INFLATION WATCH

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

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Inflation Subpar Again

- The latest CPI numbers are slightly weaker than expected.
- We think expectations for higher inflation are still on the high side.
- The global scope of inflation deceleration adds more weight to the recent soft readings.
- Patience is the right approach for the reflation trade at this point.

CPI Inflation: April Reading 0.3% (2.2% Y/Y)

The non-seasonally adjusted CPI was up 0.3% in April and 2.2% year over year (Chart 1), slightly below market expectations. Despite a rebound in energy prices from a plunge in March, the year over year change in both the gasoline and energy indexes are rolling over from high levels (Chart 2). The recent volatility in oil and commodity prices makes a turn lower more likely in the gasoline and energy indexes going forward.

We have emphasized the difficulty in achieving sustained 2-3% CPI inflation going forward. Our base case has been for inflation to roll over around mid year as the positive base effect wears off, but the weakness has arrived sooner than we anticipated.

To be clear, we are not expecting inflation to drop to the point where deflation fear is likely to resurface again. **We think expectations for higher inflation are still on the high side**, and despite recent setbacks in Trump's pro-growth policy implementation, there is still a fair amount of hope and belief that they will get implemented in a reasonable time frame. We think seeing is believing is the right attitude at this point and will caution against counting the chickens before they are hatched.

Chart 1

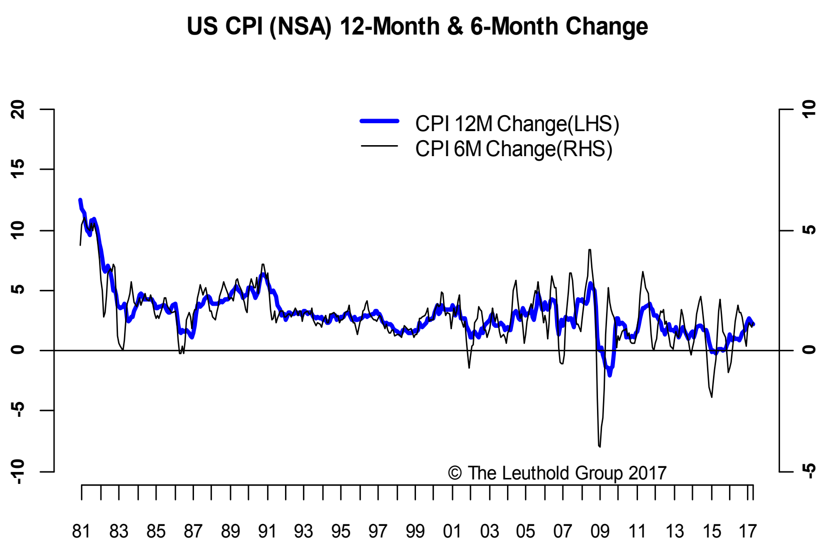


Chart 2

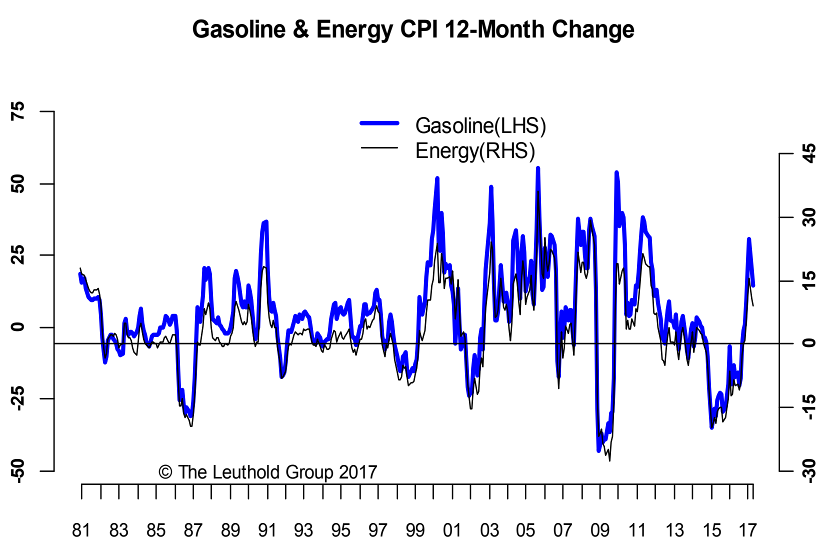


Chart 3

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

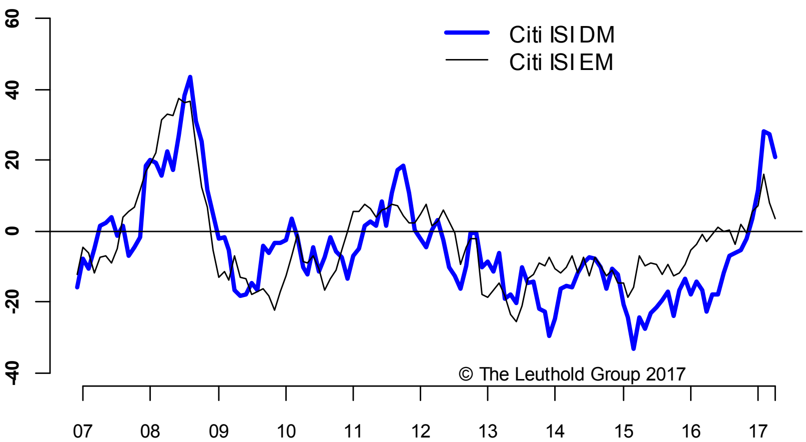
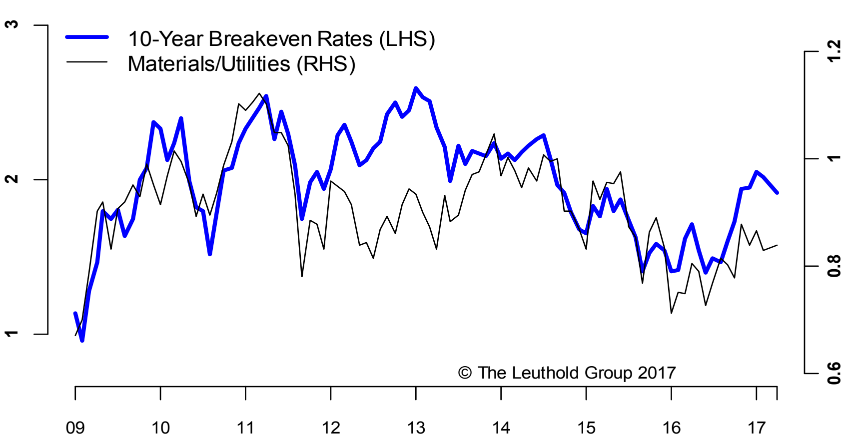


Chart 4

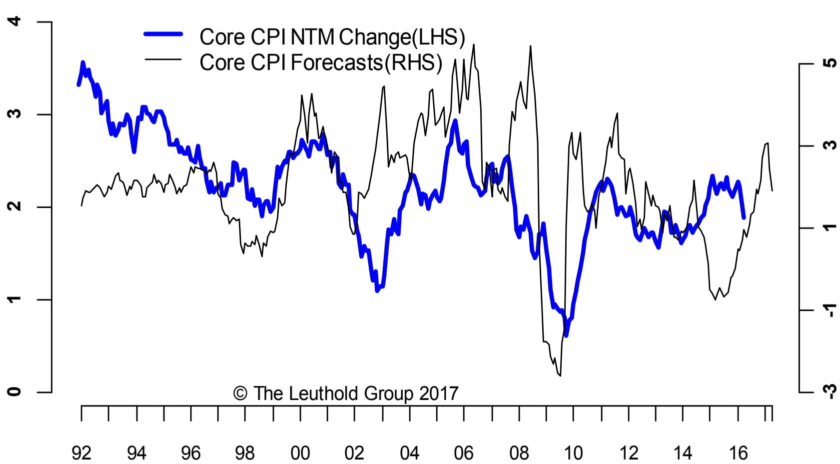
U.S. 10-Year Breakeven Rates vs. S&P 500 Materials/Utilities Total Returns



Core CPI: April Reading 0.1% (+1.9% Y/Y)

Chart 5

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



With oil and commodities being a global input, we are seeing inflation downside surprises on a global basis. Chart 3 shows both developed and emerging market Inflation Surprise Indexes rolling over from the highest levels since the financial crisis. Going forward, the base effect will become increasingly negative, even if oil stays at $50 (now around $48). **The global scope of inflation deceleration adds more weight to the recent soft readings**.

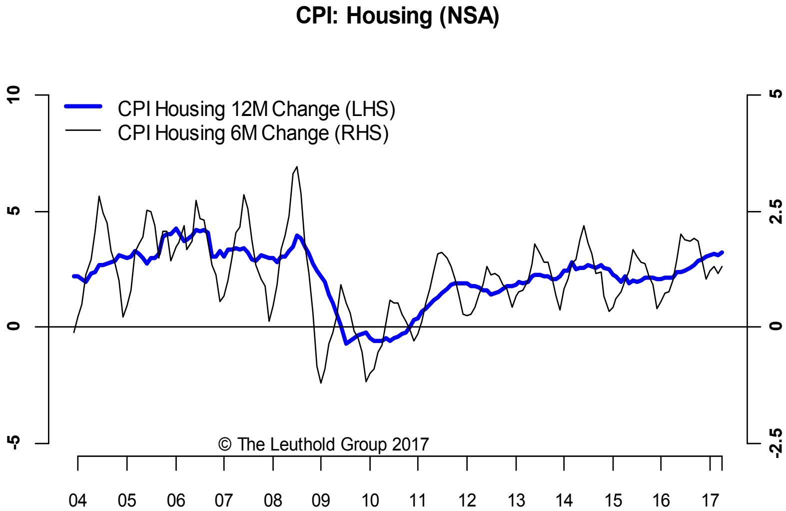
One of the more direct victims of lower inflation/inflation expectation is Materials stocks. Despite a strong start of the year in January, they have underperformed both the overall index and especially against Utilities in the last three months or so (Chart 4). This is also part of the unwinding of the Trump rally.

The U.S. Core CPI (non-seasonally adjusted) also missed expectations with a mere 0.1% month-over-month and 1.9% year-over-year change (Chart 5). This is the first sub-2% year/year reading in 19 months. Autos, apparel and medical care, wireless phone services all declined and contributed to the weak core CPI reading.

Our core CPI forecast model reading, based on past core inflation, housing, gold and commodity prices, continued to turn lower, projecting a path quite similar to the recent deceleration in global inflation. Lower readings in the core CPI forecasts should be expected unless commodity prices improved significantly. Overall, we believe inflation has likely peaked for the time being and it's hard to find a new driver that can fully offset the negative base effect in the near future**. Patience is the right approach for the reflation trade at this point.**

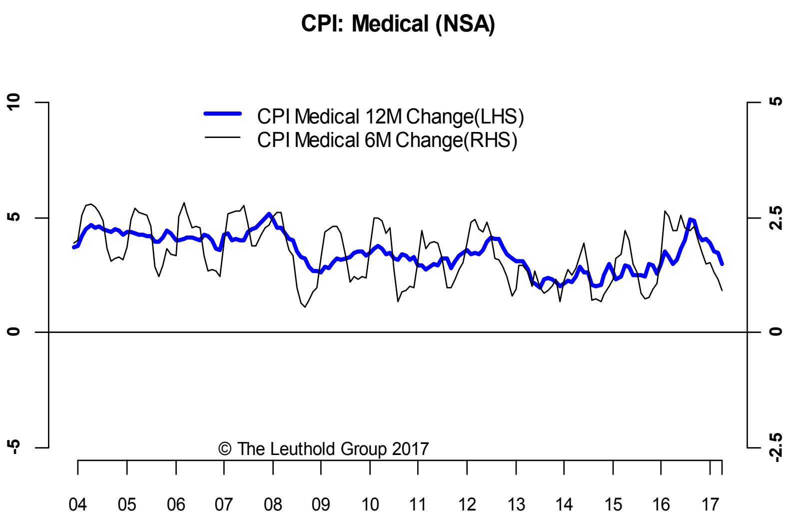
Selective CPI Subsets: Housing, Medical, And Transport

Chart 6



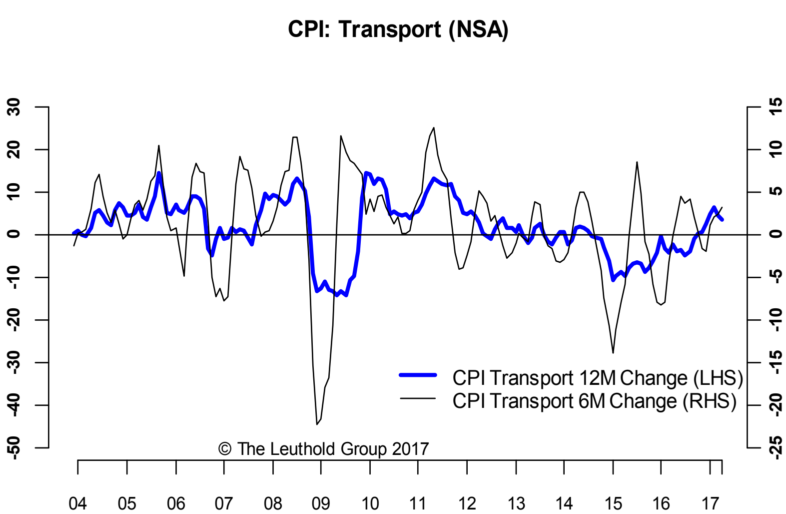
Housing Inflation Still Robust: This component is about 41% of the overall index. The overall Housing index showed a solid year-over-year change of 3.2% in April (Chart 6) but annual growth in Owners' Equivalent Rent continued to slow from a high level. With housing prices up 4.7% year/year, we think the housing market is still very healthy and both affordability and employment remain supportive going forward.

Chart 7



Medical Inflation Slipped: This subset is 6.4% of the overall index. In April, index slipped back below 3% (at 2.9%) for the first time in 12 months (Chart 7). However, this is still an above-average contributor to the overall CPI. Drug costs, medical service costs, and health insurance all turned lower in April. As we expected, higher medical costs from the previous year present a negative base effect and we expect this to continue for a while longer.

Chart 8



Transport Inflation Slowed Further: The Transport subset is about 15% of the overall index. Its increase slowed to 3.5% year-over-year in April from 4.6% in March (Chart 8). The positive base effect continued to fade and it's likely that this index has peaked and we expect lower readings ahead.