Investment Insights
Inflation Checkpoint

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Highlights

- In June, the Consumer Price Index (CPI) increased 1.6% year over year, representing another month of decelerating inflation. Core prices, excluding the volatile components of food and energy, were unchanged from the prior month at 1.7% year-over-year. Bessemer's index increased 1.8% year-over-year.
- Despite post-election expectations for fiscal stimulus to drive inflation higher, headline inflation has declined this year as a result of several factors.
- We highlight the importance of inflation trends in energy, health care, education, and housing in determining the inflation experience of Bessemer's clients going forward.

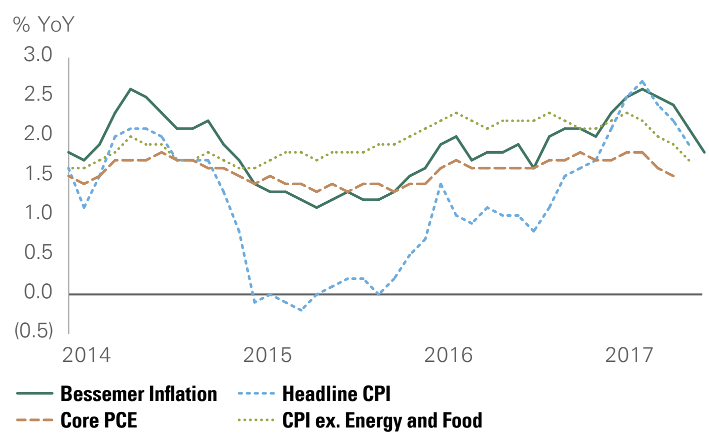
Inflation About-Face

In our January *Inflation Checkpoint*, we took note of a sharp re-rating of inflation expectations immediately following the U.S. presidential election — the result of high expectations for the Trump administration's fiscal stimulus agenda. At the time, long-dated bond yields and the U.S. dollar followed inflation higher.

However, midway through the first quarter, a number of inflation measures began to roll over (Exhibit 1), due to the following:

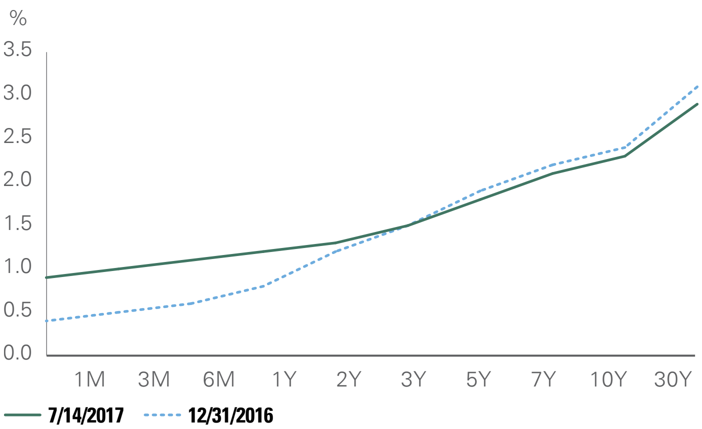
- **Pullback in energy.** The reversal in the CPI coincided with global oil prices entering bear market territory as OPEC and non-OPEC producers continued to pump and the reduction in global inventories stagnated. Energy prices, for example, declined 1.6% month-to-month in June (but increased modestly on a year-over-year basis).
- **Deflation in specific categories.** In total, just over 25% of the CPI experienced flat or deflationary pricing from a year ago as of June. Some of these categories are likely facing transitory pricing pressures, such as communication (from one-time quality adjustments as carriers switch to offering unlimited wireless data plans). Other categories, like used cars, may be facing more persistent pricing pressure, as the leasing cycle has contributed to a build-up of used-car inventory that could take some time to reduce. Airlines also saw falling prices, likely related to pass-through from lower oil prices and price competition.

Exhibit 1: Various Measures of Inflation Showing Softening



As of June 30, 2017, except Core PCE as of May 31, 2017.
Source: Bloomberg, Bureau of Labor Statistics, Federal Reserve Bank of Atlanta

Exhibit 2: U.S. Treasury Yield Curve Has Flattened Modestly This Year



As of July 14, 2017.
Source: Bloomberg

- **Broad-based declines.** Aside from the specific elements mentioned above, there has been perhaps less dramatic but more pervasive weakness across inflation categories. Of particular concern is the slowing in services inflation, which tends to be more symptomatic of underlying economic growth trends.

Despite lower-than-expected inflation, the Federal Reserve chose to continue along its path of gradual monetary policy tightening by raising rates in both March and June. While this resulted in higher rates at the front end of the Treasury curve, yields on longer maturities fell and the curve flattened as investors began to price in the possibility that slower economic growth and a more hawkish Fed would keep inflation from accelerating (Exhibit 2). Mortgage rates have fallen back below 4% this year, and the trade-weighted dollar has weakened almost 5% year-to-date.

Inflation Triggers Going Forward

Bessemer's inflation index was not immune to the deceleration, though the effect was more muted, in part due to the lower weight to energy in Bessemer's index. Going forward, we are focused on four key determinants of the inflation experienced by our clients:

1. Energy — Though difficult to predict, our base case is for oil prices to remain range-bound in the medium term. Continued access to capital markets and increased efficiencies for U.S. shale producers, along with a rebound in output from Nigeria and Libya (the two OPEC members exempt from the November and May agreement to cut production), will likely keep a cap on oil prices. Meanwhile, the global demand picture remains intact, and it is unlikely to see oil crater to levels seen at the beginning of 2016. As long as WTI remains in the $45–$55 per barrel range, energy is unlikely to have a material impact on the CPI in either direction. Energy is given a 10% weight in the CPI but only about half that in Bessemer's inflation index.

2. Healthcare — Healthcare pricing has been the subject of much scrutiny over the past few decades, and for good reason. Medical care inflation has consistently increased at a faster pace than overall headline inflation (Exhibit 3), with hospital and related services generating the most significant upward pricing pressure.

   While medical inflation has tempered in recent years, it remains nearly double that of headline inflation. Over the long term, increased public scrutiny on pricing practices (particularly for prescription drugs) and technological improvements could lower inflation; however, longer-term demographic pressures and a slowdown in cost-sharing (i.e., adoption of higher-deductible plans) for employer insurance plans are likely to lead to prices for medical care increasing faster than both overall inflation and the economy. Bessemer's index gives a higher weight to medical care than does the headline CPI, so inflating medical prices lifts our index more than the CPI.

Exhibit 3: Headline CPI and Components of Medical Inflation

	Headline CPI	Prescription Drugs	Physician Services	Hospital & Related Services
1988-2017	2.5%	4.3%	3.5%	6.3%
1990s	2.9%	5.0%	4.5%	6.2%
2000s	2.6%	3.6%	3.3%	6.7%
2010s	1.6%	3.4%	2.0%	4.8%

As of June 30, 2017.
Source: Bloomberg, Bureau of Labor Statistics

3. Tuition — Average tuition (plus room and board) at a four-year private nonprofit institution cost just under $10,000 per year in 1986; today that figure has more than tripled to $45,370[1] — a rate of inflation of 5.4% per year,[2] compared to headline CPI inflation of 2.6% annualized. Like medical care, inflation for tuition (including college, private school, and child care) has consistently been higher than overall inflation, a factor contributing to Bessemer's index having a historical average higher than the CPI. However, the gap between tuition and overall inflation has narrowed in recent years. In fact, 2017 saw the first time since the early 1980s that the rate of inflation for tuition and childcare fell below headline inflation. Long term, growth in the cost of college could be kept in check by a deceleration in demand growth (as demographics suggest the jump in college enrollment seen between 1995 and 2015 is unlikely to be repeated in the next 20 years), internet/technology, and potentially scrutiny on the federal budget.

4. Housing — Housing is an important category because it constitutes over 40% of the CPI basket; Bessemer's index gives it a much lower weight, in part because of how we think about housing *expenses* versus *investments*. Regardless, it remains the largest component of either index and contributed a meaningful inflationary impulse over the past year, despite averaging 3.0% over this recent period and just 1.4% above the headline CPI. Going forward, we expect the CPI to reflect more stable home prices, consistent with other home price indicators and where we are in the economic cycle.

Inflation is difficult to predict, and there are several factors that could cause swings in either direction. Further complicating the picture is the fact that inflation and wage growth lag economic activity. Acknowledging these risks, our base case given the four categories above is for a stable and slightly firmer inflation outlook over the next 12 months, one that will give the Federal Reserve the flexibility to continue its gradual reduction of accommodative monetary policy.

1 According to the College Board's Annual Survey of Colleges

2 According to the Bureau of Labor Statistics, the Tuition, Other School Fees, & Childcare category has inflated at a rate of 5.6% per year over the same time period.

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