KKR

Flash Macro Update

U.S. CPI | November 2024

Henry H. McVey
Head of Global Macro, Balance Sheet & Risk, CIO of KKR's Balance Sheet
henry.mcvey@kkr.com

Dave McNellis
Co-Head of Global Macro & Asset Allocation

Ezra Max
Associate, U.S. Macro

Miguel Montoya
Associate, U.S. Macro

What You Need to Know

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

Core CPI for October came in in-line with market consensus at 0.3% m/m (3.3% y/y), and below the 'whisper' number of ˜0.4% m/m. Overall, we view this as a constructive report for markets, as it shows that Core inflation is not becoming unglued.

Regardless, the absolute level of inflation remains too high, and we continue to observe rolling 'hot spots' at the sector level. Nothing in this report shifts our view that the new 'resting heartrate' of inflation is still up around 2.5% vs. 1.5% in the pre-pandemic era. Hot spots from earlier this year, including insurance pricing and vehicle maintenance costs, have improved somewhat. **At the same time, we are now seeing reacceleration in other areas, including recreation services, airfares, and used vehicles**.

Beyond a reacceleration in the aforementioned areas of inflation mentioned above, what's also new in our thinking is that tariffs are a now important consideration, presenting moderately hawkish risks to inflation and to the Fed outlook. Our preliminary base case is that tariffs present upside risk to CPI on the order of 0.3% per year in both 2025 and 2026 (*Exhibit 6*). This view incorporates our preliminary base case of 60-85% tariffs on 'List 1-3' China goods, 5-20% tariffs on 'List 4' China goods, and an average of 5% incremental new tariffs on Rest of World goods (5% being a rough simplified average of what we expect to be diverse initiatives across sectors and geographies).

Bottom line: To account for the one-time impact of higher tariffs, we are raising our CPI forecasts to 2.6% in 2025 and 2.8% in 2026, vs. our prior forecast of 2.5% for both years. Importantly, our 2025 headline CPI forecast also reflects downward adjustment to our outlook for Energy prices, which helps offset higher Core inflation. If we are right, then this means that inflation will have exceeded the Fed's forecast for 44 months in a row versus missing its mandate to the downside 37 times in the 60 months leading up to COVID. For 2027 and beyond, we continue to use 2.5% CPI as tariff effects fade.

On rates, we are sticking to our post-election view that 'neutral' for the Fed this cycle is around 3.375% (or about 75 basis points above Core CPI). However, a positive shock to inflation will discourage the Fed from moving too quickly in 2025-2026. As a result, we continue to expect a -25 basis point cut in December, but we now see the Fed cutting rates twice in 2025 and twice in 2026, versus our prior expectation of four cuts in 2025. Said differently, we think the Fed will continue targeting one percent real rates (where they expect to be at year-end 2024) and adjust nominal rates accordingly.

Meanwhile, we stick to our 10-year target of 4.25% for 2024, but we raise our 2025 target to 4.25% from 4.0% previously to account for tariff-related rates and inflation uncertainty next year (which feed into term premium in our Treasury yield model). Longer-term, we continue to see the 10-year settling at 4.0%, reflecting our view that the long end of the curve does not become 'unglued' as both deficits and inflation will ultimately stabilize at elevated levels.

This report makes us even more bullish on our Regime Change thesis. This cycle is different, and we want more linkage to nominal GDP, upfront yield, and collateral-based cash flows. We do not see a 1970s-style inflation, but we also don't think we are going back to a period of tight fiscal, loose monetary, and low inflation conditions. If we are right, one needs to think about asset allocation differently.

KEY DETAILS

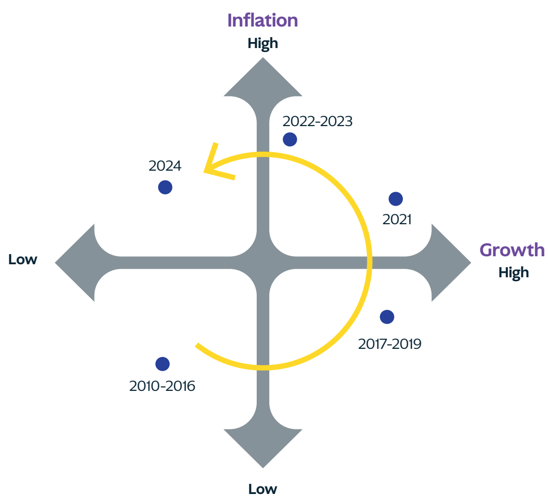
Services inflation cooled from +0.4% m/m to +0.3% m/m, driven by a big slowdown in non-shelter 'Supercore' Services (+0.3% vs. +0.6% last month). Supercore inflation has been volatile, but importantly we are seeing a slowdown in 'stickier'/structural areas of Supercore including auto insurance (which has averaged +0.6% for the last three months, vs. +1.1% for the last 12 months). On the Shelter side, OER accelerated to +0.4% m/m from +0.2% m/m in September but remains in the middle of the approximate 0.3-0.4% m/m range our models have long embedded. Looking ahead, we think Supercore will remain in the 3-4% range, higher than the Fed would like but well below the 6-8% range that prevailed in late 2023/early 2024.

Core Goods inflation remains subdued at +0.0% m/m (-1% y/y). Remember that Core Goods inflation has been a key disinflationary input into CPI over the last two years; we now see it slowing, particularly if Trump adapts a more aggressive stance on tariffs. We are still refining our scenarios for trade policy under a second Trump administration, but our best guess is that higher tariff costs could add +0.5%-1% to headline CPI, likely split over 2025-2026.

Said differently, we see 'new' hot spots replacing 'old' hot spots for CPI. One can see this in our leading inflation indicator *(Exhibits 4* and *5)*, which shows Core inflation becoming 'stuck' around 3% in the near term amidst a fading impulse from Goods deflation (which partially offsets a cooler labor market) as well as the potential for tariffs and increases in new services inflation to be a steadier headwind to cyclical disinflation than we previously thought.

Exhibit 1: Regime Change: We Have Exited a Low Growth, Low Inflation and Tight Fiscal Environment For Something Quite Different, Including a Higher Resting Heart Rate for Inflation and Rates

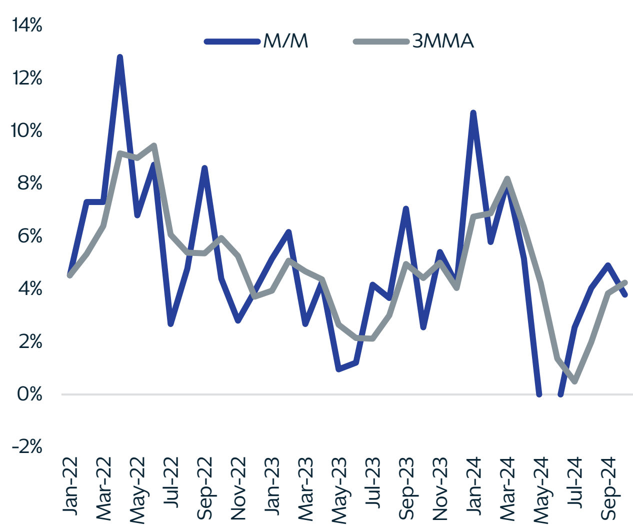
Low and High Growth and Inflation Regimes



Data as at December 31, 2023. Source: KKR Global Macro & Asset Allocation analysis.

Exhibit 2: The Good News in This Month's Report Is That Supercore Inflation Is Stabilizing in a Lower Range...

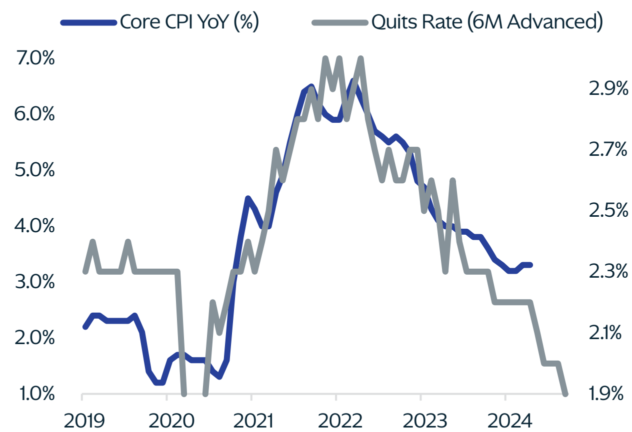
Supercore Inflation, % Annualized



Data as at October 31, 2024. Source: Haver Analytics, U.S. Bureau of Labor Statistics, KKR Global Macro & Asset Allocation analysis.

Exhibit 3: ...Particularly as the Labor Market Remains Disinflationary

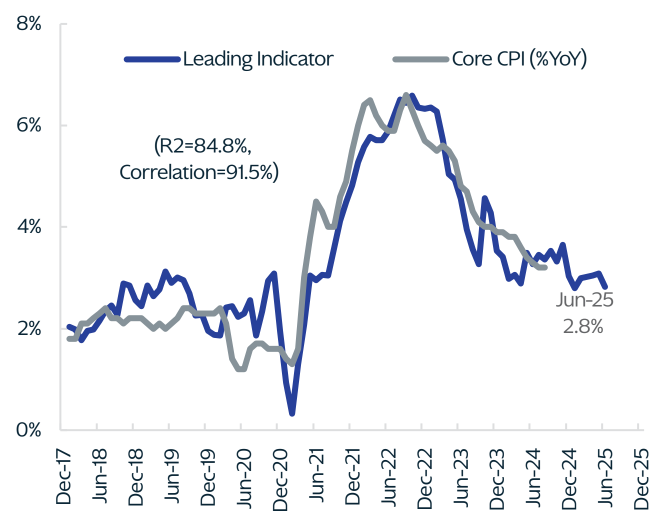
Labor Market and Inflation, %



Data as at October 31, 2024. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

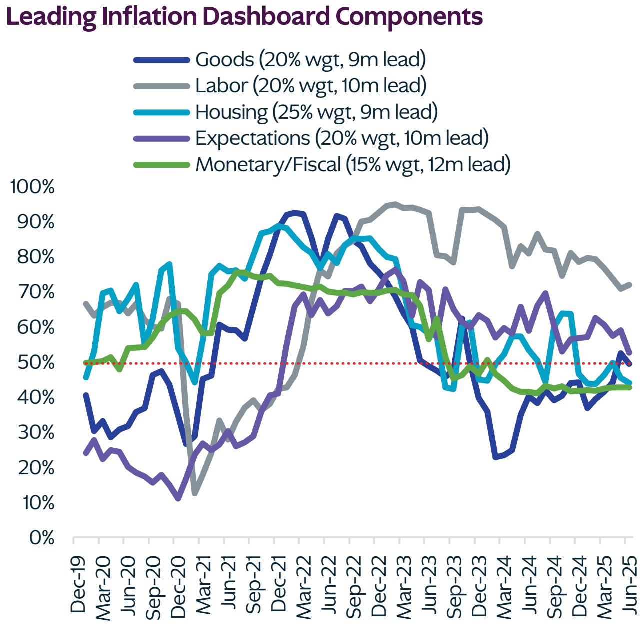
Exhibit 4: ...However, We Do Not See Core CPI Falling Meaningfully Below Three Percent in the Near Term

Core CPI Leading Indicator, %



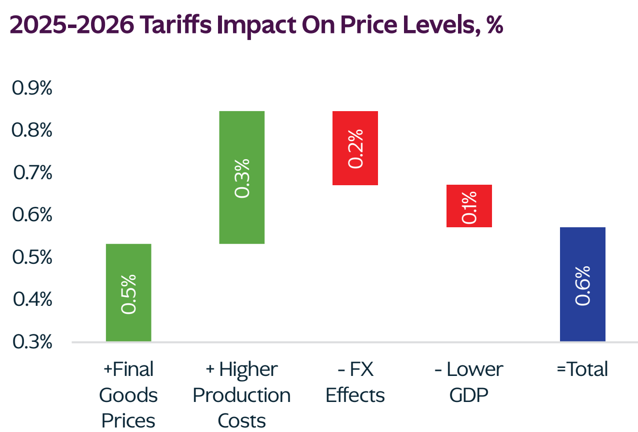
Note: model refit monthly to ensure that forward-looking projections reflect most relevant inflation drivers. Data as at October 31, 2024. Source: Bloomberg, U.S. Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 5: We Think Fading Goods Deflation Will Now Offset Cooler Labor/Services Inflation



Data as at October 31, 2024. Source: Bloomberg, U.S. Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

Exhibit 6: We See Tariffs Adding About 0.6% Cumulatively to U.S. CPI, Including 0.3%/Year in 2025-26



Data as at November 13, 2024. Source: Bloomberg, U.S. Bureau of Economic Analysis, Haver Analytics, KKR Global Macro & Asset Allocation analysis.

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Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
+ 1 (212) 750.8300
www.kkr.com