Daiwa Capital Markets

U.S. Economic Comment

- Inflation expectations: still well contained…
  … but tighter policy needed to maintain the favorable views

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Inflation Expectations

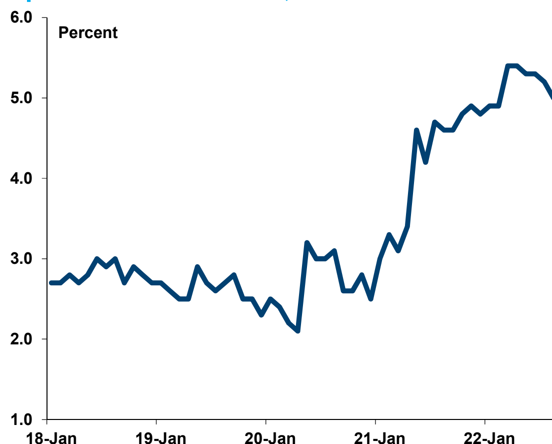
The minutes from the July meeting of the Federal Open Market Committee noted that inflation expectations would have an important influence on actual inflation and that moving to a restrictive policy stance was "essential" to keep expectations anchored. The aggressive tack taken by the FOMC seems to be paying off, as long-term expectations have been well contained. However, the views of the public have an optimistic tilt and expectations could easily change if inflation does not soon decelerate. Fed officials seem to understand that they must be unwavering in their anti-inflation efforts in order to retain the confidence of the public and to contain expectations of inflation.

The Evidence: Near-Term Pressures Expected to Subside

Published documents from the Fed (such as FOMC minutes and monetary policy reports) frequently refer to measures of inflation expectations from the Survey of Consumers conducted by the University of Michigan Survey Research Center. The near-term measure from this survey – expected inflation in the next 12 months – has naturally surged in response to actual inflation, but it has eased in the past few months, backing away from readings of 5.4 percent in March and April to 5.0 percent in the preliminary reading for August (chart, left). One might argue that the rapid tightening by the Fed has led individuals to temper their views on price pressure, although the decline in gasoline prices in July and early August probably had an influence. The recent easing is encouraging, but near-term views are still unfavorable.

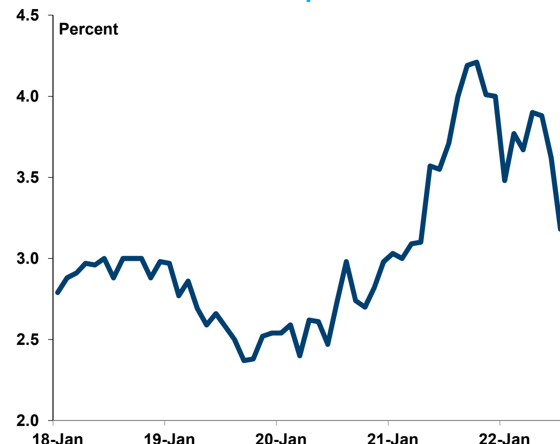
An intermediate-term gauge (next three years) from the survey of consumers conducted by the New York Fed is more encouraging, as this measure has tumbled a full percentage point since last fall and approximately 70 basis points in the past two months. The measure is now showing expected inflation of 3.2 percent over the next three years (chart, right). Given that the sizeable move started before gasoline prices began to ease, it seems likely that tight monetary policy has influenced consumer views. However, we cannot dismiss the possibility that the move is random, as consumer views can move erratically.

Expected Inflation Rate, Next Year



Source: University of Michigan Survey Research Center via Haver Analytics

Median 3-Year Ahead Expected Inflation Rate



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

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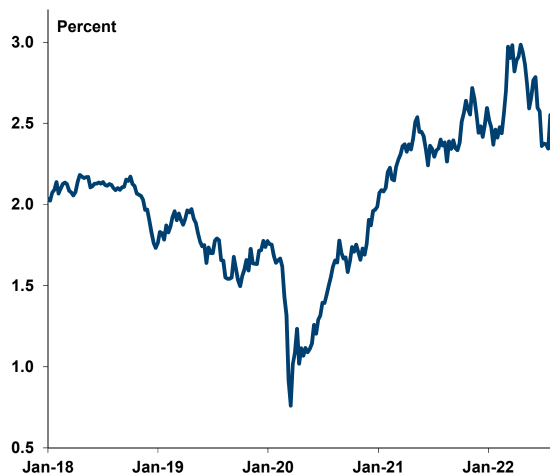
The three-year expectation in the New York Fed survey is still faster than desired by Fed officials, but much of the pressure is seen as occurring over the next year (6.2 percent from the year-ahead responses to the New York Fed survey, even faster than 5.0 percent from the University of Michigan). The implied expectation for the average in years two and three is 1.7 percent. This deceleration is pronounced as it stands, but it is even more notable because responses of individuals are probably shaped by movements in the consumer price index, which receives far more media coverage than the personal consumption expenditures price index. The CPI tends to run slightly faster than the PCE measure; thus, 1.7 percent from the NY survey could be viewed as equivalent to 1.5 percent on the PCE price index, below the Fed's target of 2.0 percent.

Because of the noise that might exist in surveys of consumers, we put more weight on breakeven rates on Treasury inflation-protected securities and on the survey of professional forecasters conducted by the Federal Reserve Bank of Philadelphia. These measures yield the same conclusion: the brisk inflation rates now evident are expected to ease in the next one to three years and settle close to two percent thereafter.

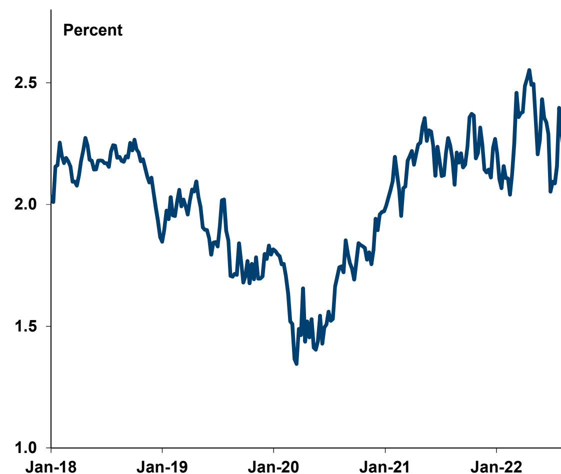
The breakeven rates on inflation protected securities show a good bit of volatility because of normal market gyrations, but underlying trends and cyclical shifts can usually be discerned. The 10-year breakeven rate climbed in the past two years or so as inflation picked up, moving from a range of 1.5 to 2.0 percent before the onset of the pandemic to a recent peak of slightly more than 3.0 percent in April. Recent readings have been in the neighborhood of 2.5 percent (chart, left). This pace is above the PCE price index target, but with this measure being based on the CPI, and with elevated inflation expected in the near and intermediate term, long-run views are in line with the Fed's inflation objective. Indeed, the 5-year/5-year forward breakeven rate has been hovering in a range around 2.3 percent, comparable to PCE-based inflation of 2.0 percent (chart, right).

10-Year Break-Even Inflation Rate*



** Expected yearly inflation over the next 10 years implied by the spread between nominal Treasury Securities and TIPS. Weekly average data.*
Source: Bloomberg

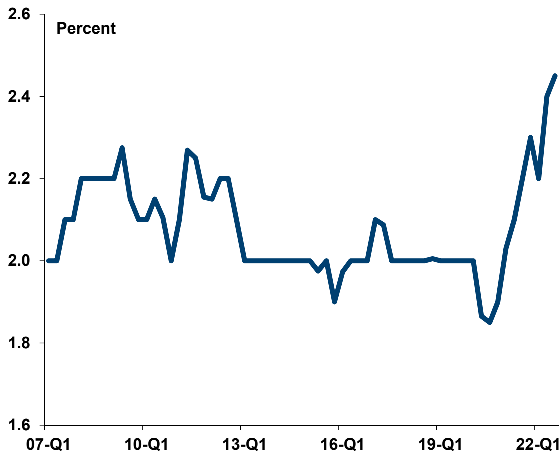
5-Year, 5-Year Forward Break-Even Inflation*



** Expected yearly inflation six to 10 years from now implied by spreads on nominal Treasury securities and TIPS. Weekly average data.*
Source: Bloomberg

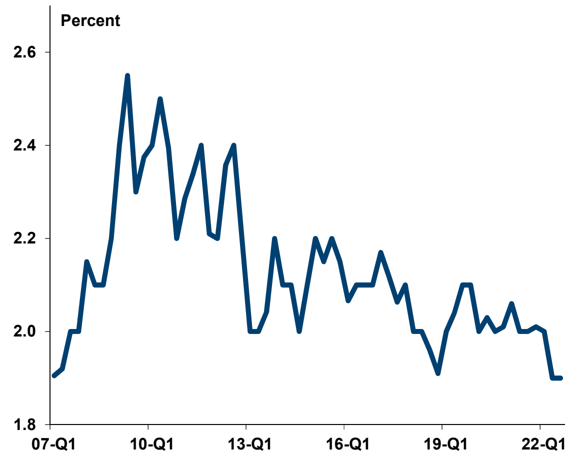
The survey of professional forecasters collects views on PCE inflation, and the latest survey shows an average rate over the next 10 years of 2.45 percent, the fastest pace since the PCE survey began in 2007 and noticeably above pre-pandemic norms of approximately 2.0 percent (chart; next page, left). As with TIPS and the consumer surveys, much of the pressure occurs in the near term. The expected average inflation rate in the first five years of the 10-year span is 3.0 percent, resulting in a 5-year/5-year forward rate of 1.9 percent, again below target (chart; next page, right).

Forecasters' Long-Term View on Inflation*



** Expected yearly inflation over the next 10 years measured by the Personal Consumption Expenditures (PCE) Price Index. Median estimate.*
Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

5-Yr., 5-Yr. Forward Infl. Expectations*



** Expected yearly PCE inflation six to 10 year from now. Median estimate.*
Sources: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia; Daiwa Capital Markets America

Doubts

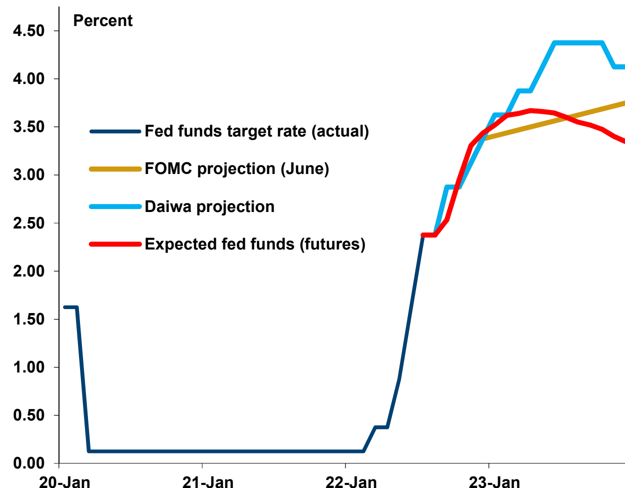
The contained nature of long-term inflation expectations will be helpful in reducing actual inflation, but we suspect market views (breakeven rates) and expectations in the Philadelphia Fed survey are too optimistic. Both see inflation receding with little additional tightening in monetary policy. Futures contracts show the federal funds rate peaking in the spring and edging lower over the balance of the year. The Phily survey does not collect forecasts for the federal funds rate, but results show the rate on three-month Treasury bills dipping in the third quarter of next year, implying actual or expected easing in monetary policy.

Moreover, the Phily survey also does not involve a recession, as the consensus view on GDP growth remains positive through the forecast horizon (2022-Q3 to 2023-Q3; quarterly growth estimates range from 1.1 percent to 1.5 percent; unemployment increases, but only to 4.0 percent; job growth slows, but remains positive). The survey asks for the probability of GDP declining in each of the next five quarters, and we viewed the responses as low (mean probabilities of a quarterly decline ranged from 34 percent to 38 percent).

The U.S. has seldom seen inflation decelerate in the absence of a recession; thus, there seems to be a disconnect between views on GDP growth and inflation. Of course, we are in a unique environment and there could be unusual forces working to reduce inflation (repair of damaged supply chains, perhaps an end to the conflict in Ukraine). Still, it is difficult to imagine inflation returning to two percent without a marked slowing in growth or more likely a recession.

Market views on monetary policy also strike us as unrealistic. Futures contracts show the federal funds rate peaking at approximately 3.7 percent next spring, but we suspect the Fed will need to push the funds rate above four percent. Moreover, the Fed will probably need to maintain

Federal Funds Target Rate*



Sources: Federal Reserve Board via Haver Analytics; Federal Open Market Committee; Bloomberg; Daiwa Capital Markets America.

a restrictive stance for a considerable period in order to squeeze inflation from the system. We would be surprised to see a rate reduction before the fourth quarter of next year, and we view risks in the direction of later rather than earlier rate reductions.

Fed officials also seem less optimistic than market participants and economists in the Phily survey. The June dot plot of the FOMC shows a median federal funds rate of 3.75 percent next year, close to the peak of 3.70 percent implied by futures contracts for the federal funds rate. However, policymakers do not envision policy easing until 2024. This view also was evident in the minutes from the July FOMC meeting, as officials noted that “it would likely take some time for inflation to move down to the Committee’s objective.” Similarly, the minutes noted that once the federal funds rate reached a sufficiently restrictive level, “it likely would be appropriate to maintain that level for some time to ensure that inflation was firmly on a path back to 2 percent.”

We share the favorable view on long-run inflation now evident in surveys and breakeven rates. However, we do not see a smooth path to get there. We suspect that the Fed will need to tighten more than is currently built into the market, and officials will probably need to hold a restrictive stance for longer than currently expected by market participants. We also suspect that the U.S. economy will drift into recession next year with GDP dipping 0.5 percent over the four quarters of 2023 and the unemployment rate climbing to 4.8 percent.

Next Comment:

Because of vacation plans, we will not publish an Economic Comment on August 26. The next Comment will be sent on September 2.

Review

Week of Aug. 15, 2022	Actual	Consensus	Comments
Housing Starts (July)	**1.446 Million (-9.6%)**	**1.527 Million (-2.1%)**	Single-family starts led the drop in July, plunging 10.1% and marking the fifth consecutive decline. Single-family activity has now moved to the lowest level since the early stages of the current expansion. Prospects for a recovery do not appear favorable, as permits have also been weak and the sentiment index from the National Association of Home Builders fell to a sub-50 level in August, signaling contraction. Multi-family starts declined 8.6%, but the change followed a jump of 18.6% in June and starts remained in the upper portion of the range from the current expansion. With high prices and elevated interest rates constraining demand for single-family homes, the outlook multi-family starts seems favorable.
Industrial Production (July)	**0.6%**	**0.3%**	Increases of 0.7% in both manufacturing and mining activity easily offset a drop of 0.8% in utility output and left a firm increase in total production. The auto sector accounted for most of the advance in manufacturing with an increase of 6.6%; activity in other manufacturing industries rose moderately (0.3%). The increase in manufacturing activity in July, while brisk, followed declines in May and June and left a slight net decline in the past three months. In the mining sector, the extraction of oil and natural gas was little changed, but other activity jumped 2.8%. Mining has had a few soft months in the past year or so, but it is generally moving along an upward trend and has now retraced much of the ground lost during the early stages of the pandemic.
Retail Sales (July)	**0.0% Total, 0.4% Ex. Autos**	**0.1% Total, -0.1% Ex. Autos**	Retail activity in July was constrained by declines at gasoline stations and auto dealers. The drop of 1.8% in gasoline sales was not troubling (in fact, it was encouraging) because it was much smaller than the decline in gasoline prices (-7.7% in the CPI). The auto component was disappointing (-1.6%), but the weakness probably reflected tight supply rather than soft demand. Excluding autos and gasoline, retail sales rose 0.7% from upward revised levels in the prior two months. With the core CPI increasing 0.3% in July, the gains in retail activity will most likely translate to growth in real terms.
Existing Home Sales (July)	**4.81 Million (-5.9%)**	**4.86 Million (-5.1%)**	The drop in sales of existing homes represented the sixth consecutive decline, with the cumulative retreat pushing activity to its lowest level since the early stages of the expansion. Affordability issues because of elevated mortgage interest rates and lofty home prices account for the recent weakening, but a limited inventory of homes for sale has been a problem in the past few years. This situation is improving, as the number of listings have increased for five consecutive months, with four of these months recording above-average advances (and the other month only a bit below average).
Leading Indicators (July)	**-0.4%**	**-0.5%**	The index of leading economic indicators eased for the fifth consecutive month in July, with negative contributions from consumer expectations and the ISM new orders index contributing importantly to the latest decline.

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

Preview

Week of Aug. 22, 2022	Projected	Comments
New Home Sales (July) (Tuesday)	**0.580 Million (-1.7%)**	Declines in the National Association of Home Builders sentiment index and in mortgage applications for a home purchase suggest that elevated mortgage interest rates are continuing to weigh heavily on the housing market. The expected decline in new home sales in July would be the sixth in the past seven months, pushing sales to a new low for the current expansion.
Durable Goods Orders (July) (Wednesday)	**0.5%**	Orders for defense-related aircraft are likely to cool from a high-side reading in June, but a surge in bookings at Boeing suggests that orders for commercial aircraft will more than offset the slide in the defense area. Elsewhere, orders should be little changed, reflecting cautious spending by individuals and businesses that offsets the effects of higher prices on nominal values.
Revised GDP (22-Q2) (Thursday)	**-0.5% (+0.4 Pct. Pt. Revision)**	Upward adjustments to consumer spending and inventory investment (smaller, but still sizable negative contribution) suggest a positive revision to Q2 GDP growth, although output likely still contracted.
Personal Income, Consumption, Core Price Index (July) (Friday)	**0.5%, 0.5%, 0.3%**	Solid gains in wages and salaries in July should be joined by firm advances in rental and investment income. On the spending side, an increase in sales of new vehicles should lead to a pickup in outlays for durable goods, while data on retail activity suggest a moderate nominal advance in outlays for nondurable items. Subdued data on the CPI for July point to a slower increase in the core PCE price index after average readings of 0.4% in the past six months.
U.S. International Trade in Goods (July) (Friday)	**-$99.5 Billion ($0.9 Billion Wider Deficit)**	Lower prices of crude oil and other commodities will probably constrain both exports and imports of industrial supplies, but the effect on exports will probably be larger because of their edge in size. Exports of food could ease from their elevated level in June, adding to the slippage in the deficit.
Revised Consumer Sentiment (August) (Friday)	**55.1 (Unrevised)**	Although gasoline prices eased into mid-August, continued price pressure at grocery stores and talk of an economic slowdown suggest that consumer sentiment was unrevised from the soft preliminary tally.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

August / September 2022

Monday 15

EMPIRE MFG

June	-1.2
July	11.1
Aug	-31.3

NAHB HOUSING INDEX

June	67
July	55
Aug	49

TIC DATA

	Net L-T	Total
Apr	\$87.6B	-\$2.0B
May	\$155.3B	\$194.5B
June	\$121.8B	\$22.1B

Tuesday 16

HOUSING STARTS

May	1.562 million
June	1.599 million
July	1.446 million

IP & CAP-U

	IP	Cap.Util.
May	-0.1%	80.1%
June	0.0%	79.9%
July	0.6%	80.3%

Wednesday 17

RETAIL SALES

	Total	Ex.Autos
May	0.4%	1.3%
June	0.8%	0.9%
July	0.0%	0.4%

BUSINESS INVENTORIES

	Inventories	Sales
Apr	1.3%	0.6%
May	1.6%	1.0%
June	1.4%	1.3%

FOMC MINUTES

Thursday 18

UNEMP. CLAIMS

	Initial (millions)	Continuing
July 23	0.237	1.420
July 30	0.248	1.430
Aug 6	0.252	1.437
Aug 13	0.250	N/A

PHILADELPHIA FED MFG BUSINESS OUTLOOK

June	-3.3
July	-12.3
Aug	6.2

EXISTING HOME SALES

May	5.41 million
June	5.11 million
July	4.81 million

LEADING INDICATORS

May	-0.7%
June	-0.7%
July	-0.4%

Friday 19

Monday 22

CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)

	Monthly	3-Mo. Avg.
May	-0.19	0.09
Jun	-0.19	-0.04
July	--	--

Tuesday 23

NEW HOME SALES (10:00)

May	0.642 million
June	0.590 million
July	**0.580 million**

Wednesday 24

DURABLE GOODS ORDERS (8:30)

May	0.8%
June	2.0%
July	**0.5%**

PENDING HOME SALES (10:00)

May	0.4%
June	-8.6%
July	--

Thursday 25

UNEMP. CLAIMS (8:30)

REVISED GDP (8:30)

	GDP	Chained Price
22-Q1	-1.6%	8.2%
22-Q2(a)	-0.9%	8.7%
22-Q2(p)	**-0.5%**	**8.7%**

Friday 26

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)

	Inc.	Cons.	Core
May	0.6%	0.3%	0.3%
June	0.6%	1.1%	0.6%
July	**0.5%**	**0.5%**	**0.3%**

INTERNATIONAL TRADE IN GOODS (8:30)

May	-\$103.5 billion
June	-\$98.6 billion
July	**-\$99.5 billion**

ADVANCE INVENTORIES (8:30)

	Wholesale	Retail
May	1.9%	1.6%
June	1.8%	2.0%
July	--	--

REVISED CONSUMER SENTIMENT (10:00)

June	50.0
July	51.5
Aug(p)	55.1

FED CHAIR POWELL AT JACKSON HOLE SYMPOSIUM (10:00)

Monday 29

Tuesday 30

FHFA HOME PRICE INDEX

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX

JOLTS

CONSUMER CONFIDENCE

Wednesday 31

MNI CHICAGO BUSINESS BAROMETER

Thursday 1

UNEMP. CLAIMS

REVISED PRODUCTIVITY

ISM MANUFACTURING

CONSTRUCTION

VEHICLE SALES

Friday 2

EMPLOYMENT REPORT

FACTORY ORDERS

Monday 5

LABOR DAY

Tuesday 6

ISM SERVICES

Wednesday 7

INTERNATIONAL TRADE

BEIGE BOOK

Thursday 8

UNEMP. CLAIMS

CONSUMER CREDIT

Friday 9

WHOLESALE TRADE

Forecasts in Bold. (a) = advance (1st estimate of GDP); (p) = preliminary (2nd estimate of GDP)

Treasury Financing

August / September 2022

Monday	Tuesday	Wednesday	Thursday	Friday
15	16	17	18	19
AUCTION RESULTS: Rate / Cover 13-week bills 2.610% 2.64 26-week bills 3.020% 2.75 **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 RESULTS:** Rate / Cover 17-week CMB 2.890% 3.06 20-yr bonds 3.380% 2.30	**AUCTION RESULTS:** Rate / Cover 4-week bills 2.150% 2.53 8-week bills 2.490% 2.77 30-yr TIPS 0.920% 2.69 **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 $60 billion 21-day CMBs for auction on Aug 23 **SETTLE:** $96 billion 13-,26-week bills	
22	23	24	25	26
AUCTION: $96 billion 13-,26-week bills `	**AUCTION:** $60 billion 21-day CMBs $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 $60 billion 21-day CMBs	**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	
5	6	7	8	9
LABOR DAY	**AUCTION:** $96 billion* 13-,26-week bills $34 billion* 52-week bills **ANNOUNCE:** $55 billion* 4-week bills for auction on Sep 8 $50 billion* 8-week bills for auction on Sep 8 $30 billion* 17-week CMBs for auction on Sep 7 **SETTLE:** $55 billion* 4-week bills $50 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Sep 12 $41 billion* 3-year notes for auction on Sep 12 $32 billion* 10-year notes for auction on Sep 12 $18 billion* 30-year bonds for auction on Sep 13 **SETTLE:** $96 billion* 13-,26-week bills $34 billion* 52-week bills	

**Estimate*