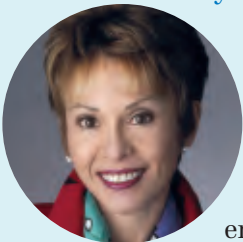


Stagflation Fears Overblown

by Sherry Cooper

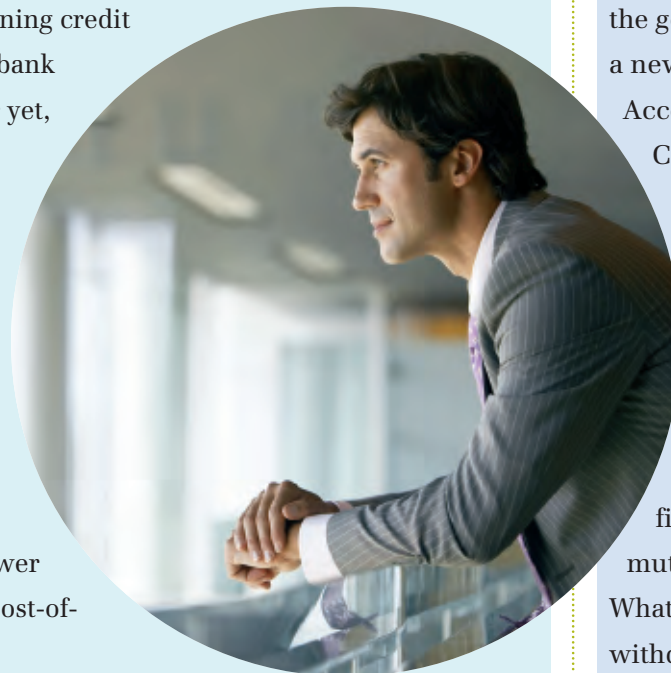


It's been a tough year for investors, as the fallout from the U.S. housing meltdown continues to hamper liquidity, reduce credit availability and cut earnings. The result has been a global economic slowdown, especially in the G7 countries, emanating from tightening credit

terms – despite this year's central bank easing. Unfortunately, it's not over yet, and with the recent turmoil stemming from Fannie and Freddie, Lehman Brothers, and AIG, it won't likely turn the corner for at least another year. In this environment, recent surges in food and energy prices have led many to fear a 1970s-style period of stagflation. Fortunately, that's unlikely, given reduced union power and labour's inability to demand cost-of-living pay raises.

Prices have escalated at their fastest pace in decades, fuelled by surging commodities. Central banks still see inflation as a significant problem, because increased oil and food costs dampen discretionary spending and reduce corporate profitability, in turn boosting recession probability. Unexpectedly, thanks to rising inflation, the Bank of Canada held rates steady this summer, while the European Central Bank actually raised rates, to help curb wage gains. Meanwhile, the credit crunch persists, and major economies are softening further. In recent weeks, commodity prices have come sharply off their highs, ratcheting down inflation expectations.

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The recent spike in headline inflation is temporary, as commodities pull back with the slowing global economy. Eurozone, the U.K. and Japan contracted in Q2, and U.S. domestic demand posted another poor performance despite tax rebates. In Canada, inflation accelerated to its highest rate in five



years, with rising food and energy prices hitting home as the loonie no longer provided a buffer. While price pressure will likely persist for a few more months, inflation should undershoot the Bank of Canada's latest forecast. But the Canadian economy has taken a turn for the worse, suffering from weak U.S. growth and an end to our housing boom. Home prices are now falling in what were previously the hottest markets, and construction is trending downward. Canadian growth will likely remain sluggish through year end, picking up only moderately in 2009.

The U.S. faces a consumer-led recession, its first in nearly two

decades. Since the crisis erupted last year, the Federal Reserve has already cut the fed funds rate by 325 basis points, and funnelled hundreds of billions of dollars in liquidity to the financial sector, in an effort to ease credit conditions. The housing market is showing hints of a bottom, but financial institutions have booked further writedowns, with more losses likely over the next year, due to the economic downturn. With other developed economies turning sharply weaker, the U.S. dollar has rebounded somewhat in recent weeks.

A stronger greenback and a slowing global economy should keep a lid on commodity prices over the coming year. The balance

of 2008 will remain difficult for equities, but 2009 should be more upbeat, because equity markets tend to rally in anticipation of economic recovery.

The Bottom Line: Stagflation fears are overblown as a slowing global economy reduces commodity demand, while rising unemployment should keep wage gains subdued. As we move into 2009, look for inflation to come down, which should allow central banks to ease monetary conditions, setting the stage for a recovery later next year.

Sherry Cooper is global economic strategist and executive vice-president, BMO Financial Group, and chief economist for BMO Capital Markets.



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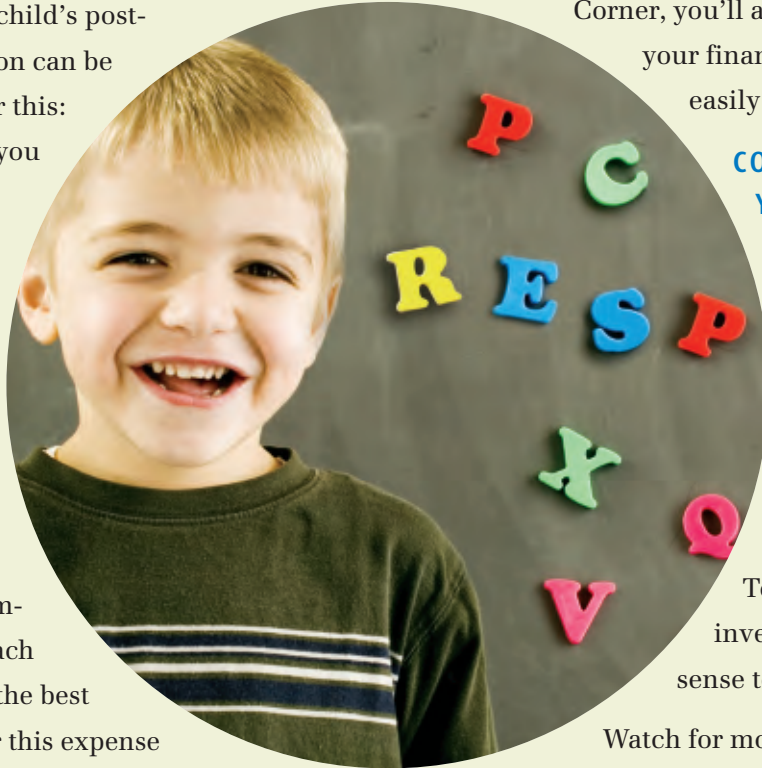
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