

INFLATION WATCH

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

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Inflation—All About That Base

- CPI numbers were strong and better than expected.
- A big part of the recent upturn in inflation has to do with the much lower base from a year ago.
- We are seeing upside inflation surprises on a global basis but wage inflation is still disappointing.
- We are encouraged by the general uptrend in inflation data but we think the real test comes after the positive base effect subsides.

CPI Inflation: January Reading 0.6% (2.5% Y/Y)

Yeah, it's pretty clear, it ain't no size two anymore. After being stuck below 0.5% for the last couple years, the month-to-month increase in the non-seasonally adjusted CPI rose 0.6% in January, above market expectations. The year-over-year change of 2.5% was also the highest it has been in the last several years (Chart 1).

We are certainly encouraged by the positive inflation data as well as the solid retail sales numbers in January, but do we have "all the right junk in all the right places?" That's a much harder call. We think **a big part of the recent upturn in inflation has to do with the much lower base from a year ago**. Remember, we were at the very bottom of the oil and credit downturn last January. Since then, oil prices have doubled, bringing all commodity prices up along the way. Chart 2 shows a strong surge in the GSCI commodity index over the last year, which helped first stabilize inflation expectations and provide the base for the subsequent Trump rally.

Despite the well-known base effect, economists tend to under-adjust their forecasts for inflation, which typically leads to reported CPI numbers outperforming expectations for an extended period of time, usually around 3 months. This implies the upside surprise streak might extend to May.

Chart 1

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

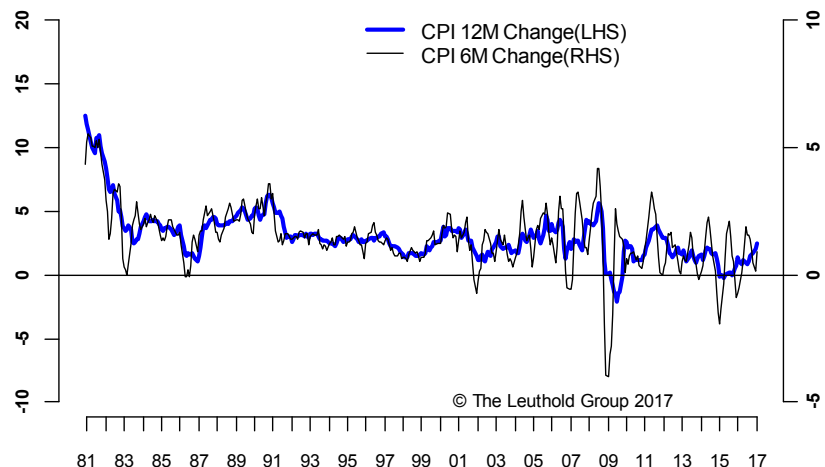


Chart 2

GSCI Commodities Index Y/Y Change vs. 10-Year Breakeven

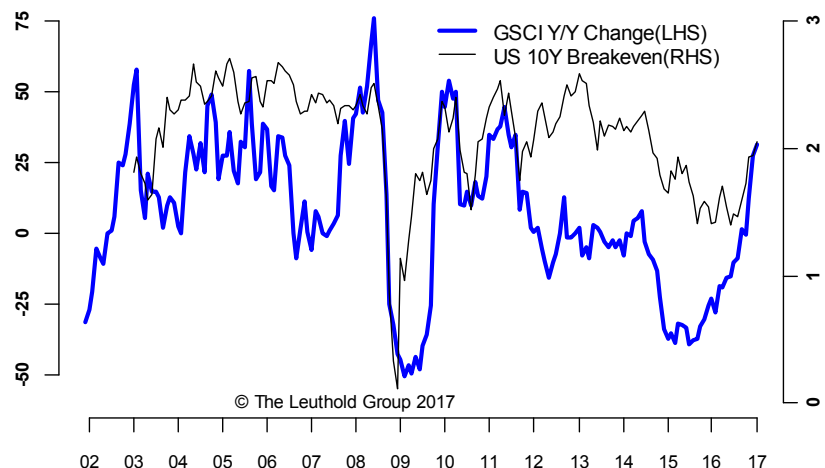


Chart 3
Citi Inflation Surprise Index (ISI)
- Developed Markets vs Emerging Markets

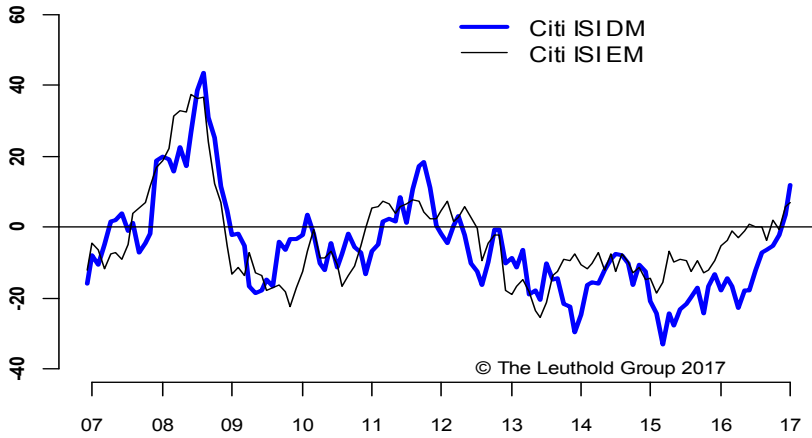
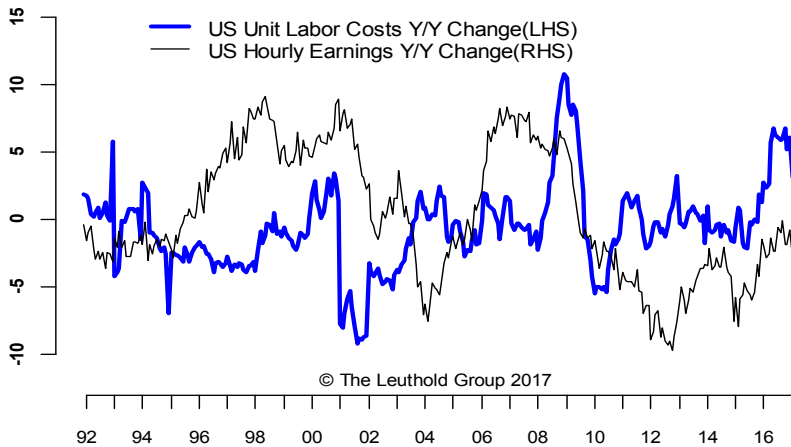


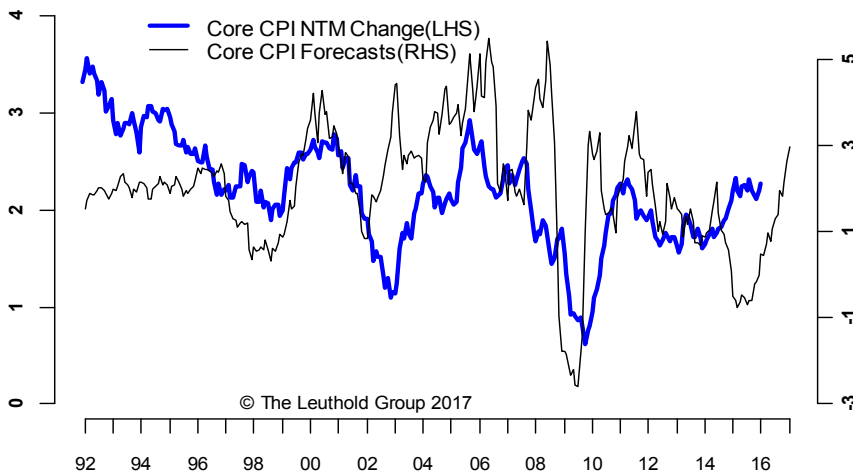
Chart 4
US Unit Labor Costs & US Hourly Earnings Y/Y Change



Core CPI: January Reading 0.4% (+2.3% Y/Y)

Chart 5

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



Already, we are seeing upside inflation surprises on a global basis. Chart 3 shows the Citi Inflation Surprise Index for developed and emerging markets and both have broken into the positive territory for the first time since 2012. The base effect is very clear in CPI reports around the world. The Eurozone (Germany in particular), Japan and China all saw huge upside surprises in their latest inflation reports. All cited the base effect as a significant contributor.

While we believe the reflation theme can continue for a while longer, the real test is when the base effect starts to wane, most likely around mid-year. We would need new inflation drivers. Potential drivers can include a new up-leg in commodities, a strong Chinese Yuan, wage inflation etc. Wage growth, one of the key drivers of inflation, has been disappointing. The average hourly earnings number just released with the employment report was the fly in the ointment. And other wage/employment costs related measures told a similar story (Chart 4). In other words, we still can't say we've got all the "right junk in all the right places" when it comes to inflation.

The U.S. Core CPI (non-seasonally adjusted) rose 0.4% month-over-month and 2.3% year-over-year, also stronger than market expectations (Chart 5). The latest core CPI forecast model readings jumped, suggesting more upside inflation surprises in the near term. **Overall, we are encouraged by the general uptrend in inflation data but we think the real test comes after the positive base effect subsides.**

Selective CPI Subsets: Housing, Medical, And Transport

Chart 6

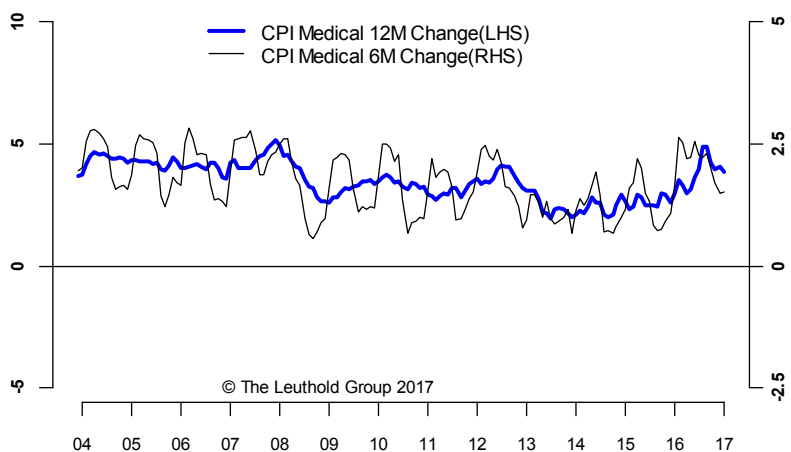
CPI: Housing (NSA)



Housing Inflation Very Robust: This component is about 41% of the overall index. The year-over-year change moved into the 3% range in January, after registering a long streak of very robust 2+% readings (Chart 6). Owners' Equivalent Rent maintained its annual pace of 3.5% (chart not shown). Housing and employment continue to be the two reliable engines that support the overall economy.

Chart 7

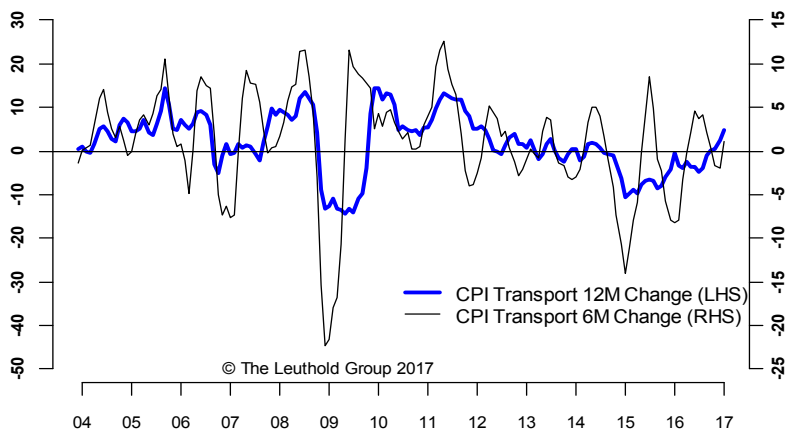
CPI: Medical (NSA)



Medical Inflation Still Strong: This subset is 6.4% of the overall index. Its increase slowed a bit to 3.9% year-over-year pace in January, still a very strong number by any standard (Chart 7). Despite the recent deceleration, it remains one of the strongest components in the overall index. Unlike oil prices, high medical costs under Obamacare becomes a negative base effect going forward and we expect a slower pace of medical inflation in the near future.

Chart 8

CPI: Transport (NSA)



Transport Continued To Improve: The Transport subset is about 15% of the overall index. It jumped 4.8% year-over-year in January (Chart 8). This is a case in point for the base effect and we expect this to provide more upside to the overall composite in the next few months.

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