INFLATION WATCH

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

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Inflation—Yield Curve Too Flat

- The latest CPI numbers are in-line with expectations.
- The divergence between inflation break-evens and the yield curve is worth close monitoring.
- Given that the global recovery is still intact, we don't think the current inflation picture justifies the flatness of the yield curve.

CPI Inflation: October Reading –0.1% (2.0% Y/Y)

The non-seasonally adjusted CPI eased –0.1% in October and the year-over-year change edged lower to 2.0%. The seasonally adjusted numbers were 0.1% and 2%, respectively, both in line with market expectations (Chart 1). Hurricane-related distortions are still working their way through the price channels, with the most noticeable impact on gasoline prices. Gas prices jumped due to refinery shutdowns in September but gave back some of those increases in October, contributing to a overall lower CPI reading (Chart 2).

The October retail sales numbers were also in line with expectations. Typically, numbers like these tend to support bond yields and inflation expectations, but the market seemed much more focused on the sudden risk-off sentiment in the last few days and basically ignored the decent CPI and retail sales data.

Another reason for the market's lack of response to the decent economic numbers is that a December Fed hike is almost completely priced in and in-line numbers don't really inspire any upward adjustments in 2018 rate hike expectations. The Citi Economic Surprise Index has stayed near the highest level of this year and the "Goldilocks" scenario remains intact for now.

Chart 1

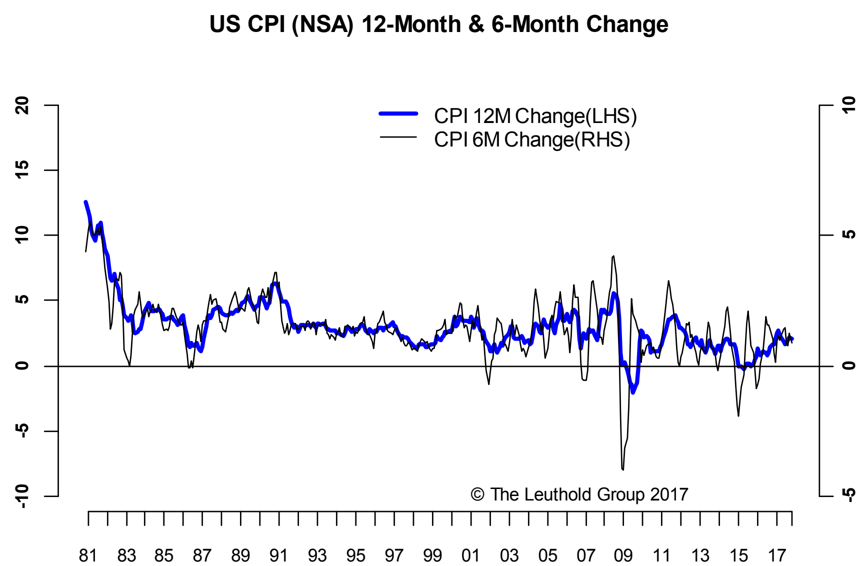

Chart 2

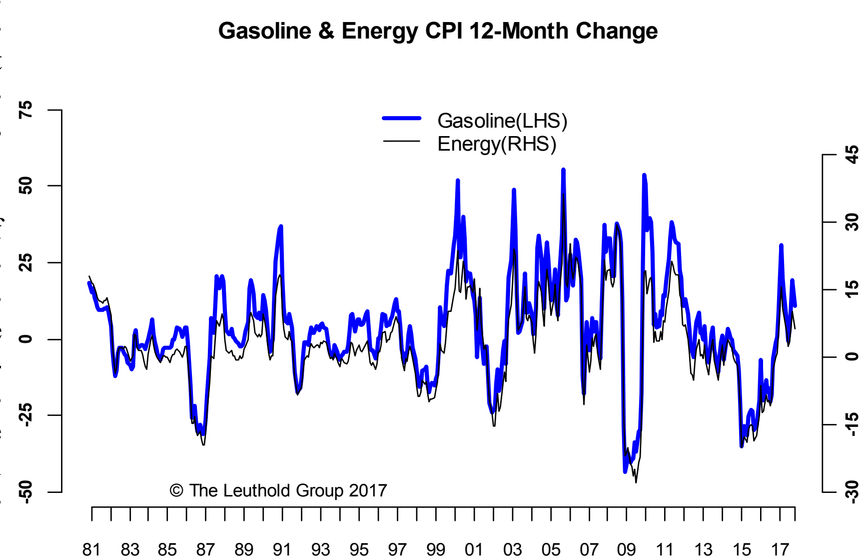

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Chart 3

US 10-Year Breakeven Rate vs. Yield Curve

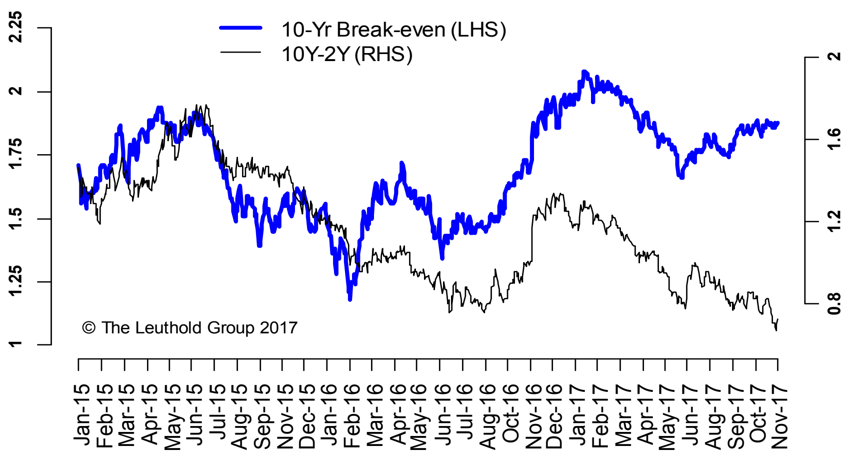
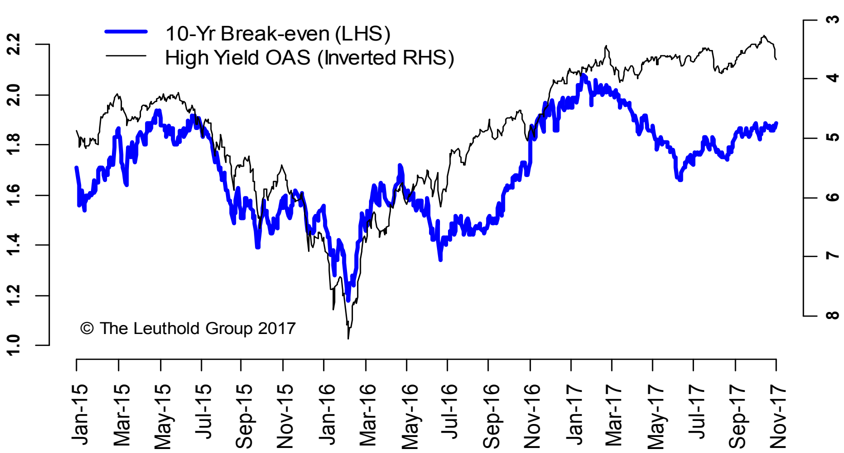


Chart 4

US 10-Year Breakeven Rate vs. Barclays US High Yield OAS



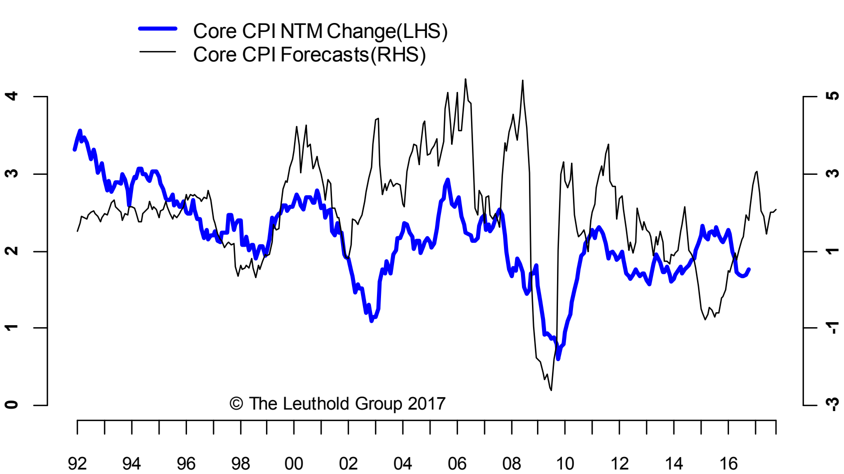
One of the hot market topics these days is the persistent flattening of the yield curve, which is now sitting at post-crisis low, even lower than mid-2016 when the 10-year yield was at an all-time record low. In fact, this year's 11-month flattening move is similar in duration to the 11-month flattening move from July 2015 to June 2016 (Chart 3). Notice that inflation expectations, a big driver of the yield curve, did not make a new low when yield curve bottomed in June 2016. This time, breakeven rates held up quite well even as yield curve continued to flatten. This is certainly a big divergence we need to monitor closely. Given the still favorable macro backdrop, we are leaning more towards the yield curve catching up to inflation breakevens, rather than breakeven rates catching down to the yield curve.

Obviously, risk markets have to hold up for our view to play out. The recent weakness in risky assets, especially high yield bonds, is a great reminder that, at these valuation levels, it wouldn't take much to trigger a sell-off. Chart 4 shows a strong tie between inflation expectations and credit market performance. In other words, credit needs to hold up for inflation expectations to not roll over.

Core CPI: October Reading 0.3% (+1.8% Y/Y)

Chart 5

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



The U.S. Core CPI (non-seasonally adjusted) beat expectations with a 0.3% month-over-month reading and a 1.8% year-over-year change (Chart 5). Our core CPI forecast model reading, based on past core inflation, housing, gold and commodity prices, moved higher again this month. **Given that the global recovery is still intact, we don't think the current inflation picture justifies the flatness of the yield curve.**

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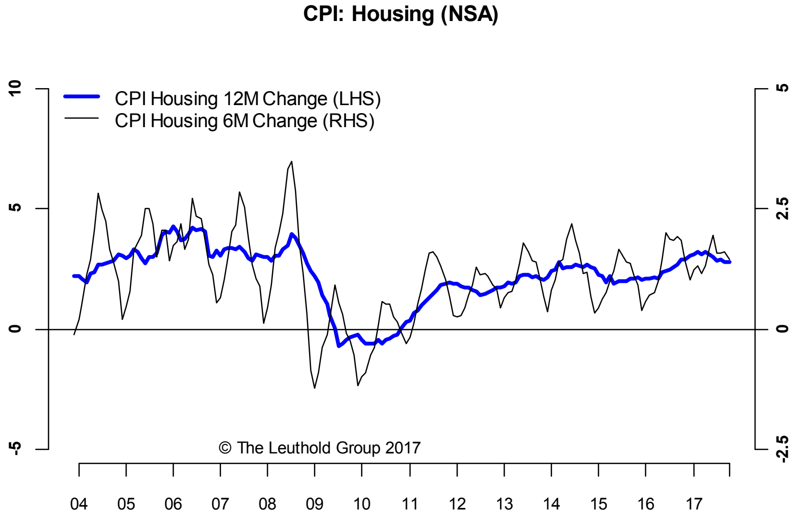
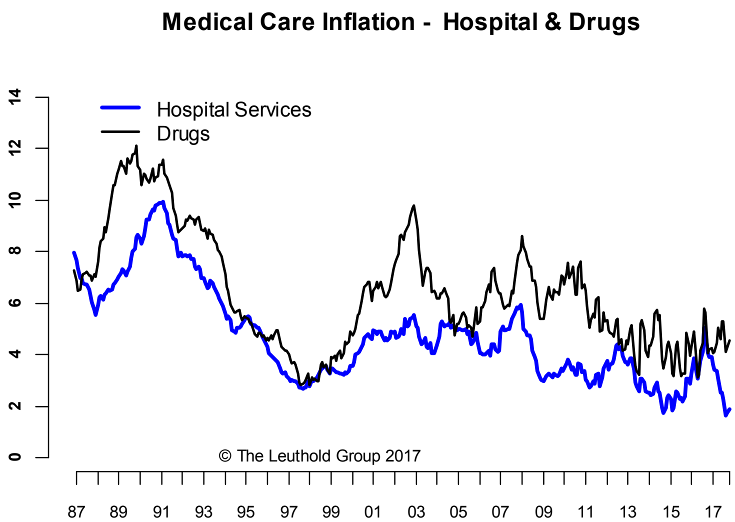
Selective CPI Subsets: Housing, Medical, And Transport

Chart 6



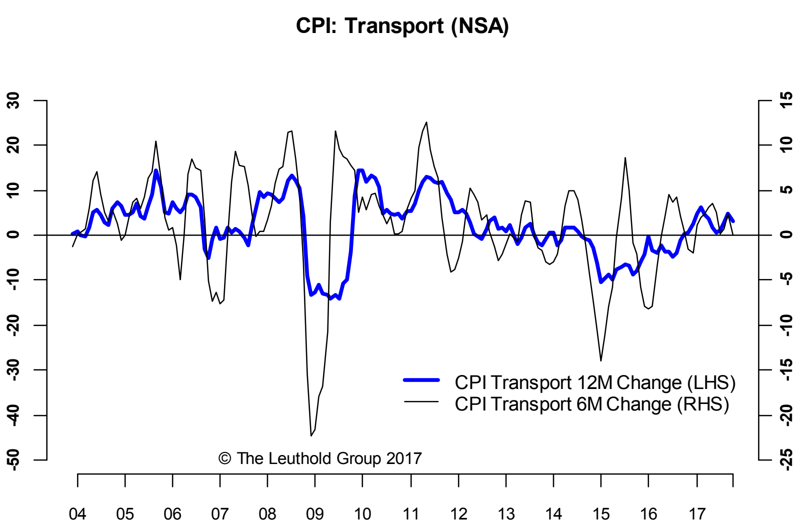
Housing Inflation Still Robust: This component is about 42% of the overall index. The overall Housing index remained at 2.8% in October (Chart 6) and annual growth in Owners' Equivalent Rent also stayed at 3.2%, a very robust number. The Lodging away from home continued to rebound. Robust housing inflation is critical to overall CPI inflation, given its big weight in the index.

Chart 7



Medical Care Inflation Ticked Up: This subset is 9% of the overall index. In October, this index rose 1.7% year over year, up from 1.6 in September (chart not shown). Both hospital services and the prescription drugs component rebounded in October (Chart 7). We believe health care inflation has likely found a bottom and is likely to contribute more positively going forward.

Chart 8



Transport Inflation Eased: The Transport subset is about 15% of the overall index. Its year-over-year increase eased to 3.2% in October (Chart 8). The pull-back in gasoline prices, lower car prices, and airline fares all contributed to a lower reading. We don't expect this component to provide materially positive support to overall inflation in the near future.

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