Daiwa Capital Markets

U.S. Economic Comment

- FOMC: behind the curve, but ready to move aggressively
- Inflation developments: more pressure on both prices and wages
- U.S. economy: slowdown in Q1 after a brisk Q4

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Monetary Policy

A reporter at Jerome Powell's press conference asked if he felt the Fed was late in removing accommodation. The Fed Chair essentially answered no:

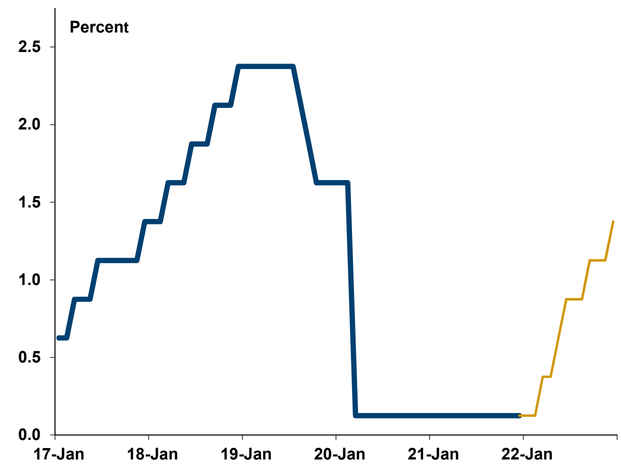
> our policy needs to be positioned to address the full range of plausible outcomes,… particularly the possibility that inflation will continue to run higher, more persistently than we'd expected. And we think we are positioned to make the changes in our policy to do that, and we're committed to doing that.

However, numerous other comments during his press conference suggested that Mr. Powell felt as though he was behind the inflation curve. He seemed to feel an urgency to tighten policy and perhaps to move aggressively. He was effusive in his description of the labor market (remarkable; very very strong), and he noted several times that the economy is much stronger than it was during the previous tightening cycle, and that difference should lead to a firmer response from the Fed. He raised the possibility of a sizeable change in interest rates ("I think there's quite a bit of room to raise interest rates without threatening the labor market"), and he raised the possibility of a restrictive stance ("the Fed [will be] moving away from a very highly accommodative policy to a substantially less accommodative policy and then, over time, to a policy that's not accommodative").

Mr. Powell's views on inflation seem to be 180 degrees away from where they were a short time ago. Most of last year, he saw price pressure as transitory; now, he sees inflation risks on the high side. He expects progress in repairing damaged supply chains, but he also expects problems to persist throughout the year. He previously believed that the published unemployment rate was understating the degree of slack in the economy because labor force dropouts would soon return to their jobs; now, he expects slow adjustment to the size of the labor force and views employment to be at its maximum level.

The pivot of Chair Powell, in our view, warrants a change in the interest rate outlook. We had been expecting four rate hikes this year, starting with a shift of 25 basis points in March and followed by similar-sized moves at every other meeting, leaving the federal funds rate 100 basis points higher at the end of the year. Now, we would look for a change of 125 basis points this year, and we would lean toward a bold move at the start of the process, either a 50 basis point increase in March or 25 basis point shifts in both March and May. Rate hikes at the next three meetings are conceivable. The Fed has several ways to signal a determined effort. The key point is to be expecting notable action from the Fed.

Federal Funds Target Rate*

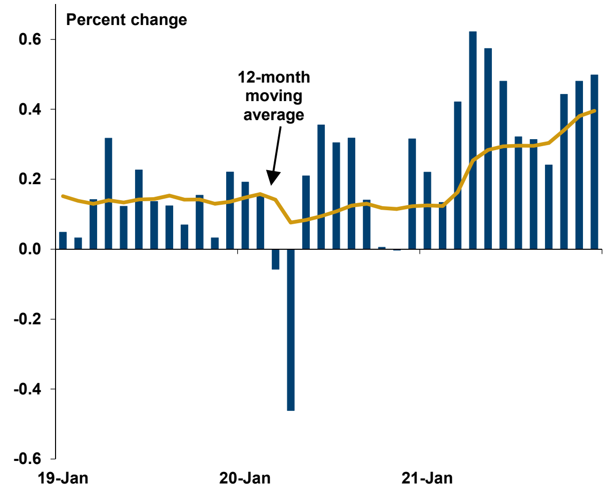


** The readings for 2022 (gold line) are forecasts.*
Sources: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Inflation: Wage-Price Interaction?

Recent news on inflation is not likely to alter the hawkish views of Chair Powell and other Fed officials. The headline price index for personal consumption expenditures (PCE) rose 0.4 percent in December, a break from increases of 0.6 percent in the prior two months. However, a dip in energy prices limited the advance, and that restraint is likely to be temporary. After softening in November and early December, prices of crude oil are marching higher again, reaching new highs for the current cycle in the past week or so.

Core PCE Price Index*

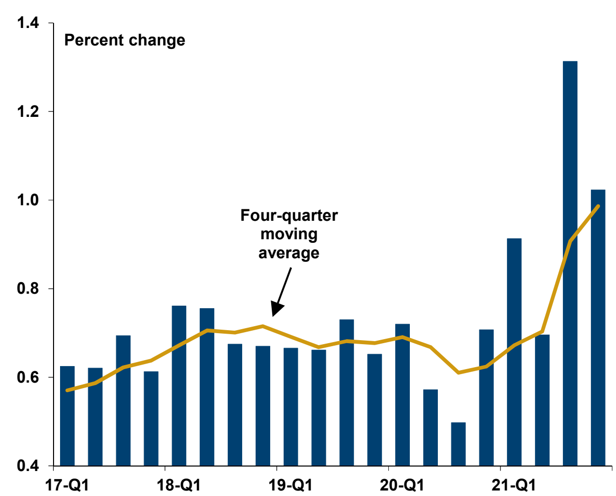


** PCE = personal consumption expenditures*
Source: Bureau of Economic Analysis via Haver Analytics

Excluding food and energy, the PCE index rose 0.5 percent in December, a touch stronger than the average in the prior nine months (chart). The latest tally left the year-over-year increase at 4.85 percent, the fastest pace since the early 1980s (although some observations in the late 1980s were close). A few items in the index showed restraint in December (televisions, alcoholic beverages, prescription drugs, physician services, tickets to sporting events), but a long list of goods and services showed noticeable increases (motor vehicles, furniture, sporting goods, jewelry, clothing, air fares, rents; in short, broad-based pressure).

Prices are rising partly to cover the hefty wage increases triggered by tight labor markets. The employment cost index, arguably the best measure of labor compensation in the U.S., rose 1.0 percent in the fourth quarter, a touch softer than the advance of 1.3 percent in Q3, but still far larger than all observations in the prior expansion and in the upper portion of the range from the past three decades (chart, below). The consecutive increases, along with the surges in consumer prices, leads one to wonder about wage-price interaction. It is probably too early to draw firm conclusions along these lines, and certainly too soon to call it a “spiral”, but recent results nevertheless have been unsettling.

Employment Cost Index



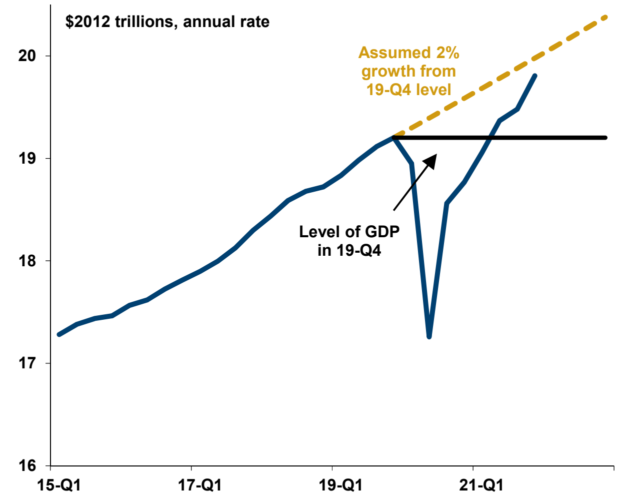
Source: Bureau of Labor Statistics via Haver Analytics

Chair Powell (correctly) focuses on wage increases relative to productivity gains. Wage growth would not be inflationary if it were accompanied by an improvement in productivity. Next week should bring a favorable reading on productivity in Q4, as available data suggest annual growth of more than five percent -- even larger than the increase in the employment cost index. However, productivity growth is highly volatile on a quarter-to-quarter basis. The likely increase in Q4, while notable, would follow a drop of 5.1 percent in the prior quarter. The advance in the past four quarters would total 1.8 percent, respectable but shy of brisk. The average increase in the past eight quarters would total 2.2 percent, better but still not overwhelming, especially for the early stages of a business expansion, when productivity tends to be strong.

GDP: slower in Q1

The U.S. economy grew briskly in the fourth quarter (6.9 percent), which left the gain over the four quarters of 2021 at 5.5 percent. Output in the U.S. is well above the pre-pandemic level, although it is still shy of where the economy might have been in the absence of Covid (see the extrapolated trend line on the chart). The economy would need to grow 5.6 percent in Q1 to return to the pre-Covid trend in early 2022. However, we are not likely to see such growth.

GDP

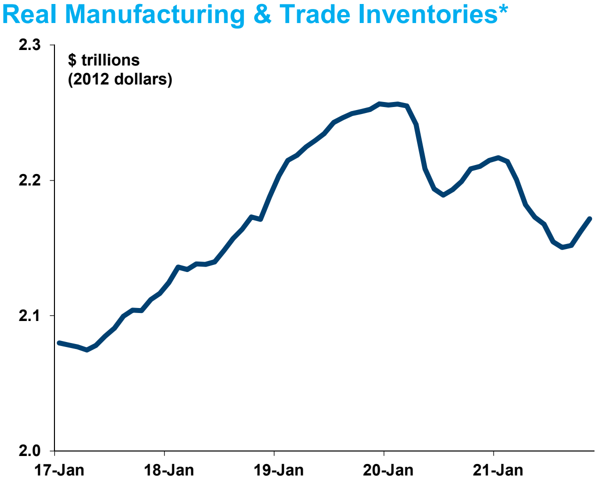


Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

Consumer spending is likely to disappoint in the first quarter. Household spending was well maintained in the fourth quarter (growth of 3.3 percent), but all of this advance occurred in October. The monthly report on income and consumption showed declines in real outlays in November and December. Early holiday shopping will explain some of the monthly variation, but Omicron might also explain some of the softness at the close of the quarter, and virus concerns could be a factor in Q1 as well. Given the lack of momentum in November and December, real outlays would need to grow almost 0.8 percent in each of the next three months to match the 3.3 percent growth rate of Q4, and that seems ambitious. Even monthly increases of approximately 0.6 percent to reach two percent growth might be a reach.

Inventory investment also raises questions. This component accounted for most of the growth in the fourth quarter, adding 4.9 percentage points to the overall increase in real GDP. This strong showing might stir thoughts of excess inventory building or at least a marked slowing in the pace of accumulation.

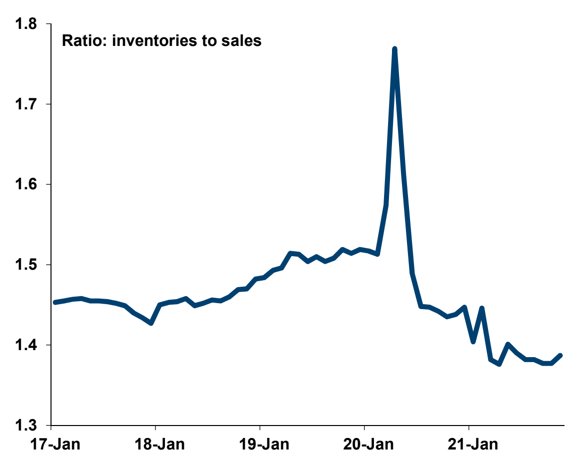
Real Manufacturing & Trade Inventories*



** The chart shows the level of inventories, which is different than inventory investment. Inventory investment is the change in inventories from month-to-month or quarter-to-quarter.*

Source: Bureau of Economic Analysis via Haver Analytics

Real Mfg. & Trade Inventories/Sales Ratio



Source: Bureau of Economic Analysis via Haver Analytics

From a long-term perspective, we are not concerned about softness in inventory investment. Many (likely most) businesses coped with supply-chain disruptions by drawing down inventories, and many (most?) are still facing lean positions. The total stock of inventories as of November (latest available) is still 3.8 percent below the pre-Covid level, and the ratio of real inventories to sales is lean as well (charts, prior page). Thus, we are confident that inventory investment will be a source of growth over the next year or two.

However, inventory investment often moves erratically, and thus a great deal of quarterly variation is likely. The first quarter will probably not match the real inventory building of $173.5 billion in Q4, which was the second strongest showing in history (exceeded only slightly by $177.3 billion in 2015-Q1). Falling shy of the Q4 total would leave a negative contribution to GDP growth in the first quarter (a slower pace of inventory building translates to a negative contribution when growth rates are calculated).

Thus, the two main engines of growth in the fourth quarter -- consumer spending and inventory investment -- might sputter in the first quarter. With sub-par performances in these areas, we would not expect GDP growth to exceed 2.5 percent, and we would not be surprised by a slower pace.

Review

Week of Jan. 24, 2022	Actual	Consensus	Comments
Consumer Confidence (January)	**113.8 (-1.4 Index Pts.)**	**111.2 (-4.6 Index Pts.)**	Individuals feel good about the labor market, but in general attitudes have not kept pace with the economic recovery, as the confidence index remained well shy of pre-pandemic levels. Inflation remains a concern, as the report showed an expected inflation rate of 6.8% over the next year. Continued restrictions associated with the pandemic are probably an issue as well.
U.S. International Trade in Goods (December)	**-\$101.0 Billion (\$3.0 Billion Wider Deficit)**	**-\$96.0 Billion (\$2.0 Billion Narrower Deficit)**	Exports of goods performed well in December, advancing 1.4%, but imports posted firmer results with a jump of 2.0%. The December shifts followed the pattern that has been evident throughout the past two years: both exports and imports have moved along firm upward trends after initial tumbles at the onset of Covid, but imports have dominated. As a result, goods trade has contributed importantly to the recent drag from net exports on GDP growth (subtracting 1.6 percentage points on average from 2020-Q3 to 2021-Q3). Results were better in Q4 (see text on GDP below).
New Home Sales (December)	**0.811 Million (+11.9%)**	**0.760 Million (+2.2%)**	The jump in new home sales in December added to a gain in the prior month and reversed a portion of the slide in the summer and fall. While the latest results signaled a firming in activity, sales were still well shy of readings in the latter part of 2020 and early 2021 (average of 0.932 million from July 2020 thru March 2021). With the latest increase in sales, the months' supply of homes available for sale fell from 6.6 in November to 6.0 in December. Even with the latest drop, the months' supply is still comfortable by historical standards.
GDP (2021-Q4)	**6.9%**	**5.5%**	Much of the economic growth in Q4 was the result of inventory investment, which accounted for 4.9 percentage points of the advance. The surge in inventories reflected efforts to replenish stocks depleted because of supply-chain disruptions. Final sales (GDP less inventory investment) grew 1.9%. Consumer spending rose at a 3.3% clip, up from 2.0% in Q3, but trailing the robust average of 11.7% in H1. Other areas lacked vigor. Business fixed investment rose 2.0%, as outlays for intellectual property offset a double-digit drop in spending for new structures and modest investment in equipment. Residential construction dropped 0.8%, and government spending slipped 2.9%. Exports represented a bright spot, surging 24.5%, but imports also were strong (up 17.7%), resulting in a neutral effect from net exports on GDP growth.

Review Continued

Week of Jan. 24, 2022	Actual	Consensus	Comments
Durable Goods Orders (December)	**-0.9%**	**-0.6%**	The decline in durable goods orders in December followed a solid gain in the prior month (3.2%), and thus the December results did little damage to the underlying upward trend. Moreover, much of the slippage was concentrated in new bookings for aircraft (off 13.5%; defense and commercial, combined). Excluding transportation items, which removes the noise associated with aircraft orders, bookings rose 0.4%, preserving their upward trend (up in 19 of the past 20 months). New orders for nondefense capital goods excluding aircraft, a series that provides insight into capital spending plans by businesses, was unchanged in December. This component has enjoyed a solid upward trend in the current recovery period, but it is perhaps starting to plateau.
Personal Income, Consumption, Core Price Index (December)	**0.3%, -0.6%, 0.5%**	**0.5%, -0.6%, 0.5%**	Wages rose briskly in December (0.7%), as did rental and investment income (0.8% and 0.6%, respectively), but proprietors' income slipped (off 1.4%) and provided a partial offset to strong results elsewhere. Personal consumption expenditures fell, as declines in outlays for goods (-2.6%) offset a pickup in spending on services (0.5%). The increases in the headline and core price indexes for personal consumption expenditures (0.4% and 0.5%, respectively), translated to year-over-year advances of 5.8% and 4.9%, the fastest increases since the early 1980s.
Employment Cost Index (2021-Q4)	**1.0%**	**1.2%**	While the increase in the employment cost index in Q4 trailed the reading of 1.3% in the prior quarter, the combined results signal a distinct acceleration in compensation costs. Growth of 4.0% over the four quarters of 2021 is the fastest since 2001. Both wages (+1.1%; 4.5% year-over-year) and benefit costs (0.9%; 2.8% year-over-year) showed an acceleration in growth; the yearly advance in wages was the fastest since 1989.

Sources: The Conference Board (Consumer Confidence); U.S. Census Bureau (U.S. International Trade in Goods, New Home Sales, Durable Goods Orders); Bureau of Economic Analysis (GDP, Personal Income, Consumption, Core Price Index); Bureau of Labor Statistics (Employment Cost Index); Consensus forecasts are from Bloomberg

Preview

Week of Jan. 31, 2022	Projected	Comments
ISM Manufacturing Index (January) (Tuesday)	**58.0% (-0.8 Pct. Pt.)**	The manufacturing sector performed well in 2021 despite supply-chain issues, materials shortages, and difficulty filling positions (average of 60.6% for the year). The spread of Omicron may have a dampening influence in January, and further progress in repairing supply-chains could lead to additional easing in the supplier delivery index, but another solid reading is likely.
Construction Spending (December) (Tuesday)	**0.6%**	The recent increase in housing starts will likely boost residential construction in December. Business related activity has drifted higher since the summer after a weak performance in most of 2020 and early 2021, and government-sponsored activity could rebound after a dip in November.
Nonfarm Productivity (2021-Q4) (Thursday)	**5.5%**	The Q4 GDP report showed a surge in the output measure used in the calculation of productivity, which was only partially offset by data on hours worked reported in the employment statistics. The results point to a brisk gain in productivity, which should about equal the expected increase in labor compensation and leave unit labor costs little changed in Q4.
ISM Services Index (January) (Thursday)	**60.0% (-2.3 Pct. Pts.)**	The influence of Omicron is likely to be felt more acutely in the service sector of the economy than in the manufacturing sector. The business activity component, while off its record high of 72.5% in November, was still elevated at 68.3% in December and therefore vulnerable to easing.
Factory Orders (December) (Thursday)	**-0.5%**	Durable goods orders slipped 0.9% in December, reflecting weakness in the volatile aircraft category. Durable bookings ex-transportation rose 0.4%, their 19th advance in the past 20 months. Orders for nondurable goods also are likely to be soft, although less-so than headline durable bookings. Lower prices could depress the petroleum and coal category, but a pickup in bookings ex-petrol (19th in the past 20 months) could mostly offset the weakness in petroleum-related goods.
Payroll Employment (January) (Friday)	**200,000**	The spread of Omicron probably restrained hiring in January, which is likely to fall well shy of average job growth of 565,000 in 2021. This report will contain benchmark revisions to the payroll figures based on a universal count as of March 2021. A preliminary estimate published in August showed that payrolls in the benchmark month were 161,000 lighter than previously believed. As with every January report, the household survey will incorporate new population controls (i.e. blow-up factors) without revising past results. Thus, figures based on the household survey for January (unemployment, labor force participation) will not be strictly comparable with previous results.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January / February 2022

Monday 24

CHICAGO FED NATIONAL ACTIVITY INDEX

	Monthly	3-Mo. Avg.
Oct	0.70	0.25
Nov	0.44	0.40
Dec	-0.15	0.33

Tuesday 25

FHFA HOME PRICE INDEX

Sept	0.9%
Oct	1.1%
Nov	1.1%

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

	SA	NSA
Sept	1.0%	0.9%
Oct	1.0%	0.8%
Nov	1.2%	1.0%

CONFERENCE BOARD CONSUMER CONFIDENCE

Nov	111.9
Dec	115.2
Jan	113.8

FOMC MEETING

Wednesday 26

U.S. INTERNATIONAL TRADE IN GOODS

Oct	-$83.1 billion
Nov	-$98.0 billion
Dec	-$101.0 billion

ADVANCE INVENTORIES

	Wholesale	Retail
Oct	2.5%	0.3%
Nov	1.7%	2.0%
Dec	2.1%	4.4%

NEW HOME SALES

Oct	0.649 million
Nov	0.725 million
Dec	0.811 million

FOMC DECISION

POWELL PRESS CONFERENCE

Thursday 27

UNEMPLOYMENT CLAIMS

	Initial (Millions)	Continuing
Jan 01	0.207	1.555
Jan 08	0.231	1.624
Jan 15	0.290	1.675
Jan 22	0.260	N/A

GDP

	GDP	Chained Price
21-Q2	6.7%	6.1%
21-Q3	2.3%	6.0%
21-Q4	6.9%	6.9%

DURABLE GOODS ORDERS

Oct	0.1%
Nov	3.2%
Dec	-0.9%

PENDING HOME SALES

Oct	7.5%
Nov	-2.3%
Dec	-3.8%

Friday 28

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX

	Inc.	Cons.	Core
Oct	0.6%	1.5%	0.4%
Nov	0.5%	0.4%	0.5%
Dec	0.3%	-0.6%	0.5%

EMPLOYMENT COST INDEX

	Comp.	Wages
21-Q2	0.7%	0.9%
21-Q3	1.3%	1.5%
21-Q4	1.0%	1.1%

REVISED CONSUMER SENTIMENT

Nov	67.4
Dec	70.6
Jan (p)	68.8
Jan (r)	67.2

Monday 31

MNI CHICAGO BUSINESS BAROMETER INDEX (9:45)

	Index	Prices
Nov	63.5	93.6
Dec	64.3	90.9
Jan	--	--

Tuesday 1

ISM MFG INDEX (10:00)

	Index	Prices
Nov	60.6	82.4
Dec	58.8	68.2
Jan	**58.0**	**68.0**

CONSTRUCTION SPEND. (10:00)

Oct	0.4%
Nov	0.4%
Dec	**0.6%**

JOLTS DATA (10:00)

	Openings (000)	Quit Rate
Oct	11,091	2.8%
Nov	10,562	3.0%
Dec	--	--

VEHICLE SALES

Nov	12.9 million
Dec	12.4 million
Jan	**12.7 million**

Wednesday 2

ADP EMPLOYMENT REPORT (8:15)

	Private Payrolls
Nov	505,000
Dec	807,000
Jan	--

Thursday 3

INITIAL CLAIMS (8:30)

PRODUCTIVITY & COSTS (8:30)

	Productivity	Unit Labor Costs
21-Q2	2.4%	5.9%
21-Q3	-5.2%	9.6%
21-Q4	**5.5%**	**0.0%**

ISM SERVICES INDEX (10:00)

	Index	Prices
Nov	68.4	83.0
Dec	62.3	83.9
Jan	**60.0**	**80.0**

FACTORY ORDERS (10:00)

Oct	1.2%
Nov	1.9%
Dec	**-0.5%**

Friday 4

EMPLOYMENT REPORT (8:30)

	Payrolls	Un. Rate
Nov	249,000	4.2%
Dec	199,000	3.9%
Jan	**200,000**	**3.9%**

Monday 7

CONSUMER CREDIT

Tuesday 8

NFIB SMALL BUSINESS OPTIMISM INDEX

TRADE BALACE

Wednesday 9

WHOLESALE TRADE

Thursday 10

INITIAL CLAIMS

CPI

FEDERAL BUDGET

Friday 11

CONSUMER SENTIMENT

Monday 14

Tuesday 15

PPI

EMPIRE MFG INDEX

TIC DATA

Wednesday 16

RETAIL SALES

IMPORT/EXPORT PRICES

IP & CAP-U

BUSINESS INVENORIES

NAHB HOUSING INDEX

FOMC MINUTES

Thursday 17

INITIAL CLAIMS

HOUSING STARTS

PHILY FED MFG BUSINESS OUTLOOK SURVEY

Friday 18

EXISTING HOME SALES

LEADING INDICATORS

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

Treasury Financing

January / February 2022

Monday	Tuesday	Wednesday	Thursday	Friday
24	25	26	27	28
AUCTION RESULTS: Rate / Cover 13-week bills 0.190% 2.81 26-week bills 0.380% 3.07 2-year notes 0.990% 2.81	**AUCTION RESULTS:** Rate / Cover 52-week bills 0.630% 2.98 5-year notes 1.533% 2.50 **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 RESULTS:** Spread / Cover 2-year FRN -0.015% 3.34 Rate / Cover 17-week CMB 0.280% 3.20	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.035% 3.09 8-week bills 0.140% 2.89 7-year notes 1.769% 2.36 **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	
14	15	16	17	18
AUCTION: $111 billion* 13-,26-week bills	**ANNOUNCE:** $50 billion* 4-week bills for auction on February 17 $40 billion* 8-week bills for auction on February 17 $40 billion* 17-week CMBs for auction on February 16 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills $40 billion* 17-week CMBs $50 billion* 3-year notes $36 billion* 10-year notes $23 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 $9 billion* 30-year TIPS **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on Feb. 22 $34 billion* 52-week bills for auction on February 22 $22 billion* 2-year FRNs for auction on February 23 $52 billion* 2-year notes for auction on February 22 $53 billion* 5-year notes for auction on February 23 $51 billion* 7-year notes for auction on February 24 **SETTLE:** $111 billion* 13-,26-week bills	

*Estimate