

# THE LAST MILE IN THE FIGHT AGAINST INFLATION: SHELTER COSTS

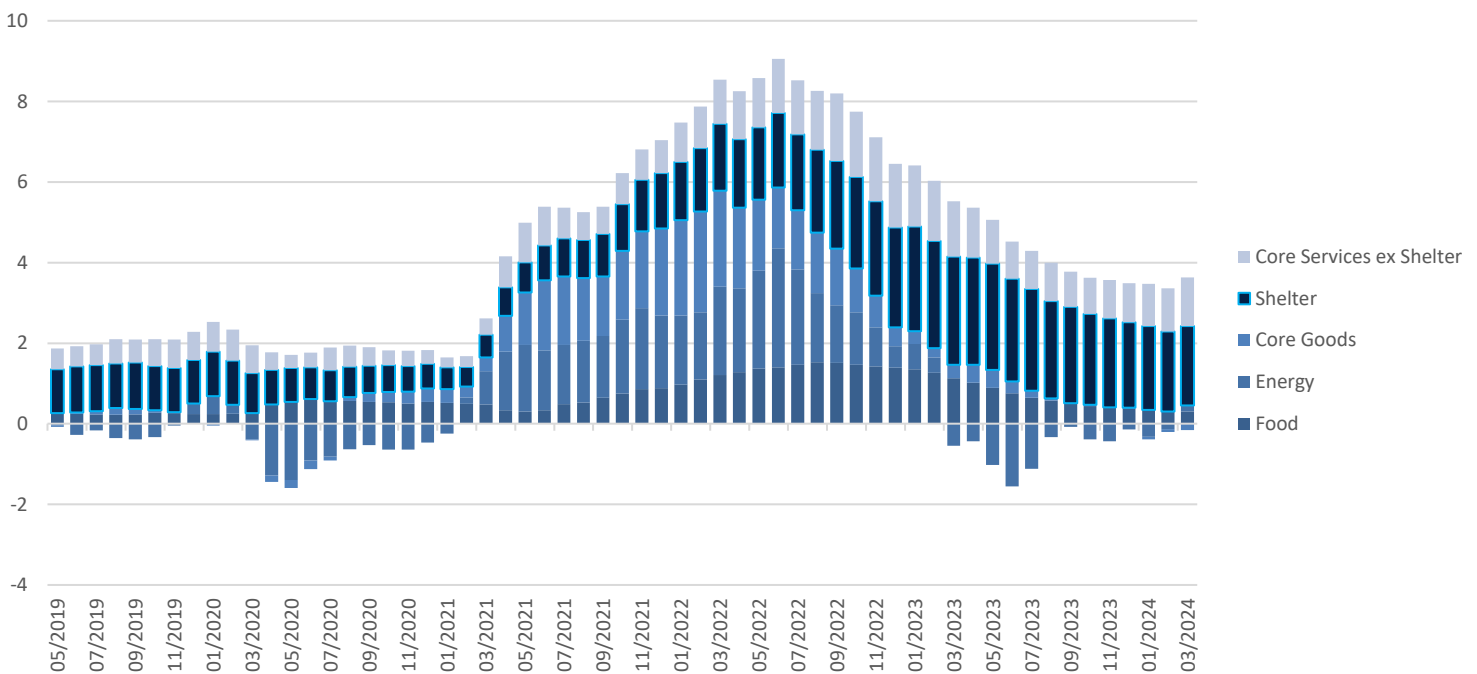
Drew Peterson, CFA, CIPM®, Corporate Bond Research Analyst and Macro Strategist

## Why the Process May Not Be as Onerous as Feared

A common refrain when discussing the Federal Reserve’s ongoing fight to quell inflation is “the last mile is the hardest.” On one hand, progress so far has come faster than many had anticipated, with both headline and core inflation falling below 4% before the end of 2023. This was largely due to volatile non-core food and energy prices, however, and core goods, where supply chain normalization has allowed transitory-after-all price pressures to quickly fade. The good news is these areas have seen inflation almost entirely abate; the bad news is that there’s little room for further progress here. **With inflation still more than a point and a half over the Fed’s 2% target, critics point out the “last mile” will require pulling down core services inflation, which tends to be stickier and harder to move.**

So far as this goes, the critics are right. However, it’s worth peeling back core services inflation a little further. Fed Chair Jerome Powell has chosen to focus on “supercore” inflation, or core services ex-housing, which remains elevated, if generally trending in the right direction. **Focusing on the supercore, however, obscures something important; more than half of current inflation, nearly two full percentage points, is attributable to shelter costs.**

Remaining Inflation is Now Predominantly Shelter Costs (annualized % change)



Source: Bureau of Labor Statistics, Bloomberg, Appleton Partners

This is important because, unlike most components of CPI, shelter is calculated on a heavily lagged basis. Understanding how the Bureau of Labor Statistics measures shelter costs offers important context. BLS sets weights annually (which itself can create January noise, as we saw this year) and then creates a segmented sample they further subdivide into six “panels.” Only one panel is sampled every month as a concession to the volume of inputs needed, and with rental prices generally resetting annually, typically only 10-15% of the overall sample reveals a price change in any given month. **In practice, this makes CPI shelter prices much stickier and slower moving than actual shelter prices.**

Other data sources can be used to supplement CPI shelter cost data, however, and looking at “live” rental cost indices can provide what’s essentially a preview of how CPI shelter costs will evolve in coming months. Zillow publishes a US Rents index that lends itself well to this task.

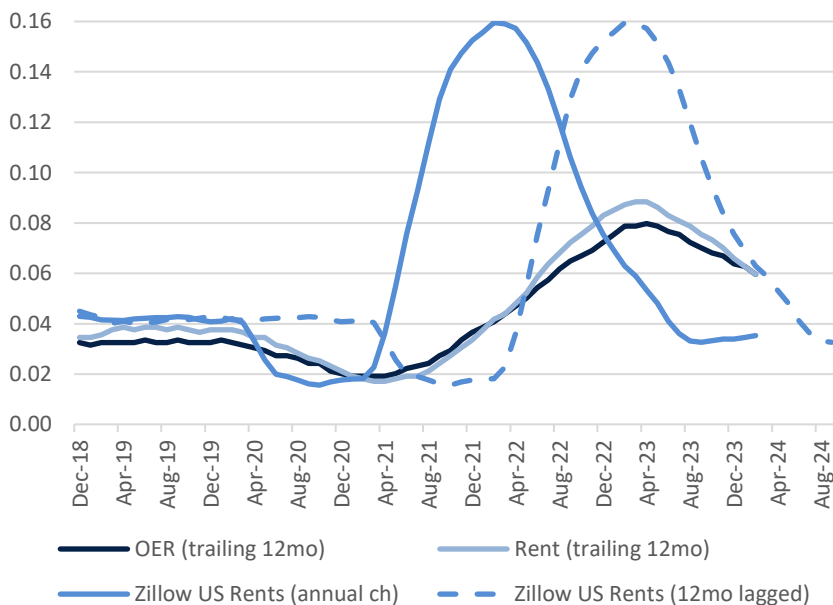
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Zillow's index lagged 12 months aligns quite well with (lagged by virtue of its sampling approach) CPI Shelter component in terms of trend, if not magnitude (which is to be expected given the partial sample methodology employed). **The two series tell essentially the same story; they peaked around early spring of 2023 and have retraced close to two-thirds of their gains since then.** The live Zillow series subsequently continued to fall from this point, halving over the next six months to its long-term range, where it remains today.

There is no guarantee that rental costs will not reaccelerate from here (and if it were to, this would be very concerning to the Fed). But, assuming rental prices remain well behaved, then it's reasonable to expect CPI shelter inflation will continue to fall back to normal levels over the next six months as stale data drops out of the sample.

Real-Time Data Suggests CPI Shelter Inflation to Normalize By Summer



Source: Bureau of Labor Statistics, Zil...

**Shelter inflation reverting to normal levels would strip about a percentage point off the top of CPI. With no other changes this would lower headline inflation to around 1.8%, just below the Fed's target, and core to around 2.5%, not quite at target but much closer.** From here further process would have to come from supercore, and the Fed is right to direct their attention there. However, it's important not to lose sight of the fact that shelter inflation is about to cover much of that "last mile" in the fight against inflation purely from sample composition. Chair Powell's cautious optimism may be out of favor with the market at the moment, but shelter costs do provide a reasonable basis for that optimism.

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