INFLATION WATCH

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

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Inflation Disappoints Again

- The CPI numbers have disappointed three months in a row.
- Weak commodity prices do not inspire higher inflation expectations.
- The global scope of inflation deceleration adds more weight to the recent soft readings.
- However, lower bond yields relative to nominal growth rate is inflationary and buffers the impact of weak inflation and rate hikes.

CPI Inflation: May Reading 0.1% (1.9% Y/Y)

The non-seasonally adjusted CPI was up 0.1% in May and 1.9% year over year (Chart 1), below market expectations. CPI inflation has disappointed for three months in a row now. Softer than expected prices were observed in both the goods and services sectors. Energy, Transportation, Apparel and Communications components all contributed to the weak reading. Retail sales numbers also came in below expectations. Obviously, the Fed is once again calling the recent weakness transitory, but when we look at the scope of recent economic data weakness, we start to pray a bit harder.

The commodities complex has already rolled over with both energy and industrial metals showing weak price actions and higher volatility (Chart 2). This does not inspire higher inflation expectations. We have mentioned in our last report that expectations for higher inflation are still on the high side while the increasingly negative base effect is likely to drag CPI lower in the second half. Without clear offsets on the upside, we think the likelihood of even lower CPI numbers has increased substantially. However, we are not expecting a deflation/recession scenario at this point. **Our base case is, in absence of significant pro-growth fiscal policies, we are drifting back towards the "lowflation" world.**

Chart 1

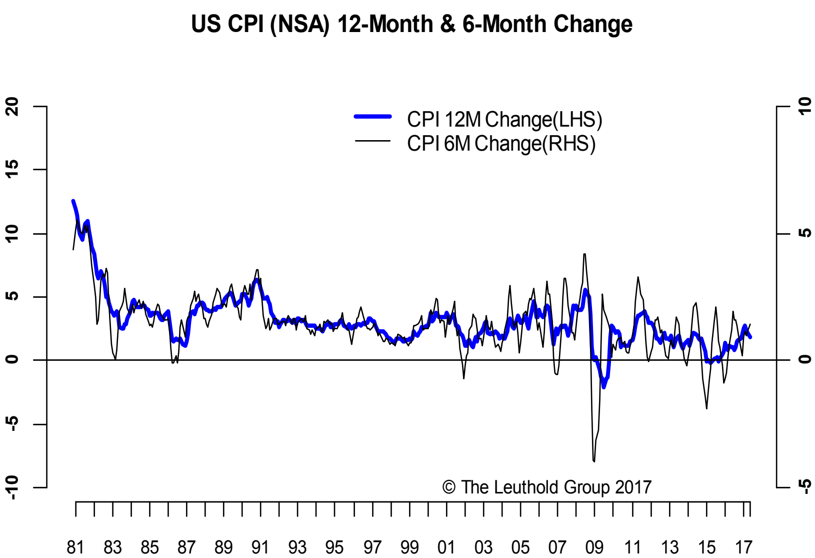


Chart 2

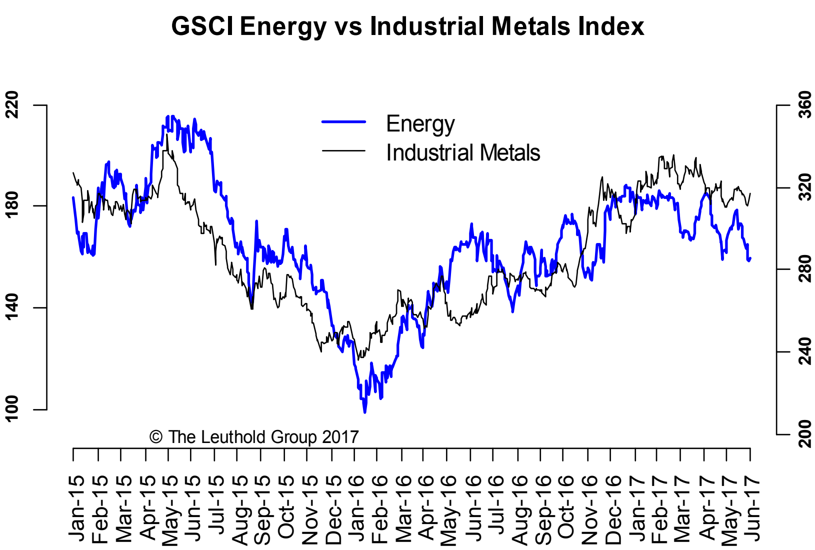


Chart 3

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

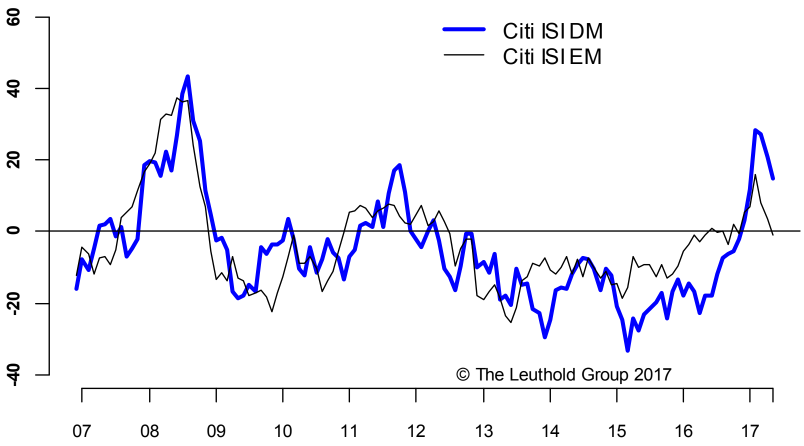
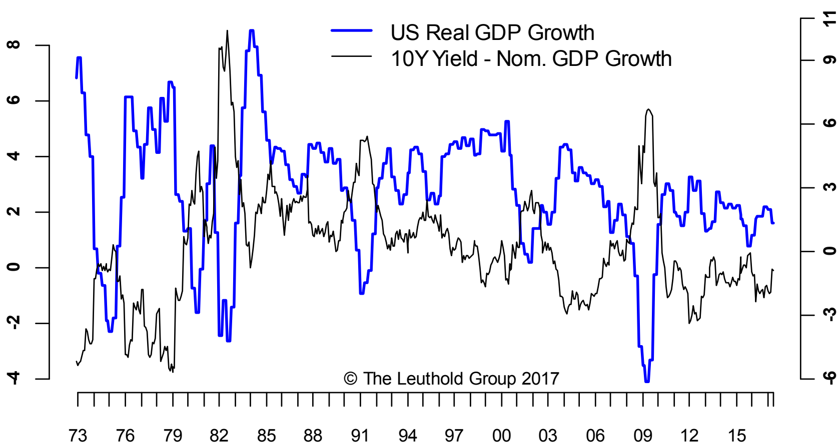


Chart 4

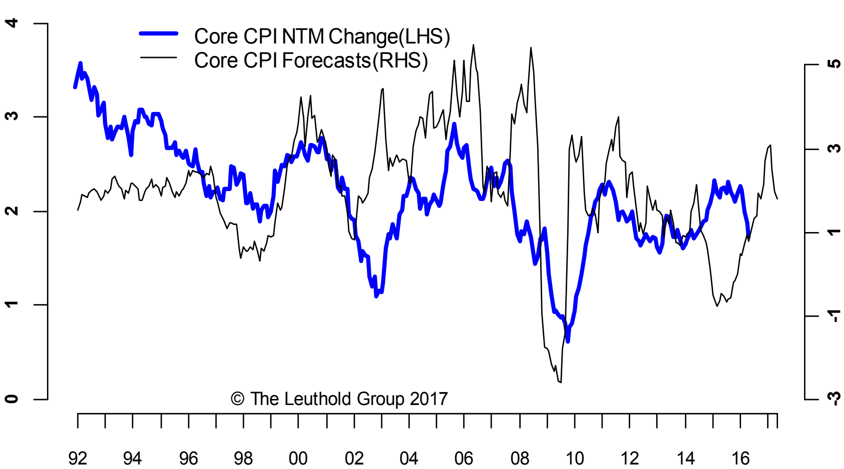
US Real GDP Growth vs. 10-Year Treasury Yield - Nominal GDP Growth



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

Chart 5

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



We also mentioned in our last report that **the global scope of inflation deceleration added more weight to the recent soft readings**. This trend is continuing with both developed and emerging countries undershooting inflation expectations (Chart 3). We have repeatedly stressed the difficulty in breaking global disinflation with monetary easing, where the main outcome has been exporting disinflation from one country to another without solving the real problem.

While we complain about persistently low inflation, the market is already self-adjusting by lowering bond yields. Historically, lower rates are a good thing for the economy. Chart 4 shows a strong negative relationship between real GDP growth and the difference between bond yields and nominal GDP growth. Lower bond yields relative to nominal growth rate is inflationary and buffers the impact of weak inflation and rate hikes.

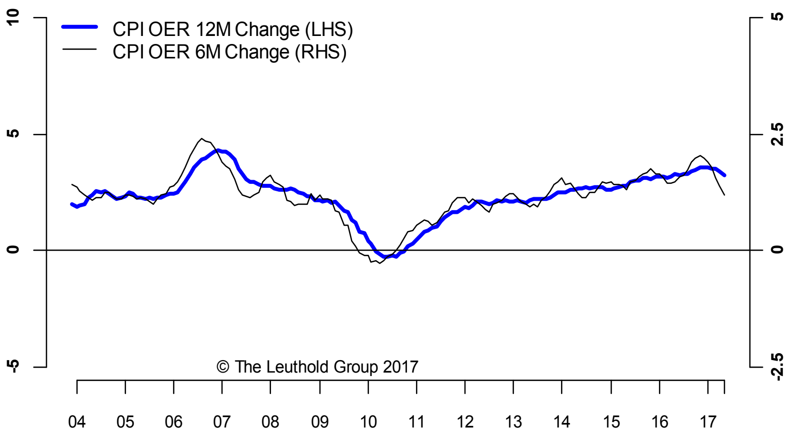
The U.S. Core CPI (non-seasonally adjusted) also missed expectations with a mere 0.1% month-over-month and 1.7% year-over-year change (Chart 5). Lower energy prices can not be used as an excuse here.

Our core CPI forecast model reading, based on past core inflation, housing, gold and commodity prices, continued to fall, tracking a path similar to the recent deceleration in global inflation. Further downside in this core CPI forecast should be expected unless commodity prices improved significantly. All things considered, we believe inflation has likely peaked for the time being and we are struggling to find a new driver that can fully offset the inflation headwinds in the near future.

Selective CPI Subsets: Housing, Apparel, And Transport

Chart 6

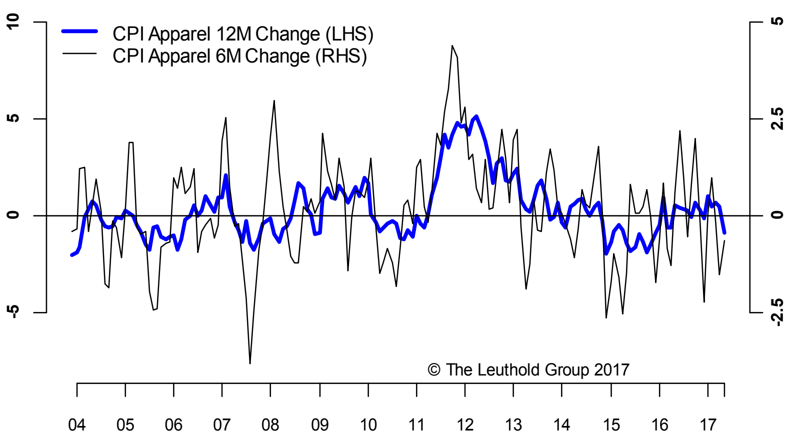
CPI: Owners Equivalent Rent (NSA)



Housing Inflation Plateaued: This component is about 42% of the overall index. The overall Housing index still showed a solid year-over-year change of 3.1% in May (Chart not shown) but annual growth in Owners' Equivalent Rent is in a noticeable slowing trend from a high level (Chart 6). While we think the housing market is still healthy, the current downturn in this index is bigger than any previous downturns since 2010. This warrants close monitoring.

Chart 7

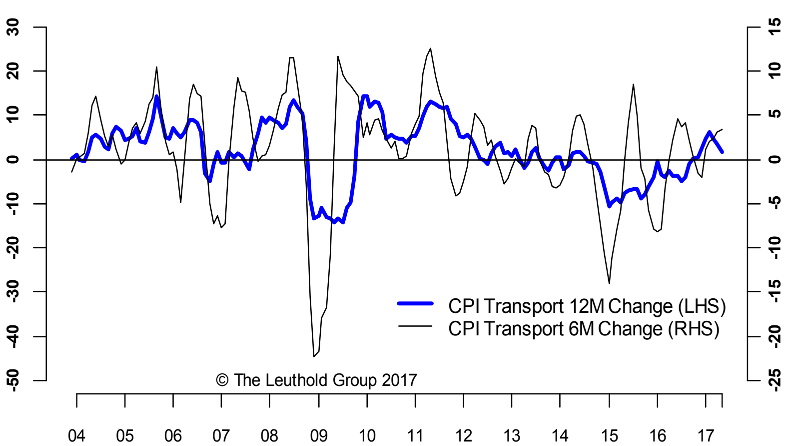
CPI: Apparel (NSA)



Apparel Inflation Slipped: This subset is 3% of the overall index. In May, this index slipped back into the negative territory (at –0.9%) for the first time this year (Chart 7). This component, albeit with smaller relative weight, is a big non-energy contributor to the weak overall CPI reading this month. However, recent weakness in the dollar will likely help this index recover in the rest of the year, all else being equal.

Chart 8

CPI: Transport (NSA)



Transport Inflation Slowed Further: The Transport subset is about 15% of the overall index. Its increase slowed substantially to 1.8% in May, from 3.5% in April (Chart 8). The base effect is turning increasingly negative for this component, as we had expected. With oil and commodity prices getting weaker, more downside should be expected in the near future.