U.S. Economic Comment

- FOMC preview: suddenly interesting
- The uncertain effects of QT
- Inflation weighs on consumer attitudes

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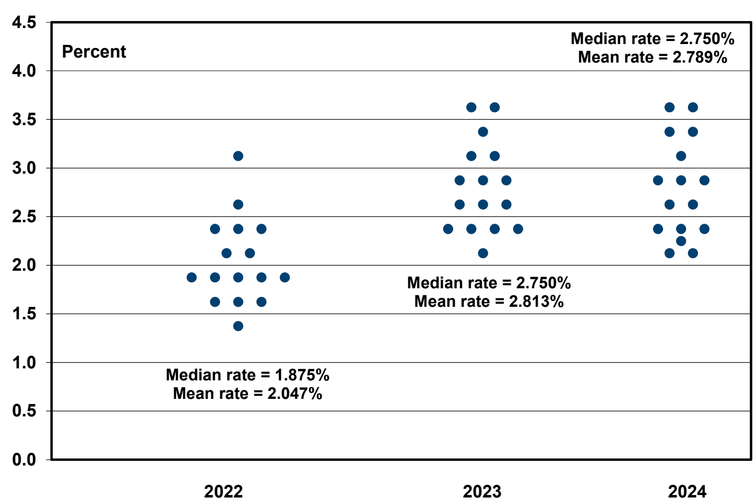
FOMC

Before the release of the consumer price index for May (up 1.0 percent overall and 0.6 percent ex food and energy), there was little doubt about the outcome of the upcoming meeting of the Federal Open Market Committee. Officials had sent clear signals that they intended to hike the federal funds rate by 50 basis points in both June and July. However, after the troubling CPI, bolder action seems necessary. Policymakers did not consider a change of 75 basis points in March, but we suspect that it will be raised as a possibility at the June meeting. If policymakers do not step up to changes of 75 basis points, they will probably continue with shifts of 50 basis points at least into September.

The new policy statement of the FOMC and the press conference of Chair Powell could provide insights into the Committee's plans for interest rates, and the new dot plot could be revealing as well (although projections may have been submitted before the release of the CPI). Officials have indicated that they wish to move to a neutral position "expeditiously", which we interpret to mean a target range for the federal funds rate of 2.25 to 2.50 percent by the end of the year. A median value of anything less than 2.375 percent on the new dot plot (versus 1.875 percent in March) would indicate that officials are emphasizing rhetoric over action. If officials submit or revise their projections after examining the CPI, we can easily envision the dot plot showing a restrictive stance at the end of 2022.

We also will be interested in other aspects of the Summary of Economic Projections, especially the unemployment rate. We do not expect much change in the low jobless rates shown in the March SEP (table, next page). Fed Governor Christopher Waller, who has a hawkish bent, made the case for continued low unemployment in his latest speech, arguing that the effect of tight policy and slow economic growth will take the form of reductions of job openings rather than layoffs of existing workers, and thus little change in unemployment. Chair Powell has advanced a similar view. If the new forecasts were to deviate from the optimistic view and show a pickup in the expected unemployment rate, we would interpret this shift as a sign that policymakers are willing to administer strong medicine to reduce inflation.

FOMC Rate View: Year-End 2022, 2023, & 2024*



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2022, 2023, and 2024. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but three governorships were open at the March 2022 meeting.*

Source: Federal Open Market Committee, Summary of Economic Projections, March 2022

Economic Projections of the FOMC, March 2022*

	2022	2023	2024	Longer Run
Change in Real GDP	2.8	2.2	2.0	1.8
Unemployment Rate	3.5	3.5	3.6	4.0
PCE Inflation	4.3	2.7	2.3	2.0
Core PCE Inflation	4.1	2.6	2.3	--
Federal Funds Rate	1.9	2.8	2.8	2.4

** Median projections*
Source: Federal Open Market Committee, Summary of Economic Projections, March 2022

The inflation forecasts will probably change because of developments in the first four months of the year. After an average monthly advance of more than 0.5 percent in PCE price index in the first four months of the year, the headline index would need to ease to an average of slightly more than 0.2 percent to reach the previous projection of 4.3 percent, which seems unlikely, especially given the likelihood of a jump in May. The core index, in contrast, could be revised lower. After an average increase of less than 0.4 percent from January through April (0.355 percent), the March projection of 4.1 seems like a high-side view, one requiring an average advance of 0.5 percent over the balance of the year.

Quantitative Tightening

The Fed will begin trimming its portfolio of Treasury securities in the upcoming week, as it will redeem $9.3 billion of its holdings of $14.9 billion of maturing 3-year notes (reinvesting $5.6 billion). At the end of the month it will redeem $20.7 billion of its holdings of $33.3 billion of 2-year, 5-year, and 7-year notes. The Fed also will redeem $30 billion of Treasuries in July and August before kicking it up to $60 billion in September and subsequent months.

The trading desk of the New York Fed will announce on June 13 (the ninth business day of the month) the anticipated amount of MBS repayments. The trading desk will redeem $17.5 billion and reinvest any repayments above this amount. The required MBS transactions will take place over the balance of June and into early July, when a new set of plans will be announced on the ninth business day of that month (and on all subsequent ninth business days). The monthly cap of $17.5 billion will be in place through August, then jump to $35 billion.

Redemptions will be sizeable, raising the possibility of notable fallout in financial markets. However, based on studies of asset purchases and redemptions in the aftermath of the financial crisis, the influence is not likely to be overwhelming.

A study by the Staff of the Federal Reserve Board in 2017 estimated that asset purchases from 2009 to 2014 totaling $3.7 trillion (23 percent of average GDP over this span) reduced the term premium on 10-year Treasury securities by 100 basis points. The influence on the 10-year rate most likely was larger than this estimate, as the QE program probably signaled to market participants a friendly tack by the Fed, which would lead to a decline in expected short-term interest rates. (Long-term rates can be viewed as equal to the sum of expected short-term interest rates and a term premium; the Fed study considered only the term premium). The QE program probably had other market influences as well, including a boost to equity prices, a narrowing of credit spreads, and a softening in the foreign exchange value of the dollar.

The Fed study provided a point estimate for the influence of QE, but it also noted a high-degree of uncertainty around the estimate. Indeed, the 90 percent confidence interval totaled plus/minus 50 basis points. That is, the effect of QE might have been as little as 50 basis points or as much as 150 basis points. (See “The Effect of the Federal Reserve’s Securities Holdings on Long-term Interest Rates”, authored by Brian Bonis, Jane Ihrig, and Min Wei. The study is available on the web site of the Board of Governors under Fed Notes.)

The Peterson Institute for International Economics in 2016 published a useful review of various studies on the effects of quantitative easing associated with the financial crisis ("Quantitative Easing: An Underappreciated Success", by Joseph Gagnon, Policy Brief 16-4). The author put the results from numerous studies on common ground by normalizing estimates to show the influence of security purchases totaling 10 percent of GDP. The results were consistent with those of the Fed study, as most of the studies focused on the term premium and the median estimate showed a reduction of approximately 50 basis points (consistent with the Fed estimate of 100 basis points based on purchases totaling 23 percent of GDP). A high degree of uncertainty also was evident in this review, as estimates shown in the report ranged from 15 to 240 basis points.

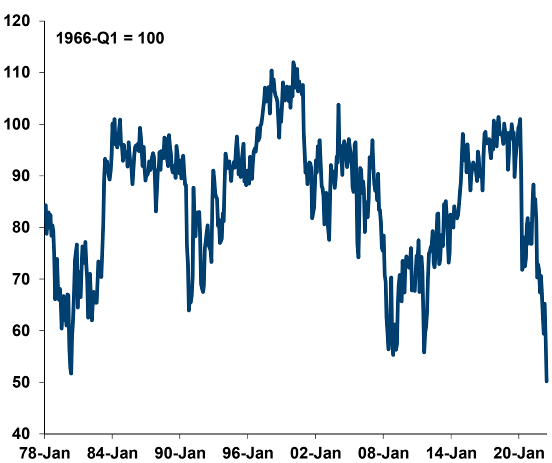
The pandemic-related QE program involved purchases of $4.6 trillion, larger than the financial crisis program and implemented over a shorter period of time (approximately two years versus six years). However, measured as a share of GDP, the latest effort was a touch lighter than the financial-crisis program (20 percent versus 23 percent).

Given the similarity between the sizes of the two QE efforts, the 100-basis-point effect suggested by economic research represents a good starting point for thinking about the influence of the Fed's QT program. We are tempted to reduce the likely effect because the Fed will not redeem all the securities purchased in the past two years. Indeed, we are expecting redemptions of $2.0 to $2.5 trillion, less than half of what the Fed purchased during QE. Recent market developments, including a jump of more than 150 basis points in the 10-year Treasury rate and a swoon in equity values, suggest a more powerful effect of QE and QT than suggested by the economic research. However, developments other than just QT are in play. Most important, inflation has entered the picture, which would boost the expected inflation component of nominal interest rates. In addition, inflation is likely to lead the Fed to push short-term interest rates noticeably higher, which will seep into longer-terms rates as well. Certainly, QT is adding to the mix, but rates would have been rising and stock prices falling even if the Fed were not adjusting its portfolio.

Consumers and Inflation

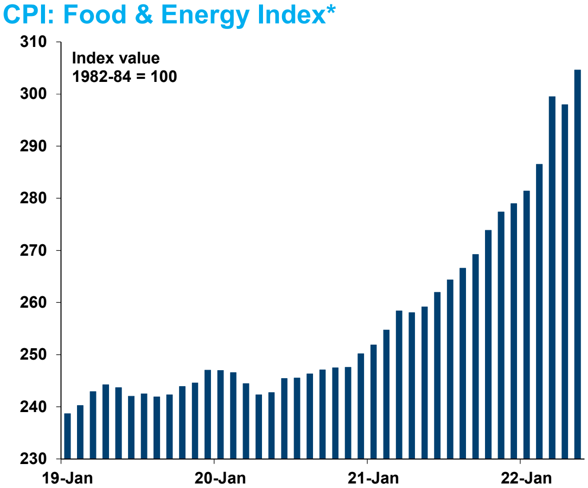
Consumers did not need to see the CPI to realize that inflation had become a problem. Another interesting report released on Friday showed that consumer sentiment has tumbled to a record low (chart, left). The pronounced drop and the low level at a time of minimal unemployment and strong job growth is shocking. The retreat in equity values this year has probably had some influence on attitudes, but we suspect that rapid inflation is the key factor behind sour moods.

Consumer Sentiment



Source: University of Michigan Survey Research Center via Haver Analytics

CPI: Food & Energy Index*



** A weighted average index of the Food and Energy components of the CPI. Weights are calculated based on the relative importance of each component in the overall CPI.*

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

The influence of higher prices is hitting hard partly because it represents a marked shift from the environment of the prior 20 years or so. In addition, much of the price pressure is coming from items that individuals confront frequently – food and energy. An index of these two components of the CPI has exploded at an annual rate of 25.3 percent in the past three months after trending sharply higher last year and the start of this year. The level of this index, which can be viewed as the price of a basket of goods and services, is far above any reading in other recent years (chart, prior page).

Individuals are getting out more now that Covid is less of an issue, and the cost of travel has probably captured the attention of many. Airfares have surged in recent months, and so too have hotel fees. Like food and energy, vacations have become far more expensive than any time in recent memory.

Review

Week of June 6, 2022	Actual	Consensus	Comments
Trade Balance (April)	**-$87.1 Billion ($20.6 Billion Narrower Deficit)**	**-$89.5 Billion ($20.3 Billion Narrower Deficit)**	Both sides of the trade ledged contributed to the narrowing in the trade deficit in April, as exports rose 3.5% and imports fell 3.4%. The goods deficit for April, while much improved on a month-to-month basis with a narrowing of $19.1 billion, has slid noticeably in the past two years, as export growth has lagged that for imports. The goods deficit in April remained notably wider than pre-Covid readings. The service surplus has been volatile in recent months, but it has traced an upward trend since last summer (including a pickup of $1.5 billion in April). The overall deficit for April raises the possibility of a positive contribution from net exports to GDP growth after drags in eight of the prior nine quarters. The data in hand suggest that international trade could add more than 1.5 percentage points to GDP growth in Q2.
CPI (May)	**1.0% Total, 0.6% Core**	**0.7% Total, 0.5% Core**	Energy prices surged 3.9% in May, exceeding by a wide margin the already brisk monthly average of 2.2% in the prior 12 months. Food prices jumped 1.2%, accelerating sharply from the average of 0.7% in the past year. The increase in the core component was broadly based, with travel-related expenses standing out (airfares, car rentals, hotel fees). Rents represented another notable source of pressure, with the rent of primary residence jumping 0.6% (versus a norm of 0.3% prior to the pandemic). Prices of new and used motor vehicles remained under pressure as well, and the costs of medical-care services have quickened in recent months. The latest changes left the headline index up 8.6% in the past year, the sharpest advance of the current cycle (beating 8.5% in March). The core component rose 6.0%, off from 6.2% in the prior month and the cyclical high of 6.5% in March.
Consumer Sentiment (June)	**50.2 (-14.0%)**	**58.1 (-0.5%)**	Consumer sentiment fell for the fifth time in the past six months, with the plunge in June leaving the University of Michigan measure at a record low level. Runaway inflation seemed to play a key role in souring moods. The year-ahead inflation gauge increased one tick to 5.4%, which matched the 40-year high in March/April 2022. The long-term inflation gauge increased from 3.0% to 3.3%, the fastest reading since a print of 3.4% in 2008.
Federal Budget (May)	**-$66.2 billion**	**-$136.5 Billion**	Federal revenues in May declined 16.1% from the same month last year. Much of the decline reflected a shift in tax filing deadlines, which inflated revenues in May of last year. Federal outlays fell by about $140 billion or 23.6%, as Covid-related spending continued to ease. The deficit for the first eight months for FY2022 totaled $426.2 billion, a vast improvement from the shortfall of $2.06 trillion in the same period in FY2021.

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

Preview

Week of June 13, 2022	Projected	Comments
PPI (May) (Tuesday)	**0.8% Total, 0.5% Ex. food & Energy**	Available quotes suggest that energy prices posted another sharp advance in May, continuing pressure that led to an average increase of 2.8% in the prior 12 months. Food prices also are likely to remain under pressure given disruptions to grain exports from Ukraine and elevated demand (average monthly increase of 1.3% since last May). Supply disruptions and higher input prices led to a surge in goods prices excluding food and energy (+0.8% per month in the past year). Services prices were little changed in April, but still averaged increases of 0.7% per month in the past year.
Retail Sales (May) (Wednesday)	**0.0% Total, 1.0% Ex. Autos**	A drop in new vehicle sales could constrain the auto component of the retail report in May, but sharply higher prices could boost the value of sales at gasoline service stations. Sales excluding autos and gasoline are likely to be mixed. Higher prices almost certainly boosted the value of sales at some outlets, but cutbacks by consumers on non-essential spending likely depressed activity in other areas.
Housing Starts (May) (Thursday)	**1.625 Million (-5.8%)**	Amid headwinds from higher mortgage rates and declining affordability, homebuilders likely trimmed single-family housing starts in May in an attempt to prevent an accumulation of excess inventories. The volatile multi-family sector surged 15.3% in April to the highest level in the past several expansions, raising the possibility of some cooling in May.
Industrial Production (May) (Friday)	**0.2%**	A pickup in factory employment suggests an increase in the manufacturing component of industrial production in May, although one that trails brisk increases averaging 1.0% in the past three months. An increase in mining employment and a jump in the rotary rig count suggest that higher petroleum prices spurred mining output. Below-average heating usage raises the prospect of a drop in utility output.
Leading Indicators (May) (Friday)	**-0.4%**	Negative contributions from stock prices, consumer expectations, and initial claims for unemployment insurance are likely to drag the index of leading economic indicators lower in May. While the measure rallied sharply as the economy emerged from recession, pushing far above pre-pandemic highs, a choppy performance in early 2022 has left little net change in the past few months.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June / July 2022

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
	TRADE BALANCE Feb -$88.1 billion Mar -$107.7 billion Apr -$87.1 billion **CONSUMER CREDIT** Feb $34.1 billion Mar $47.4 billion Apr $38.1 billion	**WHOLESALE TRADE** Inventories / Sales Feb 2.8% 1.5% Mar 2.7% 1.8% Apr 2.2% 0.7%	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) May 14 0.218 1.343 May 21 0.211 1.306 May 28 0.202 1.306 June 04 0.229 N/A	**CPI** Total / Core Mar 1.2% 0.3% Apr 0.3% 0.6% May 1.0% 0.6% **CONSUMER SENTIMENT** Apr 65.2 May 58.4 June 50.2 **FEDERAL BUDGET** 2022 / 2021 Mar -$192.6B -$659.6B Apr $308.2B -$225.6B May -$66.2B -$132.0B
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX (6:00) Mar 93.2 Apr 93.2 May -- **PPI (8:30)** Final Demand / Ex. Food & Energy Mar 1.6% 1.2% Apr 0.5% 0.4% **May 0.8% 0.5%** **FOMC MEETING**	**RETAIL SALES (8:30)** Total / Ex.Autos Mar 1.4% 2.1% Apr 0.9% 0.6% **May 0.0% 1.0%** **IMPORT/EXPORT PRICES (8:30)** Non-petrol Imports / Nonagri. Exports Mar 1.2% 4.1% Apr 0.4% 0.5% May -- -- **EMPIRE MFG (8:30)** Apr 24.6 May -11.6 June -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales Feb 1.7% 1.1% Mar 2.4% 1.8% **Apr 1.2% 0.5%** **NAHB HOUSING INDEX (10:00)** Apr 77 May 69 June -- **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)** **TIC DATA (4:00)** Total / Net Long-Term Feb $160.3B $141.7B Mar $149.2B $23.1B Apr -- --	**INITIAL CLAIMS (8:30)** **HOUSING STARTS (8:30)** Mar 1.728 million Apr 1.724 million **May 1.625 million** **PHILY FED INDEX (8:30)** Apr 17.6 May 2.6 June --	**IP & CAP-U (9:15)** IP / Cap.Util. Mar 0.9% 78.2% Apr 1.1% 79.0% **May 0.2% 78.2%** **LEADING INDICATORS (10:00)** Mar 0.1% Apr -0.3% **May 0.4%**
20	21	22	23	24
JUNETEENTH	**CHICAGO FED NATIONAL ACTIVITY INDEX** **EXISTING HOME SALES**		**INITIAL CLAIMS** **CURRENT ACCOUNT**	**REVISED CONSUMER SENTIMENT** **NEW HOME SALES**
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**

Forecasts in Bold.

Treasury Financing

June / July 2022

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
AUCTION RESULTS: Rate Cover 13-week bills 1.230% 2.98 26-week bills 1.710% 2.87	**AUCTION RESULTS:** Rate Cover 3-year notes 2.927% 2.45 **ANNOUNCE:** $35 billion 4-week bills for auction on June 9 $30 billion 8-week bills for auction on June 9 $30 billion 17-week CMBs for auction on June 8 **SETTLE:** $35 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 1.510% 3.14 10-yr notes 3.030% 2.41	**AUCTION RESULTS:** Rate Cover 4-week bills 1.040% 2.82 8-week bills 1.150% 3.06 30-yr bonds 3.185% 2.35 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on June 13 $34 billion 52-week bills for auction on June 14 **SETTLE:** $87 billion 13-,26-week bills	
13	14	15	16	17
AUCTION: $87 billion 13-,26-week bills	**AUCTION:** $34 billion 52-week bills **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:** $30 billion* 17-week CMBs **SETTLE:** $44 billion 3-year notes $33 billion 10-year notes $19 billion 30-year bonds	**AUCTION:** $35 billion* 4-week bills $30 billion* 8-week bills **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	

*Estimate