Daiwa Capital Markets

U.S. Economic Comment

- Fed balance sheet: expanding again, but much different than QE
- Federal budget: more slippage in fiscal year 2019

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The Fed: Buying Bills, Expanding Its Balance Sheet, but Not QE

The Federal Reserve announced on Friday that it will begin buying Treasury bills (not notes and bonds) in an effort to maintain stable conditions in short-term fixed-income markets. The Fed has been buying Treasury securities in the open market since it stopped the redemption of Treasury securities in August. However, these purchases represented the reinvestment of repayments on mortgage-backed securities and did not result in an increase in the size of the Fed's portfolio. The purchase of Treasury bills announced this week -- totaling $60 billion per month -- will expand the Fed's portfolio and its overall balance sheet.

Fed officials have emphasized that the effort does not represent a new round of Quantitative Easing. Questions we have received suggest that the difference is not obvious to all market participants. However, QE and the new effort are indeed distinctly different. One obvious difference is the maturity of Treasury securities involved in the transactions. Purchases under Quantitative Easing were concentrated in intermediate and long-term securities; the new purchases will involve only bills, which have maturities of one year or less. The purpose of QE was to put downward pressure on long-term interest rates. The new program should have little influence on interest rates beyond the one-year horizon.

More important, the new purchases of the Fed will be much less aggressive than they were under quantitative easing. Purchases under QE led to increases in the Fed's portfolio and balance sheet that far exceeded the advance in the size of the economy. Now, the size of the economy has reached the point where its liquidity needs have caught up to the generous provisions provided by the Fed under QE. Therefore, the Fed must allow its balance sheet to expand in order to accommodate the liquidity needs of the economy. Holding the balance sheet steady at this time would represent a passive tightening in monetary policy.

Federal Reserve Balance Sheet*

$ billions

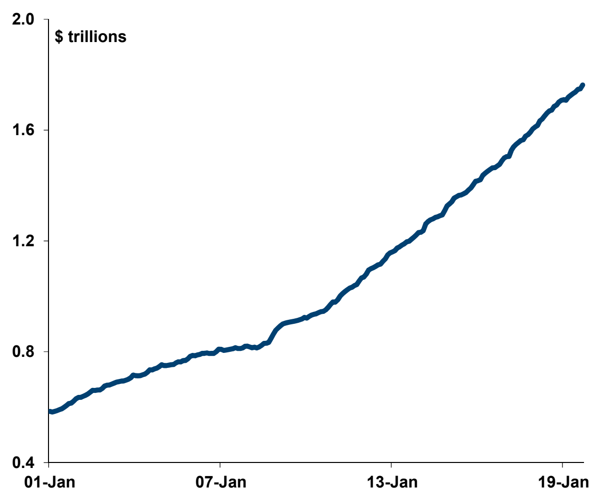
Assets				Liabilities
Securities		3,589	1,767	Currency in Circulation
U.S. Treasury Securities	2,1120			
Mortgage-backed Securities	1,467		318	Treasury General Account
Federal Agency Securities	2			
			69	Deposits**
Discount Window Loans		0		
			290	Reverse Repurchase Agreements
Repurchase Agreements		179		
			1,506	Reserve Accounts
Other		227		
			45	Other Liabilities and Capital
Total Federal Reserve Assets		3,996	3,996	Total Liabilities and Capital

* Averages of daily figures for the week ended October 10, 2019.

* Deposits include: deposits held at the Reserve Banks by international and multilateral organizations, government-sponsored enterprises, and other official accounts.

Source: H.4.1. Report, Federal Reserve Board of Governors; Daiwa Capital Markets America

Currency in Circulation*



Monthly average data, except for the last observation which is the average for the week ended October 10, 2019.

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

A close look at the Fed balance sheet will show more clearly why the time has arrived to begin purchasing securities. The Fed provides various services that generate liabilities and therefore require offsetting entries on the asset side of the balance sheet. For example, the Treasury Department and other official accounts (such as foreign central banks) hold deposit accounts at the Fed, and these accounts must have an offsetting entry on the asset side. In addition, and more important, U.S. currency circulating throughout the world is issued through the Federal Reserve, and the expansion of currency naturally requires supporting assets. As shown on the chart on the prior page, currency has increased steadily over the past several years, apparently reaching the point where the Fed must increase its portfolio to accommodate currency growth.

In other recent years, the elevated level of liquidity provided by the Fed was sufficient to accommodate currency growth. Depository institutions were holding more reserves than needed to meet reserve requirements and liquidity needs. As the public sought to increase its currency holdings, depository institutions willingly surrendered their reserve balances. Now, commercial banks are less willing to surrender reserves because the balances at the Fed represent a convenient way to meet liquidity requirements imposed after the financial crisis. The desire to hold elevated balances has now become apparent in the pressure that has emerged in the money market, especially the RP market. With banks wanting to hold elevated amounts of reserves, the Fed will accommodate that demand by expanding its balance sheet.

For the time being, the new purchases of the Fed will involve only bills (although the Fed will continue to reinvest repayments on MBS in Treasury notes and bonds). At some point in the future, the expansion of the Fed's balance sheet will involve the purchases of notes and bonds. (Notes have maturities of two to 10 years; bonds have maturities of more than 10 years. Currently, the Treasury issues only 30-year bonds). When the time comes to purchase notes and bonds, the Fed will probably still favor the short end of the maturity spectrum.

When purchases extend to notes and bonds, the Fed will probably seek to structure its portfolio to match the maturity composition of outstanding Treasury securities. As shown in the table, the Fed's current portfolio is heavy in the long end; it will need to favor short and intermediate maturities to align its holdings with the overall Treasury market.

Treasury Securities Maturity Composition*

	Fed Portfolio	Treasury Securities Outstanding
	Percent	
0 to 3 years	43.7	52.3
3 to 10 years	29.8	34.1
> than 10 years	26.5	13.5

** Calculations for the Fed's portfolio show the share of securities maturing within a certain timeframe as a share of the total Federal Reserve portfolio. Data on Treasury securities show outstandings in specified maturity ranges as a share of total outstanding marketable Treasuries.*

Source: Federal Reserve Bank of New York; U.S. Treasury Department; Daiwa Capital Markets America

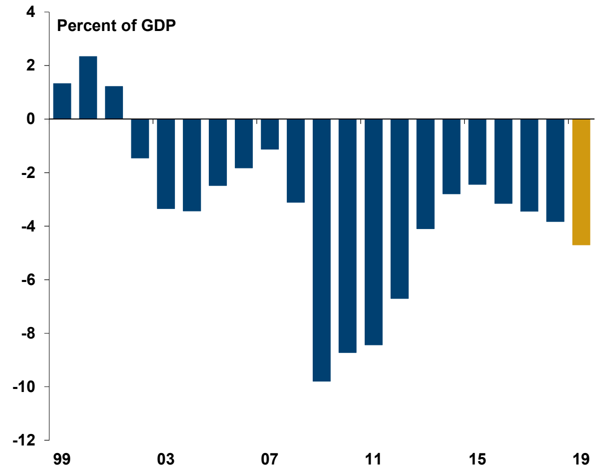
The Federal Budget in 2019

The U.S. Treasury Department in the coming week will publish budget results for the month of September, which will represent the final inputs for fiscal year 2019. While receipts and outlays for the final month of the fiscal year can only be estimated at this point, daily data released by the Treasury Department provide good insight into the outcome.

September usually involves hefty tax collections because of estimated payments by individuals and corporations, and available data show strong results for total receipts this year (up approximately nine percent from the same month last year). This inflow will most likely generate a monthly surplus of approximately $85 billion. While budget surpluses are common for September, the expected reading is among the best for this month in the past several years.

While the September results might appear favorable, the fiscal year total could be viewed as troubling. The budget for FY2019 is likely to show a deficit of nearly $1 trillion ($982 billion if the forecast proves accurate). Measured as a share of GDP, the shortfall is likely to total 4.7 percent, a reading in the upper portion of the historical range and an unusually wide deficit for a fully employed economy growing at a rate close to its potential (chart). The fiscal strategy behind such results defies logic.

Federal Budget Balance*



** Fiscal year basis. The reading for FY2019 (gold bar) is a projection by the Congressional Budget Office.*

Source: Bureau of Economic Analysis and U.S. Treasury Department via Haver Analytics; Congressional Budget Office

Total receipts of the federal government for the full fiscal year grew moderately (an estimated 4.0 percent), reflecting marked and partially offsetting changes in various revenue categories. Individual receipts were on the soft side with estimated growth of 2.0 percent. All of this softness occurred in the first four months of the year, when collections from individuals fell an average of five percent per month because of the Tax Cuts and Jobs Act. (Reduced withholding from paychecks associated with the Act began in full force in February 2018, and thus the year-over-year growth of personal tax receipts from February 2018 to January 2019 would be weak because of the reduction in tax rates. The first four months of FY2019 ran from October 2018 to January 2019, and thus the early months of the year showed weak results. Receipts from individuals averaged growth of eight percent from February through September, when year-over-year changes would not be influenced by the tax cut.)

Remittances from the Federal Reserve to the Treasury Department also were weak in the latest fiscal year, falling an estimated 25 percent. The tightening in monetary policy from December 2015 to December 2018 increased the interest payments on reserve balances held at the Federal Reserve, thereby reducing Fed earnings. The reduction in the size of the Fed's portfolio associated with balance sheet normalization affected earnings as well. (After paying its expenses, including interest on reserves, the Fed remits its income to the Treasury. Payments by the Fed to the Treasury totaled approximately $53 billion in FY2019, down from $71 billion in FY2018 and a peak of $116 billion in FY2016.)

Collections of customs duties, although a small portion of federal revenue, posted striking growth in fiscal year 2019 (an estimated 74 percent). The government had been collecting approximately $3 billion per month in customs duties in years past, but that inflow has jumped to $5 to $7 billion per month more recently. The increase has boosted duties' share of federal revenue from approximately one percent historically to approximately two percent in FY2019. We hesitate to call the surge in in customs duties a positive development, as the imposition of tariffs that led to the jump in federal revenue is likely to have negative economic consequences that could dampen economic growth and constrain other sources of federal revenue.

Corporate tax collections probably grew more than 12 percent in the latest fiscal year, ending a string of declines in the prior three fiscal years. The softness in fiscal years 2016 and 2017 reflected sluggishness in corporate earnings after a strong recovery in the earlier years of the expansion. The drop in FY2018 reflected both unimpressive earnings and the effects of the corporate provisions in the Tax Cuts and Jobs Act. As with individual receipts, the effects of the tax act on year-over-year growth are no longer in play, and thus year-over-year changes have taken on a positive slant. In addition, the available figures from the Treasury Department suggest a strong inflow of corporate taxes in September, perhaps suggesting a jump in profits.

The outlay side of the federal budget grew approximately twice as fast as the revenue side (8.2 percent versus 4.0 percent). All four major categories of federal spending (mandatory, defense, nondefense discretionary, and net interest) contributed to the surge. The three major entitlement programs of the federal government that dominate mandatory spending (Social Security, Medicare, Medicaid) posted combined growth of slightly more than seven percent. Medicare outlays were especially brisk with growth of more than 10 percent, although some of this reflected a timing shift that left a low base of comparison in 2018 and thus rapid growth in 2019.

Generous spending authorized by the two-year budget agreement passed in early 2018 led to growth of approximately 8.5 percent in defense expenditures. Nondefense discretionary spending did not match the jump in the defense area, but it still experienced firm growth at almost eight percent.

While all major spending categories posted rapid growth in the latest fiscal year, interest expenditures stood out on the firm side, with growth most likely exceeding 14 percent. Such growth might seem surprising in an environment of low interest rates, but the swelling of outstanding debt associated with wide budget deficits has more than offset the benefit of low rates.

Review

Week of October 7, 2019	Actual	Consensus	Comments
PPI (September)	**-0.3% Total, 0.0% Core***	**0.1% Total, 0.2% Core***	Food prices rose 0.3% in September, but the latest change was likely a random shift, as it followed a drop of 0.6% in August and continued a series of erratic shifts that has left little net change since January. Energy prices posted a second consecutive drop of 2.5%. The core PPI was unchanged from August. Prices of core goods slipped 0.1%, the eighth consecutive month of readings in a range of -0.1% to 0.1% (average change of 0.025%). Services prices declined 0.2% overall, but the volatile trade-services category, which feeds into the core calculation, rose 0.2% and offset the dip in core goods prices. The latest change in the headline index left the year-over-year advance at 1.4%, down four ticks from August. The change in core prices slowed to 1.7% from 1.9% in August and slipped further from a recent high of 3.1% in September of last year.
CPI (September)	**0.0% Total, 0.1% Core**	**0.1% Total, 0.2% Core**	The restrained reading on the CPI in September was influenced by a drop of 1.4% in energy prices and a modest increase in food prices (0.1%). The limited increase in the core CPI followed firm results in the June-to-August period, which followed minimal increases in the first five months of the year. The waxing and waning in the core CPI this year probably reflects random variation around an underlying trend of 0.2%. The year-over-year change of 2.4% also suggests a monthly average of approximately 0.2%.
Consumer Sentiment (October)	**96.0 (+3.0%)**	**92.0 (-1.3%)**	The increase in consumer sentiment in October reversed much of the drop in the prior two months and returned the level of the index to the middle of the range of the past few years. The long-term inflation gauge published with the report provided a downside surprise, slipping 0.2 percentage point to 2.2%. The latest reading was a record low for the series.

** The core PPI excludes food, energy, and trade services.*

Source: Bureau of Labor Statistics (PPI, CPI); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of October 14, 2019	Projected	Comments
Retail Sales (September) (Wednesday)	**0.2% Total, 0.3% Ex-Autos**	The auto component is likely to give back some of its out-sized gain in August (up 1.8%), but the firm job market and generally healthy financial positions should allow households to provide support in most other areas. Activity at nonstore retailers (catalog and on-line) has been especially brisk in recent months (up an average of 1.9% from May through August).
Housing Starts (September) (Thursday)	**1.320 Million (-3.2%)**	Home sales have stirred in response to low interest rates, which could encourage building, but construction companies responded strongly in the single-family area in August, dampening prospects for September. The volatile multi-family sector jumped well above the underlying trend in August, raising the possibility of a correction in September.
Industrial Production (September) (Thursday)	**0.1%**	A dip in manufacturing employment in September suggests that output in the factory sector was soft, and a drop in the rotary rig count points to an easing in mining activity. The utility sector, in contrast, probably registered firm results, as temperatures were warmer than normal, which most likely boosted demand for cooling services.
Leading Indicators (September) (Friday)	**0.0%**	The soft reading on the ISM index of new orders will constrain the leading indicator index, but stock prices and the leading credit index should provide an offset that leads to little change overall. The projection, if realized, would represent the third flat reading in the past four months, continuing the soft trend that began in the closing months of last year (up less than 0.1% from October 2018 through August 2019).
Federal Budget (September) (One Day This Week)	**$85.0 Billion Surplus**	September typically involves strong revenue flows because of estimated tax payments by corporations and individuals, which usually leaves a monthly budget surplus. Available data suggest that receipts this year were strong (up approximately 9% from the same month last year). Outlays are likely to be substantially larger than the total from September 2018, but the jump reflects unusually light expenditures last year associated with a calendar configuration that moved some Social Security and Medicare spending from September to August. The expected surplus, if realized, would leave the budget deficit for FY2019 at $982 billion.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

October/November 2019

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11
CONSUMER CREDIT June $13.3 billion July $23.0 billion Aug $17.9 billion	**NFIB SMALL BUSINESS OPTIMISM INDEX** July 104.7 Aug 103.1 Sept 101.8 **PPI** Final Demand / Core* July 0.2% -0.1% Aug 0.1% 0.4% Sept -0.3% 0.0%	**JOLTS DATA** Openings (000) / Quit Rate June 7,248 2.3% July 7,174 2.4% Aug 7,051 2.3% **WHOLESALE TRADE** Inventories / Sales June -0.1% -0.3% July 0.2% 0.2% Aug 0.2% 0.0% **FOMC MINUTES**	**INITIAL CLAIMS** Sept 21 215,000 Sept 28 220,000 Oct 05 210,000 **CPI** Total / Core July 0.3% 0.3% Aug 0.1% 0.3% Sept 0.0% 0.1%	**IMPORT/EXPORT PRICES** Non-fuel Imports / Nonagri. Exports July 0.0% 0.2% Aug 0.0% -0.3% Sept -0.1% -0.1% **CONSUMER SENTIMENT** Aug 89.8 Sept 93.2 Oct 96.0
14	15	16	17	18
COLUMBUS DAY **FEDERAL BUDGET (2:00) (ONE DAY THIS WEEK)** 2019 / 2018 July -$119.7B -$76.9B Aug -$200.3B -$214.1B **Sept $85.0B** $119.1B	**EMPIRE MFG (8:30)** Aug 4.8 Sept 2.0 Oct --	**RETAIL SALES (8:30)** Total / Ex.Autos July 0.8% 1.0% Aug 0.4% 0.0% **Sept 0.2% 0.3%** **NAHB HOUSING INDEX (10:00)** Aug 67 Sept 68 Oct -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales June 0.0% 0.0% July 0.3% 0.3% **Aug 0.1% 0.1%** **BEIGE BOOK (2:00)** **September Beige Book** "On balance, reports…suggested that the economy expanded at a modest pace..." **TIC DATA (4:00)** Total / Net L-T June $21.0B $100.6B July $43.8B $84.3B Aug -- --	**INITIAL CLAIMS (8:30)** **HOUSING STARTS (8:30)** July 1.215 million Aug 1.364 million **Sept 1.320 million** **PHILLY FED INDEX (8:30)** Aug 16.8 Sept 12.0 Oct -- **IP & CAP-U (9:15)** IP / Cap.Util. July -0.1% 77.5% Aug 0.6% 77.9% **Sept 0.1% 77.9%**	**LEADING INDICATORS (10:00)** July 0.4% Aug 0.0% **Sept 0.0%**
21	22	23	24	25
	EXISTING HOME SALES	**FHFA HOME PRICE INDEX**	**INITIAL CLAIMS** **DURABLE GOODS ORDERS** **NEW HOME SALES**	**REVISED CONSUMER SENTIMENT**
28	29	30	31	1
CHICAGO FED NATIONAL ACTIVITY INDEX **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES**	**S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CONSUMER CONFIDENCE** **PENDING HOME SALES** **FOMC MEETING**	**ADP EMPLOYMENT REPORT** **Q3 GDP** **FOMC DECISION**	**INITIAL CLAIMS** **PERSONAL INCOME, CONSUMPTION, PRICES** **EMPLOYMENT COST INDEX** **CHICAGO PURCHASING MANAGERS' INDEX**	**EMPLOYMENT REPORT** **ISM MFG INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES**

*Forecasts in Bold. * The core PPI excludes food, energy, and trade services.*

Treasury Financing

October/November 2019

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11
AUCTION RESULTS: Rate Cover 13-week bills 1.680% 3.16 26-week bills 1.690% 2.52	**AUCTION RESULTS:** Rate Cover 52-week bills 1.600% 2.98 3-year notes 1.413% 2.43 **ANNOUNCE:** $50 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 RESULTS:** Rate Cover 10-yr notes 1.590% 2.43	**AUCTION RESULTS:** Rate Cover 4-week bills 1.720% 2.62 8-week bills 1.685% 2.88 30-yr bonds 2.170% 2.25 **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	
14	15	16	17	18
COLUMBUS DAY	**AUCTION:** $87 billion 13-,26-week bills **ANNOUNCE:** $50 billion* 4-week bills for auction on October 17 $40 billion* 8-week bills for auction on October 17 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds		**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $17 billion 5-year TIPS **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on October 21 $20 billion* 2-year FRNs for auction on October 23 $40 billion* 2-year notes for auction on October 22 $41 billion* 5-year notes for auction on October 23 $32 billion* 7-year notes for auction on October 24 **SETTLE:** $87 billion 13-,26-week bills	
21	22	23	24	25
AUCTION: $87 billion* 13-,26-week bills	**AUCTION:** $40 billion* 2-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on October 24 $40 billion* 8-week bills for auction on October 24 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills	**AUCTION:** $20 billion* 2-year FRNs $41 billion* 5-year notes	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $32 billion* 7-year notes **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on October 28 **SETTLE:** $87 billion* 13-,26-week bills	
28	29	30	31	1
AUCTION: $87 billion* 13-,26-week bills	**ANNOUNCE:** $50 billion* 4-week bills for auction on October 31 $40 billion* 8-week bills for auction on October 31 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills	**ANNOUNCE:** $38 billion* 3-year notes for auction on November 5 $27 billion* 10-year notes for auction on November 6 $19 billion* 30-year bonds for auction on November 7	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on November 4 $28 billion* 52-week bills for auction on November 5 **SETTLE:** $87 billion* 13-,26-week bills $17 billion 5-year TIPS $20 billion* 2-year FRNs $40 billion* 2-year notes $41 billion* 5-year notes $32 billion* 7-year notes	

**Estimate*