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Weekly Economic Monitor

Fed Policy: Balance Sheet Normalization

As expected, the Federal Open Market Committee left the federal funds target range unchanged (at 1.00-1.25%) after its September 19-20 policy meeting. The FOMC also announced the beginning of balance sheet reduction. The Fed had outlined how this would work in mid-June, and officials did a good job of telegraphing when it would start. Investors were more surprised by the dot plot, which continued to show a majority of Fed officials anticipating one more rate hike by the end of the year.

The Fed's three large-scale asset purchase programs (quantitative easing, or "QE") added $3.4 trillion to the Fed's balance sheet. The Fed is not planning on selling these securities. It will continue to reinvest maturing securities, but will allow a certain amount to run-off each month. The cap on the monthly run-off starts slow ($10 billion), but increases every three months, reaching full stride ($50 billion) in October 2018.

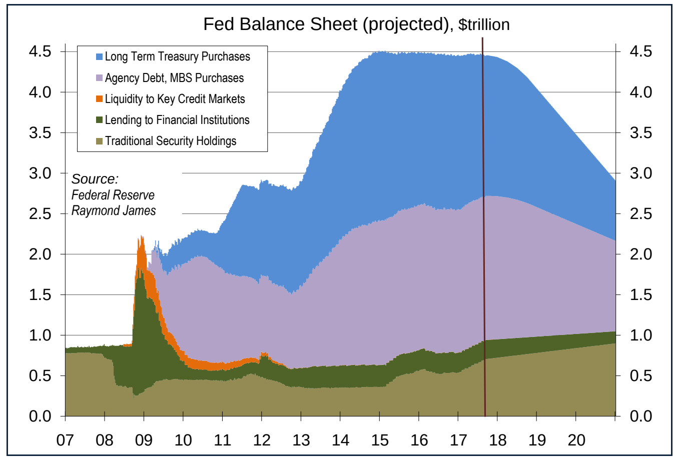
Monthly Caps on SOMA Securities Reductions

	Treasury Securities	Agency Securities*
Oct – Dec 2017	$6 billion	$4 billion
Jan – Mar 2018	$12 billion	$8 billion
Apr – Jun 2018	$18 billion	$12 billion
Jul – Sep 2018	$24 billion	$16 billion
From Oct 2018**	$30 billion	$20 billion

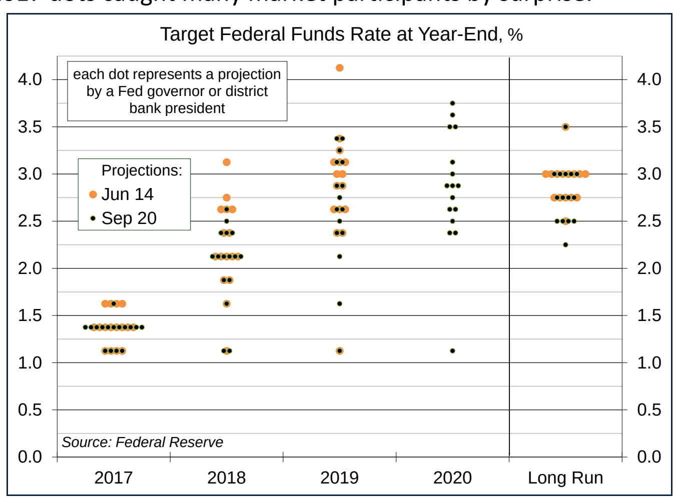
*Applies to combined principal payments of agency debt and agency MBS. **Once caps reach their maximum amounts, they will remain in effect until the Committee judges that the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively. [Source: NY Fed]

In her post-FOMC press conference, Chair Janet Yellen said that the Fed does not plan on making adjustments to the balance sheet normalization program. The run-off is not *"active"* policy. The Fed will still rely on the federal funds target rate as *"the primary means of adjusting the stance of monetary policy."* Still, the Fed could stop the program, or even purchase more securities if the economy were to experience a large negative shock (the federal funds rate would have to be dropped toward zero first). The Fed likely feared some adverse market reaction to balance sheet reduction, as we saw a few years ago with the taper tantrum. However, the Fed has signaled its plans well in advance and will start slow.

What does this mean for investors? Again, balance sheet reduction was well advertised. There's nothing surprising in the announcement. All else equal, balance sheet reduction should mean a gradual increase in long-term interest rates, but there are a lot of factors driving bond yields (including inflation expectations and bond yields outside the U.S.). QE lowered the 10-year Treasury note yield by 50-100 basis points, so the unwinding would likely push yields up accordingly (all else equal). However, the size of the balance sheet is unlikely to fall back to where it was before the Fed's asset purchases. The Fed will continue the run-off until the size of the balance sheet is *"appropriate,"* but it's unclear what that means.



The revised dot plot (the expectations of senior Fed officials of the appropriate yearend level of the federal funds target rate) showed 11 of 16 officials expecting one more rate hike this year. Note that there is a lot of uncertainty surrounding each dot (Fed decisions will remain data-dependent) and not all of the dots represent voting members of the FOMC. Still, the December 2017 dots caught many market participants by surprise.



The dots showed a wide variation in policy expectations for 2018 and 2019, but the anticipated direction (higher) was nearly uniform. In the near term, much of the economic data will be distorted by hurricanes Harvey and Irma. Some of the important data (retail sales, manufacturing output) had suggested some sluggishness ahead of the storms. Yet, the availability of credit has continued to expand despite the increase in short-term interest rates in the first half of the year.

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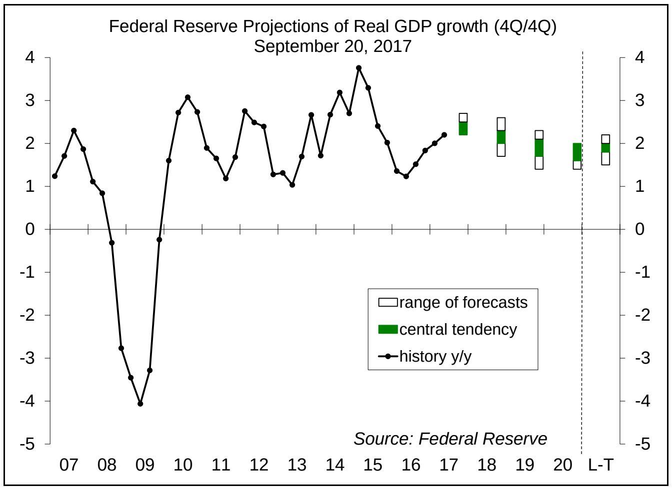
	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
8/25/17	1.03	1.11	1.23	1.35	1.47	1.77	2.17	2.75	1.187	1.287	109.24	1.249	6265.64	2443.05	21813.67
9/15/17	1.05	1.17	1.30	1.39	1.53	1.81	2.20	2.77	1.196	1.358	110.84	1.218	6448.47	2500.23	22268.34
9/22/17	1.03	1.19	1.31	1.44	1.59	1.87	2.26	2.80	1.194	1.352	112.07	1.234	6426.42	2502.21	22349.59

Recent Economic Data and Outlook

The FOMC result was as expected, but the dot plot still showed a majority of officials anticipating one more rate hike this year.



As expected, the **Federal Open Market Committee** left the target rate range for federal funds unchanged (at 1.00-1.25%) and announced that the balance sheet normalization will begin in October. As was indicated in June, the cap on the run-off is initially set at $10 billion per month ($6 billion in Treasuries, $4 billion in agency debt), but rises every three months, to $50 billion per month in October 2018, and then stays there until the Fed decides that the size of the balance sheet is appropriate.

The Fed's **Summary of Economic Projections** showed little change relative to forecasts made in June. The median forecast (of the 4 governors and 12 district bank presidents) for GDP growth was 2.4% in 2017 (4Q/4Q), 2.1% in 2018, 2.0% in 2019, and 1.8% in 2020. Inflation was expected to be 1.6% this year, 1.9% in 2018, edging up to 2.0% in 2019 and 2020. The revised dot plot, showed that 11 of 16 officials anticipate one more rate increase by the end of this year (four saw none, one saw two rate hikes). The range of dots widened for 2018 and 2019.

In her post-meeting press conference, **Fed Chair Janet Yellen** emphasized that balance sheet reduction (or "normalization") is not "active" policy, and that the federal funds target rate will remain the main policy lever. The Fed could alter the pace of the balance sheet run-off if the economy were to experience a significant negative shock (which would first lead the Fed to lower the overnight lending rate to near-zero).

Import Prices rose 0.6% in August (+2.1% y/y), reflecting a 4.8% rise in petroleum (+15.8% y/y). Ex-food & fuels, import prices rose 0.2% (+0.8% y/y), with industrial supplies and materials up 0.7% (+4.1% y/y). The price index for imported capital equipment edged up 0.1% (+0.3% y/y). Autos rose 0.2% (+0.1% y/y). Consumer goods rose 0.1% (+0.4% y/y).

Building Permits jumped 5.7% in August, to a 1.300 million seasonally adjusted annual rate (+8.6% y/y). Single-family permits slipped 1.5% (+7.7% y/y), but the trend remains strong (unadjusted single-family permits for the last three months were up 0.6% y/y). Texas counties with disaster declarations accounted for 4% of total permits in 2016. **Housing Starts** fell 0.8% (±9.6%), to a 1.180 million pace (+1.4% y/y).

Homebuilder Sentiment edged back to 64 in September, vs. 67 in August, reflecting a decrease in evaluations of new and future sales conditions. While the NAHB's index remained relatively strong by historical standards, "the recent hurricanes have intensified our members' concerns about the availability of labor and the cost of building materials."

Existing Home Sales fell 1.7% in August, to a 5.35 million seasonally adjusted annual rate (+0.2% y/y). Some of the decline may have reflected the impact of Hurricane Harvey. However, sales have been restrained by "inadequate levels of available inventory and the upward pressure it's putting on prices in several parts of the country," according to the National Association of Realtors. "Sales have been unable to break out because there are simply not enough homes for sale."

The Index of **Leading Economic Indicators** rose 0.4% in August. Positive contributions were led by building permits, the yield curve, consumer expectations, and ISM new orders. Jobless claims (a temporary, hurricane-related increase) made the only negative contribution. The Conference Board noted that the behavior of the LEI, along with coincident indicators, suggests that "the expansion in economic activity will continue through the remainder of the year, with some upside potential possible."

Economic Outlook (3Q17): 2.0-2.5% GDP growth.

Employment: The trend in private-sector job growth has remained similar to that of 2016, but is expected to slow as the job market continues to tighten.

Consumers: Recent figures suggest some loss of momentum into 3Q17. Job gains have been supportive. Inflation-adjusted wage growth has begun to weaken again.

Manufacturing: Orders and production have remained mixed across sectors, but moderate overall. Better global growth and the rebound in energy exploration have helped, but motor vehicle sales appear to have passed their peak.

Housing/Construction: Job growth has been supportive, with some weather-related shift into the earlier part of the year. Higher home prices and rising building costs are restraints.

Prices: Core inflation has continued to trend below the Fed's 2% target, partly reflecting a "one-off" plunge in wireless telecom services. Wage pressures are moderate.

Interest Rates: The Fed remains in tightening mode, and is expected to continue raising short-term rates gradually. Balance sheet reduction is expected to start in October, initially gradual, but picking up over the course of a year.

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This Week:					*forecast*	last	last –1	comments
Monday	9/25		no significant data					Happy Bday, Bob McAdoo, Scottie Pippen
Tuesday	9/26	10:00	New Home Sales, mln	Aug	***590***	571	630	likely to have partially rebounded
			% change		***+3.3***	-9.4	+1.9	but watch for revisions
		10:00	**CB Consumer Confidence**	Sep	***117.5***	122.9	120.0	likely lower
		12:45	**Yellen Speech**					*"Inflation, Uncertainty, and Mon Pol"*
		1:00	Treasury Note Auction					2-year notes
Wednesday	9/27	8:30	**Durable Goods Orders**	Aug	***+0.8%***	-6.8%	+6.4%	a partial rebound in aircraft
			ex-transportation		***+0.3%***	+0.6%	-0.0%	moderately higher
			nondef cap gds ex-aircraft		***+0.2%***	+1.0%	-0.1%	a soft-to-moderate trend
		10:00	Pending Home Sales Index	Aug	***-0.5%***	-0.8%	+1.3%	seen a bit softer
		11:30	FRN Auction					2-year FRNs
		1:00	Treasury Note Auction					5-year notes
Thursday	9/28	8:30	Jobless Claims, th.	9/23	***285***	259	282	Irma Impact
		8:30	Real GDP (3rd estimate)	2Q17	***+2.9%***	+1.2%	+1.8%	+3.0% in 2nd estimate
			Priv. Dom. Final Purchases		***+3.2%***	+3.1%	+2.7%	+3.4% in the 2nd estimate
		8:30	Advance Econ Indicators	Aug				inventory and merchandise trade figures
		10:00	Fed VC Fischer Speaks					*"Developments in Central Banking"*
		1:00	Treasury Note Auction					7-year notes
Friday	9/29	8:30	Personal Income	Aug	***+0.2%***	+0.4%	0.0%	a modest gain
			Personal Spending		***-0.1%***	+0.3%	+0.2%	weak / autos sales fell
			PCE Price Index ex-f&e		***+0.2%***	+0.1%	+0.1%	core CPI reported up 0.248%
		9:45	Chicago Business Barometer	Sep	***56.8***	58.9	58.9	likely softer
		10:00	UM Consumer Sentiment	Sep	***95.0***	96.8	93.4	95.3 at mid-month
Next Week:								
Monday	10/02	10:00	Construction Spending	Aug	***NF***	-0.6%	-1.4%	soft in recent months
		10:00	**ISM Manf. Index**	Sep	***55.6***	58.8	56.3	some pullback anticipated (hurricanes?)
Tuesday	10/03	tbd	Motor Vehicle Sales, mln	Sep	***15.4***	16.0	16.7	expecting a hurricane impact
			domestically built		***12.0***	12.5	13.0	but trend was already down in 2017
Wednesday	10/04	8:15	**ADP Payroll Estimate (th.)**	Sep	***+160***	+237	+201	likely slower (but watch for revisions)
		10:00	**ISM Non-Manf. Index**	Sep	***54.4***	55.3	53.9	moderate
Thursday	10/05	8:30	Jobless Claims, th.	9/30	***265***	***285***	259	still noisy
		8:30	Trade Balance, $bln	Aug	***NF***	-43.7	-43.5	higher oil prices add to imports
			goods only		***NF***	-65.3	-65.4	but trend in exports should remain strong
		10:00	Factory Orders	Aug	***NF***	-3.3%	+3.2%	expecting a rebound in durables
Friday	10/06	8:30	**Nonfarm Payrolls, th.**	Sep	***+145***	+156	+189	expecting some modest hurricane impact
			private-sector		***+140***	+165	+202	but trend is likely to slow regardless
			Unemployment Rate		***4.3%***	4.4%	4.3%	essentially unchanged
			employment/population		***62.9%***	62.9%	62.9%	flat
			Avg. Weekly Hours		***34.3***	34.4	34.5	some hurricane impact
			Avg. Hourly Earnings		***+0.2%***	+0.1%	+0.3%	moderate wage pressure

This Week…

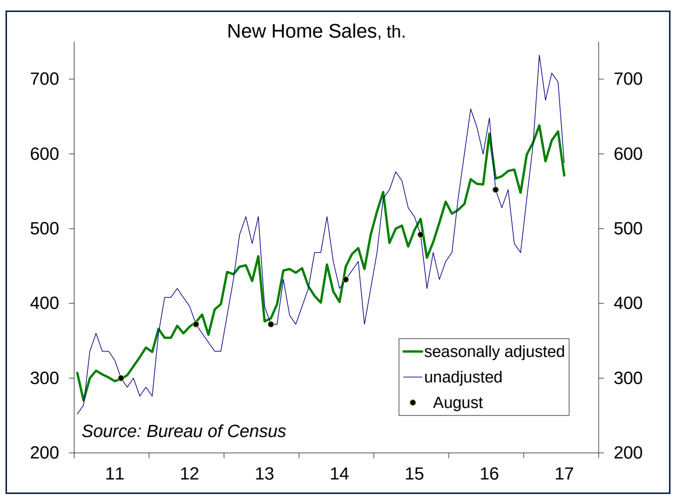
Fed Chair Yellen will speak to the National Association for Business Economics on Tuesday, but she's not expected to bring much new to the monetary policy discussion. Second quarter GDP figures will be released on Thursday, but that's ancient history at this point. August economic data (durable goods, advance economic indicators, and personal spending) will help fill in the picture for the third quarter.

Monday

No significant economic data.

Tuesday

New Home Sales (August) – The figures (which count initial transactions, such as a down payment or signed contract) are reported with a gigantic amount of uncertainty. Hurricane Harvey may have had some impact on the August total, but it will be hard to tell with any certainty.



CB Consumer Confidence (September) – The Conference Board's index includes a more direct measure of labor market

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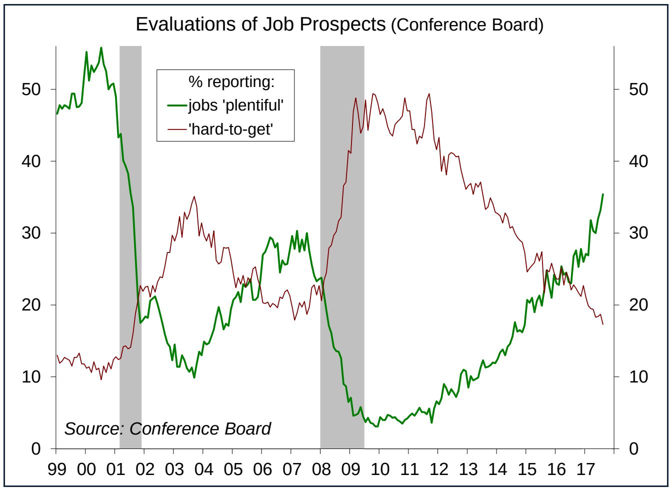
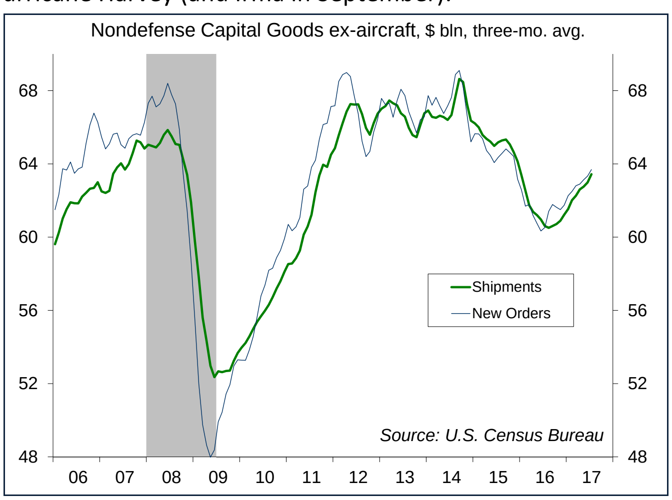
perceptions, which have been on an improving trend for the last seven years. The hurricanes may have some impact.



Fed Chair Yellen Speaks (NABE Conference) – Janet Yellen may be speaking to a room full of economists, but her comments will be geared for a wider audience. Expect her to expound further on the themes discussed in her post-FOMC press conference (the economic outlook, inflation, and balance sheet reduction). However, we're unlikely to hear much that is new.

Wednesday

Durable Goods Orders (August) – Boeing orders fell sharply in July, but only partially rebound in August. Ex-transportation, orders are likely to have risen at a lackluster-to-moderate pace, mixed across categories. Note that shipments and inventory data will help to fill in the 3Q17 GDP picture. Orders are normally choppy and we could see some distortions from Hurricane Harvey (and Irma in September).



Thursday

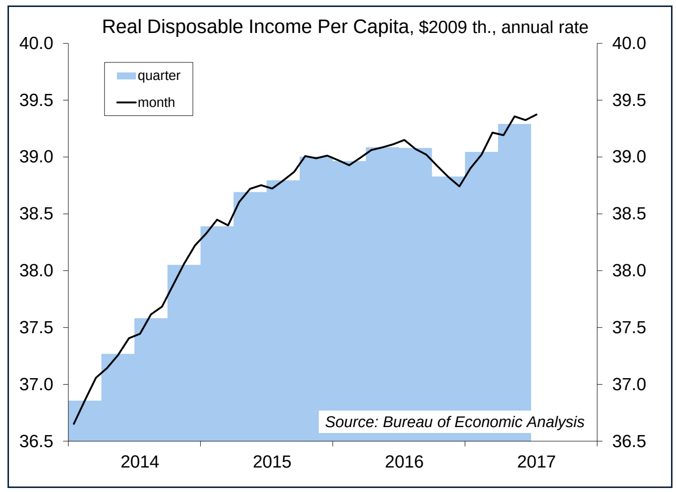
Jobless Claims (week ending September 23) – The impact of Hurricane Harvey on claims appears likely to be of much shorter duration than that of Katrina. Irma will also distort, first with downward pressure (as individuals are unable to file) and then with a spike higher. Prior to the hurricanes, the underlying trend in jobless claims was low, consistent with a further tightening in labor market conditions.

Real GDP (2Q17, 3rd estimate) – Little change is expected from the 2nd estimate of second quarter growth. June retail sales were revised down, but that's not going to move the 2Q needle much (that will matter a lot more to 3Q17 spending growth).

Advance Economic Indicators (August) – While not market-moving, the merchandise trade and inventory figures will help to refine forecasts of 3Q17 GDP growth.

Friday

Personal Income and Spending (August) – Income should have risen moderately. The Index of Aggregate Payrolls (from the employment report) fell 0.1%. Consumer spending accounts for about 70% of GDP and these are the same numbers that go into the National Income and Product Accounts. Unit auto sales fell, gasoline prices were higher, but retail sales were weak (with downward revisions to June and July. The core CPI rose 0.2% (nearly rounded up to 0.3%), so we should see a pickup in the PCE Price Index counterpart.



Next Week …

Jobs! Seasonal adjustment can be tricky in September (unadjusted, we will probably add more than 1.5 million educations jobs). Payroll data are measured for the pay period that includes the 12th of the month – so it's unclear what sort of hurricane effect will show through (although hours ought to edge lower). Wage data are important, but subject to noise.

Coming Events and Data Releases

October 9	Columbus Day (bond market closed)
October 11	FOMC Minutes (September 19-20)
October 13	Retail Sales (September) Consumer Price Index (September)
October 27	Real GDP (3Q17, advance estimate)
November 1	FOMC Policy Decision (no press conf.)
December 13	FOMC Policy Decision, Yellen press conf.
January 31	FOMC Policy Decision (no press conf.)
March 21	FOMC Policy Decision, press conf.

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