Daiwa Capital Markets

U.S. Economic Comment

- Productivity: the neglected piece of the inflation puzzle
- What was Powell's message?
- The strong (even remarkable) labor market

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Productivity: Back on Pre-Covid Trend?

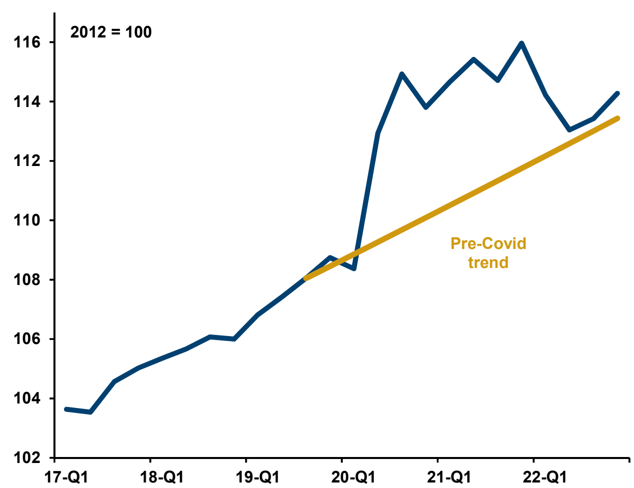
Financial market participants and Fed officials have been focusing on labor market conditions and wage growth to assess the likely path of inflation. But the degree of slack in the labor market and the resulting pressure on wages is only part of the inflation story. Labor productivity also is relevant. Businesses could grant healthy increases in wages without price consequences if productivity is strong; alternatively, even modest wage growth could stir inflation if the productivity performance is poor.

Unfortunately, the productivity picture has been muddled in the past few years. Businesses registered remarkable gains in efficiency in the early stages of the current expansion, but productivity tumbled in the first half of last year before retracing some of that swoon in the second half of 2022, especially the fourth quarter, which registered growth of 3.0 percent (annual rate). The chart below shows the level of the index of labor productivity; note the large step up in 2020-Q2 and the additional gain in Q3. Since then, productivity has shown little net change.

This unusual pattern – a surge followed by a stalling (even a decline) – most likely was related to the pandemic. Layoffs associated with Covid probably involved a disproportionate share of workers in low-productivity jobs (e.g. restaurant staff, live entertainers), and the reduction of such jobs would naturally boost the average among those still working. In addition, shifts in business models for occupations amenable to remote working probably generated efficiency gains. Once working conditions gravitated toward pre-Covid norms, these spurs to productivity began to fade or reverse, leading to a weak productivity performance in the first half of last year.

With the ups and downs to productivity generated by the pandemic largely faded, productivity might be returning to the pre-Covid trend. We suspect this is the case, but we wonder about the magnitude of productivity growth before the onset of the pandemic. The performance from mid-2017 through 2019 was quite good (average growth of approximately 2.0 percent). However, productivity growth often moves in fits and starts, and thus such a burst might not be a good representation of underlying trend. In this regard, results in the middle years of the previous expansion typically registered gains of less than 1.0 percent. A safe middle ground might be a trend of 1.5 percent (the extrapolated trend line in the chart is based on growth of 1.5 percent from the average level in the second and third quarters of 2019).

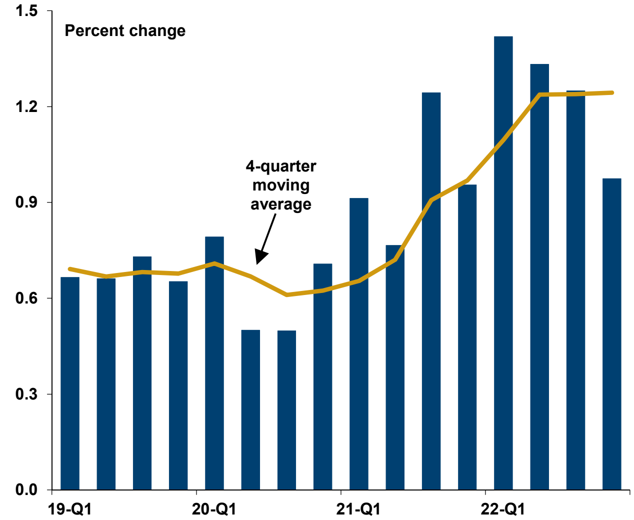
Nonfarm Productivity*



** The pre-Covid trend is based on annual growth of 1.5 percent.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

Productivity is perhaps back on track, but it might not be strong enough to counter wage pressure generated by a tight labor market. This past week brought a new reading for the employment cost index, the best measure of labor compensation in the U.S. The fourth quarter showed an increase of 1.0 percent (annual rate of 4.0 percent). If productivity is growing at an average rate of 1.5 percent, businesses would still be hoping to boost prices by 2.5 percent to cover effective employment costs.

Employment Cost Index



Source: Bureau of Labor Statistics via Haver Analytics

This set of figures suggests that employment costs are not consistent with the Fed's two percent inflation target, but there are lots of moving parts. Productivity could be stronger or weaker than the assumed 1.5 percent, and employment costs can fluctuate as well. It would not be shocking to see the employment cost index step higher given recent firm readings on the labor market (discussed below).

The Press Briefing: Clear Comments, Muddled Interpretation

The press briefing of Chair Powell this week lent itself to various interpretations. There were hawkish elements and dovish elements. Observers could draw whatever conclusion they wished; listeners could hear what they wanted to hear.

Market participants took a positive view, one consistent with the Federal Open Market Committee pivoting toward lower interest rates later this year. Investors and traders apparently seized on Mr. Powell's comment that "the disinflationary process has started". The Fed Chair also opened the possibility of rate cuts this year if inflation were to recede quickly: "If we do see inflation coming down much more quickly [than we expect], that will play into our policy setting of course."

While Mr. Powell made a few market friendly statements, we viewed his briefing in total as still hawkish. While he noted that the disinflationary process has started, he also emphasized that the process was in its early stages and that inflation is "still running very hot" especially for core services ex-housing.

Mr. Powell opened a door to possible easing this year, but he apparently sees that as a low probability event. He indicated that the Fed would need to see substantially more evidence of favorable developments before officials became convinced that inflation is on a path to two percent. In addition, he expects the path to two percent to be gradual ("moving down steadily but not quickly"). In such an environment, "it will not be appropriate to cut rates this year".

While we viewed Mr. Powell's comments as hawkish, we were not especially surprised by the favorable market reaction (lower interest rates and higher stock prices). Over the past several months, futures contracts on federal funds have shown the expectation of a pivot toward lower rates in the second half of the year. Given such a consensus, the majority of market participants naturally focused on the dovish elements of the press briefing and pushed asset values higher. Adjustments will be necessary if Mr. Powell's view of gradual inflation improvement and an extended period of restrictive policy come to pass. In fact, the market gave back some of the post-FOMC changes in response to the strong employment report.

Still-Strong Labor Market

Chair Powell, in his prepared remarks at the press briefing, noted that “the labor market remains extremely tight”. The employment report for January certainly bears this out. Not only was job growth in January strong (up 517,000), but revisions to previous results were substantial. The annual benchmark adjustment found that payroll totals as of March 2022 were 506,000 larger than previously believed. That is, the published monthly results from April 2021 through March 2022 undercounted changes by a cumulative total of 506,000. Using the new figures to recalibrate estimates since March led the Bureau of Labor Statistics to revise monthly estimates from April through December 2022 by 72,000 before seasonal adjustment (the adjustment on a seasonally adjusted basis totaled 245,000).

Few market participants monitor closely the length of the average workweek, but that is an important statistic because businesses can alter output substantially by adjusting work times. The economy currently employs 155 million individuals; each one working 0.1 or 0.2 hours longer will add up to a sizeable amount of production. The average workweek in January rose by 0.3 hour, an unusually large change for a single month.

Of course, the drop of 0.1 percentage point in the unemployment rate was notable, as this level was last seen in 1969 (the rate was steady at 3.4 percent from September 1968 through May 1969). One has to go back to October 1953 to find a lower rate (3.1 percent).

We also saw other strong labor market indicators this week. Job openings posted a sharp advance, and initial claims for unemployment insurance remained at rock-bottom levels. The rate of growth in the employment cost index eased in the fourth quarter, but it remained brisk at 1.0 percent.

Review

Week of Jan. 30, 2023	Actual	Consensus	Comments
Employment Cost Index (2022-Q4)	**1.0%**	**1.1%**	The jump in the employment cost index was the sixth quarterly shift of 1.0% or more (versus an average of 0.7% in the two years prior to the onset of the pandemic). On a year-over-year basis, compensation costs rose 5.1%, up one tick from the reading in Q3. Wage cost rose 1.0% in Q4, down from 1.3% in Q3 and a recent high of 1.5% in Q3 of last year, but still well above the pre-pandemic norm. Increases in benefit costs, while brisk in Q4 at 0.8%, eased for the third consecutive quarter after a surge of 1.8% in Q1.
Consumer Confidence (January)	**107.1 (-1.7%)**	**109.0 (+0.6%)**	Consumer confidence cooled in January after a jump of 7.5% in December 2022. The latest reading was up from the recent low of 95.3 in July when gasoline prices were close to $5 per gallon, but it was well below the cyclical high of 128.9 in June 2021. Despite talk of recession and job cuts in some industries, views on the labor market remained favorable. The net assessment of job availability (the share indicating that jobs were plentiful less the share indicating that jobs were hard to get) totaled 36.9%, down from the record of 47.1% in March 2022 but in the upper end of the historical range.
ISM Manufacturing Index (January)	**47.4 (-1.0 Index Pt.)**	**48.0 (-0.4 Index Pt.)**	The ISM manufacturing index remained below 50 in January for the third consecutive month after previously signaling expansion for 29 consecutive months. New orders, which eased for the fifth consecutive month, registered the sharpest drop among components in January (off 2.6 index points to 52.5). The production measure slipped 0.6 index point to 48.0, the second consecutive sub-50 reading. Employment dipped 0.2 index point to 50.6, but it remained in expansionary territory for the second consecutive month after signaling contraction from September through November 2022. The supplier deliveries component rose modestly and remained at a comfortable level (up 1.5 index points to 50.0), suggesting that supply-chain disruptions were no longer an issue.
Job Openings (December)	**11.012 Million (+5.5%)**	**10.300 Million (-1.5%)**	The number of job openings in the U.S. jumped 5.5% in December to 11.012 million. The new reading was a good bit shy of the record total of 11.855 million in March 2022, but it was still stratospheric relative to historical norms (more than 45% above the high of 7.558 million from the prior expansion).
Construction Spending (December)	**-0.4%**	**0.0%**	Private residential construction continued to move along a downward trend, falling 0.3% in December, the seventh consecutive decline, although the rate of decline has slowed from earlier in the year. The softness in the residential sector continued to be concentrated in the single-family area. Multi-family construction showed little net change in the first eight months of the year before surging in the final four months of 2022. The private nonresidential and government sectors also deteriorated in December after doing well in prior months. Private nonresidential construction fell 0.5% after averaging gains of 2.3% in the prior six months. The drop of 0.4% in the government sector stood in contrast to an average advance of 1.7% in the prior six months.

Review Continued

Week of Jan. 30, 2023	Actual	Consensus	Comments
Nonfarm Productivity (2022-Q4)	**3.0%**	**2.4%**	Productivity often moves erratically, but the pandemic has generated unusually large shifts in the past few years, surging early in the expansion and collapsing in the first half of 2022 (see the main text of the newsletter). The solid increase in Q4 put the productivity index back in line with the pre-Covid trend, raising the possibility of less variation in coming quarters and average growth of perhaps 1.5%.
Factory Orders (December)	**1.8%**	**2.3%**	The durable component accounted for all of the advance in total factory orders in December, posting an increase of 5.6%. The increase appeared impressive, but the advance was concentrated in the volatile aircraft component. Excluding aircraft (both commercial and defense), durable orders fell 0.4%, continuing a choppy pattern that has left little net change since August. Nondurable orders fell 1.9%, but the petroleum and coal category drove bookings lower with a drop of 9.6%, and this retreat was heavily influenced by lower prices (the price of West Texas intermediate oil fell 9.2 percent in December). Excluding petroleum and coal, new orders for nondurable goods rose 0.4%, ending a three-month slide. Nondurable bookings ex. petroleum and coal have moved sideways in recent months after moving along a smooth upward trend through much of 2021 and 2022.
Payroll Employment (January)	**517,000**	**188,000**	The surge in nonfarm payrolls exceeded by a wide margin the average of 291,000 in the prior three months. In addition, upward revisions to prior data were substantial. Benchmark revisions published with the January report showed that total employment as of March 2022 was 506,000 greater than previously believed. The undercount led the Bureau of Labor Statistics to re-estimate results after the March benchmark month, which added a cumulative total of 72,000 jobs from April to December 2022 (not seasonally adjusted; the revision totaled 245,000 after seasonal adjustment). Average hourly earnings rose 0.3% from an upwardly-revised reading in December (0.4% versus 0.3% first reported). The unemployment rate eased one tick in January to 3.4%.
ISM Services Index (January)	**55.2 (+6.0 Index Pts.)**	**50.5 (+1.3 Index Pts.)**	The ISM services Index jumped in January, nearly offsetting the drop in the prior month and returning the measure to the range in place in the second half of 2022. The new orders component accounted for most of the advance in the headline index, surging 15.2 points to 60.4, a reading in the upper portion of the range from the current expansion. With orders firm, the business activity index rose 6.9 points to 60.4, better than the average of 57.9 for 2022 but trailing the average of 64.5 for 2021. Although new orders and business activity increased sharply, the employment index rose only 0.6 point to 50.0. This measure has been bouncing within a range centered on 50.0 since early last year. All told, a favorable report, one that should dispel concerns that may have been generated by the 49.2 reading in December.

Sources: Bureau of Labor Statistics (Employment Cost Index, Job Openings, Nonfarm Productivity, Payroll Employment); The Conference Board (Consumer Confidence); Institute for Supply Management (ISM Manufacturing Index, ISM Services Index); U.S. Census Bureau (Construction Spending, Factory Orders) ; Consensus forecasts are from Bloomberg

Preview

Week of Feb.6, 2023	Projected	Comments
Trade Balance (December) (Tuesday)	**-$69.0 Billion ($7.5 Billion Wider Deficit)**	The widening of $7.4 billion in the goods trade deficit (published January 26th) is likely to dominate the report on total international trade for December. The surplus in service trade could cool after back-to-back increases pushed it to the top of the range of the past few years.
Consumer Sentiment (February) (Friday)	**65.5 (+0.9%)**	Gasoline prices remain below levels last fall, which has led to notable improvement in near-term views on inflation (the year-ahead inflation expectations measure published with the report eased to 3.9% in January from 5.4% last spring), which could brighten moods in early February. Also, the equity market mounted a notable recovery in the early weeks of 2023, possibly boosting sentiment. However, the recent wave of corporate layoff announcements and increased chatter about a recession in 2023 could limit the pickup in February.
Federal Budget (January) (Friday)	**-$55.0 Billion**	Available data suggest that federal revenues slipped approximately 3% on a year-over-year basis, with drops in income taxes and remittances by the Federal Reserve to the Treasury accounting for a large portion of the weakness. The federal government sometimes records a surplus in January because of estimated tax payments by individuals, but with revenues down and outlays expected to remain on their firm trajectory, the federal government is likely to register a deficit this January (versus a surplus of $118.7 billion in the same month last year).

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2023

Monday	Tuesday	Wednesday	Thursday	Friday
30	31	1	2	3
	EMPLOYMENT COST INDEX Comp. Wages 22-Q2 1.3% 1.4% 22-Q3 1.2% 1.3% 22-Q4 1.0% 1.0% **FHFA HOME PRICE INDEX** Sep 0.1% Oct 0.0% Nov -0.1% **S&P CASE SHILLER 20-CITY HOME PRICE INDEX** Sep -1.3% Oct -0.5% Nov -0.5% **MNI CHICAGO BUSINESS BAROMETER** Index Prices Nov 37.9 67.1 Dec 45.1 65.1 Jan 44.3 72.5 **CONFERENCE BOARD CONSUMER CONFIDENCE** Nov 101.4 Dec 109.0 Jan 107.1 **FOMC (1ST DAY)**	**ADP EMPLOYMENT REPORT** Private Payrolls Nov 212,000 Dec 253,000 Jan 106,000 **JOLTS DATA** Openings (000) Quit Rate Oct 10,512 2.6% Nov 10,440 2.7% Dec 11,012 2.7% **ISM MFG. INDEX** Index Prices Nov 49.0 43.0 Dec 48.4 39.4 Jan 47.4 44.5 **CONSTRUCTION** Oct 0.0% Nov 0.5% Dec -0.4% **FOMC DECISION** **VEHICLE SALES** Nov 14.3 million Dec 13.8 million Jan 15.7 million	**UNEMP. CLAIMS** Initial Continuing (millions) Jan 7 0.206 1.655 Jan 14 0.192 1.666 Jan 21 0.186 1.655 Jan 28 0.183 N/A **PRODUCTIVITY & COSTS** Productivity Unit Labor Costs 22-Q2 -4.1% 6.7% 22-Q3 0.8% 2.0% 22-Q4 3.0% 1.1% **FACTORY ORDERS** Oct 0.4% Nov -1.9% Dec 1.8%	**EMPLOYMENT REPORT** Payrolls Un. Rate Nov 290,000 3.6% Dec 260,000 3.5% Jan 517,000 3.4% **ISM SERVICES INDEX** Index Prices Nov 55.5 70.1 Dec 49.2 68.1 Jan 55.2 67.8
6	7	8	9	10
	TRADE BALANCE (8:30) Oct -\$77.8 billion Nov -\$61.5 billion **Dec -\$69.0 billion** **CONSUMER CREDIT (3:00)** Oct \$29.1 billion Nov \$28.0 billion Dec --	**WHOLESALE TRADE (10:00)** Inventories Sales Oct 0.6% 0.0% Nov 0.9% -0.6% **Dec 0.1% -0.1%**	**UNEMP. CLAIMS (8:30)**	**CONSUMER SENTIMENT (10:00)** Dec 59.7 Jan 64.9 **Feb 65.5** **FEDERAL BUDGET (2:00)** FY2023 FY2022 Nov -\$248.5B -\$191.3B Dec -\$85.0B -\$21.3B **Jan -\$55.0B** \$118.7B
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX **CPI**	**RETAIL SALES** **EMPIRE MFG. INDEX** **INDUSTRIAL PROD.** **BUSINESS INVENTORIES** **NAHB HOUSING INDEX** **TIC FLOWS**	**UNEMP. CLAIMS** **HOUSING STARTS** **PHILY FED MFG. INDEX** **PPI**	**IMPORT PRICES** **LEADING ECONOMIC INDICATORS**
20	21	22	23	24
PRESIDENTS' DAY HOLIDAY	**EXISTING HOME SALES**	**FOMC MINUTES**	**UNEMP. CLAIMS** **REVISED GDP** **CHICAGO FED NATIONAL ACTIVITY INDEX**	**PERSONAL INCOME, CONSUMPTION, PRICES** **NEW HOME SALES** **REVISED CONSUMER SENTIMENT**

Forecasts in Bold.

Treasury Financing

January/February 2023

Monday	Tuesday	Wednesday	Thursday	Friday
30	31	1	2	3
AUCTION RESULTS: Rate Cover 13-week bills 4.595% 2.47 26-week bills 4.680% 2.93	**ANNOUNCE:** $75 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:** $75 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills $12 billion 20-year bonds $17 billion 10-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 17-week bills 4.625% 2.86 **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 RESULTS:** Rate Cover 4-week bills 4.490% 2.47 8-week bills 4.505% 2.56 **ANNOUNCE:** $108 billion 13-,26-week bills for auction on Feb 6 **SETTLE:** $108 billion 13-,26-week bills	
6	7	8	9	10
AUCTION: $108 billion 13,26-week bills	**AUCTION:** $40 billion 3-year notes **ANNOUNCE:** $75 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:** $75 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:** $75 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	
13	14	15	16	17
AUCTION: $108 billion* 13,26-week bills	**ANNOUNCE:** $75 billion* 4-week bills for auction on Feb 16 $60 billion* 8-week bills for auction on Feb 16 $36 billion* 17-week bills for auction on Feb 15 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $15 billion* 20-year-bonds **SETTLE:** $40 billion 3-year notes $35 billion 10-year notes $21 billion 30-year bonds	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $9 billion* 30-year-TIPS **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 21 $34 billion* 52-week bills for auction on Feb 21 $42 billion* 2-year notes for auction on Feb 21 $43 billion* 5-year notes for auction on Feb 22 $35 billion* 7-year notes for auction on Feb 23 $22 billion* 2-year FRNs for auction on Feb 22 **SETTLE:** $108 billion* 13-,26-wk bills	
20	21	22	23	24
PRESIDENTS' DAY HOLIDAY	**AUCTION:** $108 billion* 13-,26 week bills $34 billion* 52-week bills $42 billion* 2-year notes **ANNOUNCE:** $75 billion* 4-week bills for auction on Feb 23 $60 billion* 8-week bills for auction on Feb 23 $36 billion* 17-week bills for auction on Feb 22 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills $43 billion* 5-year notes $22 billion* 2-year FRNs	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $35 billion* 7-year notes **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Feb 27 **SETTLE:** $108 billion* 13-,26-week bills $34 billion* 52-week bills	**SETTLE:** $22 billion* 2-year FRNs

**Estimate*