Daiwa Capital Markets

U.S. Economic Comment

- Inflation: key drivers still largely in place

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Inflation Prospects

Unsurprisingly, the consumer price index registered another hefty increase in December (0.5 percent overall, 0.6 percent excluding food and energy), which left year-over-year increases of 7.0 percent for the headline index and 5.5 percent for the core component. As widely noted by the media, the increases were the sharpest in decades (39+ years for the headline index and nearly 31 years for core prices).

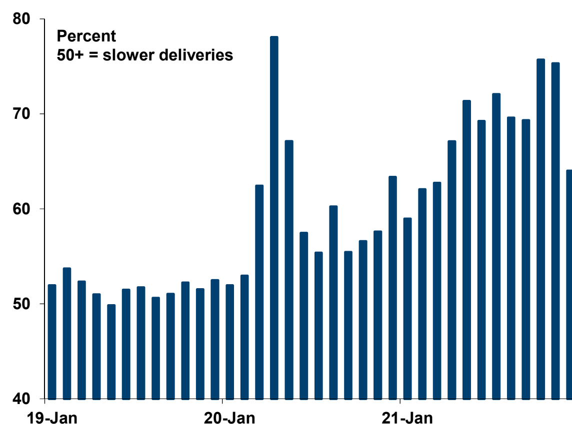
The media also raised the question: how much longer; when will inflation settle? To assess the outlook, one should consider the factors that have pushed prices higher in the past year and consider the prospects for change. This bout of inflation, in our view, has had three main drivers: supply-chain disruptions, strong demand, and a pickup in inflation expectations.

Supply Chains

Freer-flowing supply chains perhaps offer the best chance for an easing in inflation this year, as hints of improvement have emerged recently. The supplier delivery components of both the manufacturing and services indexes published by the Institute for Supply Management fell in December, signaling faster delivery times (chart, which shows a weighted average of the two). The levels of these measures are still high by historical standards, indicating that problems have not been resolved entirely, but conditions seem to have improved. A sizeable decline in the price index from the ISM manufacturing survey also was encouraging, although the price measure from the services survey has been steady at an elevated level.

Shipping costs also seem to be easing. The Baltic Dry Index is a measure of trans-oceanic transportation costs, and it has backed off stratospheric readings seen last fall (chart, right). Some of this decline might represent normal seasonal variation, but the change has been forceful enough to suggest fundamental softening. Like the supplier delivery measure, this index is still high by historical standards, but it has moved in the desired direction.

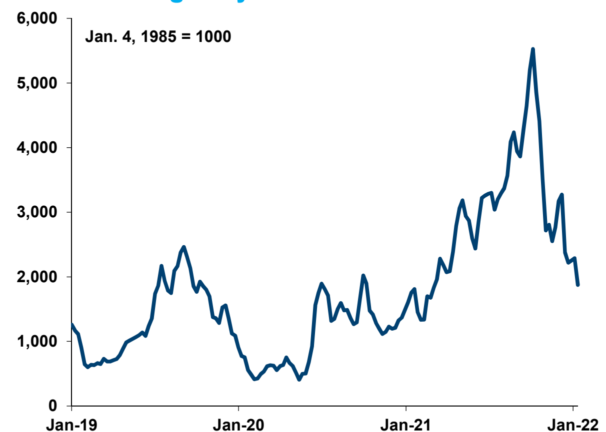
ISM Composite: Supplier Deliveries*



** Weights are calculated using GDP by industry data from the Bureau of Economic Analysis.*

Sources: Institute for Supply Management and Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

Baltic Exchange Dry Index*



** Weekly end-of-period data. The last observation is a daily quote for January 13, 2022.*

Source: The Baltic Exchange via Bloomberg

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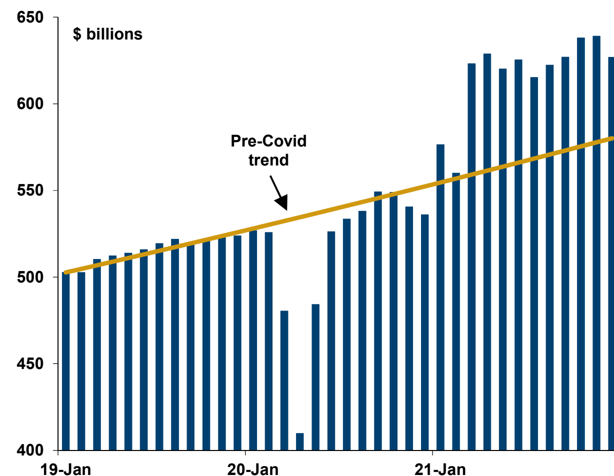
Recent supply-chain developments have been encouraging, but risks remain, as the Omicron variant of Covid-19 could reverse recent progress. Staff shortages driven by the virus have been widely reported, which could easily slow delivery times and constrain production.

Demand

Officials in Washington have been emphasizing pandemic-related supply difficulties in explaining rapid inflation, but strong demand has been a factor as well. The generous support provided by Congress, along with highly accommodative financial conditions engineered by the Federal Reserve, in our view, have fueled demand and stirred inflation.

Retail Sales*



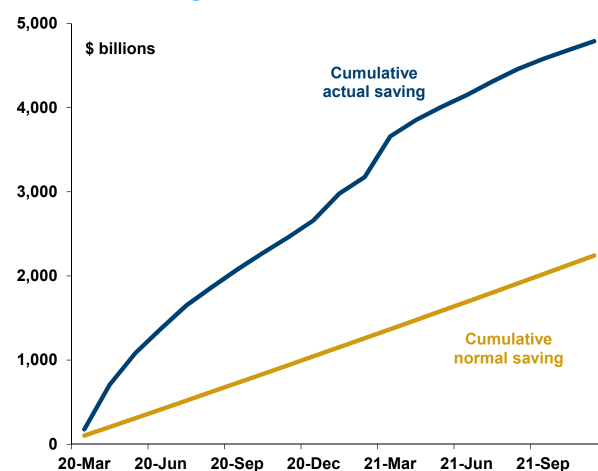
** The pre-Covid trend is based on data for 2019 and early 2020, which showed average monthly growth of 0.4 percent.*

Sources: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

A decidedly soft report on retail sales for December suggests that demand might be flagging, but we would not jump to this conclusion. Given the unique nature of the current cycle (unusually heavy policy support from Washington, and lumpiness in activity because of the pandemic), sharp swings in spending should be expected. The drop in total sales of 1.9 percent in December seems less frightening when one considers an average monthly increase of 1.2 percent from August to October (a total advance of 3.7 percent). Even with the decline in December, the level of sales was well above what would exist if the pre-virus trend had been maintained (chart). In addition, we wonder if the weak results for December were the result of a knee-jerk response to Omicron, which could be reversed once the spread of the new variant dissipates.

Focusing on fundamentals, we would look for households to remain active spenders, fueled by healthy financial positions and a strong labor market. In the financial realm, vigorous support from the federal government allowed many individuals to accumulate a large pool of savings which can support demand in the months ahead.

Personal Saving*



** Cumulative normal saving assumes that disposable personal income continued to grow at the 2018-19 pace and that the saving rate held steady at 7.5 percent.*

Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

Many analysts have argued that household demand will fade as this pool of savings is exhausted, which is certainly true, but individuals have barely tapped this spending power. As shown in the chart (right), the actual amount of accumulated savings (the top line) is far above what might have occurred in the absence of the pandemic (income growth and saving held steady at the 2018-19 rates). In fact, the current gap of $2.55 trillion is only trivially below the high of $2.56 trillion in September. Moreover, the advance in the stock market and the surge in home prices in the past year also have bolstered the financial position of the household sector.

Even if households were not financially flush, the outlook for consumer demand would be favorable because of a strong labor market. Given the stratospheric level of job openings, payroll growth is likely to be brisk throughout 2022, and wage growth is likely to continue moving along its recent firm trajectory as businesses compete to attract workers. The combination of healthy financial positions and secure employment should generate strong support from consumers.

Households were not the only active savers during the pandemic; state and local governments also have behaved cautiously in the past two years and could become more active in 2022. Congress also provided strong fiscal support to this group ($500 billion in grants along with additional funding for schools and transit systems), and outlay totals in the GDP accounts suggest that state and local governments have so far proceeded cautiously in using the funds. In addition, revenue collections have strengthened with the economic recovery. Thus, state and local governments have the wherewithal to either spend more actively or to lighten the tax burdens of their citizens.

Inflation Expectations

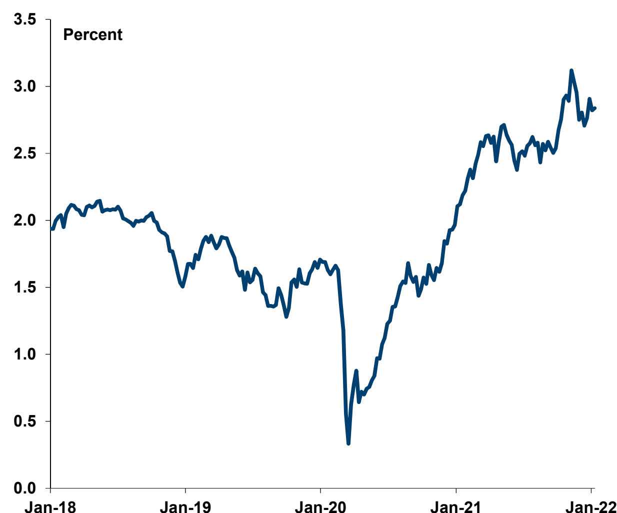
Inflation expectations have probably been a minor factor is stirring price pressure in the past year, but they could be a key contributor in 2022 and beyond. Elevated inflation expectations will lead individuals and businesses to spend early and perhaps more frequently in order to beat additional price increases. Workers will bargain more aggressively for wage increases, and firms will be willing to boost compensation because of a belief that they can pass along the higher costs to the prices of their goods or services.

Such developments already are becoming evident. Wage growth has been brisk, and settlements with striking unions have been generous (John Deere, Kellogg). A passage in the minutes from the December meeting of the Federal Open Market Committee indicated that business contacts of Fed officials were confident that they could pass along higher costs to the prices of their products.

Measures of inflation expectations have picked up. The three-year outlook from the survey of individuals conducted by the Federal Reserve Bank of New York has jumped from readings of approximately 2.5 percent in late 2019 and early 2020 to 4.0 percent in recent tallies. Market participants also have shifted views. Recent readings on the five-year break-even rate on Treasury inflation protected securities have been in the range of 2.7 percent to 3.2 percent, up from readings of 1.5 to 2.0 percent in 2019 and 2020 (chart). Longer-term measures of market-based inflation expectations (10-year and five-year/five-year forward rates) have been generally stable, suggesting that investors do not see enduring problems with inflation. Still, the five-year measure suggests that price pressure is not likely to disappear during 2022, as some analysts expect.

While we expect inflation to remain an issue for a time, we also have recently found reason to believe that price pressure will not evolve into a permanent feature of the U.S. economy. Specifically, the inflation expectations of Fed officials seem to have increased, and thus policymakers are likely to make an effort to restrain the pressure. Only a short time ago, the party line at the Fed was that inflation was a transitory phenomenon tied to the pandemic. Now, officials seem to recognize that aggressive

Five-Year Break-Even Inflation Rate*



** The rate on nominal five-year Treasury notes less the rate on 5-year Treasury inflation-protected securities (TIPS). Weekly end-of-period data.*

Source: Bloomberg

fiscal action has generated vigorous demand and that monetary policy is not properly calibrated to the current environment.

Fed officials recognize the need to adjust policy and they have already started by tapering their quantitative easing program. Recent public comments suggest that Fed officials are prepared to hike interest rates in March and that they will begin redeeming maturing securities from their portfolio shortly thereafter (i.e. quantitative tightening). We doubt that the Fed will act boldly enough to arrest inflation this year, but we are hopeful that inflation problems will not extend over a period of several years.

Review

Week of Jan. 10, 2022	Actual	Consensus	Comments
CPI (December)	**0.5% Total, 0.6% Core**	**0.4% Total, 0.5% Core**	After averaging increases of 2.4% in the prior six months, energy prices dipped 0.4% in December. However, upward pressure remained notable elsewhere. Food prices rose 0.5%, close to the average of 0.6% in the prior nine months, while the increase of 0.6% in the core component exceeded the average of 0.5% in the nine months before December. The latest figures left a 12-month change of 7.0% in the headline index and 5.5% in the core component.
Federal Budget (December)	**$21.3 Billion Deficit**	**$5.0 Billion Deficit**	Federal revenues in December surged 40.6% from the same month last year, marking the fifth consecutive month of robust growth (average of 26.3% from August to December). Some of the recent surge reflects lumpiness generated by the pandemic (e.g. businesses paying delayed payroll taxes), but a firm economy and solid income and profit growth also have boosted receipts. Outlays have waxed and waned in the past two years with the government's efforts to cushion the economy against the effects of Covid-19. The 12-month total for federal spending has eased from the peak in March 2021, but outlays are still well above pre-pandemic levels (the average in 2021-Q4 was 49% above the average in 2020-Q1, before active government support began).
PPI (December)	**0.2% Total, 0.5% Ex. Food & Energy**	**0.4% Total, 0.5% Ex. Food & Energy**	The food and energy components in December provided some relief from price pressure, as they fell 0.6% and 3.3%, respectively. Prices elsewhere continued to advance, although the increase of 0.5% for prices excluding food and energy was a bit less than the average of 0.7% in the first 11 months of the year. Given the pronounced increases in most months last year, the year-over-year changes totaled 9.7% overall and 8.3% excluding food and energy.
Retail Sales (December)	**-1.9% Total, -2.3% Ex. Autos**	**-0.1% Total, 0.1% Ex. Autos**	Some of the weakness in retail sales was the result of expected declines in the auto and gasoline components, but their effect was not especially large. Most of the tumble reflected sharp and broad-based retreats elsewhere (sales excluding autos and gasoline fell 2.5%). Nonstore retailers (primarily online and catalog) stood out with a drop of 8.7%, but this component had plenty of company on the soft side. The poor results might reflect a knee-jerk response to Omicron, which could be reversed when the spread of the new variant dissipates (we hope).

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Review Continued

Week of Jan. 10, 2022	Actual	Consensus	Comments
Industrial Production (December)	**-0.1%**	**0.2%**	Much of the decline in industrial production was the result of a 1.5% drop in utility output because warmer-than-normal temperatures. The manufacturing sector also contributed with a decline of 0.3%, reflecting a retreat of 1.3% in the auto sector and dip of 0.2% elsewhere. Despite the decline in December, manufacturing production rose at an annual rate of 4.9% in Q4. Mining activity rose 2.0% in December and 15.6 % in Q4. Despite the favorable results in recent months, mining activity was still well shy of pre-pandemic levels.
Consumer Sentiment (January)	**68.8 (-1.8 Index Pts.)**	**70.0 (-1.6 Index Pts.)**	Rapid inflation and a surging virus apparently are weighing heavily on consumer sentiment, as the measure published by the University of Michigan Survey Research Center has been below the recession low of 71.8 in five of the past six months. The observation for early January is the second lowest in the current cycle.

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

Preview

Week of Jan. 17, 2022	Projected	Comments
Housing Starts (December) (Wednesday)	**1.660 Million (-1.1%)**	An elevated inventory of unsold homes suggests that single-family housing starts could cool in December after an above-average reading in the prior month. Multi-family activity jumped to the best reading of the current expansion in November, raising the prospect of a partial retracement in December.
Existing Home Sales (December) (Thursday)	**6.50 Million (+0.6%)**	An increase in mortgage applications and elevated readings on pending home sales in recent months suggest a pickup in existing home sales in December, although limited inventories and exorbitant prices could limit the interest of potential buyers and prevent activity from testing the firm results in late 2020 and early 2021.
Leading Indicators (December) (Friday)	**0.6%**	Positive contributions from initial claims for unemployment insurance, the slope of the yield curve, and the ISM new orders index should offset a negative contribution from consumer expectations to lead to the 19th advance in the past 20 months (with the other month showing no change). The expected result in December would leave the level of the index 7.7% above the pre-pandemic high in January 2020.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January / February 2022

Monday	Tuesday	Wednesday	Thursday	Friday
10	11	12	13	14
WHOLESALE TRADE Inventories / Sales Sept 1.4% 1.7% Oct 2.5% 2.5% Nov 1.4% 1.3%	**NFIB SMALL BUSINESS OPTIMISM INDEX** Oct 98.2 Nov 98.4 Dec 98.9	**CPI** Total / Core Oct 0.9% 0.6% Nov 0.8% 0.5% Dec 0.5% 0.6% **FEDERAL BUDGET** 2021 / 2020 Oct -$165.1B -$284.1B Nov -$191.3B -$145.3B Dec -$B -$143.6B **BEIGE BOOK** "Economic activity across the United States expanded at a modest pace in the final weeks of 2021. Contacts from many Districts indicated growth continued to be constrained by ongoing supply chain disruptions and labor shortages."	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Dec 18 0.206 1.718 Dec 25 0.200 1.753 Jan 01 0.207 1.559 Jan 08 0.230 N/A **PPI** Final Demand / Ex. Food & Energy Oct 0.6% 0.4% Nov 1.0% 0.9% Dec 0.2% 0.5%	**RETAIL SALES** Total / Ex.Autos Oct 1.8% 1.8% Nov 0.2% 0.1% Dec -1.9% -2.3% **IMPORT/EXPORT PRICES** Non-petrol Imports / Nonagri. Exports Oct 0.7% 2.0% Nov 0.7% 0.6% Dec 0.3% -2.1% **IP & CAP-U** IP / Cap.Util. Oct 1.2% 76.1% Nov 0.7% 76.6% Dec -0.1% 76.5% **CONSUMER SENTIMENT** Nov 67.4 Dec 70.6 Jan 68.8 **BUSINESS INVENTORIES** Inventories / Sales Sept 0.8% 1.2% Oct 1.3% 2.2% Nov 1.3% 0.7%
17	18	19	20	21
MARTIN LUTHER KING JR DAY	**EMPIRE MFG (8:30)** Nov 30.9 Dec 31.9 Jan -- **NAHB HOUSING INDEX (10:00)** Nov 83 Dec 84 Jan -- **TIC DATA (4:00)** Total / Net L-T Sept -$27.3B $26.7B Oct $143.0B $7.1B Nov -- --	**HOUSING STARTS (8:30)** Oct 1.502 million Nov 1.679 million **Dec 1.660 million**	**INITIAL CLAIMS (8:30)** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Nov 39.0 Dec 15.4 Jan -- **EXISTING HOME SALES (10:00)** Oct 6.34 million Nov 6.46 million **Dec 6.50 million**	**LEADING INDICATORS (10:00)** Oct 0.9% Nov 1.1% **Dec 0.6%**
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **CONSUMER CONFIDENCE** **FOMC MEETING**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **NEW HOME SALES** **FOMC DECISION**	**INITIAL CLAIMS** **GDP** **DURABLE GOODS ORDERS** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, PRICE INDEXES** **EMPLOYMENT COST INDEX** **REVISED CONSUMER SENTIMENT**
31	1	2	3	4
MNI CHICAGO BUSINESS BAROMETER INDEX	**ISM MFG INDEX** **CONSTRUCTION SPEND.** **JOB OPENINGS & LABOR TURNOVER (JOLTS)** **NEW VEHICLE SALES**	**ADP EMPLOYMENT REPORT**	**INITIAL CLAIMS** **PRODUCTIVITY & COSTS** **ISM SERVICES INDEX** **FACTORY ORDERS**	**EMPLOYMENT REPORT**

Forecasts in Bold.

Treasury Financing

January / February 2022

Monday	Tuesday	Wednesday	Thursday	Friday
10	11	12	13	14
AUCTION RESULTS: Rate Cover 13-week bills 0.120% 2.96 26-week bills 0.275% 2.90	**AUCTION RESULTS:** Rate Cover 3-year notes 1.237% 2.47 **ANNOUNCE:** $50 billion 4-week bills for auction on January 13 $40 billion 8-week bills for auction on January 13 $40 billion 17-week CMBs for auction on January 12 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills $40 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 10-yr notes 1.723% 2.51 17-week CMB 0.200% 3.02	**AUCTION RESULTS:** Rate Cover 4-week bills 0.040% 3.17 8-week bills 0.050% 3.39 30-yr bonds 2.075% 2.35 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on January 18 $20 billion 20-year bonds for auction on January 19 $16 billion 10-year TIPS for auction on January 20 **SETTLE:** $111 billion 13-,26-week bills	
17	18	19	20	21
MARTIN LUTHER KING JR DAY	**AUCTION:** $111 billion 13-,26-week bills **ANNOUNCE:** $50 billion* 4-week bills for auction on January 20 $40 billion* 8-week bills for auction on January 20 $40 billion* 17-week CMBs for auction on January 19 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills $40 billion 17-week CMBs $52 billion 3-year notes $36 billion 10-year notes $22 billion 30-year bonds	**AUCTION:** $20 billion 20-year bonds $40 billion* 17-week CMBs	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $16 billion 10-year TIPS **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Jan. 24 $34 billion* 52-week bills for auction on January 25 $26 billion* 2-year FRNs for auction on January 26 $54 billion* 2-year notes for auction on January 24 $55 billion* 5-year notes for auction on January 25 $53 billion* 7-year notes for auction on January 27 **SETTLE:** $111 billion 13-,26-week bills	
24	25	26	27	28
AUCTION: $111 billion* 13-,26-week bills $54 billion* 2-year notes	**AUCTION:** $34 billion* 52-week bills $55 billion* 5-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on January 27 $40 billion* 8-week bills for auction on January 27 $40 billion* 17-week CMBs for auction on January 26 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $26 billion* 2-year FRNs $40 billion* 17-week CMBs	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $53 billion* 7-year notes **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Jan. 31 Settle: $111 billion* 13-,26-week bills $34 billion* 52-week bills	
31	1	2	3	4
AUCTION: $111 billion* 13-,26-week bills **SETTLE:** $20 billion 20-year bonds $16 billion 10-year TIPS $26 billion* 2-year FRNs $54 billion* 2-year notes $55 billion* 5-year notes $53 billion* 7-year notes	**ANNOUNCE:** $50 billion* 4-week bills for auction on February 3 $40 billion* 8-week bills for auction on February 3 $40 billion* 17-week CMBs for auction on February 2 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $40 billion* 17-week CMBs **ANNOUNCE MID-QUARTER REFUNDING:** $50 billion* 3-year notes for auction on February 8 $36 billion* 10-year notes for auction on February 9 $23 billion* 30-year bonds for auction on February 10	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Feb. 7 **SETTLE:** $111 billion* 13-,26-week bills	

**Estimate*