

INFLATION FORECAST

The following attempts to provide at least broad parameters as to what lies ahead on the inflation front. As is the case with any forecast of the future, determining with precision what inflation will be is virtually impossible. About the best one can hope to do is get the trend right or the degree of divergence from current conditions. Obviously, if inflection points can be identified, that will be instructive.

Our forecast will focus on the core rate of inflation, using the CPI as the measure. The reason we have core readings is because food and energy are notoriously volatile, and they tend to wash themselves out over time, rising in expansions and correcting in recessions, generally speaking.

When thinking about inflation it is important to remember that very high rates of inflation, and deflation, typically are outliers. Stability is more the norm. The compound annual inflation rate 1926-2008 was 3%. Its standard deviation was 4.0%, not much more than Treasury bills. Of those 83 years, 60% fell in the 0% to 4% range. Most of the outlier years were bunched together as a result of the Great Depression when deflation occurred, or the high inflation of the 70's, which were due mainly to oil inflation. In summary, the tendency over history is for inflation to be relatively contained under normal circumstances.

Currently, we do not have normal circumstances. In October the CPI was +0.3%, and yr/yr -0.2%. Core was +.02% for the month, and +1.75% y/y. The current negative y/y change in the raw CPI is largely attributable to the sharp drop in oil over the last year. While the raw CPI is experiencing deflation, the more dependable core

rate is well within the band of acceptance by the Federal Reserve.

The less than normal circumstances that I refer to are the fact that we are just now emerging from the deepest and longest recession of the post Depression era, due mainly to unprecedented monetary and fiscal stimulus. Many fear that the combination of very large federal deficits and high rates of money creation will inevitably lead to high inflation. We agree that there is a risk of high inflation several years out, but we do not assume that it is a given. Rather than try and forecast inflation in the distant future, we will simply state our bias for that time period, and try to be more precise for the shorter term.

We maintain that inflation is more than anything a function of supply and demand. The ones who worry most about future inflation are those who believe that inflation is a monetary phenomenon. Without delving into these issues, suffice it to say, we currently believe that with capacity utilization at only 70%, and employment at only 90% or less, the resources of our economy are woefully underutilized. This leads us to the conclusion that it will be very difficult for a general inflation to develop, absent a much higher utilization of resources. At some point in the future when capacity is tight, consumption is strong, employment is full, productivity is low, and credit is available at more normal levels, then we believe inflation can be a problem. We do not foresee these conditions in the next year, and probably not in the next two years. As the recovery moves in the general direction of these conditions, it is reasonable to expect some gentle upward drift in inflation, but still well within the range of normality.

Specifically, we forecast a core rate of inflation in 2010 that averages less than two percent, in a tight range of one and one half to two percent. Longer term, as recovery commences in full force, we expect inflation to experience a mild drift upward. The manner in which the Federal Reserve reverses some of its liquidity measures will be very important to the inflation outlook.

While the odds favor inflation instead of deflation in the years ahead, investors would be prudent to at least acknowledge some possibility of deflation. Government policy will be directed against such possibility, but nevertheless deflation should be acknowledged as a risk.

Our inflation forecast will be subject to revision as conditions develop.

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