Goldman Sachs | Economics Research

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US Economics Analyst

OER You Serious? (Hill/Walker)

- We expected and indeed received a large "January effect" in last week's price data, with CPI and PPI both surprising consensus to the upside. In our view, the bigger surprise was the 0.56% spike in owners' equivalent rents (OER), which outperformed the primary rent measure by the most since 1995. In this edition of the *Analyst,* we explore the scope for OER to continue to outperform and the implications of the January price data for the inflation and policy outlook.
- In principle, the rebound in the single-family housing market and the unaffordability of homebuying could drive a positive wedge between OER and rent growth. Exploring this possibility using Zillow, Yardi, and Corelogic data, we find that the outperformance of single-family rent growth is fairly moderate—around +2pp annualized—and we estimate that this gap explains less than a quarter of the January OER spike. Simply put, January OER rose 7% in annualized terms but single-family rent growth is running at less than half that pace. We also do not find a clear relationship in the city-level cross section between January OER and single-family home price appreciation.
- We believe single-family housing strength is a reason to expect OER to outperform rent CPI this year, but by nowhere close to 20bp per month. We assume a 4bp monthly boost to OER from this channel over the remainder of 2024, and we are boosting our December 2024 PCE housing inflation forecast by 0.4pp to 4.3% (yoy).
- We are not too concerned about the strength elsewhere in the January CPI and PPI reports. January price changes tend to be cyclical and volatile—what we call the "January effect"—and usually, sequential inflation slows back down in February. We had already assumed a January effect in healthcare—where the lag between costs and prices is particularly long. Additionally, 3- and 6-month trimmed inflation remained rangebound in January, *despite* a boost from the January effect. Taken together, we are boosting our 2024 core PCE forecast only modestly, by 0.1pp to 2.3% (December yoy).
- The January FOMC statement indicates that rate cuts will likely commence once inflation is moving sustainably toward 2%. If inflation evolves as we expect, core PCE inflation would fall to 2.5% at the time of the May meeting, and participants would likely anticipate further declines over the next two months given the high base effects in mid-2023. Accordingly, we continue to forecast five 25bp cuts in

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the Fed funds rate this year, with the first cut at the May meeting. This being said, last week's price data raise the stakes for the February CPI and PPI reports to confirm that the January jump in OER and non-housing services were both temporary.

OER You Serious?

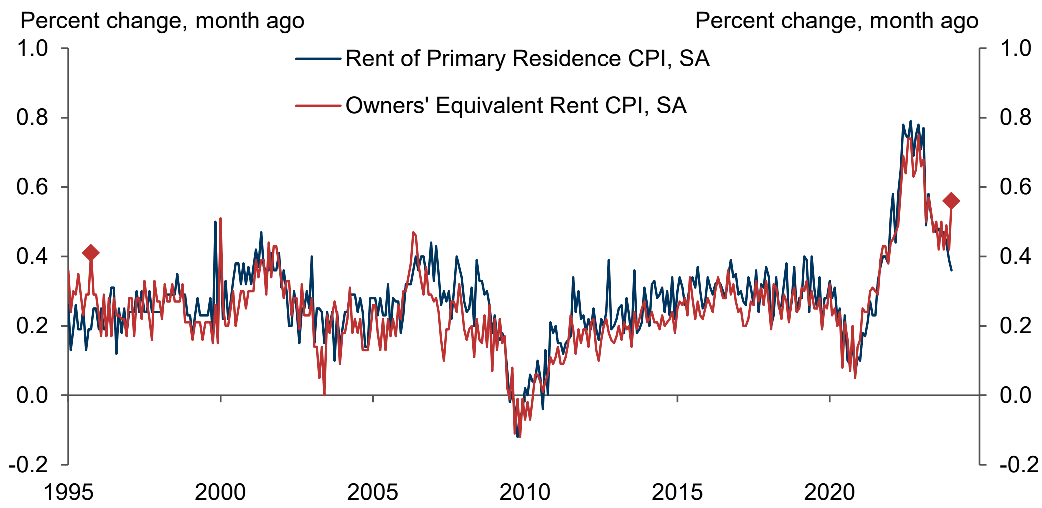
The January CPI report received a large boost from start-of-year price adjustments—what we call the January effect. Because we were expecting a temporary boost from this channel, the bigger surprise for us was the spike in owners' equivalent rents, which represent 34% of core CPI and 13% of core PCE. Despite being calculated from the same source data as the primary rent CPI, due to imputations and re-weightings, the owners' equivalent rent (OER) category jumped 0.56% in January, outperforming the primary rent measure (+0.36%) by the most since 1995. In this edition of the *Analyst*, we explore the scope for OER to continue to outperform, and we search for broader implications of last week's price data for the inflation and interest rate outlook.

A Spike in OER

The largest component of the CPI—owners' equivalent rent, or OER—tracks a price that nobody pays: an imputed rental payment from homeowners to themselves. After this category did not mirror the surge in home prices in 2021 and 2022, the Bureau of Labor Statistics (BLS) revamped the CPI methodology in January 2023 to increase the weight on rents of single-family houses.

As shown in Exhibit 1, OER spiked 0.56% in January, a nine-month high and its largest gap versus the primary rents component since 1995. Leaving aside the question of how the inflation statistics *should* treat owner-occupied housing, the large OER weight in core CPI (34%) and core PCE (13%) implies a potentially large boost to measured inflation if this gap were to persist later in 2024. Illustratively, OER outperformance contributed 7bps to monthly core CPI inflation in January, which in annualized terms adds +0.8pp to core CPI inflation and +0.3pp to the core PCE measure. Put another way, a persistent OER-rent gap of the size seen in January could potentially determine whether core PCE returns to target later this year or remains in a 2.3-2.5% range on both an annualized and year-on-year basis.

Exhibit 1: The January OER-Rent Gap Was the Largest Since 1995

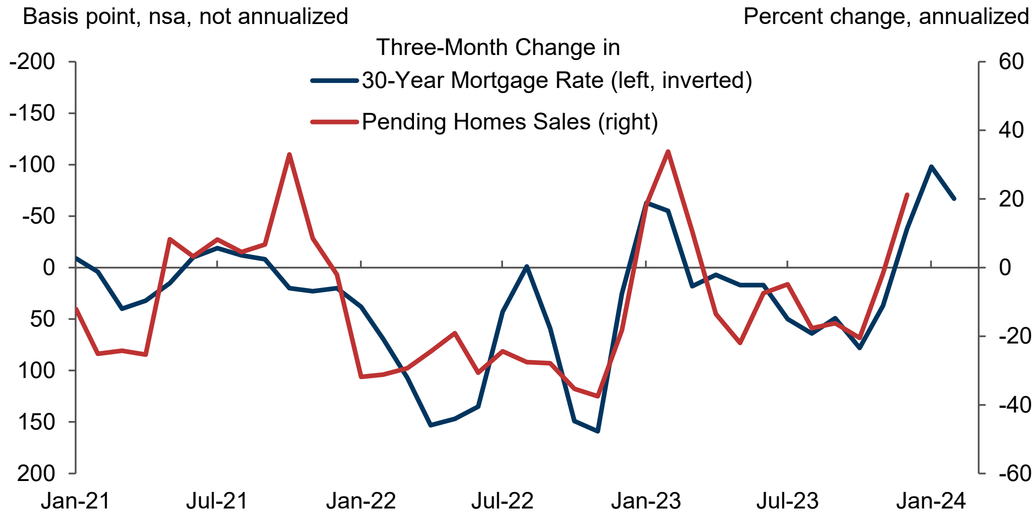


Source: US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

Because homeowners pay directly for utilities but tenants generally receive some services pre-paid as part of their rental agreement, the BLS imputes and removes utility costs from the OER index. We doubt this imputation explains the January OER spike for the simple reason that utility prices are rising—and that uptrend implies *downward pressure* on OER. The January effect is also a poor explanation for the OER jump, because most rent prices do not adjust in January.

This raises the risk of a more fundamental and persistent driver of the January OER acceleration, and the most obvious candidate is the nascent rebound in the housing market and the large affordability gap between buying and rent—because the cost of financing a home far exceeds the cost of renting, potential home buyers are forced into the rental market at a time of very low supply. As shown by Exhibit 2, the 1pp pullback in mortgage rates since the autumn has contributed to a 21 percent annualized rebound in pending home sales over the last three months. Home prices are also now rising again at a roughly 5% annualized pace (Case-Shiller, 3-mo ar, not shown).

Exhibit 2: The Housing Market Is Starting to Rebound



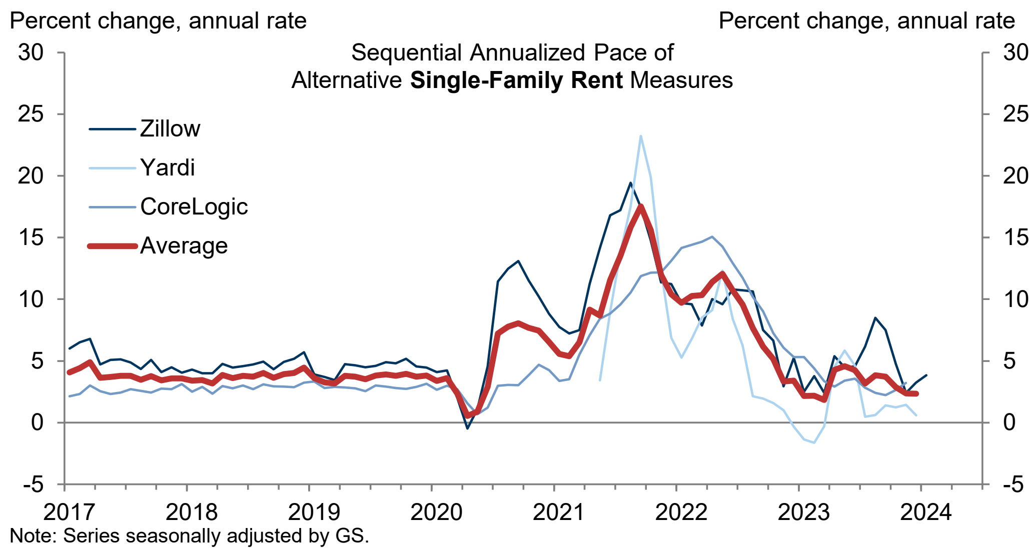
Source: Goldman Sachs Global Investment Research

Alternative Data on Single-Family Rents

While home price growth does not directly enter the CPI, it nonetheless boosts measured inflation to the extent that it spills over to the rental market—particularly for the OER subcategory that overweights single-family neighborhoods and (since January 2023) overweights single-family units.[1] In Exhibit 3, we create a composite measure of single-family rent growth combining three higher-quality series. We find that the monthly annualized growth rate of these measures has slowed from a peak of almost 18% in late-2021 to roughly 2-3% on average in recent months, arguing against a sharp pickup in new-lease single-family rent growth that might explain the January spike in OER. More simply, January OER rose 7% in annualized terms, but single-family rent growth is running at less than half that pace—and OER also includes a multifamily segment for which rent growth is even lower.

[1] If the recent rebound in the housing market were behind the acceleration in OER, we would expect the impact to first show up in the price of new leases, and especially in the price of new leases for single-family rentals—which are a closer substitute to owner-occupied housing and are heavily weighted in OER. As discussed in earlier reports, the official CPI measure of OER only sees a gradual feed-through from higher market rates because it covers rents on both new leases and continuing leases for existing tenants. The latter usually adjust more gradually, both because landlords are reluctant to alienate and lose tenants by raising their rent too abruptly and because the cost of moving reduces the risk that tenants will move out when market rents decline more quickly than their own, which is especially the case for single-family rentals.

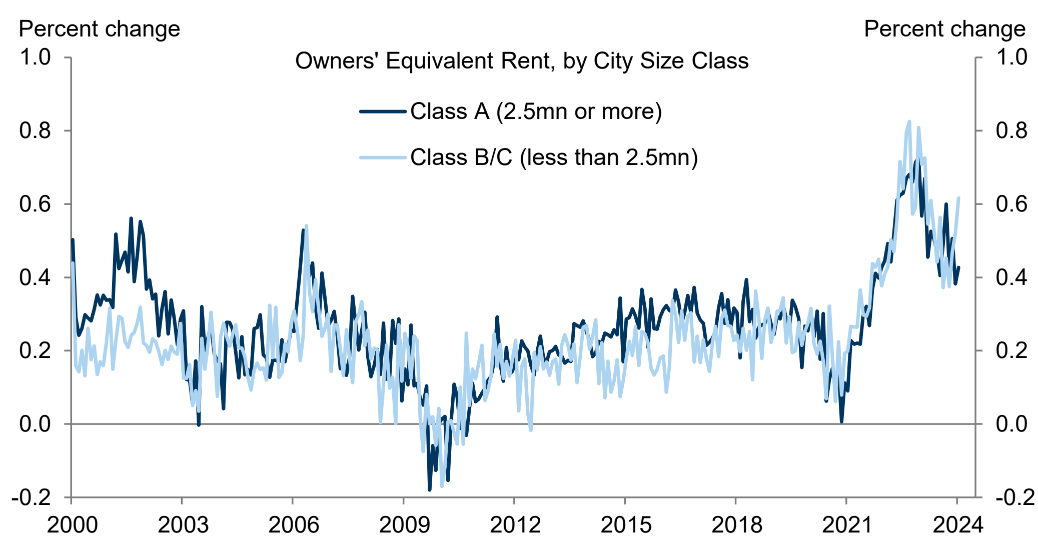
Exhibit 3: But Single-Family Rent Growth Is Not Strong by Any Measure



Source: Zillow, Yardi, CoreLogic, Goldman Sachs Global Investment Research

As an additional crosscheck for whether a hot housing market might have contributed to the pickup, we review the city-level cross section in the CPI data. Exhibit 4 shows that the January pick-up in OER was led by smaller metros: OER accelerated by more in Class B and C cities (those with populations less than 2.5mn) than in Class A cities (those with populations of 2.5mn or more).

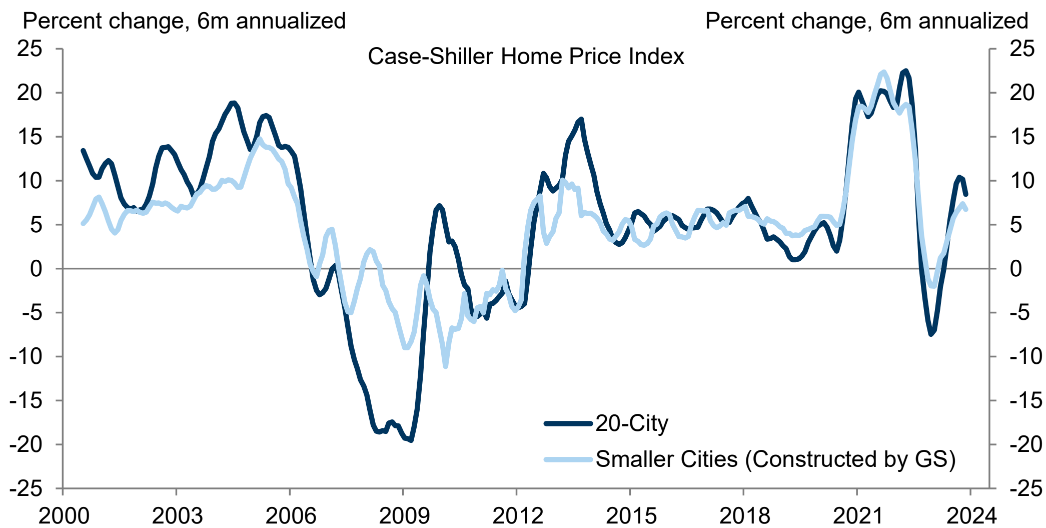
Exhibit 4: The January Surge in OER Was Led by an Acceleration in Smaller Cities



Source: US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

If a hot housing market were the source of the acceleration in OER, we would expect home price growth to be hotter in those cities. We find the opposite: home price growth in smaller cities has been running slightly *below* that of large cities over the last 6 months, as shown in Exhibit 5.

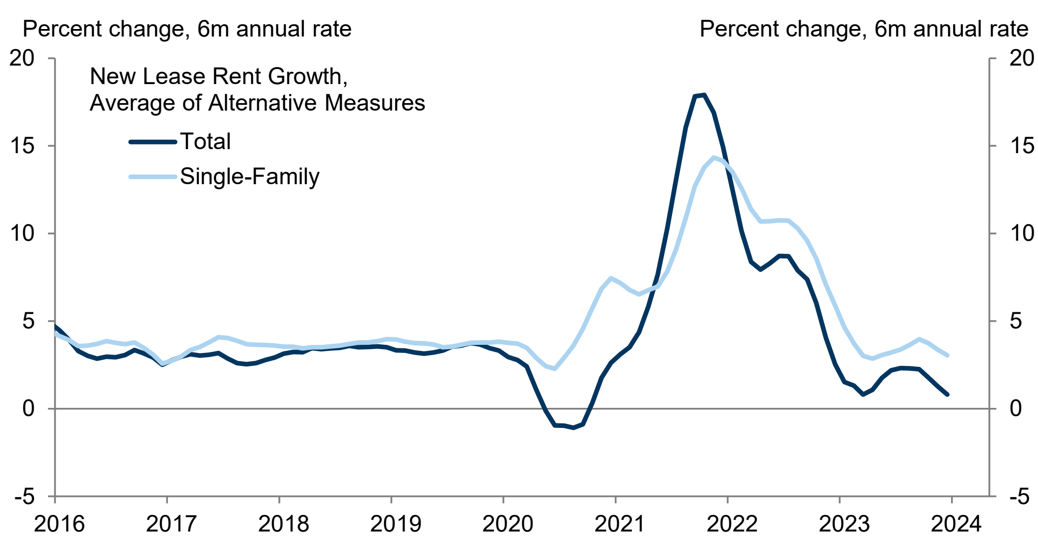
Exhibit 5: But the Housing Market Has Been Cooler in Smaller Cities



Source: S&P CoreLogic, Goldman Sachs Global Investment Research

While quantitatively unsatisfactory for January, the outperformance of single-family rent growth does argue for OER to run modestly hotter than primary rent inflation going forward. As shown in Exhibit 6, we find that single-family rents have been and are currently rising roughly 2pp faster than the broader market.

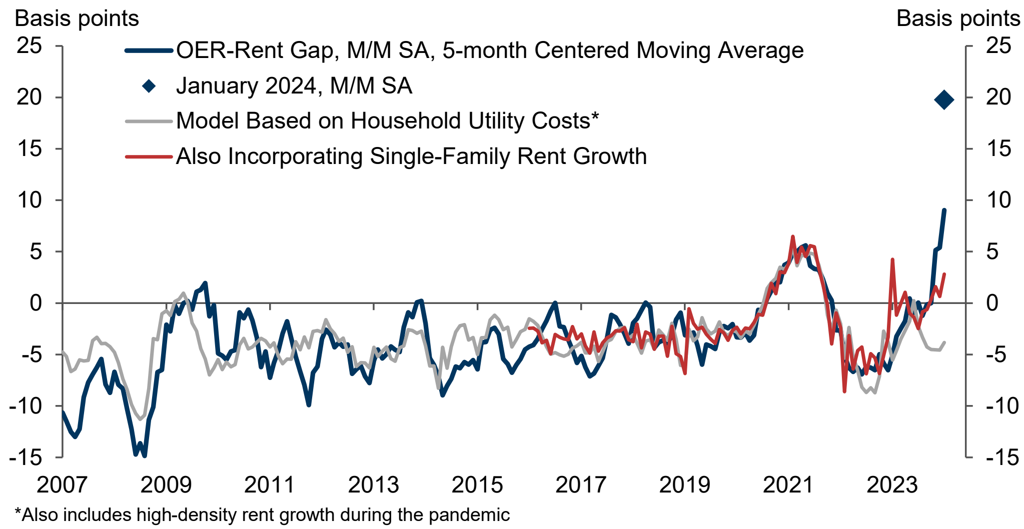
Exhibit 6: Moderate Outperformance of Single-Family Rent Growth



Source: Goldman Sachs Global Investment Research

In Exhibit 7, we model the monthly inflation gap between the OER and rent CPIs using household utility prices and using the outperformance of single-family rent growth (shown previously in Exhibit 4). We allow the coefficient on single-family rents to evolve in the month of January 2023, concurrent with the BLS methodological change that increased the weight in OER on single-family units.[2] As shown by the red line in Exhibit 7, we estimate that single-family outperformance can at most explain a quarter of the January OER spike.[3] It would also be odd for a methodological change implemented in January 2023 to produce a sustained increased in monthly inflation starting in January 2024.

Exhibit 7: We Estimate That Single-Family Outperformance Explains Less than a Quarter of the January OER Spike



Source: US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

Our analysis argues against a 20bp step-up in the monthly OER trend caused by single-family housing strength. Looking ahead, we instead assume a +4bp boost to the monthly run-rate for the remainder of 2024, relative to our previous estimates, though we also assume a third of the January spike reverses in July when the January subset of the CPI rent is next surveyed.

Reflecting the January OER spike and our +3bp upgrade to the pace of overall shelter inflation (the rent subindex is unaffected) in most other months in 2024, we are boosting our December 2024 CPI and PCE housing forecast by 0.4pp to 4.3% year-over-year. We are also boosting our assumptions for the upcoming core CPI readings to +0.27% for February and +0.25% for March, up from +0.21% and +0.22% previously).[4]

Non-Housing Services Inflation and the January Effect

Last week's CPI report also received a large boost from start-of-year price adjustments—what we call the January effect. However, we are not making significant

[2] We also include a proxy for urban flight during the pandemic: rent growth in high-density urban areas, which generally underperformed in 2020-2021.

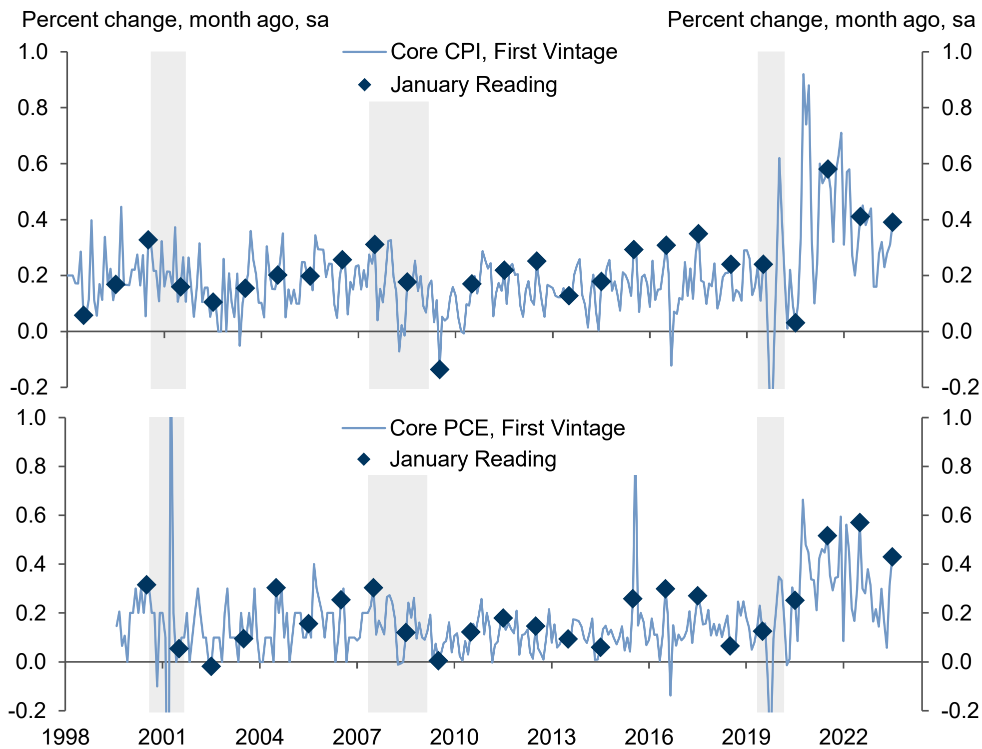
[3] We estimate between 3bp and 5bp of the +20bp OER outperformance in January can be explained by single-family rent growth, depending on whether the model is estimated in one or two stages.

[4] This reflects the particularly large weight of OER in the CPI, as well as scope for apparel prices to normalize to the upside. We continue to expect the Fed's preferred measure—core PCE—to round to +0.2% in both of those months (mom sa).

changes to our sequential inflation assumptions in affected categories, primarily because the January effect was already embedded in our forecasts.

The month of January is particularly important for inflation data, because many labor and supplier contracts are reset or renegotiated in that month.[5] This effect manifested in several labor-reliant services categories in January 2024, and in our view reflects a catch-up in prices to the upward cost pressures of 2023. As shown in Exhibit 8, January price changes tend to be cyclical and volatile, and in most past instances, sequential inflation reverses large January moves in February.[6]

Exhibit 8: January Inflation Readings Tend to Be Cyclical and Volatile, Because Firms Implement Start-of-Year Price Increases to Reflect the Prior Year's Cost Environment



Note: January 2024 core PCE datapoint reflects GS nowcast based on CPI, PPI, and import price source data. NBER recessions shaded.

Source: US Bureau of Labor Statistics, Bureau of Economic Analysis, Goldman Sachs Global Investment Research

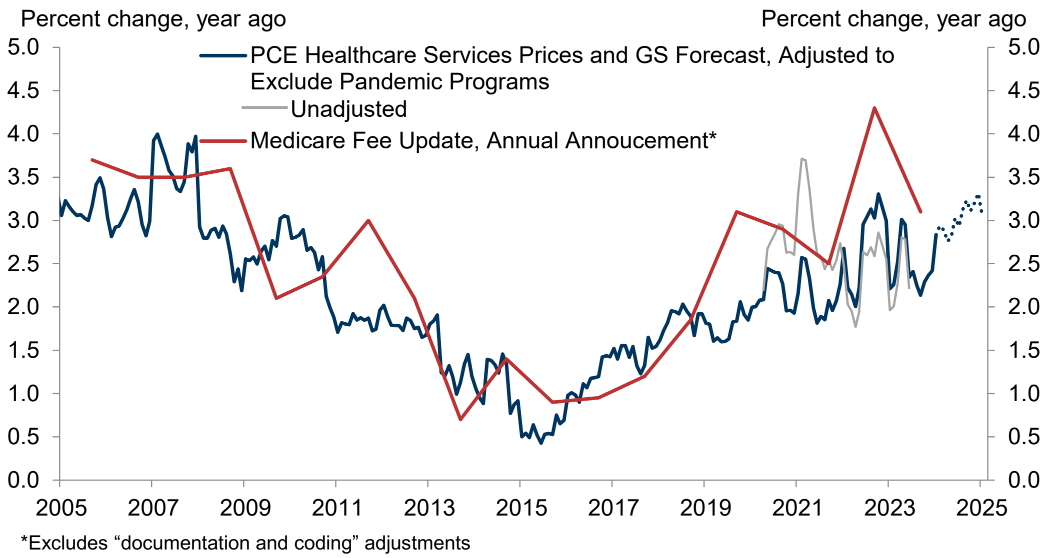
Healthcare prices were one of the stronger non-housing services segments—both in the CPI and PPI data. In our 2024 Inflation Outlook, we highlighted healthcare as one category where pent-up cost pressures would likely lead inflation higher, due to particularly long lags in that sector. This pent-up cost pressure evidently materialized in the January source data, as shown by our nowcast of healthcare services PCE in that month (see blue line in Exhibit 9).[7]

[5] We found that price changes for some goods and services are 50-100% more volatile in January—and that price and wage adjustments in January often reflect the changes in the economic environment that took place over the previous year.

[6] When the core CPI or core PCE accelerates in January by at least 5bp relative to the six-month average, it steps back down in February by at least that 5bp 55% and 62% of the time, respectively. The median retracement—inclusive of instances of further acceleration—is 42% and 55%, respectively. For February 2024, we expect an even larger retracement because of the possible outlier reading for January OER.

[7] We estimate a 0.32% increase in the PCE healthcare services component in January (mom sa).

Exhibit 9: The Strength in Healthcare Prices Was in Line With Our Assumptions and in Our View Represents a Catchup to the 2023 Cost Environment



Source: Bureau of Economic Analysis, Goldman Sachs Global Investment Research

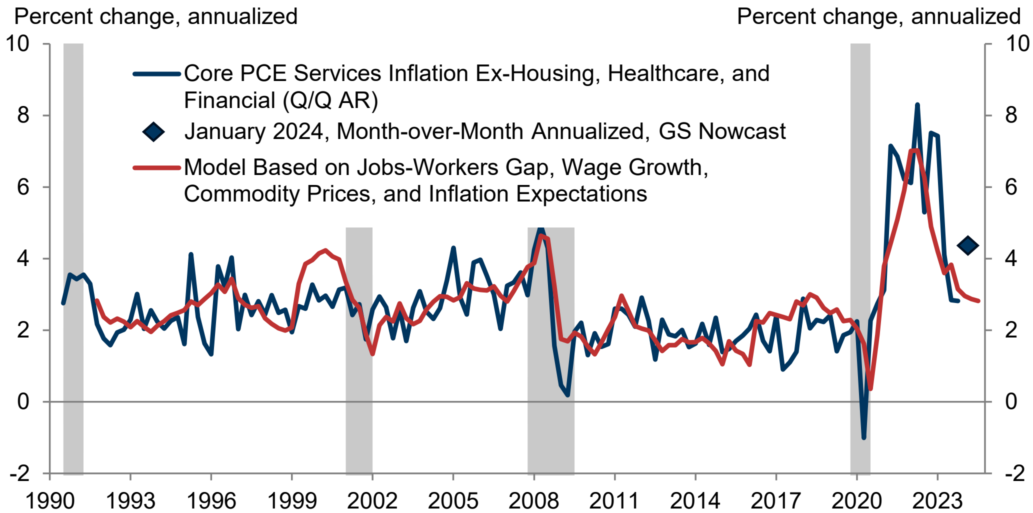
We continue to expect healthcare services inflation to rise to 3.2% year-on-year in December (see dotted line in the same exhibit), followed by a decline to 2.7% in 2025 as the cost environment normalizes further.[8]

More generally, the January price gains in non-housing services screen as an outlier relative to their key inflation drivers, as shown by our model (red line in Exhibit 10).[9]

[8] Leading indicators of healthcare inflation have started to slow, including a smaller increase in Medicare fee schedules (red line in Exhibit 9) and a 44% retracement of the healthcare jobs-workers gap: 5.5% of the healthcare labor force in Q4, down from 7.2% at the peak and compared to 3.4% pre-pandemic. Additional, hourly earnings growth for the sector has fallen back below 3% (+2.9% yoy in January vs. +7.2% at the peak and +2.2% in 2019).

[9] We exclude financial services prices as they depend much more on asset prices than on the labor market and cost environment.

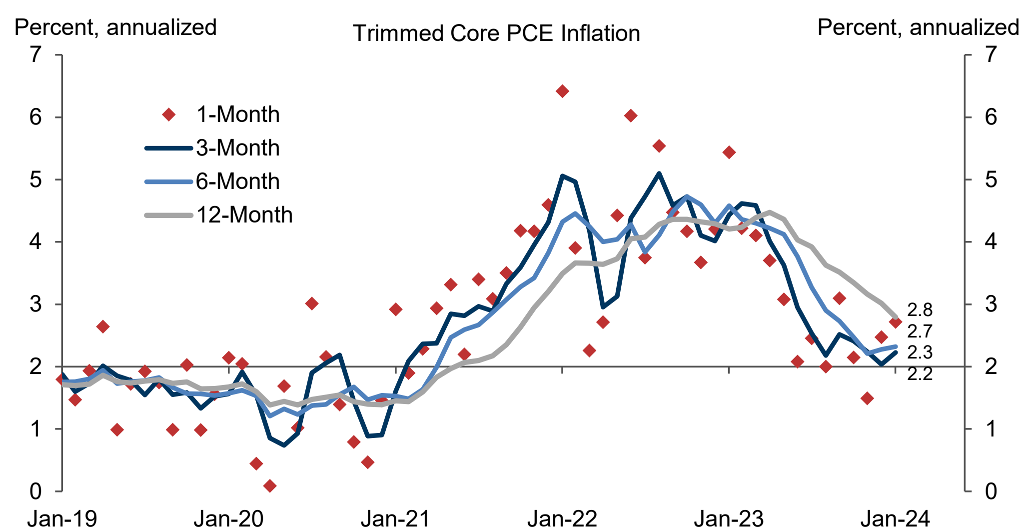
Exhibit 10: The Continued Rebalancing of the Labor Market Also Suggests that the January Rebound in Services Inflation Will Prove Temporary



Source: Bureau of Economic Analysis, Goldman Sachs Global Investment Research

We were also encouraged by the fairly modest pickup in 1-month trimmed core PCE inflation and by the rangebound readings for 3- and 6-month gauges (see Exhibit 11).[10]

Exhibit 11: Trimmed Inflation Trend Remains Rangebound, Despite the Boost from the January Effect



Source: Bureau of Economic Analysis, Goldman Sachs Global Investment Research

In some sense, the sequential price strength in January confirms last year's cost pressures, which are a fairly undisputed feature of the economy in that period. Under

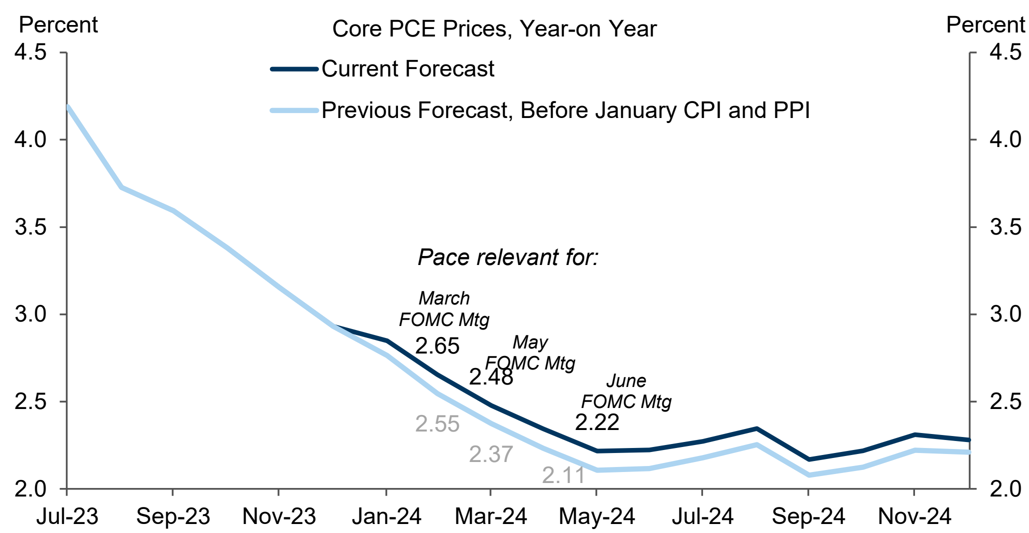
10 The January effect should also manifest itself in trimmed measures of inflation, some of which unsurprisingly picked up in January. Furthermore, year-on-year trimmed inflation—which incorporates the size of this year's January effect relative to that of the prior year—continued to decline. This is consistent with our forecast of a smaller January effect in 2024 and in our view indicates continued progress on disinflation more broadly.

that interpretation, the January price data may tell us little about the sequential pace of inflation for the remainder of 2024. Taken together, with the January CPI and PPI reports in hand we are boosting our 2024 core PCE forecast only modestly, by 0.1pp to 2.3% (December yoy).

Fed Implications

As shown in Exhibit 12, our updated forecast for 2.65% year-on-year core PCE in February remains above the threshold to begin the easing cycle at the March FOMC meeting.

Exhibit 12: The 2024 Inflation Path Looks Slightly Stronger After Last Week's Price Data



Source: Goldman Sachs Global Investment Research

Looking further ahead, we believe our forecasted decline to 2.5% for March—which the Fed will have in hand at the May meeting—is consistent with a rate cut at that meeting as long as the sequential readings in February and March are sufficiently soft and the year-on-year pace looks likely to decline further.

The January FOMC statement indicates that rate cuts will likely commence once inflation is moving sustainably toward 2%. Fed Chair Powell noted in December that this easing should occur "well before" year-on-year inflation reaches that level, however the FOMC reaction function may have shifted since then given that Powell has not repeated this "well before" comment recently and given the omission of the 6-month annualized rate from recent Fed communications.

If inflation evolves as we expect, core PCE inflation would fall to 2.5% at the time of the May meeting, and based on high base effects in mid-2023, we'd expect the Fed staff to project further declines in subsequent months. We continue to forecast five 25bp cuts in the Fed funds rate this year, with the first cut at the May FOMC meeting. This being said, last week's price data raise the stakes for the February CPI and PPI reports to confirm that the January jump in OER and non-housing services were both temporary.

Spencer Hill

Ronnie Walker

The US Economic and Financial Outlook

THE US ECONOMIC AND FINANCIAL OUTLOOK
(% change on previous period, annualized, except where noted)

	2022	2023 (f)	2024 (f)	2025 (f)	2026 (f)	2027 (f)	2023 Q1	2023 Q2	2023 Q3	2023 Q4	2024 Q1	2024 Q2	2024 Q3	2024 Q4
OUTPUT AND SPENDING														
Real GDP	1.9	2.5	2.8	2.1	2.0	2.0	2.2	2.1	4.9	3.3	2.3	2.6	2.3	2.0
Real GDP (annual=Q4/Q4, quarterly=yoy)	0.7	3.1	2.3	2.1	1.9	2.0	1.7	2.4	2.9	3.1	3.1	3.3	2.6	2.3
Consumer Expenditures	2.5	2.2	2.4	2.1	2.0	2.0	3.8	0.8	3.1	2.8	2.6	2.0	2.2	2.2
Residential Fixed Investment	-9.0	-10.7	3.6	2.8	3.0	2.4	-5.3	-2.2	6.7	1.0	5.2	4.5	3.5	2.0
Business Fixed Investment	5.2	4.4	2.6	3.3	3.8	3.6	5.7	7.4	1.5	1.9	2.7	2.5	2.0	2.7
Structures	-2.1	12.7	3.5	-1.1	2.9	3.0	30.3	16.1	11.2	3.2	5.8	1.0	-5.0	-6.0
Equipment	5.2	-0.1	1.9	5.5	3.8	3.2	-4.1	7.7	-4.4	1.0	0.7	3.0	5.0	7.0
Intellectual Property Products	9.1	4.3	2.7	3.9	4.3	4.5	3.8	2.7	1.8	2.1	2.8	3.0	3.5	4.0
Federal Government	-2.8	4.2	1.5	0.0	0.0	0.0	5.2	1.1	7.1	2.5	0.6	0.0	0.0	0.0
State & Local Government	0.2	3.8	2.9	1.1	1.0	1.0	4.6	4.7	5.0	3.7	2.1	3.0	1.0	1.0
Net Exports ($bn, '17)	-1,051	-926	-898	-929	-942	-931	-935	-928	-931	-908	-894	-896	-897	-904
Inventory Investment ($bn, '17)	128	51	65	78	60	60	27	15	78	83	40	62	78	78
Industrial Production, Mfg.	2.7	-0.6	1.1	3.4	3.3	3.3	-0.3	0.4	-0.5	-2.0	1.2	3.0	3.4	3.5
HOUSING MARKET														
Housing Starts (units, thous)	1,551	1,422	1,469	1,540	1,584	1,590	1,385	1,450	1,371	1,483	1,425	1,457	1,483	1,511
New Home Sales (units, thous)	637	668	787	840	848	885	638	691	693	652	746	777	807	818
Existing Home Sales (units, thous)	5,081	4,098	4,179	4,634	4,709	4,910	4,327	4,250	4,020	3,797	3,935	4,134	4,260	4,389
Case-Shiller Home Prices (%yoy)*	7.5	5.6	5.5	4.4	4.9	4.9	2.3	-0.2	2.5	5.6	7.6	7.4	6.4	5.5
INFLATION (% ch, yr/yr)														
Consumer Price Index (CPI)**	6.4	3.3	2.8	2.5	2.2	2.2	5.7	4.0	3.6	3.2	3.1	3.1	2.9	2.8
Core CPI **	5.7	3.9	3.0	2.4	2.3	2.3	5.5	5.2	4.4	4.0	3.7	3.3	3.3	3.1
Core PCE** †	4.9	2.9	2.3	2.0	2.0	2.0	4.8	4.6	3.8	3.2	2.7	2.3	2.3	2.3
LABOR MARKET														
Unemployment Rate (%)^	3.5	3.7	3.6	3.6	3.6	3.6	3.5	3.6	3.8	3.7	3.6	3.6	3.6	3.6
U6 Underemployment Rate (%)^	6.5	7.1	6.9	6.9	6.9	6.9	6.7	6.9	7.0	7.1	6.9	6.9	6.9	6.9
Payrolls (thous, monthly rate)	377	255	134	75	75	75	305	274	213	227	211	125	100	100
Employment-Population Ratio (%)^	60.1	60.1	60.1	59.9	59.8	59.6	60.4	60.3	60.4	60.1	60.3	60.3	60.2	60.1
Labor Force Participation Rate (%)^	62.3	62.5	62.4	62.2	62.0	61.8	62.6	62.6	62.8	62.5	62.6	62.5	62.5	62.4
Average Hourly Earnings (%yoy)	5.4	4.5	3.8	3.3	3.3	3.3	4.6	4.6	4.5	4.3	4.1	3.9	3.6	3.5
GOVERNMENT FINANCE														
Federal Budget (FY, $bn)	-1,375	-1,700	-1,700	-1,900	-1,900	-2,050	--	--	--	--	--	--	--	--
FINANCIAL INDICATORS														
FF Target Range (Bottom-Top, %)^	4.25-4.5	5.25-5.5	4-4.25	3.25-3.5	3.25-3.5	3.25-3.5	4.75-5	5-5.25	5.25-5.5	5.25-5.5	5.25-5.5	4.75-5	4.25-4.5	4-4.25
10-Year Treasury Note^	3.88	3.88	4.00	4.00	4.00	4.00	3.48	3.81	4.59	3.88	3.85	3.75	3.85	4.00
Euro (€/$)^	1.07	1.11	1.11	1.15	1.15	1.15	1.09	1.09	1.06	1.11	1.08	1.09	1.10	1.11
Yen ($/¥)^	132	141	141	130	125	120	133	144	149	141	148	144	142	141

* Weighted average of metro-level HPIs for 381 metro cities where the weights are dollar values of housing stock reported in the American Community Survey. Annual numbers are Q4/Q4.
** Annual inflation numbers are December year-on-year values. Quarterly values are Q4/Q4.
† PCE = Personal consumption expenditures. ^ Denotes end of period.
Note: Published figures in bold.

Source: Goldman Sachs Global Investment Research

Disclosure Appendix

Reg AC

We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Ronnie Walker, Manuel Abecasis, Tim Krupa, Elsie Peng and Jessica Rindels, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

Unless otherwise stated, the individuals listed on the cover page of this report are analysts in Goldman Sachs' Global Investment Research division.

Disclosures

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