Daiwa Capital Markets

U.S. Economic Comment

- QE: tapering is on the (distant) horizon

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

The Case for Tapering QE

The Federal Open Market Committee has provided only the vaguest of forward guidance on its asset purchasing program, noting that the effort would be continued until “substantial further progress” is made toward the Fed’s employment and inflation goals. Officials have consistently indicated over the past several months that the labor market is far from where they would like it to be and that inflation remains below target. Thus, the possibility of tapering the quantitative easing program has not been on the FOMC’s agenda.

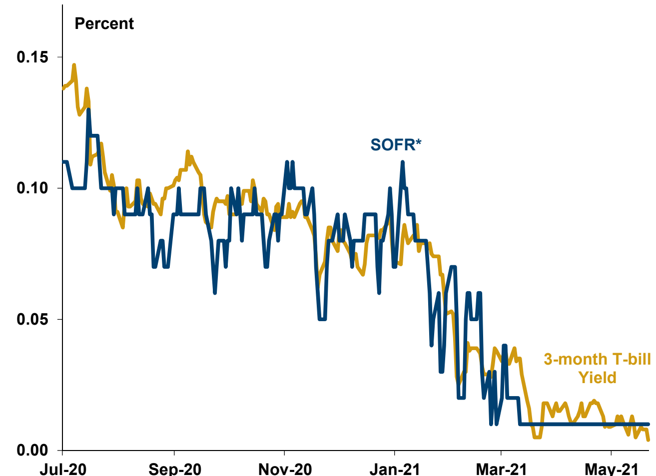
The minutes from the April FOMC meeting again noted that “it would likely be some time until the economy had made substantial further progress” toward the Committee’s goals. However, the minutes also mentioned for the first time the possibility of tapering: a “number” of Fed officials indicated that if the economy continued to improve rapidly “it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases.” The statement was guarded (it *might* be appropriate…to *begin* discussing…), and it was not strong enough to suggest a near-term change, but nevertheless, it represented a shift.

The improvement in the economy is the obvious reason to consider a change in the QE program, but two other factors are probably in play as well: the purchases are contributing to unusually low levels of interest rates in the money market, and they might be leading many investors in the long-end of the market to take excessive risks.

The Money Market

The purchase of securities by the Federal Reserve will inject reserves into the banking system, and the new reserves, all else equal, will put downward pressure on short-term interest rates. The cumulative impact of the Fed purchases on short-term rates started to become apparent in February, when rates on repurchase agreements started a descent from a range of 7 to 12 basis points (close to the midpoint of the Fed’s target range for the federal funds rate) to recent average readings of one basis point, with some transactions occurring at negative rates. Rates on Treasury bills also have retreated, with the three-month security now trading at 1 or 2 basis points, down from 10 to 15 basis points last summer and fall (chart). Three recent auctions of four-week T-bills carried stop-out rates of 0.0 percent; that is, there were no winning bids in positive territory.

Money Market Interest Rates



** SOFR is the Secured Overnight Financing Rate. It is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. The SOFR is published each business day by the Federal Reserve Bank of New York.*

Source: Federal Reserve Bank of New York via Haver Analytics; Bloomberg

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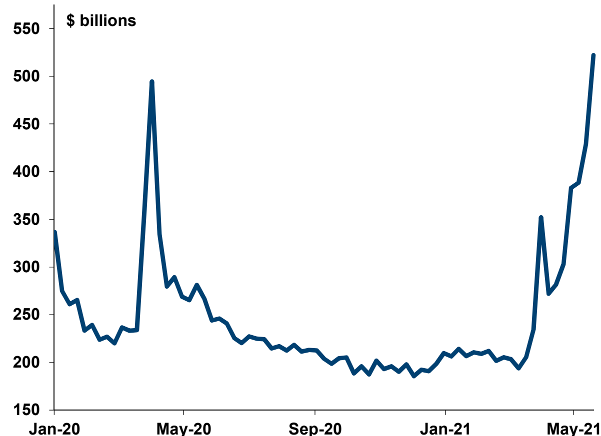
The downward pressure has intensified recently, as another factor adding reserves to the banking system has come into play. The Treasury Department ran an unusually high cash balance during the worst of the pandemic, which drained reserves from the banking system when the Treasury raised new cash in the market. The Treasury is now reducing its cash balance, which is adding reserves and leading to more downward pressure.

(The Treasury's cash balance normally fluctuates in a range of $300 to $500 billion. It jumped to an average of approximately $1.8 trillion during the worst of the pandemic, but has receded to approximately $900 billion recently. The Treasury is planning to reduce it to $800 billion by the end of June, and the debt ceiling constraint (if not lifted) will force a reduction to $450 billion by the end of July.)

Reverse Repurchase Agreements*



** Weekly end-of period data as of Wednesday. The last observation is for Wednesday May 19, 2021.*

Source: Federal Reserve Board via Haver Analytics

Despite the abundance of liquidity, money market rates have generally not moved into negative territory. Rates have remained (barely) positive because the Fed offers many institutional investors the opportunity to park funds at a Federal Reserve Bank through a reverse repurchase agreement (RRP) at a zero interest rate. Investors have flocked to this instrument recently, with utilization moving from levels in the neighborhood of $200 billion a short time ago to $522 billion on May 19 (chart, above).

The availability of RRPs has absorbed much of the downward pressure on interest rates associated with the abundance of reserves in the banking system, and the Fed could possibly push short-term interest rates higher by increasing the interest rates on this instrument. Indeed, minutes from recent FOMC meetings indicate that such a step is under consideration. Such action most likely would be effective in maintaining positive interest rates, but it is treating symptoms rather than the underlying cause. The downward pressure on short-term interest rates is a reflection of excessive reserves in the banking system. A better strategy might be to reduce the volume of reserves in the banking system, or at least stop adding them through the quantitative easing program.

Long-Term Financial Markets

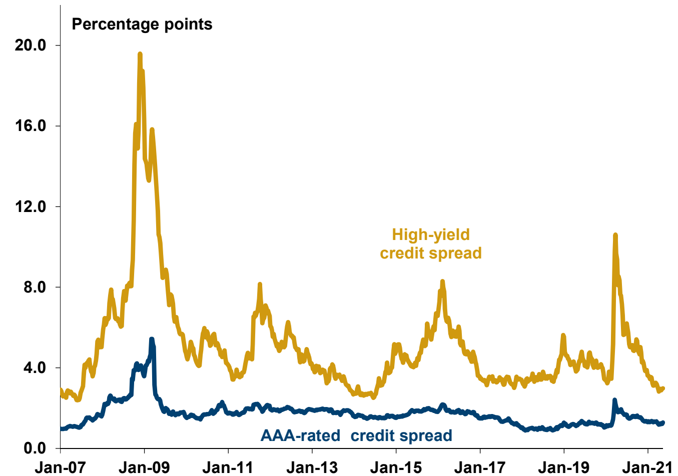
The QE program is having an influence on the short end of the fixed-income market, and it has most likely put downward pressure on long-term Treasury and mortgage rates as well. These low rates, in turn, have led investors to search for opportunities in other markets, spreading the effect of QE throughout the long end of the maturity spectrum.

The reach for higher yields has had a pronounced effect of corporate bonds, as rates on these instruments have declined more than those on Treasury securities, pushing credit spreads to the low end of their historical range (chart, next page). The latest semi-annual report on financial stability from the Federal Reserve Board noted the tight spreads and viewed them as a sign of an elevated appetite for risk. The Fed report highlighted the low level of the so-called excess bond premium, which is a measure of the gap between the corporate-Treasury rate spread and expected credit losses.

The Fed report on financial stability also noted elevated asset valuations in other investment outlets, such as leveraged loans and real estate (both commercial and residential). Of course, equity prices are elevated as

well. A price-earnings ratio constructed by the Fed staff (based on expected earnings) has moved within the range last seen during the tech bubble in the late 1990s and early 2000s.

Corporate Credit Spreads*



** The rates on investment-grade and high-yield corporate bonds less the rate on 10-year Treasury securities. Weekly average data.*

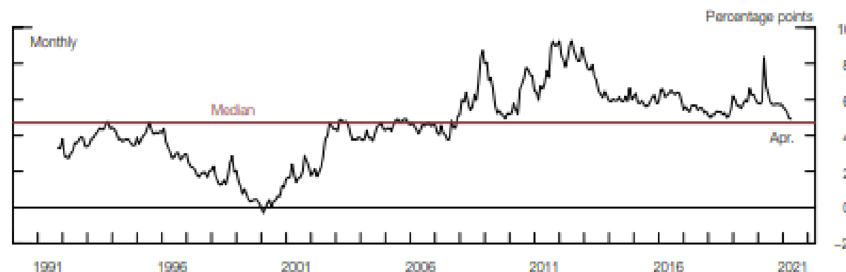
Source: ICE/Bank of America Merrill Lynch and Federal Reserve Board via Haver Analytics

The experience during the tech bubble did not end well, and thus a comparable price-earnings ratio today might stir concern about a pronounced equity correction in the months ahead. The current situation is perhaps less troubling because interest rates today are much lower than they were in the earlier cycle (the 10-year Treasury rate averaged 6.0 percent in 2000), and lower rates would justify elevated equity values. In this regard, the Fed report on financial stability included a chart showing the spread between the earnings-price ratio and the real 10-year Treasury rate. (The chart is shown below. The earnings-price ratio is the inverse of the price-earnings ratio mentioned above. It represents an expected rate of return.) This spread is approximately equal to the median value over the past few decades and comfortably above readings during the tech bubble, suggesting that current equity values are perhaps sustainable.

One wonders, though, about the sustainability of today's interest rates. The Fed will eventually have to end its QE program; continuing it indefinitely would amount to the adoption of banana-republic monetary policy. Without the support of QE, Treasury rates will most likely increase, which would probably lead to the repricing of other financial assets. Thus, today's QE effort, originally adopted to steady financial markets, might be the source of instability in the future.

Interestingly, Chair Powell has a different view. In his latest press conference, he noted that the equity market had an element of froth and that low interest rates might be having an influence. However, he felt that most of the exuberance in the stock market was the result of good progress in fighting Covid and the expectation of a brisk recovery.

Spread of Forward Earnings-to-Price Ratio of S&P 500 Firms to Expected 10-Year Real Treasury Yield



Fed Sources: Federal Reserve Board staff calculations using Refinitiv (formerly Thomson Reuters), Institutional Brokers Estimate System estimates; Department of the Treasury; Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters.

Source: Financial Stability Report (May 2021), Board of Governors of the Federal Reserve System

Review

Week of May 17, 2021	Actual	Consensus	Comments
Housing Starts (April)	**1.569 Million (-9.5%)**	**1.704 Million (-2.0%)**	A drop of 13.4% in single-family housing starts accounted for all of the weakness in new building, with activity easing to the low portion of the recent range. Multi-family building, in contrast, rose 0.8% and remained at a firm level for the second consecutive month. Building permits matched the performance of starts, with multi-family authorizations increasing 8.9% while single-family permits fell 3.8%. Multi-family permits have been firm for the past four months, suggesting that the Covid-related drop in demand for city-center living might be overstated. The decline in single-family permits was notable, but builders are holding an ample number of unused permits acquired in prior months.
Leading Indicators (April)	**1.6%**	**1.3%**	All ten components of the index of leading economic indicators had either a positive or neutral influence on the headline measure, with contributions from unemployment claims and stock prices standing out. The latest advance (the 11th in the past 12 months) pushed the index 1.2% above the pre-pandemic high in January 2020.
Existing Home Sales (April)	**5.85 Million (-2.7%)**	**6.07 Million (1.0%)**	Sales of existing homes eased in April for the third consecutive month. The recent downward shift has been pronounced, but the declines have occurred from elevated levels late last year and early this year, and thus sales remained firm relative to pre-pandemic norms. The recent softening in activity is probably more the result of tight supply rather than weak demand. With interest rates low and the labor market recovering, potential buyers are actively searching. However, the number of homes for sale is low by historical standards.

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

Preview

Week of May 24, 2021	Projected	Comments
New Home Sales (April) (Tuesday)	**1.000 Million (-2.1%)**	A limited inventory of existing homes for sale has stirred interest in the market for new homes, which should keep activity close to elevated reading in March (the best reading since mid-2006, the tail-end of the housing bubble).
Consumer Confidence (May) (Tuesday)	**120.0 (-1.7 Index Pts.)**	Several positive developments could boost consumer confidence: the economy is reopening and jobs are available, and the stock market has been strong. However, higher prices of gasoline and a general concern about inflation could shake confidence after two strong months for this measure (up 20.6% in March and 11.7% in April).
Durable Goods Orders (April) (Thursday)	**0.8%**	Supply chain difficulties could have a constraining influence in some sectors, but the expectation of strong economic activity should lead to a gain overall. If realized, the expected advance would mark the 12th consecutive increase and leave bookings comfortably above pre-pandemic levels in early 2020 (although still below the firmest observations in the previous expansion).
Revised GDP (2021-Q1) (Thursday)	**6.8% (0.4 Pct. Pt. Upward Prevision)**	Upward revisions to consumer spending, residential construction, and inventory investment should more than offset downward adjustments to business investment in structures and state and local spending.
U.S. International Trade in Goods (April) (Friday)	**-$89.0 Billion ($1.6 Billion Narrower Deficit)**	Both exports and imports are likely to ease in April after outsized gains in March (rebounds from the constraining effects of adverse weather and congested ports). Imports seem to have more downside risk, which could lead to slight improvement in the monthly trade deficit.
Personal Income, Consumption, Core Prices (April) (Friday)	**-13.0%, 0.2%, 0.5%**	Wages are likely to post a solid gain in April, but a drop in transfer payments (Economic Impact Payments and unemployment benefits) are likely to dominate the income portion of this report. On the spending side, the retail sales report raises the prospect of a decline in outlays for nondurable goods, but strong vehicle sales should lift the durable component of consumption, and the reopening in the economy could give a lift to spending on services. The reopening of the economy also could push some pandemic-related prices of goods and services closer to normal levels, which could lead to a hefty increase in the PCE price index.
Revised Consumer Sentiment (May) (Friday)	**82.8 (Unrevised)**	The surprisingly sharp decline in the preliminary estimate of sentiment (off 6.2%) might stir thoughts of a biased sample and therefore an upward revision, but troubling inflation reports will probably keep sentiment close to the disappointing level published at mid-month.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

May/June 2021

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
EMPIRE MFG Mar 17.4 Apr 26.3 May 24.3 **NAHB HOUSING INDEX** Mar 82 Apr 83 May 83 **TIC DATA** Total / Net L-T Jan $105.7B / $91.0B Feb $73.7B / $4.3B Mar $146.4B / $262.2B	**HOUSING STARTS** Feb 1.447 million Mar 1.733 million Apr 1.569 million	**FOMC MINUTES**	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Apr 24 0.590 / 3.680 May 01 0.507 / 3.640 May 08 0.478 / 3.751 May 15 0.444 / N/A **PHILLY FED INDEX** Mar 44.5 Apr 50.2 May 31.5 **LEADING INDICATORS** Feb -0.1% Mar 1.3% Apr 1.6%	**EXISTING HOME SALES** Feb 6.24 million Mar 6.01 million Apr 5.85 million
24	25	26	27	28
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Feb -1.20 / 0.07 Mar 1.71 / 0.54 Apr -- / --	**FHFA HOME PRICE INDEX (9:00)** Jan 1.0% Feb 0.9% Mar -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Jan 1.2% / 0.9% Feb 1.2% / 1.2% Mar -- / -- **NEW HOME SALES (10:00)** Feb 0.846 million Mar 1.021 million **Apr 1.000 million** **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Mar 109.0 Apr 121.7 **May 120.0**		**INITIAL CLAIMS (8:30)** **DURABLE GOODS ORDERS (8:30)** Feb 1.3% Mar 1.0% **Apr 0.8%** **REVISED GDP (8:30)** GDP / Chained Price 20-Q4 4.3% / 2.0% 21-Q1(a) 6.4% / 4.1% **21-Q1(p) 6.8% / 4.1%** **PENDING HOMES SALES (10:00)** Feb -11.5% Mar 1.9% Apr --	**U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Feb -$87.0 billion Mar -$90.6 billion **Apr -$89.0 billion** **ADVANCE INVENTORIES (8:30)** Wholesale / Retail Feb 1.0% / 0.1% Mar 1.3% / -1.4% Apr -- / -- **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Feb -7.0% / -1.0% / 0.1% Mar 21.1% / 4.2% / 0.4% **Apr -13.0% / 0.2% / 0.5%** **MNI CHICAGO BUSINESS BAROMETER INDEX (9:45)** Index / Prices Mar 66.3 / 80.4 Apr 72.1 / 91.5 May -- / -- **REVISED CONSUMER SENTIMENT (10:00)** Mar 84.9 Apr 88.3 May(p) 82.8
31	1	2	3	4
MEMORIAL DAY	**ISM MANUFACTURING INDEX** **CONSTRUCTION SPEND.**	**BEIGE BOOK** **VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **INITIAL CLAIMS** **REVISED PRODUCTIVITY & COSTS** **ISM SERVICES INDEX**	**EMPLOYMENT REPORT** **FACTORY ORDERS**
7	8	9	10	11
CONSUMER CREDIT	**NFIB SMALL BUSINESS OPTIMISM INDEX** **TRADE BALANCE** **JOLTS REPORT**	**WHOLESALE TRADE**	**INITIAL CLAIMS** **CPI** **FEDERAL BUDGET**	**CONSUMER SENTIMENT**

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

Treasury Financing

May/June 2021

Monday	Tuesday	Wednesday	Thursday	Friday
17	18	19	20	21
AUCTION RESULTS: Rate / Cover 13-week bills 0.015% 2.94 26-week bills 0.030% 3.28 **SETTLE:** $58 billion 3-year notes $41 billion 10-year notes $27 billion 30-year bonds	**AUCTION RESULTS:** Rate / Cover 52-week bills 0.055% 3.32 6-week CMB 0.005% 3.86 **ANNOUNCE:** $40 billion 4-week bills for auction on May 20 $40 billion 8-week bills for auction on May 20 $35 billion 17-week CMBs for auction on May 19 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $35 billion 17-week CMBs	**AUCTION RESULTS:** Rate / Cover 20-yr bonds 2.286% 2.24 17-week CMB 0.015% 3.51	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.000% 3.98 8-week bills 0.005% 3.38 10-yr TIPS -0.805% 2.50 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on May 24 $26 billion 2-year FRNs for auction on May 26 $60 billion 2-year notes for auction on May 25 $61 billion 5-year notes for auction on May 26 $62 billion 7-year notes for auction on May 27	$40 billion 6-week CMBs for auction on May 25 **SETTLE:** $111 billion 13-,26-week bills $34 billion 52-week bills $40 billion 6-week CMBs
24	25	26	27	28
AUCTION: $111 billion 13-,26-week bills	**AUCTION:** $60 billion 2-year notes $40 billion 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on May 27 $40 billion* 8-week bills for auction on May 27 $35 billion* 17-week CMBs for auction on May 26 **SETTLE:** $40 billion 4-week bills $40 billion 8-week bills $35 billion 17-week CMBs	**AUCTION:** $26 billion 2-year FRNs $61 billion 5-year notes $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills $62 billion 7-year notes **ANNOUNCE:** $111 billion* 13-,26-week bills for auction June 1 $40 billion* 6-week CMBs for auction on June 1 **SETTLE:** $111 billion 13-,26-week bills $40 billion 6-week CMBs	**SETTLE:** $13 billion 10-year TIPS $26 billion 2-year FRNs
31	1	2	3	4
	AUCTION: $111 billion* 13-,26-week bills $40 billion* 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on June 3 $40 billion* 8-week bills for auction on June 3 $35 billion* 17-week CMBs for auction on June 2 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills $27 billion 20-year bonds $60 billion 2-year notes $61 billion 5-year notes $62 billion 7-year notes $35 billion* 17-week bills	**AUCTION:** $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on June 7 $58 billion* 3-year notes for auction on June 8 $38 billion* 10-year notes for auction on June 9 $24 billion* 30-year bonds for auction on June 10 $40 billion* 6-week CMBs for auction on June 8 **SETTLE:** $111 billion 13-,26-week bills $40 billion 6-week CMBs	
7	8	9	10	11
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $58 billion* 3-year notes $40 billion* 6-week CMBs **ANNOUNCE:** $40 billion* 4-week bills for auction on June 10 $40 billion* 8-week bills for auction on June 10 $35 billion* 17-week CMBs for auction on June 9 **SETTLE:** $40 billion* 4-week bills $40 billion* 8-week bills $35 billion* 17-week CMBs	**AUCTION:** $38 billion* 10-year notes $35 billion* 17-week CMBs	**AUCTION:** $40 billion* 4-week bills $40 billion* 8-week bills $24 billion* 30-year bonds **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on June 14 $34 billion* 52-week bills for auction on June 15 $24 billion* 20-year bonds for auction on June 15 $16 billion* 5-year TIPS for auction on June 17 $40 billion* 6-week CMBs for auction on June 15 **SETTLE:** $111 billion* 13-,26-week bills $40 billion* 6-week CMBs	

*Estimate