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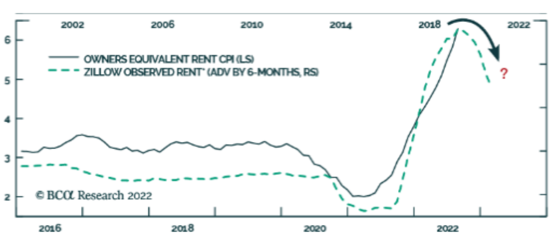
Powell, Yellen, Bernanke, Greenspan, Volcker. These are the current and past four Federal Reserve Chairs tasked with guiding the US central bank Board of Governors and communicating policy to investors. Probably our most famous US central banker, cigar chomping Paul Volcker, is known for ‘breaking the back’ of inflation in the early 1980’s. Our current Fed Chairman, Jerome Powell, has called Mr. Volcker ‘the greatest public servant” we have had, and Fed officials are currently citing the greatest mistake in Central Banking as being too timid in their approach to arrest high and rising rates of inflation in the 1970’s.

For a brief period, this summer, inflationary pressures receded as the price of gas and many goods fell (lumber is now back to pre-Covid prices). During that same period, we enjoyed the respite that came from a stock market rally; however, that was abruptly interrupted with August’s higher than expected CPI measure of inflation and a rather curt speech by Mr. Powell. His message was clear and unequivocal - the Federal Reserve will continue to raise rates until they have more convincing evidence that CPI has come down measurably. Stock, bond, and commodity markets universally reacted negatively to this news. In fact, the only asset that had a positive return in August was the US dollar.

A brief primer on inflation and our expectations for what’s to come: The Consumer Price Index has many components. Some of these components are slower to adjust than others even in the face of rising interest rates and slower economic growth. One of the largest and “stickier” components of CPI is the Index of Shelter, of which Rent and Rental Equivalence is a major contributor. Changes to rent typically take a 12-month period to reflect changed conditions and are heavily influenced by employment. Recent data predicts a downward trend for both employment and rents. We believe inflation’s downward trajectory will have a shallow slope to more acceptable levels causing sustained pressure on the Federal Reserve to maintain its tightening posture. Our research partners at the Bank Credit Analyst have also highlighted this issue and what follows is a look at the potential trajectory for CPI and the impact of shelter on the overall measure of US inflation.



We have highlighted that while the unwinding of supply-side dislocations will carve an easy path for inflation to moderate to an underlying 4%-5% range, bringing it further down towards the Fed’s 2% target is a more difficult task requiring the unraveling of some sticky components of inflation.

The largest of these components is shelter (33% and 41% of headline and core CPI, respectively), itself dominated by rent (21% of shelter) and owners’ equivalent rent (OER) (72% of shelter). Shelter inflation accelerated from 5.7% y/y to a three-decade high of 6.2% y/y in August (0.5% m/m to 0.7% m/m) and was the top contributor to the monthly increase.
Rent inflation closely tracks the tightness of the jobs market (because one needs an income to pay rent). Thus, labor market conditions need to cool to ease shelter inflation. However, recent data releases suggest that the labor market remains resilient. Prior nascent signs of softening employment conditions have either been revised upwards or reversed. The resilient labor market suggests that shelter will likely remain a source of price pressure in the US economy. Thus, the Fed will need to tighten further to combat inflation.

A silver lining lies in the fact that the Zillow Observed Rent Index has started to roll over. Although its history is short, it appears to lead the OER by six months, suggesting that rent inflation could moderate in the coming months. Still, the 2% target is unlikely to be achieved without some degree of demand destruction.
BCA Research, *Daily Insights* September 16, 2022, bcaresearch.com

Over our 23-year history, we have helped our clients navigate good and bad markets and we acknowledge that when we are in midst of negative results, it can feel like it will never end. It will. And markets and portfolios will recover. While the recovery may take longer to arrive, today's turmoil increases the likelihood of a healthier and more sustainable recovery. While opportunities in the market seem few, bonds of all stripes are now providing a decent income, even short-term US Treasuries now yield between 3.2% - 4.0%. In time, this higher income will help compensate investors for today's temporary diminution in value.

Let's please connect so that we can address any of your concerns. Together, we can review your investment portfolio and plan, and discuss how to end the year on as strong a note as possible.

We deeply value the privilege of working with you. Thank you for your continued trust.