



Summary

- The debate on inflation continues to hang in the balance. Covid-related items have calmed down, although residual pressures remain elsewhere.
- Given the noise amongst so many moving parts, uncertainty on where the underlying trend on core CPI eventually settles will remain high.
- The highly weighted rent category will be a key factor going forward, but if core CPI is solely related to rent, Fed tolerance may be higher.
- Commodity prices remain strong but the main focal point will be on the labour market.
- How far will labour participation recover and will it provide a decent check on wage growth? Will wage strength necessarily flow through to unit labour costs? Latter will depend upon how much firms try to boost productivity.
- Bank lending is generally strong apart from the special case of corporates. The QE taper is raising angst about liquidity going forward, but the system will likely remain rich in liquidity despite the taper. For example, the Fed is currently sitting on \$1.5trln of reverse repos.

About this document

US Inflation Watch presents 18 charts comprising key inflation indicators grouped into five categories including consumer/producer price inflation, commodity prices, wage inflation, inflation expectations and monetary indicators.

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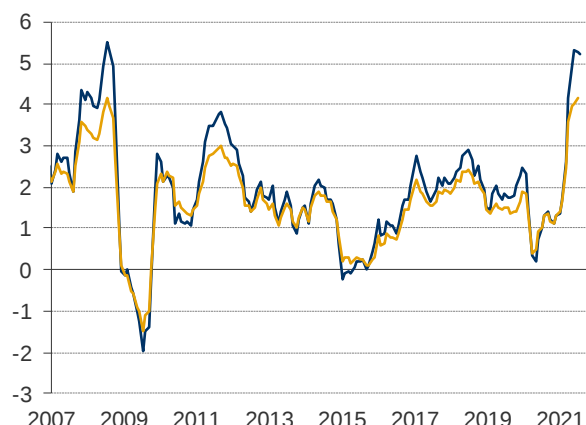
The Importance of Inflation

Inflation is the single most important indicator when measuring real wealth as it determines what wealth can buy i.e. purchasing power. If 'nominal' wealth doubles over 25 years but the level of prices also doubles, there is no net gain in 'real' wealth. It only takes annual inflation of 2.8% to cause a doubling in prices over 25 years.

About Altana Wealth

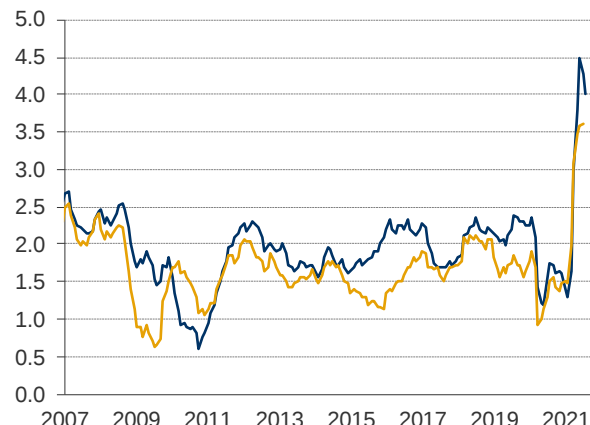
Altana Wealth is a specialist fund manager focused on delivering alpha where we have a competitive edge from niche strategies. As co-investors in all our funds, our interests are aligned with those of our investors. Altana was set-up by Lee Robinson, co-founder of highly successful Trafalgar Asset Managers in 2010. Our funds have won seven performance awards over the past three years.

Total Consumer Prices (% y/y)



— Total CPI
— Total PCE price index

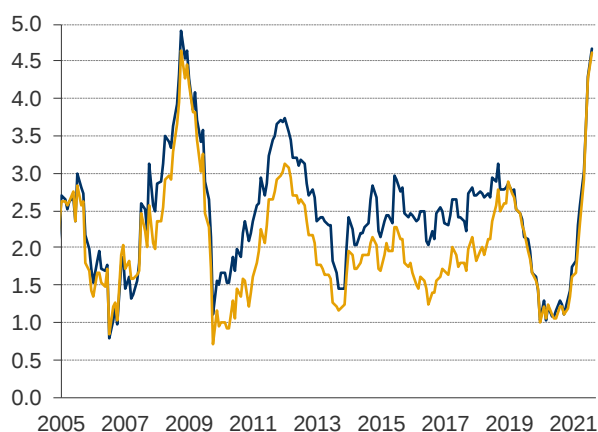
Core Consumer Prices (% y/y)



— Core CPI (ex-food and energy)
— Core PCE price index (ex-food and energy)

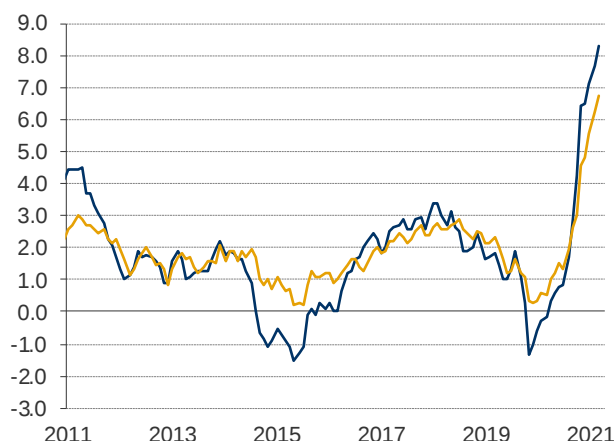
Current status: Core CPI softened in Jul-Aug as several Covid sensitive items (car rentals, car insurance, airfares, used cars and hotels) were softer compared to prior months. Clearly there is noise in this data at the moment across various moving parts and high uncertainty about how things will evolve going into 2022. New car prices remain quite strong, but should start to fade at some point, while used car prices can fall further. Airfares and hotel rates may rise once again as the latest delta variant wave subsides. There are still pockets of other strength e.g. clothing, household furnishings, although once supply issues resolve themselves these prices should also revert. The uncertainty is how long it will take, but there are differences between one-off rises and ongoing high y/y rates year after year. For y/y rates, base effects will be challenging in 2022. The elephant in the room is the highly weighted owner equivalent rent (OER) category, which for now is chugging along at just under +0.3% m/m. If this were to suddenly rise (likely given what is happening to landlord rents), it would present a more substantial and enduring support to core CPI y/y. Still, if core CPI strength is purely due to rents and not broader based the Fed may be more relaxed about it. Wages will remain a key focal point and more importantly how they feed into unit labour costs, where there is some optimism (see page 4).

Producer prices (% y/y)



— Core PPI (finished consumer goods)
— Core PPI (all finished goods)

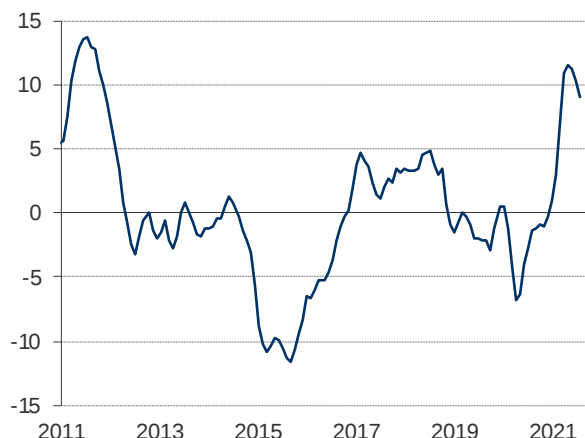
Producer prices (% y/y)



— PPI final demand
— Core PPI final demand (ex-food and energy)

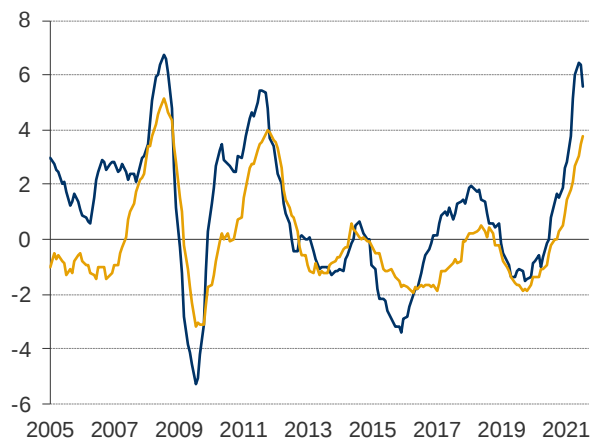
Current status: Core PPI remains strong across goods categories. Most services strength is in 'trade services' (essentially margins accrued by wholesalers/retailers of goods) and transportation services (primarily passenger services). So other than some isolated areas, services PPI is not that strong. But goods PPI (still underpinned by strength in commodities) will serve to underline the background upward pressure on some areas of CPI.

Import Prices (% y/y)



— Import prices

Import Prices – core and China (% y/y)



— Core import prices (ex-fuels)

— Import prices of Chinese goods

What is this data? Producer price indices refer to prices set by domestic producers only, so Import Prices are also monitored to gauge price pressures entering the system from abroad. Import price data excludes tariffs.

Current status: Import prices softened through Jul-Aug, particularly in the core ex-fuel categories that have showed much strength in prior months. Core industrial supplies & materials fell in both Jul and Aug, leaving the y/y rate sharply lower, albeit still high, at +24%. Within that category, building materials fell sharply m/m (-14.9% Jul, -17.3% Aug) to leave the y/y rate at +9.5% compared to an initially reported 84% in June. Unfinished metals (+39% y/y) are strong but off the highs, while capital goods (+1.9%) and consumer goods-ex autos (+1.0%) remain subdued. Prices of imported Chinese goods continue to recover. In sum, the current inflationary impulse in the US is being supported by the external sector – particularly commodities – but there are signs of it subsiding slightly in some areas.

CRB-TR/J Commodity Price Index



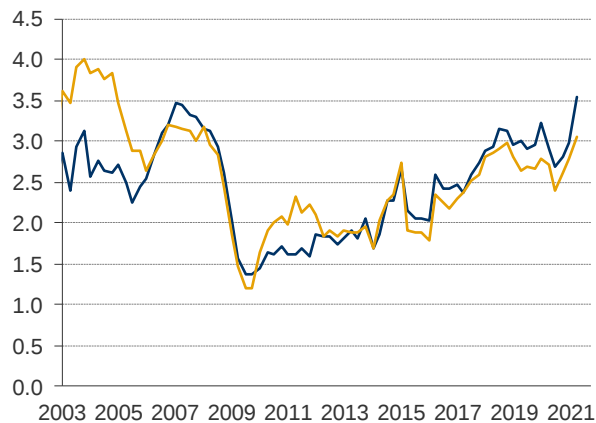
CRB-TR/J Commodity Prices (% y/y)



What is this data? CRB Index is a basket of commodity prices - a timelier indication of Crude PPI.

Current status: Sequential gains continue in commodity prices, but y/y rates are off the highs as base effects are challenging given the sharp m/m rises seen Apr-Aug last year. There seems little let up in the underlying pressure coming from the commodity complex (iron ore being an exception in response to state enforced reductions in Chinese steel output) and this will serve to underpin import prices into the US and the passthrough to PPI goods. The profile of commodities will continue to be an important backdrop for inflation expectations going into next year.

Employment Cost Indices (% y/y)



— **Total Employment Cost** (private sector)
— **Wage & Salaries component** (private sector)

Hourly Earnings (% y/y)



— **Hourly Earnings** (private sector)

What is this data? The Employment Cost Index (ECI) is the total cost of employing workers (wages, salaries, benefits) and is quarterly; 'hourly earnings' is monthly.

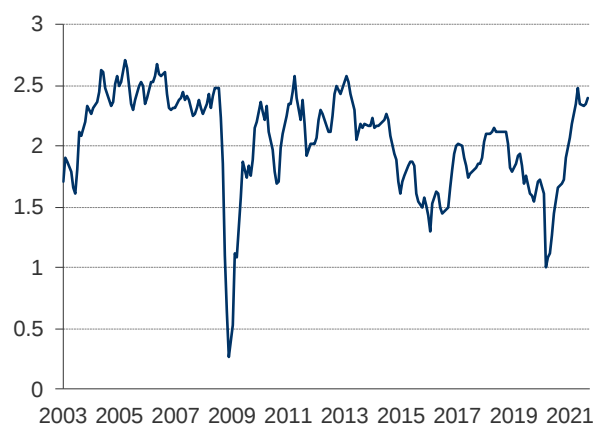
Current status: Average hourly earnings remain volatile given swings in employment & employment mix (if lower paid jobs rise by more, average hourly earnings fall). No adjustments are made for mix effects. However, even after taking account of these effects, raw pay seems to be stronger in some sectors e.g. lower paid hospitality jobs. ECI, which does adjust for mix effects, is also strong (+1.0% q/q Q2 after +1.1% in Q1) and seems to be on track for 4%-plus y/y. Going forward, there are two focal points. 1) labour participation after the ending of emergency benefits and less child-care demands and whether this is sufficient to offset higher wages and 2) whether high wages feed into unit labour costs. With labour scarce, firms could invest in new equipment to boost productivity of existing workers, reducing unit labour costs in the process. This will determine how far wage growth feeds into PPI and CPI.

Consumer Inflation Expectations (% y/y)



— **Univ. of Michigan survey of Consumer expectations for CPI over 1-y**

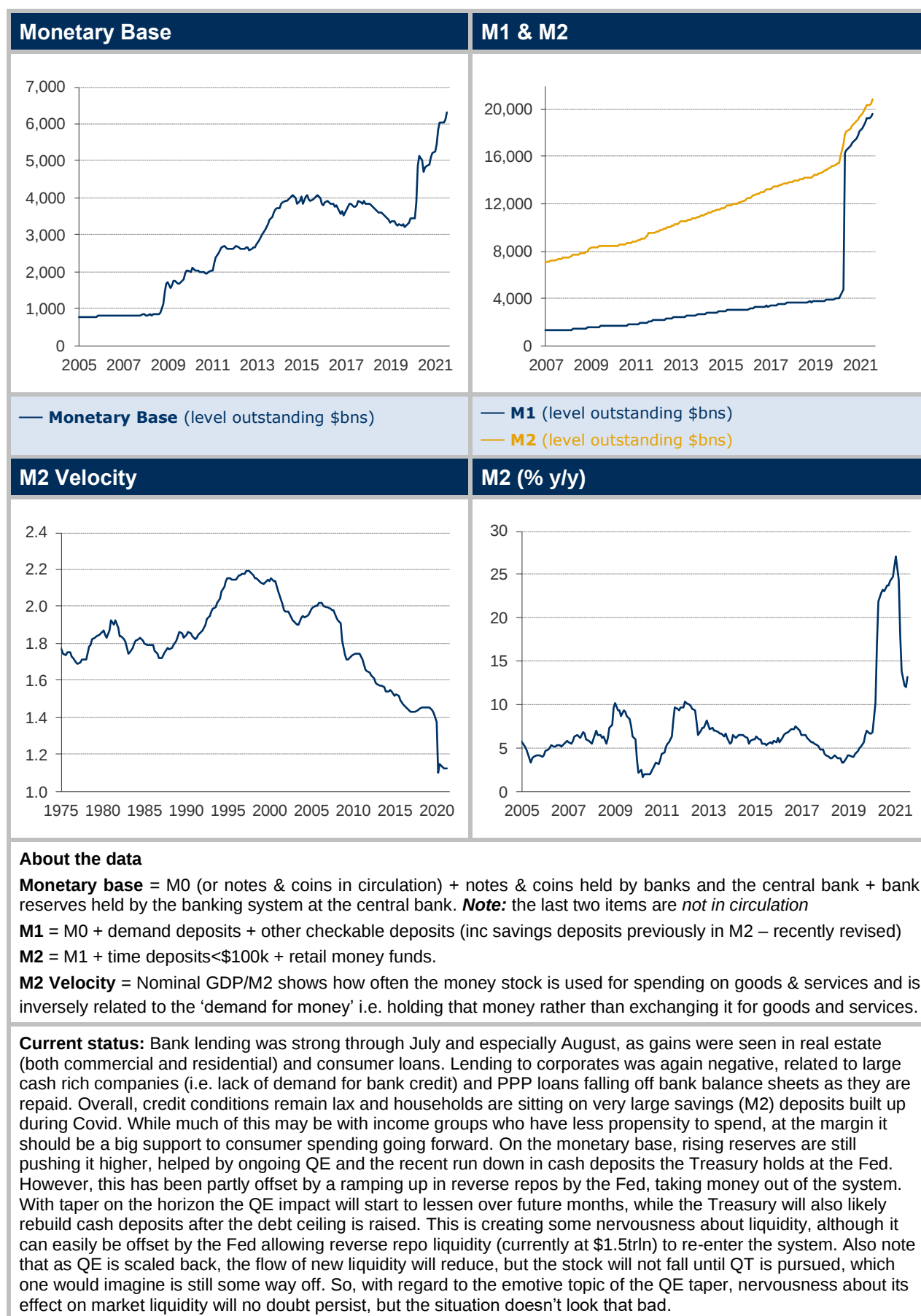
Market Inflation Expectations (% y/y)



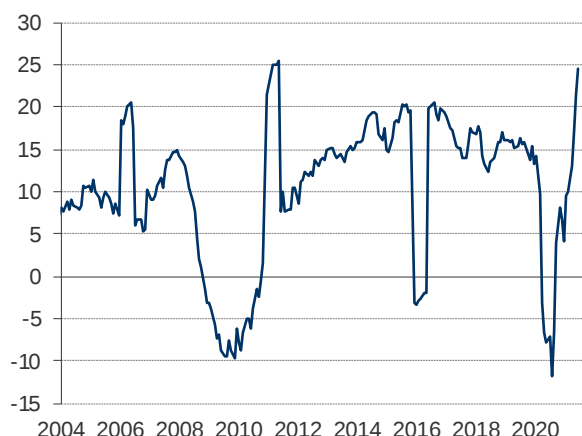
— **US 10yr Breakeven Inflation Rate** (10yr Treasury yield minus 10yr TIPS yield)

What is this data? Inflation expectations held by the public (Michigan survey) & financial market (10y breakeven inflation rate). Inflation expectations are significant e.g. higher consumer expectations of inflation may lead to higher wage demands. If market expectations of inflation are rising/falling, this may require some reaction from policymakers.

Current status: Consumer expectations remain high, but this is partly due to normal high sensitivity to fuel prices. The 5-10-yr expectation is a lower at 2.9%. Market expectations also remain elevated but remain within the range seen since June. A move above 2.75% maybe required to catch the attention of the Fed.

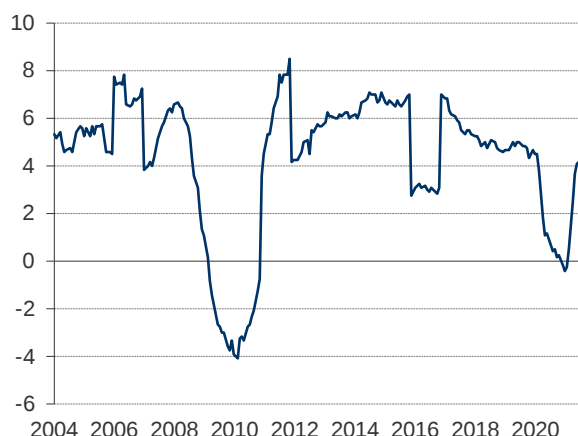


Consumer Credit



— Consumer Credit (6mth MA of m/m \$bn change)

Consumer Credit (% y/y)



— Consumer Credit

What is this data? Covers most short and intermediate-term credit extended to individuals, excluding loans secured by real estate. Consumer credit growth will directly influence money growth and monetary velocity.

Current status: The ongoing recovery in consumer credit continues, with total credit advancing with some strength in Jun & Jul. Non-revolving credit rose \$31.1bln over the combined period and revolving credit was up by a much larger than normal \$23.7bln. The first sign perhaps of the impact of some states eliminating emergency unemployment benefits. The data shows few problems with the availability of credit if required by some consumers.

Appendix A – Monetary Indicators

The monetary backdrop is somewhat profound in terms of its potential influence on inflation and is the subject of considerable debate. Below is a simple monetary framework that helps to explain the role of Money in the economy and how it can affect inflation.

A Monetary Framework

The amount of money circulating in the economy will have implications for inflation in the medium-long term. This is best expressed via the **Quantity Theory Identity**

$$M.V \equiv P.Y$$

Where M is the amount of money in the economy, V is the velocity of money (how many times the amount of money is used), P is prices and Y is real output (GDP). Together, P.Y is money or nominal GDP.

As a basic identity this is not controversial. If M (\$500) is used 5 times (V) then \$2,500 will have been spent and will be equal to the value (P.Y) of all goods sold in the economy - e.g. 2,500 items of real output (Y) at \$1 each (P) or 1,000 of (Y) at \$2.50 each (P) etc.

Where the identity becomes more interesting is in the assumptions made about its components. Traditional Monetarists contend that V is fairly stable and predictable, and Y is constrained by the capacity of the economy. So, Monetarists argue that if M is rising faster than Y and V is stable, it follows that P will also rise. In other words, money growth creates inflation.

Others contend that V is not stable and that Y can occasionally deviate substantially away from full capacity, so the relationship between M and P is less obvious. For example, since the Global Financial Crisis the Federal Reserve has made great efforts to increase the supply of money (M), but this has not led to proportionate increases in P.Y. This is due to two things. First, a reduction in velocity - any extra money balances are merely accumulating in the system (higher demand for money) rather than being spent and second, a lower money-multiplier. The money-multiplier represents the rate at which central bank created money (the monetary base) generates additional increases in the total money stock, primarily via the lending of commercial banks – more on money creation below.

In sum, this basic Quantity Theory Identity is a useful framework for analysing the potential interaction between the monetary and real sectors of the economy and the data followed in this document will seek to shed light on what is happening to the various components of this identity.

What is Money?

Another issue is how 'money' or M is defined. Definitions of money include M0, MB (the Monetary Base), M1, M2, M3 and MZM (maturity zero money) and the basic difference between them is primarily related to liquidity. The further we move along the spectrum towards M3 the less liquid 'money' becomes. For example, a large time deposit cannot be spent immediately whereas a checking deposit can. Note that M3 and MZM are no longer used in the US by the Fed.

Definitions

M0 = notes and coins *in circulation* with the non-bank public.

Monetary base = M0 + notes and coins held by banks and the central bank + bank reserves held by the banking system at the central bank (bank reserves) **Note:** the last two items are *not in circulation*.

M1 = M0 + demand deposits and other checkable deposits (including savings deposits after Fed methodological revision – they were previously in M2). **Note:** bank reserves are not included in M1 – important when looking at how Fed QE affects M1 and M2 etc.

M2 = M1 + time deposits less than \$100k + retail money funds. **Note:** institutional money market funds are not included in M2.

M3 = M2 + large time deposits + institutional money market funds + short-term repos and other large liquid assets.

MZM (Money Zero Maturity) = M2 + all money market funds less time deposits **Note:** MZM aimed to identify all forms of 'liquid' money and was a hybrid of M2 and M3.

Who creates Money?

A useful way to think about money – again relevant when considering Fed QE – is who creates it? The short answer is that both the central bank and the commercial banking system create money.

The Monetary Base is created and influenced by the Central Bank and is so-called because it is the base from which all other forms of money (non-M0, M1, M2 etc.) are created by the commercial banking system via bank lending.

For example, using QE as an example, the Fed buys T-Bonds from a bank and credits that bank's account at the Fed with the proceeds. These funds are now reserves. At this point, no money has entered circulation, so no other measure of money apart from the Monetary Base has been affected.

As the Monetary Base has increased, commercial banks are more *able* to create other money by issuing new loans and if they were to do this it would lead to a corresponding rise in deposits. Bank lending is the main driver of 'money creation'. This is because a loan, when advanced to the borrower, will be deposited in the borrowers account i.e. an immediate rise in deposits (higher M1). Or, if the 'loan' is via a credit card, the borrowers account will not be affected, but the recipient of the credit card spending will deposit the revenue in their own bank account, so deposits somewhere in the system will have increased because of the 'loan' (higher M1).

In sum, boosting the Monetary Base (via e.g. Fed QE) increases the ability of banks to create other money such as M1. But the rate at which this happens (the money-multiplier) will come down to a commercial judgement by the banks as to whether or not they would like to advance extra loans.

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