INFLATION WATCH

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

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A Dovish Hike—Positive For Inflation

- The dovish rate hike is a positive for inflation and credit.
- A hawkish message right now would have been quite detrimental and self-defeating in terms of realizing two more hikes later this year.
- We believe achieving sustained 2-3% inflation could be harder than most people expect going forward.
- Overall, we are encouraged by the dovish hike but we think the real test for inflation is when the base effect starts to wane.

CPI Inflation: February Reading 0.3% (2.7% Y/Y)

The non-seasonally adjusted CPI rose 0.3% in February, slightly above market expectations. The year-over-year change of 2.7%, in line with expectations, was also the highest it has been in the last several years (Chart 1).

However, the big event this week was the widely-expected rate hike which turned out to be a dovish hike, one of Yellen's best touches. We are relieved that the Fed didn't send a more hawkish message by either increasing the implied number of hikes or the terminal rate. **This is a positive for inflation and credit.**

We think the rate hike is appropriate but we believe a hawkish message right now would have been quite detrimental and self-defeating in terms of realizing two more hikes later this year. First of all, as we mentioned before, the recent strong inflation numbers have a lot to do with the positive base effect as we are comparing to numbers from early 2016 when oil prices were below $30. As time passes, the base effect alone (assuming no change in oil prices) is likely to drive inflation back below 1% in a few months. Now, with oil and commodity prices already in a correction mode (Chart 2), a hawkish rate hike would only exacerbate the sell-off and further dampen the inflation outlook. In other words, the dovish hike is exactly what the market needs right now.

Chart 1

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

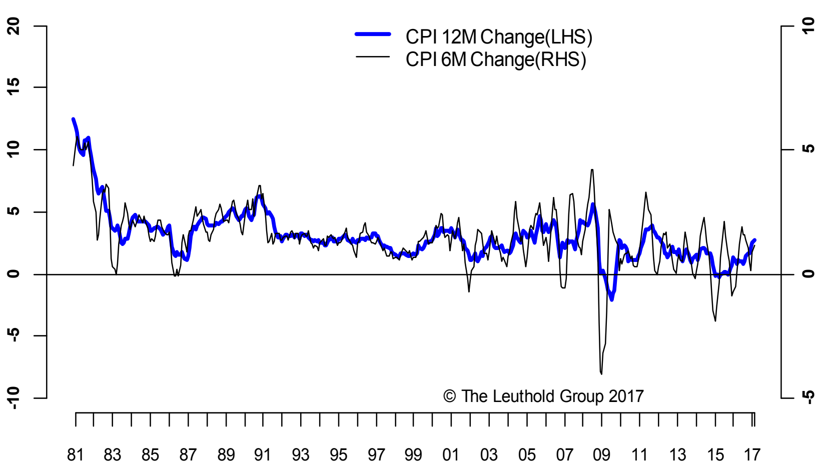


Chart 2

Oil & Copper Futures Prices

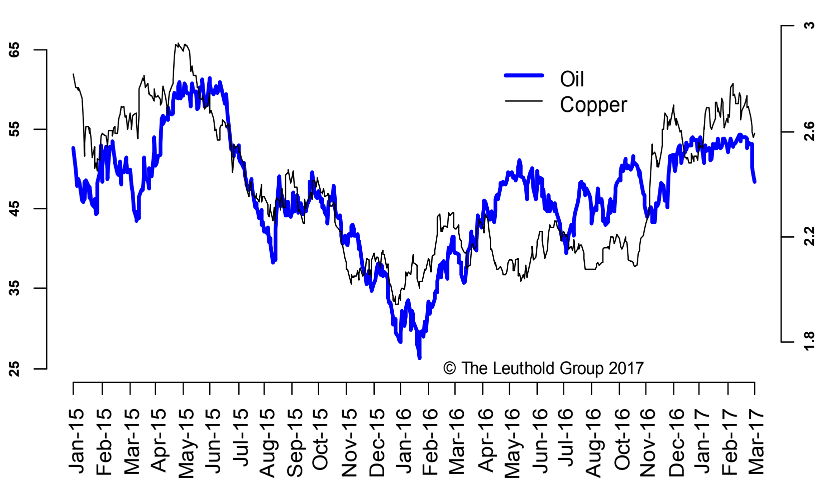


Chart 3

US 10-Year Breakeven Rates vs. Credit Spreads

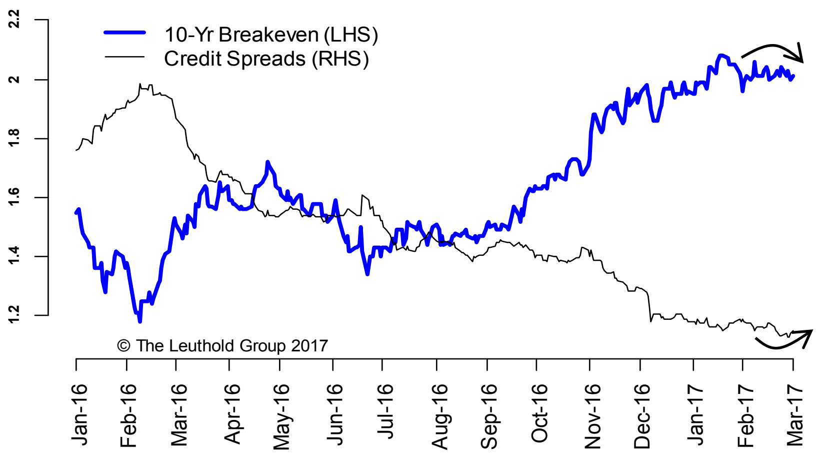
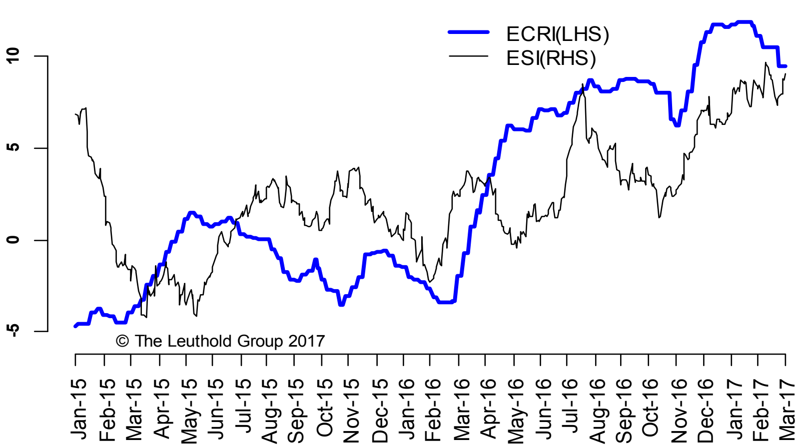


Chart 4

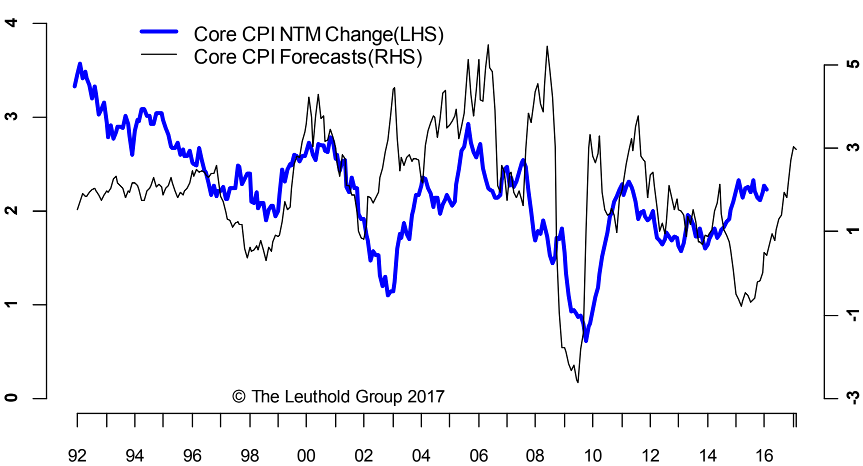
ECRI Weekly Leading Index vs. Citi US Economic Surprise Index



Core CPI: February Reading 0.4% (+2.2% Y/Y)

Chart 5

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



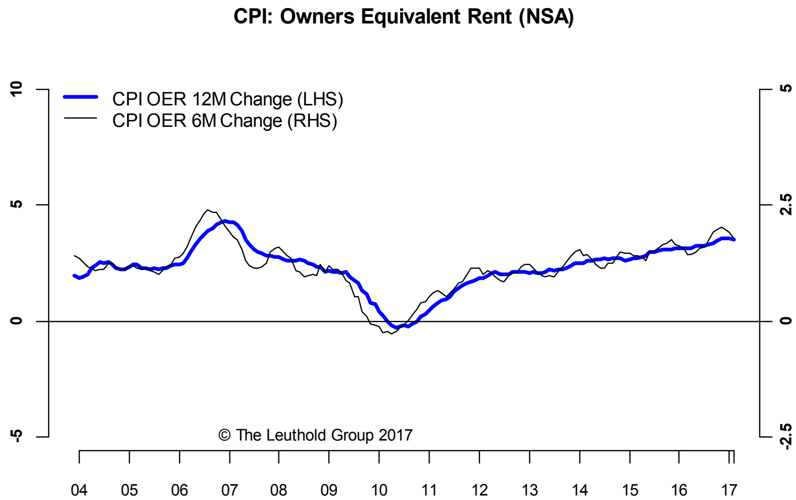
The dovish hike is also important for credit as the post-election rally in inflation-themed assets and credit started to look tired recently (Chart 3). A material reversal of inflation breakeven rates and credit spreads, on the back of a hawkish rate hike, would bring back the unpleasant memory of 2015, when oil and credit weakened dramatically due to prematurely tightened financial conditions. We are by no means suggesting that oil and credit won't weaken from here but at least the rate hike would not be a trigger this time.

As we mentioned in the last report, we believe, all else being equal, inflation numbers can continue to stay strong for a couple more months, but the real test is when the base effect starts to wane, most likely around mid-year. **We believe achieving sustained 2-3% inflation could be harder than most people expect going forward.** With no material upward pressure in wage growth, some of the leading indicators showing signs of rolling over (Chart 4), and the Atlanta Fed GDPNow forecast dropping to 0.9% for Q1 2017, as well as longer delays in Trump's pro-growth policies, it's a long and winding road to healthy inflation.

The U.S. Core CPI (non-seasonally adjusted) rose 0.4% month-over-month and 2.2% year-over-year, in line with market expectations (Chart 5). The latest core CPI forecast model reading was essentially flat. We are likely to see a fall in the forecast before a peak in core CPI reading. **Overall, we are encouraged by the dovish hike but we think the real test still lies ahead.**

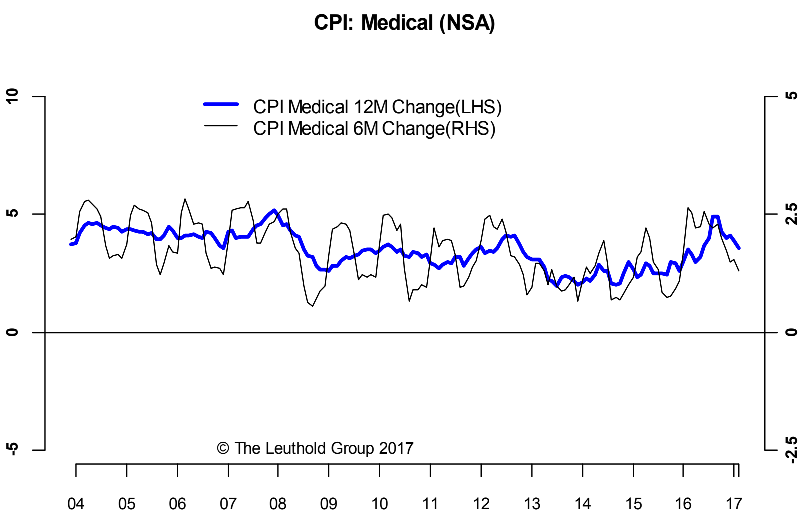
Selective CPI Subsets: Housing, Medical, And Transport

Chart 6



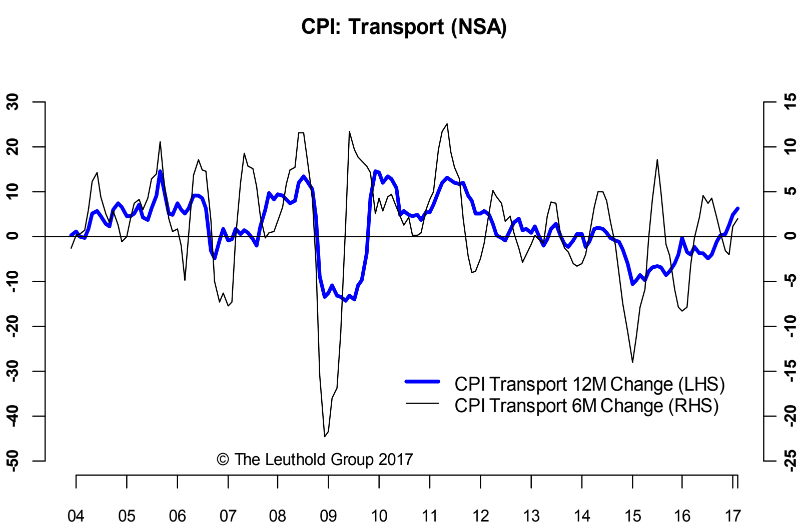
Housing Inflation Very Robust: This component is about 41% of the overall index. Both the overall Housing index and the Owners Equivalent Rent show year-over-year change of over 3% in February (Chart 6). This component has been the most robust and consistent contributor to overall inflation. Housing and employment continue to be the two reliable engines that support the overall economy.

Chart 7



Medical Inflation Decelerated: This subset is 6.4% of the overall index. Its increase slowed again to 3.5% year-over-year pace in February, still a strong number and an above-average contributor to overall CPI (Chart 7). Unlike oil prices, high medical costs under Obamacare becomes a negative base effect, and, given Trump's overall view towards healthcare costs and drug prices, we expect a slow-down in medical inflation going forward.

Chart 8



Transport Continued To Improve: The Transport subset is about 15% of the overall index. It jumped 6.3% year-over-year in February, highest since 2012 (Chart 8). The positive base effect helped but if oil prices continue to roll over, we expect this upturn to be once again transitory.