U.S. Economic Comment

- The March 19-20 FOMC: rates on hold as inflation stirs
- Fed forecasts: modest revisions expected
- Quantitative tightening: changes upcoming, but announcement of formal plans unlikely next week

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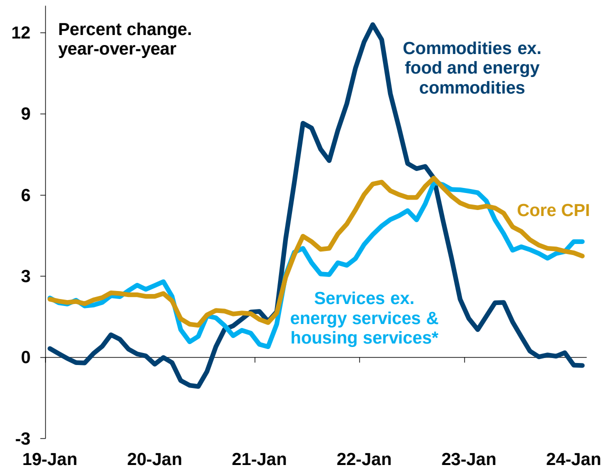
FOMC Preview

Fed Chair Jerome Powell and his colleagues seemingly dismissed a brisk inflation print for January, with the policymaker indicating in his congressional testimony last week that "we're not far" from gaining the confidence that inflation is moving sustainably back to two-percent, thereby allowing policymakers to at some point soon begin reducing the current level of monetary policy restriction. That path to "greater confidence" was surely tested again this week with the core CPI advancing 0.4 percent in February -- the second consecutive jump of that magnitude. The latest shift equated to a year-over-year change of 3.8 percent, one tick lower than the January observation and indicative of only modest additional progress after core inflation fell sharply in the second half of last year. Moreover, a broadening in the disinflationary impulse away from core goods also has failed to materialize. So-called "supercore" inflation (CPI services excluding energy services, rent of primary residence, and owners' equivalent rent) rose 0.5 percent after a surge of 0.8 percent in January, with the year-over-year change holding at 4.3 percent for the second consecutive and reversing earlier modest progress (chart, below left).

Importantly, the pressure present in the February CPI is likely to translate to a brisk increase in the Fed's preferred inflation gauge, the personal consumption expenditure price index (released March 29). Based on results for the CPI and components of the PPI that inform the PCE index, we expect the core deflator to advance 0.3 percent after last month's 0.4 percent increase. If our projection is realized, the annualized three-month change in the core PCE index would accelerate to 3.5 percent from 2.6 percent in January – almost two percentage points faster than the December reading (chart, below right). The six-month annualized change would increase to 2.9 percent, up from 2.5 percent in the prior month and well above the recent low of 1.9 percent in December. The readings do not necessarily suggest a prolonged upswing in inflation, but the reversal of recent progress speaks to the idea that inflation may be sticky in the upper-two-percent area. Thus, although Fed officials had previously telegraphed that a rate cut in March was unlikely, May now appears off the table and June or July seems more likely, provided that inflation settles in coming months.

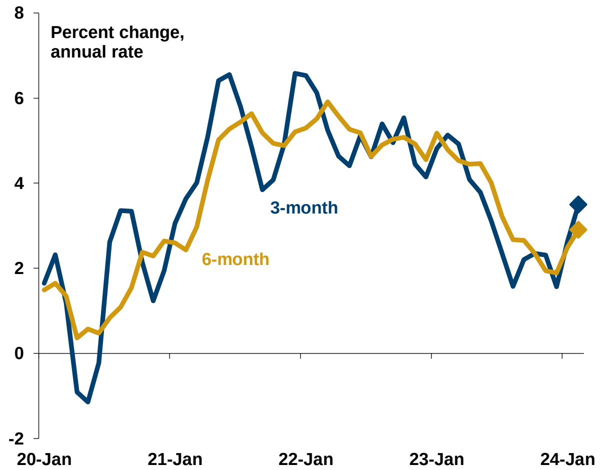
Decomposition of Core CPI



** Service prices excluding energy services, rent of primary residence, and owners' equivalent rent.*

Source: Bureau of Labor Statistics via Haver Analytics

Core PCE Price Index*



** The readings for the 3-month and 6-month annualized changes in February 2024 (blue and gold dots) are forecasts of 3.5% and 2.9%, respectively, based on a projection of a monthly change of 0.3% in the core index.*

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

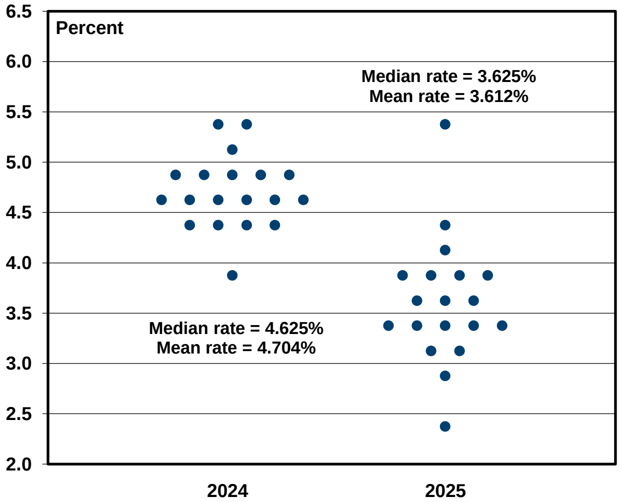
A New Dot Plot and Summary of Economic Projections

Although we strongly suspect that few, if any, meaningful changes will be made to the March FOMC statement specifically with regard to the Committee's easing bias – we will be scrutinizing the new dot plot and Summary of Economic Projections released at the conclusion of the policy meeting. The current dot plot indicates a fairly tight dispersion of views for 2024, with a median expectation of three cuts of 25 basis points by year-end. If only two officials in the three-cut group were to shift views, the median would shift to showing only two cuts. We still assign a higher probability to the median for 2024 remaining at 75 basis points of easing, as officials probably want to avoid surprising the market, but the brisk CPI print leaves the door ajar to the possibility of that shift.

Regarding out-years on the dot plot, we view material changes as unlikely at the current juncture. Provided officials' inflation narrative remains intact, with both headline and core inflation easing to the low-two-percent area, additional easing of 100 basis points in the target range for the federal funds rate to prevent an increase in real rates is reasonable. Beyond 2025, officials could adjust their views on long-run rates higher. Resilience of the economy to sharp increases in the federal funds rate could indicate that the real long-run equilibrium rate (r*) has increased after falling during the pandemic. That is, the current policy setting could be less restrictive than believed. However, given the high degree of uncertainty of current forecasts introduced by both the pandemic and the associated fiscal and monetary responses, as well as the ongoing discussion about both r* and monetary policy transmission lags, we suspect that many officials will choose to assess incoming data and further refine views before shifting projections of the long-run rate.

Changes could be on the docket for other elements of the SEP. We could foresee the median expectation for the unemployment rate in 2024 being nudged higher, particularly with the rate increasing 0.2 percentage point to 3.9 percent in February and with some labor market data suggesting more rapid softening in underlying conditions (the recent decline in the quits rate, for example). Also, we wonder if inflation projections for 2024 will be adjusted upward on account of recent readings. In our view, the previous projections indicated a linear slowing in inflation into 2024 consistent with conditions existent at the end of last year. Inflation pressure early in 2024 may call for a partial recalibration of the previous line of thinking. That said, officials may want to avoid transmitting a signal of diminished confidence in returning inflation to two-percent in the next two years.

FOMC Rate View, Dec. 2023*



** Each dot represents the expected federal funds rate of a Fed official at the end of the year.*

Source: Federal Reserve Board, Summary of Economic Projections, December 2023

Economic Projections of the FOMC, Dec. 2023*

	2024	2025	2026	Longer Run
Change in Real GDP	1.4	1.8	1.9	1.8
Unemployment Rate	4.1	4.1	4.1	4.1
PCE Inflation	2.4	2.1	2.0	2.0
Core PCE Inflation	2.4	2.2	2.0	--
Federal Funds Rate	4.6	3.6	2.9	2.5

** Median projections*

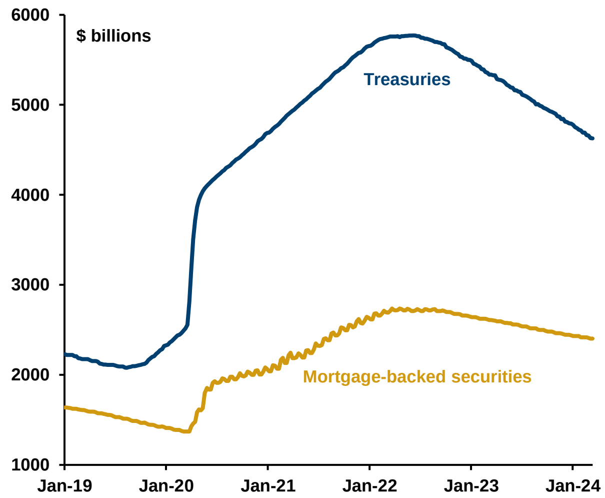
Source: Federal Reserve Board, Summary of Economic Projections, December 2023

Balance Sheet Policy

While there's little chance of an adjustment in interest rates at next week's FOMC meeting, policymakers will likely be focusing closely on another aspect of monetary policy: the current program of balance-sheet runoff that has accompanied the central bank's transition away from ultra-accommodative monetary policy (quantitative tightening, or QT). We do not anticipate the announcement of a definitive plan to slow securities redemptions, or the identification of a specific target level for bank reserves, but we do expect officials to discuss the matter at length with an eye on the summer (perhaps the June 11-12 FOMC meeting) as a possible starting point for the slowing of securities redemptions.

To provide some context for the current program of balance sheet reduction, the Fed's securities holdings swelled during the peak of the COVID crisis as policymakers sought to flood the banking system with liquidity amid severe stains to the economy. That round of quantitative easing (QE) boosted the Fed's portfolio from approximately $3.8 trillion in February 2020 to a peak of more than $8.5 trillion in the spring of 2022. Holdings of U.S. Treasury securities increased from approximately $2.5 trillion to almost $5.8 trillion, and the Fed's position in agency mortgage-back securities expanded from $1.4 trillion to $2.7 trillion (chart, right). The securities purchases boosted bank reserves from $1.7 trillion to $3.3 trillion in May 2022. The purchase operation contributed to lowering the prevailing level of interest rates for consumers and businesses, while the cash injection stabilized money markets and facilitated lending.

Federal Reserve Portfolio*

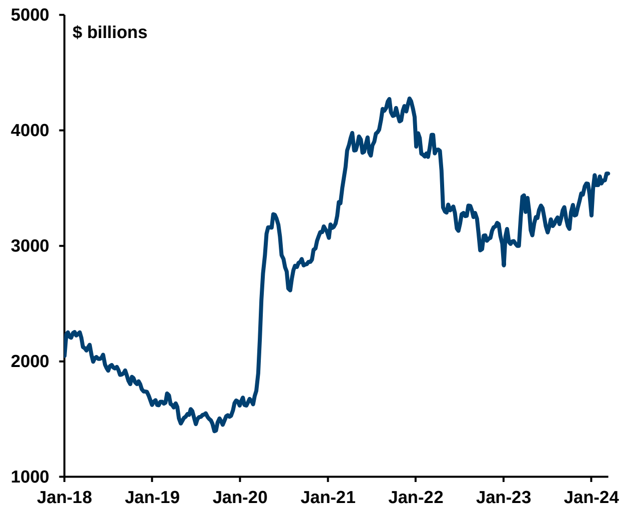


** Weekly average data*

Source: H.4.1 Report, Federal Reserve Board via Haver Analytics

Currently, the program of quantitative tightening in place since June 2022 allows for redemptions of up to $60 billion per month of Treasury securities and up to $35 billion of agency MBS. QT has reduced securities holdings by a total of $1.5 trillion, with Treasury holdings declining to $4.6 trillion as of mid-March and MBS holdings easing to $2.4 trillion; of note, MBS redemptions have in most months fallen well short of the redemption cap, as mortgage prepayments have been low in an environment of elevated interest rates. Bank reserves ultimately peaked at $4.2 trillion in the second half of 2022, but they have since eased to a still-ample $3.6 trillion (chart, below left).

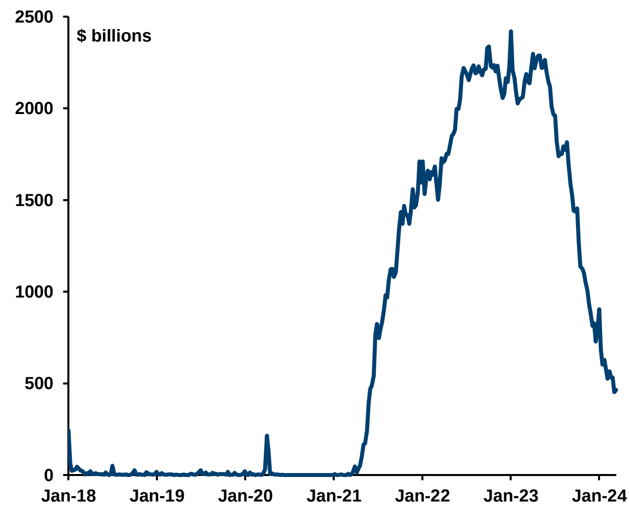
Reserve Balances with Federal Reserve Banks*



** Weekly average data*

Source: H.4.1 Report, Federal Reserve Board via Haver Analytics

Reverse Repurchase Agreements*



** Weekly average data. Excludes transactions with foreign official institutions.*

Source: H.4.1 Report, Federal Reserve Board via Haver Analytics

The issue of slowing QT has come to the forefront more recently, as the Fed’s reverse repurchase facility, where non-bank firms such as money-market funds hold excess cash, has experienced a dramatic drop in usage. Uptake excluding foreign official and international accounts has declined from $2.4 trillion in January 2023 to $464 billion (weekly average basis) as of March 13 (chart, previous page, below right). The recent decline in balances in the RRP facility, which has been tied to firms participating more actively in the market for Treasury bills where issuance has jumped recently and interest rates are slightly higher, is not problematic in isolation, but it could portend a coming drain in reserve balances.

A rapid, uneven drain in reserve balances and the emergence of a situation akin to acute volatility in money markets in September 2019 is possible if QT continues unaltered, particularly as the level of reserves necessary for maintaining smooth market function is not specifically identifiable. With that in mind, we suspect that officials desire to clearly telegraph intentions for moderation of QT with an implicit target for reserves in the range of $3.0 to $3.25 trillion, a level well above the $1.5 trillion that prevailed during September 2019 but one that could be reached fairly quickly after a drain of the RRP facility. Thus, expect action sometime later this year.

Secondary to considerations about slowing QT and the appropriate level of reserves in the banking system are issues of portfolio composition. Officials in the past few week have indicated both a desire to return to a Treasuries-only portfolio and an intention to potentially reduce the portfolio’s duration. With regard to portfolio composition, officials have become increasingly wary of being seen as allocating credit in the mortgage sector and therefore may be inclined to allow for continued reduction of MBS holdings over time. The process will be slow given the current sluggish pace of mortgage prepayments (which has generated only between $14 and $19 billion in redemptions per month in the past six months, for example), but MBS redemptions could continue even as Treasury runoff ceases. Regarding shortening the duration of the portfolio, heavier weights of T-bills or shorter coupon securities in the near term would allow for a better alignment of Fed income earned on the portfolio and expenses incurred via interest payments on reserves, etc. As Fed Governor Christopher Waller stated in his speech at the 2024 U.S. Monetary Policy Forum in early March, “Moving toward more Treasury bills would shift the maturity structure more toward our policy rate—the overnight federal funds rate—and allow our income and expenses to rise and fall together as the FOMC increases and cuts the target range.” (For more information regarding these prepared remarks, see: Waller, Christopher J. “Thoughts on Quantitative Tightening, Including Remarks on the Paper ‘Quantitative Tightening around the Globe: What Have We Learned?’" Federal Reserve Board, March 1, 2024. https://www.federalreserve.gov/newsevents/speech/waller20240301a.htm.) Again, these issues are secondary to providing guidance to the market for the taper of Treasury purchases, which is likely to be disseminated soon although not in its final form at next week’s FOMC meeting.

The Week Ahead

Housing Starts (February) (Tuesday)
Forecast: 1.450 Million (+8.9%)

Sharp drops in both single-family and multi-family housing starts of 4.7 percent and 35.6 percent, respectively, in January were likely influenced (at least to a degree) by inclement weather. Resumption of normal construction schedules could lead to an advance in total activity in February (chart, right).

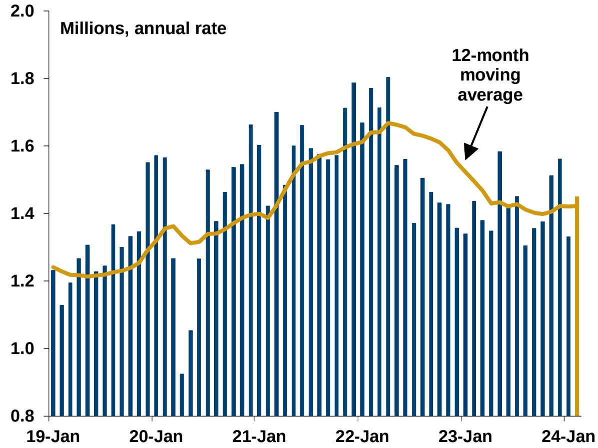
Existing Home Sales (February) (Thursday)
Forecast: 3.90 Million (-2.5%)

The drop of 4.9 percent in pending home sales in January suggests that existing home sales could dip in February after a pickup in the prior month (chart, below right). Even with some easing in mortgage interest rates, tight inventories have continued to support elevated prices and restrain activity in most markets, which suggests that sales could remain in the lower portion of the longer-term range.

Leading Indicators (February) (Thursday)
Forecast: -0.1%

Negative contributions from the slope of the yield curve, the ISM new orders index, and consumer expectations are likely to offset positive contributions from the length of the factory workweek and stock prices. If the forecast for February is realized, the index will have declined for 24 consecutive months with the projected reading 13.5 percent below the cycle peak in December 2021 (charts, below).

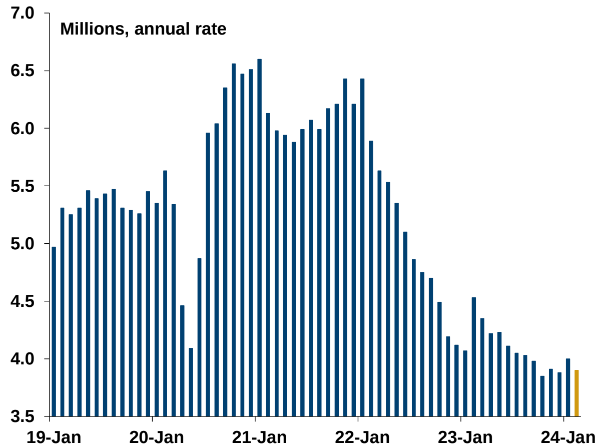
Housing Starts*



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

Sources: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

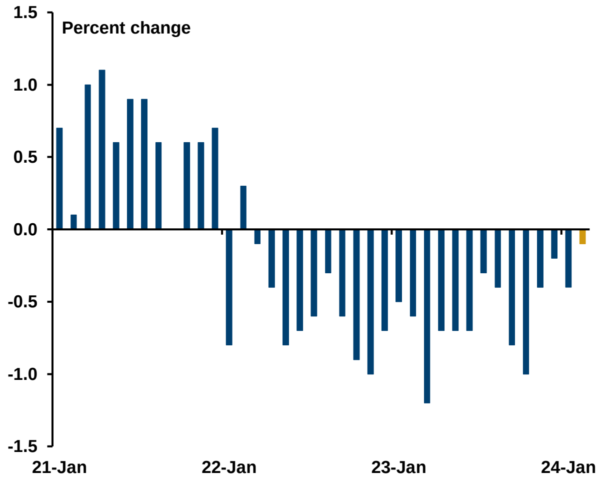
Existing Home Sales*



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

Sources: National Association of Realtors via Haver Analytics; Daiwa Capital Markets America

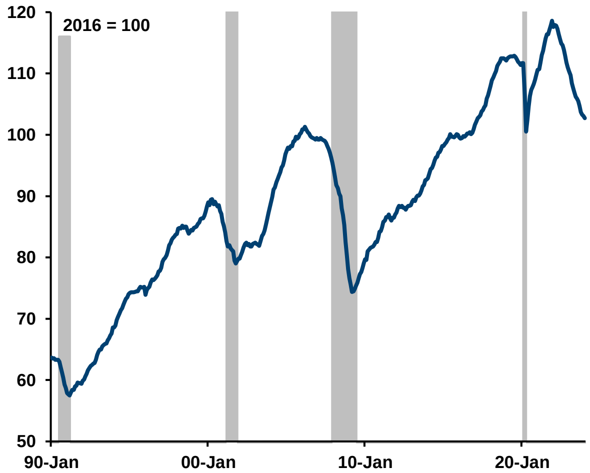
Index of Leading Economic Indicators*



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

Sources: The Conference Board via Haver Analytics; Daiwa Capital Markets America

Index of Leading Economic Indicators*



** The shaded areas indicate periods of recession in the United States.*

Sources: The Conference Board, National Bureau of Economic Research via Haver Analytics

Daiwa Capital Markets

Economic Indicators

March/April 2024

Monday	Tuesday	Wednesday	Thursday	Friday
11	12	13	14	15
	NFIB SMALL BUSINESS OPTIMISM INDEX Dec 91.9 Jan 89.9 Feb 89.4 **CPI** Total / Core Dec 0.2% 0.3% Jan 0.3% 0.4% Feb 0.4% 0.4% **FEDERAL BUDGET** FY2024 / FY2023 Dec -$129.4B -$85.0B Jan -$21.9B -$38.8B Feb -$296.3B -$262.4B		**UNEMPLOYMENT CLAIMS** Initial / Continuing (millions) Feb 17 0.200 1.805 Feb 24 0.213 1.794 Mar 2 0.210 1.811 Mar 9 0.209 N/A **PPI** Final Demand / Ex. Food & Energy Dec -0.1% 0.0% Jan 0.3% 0.5% Feb 0.6% 0.3% **RETAIL SALES** Total / Ex.Autos Dec 0.1% 0.1% Jan -1.1% -0.8% Feb 0.6% 0.3% **BUSINESS INVENTORIES** Inventories / Sales Nov -0.1% 0.0% Dec 0.3% 0.0% Jan 0.0% -1.3%	**EMPIRE MFG** Jan -43.7 Feb -2.4 Mar -20.9 **IMPORT/EXPORT PRICES** Non-Petrol Imports / Nonagri. Exports Dec 0.0% -0.7% Jan 0.6% 1.1% Feb 0.2% 0.8% **IP & CAP-U** IP / Cap.Util. Dec -0.3% 78.7% Jan -0.5% 78.3% Feb 0.1% 78.3% **CONSUMER SENTIMENT** Jan 79.0 Feb 76.9 Mar 76.5
18	19	20	21	22
NAHB HOUSING INDEX (10:00) Jan 44 Feb 48 Mar --	**HOUSING STARTS (8:30)** Dec 1.562 million Jan 1.331 million **Feb 1.450 million** **TIC FLOWS (4:00)** Long-Term / Total Nov $99.7B $223.3B Dec $160.2B $139.8B Jan -- -- **FOMC MEETING (FIRST DAY)**	**FOMC RATE DECISION (2:00)**	**UNEMP. CLAIMS (8:30)** **CURRENT ACCOUNT (8:30)** 23-Q2 -$216.8 bill. 23-Q3 -$200.3 bill. **23-Q4 -$210.0 bill.** **PHILADELPHIA FED MFG BUSINESS OUTLOOK (8:30)** Jan -10.6 Feb 5.2 Mar -- **EXISTING HOME SALES (10:00)** Dec 3.880 million Jan 4.000 million **Feb 3.900 million** **LEADING INDICATORS (10:00)** Dec -0.2% Jan -0.4% **Feb -0.1%**	
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX **NEW HOME SALES**	**DURABLE GOODS ORDERS** **FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CONFERENCE BOARD CONSUMER CONFIDENCE**		**UNEMP. CLAIMS** **REVISED Q4 GDP** **MNI CHICAGO BUSINESS BAROMETER** **REVISED CONSUMER SENTIMENT** **PENDING HOME SALES**	***GOOD FRIDAY*** **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** **INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES**
1	2	3	4	5
ISM MFG. INDEX **CONSTRUCTION**	**FACTORY ORDERS** **JOLTS DATA** **VEHICLE SALES**	**ADP EMPLOYMENT** **ISM SERVICES INDEX**	**UNEMP. CLAIMS** **TRADE BALANCE**	**EMPLOYMENT REPORT** **CONSUMER CREDIT**

Forecasts in bold.

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Treasury Financing

March/April 2024

Monday	Tuesday	Wednesday	Thursday	Friday
11	12	13	14	15
AUCTION RESULTS: Rate Cover 13-week bills 5.250% 2.53 26-week bills 5.100% 2.95 3-year notes 4.256% 2.60	**AUCTION RESULTS:** Rate Cover 10-yr notes 4.166% 2.51 42 day CMBs 5.285% 2.80 **ANNOUNCE:** $60 billion 17-week bills for auction on Mar 13 $95 billion 4-week bills for auction on Mar 14 $90 billion 8-week bills for auction on Mar 14 **SETTLE:** $60 billion 17-week bills $95 billion 4-week bills $90 billion 8-week bills	**AUCTION RESULTS:** Rate Cover 17-week bills 5.210% 3.00 30-yr bonds 4.331% 2.47	**AUCTION RESULTS:** Rate Cover 4-week bills 5.280% 2.79 8-week bills 5.275% 2.87 **ANNOUNCE:** $146 billion 13-,26-week bills for auction on Mar 18 $46 billion 52-week bills for auction on Mar 19 $13 billion 20-year bonds for auction on Mar 19 $16 billion 10-year TIPS for auction on Mar 21 $75 billion 42-day CMBs for auction on Mar 19 **SETTLE:** $149 billion 13-,26-week bills $80 billion 42-day CMBs	**SETTLE:** $56 billion 3-year notes $39 billion 10-year notes $22 billion 30-year bonds
18	19	20	21	22
AUCTION: $146 billion 13-,26-week bills	**AUCTION:** $46 billion 52-week bills $13 billion 20-year bonds $75 billion 42-day CMBs **ANNOUNCE:** $60 billion* 17-week bills for auction on Mar 20 $95 billion* 4-week bills for auction on Mar 21 $90 billion* 8-week bills for auction on Mar 21 **SETTLE:** $60 billion 17-week bills $95 billion 4-week bills $90 billion 8-week bills	**AUCTION:** $60 billion* 17-week bills	**AUCTION:** $95 billion* 4-week bills $90 billion* 8-week bills $16 billion 10-year TIPS **ANNOUNCE:** $146 billion* 13-,26-week bills for auction on Mar 25 $66 billion* 2-year notes for auction on Mar 25 $67 billion* 5-year notes for auction on Mar 26 $43 billion* 7-year notes for auction on Mar 27 $28 billion* 2-year FRNs for auction on Mar 27 **SETTLE:** $146 billion 13-,26-week bills $46 billion 52-week bills $75 billion 42-day CMBs	
25	26	27	28	29
AUCTION: $146 billion* 13-,26-week bills $66 billion* 2-year notes	**AUCTION:** $67 billion* 5-year notes **ANNOUNCE:** $60 billion* 17-week bills for auction on Mar 27 $95 billion* 4-week bills for auction on Mar 28 $90 billion* 8-week bills for auction on Mar 28 **SETTLE:** $60 billion* 17-week bills $95 billion* 4-week bills $90 billion* 8-week bills	**AUCTION:** $60 billion* 17-week bills $43 billion* 7-year notes $28 billion* 2-year FRNs	**AUCTION:** $95 billion* 4-week bills $90 billion* 8-week bills **ANNOUNCE:** $146 billion* 13-,26-week bills for auction on Apr 1 **SETTLE:** $146 billion* 13-,26-week bills $16 billion 10-year TIPS	***GOOD FRIDAY***
1	2	3	4	5
AUCTION: $146 billion* 13-,26-week bills **SETTLE:** $13 billion 20-year bonds $66 billion* 2-year notes $67 billion* 5-year notes $43 billion* 7-year notes $28 billion* 2-year FRNs	**ANNOUNCE:** $60 billion* 17-week bills for auction on Apr 3 $95 billion* 4-week bills for auction on Apr 4 $90 billion* 8-week bills for auction on Apr 4 **SETTLE:** $60 billion* 17-week bills $95 billion* 4-week bills $90 billion* 8-week bills	**AUCTION:** $60 billion* 17-week bills	**AUCTION:** $95 billion* 4-week bills $90 billion* 8-week bills **ANNOUNCE:** $146 billion* 13-,26-week bills for auction on Apr 8 $58 billion* 3-year notes for auction on Apr 9 $39 billion* 10-year notes for auction on Apr 10 $22 billion* 30-year bonds for auction on Apr 11 **SETTLE:** $146 billion* 13-,26-week bills	

**Estimate*