MARKET
SIGHT LINES

Will Shelter Inflation Cool in 2023? Shelter Plays a Key Role

By Michael O'Keeffe, *Chief Investment Officer*

The trend in inflation in 2023 is significant, as the Federal Reserve (Fed) continues to reaffirm it will continue to raise interest rates and keep rates higher for longer until Fed officials are confident that inflation is headed to its 2% target. Higher rates from here slow the economy, increase the risk of recession, dampen equity earnings, and increase market volatility. So, getting a handle on inflation looking forward is important. One inflation component, shelter, gets a lot of attention, as it represents over a third of the consumer price index (CPI) and has been "sticky," meaning it has continued to march higher even as other components have cooled. In this week's Sight|Lines, we unpack the CPI shelter component to learn why it is sticky and where it might be headed from here.

THE TAKEAWAY: SHELTER GREATLY INFLUENCES CPI, IS LAGGED, AND MAY BE COOLING.

As part of the U.S. Department of Labor, the U.S. Bureau of Labor Statistics (BLS) publishes CPI and other inflation measures each month. Shelter, a big part of CPI, has been elevated and slower to cool than many other components. Some real-time data is looking promising. In summary:

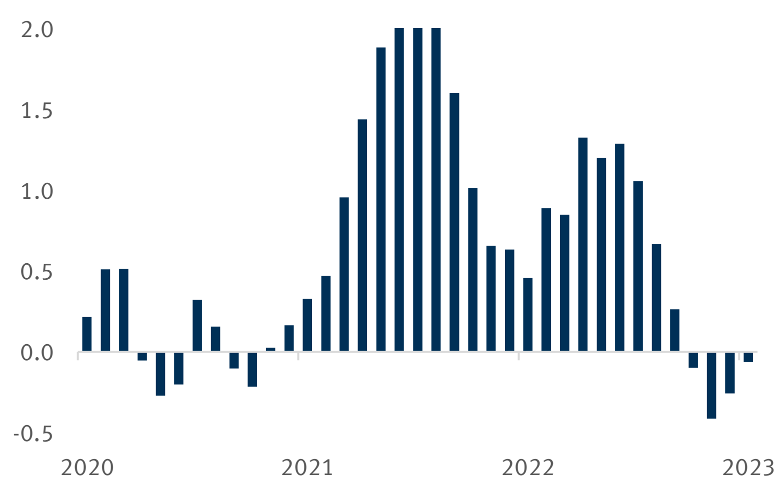
- Shelter represents 43% of core CPI, which excludes the volatile food and energy components.
- In January, annual core CPI was lower than the peak in September of 2022, with the monthly inflation cooling some over the last four months. But over those periods, shelter inflation remains more elevated.
- The BLS collects updated rental data on a sampling of specific rental units, but each unit is surveyed only every six months, creating a lagged effect in the data.
- The cost of owning a home is a big component of shelter and is inferred by the rents charged on comparable homes, a measure called owners' equivalent rent.
- More real-time data sources are signaling that shelter costs are cooling and may even be falling.

IN-DEPTH: SHELTER COMPRISES 43% OF CORE CPI; THE BLS SAMPLING APPROACH FOR RENTS IS LAGGED; AND SHELTER COSTS MAY BE COOLING, OR EVEN FALLING.

The BLS calculates CPI and other inflation measures, publishing the CPI each month. While it is popular to assess the annual, year-over-year CPI each month to gauge how quickly annual inflation is trending toward the Fed's 2% target, trends will first arise in the monthly data. Shelter, a significant component of CPI and core CPI, has been "sticky," meaning it has been elevated and slower to cool than many other components. This is due, in part, to the BLS regional survey approach to measuring shelter costs, with surveys spread over time. But as we assess real-time data, we see signs that we might well expect this lagged shelter inflation to cool in the coming months. Going deeper:

- Shelter represents 34% of CPI:
  - For this discussion, we focus on core CPI, which excludes food and energy, which are volatile.
  - Shelter represents 43% of core CPI.
- In January, annual core CPI continued to roll over, but the more recent monthly inflation cooled even more. That said, over those periods, shelter inflation has remained more elevated:
  - Core CPI was up 5.6% over the last year, with shelter up 7.9% over that time.
  - Core CPI averaged a monthly 0.4% rise over the last three months, while shelter increased 0.7%.
  - This infers that the remaining core CPI components grew at 0.08%, well below the Fed's 2% target. If shelter gets into line, inflation could cool quickly.
- The BLS measures rent inflation by surveying specific rental units:
  - The BLS samples about 48,000 rental units and divides them into six panels, collecting updated rental data for one panel every month, so each housing unit is sampled every six months.
  - For a given month, the BLS infers a monthly rate from the aggregate change in the panel's total rent (with some adjustments) over the six-month period. So it takes about six months for the index to return to the rent changes happening today, the lagged effect.
- The cost of owning a home is a big component of shelter:
  - This is captured in owners' equivalent rent, inferred by the rents charged on comparable homes.
  - So, the lagged effect described above influences owners' equivalent rent.
- More real-time data sources are signaling that shelter costs are cooling and may even be falling.
  - According to the Zillow Rent Index, year-over-year rent growth continues to decelerate and currently stands at 6.9%, its lowest reading since May 2021.
  - The Apartment List National Rent Index year-over-year rent growth has decelerated to 3.0%, its lowest reading since April 2021.

Zillow Rent Index – MoM%



Source: Stifel Investment Strategy via Bloomberg, as of March 1, 2023

CONCLUSION

The Fed is watching inflation trends carefully, and sticky components, like shelter, has slowed inflation getting back near the Fed's 2% inflation target. This means the Fed will continue to raise rates and keep rates higher for longer, increasing the risk of recession, dampening equity earnings, and increasing market volatility. Interestingly, shelter's stickiness can be attributed, at least in part, to the U.S. Bureau of Labor Statistics' measurement approach. More real-time data, like Zillow and Apartment List National Rent prices, signal that shelter costs may well be cooling later this year, which will help with inflation overall.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options.

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0323.5492291.1