U.S. Economic Comment

- FOMC: focus on technical issues, not policy
- Fed T-bill purchases: oil, not gasoline
- A challenge in the Phase One trade agreement

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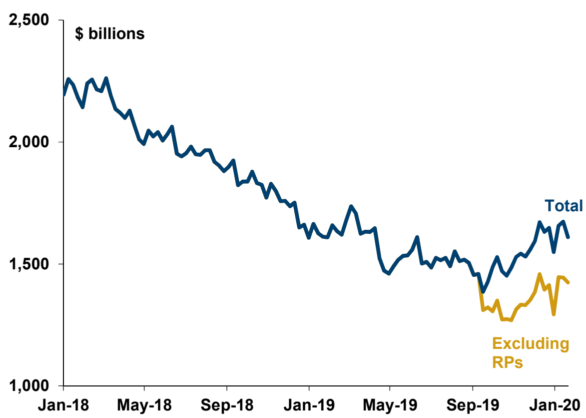
FOMC Preview

The probability of a meaningful policy change at the upcoming meeting of the Federal Open Market Committee is essentially zero. Minutes from the December FOMC meeting and recent public statements of Fed officials indicate that policymakers are reasonably pleased with the economy's performance, and they feel that monetary policy is properly calibrated. We see a good chance that the Board of Governors will raise the interest rate on required and excess reserves from its current level of 1.55 percent. However, the likely change would be modest, and the shift would be billed as a technical adjustment to nudge the federal funds rate from the low portion to the middle of the 1.50 to 1.75 percent target range.

With interest rate settings receiving limited attention at the meeting, policymakers might focus on the Fed's balance sheet. Officials have made balance sheet adjustments in the past few months to prevent a repeat of problems that emerged in the market for repurchase agreements in mid-September. Interest rates on some RP transactions at that time were as high as high as 10 percent, and the average rate on the most troublesome day (September 17) totaled 5.25 percent.

Problems at that time emerged because the supply of reserves in the banking system had become tight relative to demand. Supply had tightened because the Fed was unwinding some of the security purchases made under its quantitative easing programs. At the same time, other liabilities of the Fed, such as currency in circulation, had been increasing, which displaced some reserve balances. On the demand side, desired holdings by commercial banks were notably larger than in the past because banks were using such balances to satisfy liquidity requirements imposed by the Dodd-Frank Act. Without historical experience to draw on, the Fed was not certain of the volume of reserves that banks would wish to hold for liquidity purposes. The estimates of Fed staff suggested that total reserve balances of $1.1 trillion would represent a comfortable balance. In fact, this total was too low; balances of approximately $1.4 trillion led to problems in mid-September.

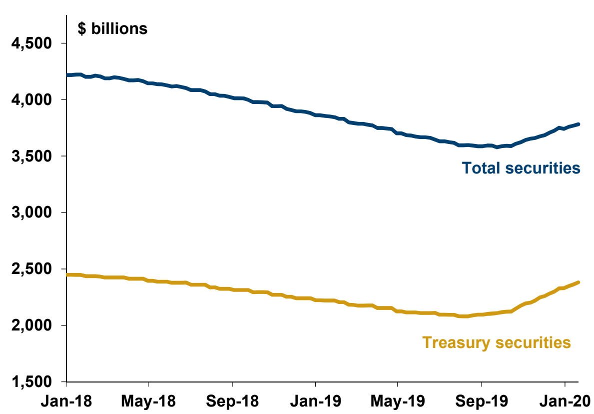
Reserve Balances*



* *Weekly end-of-period data. The last observations are for Wednesday January 22, 2020.*

Source: Federal Reserve Board via Haver Analytics

Fed Securities Portfolio*



* *Weekly end-of-period data. The last observations are for Wednesday January 22, 2020.*

Source: Federal Reserve Board via Haver Analytics

The imbalance was easily fixed; the Fed simply had to pump more reserves into the banking system to better align supply with demand. The Fed moved quickly to provide reserves by arranging repurchase agreements with primary dealers (i.e. the Fed temporarily bought securities with newly created reserve balances). In addition, the Fed ended its redemption of securities and initiated new purchases of Treasury bills ($60 billion per month). The Fed's securities portfolio has increased approximately $260 billion since the latter part of September, and the supply of reserves has increased to $1.6 trillion, an apparently comfortable total (charts, p. 1).

The Fed's adjustment, though, is not complete. Officials would like to have an abundant supply of reserves on a permanent basis rather than one provided temporarily through repurchase agreements. Thus, the Fed will continue to purchase bills in the market while it retires repurchase agreements. To date, it has provided only vague guidance on its plans; specifically, the FOMC announced that it intends to arrange RPs at least through January and to purchase bills into the second quarter. We look for Chair Powell to provide a clearer picture in his press conference.

One can make an educated guess on how the Fed might proceed. The Fed had $186 billion of RPs outstanding on January 22. If it maintained bill purchases at $60 billion per month, it could replace outstanding RPs by the end of April. Officials might wish to taper the volume of purchases as the volume of RPs shrinks, which would push the period of buying further into the second quarter. In addition, seasonal reserve needs might increase during the spring tax season, which might invite more buying, and perhaps continued use of RPs. Thus, we look for the Fed to have an active presence in the market until May or June, although the pace of bill purchases will probably be less than $60 billion per month.

The Fed will continue buying Treasury securities even after it has completed the adjustment to the imbalance that appeared in September. Some of the purchases will be the result of the reinvestment of payments on mortgage-backed and agency securities, and some will be made to allow reserve balances to grow with the economy. The Fed will broaden its buying to include longer-term issues rather than concentrate its activity in the bill market. The flow of purchases will be less regular than it has been recently, but the Fed will be a familiar participant in the market. Its balance sheet will be expanding gradually.

QE or Not QE?

The Fed has noted that its Treasury bill purchases in recent months represent a technical adjustment to limit volatility in the short-term fixed-income market; the buying is not a fundamental shift in policy. Many market participants, however, view the Fed's purchases as another round of quantitative easing. They argue that the recent surge in the equity market is a manifestation of an easier policy stance.

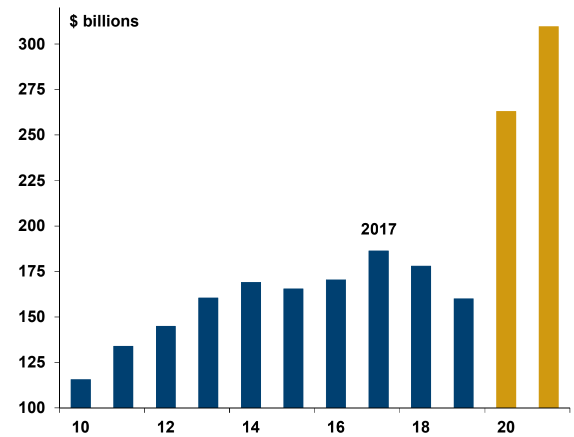
We are skeptical of the market view. We doubt that a limited buying program in the short end of the maturity spectrum would have such a strong influence on equity prices. In addition, solid advances in other equity markets around the world lead us to believe that factors other than Fed activity are involved. Hints of firmer economic activity abroad (or at least less slippage) and a lessening in trade tensions are obvious spurs that could be pushing equity markets higher.

The Fed's recent activity is merely an effort to insure the smooth operation of the money market. Discussions of monetary policy sometimes involve automobile analogies (tapping the brakes, hitting the gas, steering carefully in uncertain conditions). Another analogy seems apt in this situation. An automobile needs both gasoline and oil to function properly. Gasoline makes the car go; oil prevents moving parts in the engine from burning out. Reductions in interest rates and the purchase of long-term securities can be viewed as adding gasoline to the automobile; these actions make the economy move. The recent buying of Treasury bills is like adding oil. The purchases will not move the economy forward; they are undertaken to prevent the money market from blowing up.

A Challenge in the Trade Agreement

The trade agreement between the United States and China covered considerable ground (protection of intellectual property, limits on forced technological transfers, entry into financial markets in China by US firms, guards against currency manipulation). The agreement also involves a commitment by China to purchase over the next two years an additional $200 billion of goods and services above a 2017 benchmark ($76.7 billion in 2020 and $123.3 billion in 2021).

Exports to China*



** The observation for 2019 is an estimate based on results for goods and services through Q3 and trade in goods through November. The readings for 2020 and 2021 are the dollar amounts of purchases specified in the trade agreement added to the total in 2017.*
Sources: Bureau of Economic Analysis & U.S. Census Bureau via Haver Analytics; U.S. Trade Representative

This aspect of the agreement is curious in several respects. Most obvious, it leaves one wondering about feasibility. The high-water mark for exports to China occurred in 2017, and thus the commitment to exceed this total by a wide margin strains credibility. As shown in the chart, intended exports to China are far above any amount seen in other recent years. Moreover, the agreement specifies that purchases by China “will be made at market prices and based on commercial considerations”. Prices and commercial considerations in recent years have not generated demand in China anywhere near intended totals; one wonders what will motivate purchases in the months ahead. Perhaps China has quotas or regulatory barriers that it intends to dismantle, but the agreement does not make mention of such. It seems as though this aspect of the agreement will be driven by command and control from the Chinese government -- a step away from a free-trade environment usually sought by the United States.

Enforcement represent another issue. The benchmark in 2017 was described in vague terms: “Official Chinese trade data and official U.S. trade data shall be used to determine whether this chapter has been implemented.” Without specifics, manipulation of the data might prove to be easy. In addition, the agreement offers China an easy exemption from this obligation, as it allows China to “request consultations” if it believes that conditions in the United States are affecting its ability to make the necessary purchases.

And conditions in the U.S. could be raised as an issue. With the U.S. economy close to full employment, resources might not be readily available to meet the potential increase in demand. China can perhaps claim supply restrictions.

If the United States is able to provide the goods and services noted in the agreement, the exports to China might represent the diversion of shipments that would have gone to other countries. The pickup in exports to China, if realized, could well have no effect of the size of the U.S. trade deficit or the pace of economic activity.

We also wonder what will happen after 2021. The trade agreement notes that negotiators expect the trajectory of increases to continue in calendar years 2022 through 2025. However, the agreement does not have any provisions that might lead to such an outcome. We have doubts about exports to China in 2020 and 2021, but we are even more skeptical about the expectations beyond 2021.

Review

Week of Jan. 20, 2020	Actual	Consensus	Comments
Existing Home Sales (December)	**5.54 Million (+3.6%)**	**5.43 Million (+1.5%)**	The jump in sales of existing homes in December pushed activity to the best level of 2019, although it did not represent a cyclical high, as seven observations in the current expansion were higher. Most of the firmer readings in earlier months were only marginally better; the strongest results (5.64 million units, annual rate, in January and November 2017) were 1.8% above the December total. The National Association of Realtors again cited tight inventories as a constraint on sales, and conditions tightened even further in December, as the number of homes on the market fell 14.6%. This series is not seasonally adjusted, and inventories typically fall in the final month of the year, but the latest drop was noticeably larger than the average of 10.0% in the prior 10 years. The months' supply of homes moved to 3.0 months, a new record low.
Leading Indicators (December)	**-0.3%**	**-0.2%**	Negative contributions from initial claims for unemployment insurance, the ISM new orders index, and building permits more than offset positive contributions from stock prices, the leading credit index, and consumer expectations, generating the fourth decline in the past five months. Recent softness has offset the modest advance in the early months of 2019, leaving the index in December little changed from readings in the closing months of 2018.

Sources: National Association of Realtors (Existing Home Sales); The Conference Board (Leading Indicators); Consensus forecasts are from Bloomberg

Preview

Week of Jan. 27, 2020	Projected	Comments
New Home Sales (December) (Monday)	**0.725 Million (+0.8%)**	Like other housing-related statistics, sales of new homes will probably show a firm response to low interest rates. If the forecast proves accurate, the four strongest observations of the current expansion will have occurred since June.
Durable Goods Orders (December) (Tuesday)	**0.3%**	Manufacturing activity has stabilized in recent months after losing ground in the early portion of 2019, but its sideways movement is not likely to lead to notable growth in order flows. Most industries are likely to post soft results, although bookings for defense-related aircraft are likely to jump back to their normal level after a weak tally in November.
Conference Board Consumer Confidence (January) (Tuesday)	**128.0 (+1.2%)**	With stock prices moving to record levels, and with tensions relating to trade and geopolitical issues receding, consumer confidence is likely to move from the low portion to the middle of the recent range.
U.S. International Trade in Goods (December) (Wednesday)	**-$65.5 Billion ($2.5 Billion Wider Deficit)**	The downward trend in imports since late 2018 probably reflects the influence of tariffs, but the sharp declines in the past three months also probably contained an element of random volatility which could be reversed in December. A pickup in imports, along with a continued downward drift in exports, should lead to a wider trade deficit.
GDP (2019-Q4) (Thursday)	**2.3%**	Inventory investment is likely to make a large negative contribution to economic activity in the final quarter of 2019, and business fixed investment is likely to disappoint again. However, notable softness in imports should lead to a large positive contribution from net exports, and residential construction should advance briskly for the second consecutive quarter. Heavy defense spending could lead to firm results in the government sector, while consumer spending appears to have grown moderately.
Personal Income, Consumption, Prices (December) (Friday)	**0.2%, 0.3%, 0.1%**	A below-average increase in employment and a modest advance in average hourly earnings will probably lead to slow growth in wages and salaries. A drop in farm income after unusually strong results in November (likely related to subsidy payments) also should constrain income, and interest income is likely to be soft as well. On the expenditure side, moderate growth in outlays for nondurable goods and services should more than offset auto-related softness in spending on durable goods. Results for the CPI suggest a tame reading on the PCE price index.
Employment Cost Index (2019-Q4) (Friday)	**0.7%**	Average hourly earnings from the monthly employment report suggest that the growth of the employment cost index will remain within the recent range of observations.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2020

Monday	Tuesday	Wednesday	Thursday	Friday
20	21	22	23	24
MARTIN LUTHER KING JR. DAY		**CHICAGO FED NATIONAL ACTIVITY INDEX** Monthly / 3-Mo. Avg. Oct -0.74 -0.36 Nov 0.41 -0.31 Dec -0.35 -0.23 **FHFA HOME PRICE INDEX** Sept 0.8% Oct 0.4% Nov 0.2% **EXISTING HOME SALES** Oct 5.44 million Nov 5.35 million Dec 5.54 million	**INITIAL CLAIMS** Jan 04 214,000 Jan 11 205,000 Jan 18 211,000 **LEADING INDICATORS** Oct -0.2% Nov 0.1% Dec -0.3%	
27	28	29	30	31
NEW HOME SALES (10:00) Oct 0.710 million Nov 0.719 million **Dec 0.725 million**	**DURABLE GOODS ORDERS (8:30)** Oct 0.2% Nov -2.1% **Dec 0.3%** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Sept 0.3% 0.1% Oct 0.4% 0.1% Nov -- -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Nov 126.8 Dec 126.5 **Jan 128.0** **FOMC MEETING**	**U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Oct -\$66.7 billion Nov -\$63.0 billion **Dec -\$65.5 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail Oct 0.1% 0.1% Nov -0.1% -0.8% Dec -- -- **PENDING HOMES SALES (10:00)** Oct -1.3% Nov 1.2% Dec -- **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **GDP (8:30)** GDP / Chained Price 19-Q2 2.0% 2.4% 19-Q3 2.1% 1.8% **19-Q4 2.3% 2.0%**	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Oct 0.1% 0.3% 0.1% Nov 0.5% 0.4% 0.1% **Dec 0.2% 0.3% 0.1%** **EMPLOYMENT COST INDEX (8:30)** Comp. / Wages 19-Q2 0.6% 0.7% 19-Q3 0.7% 0.9% **19-Q4 0.7% 0.7%** **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index / Prices Nov 46.7 53.8 Dec 48.2 58.1 Jan -- -- **REVISED CONSUMER SENTIMENT (10:00)** Nov 96.8 Dec 99.3 Jan(p) 99.1
3	4	5	6	7
ISM INDEX **CONSTRUCTION SPEND.** **VEHICLE SALES**	**FACTORY ORDERS**	**ADP EMPLOYMENT REPORT** **TRADE BALANCE** **ISM NON-MFG INDEX**	**INITIAL CLAIMS** **PRODUCTIVITY & COSTS**	**EMPLOYMENT REPORT** **WHOLESALE TRADE** **CONSUMER CREDIT**
10	11	12	13	14
	NFIB SMALL BUSINESS OPTIMISM INDEX **JOLTS DATA**	**FEDERAL BUDGET**	**INITIAL CLAIMS** **CPI**	**RETAIL SALES** **IMPORT/EXPORT PRICES** **IP & CAP-U** **CONSUMER SENTIMENT** **BUSINESS INVENTORIES**

Forecasts in Bold. (p) = preliminary

Daiwa Capital Markets

Treasury Financing

January/February 2020

<table>
<tr><th>Monday</th><th>Tuesday</th><th>Wednesday</th><th>Thursday</th><th>Friday</th></tr>
<tr><td>20</td><td>21</td><td>22</td><td>23</td><td>24</td></tr>
<tr>
<td>MARTIN LUTHER KING JR. DAY</td>
<td>AUCTION RESULTS:
Rate / Cover
13-week bills 1.530% 3.00
26-week bills 1.520% 3.20
ANNOUNCE:
$40 billion 4-week bills for auction on January 23
$40 billion 8-week bills for auction on January 23
SETTLE:
$35 billion 4-week bills
$35 billion 8-week bills</td>
<td></td>
<td>AUCTION RESULTS:
Rate / Cover
4-week bills 1.500% 3.10
8-week bills 1.540% 2.82
10-yr TIPS 0.036% 2.33
ANNOUNCE:
$84 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</td>
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<tr><td>27</td><td>28</td><td>29</td><td>30</td><td>31</td></tr>
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<td>AUCTION:
$84 billion 13-,26-week bills
$40 billion 2-year notes
$41 billion 5-year notes</td>
<td>AUCTION:
$26 billion 52-week bills
$20 billion 2-year FRNs
$32 billion 7-year notes
ANNOUNCE:
$45 billion* 4-week bills for auction on January 30
$40 billion* 8-week bills for auction on January 30
SETTLE:
$40 billion4-week bills
$40 billion 8-week bills</td>
<td></td>
<td>AUCTION:
$45 billion* 4-week bills
$40 billion* 8-week bills
ANNOUNCE:
$84 billion* 13-,26-week bills for auction on February 3
SETTLE:
$84 billion 13-,26-week bills
$26 billion 52-week bills</td>
<td>SETTLE:
$14 billion 10-year TIPS
$20 billion 2-year FRNs
$40 billion 2-year notes
$41 billion 5-year notes
$32 billion 7-year notes</td>
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<tr><td>3</td><td>4</td><td>5</td><td>6</td><td>7</td></tr>
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<td>AUCTION:
$84 billion* 13-,26-week bills</td>
<td>ANNOUNCE:
$45 billion* 4-week bills for auction on February 6
$40 billion* 8-week bills for auction on February 6
SETTLE:
$45 billion* 4-week bills
$40 billion* 8-week bills</td>
<td>ANNOUNCE:
$38 billion* 3-year notes for auction on February 11
$27 billion* 10-year notes for auction on February 12
$19 billion* 30-year bonds for auction on February 13</td>
<td>AUCTION:
$45 billion* 4-week bills
$40 billion* 8-week bills
ANNOUNCE:
$84 billion* 13-,26-week bills for auction on February 10
SETTLE:
$84 billion* 13-,26-week bills</td>
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<td>AUCTION:
$38 billion* 3-year notes
ANNOUNCE:
$45 billion* 4-week bills for auction on February 11
$40 billion* 8-week bills for auction on February 11
SETTLE:
$45 billion* 4-week bills
$40 billion* 8-week bills</td>
<td>AUCTION:
$27 billion* 10-year notes</td>
<td>AUCTION:
$45 billion* 4-week bills
$40 billion* 8-week bills
$19 billion* 30-year bonds
ANNOUNCE:
$84 billion* 13-,26-week bills for auction on February 18
$8 billion* 30-year TIPS for auction on February 20
SETTLE:
$84 billion* 13-,26-week bills</td>
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*Estimate