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US inflation structure

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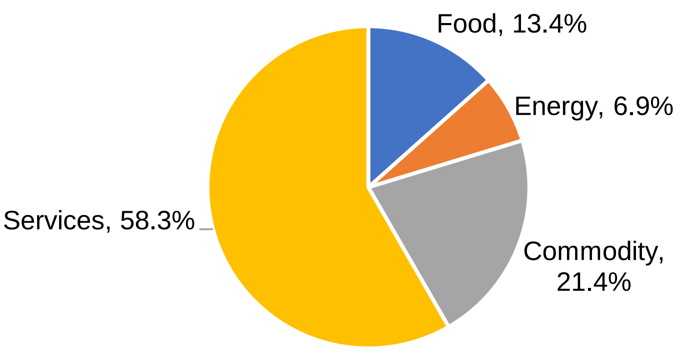
Driving forces behind monetary policy. The inflation rate and unemployment rate have a significant impact on the monetary policy of the Fed. The policy, in turn, has wide-ranging effects on global and capital markets. From Mar 2022 to Jun 2023, the Fed has raised the Fed Funds rate by 500 bp, but the unemployment rate remains stable within a narrow range of 3.4-3.7%, lower than the Fed's forecast of a 4.1% unemployment rate for 4Q23 of this year and also lower than the long-term target of a 4.0% unemployment rate. Given the latest trend in the US unemployment rate and the Fed's tolerance for unemployment, the unemployment rate is not the primary focus of the Fed's monetary policy. Considering the latest unemployment rate in the US, the inflation rate is the dominant factor influencing the Fed's monetary policy in 2H23. There are various financial instruments, such as Treasury Inflation-Protected Securities (TIPS), that can track the long-term expected inflation rate in the market. However, the TIPS market fails to provide market traders with insights on the underlying factors driving these inflation expectations and the reliability thereof.

To enhance the ability to anticipate the Fed's monetary policy, market participants must deepen their comprehension of the US inflation structure and trends. To provide an illustrative example, we selected the high-frequency inflation rate statistics, specifically the CPI (Consumer Price Index). While acknowledging that some investors may lean towards using the PCE (Personal Consumption Expenditures) price index as their preferred inflation reference, it is worth noting that the CPI inflation rate is typically released two weeks earlier on a monthly basis. Global financial and capital markets tend to respond promptly following the release of the CPI. Moreover, there is a strong correlation between CPI and PCE. As a consequence, CPI serves as an effective parameter for tracking PCE.

The Consumer Price Index (CPI) is typically comprised of a diverse range of consumer goods and services. In the context of investing, it becomes imperative to discern the key components that significantly influence the rate of inflation measured by the CPI.

Exhibit 1: US CPI Composition

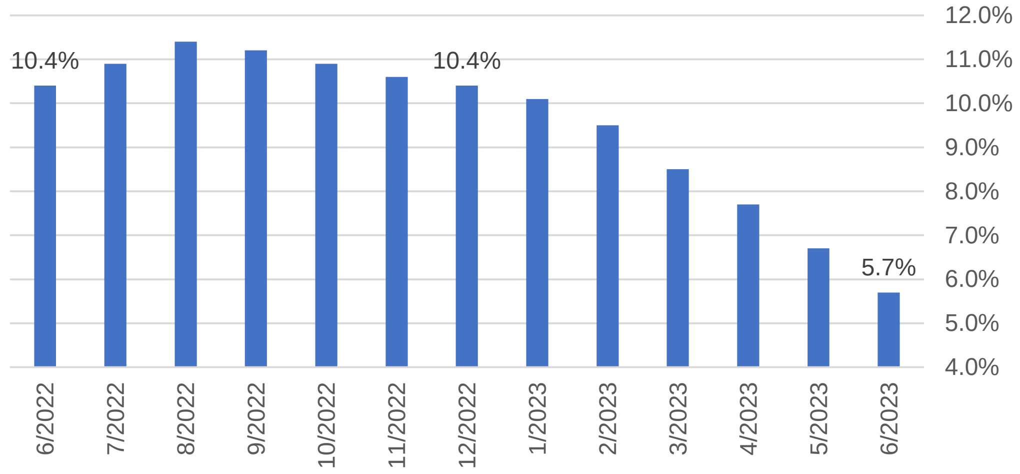


Source(s): US Dept. of Labor, ABCI Securities

The major characteristics of the US CPI structure

1. **Food accounts for ~13.4% of the US CPI.** In China, food and tobacco make up about 28% of the CPI. The proportion of food in the US CPI is about half that of China's CPI. Therefore, compared to China, the US CPI is less sensitive to changes in food prices. The US food CPI decreased from 11.2% in Sep 2022 to 10.4% in Dec 2022, 8.5% in Mar 2023, and 5.7% in Jun 2023. Food inflation pressure is showing a downtrend. Since food inflation pressure has eased and the weight is not high, food prices will not be the dominant factor affecting inflation in 2H23.

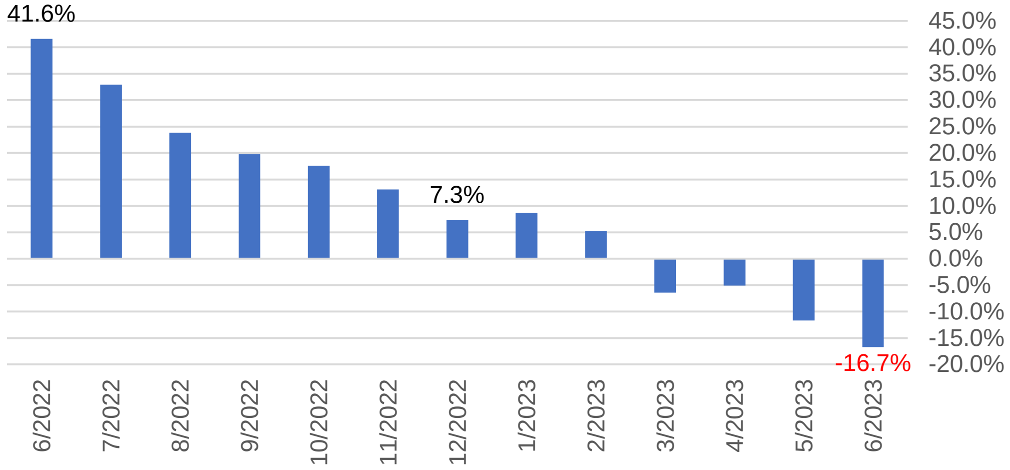
Exhibit 2: Food CPI (YoY)



Source(s): US Dept. of Labor, ABCI Securities

2. **Energy prices, such as vehicle fuel, electricity, and natural gas, account for 7% of the US CPI.** Compared to food prices, the US CPI should be less sensitive to changes in energy prices due to their lower weight. However, the significant fluctuations in energy prices during the first half of 2022 and 2023 have given the impression that energy prices are the main cause of inflation. The conflict between Russia and Ukraine in Feb 2022 pushed up crude oil prices in 2Q/3Q in 2022 . Crude oil prices peaked between Jun and Jul in 2022 before declining. As a result, due to the high base effect from the same period last year, crude oil prices will experience a significant YoY decline in 2Q/3Q23. By the end of Jun 2023, the US WTI crude oil price was nearly 42% lower than its high point in Jun last year. The energy CPI has shifted from an inflationary cycle in 2022 to a deflationary one in 2023. In Jun 2022, the energy CPI was 41.6%, 19.8% in Sep 2022, 7.3% in Dec 2022, -6.4% in Mar 2023 and -16.7%. in Jun 2023 it was -16.7%. The deflation of energy price CPI helps to drag down the overall CPI in 2Q23, but due to its low CPI weight and the weakening high base effect, the marginal effect of energy price CPI deflation will diminish in 3Q23.

Exhibit 3: Energy CPI (YoY)

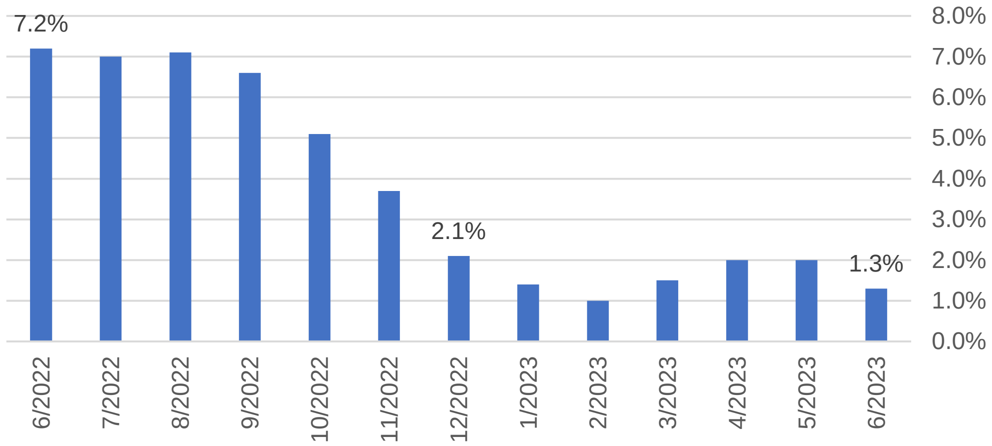


Source(s): US Dept. of Labor, ABCI Securities

3. **Food and energy prices collectively contribute to ~20% of the total weight in the US CPI.** The CPI not only reflects inflationary pressures but also indicates the proportion of local consumer spending. In the US, most consumers allocate around 20% of their expenditures to food and energy, leaving the remaining 80% to other goods and services. Consequently, this allows consumers to allocate a greater portion of their expenses towards non-food and non-energy items, which have a more significant impact on overall inflationary pressure.

4. **Consumer goods, excluding food and energy, account for 21% of the US CPI. Inflationary pressure for this category has significantly eased in 1H23.** Specifically, the CPI for non-food and non-energy consumer goods declined from 7.2% in Jun 2022 to 6.6% in Sep 2022, further decreasing to 2.1% in Dec 2022, 1.5% in Mar 2023 and 1.3% in Jun 2023. It stabilized at around 2% in 2Q23. If the inflation rate for non-food and non-energy consumer goods remains at approximately 2% in 3Q23 or 2H23, this category will push up CPI by 0.4 ppt. In simpler terms, it will not be the main reason driving or dragging inflation in 2H23.

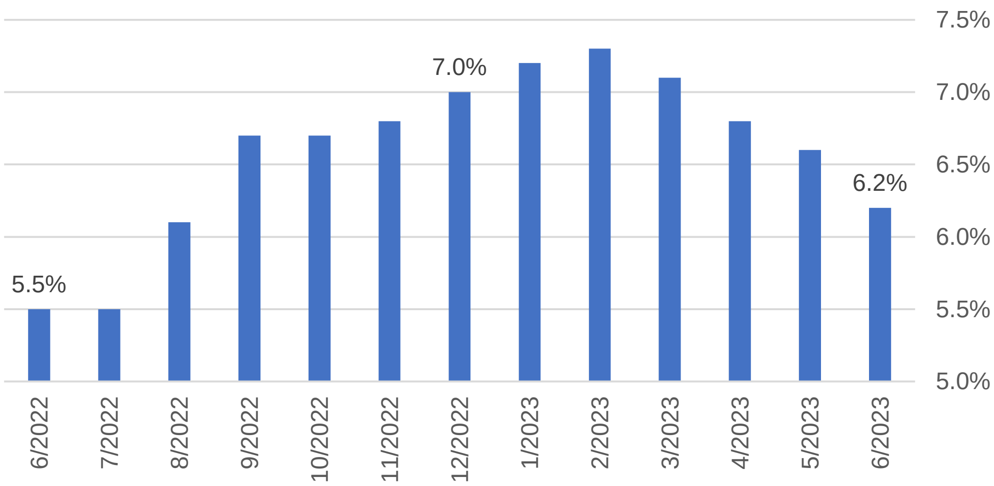
Exhibit 4: Commodity (ex. food & energy goods) CPI (YoY)



Source(s): US Dept. of Labor, ABCI Securities

5. **The prices of services excluding food and energy account for ~58% of the US CPI.** Given the higher weight of this category in the CPI, service prices have always been the main driver of inflationary pressure. Due to the significant inflationary pressure on rents, the service sector CPI slightly declined in 2Q23 but remained at a high level. The service sector CPI increased from 6.7% in Sep 2022 to 7.0% in Dec 2022, 7.1% in Mar 2023, and 6.2% in Jun 2023.

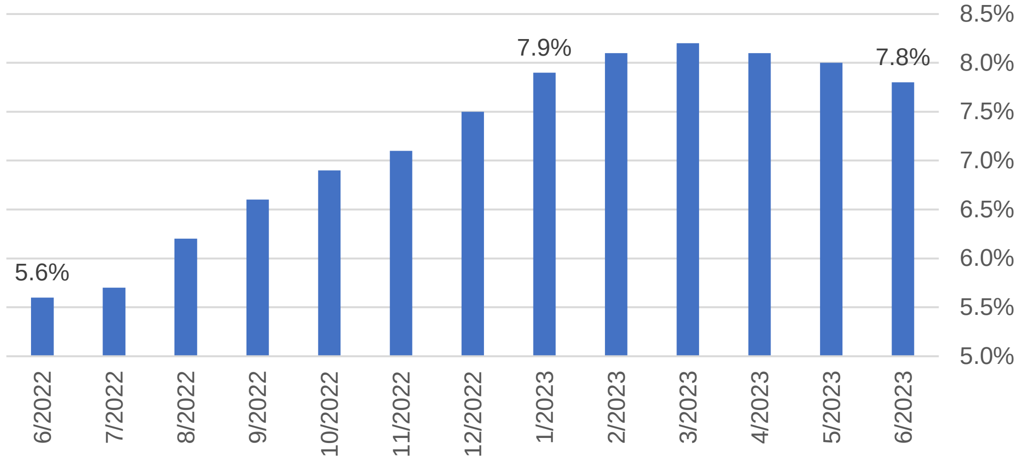
Exhibit 5: Services (ex. energy services) CPI (YoY)



Source(s): US Dept. of Labor, ABCI Securities

6. **The weight of rental prices exceeds that of food, energy, and goods.** In the service price category, roughly 60% is shelter prices, i.e., rental prices. Therefore, rental prices account for about 35% of the total CPI. The shelter CPI rose from 5.6% in Jun 2022 to 6.6% in Sep 2022, 7.0% in Dec 2022, 8.2% in Mar 2023, and 7.8% in Jun 2023. Even if the shelter CPI stabilizes at around 8% in 2H23, considering its 35% weight in the CPI, it will drive up CPI inflation rate by 2.8ppt.

Exhibit 6: Shelter (or rent) CPI (YoY)



Source(s): US Dept. of Labor, ABCI Securities

7. **Employment market conditions affect rental inflation.** A relatively low unemployment rate leads to strong demand for the rental market among employed individuals. Furthermore, the high inflation in 2022 has led property owners to demand higher rents to compensate for the increased cost of living, hence perpetuating the high rental inflation.

Statistics concerning the employment market in the US:

- The unemployment rate in Jun was 3.6%. Since Mar 2022, the US unemployment rate has fluctuated between 3.5-3.7% even though the Fed had raised the Fed Funds rate by 500bp during the period.
- The labor force participation rate in Jun was 62.6%. The average participation rate was 63% in 2018-19, and 61.9% in 2020-22. Lower labor force participation can lead to a tight labor market, lower unemployment rates, and higher wage growth.
- The average duration of unemployment in Jun was 8.7 weeks, meaning job seekers took about two months to find new employment. The average duration of unemployment was 9.3 weeks in 2018-19, and 12.4 weeks in 2020-22. Compared to the past five years, job seekers in 2023 needed less time to find new jobs.
- The hourly wages in Mar and Jun in 2023 increased by 4.3% YoY. Although real wages have declined substantially due to the inflation rate, the rise in nominal wages supports workers in paying higher rents.

Our judgement

1. **The main factor influencing inflation in 2H23 will shift from food and energy prices to service prices.** The rapid decline in the US CPI in 1H23 is due to easing inflationary pressure on food prices and the deflationary cycle of energy prices. In 2H23, the main factors determining inflation trends will be the service sector, particularly rents, and service sector inflation is sensitive to the employment market. Ease in finding new jobs, increases in nominal wages, declines in food and energy inflation, and lower inflationary pressure on consumer goods enable consumers to spend more on services. This phenomenon is also reflected in the US PMI data. Since Nov 2022, the US ISM Manufacturing PMI has consistently been below 50%. In Jun, it was 46.0%, with a second-quarter average of 46.7%. The US ISM Services PMI has remained above 50% since Jan 2023, reaching 53.9% in Jun and had a second-quarter average of 52.0%. With the service sector unlikely to cool significantly, it is difficult for the inflation rate to decline substantially in 2H23.

2. **The Fed will be tackling the most challenging aspect of inflation – core inflation.** In 2Q23, the core inflation rate in major economies was higher than the overall inflation rate. Affected by the contraction of the energy CPI in 2Q23, the US core CPI (i.e., inflation excluding food and energy items) was higher than the overall CPI. This phenomenon also occurs in China and the Eurozone. China's inflation and core inflation rates are relatively low, so combating core inflation will not be the central bank's top priority. If central banks in Europe and the US still regard fighting inflation as their main task in 2H23, they will be tackling the most challenging task of suppressing core inflation. Curbing core inflation will come at a very high economic and political cost, as it involves major parts of the economy. The risk is that overly aggressive monetary measures, while able to quickly curb core inflation, may lead to an irreversible economic downturn. To avoid recession risks, central banks in Europe and the US may increase their tolerance in 2H23, allowing core inflation to gradually decline over a longer period to smooth out economic fluctuations.

Exhibit 7: CPI&Core CPI: Core CPI is declining at a slower pace than CPI

	12/2022	3/2023	4/2023	5/2023	6/2023
US CPI	6.5%	5.0%	4.9%	4.0%	3.0%
US core CPI	5.7%	5.6%	5.5%	5.3%	4.8%
US CPI minus core CPI	0.8ppt	-0.6ppt	-0.6ppt	-1.3ppt	-1.8ppt
Eurozone CPI	9.2%	6.9%	7.0%	6.1%	5.5%#
Eurozone core CPI	5.2%	5.7%	5.6%	5.3%	5.4%#
Eurozone CPI minus core CPI	4.0%	1.2ppt	1.4ppt	0.8ppt	0.1ppt
OECD G7 CPI	6.8%	5.4%	5.4%	4.6%	
G7 core CPI	5.1%	5.1%	5.2%	5.0%	
G7 CPI minus core CPI	1.7ppt	0.3ppt	0.2ppt	-0.4ppt	
China CPI	1.8%	0.7%	0.1%	0.2%	0.0%
China core CPI	0.7%	0.7%	0.7%	0.6%	0.4%
China CPI minus core CPI	1.1ppt	0.0ppt	-0.6ppt	-0.4ppt	-0.4ppt

#: preliminary
Source(s): NBSC, Eurostat, Bureau of Labor Statistics, Bloomberg, ABCI Securities

3. **The ongoing battle between bullish and bearish forces.** Given the weak manufacturing activity since the beginning of 2023, the service sector has become the main driver of the US economy, and the Fed may not take overly aggressive measures to cool down the service sector. Yet, the current circumstances do not seem to benefit US bondholders. The gradual alleviation of inflationary pressures points towards a prolonged period of high interest rates, ultimately impacting bond prices in a negative manner. In contrast, the ongoing success of the service sector serves as a boon for stock market investors. Various stakeholders often exert pressure on the Fed, seeking decisions that align with their investment interests.

Current main market views:

1. "After significant rate hikes, the US economy remains resilient, with room for further rate increases": Positive for the stock market, but negative for the bond market.

2. "The risk of a US economic recession has increased significantly, and the interest rate cycle should peak or reverse soon": Positive for the bond market, but negative for the stock market.

   We believe that these two market views are not mutually exclusive. The first view describes the current situation, while the second view presents expectations for the near future. Because the investment or asset allocation strategy for the first scenario is opposite to that of the second scenario, the risk lies in the possibility that the second scenario may occur later than expected, resulting in bondholders bearing a higher opportunity cost.

Exhibit 8: US CPI items (YoY)
In 2H23, inflation will be driven by the service sector (specifically, rent) instead of food and energy prices

	Weighting	6/2023	5/2023	4/20223	3/2023	12/2022	9/2022	6/2022
Food & energy	20.3%	-1.9%	0.4%	3.4%	3.4%	9.3%	14.4%	22.6%
Food	13.4%	5.7%	6.7%	7.7%	8.5%	10.4%	11.2%	10.4%
Energy	6.9%	-16.7%	-11.7%	-5.1%	-6.4%	7.3%	19.8%	41.6%
Motor fuel	3.5%	-26.7%	-20.0%	-12.4%	-17.3%	-0.9%	18.8%	60.2%
Electricity	2.5%	5.4%	5.9%	8.4%	10.2%	14.3%	15.5%	13.7%
Gas utilities	0.7%	-18.6%	-11.0%	-2.1%	5.5%	19.3%	33.1%	38.4%
Commodity ex food & energy	21.4%	1.3%	2.0%	2.0%	1.5%	2.1%	6.6%	7.2%
New vehicles	4.3%	4.1%	4.7%	5.4%	6.1%	5.9%	9.4%	11.4%
Used vehicles	2.8%	-5.2%	-4.2%	-6.6%	-11.2%	-8.8%	7.2%	7.1%
Others	14.3%	1.7%	2.3%	2.5%	2.4%	3.9%	5.6%	6.0%
Services ex-energy services	58.3%	6.2%	6.6%	6.8%	7.1%	7.0%	6.7%	5.5%
Shelter	34.7%	7.8%	8.0%	8.1%	8.2%	7.5%	6.6%	5.6%
Rent of primary residence	7.6%	8.3%	8.7%	8.8%	8.8%	8.3%	7.2%	5.8%
Owner equivalent rent	25.5%	7.8%	8.0%	8.1%	8.0%	7.5%	6.7%	5.5%
Lodging away from home & insurance	1.6%	5.5%	4.7%	4.8%	8.6%	2.7%	1.5%	6.3%
Others	23.6%	3.9%	4.6%	4.9%	5.5%	6.3%	6.8%	5.4%
Airfares	0.6%	-18.9%	-13.4%	-0.9%	17.7%	28.5%	42.9%	34.1%
Total CPI	100.0%	3.0%	4.0%	4.9%	5.0%	6.5%	8.2%	9.1%

Source(s): US Dept. of Labor, ABCI Securities

Disclosures

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Definition of equity rating

Rating	Definition
Buy	Stock return rate≥ Market return rate (~9%)
Hold	- Market return rate (~-9%) ≤ Stock return rate < Market return rate (~+9%)
Sell	Stock return < - Market return (~-9%)

Notes: Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months

Market return rate: average market return rate since 2006 (For reference: HSI total return index 2006-22 averaged at 8.4%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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