Daiwa Capital Markets

U.S. Economic Comment

- An interesting FOMC meeting:
  - possible yield curve adjustments
  - likely shift in the dot plot

Michael Moran
Daiwa Capital Markets America
212-612-6392
michael.moran@us.daiwacm.com

FOMC and the Yield Curve

The shape of the yield curve has changed appreciably this year, with the increase in long-term interest rates over the past several months and a drop in short-term interest rates in recent weeks pushing the spread between 10-year yields and overnight interest rates to its widest reading since 2017 (chart, left). The shift has led many market participants to expect the Federal Open Market Committee to take some action to narrow this spread. The most common views are for the Fed to lift the rates on excess reserves (IOER) and reverse repurchase agreements (RRPs) to nudge short-term rates higher, and to shift purchases in its QE program toward the long end of the maturity spectrum to dampen the increase in long-term rates.

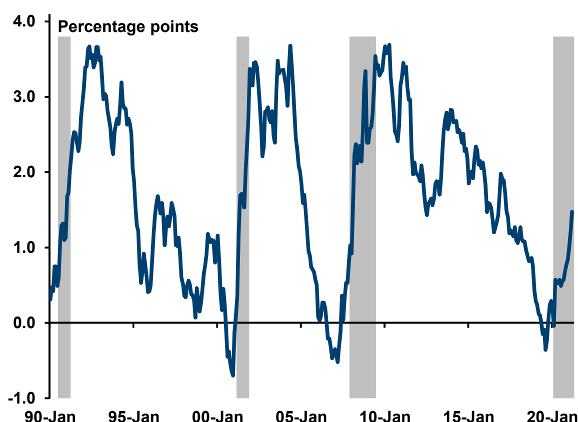
One or both of these changes are certainly possible, but we suspect that officials will hold IOER and the RRP rate steady, and that they will maintain the QE program in its current form.

The Long End of the Curve

One can perhaps make a case for increasing purchases in the long end of the curve, as the share of Treasury securities held by the Fed with maturities of more than 10 years has eased in the past year. When the Fed started its quantitative easing program in March 2020, it initially focused purchases in the short and intermediate ranges of the coupon yield curve (chart, right). The Fed has increased its activity in the long end more recently, and the share has inched higher (barely perceptible on the chart), but holdings are still light on a relative basis.

First, Fed officials are probably neither surprised nor alarmed by the change in the shape of the curve. The steepening could be viewed as the normal shift that occurs over the course of a business cycle: narrowing during the expansion phase (usually because tightening by the Fed affects short-term rates more so than

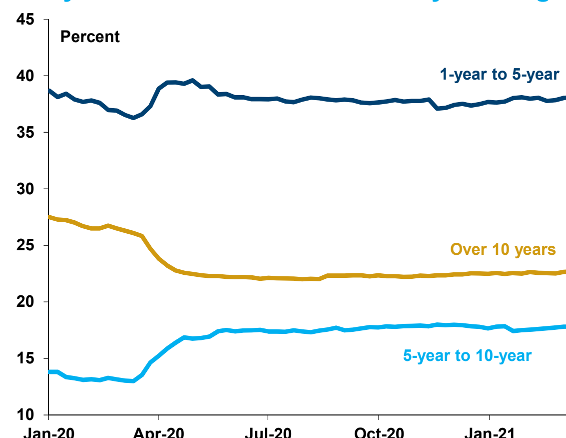
Treasury Yield Curve*



** The 10-year Treasury rate less the three-month Treasury bill rate. Monthly average data, except for the last observation which is the spread of daily average data through March 11, 2021. The shaded areas of the chart indicate periods of recession in the United States.*

Source: Federal Reserve Board and National Bureau of Economic Research via Haver Analytics

Maturity Shares of the Fed's Treasury Holdings*



** Holdings in each maturity bucket as a share of total Treasury holdings. Weekly end-of-period data. The last observations are for the week ended Wednesday March 10, 2021.*

Source: Federal Reserve Board via Haver Analytics

This report is issued by Daiwa Securities Group Inc. through its relevant group companies. Daiwa Securities Group Inc. is the global brand name of Daiwa Securities Co. Ltd., Tokyo ("Daiwa Securities") and its subsidiaries worldwide that are authorized to do business within their respective jurisdictions. These include: Daiwa Capital Markets Hong Kong Ltd. (Hong Kong), regulated by the Hong Kong Securities and Futures Commission, Daiwa Capital Markets Europe Limited (London), regulated by the Financial Conduct Authority and a member of the London Stock Exchange, and Daiwa Capital Markets America Inc. (New York), a U.S. brokerdealer registered with the U.S. Securities and Exchange Commission, a futures commission merchant regulated by the U.S. Commodity Futures Trading Commission, and a primary dealer in U.S. government securities. The data contained in this report were taken from statistical services, reports in our possession, and from other sources believed to be reliable. The opinions and estimates expressed are our own, and we make no representation or guarantee either as to accuracy, completeness or as to the existence of other facts or interpretations that might be significant.

long-term rates) and steepening during the recession and early stages of the expansion (reflecting easier monetary policy that strongly influences short-term interest rates). In addition, the magnitude of the steepening in the curve is not especially surprising, as the spread is still far below readings seen in the past.

Fed officials might even welcome the steepening, as it could be viewed as a sign that the better-than-expected performance in early 2021 is pushing real interest rates higher. The prospects of brisk growth and aggressive fiscal action that became apparent during February also would push expected inflation higher. Again, the Fed might welcome an increase in expected inflation, as some officials have expressed concern about an unmooring of expectations on the downside.

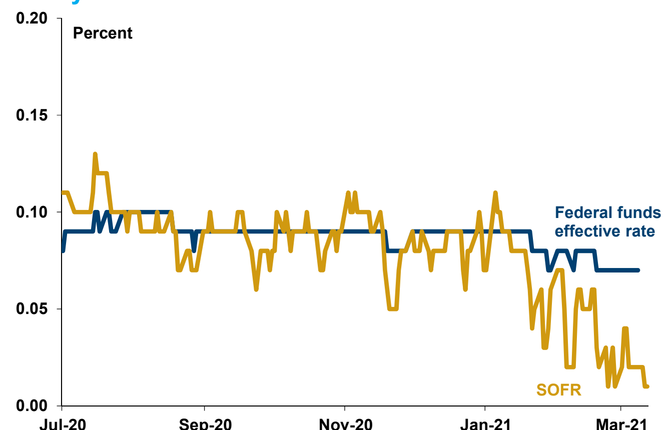
Second, attempts to twist the shape of the curve could be viewed as a form of “yield curve control”, and officials have taken a dim view of such efforts. This policy tool was discussed at two FOMC meetings last year, and officials felt that the practice would be no more effective than clear forward guidance. In addition, policymakers saw problems in communicating the intentions of the effort and in reversing the program at some point in the future.

To be sure, the Fed engaged in a twist operation in the aftermath of the financial crisis, but the setting was different at that time. The economy had less momentum than it apparently has now, and it did not have the fiscal push that will be unfolding this year. In fact, the stimulus package of the Obama Administration had started to unwind when the Fed adopted its maturity extension program.

The Short End of the Curve

The case for action at the short end of the yield curve could be viewed as strong, as rates on many money market instruments are desperately low (only one basis point on the secured overnight financing rate, chart). However, IOER and the RRP rate, which are set by the Fed rather than determined in the market, are not intended to maintain control over short-term interest rates in general. The Fed has emphasized in the past that these administered rates are used to control the federal funds rate. If the federal funds rate were to deviate noticeably from the midpoint of its target range, the Fed would raise or lower IOER and the RRP rate to keep FFR close to its midpoint.

Money Market Interest Rates*



** Daily data.*
Source: Bloomberg

Currently, the fed funds rate, at 7 basis points, is not deviating sharply from the midpoint of the 0.00 to 0.25 percent target range, and thus Fed officials might not see a need for action. If the funds rate were to ease to 5 basis points, we would look for the Fed to nudge IOER and the RRP rate higher (these rates are currently set at 10 basis points and zero, respectively).

While the Fed might attempt to nudge short-term interest rates higher, it is likely to be fighting a losing battle. The Fed can influence financial conditions, but it is not likely to be able to exert tight control over interest rates. With a huge volume of reserves in the banking system, short-term rates are naturally under downward pressure.

Fed Forecasts and the Dot Plot

The FOMC will publish a new set of projections at this meeting, with the new figures most likely showing an upward revision to projected economic growth. The median expectation of Fed officials in December called for growth of 4.2 percent over the four quarters of this year, but developments since then have generally been

favorable for the outlook. The number of Covid cases was accelerating in mid-December, but new infections have plummeted since the peak in early January, and the pace of vaccinations is picking up. The diminished threat from the virus has effectively eliminated concern about slow economic activity in early 2021. Perhaps most important, the stimulus package signed by President Biden this week was probably far larger than anything envisioned by policymakers in December.

Economic Projections of the FOMC, December 2020*

	2021	2022	2023	Longer Run
Change in Real GDP	4.2	3.2	2.4	1.8
Unemployment Rate	5.0	4.2	3.7	4.1
PCE Inflation	1.8	1.9	2.0	2.0
Core PCE Inflation	1.8	1.9	2.0	--
Federal Funds Rate	0.1	0.1	0.1	2.5

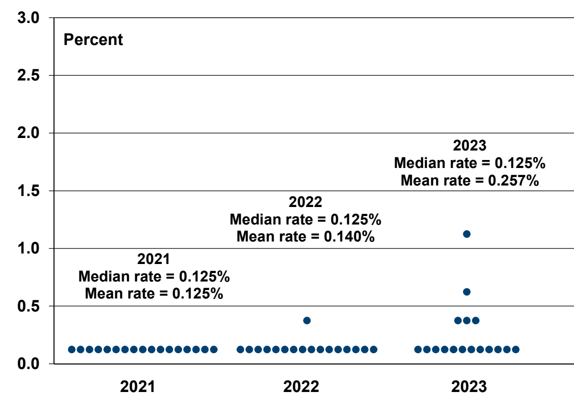
** Median projections*

Source: Federal Open Market Committee, Summary of Economic Projections, December 2020

The headline figure of $1.9 trillion on the so-called American Rescue Plan (ARP) overstates the near-term economic impact, as some of the spending and tax provisions affect future fiscal years rather than 2021. Still, the Congressional Budget Office estimates that $1.164 trillion will flow into the economy this year, an amount that equals 5.4 percent of fourth quarter GDP. There undoubtedly will be some leakages from the stimulus that dampen the economic impact, such as households saving enhanced income flows or purchasing imports rather than domestically produced goods or services, but the package will still give a good lift to the economy this year. We are looking for growth over the four quarters of this year to exceed six percent, and we would not scoff at firmer forecasts. It is difficult to envision the forecasts of Fed officials not involving upward revisions.

The new stimulus package also will provide a good bit of support in fiscal year 2022 ($529 billion according to the CBO in the estimate), which could lead officials to raise the projection for next year from the 3.2 percent in December. The expected unemployment rate in the fourth quarter of next year was already down to 4.2 percent, and it most likely will move below 4.0 percent with the new projections. This could be viewed as maximum employment, one of the criteria that must be met before the Fed begins to remove accommodation. One official already was expecting liftoff to occur next year, and a revised outlook might lead more policymakers to share this view (chart). We do not expect the median dot to suggest a hike in rates next year, but we would be surprised if the new plot does not show tightening in 2023.

FOMC Rate View: Year-End 2021, 2022, & 2023*



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2021, 2022, and 2023. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but two governorships were open at the December 2020 meeting.*

Source: Federal Open Market Committee, Summary of Economic Projections, December 2020

Review

Week of March 8, 2021	Actual	Consensus	Comments
CPI (February)	**0.4% Total, 0.1% Core**	**0.4% Total, 0.2% Core**	The advance in the headline CPI in February was led by the energy component (3.9%), with all items in the energy sector contributing. Food prices increased moderately (0.2%). The core CPI showed a range of shifts, with the Covid pandemic continuing to exert a notable influence in several areas: airfares dropped 5.1%, hotel fees fell 2.7%, and apparel prices slipped 0.7%. On a year-over-year basis, the headline CPI increased three ticks in February to 1.7%, the firmest reading in recent months, but trailing the 2.5% advance registered in January 2020. The year-over-year increase in the core CPI dipped to 1.3% from 1.4%, and it was down noticeably from a reading of 2.4% in February 2020.
Federal Budget (February)	**$310.9 Billion Deficit**	**$305.0 Billion Deficit**	Receipts jumped 32.1% on a year-over-year basis in February, but the dramatic increase reflected a later-than-normal opening of the tax filing season, which led to a drop in the issuance of tax refunds rather than a sharp improvement in tax collections. Outlays surged 32.1% from the same month last year, with the jump influenced by spending on pandemic-related programs. In the first five months of FY2021, the cumulative budget deficit totaled $1.05 trillion, $422 billion wider than the deficit in the same period in FY2020.
PPI (February)	**0.5% Total, 0.2% Ex. Food and Energy**	**0.5% Total, 0.2% Ex. Food and Energy**	The energy component of the PPI jumped 6.0% in February, marking the ninth increase in the past 10 months and pushing the index above its pre-Covid level. Food prices also showed upward pressure, increasing 1.3% after showing little net change in the prior three months. Prices ex food and energy returned to the underlying average of moderate increases (0.2% per month in the past 12 months) after a high-side reading of 1.2% in January. On a year-over year basis, the PPI ex food and energy rose 2.5%, up from 2.0% in January and the fastest advance since a reading of 2.6% in January 2019.
Consumer Sentiment (March)	**83.0 (+6.2 Index Pts.)**	**78.5 (+1.7 Index Pts.)**	Increased availability of vaccines and imminent payment of additional stimulus funds apparently lifted the spirits of individuals, as consumer sentiment reversed dips in the first two months of 2021. Despite the pickup, sentiment has recouped only 16% of the ground lost since the Covid-related low in April and it is 17.8% below the pre-virus peak of 101.0 in February 2020.

Sources: Bureau of Labor Statistics (CPI, PPI); U.S. Treasury Department (Federal Budget); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of March 15, 2021	Projected	Comments
Retail Sales (February) (Tuesday)	**0.0% Total, 0.5% Ex. Autos**	Higher prices of gasoline will probably inflate the value of sales at service stations, but activity will probably be slow in other areas, partly because of adverse weather and partly because of an easing after a burst in January triggered by the recovery rebate checks.
Industrial Production (February) (Tuesday)	**0.4%**	Challenging weather probably drove utility output higher, but the difficult conditions most likely disrupted manufacturing and mining activity, resulting in only a moderate advance in overall production.
Housing Starts (February) (Wednesday)	**1.500 Million (-5.1%)**	Low interest rates and firm home sales ordinarily would induce builders to ramp up the pace of home construction, but adverse weather is likely to constrain activity.
Leading Indicators (February) (Thursday)	**0.4%**	Sizeable positive contributions from ISM new orders, unemployment claims, and the leading credit index, along with moderate boosts from the slope of the yield curve and stock prices, should easily offset drags from the manufacturing workweek and consumer expectations. The expected increase would mark the 10th consecutive gain, with the cumulative changes retracing 92% of the ground lost in the spring.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

March/April 2021

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
WHOLESALE TRADE Inventories / Sales Nov 0.0% 0.3% Dec 0.6% 1.9% Jan 1.3% 4.9%	**NFIB SMALL BUSINESS OPTIMISM INDEX** Dec 95.9 Jan 95.0 Feb 95.8	**CPI** Total / Core Dec 0.2% 0.0% Jan 0.3% 0.0% Feb 0.4% 0.1% **FEDERAL BUDGET** FY2021 / FY2020 Dec -$143.6B -$13.3B Jan -$162.8B -$32.6B Feb -$310.9B -$235.3B	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Feb 13 0.834 4.419 Feb 20 0.736 4.337 Feb 27 0.754 4.144 Mar 06 0.712 N/A **JOLTS DATA** Openings (000) / Quit Rate Nov 6,766 2.3% Dec 6,752 2.4% Jan 6,917 2.3%	**PPI** Total / Ex. Food & Energy Dec 0.3% 0.1% Jan 1.3% 1.2% Feb 0.5% 0.2% **CONSUMER SENTIMENT** Jan 79.0 Feb 76.8 Mar 83.0
15	16	17	18	19
EMPIRE MFG (8:30) Jan 3.5 Feb 12.1 Mar -- **TIC DATA (4:00)** Total / Net L-T Nov $114.7B $149.2B Dec -$0.6B $121.0B Jan -- --	**RETAIL SALES (8:30)** Total / Ex.Autos Dec -1.0% -1.8% Jan 5.3% 5.9% **Feb 0.0% 0.5%** **IMPORT/EXPORT PRICES (8:30)** Non-petrol Imports / Nonagri. Exports Dec 0.4% 1.3% Jan 0.9% 2.2% Feb -- -- **IP & CAP-U (9:15)** IP / Cap.Util. Dec 1.3% 74.9% Jan 0.9% 75.6% **Feb 0.4% 75.8%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Nov 0.5% 0.0% Dec 0.9% 1.1% **Jan 0.3% 4.0%** **NAHB HOUSING INDEX (10:00)** Jan 83 Feb 84 Mar -- **FOMC MEETING**	**HOUSING STARTS (8:30)** Dec 1.680 million Jan 1.580 million **Feb 1.500 million** **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **PHILLY FED INDEX (8:30)** Jan 26.5 Feb 23.1 Mar -- **LEADING INDICATORS (10:00)** Dec 0.4% Jan 0.5% **Feb 0.4%**	
22	23	24	25	26
CHICAGO FED NATIONAL ACTIVITY INDEX **EXISTING HOME SALES**	**CURRENT ACCOUNT** **NEW HOME SALES**	**DURABLE GOODS ORDERS**	**INITIAL CLAIMS** **REVISED GDP**	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PERSONAL INCOME, CONSUMPTION, PRICES** **REVISED CONSUMER SENTIMENT**
29	30	31	1	2
	FHFA HOME PRICE INDEX **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CONSUMER CONFIDENCE**	**ADP EMPLOYMENT REPORT** **MNI CHICAGO PMI** **PENDING HOME SALES**	**INITIAL CLAIMS** **ISM MFG INDEX** **CONSTRUCTION SPEND.** **NEW VEHICLE SALES**	***GOOD FRIDAY*** **EMPLOYMENT REPORT**

Forecasts in Bold.

Treasury Financing

March/April 2021

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
AUCTION RESULTS: Rate / Cover 13-week bills 0.045% 3.06 26-week bills 0.060% 3.55	**AUCTION RESULTS:** Rate / Cover 3-year notes 0.355% 2.69 6-week CMB 0.030% 3.75 **ANNOUNCE:** $30 billion 4-week bills for auction on March 11 $35 billion 8-week bills for auction on March 11 $30 billion 17-week CMBs for auction on March 10 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate / Cover 10-yr notes 1.523% 2.38 17-week CMB 0.050% 3.75	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.030% 3.81 8-week bills 0.035% 3.40 30-yr bonds 2.295% 2.28 **ANNOUNCE:** $111 billion 13-,26-week bills for auction March 15 $24 billion 20-year bonds for auction on March 16 $13 billion 10-year TIPS for auction on March 18 $35 billion 6-week CMBs for auction on March 16 **SETTLE:** $105 billion 13-,26-week bills $30 billion 6-week CMBs	
15	16	17	18	19
AUCTION: $111 billion 13-,26-week bills **SETTLE:** $58 billion 3-year notes $38 billion 10-year notes $24 billion 30-year bonds	**AUCTION:** $24 billion 20-year bonds $35 billion 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on March 18 $35 billion* 8-week bills for auction on March 18 $30 billion* 17-week CMBs for auction on March 17 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $13 billion 10-year TIPS **ANNOUNCE:** $111 billion* 13-,26-week bills for auction March 22 $34 billion* 52-week bills for auction on March 23 $26 billion* 2-year FRNs for auction on March 24 $60 billion* 2-year notes for auction on March 23 $61 billion* 5-year notes for auction on March 24 $62 billion* 7-year notes for auction on March 25 $35 billion* 6-week CMBs for auction on March 23 **SETTLE:** $111 billion 13-,26-week bills $35 billion 6-week CMBs	
22	23	24	25	26
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills $60 billion* 2-year notes $35 billion* 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on March 25 $35 billion* 8-week bills for auction on March 25 $30 billion* 17-week CMBs for auction on March 24 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $26 billion* 2-year FRNs $61 billion* 5-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $62 billion* 7-year notes **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on March 29 **SETTLE:** $111 billion* 13-,26-week bills $34 billion* 52-week bills $35 billion* 6-week CMBs	**SETTLE:** $26 billion* 2-year FRNs
29	30	31	1	2
AUCTION: $111 billion* 13-,26-week bills	**ANNOUNCE:** $30 billion* 4-week bills for auction on April 1 $35 billion* 8-week bills for auction on April 1 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills $30 billion* 17-week CMBs	**SETTLE:** $24 billion 20-year bonds $13 billion 10-year TIPS $60 billion* 2-year notes $61 billion* 5-year notes $62 billion* 7-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on April 5 **SETTLE:** $111 billion* 13-,26-week bills	***GOOD FRIDAY***

**Estimate*