NEWPERSPECTIVES

Commentary from New Century Advisors
April 2017

US Inflation: Fundamentals vs. Technicals

- **The Trump reflation trade stalled in March as markets await policy progress**
- **Energy tailwinds are set to fade, while food tailwinds emerge**
    - **Front end BEIs look fully valued and increased oil volatility warrants caution**
    - **Intermediate and longer dated BEIs remain compelling**
- **Fund flows have slowed**
    - **Trump traders are the wild card; look out if they lose faith in the reflation theme**

Back to Fundamentals

Inflation assets shifted from the Trump 'Reflation Trade' to 'prove-it-to-me' mode in the first couple months of the year, but doubts started to legitimately surface in March. Prompted by Congress' failure to pass the American Health Care Act, markets tempered expectations for other Administration desired initiatives such as meaningful fiscal stimulus, including an infrastructure spending package and tax reform. While that has pushed TIPS breakevens down to the low end of their YTD ranges, we view TIPS as merely entering a period when fundamentals will once again drive valuations. With that in mind, we take a look at how the various major components of CPI are trending. Of note, while energy base effects should lead YoY headline inflation to moderate in the coming months, we see some upside risk from food prices. See below for our analysis.

In addition to shifting political winds at home, other drivers of TIPS valuations this past month which we expect to continue to impact markets include:

- The pace of the Fed's ongoing removal of monetary policy accommodation
- Oil market volatility due to the supply dynamics of growing shale production vs. OPEC production cuts
- The ongoing political struggle between globalism and nationalism, in particular the French Presidential election commencing with the first round later this month
- Flows into TIPS have slowed recently. Marginal demand for the asset class remains a critical near-term driver of performance
- Supply and index events, as always, create tactical opportunities and, depending on other factors, can lead to bigger opportunities

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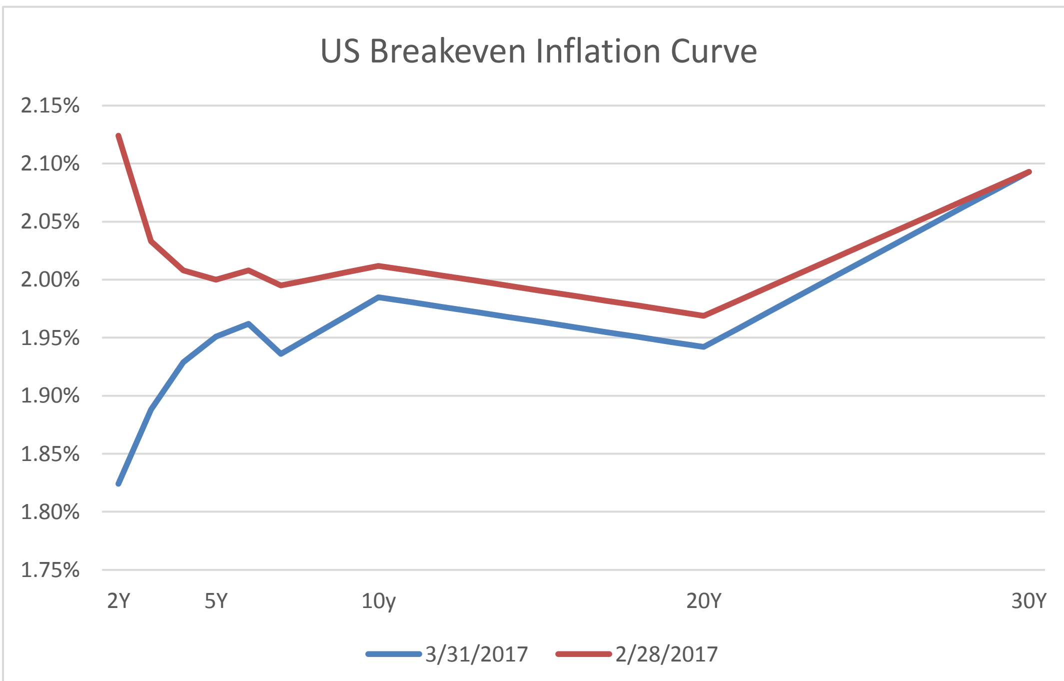
March Performance Highlights

Shorter TIPS optically underperformed on the curve in March, but the shift was due primarily to strong positive carry, which has a greater impact on shorter-maturity issues (with fewer such months remaining). While shorter TIPS also came under pressure as oil markets sold off, the sector held in well overall and rebounded along with energy prices into month end. We view the sector as being fairly valued vs. near term inflation forecasts, but flag risks from heightened oil volatility. See below for further analysis on the front end.



Source: Bloomberg and New Century Advisors

March Breakeven (TIPS – Treasury) Performance			
2 YEAR	**5 YEAR**	**10 YEAR**	**30 YEAR**
0.03%	0.07%	-0.03%	-0.46%

Source: Bloomberg and New Century Advisors

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Inflation-Linked Bond Index Returns (Local Currency Returns)				
	March		YTD	
	Total Return	vs. Nominal Comparators	Total Return	vs. Nominal Comparators
Barclays World GILB	-0.12%	-0.19%	0.57%	-0.16%
United States	-0.05%	0.00%	1.37%	0.51%
United Kingdom	0.66%	0.05%	1.74%	-0.41%
Germany	-1.91%	-1.05%	-1.66%	-1.03%
France	-1.69%	-1.05%	-3.15%	-1.02%
Spain	-0.57%	-0.72%	-0.85%	-0.38%
Denmark	-0.98%	0.02%	-0.04%	-0.05%
Sweden	-0.71%	-0.23%	-0.32%	0.03%
Canada	-0.16%	-0.63%	-1.30%	-2.22%
Japan	-0.37%	-0.34%	-1.03%	-1.01%
Australia	0.77%	0.26%	1.16%	-0.12%
Italy	-1.15%	-0.80%	-2.96%	-0.83%
New Zealand	0.73%	0.22%	0.73%	-0.95%
Argentina	1.08%	-	7.62%	-
Brazil	1.01%	-	7.03%	-
Chile	0.38%	-	1.87%	-
Columbia	0.39%	-	2.41%	-
Israel	0.26%	-	-0.81%	-
Mexico	1.83%	-	3.36%	-
Poland	-0.04%	-	2.60%	-
Turkey	1.99%	-	6.47%	-
South Korea	-0.13%	-	1.34%	-
South Africa	-2.00%	-	-0.68%	-
Thailand	0.12%	-	1.99%	-

Source: Bloomberg and New Century Advisors

A Deeper Look at US CPI

In the February CPI data, released in March, headline CPI reached 2.7% YoY, the highest level since 2012. For its part, core CPI, excluding more volatile food and energy, was 2.2% YOY, down slightly from January but right in the middle of the narrow range it's been in since early 2016 (2.1-2.3%). The chart below looks at

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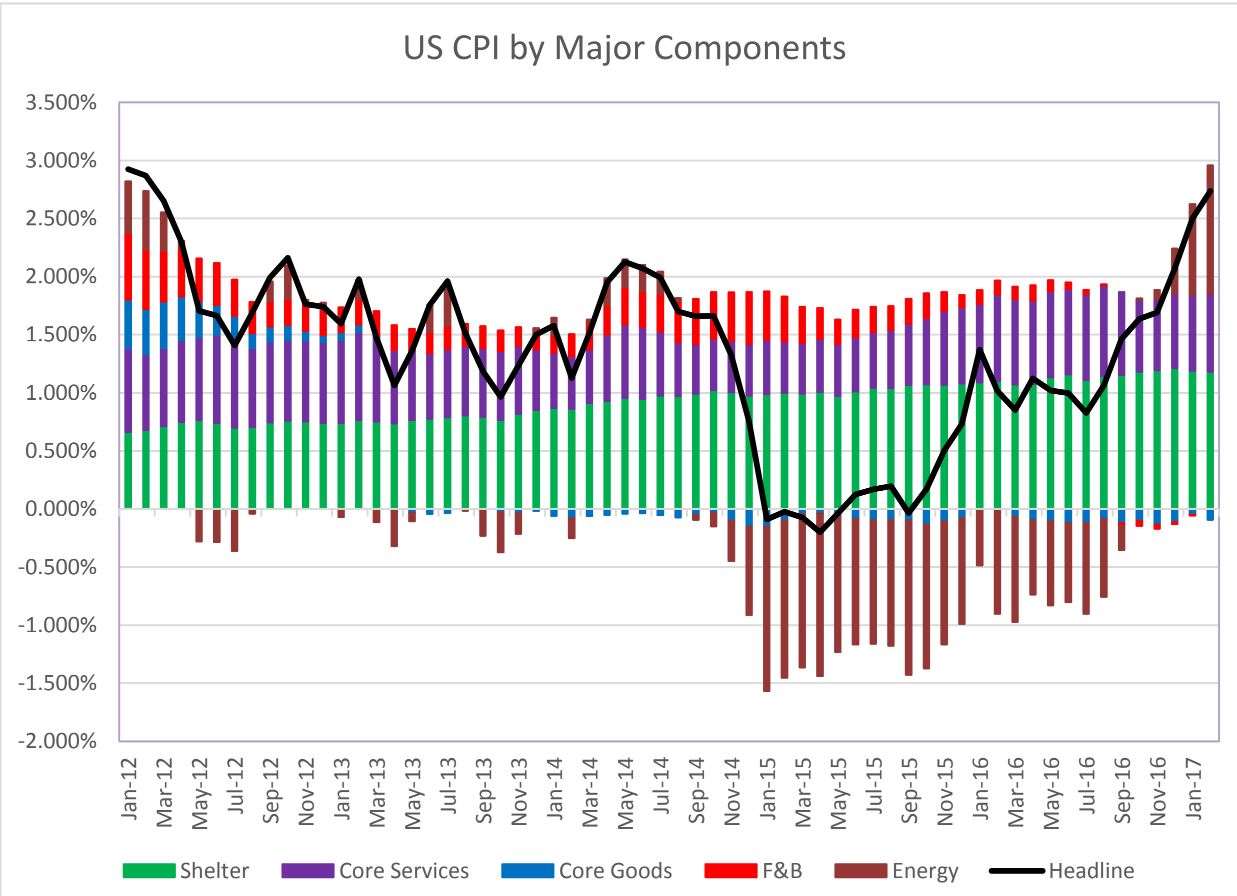
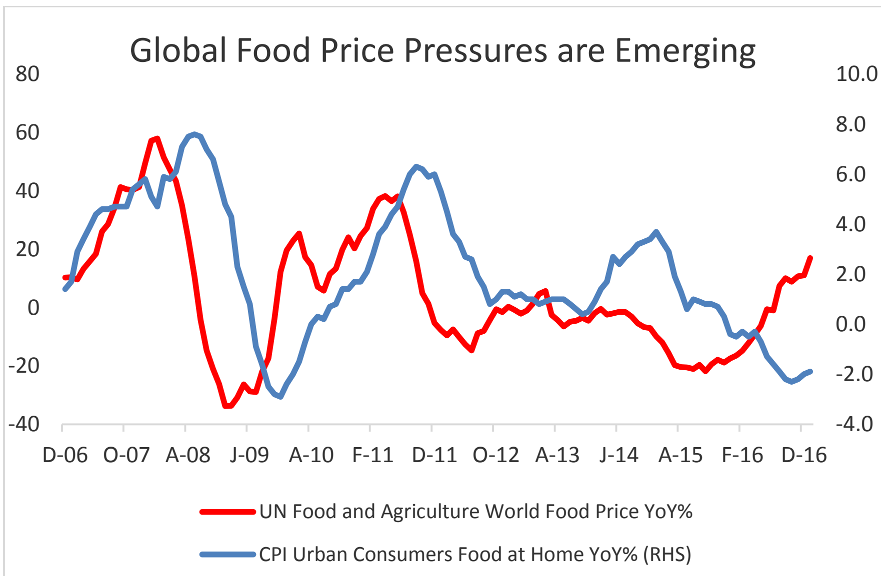
the major components of CPI by splitting out food and energy (13.7% and 7.2% of the index, respectively) and by further breaking down Core CPI into three sub-categories, shelter (33.6%), core services (26.5%), and core goods (19.1%).



Source: Bureau of Labor Statistics and New Century Advisors

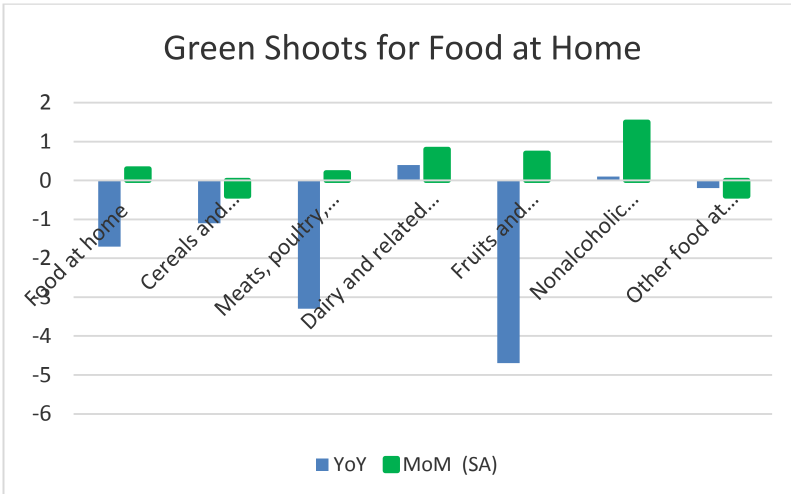
Despite its relatively small weight within the index, energy is far and away the biggest driver of swings in CPI. In addition, the stability of Core CPI is also clearly visible given the fairly steady contributions from heavyweights shelter and services (which together make up 60% of the index), particularly over the past 15 months. Also noteworthy is the negligible contribution from core goods. Though representing over 19% of the basket, nearly as much as food and energy combined, core goods' relative price stability – averaging a slight decline of just 0.3%/year since 2013 – has meant they have failed to impact the overall level of the index (a contribution of -0.06% on average over the same timeframe when multiplying by their weight).

That leaves food prices, which contributed an average of 28bps to overall inflation from 2012 through 2015 but have since seen their impact evaporate altogether (-0.01% and +0.01% in January and February, respectively). But there's upside risk in the year ahead. The chart below shows YoY UN Food and Agricultural World Food Prices (the red line), along with US CPI's Food at Home series, which makes up 58% of consumers' total food expense and carries a 7.9% weight within CPI overall. Two trends are clear: global food prices are rising, and US food prices tend to follow global food prices, albeit with a variable lag (from 8 to 12 months).



Source: OECD, Bloomberg and New Century Advisors

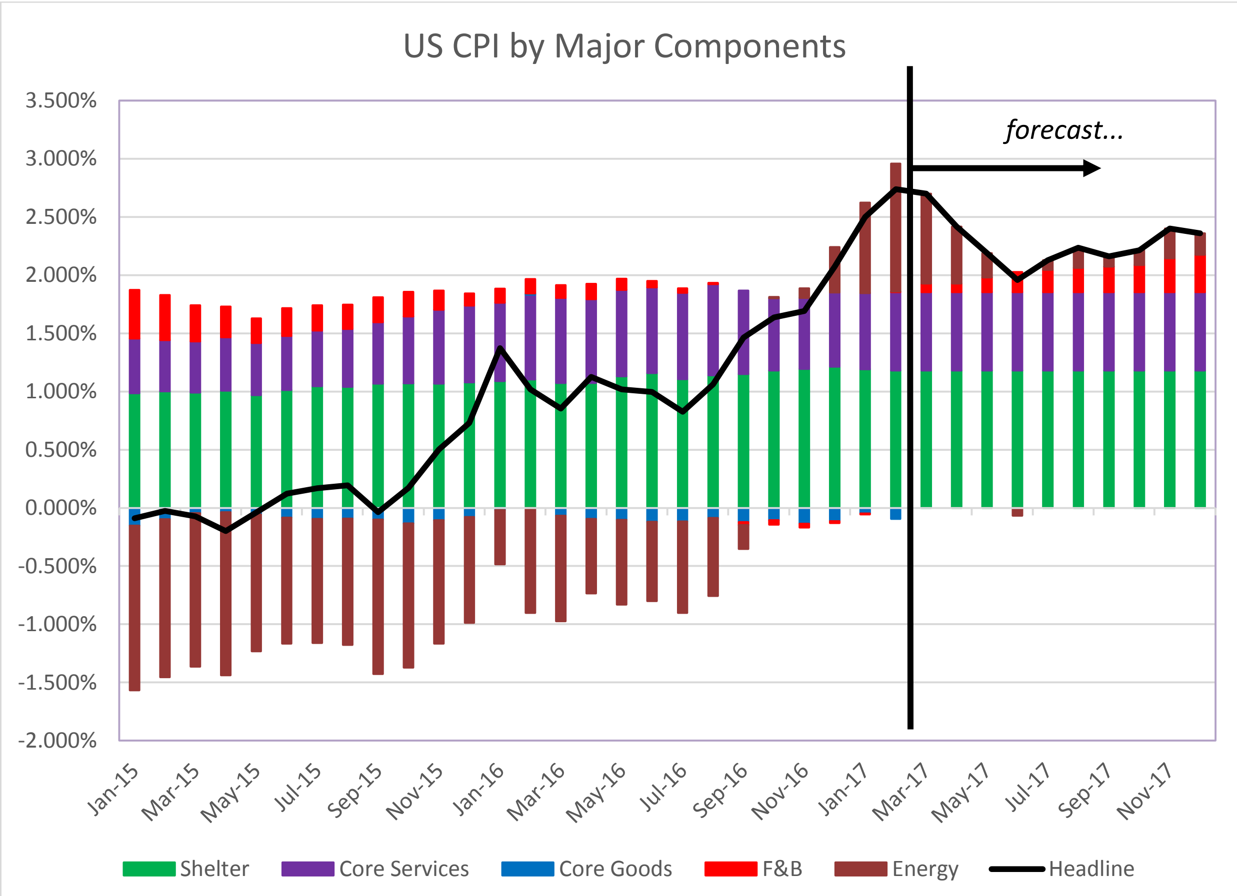
Indeed, while prices for Food at Home in the February CPI report (released in March) were still down 1.7% YoY, that was up from a low of -2.3% in October, and the monthly data show further signs that the turn is in place.



Source: BLS and New Century Advisors

While food prices appear poised to have a positive impact on inflation in the months ahead, the recent surge in the contribution from energy prices faced a significant challenge going forward – even before the recent selloff in oil. That is because of the rapidly rising base effects from last Spring, when oil rallied nearly 50% from its January lows. If we assume that energy prices settle down near current levels (far from a given but useful for the sake of this exercise), we find the contribution from energy prices on headline inflation diminishes to zero over the next few months.

We modelled headline CPI through the rest of this year under the following assumptions: shelter and core services hold at current levels (+3.52%, contributing 1.18% to the index, and +2.54%, contributing 0.67% to the index, respectively), core goods remain flat, energy prices settle down at current levels, and food prices recover back to their 2012-14 average annual growth (2.1%). Here is what the result looks like, with CPI falling from last month's print of 2.7%, hitting 2.0% in June, before firming back into the 2.3-2.4% range by year end:



Source: BLS and New Century Advisors

Front End TIPS: Fully Valued

In comparing the terminal CPI fixings implied by front end TIPS Breakevens with our forecast for CPI itself, we are able to determine which issues look rich or cheap relative to that forecast. Here is the current market snapshot:

TIPS	Mkt-based terminal CPI	Forecast CPI	bps "cheap"
Jul17s	245.192	245.250	8.6
Jan18s	246.917	247.200	14.7
Apr18s	247.445	247.980	21.0

Jul18s	250.48	250.816	10.4

Source: Bloomberg and New Century Advisors

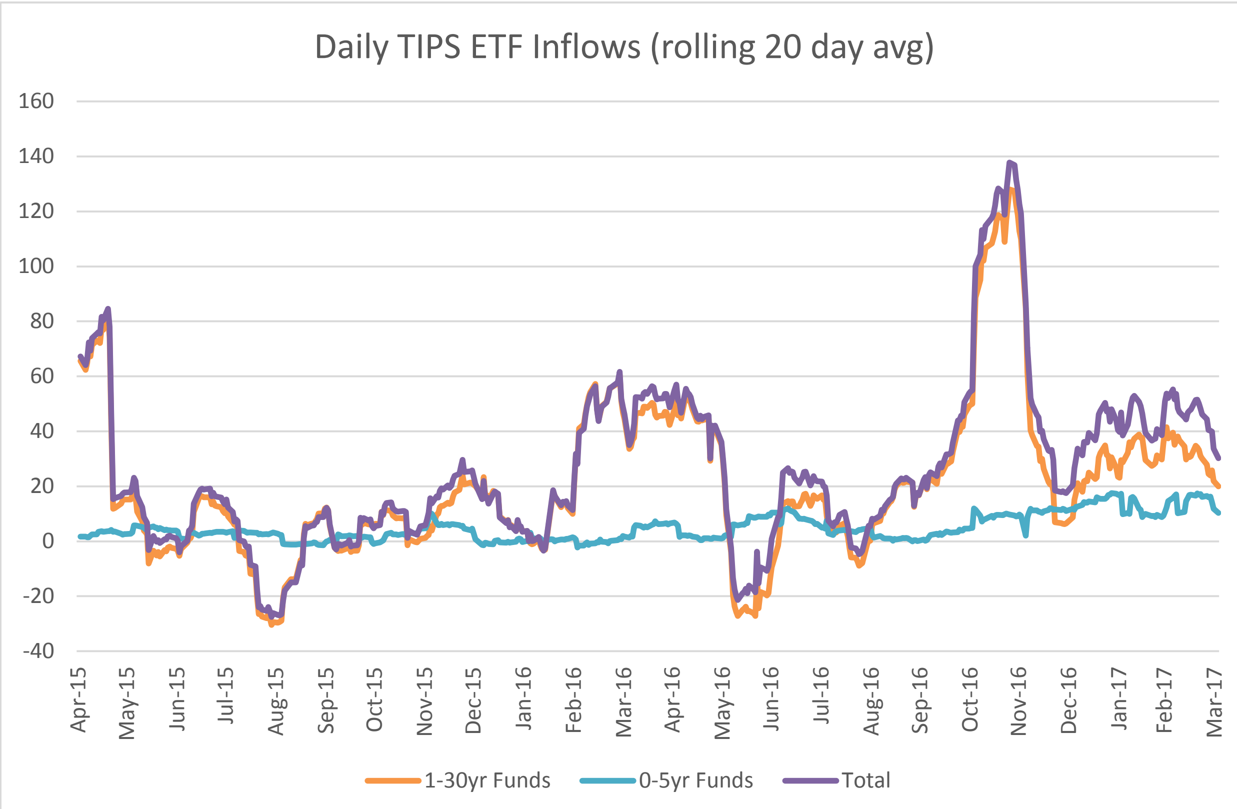
In other words, if the CPI fixing in July 15th, 2017 is 245.25 (our forecast), then the current price for Jul17s is a little over 8bps cheap. So buy all these issues, right? The problem, in addition to being too-dependent on the accuracy of our inflation forecast, is that such a strategy is too exposed to energy volatility, along with liquidity challenges prevalent in short TIPS. For these reasons, front end TIPS typically trade cheap to near-term inflation expectations – sometimes by as much as 100bps. That is when we like to own them. In general, when short TIPS trade within 10-20bps of our inflation forecast, we tend to view the sector as being "fully valued." As such, particularly with energy volatility on the rise, we favor an underweight in the sector.

Another factor that makes us wary of short TIPS in the near term is that Apr18s, the first $50bn TIPS ever issued by the U.S. Treasury, fall out of the index at the end of this month. That will trigger forced selling of the issue by passive funds. With estimates of as much as 50% of the TIPS investing universe indexed, that can add up to quite a lot of selling and subsequently weigh on not just that issue but surrounding paper as well. If oil comes back under pressure later this month, the market would likely have scant appetite to take the other side of the trade. There is no guarantee that such a selloff will occur - indeed, a further bounce in oil could lead to strong demand for short TIPS and more than offset the index-related selling. But we believe an underweight position in the sector is currently the prudent choice.

TIPS Inflows

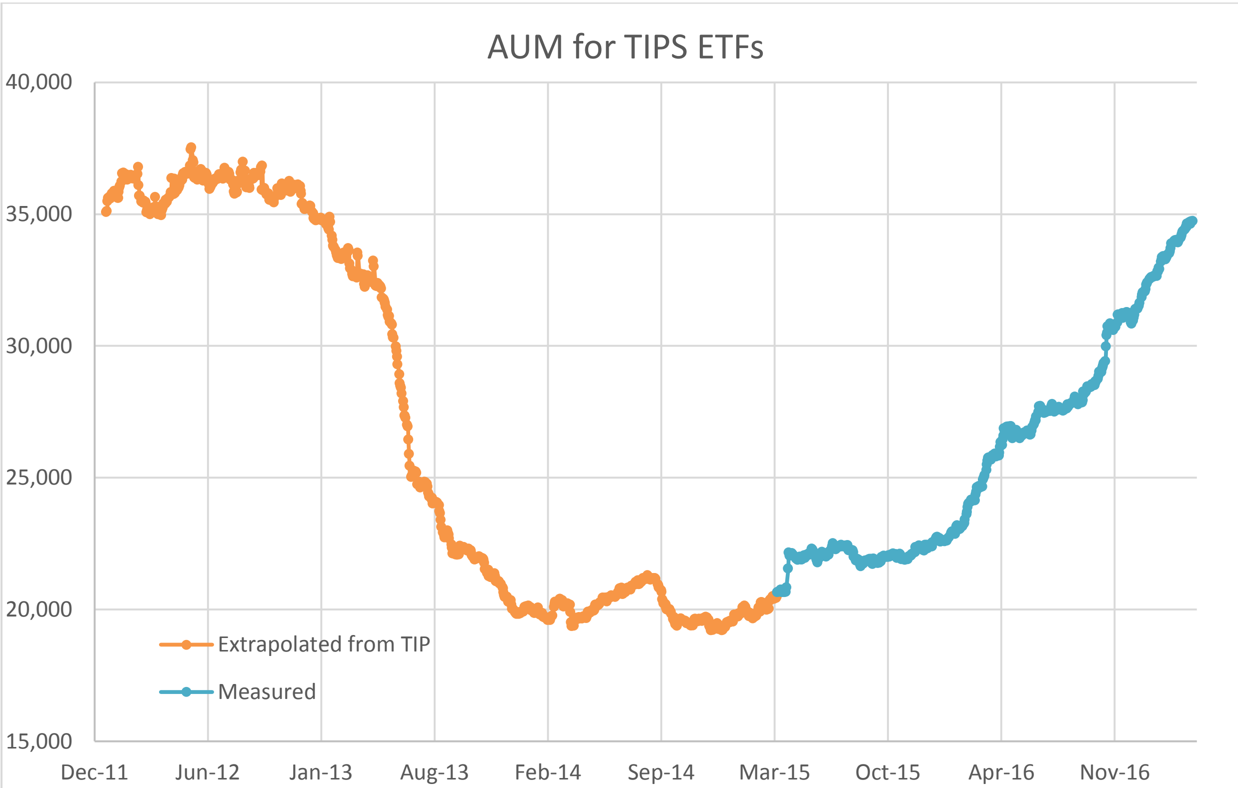
As with all asset classes, flows drive performance in TIPS. When money comes into the asset class, TIPS typically do well. When it flows out, they struggle. That is one of the reasons why we track flows into TIPS funds very carefully. ETFs, which make up a relatively small but growing sector of the TIPS market (less than 4%), give us the ability to track retail flows into TIPS on a daily basis.

Below is a chart of daily flows into the eight largest TIPS ETFs, smoothed by taking the rolling 20 day average (or approximately one month of trading days). It includes the four largest full index funds (1-30yr, the green line), and four (smaller) front-end TIPS funds (a combination of 0-5 and 1-5yr funds, the blue line). The yellow line is the combination of the two, until somewhat recently dominated by flows into full index funds. More recently, likely in a response to the Fed continuing to tighten monetary policy, the front-end TIPS funds have received a greater share of the inflows from duration-wary investors. While duration risk is one concern of course, so too is energy risk, which impacts shorter TIPS to a greater degree than issues further out the curve. We are therefore somewhat wary of the further risk to front-end outflows from this latest trend, should oil resume its recent selloff (see prior section).



Source: Bloomberg and New Century Advisors

But the chart also highlights the impact that President Trump's election had on the TIPS market, as flows spiked up to an average of $120-140mm/day immediately following his win. That far surpassed the two other recent periods of high inflows, both of which corresponded with oil market rallies. After a brief pause into year end, inflows resumed at a steady pace in January and February, helping push total AUM in TIPS ETFs back close to the highs seen before the Taper Tantrum in 2013 (as shown below. Note that while we have detailed flow and AUM data going back two years, the data before that is extrapolated using iShares TIP as a proxy for TIPS ETFs in general.)



Source: Bloomberg and New Century Advisors

But closer inspection of the daily inflow chart shows there's been a steady decrease in inflows over the past couple of weeks, presumably triggered by the recent selloff in energy and reduced expectations for fiscal stimulus following the Trump administration's failure to pass the AHCA. So far, those flows have yet to turn into outflows, but that is a risk going forward.

In Closing

Overall the fundamental backdrop remains positive for the TIPS asset class. While short-dated issues appear fully priced, valuations in the intermediate and long term issues remain compelling vs. near term spot inflation. As is often the case, technicals remain the wild card. Flows have slowed and as we discussed above, the post-election bounce have all the hallmarks of fickle money, which could be a source of pain if policy progress doesn't materialize.

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For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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