Investment Insights

Inflation Checkpoint

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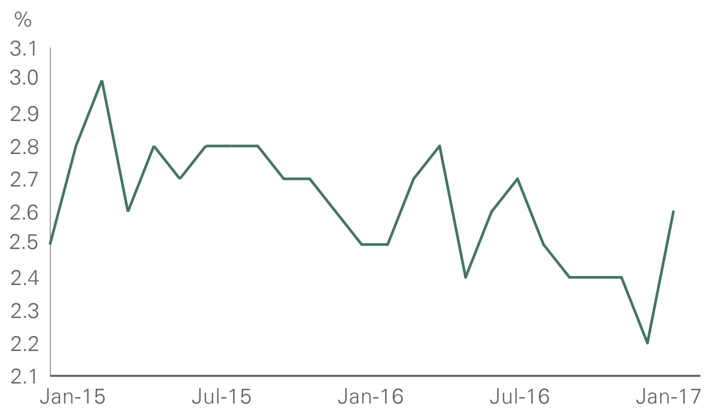
Highlights

- The December U.S. Consumer Price Index (CPI) increased 2.1% year over year, with many of the underlying trends from recent months remaining in place. Core prices (excluding food and energy) rose 2.2%. Bessemer's index increased 2.3% year over year, the highest rate since June 2014.
- Policy changes under a Trump administration are likely to continue to have important consequences on expected and realized inflation.
- Lower tax rates will likely lift Bessemer's overall inflation index through increased demand, while tariffs could have a greater inflationary impact on the prices of specific goods, including automobiles, technology, and apparel.

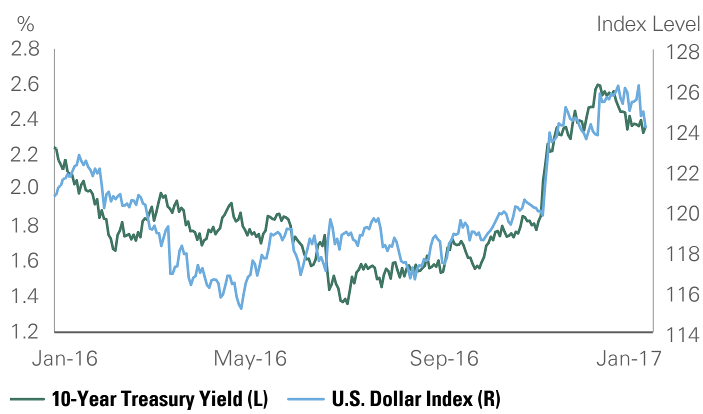
Exhibit 1: Inflation Expectations, Yields, and the Dollar Post-Election

Key Takeaway: Trump's election was followed by a sharp increase in inflation expectations, interest rates, and the U.S. dollar.

a. University of Michigan Expectations (Next 12 Months)



b. Treasury Yield and U.S. Dollar



As of January 18, 2017.

Source: Bloomberg, J.P. Morgan, University of Michigan

The Trump Effect

One of the most dramatic market rotations since the U.S. presidential election was the increase in inflation expectations. The University of Michigan's survey of inflation expectations climbed to 2.6% in January (Exhibit 1a), with some market-based measures of inflation expectations increasing even more. This has coincided with a sharp rise in Treasury bond yields and a stronger U.S. dollar (Exhibit 1b).

Consumer expectations of higher inflation do not necessarily mean realized inflation will follow, but expectations are an important part of the function. Why the sudden shift in expectations, and what does it mean for the inflation felt by our clients? While no one (with the exception of deflation-fearing central bankers) is usually pleased to see prices rise for the goods and services they purchase, we believe the source of the inflation is important in determining whether it is "bad" or "good" inflation.

Exogenous Shocks

One source of "bad inflation" is an exogenous shock that is not caused or accompanied by improving growth. Examples would be the tariffs proposed by President-elect Trump during his campaign and the border-adjusted tax system proposed by House Republicans, the latter taxing imports but not exports.

All else equal (excluding currency or other knock-on effects), tariffs would lead to higher prices for many goods without a commensurate increase in wages, thereby lowering consumers' real purchasing power.

The two countries receiving the bulk of Trump's attention are China and Mexico, which account for 16% and 14% of U.S. total trade, respectively. Goods imported from these countries tend to be concentrated in the technology, retail, and automobile industries (Exhibit 2). Companies can either eat the cost of higher tariffs through lower margins or pass them on to consumers through higher prices; in our view, a combination of these would be most likely. Tariffs would likely result in a one-time price increase, and while a portion of the effect could be offset by U.S. companies substituting some of the goods facing import tariffs with similar or similarly priced goods produced by another trade partner, tariffs would still likely have a damaging effect on consumer purchasing power.

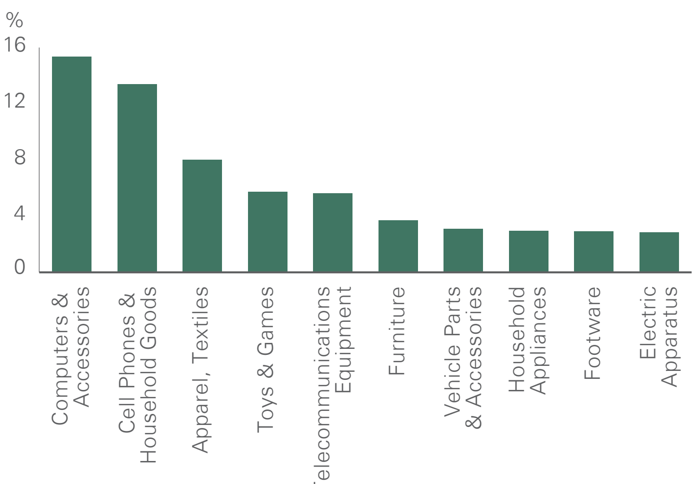
Growth-Driven Inflation

In our view, some potential inflation related to policies of the Trump administration could come from economic growth and an increase in after-tax income. One of the priorities of the new administration is tax reform, both for individuals and corporations. While there are still more questions than answers regarding what tax reform could look like, we do believe it could include a reduction in individual tax rates for all income brackets. The Tax Policy Center analyzed the House Republicans' tax reform "blueprint" and determined that it would result in an average increase in after-tax income in the first year of 2.5% for all tax brackets. The top 20% would receive a 4.6% increase, so we would expect tax cuts and increased demand to lead to higher inflation for Bessemer's index.

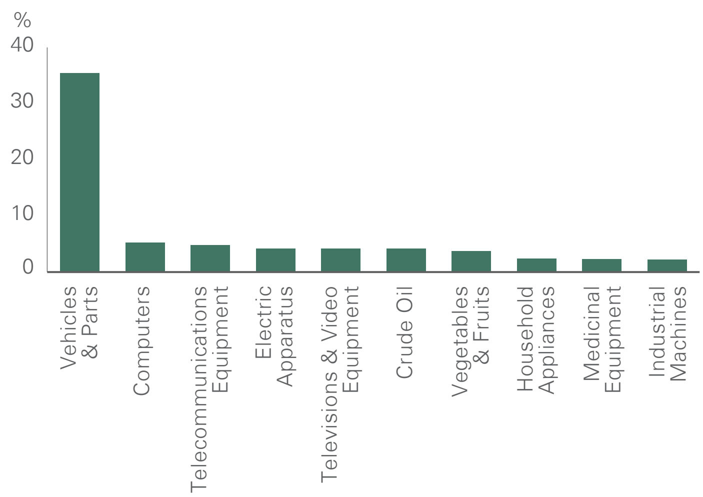
Exhibit 2: U.S. Imports from China and Mexico, by End-Use Category (as % Total Imports from Each Country)

Key Takeaway: Technology, automobile, and retail companies would be most affected by tariffs on imported goods from China or Mexico.

U.S. Imports from China



U.S. Imports from Mexico



As of November 30, 2016.

Source: U.S. Census Bureau

Looking Ahead

In the short term, we expect current inflation trends to persist and gradually lift overall prices. Rising rental, oil, and fuel prices tend to increase Bessemer's index (Exhibit 3) but less than the CPI. Longer term, should Trump proceed with tariffs or a border-adjusted tax system, we would expect higher automobile and apparel prices to modestly increase Bessemer's index relative to the CPI, while higher prices for computers and technology would have a greater inflationary impact on the CPI at the margin. At Bessemer we understand the importance of real, inflation-adjusted purchasing power and portfolio returns, and we will be monitoring policy shifts carefully to adjust portfolios and our investment-planning strategies accordingly.

Exhibit 3: Bessemer's Inflation Index

Key Takeaway: The new administration's policies could cause Bessemer's inflation index to increase slightly over the medium term.

As of December 31, 2016.

Source: Bessemer Trust, Bureau of Labor Statistics