U.S. Economic Comment

- Powell on inflation: pandemic driven
- Tapering and Treasury supply: favorable balance near term, but only near term

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The Fed's Gamble

The latest policy statement from the Federal Open Market Committee suggested that Fed officials are starting to have doubts about the transitory nature of inflation: "Inflation is elevated, largely reflecting factors that are **expected to be transitory**" (emphasis added). The previous statement, in contrast, showed a high degree of confidence in the view that price pressure would soon subside: "Inflation is elevated, largely reflecting transitory factors." (Note the absence of "expected to be".)

While the new statement opened the possibility that elevated inflation could be more than temporary, officials still seem to hold firmly to the transitory view. A new sentence in the statement added some detail to the Fed's view on inflation: "Supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable price increases in some sectors." Comments from Chair Powell's press briefing provided insights into the significance of this sentence. First, imbalances are related to the pandemic; the Fed Chair did not seem to believe that the massive dose of fiscal stimulus and a highly accommodative monetary policy were stoking price pressure. Second, price increases are concentrated in "some sectors". Mr. Powell did not see a broad-based increase in inflation.

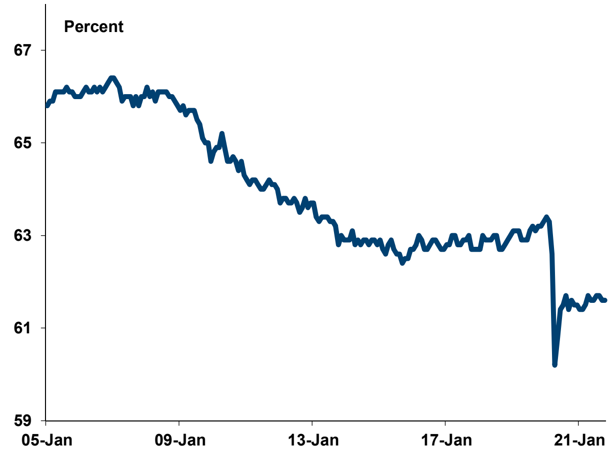
Given this benign view on inflation, Chair Powell did not see a need to adjust interest rates any time soon. His hesitancy to raise interest rates was clear in both his prepared remarks and in response to questions. In his prepared remarks, the Chair noted: "it remains the case that the drivers of higher inflation have been predominantly connected to the dislocations caused by the pandemic, specifically the effects on supply and demand from the shutdown, the uneven reopening, and the ongoing effects of the virus itself… we continue to believe that our dynamic economy will adjust to the supply and demand imbalances, and that as it does, inflation will decline to levels much closer to our 2 percent longer-run goal."

In the Q&A session, a reporter asked about adjusting interest rates to achieve balance in seeking to reach the Fed's goals on inflation and unemployment. Chair Powell did not see a need to seek balance because the source of price pressure (shortages) would not respond to tighter policy: "The inflation that we're seeing is really not due to a tight labor market. It's due to bottlenecks, and it's due to shortages, and it's due to very strong demand meeting those." Mr. Powell mentioned strong demand, but it was clear that he viewed the problem as being on the supply side.

The issue of balance emerged again later in the session, and Chair Powell's response in this instance indicated that he gave priority to employment even if demand-side inflation was an issue: "we're not at maximum employment. When that is the case, we'll look to see whether the inflation test [for raising interest rates] is met…we didn't ask ourselves whether the lift-off test is met, because, you know, it's clearly not met on the maximum employment side."

While not emphasized in the press briefing, the Fed has other possible arguments for remaining patient with policy normalization. Certain indicators suggest that labor markets are tight (elevated job openings and quit rates, sizeable increases in measures of labor compensation), but some observers, including Fed officials, believe that workers who dropped out of the labor force will return and ease some of the tightness. Vice-Chair Richard Clarida, for example, has noted in speeches that the labor force participation rate has lagged other labor market indicators in previous expansions. Workers could well return, but participation has changed little so far. After recovering a portion of lost ground in the early months of the expansion, the participation rate has trended sideways in the past year or so and remains well below its pre-pandemic level (chart). The prime-age participation rate has picked up some recently, but it too remains noticeably below pre-pandemic levels.

Labor-Force Participation Rate

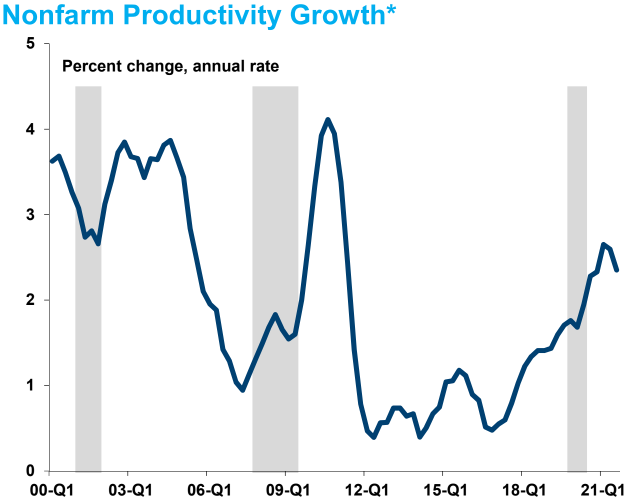


Source: Bureau of Labor Statistics via Haver Analytics

Chair Powell made mention of productivity gains helping to cushion price pressure, but the performance here has not been impressive. Labor productivity in the third quarter provided a down-side surprise with a decline of 5.0 percent (annual rate). This drop, by itself, is not deeply troubling because productivity often swings widely from quarter-to-quarter (e.g. a surge of 11.2 percent in 2020-Q2 and a drop of 3.4 percent in 2020-Q4). However, average productivity growth of 2.4 percent so far in the current recovery could be viewed as mediocre. Productivity often grows sharply in the early stages of a recovery, as businesses return to optimal levels of production and as they implement changes in business models and practices that were prompted by efforts to survive during the preceding recession. The average advance of 2.4 percent in the first six quarters of the current recovery lags readings in the neighborhood of 4.0 percent in other recent recoveries (chart).

We called this section of our weekly comment “The Fed’s Gamble” because there will be consequences if recent inflation reflects more than pandemic-related supply pressure. If firm demand associated with fiscal stimulus and accommodative monetary policy also are in play, the Fed will find itself behind the inflation curve sometime next year or in 2023. Chair Powell has indicated numerous times that the Fed has the tools to deal with such situations. No doubt, it does, but those tools would involve aggressive tightening in monetary policy, which could trigger a recession.

Nonfarm Productivity Growth*



** The chart shows a six-quarter moving average of the quarterly percent change (annual rate) in productivity growth. The shaded areas indicate periods of recession in the United States.*

Source: Bureau of Labor Statistics and National Bureau of Economic Research via Haver Analytics

Tapering and Treasury Supply

Interestingly (and purely coincidently in our view), the Fed is beginning to reduce its purchases of Treasury securities at the same time that the Treasury Department is trimming the auction sizes of its coupon securities. The shifts will have offsetting effects on the supply that must be absorbed by the market, possibly reducing the amount that must be purchased by investors.

The balance will be favorable over the next three months. The Treasury has reduced the gross volume of coupon securities that will be issued by $84 billion, which exceeds the planned reduction of $60 billion in the volume of Treasury securities purchased by the Fed over the November-January period. (Rather than purchasing $80 billion per month over the next three months, the Fed tentatively plans to purchase $70 billion in November, $60 billion in December, and $50 billion in January.) With the Treasury cuts exceeding the reductions in Fed purchases, the market will be absorbing $24 billion less than it would have if no changes had been made.

The favorable balance, however, is likely to be short lived. The Treasury has additional room to reduce auction sizes, so we might assume that the Treasury cuts its gross issuance by another $84 billion in the February-April period. The Fed's reductions in this period will be much sharper than those in the first three months of the tapering period. If the Fed maintains the planned pace of tapering, it will be buying $40 billion, $30 billion, and $20 billion in February, March, and April, respectively, for a total of $90 billion, markedly less than the $240 billion that would have been purchased if the Fed had continued with its full QE effort. The cut of $150 billion ($240 billion less $90 billion) exceeds the $84 billion assumed reduction by the Treasury Department.

The increase in the financing burden on the private sector also is evident from another perspective. In fiscal year 2021, the Treasury Department issued a net total of approximately $1.5 trillion in marketable public debt. (This total is far less than the $2.8 trillion federal deficit because the Treasury ran down the enlarged cash balance it had accumulated to cover potential pandemic-related spending.) The Fed's open market purchases of Treasuries in FY2021 totaled approximately $980 billion or approximately 65 percent of Treasury issuance. In the new fiscal year, the Treasury will probably borrow a similar amount. (The July estimate of the Congressional Budget Office shows a deficit of $1.153 trillion, but legislation now under discussion could add to the deficit, and the Treasury will probably want to boost its cash balance from the $215 billion at the end of last fiscal year to the normal level of approximately $500 billion.) The Fed, if it sticks with the current tapering plan, will purchase $360 billion of Treasury debt in the market, only about one-third of its purchases in the prior fiscal year and only about one-quarter of likely Treasury issuance.

Review

Week of Nov. 1, 2021	Actual	Consensus	Comments
ISM Manufacturing Index (October)	**60.8% (-0.3 Pct. Pt.)**	**60.5% (-0.6 Pct. Pt.)**	The modest change in the ISM manufacturing index left the measure comfortably within its recent elevated range. The new orders component softened noticeably in October, dropping 6.9 percentage points, but the change occurred from a strong showing in September and the new level of 59.8% was still firm by historical standards. Despite the slowing in orders, production was well maintained (off 0.1 percentage point to 59.3%), and the employment index increased 1.8 percentage points to 52.0%. The supplier delivery index rose for the second consecutive month (up 2.2 percentage points to 75.6%), signaling continued problems with supply chains.
Construction Spending (September)	**-0.5%**	**0.3%**	All three major components contributed to decline in construction activity in September. Private residential building slipped 0.4%, marking the second decline in the past three months and denting the upward trend that began in mid-2020. Private nonresidential building fell 0.6%, while government-sponsored construction dropped 0.7%; both areas are tracing flat trends.
ISM Services Index (October)	**66.7% (+4.8 Pct. Pts.)**	**62.0% (+0.1 Pct. Pt.)**	The ISM services index jumped to a record reading in October. Both the new orders and business activity components contributed to the strong showing, with these indexes increasing 6.2 and 7.5 percentage points, respectively. Both measures also moved to record levels (69.7% and 69.8%, respectively). The supplier deliveries component contributed to the increase in the headline index, as continued problems with supply chains drove the measure 6.9 percentage points higher to 75.7%. The employment index fell 1.4 percentage points from a less-than-impressive level, moving to 51.6%. The out-of-step reading could reflect difficulty in finding workers.
Factory Orders (September)	**0.2%**	**0.1%**	Softness in total factory orders in September was concentrated in the durable component, where bookings fell 0.3%. The weakness, in turn, was led by a drop of 27.9% in commercial aircraft bookings after a strong performance in August. Orders for durable goods excluding transportation rose 0.5%. Given the tightness in supplies, a good portion of this increase probably reflected higher prices. Orders for nondurable goods rose 0.8%. The petroleum and coal category contributed importantly with an increase of 2.1%, with a substantial portion of this advance reflecting higher prices. Excluding petroleum and coal, nondurable orders rose 0.5%, marking the seventh consecutive increase and the 16th advance in the past 17 months.

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Review Continued

Week of Nov. 1, 2021	Actual	Consensus	Comments
Nonfarm Productivity (2021-Q3)	**-5.0%**	**-3.1%**	The combination of moderate growth in output (1.7%) and a pronounced increase in hours worked (7.0%) led to a notably soft performance in nonfarm productivity in Q3. The decline left the average annual increase so far in the current expansion at 2.4%, a mediocre performance for the early stages of a business expansion. The soft results on productivity, combined with an increase of 2.9% in compensation per hour, led to a jump of 8.3% in unit labor costs.
Trade Balance (September)	**-\$80.9 Billion (\$8.1 Billion Wider Deficit)**	**-\$80.2 Billion (\$6.9 Billion Wider Deficit)**	Both sides of the trade ledger contributed to the sharp widening in the monthly trade deficit in September, as exports fell 3.0% and imports rose 0.6%. All of the widening occurred in goods trade (slippage of \$8.9 billion); the service surplus improved slightly (up \$0.8 billion). The September results were close to the assumptions built into the first estimate of Q3 GDP, but a favorable revision in August could reduce slightly the drag of 1.1 percentage points from net exports on GDP growth.
Payroll Employment (October)	**531,000**	**450,000**	Payroll growth posted a firm advance in October, with an upward revision of 235,000 in the prior two months adding an accent to the positive tone of the report. The unemployment rate posted a firm decline in the latest month (-0.2 percentage point to 4.6%), as both employment as measured by the household survey and the size of the labor force increased (up 359,000 and 104,000, respectively). The broad unemployment rate fell 0.2 percentage point to 8.3%. The number of involuntary part-time workers and the number of marginally attached individuals both declined slightly and joined the influence of the change in the narrow jobless rate to push the broad measure lower. Average hourly earnings posted a solid gain (up 0.4%, which left the year-over-year advance at 4.9%).

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 Nov. 8, 2021	Projected	Comments
PPI (October) (Tuesday)	**0.7% Total, 0.5% Ex. Food & Energy**	The upward pressure on energy prices in October will probably be magnified by seasonal adjustment, and given supply shortages and delivery problems, food prices are likely to about match the average increase of 1.3% so far this year. Prices excluding food and energy also have been under pressure most of the year (average increase of 0.6%), and tight supplies and firm demand will probably lead to another pronounced increase.
CPI (October) (Wednesday)	**0.5% Total, 0.4% Core**	Available quotes suggest that the energy component will increase for the fifth consecutive month (and the 15th in the past 17 months), and food prices will probably remain on the firm path seen in the past six months (up an average of 0.6%). Covid-related discounting that restrained the core component in September will likely diminish or disappear on October, resulting in a sharp increase.
Federal Budget (October) (Wednesday)	**$210.0 Billion Deficit**	Available data suggest that federal revenues will post double-digit year-over-year growth in October. With outlays likely to be close to the recent average, the strong revenue flow should leave a deficit that is narrower than the shortfall of $284 billion in October 2020.
Consumer Sentiment (November) (Friday)	**73.0 (+1.3 Index Pts.)**	Record readings on major equity indexes and the deceleration in the number of new Covid cases should brighten moods, but elevated inflation seems to be weighing heavily on attitudes and is likely to offset much of the influence of recent positive developments.

Source: Forecasts provided by Daiwa Capital Markets America

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Economic Indicators

November 2021

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5

Monday 1

ISM INDEX

	Index	Prices
Aug	59.9	79.4
Sept	61.1	81.2
Oct	60.8	85.7

CONSTRUCTION SPEND.

July	0.1%
Aug	0.1%
Sept	-0.5%

Tuesday 2

VEHICLE SALES

Aug	13.1 million
Sept	12.2 million
Oct	13.0 million

FOMC MEETING

Wednesday 3

ADP EMPLOYMENT REPORT

	Private Payrolls
Aug	310,000
Sept	523,000
Oct	571,000

ISM SERVICES INDEX

	Index	Prices
Aug	61.7	75.4
Sept	61.9	77.5
Oct	66.7	82.9

FACTORY ORDERS

July	0.7%
Aug	1.0%
Sept	0.2%

FOMC DECISION

POWELL PRESS CONFERENCE

Thursday 4

UNEMPLOYMENT CLAIMS

	Initial	Continuing
	(Millions)	
Oct 09	0.296	2.480
Oct 16	0.291	2.239
Oct 23	0.283	2.105
Oct 30	0.269	N/A

PRODUCTIVITY & COSTS

	Productivity	Unit Labor Costs
21-Q1	4.3%	-2.8%
21-Q2	2.4%	1.1%
21-Q3	-5.0%	8.3%

TRADE BALANCE

July	-$70.3 billion
Aug	-$72.8 billion
Sept	-$80.9 billion

Friday 5

EMPLOYMENT REPORT

	Payrolls	Un. Rate
Aug	483,000	5.2%
Sept	312,000	4.8%
Oct	531,000	4.6%

CONSUMER CREDIT

July	$16.6 billion
Aug	$13.8 billion
Sept	$29.9 billion

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12

Tuesday 9

NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)

Aug	100.1
Sept	99.1
Oct	--

PPI (8:30)

	Final Demand	Ex. Food & Energy
Aug	0.7%	0.6%
Sept	0.5%	0.2%
Oct	**0.7%**	**0.5%**

Wednesday 10

INITIAL CLAIMS (8:30)

CPI (8:30)

	Total	Core
Aug	0.3%	0.1%
Sept	0.4%	0.2%
Oct	**0.5%**	**0.4%**

WHOLESALE TRADE (10:00)

	Inventories	Sales
July	0.6%	2.1%
Aug	1.2%	-1.1%
Sept	**1.1%**	**1.0%**

FEDERAL BUDGET (2:00)

	2021	2020
Aug	-$170.6B	-$200.0B
Sept	-$61.5B	-$124.6B
Oct	**-$210.0B**	**-$284.1B**

Thursday 11

VETERANS DAY

Friday 12

JOLTS DATA (10:00)

	Openings (000)	Quit Rate
July	11,098	2.7%
Aug	10,439	2.9%
Sept	--	--

CONSUMER SENTIMENT (10:00)

Sept	72.8
Oct	71.7
Nov	**73.0**

Monday	Tuesday	Wednesday	Thursday	Friday
15	16	17	18	19
EMPIRE MFG INDEX	RETAIL SALES IMPORT/EXPORT PRICES IP & CAP-U BUSINESS INVENTORIES NAHB HOUSING MARKET INDEX TIC DATA	HOUSING STARTS	INITIAL CLAIMS PHILADELPHIA FED MFG BUSINESS OUTLOOK LEADING INDICATORS	
22	23	24	25	26
CHICAGO FED NATIONAL ACTIVITY INDEX EXISTING HOME SALES		INITIAL CLAIMS REVISED GDP DURABLE GOODS ORDERS PERSONAL INCOME, CONSUMPTION, PRICES U.S. INTERNATIONAL TRADE IN GOODS ADVANCE INVENTORIES NEW HOME SALES REVISED CONSUMER SENTIMENT FOMC MINUTES	*THANKSGIVING DAY*	

Forecasts in Bold.

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Treasury Financing

November 2021

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5
AUCTION RESULTS: Rate Cover 13-week bills 0.050% 3.72 26-week bills 0.065% 2.90 **SETTLE:** $24 billion 20-year bonds $28 billion 2-year FRNs $60 billion 2-year notes $61 billion 5-year notes $62 billion 7-year notes	**AUCTION RESULTS:** Rate Cover 52-week bills 0.160% 3.25 **ANNOUNCE:** $10 billion 4-week bills for auction on November 4 $25 billion 8-week bills for auction on November 4 $40 billion 17-week CMBs for auction on November 3 **SETTLE:** $60 billion 4-week bills $25 billion 8-week bills $40 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 0.055% 3.45 **ANNOUNCE MID-QUARTER REFUNDING:** $56 billion 3-year notes for auction on November 8 $39 billion 10-year notes for auction on November 9 $25 billion 30-year bonds for auction on November 10	**AUCTION RESULTS:** Rate Cover 4-week bills 0.040% 5.48 8-week bills 0.055% 3.53 **ANNOUNCE:** $102 billion 13-,26-week bills for auction on November 8 **SETTLE:** $102 billion 13-,26-week bills $34 billion 52-week bills	
8	9	10	11	12
AUCTION: $102 billion 13-,26-week bills $56 billion 3-year notes	**AUCTION:** $39 billion 10-year notes **ANNOUNCE:** $10 billion* 4-week bills for auction on November 10 $25 billion* 8-week bills for auction on November 10 $40 billion* 17-week CMBs for auction on November 10 **SETTLE:** $10 billion 4-week bills $25 billion 8-week bills $40 billion 17-week CMBs	**AUCTION:** $10 billion* 4-week bills $25 billion* 8-week bills $25 billion 30-year bonds $40 billion* 17-week CMBs **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Nov. 15 $23 billion* 20-year bonds for auction on November 17 $14 billion* 10-year TIPS for auction on November 18	***VETERANS DAY***	**SETTLE:** $102 billion 13-,26-week bills
15	16	17	18	19
AUCTION: $102 billion* 13-,26-week bills **SETTLE:** $56 billion 3-year notes $39 billion 10-year notes $25 billion 30-year bonds	**ANNOUNCE:** $10 billion* 4-week bills for auction on November 18 $25 billion* 8-week bills for auction on November 18 $40 billion* 17-week CMBs for auction on November 17 **SETTLE:** $10 billion* 4-week bills $25 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $23 billion* 20-year bonds $40 billion* 17-week CMBs	**AUCTION:** $10 billion* 4-week bills $25 billion* 8-week bills $14 billion* 10-year TIPS **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Nov. 22 $24 billion* 2-year FRNs for auction on November 23 $58 billion* 2-year notes for auction on November 22 $59 billion* 5-year notes for auction on November 22 $59 billion* 7-year notes for auction on November 23 **SETTLE:** $102 billion* 13-,26-week bills	
22	23	24	25	26
AUCTION: $102 billion* 13-,26-week bills $58 billion* 2-year notes $59 billion* 5-year notes	**AUCTION:** $24 billion* 2-year FRNs $59 billion* 7-year notes **ANNOUNCE:** $10 billion* 4-week bills for auction on November 24 $25 billion* 8-week bills for auction on November 24 $40 billion* 17-week CMBs for auction on November 24 **SETTLE:** $10 billion* 4-week bills $25 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $10 billion* 4-week bills $25 billion* 8-week bills $40 billion* 17-week CMBs **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Nov. 29 $34 billion* 52-week bills for auction on November 30	***THANKSGIVING DAY***	**SETTLE:** $102 billion* 13-,26-week bills $24 billion* 2-year FRNs

*Estimate