Daiwa Capital Markets

U.S. Economic Comment

- Consumer prices: brisk advance in core; trend in underlying inflation opens the door to a pause in rate hikes
- Inflation expectations: divergence in views of forecasters & consumers
- Senior Loan Officer Opinion Survey suggests tighter lending standards

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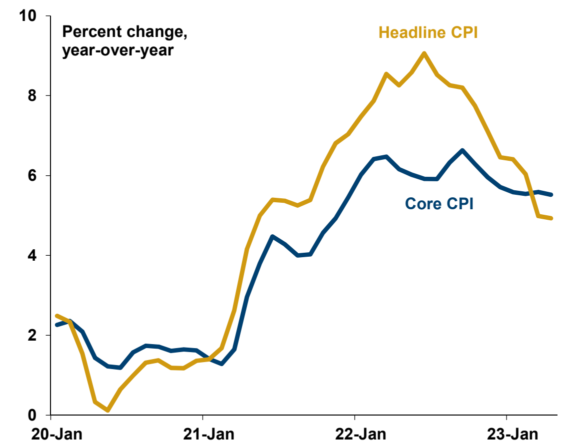
CPI: Parsing the Latest Data

Wednesday's report on consumer prices for April proved challenging to assess, both with respect to upcoming shifts in Fed policy and timing of the eventual return to two-percent inflation. On one hand, inflation is decelerating. The year-over-year change in the headline CPI eased from a recent high of 9.1 percent in June 2022 to 4.9 percent in April 2023. Core inflation also has moderated, with year-over-year growth slowing from 6.5 percent in March 2022 to 5.5 percent in April (chart, right). On the other hand, both headline and core inflation have remained well above the Federal Reserve's inflation target, with core inflation showing no additional improvement in 2023 thus far, holding in a tight range of 4.5 percent to 4.6 percent after falling by 0.8 percentage point from the recent peak last March through December 2022. Thus, the latest picture suggests that some progress has been made in the fight against rapid inflation, opening the potential for Fed officials to abstain from additional rate hikes at upcoming meetings in order to assess the cumulative impact of previous policy adjustments on the economy, but the latest data still lead us to assign a low probability to a pivot to easier policy this year.

CPI



Source: Bureau of Labor Statistics via Haver Analytics

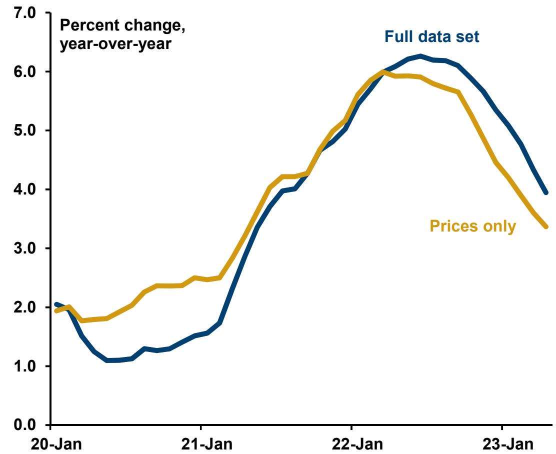
Recent developments in the food and energy components should be viewed favorably, opening the door to additional deceleration in headline inflation. Food prices have rounded to no change for two consecutive months (hinting at a peak) after averaging increases of 0.8 percent per month in 2022. Most importantly, the food at home sub-component (i.e. food purchased at grocery stores) declined in both March and April, the first outright easing in the costs of groceries since late 2020. In addition, softening in food prices at the producer level implies less pressure in the inflation pipeline. Energy prices are similarly encouraging to food data. Gasoline prices rose 3.0 percent in April, pushing the broad energy component higher (+0.6 percent), but other areas softened. Costs of fuel oil fell sharply for the fifth consecutive month (not seasonally adjusted), and costs of energy services (utility natural gas and electricity delivery) declined in the aggregate for the third month in a row.

The core CPI offered hints of easing in key areas, but pressure persisted in others with large movements at the tails of the price change distribution. With regard to key developments, the broad costs of services excluding energy services and housing services rose 0.1 percent, well below the trailing 12-month average of 0.5 percent. Additionally, the year-over-year increase slowed to 5.1 percent from 5.8 percent in March and the recent high of 6.5 percent in September 2022. This area is tracked closely by Fed officials for signs of improvement in underlying inflation, and the April reading offered the first such sign. Other price shifts were mixed. Large declines occurred in hotel fees and airfares, off 3.0 percent and 2.6 percent, respectively, but hotel fees have been under pressure in five of the prior six months and airfares have been volatile. In the opposite direction, used vehicle prices surged 4.4 percent after nine consecutive months of discounting. Importantly, housing costs have yet to exhibit any meaningful sign of softening despite expectations of Fed officials for moderation in coming months.

Underlying Inflation: Evidence of Deceleration

Close tracking of underlying inflation measures helps us cut through noise in the monthly data and better assess price trends and inflation dynamics in the broader economy. One such statistic, the Federal Reserve Bank of New York's Underlying Inflation Gauge, measures co-movement among a series of variables to assess underlying inflation – in this case, 215 disaggregated series from the CPI for the prices-only measure of the UIG and 330 variables for the full data set (the series from the CPI plus additional macroeconomic and financial variables).

Underlying Inflation Gauge



Source: Federal Reserve Bank of New York via Haver Analytics

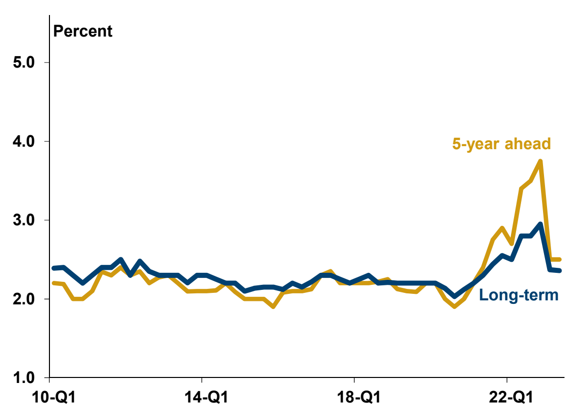
The level of underlying inflation implied by this metric does not yet signal an "all clear" with regard to inflation, as the latest year-over-year change of 3.9 percent in the full data series and 3.4 percent in the prices-only index remain above the two-percent target of the FOMC. Both measures, however, have declined sharply from their respective peaks of 6.3 percent in June 2022 and 6.0 percent in March 2022 for the prices-only index (chart, above). Moreover, this easing at least raises the possibility that the federal funds rate is sufficiently restrictive to return inflation to two percent over time. Therefore, while caution is still warranted, it appears reasonable for Fed officials to pause hikes, perhaps at the June and July meetings.

Inflation Expectations

While we project the FOMC to maintain a restrictive policy stance into 2024, well-anchored inflation expectations have been one factor working in the Committee's favor. If the outlook of economic actors do not shift toward faster increases in the costs of goods and services (and brisk wage increases to compensate for those faster price changes), officials might not have to keep a restrictive policy setting for as long, or as high, as they would have otherwise.

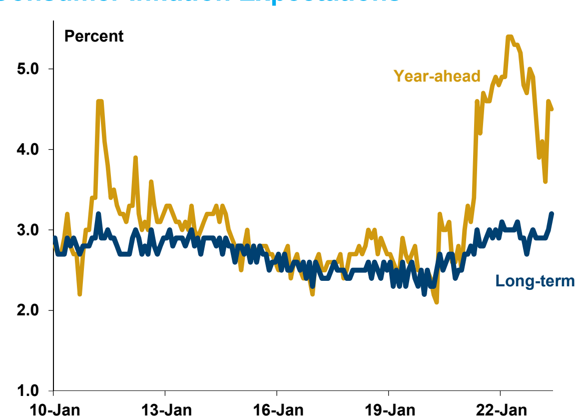
New information on both medium-term and longer-term inflation expectations released today with the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters and the early-May publication of the University of Michigan's Consumer Sentiment Survey shows a dimmer outlook from consumers than forecasters. Results from the Philly Fed survey for Q2 were consistent with those from Q1 and signaled that forecasters' expectations in both the medium-term and long-term are well contained. In contrast, the Michigan measure was less assuring. The year-ahead inflation expectations gauge eased one tick to 4.5 percent, but it had jumped in the prior month and reversed much of the progress in early 2023. The long-term measure rose 0.2 percentage point in May to 3.2 percent, the highest reading since 2011 (charts).

Forecasters' Inflation Expectations*



** Median expectations of forecasters over the next five and 10 years.*
Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

Consumer Inflation Expectations



Source: University of Michigan via Haver Analytics

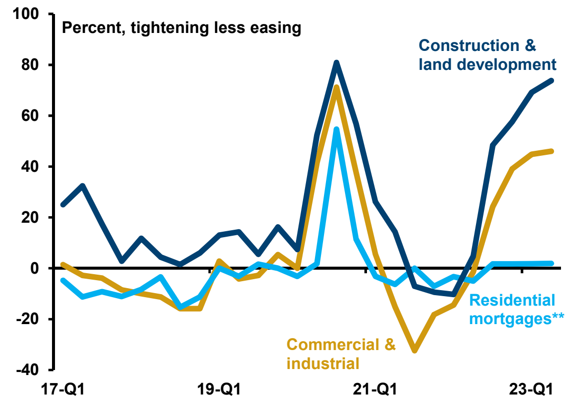
While these surveys are not a direct comparison, we're inclined to assign more weight to the views of professional forecasters, given this group's presumed firm grasp of economic theory and good pulse on the data. In addition, we suspect that the consumer data may include some upside noise, as survey participants may have responded based on elevated prices of essentials (price level) rather than projected changes in prices at a future date (price shift). In any case, the data bear close watching in case of deterioration. If longer-term inflation expectations of consumers were to move higher for an extended period, it might require additional action from the FOMC.

Bank Lending: A Key Variable for Future Policy Shifts

Volatility in the banking sector since March introduced a key risk to the economic outlook, both with regard to damaging confidence of consumers and businesses and in introducing an additional element acting to tighten financial conditions through more restrictive lending standards. Banks had already started tightening lending standards to individuals and businesses as the FOMC aggressively raised interest rates, and that trend was expected to intensify as institutions recalibrated in response to funding strains and deposit flight.

The Senior Loan Officer Opinion Survey (SLOOS), released by the Federal Reserve on Monday, ratified market participant expectations that lending standards for consumers and businesses would tighten. Shifts were pronounced with regard to business loans but more restrained for some types of consumer loans (chart). In a broad sense, the effects of tightening in lending standards on financial conditions (a qualitative variable) are harder to assess than shifts in interest rates, stock prices, or the foreign exchange value of the dollar. Thus, Fed officials will monitor credit flows in the coming months and see if survey responses translate to meaningful constraints on lending. In other words, if materially slower lending was to materialize, it would have implications for economic growth and the setting of monetary policy.

Bank Lending Standards*



** Net percentage balance (tightened less eased). Responses from large and middle-market firms.*
*** GSE-eligible residential mortgages.*
Source: Senior Loan Officer Opinion Survey, Federal Reserve Board via Haver Analytics

The Week Ahead

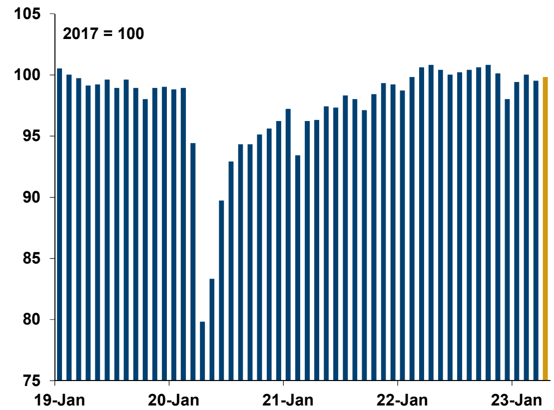
Retail Sales (April) (Tuesday)
Forecast: 0.5% Total, 0.1% Ex. Autos and Gas

Available data suggest an increase in the auto component of retail sales in April after a net decline in the prior two months, and higher prices could boost the value of sales at gasoline service stations. Sales excluding autos and gasoline could be restrained, as consumers exercise caution amid a cloudy economic outlook.

Industrial Production (April) (Tuesday)
Forecast: 0.1%, Capacity Utilization 79.8%

An increase in factory sector employment in April suggests a pickup in the manufacturing component of industrial production, although this measure has tilted lower on balance since last fall as tight financial conditions and slowing growth have constrained activity (chart). Mining activity, which has responded negatively to softening oil and natural gas prices, has stalled below pre-COVID levels. However, a pickup in hiring in April raises the possibility of a month-to-month advance. Utility output could fall with a return to more normal temperatures after unseasonably cold weather in March led to a burst in home heating usage. The expected drop could provide a partial offset to expected gains elsewhere. Keep in mind though that the projected decline in utility output reflects a swing in weather rather than economic fundamentals.

Industrial Production: Manufacturing*



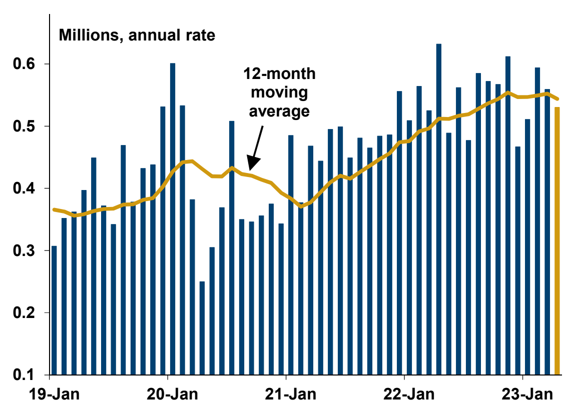
** The gold bar is a forecast for April 2023.*

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

Housing Starts (April) (Wednesday)
Forecast: 1.400 Million (-1.4%)

Multi-family housing starts, which have been a bright spot in the sluggish residential construction sector during the current expansion, have been well supported by a shift in preferences of potential homebuyers and renters from more expensive single-family housing toward smaller, more cost-effective units. While that demand has sustained a brisk pace of activity, it has shown signs of peaking recently as permit issuance has lagged new projects. The restrained permit issuance and emerging headwinds from tighter credit conditions suggest a slowing in multi-family starts in April. Single-family building has moved in the opposite direction, falling sharply for much of the past year. However, recent stirring in single-family permit issuance in response to a pickup in new homes sales opens the possibility of a third consecutive increase (chart, below right).

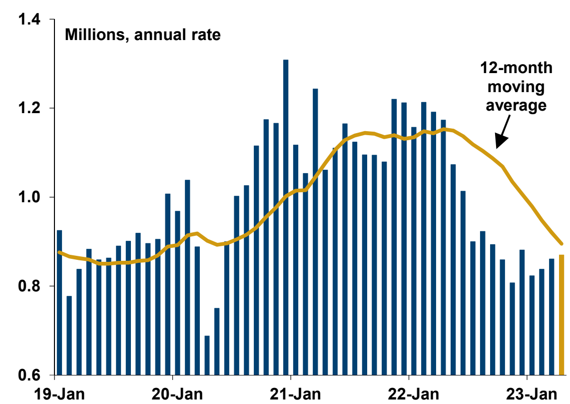
Multi-Family Housing Starts*



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

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

Single Family Housing Starts*



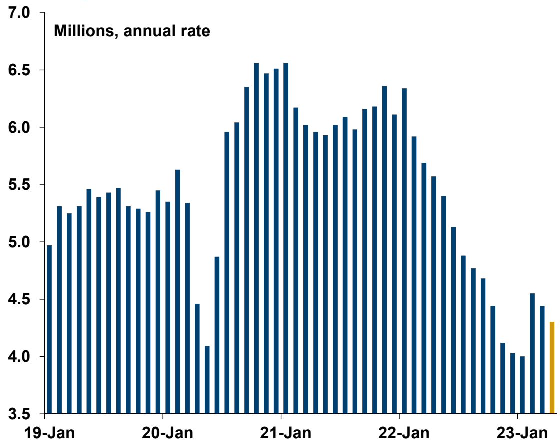
**The gold bar is a forecast for April 2023.*

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

Existing Home Sales (April) (Thursday)
Forecast: 4.300 Million (-2.3%)

The housing market showed signs of life in early 2023 as mortgage interest rates eased and prices showed hints of cooling (chart, left). However, inventories remain tight, constraining activity in many markets, and the affordability situation in the aggregate has forced many potential buyers to reevaluate plans for a home purchase. Thus, we suspect that sales could soften in April and reverse a portion of the modest recovery in the past two months after activity hit a post-COVID low in January 2023. A pullback of 5.2 percent in pending home sales in March further supports this expectation.

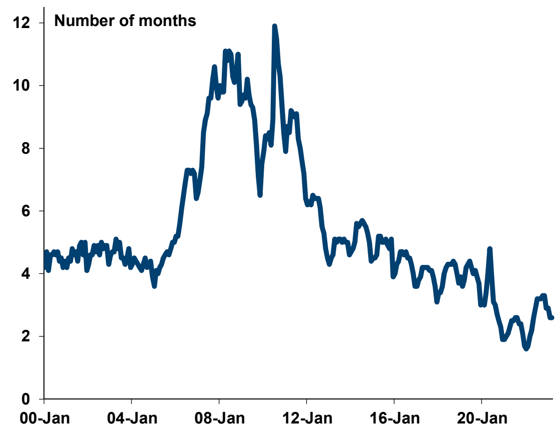
Existing Home Sales*



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

Sources: National Association of Realtors via Haver Analytics; Daiwa Capital Markets America

Months' Supply of Unsold Homes



Source: National Association of Realtors via Haver Analytics

Leading Indicators (April) (Thursday)
Forecast: -0.6%

Negative contributions from the ISM new orders, consumer expectations, and the slope of the yield curve raise the possibility of a 14th consecutive decline in the index of leading economic indicators. The expected change would leave the level of the index 8.5 percent below the cycle high in December 2021.

Economic Indicators

May/June 2023

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
WHOLESALE TRADE Inventories Sales Jan -0.6% 0.4% Feb 0.1% 0.4% Mar 0.0% -2.1%	**NFIB SMALL BUSINESS OPTIMISM INDEX** Feb 90.9 Mar 90.1 Apr 89.0	**CPI** Total Core Feb 0.4% 0.5% Mar 0.1% 0.4% Apr 0.4% 0.4% **FEDERAL BUDGET** 2023 2022 Feb -$262.4B -$216.6B Mar -$378.1B -$192.6B Apr $176.2B $308.2B	**UNEMP. CLAIMS** Initial Continuing (millions) Apr 15 0.246 1.843 Apr 22 0.229 1.801 Apr 29 0.242 1.813 May 6 0.264 N/A **PPI** Final Demand Ex. Food & Energy Feb 0.0% 0.2% Mar -0.4% 0.0% Apr 0.2% 0.2%	**IMPORT/EXPORT PRICES** Non-petrol. Imports Nonagri. Exports Feb -0.4% 0.4% Mar -0.6% -0.5% Apr -0.1% 0.2% **CONSUMER SENTIMENT** Mar 62.0 Apr 63.5 May 57.7
15	16	17	18	19
EMPIRE MFG (8:30) Mar -24.6 Apr 10.8 May -- **TIC FLOWS (4:00)** Long-Term Total Jan $31.9B $183.2B Feb $71.0B $28.0B Mar -- --	**RETAIL SALES (8:30)** Total Ex.Autos Feb -0.7% -0.6% Mar -0.6% -0.4% **Apr 0.5% 0.4%** **IP & CAP-U (9:15)** IP Cap.Util. Feb 0.2% 79.6% Mar 0.4% 79.8% **Apr 0.1% 79.8%** **BUSINESS INVENTORIES (10:00)** Inventories Sales Jan -0.1% 1.1% Feb 0.1% -0.3% **Mar 0.0% -1.1%** **NAHB HOUSING INDEX (10:00)** Mar 44 Apr 45 May --	**HOUSING STARTS (8:30)** Feb 1.432 million Mar 1.420 million **Apr 1.400 million**	**UNEMP. CLAIMS (8:30)** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Mar -23.2 Apr -31.3 May -- **EXISTING HOME SALES (10:00)** Feb 4.550 million Mar 4.440 million **Apr 4.300 million** **LEADING INDICATORS (10:00)** Feb -0.5% Mar -1.2% **Apr -0.6%**	
22	23	24	25	26
	NEW HOME SALES	**FOMC MINUTES**	**UNEMP. CLAIMS** **REVISED Q1 GDP** **CHICAGO FED NATIONAL ACTIVITY INDEX** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, PCE PRICE INDEXES** **INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **DURABLE GOODS** **REVISED CONSUMER SENTIMENT**
29	30	31	1	2
MEMORIAL DAY	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CONSUMER CONFIDENCE**	**MNI CHICAGO BUSINESS BAROMETER** **JOLTS** **BEIGE BOOK**	**UNEMP. CLAIMS** **ADP EMPLOYMENT** **REVISED Q1 PRODUCTIVITY & COSTS** **ISM MFG** **CONSTRUCTION** **VEHICLE SALES**	**EMPLOYMENT REPORT**

Forecasts in Bold.

Treasury Financing

May/June 2023

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
AUCTION RESULTS: Rate Cover 13-week bills 5.140% 2.66 26-week bills 4.890% 2.83	**AUCTION RESULTS:** Rate Cover 3-yr notes 3.695% 2.93 **ANNOUNCE:** $35 billion 4-week bills for auction on May 11 $35 billion 8-week bills for auction on May 11 $36 billion 17-week bills for auction on May 10 $45 billion 149-day CMBs for auction on May 11 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills $36 billion 17-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 5.000% 2.98 10-yr notes 3.448% 2.45	**AUCTION RESULTS:** Rate Cover 4-week bills 5.605% 3.18 8-week bills 4.680% 3.04 30-yr bonds 3.741% 2.43 149-day CMB 5.040% 2.33 **ANNOUNCE:** $108 billion 13-,26-week bills for auction on May 15 $36 billion 52-week bills for auction on May 16 $15 billion 20-year bonds for auction on May 17 $15 billion 10-year TIPS for auction on May 18 $45 billion 154-day CMBs for auction on May 16 **SETTLE:** $105 billion 13-,26-week bills	
15	16	17	18	19
AUCTION: $108 billion 13-,26-week bills **SETTLE:** $40 billion 3-year notes $35 billion 10-year notes $21 billion 30-year bonds	**AUCTION:** $36 billion 52-week bills $45 billion 154-day CMBs **ANNOUNCE:** $35 billion* 4-week bills for auction on May 18 $35 billion* 8-week bills for auction on May 18 $36 billion* 17-week bills for auction on May 17 **SETTLE:** $35 billion 4-week bills $35 billion 8-week bills $36 billion 17-week bills $45 billion 149-day CMBs	**AUCTION:** $36 billion* 17-week bills $15 billion 20-year bonds	**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills $15 billion 10-year TIPS **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on May 22 $42 billion* 2-year notes for auction on May 23 $43 billion* 5-year notes for auction on May 24 $35 billion* 7-year notes for auction on May 25 $22 billion* 2-year FRNs for auction on May 24 **SETTLE:** $108 billion 13-,26-week bills $36 billion 52-week bills $45 billion 154-day CMBs	
22	23	24	25	26
AUCTION: $108 billion* 13-,26-week bills	**AUCTION:** $42 billion* 2-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on May 25 $35 billion* 8-week bills for auction on May 25 $36 billion* 17-week bills for auction on May 24 **SETTLE:** $35 billion* 4-week bills $35 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:** $35 billion* 4-week bills $35 billion* 8-week bills $35 billion* 7-year notes **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on May 30 **SETTLE:** $108 billion* 13-,26-week bills	**SETTLE:** $22 billion* 2-year FRNs
29	30	31	1	2
MEMORIAL DAY	**ANNOUNCE:** $108 billion* 13-,26-week bills **ANNOUNCE:** $35 billion* 4-week bills for auction on June 1 $35 billion* 8-week bills for auction on June 1 $36 billion* 17-week bills for auction on May 31 **SETTLE:** $35 billion* 4-week bills $35 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills **SETTLE:** $42 billion* 2-year notes $43 billion* 5-year notes $35 billion* 7-year notes $15 billion 20-year bonds $15 billion 10-year TIPS	**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on June 5 **SETTLE:** $108 billion* 13-,26-week	

*Estimate