IDB BANK
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Monthly Market Views

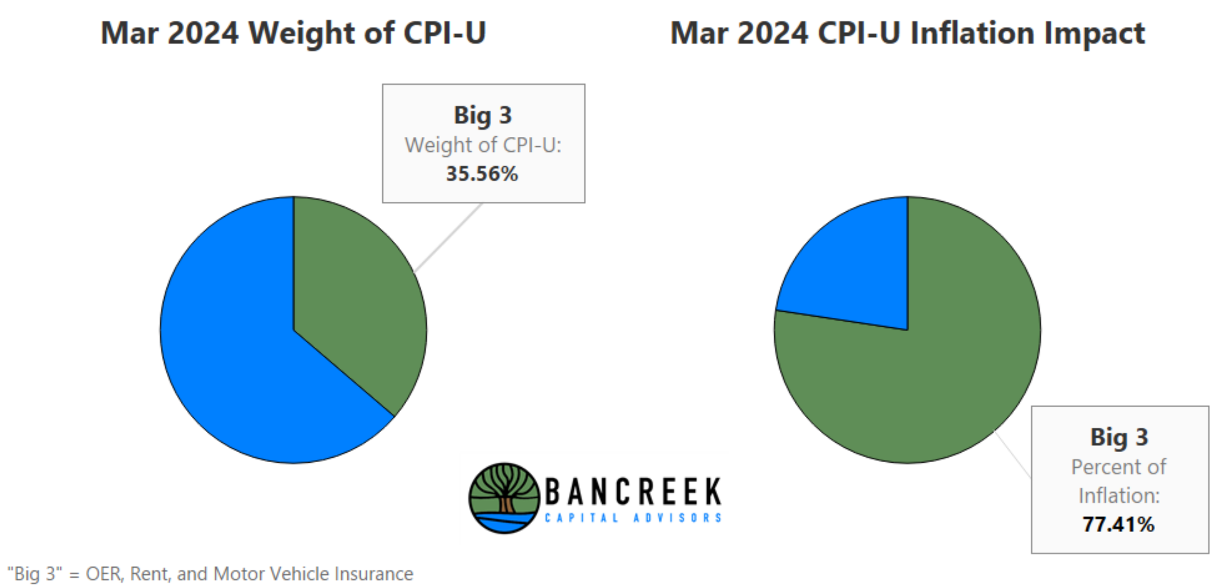
Private Banking Division

As the post-Covid-19 recovery has progressed, inflation has emerged as arguably the most-important economic indicator affecting US Federal Reserve Policy.

To gain clarity on the intricacies of the various inflation components, we sat down with Eric Pachman, Chief Analytics Officer at Bancreek Capital Management. The following is a question and answer session between **Alex Polshikov**, Chief Investment Officer of IDB Bank & **Eric Pachman**, Chief Analytics Officer at Bancreek Capital Management.

Alex: Bancreek has developed a very interesting inflation visualization tool. Have you gained any insights from this that you found to be surprising?

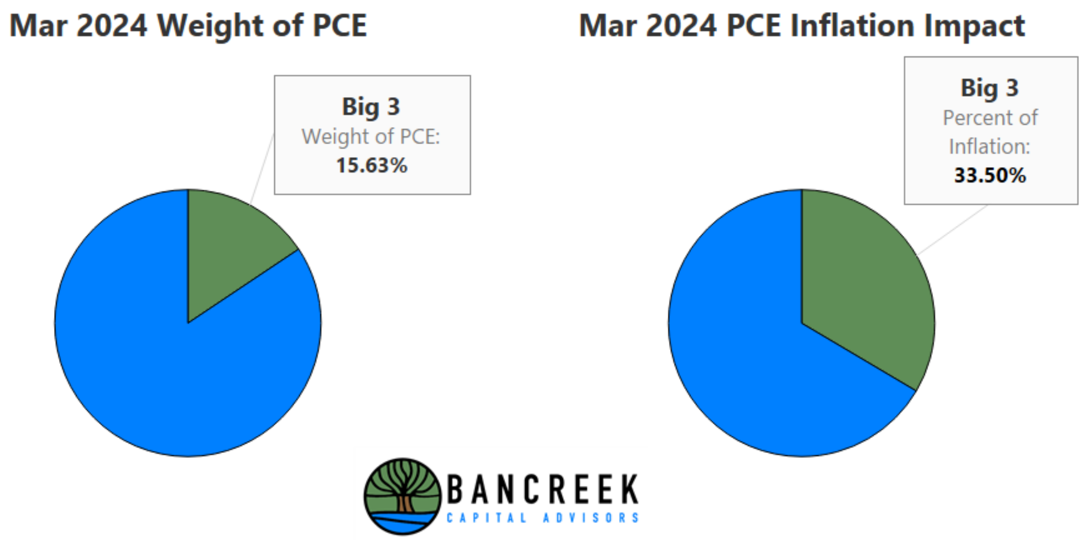
Eric: The most surprising insight that jumped out at us when we used the tool to analyze Consumer Price Index for al UrbanConsumers ("CPI-U") was that so much of CPI-U was being driven by just a few items. We found that over three-quarters of all inflation was being driven by Owners Equivalent Rent ("OER") of residences), rental of primary residences, and motor vehicle insurance. We call these three items the "Big 3".



Data Source: Bancreek Capital Management, May 31, 2024

The good news is that outside of these three items, inflation is actually quite tame. In fact, we estimate that if we were to exclude these three items, April 2024 CPI-U would have come in at just 1.2%! The bad news is that these three items seem to be unphased by the Fed's tightening to date – the pace of deceleration in these two key housing components has slowed in recent months while motor vehicle insurance inflation inexplicably has continued to accelerate. And with how large the weight is in CPI-U of these three items, it's now mathematically nearly impossible to get anywhere close to 2% headline inflation without a meaningful deceleration in the Big 3.

The other surprise is just how different Personal Consumption Expenditures ("PCE") is from CPI-U. To illustrate this, consider the following graphic which shows that the Big 3 only comprise a third of PCE inflation impact, compared to over 75% of CPI-U inflation impact.



Data Source: Bancreek Capital Management, May 31, 2024

"Big 3" = OER, Rent, and Motor Vehicle Insurance

As we wrote when we launched our PCE tools, if we didn't know the source of the data, we would have sworn these two inflation measures were from different countries. We'd urge folks to pull up the two tools side by side and compare some of the weights and inflation impacts. It's wild how different they are!

Alex: Do you see a divergence between sell-side inflation prognosticating and the underlying data?

Eric: For years we used the most rudimentary "model" to forecast the upcoming inflation print. Put simply, we assumed sequential inflation in each underlying CPI-U category got no better and then used this base case assumption to calculate year-over-year inflation. Out of curiosity we performed this forecast each month for a year or so and without fail almost always arrived at consensus expectations for year-over-year inflation within 10 basis points! Our key takeaway from this exercise was that there is not much "prognosticating" going on in consensus. Maybe individual brokers are putting out differentiated views, but when you put them all together, consensus tends to reflect a very basic continuation of the most recent sequential trends in the underlying categories.

Sadly, having better data tools doesn't inherently give you an advantage versus consensus. In fact, we would argue that the more time you spend with inflation data sets, the more you start to see each of the items that together comprise CPI-U and PCE as somewhat arbitrary measures. Each item has its own unique and complex survey methodology that may or may not line up with "reality" as measured by data that can be collected outside the Bureau of Labor Statistics ("BLS") or Bureau of Economic Analysis ("BEA"). So, studying the data just makes you more aware of the futility of relying on pinpoint forecasts in the first place!

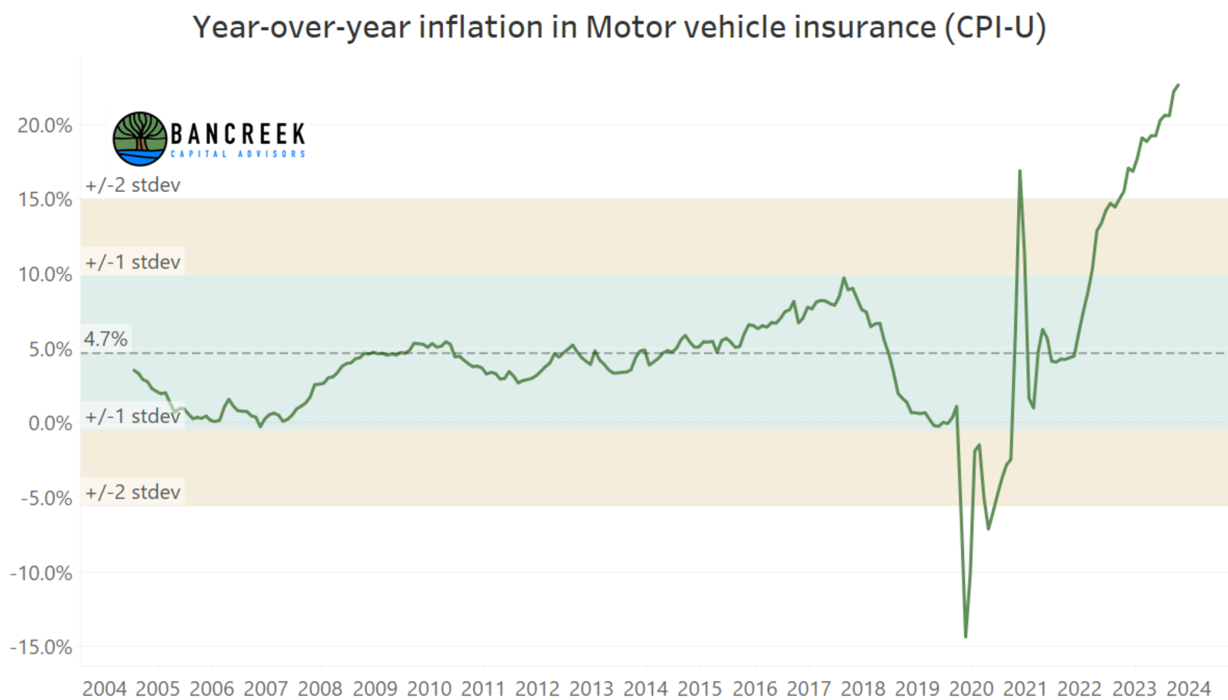
Where data provides an advantage is in helping you set realistic expectations for a range of outcomes. From quick inspection of our tools, you can see which items carry the largest weights, study their current trends, and see their historical volatility. You can then use this data to make educated guesses on the most impactful items to project a range of outcomes. This process can be far more useful than the broad prognostications commonly reported in the financial media. Such a prognostication may be for "housing inflation to continue to decelerate." A data-driven way to rephrase this would read something like this:

Based on the recent trends in OER and its normal volatility, we would expect year-over-year OER to decelerate to 5.6% in May 2024 from 5.7% in April 2024, with a range of outcomes between 5.4% and 5.8% based on this item's historical volatility. If it came in at the low end of this range, it would shave nine basis points off headline inflation.

To us, this is much more useful commentary as it tells us that even if OER came in at the low end of what the data would suggest is in the realm of normal, it still would only take nine basis points off headline inflation, suggesting that there is a lot more work to do elsewhere to bring CPI-U down from 3.4% to 2%!

Alex: What have you found as the most pertinent data point(s) to pay attention to recently?

Eric: Unless we collectively agree to revise CPI-U to exclude housing, OER and rents, these will always be the most important items to track in this inflation measure. Put simply, they now dominate CPI-U, and are just getting larger as they continue to outpace overall inflation. After that, we look at motor vehicle insurance, which is still in the process of floating off into the inflation stratosphere.



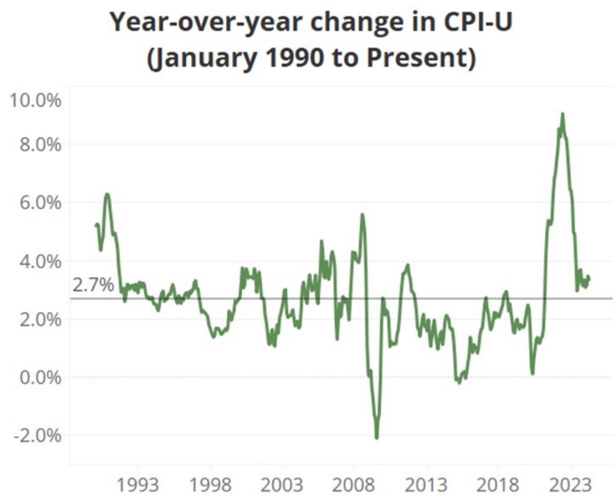
Data Source: Bancreek Capital Management, May 31, 2024

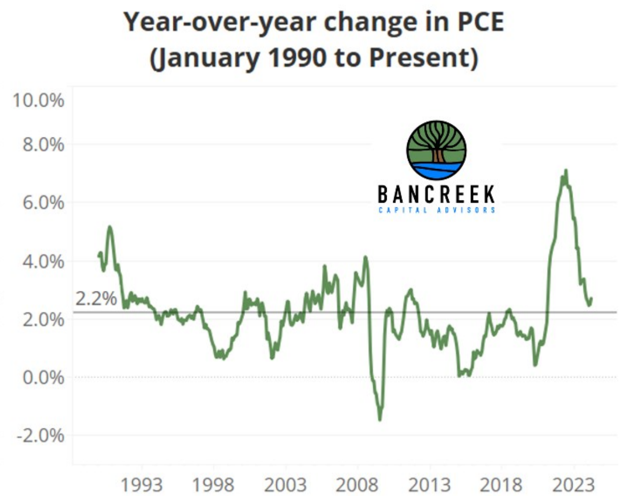
Then we immediately jump to the key medical cost items like hospital expenses and health insurance. Ultimately, we employ the same process that anyone can perform with our visualizations – just prioritize the highest ***weighted*** inflation items first and work your way down the list.

For PCE, we tend to look to medical cost inflation earlier in our analysis of the data because it carries a far higher weight. PCE is also much less top heavy (i.e., its housing weight is far smaller) so you really need to look across all items to put the story together rather than just zeroing in on a few with CPI-U.

Alex: In a recent Financial Times article, you were quoted as saying "When I look at CPI and PCE, I don't see anything more than two different groupings of weights". The US Fed has typically referenced PCE. Do you know why that might be? And should investors be doing the same?

Eric: As we mentioned in our answers to the prior questions, PCE is far more diffuse measure of U.S. inflation, primarily due to its considerably lower housing weight. PCE is more representative of ***overall*** U.S. inflation, as opposed to inflation from the perspective of the U.S. consumer, which purportedly is what CPI-U is designed to measure. At least conceptually it accounts for expenses incurred by companies, state and federal governments, non-profits, etc., in addition to the U.S. consumer. As to why the Fed prefers it, we can only assume it is because PCE is less concentrated in a handful of items – items over which the Fed increasingly has less control. Also, just looking at the last few decades of historical data, average CPI-U has run around 50 basis points higher than average PCE. So, if the Fed realistically wants to target a measure that structurally has been able to reach and hold the low 2% range, it really doesn't have much other choice than PCE. We discuss this as well in a recent article in the Boston Globe.





Data Source: Bancreek Capital Management, May 31, 2024

Q: Is there a category (e.g. shelter inflation) that you find to be the most strangely calculated? Any category that's especially straightforward/timely?

We think it's most helpful to look at all categories simply as numbers churned out by the BLS/BEA black box. In other words, do not conflate the item "motor vehicle insurance" inflation directly with our experience of motor vehicle insurance inflation. Rather, the item "motor vehicle insurance" is the output of a very complex process with a specific sampling methodology and many adjustments have evolved over many years. This process outputs an index value that happens to be labeled "motor vehicle insurance." Clearly, there is some correlation between the measure and reality. But expecting them to line up and behave in perfect unison each month with observable data outside the BLS or BEA belies how complex and nuanced their processes truly are.

Long story short, each time we dive into an item's methodology rabbit hole we are blown away by the complexity of the processes used to generate these numbers. In that way, our experience is that all items should initially be viewed as "strange," until proven otherwise!

ECONOMIC OVERVIEW

	GDP Forecast (2024)	GDP Forecast (2025)	Inflation Forecast (2024)	Inflation Forecast (2025)	IG Credit Downgrade
Argentina	-3.6%	3%	261%	76%	N/A
Brazil	2.0%	2%	4%	4%	N/A
Chile	2.5%	2%	4%	3%	Low
Mexico	2.1%	2%	4%	4%	Medium
Peru	2.5%	3%	3%	3%	Low
Uruguay	3.2%	3%	5%	6%	High
Israel	1.7%	4%	3%	3%	Low
USA	2.4%	2%	3%	2%	Very Low

Data Source: Bloomberg Terminal, as of June 3, 2024

MARKET OVERVIEW

Equity		Foreign Exchange		Fixed Income	
S&P 500 Index	11.0%			Global High Yield	2.8%
Nasdaq Composite	11.9%	USD	2.8%	Global IG Cor: 50%	-0.5%
Euro Stoxx 50 Pr	13.5%	EURUSD	-1.3%	US Corp. High Yield	1.6%
FTSE 100 Index	8.8%	GBPUSD	0.5%	Corporate (USD)	-1.1%
Nikkei 225	17.2%	USDJPY	-9.7%	EM High Yield	5.7%
Hang Seng Index	9.3%	USDCNY	-2.0%	Investment Grade	-0.8%
Brazil Ibovespa Index	-8.8%	USDBRL	-7.0%	Treasuries	-4.7%
S&P Merval Tr Ars	77.7%	USDARS	-9.8%	U.S. Treasury	-1.9%
S&P/Bmv Ipc	-8.5%	USDMXN	-4.1%	Sovereign	1.4%
MSCI ACWI	9.1%			Global Aggregate	-3.3%

Data Source: Bloomberg Terminal, as of June 3, 2024

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