Daiwa Capital Markets

U.S. Economic Comment

- The money market: a new issue for the Fed
- Uncertainty: starting to weigh more heavily

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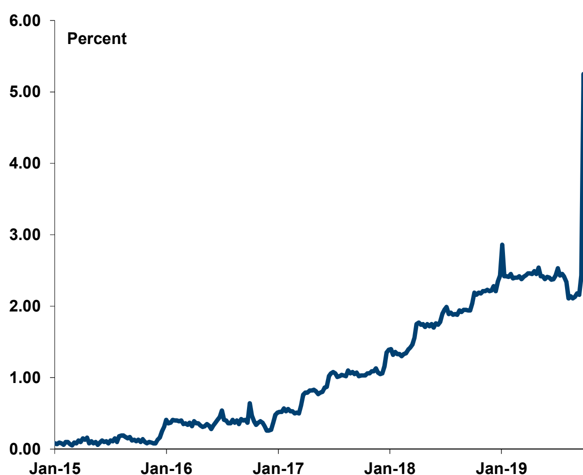
Pressure in the RP Market

Most market participants entered the latest week focused on the meeting of the Federal Open Market Committee and the likely change in monetary policy. However, attention began to shift on Monday because of surprising pressure on money market interest rates, particularly rates on repurchase agreements. The situation intensified on Tuesday, as rates on some overnight RPs briefly touched 10 percent. The so-called SOFR (secured overnight financing rate, the average rate on a broad array of RPs) totaled 5.25 percent on Tuesday, well outside the prevailing range (chart, left). The pressure eased on Wednesday and Thursday, largely because the Federal Reserve injected reserves into the banking system by arranging RPs -- that is, providing financing that was not readily available in the market.

The situation was perhaps a random episode tied to an unfortunate coincidence of events. Market participants offered several potential explanations that together could have caused the pressure: a large volume of newly auctioned Treasury securities settled on Monday, which would need financing if held by security dealers rather than placed with final investors; Monday also was a corporate tax payment date, which could have shifted funds from short-term investments to the Treasury Department; government-sponsored enterprises, normally active lenders in the overnight market, were quiet on Monday; Japan's financial markets were closed on Monday, possibly limiting the number of players in the market.

While the rate pressure was possibly random, it also might be related to a fundamental change in the money markets. Specifically, the volume of reserves in the banking system, which has been abundant in the past several years because of the Fed's quantitative easing programs, might now be tight. The Fed has redeemed some of the securities it purchased in its QE efforts, which has reduced the volume of reserves in the banking system. In addition, increases in various liabilities of the Fed -- especially currency in circulation -- have absorbed reserves as well. The total volume of reserves in the banking system has shrunk from approximately $2.8 trillion at its peak in 2014 to approximately $1.5 trillion in mid-September (chart, right).

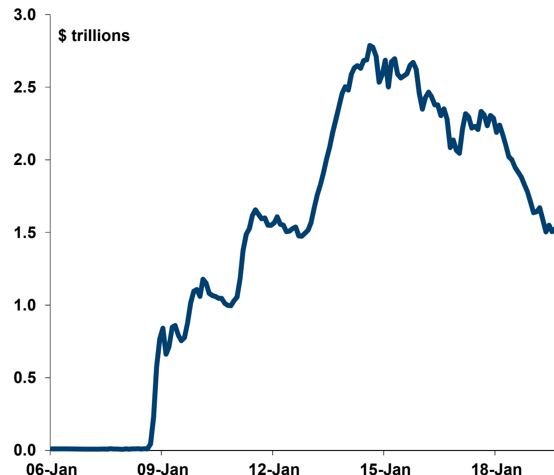
Secured Overnight Financing Rate (SOFR)*



Weekly average data, except for the last four observations which are daily quotes for September 16 -19, 2019.

Source: Federal Reserve Bank of New York via Haver Analytics

Reserve Balances with Federal Reserve Banks*



Monthly data, except for the last observation, which is the average for the first two weeks of September.

Source: Federal Reserve Board via Haver Analytics

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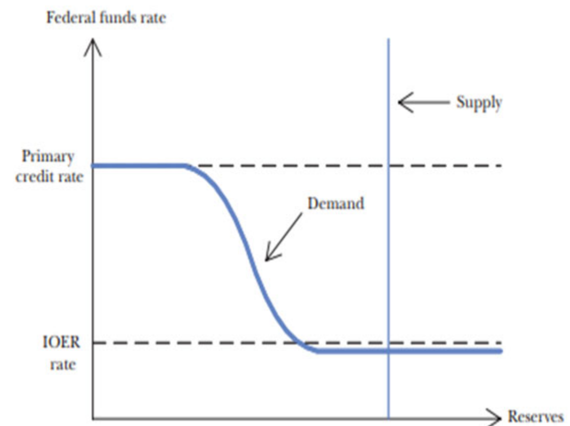
Reserves in the banking system are still enormous relative to volumes before the financial crisis, but the financial world is much different than it was then. The two most important changes are liquidity requirements imposed as a result of the crisis (which can be satisfied by reserve holdings), and reserve accounts now pay interest, which increases their attractiveness as an investment for commercial banks. Because of these changes, demand for reserves is much larger than the pre-crisis norm, and the demand-supply balance therefore might now be tight, which would put upward pressure on short-term interest rates.

A Model of the Demand and Supply of Bank Reserves*



The primary credit rate is the rate charged by the Federal Reserve for borrowing at the discount window. IOER is the interest rate on excess reserves.

Source: Ihrig, Jane E., Meade, Ellen E., & Weinbach, Gretchen C. (2015). Rewriting Monetary Policy 101: What's the Fed's Preferred Post-Crisis Approach to Raising Interest Rates?. Journal of Economic Perspectives, 29(4), 177-198.

The situation can best be illustrated with a simple supply-demand model of the reserve market (chart, which was copied from an article by Fed economists explaining the Fed's operating procedure). Depository institutions hold reserves (deposits) at the Fed to meet their required reserve obligations, to facilitate the inflow and outflow of funds associated with the payment system, and to satisfy liquidity requirements. Being a financial account, reserve holdings are sensitive to interest rates (elevated rates lead banks to economize on these balances to focus activity on more profitable alternatives), and thus the demand for reserves is a downward sloping curve.

The curve flattens at two points. At the high end, the demand curve flattens at the rate charged on borrowing at the discount window (the primary credit rate). If a bank needed to acquire reserves either to meet its required reserves or to have sufficient balances to facilitate transactions, it could acquire those funds at the Fed's discount window and thus would not be willing to borrow at a higher rate in the federal funds market.

At the low end of the rate spectrum, banks are not likely to trim reserve holdings by lending in the federal funds market at a rate below that on their reserve account at the Fed (IOER) -- thus, a flat demand curve or a willingness to hold any quantity of reserves because better opportunities are not available. The supply curve is vertical because the Fed controls the volume of reserves in the banking system and determines a particular quantity independent of the level of interest rates.

In the years immediately after the financial crisis, the supply of reserves was abundant, far out on the flat IOER portion of the demand curve, and thus short-term interest rates seldom experienced upward pressure. Now, having declined in the past few years, the supply of reserves might be on the downward portion of the demand curve, and random shifts in either supply or demand will move interest rates.

The Fed well knows that market rates could be volatile if supply and demand intersect on the downward portion of the demand curve. Thus, officials planned to maintain the supply of reserves in the flat portion of the curve to promote stability in short-term money markets. Staff economists at the Fed have been monitoring the market carefully to estimate where the curve might begin to take on slope. Early thoughts suggested that upward pressure and volatility might not become issues until reserves eased to a range of $800 to $900 billion (see the speech by Lorie K. Logan of the New York Fed, "Observations on Implementing Monetary Policy in an Ample-Reserve Regime," April 17, 2019). That estimate could well be off the mark; perhaps reserves already have eased into the downward sloping portion of the demand curve.

Chair Powell was asked about the situation in the money markets during his press briefing. He was vague in his responses, we suspect because policymakers and the staff are not certain of the factors driving the jump in rates. The upward pressure might simply be the oddities noted above (security settlements, corporate tax

payments), but it also might be that the supply-demand balance in the money market is now tight. That is, bank reserves are not as abundant relative to demand as the Fed thought. Chair Powell noted that staff will be studying the market carefully and hoped to learn a great deal over the next several weeks. The experience at the end of the quarter, when pressure often arises, could be especially educational.

The Solution

When the Fed has a better handle on what drove market volatility, it will alter its market activity to avoid similar situations. If temporary factors were the driving force, the Fed can simply counter the pressure like it did this past week -- by arranging temporary RPs in the market. If more fundamental factors are at work, that is, if the supply of reserves has drifted to the downward-sloping portion of the demand curve, the Fed most likely will boost the supply of reserves to move back onto the flat portion of the curve. The Fed will buy Treasury securities in the open market to achieve this objective.

This Is Not QE

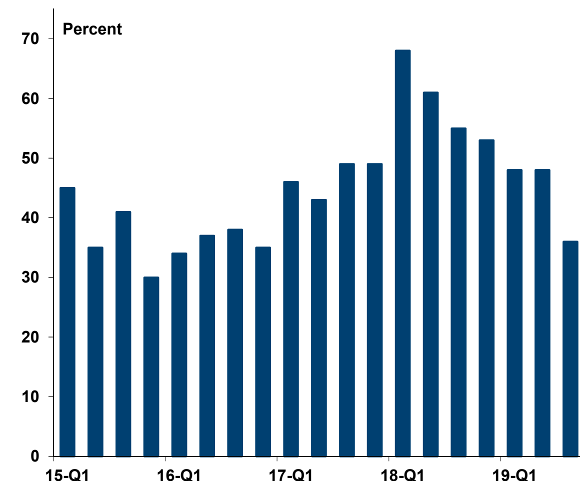
Some market participants are likely to refer to outright purchases as a new round of quantitative easing. This is a mischaracterization. The purchases by the Fed will not represent an “easing” in policy. Rather, these transactions are merely allowing the Fed’s balance sheet to grow with the economy and financial markets. If the Fed did not allow such an expansion, it would be generating a passive tightening in policy. Treasury purchases of this nature are maintaining a status quo; they are efforts to avoid passive tightenings and market volatility.

A Hint of Fallout from Uncertainty

Chair Powell has emphasized the high degree of uncertainty that exists in the economic outlook because of trade tensions and slower global economic growth. A survey of business executives released this week showed that uncertainty is indeed an issue.

The Business Roundtable, an association of executives from large corporations, conducts quarterly surveys of its members, and the past several canvases have shown an erosion in views on the outlook and plans for capital spending. The share of executives planning increases in capital spending has declined for six consecutive quarters and has moved below the elevated levels that emerged after the election of President Trump (chart). The survey is a measure of attitudes rather than fixed plans for spending, and thus the results should be interpreted cautiously. Still, the figures show that Fed officials have good reason to be concerned.

Outlook for Capital Spending*



** Outlook for capital spending by large firms. The share of respondents planning to increase capital spending in the next six months.*
Source: Business Roundtable via Haver Analytics

Next Comment

Because of travel schedules, we will not publish an Economic Comment next week. The next Comment will be published on October 4.

Review

Week of Sept. 16, 2019	Actual	Consensus	Comments
Industrial Production (August)	**0.6%**	**0.2%**	All three components contributed to the increase in industrial production in August: manufacturing output rose 0.5%, mining activity jumped 1.4%, and utility output increased 0.6%. The level of activity in manufacturing still trailed results seen during most of last year, but production has increased in three of the past four months despite a slowdown in global demand and constraints from the trade war. The jump in mining activity offset the drop in July and returned production to the upper portion of its recent range. Utility output posted a solid advance, but this sector is volatile, with changes nearly always driven by shifts in temperatures rather than economic fundamentals.
Housing Starts (August)	**1.364 Million (+12.3%)**	**1.250 Million (+5.0%)**	Both multifamily and single-family housing starts contributed to the jump in home building in August, with upward revisions adding an accent to the firm tone of the report. The volatile multi-family sector often moves in fits and starts, and this has been the case in recent months. Starts dropped 25.6% in in June and July combined after reaching and elevated level in May, but they retraced most of the lost ground with a jump of 32.8%. The latest reading left the level of multi-family activity at the top of the range of the past few years. Single family starts rose 4.4%, marking the fifth gain in the past six months. The recent improvement reversed a downward drift that began last summer and pushed the level of activity to the upper portion of the recent range.
Current Account (2019-Q2)	**-$128.2 Billion ($8.0 Billion Narrower Deficit)**	**-$127.4 Billion ($3.0 Billion Narrower Deficit)**	Trade flows deteriorated in Q2, with the deficit widening by $6.9 billion, but an increase in income flows led to a narrowing in the current account deficit. When scaled by the size of the economy, the deficit narrowed to 2.4% of GDP from 2.6%, a reading in the middle of the range of the current expansion (range of 1.8% to 3.1%).
Existing Home Sales (August)	**5.49 Million (+1.3%)**	**5.38 Million (-0.7%)**	Sales of existing homes increased for the third time in the past four months, with activity moving to the upper portion of the range of the past few years. The National Association of Realtors noted that the recent decline in mortgage rates has stirred sales after weakness around the turn of the year, but limited inventories and elevated prices are constraints.
Leading Indicators (August)	**0.0%**	**-0.1%**	Positive contributions from building permits, the leading credit index, and the factory workweek offset negative contributions from the ISM new orders index, stock prices, and the slope of the yield curve to leave the index of leading economic indicators unchanged in August. Recent changes have left only a modest upward drift in the LEI after trending sharply higher in the prior two years.

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

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Preview

Week of Sept. 23, 2019	Projected	Comments
Consumer Confidence (September) (Tuesday)	**132.0 (-2.3%)**	The pickup in the equity market in September might buoy some moods, but talk of recession in the news will make it difficult for the confidence index to maintain its elevated reading in August.
New Home Sales (August) (Wednesday)	**0.660 Million (+3.9%)**	Marked volatility in recent months has traced an upward trend in new home sales after a soft patch in the closing months of last year. With interest rates favorable, sales should increase from their low-side reading in July.
U.S. International Trade in Goods (August) (Thursday)	**-$73.0 Billion ($0.5 Billion Wider Deficit)**	Both exports and imports are likely to remain on the downward trends that have emerged since the start of the trade war. Exports also have to contend with slower global growth, which will probably lead to a larger change in exports and a slightly larger trade deficit.
Revised GDP (2019-Q2) (Thursday)	**2.0% (Unrevised)**	Consumer spending and government-related construction could be revised upward, but downward adjustments to business-related and residential construction are likely to provide offsets, leaving economic growth unrevised from the current estimate.
Personal Income, Consumption, Core Prices (August) (Friday)	**0.4%, 0.3%, 0.2%**	A healthy advance in average hourly earnings and a longer workweek suggest that wage income will jump in August, which should easily offset expected softness in farm income and interest income. On the spending side, a pickup in vehicle sales should fuel durable outlays, but a soft report on retail sales suggests that spending on nondurable goods was light. The core CPI jumped in August, but much of the pressure came in idiosyncratic areas that might not show through to the PCE price index.
Durable Goods Orders (August) (Friday)	**-1.0%**	Softness in the manufacturing sector because of slow global growth and fallout from trade tensions are likely to constrain order flows in several industries. In addition, Boeing again saw paltry bookings after a spurt in July.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

September/October 2019

Monday	Tuesday	Wednesday	Thursday	Friday
16	17	18	19	20
EMPIRE MFG July 4.3 Aug 4.8 Sept 2.0	**IP & CAP-U** IP / Cap.Util. June 0.1% / 77.8% July -0.1% / 77.5% Aug 0.6% / 77.9% **NAHB HOUSING INDEX** July 65 Aug 67 Sept 68 **TIC DATA** Total / Net L-T May $37.3B / $4.6B June $21.0B / $100.6B July $43.8B / $84.3B **FOMC MEETING**	**HOUSING STARTS** June 1.233 million July 1.215 million Aug 1.364 million **FOMC DECISION** **POWELL PRESS CONFERENCE**	**INITIAL CLAIMS** Aug 31 219,000 Sept 07 206,000 Sept 14 208,000 **CURRENT ACCOUNT** 18-Q4 -$143.9 bill. 19-Q1 -$136.2 bill. 19-Q2 -$128.2 bill. **PHILLY FED INDEX** July 21.8 Aug 16.8 Sept 12.0 **EXISTING HOME SALES** June 5.29 million July 5.42 million Aug 5.49 million **LEADING INDICATORS** June 0.0% July 0.4% Aug 0.0%	
23	24	25	26	27
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. June 0.03 / -0.30 July -0.36 / -0.14 Aug -- / --	**FHFA HOME PRICE INDEX (9:00)** May 0.2% June 0.1% July -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA May 0.1% / 0.6% June 0.0% / 0.3% July -- / -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** July 135.8 Aug 135.1 **Sept 132.0**	**NEW HOME SALES (10:00)** June 0.728 million July 0.635 million **Aug 0.660 million**	**INITIAL CLAIMS (8:30)** **REVISED GDP (8:30)** GDP / Chained Price 19-Q1 3.1% / 1.1% 19-Q2(a) 2.0% / 2.4% **19-Q2(p) 2.0% / 2.4%** **U.S. INTERNATIONAL TRADE IN GOODS (8:30)** June -$74.2 billion July -$72.5 billion **Aug -$73.0 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail June -0.1% / -0.2% July 0.2% / 0.8% Aug -- / -- **PENDING HOMES SALES (10:00)** June 2.8% July -2.5% Aug --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core June 0.5% / 0.3% / 0.2% July 0.1% / 0.6% / 0.2% **Aug 0.4% / 0.3% / 0.2%** **DURABLE GOODS ORDERS (8:30)** June 1.8% July 2.0% **Aug -1.0%** **REVISED CONSUMER SENTIMENT (10:00)** July 98.4 Aug 89.8 Sept(p) 92.0
30	1	2	3	4
CHICAGO PURCHASING MANAGERS' INDEX	**ISM INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES**	**ADP EMPLOYMENT REPORT**	**INITIAL CLAIMS** **FACTORY ORDERS** **ISM NON-MFG INDEX**	**EMPLOYMENT REPORT** **TRADE BALANCE**
7	8	9	10	11
CONSUMER CREDIT	**NFIB SMALL BUSINESS OPTIMISM INDEX** **PPI**	**JOLTS DATA** **WHOLESALE TRADE** **FOMC MINUTES**	**INITIAL CLAIMS** **CPI** **FEDERAL BUDGET (POSSIBLY POSTPONED)**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**

Forecasts in Bold a = advance (1st estimate of GDP); (p) = preliminary (2nd estimate of GDP)

Treasury Financing

September/October 2019

Monday	Tuesday	Wednesday	Thursday	Friday
16	17	18	19	20
AUCTION RESULTS: Rate / Cover 13-week bills 1.945% 2.68 26-week bills 1.870% 2.74 **SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**ANNOUNCE:** $45 billion 4-week bills for auction on September 19 $40 billion 8-week bills for auction on September 19 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills		**AUCTION RESULTS:** Rate / Cover 4-week bills 1.950% 2.66 8-week bills 1.950% 2.59 10-yr TIPS 0.174% 2.41 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on September 23 $18 billion 2-year FRNs for auction on September 25 $40 billion 2-year notes for auction on September 24 $41 billion 5-year notes for auction on September 25 $32 billion 7-year notes for auction on September 26 **SETTLE:** $87 billion 13-,26-week bills	
23	24	25	26	27
AUCTION: $87 billion 13-,26-week bills	**AUCTION:** $40 billion 2-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on September 26 $40 billion* 8-week bills for auction on September 26 **SETTLE:** $45 billion 4-week bills $40 billion 8-week bills	**AUCTION:** $18 billion 2-year FRNs $41 billion 5-year notes	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $32 billion 7-year notes **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on September 30 **SETTLE:** $87 billion 13-,26-week bills	**SETTLE:** $18 billion 2-year FRNs
30	1	2	3	4
AUCTION: $87 billion* 13-,26-week bills **SETTLE:** $12 billion 10-year TIPS $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes	**ANNOUNCE:** $45 billion* 4-week bills for auction on October 3 $40 billion* 8-week bills for auction on October 3 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills		**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on October 7 $28 billion* 52-week bills for auction on October 8 $38 billion* 3-year notes for auction on October 8 $24 billion* 10-year notes for auction on October 9 $16 billion* 30-year bonds for auction on October 10 **SETTLE:** $87 billion* 13-,26-week bills	
7	8	9	10	11
AUCTION: $87 billion* 13-,26-week bills	**AUCTION:** $28 billion* 52-week bills $38 billion* 3-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on October 10 $40 billion* 8-week bills for auction on October 10 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills	**AUCTION:** $24 billion* 10-year notes	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $16 billion* 30-year bonds **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on October 15 $17 billion* 5-year TIPS for auction on October 17 **SETTLE:** $87 billion* 13-,26-week bills $28 billion* 52-week bills	

**Estimate*