Flash Macro Update

U.S. CPI REPORT | March 2024

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What You Need to Know

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

A faster start to the year leads us to upgrade our 2024 CPI forecast to +3.1% from +2.9% previously, and to moderate our forecast for Fed cuts in 2024 to two from three. Importantly, while the February CPI report was somewhat above the market's and our expectations, the details of the report do give us more conviction that services inflation is finally moderating, further bolstering our confidence that the Fed will be in a position to cut rates in 2H24.

- See *Exhibit 1*, but higher Goods prices and 'launch effects' from higher January/February CPI add 30 basis points to our full-year 2024 CPI forecast, with a 10-basis point offset from lower Services inflation. On net, that puts our full year forecast at 3.1%, versus 2.9% previously.
- Nonetheless, we think the Fed will likely feel better about inflation this year than headline CPI numbers may suggest, as slower PCE inflation and cooler Services pricing give Chair Powell confidence that we are seeing 'broadening' disinflation in stickier categories. Against that backdrop, we think two Fed cuts will be appropriate to keep real policy rates near the Fed's two-percent benchmark through year end.

WHAT DO WE THINK THIS MEANS FOR MARKETS?

The U.S. economy has run hot out of the blocks in 2024. We came in expecting stronger growth and fewer fed cuts vs. consensus, but incoming data has now moved us to adjust forecasts higher across GDP, inflation, rates, and S&P 500 EPS. On net, we view the resilience of the economy through a positive lens, particularly amid what remains a cooling trend for core inflation.

All told, we maintain our ‘Glass Half Full’ framework for investing, and still think that the path of least resistance in equity and credit markets is higher. As we have been signalling, the technical backdrop for stocks and credit is as favorable as we have seen in decades. Key to our thinking is that: 1) Buybacks are surging and could reach $1 trillion in the SPX this year, compared to $500 billion in 2020; 2) At the same time, there is no issuance of High Yield, Leverage Loans, and IPOs. In fact, net issuance is at its lowest level since April 2009; and 3) On the economic front, the key ‘news’ in 2024 is that the Fed is not going to be tightening. Frankly, given the technical backdrop, we don’t need the Fed to ease to have stronger global capital markets.

In terms of key themes, we remain very constructive on productivity investments, especially as it relates to automation. We also still favor the intersection between surging data demand against a backdrop of limited power supply and energy transmission. Finally, we are bullish on the ‘security of everything’, including energy, data, transportation, cyber, and water/food.

HERE’S WHAT WE THINK YOU NEED TO KNOW

- **Core CPI for February came in at +3.1% y/y (+0.4% m/m), 10 basis points above consensus of +3.1% (+0.3%) and 10 basis points above last month’s reading of +3.1% (+0.3%).** Despite the upside surprise, many of the details make us feel better that inflation is not reaccelerating.

- **The above consensus reading in the CPI data this month was driven entirely by Core Goods.** Core Goods prices increased +11 basis points in February, marking the first positive reading following eight consecutive months of declines. Importantly, goods prices have been firming somewhat across both autos and other core goods, causing us to revise up our full year core goods inflation estimate to by 80 basis points to -1.3%. We still do not see significant upside risk for goods prices, however, given China’s overcapacity issues and U.S. automakers’ desire to maintain market share.

- **Finally, we think ‘Supercore’ Services inflation (ex-shelter and health insurance), which is a key focus area for Chair Powell, is likely on a cooler path. While volatile, our m/m Supercore inflation measure cooled to +0.5% m/m from +0.7% m/m in January, reversing last month’s acceleration. Bigger picture, we continue to think that Supercore inflation will follow other CPI components lower with a lag this cycle as ‘stickier’ services categories are finally looking more benign.** We think elevated readings in Shelter/Supercore inflation last month mostly reflected one-off factors, and we are actually taking down our forecast for Core Services inflation slightly. Recall that Owners’ Equivalent Rent (about one-third of Core CPI) unexpectedly surged to +0.6% m/m from +0.4% m/m in January (despite cooler rent growth); this move reversed this month, which gives us more confidence that overall housing inflation is on track to cool in tandem with real-time rent measures.

- **The details also bode well for Fed and consumer psychology.** Medical care inflation, which is the largest single component of the Fed’s preferred PCE inflation gauge, came in at -0.1% m/m (the first negative print since July of last year). Meanwhile, Food – which has an outsized impact on Consumer inflation expectations – came in at 0.0% (tied for the third-lowest reading since 2020).

- **On net, we think the Fed will be in a position to cut rates twice this year, likely starting by July or September.** Key to our thinking: labor demand is moderating, Services inflation (a top concern for Chair Powell) is on a cooler path, and PCE inflation is on track to settle in the mid-two percent range by year end. All told, we stick with our framework that the Fed will hold real rates at around two percent through year end; Given our updated inflation forecast, that would point to two rate cuts this year versus three previously.

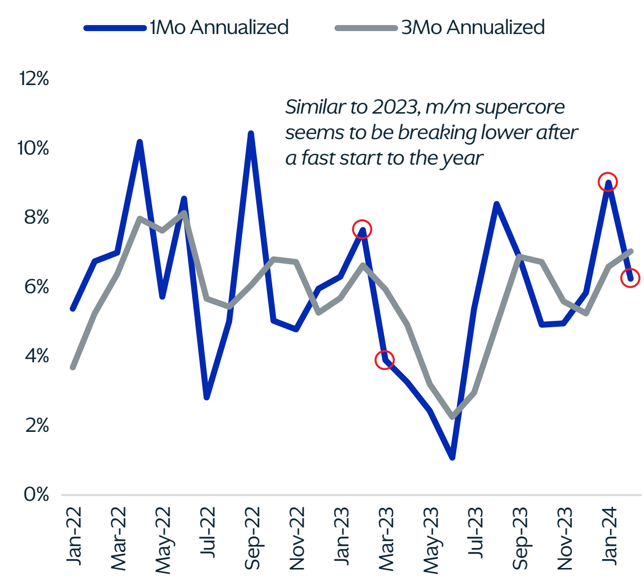
Exhibit 1: We Think Core CPI Will Continue to Cool This Year, Particularly When It Comes to the Services Categories that Have Been Most Concerning for the FOMC

KKR GMAA U.S. CPI FORECAST DETAIL	4Q23a	1Q24e	2Q24e	3Q24e	4Q24e	Full-Year 2023	Full-Year 2024e	Full-Year 2025e
Headline CPI	**3.2%**	**3.2%**	**3.2%**	**3.1%**	**3.1%**	**4.1%**	**3.1%**	**2.5%**
Energy (7%)	-3.9%	-1.6%	2.2%	-0.1%	1.2%	-4.8%	0.4%	7.5%
Food (13%)	3.0%	2.4%	2.4%	2.2%	2.0%	5.8%	2.2%	0.5%
Core CPI (80%)	**4.0%**	**3.8%**	**3.5%**	**3.5%**	**3.4%**	**4.8%**	**3.5%**	**2.4%**
Core Goods (21%)	**0.1%**	**-0.4%**	**-1.6%**	**-1.5%**	**-1.5%**	**0.9%**	**-1.3%**	**0.1%**
Vehicles (8%)	-0.6%	-0.6%	-2.4%	-2.2%	-2.5%	-0.4%	-1.9%	-0.5%
Other Core Goods (13%)	0.5%	-0.4%	-1.2%	-1.3%	-1.1%	1.7%	-1.0%	0.5%
Core Services (59%)	**5.4%**	**5.3%**	**5.2%**	**5.2%**	**5.0%**	**6.3%**	**5.2%**	**3.3%**
Shelter (34%)	6.7%	6.0%	5.5%	5.3%	4.9%	7.5%	5.4%	3.5%
Medical (6%)	-1.1%	1.2%	2.8%	4.3%	4.7%	-0.4%	3.2%	2.8%
Education (2%)	2.5%	2.6%	2.8%	2.7%	2.9%	3.1%	2.8%	2.8%
Other Core Services (17%)	6.0%	5.9%	5.9%	5.8%	5.7%	6.8%	5.9%	3.2%

Data as at February 29, 2024. Source: U.S. Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 2: February's Supercore Inflation Print Gives Us More Conviction that January CPI Picked Up a Lot of One-Off Seasonal Factors

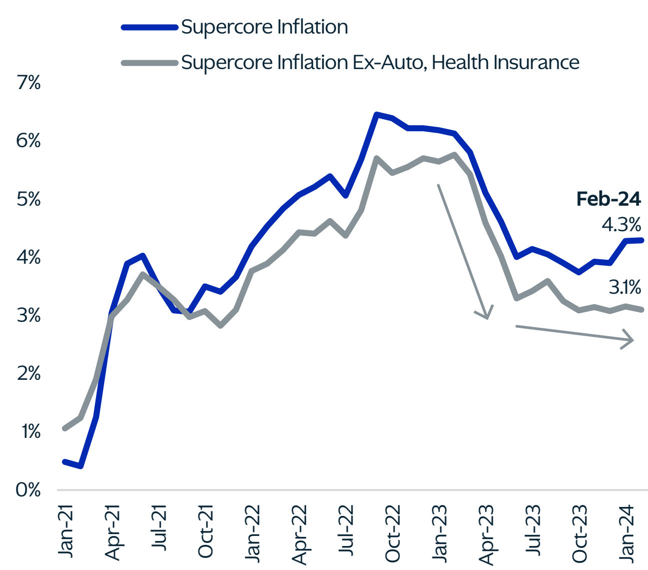
Core Services Ex-Shelter, Health Insurance, %



Data as at February 29, 2024. Source: U.S. Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 2: We Think Supercore Reflects Lagged Increases in General Inflation (e.g., Auto Prices) and Will Be on a Cooler Path by Year-End

Supercore Inflation, Y/y %



Data as at February 29, 2024. Source: U.S. Bureau of Labor Statistics, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

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