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The Morning Briefing

Wednesday, June 18, 2014
6:00 EDT; 11:00 BST
Allen Sinai, Chief Global Economist

WEDNESDAY BRIEFING POINTS – Andrew Wroblewski and Chang Liu, London/Andrew Husby, New York/Francisco Larios, Miami

United States: FOMC. The FOMC will continue to taper asset purchases, with the accompanying statement likely a "steady-as-she-goes" sort of communique. The press conference and economic projections will need to be watched closely for more color.

Canada: Wholesale trade is expected today. After declining last month a rebound is expected during April (**DE and Consensus: 0.5% M/M**).

U.S. DATA AND EVENTS OUTLOOK – Andrew Husby, New York

The highlight today is the FOMC meeting statement, at 14:00 EDT/18:00 GMT, followed by the Yellen press conference at 14:30 EDT/18:30 GMT. The Q1 current account balance will come earlier in the day, at 08:30 EDT/12:30 GMT.

FOMC—Still on Track?

DE expects the **FOMC policy statement** to be mostly steady-as-she-goes, involving a $10B taper of asset purchases (to $35B/month) and reiterating language regarding the need to keep the fed funds target on hold "for a considerable time after the asset purchase program ends." The same goes for the portion that reads, "economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run." The unemployment rate should continue to be described as "elevated," but that will presumably have to be modified at some point given continued declines.

Emphasis on a lower-than-normal funds rate level once targets have been attained is a key factor in holding longer-term interest rates lower than many envisioned at the start of 2013. Hawks see that sort of promise as raising financial stability concerns, while doves' primary emphasis is on closing the jobs gap as quickly as possible provided inflation and inflation expectations remain subdued.

Still, firmer inflation and employment readings over recent months have again boosted expectations for an earlier funds rate hike, in line with a move DE has seen likely to occur in March or June 2015. DE also sees a steeper set of increases and more normal longer-term level than the Fed and markets envision.

Watching the Dots, Projections Too

Relative to those made in March, updated economic projections will reflect quicker inflation, lower unemployment, but also slower growth over the near term given the Q1 stumble. However, focus will also be on the longer-term central tendency ranges for various measures, including the funds rate. Slightly complicating matters is that Fed Governor Stein is out, Governor Fischer's forecast will be in, Cleveland Fed President Mester has replaced Pianalto, and while recently sworn-in Governor Brainard is now in, sources indicate she will not be providing projections at this meeting.

A quick note regarding the dot chart, DE reiterates a point often omitted or misstated in commentary; the dots show the value of "an individual participant's judgment of the appropriate level of the target federal funds rate" at year-end under appropriate monetary policy, which may of course be different from the level at which participants actually expect the funds rate to be at year-

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end. A participant may judge 3% to be the appropriate level of the funds rate at year-end 2015—the dot—while actually expecting the funds rate somewhere around the median "appropriate" level of 1%. The median projection has value, but even there, not all of the dots are voting members. Currently, the median "appropriate" level of the funds rate stands at 1% at year-end 2015, and 2.25% in 2016, and 4% longer-run. Markets have moved in the direction of an earlier hike but a lower longer-term funds rate—there is a chance the dot plot does the same.

As always the press conference will need to be watched closely for further details—as will the Minutes when they are released next month. Doves still have the upper hand on accommodative policy, but firmer price pressures and/or heightened financial stability concerns will be subject to increasingly contentious debate as the year rolls on.

WESTERN HEMISPHERE ANALYSIS

UNITED STATES – Andrew Husby, New York

CPI—Firmer Prices

May consumer prices exceeded expectations, rising 0.4% on the headline (Consensus: +0.2%; DE: +0.3%), and 0.3% on the core ex-food and energy figure (Consensus and DE: +0.2%). The core increase was the highest since 2011.

One fact that tempers the upside tone is the headline came in at 0.35% and the core 0.26% to two decimal places, both rounding up, just.

Still, combined with a firming trend over the past three to six months, the results give greater confidence inflation is indeed bottoming and will head toward 2% on the Fed-relevant PCE measure. DE continues to believe price and wage data will become—and indeed, already are—of increasing importance in deciding Fed policy timing, if the remainder of the year sees continued prices firmness, and progress in the labor market.

Data details

The year-over-year headline rate accelerated to 2.1%, from 2.0% in April, and the core to 2.0%, from 1.8%.

Food and beverages rose 0.4%, posting that rate for a fourth straight month, now 2.4% y/y.

Housing prices were up 0.3%, with a 0.3% gain (3.1% y/y) in the rent of primary residence components, and 0.2% for owner's equivalent rent (2.6% y/y, and over 20% of the total).

Transportation rose 0.6% after 1.1% in April, the most recent two months coming after three declines, and five in six months.

Core services prices posted a 0.3% gain, matching the March and April results, accelerating to 2.7% y/y. Core goods prices rose 0.1%, matching April, after eight months of flat-to-negative results, coming in at -0.2% y/y.

The firmer uptrend in core services support FOMC expectations that prices will trend back to 2% over time, keeping policy intact.

Conclusion

Until wage growth picks up more convincingly, FOMC doves will rule the roost, holding off on the first rate increase for as long as the data allow. But that perch may come under pressure if running rates remain strong in the key core components of various inflation measures.

Housing Starts Edge Back

May housing starts fell a more-than-expected 6.5% to 1.001 million (Consensus: -3.9% to 1.030M; Decision Economics: -4.4%) from a marginally revised April level. Multi-family starts fell 7.6% after April 29.2%, while single-family starts fell 5.9% after April 4.6%.

FOMC observers should not see the single-family result as too disappointing, given recent months are still higher (after gains of 1% in Fed, 7.8% March, and 4.6% April) than 2013H1 levels, which cover a period prior to rate-rise and weather impacts.

Data Details

Geographically, the Northeast (-25.2%, after +42.5% in March and 2.4% in April) and Midwest (-16.5%, after +17.2% in March and 44.1% in April) saw declines, but after large recent advances. The West (-16.3%, after -5.5% in March, 14.5% April) remained choppy while the South saw another moderate advance (+7.3%, after -4.8% in March, 3.3% April).

Permits fell 6.4% to 0.991 million, the single-family portion up 3.7% and multis down nearly 20%.

Despite the drop in the month, multi-family starts remain just below post-recession highs, implying builders continue to see and expect strong rental demand.

Conclusions

The downside case for housing appears less severe than Fed officials' worst concerns, but the situation will continue to be monitored closely. Employment growth remains a key prerequisite for an entrenched and continued uptrend in the sector, and the Fed will remain wary of setting off another rapid rise in rates just as the current rate adjustment appears to be consolidating.

WESTERN EUROPE – Andrew Wroblewski, London

EUROZONE – Construction Output Bounces Clearly. Construction output bounced 0.8% M/M in April, more than correcting the pared-back 0.3% correction seen in March. Indeed, the rise was the fourth in the last five months and came in spite of (weather-induced) falls in construction activity in Germany (this being offset by clear strength in Spain, ie up 21% in the last six months). The overall bounce came in both building and civil engineering and pushed overall Y/Y growth to a fresh cycle-high of 8.0%

OTHER WESTERN EUROPE

UNITED KINGDOM – BoE Suggests 2014 Rate Hike Possibility Underpriced? Surprising some, the minutes to the June 4-5 BoE MPC meeting showed the committee still unanimous in its decision to keep the asset purchase program target unchanged and not to alter policy in the near-term.

No Change to Inflation Outlook

Notably, given somewhat hawkish signals that have been heard from some members of late (most notably Governor Carney), the minutes emphasized that there had been little news over the month to change the central views in the May Quarterly Inflation Report which was consistent with the first rate-hike coming around spring next year. Indeed, the minutes actually said the outlook for near-term inflation was weaker while the medium-term inflation outlook remained close to target.

More Uncertainty

However, the committee as a whole echoed what Governor Carney suggested last week, ie that the low probability markets had been attaching to a hike in Bank Rate in 2014 was surprising, as growth may not slow in the second half of the year in the manner that the Inflation Report predicted, thereby meaning slack would be absorbed more quickly than previously expected. This is clearly a reflection of the fact that the MPC is not only wary that more upside surprises could occur but that the weak productivity backdrop could continue therefore implying less spare capacity than currently envisaged.

But Downside Risks Too

However, the minutes also noted some downside risks, not least the further fall in inflation expectations. Most notable, however, was continuation of the slowing in the housing market. The MPC is clearly puzzled why this slowing is occurring, now suggesting that potential homebuyers are being deterred by too expensive prices. In this regard, the MPC may wish to examine the findings of the BoE Financial Policy Committee which is due to present its view on June 26. But there was a also a clear puzzle regarding the slowing in average earnings growth (something which has become even softer in data published since this June MPC meeting).

DE View: The MPC is clearly more willing to consider the possibility of raising rates in the not too distant future, but is facing an even more mixed backdrop and outlook that makes any clear policy-pointer all the more difficult to make. As a result, the MPC is trying to highlight that rates could (not will) start to rise earlier than markets (and the BoE itself) had predicted. If so, this is not just a reflection of a more uncertain BoE, but also a committee which may be trying to massage market expectations so that whenever official rates do rise, the announcement effect is as small as possible.

SWEDEN – Better Confidence Readings. National Institute (KI) data for June showed the so-called economic tendency indicator (an aggregation of all sector surveys discussed below) bouncing back, albeit with the 1.8 point rise (to 101.0) failing to unwind fully the drop seen in May. The indicators for manufacturing and the building and civil engineering industries accounted for most of the improvement, while the retail and services indicators fell back slightly, and the consumer indicator was almost unchanged. The indicators for building and civil engineering and the retail trade are now well above, and the other indicators relatively close to, the historical average.

Otherwise, within the consumer confidence survey household inflation expectations (one year ahead) stayed at 1.1%.

JAPAN – Andrew Wroblewski, London

Exports Correct Back More Clearly. Coming in smaller than expected for once, the May (unadjusted) trade balance saw a further narrowing in the deficit to ¥ 909.0 bln from a ¥ 998.2 bln shortfall in the same month of 2013. Moreover, the seasonally adjusted trade gap decreased to a shortfall of ¥ 862.2, as a 1.2% M/M fall in exports came alongside a 1.3% further drop in imports.

ASIA PACIFIC ANALYSIS – Chang Liu, London

CHINA – Stronger Business Confidence. According to Market News International, the June business confidence index rose afresh and by 1.3 points to 55.0, a six-month high and also being a twenty-first consecutive above-50 reading. The breakdown showed the latest results reflected faster growth in production and order orders as well as a two-year high in employment.

Notably, commenting on these results, the compilers noted that the rise in credit suggested that government measures to stabilize growth could already be under way and are having an impact despite their efforts publically to play down the possibility of unleashing any large stimulus packages.

THAILAND – Policy Held. In line with expectations, the Bank of Thailand (BoT) kept interest rates unchanged at 2.00% after its latest policy meeting in June. This follows a similar decision in April, a 25 bp cut in March, another paurse in January, but all coming after another 25 bp reduction in November.

Mixed Economic Outlook, Inflation Contained

The accompanying statement began with a largely unchanged view of the global economy, noting continued recoveries in major economies led by the U.S. and a stabilizing China. The assessment of the domestic economy, meanwhile, remained pessimistic, with the Bank noting that Q1 activity had contracted as a result of the political uncertainties and their impact on domestic demand and tourism. However, looking forward, the Bank actually now highlighted that “a significant reduction of political uncertainties” should lead to improving public and private spending, albeit with exports and tourism likely staying subdued for some time yet.

DE View: The last paragraph of the statement saw the Bank explain that its latest decision was motivated by the Committee's assessment that the economic recovery should pick up afresh after the military coup last month reduced both the political uncertainties in the economy and restored the functioning of public policy management. As a result, the Bank seems comfortable leaving rates on hold for the time being while fiscal policy takes on a more dominant role in supporting the recovery in coming months. Also reflecting this shift, the BoT's forecasts for full-year growth was lowered further for this year to 1.5% from 2.7% previously, but with projections for next year now raised to 5.0% from 4.8%.

AUSTRALIA – Leading Index Falls Slightly. The April Conference Board-compiled leading index slipped 0.1% to 129.6 following a 0.2% gain in the previous month, ending a run of seven successive rises. The coincident index, however, rose further and by 0.2% to 125.1, hitting a new cycle-high.

Leading Index Rises Afresh. The leading index compiled by Westpac rose 0.1% in M/M terms in May following a 0.5% drop in the previous month. The annualized growth rate, as a result, turned less negative to -0.75% from -1.12% in April.

Notably, while some of the declines seen over recent months is likely to be the immediate response to the Budget announcement in May that saw both spending cuts and tax increases targeted at households, it is worth noting that the latest slowdown was evident across nearly all components—suggesting that a genuine slowdown could be underway. However, in terms of the RBA, the Bank has already highlighted that the above-trend growth seen in Q1 will not be sustained through the remainder of the year due to weak public demand and non-mining investment. As a result, these figures should have no major impact on RBA thinking at the present, with an extended policy pause still by far the most likely outcome going forward.

NEW ZEALAND – Current Account Surplus Widens Clearly. Meeting expectations, balance of payments data for Q1 showed a surplus of NZD 1.407 bln, a significant widening from the NZD 0.107 bln surplus seen in the same quarter of 2013 and actually also the largest on record. On a seasonally adjusted basis, however, the current account deficit saw a narrowing in the last quarter to NZD 0.585 bln from a shortfall of NZD 0.921 bln in Q4. The (unadjusted) breakdown revealed the latest outcome to be the result of a more than tripling of the surplus for the goods & services balance outweighing a slightly wider income balance deficit.

As a percentage of GDP, the current account deficit shrunk to 2.8% in Q1 from 3.4% in the previous quarter. Notably, this latest outcome was almost an exact match of market expectations and is thus unlikely to have any impact on Q1 GDP projections (data released Thursday 19 June). Elsewhere, it may also be worth noting that first quarter current account data are usually the most positive due to tourism inflows through the summer.

SOUTH AFRICA – Chang Liu, London

Inflation Rises Further. Surprising to the upside yet again, May consumer price inflation picked up to 6.6% Y/Y from 6.1% in May, hitting the highest in nearly five years and again helped by food and energy prices. Meanwhile, on an M/M basis, prices rose by 0.2%.

Notably, continued weakness in the rand has caused the SARB to clearly revise up its inflation projections at its meeting at the end of January where it also implemented a 50 bp rate hike. Going forward, with inflation now having surpassed the ceiling of the Bank's target range for two successive months, the chance of a further tightening in policy is steadily increasing.