# "DEFLATE GATE"

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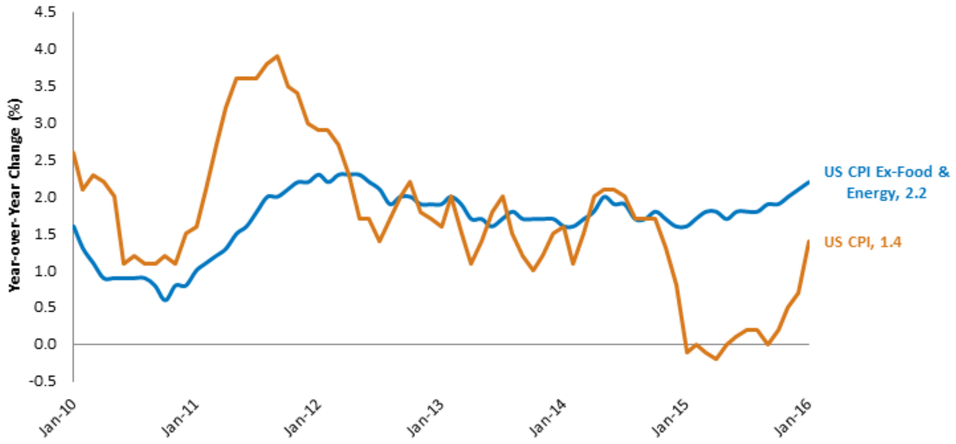
One of the primary concerns during the first six weeks of the year was that negative developments abroad would make their way onto our shores and have an adverse effect on the U.S. economy. With that in mind, incoming economic data was being viewed through a somewhat skewed prism and accordingly reduced expectations. In other words, the bar had been lowered, and Treasury yields certainly benefitted as a result, with future Federal Reserve (Fed) rate hikes being called into question. With the release of the most recent employment report, investors are now beginning to receive economic data for the first two months of 2016. Given the lowered expectations, the overall tenor of the numbers can probably be characterized as better than anticipated a month or so ago, when the R-word (recession) was beginning to creep back into the markets' conversation. The jobs report has definitely put investors' worst fears at ease. With Jan/Feb now in the books, the average monthly job gain has been pegged at +207,000, or only a bit below the 2015 tally of +229,000, while the civilian unemployment rate continues to reside at 4.9%. A figure that was receiving a lot of attention in the last year, the labor force participation rate, has been on a rising trajectory, coming in at 62.9%, up from a nearly 40-year low of 62.4% six months ago. On the disappointing side of the ledger, wages continue to be lackluster as the annualized gain in average hourly earnings dropped 0.3 percentage points in February, to +2.2%. **U.S. Consumer Price Index (CPI) vs. U.S. CPI ex-Food & Energy Year-over-Year Change from 1/31/2010 to 1/31/2016**




Source: Bloomberg, as of 1/31/2016. Past performance is not indicative of future results. You cannot invest directly in an index.

Employment is only one part of the Fed's dual mandate, the other being inflation. It is interesting to note that that side of the equation has not really received all that much attention, even though the trend has been on the upswing in the last year. As the reader will recall, deflation fears were prevalent a year or so ago, as once again concerns mounted that the U.S. could 'import' such forces from other areas of the globe. In fact, year-over-year CPI actually fell to -0.2% in April of 2015. Since then, this measure has risen to +1.4% as of January, the latest month available. Rightly or wrongly, the Fed, and by extension Treasuries, tend to be more fixated on the core measure, or CPI-ex food & energy. Similar to the overall inflation reading, the core series has also been on the upswing, with the year-over-year rate registering in at +2.2% to begin the year, the highest reading in more than 3 ½ years. Within the core CPI, all of the increase has been in the services sector (+3.0%), as the goods component was actually in negative territory (-0.1%), no surprise given the energy aspect. Leading the way in core services has been medical care (+3.3%) and shelter (+3.2%). **Conclusion** CPI is more akin to looking in the rearview mirror, so what does the future hold? Our base case does not see renewed inflation pressures of consequence, nor do they seem poised to make a more sustained comeback in the fixed income investment landscape. Pass-through effects from U.S. dollar strength, lower commodity prices, and global growth weakness have yet to be fully accounted for, while on the opposite end of the spectrum, deflation does not seem to be poised to rear its head either. ***Unless otherwise noted, data source is Bloomberg, as of 3/4/2016.***

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## DEFINITIONS

**Treasury yield** : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

**Rate Hike** : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

**Inflation** : Characterized by rising price levels.

**Deflation** : The opposite of inflation, characterized by falling price levels.

**Treasury** : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.