U.S. Economic Comment

- Covid acceleration: modest economic fallout thus far
- Fed balance sheet: favorable shrinkage…
- …perhaps the Fed has done too much

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U.S. Economy: Not in Retreat

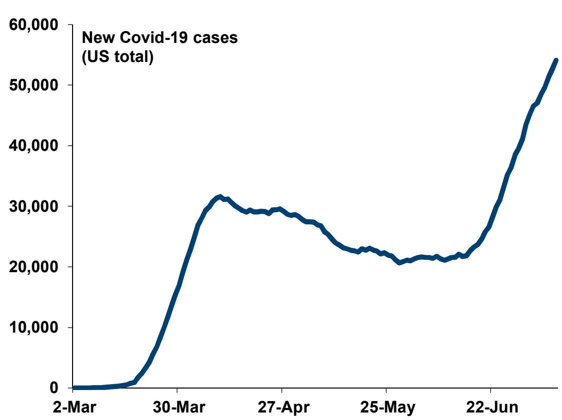
An easing in the number of new Covid-19 cases from mid-April through mid-June seemed to put the U.S. economy on track for a brisk recovery. Most of the economic statistics for May were strong, and the available figures suggest that the recovery extended into June. However, the spread of the virus turned upward in mid-June and has gathered momentum recently (chart), possibly short-circuiting the nascent recovery.

Risks have shifted to the downside, but they do not seem to be as intense as those in March and April. Many businesses seem to be altering work environments to protect workers and customers rather than shutting down completely. Many individuals seem willing to venture out cautiously (with mask and social distance) rather than to remain holed-up; some are willing to venture out recklessly. Against this background, the economic fallout is likely to be less pronounced than it was in March and April.

The available economic statistics, while limited, tend to support the view of modest influence thus far. Two of the riskiest activities from the perspective of virus exposure are flying in an airplane and eating in a restaurant. Both have picked up since the economy began to reopen in May and neither has retreated meaningfully in recent weeks. Airport throughput (the number of individuals passing through a TSA checkpoint) has continued to drift higher, as has the number of seatings at restaurants as reported by OpenTable (charts, P. 4).

The Labor market has softened, but only slightly so. Claims for unemployment insurance (both initial and continuing) are moving lower, although the rate of improvement has slowed. Declines in initial claims have been modest in the past four weeks, and the improvement in continuing claims (the number of individuals receiving unemployment benefits) has been slow and irregular, but nevertheless, they are improving rather than deteriorating.

New Covid-19 Cases in the U.S.



Source: Johns Hopkins University and Medicine Coronavirus Resource Center via Bloomberg

Homebase, a firm providing payroll and other services to small businesses, has started to publish various statistics providing insights into the pace of activity among its clients. The number of workers at small businesses reported by Homebase has drifted lower in the past few weeks, but the change has been modest, certainly not enough to suggest a major turn in the labor market. These figures, however, are available only with a two week lag; the latest reading in the chart on page 4 is for June 25.

A new statistic produced by the Federal Reserve Bank of New York provides the broadest view of recent economic activity, as it is based on 10 high-frequency (i.e. daily or weekly) indicators covering consumer behavior, employment, and production. This measure is presented as an estimate of GDP growth over the latest four quarters. As shown in the final chart on page 4, this measure has dipped in the latest week, but the change was modest.

Of course, it's early and the softness could intensify, but the available data suggest that the recovery has not derailed.

Good News: The Fed's Balance Sheet is Shrinking

The Federal Reserve responded aggressively to the pandemic, as shown by the low level of interest rates that has been in place for the past several months and by a surge in the size of the Fed's balance sheet since mid-March. Interestingly, The Fed's balance sheet has recently shifted direction recently, shrinking in each of the past four weeks. The magnitude of the change has been small, and the size of the balance is still far larger than it was before the Fed's easing campaign. Nevertheless, it has changed.

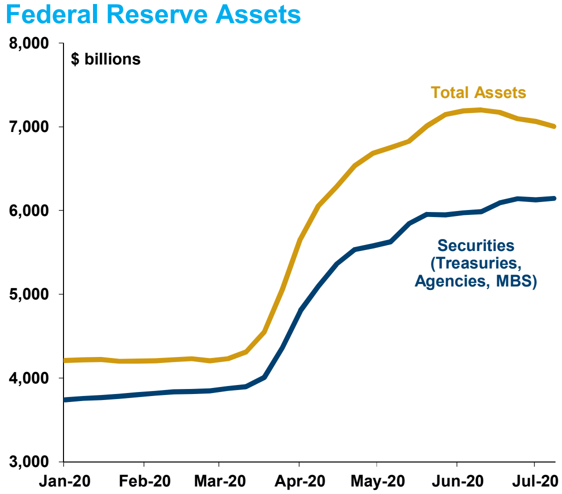
The Fed is still buying securities in the open market, but the volume is light (an average of $29 billion in the past six weeks versus an average of $272 billion in the six weeks from mid-March through April). The decline in the size of the balance sheet has largely been the result of diminished activity in the lending programs designed to address dysfunction in fixed-income markets in March. (The market for Treasury securities experienced a breakdown of sorts in March, as trading activity slowed and interest rates jumped despite an apparent flight to quality. Wide bid-ask spread also signaled problems, has dealers became hesitant to provide needed liquidity. Potential difficulty in funding positions seemed to be a factor constraining liquidity.)

The volume of repurchase transactions arranged by the Fed with primary dealers has declined noticeably, as has the use of the primary dealer credit facility, signaling calm conditions in the RP market and little difficulty in funding positions. Dollar funding in foreign markets also seems more readily available, as the liquidity swap programs of the Fed with foreign central banks has declined sharply. The Fed encouraged commercial banks to use their privilege of borrowing at the discount window, and they did for a time, but such activity as eased noticeably in recent weeks.

Use of the borrowing facilities for private-sector entities and state and local governments has picked up in recent weeks, but the volumes have been underwhelming. Activity associated with the Paycheck Protection Program has jumped, but the total of $68 billion is light relative to the more than $500 billion advanced by the Small Business Administration. The primary and secondary market credit programs for corporations now total $42 billion, well shy of the $750 billion potential. The Main Street lending programs, with a capacity of $600 billion, have accumulated only $38 billion.

Admittedly, several of the lending programs have been operational for only a short time; volumes could pickup in coming weeks. However, we suspect that activity will remain light, and we view the restrained demand for the facilities as favorable news, as the decline in the volume of RP transactions and the limited use of lending facilities suggest that the financial environment has improved since March. The private sector seems capable of providing the financial support needed to sustain the recovery. The calm environment now evident could lead the Fed to end its quantitative easing before too long. The market seems to be doing fine on its own; continuing with QE might be going too far in providing support.

Federal Reserve Assets



Source: Federal Reserve Board via Haver Analytics

Has the Fed Done Too Much?

From a broader perspective, one might wonder if the balance sheet of the Fed that has evolved from its efforts during the financial crisis and the pandemic is perhaps too large. That is, perhaps the Fed's presence in the financial markets has become excessive. In a webinar this week hosted by the Peterson Institute for International Economics, Peter Fisher, the former manager of the Federal Reserve's System Open Market Account, provided an interesting critique of the policy path that has evolved in the past 10 years or so.

Mr. Fischer argued that the large volume of reserves now in the banking system, which earn a respectable rate of interest, has constrained (almost eliminated) the volume of activity in the interbank lending market (i.e. the federal funds market). Commercial banks no longer have to manage reserve positions carefully. With abundant funds in the system, banks have little worry about falling short of regulatory reserve requirements (which the Fed eliminated in March) or amounts needed to clear transactions; at the same time, excessive holdings are not a concern because of the competitive rate paid on excess reserves.

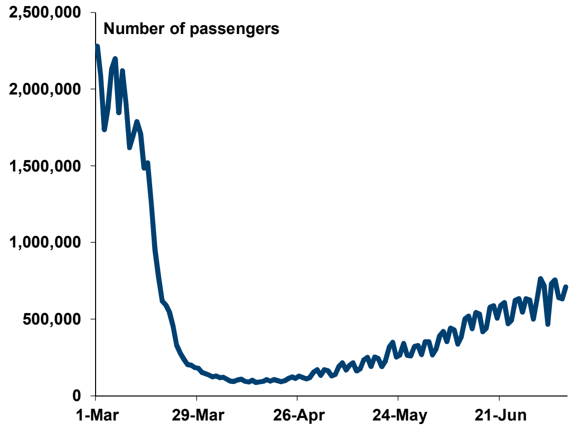
In years past, commercial banks had active, sophisticated trading desks to manage reserve positions, but these facilities are small and quiet today. The situation is as if commercial banks had comfortable bilateral trading arrangements with the Federal Reserve and had no need to participate in a broad market. The diminished activity in the broad market, in Mr. Fisher's view, has impaired the functioning of the interbank market and reduced the efficiency of the closely related market for repurchase agreements. Price signals that existed in the past and had the potential to limit the effects of shocks are no longer present; disruptions and the need for Fed support have replaced smooth market functioning.

Mr. Fisher also argued that the impairment of the interbank and RP markets was a factor behind the difficulties in the Treasury market during March. Marginal investors in the Treasury market (i.e. investors willing to alter positions, which generate needed liquidity in financial markets) to a large degree are leveraged investors, with the RP market providing the financing for levered positions. With the RP market less efficient than in the past, disruptions seep into the Treasury market.

Mr. Fisher and another participant in the webinar (Anil Kashyap of the University of Chicago Booth School of Business) both pointed to another factor that most likely played a role in the recent disruption in the Treasury market: the trading infrastructure for Treasury securities has not kept pace with the volume of outstanding Treasury securities. Unusually wide budget deficits during the financial crisis and still-hefty shortfalls in recent years have led to a marked increase in Treasury debt (even with the Fed absorbing some of that debt with its QE efforts). However, the number of primary dealers and the aggregate size of dealer balance sheets have not grown meaningfully in recent years. It is easy to envision bottlenecks: larger volumes of transactions flowing into unchanged trading conduits.

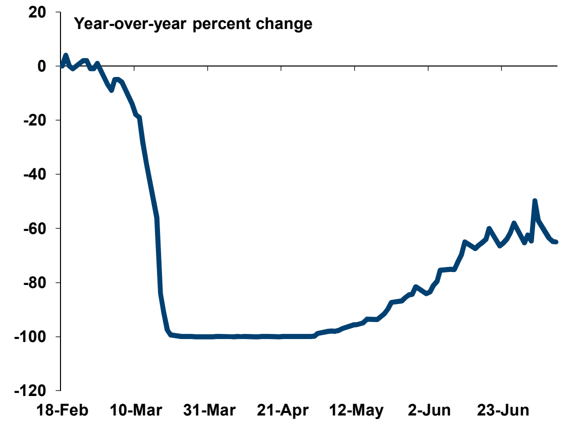
The discussion in the webinar was interesting, and in our view, not far-fetched. It is still available on line at the Peterson Institute for International Economics (The March 2020 Episode of Market Turmoil and Lessons for Future Financial Stability).

Airport Throughput*



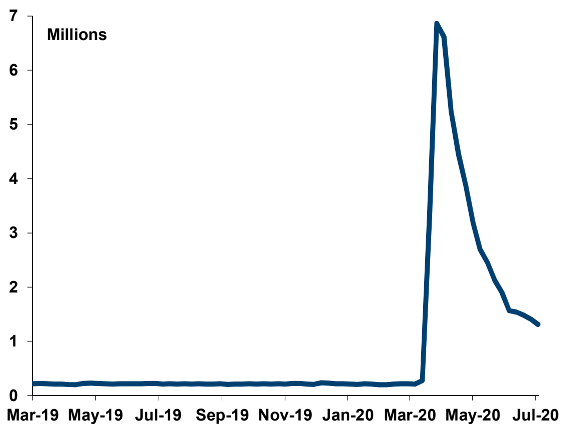
** The number of individuals passing through a TSA security checkpoint.*
Source: Transportation Security Administration via Bloomberg

Restaurant Seatings



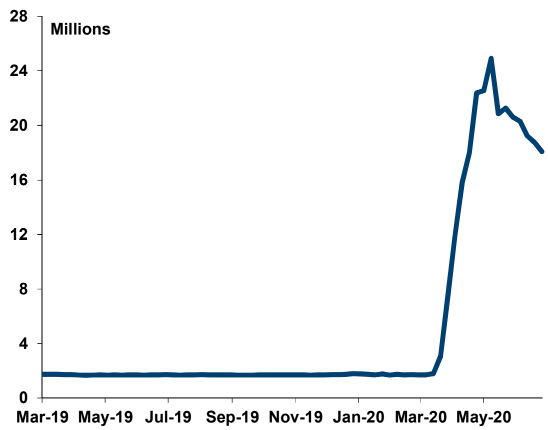
Source: OpenTable via Bloomberg

Initial Unemployment Claims



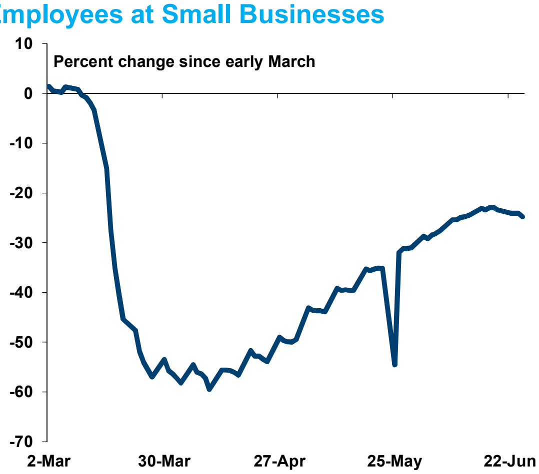
Source: Employment and Training Administration (Department of Labor) via Haver Analytics

Continuing Unemployment Claims*



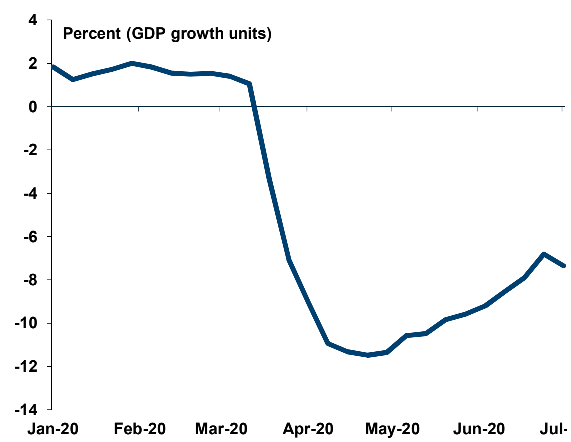
** The number of individuals receiving unemployment benefits*
Source: Employment and Training Administration (Department of Labor) via Haver Analytics

Employees at Small Businesses



Source: Homebase via Bloomberg

NY Fed Weekly Economic Index



Source: Federal Reserve Bank of New York

Review

Week of July 6, 2020	Actual	Consensus	Comments
ISM Nonmanufacturing Index (June)	**57.1% (+11.7 Percentage Pts.)**	**50.0% (+4.6 Percentage Pts.)**	The sizeable advance in the ISM nonmanufacturing index occurred despite a drop of 9.5 percentage points in the supplier delivery index, which moved close to its normal range after elevated readings in the prior few months triggered by virus-related disruptions to supply chains. Strong showings in both the new orders and business activity components drove the advance in the headline index (up 19.7 and 25.0 percentage points, respectively). Both measures exceeded 60%. The employment index showed a solid increase (11.3 percentage points), although it remained shy of 50% (43.1%).
Consumer Credit (May)	**-$18.3 Bill.**	**-$15.0 Bill.**	The drop in consumer spending because of virus-related lockdowns had a feedback effect on consumer credit, as borrowing in May fell for the third consecutive month (off $11.1 billion in March and $70.2 billion in April). Most of the softening was the result of a drop in credit card usage. Credit had been averaging increases of approximately $15 billion per month.
PPI (June)	**-0.2% Total, 0.3% Core***	**0.4% Total, 0.1% Core***	The PPI often provides surprises, and that was certainly the case in June. A surge of 7.7% in energy prices was in line with expectations, but a declines in the food, trade services, and construction categories more than offset the pressure in the energy sector. The drops of 5.2% in food prices and 1.8% in trade services seemed to represent a dose of the statistical noise that often infects the PPI, as the declines reversed upward pressure in prior months. Prices of trade services are excluded from the PPI definition of core, and absent the sharp decline, core prices jumped 0.3%. Prices of core goods were tame again, but the cost of services other than trade services jumped and pushed the core component higher.

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

Institute for Supply Management (ISM Nonmanufacturing Index); Federal Reserve Board (Consumer Credit); Bureau of Labor Statistics (PPI); Consensus forecasts are from Bloomberg

Preview

Week of July 13, 2020	Projected	Comments
Federal Budget (June) (Monday)	**$860 Billion Deficit**	Available data suggest that federal receipts will again be well shy of normal totals (off by more than 25% from the same month last year). In addition, federal spending to offset the effects of the coronavirus should have a sizeable presence again in June. Outlays by the Small Business Administration are likely to weigh heavily, as anticipated forgiveness of Paycheck Protection loans will be recorded as expenditures.
CPI (June) (Tuesday)	**0.5% Total, 0.2% Core**	Food prices could cool after marked upward pressure in the prior four months, but any constraining effect is likely to be overwhelmed by a gasoline-driven increase in energy prices. In the core area, still-soft demand should limit price increases, but some of the areas severely affected by the coronavirus could unwind a portion of the pronounced discounting in prior months (airfares, hotel fees, apparel prices).
Industrial Production (June) (Wednesday)	**4.5%**	A jump in factory employment and a longer workweek suggest that manufacturing production rose sharply. Utility output could increase slightly given an above-average number of cooling-degree days. A fifth consecutive drop in mining activity is likely to provide a partial offset to the improvements in manufacturing and utility production.
Retail Sales (June) (Thursday)	**4.0% Total, 4.0% Ex-Autos**	Some red-hot areas in May are likely to cool (building materials, food, sporting goods), but further rebounds from virus-led retrenchment in March and April should lift most components of retail sales.
Housing Starts (June) (Friday)	**1.200 Million (23.2%)**	After showing little response to an easing in lockdown restrictions and an increase in new home sales, housing starts are likely to jump in June.
Consumer Sentiment (July) (Friday)	**76.0 (-2.1 Index Pts.)**	Favorable economic statistics and stability in the stock market might bolster consumer attitudes, but the acceleration in the number of Covid cases is more likely to dampen moods.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July 2020

Monday 6

ISM NON-MFG INDEX

	Index	Prices
Apr	41.8	55.1
May	45.4	55.6
June	57.1	62.4

Tuesday 7

JOLTS DATA

	Openings (000)	Quit Rate
Mar	6,011	1.8%
Apr	4,996	1.4%
May	5,397	1.6%

Wednesday 8

CONSUMER CREDIT

Mar	-$11.1 billion
Apr	-$70.2 billion
May	-$18.3 billion

Thursday 9

UNEMPLOYMENT CLAIMS

	Initial	Continuing (Millions)
June 13	1.540	19.231
June 20	1.482	18.760
June 27	1.413	18.062
July 04	1.314	N/A

WHOLESALE TRADE

	Inventories	Sales
Mar	-1.1%	-5.1%
Apr	0.2%	-16.4%
May	-1.2%	5.4%

Friday 10

PPI

	Final Demand	Core*
Apr	-1.3%	-0.9%
May	0.4%	0.1%
June	-0.2%	0.3%

Monday 13

FEDERAL BUDGET (2:00)

	2020	2019
Apr	-$738.0B	$160.3B
May	-$398.8B	-$207.8B
June	**-$860.0B**	-$8.5B

Tuesday 14

NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)

Apr	90.9
May	94.4
June	--

CPI (8:30)

	Total	Core
Apr	-0.8%	-0.4%
May	-0.1%	-0.1%
June	**0.5%**	**0.2%**

Wednesday 15

IMPORT/EXPORT PRICES (8:30)

	Non-fuel Imports	Nonagri. Exports
Apr	-0.5%	-3.3%
May	0.1%	0.6%
June	--	--

EMPIRE MFG (8:30)

May	-48.5
June	-0.2
July	--

IP & CAP-U (9:15)

	IP	Cap.Util.
Apr	-12.5%	64.0%
May	1.4%	64.8%
June	**4.5%**	**68.5%**

BEIGE BOOK (2:00)

May Beige Book

"Economic activity declined in all Districts – falling sharply in most – reflecting disruptions associated with the COVID-19 pandemic."

Thursday 16

INITIAL CLAIMS (8:30)

RETAIL SALES (8:30)

	Total	Ex.Autos
Apr	-14.7%	-15.2%
May	17.7%	12.4%
June	**4.0%**	**4.0%**

PHILLY FED INDEX (8:30)

May	-43.1
June	27.5
July	--

BUSINESS INVENTORIES (10:00)

	Inventories	Sales
Mar	-0.3%	-5.2%
Apr	-1.4%	-14.4%
May	**-2.3%**	**8.3%**

NAHB HOUSING INDEX (10:00)

May	37
June	58
July	--

TIC DATA (4:00)

	Total	Net L-T
Mar	$355.3B	-$111.6B
Apr	$125.3B	-$128.4B
May	--	--

Friday 17

HOUSING STARTS (8:30)

Apr	0.934 million
May	0.974 million
June	**1.200 million**

CONSUMER SENTIMENT (10:00)

May	72.3
June	78.1
July	**76.0**

Monday 20

Tuesday 21

CHICAGO FED NATIONAL ACTIVITY INDEX

Wednesday 22

FHFA HOME PRICE INDEX

EXISTING HOME SALES

Thursday 23

INITIAL CLAIMS

LEADING INDICATORS

Friday 24

NEW HOME SALES

Monday 27

DURABLE GOODS ORDERS

Tuesday 28

S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX

CONSUMER CONFIDENCE

FOMC MEETING

Wednesday 29

U.S. INTERNATIONAL TRADE IN GOODS

ADVANCE INVENTORIES

PENDING HOME SALES

FOMC ANNOUNCEMENT

Thursday 30

INITIAL CLAIMS

GDP

Friday 31

PERSONAL INCOME, CONSUMPTION, PRICES

EMPLOYMENT COST INDEX

CHICAGO PMI

REVISED CONSUMER SENTIMENT

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

Treasury Financing

July 2020

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
AUCTION RESULTS: Rate Cover 13-week bills 0.150% 2.66 26-week bills 0.165% 2.81	**AUCTION RESULTS:** Rate Cover 42-day CMB 0.125% 3.32 119-day CMB 0.150% 3.18 3-year notes 0.190% 2.44 **ANNOUNCE:** $40 billion 4-week bills for auction on July 9 $40 billion 8-week bills for auction on July 9 $25 billion 105-day CMBs for auction on July 8 $30 billion 154-day CMBs for auction on July 8 **SETTLE:** $45 billion 4-week bills $45 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs	**AUCTION RESULTS:** Rate Cover 105-day CMB 0.145% 3.68 154-day CMB 0.155% 3.33 10-yr notes 0.653% 2.62	**AUCTION RESULTS:** Rate Cover 4-week bills 0.100% 3.18 8-week bills 0.120% 2.96 30-yr bonds 1.330% 2.50 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on July 13 $34 billion 52-week bills for auction on July 14 $35 billion 42-day CMBs for auction on July 14 $35 billion 119-day CMBs for auction on July 14 **SETTLE:** $105 billion 13-,26-week bills $35 billion 42-day CMBs $35 billion 119-day CMBs	
13	14	15	16	17
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $35 billion 42-day CMBs $35 billion 119-day CMBs $34 billion 52-week bills **ANNOUNCE:** $40 billion* 4-week bills for auction on July 16 $40 billion* 8-we16k bills for auction on July 9 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs	**SETTLE:** $46 billion 3-year notes $29 billion 10-year notes $19 billion 30-year bonds	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on July 20 $17 billion* 20-year bonds for auction on July 22 $14 billion* 10-year TIPS for auction on July 23 **SETTLE:** $105 billion 13-,26-week bills $34 billion 52-week bills $35 billion 42-day CMBs $35 billion 119-day CMBs	
20	21	22	23	24
AUCTION: $105 billion* 13-,26-week bills	**ANNOUNCE:** $40 billion* 4-week bills for auction on July 23 $40 billion* 8-week bills for auction on July 23 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills	**AUCTION:** $17 billion* 20-year bonds	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills $14 billion* 10-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on July 27 $24 billion* 2-year FRNs for auction on July 28 $48 billion* 2-year notes for auction on July 27 $49 billion* 5-year notes for auction on July 27 $44 billion* 7-year notes for auction on July 28 **SETTLE:** $105 billion* 13-,26-week bills	
27	28	29	30	31
AUCTION: $105 billion* 13-,26-week bills $48 billion* 2-year notes $49 billion* 5-year notes	**AUCTION:** $24 billion* 2-year FRNs $44 billion* 7-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on July 30 $40 billion* 8-week bills for auction on July 30 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills		**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on August 3 **SETTLE:** $105 billion* 13-,26-week bills	**SETTLE:** $17 billion* 20-year bonds $14 billion* 10-year TIPS $24 billion* 2-year FRNs $48 billion* 2-year notes $49 billion* 5-year notes $44 billion* 7-year notes

*Estimate