Daiwa Capital Markets

U.S. Economic Comment

- The Fed versus the market: who will blink in 2023?
- The 2023 outlook for inflation and growth

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The Fed: All Talk or Resolute Inflation Fighter?

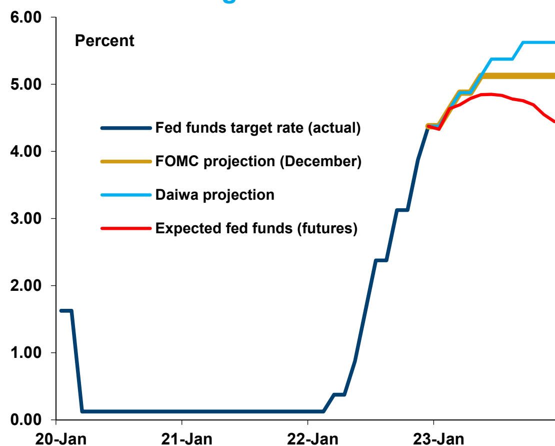
The Federal Reserve and market participants currently are reading from different pages. The latest dot plot from the Fed and comments from Chair Jerome Powell suggest that officials will drive the federal funds rate above five percent next year and hold that stance throughout 2023. Market participants, in contrast, see the fed funds rate peaking at approximately 4.9 percent in mid-2023 and easing to 4.5 percent by the end of the year (chart, left). One of these groups will be wrong.

We believe the Fed view will be closer to the mark. In fact, we suspect that officials will push the fed funds rate higher than the 5.125 percent suggested by the median dot; our view is in line with the top two dots on the latest plot (5.625 percent; chart, right). Fed officials seem to realize that they stirred inflation by easing too much during the pandemic and holding that stance for too long. They seem determined to correct their mistake. Also, they wish to avoid the severe tightening that would be needed if longer-term inflation expectations were to become unmoored.

Market participants seem to believe that slow (likely negative) economic growth and rising unemployment will arrest inflation and allow the Fed to pivot to lower interest rates. Recent readings on the consumer price index seem to support this view, which led fixed-income investors and traders to downplay the hawkish comments from Chair Powell at his press conference (although equity investors on Thursday and Friday seemed to recognize recession risks).

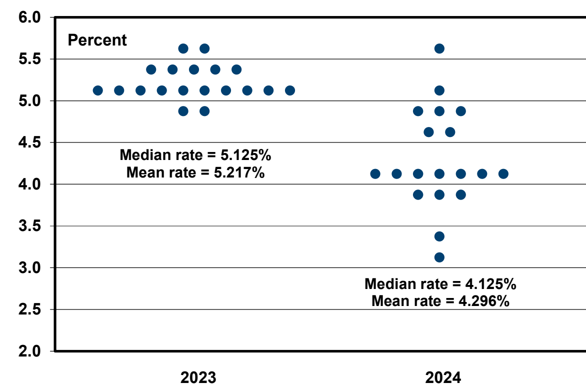
The outcome next year undoubtedly will depend on the path of inflation. If price pressure eases meaningfully, the Fed could indeed pivot. However, we suspect that inflation will recede only gradually. The November CPI might suggest this view is fanciful (up 0.1 percent overall and 0.2 percent excluding food and energy), but we were not impressed with that report.

Federal Funds Target Rate



Sources: Federal Reserve Board via Haver Analytics; Federal Open Market Committee; Bloomberg; Daiwa Capital Markets America

FOMC Rate View: Year-End 2023 & 2024*



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2023 and 2024.*

Source: Federal Open Market Committee, Summary of Economic Projections, December 2022

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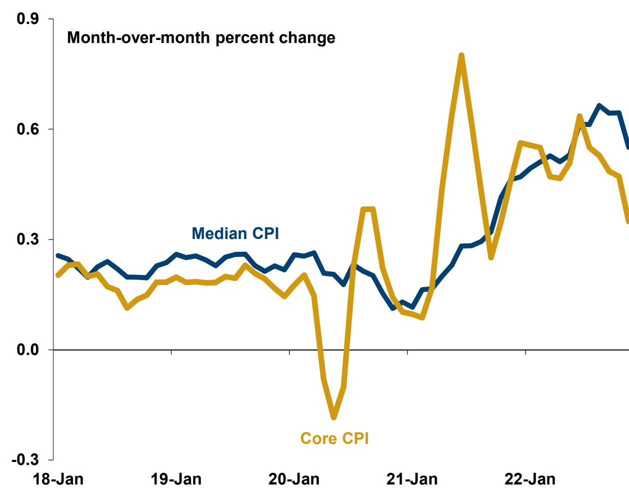
We took note of the median CPI published by the Cleveland Fed which rose 0.5 percent in November, within the elevated range of recent observations. The brisk pace of this measure indicates that the restraint in the headline and core CPI was the result of large declines in a small number of items rather than a broadly based easing in inflation. The median measure -- the middle of the price distribution -- gives a better sense of underlying inflation than the traditional core index does, and the median measure is suggesting only modest easing in price pressure.

CPI: Median versus Core*



** Three-month moving average.*

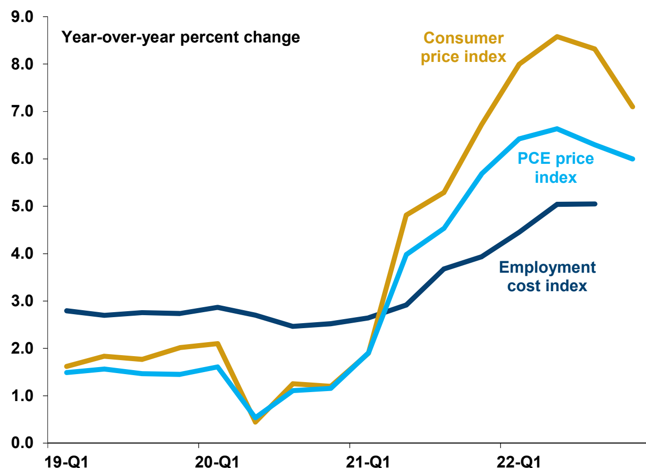
Sources: Bureau of Labor Statistics and Federal Reserve Bank of Cleveland via Haver Analytics

Some of the sharp declines reflected inevitable adjustments to prices of some items that had surged to unsustainable levels. The prices of used motor vehicles, for example, dropped 2.9 percent, the fifth consecutive decline, but this component exploded more than 50 percent in the early stages of the pandemic. Prices of new vehicles were unchanged, ending a string of 21 increases that drove the index 20 percent above its pre-Covid level. Airfares (off 3.0 percent) continued their retreat from the record high in May. Health-insurance fees, surprisingly, fell 4.3 and 4.0 percent in the past two months, breaking from a steady upward trend.

We hesitate to use the word “transitory” but there were transitory influences earlier in the cycle that drove the core CPI above the median, and now we are seeing their reversal push the core below the median (chart, above). The median index shows less volatility and is less influenced by idiosyncratic shifts. Thus, it provides a better view on underlying inflation. Recent observations suggest that underlying inflation is stabilizing, but it has not started a meaningful deceleration.

We also are not optimistic on inflation because of possible wage pressure. As noted by Chair Powell and other Fed officials, the tight labor market could trigger brisk wage growth next year. Even if labor markets were to soften, wages could remain under upward pressure because of efforts by individuals to regain lost purchasing power. Although the growth of labor compensation has quickened this year, advances have not kept pace with inflation (chart), which will lead to demands for catch-up wage increases.

Labor Costs and Consumer Inflation*



** The Q4 readings for the CPI and the personal consumption expenditures (PCE) price index show the year-over-year changes for November and October, respectively (latest available). The last reading on the ECI is for the third quarter of 2022.*

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

Interest Rates

The U.S. is likely to experience an unusual interest rate pattern next year. Historically, the Federal Reserve has reacted quickly to recession risks by easing policy, which eliminated any inversion in the yield curve that had developed or steepened the curve if it had been positively sloped. In this instance, nudging short-term rates higher and holding to a restrictive stance is likely to intensify the inversion now in place.

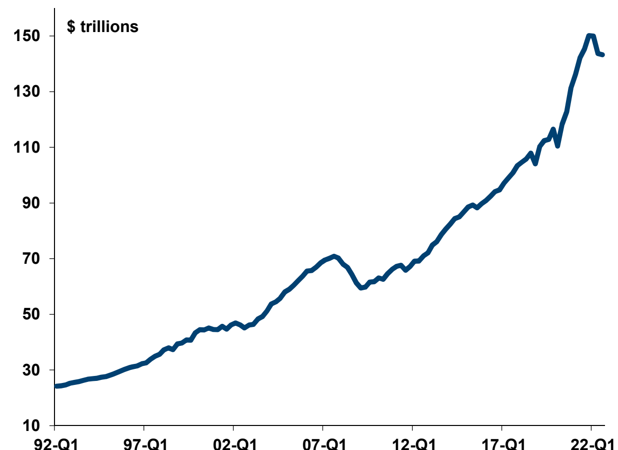
The degree of additional inversion will also depend on the movement in long-term interest rates, and here the outlook is murky. A recession ordinarily would put downward pressure on long-term rates, but next year a shift in the expected policy path is likely to push long-term rates slightly higher. That is, the realization that the Fed is likely to move higher for longer rather than pivot to lower rates will frustrate current market expectations and trigger a repricing to higher rates in the long end of the maturity spectrum. The change will probably be less than that for short-term rates, resulting in a more deeply inverted curve. We have the 10-2 curve moving above 100 basis points next year (see table on p. 4).

Economic Growth and Inflation

The chances of avoiding a recession next year are slim. The median CPI suggests that inflation is currently embedded in the economy, and history shows that inflation, once established, requires a recession to squeeze it from the system. Comments from Fed officials suggest they are willing to tolerate a downturn in the economy in order to get inflation back on its targeted track. Policymakers will probably exercise a degree of patience in returning to their inflation target (The Summary of Economic Projections has core inflation still a tick above 2.0 percent in 2025), but they will push hard enough to establish a clear downward trajectory for inflation.

While we expect a recession next year, the downturn will probably be mild, as we do not see notable imbalances in the key sectors of the economy. Households, for example, are financially strong. The large pool of savings accumulated by individuals during the pandemic, which is still sizeable, will provide a cushion and prevent a marked reduction in consumer spending. An elevated level of net worth (even after the drop in stock prices this year) also indicates a strong financial position in the household sector (chart). The expected decline in real outlays of 0.8 percent over the four quarters of next year is in the middle of the pack from prior recessions.

Household Net Worth



Source: Financial Accounts of the United States, Federal Reserve Board via Haver Analytics

We are hopeful that adjustments by businesses will be moderate. Inventories in some areas are a bit heavy, but we do not see a need for a major correction. We also expect only a modest drop in business outlays for new equipment. New orders for capital goods have been holding up well, with continued growth in nominal bookings translating to a near-steady flow after adjusting for inflation. We suspect that business investment will be supported to a degree by efforts to strengthen supply chains, which will involve rerouting investment from foreign countries to the U.S.

Activity by state and local governments sometimes moves in a pro-cyclical pattern, slowing during soft economic periods because of weak revenue flows. However, like households, state and local governments have some financial cushion from unspent funds advanced by Congress during the pandemic. We do not expect much fiscal support from the federal government, especially with a now-divided Congress, but legislators are discussing tweaks to the tax code that could provide support (enhancing the child tax credit, extending some business tax breaks).

There are risk areas. The housing market has already weakened considerably, and it will probably continue to slip in the quarters ahead. Business demand for office space will probably be weak, as remote working is likely to remain popular. The combination of a strong foreign exchange value of the dollar and weak foreign economies will probably lead to a poor export performance.

All told, we look for GDP to decline approximately 1.0 percent over the four quarters of 2023, which will drive the unemployment rate to something in the neighborhood of 5.0 percent. Inflation will recede, but slowly. We expect both headline and core inflation (and median inflation) to remain above 3.0 percent throughout the year, which is probably not slow enough to trigger a pivot by the Fed.

U.S. Economic Outlook*

(Percent change annual rate, unless otherwise noted)

		2022				2023			
Item		**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
1	Gross Domestic Product	-1.6	-0.6	2.9	0.5	-0.5	-1.2	-1.3	-0.3
2	Personal Consumption Expenditures	1.3	2.0	1.7	3.5	0.0	-1.0	-1.5	-0.8
3	Business Fixed Investment	7.9	0.1	5.1	3.0	-0.6	-2.3	-1.1	0.5
4	Residential Construction	-3.1	-17.8	-26.8	-22.0	-10.0	-8.0	-5.0	-3.5
5	Change in Business Inventories *(Contribution to growth)*	0.2	-1.9	-1.0	0.4	-0.2	-0.2	-0.1	0.1
6	Government Spending	-2.3	-1.6	3.0	2.0	2.1	2.0	2.0	2.1
7	Net Exports *(Contribution to growth)*	-3.1	1.2	2.9	-2.0	-0.1	-0.1	-0.1	0.0
	Inflation and Unemployment								
8	PCE Price Index *(Annual rate)*	7.5	7.3	4.3	3.6	4.0	3.6	3.3	3.2
9	Core PCE Price Index *(Annual rate)*	5.6	4.7	4.6	4.2	4.5	4.2	3.9	3.6
10	Unemployment Rate	3.6	3.6	3.6	3.7	4.0	4.3	4.8	5.0
	Interest Rates (End of Period)								
11	Federal Funds Target (midpoint)	0.38	1.63	3.13	4.38	4.88	5.38	5.63	5.63
12	2-year Treasury	2.18	3.08	4.22	4.30	4.70	5.00	5.00	4.70
13	10-year Treasury	2.37	3.17	3.83	3.50	3.70	3.90	3.90	3.80
14	30-year Fixed-Rate Mortgages	4.67	5.70	6.70	6.40	6.70	6.90	6.85	6.75

** The readings for 2022-Q4 to 2023-Q4 are forecasts.*

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board, Daiwa Capital Markets America

Review

Week of Dec. 12, 2022	Actual	Consensus	Comments
Federal Budget (November)	**$248.5 Billion Deficit**	**$248.0 Billion Deficit**	Federal revenues in November fell 10.3% from total in the same month last year. The drop followed a surge of 12.1% in October, but results for the first two months of FY23 were still underwhelming at 1.0%. Individual income and corporate profit receipts were soft in the past two months, and remittances by the Federal Reserve were weak. Federal spending declined 1.6% in the first two months of FY23, although results were constrained by a calendar configuration that shifted some outlays from October (FY23) into September (FY22). If not for this shifting, outlays would have increased 5.3%. The deficit in the first two months of the fiscal year totaled $336 billion ($399 billion adjusting for the outlay shift) versus $356 billion in the first two months of FY22.
CPI (November)	**0.1% Headline, 0.2% Core**	**0.3% Headline, 0.3% Core**	November marked the second consecutive month of subdued results on consumer prices (core up 0.3% in October). Several goods or services that had surged at times during the pandemic or recovery are now cooling (used car prices, airfares, hotel fees). Prices of new cars might be starting to turn a corner (unchanged in November after 21 consecutive increases). Other sources of restraint might reflect normal volatility. Recreation goods fell 0.7%, but the change merely dented a strong upward trend. Similarly, health insurance charges have declined 4.0% or more in each of the past two months, a surprising departure from a steady upward trend. Some areas remained problematic (food, rent). The bottom line: it is too soon to declare mission accomplished in the inflation fight.
Retail Sales (November)	**-0.6% Total, -0.2% Ex. Autos**	**-0.2% Total, 0.2% Ex. Autos**	The retail sales report for November carried a soft tone despite media reports of firm Black Friday shopping. New vehicle sales dropped 2.3%, with the latest shift halting signs of upward momentum after weak activity in the spring and summer. A decline of 0.2% in retail activity excluding autos and gasoline suggested caution in spending on nonessentials: sales at sporting goods stores, electronics stores, and online outlets all fell in November. Restrained behavior prevailed against a backdrop of potential recession next year.
Industrial Production (November)	**-0.2%**	**0.0%**	The decline in headline industrial production understated the degree of softening, as a temperature-related increase of 3.6% in the utility sector partially offset sharp declines in the manufacturing and mining components (off 0.6% and 0.7%, respectively). A retreat of 2.8% in motor vehicle production led the drop in the manufacturing sector, with declines in 15 of 19 additional industry groupings also contributing to the soft performance. The slippage across industries left total factory output in the low end of the range seen in the past several months. The decline in mining, which matched the drop in the prior month, was led by the drilling and extraction of oil and natural gas. Mining activity is perhaps topping at a level lower than that before the pandemic.

Sources: U.S. Treasury Department (Federal Budget); Bureau of Labor Statistics (CPI); U.S. Census Bureau (Retail Sales); Federal Reserve Board (Industrial Production); Consensus forecasts are from Bloomberg

Preview

Week of Dec. 19, 2022	Projected	Comments
Housing Starts (November) (Tuesday)	**1.400 Million (-1.8%)**	Elevated inventories of unsold new homes and slack demand suggest that builders could trim single-family starts in November, pushing them to the lowest level of the year. Multi-family starts have been well maintained, as a shift in preferences away from single-family units has spurred demand for rental housing.
Current Account (22-Q3) (Wednesday)	**-$210.0 Billion ($41.1 Billion Narrower Deficit)**	Improvement in trade flows suggests a narrowing in the current account deficit for the second consecutive quarter after a sharp widening in Q1. The expected deficit would equate to 3.3% of GDP, narrower than readings in excess of 4% in the past two quarters but still much wider than the range of 1.8% to 2.5% in the years leading up to the pandemic.
Existing Home Sales (November) (Wednesday)	**4.30 Million (-2.9%)**	Mortgage rates above 7% in November raise the possibility of the ninth consecutive decline in existing home sales, a view supported by weakness in pending sales of existing homes.
Conference Board Consumer Confidence (December) (Wednesday)	**100.0 (-0.2%)**	Strain on household budgets from rapid inflation in the costs of essentials and increased media coverage of a possible recession next year suggest that consumer confidence could remain subdued in December.
Revised GDP (22-Q3) (Thursday)	**3.0% (+0.1 Pct. Pt. Revision)**	Data received in the past month suggests that the final tally of GDP growth for Q3 is likely to be a touch firmer than the second estimate, with consumer spending slightly stronger and business related construction less of a drag than previously estimated.
Leading Indicators (November) (Thursday)	**-0.5%**	Negative contributions from consumer expectations and the ISM new orders index should offset a positive contribution from stock prices. The expected decline in November would mark the ninth consecutive easing.
Personal Income, Consumption, Core Price Index (November) (Friday)	**0.3%, 0.2%, 0.2%**	Data on average hourly earnings and workweeks suggest a moderate increase in wages and salaries. Increases in rental income have slowed since the beginning of the year, but they remain in positive territory. On the spending side, a decline in new vehicle sales could restrain outlays for durable goods, and a soft performance in key retail categories points to weak spending on nondurable items. Outlays for services have been firm in most months this year. Restrained readings on the CPI suggest tame advances in both the headline and core PCE price indexes.
Durable Goods Orders (November) (Friday)	**-1.0%**	Easing in both civilian and defense-related aircraft orders after firm readings in October could constrain headline durable goods orders in November. Uncertainty about the economic outlook could weigh on bookings in other areas, but higher prices in some categories could leave the value of orders ex transportation little changed.
New Home Sales (November) (Friday)	**0.600 Million (-5.1%)**	Despite a drop in affordability, sales of new homes have increased in two of the past three months. However, we suspect that random volatility is a factor, with a decline in buyer traffic suggesting a resumption of the downward trend in November.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

December 2022 / January 2023

Monday 12

FEDERAL BUDGET

	2022	2021
Sep	-$429.7B	-$64.9B
Oct	-$87.9B	-$165.1B
Nov	-$248.5B	-$191.3B

Tuesday 13

NFIB SMALL BUSINESS OPTIMISM INDEX

Sep	92.1
Oct	91.3
Nov	91.9

CPI

	Total	Core
Sep	0.4%	0.6%
Oct	0.4%	0.3%
Nov	0.1 %	0.2%

Wednesday 14

IMPORT/EXPORT PRICES

	Non-petrol. Imports	Nonagri. Exports
Sep	-0.3%	-1.0%
Oct	-0.2%	-0.3%
Nov	-0.3%	-0.6%

FOMC MEETING

50 basis point hike

Thursday 15

UNEMP. CLAIMS

	Initial (millions)	Continuing
Nov 19	0.241	1.609
Nov 26	0.226	1.670
Nov 3	0.231	1.671
Dec 10	0.211	N/A

RETAIL SALES

	Total	Ex.Autos
Sep	-0.2%	-0.1%
Oct	1.3%	1.2%
Nov	-0.6%	-0.2%

EMPIRE MFG

Oct	-9.1
Nov	4.5
Dec	-11.2

PHILADELPHIA FED MFG BUSINESS OUTLOOK

Oct	-8.7
Nov	-19.4
Dec	-13.8

IP & CAP-U

	IP	Cap.Util.
Sep	0.4%	80.1%
Oct	-0.1%	79.9%
Nov	-0.2%	79.7%

BUSINESS INVENTORIES

	Inventories	Sales
Aug	0.9%	0.3%
Sep	0.2%	0.0%
Oct	0.3%	0.8%

TIC FLOWS

	Long-Term	Total
Aug	$198.3B	$276.9B
Sep	$117.7B	$30.4B
Oct	$67.8B	$179.9B

Friday 16

Monday 19

NAHB HOUSING INDEX (10:00)

Oct	38
Nov	33
Dec	--

Tuesday 20

HOUSING STARTS (8:30)

Sep	1.488 million
Oct	1.425 million
Nov	**1.400 million**

Wednesday 21

CURRENT ACCOUNT (8:30)

22-Q1	-$282.5 bill.
22-Q2	-$251.1 bill.
22-Q3	**-$210.0 bill.**

EXISTING HOME SALES (10:00)

Sep	4.71 million
Oct	4.43 million
Nov	**4.30 million**

CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)

Oct	102.2
Nov	100.2
Dec	**100.0**

Thursday 22

UNEMP. CLAIMS (8:30)

REVISED GDP (8:30)

	GDP	Chained Price
22-Q2	-0.6%	9.0%
22-Q3(p)	2.9%	4.3%
22-Q3(r)	**3.0%**	**4.3%**

CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)

	Monthly	3-Mo. Avg.
Sep	0.17	0.19
Oct	-0.05	0.09
Nov	--	--

LEADING INDICATORS (10:00)

Sep	-0.5%
Oct	-0.8%
Nov	**-0.5%**

Friday 23

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

	Inc.	Cons.	Core
Sep	0.4%	0.6%	0.5%
Oct	0.7%	0.8%	0.2%
Nov	**0.3%**	**0.2%**	**0.2%**

DURABLE GOODS ORDERS (8:30)

Sep	0.2%
Oct	1.1%
Nov	**-1.0%**

NEW HOME SALES (10:00)

Sep	0.588 million
Oct	0.632 million
Nov	**0.600 million**

CONSUMER SENTIMENT (10:00)

Oct	59.9
Nov	56.8
Dec(p)	59.1

Monday 26

CHRISTMAS HOLIDAY

Tuesday 27

INTERNATIONAL TRADE IN GOODS

ADVANCE INVENTORIES

FHFA HOME PRICE INDEX

S&P CORELOGIC HOME PRICE INDEX

Wednesday 28

PENDING HOME SALES

Thursday 29

UNEMP. CLAIMS

Friday 30

MNI CHICAGO BUSINESS BAROMETER

Monday 2

NEW YEAR'S HOLIDAY

Tuesday 3

CONSTRUCTION

Wednesday 4

ISM MANUFACTUTING

JOLTS

FOMC MINUTES

VEHICLE SALES

Thursday 5

UNEMP. CLAIMS

ADP EMPLOYMENT

INTERNATIONAL TRADE BALANCE

Friday 6

EMPLOYMENT REPORT

ISM SERVICES

FACTORY ORDERS

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

Treasury Financing

December 2022 / January 2023

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
AUCTION RESULTS: Rate Cover 13-week bills 4.270% 2.51 26-week bills 4.630% 2.66 3-yr notes 4.093% 2.55 10-yr notes 3.625% 2.31	**AUCTION RESULTS:** Rate Cover 30-yr bonds 3.513 % 2.25 **ANNOUNCE:** $45 billion 4-week bills for auction on Dec 15 $45 billion 8-week bills for auction on Dec 15 $33 billion 17-week bills for auction on Dec 14 **SETTLE:** $45 billion 4-week bills $45 billion 8-week bills $33 billion 17-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 4.440% 2.96	**AUCTION RESULTS:** Rate Cover 4-week bills 3.780% 3.16 8-week bills 4.060% 2.72 **ANNOUNCE:** $99 billion 13-,26-week bills for auction on Dec 19 $12 billion 20-year bonds for auction on Dec 21 $19 billion 5-year TIPS for auction on Dec 22 **SETTLE:** $99 billion 13-,26-week bills $40 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds	
19	20	21	22	23
AUCTION: $99 billion 13-,26-week bills	**ANNOUNCE** $45 billion* 4-week bills for auction on Dec 22 $45 billion* 8-week bills for auction on Dec 22 $33 billion* 17-week bills for auction on Dec 21 **SETTLE:** $45 billion 4-week bills $45 billion 8-week bills $33 billion 17-week bills	**AUCTION:** $33 billion* 17-week bills $12 billion 20-year bonds	**AUCTION:** $45 billion* 4-week bills $45 billion* 8-week bills $19 billion 5-year TIPS **ANNOUNCE:** $99 billion* 13-,26-week bills for auction on Dec 27 $34 billion* 52-week bills for auction on Dec 27 $42 billion* 2-year notes for auction on Dec 27 $43 billion* 5-year notes for auction on Dec 28 $35 billion* 7-year notes for auction on Dec 29 $22 billion* 2-year FRNs for auction on Dec 28 **SETTLE:** $99 billion 13-,26-week bills	
26	27	28	29	30
CHRISTMAS HOLIDAY	**AUCTION:** $99 billion* 13-,26-week bills $34 billion* 52-week bills $42 billion* 2-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on Dec 29 $45 billion* 8-week bills for auction on Dec 29 $33 billion* 17-week bills for auction on Dec 28 **SETTLE:** $45 billion* 4-week bills $45 billion* 8-week bills $33 billion* 17-week bills	**AUCTION:** $33 billion* 17-week bills $43 billion* 5-year notes $22 billion* 2-year FRNs	**AUCTION:** $45 billion* 4-week bills $45 billion* 8-week bills $35 billion* 7-year notes **ANNOUNCE:** $99 billion* 13-,26-week bills for auction on Jan 3 **SETTLE:** $99 billion* 13-,26-week bills $34 billion* 52-week bills	**SETTLE:** $19 billion 5-year TIPS $22 billion* 2-year FRNs
2	3	4	5	6
NEW YEAR'S HOLIDAY	**AUCTION:** $99 billion* 13-,26-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on Jan 5 $45 billion* 8-week bills for auction on Jan 5 $33 billion* 17-week bills for auction on Jan 4 **SETTLE:** $45 billion* 4-week bills $45 billion* 8-week bills $33 billion* 17-week bills $42 billion* 2-year notes $43 billion* 5-year notes $35 billion* 7-year notes $12 billion 20-year bonds	**AUCTION:** $33 billion* 17-week bills	**AUCTION:** $45 billion* 4-week bills $45 billion* 8-week bills **ANNOUNCE:** $99 billion* 13-,26-week bills for auction on Jan 9 $40 billion* 3-year notes for auction on Jan 10 $32 billion* 10-year notes for auction on Jan 11 $18 billion* 30-year bonds for auction on Jan 12 **SETTLE:** $99 billion* 13-,26-week bills	

*Estimate