U.S. Economic Comment

- Inflation: not entirely benign

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Inflation: Transitory or Long-Lasting?

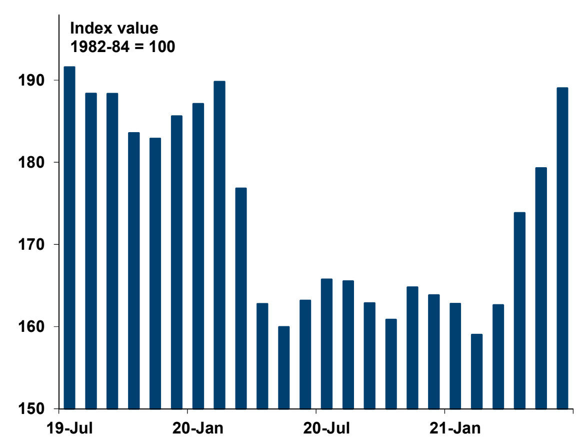
Fed Chair Jerome Powell has a good bit of evidence to support his view that the recent pickup in inflation will be transitory. However, his case is far from air-tight, as some components of the CPI and other recent statistics suggest that underlying pressure also is stirring.

Chair Powell has correctly argued that most of the pressure on the CPI has been driven by a small number of goods and services that have shown unusually sharp changes. We would group the pressure points into two categories: pandemic-sensitive items and goods and services related to personal transportation.

The pandemic-sensitive area includes items that experienced pronounced declines in demand as Covid spread, which led to deep discounts. Individuals stopped traveling, and thus hotel fees and airfares fell sharply. Similarly, with individuals working from home and not socializing, they bought fewer clothes, which led to a drop in apparel prices. A weighted-average index of these three items shows a pronounced decline last spring (i.e. discounts), and costs are now returning to normal levels, which is generating marked month-to-month increases. When prices return to normal, this pressure should abate (chart, left; the chart shows the level of the index rather than the percent change; the values on the vertical axis are akin to a price).

In the personal transportation category, we have grouped car-rental fees and the prices of new and used motor vehicles. While meaningful discounting did not emerge in these areas last year, strong demand has driven prices sharply higher in recent months (chart, right; again, the level of the constructed index). The pickup in travel has stirred demand for car rentals, but with fleets depleted during the worst of the pandemic, a pronounced supply-demand gap exists. With individuals moving out of cities and resisting public transportation, demand for vehicles has increased while supplies are tight, partly because of the semiconductor shortage. Prices in these areas have surged far above pre-pandemic levels. Logic would suggest reductions in the future and downward pressure on the CPI as the supply-demand imbalance is closed. Thus, transitory pressure.

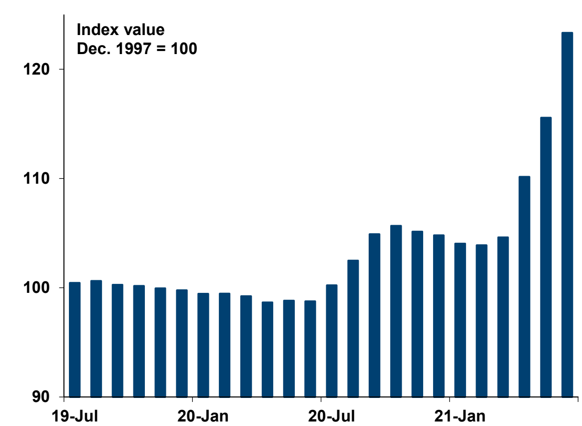
CPI: Covid-Sensitive Items*



** A weighted average index of the Apparel, Airline Fare, and Hotel/Motel components of the CPI. Weights are calculated based on the relative importance of each component in the CPI.*

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

CPI: Personal Transportation*



** A weighted average index of the Car and Truck Rental, New Vehicles, and Used Cars and Trucks components of the CPI. Weights are calculated based on the relative importance of each component in the CPI.*

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

Concerns

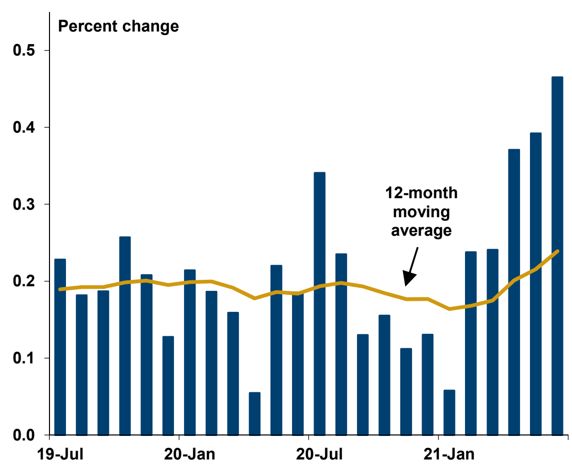
Chair Powell is correct in asserting that a small number of items account for most of the acceleration in consumer prices. However, the sources of pressure might be broader than Mr. Powell suggests. So-called trimmed-mean measures of inflation exclude some share of observations at the low and high ends of the distribution of price changes, thereby eliminating the influence of a small number of items showing unusually large shifts.

The Federal Reserve Banks of Cleveland and Dallas construct such measures, and both show 12-month changes of approximately 2.0 percent. Several Fed officials in recent public comments have highlighted the close-to-target readings as supporting the case for transitory pressure. However, even these measures are beginning to quicken. The index from the Cleveland Fed (based on the CPI) has increased 0.4 or 0.5 percent in each of the past three months (chart, left). The Dallas measure (based on the price index for personal consumption expenditures and therefore available only through May), showed above-average increases in February and March, while readings in April and May were near the top of the recent range (only one observation in the past 12 years was above the May tally; chart, right). In light of this recent stirring in these trimmed measures, it seems that more than a handful of items are stirring inflation.

Strong demand also is a concern, as shown by the pattern of retail sales so far this year. Consumer spending picked up in January, as individuals started to receive $600 rebate checks approved by Congress in December. Activity then surged in March and April, after the approval of $1,400 rebate checks authorized by the American Rescue Plan. One might have expected a cooling in activity after the March-April flurry, but sales remained close to the recent elevated level in both May and June.

The increase in total retail sales of 0.6 percent in June was especially telling, as rebate checks had slowed to a trickle that month, yet spending remained strong. Lagged effects of government support in prior months was probably a factor. More generally, the household sector has accumulated a huge pool of savings over the course of the pandemic, and many seem willing to draw on that pool to satisfy pent-up demand. (We estimate a pool of savings $2.5 trillion larger than would have existed in the absence of the pandemic, an amount equal to 11.5 percent of GDP.)

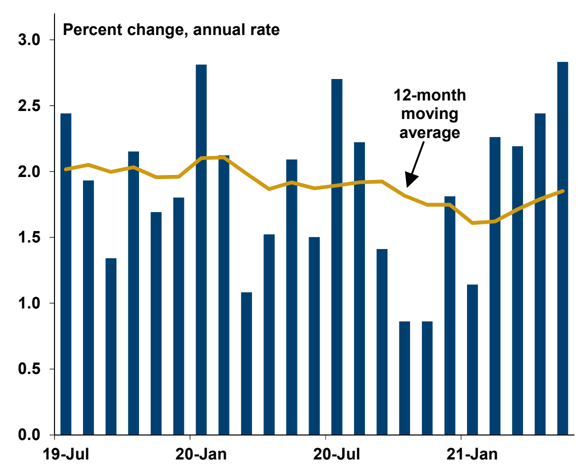
16% Trimmed-Mean CPI*



** From the Cleveland Fed: "The 16 percent trimmed-mean CPI is a weighted average of one-month inflation rates of 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 Analytic

Trimmed Mean 1-Month PCE Inflation*



** From the Dallas Fed: "The Trimmed Mean PCE inflation rate is an alternative measure of core inflation in the price index for personal consumption expenditures (PCE). It is calculated by staff at the Dallas Fed, using data from the Bureau of Economic Analysis (BEA)."*

Source: Federal Reserve Bank of Dallas via Haver Analytics

If inflation expectations were to pick up, faster inflation would most likely be longer-lasting. Thus far, market participants do not seem troubled by recent readings on the CPI, as the break-even rates on Treasury inflation-protected securities have not picked up. The five-year, five-year forward measure has eased from the recent high in mid-May and is in the low end of the range in place before the onset of the pandemic (chart, left). The measure barely moved after the publication of the CPI this week.

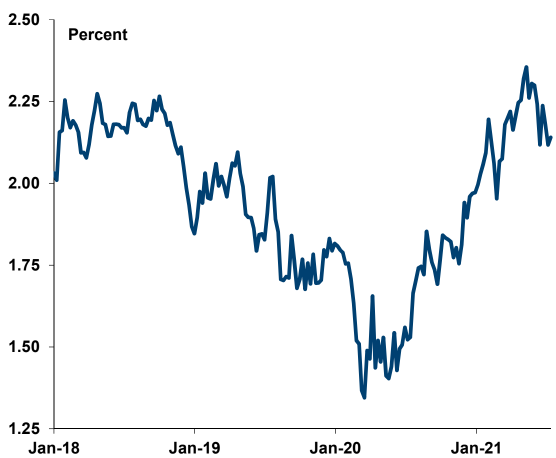
Households, though, seem concerned, as two measures published this week showed marked changes. The three-year ahead measure of inflation expectations published by the New York Fed has jumped one-half percentage point this year (from 3.0 to 3.5 percent). Most of this change (0.4 percentage point) occurred in May, and the elevated level that month held in June.

The long-term measure of inflation expectations in the University of Michigan survey of consumers has trended higher in the past year or so, moving from an average of 2.3 percent in 2019 to 2.9 percent in early July (chart, right). The latest reading was shy of 3.0 percent in May, but nevertheless indicative of a recent shift in views.

Our biggest concern on the inflation front relates to monetary policy. Milton Friedman preached that inflation is always and everywhere a monetary phenomenon, and the Fed is running a highly accommodative policy at a time when the economy is in recovery mode. The current stance is perhaps warranted in that the labor market is still shy of pre-pandemic norms, but the Fed has indicated that it will not move from its current stance until the economy has reached maximum employment. In addition, the Fed wants to see results; it does not plan to act on projections.

Such a tack runs counter to one of the bedrock principles of monetary policy: lags are long and variable, and thus officials should act preemptively; if policymakers wait until a problem has become apparent, they have waited too long. The abandonment of preemptive action seems to assure that inflation will move to an uncomfortable pace. The potential for additional fiscal stimulus from legislation now making its way through Congress does not help.

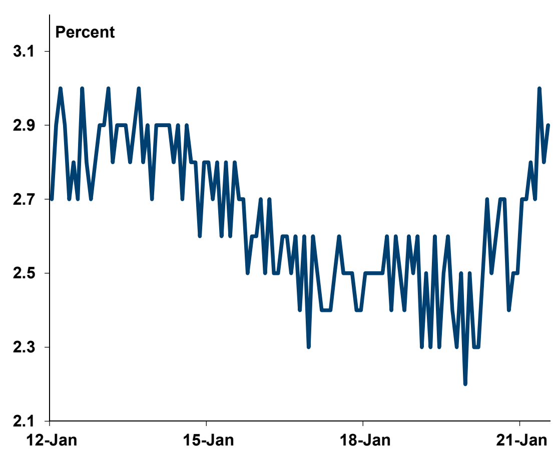
5-Year, 5-Year Forward Break-Even Inflation Rate*



** Expected average inflation per year in the five years that begin five years from now. Weekly end-of-period data.*

Source: Bloomberg

Long-Term Consumer Inflation Expectations



Source: University of Michigan Survey Research Center via Haver Analytics

Review

Week of July 12, 2021	Actual	Consensus	Comments
CPI (June)	**0.9% Total, 0.9% Core**	**0.5% Total, 0.4% Core**	Food prices showed continued upward pressure in June, jumping 0.8% after increases of 0.4% in the prior two months. Energy prices rose 1.5%, including an increase of 2.5% in the price of gasoline. Pressure in the core component has been severe in recent months in areas related to personal transportation (new and used car prices, and prices of rental vehicles). The unwinding of discounts on pandemic-sensitive items (airfares, hotel fees, apparel prices) stood out as well. The recent changes left a year-over-year increase of 5.4% in the headline measure; the core component rose 4.5% in the past 12 months. The core annual inflation rate was the fastest in almost 30 years.
Federal Budget (June)	**$174.2 Billion Deficit**	**$194.0 Billion Deficit**	The postponement of the April tax filing deadline to mid-June led to a surge of 86.5% in federal revenues from the same month last year. Federal spending fell 43.6% year-over-year, as outlays last June were boosted by a surge in activity under the Paycheck Protection Program. The latest shifts left the budget deficit in the first nine months of FY2021 at $2.24 trillion, smaller than the $2.74 trillion registered in the same period last year but huge by historical standards.
PPI (June)	**1.0% Total, 1.0% Ex. Food & Energy**	**0.6% Total, 0.5% Ex. Food & Energy**	Food prices rose 0.8% in June, adding to increases averaging 1.6% in the prior five months. Energy prices at the producer level jumped 2.1% in June and have climbed 19.9% in the first six months of the year. Prices excluding food and energy surged 1.0% after averaging increases of 0.6% in the first five months of 2021. The latest change left prices excluding food and energy 5.6% higher than those in the same month last year.
Industrial Production (June)	**0.4%**	**0.6%**	Manufacturing activity slipped 0.1% in June, led by a decline of 6.6% in the motor vehicle sector, which was constrained by shortages of semiconductors. Activity excluding the automobile sector posted a moderate advance (0.4%), with the recent increase leaving non-auto manufacturing just shy of the pre-pandemic high. The mining sector registered a gain of 1.4%, marking the seventh increase in the past eight months. Mining fell into a deep hole because of both the pandemic and low oil prices, and it remains well shy of pre-pandemic levels, but progress has been steady recently. Utility production jumped 2.7% in June, but shifts in this sector are nearly always influenced by temperature and weather rather than economic fundamentals.

Review Continued

Week of July 12, 2021	Actual	Consensus	Comments
Retail Sales (June)	**0.6% Total, 1.3% Ex. Autos**	**-0.3% Total, 0.4% Ex. Autos**	Sales of new motor vehicles weighed on total retail activity in June (-2.1%; limited by supply shortages of semiconductors), but other areas generally were firm. Activity at gasoline service stations, likely influenced by elevated prices, rose 2.5%. Sales excluding autos and gasoline increased 1.1%. Spurred by accumulated savings from government rebate checks, consumer spent actively in many key areas. Several areas moved to new highs for this recovery period (health-care, clothing, restaurants & bars). Other areas, although a bit shy of recent peaks, were still quite strong relative to pre-pandemic standards.
Consumer Sentiment (July)	**80.8 (-4.7 Index Pts.)**	**86.5 (+1.0 Index Pt.)**	Consumer sentiment fell 5.5% in early July, retreating below the average of 85.6 in Q2 and showing a continued inability to test pre-pandemic levels (pre-pandemic reading of 101.0 in February 2020). Survey respondents' views of inflation likely played a role in their recent responses, as both the short-term and long-term measures increased in the latest month. The year-ahead measure surged 0.6 percentage point to 4.8%, the highest reading since 2008. The long-term measure increased 0.1 percentage point to 2.9% (off the recent high of 3.0% in May, but otherwise the firmest since 2014).

Sources: Bureau of Labor Statistics (CPI, PPI); U.S. Treasury Department (Federal Budget); Federal Reserve Board (Industrial Production); U.S. Census Bureau (Retail Sales); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of July 19, 2021	Projected	Comments
Housing Starts (June) (Tuesday)	**1.550 Million (-1.4%)**	With sales of new homes below totals in the second half of last year, and with inventories of unsold homes increasing, builders were probably cautious in starting new single-family units in June. The volatile multi-family sector is due to ease after above-average results in the prior three months.
Existing Home Sales (June) (Thursday)	**6.00 Million (+3.4%)**	A pickup in pending home sales in May suggests that a four-month slide in the market for existing homes ended in June. The level of pending sales, although up, remained well shy of readings last summer and fall, suggesting that sales also will lag firm readings in earlier months.
Leading Indicators (June) (Thursday)	**0.8%**	Led by sizeable positive contributions from unemployment claims and ISM new orders, the leading indicator index will probably register its 13th increase in the past 14 months (one month in this span showed no change). The index first surpassed the pre-pandemic high in April, and the expected gain in June would leave the measure 2.9% above the pre-Covid benchmark.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July/August 2021

Monday 12

Tuesday 13

NFIB SMALL BUSINESS OPTIMISM INDEX

Apr	99.8
May	99.6
June	102.5

CPI

	Total	Core
Apr	0.8%	0.9%
May	0.6%	0.7%
June	0.9%	0.9%

FEDERAL BUDGET

	2021	2020
Apr	-$225.6B	-$738.0B
May	-$132.0B	-$398.8B
June	-$174.2B	-$864.1B

Wednesday 14

PPI

	Final Demand	Ex. Food & Energy
Apr	0.6%	0.7%
May	0.8%	0.7%
June	1.0%	1.0%

CHAIR POWELL'S MONETARY POLICY TESTIMONY (HOUSE)

JULY BEIGE BOOK

"The U.S. economy strengthened further from late May to early July, displaying moderate to robust growth."

Thursday 15

UNEMPLOYMENT CLAIMS

	Initial (Millions)	Continuing
June 19	0.416	3.484
June 23	0.368	3.367
July 03	0.386	3.241
July 10	0.360	N/A

IMPORT/EXPORT PRICES

	Non-petrol. Imports	Nonagri. Exports
Apr	0.8%	1.2%
May	0.9%	1.8%
June	0.7%	1.1%

EMPIRE MFG

May	24.3
June	17.4
July	43.0

PHILLY FED INDEX

May	31.5
June	30.7
July	21.9

IP & CAP-U

	IP	Cap.Util.
Apr	0.0%	74.6%
May	0.7%	75.1%
June	0.4%	75.4%

CHAIR POWELL'S MONETARY POLICY TESTIMONY (SENATE)

Friday 16

RETAIL SALES

	Total	Ex.Autos
Apr	0.9%	-0.1%
May	-1.7%	-0.9%
June	0.6%	1.3%

BUSINESS INVENTORIES

	Inventories	Sales
Mar	0.2%	5.8%
Apr	0.1%	0.6%
May	0.5%	-0.3%

CONSUMER SENTIMENT

May	82.9
June	85.5
July	80.8

TIC DATA

	Total	Net L-T
Mar	$142.6B	$262.0B
Apr	$100.1B	$100.7B
May	$105.3B	-$30.2B

Monday 19

NAHB HOUSING INDEX (10:00)

May	83
June	81
July	--

Tuesday 20

HOUSING STARTS (8:30)

Apr	1.517 million
May	1.572 million
June	**1.550 million**

Wednesday 21

Thursday 22

INITIAL CLAIMS (8:30)

CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)

	Monthly	3-Mo. Avg.
Apr	-0.09	0.17
May	0.29	0.81
June	--	--

LEADING INDICATORS (10:00)

Apr	1.3%
May	1.3%
June	**0.8%**

EXISTING HOME SALES (10:00)

Apr	5.85 million
May	5.80 million
June	**6.00 million**

Friday 23

Monday 26

NEW HOME SALES

Tuesday 27

DURABLE GOODS ORDERS

FHFA HOME PRICE INDEX

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX

CONSUMER CONFIDENCE

FOMC MEETING

Wednesday 28

ADVANCE INVENTORIES

U.S. INTERNATIONAL TRADE IN GOODS

FOMC DECISION

Thursday 29

INITIAL CLAIMS

Q2 GDP

PENDING HOME SALES

Friday 30

PERSONAL INCOME, CONSUMPTION & PRICES

EMPLOYMENT COST INDEX

MNI CHICAGO PURCHASING MANAGERS' INDEX

REVISED CONSUMER SENTIMENT

Monday 2

ISM MFG INDEX

CONSTRUCTION SPEND.

Tuesday 3

FACTORY ORDERS

VEHICLE SALES

Wednesday 4

ADP EMPLOYMENT REPORT

ISM SERVICES INDEX

Thursday 5

INITIAL CLAIMS

TRADE BALANCE

Friday 6

EMPLOYMENT REPORT

WHOLESALE TRADE

CONSUMER CREDIT

Forecasts in Bold.

Treasury Financing

July/August 2021

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
AUCTION RESULTS: Rate / Cover 13-week bills 0.050% 3.05 26-week bills 0.050% 3.74 3-year notes 0.426% 2.41 10-yr notes 1.371% 2.39	**AUCTION RESULTS:** Rate / Cover 52-week bills 0.075% 3.46 30-yr bonds 2.000% 2.19 6-week CMB 0.045% 3.89 **ANNOUNCE:** $40 billion 4-week bills for auction on July 15 $35 billion 8-week bills for auction on July 15 $30 billion 17-week CMBs for auction on July 14 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $35 billion 17-week CMBs	**AUCTION RESULTS:** Rate / Cover 17-week CMB 0.050% 4.00	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.045% 3.73 8-week bills 0.050% 3.65 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on July 19 $24 billion 20-year bonds for auction on July 21 $16 billion 10-year TIPS for auction on July 22 $35 billion 6-week CMBs for auction on July 20 **SETTLE:** $105 billion 13-,26-week bills $34 billion 52-week bills	$58 billion 3-year notes $38 billion 10-year notes $24 billion 30-year bonds $40 billion 6-week CMBs
19	20	21	22	23
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $35 billion 6-week CMBs **ANNOUNCE:** $35 billion* 4-week bills for auction on July 22 $30 billion* 8-week bills for auction on July 22 $30 billion* 17-week CMBs for auction on July 21 **SETTLE:** $40 billion 4-week bills $35 billion 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $24 billion 20-year bonds $30 billion* 17-week CMBs	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills $16 billion 10-year TIPS **ANNOUNCE:** $100 billion* 13-,26-week bills for auction on July 26 $28 billion* 2-year FRNs for auction on July 28 $60 billion* 2-year notes for auction on July 26 $61 billion* 5-year notes for auction on July 27 $62 billion* 7-year notes for auction on July 29 $35 billion* 6-week CMBs for auction on July 27 **SETTLE:** $105 billion 13-,26-week bills $35 billion 6-week CMBs	
26	27	28	29	30
AUCTION: $100 billion* 13-,26-week bills $60 billion* 2-year notes	**AUCTION:** $61 billion* 5-year notes $35 billion* 6-week CMBs **ANNOUNCE:** $35 billion* 4-week bills for auction on July 29 $30 billion* 8-week bills for auction on July 29 $30 billion* 17-week CMBs for auction on July 28 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $28 billion* 2-year FRNs $30 billion* 17-week CMBs	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills $62 billion* 7-year notes **ANNOUNCE:** $100 billion* 13-,26-week bills for auction on August 2 $35 billion* 6-week CMBs for auction on August 3 **SETTLE:** $100 billion* 13-,26-week bills $35 billion* 6-week CMBs	**SETTLE:** $16 billion 10-year TIPS
2	3	4	5	6
AUCTION: $100 billion* 13-,26-week bills **SETTLE:** $24 billion 20-year bonds $28 billion* 2-year FRNs $60 billion* 2-year notes $61 billion* 5-year notes $62 billion* 7-year notes	**AUCTION:** $35 billion* 6-week CMBs **ANNOUNCE:** $35 billion* 4-week bills for auction on August 4 $30 billion* 8-week bills for auction on August 5 $30 billion* 17-week CMBs for auction on August 4 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs **ANNOUNCE MID-QUARTER REFUNDING:** $58 billion* 3-year notes for auction on August 10 $41 billion* 10-year notes for auction on August 11 $27 billion* 30-year bonds for auction on August 12	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $100 billion* 13-,26-week bills for auction on August 9 $34 billion* 52-week bills for auction on August 10 $35 billion* 6-week CMBs for auction on August 10 **SETTLE:** $100 billion* 13-,26-week bills $35 billion* 6-week CMBs	

*Estimate