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MUFG Bank, Ltd.
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A normalizing economy

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- April's CPI readings likely don't support a pause for the Fed, but other factors are to be considered. Changes in the Federal Funds Rate are estimated to have a 14-18 month lag on economic activity, which makes a "wait and see" approach to interest rates applicable for June's FOMC meeting. And though the credit crunch that was expected to follow the recent bank failures has not materialized yet, high levels of uncertainty increase the risk of overtightening.
- April growth in retail sales falls in line with the post-2022 trend and will likely continue heading into Q3 2023. Business inventories dropped in March, but it is historically not a reliable leading indicator of a recession. A turning point in inventories may occur before or after a recession has already hit.
- Average mortgage rates have stabilized in recent months, along with construction of new homes and sales of existing homes. Fluctuations in housing starts and sales align closely with changes in lending rates.

April inflation may not support a Fed pause

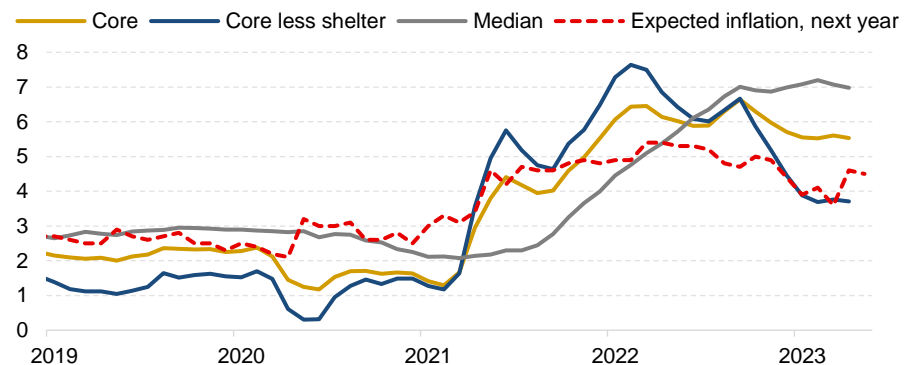
Annual growth in headline CPI dropped below 5% for the first time since April 2021. Inflation, by this measure, is now below the target Federal Funds rate which suggests that no additional tightening is needed. This argument holds in theory, but it is not a practical target.

The FF rate acts as a floor for other short-term interest rates in the US economy and it is explicitly set by the Fed. Inflation, on the other hand, is much more complex and difficult to measure and predict, making it a fuzzy comparison with the FF rate.

Using the Consumer Price Index (CPI), core inflation (excluding food and energy) is running much hotter than headline with annual growth at 5.5% as of April. Core CPI less shelter, often referred to as "super-core" inflation by Fed Chairman Powell, paints the rosier picture with annual price growth at 3.7%. Median CPI, however, has annual price growth at 7%, well above the target FF rate.

Rising inflation expectations adding pressure to price growth

Annual CPI growth and expected changes in next year inflation, %



Source: BLS, Cleveland Fed, University of Michigan, MUFG Bank Economic Research

These all have their advantages and disadvantages in measuring “underlying” price growth, a potent gauge of supply demand imbalances in the economy. But depending on which is observed, it greatly changes what the terminal rate should theoretically be.

The Fed will likely be looking at the trajectory of inflation as opposed to just the level to help determine the terminal rate. Unfortunately, most measures show that annual price growth has stalled in 2023. Annual growth in core CPI, core CPI less shelter, and median CPI have all been relatively flat in 2023, while expected inflation has risen.

Expected next year changes in inflation from the University of Michigan Consumer Sentiment Survey stood at 4.5% in May, little changed from 4.6% in April, but up from 3.6% in March. Rising inflation expectations is problematic because it can trigger consumption, with the belief that prices are lower now than they will be in the near future. This, in turn, can cause inflation to accelerate.

The logical argument to pausing interest rate hikes is not found in April’s CPI data, nor is it found in the latest employment or retail sales figures. The most convincing argument is the lag to which monetary policy works. Estimates point to a 14-18 month lag from when interest rates begin to rise and when the impact is felt in the broader economy. With the Fed keen on not overtightening, this makes June’s FOMC meeting an opportune time to pause interest rate increases, around 14 months since the tightening cycle began in March 2022.

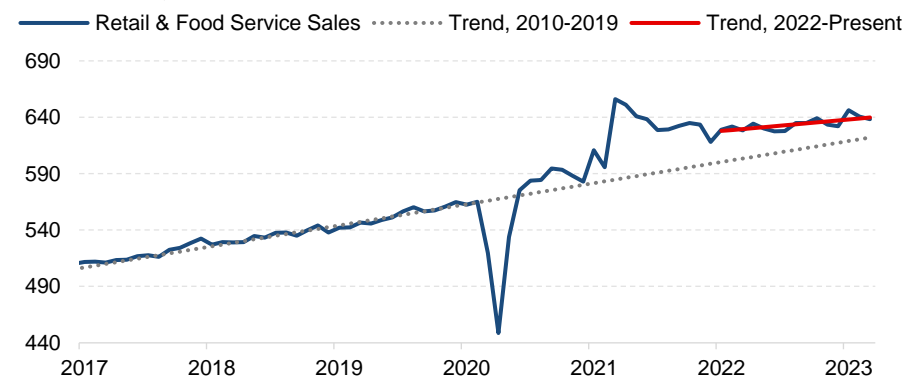
Trends in retail sales and inventories

Retail and food services sales reversed course in April and rose by 0.4%, following two consecutive months of declines. Monthly movements in retail sales figures have been volatile in the post-pandemic recovery, but they appear to have settled into a new growth trend.

Recessions typically induce a downward level shift in retail sales, followed by a new growth trend. The COVID recession was unique in that the recovery was immediate and strong, with retail sales exceeding the pre-COVID trend in just a matter of months. Waves of infections and shutdowns contributed to severe volatility up until 2022, where monthly growth appears to have stabilized. Monthly changes in retail sales will likely move along this post-2022 trend for another few months leading up to a forecasted recession in Q3 2023.

Retail sales have settled into a new trend

Real retail sales, billions



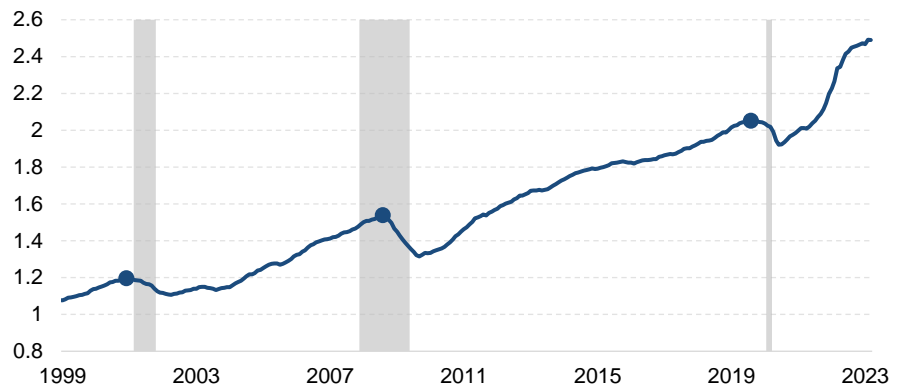
Source: Census Bureau, MUFG Bank Economic Research

While we can expect a turning point in retail sales heading into a recession, the same cannot be said of business inventories. Historically, business inventories has not been reliable leading indicator of a recession. Business inventories peaked 7 months prior to the 2001 recession, but 7 months after the 2008 recession. Additionally, inventories experienced a turning point in the first half of 2019, but it would be a more than just a stretch to say this was a leading indicator of the COVID recession. Inventories have also

had minor turning points in 2003, 2005, 2013, and 2016, none of which precluded a recession. A sustained drop will likely be a symptom of a recession, as it has in the past, but it won't necessarily be a leading indicator of one.

Business inventories are a poor leading indicator of a recession

Business inventories, trillions



Source: Census Bureau, MUFG Bank Economic Research

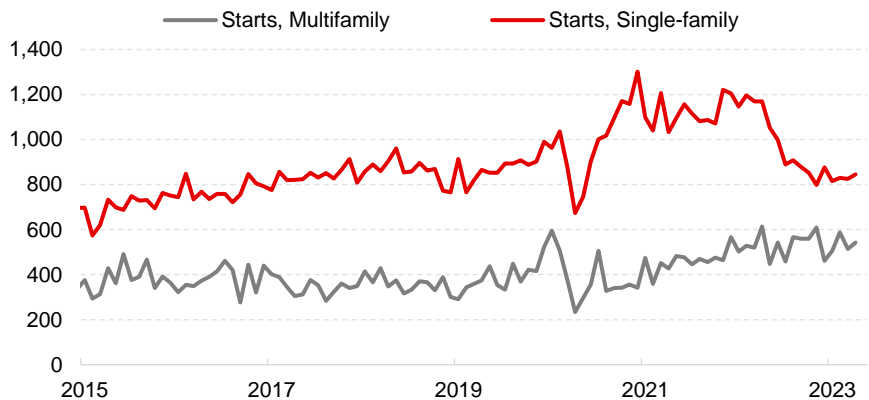
Housing market is levelling off

In recent months, average mortgage rates have levelled off between 6 and 6.5% and construction starts for single-family homes have been flat. The market for new single-family homes, both in sales and construction, has closely followed average mortgage rates.

Construction starts for multi-family homes has also been relatively flat in 2022, though more volatile than for single-family homes. Given the dynamic nature of the housing market and non-accelerating growth in new construction, we can expect housing shortages to persist which will keep price pressures high.

New housing construction has been flat

Housing starts, thousands



Source: BLS, MUFG Bank Economic Research

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