JUNCTURE
WEALTH STRATEGIES

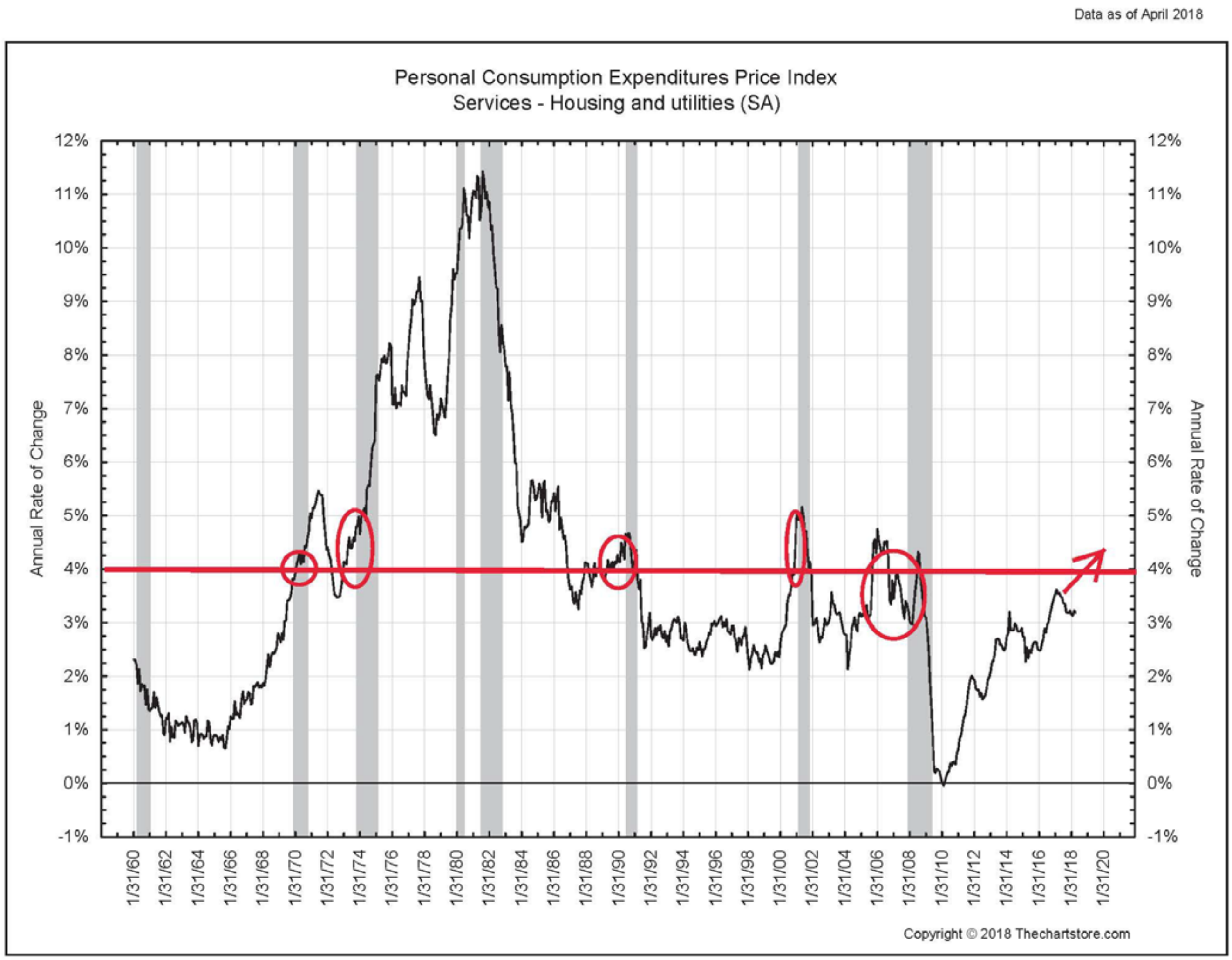
July 11, 2018

Inflation That Matters: Housing

It seems everyone has a different opinion on inflation. If you have a couple of teenage children (plus visiting teenage friends), food costs are likely a major focus of your monthly budget. If you are entering college, or supporting a recent high school graduate, tuition costs have a major impact on your perception of inflation. If you are older and need medical services, healthcare costs will shape your view of pricing pressures. All of these are real challenges for those who are facing them, but the capital markets tend to care less about any particular cost than they do on inflation more broadly. Having said that, some sources of inflation matter more than others when it comes to economic and capital market performance.

Housing Costs Typically Rise Above 4% Prior to a Recession

(the below grey bars represent recessionary periods)



A few trends have kept inflation in the US very low for the past 20 years. First, technology has had a deflationary impact on many goods and services as physical goods have become digitized (i.e. newspapers, books, music, photos, etc.) and as devices (such as cars) become more efficient. Second, offshoring, or outsourcing, manufacturing to countries with lower labor costs has been deflationary on those items (such as apparel and appliances) which have a significant labor component to their overall production costs. This can be seen in the below chart which shows that apparel costs have fallen on average over the past 20 years. "Recreation" (think streaming music and Netflix) and "Education and communications" (think online courses and unlimited data plans for mobile devices) have had inflation rates well below 2% over the past 20 years. Third, strong US dollar policies (and free trade agreements) have allowed us to mitigate domestic inflationary pressures by importing deflation from other countries. However, there are inflationary pressures which cannot be mitigated such as housing costs.

Consumer Price Indexes Statistical Summary

	Index Weight Dec 2017	May 2018	Monthly Change	Annualized Rate of Change 1 Year	2 Years	3 years	5 Years	10 Years	20 Years
U.S. city average									
Major Indexes									
All items (NSA)	100.000	251.588	0.42%	2.80%	2.34%	1.90%	1.55%	1.51%	2.20%
All items (SA)	100.000	250.535	0.21%	2.72%	2.29%	1.88%	1.56%	1.53%	2.19%
Major Sub Indexes									
Food & Beverage (SA)	14.359	252.858	0.01%	1.24%	1.06%	0.94%	1.36%	1.77%	2.29%
Housing (SA)	41.772	257.918	0.23%	2.99%	3.06%	2.83%	2.59%	1.80%	2.42%
Apparel (SA)	3.018	127.273	0.00%	1.41%	0.22%	0.34%	0.06%	0.70%	-0.21%
Transportation (SA)	16.537	209.307	0.39%	5.63%	3.67%	1.20%	-0.44%	0.53%	1.99%
Medical care (SA)	8.673	484.253	0.20%	2.38%	2.52%	2.72%	2.77%	2.93%	3.55%
Recreation (SA)	5.737	118.543	0.02%	0.24%	0.57%	0.76%	0.56%	0.49%	0.81%
Education and communication (SA)	6.707	136.523	0.38%	0.50%	-0.98%	-0.28%	0.14%	1.05%	1.54%
Other goods and services (SA)	3.198	443.130	0.06%	2.49%	2.43%	2.35%	2.04%	2.56%	3.19%
Specialty Indexes									
All items less food (SA)	86.302	250.117	0.24%	2.95%	2.49%	2.02%	1.59%	1.49%	2.16%
All items less energy (SA)	92.961	255.621	0.15%	2.07%	1.84%	1.89%	1.88%	1.80%	2.05%
All items less food and energy (SA)	79.263	256.889	0.17%	2.21%	1.98%	2.06%	1.97%	1.80%	2.00%
Energy (SA)	7.039	220.006	0.90%	11.03%	8.14%	1.75%	-1.76%	-1.03%	3.86%
Energy commodities (SA)	3.447	245.487	1.65%	21.64%	13.51%	2.25%	-3.78%	-1.92%	5.04%
Commodities (SA)	37.327	184.424	0.15%	2.42%	1.44%	0.30%	-0.22%	0.50%	1.33%
Durables (SA)	10.135	103.778	-0.28%	-1.57%	-1.77%	-1.75%	-1.49%	-0.70%	-1.02%
Nondurables (SA)	27.192	226.580	0.69%	4.11%	2.74%	1.13%	0.25%	0.90%	2.20%
Services (SA)	62.673	315.635	0.24%	2.87%	2.78%	2.80%	2.65%	2.17%	2.74%

Data Source: Bureau of Labor Statistics

Housing costs are the most significant component of broad-based inflation measures such as the Personal Consumption Expenditures (PCE; approx. 30% weight in housing) and the Consumer Price Index (CPI; approx. 40% weight in housing). Housing costs are rising due to many factors: 1) increased interest rates; 2) new household formation; 3) very low unemployment; 4) a shortage of land in desired locations; 5) a shortage of both skilled and unskilled construction workers; 5) ever increasing building code requirements; and 6) a multi-decade trend of migration from more rural areas toward more urban areas.

The recent tax reform has probably extended the current economic cycle by an additional 1-2 years, but the growing inflationary pressures within the housing industry are not likely to abate. Additionally, import tariffs have the potential to exacerbate the situation by increasing the prices of imported goods to US consumers and stricter border security may reduce the available labor pool forcing employers to pay more to attract employees. Companies may, for a brief time, absorb the increased costs, but they are unlikely to do so for a longer time period. As housing inflation approaches the four percent level, the Fed may embark on more aggressive tightening which could lay the foundation for the next recession. At this point, it appears that outcome is more likely to occur in late 2019 or early 2020, than in 2018.