Daiwa Capital Markets

U.S. Economic Comment

- Monetary policy: a change in attitude at the Federal Reserve

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FOMC: Anxious to Ease

My colleagues and I have one overarching goal: to sustain the economic expansion, with a strong job market and stable prices, for the benefit of the American people.

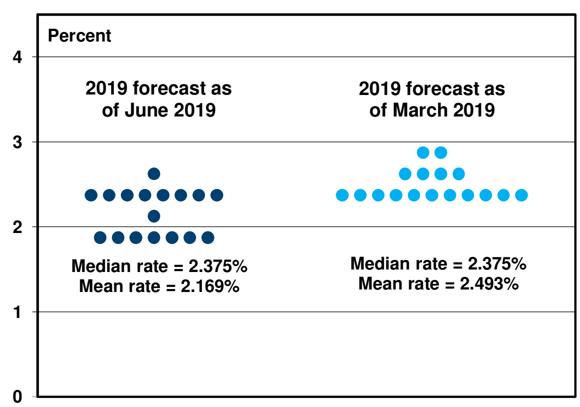
-- Jerome Powell, June 19, 2019

This opening line from Jerome Powell's press conference seemed to suggest policy developments of some import, and indeed, he proceeded to highlight "significant changes" to the policy statement of the Federal Open Market Committee. The previous three statements indicated that officials would be "patient" in adjusting policy, but now they will "closely monitor" incoming information (Fed speak for "ready to adjust interest rates"). In addition, the statement indicated that the FOMC would "act as appropriate" to sustain the expansion. The new phrasing implies that officials suspect that policy is not properly geared for the current environment and will need to be adjusted. Such a view represents a marked shift from the comments of Chairman Powell at his May press briefing when he indicated that he did not see a case for either raising or lowering interest rates.

The new interest rate forecasts of Fed officials (the dot plot) provided more striking evidence of a shift in views at the Fed. The new plot showed eight officials expecting to cut rates this year, with seven of these individuals looking for cuts totaling 50 basis points. In March, no Fed official expected to cut rates (chart). We suspected that the new dot plot would show two or three officials seeing a need for easier policy; we were shocked to see eight policymakers leaning in this direction.

We have altered our view on monetary policy and interest rates in response to these developments. We had expected the Fed to remain on the sidelines this year and to begin easing in 2020, but we have pulled two interest rate cuts into this year (table). We view September and December as the most likely months for shifts, although we remain flexible on timing; a shift in July is certainly possible.

FOMC Rate View: Year-End 2019*



* Each dot represents the expected federal funds rate of a Fed official at the end of 2019. 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 and June 2019 meetings.

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

Growth & Interest Rate Outlook*

		GDP	FFR	2-Yr	10-Yr
2019					
	Q2	1.8	2.38	1.75	2.00
	Q3	1.6	2.13	1.75	2.00
	Q4	1.5	1.88	1.70	2.00
2020					
	Q1	1.8	1.88	1.70	2.00
	Q2	1.6	1.63	1.60	1.95
	Q3	1.2	1.38	1.50	1.90
	Q4	0.6	1.38	1.50	1.80

* GDP growth is quarterly growth at an annual rate; interest rate forecasts show expected rates at the end of the quarter.

Source: Daiwa Capital Markets America

Given normal lags in monetary policy, the rate changes will have little influence on economic growth this year, but we have boosted slightly our forecast for GDP growth next year (an average of 1.3 percent over the four quarters of 2020 versus our previous view of 1.0 percent). Fed officials are likely to view the expected pace next year as disappointing, and thus they will probably cut interest rates further. Our projection has two rate cuts next year.

Investors and traders have most likely priced easier monetary policy into market interest rates. Thus, we look for Treasury yields to fluctuate within ranges centered on current levels. Market rates are likely to inch lower next year if the economy softens as we expect.

Motives and Triggers for Rate Cuts

Before this week's meeting, the public comments of Fed officials indicated that they were pleased with the economy's performance, and most seemed to believe that policy was properly calibrated. The marked change in views made us wonder what motivated the shift. Identifying the causes not only would satisfy our curiosity, but it also might be helpful in identifying triggers that might prompt a change in policy in the months ahead.

Economic Growth. Chairman Powell highlighted crosscurrents and uncertainties in the economic outlook as a motivating factor, but we do not find this explanation entirely convincing. GDP projections published with the policy statement showed no change in expected growth for 2019 from the previous set of forecasts (2.1 percent), and a slighter faster pace expected for next year (2.0 percent rather than 1.9 percent). Moreover, the range of expectations for 2019 narrowed from the downside -- that is, those at the low end of the previous distribution upped their forecasts, while the optimistic officials maintained their positive views. Shifts of this nature indicate less uncertainty and more upbeat views.

The uncertainty noted in the policy statement and by Mr. Powell in his press conference most likely related to trade negotiations. If talks with China break down, or if President Trump follows through with threatened tariffs on Mexico, Europe, and Japan, the economic outlook would darken and the Fed would respond. In this regard, the upcoming talks between Presidents Trump and Xi are possibly more important than any data release in determining the course of U.S. monetary policy.

Mr. Powell also mentioned slower global growth as a factor that led officials to contemplate easier policy. Thus, we plan to monitor international economic development more closely. At the same time, we do not want to overemphasize the foreign influence on Fed decisions. During the Q&A portion of the press briefing, a reporter asked about the influence of actions by foreign central banks, and Mr. Powell responded that policymakers will focus on their mandates and domestic conditions. Developments abroad, while important, will take a back seat to domestic considerations.

Inflation. New thinking on inflation seemed to play a major role in altering Fed attitudes. A shift was apparent in the latest set of projections, as the median expectation for headline inflation this year fell 0.3 percentage point to 1.5 percent. In addition, the range of expectations tightened (1.4 to 1.7 percent versus 1.6 to 2.1 percent in March), signaling less uncertainty in the collective view of the Committee.

The prepared remarks of Chairman Powell confirmed that views on inflation had changed, as he indicated officials had "concerns about the pace of inflation's return to two percent" and he noted that weaker global growth was likely to hold inflation down around the world. This view is sharply at odds with the characterization after the May meeting, when Mr. Powell argued that transitory factors were restraining inflation.

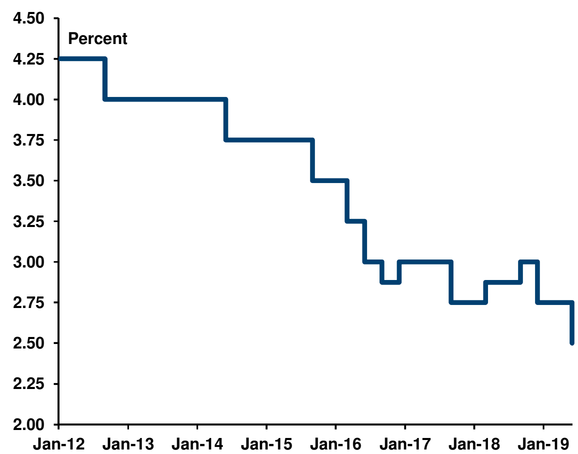
With apparently little upside risk on inflation, and faced with another year of below-target inflation, the FOMC apparently feels comfortable in adopting insurance moves to preserve the economic expansion. Thus, as long as inflation remains below two percent, the probability of the Fed easing is high.

The Current Stance. A few Fed officials in recent statements noted that monetary policy was in a comfortable position. That is, policy was approximately neutral at a time when the economy was fully employed and growing at a rate close to its potential, a stance that represents perfect calibration. This seemed to be the rationale behind Chairman Powell's view at his May press briefing that the Committee did not see a strong case for either raising or lowering interest rates.

Some Fed officials may have rethought the issue of neutral policy and perfect calibration. The new set of expectations for the federal funds rate (the dot plot) showed a decline of 25 basis points in the median long-run level of the federal funds rate. This rate could be viewed as an estimate of the neutral federal funds rate, and a drop in this measure would open (or widen) a gap between the actual and neutral federal funds rate. That is, given the new estimate of the long-run rate, some officials might now see policy as restrictive rather than neutral.

From a broader perspective, the decline in the median long-run rate added to a downward trend that has been in place for the past several years (chart). The long-downward movement in this rate might shake confidence in any estimate of the neutral rate and leave officials less willing to make judgements about the nature of policy -- whether it is accommodative or neutral. Given such uncertainty, officials are likely to place less weight on assessments of policy based on such measures. They are more likely to rely on the messages from growth and inflation, which seem to have opened a door to possible easing.

Long-Run Normal Rate*



** The chart shows the median forecast of FOMC participants for the target level of the federal funds rate in the long run.*
Source: Federal Open Market Committee

The Powell Put. There was only a vague suggestion in the press conference that developments in financial markets might have had an influence on the Fed's dovish shift. Specifically, Chairman Powell noted that "risk sentiment in financial markets has deteriorated." It was not perfectly clear what he meant by the statement, but we presume that he was referring to the drop in stock prices in May (which had only partial rebounded by the time of the FOMC meeting), along with the widening in credit spreads in May and early June.

While we do not have strong evidence that concern about market volatility had an influence on Fed thinking, we believe that the potential for corrections in both the fixed-income and equity markets played a role. The swoon in the equity market in December apparently led the Fed to change from an expected path of higher interest rates, and officials undoubtedly knew that market participants had priced in an expectation of notable easing this year. Failure to validate the market expectation could well have triggered a December-like move, which seemed to alarm Fed officials at the time. An old adage among market participants is "don't fight the Fed." In this instance, we view the roles as reversed: Fed officials did not wish to fight market sentiment.

Trump (or Risk Management). We hesitate to suggest that criticism from President Trump had an influence on the Fed's decisions. Chairman Powell and other Fed policymakers seem fully committed to conducting an independent monetary policy. At the same time, we wonder whether the President's critiques had an indirect, subconscious influence.

A tactful way to approach this sensitive issue is to argue that the combination of risk-management policies and the Trump tweets has led the Fed to move in the accommodative direction. Chairman Powell often notes that Fed officials seek to employ sound risk-management principles in implementing monetary policy. A simple explanation of what the Chairman has in mind is to say that the Fed seeks to avoid the mistake that carries the most serious consequences; alternatively, if the Fed were to make a mistake, it should be the one that is easiest to reverse.

In the current environment, these simple guidelines would argue for erring on the side of easy monetary policy. If the Fed were to move too far in providing accommodation, inflation might pick up or an asset bubble might develop, but these problems can be corrected with tighter policy. If the Fed were to adopt a stance that was too restrictive, the resulting recession could be costly because officials have little scope to reduce interest rates and have limited tools outside of interest rate reductions. Against this background, ordinary risk-management practices would tilt the Fed in the direction of accommodation.

The tweets from President Trump could be viewed as worsening the consequences that could emerge from a policy that is overly restrictive. If the economy were to soften in response to tight financial conditions, the President would lay the blame on the Federal Reserve, and the public would probably subscribe to this view. Confidence and trust in the institution would fade as a result. The Fed would have to deal with both economic and reputational damage. Thus, criticism from the President could be having an indirect effect by intensifying the fallout that would result from a mistake associated with tight policy.

We believe that the Fed strives to insulate itself from political interference, but we also suspect that badgering from the President might be having an indirect effect.

Review

Week of June 17, 2019	Actual	Consensus	Comments
Housing Starts (May)	**1.269 Million (-0.9%)**	**1.239 Million (+0.3%)**	The drop in housing starts in May occurred from an upward revised level in April (3.7% firmer than initially believed), which left the level of activity firmer than expected and in the upper portion of the recent range. Although total starts were strong, the breakdown between single-family and multi-family activity was disappointing. Single-family starts fell 6.4% and moved to the lower portion of the recent range, continuing to a downward move that began in the middle of last year. Multi-family starts moved to the upper portion of their recent range, as activity jumped 10.9% in May after sizable gains in the prior three months. Multi-family starts often move erratically, and a good portion of the recent gains probably reflects random volatility.
Current Account (2019-Q1)	**-$130.4 Billion ($13.5 Billion Narrower Deficit)**	**-$124.3 Billion ($10.1 Billion Narrower Deficit)**	Trade flows contributed importantly to the narrowing the current account deficit in the first quarter, with exports of goods and services increasing $4.7 billion and imports declining $11.9 billion. Primary income flows also contributed positively (increasing $1.1 billion). When scaled to the size of the economy, the deficit narrowed to 2.5% of GDP from 2.8%, a reading still among the widest of the current expansion. The Q1 deficit was wider than expected, but the difference was largely the result of a revised level in Q4 rather than surprises in Q1.
Leading Indicators (May)	**0.0%**	**0.1%**	Negative contributions from stock prices, the ISM new orders index, and initial claims for unemployment insurance offset positive contributions from the leading credit index and consumer expectations in May. The index has lost momentum since late last year, increasing at an average rate of less than 0.1% in the past eight months, a contrast to the average of 0.5% in 2017 and the first nine months of 2018.
Existing Home Sales (May)	**5.34 Million (+2.5%)**	**5.30 Million (+2.1%)**	The increase in existing home sales in May was joined by a modest upward revision in the prior month (0.4% firmer than previously reported), which left the level of activity in line with the average from last year but below the cyclical highs registered in late 2017 and early 2018. Activity is responding to lower interest rates, but the sector is not booming. The months' supply of unsold homes increased 0.1 month to 4.3 months, a reading in the low end of the historical range and suggestive of tight inventories.

Source: U.S. Census Bureau (Housing Starts); Bureau of Economic Analysis (Current Account); The Conference Board (Leading Indicators); National Association of Realtors (Existing Home Sales); Consensus forecasts are from Bloomberg

Preview

Week of June 24, 2019	Projected	Comments
New Home Sales (May) (Tuesday)	**0.675 Million (+0.3%)**	With mortgage rates continuing to drift lower, sales of new homes could inch higher in May, although the change is likely to be small, as activity in the prior month was already quite firm (only two temporary bursts in the current cycle were firmer).
Conference Board Consumer Confidence (June) (Tuesday)	**133.0 (-0.8%)**	The recovery in the stock market in June, along with the end of the tariff threat against Mexico, should ease possible concerns of individuals and leave the confidence index close to the elevated level in May.
Durable Goods Orders (May) (Wednesday)	**0.0%**	A paltry order flow at Boeing is likely to lead to soft results in the aircraft category. In addition, with most manufacturing-related data signaling slow activity, order flows in other areas are likely to lack vigor.
U.S. International Trade in Goods (May) (Wednesday)	**-$72.5 Billion ($1.6 Billion Wider Deficit)**	Both exports and imports are likely to rebound from low-side readings in April, with imports showing more upside potential that should lead to a wider trade deficit.
Revised GDP (2019-Q1) (Thursday)	**3.0% (-0.1 Pct. Pt. Revision)**	Roughly offsetting adjustments to various components of GDP should leave growth close to the prevailing estimate of 3.1%. Construction activity of businesses and state and local governments appears to be stronger than previously believed, but downward adjustments to net exports, residential construction, and consumer spending could provide offsets.
Personal Income, Consumption, Core Prices (May) (Friday)	**0.4%, 0.5%, 0.1%**	Slow job growth in May will probably lead to a modest advance in wages and salaries, but a jump in interest income and steady growth in rental income should provide support. On the spending side, strong vehicle sales should lead to firm outlays on durable goods, and a solid report on retail sales suggests firm results in the nondurable area. Results for the CPI point to a tame reading on the core price index for personal consumption expenditures.
Revised Consumer Sentiment (June) (Friday)	**97.9 (Unrevised)**	The final tally on the sentiment index is usually close to the preliminary estimate. We will look for no revision, but we would not be shocked by an upward adjustment because of the recovery in the equity market and the end of the tariff threat against Mexico.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June/July 2019

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
EMPIRE MFG Apr 10.1 May 17.8 June -8.6 **NAHB HOUSING INDEX** Apr 63 May 66 June 64 **TIC DATA** Total / Net L-T Feb -$21.5B / $51.9B Mar -$5.6B / -$25.9B Apr -$7.8B / $46.9B	**HOUSING STARTS** Mar 1.199 million Apr 1.281 million May 1.269 million **FOMC MEETING**	**FOMC DECISION** **SUMMARY OF ECONOMIC PROJECTIONS** **POWELL PRESS CONFERENCE**	**INITIAL CLAIMS** June 01 219,000 June 08 222,000 June 15 216,000 **CURRENT ACCOUNT** 18-Q3 -$125.7 bill. 18-Q4 -$143.9 bill. 19-Q1 -$130.4 bill. **PHILLY FED INDEX** Apr 8.5 May 16.6 June 0.3 **LEADING INDICATORS** Mar 0.2% Apr 0.1% May 0.0%	**EXISTING HOME SALES** Mar 5.21 million Apr 5.21 million May 5.34 million
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Mar 0.05 / -0.24 Apr -0.45 / -0.32 May -- / --	**FHFA HOME PRICE INDEX (9:00)** Feb 0.4% Mar 0.1% Apr -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Feb 0.3% / 0.2% Mar 0.1% / 0.7% Apr -- / -- **NEW HOME SALES (10:00)** Mar 0.723 million Apr 0.673 million **May 0.675 million** **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Apr 129.2 May 134.1 **June 133.0**	**DURABLE GOODS ORDERS (8:30)** Mar 1.7% Apr -2.1% **May 0.0%** **U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Mar -$71.8 billion Apr -$70.9 billion **May -$72.5 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail Mar 0.0% / -0.3% Apr 0.8% / 0.5% May -- / --	**INITIAL CLAIMS (8:30)** **REVISED GDP (8:30)** GDP / Chained Price 18-Q4 2.2% / 1.7% 19-Q1(p) 3.1% / 0.8% **19-Q1(r) 3.0% / 0.8%** **PENDING HOMES SALES (10:00)** Mar 3.9% Apr -1.5% May --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Mar 0.1% / 1.1% / 0.1% Apr 0.5% / 0.3% / 0.2% **May 0.4% / 0.5% / 0.1%** **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index / Prices Apr 52.6 / 50.8 May 54.2 / 53.8 June -- / -- **REVISED CONSUMER SENTIMENT (10:00)** Apr 97.2 May 100.0 June(p) 97.9
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**
8	9	10	11	12
CONSUMER CREDIT	**NFIB SENTIMENT INDEX** **JOLTS DATA**	**WHOLESALE TRADE** **FOMC MINUTES**	**INITIAL CLAIMS** **CPI** **FEDERAL BUDGET**	**PPI**

Forecasts in Bold (p) = preliminary (2nd estimate of GDP); (r) = revised (3rd estimate of GDP)

Treasury Financing

June/July 2019

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
AUCTION RESULTS: Rate Cover 13-week bills 2.170% 2.84 26-week bills 2.130% 2.88 **SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 52-week bills 1.985% 2.88 **ANNOUNCE:** $40 billion 4-week bills for auction on June 20 $35 billion 8-week bills for auction on June 20 **SETTLE:** $40 billion 4-week bills $35 billion 8-week bills		**AUCTION RESULTS:** Rate Cover 4-week bills 2.140% 2.86 8-week bills 2.105% 2.98 5-year TIPS 0.152% 2.55 **ANNOUNCE:** $72 billion 13-,26-week bills for auction on June 24 $18 billion 2-year FRNs for auction on June 26 $40 billion 2-year notes for auction on June 25 $41 billion 5-year notes for auction on June 26 $32 billion 7-year notes for auction on June 27 **SETTLE:** $72 billion 13-,26-week bills $26 billion 52-week bills	
24	25	26	27	28
AUCTION: $72 billion 13-,26-week bills	**AUCTION:** $40 billion 2-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on June 27 $35 billion* 8-week bills for auction on June 27 **SETTLE:** $40 billion 4-week bills $35 billion 8-week bills	**AUCTION:** $18 billion 2-year FRNs $41 billion 5-year notes	**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $32 billion 7-year notes **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on July 1 **SETTLE:** $72 billion 13-,26-week bills	**SETTLE:** $15 billion 5-year TIPS $18 billion 2-year FRNs
1	2	3	4	5
AUCTION: $72 billion* 13-,26-week bills **SETTLE:** $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes	**ANNOUNCE:** $40 billion* 4-week bills for auction on July 3 $35 billion* 8-week bills for auction on July 3 **SETTLE:** $40 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on July 8 $38 billion* 3-year notes for auction on July 9 $24 billion* 10-year notes for auction on July 10 $16 billion* 30-year bonds for auction on July 11	***INDEPENDENCE DAY***	**SETTLE:** $72 billion* 13-,26-week bills
8	9	10	11	12
AUCTION: $72 billion* 13-,26-week bills	**AUCTION:** $38 billion* 3-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on July 11 $35 billion* 8-week bills for auction on July 11 **SETTLE:** $40 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $24 billion* 10-year notes	**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $16 billion* 30-year bonds **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on July 15 $26 billion* 52-week bills for auction on July 16 $14 billion* 10-year TIPS for auction on July 18 **SETTLE:** $72 billion* 13-,26-week bills	

**Estimate*