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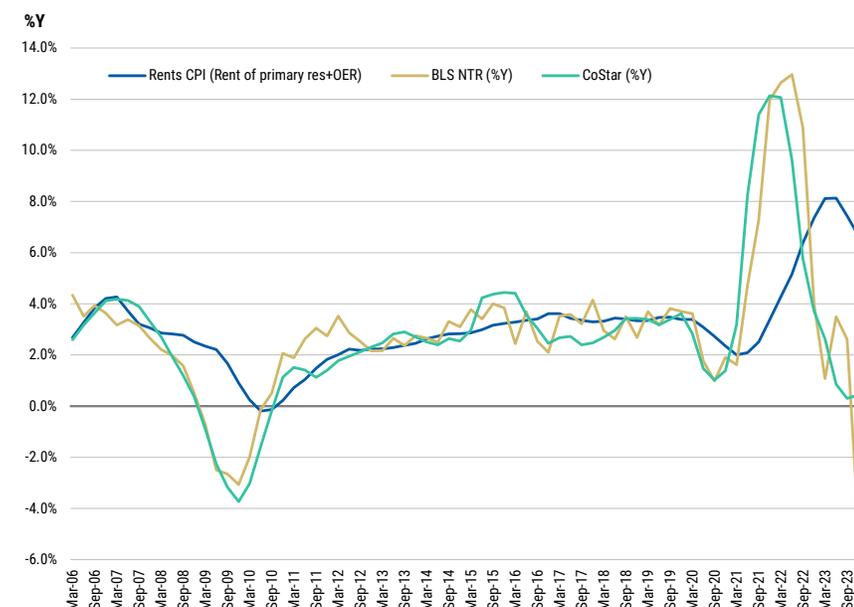
Rents - On The Path To Normal

A weaker-than-expected New Tenant Rent Index points to less rent inflation in 2H24, and lowers our 2024 forecast for core PCE inflation by 0.1pp to 2.2% (4Q/4Q). Herein we provide our updated inflation forecasts through 2025, and discuss implications for the Fed's projections.

Key Takeaways

- The BLS reported that its New Tenant Rent Index (NTR) dropped sharply in 4Q23 (-4.6%Y).
- NTR is one input in our forecasting models, leading rent CPI inflation by 3 quarters.
- We now expect a steeper decrease in rent inflation starting in July, with monthly prints reaching pre-COVID levels by the end of the year (0.27%M in Dec-24).
- The revision also lowers our 2024 forecast for core PCE inflation by 0.1pp to 2.2% (4Q/4Q) vs the Fed at 2.4%, providing scope for revision in the March SEP.
- We still see a reacceleration in 1H24 core PCE inflation holding the Fed until June. We look for a total of 100bp in cuts this year and 200bp in 2025.

Exhibit 1: NTR dropped 4.6%Y in 4Q24, and leads rent CPI by 3 quarters



Source: BLS, CoStar, Morgan Stanley Research

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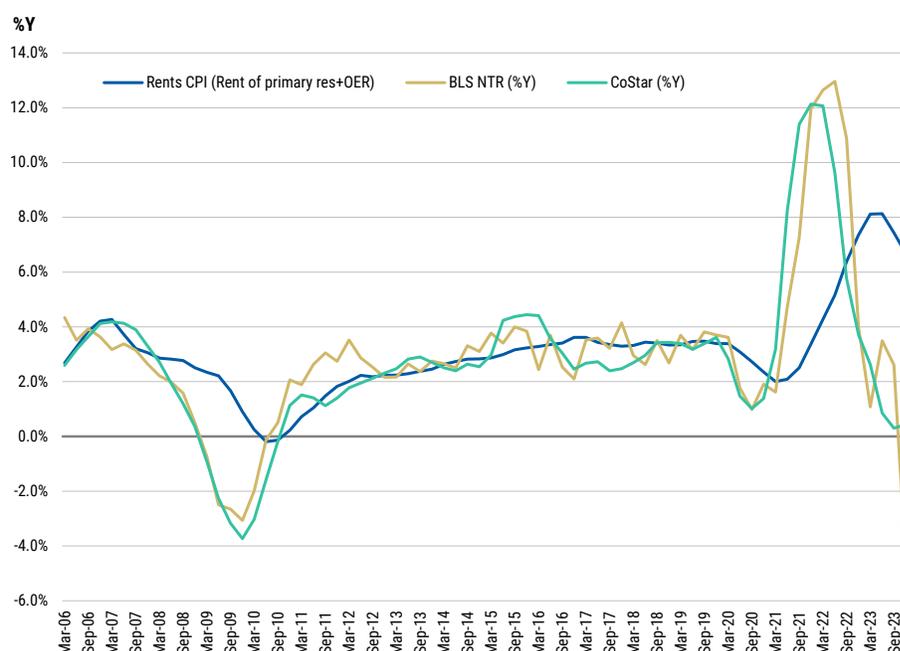
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Latest Data, New Update

Last week the New Tenant Rent Index (NTR) published by the Bureau of Labor Statistics (BLS) showed a stark decrease of 4.6%Y in 4Q23, down 6 percentage points (pp) from the prior quarter and marking a new low in the data series dating back to 2005 (Exhibit 2).

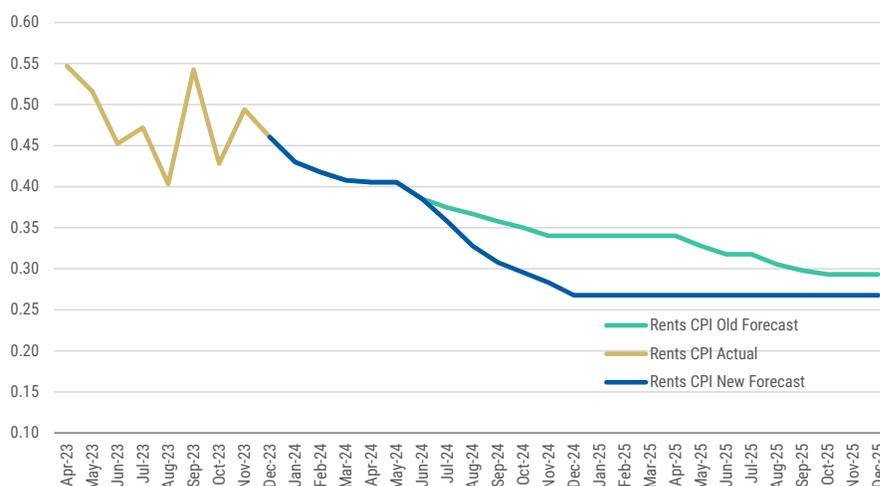
The NTR uses data from the CPI housing survey to track rents on new leases, and is a useful leading indicator for overall rental prices in CPI and PCE. Just as initial jobless claim today is a continuing claim tomorrow, a new rental lease today is an existing lease tomorrow, which naturally implies that new-lease data can provide useful signals about future housing CPI/PCE prints. We added the NTR to our set of indicators that keep track of new leases once the BLS began publishing the index regularly on its [website](#) last year.

Exhibit 2: NTR came down significantly in 4Q24 (-4.6%) signaling softer rental inflation ahead



Source: BLS, CoStar, Morgan Stanley Research.

Our models indicate a 3-quarter lag between NTR and rent CPI. As such, the larger-than-expected drop in the NTR points to lower rent inflation starting in Jul-24 than we had penciled in. We now see an average monthly pace of 0.31%M in 2H24 (vs. 0.35%M previously). Monthly prints are back to pre-Covid levels by the end of this year (0.27%M in Dec-24) (Exhibit 3). The revision also lowers our 2024 forecast for core PCE inflation by 0.1pp to 2.2% (4Q/4Q).

Exhibit 3: Rent inflation revised lower from 2H24 - old vs new path (%M)

Source: BLS, Morgan Stanley Research forecasts

Inflation is arguably the most important data given the current debate at the Fed, among economists, and in financial markets. When and how fast will the Fed cut interest rates?

We continue to expect the Fed will first cut rates in June. This forecast update does not change our expected inflation path leading into the June meeting. As detailed in our [2024 US Inflation Outlook](#), we see sticky services inflation temporarily reversing the downward trend in the 6-month core PCE inflation pace in 1H24 ([Exhibit 4](#)). The acceleration in sequential prints will be an important factor delaying the Fed's decision to cut.

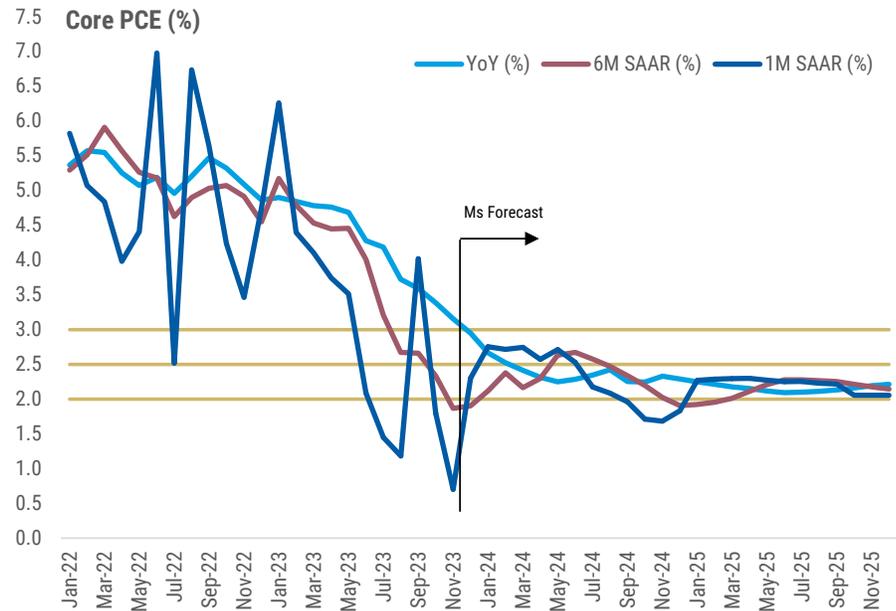
Although the NTR data affect our inflation forecasts only in the back half of this year, we are not the only ones that incorporate it in our inflation models. **We know that "several" FOMC participants also follow rents on new lease data closely, and may be sharpening their pencils as we speak.**¹ Even as the incoming data has unfolded in line with the Fed's median forecast for 2024 core inflation, full year forecasts could be adjusted downward in the March Summary of Economic Projections (SEP) such that consensus on cutting sooner can be reached. We continue to see the balance of risks to our view as being skewed to an earlier start to cuts, and place a greater probability on May than March.

In our view, the latest NTR data should affect the level of rates more so than the timing of first cut. In this note, we have taken down our 2024 forecast for core PCE inflation to 2.2% (4Q/4Q) vs 2.3% previously, and vs the Fed's December SEP of 2.4%. The SEP also revealed a median projection of 75 basis points (bp) in cuts this year vs our expectation for 100bp. **A downward revision to core inflation in the March SEP could be paired with a projection showing an additional 25bp in cuts, bringing the Fed in line with our 2024 expectation.** It would take 5 participants at the median to revise the rates path lower to move the median lower, that seems a high bar but sea changes between forecast meetings

1. The minutes from the Dec-23 FOMC meeting noted that: "Several participants assessed that housing services inflation would fall further over time as the earlier deceleration in rents on new leases continued to pass through to broader rent measures".

are not uncommon.

Exhibit 4: Bumpy inflation path ahead send trend core inflation higher in 1H24, before turning lower again

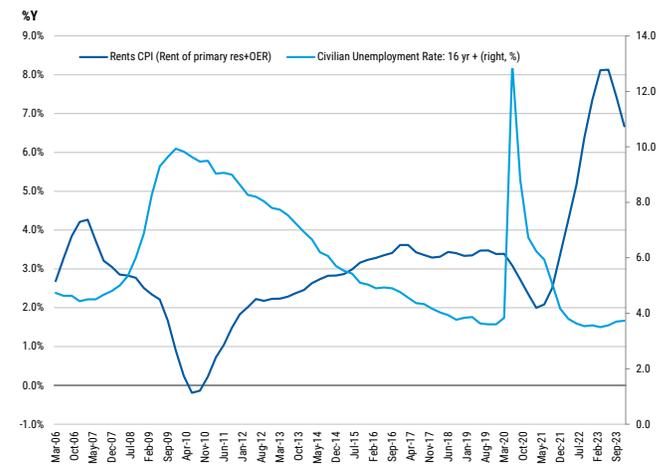


Source: BEA, Morgan Stanley Research forecasts

We don't see rent inflation below pre-COVID levels in 2024. The index is one input in our models and, although it does point to more weakness ahead, it doesn't necessarily imply that rent inflation will move below the historical trend. Several factors underpin our view.

First, **there are many other typical predictors pointing to more resilient shelter inflation.** We expect labor markets to remain relatively tight, with low unemployment rates and non-farm payroll prints above replacement rates during 1H24. And the historical relationship is clear, low unemployment means more shelter inflation

Exhibit 5: Resilient labor markets means resilient rent inflation



Source: BLS, Morgan Stanley Research.

(Exhibit 5). Moreover, our housing strategists expect only a mild drop in home prices that will help keep rent inflation at normal levels through the end of 2024. High prices means less affordability, fewer people buying, and more renting.

Second, it is hard to distinguish signal from noise with one data point, but **the recent negative print might be in part noise**. Why? Because the change in YoY rates is clearly an outlier in the sample. And the BLS acknowledges that data for recent periods are "prone to large revisions" (see [here](#)). Also, series that are typically highly correlated with NTR, like CoStar effective rents, were still in positive territory in 4-Q23 ([Exhibit 2](#)).

Third, **new leases tend to paint a weaker picture than overall CPI**. Focusing on new leases naturally leaves out renewals, which are an important part of the story. On average, people stay in their rented apartments for about 2 years and about 3 years in single family rentals (SFR), which implies that more than 50% of households renew their leases in a given year without signing a new lease. **Data on renewals are scarce, but according to our REITs analysts, renewal rents are stickier than rents on new leases.**

Also, market rents data tend to either focus exclusively on apartments, like CoStar, or put more weight in multi-family units because turnover is higher in that sector of the market. But SFR is expected to show higher rent inflation compared to multi-family. And supply and demand factors explain this difference. Both multi- and single-family units have increased supply and backlogs of homes under construction, but the past and forthcoming increase in supply is stronger for apartments. Moreover, demand for SFR is more resilient, as they tend to be rented by older and more affluent heads of household, more likely to have children, making demand more inelastic.

Lastly, **a recent methodological change likely adds more strength to OER inflation in the near term**. The new methodology puts more weight on single-family rentals for imputing OER CPI. And given that we are expecting stickier SFR compared to multi-family, the change in general adds upside risks.

[Exhibit 6](#) provides our new CPI and PCE path on a monthly and annual basis.

Exhibit 6: Inflation Forecasts

	% Change - Year-over-Year				% Change - Month-over-Month			
	Headline PCE	Core PCE	Headline CPI	Core CPI	Headline PCE	Core PCE	Headline CPI	Core CPI
Jan-23	5.5	4.9	6.4	5.6	Jan-23	0.56	0.52	0.41
Feb-23	5.2	4.8	6.0	5.5	Feb-23	0.32	0.36	0.37
Mar-23	4.4	4.8	5.0	5.6	Mar-23	0.12	0.34	0.05
Apr-23	4.4	4.8	4.9	5.5	Apr-23	0.30	0.31	0.37
May-23	4.0	4.7	4.0	5.3	May-23	0.11	0.29	0.12
Jun-23	3.2	4.3	3.0	4.8	Jun-23	0.17	0.17	0.18
Jul-23	3.3	4.2	3.2	4.7	Jul-23	0.13	0.12	0.17
Aug-23	3.3	3.7	3.7	4.3	Aug-23	0.36	0.10	0.63
Sep-23	3.4	3.6	3.7	4.1	Sep-23	0.38	0.33	0.40
Oct-23	2.9	3.4	3.2	4.0	Oct-23	0.03	0.15	0.04
Nov-23	2.6	3.2	3.1	4.0	Nov-23	-0.07	0.06	0.10
Dec-23	2.6	3.0	3.4	3.9	Dec-23	0.19	0.19	0.30
Jan-24	2.2	2.7	2.9	3.8	Jan-24	0.14	0.23	0.16
Feb-24	2.1	2.5	2.8	3.6	Feb-24	0.18	0.22	0.22
Mar-24	2.1	2.4	2.9	3.5	Mar-24	0.18	0.23	0.19
Apr-24	2.0	2.3	2.8	3.3	Apr-24	0.19	0.21	0.22
May-24	2.1	2.3	2.8	3.1	May-24	0.18	0.22	0.19
Jun-24	2.1	2.3	2.9	3.2	Jun-24	0.18	0.21	0.20
Jul-24	2.1	2.3	2.8	3.2	Jul-24	0.13	0.18	0.13
Aug-24	1.9	2.4	2.3	3.1	Aug-24	0.14	0.17	0.15
Sep-24	1.6	2.2	2.1	3.0	Sep-24	0.15	0.15	0.17
Oct-24	1.7	2.2	2.1	2.9	Oct-24	0.09	0.13	0.09
Nov-24	1.8	2.3	2.1	2.8	Nov-24	0.09	0.13	0.10
Dec-24	1.8	2.2	2.0	2.6	Dec-24	0.13	0.14	0.16
Jan-25	1.8	2.2	2.0	2.5	Jan-25	0.16	0.17	0.17
Feb-25	1.8	2.1	2.0	2.4	Feb-25	0.16	0.17	0.17
Mar-25	1.8	2.1	1.9	2.4	Mar-25	0.16	0.18	0.17
Apr-25	1.7	2.0	1.9	2.3	Apr-25	0.16	0.18	0.17
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Dec-25	1.9	2.1	2.0	2.2	Dec-25	0.15	0.16	0.16

Source: BEA, BLS, Morgan Stanley Research forecasts

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