Daiwa Capital Markets

U.S. Economic Comment

- Fed forward guidance: a closer look
- Quantitative easing: more to come, across the maturity spectrum

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Understanding the Fed's New Forward Guidance

Fed Chair Jerome Powell used his press briefing to highlight the new forward guidance offered by the Federal Open Market Committee, which he described as "powerful". This characterization is perhaps an overstatement, but nevertheless the new guidance is more revealing than that provided since March, which merely indicated that the FOMC would hold short-term interest rates close to zero until policymakers were confident that the economy has weathered recent events. The new guidance, although more precise, still has a strong element of flexibility (one might even say squishiness). To explain, it is best to show the relevant passage from the policy statement (emphasis added):

> The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to **maintain an accommodative stance** of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to **maintain this target range** until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and **is on track** to **moderately** exceed 2 percent **for some time**.

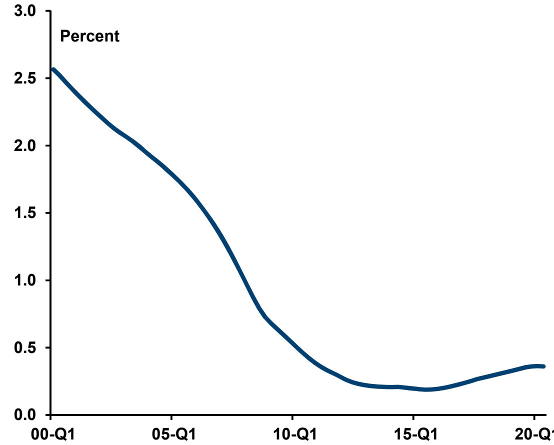
Note, the Fed has provided two doses of guidance: one for maintaining an accommodative stance and another for maintaining the current stance. This distinction is significant because it indicates that the Fed could hike the federal funds rate from its current level but still remain in an accommodative stance. Accommodation, in other words, encompasses a range of interest rates.

Thus, the first element of squishiness involves the definition of accommodation; when is policy easy and when is it tight? Fortunately, this distinction is not difficult to untangle. Policy can be viewed as easy or accommodative when the target for the federal funds rate is below the perceived neutral rate; policy is tight when the target rate is above neutral. The median long-run federal funds rate in the FOMC's Summary of Economic Projections can be used as an estimate of the neutral rate. This rate may or may not be an accurate gauge of neutral, but whether right or wrong, it represents the collective perception of Fed policymakers and thus it will be the measure influencing their decisions.

One could get more analytical in assessing the neutral rate by running or monitoring statistical models designed to estimate this gauge. The so-called Laubach-Williams model is probably the most frequently cited source of such estimates. It is currently showing a neutral real rate of approximately 35 basis points (chart, next page). Adding two percentage points to this estimate to account for expected inflation leaves the nominal neutral rate close to the median estimate in the SEP. (This model was designed by Thomas Laubach, a senior staff economist at the Board of Governors and John Williams, a former staff member at the Board of Governors and now the President of the NY Fed. Sadly, Mr. Laubach, age 55, recently passed away after a battle with cancer. Chair Powell paid tribute to him at this week's press conference.)

The dual guidance is a bit confusing, but if read carefully, it provides insight into when the Fed might begin to raise interest rates, and it suggests that the Fed might be as dovish as some market participants are now envisioning. The Fed has emphasized that it is targeting average inflation and that it will allow inflation to run above two percent for a time because of downside misses in the past several years. However, that does not mean that rate hikes are off the table until average inflation reaches two percent.

Neutral Real Federal Funds Rate



Source: Federal Reserve Bank of New York via Haver Analytics

The guidance indicates that policy will remain "accommodative" until average inflation reaches two percent, and as noted, accommodative does not mean near-zero interest rates. As long as the target federal funds rate is below 2.5 percent, the FOMC will view itself as maintaining an accommodative stance. The second dose of guidance shows even more clearly that lift-off on interest rates will occur before average inflation reaches two percent. The guidance notes that as long as inflation has reached two percent and is "on track" to exceed two percent, the FOMC would be open to hiking interest rates.

More Squishiness

The new long-run strategy of the Fed allows inflation to run above two percent, but there are limits. The Fed will only tolerate inflation moderately above two percent for some time. One wonders about the meaning of "moderately" and "for some time". A reporter at the press conference asked for details on these terms, but Chair Powell provided little insight. He merely indicated that moderate meant "not large…not very high above two percent." He was equally as elusive in defining for some time, noting that it meant not permanent. He did not seem bothered by the vague nature of the guidance, as he added that "the public will understand pretty well what we want."

The guidance is squishy, but that is by design. The Fed wants flexibility in setting policy; it wants to exercise judgement rather than implement a rule or follow a formula. The terms can mean different things in different settings; they can mean whatever the Fed wants them to mean. They give the Fed flexibility. However, they also leave market participants guessing about policy prospects.

Quantitative Easing: Ongoing

The Fed tweaked its asset purchase program at this meeting. The structure of the program did not change (new monthly purchases of approximately $80 billion of Treasury securities and $40 billion of mortgage-backed securities, and the reinvestment of all maturing securities and repayments), but the Committee altered the rationale for the program. When introduced in March, QE was billed as an effort to normalize dysfunctional conditions in the fixed income markets. Now, in addition to promoting smooth trading conditions, the Fed views its purchases as another form of policy accommodation.

The change in rationale, although subtle, is significant because it suggests that the program will be maintained for some time (there's that squishy term again). If QE were being used solely to promote normal trading conditions, it could be ended now; if it is viewed as a form of accommodation, it can be ongoing.

The table below provides an overview of the Fed's effort in the Treasury market over the past several months. The table is not a perfect representation of Fed activity across maturity classes because the figures

are based on remaining maturity, and changes in each maturity bucket will reflect both new purchases and roll downs from one bucket into another as time passes. Still, it provides some insight.

The Fed has purchased $1.9 trillion of coupon Treasury securities since mid-March. This total is slightly less than $2.0 trillion of Treasury securities purchased during the financial crisis, but that effort involved three separate programs that stretched over a period of more than five years. The current effort has been in place for six months, and thus it could be viewed as much more forceful than the effort during the financial crisis.

The Fed's recent activity also has been pronounced relative to new issuance by the Treasury Department, where gross sales of coupon securities totaled $1.7 trillion from March through mid-September. (This total is coupon securities only. The Treasury has also been active in the bill market, with outstanding bills increasing by approximately $2.5 trillion from March through mid-September.) The heavy share of coupon securities purchased by the Fed would seem to suggest that the central bank was dominating the Treasury market. Certainly, the Fed has been a major factor, but keep in mind that purchases were extreme in the early stages of the program, with average buying of $290 billion per week from late March to mid-April; purchases have been in the neighborhood of $20 billion per week more recently.

The Fed has been active across the maturity spectrum, but it has favored shorter-term securities (1 to 5 years). This also is the maturity segment favored by the Treasury in the recent past, although with the introduction of the 20-year bond and a recent hefty increase in the auction sizes of 10-year notes, the Treasury will be moving further out on the yield curve. Perhaps the Fed will follow. Moreover, if the Fed were looking for another push for the economy, it could boost purchases in the longer-end, possibly nudging longer-term rates slightly lower and stirring business investment or housing activity.

Fed Holdings of Treasury Securities & Treasury Coupon Issuance

	1 Year or Less	Over 1 Year to 5 Years	Over 5 Years to 10 Years	Over 10 Years	Total
Portfolio Composition as of March 11 (%)	24.6	36.3	13.0	26.1	100.0
Arithmetic Change in Fed Holdings ($ billions)	363.6	743.4	450.3	326.6	1,884
Share of New Purchases (%)	19.3	39.5	23.9	17.3	100.0
Portfolio Composition as of Sept. 16 (%)	22.4	37.6	17.7	22.3	100.0
Treasury Gross Coupon Issuance: March to Mid-Sept. ($ billions)	--	1,012	487	228	1,727

Source: Federal Reserve Board; U.S. Treasury Department; Daiwa Capital Markets America

Review

Week of Sept. 14, 2020	Actual	Consensus	Comments
Industrial Production (August)	**0.4%**	**1.0%**	A solid advance of 1.0% in the manufacturing component accounted for all of the increase in industrial production in August. With the latest monthly advance, the factory sector in total has now recouped 67% of the ground lost during the spring. Mining activity fell 2.5%, erasing much of the improvement in the prior two months that had suggested a correction phase might have ended. Utility output fell 0.4%, as hot weather was not as much of a factor as it was in July.
Retail Sales (August)	**0.6% Total, 0.7% Ex-Autos**	**1.0% Total, 1.0% Ex-Autos**	Retail sales have registered an impressive performance in the past several months. Surges of 18.3% and 8.6% in May and June pushed activity above the pre-Covid peak in January, and gains of 0.8% and 0.6% in July and August added accents and left an overall vigorous rebound. The strength in retail activity was broad-based, as only two components (restaurants and clothing stores) remained noticeably below their pre-virus peaks. Slow activity at restaurants is understandable given the pandemic, and the lagging performance at clothing stores probably reflects soft demand because of remote working and restraints on social activities.
Housing Starts (August)	**1.416 Million (-5.1%)**	**1.488 Million (-0.6%)**	The weakness in housing starts in August was concentrated in the volatile multi-family sector, which fell 22.7% from an elevated reading in the prior month. Even with the noticeable decline in August, multi-family starts remained within the recent range. The latest reading was not far below the average of 403,000 from last year, and it equaled or exceeded the averages in all other years of the prior expansion. Single-family starts rose 4.1% after registering sizeable gains in the prior three months. All told, single-family starts in August were in line with the hefty totals around the turn of the year, before the coronavirus was a factor in the economy.
Current Account (20-Q2)	**-$170.5 Billion ($59.0 Billion Wider Deficit)**	**-$160.0 Billion ($55.8 Billion Wider Deficit)**	A deterioration of $38 billion in trade flows was joined by slippage in income flows, leading to a sharp widening in the current account deficit in Q2. The latest reading was the widest since the second half of 2008. Calculated as a share of GDP, the shortfall of 3.5% dwarfed the 2.1% reading in Q1 and was the widest since the fourth quarter of 2008.
Leading Indicators (August)	**1.2%**	**1.3%**	Positive contributions from unemployment claims, ISM new orders, stock prices, and the length of the manufacturing workweek led to the fourth consecutive increase in the leading indicator index in August. The results in the past four months have offset more than 60% of the decline in the spring.
Consumer Sentiment (September)	**78.9 (+4.8 Index Pts.)**	**75.0 (+0.9 Index Pt.)**	Consumer sentiment rose for the second consecutive month in early September, but the combined increase of 8.8% did little to offset the virus-induced swoon in the spring. Despite improvement in the labor market and recovery in the equity market, sentiment remained 21.9% below the recent peak of 101.0 in February and 17.8% below the average of 96.0 for 2019.

Sources: Federal Reserve Board (Industrial Production); U.S. Census Bureau (Retail Sales, Housing Starts); Bureau of Economic Analysis (Current Account), The Conference Board (Leading Indicators); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Sept. 21, 2020	Projected	Comments
Existing Home Sales (August) (Tuesday)	**5.90 Million (+0.7%)**	Strong readings on pending home sales and mortgage applications suggest some follow through to the surge of 24.7% in July and 20.2% in June. Sales in July had already moved above the pre-virus high in February; the expected gain in August would push sales to their highest level since late 2006.
New Home Sales (August) (Thursday)	**0.910 Million (+1.0%)**	Brisk increases from May to July have pushed sales of new homes 16.4% above their pre-virus high in January. Ordinarily, such exuberance would stir thoughts of a correction, but a record reading on the sentiment index published by the National Association of Home Builders raises the possibility of another advance, although a much smaller one than the average increase of 16.5% in the prior three months.
Durable Goods Orders (August) (Friday)	**0.5%**	Further recovery in the manufacturing sector will probably push orders for durable goods higher for the fourth consecutive month. However, the pace is likely to slow noticeably from the average of 11.4% from May to July. Those advances have retraced 80% of the decline during the spring. Durable orders ex-transportation (to remove the influence of decidedly weak aircraft bookings) have recouped 90% of the ground lost in the spring.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

September/October 2020

Monday	Tuesday	Wednesday	Thursday	Friday
14	15	16	17	18
	EMPIRE MFG July 17.2 Aug 3.7 Sept 17.0 **IMPORT/EXPORT PRICES** Non-petrol. Imports / Nonagri. Exports June 0.4% 1.7% July 0.2% 0.9% Aug 0.7% 0.8% **IP & CAP-U** IP / Cap.Util. June 6.1% 68.7% July 3.5% 71.1% Aug 0.4% 71.4% **FOMC MEETING**	**RETAIL SALES** Total / Ex.Autos June 8.6% 8.4% July 0.9% 1.3% Aug 0.6% 0.7% **BUSINESS INVENTORIES** Inventories / Sales May -2.3% 8.5% June -1.1% 8.6% July 0.1% 3.2% **NAHB HOUSING INDEX** July 72 Aug 78 Sept 83 **FOMC DECISION** **POWELL PRESS CONFERENCE** **TIC DATA** Total / Net L-T May -$0.8B $118.1B June -$69.8B $113.0B July -$88.7B $10.8B	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Aug 22 1.011 13.292 Aug 29 0.884 13.544 Sept 05 0.893 12.628 Sept 12 0.860 N/A **HOUSING STARTS** June 1.265 million July 1.492 million Aug 1.416 million **PHILLY FED INDEX** July 24.1 Aug 17.2 Sept 15.0	**CURRENT ACCOUNT** 19-Q4 -$104.3B 20-Q1 -$111.5B 20-Q2 -$170.5B **LEADING INDICATORS** June 3.1% July 2.0% Aug 1.2% **CONSUMER SENTIMENT** July 72.5 Aug 74.1 Sept 78.9
21	22	23	24	25
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. June 5.33 -2.78 July 1.18 3.59 Aug -- --	**EXISTING HOME SALES (10:00)** June 4.70 million July 5.86 million **Aug 5.90 million**	**FHFA HOME PRICE INDEX (9:00)** May -0.2% June 0.9% July --	**INITIAL CLAIMS (8:30)** **NEW HOME SALES (10:00)** June 0.791 million July 0.901 million **Aug 0.910 million**	**DURABLE GOODS ORDERS (8:30)** June 7.7% July 11.4% **Aug 0.5%**
28	29	30	1	2
	U.S. INTERNATIONAL TRADE IN GOODS **ADVANCE INVENTORIES** **S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **CONSUMER CONFIDENCE**	**ADP EMPLOYMENT REPORT** **REVISED GDP** **CHICAGO PURCHASING MANAGERS' INDEX** **PENDING HOME SALES**	**INITIAL CLAIMS** **PERSONAL INCOME, CONSUMPTION, PRICES** **ISM INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES**	**EMPLOYMENT REPORT** **REVISED CONSUMER SENTIMENT** **FACTORY ORDERS**
5	6	7	8	9
ISM NON-MFG INDEX	**TRADE BALANCE** **JOLTS DATA**	**FOMC MINUTES** **CONSUMER CREDIT**	**INITIAL CLAIMS**	**WHOLESALE TRADE**

Forecasts in Bold.

Treasury Financing

September/October 2020

Monday	Tuesday	Wednesday	Thursday	Friday
14	15	16	17	18
AUCTION RESULTS: Rate / Cover 13-week bills 0.110% 3.12 26-week bills 0.120% 3.26	**AUCTION RESULTS:** Rate / Cover 20-yr bonds 1.213% 2.39 42-day CMB 0.095% 3.37 119-day CMB 0.110% 3.88 **ANNOUNCE:** $30 billion 4-week bills for auction on September 17 $35 billion 8-week bills for auction on September 17 $25 billion 105-day CMBs for auction on September 16 $30 billion 154-day CMBs for auction on September 16 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $50 billion 3-year notes $35 billion 10-year notes $23 billion 30-year bonds $25 billion 105-day CMBs $30 billion 154-day CMBs	**AUCTION RESULTS:** Rate / Cover 105-day CMB 0.100% 3.76 154-day CMB 0.110% 3.45	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.080% 3.74 8-week bills 0.095% 3.09 10-yr TIPS -0.966% 2.65 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on September 21 $22 billion 2-year FRNs for auction on September 23 $52 billion 2-year notes for auction on September 22 $53 billion 5-year notes for auction on September 23 $50 billion 7-year notes for auction on September 24 $30 billion 42-day CMBs for auction on September 22 $30 billion 119-day CMBs for auction on September 22 **SETTLE:** $105 billion 13-,26-week bills $30 billion 42-day CMBs $30 billion 119-day CMBs	
21	22	23	24	25
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $52 billion 2-year notes $30 billion 42-day CMBs $30 billion 119-day CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on September 24 $35 billion* 8-week bills for auction on September 24 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs	**AUCTION:** $22 billion 2-year FRNs $53 billion 5-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $50 billion 7-year notes **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on September 21 **SETTLE:** $105 billion 13-,26-week bills $30 billion 42-day CMBs $30 billion 119-day CMBs	**SETTLE:** $22 billion 2-year FRNs
28	29	30	1	2
AUCTION: $105 billion* 13-,26-week bills	**ANNOUNCE:** $30 billion* 4-week bills for auction on October 1 $35 billion* 8-week bills for auction on October 1 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills	**SETTLE:** $22 billion 20-year bonds $12 billion 10-year TIPS $52 billion 2-year notes $53 billion 5-year notes $50 billion 7-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on October 5 $34 billion 52-week bills for auction on October 6 $52 billion* 3-year notes for auction on October 6 $35 billion* 10-year notes for auction on October 7 $23 billion* 30-year bonds for auction on October 8 **SETTLE:** $105 billion* 13-,26-week bills	
5	6	7	8	9
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills $52 billion* 3-year notes **ANNOUNCE:** $30 billion* 4-week bills for auction on October 8 $35 billion* 8-week bills for auction on October 8 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $35 billion* 10-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $23 billion* 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on October 12 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills	

**Estimate*