Daiwa Capital Markets

U.S. Economic Comment

- FOMC: leading a strange interest rate cycle
- Productivity: another hurdle in the inflation fight

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Monetary Policy and Interest Rates

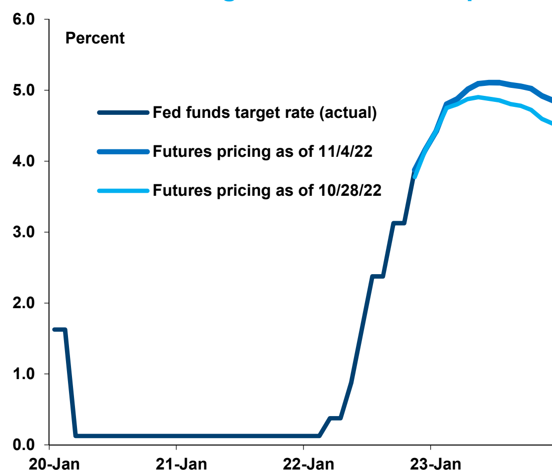
Fed officials apparently have rethought their views on monetary policy, as Fed Chair Jerome Powell noted in his latest press conference that the federal funds rate will probably need to increase more than previously expected. That is, the terminal rate of 4.625 percent suggested by the September dot plot is not likely to be sufficiently restrictive.

Market participants have adjusted views based on the Chair's comments, but not dramatically so. Futures contracts on federal funds now show a terminal rate of 5.1 percent in mid-2023, up from an expected peak of 4.9 percent evident last week. Investors and traders still expect the Fed to pivot next year, although the reduction in rates is a bit less pronounced than previously believed (a reduction of 25 basis points by December, versus a drop of 37 basis points evident on October 28; chart, left).

We have shifted our view as well, adding 75 basis points to our previous expectation, resulting in a terminal rate of 5.625 percent (chart, right). We look for a shift of 50 basis points in December and changes of 50 basis points in both the first and second quarters of next year. We have penciled in a final insurance move of 25 basis points in the third quarter. We do not see the Fed pivoting toward lower interest rates until the second quarter of 2024.

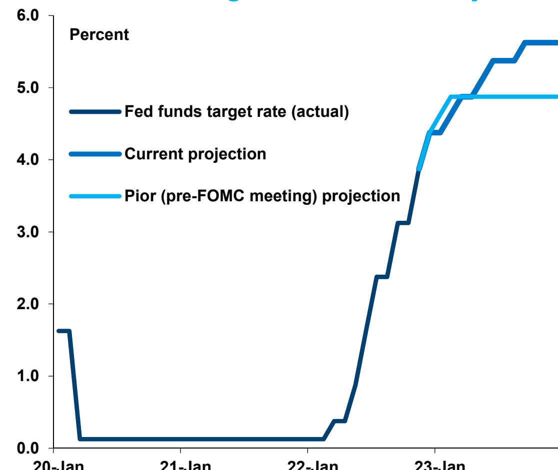
The shift in our view is pronounced, and the expected level of the federal funds rate is elevated, but we feel this projection is warranted by the hawkish tone of Chair Powell's comments ("we have a ways to go", "very premature to consider a pause"). In addition, one can raise an economic argument to justify a marked increase in policy rates. Developments in the labor market will influence Fed policy, and the labor market might not soften appreciably. The constraining influence of higher interest rates might take the form of a reduction in job postings rather than layoffs. That is, businesses will stop looking for workers rather than trimming their work forces, resulting in a modest increase in unemployment and allowing the Fed to adopt an aggressive stance.

Federal Funds Target Rate: Market Expectation*



** The expected federal funds rate implied by futures contracts.*
Sources: Federal Reserve Board via Haver Analytics; Bloomberg

Federal Funds Target Rate: Daiwa Projection*



Source: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

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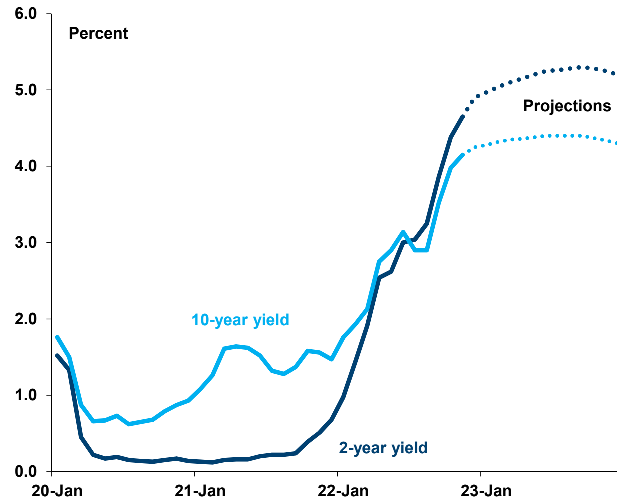
Despite a potentially modest increase in unemployment next year, the economy will most likely be in recession, which will leave the Fed in the unusual position of maintaining a restrictive policy stance during a downturn in the economy. The outlook for Treasury yields in such an environment is muddled. The tightening of monetary policy might be expected to put upward pressure on interest rates, but a recession would be working in the opposite direction.



** The dashed portions of the lines show projections (2022-Q4 to 2023-Q4).*

Sources: U.S. Treasury Department via Haver Analytics; Daiwa Capital Markets America

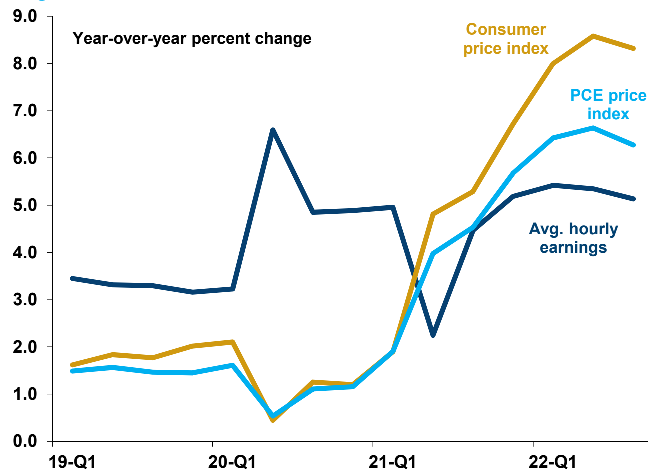
We believe that market participants are underestimating the resolve of the Federal Reserve to reduce inflation and its willingness to tolerate some increase in unemployment. We suspect that the views of market participants will gradually move in line with Fed intentions, just as they did this week in response to Chair Powell's hawkish comments. This realignment, in our judgment, will outweigh the influence of weak economic activity and push interest rates higher next year, at least in the early part of 2023.

Given the push-and-pull on interest rates, the upward pressure on market rates is not likely to be pronounced, and it is likely to be greater in the short end of the maturity spectrum. We look for the rate on two-year Treasury notes to climb to 5.3 percent when the fed funds rate reaches our expected peak in the third quarter (up from 4.7 percent currently). We envision the 10-year rate moving to 4.4 percent in 2023-Q3 versus recent readings of 4.15 percent (chart, above).

Rising rates in a likely soft economic environment is an unusual outcome, but so too is a restrictive policy stance from the Federal Reserve. Once it becomes clear that inflation is decelerating meaningfully and the Fed has reached its terminal federal funds rate, the influence of slow economic activity will begin to dominate and Treasury rates will begin to decline in anticipation of the eventual Fed pivot. We look for the easing in rates to begin in the latter part of next year.

Labor Costs and Inflation

Many factors will be influencing the inflation rate over the next year or so, with labor costs representing one of the most important. The employment report for October offered a little encouragement on this front, as the growth of average hourly earnings seems to be developing a downward tilt. This measure of wages was showing year-over-year growth in excess of five percent in earlier months this year, but it has drifted to 4.7 percent recently.



** The quarterly series on average hourly earnings runs through 2022-Q3; average hourly earnings posted a 4.7 percent year-over-year increase in October 2022.*

Sources: Bureau of Labor Statistics and Bureau of Economic Analysis via Haver Analytics

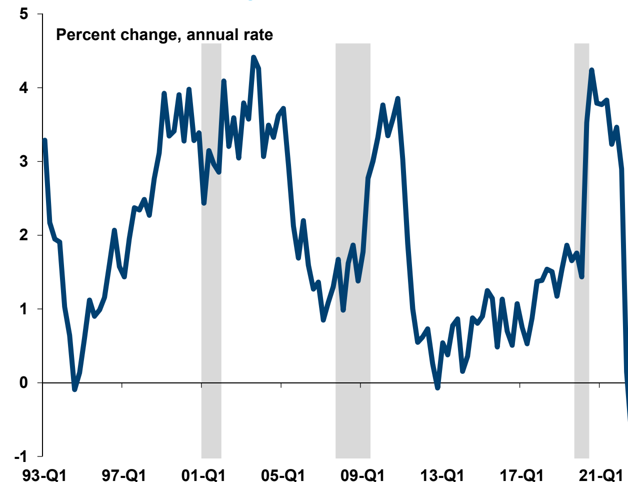
The deceleration is interesting, but we would not push it too far. Wage growth, while brisk in an absolute sense, has lagged inflation, resulting in a reduction in real wages. Wage growth of five percent a few years ago would have been notable, but it is unimpressive when measured

against increases of eight percent in the CPI and six percent in the price index for personal consumption expenditures (chart, prior page). Workers most likely will be bargaining hard for catch-up wage increases, which will probably prevent rapid deceleration in wage growth.

Moreover, wage growth is only part of the influence of labor costs on inflation; productivity growth also is an important consideration. If productivity growth is firm, businesses will be in position to absorb rising wages rather than pass them on to the prices of their products. Unfortunately, this component of effective labor costs is performing poorly.

Productivity in the nonfarm business sector rose at an annual rate of only 0.3 percent in the third quarter. This soft performance followed a tumble of 5.0 percent in the first half of the year, which has left a notably weak underlying trend. We typically focus on an eight-quarter moving average of productivity growth to smooth erratic movements and show a clear picture of trend (the series is often volatile). These weak readings have left an average decline of 0.7 percent in the past eight quarters, matching the softest reading in the 73-year history of the series. Only five other observations over this long span were in negative territory. Businesses, it seems, have no cushion to absorb rising wages.

Nonfarm Productivity*



** The chart shows an eight-quarter moving average of productivity growth. The shaded areas indicate periods of recession in the United States.*

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

One wonders what might be causing the poor performance of productivity. We hope that part of the explanation is random volatility. Productivity often moves erratically, and thus some of the weakness might reflect a strong dose of statistical noise. However, given the magnitude of the change over three consecutive quarters, fundamentals also are likely in play.

We suspect that worker inexperience is playing a role. Retirements increased considerably during the pandemic, and the loss of seasoned workers has probably dampened efficiency. Not only will retirements leave less experienced workers in key positions, but the absence of knowledgeable individuals will limit training and mentoring.

Remote working might be having a similar effect. The drop in personal interaction could lessen the flow of information and knowledge, thereby preventing maximum efficiency. In addition, perhaps workers are not as diligent when working at home (quiet quitting?).

We also would note that many individuals have changed jobs recently (record levels of quits and quit rates), which might leave many in the low segments of learning curves.

Whatever the explanation, productivity growth in recent quarters has been dismal.

Next Economic Comment

Because of business travel, we will not publish an Economic Comment next week. The next edition will be published on November 18.

Review

Week of Oct. 31, 2022	Actual	Consensus	Comments
Job Openings (September)	**10.717 Million (+4.3%)**	**9.750 Million (-3.0%)**	Job openings in the U.S. rose 437,000 (4.3%) in September from an upwardly revised reading in the prior month (upward adjustment of 2.3%). While openings have eased from the record of 11.855 million in March, they are significantly above the pre-pandemic record of 7.558 million in November 2018 and are still signaling firm demand for labor despite a slowing economy.
ISM Manufacturing Index (October)	**50.2 (-0.7 Index Pt.)**	**50.0 (-0.9 Index Pt.)**	Although the ISM manufacturing index remained above the critical value of 50 in October (indicating expansion), tight financial conditions caused by the Fed's aggressive rate hikes have led to a retreat from the average of 60.6 in 2021. Production rose modestly in October, but the latest reading of 52.3 trailed by a wide margin last year's average of 61.0. The employment and new orders indexes posted small gains, but employment was unimpressive at 50.0 and new orders remained in contractionary territory (49.2). The supplier delivery index was a drag on the headline in October, falling 5.6 index points to 46.8, but latest reading should be viewed in a positive light as it suggests that supply chains in the factory sector have mostly normalized. The prices index continued its retreat from a recent high of 87.1 in March (off 5.1 index points to 46.6).
Construction Spending (September)	**0.2%**	**-0.6%**	Private single-family activity posted its fourth consecutive large decline, as tight financial conditions weighted on the housing market, but increases in multifamily construction and improvements to existing structures left total private construction little changed in September. Business-related construction has stirred recently, posting firm advances in three of the past four months. Government-sponsored construction was dragged lower by the second consecutive large decline at the federal level.
Trade Balance (September)	**-$73.3 Billion ($7.6 Billion Wider Deficit)**	**-$72.2 Billion ($4.8 Billion Wider Deficit)**	Trade flows in September moved against the United States, as exports of goods and services slipped 1.1% while imports rose 1.5%. The decline in exports ended a string of seven consecutive gains. The pickup in imports offset a portion of sharp declines in the prior three months; previously, imports had surged in the closing months of 2021 and early this year, probably reflecting volatility related to supply-chain issues. Although the nominal trade deficit deteriorated in September, real flows for the quarter as a whole were highly favorable, which led to a contribution from net exports to GDP growth of 2.8 percentage points (likely revised to 3.0 percentage points).

Review Continued

Week of Oct. 31, 2022	Actual	Consensus	Comments
Nonfarm Productivity (2022-Q3)	**0.3%**	**0.5%**	Trade flows in September moved against the United States, as exports of goods and services slipped 1.1% while imports rose 1.5%. The decline in exports ended a string of seven consecutive gains. The pickup in imports offset a portion of sharp declines in the prior three months; previously, imports had surged in the closing months of 2021 and early this year, probably reflecting volatility related to supply-chain issues. Although the nominal trade deficit deteriorated in September, real flows for the quarter as a whole were highly favorable, which led to a contribution from net exports to GDP growth of 2.8 percentage points (likely revised to 3.0 pct. points).
ISM Services Index (October)	**54.4 (-2.3 Index Pts.)**	**55.3 (-1.4 Index Pts.)**	While still signaling growth in the service sector, the ISM services index has moved irregularly lower this year after a record reading of 68.4 in November of 2021. The new orders and business activity components fell 4.1 and 3.4 index points to 56.5 and 55.7, respectively. Both components trail the firm averages from last year (63.4 for new orders and 64.6 for business activity), but they are respectable in the current challenging environment. The employment index dropped 3.9 index points to 49.1, signaling a contraction in hiring. The supplier deliveries component increased 2.3 index points to 56.2, signaling slower delivery times and continued supply-chain difficulties in the service sector.
Factory Orders (September)	**0.3%**	**0.3%**	Durable bookings rose 0.4%, unrevised from the preliminary estimate published on October 27. The advance in durable orders was led by the transportation category, with both commercial aircraft and motor vehicles contributing; durable goods orders ex-transportation were unimpressive, declining 0.5%. Orders for nondurable goods rose 0.2%, led by a surprising increase of 1.0% in bookings for petroleum and coal products. Given the decline in energy prices in recent months, growth in nominal orders suggests a vigorous pace of real activity. Excluding petroleum and coal, nondurable orders dipped 0.1%, marking the second decline in the past three months and suggesting a slowdown in manufacturing.
Payroll Employment (October)	**261,000**	**193,000**	The increase in nonfarm payroll employment in October trailed the average of 365,000 in the prior six months, but it still represented a solid performance. While the employment report was generally favorable, the unemployment rate represented a soft spot, registering an increase of 0.2 percentage point to 3.7%. The increase reflected a decline in employment as measured by the household survey (off 328,000) that exceeded a drop of 22,000 in the size of the labor force. Average hourly earnings rose 0.4% in October, which left a year-over-year increase of 4.7%, slower than readings above 5% in the first eight months of 2022.

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

Preview

Week of Nov. 7, 2022	Projected	Comments
CPI (October) (Thursday)	**0.7% Total, 0.5% Core**	Available quotes suggest that energy prices could increase in October after a cumulative decline of 11.3% in the prior three months. Food prices could post another brisk increase, although hints of easing have emerged recently (up 0.8% in August and September versus an average of 1.0% in the first seven months of the year). Broad underlying price pressure suggests a reading in the core CPI close to the 12-month average of 0.5%.
Federal Budget (October) (Thursday)	**-$100.0 Billion**	Available data suggest that federal revenues could post double-digit year-over-year growth in October. With outlays likely to be close to the recent average (excluding the $432 billion charge in September associated with the Biden Administration's student loan forgiveness), the brisk increase in revenues should leave the deficit in the first month of FY2023 narrower than the shortfall of $165 billion in October 2021.
Consumer Sentiment (November) (Friday)	**59.5 (-0.7%)**	Rapid inflation for household essentials (food and utilities), along with widespread talk of a recession, could contribute to another soft reading for the University of Michigan sentiment gauge.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

October / November 2022

Monday 31

MNI CHICAGO BUSINESS BAROMETER

	Index	Prices
Aug	52.2	81.8
Sep	45.7	74.1
Oct	45.2	74.8

Tuesday 1

JOLTS DATA

	Openings (000)	Quit Rate
July	11,170	2.7%
Aug	10,280	2.7%
Sep	10,717	2.7%

ISM MFG. INDEX

	Index	Prices
Aug	52.8	52.5
Sep	50.9	51.7
Oct	50.2	46.6

CONSTRUCTION SPEND.

July	0.8%
Aug	-0.6%
Sep	0.2%

FOMC (1ST DAY)

VEHICLE SALES

Aug	13.2 million
Sep	13.6 million
Oct	14.9 million

Wednesday 2

ADP EMPLOYMENT REPORT

	Private Payrolls
Aug	132,000
Sep	192,000
Oct	239,000

FOMC DECISION

Thursday 3

UNEMP. CLAIMS

	Initial (millions)	Continuing
Oct 8	0.226	1.383
Oct 15	0.214	1.438
Oct 22	0.218	1.485
Oct 29	0.217	N/A

TRADE BALANCE

July	-$70.5 billion
Aug	-$65.7 billion
Sep	-$73.3 billion

PRODUCTIVITY & COSTS

	Productivity	Unit Labor Costs
22-Q1	-5.9%	8.5%
22-Q2	-4.1%	8.9%
22-Q3	0.3%	3.5%

FACTORY ORDERS

July	-1.0%
Aug	0.2%
Sep	0.3%

ISM SERVICES INDEX

	Index	Prices
Aug	56.9	71.5
Sep	56.7	68.7
Oct	54.4	70.7

Friday 4

EMPLOYMENT REPORT

	Payrolls	Un. Rate
Aug	292,000	3.7%
Sep	315,000	3.5%
Oct	261,000	3.7%

Monday 7

CONSUMER CREDIT (3:00)

July	$26.1 billion
Aug	$32.2 billion
Sep	--

Tuesday 8

NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)

Aug	91.8
Sep	92.1
Oct	--

Wednesday 9

WHOLESALE TRADE (10:00)

	Inventories	Sales
July	0.6%	-1.5%
Aug	1.4%	0.1%
Sep	**0.8%**	**0.5%**

Thursday 10

UNEMP. CLAIMS (8:30)

CPI (8:30)

	Total	Core
Aug	0.1%	0.6%
Sep	0.4%	0.6%
Oct	**0.7%**	**0.5%**

FEDERAL BUDGET (2:00)

	2022	2021
Aug	-$219.6B	-$170.6B
Sep	-$429.7B	-$64.9B
Oct	**-$100.0B**	-$165.1B

Friday 11

VETERANS DAY

CONSUMER SENTIMENT (10:00)

Sep	58.6
Oct	59.9
Nov	**59.5**

Monday 14

Tuesday 15

PPI

EMPIRE MFG. INDEX

Wednesday 16

RETAIL SALES

IMPORT PRICES

INDUSTRIAL PRODUCTION

BUSINESS INVENTORIES

NAHB HOUSING INDEX

TIC FLOWS

Thursday 17

UNEMP. CLAIMS

HOUSING STARTS

PHILY FED MFG. INDEX

Friday 18

EXISTING HOME SALES

LEADING INDICATORS

Monday 21

CHICAGO FED NATIONAL ACTIVITY INDEX

Tuesday 22

Wednesday 23

UNEMP. CLAIMS

DURABLE GOODS ORDERS

NEW HOME SALES

CONSUMER SENTIMENT

FOMC MINUTES

Thursday 24

THANKSGIVING

Friday 25

Forecasts in Bold.

Treasury Financing

October / November 2022

Monday	Tuesday	Wednesday	Thursday	Friday
31	1	2	3	4
AUCTION RESULTS: Rate / Cover 13-week bills 4.070% 2.60 26-week bills 4.440% 2.95 **SETTLE:** $12 billion 20-year bonds $21 billion 5-year TIPS $42 billion 2-year notes $43 billion 5-year notes $35 billion 7-year notes $24 billion 2-year FRNs	**AUCTION RESULTS:** Rate / Cover 52-week bills 4.505% 2.83 **ANNOUNCE:** $65 billion 4-week bills for auction on Nov 3 $55 billion 8-week bills for auction on Nov 3 $33 billion 17-week bills for auction on Nov 2 **SETTLE:** $65 billion 4-week bills $55 billion 8-week bills $33 billion 17-week bills	**AUCTION RESULTS:** Rate / Cover 17-week bills 4.280% 3.14 **ANNOUNCE:** $40 billion 3-year notes for auction on Nov 8 $35 billion 10-year notes for auction on Nov 9 $21 billion 30-year bonds for auction on Nov 10	**AUCTION RESULTS:** Rate / Cover 4-week bills 3.620% 2.53 8-week bills 3.880% 2.75 **ANNOUNCE:** $102 billion 13-,26-week bills for auction on Nov 7 **SETTLE:** $102 billion 13-,26-week bills $34 billion 52-week bills	
7	8	9	10	11
AUCTION: $102 billion 13-,26-week bills	**AUCTION:** $40 billion 3-year notes **ANNOUNCE** $65 billion* 4-week bills for auction on Nov 10 $55 billion* 8-week bills for auction on Nov 10 $33 billion* 17-week bills for auction on Nov 9 **SETTLE:** $65 billion 4-week bills $55 billion 8-week bills $33 billion 17-week bills	**AUCTION:** $33 billion* 17-week bills $35 billion 10-year notes	**AUCTION:** $65 billion* 4-week bills $55 billion* 8-week bills $21 billion 30-year bonds **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Nov 14 $15 billion* 20-year bonds for auction on Nov 16 $15 billion* 10-year TIPS for auction on Nov 17 **SETTLE:** $102 billion 13-,26-week bills	***VETERANS DAY***
14	15	16	17	18
AUCTION: $102 billion* 13-,26-week bills	**ANNOUNCE:** $65 billion* 4-week bills for auction on Nov 17 $55 billion* 8-week bills for auction on Nov 17 $33 billion* 17-week bills for auction on Nov 16 **SETTLE:** $65 billion* 4-week bills $55 billion* 8-week bills $33 billion* 17-week bills $40 billion 3-year notes $35 billion 10-year notes $21 billion 30-year bonds	**AUCTION:** $33 billion* 17-week bills $15 billion* 20-year bonds	**AUCTION:** $65 billion* 4-week bills $55 billion* 8-week bills $15 billion* 10-year TIPS **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Nov 21 $42 billion* 2-year notes for auction on Nov 21 $43 billion* 5-year notes for auction on Nov 21 $35 billion* 7-year notes for auction on Nov 22 $22 billion* 2-year FRNs for auction on Nov 22 **SETTLE:** $102 billion* 13-,26-week bills	
21	22	23	24	25
AUCTION: $102 billion* 13-,26-wk bills $42 billion* 2-year notes $43 billion* 5-year notes	**AUCTION:** $35 billion* 7-year notes $22 billion* 2-year FRNs **ANNOUNCE:** $65 billion* 4-week bills for auction on Nov 23 $55 billion* 8-week bills for auction on Nov 23 $33 billion* 17-week bills for auction on Nov 23 **SETTLE:** $65 billion* 4-week bills $55 billion* 8-week bills $33 billion* 17-week bills	**AUCTION:** $65 billion* 4-week bills $55 billion* 8-week bills $33 billion* 17-week bills **ANNOUNCE:** $102 billion* 13-,26-week bills for auction on Nov 28 $34 billion* 52-week bills for auction on Nov 29	***THANKSGIVING***	**SETTLE:** $102 billion* 13-,26-wk bills $22 billion* 2-year FRNs

**Estimate*