MORNING BRIEFING
February 15, 2023

On Consumer Inflation & Housing Activity

Check out the accompanying chart collection.

Executive Summary: Yesterday's CPI report for January showed inflation continuing to moderate but slowly. The new information isn't likely to moderate Fed officials' hawkishness, though, and doesn't much change the economic outlook. We continue to see a soft landing with disinflation as the Fed continues to raise the federal funds rate to 5.10%, then keeps it there through year-end. So the stock-market implications of the CPI results are minimal. But stocks and bonds might be ready for some consolidation after their runups since October. … Also: Melissa homes in on why home prices have been holding up and looks at housing market trends.

US Inflation: Moderating Slowly. January's CPI release yesterday showed that inflation is continuing to moderate, though perhaps more slowly than it did during H2-2022. Fed officials are likely to remain hawkish. It's unlikely that the latest inflation report will turn any of them more dovish; a few may turn more hawkish and start talking about a higher terminal federal funds rate. The FOMC's December 2022 Summary of Economic Projections (SEP) showed a median forecast of 5.1% for the end of this year, falling to 4.1% in 2024 and 3.1% in 2025. (See our *FOMC Economic Projections*.)

The next SEP will be released on March 22. A lot can happen between now and then. For now, we expect that the majority of the FOMC members will continue to favor incremental rate hikes of 25bps during the March and May meetings of the committee. We also still expect them to pause after the federal funds rate range is raised to 5.00%-5.25% at the May meeting. That's because we expect that level will be restrictive enough that the headline PCED inflation rate will continue to moderate from 5.0% during December to 3.0%-4.0% as the year progresses (*Fig. 1*). Let's review the latest CPI report:

(1) *Headline & core.* The headline and core CPI rose 6.4% y/y and 5.6% through January down from 6.5% and 5.7% during December (*Fig. 2*). The FOMC's SEP focuses on the headline and core PCED, which were up 5.0% and 4.4% in December. January's update will come out on February 24.

(2) *Goods.* The CPI for all consumer goods rose 4.5% y/y in January, down from 4.8% in December and down from the March 2022 peak of 14.2% (*Fig. 3*). Consumer nondurable

goods prices edged up to 7.5% in January, down from last year's peak of 16.2% during June (*Fig. 4*). Consumer durable goods inflation peaked at 18.7% last February and was down to -1.3% in January (*Fig. 5*). Fed Chair Jerome Powell recently remarked that consumer goods prices are disinflating. They certainly are doing just that.

(3) *Services.* On the other hand, CPI services inflation mostly remains sticky. In some services industries, rates haven't peaked at all but continue to rise. Fed officials acknowledge that much of the stickiness of rent inflation is attributable to the way this category is measured in the CPI. Inflation in new rental leases has been falling sharply since mid-2022. The CPI's rent categories rose to new highs during January, although their three-month annualized rates have stabilized over the past five months (*Fig. 6*).

The Fed's focus in recent months has been on core PCED services inflation excluding housing costs. Fed officials are troubled that it has been stuck around 4.0%-5.0% over the past year (*Fig. 7*). The CPI version of this series didn't provide any relief. It was up 6.1% y/y during January, only slightly below its 2022 near-record high of 6.6% during September. It was mostly boosted by transportation services (14.6%), recreation (5.7%), and other personal services (5.3%) (*Fig. 8*).

(4) *Market implications.* We have been in the disinflation soft-landing camp for a while. Our outlook has been relatively in sync with the FOMC's SEP scenario. As a result, we've followed the SEP's guidance (and Powell's) that the federal funds rate would be raised to 5.10% early this year and remain there through year-end. We don't believe that yesterday's CPI report changes that outlook significantly. Furthermore, we still believe that the S&P 500 bottomed on October 12 of last year and that the 10-year Treasury bond yield peaked at 4.25% on October 24 of last year. We've had nice rallies in both stocks and bonds since then. Both may be due for some consolidation.

We asked Joe Feshbach, our trading consultant, to update his views on the stock market. He reiterated his comments from last week: "The sentiment indicators were not supportive enough of a major breakout, but more in line with a breakout that would fail. The corrective process I anticipated is underway and will be resolved either through time or lower prices. I reiterate that price strength should be used as an opportunity to pare back holdings."

US Housing I: Sticky Prices. During 2022, housing sales volume dropped as mortgage rates rose above 7.0% and affordability plummeted. The high rates of housing price inflation triggered by the pandemic have declined along with sales volume. Yet price levels haven't dropped much, remaining sticky owing to constrained supply. Melissa and I expect that housing supply-side dynamics will continue to support housing prices at least until mortgage rates normalize.

The supply of new and existing homes on the market is tight for a couple of reasons: Even if mortgage rates fall this year to nearly 5.0%, as expected by the National Association of Realtors (NAR), that's still too high to entice many potential home sellers carrying mortgages at rates around 3.0% to consider putting their homes on the market. Rates of 3.0% and lower were the norm from mid-2020 through the end of 2021. And keeping the supply of new homes on the market tight has been the trend of underbuilding that began even before the pandemic. Many homebuilders have lowered their prices from the pandemic peak, however.

Here's more on where home prices are at now:

(1) *Existing single-family home price inflation drops.* Based on the 24-month percent change, the median existing single-family home price inflation rate rose to an all-time record high of 45.0% during May of last year, at the height of the pandemic housing boom, falling to 18.8% in December 2022 (*Fig. 9*).

(2) *New home single-family price inflation falls, too.* Median new home inflation has fallen to 14.7% y/y (based on the 12-month moving average) in December from a recent peak near 20.0% in April 2022 (*Fig. 10*).

(3) *New and existing single-family home prices remain sticky.* Even with the latest slowdown in housing price increases, the 12-month moving average for new home prices still topped a record $450,000 in December 2022 (*Fig. 11*). Existing home prices neared a record $400,000 for the equivalent series.

US Housing II: Turning Point. Some would-be homebuyers who walked away from the housing market last year may be starting to come back. Melissa and I doubt that the few signs of increased activity presage a strong resurgence in housing demand, but we don't see a continuation of last year's bust ahead either.

Let's take an updated tour of the housing market data:

(1) *Mortgage rates take a breath.* The 30-year fixed mortgage rate probably peaked in October at its 20-year high of 7.41%, up from 2.83% in February 2021. It since has dropped to 6.72% as of February 13 (*Fig. 12*). As rates have dropped, mortgage applications to

purchase homes have started to move higher in recent weeks (*Fig. 13*).

(2) *Affordability is still squeezing buyers.* Home price increases may be trending down. But housing affordability remains challenging. The NAR's Housing Affordability Index sank below 100.0 to 91.3 during October. It moved up in December to 101.2 (*Fig. 14*).

(3) *Green shoots.* Existing home sales continued to drop through December. But pending home sales edged up in December by 2.5% after a six-month drop of 24.7% (*Fig. 15*).

Traffic of prospective new homebuyers sank during November nearly to 2020 lows, according to the National Association of Homebuilders' Housing Market Index (*Fig. 16*). It since has also edged up in response to lower mortgage rates and housing inflation.

(4) *Homes for sale mixed.* Continuing to support prices, the months' supply of existing homes on the market remained puny at 2.9 months during December (*Fig. 17*).

New homes inventories, conversely, have been holding at around a nine months' supply, up from a pandemic low near three months' (*Fig. 18*). Homebuilders aiming to take advantage of the pandemic buying spree were stuck with completed homes that couldn't be sold as mortgage rates were rising.

Housing starts and permits both dropped in December as builders pulled back to wait out the market (*Fig. 19*).

US Housing III: The Road Ahead. The housing market's next big turning point will come when the Baby Boomers finally downsize into more manageable spaces or assisted living facilities over the coming years. That will leave younger generations to support single-family home demand. They haven't aspired to homeownership as older generations have and aren't having as many children. So smaller and more affordable housing will likely be most in demand.

In response to these demographic trends, builders are moving on the multifamily market. While multifamily housing is *forecast* to be oversupplied for the next few years, that situation should be short-lived. Consider the following:

(1) *Boomers graying.* By 2034, the elderly will outnumber children for the first time in US history, according to Census Bureau projections. There's an estimated 70 million Baby Boomers (born from 1946 to 1964) in the US. By 2030, all Boomers will be at least 65 years

old. The ranks of over-65 people grew rapidly last century, from 3 million in 1900 to 35 million in 2000, *according* to the Census Bureau. Their share of the population is expected to continue to grow, reflecting longer lives and record-low birth rates.

Many Baby Boomers have chosen to "age in place," a trend that the pandemic further supported. But their sheer numbers suggest rising demand for other forms of senior housing as well, such as senior living communities and multifamily living.

Recent market *commentary* from Fannie Mae observed that it takes years to develop institutional seniors housing facilities, but the seniors housing industry will likely "not be growing its inventory at rates approaching the speed its target population will be growing over the forecasted period."

(2) *Millennial buyer blues.* Millennials (born 1981-96) are now 27-40 years old. The 62 million cohort is now at or above prime homebuying age (early 30s). Millennials entered the labor force during a difficult recession spurred by the housing crisis. Now they're entering the housing market at a time when affordable housing is in short supply, because of both the pandemic-induced trends discussed above and Baby Boomers' desire to hang onto their homes for as long as possible. As a result, the share of first-time homebuyers hit an all-time low of 26% in 2022, down from 31% in 2021, according to NAR.

Calendars

US: Wed: Retail Sales Headline, Core, and Control Group 1.8%/0.8%/0.8%; Business Inventories 0.3%; Empire State Manufacturing Index -17.75; Headline & Manufacturing Industrial Production 0.5%/0.8%; Capacity Utilization Rate 79.0%; NAHB Housing Market Index 37; TIC Net Long-Term Transactions; Crude Oil Inventories & Gasoline Production. **Thurs:** Headline & Core PPI 0.4%m/m/5.4%y/y & 0.3%m/m/4.9%y/y; Philadelphia Fed Manufacturing Index -7.4; Housing Starts & Building Permits 1.36mu/1.35mu; Initial & Continuous Jobless Claims 200k/1.695m; Natural Gas Storage; Bullard; Cook; Mester. (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production -0.8%m/m/-0.7%y/y; Eurozone Trade Balance –€12.5b; Spain CPI -0.3%m/m/5.8%y/y; UK Headline & Core CPI 0.4%m/m/10.3%y/y & -0.5%m/m/6.2%y/y; UK PPI Input & Output 0.2%m/m/14.7%y/y & 0.1%m/m/13.3%y/y; Japan Core Machinery Orders 3.0%m/m/-6.0%y/y; Japan Adjusted Trade Balance; Japan Exports & Imports 0.8%/18.4% y/y; Australia Employment Change

20k; Australia Unemployment & Participation Rates 3.5%/66.6%; Lagarde. **Thurs:** ECB Economic Bulletin; De Guindos; Panetta; Lane; Nagel; Pill Lowe. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q4 Earnings Season Monitor (*link*): With the Q4-2022 earnings season approaching the three-fourths completion mark, it's becoming clearer that this is a relatively poor one as assessed by the four surprise metrics we measure for both earnings and revenues. Revenue and earnings surprises are deteriorating q/q due to the slowing economy, higher costs, and currency translation. With nearly 72% of S&P 500 companies finished reporting for Q4, revenues are ahead of the consensus forecast by just 1.3%, and earnings have exceeded estimates by only 1.8%. The surprises are tracking to be the weakest since Q4-2008 for earnings and since Q1-2020 for revenues. At the same point during the Q3 season, revenues were 2.2% above forecast and earnings had beaten estimates by 3.8%. For the 359 companies that have reported Q4 earnings through mid-day Tuesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings of Q2-2021 to Q3-2022. The collective y/y revenue gain for the 359 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 5.3%, and earnings are down 1.0% y/y as higher costs and increased loan-loss provisions continue to pressure profit margins. Just 68% of the Q4 reporters so far has reported a positive revenue surprise, and 70% has beaten earnings forecasts. Those are the weakest readings since the Great Virus Crisis in H1-2020. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q4 (61%) than positive y/y revenue growth (72%). These figures will change less markedly as more Q4-2022 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q4, earnings are expected to decline for the first time since Q2-2020.

US Economic Indicators

Consumer Price Index (*link*): Headline & core CPI yearly rates continued to cool in January, though the monthly gains picked up. The CPI rose 0.5% in January, after upticks of 0.1% and 0.2% the prior two months, while core prices rose 0.4% the past two months after gains of 0.3% the prior two months. The CPI *yearly rate* eased for the seventh month, from 9.1% last June (the highest since November 1981) to 6.4% this January, while the core rate eased to 5.6% last month after accelerating from 5.9% in both June and July 2022 to 6.6% by September—which was highest since August 1982. The rate for consumer durable goods (-1.3% y/y) fell further into negative territory in January, while the rate for consumer nondurable goods excluding food (4.6) continued to slow; the services' rate excluding energy remained on an accelerating trend, reaching 7.2% in January—with shelter costs particularly high. *Food costs* (10.1) eased for the fifth month from last August's 11.4%, which was the fastest pace since April 1979. Within food, the rate for food at home (11.3) slowed steadily from 13.5% last August—which was the highest since March 1979; the rate for food away from home eased from 8.6% y/y last October—the highest since fall 1981—to 8.2% by January. *Energy costs* continued to ease from last June's 41.6%, which was the fastest pace since April 1980, sinking to a 22-month low of 7.3% at the end of 2022; it accelerated 8.7% y/y in January. Within energy, the rate for fuel oil slowed to 27.7% y/y last month after blipping up from 58.1% in September to 68.5% in October; it reached a record-high 106.7% last May. The rate for gasoline prices rose 1.5% y/y during January, after slowing last year from 59.9% in June (fastest since March 1980) to -1.5% in December—which was the first negative reading since January 2021. The rate for natural gas prices accelerated for the second month to 26.7% after slowing sharply from last June's 38.4% (highest since October 2005) to an 18-month low of 15.5% in November. The electricity rate eased to a nine-month low of 11.9% y/y in January, after peaking last August at 15.8%—which was the highest since August 1981. The *consumer durable goods inflation* rate slowed for the 11th month, from 18.7% last February (highest since early 1940s) to -1.3% y/y by this January—the lowest since May 2018. The rate for new cars (6.3) was little changed in January, after easing the prior eight months from last April's near-record high of 13.2% to 6.2% by December, while the rate for used cars & trucks sank further into negative territory to -11.6% in January—the lowest since March 2009. It was as high as 41.2% last February and at a record-high 45.2% during June 2021. The rate for apparel prices edged up to 3.1% in January, after slipping to a 20-month low of 2.9% y/y at the end of 2022; before that, it fluctuated in a 5.0%-5.5% range from last April through September. It was at a recent peak of 6.8% last March—which was its fastest rate since the end of 1980. The rate for furniture & bedding (2.2) was down dramatically from last February's record high of 17.1%, while the rate for major appliances was -3.9% y/y, down from its recent peak of 12.4% last March. *Consumer nondurable goods inflation* ticked up to 7.5% y/y in January, after slowing the prior six months from 16.2% last June (which was the highest since the 1940s) 7.3% by December. *Services inflation* accelerated 7.6% y/y last month, which was the highest since the early 1980s. Within services, owners' equivalent and tenant-occupied yearly rates accelerated 7.8% and 8.6%, respectively, in January—up from recent lows of 2.0% and 1.8%—with the former at a new record high and the latter the highest since fall 1981. Over the three months through December, the owners' equivalent rent rose 8.5% (saar) and tenant rent 9.3%—exceeding their yearly rates. Meanwhile, the yearly rate for lodging away from home accelerated 7.7% y/y in January after bouncing around 3.0%; it was at a record high of 25.1% in both March and February of 2022. Turning to medical care, the yearly rate for hospitals' (3.6) services is bouncing in a volatile flat trend easing from 4.4% at the end of 2022, while the physicians' (1.7) services rate was down sharply from March 2021's 5.3% peak, though has moved up from its recent low of 0.5% during February 2022. Meanwhile, the yearly rate for airfares eased to 25.6% during January, down from 42.9% y/y last October (not far from the record high of 45.0% in September 1980); the three-month rate has been negative for the past six months.

NFIB Small Business Optimism Index (*link*): "While inflation is starting to ease for small business, owners remain cynical about future business conditions," said NFIB Chief Economist Bill Dunkelberg. "Owners have a negative outlook on the small business economy but continue to try to fill open positions and return staff to improve productivity." January's *Small Business Optimism Index* (SBOI) edged up 0.5 points in January to 90.3, after dropping 2.1 points at the end of last year. January's SBOI was below the 49-year average of 98.0 for the 13th consecutive month. The last time the index was at or above the average was December 2021 (98.9). In January, six of the 10 components of the SBOI increased while four decreased. Owners expecting better business conditions over the next six months (+6ppts to -45%) was the biggest positive contributor to the index, followed by current job openings (+4 to 45) and earnings trends (+4 to -26), with plans to increase employment (+2 to 19), now is a good time to expand (+2 to 7), and expected credit conditions (+1 to -8) minor contributors. Meanwhile, sales expectations (-4 to -14), plans to increase inventories (-4 to -8), capital outlay plans (-2 to 21), and current inventory (-2 to -1) were a drag on the SBOI. *Inflation* continued to be small business owners' single biggest problem in January but eased to an 11-month low of 26%, down 11ppts from last July's peak of 37% (which was the highest since Q4-1979. The net percentage of owners raising selling prices continued to ease, sinking to a 20-month low of 42% in January from a near-record-high 66% last March. Meanwhile, the net percentage of owners planning to increase selling prices ticked up to 29% last month from 24% in December—which was its lowest since percentage since December 2020; it was at a near record high of 52% last March. *Quality of labor* remained business owners' second biggest problem last month, at 24%, up from last November's 21% but down from November 2021's record high of 29%. A net 46% of owners reported raising compensation last month, up from its recent low of 40% last November but below its 50% record high at the start of 2022, while a net 22% plans to increase compensation in the next three months—a 20-month low and down from October 2022's 32%—which matched the record high posted the final two months of 2021.

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