U.S. Economic Comment

- Federal Reserve: policy in play this week
- Data watch: a dip in consumer sentiment, first sign of a virus effect

Michael Moran
Daiwa Capital Markets America
212-612-6392
michael.moran@us.daiwacm.com

The Federal Reserve: Further Accommodation, Perhaps Unconventional

The Federal Reserve took notable steps this past week to help financial markets cope with the tumultuous environment that has emerged because of the coronavirus. The Fed enlarged considerably the volume of repurchase agreements offered to primary dealers, and it altered its existing purchase program for Treasury securities by opening the full range of issues as eligible for purchase rather than Treasury bills only.

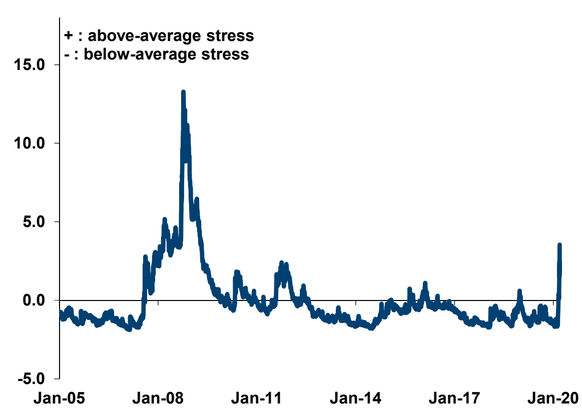
These actions were notable and market friendly, but we do not view them as efforts to provide accommodation. The new steps are not likely to have a meaningful influence on the level of interest rates, and they are not likely to stir the demand of individuals or businesses. In our view, the Fed took these steps to insure that financial markets function smoothly in the current volatile setting.

The enlarged RPs will promote calm trading in short-term fixed-income markets and avoid a replay of the erratic conditions that emerged last September. The extension of purchases across the full spectrum of Treasury securities will help prevent a tightening of liquidity in the bill market, where the recent trimming of issuance by the Treasury and heavy demand by risk-adverse investors have the potential to generate unsettled activity. The continued absorption of bills by the Fed would have worsened the situation. The extension also could help trading throughout the market. In fact, the Fed accelerated some of its planned purchases on Friday because of unusual trading conditions (pronounced volatility, wide bid-ask spreads, and wide spreads between off-the-run and on-the-run securities).

While the Fed's actions this week do not represent an easing in monetary policy, officials will most likely decide to provide additional accommodation at the meeting of the Federal Open Market Committee on March 17-18. After the rate cut of 50 basis points on March 3, we suspected that officials would not take additional steps until April. However, the economic outlook has shifted dramatically in the past two weeks. The tidal wave of cancellations and travel restrictions that has emerged recently insure that a demand shock will accompany the supply-side constraints generated by the coronavirus. While economic growth in Q1 is likely to be well maintained, it will be difficult to avoid a contraction in the economy in the second quarter, and the softness could continue into the third quarter.

The pronounced shift in financial markets also signals that trouble is on the horizon. The swoon in the equity market and the collapse in Treasury yields indicate that investors expect a downturn. A broader measure of financial stress, one tabulated daily by the Office of Financial Research at the Treasury Department, also shows a marked change in the environment. In addition to prices of equities and safe assets (Treasuries), this measure includes credit spreads and indexes of volatility and funding pressures. In late February, the measure indicated below-average stress in financial markets, but since then it has jumped to the highest level since the financial crisis.

Financial Stress Index



Source: Office of Financial Research, U.S. Treasury Department

It is difficult to envision the Fed staying on the sidelines at this juncture. Thus, we look for officials to cut interest rates again, probably 50 basis points. Such a change, though, is not likely to carry much force, as high interest rates are not an issue at this time, and lower rates are not likely to reduce the risk averse behavior that will be restraining demand.

Thus, we see a high probability that the Fed will include other changes. Many observers have expressed concern about declines in credit flows, and officials might simply encourage commercial banks to maintain existing credit standards. A more forceful action might be to encourage greater use of the discount window to promote loan flows. One option would be to restart the Term Auction Facility used during the financial crisis, where the Fed auctioned a fixed amount of funds through the discount window, with the auction facility reducing the stigma that ordinarily might inhibit borrowing. Perhaps the Fed could develop long-term lending programs to depository institutions similar to those offered by the Bank of England and the European Central Bank.

The Fed could explore direct lending programs to private sector entities other than depository institutions, although this avenue is restricted by provisions of the Dodd-Frank Act (such programs must be broad in their focus rather than targeted to a small group, and participants involved cannot be on the brink of insolvency).

We do not have deep insights into which unconventional track the FOMC might choose, but it seems like more than a cut of 50 basis point in short-term interest rates is needed.

The Fed's RPs: Overkill

The Fed acted aggressively in offering repurchase agreements to primary dealers, with $1.5 trillion of term transactions offered this week (one-month and three-month maturities). In addition, the Fed will be offering $500 billion of the one-month and three-month RPs in each of the next four weeks. If used to the max, the transactions would inject $5.5 trillion of reserves into the banking system -- a striking total, one exceeding the approximately $3.8 trillion of securities purchased under the three QE programs.

However, it seems as though dealers will not be utilizing the program to the max. In fact, interest was limited in the first three auctions. Dealers bid for only $78.4 billion of the $500 billion of three-month RPs offered on March 12. Interest in the one-month and three-month transactions on March 13 (both possibly $500 billion) was even more limited, with bids totaling $24.1 billion for the one-month RP and $17.0 billion for the three-month transaction.

The limited interest is a positive development in that it shows reasonably comfortable conditions in the funding markets. Chances of another episode like that in September seem limited.

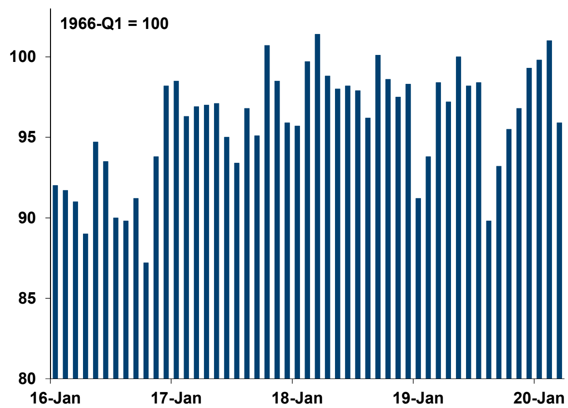
Data Watch: the First Hint of a Virus Effect

Economic reports though February were generally firm, with the weight of the evidence suggesting GDP growth in the neighborhood of 2.0 percent. We suspect that statistics for March will begin to turn, and the first hint of softness emerged on Friday with the drop of 5.0 percent in the consumer sentiment index published by the University of Michigan Survey Research Center. The drop was among the largest of the current expansion, although some months showed sharper deterioration. The level of the index was in the low portion of the recent range, although not the lowest: both January and August 2019 showed lower levels of sentiment, with volatility in the equity market the apparent trigger for these low readings (chart, next page, left).

The survey period covered the early portion of March, when the virus was the lead story in the news, and the shift in sentiment suggests that individuals are likely to be cautious in their spending (after panic buying of perceived essentials). We suspect that the revised measure published in two weeks will show an even larger drop in sentiment, as cancellations and warnings have intensified in recent days.

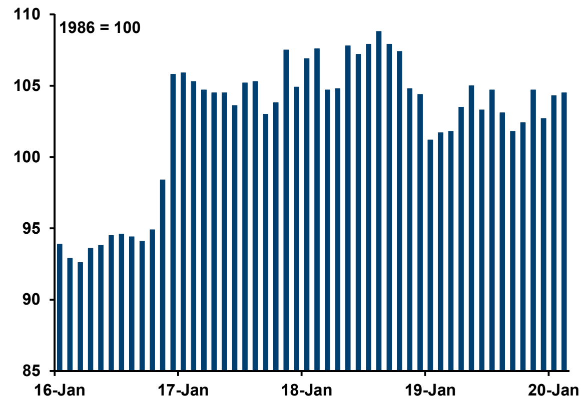
Earlier in the week, the National Federation of Independent Business, the trade association for small enterprises, published its measure of executive optimism, and this index held up well, posting a small increase and remaining comfortably within its recent range (chart, right). However, the survey period covered February, when most economic statistics were showing little or no sign of fallout from the virus. We suspect that the next survey will show some slippage.

Consumer Sentiment



Sources: University of Michigan Survey Research Center via Haver Analytics

Small Business Optimism Index



Source: National Federation of Independent Business via Haver Analytics

Review

Week of March 9, 2020	Actual	Consensus	Comments
Small Business Optimism Index (February)	**104.5 (+0.2%)**	**102.9 (-1.3%)**	Executives at small business establishments remained upbeat in February despite risks associated with the coronavirus, as the headline index of the National Federation of Independent Business remained comfortably within the recent range (above the average of 103.0 in 2019; shy of the average of 106.7 in 2018). The employment component was favorable with a reading of 21 (share planning an increase less share planning a reduction), up from 19 in January and equal to the best readings of 2019. Plans for capital spending were mildly disappointing, as the February reading fell two percentage points to 26 (share planning to make capital expenditures less share not planning), a reading in the low portion of the recent range.
CPI (February)	**0.1% Total, 0.2% Core**	**0.0% Total, 0.2% Core**	A drop of 2.0% in the energy component of the CPI was largely expected, but a jump of 0.4% in food prices -- one of the sharpest increases of the past several years – provided a surprise. The increase of 0.2% in core prices was in line with recent trends. The latest changes left the year-over-year increase in the headline index at 2.3%, down from 2.5% in January and well shy of the recent peak of 2.9% in the summer of 2018. The year-over-year change in the core index totaled 2.4%, up from 2.3% in January and equal to the recent peak in July 2018.
Federal Budget (February)	**$235.3 Billion Deficit**	**$236.8 Billion Deficit**	Federal revenues rose 12.4% on a year-over-year basis in February, led by sharp increases in individual income and payroll taxes as well as a decline in refunds paid to individuals. Outlays rose 5.5% from the same month last year, firm but lighter than the advance of 10.3% in the first four months of the fiscal year. The deficit for the first five months of FY2020 totaled $625 billion, $80 billion more than that in the same period in FY2019.
PPI (February)	**-0.6% Total, -0.1% Core***	**-0.1% Total, 0.1% Core***	The decline in the PPI in February reflected broad-based restraint across components. Energy prices fell 3.6%, continuing an up and down pattern that has left little net change in the past year (up only 0.3% in the past 12 months). Food prices declined 1.6%, reversing most of the upward pressure in the prior four months. Prices of items other than food and energy also declined (goods off 0.1% and services down 0.3%). On a year-over-year basis, the headline PPI rose 1.3%, down from 2.1% in January and off the recent high of 3.4% in July 2018. The core PPI rose 1.4% versus last February, one tick slower than the January result and sharply below readings centered around 3.0% in the second half of 2018.

Review Continued

Week of March 9, 2020	Actual	Consensus	Comments
Consumer Sentiment (March)	**95.9 (-5.0%)**	**95.0 (-5.9%)**	The drop of 5.0% in the consumer sentiment index suggests that individuals are concerned about the coronavirus and the drop in the equity market, although they are far from panicked. The headline index has moved below the averages of the past few years, but not dramatically so. Also, the level of the index has been lower in other recent months (both January and August 2019, when volatility in the equity market affected consumer attitudes). While the drop in early March was not alarming, many of the responses were probably received before the retreat in the stock market this week, raising the prospect of a downward revision in the report due on March 27.

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

Sources: National Association of Independent Business (Small Business Optimism Index); Bureau of Labor Statistics (CPI, PPI); U.S. Treasury Department (Federal Budget); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of March 16, 2020	Projected	Comments
Retail Sales (February) (Tuesday)	**0.1% Total, 0.1% Ex-Autos**	A dip in sales of new vehicles will probably lead to soft results in the auto component, and lower prices could dampen the value of sales at gasoline stations. Elsewhere, positive fundamentals for consumer spending will probably lead to respectable results. News of the coronavirus perhaps stirred precautionary buying at food stores and pharmacies.
Industrial Production (February) (Tuesday)	**0.4%**	A jump in factory employment and an increase in the length of the workweek probably led to a gain in the manufacturing component of IP. An increase in employment also suggests an advance in mining activity. Temperatures were warmer-than-normal in February, but by less so than they were in January. Thus, utility output is likely to pick up from its low level in the prior month.
Housing Starts (February) (Wednesday)	**1.475 Million (-5.9%)**	Low interest rates and firm sales of new homes will probably support single-family starts at a level close to that in January (second best of the current expansion, trailing only the lofty level in December), but the volatile multi-family sector is likely to cool from robust readings in December and January.
Current Account (2019-Q4) (Thursday)	**-$105.0 Billion ($19.1 Billion Narrower Deficit)**	A sharply narrower trade deficit and a modest changes in income flows suggest notable improvement in the current account deficit in Q4. The expected reading translates 1.9% of GDP, the best of the current expansion.
Leading Indicators (February) (Thursday)	**0.4%**	Positive contributions from increases in the manufacturing workweek, consumer expectations, and the leading credit index suggest a solid advance in the index of leading economic indicators in February after a jump of 0.8% in the prior month. The expected results for early 2020, if realized, will reverse the downward drift from the closing months of last year.
Existing Home Sales (February) (Friday)	**5.55 Million (+1.6%)**	A jump in pending home sales in January suggests that low interest rates and a firm job market have stirred housing activity, which should lead to a pickup in closings in February. The expected total represents the best showing since early 2018.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

March/April 2020

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
	NFIB SMALL BUSINESS OPTIMISM INDEX Dec 102.7 Jan 104.3 Feb 104.5	**CPI** Total Core Dec 0.2% 0.1% Jan 0.1% 0.2% Feb 0.1% 0.2% **FEDERAL BUDGET** FY2020 FY2019 Dec -$13.3B -$13.5B Jan -$32.6B $8.7B Feb -$235.3B -$234.0B	**INITIAL CLAIMS** Feb 22 219,000 Feb 29 215,000 Mar 07 211,000 **PPI** Final Demand Core* Dec 0.2% 0.2% Jan 0.5% 0.4% Feb -0.6% -0.1%	**IMPORT/EXPORT PRICES** Non-fuel Imports Nonagri. Exports Dec 0.1% -0.2% Jan 0.2% 0.7% Feb 0.3% -1.0% **CONSUMER SENTIMENT** Jan 99.8 Feb 101.0 Mar 95.9
16	17	18	19	20
EMPIRE MFG (8:30) Jan 4.8 Feb 12.9 Mar -- **TIC DATA (4:00)** Total Net L-T Nov $77.3B $27.1B Dec $78.2B $85.6B Jan -- --	**RETAIL SALES (8:30)** Total Ex.Autos Dec 0.2% 0.6% Jan 0.3% 0.3% **Feb 0.1% 0.1%** **IP & CAP-U (9:15)** IP Cap.Util. Dec -0.4% 77.1% Jan -0.3% 76.8% **Feb 0.4% 77.1%** **BUSINESS INVENTORIES (10:00)** Inventories Sales Nov -0.2% 0.5% Dec 0.0% 0.1% **Jan -0.1% 0.4%** **JOLTS DATA (10:00)** Openings (000) Quit Rate Nov 6,787 2.3% Dec 6,423 2.3% Jan -- -- **NAHB HOUSING INDEX (10:00)** Jan 75 Feb 74 Mar -- **FOMC MEETING**	**HOUSING STARTS (8:30)** Dec 1.626 million Jan 1.567 million **Feb 1.475 million** **FOMC DECISION (2:00)**	**INITIAL CLAIMS (8:30)** **CURRENT ACCOUNT (8:30)** 19-Q2 -$125.2 bill. 19-Q3 -$124.1 bill. **19-Q4 -$105.0 bill.** **PHILLY FED INDEX (8:30)** Jan 17.0 Feb 36.7 Mar -- **LEADING INDICATORS (10:00)** Dec -0.3% Jan 0.8% **Feb 0.4%**	**EXISTING HOME SALES (10:00)** Dec 5.53 million Jan 5.46 million **Feb 5.55 million**
23	24	25	26	27
CHICAGO FED NATIONAL ACTIVITY INDEX	**NEW HOME SALES**	**DURABLE GOODS ORDERS** **FHFA HOUSE PRICE INDEX**	**INITIAL CLAIMS** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **REVISED Q4 GDP**	**PERSONAL INCOME, CONSUMPTION, CORE PRICES** **REVISED CONSUMER SENTIMENT**
30	31	1	2	3
PENDING HOME SALES	**S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CHICAGO PURCHASING MANAGERS' INDEX** **CONSUMER CONFIDENCE**	**ADP EMPLOYMENT REPORT** **CONSTRUCTION SPEND.** **ISM MANUFACTURING INDEX** **VEHICLE SALES**	**INITIAL CLAIMS** **TRADE BALANCE** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **ISM NONMANUFACTURING INDEX**

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

Treasury Financing

March/April 2020

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
AUCTION RESULTS: Rate Cover 13-week bills 0.390% 2.74 26-week bills 0.400% 2.60	**AUCTION RESULTS:** Rate Cover 3-year notes 0.563% 2.20 **ANNOUNCE:** $50 billion 4-week bills for auction on March 12 $40 billion 8-week bills for auction on March 12 **SETTLE:** $50 billion 4-week bills $45 billion 8-week bills	**AUCTION RESULTS:** Rate Cover 10-yr notes 0.849% 2.36	**AUCTION RESULTS:** Rate Cover 4-week bills 0.395% 2.51 8-week bills 0.290% 2.97 30-yr bonds 1.320% 2.36 **ANNOUNCE:** $78 billion 13-,26-week bills for auction on March 16 $12 billion 10-year TIPS for auction on March 19 **SETTLE:** $78 billion 13-,26-week bills	
16	17	18	19	20
AUCTION: $78 billion 13-,26-week bills **SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**ANNOUNCE:** $50 billion* 4-week bills for auction on March 19 $40 billion* 8-week bills for auction on March 19 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills		**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $12 billion 10-year TIPS **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on March 23 $26 billion* 52-week bills for auction on March 24 $18 billion* 2-year FRNs for auction on March 25 $40 billion* 2-year notes for auction on March 24 $41 billion* 5-year notes for auction on March 25 $32 billion* 7-year notes for auction on March 26 **SETTLE:** $78 billion 13-,26-week bills	
23	24	25	26	27
AUCTION: $78 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 March 26 $40 billion* 8-week bills for auction on March 26 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills	**AUCTION:** $41 billion* 5-year notes $18 billion* 2-year FRNs	**AUCTION:** $50 billion* 4-week bills $40 billion* 8-week bills $32 billion* 7-year notes **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on March 30 **SETTLE:** $78 billion* 13-,26-week bills $26 billion* 52-week bills	**SETTLE:** $18 billion* 2-year FRNs
30	31	1	2	3
AUCTION: $78 billion* 13-,26-week bills	**ANNOUNCE:** $40 billion* 4-week bills for auction on April 2 $35 billion* 8-week bills for auction on April 2 **SETTLE:** $50 billion* 4-week bills $40 billion* 8-week bills $12 billion 10-year TIPS $40 billion* 2-year notes $41 billion* 5-year notes $32 billion* 7-year notes		**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on April 6 $38 billion* 3-year notes for auction on April 7 $24 billion* 10-year notes for auction on April 8 $16 billion* 30-year bonds for auction on April 9 **SETTLE:** $78 billion* 13-,26-week bills	

**Estimate*