U.S. Economic Comment

- FOMC: expecting restrained inflation; hoping for the best on asset prices
- FOMC: small chance of policy tweaks in coming weeks

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Policy Conflict: Quiescent Inflation, Exuberant Asset Prices

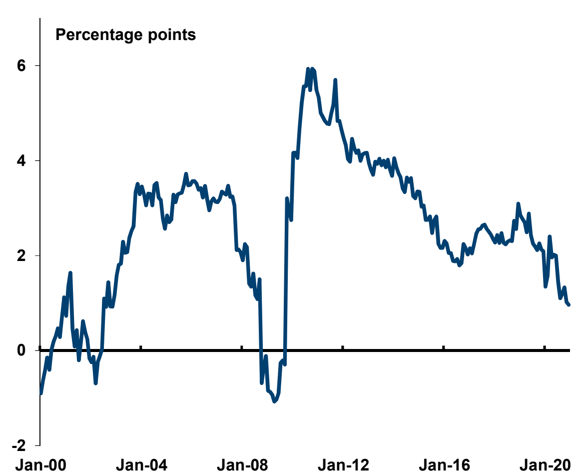
The minutes from the January meeting of the Federal Open Market Committee showed strong dovish leanings among Fed officials. The meeting summary noted several times that the labor market was far from meeting the FOMC's goal of maximum employment. In addition, officials were aware of factors that are likely to push inflation higher in the months ahead, such as the unwinding of price discounts on items sensitive to the pandemic and disruptions to supply chains that could drive input prices higher, but these influences were viewed as transitory. Risks on inflation, officials believed, were "weighted to the downside."

Officials are not deeply concerned about inflation risks, but they seem to be paying some heed to the potential for financial instability. The staff presented a periodic update on its assessment of the stability of the financial system and concluded that vulnerabilities were "notable". Previous assessments cited elevated levels of corporate debt as a concern, but this was the first time that broader risks were mentioned.

Elevated asset valuations were the trigger behind the revision in the staff's evaluation. Equity values have climbed further, leaving measures of equity risk premiums at low levels. One such measure, the spread between the earnings-price ratio and the real yield on 10-year Treasury notes is approaching the lows seen during the financial crisis and the bursting of the tech bubble (chart, left). There is still some distance between the current reading and the previous lows, but those lows represented truly unusual situations that policymakers would not like to revisit. The current reading is low enough to capture attention.

The staff also cited tight credit spreads in the corporate bond market, which are in the low ends of their historical ranges (chart, right). Previous reviews noted vulnerabilities associated with elevated prices of commercial real estate, and this report noted that prices of office buildings and retail establishments had started to fall.

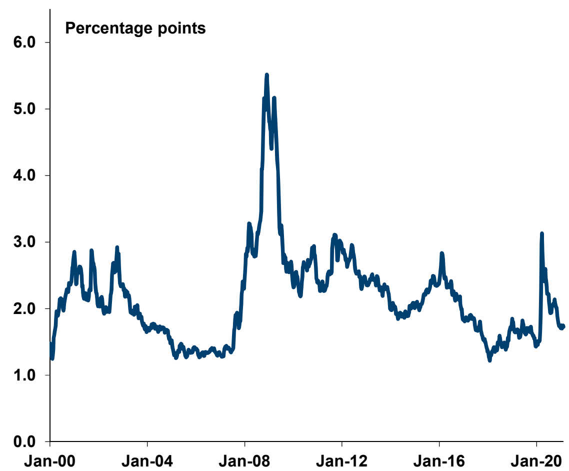
Equity Risk Premium*



** The S&P earnings-price ratio less the real 10-year Treasury yield (nominal 10-year Treasury rate less the year-over-year change in the core CPI).*

Source: Bureau of Labor Statistics, Standard and Poor's, and U.S. Treasury Department via Haver Analytics

A-Rated Corporate Bond Spread*



** The yield on A-rated corporate bonds less the rate on 10-year Treasury securities.*

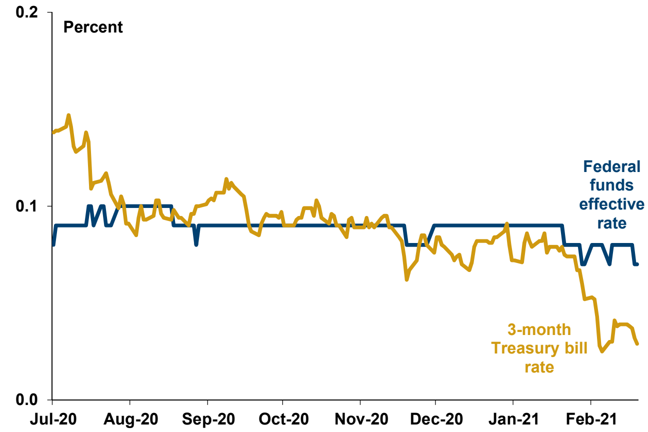
Source: ICE/Bank of America Merrill Lynch and U.S. Treasury Department via Haver Analytics

The policy implications of the new assessment are not clear. The exuberance in asset prices is at least partly related to low interest rates, which might suggest the possibility of the Fed backing away from its highly accommodative stance. However, officials see both the low level of the federal funds rate and the QE program as providing needed support to the economy. In this regard, Chair Powell in his press briefing downplayed the possibility of the Fed taking steps to contain asset values. He argued that elevated prices of equities were being driven more by prospects for vaccine success and economic recovery than by low interest rates. Thus, the policy implications seem to be “cross your fingers.”

Interest Rate or QE Tweaks

The Fed is not likely to make notable policy moves at the next FOMC meeting on March 16-17, but officials will probably discuss technical adjustments (i.e. hikes) to the interest rate on excess reserves (IOER) and the rate on reverse repurchase agreements (RRPs). The possibility of such changes has emerged because several money market interest rates have moved to unusually low levels. For example, the secured overnight financing rate (SOFR) was hovering in a tight range centered on 9 basis points during the summer and fall, but it has dropped to a range of 2 to 6 basis points recently. Similarly, the rate on three-month Treasury bills has averaged 4 basis points in the past two weeks, down from an average of 10 basis points from July through December (chart). Raising IOER and the rate on RRPs would tend to push money market rates back to their previous levels.

Short-Term Interest Rates*



** Daily data.*
Source: Bloomberg

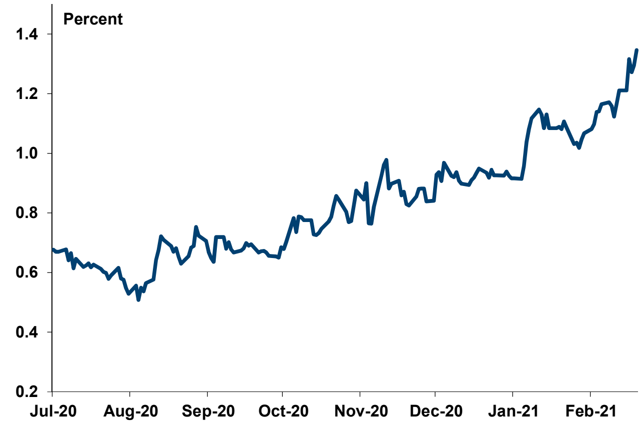
The easing in short-term rates has been noticeable, but at this point we would not expect the Fed to make an effort to push them higher. The Fed uses IOER and the rate on RRPs (currently 0.10 percent and 0.00 percent, respectively) to control the federal funds rate; it does not have targets for other short-term interest rates. The federal funds rate, perhaps surprisingly, has not experienced the same downward pressure that other money market rates have. FFR has dipped only marginally and is not far from the midpoint of its target range (chart). Thus, with the Fed focusing on the federal funds rate, officials might not see a need to adjust IOER or the rate on RRPs.

The situation might be different in coming months, as the federal funds rate could come under downward pressure. The fed funds rate primarily is driven by the supply and demand for bank reserves, and the supply is likely to increase substantially in coming months. The ongoing QE program injects $120 billion of reserves into the banking system every month, and the Treasury Department announced recently that it intends to reduce its cash balance at the Fed, which will add additional reserves as the funds are transferred from the Treasury to private accounts. This abundant supply could push the federal funds rate further from its midpoint, which might prompt an effort by the Fed to nudge it higher by increasing IOER and/or the rate on reverse repurchase agreements.

The opposite end of the yield curve could capture the attention of Fed officials at the next FOMC meeting and lead to some changes in its asset purchase program. While money market interest rates have eased in recent weeks, longer-term interest rates have climbed, with the rate on 10-year Treasuries increasing approximately 40 basis points since the turn of the year and more than 80 basis points since August. This rate stood at 1.34 percent Friday afternoon (chart, next page).

The jump in interest rates might lead some officials to suggest increasing the volume of purchases; alternatively, the Fed could hold the volume steady but boost the share of purchases in the long end of the market.

10-Year Treasury Rate*



** Daily data.*
Source: Bloomberg

We would not look for the Fed to increase the volume of purchases. The economy already is receiving a good push from the $900 billion of fiscal support authorized in December, and another sizeable package is likely to be approved soon. Some economists already are suggesting that policymakers are providing excessive support. The Fed does not need to provide another dose.

Steady volume but a heavier weighting in the long end is possible, but we view this as a low probability event. Such a change is akin to yield curve control (i.e. targeting a specific level or range of interest rates at some point on the yield curve). This tactic was discussed at recent FOMC meetings and it received a cool reception. Officials seem content with providing overall financial accommodation and allowing markets to determine the allocation of that support.

Review

Week of February 15, 2021	Actual	Consensus	Comments
Retail Sales (January)	**5.3% Total, 5.9% Ex-Autos**	**1.1% Total, 1.0% Ex-Autos**	Retail sales surged in January, with the results offsetting declines in the prior three months and pushing the level of activity well above previous readings. The latest increase was broadly based, with every major category advancing. Gains at furniture stores and electronic & appliance stores led the charge (up 12.0% and 14.7%, respectively), but they had plenty of company with strong gains in other areas. The remarkable performance no doubt was influenced by the second round of recovery rebate checks that were sent in January.
PPI (January)	**1.3% Total, 1.2% Ex-Food and Energy**	**0.4% Total, 0.2% Ex-Food and Energy**	The advance in the PPI in January was led by a surge of 5.1% in energy prices, which followed a jump of 4.9% in December. Food prices, in contrast, slipped 0.6%. Final demand less food and energy jumped 1.2%, the sharpest increase on record. Both services prices and the prices of goods excluding food and energy showed upward pressure. The latest shifts left the year-over-year increase in the headline index at 1.7%, up from 0.8% in December but below the 2% reading in January prior to the onset of Covid. Prices ex. food and energy increased 2.0%, the fastest advance since mid-2019.
Industrial Production (January)	**0.9%**	**0.4%**	Industrial production increased for the eighth time in the past nine months in January, continuing its recovery from the Covid-related swoon in the spring. Manufacturing output rose 1.0%. This area has now recovered 95% of the ground lost in the spring. Mining output (up 2.5%) has lagged most other areas of the economy because of low energy prices, but it is beginning to recover, with January bringing the third consecutive increase. Utility output fell 1.2% in January, but swings in this component are nearly always driven by shifts in the weather.
Housing Starts (January)	**1.580 Million (-6.0%)**	**1.660 Million (-0.5%)**	Housing starts fell in January from a downwardly revised level in the prior month, but home building should still be viewed as firm. Activity in December had moved well above previous readings and seemed due for a correction. Even with the larger-than-expected drop in January, the new level of starts was close to the robust totals seen in late 2019 and early 2020. Single-family starts accounted for all of the decline in January with a drop of 12.2%. Despite this soft performance, the level of single-family starts remained above all readings in the previous expansion. Multi-family starts provided an upside surprise with a jump of 17.1%. Multi-family starts came to life in January after a mediocre performance in recent months.
Existing Home Sales (January)	**6.69 Million (+0.6%)**	**6.60 Million (-2.4%)**	Sales of existing homes rose 0.6% in January from downwardly revised results in December (1.6% lighter than previously believed), but they remain quite strong by historical standards. The level of sales in January (6.690 million, annual rate) exceeded the total of 5.527 million in 2017, which was the best year for existing home sales in the previous expansion, and it was within the range of the housing boom in 2004-06. January marked the fifth consecutive month that sales were elevated.

Sources: U.S. Census Bureau (Retail Sales, Housing Starts); Bureau of Labor Statistics (PPI); Federal Reserve Board (Industrial Production); National Association of Realtors (Existing Home Sales); Consensus forecasts are from Bloomberg

Preview

Week of February 22, 2021	Projected	Comments
Leading Indicators (January) (Monday)	**0.5%**	The jump in building permits, along with sizeable positive contributions from the manufacturing workweek, ISM new orders, stock prices, and the slope of the yield curve, should lead to the ninth consecutive increase in the leading indicator index. If the expectation is accurate, the measure will have retraced 87% of its drop in the spring.
Consumer Confidence (February) (Tuesday)	**93.0 (+3.7 Index Pts.)**	The index of consumer confidence has improved only modestly from its April low, but record readings on stock prices and the receipt of recovery rebate checks might have brightened moods in February.
New Home Sales (January) (Wednesday)	**0.880 Million (+4.5%)**	Sales of new homes in the past two months have shown less vigor than other housing-related indicators. The lag probably reflects random variation rather than fundamental softness, raising the prospect of catch up in January.
Durable Goods Orders (January) (Thursday)	**0.0%**	After increasing for eight consecutive months and moving above their pre-pandemic peak, bookings are likely to pause in January. The machinery and miscellaneous categories seem due for a correction given elevated readings in December.
Revised GDP (2020-Q4) (Thursday)	**4.4% (+0.4 Pct. Pt. Revision)**	Upward adjustments to residential construction, business investment in new equipment, and inventory investment are likely to more than offset slightly softer consumer spending and business investment in new structures.
Personal Income, Consumption, Prices (January) (Friday)	**8.0%, 1.3%, 0.2%**	Wages are likely to post a firm advance, but most of the expected gain in income is likely to be driven by transfer payments, fueled by the distribution of recovery rebate payments and the implementation of the annual cost-of-living adjustment to Social Security benefits. On the spending side, strong vehicle sales are likely to boost outlays for durable goods, while a robust report on retail sales points to an exceptional performance in the nondurable area.
U.S. International Trade in Goods (January) (Friday)	**-$81.0 Billion ($2.2 Billion Narrower Deficit)**	Exports of food and miscellaneous items could cool from elevated readings in December, but continued uptrends in capital goods and consumer goods should provide offsets. A moderate increase in imports in December after sizeable gains in prior months suggests a peaking.
Revised Consumer Sentiment (February) (Friday)	**76.2 (Unrevised)**	The revised reading on sentiment is usually close to the preliminary figure published mid-month. In this instance, new record readings on major stock market indexes might favor an upward adjustment.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

February/March 2021

Monday 15

PRESIDENTS' DAY

Tuesday 16

EMPIRE MFG

Dec	4.9
Jan	3.5
Feb	12.1

TIC DATA

	Total	Net Long-Term
Oct	-$6.0B	$51.9B
Nov	$114.7B	$149.2B
Dec	-$0.6B	$121.0B

Wednesday 17

RETAIL SALES

	Total	Ex.Autos
Nov	-1.3%	-1.2%
Dec	-1.0%	-1.8%
Jan	5.3%	5.9%

PPI

	Total	Ex. Food & Energy
Nov	0.1%	-0.1%
Dec	0.3%	0.1%
Jan	1.3%	1.2%

IP & CAP-U

	IP	Cap.Util.
Nov	0.9%	73.9%
Dec	1.3%	74.9%
Jan	0.9%	75.6%

BUSINESS INVENTORIES

	Inventories	Sales
Oct	0.8%	0.9%
Nov	0.5%	0.0%
Dec	0.6%	0.8%

NAHB HOUSING INDEX

Dec	86
Jan	83
Feb	84

FOMC MINUTES

Thursday 18

UNEMPLOYMENT CLAIMS

	Initial	Continuing (Millions)
Jan 23	0.812	4.691
Jan 30	0.812	4.558
Feb 06	0.848	4.494
Feb 13	0.861	N/A

HOUSING STARTS

Nov	1.553 million
Dec	1.680 **million**
Jan	1.580 million

IMPORT/EXPORT PRICES

	Non-petrol. Imports	Nonagri. Exports
Nov	0.0%	0.5%
Dec	0.4%	1.3%
Jan	0.9%	2.2%

PHILLY FED INDEX

Dec	9.1
Jan	26.5
Feb	23.1

Friday 19

EXISTING HOME SALES

Nov	6.59 million
Dec	6.65 million
Jan	6.69 million

Monday 22

CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)

	Monthly	3-Mo. Avg.
Nov	0.31	0.59
Dec	0.52	0.61
Jan	--	--

LEADING INDICATORS (10:00)

Nov	0.7%
Dec	0.3%
Jan	**0.5%**

Tuesday 23

FHFA HOME PRICE INDEX (9:00)

Oct	1.5%
Nov	1.0%
Dec	--

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)

	SA	NSA
Oct	1.6%	1.3%
Nov	1.4%	1.1%
Dec	--	--

CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)

Dec	87.1
Jan	89.3
Feb	**93.0**

CHAIR POWELL'S MONETARY POLICY TESTIMONY (SENATE) (10:00)

Wednesday 24

NEW HOME SALES (10:00)

Nov	0.829 million
Dec	0.842 million
Jan	**0.880 million**

CHAIR POWELL'S MONETARY POLICY TESTIMONY (HOUSE) (10:00)

Thursday 25

INITIAL CLAIMS (8:30)

DURABLE GOODS ORDERS (8:30)

Nov	1.3%
Dec	0.5%
Jan	**0.0%**

GDP (8:30)

	GDP	Chained Price
20-Q3	33.4%	3.5%
20-Q4(a)	4.0%	2.0%
20-Q4(p)	**4.4%**	**2.0%**

PENDING HOMES SALES (10:00)

Nov	-2.5%
Dec	-0.3%
Jan	--

Friday 26

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)

	Inc.	Cons.	Core
Nov	-1.3%	-0.7%	0.0%
Dec	0.6%	-0.2%	0.3%
Jan	**8.0%**	**1.3%**	**0.2%**

U.S. INTERNATIONAL TRADE IN GOODS (8:30)

Nov	-$86.1 billion
Dec	-$83.2 billion
Jan	**-$81.0 billion**

ADVANCE INVENTORIES REPORT (8:30)

	Wholesale	Retail
Nov	0.0%	0.8%
Dec	0.3%	1.2%
Jan	--	--

MNI CHICAGO PMI (9:45)

	Index	Prices
Dec	58.7	73.5
Jan	63.8	75.2
Feb	--	--

CONSUMER SENTIMENT (10:00)

Dec	80.7
Jan	79.0
Feb(p)	76.2

Monday–Friday, March 1–5 and 8–12

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5
ISM MFG INDEX **CONSTRUCTION SPEND.**	**VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **ISM SERVICES INDEX** **BEIGE BOOK**	**INITIAL CLAIMS** **REVISED PRODUCTIVITY & COSTS** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **TRADE BALANCE** **CONSUMER CREDIT**
8	9	10	11	12
WHOLESALE TRADE	**NFIB SMALL BUSINESS OPTIMISM INDEX**	**CPI** **FEDERAL BUDGET**	**INITIAL CLAIMS** **JOLTS DATA**	**PPI** **CONSUMER SENTIMENT**

Forecasts in Bold. (a) = advance (1st estimate of GDP); (p) = preliminary (2nd estimate of GDP)

Treasury Financing

February/March 2021

Monday	Tuesday	Wednesday	Thursday	Friday
15	16	17	18	19
PRESIDENTS' DAY	**AUCTION RESULTS:** Rate / Cover 13-week bills 0.040% 2.72 26-week bills 0.060% 3.02 6-week CMB 0.040% 3.10 17-week CMB 0.050% 3.24 **ANNOUNCE:** $30 billion 4-week bills for auction on February 18 $35 billion 8-week bills for auction on February 18 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $58 billion 3-year notes $41 billion 10-year notes $27 billion 30-year bonds $25 billion 15-week CMBs $30 billion 22-week CMBs	**AUCTION RESULTS:** Rate / Cover 20-yr bonds 1.920% 2.15	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.025% 3.65 8-week bills 0.030% 3.78 30-yr TIPS -0.040% 2.31 **ANNOUNCE:** $105 billion* 13-,26-week bills for auction February 22 $34 billion 52-week bills for auction on February 23 $26 billion 2-year FRNs for auction on February 24 $60 billion 2-year notes for auction on February 23 $61 billion 5-year notes for auction on February 24 $62 billion 7-year notes for auction on February 25 $30 billion 6-week CMBs for auction on February 23	**SETTLE:** $105 billion 13-,26-week bills $30 billion 6-week CMBs $30 billion 17-week CMBs
22	23	24	25	26
AUCTION: $105 billion 13-,26-week bills	**AUCTION:** $34 billion 52-week bills $60 billion 2-year notes $30 billion 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on February 25 $35 billion* 8-week bills for auction on February 25 $30 billion* 17-week CMBs for auction on February 24 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills	**AUCTION:** $26 billion 2-year FRNs $61 billion 5-year notes $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $62 billion 7-year notes **ANNOUNCE:** $105 billion* 13-,26-week bills for auction March 1 $30 billion* 6-week CMBs for auction on March 2 **SETTLE:** $105 billion 13-,26-week bills $34 billion 52-week bills $30 billion 6-week CMBs	**SETTLE:** $9 billion 30-year TIPS $26 billion 2-year FRNs
1	2	3	4	5
AUCTION: $105 billion* 13-,26-week bills **SETTLE:** $27 billion 20-year bonds $60 billion 2-year notes $61 billion 5-year notes $62 billion 7-year notes	**AUCTION:** $30 billion* 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on March 4 $35 billion* 8-week bills for auction on March 4 $30 billion* 17-week CMBs for auction on March 3 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction March 8 $58 billion* 3-year notes for auction on March 9 $38 billion* 10-year notes for auction on March 10 $24 billion* 30-year bonds for auction on March 11 $30 billion* 6-week CMBs for auction on March 9 **SETTLE:** $105 billion* 13-,26-week bills $30 billion* 6-week CMBs	
8	9	10	11	12
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $58 billion* 3-year notes $30 billion* 6-week CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on March 11 $35 billion* 8-week bills for auction on March 11 $30 billion* 17-week CMBs for auction on March 10 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $38 billion* 10-year notes $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $24 billion* 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction March 15 $24 billion* 20-year bonds for auction on March 16 $13 billion* 10-year TIPS for auction on March 18 $30 billion* 6-week CMBs for auction on March 16 **SETTLE:** $105 billion* 13-,26-week bills $30 billion* 6-week CMBs	

*Estimate