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Market views and strategy

Ostrum
ASSET MANAGEMENT

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N° 045 // **November 15, 2021**

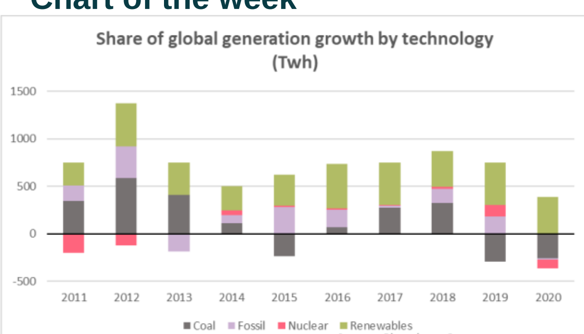
Topic of the week: Forget 'transitory', US rent inflation is a game changer.

- **So far, the rise in US inflation is mostly traceable to supply chain bottlenecks. There is more to come as service prices and shelter costs (accounting for a third of US cost of living) adjust higher.**
- **Rental values will rise in the wake of a sharp upturn in home prices sparked by monetary accommodation ;**
- **The rental market is tight as vacancy rates are low and inventories of available homes for rent appear limited ;**
- **US CPI with rent inflation below 3% appear to understate rent inflation reported by industry professionals (7-15%).**

Market review: Inflation is the price of the loss of credibility

- **US inflation hits 6.2% in October;**
- **US breakeven inflation rates at 2006 highs;**
- **Bund yields resist higher US yields;**
- **Swap spreads sharply higher in euro markets.**

Chart of the week



The evolution of energy sources shows a gradual deformation towards greener energies. While the use of coal has remained virtually unchanged since 2013, renewable energies have significantly increased their contribution on a recurring basis over the past decade.

The energy mix is therefore distorted in the right direction with an increasingly significant contribution from renewables. On the other hand, the contribution of other energies decreases only very little.

Figure of the week

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Source : Ostrum AM

Two countries have limited the scope of the Glasgow agreement on the end of fossil fuels. India and China succeeded in removing from the Joint Declaration the term "exit" of fossil fuels and replacing it with "phase-out".

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Topic of the week

Forget 'transitory', US rent inflation is a game changer

US inflation has been a hot topic this year. Much of the attention of economists has focused on goods inflation in the context of global supply-chain bottlenecks. Looking ahead, the overall US inflation outlook will be increasingly dependent on service price developments. Services, especially shelter costs, are a persistent source of inflation. Amid a run-up in home prices, rents have the potential to raise inflation durably above the 2% goal. The rent component in the US CPI is out of line with bottom-up data indicating indeed very strong rent increases.

We contend that rents entail significant upside risks for US CPI inflation going forward.

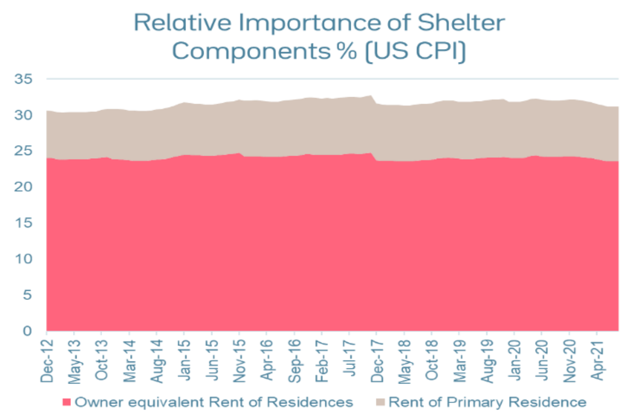
Shelter is an essential part of the cost of living

US inflation perception is highly dependent upon short-term changes in prices of goods that American consumers purchase daily. Gasoline prices have a large impact on inflation expectations even as energy spending is a relatively small share of overall spending (just 7.3% of the US CPI). Food expenditure (13.9%) is another example of highly volatile prices that may have a disproportionate impact on perceived inflation dynamics in the short run. In other words, energy and food may make up a small part of total expenditure, but, as they are non-discretionary items, volatility cannot go unnoticed.

Conversely, it is much harder for consumers to keep track of how much they spend on services. Subscriptions to mobile phone, insurance, utilities, television networks will be sticky for a while but prices reset periodically, at potentially higher-than-average annualized inflation rates. Furthermore, a significant share of total service spending is also non-discretionary. That includes health care, education and undoubtedly housing services. Shelter expenditure is indeed an essential part of cost-of-living estimates.

The most common inflation measure in the US is the Consumer Price Index published monthly by the Bureau of Labor Statistics. This is the reference price index used for indexation of Treasury Inflation-Protection Securities, or TIPS. The latest reading indicates that consumer prices rose 6.2% from a year ago in October, a much higher reading than the Fed's inflation target of 2% even under the *new* average inflation targeting regime.

In the US CPI measure, shelter accounts for roughly a third of the basket of goods and services. The shelter component is comprised of actual rents paid to landlords by households and owner equivalent-rent measures (OER). In the latter, homeowners are surveyed to 'guesstimate' their property's rental value. There may thus be measurement issues. Homeowners may have little information about the current rental value of their home and may rather infer a proxy for its rental value from monthly mortgage payments. In turn monthly mortgage installments will be influenced by interest rates on the mortgage market and loan sizes obviously depend on home prices. The OER measure, however dubious, is a large contributor to overall inflation given its sheer size but also because of its inertia.



Source: Bloomberg, Ostrum AM

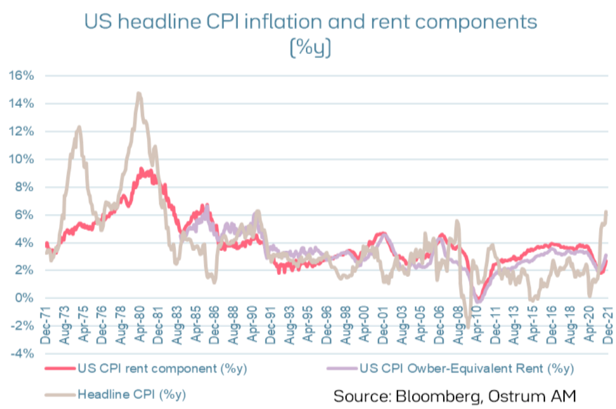
Rents are up everywhere but in the CPI numbers… for now

Rent data collection is hard. The quality, age, location and many characteristics of the housing unit must be taken into account. Available raw rent data may also include utility services, like heating or electricity, which pertain rather to the utilities' component of the US CPI.

Moreover, housing in the US is a huge industry. There are currently 126.9mn housing units occupied (3Q 2021), up about 23.5mn in the past 20 years. As stated above, homeownership remains the bedrock of the US economy. On census data, the number of homes occupied by renters is estimated at 43.6mn, or 34% of the total.

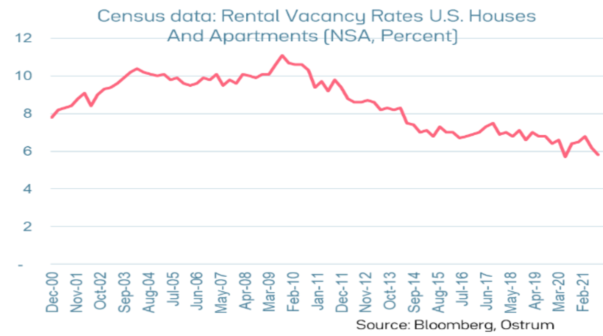
Rents and home price increases tend to show a high degree of persistence. In other words, housing exhibits long-lasting trends. Rent price developments take time to unfold as intertwined rent contracts reset periodically at the prevailing market-clearing rates. For what it is worth, the correlation of the year-on-year rate of rent inflation with itself over the subsequent 12 months is about 0.50 over the past 20 years. Comparatively the same calculation for headline CPI inflation is close to zero or even slightly negative (-0.09). Hence, rents trend whilst the overall consumer price gauge tends to mean revert. As rent inflation accelerates, the contribution of shelter expenditure to headline inflation will rise.

It has been a statistical conundrum that the CPI rent component has so far failed to reflect the sharp upturn in rents reported by a number of private-sector analyses (see below). The moratorium on rents may have distorted the picture as around 6% of renters have received rent relief. The BLS estimates that rent growth is currently running at a mere 2.7% annual clip (October). In the past three months (August to October 2021), month-on-month increases have risen to 0.39% on average, about 0.1pp above the 2018-2019 average (0.3%m). There is a chance that the BLS estimate may finally be capturing an upturn.

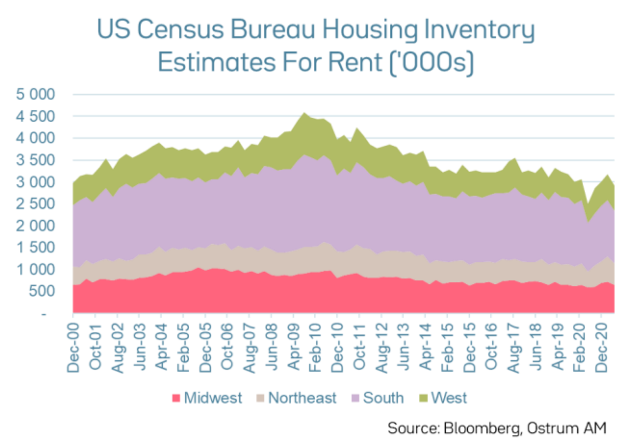


The US rental market is tight

There is an imbalance in the US housing market. An indicator of tightness in the rental market is the vacancy rate. As the ratio decreases and opportunities to rent become scarcer, rents tend to appreciate. In sum, an under-supplied housing market is quickly becoming an unaffordable one. Under supply may come from a dearth of multi-family housing starts, which has the largest direct impact on rental values.



The pandemic also had an impact on the availability of property for rent. Millennials, currently aging into their homebuying years, have embraced remote working. The potentially long-lasting shift may have spurred demand for housing away from city centers further exacerbating the preference for single-family units in the US. Under supply of multi-family unites may thus be a real issue at this juncture for the rental market.

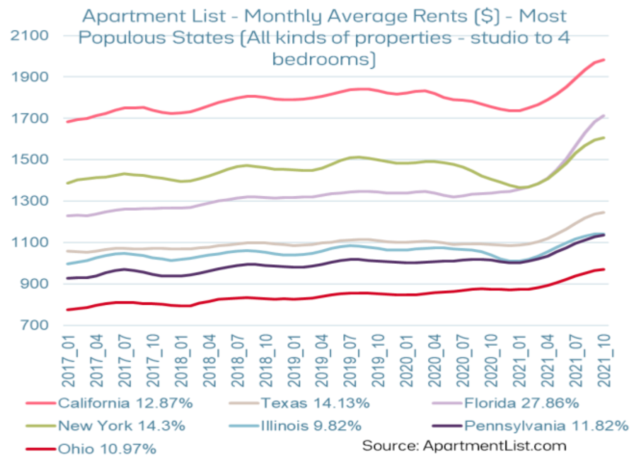


Furthermore, during the pandemic, renters were often offered discounts on new leases. This may have been an incentive to stay longer in rented property to benefit for low rates. The eviction moratoria, at both federal and local levels, may also have led renters to occupy homes longer. There are tentative signs that this summer's hectic rent growth may be cooling, even though monthly rent rises remain above the pre-pandemic norm. The decline in vacancy rates is easing somewhat in some areas. The resumption of evictions may further reduce price pressure by opening new vacancies, all the more so that the US government failed to push relief to renters quickly enough.

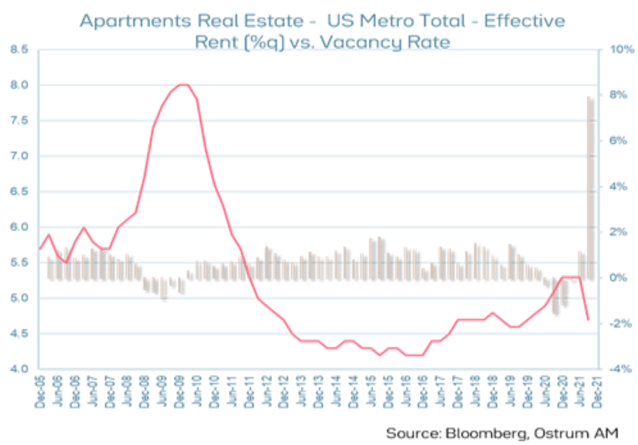
Yet, according to Apartment List data, national rent estimates are rising at a brisk pace. Rent prices jumped over 11% in the first half of 2021, more than triple the pre-pandemic trend growth. Nearly 90 of the 100 largest US cities have fully rebounded to pre-pandemic rent prices. In smaller communities, rents are up more than 30 % since

March 2020. Some select markets have not fully recovered. Sky-high rents in the Bay area and remote work opportunities in the technology industry have caused a collapse in demand for housing in the area following the implementation of stay-at-home orders. In months following the Covid outbreak, rents in the Bay area had fallen 15% relative to their March 2020 level. However, current readings suggest that rents have started to recover and are now within 5% of pre-pandemic levels.

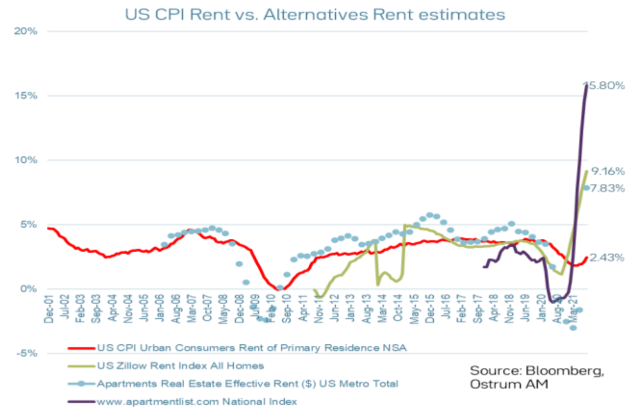
On ApartmentList data, there is a clear nationwide upturn in rent prices



Key: State and year-over-year rent increase (September 2021)



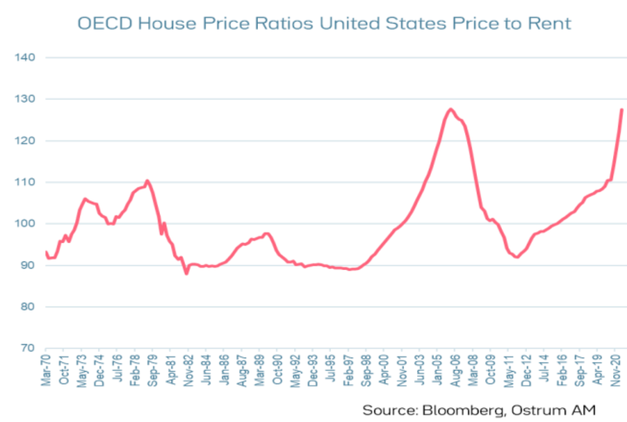
As indicated above, CPI rent may be understating the 'true' increase in rents. Again, measuring rents properly is far from easy. But, using data from industry professionals including Zillow, Apartment Real and ApartmentList, rent growth could be anywhere between 7 and 15% over the 12 months to September, double at least the CPI rent growth. In many areas, mostly in the Southern states, rents are reportedly up 30%.



The opportunity cost of renting

Households must arbitrate between renting and owning a home. The US is mostly an owner society. Most American households indeed view renting as a step towards owning residential property. The relative pricing of investing in a home rather than renting is therefore highly relevant to US households.

The price to rent ratio is the nominal house price index divided by the housing rent price index and can be considered as a measure of the profitability of home ownership. On OECD estimates, the recent surge in US home prices has dwarfed the reported increase in rents. The ratio of price to rent now stands at 2006 highs.



Signs of frothiness in housing market, what impact can we see on rents?

There are signs of frothiness, if not outright bubble, in the US housing market. The Fed's monetary policy stance fostered a swift recovery in residential investment and mortgage origination. Many investors jumped into the bandwagon in property flipping and buy-to-let schemes not so different from 2006 heady days (though credit quality is much higher).

Needless to say, a turnaround in housing valuations could spell trouble ahead. The collapse in house prices, made worse by over-supply of dwellings and lending to subprime borrowers caused the financial crisis of 2008. The rebalancing of home price and rental income can come two ways. Either home prices will have to fall, or rental values will have to rise, all the more so if mortgage rates drift higher as the Federal Reserve unwind its MBS purchases as planned. The Fed will likely dial down bond purchases from $40bn a month today to $0 by June 2022. Unlike 2008, a fall in home prices may be accompanied with continued pressure on rents.

But, even with high rent growth, home valuations raise questions about the end game in the residential investment cycle. Zillow group made headlines recently as the company sought to sell about 7k homes (seeking around $2.8bn) to recover from a fumble in its high-tech home-flipping business. Overbidding has led to high potential losses, with many properties now listed below acquisition prices. Zillow is originally known for publishing real estate listings online and estimating home values of users.

More recently it has been buying and selling thousands of homes, practicing a new spin on home-flipping called iBuying that seeks to offer sellers a better way of selling a home. Zillow invites owners to request an offer on their house and uses algorithms to generate a price. If an owner accepts, Zillow buys the property, makes light repairs and puts it back on the market. Property flipping has an impact on home prices but as investors bought roughly 9% of all homes Zillow sold in the first quarter of 2021, fire sales may have an impact on landlords' return on investment and the inventory of homes for rent in the future.

How are residential REITs faring in this environment?

It should be clear from the above that there is a unexplained gap between CPI rent inflation data and the sharp nationwide upturn in rents reported by industry professionals.

One additional way to gauge rent growth is to look at revenue of Real Estate Investment Trusts specialized in residential properties. The Residential REITs industry is a subgroup of the Real estate sector. In the S&P 500 there are five residential REIT companies. Revenue growth for this group companies was above 5% from a year ago in the third quarter. Using the Russell 2000 universe, four smaller capitalization REITS operating in the residential sector reported double-digit revenue growth in the year to 3Q 2021.

Stock performance if anything has been stellar in keeping with a recovery in the rental market from the fourth quarter of 2020 and, likely, the benefits of debt leverage in the context of low interest rates. The S&P500 residential REITs industry group is up 52% year-to-date as at November 10th, 2021, double the performance from the S&P 500. There is little doubt that rent growth contributed strongly to the sector's total return.

Conclusion

US inflation is up considerably. There could be more to come. Service inflation is accelerating. Loose monetary policy sparked home price inflation, feeding into higher rental values as return on residential investment adjusts. However, in the CPI data, rent growth (still under 3%) appears to understate underlying pressures. Alternative data sources suggest current rent inflation could be anywhere between 7 and 15%.

Axel Botte

Market review

Inflation is the price of the credibility loss

On the face of it, the Fed's schizophrenia in the face of high inflation protects financial markets.

Inflation is at its highest since 1990 in the United States. Consumer prices are up 6.2% year on year. Price increases are widespread. The economic situation is that of an economy constrained by both domestic supply and import capacity. This is a relatively new phenomenon. Inflation in the United States has long remained under the hood thanks to the dividends of globalization. The reliance on cheap imports has regularly offset domestic price pressures. The entire global supply chain disruption is now in full swing. Producer prices in China are up 13% year-over-year, despite sluggish local demand. What is worse, service prices are starting to respond to the shift in US consumer demand for durable goods onto services. The labor market situation points to an overheating economy, with more than 10 million job openings and increasing difficulties in retaining staff for many companies. The job quits rate is unprecedented. Pointing to the gap to pre-crisis employment makes no sense in a situation of excess demand for labor and rising wages. Inflation is also back in the key real estate sector where rents are picking up strongly. Furthermore, the political and energy crises in Europe is amplifying supply pressures. OPEC remains deaf to US requests to increase oil production knowing that US shale production is now limited by its climate commitments. Inflation will also have a political cost for the Administration in place since January. Joe Biden could indeed be defeated in the next midterm elections. The loss of just one Senate seat would be enough to cripple federal action for the remaining two years of the presidential term. In the background, the political risk returns. In Belarus, a migration crisis pressures the EU confronting Poland with its contradictions. Russian gas, 20% of which goes to Germany through Belarus, is used as a weapon as cold weather begins. The euro area will face the uncertainty of Italian and Portuguese polls in the coming months. In China, Xi Jinping will stay in power for a long time, maintaining the pressure on Taiwan and Hong Kong.

The current equilibrium in financial markets is a function of the inertia of US monetary policy. Admittedly, the rise in inflation creates volatility on short-term rate futures, but the envelope of rate hikes expected by financial markets remains incommensurate with the level of inflationary risk. The market remains convinced that measured tightening to a maximum of 1.5% Fred Funds rates will be enough to bring inflation down to around 2%. However, the Fed predicts a short rate to rise to 2.5% in the long term, which is consistent with a positive equilibrium real rate (+ 0.5%). The projection of a short-lived monetary cycle justifies the flattening of the curve beyond 5 years and the relative stability of the volatility of forward rates (10 years in 10 years for instance) compared to shorter maturities. The inflationary policy stance also requires the purchase of protection. Flows to index-linked bond funds are accelerating significantly. The rise in breakeven inflation rates also explains the entire yield movement over the week (+ 12bp on the T-note). Inflation breakevens are at their highest since 2006 at over 2.70% over a 10-year horizon. The US inflation swap is flirting with 3%. At the same time, the 30-year real yield fell to its historic low of below -0.50%. In the euro area, the Bund is benefiting from the reduction in risky positions in the run-up to the next ECB council meeting. The German Bund remained stable last week at around -0.25%. Sovereign spreads are narrowing nonetheless, especially in Italian BTPs, which are trading above 120bp on 10-year maturities. Inflation above 4% is being ignored by Christine Lagarde, who still pleads for an accommodative monetary policy. In December, the devil will be in the details. The terms of the next TLTROs will likely be less favorable, the bonus rate could indeed be withdrawn. This could have some impact on short-term rate expectations even if a hike in the deposit rate is still very unlikely. The size of QE remains key to financial markets. The proportion of supranational debt (green, social, etc.), corporate credit and the conditions for Greece's inclusion will be of interest for market participants.

Spreads in the corporate bond market continue to widen, in the wake of the sharp rise in swap spreads to 47bp (10-year Bund ASW). The average spread on investment grade debt in euros rose by 1bp (89bp vs. Bund). Financials, agencies and covered bonds underperform risk-free assets by 1 to 3bp. The rare movement in covered bond spreads may reflect the risk of less generous TLTROs in the future (as well as their strong link with swap rates). High yield, on the other hand, tightened by 9bp. The US speculative-grade credit market is also doing well. In addition, emerging spreads are resisting the rebound in US bond yields. The decline in real yield helps EMBI spreads to fall back below the 360bp threshold, as final investor flows improved.

The week return on equities was flat amid modest profit taking in the United States (-0.8% over five trading days). The basing resources sector posted the only notable gain over the week. Rivian's IPO values the electric vehicle start-up company at a whopping $ 112 billion. Anything goes. The CAC40 also marks a new record above the 7000-point mark.

Furthermore, the US dollar remains a anchor of stability (DXY index> 95) and the Chinese Renminbi is trading at its highest since 2016 against the basket of benchmark currencies.

Axel Botte

Global strategist

Main market indicators

G4 Government Bonds	15-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.69 %	+3	-1	+1
EUR Bunds 10y	-0.23%	+1	-6	+34
EUR Bunds 2s10s	46 bp	-2	-5	+33
USD Treasuries 2y	0.52 %	+7	+12	+39
USD Treasuries 10y	1.61 %	+12	+4	+70
USD Treasuries 2s10s	110 bp	+5	-8	+30
GBP Gilt 10y	0.96 %	+11	-14	+77
JPY JGB 10y	0.07 %	+1	-2	+5
€ Sovereign Spreads (10y)	15-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
France	36 bp	+2	+2	+13
Italy	122 bp	+9	+19	+11
Spain	73 bp	+6	+11	+12
Inflation Break-evens (10y)	15-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi (9y)	164 bp	+5	+13	-
USD TIPS	277 bp	+14	+20	+78
GBP Gilt Index-Linked	407 bp	+3	+8	+107
EUR Credit Indices	15-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	91 bp	+2	+4	-1
EUR Agencies OAS	48 bp	+3	+6	+7
EUR Securitized - Covered OAS	51 bp	+7	+11	+18
EUR Pan-European High Yield OAS	318 bp	-2	-12	-40
EUR/USD CDS Indices 5y	15-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	49 bp	+1	-2	+1
iTraxx Crossover	249 bp	+8	-8	+7
CDX IG	51 bp	+1	-1	+0
CDX High Yield	295 bp	+8	-3	+2
Emerging Markets	15-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	352 bp	-9	-14	0
Currencies	15-Nov-21	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.142	-1.48	-1.59	-6.55
GBP/USD	$1.344	-0.91	-2.27	-1.69
USD/JPY	¥113.97	-0.65	+0.22	-9.41
Commodity Futures	15-Nov-21	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$81.2	-$2.3	-$3.0	$30.6
Gold	$1 863.0	$38.8	$95.4	-$35.3
Equity Market Indices	15-Nov-21	-1wk (%)	-1m (%)	YTD (%)
S&P 500	4 678	-0.50	4.62	24.55
EuroStoxx 50	4 386	0.77	4.86	23.46
CAC 40	7 129	1.15	5.96	28.41
Nikkei 225	29 777	0.91	2.44	8.50
Shanghai Composite	3 533	0.99	-1.09	1.73
VIX - Implied Volatility Index	17.17	-0.29	5.34	-24.53

Source: Bloomberg, Ostrum Asset Management

Additional notes

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