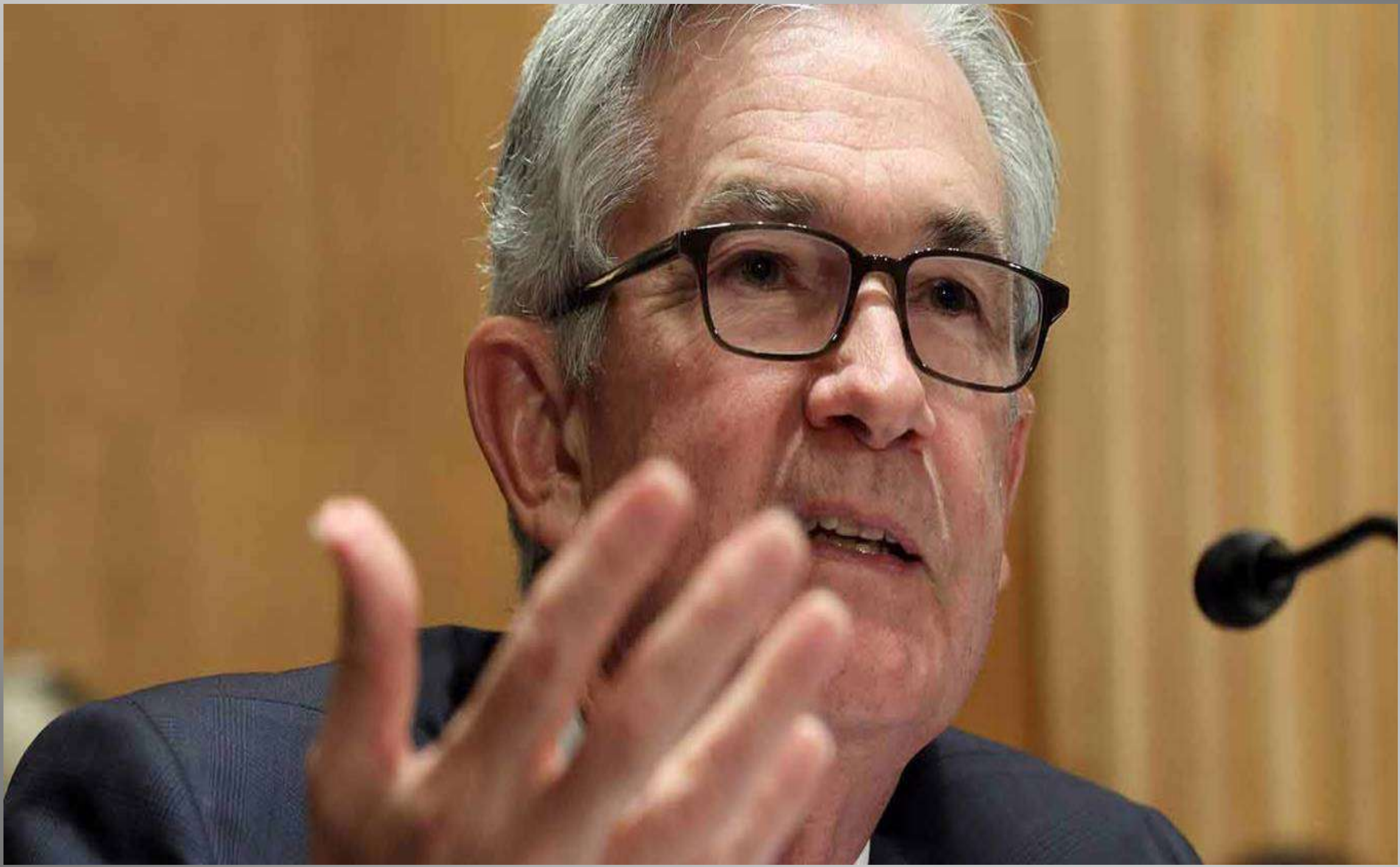
US Monetary Policy

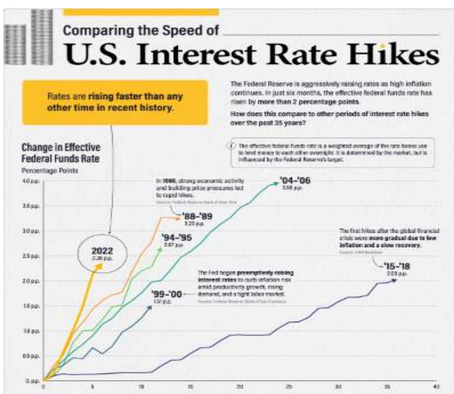


Could this be the Fed's final rate hike?

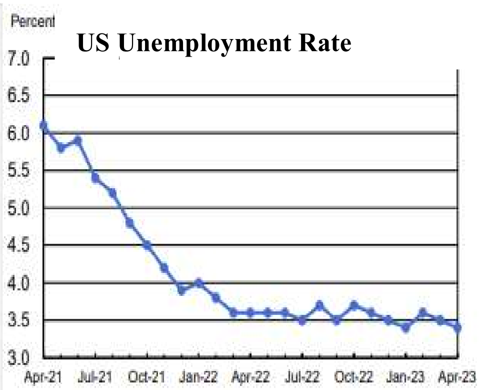
In May, Federal Open Market Committee yet again decided to increase the fed funds rate by quarter of a percentage point, bringing the benchmark rate from 5% to 5.25% –the tenth consecutive hike in fed funds rate since March 2022 and the fastest rate hike in the history by US central bank. Along with the hike in fed funds rate, FOMC will continue to decrease its holding of securities and is strongly committed in bringing down inflation to its 2 per cent target level. Although fed funds rate hike may be nearing an end as is evident from the recent press conference in which Fed Chairman Jerome Powell pointed out on omitting this line in the recent press release: "The committee anticipates that some additional policy firming may be appropriate". However, this statement was present in the March press release. Also Fed Chairman Jerome Powell said "We are prepared to do more if greater monetary policy restraint is warranted,"- indicating an increase in fed funds rate if economic data points the central bank in that direction.

The PCE (Personal Consumption Expenditure) rose 4.2% over 12 month ending in March 2023 dropping from the peak of 7% in June 2022. The increase in inflation has slowed down due to easing supply chain bottle necks and decreasing goods prices considerably in later half of 2022 but core service prices like housing services been high. Fed Chairman Jerome Powell reiterated that though inflation pace has moderated but it is still above the target rate of 2%, and is not going to come down quickly as anticipated by the committee. FOMC indicated it will take all necessary steps to bring down inflation.

The unemployment rate remained at a low level in April at 3.4% due to tighter labor market condition where demand substantially exceeds the supply of available workers; the unemployment rate is near pre covid levels of 3.5% in Feb 2020. Wage growth as computed by The Federal Reserve Bank of Atlanta (tracks the median 12 month wage growth)was 6.4% in March 2023 which was 3.4% in March 2021.Fed Chairman stated that wage growth should be around 3% for it to be consistent with long term inflation target.

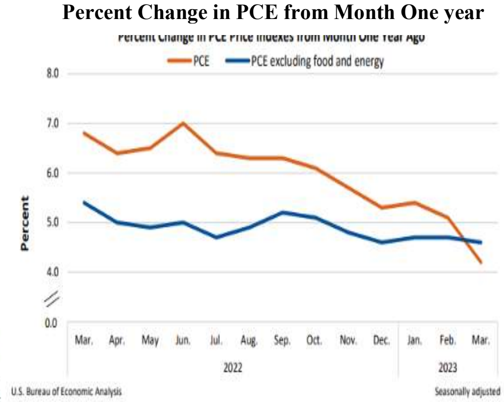


Source: Visual Capitalist



Source: US Bureau of Labor

Percent Change in PCE from Month One year



Source: US Bureau of Economic Analysis

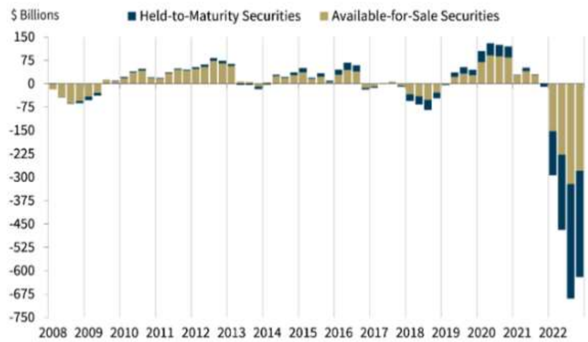
In March, the 16th largest bank in USA- Silicon Valley Bank- failed when it announced that it would be selling $21 billion worth of securities at $1.8 billion loss and would need to raise $2.25 billion to meet clients' withdrawal needs and fund new lending. The bank management started to buy securities (bonds) in hope to earn high yield, which lead to higher percentage of securities and loans as to deposits. The Fed report concluded that Silicon Valley Bank failure was result of inadequate hedging against the interest rate risk, failure of liquidity stress test, and focus on short term profits as against long-term stability.

After the fall of Silicon Valley Bank many depositors started to withdraw money from other regional banks which started a domino effect, with Signature bank failing soon after and First Republic Bank few weeks ago. After the fall of First Republic Bank regulators announce it has to be taken over. JP Morgan purchased the bank for $10.6 billion thereafter. The failing of financial institutions has raised concerns for Fed, with rising interest rates raising the price of the credit and banks raising their credit standards that can also make credit tight in the economy. According to Federal Deposit Insurance Corporation, US banks are sitting on $ 620 billion in unrealized losses at the end of 2022 which is a cause of concern for the US economy.

US 30 Years Mortgage rate

Source: Freddie Mac

U.S. Banks' Unrealized Gains/(Losses) on Investment Securities



Source: Federal Deposit Insurance Corporation

Housing sector in US contributes 15% to 18% in GDP in which residential investment contributes 3% to 5% to GDP and the sector is sensitive to fed rate hike. With Fed hiking interest rates, the mortgage rate has risen to 6.4% in May from 2.65% in January 2021 (lowest ever in US history).This in turn has made housing more unaffordable to the consumers. Also the rising of the central bank interest rate increases borrowing cost for companies developing new houses and supplying housing related products.

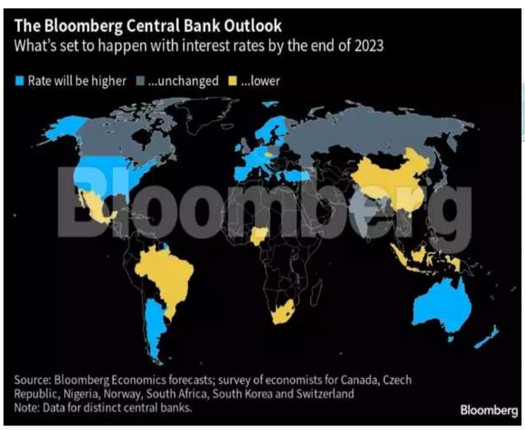
In March Atlanta Federal Reserve Governor Christopher Waller expressed that US central Bank has not made enough progress in bringing the inflation down to 2% and said monetary policy "needs to tighten further". Though Fed in May indicated there may be no further increase in fed funds rate but it will take necessary restriction if indicated by data in order to achieve the long term target rate of 2%. US economy is facing a two front problem where on one hand the regional banks are failing one after the other and on the other hand the US government is struggling to increase the debt ceiling.

Global Economic Scenario

The European Central Bank raised its benchmark interest rate by 25 basis points in May thus bringing the rate to 3.25%;though it has slowed down the pace of rate increase stepping back like the US Federal Reserve from a string of hike in rate to bring down inflation. Though the central bank told that it will not stop the hike in interest rate in future as it has to go further as economic growth slows to a crawl and with US banking instability there can be financial stress. Though the inflation has dropped from the peak of 10.6% in Oct to 7% in April, but it is still far away from the target of 2% set by ECB.Japan may stand out of the pack as it is anticipated to keep it rates unchanged until next year. According to Bloomberg at least 20 of 23 major jurisdictions are projected to lower the borrowing cost in 2024.

While central banks are focused on moderating the inflation with the help of monetary policy, fiscal policy is only potential tool left to boost growth- but unfortunately, for past three years governments have spent massive amounts on Covid-19 package and protecting households from high energy prices. This in turn has left the debt at historically elevated levels and left less room for expansionary fiscal policy. The rise in in interest rate has made these larger debt levels more costly to service, thus putting further pressure on government's finances. According to the report published by the Bloomberg on in April, UK has the highest probability (75%) to get into recession and US the third highest probability (65%).

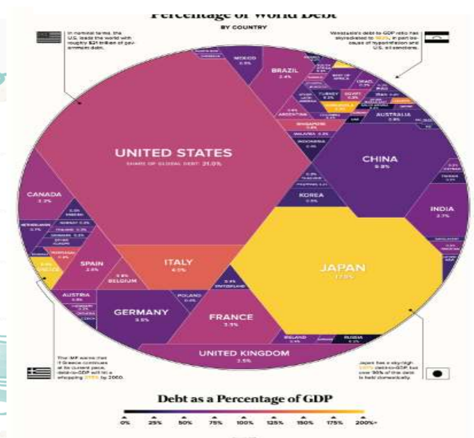
Bloomberg Central Bank Outlook (2023)



Source: Bloomberg

Source: Bloomberg

Percentage to World Wide Debt to GDP



Source: Visual Capitalist

Global real GDP is forecasted to grow by 2.2 percent in 2023, down from 3.3 percent in 2022. Most of the weakness will be concentrated in Europe, Latin America, and the US. Asian economies are expected to drive most of global growth in 2023. By and large, most of the Covid-19 related restrictions have been lifted in the region and these economies experienced less intense inflationary pressure compared to other regions. Despite rapid monetary tightening, inflation is persistent in many key economies. Thus, the monetary policy is likely to remain restrictive throughout most of 2023, despite US banks failing. This stance will act as a break on economic activity and will lead to increase in unemployment rates in various economies, particularly Europe and the US.

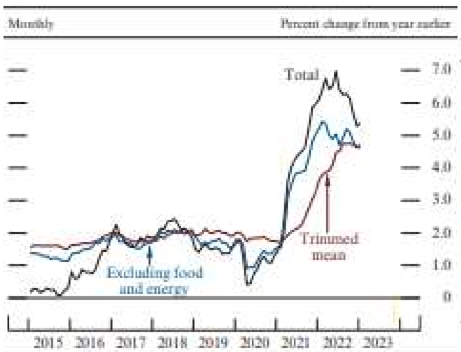
IMF projected that the global volume of world trade is expected to fall from 5.1 percent in 2022 to 2.4 percent in 2023, echoing a slowdown in global demand. Rising trade barriers and US dollar appreciation in 2022 has made traded products more costly for numerous economies (Dollar still being dominant in invoicing). China absorbs a substantial share of exports, a weaker than expected recovery in China can affect the trade's volume (mainly for commodity exporters). As China real estate market is going through a rough patch the risk of contagion looms large.

Inflation

Federal Reserve officials who held their policy meeting last week,felt that inflation is coming down but still remain elevated from their long term target of 2%. Chairman Jerome Powell have expressed that the committee is fully committed to bring down the inflation to 2% target rate, though it has indicated that there would be no further increase in fed rate but this stance is data dependent. He also pointed out that wage growth which was 6.4% in March is couple of percentage points above the target rate 3% rate which Fed thinks is consistent with 2% inflation over time. The unemployment rate is near a 50 year low, but labor market is very strong and inflation is still running high. Fortunately it has been able to bring down inflation without unemployment rate going up.

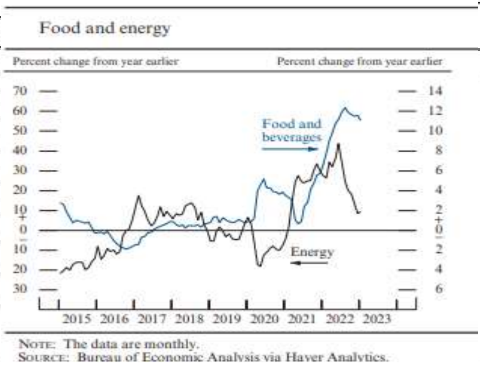
Building on a trend of moderating price increases since inflation reached a peak of 9.1% in June; the Consumer Price Index for All Urban Consumers (CPI-U) —which measures the costs of everyday goods and services from food to dental care— advanced 5.0% in March at an annualized rate, down from 6.0% in February. That was the lowest rate since May 2021, and the ninth straight month of rate declines. The steepest increases in prices in the twelve months ending February 2023 were for food and beverages and housing.

Personal consumption expenditure Price



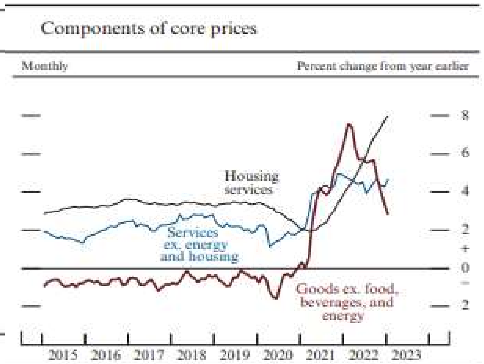
Source: US Federal Reserve

Food & Energy Prices



Source: US Federal Reserve

Components of core prices

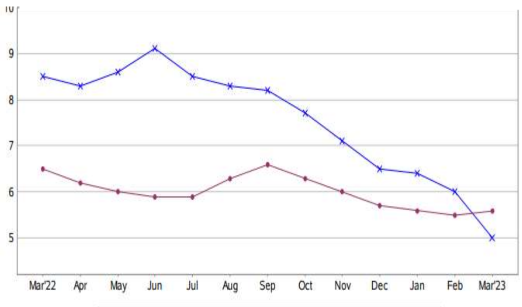


Source: US Federal Reserve

The personal consumption expenditures (PCE) price index for March increased 4.2 percent from one year ago stepped down from the peak of 7% in June 2022, reflecting increases in both goods and services. Energy prices decreased 9.8 percent while food prices increased 8.0 percent. Excluding food and energy, the PCE price index for March increased 4.6 percent from one year ago.

Inflation started in goods affected by supply chain issues, but as supply chain pressures eased, the prices of services rose. Stress in U.S. supply chains eased last year —as shipping costs and commodity prices fell, inventories grew, and consumer spending shifted away from goods towards services. The easing of COVID restrictions in China against a backdrop of weaker global demand has allowed supply conditions to improve further. For the twelve months ended in March 2023, while core goods prices rose 1.5%, down from a peak of 12.3% in February 2022, core service prices were up 7.1% according to data from the US Bureau of Labor. As the economy overcomes supply chain disruptions, and the aggressive tightening in monetary policy begins to work towards reducing excess demand, inflation is gradually decelerating. The turmoil in the banking sector has complicated the path for monetary policy, however, as the Federal Reserve strives to balance the still high inflation with maintaining financial stability

Percent Change in PCE Price Index



Source: US Bureau of Labor

12-month percent change in CPI

Source: US Bureau of Labor

Labor

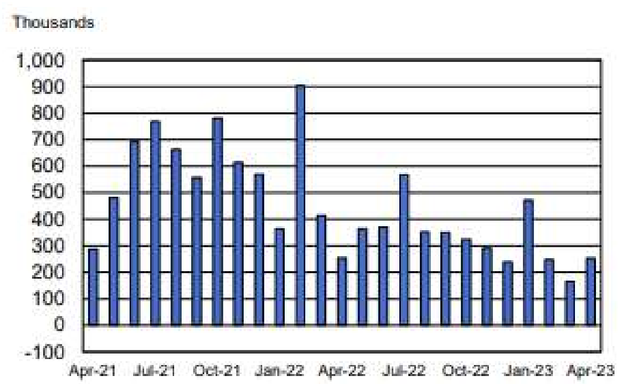
In recent meet Chairman Jerome Powell said that job market in United States remain tight where the demand for workers has exceed supplies, despite the recent turmoil in the banking sector. Total nonfarm payroll employment rose by 253,000 in April, the U.S. Bureau of Labor reported in May. Employment continued to trend up in professional and business services, health care, leisure and hospitality, and social assistance. April saw the 28th consecutive monthly gain, even as policy makers took significant steps to cool the economy and ease inflation. However, the average gain in the past three months of 345,000 is sharply lower than it was in first three months of 2022- when the average was 561,000.

The unemployment rate, which was 3.5% at the end of 2022, returned to this level in March and dropped to 3.4% in April, the lowest since 1969. The decrease was on the back of strong growth in both employment and labor force participation. According to household survey in April, total civilian workforce grew by 346,000 from March to April, driving the labor force participation rate up to 62.6% in April from 62.5% in February, helping to take the pressure off wage growth. However, the participation rate is still lower than pre pandemic level - February 2020 level – 63.3%. In order to rebalance the US labor market people looking for jobs should increase which in turn would help in weighing down the upward pressure on wage growth.

Unemployment rate

Source: US Bureau of Labor

Nonfarm payroll employment



Source: US Bureau of Labor

According to the US Bureau of Labor, despite gradual recovery, the labor force participation rate (LFPR) in March remained almost a percentage a point lower than March 2020. Caregiving responsibilities have prevented some people from returning to the workforce. In the Census Household Pulse Survey with data as of 17 January 2023, a combined 7% of respondents not working reported caregiving as the reason. This was broken down further: 5% were looking after children and 2% elderly relatives. Moreover, according to the Consumer Price Index (CPI), daycare and preschool costs have increased by more than 10% since the start of the pandemic. This is an even bigger burden for lower-income households, which could partly explain the larger labor force exits at the lower end of the income spectrum.

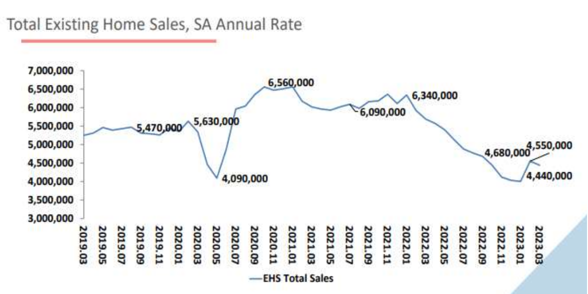
Federal Reserve Chairman Jerome Powell has pointed out that the imbalance in job opening and available workers as key drivers of inflation, as strong labor demand can drive up wages. The labor force participation has edged out in recent months, as seen above, and wage growth has slowed, both signs of a looser labor market. Average hourly earnings growth in April (0.5%) came in line with consensus expectations. Over the past year, hourly earnings were up 4.4%, down from a peak of 5.9% in March 2022 and the lowest increase since June 2021.Job openings fell below ten million in February for the first time in nearly two years, in a sign that the Federal Reserve's efforts to slow the labor market may be having some impact.

Housing Market

According to the chief economist of National Association of Realtors, consumers are very sensitive to mortgage rates and week on week change in mortgage rate is having a big impact. The Federal Reserve hiking rate has pushed the mortgages rate to 6.8% in May which made residential properties costly for an average American. According to the data published by National Association of Realtors, existing home sales dropped 2.4% in March to a seasonally adjusted annual rate of 4.44 million units. Sales declined 22.0% from a year ago, while month on month sale remaining steady in Northeast region but declining in the other three region (West, Midwest and South).

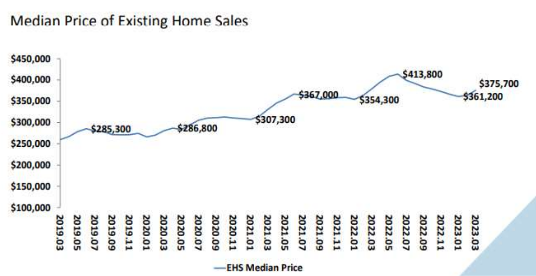
The Federal Reserve's aggressive interest rate hiking campaign has plunged the housing market into recession, with residential investment contracting for seven straight quarters, the longest such streak since the collapse of the housing bubble triggered by the 2007-2009 Great Recession. According to NRA total housing inventory registered at the end of March was 980,000 units, up 1.0% from February and 5.4% from one year ago (930,000). Unsold inventory sits at a 2.6-month supply at the current sales pace, unchanged from February but up from 2.0 months in March 2022.The median price of existing home sales was $375,000 in March from $361,200 in January which is 1.04% increase.

Total existing Home Sales



Source: National Association of Realtors

Median Price of Existing Home Sales

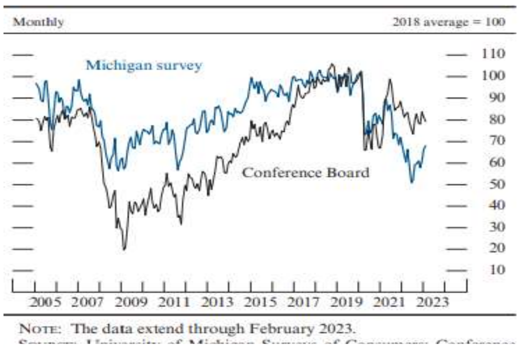


Source: National Association of Realtors

According to research done by the Goldman Sachs, higher borrowing costs for homebuyers have weighed heavily on housing affordability and the full impact likely hasn't been felt yet. The GS Research team estimates that each 100-basis-point rise in mortgage rates leads to a 6% decline in residential fixed investment after three or four quarters and a 2.5% drop in house prices after 10 quarters. Countries with higher shares of fixed-rate mortgages, for example, tend to experience delayed rate impacts. Since mortgage rates have only recently peaked in most countries and could be headed higher still, the global housing market may not have yet found its bottom.

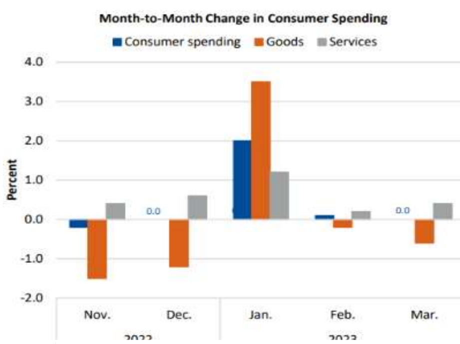
Consumer spending is plateauing as people become more averse to high prices. Government social benefit – the temporary boost by SNAP (Supplemental Nutrition Assistance program) which was authorized by the government during covid to support people affected by the pandemic expired in March. The University of Michigan index of consumer sentiment remains very low by historical standards despite an up move in second half of 2022.Despite increase in jobs and wages last year the real disposable income fell 1.4 percent in 2022. Personal income increased $67.9 billion (0.3% monthly rate), the personal saving rate (personal saving as percentage of disposable personal income) was 5.1 percent in March, compared to with 4.8% percent in February. Personal saving rate is at its lowest level since the great recession mainly due to fall in real income.

Indexes of consumer sentiment



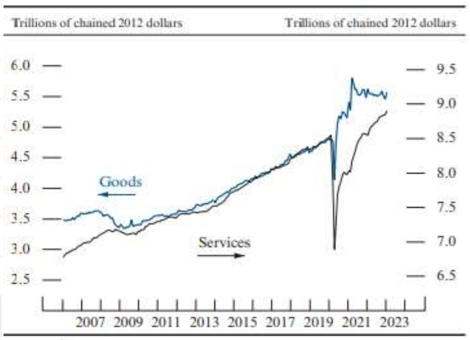
Source: University of Michigan Surveys of

Consumer Spending



US Bureau of Economic Analysis

Real personal consumption expenditures



US Bureau of Economic Analysis

Outlook

Fed officials have been forcefully winding up the interest rate since March 2022, approving the tenth straight increase in borrowing cost without any breaks. The May policy meeting statement omitted the words that anticipated future rate hike. Fed Chairman Jerome Powell did not explicitly state that a decision to pause rate hike is taken, but asserted that the rate hike decision would be based on whether the inflation is slowing down sufficiently. But change of wording showed that Fed officials beginning to feel comfortable with current fed funds rate. Thus further hike in rates looks a remote possibility. New York Fed President John Williams in May felt that unemployment rate is likely to rise to 4%-4.5% range, from its current 54- year low of 3.4%.

Amid the looming threat of federal government defaulting on its debt, another economic headwind has unexpectedly appeared: Bank Failures. According to Mark Zandi, Chief Economist at Moody’s Analytics, pointed that Treasury Department has been moving cash around via so called “extraordinary measure” to cover its debts. This measure was expected to bridge the government through August, buying lawmaker’s time to strike a deal. Tax receipts, however, are about 35 percent lower than last year, which would put the government at risk of default as early as June. The reduced lending by banks after the recent round of bank failures could serve as a means of cooling the economy, a move that could effectively have the same effect as another rate hike.

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