NEWPERSPECTIVES

Commentary from New Century Advisors
August 2017

Global Inflation: Improvement

- **Despite 4 weaker-than-expected US CPI prints, TIPS outperformed their nominal counterparts by 24bps in July. Global linkers have also begun to perform in recent weeks, with exposure to FX enhancing returns this year.**
- **TIPS were supported by a rebound in oil and commodities, as well as by a dovish turn by the Fed**
- **The global economic backdrop continues to be supportive, with firm PMI prints pointing to manufacturing strength and reduced downside risks**
- **EM continues to perform well, supported by the combination of firmer commodities and a softer dollar, along with a slightly less hawkish Fed.**

Curb Your Expectations But Not Your Enthusiasm

In last month's Dashboard, we wrote optimistically about the gains seen in the inflation markets over the latter part of June. The better tone continued through July, bolstered by rising oil and commodity prices and by a respite from the more hawkish rhetoric from the Fed and other central banks. Fed Chair Yellen set a more dovish tone in her semi-annual congressional testimony - partly in response to ongoing weakness in the inflation data - just days before the release of the June CPI data. While that report was once again a touch below economists' expectations, there were some reasons for optimism going forward, not least of which were strong shelter prices and signs of a rebound in other core services (more below).

TIPS breakevens imply that the recent softer trend in inflation is here to stay (5yr TIPS BEI ~1.70%). Given our expectation for CPI to rebound back toward 2% later this year, we would agree with the growing chorus of those who see the asset class as still fundamentally cheap. But our rationale for owning TIPS doesn't come from our faith in our inflation forecast alone, but rather the proven diversification benefit for owning TIPS in any portfolio: higher risk-adjusted returns. The case is stronger still for owning global inflation assets, along with EM, a subject we wrote about extensively last month and which we revisit briefly below.

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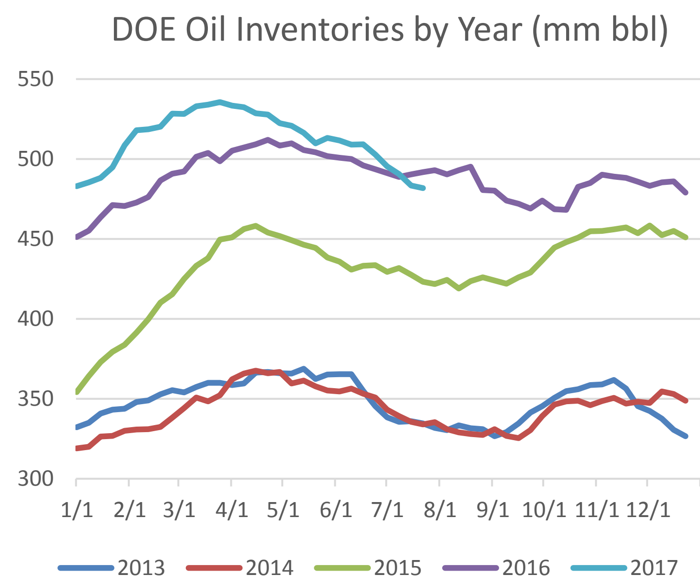
Black Gold, Texas Tea

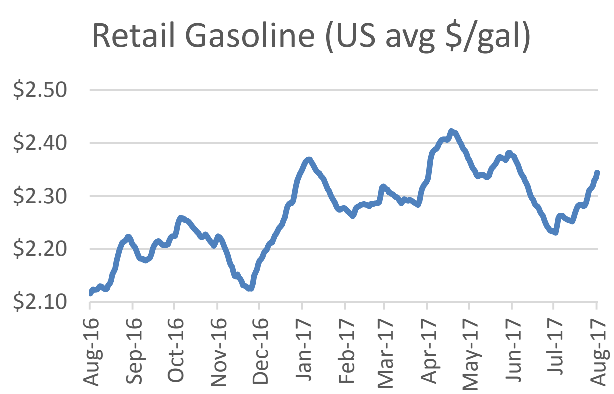
We are hesitant to extrapolate current strength too far into the future, but there is no question what the number one driver of recent TIPS returns has been: oil is up 16% since hitting a 14 month low in June. But while oil is fighting its way out from under a supply glut, it's not alone in the move higher. Copper, often seen as a global industrial bellweather, is at a more than 2yr high and is up 16% from its Q2 lows and 47% from its early 2016 lows. The S&P GSCI (commodity index) is up nearly 9% since its June lows.

What has been driving oil higher lately? Much has been written about OPEC's production caps, installed to help reduce a global supply glut. Many expected rising US production to offset the OPEC cuts, and for a while it did, but the tide has since turned. As seen in the chart to the right, US crude inventories have not only dropped 10% from their highs this spring, they've fallen below where they were at this time last year. This has come despite the release of >16mm bbl of oil from the SPR (Strategic Oil Reserve, sold to cover maintenance and upgrade costs). By most accounts, the global supply glut has fallen even faster.



Source: DOE, Bloomberg, and NCA

Why it matters: Average US retail gasoline prices have been rising since early July. The BLS (the keepers of the CPI) measure the average price over the entire month. In July, AAA reported that the average price for a gallon of gas was $2.27, down 1.75% from June but +~0.25% on a seasonally adjusted basis (pending Friday's CPI report; gasoline prices usually decline in the summer.) It is currently $2.35 and rising. If it holds right here for the remainder of the month it will be up over 3.5% MoM in August, but up 5.75% on a seasonal basis. With a 3.4% weighting within CPI,that's worth nearly 0.2% MoM for CPI, all by itself (+0.196%). That number only grows as gasoline continues to rise.

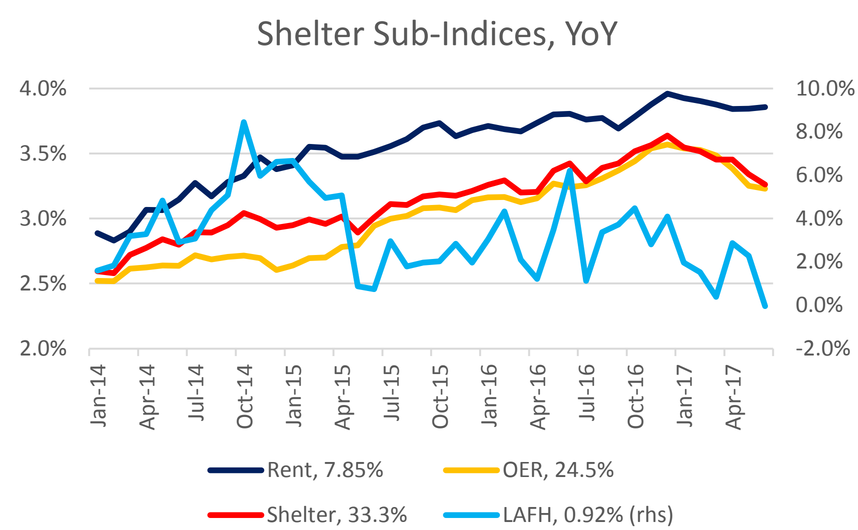


Source: AAA, Bloomberg, and NCA

Inflation Sanguinity

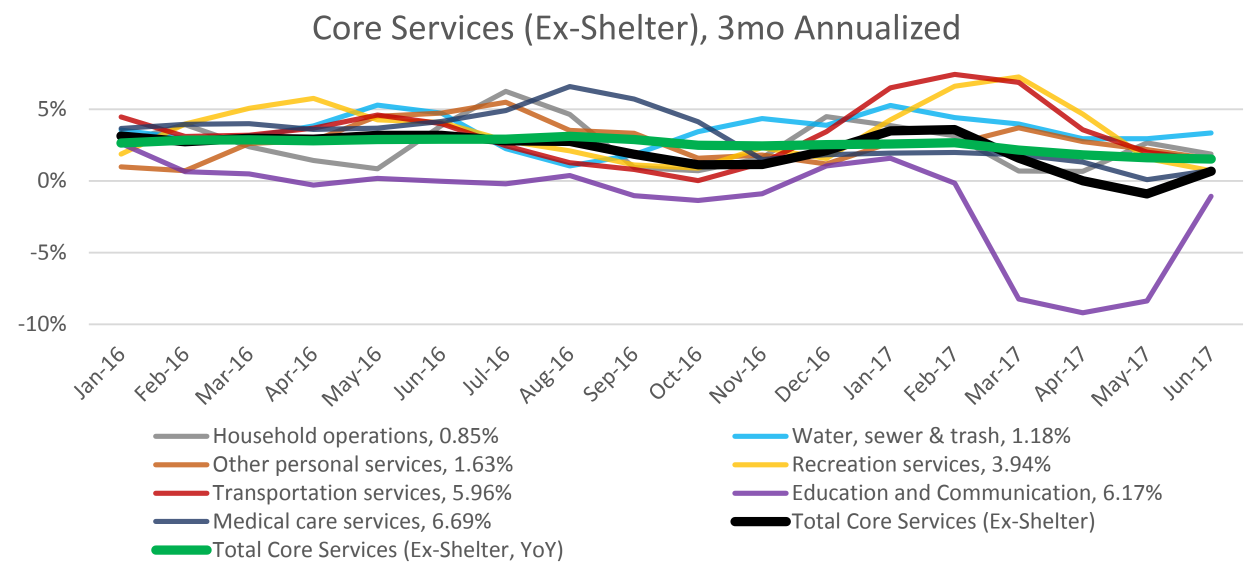
While we do pay a lot of attention to the energy markets and do see further upside risks, our hair isn't particularly on fire about oil here. Overall, we continue to be rather sanguine on inflation in the medium term, both to the upside as well as to the downside. Here's why.

The June CPI print released in July shows two trends that should comfort the Fed. First, Shelter, the 800lb gorilla in the index (33.3% of the total CPI), had its best print of the year, hotel prices notwithstanding. Rents rose 0.348% MoM in June, the most since October. Owner's Equivalent Rent, or OER, was +0.283% MoM, its biggest gain since December. Overall, Shelter rose 0.235% MoM in June, +3.262% YoY, down from its peak, 3.64% YoY in December. Hotel prices, aka Lodging Away From Home, continue to be a drag, falling 1.95% MoM in June and sliding into negative territory YoY (down 0.05%). A bit more on that in a minute.



Source: BLS and NCA

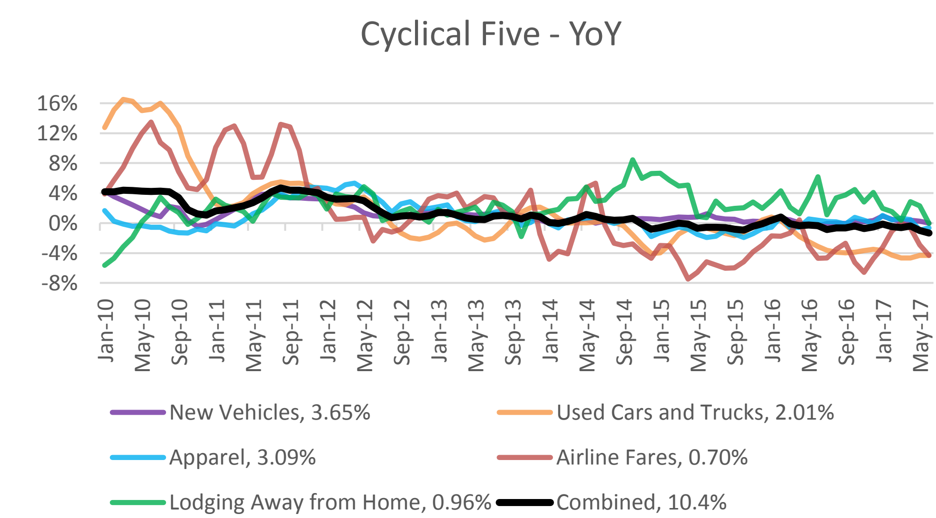
Furthermore, Core Services Ex-Shelter, which took a hit this spring largely from cell phone plans but also from a return to trend from high Recreation and Transportation costs, look to be stabilizing and even picking back up. The chart on the next page shows annualized 3 month data for the various Core Services sub-indices going back a year and a half. As the drop in cell phone plans fades further into the past its impact wanes, an effect that can clearly be seen on the black line, which combines all the sub-indices (again, 3-month annualized). That appears headed for a convergence back with the green line, which is the 12-month version of the same.



Source: BLS and NCA

The Cyclical Five

But, because there's always a 'but'…keep an eye on the cyclical five: Apparel, New & Used Cars, Airfares, and Hotels (Lodging Away from Home). These are highly consumer-driven sectors that represent 10.4% of the CPI, and they've been in steady decline for years. Combined, they fell 1.32% YoY in June. While the analysis above alleviates our concerns about the downside risks to inflation, the weakness in the discretionary categories limits our concerns about the upside risks.



Source: BLS and NCA

In Closing

The outlook remains favorable both for TIPS and global inflation markets in general. After a few weaker-than-expected prints, US CPI is likely to stabilize and eventually rebound back towards 2%, making current TIPS valuations cheap. We continue to see opportunities overseas, including EM, and believe that inflation investors can benefit from global diversification. We remain ever vigilant on flows and market positioning, keeping a close eye on various measures of investor demand.

	Local Currency Return		Local BEI Return	
	July	YTD	July	YTD
Australia	-0.16%	1.66%	-0.27%	-0.84%
Italy	0.95%	-0.59%	0.37%	-0.21%
Canada	-3.24%	-3.40%	0.14%	-2.57%
Spain	0.54%	1.41%	0.25%	0.52%
France	0.75%	-0.89%	0.58%	-0.41%
Denmark	0.60%	-0.09%	0.33%	0.13%
Germany	0.59%	-2.44%	0.62%	-0.58%
Japan	-0.38%	-1.75%	-0.40%	-1.59%
New Zealand	-0.66%	3.21%	-1.09%	-0.54%
Sweden	0.18%	-0.55%	0.44%	0.36%
UK	-1.38%	-1.93%	-1.61%	-2.44%
US	0.42%	1.37%	0.24%	-1.15%
WGILB	-0.14%	-0.19%	-0.27%	-1.40%

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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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