

Weekly Update of U.S. Economy

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How Settling Inflation Will Change the Fed's Monetary Policy

A Slower CPI

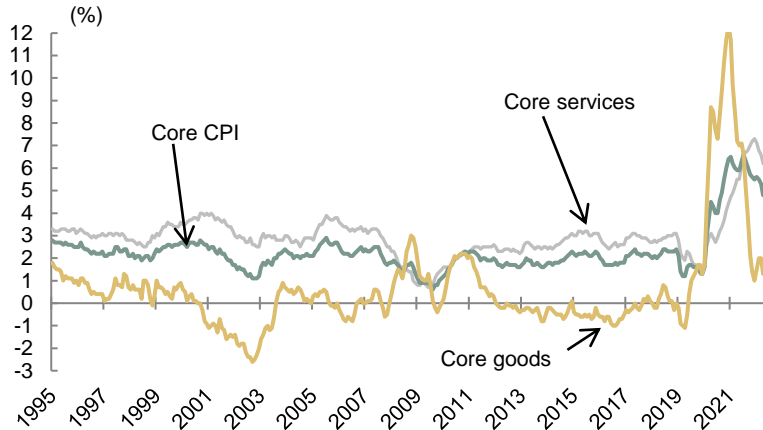
- The most notable economic indicator released this week was the Consumer Price Index (CPI) for June, which showed lower growth than previously expected.
- The core CPI excluding food and energy slowed its monthly gain to 0.2%, entering a stable area equivalent to the price target of 2%. The strengthening of inflationary pressure against the backdrop of supply constraints became clear in mid-2015. This time, the core CPI has fallen back to its earlier growth, giving confidence to the Federal Reserve Board (the "Fed"), which expects the effects of monetary tightening to materialize.
- Much milder growth of the Producer Price Index (PPI) at 0.1% on a month-over-month basis and the continued decline of import prices are also expected to alleviate the inflation pressure going forward.
- However, a big question for the Fed, which is pursuing both a return to inflation targeting and employment stability, is whether it can stop tightening monetary policy while employment continues to grow. Although it would be desirable for the Fed if employment were to remain stable and growing, tight labor supply and demand would lead to upward pressure on wages. In fact, real wages have been rising at a faster pace recently, increasing to 1.2% year over year.
- The slowdown in CPI growth may also be only transitory, and the Fed is not yet confident of a deceleration in inflation.
- Unlike normal economic conditions, the Fed will be more cautious in its assessment of inflation settling and employment stability. Based on the assumption that the historical average relationship between employment and inflation has not broken down after the coronavirus shock, an increase in the unemployment rate from the current level of around 3.5% to 4.6% would generally bring inflation in line with the 2% target. However, since the pandemic, firms' pricing behavior has changed, and the labor supply has been transformed.

Fed Biased Toward Higher for Longer

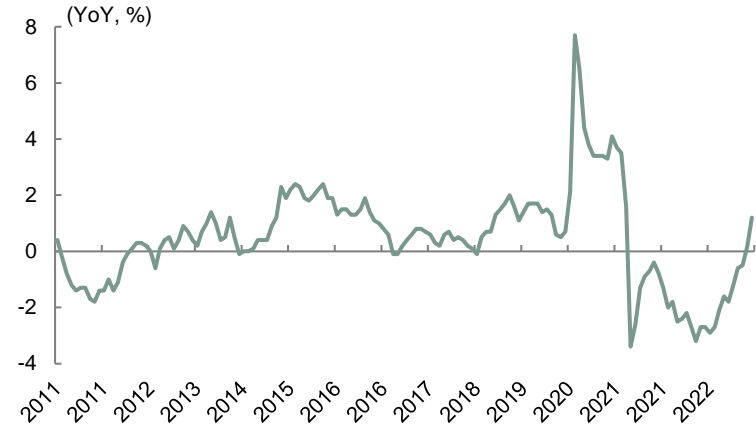
- It is the company that sets the price. A study by the Federal Reserve Bank of Richmond found that the frequency of price changes by firms changed in a wide range of industries before and after the pandemic.
- In the service sector, where price changes are considered relatively infrequent, nearly 70% of companies changed prices less than once a year before the pandemic, compared to 47% in the last year. This year, half of the companies still report that the frequency of price changes is at least twice a year.
- Price changes are likely to be asymmetric between rising and falling costs. In other words, while margins could not be maintained without a rush to pass on prices when costs were rising, it should be difficult to lower prices aggressively now that margins have started to fall unless sales volumes decidedly grow.
- The persistent bias towards price increases is evidenced in the survey of small and medium-sized enterprises (SMEs). According to the monthly survey of the National Federation of Independent Business (NFIB), the share of companies which answered that they raised their output prices over the past three months still remains high compared to the past economic expansion period. As long as many companies pursue margin maintenance, the shift away from price increases will take time.
- If labor supply and demand continue to tighten, there is a risk of further delays in the normalization of inflation through renewed wage increases. The fact that the level at which labor supply and demand is neutral has become unclear after the COVID shock will further delay the Fed's final decision for its policy pivot.
- It's quite a hurdle for the Fed to state its view that the long-term stable unemployment rate may be higher than 4.6%, which is higher than previously assumed. However, given that real wages have been rising, it's possible that estimates of labor supply and demand have been low so far as a result. As such, the Fed's monetary tightening will not be modified by a few months of subdued inflation, and monetary tightening is likely to continue for a long time.

How Settling Inflation Will Change the Fed's Monetary Policy (continued)

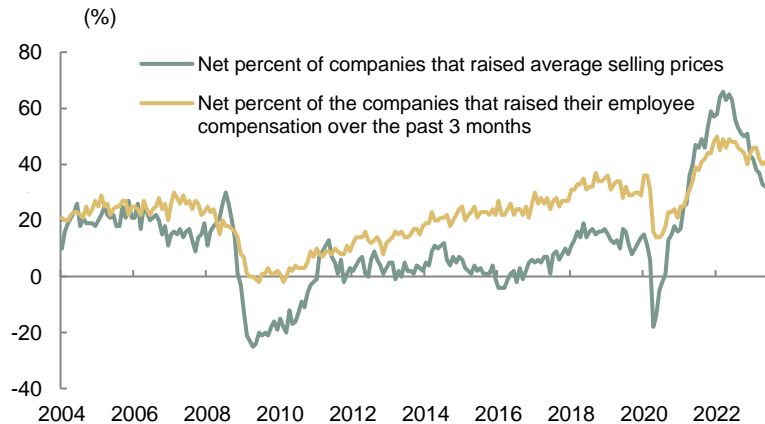
The June core CPI slowed its pace of yearly growth to 4.8%, declining from 5.3% the previous month.



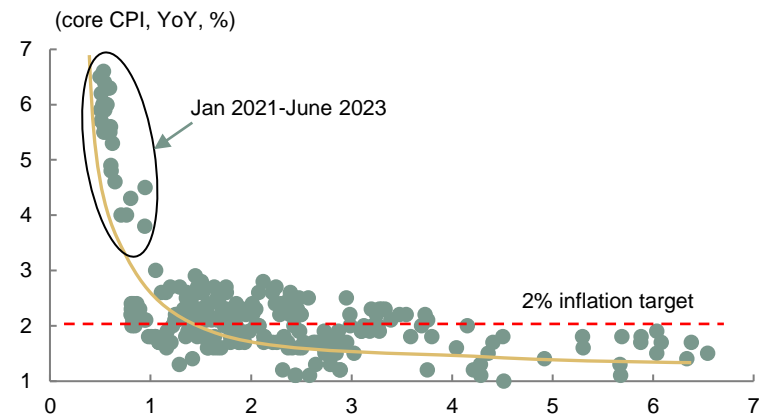
Real wage growth turned to positive territory, which is expected to support consumer expenditures going forward.



Price increases by SMEs have settled down somewhat as inflation peaks out, but the economy is still biased more towards price increases than before the pandemic.



Assuming the shape of the Phillips curve is unchanged, the jobless rate needs to increase to 4.6% in order to match the inflation target.



SMBC Economy and Rates Forecast

		2022			2023				2024				2021	2022	2023	2024
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
U.S.	Real GDP (saar)	-0.6	3.2	2.6	1.3	1.5	-0.8	0.6	0.9	1.4	1.8	2.2	5.9	2.2	1.4	1.0
	Inflation rate (YoY)	5.0	4.9	4.8	4.8	4.6	4.2	3.9	3.2	2.8	2.5	2.2	3.3	5.0	4.4	2.7
	Jobless rate	3.6	3.6	3.6	3.5	3.5	3.7	4.3	4.6	4.7	4.7	4.6	5.4	3.7	3.7	4.7
Euro area	Real GDP (qoq)	0.8	0.4	-0.1	-0.1	0.3	0.2	0.1	0.1	0.4	0.3	0.3	5.4	3.5	0.6	0.9
	Inflation rate (YoY)	8.0	9.3	10.0	8.0	6.2	4.8	3.2	3.1	2.9	2.7	2.5	2.6	8.4	5.6	2.8
	Jobless rate	6.7	6.7	6.7	6.6	6.6	6.6	6.7	6.8	6.8	6.9	6.9	7.7	6.7	6.6	6.9
Japan	Real GDP (saar)	5.6	-1.5	0.4	2.7	1.7	1.0	0.9	0.9	0.8	0.8	0.7	2.3	1.1	1.0	0.9
	Inflation rate (YoY)	2.1	2.7	3.8	3.5	3.3	2.8	2.3	2.9	2.7	2.6	2.2	-0.2	2.6	3.0	2.6
	Jobless rate	2.6	2.5	2.5	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.8	2.6	2.4	2.3
China	Real GDP (YoY)	0.4	3.9	2.9	4.5	8.4	5.7	6.3	5.4	5.2	5.1	5.0	8.4	3.0	6.3	5.2
	Inflation rate (YoY)	2.2	2.8	1.8	1.3	1.6	1.4	1.5	1.6	1.9	2.0	2.0	0.8	1.7	1.5	1.9
	Jobless rate	5.8	5.4	5.6	5.5	5.4	5.1	4.9	4.9	4.9	5.0	5.0	5.1	5.1	5.2	5.0

Rates		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
U.S.	FF target range	4.25	4.75	5.00	5.25	5.25	5.00	4.75	4.50	4.25	4.25	5.25	4.25
		~	~	~	~	~	~	~	~	~	~	~	~
		4.50	5.00	5.25	5.50	5.50	5.25	5.00	4.75	4.50	4.50	5.50	4.50
	2yr UST	3.43	4.03	4.90	4.20	4.00	3.80	3.60	3.40	3.20	4.20	4.00	3.20
	10yr UST	3.87	3.47	3.84	3.60	3.60	3.60	3.60	3.50	3.50	3.60	3.60	3.50
Germany	ECB refi rate	2.50	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	2.50	4.25	3.75
	ECB depo rate	2.00	3.00	3.50	3.75	3.75	3.75	3.75	3.50	3.25	2.00	3.50	3.25
	2yr Schatz	2.50	2.68	3.20	3.20	3.00	2.80	2.50	2.40	2.30	2.50	3.00	2.30
	10yr Bunds	2.20	2.29	2.39	2.30	2.30	2.30	2.20	2.10	2.10	2.20	2.30	2.10
Japan	IOER	-0.10	-0.10	-0.10	-0.10	-0.10	0.10	0.10	0.10	0.10	-0.10	-0.10	0.10
	2yr JGB	0.04	-0.06	-0.07	0.10	0.15	0.20	0.30	0.30	0.30	0.04	0.15	0.30
	10yr JGB	0.42	0.35	0.40	0.75	0.75	0.75	0.90	0.90	0.90	0.42	0.75	0.90
China	Policy rate	2.75	2.75	2.65	2.55	2.55	2.55	2.55	2.55	2.55	2.75	2.55	2.55
	2yr gov bond	2.40	2.41	2.11	2.16	2.24	2.32	2.39	2.49	2.59	2.40	2.24	2.59
	10yr gov bond	2.83	2.85	2.64	2.64	2.69	2.74	2.79	2.84	2.89	2.83	2.69	2.89

Source: SMBC

SMBC FX Forecast

		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
USD/JPY	Range	130.58	127.23	130.64	128.00	125.00	121.00	119.00	116.00	116.00	113.47	125.00	116.00
		~ 151.95	~ 137.91	~ 145.07	~ 147.00	~ 138.00	~ 135.00	~ 133.00	~ 130.00	~ 130.00	~ 151.95	~ 147.00	~ 135.00
	End of period	133.00	132.86	144.31	137.00	133.00	130.00	128.00	126.00	123.00	131.12	133.00	123.00
EUR/USD	Range	0.9633	1.0484	1.0635	1.0300	1.0200	1.0100	1.0000	1.0100	1.0100	0.9536	1.0200	1.0000
		~ 1.0735	~ 1.1033	~ 1.1095	~ 1.1300	~ 1.1200	~ 1.1100	~ 1.1000	~ 1.1100	~ 1.1100	~ 1.1495	~ 1.1300	~ 1.1100
	End of period	1.0705	1.0839	1.0909	1.0700	1.0600	1.0500	1.0500	1.0600	1.0600	1.0705	1.0600	1.0600
USD/CAD	Range	1.3275	1.3291	1.3151	1.3000	1.3000	1.3000	1.3000	1.2800	1.2700	1.2477	1.3000	1.2700
		~ 1.3885	~ 1.3832	~ 1.3642	~ 1.4200	~ 1.4200	~ 1.4200	~ 1.4200	~ 1.4000	~ 1.3800	~ 1.3885	~ 1.4200	~ 1.4200
	End of period	1.3554	1.3516	1.3242	1.3500	1.3600	1.3500	1.3500	1.3400	1.3300	1.3554	1.3600	1.3300
CAD/JPY	Range	96.76	95.13	97.54	95.00	91.00	90.00	88.00	88.00	85.00	89.77	91.00	85.00
		~ 109.11	~ 100.59	~ 109.21	~ 108.00	~ 103.00	~ 102.00	~ 100.00	~ 100.00	~ 98.00	~ 110.06	~ 109.21	~ 102.00
	End of period	96.76	98.28	109.04	101.48	97.80	96.30	94.81	94.03	92.48	96.76	97.80	92.48
EUR/JPY	Range	138.81	138.19	143.12	144.00	136.00	131.00	128.00	126.00	123.00	124.40	136.00	123.00
		~ 148.40	~ 145.67	~ 157.92	~ 158.00	~ 150.00	~ 145.00	~ 142.00	~ 140.00	~ 137.00	~ 148.40	~ 158.00	~ 145.00
	End of period	140.41	144.01	157.44	146.59	140.98	136.50	134.40	133.56	130.38	140.41	140.98	130.38
Oil price (WTI futures)		82.64	75.99	73.58	75.00	80.00	80.00	75.00	77.00	78.00	98.74	76.37	77.50

Source: SMBC