KKR

Flash Macro Update

U.S. CPI | July 2024

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What You Need to Know

1 How are we thinking about the June U.S. CPI report?

U.S. CPI inflation came in at 0.1% m/m in June, 10 basis points below consensus and the lowest level since 2021. Core inflation has now fallen for the last five months, driven by a slowdown in Housing inflation (which we have been expecting) and Supercore inflation (which was more abrupt than we or markets had anticipated). Overall inflation was -0.1% month-over-month and 3.0% year-over-year, compared to a consensus of 3.1%.

Reflecting these shifts, our 2024 CPI inflation forecast falls to 3.0% from 3.2% previously (*Exhibit 2*). Meanwhile, we make no change to our 2025 CPI estimate of 2.5%, which already reflected the moderation in Supercore now playing out a bit faster than expected.

Looking ahead, the 'needle-mover' for the Fed is now growth, not inflation. For the last two years, the Fed has been focused on managing upside inflation risks, especially around Services. As such, we now think Chair Powell will be more focused on managing downside growth risks. Although our base case remains that the U.S. will avoid a hard landing, we see noisy growth data (including a bifurcation between temporary help employment, which has been very weak, and capex/construction, which has remained strong) will bias the Fed toward a sooner start to rate cuts, likely in September.

We now think growth and long end yields – not inflation and short rates – will drive the cycle for risk assets. We continue to see scope for Treasury yields to move still lower towards 4% over the next year, which implies ~5.5-6.0% total return potential.

Meanwhile, we expect average cash yields of just ~5% over the next year, versus 5.375% over the last twelve months. Our bottom line is that the driver of returns is shifting from carry to convexity as the Fed becomes more focused on managing downside risks to growth.

The key pieces of our narrative for a capital markets recovery are coming into play, including a global easing cycle and mounting signs for a weaker dollar. However, broader participation will require a clearer signal on growth, which we view as a prerequisite for market breadth to widen out beyond mega-cap AI. As we detail below, we see this happening heading into 2025.

WHAT DOES THIS MEAN FOR MARKETS

1. This report could help form the top in the dollar. We expect more of an evolution, not a revolution.
2. For our rate calls (short-end and long-end), we maintain one Fed cut, but acknowledge that the Fed could do more in December if the election does not lead to more tariffs/inflationary impulses. That said, we continue to think five cuts total over 2024 and 2025 is an appropriate base case. On the long-end, we maintain our 10-year yield targets of 4.25% for this year and 4.00% over time. Looking ahead, the primary driver of returns is shifting now from carry to convexity as the Fed becomes more focused on managing downside risks to growth.
3. For equity markets, we still see further upside, as lower inflation, Fed cuts, and decent earnings growth (especially outside of the Magnificent 7) all suggest the path of least resistance is still upward.

Overall, we think we are mid-cycle for the economy, and as such, we would continue to lean in around deployment.

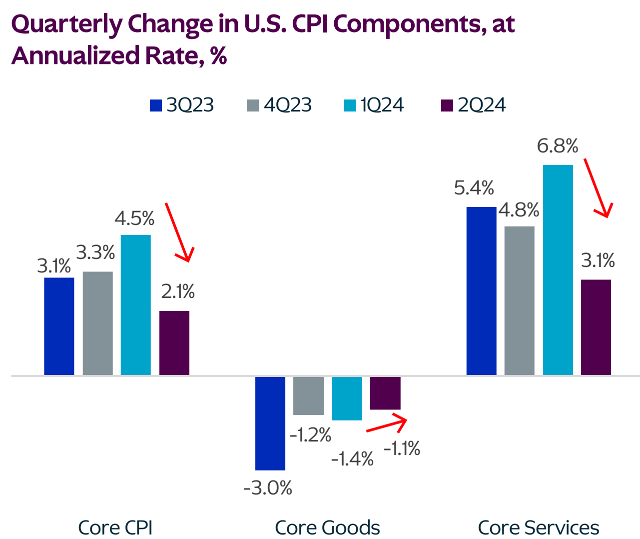
KEY DETAILS

Housing inflation is finally showing signs of slowing. After months of playing 'catch-up' to real-time rents, OER inflation came in at just 3.3% annualized in June. On a three-month moving average basis, shelter inflation is at the lowest levels since April 2021. Though it remains about ~100 basis points above its 2015-2019 average, we think the 'facts on the ground' of slower shelter inflation should give the Fed more confidence that year-over-year inflation is heading lower.

Non-housing services ('supercore') inflation came in at -0.05%, down from -0.04% in May. Said differently, super core has flattened out abruptly after centering around an eye-popping +6-7% annualized rate as recently as April. We take the slightly negative print this month as a signal that services inflation is slowing faster than we or the Fed had expected, driven by a tailing-off of insurance inflation, and a softening in formerly 'sticky' categories such as travel/leisure.

Core Goods prices fell -0.1% m/m, roughly in-line with their L3M average. Both new and used vehicle prices continued to fall in June (ticking down -0.2% m/m and -1.5% m/m, respectively), consistent with our view that consumer demand is normalizing at more moderate levels.

Exhibit 1: CPI Categories Are Converging to a More Disinflationary Trend



Data as at June 30, 2024. Source: Haver Analytics, U.S. Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

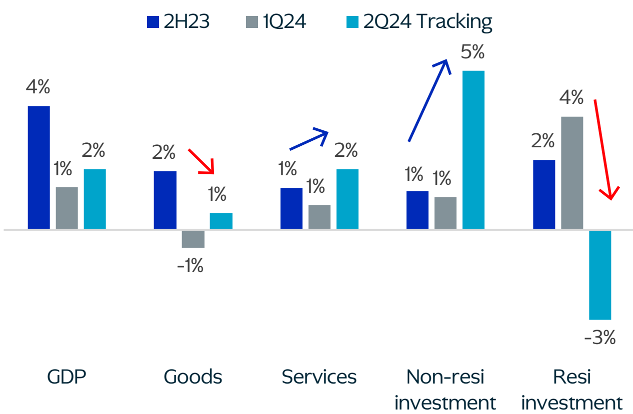
Exhibit 2: We Lower Our 2024e CPI Forecast to 3.0% from 3.2%, Led Substantially by a Decline in Our Outlook for 'Supercore' Services (ex Shelter/Medical/Education)

	4Q23a	1Q24a	2Q24e	3Q24e	4Q24e	Full-Year 2023	Full-Year 2024e	Full-Year 2025e
Headline CPI	**3.2%**	**3.2%**	**3.2%**	**2.8%**	**2.8%**	**4.1%**	**3.0%**	**2.5%**
Energy (7%)	-3.9%	-1.3%	2.3%	-1.0%	0.5%	-4.8%	0.1%	2.5%
Food (13%)	3.0%	2.3%	2.2%	2.1%	1.9%	5.8%	2.1%	1.5%
Core CPI (80%)	**4.0%**	**3.8%**	**3.40%**	**3.3%**	**3.2%**	**4.8%**	**3.4%**	**2.7%**
Core Goods (19%)	**0.1%**	**-0.4%**	**-1.5%**	**-1.5%**	**-1.6%**	**0.9%**	**-1.3%**	**0.1%**
Vehicles (6%)	-0.6%	-0.6%	-3.2%	-4.1%	-5.2%	-0.4%	-3.3%	-0.5%
Other Core Gds (12%)	0.5%	-0.4%	-0.7%	-0.3%	0.2%	1.7%	-0.3%	0.5%
Core Services (61%)	**5.4%**	**5.3%**	**5.2%**	**4.9%**	**4.7%**	**6.3%**	**5.0%**	**3.6%**
Shelter (34%)	6.7%	6.0%	5.5%	5.2%	4.8%	7.5%	5.4%	3.5%
Medical (7%)	-1.1%	1.3%	3.0%	4.4%	4.7%	-0.4%	3.4%	3.5%
Education (2%)	2.5%	2.5%	2.7%	2.8%	3.0%	3.1%	2.7%	2.8%
Other Core Services (18%)	6.0%	6.0%	5.7%	5.0%	4.9%	6.8%	5.4%	4.0%

Data as at July 11, 2024. Source: U.S. Bureau of Economic Analysis, Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 3: Meanwhile, Stabilizing GDP Growth Masks Wide Dispersions Between Stronger Services and Nonresidential Investment, and Weaker Goods and Resi Investment

GDP Component Growth, at Annualized Rate, %



Data as at July 11, 2024. Source: Atlanta Fed, Haver Analytics, U.S. Bureau of Economic Analysis, KKR Global Macro & Asset Allocation analysis.

We now think growth and long end yields – not inflation and short rates – will drive the cycle for risk assets.

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