Daiwa Capital Markets

U.S. Economic Comment

- U.S. GDP in Q1: not so bad
- Fighting inflation: little progress thus far
- Productivity: back on pre-Covid trend

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Q1 GDP: Probably in the Plus Column

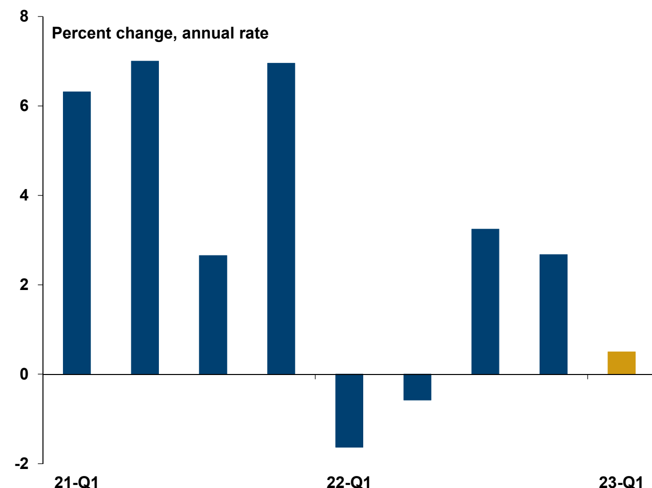
At the start of the year, we expected U.S. GDP to contract in the first quarter, with our projected drop of 0.5 percent (annual rate) representing the start of what would eventually be declared a recession. However, some recent economic reports have surprised on the upside, and thus the early evidence for the quarter suggests that the U.S. will avoid a downturn in Q1. Our projection no doubt will shift as more figures become available, but data in hand lead us to look for Q1 growth in the neighborhood of 0.5 percent.

The reports on employment and consumer spending stand out on the firm side. Strong spending by consumers (real outlay growth of 1.1 percent in January) suggests brisk demand, and job growth of 517,000 points to a sizeable gain in production to satisfy that demand. However, we also have seen some soft reports. Housing will probably be a drag again in Q1 (and beyond). The drop of a full percentage point in mortgage interest rates in December and January generated a small boost to sales of new homes, but builders continued to slow the pace of new construction. Also, mortgage rates have retraced more than half the December/January drop, which is likely to cool the modest rally in new home sales.

Tight financial conditions and an uncertain economic outlook will probably lead to cautious capital spending by businesses. Indeed, inflation-adjusted orders and shipments of capital goods other than aircraft in January were below their fourth quarter averages, suggesting contraction in early 2023. We have limited data on government activity, but the available observations have not been encouraging. Defense expenditures stepped noticeably lower in January after three strong months in the September-December period. Similarly, construction projects of state and local governments fell sharply in January after a surge last summer and fall.

Inventory investment is likely to provide the most notable constraint in early 2023. This component added considerably to economic growth in the fourth quarter of last year, accounting for more than half of the overall increase in GDP. Some adjustment seems in store after such a burst. Preliminary data show a dip in total nominal inventories in January, supporting the view of a drag of more than one percentage point from inventory investment.

GDP Growth*



** The reading for 2023-Q1 (gold bar) is a forecast.*

Sources: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

Inflation: A Tough Foe

Recent changes in interest rates suggest that market participants are starting to appreciate the difficult challenge of taming inflation. The rate on two-year Treasury notes, which is sensitive to expected changes in monetary policy, has jumped approximately 25 basis points in the past week and 80 basis points since the low in early February. Yields on 10-year notes also have climbed, but by smaller amounts (12 and 60 basis points over the same two time spans).

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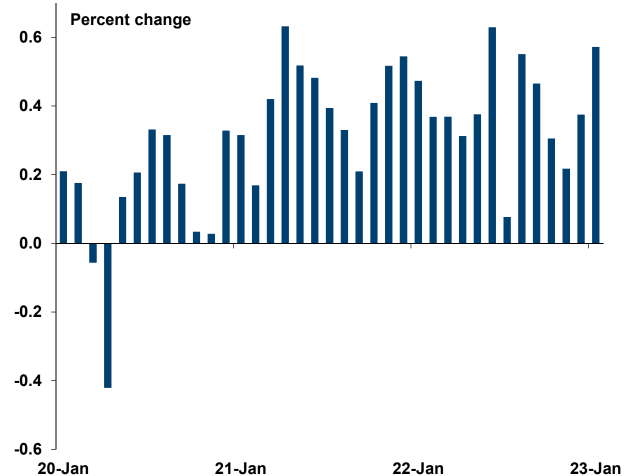
The high-side reading on the price index for personal consumption expenditures for January was the catalyst for the jump in rates in the past week. The increase of 0.6 percent in the core index could have been interpreted as random volatility, as the past year has shown a good bit of statistical noise (observations ranging from 0.1 percent to 0.6 percent, chart). However, market participants apparently saw inflation as an issue.

Core PCE Price Index *



** PCE = personal consumption expenditures.*

Sources: Bureau of Economic Analysis via Haver Analytics

Fed officials no doubt were troubled by the report. At a recent press briefing Chair Powell offered a perspective for evaluating the progress in fighting inflation, noting that progressively lower readings on inflation over periods of 12 months, six months, and three months would signal clear improvement in the price environment. By this criteria, the Fed has made essentially no progress thus far, as the core PCE inflation rate in the past three months is exactly the same as in the past 12 (and higher at the six-month interval; table, row 1). The new measure now being monitored by Fed officials – core services ex-housing – has accelerated (row 2).

Interestingly, the core CPI has shown progress, as the inflation rate in the past three months is a percentage point slower than that over the past 12 (row 3). This shift, to a large degree, reflects sizeable price declines in recent months in items that had surged during the pandemic (used motor vehicles, car rentals). The median CPI, which eliminates all outlying observations, is not showing meaningful deceleration (row 4).

Inflation Rate and Wage Growth*

	Past 12	Past 6	Past 3
Core PCE	4.7	5.0	4.7
Core PCE Services Ex-Housing	4.6	5.4	5.3
Core CPI	5.6	5.3	4.5
Median CPI	7.1	7.4	7.0
Avg. Hourly Earnings	4.4	4.3	4.5
Emp. Cost Index	5.1	4.5	3.9

** Annual percent changes over 12-month, 6-month and 3-month spans.*

Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, and Federal Reserve Bank of Cleveland via Haver Analytics; Daiwa Capital Markets America

We might apply this same perspective to wage measures, as upward pressure on wages caused by a tight labor market is likely to be the primary driving force behind inflation in the months ahead. Average hourly earnings from the monthly employment report have shown no progress, although the employment cost index has shown notable improvement (rows 4 and 5).

We would interpret the results for the ECI cautiously because the series is only available on a quarterly basis, and thus the results for the past three months reflect only one observation (2022-Q4). Any single observation could contain an element of random volatility; we would like to see slower results for another quarter before forming judgments. A modest increase in the fourth quarter of last year (sandwiched between two firm readings) supports our caution in drawing conclusions.

Productivity: A (Thin?) Cushion Against Wage Pressure

Wage growth represents only part of the influence of tight labor markets on inflation; one should also consider productivity growth. Strong gains in productivity could allow businesses to pay higher wages without increasing the prices of their products. In this regard, the latest report on productivity was disappointing, as it showed a downward revision of 1.3 percentage points in productivity growth in the fourth quarter (1.7 percent versus 3.0 percent, annual rates). Benchmark revisions to results in prior years also resulted in a downward nudge to productivity.

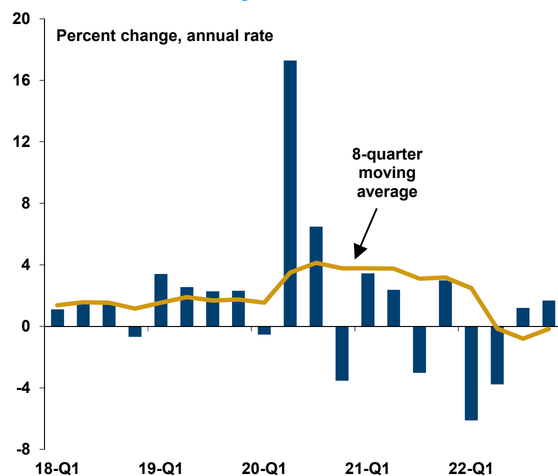
In most settings, an increase of 1.7 percent in productivity would be considered a respectable performance, as would the increase of 1.2 percent in Q3. However, these advances followed a decline of 4.9 percent in the first half, leaving declines of 1.8 percent in the past four quarters and 0.2 percent in the past eight. Declines over a span of eight quarters are rare.

One could easily conclude that the recent productivity performance has been poor. However, the recent softness might be payback for a brief surge in the early stages of the pandemic. Layoffs during the worst of the pandemic probably involved a disproportionate share of workers in low-productivity occupations (e.g. restaurant workers and live entertainers), leaving a larger share of workers in high productivity jobs. The reduced ranks of low-productivity workers helped to generate surges of 17.3 percent in 2020-Q2 and 6.5 percent in 2020-Q3, the strongest two-quarter performance in the history of the series (dating back to 1947, chart, below left). A return to normal activity would bring productivity in line with its underlying trend. In this regard, the level of the productivity index surged above its long-term trend after the onset of the pandemic, but it has now returned to the long-term norm (chart, below right).

We can perhaps downplay the weak average growth rate for productivity in the past eight quarters and look for average results of approximately 1.5 percent going ahead. However, such a pace is still not consistent with a 2.0 percent inflation rate, as wage growth of 4.5 percent (average hourly earnings) would still be pointing to an inflation rate of approximately 3.0 percent.

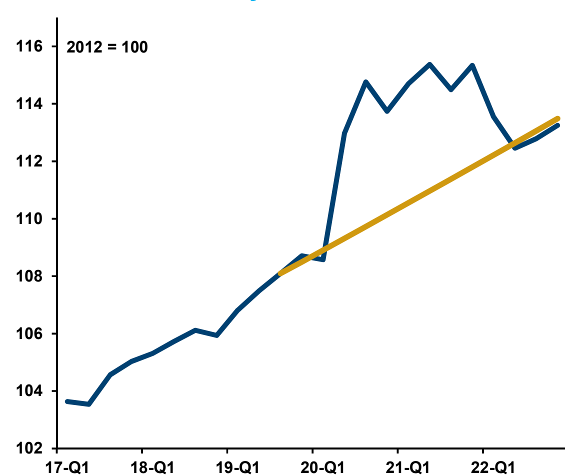
Also, productivity growth of 1.5 percent is not assured. It is too early to be confident about a prediction for productivity growth in the first quarter, but the data in hand are suggesting a soft showing. The employment report for January showed a sharp increase in hours worked (payrolls surged 517,000 and the length of the average workweek widened by 0.3 hour, an unusually large change for a single month). If GDP growth is in line with the modest advance noted above (0.5 percent), slow economic growth and a jump in hours worked will translate to weak productivity.

Nonfarm Productivity



Source: Bureau of Labor Statistics via Haver Analytics

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

Daiwa Capital Markets

Review

Week of Feb. 27, 2023	Actual	Consensus	Comments
Durable Goods Orders (January)	**-4.5%**	**-4.0%**	While the magnitude of the drop in durable goods orders in January was striking, it reflected primarily statistical noise in the volatile nondefense aircraft category, which fell 54.6% after a surge of 105.6% in December. Orders excluding transportation rose 0.7%, but assessments should be guarded, as an increase of 1.7% in the PPI for manufacturing suggests that price adjustments rather than increases in real activity heavily influenced several areas. New orders for non-defense capital goods excluding aircraft, which give insight into capital spending plans by businesses, rose 0.8%, but price increases likely played a role here as well. Data on producer prices suggest little change in capital goods orders after adjusting for inflation.
International Trade in Goods (January)	**-$91.5 Billion ($1.8 Billion Wider Deficit)**	**-$91.0 Billion ($1.3 Billion Wider Deficit)**	Both exports and imports of goods rose sharply in January (up 4.2% and 3.4%, respectively). Although the percentage change in exports was larger, the dollar volume of imports exceeded that of exports, which led to the slippage in the deficit. Choppiness in imports and exports has led to month-to-month volatility in the deficit, with the latest observation falling in the middle of the range that has been in place since the summer of 2022. Recent trade deficits have narrowed from those in late 2021 and early 2022, but they are much wider than pre-pandemic readings. Available price indexes suggest that the widening in the January trade deficit will be slightly more pronounced after adjusting for inflation, which might suggest a modest negative contribution from net exports to GDP growth in Q1.
Consumer Confidence (February)	**102.9 (-2.9%)**	**108.5 (+1.3%)**	Consumer confidence fell 5.6% combined in the first two months of 2023, reversing most of a jump in December and falling back to the middle portion of the subdued range in place for much of the past year. Presently, concerns about persistent inflation and chatter about potential recession are likely overshadowing favorable views on the labor market in the minds of consumers. With regard to the labor market, the net job assessment published with the confidence report (share of respondents reporting that jobs are plentiful less the share indicating that jobs are hard to get) rose to 41.5% from 37.0% in January. The latest reading was in the upper end of the historical range – reasonably close to the record of 47.1% in March of last year.

Review Continued

Week of Feb. 27, 2023	Actual	Consensus	Comments
ISM Manufacturing Index (February)	**47.7 (+0.3 Index Pt.)**	**48.0 (+0.6 Index Pt.)**	The ISM manufacturing index rose marginally in February, but it remained below 50 for the fourth consecutive month, signaling contraction in the manufacturing sector. The new orders index, which had previously fallen in four of the past five months, registered the only increase among components (up 4.5 index points to 47.0). The employment index slipped 1.5 index points to 49.1, and the production index lost ground as well (off 0.7 index point). The supplier deliveries index slipped 0.4 index point to 45.2, the fifth consecutive month below 50. However, the below-50 reading in this component should be interpreted favorably, as it suggests a normalization of supply chains after disruptions in 2021 and the first half of 2022.
Construction (January)	**-0.1%**	**0.2%**	Government-sponsored construction led the dip in total activity in January, falling 0.6% and marking the second consecutive decline. Government construction projects surged in the summer and fall, but that strong trend has been dented in the past two months. Private construction was flat in January as an increase of 0.9% in nonresidential building largely offset a drop of 0.6% in residential activity. The weakness in the residential sector was again led by a decline in single-family building (off 1.7%), which remained on its downward trend. Multi-family activity provided an offset, as it has in preceding months, although this sector appears to be losing momentum.
Revised Nonfarm Productivity (22-Q4)	**1.7% (-1.3 Pct. Points Revision)**	**2.5% (-0.5 Pct. Point Revision)**	The revision to productivity growth reflected both a downward adjustment to output (3.1% versus 3.5%) and an upward adjustment to hours worked (1.4% versus 0.5%). Productivity growth of 1.7% after an increase of 1.2% in Q3 is a respectable performance when viewed in isolation, but it is not especially impressive in light of a drop of 4.9% in H1. The poor showing in the first half of 2022 could be viewed as an unwinding of a surge in productivity in the early portion of the pandemic. Productivity is now back on the pre-Covid trend.
ISM Services Index (February)	**55.1 (-0.1 Index Point)**	**54.5 (-0.7 Index Point)**	The ISM services index dipped in February, but the latest observation was close to last year's average of 56.1, which can be viewed as a solid performance. The employment component posted a firm performance in February with an advance of 4.0 index points to 54.0, a reading in the upper portion of the range of the current expansion. Order flows also performed well in the latest month with a jump of 2.2 index points to 62.6. Despite firm order flows, business activity eased 4.1 index points to 56.3. The supplier deliveries index fell 2.4 index points to 47.6, a reading in the low end of the longer-run range. The latest observation adds an accent to the sharp drop since late 2021 (recent high of 75.5 in October/November 2021) and indicates that supply-chain issues from earlier in the pandemic have largely been resolved.

Sources: U.S. Census Bureau (Durable Goods Orders, International Trade in Goods, Construction); The Conference Board (Consumer Confidence); Institute for Supply Management (ISM Manufacturing Index, ISM Services Index); Bureau of Labor Statistics (Revised Nonfarm Productivity) ; Consensus forecasts are from Bloomberg

Preview

Week of March 6, 2023	Projected	Comments
Factory Orders (January) (Monday)	**-1.5%**	The already reported drop of 4.5% in durable goods orders, which reflected a plunge of 54.6% in civilian aircraft bookings after a spurt in the prior month, will probably dominate the report on total factory bookings. An advance in nondurable orders could provide a partial offset. Higher prices should boost the value of petroleum bookings, and price effects could exert an influence on nondurable orders excluding petroleum as well. However, softening in the factory sector and a brisk increase in the PPI suggest that real nondurable bookings ex. petroleum slipped in January.
Trade Balance (January) (Wednesday)	**-$69.5 Billion ($2.1 Billion Wider Deficit)**	The widening of $1.8 billion in the goods trade deficit (published February 28th) is likely to contribute importantly to the expected deterioration in total trade flows in January. Joining the widening in the goods deficit, the service surplus could ease after three consecutive increases pushed it to the top of the range of the current expansion.
Payroll Employment (February) (Friday)	**225,000**	Low levels of initial claims for unemployment insurance suggest that layoffs have been modest as firms have sought to retain workers in hard-to-fill positions, but a sharp slowing in payroll growth after a burst of 517,000 in January is likely to leave hiring in February noticeably below the average of 357,000 in the second half of 2022. Cooling in employment reported in the household survey after a jump of 894,000 raises the possibility of an uptick in the unemployment rate from the rock-bottom reading of 3.4% in January.
Federal Budget (February) (Friday)	**-$275.0 Billion**	Available data suggest that federal revenues fell in excess of 8% on a year-over year basis, as remittances by the Federal Reserve to the Treasury dropped sharply and income tax refunds ran ahead of last February's total. With revenues down and outlays expected to remain on their firm trajectory, the deficit for February 2023 appears likely to exceed the already-wide shortfall of $217 billion reported in the same month of FY2022.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

February/March 2023

Monday 27

DURABLE GOODS ORDERS

Nov	-1.8%
Dec	5.1%
Jan	-4.5%

PENDING HOME SALES

Nov	-3.2%
Dec	1.1%
Jan	8.1%

MNI CHICAGO BUSINESS BAROMETER

	Index	Prices
Dec	45.1	65.1
Jan	44.3	72.5
Feb	43.6	65.3

CONFERENCE BOARD CONSUMER CONFIDENCE

Dec	109.0
Jan	106.0
Feb	102.9

Tuesday 28

INTERNATIONAL TRADE IN GOODS

Nov	-$82.1 billion
Dec	-$89.7 billion
Jan	-$91.5 billion

ADVANCE INVENTORIES

	Wholesale	Retail
Nov	0.9%	0.0%
Dec	0.1%	0.4%
Jan	-0.4%	0.3%

FHFA HOME PRICE INDEX

Oct	0.0%
Nov	-0.1%
Dec	-0.1%

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX

Oct	-0.5%
Nov	-0.5%
Dec	-0.5%

Wednesday 1

ISM MFG. INDEX

	Index	Prices
Dec	48.4	39.4
Jan	47.4	44.5
Feb	47.7	51.3

CONSTRUCTION

Nov	0.5%
Dec	-0.7%
Jan	-0.1%

VEHICLE SALES

Dec	13.4 million
Jan	15.9 million
Feb	14.9 million

Thursday 2

UNEMP. CLAIMS

	Initial (millions)	Continuing
Feb 4	0.195	1.691
Feb 11	0.195	1.660
Feb 18	0.192	1.655
Feb 25	0.190	N/A

REVISED PRODUCTIVITY & COSTS

	Productivity	Unit Labor Costs
22-Q2	-3.8%	6.6%
22-Q3	1.2%	6.9%
22-Q4(p)	3.0%	1.1%
22-Q4(r)	1.7%	3.2%

Friday 3

ISM SERVICES INDEX

	Index	Prices
Dec	49.2	68.1
Jan	55.2	67.8
Feb	55.1	65.6

Monday 6

FACTORY ORDERS (10:00)

Nov	-1.9%
Dec	1.6%
Jan	**-1.5%**

Tuesday 7

WHOLESALE TRADE (10:00)

	Inventories	Sales
Nov	0.9%	-1.4%
Dec	0.1%	0.0%
Jan	**-0.4%**	**-0.5%**

CONSUMER CREDIT (3:00)

Nov	$33.1 billion
Dec	$11.6 billion
Jan	--

CHAIR POWELL'S SEMI-ANNUAL MONETARY POLICY TESTIMONY (SENATE) (10:00)

Wednesday 8

ADP EMPLOYMENT REPORT (8:15)

	Private Payrolls
Dec	253,000
Jan	106,000
Feb	--

TRADE BALANCE (8:30)

Nov	-$61.0 billion
Dec	-$67.4 billion
Jan	**-$69.5 billion**

JOLTS DATA (10:00)

	Openings (000)	Quit Rate
Nov	10,440	2.7%
Dec	11,012	2.7%
Jan	--	--

CHAIR POWELL'S SEMI-ANNUAL MONETARY POLICY TESTIMONY (HOUSE) (10:00)

BEIGE BOOK (2:00)

January 2023:

"Overall economic activity was relatively unchanged since the previous report. Five Districts reported slight or modest increases in overall activity, six noted no change or slight declines, and one cited a significant decline. On balance, contacts generally expected little growth in the months ahead."

Thursday 9

UNEMP. CLAIMS (8:30)

Friday 10

EMPLOYMENT REPORT (8:30)

	Payrolls	Un. Rate
Dec	260,000	3.5%
Jan	517,000	3.4%
Feb	**225,000**	**3.5%**

FEDERAL BUDGET (2:00)

	FY2023	FY2022
Dec	-$85.0B	-$21.3B
Jan	-$38.8B	$118.7B
Feb	**-$275.0B**	-$216.6B

Monday 13

Tuesday 14

NFIB SMALL BUSINESS OPTIMISM

CPI

Wednesday 15

RETAIL SALES

PPI

EMPIRE MFG INDEX

BUSINESS INVENTORIES

NAHB HOUSING INDEX

TIC FLOWS

Thursday 16

UNEMP. CLAIMS

HOUSING STARTS

IMPORT PRICES

PHILY FED MFG. INDEX

Friday 17

INDUSTRIAL PRODUCTION

CONSUMER SENTIMENT

LEADING INDICATORS

Monday 20

Tuesday 21

EXISTING HOME SALES

FOMC (FIRST DAY)

Wednesday 22

FOMC ANNOUNCEMENT

Thursday 23

UNEMP. CLAIMS

CURRENT ACCOUNT

CHICAGO FED NATIONAL ACTIVITY INDEX

NEW HOME SALES

Friday 24

DURABLE GOODS ORDERS

Forecasts in Bold. *(p) = preliminary; (r) = revised*

Treasury Financing

February/March 2023

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	1	2	3
AUCTION RESULTS: Rate / Cover 13-week bills 4.750% 2.59 26-week bills 4.940% 2.80	**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 $15 billion 16-day CMBs	**AUCTION RESULTS:** Rate / Cover 17-week bills 4.885% 2.92	**AUCTION RESULTS:** Rate / Cover 4-week bills 4.590% 2.53 8-week bills 4.655% 2.79 **ANNOUNCE:** $105 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	
6	7	8	9	10
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $40 billion 3-year notes **ANNOUNCE:** $75 billion* 4-week bills for auction on Mar 9 $60 billion* 8-week bills for auction on Mar 9 $36 billion* 17-week bills for auction on Mar 8 **SETTLE:** $75 billion 4-week bills $60 billion 8-week bills $36 billion 17-week bills	**AUCTION:** $36 billion* 17-week bills $32 billion 10-year notes	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $18 billion 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Mar 13 **SETTLE:** $105 billion 13-,26-week bills	
13	14	15	16	17
AUCTION: $105 billion* 13-,26 week bills	**ANNOUNCE:** $75 billion* 4-week bills for auction on Mar 16 $60 billion* 8-week bills for auction on Mar 16 $36 billion* 17-week bills for auction on Mar 15 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills **SETTLE:** $40 billion 3-year notes $32 billion 10-year notes $18 billion 30-year bonds	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Mar 20 $34 billion* 52-week bills for auction on March 21 $12 billion* 20-year bonds for auction on Mar 21 $15 billion* 10-year TIPS for auction on Mar 23 **SETTLE:** $105 billion* 13-,26-wk bills	
20	21	22	23	24
AUCTION: $105 billion* 13-,26 week bills	**AUCTION:** $34 billion* 52-week bills $12 billion* 20-year bonds **ANNOUNCE:** $75 billion* 4-week bills for auction on Mar 23 $60 billion* 8-week bills for auction on Mar 23 $36 billion* 17-week bills for auction on Mar 22 **SETTLE:** $75 billion* 4-week bills $60 billion* 8-week bills $36 billion* 17-week bills	**AUCTION:** $36 billion* 17-week bills	**AUCTION:** $75 billion* 4-week bills $60 billion* 8-week bills $15 billion* 10-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on Mar 27 $42 billion* 2-year notes for auction on Mar 27 $43 billion* 5-year notes for on auction on Mar 28 $35 billion* 7-year notes for auction on Mar 29 $22 billion* 2-year FRN for auction on Mar 29 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills	

**Estimate*