INFLATION WATCH

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

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Inflation—As Flat As The Yield Curve

- The latest Core CPI number disappointed again.
- The divergence between inflation break-evens and the yield curve is puzzling.
- Given the lack of inflationary pressure and the Fed's projected rate path, it would not surprise us to see a flatter curve without the help of fiscal stimulus in the next few months.

CPI Inflation: November Reading 0% (2.2% Y/Y)

The non-seasonally adjusted CPI was essentially flat in November and the year-over-year change ticked up to 2.2% (Chart 1). The headline CPI number was in line with market expectations and was largely driven by a bump up in energy and gas prices (Chart 2). On the other hand, declining health care and apparel prices weighed on the overall index.

The latest FOMC meeting was largely in line with market expectations but the market reacted by erring on the side of dovishness at least for now. The PPI numbers released earlier this week surprised on the upside but the average hourly earnings number earlier this month was disappointing. The latest CPI number and the Fed hike certainly didn't persuade bond investors to become more concerned about rising inflation in the near future.

Interestingly, all this is happening when the Citi Economic Surprise Index is near the highest level of this year around 60, a level where an imminent reversal is much more likely. One has to wonder where the next impetus for higher inflation expectations and higher rates would come from.

Chart 1

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

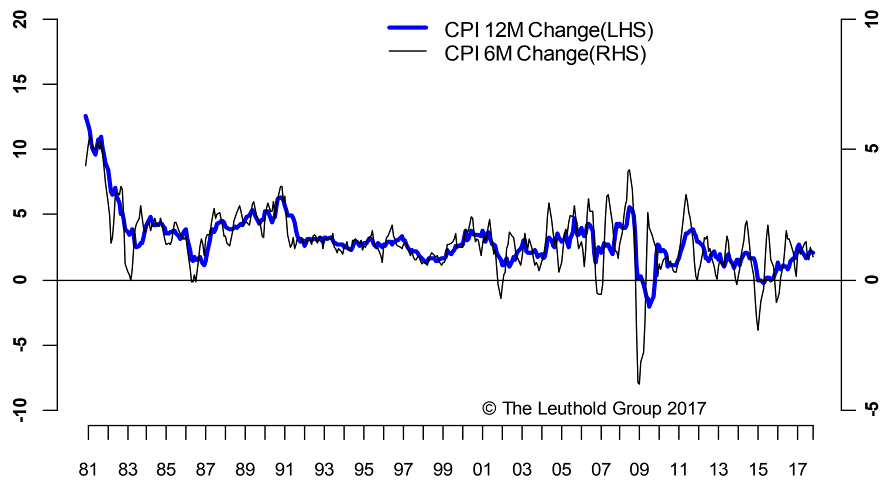


Chart 2

Gasoline & Energy CPI 12-Month Change

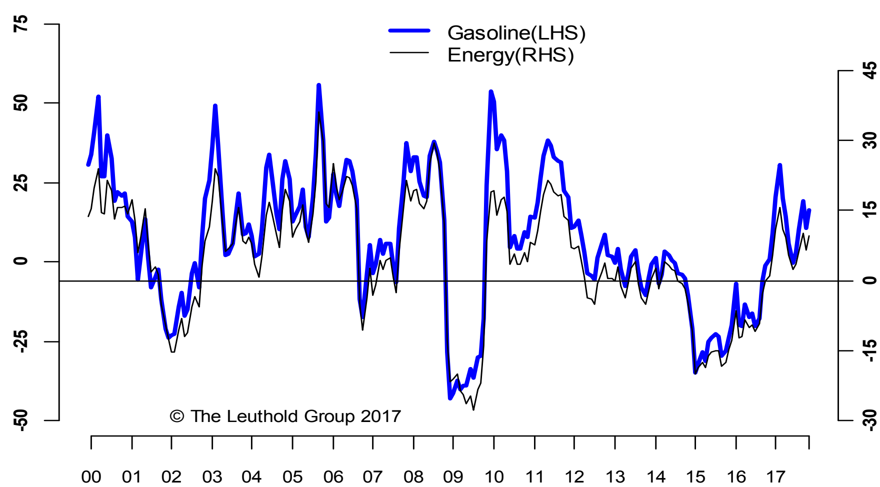
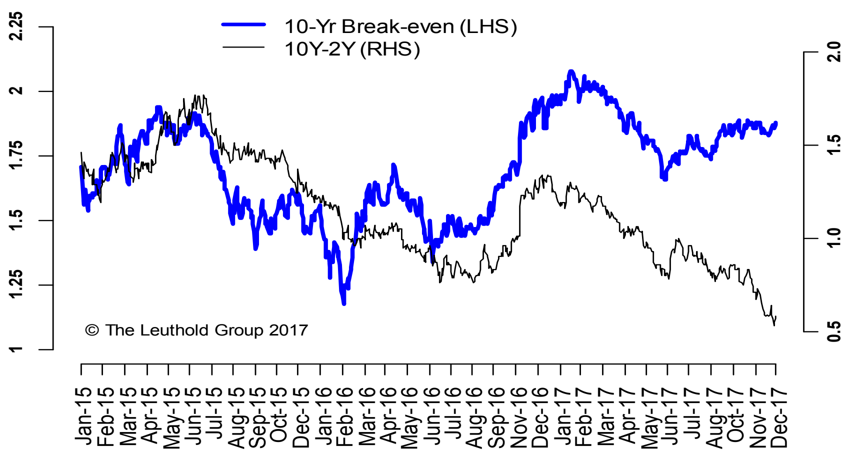


Chart 3

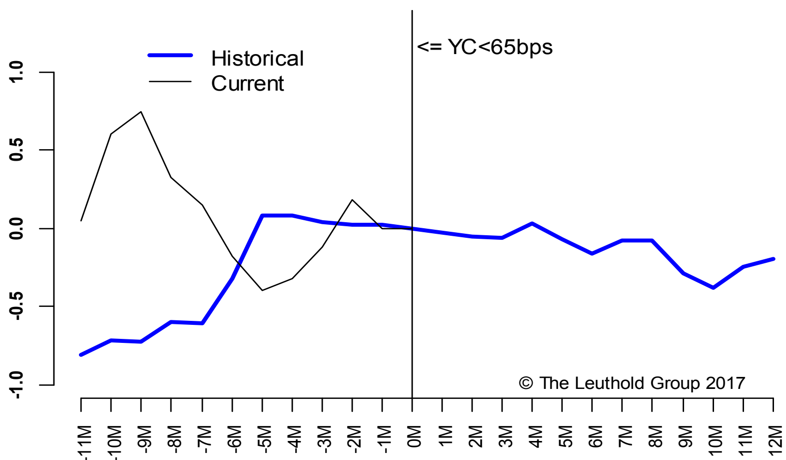
US 10-Year Breakeven Rate vs. Yield Curve



One of the main market themes is the persistent flattening of the yield curve, which is now sitting at post-crisis low (Chart 3). Surprisingly, inflation expectations, a big driver of the yield curve, are still holding up quite well so far this year. This divergence is indeed puzzling to us, given the macro backdrop where the global economy is the strongest we have seen in recent years.

Chart 4

Performance Bfr/Aft YC Flattens Below 65 bps - US CPI

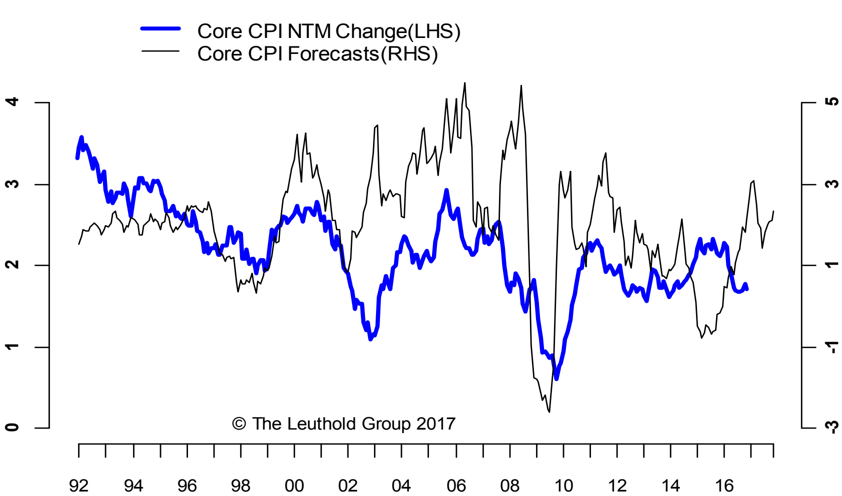


When we look at the historical pattern when the yield curve flattens below 65 bps (like right now), we notice that CPI inflation typically softens a bit more in the next twelve months (Chart 4) and inflation expectations tend to fluctuate with a downward bias too. So overall, if history is a good guide, the prospect for strong inflation readings is not great. The yield curve typically flattens for another 30 bps however concerns of an imminent recession due to an inverted curve are still premature at this point.

Core CPI: November Reading –0.1% (+1.7% Y/Y)

Chart 5

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

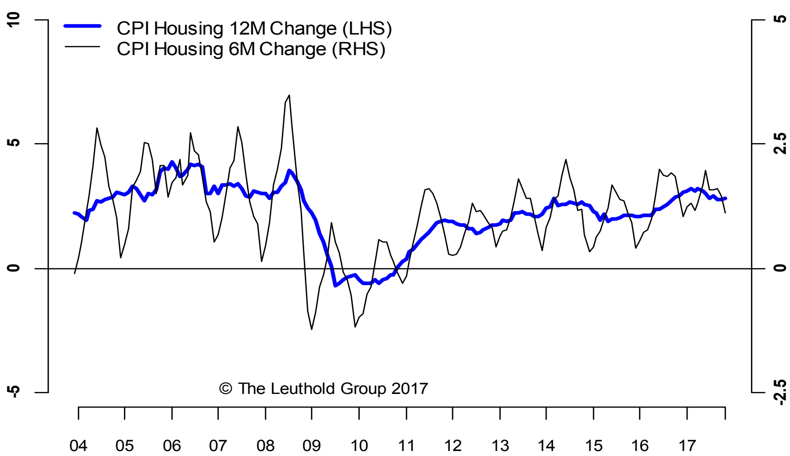


The U.S. Core CPI (non-seasonally adjusted) missed expectations with a –0.1% month-over-month reading and a 1.7% year-over-year change (Chart 5). Our core CPI forecast model reading, based on past core inflation, housing, gold and commodity prices, moved higher again this month. The gap between the model forecast and the actual Core CPI reading has increased quite a bit this year, reflecting other forces holding down inflation that are not factored in our simple model. Technological innovation, like we mentioned before, is certainly a secular disinflationary force**.** Given the lack of inflationary pressure and the Fed's projected rate path, it would not surprise us to see a flatter curve without the help of fiscal stimulus in the next few months.

Selective CPI Subsets: Housing, Apparel, And Medical

Chart 6

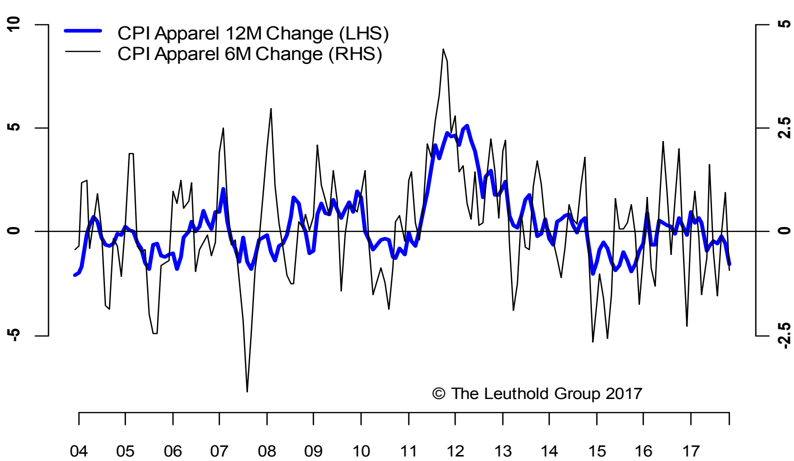
CPI: Housing (NSA)



Housing Inflation Still Robust: This component is about 42% of the overall index. The overall Housing index remained at 2.8% in November (Chart 6) and annual growth in Owners' Equivalent Rent also maintained a robust pace at 3.1%. The Lodging away from home weakened to 0.6% in November. The overall housing inflation picture remains healthy.

Chart 7

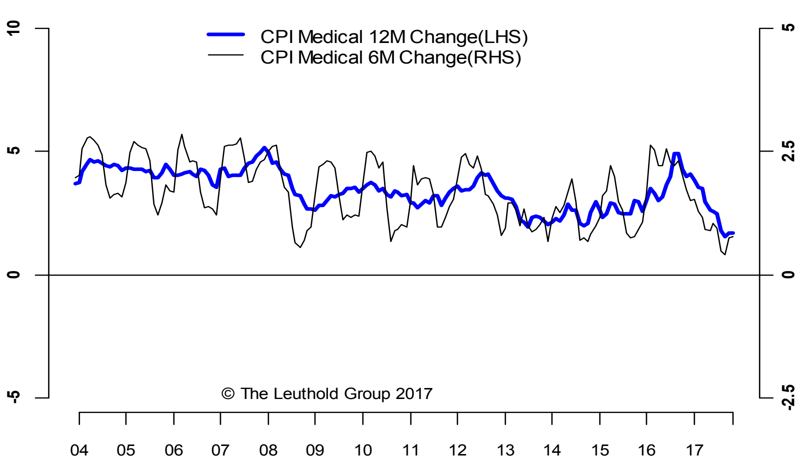
CPI: Apparel (NSA)



Apparel Inflation Slumped: This subset is 3% of the overall index. In November, this index fell –1.6% year over year, the worst reading among all components. This is also the lowest reading since mid 2015 and this index has been negative for the last 7 months, hardly an aberration (Chart 7). We believe continued headwinds are expected for this index.

Chart 8

CPI: Medical (NSA)



Medical Care Inflation Stayed At Recent Low: This subset is 9% of the overall index. In November, this index rose 1.7% year over year (Chart 8). Hospital services and the prescription drugs component canceled each other out. We believe health care inflation has probably found a medium term bottom and is likely to contribute more positively going forward.