U.S. Economic Comment

- Potential financial instability: Fed sees risks as moderate
- The Fed's policy review: making progress

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Potential Financial Instability

The pace of economic growth and the rate of inflation are the key considerations driving monetary policy, but Fed officials also are concerned about vulnerabilities in financial markets and economic fallout that might arise from disruptions. The issue is discussed at many meetings of the Federal Open Market Committee, including the October gathering, where officials concluded that risks overall were moderate despite pockets of concern.

The importance of financial risk in the eyes of Fed officials also is evident in the heightened infrastructure established at the central bank to monitor financial developments. The Fed is a member of the Financial Stability Oversight Council (FSOC) and contributes to its detailed annual review of financial conditions. In addition, the Fed is now publishing its own semiannual review of financial developments, with the third edition published last week. The tone of the latest report (as well as the first two) matched the conclusion of the FOMC: vulnerabilities exist, but they are not excessive and risks in total appear moderate. The Fed reports cover four aspects of financial risk: asset valuations, private-sector debt, leverage in the financial sector, and risks associated with short-term funding.

Asset Valuations

The surge in share values this year and record readings on major indexes of stock prices might stir concern about a bubble in the equity market. However, the earnings outlook is favorable, and measures of price-to-projected-earnings are only moderately above the long-run median and far below levels in the late 1990s when tech prices were in bubble territory (chart). In addition, with interest rates unusually low by historical standards, above-average readings on P/E ratios should be expected.

Earlier editions of the Fed's Financial Stability Report cited concern about elevated prices of commercial real estate (CRE), and Eric Rosengren, President of the Federal Reserve Bank of Boston, has raised concern about excessive risk taking in this market. However, conditions seem to have improved lately. Survey data from the Fed show that commercial banks tightened CRE lending standards in the second and third quarters, and the decline in Treasury yields this year has not been accompanied by an acceleration in prices of commercial real estate. As a result, capitalization rates for CRE (rental income relative to prices, a measure of rate of return) have increased relative to Treasury rates this year, a sign of greater risk aversion on the part of investors.

Forward P/E Ratio of S&P 500 Firms

Source: Federal Reserve Board of Governors, Financial Stability Report, November 2019

Fed Sources: Federal Reserve Board staff calculations using Refinitiv (formerly Thomson Reuters), IBES Estimates.

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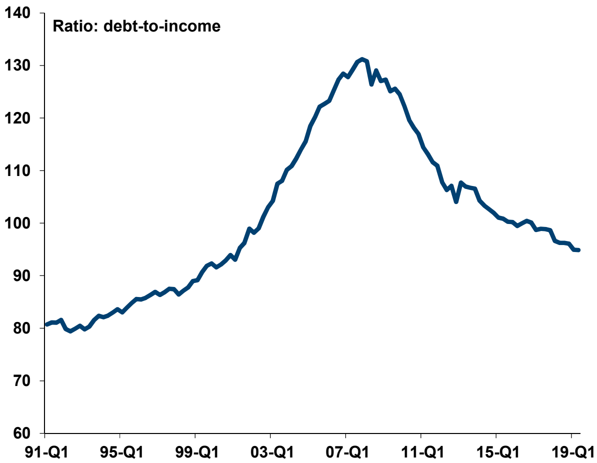
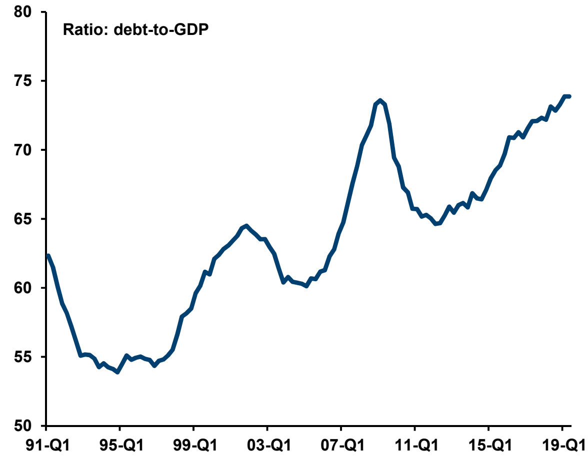
The report viewed home prices as comfortable, as they were not sharply out of line with rental rates. Prices of farmland, in contrast, have surged on average in recent years and are far above historical norms relative to rents. The report devoted one short paragraph to the farm sector, and the tone was relaxed, but a correction seems possible, especially with farm income now softening because of low crop prices and flagging demand generated by trade tensions.

Household Debt-to-Income Ratio*



** Household debt as a share of disposable personal income.*
Source: Bureau of Economic Analysis & Federal Reserve Board, Financial Accounts of the United States via Haver Analytics

Nonfinancial Business Debt to GDP Ratio*



** Nonfinancial business debt (loans and debt securities of corporate and noncorporate businesses) as a share of nominal GDP.*
Source: Bureau of Economic Analysis & Federal Reserve Board, Financial Accounts of the United States via Haver Analytics

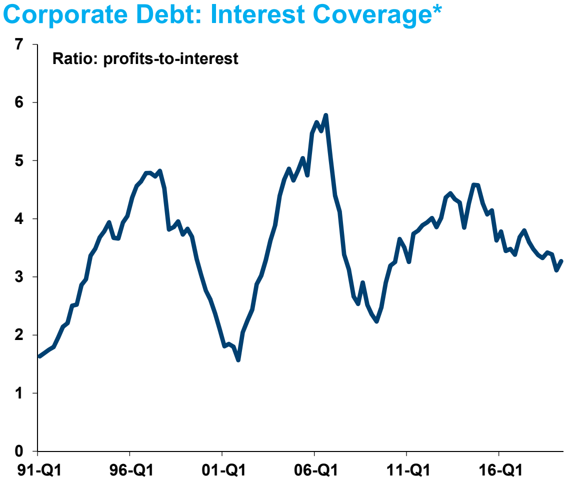
Private Nonfinancial Debt (Households and Businesses)

The household sector in the aggregate is financially strong. Judicious use of debt in recent years has pushed the ratio of debt to personal income to its lowest level in more than 15 years (chart, above left). This favorable showing most likely understates the financial health of the household sector because current figures probably involve a much larger volume of convenience credit than in the past (use of credit cards in lieu of cash). Moreover, interest rates on much of the debt will be lower than in the past, lightening burdens of the debt. Low delinquency rates on various types of consumer loans confirm that households in the aggregate are comfortable.

The business sector, however, raises questions. Debt issuance by nonfinancial firms has been robust throughout the expansion, which has pushed the ratio of business debt to GDP a touch above the previous peak in 2009 and far above previous highs (chart, above right). One might downplay the elevated level of business debt because interest rates are low and thus the burden of the debt is not excessive. Indeed, data for corporations available in the GDP accounts shows that interest coverage (profits relative to interest payments) is comfortably within the historical range (chart, right).

While the coverage ratio suggests that risks are manageable, the Fed report notes that much of the debt has been issued by firms with low credit ratings.

Corporate Debt: Interest Coverage*



** Corporate profits relative to net interest paymrents.*
Source: Bureau of Economic Analysis via Haver Analytics

That is, issuance of leveraged loans and junk bonds has been strong, and such borrowing is likely to experience repayment difficulties in a soft economic environment. Moreover, the issuance of investment-grade bonds has been concentrated in the bottom tier of this market segment. An economic slowdown could trigger downgrades, which could lead investors to liquidate such holdings into a thin market, triggering volatility.

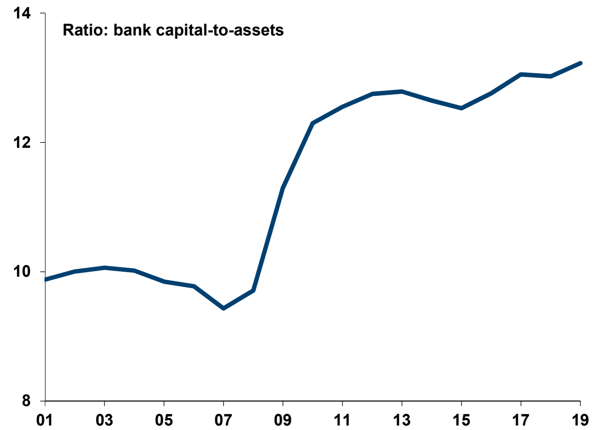
The Fed report leaves the impression that corporate debt, while not experiencing problems at this time, is the most vulnerable segment of the financial markets.

The Financial Sector

The U.S. banking industry is financially strong. Capital ratios are high relative to historical standards and well above required minimums (chart). Loan quality is high (i.e. delinquencies and defaults are low), and the latest stress tests indicated that banks are well positioned to maintain credit flows during a severe recession.

While conditions in the banking industry are favorable, the Fed report noted some concerns. The elevated capital positions of some commercial banks are likely to ease in coming quarters, as some institutions have announced plans to make generous payments to shareholders, which could lower capital ratios one to two percentage points below current levels. In addition, the decline in longer-term interest rates this year and the narrowing in the slope of the yield curve in recent years could strain the interest margins and profitability of commercial banks.

Tier-1 Capital Ratio*



Tier 1 (core) risk-based capital as a share of total risk-weighted assets of commercial banks. Year-end data, except for the reading for 2019, which is the ration as of June. Tier 1 (core) capital includes: common equity, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries less goodwill and other ineligible intangible assets.

Source: Federal Deposit Insurance Corporation, Statistics on Banking

The Fed report also noted potential difficulties at insurance companies and pension funds could arise because of low long-term interest rates. Low returns on investment portfolios at these institutions could create difficulties in meeting future obligations. Alternatively, low rates could lead insurers and pension funds to reach for yield, thereby increasing their risk profiles.

The Fed's review of the financial sector included a discussion of hedge funds. This portion was short, leaving the impression that the Fed did not have extensive data on hedge funds and has not established methodologies or benchmarks for evaluating this industry. The report merely noted that the leverage of hedge funds had stabilized this year after trending upward in the previous five years, and that current leverage ratios were about halfway between the pre-crisis peak in 2007 and the post-crisis trough in 2009.

Given the problems associated with mortgage-backed securities during the financial crisis, the Fed is monitoring the issuance of securitized products closely. The issuance of private-label asset-backed securities plummeted after peak issuance from 2005-07, and it has recovered only marginally in the past few years.

Collateralized loan obligations (CLOs) are one subset of asset-backed securities, and perhaps represent special risks because they involve leveraged loans. Leveraged loans and CLOs have grown rapidly in the past few years, but the volume is still paltry compared with that of mortgages and mortgage-backed securities. In addition, the Fed report notes that CLOs do not permit early redemptions and do not rely on short-term funding that must be rolled over before the underlying loans mature. Thus, CLOs avoid run-risk associated with deterioration in investor sentiment.

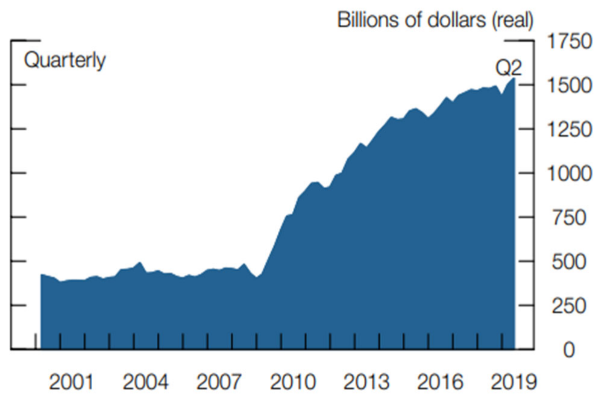
Funding Issues

A key source of difficulty during the financial crisis was the withdrawal of short-term wholesale funding, which in many cases forced asset sales into illiquid markets. The volume of short-term funding is lighter than it was at the time of the crisis (approximately 70 percent of GDP currently versus approximately 100 percent in early 2008, according to Fed data), which suggests reduced risks. In addition, commercial banks are much better insulated from funding risks than they were in 2008: usage of wholesale funding is down and holdings of liquid assets (partly because of post-crisis regulatory changes) are elevated.

Money market mutual funds experienced pronounced outflows during the crisis, but they too are now better insulated. Institutional prime money market funds now mark their assets to market, and thus they can sell securities to meet redemptions without incurring losses. In addition, these funds can limit withdrawals by charging redemption fees and setting waiting periods.

One funding vulnerability stands out. The volume of corporate bonds held by mutual funds has surged since the financial crisis (chart), and investors in these funds can typically withdraw their holdings with little notice. While mutual funds mark-to-market, a sharp change in investor sentiment and quick withdrawals could lead to market congestion and pronounced volatility. Issues have not emerged, but problems could arise.

U.S. Corporate Bonds Held by Mutual Funds



Source: Federal Reserve Board of Governors, Financial Stability Report, November 2019

Fed Sources: Federal Reserve Board staff estimates based on Federal Reserve Board Statistical release Z.1, "Financial Accounts of the United States"; Bureau of Labor Statistics, consumer price index, via Haver Analytics.

The Fed: Policy Tools Under Discussion

The minutes from the October meeting of the Federal Open Market Committee (released November 20) reviewed staff briefings and Committee discussion of the strategic review now underway at the Federal Reserve. Officials are pleased with current procedures, but they see the current environment of moderate growth, full employment, and contained inflation as an opportunity to assess their procedures and consider other approaches. Officials have conducted so-called listening tours over the past year to receive input from the public, and they are now reviewing the comments and considering changes. No decisions on new strategies have been made at this time; officials are planning to release conclusions sometime in mid-2020.

The discussion at the October meeting focused on policy tools. While the adjustment of short-term interest rates will remain the main lever of monetary policy, officials feel a need to have supplementary tools in the event that short-term interest rates fall to zero. The minutes indicated that officials felt that forward guidance and quantitative easing used during the recession were effective, and those instruments will most likely remain key elements in the Fed's tool kit.

The staff identified three types of forward guidance: qualitative, date-based, and outcome-based. Qualitative guidance involves nonspecific information on the Fed's plans and intentions. The Fed relied primarily on this form of guidance during the recession; for example, the FOMC often noted that policy would remain accommodative for an extended period. Date-based guidance designates a specific time period for maintaining an accommodative stance, while outcome-based guidance indicates that accommodation will be maintained until some economic or financial goal is achieved. The minutes implied that officials are willing to use all three types of guidance; varying economic environments might call for different types of guidance.

Officials were pleased with the efficacy of quantitative easing during the recession, and they no doubt would use this tool again if short-term interest rates were to reach zero. However, officials suggested that QE might be less effective now because long-term interest rates are lower than they were in 2008, and thus there is less scope for reducing yields. The Committee discussed a new twist on QE: buying securities to peg long-term interest rates at a certain level. That is, rather than designating a certain volume of securities to be purchased, the Fed would buy whatever quantity was needed to hold interest rates at a certain level.

The Committee discussed the possibility of pushing interest rates into negative territory, but this approach received a chilly reception. Officials noted that other central banks had achieved mixed result with negative rates, with adverse effects sometimes appearing greater than the benefits. Negative rates were seen as adding complexities and distortions to financial markets. Officials would not rule out the possibility of negative rates, but the probability of the Committee moving in this direction is low.

Review

Week of Nov. 18, 2019	Actual	Consensus	Comments
Housing Starts (October)	**1.314 Million (+3.8%)**	**1.320 Million (+5.1%)**	The increase in housing starts pushed activity to the upper portion of the range from the current expansion. Much of the advance occurred in the volatile multi-family area (up 8.6%), where starts rebounded from a low-side reading in September. Single family starts rose 2.0%, marking the fifth consecutive increase and the seventh gain in the past eight months. The level of single-family activity in October represented the third best of the current expansion.
Existing Home Sales (October)	**5.46 Million (+1.9%)**	**5.49 Million (+2.0%)**	The pickup in existing home sales in October continued the recovery in activity after sales lost ground in 2018 and the early months of this year. The recent rebound, while welcome, has not moved sales to a new high for the current cycle, as several readings in 2017 and the early portion of 2018 were firmer than recent results, but officials at the National Association of Realtors were hopeful that sales will remain brisk in coming months.
Leading Indicators (October)	**-0.1%**	**-0.1%**	Negative contributions from a drop in the ISM new orders index and a cut in the factory workweek more than offset positive contributions from building permits and the leading credit index, leaving a third consecutive decline in the index of leading economic indicators. The recent declines have offset nearly all of the net gain in other recent months and left an insignificant advance in the past year.
Revised Consumer Sentiment (November)	**96.8 (1.1% Upward Revision)**	**95.7 (Unrevised)**	The revision to the sentiment index nudged the measure above the average in the first three quarters of the year, although it trailed the average of 98.4 from last year.

Source: U.S. Census Bureau (Housing Starts); National Association of Realtors (Existing Home Sales); The Conference Board (Leading Indicators); Reuters/University of Michigan Survey Research Center (Revised Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Nov. 25, 2019	Projected	Comments
U.S. International Trade in Goods (October) (Tuesday)	**-$71.0 Billion ($0.5 Billion Wider Deficit)**	A firm dollar and slow growth abroad are likely to reinforce the downward drift in exports that has been in place for the past year. Imports also have inched lower on balance, but foreign purchases could pick up slightly from a low-side reading (especially in autos) in September.
New Home Sales (October) (Tuesday)	**0.705 Million (+0.6%)**	The increase in mortgage rates from the lows in September might have motivated fence sitters to make a commitment for a home purchase in October.
Consumer Confidence (November) (Tuesday)	**127.0 (+0.9%)**	With the equity market touching record levels, consumer confidence is likely to return to the middle portion of its recent range after a soft showing in October.
Revised GDP (2019-Q3) (Wednesday)	**1.9% (Unrevised)**	A firmer pace of investment in new structures by businesses is likely to offset small downward adjustments to several other components, leaving little if any revision to overall GDP growth.
Durable Goods Orders (October) (Wednesday)	**-0.5%**	With the manufacturing sector showing hints of improvement (e.g. a strike-adjusted employment gain in October and a net increase in manufacturing output ex-autos since July), several industries are likely to report a pickup in orders. However, continued soft results in the aircraft category will probably provide an offset.
Personal Income, Consumption, Core Price Index (October) (Wednesday)	**0.2%, 0.2%, 0.1%**	The strike-related constraint on job growth in October will probably limit the advance in wages. Interest income also has been soft recently. On the spending side, a drop in sales of new motor vehicles should constrain outlays for durable goods, while a soft tone to the latest report on retail sales raises the prospect of limited spending on nondurable goods. The CPI for October suggests that the price index for personal consumption expenditures will be contained.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

November/December 2019

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
NAHB HOUSING INDEX Sept 68 Oct 71 Nov 70 **TIC DATA** Net L-T / Total July $83.8B $44.5B Aug -$41.2B $41.9B Sept $49.5B -$37.6B	**HOUSING STARTS** Aug 1.375 million Sept 1.266 million Oct 1.314 million	**FOMC MINUTES**	**INITIAL CLAIMS** Nov 02 211,000 Nov 09 227,000 Nov 16 227,000 **PHILLY FED INDEX** Sept 12.0 Oct 5.6 Nov 10.4 **EXISTING HOME SALES** Aug 5.50 million Sept 5.36 million Oct 5.46 million **LEADING INDICATORS** Aug -0.2% Sept -0.2% Oct -0.1%	**REVISED CONSUMER SENTIMENT** Sept 93.2 Oct 95.5 Nov 96.8
25	26	27	28	29
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Aug 0.15 -0.06 Sept -0.45 -0.24 Oct -- --	**U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Aug -$73.0 billion Sept -$70.5 billion **Oct -$71.0 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail Aug 0.1% -0.2% Sept -0.4% 0.2% Oct -- -- **FHFA HOME PRICE INDEX (9:00)** July 0.4% Aug 0.2% Sept -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA July 0.0% 0.2% Aug -0.2% 0.0% Sept -- -- **NEW HOME SALES (10:00)** Aug 0.706 million Sept 0.701 million **Oct 0.705 million** **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Sept 126.3 Oct 125.9 **Nov 127.0**	**INITIAL CLAIMS (8:30)** **REVISED GDP (8:30)** GDP / Chained Price 19-Q2 2.0% 2.4% 19-Q3(a) 1.9% 1.7% **19-Q3(p) 1.9% 1.7%** **DURABLE GOODS ORDERS (8:30)** Aug 0.2% Sept -1.2% **Oct -0.5%** **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index / Prices Sept 47.1 57.3 Oct 43.2 54.8 Nov -- -- **PENDING HOMES SALES (10:00)** Aug 1.4% Sept 1.5% Oct -- **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (10:00)** Inc. / Cons. / Core Aug 0.5% 0.2% 0.1% Sept 0.3% 0.2% 0.0% **Oct 0.2% 0.2% 0.1%** **BEIGE BOOK (2:00)** **October Beige Book** "The U.S. economy expanded at a slight to modest pace since the prior report as business activity varied across the country."	***THANKSGIVING***	
2	3	4	5	6
ISM MFG INDEX **CONSTRUCTION SPEND.**	**VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **ISM NON-MFG INDEX**	**INITIAL CLAIMS** **TRADE BALANCE** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **WHOLESALE TRADE** **CONSUMER SENTIMENT** **CONSUMER CREDIT**
9	10	11	12	13
	NFIB SMALL BUSINESS OPTIMISM INDEX **REVISED PRODUCTIVITY & COSTS** **FOMC MEETING**	**CPI** **FOMC DECISION** **FEDERAL BUDGET**	**INITIAL CLAIMS** **PPI**	**RETAIL SALES** **IMPORT/EXPORT PRICES** **BUSINESS INVENTORIES**

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

Treasury Financing

November/December 2019

Monday	Tuesday	Wednesday	Thursday	Friday
18	19	20	21	22
AUCTION RESULTS: Rate Cover 13-week bills 1.540% 3.01 26-week bills 1.540% 2.89	**ANNOUNCE:** $50 billion 4-week bills for auction on November 21 $40 billion 8-week bills for auction on November 21 $15 billion 16-day CMBs for auction on November 20 **SETTLE:** $55 billion 4-week bills $40 billion 8-week bills	**AUCTION RESULTS:** Rate Cover 16-day CMB 1.540% 3.63	**AUCTION RESULTS:** Rate Cover 4-week bills 1.550% 2.82 8-week bills 1.540% 2.89 10-yr TIPS 0.149% 2.40 **ANNOUNCE:** $84 billion 13-,26-week bills for auction on November 25 $18 billion 2-year FRNs for auction on November 26 $40 billion 2-year notes for auction on November 25 $41 billion 5-year notes for auction on November 26 $32 billion 7-year notes for auction on November 27 **SETTLE:** $87 billion 13-,26-week bills	
25	26	27	28	29
AUCTION: $84 billion 13-,26-week bills $40 billion 2-year notes	**AUCTION:** $18 billion 2-year FRNs $41 billion 5-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on November 27 $40 billion* 8-week bills for auction on November 27 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills $15 billion 16-day CMBs	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $32 billion 7-year notes **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on December 2 $28 billion* 52-week bills for auction on December 3	***THANKSGIVING***	**SETTLE:** $84 billion 13-,26-week bills $18 billion 2-year FRNs $12 billion 10-year TIPS
2	3	4	5	6
AUCTION: $84 billion* 13-,26-week bills **SETTLE:** $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes	**AUCTION:** $28 billion* 52-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on December 5 $35 billion* 8-week bills for auction on December 5 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills		**AUCTION:** $45 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on December 9 $38 billion* 3-year notes for auction on December 9 $24 billion* 10-year notes for auction on December 10 $16 billion* 30-year bonds for auction on December 12 **SETTLE:** $84 billion* 13-,26-week bills $28 billion* 52-week bills	
9	10	11	12	13
AUCTION: $84 billion* 13-,26-week bills $38 billion* 3-year notes	**AUCTION:** $24 billion* 10-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on December 12 $35 billion* 8-week bills for auction on December 12 **SETTLE:** $45 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $45 billion* 4-week bills $35 billion* 8-week bills $16 billion* 30-year bonds **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on December 16 $15 billion* 5-year TIPS for auction on December 19 **SETTLE:** $84 billion* 13-,26-week bills	

**Estimate*