GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

Should Inflationary Expectations Be So Sticky?

Capital markets have brought lots of surprises this year. Two developments especially – recovering commodity markets and a falling US dollar – have important implications for future consumer prices.

Capital market participants do not seem overly sensitive to these two developments in terms of expectations of future inflation. Commodity prices are for the most part an "input" into the type of goods and services consumed. The US dollar on the other hand acts as a translator of value between goods produced abroad and domestic consumers.

Recent consumer price changes have been muted in the last few years. Monetary authorities in the US as well as abroad seem particularly troubled by the prospect of deflation and have in some cases even resorted to the use of negative policy rates to revive growth.

The April 14 BLS Report on the CPI-U estimates year-over-year inflation at just 0.9%. This number is welcome news after near zero inflation for most of 2015, but still lags the historical norm of 3% annual inflation by a wide margin.

CATEGORY	WGT	PRICE CHANGE
FOOD	14.0%	0.8%
ENERGY	6.4%	-12.6%
COMMODITIES	19.7%	-0.4%
SERVICES	59.8%	3.0%
TOTAL	100.0%	0.9%

A quick glance at the latest report provides interesting clues. Two of the four main categories of consumption categories - ***Food, Energy, Commodities Less Food & Energy, and Services*** – exhibit price depreciation over the last year.

The biggest deflationary force has been the ***Energy*** category with a 12.6% price drop. The other deflationary category is ***Commodities Less Food & Energy*** with a -0.4% year-over-year price change.

What's in the major categories of consumption?

In the ***Energy*** category we find items such as Motor Fuel and Electricity. In the ***Commodities Less Food & Energy*** classification we find Vehicles (5.9% weight) and Apparel (3.1% weight). These two top-line aggregate consumption categories combined comprise over 26% of the total consumption basket.

The largest consumption bucket in the CPI-U index corresponds to ***Services*** with a weight close to 60%. The three largest sub-categories are Shelter/Housing, Medical Services and Transportation at 33.3, 6.6 and 5.9% respectively. These expenditure categories within Services possess sticky inflationary pricing. The latest year-over-year increases came in at 3%.

Lastly, the ***Food*** category includes both Food at Home (8.2% weight) and Food away from Home (5.7% weight). The Food at Home sub-category has shown a 0.5% price decrease in the last year while food consumed away from home has gone up a robust 2.7%.

The US consumer has clearly been the beneficiary of deflationary pressures emanating from external forces such as lower raw material prices (energy and agricultural goods) as well as from lower import prices (affecting Apparel and Autos) due to the strength of the US dollar.

The consumption of ***Services***, the most important component of the CPI-U, is more heavily influenced by domestic forces such as demographics and employment. Housing expenditures are growing due to both rising rental rates and home price appreciation. Medical care service costs keep going up at above average rates partially as a function of the aging of the population in the US. Items in the ***Service*** consumption bucket have historically tended to exhibit an upward price drift over time.

The ***Food*** and ***Energy*** categories are often excluded by economists from their assessments of inflation due to their greater month to month price variability especially in relation to the Service category but many financial contracts including cost of living adjustments to Social Security recipients are tied to the inflation measures including all four major categories of consumption. In addition payments to holders of TIPS are also based on CPI inflation calculations.

Federal Reserve members seem concerned with the possibility of deflation in the US, but what about market participants?

We evaluate two measures – the breakeven rates from TIP prices measuring the expected inflation over the next 5 years (orange line) and the so called 5-over-5 rates measuring inflation expectations five years from now over the next five years (green line). To provide context we also illustrate the rolling year-over-year CPI-U inflation.

Market participant inflationary expectations are not as sanguine as those sometimes attributed to Federal Reserve members. As of the end of April the 5 year breakeven rate stood at 1.61% while 5 Year, 5 Year Forward rate stood at 1.83%. Except for a slight recent uptick expectations have been trending down for a couple of years now and remain well south of the 2% inflation number that central bankers use as a mental target.

Capital market participants are expecting an uptick to inflation, but in light of this year's commodity price increases and the depreciation of the US dollar do these expectations need to be revised? Yes, the market implied inflationary expectations seem low in relation to the resurgence in commodity prices and the depreciation of the US dollar.

Our rationale is as follows. Let's drill through each of the major consumption categories.

The ***Food*** category is up 0.8% from a year ago. In 2015 only one food-related commodity of those we track saw a price increase. That commodity was Cocoa, not exactly a staple in most people's diet. Coffee was down 31%, wheat -22%, corn -19% and soybeans -15%. What about meat for the carnivores? Hogs down 26%, live cattle down 14%.

From a food cost perspective the raw material picture could not have been better last year. But what about this year? Four months into 2016 things are changing. The Bloomberg Agricultural Index is up already 7.8%. Commodities such as corn and soybean are up 9 and 17% respectively. Live cattle prices remain in the doldrums (-9%) but in general prices across the agricultural complex are rising this year. Once these raw material prices increases are transmitted to finished Food costs it is highly likely that US consumers will see year-over-year price increases significantly higher than the 0.8% seen in the last 12 months. Maybe a good thing as we all need to eat less but most likely still a hit to the pocketbook.

What about the ***Energy*** category of the CPI-U? This category accounts for a 6.3% weight in the index and it does not take a rocket scientist to figure out that this is the category most likely to see the largest forward year-over-year increases. Last year oil prices were down from 30 to 35%. Natural gas prices were down 24%. This year natural gas is down a further 16%, but oil prices have shot up over 25% from the beginning of this year.

Energy is clearly a volatile category, but expected supply cutbacks are likely to further boost oil prices. Our working assumption is that even natural gas prices will firm up later on this year.

In any case, we do not expect to see a repeat of the deflationary pressures of the last 12 months. More likely we will see by the end of this year low single digit price increases in the Energy category.

Moving on to the ***Commodities less food and energy*** category this is where we see the impact of a falling US dollar. While import prices of such goods as Apparel and Vehicles will not immediately reflect currency movements over a longer time frame we should expect higher prices to US consumers. This year we have seen the Yen appreciate 12% versus the USD while the Euro is up 5%.

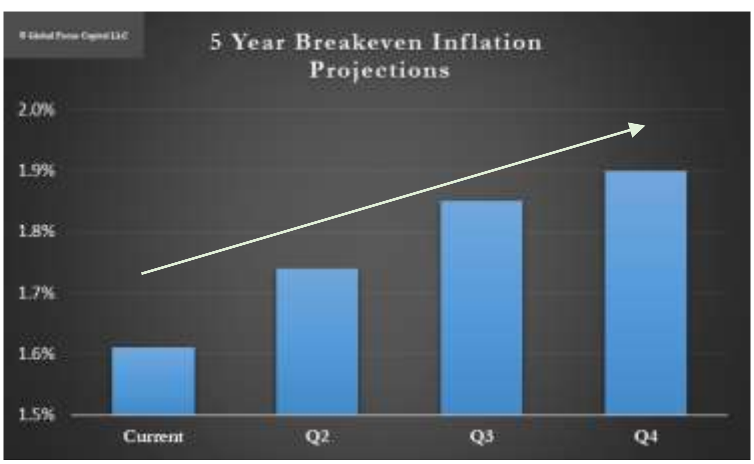
Even among emerging market currencies we have seen large re-valuations versus the USD. Thus far in 2016 we have seen a 4% drop in the trade-weighted US dollar index. In contrast in 2015 the trade weighted US dollar rose 12%. Unless currency markets do a U-Turn during the remainder of 2016 we would expect import prices to slowly trend up. The deflationary effects of a strong USD might be a thing of the past.

The ***Services*** category, the largest weight of the CPI-U index at almost 60% typically experiences steady upward price pressures. Except for the Financial Crisis of 2008-2009, annual rates of cost increases have fallen between 3 and 4%. The latest year-over-year increase clocked in at the lower end of this range at a moderate 3%. In the future we would expect cost increases in the Services category to fall within the typical 3 to 4% range.

Price changes in the ***Services*** category seem more "sticky" compared to the other three major consumption buckets. The housing market has been on the upswing in most areas of the US and both owner occupied as well as rental rates have been trending higher with barely a hiccup. Even a retrenchment of housing values due to potentially higher mortgage rates later on this year might not translate immediately into lower costs for shelter. Medical care services at a 6.6% CPI-U weight is probably the sub-category with the stickiest annual price increases. In the last year Physicians services are up 2.5% while Hospital costs have trended up 4.5%.

Where do we see inflationary expectations heading to?

Our research based on our econometric model of 5 year inflationary expectations calls for steady but moderate upward revisions. The latest market-based estimate of 1.61% is expected according to our model to rise to 1.7% by the end of Q2 and to 1.9% by the end of the year.



We are not expecting a huge bump up yet in inflationary expectations in large part due to the fact that rising commodity prices and a depreciating USD have only been in place for a short period of time.

Many strategists are still skeptical that these two trends have legs. Our view is that even if there is no further change for the remainder of the year inflationary expectations have been too low and will slowly drift up.

What are the implications for investors of slowly rising inflationary expectations? For now the more direct impact for investors of rising commodity prices and a falling US dollar is being felt through the rise of previously unloved sectors such as Energy and Materials as well as the revival of Emerging Market Equities.

The transmission mechanism from higher commodity prices and changes in the value of the US dollar to actual inflation pressures is not immediate of for that manner always straightforward as many other forces such as demographics and the overall health of the global economy come to bear.

Rising inflationary expectations would according to our risk management methodology benefit holders of risky assets such as equities, commodities and real estate. Safer assets such as bonds would suffer as we would expect higher inflationary expectations to translate to higher nominal interest rates. The effect would obviously be greater the longer the duration of the assets.

Barring a sudden jump in inflationary expectations (which we do not anticipate at the moment) our best advice to investors is to properly align their portfolio strategy to a world of lower expected capital market returns and higher forward volatility.

Our estimate that inflationary expectations will slowly drift up this year will likely provide some wiggle room to the Federal Reserve to hike short-term rates in 2016. The fear of deflation seems out of place given rising commodity prices, a falling US dollar and a still growing global economy.

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