Daiwa Capital Markets

U.S. Economic Comment

- FOMC preview: strong clues for tapering this year
- The surge in RRPs supports the case for tapering
- Interest rate liftoff: dot plot likely to continue indicating 2023

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The FOMC and QE

The Federal Open Market Committee could easily justify backing away from its indication in July that it might be appropriate to begin reducing its asset purchases this year. The acceleration in the number of Covid cases has created downside risks for the economy, with the August employment report raising the possibility of an abrupt slowdown. In addition, the August CPI provided support for the Fed view that the recent pickup in inflation will be transitory. One could easily argue for patience in making important decisions.

Despite these developments, we expect the Committee to signal that a reduction in its asset purchase program is likely to begin this year. Officials will probably stop short of establishing a fixed start date, but we expect the policy statement and Chair Powell’s comments at the press briefing to provide strong hints that tapering will begin in November or December.

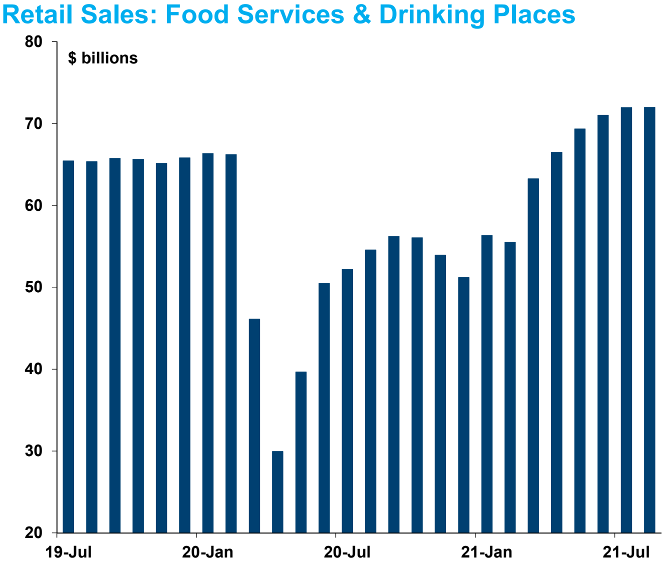
The August employment report was striking, showing only 235,000 new jobs versus an average of 636,000 in the prior seven months. However, a record level of job openings in July (latest available) suggested that underlying demand for labor was strong and that firmer payroll results were likely in coming months. The elevated number of available jobs suggested that the slowdown in hiring in August was partly the result of random volatility that sometimes creeps into the data: a pause after more than two million new jobs in June and July combined.

The retail sales report for August provided strong support for the view that the recovery remains on track. Despite a sharp drop in auto sales because of a shortage of semiconductors, total retail activity rose 0.7 percent, with most components contributing to the advance. We were especially interested in activity at restaurants and bars because of the potential influence of Covid. This area held its own, showing steady activity at a level that had already exceeded its pre-pandemic high (chart).

The core CPI certainly was well contained in August (0.1 percent), and the most dovish Fed officials are likely to highlight the restraint as a reason to maintain QE at its current pace. However, most policymakers are not likely to be swayed by a single monthly observation, especially at a time when strong demand and supply-chain disruptions have the potential to generate high-side readings on inflation.

Thus, we look for the Fed to signal that tapering will begin before the end of the year.

Retail Sales: Food Services & Drinking Places



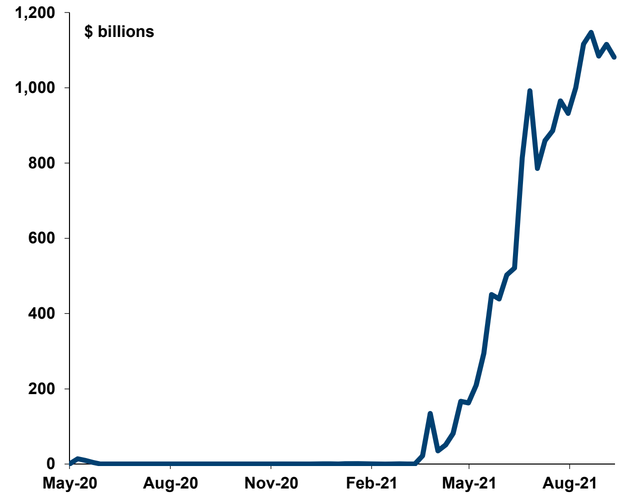
Source: U.S. Census Bureau via Haver Analytics

Another Reason for Tapering: The Surge in RRPs

Recent economic developments, while mixed, support the case for tapering, but officials wishing to reduce asset purchases can cite another reason: the Fed has already provided an abundance of reserves to the banking system; additional purchases will boost an already excessive amount of liquidity.

The generous amount of support provided by the Fed is evident in the amount of reverse repurchase agreements (RRPs) on the Fed's balance sheet. In a reverse RP, the Fed sells a Treasury security from its portfolio to a counterparty while agreeing to buy the security back at a later date (usually the next day, but term reverse RPs are arranged occasionally). Such transactions drain reserves from the banking system: the payment for the security involves a transfer of funds from a counterparty's account in the banking system to the Fed, which effectively extinguishes reserves. The volume of RRPs on the Fed's balance sheet has surged from trivial amounts before March to more than $1.0 trillion recently (chart).

Fed Reverse Repurchase Agreements*



** Weekly end-of-period data as of Wednesday. Excludes transactions with foreign official institutions.*

Source: Federal Reserve Board via Haver Analytics

These transactions are arranged through a standing facility established by the Fed. That is, the RRP facility for overnight transactions is open every day, giving counterparties the opportunity to purchase up to $80 billion of Treasury securities. The limit of $80 billion is established by the Fed and could be changed. In fact, it was increased in March from $30 billion. The Fed has approximately 130 counterparties for RRPs consisting of primary dealers, government-sponsored enterprises, large commercial banks and savings institutions ($30 billion or more in total assets), and large money market mutual funds (total assets of $2 billion or more).

Because the transactions are initiated by the counterparties, and because the counterparties have a high degree of discretion over the volume of transactions, the amount of RRPs on the Fed's balance sheet could be viewed as a measure of unwanted or unneeded reserves. In effect, the counterparties are sending reserves back to the Fed; they do not have other attractive outlets or investment opportunities. A money market mutual fund, for example, could be purchasing commercial paper, or a commercial bank could be writing a new loan; instead, they are sending the funds back to the Fed.

Fed officials might argue that the surge in reverse RPs was the result of a reduction in the volume of bills issued by the Treasury Department. In fact, Chair Powell offered this explanation in a recent press briefing. In a sense, this is true. The Treasury Department has cut the issuance of bills in recent months, and the drop in outstanding supply has put downward pressure on short-term interest rates, leaving many investors searching for alternative outlets. They have turned to the Fed's RRP facility to invest the funds previously held in bills. However, this rerouting of investments does not affect the view that elevated RRPs signal an overabundance of reserves in the banking system.

The drop in bill issuance by the Treasury Department is essentially a Covid story (and recently a debt-ceiling story). With the onset of the pandemic, Congress provided massive amounts of fiscal support, and the Treasury Department issued a large volume of securities to fund the spending by the federal government. The Treasury also increased the size of its cash balance considerably to insure that it would be able to cover uncertain cash outflows. (The normal size of the cash balance is $300 to $500 billion; during the pandemic, the Treasury held a balance in the neighborhood of $1.8 trillion.) Now, fiscal support and uncertainty regarding cash outflows are diminishing. In response, the Treasury has reduced its cash balance by trimming net bill issuance. Bill issuance has been trimmed further in recent weeks to deal with debt-ceiling issues. The unusually high level of the Treasury's cash balance during the worst of the pandemic absorbed the heavy dose of liquidity provided by the Fed. Now, the reduction in the cash balance has revealed that the Fed has provided more reserves than needed by the private sector.

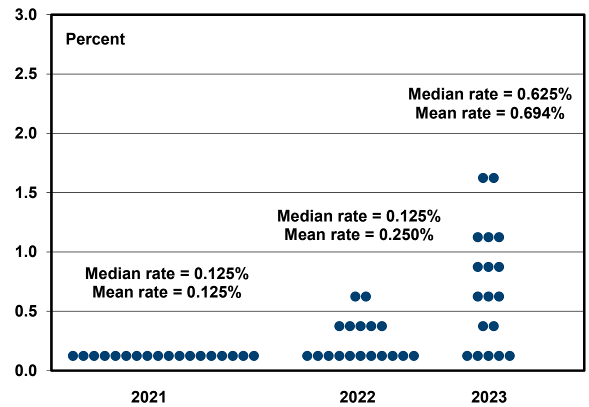
A continuation of QE would add to the abundance (overabundance?) of reserves in the banking system. The massive dose of liquidity might be viewed as benign because the standing RRP facility provides an avenue to drain the excess. However, the continuation of QE could be viewed as pointless. The Fed is adding reserves through its security purchases while counterparties are sending them back through reverse repurchase agreements. Why bother with QE?

Interest Rate Liftoff

Fed officials currently are focused on decisions regarding their asset purchase program; interest rate adjustments are not on the agenda. However, market participants are keen on searching for clues on when interest rates might be hiked.

The dot plot published in June suggested that interest rate liftoff would occur in 2023. That is, the median dot showed the first hike occurring two years from now, although several officials saw the potential for higher interest rates next year (chart). This configuration represented a marked change from that at the March meeting, when the median dot showed policy on hold through the 2023 forecast horizon.

FOMC Rate View: Year-End 2021, 2022, & 2023*



** Each dot represents the expected federal funds rate of a Fed official at the ends of 2021, 2022, and 2023. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but one governorship was open at the June 2021 meeting.*

Source: Federal Open Market Committee, Summary of Economic Projections, June 2021

It is not difficult to imagine that more Fed officials will pull their expectations for interest rate hikes forward, as recent inflation developments (August CPI notwithstanding) and resilience in the face of the Delta variant are likely to convince some officials that it would be prudent to begin removing some accommodation. However, it would take changes by three officials to pull interest rate liftoff from 2023 into next year. This seems ambitious, and thus we look for the median dot to continue suggesting liftoff in 2023.

The new set of forecasts from Fed officials is likely to involve other changes. The June projections showed an expectation of 7.0 percent for real GDP growth over the four quarters of this year. That pace now seems far too rapid. The economy grew approximately 6.5 percent in the first half, and recent figures suggest a deceleration to approximately 4.0 percent in the second half. Our view has the economy growing 5.3 percent over the four quarters of 2021. Of course, Fed views could easily differ from ours, but we would be shocked if GDP projections were not reduced from the 7.0 percent published in June.

The Fed's inflation view in June is likely to be off the mark as well. The median forecast for the core PCE price index this year was 3.0 percent in the June forecasts. The advance in H1 totaled 4.4 percent, and core prices in Q3 are on track for an increase of 4.0 percent. An increase of 3.0 percent over the four quarters of the year now seems unachievable. A new projection in the neighborhood of 4.0 percent seems likely.

Review

Week of Sept. 13, 2021	Actual	Consensus	Comments
Federal Budget (August)	**$170.6 Billion Deficit**	**$175.0 Billion Deficit**	Federal revenues rose 20.2% on a year-over-year basis, with the jump supported by sharp increases in income and payroll taxes. Federal outlays rose only moderately from last August (3.7%), but the overall level of spending remained elevated. The cumulative deficit of $2.7 trillion in the first 11 months of FY2021 was $300 billion narrower than that in the same period in FY2020.
CPI (August)	**0.3% Total, 0.1% Core**	**0.4% Total, 0.3% Core**	Energy prices increased 2.0% in August, the 13th advance in the past 15 months, and they are up 25.0% in the past year. Food prices have started to stir recently (up 0.4% in August after an average monthly increase of 0.6% in the prior four months). The core component rose only slightly in the latest month, deviating noticeably from an average change of 0.6% from March thru July. The surprising restraint on the core CPI was largely the result of cooling in items that had shown pandemic-related pressure in earlier months (airfares, used car prices, car rental fees). On a year-over-year basis, headline prices eased one tick to 5.3%. Core prices eased to 4.0% from 4.3% in July, but they remained near the top of the range of the past 30 years.
Industrial Production (August)	**0.4%**	**0.5%**	Most of the increase in industrial production in August was the result of a 3.3% jump in utility output, a change driven by warmer-than-normal temperatures. The effects of Hurricane Ida influenced results in manufacturing and mining, which rose 0.2% and slipped 0.6%, respectively. The results in manufacturing should be viewed as solid, as the increase occurred despite shutdowns in hurricane-affected industries and continued supply-chain disruptions.
Retail Sales (August)	**0.7% Total, 1.8% Ex. Autos**	**-0.7% Total, 0.0% Ex. Autos**	Sales of new motor vehicles fell 3.6% in August, restrained by shortages of semiconductors. Sales excluding autos surprised to the upside, jumping 1.8% despite elevated Covid cases in some states. With the August advance, sales excluding autos moved to a new high, one far above pre-pandemic levels. With regard to components, we were interested in the performance at restaurants and bars because of the potential influence of Covid. This area held its own, showing steady activity at a level that had already exceeded the pre-pandemic high.
Consumer Sentiment (September)	**71.0 (+0.7 Index Pt.)**	**72.0 (+1.7 Index Pts.)**	Consumer sentiment recovered only a fraction of the 13.4% drop in the prior month, and the latest reading remained below the recession trough of 71.8 in April 2020. The recent acceleration in Covid cases and stirring in inflation likely both factored into subdued moods. On the inflation front, the year-ahead measure of expectations increased one tick to 4.7%, matching the recent high in July. The recent string of elevated readings represents the fastest pace of expected year-ahead inflation in about a decade. The long-term measure of inflation expectations was unchanged at 2.9%, off the recent high of 3.0% in May but at the top of the range of the past decade.

Sources: U.S. Treasury Department (Federal Budget); Bureau of Labor Statistics (CPI); Federal Reserve Board (Industrial Production); U.S. Census Bureau (Retail Sales); University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Sept. 20, 2021	Projected	Comments
Housing Starts (August) (Tuesday)	**1.540 Million (+0.4%)**	Softening sales of new homes and rising inventories of unsold homes probably led builders to be cautious in starting new single-family units. Multi-family starts have performed well in the past seven months. Results in July were a bit below the recent average, and a pickup to the recent norm would provide an offset to an expected dip in single-family activity.
Current Account (2021-Q2) (Tuesday)	**-$185.0 Billion**	The current account balance of the U.S. in Q1 will probably be revised upward (i.e. a narrower deficit), reflecting a brighter trade picture. The balance in Q2 is likely to be little changed from the Q1 adjustment, as slight slippage in trade should be about offset by an improvement in income flows.
Existing Home Sales (August) (Wednesday)	**6.00 Million (+0.2%)**	Modest increases in June and July suggest that sales of existing homes are beginning to recover from their February-to-May retreat. However, two consecutive declines in pending home sales and a modest pickup in mortgage applications suggest slow progress.
Leading Indicators (August) (Thursday)	**0.7%**	Marked improvements in initial claims for unemployment insurance and ISM new orders are likely to lead to the 15th increase in the leading indicator index in the past 16 months. The expected increase would push the index 20.6% above its pre-pandemic level.
New Home Sales (August) (Friday)	**0.710 Million (+0.3%)**	The easing in new home sales that began early in the year seems to be stabilizing, but hints of a pickup are scarce. The index of buyer traffic through new homes has declined for four consecutive months, and mortgage applications have picked up only modestly.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

September/October 2021

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
FEDERAL BUDGET 2021 2020 June -$174.2B -$864.1B July -$302.1B -$63.0B Aug -$170.6B -$200.0B	**NFIB SMALL BUSINESS OPTIMISM INDEX** June 102.5 July 99.7 Aug 100.1 **CPI** Total Core June 0.9% 0.9% July 0.5% 0.3% Aug 0.3% 0.1%	**IMPORT/EXPORT PRICES** Nonpetrol. Imports Nonagri. Exports June 0.6% 1.1% July 0.3% 1.4% Aug -0.1% 0.2% **EMPIRE MFG INDEX** July 43.0 Aug 18.3 Sept 34.3 **IP & CAP-U** IP Cap.Util. June 0.5% 75.6% July 0.8% 76.2% Aug 0.4% 76.4%	**UNEMPLOYMENT CLAIMS** Initial Continuing (Millions) Aug 21 0.354 2.805 Aug 28 0.345 2.852 Sept 04 0.312 2.665 Sept 11 0.332 N/A **RETAIL SALES** Total Ex.Autos June 0.9% 1.7% July -1.8% -1.0% Aug 0.7% 1.8% **PHILLY FED INDEX** July 21.9 Aug 19.4 Sept 30.7 **BUSINESS INVENTORIES** Inventories Sales May 0.6% -0.2% June 0.9% 1.6% July 0.5% 0.5% **TIC DATA** Total Net Long-Term May $94.6B -$30.0B June $32.0B $110.9B July $126.0B $2.0B	**CONSUMER SENTIMENT** July 81.2 Aug 70.3 Sept 71.0
20	21	22	23	24
NAHB HOUSING INDEX (10:00) July 80 Aug 75 Sept --	**HOUSING STARTS (8:30)** June 1.650 million July 1.534 million **Aug 1.540 million** **CURRENT ACCOUNT (8:30)** 20-Q4 -$175.1 bill. 21-Q1 -$195.7 bill. **21-Q2 -$185.0 bill.** **FOMC MEETING**	**EXISTING HOME SALES (10:00)** June 5.87 million July 5.99 million **Aug 6.00 million** **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)** Monthly 3-Mo. Avg. June -0.01 0.01 July 0.53 0.23 Aug -- -- **LEADING INDICATORS (10:00)** June 0.5% July 0.9% **Aug 0.7%**	**NEW HOME SALES (10:00)** June 0.701 million July 0.708 million **Aug 0.710 million**
27	28	29	30	1
DURABLE GOODS ORDERS	**U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER HOME PRICES** **CONSUMER CONFIDENCE**	**PENDING HOME SALES**	**INITIAL CLAIMS** **REVISED GDP** **CHICAGO PURCHASING MANAGERS' INDEX**	**PERSONAL INCOME, CONSUMPTION & PRICES** **REVISED CONSUEMR SENTIMENT** **ISM MFG. INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES**
4	5	6	7	8
FACTORY ORDERS	**TRADE BALANCE** **ISM SERVICES INDEX**	**ADP EMPLOYMENT REPORT**	**INITIAL CLAIMS** **CONSUMER CREDIT**	**EMPLOYMENT REPORT** **WHOLESALE TRADE**

Forecasts in Bold.

Treasury Financing

September/October 2021

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
AUCTION RESULTS: Rate / Cover 13-week bills 0.040% 3.55 26-week bills 0.050% 3.78	**ANNOUNCE:** $15 billion 4-week bills for auction on September 16 $30 billion 8-week bills for auction on September 16 $30 billion 17-week CMBs for auction on September 15 **SETTLE:** $20 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION RESULTS:** Rate / Cover 17-week CMB 0.045% 4.35 **SETTLE:** $58 billion 3-year notes $38 billion 10-year notes $24 billion 30-year bonds	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.055% 3.96 8-week bills 0.055% 3.45 **ANNOUNCE:** $90 billion 13-,26-week bills for auction on September 20 $26 billion 2-year FRNs for auction on September 22 $24 billion 20-year bonds for auction on September 21 $14 billion 10-year TIPS for auction on September 23 **SETTLE:** $93 billion 13-,26-week bills	
20	21	22	23	24
AUCTION: $90 billion 13-,26-week bills	**AUCTION:** $24 billion 20-year bonds **ANNOUNCE:** $15 billion* 4-week bills for auction on September 23 $30 billion* 8-week bills for auction on September 23 $30 billion* 17-week CMBs for auction on September 22 **SETTLE:** $15 billion 4-week bills $30 billion 8-week bills $30 billion 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs $26 billion 2-year FRNs	**AUCTION:** $15 billion* 4-week bills $30 billion* 8-week bills $14 billion 10-year TIPS **ANNOUNCE:** $90 billion* 13-,26-week bills for auction on September 27 $60 billion* 2-year notes for auction on September 27 $61 billion* 5-year notes for auction on September 27 $62 billion* 7-year notes for auction on September 28 **SETTLE:** $90 billion 13-,26-week bills	**SETTLE:** $26 billion 2-year FRNs
27	28	29	30	1
AUCTION: $90 billion* 13-,26-week bills $60 billion* 2-year notes $61 billion* 5-year notes	**AUCTION:** $62 billion* 7-year notes **ANNOUNCE:** $15 billion* 4-week bills for auction on September 30 $30 billion* 8-week bills for auction on September 30 $30 billion* 17-week CMBs for auction on September 29 **SETTLE:** $15 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $15 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $90 billion* 13-,26-week bills for auction on October 4 $34 billion* 52-week bills for auction on October 5 **SETTLE:** $90 billion* 13-,26-week bills $24 billion 20-year bonds $14 billion 10-year TIPS $60 billion* 2-year notes $61 billion* 5-year notes $62 billion* 7-year notes	
4	5	6	7	8
AUCTION: $90 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills **ANNOUNCE:** $15 billion* 4-week bills for auction on October 7 $30 billion* 8-week bills for auction on October 7 $30 billion* 17-week CMBs for auction on October 6 **SETTLE:** $15 billion* 4-week bills $30 billion* 8-week bills $30 billion* 17-week CMBs	**AUCTION:** $30 billion* 17-week CMBs	**AUCTION:** $15 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $90 billion* 13-,26-week bills for auction on October 12 $58 billion* 3-year notes for auction on October 12 $38 billion* 10-year notes for auction on October 12 $24 billion* 30-year bonds for auction on October 13 **SETTLE:** $90 billion* 13-,26-week bills $34 billion* 52-week bills	

**Estimate*