

## Observations and Perspectives:



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*“There are more and more indications of an upward trend in inflation”*

### Do You Smell That?

What’s that smell? No political jokes. No celebrity ones either. That smell you smell is the faint whiff of inflation seeping into the economy. It’s also one of the big reasons for the cruel October bond selloff.

Let’s be clear from the start: we are not predicting the hurtling inflation of the 1970s. In fact, despite years of extraordinary efforts by central bankers to push growth and inflation higher, those levels have stayed stubbornly low. However, there are more and more indications of an upward trend in inflation, a risk that markets are not yet fully pricing.

Here are just a few signs:

- Commodities: everything from coal to oil has been on the upswing. As of October 31, the Bloomberg commodity index has bounced up 7.6% year to date and is up north of 16% since January lows.<sup>1</sup> Oil prices are up 26% since the start of the year.<sup>2</sup>
- Households are experiencing at least mid-single digit rent increases across the country, with some cities clocking double-digit increases.<sup>3</sup>
- Education expenses have skyrocketed. The cost of a 4-year public in-state education has almost doubled since 2000. A private 4-year degree is 125% more expensive.<sup>4</sup>
- Wage increases have been accelerating with average annual gains increasing consistently for more than 18 months.<sup>5</sup>

All these are backward looking statistics, though. What we find even more convincing is the forward-looking inflation outlook as measured by the Breakeven Inflation (BEI) rate. BEI is the difference between yields on 10-year notes and similar maturity Treasury Inflation Protected Securities (TIPS). It marks investor future expectations for average annual consumer-price gains.

BEI hit a low of 1.19% on February 11 this year and has charged all the way up to 1.72% by the last day of October 2016. This translates in an increase in inflation expectations going forward of over 50 basis points, a stealth bull market for inflation.

While inflation is challenging for a number of investment asset classes, there are others that benefit. Notably, TIPS can outperform relative to Treasuries.

Infrastructure-related assets have, historically, also provided inflation-hedging. Floating rate loans, as the name suggests, float their coupons with rising interest rates which may also offer a measure of inflation protection. These are all asset classes that we are buying, or warming up to, as we continue to sniff out signs of inflation.

- 1 Bloomberg
- 2 Bloomberg
- 3 Apartment Market Report, September 2016. RentCafe with data provided by YARDI Matrix.
- 4 College Board: Tuition and Fees and Room and Board over Time
- 5 U.S. Average Hourly Earnings: Production and Non-supervisory Employees. Bureau of Labor Statistics. BCA Analytics.

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