FHN FINANCIAL

SEPTEMBER 11, 2020

ECONOMIC WEEKLY

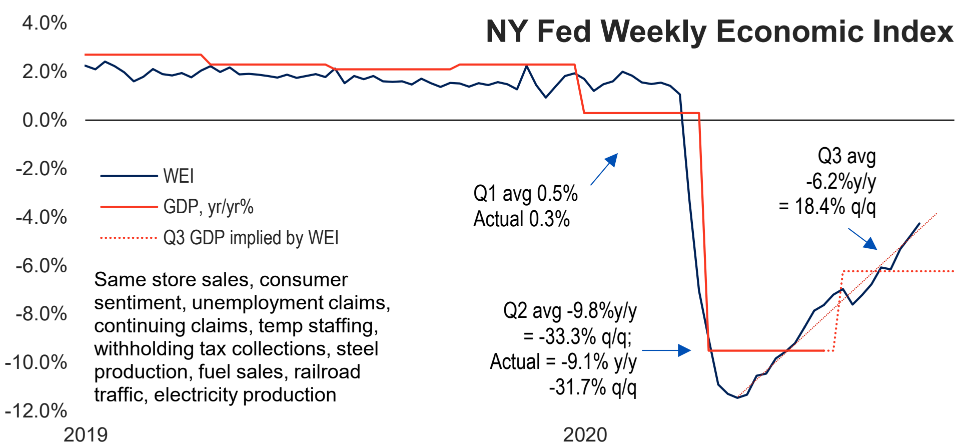
FOMC Preview: Back to the Day Job

Since March, the Fed has focused on reviving the economy and completing its policy review. In July, the review took up most of the meeting. There are still details to work out, specifics about Flexible Average Inflation Targeting, or FAIT, for instance, but there's years before FAIT will be relevant. With policy heavy lifting completed, the focus will shift back to the economy.

We expect a robust discussion at this month's meeting and the same level of worry about the economy as in July, but no action aside from a strong endorsement of fiscal stimulus. It's not that participants don't want to boost the economy, there is no policy action to add that would help at this stage.

State of the economy

GDP continues to recover at a V-shaped rate. The Fed, like just about everyone else, ourselves included, expects the recovery to lose steam, but it has not happened yet. To be perfectly fair, we expected deceleration to begin two months ago. Despite considerable volatility since July, the NY Fed's Weekly Economic Index has never strayed far from the linear trend established in May and June.



Source: New York Federal Reserve Bank, Bureau of Economic Analysis

The CARES Act did a great job alleviating income shortfalls caused by the first round of job cuts in April, while the resurgence of COVID in July did not knock the economy backward, despite partial shutdowns in large states. On balance, then, the economy is stronger than expected, despite zero support from Congress.

Yet, the Fed is just as worried about the economic outlook now as it was in March. In speech after speech, participants have talked up the need for more stimulus to restore economic strength. Their primary concern, not surprisingly, is job losses. The economy simply cannot stand on its own with a big chunk of wage and salary income missing. As for the strength of the bounce-back to date, that's easily

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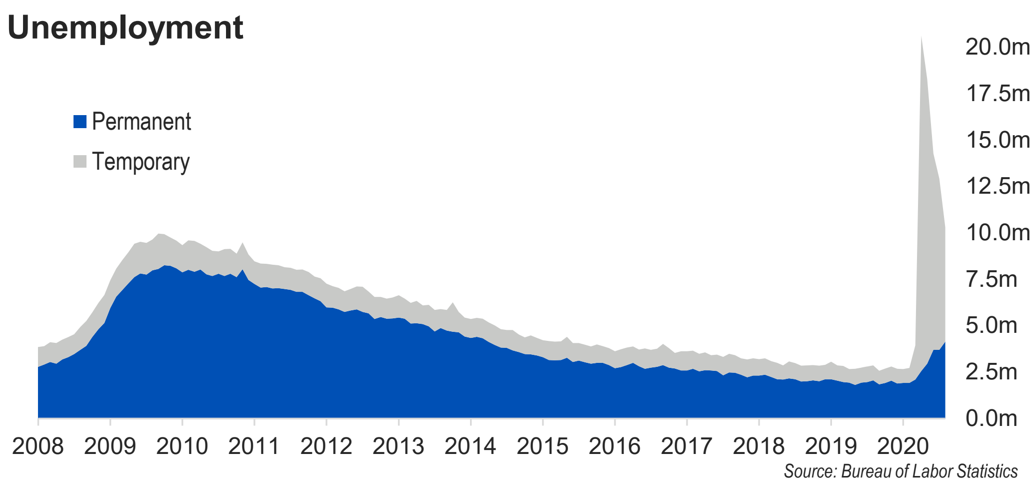
explained by the CARES Act and the lag between activity and reporting. Most pandemic aid ended more than a month ago, but the most recent data — with the exception of a jobs report and the ISM surveys — only run through July, when the aid was still flowing.

But wait, the August employment report and August ISMs were better than expected and the WEI — which includes data as recent as last week — is still going strong. Maybe the Fed is too pessimistic. While economic certainty rests on more stimulus, it's starting to look like recovery may be possible without it.

One possible reason for the economy's resilience is the ratio of temporary to permanent layoffs. Permanent unemployment is rising, but slowly. In August, it increased from 3.699m to 4.147m, the highest since 2014. More than 4 million lost jobs, however, is half the number of permanent job losses at the peak of the last recession in 2009. Meanwhile, temporary unemployment fell faster in August than in July. As a result, the total number of unemployed, 20.6m in April, or about 28m adjusted for the BLS undercount, has fallen to 10.3m in August.[1]



Despite the strength of the third quarter recovery, the July minutes reveal a very nervous Fed staff and FOMC. The odds of a disastrous economic setback get equal weight with the odds of steady recovery. COVID was the biggest risk. It is possible, but unlikely, the staff could downgrade this risk at next week's meeting. After all, the July COVID surge was less damaging than expected when case increases started creeping higher in June, and the economy is beating expectations in August. Given how little we know about COVID, however, the Fed is not likely to lower its guard unless there is a vaccine and it has proven effective. Besides, in the past month, half the FOMC is on record as very nervous about the recovery.

Policy options

The Fed's September policy options are the same as in July.

1. **Explicit forward guidance.** Temporal guidance remains possible, e.g. a two or three year moratorium against rate hikes, but goal-based guidance remains more likely as it allows the Fed to make rational policy decisions without abandoning a pledge if the forecast proves too pessimistic. The Fed's policy review means the

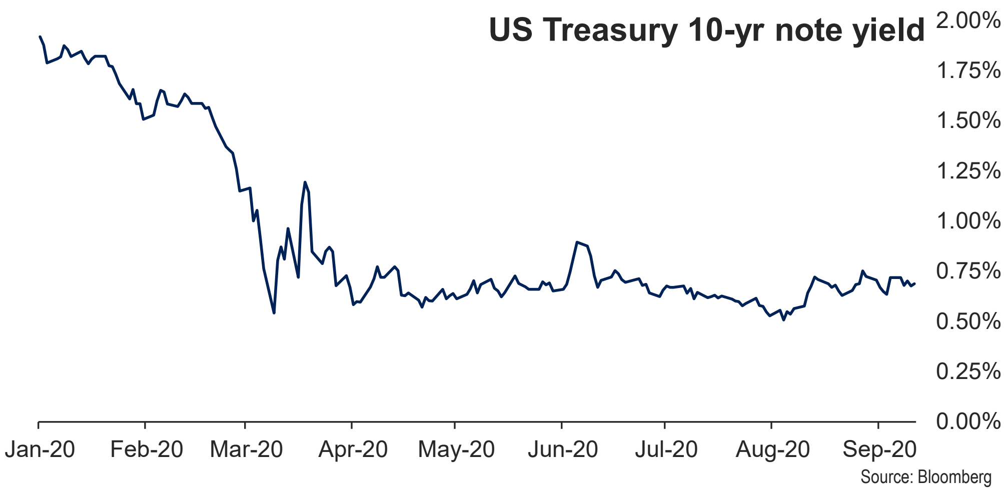
[1] The disparity between the 10.3m unemployed in the employment report and the 29m receiving unemployment benefits remains a mystery.

Fed will not use the unemployment rate in the pledge, because the Fed will no longer raise rates because unemployment is low. Instead, the pledge will hinge on inflation. Unlike the last recession, it will hinge on the actual inflation rate exceeding 2% rather than the forecast, again reflecting the policy review.

Explicit forward guidance acts on short- to mid-term interest rates. **Because the majority of the drop in interest rates since March has been in this part of the curve, it really doesn't make sense to use this tool now.** Better to wait until yields in the belly of the curve start to rise when traders anticipate rate increases.

2. **Quantitative easing.** In the last crisis, three rounds of quantitative easing resulted in lower interest rates along the entire yield curve, but each worked a little differently than the others. The biggest drop in yields came at the start of QE1, and in anticipation of QE2. Yields rose through QE3. Of course, they might have risen faster without it.

   The Fed focuses on 10-yr yields and mortgage rates when analyzing QE. Aside from a short upward blip in June, 10-yr yields have been locked into a narrow range within 25bp of their all-time low. As with explicit forward guidance, QE doesn't make much sense in September.



3. **Yield Curve Targets.** YCT is a targeted form of QE aimed at specific points on the curve with explicit targets for yields. The Bank of Japan uses it to control 10-yr JGB yields, while the Reserve Bank of Australia uses it to control 3-yr note yields. If the Fed uses it, YCT will supplement explicit guidance and will likely target 3-yr and/or 5-yr yields.

   YCT is controversial, but the FOMC will discuss it at this meeting — Vice Chair Clarida and Governor Brainard said as much in recent appearances — and the FOMC will almost certainly opt to keep it in the toolkit. That said, 3- and 5-yr yields are already low and YCT is not likely to be used – if ever – until after explicit guidance is in place. Hence, the FOMC will not implement it at this meeting.

So, three options for monetary policy this fall and none make sense now. The FOMC therefore is likely to opt for no immediate monetary action, a pledge to do whatever it takes in future, and another plea for federal pandemic relief, pretty much a repeat of July.

Wildcards

It's September and time to update the SEP. The forecast represents the best opportunity for surprise at this meeting. It's not likely the inflation forecasts will change much, but they might. And even if participants are no more optimistic about growth, the staff could sound a cautiously optimistic note about the economy and participants should be more optimistic given the strength of recent activity data including retail sales, employment, industrial production, factory orders, and the ISMs.

COVID waves are the Fed's primary concern, but the US shrugged one off in July without much damage to macro numbers. Is it really just as likely the economy will suffer a worst-case catastrophic setback as the Fed's more optimistic base-case forecast? That's what the staff believed in June and July, but it may be time for a more optimistic phrasing in September.

At the very least, the SEP unemployment forecast should fall, because the unemployment rate dropped to 8.4% in August and the June median forecast was 9.3% at year end, with a central tendency range from 9.0-10.0%. Here's how the 2020 forecasts are tracking relative to what we know now. The unemployment and inflation rates are the latest reported data, unemployment in August and inflation in July, while GDP is projected using actual first half data and second half figures based on the trend in the NY Fed's WEI index.

How the June SEP Compares to the Latest Data

	Median Forecast	Central Tendency	The latest
GDP	-6.5%	-7.6% to -5.5%	-0.5%
Unemployment rate	9.3%	9.0% to 10.0%	8.4%
PCE	0.8%	0.6% to 1.0%	1.0%
Core PCE	1.0%	0.9% to 1.1%	1.3%

Source: Federal Reserve and FHN Financial

Of the four latest data points, the GDP is the easiest to deny. After all, there is no compelling reason to expect the economy to continue healing at the rate it has so far, except for the fact the rate of improvement has not changed in four months. Still, some upward movement in the growth outlook is justified and likely. If the Fed does raise its 2020 GDP forecast, it will likely cut 2021, implying a faster recovery, not a stronger one.

A policy surprise is always possible, though not likely at this meeting. If the FOMC does opt to ease, it will take the form of explicit forward guidance. Some participants favored explicit guidance in July. The committee opted against it because yields were low already, but it's possible the committee might opt to announce it at this meeting for the psychological value of doing something.

Indeed, it is also possible the committee wanted to do it at the last meeting, but opted to wait until after Chair Powell had a chance to explain the policy review at the Jackson Hole seminar. After all, explicit guidance will look different in light of the review. Our baseline view is the FOMC will wait until explicit guidance can have an immediate market impact, but the Fed is known for sometimes resorting to actions without much benefit when there is nothing more useful in the toolkit and participants feel compelled to do something.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		CONSENSUS				
		PRIOR	HIGH	LOW	MEDIAN	FHN
Tuesday, September 15	Empire Manufacturing - Sep	3.7	10.0	0.0	5.5	**6.0**
	Import Price Index MoM - Aug	0.7%	0.6%	0.4%	0.5%	**0.4%**
	Import Price Index ex Petro MoM - Aug	0.2%	0.3%	0.3%	0.3%	**0.3%**
	Export Price Index MoM - Aug	0.8%	0.5%	0.4%	0.4%	**0.4%**
	Industrial Production MoM - Aug	3.0%	2.9%	-0.4%	1.0%	**1.2%**
	Capacity Utilization - Aug	70.6%	73.5%	70.3%	71.7%	**72.7%**
	Manufacturing (SIC) Production - Aug	3.4%	3.2%	-0.2%	2.4%	**2.5%**
Wednesday, September 16	Retail Sales Advance MoM - Aug	1.2%	4.6%	0.0%	0.9%	**1.2%**
	Retail Sales Ex Auto MoM - Aug	1.9%	5.5%	0.4%	1.1%	**1.4%**
	Retail Sales Ex Auto and Gas - Aug	1.5%	1.3%	0.5%	1.0%	**1.2%**
	Retail Sales Control Group - Aug	1.4%	3.4%	0.1%	0.4%	**0.7%**
	Business Inventories - Jul	-1.1%	0.2%	0.1%	0.2%	**0.3%**
	FOMC Rate Decision (Upper Bound)	0.25%	0.25%	0.25%	0.25%	**0.25%**
	FOMC Rate Decision (Lower Bound)	0.00%	0.00%	0.00%	0.00%	**0.00%**
	Interest Rate on Excess Reserves	0.10%	--	--	--	**0.10%**
Thursday, September 17	Building Permits - Aug	1,495k	1,570k	1,450k	1,535k	**1,570k**
	Building Permits MoM - Aug	18.80%	5.90%	-2.20%	3.50%	**5.0%**
	Housing Starts - Aug	1,496k	1,600k	1,400k	1,463k	**1,465k**
	Housing Starts MoM - Aug	22.60%	7.00%	-6.40%	-2.20%	**-2.1%**
	Philadelphia Fed Business Outlook - Sep	17.2	19.0	11.0	15.0	**15.0**
	Initial Jobless Claims - Sep 12	884k	--	--	--	**880k**
	Continuing Claims - Sep 5	13.39m	--	--	--	**13.30m**
Friday, September 18	Current Account Balance - 2Q	-$104.2b	-$142.6b	-$177.2b	-$162.7b	**-$160.0b**
	U. of Mich. Sentiment - Sep P	74.1	79.0	71.5	74.8	**75.0**

Review

This week, the ECB made no changes to rates or its bond purchase program, as expected, and ECB President Lagarde faced a barrage of questions from reporters worried about the strengthening euro.

- **During the ECB's post-meeting press conference, President Christine Lagarde** highlighted the euro area's "strong rebound" in economic activity, and for the first time in an introductory statement, the ECB noted the Governing Council's assessment of exchange rate developments as it affects the Bank's medium-term inflation outlook:

  > "In the current environment of elevated uncertainty, the Governing Council will carefully assess incoming information, including developments in the exchange rate, with regard to its implications for the medium-term inflation outlook. It continues to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry."

  The euro appreciated above 1.19 against the USD at the end of August. Throughout the press conference, reporters asked Lagarde about the euro's strength, particularly as chief economist Philip Lane said last week that the "euro-dollar rate does matter." The ECB does not target exchange rates, but the Governing Council is aware a big enough move will affect the things the ECB does target.

Lagarde said the Bank is not targeting the exchange rate "as you know," but confirmed the Council's extensive discussion on the euro's appreciation against the backdrop of its price stability mandate:

> "Clearly to the extent that appreciation of the euro exercises negative pressure on prices," she explained, "we have to monitor carefully such a matter and this was indeed extensively discussed during our Governing Council."

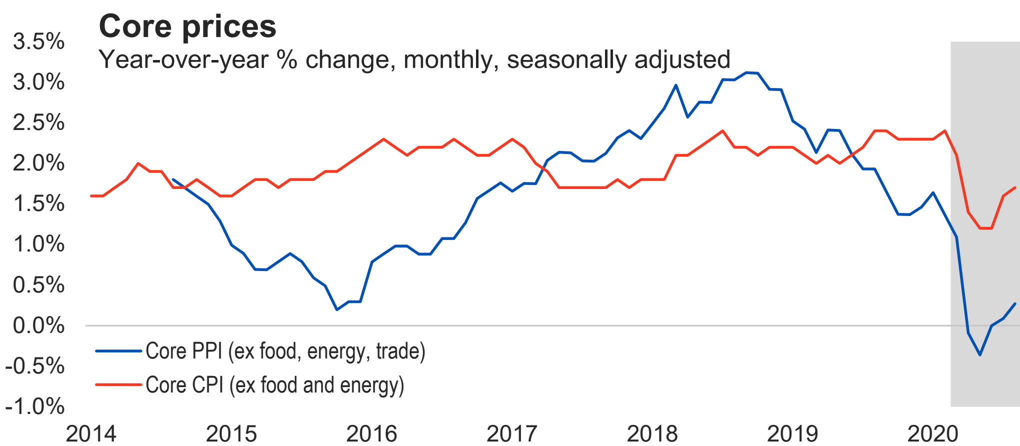
With respect to the efficiency and effectiveness of its policies, including the Pandemic Emergency Purchase Program (PEPP), Lagarde pointed to sovereign yields across the euro area, narrowed spreads, and reduced Eurozone fragmentation risk as indicators of its success.

Lagarde was also asked about the Fed's new policy framework and about its own upcoming framework review. She reminded reporters the review was postponed due to COVID but will be extensive. It will include a review of inflationary measures (a seminar is scheduled for September 23), the possibility of a digital euro, digital payments, and green investments.

When asked what structures she would like to see in place for a monetary union, she outlined a fully developed banking system, a capital markets union, and while there is an "embryonic joint fiscal capacity" that was decided pre-COVID, it needs to be strengthened.

Finally, the ECB revised its GDP forecast higher for 2020, from June's -8.7% to -8.0%. The revision reflects the impact of a large fiscal package and monetary stimulus along with a rebounding manufacturing sector. Inflation forecasts were largely unchanged, despite reports speculating about downward revisions due to the currency's strength.

- **August's Core PPI (ex food, energy, and trade) and Core CPI both rose** more than expected over the month. PPI rose 0.4% m/m lifting the year-over-year pace from 0.1% to 0.3%. Transportation and warehousing as well as government services purchases drove the increase. Core CPI also rose 0.4% m/m and 1.3% y/y, led by a broad base of increases with used vehicles accounting for the sharpest rise. They rose 5.4% m/m.



Source: BLS, NBER, Haver Analytics

The Atlanta Fed's Q3 GDPNow forecast rose from 29.6% SAAR qtr/qtr last Thursday to 30.8% SAAR qtr/qtr this week, led largely by Friday's employment report and this week's wholesale trade report. The NY Fed revised its Weekly Economic Index from -5.5% yr/yr to -4.3% yr/yr. A rise in raw steel production, rail car traffic, and tax withholdings more than offset a rise in initial claims and Redbook's retail sales data.

Preview

Note: ★ = High Impact Event
All times Eastern

Next week's biggest economic release is retail sales on Wednesday. Also on Wednesday, the FOMC release its Summary of Economic Projections along with more guidance on average inflation targeting, including…hopefully…what exactly they will be targeting.

Thursday, the Bank of Japan and Bank of England announce policy decisions.

Monday, September 14

- ★ 10:00pm – China:
  - Industrial Production – Aug (Last: 4.8% y/y; Con: 5.1% y/y)
  - Retail Sales – Aug (Last: -1.1% y/y; Con: 0.0% y/y)
  - Fixed Assets Ex Rural – Aug (Last: -1.6% YTD y/y; Con: -0.5% YTD y/y)

Tuesday, September 15

- 8:30am – US:
  - Empire Manufacturing - Sep (Last: 3.7; Con: 5.5)
  - Import Price Index – Aug (Last: 0.7% m/m; Con: 0.5% m/m)
  - Import Price Index ex Petroleum – Aug (Last: 0.2% m/m; Con: 0.3% m/m)
  - Import Price Index – Aug (-3.3% y/y)
  - Export Price Index – Aug (Last: 0.8% m/m; Con: 0.4% m/m)
  - Export Price Index – Aug (Last: -4.4% y/y)
- 9:15am – US:
  - Industrial Production – Aug (Last: 3.0% m/m; Con: 1.0% m/m)
  - Capacity Utilization – Aug (Last: 70.6%; Con: 71.7%)

Wednesday, September 16

- ★ 7:00am – US: MBA Mortgage Applications – Aug
- ★ 8:30am – US:
  - Retail Sales Advance – Aug (Last: 1.2% m/m; Con: 0.9% m/m)
  - Retail Sales Ex Autos – Aug (Last: 1.9% m/m; Con: 1.1% m/m)
  - Retail Sales Ex Autos and Gas – Aug (Last: 1.5% m/m; Con: 1.0% m/m)
  - Retail Sales Control Group – Aug (Last: 1.4% m/m; Con: 0.4% m/m)

- 10:00am – US:
  - Business Inventories – Jul (Last: -1.1% m/m; Con: 0.2% m/m)
  - NAHB Housing Market Index – Sep (Last: 78)
- ★ 2:00pm – US: FOMC policy decision
- ★ 2:30pm – US: Chair Powell press conference
- ★ 4:00pm – US:
  - Net Long-term TIC Flows – Jul (Last: $113.0b)
  - Total Net TIC Flows – Jul (Last: -$67.9b)

Thursday, September 17

- ★ Japan: The Bank of Japan announces policy.
- ★ 7:00am – UK: The Bank of England announces policy.
- ★ 8:30am – US:
  - Building Permits – Aug (Last: 1.50m; Con: 1.54m)
  - Building Permits – Aug (Last: 18.8% m/m; Con: 3.5% m/m)
  - Housing Starts – Aug (Last: 1.5m; Con: 1.46m)
  - Housing Starts – Aug (Last: 22.6% m/m; Con: -2.2% m/m)
  - Philadelphia Fed Business Outlook – Sep (Last: 17.2; Con: 15.0)
  - Initial Jobless Claims – Sep 12 (Last: 884k)
  - Continuing Claims – Sep 5 (Last: 13.4m)

Friday, September 18

- ★ 8:30am – US: Current Account Balance – Q2 (Last: -$104b; Con: -$163b)
- ★ 10:00am – US:
  - University of Michigan – Sep P (Last: 74.1; Con: 74.8)
  - Leading Index – Aug (Last: 1.4% m/m; Con: 1.3% m/m)
  - Saint Louis Fed President James Bullard discusses the COVID recovery challenge. (FOMC voter in 2022)

– Rebecca Kooshak, Economic Analyst