for the government in coming years.

NEXT UP

PREVIEW-German ind. orders seen falling but exports up

According to Reuters forecast the March services PMI up to 54.7.

Feb industry orders -0.7 pct m/m; Feb output +0.6 pct; Feb exports +4.4 pct.

The German economy emerged from its deepest post-war recession in the second quarter of last year before stalling in the final three months.

Indicators covering the first quarter have so far suggested the economy struggled to grow at the start of the year, partly due to unusually bad weather conditions, but the latest surveys point to a more durable upturn.

In March, business sentiment surged to its highest level since June 2008, and manufacturing activity expanded at its fastest pace since April 2000.

Data this week also showed that unemployment fell unexpectedly in March, posting its biggest drop since June 2008.

Economists say a fall in industry orders, after last month's sharp rise, would not dampen hopes of a sustainable recovery.

A stronger-than-expected fall in orders could weigh on the euro and drive up Bund futures.

POLL-Most Americans say now is time to buy a house

Nearly two-thirds of Americans think the time is right to buy a house, with a majority believing prices will be the same or higher over the next year, according to a Fannie Mae survey.

The 64 percent that said it is a good time to buy is just shy of the 66 percent that said the same thing in 2003 as the U.S. housing market was racing higher.

However, most of the 3,451 polled said that it would be tougher for them to get a loan than it was for their parents.

The survey comes amid signs that the U.S. housing market is recovering after suffering the worst downturn since the 1930s. But, while home prices in some regions are rising, soaring delinquency rates across the nation mean foreclosures will keep persistent pressure on the market, according to analysts.

Fannie Mae, the largest U.S. mortgage finance company, said that the public still "strongly believes" in upholding their financial commitments, though that weakens once people know someone who is defaulting.

Those who know someone in default are more than twice as likely to have seriously considered stopping payments on their own mortgage, Fannie Mae said.

DEEP DIVE Commentary and Analysis

COLUMN-Nice job, pity about falling wages

By Jim Saft

It was the strongest U.S. employment report in three years and yet just beneath the surface was plenty of evidence that inflation pressure from the labor market is more of a fond hope than a real threat.

Nonagricultural payrolls rose in March by 162,000, the most in exactly three years and for only the third time since the recession began later that year. Of course, the United States probably needs about 200,000 new jobs a month just to bring unemployment down by a point in a year's time. No sooner do jobs become available than sidelined would-be workers start seeking employment again. That kept the unemployment rate at 9.7 percent, while the key broader measure of the unemployed, the underemployed, the discouraged and the marginally attached -- those game for work but unable to find it, get to it or find child-care while they go -- hit a whopping 16.9 percent.

And that, ladies and gentlemen, is why, in an economic recovery with a growing job market, average hourly earnings actually fell by two cents an hour, or 0.1 percent from the month before.

"To see a contraction in wages in any given month is practically a 1-in-100 event and the last time it happened, in April 2003, Alan Greenspan and Ben Bernanke were busy building a 'firebreak' around deflation," David Rosenberg, chief economist and strategist at Gluskin, Sheff wrote in a note to clients.

"In a nutshell, as one chapter of the labor market downturn is closed (employment contraction), another one starts (wage deflation). March's employment data, on the surface, may well have met the challenge served up by the consensus of economists, but it fell well short of addressing the massive amount of excess slack that still exists in the labor market ... So long as we have this much spare capacity in the labor market -- with nearly one in every six unemployed Americans vying for every job opening -- deflation pressures can be expected to build," Rosenberg said.

The workweek expanded, so cash flow for those lucky enough to have a job was up, but outside of the kinds of prices set more in China than in Omaha -- energy and raw materials -- inflation does not seem to be a near-term threat.

SKILLS MISMATCH

There is clearly debate within the Federal Reserve about this. Dennis Lockhart of the Atlanta Fed indicated last week he believes the structural rate of unemployment has risen. That implies he would be willing to start fighting inflation with higher interest rates while unemployment remains elevated.

Lockhart is absolutely correct that fewer people are migrating for jobs than they used to, almost certainly because so many cannot sell their houses. I'd say that argues for a lower home ownership rate and stopping encouraging people to pay underwater mortgages in order to keep their banks solvent.

While the number of people who have been unemployed for a long time continues to rise, there is an interesting cohort which only stays unemployed briefly. The percentage of people who have been unemployed for less than five weeks has stayed unusually low during this recession, lower than in any other similar period in the 20th century, according to Lakshman Achuthan of the Economic Cycle Research Institute. This, he theorizes, may show stronger demand in certain parts of the economy where there is a shortage of hard-to-master skills. But while prospects may be good for people with high-tech skills, there is a large mass of workers in construction and manufacturing who may never see demand come back to pre-recession levels. They clearly are staying unemployed for longer periods, and when they return it is often at lower wages in totally unrelated fields.

For these people there is a huge challenge to regain marketable skills, while for the economy having a large army of the unemployed means that wages, at least for a large group, may now slide in a protracted way. Given that these people can vote, the pressure, political and otherwise, on the Fed to not raise rates this year will be intense.

The forces we are looking at are not new. During the past 15 years U.S. consumers squared the circle of stagnant real wages by taking on more debt in order to keep the ship afloat. More private debt is not going to happen, nor is another construction boom with good-paying lower-skilled jobs likely.

The Fed may respond to the threat of inflation, or to asymmetrical inflation in certain parts of the economy, with rate rises later this year, but it would be a brave play.

(James Saft is a Reuters columnist. The opinions expressed are his own. At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

COLUMN-CPI average, housing mask sectoral inflation

By John Kemp

Averages lie -- or at least conceal the truth. Low readings on the U.S. consumer price index (CPI) are hiding strong inflationary pressures in some areas of the economy amid the general downturn in housing.

Most senior officials at the Federal Reserve maintain there is no need to contemplate raising interest rates just yet because inflationary pressures remain "subdued." Consumer prices rose just 2.1 percent in the 12 months ending February 2010.

Prices excluding volatile food and energy items were up just 1.3 percent in the same period. This is well below the Fed's implicit target of 1.5-2.0 percent.

Doves on the Federal Open Market Committee (FOMC) remain more concerned about deflationary forces in the economy than inflationary ones. Fears about a renewed downturn in the housing market as the Fed removes direct support for the securitisation market or triggering a rerun of the credit crunch which ended the first recovery after the Great Depression in 1937 stalk the Committee.

In contrast, a dissident minority within the FOMC, and many more forecasters outside the Fed, openly muse about the renewed threat of inflation. They point to high levels of excess liquidity; soaring prices for commodities such as oil, copper and iron ore; and signs at least some manufacturers and service providers are confident enough to push through price increases. Surely, they cannot both be right? In fact, both sides are (partially) correct. It depends on where the analysis focuses.

MEANINGLESS AVERAGE

The consumer price index (CPI) measures price changes for a basket of items and services consumers buy, weighted according to average household expenditure patterns.

Prices for some items (including highly visible ones consumers buy frequently) have indeed been rising rapidly. But they have been offset by flat or falling prices elsewhere (mostly for big ticket items consumers buy only relatively infrequently which therefore have little visibility).

The attached chart shows inflation rates for some of the major categories of household spending, with the width of each bar reflecting its weight in average household expenditure, according to weights published by the Bureau of Labor Statistics (BLS).

It should be immediately obvious the "average" price increase of 2.1 percent is completely meaningless. Price increases for indi-



DEEP DIVE Commentary and Analysis

vidual categories vary from +36 percent to -1.3 percent. Prices for items accounting for 22 percent of household expenditures have been rising at an annual rate of +3 percent or more. Fast-increasing items include medical care (+3.6 percent), public transportation (+4.5 percent), new and used motor vehicles (+5.2 percent) and motor fuels including gasoline (+36 percent).

The headline inflation figure has been pulled down, however, by flat or falling prices for items accounting for 67 percent of households' spending. Deflationary pressures are evident in clothing (0.0 percent), food (-0.1 percent), utilities (-0.6 percent), and recreational services and items (-1.0 percent).

SHELTER COSTS DISTORT

Nowhere is the impact more visible than in housing. Shelter accounts for almost one dollar in every three of household spending (via rents to landlords or owners' equivalent rents encapsulated in the purchase of own homes). According to BLS, costs for those who owned their own homes rose just +0.3 percent in the 12 months to February 2010, and costs for all forms of shelter were down by -0.4 percent.

Flat or falling housing costs are masking faster price increases in other categories of consumer expenditure. If the housing and home rental markets started to stabilise and pick up, headline inflation could rise quite rapidly.

San Francisco Fed President Janet Yellen continues to worry about deflationary pressures and the prospect of a double dip in housing, focusing on the weak trend in shelter costs. Meanwhile Kansas City Fed President Thomas Hoenig and some others worry the Fed is unwise to commit to an extended period of low interest rates, given the re-emergence of strong inflationary pressures in some segments of the economy.

CORE IS MISTAKEN FOCUS

Some commentators, and the Fed itself, prefer to focus on the behaviour of "core" consumer price inflation excluding volatile food and energy items, arguing there is relatively little the Fed can do to affect these prices in the short term; stripping them out provides a better, more stable target for policymakers.

The chart shows this makes no sense. If food (15 percent of the

index) and energy (9 percent) are removed because they are "too volatile" and influenced by special factors, why not strip out shelter costs because they are driven by the boom and bust conditions in the housing market? In fact once food and energy are stripped out, shelter costs account for a massive 42 percent of the remaining "core" index.

Suggesting the Fed should target "core" inflation and ignore sharp movements in the broad index is pretty much the same as asking the Fed to target the cost of housing. Focusing on the core measure lulled the Fed into a false sense of security last time around.

No wonder the U.S. central bank left interest rates far too low far too long in the early and middle years of the last decade. Focusing on the wrong inflation measure directly produced an enormous bubble in housing; a series of distortions in markets for internationally traded raw materials; a gaping trade deficit; debt-drunk households; and insolvent banks.

Effective inflation control and the holy grail of financial stability require a much more sophisticated approach. Rather than focusing on just the headline number, or a rather distorted "core" measure, the Fed needs to analyse price rises throughout the economy. Policymakers need to be alert to the emergence of price pressures in specific subsectors that could herald a broader pick up in inflationary pressures.

Recent surges in the price of oil, steel, iron ore, non-ferrous metals, and some semi-manufactured items such as packaging and electronic components suggest recovery is already well under way and capacity constraints are resurfacing in at least some parts of the global economy. Ultra-low interest rates no longer look appropriate, at least not for very much longer.

Lifting rates is always painful; the Fed is prone to procrastinate while waiting for stronger evidence of a recovery. Revaluation of China's RMB and devaluation of the dollar could help relieve some of the pressure. But a gradual exit from the current abnormal monetary stance is strongly preferable to delaying and facing a much more abrupt shift later.

-- John Kemp is a Reuters market analyst. The views expressed are his own --

INSIDE DEBT is produced by Reuters in partnership with ICAP.

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