U.S. Economic Comment

- Consumer prices: some encouraging news, but still some concerns
- Probably a slower pace of tightening, but the Fed is most likely not done
- The outlook for rents: favorable (maybe)

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The CPI

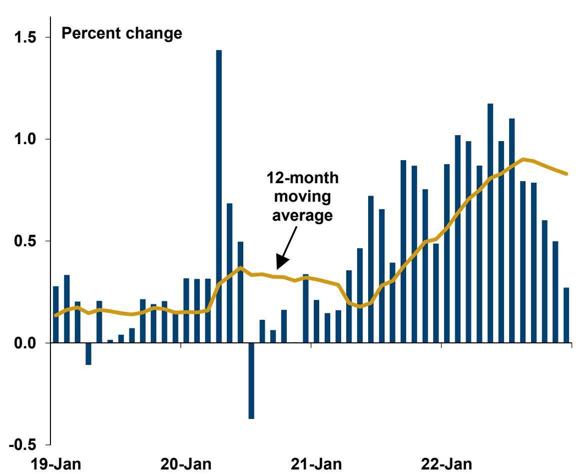
We saw some encouraging news in the latest report on consumer prices, but we also feel that it is easy to overstate the degree of improvement in inflation. The latest results will most likely lead the Federal Reserve to step back to a shift of 25 basis points on February 1, but the report on consumer prices was not favorable enough to suggest that inflation has been subdued. Additional rate hikes will probably be needed in the spring and summer, and we suspect that officials will stick with changes of 25 basis points. With a slower pace of tightening in place, we would scale back our view of the terminal rate from 5.625 percent to 5.125 percent.

We were most impressed with the food component of the CPI, which rose 0.3 percent in December. This pace is still not consistent with a two percent annual inflation rate, but the deceleration in recent months has been striking (chart, left). After averaging increases of 1.0 percent in the first nine months of the year, monthly increases were halved in October and November before backing off to 0.3 percent in the final month of the year. Given the pronounced slowing, it seems safe to conclude that food-related inflation is easing.

The drop in energy prices also was notable (off 4.5 percent, influenced by a drop of 9.4 percent in the price of gasoline). We are less excited about this shift than we are for the one in food because developments and trends in energy can change abruptly; energy prices could easily be increasing in the months ahead.

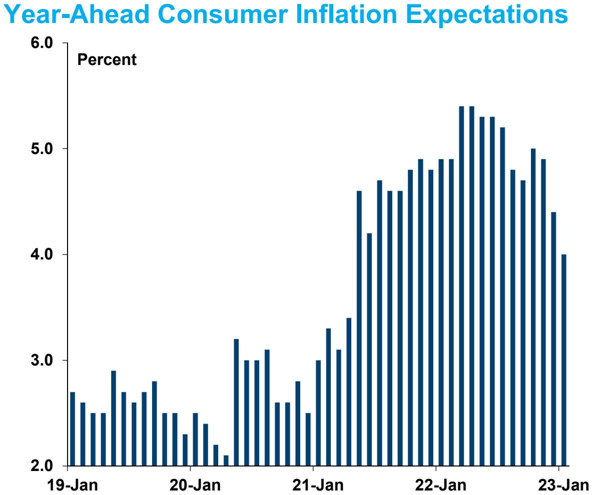
Still, we are heartened by the change in energy because of the potential influence on inflation expectations. Many individuals make purchases of energy products every week, and these expenditures no doubt have a strong influence on near-term inflation expectations. The combined shifts in food and energy are likely to temper expectations for inflation in the year or two ahead, which should prevent expectations of rapid inflation from creeping into longer horizons. In this regard, the University of Michigan survey of consumers showed a drop in year-ahead inflation to its slowest rate since the spring of 2021 (chart, right).

CPI: Food



Source: Bureau of Labor Statistics via Haver Analytics

Year-Ahead Consumer Inflation Expectations



Sources: University of Michigan Survey Research Center via Haver Analytics

We found several other elements of the inflation report encouraging. The goods component was highly favorable, with prices excluding food and energy falling 0.3 percent in December and marking the third consecutive month of lower prices. For the fourth quarter, prices of core goods fell at an annual rate of 2.7 percent.

Prices of services other than energy seemed problematic with an increase of 0.5 percent in December, a reading in the middle of the elevated range of the past year. However, much of the pressure in the service sector was the result of another hefty increase in rents (up 0.8 percent for both rent of primary residence and owners' equivalent rent). Prices of core services excluding rents were less troubling, with our calculations showing an increases of 0.3 percent in December and 0.1 percent in November, much improved from the average of 0.6 percent in the first 10 months of the year.

These developments certainly were favorable, but they should be interpreted cautiously. The restraint to a large degree was led by large changes in a few items, where the shifts might be viewed as the result of random volatility or special factors. Thus, the restraint might be fleeting.

In the goods sector, the core index has been heavily influenced by a collapse in the prices of used cars and trucks, which have declined in nine of the past 11 months. The retreat reflects an unwinding of a surge that began with the onset of the pandemic, when resistance to public transportation led to an increase in the demand for vehicles. The decline of 2.5 percent in the prices of used cars and light trucks in December was joined by similar-sized shifts in October and November, which left a decline of 21.4 percent (annual rate) in Q4. Excluding the restraint from the prices of used vehicles, core goods prices rose 0.1 percent in December and they increased at an annual rate of 2.0 percent in Q4, a decidedly different picture than the reported declines in core goods prices.

Prices of core services other than rents, a gauge now being monitored closely by Fed officials, cooled sharply in November and December, but here too restraint was concentrated in a limited number of items. Airfares stood out with a drop of approximately 3.0 percent in both November and December. In addition, health insurance premiums have posted surprising declines in the past three months (off 3.4 percent in December and down 4.3 and 4.0 percent in the prior two months).

We discount heavily the retreat in airfares because this item is highly volatile. The recent declines could be viewed as offsets to sharp increases in the spring -- that is, normal volatility. We also are dubious about the drop in health insurance premiums. This component of the CPI is a "constructed" series based on the difference between receipts and benefits paid by health insurers; the Bureau of Labor Statistics does not collect figures on premiums actually paid by individuals or employers. In our view, it is not clear what is happening to health insurance premiums, but we doubt they are dropping as rapidly as suggested by the CPI.

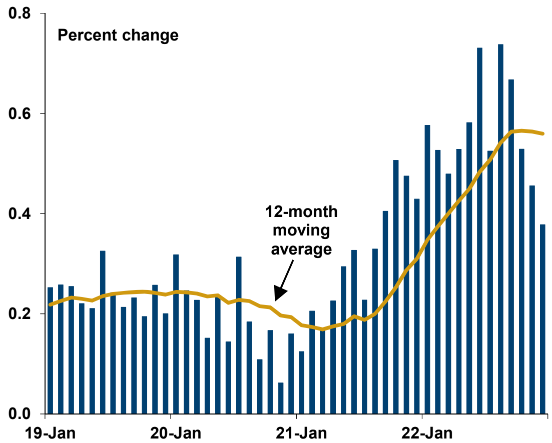
Underlying Inflation

The above micro view of various components of the CPI suggests that conclusions should be guarded, so too does a focus on measures of underlying inflation.

We view the median CPI constructed by the Federal Reserve Bank of Cleveland as a valuable indicator. This measure shows the change in the price of the single item in the middle of the distribution of price changes. That is, items with smaller price changes represent 50 percent (or thereabout) of the index, and items with larger price changes represent the other 50 percent (or thereabout). This measure has the advantage of excluding large changes that reflect special factors or random volatility.

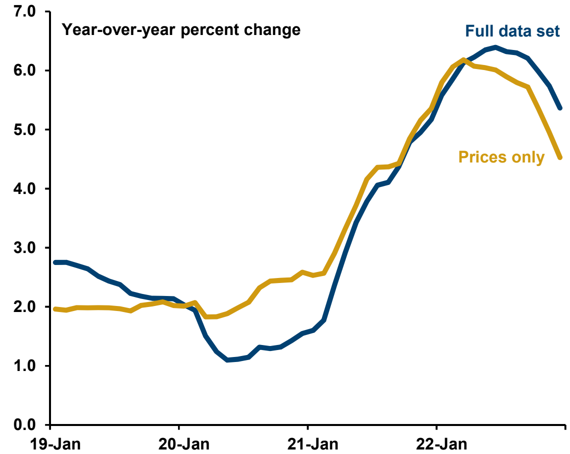
This median index rose 0.4 percent in December, a pace slower than those earlier in the year (chart; next page, left). The easing in the rate of median inflation shows that progress is underway, but the magnitude of recent changes is still notably above a pace that would generate two percent annual inflation.

Median CPI



Source: Federal Reserve Bank of Cleveland via Haver Analytics

Underlying Inflation Gauge



Sources: Federal Reserve Bank of New York via Haver Analytics

The Federal Reserve Bank of New York has constructed two series on underlying inflation -- one based on prices alone and another based on both prices and prospects for economic activity. Both indexes have decelerated recently, suggesting improvement in the price environment (chart, above right). However these indexes, like the median CPI, show that inflation remains much faster than desired.

Prospects for Rents

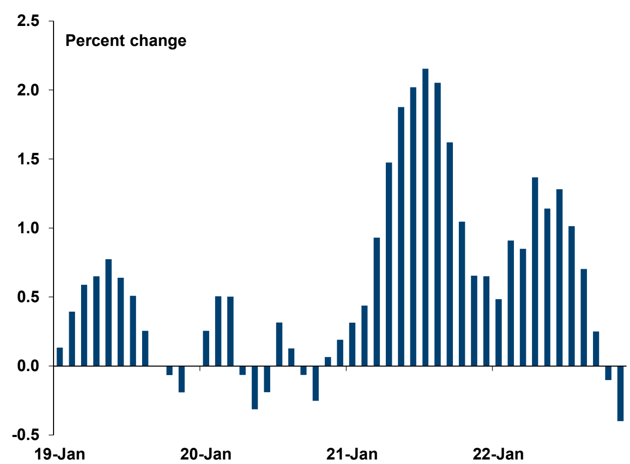
Rental rates for homes and apartments are the most important factor driving service-sector inflation, and many observers expect this component to ease later this year because offering rates on new leases have shown notable cooling. As existing leases roll into new contracts, the rental components of the CPI and the PCE price index should cool. Of course, there will be a lag in the process and a gradual deceleration during the rollover period, but prospects for slower rental inflation seem favorable. However, we have two concerns.

First, in viewing quotes on new leases, many observers are probably examining not seasonally adjusted data, and there is a clear tendency for rental rates to soften in the closing months of the year. (The chart below based on data from Zillow shows consistent declines late in the calendar year.)

We would still expect some moderation in rents, as recent softness seems slower than normal. Indeed, Zillow also has a seasonally adjusted series, and it has shown noticeable deceleration over the past several months and only a modest increase in December.

Our second concern relates to the gap between the cost of owning a home and renting. The surge in home prices over the past two years has made owning more expensive than renting, which led many individuals to favor renting and helped to fuel the surge in rents. Housing prices have softened recently, which would narrow the gap between the cost of owning and renting all else equal, but the increase in mortgage rates has probably offset the effect of lower prices. Thus, renting still has a cost advantage and demand for rental units could revive once the seasonal slowdown in real estate activity ends. We might simply be in a resting period for rents.

Observed Rent Index*



** Not seasonally adjusted*
Source: Zillow via Haver Analytics

Review

Week of Jan. 9, 2023	Actual	Consensus	Comments
CPI (December)	**-0.1% Total, 0.3% Core**	**-0.1% Total, 0.3% Core**	A drop of 4.5% in the energy component led the decline in the CPI in December, with gasoline and fuel oil prices both easing noticeably. Food prices rose in the latest month, but the change totaled only 0.3% after increases of 0.5% and 0.6% percent in the prior two months and an average of 1.0% in the first nine months of the year. Prices excluding food and energy have now increased either 0.2% or 0.3% percent for three consecutive months, a noticeable improvement from the average of 0.5% in the first nine months of the year. All of the easing came in the goods sector, where prices fell for the third consecutive month; service prices remained under pressure, in part reflecting another jump in rents (both owners' equivalent rent and rent of primary residences). The year-over-year increase in the headline CPI slowed to 6.4% from 7.1% in November (and a recent high of 9.1% in June); the advance in the core moderated to 5.7% from 6.0% (and a recent high of 6.6% in September).
Federal Budget (December)	**$85.0 Billion Deficit**	**$65.0 Billion Deficit**	Federal revenues fell 6.5% on a year-over-year basis, with a drop in remittances by the Federal Reserve and a slowing in collections of income and employment taxes accounting for much of the decline. Brisk outlays also contributed to the budget shortfall, increasing 6.3% from the same month last year. The budget situation thus far in FY2023 has deteriorated from that last fiscal year, with the cumulative shortfall of $421.4 billion in the first three months of FY2023 approximately $44 billion wider than that in the same period in FY2022. The deterioration in the FY-Q1 deficit would have been $63 billion larger were it not for a calendar configuration that shifted some outlays scheduled for October into September (part of FY2022).
Consumer Sentiment (January)	**64.6 (+8.2%)**	**60.7 (+1.7%)**	Consumer sentiment increased for the second consecutive month in January, as a favorable shift in near-term inflation expectations likely outweighed concerns about recession in the minds of consumers. With regard to inflation, the year-ahead measure released with the U. Michigan report registered its third consecutive decline, easing from 5.0% in October to 4.0% in January. The long-term measure increased one tick to 3.0%, remaining within the range of the past year (2.7% to 3.1%).

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

Preview

Week of Jan. 16, 2023	Projected	Comments
Retail Sales (December) (Wednesday)	**-0.6% Total, -0.5% Ex. Autos**	A decline in sales of new vehicles is likely to constrain the auto component of retail activity in December, and lower petroleum prices could depress the value of sales at gasoline service stations. In other areas, cautious behavior by consumers may have limited spending on non-essential items. In addition, severe winter storms in the second half of the month may have disrupted activity across categories.
PPI (December) (Wednesday)	**-0.2% Total, 0.2% Ex. Food & Energy**	Available quotes suggest that energy prices fell at the producer level for the second consecutive month in December. Food prices surged in early 2022 (average advance of 1.9% per month from January through April), and they were highly volatile in the following seven months, ranging from dips of 0.1% in June and August to a surge of 3.3% in November. A rapid reading in November raises the prospect of a cooling in food prices in December. Easing supply-chain backlogs and moderating demand seem to be containing pressure on prices excluding food and energy, which have averaged increases of 0.3% from June through November after an average of 0.7% in the first five months of the year.
Industrial Production (December) (Wednesday)	**-0.1%**	Data on employment and the average workweek in the factory sector raise the possibility of a decline in the manufacturing component of industrial production in December. The mining component could post better results than those for manufacturing, as a pickup in hiring and aggregate hours suggest an increase in output after back-to-back months of easing. Household heating usage amid colder temperatures could stir utility output, but the change could be modest given already heavy utility usage in November.
Housing Starts (December) (Thursday)	**1.400 Million (-1.9%)**	Elevated inventories of unsold new homes and sluggish demand suggest that builders could trim single-family starts in December, which would mark the 10th decline in the past 12 months and leave activity at the lowest level of the year. Multi-family starts have been well maintained, as a shift in preferences away from single-family units has spurred demand for rental housing.
Existing Home Sales (December) (Friday)	**4.00 Million (-2.2%)**	Mortgage rates in the upper-6% area raise the prospect of the 10th consecutive decline in existing home sales, a view supported by weakness in pending sales of existing homes.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2023

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
CONSUMER CREDIT Sep $25.3 billion Oct $29.1 billion Nov $28.0 billion	**NFIB SMALL BUSINESS OPTIMISM INDEX** Oct 91.3 Nov 91.9 Dec 89.8 **WHOLESALE TRADE** Inventories / Sales Sep 0.6% 0.1% Oct 0.6% 0.0% Nov 1.0% -0.6%		**UNEMP. CLAIMS** Initial / Continuing (millions) Dec 17 0.216 1.718 Dec 24 0.223 1.697 Dec 31 0.206 1.634 Jan 7 0.205 N/A **CPI** Total / Core Oct 0.4% 0.3% Nov 0.1% 0.2% Dec -0.1% 0.3% **FEDERAL BUDGET** 2022 / 2021 Oct -$87.9B -$165.1B Nov -$248.5B -$191.3B Dec -$85.0B -$21.3B	**IMPORT/EXPORT PRICES** Non-petrol. Imports / Nonagri. Exports Oct -0.2% -0.5% Nov -0.3% -0.7% Dec 0.8% -2.7% **CONSUMER SENTIMENT** Nov 56.8 Dec 59.7 Jan 64.6
16	17	18	19	20
MARTIN LUTHER KING JR. DAY	**EMPIRE MFG (8:30)** Nov 4.5 Dec -11.2 Jan --	**RETAIL SALES (8:30)** Total / Ex.Autos Oct 1.3% 1.2% Nov -0.6% -0.2% **Dec -0.6% -0.5%** **PPI (8:30)** Final Demand / Ex. Food & Energy Oct 0.3% 0.1% Nov 0.3% 0.4% **Dec -0.2% 0.2%** **IP & CAP-U (9:15)** IP / Cap.Util. Oct -0.1% 79.9% Nov -0.2% 79.7% **Dec -0.1% 79.5%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Sep 0.2% 0.0% Oct 0.2% 0.5% **Nov 0.4% -0.7%** **NAHB HOUSING INDEX (10:00)** Nov 33 Dec 31 Jan -- **BEIGE BOOK (2:00)** **Nov. 2022 Beige Book** "Economic activity was about flat or up slightly since the previous report, down from the modest average pace of growth in the prior Beige Book period." **TIC FLOWS (4:00)**	**UNEMP. CLAIMS (8:30)** **HOUSING STARTS (8:30)** Oct 1.434 million Nov 1.427 million **Dec 1.400 million** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Nov -19.4 Dec -13.8 Jan --	**EXISTING HOME SALES (10:00)** Oct 4.43 million Nov 4.09 million **Dec 4.00 million**
23	24	25	26	27
LEADING ECONOMIC INDICATORS			**UNEMP. CLAIMS** **Q4 GDP** **INTERNATIONAL TRADE IN GOODS** **DURABLE GOODS ORDERS** **ADVANCE INVENTORIES** **CHICAGO FED NATIONAL ACTIVITY INDEX** **NEW HOME SALES**	**PERSONAL INCOME, CONSUMPTION, PRICES** **PENDING HOME SALES** **CONSUMER SENTIMENT**
30	31	1	2	3
	EMP. COST INDEX **FHFA HOME PRICE INDEX** **CASE-SHILLER HOME PRICE INDEX** **MNI CHICAGO BUSINESS BAROMETER** **CONSUMER CONFIDENCE** **FOMC (1ST DAY)**	**ADP EMP. REPORT** **JOLTS** **ISM MFG. INDEX** **CONSTRUCTION** **VEHICLE SALES** **FOMC DECISION**	**UNEMP. CLAIMS** **PRODUCTIVITY & COSTS** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **ISM SERVICES INDEX**

Forecasts in Bold.

Treasury Financing

January/February 2023

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
AUCTION RESULTS: Rate Cover 13-week bills 4.560% 2.61 26-week bills 4.710% 2.48	**AUCTION RESULTS:** Rate Cover 3-year notes 3.977% 2.84 **ANNOUNCE:** $60 billion 4-week bills for auction on Jan 12 $55 billion 8-week bills for auction on Jan 12 $36 billion 17-week bills for auction on Jan 11 $60 billion 35-day CMB for auction on Jan 12 **SETTLE:** $45 billion 4-week bills $45 billion 8-week bills $33 billion 17-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 4.680% 2.79 10-yr notes 3.575% 2.53	**AUCTION RESULTS:** Rate Cover 4-week bills 4.370% 2.76 8-week bills 4.465% 2.73 30-yr bonds 3.585% 2.45 35-day CMB 4.490% 2.45 **ANNOUNCE:** $108 billion 13-,26-week bills for auction on Jan 17 $12 billion 20-year bonds for auction on Jan 18 $17 billion 10-year TIPS for auction on Jan 19 **SETTLE:** $105 billion 13-,26-week bills	
16	17	18	19	20
MARTIN LUTHER KING JR. DAY	**AUCTION:** $108 billion 13,26-week bills **ANNOUNCE:** $60 billion* 4-week bills for auction on Jan 19 $55 billion* 8-week bills for auction on Jan 19 $36 billion* 17-week bills for auction on Jan 18 **SETTLE:** $60 billion 4-week bills $55 billion 8-week bills $36 billion 17-week bills $40 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds	**AUCTION:** $36 billion* 17-week bills $12 billion 20-year bonds	**AUCTION:** $60 billion* 4-week bills $55 billion* 8-week bills $17 billion 10-year TIPS **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Jan 23 $34 billion* 52-week bills for auction on Jan 24 $24 billion* 2-year FRNs for auction on Jan 25 $42 billion* 2-year notes for auction on Jan 24 $43 billion* 5-year notes for auction on Jan 25 $35 billion* 7-year notes for auction on Jan 26 **SETTLE:** $108 billion 13-,26-wk bills $60 billion 35-day CMB	
23	24	25	26	27
AUCTION: $108 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills $42 billion* 2-year notes **ANNOUNCE:** $60 billion* 4-week bills for auction on Jan 26 $55 billion* 8-week bills for auction on Jan 26 $36 billion* 17-week bills for auction on Jan 25 **SETTLE:** $60 billion* 4-week bills $55 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $24 billion* 2-year FRNs $43 billion* 5-year notes	**AUCTION:** $60 billion* 4-week bills $55 billion* 8-week bills $35 billion* 7-year notes **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Jan 30 **SETTLE:** $108 billion* 13-,26-wk bills $34 billion* 52-wk bills	
30	31	1	2	3
AUCTION: $108 billion* 13-,26-week bills	**ANNOUNCE:** $60 billion* 4-week bills for auction on Feb 2 $55 billion* 8-week bills for auction on Feb 2 $36 billion* 17-week bills for auction on Feb 1 **SETTLE:** $60 billion* 4-week bills $55 billion* 8-week bills $36 billion* 17-week bills 12 billion 20-year bonds $17 billion 10-year TIPS $42 billion* 2-year notes $43 billion* 5-year notes $35 billion* 7-year notes $24 billion* 2-year FRNs	**AUCTION:** $36 billion* 17-week bills **ANNOUNCE:** $40 billion* 3-year notes for auction on Feb 7 $35 billion* 10-year notes for auction on Feb 8 $21 billion* 30-year bonds for auction on Feb 9	**AUCTION:** $60 billion* 4-week bills $55 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 6 **SETTLE:** $108 billion* 13-,26-week bills	

*Estimate