Daiwa Capital Markets

U.S. Economic Comment

- U.S. economy: growth track in 23-H1, but possible (mild) recession in H2
- The yield curve: inversion to persist in 2023

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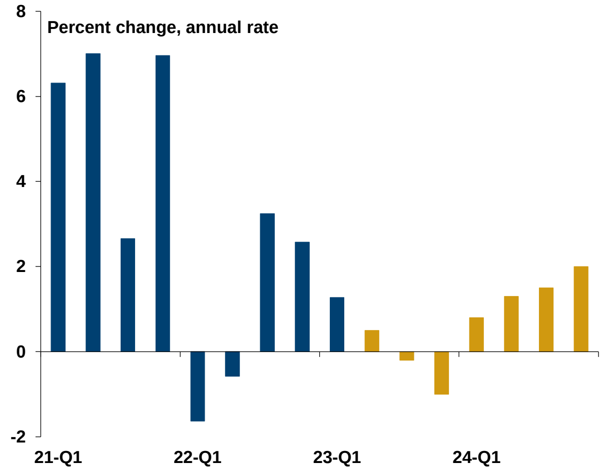
2023 Update

The U.S. economy has proven resilient in 2023 thus far, remaining on a growth track despite headwinds from rapid inflation and an aggressive response from the Federal Reserve. Moreover, it has skirted major fallout from a spate of bank failures in the spring and the near-default tied to the recent debt ceiling debacle. While an impressive performance considering these developments, we suspect that the economy will ultimately succumb to a downturn in H2 as consumers retreat and businesses recalibrate. However, we currently do not foresee a severe downturn, and we project the economy returning to a growth trajectory in early 2024. Even with the expectation of a downturn in 23-H2, we anticipate growth to be little changed over the four quarters of 2023 before registering Q4/Q4 growth of 1.6 percent next year (chart).

GDP Growth*



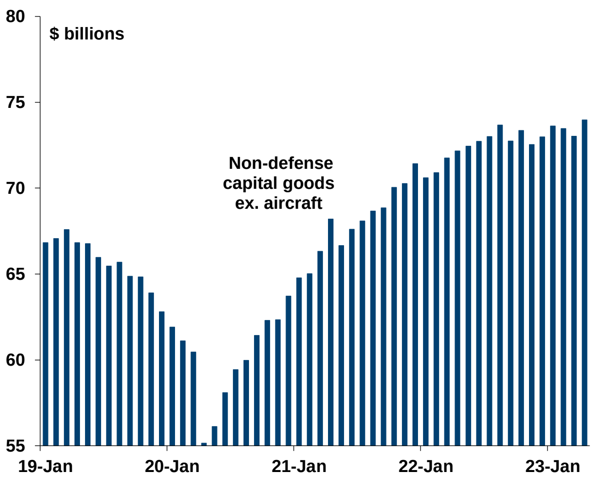
** The readings for 2023-Q2 to 2024-Q4 are forecasts.*
Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

H1 in Review

Although the economy could decelerate and possibly contract in Q2, the performance in Q1 was admirable in many respects. After consumer spending tailed off in the closing months of last year (growth of real PCE of 1.0 percent, annual rate, in Q4), consumption rose briskly in Q1 (3.8 percent, annual rate). A firm labor market, drawdown of pandemic-related savings, and credit expansion (annual growth of 9.6 percent in revolving credit in Q1) likely all contributed to support an active consumer.

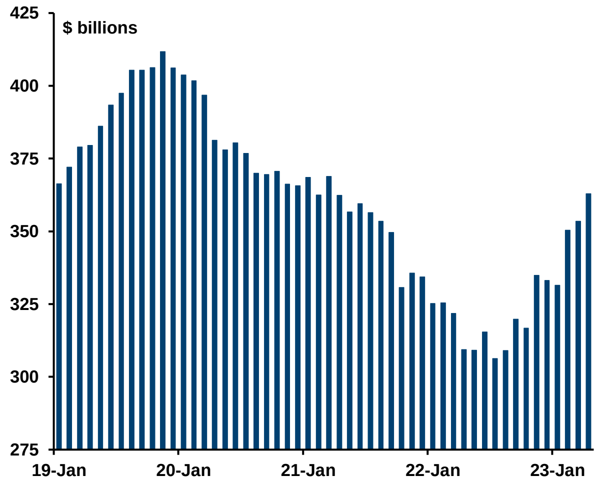
Adjustments thus far by businesses have been mild. New orders for capital goods have slowed, but not dramatically so. Business investment in new structures has rebounded sharply in recent months as well (charts).

New Orders for Durable Goods



Source: U.S. Census Bureau via Haver Analytics

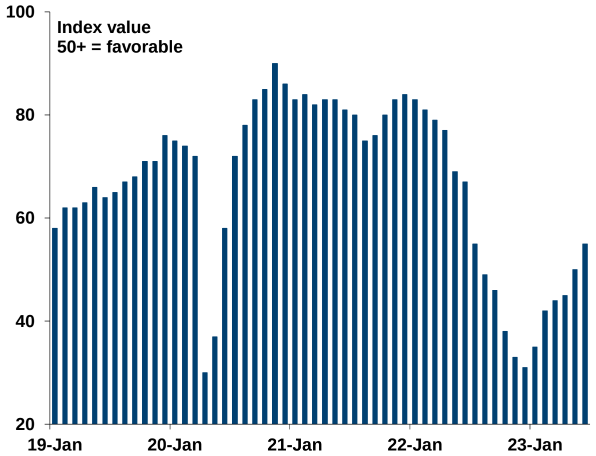
Business-Related Construction



Source: U.S. Census Bureau via Haver Analytics

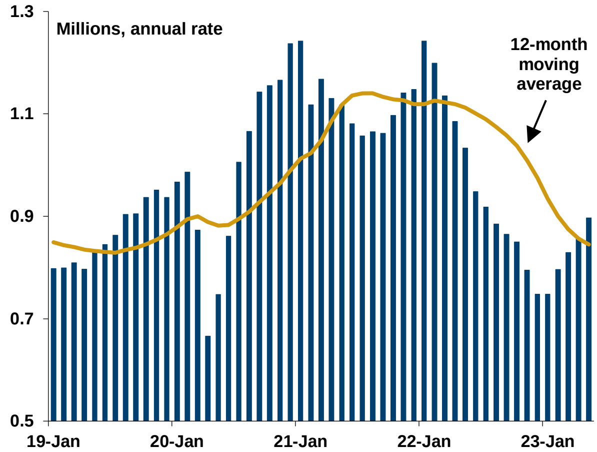
More encouragingly, the housing market and residential construction have shown signs of life despite acute affordability issues compounded by elevated interest rates, high prices, and limited inventories. The builder sentiment index published by the National Association of Home Builders has turned higher recently, and recent data on single-family housing starts and permits suggest a rebound in construction in response to improving conditions (charts). Residential construction appears poised to shift from a notable drag to a modest one. Positives aside, challenges could intensify in the months ahead (see below).

Housing Market Index



Source: National Association of Home Builders via Haver Analytics

Single-Family Building Permits

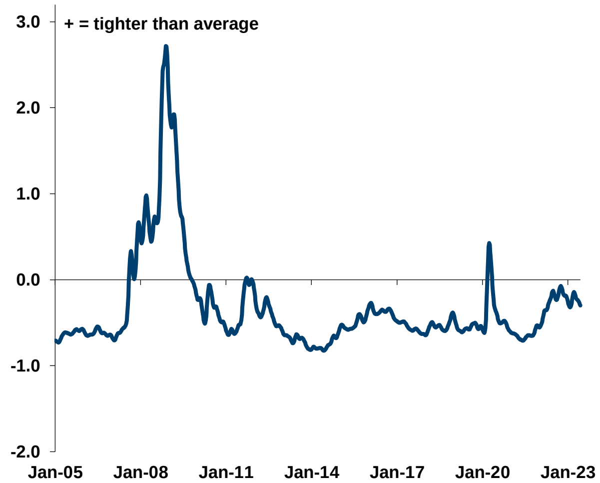


Source: U.S. Census Bureau via Haver Analytics

H2: Restrictive Policy Tips the Scales

The adjustment to the Summary of Economic Projections released with last week's FOMC statement, where the median expectation of Fed officials for the federal funds rate was raised to 5.625 percent from 5.125 percent, and the reaffirmation of the need for additional rate hikes by Fed Chair Powell in his Congressional testimony this week have increased our confidence in the resolve of policy makers to slow inflation back to the target rate in the medium term. In our view, the clear signal from Chair Powell and his colleagues is that they do not yet see inflation as settling on a trajectory back to two percent. As a result, policymakers are aiming to maintain tight financial conditions through a restrictive policy setting to further constrain aggregate demand (chart).

National Financial Conditions Index

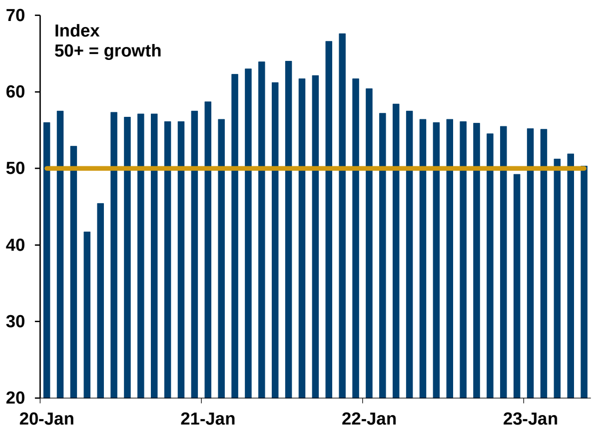


Source: Federal Reserve Bank of Chicago via Haver Analytics

Data beyond those linked to the interest-sensitive housing and factory sectors have recently suggested that the cumulative effects of restrictive monetary policy is more broadly influencing the real economy. The ISM services index, which covers industries just shy of 90 percent of economic output on a gross-value-added basis, slowed to a reading of 50.3 in May after averaging 56.1 last year and 53.8 in the first quarter of 2023 (chart; next page, left). The reading suggests that the service sector of the economy, which has driven growth for some time, could be tipping into contraction. Similarly, initial claims for unemployment insurance could be flashing warning signs, averaging 263k in the first three weeks of June after remaining close to (or below) the restrained pre-pandemic average for much of the prior 12 months (chart; next page, right). We would wait a few more weeks before drawing broad conclusions, but unemployment claims often send reliable signals on the labor market.

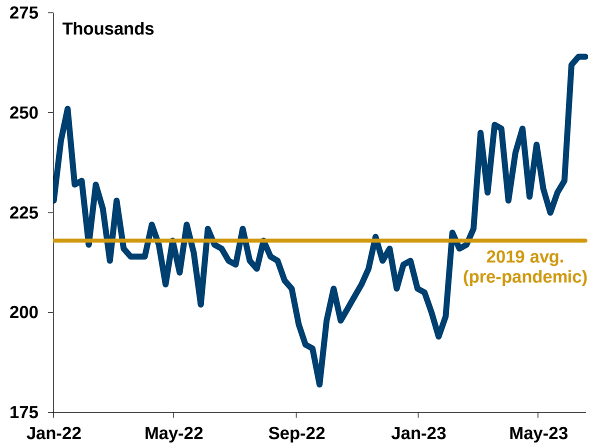
The deteriorating data heading into H2 point us in the direction of key sectors that could nudge the economy into recession, a more negative view than that transmitted by recent Fed forecasts. A softening job market could curtail activity in the consumer sector, which recent research by the Federal Reserve Bank of San Francisco suggests has already exhausted a significant portion of excess saving accumulated during the pandemic. (Abdelrahman, Hamza and Oliveira, Luiz E. “The Rise and Fall of Pandemic Excess Savings.” FRBSF Economic Letter, Federal Reserve Bank of San Francisco, 8 May 2023, https://www.frbsf.org/economic-research/publications/economic-letter/2023/may/rise-and-fall-of-pandemic-excess-savings/.) Also, upcoming resumption of federal student loan payments could further constrain consumer wherewithal. In addition, while the business sector has made moderate adjustments in 2023 thus far (see previous section), further retrenchment in capital spending or a partial reversal of the recovery in construction activity could ensue of credit conditions tighten further and underlying demand softens. Moreover, it’s easy to envision the residential construction sector turning lower again if job losses accelerate.

ISM Services Index



Source: Institute for Supply Management via Haver Analytics

Initial Claims for Unemployment Insurance



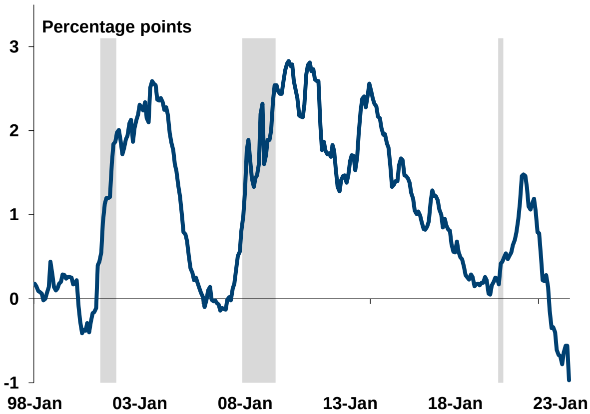
Source: U.S. Department of Labor via Haver Analytics

While examining downside risks is a necessary exercise, we would be remiss if we failed to highlight mitigating factors. The labor market may be softening, but firms appear to be retaining more workers in the face of recession than in past cycles, cutting hours rather than trimming headcounts. Survey data attributes the dynamic in part to trouble encountered rehiring skilled workers but also points to expectations for a pickup in demand in the near future. Also, we have paid close attention to intellectual property investment in the GDP accounts, which increased 8.2 percent on a Q4/Q4 basis in 2022 and 5.2 percent, annual rate, in Q1 – suggesting sustained investment in anticipation of a rapid pivot. Finally, we interpret the modest rebound in residential construction as showing an adjustment to an environment of higher interest rates. All these factors could limit downside and promote rapid recovery.

Interest Rates

The financial markets are likely to experience an unusual pattern in interest rates over the balance of the year in response to the recent economic performance and the telegraphed path of Fed policy. Historically, the Federal Reserve reacted quickly to downside risks to growth by easing policy, which eliminated any inversion in the yield curve that had developed or steepened the curve if it had been positively sloped. In this instance, the recent hawkish signals have intensified the inversion now in place (chart).

Treasury Yield Curve*



** The 10-year Treasury rate less the rate on two-year Treasury securities. Monthly data except for the last observation which is the daily spread for June 22, 2023. The shaded areas in the chart indicate periods of recession in the United States.*
Sources: National Bureau of Economic Research, Federal Reserve Board via Haver Analytics

We expect the inversion of approximately 100 basis points to reverse somewhat in coming months as slowing growth and inflation open the possibility of a peak and eventual cut in the federal funds rate, but the process is likely to unfold slowly and more near-term pressure on rates in both the short end and long end is possible as repricing occurs amid market participants digesting recent monetary policy developments (see outlook table, next page).

U.S. Economic Outlook*

(Percent change annual rate, unless otherwise noted)

Item		2023 Q1	2023 Q2	2023 Q3	2023 Q4
1	Gross Domestic Product	1.3	0.5	-0.2	-1.0
2	Personal Consumption Expenditures	3.8	1.0	-0.5	-1.5
3	Business Fixed Investment	1.4	0.8	0.8	0.6
4	Residential Construction	-5.4	-2.0	-1.5	-1.0
5	Change in Business Inventories *(Contribution to growth)*	-2.1	0.6	-0.1	-0.2
6	Government Spending	5.2	1.5	1.5	1.0
7	Net Exports *(Contribution to growth)*	0.0	-1.0	-0.4	-0.5
	Inflation and Unemployment				
9	Core PCE Price Index *(Annual rate)*	4.9	4.3	3.8	3.6
10	Unemployment Rate	3.5	3.8	4.0	4.2
	Interest Rates (End of Period)				
11	Federal Funds Target (midpoint)	4.88	5.13	5.63	5.63
12	2-year Treasury	3.95	4.75	4.70	4.50
13	10-year Treasury	3.53	3.75	3.80	3.75
14	30-year Fixed-Rate Mortgages	6.24	7.00	6.90	6.75

** The readings for 2023-Q2 to 2023-Q4 are forecasts.*

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board, Daiwa Capital Markets America

The Week Ahead

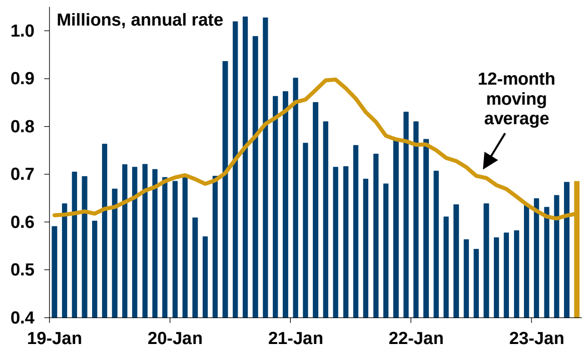
Durable Goods Orders (May) (Tuesday)
Forecast: 0.2 Percent Total; 0.0 Percent Ex. Transportation

An increase in new aircraft orders reported by Boeing suggests an advance in the civilian aircraft component in May, but a drop in defense-related aircraft bookings after back-to-back strong months could provide a partial offset. With broad economic conditions softening, and the manufacturing sector contracting, orders excluding transportation are likely to be sluggish.

New Home Sales (May) (Tuesday)
Forecast: 0.685 Million (+0.3 Percent)

Sales of new homes have moved higher since the recent low of 0.543 million in July of last year, with the recent recovery leaving sales activity close to that prior to the onset of the pandemic (chart). Activity undoubtedly is picking up, but mortgage rates exceeding seven percent and elevated prices are still meaningful constraints on buyers, which could limit additional upside after a combined jump of 8.2 percent in sales in the prior two months.

New Home Sales*



** The gold bar is a forecast for May 2023.*
Sources: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

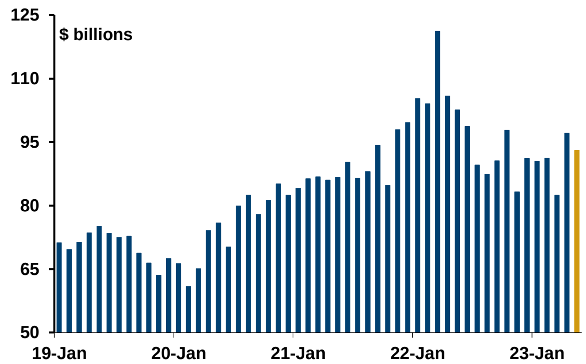
Consumer Confidence (June) (Tuesday)
Forecast: 103.0 (+0.7 Percent)

With inflation still brisk and the labor market showing signs of softening, consumer confidence is likely to remain range bound in June.

International Trade in Goods (May) (Wednesday)
Forecast: $93.0 Billion ($4.1 Billion Narrower Deficit)

The trade deficit in goods could narrow in May after a widening of $14.6 billion in the prior month, which reflected a drop of 5.3 percent in exports and pickup of 2.1 percent in imports. Sluggish growth in the economies of major trading partners could continue to weigh on U.S. exports in May, but imports could ease and lead to improvement in the monthly deficit. Lower prices of petroleum products could constrain the value of U.S. imports of industrial supplies, while imports of consumer goods could cool after back-to-back increases.

Nominal Trade Deficit in Goods*



** The gold bar is a forecast for May 2023.*
Sources: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

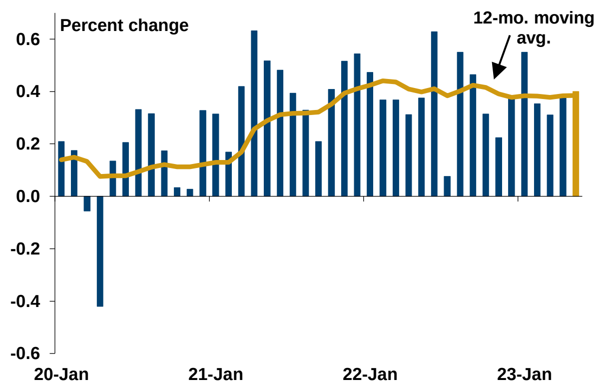
Revised GDP (2023-Q1) (Thursday)
Forecast: 1.5 Percent (+0.2 Pct. Pt. Revision)

The final estimate of GDP for Q1 is likely to be close to the previous reading, but new information on consumer spending and trade suggest a modest upward adjustment.

Personal Income, Consumption, Core PCE Price Index (May) (Friday)
Forecast: 0.2 Percent Income; 0.2 Percent Consumption; 0.4 Percent Core PCE Index

A pickup in average hourly earnings suggests a modest increase in the wages and salaries component of personal income. Growth of rental income has been brisk, and elevated interest rates could boost interest income. On the spending side, a decline in new vehicle sales could constrain outlays for durable goods, but a pickup in key retail categories could boost outlays for nondurable items. Additionally, outlays for services remained firm. Results for the CPI suggest a rapid increase in the core price index for personal consumption expenditures.

Core PCE Price Index*



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

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Economic Indicators

June/July 2023

Monday	Tuesday	Wednesday	Thursday	Friday
19	20	21	22	23
NAHB HOUSING INDEX Apr 45 May 50 June 55 **JUNETEENTH NATIONAL INDEPENDENCE DAY**	**HOUSING STARTS** Mar 1.380 million Apr 1.340 million May 1.631 million	**POWELL MONETARY POLICY TESTIMONY (HOUSE)**	**UNEMPLOYMENT CLAIMS** Initial / Continuing (millions) May 27 0.233 1.755 June 3 0.262 1.772 June 10 0.264 1.759 June 17 0.264 N/A **CHICAGO FED NATIONAL ACTIVITY INDEX** Monthly / 3-Mo. Avg. Mar -0.41 -0.12 Apr 0.14 -0.20 May -0.15 -0.14 **CURRENT ACCOUNT** 22-Q3 -$222.8 bill. 22-Q4 -$216.2 bill. 23-Q1 -$219.3 bill. **EXISTING HOME SALES** Mar 4.43 million Apr 4.29 million May 4.30 million **LEADING INDICATORS** Mar -1.2% Apr -0.6% May -0.7% **POWELL MONETARY POLICY TESTIMONY (SENATE)**	
26	27	28	29	23
	DURABLE GOODS ORDERS (8:30) Mar 3.3% Apr 1.1% **May 0.2%** **FHFA HOME PRICE INDEX (9:00)** Feb 0.7% Mar 0.6% Apr -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** Feb -0.1% Mar 0.5% Apr -- **NEW HOME SALES (10:00)** Mar 0.656 million Apr 0.683 million **May 0.685 million** **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Apr 103.7 May 102.3 **June 103.0**	**INTERNATIONAL TRADE IN GOODS (8:30)** Mar -$82.5 billion Apr -$97.1 billion **May -$93.0 billion** **ADVANCE INVENTORIES (8:30)** Wholesale / Retail Mar -0.2% 0.4% Apr -0.1% 0.1% May -- --	**UNEMP. CLAIMS (8:30)** **REVISED GDP (8:30)** GDP / Chained Price 22-Q4 2.6% 3.9% 23-Q1(p) 1.3% 4.2% **23-Q1(r) 1.5% 4.2%** **PENDING HOME SALES (10:00)** Mar -5.2% Apr 0.0% May --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Mar 0.3% 0.1% 0.3% Apr 0.4% 0.8% 0.4% **May 0.2% 0.2% 0.4%** **MNI CHICAGO BUSINESS BAROMETER (9:45)** Index / Prices Apr 48.6 70.3 May 40.4 60.9 June -- -- **REVISED CONSUMER SENTIMENT (10:00)** Apr 63.5 May 59.2 June(p) 63.9
3	4	5	6	7
CONSTRUCTION **ISM MFG.** **VEHICLE SALES**	**INDEPENDENCE DAY**	**FACTORY ORDERS** **FOMC MINUTES**	**UNEMP. CLAIMS** **ADP EMPLOYMENT** **TRADE BALANCE** **JOLTS DATA** **ISM SERVICES**	**EMPLOYMENT REPORT**
3	4	5	6	7
WHOLESALE TRADE **CONSUMER CREDIT**	**NFIB SMALL BUSINESS OPTIMISM INDEX**	**CPI** **BEIGE BOOK**	**UNEMP. CLAIMS** **PPI** **FEDERAL BUDGET**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**

Forecasts in bold. (p) = preliminary (2nd estimate of GDP); (r) = revised (3rd estimate of GDP)

Treasury Financing

June/July 2023

Monday	Tuesday	Wednesday	Thursday	Friday
19	20	21	22	23
JUNETEENTH NATIONAL INDEPENDENCE DAY	**ANNOUNCE:** 13-week bills 5.130% 2.58 26-week bills 5.170% 2.65 42-day CMBs 5.070% 2.77 **ANNOUNCE:** $70 billion 4-week bills for auction on June 22 $60 billion 8-week bills for auction on June 22 $46 billion 17-week bills for auction on June 21 **SETTLE:** $65 billion 4-week bills $55 billion 8-week bills $46 billion 17-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 5.220% 3.27 20-yr bonds 4.010% 2.87	**AUCTION RESULTS:** Rate Cover 4-week bills 5.010% 2.93 8-week bills 5.140% 2.78 5-yr TIPS 1.832% 2.56 **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 $50 billion 42-day CMBs for auction on June 27 **SETTLE:** $123 billion 13-,26-week bills $50 billion 42-day CMBs	
26	27	28	29	30
AUCTION: $123 billion 13-,26-week bills $42 billion 2-year notes	**AUCTION:** $43 billion 5-year notes $50 billion 42-day CMBs **ANNOUNCE:** $70 billion* 4-week bills for auction on June 29 $60 billion* 8-week bills for auction on June 29 $46 billion* 17-week bills for auction on June 28 **SETTLE:** $70 billion 4-week bills $60 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:** $70 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $123 billion* 13-,26-week bills for auction on July 3 **SETTLE:** $123 billion 13-,26-week bills $50 billion 42-day CMBs	**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
3	4	5	6	7
AUCTION: $123 billion* 13-,26-week bills **ANNOUNCE:** $70 billion* 4-week bills for auction on July 6 $60 billion* 8-week bills for auction on July 6 $46 billion* 17-week bills for auction on July 5	**INDEPENDENCE DAY**	**AUCTION:** $46 billion* 17-week bills **SETTLE:** $70 billion* 4-week bills $60 billion* 8-week bills $46 billion* 17-week bills	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $123 billion* 13-,26-week bills for auction on July 10 $38 billion* 52-week bills for auction on July 11 $40 billion* 3-year notes for auction on July 11 $32 billion* 10-year notes for auction on July 12 $18 billion* 30-year bonds for auction on July 13 **SETTLE:** $123 billion* 13-,26-week bills	
3	4	5	6	7
AUCTION: $123 billion* 13-,26-week bills	**AUCTION:** $38 billion* 52-week bills $40 billion* 3-year notes **ANNOUNCE:** $70 billion* 4-week bills for auction on July 13 $60 billion* 8-week bills for auction on July 13 $46 billion* 17-week bills for auction on July 12 **SETTLE:** $70 billion* 4-week bills $60 billion* 8-week bills $46 billion* 17-week bills	**AUCTION:** $46 billion* 17-week bills $32 billion* 10-year notes	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills $18 billion* 30-year bonds **ANNOUNCE:** $123 billion* 13-,26-week bills for auction on July 17 $12 billion* 20-year bonds for auction on July 19 $17 billion* 10-year TIPS for auction on July 20 **SETTLE:** $123 billion* 13-,26-week bills $38 billion* 52-week bills	

**Estimate*