NEWPERSPECTIVES

Commentary from New Century Advisors
June 2017

US Inflation: Patience Challenged as Risks Mount

- **The strengthening global economy continues to take a back seat to rising energy volatility and domestic political risks**
- **Oil resumed selling after OPEC and non-OPEC exporters voted to extend production limits**
- **Fiscal stimulus and tax and regulatory reform, once upside risks to domestic growth and inflation, have given way to political risk with the Justice Department naming a special counsel to oversee the Russia investigation**
- **The Fed is still expected to hike rates again later this month, but the path going forward is increasingly uncertain**
- **TIPS valuations remain supportive from a fundamental standpoint as breakevens remain cheap to inflation forecasts**

Life's But a Walking Shadow

The case for TIPS continues to be a fundamental one, but market professionals know too well that fundamentals don't always drive price action. The breakeven rally following the U.S. presidential election faded not long after the inauguration. We had been skeptical that the new administration's proposals would generate a meaningful boost to inflation, but valuations never even reached what we viewed as fair-value (beyond the very front end), let alone rich. As such we never felt comfortable betting against the asset class. Nonetheless, 10yr BEI is now 25bps below the multi-year highs touched the week after President Trump was sworn in.

But let's not focus on the rearview mirror. We continue to see compelling arguments for short- and long-term investors to own TIPS. At the heart of that view is the argument that TIPS are cheap relative to the expected path of inflation. Given that the last couple of CPI prints have been below consensus, we take a closer look at trends within Core CPI and take some comfort from still hefty gains in shelter prices and most – though not all – services.

In addition, this month we add a chart comparing the expected returns from TIPS to those from the corporate bond market. We've long espoused the duration diversification benefit of TIPS, an argument that is particularly valid during a Fed hiking regime. But we would also highlight their value as a high quality substitute for spread product, particularly given the limited room for further corporate spread compression.

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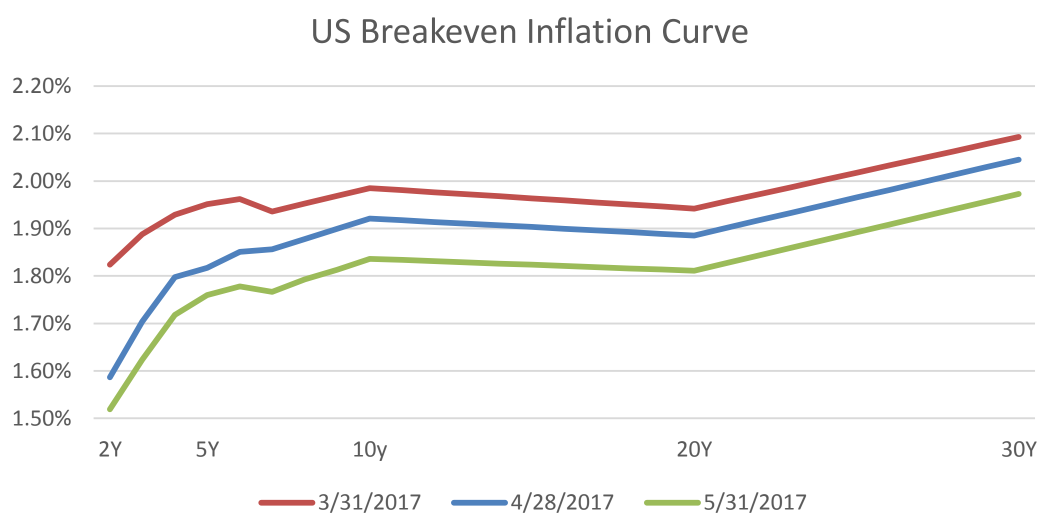
Last month we opined that while patience among TIPS investors will most likely be rewarded, it will definitely be required. That proved prescient as TIPS breakevens touched new YTD lows in May, levels they have tested again early this month. Whether TIPS are merely, "full of sound and fury, signifying nothing," remains to be seen, of course. Stay tuned.

May Performance Highlights



Source: Bloomberg and New Century Advisors

TIPS Market Moves in May (bps)				
	2 YEAR	**5 YEAR**	**10 YEAR**	**30 YEAR**
Breakevens	-6.7	-5.7	-8.5	-7.2
Real Yields	8.2	0.9	2.0	3.9

Source: Bloomberg and New Century Advisors

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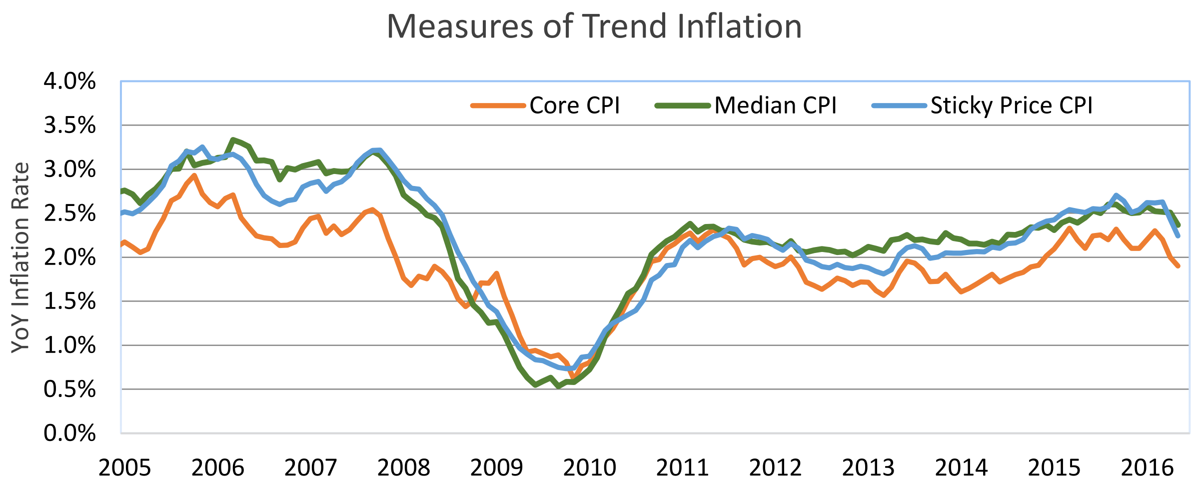
Inflation-Linked Bond Index Returns (Local Currency Returns)				
	May		YTD	
	Total Return	vs. Nominal Comparators	Total Return	vs. Nominal Comparators
Barclays World GILB	-0.43%	-1.18%	1.42%	-0.77%
United States	-0.04%	-0.87%	1.94%	-0.66%
United Kingdom	-1.71%	-2.40%	2.50%	-0.62%
Germany	-0.64%	-0.59%	-1.78%	-1.15%
France	0.30%	-0.52%	-0.96%	-1.03%
Spain	0.69%	-0.20%	0.32%	-0.23%
Denmark	0.00%	-0.10%	0.37%	0.10%
Sweden	0.73%	0.19%	0.78%	0.46%
Canada	1.26%	-0.16%	1.97%	-2.56%
Japan	-0.02%	0.23%	-0.94%	-1.08%
Australia	1.02%	-0.32%	3.38%	-0.12%
Italy	0.44%	-0.32%	-2.12%	-0.97%
New Zealand	4.31%	2.36%	6.64%	2.17%
Argentina	1.04%	-	9.28%	-
Brazil	-1.16%	-	5.45%	-
Chile	-0.92%	-	1.89%	-
Columbia	2.33%	-	6.14%	-
Israel	1.02%	-	1.14%	-
Mexico	0.50%	-	4.11%	-
Poland	0.59%	-	3.58%	-
Turkey	0.84%	-	8.49%	-
South Korea	-0.19%	-	0.64%	-
South Africa	-0.08%	-	0.37%	-
Thailand	-0.50%	-	1.39%	-

Source: Barclays, New Century Advisors

US CPI – Is Core Weakness the New Trend?

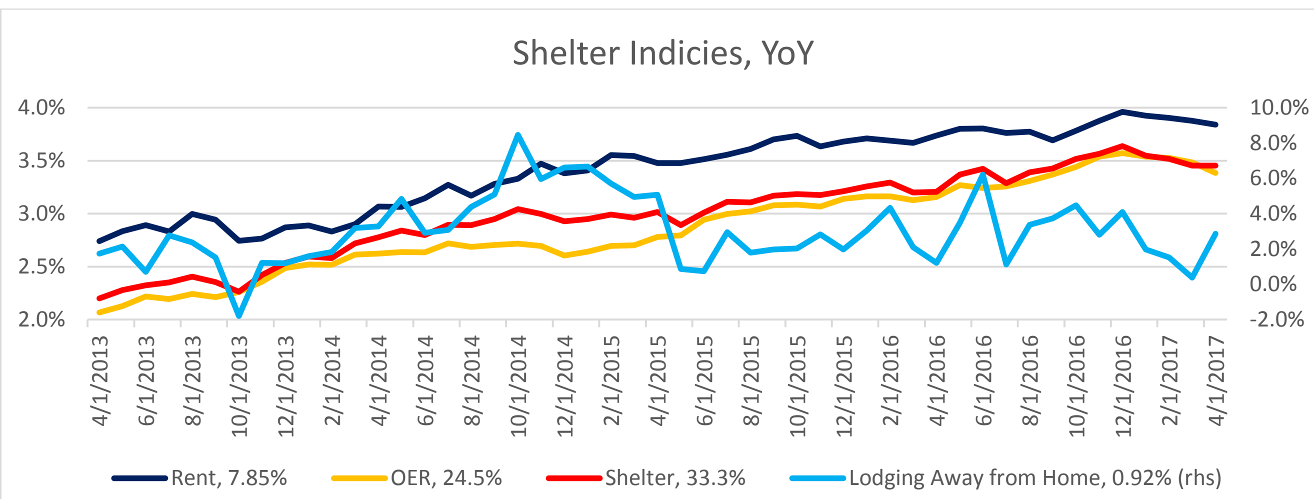
In the April CPI data, released in May, headline CPI rose 0.2% MoM, bringing the YoY print to 2.2%, down from 2.4% the prior month and a five year high of 2.7% in February. The core rose just 0.1% MoM (0.071% unrounded), a rebound from the prior month's MoM decline (-0.122%) but still below consensus for a 0.2%

rise, bringing the YoY measure down to 1.86% from a recent high of 2.26% in January. Core weakness came from continued declines in new & used car prices (-0.03% contribution), along with declines in prices for prescription drugs, physicians' services, motor vehicle insurance, and an ongoing wireless services adjustment (-0.07%, combined).



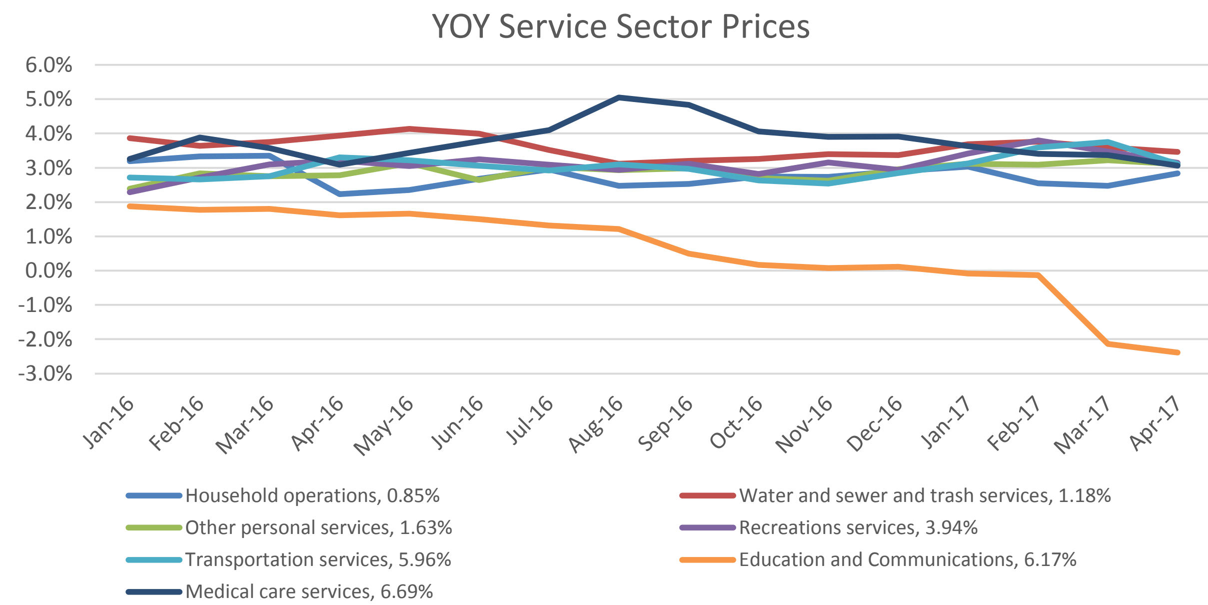
Source: BLS, Cleveland Fed, and Atlanta Fed

With core CPI and other measures of trend inflation softening in recent months (the Cleveland Fed's Median CPI and the Atlanta Fed Sticky Price CPI were 2.37% and 2.24%, respectively, but both off recent highs), we take a closer look at the largest components of Core CPI, Shelter (33.3% of Headline, 42.4% of Core) and Core Services (26.5% of Headline; 33.5% of Core)



Source: BLS and NCA

- At 1/3 of the CPI index, Shelter is by far and away the largest component
- Owners' Equivalent Rent (OER) is the largest component of Shelter. Both peaked in December at just over 3.5%, and have since eased to 3.39% and 3.45%, respectively
- OER is modeled from rental data, and is thus highly correlated with Rents (R^2=0.88)
- Rents, in turn are driven in large part by vacancy rates, which sat at 7.0% nationally as of the end of March, close to the 30yr low reached in Q2'16 (6.7%)
- While we anticipate some further deceleration in shelter prices over the remainder of 2017, with rental markets still tight, we anticipate shelter inflation to stabilize around 3.2%



Source: BLS and NCA

- Core Services make up 26.5% of the CPI
- With one exception, Service prices have risen fairly consistently at/above 3% YoY
- The outlier Is Education and Communications, which have been marked lower due to adjustments within wireless plans (1.6% of CPI), which are down 8.6% over the past two months and 12.9% YoY, primarily due to hedonic adjustments
- Given tight employment conditions and rising wages, we expect Service prices to continue to rise at a 3% annual rate, with wireless services normalizing back to trend

Based upon our analysis of the trends within core CPI, we do not expect the recent softening trend to continue. The removal of base effects from May, 2016, when core services rose at a 3.8% annualized rate, pose a challenge to the YoY rate for the May, 2017 print on June 14th, but we do expect to see core CPI stabilize at current levels before rebounding back above 2% in the following months, eventually returning to 2.2-2.3% later this year. While Core Goods (19% of CPI) have been and are expected to remain a drag

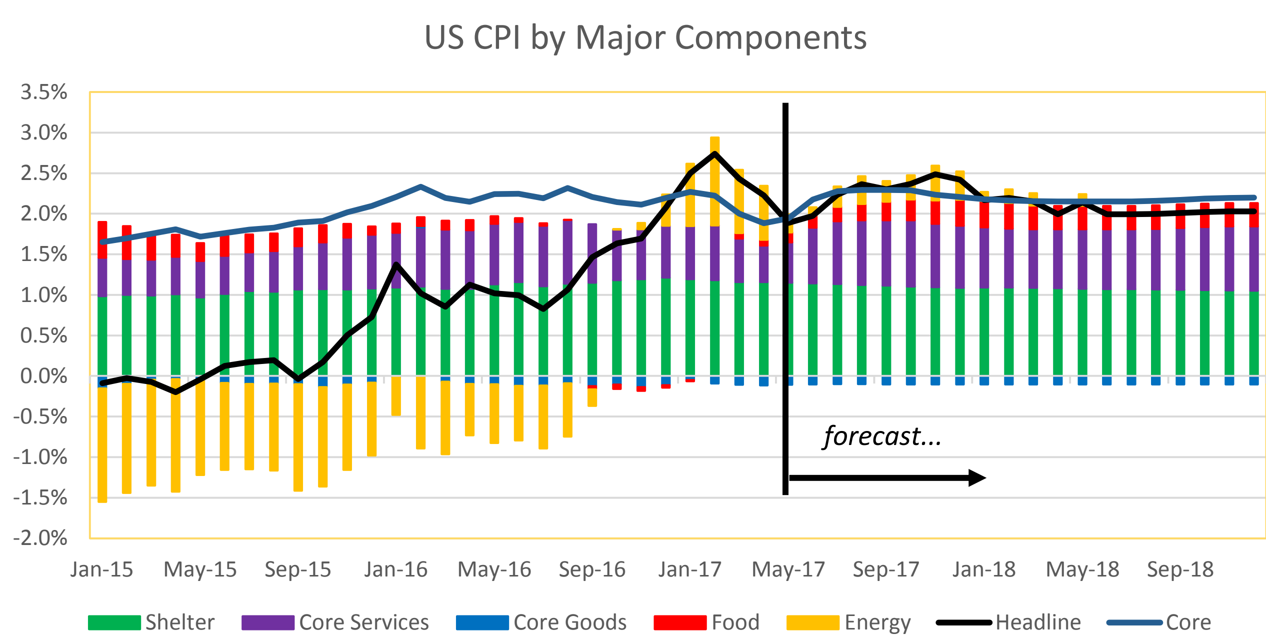
(-0.61% YoY), the broader trend in the core will continue to be driven by Shelter and Services, both of which should remain supportive.

Updating our Headline CPI Forecast

We expect Headline CPI to dip toward 2% YoY over the next couple of months (May and June prints) before stabilizing and returning to a 2.2-2.4% range for the remainder of 2017. Should energy remain range-bound, we see that range sliding to 2.0%-2.2% in 2018.

Sub-indices contributing to these forecasts:

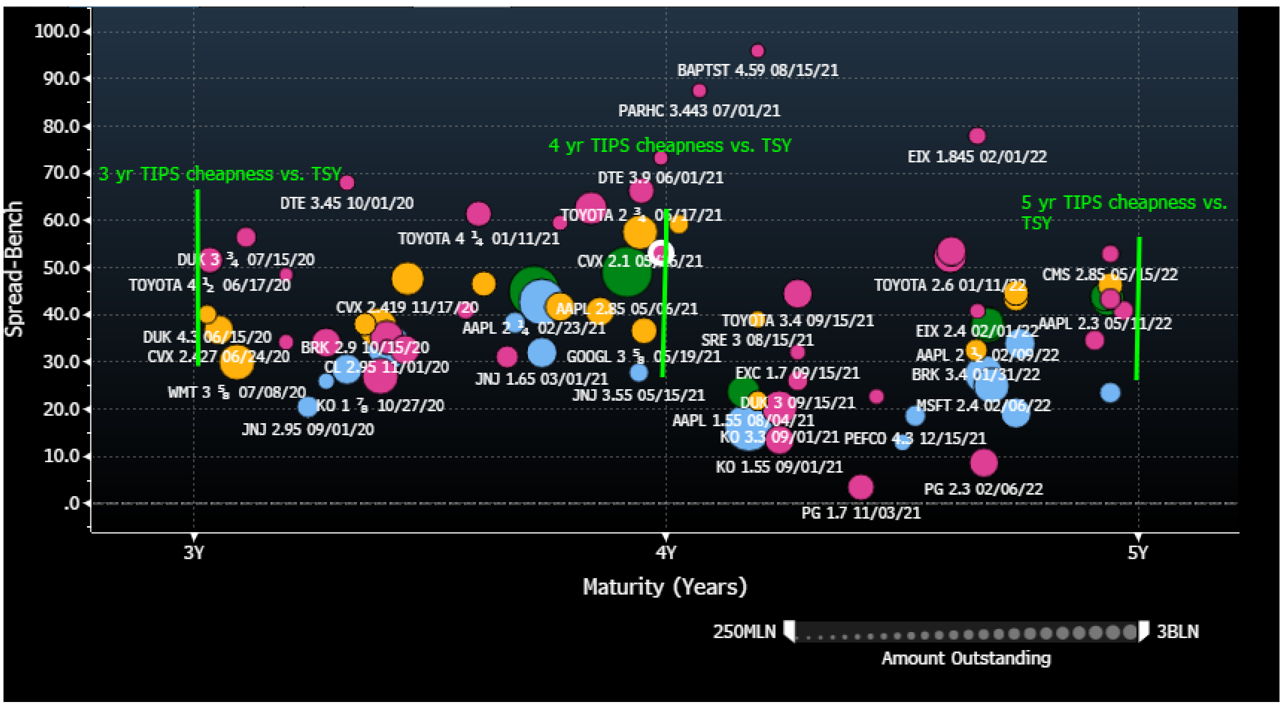
- Shelter: Currently 3.45% YoY; Expecting 3.23% year end 2017, 3.13% year end 2018. Key driver: rental vacancy rates, which remain near multi-year lows at 7.0%
- Core Services: Currently 1.70% YoY; Expecting 2.98% year end 2017, 3.12% year end 2018. Key driver: wages
- Core Goods: Currently -0.61 % YoY; Expecting -0.55% year end 2017, -0.55% year end 2018. Key driver: global growth / commodity markets
- Food: Currently 0.52 % YoY; Expecting 2.33% year end 2017, 2.12% year end 2018. Key driver: global growth
- Energy: Currently 9.27% YoY; Expecting 4.95% year end 2017, 0% year end 2018. Key driver: global growth / supply dynamics



Source: BLS and New Century Advisors

TIPS vs. Corporate Bonds – Spread Product Diversification

We thought we'd take a look at how TIPS valuations compare with the corporate bond sector, based on our current forecast for inflation (+/- 20bps). We see TIPS as a high quality substitute to spread products in a low yield environment. Credit spreads have compressed materially over the cycle and we see limited upside (tightening room) for credit spreads going forward. TIPS, on the other hand, remain well off their historical highs and have the potential to be much more resilient than other spread sectors in a down trade given our estimates of cheapness and the lack of idiosyncratic risk. The following chart shows a sample of A1 – Aaa credit spreads for 3-5 years corporate bonds. We have inserted the vertical green bars to estimate potential TIPS cheapness. As the chart shows, even at the low end of our estimates (i.e., 30 bps), TIPS appear to be a pretty good alternative to many, high quality corporates here.



Source: Bloomberg, NCA

In Closing

The fundamental backdrop remains positive for the TIPS asset class, but challenges remain. Fiscal policy delays unwound the overly-optimistic post-election trade, while political risks continue to rise. Meanwhile, a second disappointing inflation print and ongoing volatility in energy markets have further tested the asset class. The market has twice found support near current levels, but the patience of those that remain in the trade will continue to drive near-term performance.

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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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