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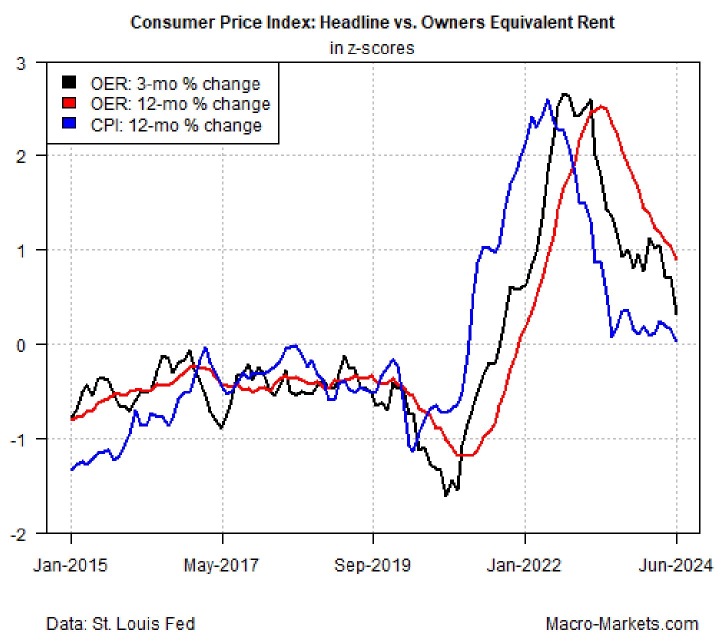
Real estate disinflation is a key factor for rate cuts

Key Points:

- *Shelter costs are a key component of consumer inflation*
- *Disinflation has strengthened recently for shelter costs*
- *The declining growth rate for shelter costs provides the Federal Reserve with more support for cutting rates*

Among the key reasons that the Federal Reserve has been reluctant to cut interest rates: sticky housing inflation. But recent data suggests shelter costs have not only peaked, but that the pace of disinflation may be picking up. The shift gives the Federal Reserve more support for cutting interest rates.

Recall that consumer inflation peaked in mid-2022 for the year-over-year change in the consumer price index (CPI). For much of the subsequent 12 months through mid-2023 the slowing rate of inflation convinced the financial markets that the central bank would soon start unwinding its sharp, swift run of rate hikes. But starting in the second-half of 2023, the slide in the inflation trend stumbled and so-called sticky inflation emerged. In due course, expectations faded that the Fed would soon cut rates.

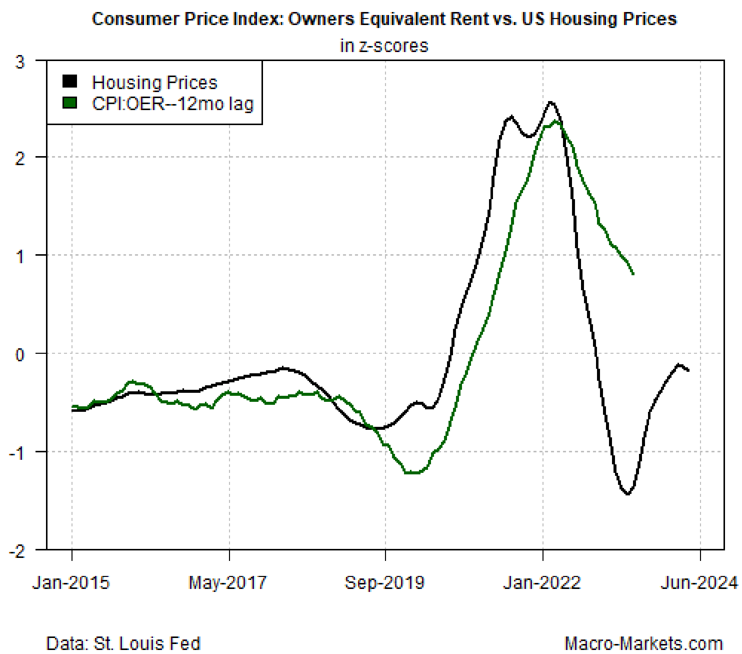


One reason that inflation generally stopped falling: housing inflation continued to strengthen, based on owners' equivalent rent (OER), which the Bureau of Labor Statistics calculates to estimate the equivalent for rent as a proxy for owning a property. Shelter costs overall represent roughly 36% of CPI, and the biggest input within shelter costs by far is OER, which comprises about 27% of CPI overall. In sum, OER casts a long shadow over the inflation trend. The fact that sticky OER inflation appears to be giving way recently implies that a key obstacle to Fed rate cuts is fading.

As shown in the chart at right, the 3-month change in OER through June (black line) has dropped sharply. That's an encouraging indicator for expecting that the recent slide in CPI's annual pace will ease further, and perhaps at a faster rate, in the months ahead. (Note: the changes in the chart are cited in z-scores, which allows for easier visual comparisons in a chart by putting all the data sets on a comparable scale.)

Comparing the annual change in housing prices (S&P CoreLogic Case-Shiller US National Home Price Index) vs. 12-month lagged OER inflation suggests that the recent slide in real estate prices will likely continue to cast a hefty disinflationary influence in the months ahead.

Sticky inflation risk due to shelter costs, in short, are fading, perhaps rapidly. That alone may or may not convince the Fed to cut rates, but it helps, in large part because it's a new trend that, until recently, was missing on the US inflation landscape.



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