Daiwa Capital Markets

U.S. Economic Comment

- The U.S. economy and monetary policy: cross currents versus fundamentals
- The yield curve: more narrowing, but still not a concern
- Balance sheet normalization: the Fed becomes a Treasury buyer again in September

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Monetary Policy: Likely Steady This Year

The latest dot plot from the Federal Open Market Committee showed that a sizeable majority of policymakers expect to hold short-term interest rates steady this year (11 of 17 officials see no change; four would hike rates once if their view of the economy comes to pass, while two officials would be willing to hike twice).

We were surprised to see the potential for two rate hikes, but as noted by Chairman Powell in his press conference, policymakers view economic fundamentals as favorable, and thus most officials have a positive view on the outlook. Two rate hikes would not be a stretch if the most optimistic forecast came to pass. However, officials also see cross currents that could have a constraining influence on economic activity, and thus patience seems warranted. A subdued inflation environment also favors steady policy.

Chairman Powell highlighted the factors that led officials to expect a favorable economic performance: the labor market remains firm despite slow job growth in February; financial conditions are supportive, as equity values have regained most of the ground lost in November and December (chart, left) and credit spreads have eased; and levels of business and consumer confidence remain elevated despite hesitation in December and January (chart, right).

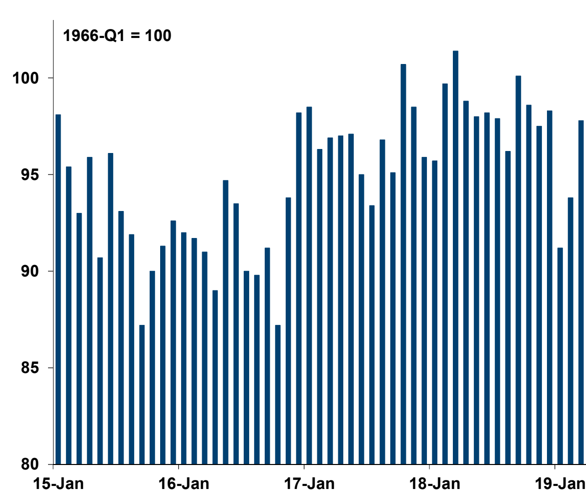
Several Fed officials have highlighted the downside risks currently in play, with slower growth in foreign economies at the top of the list. Most officials emphasize the slowdowns in Europe and China, but growth rates in Japan, Canada, and the United Kingdom are far from robust (chart, next page). Unsettled political

S&P 500 Index*

* *Weekly average data, except for the last observation which is a closing quote for March 22, 2019.*

Source: Standard and Poor's via Haver Analytics

Consumer Sentiment



Source: Reuters/University of Michigan Survey Research Center via Haver Analytics

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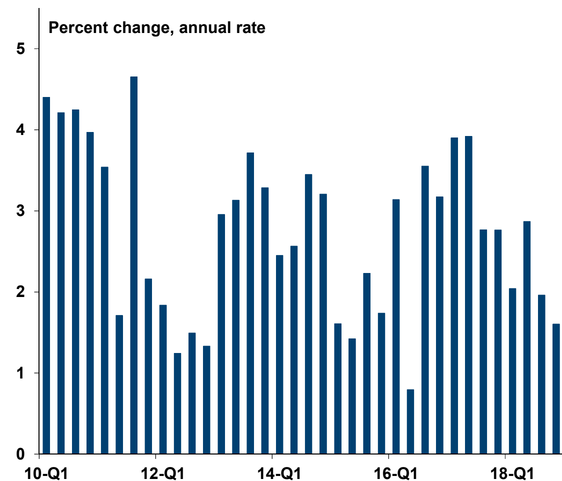
environments also are a factor, with Brexit and the U.S.-China trade dispute standing out in this regard. Upcoming negotiations in the U.S. on budget matters (debt ceiling and spending caps) also generate uncertainty, with potential disruption likely on the minds of many because of the government shutdown in December and January.

Thus, the outlook for the economy and prospects for monetary policy seem to depend on whether positive fundamentals will outweigh the cross currents now present. If fundamentals carry the day, economic growth could be faster than the median view of 2.1 percent in the latest set of Fed forecasts, and the six Fed officials expecting higher interest rates could begin to dominate the policy discussion.

Global GDP Growth*



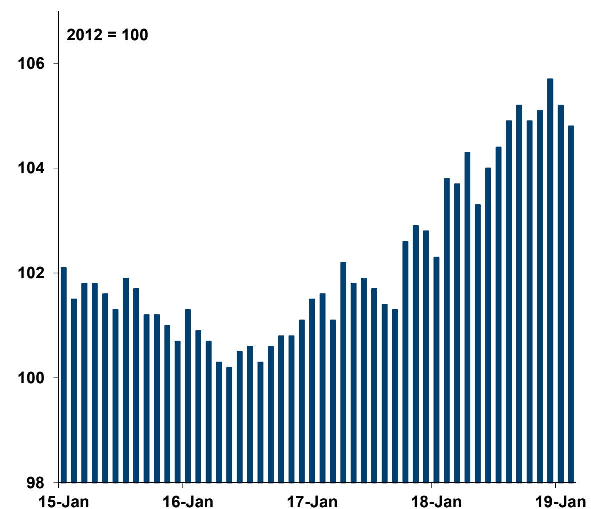
** Weighted average of GDP growth in Canada, the Euro Area, the United Kingdom, Japan, and China. Weights are based on U.S. exports to these areas.*

Source: Cabinet Office of Japan, China National Bureau of Statistics, Office of National Statistics (U.K.), Statistical Office of the European Communities, Statistics Canada, and U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

However, the recent evidence suggests that fundamentals are not winning out; underlying growth seems to be slowing and could total less than the Fed's median estimate of 2.1 percent. Results on consumer spending were disappointing in December (a drop of 0.6 percent in real terms), and the retail sales report for January suggested only a partial rebound. Personal consumption expenditures seem on track for a slow first quarter.

We suspect that consumer spending will pickup in coming months, given the firm labor market and elevated levels of confidence. However, it is hard to explain away softness in the manufacturing sector that has emerged recently. The ISM index, although still at a respectable level of 54.2 percent in February, has backed away from readings in the upper-50-percent area during much of 2017 and 2018 (and a few readings of 60 percent or more). In addition, order flows for manufactured goods have flattened, and the manufacturing component of industrial production has declined in the first two months of the year and moved below the average in the fourth quarter (chart).

Industrial Production: Manufacturing



Source: Federal Reserve Board via Haver Analytics

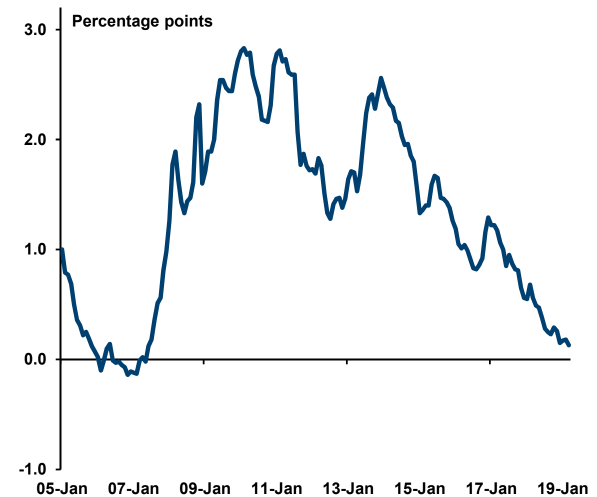
Many observers will downplay the softness in manufacturing because it is a smaller share of the economy than it was in the past. However, we monitor it carefully because it is still a highly cyclical area; if the economy is slowing, the drag will be evident in the manufacturing sector. The current softness could be temporary -- a reflection of efforts to slow the heavy pace of inventory building in the fourth quarter. However, it also might reflect underlying softening associated with weak exports or hesitation in capital spending (orders for nondefense capital goods other than aircraft have turned lower).

While less than definitive, the latest evidence suggests an underlying softening in the economy, raising odds that growth will fall short of the Fed's expectation of 2.1 percent and supporting the view that the Fed will be on hold this year.

The Yield Curve: More Narrowing

The fixed income market reacted strongly to recent developments, as the rate of 10-year Treasury notes fell 15 basis points over the course of the week and the yield curve narrowed further. The spread between 10-year and two-year rates totaled 12 basis points on Friday afternoon, down from readings of 15 to 20 basis points in the past few months (chart).

Yield Curve*



** The 10-year Treasury rate less the rate on two-year Treasury securities. Monthly average data, except for the last observation which is the spread for March 21, 2019.*

Source: Federal Reserve Board via Haver Analytics

Concern about growth prospects seemed to be the key driver behind the rate moves, as most of the drop occurred on Friday in response to a weak reading on the manufacturing sector in Germany (a drop of almost three percentage points in the purchasing managers' index to 44.7 percent, the third consecutive reading below 50 percent). Fading growth prospects in major foreign economies is serious, as the weakening will feed back to the U.S. through the trade sector. However, the shift in the yield curve, by itself, is not especially troubling.

An inverted yield curve has been a reliable signal of impending recession in the past, but we should consider the source of the narrowing before drawing conclusions about recession risks. In the past, the narrowing of the curve primarily reflected a tightening in monetary policy, where upward pressure on short-term interest rates accounted for most of the narrowing, and higher short-term rates (with variable lags) eventually pushed the economy into recession. It was tight monetary policy that caused the recession.

In the current instance, we do not view monetary policy as unusually tight. As chairman Powell and other Fed officials have noted, the federal funds rate is merely in the lower portion of a range that might be considered neutral. Few observers would view policy as tight. The narrow curve, to a large degree, reflects long-term rates that are low by historical standards. The low level of long-term rates, in turn, partly reflects the influence of quantitative easing by major central banks. The Fed has unwound much of its QE efforts, but the Bank of Japan is continuing to purchase securities, and the European Central Bank is maintaining its portfolio rather than starting the normalization process. With global linkages among financial markets now tight, the combined QE efforts of major central banks are probably a factor holding long-term rates down.

We don't mean to downplay the risks of slow growth or even recession. Our point is that today's narrow yield curve is different than those in the past, with today's curve influenced more by low long-term interest rates rather than tight monetary policy. Given the different nature of this narrow curve, past guidelines on the significance of a narrow or inverted curve do not apply.

The Balance Sheet: Treasury Purchases After September

Even before the sharp drop in interest rates on Friday, Treasury yields inched lower in response to the FOMC announcement. The heightened prospect of steady policy over the balance of the year undoubtedly was a factor. The expectation that the Fed would soon be returning to the Treasury market as a buyer also might have had an influence, as the newly announced plans for the Fed's balance sheet had a market-friendly tone.

The new procedures for normalizing the balance sheet begin in May, when the Fed will cut in half its monthly maximum of Treasury redemptions ($15 billion rather than $30 billion). It will continue to redeem a maximum of $20 billion of mortgage backed securities for the time being. After September, it will cease redemptions of

Treasuries and hold the size of its securities portfolio steady. To hold the portfolio steady after September, the Fed will roll the monthly maximum of $20 billion of MBS into Treasuries. If more than $20 billion of mortgage-backed securities are repaid by homeowners, the excess will be reinvested in additional MBS.

This plan means that the Fed will be returning to the Treasury market as a buyer beginning in October. The Fed will be buying an amount equal to whatever volume of mortgage-backed securities are repaid -- up to a maximum of $20 billion. The amount purchased will probably be less than $20 billion every month, as repayments on the Fed's holdings of mortgage-backed securities have slowed recently (the maximum of $20 billion was last reached in October; monthly redemptions have averaged $17 from November through February). Still, the Fed will be a buyer beginning in October.

Review

Week of March 18, 2019	Actual	Consensus	Comments
Factory Orders (January)	**0.1%**	**0.3%**	Durable goods orders (published last week) rose 0.3%, but the increase was concentrated in the volatile aircraft category. Orders excluding transportation dipped 0.2%. Durable bookings ex-transportation had been trending higher in 2017 and much of 2018, but they have stalled since August. A downside surprise occurred in the nondurable area, where orders fell 0.2%. The petroleum and coal category was soft (off 0.4%) despite the likely influence of higher prices. In addition, nondurable orders outside of petroleum and coal fell 0.2% and have shown little net change in the past six months. On balance, the manufacturing sector seems to have hit a soft patch, with part of the slowing probably the result of an effort to slow the accumulation of unwanted inventories and part reflecting lessening demand amid lackluster global growth.
Leading Indicators (February)	**0.2%**	**0.1%**	Positive contributions from stock prices, the leading credit index, and consumer expectations offset a negative contribution from the factory workweek to nudge the index of leading economic indicators higher in February. Despite the latest increase, the index has flattened since October after increasing sharply since late 2016. The recent movement signals a slowing in the economy although it is not soft enough to suggest impending recession.
Existing Home Sales (February)	**5.51 Million (+11.8%)**	**5.10 Million (+3.2%)**	The surge in sales of existing homes in February reversed most of the deterioration in activity from 2018. The advance, undoubtedly, was stirred by the drop of approximately one-half percentage point in mortgage interest rates since November. The advance was striking, but we wonder about sustainability. The surge could represent a flurry of activity as buyers jumped to take advantage of lower rates.
Federal Budget (February)	**$234.0 Billion Deficit**	**$227.0 Billion Deficit**	Revenues grew briskly in February (+7.5% year-over-year), a welcome pickup from a net decline of 1.7% in the first four months of the current fiscal year. On the spending side, outlays also increased sharply (+8.2% year-over-year), led by defense and Medicare. The deficit in the first five months of the fiscal year totaled $544 billion, $153 billion wider than the shortfall in the same period in FY2018.

Source: U.S. Census Bureau (Factory Orders); The Conference Board (Leading Indicators); National Association of Realtors (Existing Home Sales); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of March 25, 2019	Projected	Comments
Housing Starts (February) (Tuesday)	**1.220 Million (-0.8%)**	A drop in building permits in January suggests that the surge of 25.1% in single-family starts involved an element of random volatility; a correction in February seems likely. Adverse weather also could be a factor, as precipitation was well above average. The volatile multi-family sector is likely to rebound from a low-side reading in January, providing a partial offset to the expected decline in the single-family area.
Consumer Confidence (March) (Tuesday)	**132.5 (+1.1 Index Pts.)**	The confidence index in Feb. recouped most of the ground lost in Dec. and Jan. With the equity market continuing to perform well, the measure has additional upside potential in March. Preliminary results for the University of Michigan sentiment index in March (up 4.3%) supports the view of additional gains.
Trade Balance (January) (Wednesday)	**$56.0 Billion Deficit ($3.8 Billion Narrower Deficit)**	A rebound in exports of goods from an unusually soft reading in December is likely to lead to an improvement in the monthly trade deficit. The surplus in services also could retrace some of the slippage in the prior four months.
Current Account (2018-Q4) (Wednesday)	**$130.0 Billion Deficit ($5.2 Billion Wider Deficit)**	The trade deficit widened by slightly more than $5 billion in the fourth quarter, which will feed through to the current account. The scant information available on primary and secondary income flows suggests modest net change.
Revised GDP (2018-Q4) (Thursday)	**2.2% (-0.4 Pct. Pt. Revision)**	A downward adjustment to retail sales in December, along with light spending on services, suggest that the growth of consumer spending was slower than previously believed. Residential construction also could be revised downward.
Personal Income, Consumption, Core Price Index (January/February) (Friday)	**Income (Feb.): 0.3% Consumption (Jan.): 0.3% Core Price Index (Jan.): 0.1%**	With employment barely advancing in February, the wage component of income will probably post a meager increase, but rental income is moving along a firm path and could make a solid contribution to growth. On the spending side (January only because of the government shutdown), a drop in sales of new vehicles will probably constrain outlays for durable goods. The report on retail sales points to a jump in outlays for nondurable goods, but the increase is likely to provide only a partial offset to a drop in December.
New Home Sales (February) (Friday)	**0.615 Million (+1.3%)**	Most housing-related statistics have shown some response to the drop in mortgage rates since November. The response in sales of new homes was probably quick because the series is based on contracts signed, leaving modest upside potential in February.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

March/April 2019

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
NAHB HOUSING INDEX Jan 58 Feb 62 Mar 62	**FACTORY ORDERS** Nov -0.5% Dec 0.1% Jan 0.1% **FOMC MEETING**	**FOMC DECISION** **POWELL PRESS CONFERENCE**	**INITIAL CLAIMS** Mar 02 223,000 Mar 09 230,000 Mar 16 221,000 **PHILLY FED INDEX** Jan 17.0 Feb -4.1 Mar 13.7 **LEADING INDICATORS** Dec -0.1% Jan 0.0% Feb 0.2%	**EXISTING HOME SALES** Dec 5.00 million Jan 4.93 million Feb 5.51 million **WHOLESALE TRADE** Inventories / Sales Nov 0.4% -1.2% Dec 1.1% -0.9% Jan 1.2% 0.5% **FEDERAL BUDGET** FY2019 / FY2018 Dec -$13.5B -$23.2B Jan $8.7B $49.2B Feb -$234.0B -$215.2B
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Dec 0.05 0.16 Jan -0.43 0.00 Feb -- --	**HOUSING STARTS (8:30)** Dec 1.037 million Jan 1.230 million **Feb 1.220 million** **FHFA HOME PRICE INDEX (9:00)** Nov 0.4% Dec 0.3% Jan -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Nov 0.3% -0.2% Dec 0.2% -0.2% Jan -- -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Jan 121.7 Feb 131.4 **Mar 132.5**	**TRADE BALANCE (8:30)** Nov -$50.3 billion Dec -$59.8 billion **Jan -$56.0 billion** **CURRENT ACCOUNT (8:30)** 18-Q2 -$101.2 bill. 18-Q3 -$124.8 bill. **18-Q4 -$130.0 bill.**	**INITIAL CLAIMS (8:30)** **REVISED GDP (8:30)** GDP / Chained Price 18-Q3 3.4% 1.8% 18-Q4(p) 2.6% 1.8% **18-Q4(r) 2.2% 1.8%** **PENDING HOMES SALES (10:00)** Dec -2.3% Jan 4.6% Feb --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Dec 1.0% -0.5% 0.2% **Jan** -0.1% **0.3%** **0.1%** **Feb 0.3%** -- -- **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index / Prices Jan 56.7 67.0 Feb 64.7 71.2 Mar -- -- **REVISED CONSUMER SENTIMENT (10:00)** Jan 91.2 Feb 93.8 Mar(p) 97.8 **NEW HOME SALES (10:00)** Dec 0.652 million Jan 0.607 million **Feb 0.615 million**
1	2	3	4	5
RETAIL SALES **ISM INDEX** **CONSTRUCTION SPEND.** **BUSINESS INVENTORIES**	**DURABLE GOODS ORDERS** **VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **ISM NON-MFG INDEX**	**INITIAL CLAIMS**	**EMPLOYMENT REPORT** **CONSUMER CREDIT**
8	9	10	11	12
FACTORY ORDERS	**NFIB SMALL BUSINESS OPTIMISM INDEX** **JOLTS DATA**	**CPI** **FEDERAL BUDGET** **FOMC MINUTES**	**INITIAL CLAIMS** **PPI**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**

Forecasts in Bold. (p) = preliminary; (r) = revised

Treasury Financing

March/April 2019

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
AUCTION RESULTS: Rate / Cover 13-week bills 2.410% 2.70 26-week bills 2.450% 2.86	**ANNOUNCE:** $60 billion 4-week bills for auction on March 21 $35 billion 8-week bills for auction on March 21 **SETTLE:** $60 billion 4-week bills $35 billion 8-week bills		**AUCTION RESULTS:** Rate / Cover 4-week bills 2.470% 2.30 8-week bills 2.420% 2.89 10-year TIPS 0.578% 2.43 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on March 25 $26 billion 52-week bills for auction on March 26 $18 billion 2-year FRNs for auction on March 27 $40 billion 2-year notes for auction on March 26 $41 billion 5-year notes for auction on March 27 $32 billion 7-year notes for auction on March 28 **SETTLE:** $87 billion 13-,26-week bills	
25	26	27	28	29
AUCTION: $87 billion 13-,26-week bills	**AUCTION:** $26 billion 52-week bills $40 billion 2-year notes **ANNOUNCE:** $60 billion* 4-week bills for auction on March 28 $35 billion* 8-week bills for auction on March 28 **SETTLE:** $60 billion 4-week bills $35 billion 8-week bills	**AUCTION:** $18 billion 2-year FRNs $41 billion 5-year notes	**AUCTION:** $60 billion* 4-week bills $35 billion* 8-week bills $32 billion 7-year notes **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on April 1 **SETTLE:** $87 billion 13-,26-week bills $26 billion 52-week bills	**SETTLE:** $11 billion 10-year TIPS $18 billion 2-year FRNs
1	2	3	4	5
AUCTION: $87 billion* 13-,26-week bills **SETTLE:** $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes	**ANNOUNCE:** $60 billion* 4-week bills for auction on April 4 $35 billion* 8-week bills for auction on April 4 **SETTLE:** $60 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $60 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on April 8 $38 billion* 3-year notes for auction on April 9 $24 billion* 10-year notes for auction on April 10 $16 billion* 30-year bonds for auction on April 11 **SETTLE:** $87 billion* 13-,26-week bills	
8	9	10	11	12
AUCTION: $87 billion* 13-,26-week bills	**AUCTION:** $38 billion* 3-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on April 11 $30 billion* 8-week bills for auction on April 11 **SETTLE:** $60 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $24 billion* 10-year notes	**AUCTION:** $50 billion* 4-week bills $30 billion* 8-week bills $16 billion* 30-year bonds **ANNOUNCE:** $83 billion* 13-,26-week bills for auction on April 15 $17 billion* 5-year TIPS for auction on April 18 **SETTLE:** $87 billion* 13-,26-week bills	

**Estimate*