Daiwa Capital Markets

U.S. Economic Comment

- FOMC: on hold for an extended period, maybe

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

A Dovish Fed; Perhaps Too Dovish

The Federal Open Market Committee did not alter policy at its latest meeting, and it barely adjusted the forward guidance in its policy statement. Nevertheless, we viewed the new information provided by the Committee as meaningful because of the insights provided by the economic projections of Fed officials – the so-called Summary of Economic Projections (SEP).

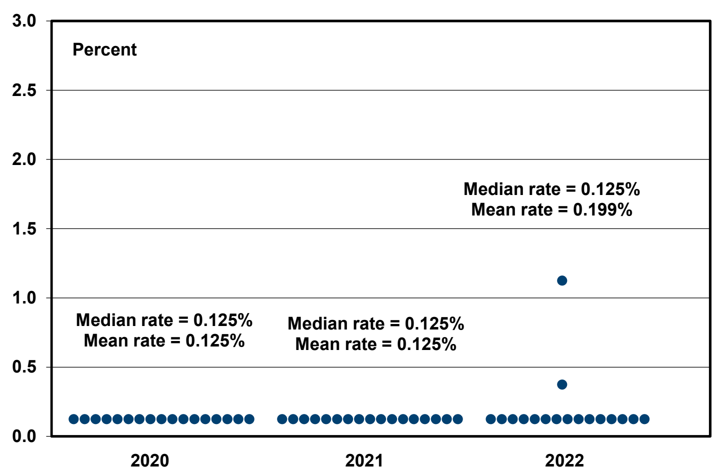
The interest rate projections of Fed officials showed a remarkable unanimity of views. All officials expect to hold policy steady this year and next, and only two officials anticipate tighter policy in 2022. One of the policymakers looking for higher rates anticipates only a modest adjustment (chart).

Plans for policy often go awry, and thus one might wonder what conditions could induce the Fed to deviate from its expected course and hike interest rates sometime within the next few years. Interestingly, the issue arose at Chair Powell's press briefing, as a reporter asked how the Fed would react if the economy recovered faster than expected. Mr. Powell indicated that the FOMC would welcome low unemployment and that Fed officials were not thinking about raising interest rates.

Still, some set of circumstances could arise that would prompt the Fed to move. In this regard, other elements in the Summary of Economic Projections are useful, particularly the unemployment rate, as the policy priority at this time is to stir economic growth and promote employment. As shown in the table on the next page, the median forecast for the unemployment rate in 2022-Q4 is 5.5 percent, but only two officials were willing to raise interest rates at that point. Thus, the trigger for tighter policy must be lower than this median.

The FOMC also publishes central tendencies for the economic variables in the SEP, which are ranges that remain after eliminating the three highest and lowest projections. The bottom of this range for the unemployment rate is 4.8 percent, which forces the conclusion that the threshold for higher interest rates is even lower unemployment. The FOMC did not provide much in the way of explicit forward guidance in its policy statement, but the information in the SEP represents an effective substitute.

FOMC Rate View: Year-End 2020, 2021, & 2022*



* *Each dot represents the expected federal funds rate of a Fed official at the ends of 2020, 2021, and 2022. 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 June 2020 meeting.*

Source: Federal Open Market Committee, Summary of Economic Projections, June 2020

Views among Fed officials on sustainable unemployment and inflation apparently have changed profoundly in recent years. The FOMC experimented with outcome-based forward guidance from December 2012 through January 2014, with an unemployment rate of 6.5 percent as the threshold that would lead the Fed to begin removing accommodation that had been applied during the financial crisis. Today, information extracted from the SEP suggests that the threshold is approximately two percentage points lower.

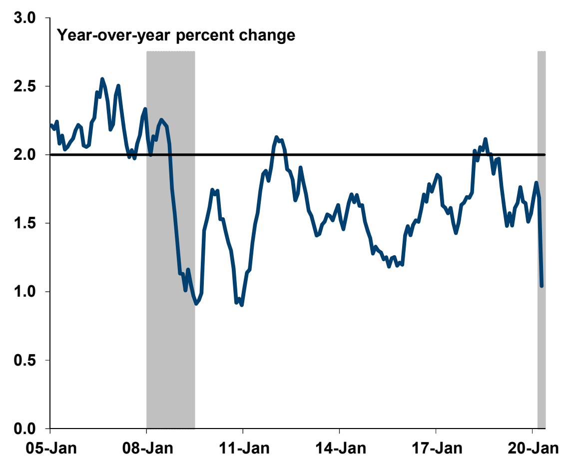
Economic Projections of the FOMC, June 2020*

	2020	2021	2022	Longer Run
Change in Real GDP	-6.5	5.0	3.5	1.8
Central Tendency	-7.6 to -5.5	4.5 to 6.0	3.0 to 4.5	1.7 to 2.0
Unemployment Rate	9.3	6.5	5.5	4.1
Central Tendency	9.0 to 10.0	5.9 to 7.5	4.8 to 6.1	4.0 to 4.3
PCE Inflation	0.8	1.6	1.7	2.0
Central Tendency	0.6 to 1.0	1.4 to 1.7	1.6 to 1.8	2.0
Core PCE Inflation	1.0	1.5	1.7	--
Central Tendency	0.9 to 1.1	1.4 to 1.7	1.6 to 1.8	--
Federal Funds Rate	0.1	0.1	0.1	2.5
Central Tendency	0.1	0.1	0.1	2.3 to 2.5

** Median projections*
Source: Federal Open Market Committee, Summary of Economic Projections, June 2020

Apparently, Fed officials have fully embraced the view of many economists that inflation dynamics have changed in recent years, with price pressure now less sensitive to the degree of slack in the economy. Chair Powell was clear in his acceptance of this view, as he noted several times in his press briefing that inflation had remained below the Fed's target of 2.0 percent during most of the recent expansion despite decades-low unemployment (chart).

Core PCE Price Index*



PCE = personal consumption expenditures
** The horizontal line at two percent is the inflation target of the FOMC. The shaded areas indicate periods of recession in the United States.*
Source: Bureau of Economic Analysis and National Bureau of Economic Research via Haver Analytics

Steady Policy Through 2022. Really?

The Fed's new-found religion on inflation certainly supports the case for an extended period of accommodative policy. Still, the view of highly accommodative policy through the end of 2022 strikes us as extreme. The current recession is notably different than those in the past, as it was driven by a medical emergency rather than economic imbalances. Long recessions and tepid recoveries are usually associated with excesses that must be worked off, but that is not the case in this cycle. If the virus subsides, the rebound in the economy should be reasonably quick.

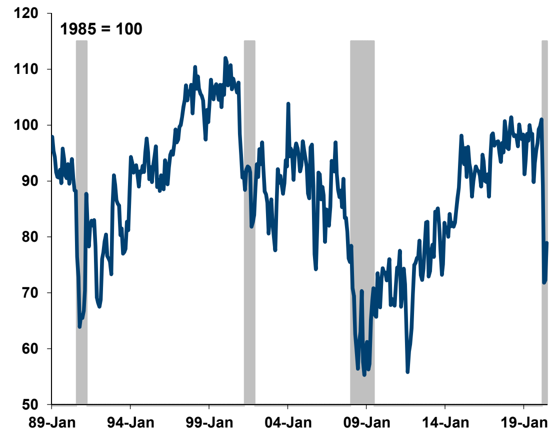
To be sure, the recovery is not likely to be V-shaped, but we do not envision a long adjustment with millions of permanent job losses described by Chair Powell. Our view has the economy returning to pre-virus levels sometime in 2022, and recall that the economy was "in a good place" (Powell's characterization) before the outbreak of the pandemic. Labor markets were tight and reports of worker shortages were common. The sudden shift to millions of permanent job losses strikes us as curious, especially with hefty fiscal and monetary support put in place with unusual speed.

Today's report on consumer sentiment offers support for the more optimistic view on the economy. Despite the highest unemployment rate since the Great Depression and most likely the steepest quarterly drop in real GDP on record, the sentiment index of the University of Michigan Survey Research Center remained comfortably above the low during the financial crisis and above the trough in the 1990-91 recession (chart, next page). Certainly, this measure has lost considerable ground in the past few months, but the drop is far from commensurate with the softness seen in many other recent economic statistics. Individuals are not deeply alarmed by the current setting or prospects for the future, and thus are not likely to alter their support dramatically once threats from the virus lessen.

If the economy were to lag more than we expect, the shortfall would probably be the result of individuals hesitating to engage in activities involving crowds, such as attending concerts or plays, traveling by air, and eating in restaurants. Easy monetary policy would not be effective in countering such constraints, which could lead the Fed to rethink the need for highly accommodative monetary policy.

We have eliminated three of the four tightenings we had in place for next year in light of the friendly tone advanced by the Fed, but we will keep in place for now one rate hike late next year in the event of a quick rebound. While the Fed could well remain on the sideline all next year, we have more confidence in prospects for tightening in 2022, as we view the pessimistic view on the economy advanced by the Fed as excessive.

Consumer Sentiment*



The shaded areas indicate periods of recession in the United States.

Source: University of Michigan Survey Research Center and National Bureau of Economic Research via Haver Analytics

Review

Week of June 8, 2020	Actual	Consensus	Comments
CPI (May)	**-0.1% Total, -0.1% Core**	**0.0% Total, 0.0% Core**	The food component of the CPI jumped 0.7% in May, reflecting primarily higher prices of food for home consumption, which was driven by still-strong demand during the lockdown. Other areas were subdued. The energy component fell 1.8%, led by a drop of 6.3% in the price of fuel oil and supported by a retreat of 3.5% in gasoline prices. Core prices fell for the third consecutive month, with areas affected by the virus accounting for most of the downward pressure (airfares, hotel fees, apparel prices). The latest results left the year-over-year change in the headline index at 0.1%, down from 0.3% in April and a recent peak of 2.5% in January. The core component rose 1.2% in the past year, down from 1.4% in the prior month and 2.4% in February.
Federal Budget (May)	**$398.8 Billion Deficit**	**$504.0 Billion Deficit**	The coronavirus weighed heavily on the budget position of the federal government for the second consecutive month in May. Federal revenues fell 25.1% on a year-over-year basis, as sharp declines in employment reduced taxes withheld from paychecks. In addition, the shift in the due date for filing federal income taxes from April to July led to a jump in refunds that would have been paid in earlier months. Outlays jumped 30.2% in May, down from the surge of more than 160% in the prior month, but still pronounced. The budget deficit of $1.88 trillion in the first eight months of FY2020 dwarfed the already large deficit of $739 billion in the same period in FY2019.
PPI (May)	**0.4% Total, 0.1% Core***	**0.1% Total, -0.1% Core***	Both the food and energy components of the PPI jumped in May (up 6.0% and 4.5%, respectively) after net declines in the early months of 2020. Core goods prices were unchanged in May, but the service component of the core index provided an offset that pulled the measure slightly higher and ended a string of three consecutive declines. The latest changes left the headline index down 0.8% in the past year, only slightly firmer than the drop of 1.2% in the prior month. The softness in the headline index reflected more than lower energy prices, as the core measure fell 0.4% in the past year.
Consumer Sentiment (June)	**78.9 (+6.6 Index Pts.)**	**75.0 (+2.7 Index Pts.)**	Consumer sentiment rose 9.1% in early June, increasing for the second consecutive month and retracing a portion of the 28.9% drop in March and April when shutdowns associated with the coronavirus were initiated. While sentiment remained in the lower portion of the range of the last economic expansion, it was notably above the low of 55.3 during the financial crisis. Moreover, the back-to-back increases may be signaling stabilization in sentiment, and the phased reopening of the economy and return to work for furloughed individuals may lead to further improvement in attitudes in coming months.

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

Sources Bureau of Labor Statistics (CPI, PPI); U.S. Treasury Department (Federal Budget); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of June 15, 2020	Projected	Comments
Retail Sales (May) (Tuesday)	**6.0% Total, 5.0% Ex-Autos**	Sales of new motor vehicles picked up in May, and the downward pressure on gasoline sales because of lower prices should be nearing an end. Perhaps most important, the easing of lockdown restrictions is likely to stir activity in most other components of retail sales.
Industrial Production (May) (Tuesday)	**2.0%**	A jump in employment in the factory sector suggests that the manufacturing component of industrial production will retrace a small portion of the sharp declines in the prior two months. The mining component is likely to provide a partial offset, as declines in both employment and the rotary rig count point to lower output. The swing in temperatures was about normal from April to May, which should leave utility output little changed.
Housing Starts (May) (Wednesday)	**1.000 Million (+12.2%)**	A jump in construction employment in May raises the possibility of a sizeable gain in housing starts. Builders were perhaps encouraged by a pickup in sales of new homes in April despite the constraining influence of the coronavirus.
Leading Indicators (May) (Thursday)	**2.3%**	The decline in claims for unemployment insurance in the past several weeks accounts for most of the expected increase in the leading indicator index, but a longer workweek in the manufacturing sector and the advance in the stock market contributed as well. The ISM new orders index and the leading credit index are likely to provide modest offsets.
Current Account (20-Q1) (Friday)	**-$112.0 Billion ($2.2 Billion Wider Deficit)**	The trade balance improved in the first quarter, but this positive influence on the current account is likely to be offset by negative income flows, leaving slight deterioration in the current account deficit (versus $109.8 billion in Q4).

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June/July 2020

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
	NFIB SMALL BUSINESS OPTIMISM INDEX Mar 96.4 Apr 90.9 May 94.4 **JOLTS DATA** Openings (000) / Quit Rate Feb 7,004 / 2.3% Mar 6,011 / 1.8% Apr 5,046 / 1.4% **WHOLESALE TRADE** Inventories / Sales Feb -0.7% / -0.7% Mar -1.1% / -5.1% Apr 0.3% / -16.9% **FOMC MEETING**	**CPI** Total / Core Mar -0.4% / -0.1% Apr -0.8% / -0.4% May -0.1% / -0.1% **FEDERAL BUDGET** 2020 / 2019 Mar -$119.0B / -$146.9B Apr -$738.0B / $160.3B May -$398.8B / -$207.8B **FOMC DECISION**	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) May 16 2.446 / 20.841 May 23 2.123 / 21.268 May 30 1.897 / 20.929 June 06 1.542 / N/A **PPI** Final Demand / Core* Mar -0.2% / -0.2% Apr -1.3% / -0.9% May 0.4% / 0.1%	**IMPORT/EXPORT PRICES** Non-fuel Imports / Nonagri. Exports Mar 0.0% / -1.4% Apr -0.5% / -3.3% May 0.1% / 0.6% **CONSUMER SENTIMENT** Apr 71.8 May 72.3 June 78.9
15	16	17	18	19
EMPIRE MFG (8:30) Apr -78.2 May -48.5 June -- **TIC DATA (4:00)** Net L-T / Total Feb $49.6B / -$14.3B Mar -$112.6B / $349.9B Apr -- / --	**RETAIL SALES (8:30)** Total / Ex.Autos Mar -8.3% / -4.0% Apr -16.4% / -17.2% **May 6.0% / 5.0%** **IP & CAP-U (9:15)** IP / Cap.Util. Mar -4.5% / 73.2% Apr -11.2% / 64.9% **May 2.0% / 66.5%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Feb -0.4% / -0.5% Mar -0.3% / -5.3% **Apr -1.3% / -15.2%** **NAHB HOUSING INDEX (10:00)** Apr 30 May 37 June -- **MONETARY POLICY TESTIMONY (SENATE) (10:00)**	**HOUSING STARTS (8:30)** Mar 1.276 million Apr 0.891 million **May 1.000 million** **MONETARY POLICY TESTIMONY (HOUSE) (10:00)**	**INITIAL CLAIMS (8:30)** **PHILLY FED INDEX (8:30)** Apr -56.6 May -43.1 June -- **LEADING INDICATORS (10:00)** Mar -7.4% Apr -4.4% **May 2.3%**	**CURRENT ACCOUNT (8:30)** 19-Q3 -$125.4 bill. 19-Q4 -$109.8 bill. **20-Q1 -$112.0 bill.**
22	23	24	25	26
CHICAGO FED NATIONAL ACTIVITY INDEX **EXISTING HOME SALES**	**NEW HOME SALES**	**FHFA HOME PRICE INDEX**	**INITIAL CLAIMS** **REVISED GDP** **DURABLE GOODS ORDERS** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES**	**PERSONAL INCOME, CONSUMPTION, PRICES** **REVISED CONSUMER SENTIMENT**
29	30	1	2	3
PENDING HOME SALES	**S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **CHICAGO PURCHASING MANAGERS' INDEX** **CONSUMER CONFIDENCE**	**ADP EMPLOYMENT REPORT** **ISM MFG. INDEX** **CONSTRUCTION SPEND.** **FOMC MINUTES** **VEHICLE SALES**	**INITIAL CLAIMS** **EMPLOYMENT REPORT** **TRADE BALANCE** **FACTORY ORERS**	***INDEPENDENCE DAY (OBSERVED)***

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

Treasury Financing

June/July 2020

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
AUCTION RESULTS: Rate Cover 13-week bills 0.170% 2.71 26-week bills 0.185% 3.01 3-year notes 0.280% 2.55	**AUCTION RESULTS:** Rate Cover 42-day CMB 0.165% 2.70 119-day CMB 0.185% 3.30 10-year notes 0.832% 2.26 **ANNOUNCE:** $70 billion 4-week bills for auction on June 11 $60 billion 8-week bills for auction on June 11 $35 billion 105-day CMBs for auction on June 10 $40 billion 154-day CMBs for auction on June 10 **SETTLE:** $80 billion 4-week bills $70 billion 8-week bills $40 billion 105-day CMBs $40 billion 154-day CMBs	**AUCTION RESULTS:** Rate Cover 105-day CMB 0.180% 3.50 154-day CMB 0.190% 2.95	**AUCTION RESULTS:** Rate Cover 4-week bills 0.130% 2.99 8-week bills 0.155% 2.86 30-yr bonds 1.450% 2.30 **ANNOUNCE:** $114 billion 13-,26-week bills for auction on June 15 $50 billion 42-day CMBs for auction on June 16 $40 billion 119-day CMBs for auction on June 16 $34 billion 52-week bills for auction on June 16 $17 billion 20-year bonds for auction on June 17 $15 billion 5-year TIPS for auction on June 18 **SETTLE:** $117 billion 13-,26-week bills $60 billion 42-day CMBs $40 billion 119-day CMBs	
15	16	17	18	19
AUCTION: $114 billion 13-,26-week bills **SETTLE:** $44 billion 3-year notes $29 billion 10-year notes $19 billion 30-year bonds	**AUCTION:** $34 billion 52-week bills $50 billion 42-day CMBs $40 billion 119-day CMBs **ANNOUNCE:** $70 billion* 4-week bills for auction on June 18 $60 billion* 8-week bills for auction on June 18 **SETTLE:** $70 billion 4-week bills $60 billion 8-week bills $35 billion 105-day CMBs $40 billion 154-day CMBs	**AUCTION:** $17 billion 20-year bonds	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills $15 billion 5-year TIPS **ANNOUNCE:** $114 billion* 13-,26-week bills for auction on June 22 $20 billion* 2-year FRNs for auction on June 24 $46 billion* 2-year notes for auction on June 23 $47 billion* 5-year notes for auction on June 24 $41 billion* 7-year notes for auction on July 25 **SETTLE:** $114 billion 13-,26-week bills $34 billion 52-week bills $50 billion 42-day CMBs $40 billion 119-day CMBs	
22	23	24	25	26
AUCTION: $114 billion* 13-,26-week bills	**AUCTION:** $46 billion* 2-year notes **ANNOUNCE:** $70 billion* 4-week bills for auction on June 25 $60 billion* 8-week bills for auction on June 25 **SETTLE:** $70 billion* 4-week bills $60 billion* 8-week bills	**AUCTION:** $20 billion* 2-year FRNs $47 billion* 5-year notes	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills $41 billion* 7-year notes **ANNOUNCE:** $114 billion* 13-,26-week bills for auction on June 29 **SETTLE:** $114 billion* 13-,26-week bills	**SETTLE:** $20 billion* 2-year FRNs
29	30	1	2	3
AUCTION: $114 billion* 13-,26-week bills	**ANNOUNCE:** $70 billion* 4-week bills for auction on July 2 $60 billion* 8-week bills for auction on July 2 **SETTLE:** $70 billion* 4-week bills $60 billion* 8-week bills $17 billion 20-year bonds $15 billion 5-year TIPS $46 billion* 2-year notes $47 billion* 5-year notes $41 billion* 7-year notes		**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $114 billion* 13-,26-week bills for auction on July 6 $46 billion* 3-year notes for auction on July 7 $29 billion* 10-year notes for auction on July 8 $19 billion* 30-year bonds for auction on July 9 **SETTLE:** $114 billion* 13-,26-week bills	***INDEPENDENCE DAY (OBSERVED)***

**Estimate*