opinion

# David Rosenberg: Those betting inflation is going to be sticky are in for a shock

David Rosenberg
Special to The Globe and Mail
Published Yesterday
For Subscribers

*David Rosenberg is founder of* Rosenberg Research*, and author of the daily economic report,* Breakfast with Dave.

It is incredible that the inflation debate has moved from transitory to sticky. An 18-month pandemic bulge in U.S. inflation, in the overall annals of economic history, was transitory. And the consensus narrative of inflation being sticky to the downside is going to be in for a very big surprise. There are no new eras. Excesses are never permanent. And when all the experts and gurus agree, something else is going to happen. Bet against Bob Farrell's market rule at your peril!

I want to first start discussing what is happening with the data in the United States. I keep hearing about how inflation has been sticky to the downside, but in reality, the 5.1 percentage point decline in the headline inflation rate from 9.1% in June of last year to 4.0% currently has only been surpassed over an 11-month time span in 1975, 1982 and 2009. Three other times in the post-WWII experience is pretty epic. The plunge in producer price inflation, which is not just goods but actually has a 66% service sector orientation, has posted an even more dramatic decline from 11.1% this time last year to 1.1% currently and this is the slowest pace since December 2020. Just because Jay Powell never discusses this doesn't mean it's not important and the PPI after all is a leading indicator for the CPI, not the other way around.

What makes the Producer Price Index special is that it has a higher weighting towards transportation services; I'm talking about shipping and freight and this component has swung violently from +23.4% a year back to a record low -6.8% deflation rate currently. This you will not find in the CPI because 40% of the CPI is imputed guesswork from the government statisticians when it comes to the service sector and primarily with regards to residential rents. With that in mind, let's take note that excluding rents, CPI inflation is actually running below 3.0% on a year-over-year basis and that is a significant decline from 9.5% this time in 2022. In fact, CPI ex-rents is running at a 1.8% annual rate on a six-month basis and a 0.9% annual rate on a three-month basis so the declining momentum I would say is rather spectacular. This time last year, both these near-term trends were running well in excess of a 10.0% annual rate.

There is this view that the easy work has been done, and that the next leg down in inflation is going to prove to be very difficult. I'm not convinced that is the case. And I'll tell you why. First, we're going to see lags from two very powerful forces, apartment rents and oil that will feed through in the next several months and quarters into much lower headline inflation rates. Oil touches everything including the core and with lags that have yet to be seen. But the really big story is going to be in residential rents.

I'm not sure if anybody saw the latest data from the Apartment List report, but seasonally adjusted, residential rents in the United States declined 0.6% last month and have now flattened completely on a year-over-year basis. Because of the three-year distributive lags in the CPI we still have the official data including rents that were leases signed back in 2021 and 2022, when there was no new supply; but the future is going to be one where the current deflation in sequential residential rents under a totally new supply regime will soon dominate. This critical 30% chunk of the consumer price index in this process is not well appreciated or understood.

The fastest growing component of the U.S. economy is the multi-family housing sector where starts have boomed 33% over the past year to the highest level in 37 years and units under construction have accelerated by 17% over the past 12 months to the highest level on record dating back to 1970 at 978k units. These will be coming on stream in the next 12 months. And the lagged impact of the previous boom in multi-family, given the 18-month gestation period from start to finish, is already showing through in apartment completions which are up 24% over the past 12 months.

The pipeline of construction in the multi-family housing sector is virtually unprecedented and is going to swamp the natural demographic demand for rentals by a factor of five over the next one to three years. We have traced all this through in terms of what it means for vacancy rates and for rental rate patterns and what our model spits out is headline inflation going from 4.0% today, to 3.0% by the end of this year, 2.0% by the end of 2024, and 1.5% by the end of 2025. This is a process. Inflation is not bitcoin, or the NASDAQ; it doesn't bounce around like a yoyo. It does tend to move glacially, but the disinflation momentum in the coming months, quarters and years promises to be the big surprise for the central banks and investors who believe in the "higher for longer" sticky narrative.

Let me then take a more academic view, or maybe the better term is holistic view, towards the disinflation production on my part. Let's start with the Quantity Theory of Money, which is not really a theory at all, but a hard accounting identity, otherwise known as the Fisherian identity, which shows that money supply multiplied by velocity equates to prices multiplied by real national income or output. We have M2 right now declining at a 4% annual rate. That is a fact. We also have the real economy depending on whether you want to assess it on an income or output perspective, at barely more than a 1% pace. The key to then identifying where the "P" or inflation is going, is to identify the future path of money velocity.

On this score, we know from two surveys, the Fed Senior Loan Officer survey and the Dallas Fed's banking sector loan volume and demand survey, that we are entering into a period of credit contraction. In fact, the annual growth rate in aggregate commercial bank lending which was running at a 9.5% year-over-year rate this time in 2022 has throttled back to 1.8%, which is the

most sluggish pace last seen over 11 years. The banks are shrinking their balance sheets, and there is nothing inflationary about that. But more to the point, we find that there is a 50% inverse correlation between these lending surveys and the implications for money velocity, and when we trace out where the "V" is going, the equations we ran point to a decline in the coming year of 8%. We can see that from a bird's-eye perspective, in the absence of a turnaround in the contracting money supply data, the principal risk is that the economy actually ends up slipping into outright deflation. This obviously will come as a huge surprise to practically everybody in the universe outside of me, Lacy Hunt, and Gary Shilling.

Story continues below advertisement

Let me then take this analysis to another level, which is the examination of the interaction between aggregate supply and aggregate demand. We know that demand growth at this stage is running a little better than a 1.0% annual rate. That may not be recession, but it is a stall speed economy from a demand perspective. From a supply perspective, we know that the production bottleneck pressures have totally abated. We also see that in the previously aforementioned producer price index, but we know that from the New York Fed's own global supply chain price index which was running at 2.6% a year ago has swung to -1.7% right now and is even weaker than it was in November 2008 or April 2001 and both months encompassed recession. In February 2020, just before the pandemic really hit us hard, this index was running at 1.1% positive. It is now -1.7%. And this is confirmed by the ISM's, whether they be in manufacturing or services, both not only slicing below pre-pandemic levels but also where they both were through much of the 2008-09 Great Recession (!) when nobody I can assure you was really talking about chronic or structural inflation.

We see from the labor market, that the participation rate for prime adult workers in the 25- to 54-year-old age cohort rising to 83.4% from 82.4% at the end of last year and is now at the highest level in 16 years. This is a significant thaw taking place within the confines of the labor market that receives scant attention but is inherently disinflationary. For those that cling to tight labor markets, let me just explain that in February 2020 we had the unemployment rate at 3.5% and coinciding with that alleged super tight labor market was an inflation rate of 2.3%, a Fed funds rate of 1.75% and a 10-year Treasury note yield of below 2%.

With respect to the product market, when you dig through the details of the monthly industrial production reports which are published by the Federal Reserve itself, what you will see is that the growth in industrial capacity in the United States has shifted from -0.5% this time last year to +1.5% year-over-year currently. That 1.5% growth in production capacity in the industrial sector is consistent with the underlying trend in total multifactor productivity, and we also now have a 1.0% growth pulse occurring in the labor force. What that means is that potential GDP growth or the supply side of the economy is expanding at a 2.5% annual rate at a time when aggregate demand is running closer to 1.0%. Assuming that we are at full employment currently, means an expansion in the output gap (aka excess supply) that will only serve to generate disinflation momentum ahead, not positive inflation momentum.

Finally, it is encouraging for me to see that there are other pieces of data that support my view. The Cleveland Fed's own 10 year inflation expectation metric has declined from 2.4% a year ago

to 1.66% currently and the five-year estimate is down to 1.58% from 2.45% a year ago; the New York Fed's Underlying Inflation Gauge which is a leading indicator has declined now for eleven straight months. It was 6.2% a year ago and has since come down to 3.5% as of May and at its lowest level in two years — I find that very encouraging. I also find very encouraging the fact that whether you look at two-year, five-year or ten-year TIPS breakeven levels, market-based inflation expectations are running at or just a little above the Fed's holy-grail 2% inflation target. The reason why the Fed is raising interest rates is merely to take out added insurance that inflation will not stage a comeback, but in doing so, I think it will produce a nearly equal undershoot on inflation as the grotesque amount of monetary accommodation in 2020 and 2021 generated a dramatic overshoot in inflation, which is now visibly in the rearview mirror.

I realize that there is a lot of discussion over fiscal policy, but the impact of this is uncertain, considering that government largesse typically crowds out private investment, and generally has little multiplier impact on aggregate demand. And even if it does, the sort of government spending we're seeing right now is no longer in the form of stimulus checks but more in the way of expanding productive capacity. So again, it is uncertain as to what the inflationary impact will be down the road. Let's face it: if government debt was inflationary, then Japan would hardly have one of the lowest inflation rates on the planet, and that's been the case for many years. I have done the work on this and found that there is no significant correlation between public sector deficits and inflation, and in fact, there are many years where the deficit rises and both inflation and bond yields go down. Go figure.

Inflation is obviously a very complex subject, but to focus on one variable when there are hundreds, if not, thousands of factors at play, to me sounds myopic. We must keep in mind all the distortions that took place these past few years because of COVID-19, and the policy responses to COVID-19, and one of them was to generate an unprecedented frontloading of spending on durable goods which is in the rearview mirror, and now ushers in a prolonged period of flat or negative demand for this part of the economy and pricing structure. This is 40% of the CPI. We also must consider that China's economy is sputtering, and it accounts for 50% of the global consumption of raw materials including energy and this at most will keep basic materials stuck in a range if not in a cyclical bear market, even with the support of a fairly inelastic supply curve for resources following these past number of years of a lack of capital investment. The sharp correction we have seen in commodities in recent months across virtually all categories speaks to the reality that the products sector is facing supply abundance; the prior era of shortages is behind us (though many economists and policymakers have yet to catch on, for whatever reason).

The real kicker as I said will be the flawed nature of how the CPI is constructed, with 35% of the index, concentrated in residential rents, and 44% of the core concentrated in residential rents, which has been a principal source of this inflation story, but it is soon to come to an end, and the movie set to rewind in the opposite direction. All you need to know is what rents will be doing in the context of a rising apartment vacancy rate, which at 7.2% already matches the pandemic high of early 2020 and is likely to test or breach 9.0% in the next year or two. This supply and demand framework will take us from over 8.0% rental inflation in CPI right now to low single digits by the end of this year, near zero by the end of next year and slightly negative by the end of 2025. Without having a framework on where residential rates are going you cannot possibly

have a framework as to where headline CPI inflation is going to be landing over the course of the next one to three years.

My conviction level is strong.

*David Rosenberg is founder of Rosenberg Research, and author of the daily economic report, Breakfast with Dave.*