Daiwa Capital Markets

U.S. Economic Comment

- RP market: calm at year-end; likely to remain so in the months ahead
- Forecast review: slower growth, but no recession in 2020; noise from Boeing

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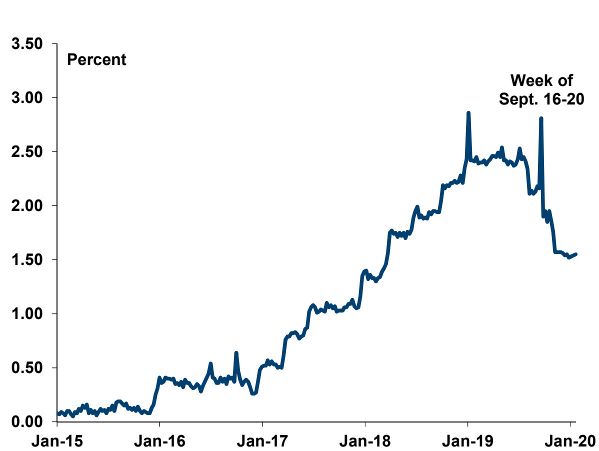
Stable Money Markets at Year-End

Concern about pressure in the market for repurchase agreements over year-end proved unfounded, as trading proceeded smoothly and rates were generally contained. The market for overnight funding on December 31 opened with a rate of 1.85 percent, but it eased to a range of 1.60 to 1.65 percent by 10:00 AM, and SOFR totaled 1.55 percent on the day, up only marginally from the recent low of 1.52 percent and within the range of observations in the past two months (chart, left). (SOFR is the Secured Overnight Financing Rate, which is the volume-weighted median rate on a broad range of RP transactions collateralized by Treasury securities.)

The calm conditions partly reflected the fact that some borrowers had secured financing in advance, and they paid up for the certainty of avoiding unsettled conditions like those in mid-September. Our RP desk saw forward trading for December 31 in the prior two months at rates as high as 3.65 percent. The more important reason for stable conditions was aggressive action by the Federal Reserve to keep short-term interest rates contained. The Fed provided a considerable degree of financing by arranging RPs with primary dealers, with $255.6 billion of such transactions on the Fed's balance sheet on December 31 (overnight and term combined). In addition, the Fed injected additional reserves into the banking system by purchasing approximately $120 billion of Treasury securities in the final two months of the year.

Looking ahead, we suspect that the RP market will remain generally stable. While fluctuations are likely to occur, pronounced shifts similar to those in mid-September will probably be rare, perhaps nonexistent. Commentators have offered various explanations for the volatility at that time, such as corporate tax payments, settlement of Treasury securities, reduced lending in the RP market by commercial banks because of balance sheet changes, and increased borrowing in the market by nontraditional participants. (See the box on RP stress in the Quarterly Review published by the Bank for International Settlements on December 8. The Chicago Fed Letter Number 423 also has a good discussion.)

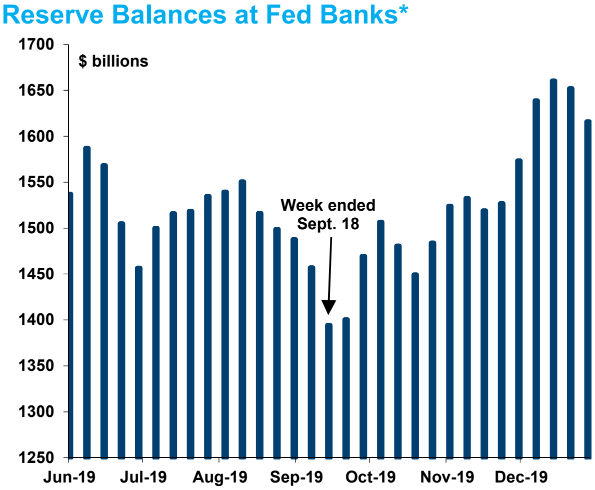
Secured Overnight Financing Rate (SOFR)*



* *Weekly average data.*

Source: Federal Reserve Bank of New York via Haver Analytics

Reserve Balances at Fed Banks*



* *Weekly average data on a Thursday to Wednesday basis.*

Source: Federal Reserve Board via Haver Analytics

These factors undoubtedly played a role, but such elements are common in financial markets and they typically have a modest influence on market interest rates. The mid-September disruption, in our view, can be explained better by a broader factor: the Federal Reserve inadvertently deviated from the operating procedures it developed during and after the financial crisis that would have countered the shifts in market factors that put upward pressure on interest rates.

The Fed over the past several years has employed an operating framework involving an abundant supply of bank reserves. With reserves readily available, there would be ample liquidity to handle the payment of corporate taxes or the settlement of Treasury securities; surprising demand for financing by nontraditional participants could be covered. A large volume of reserves in the banking system, might drive short-term interest rates to zero, but the Fed managed to keep them in positive territory and to control them closely by setting administered rates, specifically the interest rate on excess reserves and the rate on overnight reverse repurchase agreements.

The system worked -- until reserves started to become less abundant. Because of the Fed's effort to unwind its quantitative easing programs, and because of natural growth in Fed liabilities that displace bank reserves (primarily currency held by the public), the supply of reserves in the banking system has been shrinking gradually over the past few years. The Fed knew that the shrinking supply of reserves would eventually cause tightness in money markets and upward pressure on short-term interest rates, but it was not certain on when such conditions would emerge. New regulatory requirements imposed in the aftermath of the financial crisis increased the demand for bank reserves, but the Fed was not certain on the quantity that banks would desire to hold. The Fed had no history to draw from to estimate the new demand for bank reserves; it had to learn from experience.

A speech last year by a Fed economist on the New York trading desk noted that estimates based on market movements and surveys of commercial banks suggested that tightness in money markets would emerge as the quantity of bank reserves approached $1.1 trillion (versus a peak near $2.8 trillion in 2014). However, the estimate was off the mark, as tightness in the market emerged in mid-September with reserves in the neighborhood of $1.4 trillion (chart, p. 1).

The solution to the problems that emerged in mid-September is obvious and easily achieved: the Fed needs to push reserves back to an "abundant" level, which now seems to be a total in the range of $1.5 to $1.6 trillion (see p. 1 chart). It has done so with the arrangement of RPs with primary dealers and the purchase of Treasury securities. This action to a large degree was a temporary fix to get through the year end. The Fed would like to have an abundant supply of reserves on a permanent basis. Accordingly, it will continue to purchase Treasuries over the next few months to add reserves permanently, which will allow it to rely less on RPs. We suspect that the Fed will not hesitate to use RPs in the future, but the planned increase in its security portfolio should limit the need for the temporary reserve injections through repurchase agreements.

The Economic Outlook for 2020

We published our economic outlook for 2020 in early November (November 8 Economic Comment), but a quick review is warranted now that the year is underway. In addition, the December announcement by Boeing that it will cease production of the 737 MAX in early January led us to tweak the timing of economic activity, slowing it in the first quarter and then boosting it later in the year when (if?) production resumes.

We find ourselves on the soft side of the consensus view. The Blue Chip forecast survey from December showed average growth of 1.75 percent over the four quarters of 2020 versus our view of approximately 1.6 percent. More important is the trajectory of growth. The Blue Chip survey shows a generally steady advance, with growth totaling 1.8 percent in the first and second quarters followed by 1.7 percent in Q3 and Q4. Our view has underlying growth of approximately 2.0 percent in Q1 (ex-Boeing effect discussed below) decelerating to an increase of 1.4 percent in Q4 (table p. 4).

Several areas are likely to contribute to the deceleration in growth this year. The housing sector has responded to the drop in interest rates in 2019 and is currently performing well, but with interest rates off their lows, that positive influence will probably begin to fade. The downward trajectory to housing activity that was evident in 2018 will probably return. The trade sector also is likely to provide challenges. Potential damage from the trade war has perhaps been lessened by "phase one" of the trade agreement with China, but a firm foreign exchange value of the dollar and slow growth abroad are likely to lead to a negative contribution to growth from net exports.

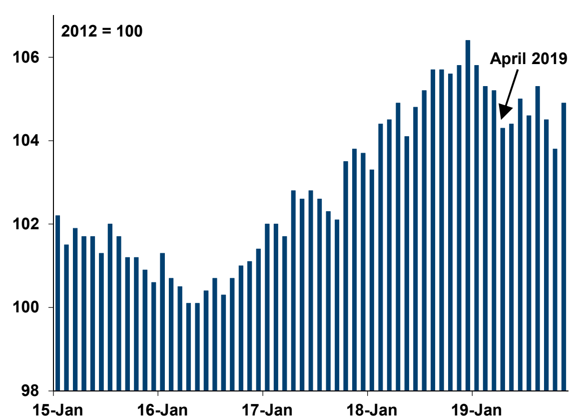
We expect business capital spending to remain weak. Oil prices at current levels leave thin profit margins in the extraction of oil and natural gas, and thus investment in mining structures and equipment will probably be limited. More generally, uncertainty on several fronts is likely to lead business executives to proceed cautiously with major investment projects. Uncertainty associated with the trade war has lessened, but it has not disappeared, and thus we look for trade issues to remain a constraint. In addition, slow economic growth abroad is likely to limit investment activity by firms with an international footprint. Moreover, the 2020 election cycle also might lead businesses to postpone activity until the political outlook becomes clearer. Finally, geopolitical risks will be in play, a factor exposed in a dramatic way this past week with the violence in Iraq.

Consumer spending is a bright spot for the U.S. economy, as a strong labor market and generally healthy financial positions should allow individuals to continue providing support. However, we suspect that this sector will lose some vigor over the course of the year. Job growth, although brisk, has slowed over the past year and we suspect the deceleration will continue in 2020. In addition, the improvement in financial positions is likely to slow, as the equity market will struggle to repeat the performance of 2019, and home price appreciation seems to be slowing as well. Consumer spending will still lead the economy, but its push will probably diminish over the course of the year.

The Boeing Effect

Thus far, the problems experienced by Boeing with the 737 MAX aircraft have had little effect on the economy. Although Boeing is not shipping the plane to its customers, it has continued to produce the aircraft, placing the completed units in inventory. It made a moderate adjustment to the production schedule in mid-April, downshifting from a pace of 52 aircraft per month to 42. This change contributed to a drop of 0.9 percent in the manufacturing component of industrial production in April (chart), and it probably constrained the growth of Q2 GDP by approximately one-quarter percentage point. With production stable after April, monthly and quarterly statistics related to aircraft production would not be influenced by developments at Boeing.

Industrial Production: Manufacturing



Fed Sources: Federal Reserve Board via Haver Analytics

Just as the production cut in April influenced Q2 results last year, the planned reduction in January will influence the first quarter. Back-of-the-envelope calculations of ball-park figures provide insight. The quoted price of a 737 MAX is approximately $125 million, which would translate to an inflation-adjusted price tag of approximately $110 million in GDP calculations. Thus, a production cut of 42 planes per month would result in a drop in real output of slightly more than $55 billion per year (42 x 110 x 12; U.S. GDP figures are always annualized), which represents one quarter percentage point of GDP. Because published growth rates for U.S. GDP also are annualized, this one-quarter percentage point reduction in the value of output, all else equal, would translate to a full percentage point reduction in the annual growth rate for the first quarter.

There will be some offsets to this direct effect, which will temper the constraint on GDP growth. Many of the inputs into the 737 MAX are foreign-sourced, and thus the production cuts could lead to a drop in imports, which would tend to boost reported GDP. In addition, Boeing could shift workers to the production of other aircraft, which would limit the reduction in total activity at Boeing. In this regard, the press release issued by Boeing suggested that layoffs were not involved in the production cut, implying that workers would indeed be shifted elsewhere.

Still, the cutback in 737 MAX production could have a discernable effect on GDP growth. A constraint of one percentage point implied by the back-of-the-envelope calculations represents an upper bound on the effect; a more realistic view might be one-half percentage point. The underlying pace of growth in the economy appears to be approximately two percent. The shift at Boeing could trim the advance in Q1 to 1.5 percent.

The resumption of 737 MAX production later this year would lead to a jump in reported GDP growth, although the timing and magnitude of pickup are not clear at this point. Boeing will not be able to deliver completed aircraft to foreign customers until regulators in the relevant countries approve, and we suspect that many will exercise extreme caution in approving use of the aircraft. There could be a long delay and a gradual resumption of production.

U.S. Economic Outlook*

(Percent change annual rate, unless otherwise noted)

		2019				2020			
Item		**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
1	Gross Domestic Product	3.1	2.0	2.1	2.4	1.5	2.0	1.7	1.4
2	Personal Consumption Expenditures	1.1	4.6	3.2	2.2	2.3	1.9	1.6	1.3
3	Business Fixed Investment	4.4	-1.0	-2.3	0.2	2.0	1.8	3.5	2.9
4	Residential Construction	-1.0	-3.0	4.6	3.5	3.5	0.0	-2.0	-2.5
5	Change in Business Inventories *(Contribution to growth)*	0.5	-0.9	0.0	-0.8	-0.5	0.4	0.1	0.1
6	Government Spending	2.9	4.8	1.7	1.4	1.0	0.8	0.7	0.4
7	Net Exports *(Contribution to growth)*	0.7	-0.7	-0.1	1.3	-0.2	-0.1	0.0	0.1
	End of Period Figures:								
	Inflation and Unemployment								
8	Core PCE Deflator *(Annual rate)*	1.1	1.9	2.1	1.5	2.1	2.0	2.0	1.9
9	Unemployment Rate	3.8	3.7	3.5	3.6	3.7	3.8	4.0	4.2
	Interest Rates								
10	Federal Funds Target (midpoint)	2.38	2.38	1.88	1.63	1.63	1.38	1.13	1.13
11	2-year Treasury	2.27	1.75	1.63	1.58	1.60	1.30	1.00	0.95
12	10-year Treasury	2.41	2.00	1.68	1.92	1.90	1.75	1.60	1.50
13	30-year Fixed-Rate Mortgages	4.06	3.73	3.64	3.74	3.85	3.75	3.70	3.70

* *The readings for 2019-Q4 to 2020-Q4 are forecasts.*

Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; Daiwa Capital Markets America

Daiwa Capital Markets

Review

Week of Dec. 30, 2019	Actual	Consensus	Comments
U.S. International Trade in Goods (November)	**-$63.2 Billion ($3.6 Billion Narrower Deficit)**	**-$68.7 Billion ($1.9 Billion Wider Deficit)**	Both sides of the trade ledger contributed to the narrowing in the nominal goods deficit in November, as exports rose 0.7% and imports fell 1.3%. The shift in the deficit occurred from an already lean reading in October, leaving the shortfall at its lowest level since December 2016. While the report did not include price-adjusted data on imports and exports of goods, nor data on services trade, the available figures suggest a positive contribution from net exports to GDP growth in Q4 -- something in the neighborhood of 1½ percentage points.
Consumer Confidence (December)	**126.5 (-0.2%)**	**128.5 (+2.4%)**	The dip in consumer confidence occurred from an upwardly revised level in November (126.8 versus an initial estimate of 125.5). The latest reading was in the low portion of the range of the past two years (average of 133.6 in 2018-Q4 and 130.1 for all of 2018), although it was still firm by historical standards. Indeed, recent readings bested all observations in the previous expansion.
ISM Manufacturing Index (December)	**47.2% (-0.9 Pct. Pt.)**	**49.0% (+0.9 Pct. Pt.)**	The December reading on the ISM manufacturing index represented the fifth consecutive reading below 50% and the softest total in more than 10 years (June 2009, the trough of the Great Recession, registered an index value of 46.3%). The production component led the retreat in the headline index, dropping 5.9 percentage points to 43.2%, easily the softest result of the current expansion. The employment index also was weak, posting a drop of 1.5 percentage points to 45.1%. One observation in the current expansion was lower (January 2016, 44.6%). The new orders component fell only slightly (off 0.4 percentage point), but it started at a low level and the new reading of 46.8% represented the weakest showing in more than 10 years.
Construction Spending (November)	**0.6%**	**0.4%**	The increase in construction activity in November was joined by upward revisions in the prior two months, with the combined adjustments leaving the level of building in October 2.0% firmer than previously believed. Private residential construction led the advance with an increase of 1.9%. Construction of new single-family homes was strong (up 1.2%, marking the fifth consecutive increase), as was improvements to existing homes (up 3.4%, also marking the fifth consecutive advance). Private nonresidential activity fell 1.2%, continuing the downward drift that began in the spring. Government-related construction rose 0.9%, marking the fifth consecutive increase and nearly offsetting all of a soft patch seen in the spring.

Source: U.S. Census Bureau (U.S. International Trade in Goods, Construction Spending); The Conference Board (Consumer Confidence); Institute for Supply Management (ISM Manufacturing Index); Consensus forecasts are from Bloomberg

Preview

Week of Jan. 6, 2020	Projected	Comments
Trade Balance (November) (Tuesday)	**-$43.5 Billion ($3.7 Billion Narrower Deficit)**	With trade in services typically showing little month-to-month variation, the change in the total trade deficit will probably be dominated by the already reported narrowing of $3.6 billion in the merchandise shortfall. Both exports and imports contributed to the improvement in merchandise flows (exports rose 0.7% while imports fell 1.3%).
ISM Nonmanufacturing Index (December) (Tuesday)	**55.0% (+1.1 Pct. Pts.)**	Progress in trade negotiations with China and the optimistic turn in financial markets are likely to generate more favorable perceptions among purchasing managers, which should lead to a pickup in the nonmanufacturing index. The expected reading is comfortably within the range of observations for 2019, but it lags the average of 58.9% in 2018.
Factory Orders (November) (Tuesday)	**-0.8%**	The already reported drop of 2.0% in orders for durable goods should push total factory orders lower. This drop reflected a retreat of 35.2% in bookings for aircraft and an increase of only 0.1% elsewhere. In the nondurable area, higher prices could boost the value of orders for petroleum products. In addition, we look for nondurable orders ex-petroleum to return to a growth track after declines in September and October (total nondurable orders expected to increase 0.4%).
Payroll Employment (December) (Friday)	**150,000**	The labor market remains firm, although the surge of 266,000 in November probably contained a strong dose of upside volatility. We expect job growth to move back in line with what we perceive as the underlying average. This pace of job growth would reduce unemployment in many situations, but an increase in the size of the labor force after a slow month in November could nudge the jobless rate higher.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

December 2019/January 2020

Monday	Tuesday	Wednesday	Thursday	Friday
30	31	1	2	3
U.S. INTERNATIONAL TRADE IN GOODS Sept -$70.7 billion Oct -$66.8 billion Nov -$63.2 billion **ADVANCE INVENTORIES** Wholesale / Retail Sept -0.7% / 0.1% Oct 0.0% / 0.1% Nov 0.0% / -0.7% **CHICAGO PURCHASING MANAGERS' INDEX** Index / Prices Oct 43.2 / 54.8 Nov 46.3 / 53.5 Dec 48.9 / 58.4 **PENDING HOMES SALES** Sept 1.4% Oct -1.3% Nov 1.2%	**FHFA HOME PRICE INDEX** Aug 0.2% Sept 0.7% Oct 0.2% **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** SA / NSA Aug 0.2% / 0.1% Sept 0.3% / 0.1% Oct 0.4% / 0.1% **CONFERENCE BOARD CONSUMER CONFIDENCE** Oct 126.1 Nov 126.8 Dec 126.5	***NEW YEAR'S DAY***	**INITIAL CLAIMS** Dec 14 235,000 Dec 21 224,000 Dec 28 222,000	**ISM INDEX** Index / Prices Oct 48.3 / 45.5 Nov 48.1 / 46.7 Dec 47.2 / 51.7 **CONSTRUCTION SPEND.** Sept 0.7% Oct 0.1% Nov 0.6% **FOMC MINUTES** **VEHICLE SALES** Oct 16.5 million Nov 17.1 million **Dec 17.0 million**
6	7	8	9	10
	TRADE BALANCE (8:30) Sept -$51.1 billion Oct -$47.2 billion **Nov -$43.5 billion** **ISM NON-MFG INDEX (10:00)** Index / Prices Oct 54.7 / 56.6 Nov 53.9 / 58.5 **Dec 55.0 / 58.0** **FACTORY ORDERS (10:00)** Sept -0.8% Oct 0.1% **Nov -0.8%**	**ADP EMPLOYMENT REPORT (8:15)** Private Payrolls Oct 121,000 Nov 67,000 Dec -- **CONSUMER CREDIT (3:00)** Sept $9.6 billion Oct $18.9 billion Nov --	**INITIAL CLAIMS (8:30)**	**EMPLOYMENT REPORT (8:30)** Payrolls / Un. Rate Oct 156,000 / 3.6% Nov 266,000 / 3.5% **Dec 150,000 / 3.6%** **WHOLESALE TRADE (10:00)** Inventories / Sales Sept -0.7% / -0.1% Oct 0.0% / -0.7% **Nov 0.0% / -0.3%**
13	14	15	16	17
FEDERAL BUDGET	**NFIB SMALL BUSINESS OPTIMISM** **CPI**	**PPI** **EMPIRE MFG INDEX** **BEIGE BOOK**	**INIITIAL CLAIMS** **RETAIL SALES** **IMPORT/EXPORT PRICES** **PHILLY FED INDEX** **BUSINESS INVENTORIES** **NAHB HOUSING INDEX** **TIC DATA**	**HOUSING STARTS** **IP & CAP-U** **CONSUMER SENTIMENT** **JOLTS DATA**
20	21	22	23	24
MARTIN LUTHER KING JR. DAY		**CHICAGO FED NATIONAL ACTIVITY INDEX** **FHFA HOME PRICE INDEX** **EXISTING HOME SALES**	**INIITIAL CLAIMS** **LEADING INDICATORS**	

Forecasts in Bold. The December 2019 reading for vehicle sales (in bold) shows the Bloomberg consensus estimate.

Treasury Financing

December 2019/January 2020

Monday	Tuesday	Wednesday	Thursday	Friday
30	31	1	2	3
AUCTION RESULTS: Rate / Cover 13-week bills 1.520% 3.21 26-week bills 1.560% 2.81 52-week bills 1.550% 2.95	**ANNOUNCE:** $35 billion 4-week bills for auction on January 2 $35 billion 8-week bills for auction on January 2 **SETTLE:** $35 billion 4-week bills $35 billion 8-week bills $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes $15 billion 5-year TIPS	***NEW YEAR'S DAY***	**AUCTION RESULTS:** Rate / Cover 4-week bills 1.500% 3.31 8-week bills 1.515% 3.15 **ANNOUNCE:** $78 billion 13-,26-week bills for auction on January 6 $38 billion 3-year notes for auction on January 7 $24 billion 10-year notes for auction on January 8 $16 billion 30-year bonds for auction on January 9 **SETTLE:** $78 billion 13-,26-week bills $26 billion 52-week bills	
6	7	8	9	10
AUCTION: $78 billion 13-,26-week bills	**AUCTION:** $38 billion 3-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on January 9 $35 billion* 8-week bills for auction on January 9 **SETTLE:** $35 billion 4-week bills $35 billion 8-week bills	**AUCTION:** $24 billion 10-year notes	**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills $16 billion 30-year bonds **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on January 13 **SETTLE:** $78 billion 13-,26-week bills	
13	14	15	16	17
AUCTION: $78 billion* 13-,26-week bills	**ANNOUNCE:** $35 billion* 4-week bills for auction on January 16 $35 billion* 8-week bills for auction on January 16 **SETTLE:** $35 billion* 4-week bills $35 billion* 8-week bills	**SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on January 21 $14 billion* 10-year TIPS for auction on January 23 **SETTLE:** $78 billion* 13-,26-week bills	
20	21	22	23	24
MARTIN LUTHER KING JR. DAY	**AUCTION:** $78 billion* 13-,26-week bills **ANNOUNCE:** $35 billion* 4-week bills for auction on January 23 $35 billion* 8-week bills for auction on January 23 **SETTLE:** $35 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills $14 billion* 10-year TIPS **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on January 27 $26 billion* 52-week bills for auction on January 28 $20 billion* 2-year FRNs for auction on January 28 $40 billion* 2-year notes for auction on January 27 $41 billion* 5-year notes for auction on January 27 $32 billion* 7-year notes for auction on January 28 **SETTLE:** $78 billion* 13-,26-week bills	

**Estimate*