RESEARCH BRIEF
INFLATION

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Elevated Services Costs Stymie Fed's Bid to Rein in Core Inflation

Rising shelter prices keep core inflation high. The average 30-year fixed-rate mortgage climbed above 7.5 percent in October, marking a 23-year peak. Previous Federal Reserve actions have increased interest rates, which — in conjunction with higher home prices — have resulted in more expensive housing costs. The shelter index lifted 7.2 percent year-over-year in September, driven by the owner's equivalent rent segment increasing in that month. This component surveys how much homeowners would accept to rent their own residences, capturing more costly ownership expenses and still-elevated home values. Higher prices for single-family housing, as well as a lack of for-sale inventory entering the market, underscore the long-term cost benefit of renting an apartment. Comparatively lower expenses and greater availability among multifamily rentals will capture some of the single-family demand, helping curb this component of services inflation over time.

Overall pricing pressures plateau. The headline Consumer Price Index rose 3.7 percent annually in September, matching August's reading. Elevated food and gasoline prices kept inflation up, with the two continuing to increase in the month. Food and energy costs tend to be more volatile, however, and when stripping them out, core CPI decelerated to a two-year low of 4.1 percent in September. While the metric's slowdown is a welcome sign for consumers, it still remains above levels acceptable to the Fed. Core pricing pressures were cooled by flat costs for durable goods; yet, persistently elevated services costs are proving to be the Fed's final hill to summit on its quest to tamp down core inflation.

Transportation expenses climb. Along with higher shelter costs, a 9.1 percent hike in the transportation services index also kept core pricing pressures elevated. Its largest component, motor vehicle insurance, advanced 18.1 percent. Earlier inflation played a large part in driving up the cost of repairing motor vehicles, including for parts and labor, requiring insurers to raise premiums. While the expense is a necessity for consumers and is unlikely to affect the behavior of many, the increase underscores the overall higher cost of owning and operating vehicles. For e-commerce and transportation companies that require large fleets, this rising operational expense could become a hurdle down the line. However, operations currently remain in solid shape, with these firms continuing to bolster payrolls on a nationwide basis in September.

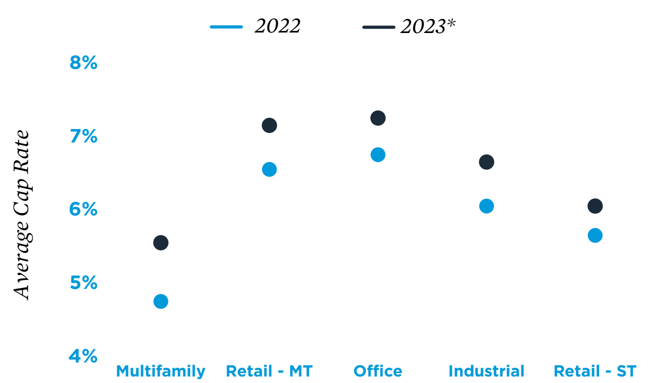
Markets predict Fed pause at next meeting. Wall Street is currently pricing a close-to 95 percent chance for the Federal Reserve to hold rates flat in November. Core CPI inflation has fallen by 250 basis points from the September 2022 peak, and the remaining challenge — rising services costs — is one that the Fed understands works with lags. The shelter index, in particular, tends to reflect trends from prior periods due to the annual basis of most leases. As this caveat bolsters the potential for a Fed pause, greater interest rate stability should improve the deal-making process for lenders and investors in the commercial real estate industry.

Fed still intends to temper investment activity. While the overnight lending rate approaches more solid footing, the Fed continues to cool the economy by reducing its balance sheet, having unloaded $900 billion in the last year. This has pushed up long-term interest rates, limited lenders' liquidity, and required higher yields for commercial real estate deals to pencil. As the process continued to play out this past quarter, cap rates experienced upward pressure, with the impact varying by individual property performance, location and asset type.

3.7%
Increase in Headline CPI Year-Over-Year

4.1%
Increase in Core CPI Year-Over-Year

Cap Rates Rise on a National Basis



**Trailing 12-month average through 3Q estimate*
Includes sales $1 million and greater
Sources: IPA Research Services; Freddie Mac; Bureau of Labor Statistics; CME Group; Federal Reserve; RealPage, Inc.; Census Bureau; Bureau of Economic Analysis; CoStar Group, Inc.; Real Capital Analytics