U.S. Economic Comment

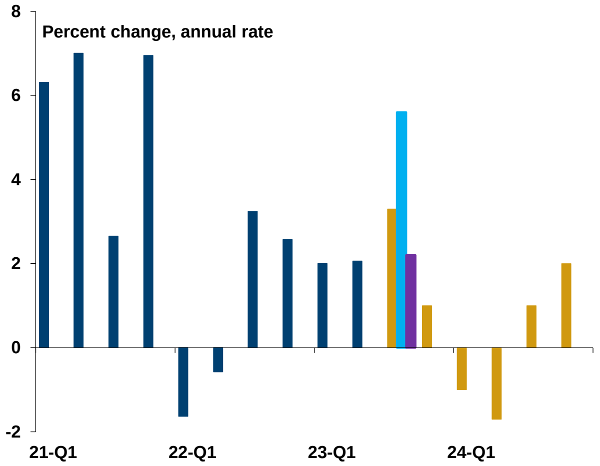
- Forecast update: brisk near-term growth, but odds still favor recession next year
- Monetary policy: FOMC to maintain restrictive policy "for some time" to combat sticky inflation

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

Forecast Update

With data for the third quarter of 2023 beginning to trickle in, and with the Federal Open Market Committee set to meet in two weeks, it seemed appropriate to provide an updated view on the trajectories of the U.S. economy and Federal Reserve policy. The task of projecting the path of the economy is particularly challenging at this juncture. On one hand, the U.S. economy has proved resilient to rapid removal of monetary accommodation. Consumers appeared active in the early summer, the labor market remains on solid footing, and businesses have not retrenched despite a challenging landscape. On the other hand, consumers may be reaching a tipping point, cracks are showing in the commercial real estate market, and the banking sector only narrowly avoided more severe volatility amid a series of failures in the spring.

GDP Growth*



** The gold bars are forecasts for 2023-Q3 to 2024-Q4, while the light blue and purple bars are estimates for 2023-Q3 from the Federal Reserve Bank of Atlanta's GDPNow model and the Federal Reserve Bank of New York's GDP Nowcast, respectively.*

Sources: Bureau of Economic Analysis via Haver Analytics; Federal Reserve Bank of Atlanta; Federal Reserve Bank of New York; Daiwa Capital Markets America

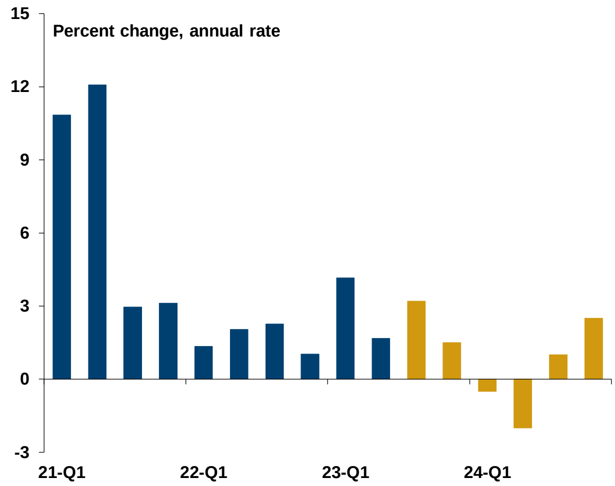
It is important to avoid giving into recency bias in assessing the economic landscape. The economy has remained on track while inflation has moderated, and chatter about a so-called "soft landing" has persisted, perhaps even intensified, despite the relatively low probability of such an outcome. In addition, the early data suggest that growth in Q3 is shaping up to be brisk (chart). We do not share the optimism of the Atlanta Fed GDPNow model, which projects growth of 5.6 percent (!), but even a more restrained performance would be highly favorable. For instance, growth close to that of the just relaunched New York Fed Nowcast model of 2.2 percent would mark the third consecutive quarter of above-potential output growth, which we view as 1.50 to 1.75 percent. However, the more salient concern is how the economy will evolve over the next six to 12 months as the prior adjustments to monetary policy, which often transmit with long lags, constrain economic activity. It is tempting to extrapolate the current performance into next year (a "soft landing," or perhaps a "no landing" scenario), but we caution against this view. Given developments under the surface, we suspect that risks are tilted to the downside and that recession could emerge next year. Specifically, we see the economy contracting in 24-H1 before rebounding the second half of the year (Q4/Q4 growth of 0.1 percent 2024 following 2.1 percent in 2023).

Growth in Q3 and Beyond

The near-term performance of the U.S. economy is particularly favorable (see above), with consumer spending a key driver of the anticipated strong performance. Data on real consumer spending for July (+0.6 percent) suggests a quarterly advance in the area of 3.0 to 3.5 percent, annual rate (chart, next page). Moreover, anecdotal news reports indicate that consumers appear eager to shake remaining memories of COVID-related shutdowns. People are traveling, arenas are full for concerts and sporting events, and restaurants and bars are bustling. We suspect that the momentum could carry over into Q4, especially as the holidays approach, but we are concerned about its performance thereafter.

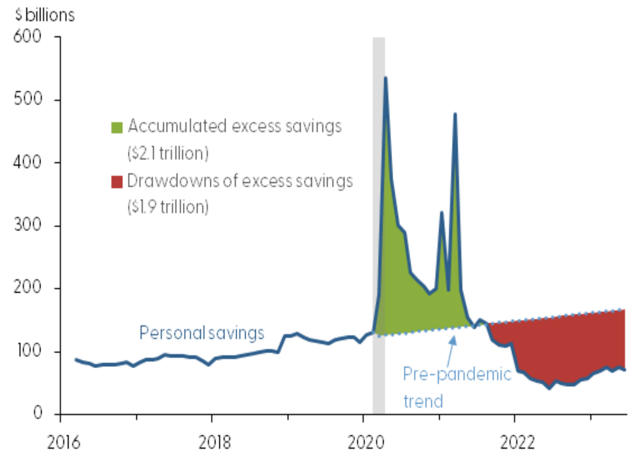
Beyond Q4, we suspect that excess saving accumulated during the pandemic by way of various tax credits and government transfers, a key tailwind for consumer spending, will have run its course. This view is supported by recent research from the Federal Reserve Bank of San Francisco (chart, below left). Moreover, the pandemic-related pause in student loan repayments, in effect since March 2020, is set to end in October. Data from the Treasury Department's Daily Treasury Statement indicate that repayments have already restarted, with deposits made with the Department of Education between Monday August 1st and Wednesday September 6th (latest available) cumulating to $9.2 billion versus $2.1 billion in July and $1.2 billion in June (chart, below right). The payments are not entirely composed of student loans, but the dramatic shift represents predominately those remittances to the government. The constraint on outlays in coming months could act as a significant cap on discretionary spending, especially coupled with dwindling savings.

Growth of Real Consumer Spending*



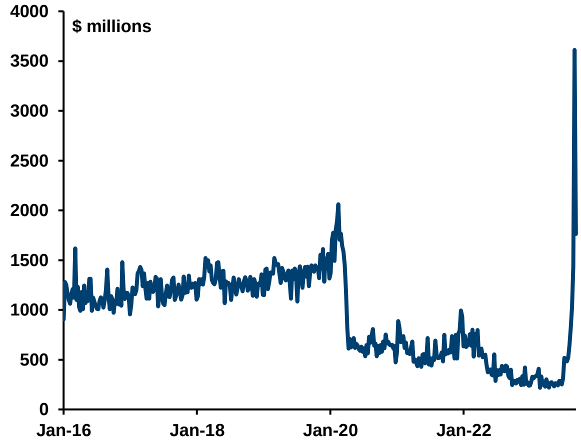
** The readings for 2023-Q3 to 2024-Q4 are forecasts.*
Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

Aggregate Personal Savings



Source: Abdelrahman, Hamza et al., "Excess No More? Dwindling Pandemic Savings," Federal Reserve Bank of San Francisco, Aug. 2023.
https://www.frbsf.org/our-district/about/sf-fed-blog/excess-no-more-dwindling-pandemic-savings/

Cash Deposited to the Department of Edu.*

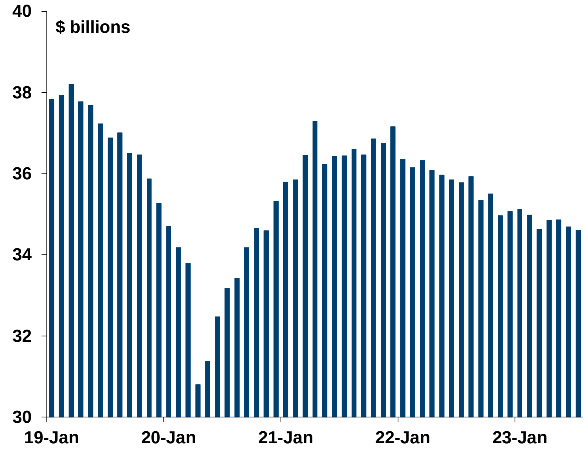


** Weekly data except for the latest observation which is the sum of daily quotes for September 5 and 6, 2023.*
Source: U.S. Department of the Treasury via Haver Analytics; Daiwa Capital Markets America

Furthermore, prospects for the business sector leave us less enthusiastic as well. Business investment in structures has posted double-digit growth in the past three quarters, including an advance of 11.3 percent, annual rate, in Q2 after contracting for much of the current expansion. However, beyond a near-term boost from onshoring of capacity for microprocessors and development of factory space to assist in the "Green Transition," we expect the environment to remain challenging as long as financial conditions remain tight. Credit standards for commercial and industrial loans and real estate have only recently tightened, and interest rates for corporate borrowing have moved higher. Subsequently, the availability of cheap financing is fading. Similarly, although equipment spending picked up in Q2 (+7.7 percent, annual rate), it declined in the prior two quarters and firms are unlikely to engage in robust equipment spending with current risks to the outlook. Data on inflation-adjusted new orders for capital goods excluding aircraft support the view of this reluctance to invest (chart, next page, below left).

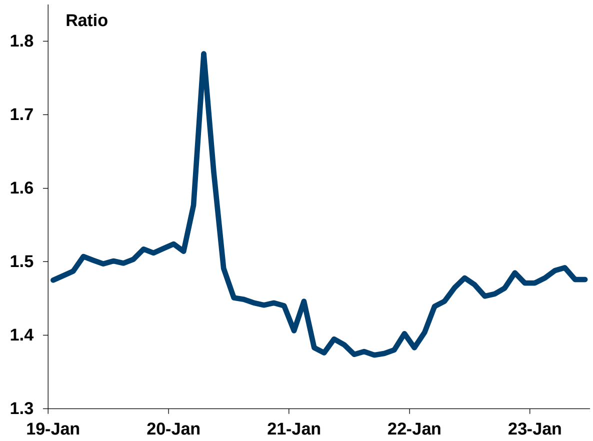
Hesitancy on the part of firms because of an uncertain outlook also has led to cautious inventory management after wide swings in the past few years stemming from pandemic-related disruptions. While we suspect that inventory investment will be an ongoing modest drag on growth in coming quarters, inventories are relatively well aligned to sales, with the real ratio comparable to where it was prior to the onset of the pandemic, and to longer-term norms (chart, below right). The chance of wide swings in the near-term appear to have been substantially reduced through careful inventory management and.

New Orders for Durable Goods*



** Nominal orders of nondefense capital goods excluding aircraft adjusted by the private capital equipment component of the producer price index.*
Sources: Bureau of Labor Statistics and U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

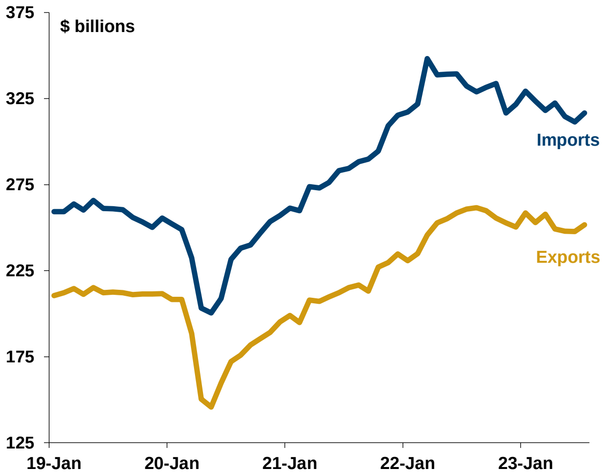
Real Inventories/Sales Ratio



Source: Bureau of Economic Analysis via Haver Analytics

Other sectors of the economy are likely to make modest contributions, some favorable and others less so. Continued deployment of unspent funds from the pandemic could boost government spending, although that impulse should fade into next year. On the other side of the coin, the recent surge in mortgage interest rates and resulting drop in demand could crush the nascent rebound in single-family construction even as multi-family building retreats from a strong performance earlier in the recovery. Watching the trade sector especially closely, we are expect net exports to be a modest drag on growth over the forecast horizon, as sluggish performances in the economies of major trading partners and a firm foreign exchange value of the dollar act as constraints on exports, but potential sharp slowing in China's growth trajectory, among other potential developments, pose risks to the outlook (charts).

U.S. Imports & Exports of Goods & Services



Source: Bureau of Economic Analysis via Haver Analytics

Dollar Index Spot*

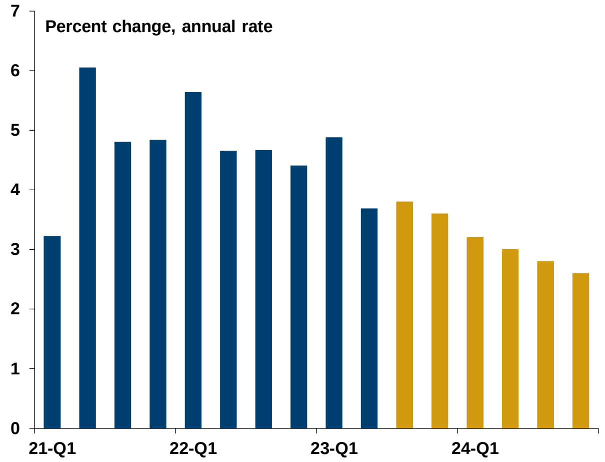
** Weekly average data except for the latest observation which is a daily quote from September 8, 2023.*
Source: Bloomberg

Inflation and the Fed's Ongoing Response

Amid firm near-term growth and continued supply-demand imbalances in both the labor market and broader economy, we anticipate that inflation – which has fallen sharply from its peak – will continue to recede on account of both sufficiently restrictive monetary policy and a return to more normal conditions in the economy post-COVID.

However, we suspect that continued deceleration in core PCE inflation from 4.2 percent, year-over-year, currently (and a peak of 5.4 percent in March 2022) back to the Federal Reserve's two percent target will take place slowly over the next two years (chart). Goods inflation has cooled sharply, but more may be required. Moreover, shelter inflation has moderated, but the current pace is still inconsistent with the two percent inflation target and recent data again suggest that shelter costs are again accelerating. Costs of core services excluding shelter have yet to show meaningful deceleration.

Core PCE Price Index*



** PCE = personal consumption expenditures. The readings for 2023-Q3 to 2024-Q4 are forecasts.*

Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

In the current environment and especially considering Chair Powell's emphasis at the Jackson Hole Monetary Policy Symposium that inflation remains "too fast," we do not expect the Fed to yet declare victory on inflation. That said, we suspect that New York Fed President John Williams' characterization this week of policy being in a "good place" indicates that it is close to being sufficiently restrictive to bring down inflation over time. We still anticipate the FOMC hiking rates once more, thereby matching the Committee's median projection of 5.625 percent in the June dot plot published with the Summary of Economic Projections, but we suspect that the focus of Fed officials now will shift to assessing what defines "an extended period" of restrictive policy. We currently project the pivot to occur mid-year 2024, as the combination of sluggish economic activity and compelling evidence of a deceleration in inflation toward two percent take hold.

U.S. Economic Outlook Table*

(Percent change annual rate, unless otherwise noted)

		2023				2024			
Item		**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
1	Gross Domestic Product	2.0	2.1	3.3	1.0	-1.0	-1.7	1.0	2.0
2	Personal Consumption Expenditures	4.2	1.7	3.2	1.5	-0.5	-2.0	1.0	2.5
3	Business Fixed Investment	0.6	6.1	0.9	-2.0	-4.2	-1.0	1.2	2.0
4	Residential Construction	-4.0	-3.6	4.0	1.5	-1.0	-1.5	2.5	4.0
5	Change in Business Inventories *(Contribution to growth)*	-2.1	-0.1	0.4	0.0	-0.1	-0.1	0.1	0.0
6	Government Spending	5.0	3.3	2.5	1.0	0.5	0.5	0.5	0.4
7	Net Exports *(Contribution to growth)*	0.6	-0.2	0.0	0.0	-0.1	-0.1	-0.1	-0.2
	Inflation and Unemployment								
9	Core PCE Price Index *(Annual rate)*	4.9	3.8	3.3	3.2	3.2	3.0	2.8	2.6
10	Unemployment Rate	3.5	3.6	3.9	4.0	4.2	4.4	4.3	4.3
	Interest Rates (End of Period)								
11	Federal Funds Target (midpoint)	4.88	5.13	5.38	5.63	5.63	5.13	4.63	4.13
12	2-year Treasury	3.95	4.87	4.75	4.50	4.20	3.85	3.50	3.20
13	10-year Treasury	3.53	3.81	4.00	3.95	3.80	3.70	3.55	3.35
14	30-year Fixed-Rate Mortgages	6.24	6.70	7.10	6.85	6.65	6.45	6.20	5.95

** The readings for 2023-Q3 to 2024-Q4 are forecasts.*

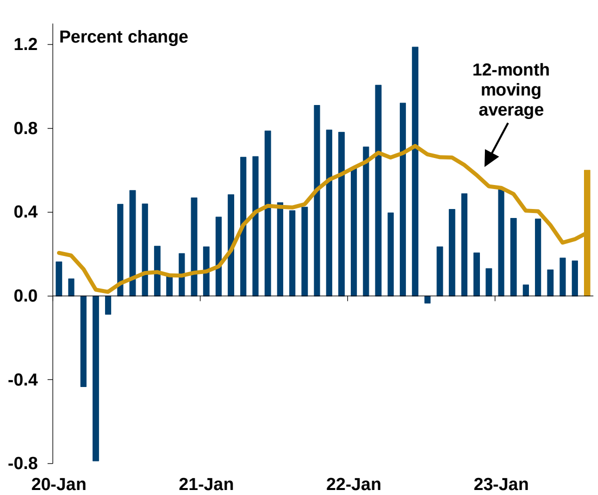
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board, Daiwa Capital Markets America

The Week Ahead

CPI (August) (Wednesday)
Forecast: 0.6% Total, 0.2% Core

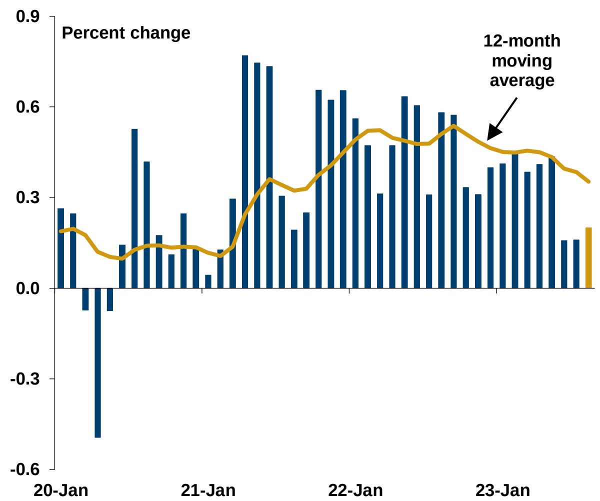
Shifts in retail gasoline prices raise the possibility of a jump in the energy component in August, which could mark a turning point in the downward trend since the expansion peak in June 2022. At the peak, energy prices were more than 83 percent above the post-shutdown low in May 2020; even with recent cooling, the energy component remains well above pre-COVID readings. The trend in food inflation has moderated sharply, with price increases averaging 0.2 percent per month in the first seven months of 2023 versus 0.8 percent per month in 2022. However, food prices are still approximately 20 percent above expansion lows. The core component could match the subdued increases of 0.2 percent in the prior two months after averaging 0.4 percent in the first five months of 2023 (chart, right). Core goods inflation has eased sharply, while shelter inflation has only slowed somewhat from its previously rapid pace.

Headline CPI*



** The gold bar is a forecast for August 2023.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

Core CPI*



** The gold bar is a forecast for August 2023.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

Federal Budget (August) (Wednesday)
Forecast: -$230.0 Billion

A decline of approximately 10 percent in fiscal year-to-date revenues and a similar jump in outlays have led to a sharp deterioration in the U.S. government's already strained fiscal position, with the deficit in the first 10 months of FY2023 of $1.61 trillion already exceeding the already wide deficit of $1.38 trillion for the entirety of FY2022. Adding to the rather bleak picture, data in hand suggest that the monthly deficit could eclipse $200 billion for the fourth consecutive month, with the projected tally pushing the cumulative deficit for the first 11 months of FY2023 to $1.84 trillion.

PPI (August) (Thursday)
Forecast: 0.5% Total, 0.2% Ex. Food & Energy

Available data suggest that energy prices jumped during the August survey period. Food prices at the producer level often move erratically, but they have fallen in six of the past eight months (and have shown almost imperceptible month-to-month changes, on average, in the past 12 months), suggesting the bout of price pressure in this area has largely subsided. Core goods prices have increased 0.1 percent per month, on average, while core service prices have advanced at a slightly faster pace -- 0.15 percent inclusive of a jump of 0.5 percent in July. The trend in construction costs has slowed notably, with an average decline of 0.2 percent per month in the past six months after a surge of 1.9 percent in January.

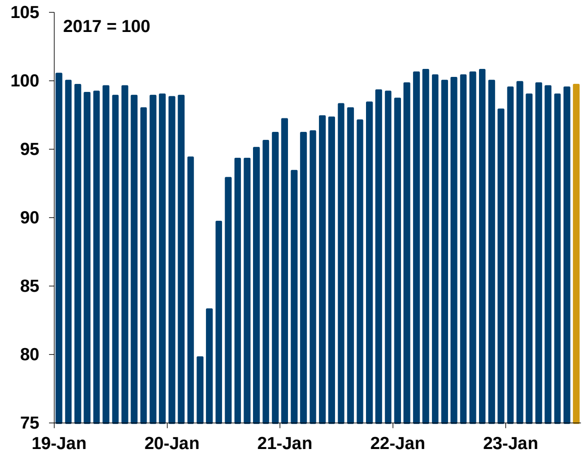
Retail Sales (August) (Thursday)
Forecast: 0.4% Total, 0.8% Ex. Autos, 0.3% Ex. Autos & Gasoline

A notable portion of the expected advance in retail sales in August reflects our expectation that higher prices contributed to brisk (nominal) activity at gasoline stations. While a drop in vehicle sales suggests that the auto component eased, and activity excluding autos and gas could increase only moderately after a jump of 1.0 percent in July, the consumer has remained surprisingly active despite headwinds from rapid inflation and diminished savings acquired during the pandemic-related shutdowns.

Industrial Production (August) (Friday)
Forecast: 0.3%

Data on hiring and hours worked in the factory sector suggest a modest advance in the manufacturing component of industrial production (0.2 percent) after a jump of 0.5 percent in July, although the gains – realized and anticipated – would merely offset easing in May/June and leave a flat trend (chart). Longer workweeks in the mining sector also suggest a pickup in output, although this area is still well-below pre-COVID readings. A pickup in home cooling likely led to an uptick in utility output after a surge of 5.4 percent in July, although this area often swings widely and changes reflect shifts in weather rather than in economic fundamentals.

Industrial Production: Manufacturing*

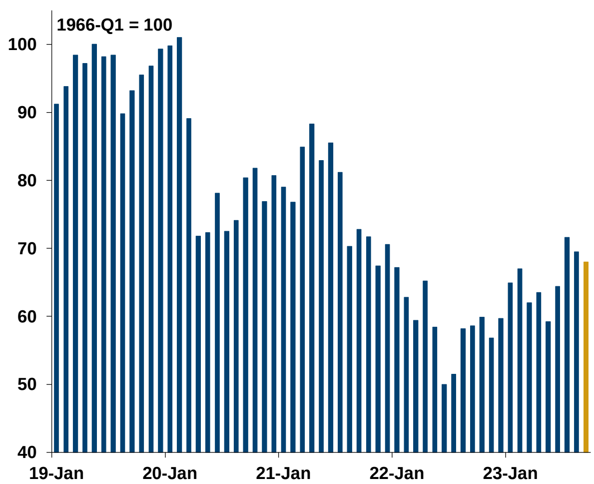


** The gold bar is a forecast for August 2023.*
Sources: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Consumer Sentiment (September) (Friday)
Forecast: 68.0 (-2.2%)

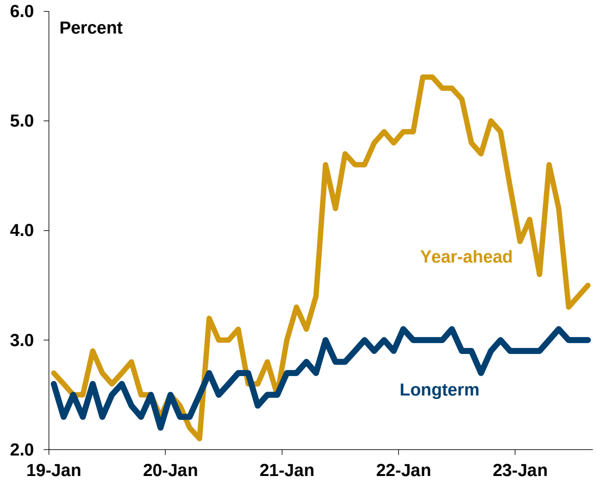
The recent jump in gasoline prices could contribute to a second consecutive decline in attitudes in early September, as could the looming resumption of student loan payments (chart, below left). Given the recent stirring in gas prices, we're keeping a close eye on the inflation gauges published with the Michigan report. The year-ahead measure is well off the recent high of 5.4 percent in March/April 2022, but it increased by one tick in each of the past two months after falling from 4.2 percent in May to 3.3 percent in June. The long-term measure, which is less responsive to fluctuations in energy prices, has remained in a tight range in 2023 (2.9 to 3.1 percent; chart, below right).

Consumer Sentiment*



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

Consumer Inflation Expectations



Source: University of Michigan via Haver Analytics

Economic Indicators

September 2023

Monday	Tuesday	Wednesday	Thursday	Friday
4	5	6	7	8
LABOR DAY	**FACTORY ORDERS** May 0.4% June 2.3% July -2.1%	**TRADE BALANCE** May -$66.8 billion June -$63.7 billion July -$65.0 billion **ISM SERVICES INDEX** Index / Prices June 53.9 / 54.1 July 52.7 / 56.8 Aug 54.5 / 58.9 **BEIGE BOOK** **August 2023:** "Contacts from most Districts indicated economic growth was modest during July and August."	**UNEMPLOYMENT CLAIMS** Initial / Continuing (millions) Aug 12 0.240 / 1.697 Aug 19 0.232 / 1.719 Aug 26 0.229 / 1.679 Sep 2 0.216 / N/A **REVISED PRODUCTIVITY & COSTS** Productivity / Unit Labor Costs 23-Q1 -1.2% / 3.3% 23-Q2 (p) 3.7% / 1.6% 23-Q2 (r) 3.5% / 2.2%	**WHOLESALE TRADE** Inventories / Sales May -0.4% / -0.5% June -0.7% / -0.8% July -0.2% / 0.8% **CONSUMER CREDIT** May $0.0 billion June $14.0 billion July $10.4 billion
11	12	13	14	15
	NFIB SMALL BUSINESS OPTIMISM INDEX (6:00) June 91.0 July 91.9 Aug --	**CPI (8:30)** Total / Core June 0.2% / 0.2% July 0.2% / 0.2% **Aug 0.6% / 0.2%** **FEDERAL BUDGET (2:00)** 2023 / 2022 June -$227.8B / -$88.8B July -$220.8B / -$211.1B **Aug -$230.0B** / -$219.6B	**UNEMP. CLAIMS (8:30)** **PPI (8:30)** Final Demand / Ex. Food & Energy June 0.0% / -0.1% July 0.3% / 0.3% **Aug 0.5% / 0.2%** **RETAIL SALES (8:30)** Total / Ex.Autos June 0.3% / 0.2% July 0.7% / 1.0% **Aug 0.4% / 0.8%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales May 0.0% / 0.1% June -0.1% / -0.1% **July 0.1% / 0.7%**	**EMPIRE MFG (8:30)** July 1.1 Aug -19.0 Sep -- **IMPORT/EXPORT PRICES (8:30)** Non-Petrol Imports / Nonagri. Exports June -0.3% / -0.6% July 0.0% / 0.6% Aug -- / -- **IP & CAP-U (9:15)** IP / Cap.Util. June -0.8% / 78.6% July 1.0% / 79.3% **Aug 0.3% / 79.3%** **CONSUMER SENTIMENT (10:00)** July 71.6 Aug 69.5 **Sep 68.0**
18	19	20	21	22
NAHB HOUSING INDEX **TIC FLOWS**	**HOUSING STARTS** **FOMC MEETING (FIRST DAY)**	**FOMC DECISION**	**UNEMP. CLAIMS** **CURRENT ACCOUNT** **PHILLY FED INDEX** **EXISTING HOME SALES** **LEADING INDICATORS**	
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **NEW HOME SALES** **CONSUMER CONFIDENCE**	**DURABLE GOODS ORDERS**	**UNEMP. CLAIMS** **REVISED Q2 GDP** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, AND PCE PRICE INDEX** **INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **MNI CHICAGO BUSINESS BAROMETER** **REVISED CONSUMER SENTIMENT**

Forecasts in bold. (p) = preliminary, (r) = revised

Treasury Financing

September 2023

Monday	Tuesday	Wednesday	Thursday	Friday
4	5	6	7	8
LABOR DAY	**AUCTION RESULTS:** Rate / Cover 13-week bills 5.315% 2.94 26-week bills 5.300% 3.02 52-week bills 5.120% 3.14 42-day CMBs 5.285% 3.04 **ANNOUNCE:** $50 billion 17-week bills for auction on Sep 6 $80 billion 4-week bills for auction on Sep 7 $70 billion 8-week bills for auction on Sep 7 **SETTLE:** $50 billion 17-week bills $80 billion 4-week bills $70 billion 8-week bills	**AUCTION RESULTS:** Rate / Cover 17-week bills 5.335% 2.98	**AUCTION RESULTS:** Rate / Cover 4-week bills 5.280% 2.70 8-week bills 5.290% 2.79 **ANNOUNCE:** $131 billion 13-,26-week bills for auction on Sep 11 $44 billion 3-year notes for auction on Sep 11 $35 billion 10-year notes for auction on Sep 12 $20 billion 30-year bonds for auction on Sep 13 $60 billion 42-day CMBs for auction on Sep 12 **SETTLE:** $131 billion 13-,26-week bills $42 billion 52-week bills $60 billion 42-day CMBs	
11	12	13	14	15
AUCTION: $131 billion 13-,26-week bills $44 billion 3-year notes	**AUCTION:** $35 billion 10-year notes $60 billion 42-day CMBs **ANNOUNCE:** $50 billion* 17-week bills for auction on Sep 13 $80 billion* 4-week bills for auction on Sep 14 $70 billion* 8-week bills for auction on Sep 14 **SETTLE:** $50 billion 17-week bills $80 billion 4-week bills $70 billion 8-week bills	**AUCTION:** $50 billion* 17-week bills $20 billion 30-year bonds	**AUCTION:** $80 billion* 4-week bills $70 billion* 8-week bills **ANNOUNCE:** $131 billion* 13-,26-week bills for auction on Sep 18 $13 billion* 20-year bonds for auction on Sep 19 $15 billion* 10-year TIPS for auction on Sep 21 **SETTLE:** $131 billion 13-,26-week bills $60 billion 42-day CMBs	**SETTLE:** $44 billion 3-year notes $35 billion 10-year notes $20 billion 30-year bonds
18	19	20	21	22
AUCTION: $131 billion* 13-,26-week bills	**AUCTION:** $13 billion* 20-year bonds **ANNOUNCE:** $50 billion* 17-week bills for auction on Sep 20 $80 billion* 4-week bills for auction on Sep 21 $70 billion* 8-week bills for auction on Sep 21 **SETTLE:** $50 billion* 17-week bills $80 billion* 4-week bills $70 billion* 8-week bills	**AUCTION:** $50 billion* 17-week bills	**AUCTION:** $80 billion* 4-week bills $70 billion* 8-week bills $15 billion* 10-year TIPS **ANNOUNCE:** $131 billion* 13-,26-week bills for auction on Sep 25 $48 billion* 2-year notes for auction on Sep 26 $49 billion* 5-year notes for auction on Sep 27 $37 billion* 7-year notes for auction on Sep 28 $24 billion* 2-year FRNs for auction on Sep 27 **SETTLE:** $131 billion* 13-,26-week bills	
25	26	27	28	29
AUCTION: $131 billion* 13-,26-week bills	**AUCTION:** $48 billion* 2-year notes **ANNOUNCE:** $50 billion* 17-week bills for auction on Sep 27 $80 billion* 4-week bills for auction on Sep 28 $70 billion* 8-week bills for auction on Sep 28 **SETTLE:** $50 billion* 17-week bills $80 billion* 4-week bills $70 billion* 8-week bills	**AUCTION:** $50 billion* 17-week bills $49 billion* 5-year notes $24 billion* 2-year FRNs	**AUCTION:** $80 billion* 4-week bills $70 billion* 8-week bills $37 billion* 7-year notes **ANNOUNCE:** $131 billion* 13-,26-week bills for auction on Oct 2 $42 billion* 52-week bills for auction on Oct 3 **SETTLE:** $131 billion* 13-,26-week bills	**SETTLE:** $15 billion* 10-year TIPS $24 billion* 2-year FRNs

**Estimate*