Daiwa Capital Markets

U.S. Economic Comment

- The current U.S. economic setting: muddled, but still reasonably firm
- The Fed's policy review: clues on upcoming changes

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Recent Economic Statistics: More Favorable than Unfavorable

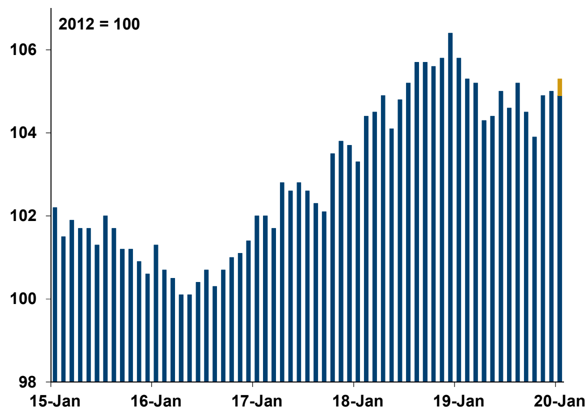
The preliminary estimates of the Markit purchasing managers indexes released on Friday caused a stir in financial markets, as the manufacturing index posted its third consecutive decline and approached the critical value of 50 percent (50.8 percent). The services index was more telling, as it dipped below 50 percent (49.4 percent).

While these figures were decidedly soft, we would interpret the declines cautiously. These measures are largely impressionistic; they are based more on the attitudes and perceptions of purchasing managers rather than hard data. If respondents become concerned about the current economic setting or the outlook, they might respond negatively even if underlying conditions have not changed. That could well be the case at this time, as stories related to the coronavirus may have swayed attitudes ahead of economic conditions and triggered negative responses.

More important, several other recent economic statistics have been surprisingly firm. The industrial production report for January, for example, had several encouraging elements. The headline measure fell 0.3 percent, but this was largely because of a weather-related decline in utility output. Mining activity rose sharply for the second consecutive month, and the manufacturing component fell only marginally despite a plunge in the aerospace component because of the halting of production of the 737 Max. Were it not for the retreat in aircraft production, the manufacturing component would have increased approximately 0.3 percent, suggesting stability or slight improvement in the manufacturing sector (chart, left).

The latest readings on regional manufacturing indexes also showed surprising strength (the Empire and Philadelphia indexes released by Federal Reserve Banks). We do not put much weight on these measures

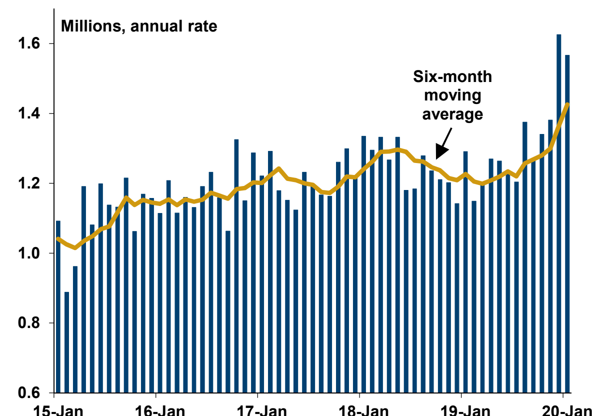
Industrial Production: Manufacturing*



The downward shifts in September and October 2019 reflect the effect of the strike at General Motors. The gold portion of the bar for January 2020 shows an addition to the level of the manufacturing component of industrial production had Boeing not suspended production of the 737 MAX aircraft.

Sources: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Housing Starts



Source: U.S. Census Bureau via Haver Analytics

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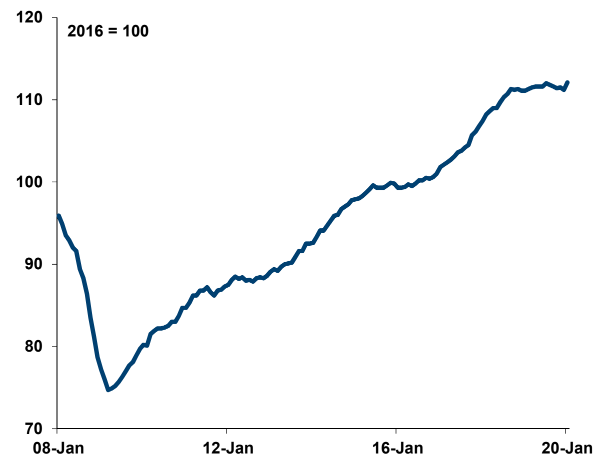
because of marked volatility, but neither do we ignore them, and recent results suggest favorable developments.

Housing activity has picked up, with starts increasing dramatically in December and January (chart, p. 1, right). Some observers attribute the increases to favorable weather, but we would not push this explanation too far. Temperatures were warmer than normal, but not dramatically so (less than one standard deviation from the mean in December and only 1.3 standard deviations in January). In addition, precipitation -- probably a more important consideration than temperature for housing starts -- was close to normal in December and heavier than normal in January. We suspect an element of statistical noise in recent results, but not enough to wipe away all of the recent gains. Housing certainly is not a problem at this time.

The index of leading economic indicators might serve as a convenient summary of recent economic statistics, and the January measure jumped 0.8 percent, a firm performance. The measure is less impressive when viewed from a longer perspective, as it had declined in four of the prior five months and it has posted only a marginal increase since late 2018 (chart). Also, it is a January tally, and fallout from the virus would have been minimal in this month. Nevertheless, the index suggests that the economy remained on track at the start of the year.

Index of Leading Economic Indicators



Source: The Conference Board Haver Analytics

The Fed's Strategic Framework

Apparent structural changes in the U.S. economy in the past several years have motivated Fed officials to review and most likely alter their policy framework. The level of neutral interest rates has trended lower, which has left the Fed with less space to offset a flagging economy with conventional policy tools. In addition, inflation dynamics seem to have changed, as price pressure is not reacting with much force to the ups and downs of the business cycle. In such an environment, officials are wise to consider changes in their policymaking process.

The review began early 2019 when the Fed initiated its so-called Fed Listens tours, a series of 14 seminars or town-hall meetings where officials received input from academics, market participants, and main-street individuals. Fed staff and policymakers are now reviewing the collected information and discussing potential changes in the Fed's policy framework. Officials intend to announce their conclusions and the resulting changes in the policy process around the middle of the year. Officials are considering shifts in three broad categories: strategy, policy tools, and communication practices. Minutes from recent FOMC meetings have offered summaries of the discussions in these areas. Officials have not made any decisions at this point, but the minutes offer hints on possible changes.

Strategy

In one sense, the strategy of monetary policy will not change dramatically. The Fed will continue to alter short-term interest rates in order to influence the pace of economic activity. However, with limited policy space because of low neutral interest rates, the Fed will probably behave differently than it has historically. The minutes have noted that the experience during the recession and its aftermath have led many officials to conclude that they should act early and aggressively to counter a slowdown in the economy. An alternative view might be to conserve limited policy space until decisive action is needed (a keep-your-powder-dry approach), but the minutes show strong support for early and aggressive action. This view also was

articulated by John Williams, President of the New York Fed, in a recent speech: "when you only have so much stimulus at your disposal, it pays to act quickly to lower rates at the first sign of economic distress."

The Fed also is likely to follow a different path in unwinding policy accommodation. Modest declines in short-term interest rates because of limited policy space might not provide much punch, but the muted impact can perhaps be offset by holding interest rates at a low level for a considerable period into the expansion phase of the cycle. "Lower for longer" represents a pithy summary of this aspect of the policy strategy.

Perhaps the most notable shift in policy strategy involves the role of the Fed's inflation target. Officials have already indicated that the target will remain at 2.0 percent as measured by the price index for personal consumption expenditures. However, they are considering steps that might be taken to offset past deviations from target -- so called makeup strategies. The most obvious approach to offsetting past deviations is to target average inflation over a long time frame; inflation of 1.5 percent in one period would be countered by inflation of 2.5 percent in some future period. This approach also could be couched in terms of targeting the level of the PCE price index, with the targeted level at different points in time consistent with a 2.0 percent inflation rate.

Minutes from recent FOMC meetings suggest that this approach did not receive enthusiastic support from Fed officials. Simulations from staff models showed that following makeup strategies did not meaningfully alter the course of the economy. In addition, officials felt that the effort would succeed only if the public understood the strategy and believed that officials would follow through with the plan -- and policymakers in the future might not feel compelled to adopt policies rooted in the past.

As an alternative to a makeup strategy, officials could adopt a target range for inflation rather than a single point -- inflation, say, of 1.5 to 2.5 percent rather than 2.0 percent. While not as precise as targeting average inflation of 2.0 percent over some specified period, it would allow officials to tolerate (even strive for) inflation above 2.0 percent if it had been below the mid-point for a time. The Fed also could adopt a strategy of flexible target ranges that would aid in signaling the FOMC's priorities and tolerance levels. For example, after a period of sub-two-percent inflation, the FOMC could set the range at 1-3/4 to 2-3/4 percent to show tolerance for high-side results on inflation. A shift to target ranges for inflation seems likely, as the issue received considerable discussion at the January FOMC meeting.

Tools

FOMC minutes show clearly that Fed officials believe that unconventional policies adopted during the recession (quantitative easing and forward guidance) helped to ease financial conditions and provided strong support to the economy. The framework that will be introduced later this year will most likely include these measures as standard items in the Fed's toolkit. They will not be the first line of defense against economic slowdowns -- lower interest rates will continue to fulfill that role -- but quantitative easing and forward guidance will no longer be billed as unconventional policies.

Forward guidance received careful attention at the October FOMC meeting, with officials considering three types of guidance: qualitative, date-based, and outcome based. Qualitative guidance offers nonspecific indications of the expected duration of a policy stance. This was the approach initially followed by the FOMC during and after the recession, with policy statements noting that accommodation would remain in place "for some time". The statement was subsequently strengthened by noting that easy policy would be in place "for an extended period". We suspect that officials will emphasize qualitative guidance, although there is no reason why they could not shift to date-based or outcome-based guidance at times. Indeed, the Fed eventually moved in this direction to push the economy forward in the early years of the recovery. In August 2011 the policy statement noted that low rates would be maintained "at least through mid-2013"; the time frame was later shifted to at least late 2014. The Fed also used outcome-based guidance, noting in December 2012 that accommodation would be appropriate at least as long as unemployment remains above 6-1/2 percent, especially if inflation remained contained.

Minutes from FOMC meetings note that research shows a wide range of estimates on the effectiveness of quantitative easing, but policymakers generally view the effort as providing solid support to the economy. Future efforts might have a smaller effect because interest rates are at a lower level than they were when the Fed first adopted the program, but we suspect that the Fed will move quickly to revive QE when short-term interest rates reach the zero lower bound.

Policymakers might become more adventuresome with QE, as officials have discussed the possibility of not only purchasing long-term securities to lower long-term interest rates, but also the possibility of pegging long rates at some specified level or establishing ceilings on long rates. We would be surprised if the Fed highlights such an approach when it introduces its new framework, but it could shift in this direction in the future if conditions were to become extreme.

The FOMC has discussed the possibility of adopting negative short-term interest rates as a policy target, but this possibility received a cool reception. Officials noted that foreign countries have not achieved great success with negative rates. In addition, negative interest rates could have detrimental side effects, such as restrained lending by financial institutions and distortions in financial markets. The FOMC is not likely to embrace negative interest rates as a policy tool.

The Fed staff briefed the FOMC on the possibility of reintroducing lending programs like those used during the recession and its aftermath, but the minutes have not mentioned discussion of such tools.

Communication

Fed officials believe that clear communication of objectives and plans are essential elements of an effective monetary policy. The Federal Reserve adopted a formal statement of its long-run goals and strategy in 2012 (subsequently amended), and this statement represents the starting point or foundation for the Fed's communication with the public. We expect the Fed to make a major revision to this statement when it introduces its revised policy framework.

The current statement acknowledges the Fed's statutory mandates of maximum employment, stable prices, and moderate long-term interest rates. Stable prices are defined as an inflation rate of 2.0 percent as measured by the price index for personal consumption expenditures, and the statement emphasizes that deviations both above and below the target are cause for concern. The statement does not specify a definition of maximum employment because that total will change over time and is determined by nonmonetary factors affecting the structure of the labor market. The Fed considers a wide range of indicators in making judgments about maximum employment.

The new statement it likely to be longer and more detailed than the current one. The FOMC minutes have noted several aspects of policy that might be mentioned in the revised document, such as the role of inflation expectations in setting policy and the time frame for meeting the Fed's objectives. The statement also might note structural changes in recent years and the complications that they generate for monetary policy, especially the apparent declines in neutral interest rates and the natural rate of unemployment.

We have not seen much discussion of major changes to other forms of communication from the FOMC. The Fed is likely to continue using the post-meeting policy statement and press briefing to announce changes in policy and to provide guidance on possible changes in the future.

The Minutes have noted that officials see the Summary of Economic Projections (SEP) as an effective means of communicating with the public, and it could well be enhanced. For example, it could provide more information on the distribution of views on the economy rather than the current procedure of showing only central tendencies. Market participants would like to see the specific forecasts of each Fed official, but policymakers might be reluctant to go this far in providing information.

While the Fed might provide more information on the forecasts for economic growth, inflation, and unemployment, we suspect that it might limit -- or change significantly -- the information it releases on the outlook for interest rates. Specifically, we suspect that the dot plot will either be discontinued or changed substantially. This plot at times has generated more confusion than insight, and it does not seem to have provided clear guidance on policy in coming months. FOMC minutes have not offered any information on possible changes to the dot plot, but we would be surprised if the Committee retained the current format.

Review

Week of Feb. 17, 2020	Actual	Consensus	Comments
Housing Starts (January)	**1.567 Million (-3.6%)**	**1.428 Million (-11.2%)**	Housing starts slipped in January, but the change occurred from an unusually strong reading in December. In addition, results in the prior two months were revised upward by the equivalent of 0.8 percentage point of growth. All told, the past two months easily represented the strongest showing of the current expansion, with the average number of starts in December and January 16.1% above the previous high for the current expansion. Single family starts fell 5.9% from the best level of the expansion thus far, but they remained above all other readings in the current cycle. Multi-family starts, already robust in December, rose 0.7% to a new high for the current cycle.
PPI (January)	**0.5% Total, 0.4% Core***	**0.1% Total, 0.1% Core***	Energy prices at the producer level slipped 0.7% in January, offsetting a portion of the jump of 1.5% in December and continuing along the irregular downward trend in place since late 2018. Food prices rose 0.2%, comfortably within the wide range of observations in the past year. Much of the surge in the core PPI reflected a jump of 0.7% in the service component after showing little net change in the second half of 2019. Core goods prices rose 0.3% after averaging monthly increases of less than 0.1% in 2019, influenced by high-side readings on prices for construction goods and goods purchased by governments. On a year-over-year basis, headline prices rose 2.1%, up eight ticks from the December reading but slower than the recent high of 3.4% in July 2018. Core prices rose 1.5% year-over-year, unchanged from December and below readings in the low-to-mid 2% area in early 2019.
Leading Indicators (January)	**0.8%**	**0.4%**	Sizable positive contributions from increases in building permits and stock prices and a decline in initial claims for unemployment insurance offset a negative contribution from a decline in the ISM new orders index in January. The latest shift did not signal a meaningful breakout from the flat trend in place since late 2018, but it did reverse all of the more recent downward drift in the series (slippage of 0.7% from August to December of 2019).
Existing Home Sales (January)	**5.46 Million (-1.3%)**	**5.44 Million (-1.8%)**	Sales of existing homes in January dipped from an elevated level but remained in the upper end of the range of the current expansion. Although the National Association of Realtors lauded the recent performance in existing home sales, elevated prices driven by limited inventories were cited as an ongoing constraint on the market. Although the inventory situation remained tight, the dip in sales led the months' supply of homes available for sale to rise 0.2 months to 3.3 months. However, the latest reading remained close to the historical low of 3.0 months registered in November 2019.

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

Sources: U.S. Census Bureau (Housing Starts); Bureau of Labor Statistics (PPI); The Conference Board (Leading Indicators); National Association of Realtors (Existing Home Sales); Consensus forecasts are from Bloomberg

Preview

Week of Feb. 24, 2020	Projected	Comments
Conference Board Consumer Confidence (February) (Tuesday)	**133.0 (1.1%)**	With the equity prices touching record highs in recent weeks, and with the labor market still firm, the Conference Board measure of consumer confidence is likely to post its fourth consecutive increase.
New Home Sales (January) (Wednesday)	**0.710 Million (+2.3%)**	Sales of new homes, which are based on contracts signed rather than closings, could respond to the drop in interest rates that unfolded in January. The expected pickup, if realized, would offset approximately half of the cumulative decline in the prior three months.
Durable Goods Orders (January) (Thursday)	**-2.0%**	Boeing orders eased from paltry in December to zero in January, which will probably lead to soft bookings for commercial aircraft. Bookings for defense-related aircraft will probably ease from their above-average level in December, and orders for miscellaneous transportations items (primarily ships and boats) could tumble after a spike in December. With the manufacturing sector soft, other areas are not likely to provide meaningful offsets to the expected weakness in the transportation component.
Revised GDP (2019-Q4) (Thursday)	**1.9% (-0.2 Pct. Pt. Revision)**	Business fixed investment is likely to be revised upward (i.e. show less of a decline), but downward adjustments to spending by consumers and state and local governments are likely to provide offsets and keep GDP growth close to the initial estimate of 2.1%.
Personal Income, Consumption, Core Prices (January) (Friday)	**0.3%, 0.3%, 0.2%**	Strong job growth in January should lead to a firm increase in wages, but investment income could be soft given a drop in interest rates and sluggish increases in dividends in recent months. On the spending side, the retail sales report suggested slow growth in spending on nondurable goods, but a pickup in sales of new vehicles should lead to respectable growth in outlays for durable goods, and growth in service expenditures should remain on their recent steady path. Results for the CPI suggest a moderate increase in the core PCE price index, although it would not be shocking to see the increase round up to 0.3%.
U.S. International Trade in Goods (January) (Friday)	**-$68.0 Billion ($0.7 Billion Narrower Deficit)**	Both exports and imports showed surprising breaks in December from their downward trends, but they will probably give back some of those gains in January. Imports seem to have more downside risk, as its underlying trend has been weaker than that for exports and its increase in December was larger. A sharper drop in imports would lead to a narrower trade deficit.
Revised Consumer Sentiment (February) (Friday)	**100.9 (Unrevised)**	The Coronavirus represents the most obvious factor that might shake confidence, but risks for U.S. individuals do not seem to have deepened in the past few weeks. Thus the sentiment index should be able to hold the preliminary estimate released on February 14.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

February/March 2020

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
PRESIDENTS' DAY	**EMPIRE MFG** Dec 3.3 Jan 4.8 Feb 12.9 **NAHB HOUSING INDEX** Dec 76 Jan 75 Feb 74 **TIC DATA** Total / Net Long-Term Oct -$57.1B $36.4B Nov $77.3B $27.1B Dec $78.2B $85.6B	**HOUSING STARTS** Nov 1.381 million Dec 1.626 million Jan 1.567 million **PPI** Final Demand / Core* Nov -0.1% -0.1% Dec 0.2% 0.2% Jan 0.5% 0.4% **FOMC MINUTES**	**INITIAL CLAIMS** Feb 01 203,000 Feb 08 206,000 Feb 15 210,000 **PHILLY FED INDEX** Dec 2.4 Jan 17.0 Feb 36.7 **LEADING INDICATORS** Nov 0.1% Dec -0.3% Jan 0.8%	**EXISTING HOME SALES** Nov 5.32 million Dec 5.53 million Jan 5.46 million
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Nov 0.41 -0.31 Dec -0.35 -0.23 Jan -- --	**FHFA HOME PRICE INDEX (9:00)** Oct 0.4% Nov 0.2% Dec -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Oct 0.5% 0.1% Nov 0.5% 0.1% Dec -- -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Dec 128.2 Jan 131.6 **Feb 133.0**	**NEW HOME SALES (10:00)** Nov 0.697 million Dec 0.694 million **Jan 0.710 million**	**INITIAL CLAIMS (8:30)** **DURABLE GOODS ORDERS (8:30)** Nov -3.1% Dec 2.4% **Jan -2.0%** **REVISED GDP (8:30)** GDP / Chained Price 19-Q3 2.1% 1.8% 19-Q4(a) 2.1% 1.4% **19-Q4(p) 1.9% 1.4%** **PENDING HOMES SALES (10:00)** Nov 1.2% Dec -4.9% Jan --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Nov 0.4% 0.4% 0.1% Dec 0.2% 0.3% 0.2% **Jan 0.3% 0.3% 0.2%** **U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Nov -$63.7 billion Dec -$68.7 billion **Jan -$68.0 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail Nov 0.1% -0.9% Dec -0.2% 0.0% Jan -- -- **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index / Prices Dec 48.2 58.1 Jan 42.9 56.1 Feb -- -- **REVISED CONSUMER SENTIMENT (10:00)** Dec 99.3 Jan 99.8 Feb(p) 100.9
2	3	4	5	6
ISM MFG INDEX **CONSTRUCTION SPEND.**	**VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **ISM NON-MFG INDEX** **BEIGE BOOK**	**INITIAL CLAIMS** **REVISED PRODUCTIVITY & COSTS** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **TRADE BALANCE** **WHOLESALE TRADE** **CONSUMER CREDIT**
9	10	11	12	13
	NFIB SMALL BUSINESS OPTIMISM INDEX	**CPI** **FEDERAL BUDGET**	**INITIAL CLAIMS** **PPI**	**IMPORT/EXPORT PRICES** **CONSUMER SENTIMENT**

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

Forecasts in Bold. (a) = advanced; (p) = preliminary

Treasury Financing

February/March 2020

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
PRESIDENTS' DAY	**AUCTION RESULTS:** Rate / Cover 13-week bills 1.545% 2.91 26-week bills 1.510% 3.09 21-day CMB 1.585% 2.71 **ANNOUNCE:** $50 billion 4-week bills for auction on February 20 $45 billion 8-week bills for auction on February 20 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills $38 billion 3-year notes $27 billion 10-year notes $19 billion 30-year bonds		**AUCTION RESULTS:** Rate / Cover 4-week bills 1.575% 2.69 8-week bills 1.570% 2.77 30-yr TIPS 0.261% 2.40 **ANNOUNCE:** $84 billion 13-,26-week bills for auction on February 24 $26 billion 52-week bills for auction on February 25 $18 billion 2-year FRNs for auction on February 26 $40 billion 2-year notes for auction on February 25 $41 billion 5-year notes for auction on February 26 $32 billion 7-year notes for auction on February 27 **SETTLE:** $84 billion 13-,26-week bills $40 billion 21-day CMBs	
24	25	26	27	28
AUCTION: $84 billion 13-,26-week bills	**AUCTION:** $26 billion 52-week bills $40 billion 2-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on February 27 $45 billion* 8-week bills for auction on February 27 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills	**AUCTION:** $18 billion 2-year FRNs $41 billion 5-year notes	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills $32 billion 7-year notes **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on March 2 **SETTLE:** $84 billion 13-,26-week bills $26 billion 52-week bills	**SETTLE:** $8 billion 30-year TIPS $18 billion 2-year FRNs
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	**ANNOUNCE:** $50 billion* 4-week bills for auction on March 5 $45 billion* 8-week bills for auction on March 5 **SETTLE:** $50 billion* 4-week bills $45 billion* 8-week bills		**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on March 9 $38 billion* 3-year notes for auction on March 10 $24 billion* 10-year notes for auction on March 11 $16 billion* 30-year bonds for auction on March 12 **SETTLE:** $84 billion* 13-,26-week bills	
9	10	11	12	13
AUCTION: $84 billion* 13-,26-week bills	**AUCTION:** $38 billion* 3-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on March 12 $45 billion* 8-week bills for auction on March 12 **SETTLE:** $50 billion* 4-week bills $45 billion* 8-week bills	**AUCTION:** $24 billion* 10-year notes	**AUCTION:** $50 billion* 4-week bills $45 billion* 8-week bills $16 billion* 30-year bonds **ANNOUNCE:** $84 billion* 13-,26-week bills for auction on March 16 $12 billion* 10-year TIPS for auction on March 19 **SETTLE:** $84 billion* 13-,26-week bills	

**Estimate*