INFLATION WATCH

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

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Inflation—First Upside Surprise In Six Months

- While still too early to call an upturn in inflation, we believe at least expectations are perhaps low enough to make the odds in favor of upside surprises in the near term.

- We don't think one small beat on the CPI is likely to turn the Fed more hawkish at the upcoming September FOMC meeting.

CPI Inflation: August Reading +0.3% (1.9% Y/Y)

The non-seasonally adjusted CPI rose +0.3% in August and the year-over-year change moved higher to 1.9% (Chart 1). Both numbers beat market estimates and this is the first month of upside surprise after five months of disappointment. While it is only a small beat, what it means to us is that maybe expectations are finally low enough. In fact, we got the feeling that the proverbial pendulum has perhaps swung a bit too far to the pessimistic side for both the economic data and Trump's policies. **While it's still too early to see a trend, we should get ourselves ready for more upside inflation surprises in Q4**.

Hurricane Harvey certainly had a positive impact in this month's numbers. Gasoline and Energy prices jumped partly due to the storm and partly due to the summer driving season (Chart 2). We expect gas and energy to contribute positively in the next couple months too. Recent strength in oil prices also lends more support to the inflation picture.

On the other hand, we don't think one small beat on the CPI is likely to turn the Fed more hawkish at the upcoming September FOMC meeting. Remember, the Fed's rate hike projections are already much higher than what the market is currently pricing. We do expect a balance sheet reduction but that's already fully priced in.

Chart 1

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

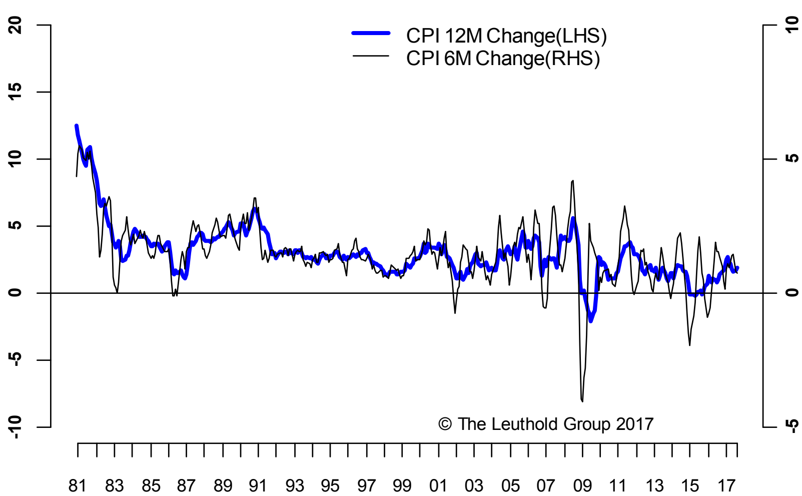


Chart 2

Gasoline & Energy CPI 12-Month Change

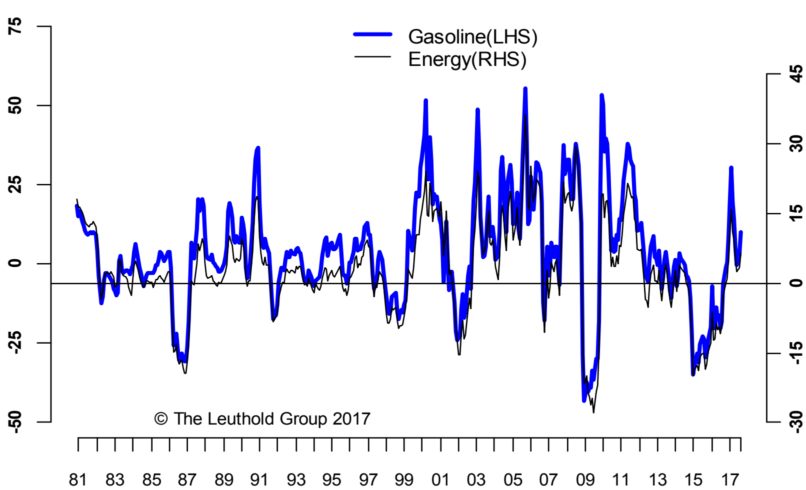


Chart 3

ISM Non-Manufacturing/Manufacturing Index vs. DXY

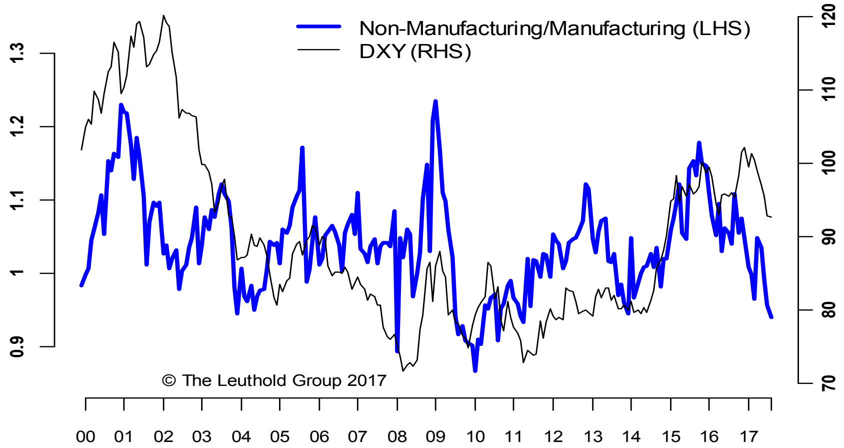
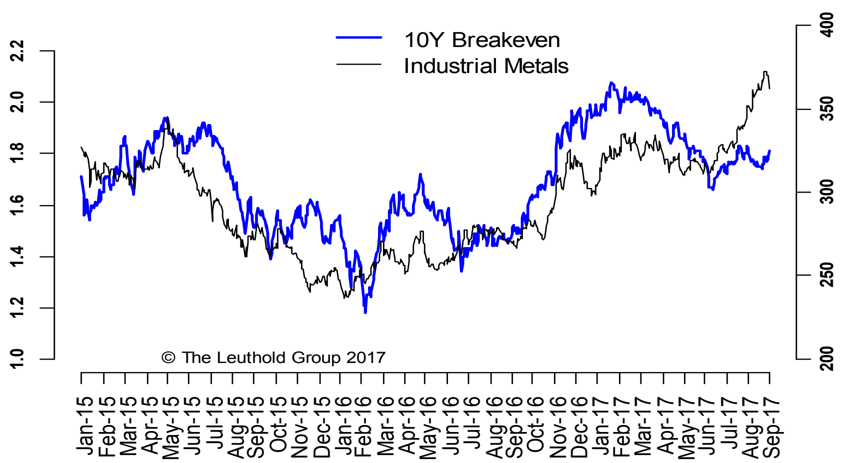


Chart 4

US 10-Year Breakeven Rates vs GSCI Industrial Metals Index



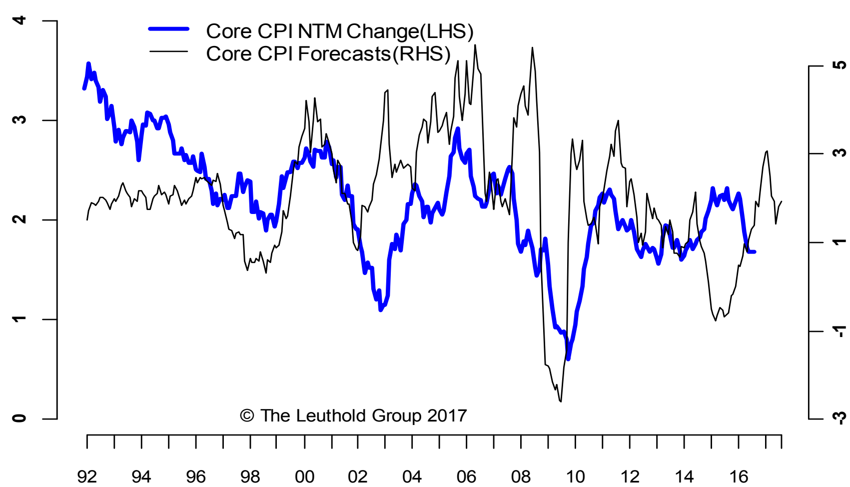
That likely means, without positive news on the fiscal policy, the Fed alone is unlikely to provide much further support to the recent bounce in the dollar. A weak or weaker dollar is not a bad thing at all. As we have mentioned numerous times, a weaker dollar is positive for inflation and the overall financial conditions in the U.S. Additionally, Chart 3 shows it is particularly good for the manufacturing sector.

We have also highlighted in our previous reports the important role China plays in the global inflation picture. One of the strongest links is still through the commodities channel. Recent rally in industrial metals is likely to lead to higher inflation expectations in the U.S. going forward (Chart 4). However, since whatever happens in China is still dependent on its credit growth, we remain cautious as its credit impulse , which contributed to 80% of the world's total credit growth in 2016, might wane after the upcoming leadership reshuffle in October. So a linear extrapolation from the past into the future would not be recommended at this point.

Core CPI: August Reading 0.2% (+1.7% Y/Y)

Chart 5

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

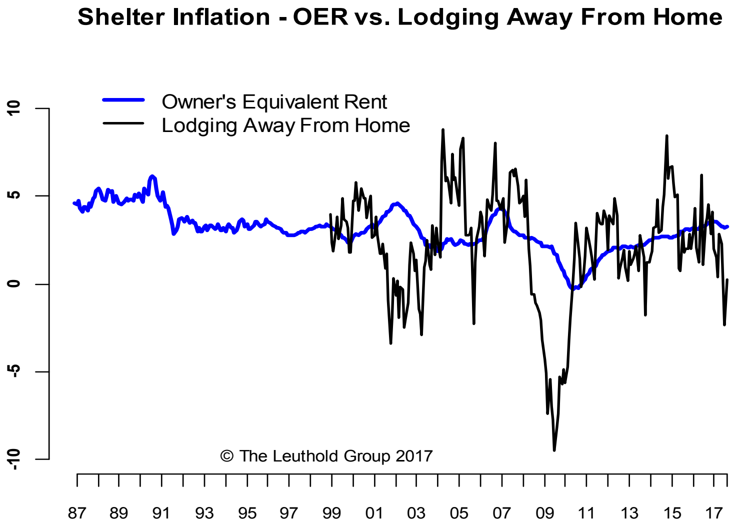


The U.S. Core CPI (non-seasonally adjusted) matched expectations with a 0.2% month-over-month reading and a 1.7% year-over-year change (Chart 5).

Our core CPI forecast model reading, based on past core inflation, housing, gold and commodity prices, also edged slightly higher this month. We mentioned in our last report that "further downside in the core CPI might be limited" and it looks like we might see an upturn from here on. **While still too early to call an upturn in inflation, we believe at least expectations are perhaps low enough to make the odds in favor of upside surprises in the near term.**

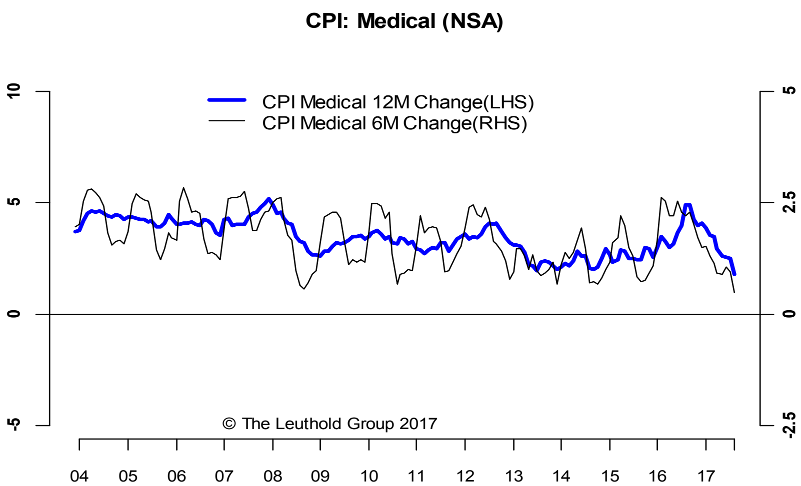
Selective CPI Subsets: Housing, Medical, And Transport

Chart 6



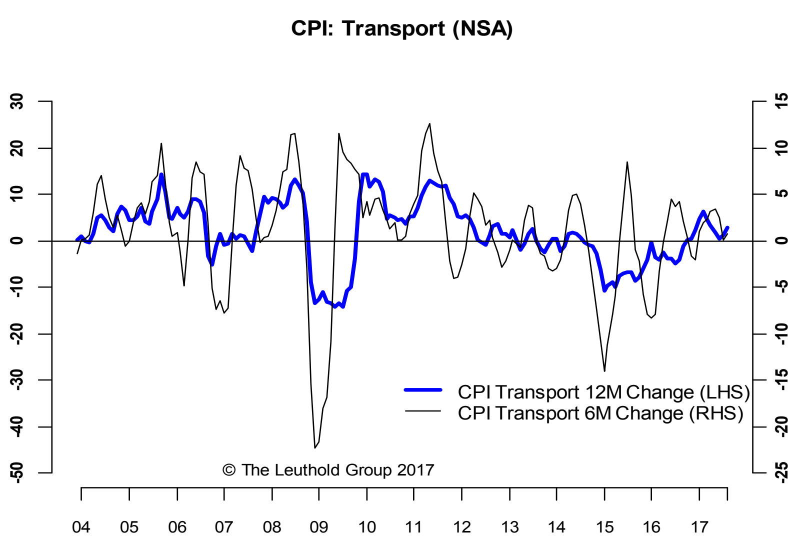
Housing Inflation Still Robust: This component is about 42% of the overall index. The overall Housing index ticked up a bit to 2.9% in August (Chart not shown) and annual growth in Owners' Equivalent Rent also turned up. The Airbnb effect on lodging was partially reversed as the peak vacation/travel season boosted prices(Chart 6)! We are encouraged by the robustness of this component, considering its big weight in the overall index.

Chart 7



Medical Care Inflation Slipped Again: This subset is 9% of the overall index. In August, this index rose 1.8% year over year, the slowest pace since 1965 (Chart 7). The prescription drugs component contributed to the slide by posting a 2.7% annual increase, down from 4.2% in August. While the recent trend is alarming, we still expect the deceleration in this particular component to be transitory.

Chart 8



Transport Inflation higher: The Transport subset is about 15% of the overall index. Its year-over-year increase continued to move higher, now at 2.8% in August (Chart 8). The recent rally in energy and gasoline prices helped quite a bit. This is one of the more volatile components in the index and we expect moderately positive net contribution from this component in the near future.