MIRACLE MILE ADVISORS
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FROM THE CIO'S DESK
MARKET COMMENTARY

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The Last Mile of Inflation

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KEY TAKEAWAYS

- **Stubbornly high inflation is driven by factors like shelter and auto insurance costs. However, an increase in multi-family housing supply may alleviate shelter prices soon. With auto insurance prices soaring 22% over the past year,[1] we anticipate premiums to stabilize eventually.**
- **Rising oil and gasoline prices pose a new challenge to inflation. Geopolitical tensions and low inventories have boosted oil prices by roughly 20% year-to-date. This hike affects not just gas prices but also transportation costs, amplifying broader price pressures.**
- **We expect fluctuations in inflation readings ahead. Piecing multiple readings together will be more informative than reacting to one good or bad monthly report.**

In March, the Consumer Price Index (CPI), a common measure of inflation, came in hotter than economists and markets expected. Prices rose by 0.4% during the month of March alone, and over the past year, the CPI has risen by 3.5%. This is much better than the 9.1% annualized rate of inflation that existed in June of 2022, but after bottoming at 3.0% in June of 2023, the Consumer Price Index has remained stuck in a 3% to 4% range over the past nine months.[1] The level of inflation continues to exceed the Federal Reserve's stated target of a 2% average. This remaining variance, or last mile, of inflation, is proving to be the hardest to eradicate.

Key contributors to the stubbornly sticky inflation readings have been categories such as shelter and auto insurance. These drivers are typically more transitory, as increasing supply of multi-family housing should translate to shelter prices easing in the following months. In addition, with auto insurance prices up 22%[1] over the past year, we would expect policy premiums to moderate over time.

An emerging factor that could challenge headline inflation has been the rise in oil and gasoline prices. The significant drop in oil prices following their peak in June of 2022 has contributed to the meaningful decline in the annualized rate of inflation. More recently, lower inventory levels and rising geopolitical concerns have pivoted the direction of oil prices, which are now up roughly 20% year-to-date. A lack of drilling activity and new supply would indicate the price of oil may remain elevated for some time, spurring added inflation.

The impact of higher oil prices extends beyond just gasoline prices but can possibly lead to higher freight and transportation costs, reverberating into broader price pressures across the economy.

As we consider these and other factors, it's reasonable to expect there to be a variety of puts and takes to inflation readings in the months to come. Piecing multiple readings together will be more informative than reacting to one good or bad monthly report. As we've seen three consecutive inflation readings that have been surprisingly higher than expected, it's fair to say the Federal Reserve continues to face the challenge of eradicating the last mile of inflation.

Our expectation is that the recent inflation data, combined with what remains a robust and healthy job market, enables the Federal Reserve to exercise patience in its path to cutting interest rates. Based on the data today, it's increasingly likely that the Fed won't cut rates until the back half of 2024 at the earliest. We'd expect the elevated volatility in interest rates to remain as the market continues to parse through economic data and adjust expectations for the timing and pace of rate cuts. If 2024 has demonstrated anything, the current data-dependent state of Federal Reserve policy creates more ambiguity and makes forecasting interest rates even more challenging. Case in point, just three months ago the market was expecting the Federal Reserve to reduce interest rates seven times in 2024. That expectation now sits at a mere two rate cuts.[2]

The unexpected uptick in inflation has resulted in higher bond yields thus far in 2024, leaving us more constructive on the return potential for the asset class. We think it's healthy for bond investors to look past any noise in short-term movements in bond yields (good or bad) and focus on the absolute level of yield they can earn. The broader bond market, as measured by the Bloomberg Aggregate index, presently offers a yield of 5%, a level we view as reasonably attractive, particularly in the context of where bond yields have been over the past twenty years. Extending out over a multi-year horizon, as the last mile of inflation begins to ease, there is opportunity for investors to earn added return from appreciation in the price of their bonds should yields ultimately decline.

It's clear that the last mile of inflation will take time to tame. Markets don't like ambiguity and as such the impact of uncertain inflation will continue to create episodes of volatility for bond prices. Even though the current rate of inflation remains above target, it has much improved from the levels that existed two years ago. Investors should take greater comfort in the present level of bond yields and the more attractive risk/reward profile that exists in the asset class today.

[1]: Source Bureau of Labor Statistics, Consumer Price Index – March 2024, [2] Source: Bloomberg, as of 4/10/2024