Analyzing CPI: Insights, Trends, and Market Dynamics

First quarter inflation prints came in broadly hotter than expected, causing markets to materially reprice expectations for Fed cuts in 2024 from close to six to around two. April CPI showed hints of moderation from this trend, and the recent stickier inflation meant the in-line print was better than markets feared. Growth continues to be solid in the U.S., and the labor market remains healthy despite recent signs of moderate softening. Against this backdrop, the Fed has the luxury of remaining hyper-focused on returning inflation to its 2% target, without causing immediate economic damage by keeping their policy rate elevated. Powell has communicated that unless there is evidence of material degradation in labor market conditions, the focus will remain on price stability. From a market perspective, we believe inflation data will likely continue to be the largest driver of volatility going forward.

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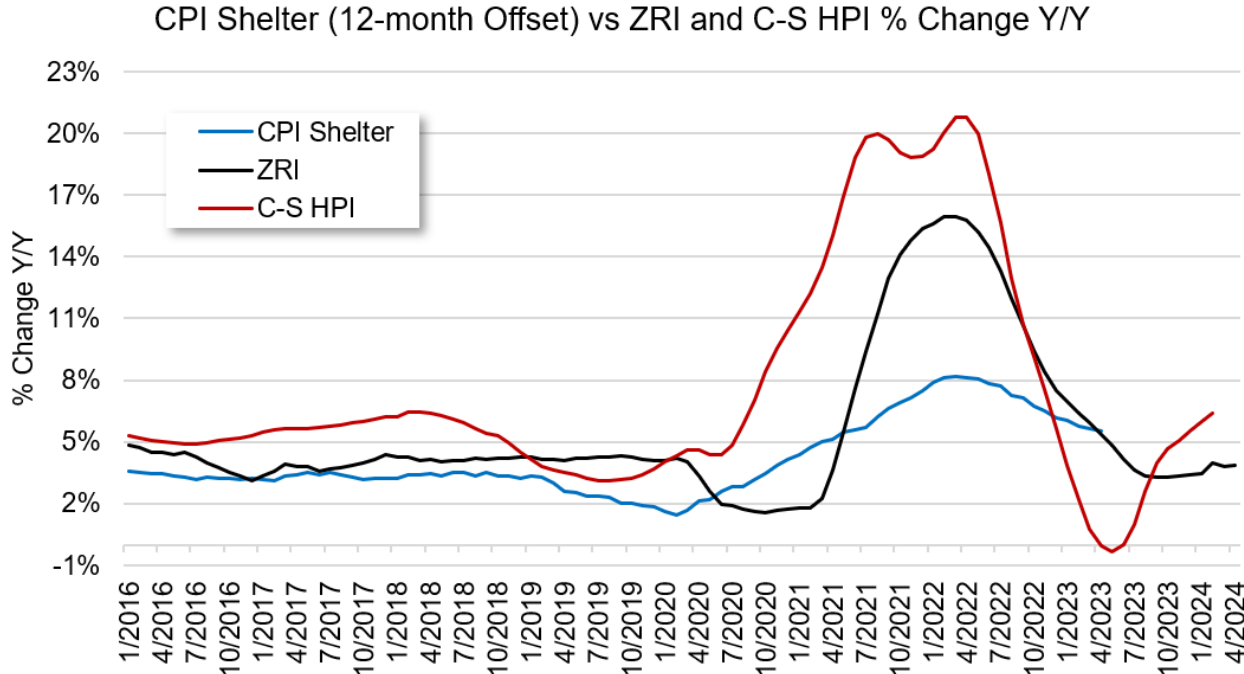
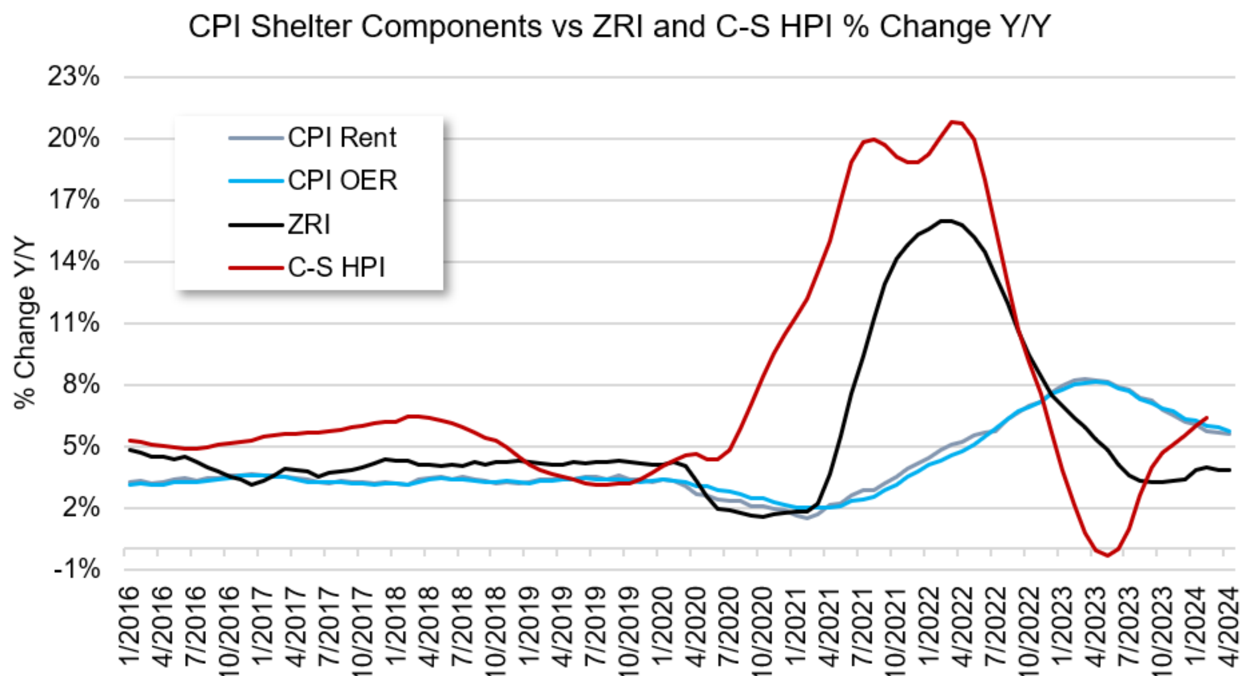
One of the components that has been keeping inflation data stickier than expected has been housing. This is especially true for CPI vs PCE due to differing weighting methodologies, with shelter comprising ~36% of the overall weight in the CPI index vs ~15% of PCE. This specific weighting differential is one of the main drivers of the current wedge between CPI and PCE inflation readings. Another key function that drives housing inflation readings is the typical lag experienced between real-time rental data (like the Zillow Rent Index) and when it shows up in the CPI index. Through its data collection procedures, CPI measures what people are currently paying, rather than what they would have to pay if they had to take on a new lease today. Rental leases are typically structured on a 12-month basis and rates are static throughout that period, so pricing changes typically aren't updated until existing leases are renewed, or new leases are initiated. This helps to explain the typical one-year lag between real-time rental data and CPI housing inflation. Understanding this relationship can provide insight into future housing inflation directionality. The Zillow Rent Index y/y increase peaked in April of 2022, and has returned to a more historically typical clip of close to 4% recently. CPI shelter y/y peaked in March 2023, illustrating the typical lag effects, and has slowly receded but remains elevated.

CPI Shelter Y/Y percent change vs Zillow Rent Index (ZRI) y/y percent change and Case-Shiller Home Price Index (C-S HPI) y/y percent change:



Source: Smith Capital Investors, Bloomberg (5/15/2024)

CPI Rent y/y percent change vs CPI Owner's Equivalent Rent (OER) y/y percent change vs Zillow Rent Index (ZRI) y/y percent change vs Case-Shiller Home Price Index (C-S HPI) y/y percent change:



Source: Smith Capital Investors, Bloomberg (5/15/2024)

If the typical relationship between market-observed rents and housing inflation holds, the shelter components of CPI should continue to soften over the next few months and provide downside relief to overall core inflation readings, albeit with greater magnitude for CPI than PCE. The April CPI print did show moderation in shelter components, though rent and Owner's Equivalent Rent (OER) remain sticky. From a seasonal perspective, May through July are typically supportive of softer non-seasonally adjusted (NSA) m/m core CPI prints, which feed into the y/y core CPI number that the Fed uses as a gauge.

While the Fed officially targets core PCE as its preferred gauge of inflation, we believe softness in CPI will likely be a catalyst for further repricing of increased rate cut expectations through the end of the year after a significant repricing since January. Our fundamental outlook remains unchanged: growth is strong but slowing, the labor market is softening but healthy, and inflation is coming down but sticky. This supports the view that the Fed can remain on hold for longer to ensure that the fragile structure of inflation eventually collapses, despite its resilience up to now. Markets, however, don't typically align with the Fed for long and will continue to be volatile around incoming data. We continue to be active in our approach to take advantage of opportunities during perceived market dislocations.

Let's keep talking!

Smith Capital Investors

Our mailing address is:
Smith Capital Investors
1430 Blake Street
Denver, CO 80202
303-597-5555
833-577-6484
info@smithcapitalinvestors.com

www.smithcapitalinvestors.com

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