Daiwa Capital Markets

U.S. Economic Comment

- Inflation: encouraging signs in July
- Housing services: a disinflationary tailwind
- Inflation expectations: well grounded

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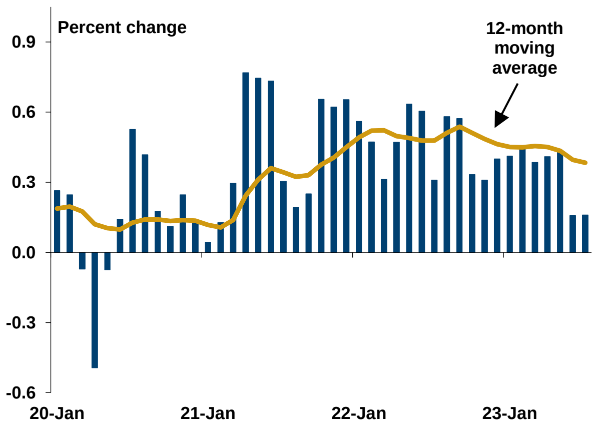
The July CPI

Key inflation data released this week suggest that restrictive monetary policy is making headway in the fight against rapid underlying inflation. We approached the June CPI report with guarded optimism when the core printed at 0.158 percent (month-over-month), but cautioned that a single favorable reading was unlikely to deter Fed officials from hiking the federal funds rate to a range of 5.50 to 5.75 percent by the end of 2023. Indeed, the FOMC raised rates by 25 basis points at the July meeting (range of 5.25 to 5.50 percent) and indicated that an additional shift in policy would be contingent on the evolution of the incoming data. The latest CPI report -- one of two between now and the September FOMC meeting -- showed a similar result on core inflation to that in June (chart, below left).

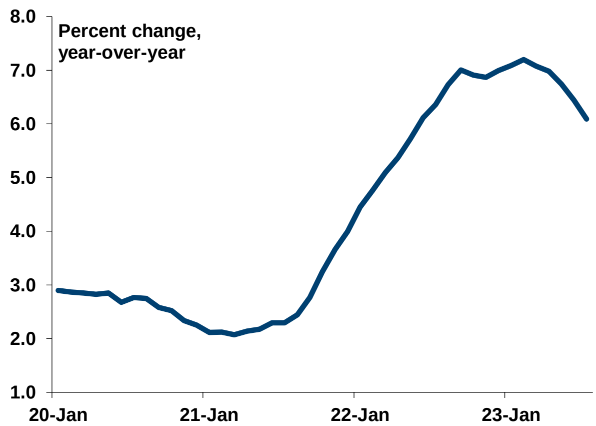
We view the July CPI reading as currently tilting the Committee toward a pause at the September meeting, but anticipate that the body of data between now and the end of the year will still suggest the need for additional policy restriction, with the final hike of 25 basis points possibly occurring at the October/November meeting. Essential to our view that additional policy firming is possibly required and that maintenance of a restrictive stance is likely for some time are readings of underlying inflation. One of our preferred measures of underlying inflation, the median CPI from the Federal Reserve Bank of Cleveland, has shown sharp month-to month deceleration recently, including an increase of 0.2 percent in July, but year-over-year inflation of 6.1 percent still indicates persistent price pressure (chart, below right).

Core CPI



Source: Bureau of Labor Statistics via Haver Analytics

Median CPI



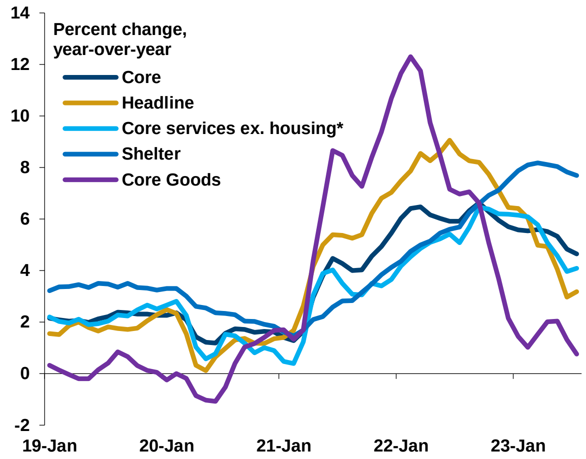
Source: Federal Reserve Bank of Cleveland via Haver Analytics

A Disinflationary Impulse from Housing Services

The downward trajectory of inflation in coming months relies heavily on continued moderation in the costs of shelter, which made a significant contribution to inflation in July. Shelter, which incorporates the Rent of Primary Residence and Owners' Equivalent Rent of Residences components from the CPI, accounts for approximately 35 percent of the total index. To date, core goods inflation has responded forcefully to restrictive Fed policy, but core service inflation has remained elevated in part because of sticky shelter costs (chart, next page). Fed officials and market participants are appearing to coalesce around the view that shelter costs will moderate further in coming months as the stock of existing rents turns over, but views on the speed and extent of the deceleration vary widely.

The Federal Reserve Bank of San Francisco weighed in on the discussion this week with a paper by staff economists that modeled the trajectory of shelter inflation based on various home price and rental cost indexes (Augustus, Kmetz, Schuyler Louie, and John Mondragon (2023). Where is Shelter Inflation Headed?" FRBSF Economic Letter. Federal Reserve Bank of San Francisco, August 7, 2023, *https://www.frbsf.org/economic-research/publications/economic-letter/2023/august/where-is-shelter-inflation-headed/*). Specifically, the team's statistical model forecast shelter inflation over an 18-month time horizon based on inputs from 18 core-based statistical areas (CBSAs; i.e., "cities and surrounding communities that can provide a useful economic unit for thinking about housing markets") and a wide range of other housing market indicators. In theory, the broad approach enhances the precision of the model, as no one measure is representative of the U.S. housing market and does not track precisely with the CPI shelter index (chart, below left).

CPI

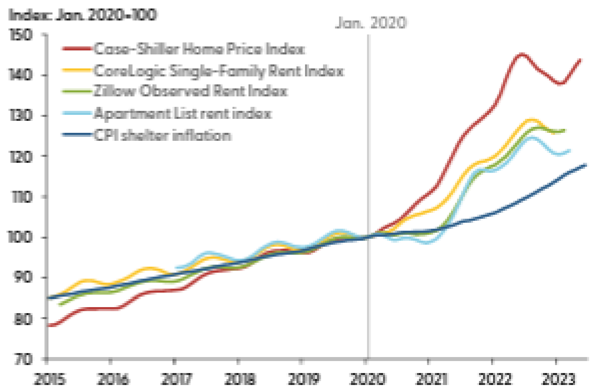


** Services excluding energy services and housing services. The index is calculated by Haver Analytics.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

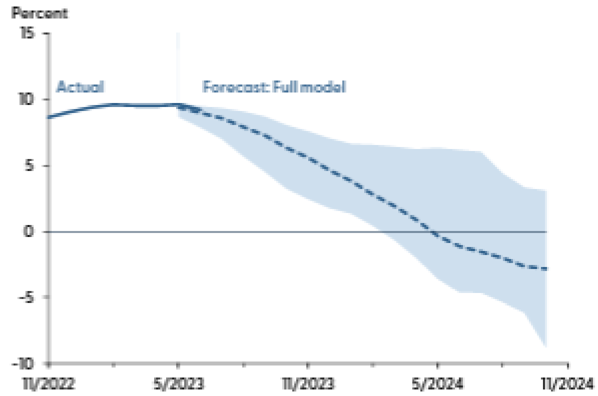
The encouraging takeaway from this analysis is that aggressive increase in the federal funds rate since March of last year had a "significant effect on slowing housing markets" and that the trend is likely to continue (even potentially leading to deflation in shelter costs). However, we caution that the wide error band around the baseline forecast indicates that the cooling is not a pre-determined outcome (chart, below right). Therefore while the note strikes a hopeful tone and offers evidence that restrictive policy is working it also underscores that it is not yet time to pivot away from the current policy setting.

Shelter Inflation & Market Indexes



Source: Kmetz, Augustus et al., "Where Is Shelter Inflation Headed?" Federal Reserve Bank of San Francisco, Aug. 2023. https://www.frbsf.org/economic-research/publications/economic-letter/2023/august/where-is-shelter-inflation-headed/

Forecast of Year-over-Year Shelter Inflation*



** The solid line shows actual year-over-year changes; dashed line shows average forecast, with shaded 95% confidence band.*

Source: Kmetz, Augustus et al., "Where Is Shelter Inflation Headed?" Federal Reserve Bank of San Francisco, Aug. 2023. https://www.frbsf.org/economic-research/publications/economic-letter/2023/august/where-is-shelter-inflation-headed/

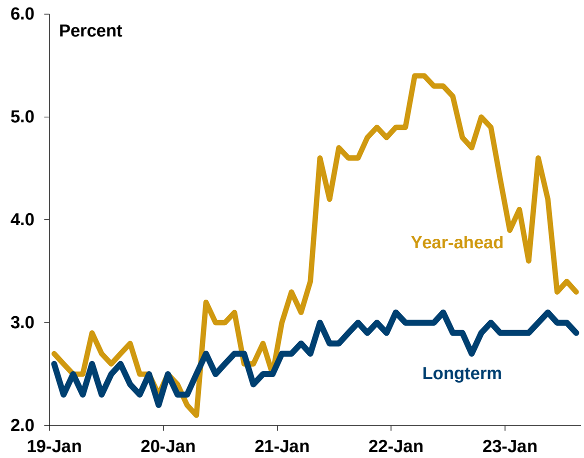
Inflation Expectations: Consistent with 2 Percent in the Longer-Term

We have been monitoring developments with inflation expectations because views of consumers and businesses over time impact actual inflation, in part through wage demands and forward-looking price setting. Expectations have ebbed and flowed over the course of the current expansion, but they remained mostly contained despite a bout of brisk inflation that is only now starting to slow. The anchoring of inflation expectations, which Fed officials view as a necessary condition to retuning actual inflation to two percent over time, is influenced importantly by clear communication by Fed officials and the proper calibration of monetary policy to evolving conditions in the economy.

Additional evidence of the Fed's success in guiding the inflation expectations of consumers and market participants emerged on Friday with the release of the preliminary report on Consumer Sentiment from the University of Michigan and the Survey of Professional Forecasters compiled by the Federal Reserve Bank of Philadelphia. We tend to assign more weight to the Philly SPF because survey respondents are likely more adept at interpreting inflation data and economic developments more broadly, although we view both reports as signaling favorable developments.

With regard to the University of Michigan data, both the year-ahead and long-term measures of inflation expectations declined 0.1 percentage point in early August to 3.3 percent and 2.9 percent respectively. The year ahead measure, tracking closely movements in gasoline pump prices has fallen from a cycle high of 5.4 percent in March/April 2022; the longer-term measure has shown less variation, moving in a tight range of 2.7 to 3.1 percent in the past 12 months – up from 2.2 percent to 2.6 percent in the months immediately preceding the pandemic but still consistent with what fed officials view as well-grounded inflation expectations (chart, right).

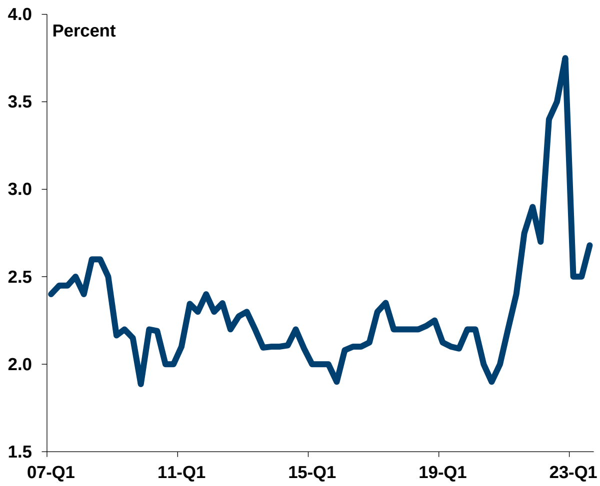
Consumer Inflation Expectations



Source: University of Michigan via Haver Analytics

The results on longer-term inflation expectations from the 23-Q3 iteration of the Survey of Professional Forecasters offer a similar view to those in the Michigan survey. The median five-year-ahead expectation for the change in the CPI rose 18 basis points to 2.68 percent, but we do not view the shift as terribly concerning in light of the drop around the turn of last year (chart, below left). More importantly, the 10-year median forecast rose only four basis points to 2.4 percent, comparable to pre-pandemic readings. More importantly, expected inflation in the back five years of the 10-year horizon actually eased to 2.12 percent from 2.22 percent, essentially matching the FOMC's target (chart, below right). Forecasts imply that market participants have a high degree of confidence that the Fed will meet its price stability mandate.

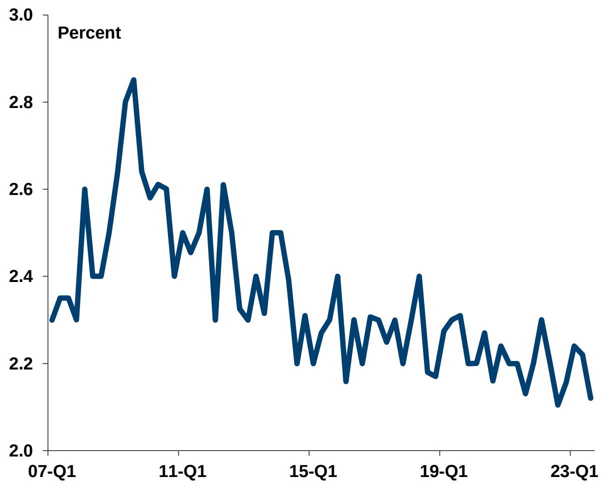
5-Year Ahead CPI Forecast*



** Average expected inflation per year over the next five years. Median estimate.*

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

5-Year / 5-Year Forward CPI Forecast*



** Expected yearly inflation per year in years six through 10 of a 10-year time horizon. Based on median expectations for five-year and 10-year CPI inflation.*
Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

The Week Ahead

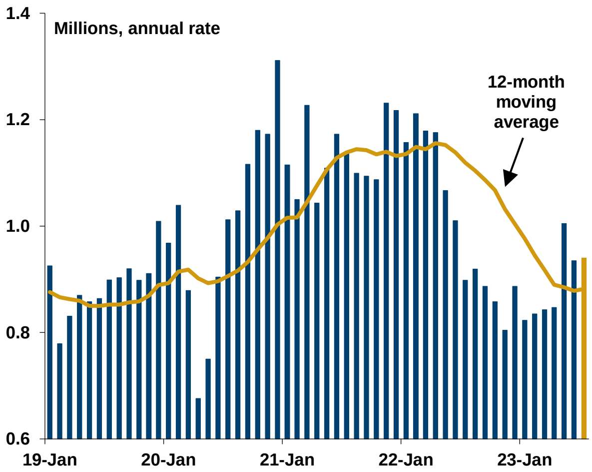
Retail Sales (July) (Tuesday)
Forecast: 0.4% Total, 0.4% Ex. Autos

Data on new vehicle sales suggest an increase in the auto component of retail sales in July. Sales excluding autos could remain on solid footing, supported by still-brisk credit expansion and firm wage growth generated by tight-labor market conditions.

Housing Starts (July) (Wednesday)
Forecast: 1.450 Million (+1.1%)

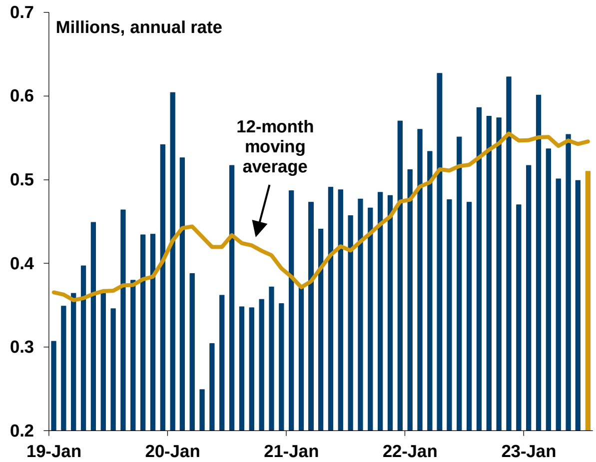
Recent improvement in builder sentiment in response to stirring in new home sales suggests that firms could again boost single-family housing starts in July after a decline of 7.0 percent in June. Multi-family starts fell in three of the past four months, including a drop of 9.9 percent in June, as preferences appear to be shifting back toward homeownership rather than renting. However, multi-family starts are often volatile from month-to-month, and we suspect recent declines overstated to a degree weakness in the multi-family area.

Single-Family Housing Starts*



** The gold bar is a forecast for July 2023.*
Sources: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets of America

Multi-Family Housing Starts*

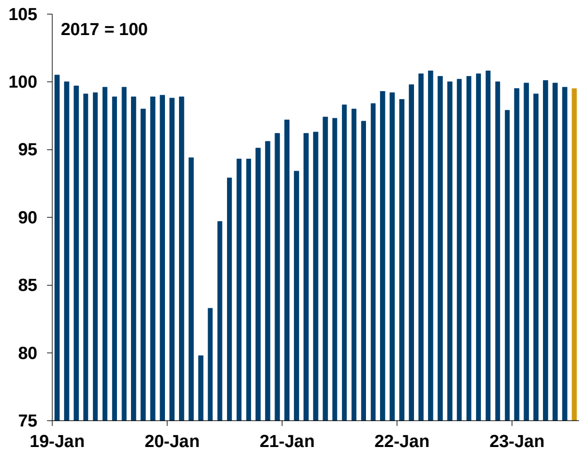


** The gold bar is a forecast for July 2023.*
Sources: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets of America

Industrial Production (July) (Wednesday)
Forecast: 0.0% Total, -0.1% Manufacturing

The anticipated flat reading in industrial production in July likely will reflect a jump in utility output that is offset by easing in the cyclically sensitive manufacturing and mining components. Utility output should be boosted by summer weather conditions (i.e. an increase in home cooling) after sharp declines in five of the past six months. In contrast, cuts to factory employment and worktimes suggest softening in manufacturing output and cuts to the mining workweek and rotary rig count imply weak mining activity.

Industrial Production: Manufacturing*



** The gold bar is a forecast for July 2023.*
Sources: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Leading Indicators (July) (Thursday)
Forecast: -0.3%

Negative contributions from the ISM new orders index, the slope of the yield curve, and the factory workweek are likely to offset positive contributions from stock prices and unemployment claims and tip the monthly change in the index of leading economic indicators into negative territory for the 16th consecutive month. If the projected decline is realized, the index will have fallen 10.2 percent from the cyclical peak in December 2021.

Economic Indicators

August/September 2023

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11
CONSUMER CREDIT Apr $22.3 billion May $9.5 billion June $17.8 billion	**NFIB SMALL BUSINESS OPTIMISM INDEX** May 89.4 June 91.0 July 91.9 **TRADE BALANCE** Apr -$74.4 billion May -$68.3 billion June -$65.5 billion **WHOLESALE TRADE** Inventories Sales Apr -0.3% 0.0% May -0.4% -0.5% June -0.5% -0.7%		**UNEMPLOYMENT CLAIMS** Initial Continuing (millions) July 15 0.228 1.679 July 22 0.221 1.692 July 29 0.227 1.684 Aug 5 0.248 N/A **CPI** Total Core May 0.1% 0.4% June 0.2% 0.2% July 0.2% 0.2% **FEDERAL BUDGET** 2023 2022 May -$240.3B -$66.2B June -$227.8B -$88.8B July -$220.8B -$211.1B	**PPI** Final Demand Ex. Food & Energy May -0.3% 0.2% June 0.0% -0.1% July 0.3% 0.3% **CONSUMER SENTIMENT** June 64.4 July 71.6 Aug 71.2
14	15	16	17	18
	RETAIL SALES (8:30) Total Ex.Autos May 0.5% 0.3% June 0.2% 0.2% **July 0.4% 0.4%** **IMPORT/EXPORT PRICES (8:30)** Non-Petrol Imports Nonagri. Exports May -0.2% -1.9% June -0.3% -0.9% July -- -- **EMPIRE MFG. (8:30)** June 6.6 July 1.1 Aug -- **BUSINESS INVENTORIES (10:00)** Inventories Sales Apr 0.1% -0.1% May 0.0% 0.1% **June 0.0% 0.2%** **NAHB HOUSING INDEX (10:00)** June 55 July 56 Aug -- **TIC FLOWS (4:00)** Long-Term Total Apr $127.8B $35.3B May $25.8B -$167.6B June -- --	**HOUSING STARTS (8:30)** May 1.559 million June 1.434 million **July 1.450 million** **IP & CAP-U (9:15)** IP Cap.Util. May -0.5% 79.4% June -0.5% 78.9% **July 0.2% 78.8%** **FOMC MINUTES (2:00)**	**UNEMP. CLAIMS (8:30)** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** June -13.7 July -13.5 Aug -- **LEADING INDICATORS (10:00)** May -0.6% June -0.7% **July -0.3%**	
21	22	23	24	25
	EXISTING HOME SALES	**NEW HOME SALES**	**UNEMP. CLAIMS** **DURABLE GOODS ORDERS** **CHICAGO FED NATIONAL ACTIVITY INDEX**	**REVISED CONSUMER SENTIMENT**
28	29	30	31	1
	FHFA HOME PRICE INDEX **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **JOLTS DATA** **CONSUMER CONFIDENCE**	**ADP EMPLOYMENT** **REVISED Q2 GDP** **INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PENDING HOME SALES**	**UNEMP. CLAIMS** **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** **MNI CHICAGO BUSINESS BAROMETER**	**EMPLOYMENT REPORT** **ISM MFG. INDEX** **CONSTRUCTION** **VEHICLE SALES**

Forecasts in bold.

Treasury Financing

August/September 2023

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11
AUCTION RESULTS: Rate / Cover 13-week bills 5.290% 2.83 26-week bills 5.265% 2.92	**AUCTION RESULTS:** Rate / Cover 52-week bills 5.060% 2.97 3-yr notes 4.398% 2.90 42-day CMBs 5.275% 2.95 **ANNOUNCE:** $75 billion 4-week bills for auction on Aug 10 $65 billion 8-week bills for auction on Aug 10 $48 billion 17-week bills for auction on Aug 9 **SETTLE:** $70 billion 4-week bills $60 billion 8-week bills $46 billion 17-week bills	**AUCTION RESULTS:** Rate / Cover 17-week bills 5.310% 3.19 10-yr notes 3.999% 2.56	**AUCTION RESULTS:** Rate / Cover 4-week bills 5.280% 2.62 8-week bills 5.280% 2.96 30-yr bonds 4.189% 2.42 **ANNOUNCE:** $131 billion 13-,26-week bills for auction on Aug 14 $60 billion 42-day CMBs for auction on Aug 15 **SETTLE:** $127 billion 13-,26-week bills $40 billion 52-week bills $55 billion 42-day CMBs	
14	15	16	17	18
AUCTION: $131 billion 13-,26-week bills	**AUCTION:** $60 billion 42-day CMBs **ANNOUNCE:** $75 billion* 4-week bills for auction on Aug 17 $65 billion* 8-week bills for auction on Aug 17 $48 billion* 17-week bills for auction on Aug 16 **SETTLE:** $75 billion 4-week bills $65 billion 8-week bills $48 billion 17-week bills $42 billion 3-year notes $38 billion 10-year notes $23 billion 30-year bonds	**AUCTION:** $48 billion* 17-week bills **ANNOUNCE:** $42 billion* 3-year notes for auction on Aug 8 $37 billion* 10-year notes for auction on Aug 9 $23 billion* 30-year bonds for auction on Aug 10	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $131 billion* 13-,26-week bills for auction on Aug 21 $22 billion* 2-year FRNs for auction on Aug 23 $16 billion* 20-year bonds for auction on Aug 23 $8 billion* 30-year TIPS for auction on Aug 24 **SETTLE:** $131 billion 13-,26-week bills $60 billion 42-day CMBs	
21	22	23	24	25
AUCTION: $131 billion* 13-,26-week bills	**ANNOUNCE:** $75 billion* 4-week bills for auction on Aug 24 $65 billion* 8-week bills for auction on Aug 24 $48 billion* 17-week bills for auction on Aug 23 **SETTLE:** $75 billion* 4-week bills $65 billion* 8-week bills $48 billion* 17-week bills	**AUCTION:** $48 billion* 17-week bills $22 billion* 2-year FRNs $16 billion* 20-year bonds	**AUCTION:** $75 billion* 4-week bills $65 billion* 8-week bills $8 billion* 30-year TIPS **ANNOUNCE:** $131 billion* 13-,26-week bills for auction on Aug 28 45 billion* 2-year notes for auction on Aug 28 $46 billion* 5-year notes for auction on Aug 28 $36 billion* 7-year notes for auction on Aug 29 **SETTLE:** $131 billion* 13-,26-week bills	**SETTLE:** $22 billion* 2-year FRNs
28	29	30	31	1
AUCTION: $131 billion* 13-,26-week bills $45 billion* 2-year notes $46 billion* 5-year notes	**AUCTION:** $36 billion* 7-year notes **ANNOUNCE:** $75 billion* 4-week bills for auction on Aug 31 $65 billion* 8-week bills for auction on Aug 31 $48 billion* 17-week bills for auction on Aug 30 **SETTLE:** $75 billion* 4-week bills $65 billion* 8-week bills $48 billion* 17-week bills	**AUCTION:** $48 billion* 17-week bills	**AUCTION:** $75 billion* 4-week bills $65 billion* 8-week bills **ANNOUNCE:** $131 billion* 13-,26-week bills for auction on Sep 5 $42 billion* 52-week bills for auction on Sep 5 **SETTLE:** $131 billion* 13-,26-week bills $16 billion* 20-year bonds $8 billion* 30-year TIPS $45 billion* 2-year notes $46 billion* 5-year notes $36 billion* 7-year notes	

**Estimate*