Daiwa Capital Markets

U.S. Economic Comment

- FOMC preview: aggressive in September…and beyond
- Recent inflation developments: bits of favorable news overwhelmed by the August CPI

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U.S. Monetary Policy: What's After September?

Fed Governor Christopher Waller noted in an early September speech that "the policy decision at our next meeting will be straightforward" – meaning there is little doubt that the Federal Open Market Committee will adopt another rate hike of 75 basis points (the third consecutive such shift). Since his talk, the troubling report on consumer prices in August raised the possibility of a 100 basis point change, but we believe odds still favor a shift of 75 basis points.

While Fed officials believe that a quick move to a restrictive policy stance is warranted, they also recognize the possibility of moving too far, too fast. As noted in the minutes from the July FOMC meeting, "many" officials noted the risk of tightening more than necessary to restore price stability. Similarly, Esther George of the Kansas City Fed dissented from the 75 basis point change in June, favoring a shift of 50 basis points, because she was concerned about the possibility of "oversteering". Thus, policymakers are likely to be content with a still-aggressive hike of 75 basis points.

There is not much mystery surrounding the outcome of the September meeting, but there is a wide range of possibilities over the balance of this year and into 2023. Fed officials are avoiding forward guidance at this time, arguing that they need to assess how consumers and businesses are reacting to tighter financial conditions before they make judgments on additional policy changes. However, the new Summary of Economic Projections (SEP) that will be released at the upcoming meeting will offer clues on what officials are envisioning.

After a 75 basis point change at the upcoming meeting, the federal funds rate will be only slightly below the year end expectation of 3.4 percent shown in the June SEP. With more tightening likely in November and December, the new expectation is likely to be close to 4.0 percent. Similarly, the expectation for year end 2023 is likely to exceed the 3.8 percent shown in June.

Fed officials will probably reduce their expectation for GDP growth given results in the first half of the year (-1.1 percent) and the constraining influence of tighter monetary policy. We view the probability of a recession as high, although we doubt that the SEP will show declines in GDP. Similarly, we expect the SEP to show only a modest increase in the expected unemployment rate. Some Fed officials have argued that softening in the labor market will take the form of a reduction in job openings rather than a pickup in layoffs, which would leave the jobless rate little changed.

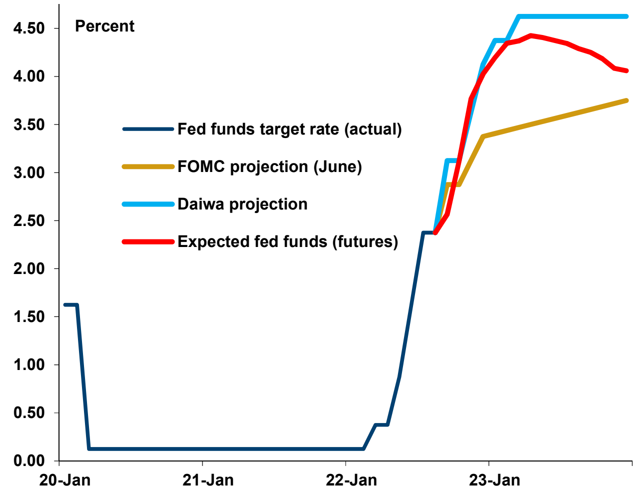
Economic Projections of the FOMC, June 2022*

	2022	2023	2024
Change in Real GDP	1.7	1.7	1.9
Unemployment Rate	3.7	3.9	4.1
PCE Inflation	5.2	2.6	2.2
Core PCE Inflation	4.3	2.7	2.3
Federal Funds Rate	3.4	3.8	3.4

** Median projections*
Source: Federal Open Market Committee, Summary of Economic Projections, June 2022

The focus of Fed officials on job openings has received support from two recent studies (one from the Brookings Institution and one from the San Francisco Fed) showing that openings (or the ratio of openings to unemployment) was a better indicator than the unemployment rate when assessing slack in the labor market. That is, the ratio of openings to unemployment is a better predictor of wage and price pressure.

Federal Funds Target Rate



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

Our View

Changing views on Fed policy are not surprising given the results from the August CPI (discussed below). We viewed the report as troubling, and we altered our expectations on the likely path of the federal funds rate in response. We were previously looking for another 50 basis points over the balance of the year after the 75 basis point hike in September. Now, we expect changes of 50 basis points in each of the final two meetings this year, leaving the federal funds rate at 4.125 percent in December (chart). We look for additional tightening in early 2023, with the funds rate peaking at 4.625 percent (versus our previous view of 4.375 percent). We previously looked for the Fed to begin easing policy in late 2023, but that process will probably not start until 2024.

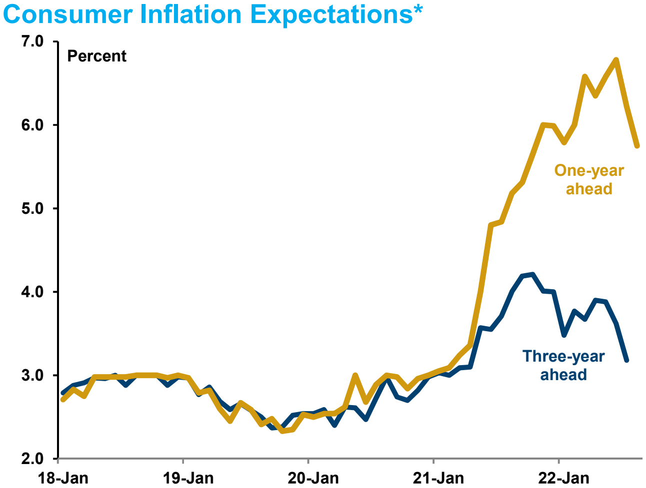
We expect this policy stance to trigger a recession, with GDP slipping approximately 0.5 percent over the four quarters of this year and next. We expect the unemployment rate to move close to 5.0 percent.

Inflation Developments

The latest week brought some favorable news on inflation: survey measures of inflation expectations eased in August and September, and nonpetroleum import prices seem to be moving onto a downward trend.

The New York Fed publishes two measures of consumer expectations, expected price pressure one year ahead and three years ahead, and both have moved noticeably lower in recent months. The one-year measure stood at 5.75 percent in August, down more than a percentage point from the peak in June. The three-year ahead measure has tumbled to 2.76 percent, off considerably from 4.21 percent in October of last year (chart).The New York Fed has started to survey expectations five years ahead. Figures are available for only this year, but they have shown a pronounced shift, falling from 3.0 percent in January to 2.0 percent in August.

Consumer Inflation Expectations*



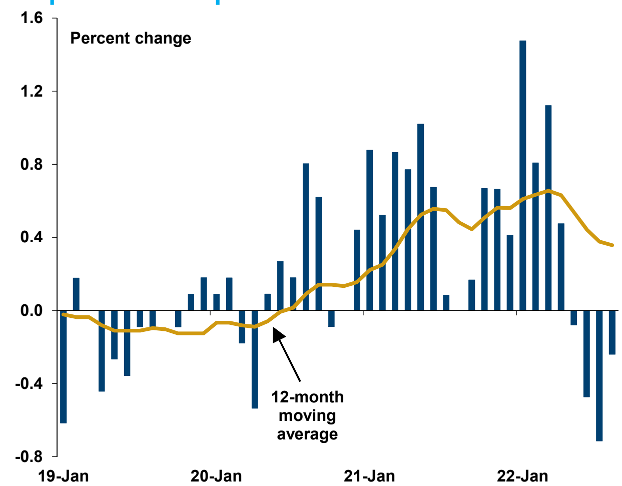
** Median estimates*

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

The survey of consumers conducted by the University of Michigan Survey Research Center also shows a cooling in inflation expectations, with the one-year measure moving to 4.6 percent in early September from a recent peak of 5.4 percent in March and April. Expectations six to 10 years from now have wiggled lower to 2.8 percent in September from 3.1 percent in June.

The firm dollar on foreign exchange markets has the potential to reduce prices of imported goods, and such a trend seems to be emerging. Nonpetroleum prices fell 0.2 percent in August, which followed declines in the prior three months averaging 0.4 percent (chart). The year-over-year change has turned a corner and has eased almost four percentage points this year (4.3 percent in August versus 8.1 percent in March). The inflation rate in the U.S. will be driven primarily by domestic conditions, but competition from imports is likely to have some influence.

Nonpetroleum Import Prices



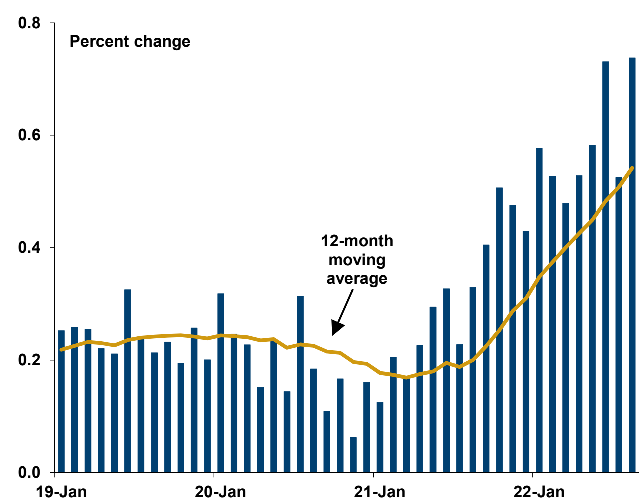
Source: Bureau of Labor Statistics via Haver Analytics

These developments are noteworthy, but they do little to ease concern about price pressure given the CPI for August. The report on consumer prices was troubling, as it suggested that the U.S. is now experiencing broadly based inflation that is likely to be difficult to eliminate. The problematic nature of report is evident from several perspectives.

The increase of 0.6 percent in the core component was notably faster than the consensus (and our) expectation of 0.3 percent. Our view was based on the fact that prices of several key items had climbed to levels well above pre-pandemic norms and seemed due for downward adjustments (think airfares, hotel fees, and prices of clothing, household appliances, used motor vehicles, and tickets to live entertainment). These areas were in fact contained in August, but core prices still rose 0.6 percent despite subdued changes in these items. The sizeable increase signaled problems in other components of the CPI.

The broad-based nature of price pressure also was evident in the median CPI, which rose 0.7 percent, matching the sharpest increase in the current cycle (chart). The shift in the median value signals that the entire distribution of price changes has shifted to the right; pressure is not the result of unusually large changes in a handful of items.

Median CPI



Source: Federal Reserve Bank of Cleveland via Haver Analytics

The speech by Christopher Waller noted in our opening paragraph also contained an interesting figure showing the broad-based nature of inflation. Mr. Waller indicated that at least 60 percent of the categories in the CPI had increased by three percent or more – and that was before the publication of the August data.

In short, the U.S. has a genuine inflation problem.

Review

Week of Sept. 12, 2022	Actual	Consensus	Comments
CPI (August)	**0.1% Total, 0.6% Core**	**-0.1% Total, 0.3% Core**	Energy prices fell 5.0% in August after a drop of 4.6% in the prior month, but other components of the CPI remained under pressure. Food prices jumped 0.8%, only a touch slower than average of 0.9% in the prior 12 months. The surge in the core component eclipsed the average of 0.5% in the previous 12 months, dispelling the notion that price pressure might be starting to ease. The costs of housing, medical care, and auto insurance all posted brisk increases. The latest month-to-month changes left the headline index up 8.3% in August from the same month last year, down from a recent high of 9.1% in June. The core index rose 6.3% on a year-over-year basis, up four ticks from the reading in July and only a touch below the recent high of 6.5% in March.
Federal Budget (August)	**$219.6 Billion Deficit**	**$217.0 Billion Deficit**	Federal revenues in August rose briskly from the same month last year (up 12.8%), but outlays also increased from a light-side reading in August of last year (up 8.9%), leaving year-over-year slippage in the budget deficit (vs. $170.6 billion in August 2021). While the monthly deficit deteriorated from last August's total, the cumulative shortfall of $945.7 billion in the first 11 months of FY2022 was sharply narrower than the $2.711 trillion in the same period in FY2021.
PPI (August)	**-0.1% Final Demand, 0.4% Ex. Food & Energy**	**-0.1% Final Demand, 0.3% Ex. Food & Energy**	A drop of 6.0% in energy prices in August followed a decline of 9.0% in July, with the recent changes contrasting sharply with the average advance of 5.5% in the first six months of 2022. Food prices at the producer level were unchanged in August, continuing a deceleration that began in the spring (average increase of 0.5% from May thru July versus an average of 1.9% in the first four months of the year). Prices excluding food and energy averaged increases of 0.4% since April after a Q1 pace of 0.9% per month.
Retail Sales (August)	**0.0% Total, -0.3% Ex. Autos**	**-0.1% Total, 0.0% Ex. Autos**	A jump of 2.8% in sales at motor vehicle dealers contributed importantly to the month-to-month change in total retail activity, but the results were less impressive when viewed from a longer-term perspective: the vehicle component has drifted irregularly lower since the early months of the year. Transactions at gasoline service stations slumped 4.2% in the latest month, but prices fell by a larger amount (10.6% in the CPI), suggesting a second consecutive sizable gain in real consumption. Activity excluding autos and gasoline rose 0.3%. Several areas posted solid results, although the pickups represented payback for soft activity in previous months, and higher prices also may have played a role in inflating the value of sales.

Review Continued

Week of Sept. 12, 2022	Actual	Consensus	Comments
Industrial Production (August)	**-0.2%**	**0.0%**	The weakness in industrial production in August was concentrated in the utility sector (-2.4%), where changes are usually driven by shifts in temperatures rather than economic fundamentals. Manufacturing activity rose 0.1%, which marked the second consecutive gain, but the change in August was modest and the past two shifts offset only a portion of the declines in May and June. Thus, manufacturing output in August remained a touch shy of the cyclical high registered in April. A flat reading in mining activity after five consecutive gains perhaps signals the beginning of a soft patch in response to declines in the prices of crude oil and industrial metals.
Consumer Sentiment (September)	**59.5 (+2.2%)**	**60.0 (+3.1%)**	Consumer sentiment rose for the third consecutive month, although the changes have been small and the measure remained close to the record low reading of 50.0 in June. Rapid inflation in the costs of household essentials (groceries, medical care, utilities) likely is dampening moods despite the recent easing in gasoline prices.

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 Sept. 19, 2022	Projected	Comments
Housing Starts (August) (Tuesday)	**1.470 Million (+1.7%)**	Single-family starts could stabilize after builders cut activity in the past five months amid slowing demand for new homes. Multi-family activity has been well maintained despite a decline in July, as preferences have shifted to cheaper units in multi-family dwellings.
Existing Home Sales (August) (Wednesday)	**4.75 Million (-1.2%)**	A drop in housing affordability (high prices joined by a surge in interest rates) suggests further downside risks in the market for existing homes in August after declines in the past six months, a view supported by slippage in pending home sales and mortgage applications for a home purchase.
Current Account (2022-Q2) (Thursday)	**-$255.0 Billion ($36.4 Billion Narrower Deficit)**	An improvement in trade and income flows suggests a narrowing in the current account deficit after a sharp widening in Q1. The expected deficit would equate to 4.1% of GDP, narrower than the 4.8% registered in Q1, but much wider than the 1.8% to 2.5% range in the years leading up to the pandemic.
Leading Indicators (August) (Thursday)	**-0.1%**	Negative contributions from consumer expectations, the factory workweek, and the ISM new orders index are likely to offset positive contributions from stock prices and the slope of the yield curve, raising the prospect of the sixth consecutive decline in the index of leading economic indicators. The expected result in August would leave the measure 2.4% below the cyclical peak in February.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

September / October 2022

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
	NFIB SMALL BUSINESS OPTIMISM INDEX June 89.5 July 89.9 Aug 91.8 **CPI** Total / Core June 1.3% 0.7% July 0.0% 0.3% Aug 0.1% 0.6% **FEDERAL BUDGET** 2022 / 2021 June -$88.8B -$174.2B June -$211.1B -$302.1B Aug -$219.6B -$170.6B	**PPI** Final Demand / Ex. Food & Energy June 1.0% 0.4% July -0.4% 0.3% Aug -0.1% 0.4%	**UNEMP. CLAIMS** Initial / Continuing (millions) Aug 20 0.237 1.437 Aug 27 0.228 1.401 Sep 3 0.218 1.403 Sep 10 0.213 N/A **RETAIL SALES** Total / Ex.Autos June 1.0% 1.1% July -0.4% 0.0% Aug 0.3% -0.3% **IMPORT/EXPORT PRICES** Non Petrol / Nonagri Exports June -0.5% 1.2% July -0.7% -3.8% Aug -0.2% -1.8% **IP & CAP-U** IP / Cap.Util. June 0.0% 79.9% July 0.5% 80.2% Aug -0.2% 80.0% **EMPIRE MFG** July 11.1 Aug -31.3 Sep -1.5 **PHILADELPHIA FED MFG BUSINESS OUTLOOK** July -12.3 Aug 6.2 Sep -9.9 **BUSINESS INVENTORIES** Inventories / Sales May 1.6% 1.0% June 1.4% 1.2% July 0.6% -0.9%	**CONSUMER SENTIMENT** July 51.5 Aug 58.2 Sept 59.5 **TIC DATA** Net L-T / Total May $155.3B 194.5B June $121.8B $22.3B July $21.4B $153.5B
19	20	21	22	23
NAHB HOUSING INDEX (10:00) July 55 Aug 49 Sep --	**HOUSING STARTS (8:30)** June 1.599 million July 1.446 million **Aug 1.470 million** **FOMC MEETING (1ST DAY)**	**EXISTING HOME SALES (10:00)** June 5.11 million July 4.81 million **Aug 4.75 million** **FOMC DECISION (2:00)**	**UNEMP. CLAIMS (8:30)** **CURRENT ACCOUNT (8:30)** 21-Q4 -$224.8 bill. 22-Q1 -$291.4 bill. **22-Q2 -$255.0 bill.** **LEADING INDICATORS (10:00)** June -0.7% July -0.4% **Aug -0.1%**	
26	27	28	29	30
CHICAGO FED NATIONAL ACTIVITY INDEX	**DURABLE GOODS ORDERS** **FHFA HOME PRICE INDEX** **S&P CORELOGIC HOME PRICE INDEX** **NEW HOME SALES** **CONSUMER CONFIDENCE**	**INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PENDING HOME SALES**	**UNEMP. CLAIMS** **REVISED GDP**	**PERSONAL INCOME, CONSUMPTION, PRICES** **MNI CHICAGO BUSINESS BAROMETER** **REVISED CONSUMER SENTIMENT**
3	4	5	6	7
ISM MANUFACTURING **CONSTRUCTION** **VEHICLE SALES**	**FACTORY ORDERS** **JOLTS**	**ADP EMPLOYMENT** **INTERNATIONAL TRADE** **ISM SERVICES**	**UNEMP. CLAIMS**	**EMPLOYMENT REPORT** **WHOLESALE TRADE** **CONSUMER CREDIT**

Forecasts in Bold.

Treasury Financing

September / October 2022

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
AUCTION RESULTS: Rate Cover 13-week bills 3.075% 2.74 26-week bills 3.465% 3.03 3-year notes 3.564% 2.49 10-year notes 3.330% 2.37	**AUCTION RESULTS:** Rate Cover 30-yr bonds 3.511% 2.42 **ANOUNCE:** $50 billion 4-week bills for auction on Sep 15 $45 billion 8-week bills for auction on Sep 15 $30 billion 17-week CMBs for auction on Sep 14 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 3.550% 3.14	**AUCTION RESULTS:** Rate Cover 4-week bills 2.670% 2.70 8-week bills 2.925% 2.64 **ANNOUNCE:** $96 billion 13-,26-week bills for auction on Sep 19 $12 billion 20-year bonds for auction on Sep 20 $15 billion 10-year TIPS for auction on Sep 22 **SETTLE:** $96 billion 13-,26-week bills $41 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds	
19	20	21	22	23
AUCTION: $96 billion 13-,26-week bills	**AUCTION:** $12 billion 20-year bonds **ANNOUNCE** $50 billion* 4-week bills for auction on Sep 22 $45 billion* 8-week bills for auction on Sep 22 $30 billion* 17-week CMBs for auction on Sep 21 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills $15 billion 10-year TIPS **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Sep 26 $43 billion* 2-year notes for auction on Sep 26 $44 billion* 5-year notes for auction on Sep 27 $36 billion* 7-year notes for auction on Sep 28 $22 billion* 2-year FRNs for auction on Sep 28 **SETTLE:** $96 billion 13-,26-week bills	
26	27	28	29	30
AUCTION: $96 billion* 13-,26-week bills $43 billion* 2-year notes	**AUCTION:** $44 billion* 5-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on Sep 29 $45 billion* 8-week bills for auction on Sep 29 $30 billion* 17-week CMBs for auction on Sep 28 **SETTLE:** $50 billion* 4-week bills $45 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $36 billion* 7-year notes $22 billion* 2-year FRNs	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Oct 3 $34 billion* 52-week bills for auction on Oct 4 **SETTLE:** $96 billion* 13-,26-week bills	**SETTLE:** $12 billion 20-year bonds $15 billion 10-year TIPS $43 billion* 2-year notes $44 billion* 5-year notes $36 billion* 7-year notes $22 billion* 2-year FRNs
3	4	5	6	7
AUCTION: $96 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills **ANNOUNCE:** $50 billion* 4-week bills for auction on Oct 6 $45 billion* 8-week bills for auction on Oct 6 $30 billion* 17-week CMBs for auction on Oct 5 **SETTLE:** $50 billion* 4-week bills $45 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Oct 11 $40 billion* 3-year notes for auction on Oct 11 $32 billion* 10-year notes for auction on Oct 12 $18 billion* 30-year bonds for auction on Oct 13 **SETTLE:** $96 billion* 13-,26-week bills $34 billion* 52-week bills	

*Estimate