INFLATION WATCH

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

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Inflation—Deflationary Fears Further In Rearview Mirror

- CPI figures for December matched consensus estimates.
- The Federal Reserve should be pleased to see the modest uptrend in prices.
- Sustained price inflation still faces a number headwinds including: resource slack, a strong Dollar and a weakening Yuan.
- Energy prices saw the largest gains in 2016 after a brutal 2015. Within the Core CPI, medical care experienced notable gains.

CPI Inflation: December Reading +0.3% (+2.1% Y/Y)

The CPI rose 0.3% in December on a seasonally adjusted basis—matching consensus estimates. Year-over-year, prices increased by 2.1% before seasonal adjustment. This is the largest twelve month increase since June of 2014. Year-over-year CPI figures have been growing steadily each month since July's anemic 0.8% reading.

After spending the bulk of 2015 with 12 month CPI figures at or around 0%, headline inflation finally clawed its way back to the Fed's 2% objective threshold. December's reading, coupled with the rest of the back half of 2016, supports the overall narrative that inflation has accelerated in recent months.

In light of their recent rate hike, Federal Reserve members should be relieved to see this modest uptrend in prices. In a speech given Tuesday, New York Fed President William Dudley said, "inflation is simply not a problem," and "underlying inflation trends are very subdued." We agree with President Dudley. Current levels of price increases—especially compared to 2015—are certainly not problematic.

Chart 1

U.S. CPI (NSA) 12-Month & 6-Month Change

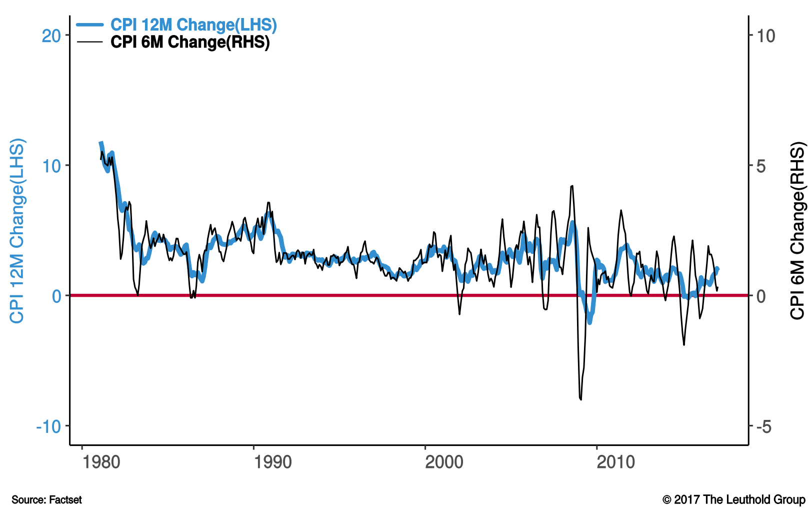


Chart 2

World CPI Composite

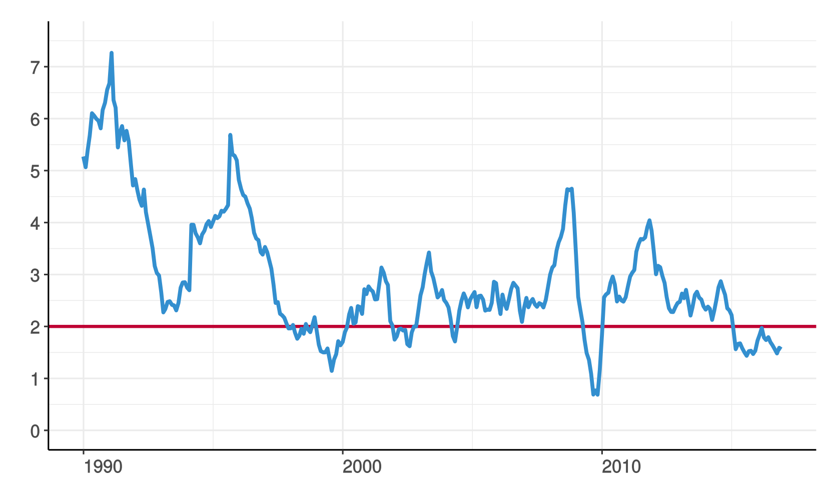
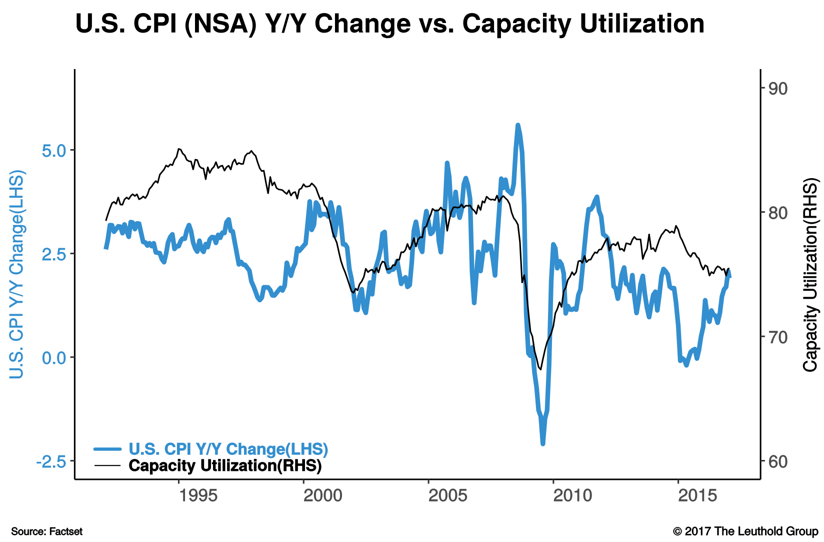


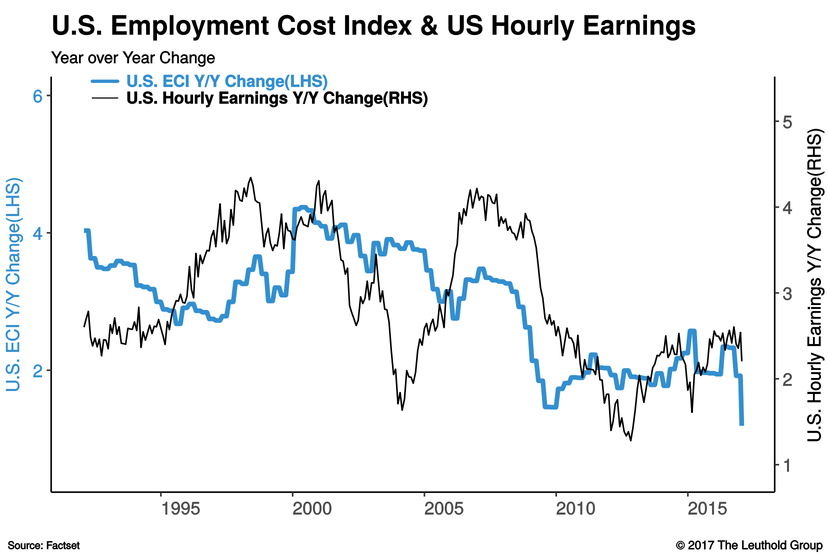
Chart 3



While the members of the Fed pat each other on the back, let's look at a few of the headwinds still facing sustained inflation.

Capacity utilization (Chart 3) has yet to make a meaningful move to the upside. The extra slack in the economy (underemployed capital and labor) should mean that further economic expansion can probably be absorbed without dramatic price increases. If we use capacity utilization as a leading indicator for inflation, the recent leg up in the CPI may not be justified.

Chart 4



Even with an unemployment rate of 4.7%, year-over-year growth in our employment costs are stubbornly low (from the worker's point of view, of course). If we look at wage growth in past "sunny" economic periods, (Chart 4) our current situation of slow growth becomes much more clear. A wage driven inflation story doesn't seem to be in the cards.

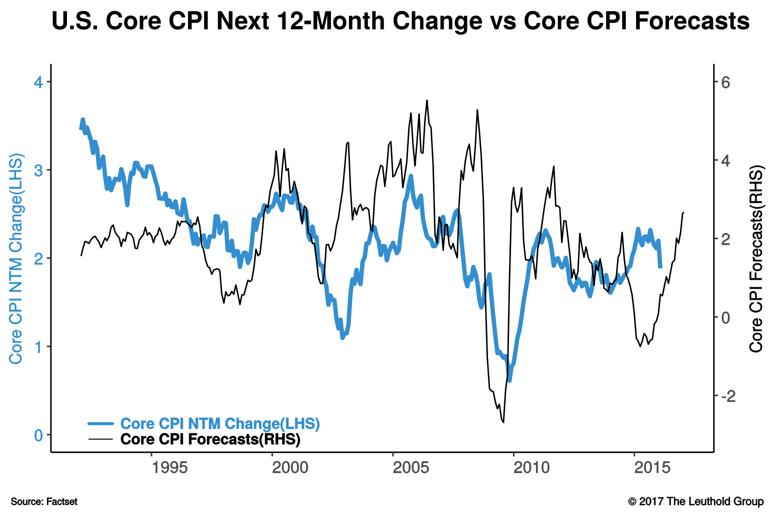
Chart 5

The US Dollar Index remains within spitting distance of a 13 year high made in December. Couple this with the declining value of the Chinese Yuan, inflation is looking at a 1-2 punch from currency moves. Both changes will put downward pressure on import prices for US consumers. It should also limit the ability for domestic producers to increase prices.

We recognize inflation figures are turning away from the dark abyss of deflation. We are, however, underwhelmed by the lack of catalysts to push inflation higher.

Core CPI: December Reading +2.2% Y/Y

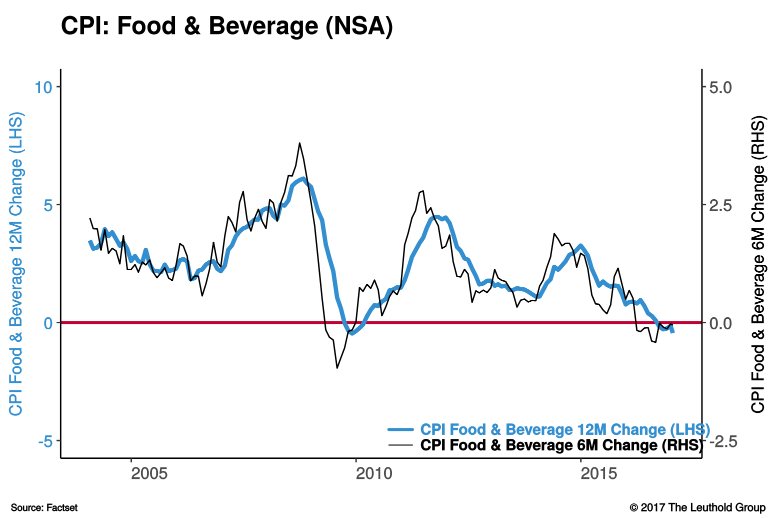
Chart 6



Core CPI (ex food and energy) rose at a year-over-year rate of 2.2% in December. This much less volatile measurement of inflation remained between 2.1% and 2.3% for the entire year of 2016.

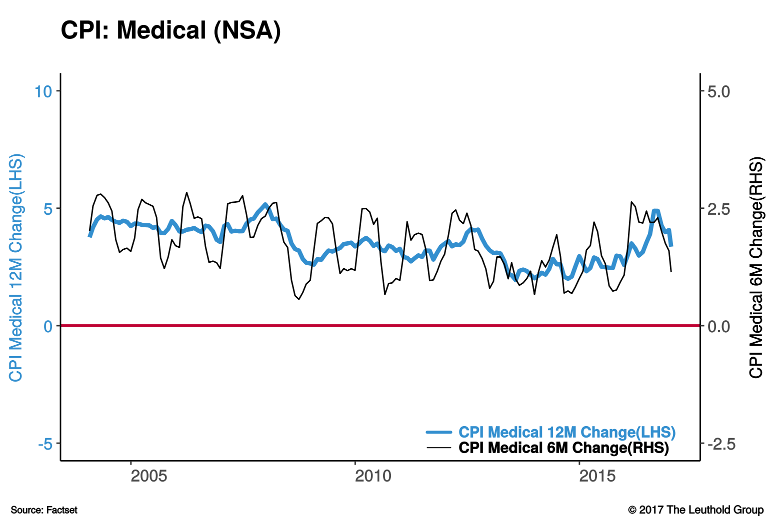
A steep increase in gasoline prices boosted headline inflation (2.1%) and significantly narrowed the gap with the core measurement (0.4% down to 0.1%) from November's readings.

Chart 7



Food and Beverages get cheaper in 2016. Despite what you heard from your older relatives during the holidays, the food index fell 0.2% over the past year. The food at home index fell even more, decreasing by 2% over the past twelve months—great news for that Super Bowl party you're throwing.

Chart 8



Medical care costs continue to rise. Within the Core CPI measurement, medical costs were 2016's fastest growing segment (+4.7% for the year). This was its largest December-to-December increase for this category since 2007. The next few years should be very interesting for the medical care component of the CPI. Can the new administration put a lid on health care costs? We're skeptical.