U.S. Economic Comment

- Consumer prices: numerous "transitory" changes; still-brisk underlying pace
- Will slow money growth tame inflation?

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CPI: Separating Signal from Noise

Market commentators in the past year have been avoiding the term "transitory" when discussing inflation, not wanting to relive embarrassing analyses from 2021. However, temporary factors often creep into monthly price reports, and such influences should be discounted when assessing the outlook for inflation. The January report on consumer prices, in our view, contained numerous shifts (some up, others down) that are likely to be short-lived, and thus they complicate the analysis of the CPI. Consider the following:

Hotel fees, often a noisy component of the CPI, jumped 1.4 percent in January. The increase marked the third sizeable increase in the past four months, but the shifts merely offset soft readings during the summer and left little change from a longer-term perspective.

Apparel prices, another volatile area, broke out of their sideways movement in the prior six months with an increase of 0.8 percent; perhaps normal volatility.

Rents remained under pressure (up 0.7 percent), but many analysts expect the rate of advance to slow in coming months.

Prices of prescription drugs, after modest ups and downs in most months of 2022, surged 2.1 percent, marking the sharpest monthly increase in the history of the series (records back to 1969). A puzzle.

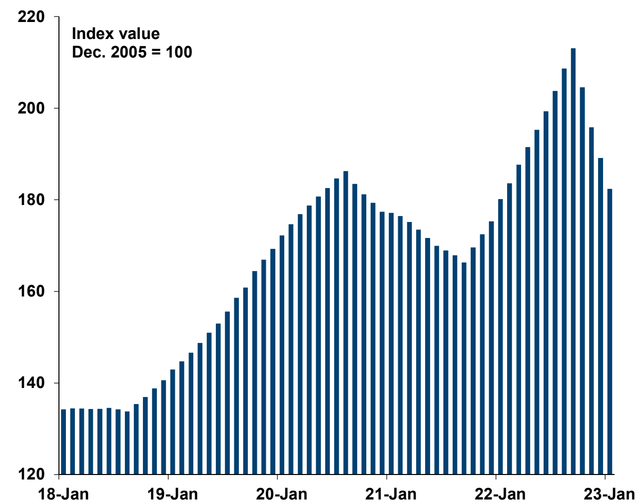
The January report also contained considerable noise on the downside:

Prices of used motor vehicles fell 1.9 percent, continuing the downward trend that began early last year after the explosion in prices in late 2020 and most of 2021. This movement is more the result of unique circumstances in the auto sector rather than macroeconomic developments.

Airfares (off 2.1 percent), fell for the seventh time in the past eight months, continuing to unwind a spike in charges last spring.

The cost of health insurance dropped 3.6 percent, marking the fourth consecutive pronounced decline after a sharp upward trend in the 12 months before the recent soft patch (chart; the chart shows the level of the index rather than the percent change).

CPI: Health Insurance*



** Not seasonally adjusted.*
Source: Bureau of Labor Statistics via Haver Analytics

We wonder about the drop in health insurance premiums because results are not based on payments made by individuals or employers offering health plans. Rather, the figures are derived from the retained earnings of health insurers (it's complicated). The smooth pattern in the chart suggests that a good bit of judgment enters into the estimate. The analysts at the Bureau of Labor Statistics most likely capture broad swings in insurance premiums, but we are skeptical about the accuracy of month-to month changes. Misestimates could be consequential, as changes in recent months, given the relative importance of this component, subtracted nearly 0.1 percentage point from the monthly change in the headline and core CPI.

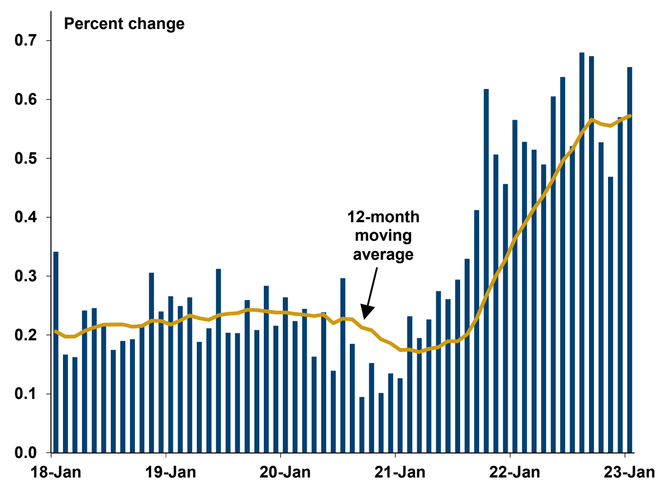
With marked price changes on both the high-side and low-side, and with many of the shifts likely to be transitory, the underlying pace of inflation is not perfectly clear. Some method to separate signal from noise is needed. The core CPI falls short of this need. This measure eliminates the volatility from food and energy, but as noted above, a good bit of noise remains. Even the new grouping favored by Fed officials (core service prices excluding shelter costs) is suboptimal because of temporary influences.

We like trimmed-mean indexes because most of the extreme (and likely temporary) influences will be eliminated. The trimmed-mean CPI calculated by the Federal Reserve Bank of Cleveland rose 0.57 percent in January, a reading in the middle of the range from the past year.

The weighted median CPI (also from the Cleveland Fed) is an even better measure. This index focuses on the single item in the CPI that divides the price distribution in half. As constructed, noisy elements are eliminated, leaving one with a clear view of the underlying trend. This measure rose 0.65 percent in January, a reading in the upper portion of the recent range. The 12-month moving average has been essentially steady since last September, signaling little shift in underlying inflation (chart).

The Federal Reserve Bank of New York has constructed an index of underlying inflation using a statistical technique that extracts co-movements among a group of variables, in this case 215 components of the CPI. Items with extreme price changes will be included in the estimation, but by extracting common movements, noise presumably will be lessened or eliminated. This index has decelerated, moving from peak annual inflation of 6.1 percent in March 2022 to 4.2 percent in January -- improvement, but still a brisk pace.

Median CPI



Source: Federal Reserve Bank of Cleveland via Haver Analytics

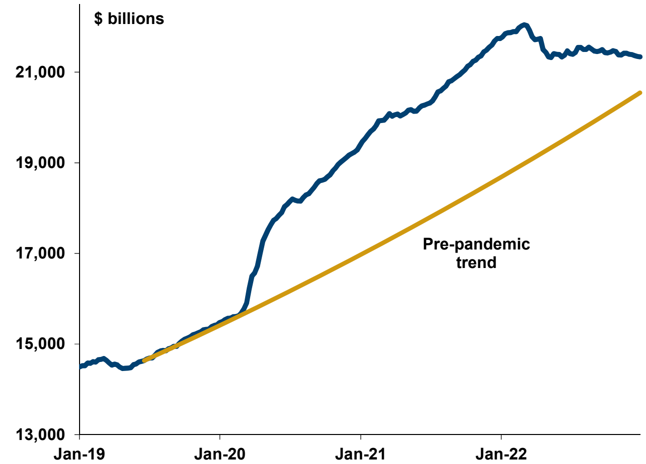
Money Growth and Inflation

John Greenwood and Steve H. Hanke, both associated with Johns Hopkins University, published an editorial in the *Wall Street Journal* on February 15 arguing that inflation would soon recede because of notable slowing in the growth of the money supply. They highlighted their accurate prediction of rapid inflation last year because of strong money growth in 2020 and 2021, and they now posit that a decline in M2 of 3.3 percent (annual rate) in the past nine months will eliminate inflation as an issue.

We are fully on board with the powerful role of monetary policy in driving inflation, but we are skeptical of the money supply rationale. Like many economic and financial variables, the money supply has been influenced by pandemic-related developments. M2 surged in 2020 and 2021 because of easy monetary policy and the flood of fiscal support provided by Congress. With the Fed now tightening and with Covid-related support largely over, trends have shifted.

The implications for the economy, though, are not clear. In measuring money growth and assessing its effect, one should ask: relative to what? Compared to the peak in March 2022, money has certainly weakened. However, M2 is still above an extrapolation of the pre-pandemic trend (chart). One might argue that there is still "excess" money in the system. That is, there is perhaps some residual stimulus from aggressive steps taken to combat the effects of Covid. Despite the recent softening in M2, it might not be restrictive enough to push inflation back to target.

Money Supply (M2)



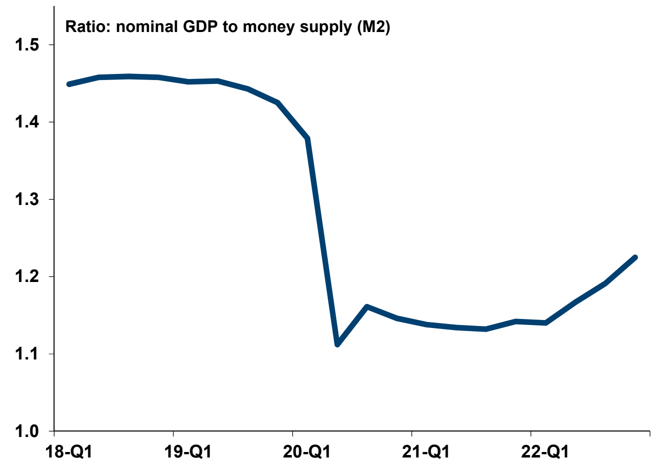
Sources: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

The uncertainty associated with the effect of M2 can also be seen by tracking the movement of the velocity of money over the past few years. (Velocity is the rate of turnover in the money supply; it is measured as the ratio of nominal GDP to the money supply. Changes in velocity will influence the economy as much as changes in the quantity of money will.)

Interestingly, velocity plummeted during the worst of the pandemic and the early portion of the recovery. This is not surprising. With individuals locked down because of the pandemic, a large share of the stimulus checks and unemployment benefits received by individuals sat idle in deposit accounts or other investment vehicles. Given weak velocity, the increase in the money supply alone does not seem capable of explaining the surge in inflation. Fiscal stimulus was undoubtedly a factor, and supply chain problems played a role as well.

Note in the chart to the right that velocity has picked up in the past three quarters. The increase should dampen concern about the slowing in M2; weakness in M2 could be at least partially offset by a pickup in velocity. We do not mean to suggest that monetary policy is ineffective; our point is that M2 in isolation does not provide a clear view on the path of the economy or inflation. Both economic growth and inflation will be determined by numerous factors; analysts will be best served by maintaining a broad perspective.

Velocity of Money*



** The ratio of nominal GDP to money supply (M2).*

Sources: Bureau of Economic Analysis and Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Review

Week of Feb. 13, 2023	Actual	Consensus	Comments
CPI (January)	**0.5% Total, 0.4% Core**	**0.5% Total, 0.4% Core**	Energy prices rose 2.0%, marking only the second increase in the past seven months. The increase perhaps signaled the end of a soft patch in energy prices, but it was not forceful enough to indicate a major turning point. Food prices rose 0.5%, slower than the average of 1.0% in the first half of last year and 0.7% in the second half, but still an uncomfortable pace. The increase of 0.421% in the core component represented an improvement from the average of 0.525% in the first half of 2022, but it was nearly identical to the average of 0.418% in the second half of last year. Monthly changes in core prices have been stuck in a range of 0.3% to 0.7% since late 2021.
Retail Sales (January)	**3.0% Total, 2.3% Ex. Autos**	**2.0% Total, 0.9% Ex. Autos**	The surge in retail sales spanned all key categories in January, with activity at general merchandise stores (up 3.2%) and restaurants (+7.2%) standing out on the firm side. The jump in total sales followed two soft months, so the advance to a large degree represented the regaining of lost ground rather than an acceleration of the underlying trend. Still, the report was encouraging, as it suggested that the softness in November and December represented statistical noise rather than a fundamental softening.
Industrial Production (January)	**0.0%**	**0.5%**	The softness in industrial production in January was concentrated in the utility sector (off 9.9%), reflecting a shift from colder-than-normal temperatures in December to warmer-than-normal in January. More important, the manufacturing and mining components performed well, increasing 1.0% and 2.0%, respectively. The gain in manufacturing was broadly based, with 15 of the 20 major industry categories advancing. However, while the results for manufacturing and mining were firm in isolation, sharp downward revisions to data in prior months tempered the tone of the overall report.
PPI (January)	**0.7% Total, 0.5% Ex. Food & Energy**	**0.4% Total, 0.3% Ex. Food & Energy**	Food prices fell for the second consecutive month (off 1.0% after a decline of 0.9% in December), but the shifts only partially offset a surge of 3.3% in November, leaving a still-sharp upward trend. Energy prices at the producer level, which often swing widely, jumped 5.0% after plunging 8.7% in November and December combined. The increase in prices excluding food and energy was broadly based and suggested continued underlying price pressure: consumer goods prices jumped 0.7%, capital goods prices rose 0.8%, and services prices increased 0.4%.

Review Continued

Week of Feb. 13, 2023	Actual	Consensus	Comments
Housing Starts (January)	**1.309 Million (-4.5%)**	**1.356 Million (-1.9%)**	Both multi-family and single-family activity contributed to the drop in housing starts in January (off 4.9% and 4.3%, respectively). The decline in multi-family activity was perhaps the more notable of the changes. Multifamily starts had been a bright spot in the housing sector for much of the current expansion, with a drop in affordability in single-family housing pushing many potential buyers into the rental market. Multi-family starts have now fallen sharply in back-to-back months, moving from the top of the recent range to the middle, with the January level 23.5% below the November reading. Single-family housing starts continued on their sharp downward trend that began in early 2022. The latest reading remained in the bottom of the range of the current expansion.
Leading Indicators (January)	**-0.3%**	**-0.3%**	Negative contributions from the ISM new orders index, consumer expectations, and the slope of the yield curve contributed importantly to the overall decline in the index of leading economic indicators in January. The measure has now fallen for 10 consecutive months, with the cumulative drop leaving the level of the index 6.4% below the cyclical peak in December 2021.

Sources: Bureau of Labor Statistics (CPI, PPI); U.S. Census Bureau (Retail Sales, Housing Starts); Federal Reserve Board (Industrial Production); The Conference Board (Leading Indicators); Consensus forecasts are from Bloomberg

Preview

Week of Feb.20, 2023	Projected	Comments
Existing Home Sales (January) (Tuesday)	**4.10 Million (+2.0%)**	The drop in mortgage interest rates in the past few months likely injected some energy into the housing market. The expected increase in sales of existing homes would end a string of eleven consecutive declines that has pushed activity below the pandemic-related low in May 2020.
Revised GDP (2022-Q4) (Thursday)	**2.7% (-0.2 Pct. Pt. Revision)**	The growth of consumer spending is likely to be a touch softer than the initial estimate of 2.1%. A downward adjustment in inventory investment also should be a factor in nudging GDP growth lower.
Personal Income, Consumption, Core Price Index (January) (Friday)	**1.0%, 1.0%, 0.4%**	The strong employment results for January should lead to a brisk increase in wages and salaries, and transfer payments are likely to be robust as well, reflecting the large cost of living adjustment to Social Security benefits. On the spending side, strong sales of new motor vehicles should fuel consumption of durable goods, and robust retail activity suggests firm spending on nondurable goods. Results for the CPI suggest sharp increases in the personal consumption expenditure price indexes.
New Home Sales (January) (Friday)	**0.630 Million (+2.3%)**	Sales of new homes, which are based on contracts signed rather than closings, have already responded slightly to lower interest rates, with sales moving off the low registered last July. Activity was still light in December, and thus additional improvement is likely in January.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

February/March 2023

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17

Monday 13

Tuesday 14

NFIB SMALL BUSINESS OPTIMISM INDEX

Nov	91.9
Dec	89.8
Jan	90.3

CPI

	Total	Core
Nov	0.2%	0.3%
Dec	0.1%	0.4%
Jan	0.5%	0.4%

Wednesday 15

RETAIL SALES

	Total	Ex.Autos
Nov	-1.1%	-0.8%
Dec	-1.1%	-0.9%
Jan	3.0%	2.3%

EMPIRE MFG

Dec	-11.2
Jan	-32.9
Feb	-5.8

IP & CAP-U

	IP	Cap.Util.
Nov	-0.6%	79.3%
Dec	-1.0%	78.4%
Jan	0.0%	78.3%

BUSINESS INVENTORIES

	Inventories	Sales
Oct	0.2%	0.4%
Nov	0.3%	-1.2%
Dec	0.3%	-0.6%

NAHB HOUSING INDEX

Dec	31
Jan	35
Feb	42

TIC FLOWS

	Long-Term	Total
Oct	$67.8B	$179.0B
Nov	$171.5B	$213.4B
Dec	$152.8B	$28.6B

Thursday 16

UNEMP. CLAIMS

	Initial (millions)	Continuing
Jan 21	0.186	1.650
Jan 28	0.183	1.680
Feb 4	0.195	1.696
Feb 11	0.194	N/A

PPI

	Final Demand	Ex. Food & Energy
Nov	0.3%	0.3%
Dec	-0.2%	0.3%
Jan	0.7%	0.5%

HOUSING STARTS

Nov	1.419 million
Dec	1.371 million
Jan	1.309 million

PHILY FED MFG OUTLOOK

Dec	-13.7
Jan	-8.9
Feb	-24.3

Friday 17

IMPORT/EXPORT PRICES

	Non-petrol Imports	Nonagri. Exports
Nov	-0.3%	-0.9%
Dec	0.7%	-3.3%
Jan	0.2%	0.8%

LEADING INDICATORS

Nov	-0.9%
Dec	-0.8%
Jan	-0.3%

Monday	Tuesday	Wednesday	Thursday	Friday
20	21	22	23	24

Monday 20

PRESIDENTS' DAY HOLIDAY

Tuesday 21

EXISTING HOME SALES (10:00)

Nov	4.08 million
Dec	4.02 million
Jan	**4.10 million**

Wednesday 22

FOMC MINUTES (2:00)

Thursday 23

UNEMP. CLAIMS (8:30)

REVISED GDP (8:30)

	GDP	Chained Price
22-Q3	3.2%	4.4%
22-Q4(a)	2.9%	3.5%
22-Q4(p)	**2.7%**	**3.5%**

CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)

	Monthly	3-Mo. Avg.
Nov	-0.51	-0.14
Dec	-0.49	-0.33
Jan	--	--

Friday 24

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

	Inc.	Cons.	Core
Nov	0.3%	-0.1%	0.2%
Dec	0.2%	-0.2%	0.3%
Jan	**1.0%**	**1.0%**	**0.4%**

NEW HOME SALES (10:00)

Nov	0.602 million
Dec	0.616 million
Jan	**0.630 million**

REVISED CONSUMER SENTIMENT (10:00)

Dec	59.7
Jan	64.9
Feb(p)	66.4

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	1	2	3
DURABLE GOODS ORDERS **PENDING HOME SALES**	**GOODS TRADE BALANCE** **ADVANCED INVENTORIES** **FHFA HOME PRICE INDEX** **S&P CASE-SHILLER HOME PRICE INDEX** **MNI CHICAGO BUSINESS BAROMETER** **CONSUMER CONFIDENCE**	**ISM MFG. INDEX** **CONSTRUCTION** **NEW VEHICLE SALES**	**UNEMP. CLAIMS** **REVISED PRODUCTIVITY**	**ISM SERVICES INDEX**
6	7	8	9	10
FACTORY ORDERS	**WHOLESALE TRADE** **CONSUMER CREDIT**	**ADP EMPLOYMENT** **INTERNATIONAL TRADE** **JOLTS** **BEIGE BOOK**	**UNEMP. CLAIMS**	**EMPLOYMENT REPORT** **FEDERAL BUDGET**

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

Treasury Financing

February/March 2023

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
AUCTION RESULTS: Rate Cover 13-week bills 4.680% 2.60 26-week bills 4.840% 2.54	**AUCTION RESULTS:** Rate Cover 12-day CMBs 4.540% 3.79 **ANNOUNCE:** $75 billion 4-week bills for auction on Feb 16 $60 billion 8-week bills for auction on Feb 16 $36 billion 17-week bills for auction on Feb 15 **SETTLE:** $75 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 4.800% 2.93 20-yr bonds 3.977% 2.54 **SETTLE:** $40 billion 3-year notes $35 billion 10-year notes $21 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 4-week bills 4.510% 2.77 8-week bills 4.650% 2.51 30-yr TIPS 1.550% 2.38 **ANNOUNCE:** $108 billion 13-,26-week bills for auction on Feb 21 $34 billion 52-week bonds for auction on Feb 21 $42 billion 2-year notes for auction on Feb 21 $43 billion 5-year notes for auction on Feb 22 $35 billion 7-year notes for auction on Feb 23 $22 billion 2-year FRNs for auction on Feb 22 **SETTLE:** $108 billion 13-,26-wk bills $25 billion 12-day CMBs	
20	21	22	23	24
PRESIDENTS' DAY HOLIDAY	**AUCTION:** $108 billion 13,26-week bills $34 billion 52-week bills $42 billion 2-year notes **ANNOUNCE:** $75 billion* 4-week bills for auction on Feb 23 $60 billion* 8-week bills for auction on Feb 23 $36 billion* 17-week bills for auction on Feb 22 **SETTLE:** $75 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills	**AUCTION:** $36 billion* 17-week bills $43 billion 5-year-notes $22 billion 2-year FRNs	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $35 billion 7-year-notes **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 27 **SETTLE:** $108 billion 13-,26-wk bills $34 billion 52-week bills	**SETTLE:** $22 billion 2-year FRNs
27	28	1	2	3
AUCTION: $108 billion* 13-,26 week bills	**ANNOUNCE:** $75 billion* 4-week bills for auction on Mar 2 $60 billion* 8-week bills for auction on Mar 2 $36 billion* 17-week bills for auction on Mar 1 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills $15 billion 20-year bonds $9 billion 30-year TIPS $42 billion 2-year notes $43 billion 5-year notes $35 billion 7-year notes	**AUCTION:** $36 billion* 17-week bills	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Mar 6 $40 billion* 3-year notes for auction on Mar 7 $32 billion* 10-year notes for auction on Mar 8 $18 billion* 30-year bonds for auction on Mar 9 **SETTLE:** $108 billion* 13-,26-wk bills	
6	7	8	9	10
AUCTION: $108 billion* 13-,26 week bills	**AUCTION:** $40 billion* 3-year notes **ANNOUNCE:** $75 billion* 4-week bills for auction on Mar 9 $60 billion* 8-week bills for auction on Mar 9 $36 billion* 17-week bills for auction on Mar 8 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $32 billion* 10-year notes	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $18 billion* 30-year bonds **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Mar 13 **SETTLE:** $108 billion* 13-,26-week bills	

**Estimate*