KKR

Flash Macro Update

U.S. CPI REPORT | February 2024

Henry H. McVey
Head of Global Macro
& Asset Allocation
henry.mcvey@kkr.com

Dave McNellis
Head of U.S. Macro

Ezra Max
Associate, U.S. Macro

What You Need to Know

1 How are we thinking about the January U.S. CPI report?

The January CPI report strengthens our view that growth and inflation will be more resilient this year, even more than we previously thought. As such, we now expect even fewer Fed cuts this year.

Overall, we continue to argue to argue that we are in a Regime Change where there is a 'higher resting heart rate' for inflation this cycle. This report confirms our view that investors have been overly optimistic about the Fed cutting rates into an environment that is defined by low growth, low inflation, loose monetary policy, and tight fiscal policy. That environment is one that we have permanently exited, we believe. Key to our thinking is that four drivers – more fiscal stimulus, a messy energy transition, heightened geopolitics, and tight labor markets – will make this cycle different.

	New	Old	Consensus
CPI (2024)	2.9%	2.6%	2.7%
GDP (2024)	2.5%	2.0%	1.7%
Fed Funds (2024)	4.6%	4.4%	4.4%
Fed Funds (2025)	3.9%	3.6%	3.3%
10-Year U.S. Treasuries (2024)	4.25%	4.0%	3.7%

As a result, higher rates for longer will continue to put more pressure on companies that were betting on lower rates to help them boost their coverage ratios. This reality is expected to play out more noticeably across Real Estate and Private Credit, we believe. Meanwhile, we think that the correlation between stocks and bonds has moved to be a positive one from a negative one, which means that greater diversification, especially in Real Assets, will be required.

If there is good news, we think that public valuations outside of large capitalization growth stocks still look attractive. Moreover, higher nominal GDP growth makes us much more optimistic on the outlook for earnings and the profitability of companies that are more closely linked to nominal GDP. Against that backdrop, we retain our 'Glass Half Full' perspective and think that the current environment is a favorable one for deployment in Private Markets.

WHAT WE THINK YOU NEED TO KNOW

- **Core CPI came in at +3.9% y/y and +0.4% m/m, above consensus of +3.7% and +0.3%.** Beneath the surface, Core Services printed the highest monthly increase since April 2022, even as Goods prices continued to fall. Though there was some seasonal noise, the hot start to the year for Supercore and Rent inflation leads us to raise our 2024 CPI forecast to +2.9% from +2.6% previously (consensus is +2.7%).
- **It's not just inflation; growth has been more resilient, too.** Netting together this month's data (including payrolls, ISMs, and claims), we are raising our 2024 real GDP forecast even further above consensus to +2.5%, up from +2.0% previously (consensus is +1.7%). These increases support our view that we are living in a higher nominal GDP environment this cycle.
- **Higher inflation means fewer cuts are required to keep 'real rates' at two percent.** We think seasonals will push Services CPI lower by this summer *(Exhibit 1)*, allowing the Fed to start cutting in June (vs. our prior May baseline). Our base case now moves back to three cuts this year (versus four previously), which raises our YE 2024 fed funds forecast to 4.625%. Our YE 2025 forecast rises to 3.875%, from 3.625% previously.
- **Bond yields are likely to trade in a higher range.** Markets will continue to put less weight on the 'tail risk' of a hard landing, which gives the 10Y UST scope to trade in the 4.25-4.5% range in the near term. We raise our YE 2024 10Y UST target to 4.25% from 4.0% previously, while retaining our longer-term view that bond yields settle around 4.0% (meaning 4.25-4.5% represents reasonable value for longer term allocators).

DETAILS

January CPI came in at +3.1% y/y and +0.3% m/m, well above consensus of +2.9% and +0.2%. Despite some seasonal noise, the details suggest that Core Services inflation (the key focus area for Fed policymakers right now) remains even more resilient than we had expected.

Core Services came in at +0.7% m/m, which was the highest reading since September 2022. Supercore inflation (Services inflation ex-Shelter and Healthcare) accelerated for the third month in a row and is now running at around six to seven percent annualized on a three-month moving average basis *(Exhibit 1)*. While we think that there is some residual seasonality at play here (e.g., we saw a similar 'blip' around 3Q/4Q last year), it is clearly taking longer than policymakers had hoped for inflation to cool in labor-sensitive sectors.

Meanwhile, Shelter inflation unexpectedly accelerated to +0.5% from +0.4% in December, driven by a sharp increase in Owners' Equivalent Rent *(Exhibit 2)*. Although market rents have been on a cooler path, Chair Powell's latest press conference suggests that he wants to see that slowdown reflected in official BLS data; all else equal, the January data will encourage Fed policymakers to take a more patient approach to rate cuts.

Goods inflation remains quite favorable. Core Goods prices fell -0.3% m/m in January, in one of the weakest readings since the pandemic. Bigger picture, we think that auto companies are once again focused on volume vs. price growth, while China is starting to export deflation, both of which should translate into lower

Goods prices despite a reacceleration in consumer demand (our forecasts still have Core Goods ending the year at -2.9%). That is helpful, but Goods deflation alone will not be enough for the Fed to declare victory, as FOMC members have repeatedly emphasized in recent weeks.

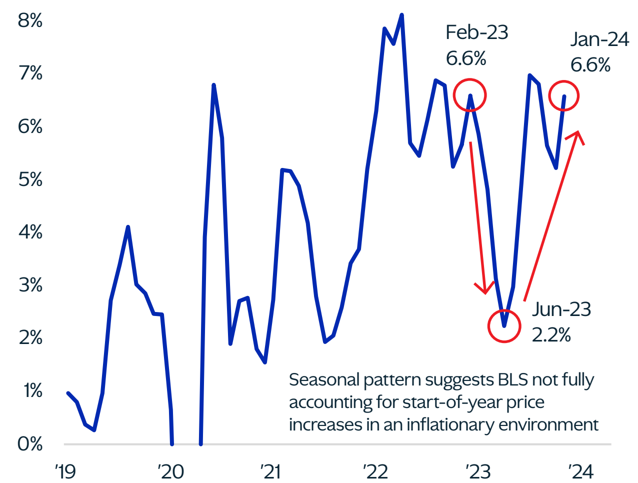
WHAT DOES THIS MEAN FOR OUR FORECASTS?

- **'Sticky' services inflation leads us to raise our 2024 CPI forecast to +2.9% from +2.6% previously.** While goods deflation is playing out in-line with our forecasts, services inflation is proving more persistent than expected, likely exacerbated by seasonal factors.
- **Meanwhile, real growth remains very resilient.** We are taking up our GDP forecast to +2.5%, up from +2.0% previously and well above consensus of +1.7%. While we continue to expect a slowdown in the second half of the year, the odds of a 'hard landing' feel increasingly remote.
- **Higher inflation and stronger growth raise the bar for Fed cuts.** We still think the Fed intends to keep real rates around two percent this year, but our higher CPI forecast means that nominal rates only need to fall to 4.625% this year and 3.875% next year in order to achieve this (our previous forecast was 4.375% at YE2024 and 3.625% at YE2025). Meanwhile, stronger growth gives the Fed more breathing room before it starts cutting rates, which is why we now expect no rate cuts until this summer.
- **Bond yields are likely biased higher in the near term; 4.25-4.5% represents reasonable value for 10-year U.S. Treasuries.** We are taking up our 2024 10-year U.S. Treasuries forecast to 4.25%, from 4.0% previously, while maintaining our longer-term forecast of 4.0%.

It's not just inflation; growth has been more resilient, too.

Exhibit 1: There Is Some Seasonal 'Noise', But Supercore Services Inflation Remains Quite Elevated

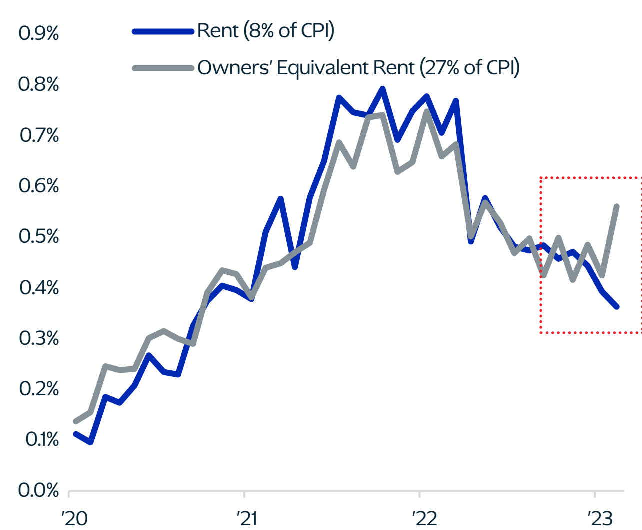
Core Services Ex-Shelter, Energy, Health Insurance, 3-Month Moving Average, % Annualized



Data as at January 31, 2024. Source: Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 2: Owners' Equivalent Rent Showed an Unsettling Uptick This Month, But We Do Not Think This Is Sustainable

Rent vs. Owners Equivalent Rent, %



Data as at January 31, 2024. Source: Zillow, Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 3: January CPI Details

	MoM%						YoY%
	Jan-24	Dec-23	Nov-23	Oct-23	Sep-23	Aug-23	Jan-24
All items	**0.3%**	**0.2%**	**0.2%**	**0.1%**	**0.4%**	**0.5%**	**3.1%**
ex-Food/Energy	**0.4%**	**0.3%**	**0.3%**	**0.2%**	**0.3%**	**0.2%**	**3.9%**
ex-Food	0.3%	0.2%	0.2%	0.0%	0.4%	0.6%	3.2%
ex-Energy	0.4%	0.3%	0.3%	0.2%	0.3%	0.2%	3.7%
ex-Food/EnergyShelter	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%	2.2%
Energy	**-0.9%**	**-0.2%**	**-1.6%**	**-2.1%**	**1.2%**	**4.4%**	**-4.6%**
Energy Commodities	-3.2%	-0.7%	-3.8%	-4.3%	1.8%	8.3%	-6.9%
Gasoline (All)	-3.3%	-0.6%	-4.0%	-4.3%	1.6%	8.3%	-6.4%
Services	**0.7%**	**0.4%**	**0.5%**	**0.3%**	**0.5%**	**0.4%**	**4.9%**
Services ex-energy	**0.7%**	**0.4%**	**0.5%**	**0.3%**	**0.5%**	**0.4%**	**5.4%**
Housing	0.6%	0.3%	0.4%	0.3%	0.5%	0.3%	4.6%
Shelter	0.6%	0.4%	0.4%	0.3%	0.6%	0.3%	6.0%
OER Residences	0.6%	0.4%	0.5%	0.4%	0.5%	0.4%	6.2%
Fuels & Utilities	1.2%	0.2%	0.8%	0.2%	0.5%	0.5%	-0.7%
Food/beverages	0.4%	0.2%	0.2%	0.3%	0.2%	0.2%	2.6%
Food	0.4%	0.2%	0.2%	0.3%	0.2%	0.2%	2.6%
Apparel	-0.7%	0.0%	-0.6%	0.0%	-0.3%	0.2%	0.1%
Transportation	-0.6%	0.1%	-0.2%	-0.7%	0.3%	2.0%	1.6%
New Vehicles	0.0%	0.2%	0.0%	-0.1%	0.2%	0.2%	0.7%
Used Cars & Trucks	-3.4%	0.6%	1.4%	-0.4%	-1.8%	-1.9%	-3.5%
Airline Fares	1.4%	0.9%	-0.2%	0.7%	0.2%	2.3%	-6.4%
Medical care	0.5%	0.4%	0.5%	0.2%	0.1%	0.1%	1.1%
Recreation	0.5%	0.4%	-0.2%	0.1%	0.4%	-0.2%	2.8%
Education, Comm.	0.4%	0.1%	-0.3%	-0.2%	0.1%	0.0%	0.0%
Other Goods, Services	0.5%	0.0%	0.4%	0.6%	0.6%	0.4%	5.7%
Goods	**-0.3%**	**0.0%**	**-0.4%**	**-0.3%**	**0.1%**	**0.7%**	**0.1%**
ex-Food and Beverage	-0.7%	-0.2%	-0.8%	-0.7%	0.1%	1.0%	-1.4%
Goods ex-food/energy	**-0.3%**	**-0.1%**	**-0.2%**	**0.0%**	**-0.2%**	**-0.2%**	**-0.3%**

Data as at January 31, 2024. Source: Bloomberg.

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Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
+ 1 (212) 750.8300
www.kkr.com