Daiwa Capital Markets

U.S. Economic Comment

- Next week's FOMC meeting: officials send "pause" signal
- Financial conditions: recent tightening may eliminate need for further hikes
- Growth and inflation data: still firm but unlikely to sway Committee views

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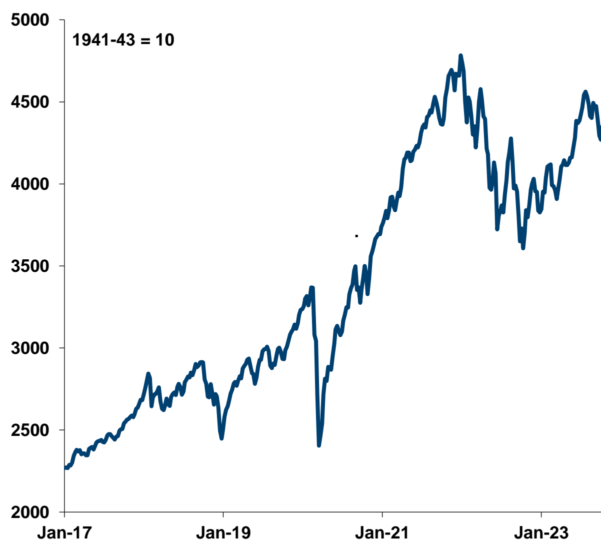
FOMC Preview

The conclusion of next week's FOMC meeting is unlikely to yield any meaningful surprises. It appears that much of the required policy response to entrenched inflation has been accomplished in raising the federal funds rate by 525 basis points over the past 18 months, leaving monetary policy in restrictive territory. Moreover, Chair Powell reiterated in a presentation at the Economic Club of New York on October 19th that he and his colleagues on the FOMC are "proceeding carefully," as the full effects of previous increases in the target range for the federal funds rate are only now working their way through the economy. That caution, it seems, stems from a growing consensus among officials that risks have become more two-sided: the danger of overtightening and causing unwarranted damage to the economy must be considered alongside concerns that monetary policy is not restrictive enough to tame elevated (but moderating) inflation.

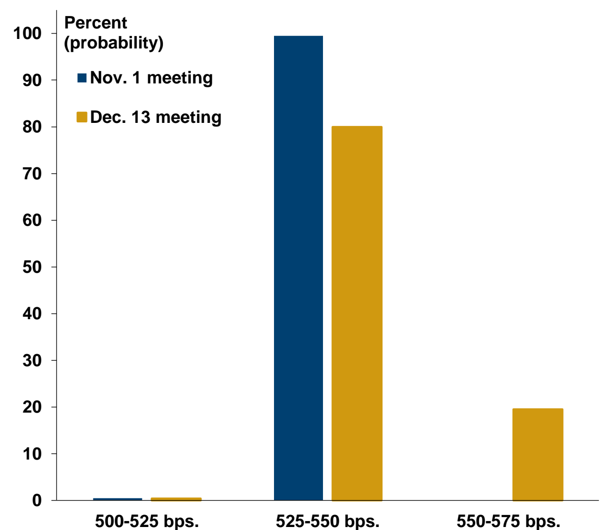
Market participants have seemingly internalized the forward guidance provided by Fed officials, that of higher for longer on rates while likely at or approaching the peak in the target range. Equites have recently come under pressure, with both policy expectations and a murkier economic outlook leading to an easing in the benchmark S&P 500 index of approximately 10 percent from its high in late July (chart, left). Concurrently, the two-year Treasury yield moved from a range in the mid-to-upper four-percent area in July to above five percent in October. The move in the two-year Treasury, in our view, affirms market expectations of higher for longer, but it also discounts the potential for additional rate hikes despite brisk near-term growth and inflation acknowledged by policy makers as still too high (and likely to recede only slowly). On that point, the probability of a rate hike is essentially nonexistent in November and below 25 percent for the final FOMC meeting of the year in December (chart, right).

S&P 500*



** Weekly average data except for the latest observation which is a midday quote from October 27, 2023.*
Sources: Standard & Poor's via Haver Analytics; Bloomberg

Probabilities for the Federal Funds Rate*



** The probabilities assigned to either no change or an increase in the target range for the federal funds rate as implied by fed funds futures contracts.*
Source: CME Fed Watch Tool, CME Group

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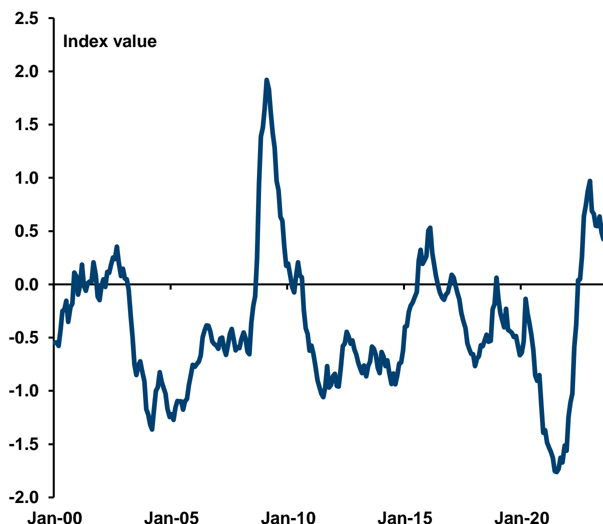
Financial Conditions and the Treasury Term Premium

Incorporated into the market view that implies the FOMC is likely done hiking interest rates is likely recent tightening in financial conditions, which is seen as more impactful than an additional hike of 25 basis points (and thus eliminates the need for the additional increase in the ffr). As the federal funds rate is only a short rate that has little influence on the broader economy, the Central Bank relies on financial conditions as the transmission mechanism, and this mechanism more recently may be acting with greater force on aggregate demand. A Federal Reserve Board measure of financial conditions that incorporates longer-term yields, credit spread, equity values, and the foreign exchange value of the dollar, is off its recent peak but moving higher again. Moreover, according to this measure, financial conditions are in a range last seen in 2008-09, although not quite at the extremes realized during that period (chart, left; last reading is for September 2023).

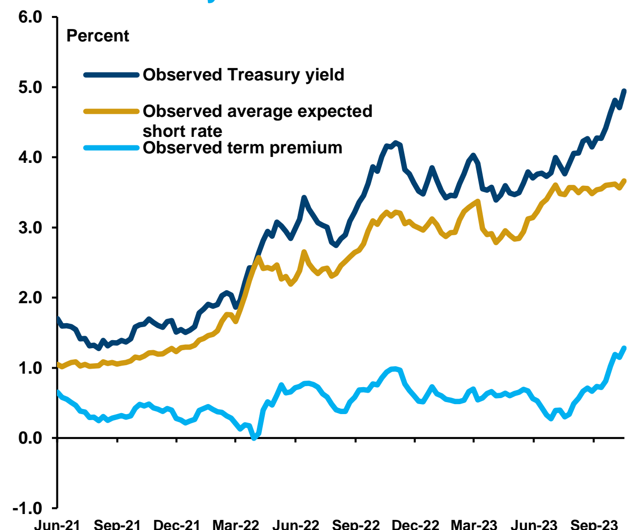
One critical variable, long-term interest rates, has been the focus of multiple officials in the past few weeks. The yield on the 10-year Treasury has climbed from approximately 4.24 percent in mid-September to 4.83 percent on Friday (and it briefly touched five percent last week). The spike has largely been attributed to a jump in the term premium, or investor compensation for holding longer-dated securities, rather than a shift in the observed expected short rate. While estimates of term premiums vary by security duration and model used, data from the San Francisco Fed are useful in illustrating the components of 10-year yield and where the increase occurred, which in the past several weeks was concentrated in the term premium. There are a variety of reasons ascribed to the increase (continuation of quantitative tightening, expectations for an upcoming deluge of Treasury issuance, etc.), with the clear outcome of pushing longer-term borrowing rates higher across the economy. Observing the shift, Lorie Logan of the Dallas Fed, a 2023 voter, indicated in her latest speech, “If long-term interest rates remain elevated because of higher term premiums, there may be less need to raise the fed funds rate.” Chair Powell, in last week’s aforementioned appearance, indicated that higher yields could trim the need for additional rate hikes “at the margin.” Thus, the market may be doing the final bit of heavy lifting for the FOMC.

Financial Conditions Index



Source: Ajello, Andrea et al. “A New Index to Measure U.S. Financial Conditions,” Federal Reserve Board, Jun. 2023. https://www.federalreserve.gov/econres/notes/feds-notes/a-new-index-to-measure-us-financial-conditions-20230630.html

10-Year Treasury Yield Premium*



** Weekly average data with the latest observation occurring for the week ended October 20, 2023.*

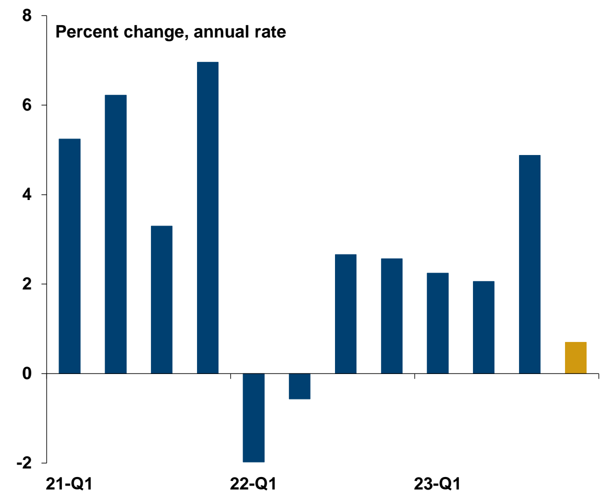
Source: Christensen, Jens H.E., and Glenn D. Rudebusch. 2012. "The Response of Interest Rates to U.S. and U.K. Quantitative Easing." Economic Journal 122, pp. F385-F414; Federal Reserve Bank of San Francisco via Haver Analytics

What About the Data?

While financial conditions are tightening, data this week would seem to be pushing Fed officials toward needing to hike rates further. Notably, the first estimate of GDP growth in Q3 recorded a surge of 4.9 percent in output, well above the economy’s potential growth rate in the upper-one-percent area and on its face inconsistent with the narrative that aggregate demand is easing to a degree necessary to alleviate inflationary pressures. Yet, market

participants appeared unfazed by the robust results. Views on fourth quarter growth are critical in understanding the response; third-quarter results are projected to be transient, with tight financial conditions and the reversal of near-term boosts from some areas giving way to below-trend growth in Q4 (chart). Importantly, consumer spending is expected to slow sharply after a burst of 4.0 percent and inventory investment is anticipated to contract after a contribution of 1.2 percentage points to growth. Reversals in these areas rely on the assumptions that consumer wherewithal has been diminished greatly amid a flurry of post-COVID spending and that firms want to maintain lean inventories amid an expected slowdown in demand. In our estimation, both are reasonable ideas.

GDP Growth*

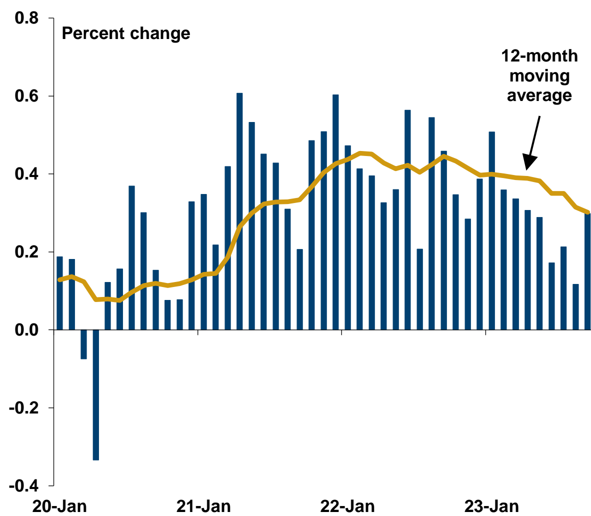


** The gold bar is an estimate from the October 2023 issue of Blue Chip Economic Indicators.*

Sources: Bureau of Economic Analysis via Haver Analytics; Blue Chip Economic Indicators

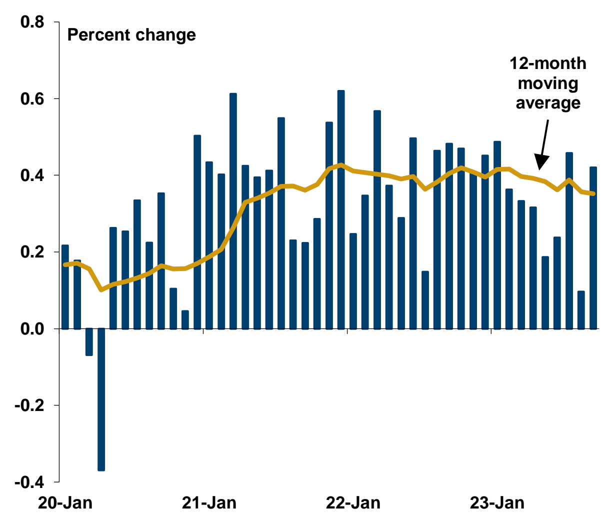
Similarly, the near-term inflation data appear to warrant additional policy firming. The price index for personal consumption expenditures, updated in today's Personal Income and Consumption Report, recorded brisk increases – the headline price index increased 0.4 percent and the core jumped 0.3 percent (chart, left). Moreover, the "supercore" measure (service inflation excluding the costs of energy services and housing services) surged 0.4 percent, the second sharp increase in the past three months (chart, right). Despite the month-to-month pressure, the year-over-year change in the core eased to 3.7 percent from 3.8 percent and a high of 5.6 percent in February 2022, and year-over-year growth in the supercore slipped to 4.3 percent from 4.4 percent. That incremental progress, rather than monthly volatility, appears aligned with officials' expectations that inflation will recede slowly (and nonlinearly) but also that the current policy setting is consistent with getting the job done. The data may yet demand that policymakers adjust rates further, but at least in the near-term the current mix of tight financial conditions and evolution in the economy allow for a cautious approach to further policy adjustments.

Core PCE Price Index



Source: Bureau of Economic Analysis via Haver Analytics

PCE: Core Services ex. Housing Services*



** Service prices excluding energy and housing services.*

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

The Week Ahead

Employment Cost Index (2023-Q3) (Tuesday) Forecast: +1.0% Total Compensation; +1.0% Wages

Readings on average hourly earnings from the employment report suggest that compensation growth remained firm in Q3. The expected increase is likely to trail the brisk average of 1.3 percent in the first half of 2022 (quarterly rate, not annualized) but remain close to the average of 1.1 percent in the past four quarters. The forecast, if realized, would translate to a year-over-year increase of 4.3 percent, down from 4.5 percent in Q2 and off the recent high of 5.1 percent in 2022-Q2.

Consumer Confidence (October) (Tuesday) Forecast: 100.0 (-3.0 Index Pts or -2.9%)

Constraints on consumer budgets from elevated prices of essentials and heightened borrowing costs are likely to weigh on consumer moods in October, a view supported by a drop of 6.0 percent in the University of Michigan sentiment gauge.

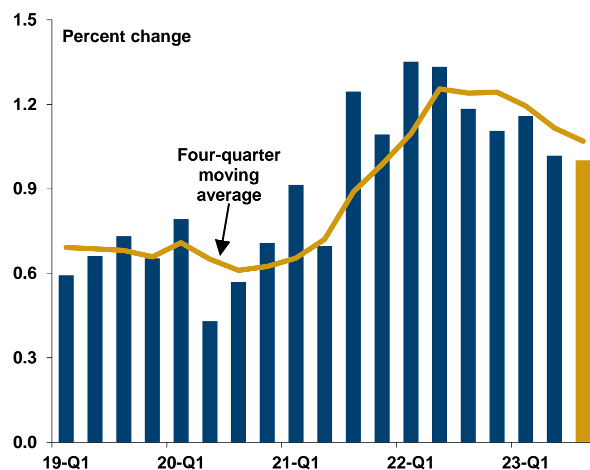
ISM Manufacturing (October) (Wednesday) Forecast: 48.5 (-0.5 Index Pt)

Headwinds from restrictive monetary policy have weighed heavily on the manufacturing sector, which has translated to sub-50 readings on the ISM factory gauge for 11 consecutive months. The measure has stirred recently, increasing in the past here months after a recent low of 46.0 in June, but the production component could ease after rising to its highest reading of the year in September (despite sluggish order flows) which would nudge the headline lower in the latest month.

Nonfarm Productivity (2023-Q3) (Thursday) Forecast: +4.0% Productivity; -0.4% Unit Labor Cost

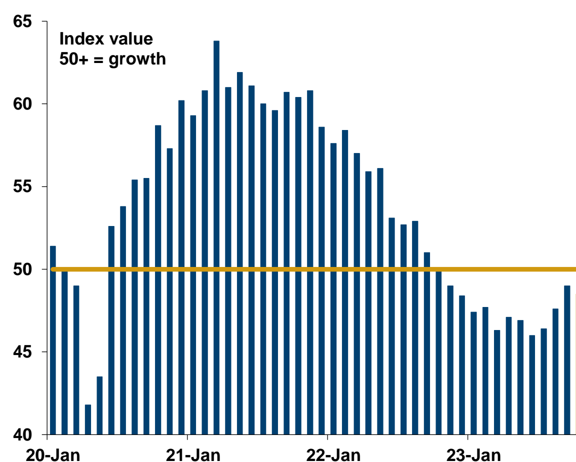
Output in the nonfarm business sector registered a brisk increase in Q3 and hours worked rose moderately, suggesting a strong gain in nonfarm productivity after a jump of 3.5 percent in Q2. The recent performance suggests that productivity could be stirring after a year-over-year contraction in 2022 (-1.6 percent) and soft performance in 23-Q1 (-1.2 percent, annual rate). Available data imply a firm increase in compensation per hour (3.7 percent, annual rate), but the expected jump in productivity raises the prospect of a dip in unit labor costs.

Employment Cost Index*



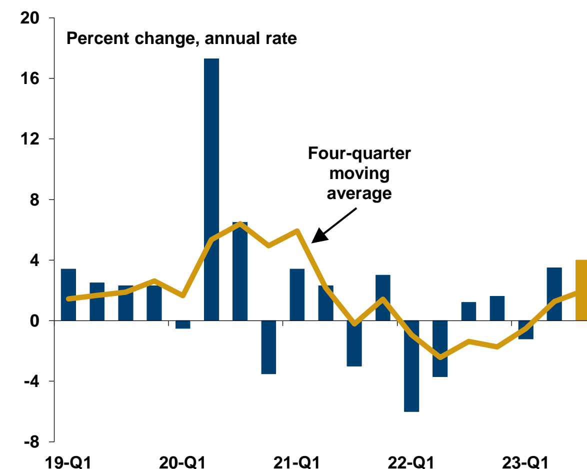
** The gold bar is a forecast for 2023-Q3.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

ISM Manufacturing Index*



** The gold bar is a forecast for October 2023.*
Sources: Institute for Supply Management via Haver Analytics; Daiwa Capital Markets America

Nonfarm Productivity*



** The gold bar is a forecast for 2023-Q3.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

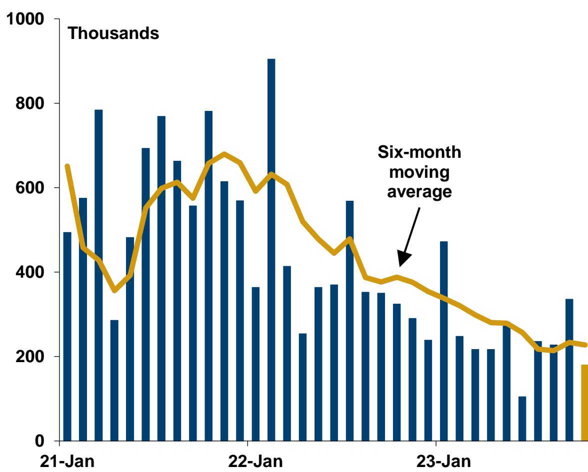
Factory Orders (September) (Thursday)
Forecast: +2.5%

Durable goods orders surged in October (+4.7 percent; published October 26), in part reflecting a surge of 64.9 percent in aircraft bookings. Durable orders excluding the volatile transportation category rose 0.5 percent, the fifth consecutive increase. Nondurable bookings (the new information in the factory orders report) also could register a firm increase. However, much of the expected advance would reflect higher prices of petroleum-related bookings. Nondurable orders excluding petroleum have drifted modestly higher in 2023 thus far.

Nonfarm Payrolls (October) (Friday)
Forecast: 180,000

Low levels of unemployment claims and elevated job openings suggest solid payroll growth in October, although the anticipated increase is likely to trail by a wide margin the spurt of 336,000 in September – a reading well-above the average of 250,000 in the first eight months of 2023. Moderate employment and labor force growth could be approximately offsetting in October, leaving the unemployment rate unchanged at 3.8 percent, a reading below the FOMC's long-run full-employment estimate of 4.0 percent.

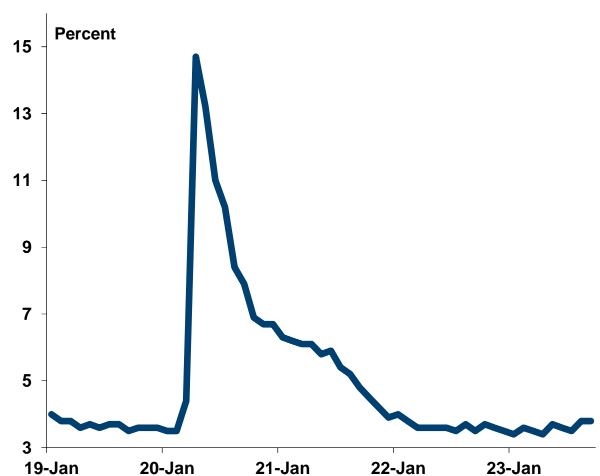
Change in Nonfarm Payrolls*



** The gold bar is a forecast for October 2023.*

Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

Unemployment Rate

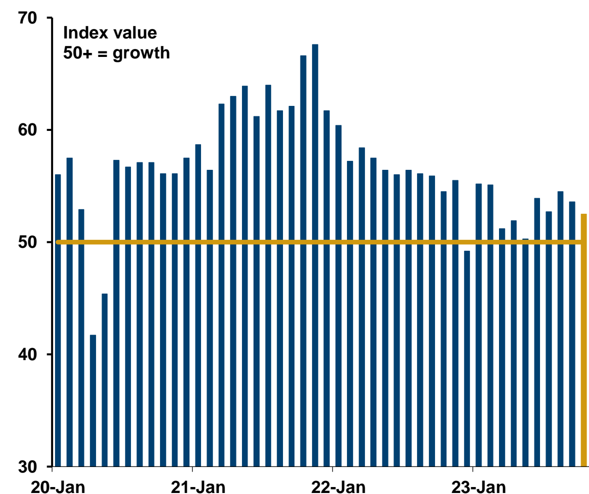


Source: Bureau of Labor Statistics via Haver Analytics

ISM Services (October) (Friday)
Forecast: 52.5 (-1.1 Index Pts)

The service sector of the economy has thus far proven resilient to aggressive tightening in monetary policy, but the recent surge in interest rates, which has filtered through to all sectors of the economy, could exert an additional constraining influence on activity in coming months. The business activity component, in particular, appears vulnerable to correction in October after a high-side reading in September (58.8) amid only modestly increasing order flows (51.8).

ISM Services Index*



** The gold bar is a forecast for October 2023.*

Sources: Institute for Supply Management via Haver Analytics; Daiwa Capital Markets America

Economic Indicators

October/November 2023

Monday 23

CHICAGO FED NATIONAL ACTIVITY INDEX

	Monthly	3-Mo. Avg.
July	0.20	-0.13
Aug	-0.22	-0.14
Sep	0.02	0.00

Tuesday 24

Wednesday 25

NEW HOME SALES

July	0.736 million
Aug	0.676 million
Sep	0.759 million

ADVANCE INVENTORIES

	Wholesale	Retail
July	-0.3%	0.5%
Aug	-0.1%	1.1%
Sep	0.0%	0.9%

PENDING HOME SALES

July	0.5%
Aug	-7.1%
Sep	1.1%

Thursday 26

UNEMPLOYMENT CLAIMS

	Initial	Continuing
	(millions)	
Sep 30	0.209	1.705
Oct 7	0.211	1.727
Oct 14	0.200	1.790
Oct 21	0.210	N/A

GDP

	GDP	Chained Price
23-Q1	2.2%	3.9%
23-Q2	2.1%	1.7%
23-Q3	4.9%	3.5%

DURABLE GOODS ORDERS

July	-5.6%
Aug	-0.1%
Sep	4.7%

INTERNATIONAL TRADE IN GOODS

July	-$90.9 billion
Aug	-$84.6 billion
Sep	-$85.8 billion

Friday 27

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX

	Inc.	Cons.	Core
July	0.2%	0.8%	0.2%
Aug	0.4%	0.4%	0.1%
Sep	0.3%	0.7%	0.3%

REVISED CONSUMER SENTIMENT

Sep	67.9
Oct (p)	63.0
Oct (r)	63.8

Monday 30

Tuesday 31

EMPLOYMENT COST INDEX (8:30)

	Comp.	Wages
23-Q1	1.2%	1.2%
23-Q2	1.0%	1.0%
23-Q3	**1.0%**	**1.0%**

FHFA HOME PRICE INDEX (9:00)

June	0.4%
July	0.8%
Aug	--

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)

June	0.9%
July	0.9%
Aug	--

MNI CHICAGO BUSINESS BAROMETER (9:45)

	Index	Prices
Aug	48.7	74.0
Sep	44.1	59.5
Oct	--	--

CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)

Aug	108.7
Sep	103.0
Oct	**100.0**

FOMC MEETING (FIRST DAY)

Wednesday 1

ADP EMPLOYMENT (8:15)

	Private Payrolls
Aug	180,000
Sep	89,000
Oct	--

ISM MFG. INDEX (10:00)

	Index	Prices
Aug	47.6	48.4
Sep	49.0	43.8
Oct	**48.5**	**46.0**

CONSTRUCTION (10:00)

July	0.9%
Aug	0.5%
Sep	**0.3%**

JOLTS DATA (10:00)

	Openings (000)	Quit Rate
July	8,920	2.3%
Aug	9,610	2.3%
Sep	--	--

FOMC DECISION (2:00)

VEHICLE SALES

Aug	15.4 million
Sep	15.7 million
Oct	**15.4 million**

Thursday 2

UNEMP. CLAIMS (8:30)

PRODUCTIVITY & COSTS (8:30)

	Productivity	Unit Labor Costs
23-Q1	-1.2%	3.3%
23-Q2	3.5%	2.2%
23-Q3	**4.0%**	**-0.4%**

FACTORY ORDERS (10:00)

July	-2.1%
Aug	1.0%
Sep	**2.5%**

Friday 3

EMPLOYMENT REPORT (8:30)

	Payrolls	Un. Rate
Aug	227,000	3.8%
Sep	336,000	3.8%
Oct	**180,000**	**3.8%**

ISM SERVICES INDEX (10:00)

	Index	Prices
Aug	54.5	58.9
Sep	53.6	58.9
Oct	**52.5**	**58.5**

Monday 6

Tuesday 7

TRADE BALANCE

CONSUMER CREDIT

Wednesday 8

WHOLESALE TRADE

Thursday 9

UNEMP. CLAIMS

Friday 10

CONSUMER SENTIMENT

FEDERAL BUDGET

Monday 13

Tuesday 14

NFIB SMALL BUSINESS OPTIMISM INDEX

CPI

Wednesday 15

PPI

RETAIL SALES

EMPIRE MFG

BUSINESS INVENTORIES

Thursday 16

UNEMP. CLAIMS

IMPORT/EXPORT PRICES

PHILLY FED INDEX

IP & CAP-U

NAHB HOUSING INDEX

TIC FLOWS

Friday 17

HOUSING STARTS

Forecasts in bold. (p) = preliminary, (r) = revised

Treasury Financing

October/November 2023

Monday	Tuesday	Wednesday	Thursday	Friday
23	24	25	26	27
AUCTION RESULTS: Rate / Cover 13-week bills 5.310% 2.85 26-week bills 5.325% 2.70	**AUCTION RESULTS:** Rate / Cover 2-yr notes 5.055% 2.64 42-day CMBs 5.300% 3.01 **ANNOUNCE:** $56 billion 17-week bills for auction on Oct 25 $95 billion 4-week bills for auction on Oct 26 $85 billion 8-week bills for auction on Oct 26 **SETTLE:** $56 billion 17-week bills $95 billion 4-week bills $85 billion 8-week bills	**AUCTION RESULTS:** Rate / Cover 17-week bills 5.335% 2.96 5-yr notes 4.899% 2.36 Spread / Cover 2-yr FRNs 0.170% 3.23	**AUCTION RESULTS:** Rate / Cover 4-week bills 5.295% 2.94 8-week bills 5.330% 2.52 7-yr notes 4.908% 2.70 **ANNOUNCE:** $143 billion 13-,26-week bills for auction on Oct 30 $44 billion 52-week bills for auction on Oct 31 $75 billion 42-day CMBs for auction on Oct 31 **SETTLE:** $143 billion 13-,26-week bills $75 billion 42-day CMBs	
30	31	1	2	3
AUCTION: $143 billion 13-,26-week bills	**AUCTION:** $44 billion 52-week bills $75 billion 42-day CMBs **ANNOUNCE:** $56 billion* 17-week bills for auction on Nov 1 $95 billion* 4-week bills for auction on Nov 2 $85 billion* 8-week bills for auction on Nov 2 **SETTLE:** $56 billion 17-week bills $95 billion 4-week bills $85 billion 8-week bills $13 billion 20-year bonds $22 billion 5-year TIPS $51 billion 2-year notes $52 billion 5-year notes $38 billion 7-year notes $26 billion 2-year FRNs	**AUCTION:** $56 billion* 17-week bills **ANNOUNCE:** $48 billion* 3-year notes for auction on Nov 7 $41 billion* 10-year notes for auction on Nov 8 $25 billion* 30-year bonds for auction on Nov 9	**AUCTION:** $95 billion* 4-week bills $85 billion* 8-week bills **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Nov 6 **SETTLE:** $143 billion 13-,26-week bills $44 billion 52-week bills $75 billion 42-day CMBs	
6	7	8	9	10
AUCTION: $143 billion* 13-,26-week bills	**AUCTION:** $48 billion* 3-year notes **ANNOUNCE:** $56 billion* 17-week bills for auction on Nov 8 $95 billion* 4-week bills for auction on Nov 9 $85 billion* 8-week bills for auction on Nov 9 **SETTLE:** $56 billion* 17-week bills $95 billion* 4-week bills $85 billion* 8-week bills	**AUCTION:** $56 billion* 17-week bills $41 billion* 10-year notes	**AUCTION:** $95 billion* 4-week bills $85 billion* 8-week bills $25 billion* 30-year bonds **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Nov 13 **SETTLE:** $143 billion* 13-,26-week bills	
13	14	15	16	17
AUCTION: $143 billion* 13-,26-week bills	**ANNOUNCE:** $56 billion* 17-week bills for auction on Nov 15 $95 billion* 4-week bills for auction on Nov 16 $85 billion* 8-week bills for auction on Nov 16 **SETTLE:** $56 billion* 17-week bills $95 billion* 4-week bills $85 billion* 8-week bills	**AUCTION:** $56 billion* 17-week bills **SETTLE:** $48 billion* 3-year notes $41 billion* 10-year notes $25 billion* 30-year bonds	**AUCTION:** $95 billion* 4-week bills $85 billion* 8-week bills **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Nov 20 $17 billion* 20-year bonds for auction on Nov 20 $16 billion* 10-year TIPS for auction on Nov 21 $26 billion* 2-year FRNs for auction on Nov 21 **SETTLE:** $143 billion* 13-,26-week bills	

**Estimate*