U.S. Economic Comment

- FOMC: some interesting developments could emerge
- Inflation: largely transitory thus far, but other risk factors also present

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FOMC Preview

There is essentially no chance that the Federal Open Market Committee will alter its interest rate stance at the meeting on June 15-16, but nevertheless, we expect some interesting developments. We will be focusing on three issues: the new set of forecasts, especially the dot plot; clues on the Committee's plans for its asset-purchase program (quantitative easing); and hints on the likelihood of an increase in the interest rates on reverse RPs and/or excess reserves (if these rates are not hiked at this meeting).

Forecasts. We suspect that the median view of Fed officials on GDP growth will show a slightly faster pace than the March projection of 6.5 percent. After growth of 6.4 percent in the first quarter, GDP seems on track to grow at a noticeably faster rate in Q2 (probably in the neighborhood of nine percent), and several indicators suggest that growth will remain brisk in the second half of the year. Our current projection shows GDP growth of 7.2 percent over the four quarters of 2021, and the latest Blue Chip Economic survey shows growth of 7.1 percent (Q4/Q4 basis). We look for the FOMC's new median forecast to move close to these views.

The previous inflation forecast from the Summary of Economic Projection in March (2.4 percent, table) is likely to be wide of the mark. The price index for personal consumption expenditures rose at an annual rate of 3.7 percent in the first quarter, and results for April (along with insights from the May CPI) suggest that inflation will exceed five percent in the second quarter (partly because of energy prices, but core inflation also is on track to exceed five percent). Fed officials will argue that recent price pressure is likely to be transitory, but nevertheless, given this start on inflation, it is difficult to imagine a scenario that produces an inflation rate of 2.4 percent over the four quarters of 2021.

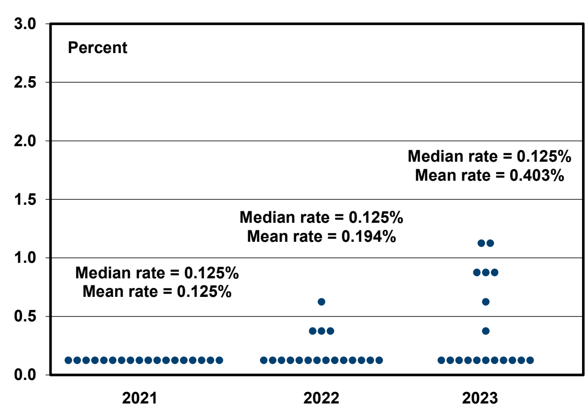
Economic Projections of the FOMC, March 2021*

	2021	2022	2023	Longer Run
Change in Real GDP	6.5	3.3	2.2	1.8
Unemployment Rate	4.5	3.9	3.5	4.0
PCE Inflation	2.4	2.0	2.1	2.0
Core PCE Inflation	2.2	2.0	2.1	--
Federal Funds Rate	0.1	0.1	0.1	2.5

** Median projections*

Source: Federal Open Market Committee, Summary of Economic Projections, March 2021

FOMC Rate View, March 2021*



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2021, 2022, and 2023. 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 March 2021 meeting.*

Source: Federal Open Market Committee, Summary of Economic Projections, March 2021

The likely shifts in the outlooks for growth and inflation could have implications for the dot plot. Recent dot plots have shown steady interest rate policy through 2023, but with the economy growing briskly and with inflation more threatening than previously expected, we look for the new plot to show an interest rate hike in 2023. The March dot plot showed that seven officials expected to hike interest rates in 2023 (chart, p.1). Only three more are needed to move the median dot above the current target of 0.0 to 0.25 percent and signal an interest rate hike in 2023.

Quantitative Easing. The FOMC has provided only vague guidance on its plans for asset purchases, noting that the program would be continued until the Fed achieves "substantial further progress" toward its policy goals. The Committee added a germ of additional information in the minutes from the April FOMC meeting by indicating that officials needed to see substantial further progress ***relative to conditions prevailing in December 2020***. The qualification meant that the improvement in the labor market last summer and fall would not count when assessing when progress had become "substantial"; The Fed must see marked improvement from December, when the unemployment rate was 6.7 percent and payrolls were 10.0 million below their pre-Covid level.

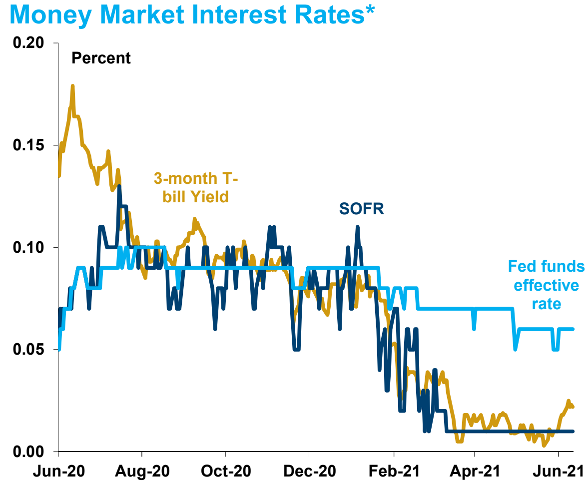
While the Fed has effectively offered no guidance on its plans for QE, it has promised to communicate its intentions well in advance of any changes. We believe the process of preparing the market for an eventual tapering of the program has already started, as the minutes from the April meeting had a second revealing passage relating to QE:

> A number of participants suggested that if the economy continued to make rapid progress toward the Committee's goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases.

The sentence was guarded (it ***might*** be appropriate… to ***begin*** discussing), but it represented the first suggestion that tapering is on the horizon. We suspect that additional clues will dribble out in the weeks ahead, with statements gradually becoming less hedged and more definitive. In fact, we expect some indication at the upcoming meeting that tapering is now on the minds of Fed officials. We are not looking for changes to the policy statement, but we suspect that Chair Powell will offer a new view in his press conference. In the past, he was dismissive of the possibility of tapering, but we suspect he will be more open-minded in this instance.

The strong performance of the economy represents the main reason to alter the QE program, but technical conditions in the money market have bolstered the argument for reducing asset purchases. The purchase of securities by the Fed injects reserves into the banking system, and the abundance of reserves has pushed short-term interest rates to rock-bottom levels, with most rates barely above zero percent and some transactions occurring at negative interest rates (chart).

Money Market Interest Rates*

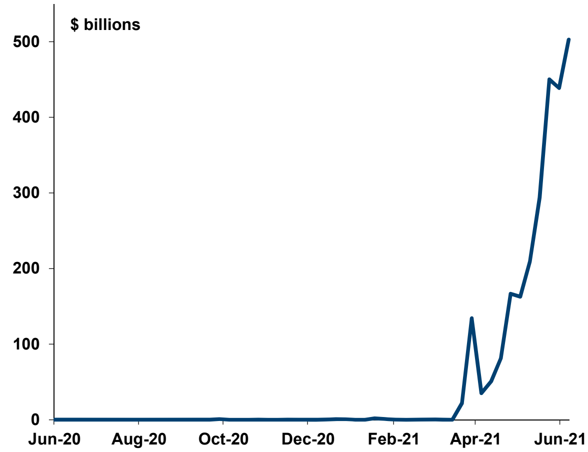


** SOFR is the Secured Overnight Financing Rate. It is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. The SOFR is published each business day by the Federal Reserve Bank of New York.*

Source: Federal Reserve Bank of New York via Haver Analytics; Bloomberg

Negative interest rates would most likely be more prevalent were it not for reverse repurchase agreements (RRPs) offered by the Fed (the Fed sells a security and agrees to buy it back the next day; the transactions absorb funds seeking a short-term investment outlet, thereby easing downward pressure on money-market interest rates). The transactions are currently arranged at zero percent, but take-up has surged to more than $500 billion recently because the alternative most likely would be a negative interest rate in a market transaction (chart).

Reverse Repurchase Agreements*



** The series excludes reverse repurchase agreements with foreign official and international accounts. Weekly end-of period data as of Wednesday. The last observation is for June 9, 2021.*

Source: Federal Reserve Board via Haver Analytics

The current situation, in a sense, is bizarre. The Fed is providing reserves to the banking system with its purchases of securities, but investors are giving them back to the Fed when they utilize the RRP facility. The unusual situation indicates an abundance of liquidity and highly accommodative financial conditions, perhaps excessively accommodative.

One could also argue that current conditions are a symptom of distortions in the market related to the support offered by the Federal Reserve. Tapering (and soon eliminating) QE would lead to a better supply/demand balance in the money market, leading to a drop in usage of the Fed's RRP facility and higher money market rates. The long-end of the maturity spectrum also would probably see an increase in rates, but the economy apparently does not need the high degree of support now provided by the Federal Reserve.

Administered Rates. The interest rate on reverse repurchase agreements is not market-determined; it is set by the Federal Open Market Committee and currently pays zero percent. Another rate in the Fed's tool kit – the interest rate on excess reserves (IOER) – is set by the Board of Governors of the Federal Reserve and currently stands at 0.10 percent. The Fed uses these so-called administered rates to control the federal funds rate, the Fed's policy rate. (The Fed in late July will change the name of this rate to the interest rate on reserve balances (IORB). The Fed eliminated required reserves last year in its efforts to provide support in response to the pandemic, and thus by definition, there are no excess reserves. Therefore, a name change.)

Many market participants are expecting an increase in either the RRP rate or IOER or both in order to nudge money-market rates slightly higher and minimize the risk of dropping into negative territory. To be sure, the Fed would like to avoid negative interest rates, but some policymakers might be reluctant to make an adjustment at this time.

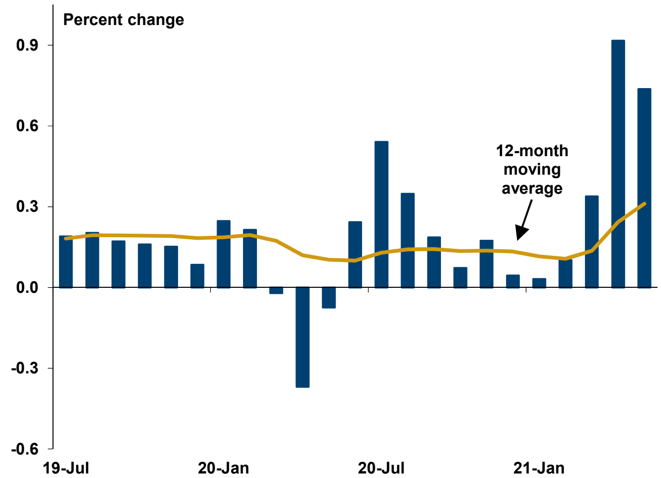
The administered rates are used by the Fed to control the federal funds rate, and the funds rate has not experienced the same degree of downward pressure as other money-market rates have (see chart on p. 2). Federal funds were trading at 7 basis points in the early portion of the year, and they have dipped only slightly lower in the past few weeks (6 basis points). Officials seem to believe that the current level of the federal funds rate is close enough to the mid-point of the target range, and thus the administered rates do not need to be adjusted.

Fed officials also might hesitate to adjust the administered rates because the change could be misinterpreted as a policy shift. Officials no doubt would characterize the rate increase as a technical adjustment designed to avoid negative interest rates and to move the federal funds rate closer to the midpoint of the target range, but nevertheless, some investors and traders might view the change as a policy tightening.

The Fed and Inflation

We suspect that Chair Powell will receive several questions on inflation at his upcoming press briefing, as the CPI for May posted high-side results for the second consecutive month (up 0.6 percent overall in May and 0.7 percent excluding food and energy; these measures were up 0.8 and 0.9 percent in April; chart).

Core CPI



Source: Bureau of Labor Statistics via Haver Analytics

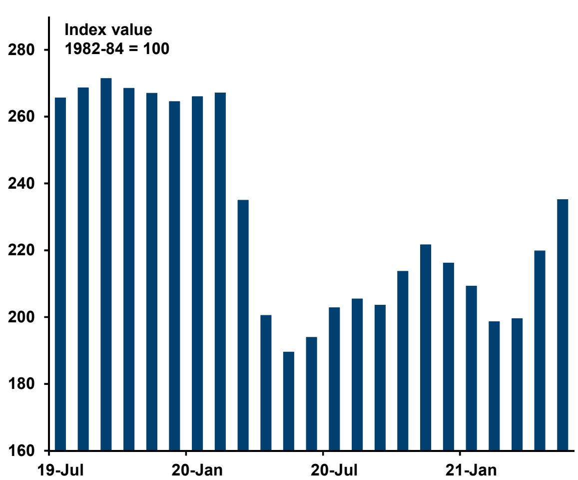
As he has done in the past, Mr. Powell will probably argue that recent pressure will be temporary. He can make a strong case at this time because much of the pressure came in areas affected by the pandemic. For example, airfares jumped 7.0 percent in the latest month after a surge of 10.2 percent April (chart, below left), but these shifts merely represent prices beginning to return to normal levels after discounting during the worst of the pandemic last year. Similar shifts have occurred in hotel fees, admissions to sporting events, and apparel. Month-to-month changes on such items should settle once prices return to normal.

At the same time, price increases for some items are harder to dismiss. Prices of new cars, for example, jumped 1.6 percent in May, with this pressure likely driven by the combination of strong demand and limited supply because of the semiconductor shortage (chart, below right). Spillover effects seem to have occurred in the market for used vehicles, where prices jumped 7.3 percent in May after an increase of 10.0 percent in April. Pressure on vehicle prices, and other items affected by supply-chain disruptions, could linger.

Labor costs could become an issue as well. Average hourly earnings from the monthly employment report jumped in both April and May, and the employment cost index for the first quarter posted a brisk advance. Additional increases in compensation might be needed to coax idle workers back into the labor force.

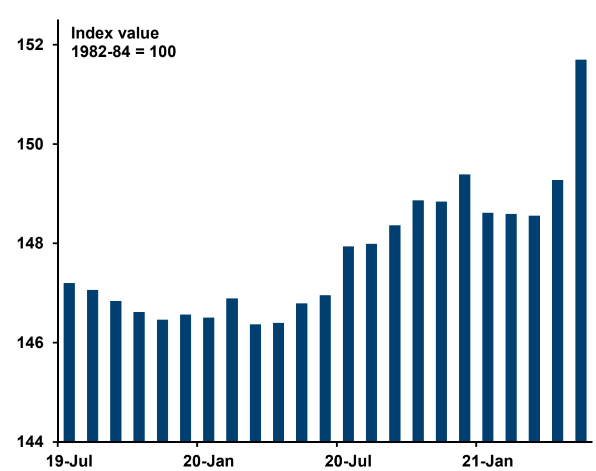
Thus, while transitory pressure is clearly in play, inflation will not necessarily settle at its pre-pandemic rate.

CPI: Airline Fares*



** The chart shows the level of the airline fare index rather than the month-to-month percent change.*
Source: Bureau of Labor Statistics via Haver Analytics

CPI: New Vehicles*



** The chart shows the level of the new vehicle index rather than the month-to-month percent change.*
Source: Bureau of Labor Statistics via Haver Analytics

Review

Week of June 7, 2021	Actual	Consensus	Comments
Trade Balance (April)	**-$68.9 Billion ($6.1 Billion Narrower Deficit)**	**-$68.7 Billion ($5.7 Billion Narrower Deficit)**	The narrowing of the trade deficit in June reflected an increase of 1.1% in exports and a drop of 1.4% in imports. All of the improvement in April occurred in the goods sector, where the deficit narrowed by $6.2 billion; the surplus in service trade was essentially unchanged. The improvement in the deficit suggests that net exports will contribute positively to GDP growth in Q2, something in the neighborhood of one-half percentage point, although results for May and June could alter the picture.
CPI (May)	**0.6% Total, 0.7% Core**	**0.5% Total, 0.5% Core**	The energy component was tame in May, showing no change, but food prices rose 0.4%, matching the increase in the prior month and representing the firmest increase in the current recovery period. Core prices rose 0.7%, a bit softer than the increase of 0.9% in the prior month, but still hefty. Some of the advance in the core component reflected reversals of discounts that emerged during lock-down periods (e.g. air fares, admissions to sporting events, hotel fees). Strong demand and supply-chain disruptions also had an influence in May (e.g. new car prices). The year-over-year change in the headline index jumped 0.8 percentage point to 5.0%, the fastest increase since 2008. The core index rose 3.8% year-over-year, up from 3.0% in April, and the fastest increase since early 1996.
Federal Budget (May)	**$132.0 Billion Deficit**	**$250.0 Billion Deficit**	Federal revenues surged 168% in May from the same month last year, but the massive gain in receipts mostly reflected the postponement of the tax filing deadline for 2020 settlements from April into May. Outlays rose 4.0% from the same month last year, but a calendar configuration that shifted some outlays from May into April restrained the total. While the deficit for May was tame relative to other recent readings, fiscal support provided by the American Rescue Plan (and previous Covid-related measures) continued to weigh on the longer-term budget picture. The deficit for the first eight months of FY2021 totaled $2.06 trillion, $184 billion wider than the deficit in the same period in FY2020.
Consumer Sentiment (June)	**86.4 (+3.5 Index Pts.)**	**84.2 (+1.3 Index Pts.)**	Consumer sentiment rose 4.2% in June, but the advance reversed only a portion of the decline in the prior month, and sentiment remained low relative to the performance prior to the onset of the virus. To date, the University of Michigan measure has recouped only 50% of the ground lost from the pre-Covid reading of 101.0 in February 2020. Elevated equity prices and a strong job market likely bolstered moods in the latest month, but concern about rising prices likely provided a partial offset. The inflation rate expected in the year ahead totaled 4.0%, down from 4.6% in May but still elevated. The longer-term measure (average inflation in the next five-to-10 years) slipped to 2.8% from 3.0%, but it too was in the upper end of the range from the past four years.

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

Preview

Week of June 14, 2021	Projected	Comments
Retail Sales (May) (Tuesday)	**-0.8% Total, -0.2% Ex. Autos**	A drop in sales of new vehicles probably constrained the auto component of the retail report, and a less-than-seasonal increase in gasoline prices probably limited the value of sales at service stations. Areas boosted by government rebate checks in March and April are likely to remain elevated relative to historical norms, but several probably eased in May.
PPI (May) (Tuesday)	**0.4% Total, 0.5% Ex. Food & Energy**	The prices of gasoline and other petroleum-related products, although up in May, will probably register little change after seasonal adjustment. Food prices could pause after four consecutive months of hefty increases (average of 1.4%). Excluding food and energy, the combination of pandemic-related adjustments, strong demand, and supply-chain disruptions probably led to sharp increases in the prices of many goods and services.
Industrial production (May) (Tuesday)	**0.7%**	A solid gain in factory employment probably pushed the manufacturing component of industrial production to its highest level of the recovery thus far (although still slightly shy of the pre-Covid peak), and a pickup in the rotary-rig count points to a gain in mining activity. Temperatures were slightly cooler than normal in May, which could generate residual demand for heating services and an increase in utility output.
Housing Starts (May) (Wednesday)	**1.630 Million (+3.9%)**	Strong demand and a lean inventory of homes for sale should lead to a solid gain in single-family starts after a light-side reading in April. Multi-family activity could drop after two strong months, providing a partial offset to strong results in the single-family sector.
Leading Indicators (May) (Thursday)	**1.5%**	With few components making negative contributions, the index of leading economic indicators is likely to register its 12th increase in the past 13 months. The expected increase in May, if realized, would leave the index 3.0% above the pre-pandemic peak in January 2020.

Source: Forecasts provided by Daiwa Capital Markets America

Daiwa Capital Markets

Economic Indicators

June/July 2021

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11

Monday 7

CONSUMER CREDIT

Feb	$18.2 billion
Mar	$18.6 billion
Apr	$18.6 billion

Tuesday 8

NFIB SMALL BUSINESS OPTIMISM INDEX

Mar	98.2
Apr	99.8
May	99.6

TRADE BALANCE

Feb	-$70.6 billion
Mar	-$75.0 billion
Apr	-$68.9 billion

JOLTS DATA

	Openings (000)	Quit Rate
Feb	7,526	2.4%
Mar	8,288	2.5%
Apr	9,286	2.7%

Wednesday 9

WHOLESALE TRADE

	Inventories	Sales
Feb	1.0%	0.0%
Mar	1.2%	4.3%
Apr	0.8%	0.9%

Thursday 10

UNEMPLOYMENT CLAIMS

	Initial	Continuing (Millions)
May 15	0.444	3.611
May 22	0.405	3.757
May 30	0.385	3.499
June 06	0.376	N/A

CPI

	Total	Core
Mar	0.6%	0.3%
Apr	0.8%	0.9%
May	0.6%	0.7%

FEDERAL BUDGET

	2021	2020
Mar	-$659.6B	-$119.0B
Apr	-$225.6B	-$738.0B
May	-$132.0B	-$398.8B

Friday 11

CONSUMER SENTIMENT

Apr	88.3
May	82.9
June	86.4

Monday	Tuesday	Wednesday	Thursday	Friday
14	15	16	17	18

Tuesday 15

RETAIL SALES (8:30)

	Total	Ex.Autos
Mar	10.7%	9.0%
Apr	0.0%	-0.8%
May	**-0.8%**	**-0.2%**

PPI (8:30)

	Final Demand	Ex. Food & Energy
Mar	1.0%	0.7%
Apr	0.6%	0.7%
May	**0.4%**	**0.5%**

EMPIRE MFG (8:30)

Apr	26.3
May	24.3
June	--

IP & CAP-U (9:15)

	IP	Cap.Util.
Mar	2.2%	74.2%
Apr	0.5%	74.6%
May	**0.7%**	**75.0%**

BUSINESS INVENTORIES (10:00)

	Inventories	Sales
Feb	0.6%	-1.6%
Mar	0.2%	5.6%
Apr	**-0.1%**	**0.3%**

NAHB HOUSING INDEX (10:00)

Apr	83
May	83
June	--

TIC DATA (4:00)

	Total	Net L-T
Feb	$73.7B	$4.3B
Mar	$146.4B	$262.2B
Apr	--	--

FOMC MEETING

Wednesday 16

HOUSING STARTS (8:30)

Mar	1.733 million
Apr	1.569 million
May	**1.630 million**

IMPORT/EXPORT PRICES (8:30)

	Non-petrol. Imports	Nonagri. Exports
Mar	0.8%	2.4%
Apr	0.7%	0.9%
May	--	--

FOMC DECISION (2:00)

POWELL PRESS CONFERENCE (2:30)

Thursday 17

INITIAL CLAIMS (8:30)

PHILLY FED INDEX (8:30)

Apr	50.2
May	31.5
June	--

LEADING INDICATORS (10:00)

Mar	1.3%
Apr	1.6%
May	**1.5%**

Monday	Tuesday	Wednesday	Thursday	Friday
21	22	23	24	25
CHICAGO FED NATIONAL ACTIVITY INDEX	EXISTING HOME SALES	CURRENT ACCOUNT NEW HOME SALES	INITIAL CLAIMS DURABLE GOODS ORDERS U.S. INTERNATIONAL TRADE IN GOODS ADVANCE INVENTORIES REVISED GDP	PERSONAL INCOME, CONSUMPTION, PRICES REVISED CONSUMER SENTIMENT
28	29	30	1	2
	FHFA HOME PRICE INDEX S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX CONSUMER CONFIDENCE	ADP EMPLOYMENT REPORT MNI CHICAGO PURCHASING MANAGERS' INDEX PENDING HOME SALES	INITIAL CLAIMS ISM MANUFACTURING INDEX CONSTRUCTION SPEND. VEHICLE SALES	EMPLOYMENT REPORT TRADE BALANCE FACTORY ORDERS

Forecasts in Bold.

Treasury Financing

June/July 2021

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11
AUCTION RESULTS: Rate / Cover 13-week bills 0.025% 2.79 26-week bills 0.040% 3.31	**AUCTION RESULTS:** Rate / Cover 3-year notes 0.325% 2.47 6-week CMB 0.010% 3.12 **ANNOUNCE:** $40 billion 4-week bills for auction on June 10 $40 billion 8-week bills for auction on June 10 $35 billion 17-week CMBs for auction on June 9 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $35 billion 17-week CMBs	**AUCTION RESULTS:** Rate / Cover 10-yr notes 1.497% 2.58 17-week CMB 0.030% 3.95	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.005% 3.16 8-week bills 0.020% 2.89 30-yr bonds 2.172% 2.29 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on June 14 $34 billion 52-week bills for auction on June 15 $24 billion 20-year bonds for auction on June 15 $16 billion 5-year TIPS for auction on June 17 $40 billion 6-week CMBs for auction on June 15 **SETTLE:** $111 billion 13-,26-week bills $40 billion 6-week CMBs	
14	15	16	17	18
AUCTION: $111 billion 13-,26-week bills	**AUCTION:** $34 billion 52-week bills $24 billion 20-year bonds $40 billion 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on June 17 $40 billion* 8-week bills for auction on June 17 $35 billion* 17-week CMBs for auction on June 16 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $58 billion 3-year notes $38 billion 10-year notes $24 billion 30-year bonds $35 billion 17-week bills	**AUCTION:** $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills $16 billion 5-year TIPS **ANNOUNCE:** $111 billion* 13-,26-week bills for auction June 21 $26 billion* 2-year FRNs for auction on June 23 $60 billion* 2-year notes for auction on June 22 $61 billion* 5-year notes for auction on June 23 $62 billion* 7-year notes for auction on June 24 $40 billion* 6-week CMBs for auction on June 22 **SETTLE:** $111 billion 13-,26-week bills $34 billion 52-week bills $40 billion 6-week CMBs	
21	22	23	24	25
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $60 billion* 2-year notes $40 billion* 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on June 24 $40 billion* 8-week bills for auction on June 24 $35 billion* 17-week CMBs for auction on June 23 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $26 billion* 2-year FRNs $61 billion* 5-year notes $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills $62 billion* 7-year notes **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on June 28 $40 billion* 6-week CMBs for auction on June 29 **SETTLE:** $111 billion* 13-,26-week bills $40 billion* 6-week CMBs	**SETTLE:** $26 billion* 2-year FRNs
28	29	30	1	2
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $40 billion* 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on July 1 $40 billion* 8-week bills for auction on July 1 $35 billion* 17-week CMBs for auction on June 30 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $35 billion* 17-week CMBs **SETTLE:** $24 billion 20-year bonds $16 billion 5-year TIPS $60 billion* 2-year notes $61 billion* 5-year notes $62 billion* 7-year notes	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on July 6 $40 billion* 6-week CMBs for auction on July 6 **SETTLE:** $111 billion* 13-,26-week bills $40 billion* 6-week CMBs	

*Estimate