U.S. Economic Comment

- FOMC Preview: pause in June but additional hikes possible later this year

Lawrence Werther
Daiwa Capital Markets America
212-612-6393
lawrence.werther@us.daiwacm.com

Monetary Policy: A Break from Tightening

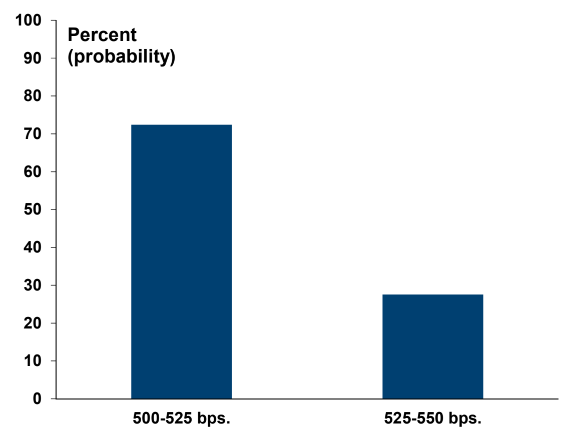
We could easily envision the Federal Open Market Committee hiking the federal funds rate by 25 basis points at its upcoming meeting on June 13-14, but mixed signals from Fed officials in the weeks preceding the pre-meeting blackout suggest that they will hold the federal funds target rate at 5.125 percent in June before revisiting the question in July.

The minutes from the May FOMC meeting indicated that participants "expressed uncertainty about how much more policy tightening may be appropriate," and "several" noted that "further policy firming may not be necessary." Fed Governor, Philip Jefferson, President Biden's appointee for Vice Chair, and Philly Fed President Harker, a 2023 voter, both indicated their preference for pausing in June.

Chair Powell has done a remarkable job building a consensus around monetary policy decisions, having dissents at only two meetings since 2021, and the robust debate among officials may signal to him that a pause is appropriate at this time, while still keeping the door wide open to the possibility of additional hikes. This so-called hawkish pause would allow the Committee to take time to evaluate the incoming data (including CPI and PPI reports published during the two-day meeting).

Previously, we suspected that market participants would have inferred from a pause that officials reached the end of the hiking cycle, and that the next move would be a cut in the funds rate. However, a surprise increase in rates by the Bank of Canada after a pause at its previous meeting seemingly led to a reevaluation of central bank tactics by market participants. Futures prices suggest a high probability of a pause next week, but current expectations favor the resumption of policy firming at upcoming meetings (chart).

Target Rate Probability for June Fed Meeting



Source: CME Group, FedWatch Tool

The Case for Additional Policy Firming

While views expressed in the May FOMC Minutes and in subsequent presentations by Fed officials offer a wide dispersion of views on the need for additional rate hikes, policymakers appeared unified in the position that they would rely on incoming data to inform their expectations for future shifts in the federal funds rate. In our view, recent economic developments and data raise the prospect of additional tightening and the maintenance of a restrictive policy stance into 2024.

Two notable threats to the broader economy, turmoil in the banking sector that began in March and the recent U.S. flirtation with sovereign default stemming from a near-breach of the $31.4 trillion debt ceiling, have been resolved with limited fallout. Recalibration by banks after the recent crisis could result in tighter credit standards and reduced extension of credit to households and businesses, but impacts have been limited thus far. In addition, the impact on financial markets stemming from the debt ceiling debacle has been limited, and the agreed-upon suspension effectively punts the issue to early 2025.

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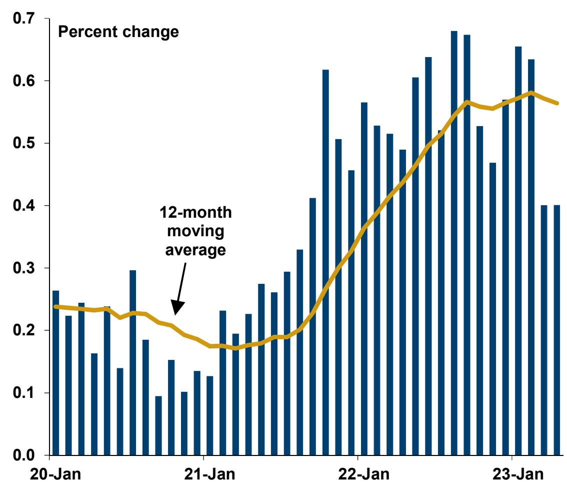
With regard to the data, recent figures suggest solid underlying momentum in the economy and persistent price pressure inconsistent with the Fed's two-percent inflation target. The May employment report recorded job growth of 339,000 in May and a year-over-year advance of 4.3 percent in average hourly earnings, with current underlying conditions in the labor market pointing to only a slow deceleration in wage growth. In addition, GDP growth in Q1 was revised higher from 1.1 percent to 1.3 percent, and the Atlanta Fed GDPNow model is currently estimating growth of 2.2 percent (annual rate) in Q2.

Perhaps more important than the recent performance of other economic statistics, measures of underlying inflation have shown little progress in recent months. Our preferred measure of underlying inflation, the Median CPI released by the Federal Reserve Bank of Cleveland, strips away all but the median point in the distribution of price changes in a given month. Thus, not only shifts at the tails, but all other changes are removed from the estimate to give a clearer picture of the underlying trend in the data. Month-to-month changes slowed to 0.4 percent per month in the past two months from 0.6 percent in the prior 12 months, but the 12-month change still totaled 7.0 percent, only a shade below the recent high of 7.2 percent in February (chart, below left). The measure implies a wide gap between underlying inflation and the Feds inflation target.

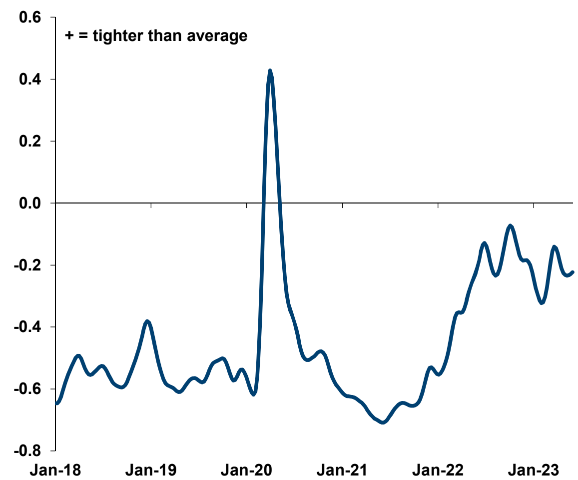
In the medium term, a restrictive stance of policy will be necessary to maintain sufficiently tight financial conditions and slow economic activity by enough to return inflation to target. Rapid rate hikes have led to measurable tightening in financial conditions in the post-pandemic period, but a broad measure compiled by the Federal Reserve Bank of Chicago suggests some easing more recently, consistent with a rally in the equity market, relatively narrow credit spreads, and a dip in mortgage rates (chart, below right). Fed officials have maintained that tightening in credit standards is a key variable not necessarily picked up by broad measures of financial conditions, and could have an additional constraining effect on the economy. However, consumers and businesses appear resilient thus far. It appears that more restraint may be required, and a bias toward tighter policy would convey this to the market.

Median CPI



Source: Federal Reserve Bank of Cleveland via Haver Analytics

National Financial Conditions Index



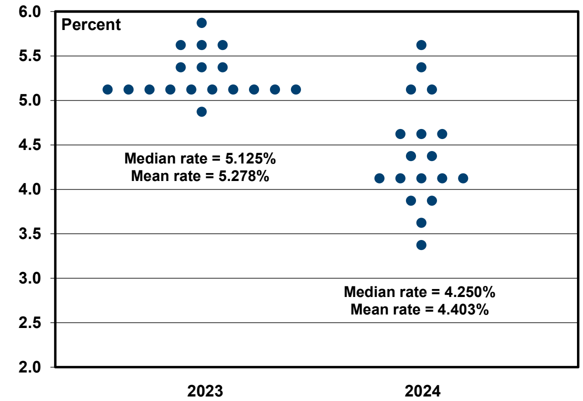
Source: Source: Federal Reserve Bank of Chicago via Haver Analytics

The Dot Plot: Possible Adjustment Higher

The FOMC will publish a new Summary of Economic Projections at the upcoming meeting, including an updated dot plot. Given recent results on inflation, and the anticipation of another firm increase in the core when results for May are published next Tuesday, we suspect that the new dot plot will show a median for 2023 that exceeds the previous view of 5.125 percent. In the previous iteration of the dot plot released following the conclusion of the March FOMC meeting, seven of 18 officials submitted estimates above the median – including one with a year-end target of 5.875 percent (chart, next page). It would take only two or three policymakers shifting views to signal additional rate hikes (a shift in two dots would imply a median of 5.250 percent, while three officials changing views would move the median to 5.375 percent). Given the divergence of views among officials signaled in the week preceding the pre-meeting blackout period, we view an additional shift above a median of 5.375 percent for 2023 as unlikely.

A change in the median for 2023 likely would trigger parallel adjustments to the 2024 and 2025 medians of 4.250 percent and 3.125 percent, respectively, provided that officials do not want to signal an additional degree of easing in those years by adjusting expectations for 2023 only. For 2024, one of nine dots at or below 4.125 percent would have to shift to 4.375 percent, while at least two dots would have to shift above 3.125 percent for 2025. We do not project a change in the long-term median of 2.500 percent, which has shown little variation since easing from 2.750 percent in March 2019 to 2.500 percent with the June 2019 forecast update.

FOMC Rate View, March 2023*



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

The Week Ahead

Federal Budget (May) (Monday)
Forecast: -$235.0 Billion

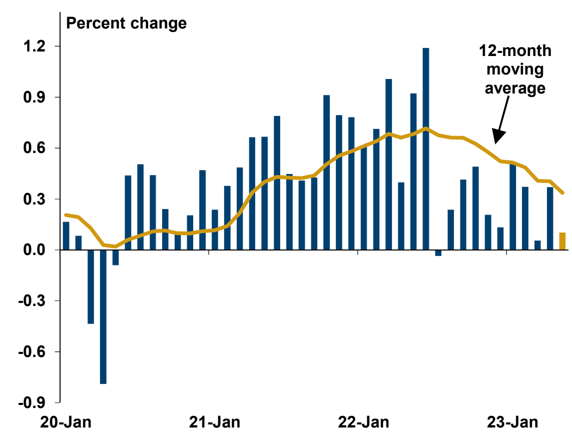
The budget position of the federal government deteriorated sharply in the first seven months of FY2023, with revenues contracting approximately 11 percent and outlays jumping nine percent. With regard to outlays, jumps in expenditures for the Social Security and Medicare programs (up 11 percent and 17 percent, respectively), as well as a surge of more than 30 percent in debt service expenses, stand out for their rapid year-to-date deterioration.

The situation is unlikely to improve in May, as available data suggest that a year-over-year drop of 20 percent in revenues and an increase of five percent in outlays contributed to a deficit of about $235 billion (versus -$66.2 billion in May 2022). If the projection is realized, the deficit in the first eight months of FY2023 would total almost $1.2 trillion (versus a deficit of $426 billion in the same period in FY2022).

CPI (May) (Tuesday)
Forecast: 0.1% Total, 0.4% Core

While energy prices are still well above pre-COVID levels, they have fallen 14 percent since the peak last June. Moreover, available quotes suggest that gasoline prices declined in May, which should contribute to further easing in energy prices. Prices of energy services (electricity and natural gas service) also could slide for the fourth consecutive month after surging to a cycle high in January (up 15.6 percent year-over-year through January before declining 5.6 percent in the subsequent three months). Increases in food prices have slowed markedly, with the component registering a pickup of 0.4 percent in February and then little net change in the following two months. Food prices were under substantial pressure in the 12 months preceding February, posting an average monthly surge of 1.0 percent in the six months that ended July 2022 and 0.6 percent in the six-month period concluding January 2023. In the core component, goods prices have moderated since a spike during the pandemic and early stages of the current expansion (average increase of 0.2 percent in the past 12 months), but prices of services excluding energy have remained under pressure (average advance of 0.6 percent in the past 12 months). Costs of services could again drive the projected firm increase in the core CPI.

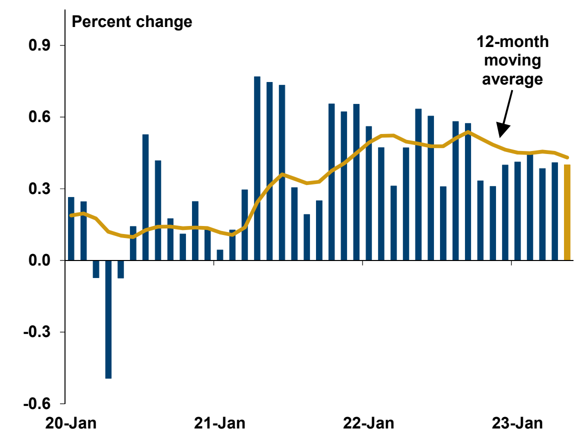
Headline CPI*



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

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

Core CPI*



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

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

PPI (May) (Wednesday)
Forecast: -0.2% Total, 0.2% Ex. Food and Energy

Data from wholesale energy markets suggest that energy prices eased during the May survey period. Food prices at the producer level often move erratically from month-to-month, although the underlying trend is indicating slowdown. Prices averaged declines of 0.2 percent per month in the past six months after averaging monthly jumps of 0.7 percent in the six-month period ending October 2022. Prices excluding food and energy could post a moderate advance. Core goods prices have increased 0.3 percent per month in the past six months, while service prices have averaged 0.2 percent. The trend in construction costs has slowed, with an average increase of 0.3 percent per month in the past six months versus 1.5 percent in the six months ended October 2022.

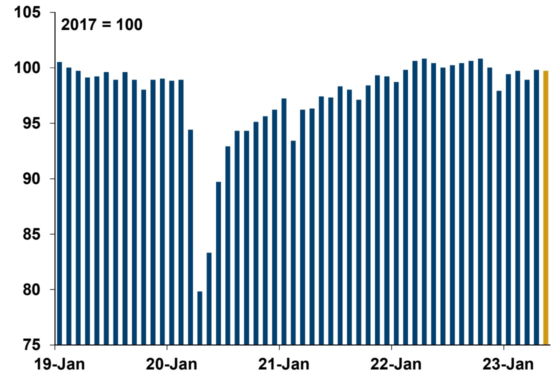
Retail Sales (May) (Thursday)
Forecast: 0.0% Total, 0.0% Ex. Autos, 0.2% Ex. Autos & Gas

Available sales data point to a dip in the auto component of retail sales in May, while lower prices could constrain activity at gasoline service stations. Consumers could slow outlays in other retail categories after a jump in activity in April.

Industrial Production (May) (Thursday)
Forecast: 0.0%

A dip in factory sector employment in May suggests an easing in the manufacturing component of industrial production, which has tilted lower since last fall (chart). Mining activity, which has responded negatively to softening oil and natural gas prices, could slip in May – a view supported by the cut in the rotary rig count. Utility output could pick up in May after wide temperature swings led to sharp declines in three of the past four months. The expected increase could provide an offset to expected dips in manufacturing and mining.

Industrial Production: Manufacturing*

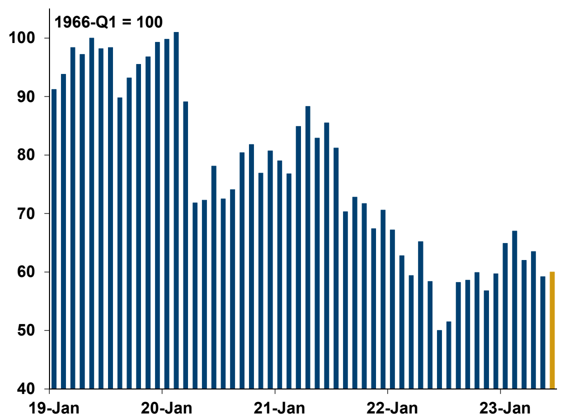


** The gold bar is a forecast for May 2023.*
Source: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Consumer Sentiment (June) (Friday)
Forecast: 60.0

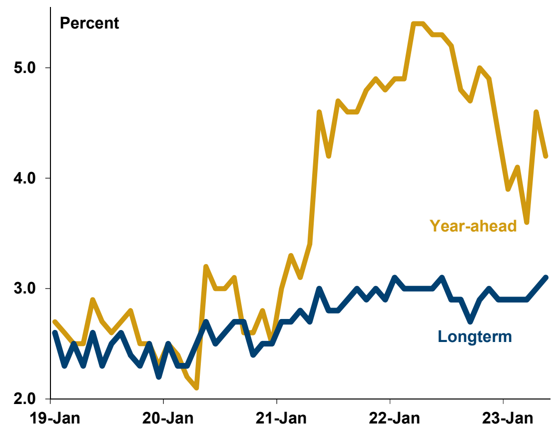
Strains on household budgets from the ongoing bout of brisk inflation suggest that consumer sentiment is likely to remain depressed in early June. Keep an eye on the year-ahead and long-term inflation expectation measures, which have both shown some deterioration in recent months.

Consumer Sentiment*



** The gold bar is a forecast for June 2023.*
Sources: University of Michigan via Haver Analytics; Daiwa Capital Markets America

Consumer Inflation Expectations



Source: University of Michigan via Haver Analytics

Economic Indicators

June 2023

Monday	Tuesday	Wednesday	Thursday	Friday
5	6	7	8	9
FACTORY ORDERS Feb -1.7% Mar 0.6% Apr 0.4% **ISM SERVICES INDEX** Index / Prices Mar 51.2 / 59.5 Apr 51.9 / 59.6 May 50.3 / 56.2		**TRADE BALANCE** Feb -$70.2 billion Mar -$60.6 billion Apr -$74.6 billion **CONSUMER CREDIT** Feb $8.2 billion Mar $22.8 billion Apr $23.0 billion	**UNEMPLOYMENT CLAIMS** Initial / Continuing (millions) May 13 0.225 / 1.789 May 20 0.230 / 1.794 May 27 0.233 / 1.757 June 3 0.261 / N/A **WHOLESALE TRADE** Inventories / Sales Feb 0.0% / 0.4% Mar -0.2% / -2.7% Apr -0.1% / 0.2%	
12	13	14	15	16
FEDERAL BUDGET (2:00) 2023 / 2022 Mar -$378.1B / -$192.6B Apr $176.2B / $308.2B **May** **-$235B** / -$66.2B	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** Mar 90.1 Apr 89.0 May -- **CPI (8:30)** Total / Core Mar 0.1% / 0.4% Apr 0.4% / 0.4% **May** **0.1%** / **0.4%** **FOMC MEETING (FIRST DAY)**	**PPI (8:30)** Final Demand / Ex. Food & Energy Mar -0.4% / 0.0% Apr 0.2% / 0.2% **May** **-0.2%** / **0.2%** **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**UNEMP. CLAIMS (8:30)** **RETAIL SALES (8:30)** Total / Ex.Autos Mar -0.7% / -0.5% Apr 0.4% / 0.4% **May** **0.0%** / **0.0%** **IMPORT/EXPORT PRICES (8:30)** Non-Petrol Imports / Nonagri. Exports Mar -0.6% / -0.5% Apr -0.1% / 0.2% May -- / -- **EMPIRE MFG (8:30)** Apr 10.8 May -31.8 June -- **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Apr -31.3 May -10.4 June -- **IP & CAP-U (9:15)** IP / Cap.Util. Mar 0.0% / 79.4% Apr 0.5% / 79.7% **May** **0.0%** / **79.5%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Feb 0.1% / -0.2% Mar -0.2% / -1.4% **Apr** **0.2%** / **0.1%** **TIC FLOWS (4:00)** Long-Term / Total Feb $56.6B / $13.7B Mar $133.3B / $56.7B Apr -- / --	**CONSUMER SENTIMENT (10:00)** Apr 63.5 May 59.2 **June** **60.0**
19	20	21	22	23
NAHB HOUSING INDEX **JUNETEENTH NATIONAL INDEPENDENCE DAY**	**HOUSING STARTS**		**UNEMP. CLAIMS** **CHICAGO FED NATIONAL ACTIVITY INDEX** **CURRENT ACCOUNT** **EXISTING HOME SALES** **LEADING INDICATORS**	
26	27	28	29	30
	DURABLE GOODS ORDERS **FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **NEW HOME SALES** **CONSUMER CONFIDENCE**	**INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES**	**UNEMP. CLAIMS** **REVISED Q1 GDP** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, & PCE PRICE INDEXES** **MNI CHICAGO BUSINESS BAROMETER** **REVISED CONSUMER SENTIMENT**

Forecasts in Bold.

Treasury Financing

June 2023

Monday	Tuesday	Wednesday	Thursday	Friday
5	6	7	8	9
AUCTION: Rate Cover 13-week bills 5.220% 3.15 26-week bills 5.250% 3.14 44-day CMBs 5.150% 3.19 **SETTLE:** $15 billion 1-day CMBs $50 billion 38-day CMBs	**ANNOUNCE:** $60 billion 4-week bills for auction on June 8 $50 billion 8-week bills for auction on June 8 $46 billion 17-week bills for auction on June 7 **SETTLE:** $35 billion 4-week bills $35 billion 8-week bills $44 billion 17-week bills $50 billion 44-day CMBs	**AUCTION RESULTS:** Rate Cover 17-week bills 5.200% 3.36	**AUCTION RESULTS:** Rate Cover 4-week bills 5.090% 2.49 8-week bills 5.120% 2.86 **ANNOUNCE:** $123 billion 13-,26-week bills for auction on June 12 $38 billion 52-week bills for auction on June 13 $40 billion 3-year notes for auction on June 12 $32 billion 10-year notes for auction on June 12 $18 billion 30-year bonds for auction on June 13 $45 billion 42-day CMBs for auction on June 13 **SETTLE:** $123 billion 13-,26-week bills	
12	13	14	15	16
AUCTION: $123 billion 13-,26-week bills $40 billion 3-year notes $32 billion 10-year notes	**AUCTION:** $38 billion 52-week bills $18 billion 30-year bonds $45 billion 42-day CMBs **ANNOUNCE:** $60 billion* 4-week bills for auction on June 15 $50 billion* 8-week bills for auction on June 15 $46 billion* 17-week bills for auction on June 14 **SETTLE:** $60 billion 4-week bills $50 billion 8-week bills $46 billion 17-week bills	**AUCTION:** $46 billion* 17-week bills	**AUCTION:** $60 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $123 billion* 13-,26-week bills for auction on June 20 $12 billion* 20-year bonds for auction on June 21 $19 billion* 5-year TIPS for auction on June 22 **SETTLE:** $123 billion 13-,26-week bills $38 billion 52-week bills $40 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds $45 billion 42-day CMBs	
19	20	21	22	23
JUNETEENTH NATIONAL INDEPENDENCE DAY	**AUCTION:** $123 billion* 13-,26-week bills **ANNOUNCE:** $60 billion* 4-week bills for auction on June 22 $50 billion* 8-week bills for auction on June 22 $46 billion* 17-week bills for auction on June 21 **SETTLE:** $60 billion* 4-week bills $50 billion* 8-week bills $46 billion* 17-week bills	**AUCTION:** $46 billion* 17-week bills $12 billion* 20-year bonds	**AUCTION:** $60 billion* 4-week bills $50 billion* 8-week bills $19 billion* 5-year TIPS **ANNOUNCE:** $123 billion* 13-,26-week bills for auction on June 26 $42 billion* 2-year notes for auction on June 26 $43 billion* 5-year notes for auction on June 27 $35 billion* 7-year notes for auction on June 28 $22 billion* 2-year FRNs for auction on June 28 **SETTLE:** $123 billion* 13-,26-week bills	
26	27	28	29	30
AUCTION: $123 billion* 13-,26-week bills $42 billion* 2-year notes	**AUCTION:** $43 billion* 5-year notes **ANNOUNCE:** $60 billion* 4-week bills for auction on June 29 $50 billion* 8-week bills for auction on June 29 $46 billion* 17-week bills for auction on June 28 **SETTLE:** $60 billion* 4-week bills $50 billion* 8-week bills $46 billion* 17-week bills	**AUCTION:** $46 billion* 17-week bills $35 billion* 7-year notes $22 billion* 2-year FRNs	**AUCTION:** $60 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $123 billion* 13-,26-week bills for auction on July 3 **SETTLE:** $123 billion* 13-,26-week bills	**SETTLE:** $12 billion* 20-year bonds $19 billion* 5-year TIPS $42 billion* 2-year notes $43 billion* 5-year notes $35 billion* 7-year notes $22 billion* 2-year FRNs

**Estimate*