NEWPERSPECTIVES

Commentary from New Century Advisors
May 2017

US Inflation: Fundamentals Call for Patience

- **Unpacking the weak March CPI print**
- **Energy risks flare up again, but food tailwinds pick up**
- **Front end BEIs continue to look fully valued and increased oil volatility warrants caution**
- **Intermediate and longer dated BEIs remain compelling**

It was the best of times; it was the *blurst* of times?!?

- Last month we discussed the market shift from blind reflation optimism to a more fundamental focus. That transition has seen TIPS positions shift from marginal players with shorter trading horizons to longer-term investors and has induced some hiccups along the way. A weak March CPI report added further volatility. But just as 1,000 monkeys tapping away on 1,000 typewriters will eventually write every great work of literature, we believe that patient inflation investors will be rewarded (and hopefully much sooner than in our analogy.) That said, you're bound to get some interesting results along the way. While patience will most likely be rewarded, it will definitely be required.

Inflation-Linked Bond Index Returns (Local Currency Returns)

	April		YTD	
	Total Return	vs. Nominal Comparators	Total Return	vs. Nominal Comparators
Barclays World GILB	1.28%	0.59%	1.85%	0.43%
United States	0.61%	-0.29%	1.98%	0.22%
United Kingdom	2.50%	2.23%	4.29%	1.86%
Germany	0.52%	0.48%	-1.15%	-0.56%
France	1.95%	0.54%	-1.26%	-0.51%
Spain	0.49%	0.36%	-0.37%	-0.03%
Denmark	0.41%	0.25%	0.38%	0.20%
Sweden	0.37%	0.24%	0.05%	0.26%
Canada	2.03%	-0.10%	0.70%	-2.37%
Japan	0.12%	-0.30%	-0.92%	-1.31%
Australia	1.16%	0.32%	2.34%	0.21%
Italy	0.42%	0.18%	-2.55%	-0.66%

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New Zealand	1.49%	0.71%	2.24%	-0.24%
Argentina	0.50%	-	8.15%	-
Brazil	-0.32%	-	6.69%	-
Chile	0.94%	-	2.83%	-
Columbia	1.28%	-	3.73%	-
Israel	0.94%	-	0.12%	-
Mexico	0.22%	-	3.59%	-
Poland	0.36%	-	2.97%	-
Turkey	1.05%	-	7.59%	-
South Korea	-0.50%	-	0.83%	-
South Africa	1.15%	-	0.46%	-
Thailand	-0.08%	-	1.91%	-

Source: Bloomberg and New Century Advisors

Revisiting US CPI

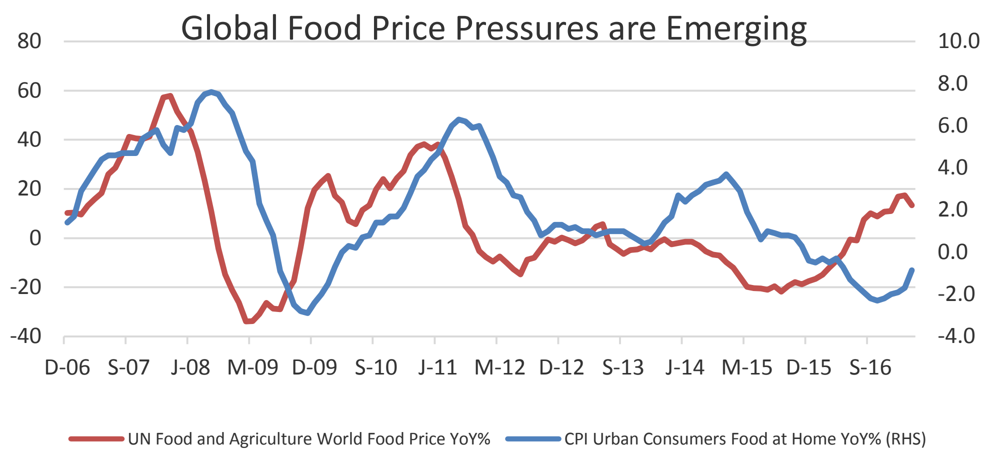
In the March CPI data, released in April, headline CPI fell 0.3% MoM, bringing the YoY print to 2.4% from a five-year high of 2.7% the prior month. The slide came from the combined effects of an unwinding of exceptionally weak base-effects in energy prices (expected) and a reversal of what had been a very strong start to the year by several components in the core (less expected but still not overly surprising.)

- Core weakness came from 'give back' by the cyclical 5 (apparel, hotels, airfares, and new and used cars contributed -0.07%; had been +0.10% combined in Jan & Feb)
- Additional core surprise from a 7% decline in wireless fees
- Though still rising 3.45% annually, shelter costs have backed off of recent highs (3.62% in Dec)
- Retail gasoline prices fell 6.2% seasonally adjusted in March. Expected to have risen ~1.2% in April
- Food prices gained 0.3% MoM in March, up 0.48% YoY. They had been -0.41% YoY in October. Recovery led by Food at Home, +0.48% MoM. Though still down 0.86% YoY, FaH had been down 2.3% YoY in October (See below for more on Food prices)

Let's take a closer look at food prices.

Let's Eat

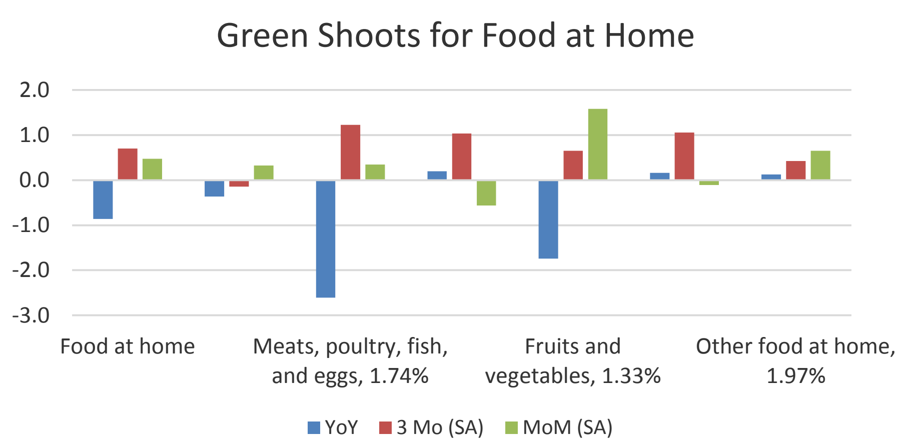
Last month we discussed how we expected to see rising global food prices lead to upward pressure on Food at Home in the U.S., which makes up 58% of consumers' total food expense and carries a 7.9% weight in CPI overall. Two trends are clear: global food prices are rising, and US food prices tend to follow global food prices, albeit with a variable lag (from 8 to 14 months). We included this chart last month, but it's worth revisiting as the convergence since then is clear.



Source: OECD, Bloomberg and New Century Advisors

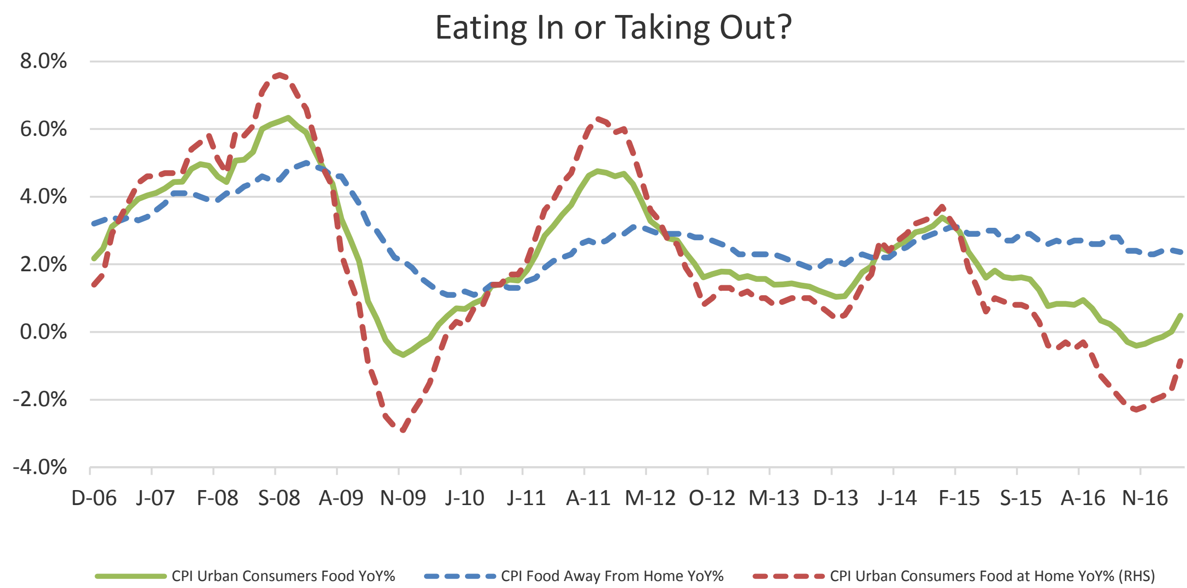
Global food prices rose 13.4% YoY in March. While that was down from its recent peak, we expect the broader upward trend in global food prices to continue. While factors such as weather, disease, and other catastrophes are hard to predict, food prices are under consistent upward pressure from bio-fuel subsidies (which reduce the supply of corn and other grains available for food) and increased meat consumption (which is correlated with growing global affluence.)

Meanwhile, within the U.S., all six subcategories of Food at Home prices are showing meaningful signs of having bounced off of last year's lows, with March adding to the clear upward trend in Q1.



Source: BLS and New Century Advisors

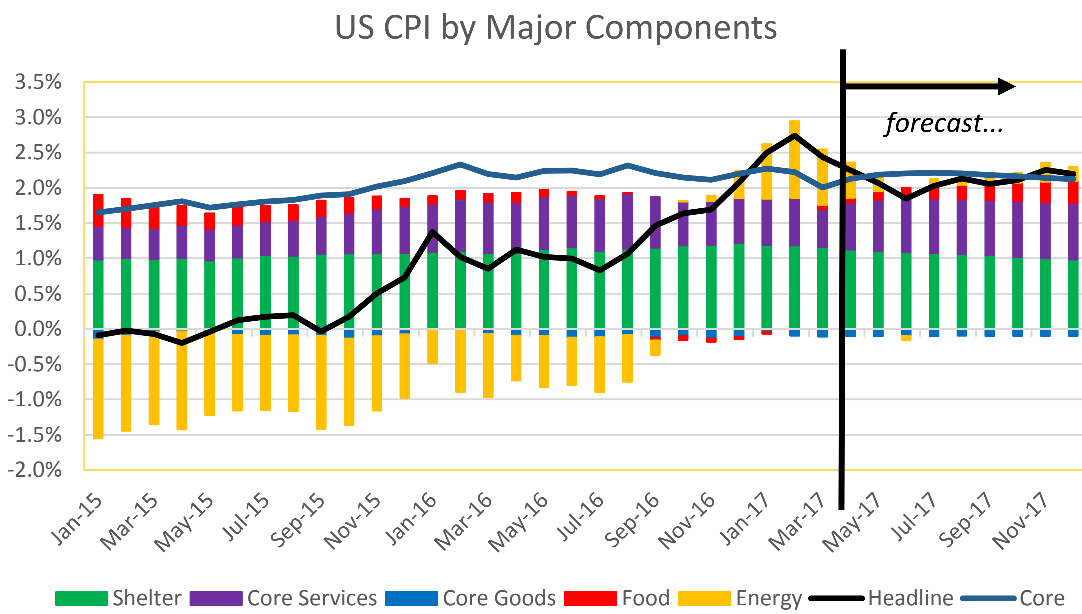
Food at Home (7.9% of CPI) combines with Food Away From Home (5.8%) to make up the US CPI Food Index (13.7%). Food at Home is the more volatile of the two components and carries a slightly higher weight in the index. It remains low but is rising as we have seen. Food Away From Home prices are rising at a more stable – but higher – rate given the other factors (such as labor) that drive this category. We anticipate the two components combining to bring the overall CPI Food Index back above 2.0% YoY by late 2017.



Source: BLS and New Century Advisors

Updating our CPI Forecast

The recent deceleration in rents has us looking for the shelter component of CPI to soften further from its current 3.45% YoY growth rate back toward a still robust 3% over the course of this year. Meanwhile, wage pressure should continue to put upward pressure on core services, which dipped from 2.5% in February to just over 2.0% in March thanks in large part to a drop in wireless plans. We look for them to revert to trend in the April report and continue to gravitate toward 3% over the remainder of the year. Adding in a slight headwind from core goods (-0.50% YoY), energy prices stabilizing near current levels, and our rising food prices gives us the following outlook for CPI over the remainder of 2017, with the YoY Headline and Core prints converging just above 2% in H2 2017.



Source: BLS and New Century Advisors

In Closing

Overall we believe that the fundamental backdrop remains positive for the TIPS asset class. While short-dated issues appear close to fully-priced and continue to face near-term risks from rising energy volatility, valuations in the intermediate and longer-term issues remain compelling. As has been the case, technicals are the wild card. Inflows into the asset class remain light. Much of the post-election TIPS breakeven bounce has been unwound. With potential upside risks from policy initiatives continuing to be pushed further into the future, the patience of those that remain in the trade will continue to drive near-term performance.

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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