NOVEMBER CPI RECAP: *NOW* CAN WE CALL IT "PERSISTENT?

Inflation has been a hot topic this year, and for a good reason. For months, central bankers have been telling us not to worry about "transitory" price pressures, but Federal Reserve (Fed) Chair Jerome Powell ditched the use of that word to describe inflation last week. So if it's not transitory, is it persistent? We say no.

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Friday's release of the November Consumer Price Index (CPI) report startled some investors. Headline CPI rose 0.8% month-to-month and 6.8% versus a year ago. You have to scroll back to 1982 to find a higher year-over-year headline CPI reading. Core CPI rose 0.5% in November and 4.9% since last November, the highest reading on the ex-food, ex-energy index since 1991.

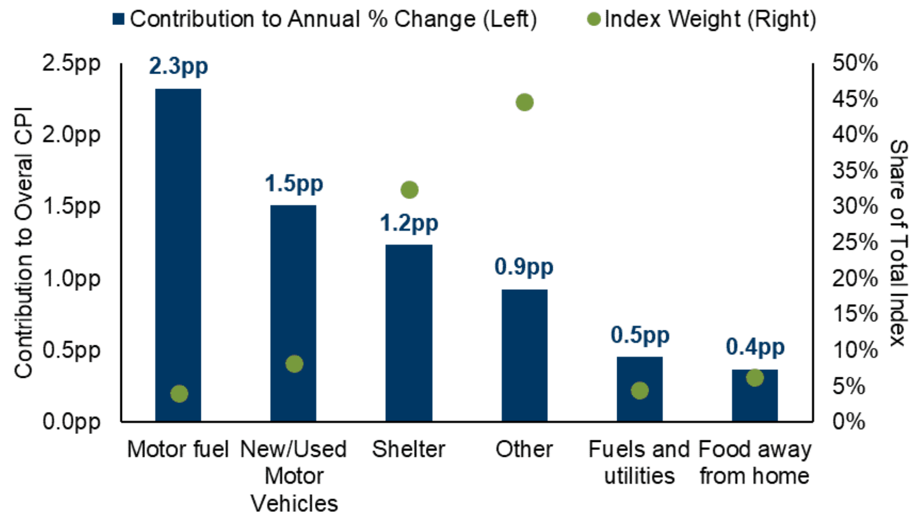
Not only has inflation been elevated, but it's also been elevated for a while. In fact, for eight consecutive months, both headline and core CPI have been above the 2.5% threshold—for core CPI, this was the longest above-2.5% stretch since 2006.

Yet the critical question for policymakers and investors is whether inflation is becoming more widespread and therefore more persistent? We confess, the transitory term no longer applies.

Further, in November, a broader array of price categories contributed to price gains. How do we know? The median price change in the CPI is now 3.5% year-over-year. Trimmed mean, which excludes the volatile outliers, also moved up to 4.6% year-over-year.

However, the good news in November is that just two categories explain the bulk of the rise in CPI over the last year: motor fuels and new & used cars together account for 3.8 percentage points of the 6.8% increase in overall inflation (**see chart below**).

Most of the CPI Print Can Be Attributed To Motor Fuel and New/Used Vehicles
5 Largest Contributors to November CPI Print



Source: Bureau of Labor Statistics

More good news is that the new and used car price situation remains uniquely pandemic driven. For example, new vehicle prices surged 11% in the last 12 months, something we haven't seen since 1975!

What about other key drivers of inflation? The shelter component is also rising, driven by owners' equivalents rent (OER), rents and lodging away from home. Historically, house prices impact CPI, but not on a 1:1 basis, and generally with a bit of a lag. For example, since 2000, every 1% increase in house prices has translated into 11 basis points in the Shelter component of CPI, with a 16-month lag, according to the White House Council of Economic Advisors (CEA). As a result, a 20% rise in house prices should boost Shelter CPI by roughly two percentage points, a process well underway.

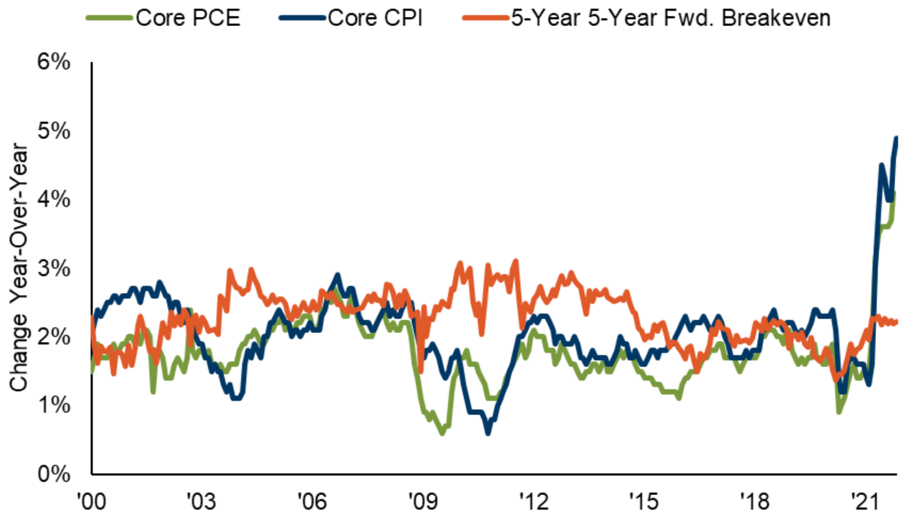
Does the shelter component confirm the price pressures we're seeing will prove to be more persistent or "sticky"? First, it's worth noting that the pandemic itself set off the sharp acceleration in house price growth. The pandemic inspired households to shift to the suburbs, with historically low mortgage rates as an added incentive. At the same time, according to Realtor.com, housing inventory as measured by active listings has shrunk by 50% since pre-Covid! Like so many other sectors affected over the last two years, a supply shortage in the face of a sharp demand spike boosted prices dramatically.

Further, as mentioned above, headline and core CPI have exceeded 2.5% for eight months. However, and importantly, CPI is *not* what the Fed targets. So despite the media and investor attention on Friday's November CPI report, PCE is in the Fed's crosshairs. But that doesn't mean we can ignore CPI. Typically, core PCE runs about 30-50 basis points below core CPI, implying we can expect a 4.5% core PCE print for November when the data is released—well above the Fed's 2% target and policymakers' forecasts. That said, some components, like shelter, have a much smaller weight in core PCE. For example, shelter averages 18%, compared to 40% in core CPI, implying less pass-through from house prices.

In short, inflation has been higher than expected for longer than expected. However, as we've argued above, the key drivers are still pandemic-driven and could change as the pandemic abates. In the end, to gauge whether inflation pressures witnessed in November will prove to be persistent, one needs to examine the underlying drivers of each category, not just rely on simple, top-down metrics.

Well-Anchored...For Now

Core PCE, CPI Versus Market Based Inflation Expectations



Source: Bloomberg, BEA, BLS

Adding to the uncertainty, we don't know how policymakers view the underlying data. Aside from the egg-on-their-faces forecast errors as well as a poor choice of words ("transitory"), policymakers fear "unanchored" inflation expectations the most. Fortunately, inflation expectations remain pretty well anchored (**see chart above**) despite the discussed inflation surge to date.

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