

US Macroeconomics

May 30, 2023

Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

Now We Can Refocus on the Data and the Fed

The Administration and Speaker McCarthy reached agreement on the broad contours of a debt ceiling increase that will extend out until 2025, which will be well past next year's Presidential Election. As expected, unused Covid-related funds will be returned and count towards deficit reduction (about \$60 billion). Internal Revenue Service funding will be reduced \$20 billion, but this was after last year's \$80 billion increase. Biden's defense budget and monies appropriated for the Inflation Reduction Act are untouched.

However, nondefense discretionary spending is scheduled to decline in 2024 to around fiscal year 2022 levels and then increase just 1% in 2025. Whether this modest belt-tightening stays in place over the next couple of appropriations cycles remains to be seen. History counsels caution.

In terms of timing, **the House of Representatives votes on the debt ceiling bill tomorrow, and the Senate votes on Friday**. This should provide enough time for the bill to become law by June 5, the new Treasury X-date. Consequently, investors should now look past the latest debt ceiling imbroglio and worry about the Fed. The futures market is discounting a better than 50% chance of a 25 basis point (bp) June 14 rate hike. A 25 bp hike by the July 26 FOMC meeting is nearly fully priced. Whether the Fed hikes next month, and we still believe they will not, is based on three factors — employment, market expectations and the consumer price index (CPI).

The June employment report is released this Friday. Our nonfarm payrolls projection is modestly above consensus on May jobs (220k versus 195k) but this does not change the downward trajectory in hiring. The three-month moving average slips from 222k to 213k if we are on the mark. While the unemployment rate is expected to remain at a 54-year low (3.4%), average hourly earnings are anticipated to be up just 0.3% which keeps the year-over-year rate at 4.4%. **If, however, we get a blowout NFP report, the Fed will lift rates because the bond market will be expecting it**. Policymakers almost never disappoint strong market expectations of a particular action, so we doubt this time will be different.

The only way the Fed would not hike in the face of a strong employment print is if the May CPI is much weaker than anticipated. But with the consensus of forecasters looking for 0.3% increases in both the headline and core, such results will not sway market expectations.

Another interest rate hike is likely to further invert the Treasury yield curve and exacerbate deposit flight out of regional commercial banks who have been unable to compete with the return on money market accounts. The economy is already weak and Leading Economic Indicators suggest it will get weaker.

Over the last five quarters, real GDP has grown at a meager 1.0% annualized rate. Some economists believe real Gross Domestic Income (GDI) is a more accurate measure because it is based off tax receipts. **Over the last five quarters, real GDI has declined 0.6%**. The last two quarters have been notably soft, declining 3.3% in Q4 2022 and -2.3% in Q1 2023. Does a more meaningful slowdown in the labor market await us? We think so.

Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko’s economist(s). The views, statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views, statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.