Daiwa Capital Markets

U.S. Economic Comment

- FOMC: decelerating inflation opens a door to a 25 basis point change…
  …possible mention of a pause, but that hurdle is high
- U.S. GDP: solid in Q4, but challenges in Q1 and beyond

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FOMC Preview

Public comments from Fed officials have indicated strong support for a 25-basis-point rate hike at the FOMC meeting on February 1 (down from 50 basis points in December and 75 at the four meetings before December). Such a downshift, no doubt, is contingent on evidence that inflation is beginning to ease, but the latest report on the price index for personal consumption expenditures (PCE) seems to provide the sufficient cover. Indeed, some observers might be looking for the policy statement to signal a pause in the tightening process, or for Chair Powell to suggest such in his press conference.

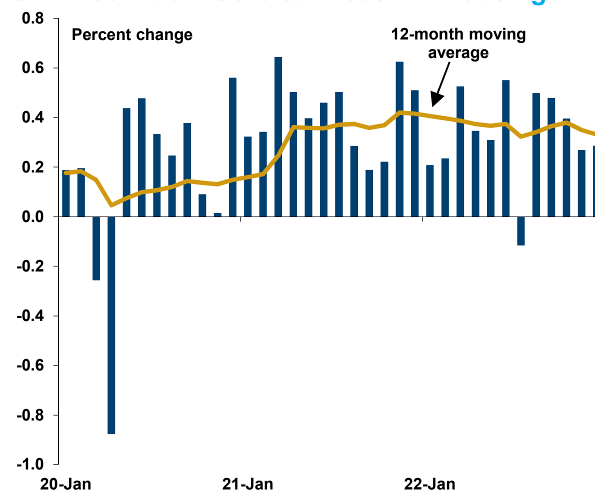
The headline PCE index rose only 0.1 percent in December, restrained by a drop of 5.1 percent in the energy component. The retreat in energy prices might be downplayed because of their tendency to move erratically, but the change marked the fifth decline in the past six months, suggesting a fundamental softening. Moreover, because energy prices are highly visible for most consumers, the recent performance will help to contain inflation expectations.

We also viewed the food component as notable, which rose 0.2 percent in December after increases of 0.3 percent and 0.4 percent in the prior two months. The deceleration in the past three months suggests fading pressure and represents a welcome break from the average increase of 1.1 percent in the first nine months of the year. This deceleration, like that for energy, will help to contain inflation expectations.

The core PCE index rose 0.3 percent in December, marking the third consecutive month with increases of 0.2 or 0.3 percent and supporting the view that inflation is decelerating. Chair Powell noted in a press briefing last year that progress in containing inflation would be evident when the rate of inflation in the past six months was slower than that in the past 12 months, and the rate in the past three months was slower than that in the past six. That pattern is now in place, as the changes in the core PCE price index the past 12, 6, and 3 months have totaled 4.4 percent, 3.7 percent, and 3.0 percent.

Fed officials will most likely view recent developments as encouraging, but they are not likely to conclude that the inflation battle has been won or that policy is now sufficiently restrictive. Minutes from FOMC meetings and public comments from Fed officials indicate that policymakers view the labor market as tight, which is likely to lead to brisk wage growth and continued pressure on prices, especially in the service sector.

PCE Price Index: Core Services Ex. Housing*



** PCE = personal consumption expenditures. The chart shows the month-to-month percent change in the PCE price index for services excluding energy and gas services and housing services. Weights are calculated based on component shares of total outlays for services.*

Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

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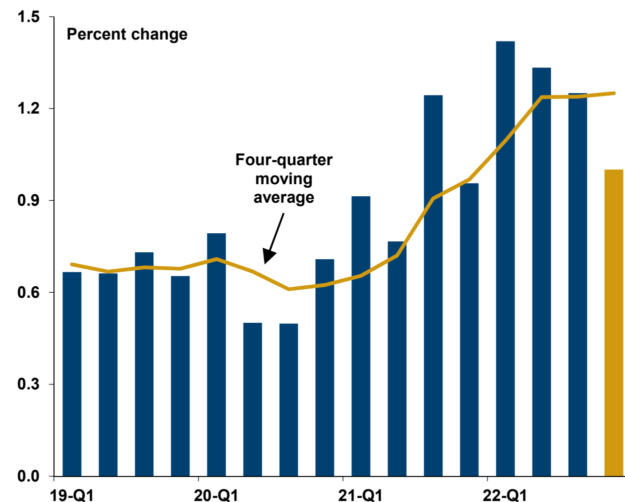
Because of such risks, Chair Powell has highlighted a measure that will have a strong influence on Fed decisions: core service prices excluding housing. This index has cooled somewhat in the past two months (0.28 percent versus 0.34 percent in the first 10 months of the year; chart, prior page). Given the degree of volatility in the measure (note the soft readings at the start of 2022 and the drop in July), recent changes have not been large enough or persistent enough to send an all-clear signal on inflation. It also does not provide convincing evidence on the deceleration of inflation using the 12-, 6-, 3-month guideline. Changes over these three periods have totaled 4.0 percent, 3.6 percent, and 3.8 percent, respectively.

Given this performance, we suspect that most Fed officials will conclude that it is premature to suggest a pause. However, policymakers will receive another key economic indicator on January 31 (the employment cost index) that could sway the decisions of the FOMC. We view this quarterly index as the best measure of labor compensation in the United States. Its rate of increase has picked up considerably in recent quarters (chart), and a notable cooling in Q4 could ease concern about labor costs and service prices. We look for an increase of 1.0 percent in Q4, only a moderate improvement from the average of 1.2 percent in the prior five quarters.

Thus, we do not dismiss the possibility of a pause signal, but we look for the policy statement and the press briefing of Chair Powell to signal that the tightening process is ongoing.

Employment Cost Index*



** The observation for 2022-Q4 is a forecast.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

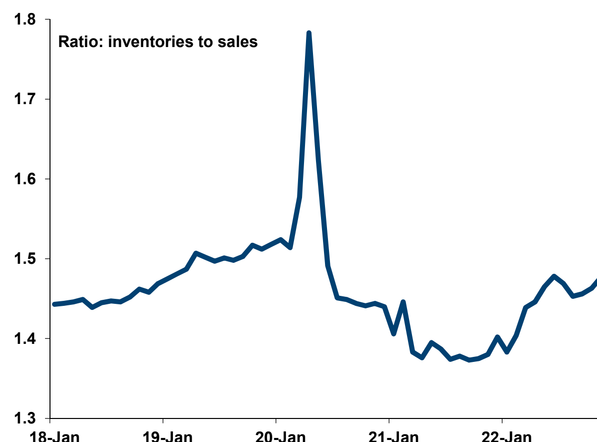
Q4 U.S. GDP: Implications for Q1

The U.S. economy posted a solid pace of growth in the fourth quarter (2.9 percent), although the sources of growth did not provide much encouragement for the outlook. Inventory investment and net exports drove much of the expansion, and these components are likely to fade in the months ahead. Final domestic demand grew sluggishly (0.8 percent), and this pace could be difficult to sustain.

The aggregate inventory situation in the U.S. is comfortable. The ratio of inflation-adjusted inventories to sales is up sharply from the lows in 2021, but those readings reflected supply-chain problems and should be viewed as the result of special factors. Recent observations are in line with pre-pandemic norms, suggesting a comfortable or sustainable situation (chart). We do not expect a sizeable inventory correction.

At the same time, we suspect that threats of recession will lead business managers to manage stocks cautiously in order to prevent undesired accumulation. Thus, we expect additions to inventories to fall shy of the $130 billion registered in the fourth quarter, which was among the heftiest totals of recent years and added 1.5 percentage points to GDP growth. We look for smaller additions in Q1, which will reduce the level of GDP and result in a negative contribution to growth from inventory investment.

Real Manufacturing & Trade Inventory/Sales Ratio



Source: Bureau of Economic Analysis via Haver Analytics

If the contribution were to be positive, the buildup of stocks would probably represent unplanned accumulation, which would set the stage for negative contributions in subsequent quarters.

The real trade deficit of the U.S. narrowed in the fourth quarter, which added approximately 0.6 percentage point to GDP growth. The favorable outcome, though, had a negative aspect: both exports and imports fell in the fourth quarter; the improvement in the deficit occurred because imports were weaker than exports. It is not unusual for the trade deficit in the U.S. to improve during weak periods, as slow demand often leads to reduced purchases of foreign products and a retreat in imports. In fact, this is the typical performance during recession in the U.S.

In the current cycle, however, we wonder whether this typical pattern will play out. Economies of major trading partners also will be softening, and thus exports in coming quarters could slow more than imports. Also, the foreign exchange value of the dollar, although off its recent highs, is still firm relative to historical standards, which could soften exports and fuel imports.

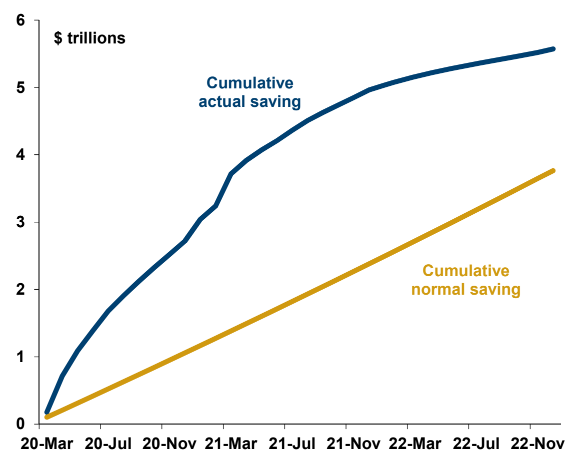
We see downside potential in inventory investment and net exports, but our biggest concern involves consumer spending. Real personal consumption expenditures rose 2.1 percent in Q4, in line with the pace of the past year, but all of the strength occurred early in the quarter. In fact, real outlays fell in both November and December, suggesting cautious behavior among individuals.

The soft end to consumer activity in the fourth quarter sets the stage for weak results in the first quarter of this year. The level of spending in December was below the average in Q4, and thus spending will have to jump just to catch up with the average level of activity in the final quarter of 2022. If real consumer spending were to show no growth in the first three months of 2023, holding the December level, the GDP statistics would show Q1 growth of -1.0 percent. If real outlays increase 0.2 percent in each of the next three months, the average for the first quarter would translate to growth of approximately 0.5 percent (annual rate) from the average in the fourth quarter.

Given the soft ending to the fourth quarter, consumer spending will not be providing much support in the first quarter. Beyond the first quarter, many observers are concerned that a source of support for consumers in the past two years may be fading, leaving dim growth prospects.

Specifically, the generous financial support provided by Congress during the worst of the pandemic generated "excess savings"; that is, savings well above what might have occurred in the absence of the

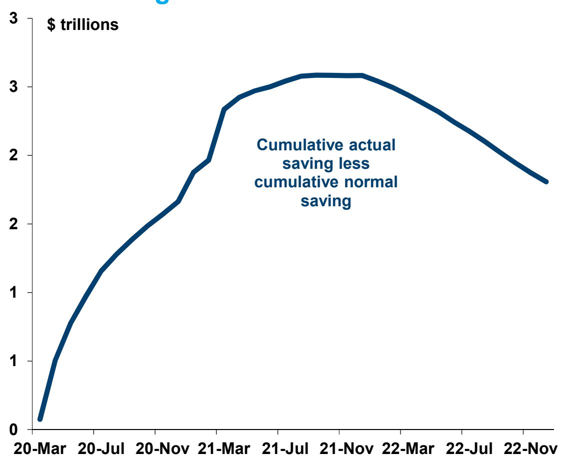
Personal Saving*



** Cumulative normal saving assumes that disposable personal income continued to grow at the 2018-19 pace and that the saving rate held steady at 7.5 percent.*

Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

Excess Saving



Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

pandemic. The left chart below shows amount of savings actually accumulated by households since the start of the pandemic (top line) versus what might have occurred otherwise (if personal income continued to grow at its pre-Covid pace and if the saving rate remained constant at the pre-Covid average). The cumulative difference rose to a peak of $2.5 trillion in 2021 (chart; prior page, right).

Consumers have been tapping that backstop and it now stands at $1.8 trillion. This is still sizeable, but many individuals, in light of recession rumors, might be viewing the pool as a precautionary balance rather than a source of discretionary spending.

Given the downside risks on inventory investment and net exports, and potentially lethargic spending by individuals, we are comfortable with our view that the economy is likely to contract in the first quarter (current view is a drop of 0.5 percent in GDP). With the Fed nudging interest rates higher, the economy is likely to contract over the balance of the year as well. We see GDP falling 0.8 percent over the four quarters of 2023.

Review

Week of Jan. 23, 2023	Actual	Consensus	Comments
Leading Indicators (December)	**-1.0%**	**-0.7%**	Negative contributions from eight of 10 components of the index of leading economic indicators pushed the measure lower for the 10th consecutive month. Declines in 22-Q4 averaged 1.0% per month, accelerating from 0.4% in the July-to-September period.
GDP (2022-Q4)	**2.9%**	**2.6%**	Inventory investment and net exports both made sizable positive contributions to GDP growth in Q4 contributing 1.5 percentage point and 0.6 percentage point, respectively. Final domestic demand (which excludes trade and inventory investment) grew only moderately (0.8%). With regard to domestic demand, consumer spending grew at a solid clip (2.1%), but the change reflected strong activity in October that tailed off in the subsequent two months. Business fixed investment increased modestly (0.7%), with investment in intellectual property and structures offsetting a contraction in equipment spending. Tight financial conditions and sluggish demand for new single-family housing continued to constrain residential construction, which plunged 26.7%.
International Trade in Goods (December)	**-$90.3 Billion ($7.4 Billion Wider Deficit)**	**-$87.9 Billion ($5.0 Billion Wider Deficit)**	Both sides of the trade ledger contributed to the slippage in December, as exports fell 1.6% and imports rose 1.9%. The ups and downs of imports and exports in recent months have left a choppy pattern for the monthly deficit.
Durable Goods Orders (December)	**5.6%**	**2.5%**	Durable goods orders jumped in December, reflecting primarily a surge of 88.6% in aircraft bookings (both commercial and defense combined). Orders excluding transportation edged lower in December (-0.1%), and they have shown little net change on balance in recent months. However, the performance was probably more favorable after adjusting for inflation. The PPI for December showed lower prices in the manufacturing sector, pointing to a jump in real orders for durable goods excluding transportation.
New Home Sales (December)	**0.616 Million (2.3%)**	**0.612 Million (-4.4%)**	Sales of new homes rose in December from a downward revised reading in the prior month (an adjustment of -5.9%; 0.602 million versus 0.640 million first reported). The December performance added to a sideways trend at a low level in the second half of 2022 after a sharp drop in activity in the late 2021 and the first half of the year.
Personal Income, Consumption, Core Price Index (December)	**0.2%, -0.2%, 0.3%**	**0.2%, -0.2%, 0.3%**	Moderate growth in wages and salaries and a jump in rental income contributed importantly to the pickup in total income in December. Consumer spending fell in the latest month, with the decline in real terms (-0.3%) exceeding the nominal dip. The uninspiring result signals that consumer spending could stall in early 2023. The headline PCE price index was constrained by a drop of 5.1% in energy prices; food prices rose modestly (0.2%) after remaining under pressure for most of the year. The core price index posted its third consecutive subdued advance, averaging 0.2% over this span versus 0.4% in the first nine months of the year.

Sources: The Conference Board (Leading Indicators); Bureau of Economic Analysis (GDP, Personal Income, Consumption, Core Price Index); U.S. Census Bureau (International Trade in Goods, Durable Goods Orders, New Home Sales); Consensus forecasts are from Bloomberg

Preview

Week of Jan. 30, 2023	Projected	Comments
Employment Cost Index (2022-Q4) (Tuesday)	**1.0%**	Average hourly earnings from the employment report suggest that wage growth has slowed in recent weeks, but it remains brisk. The expected increase in Q4 is softer than the average of 1.2% in the prior four quarters but firmer than the pre-pandemic norm of 0.7% to 0.8%.
Consumer Confidence (January) (Tuesday)	**111.0 (+2.5%0**	The job market has perhaps lost some of its sharp edge, but softer energy prices and a pickup in equity values should boost confidence. The expected reading essentially matches the best reading of 2022, but it trails the highest of the current expansion by a sizeable margin (128.9 in June 2021).
ISM Manufacturing Index (January) (Wednesday)	**48.0 (-0.4 Index Pt.)**	Most indicators tied to the manufacturing sector have been signaling slowdown, suggesting that the ISM index will continue to move along its downward trend (off in 10 of the past 13 months, with modest increases in the other three months). The expected reading represents the third consecutive sub-50 observation.
Construction Spending (December) (Wednesday)	**0.3%**	A pickup in single family housing starts in December should lighten the drag from the residential component of total construction, while private-nonresidential and government-sponsored construction continue to move along their recent upward (nominal) trends.
Nonfarm Productivity (2022-Q4) (Thursday)	**2.8%**	Businesses achieved solid economic growth in the fourth quarter with a moderate increase in hours worked, implying a favorable performance in productivity. The expected increase is much improved from the average of -1.3% (annual rate) in the prior four quarters.
Factory Orders (December) (Thursday)	**1.0%**	The already reported surge of 5.6% in orders for durable goods (fueled by the volatile aircraft component) will probably dominate the report on total factory bookings. A drop in orders for nondurable goods, reflecting a price-led swoon in petroleum products, is likely to provide a partial offset. Emerging softness in the manufacturing sector will probably dampen orders for nondurable goods ex-petroleum.
Payroll Employment (January) (Friday)	**190,000**	Low levels of initial claims for unemployment insurance suggest that layoffs have not increased meaningfully, but cautious hiring is likely to leave net job growth below the average of 261k in the prior five months. The January report will include benchmark revisions to the payroll data. A preliminary estimate released in August indicated an upward adjustment of 462k to the level of employment in the benchmark month (March 2022; 0.3% of total employment). The report also will include new population controls for the household survey (i.e. blow-up factors applied to sample data). The new controls will not be applied to prior data, which could distort comparisons with pre-2023 figures.
ISM Services Index (January) (Friday)	**52.0 (+2.8 Index Pts.)**	The service sector of the economy is most likely easing in response to tight monetary policy, but the plunge of 6.3 index points in December to a sub-50 reading probably overstates the degree of weakness. Some retracement seems likely.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2023

Monday 23

LEADING INDICATORS

Oct	-1.0%
Nov	-1.1%
Dec	-1.0%

Tuesday 24

Wednesday 25

CHICAGO FED NATIONAL ACTIVITY INDEX

	Monthly	3-Mo. Avg.
Oct	0.00	0.09
Nov	-0.51	-0.14
Dec	-0.49	-0.33

NEW HOME SALES

Oct	0.598 million
Nov	0.602 million
Dec	0.616 million

Thursday 26

UNEMP. CLAIMS

	Initial (millions)	Continuing
Dec 31	0.206	1.630
Jan 7	0.206	1.655
Jan 14	0.192	1.675
Jan 21	0.186	N/A

GDP

	GDP	Chained Price
22-Q2	-0.6%	9.0%
22-Q3	3.2%	4.4%
22-Q4	2.9%	3.5%

INTERNATIONAL TRADE IN GOODS

Oct	-$98.6 billion
Nov	-$82.9 billion
Dec	-$90.3 billion

DURABLE GOODS ORDERS

Oct	0.7%
Nov	-1.7%
Dec	5.6%

ADVANCE INVENTORIES

	Wholesale	Retail
Oct	0.6%	-0.4%
Nov	0.9%	0.0%
Dec	0.1%	0.5%

Friday 27

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX

	Inc.	Cons.	Core
Oct	0.8%	0.8%	0.3%
Nov	0.3%	-0.1%	0.2%
Dec	0.2%	-0.2%	0.3%

REVISED CONSUMER SENTIMENT

Nov	56.8
Dec	59.7
Jan(p)	64.6
Jan(r)	64.9

PENDING HOME SALES

Sep	-4.7%
Oct	-2.6%
Nov	2.5%

Monday 30

Tuesday 31

EMPLOYMENT COST INDEX (8:30)

	Comp.	Wages
22-Q2	1.3%	1.4%
22-Q3	1.2%	1.3%
22-Q4	**1.0%**	**1.1%**

FHFA HOME PRICE INDEX (9:00)

Sep	0.1%
Oct	0.0%
Nov	--

S&P CASE SHILLER 20-CITY HOME PRICE INDEX (9:00)

Sep	-1.3%
Oct	-0.5%
Nov	--

MNI CHICAGO BUSINESS BAROMETER (9:45)

	Index	Prices
Nov	37.9	67.1
Dec	45.1	65.1
Jan	--	--

CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)

Nov	101.4
Dec	108.3
Jan	**111.0**

FOMC (1ST DAY)

Wednesday 1

ADP EMPLOYMENT REPORT (8:15)

	Private Payrolls
Nov	182,000
Dec	235,000
Jan	--

JOLTS DATA (10:00)

	Openings (000)	Quit Rate
Oct	10,512	2.6%
Nov	10,458	2.7%
Dec	--	--

ISM MFG. INDEX (10:00)

	Index	Prices
Nov	49.0	43.0
Dec	48.4	39.4
Jan	**48.0**	**39.0**

CONSTRUCTION (10:00)

Oct	-0.2%
Nov	0.2%
Dec	**0.3%**

FOMC DECISION (2:00)

VEHICLE SALES

Thursday 2

UNEMP. CLAIMS (8:30)

PRODUCTIVITY & COSTS (8:30)

	Productivity	Unit Labor Costs
22-Q2	-4.1%	6.7%
22-Q3	0.8%	2.4%
22-Q4	**2.8%**	**1.5%**

FACTORY ORDERS (10:00)

Oct	0.4%
Nov	-1.5%
Dec	**1.0%**

Friday 3

EMPLOYMENT REPORT (8:30)

	Payrolls	Un. Rate
Nov	256,000	3.6%
Dec	223,000	3.5%
Jan	**190,000**	**3.6%**

ISM SERVICES INDEX (10:00)

	Index	Prices
Nov	55.5	70.1
Dec	49.2	68.1
Jan	**52.0**	**67.0**

Monday 6

Tuesday 7

TRADE BALANCE

CONSUMER CREDIT

Wednesday 8

WHOLESALE TRADE

Thursday 9

UNEMP. CLAIMS

Friday 10

CONSUMER SENTIMENT

FEDERAL BUDGET

Monday 13

Tuesday 14

NFIB SMALL BUSINESS OPTIMISM INDEX

CPI

Wednesday 15

RETAIL SALES

EMPIRE MFG. INDEX

INDUSTRIAL PROD.

BUSINESS INVENTORIES

NAHB HOUSING INDEX

TIC FLOWS

Thursday 16

UNEMP. CLAIMS

HOUSING STARTS

PHILY FED MFG. INDEX

PPI

Friday 17

IMPORT PRICES

LEADING ECONOMIC INDICATORS

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

Treasury Financing

January/February 2023

Monday	Tuesday	Wednesday	Thursday	Friday
23	24	25	26	27
AUCTION RESULTS: Rate / Cover 13-week bills 4.575% 2.68 26-week bills 4.685% 2.76	**AUCTION RESULTS:** Rate / Cover 52-week bills 4.470% 2.87 2-year notes 4.139% 2.94 **ANNOUNCE:** $75 billion 4-week bills for auction on Jan 26 $60 billion 8-week bills for auction on Jan 26 $36 billion 17-week bills for auction on Jan 25 **SETTLE:** $70 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills $60 billion 44-day CMBs	**AUCTION RESULTS:** Rate / Cover 17-week bills 4.620% 2.90 5-year notes 3.530% 2.64 Spread / Cover 2-year FRNs 0.200% 2.80	**AUCTION RESULTS:** Rate / Cover 4-week bills 4.500% 2.59 8-week bills 4.525% 2.57 7-year notes 3.517% 2.69 **ANNOUNCE:** $108 billion 13-,26-week bills for auction on Jan 30 **SETTLE:** $108 billion 13-,26-week bills $34 billion 52-week-bills	
30	31	1	2	3
AUCTION: $108 billion 13,26-week bills	**ANNOUNCE:** $75 billion* 4-week bills for auction on Feb 2 $60 billion* 8-week bills for auction on Feb 2 $36 billion* 17-week bills for auction on Feb 1 **SETTLE:** $75 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills $12 billion 20-year bonds $17 billion 10-year TIPS $24 billion 2-year FRNs $42 billion 2-year notes $43 billion 5-year notes $35 billion 7-year notes	**AUCTION:** $36 billion* 17-week bills **ANNOUNCE:** $40 billion* 3-year notes for auction on Feb 7 $35 billion* 10-year notes for auction on Feb 8 $21 billion* 30-year bonds for auction on Feb 9	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 6 **SETTLE:** $108 billion 13-,26-week bills	
6	7	8	9	10
AUCTION: $108 billion* 13,26-week bills	**AUCTION:** $40 billion* 3-year notes **ANNOUNCE:** $75 billion* 4-week bills for auction on Feb 9 $60 billion* 8-week bills for auction on Feb 9 $36 billion* 17-week bills for auction on Feb 8 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $35 billion* 10-year notes	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $21 billion* 30-year bonds **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 13 $15 billion* 20-year bonds for auction on Feb 15 $9 billion* 30-year TIPS for auction on Feb 16 **SETTLE:** $108 billion* 13-,26-wk bills	
13	14	15	16	17
AUCTION: $108 billion* 13-,26-week bills	**ANNOUNCE:** $75 billion* 4-week bills for auction on Feb 16 $60 billion* 8-week bills for auction on Feb 16 $36 billion* 17-week bills for auction on Feb 15 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $15 billion* 20-year-bonds **SETTLE:** $40 billion* 3-year notes $35 billion* 10-year notes $21 billion* 30-year bonds	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $9 billion* 30-year-TIPS **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 21 $34 billion* 52-week bills for auction on Feb 21 $42 billion* 2-year notes for auction on Feb 21 $43 billion* 5-year notes for auction on Feb 22 $35 billion* 7-year notes for auction on Feb 23 $22 billion* 2-year FRNs for auction on Feb 22 **SETTLE:** $108 billion* 13-,26-week bills	

**Estimate*