U.S. Economic Comment

- FOMC preview: a sizeable interest rate hike and details on QT
- Q1 GDP: implications for the outlook

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FOMC: 25 Is So Passe´

Chair Powell indicated in his recent panel discussion at the International Monetary Fund that a 50 basis point rate hike will be on the table at the May 3-4 meeting of the Federal Open Market Committee. We suspect that a 75 basis point increase also will be on the table. Recent comments from several Fed officials suggest that the Committee is anxious to get to a neutral policy stance, and it will not get there quickly with shifts of 25 basis points. Thus, some policymakers will probably push for 75. We look for the FOMC to settle on a 50 basis point hike, but we would not be shocked by a larger change.

We do not attach great importance to the interest rate decision at this meeting because it seems clear where the Fed is going. Officials are deeply disturbed by the current inflation rate, and they are on a path toward neutral policy (a federal funds rate of 2.25 to 2.50 percent) as a first stop. Public comments suggest they hope to be in such a position by late this year, and they are prepared to move further if inflation is not easing substantially by that time. Given a clear view on the end point, the precise path seems less critical.

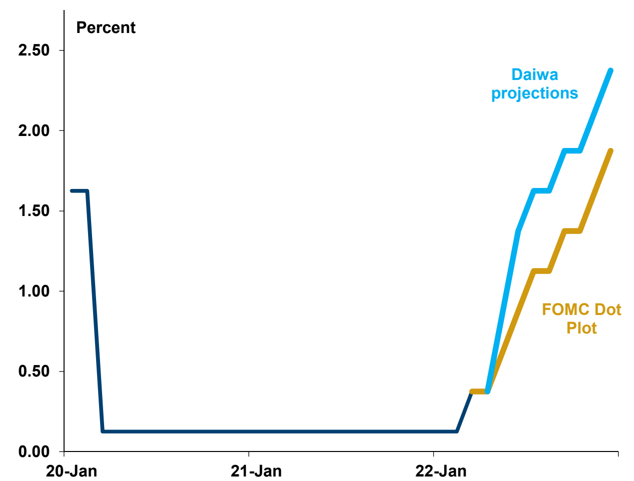
Whatever path the Fed chooses, interest rates later this year are likely to be higher than the year-end reading of 1.875 percent suggested by the dot plot published in March. We expect shifts of 50 basis points at the next two meetings followed by changes of 25 basis points at the remaining four meetings of the year, which would leave the federal funds rate at 2.375 percent in December (chart).

Quantitative Tightening

We will be more interested in new information on plans for the Fed’s balance sheet. The minutes from the March FOMC meeting provided a good bit of information: the process will start soon (probably May), and redemptions will quickly be phased up to $60 billion per month for Treasury securities and $35 billion for mortgage-backed securities. The Fed holds less than $60 billion of maturing Treasury coupon securities in several upcoming months; in these instances, the Fed will redeem some of its $326 billion holdings of Treasury bills. The Fed is open to selling MBS outright after the program is well underway if the portfolio is not shrinking fast enough.

The open issue is how far the Fed will proceed. The March minutes and other statements suggest that the volume of reserves in the banking system will be the key consideration in deciding when to stop QT. The Fed wants to maintain an “ample” volume of reserves, but this vague characterization does not provide much guidance.

Fed Funds Target Rate



Source: Federal Reserve Board via Haver Analytics; Summary of Economic Projections, March 15-16 FOMC Meeting, Federal Open Market Committee; Daiwa Capital Markets America

A look at the balance sheet trimming after the financial crisis might provide some insight. The Fed redeemed securities for two years in that episode (October 2017 to September 2019), reducing its securities portfolio by almost $700 billion. Bank reserves fell by approximately $900 billion during this period (other technical factors, such as currency held by the public, also absorbed reserves) moving from 11.4 percent of GDP to 6.4 percent.

If the Fed would like to see bank reserves equal to 6.5 percent of GDP, it would need an immediate reduction of approximately $2.2 trillion in its portfolio. Reducing the portfolio over time would lessen the amount of needed redemptions because growth of nominal GDP will do some of the work in reducing the reserve-GDP ratio and because other technical factors will be absorbing reserves. Still, based on the assumption of a 6.5 percent target for reserves/GDP, we would be looking for total redemptions of $2 trillion or slightly less. At a pace of $95 billion per month, this adjustment would take 1-1/2 to two years. Of course, 6.5 percent is just an assumption; Fed officials could have another figure in mind. We hope to learn.

Some Help for the Fed

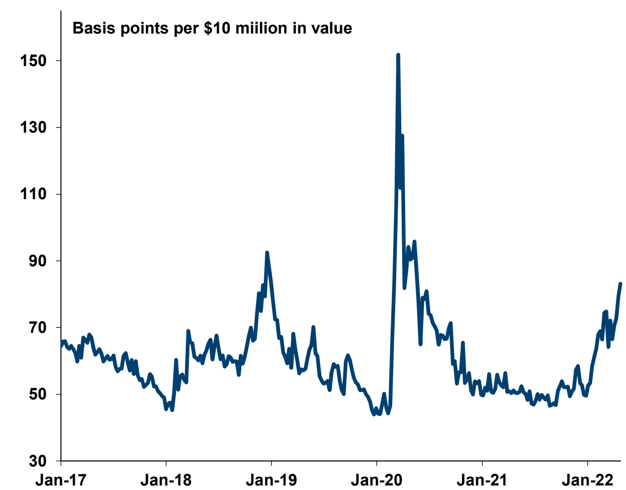
With QT proceeding at a steady pace in the background, the Fed will be concentrating its tightening effort on the federal funds rate. In judging the amount of restraint on short-term rates that might be needed, Chair Powell has noted that officials will be taking a broad view of financial conditions. So far in the tightening process, overall financial conditions are moving in the desired direction – tighter.

Interest rates and stock prices have already moved noticeably. The yield on 10-year Treasury securities has climbed approximately 140 basis points since the end of last year. This pressure, along with widening credit spreads, will increase the borrowing costs of individuals and businesses. Mortgage rates, for example, have climbed 200 basis points since the turn of the year, leaving the mortgage/Treasury spread 60 basis points wider than it was late last year.

Interestingly, corporate credit spreads have not changed appreciably so far this year, but we suspect that technical trading factors are in play. Changes in premiums on credit default swaps have increased sharply in recent months, moving to the upper portion of the range from the past several years (chart, above right). This apparent change in risk appetite will most likely soon show through to interest rates on corporate bonds.

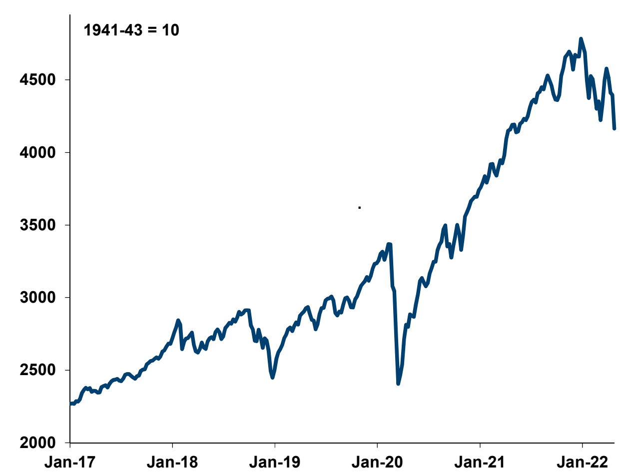
The S&P 500 has declined approximately 13.5 percent so far this year, which will raise the cost of capital for businesses and soften the net worth of individual investors, both of which will dampen demand (although if individuals take a long-term

Credit Default Swap Index*



** Composed of credit default swaps on investment grade entities. Five-year tenor. Weekly end-of-period data.*
Source: IHS Markit via Bloomberg

S&P 500 Index*

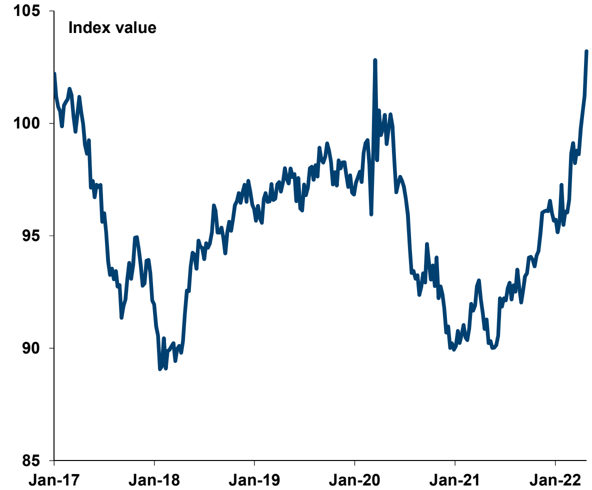


** Weekly average data. The last observation is a daily quote for April 29, 2022.*
Sources: Standard and Poor's via Haver Analytics; Bloomberg

view they might still feel comfortable, as prices are more than 22 percent above their pre-pandemic level; chart, prior page).

Monetary policy not only influences the economy through interest rate channels, but it also affects foreign exchange rates and international trade. The Bloomberg dollar index has jumped more than seven percent this year and moved to its highest level in 20 years (chart). The trade sector already was facing challenges because of slowing growth abroad, and the firm foreign exchange value of the dollar represents another constraining element.

Bloomberg Dollar Index*



** Weekly end-of-period data.*
Source: Bloomberg

Such developments could lessen the amount of tightening undertaken by the Fed, but the FOMC undoubtedly will need to be aggressive in the months ahead. Shifts in these market factors were triggered by expectations of bold moves by the Fed. Tighter financial conditions reflect the expectation of 50 basis point changes in the federal funds rate at the next two or three meetings and additional moves thereafter. If the Fed does not follow through, market conditions will ease and inflation pressures will remain an issue.

GDP: Challenges Ahead

The report on first quarter GDP carried some bright spots: business fixed investment was firm (growth of 9.2 percent), and consumer spending was respectable (2.7 percent). Other data this week offered hope that these sectors will remain on track. The report on durable goods orders showed an increase of 1.0 percent in bookings for nondefense capital goods other than aircraft, continuing its steady upward trend (the 21st increase in the past 23 months). Unfilled orders for this component rose 0.4 percent, marking their 24th consecutive increase. In addition, the report on personal income and consumption showed that consumer spending remained on track despite the potential constraining influences of elevated (and rising) food and energy prices. If the next three months show moderate growth in real outlays (say 0.2 percent per month), the growth of consumer spending in Q2 will come close to the 2.7 percent advance in Q1.

The GDP report also showed some soft spots that raised questions about the sustainability of the expansion. Most important, net exports posted shocking results, with firmer imports and softer exports subtracting 3.2 percentage points from GDP growth. With global growth slowing, and with the foreign exchange value of the dollar elevated, additional negative contributions are likely in coming quarters.

Inventory investment also constrained GDP growth, subtracting 0.8 percentage point from the overall advance. Businesses have made good progress in rebuilding inventories after drawing down stocks during the worst of the pandemic. Inventories are still below pre-Covid levels, and thus firms will continue to make additions. However, new additions will probably be smaller than those made in the past two quarters. The additions to inventories fed into the level of GDP, but it is the changes in additions that determine the contribution to GDP growth. With the sizes of additions likely diminishing, we could see additional negative contributions to GDP growth from inventory investment.

Residential construction was in the plus column in the first quarter (growth of 2.1 percent), but we suspect that recent increases in interest rates will soften activity in the months ahead. In fact, sales of new and existing homes already have started to ease and are likely to slip further, which will have a direct influence on residential construction (brokerage commissions are a component of residential construction, and the recent softening in sales led to a drop of 13.4 percent in Q1). Slower sales will have an even stronger influence if (as seems likely) builders slow the pace of new construction.

We still lean on the optimistic side of potential outcomes. We believe that upcoming drags from net exports and inventory investment will be less pronounced than they were in Q1, and we are hopeful that consumer spending and business investment will remain on track. But it is time to heighten surveillance for signs of weakness.

Review

Week of April 25, 2022	Actual	Consensus	Comments
Durable Goods Orders (March)	**1.0%**	**0.8%**	A combined drop of 13.7% in the volatile civilian and defense aircraft components restrained transportation-related bookings in March (+0.2%), but motor vehicle bookings jumped 5.0%, offsetting the weakness in aircraft and perhaps signaling an easing in supply shortages (semiconductors). Orders ex-transportation showed more vigor (+1.1%), although a portion of the increase reflected a random shift (a surge of 3.9% in electrical equipment to a reading sharply above the underlying trend). Orders for nondefense capital goods excluding aircraft, which provide insight into capital spending by businesses, rose 1.0%, the 21st increase in the past 23 months.
Consumer Confidence (April)	**107.3 (-0.3%)**	**108.2 (+0.9%)**	Consumer confidence was little changed in April for the second consecutive month and noticeably below readings last spring and summer (average of 120.3 from March to August 2021). The measure also is well off the pre-pandemic high of 132.6 in February 2020. Consumer moods are being restrained by assessments of future conditions, as the expectations component is in the low portion of ranges seen in prior expansions. Views on current conditions have held up reasonably well, fueled by positive assessments of the labor market.
New Home Sales (March)	**0.763 Million (-8.6%)**	**0.768 Million (-0.6%)**	Sales of new homes fell in March from upwardly revised results in the prior three months. The revisions left a brisk pace of activity from December through February (average of 850,000), which seems to reflect efforts by individuals to beat increases in interest rates signaled by suggestions of tighter monetary policy. Now, higher interest rates and elevated prices are starting to weigh on sales. Although the March reading trailed by a wide margin the performance in the second half of 2020 and first quarter of 2021 (average sales of 932,000, annual rate), it was still above all readings in the prior expansion and should be considered a firm performance from a longer-term perspective.
U.S. International Trade in Goods (March)	**-$125.3 Billion ($19.0 Billion Wider Deficit)**	**-$105.0 Billion ($1.3 Billion Narrower Deficit)**	Both exports and imports surged in March (up 7.2% and 11.5%, respectively), with the larger change in imports leading to a massive widening in the goods trade deficit. The latest shortfall of $125.3 billion was notably wider than the average deficits of $106.9 billion in the first two months of the year and $93.5 billion in the fourth quarter of last year. The deterioration in the trade deficit in March contributed to a sizable drag from net exports on GDP in Q1 (see below).

Review Continued

Week of April 25, 2022	Actual	Consensus	Comments
GDP (22-Q1)	**-1.4%**	**1.0%**	The GDP report for Q1 carried a soft tone, although it also had some bright spots. Net exports and inventory investment made large negative contributions to economic activity, subtracting 3.2 and 0.8 percentage points from growth, respectively. While the negative contribution from inventory investment comes on the heels of a positive contribution of 5.3 percentage points in Q4, net exports have been a drag for much of the current expansion, and slowing global growth and a strong dollar present additional headwinds to trade. Government spending provided a downside surprise with a contraction of 2.7%, led by a retreat of 8.5% in defense spending, which will undoubtedly strengthen in coming quarters. On the bright side, business investment spending jumped 9.2% and consumer expenditures posted a respectable performance with an advance of 2.7% Residential construction was in the plus column (2.1%), but high interest rates pose a challenge going forward.
Employment Cost Index (22-Q1)	**1.4%**	**1.1%**	Compensation costs rose 1.0% or more for the third consecutive quarter, with the Q1 advance the largest of the recent brisk increases. On a year-over-year basis, compensation costs jumped 4.5%, the fastest reading in more than 20 years. A surge in benefit costs stood out, with the quarterly advance of 1.8% pushing the year-over-year increase to 4.0%, the fastest year-over-year change since 2005. The change in wages lagged that for benefits, but it was still brisk at 1.2% (the fourth increase in the past five quarters of 1.0% or more; up 4.6% on a year-over-year basis.
Personal Income, Consumption, Core PCE Price Index (March)	**0.5%, 1.1%, 0.3%**	**0.4%, 0.6%, 0.3%**	Nominal income flows were only moderate in March. Rental income and farm income were strong (0.7% and 13.0%), but wages and salaries and investment income were less impressive (0.6% and 0.4%). After adjusting for inflation, incomes slipped 0.4%. Consumers remained active in March, with nominal outlays increasing 1.1%, which translated to a gain of 0.2% in real terms. Individuals continued to pivot toward service spending, as real outlays in this category rose 0.6% versus a drop of 0.5% in real outlays for goods. The core price index for personal consumption expenditures rose 0.3% for the second consecutive month, slower than the average of 0.5% from October 2021 through January 2022. Prices excluding food and energy rose 5.2% in the past 12 months, still brisk but lighter than the 5.3% advance in February.

Sources: U.S. Census Bureau (Durable Goods Orders, New Home Sales, U.S. International Trade in Goods); The Conference Board (Consumer Confidence); Bureau of Economic Analysis (GDP, Personal Income, Consumption, and Core PCE Price Index); Bureau of Labor Statistics (Employment Cost Index); Consensus forecasts are from Bloomberg

Preview

Week of May 2, 2022	Projected	Comments
ISM Manufacturing Index (April) (Monday)	**56.0 (-1.1 Index Pts.)**	The manufacturing sector has held up reasonably well despite supply-chain disruption and materials shortages, which raises the prospect of the ISM index posting another solid reading in April. However, the employment component registered an above-trend reading in March, and could ease in the latest month as firms experience difficulty filling positions.
Construction Spending (March) (Monday)	**0.8%**	A strong performance in multifamily housing starts, in addition to further work on previously started single-family units, suggests another firm increase in private residential construction in March (average gain of 1.3% in the past 12 months). Business-related and government-sponsored activity could advance as well, although at least a portion of the expected gains will likely reflect higher prices.
Factory Orders (March) (Tuesday)	**2.0%**	Durable goods orders (up 0.8%, published April 26) posted moderate growth outside the transportation sector (1.1%) that was partially offset by a drop of 13.7% in aircraft bookings. Nondurable orders could post a stronger gain, with higher prices influencing the values of both petroleum-related orders and those ex-petrol.
Trade Balance (March) (Wednesday)	**-$107.5 ($18.3 Billion Wider Deficit)**	The already reported widening of $19.0 billion in the goods deficit is likely to dominate the overall trade report in March. The surplus in service trade has eased in the past two months after a jump in December.
ISM Services Index (April) (Thursday)	**57.5 (-0.8 Index Pt.)**	The ISM services index slowed in Q1 from the torrid pace in the closing months of last year (average of 58.2 in Q1 versus 65.8 in Q4), but it is still elevated from a longer-term perspective. The employment measure has been volatile in recent months, and could ease after a jump of 5.5 index points in March.
Nonfarm Productivity (22-Q1) (Thursday)	**-5.0%**	Output declined in Q1 despite gains in employment and hours worked. The results point to a drop in productivity, which when combined with increases in compensation, suggest a surge in unit labor costs.
Payroll Employment (April) (Friday)	**500,000**	Continued strong demand for labor should support hiring in April close to the average of 541,000 in the prior 12 months, a view supported by an elevated level of job openings and minimal claims for unemployment insurance. Both employment reported in the household survey and the size of the labor force have registered firm gains in recent months, but those in employment have been larger, therefore raising the possibility of another decline in the unemployment rate.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

April / May 2022

Monday	Tuesday	Wednesday	Thursday	Friday
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX Monthly / 3-Mo. Avg. Jan 0.75 0.44 Feb 0.54 0.43 Mar 0.44 0.57	**DURABLE GOODS ORDERS** Jan 1.5% Feb -1.7% Mar 0.8% **FHFA HOME PRICE INDEX** Dec 1.3% Jan 1.6% Feb 2.1% **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** SA / NSA Dec 1.5% 1.1% Jan 1.7% 1.4% Feb 2.4% 2.4% **CONFERENCE BOARD CONSUMER CONFIDENCE** Feb 105.7 Mar 107.6 Apr 107.3 **NEW HOME SALES** Jan 0.845 million Feb 0.835 million Mar 0.763 million	**U.S. INTERNATIONAL TRADE IN GOODS** Jan -$107.4 billion Feb -$106.3 billion Mar -$125.3 billion **ADVANCE INVENTORIES** Wholesale / Retail Jan 1.2% 1.8% Feb 2.6% 1.5% Mar 2.3% 2.0% **PENDING HOME SALES** Jan -5.8% Feb -4.0% Mar -1.1%	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Apr 02 0.168 1.474 Apr 09 0.186 1.409 Apr 16 0.185 1.408 Apr 23 0.180 N/A **GDP** GDP / Chained Price 21-Q3 2.3% 6.0% 21-Q4 6.9% 7.1% 22-Q1 -1.4% 8.0%	**EMPLOYMENT COST INDEX** Comp. / Wages 21-Q3 1.2% 1.5% 21-Q4 1.0% 1.0% 22-Q1 1.4% 1.2% **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. / Cons. / Core Jan 0.2% 2.0% 0.5% Feb 0.7% 0.6% 0.3% Mar 0.5% 1.1% 0.3% **MNI CHICAGO BUSINESS BAROMETER INDEX** Index / Prices Feb 56.3 86.5 Mar 62.9 85.7 Apr 56.4 86.1 **REVISED CONSUMER SENTIMENT** Feb 62.8 Mar 59.4 Apr(p) 65.7 Apr(r) 65.2
2	3	4	5	6
ISM INDEX (10:00) Index / Prices Feb 58.6 75.6 Mar 57.1 87.1 **Apr 56.0 85.0** **CONSTRUCTION SPEND. (10:00)** Jan 1.6% Feb 0.5% **Mar 0.8%**	**FACTORY ORDERS (10:00)** Jan 1.5% Feb -0.3% **Mar 2.0%** **JOLTS DATA (10:00)** Openings (000) / Quit Rate Jan 11,283 2.8% Feb 11,266 2.9% Mar -- -- **VEHICLE SALES** Feb 14.0 million Mar 13.3 million **Apr 13.9 million** **FOMC MEETING**	**ADP EMPLOYMENT REPORT (8:15)** Private Payrolls Feb 486,000 Mar 455,000 Apr -- **TRADE BALANCE (8:30)** Jan -$89.2 billion Feb -$89.2 billion **Mar -$107.5 billion** **ISM SERVICES INDEX (10:00)** Index / Prices Feb 56.5 83.1 Mar 58.3 83.8 **Apr 57.5 82.0** **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **PRODUCTIVITY & COSTS (8:30)** Productivity / Unit Labor Costs 21-Q3 -3.9% 10.6% 21-Q4 6.6% 0.9% **22-Q1 -5.0% 10.0%**	**EMPLOYMENT REPORT (8:30)** Payrolls / Un. Rate Feb 750,000 3.8% Mar 431,000 3.6% **Apr 500,000 3.5%** **CONSUMER CREDIT (3:00)** Jan $8.9 billion Feb $41.8 billion Mar --
9	10	11	12	13
WHOLESALE TRADE	**NFIB SMALL BUSINESS OPTIMISM INDEX**	**CPI** **FEDERAL BUDGET**	**INITIAL CLAIMS** **PPI**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**
16	17	18	19	20
EMPIRE MFG INDEX **TIC DATA**	**RETAIL SALES** **IP & CAP-U** **BUSINESS INVENTORIES** **NAHB HOUSING INDEX**	**HOUSING STARTS**	**INITIAL CLAIMS** **PHILY FED INDEX** **EXISTING HOME SALES** **LEADING INDICATORS**	

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

Treasury Financing

April / May 2022

Monday	Tuesday	Wednesday	Thursday	Friday
25	26	27	28	29
AUCTION RESULTS: Rate / Cover 13-week bills 0.890% 2.96 26-week bills 1.370% 2.99	**AUCTION RESULTS:** Rate / Cover 2-year notes 2.585 2.74 **ANNOUNCE:** $35 billion 4-week bills for auction on April 28 $30 billion 8-week bills for auction on April 28 $30 billion 17-week CMBs for auction on April 27 **SETTLE:** $35 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate / Cover 17-week CMB 1.110% 3.56 5-year notes 2.785% 2.41 Spread / Cover 2-year FRN -0.075% 2.51	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.480% 3.50 8-week bills 0.710% 3.64 7-year notes 2.908% 2.41 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on May 2 **SETTLE:** $96 billion 13-,26-week bills	**SETTLE:** $20 billion 5-year TIPS
2	3	4	5	6
AUCTION: $87 billion 13-,26-week bills **SETTLE:** $16 billion 20-year bonds $24 billion 2-year FRNs $48 billion 2-year notes $49 billion 5-year notes $44 billion 7-year notes	**ANNOUNCE:** $35 billion* 4-week bills for auction on May 5 $30 billion* 8-week bills for auction on May 5 $30 billion* 17-week CMBs for auction on May 4 **SETTLE:** $35 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs **ANNOUNCE:** $45 billion* 3-year notes for auction on May 10 $36 billion* 10-year notes for auction on May 11 $22 billion* 30-year bonds for auction on May 12	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on May 9 **SETTLE:** $87 billion 13-,26-week bills	
9	10	11	12	13
AUCTION: $87 billion* 13-,26-week bills	**AUCTION:** $45 billion* 3-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on May 12 $30 billion* 8-week bills for auction on May 12 $30 billion* 17-week CMBs for auction on May 11 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $36 billion* 10-year notes	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills $22 billion* 30-year bonds **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on May 16 $34 billion* 52-week bills for auction on May 17 $16 billion* 20-year bonds for auction on May 18 $14 billion* 10-year TIPS for auction on May 19 **SETTLE:** $87 billion* 13-,26-week bills	
16	17	18	19	20
AUCTION: $87 billion* 13-,26-week bills **SETTLE:** $45 billion* 3-year notes $36 billion* 10-year notes $22 billion* 30-year bonds	**AUCTION:** $34 billion* 52-week bills **ANNOUNCE:** $35 billion* 4-week bills for auction on May 19 $30 billion* 8-week bills for auction on May 19 $30 billion* 17-week CMBs for auction on May 18 **SETTLE:** $35 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $16 billion* 20-year bonds	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills $14 billion* 10-year TIPS **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on May 23 $47 billion* 2-year notes for auction on May 24 $48 billion* 5-year notes for auction on May 25 $43 billion* 7-year notes for auction on May 26 **SETTLE:** $87 billion* 13-,26-week bills $34 billion* 52-week bills	

**Estimate*