BEHIND THE HEADLINES

with **Ronald Temple**, Chief Market Strategist

September 13, 2024

The Week Behind

1. **The US Core Consumer Price Index (CPI) rose more than expected as shelter inflation remained stubbornly high.**

   Headline inflation rose 0.2% month-on-month (m-o-m) while core CPI increased 0.3%. On a year-on-year (y-o-y) basis, headline inflation decelerated to 2.5% from 2.9% in July, as expected, while core prices rose 3.2%, in line with the July pace.

   While the upside surprise might worry some, the details tell a more encouraging story. Shelter inflation drove the upside surprise with owners' equivalent rent (OER) playing the spoiler. OER is meant to capture the amount homeowners would be willing to pay to rent their homes. OER is not measured through a survey. Instead, it's a triangulation exercise that one should assume is subject to some degree of error. Given that OER accounts for 34% of the core CPI, it is consequential to the total figure. In August, OER rose by 50 basis points (bps) month-on-month (m-o-m), about 25% higher than the average level of the last six months. This figure is astounding given that rent of a primary residence, which measures rent paid by people who are actually renting their homes, rose 37 bps, an amount 7% below the average of the last six months. As I indicated last week, Zillow's Observed Rent Index indicates that rent inflation for new leases has been at or below 3.5% year-on-year (y-o-y) for the last 13 months, and yet the OER metric in CPI is up 5.4%.

   Put simply, the preponderance of evidence suggests to me that shelter inflation is well below what the CPI suggests. I expect the CPI shelter inflation metrics to converge with private sector data imminently, reducing fears of sticky inflation.

   Looking beyond shelter, services inflation ex-shelter and ex-energy services rose to 33 bps m-o-m from 21 bps in July and negative levels in June and July. Airfare and auto insurance drove the rebound. The two components only represent 15% of services ex-shelter and ex-energy services by weight but accounted for two-thirds of the contribution to core CPI.

   Bottom line: The disinflation story has not been disrupted. This month's reading is unlikely to preclude the Federal Open Market Committee (FOMC) from cutting rates next week.

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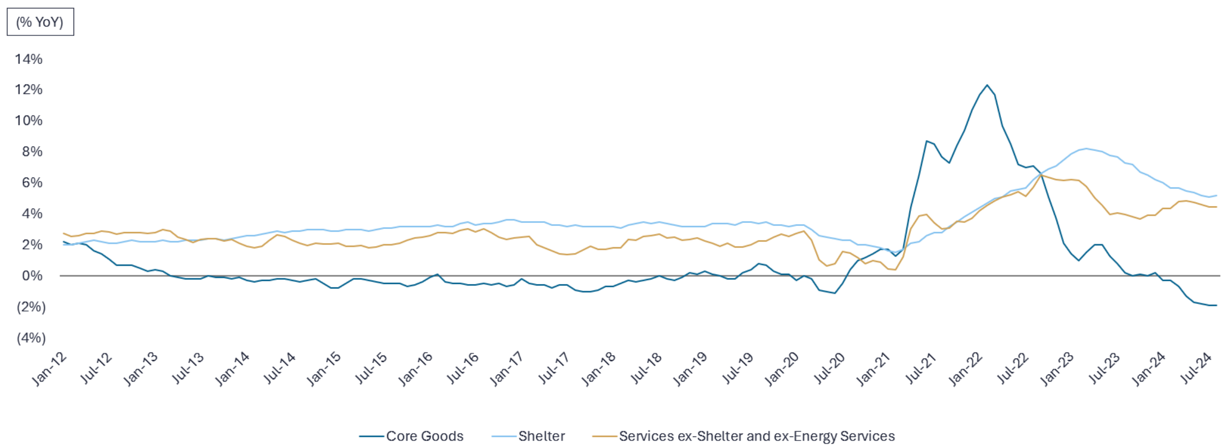
Upside CPI Surprises in the First Quarter Were Driven Primarily by Services ex-Shelter

US Consumer Price Inflation for Key Categories



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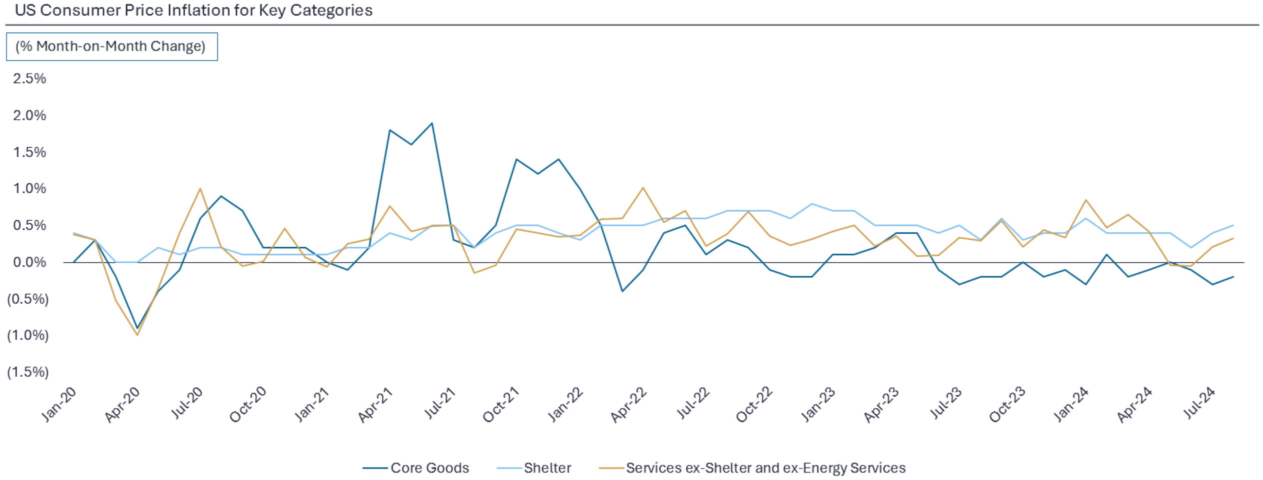
Source: Bureau of Labor Statistics, Haver Analytics
Note: As of August 2024
Core goods represent ~23% of core CPI, shelter represents ~46%, and other services ex-shelter and ex-energy services represent ~31%.

CPI Shelter Inflation Continues to Diverge from Private Sector Rent Metrics

US Consumer Price Inflation for Key Categories



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Source: Bureau of Labor Statistics, Haver Analytics
Note: As of August 2024
Core goods represent ~23% of core CPI, shelter represents ~46%, and other services ex-shelter and ex-energy services represent ~31%.

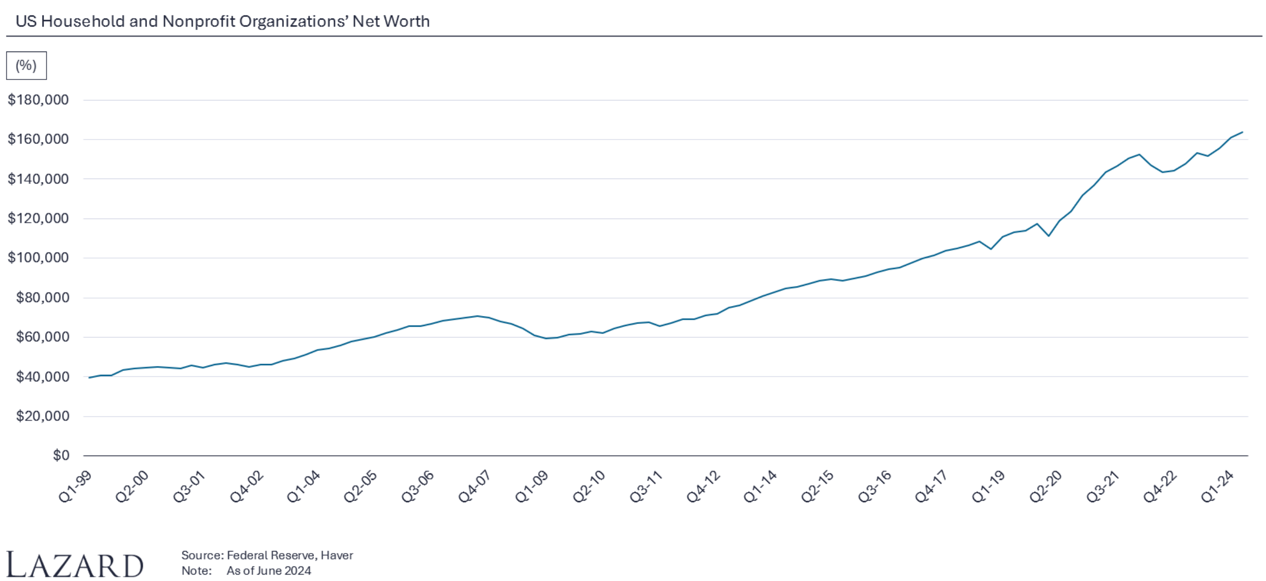
2. **US household net worth reached a new record high of $163.8 trillion, an increase of $2.76trn from last quarter's record level.**

   Rising residential real estate values and equity prices lifted household assets and net worth to new record highs. Household net worth has increased by a stunning $46.5trn from the pre-pandemic peak of Q4-19.

   Of the increase in the second quarter, 65% was driven by real estate values while an additional 19% was related to equity and mutual fund holdings.

   Bottom line: While it is popular to focus on the demise of American society and the US economy, the reality is that American households have never been wealthier, and the level and growth of net worth still far surpasses any other economy globally.

US Household and Nonprofit Organizations' Net Worth Reached a Record High of $163.8 Trillion



Source: Federal Reserve, Haver
Note: As of June 2024

3. **The preliminary University of Michigan Sentiment for September increased more than expected.**

   The University of Michigan Sentiment index rose more than expected as did current conditions and expectations. Inflation expectations on a 1-year horizon declined to 2.7% from 2.8% while the expectations for inflation over a 5- to 10-year horizon rose to 3.1% from 3.0%.

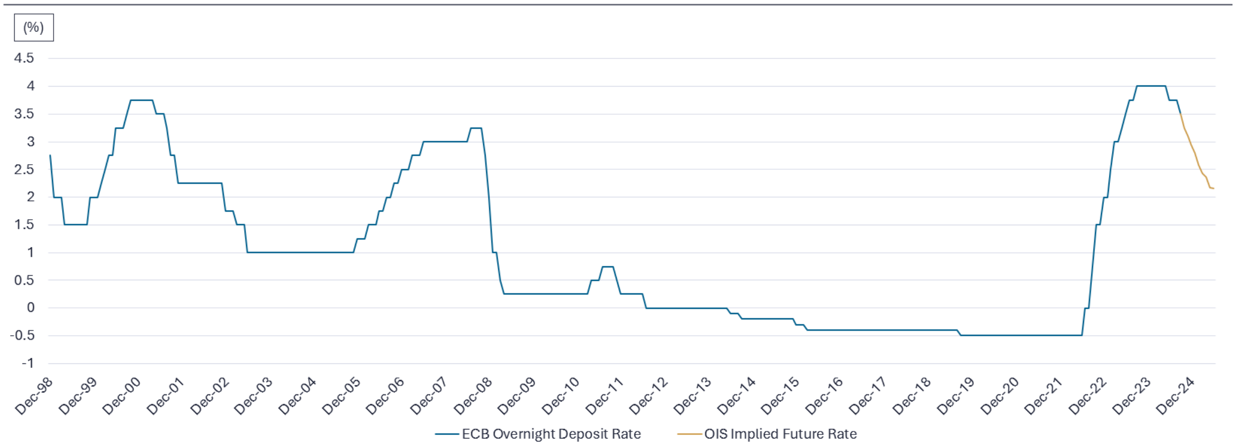
4. **The European Central Bank (ECB) reduced rates by 25 bps as expected.**

   ECB President Christine Lagarde did not offer any hints in terms of future policy moves, indicating that the ECB will remain data-dependent, but not data point dependent. The ECB staff projections for inflation average 2.5% in 2024, 2.2% in 2025, and 1.9% in 2026, the same as the June projections. Lagarde indicated that the risks to ECB economic expectations are to the downside and acknowledged that while wage gains remain elevated, corporate profit margins are compressing to accommodate these costs.

   Overall, the ECB meeting was a non-event. I expect two more rate cuts this year as the ECB gains confidence in the disinflationary trajectory. Markets are less convinced with overnight index swap markets suggesting a 55% chance of a cut at the October ECB meeting and certainty of a cut in December.

Markets Suggest ~39 bps of Additional ECB Rate Cuts in 2024

Implied Eurozone Deposit Rate through June 2025



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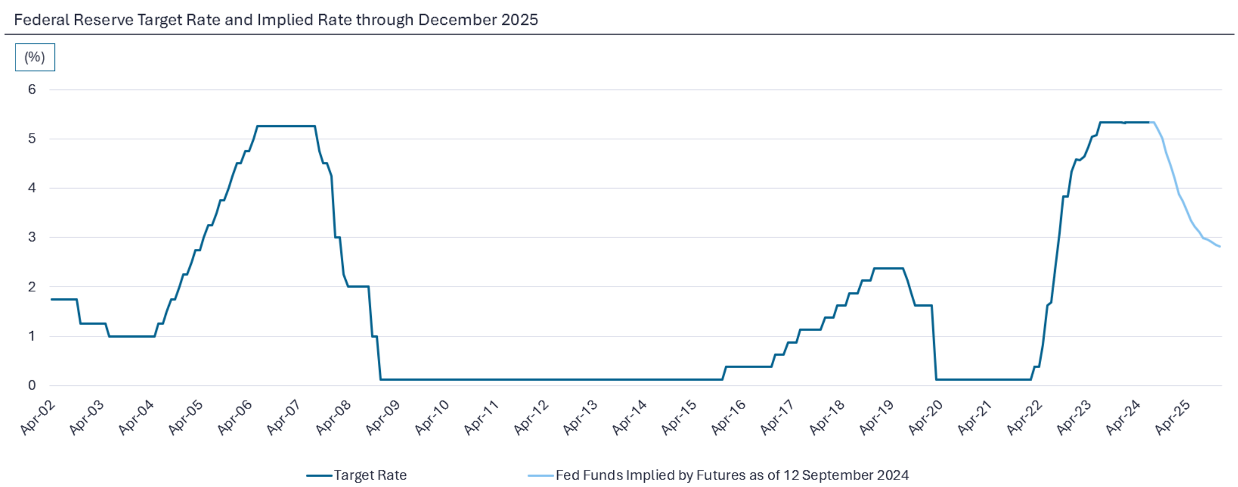
Source: Bloomberg
Note: As of 12 September 2024
* Markets imply a 56% chance of a 25-bps rate cut at the October meeting and a 99% chance of an additional 25-bps cut by the December meeting.

The Week Ahead

1. **The FOMC is expected to initiate its easing cycle by cutting rates by 25 bps.**

   Markets now expect 109 bps of rate reductions from the FOMC by year end and 234 bps by the July 2025 FOMC meeting. I continue to believe these expectations are too dovish, as the evidence of recession is insufficient to warrant such aggressive easing. What would change my view? If we get two more months in which non-farm payroll growth is at or below 100k, I would call aggressively for a 50-bps rate cut. However, at this point, the labor market data and other consumer metrics suggest to me that the economy has merely downshifted from being very strong to “merely” strong. If that is the case, gradual easing makes more sense than an aggressive approach.

Markets Are Pricing ~110 bps of Fed Easing in 2024 with a 33% Chance of a 50-bps Cut in September*



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Source: Bloomberg, Chicago Mercantile Exchange, Federal Reserve
Note: As of 12 September 2024
* Markets imply a 100% chance of a 25-bps cut at the September meeting and a 33% chance of a 50-bps reduction at the September meeting.

2. **August US retail sales are expected to have declined by 0.2% m-o-m while the control group is expected to have increased by 0.3%.**

   Given recent worries about economic weakening, retail sales data will be closely watched for signs of consumers closing their wallets.

August US Retail Sales	Consensus	Actual	Prior Month
Retail Sales m-o-m	-0.2%		1.0%
Retail Sales ex-Auto m-o-m	0.3%		0.4%
Retail Sales ex-Auto and Gas m-o-m	0.4%		0.4%
Retail Sales Control Group	0.3%		0.3%

Source: Bloomberg, US Census Bureau

3. **China will release an array of August economic data in the next 24 hours.**

   Last week, I included this in the “week ahead” section, but the data release will actually be after markets close in the United States on Friday, 13 September. As a reminder, the consensus expectations are in the table below.

August China Economic Data		Consensus	Actual	Prior Month
Industrial Production	y-o-y	4.7%		5.1%
	YTD y-o-y	5.8%		5.9%
Retail Sales	y-o-y	2.5%		2.7%
	YTD y-o-y	3.4%		3.5%
Fixed Asset Investment	YTD y-o-y	3.5%		3.6%
Property Investment	YTD y-o-y	-10.0%		-10.2%
Residential Property Sales	YTD y-o-y	*		-25.9%
New Home Prices	m-o-m	*		-0.65%
Used Home Prices	m-o-m	*		-0.80%

Source: Bloomberg, National Bureau of Statistics
* No consensus estimate available on Bloomberg.

4. **European Union consumer confidence is expected to improve slightly to -13.4 from -13.5.**

   EU consumer confidence has been negative every month since 1985. This month, confidence is expected to nudge marginally higher. Historically, a level of -17 represents the demarcation between rising and falling EU retail sales.

5. **Japanese inflation is expected to accelerate marginally on a y-o-y basis.**

   Headline inflation in Japan is expected to accelerate to 3.0% y-o-y from 2.8% in July, while core inflation (ex-fresh food) is expected to rise to 2.8% from 2.7%. Core-core inflation (ex-fresh food and energy) is expected at 2.0% y-o-y, up from 1.9% in July.

6. **The Bank of Japan (BoJ) is expected to hold policy constant.**

   Markets are pricing zero chance of a rate hike at the 20 September BoJ meeting with 9 bps of total rate increases by year end.

7. **The Bank of England (BoE) is expected to hold rates constant at its 19 August meeting.**

   Markets ascribe a 15% chance of a 25-bps rate cut next week with 47 bps of rate cuts by year end. Investors will be watching for any signals regarding the November BoE meeting.

8. **UK CPI is expected to increase 0.2% m-o-m and 2.2% y-o-y.**

   While m-o-m inflation is expected to pivot back to positive territory from -0.2% in July, y-o-y inflation is expected to be unchanged. Services CPI, which rose 5.2% y-o-y in July and remains stubbornly high, is the most important metric to watch in this report.

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