U.S. Economic Comment

- Inflation: restraints and accelerants both in play…
  … accelerants likely to be stronger
- Industrial production: a valuable indictor in the current environment

Michael Moran
Lawrence Werther
Daiwa Capital Markets America
michael.moran@us.daiwacm.com
lawrence.werther@us.daiwacm.com

Inflation

The consumer price index for June surprised on the upside, with the headline index increasing 1.3 percent and the core component advancing 0.7 percent. Certain components of the report, such as service prices in general and rents in particular, also raised concern about continued upward pressure in coming months. At the same time, it might be possible to argue that the results, although disappointing, could represent a peak in inflation. Optimists can point to a downward drift in the year-over-year change in the core CPI and to recent softening in various commodity prices. The upbeat view is interesting, but we do not find it compelling.

The (Not So) Good News

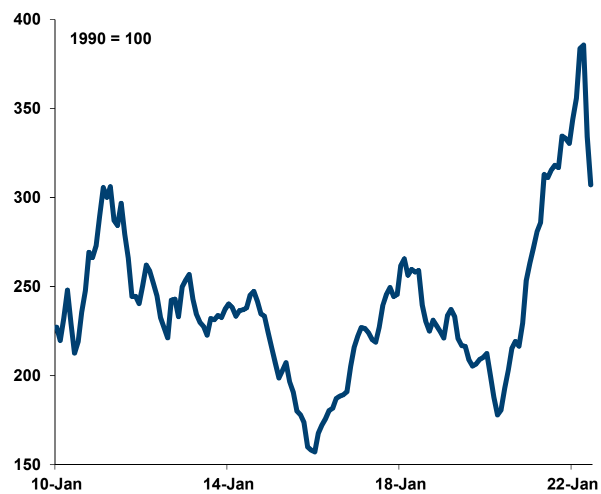
The year-over-year change in the core CPI totaled 5.9 percent in June, which marked the third consecutive decline and left the measure more than one-half percentage point shy of the recent peak of 6.5 percent in March. However, the easing was the result of favorable base effects that are likely to at least partially reverse in coming months. The core CPI rose at an average rate of 0.8 percent from April through June of last year. These advances dropped out of the year-over-year calculations in the past three months and were replaced by changes that averaged 0.6 percent. Thus, an easing in the year-over-year change.

The picture is likely to move in the opposite direction over the next three months. Increases in core prices that barely averaged 0.3 percent in July to September last year (0.251 percent) will be replaced by increases that most likely will be larger, leaving a pickup in the year-over-year change. If changes in the core CPI over the next three months average 0.5 percent, the year-over-year change in September would total approximately 6.7 percent, a new cyclical high. Increases of 0.4 percent would leave the annual increase at 6.4 percent, only a touch below the March high.

The recent decline in commodity prices is perhaps more interesting. The price of crude oil has drifted from approximately $120 per barrel in early June to $98 as of Friday afternoon. The retail price of gasoline is following this lead, dropping from $5.10 per gallon in early June to approximately $4.75 recently. Gasoline prices will ease further if the full shift in crude prices feeds through to the consumer.

The softening in commodity prices is not limited to crude oil, as various measures are off from nine percent to 18 percent in the past few months (indexes published by Bloomberg, the Commodity Research Bureau, and the Foundation for International Business and Economic Research -- FIBER). Changes in the prices of metals have been especially pronounced, as the FIBER subindex has dropped 30 percent since early April (chart).

FIBER Industrial Materials Index: Metals

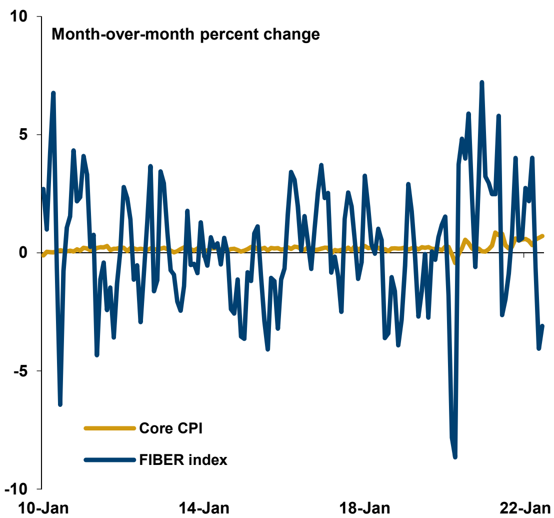


Source: Foundation for International Business and Economic Research via Haver Analytics

While the softening in commodity prices has been distinct, we do not believe that the changes will have a meaningful influence on inflation. The notion that inflation will slow because of lower commodity prices has intuitive appeal, but statistical support for this view is decidedly weak. Commodity prices are highly volatile, with most of the ups and downs absorbed in the profit margins of businesses that use the materials as inputs. Firms are able to absorb the effects of commodities because these inputs generally represent a small share of total production costs (the cost of labor is far more important in most industries). In addition, upward and downward shifts in commodity prices tend to wash out over time.

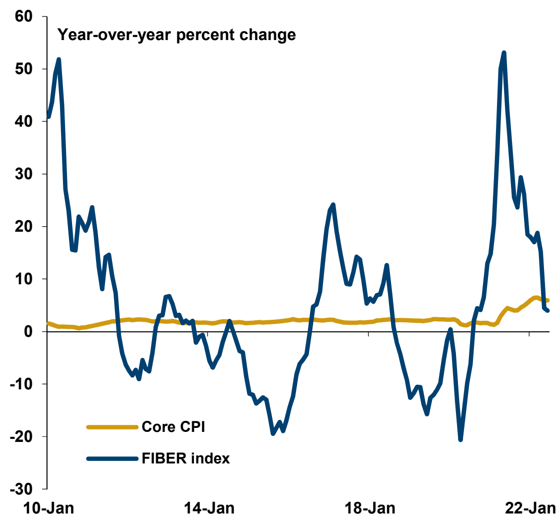
The low correlation between commodity prices and final prices to consumers is evident in the charts below. Month-to month changes can be wild and they are often short-lived, resulting in no apparent influence on the core CPI (chart, left). Even year-over-year changes do not seem to be a factor in final prices (chart, right).

FIBER Index versus Core Inflation



Sources: Bureau of Labor Statistics and Foundation for International Business and Economic Research via Haver Analytics

FIBER Index versus Core Inflation



Sources: Bureau of Labor Statistics and Foundation for International Business and Economic Research via Haver Analytics

Upside Risks

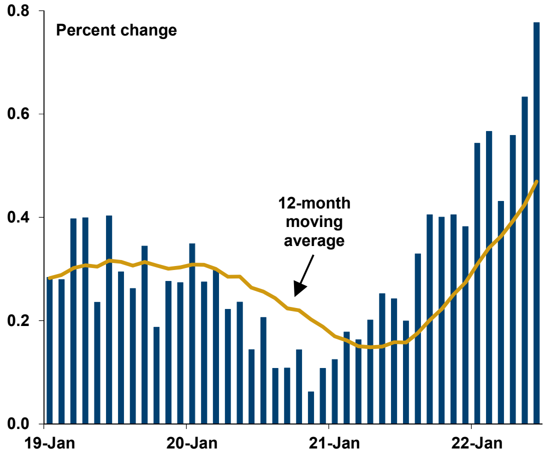
Not long ago, many observers were hopeful that a shift in consumer demand from goods to services would have a constraining influence on inflation. Such a shift is underway, and price pressure on goods excluding food and energy has eased (a monthly average of 0.4 percent in the first six months of this year versus 1.1 percent in the final nine months of last year). However, this easing has been offset to a degree by an acceleration in services prices (up an average of 0.6 percent so far this year versus 0.3 percent in 2021).

A good bit of the recent pressure on service prices was related to a pickup in travel, as airfares, hotel fees, and charges for vehicle rentals all surged to levels well above pre-pandemic norms. Given recent levels of these prices, they may not have much upside potential in coming months and therefore could be less of a factor in driving inflation. In fact, prices of all three of these services eased in June.

Another item in the service sector, though, seems to have marked upside potential. Residential rents, which quieted during the worst of the pandemic, started to accelerate last year and the pace has quickened this year, with rent of primary residence jumping 0.8 percent in June (chart; next page, left). Unlike the situation with travel-related expenses, rents seem likely to remain under pressure in coming months.

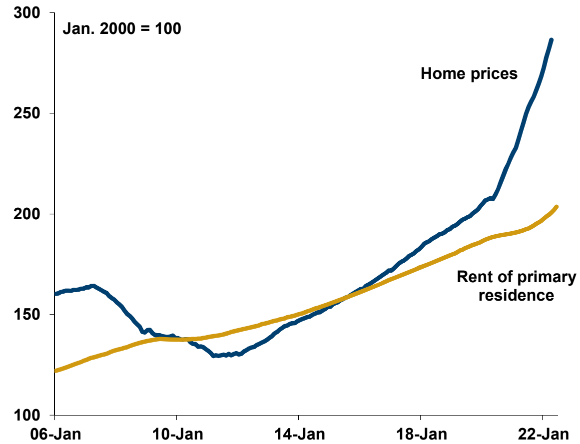
Renting and owning homes are substitutes, and thus the cost of each should follow similar paths. However, housing prices have surged in the past two years, far outstripping the increase in rents. The gap between the index of home prices published by the Federal Housing Finance and the rental component of the CPI (both reindexed to allow a comparison) has jumped to 43 percent, an enormous spread by historical standards – wider than spreads in the low-30-percent area during the housing bubble in 2005-06 (chart, right). This gap most likely will narrow over time. Lower home prices could drive some of the adjustment, but recent developments suggest that climbing rents will be the key factor. The recent acceleration in rents could well represent the early stages of a long adjustment process.

CPI: Rent of Primary Residence



Source: Bureau of Labor Statistics via Haver Analytics

Home Prices versus Rents*



** The Rent of Primary Residence index from the CPI and the FHFA home price index are rebased to equal 100 in January 2000. Data for the FHFA home price index are only available through April; June data are the latest available for rents.*

Sources: Bureau of Labor Statistics and Federal Housing Finance Agency via Haver Analytics

Insights from Industrial Production

Inflation has complicated the analysis of many economic reports because of difficulty in separating the influence of higher prices and real economic activity in nominal statistics. The report on retail sales for June is a case in point, as growth of 1.0 percent seems strong, but most of this advance was probably driven by higher prices rather than growth in real spending.

The report on industrial production has an advantage in this regard, as it is a "real" report; that is, results are based on the volume of physical production rather than the nominal value of that production. Inflation distortions are not a factor.

Some observers might not be impressed with this advantage, as the three main components of this index (manufacturing, mining, utilities) represent small shares of the economy (approximately 14 percent of GDP in total; manufacturing alone represents approximately 11 percent of GDP). However, the headline index, and especially the manufacturing component, are highly cyclical, performing well during expansions but weakening during recessions (chart). In an environment involving both recession risks and rapid inflation, a cyclically sensitive real statistic

Industrial Production: Manufacturing*

** The shaded areas show period of recession in the United States.*

Sources: Federal Reserve Board and National Bureau of Economic Research via Haver Analytics will be highly valuable: it will provide information on the pace of growth without being distorted by price changes. Thus, industrial production (especially the manufacturing component) merits attention.

Manufacturing activity had been performing well, with growth over the 12 months of 2021 totaling 3.9 percent. Results remained firm in the first four months of the year, as monthly increases in manufacturing output averaged 0.6 percent (annual rate of 7.2 percent). However, activity fell 0.5 percent in both May and June, and the declines were broadly based (13 of 20 major industries posted declines in May and 12 retreated in June). Given the strong results in the first four months of the year, the recent declines did not do severe damage to the longer-term trend; the changes could be viewed as within the normal range of volatility for this series. However, with the Fed in tightening mode, and with consumers and businesses possibly shifting to cautious spending because of economic uncertainty, the changes could have information value.

Review

Week of July 11, 2022	Actual	Consensus	Comments
CPI (June)	**1.3% Total, 0.7% Core**	**1.1% Total, 0.5% Core**	The food and energy components accounted for much of the increase in the headline CPI in June with jumps of 1.0% and 7.5%, respectively. Both measures exceeded their already brisk averages in the preceding 12 months (0.8% for food and 2.5% for energy). The core component behaved similarly, as the surge of 0.7% was two ticks faster than the average in the prior year. Travel-related expenses (airfares, hotel stays, vehicle rentals) eased in the latest month after climbing to sky-high levels, but residential rents have emerged as a new area of concern. The jump of 0.8% in rent of primary residence was the fastest since pressure emerged last fall. Prices of vehicles (both new and used) and medical-care services also rose sharply.
Federal Budget (June)	**$88.8 Billion Deficit**	**$75.0 Billion Deficit**	Federal revenues rose 2.6% in June from the same month last year, largely boosted by a drop in individual income tax refunds from an elevated level last year that was driven by a shift in filing deadlines. Outlays dropped 11.8% on a year-over-year basis, reflecting the continued easing of pandemic-related expenditures. The deficit for the first nine months of FY2022 totaled $515.1 billion, a dramatic improvement from the $2.24 trillion in the same period in FY2021.
PPI (June)	**1.1% Total, 0.4% Ex. Food & Energy**	**0.8% Total, 0.5% Ex. Food & Energy**	Energy prices accounted for much of the advance in the headline PPI in June, with the surge of 10.0% more than three times faster than the average of 3.1% in the prior year. Food prices, in contrast, rose modestly (0.1%) after averaging increases of 1.1% in the prior 12 months. Goods prices excluding food and energy rose 0.5%, slower than the average of 0.8% in the prior year. Much of the restraint was the result of prices of goods destined for export (unchanged in June after an increase of "only" 0.3% in May). The recent subdued changes most likely reflect efforts by firms to counter the effects of a strong foreign exchange value of the dollar in an effort to remain competitive in foreign markets. Prices of consumer goods excluding food and energy, which are more pertinent to domestic inflation pressures, rose 0.6% -- close to the recent average. Increases in prices of services slowed slightly from their underlying average (up 0.4% versus an average of 0.6% in the prior 12 months).
Retail Sales (June)	**1.0% Total, 1.0% Ex. Autos**	**0.9% Total, 0.7% Ex. Autos**	Headline retail sales posted a brisk advance in June, although a portion of the firm results likely reflected higher prices rather than increases in real activity. Sales at gasoline service stations stand out in this regard, as nominal activity jumped 3.6% but the gasoline component of the CPI surged 11.2%. Sales excluding autos and gasoline rose 0.7%. Discretionary categories performed well (restaurants and sporting goods stores, for example), but price effects likely played a role in these areas as well.

Review Continued

Week of July 11, 2022	Actual	Consensus	Comments
Industrial Production (June)	**-0.2%**	**0.1%**	The second consecutive decline of 0.5% in the cyclically sensitive manufacturing component accounted for most of the drop in industrial production. The recent easing followed solid results in the prior three months (average growth of 0.9%), and thus the recent softening did not severely damage the underlying trend. Utility output fell 1.4%, reflecting moderate temperatures and a reduction in demand for cooling services. Higher prices of crude oil seem to be stirring activity in the mining sector, as output rose 1.7% in June after averaging gains of 1.5% in the prior three months. Mining output is still 2.9% below its level just before the onset of the pandemic, but the trend has been upward.
Consumer Sentiment (July)	**51.1 (+2.2%)**	**50.0 (Unchanged)**	The uptick in consumer sentiment in July could be viewed as inconsequential, as the new reading was the second lowest in history, exceeding only that in the prior month. Moods are still quite sour. However, positive news emerged on the inflation front. The long-term measure of inflation expectations eased to 2.8% from 3.1%, a reading in the middle of the range from the past two years (2.4% to 3.1%) and a notable cooling from the preliminary June observation of 3.3% (which Chair Powell cited as a key factor in the FOMC's decision to hike interest rates by 75 basis points in June).

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 July 18, 2022	Projected	Comments
Housing Starts (June) (Tuesday)	**1.580 Million (+2.0%)**	Elevated inventories and the prospect of slowing sales likely led builders to trim single-family housing starts for the sixth time in the past seven months. A shift in preferences away from expensive single-family dwellings has led to a spurt in multi-family building in the current expansion, although activity has shown a good bit of month-to-month volatility. Random shifts have been evident recently, as multi-family starts plunged to a low level in May after the best reading of the current expansion in April. A return to trend would involve a pickup in June.
Existing Home Sales (June) (Wednesday)	**5.40 Million (-0.2%)**	A pickup in pending home sales suggests that sales of existing homes were stable in June after headwinds from rising mortgage rates and elevated prices led to four consecutive declines. The cumulative drop of 16.6% in the prior four months left the level of sales in the low end of the range of the current expansion and off sharply from the recent peak of 6.65 million in January 2021.
Leading Indicators (June) (Thursday)	**-0.6%**	Negative contributions from consumer expectations, stocks prices, initial claims for unemployment insurance, and the factory workweek are likely to lead to the fourth consecutive decline in the index of leading economic indicators. The measure rose sharply from mid-2020 through the end of last year, surpassing the high of the previous expansion, but declines in recent months have left a downward drift thus far in 2022.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July / August 2022

Monday	Tuesday	Wednesday	Thursday	Friday
11	12	13	14	15
	NFIB SMALL BUSINESS OPTIMISM INDEX Apr 93.2 May 93.1 Jun 89.5	**CPI** Total / Core Apr 0.3% / 0.6% May 1.0% / 0.6% June 1.3% / 0.7% **FEDERAL BUDGET** 2022 / 2021 Apr $308.2B / -$225.6B May -$66.2B / -$132.0B June -$88.8B / -$174.2B **JULY BEIGE BOOK** "Economic activity expanded at a modest pace, on balance since mid-May; however, several Districts reported growing signs of a slowdown in demand, and contacts in five Districts noted concerns over an increased risk of a recession."	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) June 18 0.233 / 1.324 June 25 0.231 / 1.372 July 2 0.235 / 1.331 July 9 0.244 / N/A **PPI** Final Demand / Ex. Food & Energy Apr 0.4% / 0.3% May 0.9% / 0.6% June 1.1% / 0.4%	**RETAIL SALES** Total / Ex.Autos Apr 0.7% / 0.5% May -0.1% / 0.6% June 1.0% / 1.0% **EMPIRE MFG** May -11.6 June -1.2 July 11.1 **IMPORT/EXPORT PRICES** Non-petrol. Imports / Nonagri. Exports Apr 0.5% / 0.9% May -0.2% / 3.0% June -0.4% / 0.9% **IP & CAP-U** IP / Cap.Util. Apr 0.8% / 80.4% May 0.0% / 80.3% June -0.2% / 80.0% **BUSINESS INVENTORIES** Inventories / Sales Mar 2.4% / 1.6% Apr 1.3% / 0.6% May 1.4% / 0.7% **CONSUMER SENTIMENT** May 58.4 June 50.0 July 51.1
18	19	20	21	22
NAHB HOUSING INDEX (10:00) May 69 June 67 July -- **TIC DATA (4:00)** Net L-T / Total Mar $23.1B / $108.7B Apr $87.7B / $1.3B May -- / --	**HOUSING STARTS (8:30)** Apr 1.810 million May 1.549 million **June 1.580 million**	**EXISTING HOME SALES (10:00)** Apr 5.60 million May 5.41 million **June 5.40 million**	**UNEMPLOYMENT CLAIMS (8:30)** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** May 2.6 June -3.3 July -- **LEADING INDICATORS (10:00)** Apr -0.4% May -0.4% **June -0.6%**	
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER HOME PRICES** **CONSUMER CONFIDENCE** **NEW HOME SALES** **FOMC MEETING**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **DURABLE GOODS ORDERS** **PENDING HOME SALES** **FOMC DECISION**	**UNEMPLOYMENT CLAIMS** **Q2 GDP**	**PERSONAL INCOME, CONSUPTION, PCE PRICE INDEXES** **EMPLOYMENT COST INDEX** **CHICAGO PURCHASING MANAGERS' INDEX** **REVISED CONSUMER SENTIMENT**
1	2	3	4	5
ISM MFG. INDEX **CONSTRUCTION SPEND.**	**JOB OPENINGS & LABOR TURNOVER (JOLTS)** **VEHICLE SALES**	**FACTORY ORDERS** **ISM SERVICES INDEX**	**UNEMPLOYMENT CLAIMS** **INTERNATIONAL TRADE**	**EMPLOYMENT REPORT** **CONSUMER CREDIT**

Forecasts in Bold.

Treasury Financing

July / August 2022

Monday	Tuesday	Wednesday	Thursday	Friday
11	12	13	14	15
AUCTION RESULTS: Rate Cover 13-week bills 2.110% 2.49 26-week bills 2.685% 2.67 3-year notes 3.093% 2.43	**AUCTION RESULTS:** Rate Cover 52-week bills 2.960% 3.17 10-yr notes 2.960% 2.34 **ANNOUNCE:** $45 billion 4-week bills for auction on July 14 $40 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 RESULTS:** Rate Cover 17-week CMB 2.600% 2.95 30-yr bonds 3.115% 2.44	**AUCTION RESULTS:** Rate Cover 4-week bills 1.980% 2.75 8-week bills 2.270% 2.47 **ANNOUNCE:** $96 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:** $93 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
18	19	20	21	22
AUCTION: $96 billion 13-,26-week bills	**ANNOUNCE:** $45 billion* 4-week bills for auction on July 21 $40 billion* 8-week bills for auction on July 21 $30 billion* 17-week CMBs for auction on July 20 **SETTLE:** $45 billion 4-week bills $40 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $14 billion 20-year bonds	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $17 billion 10-year TIPS **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on July 25 $24 billion* 2-year FRNs for auction on July 27 $45 billion* 2-year notes for auction on July 25 $46 billion* 5-year notes for auction on July 26 $38 billion* 7-year notes for auction on July 28 **SETTLE:** $96 billion 13-,26-week bills	
25	26	27	28	29
AUCTION: $96 billion* 13-,26-week bills $45 billion* 2-year notes	**AUCTION:** $46 billion* 5-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on July 28 $40 billion* 8-week bills for auction on July 28 $30 billion* 17-week CMBs for auction on July 27 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $24 billion* 2-year FRNs	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $38 billion* 7-year notes **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Aug 1 **SETTLE:** $96 billion* 13-,26-week bills	**SETTLE:** $17 billion 10-year TIPS
1	2	3	4	5
AUCTION: $96 billion* 13-,26-week bills **SETTLE:** $14 billion 20-year bonds $24 billion* 2-year FRN $45 billion* 2-year notes $46 billion* 5-year notes $38 billion* 7-year notes	**ANNOUNCE:** $45 billion* 4-week bills for auction on Aug 4 $40 billion* 8-week bills for auction on Aug 4 $30 billion* 17-week CMBs for auction on Aug 3 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs **ANNOUNCE:** $43 billion* 3-year notes for auction on Aug 9 $36 billion* 10-year notes for auction on Aug 10 $38 billion* 30-year bonds for auction on Aug 11	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on August 8 $34 billion* 52-week bills for auction on Aug 9 **SETTLE:** $96 billion* 13-,26-week bills	

*Estimate