U.S. Economic Comment

- Consumer inflation: relief in the pipeline?
- Recent Fed quotes: insights into the (far off) pivot

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

Inflation

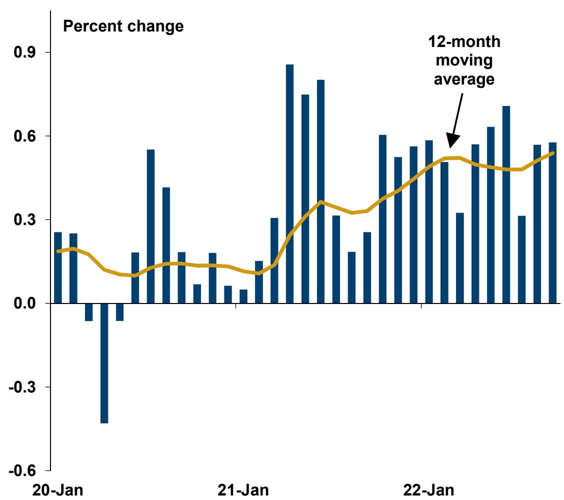
The U.S. registered another troubling report on consumer inflation in September, as the core CPI rose 0.6 percent, marking the fifth time in the past six months that the measure has increased by this amount or more (chart, left). The year-over-year change totaled 6.6 percent, a new high for the current cycle and the fastest pace in 40 years (7.1 percent in August 1982).

Energy prices brought some relief with a drop of 2.1 percent, which followed an average decline of 4.8 percent in the prior two months. However, gasoline prices have moved higher in recent weeks, which will probably lead to an increase in the energy component in October. Food prices remained under pressure with an increase of 0.8 percent, only a touch slower than the average of 0.9 percent in the prior 12 months.

While the CPI was troubling, the producer price index was less problematic. Food and energy prices continued to misbehave (up 1.2 percent and 0.7 percent, respectively), but prices excluding food and energy rose only 0.3 percent for the third consecutive month, down from an average of 0.4 percent in the second quarter and 0.9 percent in Q1 (chart, right). Many observers are likely to be heartened by this performance, as producer prices are viewed by some as a leading indicator for consumer prices – pipeline inflation is sometimes noted in the popular press.

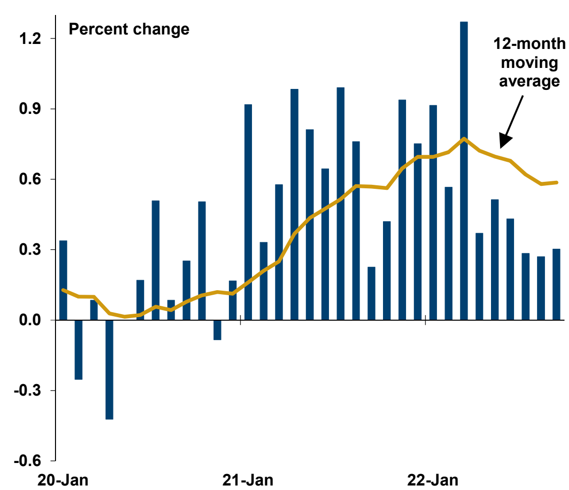
We would be less sanguine. While the PPI and CPI generally follow similar paths over long periods, deviations occur frequently over shorter intervals, raising doubts about the predictive power of the PPI. In addition, the PPI is more volatile than the CPI, raising the possibility that recent light readings on producer prices reflect an element of random volatility rather than a fundamental shift.

Core CPI



Source: Bureau of Labor Statistics via Haver Analytics

PPI Excluding Food & Energy



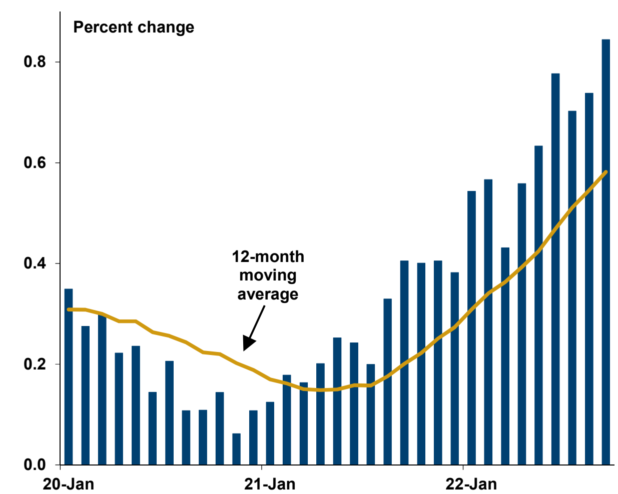
Source: Bureau of Labor Statistics via Haver Analytics

Even a fundamental shift in the PPI might not be relevant for consumer prices. The producer price index includes prices of goods destined for export, and this component of the PPI has declined for three consecutive months. This change is probably more than statistical noise. U.S. producers seem to restraining export prices to cushion the effects of a strong foreign exchange value of the dollar on the prices of their products in foreign markets. This effect on export prices will not be a factor in U.S. inflation, and thus the CPI should not be expected to follow the lead of the PPI.

(The strong dollar, though, might help restrain the CPI by leading to lower import prices. However, we have seen only a modest effect thus far. The price index for imported consumer goods (ex-autos) published by the Bureau of Labor Statistics fell moderately in May and June, but it retraced a portion of these declines in July and August and showed no change in September. On balance, the index has declined at an annual rate of only 0.4 percent in the past five months.)

A link between the PPI and CPI also is in doubt because much of the pressure on consumer prices has been the result of surging rental rates for housing, which are not included in the PPI. Rental rates were tame during the Covid recession and its aftermath (only 0.1 percent on average in late 2020 and early 2021). However, they have surged in the past year or so, gradually building to the 0.8 percent registered in September, far above the typical increases of 0.3 percent evident before the pandemic (chart). Given this performance, a gap between the PPI and CPI should be expected.

CPI: Rent of Primary Residence

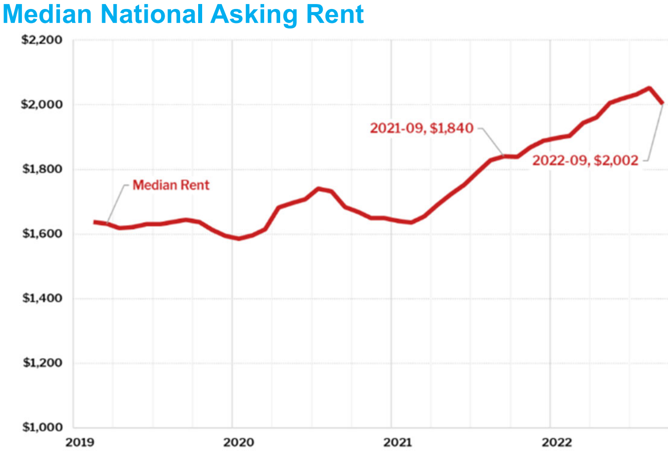


Source: Bureau of Labor Statistics via Haver Analytics

The pressure on rents evident in the CPI is likely to persist for some time. The rental component in the CPI is based on a sample of properties, and the sampling naturally involves a mixture of new and existing leases. If rental rates take a step higher, the effects feed gradually into the CPI because it takes time for existing leases to roll into new contracts involving higher rental rates. In addition, the lag effect is compounded because the Bureau of Labor Statistics uses a six-month average of rents in calculating the CPI.

Thus, rents as measured by the CPI are likely to remain on a firm upward path for at least the next year or so. However, there is possibly a light at the end of the tunnel. The outlook for CPI rents one to two years out will depend on changes in asking rents; that is rental rates on new leases, and recent news on this front is mildly encouraging. Redfin, a real estate listing service, publishes a rent tracker based on new leases. This measure started to accelerate in the spring of 2021, and these are the increases that have been feeding into the CPI. The pace of growth in asking rents started to slow late last year, offering hope that the pace of rent increases in the CPI at some point on the horizon will begin to ease.

Median National Asking Rent



Source: "Rental Market Tracker: Rents Are Growing Half as Fast as They Were Six Months Ago." Redfin, 13 Oct 2022, https://www.redfin.com/news/redfin-rental-report-september-2022/.

The news from Redfin in September was even more encouraging, as asking rents showed a dip rather than merely slower growth (chart).

Interestingly, another listing service (Apartment List) also maintains a rent index based on new leases, and it too showed a dip in September. The declines were small and could be the result of statistical noise rather than a fundamental shift. Also, even if the change represents a fundamental cooling rather than random volatility, it will take time to feed into the CPI. Thus, the rental component of CPI will continue to show pressure in the months ahead, but the medium term outlook is perhaps not dire.

Interesting Fed Quotes

The Federal Open Market Committee and market participants seem to be on different wave lengths when thinking about the duration of restrictive policy. The minutes from the September FOMC meeting indicated that officials planned to maintain a restrictive stance for an extended period, while many market participants expect the Fed to begin unwinding its restrictive stance next year.

The difference in outlooks, most likely, reflects contrasting views on progress in taming inflation and tolerance for rising unemployment. Market participants seem to believe that Fed officials will lose their nerve to restrain the economy when unemployment begins to increase. In addition, the inflation views of investors and traders have probably been shaped by the calm environment before the pandemic, which would lead them to be optimistic regarding the outlook.

Fed officials, in contrast, claim to be committed to reducing inflation and they seem to believe that returning to two percent inflation will require an increase in unemployment. (September minutes: “Participants judged that a softening in the labor market would be needed to ease upward pressures on wages and prices. Participants expected that the transition toward a softer labor market would be accompanied by an increase in the unemployment rate”.)

In addition, Fed officials most likely expect inflation to fall gradually. Fed Governor Christopher Waller noted in his latest speech that “inflation is far from the FOMC’s goal and not likely to fall quickly.” The potential for stickiness in inflation was even more evident in an interview granted by a former Fed official (Don Kohn, a member of the Board of Governors from 2002 to 2010). When asked by the *Washington Post* about the best case scenario, Mr. Kohn replied “Pressure comes off the labor markets pretty quickly, wage increases are lower and price increases are a lot lower, and this thing simmers down pretty quickly over the next couple years.” Quickly? Couple years? We doubt that market participants would view a “couple years” as a quick response; investors and traders seem to be expecting faster results.

However long it takes to corral inflation, a key issue is what set of economic variables will induce the Fed to begin reducing interest rates. That is, what rate of inflation or level of unemployment would induce rate cuts. Presumably, the Fed does not have to wait until inflation reaches two percent before it begins to pivot; as long as policymakers are confident that inflation is on a path to two percent, they can begin to back away from a restrictive stance.

Fed Governor Christopher Waller, in the same speech noted above, provided a clue on the inflation rate that would begin to ease his concern about price pressure, noting that three percent inflation would represent a meaningful improvement in his view. He stopped short of indicating that he would be willing to cut rates at that point, but it gives a sense of when he might start to think about a pivot.

Review

Week of Oct. 10, 2022	Actual	Consensus	Comments
PPI (September)	**0.4% Total, 0.3% Ex. Food & Energy**	**0.2% Total, 0.3% Ex. Food & Energy**	Energy prices at the producer level provided an upside surprise in September, jumping 0.7%, a contrast to market quotes that suggested a third consecutive decline. Food prices remained under pressure, registering an increase of 1.2%. The food component had shown hints of easing in recent months (declines of 0.1% in June and August), but surrounding months have shown hefty increases. Excluding food and energy, producer prices rose 0.3% for the third consecutive month, softer than the average of 0.4% in Q2 and well below the average of 0.9% in Q1. Prices of goods destined for export rose at slower paces than in other recent months; increases in services prices also have slowed, with advances averaging 0.3% in the past three months versus 0.6% in the first half of the year.
CPI (September)	**0.4% Total, 0.6% Core**	**0.2% Total, 0.4% Core**	Although energy prices fell 2.1%, food prices remained under pressure (up 0.8% in the past two months versus an average of 1.0% in the first seven months of the year). Core prices surged 0.6%, the fifth increase of 0.6% or more in the past six months. Services accounted for nearly all of the pressure in September, with several areas standing out: primary rents and owners' equivalent rent both rose 0.8% and costs of medical care services jumped 1.0%. With price increases carrying the day, the sharp month-to-month advance in the core translated to a year-over-year surge to 6.6%, up from 6.3% in August and a new high for the current cycle.
Retail Sales (September)	**0.0% Total, 0.1% Ex. Autos**	**0.2% Total, -0.1% Ex. Autos**	The auto component of the retail sales report dipped in September, despite a pickup in new vehicle sales reported by auto manufacturers. Activity at gasoline service stations declined for the third consecutive month in September (off 1.4%), but the change likely reflected lower prices rather than a drop in real outlays (the gasoline component of the CPI fell 4.9% in September). Sales excluding autos and gasoline rose 0.3% from an upward revised reading in August. The results showed that consumers are still spending in discretionary areas (general merchandise stores, clothing stores, restaurants), although outlays in most categories were probably light or down after adjusting for inflation (the core CPI rose 0.6%).
Consumer Sentiment (October)	**59.8 (+2.0%)**	**58.8 (+0.3%)**	Consumer Sentiment rose for the fourth consecutive month in October, but the increases occurred from a record low reading in June, and thus the level of the index remained in the low end of its historical range. Rapid inflation for household essentials (utilities, food, medical care) and increased chatter about recession are likely weighing on attitudes. The long-term gauge of inflation expectations released with the survey increased two ticks to 2.9% in October, a reading in the middle of the 2021-22 range (2.7% to 3.1%).

Sources: Bureau of Labor Statistics (PPI, CPI); U.S. Census Bureau (Retail Sales); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Oct. 17, 2022	Projected	Comments
Industrial Production (September) (Tuesday)	**0.2%**	A pickup in hiring and a longer factory workweek suggest an increase in the manufacturing component of industrial production in September. The drop in the price of crude oil since June could discourage mining activity. Utility output should be little changed because weather conditions did not change appreciably from month-to-month.
Housing Starts (September) (Wednesday)	**1.500 Million (-4.8%)**	Single-family housing starts could be little changed at a low level in September after builders cut starts in five of the past six months in an attempt to control elevated inventories. Multi-family activity has been well maintained as elevated home prices and high interest rates have shifted demand toward rental units, but activity was unusually strong in August (up 28% to a new cyclical high), opening a door to a correction in September.
Existing Home Sales (September) (Thursday)	**4.75 Million (-1.0%)**	A continued surge in mortgage interest rates suggests additional easing in existing home sales in September after declines in the past seven months, a view supported by weakness in mortgage applications for home purchases and pending home sales.
Leading Indicators (September) (Thursday)	**-0.3%**	Negative contributions from stock prices, consumer expectations, and the ISM new orders index are likely to offset positive contributions from initial claims for unemployment insurance and the slope of the yield curve, raising the possibility of the seventh consecutive decline in the index of leading economic indicators. The projected result for September would leave the measure 3.0% below the cyclical peak in February.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

October / November 2022

Monday	Tuesday	Wednesday	Thursday	Friday
10	11	12	13	14
COLUMBUS DAY	**NFIB SMALL BUSINESS OPTIMISM INDEX** July 89.9 Aug 91.8 Sep 92.1	**PPI** Final Demand / Ex. Food & Energy July -0.4% 0.3% Aug -0.2% 0.3% Sep 0.4% 0.3% **FOMC MINUTES**	**UNEMP. CLAIMS** Initial / Continuing (millions) Sep 17 0.209 1.346 Sep 24 0.190 1.365 Oct 1 0.219 1.368 Oct 8 0.228 N/A **CPI** Total / Core July 0.0% 0.3% Aug 0.1% 0.6% Sep 0.4% 0.6%	**RETAIL SALES** Total / Ex.Autos July -0.4% -0.1% Aug 0.4% -0.1% Sep 0.0% 0.1% **IMPORT/EXPORT PRICES** Non-Petrol Imports / Nonagri. Exports July -0.6% -3.8% Aug -0.2% -1.8% Sep -0.5% -0.9% **BUSINESS INVENTORIES** Inventories / Sales June 1.4% 1.2% July 0.5% -1.0% Aug 0.8% 0.3% **CONSUMER SENTIMENT** Aug 58.2 Sep 58.6 Oct 59.8
17	18	19	20	21
EMPIRE MFG (8:30) Aug -31.3 Sep -1.5 Oct -- **FEDERAL BUDGET (ONE DAY THIS WEEK)** 2022 / 2021 July -\$211.1B -\$302.1B Aug -\$219.6B -\$170.6B **Sep -\$430.0B** -\$64.9B	**IP & CAP-U (9:15)** IP / Cap.Util. July 0.5% 80.2% Aug -0.2% 80.0% **Sep 0.2% 80.0%** **NAHB HOUSING INDEX (10:00)** Aug 49 Sep 46 Oct -- **TIC FLOWS (4:00)** Long-Term / Total June \$121.8B \$22.3B July \$21.4B \$153.5B Aug -- --	**HOUSING STARTS (8:30)** July 1.404 million Aug 1.575 million **Sep 1.500 million** **BEIGE BOOK (2:00)** **Sept. Beige Book** Economic activity was unchanged, on balance, since early July, with five Districts reporting slight to modest growth in activity and five others reporting slight to modest softening.	**UNEMP. CLAIMS (8:30)** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Aug 6.2 Sep -9.9 Oct -- **EXISTING HOME SALES (10:00)** July 4.82 million Aug 4.80 million **Sep 4.75 million** **LEADING INDICATORS (10:00)** July -0.5% Aug -0.3% **Sep -0.3%**	
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **S&P CORELOGIC HOME PRICE INDEX** **CONSUMER CONFIDENCE**	**INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **NEW HOME SALES**	**UNEMP. CLAIMS** **Q3 GDP** **DURABLE GOODS ORDERS**	**PERSONAL INCOME, CONSUMPTION, PRICES** **EMP. COST INDEX** **REVISED CONSUMER SENTIMENT** **PENDING HOME SALES**
31	1	2	3	4
MNI CHICAGO BUSINESS BAROMETER	**JOLTS** **ISM MANUFACTURING** **CONSTRUCTION** **VEHICLE SALES** **FOMC (1ST DAY)**	**ADP EMPLOYMENT** **FOMC DECISION**	**UNEMP. CLAIMS** **INTERNATIONAL TRADE** **Q3 PRODUCTIVITY** **ISM SERVICES** **FACTORY ORDERS**	**EMPLOYMENT REPORT**

Forecasts in Bold.

Treasury Financing

October / November 2022

Monday	Tuesday	Wednesday	Thursday	Friday
10	11	12	13	14
COLUMBUS DAY	**AUCTION RESULTS:** Rate Cover 13-week bills 3.510% 2.39 26-week bills 4.030% 2.86 3-year notes 4.318% 2.57 **ANOUNCE:** $60 billion 4-week bills for auction on Oct 13 $50 billion 8-week bills for auction on Oct 13 $33 billion 17-week CMBs for auction on Oct 12 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-wk CMBs 3.890% 3.23 10-yr notes 3.930% 2.34	**AUCTION RESULTS:** Rate Cover 4-week bills 3.250% 2.50 8-week bills 3.480% 2.48 30-yr bonds 3.930% 2.39 **ANNOUNCE:** $102 billion 13-,26-week bills for auction on Oct 17 $12 billion 20-year bonds for auction on Oct 19 $21 billion 5-year TIPS for action on Oct 20 **SETTLE:** $102 billion 13-,26-week bills	
17	18	19	20	21
AUCTION: $102 billion 13-,26-week bills **SETTLE:** $40 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds	**ANNOUNCE** $60 billion* 4-week bills for auction on Oct 20 $50 billion* 8-week bills for auction on Oct 20 $33 billion* 17-week bills for auction on Oct 19 **SETTLE:** $60 billion 4-week bills $50 billion 8-week bills $33 billion 17-week CMBs	**AUCTION:** $33 billion* 17-week bills $12 billion 20-year bonds	**AUCTION:** $60 billion* 4-week bills $50 billion* 8-week bills $21 billion 5-year TIPS **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Oct 24 $42 billion* 2-year notes for auction on Oct 25 $43 billion* 5-year notes for auction on Oct 26 $35 billion* 7-year notes for auction on Oct 27 $24 billion* 2-year FRNs for auction on Oct 26 **SETTLE:** $102 billion 13-,26-week bills	
24	25	26	27	28
AUCTION: $102 billion* 13-,26-week bills	**AUCTION:** $42 billion* 2-year notes **ANNOUNCE:** $60 billion* 4-week bills for auction on Oct 27 $50 billion* 8-week bills for auction on Oct 27 $33 billion* 17-week bills for auction on Oct 26 **SETTLE:** $60 billion* 4-week bills $50 billion* 8-week bills $33 billion* 17-week CMBs	**AUCTION:** $33 billion* 17-week bills $43 billion* 5-year notes $24 billion* 2-year FRNs	**AUCTION:** $60 billion* 4-week bills $50 billion* 8-week bills $35 billion* 7-year notes **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Oct 31 $34 billion* 52-week bills for auction on Nov 1 **SETTLE:** $102 billion* 13-,26-week bills	
31	1	2	3	4
AUCTION: $102 billion* 13-,26-week bills **SETTLE:** $12 billion 20-year bonds $21 billion 5-year TIPS $42 billion* 2-year notes $43 billion* 5-year notes $35 billion* 7-year notes $24 billion* 2-year FRNs	**AUCTION:** $34 billion* 52-week bills **ANNOUNCE:** $60 billion* 4-week bills for auction on Nov 3 $50 billion* 8-week bills for auction on Nov 3 $33 billion* 17-week bills for auction on Nov 2 **SETTLE:** $60 billion* 4-week bills $50 billion* 8-week bills $33 billion* 17-week bills	**AUCTION:** $33 billion* 17-week bills **ANNOUNCE:** $40 billion* 3-year notes for auction on Nov 8 $35 billion* 10-year notes for auction on Nov 9 $21 billion* 30-year bonds for auction on Nov 10	**AUCTION:** $60 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Nov 7 **SETTLE:** $102 billion* 13-,26-week bills $34 billion* 52-week bills	

*Estimate