Daiwa Capital Markets

U.S. Economic Comment

- The Fed, the labor market, the bond market: a confusing picture
- U.S. consumers: amazing fire power
- ISMs: elevated price indexes, but weak inflation signals

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The Fed: Content With Its Current Stance

Fed officials have not been impressed with the recent developments in the labor market. The party line spoken by most Fed officials is that the U.S. is still far below maximum employment. Policymakers emphasize that nonfarm payrolls are still 10 million shy of pre-pandemic levels and that the published unemployment rate understates the degree of joblessness. They emphasize that the effective unemployment rate is approximately 10 percent after taking account of the number of individuals that are misclassified as employed but temporarily not at work and adding in those that have dropped out of the labor force (chart).

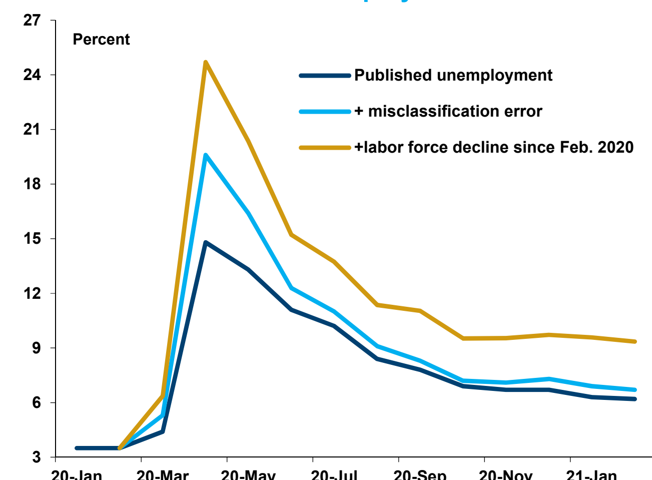
The latest employment report is not likely to alter the Fed's assessment of the labor market. Job growth of 379,000 in February would be viewed as solid in most settings, but it is underwhelming relative to the ground that must be regained to return to pre-pandemic levels of employment (the market has so far regained only 58 percent of the drop from last spring). In addition, the downward trend in the hypothetical unemployment rate cited by many officials has essentially stalled.

Such views of the labor market might argue for more support from the Fed, and the recent increase in intermediate and long-term interest rates might bolster the case for additional easing in monetary policy. However, Chair Powell implied in his recent Q&A session with the *Wall Street Journal* that officials are content with their current settings.

Mr. Powell also offered an explanation for why the Federal Open Market Committee was not inclined to adjust policy at this time. He noted that the FOMC was taking a broad view of financial conditions, and a view incorporating numerous financial measures still shows highly accommodative conditions. Several Federal Reserve Banks construct indexes of financial stress, and they all show supportive conditions. The measure published by the Chicago Fed is perhaps the broadest, as it incorporates numerous metrics from the debt and equity markets as well as statistics relating to the traditional and shadow banking systems. As shown in the chart on the next page, this index is indicating broadly accommodative financial conditions.

While such measures suggest little need to alter monetary policy, market participants tend to focus on interest rates, and striking shifts in recent weeks (surprisingly low money market rates and sharp increases in long-term interest rates) have led some investors and traders to argue that the Fed has lost control of the yield curve. This view has led many market participants to expect

Official and Alternative Unemployment Rates*



** The data are from the Bureau of Labor Statistics and Federal Reserve Board staff calculations. Results were updated by Daiwa Capital Markets America to include February 2021 data.*

Source: Powell, Jerome H. "Getting Back to a Strong Labor Market." 10 Feb. 2021. Federal Reserve Board: https://www.federalreserve.gov/newsevents/speech/powell20210210a.htm

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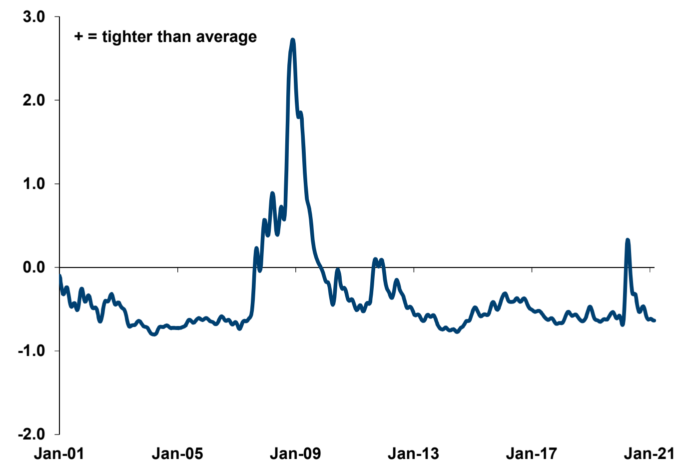
adjustments to Fed policy. Many are looking for the Fed to increase the volume of purchases in its QE program or to shift the current volume toward longer-term issues. In the short end of the market, participants are thinking that the Fed might increase the interest rate on excess reserves (IOER) or the rate on reverse repurchase agreements in order to boost short-term interest rates.

National Financial Conditions Index



Source: Federal Reserve Bank of Chicago via Haver Analytics

However, the Fed is not seeking to control the curve, and thus it is difficult to argue that it has lost control. Its QE program has contributed to a friendly tone throughout the financial system as evidenced in the Chicago Fed financial conditions index. Also, Fed officials might be hesitant to seek control over Treasury rates because of concern about market distortions. Officials most likely would want to maintain a high degree of market influence on interest rates and the allocation of credit. As long as overall financial conditions are supportive, Fed officials are likely to let the market function.

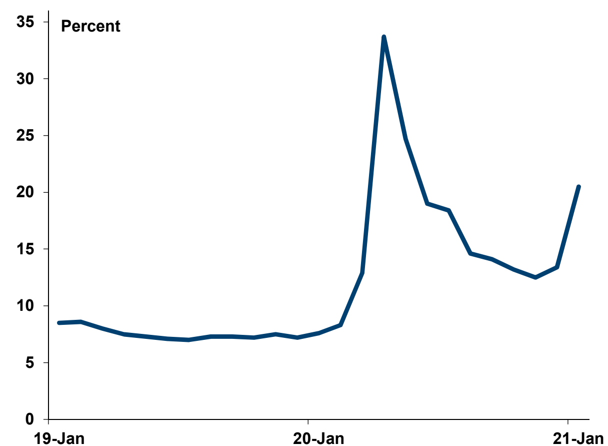
We also suspect that the Fed will not be concerned about low interest rates on RPs and Treasury bills. As in the long end of the market, the Fed is not targeting these rates. The key interest rate in the short end of the market is the federal funds rate. The Fed will seek to keep this measure in the middle of the 0.00 to 0.25 percent target range. As long as this objective is met, officials will let the market determine the level of other money market interest rates.

Recent readings on the federal funds rate have been in the range of 7 to 8 basis points, reasonably close to the 0.125 percent midpoint of the target range. If the funds rate were to move lower, say to 5 basis points, the case for a hike in IOER or the rate on reverse RPs would strengthen, but as it stands, we suspect that officials do not see a need to alter IOER or the rate on reverse RPs.

Pent-Up Wherewithal

Virtually every forecast of the U.S. economy involves brisk spending by households once vaccines are widely distributed and concerns about Covid diminish. Individuals will be anxious to travel, to attend sporting and entertainment events, and to dine out. They will have the means to do so. The saving rate has jumped during the pandemic, with high-side readings in most months in the past year joined by surges last spring and in January in response to the distribution of recovery rebate checks (chart). The buildup of savings has left the aggregate household sector financially flush.

Personal Saving Rate*



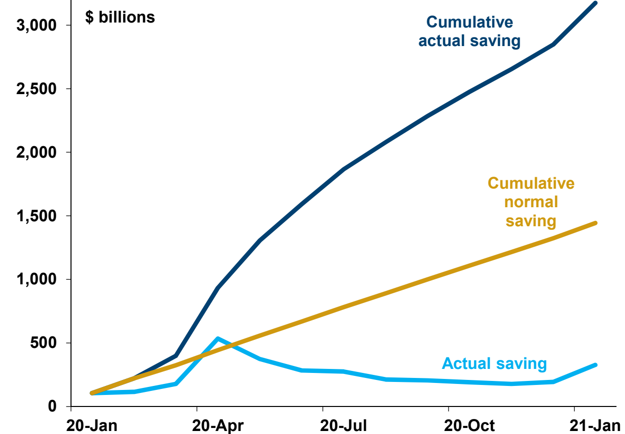
** Personal saving as a share of disposable personal income.*
Source: Bureau of Economic Analysis via Haver Analytics

The chart on the next page provides insight into the magnitude of the push that might come from consumer spending. The bottom line shows the monthly volume of saving by individuals, while the top line shows the cumulative total of those monthly flows. The middle line shows a hypothetical cumulative flow of saving that would

have occurred if the saving rate had matched the pre-pandemic average in 2018 and 2019. The difference between the top and middle lines could be viewed as unanticipated or excess financial resources. These are funds that many households would not hesitate to spend.

The magnitude of the difference is sizeable: $1.7 trillion. If individuals were to spend the entire pool this year, consumer outlays would be approximately 12 percent firmer than they would be otherwise. If the funds were spent on domestically produced goods or services, the activity would add approximately eight percentage points to GDP growth. This is a hefty total on its own, but keep in mind that the totals represent excess demand; that is, demand that would be added to that generated by normal income flows. In addition, the federal government will be sending another round of recovery rebate checks (and other financial support) that will fuel more spending.

Personal Saving



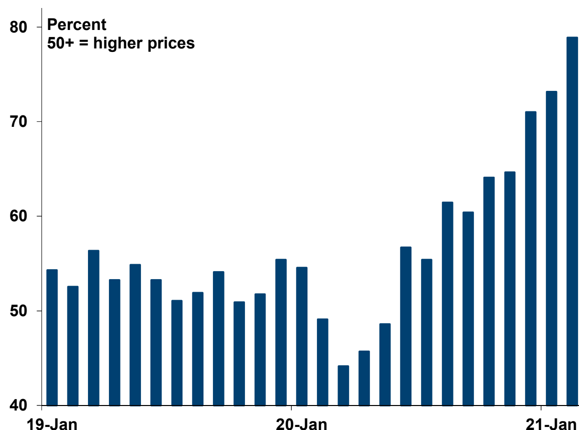
Source: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

The potential increase in demand is substantial, but there will be some tempering factors. Some households undoubtedly will use the funds to pare debt or build savings, and some individuals will purchase imports rather than domestically produced goods or services. But even with these leakages, the boost to demand later this year is likely to be sizeable.

ISM and Inflation

With strong demand on the horizon, it is natural to wonder about a pickup in inflation, and recent readings on the ISM indexes might suggest that such concerns are warranted. The price measure in the manufacturing report has increased sharply in each of the past three months (December to February), while the price index in the services report surged in February from above-average readings in the prior three months. An average of these two measures, although not a record, is very much in the upper end of the historical range (chart, left).

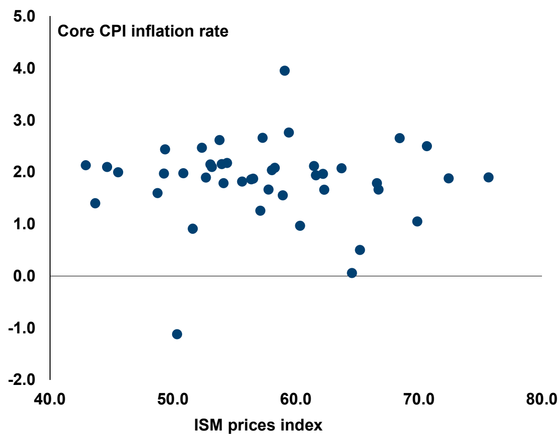
ISM Composite Prices Paid Index*



** An average of the ISM manufacturing prices paid index and the ISM services prices paid index.*

Source: Institute for Supply Management via Haver Analytics; Daiwa Capital Markets America

ISM Composite Prices Paid vs. Core CPI*



** The chart shows a quarterly average of a composite ISM prices index (average of the ISM manufacturing and services prices paid indexes) and the quarter-to-quarter percent change in the core CPI at an annual rate. The chart shows data through 2020-Q4.*

Source: Bureau of Labor Statistics and Institute for Supply Management via Haver Analytics; Daiwa Capital Markets America

The movement has been striking, but we would not be overwrought by the pickup, as these measures are not highly correlated with actual inflation. As evident in the chart on the prior page, there is essentially no correlation between the ISM average price index and core consumer inflation. A chart based on various lags of the ISM price index is similar to the one shown. Predictions of inflation based on the ISM price index would be especially hazardous at this time because the source of the apparent pressure is not clear. Strong demand could be having an influence, but disruptions to supply chains generated by the pandemic could be the key driver. Such pressure would probably fade as the virus dissipates, and thus would not lead to a persistent increase in inflation.

A more fundamental issue with ISM as a predictor relates to the nature of the index: its design is not well suited for judging magnitude. The questions in the survey offer only three possible responses: conditions are getting better, worsening, or staying the same. Respondents do not convey information on the degree of change. A high reading on the price measure could be the result of many purchasing managers seeing modest increases in price.

We do not mean to dismiss concerns about a pickup in inflation. The surge in demand that could unfold in the months ahead easily could stir inflation, but we would not view the recent high-side readings on the ISM price indexes as a signal that price pressure has arrived.

Review

Week of March 1, 2021	Actual	Consensus	Comments
ISM Manufacturing Index (February)	**60.8% (+2.1 Pct. Pts.)**	**58.9% (+0.2 Pct. Pt.)**	The latest observation on the ISM index was not a record, but it matched the best reading of the previous expansion, and it was in the upper portion of the long-run historical range. The supplier delivery component led the advance with a jump of 3.8 percentage points to 72.0%. Much of this increase (as well as the surge of 6.0 percentage points in December) probably reflected disruptions to supply chains, but we suspect that brisk demand also had an influence, as other components were strong. The new orders index jumped 3.7 percentage points to 64.8%, and the production component rose 2.5 percentage points to 63.2%. The employment index had been less than impressive in recent months, but it showed improvement in February with an increase of 1.8 percentage points to 54.4%.
Construction Spending (January)	**1.7%**	**0.8%**	Total construction activity rose January, increasing for the seventh time in the past eight months. Private residential activity again led the advance, as the increase of 2.5% marked the eight consecutive increase and pushed activity far above pre-pandemic totals. Government-sponsored construction rose 1.7%, which moved the level of activity slightly above the pre-virus peak in March. Private nonresidential construction rose 0.4%, a modest change that offset a minuscule portion of the retreat in the past year or so (down in 11 of the 13 months before January).
ISM Services Index (February)	**55.3% (-3.4 Pct. Pts.)**	**58.7% (Unchanged)**	The ISM services index slipped in February to its lowest point since recovery began in June. The new orders component led the retreat, tumbling 9.9 percentage points to 51.9%. With orders soft, businesses slowed the pace of activity, with this component dropping 4.4 percentage points to 55.5%. The employment index also eased, falling 2.5 percentage points to 52.7%. The supplier delivery index rose 3.0 percentage points to 60.8%, but given declines in other areas, the pickup most likely reflected supply-chain disruptions rather than stronger demand.
Revised Nonfarm Productivity (2020-Q4)	**-4.2% (0.6 Pct. Pt. Upward Revision)**	**-4.7% (0.1 Pct. Pt. Upward Revision)**	Growth of output was revised higher in Q4 (5.5%, annual rate versus 5.3%) and hours growth was revised lower, which led to a modest improvement in productivity (i.e. a slightly smaller decline). However, over the four quarters of 2020, productivity advanced 2.4%, faster than the 1.9% pace in 2019 and 1.1% in 2018. Growth in labor compensation was slower than first reported (1.5% versus 1.7%), which combined with the improvement in productivity, led to a downward adjustment to unit labor costs (growth of 6.0% versus an initial estimate of 6.8%).

Review Continued

Week of March 1, 2021	Actual	Consensus	Comments
Factory Orders (January)	**2.6%**	**2.1%**	The broad-based increase in orders for durable goods (3.4%, published Feb. 25) accounted for much of the advance in total factory bookings in January, with the change leavings bookings 4.3% above the pre-virus peak last February. The nondurable component also advanced (1.9%). Part of the increase reflected a surge of 7.3% in the petroleum and coal category, which likely reflected higher prices, but bookings excluding petroleum and coal rose 0.7%, their ninth consecutive advance. Nondurable bookings excluding petroleum are now 3% above the pre-virus reading in February 2020.
Payroll Employment (February)	**379,000**	**200,000**	The increase in nonfarm payrolls in February was joined by a net upward revision of 38,000 in December and January. The results, while favorable, were not overwhelming considering the ground that needs to be regained to return to pre-pandemic levels. The leisure industry stood out on the firm side with job growth of 355,000. The gain represented only a partial offset to the drop of 523,000 in the prior two months, but it was a welcome change in a sector that is still struggling with fallout from Covid. On the soft side, the construction industry shed 61,000 jobs, perhaps temporary cuts driven by severe weather. The unemployment rate fell 0.1 percentage point to 6.2%. The change reflected a moderate increase in employment as measured by the household survey (up 208,000) that exceeded an increase of 50,000 in the size of the labor force.
Trade Balance (January)	**$68.2 Billion Deficit ($1.2 Billion Wider Deficit)**	**$67.5 Billion Deficit ($0.9 Billion Wider Deficit)**	Both exports and imports in January continued to move along their upward trends. As in most other recent months, the increase in imports was larger (up 1.2% versus 1.0% for exports), which left a wider trade deficit. The real trade deficit in goods provides insight into the influence of net exports on GDP growth, and this figure for January was a bit wider than the average in Q4, suggesting that international trade will be a drag on economic growth, perhaps subtracting one-half to three-quarters of a percentage point from GDP growth in Q1.

Sources: Institute for Supply Management (ISM Manufacturing Index, ISM Services Index); U.S. Census Bureau (Construction Spending, Factory Orders); Bureau of Labor Statistics (Nonfarm Productivity, Payroll Employment); Bureau of Economic Analysis (Trade Balance); Consensus forecasts are from Bloomberg

Preview

Week of March 8, 2021	Projected	Comments
CPI (February) (Wednesday)	**0.4% Total, 0.2% Core**	The energy component is likely to register its ninth consecutive increase, with the expected jump of approximately of 4.0% pushing prices close to their pre-pandemic level. Food prices have fluctuated widely in recent months, but they have advanced moderately on balance. Items outside of food and energy have shown notable variation in recent months, as the pandemic has triggered marked weakness in some areas and brisk activity in other sectors. Softness has tended to dominate in recent months, but with the economy recovering, positive influences should begin to become more of a factor.
Federal Budget (February) (Wednesday)	**$280.0 Billion Deficit**	A later-than-normal opening of the tax filing season delayed the issuance of tax refunds, which is likely to result in a year-over-year surge in net revenues. Outlays also are likely to register rapid growth relative to February last year because of pandemic-related spending now in place. Strength in outlays will probably dominate the surge in revenues, leaving the deficit wider than the shortfall of $235 billion in February 2020.
PPI (February) (Friday)	**0.4% Total, 0.0% Ex. Food and Energy**	The energy component of the PPI is likely to jump, led by pressure on gasoline prices and reinforced by upward movement in fuel oil prices. The food component has been little changed in recent months and is likely to stay tame. The PPI excluding food and energy is likely to settle after an outsized increase of 1.2% in January. The volatile service sector, which rose 1.3% in January is likely to account for most of the deceleration, but prices of goods ex-food and energy, which rose 0.8% in January, could cool as well.
Consumer Sentiment (March) (Friday)	**80.0 (+3.2 Index Pts.)**	Although the distribution of vaccines has been slower than hoped, the U.S. has made solid progress in slowing the spread of Covid, which has helped to support firm economic activity. The generally good performance, along with the prospect of aggressive fiscal stimulus, should boost consumer spirits.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

March 2021

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5
ISM INDEX Index / Prices Dec 60.5 77.6 Jan 58.7 82.1 Feb 60.8 86.0 **CONSTRUCTION SPEND.** Nov 1.4% Dec 1.1% Jan 1.7%	**VEHICLE SALES** Dec 16.2 million Jan 16.6 million Feb 15.7 million	**ADP EMPLOYMENT REPORT** Private Payrolls Dec -75,000 Jan 195,000 Feb 117,000 **ISM SERVICES INDEX** Index / Prices Dec 57.7 64.4 Jan 58.7 64.2 Feb 55.3 71.8 **BEIGE BOOK** "Economic activity expanded modestly from January to mid-February for most Federal Reserve Districts."	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Feb 06 0.848 4.520 Feb 13 0.834 4.419 Feb 20 0.736 4.295 Feb 27 0.745 N/A **REVISED PRODUCTIVITY & COSTS** Productivity / Unit Labor Costs 20-Q3 4.2% -9.6% 20-Q4(p) -4.8% 6.8% 20-Q4(r) -4.2% 6.0% **FACTORY ORDERS** Nov 1.3% Dec 1.6% Jan 2.6%	**EMPLOYMENT REPORT** Payrolls / Un. Rate Dec -306,000 6.7% Jan 166,000 6.3% Feb 379,000 6.2% **TRADE BALANCE** Nov -$69.0 billion Dec -$67.0 billion Jan -$68.2 billion **CONSUMER CREDIT** Nov $13.4 billion Dec $8.8 billion Jan -$1.3 billion
8	9	10	11	12
WHOLESALE TRADE (10:00) Inventories / Sales Nov 0.0% 0.3% Dec 0.5% 1.2% **Jan 1.3% 0.5%**	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** Dec 95.9 Jan 95.0 Feb --	**CPI (8:30)** Total / Core Dec 0.2% 0.0% Jan 0.3% 0.0% **Feb 0.4% 0.2%** **FEDERAL BUDGET (2:00)** FY2021 / FY2020 Dec -$143.6B -$13.3B Jan -$162.8B -$32.6B **Feb -$280.0B** -$235.3B	**INITIAL CLAIMS (8:30)** **JOLTS DATA (10:00)** Openings (000) / Quit Rate Nov 6,572 2.2% Dec 6,646 2.3% Jan -- --	**PPI (8:30)** Total / Ex. Food & Energy Dec 0.3% 0.1% Jan 1.3% 1.2% **Feb 0.4% 0.0%** **CONSUMER SENTIMENT (10:00)** Jan 79.0 Feb 76.8 **Mar 80.0**
15	16	17	18	19
EMPIRE MFG INDEX **TIC DATA**	**RETAIL SALES** **IMPORT/EXPORT PRICES** **IP & CAP-U** **BUSINESS INVENTORIES** **NAHB HOUSING INDEX** **FOMC MEETING**	**HOUSING STARTS** **FOMC DECISION**	**INITIAL CLAIMS** **PHILLY FED INDEX** **LEADING INDICATORS**	
22	23	24	25	26
CHICAGO FED NATIONAL ACTIVITY INDEX **EXISTING HOME SALES**	**CURRENT ACCOUNT** **NEW HOME SALES**	**DURABLE GOODS ORDERS**	**INITIAL CLAIMS** **REVISED GDP**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PERSONAL INCOME, CONSUMPTION, PRICES** **REVISED CONSUMER SENTIMENT**

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

Treasury Financing

March 2021

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5
AUCTION RESULTS: Rate Cover 13-week bills 0.040% 3.06 26-week bills 0.060% 2.91 **SETTLE:** $27 billion 20-year bonds $60 billion 2-year notes $61 billion 5-year notes $62 billion 7-year notes	**AUCTION RESULTS:** Rate Cover 6-week CMB 0.040% 3.54 **ANNOUNCE:** $30 billion 4-week bills for auction on March 4 $35 billion 8-week bills for auction on March 4 $30 billion 17-week CMBs for auction on March 3 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 0.050% 3.71	**AUCTION RESULTS:** Rate Cover 4-week bills 0.030% 3.40 8-week bills 0.035% 3.34 **ANNOUNCE:** $105 billion 13-,26-week bills for auction March 8 $58 billion 3-year notes for auction on March 9 $38 billion 10-year notes for auction on March 10 $24 billion 30-year bonds for auction on March 11 $30 billion 6-week CMBs for auction on March 9 **SETTLE:** $105 billion 13-,26-week bills $30 billion 6-week CMBs	
8	9	10	11	12
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $58 billion 3-year notes $30 billion 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on March 11 $35 billion* 8-week bills for auction on March 11 $30 billion* 17-week CMBs for auction on March 10 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $38 billion 10-year notes $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $24 billion 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction March 15 $24 billion* 20-year bonds for auction on March 16 $13 billion* 10-year TIPS for auction on March 18 $30 billion* 6-week CMBs for auction on March 16 **SETTLE:** $105 billion 13-,26-week bills $30 billion 6-week CMBs	
15	16	17	18	19
AUCTION: $105 billion* 13-,26-week bills **SETTLE:** $58 billion 3-year notes $38 billion 10-year notes $24 billion 30-year bonds	**AUCTION:** $24 billion* 20-year bonds $30 billion* 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on March 18 $35 billion* 8-week bills for auction on March 18 $30 billion* 17-week CMBs for auction on March 17 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $13 billion* 10-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction March 22 $34 billion* 52-week bills for auction on March 23 $26 billion* 2-year FRNs for auction on March 24 $60 billion* 2-year notes for auction on March 23 $61 billion* 5-year notes for auction on March 24	$62 billion* 7-year notes for auction on March 25 $30 billion* 6-week CMBs for auction on March 23 **SETTLE:** $105 billion* 13-,26-week bills $30 billion* 6-week CMBs
22	23	24	25	26
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills $60 billion* 2-year notes $30 billion* 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on March 25 $35 billion* 8-week bills for auction on March 25 $30 billion* 17-week CMBs for auction on March 24 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $26 billion* 2-year FRNs $61 billion* 5-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $62 billion* 7-year notes **ANNOUNCE:** $105 billion* 13-,26-week bills for auction March 29 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills $30 billion* 6-week CMBs	**SETTLE:** $26 billion* 2-year FRNs

*Estimate