U.S. Economic Comment

- A firm CPI reading in September suggests more work ahead for the Fed
- Financial conditions: signs of tightening for consumers and small businesses

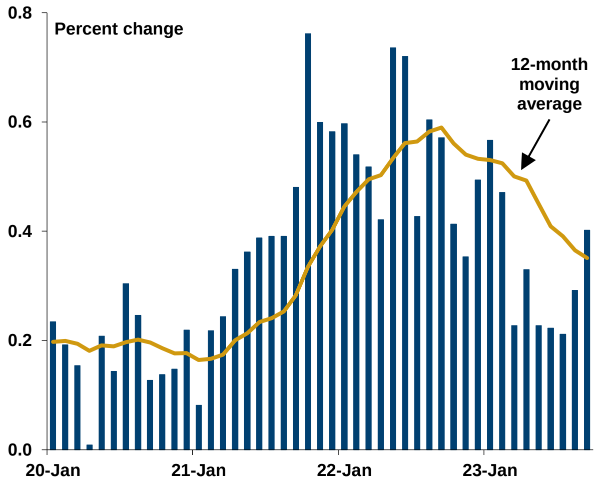
Lawrence Werther
Daiwa Capital Markets America
212-612-6393
lawrence.werther@us.daiwacm.com

Inflation: Vigilance Required

Yesterday's CPI report offered a blunt reminder to market participants that the fight against inflation above the Federal Reserve's two-percent target is ongoing, even as comments by Fed officials this past week suggest that we may have already reached a peak in the target range for the federal funds rate. Among the noteworthy comments, Atlanta Federal Reserve Bank President Raphael Bostic, a 2024 FOMC voter, said, "I actually don't think we need to increase rates anymore," a sentiment echoed by Philadelphia Fed President Patrick Harker (a 2023 voter). Similarly, Fed Governor Christopher Waller, a noted hawk on the FOMC, appeared to deviate from his prior stance (calling for an additional rate hike) during a discussion forum. Noting the recent move higher in long-term interest rates, he observed, "Financial markets are tightening up, and they are doing some of the work for us." That is, market interest rates have repriced upward without additional tightening in the federal funds rate. We do not view officials' collective statements as signaling an early easing in monetary policy, nor a wavering in the Committee's resolve as an inflation fighter, but we do suspect that market perceptions have shifted recently toward viewing inflation as an enemy already defeated. However, the latest CPI report is a caution against prematurely declaring victory.

After subdued increases in both the headline CPI and the core in June and July (0.2 percent per month for both), pressure reemerged in August and September with headline increases of 0.6 percent and 0.4 percent, respectively, and core advances of 0.3 percent in both months. Favorable trends have persisted in some areas, such as the deceleration of food inflation; increases in that component slowed to an average of 0.2 percent per month in 2023 thus far (2.6 percent, annual rate) versus 0.8 percent per month in 2022 (10.4 percent, annual rate). Core goods inflation has registered even more dramatic results, falling in the past four months (including a drop of 0.4 percent in September) and returning to its subdued pre-pandemic trend. As supply chains healed and consumer behavior returned to normal, core goods inflation fell from a 10.7 percent annual rate in 2021 to 2.1 percent last year and 0.6 percent in the first nine months of 2023. However, curbing core service inflation has proved more challenging, as this area has averaged increases of 0.4 percent per month in 2023, including a jump of 0.6 percent in September, down only moderately from 0.6 percent in 2022 (annual growth of 5.4 percent in 2023 thus far versus 7.0 percent in 2022).

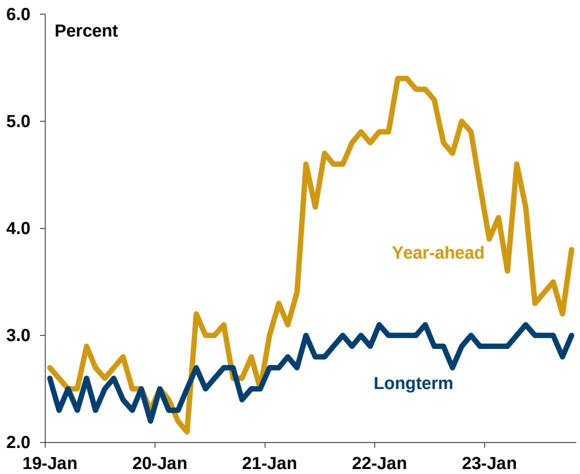
16% Trimmed-Mean CPI*



** A weighted average of one month inflation rates of CPI components whose expenditure weights fall below the 92nd percentile and above the 8th percentile of price changes.*

Source: Federal Reserve Bank of Cleveland via Haver Analytics

Consumer Inflation Expectations



Source: University of Michigan via Haver Analytics

Shelter costs have been a critical component of the story (annual growth of 6.6 percent in 2023 versus 7.5 percent in 2022), as have service costs excluding housing, which are influenced by tight labor market conditions (annual growth of 3.8 percent in 2023 versus 6.2 percent last year). Price changes in these areas have slowed but not enough to ensure a return to the FOMC's inflation target. Looking to the Federal Reserve Bank of Cleveland's Trimmed Mean CPI, which cuts off the tails (outliers) in the distribution of monthly price changes and more accurately reflects underlying inflation, it had moderated since the spring, but has since stepped higher in the past two months with a still-brisk year-over-year change of 4.3 percent in September (chart, left). Moreover, tensions in the Middle East could complicate the inflation fight further, particularly if they escalate into a broader regional conflict and surge in oil prices.

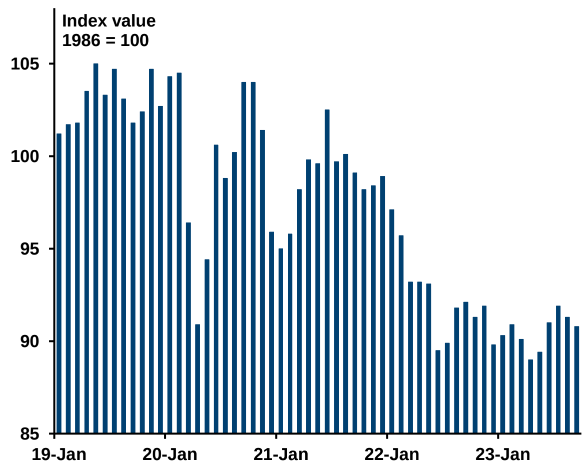
Further caution is warranted following the jump in consumer inflation expectations noted in today's preliminary report on consumer sentiment from the University of Michigan. Short-term inflation expectations had previously fallen to 3.2 percent in September (the lowest reading since the spring of 2021), but they jumped back to 3.8 percent in early October. In one sense, it would be easy to dismiss this change, as the measure correlates with gasoline prices and can move sharply each month. However, longer-term inflation expectations, which are generally more stable, rose 0.2 percentage point to 3.0 percent, a reading at the top of the recent range (chart, right). While the move may be transient, Fed officials heavily weigh inflation expectations in their views of longer-term inflation outcomes. The latest development was certainly unwelcome, especially considering prior progress. Fed action thus far has contained inflation – and kept inflation expectations mostly in check – but developments this week suggest that there is yet more work to be done.

Tighter Financial Conditions for Consumers and Businesses Likely to Constrain Activity in Coming Months

Recent reports on both the small business sector and consumers suggest that restrictive monetary policy is beginning to have a measureable impact on the real economy. Although the Federal Reserve only has direct control over the short-term policy rate, signals from changes in that rate manifest in the real economy through channels including lending standards and term borrowing costs.

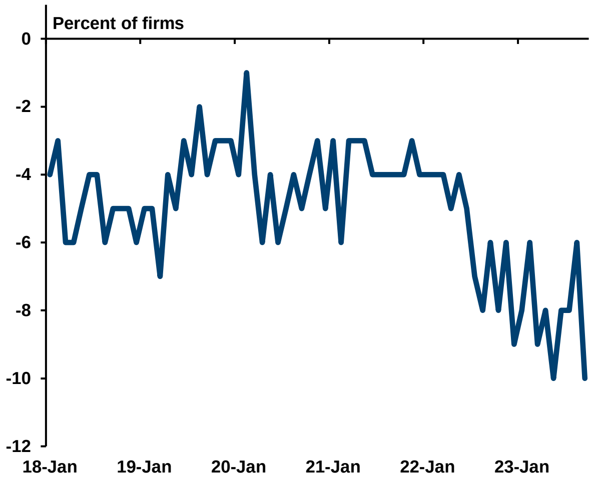
The Small Business Economic Trends survey released by the National Federation of Independent Business indicated that small business optimism eased for the second consecutive month after mounting a modest recovery earlier in the summer (chart). Conditions for small businesses have proved challenging for much of the current expansion due to inflation, worker shortages, and supply-chain disruptions. In the latest month, the expected credit conditions component fell, matching the low of the current cycle (share of survey respondents expecting credit conditions to ease less the share expecting conditions to tighten; chart, next page, left). This deterioration was accompanied by a surge of 0.8 percentage point in the interest rate paid on short-term loans after a previous run-up of approximately 1.5 percentage points since the beginning of 2023 (9.8 percent versus 9.0 percent in August; chart, next page, right). Moreover, another survey component indicated that the net availability of loans versus three months ago (more available versus less) fell by four percentage points to -8.

Small Business Optimism Index



Source: National Federation of Independent Business via Haver Analytics

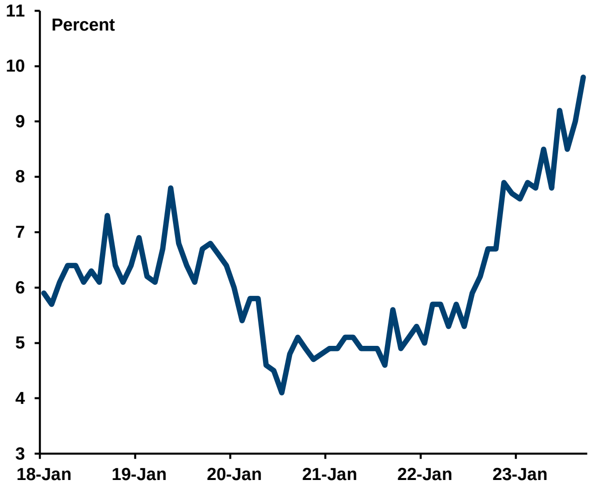
Firms Expecting Credit Conditions to Ease*



** Share of small businesses that expect credit conditions to ease less those that expect conditions to tighten.*

Source: National Federation of Independent Business via Haver Analytics

Actual Interest Rate Paid on Short-Term Loans*

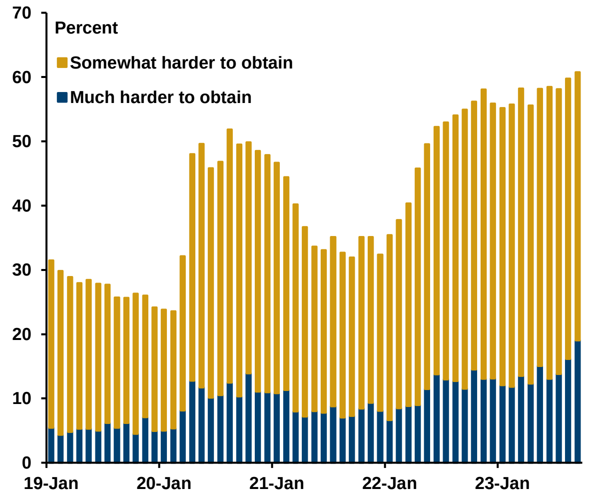


** For small businesses*

Source: National Federation of Independent Business via Haver Analytics

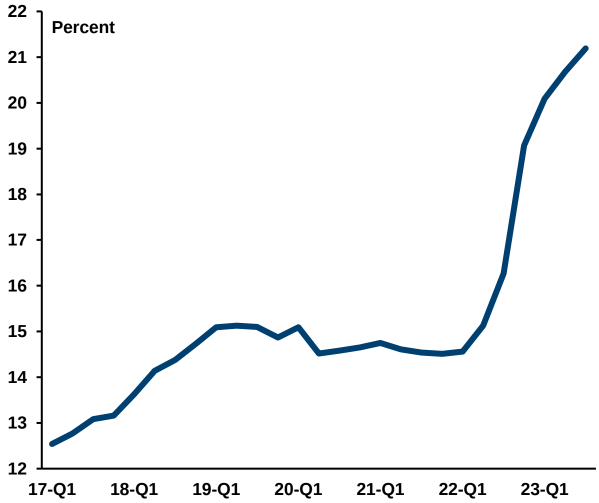
Similar signals were sent by a credit access question in the Federal Reserve Bank of New York's Survey of Consumer Expectations. The share of survey respondents reporting that credit availability was much harder to obtain versus one year ago rose approximately 2.8 percentage points to 19.0 percent, and the share indicating that it was somewhat harder to get remained elevated at 41.8 percent (chart, below left). The tightening in credit availability has occurred concurrently with a jump in consumer borrowing costs, with the surge in credit card interest rates a notable example (chart, below right). While consumer spending has been firm thus far in 2023, developments around credit availability and interest rates give credence to the statements of Fed officials that the full force of current monetary policy tightening has not yet been realized in the economy. By all accounts, tighter lending standards and higher interest rates will likely cause additional slowing across all sectors of the economy, including small business and consumer activity.

Change in Credit Availability from 1 Year Ago



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

Interest Rates on Credit Card Plans



Source: Federal Reserve Board via Haver Analytics

The Week Ahead

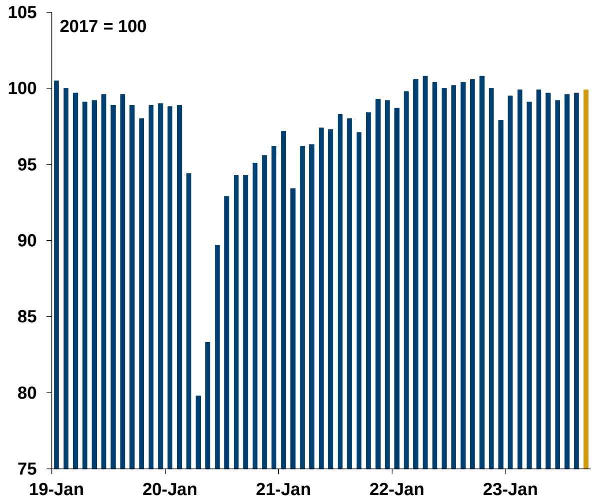
Retail Sales (September) (Tuesday)
Forecast: 0.5% Total, 0.3% Ex. Autos

An increase in vehicle sales could boost the auto component of retail sales. Additionally, the gasoline component could increase after seasonal adjustment despite a slight decline in average gasoline prices. Activity excluding autos and gas could increase only modestly for the second consecutive month after a jump in July, as consumers struggle with elevated prices and diminished excess savings from the pandemic period.

Industrial Production (September) (Tuesday)
Forecast: 0.2% Total, 0.2% Manufacturing

Data on employment and hours worked in the factory sector suggest a third consecutive increase in the manufacturing component of industrial production, although the index is likely to remain below year-ago levels even with the recent (and anticipated) pickup (chart, below left). With the rotary rig count down in September, mining activity could soften after a jump of 1.4 percent in August pushed the index back to pre-COVID levels (chart, below right). Utility output has swung widely for much of 2023, but the shifts reflected swings in weather rather than economic fundamentals. Data on average temperatures and heating and cooling usage suggest only an inconsequential change in the latest month after a cumulative jump of 5.4 percent in the previous two months.

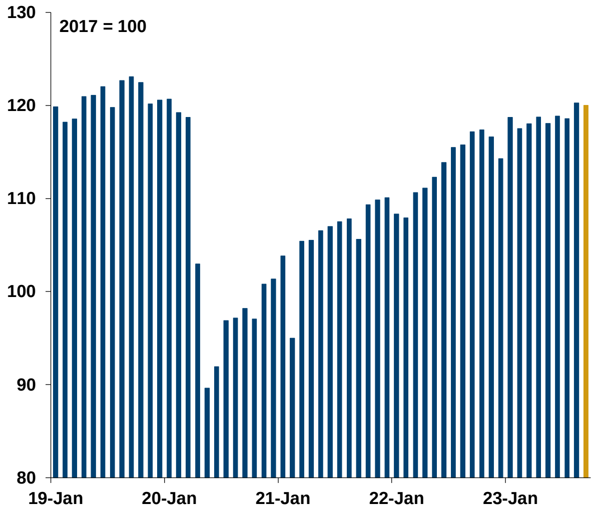
Industrial Production: Manufacturing*



** The gold bar is a forecast for September 2023.*

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

Industrial Production: Mining*



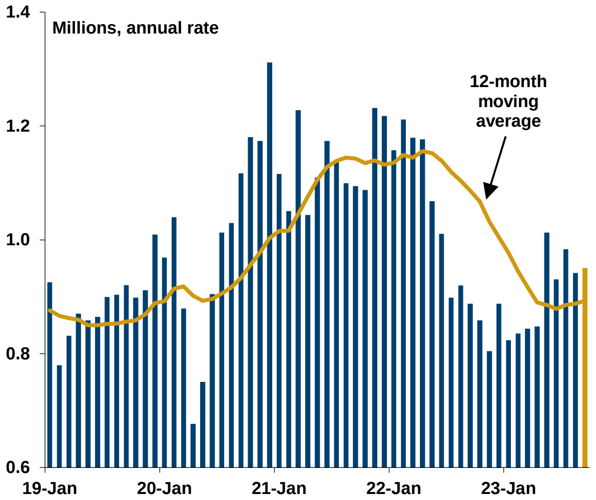
** The gold bar is a forecast for September 2023.*

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

Housing Starts (September) (Wednesday)
Forecast: 1.350 Million (+5.2%)

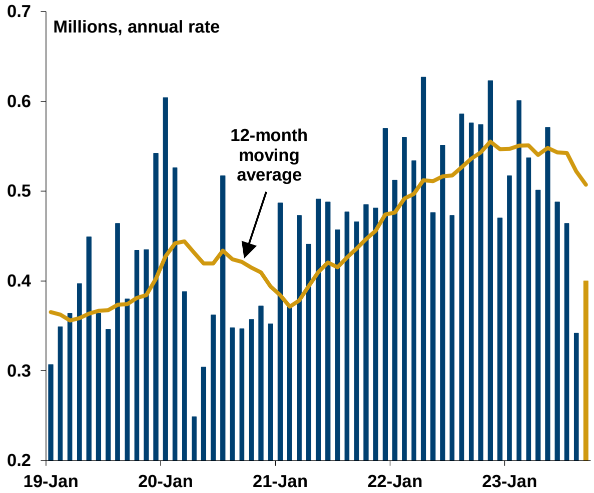
Although inventories of new homes available for sale are elevated, an uptick in building permits in August suggests a pickup in single-family housing starts in September (chart; next page, left). Multi-family starts could rebound sharply in September after a cumulative plunge of 40.1 percent in the prior three months, a view supported by a jump of 15.6 percent in multi-family permit issuance in August (chart; next page, right). Builders appear to have curtailed multi-family projects as preferences may have shifted back toward single-family homes, but the magnitude of the recent declines pushed activity to the low end of the range of the past decade, which implies that an element of random volatility may be at play.

Single-Family Housing Starts



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

Multi-Family Housing Starts*



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

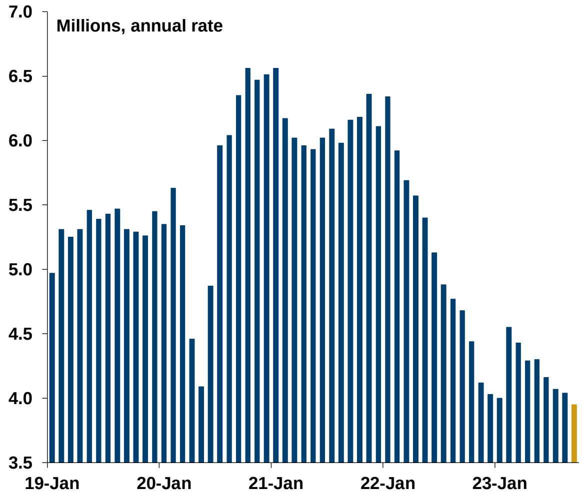
Existing Home Sales (September) (Thursday)
Forecast: 3.95 Million (-2.2%)

With mortgage rates hovering in the mid-seven-percent area and prices high, sales of existing homes could ease for the fourth consecutive month in September -- a view supported by a recent drop in the index of pending home sales. The sharp softening in the market for existing homes since the spring of 2022, which was interrupted only briefly earlier this year, has left activity in the low end of the longer-run range (chart).

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

Negative contributions from the ISM new orders index, the slope of the yield curve, and stock prices raise the possibility of the Index of Leading Economic Indicators contracting for the 18th consecutive month. If the forecast proves accurate, the level of the index will have fallen 10.8 percent from the cycle high in December 2021.

Existing Home Sales*



** The gold bar is a forecast for September 2023.*
Sources: National Association of Realtors via Haver Analytics; Daiwa Capital Markets America

Economic Indicators

October/November 2023

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
COLUMBUS DAY	**NFIB SMALL BUSINESS OPTIMISM INDEX** July 91.9 Aug 91.3 Sep 90.8 **WHOLESALE TRADE** Inventories Sales June -0.7% -0.8% July -0.3% 1.2% Aug -0.1% 1.8%	**PPI** Final Demand Ex. Food & Energy July 0.6% 0.6% Aug 0.7% 0.2% Sep 0.5% 0.3% **FOMC MINUTES**	**UNEMPLOYMENT CLAIMS** Initial Continuing (millions) Sep 16 0.202 1.665 Sep 23 0.205 1.672 Sep 30 0.209 1.702 Oct 7 0.209 N/A **CPI** Total Core July 0.2% 0.2% Aug 0.6% 0.3% Sep 0.4% 0.3%	**IMPORT/EXPORT PRICES** Non-Petrol Imports Nonagri. Exports July 0.0% 0.4% Aug -0.1% 1.5% Sep -0.3% 1.0% **CONSUMER SENTIMENT** Aug 69.5 Sep 68.1 Oct 63.0
16	17	18	19	20
EMPIRE MFG (8:30) Aug -19.0 Sep 1.9 Oct -- **FEDERAL BUDGET (2:00) (ONE DAY THIS WEEK)** 2023 2022 July -$220.8B -$211.1B Aug $89.3B -$219.6B **Sep -$166.0B** -$429.8B	**RETAIL SALES (8:30)** Total Ex.Autos July 0.5% 0.7% Aug 0.6% 0.6% **Sep 0.5% 0.3%** **IP & CAP-U (9:15)** IP Cap.Util. July 0.7% 79.5% Aug 0.4% 79.7% **Sep 0.2% 79.7%** **NAHB HOUSING INDEX (10:00)** Aug 50 Sep 45 Oct -- **BUSINESS INVENTORIES (10:00)** Inventories Sales June -0.1% -0.2% July 0.1% 0.8% **Aug 0.4% 1.3%** **TIC FLOWS (4:00)** Long-Term Total June $186.0B $137.9B July $8.8B $140.6B Aug -- --	**HOUSING STARTS (8:30)** July 1.447 million Aug 1.283 million **Sep 1.350 million** **BEIGE BOOK (2:00)** **August 2023:** "Contacts from most Districts indicated economic growth was modest during July and August."	**UNEMP. CLAIMS (8:30)** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Aug 12.0 Sep -13.5 Oct -- **EXISTING HOME SALES (10:00)** July 4.070 million Aug 4.040 million **Sep 3.950 million** **LEADING INDICATORS (10:00)** July -0.3% Aug -0.4% **Sep -0.3%**	
23	24	25	26	27
CHICAGO FED NATIONAL ACTIVITY INDEX		**NEW HOME SALES**	**UNEMP. CLAIMS** **GDP** **DURABLE GOODS ORDERS** **INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** **REVISED CONSUMER SENTIMENT**
30	31	1	2	3
	EMPLOYMENT COST INDEX **FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **MNI CHICAGO BUSINESS BAROMETER** **CONFERENCE BOARD CONSUMER CONFIDENCE** **FOMC MEETING (FIRST DAY)**	**ADP EMPLOYMENT** **ISM MFG. INDEX** **CONSTRUCTION** **JOLTS DATA** **FOMC DECISION** **VEHICLE SALES**	**UNEMP. CLAIMS** **PRODUCTIVITY & COSTS** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **ISM SERVICES INDEX**

Forecasts in bold.

Treasury Financing

October/November 2023

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
COLUMBUS DAY	**AUCTION RESULTS:** Rate / Cover 13-week bills 5.340% 2.79 26-week bills 5.320% 2.79 3-yr notes 4.740% 2.56 43-day CMBs 5.360% 2.74 **ANNOUNCE:** $56 billion 17-week bills for auction on Oct 11 $95 billion 4-week bills for auction on Oct 12 $85 billion 8-week bills for auction on Oct 12 **SETTLE:** $54 billion 17-week bills $90 billion 4-week bills $80 billion 8-week bills	**AUCTION RESULTS:** Rate / Cover 17-week bills 5.355% 3.37 10-yr notes 4.610% 2.50	**AUCTION RESULTS:** Rate / Cover 4-week bills 5.325% 2.79 8-week bills 5.345% 2.88 30-yr bonds 4.837% 2.35 **ANNOUNCE:** $143 billion 13-,26-week bills for auction on Oct 16 $13 billion 20-year bonds for auction on Oct 18 $22 billion 5-year TIPS for auction on Oct 19 $75 billion 42-day CMBs for auction on Oct 17 **SETTLE:** $139 billion 13-,26-week bills $70 billion 43-day CMBs	
16	17	18	19	20
AUCTION: $143 billion 13-,26-week bills **SETTLE:** $46 billion 3-year notes $35 billion 10-year notes $20 billion 30-year bonds	**AUCTION:** $75 billion 42-day CMBs **ANNOUNCE:** $56 billion* 17-week bills for auction on Oct 18 $95 billion* 4-week bills for auction on Oct 19 $85 billion* 8-week bills for auction on Oct 19 **SETTLE:** $56 billion 17-week bills $95 billion 4-week bills $85 billion 8-week bills	**AUCTION:** $56 billion* 17-week bills $13 billion 20-year bonds	**AUCTION:** $95 billion* 4-week bills $85 billion* 8-week bills $22 billion 5-year TIPS **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Oct 23 $51 billion* 2-year notes for auction on Oct 24 $52 billion* 5-year notes for auction on Oct 25 $38 billion* 7-year notes for auction on Oct 26 $26 billion* 2-year FRNs for auction on Oct 25 **SETTLE:** $143 billion 13-,26-week bills $75 billion 42-day CMBs	
23	24	25	26	27
AUCTION: $143 billion* 13-,26-week bills	**AUCTION:** $51 billion* 2-year notes **ANNOUNCE:** $56 billion* 17-week bills for auction on Oct 25 $95 billion* 4-week bills for auction on Oct 26 $85 billion* 8-week bills for auction on Oct 26 **SETTLE:** $56 billion* 17-week bills $95 billion* 4-week bills $85 billion* 8-week bills	**AUCTION:** $56 billion* 17-week bills $52 billion* 5-year notes $26 billion* 2-year FRNs	**AUCTION:** $95 billion* 4-week bills $85 billion* 8-week bills $38 billion* 7-year notes **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Oct 30 $44 billion* 52-week bills for auction on Oct 31 **SETTLE:** $143 billion* 13-,26-week bills	
30	31	1	2	3
AUCTION: $143 billion* 13-,26-week bills	**AUCTION:** $44 billion* 52-week bills **ANNOUNCE:** $56 billion* 17-week bills for auction on Nov 1 $95 billion* 4-week bills for auction on Nov 2 $85 billion* 8-week bills for auction on Nov 2 **SETTLE:** $56 billion* 17-week bills $95 billion* 4-week bills $85 billion* 8-week bills $13 billion 20-year bonds $22 billion 5-year TIPS $51 billion* 2-year notes $52 billion* 5-year notes $38 billion* 7-year notes $26 billion* 2-year FRNs	**AUCTION:** $56 billion* 17-week bills **ANNOUNCE:** $48 billion* 3-year notes for auction on Nov 7 $41 billion* 10-year notes for auction on Nov 8 $25 billion* 30-year bonds for auction on Nov 9	**AUCTION:** $95 billion* 4-week bills $85 billion* 8-week bills **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Nov 6 **SETTLE:** $143 billion* 13-,26-week bills $44 billion* 52-week bills	

**Estimate*