Daiwa Capital Markets

U.S. Economic Comment

- FOMC preview: likely upward shift in the dot plot
- Tariffs: early reaction suggests constraint on growth

Michael Moran
Daiwa Capital Markets America
212-612-6392
michael.moran@us.daiwacm.com

FOMC Preview

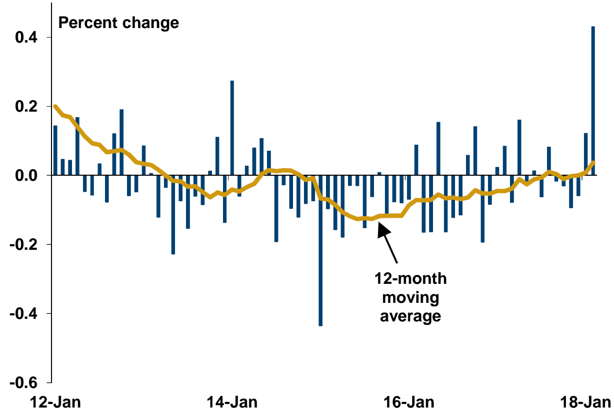
It is difficult to imagine the Federal Open Market Committee remaining idle at its meeting on March 20-21. Fed officials seem pleased with the performance of the economy, and they have repeatedly emphasized the importance of continuing to normalize policy. Market participants have priced in a hike at the upcoming meeting, and public comments from policymakers have not challenged this perception. Thus, the Committee is likely to increase the target federal funds rate 25 basis points to a range of 1.50-1.75 percent.

The key issue at this meeting involves expectations for rate changes over the balance of the year -- that is, whether the dot plot continues to show three tightenings or shifts upward to four. We had been looking for three tightenings this year, and we suspected that the new dot plot also would suggest three hikes. However, the latest economic news, while mixed, carried a strong tone on balance and led us to believe that four policy changes are now more likely.

The latest report on consumer prices was tame. The Bureau of Labor Statistics published an increase of 0.2 percent in the core CPI, but it rounded up to that total (0.182 percent), and sources of the upward move seemed to be influenced by random volatility (e.g. a surge in apparel prices after soft readings in the closing months of last year). Several key items in the CPI showed modest increases or price declines. Retail sales in February also were soft, but underlying fundamentals for consumer spending are positive (firm labor market and healthy balance sheets), and thus we did not view the slow results as troubling.

Other economic statistics this week were robust. We were struck by the shift in import prices, which rose 0.4 percent overall and 0.5 percent excluding petroleum products. We monitor an index of finished goods prices to eliminate all the random volatility from commodity prices, and this measure was up 0.4 percent, a marked pick up from other recent observations (chart, left). All three components of this index contributed

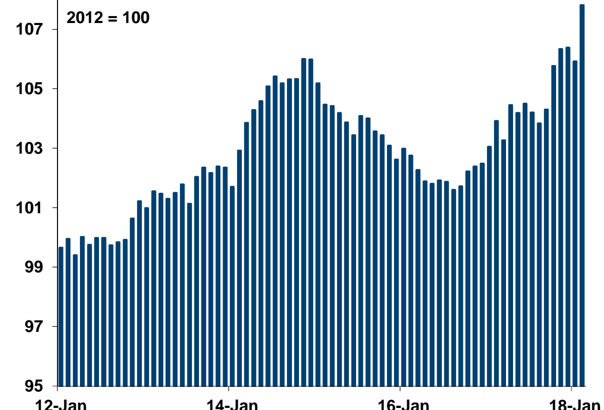
Key Import Prices*



* A weighted average index of capital goods, consumer goods, and automobile prices. Weights are derived from import shares into the United States.

Source: Bureau of Labor Statistics; Bureau of Economic Analysis; Daiwa Capital Markets America

Industrial Production: Manufacturing & Mining*



* A weighted average of the manufacturing and mining components of industrial production. Weights are based on industry shares as of 2017.

Source: Federal Reserve Board; Daiwa Capital Markets America

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(consumer goods, capital goods, motor vehicles). Fed officials have cited declining import prices as a factor restraining inflation last year, and they have noted the possibility of a reversal of this trend pushing inflation higher this year. That view seems to be unfolding, thereby supporting the Fed view that inflation will move to the target of two percent in the medium term. In fact, the new figures suggest that inflation could pick up sooner than expected by some Fed officials.

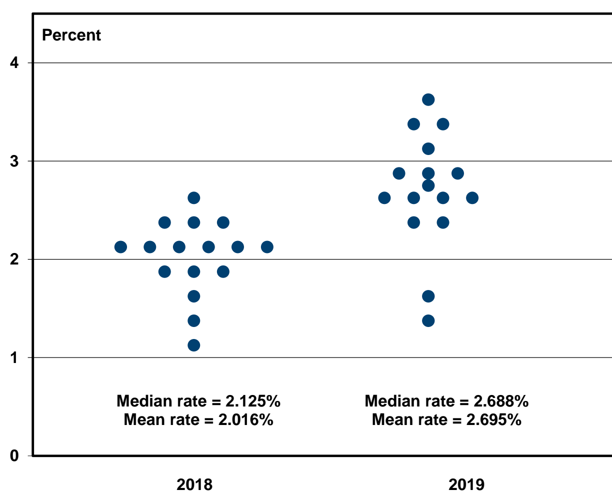
The report on industrial production was vigorous, showing an increase of 1.1 percent in February despite a weather/temperature-related drop in the utility sector. A broad-based increase in the manufacturing sector (18 of 20 industries registering gains), along with a marked pickup in mining activity, pushed production well above other recent readings (chart, p. 1, right). Some of the jump most likely reflected payback for a dip in January, and random volatility might have been a factor as well. Still, the new data suggest that the underlying trend is firm.

Two other reports rounded out a week of mostly positive economic news. Consumer sentiment rose to a new cyclical high, with the current conditions component moving to a record level. The favorable reading on this measure supports our view that the recent softness in retail sales is not a concern. A strong job market no doubt is influencing consumer attitudes, and a final report this week suggested that the labor market will remain firm. Specifically, the number of job openings rebounded from two small declines and moved to a new record level in January.

While the latest economic statistics lead us to lean toward four tightenings, we would not be shocked if the dots continued to indicate three rate hikes. The "arithmetic" behind an upward shift in the median dot is challenging. As shown on the chart below, 12 of 16 officials at the December meeting were at or below the median of 2.125 percent for year-end 2018. Assuming that none of the six officials below the December median move above that level, four of the six individuals at the median would need to alter their view in order to signal four interest rate increases. If Janet Yellen were one of the policymakers at the December median, then four of the remaining five would need to shift. That seems to be a tall order.

A tall order, indeed, but far from insurmountable. Recent comments from Fed officials suggest that views have changed considerably since the end of last year, and thus four of six (or five of six ex-Yellen) easily could

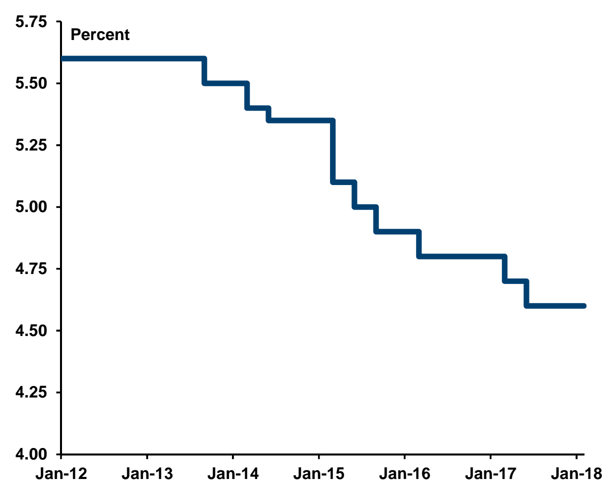
Expected Fed Funds Rate (Year-End '18 & '19)*



Expectations as of December 2017. Each dot represents the expected federal funds rate of a Fed official at the end of the designated year (2018 and 2019). Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but three governorships were open at the times of the December 2017 meeting. The plot from the upcoming meeting will contain 15 dots (four governorships now open).

Source: Federal Open Market Committee

Longer-Run Unemployment Rate*



Data from June 2015 forward show the median view of Fed officials. Earlier observations are the midpoint of the central tendency.

Source: Federal Open Market Committee

change. Alternatively, an official below the December median could make a bold jump and signal four tightenings.

Consider some of the comments made in recent weeks: Chairman Powell noted in his monetary policy testimony that he had become more optimistic since December; William Dudley of the New York Fed has emphasized gradual changes in policy, but noted that four shifts can be viewed as gradual; Eric Rosengren of the Boston Fed indicated that normalization might need to proceed at a pace slightly faster than that envisioned in December. The most striking set of comments, in our view, came from a speech by Governor Lael Brainard earlier this month. She highlighted the firm performance of the economy and emphasized the importance of normalizing policy. Ms. Brainard has been among the most dovish of Fed officials, and we doubt that she would favor four rate hikes, but the hawkish bent of her new talk signaled a profound change in view. If other officials have altered views to a similar degree, the dots are likely to show a marked upward shift.

Thus, we now look for an upward shift in the dot plot, with the median dot moving from 2.125 percent to 2.375 percent.

We are interested in another aspect of the new set of forecasts from the FOMC: the long-run unemployment rate, which can be viewed as the Committee's collective estimate of the natural rate (or noninflationary rate) of unemployment. We see a good chance that the new figure will be lower than the 4.6 percent that has been in place since June 2017 (chart, prior page, right). The actual unemployment rate has been below this benchmark for approximately one year without inflation stirring meaningfully. Thus, we suspect that some officials are likely to reduce their estimate of the noninflationary rate of unemployment. If the new estimate were to fall as low as 4.0 percent, this would suggest that officials see some inflation resistance in the economy and would lessen the urgency to tighten policy. However, a shift from 4.6 percent to 4.0 percent is a huge adjustment; we would be surprised if it moved to this degree.

Tariffs: Markets Are Already Reacting

The imposition of tariffs on steel and aluminum create downside risks for the U.S. economy, although the outcome is highly uncertain. Much depends on the number of exemptions granted by the Trump administration. Canada and Mexico, at least initially, will not be subject to the charges, and some have suggested that other close allies also might receive preferential treatment (the European Union, Japan, Australia come to mind in this regard). If exemptions are widespread, the influence of the tariffs on the U.S. economy would be limited.

The potential for numerous exemptions is encouraging, but the economy could still be damaged if major trading partners retaliate, and many foreign officials have indicated that they plan to respond proportionally to the U.S. action.

The influence of tariffs on the U.S. economy also will depend on the response of domestic producers. If they were to boost production to offset a drop in imports, the U.S. economy and inflation would probably deviate modestly or not at all from their current paths. However, if domestic firms respond to lessened competition from abroad by raising prices, economic growth would slow and inflation would quicken.

Unfortunately, odds seem to favor U.S. firms using the shelter from competition to raise prices, as steel quotes have surged recently (chart, next page, left). The upward pressure on prices began last November, suggesting that factors other than tariffs were involved, but the pace has accelerated since the March 1, when President Trump announced his intention to impose tariffs. The average weekly price change accelerated from 1.6 percent from mid-November through February to 4.6 percent in the first two full weeks of March.

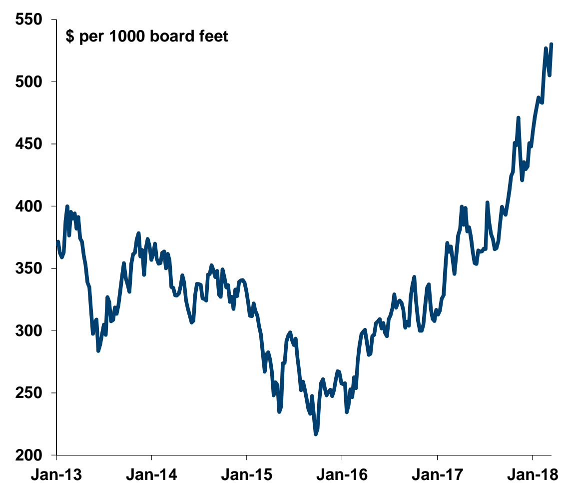
The experience in the lumber market also suggests a sizeable price response to the imposition of tariffs. Lumber prices started to increase sharply in early 2017 in response to a petition from U.S. producers for

Steel Price*

** The price of hot-rolled steel coil produced at U.S Midwest mills. Weekly average data, except for the last observation which is a quote for March 15, 2018.*

Source: Wall Street Journal

Lumber Price*



** The price of lumber according to the first-expiring CME futures contract. Weekly average data, except for the last observation which is a quote for March 15, 2018.*

Source: Chicago Mercantile Exchange

protection from subsidized lumber from Canada. The Commerce Department determined that the claim was valid in November and tariffs became effective around the turn of the year, leading to a faster rate of increase in lumber prices (chart, right). An article in a recent Bloomberg/Businessweek magazine noted that construction companies are reacting to higher lumber prices by building smaller units and multi-family structures and by moving to new designs that limit the use of lumber -- changes that translate to reductions in the real value of new housing (i.e. slower growth in GDP).

We suspect that economic activity will ease in response to the tariffs. The experience in 2002-03 when President George W. Bush imposed steel tariffs provides guidance. The economy and labor market sputtered after the adoption of the tariffs in March. While many factors undoubtedly were influencing the economy, the tariffs played a key role. One study concluded that the import charges led to 200,000 job losses from April through November 2002 (total payroll employment fell 47,000 over this span). The number of individuals losing their jobs was larger than the 187,000 workers in the steel industry at that time. (Joseph Francois and Laura M. Baughman, “The Unintended Consequences of U.S. Steel Import Tariffs: A Quantification of the Impact During 2002,” a study prepared for The Consuming Industries Trade Action Coalition Foundation, February 2003.)

Isolating the effects of the Trump tariffs is not possible without having more information on exemptions and retaliations (and second-round effects by Trump in response to retaliations). However, Macroeconomic Advisers in St. Louis, a reliable forecasting firm, ran several simulations on its econometric model. The best case scenario -- a positive supply response from domestic producers rather than price hikes, no additional tightening in monetary policy by the Federal Reserve, and no retaliation by foreign countries -- involved a negligible effect on GDP, employment, and inflation.

Alternatively, if firms raise prices by the amounts of the tariffs rather than boosting output, GDP in 2020 would be almost 0.4 percent lower than it would be otherwise, while the unemployment rate would be 0.25 percentage point higher than it would be in an environment without tariffs. Inflation also would pick up, with the CPI in 2020 0.65 percent higher than otherwise.

Given the recent movement in steel prices, we view the best-case scenario noted above as unlikely. The alternative view is closer to the mark, but it is probably too tame because it does not allow for retaliation, which seems likely. Moreover, press reports indicate that President Trump is considering additional tariffs on China, which would heighten the probability of a trade war. This is not likely to end well.

Review

Week of March 12, 2018	Actual	Consensus	Comments
Federal Budget (February)	**$215.2 Billion Deficit**	**$216.0 Billion Deficit**	Federal revenues slipped 9.4% on a year-over-year basis, markedly slower than the average advance of 4.3% in the first four months of FY2018. The retreat partly reflected reduced withholdings from paychecks because of the Tax Cut and Jobs Act, but hefty refunds from past payments played a much larger role. Outlays were firmer than the recent average and 2.0% higher than spending in the same month last year. The combination of weak revenues and above-average expenditures left the February shortfall noticeably wider than the monthly average of $192.6 billion in the prior four fiscal years.
CPI (February)	**0.2% Total, 0.2% Core**	**0.2% Total, 0.2% Core**	Energy price rose 0.1% in February, edging higher after surging more than 13% in the prior six months. The published increase of 0.2% in the core CPI belied the subdued tone of this component. The increase rounded up to this total (0.182%), and the sources of the increase were driven by random volatility rather than fundamentals (e.g. a jump in apparel prices after two sharp declines in late 2017). The year-over-year change in the core index was steady at 1.8% and up only slightly from 1.7% last spring and summer.
Retail Sales (February)	**-0.1% Total, 0.2% Ex. Autos**	**0.3% Total, 0.4% Ex. Autos**	A drop of 0.9% in the motor vehicle component contributed to the weakness in the February retail sales report, as sales eased from a spurt late last year when consumers replaced vehicles damaged by hurricanes. Sales at service stations also fell despite higher prices. Sales excluding autos and gasoline rose 0.3%, a respectable pace when viewed in isolation, but results were flat or down in the prior two months, leaving little net change since November. While activity has been lackluster recently, fundamentals for consumer spending are solid (strong job market and healthy balance sheets), and thus consumer spending should be well maintained in coming months.
PPI (February)	**0.2% Total, 0.2% Core**	**0.1% Total, 0.2% Core**	Prices of both food and energy slipped in January (off 0.4% and 0.5%, respectively), but a moderate increase in the core PPI nudged the headline index higher. The latest changes left the year-over-year increase in the headline index at 2.8%, up one tick from the January reading but still below the recent high of 3.1% in November. The core component rose 2.5% year-over-year, the fastest pace since February 2012.

Review Continued

Week of March 12, 2018	Actual	Consensus	Comments
Housing Starts (February)	**1.236 Million (-7.0%)**	**1.290 Million (-2.7%)**	The drop in housing starts occurred entirely in the multi-family sector (-26.1%), with the change likely reflecting random volatility as multi-family activity surged in January (+25.6%) and moved well above the underlying trend. Single-family activity rose 2.9%, continuing a choppy pattern that is tracing an upward trend. The level of single-family starts remained below the cyclical high in November, but the latest reading represented the second highest of the current expansion.
Industrial Production (February)	**1.1%**	**0.4%**	Both manufacturing (+1.2%) and mining (+4.3%) contributed to the surge in industrial production in February, with both components advancing sharply above underlying trends. Utility output slipped 4.7%, but the drop was driven bny a swing in temperatures and was not meaningful in an economic sense. The gain in manufacturing output was broad-based, with 18 of 20 industries posting increases. The motor vehicle area was one of the strongest (+3.9%), but other areas also were robust, as shown by an increase of 1.0% in manufacturing output excluding vehicles.
Consumer Sentiment (March)	**102.0 (+2.3 Index Pts.)**	**99.3 (-0.4 Index Pt.)**	The gain in consumer sentiment in March pushed the measure to a new high for the current cycle, although it remained shy of numerous observations in the late 1990s and 2000. The current conditions index accounted for all of the jump in the headline measure with an increase of 6.9%. The advance pushed the current conditions index to a new record level. The expectations component fell 1.6%, but it remained comfortably within the recent range. The firm economic environment led individuals to expect more inflation in the near term, as the year-ahead gauge of expected inflation moved to 2.9%, up from 2.7% in the prior month and the highest since March 2015. The long-term measure of expected inflation was steady at 2.5%, which also matched the average from last year.

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

Preview

Week of March 19, 2018	Projected	Comments
Current Account (2017-Q4) (Wednesday)	**-$125.0 Billion ($24.4 Billion Wider Deficit)**	Net exports slipped in the fourth quarter, which should feed through to the current account and leave a wider deficit. Income flows also face downside risks.
Existing Home Sales (February) (Wednesday)	**5.45 Million (+0.9%)**	Sharp declines in sales in December and January seemed to represent offsets to a surge in November rather than a fundamental pullback. Activity should move back toward trend from the low level in January.
Leading Indicators (February) (Thursday)	**0.6%**	Building permits and stock prices are likely to make negative contributions to the index of leading economic indicators, but most other components are likely to contribute positively. The ISM orders index and the manufacturing workweek will probably be the strongest elements; unemployment claims, the slope of the yield curve, and consumer expectations also should stand out on the positive side. If the expectation is realized, February will mark the 21st consecutive month without a decline (one reading of no change in this span).
Durable Goods Orders (February) (Friday)	**1.5%**	Indicators related to the manufacturing sector in February have been uniformly robust thus far (ISM, factory employment, industrial production). The strength is also likely to be reflected in new orders for durable goods.
New Home Sales (February) (Friday)	**0.620 Million (+4.6%)**	Sharp declines in sales in December and January seemed to represent offsets to a surge in November rather than a fundamental pullback. Activity should move back toward trend from the low level in January.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

March/April 2018

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
FEDERAL BUDGET FY2018 FY2017 Dec -$23.2B -$27.3B Jan $49.2B $51.3B Feb -$215.2B -$192.0B	**NFIB SMALL BUSINESS OPTIMISM INDEX** Dec 104.9 Jan 106.9 Feb 107.6 **CPI** Headline Core Dec 0.2% 0.2% Jan 0.5% 0.3% Feb 0.2% 0.2%	**RETAIL SALES** Total Ex.Autos Dec -0.1% 0.0% Jan -0.1% 0.1% Feb -0.1% 0.2% **PPI** Final Demand Core Dec 0.0% -0.1% Jan 0.4% 0.4% Feb 0.2% 0.2% **BUSINESS INVENTORIES** Inventories Sales Nov 0.4% 1.4% Dec 0.6% 0.5% Jan 0.6% -0.2%	**INITIAL CLAIMS** Feb 24 210,000 Mar 03 230,000 Mar 10 226,000 **IMPORT/EXPORT PRICES** Non-fuel Imports Nonagri. Exports Dec -0.2% 0.1% Jan 0.5% 0.8% Feb 0.5% 0.2% **EMPIRE MFG** Jan 17.7 Feb 13.1 Mar 22.5 **PHILLY FED INDEX** Jan 22.2 Feb 25.8 Mar 22.3 **NAHB HOUSING INDEX** Jan 72 Feb 71 Mar 70 **TIC DATA** Total Net L-T Nov $32.0B $57.5B Dec -$122.5B $23.3B Jan $119.7B $62.1B	**HOUSING STARTS** Dec 1.207 million Jan 1.329 million Feb 1.236 million **IP & CAP-U** IP Cap.Util. Dec 0.5% 77.8% Jan -0.3% 77.4% Feb 1.1% 78.1% **JOLTS DATA** Openings (000) Quit Rate Nov 5,933 2.2% Dec 5,667 2.3% Jan 6,312 2.2% **CONSUMER SENTIMENT** Jan 95.7 Feb 99.7 Mar 102.0
19	20	21	22	23
	FOMC MEETING	**CURRENT ACCOUNT (8:30)** 17-Q2 -$124.4 bill. 17-Q3 -$100.6 bill. **17-Q4 -$125.0 bill.** **EXISTING HOME SALES (10:00)** Dec 5.56 million Jan 5.38 million **Feb 5.45 million** **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **FHFA HOME PRICE INDEX (9:00)** Nov 0.5% Dec 0.3% Jan -- **LEADING INDICATORS (10:00)** Dec 0.6% Jan 1.0% **Feb 0.6%**	**DURABLE GOODS ORDERS (8:30)** Dec 2.7% Jan -3.6% **Feb 1.5%** **NEW HOME SALES (10:00)** Dec 0.643 million Jan 0.593 million **Feb 0.620 million**
26	27	28	29	30
CHICAGO FED NAT'L ACTIVITY INDEX	**S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **CONSUMER CONFIDENCE**	**REVISED GDP** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PENDING HOME SALES**	**INITIAL CLAIMS** **PERSONAL INCOME, CONSUMPTION, PRICE INDEXES** **CHICAGO PURCHASING MANAGERS' INDEX** **REVISED CONSUMER SENTIMENT**	***GOOD FRIDAY***
2	3	4	5	6
ISM MFG INDEX **CONSTRUCTION SPEND.**	**NEW VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **ISM NON-MFG INDEX** **FACTORY ORDERS**	**INITIAL CLAIMS** **TRADE BALANCE**	**EMPLOYMENT REPORT** **CONSUMER CREDIT**

Forecasts in Bold

Daiwa Capital Markets

Treasury Financing

March/April 2018

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
AUCTION RESULTS: Rate / Cover 3-mo bills 1.670% 3.13 6-mo bills 1.850% 3.67 3-year notes 2.436% 2.94 10-yr notes 2.889% 2.50 **ANNOUNCE:** $65 billion 4-week bills for auction on March 13	**AUCTION RESULTS:** Rate / Cover 4-week bills 1.650% 2.58 30-yr bonds 3.109% 2.38		**ANNOUNCE:** $96 billion 13-,26-week bills for auction on March 19 $11 billion 10-year TIPS for auction on March 22 **SETTLE:** $96 billion 13-,26-week bills $65 billion 4-week bills $28 billion 3-year notes $21 billion 10-year notes $13 billion 30-year bonds	
19	20	21	22	23
AUCTION: $96 billion 13-,26-week bills **ANNOUNCE:** $65 billion* 4-week bills for auction on March 20	**AUCTION:** $65 billion* 4-week bills		**AUCTION:** $11 billion 10-year TIPS **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on March 26 $22 billion* 52-week bills for auction on March 27 $15 billion* 2-year FRNs for auction on March 28 $30 billion* 2-year notes for auction on March 26 $35 billion* 5-year notes for auction on March 27 $29 billion* 7-year notes for auction on March 28 **SETTLE:** $96 billion 13-,26-week bills $65 billion* 4-week bills	
26	27	28	29	30
AUCTION: $96 billion* 13-,26-week bills $30 billion* 2-year notes **ANNOUNCE:** $65 billion* 4-week bills for auction on March 27	**AUCTION:** $65 billion* 4-week bills $22 billion* 52-week bills $35 billion* 5-year notes	**AUCTION:** $15 billion* 2-year FRNs $29 billion* 7-year notes	**ANNOUNCE:** $96 billion* 13-,26-week bills for auction on April 2 **SETTLE:** $96 billion* 13-,26-week bills $65 billion* 4-week bills $22 billion* 52-week bills $11 billion 10-year TIPS	***GOOD FRIDAY***
2	3	4	5	6
AUCTION: $96 billion* 13-,26-week bills **ANNOUNCE:** $65 billion* 4-week bills for auction on April 3 **SETTLE:** $15 billion* 2-year FRNs $30 billion* 2-year notes $35 billion* 5-year notes $29 billion* 7-year notes	**AUCTION:** $65 billion* 4-week bills		**ANNOUNCE:** $96 billion* 13-,26-week bills for auction on April 9 $30 billion* 3-year notes for auction on April 10 $21 billion* 10-year notes for auction on April 11 $13 billion* 30-year bonds for auction on April 12 **SETTLE:** $96 billion* 13-,26-week bills $65 billion* 4-week bills	

*Estimate