Daiwa Capital Markets

U.S. Economic Comment

- Food and energy prices: persistent pressure
- Federal budget: improvement in fiscal year 2021

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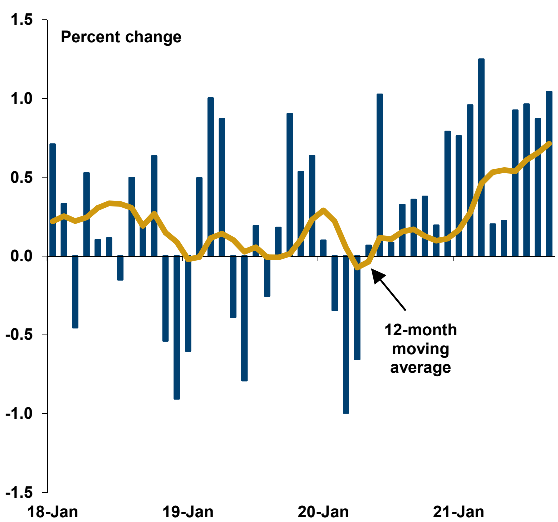
Food and Energy

Prices of food and energy often move erratically, and thus fluctuations can usually be downplayed when assessing the inflation environment. However, in the current instance, these goods and services are likely to show more than transitory price increases, and thus they could play a role in determining the underlying inflation rate.

Already, prices of food and energy have registered changes that might be viewed as persistent. A combined index of these two components of the CPI began advancing in the summer of 2020, and the pace quickened around the turn of the year. In the past 10 months, the measure has increased at an annual rate of 9.9 percent (chart, left). The duration and magnitude of the change suggest more than a transitory shift.

Looking ahead also suggests that pressure could persist. Tight supplies have been evident on shelves of grocery stores, and thus food prices could continue to increase for a time. The situation is more acute in the energy sector. Inventories of crude oil in the U.S. have drifted to the low end of the range from the past several years, and oil extraction has not picked up meaningfully in response to higher prices. Indeed, the number of barrels extracted per day is only marginally higher than it was during the recession (chart, right). Oil frackers seem to be focusing on profits and trying to avoid a boom-bust cycle that could result in poor returns. The U.S. has evolved into a swing producer in the oil market, but thus far it is not swinging in a meaningful way.

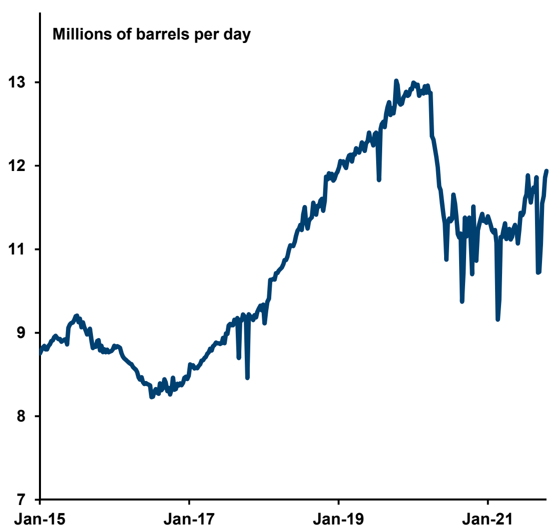
CPI: Food & Energy Index*



** The Food and Energy index is a weighted average of the Food and Energy components of the CPI. Weights are calculated based on the relative importance of each component in the CPI.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

U.S. Crude Oil Production*

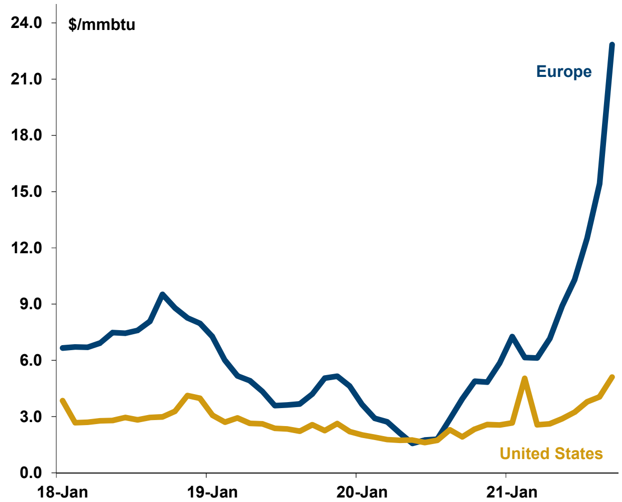


** Weekly data. The last observation is for the week ended October 12, 2021*

Source: Energy Information Administration via Haver Analytics

The situation in the market for natural gas is more severe. Prices of natural gas at the wellhead in the U.S. have already moved to the top portion of the range from the past 10 years, and these prices are far below those in other parts of the world (chart). We suspect that supplies will begin shifting to help close the gap, which will most likely generate additional upward pressure on the price of natural gas in the United States.

Domestic & Foreign Natural Gas Prices*



** MMBtu = Metric Million British Thermal Units. Monthly data. The last observation is for September 2021.*

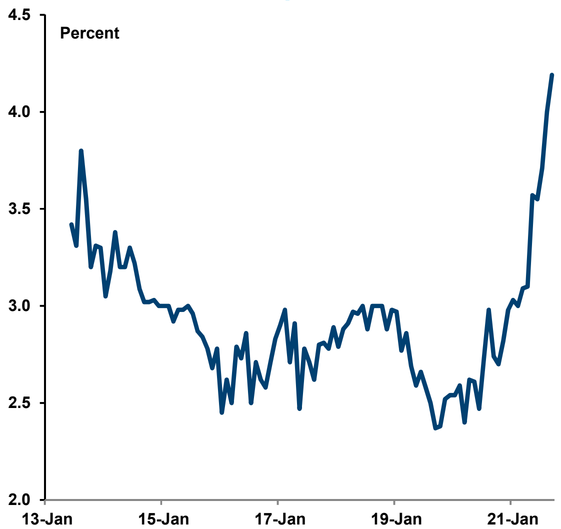
Sources: The World Bank: World Bank Commodity Price Data: Bloomberg, The Wall Street Journal, Thomson Reuters Datastream, and World Gas Intelligence

Outlays for food and energy are perhaps the most prominent expenditures of individuals, and thus the prices of these items could have a strong influence on expectations of inflation and the underlying inflation environment. Indeed measures of consumers price expectations have already moved considerably, as shown by a surge in the survey conducted by the Federal Reserve Bank of New York (chart, below left). The survey conducted by the University of Michigan Survey Research Center also has shown a pickup in consumer expectations of inflation.

Views on inflation are probably an important factor behind the poor performance of the sentiment index from the University of Michigan, which has recently moved close to the low seen during the recession (chart, below right; the consumer confidence index from the Conference Board also has lost ground recently).

While consumer views on inflation have changed markedly, market participants have been more circumspect, as shown by the breakeven rates on inflation-protected securities. These measures have moved above levels that were common before the pandemic, but they have not changed dramatically in response to the burst in inflation in the spring and summer. However, they have recently climbed back to the top of the range seen during the recovery (chart, next page). If pressure on the prices of food and energy were to

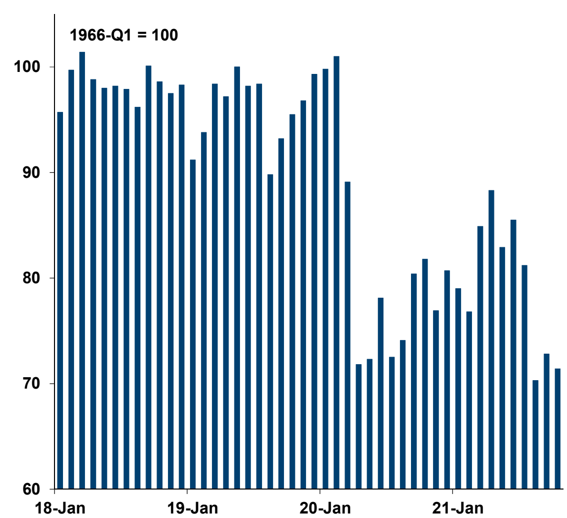
Consumer Inflation Expectations



** The median three-year ahead expected inflation rate. The survey begins in June 2013.*

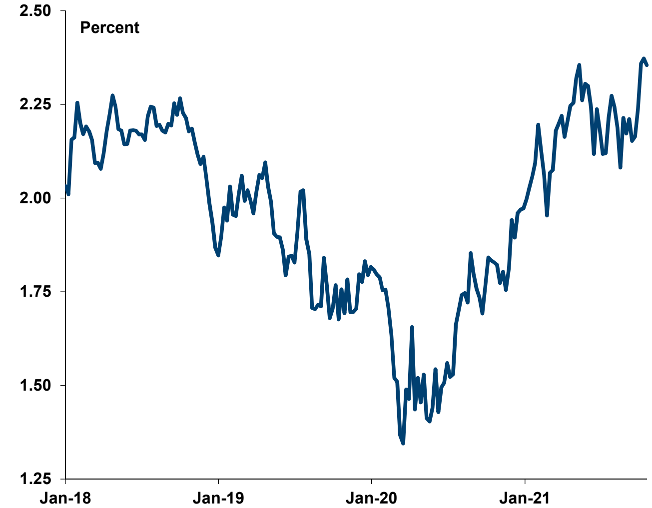
Source: Survey of Consumer Expectations, Federal Reserve Bank of New York via Haver Analytics

Consumer Sentiment



Source: University of Michigan Survey Center via Haver Analytics persist, breakeven rates might begin to move more forcefully. These measures should be monitored carefully, as a broadening in expectations of faster inflation beyond the consumer sector would most likely prompt a rate response from the Federal Reserve.

Five-Year Forward Break-Even Inflation Rate*



** A market-based measure of expected inflation over the five-year period that starts five years from now. Weekly end-of-period data.*

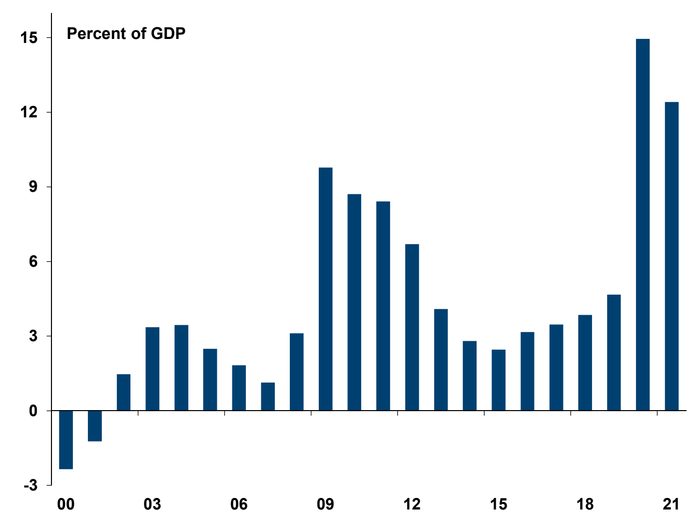
Source: Bloomberg

Federal Budget FY2021

Not many observers are concerned these days about the size of the federal budget deficit; certainly, few members of Congress pay heed. However, we believe that the size of the federal budget deficit is important, as excessive shortfalls eventually will have adverse economic consequences. Easy financing of recent deficits at low interest rates might argue otherwise, but the rate environment in the future might be less favorable, and refunding the debt generated by wide deficits could be problematic. Moreover, wide deficits and ballooning debt will limit fiscal space and constrain the ability of the federal government to react to recessions or emergencies in the future. Finally, persistent deficits will necessitate a transfer of resources from the private sector to the government, which will lead to a less-productive, less-innovative, slower-growing economy.

The Treasury Department on Friday afternoon released budget results for the month of September, which completed fiscal year 2021. A modest deficit for the final month of the year ($61.5 billion) left the fiscal-year total at $2.772 trillion, an improvement from the shortfall of $3.132 trillion in the prior year and better than the $3.003 trillion estimate the Congressional Budget Office made in July. Measured as a share of GDP, the deficit shifted from 15.0 percent in FY2020 to 12.4 percent in the latest year (chart, right).

U.S. Federal Budget Deficit*



** The federal budget deficit as a share of nominal GDP. Negative values are budget surpluses. Fiscal-year basis. The reading for FY2021 includes an estimate of FY21-Q4 GDP by Daiwa Capital Markets America.*

Sources: Office of Management and Budget via Haver Analytics; Daiwa Capital Markets America

The CBO's error occurred on the revenue side of the budget, as it underestimated receipts by 5.3 percent. The federal government enjoyed a flurry of inflows in the closing months of the year, which left revenue growth of 18.3 percent for the full fiscal year. Personal tax collections were strong (up 27.1 percent), reflecting solid growth in taxes on wage income and reinforced by robust growth in non-withheld payments (most likely fueled by estimated payments on capital gains income).

Corporate profits recovered quickly from their drop in the recession, which fueled striking growth of 75.5 percent in corporate tax collections. The Federal Reserve also contributed to the government's revenue flow, as its remittances to the Treasury rose by 22.2 percent. With interest rates at rock-bottom levels, the Fed paid little on reserve balances held at the central bank; with its portfolio of securities growing because of quantitative easing, the Fed's revenue increased substantially.

The outlay side of the budget grew moderately (4.1 percent), but that moderate shift occurred from an elevated level, and thus spending dwarfed the norms of pre-pandemic years. Generous unemployment benefits, refundable tax credits, other support for individuals (rental assistance, loan deferrals, food and health-care subsidies), along with support for state and local governments, educational institutions, and certain businesses, all contributed to enormous federal spending.

The government's swift and aggressive action to address the pandemic has won widespread praise in most corners, and certainly the efforts averted an economic disaster (although many of the programs could have been better targeted to the needy and many could have used stronger safeguards to prevent fraud). One would hope that with the economy getting back on track, the next step from Congress would be to search for avenues to reduce the budget deficit and allow debt as a share GDP to decline over time. However, Congress seems to be moving in the opposite direction, with its social-spending bill now under discussion likely to lead to troubling budget deficits in coming years.

Review

Week of Oct. 18, 2021	Actual	Consensus	Comments
Industrial Production (September)	**-1.3%**	**0.1%**	Special factors had a strong influence on the surprising softness in industrial production. Lingering effects of Hurricane Ida more than accounted for the decline of 2.3% in mining activity, and the lagged effects of the storm contributed 0.3 percentage point to the 0.7% drop in the manufacturing component. In addition to hurricane effects, the manufacturing sector was influenced by the semiconductor shortage, most evident in auto production (off 7.2%). Utility output also played a role, declining 3.6% because of a swing in temperatures.
Housing Starts (September)	**1.555 Million (-1.6%)**	**1.615 Million (0.0%)**	All of the softness in September housing starts occurred in the multi-family sector, where new building fell 5.0%. However, the latest results were not deeply disappointing. This sector has performed well this year, with the average of 467,000 units in the first nine months of the year eclipsing the pre-pandemic total of 403,000 in 2019. Single-family activity, in contrast, was a bit disappointing. While single-family starts were unchanged in September, they have lost ground this year and have not shown signs of revival, although they are still above pre-pandemic levels.
Existing Home Sales (September)	**6.29 Million (+7.0%)**	**6.10 Million (+3.7%)**	Sales of existing homes rose for the third time in the past four months in September, with the jump in the latest month suggesting that a revival might be developing after inventory shortages and elevated prices led to softer sales in the spring. The rebound in sales led to a tightening in the already lean inventory situation. The months' supply of homes available for sale dropped from 2.6 months to 2.4 months, a reading above the recent bottom of 1.9 months in December and January but still quite low by historical standards.
Leading Indicators (September)	**0.2%**	**0.4%**	The index of leading economic indicators rose for the 16th time in the past 17 months in September (the other month showing no change). The advance in the past year and one-half has left the level of the index 4.9% above the pre-pandemic high in January 2020. The ISM new orders index and the slope of the yield curve made the largest positive contributions to the latest advance; a negative contribution from building permits provided a partial offset.
Federal Budget (September)	**$61.5 Billion Deficit**	**$59.0 Billion Deficit**	September marked the closing month of FY2021 for the federal government. Federal revenues for the year rose sharply (up 18.3%), buoyed by increased collections of individual and corporate income taxes. Federal outlays rose moderately in FY2021 (4.1%), as spending related to the pandemic (stimulus payments, unemployment benefits, child tax credits, etc.) continued to boost outlays. The annual budget shortfall of $2,772 billion represented an improvement from a deficit of $3,132 billion in FY2020, but it was still huge by historical standards.

Sources: Federal Reserve Board (Industrial Production); U.S. Census Bureau (Housing Starts); National Association of Realtors (Existing Home Sales); The Conference Board (Leading Indicators); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of Oct. 25, 2021	Projected	Comments
New Home Sales (September) (Tuesday)	**0.775 Million (+4.7%)**	Increases in buyer traffic and builder sentiment suggest that new home sales could increase for the third consecutive month after losing considerable ground from February through June.
Consumer Confidence (October) (Tuesday)	**107.0 (-2.3 Index Pts.)**	Three consecutive declines in the confidence index suggest that the spread of Covid-19 and the pickup in inflation have affected consumer attitudes. The spread of the virus has started to ease, but shortages of goods and rising prices of food and energy are likely to contribute to sour moods.
U.S. International Trade in Goods (September) (Wednesday)	**-$89.0 Billion ($0.8 Billion Wider Deficit)**	Despite problems with shipping and port congestion, exports and imports have held up well this year, with both recovering and moving well above pre-pandemic levels. Imports have generally been stronger than exports during the recovery, and the trade deficit has widened noticeably as a result. However, exports have rallied recently and the deficit this year has been range bound. Modest changes in both exports and imports in September probably left the deficit close to recent readings.
Durable Goods Orders (September) (Wednesday)	**-1.0%**	The manufacturing sector is generally performing well, which should translate to favorable order flows in several industries. However, the shortage of semiconductors could constrain bookings in the auto sector, and a correction to the volatile commercial aircraft category after a high-side reading in August will probably lead to a decline in total orders.
GDP (2021-Q3) (Thursday)	**2.5%**	A marked deceleration in consumer spending is likely to standout in the latest GDP report, probably increasing less than 1% versus 11.7% in the first half of the year. Residential construction and business investment in new equipment also are likely to be soft spots. Government spending and inventory investment are likely to account for most of the advance in GDP, with the positive contribution from inventory investment occurring because the drawdown was lighter than that in the prior quarter.
Personal Income, Consumption, Core Price Index (September) (Friday)	**-0.4%, 0.4%, 0.2%**	Wages and salaries are likely to post a solid advance, but a decline in transfer payments (primarily unemployment benefits) will probably more than offset the boost from wages. On the spending side, a decline in sales of new vehicles probably led to weak results in the durable goods component, but expenditures on nondurable goods and services should lead to a moderate advance.
Employment Cost Index (2021-Q3) (Friday)	**1.0%**	Efforts to attract workers probably led to sizeable increases in wages and benefits.

Source: Forecasts provided by Daiwa Capital Markets America

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Economic Indicators

October/November 2021

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
IP & CAP-U IP / Cap.Util. July 1.0% 76.3% Aug -0.1% 76.2% Sept -1.3% 75.2% **NAHB HOUSING INDEX** Aug 75 Sept 76 Oct 80 **TIC DATA** Net L-T / Total June $110.9B $32.8B July $2.0B $164.1B Aug $79.3B $91.0B	**HOUSING STARTS** July 1.562 million Aug 1.580 million Sept 1.555 million	**OCTOBER BEIGE BOOK** "Economic activity grew at a modest to moderate rate, according to the majority of Federal Reserve Districts."	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Sept 25 0.364 2.727 Oct 02 0.329 2.603 Oct 09 0.296 2.481 Oct 16 0.290 N/A **PHILLY FED INDEX** Aug 19.4 Sept 30.7 Oct 23.8 **EXISTING HOME SALES** July 6.00 million Aug 5.88 million Sept 6.29 million **LEADING INDICATORS** July 0.9% Aug 0.8% Sept 0.2%	**FEDERAL BUDGET** 2021 / 2020 July -$302.1B -$63.0B Aug -$170.6B -$200.0B Sept -$61.5B -$124.6B
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. July 0.75 0.36 Aug 0.29 0.43 Sept -- --	**FHFA HOME PRICE INDEX (9:00)** June 1.7% July 1.4% Aug -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA June 1.8% 2.0% July 1.5% 1.5% Aug -- -- **NEW HOME SALES (10:00)** July 0.729 million Aug 0.740 million **Sept 0.775 million** **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Aug 115.2 Sept 109.3 **Oct 107.0**	**U.S. INTERNATIONAL TRADE IN GOODS (8:30)** July -$86.9 billion Aug -$88.2 billion **Sept -$89.0 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail July 0.6% 0.4% Aug 1.2% 0.1% Sept -- -- **DURABLE GOODS ORDERS (8:30)** July 0.5% Aug 1.8% **Sept -1.0%**	**INITIAL CLAIMS (8:30)** **GDP (8:30)** GDP / Chained Price 21-Q1 6.3% 4.3% 21-Q2 6.7% 6.1% **21-Q3 2.5% 6.0%** **PENDING HOME SALES (10:00)** July -2.0% Aug 8.1% Sept --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core July 1.1% -0.1% 0.3% Aug 0.2% 0.8% 0.3% **Sept -0.4% 0.4% 0.2%** **EMPLOYMENT COST INDEX (8:30)** Comp. / Wages 21-Q1 0.9% 1.0% 21-Q2 0.7% 0.9% **21-Q3 1.0% 1.2%** **MNI CHICAGO BUSINESS BAROMETER INDEX (9:45)** Index / Prices Aug 66.8 93.9 Sept 64.7 90.7 Oct -- -- **REVISED CONSUMER SENTIMENT (10:00)** Aug 70.3 Sept 72.8 Oct(p) 71.4
1	2	3	4	5
ISM MANUFACTURING INDEX CONSTRUCTION SPEND.	NEW VEHICLE SALES FOMC MEETING	ADP EMPLOYMENT REPORT ISM SERVICES INDEX FACTORY ORDERS FOMC DECISION	INITIAL CLAIMS PRODUCTIVITY & COSTS TRADE BALANCE	EMPLOYMENT REPORT CONSUMER CREDIT
8	9	10	11	12
	NFIB SMALL BUSINESS OPTIMISM INDEX PPI	INITIAL CLAIMS CPI WHOLESALE TRADE FEDERAL BUDGET	*VETERANS DAY*	JOLTS DATA CONSUMER SENTIMENT

Forecasts in Bold. *(p) = preliminary*

Treasury Financing

October/November 2021

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
AUCTION RESULTS: Rate Cover 13-week bills 0.055% 3.06 26-week bills 0.060% 3.12 **SETTLE:** $60 billion 39-day CMBs	**AUCTION RESULTS:** Rate Cover 40-day CMB 0.055% 3.11 **ANNOUNCE:** $60 billion 4-week bills for auction on October 21 $25 billion 8-week bills for auction on October 21 $40 billion 17-week CMBs for auction on October 20 $60 billion 27-day CMBs for auction on October 20 **SETTLE:** $25 billion 4-week bills $25 billion 8-week bills $35 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 20-yr bonds 2.100% 2.25 17-week CMB 0.055% 3.65 27-day CMB 0.055% 3.39	**AUCTION RESULTS:** Rate Cover 4-week bills 0.050% 3.52 8-week bills 0.100% 3.23 5-year TIPS -1.685% 2.45 **ANNOUNCE:** $102 billion 13-,26-week bills for auction on October 25 $28 billion 2-year FRNs for auction on October 27 $60 billion 2-year notes for auction on October 26 $61 billion 5-year notes for auction on October 27 $62 billion 7-year notes for auction on October 28 $40 billion 48-day CMBs for auction on October 26 **SETTLE:** $93 billion 13-,26-week bills $60 billion 40-day CMBs	**SETTLE:** $60 billion 27-day CMBs
25	26	27	28	29
AUCTION: $102 billion 13-,26-week bills	**AUCTION:** $60 billion 2-year notes $40 billion 48-day CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on October 28 $30 billion* 8-week bills for auction on October 28 $40 billion* 17-week CMBs for auction on October 27 **SETTLE:** $60 billion 4-week bills $25 billion 8-week bills $40 billion 17-week CMBs	**AUCTION:** $28 billion 2-year FRNs $61 billion 5-year notes $40 billion 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $30 billion* 8-week bills $62 billion 7-year notes **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Nov. 1 $34 billion* 52-week bills for auction on November 2 **SETTLE:** $102 billion 13-,26-week bills $40 billion 48-day CMBs	**SETTLE:** $19 billion 5-year TIPS
1	2	3	4	5
AUCTION: $105 billion* 13-,26-week bills **SETTLE:** $24 billion 20-year bonds $28 billion 2-year FRNs $60 billion 2-year notes $61 billion 5-year notes $62 billion 7-year notes	**AUCTION:** $34 billion* 52-week bills **ANNOUNCE:** $30 billion* 4-week bills for auction on November 4 $30 billion* 8-week bills for auction on November 4 $40 billion* 17-week CMBs for auction on November 3 **SETTLE:** $30 billion* 4-week bills $30 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $40 billion* 17-week CMBs **ANNOUNCE:** $55 billion* 3-year notes for auction on November 8 $38 billion* 10-year notes for auction on November 9 $24 billion* 30-year bonds for auction on November 10	**AUCTION:** $30 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Nov. 8 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills	
8	9	10	11	12
AUCTION: $105 billion* 13-,26-week bills $55 billion* 3-year notes	**AUCTION:** $38 billion* 10-year notes **ANNOUNCE:** $30 billion* 4-week bills for auction on November 10 $30 billion* 8-week bills for auction on November 10 $40 billion* 17-week CMBs for auction on November 10 **SETTLE:** $30 billion* 4-week bills $30 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $30 billion* 8-week bills $24 billion* 30-year bonds $40 billion* 17-week CMBs **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Nov. 15 $24 billion* 20-year bonds for auction on November 17 $14 billion* 10-year TIPS for auction on November 18	***VETERANS DAY***	**SETTLE:** $105 billion* 13-,26-week bills

*Estimate