Daiwa Capital Markets

U.S. Economic Comment

- FOMC preview: setting the stage for rate hikes and QT
- GDP preview: firm in Q4, moderate in Q1

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

Monetary Policy

Although Fed officials have signaled their intention to tighten monetary policy this year, we do not expect any meaningful changes at the meeting of the Federal Open Market Committee on January 25-26. Chair Jerome Powell and others have been clear that they will not hike short-term interest rates until the asset purchase program has been completed, and that effort will not end until mid-March. The most we can expect from the policy statement and the press conference is a suggestion that the FOMC will adopt tightening measures shortly after the end of quantitative easing.

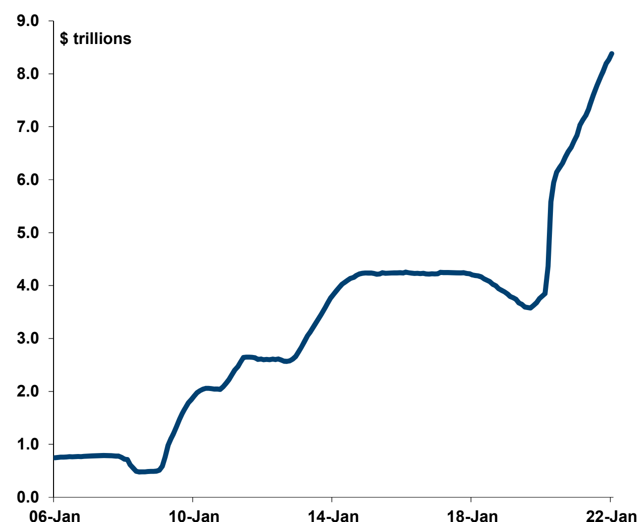
The policy statement and Chair Powell's prepared remarks at the press conference are not likely to be deeply revealing, but reporters in the Q&A session will probably press for details on interest rates. One question likely to arise involves the potential for an aggressive initial move by the FOMC, as some observers have speculated that rapid inflation might lead the Fed to start the tightening process with a 50 basis point move.

We would not dismiss the possibility of a bold move, but we would be surprised by anything other than a 25 basis point shift. Although Fed officials see a need to adjust policy, they apparently do not see an urgency to move. The FOMC's preference for a gradual adjustment is evident in its approach to ending the asset purchase program. The case for tighter policy is strong (a tight labor market and rapid inflation), yet the Fed is still purchasing securities in the market; that is, officials are adding stimulus. The pace of new support is slowing, but the Fed is still on the accommodative side.

With the interest rate intentions of the FOMC reasonably clear, market participants will probably start to speculate about the next component of policy normalization: quantitative tightening (QT), or reducing the size of the Fed's portfolio of securities, which currently stands at $8.38 trillion (chart, $5.69 trillion of Treasuries and $2.69 trillion of agency and mortgage-backed securities). The Committee opened discussion of this issue at its December meeting, and we suspect it will dive deeper on January 25-26. We are not expecting conclusions on quantitative tightening, but we are hopeful for some hints on timing and pace.

The minutes from the December meeting contained a few germs of information. The key insight was the likelihood of a more aggressive pace of reductions than that adopted after the financial crisis. The current environment is radically different than it was in the previous tightening cycle, the minutes noted, and thus a

The Federal Reserve's Securities Portfolio*



** Securities held by the Fed include Treasuries, agency securities, and agency mortgage-backed securities. Monthly end-of-period data thru December 2021. The last observation is for the week ended Wednesday January 19, 2022.*

Source: Federal Reserve Board via Haver Analytics

This report is issued by Daiwa Securities Group Inc. through its relevant group companies. Daiwa Securities Group Inc. is the global brand name of Daiwa Securities Co. Ltd., Tokyo ("Daiwa Securities") and its subsidiaries worldwide that are authorized to do business within their respective jurisdictions. These include: Daiwa Capital Markets Hong Kong Ltd. (Hong Kong), regulated by the Hong Kong Securities and Futures Commission, Daiwa Capital Markets Europe Limited (London), regulated by the Financial Conduct Authority and a member of the London Stock Exchange, and Daiwa Capital Markets America Inc. (New York), a U.S. brokerdealer registered with the U.S. Securities and Exchange Commission, a futures commission merchant regulated by the U.S. Commodity Futures Trading Commission, and a primary dealer in U.S. government securities. The data contained in this report were taken from statistical services, reports in our possession, and from other sources believed to be reliable. The opinions and estimates expressed are our own, and we make no representation or guarantee either as to accuracy, completeness or as to the existence of other facts or interpretations that might be significant.

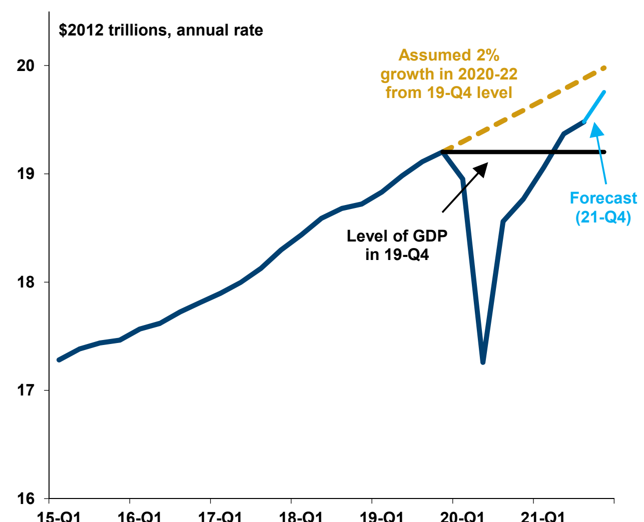
different tack is warranted. The economy is stronger, the labor market is tighter, inflation is running faster, and the portfolio is much larger than it was in the previous episode. Thus, officials seemed to favor more aggressive QT.

Both the timing and pace of QT will diverge substantially from the prior experience. The FOMC first increased interest rates after the financial crisis in December 2015, but it did not begin reducing its portfolio until almost two years later (October 2017). In addition, the pace of redemptions was slow. The Committee started the unwinding by redeeming $6 billion of Treasuries and $4 billion of mortgage-backed securities per month. Redemptions were increased by these amounts at three-month intervals until the totals reached $30 billion for Treasuries and $20 billion for MBS. We would expect the FOMC to adopt monthly caps on its redemptions in this instance, but they are likely to be far larger than those in 2017-19. We suspect something in the neighborhood of $50 billion for both Treasuries and mortgage-backed securities. Also, we suspect that redemptions will start a few months after interest rate liftoff -- certainly not two years later.

GDP: Firm in Q4; Omicron Effect in Q1

In addition to an FOMC meeting, the upcoming week will bring the first estimate of GDP for the fourth quarter. Our estimate shows growth of 5.8 percent, which would leave the expansion over the four quarters of the year at 5.4 percent. This gain would push output further above the pre-pandemic level, although it would remain 1.1 percent below the pre-Covid trend (chart). Stated in terms of compound annual growth, the usual metric for U.S. GDP, activity in Q4 would need an additional 4.6 percentage points of growth to return to the pre-pandemic trend.

GDP



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

Although 5.8 percent represents a brisk advance, many observers might be disappointed with the outcome, as much of the growth is likely to be driven by inventory investment, which might be viewed as a temporary spur to growth. Real final demand (GDP less inventory investment) is likely to grow approximately 2.5 percent, a less-than-vigorous advance. Consumer spending and residential construction are likely to be respectable, both growing at annual rates of approximately three percent, while business investment and government spending will probably advance at slower rates. We expect net exports to have an approximately neutral effect on GDP growth.

We would not downplay the strength in inventory investment. Certainly, the pace will not be maintained for an extended period, but strong activity in this area is warranted. We view the jump as a substitute for production that would have occurred earlier in the year were it not for pandemic-related disruptions. Many businesses responded to broken supply chains by drawing down inventories. Now, production is catching up, allowing businesses to replenish lean inventories. Even with the heavy accumulation in Q4, inventories are probably still shy of desired levels; rebuilding has further to go.

The rebuilding effort might pause in the first quarter, as the spread of the Omicron variant could weaken supply chains and slow production. Hints of slower activity have already started to emerge. The manufacturing component of industrial production, for example, slipped 0.3 percent in December, perhaps reflecting an early effect of Omicron. More recently, claims for unemployment insurance have stepped up, suggesting that some firms have slowed production. Further, we took note of a plunge in the Empire

Manufacturing Index (a figure from the New York Fed), which moved from a level signaling strong activity to one indicating contraction (although mild contraction). We do not put great weight on this index because it often moves erratically and because a similar measure from the Philadelphia Fed showed a pickup in January. Still, the NY Fed index suggests that downside risks have emerged.

Another measure from the New York Fed gives clearer and more reliable signals on economic activity. The so-called Weekly Economic Index is a composite measure of 10 high-frequency indicators that shows a high degree of correlation (and leading indicator properties) with GDP growth (chart). This measure has been drifting downward over the past year, a natural and non-troubling development as the economy moves toward normal activity after the burst of growth in the early stages of the expansion. However, the measure has taken a sharper step downward in the past few weeks. It doesn't signal recession, but certainly it implies slower growth.

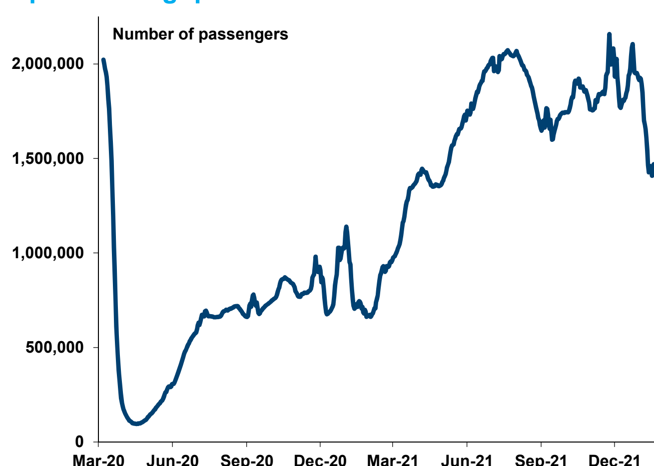
Weekly Economic Index

Source: Federal Reserve Bank of New York via Haver Analytics

The spread of the Omicron variant also poses threats because of potentially soft consumer spending generated by self-imposed lockdowns. Individual have started to restrict travel, and they are dining out less frequently. A daily measure on airport throughput (the number of individuals passing through a security checkpoint) has tumbled since early January. The measure held up well during the holidays, but has retreated more recently. Figures on restaurant reservations booked online show a similar pattern. We hesitate to conclude that total consumer spending will weaken dramatically, but individuals are avoiding activities with high-side virus risks.

Available data are suggesting restraints from Covid, but the amount of data on activity in late 2021 and early 2022 is scant. We will have a better picture as the major economic reports become available, such as employment and retail sales. We will start the quarter with an expectation that GDP will grow 2.5 percent in Q1, but we will remain flexible in our views.

Airport Throughput*



** Seven-day moving average. The last observation is for January 20, 2022.*
Source: Transportation Security Administration (TSA) via Bloomberg

Daiwa Capital Markets

Review

Week of Jan. 17, 2022	Actual	Consensus	Comments
Housing Starts (December)	**1.702 Million (+1.4%)**	**1.650 Million (-1.7%)**	The advance in housing starts in December added to a jump of 8.1% in the prior month, offsetting most of the slide that occurred in the summer and early fall and leaving starts in the upper portion of the range from the current expansion (only a shade below the high of 1.725 million in March 2021). All of the advance in housing starts in December was the result of a jump of 10.6% in the multi-family sector to 0.530 million units (annual rate), the highest level of the current expansion and close to the impressive string of observations in late 2019 and early 2020. Single-family activity, in contrast, slipped 2.3% to 1.172 million. However, the drop occurred from an elevated level and single-family starts were still comparable to firm results in late 2020 and early 2021.
Existing Home Sales (December)	**6.18 Million (-4.6%)**	**6.42 Million (-0.6%)**	The drop in sales of existing homes in December erased a good portion of the gains in the prior three months and returned activity to the middle of the range from the past 18 months. While the month-to-month decline softened the trajectory of activity into the close of 2021, the recent performance should be considered firm from a longer-term perspective. Sales in December were a touch above the average of 6.13 million for all of 2021 and these results represented the best performance since 2006, when the housing bubble started to deflate. Moreover, surprising softness in December was probably more the result of limited supply than flagging demand. The months' supply of homes available for sale slumped from 2.1 in November to 1.8 months in December, a record low and well shy of four to five months that might be considered normal.
Leading Indicators (December)	**0.8%**	**0.8%**	Positive contributions from initial claims for unemployment insurance, building permits, the slope of the yield curve, and the ISM new orders index offset a drag from consumer expectations and led to the 19th advance in the past 20 months in the index of leading economic indicators. The result for December left the level of the index 7.5% above the pre-pandemic high in January 2020.

Sources: U.S. Census Bureau (Housing Starts); National Association of Realtors (Existing Home Sales); The Conference Board (Leading Indicators); Consensus forecasts are from Bloomberg

Preview

Week of Jan. 24, 2022	Projected	Comments
Conference Board Consumer Confidence (January) (Tuesday)	**112.0 (-3.8 Index Pts.)**	A combination of the spread of the Omicron variant of Covid and a jump in prices of goods and services purchased by consumers is likely to sour moods in early 2022, a view supported by a decline in the University of Michigan sentiment gauge published mid-month.
U.S. International Trade in Goods (December) (Wednesday)	**-$96.0 Billion ($2.0 Billion Narrower Deficit)**	Shipping delays and port congestion have led to heightened volatility in the trade statistics in recent months, with the goods deficit narrowing sharply in October (led by a surge of 11.1% in exports) and then erasing all of the improvement in November (when imports jumped 5% and exports slipped 1.9%). A cooling in imports and rebound in exports in December could again lead to improvement in the goods deficit.
New Home Sales (December) (Wednesday)	**0.760 Million (+2.2%)**	Pickups in buyer traffic and mortgage applications for a home purchase suggest that new home sale could increase in back-to-back months after losing ground from April through October. The expected performance in December would trail the lofty readings in late 2020 and early 2021 (average of 908,000, annual rate, from December 2020 to March 2021), but it would match the best readings of the prior expansion.
GDP (2021-Q4) (Thursday)	**5.8%**	A large positive contribution from inventory investment is likely to drive the rebound in GDP growth in Q4, and moderate growth in consumer spending probably provided support as well. Net exports seem to have had an approximately neutral influence on growth, while business fixed investment and government expenditures probably grew modestly.
Durable Goods Orders (December) (Thursday)	**-0.5%**	Although the manufacturing sector is performing well, uncertainty surrounding the flare in Omicron could dampen activity. In addition, bookings for defense-related aircraft, a volatile area, could cool after three strong months.
Personal Income, Consumption, Core Price Index (December) (Friday)	**0.5%, -0.4%, 0.5%**	A brisk increase in average hourly earnings suggest a firm advance in wages, and recent improvement in rental and investment income should continue. On the outlay side, a decline in new vehicle sales and a drop in retail activity raise the possibility of a soft month for consumer spending. Results for the CPI suggest another high-side reading on the price index for personal consumption expenditures.
Employment Cost Index (2021-Q4) (Friday)	**1.0%**	Competition for scarce labor and concessions made to current employees in an environment of rapid inflation likely led to a sharp increase in wage and benefit costs in Q4.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January / February 2022

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
MARTIN LUTHER KING JR DAY	**EMPIRE MFG** Nov 30.9 Dec 31.9 Jan -0.7 **NAHB HOUSING INDEX** Nov 83 Dec 84 Jan 83 **TIC DATA** Total / Net L-T Sept -$6.2B $26.7B Oct $139.3B $7.1B Nov $223.9B $137.4B	**HOUSING STARTS** Oct 1.552 million Nov 1.678 million Dec 1.702 million	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Dec 25 0.200 1.753 Jan 01 0.207 1.551 Jan 08 0.231 1.635 Jan 15 0.286 N/A **PHILADELPHIA FED MFG BUSINESS OUTLOOK** Nov 39.0 Dec 15.4 Jan 23.2 **EXISTING HOME SALES** Oct 6.34 million Nov 6.48 million Dec 6.18 million	**LEADING INDICATORS** Oct 0.7% Nov 0.7% Dec 0.8%
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Oct 0.75 0.25 Nov 0.37 0.37 Dec -- --	**FHFA HOME PRICE INDEX (9:00)** Sept 0.9% Oct 1.1% Nov -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Sept 1.0% 0.8% Oct 0.9% 0.8% Nov -- -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Nov 111.9 Dec 115.8 **Jan 112.0** **FOMC MEETING**	**U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Oct -$83.1 billion Nov -$98.0 billion **Dec -$96.0 billion** **ADVANCE INVENTORIES (8:30)** Wholesale / Retail Oct 2.5% 0.3% Nov 1.4% 2.0% Dec -- -- **NEW HOME SALES (10:00)** Oct 0.662 million Nov 0.744 million **Dec 0.760 million** **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **GDP (8:30)** GDP / Chained Price 21-Q2 6.7% 6.1% 21-Q3 2.3% 6.0% **21-Q4 5.8% 6.0%** **DURABLE GOODS ORDERS (8:30)** Oct 0.1% Nov 2.6% **Dec -0.5%** **PENDING HOME SALES (10:00)** Oct 7.5% Nov -2.2% Dec --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Oct 0.5% 1.4% 0.5% Nov 0.4% 0.6% 0.5% **Dec 0.5% -0.4% 0.5%** **EMPLOYMENT COST INDEX (8:30)** Comp. / Wages 21-Q2 0.7% 0.9% 21-Q3 1.3% 1.5% **21-Q4 1.0% 1.2%** **REVISED CONSUMER SENTIMENT (10:00)** Nov 67.4 Dec 70.6 Jan (p) 68.8
31	1	2	3	4
MNI CHICAGO BUSINESS BAROMETER INDEX	**ISM MFG INDEX** **CONSTRUCTION SPEND.** **JOB OPENINGS & LABOR TURNOVER (JOLTS)** **NEW VEHICLE SALES**	**ADP EMPLOYMENT REPORT**	**INITIAL CLAIMS** **PRODUCTIVITY & COSTS** **ISM SERVICES INDEX** **FACTORY ORDERS**	**EMPLOYMENT REPORT**
7	8	9	10	11
CONSUMER CREDIT	**NFIB SMALL BUSINESS OPTIMISM INDEX** **TRADE BALACE**	**WHOLESALE TRADE**	**INITIAL CLAIMS** **CPI** **FEDERAL BUDGET**	**CONSUMER SENTIMENT**

Forecasts in Bold. *(p) = preliminary*

Treasury Financing

January / February 2022

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
MARTIN LUTHER KING JR DAY	**AUCTION RESULTS:** Rate / Cover 13-week bills 0.170% 2.56 26-week bills 0.365% 2.70 **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 RESULTS:** Rate / Cover 20-yr bonds 2.210% 2.48 17-week CMB 0.275% 3.08	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.040% 3.16 8-week bills 0.085% 2.75 10-yr TIPS -0.540% 2.30 **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	
31	1	2	3	4
AUCTION: $111 billion* 13-,26-week bills **SETTLE:** $20 billion 20-year bonds $16 billion 10-year TIPS $26 billion 2-year FRNs $54 billion 2-year notes $55 billion 5-year notes $53 billion 7-year notes	**ANNOUNCE:** $50 billion* 4-week bills for auction on February 3 $40 billion* 8-week bills for auction on February 3 $40 billion* 17-week CMBs for auction on February 2 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills $40 billion* 17-week CMBs	**AUCTION:** $40 billion* 17-week CMBs **ANNOUNCE MID-QUARTER REFUNDING:** $50 billion* 3-year notes for auction on February 8 $36 billion* 10-year notes for auction on February 9 $23 billion* 30-year bonds for auction on February 10	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Feb. 7 **SETTLE:** $111 billion* 13-,26-week bills	
7	8	9	10	11
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $50 billion* 3-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on February 10 $40 billion* 8-week bills for auction on February 10 $40 billion* 17-week CMBs for auction on February 9 **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 $23 billion* 30-year bonds **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Feb. 14 $20 billion* 20-year bonds for auction on February 16 $9 billion* 30-year TIPS for auction on February 17 **SETTLE:** $111 billion* 13-,26-week bills	

**Estimate*