RESEARCH BRIEF

Marcus & Millichap

INFLATION **FEBRUARY 2024**

While Challenging for the Fed, Strong Demand for Services is a Positive Sign for CRE

Inflation metrics present mixed bag. The headline Consumer Price Index rose 3.1 percent over the year ended January, down 30 basis points from the December reading. Falling energy prices and flattening costs for food helped slow inflation, as supply chains remained fluid despite ongoing global conflict. However, when stripping these indices out, the core CPI measure held at 3.9 percent over the year ended January, the same annual rate as last month. While sustained core pricing pressures reduced investor expectations for a rate cut in March, the trend is signaling — amid elevated wage and GDP growth — that the economy is still running hotter than the Fed intends. Yet, this presents positive implications for commercial real estate in 2024.

Higher wages boost household formations and apartment demand. Over the year ended January, average hourly earnings for all U.S. employees jumped by 4.5 percent, ahead of core inflation. Government spending — by way of programs like RAISE, the Affordable Care Act, and the CHIPS Act — will continue to proliferate through the economy, helping sustain labor and wage gains in several sectors. This trend is expected to materialize in a near-doubling of household formations compared to 2023, aiding demand within a U.S. multifamily sector awaiting an all-time high delivery slate of 480,000 units this year. As such, the nation is expected to record its second-strongest calendar year for net absorption since 1994, slowing the annual vacancy increase by two-thirds and ticking effective rent gains up to 1.5 percent.

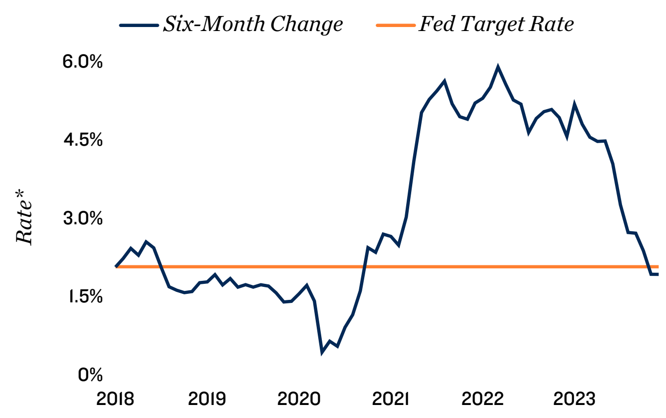
Elevated services activity a precursor to industrial demand. Annual services inflation landed at 5.4 percent in January, reflecting sustained demand for a variety of business and consumer services. The Institute for Supply Management Services Index, which surveys non-manufacturing business-to-business activity, rose 3 percent in January. This follows a 2.5 percent bump in real GDP last year, reflecting the still-expansionary state of the economy. Meanwhile, the ISM Manufacturing Index, which has contracted since November 2022, also registered at its highest level since that point. These two trends are a promising signal for industrial space needs, as businesses continue to expand capacity to efficiently meet demand for services such as transportation, warehousing and packaging. The U.S. is anticipated to absorb 190 million square feet of industrial space in 2024, helping keep asking rent growth above the post-2000 average of 3.4 percent.

Medical offices benefit from policy widening. The medical commodities index grew 3.0 percent in the last year, motivating the U.S. government to increase healthcare expenditures to safeguard consumer coverage. In 2023, the national uninsured rate reached a record low. Paired with sustained population aging, this widening of healthcare policies should boost medical visits, motivating healthcare providers to expand footprints. These tailwinds will keep medical office vacancy under 10 percent, even amid a 17-year high delivery slate in 2024.

Fed takes cautious stance. Markets are pricing a less-than 15 percent chance that the Fed reduces rates in March. The economy is showing signs of expanding, while higher wages and asset values are bolstering the spending power of consumers, likely leading the central bank to hold rates to keep growth in check. This remains true even as pricing pressures flattened over the second half of 2023. The trailing six-month annualized rate of core PCE inflation during this span was only 1.9 percent. While this is below the Fed's 2.0 percent target, officials have intimated that they want to see lowered inflationary pressures over a longer time frame before changing direction on fiscal policy.

3.1% *Increase in Headline CPI Year-Over-Year*	3.9% *Increase in Core CPI Year-Over-Year*

Six-Month Core PCE Change Under Fed Target



*Annualized six-month change

Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CME Group; Federal Reserve; RealPage, Inc.; Census Bureau; Bureau of Economic Analysis; CoStar Group, Inc.; Real Capital Analytics; Institute for Supply Management; The White House

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