NEWPERSPECTIVES

Commentary from New Century Advisors
September 2017

Inflation Gets Back On Track

- **After five weaker-than-expected prints, CPI picked up in August, boosted by energy and shelter in particular**
- **While much of the headline increase was due to Hurricane Harvey's temporary impact on energy, increases in other areas – particularly services – support our broader outlook for CPI to return to 2% YoY**
- **TIPS returns lagged their nominal counterparts by 25bps in August but have already outperformed by 50bps MTD in September, pricing in much of the good news in the August CPI print ahead of time**
- **The FOMC will focus on balance sheet reduction at their September meeting, but a December hike is very much on the table, particularly if inflation matches our outlook in the coming months**
- **The global economic backdrop continues to be supportive, with firm PMI prints pointing to ongoing manufacturing strength and reduced downside risks**
- **EM continues to perform well despite the recent bounce in the dollar**

Where was the Kaboom?!?

If there was a surprise in the August CPI report, beyond the rebound in Shelter, it was the relative lack of a reaction the CPI release generated in the rates market. Headline CPI rose 0.4% MoM in August (+0.3% MoM on a non-seasonally-adjusted or NSA basis), bringing the index to +1.94% YoY. It had dipped to 1.63% as recently as June. Moreover, core CPI rose 0.248% MoM, its biggest gain since January, keeping it at 1.7% YoY vs. economists' predictions of a dip to 1.6%. But despite this beat, 10yr Notes closed the day trading at 2.19%, unchanged from the prior day's close.

Much of the good news was priced into the market ahead of time. 10yr notes had already sold off 15bps from YTD yield lows in the past week, while 10yr TIPS breakevens widened 10bps since late August and nearly 20bps since their YTD lows in June. In our view, the August CPI print supports our broader inflation outlook, outlined in this space last month, that, "US CPI is likely to stabilize and eventually rebound back towards 2%."

Last month we highlighted upside risks to energy prices, ongoing strength in shelter costs, and rebounding service inflation, all of which informed our 'sanguine' outlook for inflation despite what was, , a worrying trend in the recent monthly data. While Harvey led to a temporary spike in gasoline costs well in excess of anything we could have expected prior to the hurricane, the August CPI report reaffirmed our broader

www.newcenturyadvisors.com
research@ncallc.com

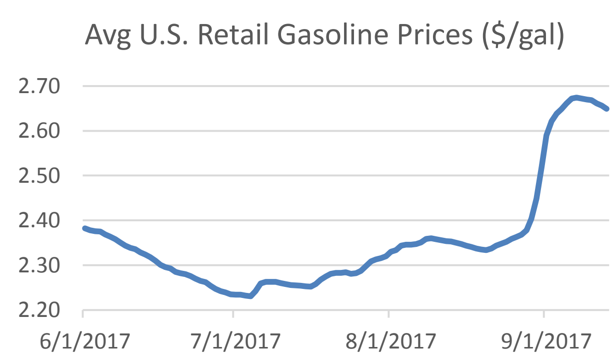
outlook. In so doing it should also bring some comfort to the Fed, who will initiate their balance sheet reduction plan at their meeting next week but are also still inclined to raise rates again in December.

Stormy Weather

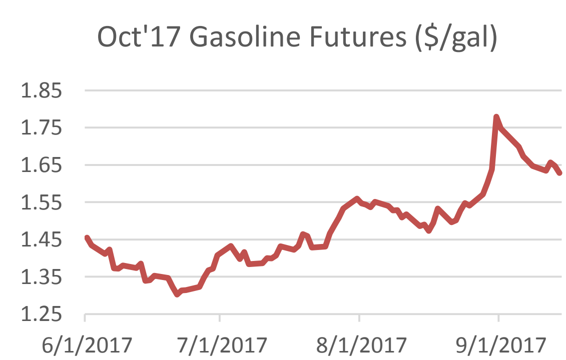
Our thoughts go out to all those who have lived through, and are still living with the aftermath of, hurricanes Harvey and Irma. Aside from the tragic personal toll, many are wondering what economic impact the country might face as a result of the devastation. **The quick take from our analysis is that there is likely to be little longer-term impact on inflation from these devastating storms.**

Gasoline prices, which were already rising even before Harvey struck the heart of the gulf coast refinery region, jumped 30 cents in little more than a week (first chart, below.) Should prices remain at their current level, that would represent a 12.2% month-over-month increase over August, which already saw a 4% increase over July (6.3% on a Seasonally Adjusted basis.) With a 3.3% weight in CPI, that translates to a 40bp contribution to the MoM headline print.

That said, gasoline prices are unlikely to remain at current levels for long. Indeed, as the second chart shows, gasoline futures have already begun to reverse the move as refiners have come back online. Retail gasoline prices tend to lag futures prices by 1-2 weeks – typically longer on the way down than on the way up (surprise, surprise.) **But we have already seen retail prices start to slide, and a more meaningful reversal seems likely in the near term. If retail gasoline slides back toward $2.50 over the coming weeks, that would leave the MoM rise at 9-10%, contributing a still-strong 30+bps to headline CPI.**



Source: AAA



Source: NY Mercantile Exchange

Any gasoline price gains in September are likely to be reversed, at least in part, in October. Should prices merely hold ~$2.50/gal, that would represent a ~3% drop vs. September. **Should prices decline further, to say $2.40/gal, which is possible given seasonal factors and the shift toward cheaper winter blends, that**

would be a 6-7% drop vs. September. In short, most of the gasoline-led rise in headline inflation expected in September looks to be very short-lived.

Making landfall in Florida, Hurricane Irma did not have the same impact on the gasoline supply chain. If anything, the initial spike in demand from the evacuation notwithstanding, demand destruction could actually hasten the correction back to pre-Harvey gasoline prices. On the other hand, frozen concentrated orange juice (FCOJ) futures are up 12% on the month, down from a peak of +18%. But citrus fruits comprise a mere 0.16% of CPI, while the entire non-carbonated juices and drinks segment is 0.39% of the index. In short, while retail OJ prices are likely to go up in the coming months, the overall impact on CPI will be negligible.

One area that could see an impact from Harvey and Irma in the medium term is new and used car prices. **Early estimates vary, but flooding from Harvey may have destroyed as many as 500,000 cars.** Though likely destroying far fewer vehicles, Irma will add to that total. New and used car prices have been a persistent area of weakness within CPI this year, largely due to oversupply, with new car inventories lingering at close to 2.5 months' supply, or over 3mm vehicles, a 10% increase over last year.[1] New car prices have declined 1.7% since February, while used car prices have fallen nearly 4%.[2] With weights of 3.6% and 2.0%, respectively, the overall impact on CPI has added up. At the margin, the need to replace so many flood-destroyed vehicles will help to reverse these trends. While demand to replace flooded cars won't send the country into a shortage, it will nonetheless help work off the imbalance that has recently weighed on prices.

Finally, in the longer term, rebuilding destroyed homes and commercial properties could lead to a shortage of building materials such as plywood, putting upward pressure on new construction costs. Construction materials have a 5% weight within the Intermediate Demand measure of PPI and are currently up 2.7% YoY.[3] Demand for construction workers could also put upward pressure on wages, which are currently rising at 2.65%.[4] **Thus, between car prices and housing costs, the storms do create some idiosyncratic upside risks to inflation in the medium term.** As with energy, however, we expect any such effects to ultimately prove temporary.

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[1] Wards Auto: http://wardsauto.com/datasheet/us-light-vehicle-inventory-august-2017

[2] Bureau of Labor Statistics: https://www.bls.gov/news.release/cpi.toc.htm

[3] Bureau of Labor Statistics: https://www.bls.gov/news.release/ppi.t02.htm

[4] YoY Avg Hourly Earnings gain for all construction workers, Seasonally Adjusted. Bureau of Labor Statistics: https://data.bls.gov/cgi-bin/dsrv

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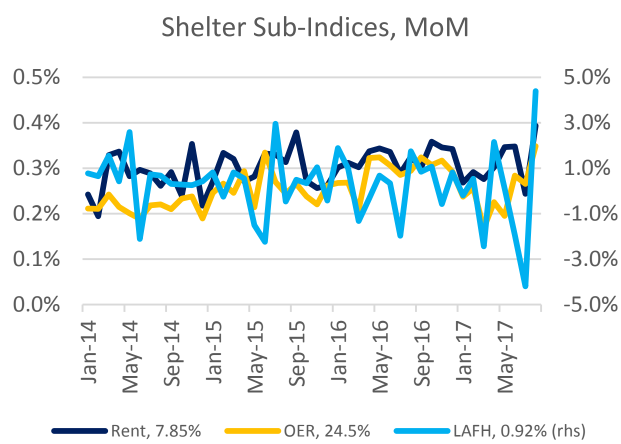
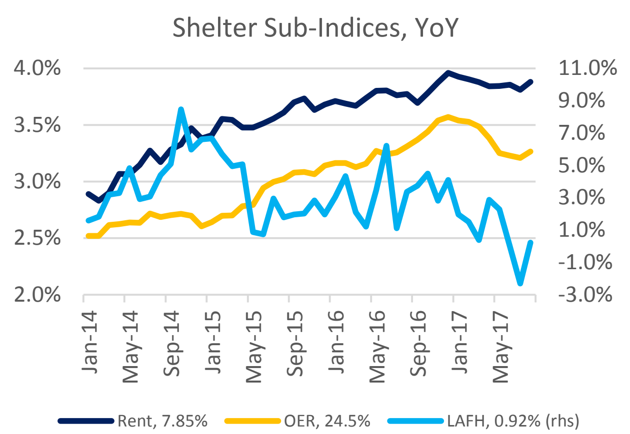
Our Call Stands

Our call for US CPI to rebound back toward 2% later this year holds. Due to the Harvey-induced spike in gasoline prices discussed above, YoY CPI may actually rise as high as 2.2% in September, but it should revert back to 2.0% in subsequent months. The strong August CPI report reduces near term downside inflation risks and gives credence to the Fed's view that recent weakness was due to a series of transitory one-offs. That gives them the green light to not only formally announce their balance sheet reduction plan as widely anticipated next week (see our publication from earlier this month, available here, on the details and expected market impact) but also to eventually hike rates again in December.

Rents rose 0.39% MoM in August, the biggest gain since 2008. Owners' Equivalent Rent rose 0.35%, the biggest increase since 2006. After falling 4.2% MoM in July, Lodging Away From Home (i.e., hotel prices), bounced back 4.4%, suggesting a quirk in the seasonality (though to a lesser degree, the data show a similar short-lived dip last summer as well.) **Altogether, the 0.46% rise in Shelter costs was the biggest MoM gain in 12 years, and contributed 80% of the overall gain in Core CPI.**



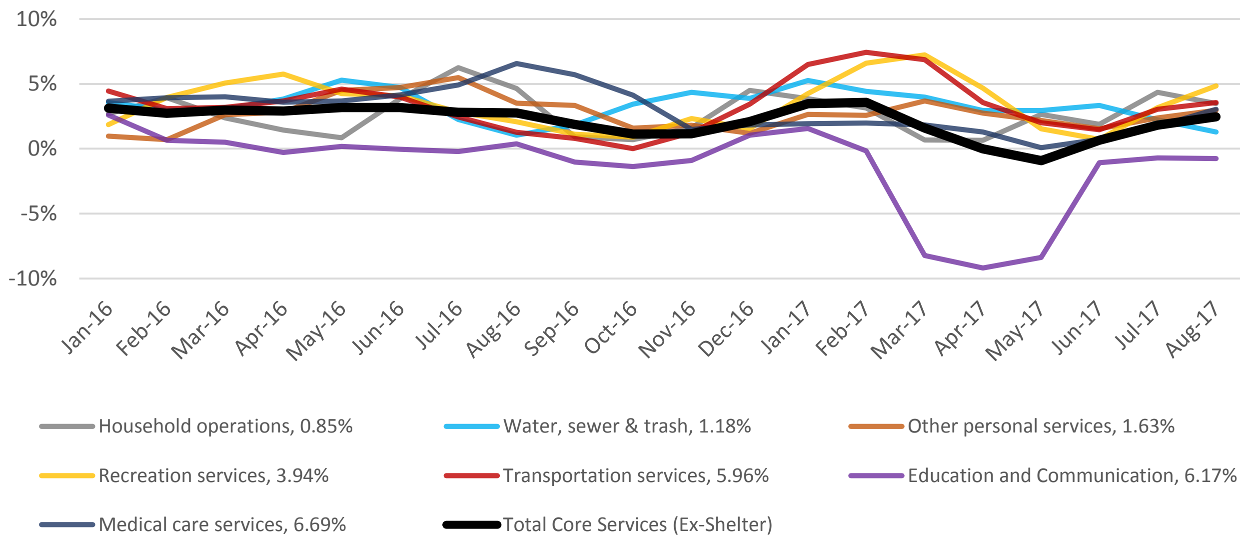
Source: BLS and NCA



Source: BLS and NCA

But while Shelter drew all the attention, the rest of the Core Services sector quietly rose by the most since February, an upward trend that has been in place since Education and Communications fell nearly 2% back in March due to a 7% decline in wireless fees. **Comprising 26% of CPI, Core Services Ex-Shelter prices have risen at a 2.5% annualized clip over the past three months.**

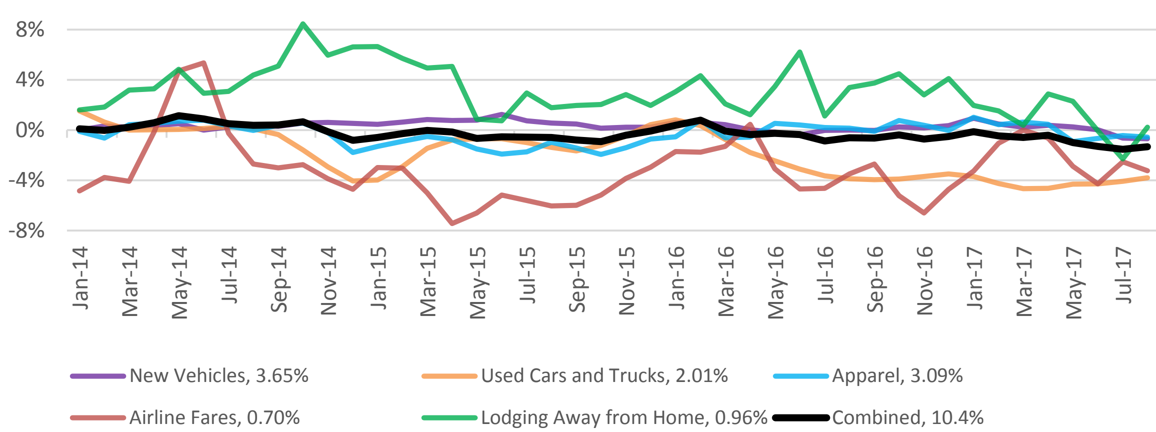
Core Services (Ex-Shelter), 3mo Annualized



Source: BLS and NCA

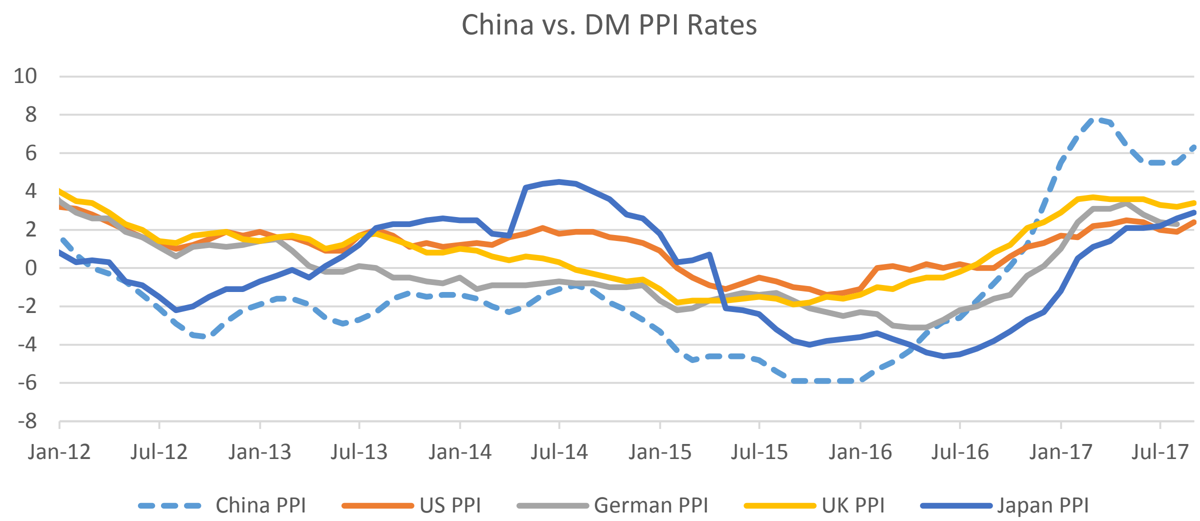
Not all prices have turned higher. Core Goods (18.9% of CPI) are still a drag, falling every month since January and down 0.85% YoY, the biggest annual decline since 2004. Meanwhile, the Cyclical Five (New and Used Cars, Apparel, Airfares, and Lodging Away From Home), which we flagged last month as a potential risk, rose in August for the first time since February, helped by the 4.4% gain in hotel prices. But the group is still down 1.34% YoY.

Cyclical Five - YoY

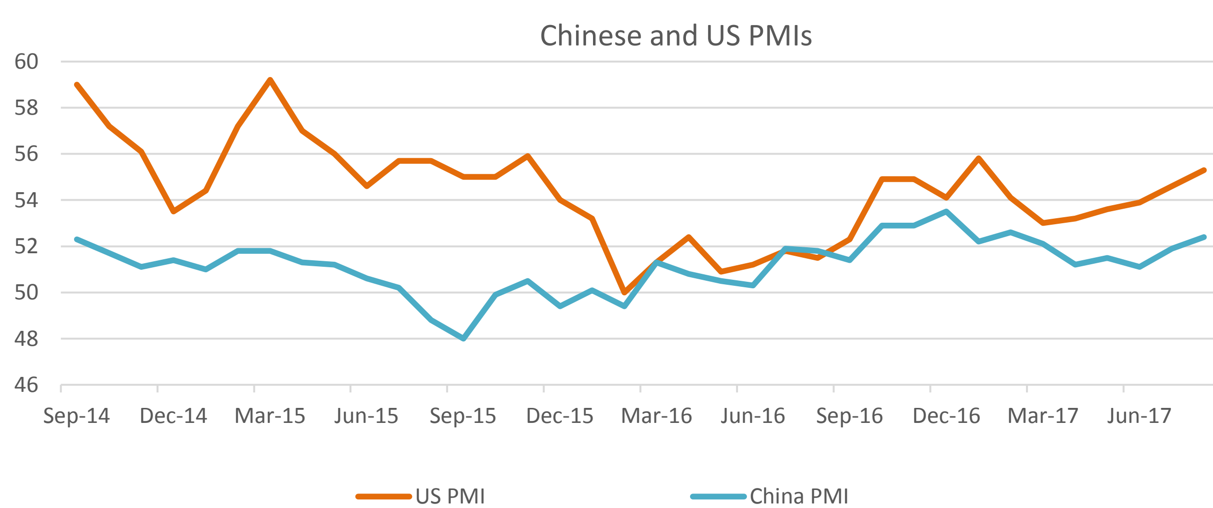


Source: BLS and NCA

That said, the global backdrop remains supportive for inflation general. After a shallow dip in Q2, producer prices, led by China, have once again accelerated, supported by rising PMI surveys.



Source: Bloomberg and NCA



Source: Bloomberg and NCA

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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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