Mike Salice, CFA
Sr. PM, Dir. of Research & Strategy
msalice@skyhcm.com
January 15, 2024

SKY Harbor Weekly Briefing

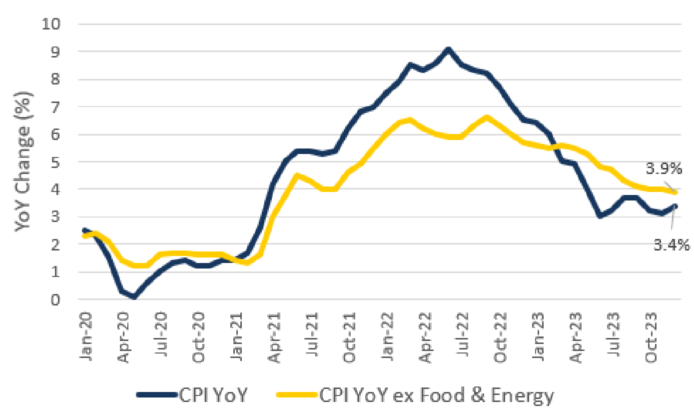
The "Last Mile"

December CPI data came in a touch hotter than expected, though "core" readings were closer to consensus heading into the release. Higher rent was largely to blame, as shelter costs remain stubbornly elevated. Though YoY CPI ex Food & Energy dipped below 4.0% for the first time since May 2021, several market commentators continue to be of the view that the "last mile" of inflation normalization will be a bumpy path, largely a function of aforementioned shelter headwinds. In this *Weekly Briefing*, we review the December CPI release, and find several datapoints that support a move toward housing market normalization in the coming quarters.

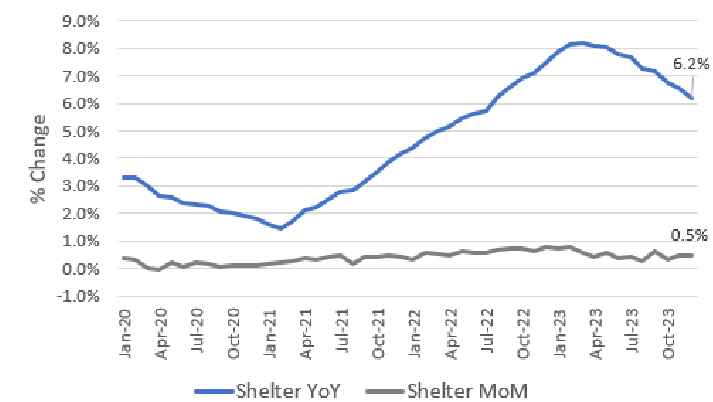
A December Uptick

The consumer price index increased 0.3% on a sequential basis in December, 0.1% above consensus expectations, though essentially in-line (also +0.3%) after stripping out volatile food and energy components. On a YoY basis, core CPI increased 3.9%, 0.1% above expectations but down from 4.0% in November, representing the first sub 4.0% reading in over two years. Though several items stood out in the report – motor vehicle insurance, health insurance, and used vehicle prices increased notably – most attention was paid to the shelter line. According to the Labor Department, **shelter costs increased by 0.5% sequentially, driving more than half of the uptick in core CPI**. On a YoY basis, shelter costs accelerated by 6.2%.

Dec CPI A Touch Hotter Than Expected, But Peak Behind Us
monthly data



Shelter Costs Accounted for More Than Half of the Increase
monthly data

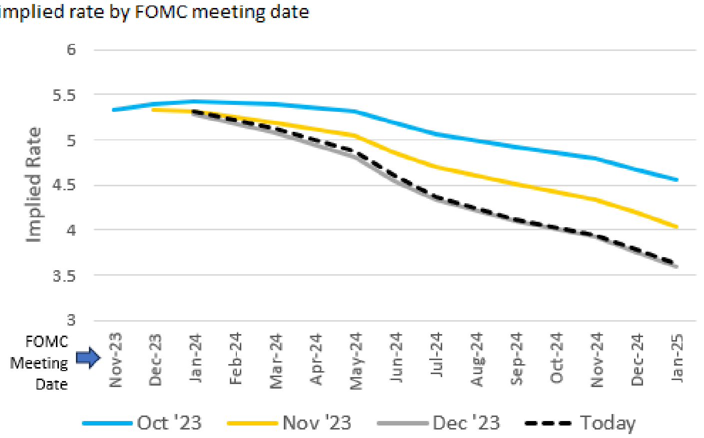


Source: SKY Harbor, Bureau of Labor Statistics, Bloomberg

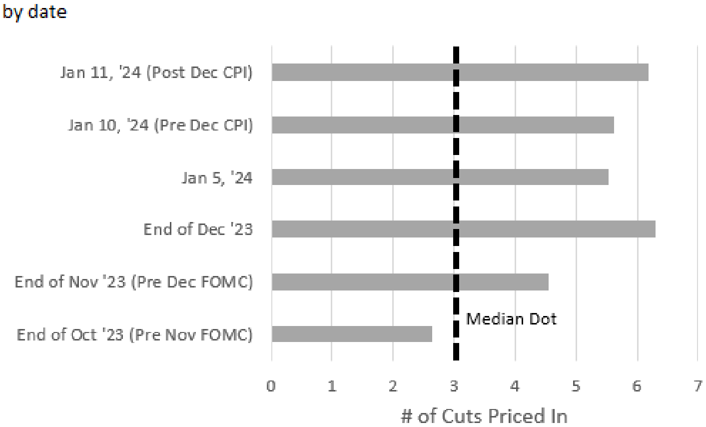
Market Continues to Price in Cuts

A modestly hotter than anticipated CPI reading, along with continued signs of labor market strength (initial and continuing claims both came in above consensus expectations) were not enough to derail investor enthusiasm for rate cuts, with Treasury yields ending lower on the day. Additionally, and despite Fed commentary to the contrary, **investors continue to see a > 75% chance of a March rate cut**. In fact, Fed Funds Futures now imply 6 cuts this year, twice what is reflected by the median dot. Though the consensus view is that the Fed hiking cycle has come to an end (notwithstanding recent comments from Fed Governor Bowman and Dallas Fed President Logan), we suspect the magnitude and cadence of future cuts keep underlying volatility elevated in the near term.

Market Sees > 75% Chance of Rate Cut in March...
implied rate by FOMC meeting date



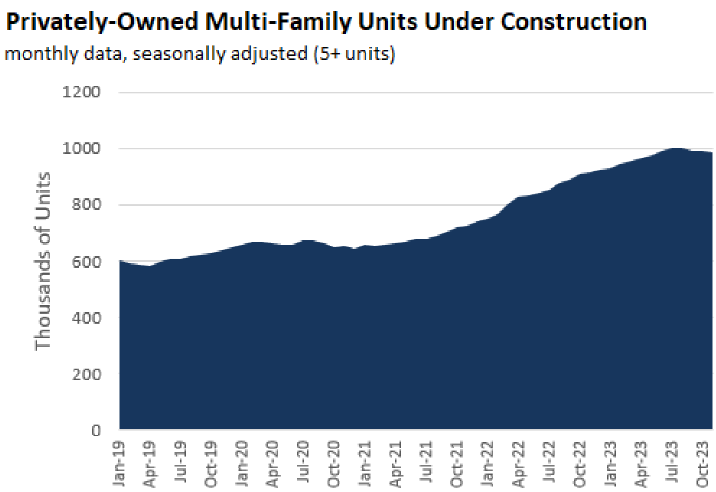
...And 6+ Cuts in 2024, Despite Fed Dot Plot
by date

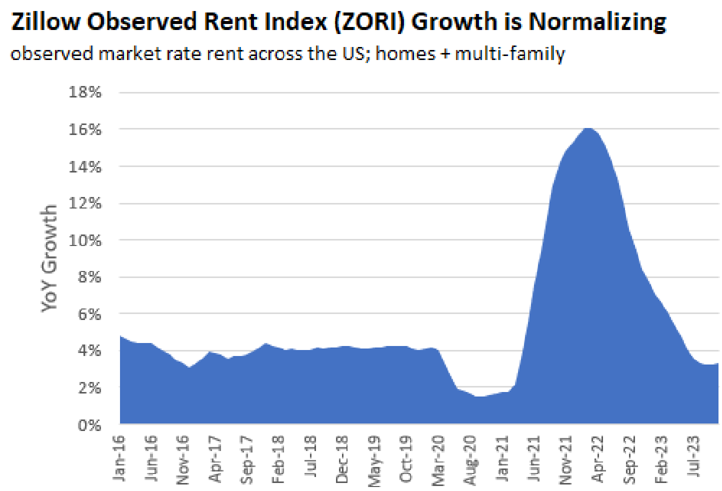


Source: SKY Harbor, Federal Reserve, Bloomberg

A Bumpy Ride Ahead?

The market now seems to be coalescing around the view that the final push to a more normalized inflationary backdrop – or approximately 2% – will be non-linear in nature and highly dependent upon the trajectory of rent expense, which has remained stubbornly high and represents a significant share of the CPI basket. There are several datapoints that underpin optimism, however. First, and as demonstrated in the left chart below, **new construction has been elevated, with additional multi-family units likely to hit the market in coming quarters**. Additionally, a 100 bps decrease in average 30-year fixed mortgage rates could increase housing turnover, leading to a re-set in prices and/or migration into home ownership, potentially freeing up additional rental space. Finally, and as demonstrated in the right chart below, higher frequency data provided by Zillow imply some cooling in rental rates, which have recently fallen to growth levels more closely aligned with the pre-pandemic period.

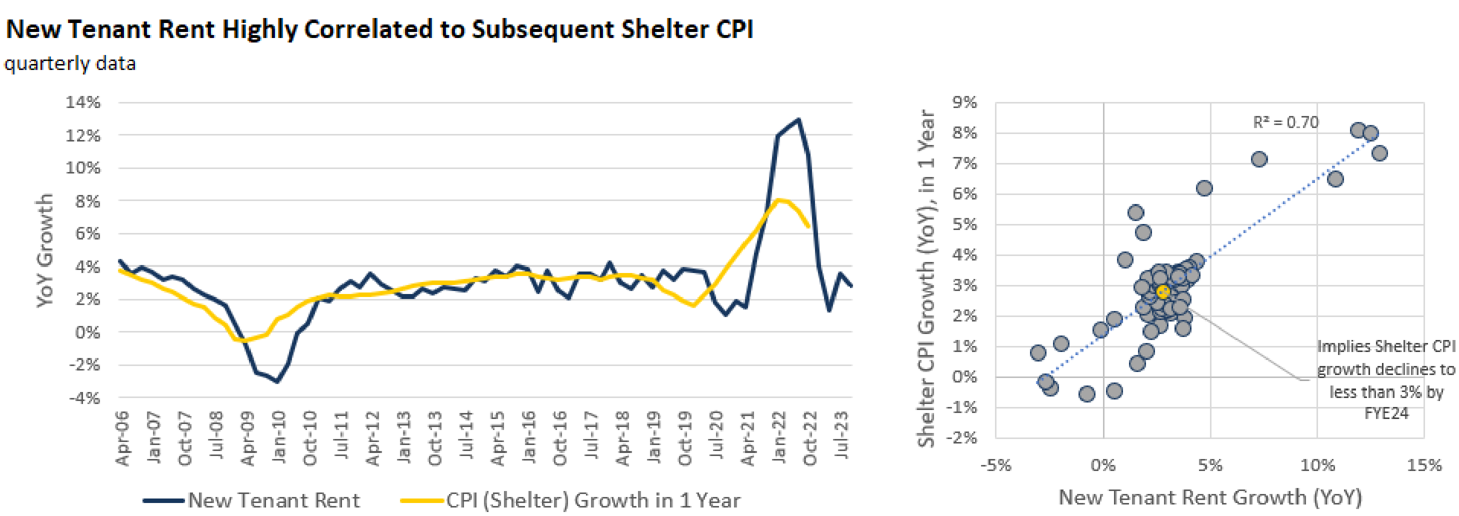




Source: SKY Harbor, St. Louis Fed, Zillow, The Wall Street Journal

An Alternative Approach

The New Tenant Rent Index (NTR) is a data series that utilizes rental figures from the housing survey that drives CPI, but somewhat differs in that it measures prices renters would pay if they signed a new lease every quarter[1]. As such, while the shelter component of CPI measures new rents, renewals, and payments in the middle of leases, the NTR only uses net new data as renters move into their new dwellings. Many economists view this measure to be more forward-looking in nature, and we find (demonstrated below) that **it remains highly correlated to subsequent year growth in the shelter component of CPI** (correlation = .84). Based on this historical relationship, shelter inflation could fall to ~ 2.8% by the end of 2024 on a YoY basis, vs. over 6% growth in the most recent quarter.



Source: SKY Harbor, Cleveland Fed, Bureau of Labor Statistics

Everything in Moderation

Though data highlighted above suggests the potential for continued alleviation of pressure on the inflation side, the significant divergence between market and Fed expectations as it relates to the path of rate cuts make it difficult to get overly optimistic on duration, particularly since peak enthusiasm may very well be priced into market levels at present. As such, we think the bigger takeaway remains underlying resilience of the economy, and as such our focus remains on identifying attractively priced credits on a micro basis, particularly as every step lower in rates makes successful refinancing and continuation of free cash flow generation increasingly likely, thereby reducing default risk in our market.

---

[1] https://www.bls.gov/pir/new-tenant-rent.htm

Important Disclosures and Disclaimers

This analysis and the opinions expressed herein are intended solely for institutional and professional investors that are responsible for assessing their own risk tolerances under prevailing market conditions. SKY Harbor Capital Management, LLC ("SKY Harbor") provides this document for informational purposes only. Nothing contained in this document is or should be construed as an advertisement, or an offer to enter any contract, investment advisory agreement, a recommendation to buy or sell securities of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle, or derivative.

This document contains forward-looking statements that are based on SKY Harbor's current views and assumptions. Forward-looking statements such as the findings of our analytical research, our outlook for interest rates, Fed policy, the economy, high yield markets and the like, or our intended adjustments to the portfolios within our strategies are subject to inherent risks, biases and uncertainties that are beyond SKY Harbor's control and may cause actual results to differ materially from the expectations expressed herein.

The information contained herein is subject to change, and SKY Harbor is under no obligation to update any information contained herein. Certain information contained in this document has been obtained from third-party sources and, although believed to be reliable, has not been independently verified, and its accuracy or completeness cannot be guaranteed. SKY Harbor, its affiliates, officers, directors and employees hereby disclaim any liability whatsoever related to the use of this publication or its content and make no express or implied warranties of merchantability or fitness for any particular purpose or use with respect to the data, projections, analysis, content, or conclusions included in this publication.

Investing in securities involves risk of loss and past performance is not necessarily indicative of future results. Fixed income securities, especially high yield debt securities, are subject to loss of income and principal arising from credit risk, which is the risk that the issuer will be unable to make interest and principal payments when due. Material risks in investing in high yield debt securities also include, but are not limited to, opportunity cost (the risk that an issuer's credit trends deteriorate resulting in a higher level of compensation demanded by the market relative to the initial investment), interest rate risk, liquidity risk, selection risk, and overall market risk. In general, issuers of high yield debt securities have a greater likelihood of defaulting on the payment of interest or principal than issuers of investment grade bonds. There can be no assurance that the investment objectives described herein will be achieved or that substantial losses can be avoided.

Gross performance results do not reflect the deduction of investment advisory fees, which would reduce an investor's actual return. For example, assume that $1 million is invested in an account with the Firm, and this account achieves a 6% compounded annualized return, gross of fees, for five years. At the end of five years that account would grow to $1,338,226 before the deduction of management fees. Assuming management fees of 0.55% per year are deducted annually from the average annual AUM, the value of the account at the end of five years would be $1,302,846, which is the equivalent of an annual compounded rate of 5.43%. For a ten-year period, the ending dollar values before and after fees would be $1,790,848 and $1,697,408, respectively. SKY Harbor's asset-based fees are generally billed monthly or quarterly in arrears. Please refer to the SKY Harbor's ADV Part 2A or applicable Offering Documents for more information on fees. Consultants supplied with gross results are to use this data in accordance with SEC, CFTC, NFA or the applicable jurisdiction's guidelines.

SKY Harbor is not a tax or legal advisor. Prospective investors should consult their tax or legal advisors before making tax-related investment decisions.

The ICE BofA Index data referenced herein is the property of ICE Data Indices, LLC ("ICE BofA") and/or its licensors and has been licensed for use by SKY Harbor. ICE BofA PERMITS USE OF THE ICE BofA INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE BofA INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND SKY Harbor or ANY OF ITS PRODUCTS OR SERVICES.