U.S. Economic Comment

- Inflation: transitory, at least for now
- Inflation expectations: beginning to shift

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Consumer Prices: Benign in April, but Still Upside Risks

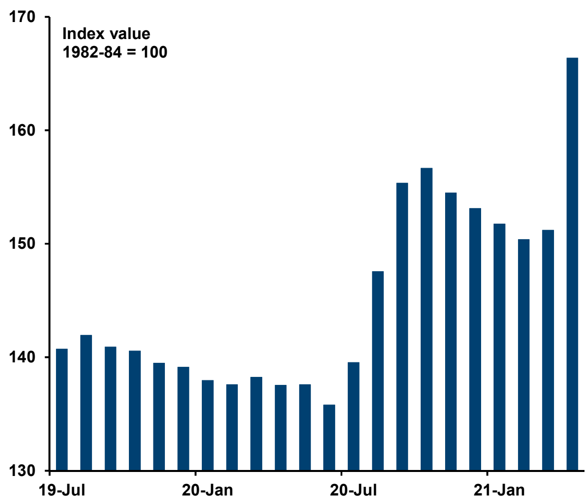
The shocking increases in consumer prices in April (0.8 percent overall and 0.9 percent excluding food and energy) were less-than-troubling after viewing details. The jumps were driven primarily by special factors or the unwinding of pandemic-related discounts. The results are not likely to alter the view of Fed officials that price pressure this spring and summer will be transitory. However, we believe policymakers are on less secure ground in arguing that inflation will settle late this year and next year. We see a high probability of elevated inflation lingering for a time.

Inflation in April and in Coming Months

The transitory nature of the pressure in April was most apparent in the index of prices of used cars and trucks, which rose 10 percent (not annualized!) from a level that was already noticeably above pre-pandemic norms. (See the chart below, which shows the level of the index rather than the percent change. The vertical axis can be viewed as a price-like measure). The extreme reading in April suggests that a special factor was at work. A shortage of new cars on the market offers a possible explanation, but a less-than-convincing one because an ample inventory of new vehicles was available in April and sales were strong. We view the surge as an aberration that is unlikely to be sustained.

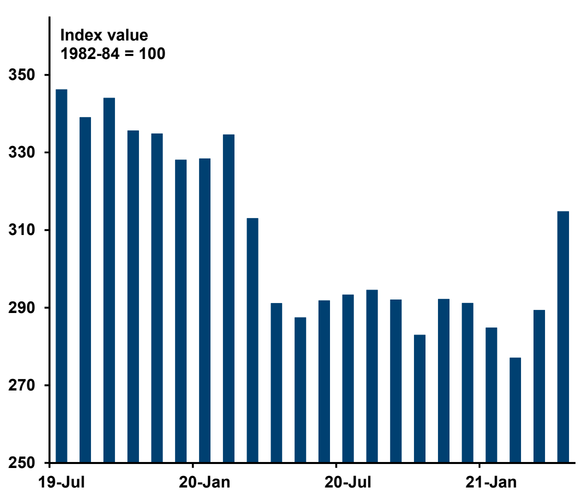
Additional pressure on the CPI came from prices that had fallen to a low level during the worst of the pandemic and now are returning to normal. The cost of a hotel stay, for example, rose 8.8 percent and was still below pre-Covid levels (chart, right; again, the chart shows the level of the index rather than the percent change). Similarly, air fares jumped 10.2 percent and are still almost 18 percent below the February 2020 reading. Sharp pressure also was evident in rental car rates and admission fees to entertainment events. Individuals are returning to normal behavior, and in response, prices of many goods and services are returning to normal levels.

CPI: Used Cars and Trucks



Source: Bureau of Labor Statistics via Haver Analytics

CPI: Hotel/Motel Stays



Source: Bureau of Labor Statistics via Haver Analytics

Prices of several pandemic-sensitive items in the CPI are still below pre-virus norms, and thus April will not be the last high-side reading that we see on inflation. The return to normal levels for the prices of these goods and services will represent a transitory influence on inflation; once back to normal, month-to-month changes will settle.

The return to normal levels, though, will not be the only inflation force at work. Supply-chain disruptions will be a factor as well. This pressure also could be viewed as temporary, although it could take several months for problems to be resolved. Indeed, press reports have indicated that the shortage of semiconductors could extend into 2022; one industry expert suggested that problems could extend into 2023.

Supply-chain disruptions will lead to higher costs of parts in manufactured goods, and labor costs could increase as well. Generous unemployment benefits seem to be keeping many individuals out of the labor force, and thus higher wages might be necessary to coax them back into employment. Also, structural changes in the economy triggered by the pandemic will require a reallocation of workers across industries, and higher wages might be necessary to lure individuals to particular sectors or geographic locations. In fact, two measures of labor compensation have recently shown upward pressure (the employment cost index jumped 0.9 percent in the first quarter, and average hourly earnings rose 0.7 percent in April; the gain in average hourly earnings seemed to be a genuine increase in wages rather than a shift related to the composition of the work force).

Demand-side factors will be at work as well. Because of monumental government support, personal income has grown rapidly in the past year and large portions of the flow have been saved. Given an average saving rate of 18.8 percent in the past 12 months, households are holding excess savings of approximately $2 trillion (that is, $2 trillion of savings above what would have occurred if the pre-pandemic trend had been maintained). This total could translate into an additional 14 percentage points added to the growth of consumer spending and 10 percentage point to GDP growth, although a portion most likely will remain in household portfolios.

Expectations of Inflation

Perhaps the most important consideration in the inflation outlook is a potential shift in inflation expectations. If business executives and individuals were to expect a faster pace of inflation, associated behavioral changes would most likely generate a pickup in the underlying inflation rate, and we are starting to see stirrings in expectations.

Investors and traders certainly are concerned about upside risks on inflation. Much of the commentary in the financial press has been focused on potential price pressure, and interest rates in the Treasury security market show concern about inflation as well. Break-even rates on inflation protected securities have jumped since late last year, with both 5-year and 10-year horizons moving to the tops of their ranges from the past several years (see charts on p. 4).

Business executives seem to expect cost pressures in the near term and hope to pass at least some of the added expense on to the ultimate buyers of their products. The most telling indicator is a survey of business executives conducted by the Federal Reserve Bank of Atlanta, which has shown a steady increase in the expected growth of costs since mid-2020. Expected growth of 2.8 percent in May represented a record reading (chart, p. 4; series started in 2011).

A survey of business leaders conducted by the Federal Reserve Bank of New York shows that businesses will try to pass the costs along, as the index of expected prices received has moved to the upper portion of its historical range. The measures from the Atlanta and New York Feds, however, should not be pushed too hard because they relate only to the next six months to one year and probably reflect supply chain disruptions and pandemic-related rebounds rather than changes in underlying inflation.

Surveys of longer-term views among individuals are available, and they show notable near-term shifts. The latest survey of consumers conducted by the University of Michigan Survey Research Center (early May) showed a surge in the expected inflation rate in the next five to ten years (chart, p. 4). This series often jumps around from month-to-month, and thus changes should be interpreted cautiously, but the shift from 2.7 percent in April to 3.1 percent in May was especially large, and the jump to a multi-year high suggests that individuals have sensed a shift in the inflation environment.

A survey of consumers conducted by the New York Fed also shows a pickup in expected inflation (chart, p. 4). The change was less dramatic than that for the Michigan survey, and it relates to a shorter horizon (three years), but it too shows an expectation of faster inflation.

We believe two measures of expected inflation merit special attention. We plan to follow closely the 10-year expected inflation rate in the Survey of Professional Forecasters published by the Federal Reserve Bank of Philadelphia. This survey will be beneficial because it can provide insight into whether two arguments advanced by Fed officials for a restrained inflation outlook have merit.

Chair Powell has argued in his press conferences that the underlying dynamics that have generated subdued inflation in the past several years will reassert themselves once the price pressure generated by the pandemic begins to dissipate. Professional forecasters are well aware of the forces that have contained inflation (globalization, technology, demographics), and their forecasts will reveal if they sense a change in the underlying dynamics. An upward drift in this series would signal a fundamental change in the inflation environment.

Fed officials also have indicated that they will respond with tighter policy if inflation begins to emerge as a problem. The views of professional forecasters will be influenced by the degree of credibility they sense from the Fed. If forecasters see promises of tighter policy as idle chatter rather than a commitment to contain inflation, longer-term projections will increase. Thus, this survey will provide insight into the credibility of the Fed as an inflation fighter.

Interestingly, the results from the second quarter survey were released today (May 14), and they showed a slight uptick in the average increase in the CPI expected in the next 10 years (2.3 percent versus 2.2 percent in the prior survey). The change was modest, but it was in the upward direction, and it matched the firmest reading since 2012. We would still view this measure as signaling contained expectations of inflation, but it also showed a tilt upward.

Another useful gauge was developed by staff economists at the Board of Governors of the Federal Reserve. The so-called Index of Common Inflation Expectations is a composite measure of inflation expectations based on 21 individual indicators. The various indicators cover different time periods and involve different measures of inflation. Thus, the components must be reindexed and processed with a statistical model (a dynamic factor model) that produces results with a mean of zero. With a mean of zero, the output of the model does not have an intuitive meaning; it does not resemble an inflation rate. However, its changes provide a view on shifts in expected inflation and the results can be “projected” onto an index of inflation to give the model’s results an intuitive meaning.

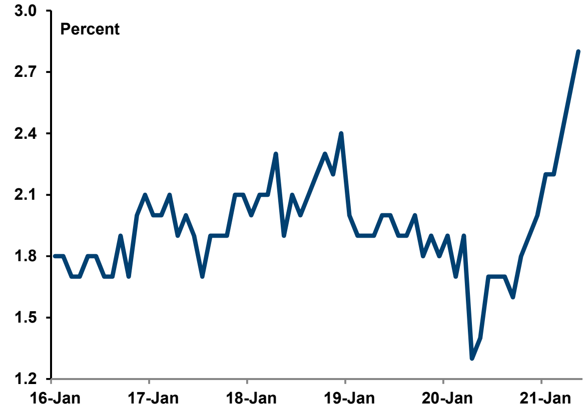
The chart on page 4 projects the latest observation from this model onto the 10-year projection from the Philadelphia Fed’s Survey of Professional Forecasters. The average inflation rate generated by this model, like the Phily index it is projected onto, has moved in a narrow range in recent years and remains below the highest readings seen in the past several years. However, it has ticked upward in recent quarters, suggesting a wavering in inflation expectations. Fed Vice-Chair Richard Clarida has mentioned this measure in some recent speeches, indicating that he intends to monitor it closely in making policy decisions. We view Governor Clarida as an influential individual on the FOMC. If he is monitoring closely, market participants should follow this lead.

5-Year Break-Even Inflation Rate*

** The rate implied by subtracting the 5-year TIPS yield from the 5-year nominal Treasury yield. Weekly end-of-period data. The last observation is the break-even rate for May 14, 2021.*

Source: Bloomberg

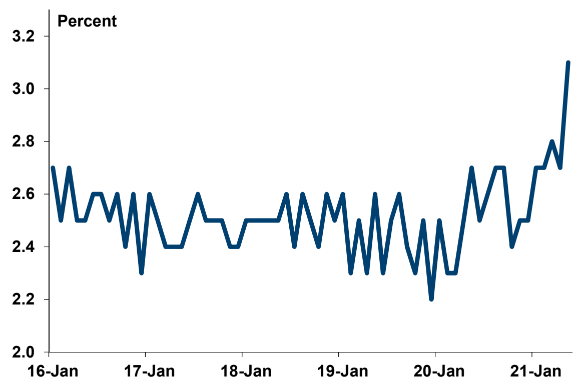
Businesses' Expected Change to Unit Costs*



** Expected change to unit costs over the next 12 months.*

Source: Business Inflation Expectations Survey, Federal Reserve Bank of Atlanta via Haver Analytics

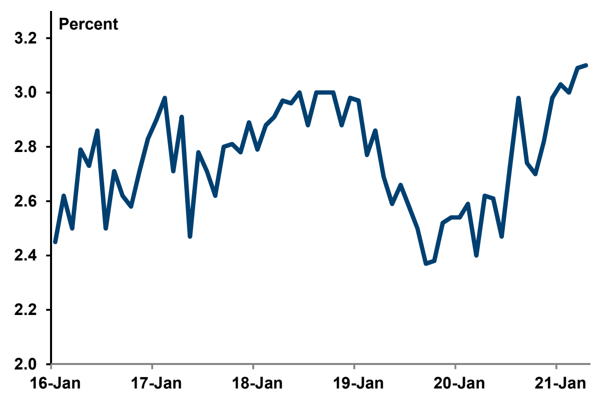
Long-Term Consumer Inflation Expectations*



** The expected average increase in inflation per year during the next five to 10 years.*

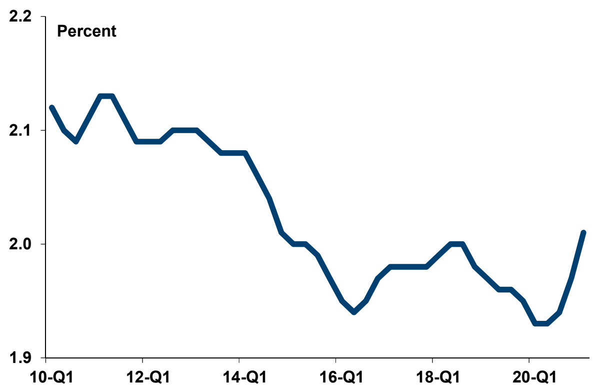
Source: Survey of Consumers, University of Michigan Survey Research Center via Haver Analytics

Median 3-Year Ahead Expected Infl. Rate



Source: Survey of Consumer Expectations, Federal Reserve Bank of New York via Haver Analytics

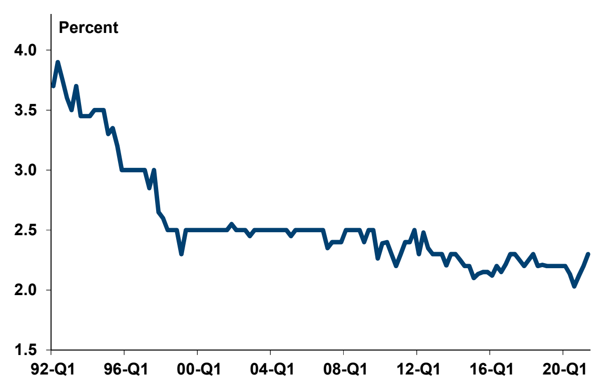
Index of Common Inflation Expectations*



** Projected onto the Philadelphia Fed's Survey of Professional Forecasters 10-year-ahead PCE (personal consumption expenditures) inflation expectations.*

Source: Ahn, Hie Joo, and Chad Fulton (2020). "Index of Common Inflation Expectations," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, September 02, 2020, https://doi.org/10.17016/2380-7172.2551.

Forecasters' Long-Term Inflation Expectations*



** The expected annual average CPI inflation rate over the next 10 years. Median estimate.*

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

Review

Week of May 10, 2021	Actual	Consensus	Comments
CPI (April)	**0.8% Total, 0.9% Core**	**0.2% Total, 0.3% Core**	Energy prices dipped 0.1% in April, but food prices rose 0.4% after an average increase of 0.1% per month in Q1. The core CPI jumped in the latest month, but the change was not broadly based. Most notable, prices of used motor vehicles surged 10.0% and moved far above levels in other recent months. In addition, air fares rose 10.2% and hotel fees increased 8.8%, but both remained below pre-Covid levels. The striking changes left the year-over-year increases at 4.2% overall and 3.0% excluding food and energy, up from Q1 averages of 1.9% and 1.4%, respectively.
Federal Budget (April)	**-$225.6 Billion**	**-$208.0 Billion**	Federal revenues surged 81.6% in April from the same month last year, with the change reflecting both the weak economy and the postponement of the April tax filing deadline. Outlays fell 32.2% year-over-year because of the magnitude of spending in the early months of the pandemic last year. However, despite declining year-over-year, spending associated with the American Rescue Plan kept government expenditures elevated in an absolute sense. The deficit for the first seven months of FY2021 totaled $1.93 trillion, $450 billion wider than the results in the same period in FY2020.
PPI (April)	**0.6% Total, 0.7% Ex. Food & Energy**	**0.3% Total, 0.4% Ex. Food & Energy**	Energy prices at the producer level declined 2.4% in April, settling after sharp increases in the prior six months. Food prices, in contrast, jumped 2.1%, with the latest increase pushing prices 1.8% above the recent high in May 2020 when prices moved sharply higher in the early months of the pandemic. Prices excluding food and energy advanced 0.7% for the second consecutive month, with both the costs of goods and services contributing (up 1.0% and 0.6%, respectively). Headline prices jumped 6.2% on a year-over-year basis, the fastest increase in the history of the series (dating back to late 2010). Prices ex. food and energy advanced 1.0 percentage point to 4.1%, also a record.
Retail Sales (April)	**0.0% Total, -0.8% Ex. Autos**	**1.0% Total, 0.6% Ex. Autos**	Although retail sales were unchanged in April, the report should not be viewed as disappointing. Sales merely failed to add to an already robust total in the prior month. Moreover, results in the prior two months were revised upward, with February showing marginally firmer results and March posting growth a percentage point firmer than the initial estimate (10.7% versus 9.7%). All told, sales in the past two months were far above pre-pandemic norms. The exceptional level of sales in the past two months, heavily influenced by Economic Impact Payments, will be difficult to sustain, although hefty savings balances will allow consumers to remain active.

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Review Continued

Week of May 10, 2021	Actual	Consensus	Comments
Industrial Production (April)	**0.7%**	**0.9%**	Much of the advance in industrial production was the result of an increase of 2.6% in the utility sector, which was a function of a shift from warmer-than-normal temperatures to normal, which boosted demand for heating services. Mining activity rose 0.7%, marking the fifth increase in the past six months. Despite this recent improvement, mining activity is still 12% below pre-pandemic levels. Manufacturing activity rose 0.4%, reflecting mixed results driven by special factors. Production fell sharply in the auto industry because of the shortage of semiconductors (off 4.3%). This drop was more than offset by an increase of 0.7% in non-auto industries, which partly reflected further recovery from a weather-related decline in February.
Consumer Sentiment (May)	**82.8 (-5.5 Index Pts.)**	**90.0 (+1.7 Index Pts.)**	The drop of 6.2% in consumer sentiment in early May continued a pattern of up and down movements that have left only modest improvement in the index in recent months. After the latest decline, the measure remains 18% below the pre-Covid peak of 101.0 in February. The measures of expected inflation published with this report surged in May, with the one-year ahead measure jumping to 4.6% from an already elevated reading of 3.4% in April. The measure of long-term expectations (over the next five to ten years) rose to 3.1% from readings of 2.7% to 2.8% in the prior four months.

Sources: Bureau of Labor Statistics (CPI, PPI); U.S. Treasury Department (Federal Budget); U.S. Census Bureau (Retail Sales); Federal Reserve Board (Industrial Production); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of May 17, 2021	Projected	Comments
Housing Starts (April) (Tuesday)	**1.710 Million (-1.7%)**	Strong sales of single-family homes should induce builders to add to the already elevated level of starts in March. However, a correction to high-side results for multi-family activity in the prior month is likely to more than offset the expected gain in the single-family area.
Leading Indicators (April) (Thursday)	**1.4%**	Although pieces of the puzzle are missing, the available information is showing positive or neutral contributions from all the 10 components of the leading indicator index. Claims for unemployment insurance are likely to be the leader among positive contributors, but the leading credit index, stock prices, and ISM new orders should provide solid support as well. The new observation on Leading Indicators should be the first to move above the pre-pandemic high in January 2020.
Existing Home Sales (April) (Friday)	**6.00 Million (-0.2%)**	Fundamentals for housing are favorable (low interest rates, a recovering labor market, a Covid-driven shift in demand for single-family homes outside city centers), but a limited inventory of homes on the market will probably keep sales shy of hefty totals seen late last year and early this year (an average of 6.614 million from September through January).

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

May/June 2021

Monday	Tuesday	Wednesday	Thursday	Friday
10	11	12	13	14
	NFIB SMALL BUSINESS OPTIMISM INDEX Feb 95.8 Mar 98.2 Apr 99.8 **JOLTS DATA** Openings (000) Quit Rate Jan 7,099 2.3% Feb 7,526 2.4% Mar 8,123 2.4%	**CPI** Total Core Feb 0.4% 0.1% Mar 0.6% 0.3% Apr 0.8% 0.9% **FEDERAL BUDGET** 2021 2020 Feb -$310.9B -$235.3B Mar -$659.6B -$119.0B Apr -$225.6B -$738.0B	**UNEMPLOYMENT CLAIMS** Initial Continuing (Millions) Apr 17 0.566 3.653 Apr 24 0.590 3.700 May 01 0.507 3.655 May 08 0.473 N/A **PPI** Final Demand Ex. Food & Energy Feb 0.5% 0.2% Mar 1.0% 0.7% Apr 0.6% 0.7%	**RETAIL SALES** Total Ex.Autos Feb -2.9% -2.7% Mar 10.7% 9.0% Apr 0.0% -0.8% **IMPORT/EXPORT PRICES** Ex. Petrol Imports Nonagri. Exports Feb 0.5% 1.5% Mar 0.8% 2.4% Apr 0.7% 0.9% **IP & CAP-U** IP Cap.Util. Feb -3.5% 72.7% Mar 2.4% 74.4% Apr 0.7% 74.9% **CONSUMER SENTIMENT** Mar 84.9 Apr 88.3 May 82.8 **BUSINESS INVENTORIES** Inventories Sales Jan 0.6% 4.6% Feb 0.6% -1.6% Mar 0.3% 5.7%
17	18	19	20	21
EMPIRE MFG (8:30) Mar 17.4 Apr 26.3 May -- **NAHB HOUSING INDEX (10:00)** Mar 82 Apr 83 May -- **TIC DATA (4:00)** Total Net L-T Jan $105.8B $91.0B Feb $72.6B $4.2B Mar -- --	**HOUSING STARTS (8:30)** Feb 1.457 million Mar 1.739 million **Apr 1.710 million**	**FOMC MINUTES (2:00)**	**INITIAL CLAIMS (8:30)** **PHILLY FED INDEX (8:30)** Mar 44.5 Apr 50.2 May -- **LEADING INDICATORS (10:00)** Feb -0.1% Mar 1.3% **Apr 1.4%**	**EXISTING HOME SALES (10:00)** Feb 6.24 million Mar 6.01 million **Apr 6.00 million**
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **NEW HOME SALES** **CONSUMER CONFIDENCE**		**INITIAL CLAIMS** **DURABLE GOODS ORDERS** **REVISED Q1 GDP** **PENDING HOME SALES**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PERSONAL INCOME, CONSUMPTION, PRICE INDEXES** **MNI CHICAGO BUSINESS BAROMETER INDEX** **REVISED CONSUMER SENTIMENT**
31	1	2	3	4
MEMORIAL DAY	**ISM MANUFACTURING INDEX** **CONSTRUCTION SPEND.**	**BEIGE BOOK** **VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **INITIAL CLAIMS** **REVISED PRODUCTIVITY & COSTS** **ISM SERVICES INDEX**	**EMPLOYMENT REPORT** **FACTORY ORDERS**

Forecasts in Bold.

Treasury Financing

May/June 2021

Monday	Tuesday	Wednesday	Thursday	Friday
10	**11**	**12**	**13**	**14**
AUCTION RESULTS: Rate Cover 13-week bills 0.015% 2.72 26-week bills 0.035% 3.28	**AUCTION RESULTS:** Rate Cover 3-year notes 0.329% 2.42 6-week CMB 0.005% 3.95 **ANNOUNCE:** $40 billion 4-week bills for auction on May 13 $40 billion 8-week bills for auction on May 13 $35 billion 17-week CMBs for auction on May 12 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $35 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 10-yr notes 1.684% 2.45 17-week CMB 0.020% 3.24	**AUCTION RESULTS:** Rate Cover 4-week bills 0.000% 4.17 8-week bills 0.010% 3.47 30-yr bonds 2.395% 2.22 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on May 17 $34 billion 52-week bills for auction on May 18 $27 billion 20-year bonds for auction on May 19 $13 billion 10-year TIPS for auction on May 20	$40 billion 6-week CMBs for auction on May 18 **SETTLE:** $111 billion 13-,26-week bills $40 billion 6-week CMBs
17	**18**	**19**	**20**	**21**
AUCTION: $111 billion 13-,26-week bills **SETTLE:** $58 billion 3-year notes $41 billion 10-year notes $27 billion 30-year bonds	**AUCTION:** $34 billion 52-week bills $40 billion 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on May 20 $40 billion* 8-week bills for auction on May 20 $35 billion* 17-week CMBs for auction on May 19 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $35 billion 17-week CMBs	**AUCTION:** $27 billion 20-year bonds $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills $13 billion 10-year TIPS **ANNOUNCE:** $111 billion* 13-,26-week bills for auction May 24 $26 billion* 2-year FRNs for auction on May 26 $60 billion* 2-year notes for auction on May 25 $61 billion* 5-year notes for auction on May 26 $62 billion* 7-year notes for auction on May 27 $40 billion* 6-week CMBs for auction on May 25 **SETTLE:** $111 billion 13-,26-week bills $34 billion 52-week bills $40 billion 6-week CMBs	
24	**25**	**26**	**27**	**28**
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $60 billion* 2-year notes $40 billion* 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on May 27 $40 billion* 8-week bills for auction on May 27 $35 billion* 17-week CMBs for auction on May 26 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $26 billion* 2-year FRNs $61 billion* 5-year notes $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills $62 billion* 7-year notes **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on June 1 $40 billion* 6-week CMBs for auction on June 1 **SETTLE:** $111 billion* 13-,26-week bills $40 billion* 6-week CMBs	**SETTLE:** $13 billion 10-year TIPS $26 billion* 2-year FRNs
31	**1**	**2**	**3**	**4**
MEMORIAL DAY	**AUCTION:** $111 billion* 13-,26-week bills $40 billion* 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on June 3 $40 billion* 8-week bills for auction on June 3 $35 billion* 17-week CMBs for auction on June 2 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills $27 billion 20-year bonds $60 billion* 2-year notes $61 billion* 5-year notes $62 billion* 7-year notes $35 billion* 17-week CMBs	**AUCTION:** $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on June 7 $40 billion* 6-week CMBs for auction on June 8 $58 billion* 3-year notes for auction on June 8 $38 billion* 10-year notes for auction on June 9 $24 billion* 30-year bonds for auction on June 10 **SETTLE:** $111 billion* 13-,26-week bills $40 billion* 6-week CMBs	

*Estimate