Daiwa Capital Markets

U.S. Economic Comment

- The inflation fight: will the Fed win?

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The Push and Pull on Inflation

Many observers have been encouraged by recent inflation developments, as virtually all major indexes have decelerated. Headline measures have tumbled because of declining energy prices, and core measures have slowed as well. However, challenges remain. Workers will be bargaining aggressively for wage increases to regain purchasing power lost to inflation, and with the labor market tight, they are likely to realize hefty gains in compensation. In addition, monetary policy, while starting to constrain the economy, is probably not restrictive enough to reduce inflation to the Fed's target. The Fed has pushed short-term rates noticeably higher, but financial conditions in a broad sense are not especially constraining.

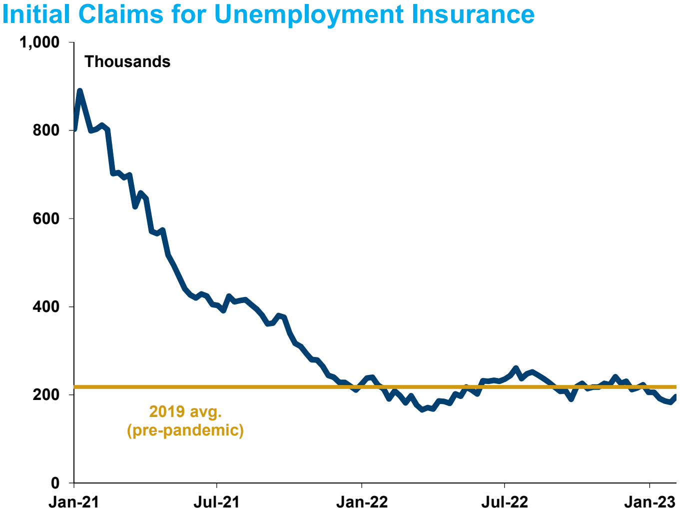
Chair Powell and other Fed officials seem to appreciate the challenges, as they have emphasized that restrictive policy will need to be maintained for some time, and Mr. Powell noted this week that interest rates might need to move higher than currently suggested by the Fed's latest dot plot. Officials seem to be in "whatever it takes mode", and because of their willingness to push further for longer, they are likely to ultimately win the battle against inflation. Policymakers also have a tailwind in their effort in the form of contained inflation expectations.

The Labor Market

The striking advance of 517,000 in payroll employment in January should have removed all doubt that the U.S. labor market is strong, although some observers remained skeptical because of the influence of seasonal adjustment. Businesses actually cut payrolls by more than 2.5 million in January, but adjusting for the typical loss of jobs in holiday-related and weather-sensitive areas translated a sharp decline into to a hefty gain.

Skepticism is understandable, but we do not view the reported gain as a statistical artifact. Rather, it is a reflection of employers' response to a supply-demand imbalance for labor: managers are reluctant to let workers go at a time when positions are difficult to fill. That is, businesses are hoarding workers. The gain in seasonally adjusted employment may have been more the result of worker retention than vigorous new hiring, but it still showed strong demand for labor; we do not view the sharp gain in jobs during January as a statistical glitch.

Initial Claims for Unemployment Insurance



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

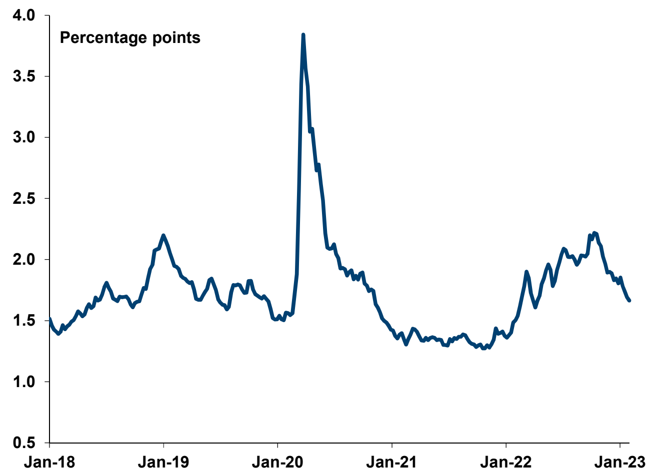
Worker hoarding also is apparent in claims for unemployment insurance, which have inched lower in the past two months despite a wave of layoff announcements by large corporations (chart). Several explanations can be offered for the peculiar movement. The same seasonal story behind the employment figures can be applied to the claims data: filings for benefits have picked up on a not seasonally adjusted basis, but the increases have been lighter than normal, resulting in declines on a seasonally adjusted basis. In addition, the announcements in many cases represent plans for payroll adjustments that will be implemented over several months rather than immediately. Finally, many of the announcements have occurred in the Tech sector, and the affected workers (probably highly skilled) may have found new positions quickly and thus did not file for jobless benefits.

Financial Conditions

The federal funds rate, and other short-term interest rates, have only a moderate influence on economic activity. Monetary policy has sway on the economy primarily because changes in short-term interest rates will influence other financial variables, and the broad change in financial conditions will affect the economy and eventually inflation. Forward guidance offered by the Fed can add force to changes in short-term interest rates.

Broad financial conditions are tighter than they were in early 2022 when the Fed started its tightening campaign, but they have lost force recently. For example, equity values in the past few months have retraced approximately 40 percent of the ground lost in the first nine months of last year. Similarly, corporate bond rates increased considerably in the February-October 2022 period as Treasury yields climbed and as credit spread widened. The yield spread between investment grade corporate bonds and Treasury securities widened by more than a full percentage point in the February-October span, but it has retraced half of that shift in the past few months (chart). Finally, the foreign exchange value of the dollar, an often-ignored channel of monetary policy, appreciated approximately 16 percent during the period of aggressive Fed tightening, but it has depreciated approximately eight percent since October.

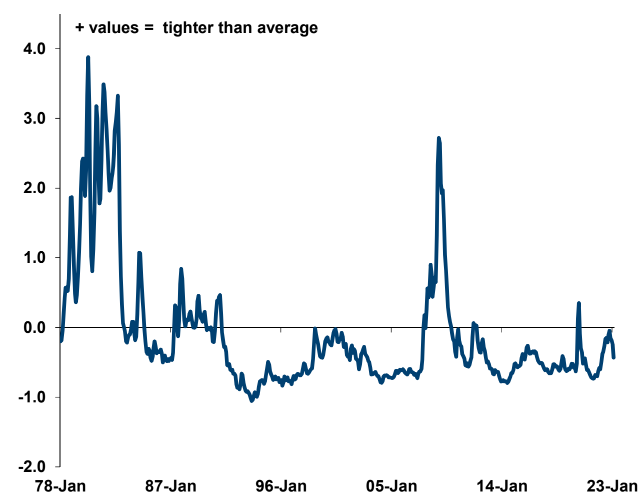
Corporate Credit Spread*



** The composite rate of a broad basket of 10-to-15-year corporate bonds less the rate on 10-year Treasury securities.*
Source: ICE BofA Merrill Lynch via Haver Analytics

Broad measures of financial conditions tell a similar story. For example, the so-called National Financial Conditions Index published by the Federal Reserve Bank of Chicago rose during much of 2022, signaling tighter financial conditions, but it merely returned to its long-run average. It never broke into tighter-than-average conditions, and in recent months it is back to below-average readings (chart).

Financial Conditions Index*



** Monthly data. The last observation is a weekly result for the period ended February 3, 2023.*
Source: Federal Reserve Bank of Chicago via Haver Analytics

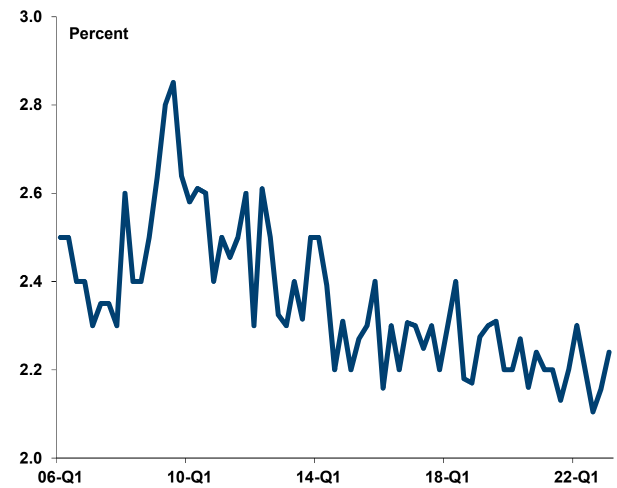
It is useful to note levels of the Chicago index in other instances of brisk inflation. The measure moved to extreme values in the late 1970s and early 1980s, when the Fed was fighting double-digit inflation. Today's price problems are less severe than they were then, and thus policy does not need to tighten to that degree. The episode in the late 1980s, when the core CPI was increasing in the neighborhood of 4.5 percent, provides better guidance. The Fed moved to a clearly restrictive stance in that instance, suggesting that it will need to do so again.

As we interpret the comments of Fed officials, they seem to realize that policy is still not sufficiently restrictive to push inflation to two percent, but they also seem willing to push ahead with their tightening campaign. Whatever it takes.

Inflation Expectations

While we believe the Fed needs to add more restraint, inflation expectations represent one factor working in its favor and perhaps lessening the degree of additional tightening that will be needed. Long-term inflation expectations have been well contained throughout this episode of brisk inflation, as shown by the 5-year/5-year forward expectation from the Survey of Professional Forecasters conducted by the Philadelphia Fed (i.e. expected inflation 6 to 10 years from now; chart). This measure, despite a bounce in the reading for the current quarter, has tilted downward in the past few years. The 5-year/5-year forward reading on inflation compensation from the TIPS market has less of a downward tilt, but it too is restrained.

Five-Year, Five-Year Forward Inflation Expectations*

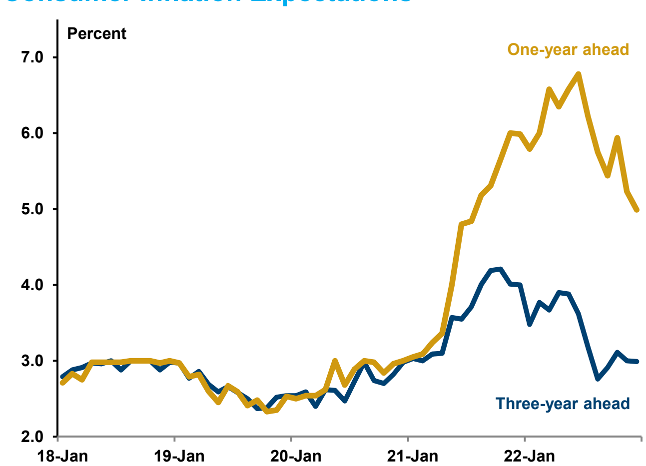


** Expected average inflation per year six to 10 years from now. CPI basis.*
Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

The challenge for the Fed is with near-term expectations, those for the next one to three years. Such measures surged as inflation picked up, reflecting price pressures in general and a heavy influence from the costs of food and energy. If the Fed does not make good progress in pushing inflation lower, expectations for brisk inflation easily could creep into the out years, unleashing longer-term expectations and most likely generating persistent inflation.

Fortunately, inflation has eased to a degree, and near-term expectations have started to recede. The year-ahead expectation from the survey of consumers conducted by the Federal Reserve Bank of New York has moved from a peak of 6.8 percent last summer to 5.0 percent in December. The new reading is still elevated, but it is moving in the right direction. Moreover, a comfortable reading for inflation three years out (3.0 percent, within the range in the years before the onset of Covid) suggests that individuals expect inflation to continue to cool.

Consumer Inflation Expectations*



** Median estimate.*
Source: Survey of Consumer Expectations, Federal Reserve Bank of New York via Haver Analytics

The year-ahead measure from the University of Michigan survey of consumers ticked up in early February (4.2 percent versus 3.9 percent in January), but it remained noticeably below the peak of 5.4 percent last year and the average of 4.8 percent in the fourth quarter. The pickup seemed like a random wiggle rather than a fundamental shift.

Review

Week of Feb. 6, 2023	Actual	Consensus	Comments
Trade Balance (December)	**-$67.4 Billion ($6.4 Billion Wider Deficit)**	**-$68.5 Billion ($7.0 Billion Wider Deficit)**	Exports fell 0.9% in December while imports rose 1.3%, leaving the trade deficit in December wider than that in the prior month. All of the deterioration in trade in December occurred in the goods sector; the surplus in service trade increased for the third consecutive month, with the recent gains pushing the service surplus to its best reading since the onset of Covid. This week's trade data suggest a modest downward adjustment to net exports in Q4, which added 0.6 percentage point to the preliminary tally of GDP growth.
Consumer Sentiment (February)	**66.4 (+2.3%)**	**65.0 (+0.2%)**	Consumer sentiment rose for the third consecutive month in February, but the latest gain was modest, most likely because of an upward drift in gasoline prices and a steady flow of layoff announcements. The year-ahead inflation expectations measure released with the Michigan survey increased 0.3 percentage point to 4.2% after easing in the prior three months. Despite the latest pickup, year-ahead expectations are still 1.2 percentage points below the current cyclical high of 5.4% in March/April 2022. Long-term expectations were unchanged at 2.9% for the third consecutive month.
Federal Budget (January)	**-$38.8 Billion**	**-$55.0 Billion**	Federal revenues slipped 3.8% in January from the same month last year, with a drop in remittances by the Federal Reserve to the Treasury contributing notably to the decline. Outlays surged 40.3% year-over-year. Spending on Social Security benefits represented one pressure point, with this area boosted by an 8.7% cost of living adjustment for 2023 that took place in January. The cumulative budget deficit of $460.2 billion for the first four months of FY2023 is $201.2 billion wider than that in the same period in FY2022.

Sources: Bureau of Economic Analysis (Trade Balance); University of Michigan Survey Research Center (Consumer Sentiment); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of Feb.13, 2023	Projected	Comments
CPI (January) (Tuesday)	**0.5% Total, 0.3% Core**	Pressure on food prices has eased considerably in recent months, with monthly increases of approximately 1.0% earlier in the year slowing to 0.3% in December. However, with gasoline prices rising noticeably, the energy component is likely to break from the downtrend in the second half of last year. Continued corrections to elevated airfares and used cars prices should help to contain the core component, but this downward pressure could start to lessen.
Retail Sales (January) (Wednesday)	**1.5% Total, 0.8% Ex. Autos**	A jump in sales of new vehicles is likely to lead to a sharp advance in the auto component of the retail report, while higher prices will likely inflate the value of sales at service stations. Elsewhere, talk of recession could lead to cautious spending, but we see some upside potential after two weak months of activity excluding autos and gasoline.
Industrial Production (January) (Wednesday)	**0.5%**	Solid employment gains in manufacturing and mining suggest firm activity in these two components of industrial production. The utility sector, though, is likely to provide a partial offset, as above-average temperatures in January likely reduced demand for heating services.
PPI (January) (Thursday)	**0.4% Total, 0.3% Ex. Food & Energy**	Because of an early survey date for the PPI, only a portion of the increase in energy prices in January will be incorporated into the index, which will probably leave little change after seasonal adjustment. Food prices have shown notable volatility in the past two months (up in November, down in December), but the underlying trend remains upward. Outside of food and energy, the measure should increase moderately, as price pressure on both services and core goods has eased in recent months.
Housing Starts (January) (Thursday)	**1.350 Million (-2.3%)**	Sales of new homes have stirred in response to reductions in mortgage interest rates in the past few months, but activity is still soft and builders are holding ample inventories of unsold homes. Thus, single-family starts will probably give back some of the surprising 11.3% increase in December. The multi-family sector is likely to pick up from a low-side reading in December, but it will have trouble returning to robust levels seen during much of last year.
Leading Indicators (January) (Friday)	**-0.4%**	Negative contributions from the ISM new orders index, consumer expectations, and the slope of the yield curve are likely to be only partially offset by positive readings on the factory workweek and initial claims for unemployment insurance. The shifts raise the possibility of the 10th consecutive decline in the index of leading economic indicators.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

February/March 2023

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
	TRADE BALANCE Oct -$77.3 billion Nov -$61.0 billion Dec -$67.4 billion **CONSUMER CREDIT** Oct $32.3 billion Nov $33.1 billion Dec $11.6 billion	**WHOLESALE TRADE** Inventories / Sales Oct 0.6% 0.0% Nov 0.9% -1.4% Dec 0.1% 0.0%	**UNEMP. CLAIMS** Initial / Continuing (millions) Jan 14 0.192 1.666 Jan 21 0.186 1.650 Jan 28 0.183 1.688 Feb 4 0.196 N/A	**CONSUMER SENTIMENT** Dec 59.7 Jan 64.9 Feb 66.4 **FEDERAL BUDGET** FY2023 / FY2022 Nov -$248.5B -$191.3B Dec -$85.0B -$21.3B Jan -$38.8B $118.7B
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX (6:00) Nov 91.9 Dec 89.8 Jan -- **CPI (8:30)** Total / Core Nov 0.2% 0.3% Dec 0.1% 0.4% **Jan 0.5% 0.3%**	**RETAIL SALES (8:30)** Total / Ex.Autos Nov -1.0% -0.6% Dec -1.1% -1.1% **Jan 1.5% 0.8%** **EMPIRE MFG (8:30)** Dec -11.2 Jan -32.9 Feb -- **IP & CAP-U (9:15)** IP / Cap.Util. Nov -0.6% 79.4% Dec -0.7% 78.8% **Jan 0.5% 79.0%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Oct 0.2% 0.4% Nov 0.3% -1.1% **Dec 0.3% -0.6%** **NAHB HOUSING INDEX (10:00)** Dec 31 Jan 35 Feb -- **TIC FLOWS (4:00)** Long-Term / Total Oct $67.8B $179.3B Nov $171.5B $213.1B Dec -- --	16 **UNEMP. CLAIMS (8:30)** **PPI (8:30)** Final Demand / Ex. Food & Energy Nov 0.2% 0.2% Dec -0.5% 0.1% **Jan 0.4% 0.3%** **HOUSING STARTS (8:30)** Nov 1.401 million Dec 1.382 million **Jan 1.350 million** **PHILY FED MFG OUTLOOK (8:30)** Dec -13.7 Jan -8.9 Feb --	**IMPORT/EXPORT PRICES (8:30)** Non-petrol Imports / Nonagri. Exports Nov -0.3% -0.7% Dec 0.8% -2.7% Jan -- -- **LEADING INDICATORS (10:00)** Nov -0.8% Dec -0.8% **Jan -0.4%**
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**
27	28	1	2	3
DURABLE GOODS ORDERS **PENDING HOME SALES**	**GOODS TRADE BALANCE** **ADVANCED INVENTORIES** **FHFA HOME PRICE INDEX** **S&P CASE-SHILLER HOME PRICE INDEX** **MNI CHICAGO BUSINESS BAROMETER** **CONSUMER CONFIDENCE**	**ISM MFG. INDEX** **CONSTRUCTION** **NEW VEHICLE SALES**	**UNEMP. CLAIMS** **REVISED PRODUCTIVITY**	**ISM SERVICES INDEX**

Forecasts in Bold.

Treasury Financing

February/March 2023

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
AUCTION RESULTS: Rate Cover 13-week bills 4.590% 2.69 26-week bills 4.755% 2.63	**AUCTION RESULTS:** Rate Cover 3-year notes 4.073% 2.33 **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 RESULTS:** Rate Cover 17-week bills 4.700% 2.59 10-yr notes 3.613% 2.66	**AUCTION RESULTS:** Rate Cover 4-week bills 4.520% 2.63 8-week bills 4.600% 2.32 30-yr bonds 3.686% 2.25 **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 $25 billion 12-day CMBs for auction on Feb 14 **SETTLE:** $108 billion 13-,26-week bills	
13	14	15	16	17
AUCTION: $108 billion 13,26-week bills	**AUCTION:** $25 billion 12-day CMBs **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 $25 billion 12-day CMBs	
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-wk bills $34 billion* 52-week bills	**SETTLE:** $22 billion* 2-year FRNs
27	28	1	2	3
AUCTION: $108 billion* 13-,26 week bills	**ANNOUNCE:** $75 billion* 4-week bills for auction on Mar 2 $60 billion* 8-week bills for auction on Mar 2 $36 billion* 17-week bills for auction on Mar 1 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills $15 billion 20-year bonds $9 billion 30-year TIPS $42 billion* 2-year notes $43 billion* 5-year notes $35 billion* 7-year notes	**AUCTION:** $36 billion* 17-week bills	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $108 billion* 13-,26-week bills for auction on Mar 6 $40 billion* 3-year notes for auction on Mar 7 $32 billion* 10-year notes for auction on Mar 8 $18 billion* 30-year bonds for auction on Mar 9 **SETTLE:** $108 billion* 13-,26-week bills	

*Estimate