

AEGON INSIGHTS

Macro musings: The great inflation caper

- *The January consumer price index (CPI) report showed a surprising monthly increase in owner's equivalent rent (OER) to 0.56%.*
- *The Bureau of Labor Statistics (BLS), which compiles the CPI report, sent an email (which was retracted two hours later) explaining that the jump in shelter prices was due to a methodological change that puts more weight on single-family rental units within the OER number.*
- *Since single-family rent inflation is running faster than multifamily, it boosted the OER reading.*

Economists are all atwitter trying to make sense of this: What does this mean going forward? Does it raise inflation forecasts? Will it affect the Federal Reserve's policy decisions?

While we wait for more detail to come from the BLS here is our take:

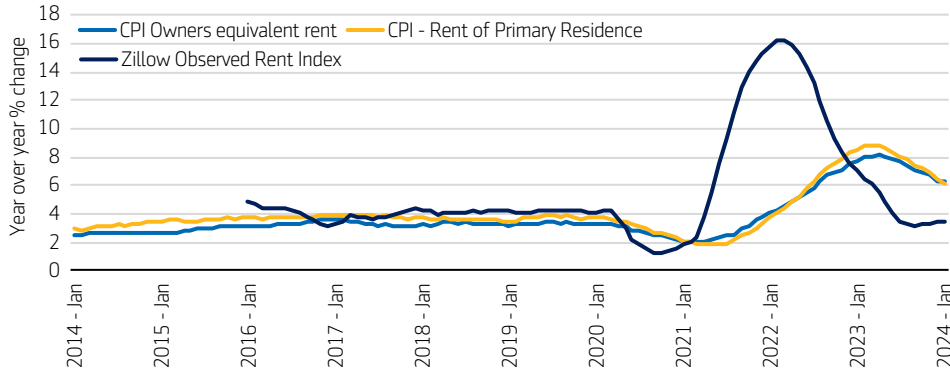
1. This episode illustrates the importance of the dashboard approach for analyzing inflation: The Fed looks at a host of inflation indicators, from the actual data like the CPI and PCE indexes (and all of their derivatives) to the inflation expectation readings in surveys from the University of Michigan, the New York Federal Reserve and others.
2. The Fed rightfully puts more weight on the PCE, which, while it uses the same methodology for OER that the CPI does, has a much smaller weighting (the core PCE housing weight is less than 20% compared to over 40% for the CPI). Furthermore, both headline and core PCE are both running below 3% on a year-over-year basis.
3. The Fed also looks at ex-shelter measures (such as core ex-shelter, core services ex-housing, etc.). If the OER reading has increased due to technical issues, but it's not passing through to other measures, then the Fed likely sees through it to a degree.
4. It's also worth noting that the housing inflation calculation is a lagged number—it's essentially a 6-month moving average of rental prices. The chart on the following page shows this smoothed out lag effect compared to observed rents.



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Frank Rybinski, CFA, is head of macro strategy responsible for guiding the firm's global macroeconomic view as it pertains to tactical and strategic asset allocation. This includes analysis of the economy, interest rates, and the relative value between asset classes. In this capacity, Frank frequently appears in leading financial media outlets like Bloomberg, CNBC, Fox Business and the Wall Street Journal. Prior to his current role, Frank was a credit strategist for UBS Investment Bank. Prior to that, he worked as an analyst for ZT Zurich Trust in Zurich, Switzerland. Frank began his career as a trader for Spear, Leeds & Kellogg and held a similar position at The Royal Bank of Scotland. He has been in the industry since 1996 and started with the firm in 2008. Frank received his BA in economics from Boston College. He is a CFA® charterholder.

Housing inflation Year-over-year % change

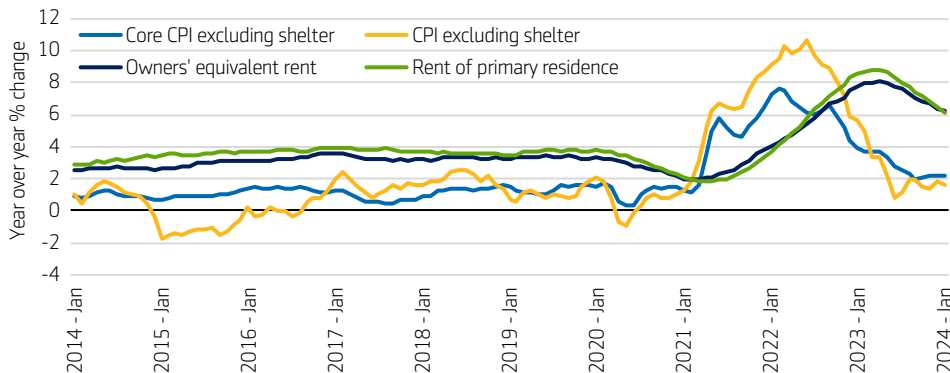


Sources: Bureau of Labor Statistics, Zillow, Haver Analytics

- The housing market represents a structural shortage of supply and thus its respective inflation tends to run faster than the broader economy. The Fed's 2% inflation goal is for the whole pie, not each individual category (i.e., during the last cycle goods tended to be in deflation, which offset the above 2% rate of inflation in services prices). Housing inflation will eventually come down over time, but is likely to run higher than the 2.0% headline goal (at least in a sustainable fashion).

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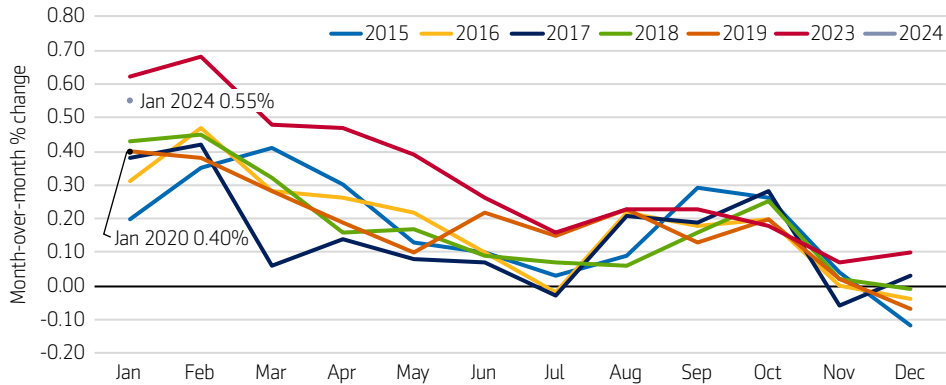
Housing inflation vs. overall inflation Year over year % change



Sources: Bureau of Labor Statistics, Haver Analytics

- There is a case to be made that there could be a residual seasonality effect occurring. The months of January and February typically see the highest core inflation rates of the year, after which inflation usually steadily decelerates during the rest of the year. The January 2023 and 2024 core CPI readings were abnormally higher on a non-seasonally adjusted basis, which raises questions about the accuracy of the seasonal adjustments. This would distort the underlying trend messages in shorter averages (such as 3-month or 6-month) and puts more of a onus on the year-over-year number.

Core CPI (not seasonally adjusted) Month-over-month % change



Sources: Bureau of Labor Statistics, Haver Analytics

We believe that the January and February 2024 aggregate inflation data could represent the high-water mark for the rest of the year. As such, we've never believed in a March 2024 kickoff for the Fed's rate-cutting cycle. Our base case remains that the rate-cutting cycle will start in July 2024. But obviously that can be fluid depending on how inflation actually behaves.

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Inflation: Slice & dice

	As of	% of Index	m/m	m/m AR	3m AR	6m AR	YoY	Change vs. December 2020
CPI-U	Jan-24	100%	0.31%	3.7%	2.4%	3.2%	3.1%	17.6%
CPI-U: Core	Jan-24	80%	0.39%	4.8%	3.6%	3.4%	3.9%	15.5%
CPI-U: Core, ex-Shelter	Jan-24	44%	0.20%	2.5%	2.2%	1.8%	2.2%	13.4%
CPI-U: Core, ex-Shelter & Used Autos	Jan-24	42%	0.40%	4.9%	2.3%	2.2%	2.5%	13.0%
CPI-U: Services, ex-Shelter	Jan-24	28%	0.85%	10.7%	5.2%	3.9%	4.4%	14.1%
Cleveland Fed Trimmed Mean CPI	Jan-24	84%	0.47%	5.8%	3.6%	3.3%	3.7%	15.7%
Cleveland Fed Median CPI	Jan-24	-	0.53%	6.5%	4.7%	4.3%	4.9%	16.0%
PCE	Jan-24	100%	0.34%	4.2%	1.4%	2.4%	2.4%	14.8%
PCE - Core	Jan-24	88%	0.42%	5.1%	2.2%	2.3%	2.8%	13.3%
PCE - Core Services, ex-Housing	Jan-24	-	0.60%	7.4%	3.2%	3.0%	3.5%	13.6%
Dallas Fed Trimmed Mean PCE	Jan-24	45%	0.41%	5.0%	2.5%	2.8%	3.2%	11.5%
Cleveland Fed Median PCE	Jan-24	-	0.43%	5.3%	3.0%	3.2%	3.5%	13.6%
San Fran Fed - Cyclical PCE Inflation	Jan-24	-	0.57%	7.1%	4.8%	5.0%	5.3%	18.8%
San Fran Fed - Acyclical PCE Inflation	Jan-24	-	0.32%	3.9%	0.6%	0.8%	1.4%	10.5%

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