Some Bumps on the Road to 2%

The Fed’s ‘supercore’ measure in the consumer price index (CPI) has accelerated in back-to-back months, while energy prices have risen considerably, best demonstrated by the 31% up-move in WTI since June 27th. These factors are likely to draw the ire of Fed policymakers and encourage near term hawkish posturing. Yet, we are committed to our view that inflation will decelerate to the Fed’s 2% target. In fact, we are forecasting sub-2% inflation by year end 2024. Evolving shelter cost dynamics are foundational to this view.

The Federal Reserve Bank of Cleveland’s new tenant repeat rent index shows rental prices actually declining 0.1% on a year-over-year basis. This is the lowest rate of change since Q2 2010. This series leads the BLS-measured rents index by approximately nine months and shows more rental disinflation is still in the pipeline (shown below). Further, Case-Shiller home prices, with a 16-month lead, suggest a similar story with shelter costs more broadly. The trends from home prices and the Cleveland Fed’s new tenant repeat rent index econometrically imply that shelter costs will fall below 3% between now and the fall of 2024 (compare this with August’s 7.8% YoY print). Considering that shelter holds a 34% weight in the CPI, this is the dominant inflation dynamic.

There are near-term bumps in the road, however. Rising energy costs will ultimately boost both headline and core inflation temporarily. Additionally, a possible auto workers strike is a stagflationary event at a time when inventories still have not yet fully recovered (below). A dramatic reduction in car production supports prices at a time when auto prices, auto insurance premiums and energy hold a combined 16.9% CPI weight. In sum, look for more disinflation over the next year, but not before hotter near-term pressures and more hawkish Fed rhetoric.
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