MAKENA STRATEGY INSIGHTS NOTE

January 2017

Inflation: Reasonably Strong Fundamentals + Trump = Higher Future Inflation in the US

Over the last 12 to 18 months, we have argued that low headline inflation metrics were improperly capturing the underlying resilience in the US economy. This has largely been driven by the fact that the one third of the CPI that is heavily influenced by imported goods has been experiencing high single digit deflation, thereby bringing down headline CPI, and masking the fact that domestic wages have been experiencing reasonably strong growth for several quarters. This is why when one focuses on core inflation metrics the figures (as we show below) seem well within normal ranges, with the Core PCE in particular right at its long-term average and the Core CPI breaking above 2%.

The question therefore becomes when will headline numbers reflect higher inflation. The forces responsible for the deflationary influences on CPI are driven by (1) overcapacity in Asian manufacturing and (2) the strengthening of the US dollar. After a very strong rally of the US dollar over the past several years, the dollar seems to now be closer to fair value and appreciation expectations going forward imply a more modest strengthening of the dollar. In other words, it is reasonable to expect that the deflationary forces emanating from Asia should abate somewhat, implying a strengthening headline CPI. Furthermore, wages continue to accelerate, reflecting a healthy domestic services sector, also implying a strengthening headline CPI.

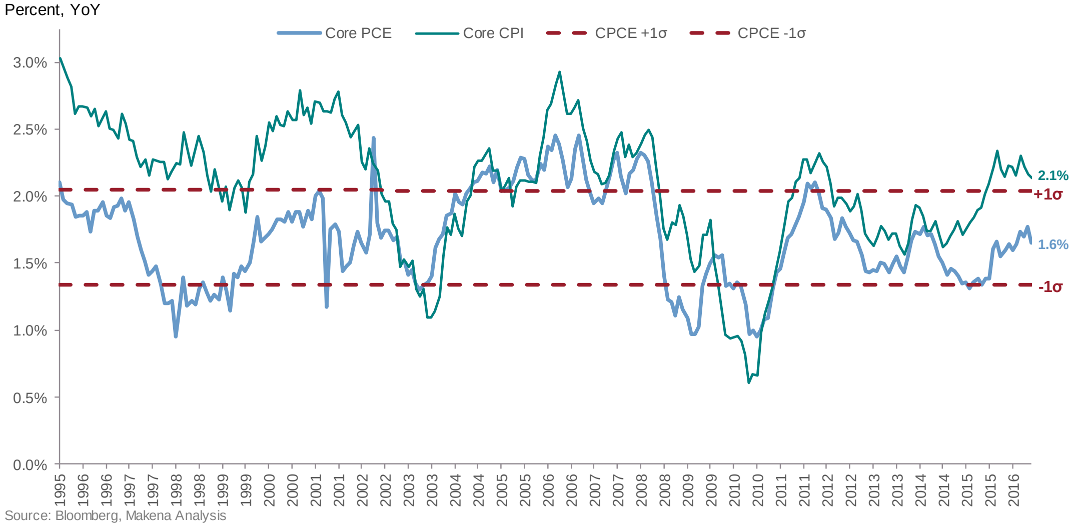
The Trump election has served to strengthen the case for growing inflationary force. On the demand side, increased government expenditure and increased personal consumption due to tax cuts, and on the supply side, potential barriers to trade thereby increasing the cost of imports and the price level of those very components that were responsible for deflationary forces in the CPI up until now.

Market expectations for fed rate hikes, long having been too low, currently reflect more appropriately the forward-looking inflation outlook. It is important to distinguish between real rates and nominal rates in a rising rate environment. The current rate hike expectations reflect heightened inflation expectations, not heightened real rate expectations. This makes sense as the world continues to be awash in liquidity and therefore there is little reason to believe that real rates should rise. In an environment where rates are driven by inflation expectations, real assets should continue to perform well as inflation is typically embedded into the pricing of those assets.

1) Setting the scene, what inflation do we have right now?
   a. Core PCE is right in the middle of its long-term range, and Core CPI (a less dynamic measure) is above the 2% target. This has been the case for quite some time.

Core US Inflation Indices

Percent, YoY

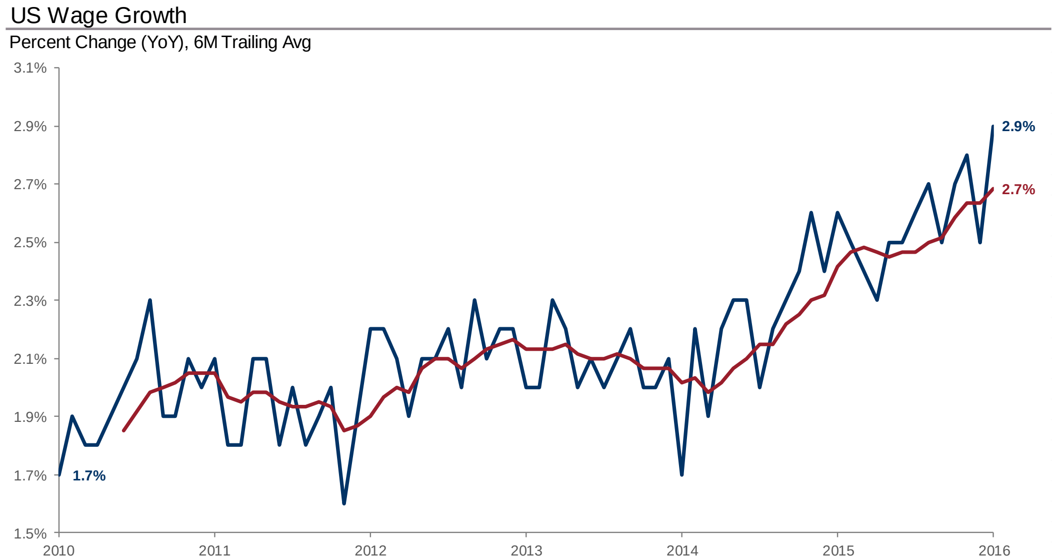


Source: Bloomberg, Makena Analysis

2) Tightening labor market
   a. Cost of labor: The US has added, on average, ~200k jobs per month over the last five years. In retrospect it seems fairly clear that a fair amount of the job growth was absorbing people who were technically outside the workforce having been unemployed for quite a while, or were working part-time when in fact they wanted a full-time job. It seems that dynamic is

fading and as a result, wages are accelerating. From this point forward, we would expect a more normal supply-demand relationship, where a shrinking labor supply will drive wage growth.

b. Additionally, rhetoric from President-Elect Trump indicates an appetite to reduce foreign labor in the US labor market, which would exacerbate the wage and labor market pressure.



Source: Bloomberg, Makena Analysis

3) Substantial fiscal policy expectations

a. **Personal consumption:** Treasury Sec. Mnuchin has indicated that tax cuts will likely be aimed at supporting the middle and lower income populations, groups that have a higher propensity to consume, which should in turn support demand and drive inflation.

b. **Corporate investment:** The impact from a revised corporate tax policy is less clear; please see the extended discussion in the Q3 newsletter.

c. **Government consumption:** demand growth from the government will likely come in two forms:

    i. Defense: spending in this category is easier to effectuate both tangibly (we know we need new planes, etc.) and legally and, generally, has a >1 fiscal multiplier

    ii. Infrastructure: this category garner's much media attention because of its implications for job growth; however, there are meaningful hurdles to achieving economically net beneficial investments, e.g. building bridges we need instead of re-finishing sidewalks in Menlo Park. Furthermore, there are state and local hurdles that need to be handled before a significant project can be undertaken; therefore, these projects are longer term in nature.

d. **Trade/Tax Policy:** Import barriers directed against Mexico and China, would increase the price of imports, thereby driving prices up as companies are forced to either 1) pay the tax and pass-through costs (think Walmart who has very thin margins) or 2) relocate manufacturing back to the US, which would increase input costs, thereby also goosing inflation.

4) The tradable components of CPI are also recovering:

a. Recent oil production caps from OPEC will help stabilize the oil market. However, US shale production will serve to limit the upside in oil prices for the near future.

b. Emerging markets have stabilized and slowed the rate at which the US imports deflation.

c. Remember, the US is a relatively closed economy so domestic factors are more important than international factors.

5) Isn't the Fed tightening going to drive the yield curve up and counteract fiscal expansion?

a. To an extent, yes. However, Japan has anchored its 10-year rate at zero and the EU remains highly accommodative. As the rate differential between UST's and JGB's/Bunds increases, capital will flow to the US to earn the higher yield, which may slow the natural increase in longer dated points of the curve.

Overall – whether by higher input costs through a tighter labor market, increased demand from government through borrowing and spending, or tax cuts for high consumption populations, inflation appears poised to break its current range on a forward basis.

Portfolio Implications:

1) *Inflation protected bonds* will offset inflation risk imbedded in nominal bonds, as will EM FX.

2) *Real Assets* offer inflation protection through their ability to pass through price increases.

3) *Hedging low-cost currencies* may offer protection in this scenario because a spike in inflation likely indicates above trend growth materializing which is bullish for the dollar.

4) *Continued focus on small cap companies*, especially private small caps, which offer better valuations, are more US centric, and therefore stand the highest chance to benefit from proposed Trump policies.