

## **Sevens Report Alpha Webinar – Understanding CPI (Knowing When the Inflation Decline Begins)**

**September 15<sup>th</sup>, 2022**

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## A Brief History of CPI

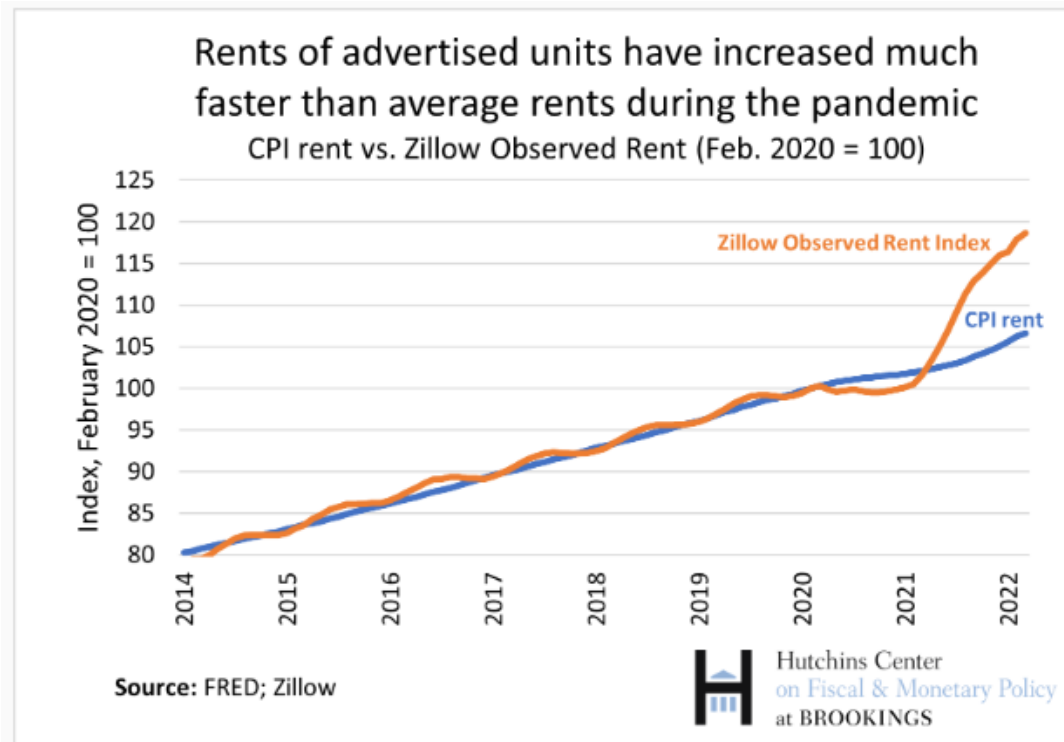
- First envisioned in the late 1800's.
- Became more structured in the early 1900's as a means of settling labor disputes.
- The initial point of what became CPI was to measure what the “cost of living” was during the early 1900's.
- This mattered because during that period there were frequent labor strikes, and the government wanted a way to determine a fair “living wage” and appropriate “costs of living increases” to settle the various labor disputes.
- The first “official” government CPI was released in 1919.

## CPI Composition

Category	Weight
Housing	42.4%
Transportation	18.2%
Food and Beverage	14.3%
Medical Care	8.5%
Education & Communication	6.4%
Recreation	5.1%
Other Goods & Services	2.7%
Apparel	2.5%

- Housing – the major component in CPI.
  - Housing is comprised of 33% “shelter” costs and about 9% utilities, furniture, etc.
  - “Shelter” is the cost of renting or owning a home, and it’s comprised mainly of “Tenant Rent” and “Owner’s Equivalent Rent.”
  - Tenant Rent measures the rental cost, plus utilities, of actively rented properties.
  - Owner’s Equivalent Rent is for homes that are occupied by the owner. It measures the rent the homeowner would have to pay to live in the same house.
  - The sample size is 50,000 residences, one-sixth of the sample is replaced each year, and a sample is taken every six months.

## Why is Housing A Problem in CPI?



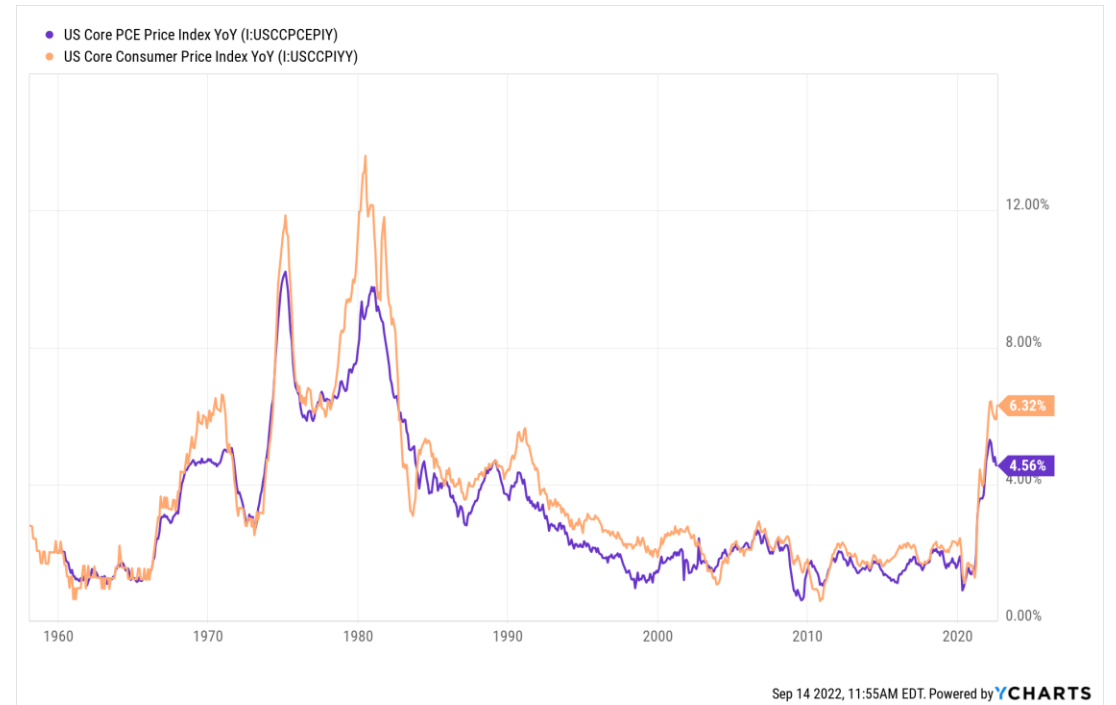
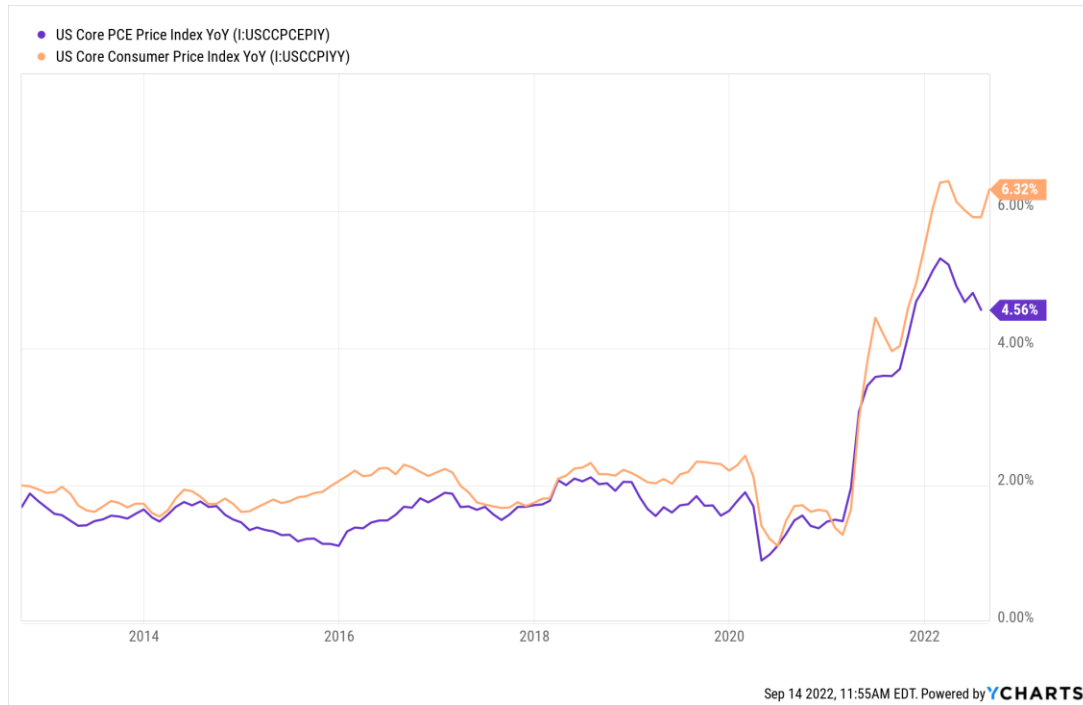
- CPI is notoriously slow to reflect increases in rents, seeing as they usually only occur when leases are up (usually annually).
- So, while CPI is measuring the “cost” of housing currently, it’s slow to reflect any sudden upward pressure – and that is why we are seeing housing metrics rise in CPI even though housing and rent prices have been elevated for well over a year.
- According to the Dallas Fed, OER (Owner’s Equivalent Rent) inflation takes about 16 months to reflect 75% of actual price gains.
- What’s it all mean?
  - The San Francisco Fed projects rent inflation will rise by 7%-ish in 2022 and 2023, which is double the five-year pre-pandemic average, and that will account for a 1.1% increase in CPI (all else being equal).
- Takeaway: Housing prices in CPI need to catch up with the real world, and this will support CPI even if “real” inflation is declining.

## CPI Composition

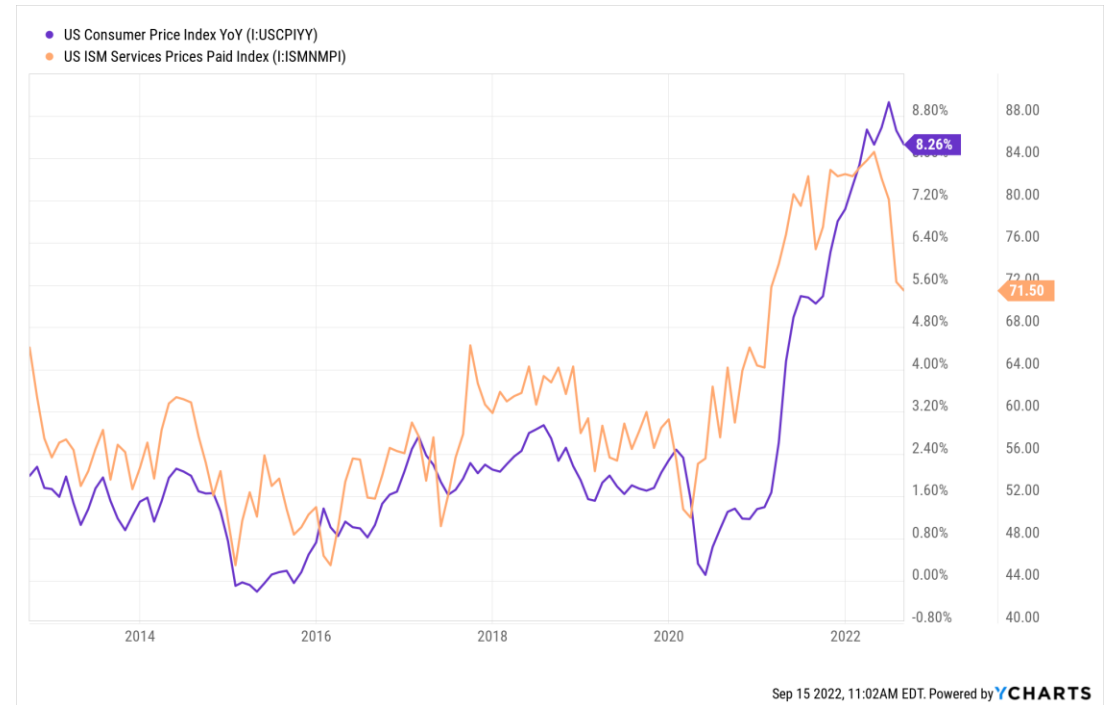
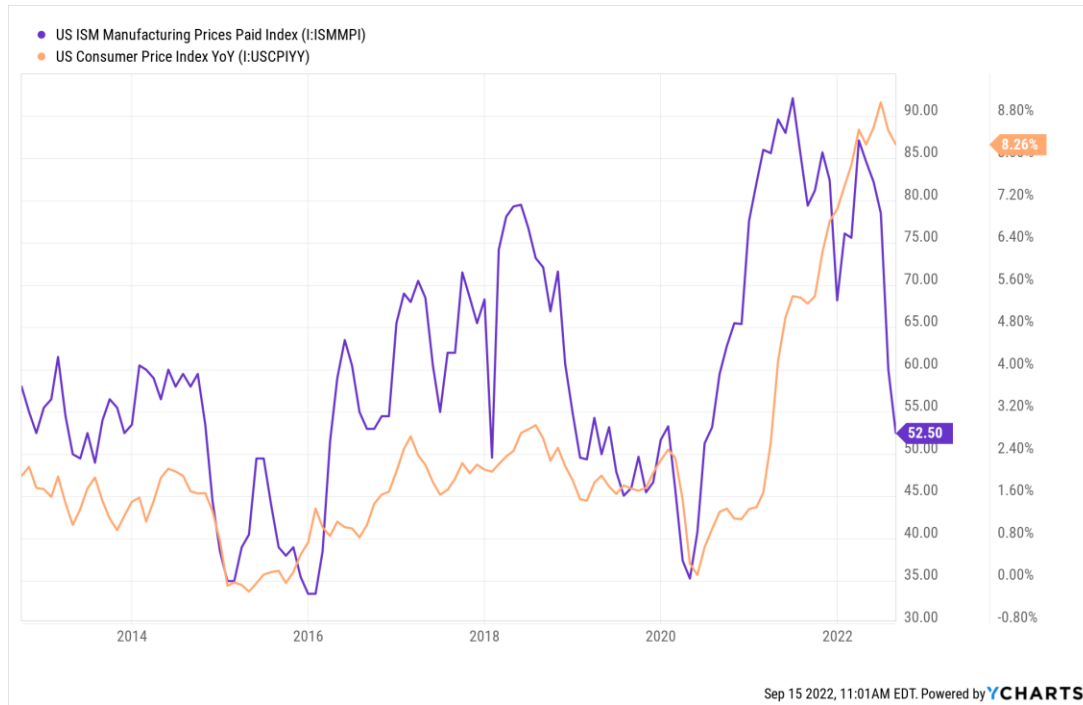
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- This was never about used cars or travel costs.
  - New and used motor vehicles make up 9.2% of CPI.
  - Travel costs, including airfare, food away from home, and hotel costs are well under 10% of CPI.
- It's not about energy, either.
  - Energy is split between transportation (gas) and housing (electricity) but combined makes up about 8% of CPI.
- The increase in CPI has been broad and deep, with different categories leading the charge at times (used cars, airfare, commodities, housing, etc).
- Takeaway: The rise in CPI hasn't been driven by one factor - it's been a rolling phenomenon. For prices to decline, we'll need to see a broad decline in aggregate demand, which means rising unemployment.

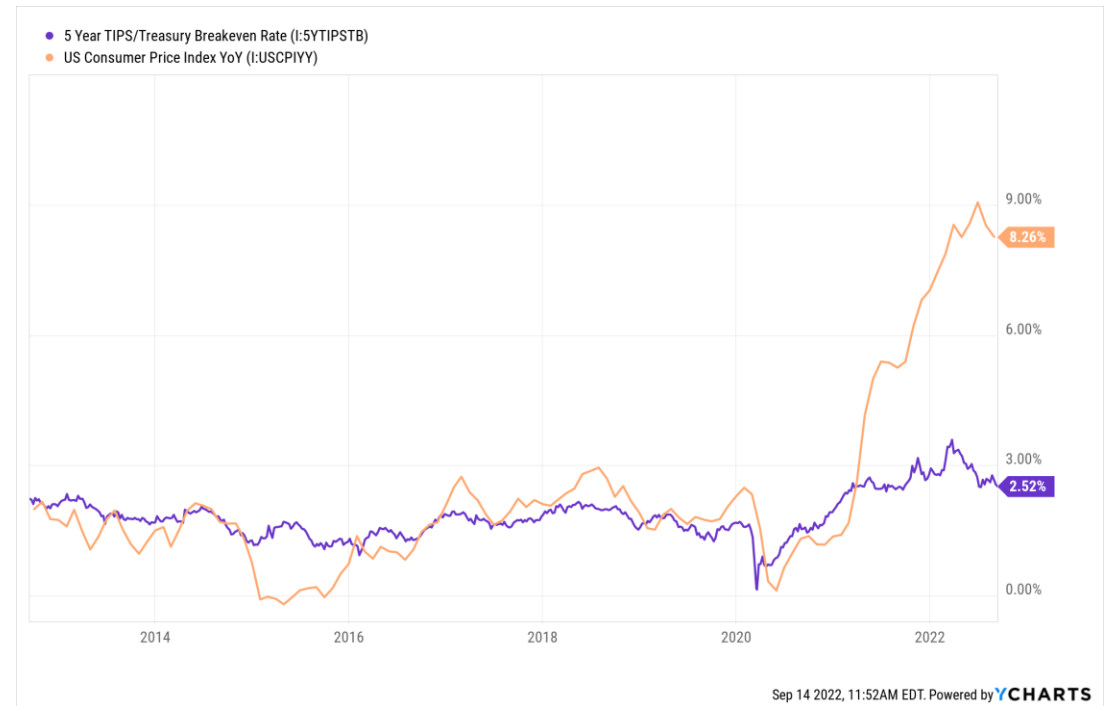
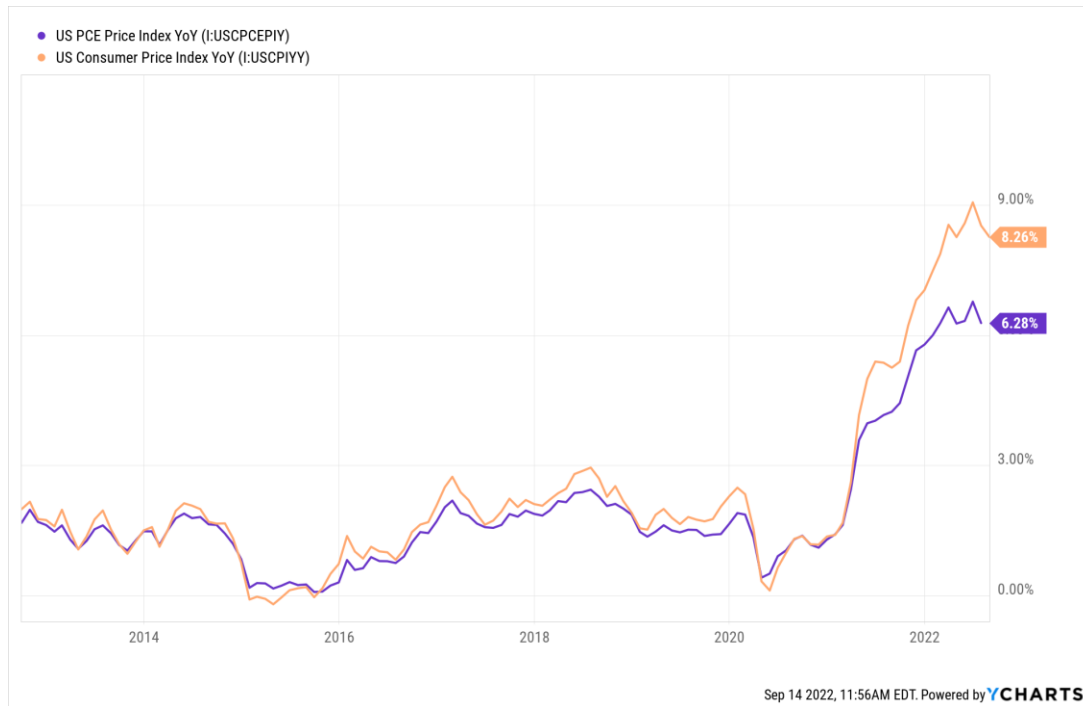
# What Are Other Inflation Metrics Saying?



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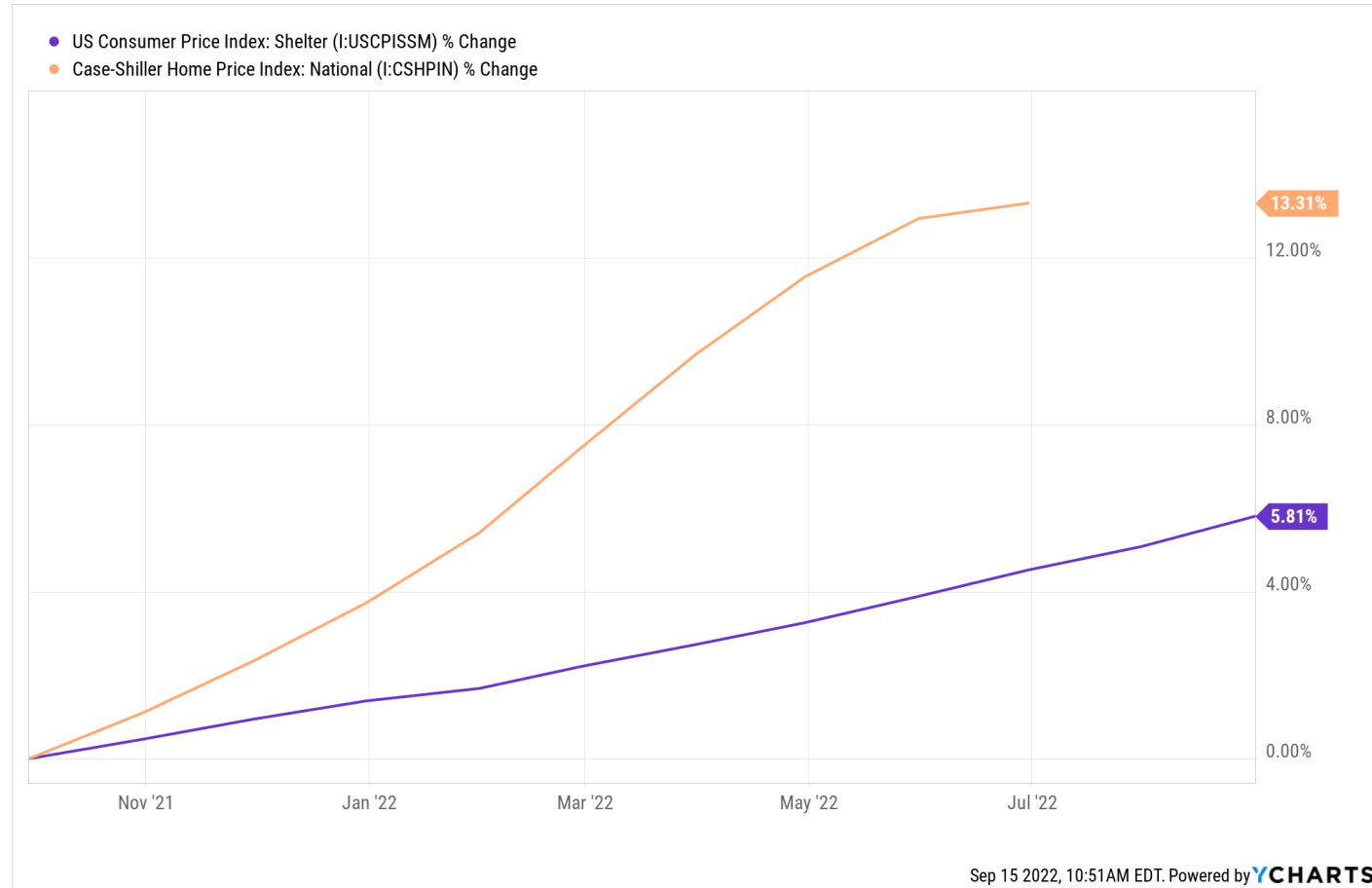


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## Takeaways – Key Prices to Watch

- CPI offers a delayed reflection of actual inflation pressures, mainly because of the lag in housing.
- Practically speaking, inflation has almost certainly peaked. But, any rapid decline in CPI will have to be driven by falling prices in 1) Housing and 2) Transportation, as those two factors make up more than 60% of CPI.
- With aggregate demand still strong and CPI reflecting housing on a multi-month lag, we shouldn't expect any steep drops in CPI in the near term.
- From a market standpoint, that means that high CPI will be a market headwind, although it likely won't make the Fed more hawkish.
  - We can't say we're at peak hawkishness until inflation is falling quickly. Prior to that, the Fed may well just "pause" the rate hike cycle, but that doesn't mean peak hawkishness (they can always hike again).
- Key metrics to watch:
  - Zillow Observed Rent Index
  - Case-Shiller HPI
  - Grocery Prices (Food at Home in CPI, anecdotal experience)
  - New & Used Car Prices (Manheim Used Vehicle Value Index)
  - Gas prices (AAA National Average Gas Prices)
  - Electricity costs (Household energy in CPI)
  - Airfare (Airline Fares in U.S. City Average, Consumer Airfare Index Report)
- When we see those prices stable or fall in our real lives, that will be a prelude to a steep drop in inflation, which will bring about "Peak Hawkishness" and ultimately a bottom in this market (and if we see these prices falling, we want to start to gradually add long positions).