Economics

IN FOCUS

July 11, 2024

Seeking shelter from shelter inflation

by **Avery Shenfeld** avery.shenfeld@cibc.com and **Ali Jaffery** ali.jaffery@cibc.com

As they say, a person's home is their castle, but it's a castle that's costing a lot more these days, and boosting inflation in the process. Given its heavy weighting, shelter inflation has been the most stubborn barrier to getting overall inflation back to the 2% target in both Canada and the US. But for somewhat different reasons, we see reason to expect considerable progress from here to the end of 2025, even if, and to some extent because, central banks will be cutting interest rates.

MIC drop coming

The component of the Canadian shelter basket capturing mortgage interest costs (MIC) has been the fastest growing item in the CPI, running at 23% year-on-year as of May. It captures typical monthly mortgage interest costs, and gets added to other costs (repairs, replacing parts of the house over time, etc.) to assess shelter inflation facing homeowners.

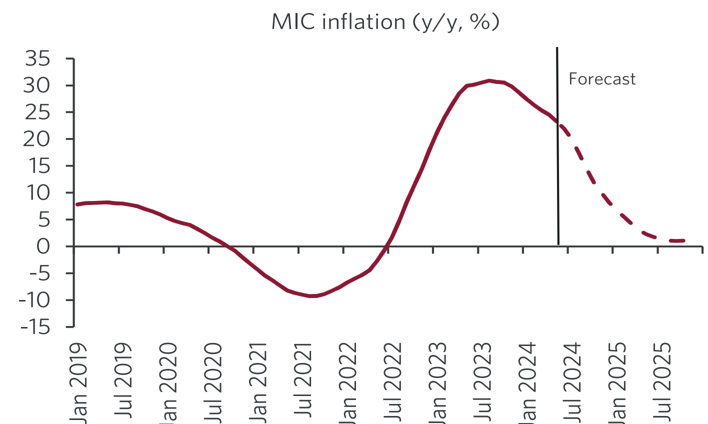
The principal on which interest is calculated rises over time as average mortgage sizes increase with house prices, but that's a slow moving process. Mortgages are assumed to run for 25 years, so there's only a gradual change in average principals as this year's house prices and mortgage sizes get factored in, and those bought 25 years ago drop out.

Even if house prices see some pickup as interest rates fall, their pressure on the MIC index would be outweighed by the direct impact of changes in mortgage rates. But projecting the MIC is still complex. For example, in the coming year, those with variable or one-year mortgages could be reaping substantial savings as rates decline. By the end of this year, our forecast would have trimmed a full 100 bps off variable rate mortgages versus their peak. But others in 2025, renewing 4- or 5-year mortgages issued at the cycle's low yields in 2020 or 2021 respectively, will see their payments increase, while still others with term mortgages see no change until they reach their reset date.

To simulate the likely path for the MIC component, we built a model that approximates Statistics Canada's granular calculation, while using more aggregated data on mortgage rates and terms. It captures the likely climb in average principals based on a weighted average of new and resale house prices. Our overnight rate and bond yield forecasts are translated into their impact on newly issued mortgages based on an estimated historical relationship. We assume lending gradually picks up to its pre-pandemic pace, and that the mix of new mortgages between variable and various fixed terms gradually normalizes to be in line with where they stood when yields were lower and home sales were more active, anchored to the middle of 2021. We model the historical relationship between our MIC proxy and the actual index, and after determining that it does reasonably well in out-of-sample tests, use that equation to project the MIC index ahead.

The result is that under our interest rate outlook, which has the overnight rate levelling off at 2.75% by the end of 2025, and the rest of the curve seeing a steepening rally, we expect MIC inflation to cool dramatically over the coming year and a half (Chart 1). Whether the path ahead for MIC is good or bad news is in the eye of the beholder. Pessimists will note that MIC inflation will stay elevated until we're into 2025. But optimists

Chart 1: MIC to drop to around 1% y/y by end-2025, by then adding just 0.1%-points to CPI inflation



Source: Statistics Canada, CIBC calculations

should take comfort in the fact that MIC inflation could drop like a stone over in the latter half of this year and only modestly contribute to headline inflation next year.

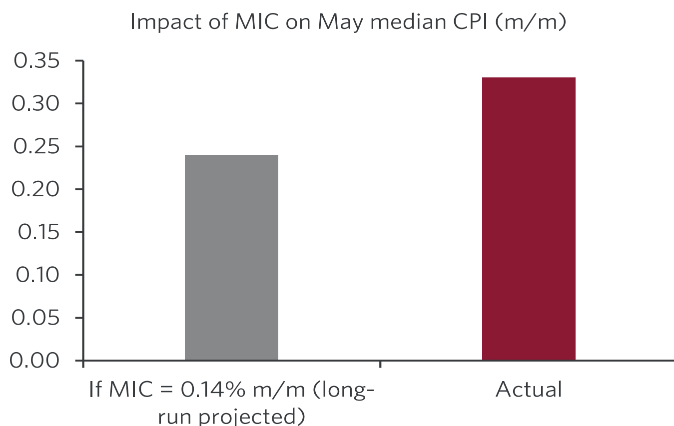
An uncomfortable truth resurfaces

For core inflation measures, that will also be meaningful. MIC will cease to be one of the items omitted in the "trimmed" core measure, allowing other elevated components of the CPI to get trimmed out of the measure. Given that MIC is now taking up more space in the basket, with its weight in CPI revised up substantially to 5.6% as of May 2024 from its prior weight of 3.8%, more higher-inflation items will have to be filtered out of CPI-trim and CPI-median, and will put more emphasis on a softer MIC component. A moderately-paced MIC could represent almost 10% of CPI-trim inflation once it is no longer trimmed out.

To illustrate the scale of these impacts, consider how much different the median monthly CPI inflation in May would have been had MIC been running at our average 2025 forecast for that component, keeping all other price changes the same. That alone would have pushed down median inflation from 0.3% m/m to 0.2% m/m in that month (Chart 2), or above a 1%-point difference on an annualized basis. True, lower MIC would imply higher house prices. But that will not provide much of an offset given MIC's weight is close to three times larger than the sub-component that tracks house prices in the CPI.

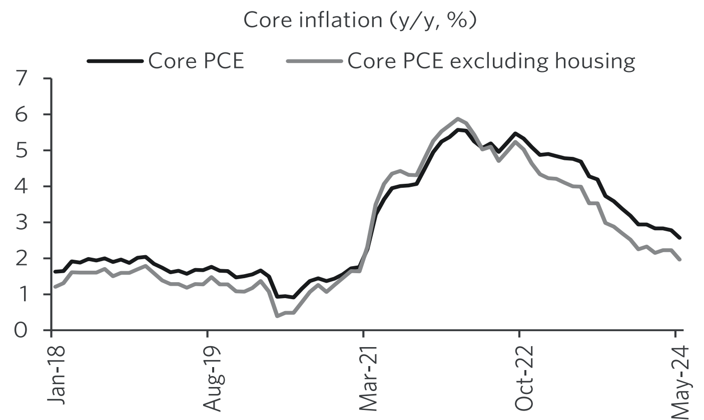
That reinforces the fact the MIC inflation rate can have a significant impact on the BoC's two core measures of inflation, even if its currently one of the items trimmed out. That uncomfortable truth is why we've argued that the Bank should put a former core measure, CPIX, which excludes MIC entirely, back into the starting lineup of "preferred" core measures as a complement to trim and median inflation (See Rotten to the core? Why some old measures of inflation are back)

Chart 2: The Bank's core inflation measures are also affected by MIC



Source: Statistics Canada, CIBC calculations

Chart 3: US core PCE inflation is being partly held up by shelter inflation



Source: Bureau of Economic Analysis, CIBC

While not in double-digit territory, rent inflation, running at 9% year-on-year, has been the other problematic component of Canada's shelter basket. There too, lower interest rates could ultimately support some cooling by inducing more supply from developers, and easing rental demand by letting more Canadians purchase homes. Slower population growth in 2025 could also be a major factor on the demand side. Urbanation's rent measure suggests that rental inflation is beginning to ease.

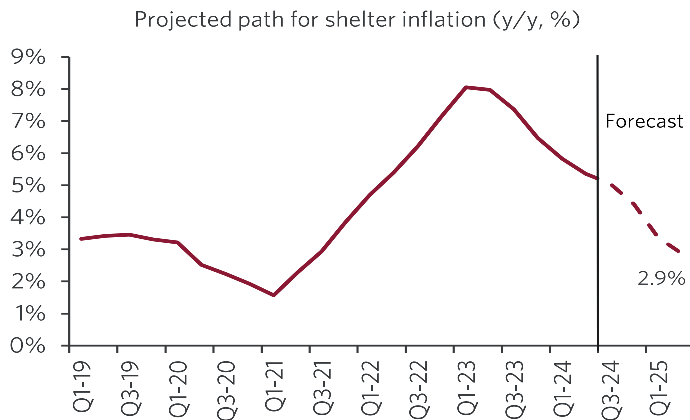
That said, forecasting rent inflation has its own complexities: rents for existing tenants can be slow to catch up to market rents given rent controls in some areas, implying the risk of further upside. But there are also limits to what renters can afford to pay, and that can be binding given the high proportion of income devoted to shelter. There are more practical barriers as well. The lack of historical data on market-based rent measures and StatCan's methodological changes to rent CPI make this near impossible to do credibly from an empirical point of view.

US rents and the last mile

In the US, one can't avoid looking at rents, or the broader shelter component, because it is one of the keys to the last mile towards the Fed's 2% inflation target. Core PCE inflation is still running at 2.6%, but take housing out of the picture, and we're already at the 2% target (Chart 3). Rents are used as a measure of inflation for both renters and homeowners, with the latter tracked by measuring the cost of renting a mix of apartments or houses that matches those in the owned-housing market.

We shared the view of many economists, and apparently Jay Powell, that the sharp deceleration seen in market-based rent measures would show up before too long in the CPI rent measures.

Chart 4: Combining research out of the Boston and Richmond Fed implies shelter inflation will fall to about 3% by mid-2025



Note: Forecast represents the average of O'Trakoun (2023) and Cotton (2024), based on the implicit sequential forecasts of shelter inflation over that period.

Source: Bureau of Labor Statistics, O'Trakoun (2023), Cotton (2024), CIBC calculations

Happily, research out of the Richmond[1] and Boston Fed[2], using two very different methodologies, arrive at broadly similar conclusions: by the middle of next year, shelter inflation should come down to close to its pre-pandemic average of 3% (Chart 4). The Richmond Fed estimate is more aggressive, suggesting shelter should fall by 3%-points to around 2% while the Boston Fed paper has a more steady pace of disinflation resulting in a 2%-point decline. But both suggest major progress is right around the corner.

Estimating the lag relationship between the Zillow rent index, or the Cleveland Fed's new tenant rent measure, and shelter inflation, a researcher at the Richmond Fed shows that it takes about a year for the pass-through of market-based rent measures to pass-through into the CPI shelter, which measures changes in rents of both new and existing tenants (O'Trakoun, 2023). Both these measures remain well below the CPI rent and have fallen further more recently, suggesting that a lot of disinflation remains in the pipeline (Chart 5).

The analysis out of the Boston Fed tries to tackle the speed at which the gap between market-based rents and CPI shelter closes (Cotton, 2024). Using granular data at the metropolitan level, the author estimates that a gap can persists and grow for over a year, explaining what appears to be some of the slower progress we have seen so far. Ultimately their forecast calls for shelter inflation to slow over the next year as the gap dissipates, with the most progress occurring during the second half of this year.

While progress could still be a bit bumpy, these analyses increase our confidence that the trend in shelter inflation is clearly down, the deceleration has in fact been consistent with past relationships to other rent measures, and that the pace of disinflation should speed up within the next year.

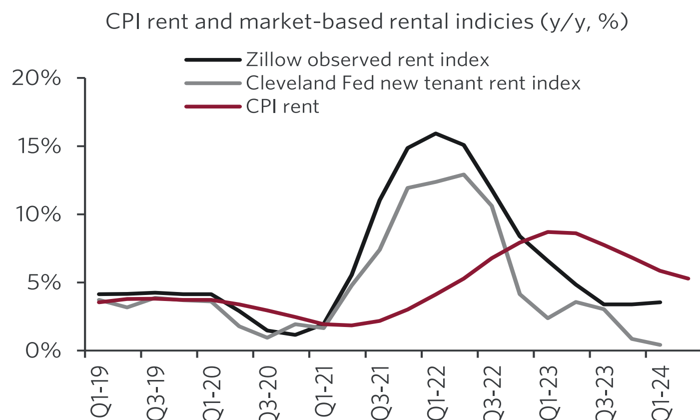
Even taking the Boston Fed's less optimistic projection, the 2%-point decline in shelter could drop year-over-year Core CPI by 0.9%-points. Mechanically subtracting that from today's Core CPI inflation would bring us to 2.5%. The same exercise for Core PCE inflation, which has a much smaller weight on shelter (18% vs 46%), would come down by 0.4%-points to 2.2%, with a hair of the official target.

There's more to the inflation story than shelter in both the US and Canada. But gaining some shelter from rising costs for accommodation is no small part of the last mile. It's also an important part of keeping inflation expectations anchored and therefore material to supporting interest rate reductions in both countries through 2025.

[1] John O'Trakoun, "When Will a Decline in Asking Rents Be Reflected in Rent CPI?", Richmond Fed: Macro Minute, April 2023

[2] Christopher Cotton, "A Faster Convergence of Shelter Prices and Market Rent: Implications for Inflation", Boston Fed: Current Policy Perspectives, June 2024

Chart 5: Market-based rent indices continue to point to shelter disinflation



Source: Zillow, Bureau of Labor Statistics, CIBC

Contacts:

Avery Shenfeld
avery.shenfeld@cibc.com

Benjamin Tal
benjamin.tal@cibc.com

Andrew Grantham
andrew.grantham@cibc.com

Ali Jaffery
ali.jaffery@cibc.com

Katherine Judge
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice. This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2024 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

The CIBC logo and "CIBC Capital Markets" are trademarks of CIBC, used under license..