U.S. Economic Comment

- FOMC: inflation, not economic growth, will determine the pivot

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

FOMC: Focused on Inflation

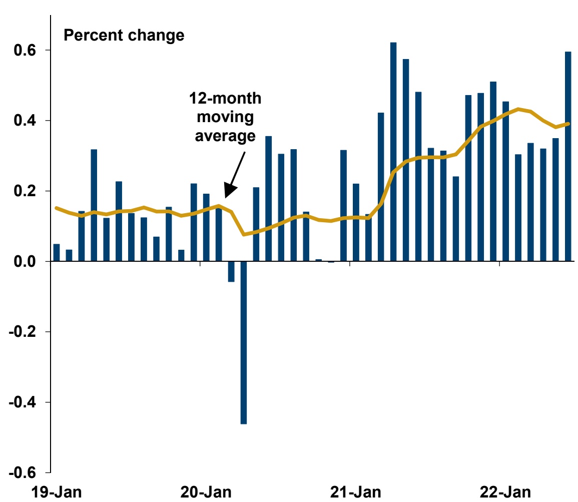
Market participants were heartened by the comments of Jerome Powell at his recent press briefing. The Fed Chair noted that policy was now in a neutral position and that the Federal Open Market Committee could soon slow the pace of tightening. The publication of second quarter GDP (off 0.9 percent after a decline of 1.6 percent in Q1) reinforced the upbeat mood of traders and investors, as many seem to believe that a recession or slow growth will lead to only a brief period of policy restraint. The futures market shows the federal funds rate peaking early next year and beginning to decline in the spring.

We are perplexed by the market euphoria. While Chair Powell certainly made a few market-friendly comments, his central message, in our view, was that the Fed is focused on slowing inflation; he implied that policymakers are willing to endure a recession if that is necessary to reduce price pressure. This view also was evident in a recent speech by new Fed Governor Christopher Waller (who we sense has become an influential member of the FOMC):

> We are achieving our mandate when it comes to maximum employment, but we are far from achieving our goal of stable prices. Consequently,…the FOMC is now, and must be, utterly focused on moving inflation down toward our 2 percent target.

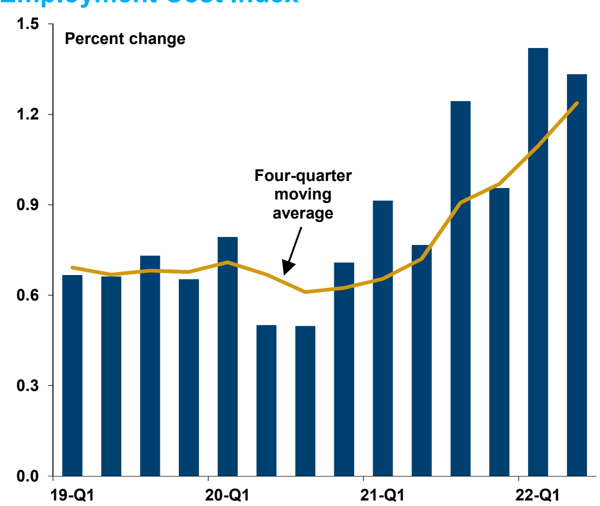
Thus, inflation, more so than economic growth, will be driving Fed decisions in the months ahead. Friday (July 29) brought three reports dealing with inflation, and the new information was not favorable.

Core PCE Price Index*



* PCE = personal consumption expenditures
Source: Bureau of Economic Analysis via Haver Analytics

Employment Cost Index



Source: Bureau of Labor Statistics via Haver Analytics

The price index for personal consumption expenditures, as widely expected, showed considerable pressure in the energy sector (7.5 percent, not annualized!), and the food component remained problematic as well (1.0 percent). The core component, which undoubtedly will receive close scrutiny from Fed officials, rose 0.6 percent, ending a string of four readings of 0.3 percent and matching the sharpest increases of the past year-and-one-half (chart; prior page, left). The year-over-year change of 4.8 percent remained below the recent peak of 5.3 percent in February, but the pace remained well above the Fed's objective, and the latest monthly results raised doubts about prospects for a downward trend.

The detail of the core component showed mixed results. Some goods or services that had been under upward pressure because of strong consumer demand were subdued in June (charges for vehicle rental and hotel stays declined, while prices of appliances and sporting equipment rose only modestly). However, a long list of items continued to register notably higher prices (new and used vehicles, furniture, jewelry, clothing, motion picture theatres, live entertainment ex-sports). Rents and airfares, which have registered especially sharp increases in recent months, again showed troubling results.

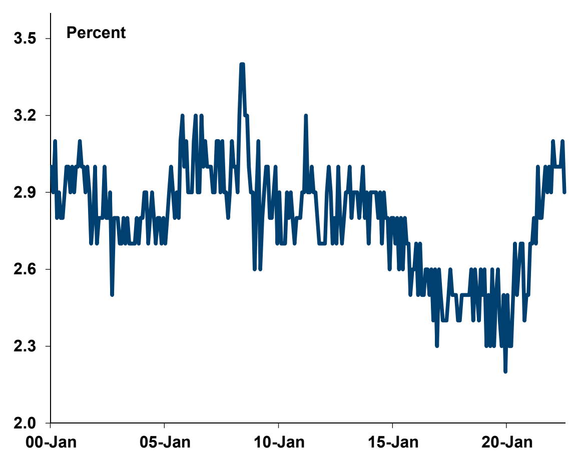
The second indicator, the employment cost index, rose 1.3 percent in the second quarter, only a touch slower than the jump of 1.4 percent in Q1 and faster than other recent readings (chart, prior page, right). Chair Powell highlighted this measure in his recent press conference, noting that it is a better measure than average hourly earnings from the monthly employment report because it is a fixed-weight measure. That is, changes are not influenced by shifts in the composition of the work force; the index will move only if wages or benefits rise or decline. The growth of average hourly earnings has shown hints of easing in recent months, but that is not the case with the more meaningful employment cost index.

Some observers argue that inflation will soon subside because a wage-price spiral has not developed. The recent behavior of the employment cost index suggests that this is an optimistic view. Perhaps the term "spiral" is too strong because escalator clauses in labor contracts are rare, but certainly a wage-price interaction is underway. Fed officials are not likely to believe that underlying inflation is receding until they see slower growth in labor costs.

In addition to labor costs, Fed officials will be focused on inflation expectations in their policy discussions. In fact, Chair Powell indicated in his June press conference that a pickup in long-term inflation expectations in the University of Michigan survey of consumers was a key factor behind the decision to hike the federal funds rate by 75 basis points. The initial read on expectations of 3.3 percent (a June observation) was revised lower to 3.1 percent, and the final tally for July, published on Friday, eased to 2.9 percent (although revised up from 2.8 percent).

The latest result is obviously better than the initial estimate of 3.3 percent. Conceivably, the FOMC might have limited the policy change in June to 50 basis points if officials had a sub-three-percent reading in hand. However, policymakers undoubtedly would have been tightening, as recent results show a noticeable pickup from readings centered on 2.5 percent in the five years before the current cycle (chart).

Long-Term Inflation Expectations*



** Average inflation per year over the next five to 10 years.*
Source: University of Michigan Survey Research Center via Haver Analytics

Help From Congress?

Senate negotiators, specifically Chuck Schumer and Joe Manchin, have agreed on an outline for new legislation that will be introduced as “The Inflation Reduction Act of 2022.” We view the proposed title as misleading. The legislation deals primarily with climate change and health care. The plan also includes tax increases that exceed new spending estimates, which presumably will reduce future budget deficits and therefore possibly ease price pressure.

However, the focus of the agreement is not on inflation, and we do not see the legislation as providing significant inflation relief. The title was probably selected to placate Senator Manchin, who believes that massive budget deficits associated with the pandemic have been a key factor behind today’s inflation rate. In addition, an anti-inflation title might win favor among some voters before the midterm elections.

The tax increases in the proposal are focused on large corporations and drug manufacturers. These hikes could slow demand and price increases for capital equipment, but they will have little influence on consumer goods and services. Individuals are affected indirectly on the tax front because of a proposed increase in the budget of the Internal Revenue Service, which presumably will tighten enforcement. This could have a constraining influence on consumer demand and possibly inflation, but the legislation also has tax credits and subsidies for health care and clean energy sources, which could spur consumer demand.

Even if the legislation actually delivers meaningful deficit reduction, most of the benefit will not emerge in the near term. The Committee for a Responsible Federal Budget estimates that a small degree of deficit reduction will occur in 2023, but the lion’s share will occur in 2027 and beyond.

Congress also is considering separate legislation to promote the development of the semiconductor industry in the United States (The Chips and Science Act of 2022). The price tag of this bill totals $280 billion, almost equal to the estimated deficit reduction of $300 billion in The Inflation Reduction Act. Like The Inflation Reduction Act, the impact of this measure is likely to be felt more in coming years rather than the near term. Thus, the combined influence of the two bills is likely to involve minimal deficit reduction, and the modest cuts will occur down the road.

Review

Week of July 25, 2022	Actual	Consensus	Comments
New Home Sales (June)	**0.590 Million (-8.1%)**	**0.655 Million (-5.9%)**	Sales of new homes slumped in June to the bottom portion of the range from the current expansion -- only a touch above the pandemic low of 582,000 (annual rate) in April 2020. The jump in mortgage interest rates (approximately 5.5% in June versus readings in the low-three-percent area in December of last year), along with elevated prices, has reduced affordability and pushed many prospective buyers to the sidelines.
Consumer Confidence (July)	**95.7 (-2.7%)**	**97.0 (-1.7%)**	The drop in consumer confidence in July marked the third consecutive decline and pushed the measure to the low portion of the range from the current expansion. The pickup in inflation has probably been the most important factor affecting confidence, although views on the labor market also have slipped a bit in the past four months. The share of survey respondents indicating that jobs are plentiful fell from a recent peak of 56.7% in March to 50.1% in July. The share indicating that jobs are hard to get has shown random shifts and a net sideways movement centered on 11.5%.
International Trade in Goods (June)	**-$98.2 Billion ($5.9 Billion Narrower Deficit)**	**-$103.0 Billion ($1.0 Billion Narrower Deficit)**	The U.S. goods trade deficit narrowed sharply in June, with both sides of the trade ledger contributing (exports jumped 2.5% while imports fell 0.5%). The increase in exports was concentrated in food and industrial supplies, and higher prices undoubtedly played a role. The softness in imports was concentrated in food and motor vehicles. June marked the third consecutive decline in imports, but the recent softness offset only a portion of a surge in the first three months of the year. For the first half as a whole, imports were firm and the trade deficit widened noticeably.
Durable Goods Orders (June)	**1.9%**	**-0.4%**	Transportation bookings accounted for much of the brisk advance in durable goods orders in June. Bookings for defense aircraft surged (up 80.6%) and orders for motor vehicles and parts rose for the fourth consecutive month (up 8.0% over the March-to-June span). The bounce in orders for defense aircraft most likely represented a one-off shift (surges and pauses are common for this series). Orders excluding transportation rose for the 25th time in the past 26 months (up 0.3%), an impressive trend but one wonders about the influence of higher prices. Orders for nondefense capital goods excluding aircraft, which provide insight into capital spending plans by businesses, increased 0.5%, but the advance likely translated to a dip after adjusting for inflation.

Review Continued

Week of July 25, 2022	Actual	Consensus	Comments
GDP (22-Q2)	**-0.9%**	**0.4%**	Back-to-back declines in output (Q1 GDP contracted 1.6%) may not yet signal an economy in recession, but they do suggest that tighter financial conditions and headwinds from global developments have sapped much of the vigor from the expansion. Consumer spending remained on a growth track in Q2 (up 1.0%), although outlays slowed from the pace in the prior three quarters (average growth of 2.1%). The trade sector also made a positive contribution to growth (adding 1.4 percentage points), but trade had contracted sharply in Q1 (subtracting 3.2 percentage points from growth) and slowing global demand and a strong dollar represent notable headwinds for the trade sector. Other key sectors of the economy constrained growth in Q2: business fixed investment, residential construction, and government spending all declined. Inventory investment subtracted 2.0 percentage points from GDP growth.
Personal Income, Consumption, Core Price Index (June)	**0.6%, 1.1%, 0.6%**	**0.5%, 1.0%, 0.5%**	Rental income and proprietors income increased firmly in June (2.5% and 1.4%, respectively), but wages posted only moderate growth (0.4%). After adjusting for inflation, real incomes slipped 0.3%. Nominal consumer spending jumped, but the change was paltry after adjusting for inflation (0.1%). Notably, real spending on gasoline and food eased, indicating that consumers are purchasing less in the way of essentials (although they are paying more). The headline price index for personal consumption expenditures surged 1.0%, accelerating from the already brisk average of 0.5% in the prior 12 months. The core index jumped 0.6% versus an average of 0.4% in the prior 12 months. The shifts in the PCE price indexes translated to year-over-year jumps of 6.8% in the headline measure (versus 6.3% in May) and 4.8% in the core component (up one tick from May but down from a peak of 5.3% in February).
Employment Cost Index (22-Q2)	**1.3%**	**1.2%**	Compensation costs rose 1.0% or more for the fourth consecutive quarter (range of 1.0% to 1.4%, not annualized). On a year-over-year basis, total labor compensation surged 5.0%, the fastest reading since 1990. A jump of 1.4% in wages led the advance in Q2, pushing the year-over-year change to 5.2% -- among the fastest increases in the history of the series. Benefit costs rose 1.2%, easing from the surge of 1.8% in Q1. The year-over-year change in benefits accelerated to 4.8% from 4.0% in Q1.

Sources: U.S. Census Bureau (New Home Sales, International Trade in Goods, Durable Goods Orders); The Conference Board (Consumer Confidence); Bureau of Economic Analysis (GDP, Personal Income, Consumption, Core PCE Price Index); Bureau of Labor Statistics (Employment Cost Index); Consensus forecasts are from Bloomberg

Preview

Week of Aug. 1, 2022	Projected	Comments
ISM Manufacturing Index (July) (Monday)	**52.0 (-1.0 Index Pt.)**	Slowing growth and rising risks of recession suggest that the ISM index could ease in July. The production measure in particular appears to have downside potential, as new orders slumped below the critical value of 50 in June, and firms could respond in July by curtailing output.
Construction Spend. (June) (Monday)	**-0.5%**	Recent sharp declines in single-family housing starts suggest that residential construction is likely to be soft in June, and slowing economic growth and tighter financial conditions could lead business executives to postpone investment in new structures. Government-sponsored building has moved sideways since last fall.
Factory Orders (June) (Wednesday)	**1.3%**	The already reported jump of 1.9% in durable goods orders, led by a surge in bookings for defense-related aircraft, will contribute importantly to a firm reading on total factory orders for June. In the nondurable area, an easing in petroleum prices should lead to a cooling in the petroleum and coal category, but higher prices could play a role in boosting the value of orders ex-petrol.
ISM Services Index (July) (Wednesday)	**54.0 (-1.3 Index Pts.)**	With tighter monetary policy slowing economic activity, the ISM services index is likely to continue moving along the downward trend that began around the turn of the year.
Trade Balance (June) (Thursday)	**-$79.5 Billion ($6.0 Billion Narrower Deficit)**	The already reported narrowing of $5.9 billion in the goods trade deficit for June should dominate the total trade report. The surplus in service trade has bounced around from month-to-month in the past year, leaving a modest net decline.
Payroll Employment (July) (Friday)	**275,000**	Talk of a possible recession probably led many firms to slow hiring, and an uptick in unemployment claims suggests that some businesses reduced headcounts. While net hiring is not likely to match the average of 562,000 last year, the expected July increase and the average gain of 375,000 in Q2 still represent solid performances. The expected pace of job gains in July should maintain the unemployment rate at 3.6%.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July / August 2022

Monday	Tuesday	Wednesday	Thursday	Friday
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX Monthly 3-Mo. Avg. Apr 0.26 0.33 May -0.19 0.09 June -0.19 -0.04	**FHFA HOME PRICE INDEX** Mar 1.5 % Apr 1.5% May 1.4% **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** SA NSA Mar 2.4% 3.1% Apr 1.7% 2.2% May 1.3% 1.5% **NEW HOME SALES** Apr 0.604 million May 0.642 million June 0.590 million **CONFERENCE BOARD CONSUMER CONFIDENCE** May 103.2 June 98.4 July 95.7 **FOMC MEETING (DAY 1)**	**INTERNATIONAL TRADE IN GOODS** Apr -$106.8 billion May -$104.0 billion June -$98.2 billion **ADVANCE INVENTORIES** Wholesale Retail Apr 2.3% 0.8% May 1.9% 1.6% June 1.9% 2.0% **DURABLE GOODS ORDERS** Apr 0.4% May 0.8% June 1.9% **PENDING HOME SALES** Apr -4.0% May 0.4% June -8.6% **FOMC DECISION**	**UNEMPLOYMENT CLAIMS** Initial Continuing (millions) July 2 0.236 1.333 July 9 0.244 1.384 July 16 0.261 1.359 July 23 0.256 N/A **GDP** GDP Chained Price 21-Q4 6.9% 7.1% 22-Q1 -1.6% 8.2% 22-Q2 -0.9% 8.7%	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. Cons. Core Apr 0.5% 0.5% 0.3% May 0.6% 0.3% 0.3% June 0.6% 1.1% 0.6% **EMPLOYMENT COST INDEX** Comp. Wages 21-Q4 1.0% 1.0% 22-Q1 1.4% 1.2% 22-Q2 1.3% 1.4% **MNI CHICAGO BUSINESS BAROMETER** Index Prices May 60.3 88.6 June 56.0 79.6 July 52.1 81.9 **REVISED CONSUMER SENTIMENT** May 58.4 June 50.0 July(p) 51.1 July(r) 51.5
1	2	3	4	5
ISM INDEX (10:00) Index Prices May 56.1 82.2 June 53.0 78.5 **July 52.0 75.0** **CONSTRUCTION SPEND. (10:00)** Apr 0.8% May -0.1% June -0.5%	**JOLTS DATA (10:00)** Openings (000) Quit Rate Apr 11,681 2.9% May 11,254 2.8% June -- -- **VEHICLE SALES** May 12.7 million June 13.0 million **July 13.5 million**	**FACTORY ORDERS (10:00)** Apr 0.7% May 1.6% **June 1.3%** **ISM SERVICES INDEX (10:00)** Index Prices May 55.9 82.1 June 55.3 80.1 **July 54.0 78.0**	**UNEMPLOYMENT CLAIMS (8:30)** **TRADE BALANCE (8:30)** Apr -$86.7 billion May -$85.5 billion **June -$79.5 billion**	**EMPLOYMENT REPORT (8:30)** Payrolls Un. Rate May 384,000 3.6% June 372,000 3.6% **July 275,000 3.6%** **CONSUMER CREDIT (3:00)** Apr $36.8 billion May $22.3 billion June --
8	9	10	11	12
	NFIB SMALL BUSINESS OPTIMISM INDEX **PRODUCTIVITY & COSTS**	**CPI** **WHOLESALE TRADE** **FEDERAL BUDGET**	**UNEMPLOYMENT CLAIMS** **PPI**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**
15	16	17	18	19
EMPIRE MFG. INDEX **NAHB HOUSING INDEX** **TIC FLOWS**	**HOUSING STARTS** **IP & CAP-U**	**RETAIL SALES** **BUSINESS INVENTORIES** **FOMC MINUTES**	**UNEMPLOYMENT CLAIMS** **PHILY FED INDEX** **EXISTING HOME SALES** **LEADING INDICATORS**	

Forecasts in Bold. (p) = preliminary (r) = revised

Treasury Financing

July / August 2022

Monday	Tuesday	Wednesday	Thursday	Friday
25	26	27	28	29
AUCTION RESULTS: Rate Cover 13-week bills 2.520% 2.95 26-week bills 2.920% 3.16 2-year notes 3.015% 2.58	**AUCTION RESULTS:** Rate Cover 5-year notes 2.860% 2.46 **ANNOUNCE:** $55 billion 4-week bills for auction on July 28 $50 billion 8-week bills for auction on July 28 $30 billion 17-week CMBs for auction on July 27 **SETTLE:** $55 billion 4-week bills $50 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 2.690% 3.69 Spread Cover 2-year FRNs 0.037% 3.13	**AUCTION RESULTS:** Rate Cover 4-week bills 2.140% 2.66 8-week bills 2.210% 2.79 7-year notes 2.730% 2.60 **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:** $55 billion* 4-week bills for auction on Aug 4 $50 billion* 8-week bills for auction on Aug 4 $30 billion* 17-week CMBs for auction on Aug 3 **SETTLE:** $55 billion 4-week bills $50 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 $22 billion* 30-year bonds for auction on Aug 11	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Aug 8 $34 billion* 52-week bills for auction on Aug 9 **SETTLE:** $96 billion 13-,26-week bills	
8	9	10	11	12
AUCTION: $96 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills for $43 billion* 3-year notes **ANNOUNCE:** $55 billion* 4-week bills for auction on Aug 11 $50 billion* 8-week bills for auction on Aug 11 $30 billion* 17-week CMBs for auction on Aug 10 **SETTLE:** $55 billion* 4-week bills $50 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $36 billion* 10-year notes	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills $22 billion* 30-year bonds **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Aug 15 $17 billion* 20-year bonds for auction on Aug 17 $8 billion* 30-year TIPS for auction on Aug 18 **SETTLE:** $96 billion* 13-,26-week bills $34 billion* 52-week bills	
15	16	17	18	19
AUCTION: $96 billion* 13-,26-week bills **SETTLE:** $43 billion* 3-year notes $36 billion* 10-year notes $22 billion* 30-Year bonds	**ANNOUNCE:** $55 billion* 4-week bills for auction on Aug 18 $50 billion* 8-week bills for auction on Aug 18 $30 billion* 17-week CMBs for auction on Aug 17 **SETTLE:** $55 billion* 4-week bills $50 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $17 billion* 20-year bonds	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills $8 billion* 30-year TIPS **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Aug 22 $22 billion* 2-year FRNs for auction on Aug 24 $45 billion* 2-year notes for auction on Aug 23 $46 billion* 5-year notes for auction on Aug 24 $38 billion* 7-year notes for auction on Aug 25 **SETTLE:** $96 billion* 13-,26-week bills	

**Estimate*