Daiwa Capital Markets

U.S. Economic Comment

- December employment: solid payroll print, with caveats; brisk earnings growth; concerns with household data
- ISM services: still indicating growth, but a concerning drop in the employment component

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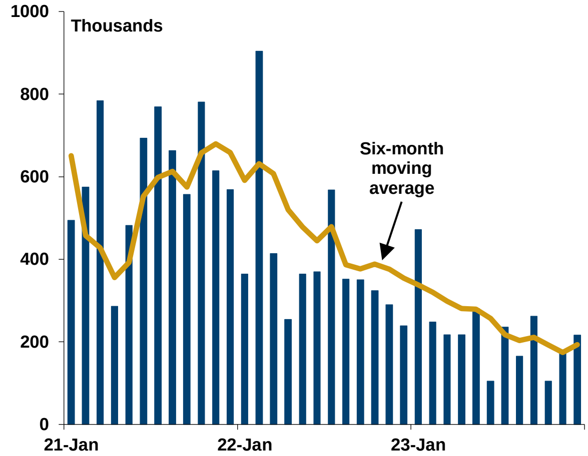
December Employment

In our view, the December employment data pushed back against market expectations of the Federal Open Market Committee cutting the federal funds rate at its March meeting. Nonfarm payrolls increased solidly, average hourly earnings rose briskly, and the unemployment rate was consistent with a fully employed economy. At the same time, we were concerned about the drivers of payroll growth in December, as well as about various components of the household survey which suggest that underlying conditions in the labor market could be softening more rapidly than implied by metrics such as job growth, the unemployment rate, or wages.

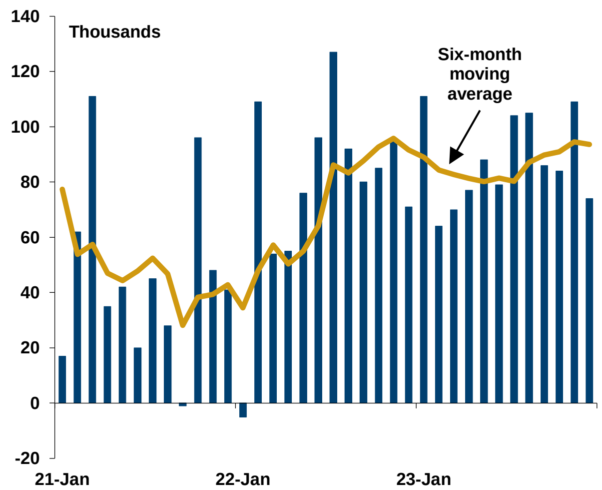
Change in Nonfarm Payrolls



Source: Bureau of Labor Statistics via Haver Analytics

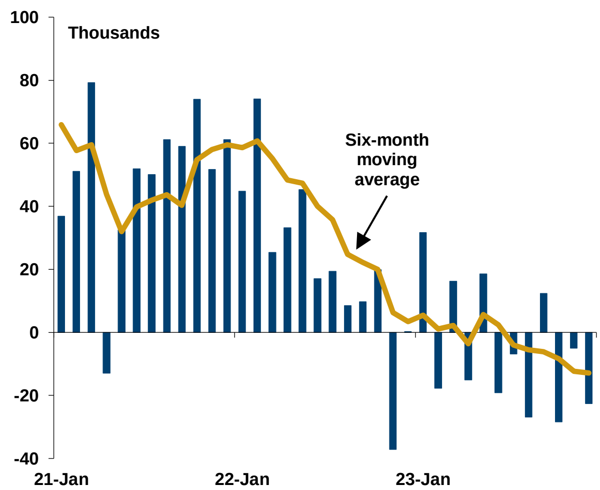
Regarding payrolls, growth of 216,000 was firmer than the consensus expectation of 175,000, and average results of 174,000 in the prior six months (June to November) were just shy of that view (chart, top right). Less favorable was the composition of payroll growth in December. The government sector added 52,000 jobs, 45,000 of which occurred at the state and local levels. These jobs are often well-paying and immune from economic downturns, and therefore they also could be sending a false signal about the strength of underlying employment growth. Average gains of 48,000 per month in 2023 while private-sector job growth is slowing suggest that previously unspent COVID funds or some other stream of financing is supporting an expansion of hiring while private-sector firms are exercising more restraint.

Change in Health Care & Education Payrolls



Source: Bureau of Labor Statistics via Haver Analytics

Change in Transport. & Warehousing Payrolls

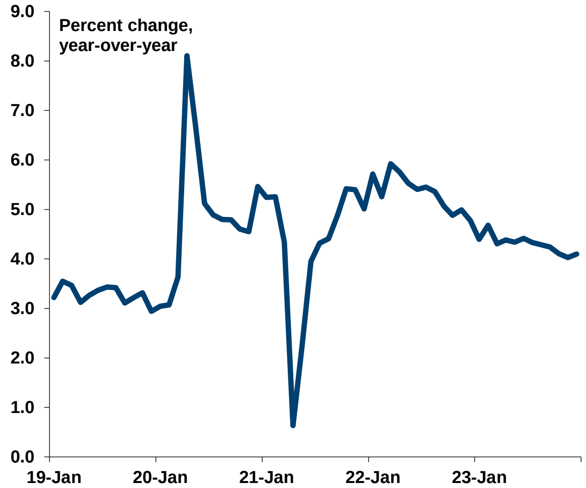


Source: Bureau of Labor Statistics via Haver Analytics

Moderation in private-sector job growth (164,000 jobs added in December and a 12-month average of 169,000 versus an average of 376,000 in 2022) is a desirable outcome in that the Federal Reserve needs labor market conditions ease in order to slow wage growth. However, we note with concern a narrowing in the dispersion of job gains in recent months. For instance, education and healthcare, counter-cyclical areas, added a combined 74,000 positions in December, and averaged increases of 89,000 in the prior 11 months (chart, previous page, below left). At the same time, cyclically sensitive areas are showing decidedly weaker results. Manufacturing firms added 6,000 jobs in December, but the sector has added only 1,000 jobs in total in the second half of 2023. Similarly, logistics-related firms in transportation and warehousing, which provide a view on the pace of commerce, cut 23,000 jobs in December and 77,000 positions in total in the July-to-December period (chart, previous page, below right). Hiring is not falling off a cliff, but weakness prevailed in many areas and layoffs appeared to be accelerating in others – concerning developments to be sure that raise the possibility that headline payrolls are overstating labor market strength.

Wage growth sent perhaps a less ambiguous signal on labor market tightness, with average hourly earnings increasing 0.4 percent after a firm advance in November. The shift led to a 0.1 percentage point pickup in the year-over-year change to 4.1 percent (chart). The increase was a bit slower for production and non-supervisory workers (+0.3 percent), but the change followed consecutive advances of 0.4 percent and the year-over-year increase eclipsed that for all workers (4.3 percent, down from 4.4 percent in November). As it stands, compensation growth of 4.0 percent is likely viewed by Fed officials as inconsistent with a sustainable return to two percent inflation over time, particularly because wage costs are readily passed along to the prices of services – where inflation is still running hot. (For reference, desirable wage growth would probably be closer to 3.0 to 3.5 percent. Trend productivity growth -- perhaps 1.0 to 1.5 percent-- plus the central bank's inflation target). Moreover, wage growth could prove sticky even as the labor market slows. Many workers saw real compensation declines amid recent rapid inflation, and some are pushing for significant pay increases – particularly in high-demand positions and in union shops. Additionally, 22 states increased the minimum wage in 2024, which will start to influence average earnings in the months ahead.

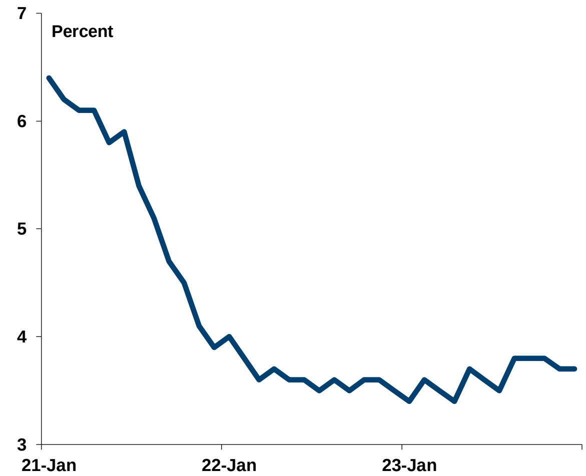
Average Hourly Earnings



Source: Bureau of Labor Statistics via Haver Analytics

Data from the household survey were somewhat more concerning. The unemployment rate surprised, holding at a subdued 3.7 percent in December, but the change should be viewed as a soft one (chart). A striking drop of 683,000 in employment measured by the household survey exceeded a contraction of 676,000 in the size of the labor force (charts, next page, top right and left). The drop in the labor force arrested recent progress in the participation rate, which fell 0.3 percentage point to 62.5 percent. That drop in the labor force, in turn, could complicate the task of constraining wage growth, as a tight supply was previously contributing to tight labor market conditions and sustaining strong wage growth. Also notable was a significant shift in the composition of employment. Full-time employment fell by 1.531 million, the largest drop since the labor market began to normalize post COVID (chart, next page, bottom left). However, part-time positions provided a partial offset with an increase of 762,000 (chart, next page, bottom right).

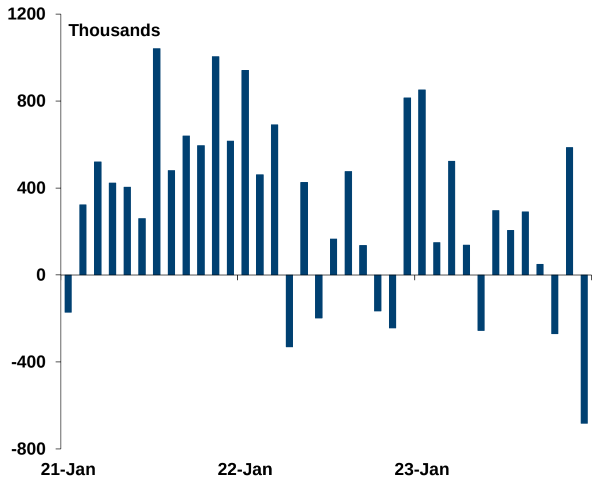
Unemployment Rate



Source: Bureau of Labor Statistics via Haver Analytics

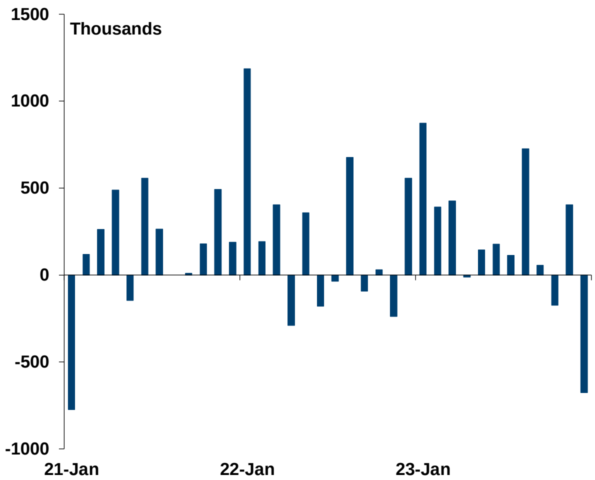
We don't want to overemphasize one month's worth of data. Results for the household survey are often erratic and could sent misleading short-term signals. However, if data in the next few months ratify what we're seeing in December, the conditions in the labor market could be deteriorating rapidly.

Change in Household Employment



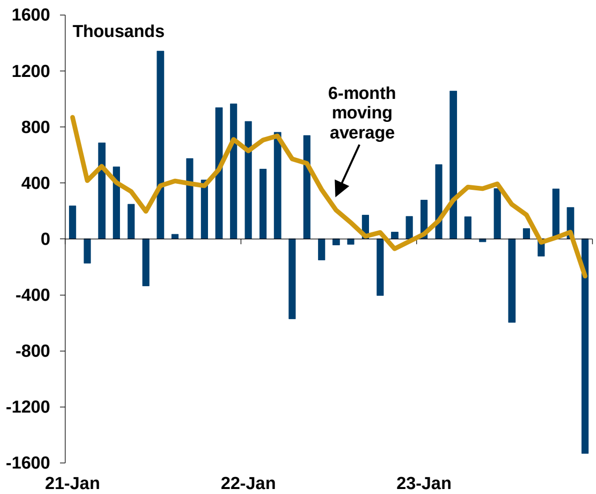
Source: Bureau of Labor Statistics via Haver Analytics

Change in the Labor Force



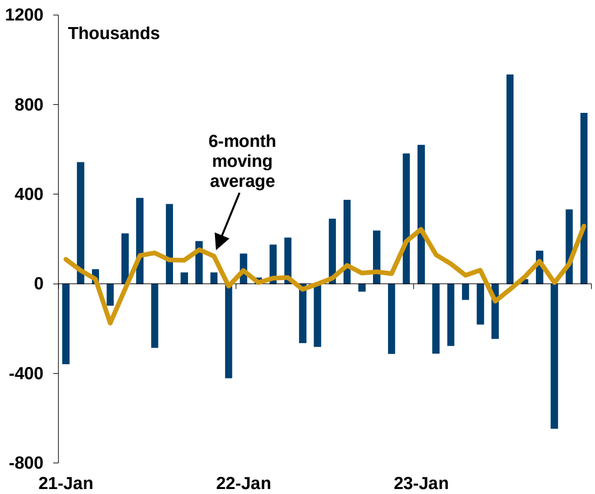
Source: Bureau of Labor Statistics via Haver Analytics

Change in Full-Time Employment



Source: Bureau of Labor Statistics via Haver Analytics

Change in Part-Time Employment



Source: Bureau of Labor Statistics via Haver Analytics

ISM Services Index Suggests Slower Growth

We have been pleasantly surprised for some time by the performance of the economy amid forceful action by the Federal Reserve and a rapid, sharp tightening in financial conditions. The economy expanded at a rate of almost five percent in Q3, and by our estimate GDP is set to register growth between one-and-a-half and two percent in Q4. That said, we value various purchasing managers' indexes because they provide closer to real-time insights into the economy; in particular, we follow closely the Manufacturing and Services PMIs from the Institute for Supply Management.

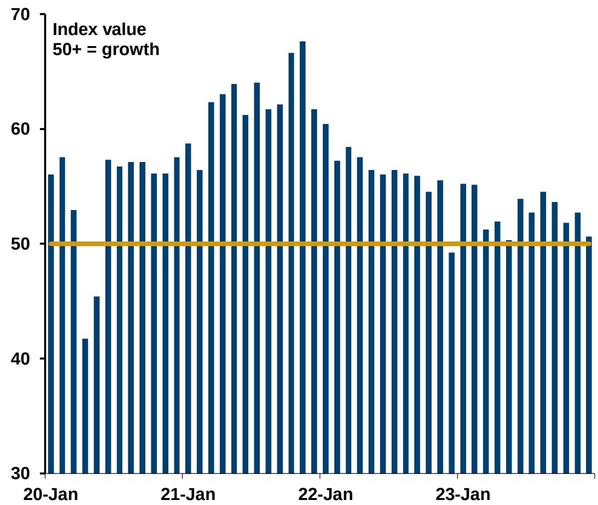
The manufacturing gauge, released on Wednesday, continued on its soft trend, with the reading of 47.4 for December being the 14th consecutive observation indicating contraction in the factory sector. Yet, while the measure was soft, manufacturing makes up a relatively small share of U.S. economic output. Additionally, comments in the release suggested stabilization and raised the possibility of improved conditions later in 2024. More concerning was the deterioration noted in today's services report, with the headline slipping 2.1 index points to 50.6 – the lowest reading since May (50.3) after a monthly average of 53.2 in the June-to-November period (chart, next page, below left). The service sector makes up a significantly larger share of the economy (almost 90 percent in terms of gross value added) and therefore a sharp slowing could signal that the economic engine is stalling.

Of key concern was the plunge of 7.4 index points in the employment component to 43.3, the lowest reading since a 43.0 print in July 2020 when the economy was emerging from the brief but severe COVID-generated recession (chart, below right). Comments from the ISM release indicated some issues with skilled employee retention as workers left to seek jobs with hybrid arrangements, while others noted layoffs in a “climate of economic uncertainty and decreasing customer demand.” On balance, seven industry groups increased headcounts, and eight reduced payrolls. Thus, this component should be monitored closely as it could portend additional slowing in hiring or a potential pickup in layoffs.

Performances in other key components varied. Business activity rose by 1.5 index points to 56.6, a reading slightly better than the average of 56.1 in the preceding 11 months of 2023 and indicative of a solid performance. However, the sustainability of the current pace of business activity was called into question, as the new orders component dropped 2.7 index points to 52.8. Orders activity is not contracting, but it is sluggish relative to flows that generated an average reading of 55.9 in the prior 11 months. The reading of 49.5 for the supplier deliveries component was one tick below the previous reading; observations below 50 indicate “faster” deliveries. Readings since the fall of 2022 suggest that supply chain issues created by the onset of COVID have been fully resolved.

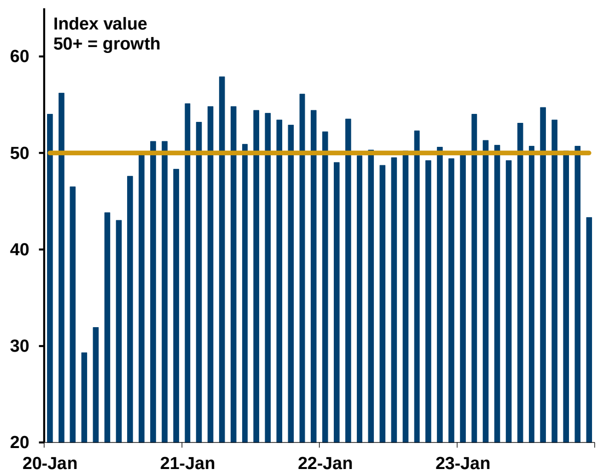
Today’s report does not suggest that a recession is imminent, but it does provide another clue that the labor market could be slowing more sharply than indicated by topline payroll growth or the sub-four-percent unemployment rate. If the full effects of restrictive monetary policy have yet to be felt, then the economy could well slow more rapidly in coming months.

ISM Services: Headline Index



Source: Institute for Supply Management via Haver Analytics

ISM Services: Employment Index



Source: Institute for Supply Management via Haver Analytics

The Week Ahead

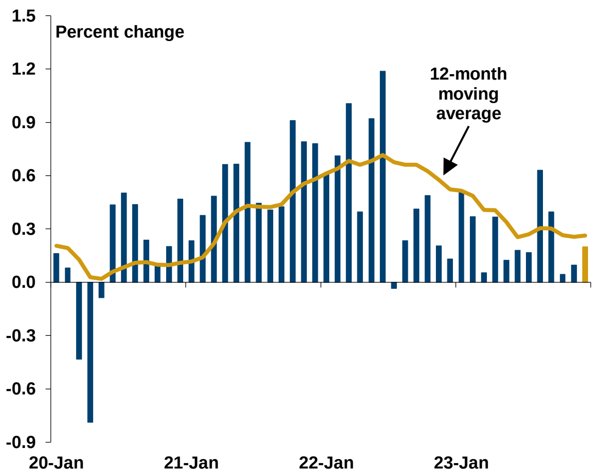
Trade Balance (November) (Tuesday)
Forecast: -$65.0 Billion ($0.7 Billion Wider Deficit)

The widening of $0.7 billion in the goods deficit released on December 28 raises the possibility of similar deterioration in the total trade deficit for November. The surplus in service trade has eased slightly on balance in the past two months ($0.6 billion combined) after surging higher for most of 2023.

CPI (December) (Thursday)
Forecast: 0.2% Total, 0.3% Core

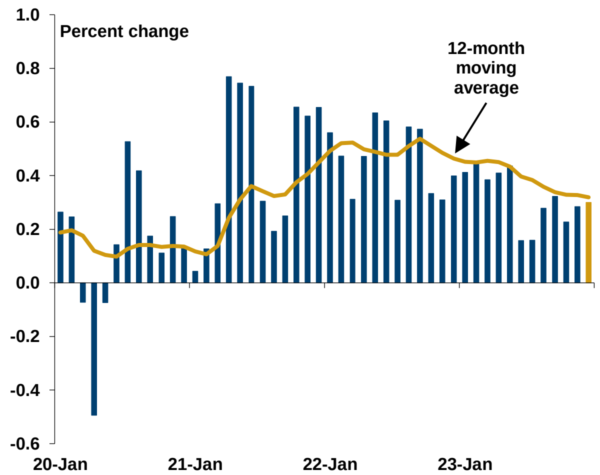
Gasoline prices eased during the December survey period, but the energy component could tilt higher after seasonal adjustment. The trend in food inflation has moderated sharply, raising the possibility of another advance of 0.2 percent (matching the average in 2023 thus far). We suspect that core inflation could tilt on the firm side in December. Core goods prices have declined for six consecutive months (and averaged flat monthly readings in 2023 thus far), but core service price have remained under pressure (average monthly increase of 0.4 percent in 2023) – in part reflecting continued firm advances in rents and owner-occupied housing costs.

Headline CPI*



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

Core CPI*



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

Federal Budget (December) (Thursday)
Forecast: -$90.0 Billion

While federal spending appears to have remained on its firm trajectory in December, available data suggest that revenues appear to have declined as well (-4.5 percent year-over-year expected). If the forecast is realized, the budget shortfall for the first three months of FY2023 would total approximately $471 billion, about $49 billion wider than the deficit in the same period in FY2022.

PPI (December) (Friday)
Forecast: 0.2% Total, 0.2% Ex. Food & Energy

Available data suggest that energy prices at the producer level could pick up in December after back-to-back declines. Food prices reported in the PPI are often volatile, with the recent patter of price shifts suggesting a dip after a jump of 0.6 percent in November. Core goods prices have increased 0.1 percent per month, on average, in the first 11 months of 2023, while service prices have advanced at a slightly faster rate (0.146 percent and 0.155 percent, respectively, with less rounding). Construction costs have increased slightly on balance in 2023 thus far.

Economic Indicators

January 2024

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5
NEW YEAR'S DAY	**CONSTRUCTION** Sep 0.4% Oct 1.2% Nov 0.4%	**ISM MFG. INDEX** Index Prices Oct 46.7 45.1 Nov 46.7 49.9 Dec 47.4 45.2 **JOLTS DATA** Openings (000) Quit Rate Sep 9,350 2.3% Oct 8,852 2.3% Nov 8,790 2.2% **FOMC MINUTES** **VEHICLE SALES** Oct 15.4 million Nov 15.3 million Dec 15.8 million	**ADP EMPLOYMENT** Private Payrolls Oct 106,000 Nov 101,000 Dec 164,000 **UNEMPLOYMENT CLAIMS** Initial Continuing (millions) Dec 9 0.203 1.861 Dec 16 0.206 1.886 Dec 23 0.220 1.855 Dec 30 0.202 N/A	**EMPLOYMENT REPORT** Payrolls Un. Rate Oct 105,000 3.8% Nov 173,000 3.7% Dec 216,000 3.7% **ISM SERVICES INDEX** Index Prices Oct 51.8 58.6 Nov 52.7 58.3 Dec 50.6 57.4 **FACTORY ORDERS** Sep 2.3% Oct -3.4% Nov 2.6%
8	9	10	11	12
CONSUMER CREDIT (3:00) Sep $12.2 billion Oct $5.1 billion Nov --	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** Oct 90.7 Nov 90.6 Dec -- **TRADE BALANCE (8:30)** Sep -$61.2 billion Oct -$64.3 billion **Nov -$65.0 billion**	**WHOLESALE TRADE (10:00)** Inventories Sales Sep 0.0% 2.0% Oct -0.3% -1.3% **Nov -0.2% 0.5%**	**UNEMP. CLAIMS (8:30)** **CPI (8:30)** Total Core Oct 0.0% 0.2% Nov 0.1% 0.3% **Dec 0.2% 0.3%** **FEDERAL BUDGET (2:00)** 2023 2022 Oct -$66.6B -$87.9B Nov -$314.0B -$248.5B **Dec -$90.0B** -$85.0B	**PPI (8:30)** Final Demand Ex. Food & Energy Oct -0.4% 0.0% Nov 0.0% 0.0% **Dec 0.2% 0.2%**
15	16	17	18	19
MARTIN LUTHER KING JR DAY	**EMPIRE MFG**	**RETAIL SALES** **IMPORT/EXPORT PRICES** **IP & CAP-U** **NAHB HOUSING INDEX** **BUSINESS INVENTORIES** **BEIGE BOOK**	**UNEMP. CLAIMS** **HOUSING STARTS** **PHILLY FED INDEX**	**CONSUMER SENTIMENT** **EXISTING HOME SALES** **TIC FLOWS**
22	23	24	25	26
LEADING INDICATORS			**UNEMP. CLAIMS** **Q4 GDP** **DURABLE GOODS ORDERS** **INTERNATIONAL TRADE IN GOODS** **CHICAGO FED NATIONAL ACTIVITY INDEX** **ADVANCE INVENTORIES** **NEW HOME SALES**	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** **PENDING HOME SALES**

Forecasts in bold.

Daiwa Capital Markets

Treasury Financing

January 2024

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5
NEW YEAR'S DAY	**AUCTION RESULTS:** Rate / Cover 13-week bills 5.245% 2.71 26-week bills 5.045% 3.06 42 day CMBs 5.290% 2.72 **ANNOUNCE:** $56 billion 17-week bills for auction on Jan 3 $80 billion 4-week bills for auction on Jan 4 $80 billion 8-week bills for auction on Jan 4 **SETTLE:** $56 billion 17-week bills $80 billion 4-week bills $80 billion 8-week bills $13 billion 20-year bonds $57 billion 2-year notes $58 billion 5-year notes $40 billion 7-year notes	**AUCTION RESULTS:** Rate / Cover 17-week bills 5.200% 3.09	**AUCTION RESULTS:** Rate / Cover 4-week bills 5.290% 2.96 8-week bills 5.285% 2.80 **ANNOUNCE:** $143 billion 13-,26-week bills for auction on Jan 8 $52 billion 3-year notes for auction on Jan 9 $37 billion 10-year notes for auction on Jan 10 $21 billion 30-year bonds for auction on Jan 11 $70 billion 42-day CMBs for auction on Jan 9 **SETTLE:** $143 billion 13-,26-week bills $70 billion 42-day CMBs	
8	9	10	11	12
AUCTION: $143 billion 13-,26-week bills	**AUCTION:** $52 billion 3-year notes $70 billion 42-day CMBs **ANNOUNCE:** $56 billion* 17-week bills for auction on Jan 10 $80 billion* 4-week bills for auction on Jan 11 $80 billion* 8-week bills for auction on Jan 11 **SETTLE:** $56 billion 17-week bills $80 billion 4-week bills $80 billion 8-week bills	**AUCTION:** $56 billion* 17-week bills $37 billion 10-year notes	**AUCTION:** $80 billion* 4-week bills $80 billion* 8-week bills $21 billion 30-year bonds **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Jan 16 $13 billion* 20-year bonds for auction on Jan 17 $18 billion* 10-year TIPS for auction on Jan 18 **SETTLE:** $143 billion 13-,26-week bills $70 billion 42-day CMBs	
15	16	17	18	19
MARTIN LUTHER KING JR DAY	**AUCTION:** $143 billion* 13-,26-week bills **ANNOUNCE:** $56 billion* 17-week bills for auction on Jan 17 $80 billion* 4-week bills for auction on Jan 18 $80 billion* 8-week bills for auction on Jan 18 **SETTLE:** $56 billion* 17-week bills $80 billion* 4-week bills $80 billion* 8-week bills $52 billion 3-year notes $37 billion 10-year notes $21 billion 30-year bonds	**AUCTION:** $56 billion* 17-week bills $13 billion* 20-year bonds	**AUCTION:** $80 billion* 4-week bills $80 billion* 8-week bills $18 billion* 10-year TIPS **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Jan 22 $44 billion* 52-week bills for auction on Jan 23 $60 billion* 2-year notes for auction on Jan 23 $61 billion* 5-year notes for auction on Jan 24 $41 billion* 7-year notes for auction on Jan 25 $28 billion* 2-year FRNs for auction on Jan 24 **SETTLE:** $143 billion* 13-,26-week bills	
22	23	24	25	26
AUCTION: $143 billion* 13-,26-week bills	**AUCTION:** $44 billion* 52-week bills $60 billion* 2-year notes **ANNOUNCE:** $56 billion* 17-week bills for auction on Jan 24 $80 billion* 4-week bills for auction on Jan 25 $80 billion* 8-week bills for auction on Jan 25 **SETTLE:** $56 billion* 17-week bills $80 billion* 4-week bills $80 billion* 8-week bills	**AUCTION:** $56 billion* 17-week bills $61 billion* 5-year notes $28 billion* 2-year FRNs	**AUCTION:** $80 billion* 4-week bills $80 billion* 8-week bills $41 billion* 7-year notes **ANNOUNCE:** $143 billion* 13-,26-week bills for auction on Jan 29 **SETTLE:** $143 billion* 13-,26-week bills $44 billion* 52-week bills	

*Estimate