Daiwa Capital Markets

U.S. Economic Comment

- Tight monetary policy begins to bite
- A defense for the debt ceiling

Michael Moran
Lawrence Werther
Daiwa Capital Markets America
michael.moran@us.daiwacm.com
lawrence.werther@us.daiwacm.com

Signs of Slower Economic Growth

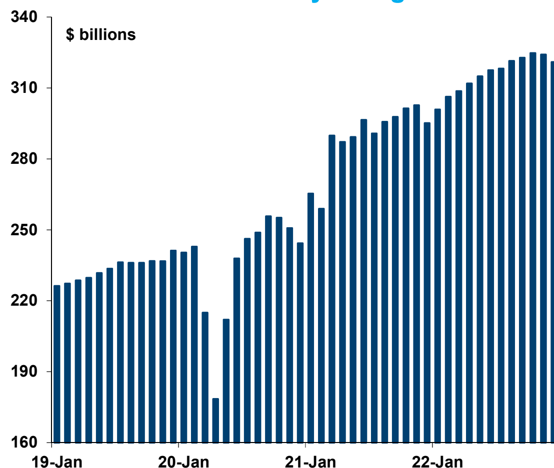
Market participants reacted strongly to a weak report on retail sales for December, sending both interest rates and stock prices lower. The market shifts seemed warranted, as the new figures suggested that consumers have become cautious in their spending, which could easily (and most likely will) push the economy into recession.

The retail figures showed a sizeable decline overall in December (-1.1 percent), and downwardly revised figures for November indicated notable weakness as well (-1.0 percent). Some of the softness was the result of lower prices of gasoline and a drop in the volatile auto component, but other areas also showed weak spending. Perhaps the most telling result was the second consecutive decline in a grouping of vendors that deal primarily with discretionary spending. This retreat ended a string of 10 consecutive gains, suggesting that consumers are starting to rethink their spending patterns (chart, left).

Market participants did not seem to pay as much attention to the report on industrial production, but we view these figures as equally insightful as those on retail sales. The manufacturing component of IP, like many figures in the retail sales report, fell for the second consecutive month, interrupting (perhaps ending) an irregular but distinct upward trend (chart, right).

Investors and traders probably focused less on the IP report because industrial activity is now a small share of the economy (approximately 11 percent). However, it is still a highly cyclical sector, and thus can provide a useful perspective on the economy. We have seen ups and downs in this sector in the past two years, but the shifts in November and December were the most pronounced on the downside, perhaps signaling a turn in the economy.

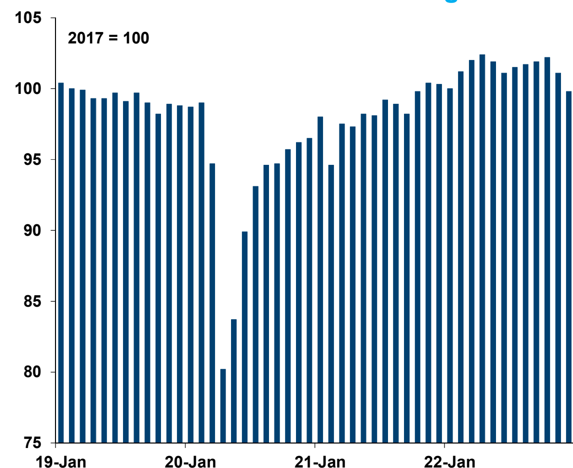
Retail Sales: Discretionary Categories*



** Discretionary categories include: furniture & home furnishing stores; electronics & appliance stores; clothing & accessory stores; sporting goods, hobby, book & music stores; general merchandise stores; restaurants & bars; nonstore retailers (online, catalog, and fuel oil dealers).*

Sources: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

Industrial Production: Manufacturing



Source: Federal Reserve Board via Haver Analytics

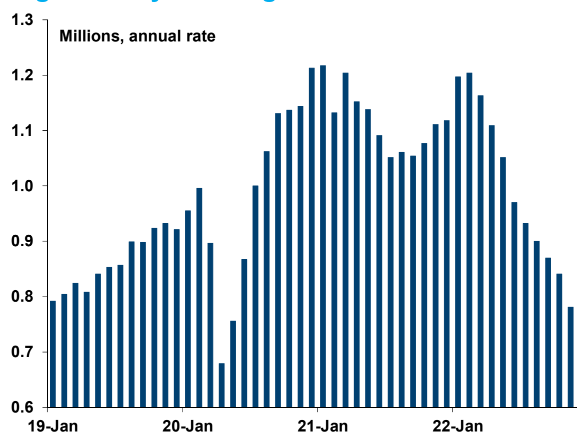
This report is issued by Daiwa Securities Group Inc. through its relevant group companies. Daiwa Securities Group Inc. is the global brand name of Daiwa Securities Co. Ltd., Tokyo ("Daiwa Securities") and its subsidiaries worldwide that are authorized to do business within their respective jurisdictions. 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.

The regional manufacturing indexes published by some Federal Reserve Banks also lead one to wonder about the factory sector. Measures from both the New York and Philadelphia Feds showed notable declines in recent months (especially January). These figures should be interpreted cautiously because they are highly volatile, but we shouldn't ignore them. Given the soft performance in industrial production, they probably have some signal value in this instance. Sub-50 readings on the ISM manufacturing index for November and December also suggest a turn in this cyclical sector.

The housing sector, in response to higher interest rates, is well into a downward cycle, and the information released this week suggested that a bottom is not on the horizon. Sales of existing homes continued to move along a downward trend in December, falling 1.5 percent. The drop was less than expected, but it was still enough to signal continued retreat in housing.

The report on housing starts seemed to contain good news with an increase of 11.3 percent in single-family activity. However, we suspect that the gain involved a good bit of random volatility, as building permits continued to move lower, with the 6.5 percent drop in authorizations marking the 10th consecutive decline. Permits tend to be more stable than starts and provide a clearer view on underlying trends, and this trend is decidedly downward (chart).

Single-Family Building Permits



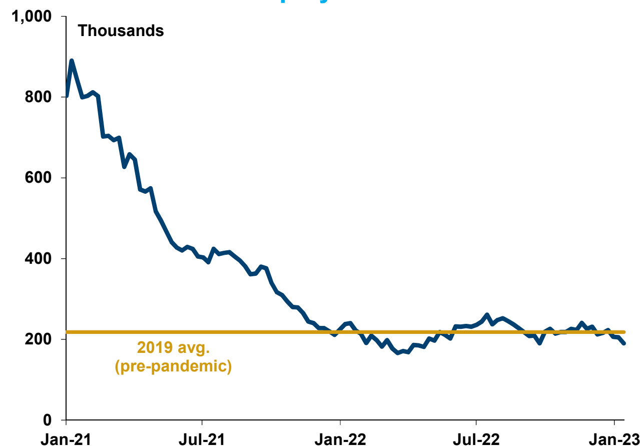
Source: U.S. Census Bureau via Haver Analytics

Permits in the multi-family sector also were unsettling. Although authorizations rose 5.3 percent in December, they fell nearly 18 percent over the prior two months, leaving results in the past two months in the low end of the range from the past two years. Multi-family construction was generally strong in 2022, but recent figures on permits lead us to wonder if activity has peaked.

We suspect that the soft results noted above, along with calmer inflation statistics, will lead Fed officials to slow the pace of tightening further at the FOMC meeting on February 1, stepping back to a change of 25 basis points rather than 50. Some observers might be looking for a pause at the next meeting, believing that the lagged effects of past changes will be sufficient to push inflation back to two percent. However, a high hurdle standing in the way of a pause is the still-strong labor market.

Initial claims for unemployment insurance historically have been a reliable indicator of shifting trends in the labor market, and thus far in the current cycle, they have been unwavering. Early last year, claims eased into the low range seen before the onset of Covid, and they have shown only modest fluctuations since then. The past few readings were in the low end of the tight range (chart).

Initial Claims for Unemployment Insurance



Source: U.S. Department of Labor via Haver Analytics

Steady readings on unemployment claims are surprising given the announcements of layoffs by large businesses. Part of the disconnect most likely reflects the fact that announcements represent "plans" and those plans are often implemented over time and perhaps not fulfilled

in total. Alternatively, it might be that media coverage of layoffs that has picked up rather than actual job cuts. With monetary policy now notably tighter than it was, and with many forecasters expecting recession, news outlets are naturally more focused on the issue.

Whatever lies behind low unemployment claims, they support the view that businesses are reluctant to trim payrolls and that the labor market remains tight. Fed officials see notable inflation risks from brisk wage growth in such a market, and thus they will probably be seeking additional cooling in the economy.

The Debt Ceiling

Here we go again! With the settlement of seven new securities on Thursday, the Treasury has essentially reached the Congressionally mandated debt ceiling of $31.381 trillion (0.1 percent below at $31.342 trillion). Reaching the ceiling will not have immediate consequences because the Treasury Department will temporarily redeem certain nonmarketable debt securities issued to government agencies and suspend new investments into such securities. These so-called extraordinary measures will open room under the ceiling and allow the government to operate as normal until the early summer.

As noted in the widespread media coverage of this issue, failure by Congress to increase the ceiling in a timely manner would have severe consequences for financial markets and the economy. However, this is a low probability event. We have seen numerous instances of debt-ceiling constraints, and they have all ended in the same way: Congress has kicked this political football around until the 11th hour, but it has always raised or suspended the ceiling to avoid catastrophe. The only notable fallout occurred in 2011, when uncertainty about the ceiling led Standard & Poor’s to reduce the credit rating of the United States from AAA to AA+.

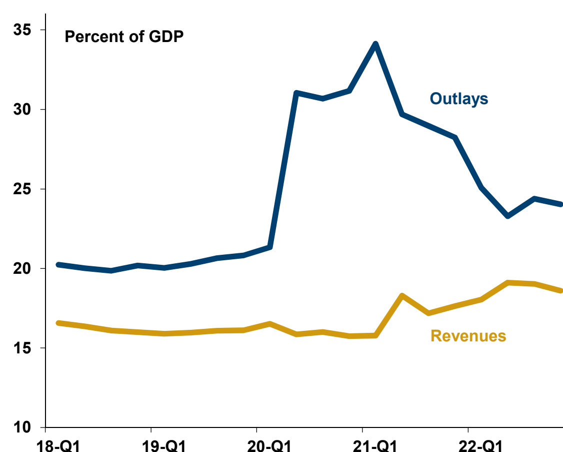
The political machinations have led many observers to call for the abolishment of the debt ceiling. They argue that the political brinkmanship that arises during these episodes creates uncertainty and usually fails to generate notable fiscal improvement. We are sympathetic to this dim view on the value of the debt ceiling, but we also see a benefit.

The debt ceiling debate will at least force members of Congress to think about fiscal responsibility and the merits of their taxing and spending plans. In addition, it will provide the public with information on the financial position of the government, which will allow for informed voting.

The current situation represents a good example of the benefits that might arise from the debt ceiling. The federal budget deficit could be viewed as uncomfortably wide. It has eased from the pandemic-related surges in fiscal years 2020 and 2021, but it remained elevated in FY2022 ($1.375 trillion or 5.5 percent of GDP). Recent figures show possible further widening in the current fiscal year. The budget shortfall in the first quarter of the current fiscal year widened by $43 billion from the same period in FY2022 ($421 billion versus $378 billion; the shortfall would have been $63 billion wider were it not for a calendar configuration that shifted some outlays scheduled for October into September, the final month of FY2022).

The slippage in the underlying budget position has occurred on the spending side. Revenues as a share of GDP have shown only moderate variation in the past few years and are slightly larger than they were before the pandemic.

Federal Revenues & Outlays*



** Four-quarter moving averages of outlays and revenues as a share of nominal GDP (de-annualized). The GDP reading for 2022-Q4 is an estimate by Daiwa Capital Markets America.*

Sources: Bureau of Economic Analysis and U.S. Treasury Department via Haver Analytics; Daiwa Capital Markets America

Outlays, in contrast, while down substantially from Covid-driven spending in FY2020-21, are noticeably wider than they were before 2020 (24 percent of GDP versus 21 percent pre-pandemic; chart, prior page).

Spending adjustments are now under discussion, and we suspect that serious consideration of changes would not be on the table in the absence of the debt ceiling. Those favoring spending cuts might not succeed, but they are at least having their case heard.

The Biden Administration and others argue that increasing the debt ceiling should not be held conditional on other changes, such as spending reductions. We would argue the opposite. The purpose of the debt ceiling is to induce members of Congress to assess their spending and taxing programs and to make adjustments to keep the government on a sound fiscal path. Allowing unconditional passage, or abolishing the ceiling entirely, amounts to discarding one form of fiscal discipline.

Review

Week of Jan. 16, 2023	Actual	Consensus	Comments
Retail Sales (December)	**-1.1% Total, -1.1% Ex. Autos**	**-0.9% Total, -0.5% Ex. Autos**	Consumers exercised broad restraint in goods outlays in December, as retail sales declined approximately 1.0% for the second consecutive month. Much of the softness in December came in the auto and gasoline components (off 1.2% and 4.6%, respectively). The declines were well anticipated because of a drop in sales of new cars and light trucks and because of lower gasoline prices. Activity elsewhere also was soft, with most categories declining and leaving a drop of 0.7% excluding autos and gasoline.
PPI (December)	**-0.5% Total, 0.1% Ex. Food & Energy**	**-0.1% Total, 0.1% Ex. Food & Energy**	Prices of food and energy played a key role in constraining the headline PPI in December, with a plunge of 7.9% in energy standing out on the soft side. Food prices fell 1.2%, but the drop offset only a portion of a 3.3% surge in the prior month and left a still-pronounced upward trend. Growth in prices excluding food and energy slowed to an average of 0.25% in the past six month after registering a monthly average of 0.67% in H1.
Industrial Production (December)	**-0.7%**	**-0.1%**	The manufacturing component led the decline in industrial production in December with a drop of 1.3%. Weakness was broadly based, with 17 of 20 industrial categories posting declines. The latest drop, which joined a sizable retreat in November, suggested that the factory sector may be in retreat. The mining area also was soft, falling 1.0% after easing in the prior two months. The utility sector partially offset the weakness in manufacturing and mining with an increase of 3.8%, but changes in utility production are nearly always a function of the weather rather than economic fundamentals.
Housing Starts (December)	**1.382 Million (-1.4%)**	**1.358 Million (-4.8%)**	All of the decline in housing starts in December occurred in the multi-family area (off 19.0%), which had been strong for much of 2022 as elevated prices and interest rates forced many potential home buyers into the rental market. However, this area may have peaked, as multi-family permits in the past three months have moved to the bottom of the range of the past two years. Single-family starts rose 11.3%, but the change occurred from a low level and the number of new starts remained near the bottom of the range of the current expansion. The pickup in December likely reflected random volatility rather than a fundamental improvement, a view supported by a weak reading on permits (off 6.5%, marking the 10th consecutive decline).
Existing Home Sales (December)	**4.02 Million (-1.5%)**	**3.95 Million (-3.4%)**	The drop in existing home sales in December marked the 11th consecutive decline, with the level of 4.02 million units (annual rate) falling below the recent low of 4.07 million in May 2020, when pandemic-related lockdowns choked activity. The December reading was not a record low, but one has to go back to the years following the housing bust and financial crisis to see softer results.

Sources: U.S. Census Bureau (Retail Sales, Housing Starts); Bureau of Labor Statistics (PPI); Federal Reserve Board (Industrial Production); National Association of Realtors (Existing Home Sales); Consensus forecasts are from Bloomberg

Preview

Week of Jan. 23, 2023	Projected	Comments
Leading Indicators (December) (Monday)	**-0.7%**	Negative contributions from the ISM new orders index, the factory workweek, and consumer expectations should offset a positive contribution from a low level of initial claims for unemployment insurance. The expected decline in December would mark the 10th consecutive easing.
GDP (2022-Q4) (Thursday)	**2.5%**	Available data suggest that consumer spending made a solid contribution to GDP growth in Q4, with business equipment spending and inventory investment expected to contribute positively as well. The boosts from these firm areas are likely to be partially offset by weak construction activity (both residential and business-related) and slippage in net exports. The soft performance in the trade sector reflects sluggish economic activity abroad and lagged effects of a strong foreign exchange value of the dollar.
International Trade in Goods (December) (Thursday)	**-$87.0 Billion ($4.1 Billion Wider Deficit)**	Lower prices of petroleum products could reduce the value of exported industrial supplies in December, and a strong foreign exchange value of the dollar and slow growth abroad could constrain foreign shipments. On the import side, consumer goods and autos posted unusually soft results in November (off 12.8% and 9.2% respectively), raising the possibility rebounds in December. On balance, the projected sluggish performance in exports and rebound in imports suggest a widening in the monthly goods trade deficit.
Durable Goods Orders (December) (Thursday)	**1.5%**	Firm orders reported by Boeing rise the possibility of a jump in civilian aircraft bookings in December after a drop in the prior month. Uncertainty about the economic outlook could constrain orders in other categories, but higher prices in some areas could leave the value of orders excluding transportation little changed.
New Home Sales (December) (Thursday)	**0.610 Million (-4.7%)**	Although sales of new homes increased in October and November, the moves represented only moderate changes from a low level; activity remained in the low end of the range from the past two years. Sluggish buyer traffic in December suggests that some of the October-November gains will be reversed.
Personal Income, Consumption, Core Price Index (December) (Friday)	**0.2%, 0.0%, 0.2%**	Data on average hourly earnings and worktimes suggest a modest increase in wages and salaries. Higher interest rates could give a boost to investment income. A soft performance in retail spending suggests a drop in outlays for nondurable items, and a decline in vehicle sales implies that outlays for durable goods also are likely to be weak. Nominal spending on services has been firm in most months this year, which could provide an offset and leave total consumer spending unchanged. Lower energy prices should offset a pickup in food prices and leave the headline PCE price index unchanged in December. Results from the CPI suggest that the advance in the core PCE price index will be closer to the average of 0.2% in the past two months than to the average of 0.4% in the first nine months of 2022.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2023

Monday	Tuesday	Wednesday	Thursday	Friday
16	17	18	19	20
MARTIN LUTHER KING JR. DAY	**EMPIRE MFG** Nov 4.5 Dec -11.2 Jan -32.9	**RETAIL SALES** Total / Ex.Autos Oct 1.1% 1.0% Nov -1.0% -0.6% Dec -1.1% -1.1% **PPI** Final Demand / Ex. Food & Energy Oct 0.4% 0.2% Nov 0.2% 0.2% Dec -0.5% 0.1% **IP & CAP-U** IP / Cap.Util. Oct 0.0% 80.0% Nov -0.6% 79.4% Dec -0.7% 78.8% **BUSINESS INVENTORIES** Inventories / Sales Sep 0.2% 0.0% Oct 0.2% 0.4% Nov 0.4% -0.8%	**UNEMP. CLAIMS** Initial / Continuing (millions) Dec 24 0.223 1.697 Dec 31 0.206 1.630 Jan 7 0.205 1.647 Jan 14 0.190 N/A **HOUSING STARTS** Oct 1.426 million Nov 1.401 million Dec 1.382 million **PHILADELPHIA FED MFG INDEX** Nov -15.5 Dec -13.7 Jan -8.9	**EXISTING HOME SALES** Oct 4.43 million Nov 4.08 million Dec 4.02 million
23	24	25	26	27
LEADING INDICATORS (10:00) Oct -0.9% Nov -1.0% **Dec -0.7%**			**UNEMP. CLAIMS (8:30)** **GDP (8:30)** GDP / Chained Price 22-Q2 -0.6% 9.0% 22-Q3 3.2% 4.4% **22-Q4 2.5% 4.5%** **INTERNATIONAL TRADE IN GOODS (8:30)** Oct -$98.6 billion Nov -$82.9 billion **Dec -$87.0 billion** **DURABLE GOODS ORDERS (8:30)** Oct 0.7% Nov -2.1% **Dec 1.5%** **ADVANCE INVENTORIES (8:30)** Wholesale / Retail Oct 0.6% -0.4% Nov 1.0% 0.1% Dec -- -- **CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)** Monthly / 3-Mo. Avg. Oct -0.05 0.09 Nov N/A N/A Dec -- -- **NEW HOME SALES (10:00)** Oct 0.605 million Nov 0.640 million **Dec 0.610 million**	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Oct 0.7% 0.9% 0.3% Nov 0.4% 0.1% 0.2% **Dec 0.2% 0.0% 0.2%** **REVISED CONSUMER SENTIMENT (10:00)** Nov 56.8 Dec 59.7 Jan(p) 64.6 **PENDING HOME SALES (10:00)** Sep -4.7% Oct -4.0% Nov --
30	31	1	2	3
	EMP. COST INDEX **FHFA HOME PRICE INDEX** **CASE-SHILLER HOME PRICE INDEX** **MNI CHICAGO BUSINESS BAROMETER** **CONSUMER CONFIDENCE** **FOMC (1ST DAY)**	**ADP EMP. REPORT** **JOLTS** **ISM MFG. INDEX** **CONSTRUCTION** **VEHICLE SALES** **FOMC DECISION**	**UNEMP. CLAIMS** **PRODUCTIVITY & COSTS** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **ISM SERVICES INDEX**
6	7	8	9	10
	TRADE BALANCE **CONSUMER CREDIT**	**WHOLESALE TRADE**	**UNEMP. CLAIMS**	**CONSUMER SENTIMENT** **FEDERAL BUDGET**

Forecasts in Bold. (p) = preliminary

Treasury Financing

January/February 2023

Monday	Tuesday	Wednesday	Thursday	Friday
16	17	18	19	20
MARTIN LUTHER KING JR. DAY	**AUCTION RESULTS:** Rate Cover 13-week bills 4.560% 2.69 26-week bills 4.685% 2.68 **ANNOUNCE:** $70 billion 4-week bills for auction on Jan 19 $60 billion 8-week bills for auction on Jan 19 $36 billion 17-week bills for auction on Jan 18 $60 billion 44-day CMBs for auction on January 19 **SETTLE:** $60 billion 4-week bills $55 billion 8-week bills $36 billion 17-week bills $40 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 17-week bills 4.610% 2.97 20-yr bonds 3.678% 2.83	**AUCTION RESULTS:** RateCover 4-week bills 4.480% 2.41 8-week bills 4.520% 2.53 10-year TIPS 1.220% 2.79 44-day CMB 4.525% 2.85 **ANNOUNCE:** $108 billion 13-,26-week bills for auction on Jan 23 $34 billion 52-week bills for auction on Jan 24 $24 billion 2-year FRNs for auction on Jan 25 $42 billion 2-year notes for auction on Jan 24 $43 billion 5-year notes for auction on Jan 25 $35 billion 7-year notes for auction on Jan 26 **SETTLE:** $108 billion 13-,26-wk bills $60 billion 35-day CMB	
23	24	25	26	27
AUCTION: $108 billion 13,26-week bills	**AUCTION:** $34 billion 52-week bills $42 billion 2-year notes **ANNOUNCE:** $70 billion* 4-week bills for auction on Jan 26 $60 billion* 8-week bills for auction on Jan 26 $36 billion* 17-week bills for auction on Jan 25 **SETTLE:** $70 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills $60 billion 44-day CMBs	**AUCTION:** $36 billion* 17-week bills $24 billion 2-year FRNs $43 billion 5-year notes	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills $35 billion 7-year notes **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Jan 30 **SETTLE:** $108 billion 13-,26-week bills $34 billion 52-week bills	
30	31	1	2	3
AUCTION: $108 billion* 13-,26-week bills	**ANNOUNCE:** $70 billion* 4-week bills for auction on Feb 2 $60 billion* 8-week bills for auction on Feb 2 $36 billion* 17-week bills for auction on Feb 1 **SETTLE:** $70 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills $12 billion 20-year bonds $17 billion 10-year TIPS $24 billion 2-year FRNs $42 billion 2-year notes $43 billion 5-year notes $35 billion 7-year notes	**AUCTION:** $36 billion* 17-week bills **ANNOUNCE:** $40 billion* 3-year notes for auction on Feb 7 $35 billion* 10-year notes for auction on Feb 8 $21 billion* 30-year bonds for auction on Feb 9	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 6 **SETTLE:** $108 billion* 13-,26-wk bills	
6	7	8	9	10
AUCTION: $108 billion* 13-,26-week bills	**AUCTION:** $40 billion* 3-year notes **ANNOUNCE:** $70 billion* 4-week bills for auction on Feb 9 $60 billion* 8-week bills for auction on Feb 9 $36 billion* 17-week bills for auction on Feb 8 **SETTLE:** $70 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $35 billion* 10-year notes	**AUCTION:** $70 billion* 4-week bills $60 billion* 8-week bills $21 billion* 30-year bonds **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 13 $15 billion* 20-year bonds for auction on Feb 15 $9 billion* 30-year TIPS for auction on Feb 16 **SETTLE:** $108 billion* 13-,26-week bills	

**Estimate*