Daiwa Capital Markets

U.S. Economic Comment

- The labor market: household versus establishment surveys
- Fed view of the labor market: effectively at maximum employment
- Quantitative tightening to begin soon after interest rate liftoff

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Job Growth: Strong or Sluggish?

The monthly labor market report contains two measures of employment, one based on a survey of business establishments and the other based on a survey of households. The survey of business establishments is the one that generates the monthly change in nonfarm payrolls that captures the attention of market participants. The employment figure from the household survey typically is not scrutinized by investors and traders, but the measure is valuable because it is used in the calculation of the unemployment rate (the number of unemployed is equal to the labor force less employment from the household survey).

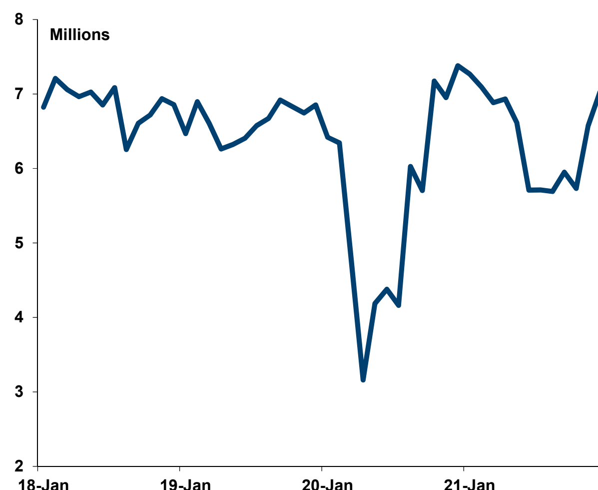
The surveys for November and December have shown radically different pictures of the labor market. The survey of establishments has shown sluggish job growth (an average of 224,000 in the past two months versus 600,000 in the first 10 months of the year). The household survey, in contrast, suggests vigorous activity (an average of 870,500 in November and December versus 435,000 from January through October).

One wonders if the closely followed establishment survey is undercounting job growth, but we view the figures from the household survey as the aberration. This series often moves erratically, and we suspect that the recent spurt is an offset to lagging results earlier this year.

The chart below shows the difference between the levels of employment (not the monthly change) in the two surveys. The household measure is larger, as it includes agricultural workers, self-employed individuals, and unpaid family workers, with the difference typically in a range of 6.5 to 7.0 million. From June through October this year, the differential fell below six million as the household survey posted low-side results. Now, above-average gains have emerged to bring the household measure back to its normal relationship with the establishment figures.

The movement in the household series, in our view, is nothing more than statistical noise. The sample in the household series is small (60,000 households versus almost 700,000 worksites in the establishment survey). In addition, the household sample is constantly changing, and a small shifting sample will naturally generate a large dose of random volatility. The statistical noise will cause the employment figure from the household survey to lag the establishment figure in some instances and to exceed it at other times. It can deviate from the normal underlying relationship in the short run, but it will gravitate to the norm in the long run, as it has in the past several months.

Employment Differential*



** Total employment measured by the household survey less employment measured by the establishment survey.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

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The employment figures from the household survey often move erratically, but the noise does not necessarily affect the unemployment rate. The size of the labor force, the other key figure in the calculation of unemployment, also is collected in the household survey, and this figure also shows random movement. The random changes in both figures tend to cancel, leaving an unemployment rate with little statistical noise.

The unemployment rate has tumbled this year, including a combined drop of 0.7 percentage point in November and December. Such a pronounced change might stir thoughts of statistical noise, but we view the improvement as more fundamental than random. Certainly, special factors were at work, but these influences are best viewed as fundamental in nature.

Specifically, the pandemic has played a key role in restraining the labor force, which has helped to push the unemployment rate lower. The virus has forced some individuals with caregiving responsibilities to drop out of the labor force, and it has led many to retire early. In addition, the heavy fiscal support provided by the federal government has provided flexibility for individuals to pursue other activities, at least for a time. These changes reflect individuals reacting to economic (or nature's) forces, not random shifts.

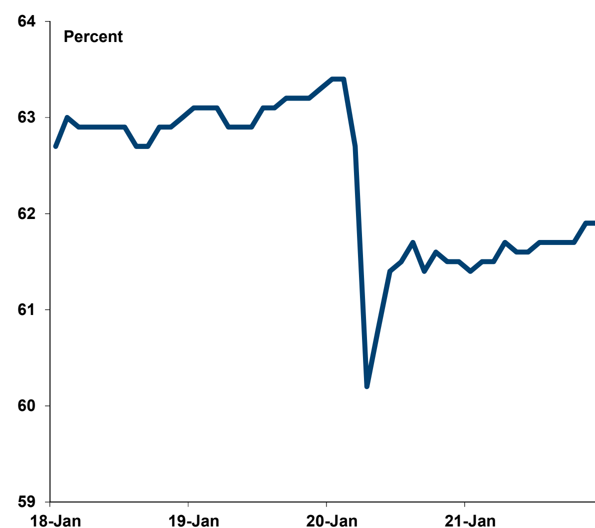
The Fed: No More Hurdles for Interest Rate Liftoff

The forward guidance provided by the Federal Open Market Committee indicates that officials will not raise their target interest rate until inflation has picked up and the economy has achieved maximum employment. Inflation certainly has picked up, and Chair Powell has acknowledged that the inflation criterion for liftoff has been met. Moreover, minutes from the December FOMC meeting suggest that the goal of maximum employment is no longer an effective barrier to policy tightening.

The minutes noted that "several" Fed officials believe that the economy has already reached maximum employment, and "many" feel that the economy is fast approaching this goal. Some Fed officials might hesitate to conclude that maximum employment has been achieved because payrolls are still 3.6 million shy of the pre-pandemic total and the jobless rate is still 0.4 percentage point above the previous low. However, we suspect that these dovish policymakers will be easily convinced to join in approving an interest rate increase. We were struck by a passage in the minutes from the December meeting indicating that even officials who wanted to proceed cautiously with policy normalization felt that "the Committee should convey a strong commitment to address elevated inflation pressures." It seems as though resistance will not be forceful.

In addition, the Fed officials who believe that maximum employment has been achieved can offer strong arguments in favor of their view. Importantly, as noted in the long-run strategy statement of the FOMC (and mentioned at the December meeting), maximum employment is a concept that will change over time. The combination of demographics (an aging workforce) and the pandemic could well have lowered the threshold of maximum employment in this instance. The widely noted difficulty in finding workers and the recent brisk increase in wages support this view. In addition, Fed officials seem to have abandoned hope that individuals will return to the labor force and ease the current degree of tightness. As noted in the December minutes: "A number of participants judged that a substantial improvement in labor force participation would

Labor Force Participation Rate



Source: Bureau of Labor Statistics via Haver Analytics

take longer than previously expected. A few others assessed that any further improvement in labor force participation would be quite modest.” (See the chart on labor force participation.)

Even if some officials believe that the employment objective has not been met, they may concede to a near-term interest rate increase. As noted in the minutes from the December meeting: “there could be circumstances in which it would be appropriate for the Committee to raise the target range for the federal funds rate before maximum employment had been fully achieved”. Brisk inflation represents such a condition, and we have that.

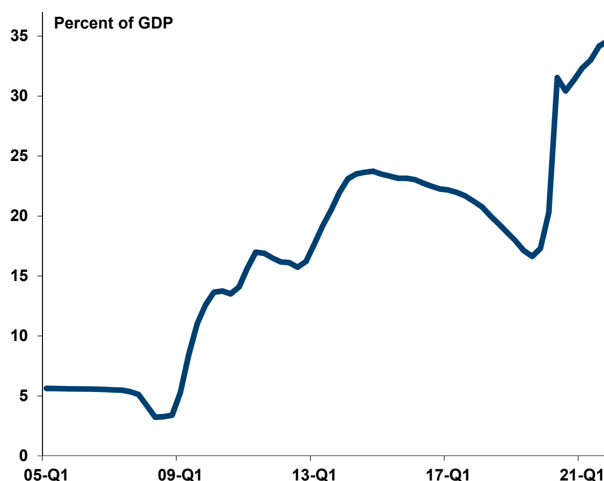
Quantitative Tightening Also on the Horizon

At the December FOMC meeting, the staff of the Fed’s Board of Governors presented several briefings on reversing the Committee’s asset purchase program, and officials discussed the issue extensively. Policymakers did not make any decisions on the timing of the reversal, the pace of change, or the method of adjustment (selling securities or merely redeeming maturing issues). However, they seemed receptive to the idea of “quantitative tightening” (a market term, not a Fed term).

The case for QT seems strong, as the Fed’s portfolio has surged far beyond previous levels. Measured as a share of GDP (a perspective mentioned in the minutes of the December FOMC meeting), the current level of 34.5 percent is notably larger than the peak of 23.7 percent in the aftermath of the financial crisis (chart, left). In addition, a surge in the past year in the amount of reverse repurchase agreements arranged by the Fed’s counter parties indicates that the market is awash in liquidity (chart, right).

(A reverse RP is a transaction that drains reserves from the banking system. The transactions are initiated by the Fed’s counterparties, and the hefty volume indicates that the market has more reserves than needed or wanted. That is, the Fed has provided too much liquidity. Interestingly, this facility was used only sparingly before last spring. The limited usage was because the Treasury Department had flooded the market with Treasury bills to build a precautionary balance during the period of heavy fiscal support, and the supply of bills absorbed the excessive amount of reserves provided by the Fed. When the Treasury’s cash balance returned to normal, the supply of bills shrank and market participants needed a new outlet to dump excess liquidity, and they turned to the Fed’s reverse RP facility.)

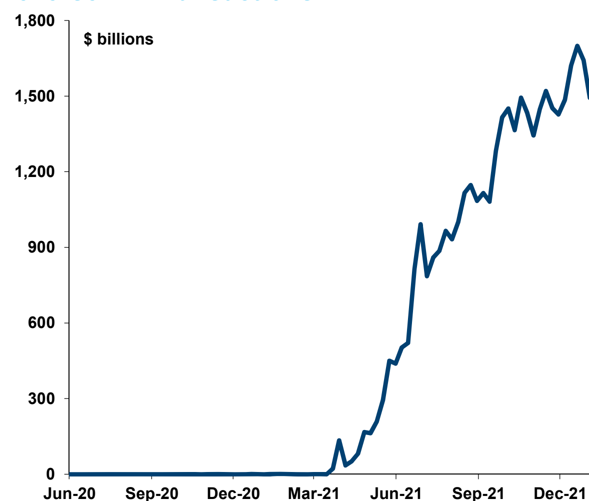
The Fed’s Securities Portfolio*



** The Federal Reserve’s securities portfolio as a share of nominal GDP. The portfolio includes: U.S. Treasury securities, federal agency securities, and agency mortgage-backed securities. The observation for 2021-Q4 includes Daiwa’s estimate of nominal GDP.*

Sources: Bureau of Economic Analysis and Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Reverse RP Transactions*



** Weekly end-of-period data as of Wednesday. Excludes transactions with foreign official institutions.*

Source: Federal Reserve Board via Haver Analytics

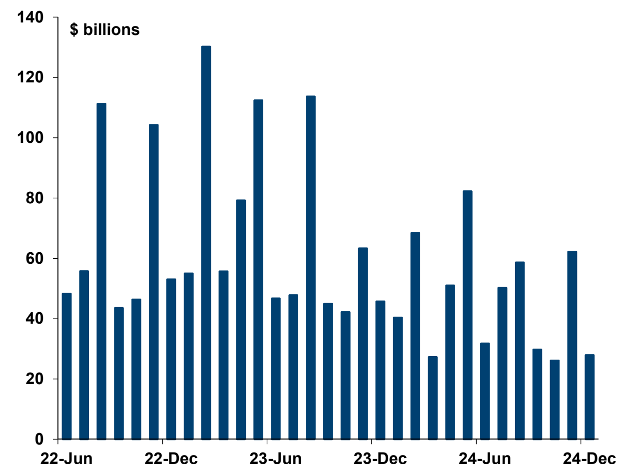
It is not clear how much trimming the Fed might do. Without question, the share will remain well above that in place before the financial crisis, as the Fed has shifted operating strategies and is now using an "abundant reserve" mechanism. However, we suspect that officials will want the share to be less than the peak in the aftermath of the financial crisis, perhaps seeking a share in the range of 15 to 20 percent of GDP, about half the share currently held.

Some of this reduction will occur because of an increase in GDP; that is, the reserve needs of the economy will catch up with the amount provided by the Fed. Still, the Fed will need to do sizeable trimming. If it wishes to reduce its portfolio share to 20 percent of GDP by the end of 2023, it would need to reduce its portfolio by approximately $3.0 trillion, moving to slightly more than $5.0 trillion from current holdings of $8.3 trillion.

Such a reduction represents a hefty task, as the Fed is currently holding only $1.6 trillion of securities that mature between now and the end of 2023. The redemption of repayments on mortgage-backed securities could help with portfolio trimming, but the Fed would still need to sell securities to reach 20 percent of GDP by the end of 2023.

We do not expect such an objective. We suspect the Fed will rely on redemptions only and stay away from outright sales. Thus, we look for the Fed to extend the process over several years. The volume of maturing securities held by the Fed seldom exceeds $40 billion per month (chart), and thus we look for the Fed to be content with redemptions of $30 to $40 billion per month, likely supplemented by redemptions of MBS repayments.

The Fed's Portfolio: Maturing Securities By Month*



** Securities held in the Fed's portfolio as of January 5, 2022. Securities include nominal Treasury notes and bonds, Treasury inflation-protected securities (TIPS), and floating-rate notes.*

Source: Federal Reserve Bank of New York

Review

Week of Jan. 3, 2022	Actual	Consensus	Comments
Construction Spending (November)	**0.4%**	**0.6%**	Private residential building (0.9%) continued on its upward trend in November, leading the advance in total construction activity. Private non-residential construction (0.1%) rose for the fifth consecutive month, although the increases have been only moderate and activity remained well below pre-Covid levels. Public construction dipped (-0.1%), but strong gains in the prior four months hinted at a revival after activity fell from the spring of 2020 thru the first half of 2021.
ISM Manufacturing Index (December)	**58.7% (-2.4 Pct. Pts.)**	**60.0% (-1.1 Pct. Pts.)**	The supplier delivery component led the retreat in the ISM manufacturing index in December, as it fell 7.3 percentage points to 64.9%. This drop should be viewed as a positive development for the economy, as it signaled progress in resolving supply chain disruptions. The new orders and production indexes also eased (off 1.1 and 2.3 percentage points, respectively), but readings of 60.4% for new orders and 59.2% for production were strong by historical standards. The employment component, in contrast, rose 0.9 percentage point to 54.2%, marking the fourth consecutive increase from a sub-50 reading in August.
Trade Balance (November)	**-$80.2 Billion ($13.0 Billion Wider Deficit)**	**-$81.0 Billion ($13.9 Billion Wider Deficit)**	The sharp widening in the trade deficit in November reflected a jump of 4.6% in imports that dwarfed a pickup of 0.2% in exports. The shift reversed the surprising improvement in October and pushed the deficit close to the sizeable shortfall in Q3. In addition, price-adjusted results on goods trade suggest slippage in real terms and therefore a negative contribution from net exports to GDP growth in the final months of the year. However, the data in hand suggest that the drag would be much less than the average of -1.6 percentage points in the prior five quarters.
ISM Services Index (December)	**62.0% (-7.1 Pct. Pts.)**	**67.0% (-2.1 Pct. Pts.)**	The ISM services index tumbled in December, but the drop occurred from a record reading in November and the new tally remained elevated relative to historical standards. The supplier delivery index posted the sharpest change, dropping 11.8 percentage points to 63.9%, but the drop signaled an easing in supply chain congestion rather than a deterioration in underlying conditions. The new orders and business activity components also fell noticeably (off 8.2 and 7.0 percentage points respectively to 61.5% and 67.6%), but the declines occurred from record levels in November and the new readings remained consistent with firm activity. The employment component fell only slightly, off 1.6 percentage points to a still-respectable reading of 54.9%.

Review Continued

Week of Jan. 3, 2022	Actual	Consensus	Comments
Factory Orders (November)	**1.6%**	**1.5%**	A jump of 2.6% in durable goods bookings led the advance in total factory orders in November. A portion of the increase in durable orders reflected a jump of 23.7% in the volatile aircraft category (civilian and defense combined), but durable orders ex-transportation also performed well, advancing 0.9%. Orders for nondurable goods rose 0.7%. The petroleum and coal category made a sizable contribution with an increase of 1.2%. The advance was especially impressive because petroleum-related prices started to edge lower in November, suggesting that much of the gain reflected a pickup in real terms. Orders excluding petroleum and coal also rose, increasing 0.5% and marking the 18th advance in the past 19 months.
Payroll Employment (December)	**199,000**	**450,000**	The increase in payroll employment in December was joined by upward revisions of 141,000 in the prior two months, but the figures carried a soft tone nonetheless. The latest reading was the softest gain of the year, and it trailed by a wide margin the average gain of 568,000 in the first 11 months of 2021. While the payroll figures disappointed, the unemployment rate posted a surprisingly sharp decline, falling 0.3 percentage point to 3.9%. Employment as measured by the household survey rose 651,000, a change that dwarfed the increase of 168,000 in the size of the labor force. The broad unemployment rate posted a larger decline (off 0.4 percentage point to 7.3%), reflecting a decline in the number of individuals working part-time involuntarily. The number of involuntary part-timers has now declined for four consecutive months and in eight of the past 10 months. Average hourly earnings rose 0.6% in December, a change in the upper portion of the recent range.

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

Preview

Week of Jan. 10, 2022	Projected	Comments
CPI (December) (Wednesday)	**0.4% Total, 0.4% Core**	Energy prices seem to have settled after six months of brisk increases, although they could rise after seasonal adjustment. Food prices are likely to continue moving along their recent firm path (up an average of 0.7% in the prior six months). Omicron could limit price pressure in some Covid-sensitive areas (air fares, hotel fees), but pressure from supply-chain disruptions and strong demand is likely to persist.
Federal Budget (December) (Wednesday)	**$25.0 Billion Deficit**	Available data suggest that federal revenues will register double-digit growth for the fifth consecutive month, with the latest surge possibly approaching 40% (versus an average of 23% in the prior four months). Some of the strength in revenue reflects offsets to pandemic effects (businesses now paying delayed payroll taxes and states replenishing unemployment insurance trust funds), but firm income growth also is a driving force. Outlays are still above pre-pandemic levels, but well below totals in 2020 and the early portion of 2021. The projected deficit would leave a shortfall of $381 billion in the first three months of the fiscal year, down from $573 billion in Oct-Dec 2020.
PPI (December) (Thursday)	**0.4% Total, 0.4% Ex. Food & Energy**	An easing in energy prices is likely to be countered by continued upward pressure on food prices. Excluding food and energy, prices of goods are likely to be influenced by supply-side disruptions, while prices of services are likely to add to their string of 11 consecutive increases (average pace of 0.6%).
Retail Sales (December) (Friday)	**0.2% Total, 0.4% Ex. Autos**	A strong holiday shopping season is likely to lead to firm results in several categories, but a dip in sales of new motor vehicles is likely to constrain the auto component, and lower prices could lead to weak results at gasoline service stations.
Industrial Production (December) (Friday)	**0.2%**	Employment gains suggest moderate increases in manufacturing and mining output, but warmer-than-normal temperatures probably led to a drop in utility output and a partial offset to gains in manufacturing and mining.
Consumer Sentiment (January) (Friday)	**72.0 (+1.4 Index Pts.)**	A strong labor market and record equity values should bolster consumer moods, but the spread of Omicron and elevated inflation are likely to prevent a surge. The expected reading is only marginally above the recession low of 71.8 in April 2020.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January 2022

Monday	Tuesday	Wednesday	Thursday	Friday
3	4	5	6	7
CONSTRUCTION SPEND. Sept 1.0% Oct 0.4% Nov 0.4%	**ISM MANUFACTURING INDEX** Index / Prices Oct 60.8 85.7 Nov 61.1 82.4 Dec 58.7 68.2 **JOB OPENINGS & LABOR TURNOVER SURVEY** Openings (000) / Quit Rate Sept 10,602 3.0% Oct 11,091 2.8% Nov 10,562 3.0% **VEHICLE SALES** Oct 13.1 million Nov 12.9 million Dec 12.4 million	**ADP EMPLOYMENT REPORT** Private Payrolls Oct 563,000 Nov 505,000 Dec 807,000 **FOMC MINUTES**	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Dec 11 0.205 1.856 Dec 18 0.206 1.718 Dec 25 0.200 1.754 Jan 01 0.207 N/A **TRADE BALANCE** Sept -$81.4 billion Oct -$67.2 billion Nov -$80.2 billion **ISM SERVICES INDEX** Index / Prices Oct 66.7 82.9 Nov 69.1 82.3 Dec 62.0 82.5 **FACTORY ORDERS** Sept 0.5% Oct 1.2% Nov 1.6%	**EMPLOYMENT REPORT** Payrolls / Un. Rate Oct 648,000 4.6% Nov 249,000 4.2% Dec 199,000 3.9% **CONSUMER CREDIT** Sept $26.0 billion Oct $16.0 billion Nov $40.0 billion
10	11	12	13	14
WHOLESALE TRADE (10:00) Inventories / Sales Sept 1.4% 1.7% Oct 2.5% 2.2% **Nov 1.2% 1.0%**	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** Oct 98.2 Nov 98.4 Dec --	**CPI (8:30)** Total / Core Oct 0.9% 0.6% Nov 0.8% 0.5% **Dec 0.4% 0.4%** **FEDERAL BUDGET (2:00)** 2021 / 2020 Oct -$165.1B -$284.1B Nov -$191.3B -$145.3B **Dec -$25.0B** -$143.6B **BEIGE BOOK (2:00)** **Dec 2021 Beige Book** “Economic activity grew at a modest to moderate pace in most Federal Reserve Districts during October and early November.”	**INITIAL CLAIMS (8:30)** **PPI (8:30)** Final Demand / Ex. Food & Energy Oct 0.6% 0.4% Nov 0.8% 0.7% **Dec 0.4% 0.4%**	**RETAIL SALES (8:30)** Total / Ex.Autos Oct 1.8% 1.8% Nov 0.3% 0.3% **Dec 0.2% 0.4%** **IMPORT/EXPORT PRICES (8:30)** Non-petrol Imports / Nonagri. Exports Oct 0.6% 1.7% Nov 0.7% 1.0% Dec -- -- **IP & CAP-U (9:15)** IP / Cap.Util. Oct 1.7% 76.5% Nov 0.5% 76.8% **Dec 0.2% 76.9%** **CONSUMER SENTIMENT (10:00)** Nov 67.4 Dec 70.6 **Jan 72.0** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Sept 0.8% 1.2% Oct 1.3% 2.1% **Nov 1.3% 0.6%**
17	18	19	20	21
MARTIN LUTHER KING JR DAY	**EMPIRE MFG INDEX** **NAHB HOUSING INDEX** **TIC DATA**	**HOUSING STARTS**	**INITIAL CLAIMS** **PHILY FED BUSINESS OUTLOOK SURVEY** **EXISTING HOME SALES**	**LEADING INDICATORS**
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **CONSUMER CONFIDENCE** **FOMC MEETING**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **NEW HOME SALES** **FOMC DECISION**	**INITIAL CLAIMS** **GDP** **DURABLE GOODS ORDERS** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, PRICE INDEXES** **EMPLOYMENT COST INDEX** **REVISED CONSUMER SENTIMENT**

Forecasts in Bold.

Treasury Financing

January 2022

Monday	Tuesday	Wednesday	Thursday	Friday
3	4	5	6	7
AUCTION RESULTS: Rate Cover 13-week bills 0.090% 2.86 26-week bills 0.220% 3.21	**ANNOUNCE:** $50 billion 4-week bills for auction on January 6 $40 billion 8-week bills for auction on January 6 $40 billion 17-week CMBs for auction on January 5 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills $40 billion 17-week CMBs	**AUCTION RESULTS:** Rate Cover 17-week CMB 0.150% 3.06	**AUCTION RESULTS:** Rate Cover 4-week bills 0.050% 3.53 8-week bills 0.055% 3.24 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on January 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	
10	11	12	13	14
AUCTION: $111 billion 13-,26-week bills	**AUCTION:** $52 billion 3-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on January 13 $40 billion* 8-week bills for auction on January 13 $40 billion* 17-week CMBs for auction on January 12 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills $40 billion 17-week CMBs	**AUCTION:** $36 billion 10-year notes $40 billion* 17-week CMBs	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $22 billion 30-year bonds **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Jan. 18 $20 billion* 20-year bonds for auction on January 19 $16 billion* 10-year TIPS for auction on January 20 **SETTLE:** $111 billion 13-,26-week bills	
17	18	19	20	21
MARTIN LUTHER KING JR DAY	**AUCTION:** $111 billion* 13-,26-week bills **ANNOUNCE:** $50 billion* 4-week bills for auction on January 20 $40 billion* 8-week bills for auction on January 20 $40 billion* 17-week CMBs for auction on January 19 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills $40 billion* 17-week CMBs $52 billion 3-year notes $36 billion 10-year notes $22 billion 30-year bonds	**AUCTION:** $20 billion* 20-year bonds $40 billion* 17-week CMBs	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $16 billion* 10-year TIPS **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Jan. 24 $34 billion* 52-week bills for auction on January 25 $26 billion* 2-year FRNs for auction on January 26 $54 billion* 2-year notes for auction on January 24 $55 billion* 5-year notes for auction on January 25 $53 billion* 7-year notes for auction on January 27 **SETTLE:** $111 billion* 13-,26-week bills	
24	25	26	27	28
AUCTION: $111 billion* 13-,26-week bills $54 billion* 2-year notes	**AUCTION:** $34 billion* 52-week bills $55 billion* 5-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on January 27 $40 billion* 8-week bills for auction on January 27 $40 billion* 17-week CMBs for auction on January 26 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $26 billion* 2-year FRNs $40 billion* 17-week CMBs	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $53 billion* 7-year notes **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Jan. 31 **SETTLE:** $111 billion* 13-,26-week bills $34 billion* 52-week bills	

**Estimate*