Daiwa Capital Markets

U.S. Economic Comment

- FOMC preview: little doubt about September tightening; high probability for December
- Household balance sheets: further improvement in Q2
- Corporate balance sheets: some influence from the new tax act

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U.S. Monetary Policy

It would be shocking if the Federal Open Market Committee did not hike interest rates at its meeting on September 26. The economy is performing well, and public statements of Fed officials have strongly suggested that the Committee is prepared to move again. Chairman Powell noted in his Jackson Hole speech that the strong performance of the economy is likely to continue and that "further gradual increases in the target range for the federal funds rate will likely be appropriate." We also found speeches by Fed Governor Lael Brainard and Chicago Fed President Charles Evans to be informative. Both have historically been solidly in the dovish camp, but both are now fully on board for policy normalization.

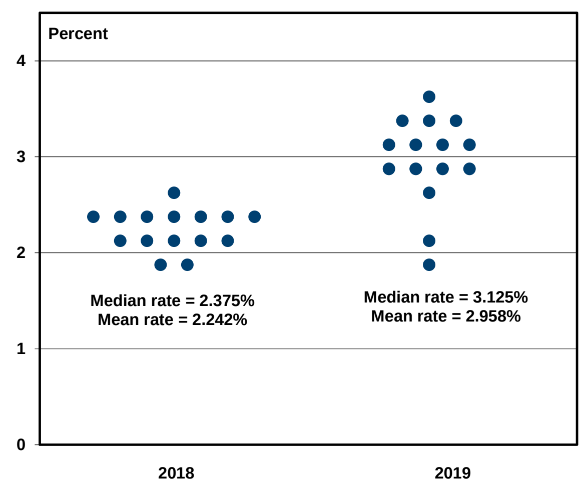
With the September outcome involving little mystery, market participants are already focusing on prospects for a fourth rate hike this year. We expect a December move; November seems doubtful because of the Committee's intention to move gradually. This view is supported by the dot plot in June, which showed a median view of four rate hikes this year (chart). We would not be surprised if the new dot plot shows more officials sympathetic to a fourth shift in 2018.

We also will be interested in the dots for 2019. The median dot in June suggested another three rate hikes next year (to 3.125 percent), although there was a high degree of dispersion around that median, indicating considerable uncertainty about the outcome for next year. We look for the median dot to again suggest three tightenings, and we suspect there will be less dispersion than there was in June.

The policy statement released by the Committee will probably provide little guidance about future rate changes, although we will be keenly interested in seeing if the Committee retains the sentence that describes policy as "accommodative". If this sentence remains, odds strongly favor another rate hike in December. If the Committee drops or alters this assessment, observers will probably conclude that officials now see policy as close to neutral, which would dampen prospects for additional tightening.

Even if the statement is changed, we would not rule out additional tightening in December or early 2019. Officials might see policy as neutral at this time, but the neutral setting could change. The September 12 speech by Governor Brainard argued that the neutral rate moves with the business cycle, increasing during expansions and contracting in recessions, and she cited factors that could be pushing the neutral rate higher in the current environment, such as fiscal stimulus and elevated levels of asset valuations and confidence measures. Additional tightening might be needed to remain neutral or perhaps to move to a slightly restrictive stance because of continued brisk economic growth.

Expected Fed Funds Rate (Year End '18 & '19)



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2018 and 2019. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but four governorships were open at the June 2018 meeting.*

Source: Federal Open Market Committee

Recent research by the staff of the Board of Governors also leads us to keep open the door for further tightening. Previous research showed that rapid inflation in the 1970s to a large degree was the result of an easy monetary policy, and the easy stance, in turn, reflected misestimates of the natural rate of unemployment. Officials saw the natural rate as low, and therefore did not view the labor market as tight. The policy lesson drawn from this experience was to deemphasize the gap between the actual unemployment rate and the estimated natural rate and to draw conclusions about tightness in the labor market from shifts in wage growth and inflation.

The latest research from the Fed moves in the other direction, suggesting that the weight placed on inflation should be lightened and that signals from the labor market should be considered carefully. This new view is based on econometric simulations under different policy regimes, with superior results for achieving the Fed's dual objectives when giving the labor market its due. The change in perspective has occurred because of an easing in the relationship between unemployment and inflation. Specifically, inflation has become less sensitive to unemployment or output gaps -- the Philips curve has flattened -- and therefore signals from inflation have become less reliable. The strongest argument for those in the dovish camp -- stable inflation -- has been weakened. (See Christopher Erceg, James Hebden, Michael Kiley, David L´opez-Salido, and Robert Tetlow (2018). "Some Implications of Uncertainty and Misperception for Monetary Policy," Finance and Economics Discussion Series 2018-059. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2018.059.)

Chairman Powell cited this research in his Jackson Hole speech and seemed to embrace its conclusions, as he noted that officials should look beyond inflation for signs of excess and that policymakers should be guided by a broad range of indicators. Slow inflation might tempt Fed officials to allow the economy to run hot, but signals from other economic and financial variables argue for further policy adjustments.

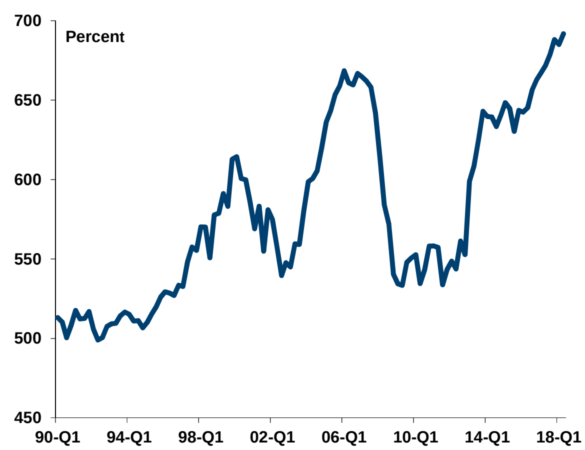
Household Balance Sheet: Healthy and Still Improving

Analysts tend to focus on job and income growth when assessing prospects for consumer spending, but the balance sheet position (or wealth standing) is also an important consideration. Like the job market, the balance sheet of the household sector is robust, suggesting that individuals will continue to provide good support to the economy.

The latest set of Financial Accounts of the United States released by the Federal Reserve Board (previously called the Flow of Funds Accounts) showed that the aggregate net worth of the household sector continued to advance. Household wealth rose $2.2 trillion in the second quarter, among the best showings of the current expansion (only eight other quarters since 2009 showed gains in excess of $2.0 trillion; the average advance in the prior 35 quarters of the current expansion totaled $0.9 trillion). Measured as a share of personal income (to scale for the growing size of the economy over time), net worth climbed further from the record in the prior quarter and towered over historical norms (chart).

The robust performance in net worth is primarily a reflection of the surge in stock prices over the past several years and the recovery in home prices. But that is not the only story. Other financial assets also have picked up, and individuals have used debt cautiously. Indeed, mortgage debt is still below the peak seen in 2008, and the growth of other debt has been moderate.

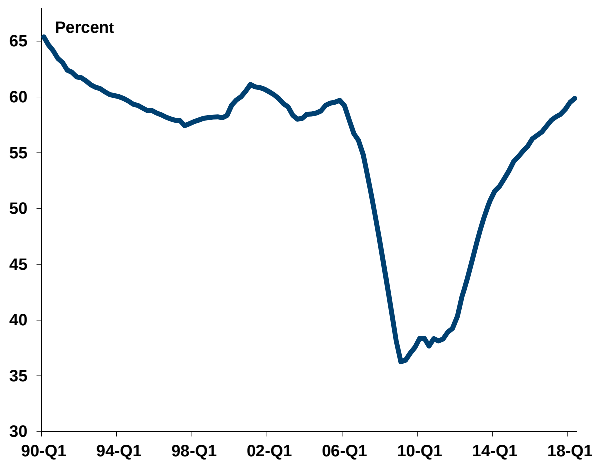
Household Net Worth*



** Household net worth as a share of disposable personal income.*

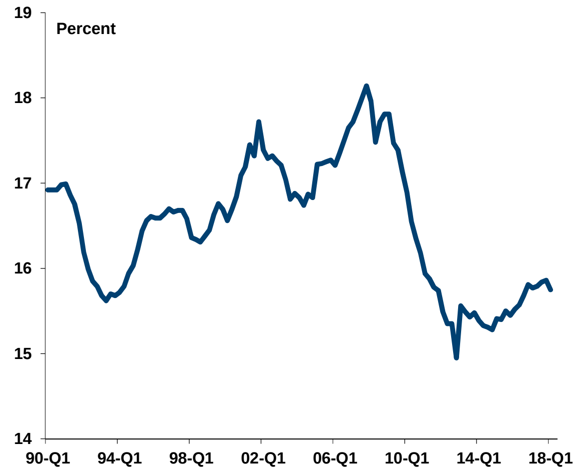
Source: Federal Reserve Board, Financial Accounts of the United States via Haver Analytics

Household Equity in Real Estate*



Owners' equity in real estate as a share of household real estate.
Source: Federal Reserve Board, Financial Accounts of the United States via Haver Analytics

Household Financial Obligations*



The ratio of financial obligations to disposable personal income. Financial obligations include required loan payments, lease payments, rental payments for tenant-occupied property, homeowners insurance premiums, and property tax payments.
Source: Federal Reserve Board via Haver Analytics

With home prices by most measures higher than at the time of the housing bubble, and with mortgage debt still below the previous peak, the constraining influence of underwater mortgages is no longer a serious issue. The Financial Accounts show that equity in homes as a share of total real estate value is now back within the range evident before the bursting of the housing bubble (chart, left).

Moderate growth in borrowing, along with low interest rates, has led to minimal burdens in servicing the debt of households. The financial obligation ratio published by the Federal Reserve tumbled during the recession and early recovery and has retraced only a small portion of the decline in recent years. Debt burdens are near the bottom of the historical range (chart, right).

The evidence relating to the financial position of the household sector is uniformly favorable, suggesting good support to economic growth from individuals. Many observers will note that wealth in the household sector is not evenly distributed and that the skew will diminish the push provided by a strong aggregate wealth position. This view has merit, but nevertheless we see the financial position of the household sector as a positive factor in the economic outlook.

Corporate Balance Sheets: Muddled in Q2

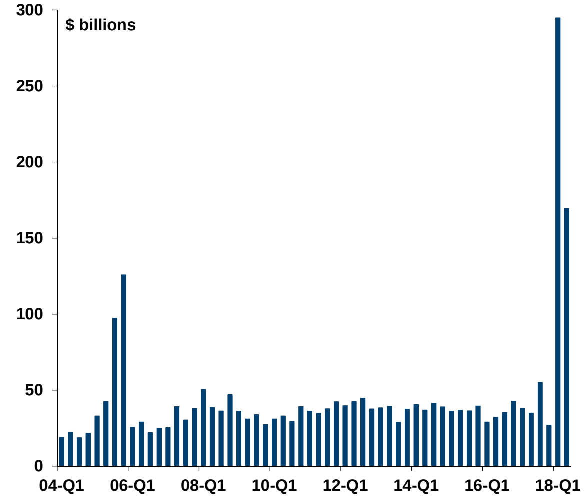
While reviewing recent developments in household finance, we also took a glance at the latest changes in corporate balance sheets. We saw several puzzling results; we suspect that the odd movements are related to changes motivated by the Tax Cuts and Jobs Act passed late last year. The preliminary figures on corporate financial activity also might reflect the limited availability of data to trace flows accurately.

The Financial Accounts showed that corporate borrowing (credit market instruments plus loans) surged in the second quarter, growing at an annual rate of 14.0 percent, easily the fastest of the current expansion (10.6 percent in 2015-Q2 is now the second fastest). The surge occurred despite almost no net activity in the corporate bond market; loan growth, and specifically loans from the rest of the world, accounted for most of the jump.

Possibly, the increase in foreign borrowing was tied to the efforts of corporations to remit foreign earnings to the United States. Before the passage of the Tax Cuts and Jobs Act, the profits of foreign subsidiaries were not taxed until they were remitted to the parent company in the United States, creating an incentive to book and retain profits abroad. TCJA levied a one-time tax on foreign corporate profits accumulated and retained abroad since 1986 (payable over the next eight years). The new tax effectively eliminated the incentive to book and hold profits in foreign subsidiaries, which may have led some corporations to repatriate profits to the United States.

The detailed statistics published with the current account show that the repatriation of profits has indeed picked up, as dividends paid by foreign subsidiaries in the first two quarters were far above historical norms (chart). Borrowing in foreign countries evident in the Financial Accounts may have somehow facilitated these transactions.

Corporate Repatriations*



** Dividends and withdrawals from equity investments in foreign countries.*
Source: Bureau of Economic Analysis via Haver Analytics

The question naturally arises: how did corporations utilize the funds remitted from abroad? Stock buy backs seem to be one outlet. The Financial Accounts show a sizeable drop in net equity issuance in the second quarter, and a research note by Fed staff based on financial statements of large corporations with foreign profits showed a jump in stock buybacks. (Michael Smolyansky, Gustavo Suarez, and Alexandra Tabova (2018). "U.S. Corporations' Repatriation of Offshore Profits," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, September 4, 2018, https://doi.org/10.17016/2380-7172.2239.)

However, there also is some mystery in what corporations did with the funds. The Financial Accounts indicated that corporations reduced liabilities, with the largest change occurring in the miscellaneous category. A portion of this reduction reflected the prepayment of pension obligations (TCJA offered an incentive to bolster pension payments before September 15), but the vast majority of the drop in the miscellaneous category is not clear at this point. We suspect that data at this early date is not sufficiently robust to offer a complete picture on corporate financial flows, and information gaps were closed by filling the miscellaneous category.

As an aside, the payment of dividends by foreign subsidiaries shown in the above chart represents a marked shift from the typical flows in previous years, but they are meager compared with totals that might have been expected. The Joint Committee on Taxation estimated that profits held abroad totaled $2.6 trillion as of 2015, and some commentators suggested that much of this total would return to the United States. Thus far, however, the amount brought to the U.S. in the first two quarters represented only 18 percent of the estimated total.

We are not entirely surprised by the modest response thus far, as we do not see the incentive to bring funds home to be especially great. Corporations are not constrained financially in the United States: profits are strong, liquid assets are elevated, and funds are available in the bond market at low interest rates. Many corporations do not need additional sources of funding at this time. In addition, profits booked abroad are undoubtedly invested in some income-earning asset, and therefore, a financial manager would be motivated to shift this asset only if a higher return were available in the United States. Moreover, that current asset might already be invested in the U.S. A foreign subsidiary under the previous tax regime could convert its profits to dollars and invest in a U.S. asset without a tax obligation, as long as that asset remained on the books of the foreign subsidiary. We suspect that corporations do not see an urgency in reordering their existing financing arrangements.

Review

Week of Sept. 17, 2018	Actual	Consensus	Comments
Housing Starts (August)	**1.282 Million (+9.2%)**	**1.240 Million (+6.2%)**	Despite the sizeable jump in housing starts in August, the report suggested that residential construction has hit a soft patch. Most of the advance was the result of a surge of 29.3% in the multi-family sector, which merely offset weak readings in earlier months. The recent trend in multi-family starts has been sideways at a lower level than that in 2016 and early 2017. Single-family starts rose 1.9% in August after an increase of 1.1% in the prior month. However, the recent advances offset only a portion of the 9.3% tumble in June and left activity below most observations in the first half of the year. Building permits in August also were disappointing, as total authorizations fell 5.7%, with both single-family and multi-family adding to erosions that began earlier this year.
Current Account (2018-Q2)	**-\$101.5 Billion (\$20.2 Billion Narrower Deficit)**	**-\$103.4 Billion (\$20.7 Billion Narrower Deficit)**	A sharp narrowing in the trade deficit in the second quarter fed through to the current account, pushing this deficit to the low portion of the range from the past few years. Income flows (investment income, employee compensation, and remittances from US residents to individuals abroad) contributed marginally to the improvement in the current account deficit. The narrowing in the deficit might prove to be temporary, as the shift in trade flows seemed related to a rush to export food to China before tariffs took effect. Early results for Q3 show slippage in the trade deficit.
Existing Home Sales (August)	**5.34 Million (Unchanged)**	**5.37 Million (+0.5%)**	A flat reading on existing home sales in August broke a string of four consecutive declines, although the pace of activity was disappointing. The cumulative change in the spring and summer left sales 3.5% below the average from last year and in the lower portion of the range of the past three years. The National Association of Realtors has highlighted tight inventories as a factor in the slow pace of sales, but slack demand caused by decreased affordability (elevated prices and higher interest rates) also may be playing a role.
Leading Indicators (August)	**0.4%**	**0.5%**	The index of leading economic indicators increased for the 25th time in the past 27 months in August, with the other two months registering no change. Positive contributions from the ISM new orders index, the leading credit index, and the slope of the yield curve offset negative contributions from building permits and the factory workweek. The latest monthly change left the level of the index 8.6% above the peak in the prior expansion.

Source: U.S. Census Bureau (Housing Starts); Bureau of Economic Analysis (Current Account); The Conference Board (Leading Indicators); National Association of Realtors (Existing Home Sales); Consensus forecasts are from Bloomberg

Preview

Week of Sept. 24, 2018	Projected	Comments
Consumer Confidence (September) (Tuesday)	**132.0 (-1.4 Index Pts.)**	A strong job market and elevated equity values should keep the confidence index close to the cyclical high registered in August, although weekly measures suggest a slight downward adjustment.
New Home Sales (August) (Wednesday)	**0.645 Million (+2.9%)**	Increases in prices and interest rates have created affordability problems for many potential home buyers, but a firm labor market should keep others interested and lead to a small bounce in sales of new homes after easing on balance in the past four months.
Revised GDP (2018-Q2) (Thursday)	**4.2% (Unrevised)**	Firmer consumer spending on services and modestly stronger construction activity could lead to slightly faster GDP growth, although the final estimate of GDP incorporates numerous esoteric items that sometimes provide surprises.
Durable Goods Orders (August) (Thursday)	**0.5%**	With the manufacturing sector performing well, several industries should report firm order flows, which are likely to be accented by a rebound in the volatile aircraft component after a slow month in July.
U.S. International Trade in Goods (August) (Thursday)	**$71.5 Billion Deficit ($0.5 Billion Narrower Deficit)**	Firm demand will probably continue to pull imports into the U.S., but exports are likely to show a larger change as several categories rebound from unusually soft readings in July.
Personal Income, Consumption, and Core Price Index (August) (Friday)	**0.4%, 0.4%, 0.1%**	With payrolls advancing sharply in August, and with average hourly earnings jumping, wage and salary income should grow briskly. Dividends, rental income, and proprietors' returns also should contribute, while farm income probably softened. On the spending side, a dip in sales of motor vehicles suggests that outlays for durable goods will be soft, but spending on nondurable goods and services is likely to be well maintained. The CPI points to a slow advance in core prices for personal consumption expenditures.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

September/October 2018

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
EMPIRE MFG July 22.6 Aug 25.6 Sept 19.0	**NAHB HOUSING INDEX** July 68 Aug 67 Sept 67 **TIC DATA** Total / Net L-T May $70.3B / $45.5B June $189.7B / -$36.5B July $52.2B / $74.8B	**HOUSING STARTS** June 1.177 million July 1.174 million Aug 1.282 million **CURRENT ACCOUNT** 17-Q4 -$116.1 bill. 18-Q1 -$121.7 bill. 18-Q2 -$101.5 bill.	**INITIAL CLAIMS** Sept 01 205,000 Sept 08 204,000 Sept 15 201,000 **PHILLY FED INDEX** July 25.7 Aug 11.9 Sept 22.9 **LEADING INDICATORS** June 0.5% July 0.7% Aug 0.4% **EXISTING HOME SALES** June 5.38 million July 5.34 million Aug 5.34 million	
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. June 0.48 / 0.20 July 0.13 / 0.05 Aug -- / --	**FHFA HOME PRICE INDEX (9:00)** May 0.4% June 0.2% July -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA May 0.2% / 0.8% June 0.1% / 0.5% July -- / -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** July 127.9 Aug 133.4 **Sept 132.0** **FOMC MEETING**	**NEW HOME SALES (10:00)** June 0.638 million July 0.627 million **Aug 0.645 million** **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **REVISED GDP (8:30)** GDP / Chained Price 18-Q1 2.2% / 2.0% 18-Q2(p) 4.2% / 3.0% **18-Q2(r) 4.2% / 3.0%** **U.S. INTERNATIONAL TRADE IN GOODS (8:30)** June -$67.9 billion July -$72.0 billion **Aug -$71.5 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail June 0.1% / -0.1% July 0.6% / 0.5% Aug -- / -- **DURABLE GOODS ORDERS (8:30)** June 0.9% July -1.7% **Aug 0.5%** **PENDING HOMES SALES (10:00)** June 1.0% July -0.7% Aug --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core June 0.4% / 0.4% / 0.1% July 0.3% / 0.4% / 0.2% **Aug 0.4% / 0.4% / 0.1%** **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index / Prices July 65.5 / 82.1 Aug 63.6 / 81.0 Sept -- / -- **REVISED CONSUMER SENTIMENT (10:00)** July 97.9 Aug 96.2 Sept(p) 100.8
1	2	3	4	5
ISM MFG INDEX **CONSTRUCTION SPEND.** **VEHICLE SALES**		**ADP EMPLOYMENT REPORT** **ISM NON-MFG INDEX**	**INITIAL CLAIMS** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **TRADE BALANCE** **CONSUMER CREDIT**
8	9	10	11	12
COLUMBUS DAY	**NFIB SMALL BUSINESS OPTIMISM INDEX**	**PPI** **WHOLESALE TRADE**	**INITIAL CLAIMS** **CPI** **FEDERAL BUDGET**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**

Forecasts in Bold (p) = preliminary (2nd estimate of GDP); (r) = revised (3^{rd} estimate of GDP)

Treasury Financing

September/October 2018

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
AUCTION RESULTS: Rate Cover 3-mo bills 2.125% 2.94 6-mo bills 2.290% 3.09 **ANNOUNCE:** $40 billion 4-week bills for auction on September 18 **SETTLE:** $35 billion 3-year notes $23 billion 10-year notes $15 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 4-week bills 2.020% 3.38		**AUCTION RESULTS:** Rate Cover 10-yr TIPS 0.910% 2.57 **ANNOUNCE:** $90 billion 13-,26-week bills for auction on September 24 $17 billion 2-year FRNs for auction on September 25 $37 billion 2-year notes for auction on September 24 $38 billion 5-year notes for auction on September 25 $31 billion 7-year notes for auction on September 27 **SETTLE:** $90 billion 13-,26-week bills $40 billion 4-week bills	
24	25	26	27	28
AUCTION: $90 billion 13-,26-week bills $37 billion 2-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on September 25	**AUCTION:** $40 billion* 4-week bills $17 billion 2-year FRNs $38 billion 5-year notes		**AUCTION:** $31 billion 7-year notes **ANNOUNCE:** $90 billion* 13-,26-week bills for auction on October 1 **SETTLE:** $90 billion 13-,26-week bills $40 billion* 4-week bills	**SETTLE:** $17 billion 2-year FRNs $11 billion 10-year TIPS
1	2	3	4	5
AUCTION: $90 billion* 13-,26-week bills **ANNOUNCE:** $40 billion* 4-week bills for auction on October 2 **SETTLE:** $37 billion 2-year notes $38 billion 5-year notes $31 billion 7-year notes	**AUCTION:** $40 billion* 4-week bills		**ANNOUNCE:** $40 billion* 4-week bills for auction on October 9 $90 billion* 13-,26-week bills for auction on October 9 $26 billion* 52-week bills for auction on October 9 $36 billion* 3-year notes for auction on October 10 $23 billion* 10-year notes for auction on October 10 $15 billion* 30-year bonds for auction on October 11 **SETTLE:** $90 billion* 13-,26-week bills $40 billion* 4-week bills	
8	9	10	11	12
COLUMBUS DAY	**AUCTION:** $40 billion* 4-week bills $90 billion* 13-,26-week bills $26 billion* 52-week bills	**AUCTION:** $36 billion* 3-year notes $23 billion* 10-year notes	**AUCTION:** $15 billion* 30-year bonds **ANNOUNCE:** $90 billion* 13-,26-week bills for auction on October 15 $5 billion* 30-year TIPS for auction on October 18 **SETTLE:** $90 billion* 13-,26-week bills $40 billion* 4-week bills $26 billion* 52-week bills	

**Estimate*