U.S. Economic Comment

- Employment costs: limited upward pressure
- Interest on reserves: a floor on the federal funds rate

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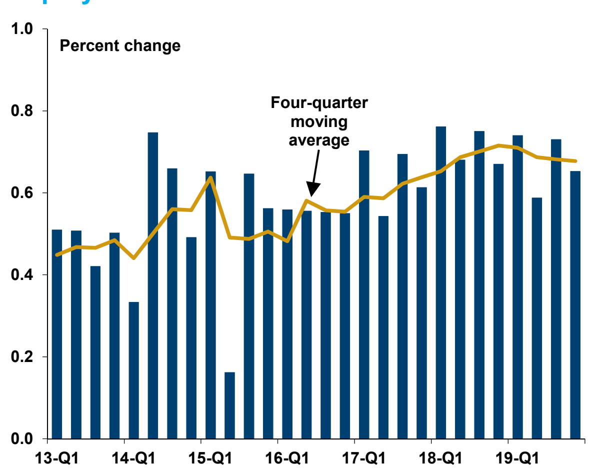
Employment Costs: A Nonissue for Inflation

The employment cost index, arguably the best measure of labor compensation in the United States, rose 0.7 percent in the fourth quarter. The latest increase, while close to other recent observations, was a tad on the light side, as it rounded up to 0.7 percent and it led to a downward drift in year-over-year growth (chart, left; 2.7 percent over the four quarters of 2019 versus the recent peak of 2.9 percent in 2018). The easing in year-over-year growth is consistent with recent results on average hourly earnings from the employment report (2.9 percent in the 12 months ended December 2019 versus 3.3 percent as of December 2018).

Some observers might not be puzzled by the recent deceleration, as they can argue that the easing has been mild and that compensation growth is still close to the sum of expected inflation and productivity growth, which might be viewed as an equilibrium or sustainable pace. This view on compensation has merit, but we find it less than compelling. Compensation growth equal to inflation plus productivity is merely a theoretical equilibrium; growth could easily fall short of this gauge in slow times and it most likely would be faster in a tight labor market.

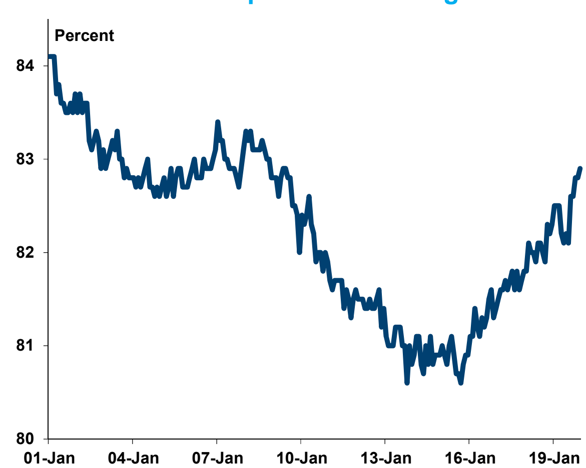
We view moderate wage growth in the current cycle as puzzling, but we can offer two possible explanations. First, the labor market probably still has element of slack, and thus upward pressure on compensation has not been intense. A sharp advance in the labor force participation rate for prime-aged workers in the past few years, including a surge in the second half of 2019, supports this view (chart, right). While firms reportedly have had to bolster their recruitment efforts to find workers, the increase in the participation rate suggests that employers have been able to pull individuals from the sidelines without sizeable increases in compensation. The overall participation rate has not picked up meaningfully because of the offsetting effects of retiring baby boomers, but firms most likely would be seeking prime-aged workers rather than older ones. In addition, a shift from older workers (possibly in their peak earning years) to younger ones (at lower pay scales) is possibly restraining average wages.

Employment Cost Index



Source: Bureau of Labor Statistics via Haver Analytics

Labor-Force Participation: Prime-Age Workers*

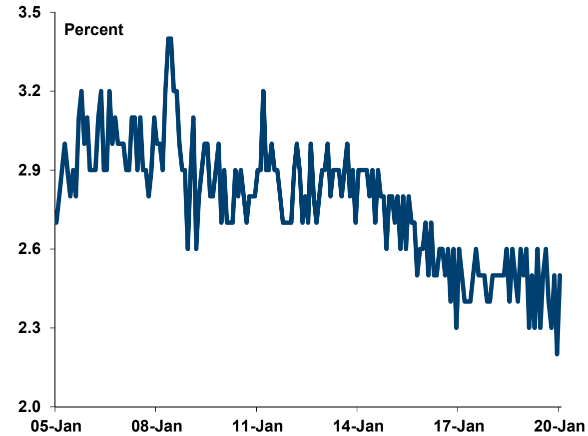


** Labor-force participants aged 25 to 54 as a share of the civilian noninstitutional population aged 25 to 54.*

Source: Bureau of Labor Statistics via Haver Analytics

Inflation expectations, in our view, represent another key factor restraining compensation growth. Surveys of consumers show that expectations of inflation have moved lower in the past several years (chart), and those perceptions are playing an important role in setting wages. Not only are expectations contained overall, but the survey of consumers conducted by the Federal Reserve Bank of New York shows that expectations of younger individuals (under 40) are lower than those of older ones (over 60). This difference in views is not surprising in that those under 40 years old did not experience the rapid inflation of the 1970s and early 1980s, but the difference is important because most of the supply of new workers is coming from younger or prime-aged workers, and they have limited concern about wages keeping pace with inflation.

Long-Term Inflation Expectations*



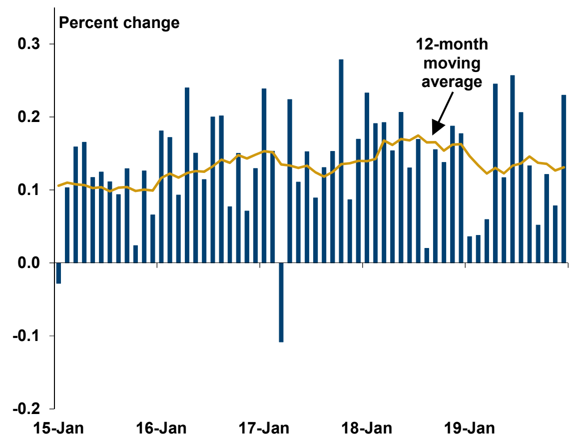
* *Survey respondents' expected annual change in prices over the next 5 to 10 years.*

Source: University of Michigan Survey of Consumers via Haver Analytics

Inflation: Contained

The stability in compensation growth last year and the deceleration this year suggest that inflation is likely to remain subdued, and the latest report on the price index for personal consumption expenditures supports this view. The December report showed a noticeable increase in prices excluding food and energy (0.23%, chart), but this increase followed tame readings in the prior four months and did little damage to the restrained underlying trend (1.6 percent year-over-year, still below the Fed's target of 2.0 percent). The core PCE price index has been volatile this year, showing minimal changes in the opening months of 2019 before jumping in the spring and early summer. The measure then quieted from August to November. We view the above-average increase in December as another instance of random volatility.

Core PCE Price Index



PCE = personal consumption expenditures

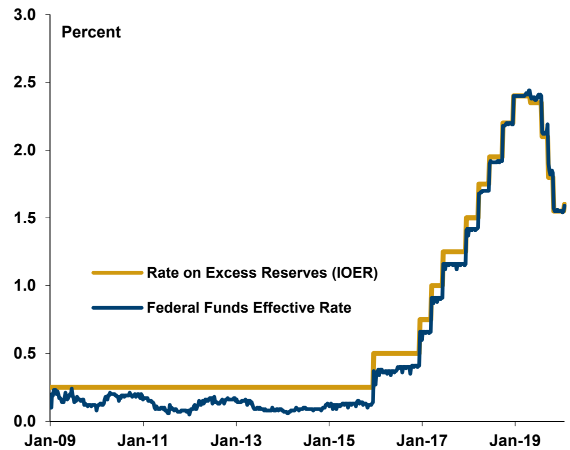
Source: Bureau of Economic Analysis via Haver Analytics

IOER: A Floor on the Federal Funds Rate

A reporter at Chair Powell's press conference asked about the Fed's adjustment of the interest rate on excess reserves (IOER), which the Board of Governors raised five basis points to 1.60 percent. The reporter wondered about the level sought by the Fed; was this an effort to raise the rate on reserves above the federal funds rate, like it was from 2008 until late 2015 (chart, next page)? This individual obviously did not have a clear view of the likely relationship between the federal funds rate and the interest rate on excess reserves. Questions we have received from clients also suggest that some market participants do not have a deep understanding. A discussion seems warranted.

In most circumstances, the federal funds rate will be equal to or slightly higher than the interest rate on excess reserves. That is, IOER should represent a floor on FFR. There is a simple, logical explanation for this relationship. In managing the normal inflow and outflow of funds in its reserve account at the Fed, a commercial bank has two options for balances that might be larger than desired: it can lend them in the federal funds market, or it can hold them in its reserve account at the Fed. A commercial bank is not likely to lend in the federal funds market at a rate below the risk-free return that it can obtain at the Federal Reserve; that is, a bank is not likely to lend in the fed funds market at a rate below IOER. Thus, the fed funds rate is likely to be slightly higher than IOER.

Federal Reserve Policy Rates



Source: Federal Reserve Board via Haver Analytics

As noted by the reporter at the press briefing and shown on the chart, this was not the case for several years after the Fed started paying interest on reserves in 2008. However, the IOER was higher than the fed funds rate at that time because of the large QE programs of the Fed, which left an abundant supply of reserves in the banking system. Some institutions with reserve accounts at the Fed are not eligible to receive interest payments on their balances (government-sponsored enterprises, for example), and these institutions would be lending in the fed funds market if their reserve accounts were heavy. With reserves abundant, such transactions were common and they pushed the funds rate lower. Now, reserves are less abundant and such lending in most cases will not be large enough to push the federal funds rate below IOER. Random shifts in reserves could lead to excessive amounts at government-sponsored enterprises at times, which could push the fed funds rate below IOER, but such instances will probably be rare and brief.

The Fed will occasionally make a change in IOER independent of a shift in the federal funds rate, as it did this week. Such changes are technical adjustments rather than meaningful changes in monetary policy. They are made to nudge the federal funds rate up or down so that it is close to the middle of the target range. Federal funds in recent weeks had been trading in the neighborhood of 1.55 percent, the low portion of the 1.50 to 1.75 percent target range. The hike in IOER, as intended, pushed FFR closer to the middle of the target range (1.60 percent on Thursday and likely to match this average on Friday).

Review

Week of Jan. 27, 2020	Actual	Consensus	Comments
New Home Sales (December)	**0.694 Million (-0.4%)**	**0.730 Million (+1.5%)**	The drop in sales of new homes occurred from a downward revised level November (3.1% lower than previously believed). Despite the downside surprise, the number of homes sold was still in the upper portion of the recent range. Results varied sharply by geographic region: robust in the West and favorable the Midwest; weak in the South and mildly disappointing in the Northeast. Variations in weather across the country might account for the marked difference in sales across regions.
Durable Goods Orders (December)	**2.4%**	**0.3%**	The surprising jump in orders for durable goods reflected unusual volatility in the transportation category. Striking advances in bookings for defense-related aircraft (168.3%) and miscellaneous transportation items (71.7%, no detail available, but we suspect ships) more than offset a tumble in orders for commercial aircraft (-74.7%) and an easing in bookings for motor vehicles (-0.9%). Orders excluding transportation eased 0.1%, continuing a downward drift that has been in place since the closing months of 2018.
Consumer Confidence (January)	**131.6 (+2.7%)**	**128.0 (+1.2%)**	The increase in consumer confidence occurred from an upward revised level in December (1.3% firmer than initially estimated), which pushed the measure to the upper portion of the elevated range from the past two years. The surge in equity values in the past two months probably influenced attitudes, and the signing of the Phase One trade agreement also might have been noticed by some individuals. A favorable view of the labor market also played a role, as the assessment of the labor market (are jobs plentiful or hard to get?) moved to the second-best level of the current expansion.
U.S. International Trade in Goods (December)	**-\$68.3 Billion (\$5.3 Billion Wider Deficit)**	**-\$65.0 Billion (\$2.0 Billion Wider Deficit)**	All of the slippage in the goods trade deficit in December occurred on the import side, with foreign purchases increasing 2.9%. Although imports rose noticeably, the jump offset only a portion of the slide in the prior three months, leaving a downward trend in the past year. Exports rose 0.3% after a gain of 0.8% in the prior month. These advances, however, followed sharper declines in the prior two months and thus left an approximately flat trend in the past year. Shifts in exports and imports for the quarter added 1.5 percentage points to GDP growth, although the contribution was not necessarily favorable, as it was driven by weak imports rather than firm exports.

Review Continued

Week of Jan. 27, 2020	Actual	Consensus	Comments
GDP (2019-Q4)	**2.1%**	**2.0%**	Much of the economic growth in Q4 was the result of a 1.5 percentage point contribution from net exports, but this was not necessarily a sign of strength, as it reflected primarily a sharp drop in imports. Two key components of domestic demand tilted on the soft side. Consumer spending rose 1.8%, about one-half percentage point slower that the recent average, and business fixed investment fell for the third consecutive quarter. Businesses also showed caution with a paltry pace of inventory investment. Residential construction was a clear bright spot, increasing for the second consecutive quarter after a six-quarter slide. Investment by state and local governments returned to a firm underlying trend after a dip in Q3.
Personal Income, Consumption, Prices (December)	**0.2%, 0.3%, 0.2%**	**0.3%, 0.3%, 0.1%**	The increase in personal income trailed the average advance of 0.4% in the first 11 months of the year. Wages and salaries posted a respectable advance (0.3%), and rental income (0.6%) and interest income (1.6%) were firm. However, a slump in farm income (-60.9%) restrained the total (the drop reflected a return to normal after a boost from subsidy payments in November). The advance in nominal consumer spending was within the range of recent observations, but it rose only modestly after adjusting for inflation (0.1%), contributing to below-average growth in Q4 (1.8%, annual rate). The core PCE price index posted a high-side reading (0.230%), but the latest advance followed tame readings in the prior four months. The year-over-year reading on the core index accelerated one tick to 1.6%, a reading in the middle of the range of 2019 and off readings of 2.0% in the second half of last year.
Employment Cost Index (2019-Q4)	**0.7%**	**0.7%**	The increase in the employment cost index in Q4 was a tad lighter than some other recent observations and led to a downward drift in year-over-year growth (2.7% versus a recent high of 2.9% in 2018-Q4). Wage growth has been generally stable in the past year at approximately 2.9%, but benefits costs have cooled (2.2% year-over-year versus and a recent high of 2.9% in 2018-Q2).
Revised Consumer Sentiment (January)	**99.8 (+0.7% Revision)**	**99.1 (Unrevised)**	The upward revision to consumer sentiment in January left the measure near the top of the range of the current expansion. Only a handful of monthly results were better, including the recent high of 101.4 in March of 2018.

Sources: U.S. Census Bureau (New Home Sales, Durable Goods Orders, U.S. International Trade in Goods); The Conference Board (Consumer Confidence); Bureau of Economic Analysis (GDP, Personal Income, Consumption, Prices); Bureau of Labor Statistics (Employment Cost Index); University of Michigan (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Feb. 3, 2020	Projected	Comments
ISM Manufacturing Index (January) (Monday)	**48.0% (+0.8 Pct. Pt.)**	Activity in the manufacturing sector seems to have stabilized after a slide earlier in the year, but recovery has been elusive, and thus the ISM index is likely to show little change.
Construction Spending (December) (Monday)	**1.0%**	The residential sector should be strong, as a jump in housing starts suggests that construction of new homes was brisk. The private nonresidential sector, in contrast, has been soft lately, and uncertainties have probably not eased enough to spur business activity. Strong investment activity by state and local governments evident in the GDP report points to favorable results in the public sector.
Factory Orders (December) (Tuesday)	**1.4%**	The already published increase of 2.4% in the durable component accounts for most of the expected increase in factory orders. This gain, in turn, reflected primarily surges in bookings for defense-related aircraft and miscellaneous transportation items. Orders for nondurable goods are likely to increase moderately, but much of the gain will probably be the result of higher prices of petroleum products.
Trade Balance (December) (Wednesday)	**-$48.5 Billion ($5.4 Billion Wider Deficit)**	The surplus in service trade typically shows little month-to-month variation, thus the change in the total trade balance is likely to be driven mainly by the already published slippage of $5.3 billion in the goods trade deficit.
ISM Nonmanufacturing Index (January) (Wednesday)	**55.5% (+0.5 Pct. Pt.)**	Economic activity outside of the manufacturing sector seems to be performing reasonably well, and thus the ISM nonmanufacturing index should remain close to the recent readings in the mid-50 percent area.
Nonfarm Productivity (2019-Q4) (Thursday)	**1.7%**	The increase in output in the nonfarm business sector (approximately 2.5% based on figures from the Q4 GDP report) was achieved with moderate growth in labor input, which should leave a solid increase in productivity. GDP statistics also suggest a firm increase in compensation per hour, which should leave the growth of unit labor costs at approximately 2.0%.
Payroll Employment (January) (Friday)	**150,000**	Job postings have eased in recent months, but they are still high enough to support solid job growth. The upcoming report will include benchmark revisions to the payroll figures, which will involve a reduction of approximately 500k jobs as of the March 2019 benchmark date (0.3% of total employment, a larger-than-normal adjustment, but not an unprecedented one). Data from the household survey, used to calculate the unemployment rate, will incorporate new population controls (i.e. factors to inflate the sample data to the population level). Past data will not be subject to the new population controls, and thus the new figures will not be strictly comparable to historical data.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2020

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	29	30	31
NEW HOME SALES Oct 0.705 million Nov 0.697 million Dec 0.694 million	**DURABLE GOODS ORDERS** Oct 0.2% Nov -3.1% Dec 2.4% **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** SA NSA Sept 0.4% 0.1% Oct 0.5% 0.1% Nov 0.5% 0.1% **CONFERENCE BOARD CONSUMER CONFIDENCE** Nov 126.8 Dec 128.2 Jan 131.6 **FOMC MEETING**	**U.S. INTERNATIONAL TRADE IN GOODS** Oct -$66.7 billion Nov -$63.0 billion Dec -$68.3 billion **ADVANCE INVENTORIES REPORT** Wholesale Retail Oct 0.1% 0.1% Nov 0.1% -0.8% Dec -0.1% 0.0% **PENDING HOMES SALES** Oct -1.3% Nov 1.2% Dec -4.9% **FOMC DECISION** **POWELL PRESS CONFERENCE**	**INITIAL CLAIMS** Jan 11 205,000 Jan 18 223,000 Jan 25 216,000 **GDP** GDP Chained Price 19-Q2 2.0% 2.4% 19-Q3 2.1% 1.8% 19-Q4 2.1% 1.4%	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. Cons. Core Oct 0.1% 0.2% 0.1% Nov 0.4% 0.4% 0.1% Dec 0.2% 0.3% 0.2% **EMPLOYMENT COST INDEX** Comp. Wages 19-Q2 0.6% 0.7% 19-Q3 0.7% 0.9% 19-Q4 0.7% 0.7% **CHICAGO PURCHASING MANAGERS' INDEX** Index Prices Nov 46.7 53.8 Dec 48.2 58.1 Jan 42.9 56.1 **REVISED CONSUMER SENTIMENT** Nov 96.8 Dec 99.3 Jan 99.8
3	4	5	6	7
ISM INDEX (10:00) Index Prices Nov 48.1 46.7 Dec 47.2 51.7 **Jan 48.0 50.0** **CONSTRUCTION SPEND. (10:00)** Oct 0.1% Nov 0.6% **Dec 1.0%** **VEHICLE SALES** Nov 17.1 million Dec 16.7 million **Jan 16.8 million**	**FACTORY ORDERS (10:00)** Oct 0.2% Nov -1.2% **Dec 1.4%**	**ADP EMPLOYMENT REPORT (8:15)** Private Payrolls Nov 124,000 Dec 202,000 Jan -- **TRADE BALANCE (8:30)** Oct -$46.9 billion Nov -$43.1 billion **Dec -$48.5 billion** **ISM NON-MFG INDEX (10:00)** Index Prices Nov 53.9 58.5 Dec 55.0 58.5 **Jan 55.5 58.0**	**INITIAL CLAIMS (8:30)** **PRODUCTIVITY & COSTS (8:30)** Productivity, Unit Labor Costs 19-Q2 2.5% 0.1% 19-Q3 -0.2% 2.5% **19-Q4 1.7% 2.0%**	**EMPLOYMENT REPORT (8:30)** Payrolls Un. Rate Nov 256,000 3.5% Dec 145,000 3.5% **Jan 150,000 3.5%** **WHOLESALE TRADE (10:00)** Inventories Sales Oct 0.1% -0.9% Nov 0.1% 1.5% **Dec -0.1% -0.3%** **CONSUMER CREDIT (3:00)** Oct $19.0 billion Nov $12.5 billion Dec --
10	11	12	13	14
	NFIB SMALL BUSINESS OPTIMISM INDEX **JOLTS DATA**	**FEDERAL BUDGET**	**INITIAL CLAIMS** **CPI**	**RETAIL SALES** **IMPORT/EXPORT PRICES** **IP & CAP-U** **CONSUMER SENTIMENT** **BUSINESS INVENTORIES**
17	18	19	20	21
PRESIDENTS' DAY	**EMPIRE MFG INDEX** **NAHB HOUSING INDEX** **TIC DATA**	**HOUSING STARTS** **PPI** **FOMC MINUTES**	**INITIAL CLAIMS** **PHILLY FED INDEX** **LEADING INDICATORS**	**EXISTING HOME SALES**

Forecasts in Bold.

Treasury Financing

January/February 2020

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	29	30	31
AUCTION RESULTS: Rate / Cover 13-week bills 1.530% 2.66 26-week bills 1.535% 2.76 2-year notes 1.440% 2.65 5-year notes 1.448% 2.33	**AUCTION RESULTS:** Rate / Cover 52-week bills 1.490% 3.36 7-year notes 1.570% 2.37 Spread / Cover 2-year FRN 0.154% 3.23 **ANNOUNCE:** $45 billion 4-week bills for auction on January 30 $45 billion 8-week bills for auction on January 30 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills		**AUCTION RESULTS:** Rate / Cover 4-week bills 1.545% 2.69 8-week bills 1.550% 3.01 **ANNOUNCE:** $84 billion 13-,26-week bills for auction on February 3 **SETTLE:** $84 billion 13-,26-week bills $26 billion 52-week bills	**SETTLE:** $14 billion 10-year TIPS $20 billion 2-year FRNs $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes
3	4	5	6	7
AUCTION: $84 billion 13-,26-week bills	**ANNOUNCE:** $45 billion* 4-week bills for auction on February 6 $45 billion* 8-week bills for auction on February 6 **SETTLE:** $45 billion 4-week bills $45 billion 8-week bills	**ANNOUNCE MID-QUARTER REFUNDING:** $38 billion* 3-year notes for auction on February 11 $27 billion* 10-year notes for auction on February 12 $19 billion* 30-year bonds for auction on February 13	**AUCTION:** $45 billion* 4-week bills $45 billion* 8-week bills **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on February 10 **SETTLE:** $84 billion 13-,26-week bills	
10	11	12	13	14
AUCTION: $84 billion* 13-,26-week bills	**AUCTION:** $38 billion* 3-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on February 13 $45 billion* 8-week bills for auction on February 13 **SETTLE:** $45 billion* 4-week bills $45 billion* 8-week bills	**AUCTION:** $27 billion* 10-year notes	**AUCTION:** $45 billion* 4-week bills $45 billion* 8-week bills $19 billion* 30-year bonds **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on February 18 $8 billion* 30-year TIPS for auction on February 20 **SETTLE:** $84 billion* 13-,26-week bills	
17	18	19	20	21
PRESIDENTS' DAY	**AUCTION:** $84 billion* 13-,26-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on February 20 $45 billion* 8-week bills for auction on February 20 **SETTLE:** $45 billion* 4-week bills $45 billion* 8-week bills $38 billion* 3-year notes $27 billion* 10-year notes $19 billion* 30-year bonds		**AUCTION:** $45 billion* 4-week bills $45 billion* 8-week bills $8 billion* 30-year TIPS **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on February 24 $26 billion* 52-week bills for auction on February 25 $18 billion* 2-year FRNs for auction on February 26 $40 billion* 2-year notes for auction on February 25 $41 billion* 5-year notes for auction on February 26 $32 billion* 7-year notes for auction on February 27 **SETTLE:** $84 billion* 13-,26-week bills	

**Estimate*