Daiwa Capital Markets

U.S. Economic Comment

- Labor market: hints (but only hints) of supply/demand rebalancing
- Interest rates: a long-term perspective

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The U.S. Labor Market

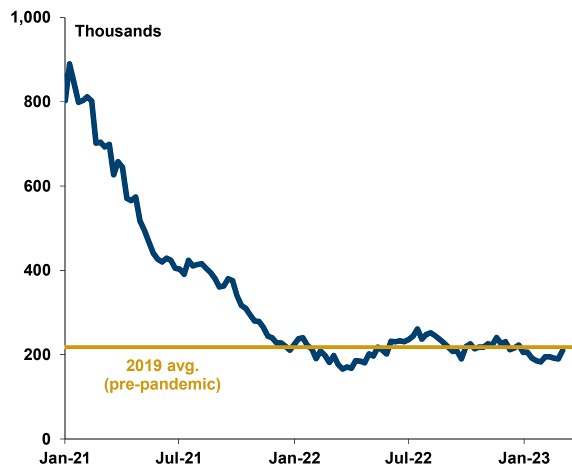
The latest employment report showed still-tight conditions in the labor market. Job growth was strong in February, and the robust gain in employment in January was revised down only modestly. Businesses obviously are striving to bring workers on board.

At the same time, the latest batch of labor market statistics showed subtle signs of supply and demand becoming more closely aligned. We took notice of the latest reading on initial claims for unemployment insurance, which increased 21,000 in the first week of March to 211,000, the first reading above 200,000 since early January. The low level and stability of claims in prior weeks was puzzling given the wave of layoff announcements in the financial press. We suspect that the announcements were plans for adjustments that are perhaps now being implemented. If so, additional increases could unfold in coming weeks.

The January report on job openings and labor turnover (JOLTS, lagged one month from other employment statistics) also brought a hint of supply-demand improvement. The number of individuals quitting their jobs fell noticeably (off 5.1 percent), marking the seventh drop in the past nine months. The retreat perhaps suggests that individuals are less confident in their ability to find a new job or that offers from alternative employers are not as attractive as they were previously.

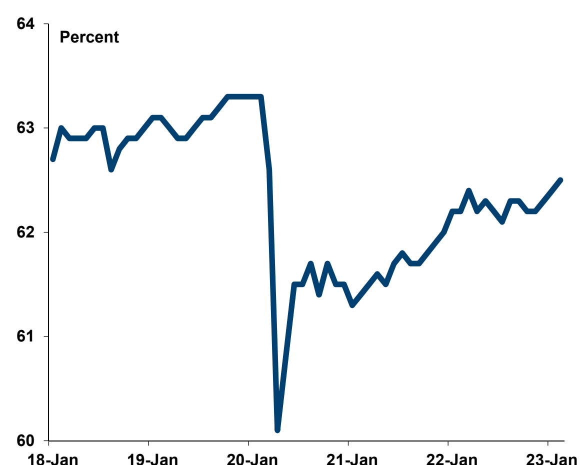
Recent changes in average hourly earnings support the notion that pay packages are perhaps becoming less attractive. February showed an increase of 0.24 percent, the slowest advance since the flat reading in February of last year. Moreover, recent months have shown steady deceleration: after averaging increases of 0.40 percent from March to November of last year, the past three months have registered changes of 0.37 percent, 0.27 percent, and 0.24 percent.

Initial Claims for Unemployment Insurance



Source: U.S. Department of Labor via Haver Analytics

Labor Force Participation Rate



Source: Bureau of Labor Statistics via Haver Analytics

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Changes on the supply side in recent months have eased a bit of the imbalance between supply and demand. The size of the labor force has posted notable increases in each of the past three months. The changes have pushed the labor force participation rate to its highest level since the early stages of the pandemic (before Covid forced many from the labor market; chart, prior page). With not all of the new entrants finding jobs, the unemployment rate rose 0.2 percentage point in February to 3.6 percent. The increase, though, should be viewed in a favorable light, as it reflected an increase in supply rather than a reduction in demand, and it eased a degree of tightness in the labor market.

The Fed

Fed Chair Jerome Powell this week opened the possibility of a 50 basis point rate hike at the meeting of the Federal Open Market Committee on March 22. The labor market data this week does not settle the issue of 25 versus 50 basis points. The narrowing in the supply-demand imbalance was not pronounced enough to take 50 off the table, but the hints of improvement could leave officials content with a shift of 25 basis points. The report on consumer prices on March 14 no doubt will have a strong influence on the Fed's decision. We will wait to review that report before making the 25/50 call. Whatever path officials choose, the terminal rate is likely to be higher than our current view (and the view implied by the December dot plot) of 5.125 percent. We are leaning toward a revised expectation of 5.625 percent, but we are willing to go higher if the upcoming CPI proves troublesome.

Interest Rates: The Long View

Market participants seem engulfed in short-term financial considerations: will the next shift by the Federal Reserve be 25 or 50 basis points? Will the terminal federal funds rate be 5.0 percent or 5.5 percent; could it possibly be 6.0 percent? Certainly, these are important issues, but there also is a larger question lurking on the distant horizon: what will be the nature of the financial environment when the current tightening cycle is completed and monetary policy has returned to a neutral setting? Will the short-term neutral interest rate be in the neighborhood of zero percent, like it appeared to be before the onset of the pandemic, or have financial markets jumped to a higher neutral rate?

The Peterson Institute for International Economics explored the long-run issue this week with a discussion between two heavyweight academic economists, Lawrence Summers of Harvard University and Olivier Blanchard of the Massachusetts Institute of Technology and the Peterson Institute. The discussants raised compelling arguments for both low-rate and high-rate environments, but we felt the higher-rate view carried the day.

Interestingly, Mr. Summers presented the high-rate case. This was surprising in that he was the leader of the "secular stagnation" camp in years past, which argued that soft investment and elevated saving had resulted in a chronic deficiency in demand and fueled the long-term decline in real interest rates. He now views the period of secular stagnation as over. Part of his new view was related to demographics, as the aging of the population was boosting the ratio of dis-savers to savers. Although not emphasized by Mr. Summers, the pickup in pandemic-related retirements would be adding an accent to the demographic shift.

Mr. Summers leaned primarily on strong demand as the explanation for higher real interest rates. He was impressed with the current resilience of the economy in the face of tight monetary policy, leading him to suspect that the economy has become less interest sensitive and therefore would need higher rates than previously to maintain a noninflationary balance. He also saw potentially heavy financing needs in the years ahead that could pressure interest rates. Specifically, military threats will probably lead to higher defense expenditures, and the shift to green energy will involve considerable investment in infrastructure. In general, he was concerned about the enlarged budget deficits currently projected and the likelihood that such projections will understate actual budget shortfalls. At least some expiring tax breaks are likely to be extended, and economic assumptions behind projections could prove to be optimistic. Business investment also could be spurred by the reworking of supply chains (reshoring).

Mr. Blanchard also noted the current strength of the economy and the need for higher interest rates to cool activity. However, he viewed the resilience as driven by the generous fiscal stimulus provided by Congress in response to the pandemic, and this support, along with today's elevated level of interest rates, will fade over time. He viewed the low level of real interest rates in the decades before the pandemic as driven by "deep forces" that are not likely to change direction quickly. He did not go into detail regarding the deep forces at work, but it was clear that he was thinking in terms of light investment demand, elevated saving rates, and a preference for safe assets. These forces were global in nature rather than restricted to the United States.

Mr. Blanchard's explanation was compelling, but he weakened his argument by noting that investment spending might not remain weak. He suggested that innovations tied to artificial intelligence could stir a wave of investment. He also recognized reshoring, defense spending, and investment in green energy as factors that could lift interest rates. In essence, he was receptive to the view that real interest rates would not return to the low levels in place before the pandemic. He considered the financial environment that was likely to evolve as "low-rate" because short-term real interest rates were likely to be below the potential growth rate of the economy (in economic argot, $r < g$).

Thus, the views of the two academics were actually quite close. Both saw interest rates higher than they were in the pre-pandemic years. The difference in views largely involved semantics. Summers focused on the difference between his expectation and the pre-pandemic years, and his expectation was for higher rates. Blanchard was concerned about r versus g, and he viewed r as still less than g; therefore, a still-comfortable rate environment.

Inflation

The discussion between Summers and Blanchard involved primarily real interest rates, but the issue of inflation also arose because it will affect nominal interest rates in the future. Fed officials believe that inflation expectations are largely anchored, but the perception of Mr. Summers has changed. He offered an interesting view:

> The 2% inflation target has sort of morphed from being a ceiling that we were trying to reach to being an average that we hope to attain over time to being a floor that we hope to touch at the trough of an inflation process. That evolution, it seems to me, has to lead one to think that expected inflation is going to be higher than whatever one thought before.

He provided a back-of-the-envelope calculation to suggest that long-term interest rates should be five percent or higher. He expects the neutral real short-term real rate in the future to be in a range of 1.5 to 2.0 percent; expected inflation of 2.5 percent would push nominal rates to 4.0 to 4.5 percent; a common spread of 100 basis points between long-term and short-term rates would leave long-term nominal yields at 5.0 to 5.5 percent. The rate would even be higher if an inflation risk premium became involved.

Review

Week of March 6, 2023	Actual	Consensus	Comments
Factory Orders (January)	**-1.6%**	**-1.8%**	The decline of 4.5% in new orders for durable goods accounted for all of the decline in total factory bookings. This weakness, in turn, reflected a drop of 54.5% in the civilian aircraft category, which occurred after a surge of 105.7% in December. Excluding the transportation component, durable goods orders rose 0.8 percent, although a jump in the PPI suggests that real bookings declined. Orders for nondurable goods rose 1.5%. Much of the advance in the nondurable area reflected a jump of 5.1% in the petroleum and coal category, which was influenced in part by higher prices. Nondurable bookings excluding petroleum and coal increased 0.5%, the second consecutive pickup after easing in three of the prior four months. The latest readings reversed the softness in late 2022 and left a flat trend.
Trade Balance (January)	**-$68.3 Billion ($1.1 Billion Wider Deficit)**	**-$68.7 Billion ($1.3 Billion Wider Deficit)**	Both imports and exports rose briskly in January (up 3.0% and 3.4%, respectively). Although exports showed a larger percentage change, the dollar volume of imports exceeded that of exports and thus the trade deficit widened. A narrowing in the service surplus accounted for all of the narrowing in the overall deficit in February after widening in the prior three months. The goods deficit narrowed slightly. After adjusting for inflation, the real goods deficit of $101.8 billion was slightly narrower than the average of $102.2 billion in 22-Q4, which might suggest a slight positive contribution from net exports to GDP growth. However, the slippage in service trade provided an offset, suggesting an approximately neutral influence from international trade to GDP growth in early 2023.
Payroll Employment (February)	**311,000**	**225,000**	The jump in nonfarm payrolls in February, which followed a surge of 504,000 in the prior month, suggests that demand for labor remained strong in early 2023. The unemployment rate increased 0.2 percentage point in February to 3.6%, as an expansion of 419,000 in the size of the labor force exceeded a gain of 177,000 in employment measured in the household survey. The increase in employment was underwhelming, but it was not a deep concern given surges of 894,000 and 717,000 in the prior two months. Average hourly earnings rose 0.2%, slowing from the underlying pace of 0.357% in the prior 12 months. Fed officials are likely to be pleased with the subdued increase in February, but they will need much more than one month of cooling to alter their views on inflation risks.

Review (continued)

Week of March 6, 2023	Actual	Consensus	Comments
Job Openings (January)	**10.824 Million**	**10.546 Million**	The number of job openings in the U.S. eased 3.7% in January, but the adjustments did little to alter the picture in the post-pandemic period. Demand for labor remained strong, with openings far exceeding prior observations (recent peak of 12.027 million in March 2022 versus a pre-pandemic peak of 7.594 million in November 2018). The number of openings per unemployed individual totaled 1.901 million in January, shy of the record of 2.014 million in March of last year, but elevated relative to historical norms.
Federal Budget (February)	**-$262.4 Billion**	**-$263.0 Billion**	Federal revenues fell 9.6% on a year-over year basis, as income and payroll taxes declined sharply (primarily reflecting a jump in personal income tax refunds). Drops in remittances by the Federal Reserve to the Treasury and in corporate income taxes also contributed to the weak performance in revenues. On the outlay side, spending on social support programs and interest on the public debt contributed importantly to the year-over-year increase of 3.6%. With revenues softening and outlays picking up, the budget deficit for the first five months of FY2023 widened to $723 billion from $476 billion in the same period in FY2022.

Sources: U.S. Census Bureau (Factory Orders); Bureau of Economic Analysis (Trade Balance); Bureau of Labor Statistics (Payroll Employment); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of March 13, 2023	Projected	Comments
CPI (February) (Tuesday)	**0.5% Total, 0.4% Core**	Pressure on food prices has eased recently, slowing to increases of 0.5% in the past three months from advances ranging from 0.8% to 1.1% in the first three quarters of 2022. Available data suggest that energy prices could rise for the second consecutive month, although the change in February is expected to be modest. While core goods prices have moderated, broad pressure in service prices suggests another brisk increase in the core component.
Retail Sales (February) (Wednesday)	**-0.5% Total, -0.4% Ex. Autos**	Higher prices are likely to boost the nominal value of sales at gasoline service stations, but cooling in areas that fueled robust activity in January will probably lead to a decline in overall retail activity. Auto dealers, general merchandise stores, and restaurants seem especially vulnerable to downside risks.
PPI (February) (Wednesday)	**0.4% Total, 0.3% Ex. Food & Energy**	Energy prices rose during the survey period, and food prices could resume their upward trend after notable downside volatility around the turn of the year. Outside of food and energy, the measure should increase moderately. Service prices have averaged increases of 0.3% in the past six months, but core goods prices could cool after an above-trend advance of 0.6% in January. In addition, construction prices could be soft, as they follow a distinct pattern of a brisk increase in the first month of a quarter and only modest changes in the following two months.
Housing Starts (February) (Thursday)	**1.300 Million (-0.7%)**	The drop in mortgage interest rates in December and January stirred sales of new homes, but builders probably remained cautious in February because of ample inventories of unsold homes and possibly slower sales in response to the backup in mortgage rates. Single family starts are likely to post their 10th decline in the past 12 months, but a pickup in multi-family activity after two soft months could provide a partial offset.
Industrial Production (February) (Friday)	**-0.4%**	A dip in factory-sector employment and a shorter workweek point to weak results in the manufacturing component of industrial production, while a decline in the rotary rig count suggests slow activity in the mining component. Temperatures were warmer than normal in February, but by less so than in January. Thus, demand for heating services and utility output probably rose on a month-to-month basis, which should offset some of the expected weakness in manufacturing and mining.
Consumer Sentiment (March) (Friday)	**67.5 (+0.7%)**	Easing gasoline prices and a favorable labor market likely contributed to improvement in consumer sentiment from December through February, but uncertainty about the economic outlook could limit the possibility of further improvement in March.
Leading Indicators (February) (Friday)	**-0.5%**	Negative contributions from the ISM new orders index, the factory workweek, and consumer expectations are likely to offset a positive contribution from stock prices. The shifts raise the prospect of the 11th consecutive decline in the index of leading economic indicators.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

March 2023

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
FACTORY ORDERS Nov -1.9% Dec 1.7% Jan -1.6%	**WHOLESALE TRADE** Inventories / Sales Nov 0.9% / -1.4% Dec 0.1% / -0.2% Jan -0.4% / 1.0% **CONSUMER CREDIT** Nov $36.1 billion Dec $10.7 billion Jan $14.8 billion **CHAIR POWELL'S SEMI-ANNUAL MONETARY POLICY TESTIMONY (SENATE)**	**ADP EMPLOYMENT REPORT** Private Payrolls Dec 253,000 Jan 119,000 Feb 242,000 **TRADE BALANCE** Nov -$60.6 billion Dec -$67.2 billion Jan -$68.3 billion **JOLTS DATA** Openings (000) / Quit Rate Nov 10,746 / 2.7% Dec 11,234 / 2.6% Jan 10,824 / 2.5% **CHAIR POWELL'S SEMI-ANNUAL MONETARY POLICY TESTIMONY (HOUSE)** **BEIGE BOOK** **March 2023:** "Overall economic activity increased slightly in early 2023. Six Districts reported little or no change in economic activity since the last report, while six indicated economic activity expanded at a modest pace."	**UNEMP. CLAIMS** Initial / Continuing (millions) Feb 11 0.195 / 1.660 Feb 18 0.192 / 1.649 Feb 25 0.190 / 1.718 Mar 4 0.211 / N/A	**EMPLOYMENT REPORT** Payrolls / Un. Rate Dec 239,000 / 3.5% Jan 504,000 / 3.4% Feb 311,000 / 3.6% **FEDERAL BUDGET** FY2023 / FY2022 Dec -$85.0B / -$21.3B Jan -$38.8B / $118.7B Feb -$262.4B / -$216.6B
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX (6:00) Dec 89.8 Jan 90.3 Feb -- **CPI (8:30)** Total / Core Dec 0.1% / 0.4% Jan 0.5% / 0.4% **Feb 0.5% / 0.4%**	**RETAIL SALES (8:30)** Total / Ex.Autos Dec -1.1% / -0.9% Jan 3.0% / 2.3% **Feb -0.5% / -0.4%** **PPI (8:30)** Final Demand / Ex. Food & Energy Dec -0.2% / 0.3% Jan 0.7% / 0.5% **Feb 0.4% / 0.3%** **EMPIRE MFG (8:30)** Jan -32.9 Feb -5.8 Mar -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales Nov 0.3% / -1.2% Dec 0.3% / -0.7% **Jan -0.1% / 1.3%** **NAHB HOUSING INDEX (10:00)** Jan 35 Feb 42 Mar -- **TIC FLOWS (4:00)** Long-Term / Total Nov $171.5B / $213.4B Dec $152.8B / $28.6B Jan -- / --	**UNEMP. CLAIMS (8:30)** **HOUSING STARTS (8:30)** Dec 1.371 million Jan 1.309 million **Feb 1.300 million** **IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports / Nonagri. Exports Dec 0.7% / -3.3% Jan 0.2% / 0.8% Feb -- / -- **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Jan -8.9 Feb -24.3 Mar --	**IP & CAP-U (9:15)** IP / Cap.Util. Dec -1.0% / 78.4% Jan 0.0% / 78.3% **Feb -0.4% / 77.7%** **CONSUMER SENTIMENT (10:00)** Jan 64.9 Feb 67.0 **Mar 67.5** **LEADING INDICATORS (10:00)** Dec -0.8% Jan -0.3% **Feb -0.5%**
20	21	22	23	24
	EXISTING HOME SALES **FOMC (FIRST DAY)**	**FOMC ANNOUNCEMENT**	**UNEMP. CLAIMS** **CURRENT ACCOUNT** **CHICAGO FED NATIONAL ACTIVITY INDEX** **NEW HOME SALES**	**DURABLE GOODS ORDERS**
27	28	29	30	31
	INTERNATIONAL TRADE IN GOODS **ADVANCED INVENTORIES** **FHFA HOME PRICE INDEX** **S&P CASE-SHILLER HOME PRICE INDEX** **CONSUMER CONFIDENCE**	**PENDING HOME SALES**	**REVISED Q4 GDP**	**PERSONAL INCOME, CONSUMPTION, PRICES** **MNI CHICAGO BUSINESS BAROMETER** **REVISED CONSUMER SENTIMENT**

Forecasts in Bold.

Treasury Financing

March 2023

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
AUCTION RESULTS: Rate / Cover 13-week bills 4.765% 2.93 26-week bills 4.970% 2.80	**AUCTION RESULTS:** Rate / Cover 3-year notes 4.635% 2.73 **ANNOUNCE:** $65 billion 4-week bills for auction on Mar 9 $55 billion 8-week bills for auction on Mar 9 $36 billion 17-week bills for auction on Mar 8 **SETTLE:** $75 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills	**AUCTION RESULTS:** Rate / Cover 17-week bills 5.045% 2.62 10-yr notes 3.985% 2.35	**AUCTION RESULTS:** Rate / Cover 4-week bills 4.640% 2.75 8-week bills 4.820% 2.30 30-yr bonds 3.877% 2.35 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on Mar 13 **SETTLE:** $105 billion 13-,26-week bills	
13	14	15	16	17
AUCTION: $105 billion 13-,26-week bills	**ANNOUNCE:** $65 billion* 4-week bills for auction on Mar 16 $55 billion* 8-week bills for auction on Mar 16 $36 billion* 17-week bills for auction on Mar 15 **SETTLE:** $65 billion 4-week bills $55 billion 8-week bills $36 billion 17-week bills	**AUCTION:** $36 billion* 17-week bills **SETTLE:** $40 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds	**AUCTION:** $65 billion* 4-week bills $55 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Mar 20 $34 billion* 52-week bills for auction on Mar 21 $12 billion* 20-year bonds for auction on Mar 21 $15 billion* 10-year TIPS for auction on Mar 23 **SETTLE:** $105 billion 13-,26-week bills	
20	21	22	23	24
AUCTION: $105 billion* 13-,26 week bills	**AUCTION:** $34 billion* 52-week bills $12 billion* 20-year bonds **ANNOUNCE:** $65 billion* 4-week bills for auction on Mar 23 $55 billion* 8-week bills for auction on Mar 23 $36 billion* 17-week bills for auction on Mar 22 **SETTLE:** $65 billion* 4-week bills $55 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills	**AUCTION:** $65 billion* 4-week bills $55 billion* 8-week bills $15 billion* 10-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Mar 27 $42 billion* 2-year notes for auction on Mar 27 $43 billion* 5-year notes for on auction on Mar 28 $35 billion* 7-year notes for auction on Mar 29 $22 billion* 2-year FRN for auction on Mar 29 **SETTLE:** $105 billion* 13-,26-wk bills $34 billion* 52-week bills	
27	28	29	30	31
AUCTION: $105 billion* 13-,26 week bills $42 billion* 2-year notes	**AUCTION:** $43 billion* 5-year notes announce: $65 billion* 4-week bills for auction on Mar 30 $55 billion* 8-week bills for auction on Mar 30 $36 billion* 17-week bills for auction on Mar 29 **SETTLE:** $65 billion* 4-week bills $55 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $35 billion* 7-year notes $22 billion* 2-year FRN	**AUCTION:** $65 billion* 4-week bills $55 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Apr 3 **SETTLE:** $105 billion* 13-,26-week bills	**SETTLE:** $12 billion* 20-year bonds $15 billion* 10-year TIPS $42 billion* 2-year notes $43 billion* 5-year notes $35 billion* 7-year notes $22 billion* 2-year FRN

**Estimate*