U.S. Economic Comment

- U.S. economy: meeting challenges in 2022

Michael Moran
Daiwa Capital Markets America
212-612-6392
michael.moran@us.daiwacm.com

The U.S. Economy: On Track

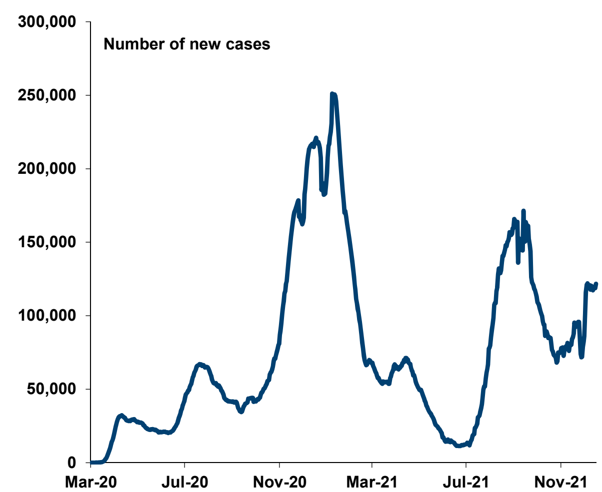
The U.S. economy seems to be rebounding in the final months of the year from the listless advance of 2.1 percent in the third quarter. Available data point to growth in excess of six percent, and a gain near seven percent is possible if December shows strong results. Consumers have been active and their outlays will stand out in leading the pickup. In addition, net exports are likely to make a positive contribution to growth after constraining activity for five consecutive quarters. Businesses do not appear to have been especially active in the fixed-investment area, but data suggest they added to inventories after supply-chain disruptions forced them to draw down stocks of goods in the first three quarters of the year. We expect a sizeable contribution to Q3 GDP growth from inventory investment.

The strong performance in the fourth quarter suggests bright prospects for 2022, although the economy faces two notable challenges: the constraining influence of another acceleration in Covid-19, and the removal of policy stimulus -- both fiscal and monetary.

Predicting the course of the virus and its effect on the economy is a fool's errand. We claim no prescience on this issue; rather, we base our forecast for 2022 on the assumption that the latest acceleration of Covid does not involve meaningful constraints on economic activity. This view, while optimistic, is not entirely fanciful. The number of new Covid cases is noticeably below the level seen at this time last year, suggesting that the nation has moved to a higher level of immunization (chart, left). In addition, individuals and businesses have gained experience in dealing with the virus, and thus they can carry on better than they have in the past. Finally, early indications suggest that the Omicron variant does not involve serious illness.

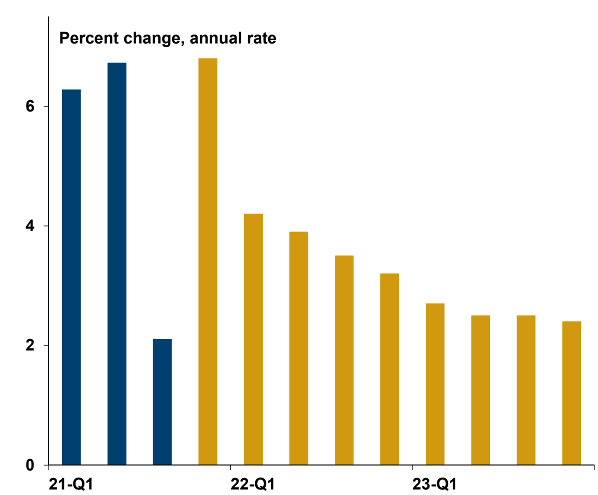
Even with limited fallout from the latest round of Covid, the economy is not likely to maintain the pace of growth seen in the fourth quarter. Still, growth is likely to be solid, with the gradual easing leaving an advance

New Covid-19 Cases*



** Seven-day moving average. The last reading is for December 16, 2021.*
Source: Johns Hopkins University and Medicine via Bloomberg

GDP Growth*



** The readings for 2021-Q4 to 2023-Q4 (gold bars) are forecasts.*
Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

of 3.7 percent over the four quarters of 2022 and 2.5 percent in 2023 (chart, prior page, right). This pace is fast enough to continue pushing unemployment lower, but it is also strong enough to prevent a quick easing in inflation pressures. We expect inflation to remain above 3.0 percent in 2022 (table, page 4).

Fiscal Policy

The federal government provided a tremendous amount of fiscal support to help the economy weather the Covid storm: legislative actions involving spending increases or tax relief totaled almost $5 trillion. In addition, the government offered administrative changes such as eviction moratoria and suspensions of student-loan payments that helped individuals deal with the shock. That support has now largely faded, possibly leaving the economy vulnerable to another wave of Covid.

The waning fiscal support is apparent with a simple review of budget figures. The budget deficit of the federal government totaled $3.1 trillion in fiscal year 2020 and $2.8 trillion in FY2021. The projection of the Congressional Budget Office for the current fiscal year totals $1.5 trillion, a marked pullback by the federal government.

However, in this instance, the year-to-year change in the size of the budget deficit, in our view, overstates the degree of fiscal restraint. While the government pushed a massive amount of funding out the door in fiscal years 2020 and 2021, a large share of this stimulus has yet to filter into the economy, as much of the federal support was initially saved.

The personal saving rate, for example, averaged 18.0 percent in the first 10 months after the onset of the pandemic (March to December 2020), and it remained elevated at 15.4 percent in the first half of this year. These elevated rates allowed the household sector in the aggregate to accumulate approximately $2.5 trillion in excess savings (i.e. savings in excess of what would have unfolded if pre-Covid trends had remained in place). Some households will use the accumulated savings to bolster their financial positions, but a large share can be drawn on to support spending. Strong consumer outlays in Q4 (expected real growth of 5.5 percent) attests to the potential push from the large pool of household saving. The rally in the equity market this year also could provide support by triggering wealth-related spending.

State and local governments also seem to have utilized a small portion of support offered by the federal government. The Cares Act and the American Rescue Plan provided a combined $500 billion in grants to state and local governments. These acts also provided funds to fight Covid and to maintain operations in schools and transit systems. All told, Congress funneled almost $900 billion to state and local governments (estimate tallied by the Committee for a Responsible Federal Budget). The pace of spending by state and local governments evident in the GDP accounts has only recently (Q3) started to quicken, raising the prospect of strong results in the quarters ahead.

Monetary Policy

The Federal Reserve shifted gears this week by accelerating the pace of tapering its quantitative easing program and by signaling that policymakers anticipate raising interest rates in 2022. According to the latest dot plot, no Fed official sees steady interest rate policy next year, while two officials anticipate four interest rate hikes. The median dot shows three rate hikes. We view the current Fed as having a strong dovish bias, which will leave it slow to admit to inflation issues and hesitant to react with tighter policy. Thus, the median dot probably underestimates the amount of restraint that will be needed and eventually be applied. Accordingly, we are building in four rate hikes next year (table, p. 4).

The Fed could possibly add to the restraint by winding down its balance sheet; that is, redeeming securities after it completes the tapering process and after it starts lifting interest rates. We had been looking for a long lag between interest rate liftoff and balance sheet normalization, but Fed Governor Christopher Waller in a talk and Q&A session on Friday raised the possibility of a short lag between the first interest rate hike and the redemption of securities.

Tighter financial conditions triggered by interest rate liftoff and balance sheet normalization will have a constraining influence on the economy, but we do not see the four hikes built into our forecast as derailing the expansion. In assessing the impact of a one percentage point increase interest rates, one should consider the starting point, and the U.S. is starting from an unusually accommodative set of financial conditions. Even after the rate adjustments expected next year, monetary policy will be shy of neutral and nowhere near restrictive.

Interest sensitive sectors of the economy are not likely to be severely constrained by the expected increase in interest rates. Outlays for consumer durable goods are likely to soften, as this sector already was primed to decelerate because of active spending during much of 2020 and 2021. However, even in the durable area, the retreat is not likely to be pronounced, as pent up demand for motor vehicles is likely to be strong because of the limited number of cars and trucks available at this time.

The situation in housing is similar. Higher interest rates will squeeze some borrowers from the market, but a tight inventory in the past two years has frustrated many potential buyers. Some will remain active, hoping to make a purchase while mortgage rates are still low by historical standards. In fact, as sometimes is the case in housing, the initial move upward in rates could stir activity, as fence sitters intensify their efforts in order to beat further interest rate increases.

We do not anticipate a marked negative response from business fixed investment. Spending in this area typically is driven more by sales and profit prospects than by interest rates. Also, structural changes now underway are likely to promote new investment. Specifically, some supply-chain disruptions are likely to be remedied by shortening the chains; that is, by bringing suppliers closer to home, possibly reshoring entirely. Such reworking will require new investment. A large backlog of orders for capital equipment also bodes well for investment spending.

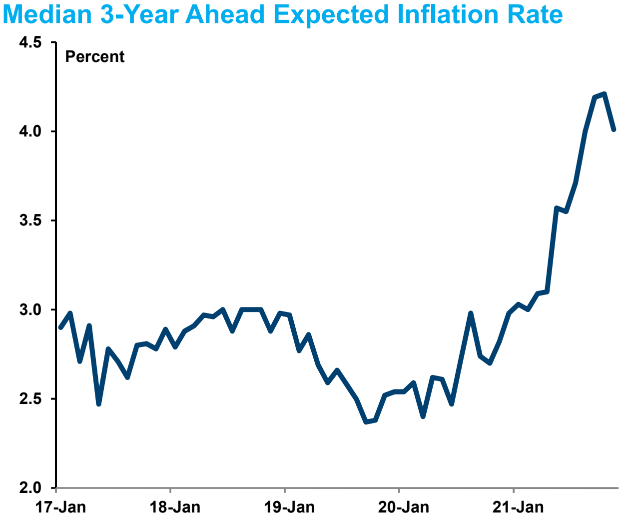
Inflation

Inflation most likely will ease next year. We fully embrace the view that temporary factors have played a role in boosting inflation this year, and many of these pressures will fade. Hotel fees, for example, surged early this year as pandemic-related discounting was reversed. This adjustment is largely behind us, and other similar pressure points are likely to fade as well. At the same time, the strong fiscal stimulus provided by Congress and the highly accommodative stance of the Federal Reserve have probably lifted the underlying inflation rate. In our view, this shift in the underlying rate will keep inflation above three percent next year and in the upper two-percent area in 2023 (table, p. 4).

The current situation, in a sense, reminds us of the experience of double-digit inflation in the 1970s. At that time, a series of shocks, such as oil embargos and crop failures, seemed to be the proximate cause of inflation. However, more than random shocks were at work. Excessive government spending associated with the Vietnam War and an accommodative stance of the Fed were playing roles. Fed officials focused on the pressure from oil and food shocks and saw a limited ability to control these prices. Inflation expectations increased as the price pressure persisted and things got out of hand.

Chair Powell's comments in his recent press briefing suggested a similar view. He saw inflation as largely driven by pandemic-related developments -- today's counterpart to the oil

Median 3-Year Ahead Expected Inflation Rate



Source: Survey of Consumer Expectations, Federal Reserve Bank of New York via Haver Analytics and food shocks of the 1970s. Similarly, he does not see the Fed and Congress as playing important roles, as he argued that the current inflation rate was not driven by tight labor markets and wage developments.

Chair Powell also has argued that inflation expectations are reasonably well anchored, but we see hints of shifts on this front. Several measures of near-term and intermediate-term expectations have shifted (the New York Fed's measure of expectations over the next three years has surged, chart, prior page). In addition, we were struck by recent labor union developments that suggest shifting expectations. Workers at John Deere were successful in having an automatic cost of living adjustment built into their latest contract, and workers at a Starbucks in Buffalo, NY approved the formation of a union. Starbucks workers at some locations in Massachusetts have started procedures to form a union. We doubt that such developments would be emerging if inflation were not an issue.

Fortunately, although Chair Powell does not see heavy stimulus as a major factor behind the pickup in inflation this year, he recognizes that pressures are broadening and he apparently sees a need to provide resistance. We are concerned about a potentially timid response from the Fed, but we are encouraged that the Fed will soon start the process of removing accommodation.

U.S. Economic Outlook*

(Percent change annual rate, unless otherwise noted)

		2021	2022				2023			
Item		**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
1	Gross Domestic Product	6.8	4.2	3.9	3.5	3.2	2.7	2.5	2.5	2.4
2	Personal Consumption Expenditures	5.5	3.5	3.1	2.8	2.6	2.3	2.0	2.0	1.8
3	Business Fixed Investment	3.2	4.1	4.3	4.2	4.3	3.9	3.9	3.7	3.7
4	Residential Construction	1.0	2.0	3.5	2.8	1.5	1.5	1.3	1.1	1.0
5	Change in Business Inventories *(Contribution to growth)*	1.5	0.5	0.3	0.1	0.0	-0.1	-0.1	0.0	0.0
6	Government Spending	3.0	5.0	4.9	4.6	4.2	3.7	3.4	3.1	3.1
7	Net Exports *(Contribution to growth)*	0.5	-0.3	-0.1	0.0	0.0	0.1	0.1	0.0	0.1
	Inflation and Unemployment									
8	Core PCE Price Index *(Annual rate)*	4.3	3.7	3.7	3.2	3.0	2.9	2.7	2.6	2.6
9	Unemployment Rate	4.3	4.0	3.8	3.7	3.6	3.5	3.4	3.3	3.3
	Interest Rates (End of Period)									
10	Federal Funds Target (midpoint)	0.13	0.13	0.38	0.88	1.13	1.38	1.63	1.88	2.13
11	2-year Treasury	0.60	0.70	1.00	1.35	1.65	1.95	2.20	2.40	2.60
12	10-year Treasury	1.45	1.60	1.85	2.10	2.35	2.60	2.80	2.95	3.15
13	30-year Fixed-Rate Mortgages	3.10	3.10	3.40	3.65	3.95	4.20	4.45	4.70	4.90

** The readings for 2021-Q4 to 2023-Q4 are forecasts.*
Source: Daiwa Capital Markets America

Review

Week of Dec. 13, 2021	Actual	Consensus	Comments
PPI (November)	**0.8% Total, 0.7% Ex. Food & Energy**	**0.5% Total, 0.4% Ex. Food & Energy**	Energy prices at the producer level jumped 2.6% in November, leaving a surge of 37% in the first 11 months of 2021. Food prices also rose briskly in November (1.2%), with the cumulative change in 2021 thus far totaling 13.3%. The increase of 0.7% in prices excluding food and energy left a year-to-date increase of 7.6%.
Retail Sales (November)	**0.3% Total, 0.3% Ex. Autos**	**0.8% Total, 0.9% Ex. Autos**	Retail sales rose only modestly in November, and a good portion of the reported increase was driven by higher prices (most evident in in the gasoline and food components, up 1.7% and 1.3%, respectively). Total sales most likely fell in real terms. Although the overall tone was soft, the slow results could well represent a natural pause after three months of brisk growth rather than a sign of flagging support from consumers. Solid gains in a few areas offered some encouragement (sporting goods stores, building supply stores, restaurants).
Housing Starts (November)	**1.679 Million (+11.8%)**	**1.567 Million (+3.1%)**	The sharp gain in housing starts in November offset much of the slide that occurred in the summer and early fall and returned total activity to the upper portion of the range from the current expansion (and above the pre-pandemic levels in early 2020). Activity in the single-family area rose 11.3% from upward revised levels in the prior two months, with the changes pushing starts back into the firm range seen in the closing months of last year. Multi-family starts added to their strong performance this year, increasing 12.9%. The latest jump was strong enough to push multi-family starts to the highest level of the current expansion.
Industrial Production (November)	**0.5%**	**0.6%**	The manufacturing component of industrial production rose briskly in November (up 0.7%). Manufacturing activity has been drifting higher throughout the year, with the changes pushing the index above pre-pandemic levels and to the firmest showing since late 2018, which represented the strongest period in the prior expansion. Mining activity also performed well in November (+0.7%). The mining component of IP has increased in most months of the current expansion, but it has regained only 65% of the ground lost during the recession. Utility output fell 0.8%, but changes in this sector are nearly always driven by temperature swings rather than economic fundamentals.

Sources: Bureau of Labor Statistics (PPI); U.S. Census Bureau (Retail Sales, Housing Starts); Federal Reserve Board (Industrial Production); Consensus forecasts are from Bloomberg

Preview

Week of Dec. 20, 2021	Projected	Comments
Leading Indicators (November) (Monday)	**1.0%**	A strong positive contribution from initial claims for unemployment insurance, along with good support from stock prices, the slope of the yield curve, the ISM new orders index, and building permits should lead to the 18th increase in the leading indicator index in the past 19 months (no change in the other month).
Current Account (2021-Q3) (Tuesday)	**-$205.0 Billion ($14.7 Billion Wider Deficit)**	Available data suggest that net income flows were a net positive for the U.S. in Q3, but marked slippage in the trade balance is likely to dominate and lead to noticeable widening in the current account deficit.
Revised GDP (2021-Q3) (Wednesday)	**2.1% (Unrevised)**	Modest revisions to key indicators suggest that the final estimate of GDP growth for Q3 will be close to the prevailing tally of 2.1%.
Consumer Confidence (December) (Wednesday)	**111.0 (+1.5 Index Pts.)**	The latest inflation news was troubling, and the emergence of the Omicron variant of Covid-19 probably unnerved some, but a firm labor market and a rebound in the stock market from the November low could provide an offset.
Existing Home Sales (November) (Wednesday)	**6.40 Million (+0.9%)**	A pickup in pending home sales in October suggests that sales of existing homes could register their third consecutive increase in November, although the expected level of activity remains below the readings in late 2020 and the start of this year.
Personal Income, Consumption, Core Price Index (November) (Thursday)	**0.3%, 0.6%, 0.4%**	Diminishing transfer payments are likely to constrain income again (6th time in the past 8 months), but moderate growth in wages and investment income should easily offset the drag. On the spending side, a pickup in vehicle sales should stir the durable component of spending, and outlays for services should continue to revive. Slow retail sales suggest light spending on nondurable goods. All price indicators point to another hefty increase in the price indexes for personal consumption expenditures.
Durable Goods Orders (November) (Thursday)	**1.5%**	With the manufacturing sector performing well, most industries are likely to post respectable order flows. In addition, a pickup in bookings at Boeing suggests a potential jump in orders for commercial aircraft.
New Home Sales (November) (Thursday)	**0.760 Million (+2.0%)**	Recent increases in buyer traffic and builder sentiment suggest that the pace of new home sales has picked up. The expected increase, if realized, would mark the fifth consecutive gain after easing from the cyclical high in November of last year.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

December 2021 / January 2022

Monday 13

Tuesday 14

NFIB SMALL BUSINESS OPTIMISM INDEX

Sept	99.1
Oct	98.2
Nov	98.4

PPI

	Final Demand	Ex. Food & Energy
Sept	0.6%	0.4%
Oct	0.6%	0.4%
Nov	0.8%	0.7%

FOMC MEETING

Wednesday 15

RETAIL SALES

	Total	Ex.Autos
Sept	0.7%	0.6%
Oct	1.8%	1.8%
Nov	0.3%	0.3%

IMPORT/EXPORT PRICES

	Ex. Petrol. Imports	Nonagri. Exports
Sept	0.2%	0.5%
Oct	0.6%	1.7%
Nov	0.7%	1.0%

EMPIRE MFG

Oct	19.8
Nov	30.9
Dec	31.9

BUSINESS INVENTORIES

	Inventories	Sales
Aug	0.8%	0.1%
Sept	0.8%	1.2%
Oct	1.2%	2.1%

NAHB HOUSING INDEX

Oct	80
Nov	83
Dec	84

FOMC DECISION

TIC DATA

	Total	Net L-T
Aug	$91.1B	$79.3B
Sept	-$27.3B	$26.7B
Oct	$143.0B	$7.1B

Thursday 16

UNEMPLOYMENT CLAIMS

	Initial	Continuing
	(Millions)	
Nov 20	0.194	1.954
Nov 27	0.227	1.999
Dec 04	0.188	1.845
Dec 11	0.206	N/A

HOUSING STARTS

Sept	1.550 million
Oct	1.502 million
Nov	1.679 million

PHILADELPHIA FED MFG BUSINESS OUTLOOK

Oct	23.8
Nov	39.0
Dec	15.4

IP & CAP-U

	IP	Cap.Util.
Sept	-1.0%	75.3%
Oct	1.7%	76.5%
Nov	0.5%	76.8%

Friday 17

Monday 20

LEADING INDICATORS (10:00)

Sept	0.1%
Oct	0.9%
Nov	**1.0%**

Tuesday 21

CURRENT ACCOUNT (8:30)

21-Q1	-$189.4 bill.
21-Q2	-$190.3 bill.
21-Q3	**-$205.0 bill.**

Wednesday 22

CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)

	Monthly	3-Mo. Avg.
Sept	-0.18	0.22
Oct	0.76	0.21
Nov	--	--

REVISED GDP (8:30)

	GDP	Chained Price
21-Q2	6.7%	6.1%
21-Q3(p)	2.1%	5.9%
31-Q3(r)	**2.1%**	**5.9%**

CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)

Oct	111.6
Nov	109.5
Dec	**111.0**

EXISTING HOME SALES (10:00)

Sept	6.29 million
Oct	6.34 million
Nov	**6.40 million**

Thursday 23

INITIAL CLAIMS (8:30)

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)

	Inc.	Cons.	Core
Sept	-1.0%	0.6%	0.2%
Oct	0.5%	1.3%	0.4%
Nov	**0.3%**	**0.6%**	**0.4%**

DURABLE GOODS ORDERS (8:30)

Sept	-0.4%
Oct	-0.4%
Nov	**1.5%**

NEW HOME SALES (10:00)

Sept	0.742 million
Oct	0.745 million
Nov	**0.760 million**

REVISED CONSUMER SENTIMENT (10:00)

Oct	71.7
Nov	67.4
Dec(p)	70.4

Friday 24

CHRISTMAS DAY (OBSERVED)

Monday 27

Tuesday 28

FHFA HOME PRICE INDEX

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX

Wednesday 29

U.S. INTERNATIONAL TRADE IN GOODS

ADVANCE INVENTORIES

PENDING HOME SALES

Thursday 30

INITIAL CLAIMS

MNI CHICAGO BUSINESS BAROMETER INDEX

Friday 31

Monday 3

CONSTRUCTION SPEND.

Tuesday 4

ISM MFG INDEX

JOB OPENINGS & LABOR TURNOVER SURVEY

VEHICLE SALES

Wednesday 5

ADP EMPLOYMENT REPORT

FOMC MINUTES

Thursday 6

INITIAL CLAIMS

TRADE BALANCE

ISM SERVICES INDEX

FACTORY ORDERS

Friday 7

EMPLOYMENT REPORT

CONSUMER CREDIT

Forecasts in Bold. (p) = preliminary (2nd estimate of GDP); (r) = revised (3rd estimate of GDP)

Treasury Financing

December 2021 / January 2022

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
AUCTION RESULTS: Rate Cover 13-week bills 0.055% 2.78 26-week bills 0.130% 3.19	**ANNOUNCE:** $30 billion 4-week bills for auction on December 16 $25 billion 8-week bills for auction on December 16 $35 billion 17-week CMBs for auction on December 15 **SETTLE:** $10 billion 4-week bills $25 billion 8-week bills $35 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 0.090% 2.96 **SETTLE:** $54 billion 3-year notes $36 billion 10-year notes $22 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 4-week bills 0.030% 3.06 8-week bills 0.050% 3.10 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on Dec. 20 $20 billion 20-year bonds for auction on December 21 $17 billion 5-year TIPS for auction on December 22 $60 billion 23-day CMBs for auction on December 17 $60 billion 78-day CMBs for auction on December 20 **SETTLE:** $108 billion 13-,26-week bills	**AUCTION RESULTS:** Rate Cover 23-day CMB 0.050% 2.71
20	21	22	23	24
AUCTION: $111 billion 13-,26-week bills $60 billion 78-day CMBs	**AUCTION:** $20 billion 20-year bonds **ANNOUNCE:** $30 billion* 4-week bills for auction on December 23 $25 billion* 8-week bills for auction on December 23 $35 billion* 17-week CMBs for auction on December 22 **SETTLE:** $30 billion 4-week bills $25 billion 8-week bills $35 billion 17-week CMBs $60 billion 23-day CMBs	**AUCTION:** $17 billion 5-year TIPS $35 billion* 17-week CMBs **SETTLE:** $60 billion 78-day CMBs	**AUCTION:** $30 billion* 4-week bills $25 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Dec. 27 $34 billion* 52-week bills for auction on December 28 $24 billion* 2-year FRNs for auction on December 29 $56 billion* 2-year notes for auction on December 27 $57 billion* 5-year notes for auction on December 28 $56 billion* 7-year notes for auction on December 29 **SETTLE:** $111 billion 13-,26-week bills	***CHRISTMAS DAY (OBSERVED)***
27	28	29	30	31
AUCTION: $111 billion* 13-,26-week bills $56 billion* 2-year notes	**AUCTION:** $34 billion* 52-week bills $57 billion* 5-year notes **ANNOUNCE:** $30 billion* 4-week bills for auction on December 30 $25 billion* 8-week bills for auction on December 30 $35 billion* 17-week CMBs for auction on December 29 **SETTLE:** $30 billion* 4-week bills $25 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $24 billion* 2-year FRNs $56 billion* 7-year notes $35 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $25 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on January 3 **SETTLE:** $111 billion* 13-,26-week bills $34 billion* 52-week bills	**SETTLE:** $20 billion 20-year bonds $17 billion 5-year TIPS $24 billion* 2-year FRNs $56 billion* 2-year notes $57 billion* 5-year notes $56 billion* 7-year notes
3	4	5	6	7
AUCTION: $111 billion* 13-,26-week bills	**ANNOUNCE:** $30 billion* 4-week bills for auction on January 6 $25 billion* 8-week bills for auction on January 6 $35 billion* 17-week CMBs for auction on January 5 **SETTLE:** $30 billion* 4-week bills $25 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $35 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $25 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Jan. 10 $52 billion* 3-year notes for auction on January 11 $36 billion* 10-year notes for auction on January 12 $22 billion* 30-year bonds for auction on January 13 **SETTLE:** $111 billion* 13-,26-week bills	

*Estimate