U.S. Economic Comment

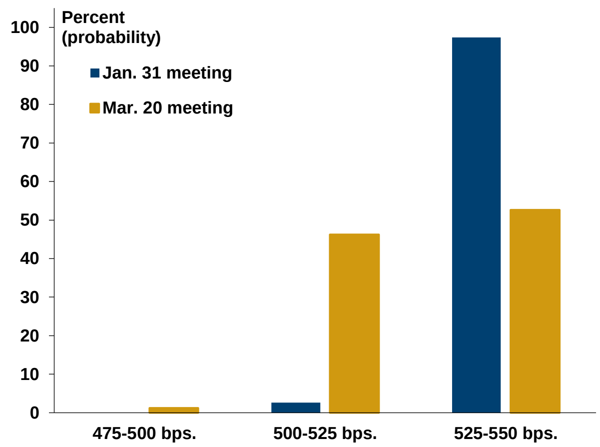
- FOMC: on hold next week
- QT update: taper unlikely in near term, but possible update in coming months
- Inflation: significant progress, but further slowing required

Lawrence Werther
Daiwa Capital Markets America
212-612-6393
lawrence.werther@us.daiwacm.com

January FOMC Meeting

Market expectations and Fed messaging appear well-aligned insofar as there is little chance of a cut in the federal funds rate at the conclusion of the policy meeting on January 30-31 (chart). The report on Q4 GDP released earlier this week indicated that the economy expanded at a brisk clip in the closing months of 2023 (3.3 percent, annual rate) and registered a firm advance for the year (growth of 3.1 percent Q4/Q4 in 2023). In addition, the GDPNow model from the Federal Reserve Bank of Atlanta is projecting growth in the current quarter of 3.0 percent. With economic output strong and a moderating labor market still tight enough to generate 4.0 percent annual wage growth, officials are unlikely to pivot early and risk a reacceleration in inflation.

Target Rate Probabilities for FOMC Meetings



Source: CME Group, FedWatch Tool

On that point, Raphael Bostic, President of the Atlanta Fed and a 2024 FOMC voter (who, in our view, leans dovish), noted in a recent speech that inflation has improved enough for him to adjust his expectations on a pivot. However, his expectation for the first rate cut has only shifted from Q4 to Q3. Correspondingly, President Bostic's assessment should quell remaining market calls for a rate cut in March, a sentiment that has lingered after what was perceived as dovish comments by Chair Powell in his press conference at the conclusion of the December FOMC meeting. (For more information see: Bostic, Raphael, "The Arc of Monetary Policy May Start Bending Soon," Federal Reserve Bank of Atlanta, January 18, 2024. https://www.atlantafed.org/news/speeches/2024/01/18/bostic--arc-of-monetary-policy).

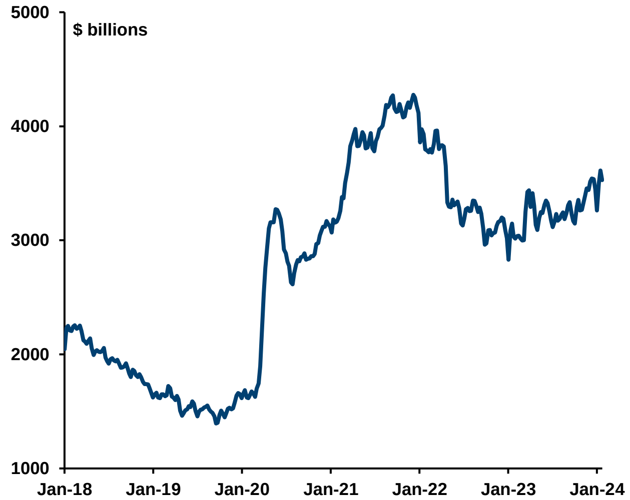
Although the growth and inflation data (and comments of Fed officials) appear to preclude a shift in interest rates at FOMC meetings in Q1, we anticipate other critical issues receiving attention at upcoming gatherings. Chief among these are plans for tapering quantitative tightening (QT) in light of recent developments on the Fed's balance sheet. We do not foresee a significant announcement on this front at the conclusion of next week's meeting, but the December FOMC minutes indicated that issues relating to the balance sheet were on the Committee's radar: "Several participants remarked that the Committee's balance sheet plans indicated that it would slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level judged consistent with ample reserves. These participants suggested that it would be appropriate for the Committee to begin to discuss the technical factors that would guide a decision to slow the pace of runoff…" ("Minutes of the Federal Open Market Committee: December 12-13, 2023," Federal Reserve Board, January 3, 2024. https://www.federalreserve.gov/monetarypolicy/fomcminutes20231213.htm).

The RRP Facility: A Likely Catalyst for Wind-Down of QT

Since June 2022, the Federal Reserve has embarked on a second round of balance sheet normalization, also known as quantitative tightening (QT). This round of portfolio reduction was implemented to segue away from the pandemic-related crisis response wherein quantitative easing (QE) caused the asset side of the Fed's balance sheet to jump to a record $8.96 trillion in April 2022 (36 percent of GDP). A return to normal operating parameters of an "ample reserves" policy regime from one with "abundant reserves" has involved allowing redemptions of maturing securities to commence at a rate currently of $60 billion per month of Treasury securities and up to $35 billion of agency MBS. The shrinkage of the securities has since reduced Fed assets to approximately 28 percent of GDP (assets as of January as a share of 2023 nominal GDP) while concurrently draining reserves from the banking system, which have slipped from $4.2 trillion to approximately $3.5 trillion (chart, below left).

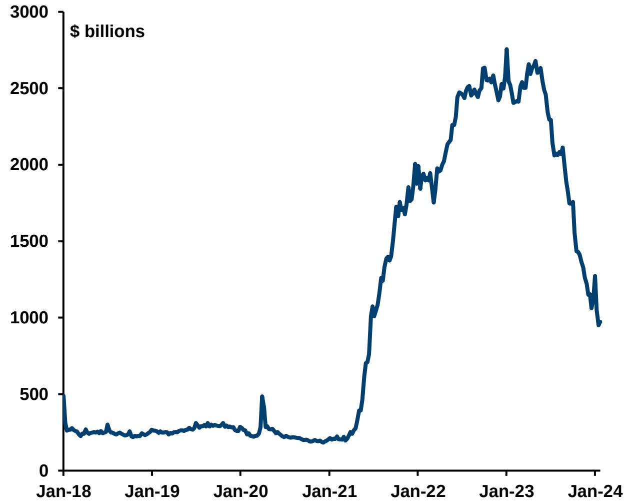
Although bank reserves are down from their peak, they have actually drifted higher since the Fed intervened to stem volatility in the banking sector last spring and stabilized more recently despite ongoing portfolio runoff. Amid this development, officials have monitored funds placed in the reverse repurchase facility (RRP), one of two primary tools along with interest paid on reserve balances held at the Fed (IORB), that maintain the federal funds target rate in an abundant reserves regime. When RRP uptake is at elevated levels, as it was from the summer of 2022 through this past summer, it suggests that there is significant excess liquidity in the funding markets that is being offloaded at the Fed. However, conditions have shifted recently with funds in the RRP reported at less than $630 million as of the week ending January 24th (chart, below right).

Reserve Balances with Federal Reserve Banks*



** Weekly average data*
Source: Federal Reserve Board via Haver Analytics

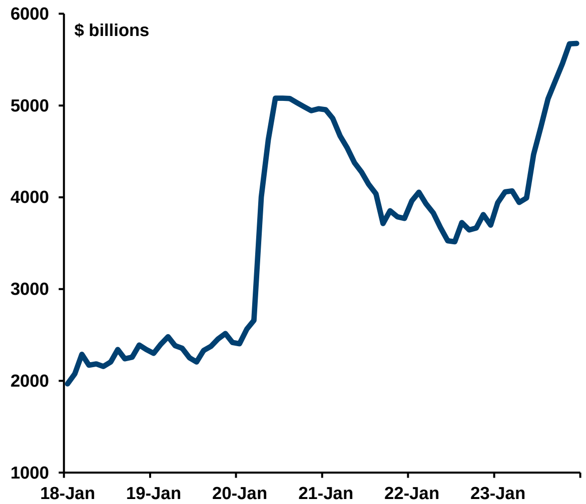
Reverse Repurchase Agreements*



** Weekly average data*
Source: Federal Reserve Board via Haver Analytics

The plunge in recent months has been attributed primarily to investors shifting resources to the Treasury market, where a surge in the issuance of T-bills with marginally higher rates has caused funds to shift away from the RRP facility (chart; monthly data through December). By itself, this development does not imply a shortage of liquidity in the banking system, as repo rates have settled after coming under pressure late last year. That said, the rapid decline in RRP usage does raise the prospect that bank reserves could next begin to fall and quickly approach a range of 9.0 to 11.0 percent of nominal GDP, which is highlighted by some Fed officials as consistent with a well-functioning abundant reserves regime (by comparison, reserves currently exceed 12.5 percent of GDP). Thus, officials have begun to discuss tapering QT to circumvent a potential liquidity drain that could lead to reserve scarcity and volatility in short-term funding markets, should reserves fall below acceptable thresholds. (For more information on the ample-reserves regime and the Fed's operating framework see: Ihrig, Jane et al. "The Fed's 'Ample-Reserves' Approach to Implementing Monetary Policy," Federal Reserve Board, February 2020.

Treasury Bills Outstanding



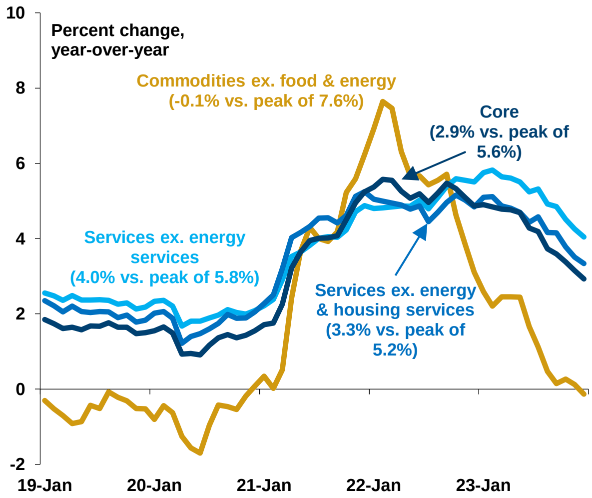
Source: U.S. Treasury via Haver Analytics https://www.federalreserve.gov/econres/notes/feds-notes/implementing-monetary-policy-in-an-ample-reserves-regime-the-basics-note-1-of-3-20200701.html. For more on policy implementation, see: “Monetary Policy Implementation,” Federal Reserve Bank of New York. https://www.newyorkfed.org/markets/domestic-market-operations/monetary-policy-implementation).

Inflation Developments

Beyond considerations about the balance sheet, Fed officials are still keenly focused on inflation. While price pressure has eased substantially since the Fed embarked on its aggressive campaign of policy tightening, officials have yet to declare victory -- an approach that, in our view, limits the potential for a policy mistake (a premature pivot) that would allow a reacceleration in inflation.

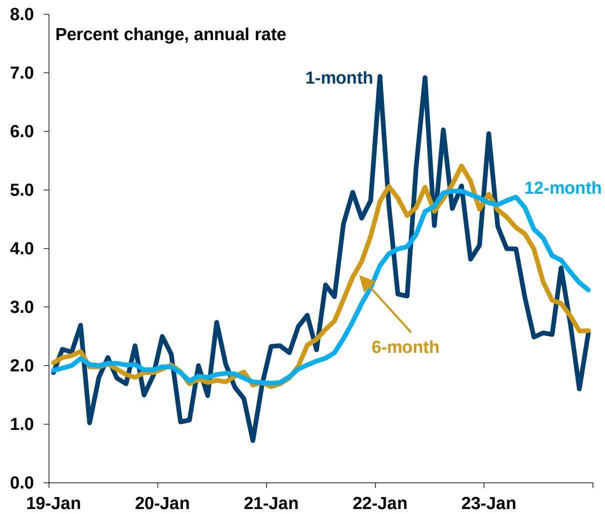
The December reading on the price index for personal consumption expenditures, released earlier today in the Personal Income and Consumption Report from the Bureau of Economic Analysis, provided a key illustration of this point. Both headline and core inflation rose 0.2 percent (2.6 percent and 2.9 percent year-over-year, respectively), and key areas within core remained on recent trends (subdued inflation in core goods, but ongoing pressure in services; chart, below left). Moreover, the Trimmed Mean PCE Inflation Rate, which gives a good indication of the underlying inflation trend, eased on a 12-month basis (3.29 percent versus 3.42 percent in November) and was 0.7 percentage point below that on a six-month basis (2.6 percent for the second consecutive month) but it jumped on a one-month basis (2.56 percent versus 1.60 percent in November; chart, below right). The reading supports the assessment of Fed officials that inflation has improved dramatically from its peak in mid-2022, but it also shows that additional progress will be nonlinear and is not yet guaranteed. As consistently mentioned by Fed officials, additional data will be required to make the case for a sustainable return to the two-percent inflation target.

Decomposition of Core PCE



Source: Bureau of Economic Analysis via Haver Analytics

Trimmed-Mean PCE Inflation*



** This measure is calculated by excluding the lowest 24 percent and highest 31 percent of price changes (determined by expenditure weight) to provide a more stable indicator of underlying inflation trends. The blue, gold and light blue lines illustrate the one-month, six-month and twelve-month change in the price level, annual rate, respectively.*

Source: Federal Reserve Bank of Dallas via Haver Analytics

The Week Ahead

Conference Board Consumer Confidence (January) (Tuesday)
Forecast: 114.0 (+3.3 Index Pts.)

The retreat in gasoline prices in the past few months, along with moderation in broader inflation trends, could boost consumer attitudes in early 2024, a view supported by a jump of 13.1 percent in the early-January read from the University of Michigan sentiment gauge.

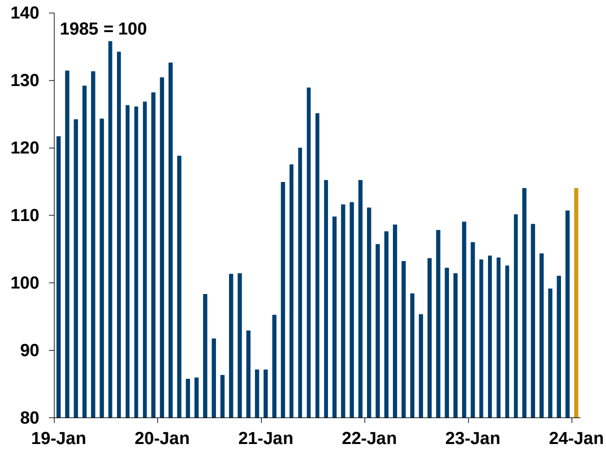
Employment Cost Index (2023-Q4) (Wednesday)
Forecast: 1.0%

Readings on average hourly earnings from the employment report suggest that wage growth remained close to the firm average of 1.1 percent (not annualized) in the first three quarters of 2023 but a bit slower than the 1.3 percent average in 2022 (4.5 percent Q4/Q4 in 2023, if the projection is realized, versus 5.1 percent in 2022). Growth of benefit costs also has eased modestly, averaging 1.0 percent in 2023 thus far versus 1.2 percent in 2022 (4.7 percent Q4/Q4 in 2023, if the projection is realized, versus 4.9 percent in 2023). The combined projections suggest total compensation growth of 1.0 percent, a bit slower than the averages of 1.1 percent in 2023 thus far and 1.2 percent in 2022 (4.3 percent Q4/Q4 in 2023, if the projection is realized, versus 5.1 percent in 2023).

Nonfarm Productivity (2023-Q4) (Thursday)
Forecast: 3.0%

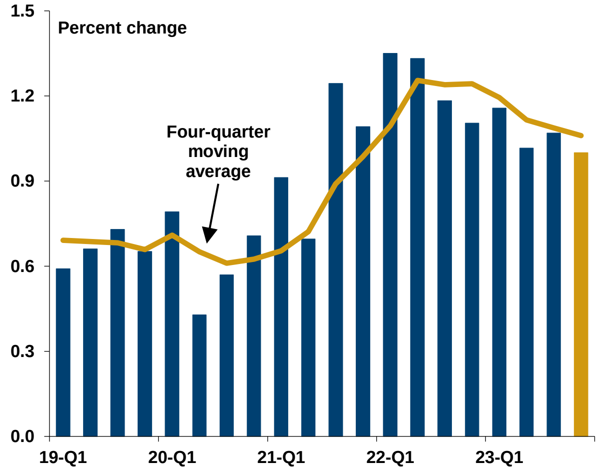
Output in the nonfarm business sector registered a brisk increase in Q4 and hours worked rose moderately, suggesting a brisk increase after strong performances in the prior two quarters (annualized growth of 5.2 percent and 3.6 percent in Q3 and Q2, respectively). The recent performance suggests that productivity could be stirring after a year-over-year contraction in 2022 (-2.0 percent) and sluggish performance in 23-Q1 (-0.8 percent, annual rate). Available data imply a firm increase in compensation per hour (4.0 percent, annual rate), but the expected jump in productivity raises the prospect of a moderate increase in unit labor costs (+1.0 percent expected) after a decline of 1.2 percent in Q3.

Consumer Confidence*



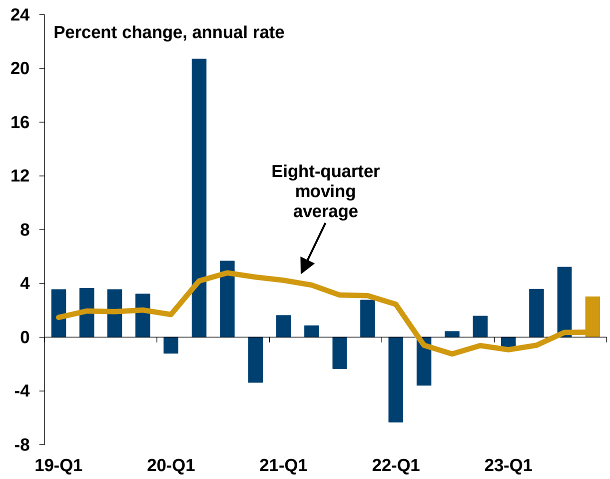
** The gold bar is a forecast for January 2024.*
Sources: The Conference Board via Haver Analytics; Daiwa Capital Markets America

Employment Cost Index*



** The gold bar is a forecast for 2023-Q4.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

Nonfarm Productivity*

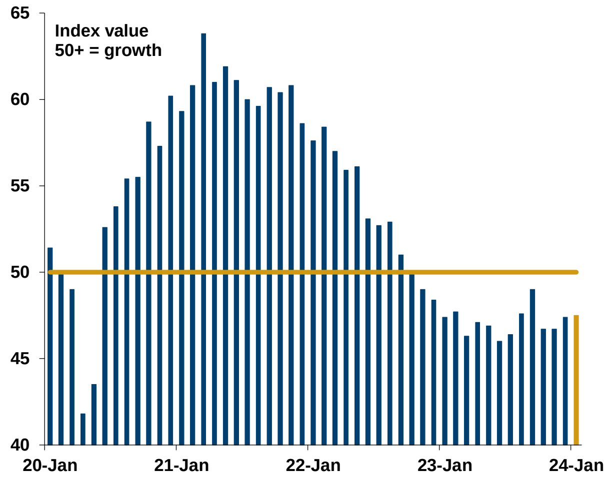


** The gold bar is a forecast for 2023-Q4.*
Sources: Bureau of Labor Statistics via Haver Analytics; Daiwa Capital Markets America

ISM Manufacturing Index (January) (Thursday)
Forecast: 47.5 (+0.1 Index Pt.)

With the manufacturing sector constrained by subdued demand, the ISM index could remain in contraction territory for the 15th consecutive month. Ongoing weak performances for key regional manufacturing indexes (readings of -43.7 for the New York Fed's Empire index and -10.6 for the Philadelphia Fed measure) also suggest limited prospects for a near-term recovery in the ISM measure.

ISM Manufacturing Index*



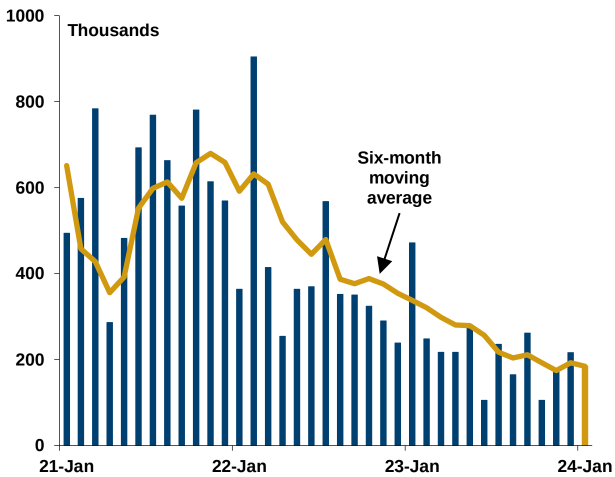
** The gold bar is a forecast for January 2024.*

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

Payroll Employment (January) (Friday)
Forecast: 185,000

With sluggish hiring trends in cyclical areas (transportation and warehousing and financial services, for example) and anecdotal reports of layoffs picking up, underlying conditions in the labor market appear to be softening but not deteriorating rapidly. That said, hiring in January could be close the average of 193,000 in the second half of last year. A rebound in the labor force after a plunge in December (-676,000 versus an average of +284,000 in the first 11 months of 2023) could nudge the unemployment rate one tick higher to 3.8 percent. Moreover, an anticipated solid pace of hiring could support growth of average hourly earnings at a pace close to the 2023 average of +0.3 percent after high-side readings in November and December (a year-over-year pace of +4.1 percent, if the projection is realized).

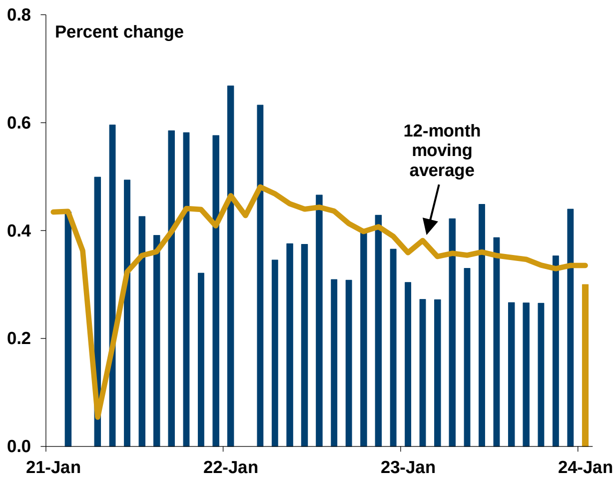
Change in Nonfarm Payrolls*



** The gold bar is a forecast for January 2024.*

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

Average Hourly Earnings*



** The gold bar is a forecast for January 2024.*

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

Factory Orders (December) (Friday)
Forecast: 0.4%

Durable goods orders were flat in December after a surge of 5.5 percent in November that reflected upside volatility in the transportation area. Durable bookings excluding transportation showed signs of stirring, increasing 0.6 percent after a similar pickup in the previous month and giving an upward tilt to the previously flat trend. Nondurable bookings, the new information in the factory orders report, could register a modest increase. Low prices could again restrain the value of bookings in the petroleum and coal category, but orders excluding petroleum and coal have drifted higher in the six months ended November.

Economic Indicators

January/February 2024

Monday	Tuesday	Wednesday	Thursday	Friday
22	23	24	25	26
LEADING INDICATORS Oct -1.0% Nov -0.5% Dec -0.1%		**CHICAGO FED NATIONAL ACTIVITY INDEX** Monthly / 3-Mo. Avg. Oct -0.68 -0.31 Nov 0.01 -0.24 Dec -0.15 -0.28 **ADVANCE INVENTORIES** Wholesale / Retail Oct -0.3% 0.0% Nov -0.4% 0.1% Dec 0.4% 0.8% **NEW HOME SALES** Oct 0.676 million Nov 0.615 million Dec 0.664 million	**UNEMPLOYMENT CLAIMS** Initial / Continuing (millions) Dec 30 0.203 1.833 Jan 6 0.203 1.806 Jan 13 0.189 1.833 Jan 20 0.214 N/A **GDP** GDP / Chained Price 23-Q2 2.1% 1.7% 23-Q3 4.9% 3.3% 23-Q4 3.3% 1.5% **DURABLE GOODS ORDERS** Oct -5.1% Nov 5.5% Dec 0.0% **INTERNATIONAL TRADE IN GOODS** Oct -$89.7 billion Nov -$89.3 billion Dec -$88.5 billion	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. / Cons. / Core Oct 0.3% 0.0% 0.1% Nov 0.4% 0.4% 0.1% Dec 0.3% 0.7% 0.2% **PENDING HOME SALES** Oct -1.2% Nov -0.3% Dec 8.3%
29	30	31	1	2
	FHFA HOME PRICE INDEX (9:00) Sep 0.7% Oct 0.3% Nov -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** Sep 0.7% Oct 0.6% Nov -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Nov 101.0 Dec 110.7 **Jan 114.0** **JOLTS DATA (10:00)** Openings (000) / Quit Rate Oct 8,852 2.3% Nov 8,790 2.2% Dec -- -- **FOMC MEETING (FIRST DAY)**	**ADP EMPLOYMENT (8:15)** Private Payrolls Nov 101,000 Dec 164,000 Jan -- **EMPLOYMENT COST INDEX (8:30)** Comp. / Wages 23-Q2 1.0% 1.0% 23-Q3 1.1% 1.2% **23-Q4 1.0% 1.1%** **MNI CHICAGO BUSINESS BAROMETER (9:45)** Index / Prices Nov 55.6 61.5 Dec 47.2 68.0 Jan -- -- **FOMC RATE DECISION (2:00)**	**UNEMP. CLAIMS (8:30)** **PRODUCTIVITY & COSTS (8:30)** Productivity / Unit Labor Costs 23-Q2 3.6% 2.6% 23-Q3 5.2% -1.2% **23-Q4 3.0% 1.0%** **ISM MFG. INDEX (10:00)** Index / Prices Nov 46.7 49.9 Dec 47.4 45.2 **Jan 47.5 47.0** **CONSTRUCTION (10:00)** Oct 1.2% Nov 0.4% **Dec 0.5%** **VEHICLE SALES** Nov 15.3 million Dec 15.8 million **Jan 15.7million**	**EMPLOYMENT REPORT (8:30)** Payrolls / Un. Rate Nov 173,000 3.7% Dec 216,000 3.7% **Jan 185,000 3.8%** **FACTORY ORDERS (10:00)** Oct -3.5% Nov 2.6% **Dec 0.4%** **REVISED CONSUMER SENTIMENT (10:00)** Nov 61.3 Dec 69.7 Jan (p) 78.8
5	6	7	8	9
ISM SERVICES INDEX		**TRADE BALANCE** **CONSUMER CREDIT**	**UNEMP. CLAIMS** **WHOLESALE TRADE**	
12	13	14	15	16
FEDERAL BUDGET	**NFIB SMALL BUSINESS OPTIMISM INDEX** **CPI**		**UNEMP. CLAIMS** **RETAIL SALES** **IMPORT/EXPORT PRICES** **EMPIRE MFG** **PHILLY FED INDEX** **IP & CAP-U** **NAHB HOUSING INDEX** **BUSINESS INVENTORIES** **TIC FLOWS**	**PPI** **HOUSING STARTS** **CONSUMER SENTIMENT**

Forecasts in bold. (p) = preliminary

Treasury Financing

January/February 2024

Monday	Tuesday	Wednesday	Thursday	Friday
22	23	24	25	26
AUCTION RESULTS: Rate Cover 13-week bills 5.225% 3.03 26-week bills 5.020% 2.92	**AUCTION RESULTS:** Rate Cover 52-week bills 4.570% 3.05 2-yr notes 4.365% 2.57 42 day CMBs 5.280% 2.85 **ANNOUNCE:** $60 billion 17-week bills for auction on Jan 24 $90 billion 4-week bills for auction on Jan 25 $90 billion 8-week bills for auction on Jan 25 **SETTLE:** $58 billion 17-week bills $85 billion 4-week bills $85 billion 8-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 5.185% 2.76 5-yr notes 4.055% 2.31 Spread Cover 2-yr FRNs 0.245% 3.61	**AUCTION RESULTS:** Rate Cover 4-week bills 5.280% 2.86 8-week bills 5.275% 2.85 7-yr notes 4.109% 2.57 **ANNOUNCE:** $149 billion 13-,26-week bills for auction on Jan 29 $80 billion 42-day CMBs for auction on Jan 30 **SETTLE:** $147 billion 13-,26-week bills $46 billion 52-week bills $75 billion 42-day CMBs	
29	30	31	1	2
AUCTION: $149 billion 13-,26-week bills	**AUCTION:** $80 billion 42-day CMBs **ANNOUNCE:** $60 billion* 17-week bills for auction on Jan 31 $90 billion* 4-week bills for auction on Feb 1 $90 billion* 8-week bills for auction on Feb 1 **SETTLE:** $60 billion 17-week bills $90 billion 4-week bills $90 billion 8-week bills	**AUCTION:** $60 billion* 17-week bills **ANNOUNCE:** $54 billion* 3-year notes for auction on Feb 6 $42 billion* 10-year notes for auction on Feb 7 $25 billion* 30-year bonds for auction on Feb 8 **SETTLE:** $13 billion 20-year bonds $18 billion 10-year TIPS $60 billion 2-year notes $61 billion 5-year notes $41 billion 7-year notes $28 billion 2-year FRNs	**AUCTION:** $90 billion* 4-week bills $90 billion* 8-week bills **ANNOUNCE:** $149 billion* 13-,26-week bills for auction on Feb 5 **SETTLE:** $149 billion 13-,26-week bills $80 billion 42-day CMBs	
5	6	7	8	9
AUCTION: $149 billion* 13-,26-week bills	**AUCTION:** $54 billion* 3-year notes **ANNOUNCE:** $60 billion* 17-week bills for auction on Feb 7 $90 billion* 4-week bills for auction on Feb 8 $90 billion* 8-week bills for auction on Feb 8 **SETTLE:** $60 billion* 17-week bills $90 billion* 4-week bills $90 billion* 8-week bills	**AUCTION:** $60 billion* 17-week bills $42 billion* 10-year notes	**AUCTION:** $90 billion* 4-week bills $90 billion* 8-week bills $25 billion* 30-year bonds **ANNOUNCE:** $149 billion* 13-,26-week bills for auction on Feb 12 **SETTLE:** $149 billion* 13-,26-week bills	
12	13	14	15	16
AUCTION: $149 billion* 13-,26-week bills	**ANNOUNCE:** $60 billion* 17-week bills for auction on Feb 14 $90 billion* 4-week bills for auction on Feb 15 $90 billion* 8-week bills for auction on Feb 15 **SETTLE:** $60 billion* 17-week bills $90 billion* 4-week bills $90 billion* 8-week bills	**AUCTION:** $60 billion* 17-week bills	**AUCTION:** $90 billion* 4-week bills $90 billion* 8-week bills **ANNOUNCE:** $149 billion* 13-,26-week bills for auction on Feb 20 $46 billion* 52-week bills for auction on Feb 20 $16 billion* 20-year bonds for auction on Feb 21 $10 billion* 30-year TIPS for auction on Feb 22 $28 billion* 2-year FRNs for auction on Feb 21 **SETTLE:** $149 billion* 13-,26-week bills $54 billion* 3-year notes $42 billion* 10-year notes $25 billion* 30-year bonds	

**Estimate*