INFLATION WATCH

...A mid-month focus on inflation via Traditional Indexes, Commodity Prices, and Labor Costs.

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Inflation—Weaker Sooner Than Expected

- The latest CPI is weaker and the softness was sooner than we expected.
- More alarming is the recent broad-based deterioration in economic data.
- Lower inflation expectations have flattened the yield curve recently, which hurt Financial stocks.
- We believe inflation has likely peaked for the time being and patience is the right approach for the reflation trade at this point.

CPI Inflation: March Reading 0.1% (2.4% Y/Y)

The non-seasonally adjusted CPI was up 0.1% in March and 2.4% year over year (Chart 1), both quite a bit below market expectations. The soft headline reading was mostly driven by a big plunge in energy, with gasoline prices falling over 6%.

We mentioned in the last report that "*we believe achieving sustained 2-3% inflation could be harder than most people expect going forward*". We had expected inflation to roll over around mid year as the positive base effect wears off, so the softness in the CPI is indeed sooner than we expected. Although oil prices have rebounded nicely in the last few weeks, the base effect will still be negative even if oil prices stay in the current range.

More alarming is the recent broad-based deterioration in economic data, from the multi-standard-deviation miss in the payroll numbers, weaker-than-expected ISM non-manufacturing survey, to disappointing retail sales. We are not too surprised by the peaking of economic data and we have shown in previous reports the leading tendency of the ECRI Weekly Leading index for economic data surprises (Chart 2). Given that these indices are reversing from pretty extreme positive levels, more downside should be expected.

Chart 1

US CPI (NSA) 12-Month & 6-Month Change

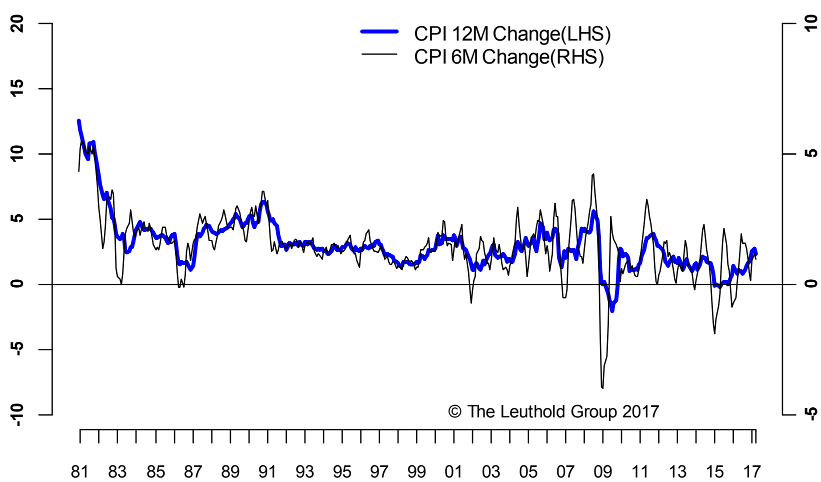


Chart 2

ECRI Weekly Leading Index vs. Citi US Economic Surprise Index

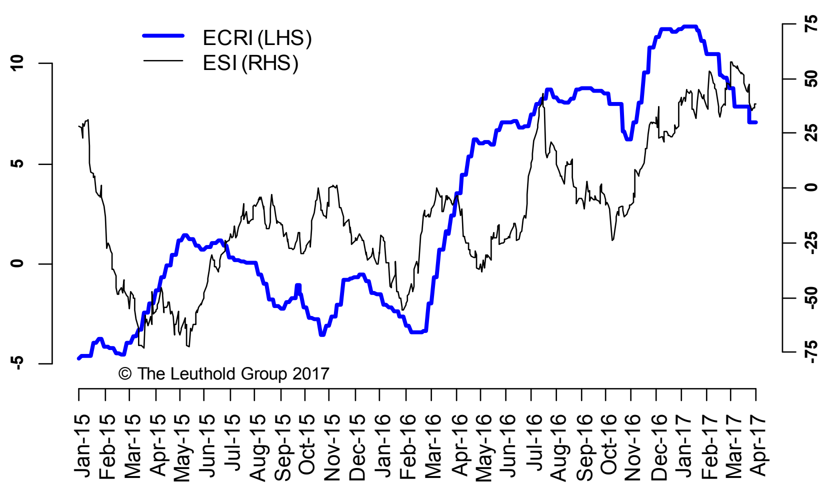


Chart 3

US 10-Year Breakeven Rate vs. Yield Curve

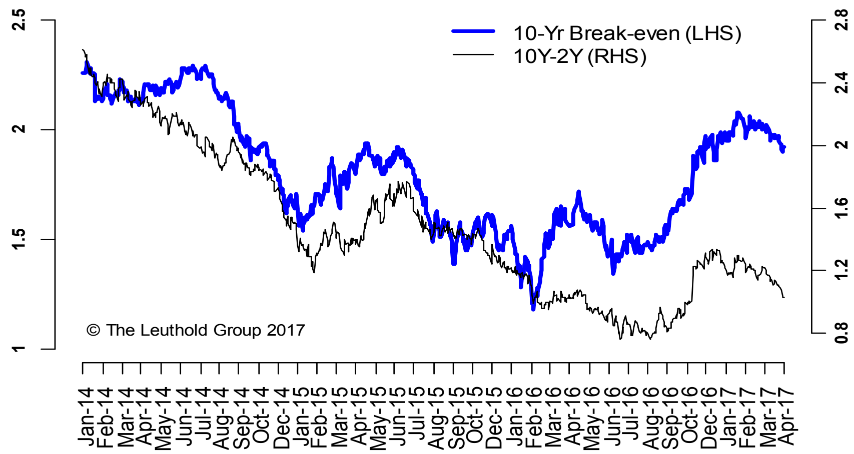
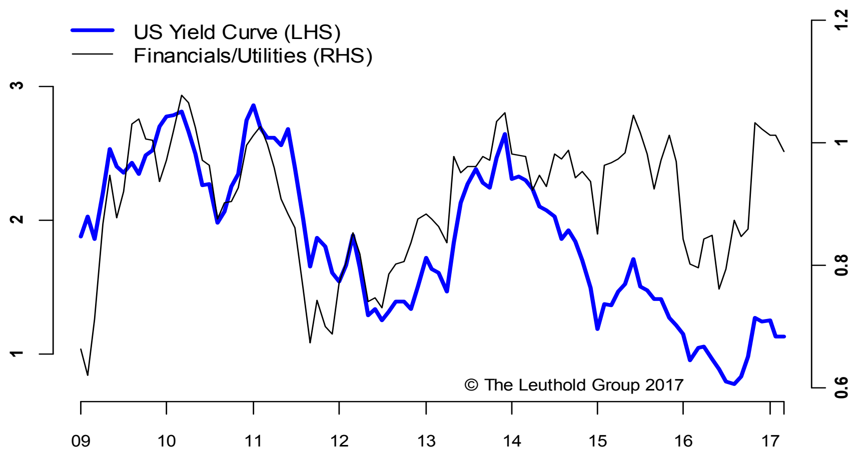


Chart 4

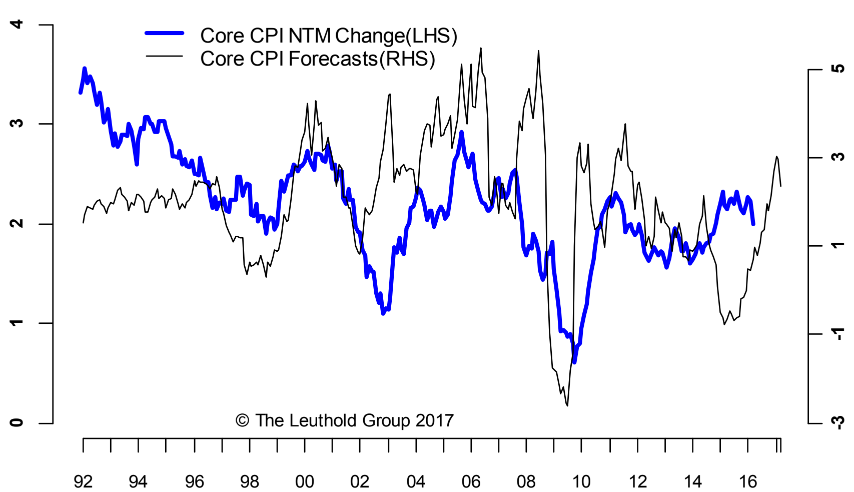
U.S. Yield Curve vs. S&P 500 Financials/Utilities Total Returns



Core CPI: March Reading 0.1% (+2% Y/Y)

Chart 5

US Core CPI Next 12-Month Change vs Core CPI Forecasts



The weaker CPI number certainly didn't help the down trend in the break-even rates that started earlier this year. With the hope for Trump's pro-growth policies dwindling, the market is re-pricing its inflation expectations. With geopolitical activities heating up around the world and the election calendar kicking into high gear, it's reasonable to expect a cautious tone in the market. As a result, yield curves have flattened along with lowered inflation expectations (Chart 3). We believe the new catalyst that is needed to restart the reflation trade is still quite elusive at this point.

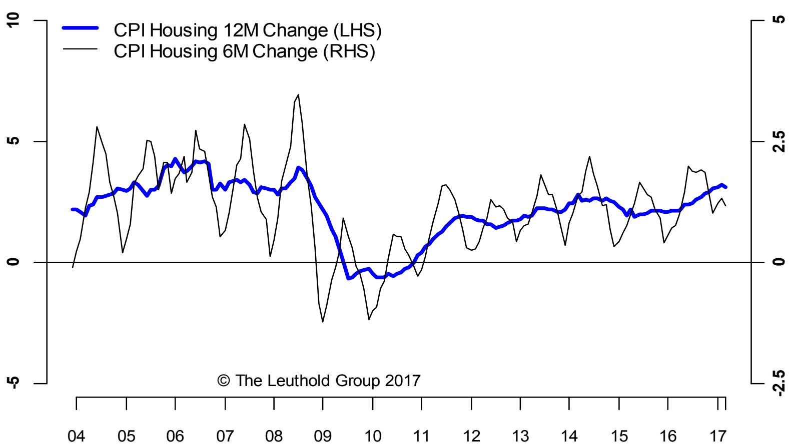
One of the more direct victims of a flatter yield curve is Financial stocks. They have underperformed so far this year, especially relative to Utilities (Chart 4). This is part of the overall unwinding of the Trump trade. While some of the key Trump trade positions (such as short bond and long dollar) have been pared back significantly, we are still not seeing enough evidence that suggests the unwinding is over.

The U.S. Core CPI (non-seasonally adjusted) also failed to meet expectations with a mere 0.1% month-over-month and 2% year-over-year change (Chart 5). Lower energy prices can not be an excuse here. New and used autos, apparel and wireless phone services all contributed to a weak core CPI reading. Our core CPI forecast model reading also turned lower and we expect lower readings in the core CPI forecasts going forward. Overall, we believe inflation has likely peaked for the time being and it's hard to find a new driver that can fully offset the negative base effect in the near future**. Patience is the right approach for the reflation trade at this point.**

Selective CPI Subsets: Housing, Medical, And Transport

Chart 6

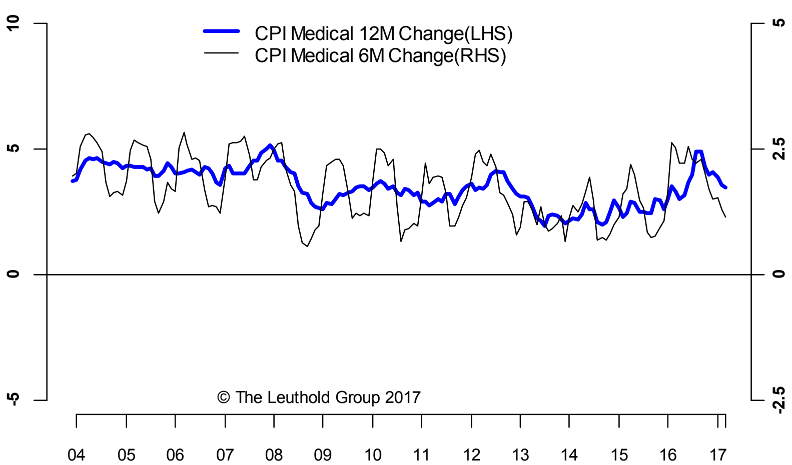
CPI: Housing (NSA)



Housing Inflation Still Robust: This component is about 41% of the overall index. The overall Housing index showed a still robust year-over-year change of 3.1% in March (Chart 6) but the pace has slowed a bit. We are not yet concerned about housing inflation at this point as both affordability and employment remain supportive of a healthy housing market. The recent pull-back in interest rates should help too.

Chart 7

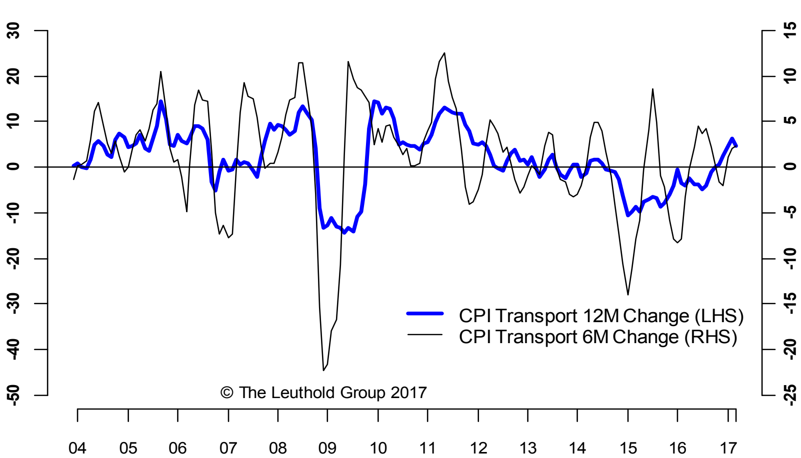
CPI: Medical (NSA)



Medical Inflation Steady: This subset is 6.4% of the overall index. Its increase stayed the same at 3.5% year-over-year pace in March, still a strong number and an above-average contributor to overall CPI (Chart 7). Unlike oil prices, high medical costs from the previous year becomes a negative base effect and we still expect a slow-down in medical inflation going forward as lower drug prices seem to be a focus of the current administration, regardless of the success of Obamacare repeal.

Chart 8

CPI: Transport (NSA)



Transport Inflation Slowed: The Transport subset is about 15% of the overall index. Its increase slowed to 4.6% year-over-year in March from 6.3% in February (Chart 8). The positive base effect is starting to fade away and it's likely that this index has peaked and the upturn is once again transitory.