Daiwa Capital Markets

U.S. Economic Comment

- FOMC preview: hike of 25 basis points anticipated, spurred by latest inflation data

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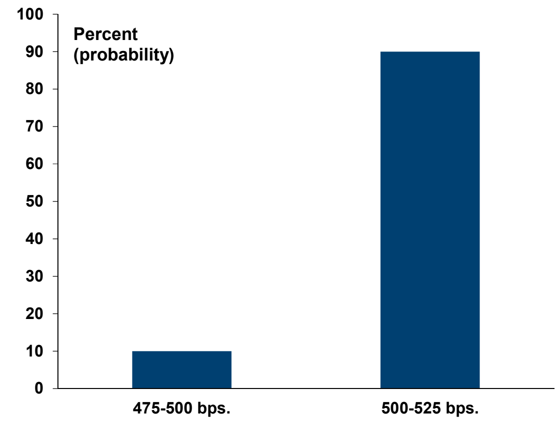
FOMC: Another Hike Expected in May

In adapting the March FOMC statement to indicate that "some additional policy firming" rather than "ongoing increases" in the target range for the federal funds rate could be required to attain a sufficiently restrictive monetary policy setting, we viewed Fed officials as shifting toward a pause in rate hikes at upcoming FOMC meetings. While that pause appears likely this summer as officials take a step back to assess the effects of rapid policy firming and volatility in the banking sector on the economy, we assign a low probability to this outcome occurring at next week's meeting. Our view aligns with broader market expectations that the odds of a 25-basis-point hike far exceed the likelihood of a pause in May, spurred by inflation data that showed less progress than hoped for (see the chart on the implied probability of a hike at next week's meeting).

Target Rate Probabilities For May FOMC



Source: CME Fed Watch Tool, CME Group

Recent turmoil in the banking sector, including the failures of Silicon Valley Bank and Signature Bank, had the potential to supplant inflation as the dominant near-term concern of policymakers, but officials pushed back against this view, including Chair Powell, who noted in his last post-FOMC press conference that the "banking system is sound and resilient." Worries flared again this week as First Republic Bank, another mid-sized institution that first encountered liquidity issues in mid-March, appears headed toward FDIC receivership, but recent data suggest that broad stress in the banking sector has not intensified.

Statistics on the Federal Reserve's balance sheet published yesterday in the weekly H.4.1 report suggested that usage of the Fed's credit facilities by troubled institutions has remained contained. Discount window borrowing increased $1.1 billion to $71.0 billion for the week ending April 19 (weekly average basis), but it remained below the recent peak of $117.0 billion in late March. Usage of the new Bank Term Funding Program increased by $3.0 billion to $76.5 billion, a new high but not out-of-line with other recent observations. The tools to facilitate liquidity in the banking system appear to be working, providing policymakers flexibility to utilize the federal funds rate for broad monetary policy objectives.

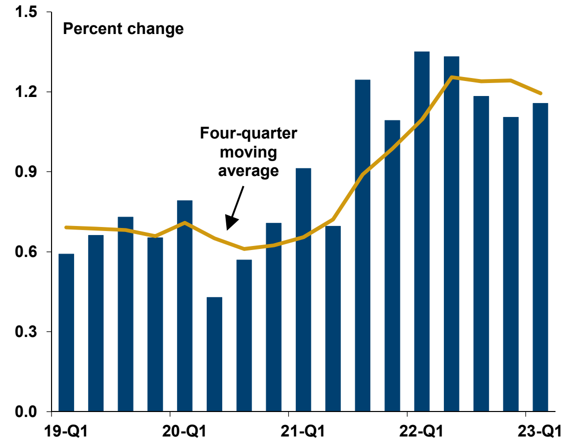
Friday Inflation Data: Still Too Firm

A final view on inflation was provided today ahead of next week's FOMC meeting with the release of the employment cost index for Q1 and the price indexes for personal consumption expenditures for March. The data on compensation growth suggested little progress in subduing wage inflation, while the PCE data offered hints of moderation.

The employment cost index increased 1.2 percent in the first quarter, matching the average in the past year (chart, next page). The year-over-year advance slowed to 4.8 percent from 5.1 percent. Wages and salaries rose 1.2 percent (5.0 percent year-over-year), with benefit costs increasing by the same amount month-to-month (4.5 percent year-over-year). Recent labor market data (moderating job growth in March, declines in job openings, and a pickup in layoffs) suggest that labor market conditions may be easing, but Fed officials likely view the latest compensation data as implying that tight conditions are still generating persistent and unacceptably high wage pressure.

The PCE price index offered more encouraging signs, though likely not enough to trigger a pause in rate hikes next week. The headline PCE price index rose 0.1 percent, with the year-over-year change slowing to 4.2 percent from 5.1 percent. Energy prices fell 3.7 percent (mo/mo) and food prices declined for the first time since November 2020 (off 0.2 percent). Food prices have finally shown sustainable signs of deceleration after remaining under pressure in late 2021 and much of 2022 (chart, below left).

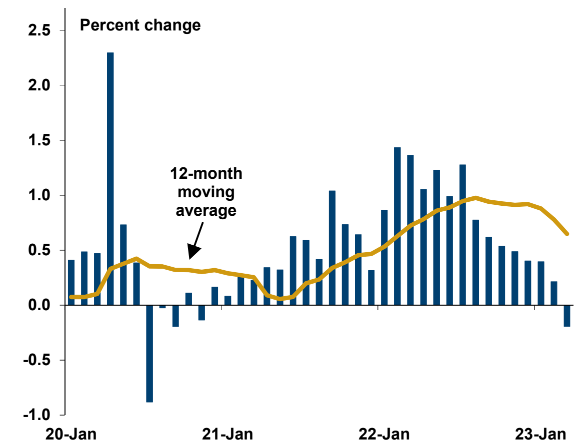
Employment Cost Index



Sources: Bureau of Labor Statistics via Haver Analytics

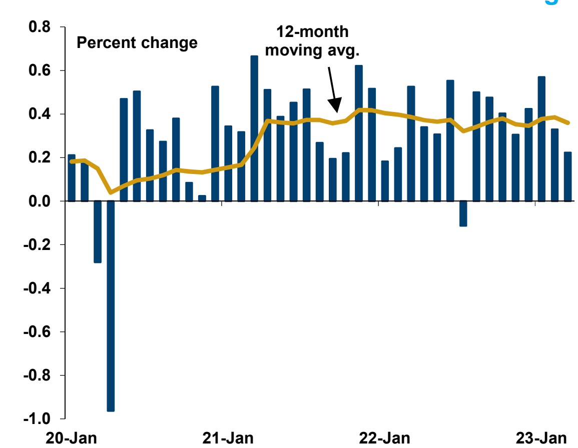
The core component was less favorable, with the increase of 0.3 percent, and the year-over-year advance remained elevated at 4.6 percent – only a moderate improvement from the recent high of 5.4 percent in February 2022. While goods prices have moderated substantially, officials continue to monitor service prices as a key barometer for additional improvement in underlying inflation. Rents, a key driver of service inflation, showed hints of improvement and Fed officials anticipate that they will cool further this year. Rent of tenant-occupied housing and imputed rent of owner-occupied housing both increased 0.5 percent in March (versus averages of 0.8 percent and 0.7 percent, respectively, in the past six months). Core services excluding housing, a metric identified by Chair Powell as influenced importantly by labor costs and providing insight into the direction of underlying inflation, moderated for the second consecutive month (chart, below left). However, the year-over-year change of 4.4 percent (versus 4.7 percent in February) was still brisk, and we suspect that further slowing is needed before officials will be satisfied that this component is on a sustainable path lower.

PCE Price Index: Food



Sources: Bureau of Labor Statistics via Haver Analytics

PCE Price Index: Core Services Ex. Housing



Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

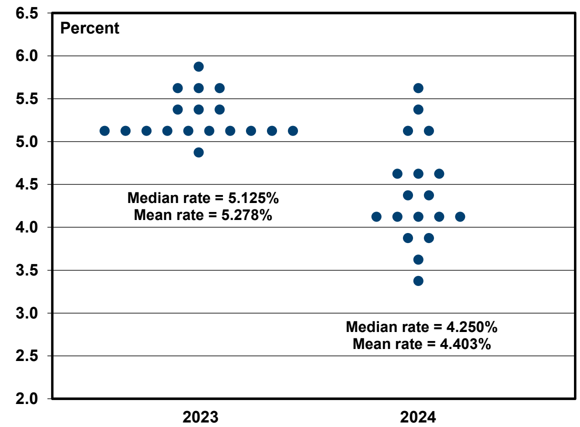
A Pivot in 2023?

While our near-term views align with those of market participants for the outcomes of upcoming FOMC meetings (increase in May before an anticipated pause at summer meetings), we suspect that expectations for a pivot to easier policy by the fall are off the mark. Fed officials had time to survey developments in the banking sector ahead of the previous policy meeting in March, and they did not revise lower expectations for the federal funds rate in 2023 despite the emerging risks. One official did not foresee hikes beyond the 25-basis-point increase at the March meeting, but the median view expressed on the Fed's updated dot plot remained at 5.125 percent, and the expectations of seven officials were above the median (including one projecting a terminal rate of 5.875 percent; chart, next page).

The maintenance of a restrictive policy setting into 2024 likely stems from officials' view that inflation, rather than a tightening in credit conditions, remains the dominant risk to the Fed's macroeconomic objectives. And, for officials to ascertain that the risk of persistent elevated inflation has diminished, they need to see compelling evidence that inflation is moving toward target. Despite hints of improvement in the latest data, we doubt that the "compelling evidence" test has been satisfied.

Our view remains that entrenched inflation will be slow to recede, and that while we are likely close to the terminal rate, additional policy firming may be required later this year. We suspect that it could take the form of two additional hikes of 25 basis points beyond that expected in May (potentially occurring in the fall after the anticipated pause in the summer). We are less confident in this view than we were prior to the emergence of stress in the banking sector, and we readily admit that tightening in financial conditions caused by a potential retrenchment in bank lending could eliminate the need for additional hikes beyond that expected in May, but we hesitate to declare victory yet against what has proved to be a challenging bout of inflation.

FOMC Rate View: Year-End*



**Each dot represents the expected federal funds rate of a Fed official at the end of the year.*
Source: Federal Open Market Committee, Summary of Economic Projections (March 2023)

The Week Ahead

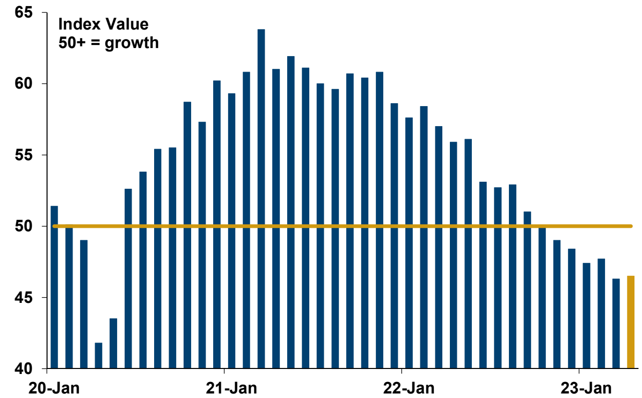
Construction (March) (Monday)
Forecast: 0.3%

A pickup in single-family housing starts in March could lessen the expected drag on total construction activity from the private residential component. Business-related activity has trended higher since last summer, as has government-sponsored construction despite a dip in February.

ISM Manufacturing Index (April) (Monday)
Forecast: 46.5 (+0.7 Index Point)

Most indicators tied to the manufacturing sector have been signaling slowdown, suggesting that the ISM index is likely to remain in contraction territory for the sixth consecutive month (chart, right).

ISM Manufacturing Index*



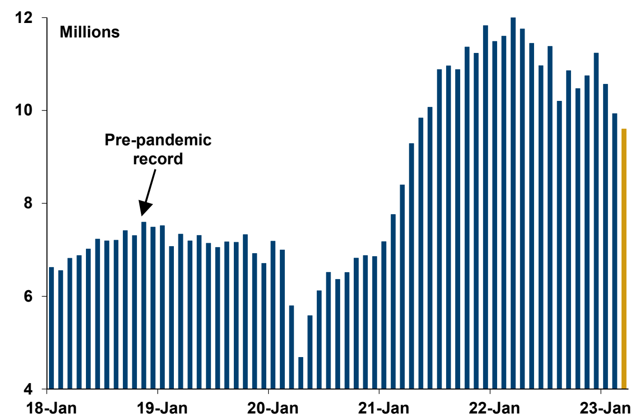
The gold bar is a forecast for April 2023.

Sources: Institute for Supply Management via Haver Analytics; Daiwa Capital Markets America

Job Openings (March) (Tuesday)
Forecast: 9.600 Million (-3.3%)

A slowing in job growth in March from robust totals in early 2023 suggests that underlying demand for labor is softening, which should exert downward pressure on job openings. The projected decline of 331k would leave openings approximately 2.4 million below the record high of 12.027 million in March of 2022 but well above the pre-COVID peak of 7.594 million in November 2018 (chart).

Job Openings*



The gold bar is a forecast for March 2023.

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

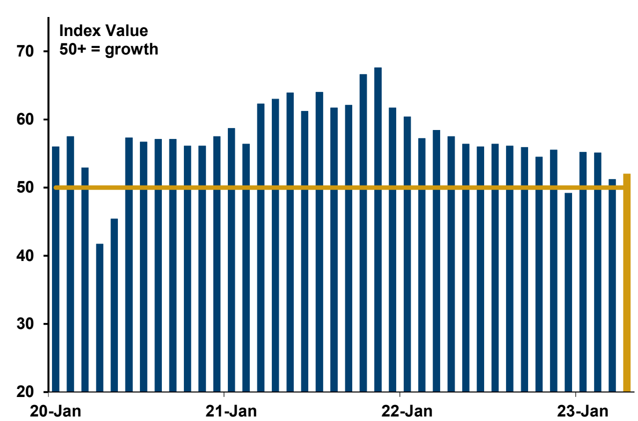
Factory Orders (March) (Tuesday)
Forecast: 1.5%

The jump of 3.2 percent in durable goods orders in March, reported earlier this week, reflected a surge in aircraft bookings, an area marked by wide swings in recent months. Durable orders excluding transportation rose 0.3 percent, but they have tilted lower since last summer. Nondurable bookings (the new information in this report) could be soft, as lower prices depress the value of petroleum-related orders. Similarly, sluggish conditions in the factory sector could constrain orders for nondurable goods excluding petroleum.

ISM Services Index (April) (Wednesday)
Forecast: 52.0 (+0.8 Index Point)

The service sector of the economy is likely easing in response to tight monetary policy, but the drop of 3.9 index points in March possibly overstated the degree of weakness (chart, right). The drop was concentrated in the new orders component, which plunged 10.4 index points. A partial retracement could nudge the headline higher in April.

ISM Services Index*



The gold bar is a forecast for April 2023.

Sources: Institute for Supply Management via Haver Analytics; Daiwa Capital Markets America

Trade Balance (March) (Thursday)
Forecast: -$62.5 Billion ($8.0 Billion Narrower Deficit)

The narrowing of $7.4 billion in the goods deficit (published April 26) is likely to make a significant contribution to the expected improvement in the overall trade deficit for March (chart). The surplus in service trade could improve for the second consecutive month after a drop in January.

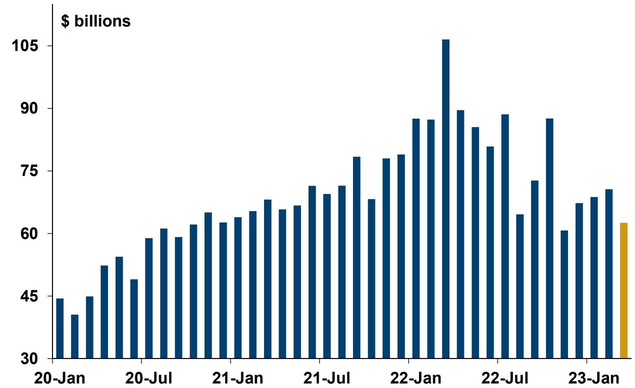
Nonfarm Productivity (23-Q1) (Thursday)
Forecast: -2.0%; Unit Labor Cost 6.0%

Nonfarm businesses achieved only a small increase in output in Q1 and hours worked increased at a brisk pace, suggesting a weak performance in productivity (chart, right). The expected decline is in line with last year's soft performance, where a drop in H1 offset a modest increase in H2 and left a contraction of 1.7 percent in productivity for the year. The projected decline in productivity and jump in compensation implies a surge of 6.0 percent in unit labor cost.

Nonfarm Payrolls (April) (Friday)
Forecast: 225,000

An upward drift in initial claims for unemployment insurance, along with increased caution by firms amid signs of deteriorating economic conditions, suggests payroll growth in April closer to the 236k reported in March versus the average of 399k in the first two months of 2023 (chart, below left). The unemployment rate dipped to 3.5 percent in March (down 0.1 percent) as a jump of 577k in employment, measured by the household survey, surpassed labor force growth of 480k. While the employment measure from the household survey could slow in April from the firm advance in the prior month, new entries into the labor force have been accelerating recently (average increase of 551k in the past four months), which could offset employment growth in April and lead to an uptick in the unemployment rate to 3.6 percent (chart, below right).

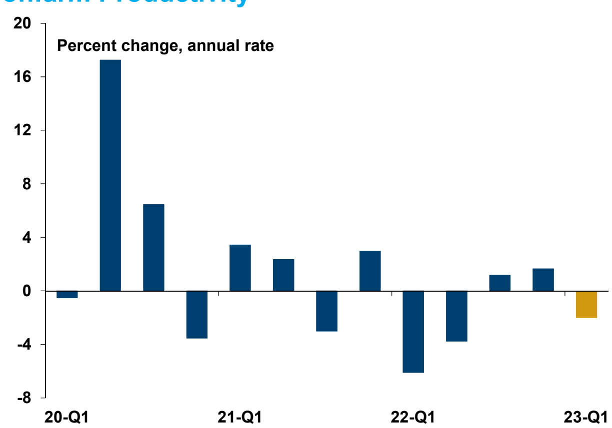
Trade Deficit in Goods & Services*



**The gold bar is a forecast for March 2023.*

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

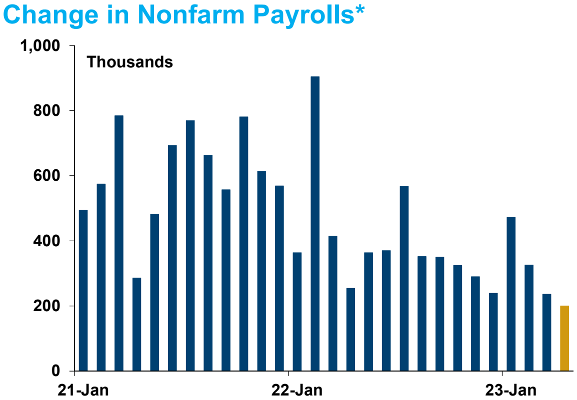
Nonfarm Productivity*



**The gold bar is a forecast for 23-Q1.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

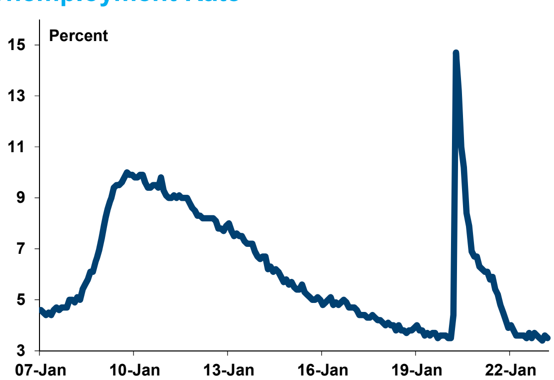
Change in Nonfarm Payrolls*



**The gold bar is a forecast for April 2023.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

Unemployment Rate



Source: Bureau of Labor Statistics via Haver Analytics

Economic Indicators

April/May 2023

Monday	Tuesday	Wednesday	Thursday	Friday
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX Monthly / 3-Mo. Avg. Jan 0.41 -0.20 Feb -0.19 -0.09 Mar -0.19 0.01	**FHFA HOME PRICE INDEX** Dec 0.0% Jan 0.1% Feb 0.5% **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** Dec -0.5% Jan -0.4% Feb 0.1% **NEW HOME SALES** Jan 0.648 million Feb 0.623 million Mar 0.683 million **CONFERENCE BOARD CONSUMER CONFIDENCE** Feb 103.4 Mar 104.0 Apr 101.3	**U.S. INTERNATIONAL TRADE IN GOODS** Jan -$91.3 billion Feb -$92.0 billion Mar -$84.6 billion **ADVANCE INVENTORIES** Wholesale / Retail Jan -0.6% 0.3% Feb 0.1% 0.3% Mar 0.1% 0.7% **DURABLE GOODS ORDERS** Jan -5.0% Feb -1.2% Mar 3.2%	**UNEMP. CLAIMS** Initial / Continuing (millions) Apr 1 0.228 1.804 Apr 8 0.240 1.861 Apr 15 0.246 1.858 Apr 22 0.230 N/A **GDP** GDP / Chained Price 22-Q3 3.2% 4.4% 22-Q4 2.6% 3.9% 23-Q1 1.1% 4.0% **PENDING HOME SALES** Jan 8.1% Feb 0.8% Mar -5.2%	**EMPLOYMENT COST INDEX** Comp. / Wages 22-Q3 1.2% 1.3% 22-Q4 1.1% 1.2% 23-Q1 1.2% 1.2% **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. / Cons. / Core Jan 0.6% 2.0% 0.6% Feb 0.3% 0.1% 0.4% Mar 0.3% 0.1% 0.3% **MNI CHICAGO BUSINESS BAROMETER** Index / Prices Feb 43.6 65.3 Mar 43.8 65.6 Apr 48.6 70.3 **REVISED CONSUMER SENTIMENT** Mar 62.0 Apr(p) 63.5 Apr(r) 63.5
1	2	3	4	5
CONSTRUCTION (10:00) Jan 0.4% Feb -0.1% **Mar** **0.3%** **ISM MFG. INDEX (10:00)** Index / Prices Feb 47.7 51.3 Mar 46.3 49.2 **Apr** **46.5** **49.0**	**JOLTS DATA (10:00)** Openings (000) / Quit Rate Jan 10,563 2.5% Feb 9,931 2.6% **Mar** **9,600** **2.5%** **FACTORY ORDERS (10:00)** Jan -2.1% Feb -0.8% **Mar** **1.5%** **VEHICLE SALES** Feb 15.0 million Mar 14.8 million **Apr** **14.7 million** **FOMC (FIRST DAY)**	**ADP EMPLOYMENT (8:15)** Private Payrolls Feb 261,000 Mar 145,000 Apr -- **ISM SERVICES INDEX (10:00)** Index / Prices Feb 55.1 65.6 Mar 51.2 59.5 **Apr** **52.0** **58.0** **FOMC ANNOUNCEMENT (2:00)**	**UNEMP. CLAIMS (8:30)** **TRADE BALANCE (8:30)** Jan -$68.7 billion Feb -$70.5 billion **Mar** **-$62.5 billion** **PRODUCTIVITY & COSTS (8:30)** Productivity / Unit Labor Costs 22-Q3 1.2% 6.9% 22-Q4 1.7% 3.2% **23-Q1** **-2.0%** **6.0%**	**EMPLOYMENT REPORT (8:30)** Payrolls / Un. Rate Feb 326,000 3.6% Mar 236,000 3.5% **Apr** **225,000** **3.6%** **CONSUMER CREDIT (3:00)** Jan $19.5 billion Feb $15.3 billion Mar --
8	9	10	11	12
WHOLESALE TRADE	**NFIB SMALL BUSINESS OPTIMISM INDEX)**	**CPI** **FEDERAL BUDGET**	**UNEMP. CLAIMS** **PPI**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**
15	16	17	18	19
EMPIRE MFG **TIC FLOWS**	**RETAIL SALES** **IP & CAP-U** **BUSINESS INVENTORIES** **NAHB HOUSING INDEX**	**HOUSING STARTS**	**UNEMP. CLAIMS** **PHILLY FED INDEX** **EXISTING HOME SALES** **LEADING INDICATORS**	

Forecasts in Bold. (p) = preliminary, (r) = revised

Treasury Financing

April/May 2023

Monday	Tuesday	Wednesday	Thursday	Friday
24	25	26	27	28
AUCTION RESULTS: Rate Cover 13-week bills 5.065% 2.74 26-week bills 4.840% 2.77	**AUCTION RESULTS:** Rate Cover 2-yr notes 3.969% 2.68 **ANNOUNCE:** $50 billion 4-week bills for auction on Apr 27 $45 billion 8-week bills for auction on Apr 27 $36 billion 17-week bills for auction on Apr 26 $45 billion 17-day CMBs for auction on Apr 27 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills $36 billion 17-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 4.975% 2.85 5-yr notes 3.500% 2.54 Spread Cover 2-yr FRNs 0.169% 3.04	**AUCTION RESULTS:** Rate Cover 4-week bills 3.830% 2.50 8-week bills 4.940% 2.70 7-yr notes 3.563% 2.41 17-day CMB 4.350% 2.44 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on May 1 $40 billion 21-day CMBs for auction on May 2 **SETTLE:** $105 billion 13-,26-week bills	**SETTLE:** $21 billion 5-year TIPS
1	2	3	4	5
AUCTION: $105 billion 13-,26-week bills **SETTLE:** $42 billion 2-year notes $43 billion 5-year notes $35 billion 7-year notes $12 billion 20-year bonds $24 billion 2-year FRNs $45 billion 17-day CMBs	**AUCTION:** $40 billion 21-day CMBs **ANNOUNCE:** $50 billion* 4-week bills for auction on May 4 $45 billion* 8-week bills for auction on May 4 $36 billion* 17-week bills for auction on May 3 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills $36 billion 17-week bills	**AUCTION:** $36 billion* 17-week bills **ANNOUNCE:** $40 billion* 3-year notes for auction on May 9 $35 billion* 10-year notes for auction on May 10 $21 billion* 30-year bonds for auction on May 11	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on May 8 **SETTLE:** $105 billion 13-,26-week bills $40 billion 21-day CMBs	
8	9	10	11	12
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $40 billion* 3-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on May 11 $45 billion* 8-week bills for auction on May 11 $36 billion* 17-week bills for auction on May 10 **SETTLE:** $50 billion* 4-week bills $45 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $35 billion* 10-year notes	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills $21 billion* 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on May 15 $34 billion* 52-week bills for auction on May 16 $15 billion* 20-year bonds for auction on May 17 $15 billion* 10-year TIPS for auction on May 18 **SETTLE:** $105 billion* 13-,26-week bills	
15	16	17	18	19
AUCTION: $105 billion* 13-,26-week bills **SETTLE:** $40 billion* 3-year notes $35 billion* 10-year notes $21 billion* 30-year bonds	**ANNOUNCE:** $34 billion* 52-week bills **ANNOUNCE:** $50 billion* 4-week bills for auction on May 18 $45 billion* 8-week bills for auction on May 18 $36 billion* 17-week bills for auction on May 17 **SETTLE:** $50 billion* 4-week bills $45 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $15 billion* 20-year bonds	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills $15 billion* 10-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on May 22 $42 billion* 2-year notes for auction on May 23 $43 billion* 5-year notes for auction on May 24 $35 billion* 7-year notes for auction on May 25 $22 billion* 2-year FRNs for auction on May 24 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills	

*Estimate