

Bellwether

Chart FOR Thought

Shelter CPI Analyzed

Resurgence of Inflation Shifting Market Expectations

March 2024 CPI and core CPI¹ inflation came in slightly higher than expected at 0.6% m-o-m (3.5% y-o-y) and 0.5% m-o-m (3.8% y-o-y), respectively². Shelter costs continued to rise, at 0.6% m-o-m (5.7% y-o-y), up from 0.5% m-o-m reported in February². Over the last 12 months, shelter cost was the largest contributor to core CPI, accounting for nearly 60% of the total increase of 3.8%².

Hotter-than-expected inflation was a trend throughout 1Q 2024, with 3-month annualized CPI and core CPI at 7.3% and 6.6%, respectively². This resurgence in inflation has dramatically shifted market expectations for interest rate cuts. At the beginning of 2024, the market was pricing in six to seven rate cuts for the year. After three consecutive months of elevated inflation, the market is now pricing in only one to two rate cuts in 2024³.



Shelter CPI Flawed Methodology

Shelter cost is the largest CPI category, making up over 36% of the calculation weighting. Specific components include:

Shelter Cost Components	Headline CPI Weight ⁴	% of Shelter Cost
Owners' equivalent rent of primary residence	26.7%	73.8%
Rent of primary residence	7.6%	21.1%
Lodging away from home	1.4%	3.9%
Tenants' and household insurance	0.4%	1.1%
Shelter Cost	36.2%	100.0%

The main component, owners' equivalent rent of primary residence ("OER"), makes up roughly 74% of shelter cost or just over a quarter of the CPI calculation weighting. As noted by the BLS, the determination of OER relies on the hypothetical and subjective survey question below, which is asked to consumers who own their primary residence:

"If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?"⁵

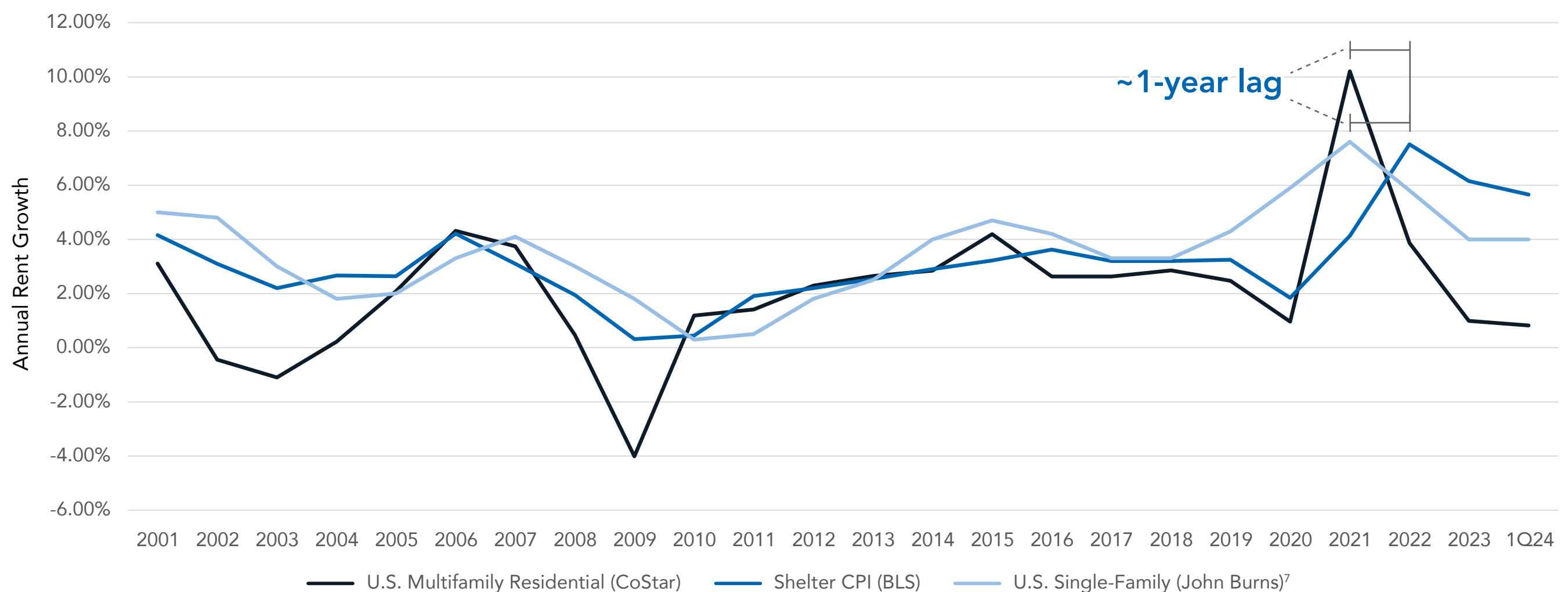
To emphasize, this means that just over a quarter of the CPI calculation (i.e., OER) relies on consumer answers to a hypothetical and subjective survey question rather than utilizing actual rent data, which is abundantly available, well-measured, and easily accessible.



Shelter CPI Lags Other Real-Time Indexes

According to the Federal Reserve Bank of Dallas, shelter CPI lags measures of market rents by roughly a year “because the CPI considers rents for all tenants, reflecting leases signed over the past year or so, and only gradually shows changes in market rents as leases are renewed.”⁶

U.S. Annual Rent Growth for Selected Indexes



As seen in the chart above, the recent peak in shelter CPI lags the U.S. multifamily and single-family residential (“SFR”) rent growth indices by roughly a year. However, that relationship among the indices in prior periods is less observable. Further, the level of shelter CPI more closely tracks SFR rent growth over time (due to OER’s 74% weighting), but relative to recent history, the variance between all three indices has become much larger post-2020. This brings into question the reliability of shelter CPI (36% of CPI) and, therefore, CPI.

Conclusion

All else equal, the inherent lag in shelter CPI causes CPI to remain muted for longer during periods of rising rents and remain elevated for longer during periods of falling rents. As a result, this may mislead policymakers and investors, especially during economic crises, when the cost of decision-making is highest. The post-2020 increase in the variance of multifamily and SFR rent indices compared to shelter CPI further exacerbates the problem.

Ultimately, the combination of shelter CPI's lag effect and its deeply flawed calculation methodology largely decreases the utility of CPI for global investors, central banks, and citizens.

Since U.S. CPI inflation majorly influences global monetary policy, asset allocation, and U.S. Treasury bond rates (i.e., global risk-free rates), will the shelter CPI calculation methodology ever be enhanced to utilize actual rent data?



Endnotes

1. All items less food & energy
2. Bureau of Labor Statistics (Not Seasonally Adjusted)
3. Federal funds futures probability as of May 9, 2024
4. As of March 31, 2024
5. <https://www.bls.gov/cpi/factsheets/owners-equivalent-rent-and-rent.htm>
6. <https://www.dallasfed.org/research/economics/2023/0620>
7. As of February 29, 2024

