U.S. Economic Comment

- Price pressures: demand side versus supply-side

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Fighting Inflation

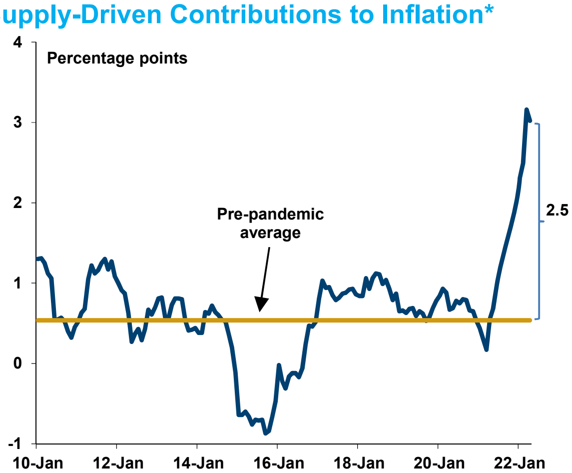
The Fed chair usually receives a wide array of questions at the semi-annual testimony on monetary policy. In the latest round, however, the Q&A was narrowly focused, with inflation dominating the discussion. Chair Powell noted (repeatedly) that both supply-side and demand-side forces were in play. He also emphasized that supply-side pressures were outside the Fed's control, but he pledged a vigorous effort to contain demand pressures.

The outlook for inflation, thus, depends on the relative degrees of pressure from demand versus supply. If supply is the dominant force, inflation could persist; if strong demand is the primary source of price pressure, an aggressive Fed is likely to achieve its inflation mandate. Interestingly, a study published this week by the San Francisco Fed provided insight into the contributions of demand and supply to the acceleration in inflation. As shown in the charts below, supply problems boosted the inflation rate by an estimated 2.5 percentage points (about one-half the overall pickup relative to the pre-pandemic rate), while demand was seen as adding 1.4 percentage points (about one-third of the acceleration; the source of the remaining one-sixth was ambiguous).

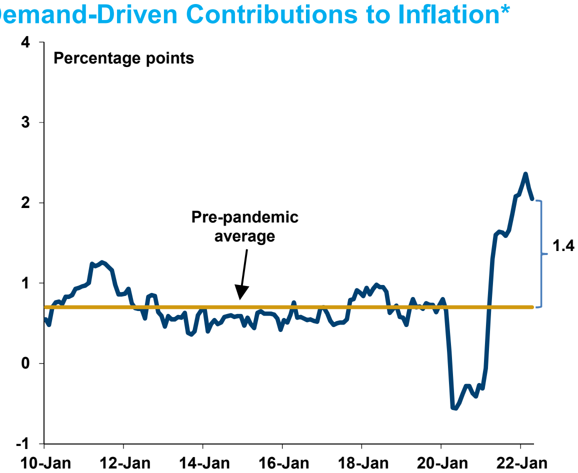
Supply-Side Prospects

Given the large contribution from the supply side, the outlook for inflation will be problematic if tight conditions persist. However, we have seen some encouraging developments recently. The price of crude oil has eased a bit, with West Texas intermediate falling from $120 per barrel in early June to $107 on Friday afternoon. However, we would not put much weight on this shift, as oil prices often move erratically, and they are likely to be especially volatile in the current environment because of the Russia-Ukraine conflict.

Supply-Driven Contributions to Inflation*



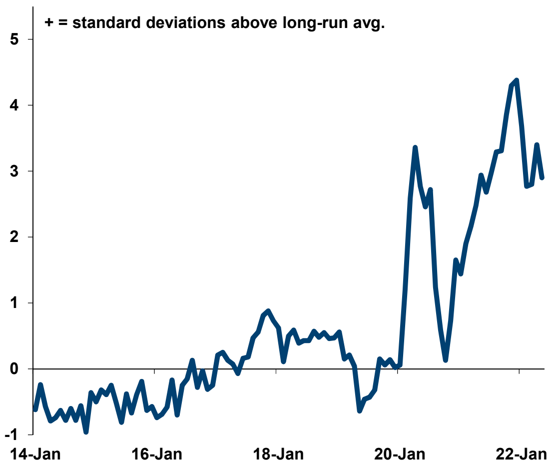
Demand-Driven Contributions to Inflation*



** The contributions of supply and demand-driven factors to headline PCE inflation.*

Source: Shapiro, Adam. 2022. "How Much Do Supply and Demand Drive Inflation?" FRBSF Economic Letter 2022-15 (June 21). https://www.frbsf.org/economic-research/publications/economic-letter/2022/june/how-much-do-supply-and-demand-drive-inflation/

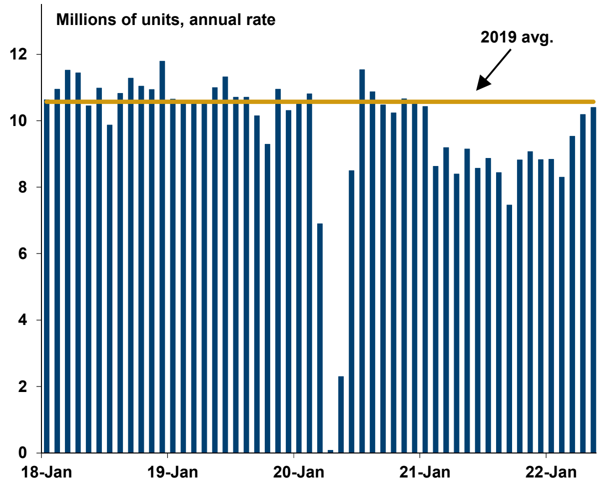
Global Supply Chain Pressure Index*



** The measure is constructed using 27 variables including: country-specific supply-chain variables from the Euro Area, China, Japan, South Korea, Taiwan, the U.K. and the U.S., global shipping rates and airfreight costs.*

Source: Federal Reserve Bank of New York, Global Supply Chain Pressure Index, https://www.newyorkfed.org/research/gscpi.html.

Industrial Prod.: Motor Vehicle Assemblies*



** Autos and light trucks. Excludes medium and heavy trucks.*

Source: Federal Reserve Board via Haver Analytics

More notable, a measure of supply chain pressure published by the New York Fed has been approximately stable in the past few months (chart, left). The measure is still quite high and one would hope for improvement rather than mere stability. However, given the upside risks from lockdowns in China and the Russia-Ukraine situation, stability can be viewed as a favorable development, one suggesting underlying improvement in supply chains that are being temporarily offset by the new disruptions.

We also have seen interesting changes in some recent economic statistics that suggest progress on the supply side. For example, as noted in last week’s Economic Comment, real merchandise trade flows (i.e. the sum of inflation-adjusted exports and imports) have picked up in April and May, suggesting an easing in port congestion.

Similarly, the production of cars and light trucks has increased for three consecutive months, with output in May returning to the pre-pandemic range (production of 10.40 million vehicles in May, annual rate, versus a total of 10.57 million in 2019; chart, above right). Semiconductors, apparently, have become more readily available. This is not to suggest that problems have been resolved, as inventories of motor vehicles are lean and manufacturers no doubt would like to be producing more to replenish stocks; still, things are moving in the right direction.

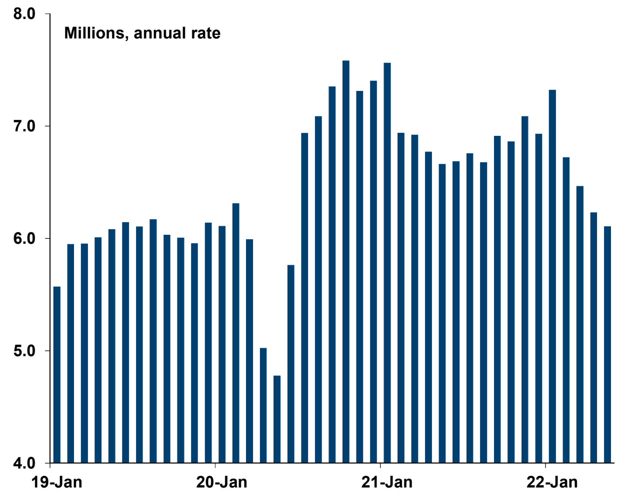
Perhaps the most important consideration on the supply side is the availability of labor, and here the news is not especially encouraging. The labor force participation rate has started to increase again after stalling in late 2020 and much of 2021, but the net increase has been modest and the rate is still 1.1 percentage points lower than the pre-Covid level. We can hope for additional improvement in labor force participation, but the wage pressure generated by the supply-demand imbalance might have to be eased by reducing demand.

The Demand Side

The Federal Reserve is in charge of the demand side, and the rhetoric and actions of Fed officials thus far suggest that policymakers plan to be aggressive. The Fed most likely will be in a restrictive stance by the end of the year, and officials seem willing to push even further in 2023. Chair Powell implied in his Congressional testimony this week that he will tolerate a recession if that is necessary to tame inflation.

The Fed already has achieved some success in slowing demand. The housing market has cooled to a degree, as total sales (new and existing) have declined for four consecutive months, moving to the low portion of the range from the past two years (chart). We suspect that further declines are in store. Recent activity has probably involved a scramble to transact before interest rates increase further, and such activity will naturally cool. In addition, some potential buyers will probably pull to the sidelines as the Fed pushes interest rates higher.

Total Home Sales*



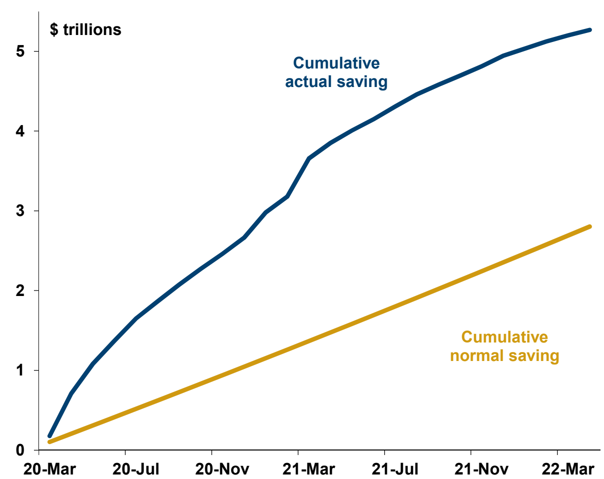
** Sales of existing and new homes.*

Sources: National Association of Realtors and U.S. Census Bureau via Haver Analytics

We suspect that business investment also will slow. Higher interest rates will have a dampening influence, but a more important consideration is the high degree of uncertainty in the economic outlook. Business executives most likely will postpone or cancel investment projects if they are unsure about profit prospects. In fact, inflation-adjusted orders for capital goods have eased on balance in the past three months, signaling hesitation.

Housing and business investment are important, but consumer behavior will probably determine whether the economy remains on track or slips into recession. In some respects, the outlook is favorable. The labor market is strong, with job growth averaging 408,000 in the past three months and elevated job openings suggesting that firm results could continue. In addition, financial positions are healthy, as the savings accumulated in the past two years is far larger than what might have occurred in the absence of the pandemic, and balances have not been dented by the absence of new federal stimulus payments (chart).

Personal Saving*



** Cumulative normal saving assumes that disposable personal income continued to grow at the 2018-19 pace and that the saving rate held steady at 7.5 percent.*

Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

At the same time, there are downside risks for consumer spending. Tighter monetary policy is likely to weaken the labor market. Fed officials hope that the softening takes the form of reduced openings rather than layoffs, but this will still shift the tone of the market. Individuals will have difficulty finding jobs, and new entrants will struggle as well. Unemployment is likely to increase.

The retreat in the stock market this year also could have an influence. Those with exposure the market have seen noticeable declines in wealth, and thus could be reluctant to spend; many will want to hold on to their excess savings. Even those not exposed to the market might become unnerved by the equity retreat, fearing that the decline is a sign of trouble in the economy.

Of course, inflation will have an influence on spending, especially with prices of food and energy accounting for much of the pressure. Budgets of many will be squeezed, forcing reductions in outlays for other goods and services.

Thus, while there are favorable elements in the outlook for consumer spending, the combination of a softer job market and challenged finances is likely to generate caution. Chair Powell is likely to get the recession he is willing to tolerate, but he has a good chance of bringing inflation under control.

Review

Week of June 20, 2022	Actual	Consensus	Comments
Existing Home Sales (May)	**5.41 Million (-3.4%)**	**5.40 Million (-3.7%)**	Sales of existing homes declined for the fourth consecutive month in May, with the cumulative change pushing activity to its lowest level since the early stages of the current expansion. Affordability seems to be the driving force behind the recent easing, as increases in mortgage rates in the past few months and home prices in the past two years have pushed many potential buyers to the sidelines. A tight inventory of homes for sale also is playing a role. Although the situation has improved in the past two months, the number of homes on the market is low by historical standards.
Current Account (22-Q1)	**-$291.4 Billion ($66.6 Billion Wider Deficit)**	**-$275.0 Billion ($57.1 Billion Wider Deficit)**	The current account deficit widened by $66.6 billion, led by a sharp deterioration in trade flows. A decline in income flows also contributed, accounting for approximately 12% of the overall slippage. When measured as a share of GDP, the deficit translated to 4.8%, up from 3.7% percent in 2021 and readings in the neighborhood of two percent prior to the pandemic.
Revised Consumer Sentiment (June)	**50.0 (-0.4% Revision)**	**50.2 (Unrevised)**	Rapid inflation and elevated gasoline prices nudged the sentiment index lower from what was already the softest reading on record. On the plus side, long-term inflation expectations, which Fed Chair Jerome Powell flagged this week as a concern, eased slightly (3.1% versus a preliminary tally of 3.3%).
New Home Sales (May)	**0.696 Million (10.7%)**	**0.590 Million (-0.2%)**	Sales of new homes rose in May, although they were still in the low end of the range of the past few years. Elevated prices and higher mortgage rates have sapped much of the vigor present earlier in the expansion. The number of homes on the market rose 1.6%, adding to a notable upward trend. Unlike the situation in the market for existing homes, the number of new homes for sale is abundant.

Sources: National Association of Realtors (Existing Home Sales); Bureau of Economic Analysis (Current Account); University of Michigan Survey Research Center (Consumer Sentiment); U.S. Census Bureau (New Home Sales); Consensus forecasts are from Bloomberg

Preview

Week of June 27, 2022	Projected	Comments
Durable Goods Orders (May) (Monday)	**0.5%**	Recent figures on employment and industrial production showed a hint of slower activity in the manufacturing sector, but not enough to suggest a downturn. Continued moderate growth, along with higher prices, should lead to an increase in the value of new orders.
U.S. International Trade in Goods (May) (Tuesday)	**-$112.0 Billion ($5.3 Billion Wider Deficit)**	Exports are likely to pause after two strong months, while still-firm demand in the U.S. and a strong foreign exchange value of the dollar are likely to pull imports into the country.
Conference Board Consumer Confidence (June) (Tuesday)	**100.0 (-6.0%)**	Rapid inflation and media reports on a possible recession are likely to depress consumer moods. The recent weakness in the stock market also is likely to influence the attitudes of many.
Revised GDP (22-Q1) (Wednesday)	**-1.8% (-0.3 Pct. Pt. Revision)**	A downward revision to consumer spending (primarily on services) should more than offset upward adjustments to inventory investment and construction (both residential and business-related). Net exports, which accounted for most of the retreat in Q1 GDP, is likely to show a modest adjustment, leaving a large negative contribution from this sector.
Personal Income, Consumption, Core PCE Price Index (May) (Thursday)	**0.4%, 0.3%, 0.4%**	Respectable gains in employment and earnings suggest that wages and salaries performed well. The surge in rental rates in the CPI in recent months should boost the income of landlords, and tighter monetary policy will probably lead to an increase in interest income. On the spending side, a drop in sales of new vehicles will restrain outlays for durable goods, but individuals probably spent actively on nondurable goods and services. Energy prices most likely will drive the headline price index higher, accenting a firm underlying pace evident in the core component.
ISM Manufacturing Index (June) (Friday)	**55.0 (-1.1 Index Pts.)**	Recession risks may have led business executives to respond cautiously to the ISM survey. The expected reading for June, while respectable by historical standards, is well shy of 60+ readings that were evident much of last year.
Construction Spending (May) (Friday)	**-0.5%**	Three consecutive declines in single-family housing starts suggest that residential construction is likely to be soft, and the uncertain economic environment could lead business executives to slow or shelve major investment projects. Construction expenditures by state and local governments are likely to continuing moving along their sideways trend.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June / July 2022

Monday	Tuesday	Wednesday	Thursday	Friday
20	21	22	23	24
JUNETEENTH	**CHICAGO FED NATIONAL ACTIVITY INDEX** Monthly / 3-Mo. Avg. Mar 0.19 0.43 Apr 0.40 0.40 May 0.01 0.20 **EXISTING HOME SALES** Mar 5.75 million Apr 5.60 million May 5.41 million	**MONETARY POLICY TESTIMONY (SENATE)**	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) May 28 0.202 1.309 June 04 0.232 1.310 June 11 0.231 1.315 June 18 0.229 N/A **CURRENT ACCOUNT** 21-Q3 -$226.4 bill. 21-Q4 -$224.8 bill. 22-Q1 -$291.4 bill. **MONETARY POLICY TESTIMONY (HOUSE)**	**REVISED CONSUMER SENTIMENT** Apr 65.2 May 58.4 June(p) 50.2 June(r) 50.0 **NEW HOME SALES** Mar 0.715 million Apr 0.629 million May 0.696 million
27	28	29	30	1
DURABLE GOODS ORDERS (8:30) Mar 0.7% Apr 0.5% **May 0.5%** **PENDING HOME SALES (10:00)** Mar -1.6% Apr -3.9% May --	**U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Mar -$125.7 billion Apr -$106.7 billion **May -$112.0 billion** **ADVANCE INVENTORIES (8:30)** Wholesale / Retail Mar 2.7% 3.1% Apr 2.2% 0.7% May -- -- **FHFA HOME PRICE INDEX (9:00)** Feb 1.9% Mar 1.5% Apr -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Feb 2.4% 2.5% Mar 2.4% 3.1% Apr -- -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Apr 108.6 May 106.4 **June 100.0**	**REVISED GDP (8:30)** GDP / Chained Price 21-Q4 6.9% 7.1% 22-Q1(p) -1.5% 8.1% **22-Q1(r) -1.8% 8.1%**	**INITIAL CLAIMS (8:30)** **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Mar 0.6% 1.4% 0.3% Apr 0.4% 0.9% 0.3% **May 0.4% 0.3% 0.4%** **MNI CHICAGO BUSINESS BAROMETER INDEX (9:45)** Index / Prices Apr 56.4 86.1 May 60.3 88.6 June -- --	**ISM INDEX (10:00)** Index / Prices Apr 55.4 84.6 May 56.1 82.2 **June 55.0 80.0** **CONSTRUCTION SPEND. (10:00)** Mar 0.3% Apr 0.2% **May -0.5%** **VEHICLE SALES** Apr 14.5 million May 12.7 million **June 13.5 million**
4	5	6	7	8
INDEPENDENCE DAY	**FACTORY ORDERS**	**ISM SERVICES INDEX** **JOB OPENINGS & LABOR TURNOVER (JOLTS)** **FOMC MINUTES**	**ADP EMPLOYMENT REPORT** **INITIAL CLAIMS** **TRADE BALANCE**	**EMPLOYMENT REPORT** **WHOLESALE TRADE** **CONSUMER CREDIT**
11	12	13	14	15
	NFIB SMALL BUSINESS OPTIMISM INDEX	**CPI** **FEDERAL BUDGET** **BEIGE BOOK**	**INITIAL CLAIMS** **PPI**	**RETAIL SALES** **EMPIRE MFG INDEX** **IMPORT/EXPORT PRICES** **IP & CAP-U** **BUSINESS INVENTORIES** **CONSUMER SENTIMENT**

Forecasts in Bold. (p) = preliminary (2nd estimate of GDP); (r) = revised (3rd estimate of GDP)

Treasury Financing

June / July 2022

Monday	Tuesday	Wednesday	Thursday	Friday
20	21	22	23	24
JUNETEENTH	**AUCTION RESULTS:** Rate Cover 13-week bills 1.670% 2.83 26-week bills 2.390% 2.44 **ANNOUNCE:** $35 billion 4-week bills for auction on June 23 $30 billion 8-week bills for auction on June 23 $30 billion 17-week CMBs for auction on June 22 **SETTLE:** $35 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Margin Cover 2-year FRN -0.003% 3.49 RateCover 17-week CMB 2.060% 3.00 20-yr bonds 3.488% 2.60	**AUCTION RESULTS:** Rate Cover 4-week bills 1.100% 2.90 8-week bills 1.500% 2.97 5-year TIPS 0.362% 2.61 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on June 27 $46 billion 2-year notes for auction on June 27 $47 billion 5-year notes for auction on June 27 $40 billion 7-year notes for auction on June 28 **SETTLE:** $87 billion 13-,26-week bills	**SETTLE:** $22 billion 2-year FRNs
27	28	29	30	1
AUCTION: $87 billion 13-,26-week bills $46 billion 2-year notes $47 billion 5-year notes	**AUCTION:** $40 billion 7-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on June 30 $30 billion* 8-week bills for auction on June 30 $30 billion* 17-week CMBs for auction on June 29 **SETTLE:** $35 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on July 5 **SETTLE:** $87 billion 13-,26-week bills $14 billion 20-year bonds $18 billion 5-year TIPS $46 billion 2-year notes $47 billion 5-year notes $40 billion 7-year notes	
4	5	6	7	8
INDEPENDENCE DAY	**AUCTION:** $87 billion* 13-,26-week bills **ANNOUNCE:** $35 billion* 4-week bills for auction on July 7 $30 billion* 8-week bills for auction on July 7 $30 billion* 17-week CMBs for auction on July 6 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on July 11 $34 billion* 52-week bills for auction on July 12 $43 billion* 3-year notes for auction on July 11 $33 billion* 10-year notes for auction on July 12 $19 billion* 30-year bonds for auction on July 13 **SETTLE:** $87 billion* 13-,26-week bills	
11	12	13	14	15
AUCTION: $87 billion* 13-,26-week bills $43 billion* 3-year notes	**AUCTION:** $34 billion* 52-week bills $33 billion* 10-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on July 14 $30 billion* 8-week bills for auction on July 14 $30 billion* 17-week CMBs for auction on July 13 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $19 billion* 30-year bonds	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on July 18 $14 billion* 20-year bonds for auction on July 20 $17 billion* 10-year TIPS for auction on July 21 **SETTLE:** $87 billion* 13-,26-week bills $34 billion* 52-week bills	**SETTLE:** $43 billion* 3-year notes $33 billion* 10-year notes $19 billion* 30-year bonds

**Estimate*