U.S. Economic Comment

- Chair Powell: "strongly committed to bringing inflation back down"…
  … and "moving expeditiously to do so."
- But also raising the probability of recession

Michael Moran
Lawrence Werther
Daiwa Capital Markets America
michael.moran@us.daiwacm.com
lawrence.werther@us.daiwacm.com

FOMC: No Stopping at Neutral

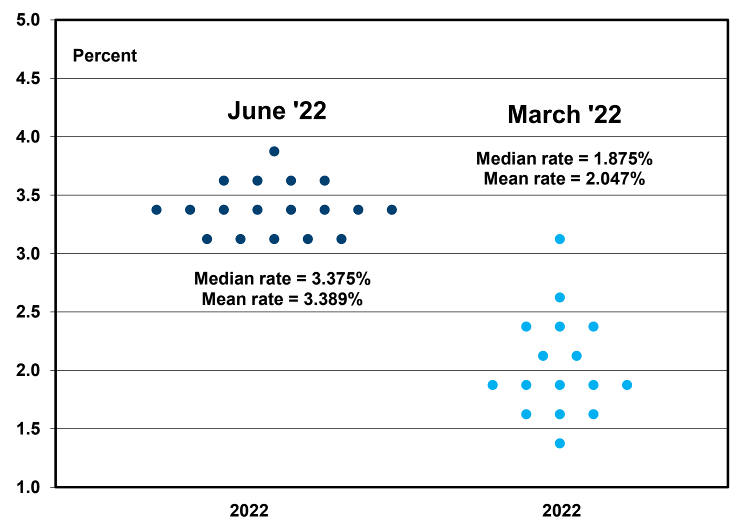
Fed Chair Jerome Powell seems serious in his drive to squeeze inflation from the U.S. economy, and a marked upward shift in the dot plot suggests that other Fed officials are on board with the commitment. The median dot showed an increase of 150 basis points from March to June (chart), and all officials now see policy moving to a restrictive stance by the end of the year (a median view of 3.375 percent versus the perceived neutral rate of 2.5 percent). The FOMC expects that the tightening cycle will extend into 2023, with additional increases leaving the peak funds rate in the neighborhood of 3.75 percent.

We expect the aggressive tack of the Federal Reserve to quell price pressure – at least the demand-based sources of pressure – but it also heightens the risk of recession. In effect, the Fed is slamming on the brakes, and aggressive, catch-up efforts to tame inflation carry a high probability of recession. The U.S. can probably muddle through the balance of this year, as the economy in early 2022 had a good bit of momentum. In addition, monetary policy is still in a position that can be viewed as accommodative; restrictive policy will not begin to bite hard until later this year. Next year, it will be difficult for the economy to remain on track; we expect activity to be flat or down in every quarter of 2023 (table, p. 3).

We look for housing and business investment to stand out in constraining economic growth. Mortgage interest rates have increased more sharply than yields on Treasury securities and corporate bonds have, and the interest-sensitive housing sector is already beginning to slow. Higher interest rates will have a dampening influence on business investment, but a more important consideration will be the uncertain economic environment, which will most likely leave executives hesitant to undertake new investment projects.

The outlook for consumer spending was bright at the start of the year. With a firm labor market and healthy financial positions, individuals seemed set to lead the expansion. However, the retreat in the equity market has weakened the net worth of many, and elevated prices of food and energy have challenged the budgets of most. In addition, the labor market is perhaps losing its sharp edge, as job growth eased to an average of 408,000 from March through May versus an average of 592,000 in the six months before March. Tighter policy from the Fed will most likely lead to additional softening in the labor market, which will constrain consumer demand.

FOMC Rate View: Year-End 2022*



** Each dot represents the expected federal funds rate of a Fed official at the end of 2022. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but one governorship was open at the June 2022 meeting and three governorships were open at the March 2022 meeting.*

Sources: Federal Open Market Committee, Summary of Economic Projections, June 2022 & March 2022

Fed officials are hopeful that their restrictive policy stance will not push the unemployment rate noticeably higher. The Summary of Economic Projections shows an expected jobless rate of 3.7 percent in the fourth quarter of this year, increasing gradually to 4.1 percent in late 2024. Fed Governor Christopher Waller argued in a recent speech that softer demand for labor will take the form of reduced search efforts for new workers – that is, a reduction in job openings – rather than cuts to existing workforces.

This view has merit, but we suspect that unemployment will increase more than policymakers are expecting. Reduced openings will make it more difficult for new entrants to find jobs, and we suspect that layoffs will pickup to some degree. We see an unemployment rate in the upper-four-percent area in late 2024.

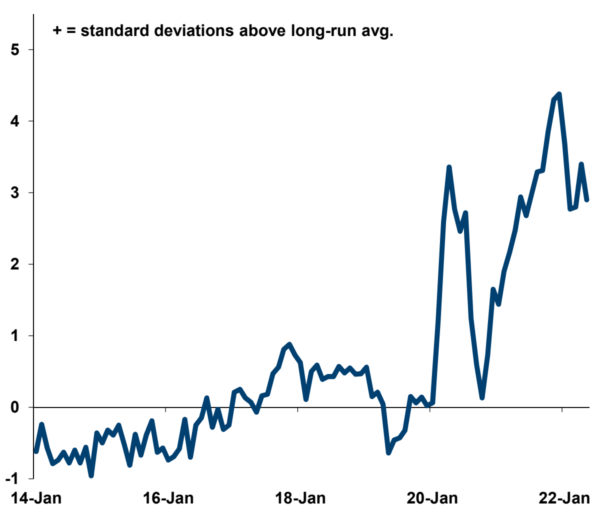
Stagflation?

With inflation raging and recession looming, many observers already are talking about stagflation. However, we do not view our projection as representing a stagflationary situation. The inflation rate, although currently elevated, is likely to recede. Progress might be slow, and inflation will most likely remain above the Fed's target of two percent throughout the forecast horizon, but it will be moving in the desired direction.

Inflation currently has both demand-side and supply-side elements. Demand-side pressure was stirred by generous fiscal support during the worst of the pandemic and by the extended period of monetary accommodation. Supply-side pressures reflect the lingering effects of Covid-related restrictions and the recent disruptions associated with the Russia-Ukraine conflict. Demand-side pressures should fade. The effects of fiscal support will be waning, and tighter policy by the Fed will dampen demand as well.

We also are hopeful that supply-side pressures will begin to diminish. We have been heartened by recent hints that conditions are improving (or at least not worsening). For example, the supply-chain pressure index published by the New York Fed is off the peak seen late last year and has not picked up meaningfully despite lockdowns in China and possible fallout from the Russia-Ukraine conflict (chart, left). Similarly, U.S. trade flows have picked up, suggesting an easing in port congestion. The chart on the right shows the sum of real U.S. exports and imports, with results for March and April showing notable improvement.

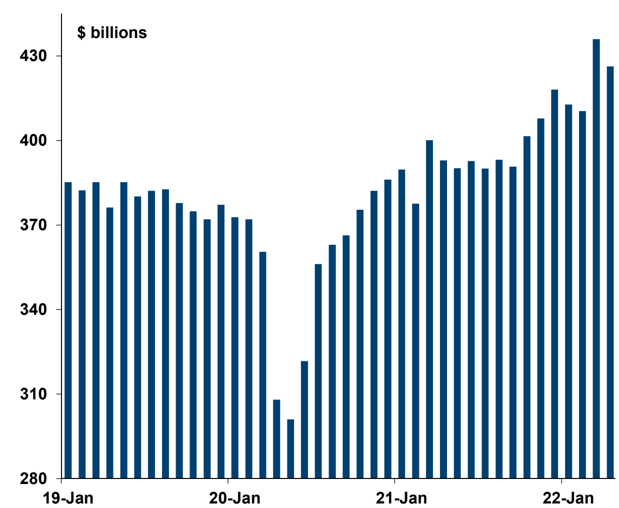
Global Supply Chain Pressure Index*



** The measure is constructed using 27 variables including: country-specific supply-chain variables from the Euro Area, China, Japan, South Korea, Taiwan, the U.K. and the U.S., global shipping rates and airfreight costs.*

Source: Federal Reserve Bank of New York, Global Supply Chain Pressure Index, https://www.newyorkfed.org/research/gscpi.html.

Real Trade Flows*



** The sum of real imports and exports of goods.*

Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

Recent developments have been encouraging, but potential supply-side developments merit close attention. If stagflation were to emerge as a genuine issue, it will be driven by supply-side problems: production constraints will both limit output and drive prices higher. Unfortunately, it is difficult to know what might develop on the supply side. A new variant of Covid could generate problems, and who knows what might transpire in Eastern Europe. It is quite possible that supply-side problems will cause inflation to linger while also worsening the constraining influence of tight monetary policy. At the same time, the U.S. could get lucky, with pronounced improvement in supply chains sending key prices lower and sharply reducing the inflation rate.

U.S. Economic Outlook*

(Percent change annual rate, unless otherwise noted)

		2022				2023			
Item		**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
1	Gross Domestic Product	-1.5	1.5	0.9	0.7	-0.1	-0.8	-0.9	0.0
2	Personal Consumption Expenditures	3.1	3.0	2.0	1.5	0.7	-0.2	-1.5	-0.8
3	Business Fixed Investment	9.2	-1.0	2.4	2.1	-0.2	-2.6	-1.4	0.3
4	Residential Construction	0.4	-10.0	-8.0	-9.0	-10.0	-12.0	-6.0	-5.0
5	Change in Business Inventories *(Contribution to growth)*	-1.1	-1.2	-0.4	-0.4	-0.2	-0.2	-0.1	0.0
6	Government Spending	-2.7	2.0	2.5	3.0	2.7	2.4	2.1	2.1
7	Net Exports *(Contribution to growth)*	-3.2	0.9	-0.5	-0.4	-0.3	-0.1	0.3	0.3
	Inflation and Unemployment								
8	Core PCE Price Index *(Annual rate)*	5.1	4.6	4.3	4.0	3.8	3.5	3.1	2.9
9	Unemployment Rate	3.6	3.6	3.7	3.8	4.0	4.2	4.4	4.8
	Interest Rates (End of Period)								
10	Federal Funds Target (midpoint)	0.38	1.63	2.63	3.38	3.63	3.88	4.13	4.38
11	2-year Treasury	2.28	3.40	4.30	4.80	4.95	5.00	5.05	5.10
12	10-year Treasury	2.32	3.40	4.20	4.65	4.75	4.80	4.90	5.00
13	30-year Fixed-Rate Mortgages	4.67	5.65	6.50	6.95	7.15	7.30	7.40	7.50

** The readings for 2022-Q2 to 2023-Q4 are forecasts.*
Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; Freddie Mac; Daiwa Capital Markets America

Review

Week of June 13, 2022	Actual	Consensus	Comments
PPI (May)	**0.8% Total, 0.5% Ex. Food & Energy**	**0.8% Total, 0.6% Ex. Food & Energy**	Energy prices jumped 5.0% in May, almost double the brisk average of 2.8% in the prior 12 months. Food prices were little changed in the latest month, but the pause followed average monthly increases of 1.3% in the prior year. Goods prices excluding food and energy suggested broad inflation pressure with an advance of 0.7%. The volatile services area rose 0.4% after a decline of 0.2% in April. The recent hint of restraint followed monthly increases of 0.7% in the 12 months ended March. Monthly changes in May left the year-over-year advance in the headline index at 10.8%, down from 10.9% in April and the recent high of 11.5% in March. Prices excluding food and energy advanced 8.3% versus 8.6% in April.
Retail Sales (May)	**-0.3% Total, 0.5% Ex. Autos**	**0.1% Total, 0.7% Ex. Autos**	A drop of 3.5% in the auto component was a notable drag on retail sales in May, but sales at gasoline stations provided an offset with a jump of 4.0%. As in other recent months, the advance in gasoline sales reflected higher prices at the pump rather than an increase in real activity. Sales excluding autos and gasoline rose 0.1%; the tepid increase in nominal activity probably translated to a decline after adjusting for inflation. Moreover, outright declines in discretionary categories (electronic and appliance stores, furniture stores) suggested that increased outlays for essentials are causing consumers to cut back in other areas.
Housing Starts (May)	**1.549 Million (-14.4%)**	**1.693 Million (-1.8%)**	Both single-family and multi-family activity contributed to the drop in housing starts in May. Single-family starts fell 9.2% to 1.051 million, dropping to the bottom of the range of the past 18 months. Multi-family starts fell 23.7% to 498,000 units. Most of this decline represented an offset to an unusually firm reading in the prior month (the highest level in the past three expansions). The total for multi-family starts remained comfortably within the firm range of the prior 12 months. Multi-family activity could continue to perform well as affordability issues lead to softer demand for single-family homes.
Industrial Production (May)	**0.2%**	**0.4%**	Manufacturing activity dipped 0.1% in May, but the soft performance followed brisk average increases of 1.0% in the prior three months. Auto production signaled further easing in supply constraints, advancing for the third consecutive month (+0.7%; a cumulative jump of 13.4% from March thru May). Mining activity rose 1.3% (with a surge of 5.7% in the March-to-May period), spurred by higher petroleum prices. Utility output rose 1.0%, but changes in this area usually reflect shifts in weather rather than economic fundamentals.
Leading Indicators (May)	**-0.4%**	**-0.4%**	Negative contributions from stock prices, consumer expectations, and building permits accounted for the decline in the index of leading economic indicators in May. The measure surged above pre-pandemic levels as the economy emerged from recession, but it leveled out in early 2022 before tilting lower in the past two months.

Sources: Bureau of Labor Statistics (PPI); U.S. Census Bureau (Retail Sales, Housing Starts); Federal Reserve Board (Industrial Production); The Conference Board (Leading Indicators); Consensus forecasts are from Bloomberg

Preview

Week of June 20, 2022	Projected	Comments
Existing Home Sales (May) (Tuesday)	**5.50 Million (-2.0%)**	Six consecutive declines in pending home sales suggest that a drop in affordability (elevated interest rates and high prices) is limiting demand in the market for existing homes. Razor-thin inventories in many markets also are limiting activity. The challenging conditions suggest that sales of existing homes fell for the fifth time in the past six months, with the projected level of activity 17.3% below the recent peak of 6.654 million in January 2021.
Current Account (22-Q1) (Thursday)	**-$280.0 Billion ($62.1 Billion Wider Deficit)**	A notable deterioration in trade flows in Q1 suggests substantial widening in the current account deficit. The expected shortfall translates to 4.6% when measured as a share of GDP, up from 3.6% in 2021, which already represented a marked deterioration from readings in the high one-percent and low two-percent area prior to the onset of the pandemic.
Revised Consumer Sentiment (June) (Friday)	**50.2 (Unrevised)**	With gasoline prices averaging five dollars per gallon through mid-June, and with rapid inflation increasing prices of groceries, a meaningful upward adjustment to consumer sentiment from the record low tally published earlier in the month seems unlikely; a nudge lower would not be surprising.
New Home Sales (May) (Friday)	**0.600 Million (+1.5%)**	Although the housing market is facing substantial headwinds in the form of elevated prices and interest rates, the plunge of 16.6% in sales of new homes in April may have overstated the degree of weakness in this sector. A small rebound is possible in May, although sales are likely to remain well below the average of 750,000 in the 12 months prior to the swoon in April.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June / July 2022

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX Mar 93.2 Apr 93.2 May 93.1 **PPI** Final Demand / Ex. Food & Energy Mar 1.6% 1.2% Apr 0.4% 0.2% May 0.8% 0.5% **FOMC MEETING**	**RETAIL SALES** Total / Ex.Autos Mar 1.2% 2.0% Apr 0.7% 0.4% May -0.3% 0.5% **IMPORT/EXPORT PRICES** Non-petrol Imports / Nonagri. Exports Mar 1.2% 4.2% Apr 0.5% 0.7% May -0.1% 2.9% **EMPIRE MFG INDEX** Apr 24.6 May -11.6 June -1.2 **BUSINESS INVENTORIES** Inventories / Sales Feb 1.7% 1.1% Mar 2.4% 1.6% Apr 1.2% 0.4% **NAHB HOUSING INDEX** Apr 77 May 69 June 67 **FOMC DECISION** **POWELL PRESS CONFERENCE** **TIC DATA** Total / Net Long-Term Feb $201.2B $141.7B Mar $108.7B $23.1B Apr $1.3B $87.7B	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) May 21 0.211 1.306 May 28 0.202 1.309 June 04 0.232 1.312 June 11 0.229 N/A **HOUSING STARTS** Mar 1.716 million Apr 1.810 million May 1.549 million **PHILY FED INDEX** Apr 17.6 May 2.6 June -3.3	**IP & CAP-U** IP / Cap.Util. Mar 0.5% 77.9% Apr 1.4% 78.9% May 0.2% 79.0% **LEADING INDICATORS** Mar -0.1% Apr -0.4% May -0.4%
20	21	22	23	24
JUNETEENTH	**CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)** Monthly / 3-Mo. Avg. Mar 0.36 0.49 Apr 0.47 0.48 May -- -- **EXISTING HOME SALES (10:00)** Mar 5.75 million Apr 5.61 million **May 5.50 million**	**MONETARY POLICY TESTIMONY (SENATE) (10:00)**	**INITIAL CLAIMS (8:30)** **CURRENT ACCOUNT (8:30)** 21-Q3 -$219.9 bill. 21-Q4 -$217.9 bill. **22-Q1 -$280.0 bill.** **MONETARY POLICY TESTIMONY (HOUSE) (10:00)**	**REVISED CONSUMER SENTIMENT (10:00)** Apr 65.2 May 58.4 June(p) 50.2 **NEW HOME SALES (10:00)** Mar 0.709 million Apr 0.591 million **May 0.600 million**
27	28	29	30	1
DURABLE GOODS ORDERS **PENDING HOME SALES**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER HOME PRICES** **CONSUMER CONFIDENCE**	**REVISED GDP**	**INITIAL CLAIMS** **PERSONAL INCOME, CONSUMPTION, PRICES** **CHICAGO PURCHASING MANAGERS' INDEX**	**ISM MFG INDEX** **CONSTRUCTION SPEND.** **NEW VEHICLE SALES**
4	5	6	7	8
INDEPENDENCE DAY	**FACTORY ORDERS**	**ISM SERVICES INDEX** **JOB OPENINGS & LABOR TURNOVER (JOLTS)** **FOMC MINUTES**	**ADP EMPLOYMENT REPORT** **INITIAL CLAIMS** **TRADE BALANCE**	**EMPLOYMENT REPORT** **WHOLESALE TRADE** **CONSUMER CREDIT**

Forecasts in Bold. (p) = preliminary

Treasury Financing

June / July 2022

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
AUCTION RESULTS: Rate Cover 13-week bills 1.640% 2.27 26-week bills 2.160% 3.26	**AUCTION RESULTS:** Rate Cover 52-week bills 3.020% 3.14 **ANNOUNCE:** $35 billion 4-week bills for auction on June 16 $30 billion 8-week bills for auction on June 16 $30 billion 17-week CMBs for auction on June 15 **SETTLE:** $35 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 2.090% 3.20 **SETTLE:** $44 billion 3-year notes $33 billion 10-year notes $19 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 4-week bills 1.180% 3.17 8-week bills 1.470% 3.28 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on June 21 $22 billion 2-year FRNs for auction on June 22 $14 billion 20-year bonds for auction on June 22 $18 billion 5-year TIPS for auction on June 23 **SETTLE:** $87 billion 13-,26-week bills $34 billion 52-week bills	
20	21	22	23	24
JUNETEENTH	**AUCTION:** $87 billion 13-,26-week bills **ANNOUNCE:** $35 billion* 4-week bills for auction on June 23 $30 billion* 8-week bills for auction on June 23 $30 billion* 17-week CMBs for auction on June 22 **SETTLE:** $35 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $22 billion 2-year FRNs $14 billion 20-year bonds	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills $18 billion 5-year TIPS **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on June 27 $46 billion* 2-year notes for auction on June 27 $47 billion* 5-year notes for auction on June 27 $40 billion* 7-year notes for auction on June 28 **SETTLE:** $87 billion 13-,26-week bills	**SETTLE:** $22 billion 2-year FRNs
27	28	29	30	1
AUCTION: $87 billion* 13-,26-week bills $46 billion* 2-year notes $47 billion* 5-year notes	**AUCTION:** $40 billion* 7-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on June 30 $30 billion* 8-week bills for auction on June 30 $30 billion* 17-week CMBs for auction on June 29 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on July 5 **SETTLE:** $87 billion* 13-,26-week bills $14 billion 20-year bonds $18 billion 5-year TIPS $46 billion* 2-year notes $47 billion* 5-year notes $40 billion* 7-year notes	
4	5	6	7	8
INDEPENDENCE DAY	**AUCTION:** $87 billion* 13-,26-week bills **ANNOUNCE:** $35 billion* 4-week bills for auction on July 7 $30 billion* 8-week bills for auction on July 7 $30 billion* 17-week CMBs for auction on July 6 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on July 11 $34 billion* 52-week bills for auction on July 12 $43 billion* 3-year notes for auction on July 11 $33 billion* 10-year notes for auction on July 12 $19 billion* 30-year bonds for auction on July 13 **SETTLE:** $87 billion* 13-,26-week bills	

*Estimate