INFLATION WATCH

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

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Published By The Leuthold Group, LLC

August 11, 2017
Vol. 25, No. 8

Inflation—A Challenge For The Fed

- The CPI numbers have disappointed five months in a row.
- The real bad news for inflation hawks is that the weakness in core CPI is broad-based.
- There is hope for inflation to stem its recent weakening trend soon as the Chinese CPI has already stabilized and started to turn up.

CPI Inflation: July Reading -0.1% (1.7% Y/Y)

The non-seasonally adjusted CPI fell -0.1% in July and the year-over-year change was also weak at 1.7% (Chart 1). CPI inflation has disappointed five months in a row now and it is a real challenge to the Fed's claim that the dip in inflation should be transitory. We have been anticipating a downturn in inflation since the beginning of the year and it's playing out like we expected. **The real bad news for inflation hawks is that the weakness in core CPI is broad-based**. Cell phone contract prices and prescription drugs have been cherry-picked by the Fed as support for their "transitory" argument. Hogwash! These two components combined only amount to 3% of the index. Besides, core CPI excluding cell phone services and drugs continued to weaken too.

This can be puzzling in light of the large depreciation in the dollar and the recent rebound in oil prices (Chart 2). Well, the impact of a weak dollar takes time to work its way through the import price channel and, so far, year-over-year import price changes have gone lower, not higher (chart not shown). If the dollar stays weak, we might see the upward lift in import prices late this year or early next year. When it comes to oil, despite the recent rebound, it's still lower than the end of last year and at about the same level it was a year ago. So the base effect is working against inflation here. Oil needs to break above 60 to make a difference.

Chart 1

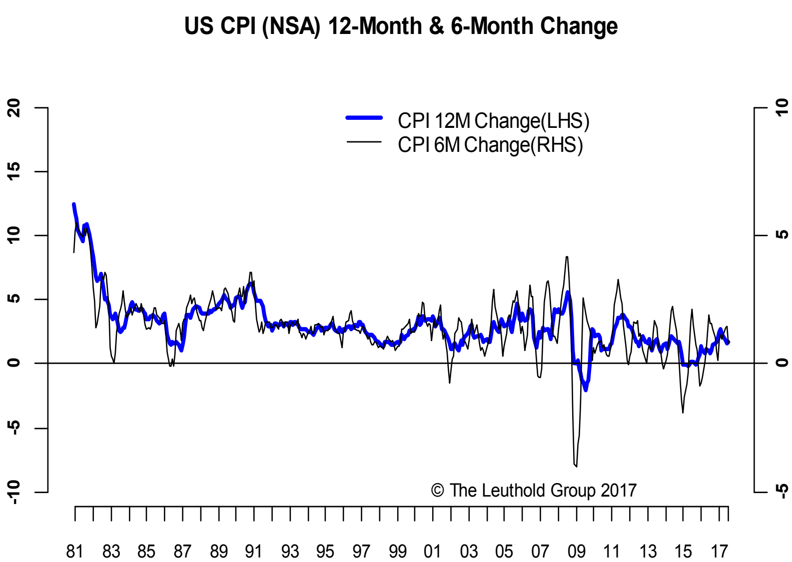

Chart 2

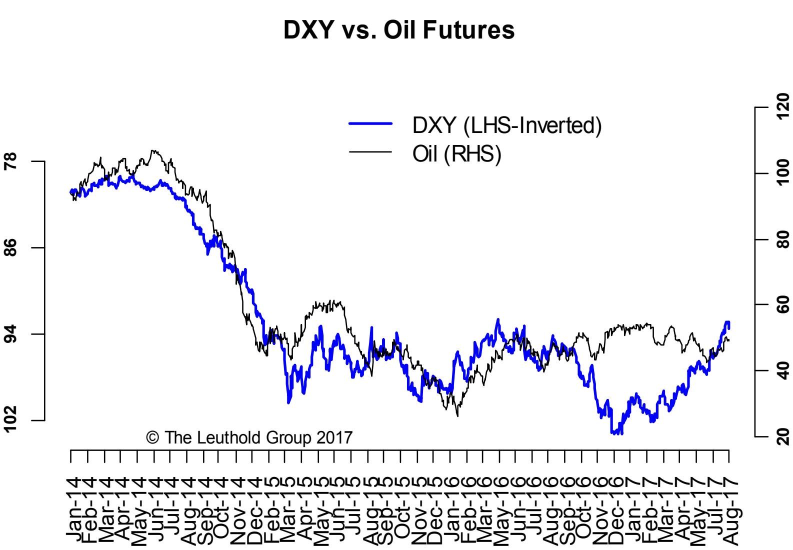

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Chart 3

World CPI Composite

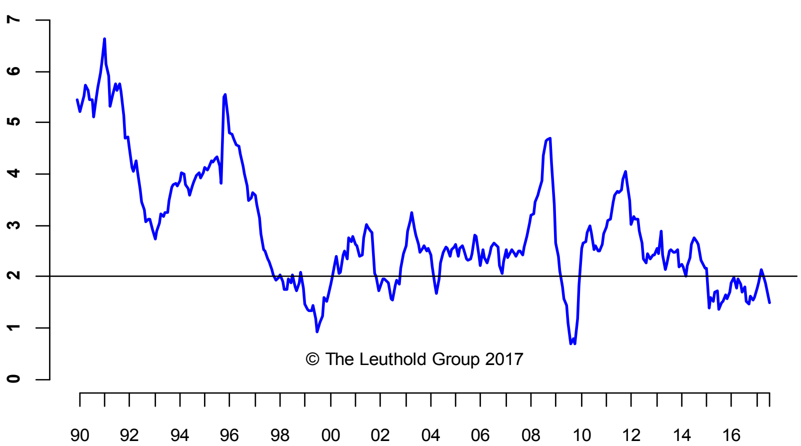
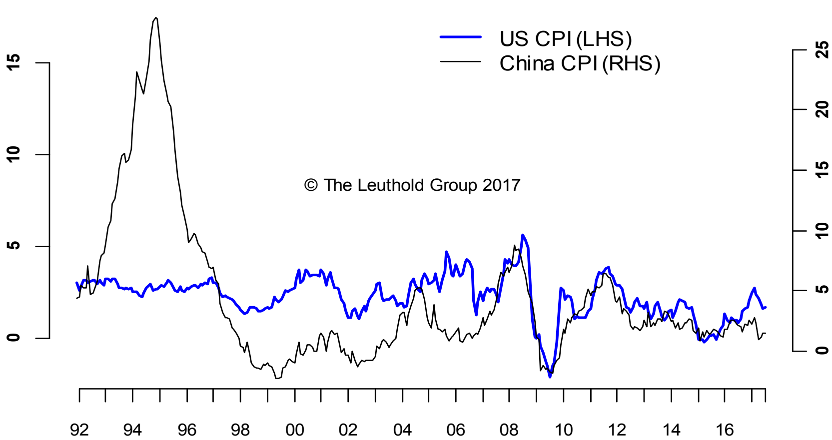


Chart 4

US CPI vs China CPI



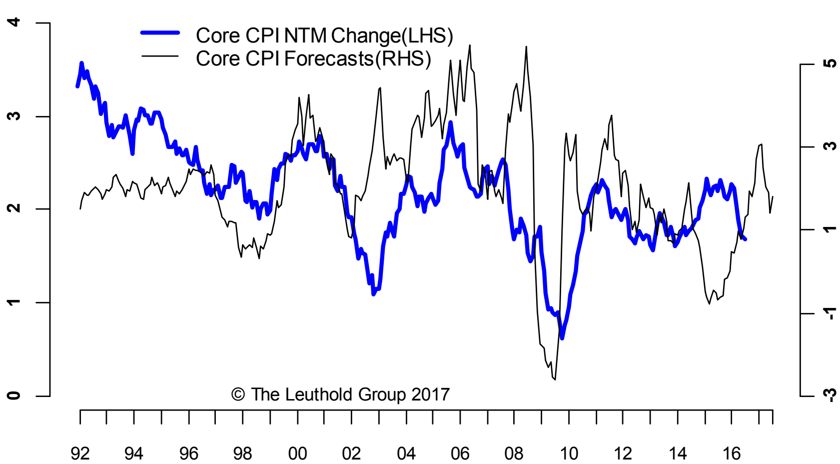
While oil price is a factor for global inflation, the dollar's role in the inflation picture is much more dubious. We have mentioned numerous times that currency depreciation does nothing more than exporting deflation from one country to another and the impact on overall global inflation is weak at best. Chart 3 shows a pretty clear global inflation deceleration, which added more weight to the persistence of soft inflation readings. In fact, both developed and emerging countries have been undershooting inflation expectations (chart not shown).

While we don't see any imminent threat of higher inflation, we are certainly not in the deflation/ recession camp either. In fact, one of the leading inflation series, the Chinese CPI, has already stabilized and started to turn up, which partially explains the rally in commodities in the last couple months. So there is hope for inflation to stem its recent weakening trend soon.

Core CPI: July Reading 0% (+1.7% Y/Y)

Chart 5

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



The U.S. Core CPI (non-seasonally adjusted) also missed expectations with a flat month-over-month reading and 1.7% year-over-year change (Chart 5). Deceleration is broad-based here.

Our core CPI forecast model reading, based on past core inflation, housing, gold and commodity prices, rebounded this month on the back of higher commodity prices. This suggests further downside in the core CPI might be limited but it's certainly too early to tell. All things considered, we believe inflation headwinds are likely to persist for a while longer and we are taking a "seeing is believing" approach when it comes to inflation.

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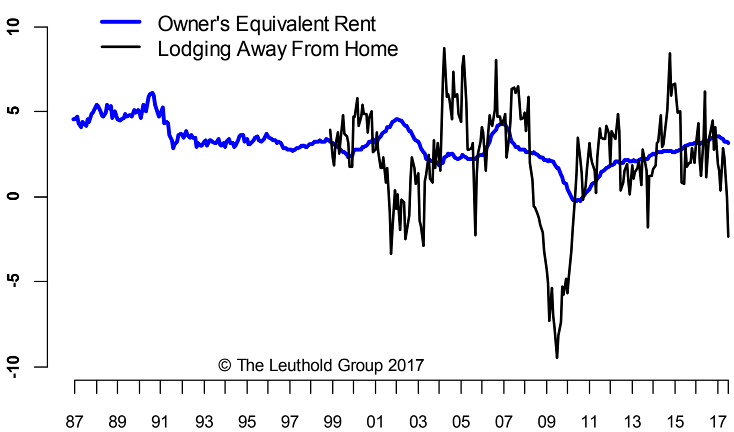
Selective CPI Subsets: Housing, Medical, And Transport

Chart 6

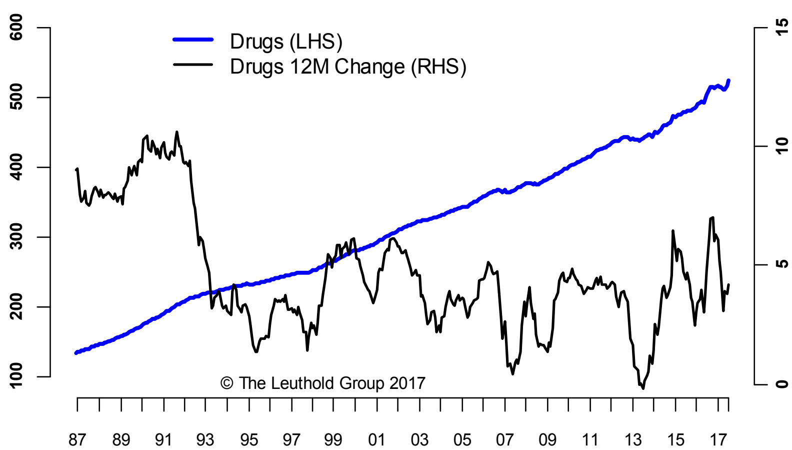
Shelter Inflation - OER vs. Lodging Away From Home



Housing Inflation Plateaued: This component is about 42% of the overall index. The overall Housing index slipped below 3% for the first time this year to a still decent reading of 2.8% in July (Chart not shown) but annual growth in Owners' Equivalent Rent is also in a slowing trend. And here comes the Airbnb effect on lodging (Chart 6)! While we think the housing market is still healthy, the current downturn in housing, given its big weight, is not helping the inflation story.

Chart 7

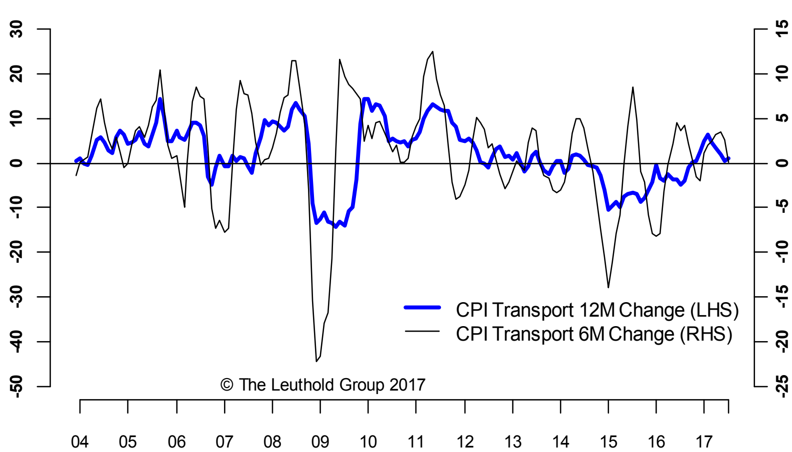
CPI Index - Prescription Drugs



Medical Care Inflation Slipped: This subset is 9% of the overall index. In July, this index rose 2.5% year over year. The prescription drugs component, on the other hand, rebounded to 4.2% after a few months of sharp deceleration (Chart 7). While we do expect the deceleration in this particular component to be transitory, we can't really say the same about the overall inflation trend.

Chart 8

CPI: Transport (NSA)



Transport Inflation Edged Higher: The Transport subset is about 15% of the overall index. Its year-over-year increase bounced off the zero line to 1.2% in July (Chart 8). The base effect is still negative for this component but the recent rally in oil helped quite a bit. This is one of the more volatile components in the index and we expect little net contribution from this component in the near future.

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