

U.S. Economic Comment

- FOMC preview: dampening market expectations of policy easing

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The Fed: Only Modest Changes to the Outlook

The upcoming meeting of the Federal Open Market Committee is an important one. We sense that Fed officials and market participants are on different pages. Market participants expect the Fed to ease aggressively this year, with many looking for rate cuts to total 75 basis points; Fed officials, we believe, see less urgency in adjusting policy and are likely to maintain their current stance for some time. We look for a resolution of these conflicting views in the coming week: either the Fed will dampen market expectations, or we will learn that our perceptions of the Fed are off the mark.

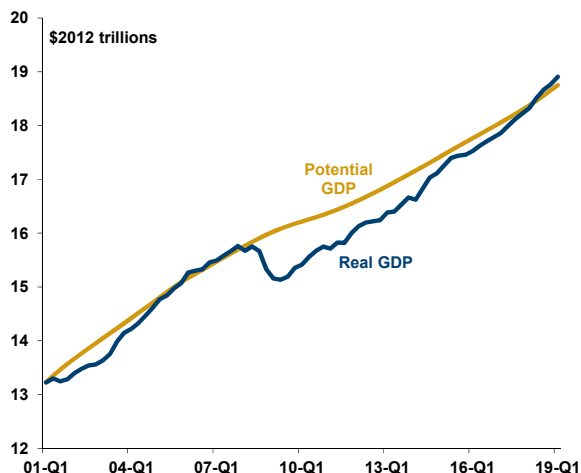
The Market View

The market view of notable easing this year seems partly based on the belief that the tightening of monetary policy in December was a mistake -- one step too far by the Fed. Somehow, this perception has become the conventional wisdom among market participants. We find this view puzzling and most likely wrong.

The economy was strong at the time of the December rate hike, with economic growth in the first three quarters of the year totaling 3.2 percent (Q4 unavailable at the time). That advance had finally returned real GDP to its potential (in fact, slightly above potential) after trailing this benchmark since the recession (chart, left). In addition, the labor market -- always a key consideration in Fed decisions -- was robust.

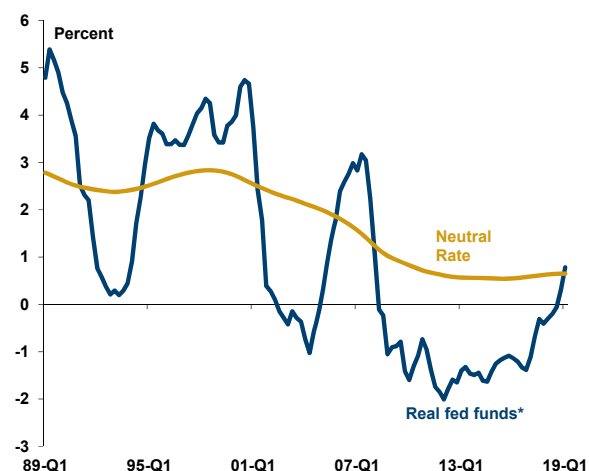
The rate hike in December was not a bold move, as it merely brought the real federal funds rate in line with an estimate of the neutral rate (chart, right). Moreover, the change was widely anticipated by market participants. Steady policy at the time would have been a shock that generated confusion among investors and traders.

Real GDP: Actual vs. Potential



Source: Bureau of Economic Analysis and Congressional Budget Office via Haver Analytics

Estimated Neutral Real Fed Funds Rate



* The real fed funds rate is the effective federal funds rate less the year-over-year change in the core PCE price index. Quarterly average data.

Source: Federal Reserve Bank of San Francisco; Thomas Laubach and John C. Williams, "Measuring the Natural Rate of Interest," Review of Economics and Statistics, November 2003; Bureau of Economic Analysis, Federal Reserve Board, and Federal Reserve Bank of New York via Haver Analytics; Daiwa Capital Markets America

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Rather than representing a policy mistake, the December change can be viewed as a perfect calibration of monetary policy: officials had moved to a neutral position at a time when the economy was fully employed and moving along a path consistent with potential GDP. This is policy nirvana; calling the December rate hike a mistake is nonsensical.

The Fed View

Market expectations for a rate cut intensified after president Trump raised the possibility of tariffs on imports from Mexico. That threat seemed to have an influence on Fed officials as well, as Chairman Powell opened a door to an easing in policy with his comment on June 4 that officials were monitoring developments and “will act as appropriate to sustain the expansion.” However, with the tariff threat now removed (or at least postponed), we suspect that Fed officials will feel comfortable with their current stance.

The latest public comments of Fed officials suggest a high degree of comfort. Chairman Powell’s view at the conclusion of the previous meeting of the FOMC on May 1 is a useful benchmark. He noted in his press conference that “solid underlying fundamentals” were supporting the economy and he argued that “cross currents” that presented downside risks at the start of the year had diminished. Richard Clarida, the Vice Chair of the Board of Governors, was equally as optimistic in a speech on May 30 (the day before Trump’s threat of tariffs on Mexican imports), as he indicated that “the U.S. economy is in a good place.”

John Williams, the President of the New York Fed and the Vice Chair of the FOMC, noted in an April 4 speech that signs of slower economic growth were beginning to appear, but he also argued that the U.S. economy did not have great potential to grow. Demographics and productivity (or lack thereof) probably limit the sustainable pace of growth to approximately two percent. Against this background, Williams argued that “slower growth is -- far from a sign of doom and gloom -- what we should expect.” Given the current potential growth of the U.S. economy, Williams concluded that “monetary policy is in the right place.”

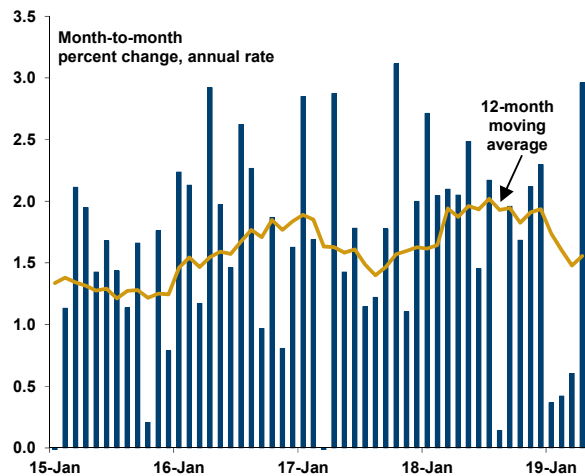
Comments from Neel Kashkari, President of the Minneapolis Fed, were perhaps the strongest signal of dim prospects for a rate cut. Mr. Kashkari is arguably the most dovish of all Fed officials; he undoubtedly would be leading any effort cut interest rates. However, he indicated in a May 13 interview that he was not quite in the rate-cut camp. He felt that there was still slack in the economy, and he wanted to see a faster rate of inflation, but with job growth still strong, he did not see an urgency to ease policy: “I feel pretty good about where we are. I think we have rates roughly at neutral.”

Mr. Kashkari might be more receptive to a rate cut after the May employment report (job growth of 75,000), but we doubt that the latest tally will sway the FOMC overall. Fed officials undoubtedly recognize that economic data sometimes move erratically. Policymakers tend to focus on underlying trends rather than one-month swings, and employment growth remains firm on average (job growth of 164,000 per month so far this year). Officials also are likely to look for evidence to corroborate slower job growth, and they will come up empty in this regard. Both sides of the employment ledger (hiring and firing) point to favorable conditions: job postings remain near record levels, and minimal claims for unemployment insurance suggests that layoffs are not an issue.

Inflation

The current and likely pace of economic growth does not present a compelling case for easier monetary policy, nor does the state of the labor market. However, a contained rate of inflation, and a shift in inflation dynamics (i.e. limited response of prices to economic conditions -- a flatter Phillips curve), might allow the Fed to ease as insurance against downside risks to the economy. This view was certainly pushed at the Powell press briefing on May 1, as reporters raised the issue of below-target inflation several times. Chairman Powell responded consistently that core inflation was close to target last year and that the recent down-side deviation seemed to be the result of transitory factors. Officials expect inflation to move toward two percent in the months ahead.

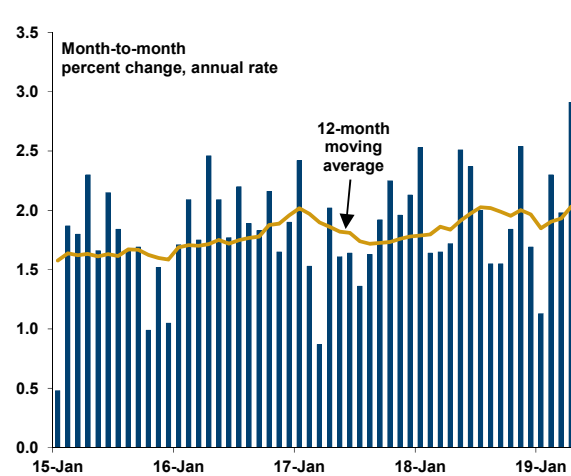
Core PCE Price Index



PCE = personal consumption expenditures

Source: Bureau of Economic Analysis via Haver Analytics

Trimmed-Mean 1-Month PCE Inflation*



* The average inflation rate for the middle 45 percent of the the distribution of price changes in the personal consumption expenditures (PCE) price index. The measure excludes 24 percent of items with the smallest price changes and 31 percent with the largest price changes.

Source: Federal Reserve Bank of Dallas via Haver Analytics

The core price index for personal consumption expenditures for April offered support for Mr. Powell's view. After posting minimal increases in the first three months of the year, the core PCE measure showed a sizeable increase in April and pulled the 12-month average slightly higher (chart, left). Chairman Powell also cited the trimmed mean PCE price index to support his view that slow inflation did not provide strong support for an easing in policy. This measure, which removes outlying price changes at both the high and low ends of the distribution, has been fluctuating in a tight range in the neighborhood of two percent (chart, right). By this measure, inflation is essentially on target. This index seems to be attracting more attention from Fed officials, as we have seen it mentioned frequently in recent public comments. We suspect it is playing a more important role in policy decisions than it did in the past.

Guidelines to the Meeting Outcome: Statement, Dots, Press Briefing

The policy statement released by the FOMC has the potential to send a strong message to market participants. The last sentence in paragraph two is the key: "In light of global economic and financial developments and muted inflation pressures, the Committee will be **patient** as it determines what future adjustments to the target range for the federal funds rate may be appropriate..." (emphasis added). If officials retain "patient" to describe their expected pace of action, we would view this as a strong effort to dissuade market participants of the view that the Fed will be easing policy aggressively. We suspect the wording will be changed, which will open a door to a possible ease, but it will fall well shy of suggesting that a rate cut is imminent. We look for wording similar to that in Mr. Powell's the June 4 statement: e.g. "The Fed is prepared to act, if necessary."

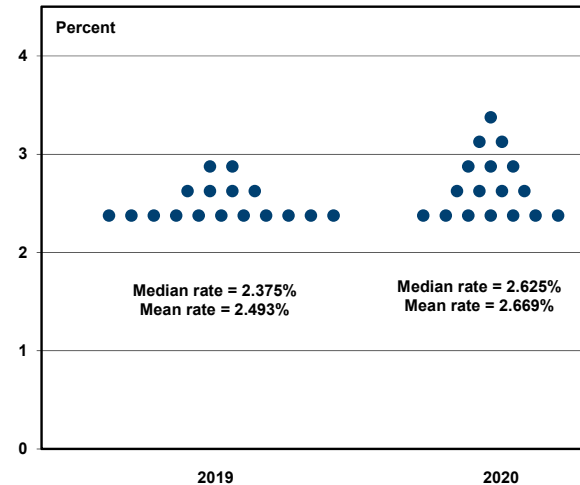
The FOMC is also likely to alter the first paragraph of the statement, which describes current economic conditions. The May 1 statement described the growth of jobs and economic activity as "solid," but that might be viewed as an overstatement at this time; "firm" or "well maintained" might be good substitutes.

The dot plot, although disparaged by many observers, will undoubtedly be scrutinized. The previous plot showed most officials expecting to hold policy steady with the federal funds rate at 2.375 percent, although six officials expected to tighten -- four with one additional hike and two with two policy changes (chart, next page). We suspect the new plot to show that no one will be expecting to raise interest rates this year, and some possibly looking to ease policy. However, we expect nearly all officials to be looking for a federal funds rate of 2.375 percent at the end of the year -- steady policy rather than aggressive easing.

The press briefing will probably resemble the one on May 1. Reporters are likely to press Chairman Powell about prospects for easier policy, with slow inflation cited as the trigger for a rate cut. We suspect that Mr. Powell will continue to argue that transitory factors were limiting price pressure in early 2019 and that inflation is likely to move to two percent in the months ahead. Adverse effects of tariffs also are likely to be mentioned as a potential trigger, but all Mr. Powell can offer on this issue is that developments are uncertain and Fed officials will be monitoring conditions carefully.

All told, we expect the new information from the Federal Open Market Committee to suggest that an easing in policy later this year is possible, but far from assured. If easing does unfold, it is likely to be moderate.

FOMC Rate View: Year-End 2019 & 2020*



* Each dot represents the expected federal funds rate of a Fed official at the end of 2019 and 2020. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but two governorships were open at the March 2019 FOMC meeting.

Source: Federal Open Market Committee, Summary of Economic Projections, March 2019

Review

Week of June 10, 2019	Actual	Consensus	Comments
PPI (May)	0.1% Total, 0.4% Core*	0.1% Total, 0.2% Core*	Energy prices slipped 1.0% in May, but the decline offset only a small portion of a 9.3% surge in the prior three months and left energy prices in the middle of the range of the past year and one-half. Food prices slipped 0.3%, adding to a moderate decline after a jump in the closing months of 2018. The core PPI registered a sharp increase for the second month in a row, with pressure concentrated in the volatile service category. Core goods prices, in contrast, were unchanged in May. The monthly shifts left the year-over-year change in the headline PPI at 1.8%, down from 2.2% in April and a recent high of 3.4% last July. The core PPI rose 2.3%, up one tick from the reading in April but it remained below the recent high of 3.1% in September 2018.
CPI (May)	0.1% Total, 0.1% Core	0.1% Total, 0.2% Core	The energy component (-0.6%) helped restrain the headline CPI in May. The drop was a small offset to sharp increases in the prior two months, but those jumps were offsets to lower prices in earlier months. Food prices rose 0.3%, matching the average in the prior five months and quicker than the average of 0.1% in the first 11 months of last year. The modest increase in the core CPI was the most notable aspect of the report. Some of the restraint could be viewed as random movement -- restrained changes in some components after firm increases in the prior month. At the same time, the results suggested fundamental restraint, as only a few items posted noticeable increases in price, and they too might be described as mere noise. The latest changes left the year-over-year increase in the headline index at 1.8%, down from 2.0% in April and a recent peak of 2.9% in July of last year. The year-over-year change in the core index totaled 2.0%, down from 2.1% in April and 2.4% in July of last year.
Federal Budget (May)	-\$207.8 Billion	-\$202.5 Billion	Federal revenues in May rose 6.9% from the same month last year, with the results primarily reflecting firm collections from individuals but also influenced by a sharp increase in customs duties stemming from the Trump administration's tariffs on imports. A year-over-year jump of 20.9% in outlays dwarfed the advance in revenues, but the sharp increase was partly the result of a calendar configuration that shifted some spending from June into May. The results left the budget deficit in the first eight months of FY2019 at \$738.6 billion, \$206.4 billion wider than the deficit in the same period in FY2018.

Review Continued

Week of June 10, 2019	Actual	Consensus	Comments
Retail Sales (May)	0.5% Total, 0.5% Ex-Autos	0.6% Total, 0.4% Ex-Autos	The retail sales report carried a favorable tone in May, as firm spending across categories was joined by upward revisions in the prior two months. The volatile auto and gasoline components contributed positively in the latest month (up 0.7% and 0.3%, respectively), but sales ex-autos and gasoline also were firm (+0.5%). Nonstore retailers (mostly catalog and online) have been performing strongly, and they were especially firm in May (up 1.4%). General merchandise stores also did well with an increase of 0.7% that reinforced an upward trend. A few areas (clothing stores, furniture stores, building-supply stores) posted soft results, but these areas did not alter the favorable tone of the report.
Industrial Production (May)	0.4%	0.2%	Much of the advance in industrial production in May reflected a jump of 2.1% in the utility sector, where swings in activity are nearly always driven by changes in the weather rather than economic fundamentals. The manufacturing and mining sectors are more important for assessing the economic environment, and they have been unimpressive in recent months. Manufacturing activity rose 0.2%, but it has slipped 1.5% since the recent peak in December and it is in the lower end of the range of the past year. Mining activity rose 0.1% to a new high for the cycle, but the latest reading was close to other recent observations and the trend has flattened after activity surged in the second half of 2017 and 2018.
Consumer Sentiment (June)	97.9 (-2.1%)	98.0 (-2.0%)	Volatility in the equity market and the potential economic fallout from tariffs probably influenced attitudes in June and led to the decline in consumer sentiment. Although the index moved lower, it remained at a respectable level -- comfortably within the recent range and elevated relative to historical standards. The measure was only slightly below the average from last year (index value of 97.9 in early June versus an average of 98.4 in 2018). The long-term measure of inflation expectations published with the report fell 0.4 percentage points to 2.2%. The new reading represented a record low, although several other observations were close at 2.3%.

* The core PPI excludes food, energy, and trade services.

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

Preview

Week of June 17, 2019	Projected	Comments
Housing Starts (May) (Tuesday)	1.240 Million (+0.4%)	Sales of new homes in recent months have jumped to the upper portion of the range from the past few years, which should stir the construction of single-family homes. The volatile multi-family sector could provide a partial offset, as activity in April jumped to the upper portion of its recent range and seems due for a correction.
Current Account (2019-Q1) (Thursday)	-\$120.0 Billion (\$14.4 Billion Narrower Deficit)	An improvement in the trade balance in the first quarter should more than offset likely slippage in income flows and lead to a narrowing in the current account deficit.
Leading Indicators (May) (Thursday)	0.0%	Lower claims for unemployment insurance, along with increases in stock prices and ISM new orders, point to a drop in the leading indicator index, but our estimates of consumer expectations and the leading credit index suggest an offset that could leave the index unchanged. Building permits have not been published and thus represent a wild card (the forecast assumes no change).
Existing Home Sales (May) (Friday)	5.30 Million (2.1%)	With mortgage rates continuing to drift lower during the spring, sales of existing homes probably advanced in May. The expected level of activity, while up from recent lows, is still noticeably below the average of 5.5 million in 2017 and the first half of 2018.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June/July 2019				
Monday	Tuesday	Wednesday	Thursday	Friday
10	11	12	13	14
JOLTS DATA Openings (000) Quit Rate Feb 7,142 2.3% Mar 7,474 2.3% Apr 7,449 2.3%	NFIB SMALL BUSINESS OPTIMISM INDEX Mar 101.8 Apr 103.5 May 105.0 PPI Final Demand Core* Mar 0.6% 0.0% Apr 0.2% 0.4% May 0.1% 0.4%	CPI Total Core Mar 0.4% 0.1% Apr 0.3% 0.1% May 0.1% 0.1% FEDERAL BUDGET 2019 2018 Mar -\$146.9B -\$208.7B Apr \$160.3B \$214.3B May -\$207.8B -\$146.8B	INITIAL CLAIMS May 25 218,000 May 01 219,000 April 08 222,000 IMPORT/EXPORT PRICES Non-fuel Nonagri. Imports Exports Mar -0.2% 0.7% Apr -0.1% 0.2% May -0.3% -0.2%	RETAIL SALES Total Ex.Autos Mar 1.8% 1.4% Apr 0.3% 0.5% May 0.5% 0.5% IP & CAP-U IP Cap.Util. Mar 0.1% 78.4% Apr -0.4% 77.9% May 0.4% 78.1% CONSUMER SENTIMENT Apr 97.2 May 100.0 June 97.9 BUSINESS INVENTORIES Inventories Sales Feb 0.3% 0.1% Mar 0.0% 1.3% Apr 0.5% -0.2%
17	18	19	20	21
EMPIRE MFG (8:30) Apr 10.1 May 17.8 June -- NAHB HOUSING INDEX (10:00) Apr 63 May 66 June -- TIC DATA (4:00) Total Net L-T Feb -\$21.5B \$51.9B Mar -\$8.1B -\$28.4B Apr -- --	HOUSING STARTS (8:30) Mar 1.168 million Apr 1.235 million May 1.240 million FOMC MEETING	FOMC DECISION (2:00) SUMMARY OF ECONOMIC PROJECTIONS (2:00) POWELL PRESS CONFERENCE (2:30)	INITIAL CLAIMS (8:30) CURRENT ACCOUNT (8:30) 18-Q3 -\$126.6 bill. 18-Q4 -\$134.4 bill. 19-Q1 -\$120.0 bill. PHILLY FED INDEX (8:30) Apr 8.5 May 16.6 June -- LEADING INDICATORS (10:00) Mar 0.3% Apr 0.2% May 0.0%	EXISTING HOME SALES (10:00) Mar 5.21 million Apr 5.19 million May 5.30 million
24	25	26	27	28
CHICAGO FED NAT'L ACTIVITY INDEX	FHFA HOME PRICE INDEX S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX NEW HOME SALES CONSUMER CONFIDENCE	DURABLE GOODS ORDERS U.S. INTERNATIONAL TRADE IN GOODS ADVANCE INVENTORIES	INITIAL CLAIMS REVISED GDP PENDING HOME SALES	PERSONAL INCOME, CONSUMPTION, PRICES CHICAGO PURCHASING MANAGERS' INDEX REVISED CONSUMER SENTIMENT
1	2	3	4	5
ISM INDEX CONSTRUCTION SPEND.	VEHICLE SALES	ADP EMPLOYMENT REPORT INITIAL CLAIMS TRADE BALANCE FACTORY ORDERS ISM NON-MFG INDEX	INDEPENDENCE DAY	EMPLOYMENT REPORT

* The core PPI excludes food, energy, and trade services.

Forecasts in Bold

Treasury Financing

June/July 2019																																					
Monday	Tuesday	Wednesday	Thursday	Friday																																	
10	11	12	13	14																																	
AUCTION RESULTS: <table><tr><td></td><td>Rate</td><td>Cover</td></tr><tr><td>13-week bills</td><td>2.240%</td><td>3.21</td></tr><tr><td>26-week bills</td><td>2.140%</td><td>2.98</td></tr></table>		Rate	Cover	13-week bills	2.240%	3.21	26-week bills	2.140%	2.98	AUCTION RESULTS: <table><tr><td></td><td>Rate</td><td>Cover</td></tr><tr><td>3-year notes</td><td>1.861%</td><td>2.62</td></tr></table> ANNOUNCE: \$40 billion 4-week bills for auction on June 13 \$35 billion 8-week bills for auction on June 13 SETTLE: \$40 billion 4-week bills \$35 billion 8-week bills		Rate	Cover	3-year notes	1.861%	2.62	AUCTION RESULTS: <table><tr><td></td><td>Rate</td><td>Cover</td></tr><tr><td>10-yr notes</td><td>2.130%</td><td>2.49</td></tr></table>		Rate	Cover	10-yr notes	2.130%	2.49	AUCTION RESULTS: <table><tr><td></td><td>Rate</td><td>Cover</td></tr><tr><td>4-week bills</td><td>2.215%</td><td>2.88</td></tr><tr><td>8-week bills</td><td>2.200%</td><td>3.12</td></tr><tr><td>30-yr bonds</td><td>2.607%</td><td>2.32</td></tr></table> ANNOUNCE: \$72 billion 13-,26-week bills for auction on June 17 \$26 billion 52-week bills for auction on June 18 \$15 billion 5-year TIPS for auction on June 20 SETTLE: \$72 billion 13-,26-week bills		Rate	Cover	4-week bills	2.215%	2.88	8-week bills	2.200%	3.12	30-yr bonds	2.607%	2.32	
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*Estimate