TD Securities

Commentary

Global Rates, FX & Commodities Strategy

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▶ US ▶ RATES ▶ GLOBAL MARKETS

US CPI (Sep): Still High, Including Rents

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- The total CPI was +0.4% m/m in September (5.4% y/y), above the 0.3% consensus. The core index was +0.2% m/m (4.0% y/y), matching consensus, but the details were relatively strong as the rent parts showed strong gains (OER rose 0.4%, primary rents 0.5%) and the rise in core was 0.243% before rounding. The strength in rents offset some weakening in the travel-related parts that have led this year's surge.
- We continue to expect significant slowing in the year ahead, with used vehicle prices in particular likely to swing to a minus from a plus. That said, the momentum in rents suggests some further upside risk to our forecast for the core CPI to be up just 2.3% in 2022 (Q4/Q4)—and to our 2.0% Q4/Q4 forecast for core PCE prices.
- **Rates:** A stronger headline print helped widen TIPS BEs and continued to exert flattening pressure on the curve. We like owning 2y BEs and stay long 5y nominals. We don't think that the Fed will respond to supply chain and energy-led inflation by hiking as soon as October 2022.

The total CPI was +0.4% m/m in September, above the 0.3% consensus (TD: 0.3%). The core index was +0.2% m/m, matching consensus, but the rent parts in particular were quite strong. The rise in core was a "high" 0.2%: 0.243% before rounding.

The 12-month change in the overall CPI rose to 5.4% from 5.3% (consensus & TD: 5.3%). The 12-month change in the core index held at 4.0% (consensus & TD: 4.0%).

Energy prices were +1.3% m/m, about what we expected. Food prices were stronger than we expected, with 0.9% m/m. The rise was led by a 1.2% increase in food at home prices; food away from home (restaurants) prices rose 0.5%.

The nsa CPI was 274.310, up from 273.567.

The 0.2% m/m rise in the core index followed +0.1% in August, 0.3% in July, 0.9% in June, 0.7% in May and 0.9% in April. A key driver of the slowing in the last two months has been used vehicle prices, but other travel items have contributed as well.

Used vehicle prices were -0.7% m/m after -1.5% m/m in August, +0.2% in July, +10.5% in July, +7.3% in June and +10.0% in May. We expect much more weakening in the year ahead, but there will probably also be a some renewed strength in the very near term judging by the latest Manheim wholesale price data. The level is still up 40.5% since February 2020 (pre-COVID).

Other travel items on the weak side in September were airfares (-6.4% m/m), lodging (-0.6%), and car and truck rental (-2.9%). The data were likely held down by fallout from the Delta wave, which now appears to be subsiding. Apparel was fairly weak as well (-1.1% m/m).

Conversely, rents were relatively strong. OER rose 0.43% m/m following 0.25% in August, 0.29% in July and 0.32% in June, while rent of primary residence rose 0.45% following 0.31% in August, 0.16% in July and 0.23% in June. The trend in both series was around 0.3% per month before COVID, and fell to around 0.1% at the low in late 2020.

Household furnishings and supplies (+1.3% m/m) and new vehicles (+1.3%) were also relatively strong in September.

In short, stronger than expected, most notably the key rent details. The strength in rents could potentially be more trend-setting ultimately than the swings in travel-related prices, although we expect upward pressure on rents to fade as the boost to the economy generally from reopening fades. In turn, we continue to expect significant slowing in the inflation data in aggregate the year ahead. That said, the momentum in rents suggests some further upside risk to our forecast for the core CPI to be up just 2.3% in 2022 (Q4/Q4)—and to our 2.0% Q4/Q4 forecast for core PCE prices.

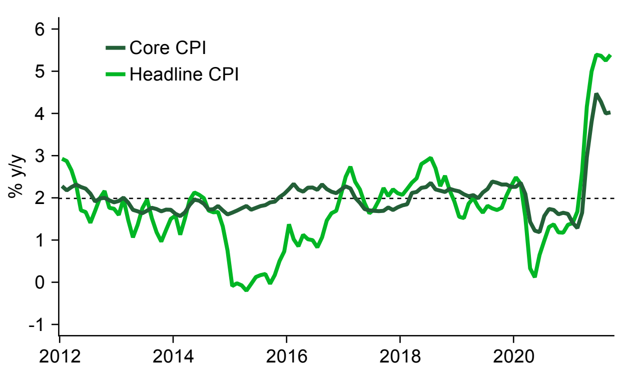
For more on inflation, see our note from last week: US Inflation: Still Saying Yes to Transitory (and No to Stagflation).

Look at 19-Month, Not 12-Month Changes

As noted, the y/y change in the core CPI was 4.0% in September, which is up sharply from 2.4% in February 2020 (pre-COVID). That calculation certainly overstates the trend, however, as some of the strength reflects a reversal of weakness in the first few months of the pandemic, and the strength in used vehicle prices in particular looks exaggerated.

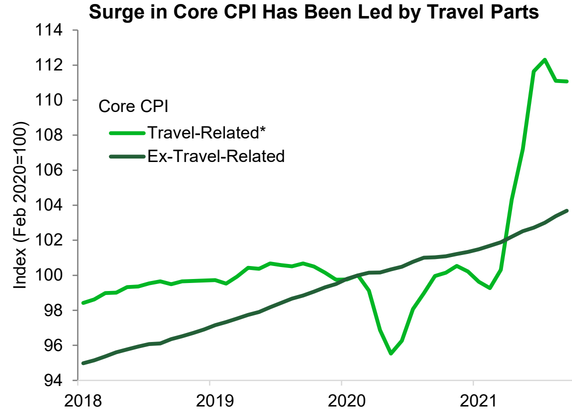
The core CPI is up at a 3.1% AR in the 19 months since February 2020, up from the 2.4% pace in the 12 months through February 2020, but the acceleration is almost fully accounted for by the boost from used vehicle prices. We show those data in a detailed table below. We believe the surge in used vehicle prices in particular is likely to be at least partly reversed in the year ahead.

Core Inflation Showing Signs of Peaking After Being Boosted by Reopening and Base Effects



Source: BLS, TD Securities

Surge in Core CPI Has Been Led by Travel Parts



*Transportation items (ex motor fuel) and lodging away from home (17% of core CPI)
Source: BLS, TD Securities

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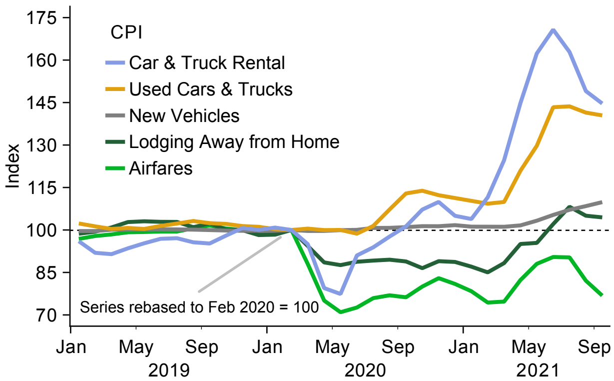
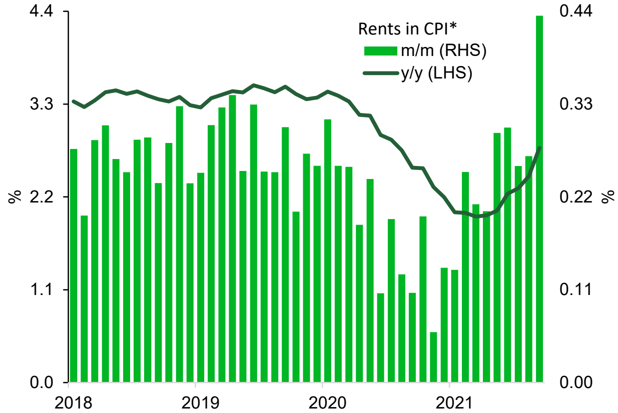
Used Vehicle and Car Rental Prices Appear to Be Peaking



Source: BLS, TD Securities

Reacceleration in Rents



*Weighted average of rent of primary residence and owners' equivalent rent
Source: BLS, TD Securities

Net Pickup in Core Inflation Accounted for by Used Vehicles

	Relative Importance (%)*	% Chg, m/m		% Chg. From 12 Months Earlier			% Chg, AR			
		Aug 2021	Sep 2021	Jul 2021	Aug 2021	Sep 2021	12 Months Through Feb 2020	19 Months Since Feb 2020	Accel/Decel (Pct. Pts.)	Contribution to Accel/Decel (Pct Pts)
Total CPI	**100.0**	**0.3**	**0.4**	**5.4**	**5.3**	**5.4**	**2.3**	**3.7**	**1.4**	**1.4**
Food	14.0	0.4	0.9	3.4	3.7	4.6	1.8	4.7	2.9	0.4
At Home	7.7	0.4	1.2	2.6	3.0	4.5	0.8	4.8	4.0	0.3
Away From Home	6.3	0.4	0.5	4.6	4.7	4.7	3.0	4.6	1.6	0.1
Energy	7.3	2.0	1.3	23.8	25.0	24.8	2.8	8.8	6.0	0.4
Core (Ex Food & Energy)	**78.7**	**0.1**	**0.2**	**4.3**	**4.0**	**4.0**	**2.4**	**3.1**	**0.7**	**0.6**
Alcoholic Beverages	1.0	0.3	0.2	2.4	2.6	2.8	0.9	2.6	1.8	0.0
Rent Of Primary Residence	7.6	0.3	0.5	1.9	2.1	2.4	3.8	2.4	-1.4	-0.1
Owners' Equivalent Rent (OER)	23.6	0.3	0.4	2.4	2.6	2.9	3.3	2.6	-0.7	-0.2
Lodging Away From Home	1.0	-2.9	-0.6	21.5	17.4	17.5	0.8	2.8	2.0	0.0
Water/Sewer/Trash Collection	1.1	0.3	0.5	3.7	3.5	3.7	3.2	3.6	0.4	0.0
Household Furnishings	4.7	1.3	1.0	3.8	4.0	5.1	0.7	4.8	4.0	0.2
Apparel	2.7	0.4	-1.1	4.2	4.2	3.4	-0.9	-1.5	-0.5	0.0
New Vehicles	3.8	1.2	1.3	6.4	7.7	8.8	0.4	6.1	5.7	0.2
Used Cars & Trucks	**3.3**	**-1.5**	**-0.7**	**41.7**	**31.9**	**24.4**	**-1.3**	**23.9**	**25.3**	**0.6**
Leased Cars & Trucks	NA	NA	NA	NA	NA	NA	-3.6	NA	NA	NA
Car & Truck Rental	0.2	-8.5	-2.9	73.5	52.6	42.9	8.6	26.3	17.7	0.0
Motor Vehicle Parts & Equip.	0.4	1.7	0.8	4.3	6.1	6.9	2.1	4.2	2.1	0.0
Public Transportation	1.0	-5.5	-5.0	14.0	8.4	1.6	1.6	-9.3	-10.9	-0.1
Airline Fare	0.6	-9.1	-6.4	19.0	6.7	0.8	2.4	-15.3	-17.7	-0.1
Medical Care	8.5	0.2	0.0	0.3	0.4	0.4	4.6	1.6	-3.0	-0.3
Commodities	1.5	-0.2	0.3	-2.1	-2.5	-1.6	1.8	-1.3	-3.1	0.0
Services	7.0	0.3	-0.1	0.8	1.0	0.9	5.3	2.2	-3.1	-0.2
Recreation	5.7	0.5	0.2	3.5	3.4	3.5	1.5	2.4	0.9	0.1
Education	2.9	0.0	0.4	1.2	1.4	2.0	2.2	1.5	-0.6	0.0
Communication	3.6	0.3	0.4	1.1	1.0	1.5	1.0	2.3	1.4	0.1
Other	3.1	0.4	0.1	2.9	3.5	3.4	2.7	2.6	0.0	0.0

*As of August 2021.   Source: BLS, TD Securities

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Rates Market Implications

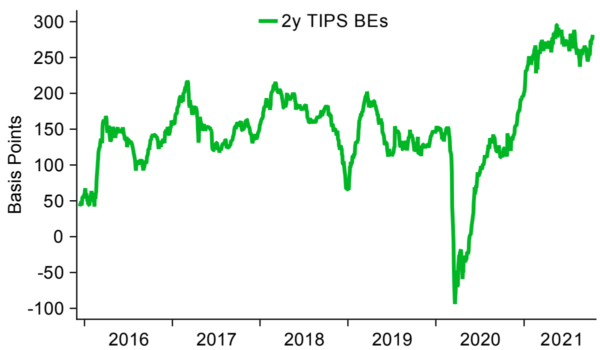
The higher than expected NSA CPI of 274.31 compared to the 274.11 being priced in ahead of the release helped bear flatten the curve sharply as the belly and front-end came under significant pressure. The market has now pulled forward the timing of the first rate hike to October 2022 but has kept the terminal rate fixed at around 1.65%. While the core reading showed a bit more stability as COVID-impacted sectors began to weigh on prices (such as apparel, air fares, used cars, hotel prices, etc.), shelter prices spooked the market as OER rose 0.429% and rents were up 0.453%.

We remain long 2y TIPS BEs, which should benefit from higher carry. We are also long 5y nominal rates, which will be hurt with the stronger CPI number. However, we continue to like being long 5s for two reasons:

- Core inflation continues to suggest some moderation.
- The market is priced in for the first hike October 2022 and we think that the Fed will be reluctant to hike so early due to supply chain constraints or energy-led inflation pressures.

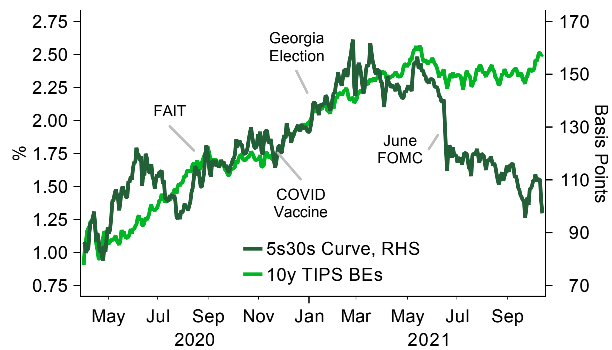
We will be watching the September FOMC minutes later today for hints about the potential Fed reaction function to higher inflation. While the curve continues to flatten as the policy mistake idea gets priced in (with the Fed forced to tighten inflation, which would weigh on growth momentum), we don't believe the Fed will be keen to hike preemptively if the labor market doesn't show maximum employment. This should ultimately help steepen the curve as the market prices in more inflation risk premium and TIPS BEs remain solid.

We Continue to Like 2y TIPS BEs to Hedge the High Inflation Tail Risk



Source: Bloomberg, TD Securities

Policy Mistake Notion is Evident in the Disconnect Between the 5s30s Curve and TIPS BEs



Source: Bloomberg, TD Securities