RATHBONES

GIMME SHELTER

REVIEW OF THE WEEK
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HOUSING COSTS MAKE UP A BIG PART OF PEOPLE'S SPENDING, YET THEY CAN OFTEN OBSCURE WHAT'S GOING ON WITH INFLATION.

Headline American inflation disappointed last week, sending a small ripple of concern through markets. December's CPI inflation rose 30 basis points to 3.4%. The measure was expected to rise, as the power of falling energy prices to drag overall inflation down fades away. However, the move higher was much stronger than most economists had forecast.

The two main reasons for higher-than-hoped-for inflation were increases in the cost of used cars and housing. The good news is that reliable leading indicators show that price rises in both components should slow sharply in the coming months. Added to this, housing is especially unhelpful when it comes to inflation. While putting a roof over our heads is one of the biggest bills most of us pay each month, the way it's measured and reported often muddies the waters. We can hear the chorus already: "Classic economists, ignoring a large input because it ruins the model." Yet bear with us.

There are obviously two main ways to pay for housing: rent and mortgage payments. These aren't interchangeable. A mortgage payment has an element of investment in it and is influenced by market interest rates (or not, if it's a fixed rate deal). A savvy landlord would incorporate maintenance costs and property taxes into the rent they charge, whereas these aren't included in a mortgage payment. Also, there's that age-old axiom: location, location, location. For the price of a modest two-bedroom flat in central London, you could buy a sprawling mansion in Blackpool. Creating an average that caters for all these differences is plagued with problems. And then there are the timing issues. Most housing costs are fixed for a period of time and then change at point of renewal. This can introduce a lag in the way prices respond. Also, gathering all the information, processing and then reporting it has a lag of its own. It can be a recipe for disaster, so many inflation indices dispense with it. The US perseveres with housing costs in its CPI (it represents a third of the index), yet that could be part of the reason why the US Federal Reserve famously favours other forms of inflation, such as PCE, which has roughly half the weighting to housing.

There are, however, much more timely indicators of housing costs that tend to give us a fairly good steer on where the costs in the US inflation index are heading. The Bureau of Labor Statistics – the same people who calculate the inflation data – has a measure that only looks at new rental agreements, which has historically led the inflation series by nine months. This suggests that it will get back to 2.5-3.5% this year from near 7% today. Real time data based on advertised rents and house prices from online estate agents send similar messages.

Of course, an effect of the housing inflation of recent years is that households have less to spend elsewhere if their rent or mortgage bills have increased markedly. US creative services software developer Adobe has an interesting monthly dataset that scrapes the internet for the prices of 100 million products and plots how they change. After a pandemic-induced surge between 2020 and 2022, the prices of nice-to-have products (what economists call 'discretionary') in Adobe's data have been falling significantly. eCommerce is often deflationary, undercutting goods sold by traditional retailers. But in November the products' prices were falling faster than any other month going back to the start of the measure in 2015. This can be a signal of recession on the horizon. Meanwhile, those products that are a must ('non-discretionary'), are still rising roughly in line with headline inflation.

The path ahead

Investors have been right to cheer the tremendous progress towards a more normal environment for prices. Nevertheless, we expect the last mile of inflation **to be a bumpy road** , for most countries. Leading indicators suggest that inflation should keep falling over the coming months, particularly in Europe, yet its downward momentum in the US is now weaker, with some goods and services starting to rise a little more rapidly again. In English, disappointment becomes easier and more frequent.

Most of the quick wins are now in the past – the subsidence of the energy price surges, the pandemic-fuelled supply upheavals and the food shocks from the Ukraine war have dragged down inflation about as much as they can. Now we're left with relatively tight jobs markets and higher costs squeezing businesses, encouraging them to raise prices to defend their profit margins. Also, there's always the chance of new shocks causing setbacks for inflation – the recent rise in shipping costs because of piracy in the Red Sea is a case in point.

A helpful sign for American inflation is PPI (producer price inflation, or 'factory gate' prices). This has been running at 2% or below for eight months now, showing that the cost of producing goods has stabilised well below the CPI ('shop shelf') inflation. You would expect that to flow through to CPI in the months ahead. Of course, it's hard to know whether this is completely benign or whether falling factory prices signal a drop in household demand that is leading to a recession.

Take the UK: a year ago its producer price inflation was 14.4%; today it's -0.2% and has been below 1% for six months. That could be because of a significant fall in economic demand here in the UK. Meanwhile, our CPI inflation has fallen more slowly, to just 3.9% in November. December's CPI figure is expected to drop slightly to 3.8% when it's released this week. Still, UK PPI tends to lead CPI by a few months, so this should continue to pressure UK inflation lower in the first half of 2024.

We think the UK (along with Europe) is at a higher risk of recession in 2024 than other nations, most particularly the US. Britain delivered a better November than expected, however, with monthly GDP figures showing a 0.3% jump in activity, driven by stronger services. In its release, the Office for National Statistics also revised up its estimate of October GDP. Whereas it had originally reported a 0.3% drop, it now believes the fall was just 0.1%.

That slightly lowers the chance of the UK having entered a recession (two quarters of falling GDP) in the second half of last year, yet the big picture is one of stagnation. The UK economy has barely grown since May 2022. It would take a 0.2% contraction in December to cause a slight recession, and while that doesn't seem the most likely outcome based on the early indicators we have, it wouldn't be too far-fetched.

Meanwhile, another UK banking scandal appears to be gathering pace: the Financial Conduct Authority (FCA) is investigating the motor finance market and historic mis-selling. Before sales commissions on finance agreements were banned in 2021, car dealers and insurance brokers used to have agreements where the commission they received on loan deals was linked to the interest rate that the customer paid. This, of course, incentivised salespeople to increase people's costs.

The Financial Ombudsman Service has already ruled in favour of complainants in two cases against Lloyds' Black Horse Finance business and Barclays. There's a reasonable chance that the FCA will implement a PPI-style campaign to encourage people to make claims for historic motor finance agreements, which could mean a period of unhelpful newsflow and rising liabilities for UK banks.

While this is negative for a sector already facing cyclical headwinds, it's important to note the strength of the lenders' capital positions: regulatory changes mean they have roughly 13% of their assets funded by equity, which is much higher than a decade or more ago. This makes it likely that they should be able to fund claim payments even if ordinary income comes under pressure from a cyclical downturn. Regardless, it's not exactly helping the UK regain a sense of dynamism…

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