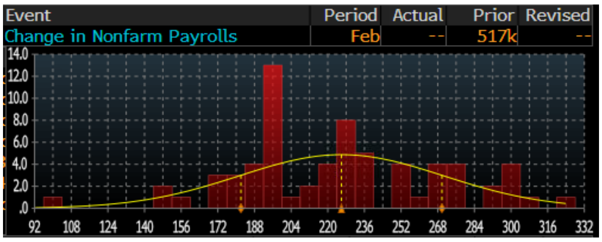
MNI PREVIEW: Only Limited Payback Of Jan Surge

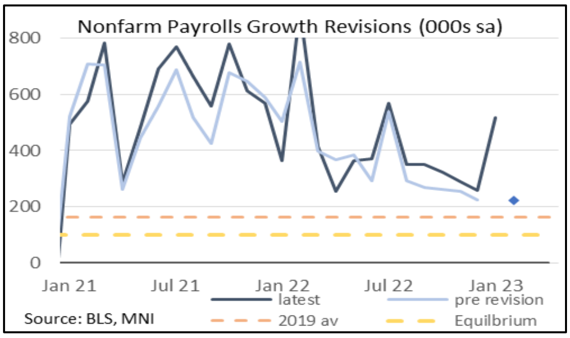
By Chris Harrison

Executive Summary

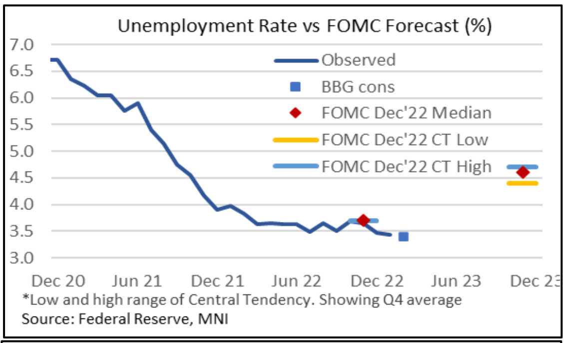
- Bloomberg consensus looks for still strong nonfarm payrolls growth of 225k in February after the storming 517k of January. If both still stand it would be only limited payback after mild weather and favourable seasonal factors seen in January.
- Revisions to that January figure are likely to play an important role after Fed Chair Powell opened the door to a 50bp hike in his Senate appearance.
- A consensus reading with minimal revisions could pave the way for 50bp on Mar 22 barring any CPI surprises Tuesday, but notable downward revisions and/or February payback could draw a significantly dovish reaction after the ramping higher of Fed rate expectations.
- Also watch average weekly hours worked after their surprise surge, a not expected but potential tick higher on rounding to the u/e rate (3.43% in Jan) and AHE growth with primary dealer skew to a hawkish surprise.

The Bloomberg median sees nonfarm payrolls rising 225k in Feb with no sign of payback after the substantially stronger than expected 517k in Jan. Estimates range from 100k (outlier) to 325k, while the primary dealer median sits at 240k. As a result of that Jan strength but also prior upward revisions, a consensus reading would leave both the 3- and 6-month averages at circa 330k, double the 165k averaged in 2019's historically tight labour market and far above the increasingly misplaced focus on a long-run sustainable ~100k per month noted by Powell back in November at Brookings. Unusually mild weather was seen boosting the payrolls surge in Jan (analysts note SF Fed estimates worth 120-130k) but it's unclear how much, if any, clawback there might have been in February – see various views in the analyst section below. Deutsche, at the top end of consensus with 300k, note that heating degree days relative to normal for the February survey week were still mild at -30 after -43 in Jan, but others point to a seasonal adjustment payback.

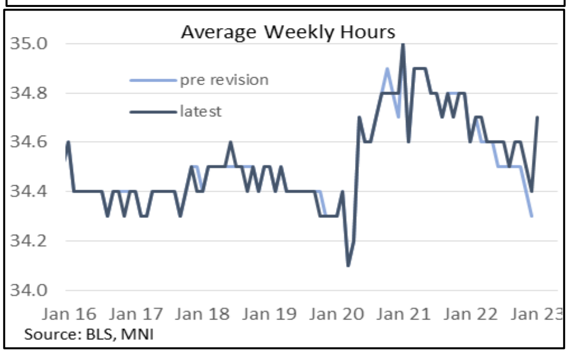




The unemployment rate and AHE growth, two of the other key readings in the report, are seen holding onto January's strong trend. The unemployment rate is seen holding at 3.4% after surprisingly falling from 3.47% to 3.43% in Jan to the lowest since 1969, although won't take much for this to push a tenth higher on rounding. That forecast is against a backdrop of no change seen in the participation rate after last month's small rise was flattered by rounding, although masked a more notable jump in prime-age participation back within less than 0.5pp of pre-pandemic levels. AHE growth meanwhile is seen repeating the 0.3% M/M from Jan although that's enough to push the Y/Y rate three tenths higher to 4.7% Y/Y whilst the primary dealer survey is skewed to a hawkish surprise in M/M terms (more on this below). Revisions in the latter should once again be watched having seen sizeable two-way changes over the past few releases.

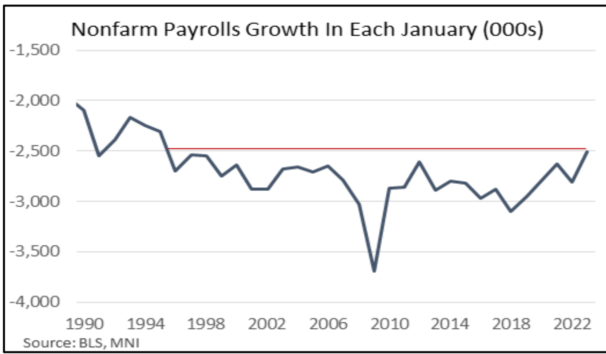


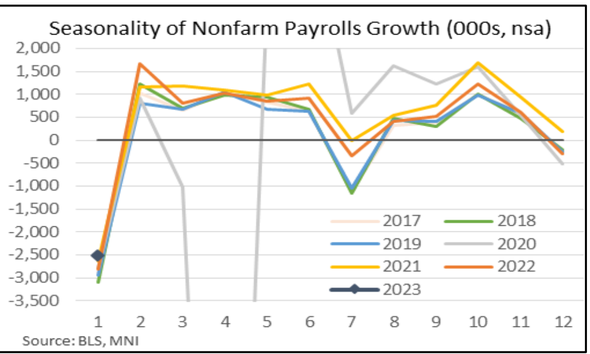
Average weekly hours are also to be watched closely, expected to only edge 0.1 lower to 34.6 hours after strong upward revisions and a surprise jump from 34.4 to 34.7 (cons 34.3) in Jan. That January move meant that hours had been seen at the bottom of the pre-pandemic range but are now above



the top-end of the range, strongly at odds with the prior trend of softer labour demand after those lower levels had previously been noted by more dovish FOMC members.

Seasonality discussions are also likely going to play another prominent role on Friday as well. January is an unusual month with large job losses. The surprising strength in the seasonally adjusted figure was down to the 2.5 million jobs lost in the month being the smallest since the mid-1990s, potentially a sign of reluctance to lay people off rather than new job creation. Whilst clearly a sign of a very tight labour market it will be interesting to see developments in a month that typically sees sizeable job gains, with February typically being one such month.





Key points from labour market summary in Fed Beige Book (released Mar 8)

- "Labor market conditions remained solid. Employment continued to increase at a modest to moderate pace in most Districts despite hiring freezes by some firms and scattered reports of layoffs."
- "Several Districts indicated that a lack of available childcare continued to impede labor force participation. While labor markets generally remained tight, a few Districts noted that firms are becoming less flexible with employees and beginning to reduce remote work options."
- "Wages generally increased at a moderate pace, though some Districts noted that wage pressures had eased somewhat. Wage increases are expected to moderate further in the coming year."

In Line Payrolls and CPI = 50bp Hike Later This Month?
Fed Chair Powell's decision to put a re-acceleration to a 50bp hike on the table at his Senate appearance on Mar 7 was not an offhand comment. It was a big change from the February step-down to 25bp / Powell's dovish press conference, and December's comments that de-emphasized the size of hikes ("*It's now not so important how fast we go. It's far more important to think, what is the ultimate level? And then it's-at a certain point, the question will become, how long do we remain restrictive?*"). As a result, Fed Funds futures now price a 43bp hike for the Mar 22 decision from ~30bp pre-Powell, with a sense that if both payrolls and core CPI meet relatively robust expectations that they could drive that 50bp hike. Similarly, the terminal is now seen to sit 110bps higher than the current effective rate for not far off 5.7% (with only half a cut priced to year-end) and some analysts have revised higher their terminal rate forecasts and what the median 2023 dot could be for the upcoming SEP ahead of the data.

The scale of the shift higher before payrolls and CPI (the latter landing in the media blackout window but not necessarily an issue for Fed guidance) could pave the way for a sizeable retracement in the event of surprisingly soft data, but at this juncture it would be fighting what for now at least appears a clear signal from the Fed – see the quote from Powell below. Either way, revisions to January's strength are likely to play a particularly important role here, with a weak Feb print and downward revisions plausibly shutting the door on a 50bp hike again, whilst strength and/or upward revisions to January could tee up CPI next week for 50bp confirmation.

Primary Dealers See Hawkish AHE, Balanced U/E

	Payrolls	U/E	AHE
NatWest	175	3.5	0.4
HSBC	190	3.5	0.3
Morgan Stanley	190	3.4	0.3
CS	200	3.4	0.3
J.P.Morgan	200	3.4	0.3
BMO	220	3.4	0.4
Barclays	225	3.4	0.3
BoA	230	3.4	0.4
TD Securities	230	3.4	0.4
BNP Paribas	240	3.4	0.5
Scotiabank	240	3.4	0.3
Goldman Sachs	250	3.4	0.3
Citi	255	3.4	0.4
Nomura	265	3.4	0.4
Wells Fargo	270	3.4	0.4
UBS	275	3.4	0.4
Societe Generale	280	3.4	0.3
Jefferies	290	3.4	0.4
Deutsche Bank	300	3.4	0.3
Mizuho	300	3.3	0.3
Median	**240**	**3.4**	**0.3**

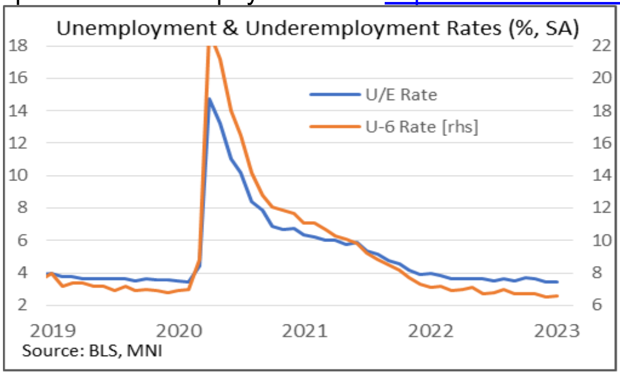
Where entered in BBG survey or seen by MNI
(Missing Amherst, RBC)
Red denotes tighter than consensus, blue looser

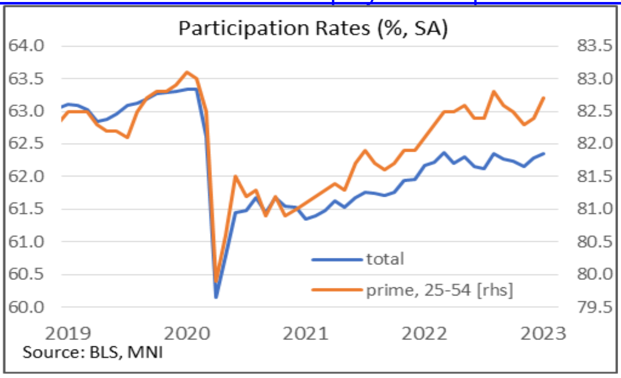
As an aside, the primary dealer skew towards the unemployment rate proved to be a useful guide last month although less so for AHE. This month, there is unusually broad consensus on the u/e rate but some sizeable upside skew for AHE growth, which if the latter materialises could further help drive a hawkish reaction.

Powell speaking at the Senate on March 7: *"If you look at the data that's been coming in since earlier this year, you have seen stronger labor market conditions, higher inflation, stronger consumer spending. And also, we saw some of the low inflation readings from the fourth quarter of last year revised away. You take all of those; they, kind of, all -- they may be to some extent related to things like seasonal adjustments or -- or a warm January. But nonetheless they all point in the same direction and they do suggest that -- the possibility that we ultimately would need to raise rates higher than had been expected."*

Recent Labour Market Developments

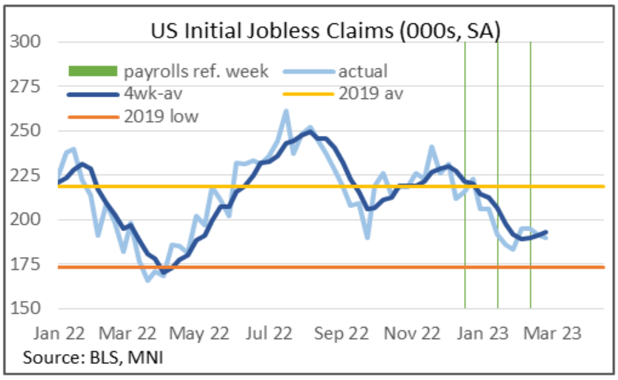
Recap of last month's payrolls here: https://roar-assets-auto.rbl.ms/files/51126/USEmploymentReportFeb2023.pdf

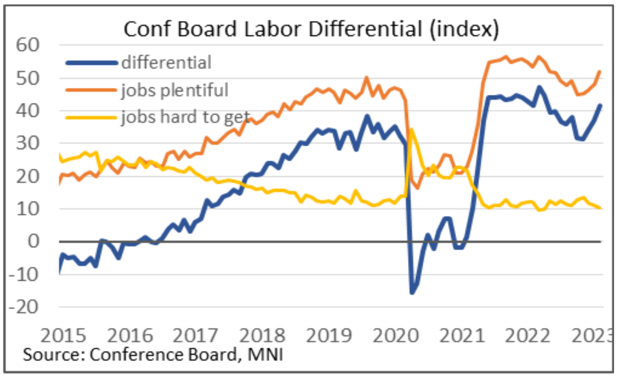


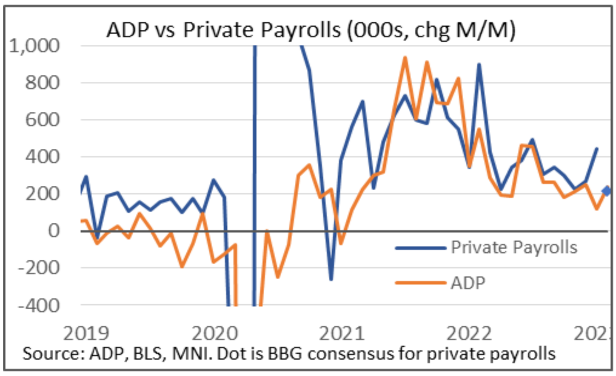


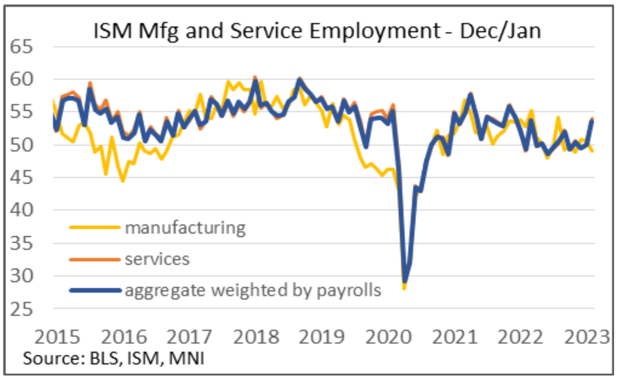
Labour indicators since the last payrolls report:

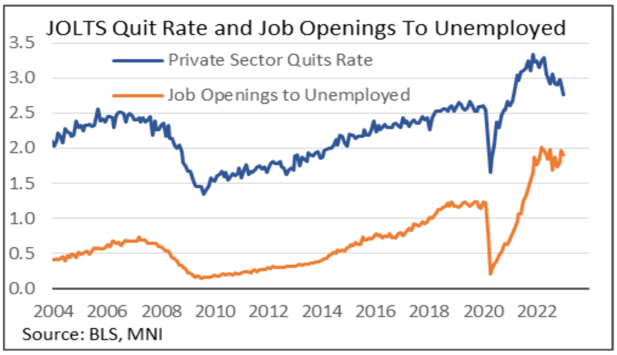
- Surprise strength across a variety of non-big data measures: initial claims, Conference Board labor differential, ISM services employment, JOLTS openings (ratio to unemployed 1.90) and ADP have all come in stronger (although ADP at 242k was close enough not to move the dial for payrolls estimates).
- JOLTS quit rates were one of the few areas moving softer, closer to pre-pandemic averages.

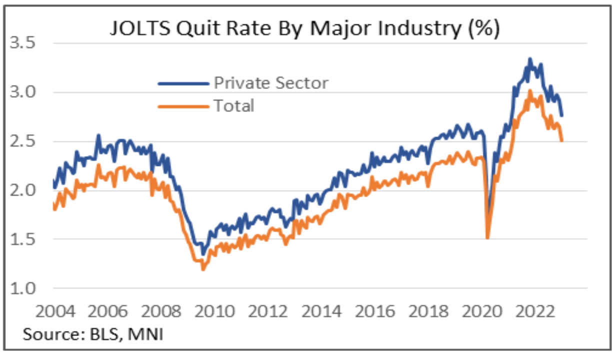












Sell-Side Views

Ranked from largest to smallest NFP figure, many of which were written prior to latest alternate indicators.

DB: Further Impact From Mild Weather, Risk Of 3.3% Unemployment Rate

- Deutsche Bank are very near the top of consensus with a call of 300k (private 300k) given mild weather once again during the survey week.
- Recall that last month, the leisure and hospitality sector added 128k jobs – well above the three-month trailing average of 83k. The same can be said for other weather-prone sectors such as retail trade (+30k in January vs. -17k three-month trailing average).
- Heating degree days relative to normal for the February survey week were -30, which while not as mild as the January survey week (-43), still point to upside risks for these sectors given the unusually mild weather.
- Equally as important will be hours worked (34.6hrs vs. 34.7hrs), which were also likely boosted by the aforementioned mild weather.
- In addition, we expect AHE to hold at 0.3% M/M. If close, it would raise the Y/Y growth rate of AHEs by 30bps to 4.7%. However, Fed officials are likely to focus more on the near-term trend and in this case the three-month annualized growth rate would fall by around 50bps (to 4.1%).
- They see the unemployment rate holding steady at 3.4% but there is risk it rounds down to 3.3% should participation contract slightly.

SocGen: Current Pace Of Layoffs Still Low And Quickly Starting New Jobs, For Now

- SocGen expect a 280k increase for NFP in Feb.
- We hear the reports about layoffs but each week, both initial jobless claims and continuing jobless claims hold steady at very low levels. By historical standards, the current pace of layoffs is low.
- Layoffs have not raised the number of unemployed, and that is reflected in both the monthly employment and weekly jobless claim numbers. Laid-off employees are quickly starting new jobs. How long this will last is a focus of our attention.
- Total employment in restaurant, healthcare and education sectors remains below their February 2020 levels although potential growth is diminishing after recent strength.
- They see the u/e rate holding steady at 3.4% and AHE also at 0.3% M/M.

UBS: Risks and Potential For Noise Appear Wide

- UBS see NFP growth at a strong 275K in February after the 517K pace in January, with no strong view as to whether January would revise down (see risks in both direction).
- Should February's NSA change be strong enough, the seasonal adjustment routines could interpret that as a stronger employment trend, and apply less downward pressure to the January over-the-month change, essentially the filters feeding back in time some of the most recent months' strength, and revising up the January SA change.
- We expect private employment expanded 250K, implicitly supported by a relatively warm reference week. However, overall we expect the direct impact of weather to be zero. Our estimates of weather suggest that Jan was supported by between 70k-120K, depending upon the specification, but that February was warm

enough that none of the January gain pulled forward jobs at February's expense. Our estimates of weather-related effects on February employment range from -15K to +15K.
- Elsewhere, they see the u/e rate in line with consensus at 3.4% with a steady participation rate of 62.4%.
- AHE growth meanwhile seen a tenth higher than consensus at 0.40% M/M. The workweek is a risk though after average weekly hours climbed 0.3 hours in a jump of unusual magnitude in January, and completely at odds with the trend of the prior year and a half.

Wells Fargo: Undeniable Momentum Despite Warm Weather and Seasonal Factors Flattering
- Wells Fargo look for NFP growth to downshift from the torrid January pace but to remain strong at 270K.
- Unusually warm weather and other seasonal factors may have flattered the January employment reading, but even setting these aside, there has been undeniable momentum in hiring over the past several months.
- Equally important to Fed officials will be data on labor force participation and AHE. Slowing wage growth would be a sign that labor supply and demand are coming back into a healthier balance.

GS: Not Expecting A Large Drag From Weather
- Goldman see nonfarm payroll growth of 250k in Feb. Job growth tends to remain strong in February when the labor market is tight as some firms front-load spring hiring, and Big Data employment indicators were indeed strong in the month.
- We also expect high but falling US labor demand to more than offset rebounding layoffs in the IT sector.
- We do not expect a large drag from weather in the February report. While temperatures partially normalized from an abnormally warm January, the February survey week exhibited little snowfall in major population centers, and the major winter storm of February 21st arrived three days after the end of the survey week.
- The u/e rate is seen unchanged at 3.4%, reflecting a rise in household employment offset by flat-to-up labor force participation (unchanged on a rounded basis at 62.4%).
- AHE seen 0.30% M/M, boosting the year-on-year rate to 4.75%, reflecting continued but waning wage pressures and neutral calendar effects.

Commerzbank: Looking For A Noteworthy 240k Increase
- Commerzbank look for payrolls at a far from weak 240k. This is because disposable incomes of private households rose by 2% in January, partly due to hefty increases in social security transfers and lower tax payments (the dollar amounts for federal income tax brackets and many tax code provisions are adjusted annually for inflation), which boosted private consumption.
- January’s 517k was boosted by special effects (SF Fed estimates 130k of jobs were added by unusually mild weather and a returning 36k of university employees from strike) but was still significantly stronger than expected.
- Such an increase in employment would also be noteworthy because the U.S. labor market is already extremely tight with an unemployment rate of 3.4%, the lowest since 1969, and this figure is unlikely to have changed in February.

BofA: Real Risk That The Unemployment Rate Falls To 3.3%
- BofA expect NFP growth of 230k (private 215k) after January’s 517k was closer to 350k or less when allowing for the rough 120k boost from unseasonably warm weather (SF Fed estimates) and about 40k returning University of California workers.
- Weather was still unseasonably warm during February, but not to the same extent as January.
- Payrolls also have a mean-reverting nature. Typically, when payroll growth records a sizable increase or decrease, we see a reversal in the following month, e.g. in July nonfarm payroll growth jumped by 153k then fell by 216k in August.
- We suspect that services will again drive job growth as there is still ample room for hiring in leisure and hospitality. Additionally, we see few signs of increased layoffs in aggregate. While there has been an increase in mentions of "layoffs" in earnings transcripts, initial jobless claims remained at very low levels in the first half of February.
- In addition to our forecast for nonfarm payrolls, we expect private payrolls increased by 215k.
- AHE seen increasing 0.4% m/m or 4.8% y/y, whilst average weekly hours worked seen falling to 34.5 after a surprising jump to 34.7 in January, the increase also likely due to favorable weather.
- Unemployment rate to hold at 3.4% after rounding, but there is a real risk that it rounds down to 3.3%, whilst participation should be unchanged at 62.4%.

Barclays: Sitting On Payrolls Forecast After Weather Distortion

- Barclays see NFP growth of 225k with private at 200k. Our forecast is closer to the lower end of the range of possibilities suggested by our monthly models (suggest gains anywhere from 132k to 371k in February), reflecting our view that January's robust increase was boosted by payback effects from December's harsh cold snap, which held back net hiring in that month.
- AHE seen increasing at another 0.3% M/M (rounded lower) and the workweek to tick down, 0.1 to 34.6 hours, retaining most of January's 0.3 hour jump, consistent with net tightening of labor demand amid worker shortages.
- U/E rate expected to hold steady at 3.4% with a slight increase in the labor force participation helping to offset the effect of another gain in household employment. A further tick downward would be a significant development, with January's level at the lowest since 1969.

CIBC: Weather Improvement In Jan Adds Downside Risk To February

- CIBC expect a brisk 205k seeing as jobless claims were little changed over the Feb employment survey reference period and while the Conference Board's survey showed that jobs were still plentiful.
- An improvement in the weather in January likely overstated job gains at the start of the year, and adds downside risk to February's print.
- They expect the unemployment rate to remain at 3.4% and suspect that January's surge in hiring represented a filling of job openings rather than new demand for labor, with layoffs in sectors that outperformed during the height of the pandemic providing a new source of labor supply.
- If that's true, lower job openings ahead, as implied by the downtrend in private job vacancy measures, would be consistent with a deceleration in hiring in February, in combination with pressure on cyclical sectors that are slowing in response to higher interest rates.
- A 205K pace of hiring is still well above what would satisfy the Fed's desire to add slack to the labor market, leaving policymakers on track for at least another two 25bp rate hikes ahead [**MNI note:** written pre-Powell].

MS: Normalising Payrolls Growth And Workweek

- Morgan Stanley see a big step down in nonfarm payrolls growth to 190k in Feb from 517k, with private payrolls should be slightly softer at 168k vs. 443k prior.
- January payrolls benefitted from an extremely low seasonal hurdle (-3mm jobs) while February requires
- the addition of at least 770k jobs in order to record a positive payroll number. With labor market indicators pointing towards labor hoarding, less seasonal fluctuation in hiring should be a drag on February jobs numbers.
- A jobs increase in line with our forecast, along with a further uptick in the labor force participation rate from 62.35% to 62.39%, should keep the unemployment rate at 3.4% in February. Gains in participation and the slowing in job growth together will push up the unemployment rate up for the foreseeable future.
- They expect AHE to increase by 0.3% M/M and the average workweek to normalize back to 34.5.

Unicredit: Wouldn't Be Surprised If January Payrolls And Hours Revised Down

- Unicredit look for still-robust payrolls growth of 190k in February. The January surge of 517k looks odd, as well as the jump in average hours worked, and we wouldn't be surprised if both are revised downwards.
- At this stage, we put it down to very mild weather, seasonal factors and the return of striking government workers. We believe underlying labor demand is softening, as indicated by private surveys of job openings.
- The unemployment rate probably held at 3.4% – the lowest since 1969. Challenger reported that announced job cuts are rising, and not only in tech, but they will take time to be implemented.
- AHE growth likely rose 0.3% mom with risks skewed to the upside (assuming average hours fall back). It would take the yoy rate to 4.7% from 4.4%, which is too high for the Fed's liking.

Westpac: Eyeing Downward Revisions After Shocking January Strength

- Westpac are below consensus with a forecast of 180k as the state of the economy and statistics argue for a snap back below 200k in the month and likely some downward revisions to the prior two periods.
- The strength of the January nonfarm payrolls report shocked markets. Even taking the average of the three months to January, the pace of job creation still stood at 3.5 times the 100k believed necessary to balance demand and supply.
- They are in line for the u/e rate though at 3.4%.

NatWest: Don't Rule Out Downward Revision, Also Doesn't Take Much To Round U/E Rate Higher

- NatWest expect NFP growth of 175k. At least part of the strength in January payrolls looks like it was due to generous seasonal adjustment factors and we expect some payback in Feb, and would not rule out the possibility that some of seasonally adjusted gain for Jan is ultimately revised lower.
- Meanwhile, the u/e rate is seen rounding up to 3.5% from last month's 3.434%. However, the backdrop heading into the report is even more unclear than usual. The "jobs-plentiful" index in the Conference Board's consumer confidence report suggests that the underlying trend in the unemployment rate is still edging down, while seasonal adjustment dynamics in the household (and payroll) survey could reverse a bit in February and push up the unemployment rate (and weigh on payrolls) in February.
- Like the recent price data, we suspect AHE firmed in Feb, with overall earnings up by 0.4% M/M (after 0.3% in January) and the y/y pace picked back up to 4.8% from 4.4% y/y in January. The preCOVID trend was around 3% y/y.

Wrightson ICAP: Looking For Correction From January's Seasonal Exaggeration

- The February employment report should be less threatening than the January edition, with Wrightson ICAP forecasting a 150k increase. They have less conviction about payrolls than about the unemployment rate, but we think the risks are on the weak side of market expectations here as well.
- They think the strength in the Jan employment data was exaggerated by seasonal adjustment challenges, and look for a correction this month.
- They see the odds the unemployment rate returns to 3.5% as very good. At this point last month, they thought that the unemployment rate would fall to 3.4% in Jan (which it did) and rebound to 3.5% in Feb, and none of the data released since then have changed this. Looking for 3.6% in the next month or two with further gradual increases beyond.
- AHE are the only major item in the February employment report that they think might be stronger than last month, forecasting 0.4% M/M. The gradual softening of the labor market is expected to lead to milder wage gains as 2023 progresses, but their very low-conviction guess is that the January number was an outlier on the downside – AHE growth isn't seen falling to a 0.3% average on a sustained basis until the spring.
- Regardless of whether AHE rise by 0.3% or 0.4%, the Y/Y rate will rise sharply because a weather-distorted reading of 0.0% from last February falling out.

CBA: Looking For Payrolls Growth of 100k or Less

- CBA are notably below consensus with a call of 100k or less. The 500k+ surge in January may reflect issues with seasonal adjustment or simply a rogue number. Still, jobless claims suggest the labour market remains very tight with a very low unemployment rate.
- They look for AHE growth in line with consensus at 0.3% M/M.

MNI Policy Team Insights

MNI: StL Fed Model Sees Moderate Increase in Feb Employment

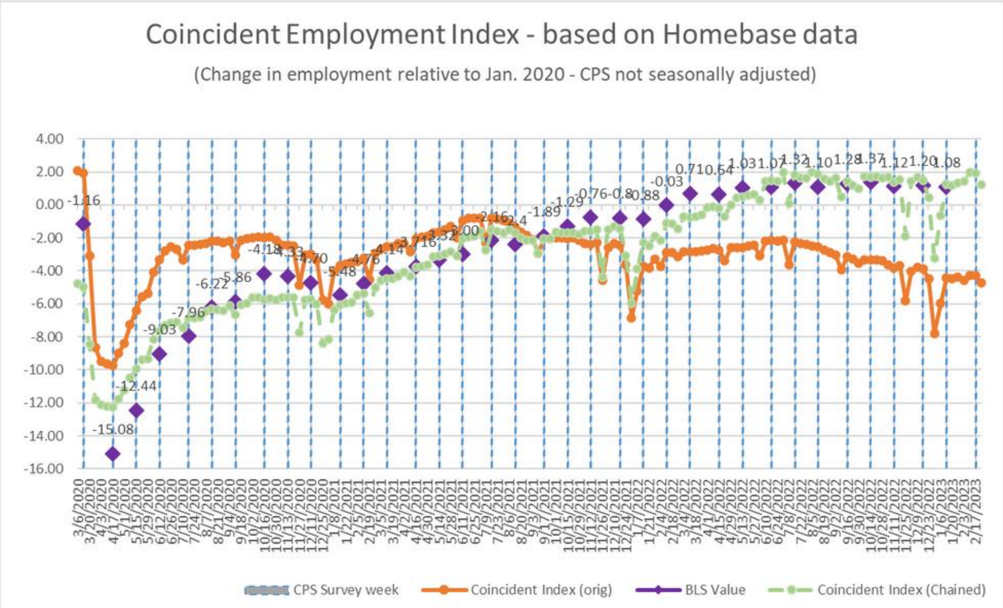
By Jean Yung, published Mar 8

U.S. employment showed a "moderate increase" in February while the pace of moderation on wage growth has slowed, according to a St. Louis Fed analysis of real-time data from employee scheduling software provider Homebase, bank economist Max Dvorkin told MNI.

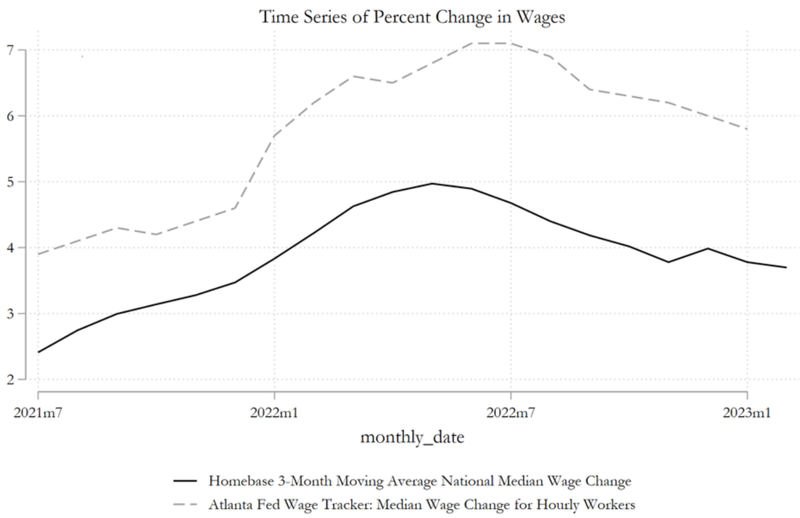
The St. Louis Fed's Coincident Employment Index predicts a seasonally adjusted 234,000 increase in the number of employed people last month, down from 580,000 in January. The unadjusted employment growth for February is around 1 million. These figures correspond to the Bureau of Labor Statistic's household survey.

The CEI for January "pointed to an important increase in employment suggesting a positive surprise in employment growth relative to market expectations, which was ultimately reflected in the data," Dvorkin said. "For February, the coincident employment index shows a moderate increase once seasonality is taken into account," he said.

Meanwhile, his analysis of high frequency U.S. pay data collected by Homebase shows wage inflation is lower than last year, but "the pace of moderation has slowed down when compared to the evolution since mid-2022."



Source: Homebase data and author's calculations. Max Dvorkin - Federal Reserve Bank of St. Louis



MNI INTERVIEW: Fed Likely Needs To Move Rates Above 6%-Mishkin

By Evan Ryser, published Mar 8

The Federal Reserve will likely need to raise interest rates above 6% to defeat inflation, and while the economy has so far remained strong it should not buckle if it tips into recession, former Fed governor Frederic Mishkin told MNI.

"I'm a little worried the economy's stronger than expected and that is likely to mean they have to go a little bit higher above 6%," he said in an interview, adding his name to a list of outside advisers who've told MNI recently there's a risk rates will move above 6%.

The drag on GDP growth from last year's fiscal and monetary policy tightening is fading and that means that a key risk for the economy is a premature reacceleration, he said. "The Fed has to tighten substantially further, and secondly it has to stick to its guns. It can't make the mistake of pivoting just because a recession occurs."

Fed officials have emphasized inflation expectations as a key factor in helping to bring prices and wages down, but Mishkin stressed it will also require cooling the labor market.

MORE RESTRICTIVE

"Monetary policy has mostly only removed accommodation and didn't really get back to neutral until about six months ago and it takes a long time to have an effect," said Mishkin, also a former NY Fed director of research. "Policy is restrictive now but it needs to be a lot more restrictive."

While Mishkin has previously argued, in a 2010 paper coauthored with Jean Boivin and Michael Kiley, that changes in the structure of the banking industry could reduce the sensitivity of the economy to rate hikes, he told MNI that the central bank's conventional tools including the fed funds rate are as strong as ever, but the Fed will have to raise rates higher since it got caught behind the curve.

The long-dormant Phillips Curve between inflation and unemployment has returned with a vengeance and the Fed's failure to pre-empt inflation in 2021 has restored the pre-1985 pattern of greater persistence of movements in both inflation and inflation expectations, he said, pointing to a recent paper produced for the Chicago Booth Monetary Policy Forum.

"It was clear that the Philips Curve was still around and would come back, particularly if the Fed stopped being preemptive," said Mishkin, now at Columbia University. "They thought it was flat and sure enough it's not flat. It's real."

PHILIPS CURVE ALIVE

Fed Chair Jerome Powell Tuesday opened the door for the central bank to accelerate the pace of rate hikes and raise the target range of the fed funds rate more than anticipated just months ago when Fed officials saw a peak rate in the range of 5.1% to 5.4%. (See: MNI: Powell-Fed Rate Peak Likely Higher; Could Quicken Hikes)

Mishkin said he's expecting the Fed's next SEP to be released March 22 to show a fed funds rate peak around 5.6%. "There's more recognition that the Phillips Curve was alive and that they made mistakes, and that's one of the reasons they've been continually raising the SEP forecasts," he said.

"There's a really strong possibility they'll go even higher," he added. "It makes it very likely that a recession will occur. In fact, it would be unprecedented to not have a recession in this context."

MNI INTERVIEW: Hot US Labor Market To Keep Rent Inflation High

By Jean Yung, published Mar 8

(MNI) WASHINGTON - The rate of U.S. housing services inflation will likely settle higher than before the pandemic and potentially contribute 2.5 percentage points to core CPI for as long as the labor market stays tight, nearly twice as much as pre-Covid, Kansas City Fed economist A. Lee Smith told MNI.

Rent inflation has been on a steady climb since 2021 and is already the largest contributor to elevated core inflation. While Fed officials are expecting a reversal in the second half of the year, citing falling market rates on new leases, new research by Smith and colleagues at the Kansas City Fed shows housing disinflation may be limited, because rents are sensitive to measures of labor market tightness, as are other core services components like health care and hospitality.

"Our view is that the labor market will underpin demand for shelter. That was true pre-pandemic even as the acceleration in rents during the pandemic suggests other forces at play," such as a greater demand for space as people spent more time at home, Smith said in an interview.

"Once the dust settles on that, the labor market will be the driver of rent inflation going forward."

SLOW SUPPLY CHANGES

Housing services contributed half of the 6% core CPI in the fourth quarter, compared to an average of 1.5 pp when inflation was running near 2% percent before the pandemic. Shelter comprises 40% of the core CPI basket, though it's a smaller component of the Fed's preferred PCE price index basket.

Smith and his co-authors measured labor market tightness using the ratio of job vacancies to the number of unemployed workers and found both housing inflation and non-housing core services inflation respond to a tight labor market three times as much as core goods inflation.

Unlike non-housing core services, housing inflation is not labor intensive. Yet it is clear that "changes in demand for shelter largely shape rent inflation over economic cycles," Smith and his co-authors wrote.

"If you do a back-of-the-envelope calculation, if the tight labor market persists, the contribution of housing services to core CPI could remain near 2.5 pp on an ongoing basis, which would be considerably higher than the 1.5 pp contribution pre-pandemic," Smith said.

MORE SIGNS

Supply-side shifts in housing are too slow-moving to have much of an effect, Smith added, even as the pandemic housing boom will deliver more new-construction multifamily units this year than at any time since the 1980s. New supply tends to be higher-end luxury homes, Smith said, and "that could limit the extent to which it will lower overall rent inflation."

There are other reasons to think a return to pre-pandemic rates of rent inflation could prove elusive.

The Zillow rent index, a measure of what landlords are asking on new leases, has climbed about 27% since December 2019 while the Labor Department's rent index has increased just 15%. "If you think that gap has to close somehow, then there is scope for the Zillow metric to undershoot BLS rent inflation for some time," Smith said.

Additionally, consumers' expectations of rent inflation moved up significantly last year, according to the annual New York Fed housing survey. Households on average last year expected rent increases of 11.5% over the next twelve months, compared with 6.6% a year earlier. Over the next five years, they saw annual rent increases of 5.2%, up from 4.4% in 2021. An update for 2023 is expected in April.

"If consumers are already expecting increases, there will be little resistance when landlords ask for those increases," Smith said.