Inflation
By Eduardo Cortes, CIO
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On March 12, 2024, the Bureau of Labor Statistics released the Consumer Price Index (CPI) for February. The level came in at 0.4% for the month, equaling the consensus but disappointing many observers who had expected a lower number. Not including food or energy the number was still 0.4%, higher than consensus by 0.1%. Within four days the yield on the ten-year treasury had risen 18 b.p. The yield on the two-year rose 14 b.p. over the same period. March's CPI report was released April 10 and again the monthly increase was 0.4%, although this result exceeded expectations by 0.1% and marked the second consecutive 0.4% print after 0.3% for January. These numbers marked a considerable reversal of the year-end 2023 trend in inflation and disrupted widely held expectations for a move toward the Fed's 2.0% target. Not surprisingly, the ten-year treasury rose another 30 b.p. and the two-year added 20 b.p. These data and the bond market's reaction dramatically unsettled forecasts related to the Fed's policy decisions and the likely level of interest rates this year.

In deference to other factors affecting the markets, economic data away from CPI, including the employment picture, manufacturing, and consumer activity affirmed a more robust economic outcome than investors and economists predicted as 2024 began. As the first quarter ended, the consensus narrative of a slowing economy enabling Fed easing to achieve a soft landing and eventual recovery in 2025, began to be questioned. Unexpectedly, the challenge to the narrative was associated with strength rather than weakness which dominated the conversation in the fourth quarter of 2023. Confronted with higher-than-expected economic activity again, should we worry about resurgent inflation and a reversal of the Fed's policy direction?

Over the last six months, CPI expanded at an annualized rate of 3.2%, well above the Fed's 2.0% target. However, during the fourth quarter of 2023 inflation advanced at an annual rate of 1.9% compared to the discomforting rate of 4.6% during the first quarter of 2024. As is known to market participants, shelter makes up about 36.2% of the CPI. Over the last three months, shelter increased 7.1% at an annual rate and contributed 55% of the change in inflation. Housing constitutes most consumers' largest ongoing expenditure, although it seems odd that a consumption category burdened by the drag of higher funding costs would be influencing prices so dramatically.

The housing market went through a tumultuous few years due to the pandemic. It is logical to assume that the shelter component in CPI should have a close relationship with home prices. Prior to Covid, the housing market was sluggish and home prices increased at an unremarkable clip. From 2016 through 2019, the shelter component of CPI increased at an average rate of 3.3% per annum which reflected about 70% of the change in home prices over those years. During the pandemic years of 2020, 2021, and 2022 home prices rose by a cumulative 38.7%.[1] Over the same period, the cumulative increase in the shelter component of CPI was only 14.1%. Moreover, after being the overwhelming contributor to CPI early in the pandemic, shelter contributed only 25% of the price increases, on average, in 2021 and 2022.

Home prices continued to rise in 2023 while the shelter component began to catch up rising more. After the torrid three-year pace, home prices rose another 5.6% in 2023 while the shelter component rose nearly 6.2%. It seems tempting to assume shelter CPI has to rise further to catch up with home prices, and the first quarter data certainly reflects that possibility. However, housing market data do not justify that conclusion.

The Mortgage Bankers Association publishes an index that measures weekly mortgage applications for single family home purchases. That index hit a high of 1,172.10 in March 2020 and a low of 161.80 in October 2023, a staggering decline that illustrates the impact of higher mortgage rates on demand. In addition, existing home sales hit a 13-year low in October 2023, at an annual rate that was nearly 2.0 million units below the pandemic-boosted cyclical high in 2020. Real estate

[1] S&P CoreLogic Case Shiller

experts argue a deficit of supply artificially lowered volumes. It seems more likely the combination of higher mortgage rates and elevated home prices are curtailing demand.

Another significant and highly volatile component of CPI is energy. While energy's weight in the index has declined to about 6.75%, its influence can be large due to oil price volatility. In March 2024, energy contributed 0.2% to the 0.4% final number. Oil prices rose in March as global demand improved and geopolitical events lifted supply fears. The peak year-over-year inflation rate over the cycle that began with the pandemic was 9.1% in June 2022. That was about four months after Russia invaded Ukraine, causing a spike in oil and grain prices. The energy component of CPI rose 41.62% over the twelve months ended June 30, 2022 and contributed about 2.8% to the year's price surge.

Oil prices started declining by the end of June 2022 and the energy component followed suit. For the twelve months between June 2022 and June 2023, energy declined nearly 17% and helped reduce CPI by about 1.1%. As of the March, 2024 the energy component index closed slightly above its June 2023 level. While geopolitics remain fragile and global economic data looks better, we believe it is unlikely the "war premium" returns the energy index to June 2022 levels. The supply/demand dynamics for oil, absent geopolitical disruptions, can readily accommodate a higher growth rate at lower prices.

The CPI releases in 2024 were disappointing given the progress that was made after experiencing 2022's shocking levels. Fundamentally, the economy continues to perform well, although the rate of growth is likely decelerating and it does not justify a sharp reversal in the inflationary trend. We believe there are underlying forces, especially in housing, that suggest the downward trend in inflation should be restored soon. This will be especially true if mortgage rates remain painfully high.

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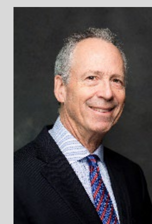

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