NEWPERSPECTIVES

Commentary from New Century Advisors
October 2017

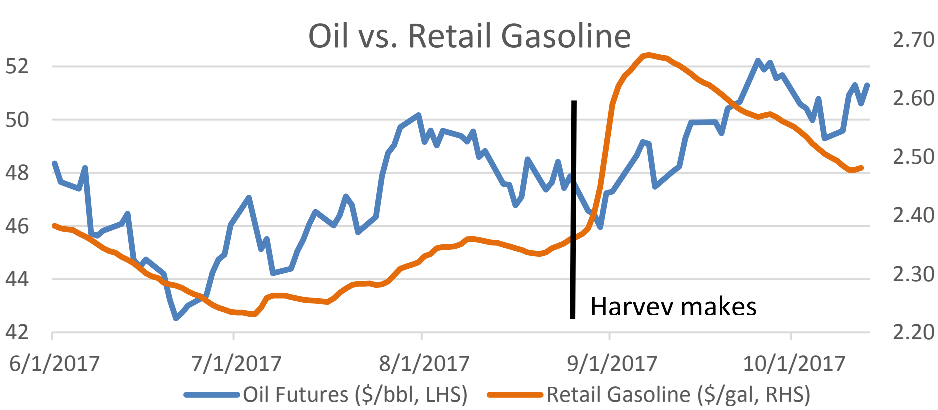
CPI – Hurricane Headline vs. Calm Core

- **September CPI rose 0.5% MoM (2.2% YoY), led by a (temporary) 13% rise in gasoline prices due to Hurricane Harvey**
- **Core CPI was more muted, rising just 0.127% MoM (1.71% YoY), a touch below expectations. Core CPI is up 0.49% in the past 3 months, or 1.97% annualized, after nearly flatlining this spring**
- **The hurricane impact was limited outside of gasoline (but stay tuned)**
- **Services and goods continue to diverge within Core CPI**
- **The Fed is still likely to hike in December (the market agrees)**
- **Looking to next year: Upside risks to inflation but a glaring question overhangs the path of monetary policy**

The More Things Change, the More They Stay the Same

The BLS released their CPI report for the month of September on Friday. While the core measure was a touch softer than anticipated, there was little change to our broader outlook on inflation. As transitory factors from earlier in the year continue to wane, inflation should stabilize back at or above 2%.

Headline CPI jumped to 2.2% YoY, from 1.9% in August, led by a nearly 11% jump in retail gasoline prices (13.1 % when accounting for a 2.5% seasonal adjustment – gasoline prices normally fall in September.) But much of the gain will be temporary as retail prices have already fallen 5% from September levels. Even so, setting aside the hurricane impact, oil prices have rallied since their June lows and there are signs that gasoline could stabilize near current levels.



Source: AAA, Bloomberg, and New Century Advisors

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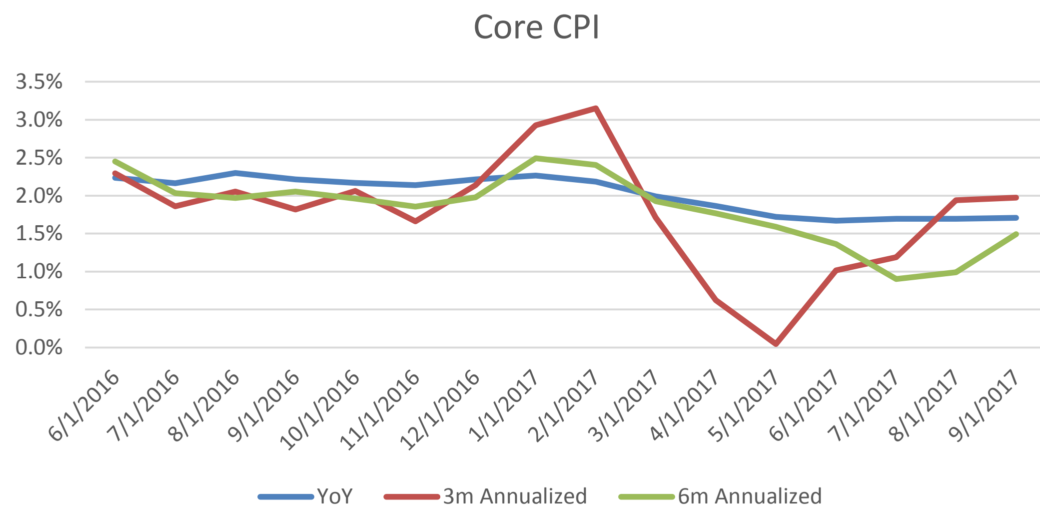
But while headline CPI jumped, Core CPI rose a more pedestrian 0.127% MoM, or 1.71% YoY. It was the fifth consecutive month that the Core has been at 1.7%, although even within that stability the data have shown signs of rebounding after the precipitous drop this spring. The 3-month annualized rate, which flatlined at a mere 5bps back in May, has since bounced back to 1.97%, with the 6-month annualized rate clawing back to 1.50% from a low of 0.90% as recently as July.

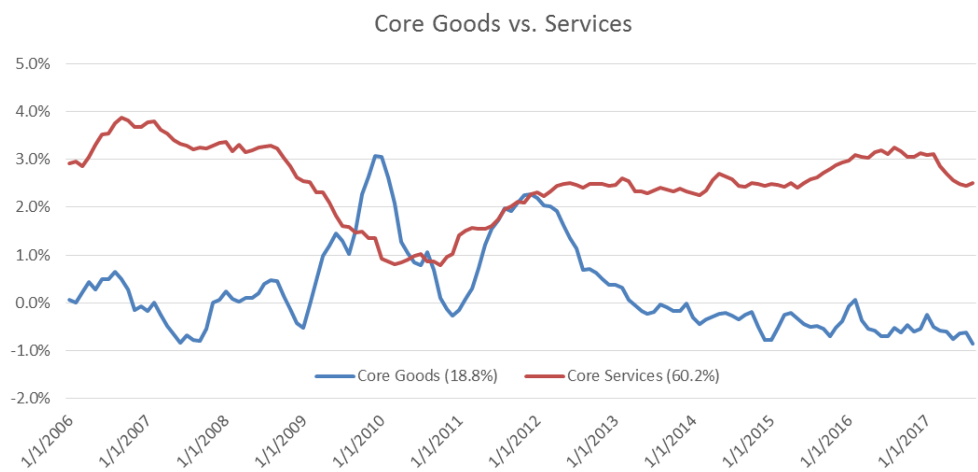


Source: The BLS and New Century Advisors

Of note, there was little if any hurricane impact outside of the as-expected jump in gasoline prices. Vehicle sales jumped 15% to a 12-year high as consumers replaced cars destroyed by flooding. Yet auto prices declined for the 8th straight month. New vehicle prices fell 0.37% in September and are down 1.0% YoY, while used car and truck prices are down 3.75% YoY and over 10% from their peak nearly four years ago. Certainly the wave of hurricane-induced buying should support pricing at the margin as dealers clear out inventory ahead of the new model year. Stay tuned.

Two Roads Diverged in a Yellow Wood

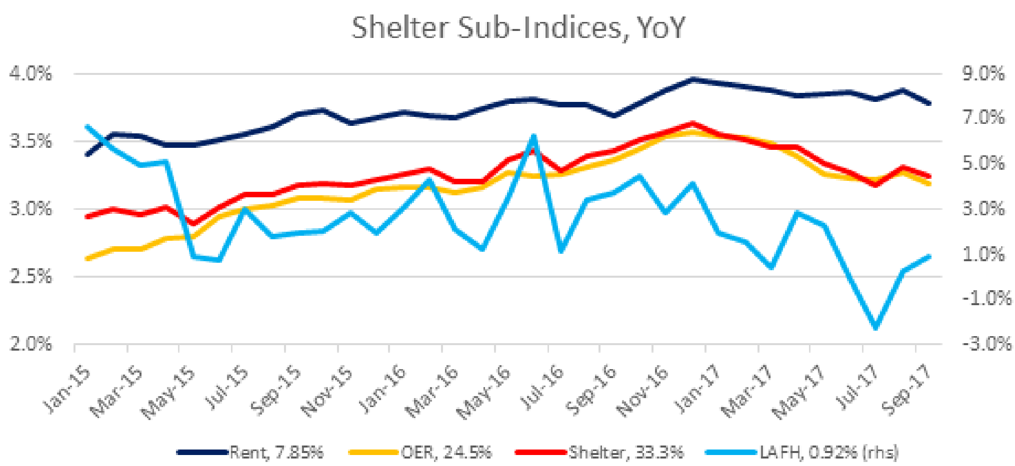
The divergence between the prices of goods and services within the core continues to widen, with Core Goods (18.8% of the index) now down 1.0% YoY, the biggest drop since 2004. Meanwhile Services (60.2% of the index) are up 2.56% YoY and have shown signs of picking up once again following the wireless plan-induced drop this spring.



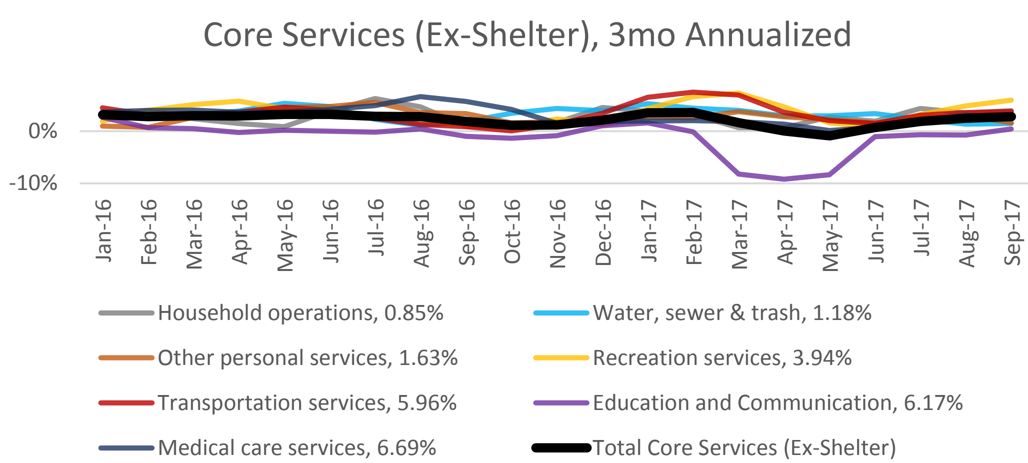
Source: The BLS and New Century Advisors

Service prices continue to be buoyed by Shelter, the 800lb gorilla in the room at 33.8% of CPI. Shelter is up 3.24% YoY and 3.5% on a 3-month annualized basis, the fastest pace since December. But caution is warranted as Rent rose a relatively modest 0.205% MoM, which annualizes to a still healthy 2.5% YoY but is the lowest monthly increase in over 3 years. That followed a 0.393% rise in August, the highest in over 9 years, so there is some month to month volatility at play. At 7.85% of CPI, Rent is less than 25% of Shelter, but it is the primary driver of Owners' Equivalent Rent, which makes up 24.5% of the Index. So as Rents go, so goes Shelter, so watch this space closely.

While Shelter presents a potential downside risk, the Ex-Shelter Core Services story is an increasingly positive one. The series is up 1.75% YoY, an increase of over 20bps from August, and up 2.74% on a 3-month annualized basis, the fast pace YTD. Within Services at least, the Fed's view that the recent weakness was transitory is proving correct.



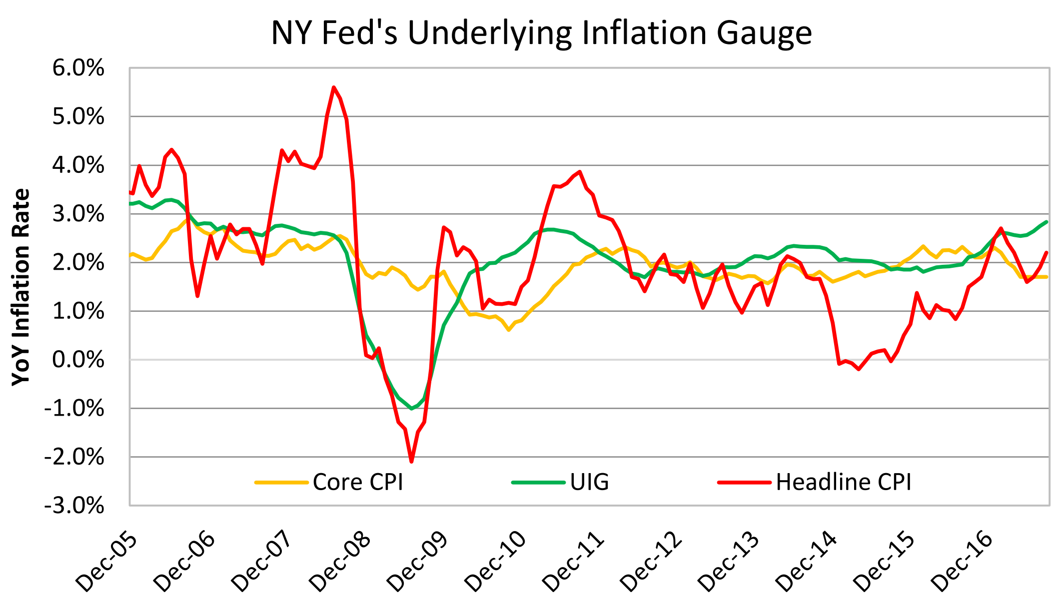
Source: The BLS and New Century Advisors



Source: The BLS and New Century Advisors

Fed Still On Track to Hike in December

Friday's CPI report did little to move expectations for the Fed, with market pricing shifting the odds for a rate hike in December only slightly, from 80% prior to the print to 78.5% as of this writing. Speaking at the G30 Banking Seminar over the weekend, Fed Chair Yellen reiterated her expectation for a rebound in inflation next year, citing, "ongoing strengthening of labor markets."[1] Moreover, the NY Fed's newest measure of trend inflation, the Underlying Inflation Gauge, or UIG, continues to move higher, hitting 2.83% in September, the highest level since the financial crisis (see below). Add in firm and rising global PPI prints, rising commodity markets, robust Purchasing Manager Indices (PMIs), and supportive base effects (Q2'17 weak prints dropping out of the YoY data), and we think the Fed has enough confidence in their inflation outlook to hike a third time in 2017.



Source: The BLS, NY Federal Reserve, and New Century Advisors

Beyond December, the direction of monetary policy remains highly uncertain because we don't know who will be leading the Fed once Yellen's term as Chair expires at the end of January. Market expectations have settled largely on two potential nominees, current Fed Governor Jerome Powell and former Fed Governor Kevin Warsh. A Powell pick would be seen as a continuation of the status quo: his generally dovish outlook aligns with Yellen's own, although he has voiced some willingness to reduce financial regulations - particularly on smaller banks - something that no doubt endears him to the President. Warsh, on the other hand, would be a disruptor: he has been outspoken against the Fed's $4.5trn balance sheet and has written extensively about the need to restructure how the Fed conducts monetary policy. While he is clearly more hawkish than Yellen, it is unclear how much more aggressive a Warsh-led Fed would be in hiking rates.

[1] Janet L. Yellen, The U.S. Economy and Monetary Policy, G-30 International Banking Seminar, Washington D.C., October 15, 2017: https://www.federalreserve.gov/newsevents/speech/yellen20171015a.htm

There is also the chance the President renames Yellen to the post, and National Economic Council director Gary Cohn and Stanford University economist John Taylor are also said to still be in the running. In short, until the President makes his announcement - expected to be sometime in November - the future path of monetary policy remains highly uncertain.

Where the Rubber Meets the Road

The TIPS market continues to trade cautiously but healthily, keeping a margin of error in breakeven pricing across the length of the curve. This is a departure from historical TIPS market trading dynamics when inflation risk premia often pushed breakevens above inflation expectations. While we don't see a catalyst for breakevens to return to those halcyon days in the near term, a return to above-trend inflation next year - possibly in Q2 thanks to supportive base-effects - could lead TIPS to once again trade with a premium. In the meantime, during this new 'show me the inflation' regime, we continue to see TIPS and breakevens as offering value in a number of capacities.

- Hedge for risk assets. One of the greatest risks we see to the lower-for-longer carry trade world in which we find ourselves is a move higher in inflation that forces the Fed to move faster and pushes global rates higher. Inflation complacency abounds.

- Duration trading vehicle. For traditional fixed income investors, TIPS can offer a more efficient way to express duration underweights in anticipation of higher rates.

- Carry trade. TIPS remain cheap vs. inflation forecasts and thus could be a good, high quality substitute vs. other high quality, low yielding sectors including Agencies, MBS and select corporate issues.

As always, feel free to contact us. We are happy to discuss these ideas, and more, in detail.

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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