Daiwa Capital Markets

U.S. Economic Comment

- Inflation: trending lower, or lingering?
- If inflation lingers, so too will tight monetary policy

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Inflation: Starting to Ease, But Progress Will Probably Be Slow

The latest week bought favorable news on the inflation front, with the consumer price index showing no change in July and the producer price index falling 0.5 percent. While the results were better than expected, they were not shocking because they were heavily influenced by lower energy prices, which were well anticipated by market participants. The more striking news involved restrained readings on prices excluding food and energy, which rose only 0.3 percent and 0.2 percent at the consumer and producer levels, respectively, a marked contrast to averages of 0.6 percent and 0.7 percent in the first half of the year.

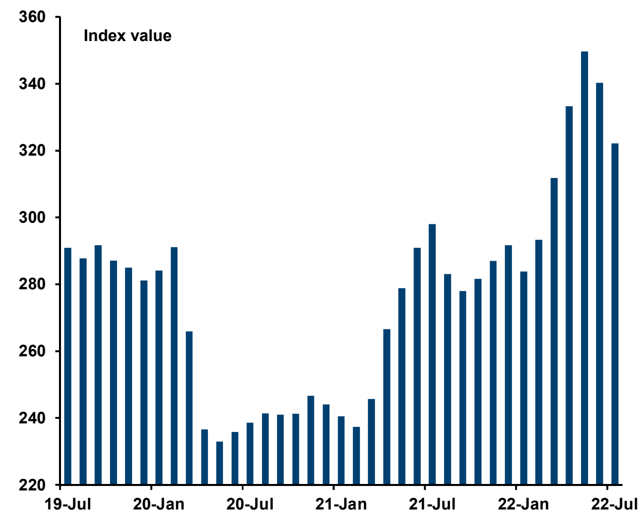
The modest (by recent standards) increase in core prices support the burgeoning view in financial markets that inflation has peaked. We are fully on board with this view, as we see additional restraint from items that generated the favorable results in July. In addition, progress in repairing damaged supply-chains should bring some price relief. However, the peaking of inflation is not the relevant issue; the key considerations are the rate of deceleration and the likelihood of returning to two percent inflation rate. We see a high probability of inflation lingering at rates that will be viewed as uncomfortable.

Further Progress is Likely

The core component of the CPI in July was heavily influenced by price cuts on items that had surged with the recovery of the economy in 2021. For example, airfares and fees for car rentals and hotel stays jumped last year and earlier this year when individuals began to travel more actively, but they have declined in the past two months. The costs of these services are still elevated by historical standards and easily could retreat further in coming months (chart; the chart shows the level of an index of airfares, hotel fees, and car-rental charges; the vertical axis could be viewed as the dollar cost of a travel package).

At the producer level, the modest increase in prices excluding food and energy to a large degree was the result of a decline of 0.6 percent in the prices of goods destined for export. This decline followed no change in June, leading us to suspect that a soft trend is developing because of the strong dollar on foreign exchange markets. That is, domestic producers are possibly reducing prices to offset the effects of currency changes in an effort to remain competitive in foreign markets. We easily could see similar changes in coming months. Such actions might restrain the PPI, but would have no influence on the CPI or other domestic price gauges.

CPI: Travel-Related Expenses*



** A weighted average of airfares, hotel fees, and rental-car charges. The vertical axis shows the level of the index rather than the percent change. The values on the axis could be viewed as the cost of a travel package.*

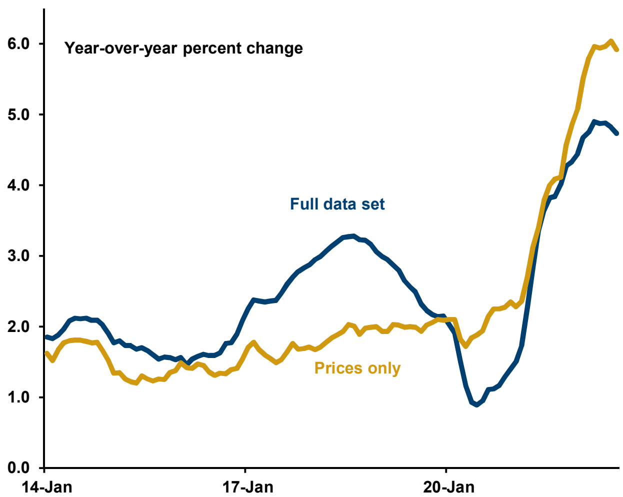
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

But Inflation Could Linger

Although we may have seen the peak in inflation, recent data do not assure a rapid descent or a return to two percent within a reasonable time period. In fact, the July statistics also contained suggestions of persistent price pressure. Rent measures in the CPI stood out in this regard, as they continued to accelerate in July. With rental rates still attractive relative to elevated home prices, rapid increases in rents are likely to remain an issue. In addition, prices of new motor vehicles continued to climb, reflecting both supply and demand factors, and prices of recreation and health-care items continued to move along at uncomfortable paces.

In the PPI, we were struck by suggestions that price pressures were spread throughout the economy. This measure also includes prices paid by businesses for capital goods and by governments for a broad range of goods and services. The July increases in these areas were below the averages in the first half of the year, but they remained brisk (up 0.5 percent and 0.6 percent, respectively). Construction costs in the PPI are exploding. This component seems to have a seasonal glitch (surging in the first month of a quarter), and thus it is best monitored on a year-over-year basis. The 12-month change in July was mind-boggling at 23.1 percent.

Underlying Inflation Gauge



Source: Federal Reserve Bank of New York via Haver Analytics

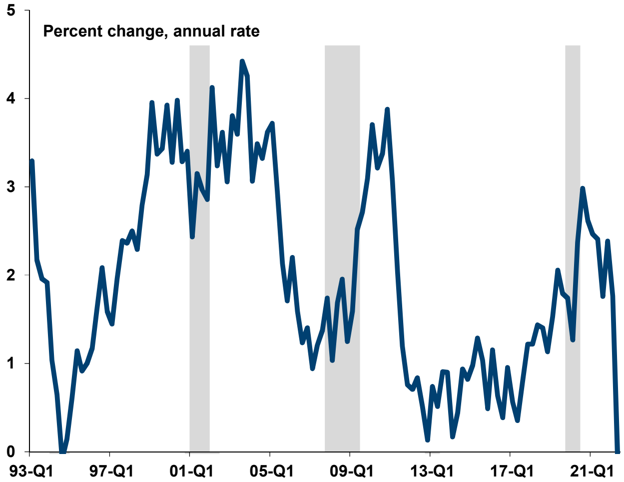
The potential for sticky inflation also was evident in the so-called Underlying Inflation Gauge, a measure constructed by the Federal Reserve Bank of New York. This index, which is based on 215 goods and services in the CPI, seeks to find common movements among the components, thereby eliminating random shifts and providing a view on the underlying trend. A related measure from the NY Fed adds 115 nominal, real, and financial variables to the CPI components to incorporate the influence of economic activity on inflation. Both the prices-only measure and full data set provide a similar picture: inflation has shown a slight downward tilt in recent months, but it seems premature to described the trend as downward (chart). Inflation may have peaked, but it is not showing meaningful signs of decelerating.

The still-tight labor market also leads us to suspect that inflation will decelerate slowly, as all measures of labor compensation are growing briskly, and the pace is not likely to ease soon. The supply of labor does not offer much hope of relieving the tightness. The labor force participation is still more than a percentage point below its pre-pandemic level, and it has lost ground in recent months. The demand for labor has eased slightly (unemployment claims have drifted upward, and job postings have declined), but businesses in total seem anxious to expand their work forces. Strong demand for labor will no doubt subside as the Fed tightens monetary policy further, but the pull back is not likely to be sudden or swift.

Moreover, wage pressure could remain problematic for a time after the demand for labor has cooled. Many individuals have seen real wages decline in the past year or so, and they will be seeking to restore previous living standards in upcoming negotiations. Businesses, in turn, will most likely attempt to pass catch-up wage increases on to the prices of their products.

Businesses could absorb wage increases without increasing product prices if productivity growth were firm. However, efficiency gains in recent quarters have been poor. Productivity in the nonfarm business sector tumbled 4.6 percent in the second quarter after a drop of 7.4 percent in Q1 (annual rates). The recent

Growth of Nonfarm Productivity*



** An eight-quarter moving average of productivity growth in the nonfarm business sector.*
Source: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

performance represents the weakest two-quarter showing in the history of the series (started in 1947).

We monitor an eight-quarter moving average of productivity growth to smooth the high degree of volatility often evident in this series. Recent weakness has pushed this average into negative territory, a rare event in the United States. The last such result occurred in 1994, when the drop of 0.1 percent matched the current observation (chart). Two other negative readings occurred during or shortly after recessions (1975 and 1980).

The weakness in productivity might be the result of misestimates in either output or labor input. The declines in GDP in Q1 and Q2 were heavily influenced by noisy components (net exports and inventory investment), which could be revised in coming months (benchmark revisions will be published in September). Firmer output would boost the productivity figures.

While data errors might be a factor in the recent productivity performance, the more likely explanation is fallout from Covid. Early retirements and reshuffling of individuals into new occupations has left less experienced (and thus less efficient) workers in many positions. Supply-chain disruptions also are likely constraining output and thus productivity.

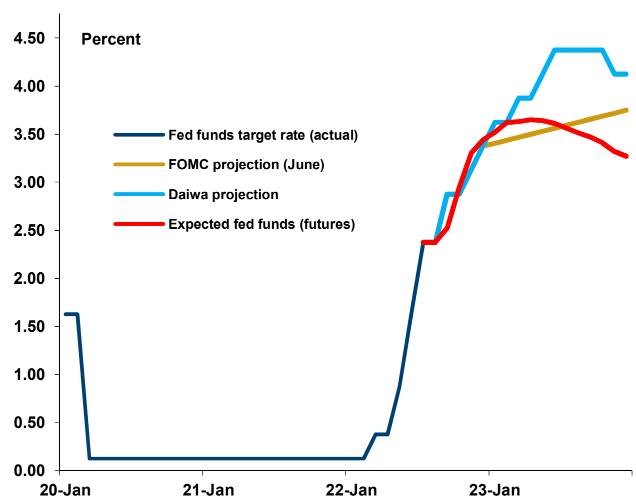
The slowdown in productivity is occurring at an inopportune time, as it reduces the cushion that businesses might have to absorb wage increases. Weak productivity adds to the inflation risk.

Policy Implications

Many market participants are expecting an early end to the Federal Reserve's tightening campaign. Futures contracts show the federal funds rate peaking next spring and drifting lower over the balance of the year. This view contrasts with the rate path shown in the June dot plot of the Federal Open Market Committee, which has officials raising rates through 2024 (chart).

The market expectation, by our reckoning, is optimistic. It seems to assume that inflation will dissipate quickly, but we see a high probability of price pressure lingering. Alternatively, market participants might be expecting the Fed to shift gears and focus on boosting economic growth once unemployment begins to rise. We

Federal Funds Rate: Alternative Views



Sources: Federal Reserve Board via Haver Analytics; Bloomberg; Daiwa Capital Markets America read the Fed differently. Fed officials seem to realize they made policy mistakes during the pandemic and are now determined to correct the errors. In addition, they seem to be concerned about long-term inflation expectations becoming unmoored, and they seem willing to tolerate a recession to prevent such an outcome.

Thus, we expect the federal funds rate to move above four percent early next year, and we would not look for policymakers to begin trimming short-term interest rates until inflation has declined considerably and seems to be on a path to two percent. We would not expect a rate cut until inflation was in the neighborhood of three percent, which is not likely to occur until late next year.

Review

Week of Aug. 8, 2022	Actual	Consensus	Comments
Nonfarm Productivity (22-Q2)	**-4.6%**	**-4.5%**	Output in the nonfarm business sector fell 2.1 percent in the second quarter (annual rate) despite an increase of 2.6% in labor input, resulting in a marked decline in productivity. The drop of 4.6% in productivity followed an even sharper retreat in Q1 (off 7.4%), resulting in the sharpest two-quarter decline in the history of the series. The poor productivity performance is occurring at an inopportune time, as it reduces the ability of businesses to absorb brisk growth in labor compensation.
CPI (July)	**0.0% Total, 0.3% Core**	**0.3% Total, 0.5% Core**	Sharply lower energy prices (off 4.6%) and a surprisingly restrained core component left consumer prices unchanged in July. The restraint in the core component was driven primarily by an easing in prices that had surged during the pandemic (air travel, hotel stays, car rental, household appliances). While the report was favorable overall, it also involved pressure points that could persist (rents, food, new motor vehicles, recreation, medical care).
Federal Budget (July)	**-$211.1 Billion**	**-$175.0 Billion**	Federal revenues rose moderately in July (2.8%), as firm collections from individuals offset a drop in receipts from corporations. Federal outlays continued to decline on a year-over-year basis (off 14.8%), reflecting continued dwindling in Covid-related spending. The latest results left the cumulative deficit in the first 10 months of FY2022 at $726 billion, down from $2.54 trillion in the same period in FY2021.
PPI (July)	**-0.5% Total, 0.2% Ex. Food & Energy**	**0.2% Total, 0.4% Ex. Food & Energy**	A drop of 9.0% in the energy component pushed the PPI into negative territory in July. Food prices, in contrast, remained a problem, as they jumped 1.0% after two relatively quiet months (-0.2% in June and 0.5% in May versus an average of 1.9% in the first four months of the year). Excluding food and energy, producer prices rose only 0.2%, down from an average of 0.7% in the first six months of the year. Goods destined for export accounted for most of the restraint on prices ex food and energy. Prices of services also were tame (0.1% versus an average of 0.6% in the prior six months).
Consumer Sentiment (August)	**55.1 (+7.0%)**	**52.0 (+1.0%)**	Individuals took a dim view of current economic conditions in early August, as this component fell 4.5%, reversing most of the gain in July and moving close to the record low in June. The expectations component jumped 16.1%, but the advance occurred from a near-record low, and the level of the index remained near the bottom of the historical range. The headline measure also disappointed from a historical perspective (third lowest on record). Expected inflation in the year ahead eased 0.2 percentage point from July to 5.0 percent and was down from recent highs of 5.4% in March and April. Expected inflation in the next five to 10 years rose one tick to 3.0 percent; elevated by historical standards but slightly below readings of 3.1% in January and June.

Sources: Bureau of Labor Statistics (Nonfarm productivity, CPI, PPI); U.S. Treasury Department (Federal Budget); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Aug. 15, 2022	Projected	Comments
Housing Starts (July) (Tuesday)	**1.510 Million (-3.1%)**	With sales of new homes weakening and inventories of unsold units accumulating, builders probably trimmed the number of new single-family starts. Multi-family starts will probably return to their underlying average after a high-side reading in June.
Industrial Production (July) (Tuesday)	**0.3%**	A solid gain in factory employment suggests a positive contribution from the manufacturing component of IP, and advances in employment and the rotary rig count point to a brisk increase in mining activity. Above-average temperatures probably stirred demand for cooling services, which should boost utility output.
Retail Sales (July) (Wednesday)	**-0.5% Total -0.3% Ex-Autos 0.2% Ex Autos & Gas**	A price-led drop in gasoline sales will probably dominate the report on retail activity. Other areas are likely to show modest increases on average, as higher prices inflate nominal values and offset the effects of cautious spending by individuals.
Existing Home Sales (July) (Thursday)	**4.95 Million (-3.3%)**	Soft mortgage applications and weak pending home sales point to the sixth consecutive monthly decline in existing home sales.
Leading Indicators (July) (Thursday)	**-0.4%**	Negative contributions from consumer expectations, ISM new orders, and initial claims for unemployment insurance are likely to more than offset positive contributions from the slope of the yield curve and the leading credit index, leaving a fifth consecutive decline in the headline measure.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

August / September 2022

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
	NFIB SMALL BUSINESS OPTIMISM INDEX May 93.1 June 89.5 July 89.9 **PRODUCTIVITY & COSTS** Productivity / Unit Labor Costs 21-Q4 6.3% 3.9% 22-Q1 -7.4% 12.7% 22-Q2 -4.6% 10.8%	**CPI** Total / Core May 1.0% 0.6% June 1.3% 0.7% July 0.0% 0.3% **WHOLESALE TRADE** Inventories / Sales Apr 2.3% 0.8% May 1.9% 0.7% June 1.8 % 1.8% **FEDERAL BUDGET** 2022 / 2021 May -$66.2B -$132.0B June -$88.8B -$174.2B July -$211.1B -$302.1B	**UNEMP. CLAIMS** Initial / Continuing (millions) July 16 0.261 1.365 July 23 0.237 1.420 July 30 0.248 1.428 Aug 6 0.262 N/A **PPI** Final Demand / Ex. Food & Energy May 0.8% 0.5% June 1.0% 0.4% July -0.5% 0.2%	**IMPORT/EXPORT PRICES** Non-petrol. Imports / Nonagri. Exports May -0.1% 2.8% June -0.5% 0.8% July -0.7% -3.3% **CONSUMER SENTIMENT** June 50.0 July 51.5 Aug 55.1
15	16	17	18	19
EMPIRE MFG (8:30) June -1.2 July 11.1 Aug -- **NAHB HOUSING INDEX (10:00)** June 67 July 55 Aug -- **TIC DATA (4:00)** Net L-T / Total Apr $87.2B -$2.7B May $155.3B $182.5B June -- --	**HOUSING STARTS (8:30)** May 1.591 million June 1.559 million **July 1.510 million** **IP & CAP-U (9:15)** IP / Cap.Util. May 0.0% 80.3% June -0.2% 80.0% **July 0.3% 80.2%**	**RETAIL SALES (8:30)** Total / Ex.Autos May -0.1% 0.6% June 1.0% 1.0% **July -0.5% -0.8%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Apr 1.3% 0.6% May 1.6% 0.8% June 1.4% 1.3% **FOMC MINUTES (2:00)**	**UNEMP. CLAIMS (8:30)** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** June -3.3 July -12.3 Aug -- **EXISTING HOME SALES (10:00)** May 5.41 million June 5.12 million **July 4.95 million** **LEADING INDICATORS (10:00)** May -0.6% June -0.8% **July -0.4%**	
22	23	24	25	26
CHICAGO FED NATIONAL ACTIVITY INDEX	**NEW HOME SALES**	**DURABLE GOODS ORDERS** **PENDING HOME SALES**	**UNEMP. CLAIMS** **REVISED GDP**	**PERSONAL INCOME, CONSUMPTION, PRICES** **INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **REVISED CONSUMER SENTIMENT**
29	30	31	1	2
	FHFA HOME PRICE INDEX **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **JOLTS** **CONSUMER CONFIDENCE**	**MNI CHICAGO BUSINESS BAROMETER**	**UNEMP. CLAIMS** **REVISED PRODUCTIVITY** **ISM MANUFACTURING** **CONSTRUCTION** **VEHICLE SALES**	**EMPLOYMENT REPORT** **FACTORY ORDERS**

Forecasts in Bold.

Daiwa Capital Markets

Treasury Financing

August / September 2022

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
AUCTION RESULTS: Rate Cover 13-week bills 2.580% 2.84 26-week bills 3.040% 3.09	**AUCTION RESULTS:** Rate Cover 52-week bills 3.200% 3.05 3-year notes 3.202% 2.50 **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 RESULTS:** Rate Cover 17-week CMB 2.780% 2.82 10-yr notes 2.755% 2.53	**AUCTION RESULTS:** Rate Cover 4-week bills 2.150% 2.44 8-week bills 2.430% 2.35 30-yr bonds 3.106% 2.31 **ANNOUNCE:** $96 billion 13-,26-week bills for auction on Aug 15 $15 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:** $42 billion 3-year notes $35 billion 10-year notes $21 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 $15 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 $44 billion* 2-year notes for auction on Aug 23 $45 billion* 5-year notes for auction on Aug 24 $37 billion* 7-year notes for auction on Aug 25 **SETTLE:** $96 billion 13-,26-week bills	
22	23	24	25	26
AUCTION: $96 billion* 13-,26-week bills	**AUCTION:** $44 billion* 2-year notes **ANNOUNCE:** $55 billion* 4-week bills for auction on Aug 25 $50 billion* 8-week bills for auction on Aug 25 $30 billion* 17-week CMBs for auction on Aug 24 **SETTLE:** $55 billion* 4-week bills $50 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $22 billion* 2-year FRNs $45 billion* 5-year notes	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills $37 billion* 7-year notes **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Aug 29 **SETTLE:** $96 billion* 13-,26-week bills	**SETTLE:** $22 billion* 2-year FRNs
29	30	31	1	2
AUCTION: $96 billion* 13-,26-week bills	**ANNOUNCE:** $55 billion* 4-week bills for auction on Sep 1 $50 billion* 8-week bills for auction on Sep 1 $30 billion* 17-week CMBs for auction on Aug 31 **SETTLE:** $55 billion* 4-week bills $50 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs **SETTLE:** $8 billion 30-year TIPS $15 billion 20-year bonds $44 billion* 2-year notes $45 billion* 5-year notes $37 billion* 7-year notes	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Sep 6 $34 billion* 52-week bills for auction on Sep 6 **SETTLE:** $96 billion* 13-,26-week bills	

*Estimate