Instant Insights - **Sticky CPI Situation**

Inflation once again surprised to the upside. Headline CPI came in slightly above expectations at 8.2%, vs 8.1% expected. However, core CPI unexpectedly reached a new 40-year peak at 6.7%. Core services continued their march higher, which is a headache for the Fed, as these tend to be the "stickiest" CPI sectors.

Core CPI will likely be the Fed's clear focus from here. Bringing it down will require a forceful hand. A 75bp hike in November and at least another 50bp in December is likely in our view. We believe credit investors need to be diligent and focus on compelling yield opportunities within resilient names and prepare for more volatility.

Sticky CPI sectors continue to march up

Flexible CPI sectors contributed negatively again on a month-on-month basis. Energy prices fell for the third straight month and were once again the largest detractor in the index. Related sectors such as used cars, apparel and airfares also continued to fall. Meanwhile, the sticky sectors continued their steady march higher.

Figure 1: The "sticky" sectors are now driving CPI, causing a tough environment for the Fed[1]

	Core (sticky)		Core (flexible)			Non-Core (flexible)	
	Health services	**Owners' Equivalent Rent**	**Airfare**	**Used Cars**	**Apparel**	**Food**	**Energy**
12-month Average	**0.5%**	**0.5%**	**2.6%**	**0.5%**	**0.4%**	**0.9%**	**1.6%**
May-22	0.4%	0.6%	12.6%	1.8%	0.7%	1.2%	3.9%
Jun-22	0.7%	0.7%	-1.8%	1.6%	0.8%	1.0%	7.5%
Jul-22	0.4%	0.6%	-7.8%	-0.4%	-0.1%	1.1%	-4.6%
Aug-22	0.8%	0.7%	-4.6%	-0.1%	0.2%	0.8%	-5.0%
Sep-22	**1.0%**	**0.8%**	**0.8%**	**-1.1%**	**-0.3%**	**0.8%**	**-2.1%**

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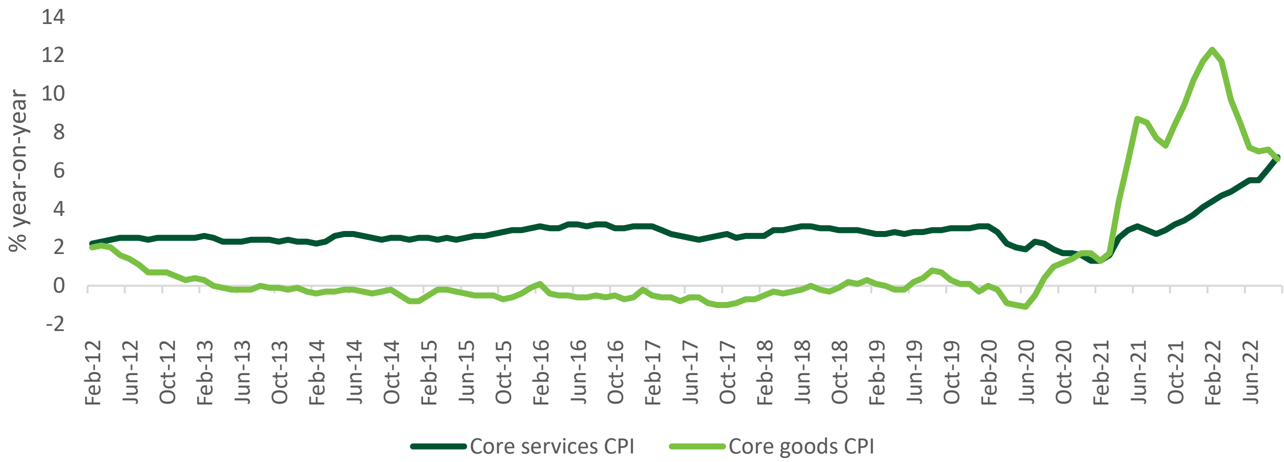
Core services CPI now contributes more than goods CPI

Outside the historically volatile "non-core" food and energy categories, goods inflation is clearly falling faster than services inflation is rising (Figure 2), which may offer some comfort to the Fed.

[1] Bureau of Labor Statistics, October 2022

Figure 2: Falling core goods inflation offers some comfort to the Fed[2]



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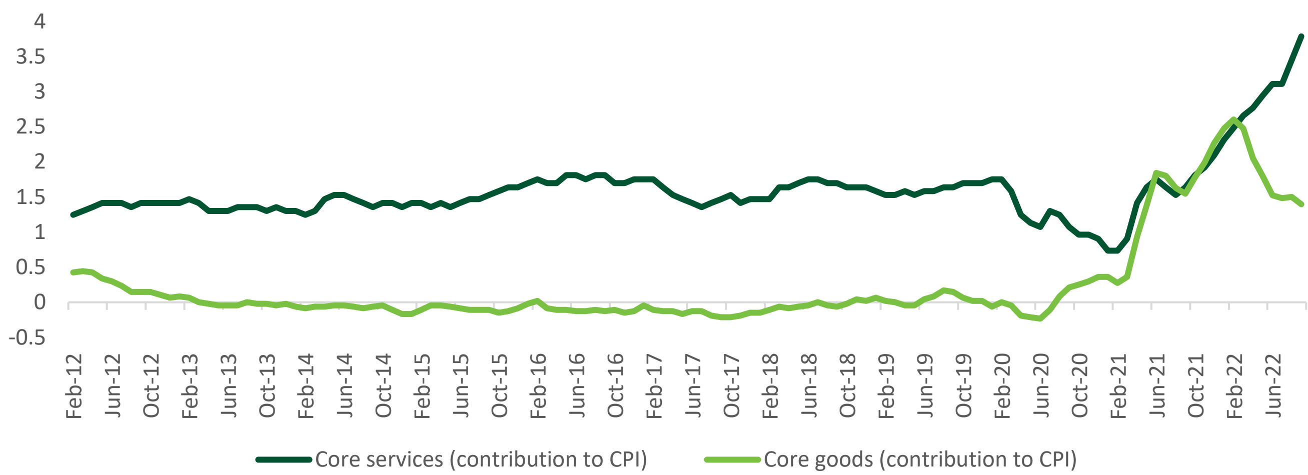
However, far less comforting is the fact that core services have over double the weighting of core goods in the CPI index (at 57% versus 21%). When taking the higher weighting into account, services inflation is rising about as fast as goods inflation is falling (Figure 3).

Figure 3: Core services are now contributing more inflation than goods[3]



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This means that even if goods inflation falls faster, it is unlikely to be enough to bring core CPI down in the near term. Core services contain most of the “sticky” sectors, which will make achieving the Fed’s 2% target particularly difficult.

Nonetheless, there are at least some signs that that core goods inflation will continue to fall, and at least will not add to the Fed’s problem. Supply chains continue to show signs of untangling. Yesterday’s PPI report came in hotter than expected, except for core goods. Further, a digital inflation index, maintained by software company Adobe Inc.[4], showed that online goods (particularly electronics) moved into deflation on a monthly basis for the first time since the pandemic.

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[2] Bureau of Labor Statistics, Insight calculations, October 2022

[3] Bureau of Labor Statistics, Insight calculations (using current CPI weights), October 2022

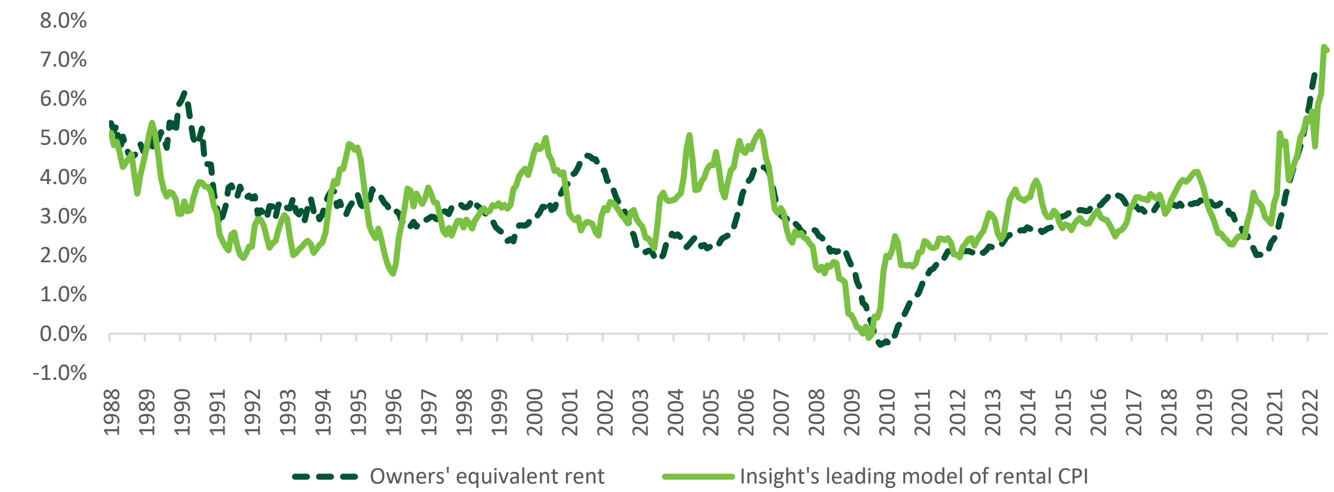
[4] Adobe, October 2022

We believe that rents are the major headwind to relief in services inflation

Within core services sectors, our focus (as we have long stressed) is squarely on the rental component of CPI, which comprises over 30% of the CPI index.

In March, we modelled rental inflation with a 6-month lead using home prices, disposable incomes and mortgage rates. Refreshing the model, we find it has done a good job of projecting rental inflation since then (Figure 4). However, over the next six months it indicates rents will accelerate further (Figure 4).

Figure 4: Insight's rental model indicates that rental inflation (and thus core services) will rise further[5]



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We also explained in the paper that rental CPI tends act as something of an anchor for Core CPI overall, with a good rule-of-thumb being that rental CPI runs about one percentage point higher. This implies that the center of gravity for Core CPI over the next six months will be 5% to 6%, still well above the Fed's target and imply painfully slow progress.

However, there are some signs that, beyond six months, rental inflation may fall. Last week, the Bureau of Labor Statistics authored a new working paper on its rental index. The authors also found that rental CPI tends to directionally lag private rental indices maintained by firms like Zillow and CoreLogic by about a year. Zillow's rental index has been slowed from ~17% to ~11% since March[6] (the measures are higher than rental CPI due to a focus on leases for new tenants rather than those paid by all tenants), which implies rental CPI could fall into Q2 next year.

Energy CPI remains a risk, but if oil stays below $100/barrel it may not be a threat

The three-month negative energy CPI run will likely end next month as global oil prices have inched back up in recent week (albeit still well below $100 per barrel). This has allowed unleaded gasoline prices to snap 98 consecutive daily price falls, although prices are still 22% down from their summer peak of $5/gallon, and only 8% higher than they were just before Russia invaded Ukraine.

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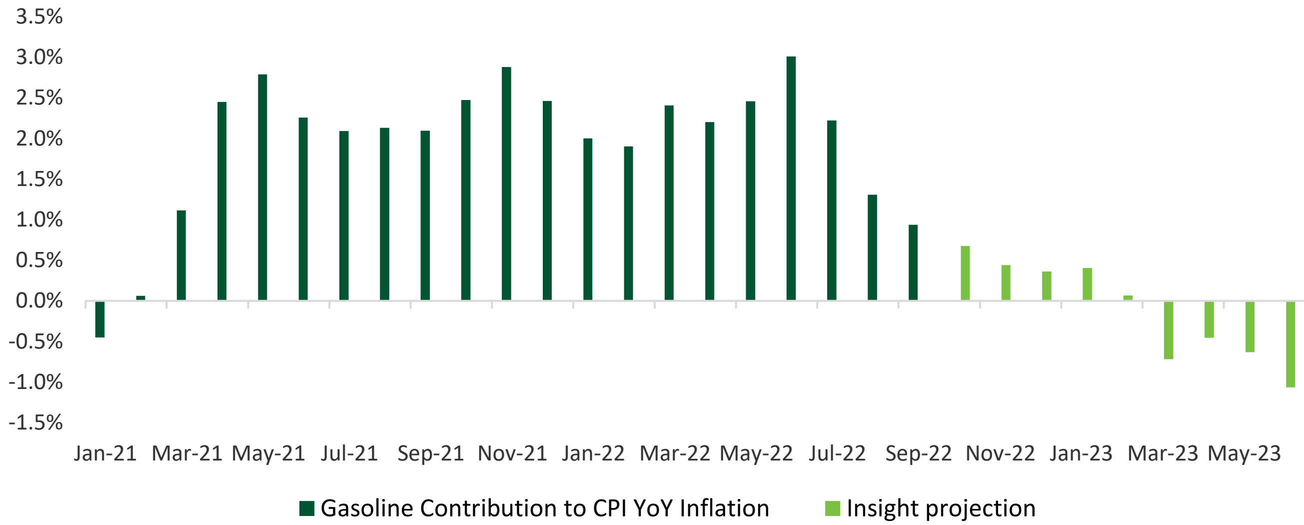
[5] Insight calculations, October 2022. WHERE MODEL OR SIMULATED RESULTS ARE PRESENTED, THEY HAVE MANY INHERENT LIMITATIONS. MODEL INFORMATION DOES NOT REPRESENT ACTUAL TRADING AND MAY NOT REFLECT THE IMPACT THAT MATERIAL ECONOMIC AND MARKET FACTORS MIGHT HAVE HAD ON INSIGHT'S DECISION-MAKING.

[6] Zillow, Bloomberg, October 2022

Politics will add uncertainty, as OPEC has cut production by two million barrels a day to shore up oil prices and the Biden administration is reportedly once again considering tapping into strategic reserves. However, if oil remains below $100/ barrel, we expect gasoline to have a negative year-on-year contribution to CPI by mid-2023 (Figure 5), but more disruption from rising prices cannot be ruled out.

Figure 5: Global oil prices will turn negative next year, but it depends on oil prices staying below $100 per barrel[7]



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The Fed's focus will be on core CPI

With Core CPI moving in the wrong direction and headline CPI still above 8%, the Fed will remain emboldened to raise rates to continue its fight against inflation. In our view, the Fed's main hope for bringing inflation back to target is to ensure core services CPI does not become entrenched. That will require restrictive policy.

According to the Fed's "dot plot" in September, the committee's median expectation is for 150bp of hikes into year-end. We believe a 75bp hike in November is essentially a done deal, with the main question being is if it will be followed by a 50bp or 75bp hike in December. At present, we expect to see 50bp in December, albeit it will depend on data in the interim.

This means credit investors need to prepare for continued uncertainty and potential volatility. We believe investors need to stick to resilient credits and ensure careful sector and security selection. We see the most compelling value in credits that are "secular winners" or those that are benefiting from the reopening of the economy. The rising yield environment now offers potentially compelling income opportunities for diligent investors.

[7] Bureau of Labor Statistics, September 2022

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The **Consumer Price Index** (**CPI**) measures change over time in the prices paid by consumers for a representative basket of goods and services.

Flexible CPI is calculated from a subset of goods and services included in the CPI that change price relatively frequently. Sticky CPI is calculated from a subset of goods and services included in the CPI that change price relatively slowly. Core CPI is a measure of the average change overtime in the prices paid by urban consumers for a market basket of consumer goods and services, excluding food and energy.

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