Daiwa Capital Markets

U.S. Economic Comment

- FOMC: good progress toward its near-term objective…
- …financial conditions have tightened and the economy is slowing
- GDP preview: weak results in Q2, but it's not a recession (yet)

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U.S. Monetary Policy

The upcoming meeting of the Federal Open Market Committee does not involve much mystery: forward guidance offered in June, along with recent comments of Fed officials, suggest that policymakers will hike the federal funds rate by 75 basis points. A jump of 100 basis points in response to another troubling report on the consumer price index seems to be off the table.

Even without the comments of Fed officials that dashed prospects for a 100 basis point change, recent market and economic developments probably would have dampened the expectations of market participants for the bold move. Financial markets have done much of the Fed's work in removing policy accommodation, and the economy is beginning to slow in response.

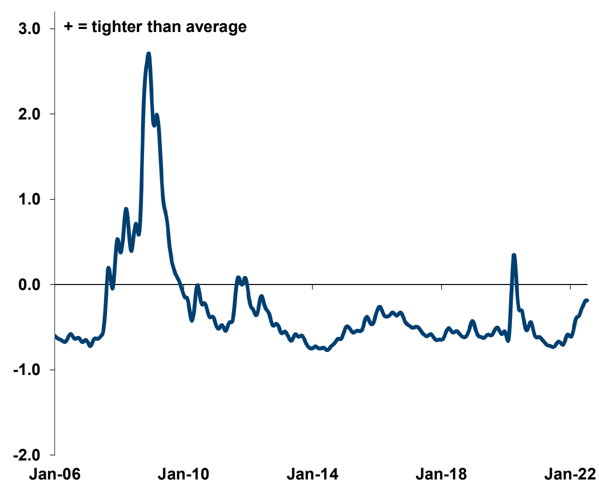
The current federal funds target of 1.625 percent rate is still well shy of the perceived neutral level of 2.5 percent, but policymakers are focused on financial conditions in a broad sense, and broad conditions have tightened considerably. Longer-term Treasury rates have climbed approximately 150 basis points since the end of last year, and the equity market, despite improvement in recent weeks, has lost substantial ground this year. We would also highlight wider credit spreads in the bond and mortgage markets and notable strength in the foreign exchange value of the dollar. These two factors typically do not receive extensive discussion when evaluating the stance of monetary policy, but they represent important channels of influence.

Broad measures of financial conditions are available, and they show notable change. The National Financial Conditions Index assembled by the Federal Reserve Bank of Chicago is exceptionally broad, as it encompasses 105 financial variables. This measure was in the low end of its historical range during the worst of the pandemic, but it has recently moved close to its long-run average, which might be viewed as a neutral position (chart). A similar measure published by the Kansas City Fed has already returned to its neutral position.

This is not to say that the Fed's work is done. Financial conditions in a broad sense are neutral at best, and the Fed is aiming for a restrictive setting. Moreover, inflation is still raging, and the desired easing in price pressure will follow the economy with a lag – perhaps a long one. Thus, there is more tightening to be done, but at this point a 75 basis point shift is probably the proper dose. Moreover, we are inclined to look for a downshift to 50 basis points in September and 25 basis points in November and December.

Developments in the economy also suggest that a shift of 100 basis points could be overkill. The housing market, probably the most interest-sensitive sector of the economy, is slowing noticeably. The

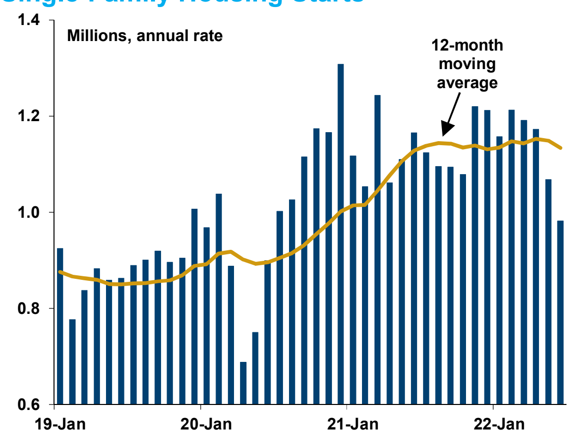
National Financial Conditions Index



Source: Federal Reserve Bank of Chicago via Haver Analytics latest week brought three reports on residential activity, and all were soft. Sales of existing homes and single-family housing starts continued their multi-month retreats (chart, left). This softening cannot be attributed to idiosyncratic factors such as adverse weather or material shortages; a fundamental shift in response to tighter financial conditions seems to be underway. A tumble in the sentiment index published by the National Association of Home Builders supports the view that the housing cycle is turning.

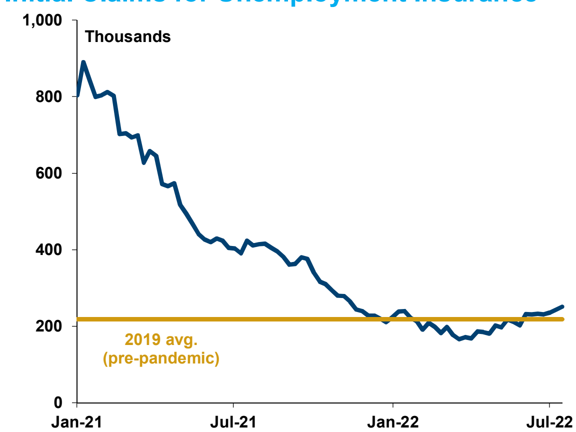
The labor market also seems to be easing to a degree. Initial claims for unemployment insurance have moved off their low readings in March and April and have recently moved above the average in 2019, before Covid became an issue (chart, right). The latest level is still low by historical standards, but the recent upward drift suggests that the labor market has lost some of its sharp edge.

Single-Family Housing Starts



Source: U.S. Census Bureau via Haver Analytics

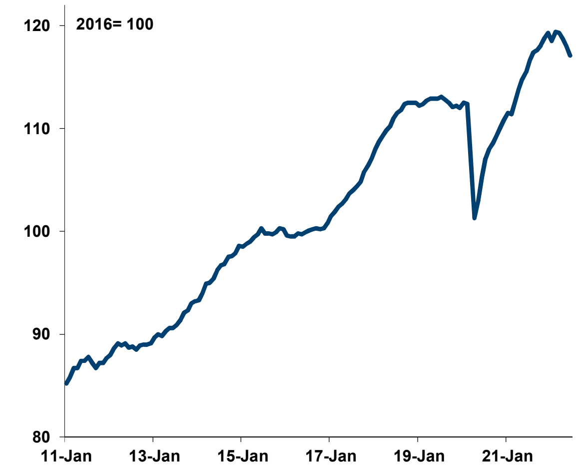
Initial Claims for Unemployment Insurance



Source: U.S. Department of Labor via Haver Analytics

We do not put much weight on the index of leading economic indicators. It is not a good forecasting tool, as observations are not easily translated into a projection for economic growth or inflation. Its purpose is to offer clues on turning points in the economy rather than to generate forecasts. While often ignored, the measure merits attention at this time because recent results are flashing caution. The June reading released this week marked the fourth consecutive decline, with sizeable retreats in the past three months leaving a clear turn (chart).

Index of Leading Economic Indicators



Source: The Conference Board via Haver Analytics

GDP Preview: Another Weak Quarter

The upcoming report on second quarter GDP also is likely to stir thoughts of recession, as results are likely to be soft after a decline of 1.6 percent in Q1. Consumer spending probably registered a mediocre performance (growth in the neighborhood of 1.0 percent), while available data suggest that business fixed investment and residential construction declined. Inventory investment likely made a negative contribution, and we expect government spending to be underwhelming. Net exports probably made a positive contribution to economic growth, but only because the trade deficit in Q2 was less dreadful than it was in the first quarter. Net exports for the first and second quarters combined were decidedly soft and international trade was a drag on growth in the first half.

As we tally the figures, GDP growth remained in positive territory in the second quarter (0.2 percent), but some forecasters expect another decline in economic activity. If the economy were to contract, it would mark the second consecutive quarterly decline, which is a frequently cited definition of a recession. While frequently cited, it is not the official definition. Dates for recession and expansion in the United States are set by the National Bureau of Economic Research (an economic think tank), and it uses the following definition: “a significant decline in economic activity that is spread across the economy and that lasts more than a few months.”

Note the three criteria (the three Ds): depth (a significant decline), diffusion (spread across the economy), and duration (lasts more than a few months). While the dating committee at NBER prefers all three criteria to be satisfied, exceptions are sometimes warranted. In the Covid-related recession, for example, the duration was brief, but the depth and diffusion were so pronounced that a recession was obvious.

In the current instance, a drop in second quarter GDP would probably not be sufficient to sway the dating committee. The duration of softness (two quarters) is merely borderline, while depth and diffusion are lacking. The economic hole that emerged in Q1 was not especially deep (-1.6 percent), and if the economy did contract in Q2, we suspect that the drop would be even shallower than that in the first quarter. We also suspect that softness was not sufficiently diffused through the economy. If weakness were broadly based, job growth would slow markedly and likely decline, while unemployment would undoubtedly increase. However, neither has occurred thus far.

Another figure, gross domestic income, also suggests that depth and diffusion are lacking at this time. GDI is the sum of all incomes earned in the production process. Conceptually, it should be equal to GDP, as the value of output will be disbursed as income among those involved in the production process (wages to workers, interest to investors, rents to landlords, profits to businesses). However, GDP and GDI are constructed from different data sources, which leads to statistical discrepancies.

The discrepancy was notable in the first quarter, as gross domestic income rose 1.8 percent, raising doubt about a decline in economic activity. This doubt is reinforced by the still-favorable performance in the labor market in the early months of the year.

We don’t mean to present an optimistic picture. The economy is slowing, and we expect it to continue easing as the Fed tightens policy. A recession will probably develop eventually, but we are not there yet.

Review

Week of July 18, 2022	Actual	Consensus	Comments
Housing Starts (June)	**1.559 Million (-2.0%)**	**1.580 Million (+2.0%)**	The softness in housing starts during June was concentrated in the single-family sector, where activity fell 8.1%. The retreat marked the fourth consecutive decline, with the cumulative change over this span pushing activity to its lowest level since the early stages of the expansion. With interest rates elevated and the inventory of unsold homes sizeable, the outlook does not appear bright. Multi-family starts, in contrast, are performing well. Activity has been volatile on a month-to-month basis, but the ups and downs are tracing a solid upward trend, which was reinforced by a jump of 10.3% in June. The outlook for multi-family starts seems favorable, as elevated prices of single-family homes and high interest rates are pushing some potential home buyers into the rental market.
Existing Home Sales (June)	**5.12 Million (-5.4%)**	**5.35 Million (-1.1%)**	The drop in sales of existing homes represented the fifth consecutive decline, with the cumulative change pushing activity to its lowest level since the early stages of the expansion. Despite the slow pace of sales, home prices continued to advance, with the median price in June at $416,000, up from $408,400 in May and $366,900 in June of last year. A tight supply of homes on the market has played a role in pushing prices higher, but this situation is beginning to improve. The number of homes on the market rose 9.6% in June, notably stronger than the usually modest change for this month. The increase in inventory pushed the months' supply of homes for sale to 3.0 months, up from 2.6 in May and the record low of 1.6 in January.
Leading Indicators (June)	**-0.8%**	**-0.6%**	Negative contributions from consumer expectations, stock prices, initial claims for unemployment insurance, and the factory workweek led to the fourth consecutive decline in the index of leading economic indicators. The measure rose sharply from mid-2020 through the end of last year, surpassing the high of the previous expansion, but declines in recent months have left a downward tilt thus far in 2022.

Sources: U.S. Census Bureau (Housing Starts); National Association of realtors (Existing home Sales); The Conference Board (Leading Indicators); Consensus forecasts are from Bloomberg

Preview

Week of July 25, 2022	Projected	Comments
New Home Sales (June) (Tuesday)	**0.625 Million (-10.2%)**	A sharp decline in the index published by the National Association of Home Builders suggests that the increase in mortgage interest rates this year is starting to bite hard on the housing market. The expected decline in new home sales would erase nearly all of the surprising gain in the prior month and push activity back to the low end of the range of the current expansion.
Conference Board Consumer Confidence (July) (Tuesday)	**100.0 (+1.3%)**	While consumer moods most likely remain sour, an easing in gasoline prices and a pickup in the equity market in the past few weeks could lift spirits slightly.
International Trade in Goods (June) (Wednesday)	**-$106.0 Billion ($2.0 Billion Wider Deficit)**	Demand in the United States, while beginning to ease, is probably firmer than that among its major trading partners, and thus imports are likely to remain stronger than exports, leading to slippage in the trade balance. A firm dollar on foreign exchange markets also suggests a widening in the trade deficit, although currency changes typically operate with long lags.
Durable Goods Orders (June) (Wednesday)	**0.5%**	Concern about a potential recession will probably discourage order flows, but higher prices will probably leave a small increase in nominal terms.
GDP (22-Q2) (Thursday)	**0.2%**	Soft results on residential construction and business spending (including inventory investment) should nearly offset moderate growth in consumer spending and a positive contribution from net exports.
Personal Income, Consumption, Core Price Index (June) (Friday)	**0.4%, 0.8%, 0.5%**	A moderate gain in wages and salaries should be supplemented by solid growth in rental income and an improvement in interest income. A slight pickup in vehicle sales should lead to a modest advance in outlays for durable goods, while a sharp increase in retail activity points to strong results in the nondurable goods area, at least in nominal terms. Hefty increases in the PCE price indexes suggest that the nominal gain in spending will translate to little change in real terms.
Employment Cost Index (22-Q2) (Friday)	**1.0%**	Results on average hourly earnings suggest that upward pressure on labor compensation will cool from the jump of 1.4% in Q1, but the advance is still likely to be brisk.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July / August 2022

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
NAHB HOUSING INDEX May 69 June 67 July 55 **TIC DATA** Net L-T / Total Mar $23.1B / -$115.7B Apr $87.2B / -$2.7B May $155.3B / $182.5B	**HOUSING STARTS** Apr 1.805 million May 1.591 million June 1.559 million	**EXISTING HOME SALES** Apr 5.60 million May 5.41 million June 5.12 million	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) June 25 0.231 / 1.372 July 2 0.236 / 1.333 July 9 0.244 / 1.384 July 16 0.251 / N/A **PHILADELPHIA FED MFG BUSINESS OUTLOOK** May 2.6 June -3.3 July -12.3 **LEADING INDICATORS** Apr -0.5% May -0.6% June -0.8%	
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Apr 0.40 / 0.40 May 0.01 / 0.20 Jun -- / --	**FHFA HOME PRICE INDEX (9:00)** Mar 1.6% Apr 1.6% May -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Mar 2.4% / 3.1% Apr 1.8% / 2.3% May -- / -- **NEW HOME SALES (10:00)** Apr 0.629 million May 0.696 million **June 0.625 million** **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** May 103.2 June 98.7 **July 100.0** **FOMC MEETING (DAY 1)**	**INTERNATIONAL TRADE IN GOODS (8:30)** Apr -$106.8 billion May -$104.0 billion **June -$106.0 billion** **ADVANCE INVENTORIES (8:30)** Wholesale / Retail Apr 2.3% / 0.8% May 1.8% / 1.1% June -- / -- **DURABLE GOODS ORDERS (8:30)** Apr 0.4% May 0.8% **June 0.5%** **PENDING HOME SALES (10:00)** Apr -4.0% May 0.7% June -- **FOMC DECISION (2:00)**	**UNEMPLOYMENT CLAIMS (8:30)** **GDP (8:30)** GDP / Chained Price 21-Q4 6.9% / 7.1% 22-Q1 -1.6% / 8.2% **22-Q2 0.2% / 8.0%**	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Apr 0.5% / 0.6% / 0.3% May 0.5% / 0.2% / 0.3% **June 0.4% / 0.8% / 0.5%** **EMPLOYMENT COST INDEX (8:30)** Comp. / Wages 21-Q4 1.0% / 1.0% 22-Q1 1.4% / 1.2% **22-Q2 1.0% / 1.0%** **MNI CHICAGO BUSINESS BAROMETER INDEX (9:45)** Index / Prices May 60.3 / 88.6 June 56.0 / 79.6 July -- / -- **REVISED CONSUMER SENTIMENT (10:00)** May 58.4 June 50.0 July(p) 51.1
1	2	3	4	5
ISM MFG. INDEX **CONSTRUCTION**	**JOLTS** **VEHICLE SALES**	**FACTORY ORDERS** **ISM SERVICES INDEX**	**UNEMPLOYMENT CLAIMS** **INTERNATIONAL TRADE**	**EMPLOYMENT REPORT** **CONSUMER CREDIT**
8	9	10	11	12
	NFIB SMALL BUSINESS OPTIMISM INDEX **PRODUCTIVITY & COSTS**	**CPI** **WHOLESALE TRADE** **FEDERAL BUDGET**	**UNEMPLOYMENT CLAIMS** **PPI**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**

Forecasts in Bold. (p) = preliminary

Daiwa Capital Markets

Treasury Financing

July / August 2022

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
AUCTION RESULTS: Rate / Cover 13-week bills 2.470% 2.97 26-week bills 2.910% 2.65	**ANNOUNCE:** $55 billion 4-week bills for auction on July 21 $50 billion 8-week bills for auction on July 21 $30 billion 17-week CMBs for auction on July 20 **SETTLE:** $45 billion 4-week bills $40 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate / Cover 17-week CMB 2.720% 3.87 20-yr bonds 3.420% 2.65	**AUCTION RESULTS:** Rate / Cover 4-week bills 2.120% 2.44 8-week bills 2.230% 2.71 10-yr TIPS 0.630% 2.18 **ANNOUNCE:** $96 billion 13-,26-week bills for auction on July 25 $24 billion 2-year FRNs for auction on July 27 $45 billion 2-year notes for auction on July 25 $46 billion 5-year notes for auction on July 26 $38 billion 7-year notes for auction on July 28 **SETTLE:** $96 billion 13-,26-week bills	
25	26	27	28	29
AUCTION: $96 billion 13-,26-week bills $45 billion 2-year notes	**AUCTION:** $46 billion 5-year notes **ANNOUNCE:** $55 billion* 4-week bills for auction on July 28 $50 billion* 8-week bills for auction on July 28 $30 billion* 17-week CMBs for auction on July 27 **SETTLE:** $55 billion 4-week bills $50 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $24 billion 2-year FRNs	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills $38 billion 7-year notes **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Aug 1 **SETTLE:** $96 billion 13-,26-week bills	**SETTLE:** $17 billion 10-year TIPS
1	2	3	4	5
AUCTION: $96 billion* 13-,26-week bills **SETTLE:** $14 billion 20-year bonds $24 billion 2-year FRN $45 billion 2-year notes $46 billion 5-year notes $38 billion 7-year notes	**ANNOUNCE:** $50 billion* 4-week bills for auction on Aug 4 $50 billion* 8-week bills for auction on Aug 4 $30 billion* 17-week CMBs for auction on Aug 3 **SETTLE:** $55 billion* 4-week bills $50 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs **ANNOUNCE:** $45 billion* 3-year notes for auction on Aug 9 $36 billion* 10-year notes for auction on Aug 10 $22 billion* 30-year bonds for auction on Aug 11	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on Aug 8 $34 billion* 52-week bills for auction on Aug 9 **SETTLE:** $96 billion* 13-,26-week bills	
8	9	10	11	12
AUCTION: $96 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills for $45 billion* 3-year notes **ANNOUNCE:** $55 billion* 4-week bills for auction on Aug 11 $50 billion* 8-week bills for auction on Aug 11 $30 billion* 17-week CMBs for auction on Aug 10 **SETTLE:** $55 billion* 4-week bills $50 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $36 billion* 10-year notes	**AUCTION:** $55 billion* 4-week bills $50 billion* 8-week bills $22 billion* 30-year bonds **ANNOUNCE:** $96 billion* 13-,26-week bills for auction on August 15 $14 billion* 20-year bonds for auction on Aug 17 $8 billion* 30-year TIPS for auction on August 18 **SETTLE:** $96 billion* 13-,26-week bills $34 billion* 52-week bills	

*Estimate