U.S. Economic Comment

- FOMC: looking for clues on interest rate liftoff
- CPI pressure: partly pandemic-related, partly fundamental

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Monetary Policy: Preparing for the Next Step

The upcoming meeting of the Federal Open Market Committee is likely to be eventful. Chair Powell has indicated that price pressure is no longer transitory and that the FOMC will consider speeding the pace of tapering its asset purchase program. Given Mr. Powell's change of heart, and considering similar comments from other Fed officials, it is difficult imagine the Committee maintaining the current pace of tapering. We look for officials to double the monthly reductions in asset purchases to $20 billion for Treasuries and $10 billion for mortgage-backed securities, which would end the program in mid-March.

Chair Powell has emphasized in the past that tapering the asset purchase program does not carry any implications for the Fed's interest rate policy. However, speeding the pace of tapering seems to send a strong signal that the Fed is not far from interest rate liftoff. We hope to find clues regarding the next phase of policy normalization in either the meeting materials published by the FOMC or the press briefing of Chair Powell.

The Committee will release a new Summary of Economic Projections at the conclusion of its meeting, and the dot plot will provide some insight into what might unfold on the interest rate front. The plot from the September meeting showed an even split between those who favored steady interest rate policy and those who saw a need to raise rates. The new plot will probably show a clear majority anticipating higher interest rates next year. In fact, we suspect that the new dot plot will show two interest rate hikes in 2022. In our view, two hikes will not be sufficient to contain inflation; we will be looking for three increases next year.

The inflation projection in the Summary of Economic Projections also will be revealing. The outlook published in September had inflation settling at 2.2 percent next year, a pace presumably desired by the FOMC (the Committee is seeking inflation moderately above the official target of 2.0 percent to compensate for undershoots in years past). That projection essentially indicated that officials in September viewed inflation as transitory, settling to its desired pace within a year.

The new projection of inflation most likely will be notably slower than the current year-over-year pace of 5.0 percent, as there are indeed some temporary factors fueling inflation. However, Fed officials are now viewing price pressure as being more broadly based and longer-lasting than previously believed, and thus inflation projections are likely to be well above the benign forecasts in September.

What is Maximum Employment?

While the Fed has both inflation and employment mandates, it has been focused in recent years on the goal of maximum employment. Indeed, the forward guidance offered by the Fed indicates that interest rate liftoff will not occur until the economy has reached maximum employment. Unfortunately, it is not clear what constitutes maximum employment. The Fed's official statement on policy strategy has the vaguest of descriptions: a broad-based and inclusive goal that is not directly measurable and changes over time. This definition gives essentially no guidance. Chair Powell has been asked at times to provide clarity, but he has merely noted that the Fed monitors a broad array of labor market indicators and that the weight of the evidence indicates we are still shy of the max.

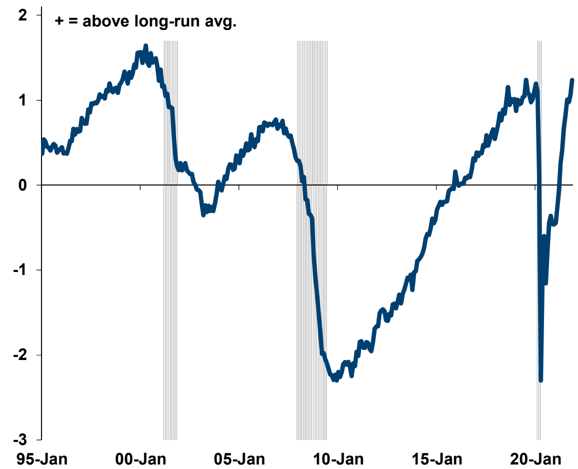
Chair Powell conceivably could argue that the U.S. is still shy of maximum employment, as nonfarm payrolls are 3.9 million below their pre-pandemic peak and the unemployment rate is 0.7 percentage point above the low in the previous expansion. However, we look for Mr. Powell to be open to the possibility that the economy has essentially reached maximum employment.

While Chair Powell has not provided specifics on the Fed's employment goal, Richard Clarida, the Vice-Chair of the Board of Governors, has offered a clear and simple perspective. In his view, maximum employment is the highest level that does not generate sustained price pressure. Given recent increases in wages and the pickup in inflation, one can easily argue that this definition has been met.

If one uses the broad array of labor market indicators noted by Mr. Powell, the conclusion also would be that the economy has reached maximum employment. The Federal Reserve Bank of Kansas City maintains a labor market conditions index consisting of 24 employment-related indicators. This measure has climbed to the top of the range from the previous expansion (fractionally below only one observation), and it is comfortably above all observations from the expansion in the mid-2000s. It trails somewhat the record readings seen during the tech boom in the late 1990s and the early 2000s (chart).

This measure has captured the attention of Fed officials, as it has been noted in minutes from FOMC meetings. With the Kansas City index now in the upper reaches of its historical range, interest rate liftoff is probably not far off.

Labor Market Conditions Index: Activity*



** The Labor Market Conditions Index (LMCI) is a monthly measure of labor market activity that is based on 24 labor market variables. A positive reading indicates that labor market conditions are above their long-run average, whereas a negative value indicates that conditions are below their long-run average. The shaded areas on the graph indicate periods of recession in the United States.*

Sources: Federal Reserve Bank of Kansas City and National Bureau of Economic Research via Haver Analytics

The Balance Sheet

With the Federal Reserve now using its balance sheet to influence economic activity, policy tightening at some point will probably involve a reduction in the size of the Fed's portfolio. That is, a period of quantitative tightening (QT) will most likely follow the latest round of quantitative easing (QE). Conceivably, the FOMC could initiate policy normalization by trimming its security holdings before it begins to increase interest rates. However, once the Fed is done purchasing securities, we expect it to shift to interest rate increases. Officials now seem to view QE and QT as standard tools of policy, but interest rate changes are the preferred instrument and will most likely lead a change in the direction of policy.

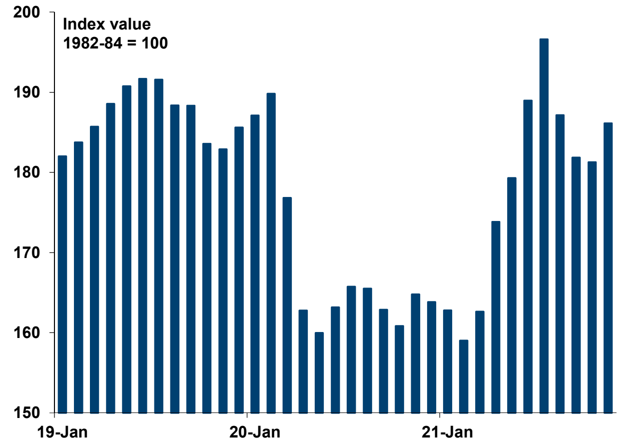
Not only do we expect the Fed to begin the tightening phase of its policy cycle by raising interest rates, but we also suspect that it will not begin reducing the size of its portfolio for a considerable time. The FOMC as a group seems to have a strong dovish tilt, and that will probably intensify when President Biden appoints new individuals to the Board of Governors (three appointments are on the near-term horizon). Thus, the Committee will probably move cautiously.

The experience with QT after the financial crisis also suggests that the Committee will not move quickly in reducing its portfolio. The Fed first raised interest rates after the Great Recession in December 2015, but it did not begin to reduce its portfolio until almost two years later (October 2017). That expansion was notably different than the current one (slower growth and no inflation issues), and thus one should be cautious in using it as a guide, but it nevertheless supports the view that QT could lag the first interest rate hike considerably.

Consumer Prices

Although they will not use the term "transitory", Fed officials might not be alarmed by the November results on the consumer price index, as much of the pressure seemed to come from items affected by the pandemic. Goods or services that were heavily discounted during the worst of the pandemic have increased noticeably in price this year. For example, the chart to the right shows an index for airfares, hotel fees, and apparel prices. (The chart shows the level of the index rather than the percent change, so the vertical scale could be viewed as the combined cost of this set of goods and services.) Discounting last year was obvious, and prices this year are sharply higher. Other items affected by Covid-19 might be included in a list of prices that have surged this year and are likely to quiet down in the months ahead (motor vehicles, vehicle rentals, admissions to live entertainment).

CPI: Pandemic-Sensitive Areas Index*



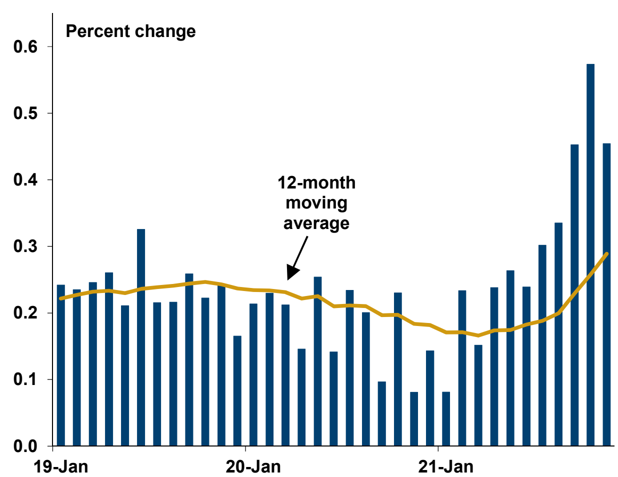
** The pandemic-sensitive areas index is a weighted average of the Airline Fare, Apparel, and Other Lodging Away from Home Hotels/Motels components of the CPI. Weights are calculated based on the relative importance of each component in the CPI.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

While there are pressures that certainly will lessen, we would not downplay inflation risks. We would first argue that demand is relevant. Note in the pandemic-sensitive chart above that prices picked up in November (2.7 percent), most likely reflecting a pickup in travel and socializing around the Thanksgiving holiday. With the economy on a solid growth track, demand and price pressure are likely to remain firm.

In addition, while some pandemic-sensitive items in the CPI stand out as sources of inflation, pressures are not narrowly based. An acceleration in the median CPI suggests that the distribution of price changes has shifted to the right (chart), that is, toward higher prices. It is not merely a handful of price changes influenced by the pandemic that has generated high-side readings on inflation.

Median CPI

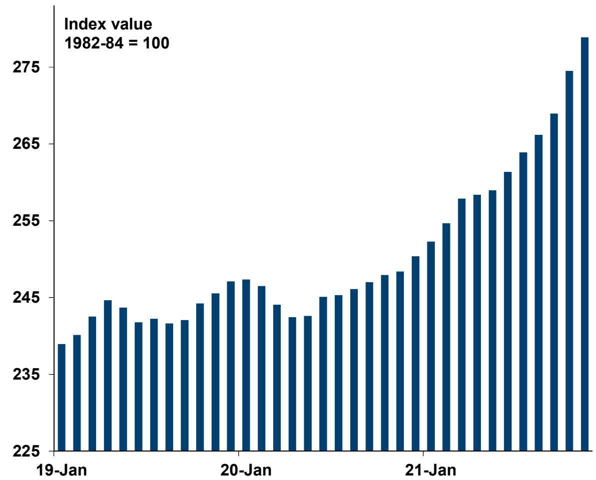


Source: Federal Reserve Bank of Cleveland via Haver Analytics

Some items not directly related to the pandemic merit special mention as possible sources of inflation in the months ahead. We plan to monitor prices of food and energy closely, as these have traced an exponential-like path since the spring (chart, next page, presented in levels rather than percent change). While economists often ignore prices of food and energy because of pronounced month-to-month volatility, they are important if underlying trends are shifting. Food and energy are among the most frequent purchases made by households, and for many they represent a large share of monthly budgets. These items, more than any other, have the potential to influence inflation expectations and to trigger a wage-price spiral.

We also view rents as crucial in the current cycle. Home prices have exploded in the past year or so, running far above the cost of renting a home or apartment. The costs of owning and renting shelter should track closely over time, but a sizeable gap currently exists that could be closed by an acceleration in rents. The pace already seems to have quickened, as rent of primary residence and owners' equivalent rent have both increased 0.4 percent or more for three consecutive months (chart, shown as percent change). These measures averaged increases of 0.2 percent last year and 0.3 percent in 2019 (pre-pandemic).

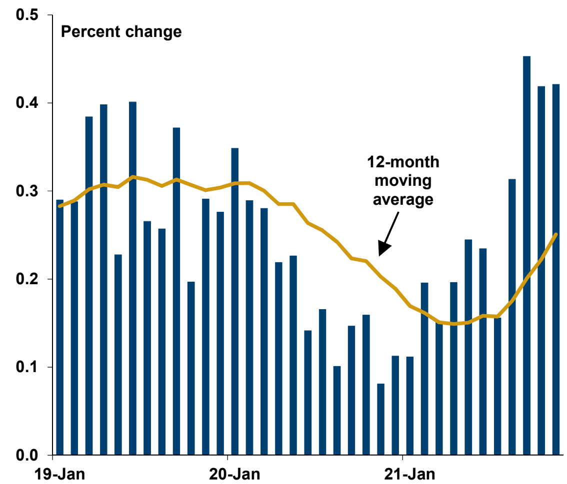
CPI: Food & Energy Index*



** The food and energy index is a weighted average of the Food and Energy components of the CPI. Weights are calculated based on the relative importance of each component in the CPI.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets Americ

CPI: Rent of Primary Residence



Source: Bureau of Labor Statistics via Haver Analytics

Review

Week of Dec. 6, 2021	Actual	Consensus	Comments
Revised Nonfarm Productivity (2021-Q3)	**-5.2% (-0.2 Pct. Pt. Revision)**	**-4.9% (+0.1 Pct. Pt. Revision)**	Output in the nonfarm business sector was revised upward (1.8% vs. 1.7%), but hours worked were adjusted by a larger amount (7.4% vs. 7.0%), offsetting the positive effect of output and leading to a downward revision to productivity growth in Q3. The weak results in Q3 left a drop of 0.5% in the past year, and the average advance of 2.3% in the past six quarters is not especially impressive for the early stages of a business expansion. Compensation per hour rose at a solid pace (3.9%, revised from 2.9%). This advance, combined with the drop in productivity, led to a jump of 9.6% (vs. 8.3%) in unit labor costs. In addition, unit labor costs in Q2 were revised noticeably higher (5.9% vs. 1.1%).
Trade Balance (October)	**-$67.1 Billion ($14.3 Billion Narrower Deficit)**	**-$66.8 Billion ($14.1 Billion Narrower Deficit)**	A jump of 8.1% in exports overwhelmed an increase of 0.9% in imports in October, with the shifts leading to a sharp narrowing in the monthly trade deficit. We suspect that shipping delays and port congestion played a role in the marked improvement, as the narrowing in the deficit followed a notable widening of $8.2 billion in September. The data in hand raise the possibility that real net exports will make a positive contribution to GDP growth in Q4, which would break a string of five consecutive negative contributions.
CPI (November)	**0.8% Total, 0.5% Core**	**0.7% Total, 0.5% Core**	The food and energy components of the CPI remained under pressure in November, increasing 0.7% and 3.5%, respectively. Both have been on exponential-like paths since early in the year. The core component rose sharply, the fifth month in the past eight posting an advance of 0.5% of more. The latest shift was heavily influenced by pandemic-sensitive areas, but other items also showed signs of pressure, including rents, home furnishings, and recreation commodities. The latest monthly results left the year-over-year increase in the headline index at 6.8%, up from 6.2% in October and the fastest pace since June 1982. The core component rose 4.9% in the past 12 months, up from 4.6% in October and the fastest since June 1991.
Consumer Sentiment (December)	**70.4 (+3.0 Index Pts.)**	**68.0 (+0.6 Index Pt.)**	The pickup of 4.5% in consumer sentiment did little to reverse the underwhelming performance of recent months, with four of the past five readings (including that for early December) below the recession low of 71.8 in April 2020, when the economy was shut down because of the Covid outbreak. Both the year-ahead and long-term inflation measures were unchanged in December at 4.9% and 3.0%, respectively. Both were elevated from a longer-term perspective.
Federal Budget (November)	**$191.3 Billion Deficit**	**$193.0 Billion Deficit**	Revenues grew briskly in November (up 28.1% year-over-year, the fourth consecutive month of revenue growth in the neighborhood of 20%). Outlays also rose sharply (29.5% year-over-year). The latest shifts led to a widening of $46 billion versus the deficit in the same month in FY 2021

Sources: Bureau of Labor Statistics (Revised Nonfarm Productivity, CPI); Bureau of Economic Analysis (Trade Balance); University of Michigan Survey Research Center (Consumer Sentiment); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of Dec. 13, 2021	Projected	Comments
PPI (November) (Tuesday)	**0.5% Total, 0.3% Ex. Food & Energy**	Higher gasoline prices are likely to drive the energy component higher again (up in 12 of the past 13 months), and the food component is likely to return to its upward trend after a dip in October. Prices excluding food and energy have increased every month so far this year, registering an average advance of 0.6%. A correction in construction-related inflation after a surge in October is likely to leave a below-average increase outside of food and energy.
Retail Sales (November) (Wednesday)	**0.9% Total, 1.0% Ex. Autos**	Higher prices, combined with a strong push from seasonal adjustment, probably drove the gasoline component higher. Media reports of supply shortages probably induced individuals to accelerate their holiday shopping, which could pull planned spending from December into November. On the downside, the spread of the Delta variant and the emergence of Omicron could constrain activity at restaurants and bars.
Housing Starts (November) (Thursday)	**1.550 Million (+2.0%)**	Multi-family starts are likely to remain within the elevated range that has been evident all year, while improvement in sales and buyer traffic could lead builders to a pick up the pace of single-family starts, which would offset a portion of the slide that began in January.
Industrial production (November) (Thursday)	**0.7%**	A solid gain in employment and a longer workweek in the factory sector point to a brisk advance in the manufacturing component of industrial production. Utility output also could increase, as temperatures returned to normal in November after a warm October that constrained demand for heating services. Mining output is likely to be little changed, as employment and hours worked were on the soft side in November.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

December 2021

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
	REVISED PRODUCTIVITY & COSTS Productivity / Unit Labor Costs 21-Q2 2.4% 5.9% 21-Q3(p) -5.0% 8.3% 21-Q3(r) -5.2% 9.6% **TRADE BALANCE** Aug -$73.2 billion Sept -$81.4 billion Oct -$67.1 billion **CONSUMER CREDIT** Aug $13.4 billion Sept $27.8 billion Oct $16.9 billion	**JOB OPENINGS & LABOR TURNOVER** Openings (000) / Quit Rate Aug 10,629 2.9% Sept 10,602 3.0% Oct 11,033 2.8%	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Nov 13 0.270 2.055 Nov 20 0.194 1.954 Nov 27 0.227 1.992 Dec 04 0.184 N/A **WHOLESALE TRADE** Inventories / Sales Aug 1.3% -0.9% Sept 1.4% 1.7% Oct 2.3% 2.2%	**CPI** Total / Core Sept 0.4% 0.2% Oct 0.9% 0.6% Nov 0.8% 0.5% **CONSUMER SENTIMENT** Oct 71.7 Nov 67.4 Dec 70.4 **FEDERAL BUDGET** 2021 / 2020 Sept -$61.6B -$124.6B Oct -$165.1B -$284.1B Nov -$191.3B -$145.3B
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX (6:00) Sept 99.1 Oct 98.2 Nov -- **PPI (8:30)** Final Demand / Ex. Food & Energy Sept 0.5% 0.2% Oct 0.6% 0.4% **Nov 0.5% 0.3%** **FOMC MEETING**	**RETAIL SALES (8:30)** Total / Ex.Autos Sept 0.8% 1.7% Oct 1.7% 1.7% **Nov 0.9% 1.0%** **IMPORT/EXPORT PRICES (8:30)** Ex. Petrol. Imports / Nonagri. Exports Sept 0.2% 0.6% Oct 0.5% 1.5% Nov -- -- **EMPIRE MFG (8:30)** Oct 19.8 Nov 30.9 Dec -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales Aug 0.8% 0.1% Sept 0.8% 1.2% **Oct 1.2% 2.0%** **NAHB HOUSING INDEX (10:00)** Oct 80 Nov 83 Dec -- **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)** **TIC DATA (4:00)** Total / Net L-T Aug $91.1B $79.3B Sept -$26.8B $26.3B Oct -- --	**INITIAL CLAIMS (8:30)** **HOUSING STARTS (8:30)** Sept 1.530 million Oct 1.520 million **Nov 1.550 million** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Oct 23.8 Nov 39.0 Dec -- **IP & CAP-U (9:15)** IP / Cap.Util. Sept -1.3% 75.2% Oct 1.6% 76.4% **Nov 0.7% 76.9%**	
20	21	22	23	24
LEADING INDICATORS	**CURRENT ACCOUNT**	**CHICAGO FED NATIONAL ACTIVITY INDEX** **REVISED GDP** **CONSUMER CONFIDENCE** **EXISTING HOME SALES**	**INITIAL CLAIMS** **PERSONAL INCOME, CONSUMPTION, PCE PRICES** **DURABLE GOODS ORDERS** **NEW HOME SALES** **REVISED CONSUMER SENTIMENT**	***CHRISTMAS DAY (OBSERVED)***
27	28	29	30	31
	FHFA HOME PRICE INDEX **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PENDING HOME SALES**	**INITIAL CLAIMS** **MNI CHICAGO BUSINESS BAROMETER INDEX**	

Forecasts in Bold. (p) = preliminary; (r) = revised

Treasury Financing

December 2021

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
AUCTION RESULTS: Rate Cover 13-week bills 0.055% 2.82 26-week bills 0.105% 2.86	**AUCTION RESULTS:** Rate Cover 3-year notes 1.000% 2.43 **ANNOUNCE:** $10 billion 4-week bills for auction on December 9 $25 billion 8-week bills for auction on December 9 $35 billion 17-week CMBs for auction on December 8 **SETTLE:** $10 billion 4-week bills $25 billion 8-week bills $40 billion 17-week CMBs $40 billion 8-day CMBs	**AUCTION RESULTS:** Rate Cover 10-yr notes 1.518% 2.43 17-week CMB 0.090% 3.28	**AUCTION RESULTS:** Rate Cover 4-week bills 0.030% 5.56 8-week bills 0.050% 3.70 30-yr bonds 1.895% 2.22 **ANNOUNCE:** $108 billion 13-,26-week bills for auction on Dec. 13 **SETTLE:** $108 billion 13-,26-week bills	
13	14	15	16	17
AUCTION: $108 billion 13-,26-week bills	**ANNOUNCE:** $10 billion* 4-week bills for auction on December 16 $25 billion* 8-week bills for auction on December 16 $35 billion* 17-week CMBs for auction on December 15 **SETTLE:** $10 billion 4-week bills $25 billion 8-week bills $35 billion 17-week CMBs	**AUCTION:** $35 billion* 17-week CMBs **SETTLE:** $54 billion 3-year notes $36 billion 10-year notes $22 billion 30-year bonds	**AUCTION:** $10 billion* 4-week bills $25 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Dec. 20 $20 billion* 20-year bonds for auction on December 21 $17 billion* 5-year TIPS for auction on December 22 **SETTLE:** $108 billion 13-,26-week bills	
20	21	22	23	24
AUCTION: $108 billion* 13-,26-week bills	**AUCTION:** $20 billion* 20-year bonds **ANNOUNCE:** $10 billion* 4-week bills for auction on December 23 $25 billion* 8-week bills for auction on December 23 $35 billion* 17-week CMBs for auction on December 22 **SETTLE:** $10 billion* 4-week bills $25 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $17 billion* 5-year TIPS $35 billion* 17-week CMBs	**AUCTION:** $10 billion* 4-week bills $25 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Dec. 27 $34 billion* 52-week bills for auction on December 28 $24 billion* 2-year FRNs for auction on December 29 $56 billion* 2-year notes for auction on December 27 $57 billion* 5-year notes for auction on December 28 $56 billion* 7-year notes for auction on December 29 **SETTLE:** $108 billion* 13-,26-week bills	***CHRISTMAS DAY (OBSERVED)***
27	28	29	30	31
AUCTION: $108 billion* 13-,26-week bills $56 billion* 2-year notes	**AUCTION:** $34 billion* 52-week bills $57 billion* 5-year notes **ANNOUNCE:** $10 billion* 4-week bills for auction on December 30 $25 billion* 8-week bills for auction on December 30 $35 billion* 17-week CMBs for auction on December 29 **SETTLE:** $10 billion* 4-week bills $25 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $24 billion* 2-year FRNs $56 billion* 7-year notes $35 billion* 17-week CMBs	**AUCTION:** $10 billion* 4-week bills $25 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Jan. 03 **SETTLE:** $108 billion* 13-,26-week bills $34 billion* 52-week bills	**SETTLE:** $20 billion* 20-year bonds $17 billion* 5-year TIPS $24 billion* 2-year FRNs $56 billion* 2-year notes $57 billion* 5-year notes $56 billion* 7-year notes

**Estimate*