U.S. Economic Comment

- FOMC preview: a new view on QE; no urgency on forward guidance; …perhaps more information on the new long-run strategy
- Inflation expectations: the key variable in future Fed policy decisions

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Monetary Policy

The Federal Open Market Committee is not likely to meaningfully alter monetary policy at its meeting on September 15-16, although we can envision a modest change in the quantitative easing program. The Fed introduced its QE effort in March to promote the smooth functioning of financial markets. Market activity is now essentially normal, and therefore the Fed could end the program. However, quantitative easing also is helping to restrain long-term interest rates and providing support to the economy. Rather than dropping the effort, we look for the Fed to alter the rationale, billing it as another form of accommodation and providing information on the likely duration of the program. We would look for the Fed to continue purchasing securities at the current rate through the end of the year and to begin tapering next year.

The FOMC also might offer more explicit forward guidance on its interest rate stance. Currently, the Committee is quite vague on its policy plans, merely noting that it “expects to maintain this target range [0-0.25 percent on the federal funds rate] until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.” Officials have discussed providing more definitive guidance at recent FOMC meetings, most likely identifying some inflation threshold that would trigger an interest rate hike. However, there is no urgency to provide clearer direction at this time. With inflation currently below the 2.0 percent target, and with the Fed now receptive to overshooting its target to compensate for past misses, the Fed will not be raising interest rates any time soon.

While the upcoming meeting is likely to be underwhelming from a near-term policy perspective, we are hoping to learn more about the FOMC’s new long-run strategy. We suspect that Chair Powell will not offer much more than he did in his Jackson Hole speech on August 27, but we expect reporters at his press briefing to push hard for details.

Certainly, there is more to learn, as the new statement is vague in several respects. For example, the Fed opened the door to inflation running above the target of two percent, but the well-hedged wording left the Committee’s intentions less than clear. Consider this passage (emphasis added):

> …following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will **likely** aim to achieve inflation **moderately** above 2 percent **for some time**.

The inclusion of “likely” is curious, as it suggests that the Fed is not fully committed to targeting average inflation; there apparently will be circumstances when the FOMC seeks other goals or targets. The other two emboldened elements in the statement raise the obvious questions of how much above two percent will be sought and for how long. Of course, appropriate policy changes will vary with the situation, and the statement had to allow for flexibility. Still, the statement is bare-bones in the extreme; some detail could be added.

We viewed changes regarding the goal of maximum employment as more important than those for inflation. Chair Powell emphasized in his Jackson Hole speech a modest wording change that carried great import: the Fed will now seek to minimize **shortfalls** from maximum employment rather than **deviations**. That is, the Fed is willing to ease policy when employment is believed to be below its maximum level, but officials will not be

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alarmed by low unemployment and they will not resist labor market strength unless it is accompanied by evidence of accelerating inflation. The Fed will allow the labor market to run hot.

Another change relating to the employment goal received less attention in Mr. Powell's speech and in the financial press, but it also is important. The new statement indicates that maximum employment is "a broad-based and inclusive goal." This characterization implies that the Fed now sees itself as playing a role in boosting underserved communities and racial and ethnic groups. Historically, the Fed has steered clear of such issues, believing that it did not have the tools to address the underlying problems. Partly because of information gathered in the *Fed Listens* tour, officials now believe they can have an effect. The statement implies that officials have taken on an obligation to address inequalities.

This new self-imposed mandate adds a wrinkle to Fed watching, as analysts will need to discern various measures of labor-market inclusiveness monitored by the Fed. The strategy statement noted that officials will monitor "a wide range of indicators" in assessing progress toward maximum employment, but it offered no clues on what the Fed might be watching. Thus, there will be a learning curve to climb.

We also took note of another new provision in the strategy statement:

> …sustainably achieving maximum employment and price stability depends on a stable financial system. Therefore, the Committee's policy decisions [will] reflect…risks to the financial system that could impede the attainment of the Committee's goals.

In one sense, this addition is not especially notable, as Fed officials have stepped in numerous times to assure smooth functioning of financial markets. The restart of quantitative easing in March represented the latest example, but one does not have to think long to recall other examples (2008 financial crisis, Long-Term Capital Management). Still, the addition at this time leads one to wonder if the Fed plans to be more active in support of financial markets or more preemptive in preventing instability. The new strategy seems to have given financial stability a higher priority than in the past. We will be anxious to see if, and how, it affects Fed behavior.

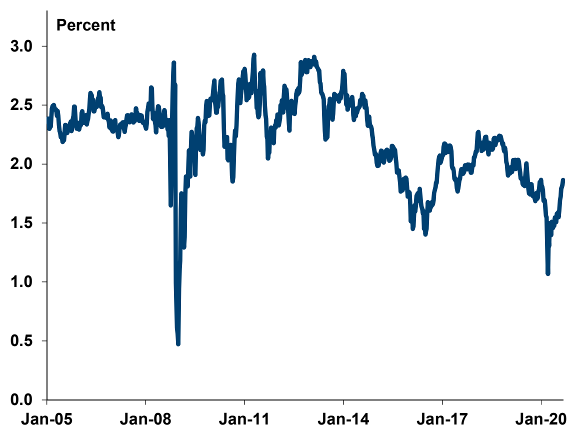
An Elevated Role for Inflation Expectations

The new strategy of the Fed suggests that market participants should be paying heed to new indicators related to employment diversity and financial stability. In addition, analysts and investors can perhaps lighten their focus on overall employment or unemployment because it will be playing a limited and asymmetric role in policy decisions, prompting easier policy in slow environments but carrying little or no influence during robust periods. Inflation is likely to be the key consideration in setting monetary policy, and inflation expectations are likely to be the most important consideration in gauging inflation risks.

A heightened role for inflation expectations can be surmised from the inflation model that was at the heart of Fed thinking in the past. Former Fed Chair Janet Yellen gave a couple of technical speeches during her term on inflation dynamics, and her view provides interesting insights into the situation today. Chair Yellen emphasized three key variables that drive inflation. Inflation expectations serve as the foundation in her model, as this variable determines the underlying inflation rate. Two other variables, then, generate fluctuations around this trend: slack and idiosyncratic factors. Slack can be measured by deviations of employment from perceived measures of full employment (or deviations of real GDP from its potential); idiosyncratic factors can cover a long list of items, but shifts in the prices of food, energy, and imports are the most common.

The inflation model today would be different in that slack would either be dropped or given a modest weight, as Fed officials have concluded that slack has had a minimal influence on wage growth or inflation in recent years. Elevated unemployment during the financial crisis did not drive inflation lower, and the decades-low level of unemployment in the prior few years did not push wage growth and inflation higher. Thus, one is left with inflation expectations and idiosyncratic factors as the key determinants of inflation, and idiosyncratic

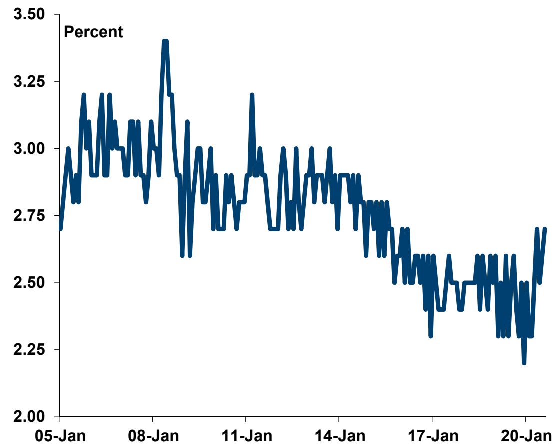
Implied Five-Year Forward Inflation Rate*



** The market expectation for the average annual inflation rate six to ten years from now as implied by 5-year and 10-year TIPS yields. Weekly average data.*

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

Long-Term Inflation Expectations*



** The average increase in prices per year during the next five to ten years.*

Source: University of Michigan Survey of Consumers via Haver Analytics

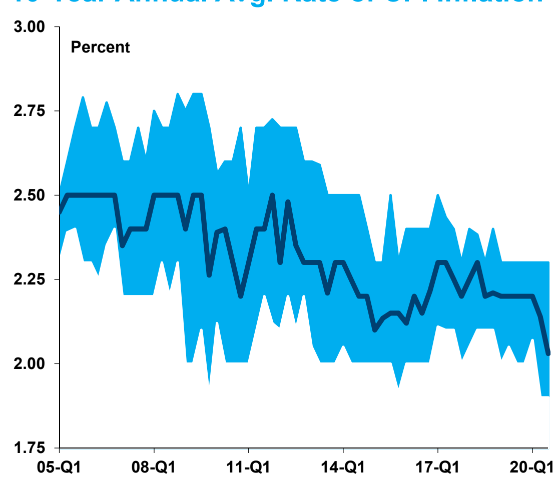
factors most likely would be viewed as temporary influences by Fed officials. Inflation expectations seem to be in the driver's seat.

Unfortunately, there is not a single definitive measure of inflation expectations, although there are several gauges that can be monitored. Some measures have picked up recently and might be suggesting a fundamental change. Breakeven rates on inflation-protected securities, for example, have jumped since March, and the long-term measure from the University of Michigan survey of consumers also has increased in the past three months (charts, above).

However, we are not ready to conclude that expectations have changed meaningfully. Breakeven rates often swing widely because of changes in risk and liquidity premiums, and thus shifts should be interpreted cautiously. Also, recent changes have merely moved this gauge from the low portion of the range from the past several years to the middle portion. The measure from the University of Michigan survey also has a high degree of volatility, and thus we would need to see a few more observations at recent levels before we begin thinking about a fundamental shift. Also, we wonder if the responses of individuals in the survey are somehow affected by the unique environment associated with the pandemic.

We also take heart from the Survey of Professional Forecasters conducted by the Philadelphia Fed, which showed a dip in inflation expectations in the third quarter (chart). This survey is valuable because it has information on the dispersion of expectations (the inter-quartile range, or observations at the 25 and 75 percentiles). This range remained tight, and the upper quartile measure has not changed recently. One might have guessed that the aggressive fiscal and monetary steps to counter the effects of the coronavirus would generate concern about inflation among some observers, which would likely raise the upper quartile. However, there is no evidence of such in this measure.

10-Year Annual Avg. Rate of CPI Inflation*



** The dark blue line shows the median estimate of the average rate of CPI inflation expected over the next 10 years. The shaded areas show the interquartile range of estimates.*

Source: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

Review

Week of Sept. 7, 2020	Actual	Consensus	Comments
PPI (August)	**0.3% Total, 0.3% Core***	**0.2% Total, 0.2% Core***	Prices of food and energy were soft in August (down 0.4% and 0.1%, respectively). The drop in the food component continued a soft trend that has been evident during most of 2020. The dip in energy prices ended a string of three monthly increases that countered a portion of price reductions in the early months of the year. Prices elsewhere jumped 0.4% after an increase of 0.5% in July. Prices of goods other than food and energy rose 0.3% for the second consecutive month, but service prices played a larger role with increases of 0.5% in both July and August. Despite the recent pressure outside of food and energy, prices are still subdued on a year-over-year (up only 0.3%). The headline index has been even more restrained in the past year, declining 0.2%.
CPI (August)	**0.4% Total, 0.4% Core**	**0.3% Total, 0.2% Core**	Energy prices rose 0.9%in August, advancing for the third consecutive month but still off sharply from readings in late 2019 and early 2020. Food prices were tame (0.1%), as a dip in prices of food for home consumption dampened an increase of 0.3% in food away from home. An upside surprise occurred in the core component, which rose 0.4% in August after a jump of 0.6% in July. Several items affected by the pandemic offered substantial discounts in the spring, and these goods or services are now reversing some of the declines; air travel, hotel stays, recreation commodities, and apparel stand out in this regard. Prices of used cars and trucks also contributed to the recent increases in the core component, with July and August both showing unusually firm increases. Recent changes left the headline index up 1.3% in the past year; the core component has increased 1.7%.
Federal Budget (August)	**$200.1 Billion Deficit**	**$242.7 Billion Deficit**	Federal revenues slipped 2.1% on a year-over-year basis in August, reflecting both slower economic activity and some lightening of burdens associated with legislation to combat the effects of the coronavirus. Remittances by the Federal Reserve to the Treasury provided a bright spot, jumping 141% ($5 billion). Spending was restrained in August, declining 1.2% year-over-year, but the drop primarily reflected a calendar configuration that shifted the allocation of outlays. If not for calendar shifts, spending would have been approximately 27% firmer than that last August, with outlays related to the CARES Act leading the jump. For the first 11 months of FY2020, the deficit totaled $3.0 trillion, dwarfing the already huge deficit of $1.1 trillion during the same period in FY2019.

** The core PPI excludes food, energy, and trade services.*
Source Bureau of Labor Statistics (PPI, CPI:); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of Sept. 14, 2020	Projected	Comments
Industrial Production (August) (Tuesday)	**0.7%**	A firm reading on the ISM index and strong order flows suggest that the factory sector is in recovery mode, which should lead to the fourth consecutive increase in the manufacturing component of industrial production. An increase in mining activity in July ended a five-month slide and suggested that the correction had run its course. Utility output could dip as temperatures were closer to normal in August after a hot July.
Retail Sales (August) (Wednesday)	**0.5% Total, 0.7% Ex-Autos**	With several key components already above pre-virus levels, retail activity is not likely to see the vigor that was evident in the average gain of 9.3% from May to July. The expiration of enhanced unemployment benefits also could lead to a cooling in activity.
Housing Starts (August) (Thursday)	**1.450 Million (-3.1%)**	Strong sales of new homes probably induced builders to ramp up production of single-family homes, but a correction to a high-side reading on multi-family units in July is likely to provide an offset. The drop in multi-family starts probably reflects normal random volatility and should not be viewed as a sign of a faltering recovery in housing activity.
Current Account (20-Q2) (Friday)	**-$160.0 Billion ($55.8 Billion Wider Deficit)**	Pronounced deterioration in trade in Q2 is likely to be joined by slippage in income flows, leading to a marked widening in the current account deficit. The expected shortfall, if realized, would be the widest since 2008-Q3. The expected deficit totals approximately 3.0% of GDP, up noticeably from 1.9% in Q1 but not widely out of line with readings close to 2.5% in the latter part of 2018 and the first half of 2019.
Leading Indicators (August) (Friday)	**1.4%**	Positive contributions from unemployment claims, ISM new orders, stock prices, and the length of the manufacturing workweek should lead to the fourth consecutive increase in the leading indicator index. The cumulative gain would offset nearly 60% of the decline in the spring.
Consumer Sentiment (September) (Friday)	**76.0 (+1.9 Index Pts.)**	Record readings on major stock indexes, although fleeting, could give sentiment a boost in early September. Continued gradual improvement in the labor market also could brighten moods.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

September/October 2020

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11
LABOR DAY	**NFIB SMALL BUSINESS OPTIMISM INDEX** June 100.6 July 98.8 Aug 100.2 **CONSUMER CREDIT** May -$14.6 billion June $11.4 billion July $12.2 billion	**JOLTS DATA** Openings (000) Quit Rate May 5,371 1.6% June 6,001 1.9% July 6,618 2.1%	**UNEMPLOYMENT CLAIMS** Initial Continuing (Millions) Aug 15 1.104 14.492 Aug 22 1.011 13.292 Aug 29 0.884 13.385 Sept 05 0.884 N/A **PPI** Final Demand Core* June -0.2% 0.3% July 0.6% 0.3% Aug 0.3% 0.3% **WHOLESALE TRADE** Inventories Sales May -1.2% 5.7% June -1.3% 8.9% July -0.3% 4.6%	**CPI** Total Core June 0.6% 0.2% July 0.6% 0.6% Aug 0.4% 0.4% **FEDERAL BUDGET** 2020 2019 June -$864.1B -$8.5B July -$63.0B -$119.7B Aug -$200.1B -$200.3B
14	15	16	17	18
	EMPIRE MFG (8:30) July 17.2 Aug 3.7 Sept -- **IMPORT/EXPORT PRICES (8:30)** Non-petrol. Imports Nonagri. Exports June 0.3% 1.2% July 0.2% 0.7% Aug -- -- **IP & CAP-U (9:15)** IP Cap.Util. June 5.7% 68.5% July 3.0% 70.6% **Aug 0.7% 70.9%** **FOMC MEETING**	**RETAIL SALES (8:30)** Total Ex.Autos June 8.4% 8.3% July 1.2% 1.9% **Aug 0.5% 0.7%** **BUSINESS INVENTORIES (10:00)** Inventories Sales May -2.3% 8.5% June -1.1% 8.5% **July 0.1% 3.3%** **NAHB HOUSING INDEX (10:00)** July 72 Aug 78 Sept -- **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)** **TIC DATA (4:00)** Total Net L-T May -$15.9B $118.1B June -$67.9B $113.0B July -- --	**INITIAL CLAIMS (8:30)** **HOUSING STARTS (8:30)** June 1.220 million July 1.496 million **Aug 1.450 million** **PHILLY FED INDEX (8:30)** July 24.1 Aug 17.2 Sept --	**CURRENT ACCOUNT (8:30)** 19-Q4 -$104.3B 20-Q1 -$104.2B **20-Q2 -$160.0B** **LEADING INDICATORS (10:00)** June 3.0% July 1.4% **Aug 1.4%** **CONSUMER SENTIMENT (10:00)** July 72.5 Aug 74.1 **Sept 76.0**
21	22	23	24	25
CHICAGO FED NATIONAL ACTIVITY INDEX	**EXISTING HOME SALES**	**FHFA HOME PRICE INDEX**	**INITIAL CLAIMS** **NEW HOME SALES**	**DURABLE GOODS ORDERS**
28	29	30	1	2
	U.S. INTERNATIONAL TRADE IN GOODS **ADVANCE INVENTORIES** **S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **CONSUMER CONFIDENCE**	**ADP EMPLOYMENT REPORT** **REVISED GDP** **CHICAGO PURCHASING MANAGERS' INDEX** **PENDING HOME SALES**	**INITIAL CLAIMS** **PERSONAL INCOME, CONSUMPTION, PRICES** **ISM INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES**	**EMPLOYMENT REPORT** **REVISED CONSUMER SENTIMENT** **FACTORY ORDERS**

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

Treasury Financing

September/October 2020

Monday	Tuesday	Wednesday	Thursday	Friday
7	8	9	10	11
LABOR DAY	**AUCTION RESULTS:** Rate / Cover 13-week bills 0.115% 2.74 26-week bills 0.125% 2.86 52-week bills 0.140% 3.04 3-year notes 0.170% 2.28 42-day CMB 0.105% 3.19 119-day CMB 0.120% 3.55 **ANNOUNCE:** $30 billion 4-week bills for auction on September 10 $35 billion 8-week bills for auction on September 10 $25 billion 105-day CMBs for auction on September 9 $30 billion 154-day CMBs for auction on September 9 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs	**AUCTION RESULTS:** Rate / Cover 10-yr notes 0.704% 2.30 105-day CMB 0.115% 3.70 154-day CMB 0.120% 3.29	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.090% 3.53 8-week bills 0.105% 3.23 30-yr bonds 1.473% 2.31 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on September 14 $22 billion 20-year bonds for auction on September 15 $12 billion 10-year TIPS for auction on September 17 $30 billion 42-day CMBs for auction on September 15 $30 billion 119-day CMBs for auction on September 15 **SETTLE:** $105 billion 13-,26-week bills $34 billion 52-week bills $30 billion 42-day CMBs $30 billion 119-day CMBs	
14	15	16	17	18
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $22 billion 20-year bonds $30 billion 42-day CMBs $30 billion 119-day CMBs announce: $30 billion* 4-week bills for auction on September 17 $35 billion* 8-week bills for auction on September 17 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $50 billion 3-year notes $35 billion 10-year notes $23 billion 30-year bonds $25 billion 105-day CMBs $30 billion 154-day CMBs		**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $12 billion 10-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on September 21 $22 billion* 2-year FRNs for auction on September 23 $52 billion* 2-year notes for auction on September 22 $53 billion* 5-year notes for auction on September 23 $50 billion* 7-year notes for auction on September 24 **SETTLE:** $105 billion 13-,26-week bills $30 billion 42-day CMBs $30 billion 119-day CMBs	
21	22	23	24	25
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $52 billion* 2-year notes **ANNOUNCE:** $30 billion* 4-week bills for auction on September 24 $35 billion* 8-week bills for auction on September 24 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $22 billion* 2-year FRNs $53 billion* 5-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $50 billion* 7-year notes **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on September 28 **SETTLE:** $105 billion* 13-,26-week bills	**SETTLE:** $22 billion* 2-year FRNs
28	29	30	1	2
AUCTION: $105 billion* 13-,26-week bills	**ANNOUNCE:** $30 billion* 4-week bills for auction on October 1 $35 billion* 8-week bills for auction on October 1 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills	**SETTLE:** $22 billion 20-year bonds $12 billion 10-year TIPS $52 billion* 2-year notes $53 billion* 5-year notes $50 billion* 7-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on October 5 $34 billion 52-week bills for auction on October 6 $52 billion* 3-year notes for auction on October 6 $35 billion* 10-year notes for auction on October 7 $23 billion* 30-year bonds for auction on October 8 **SETTLE:** $105 billion* 13-,26-week bills	

*Estimate