WEEKLY MARKET OUTLOOK
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A Whole Lotta Cash

While some are fretting about market liquidity in the U.S. financial system, there's still a whole lot of cash floating around and no immediate cause for concern. Market liquidity is the extent to which a market allows assets to be bought and sold at stable prices. Cash is considered the most liquid asset, and there is a ton of it available.

Marshallian K, or the difference between year-over-year growth in M2 money supply and GDP, turned negative in the second quarter. This was the first decline since the first quarter of 2019. Still, this has raised some concerns that liquidity could become an issue for equity markets. However, there is little correlation between Marshallian K and equity returns, even when adjusting for various lags. Though there have been instances when Marshallian K turned negative and equity markets fell, those appear to be instances of spurious correlations.

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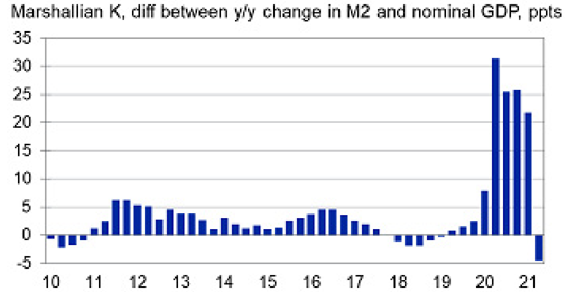
Liquidity Isn't Drying Up Quickly



Sources: Federal Reserve, BEA, Moody's Analytics

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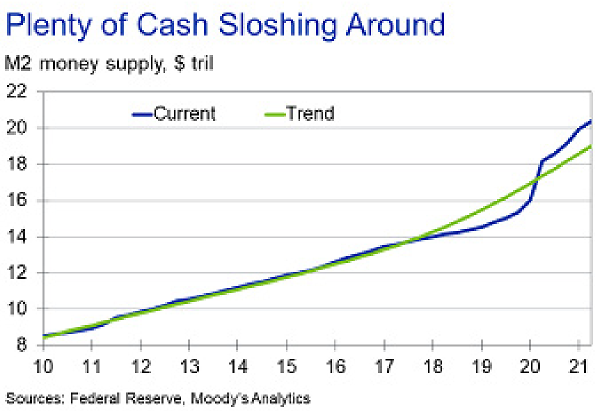
Something to keep in mind is that the pandemic has made year-over-year comparisons difficult. Therefore, when it comes to liquidity, levels don't lie. M2 is $1.37 trillion, or 7.3%, above its pre-COVID-19 trend. The deviation from trend will close over time and this closing could be underway, but it will take a while before liquidity concerns are justified even with the Fed likely to begin tapering its $120 billion in monthly asset purchases either late this year or early next.



Also, banks have a significant amount of excess liquidity as the gap between deposits and loans continues to widen. Some of this excess liquidity is finding its way into financial markets, which is making financial market conditions extremely loose, while some is parked at the Fed via the central bank's overnight reverse repos. Daily overnight reverse repo agreements have been north of $1 trillion since mid-August and were less than $200 billion as recently as May. If liquidity was an issue, banks wouldn't park this much money at the Fed.

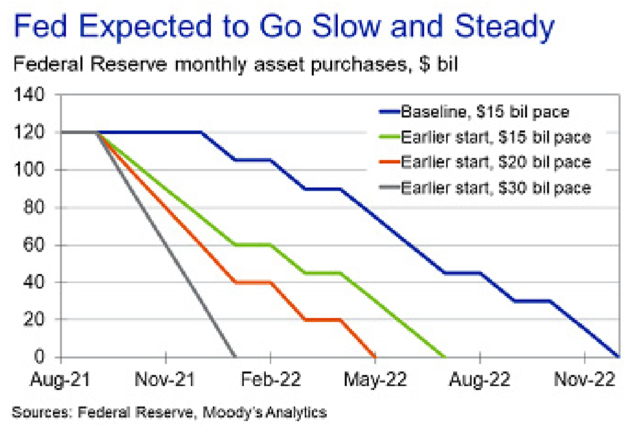
The lack of volatility in either U.S. stock prices or the bond market also implies that liquidity is ample, for now. Our forecast is for Marshallian K to remain negative through the end of next year. The level of M2 money supply will return to trend by late 2022 or early 2023.

Don't expect Jackson Hole fireworks

We don't anticipate that Federal Reserve Chairman Jerome Powell will give strong forward guidance about the timing and composition of the tapering of the central bank's monthly asset purchases during his speech set for Friday at the Jackson Hole Economic Symposium. Doing so would be surprising; it would constitute front running the Federal Open Market Committee, and chairs typically avoid that.

We still expect the Fed to announce its tapering plans in September and for $15-billion reductions in monthly asset purchases to be called for at each FOMC meeting in 2022. The Fed has signaled that it wants tapering to be on autopilot. Once its monthly asset purchases have been reduced from $120 billion to zero, the Fed will reinvest proceeds from maturing assets to ensure its balance sheet doesn't contract, which would amount to contractionary monetary policy.

In our baseline forecast, the Fed's tapering ends by the end of 2022. But there are scenarios where it is completed earlier than we anticipate. Some Fed officials, primarily the hawkish regional Fed presidents, have pushed for an earlier start to tapering. Markets seem increasingly focused on the potential for the Fed to begin tapering in October. Assuming that, and that the pace is identical to the baseline, monthly asset purchases would decline to zero by July 2022.



If the Fed wants to wrap up tapering earlier, it will need to begin in October and increase the pace. For example, if the reduction in monthly asset purchases is $20 billion, rather than the $15 billion in our baseline, tapering would be concluded by May 2022. A Fed official has said that their preference was to have tapering wrapped early in the first quarter of next year. This could be accomplished by starting in October and reducing monthly asset purchases by $30 billion.

We don't believe a shift in the timing or the size of tapering of the Fed's monthly asset purchases will have a significant impact on the bond market. However, there could be movement in interest rates because of the signaling channel. Therefore, how the Fed communicates its tapering approach will be important. That is why we believe the central bank will want changes to its monthly asset purchases to be on autopilot, although the Fed says the pace could be adjusted based on financial market conditions and the health of the economy; the Fed wants flexibility. We don't believe the Fed will want to rapidly reduce its asset purchases, because doing so could signal to the bond market that the central bank is worried that the economy is overheating or that the recent burst in inflation isn't transitory.

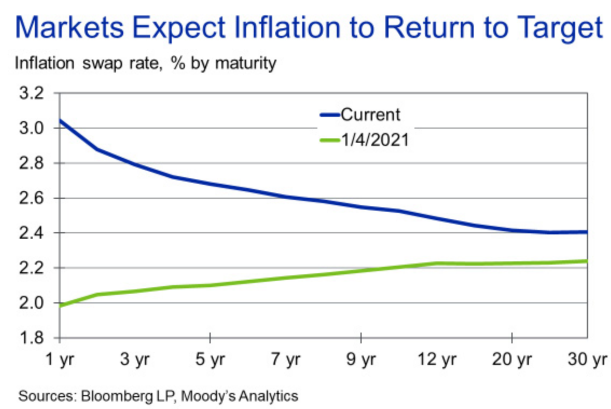
Tapering won't be disinflationary, could pay dividends

There are some worries that the expansion of the Fed's balance sheet, which is 36% of nominal GDP, stoked inflation. This concern often focuses on the central bank printing money or monetizing the debt, but with the central bank able to pay interest on excess reserves, the size of its balance sheet does not impact its ability to control the fed funds rate. Therefore, the Fed would have to opt not to control inflation for its balance sheet to lead to inflation. This hasn't happened, and the acceleration in inflation is attributable to transitory factors, the reopening of the economy, and supply-chain issues.

Also, the surge in M2 money supply might have boosted inflation a little as some of this money was directed toward goods and services that boost GDP. However, M2 had been surging well before the recent and temporary acceleration of inflation. One reason it wasn't inflationary then is that the velocity of money had collapsed, and it has been little changed recently. The velocity of money is among the lowest on record and for this current bout of inflation to turn into something worse, the velocity of money would need to increase.

Though tapering won't be disinflationary, it could help keep market-based measures of inflation expectations anchored, since tapering is the preamble to the Fed beginning to tighten monetary policy either by allowing its balance sheet to decline and/or by increasing the target range for the fed funds rate.

Inflation expectations are also important in the future path of inflation. The Fed is keeping close tabs on various measures of inflation expectations and they appear to be anchored. The 5-Year, 5-Year forward Inflation expectation rate is currently around 2.2%. This is based on the consumer price index. If we adjust for the tendency for the CPI to run ahead of the PCE deflator, the Fed's preferred measure of inflation, investors are expecting inflation to be at the Fed's target. One caveat: The Fed could be distorting this a little, since the 5-Year, 5-Year forward Inflation expectation rate incorporates Treasury Inflation Protected Securities, and the Fed holds 2% of the TIPS market. As the Fed begins to taper, TIPS yields might climb.



Still, there are other signs that market-based inflation expectations will moderate and settle around the Fed's 2% objective. This is visible in the U.S. dollar zero coupon inflation swap curve. The curve looks different today than earlier this year because of the acceleration in realized inflation, which was more than many anticipated. Still, the current inflation swap curve shows markets are buying into the transitory view of inflation.

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TOP OF MIND

COVID-19 Surges Matter, UI Cuts Don't, So Far

BY ADAM KAMINS

State payroll data for July were released last week, and with them came the earliest official indications of whether recent developments have had a meaningful economic impact. While it remains premature to draw conclusions, the Bureau of Labor Statistics data resemble real-time metrics in revealing little benefit from reduced unemployment benefits and a modest slowdown in states with recent COVID-19 outbreaks.

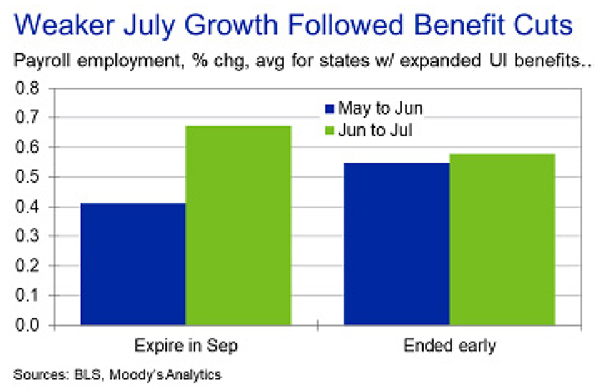
This is evident when evaluating the best and worst performers of the past month as well as when using more involved techniques, such as examining correlations and running a simple regression.

The context

State payroll data for last month attracted more attention than usual in large part because they reflect the first opportunity to use official government data to assess the early returns on just over half of states ending the $300 per week in supplemental unemployment insurance benefits. And so far, any evidence of a boost is all but nonexistent.

This is consistent with real-time metrics, showing minimal impact associated with either the announcement or implementation of benefit cuts. The simplest view can be seen when comparing job growth in states that ended programs early against those that did not. The former group experienced aggregate gains that were about 10 basis points lower than those that made no changes. Although this gap is not large enough to reflect a meaningful difference, the fact that growth was weaker in states that cut benefits makes it clear that the hoped-for flood of worker re-entries into the labor force has not materialized.

A potential counterargument could involve the fact that the mostly Democratic states that are accepting the additional federal funds until they expire early next month are growing more rapidly because of a lower starting point, owing largely to more severe lockdowns throughout the pandemic. But this is undermined when comparing against the previous jobs report. In fact, from May to June the states that announced plans to end benefits early saw growth modestly exceed that of the rest of the nation.



Though this could have reflected anticipation of a policy change, there is little anecdotal evidence that behavior meaningfully changed following initial announcements. Further, the acceleration in job gains across the nation from June to July suggests that there was no onetime spark around the time of implementation. In fact, the first four states to cut benefits—Alaska, Iowa, Mississippi and Missouri—were generally middling to below-average performers in June.

All told, these results suggest a negative relationship between cutting UI benefits and job growth. This undermines the rationale offered by many governors while calling into question whether reduced income may have spilled into consumer demand, creating a net negative effect.

Virus surges

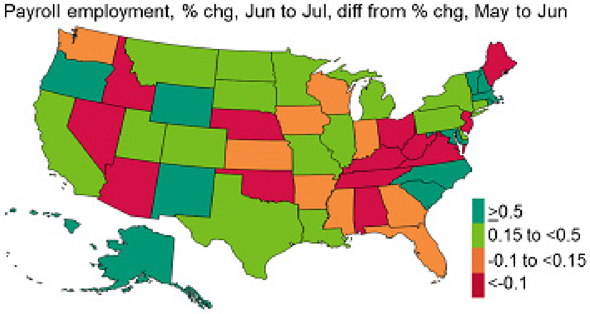
Of course, the July numbers reflect more than just the impact of policy decisions. The Delta variant of COVID-19 began to make its impact felt just as last month's payroll survey was being conducted, providing the first clues into whether the BLS figures are affected by recent outbreaks.

As expected, the statistical relationship is tenuous, but there is evidence of a positive link between new per capita cases by state in the four weeks leading up to the payroll reference week and the jobs number. The weakest performers were disproportionately concentrated in the South, where the combination of elevated cases and low vaccination rates likely suppressed activity. Arkansas, Indiana and Oklahoma also wound up near the bottom—all three states have faced at least partially successful court challenges to their early termination of UI benefits in addition to vaccination rates in the bottom quartile nationally, sowing uncertainty on multiple levels. Meanwhile, Vermont's presence in the top spot for both job growth and virus containment bolsters the positive relationship.

Similarly, the change in one-month growth rates reveals evidence of a link with the virus. About a third of states experienced a slowdown from June to July, with the South, Midwest and Rockies accounting for the majority.

Slowdown Was Worst in Southeast

Payroll employment, % chg, Jun to Jul, diff from % chg, May to Jun



Sources: BLS, Moody's Analytics

In order to better understand the impact of various trends and policies on July employment, a pair of simple regressions were run. Both used new cases in July and a dummy for whether UI benefits ended early as exogenous drivers. The two endogenous series were June to July job growth and the change in monthly job growth.

The results hardly yield any epiphanies, but they highlight a few takeaways. First is that even after controlling for virus spread, the early evidence suggests that cutting UI benefits was not only ineffective but may have actually produced the opposite effect of what was intended given the negative sign on the benefit cut dummy. And second, the latest virus surges are weakly linked to slower growth, after a few months in which the relationship was practically nonexistent.

Impact of COVID-19 Cases and UI Benefits on Employment, Jul 2021

Each observation represents a state

Independent variable	Job growth, % chg	Difference in % chg
Per capita new COVID-19 cases, Jun 15-Jul 12	-0.036	-0.046
	(0.068)	(0.090)
Early UI termination dummy	-0.203*	-0.094
	(0.140)	(0.184)
Constant	0.807***	0.351**
	(0.114)	(0.150)
N	51	51
Adj. R2	0.024	-0.025

***Denotes significance at the 1% level. **Denotes significance at the 5% level. *Denotes significance at the 20% level.

Sources: BLS, Moody's Analytics

July's early signs should give way to a more conclusive verdict come August. And real-time figures suggest that the subtle patterns observed last month will prove far clearer soon enough.

To see this, seated diner reservations from OpenTable were analyzed for the first three weeks of both July and August. They reveal that the change in the index—which compares each day with 2019 levels—was closely linked to virus outbreaks. In fact, among the 40 states tracked by OpenTable, each of the seven largest declines from July to August occurred in a place with one of the 10 highest per capita incidences of new cases.

The correlation coefficient between new cases and the shift in the OpenTable index signals that a whopping 70% of the change in seated diners is linked to the degree to which the virus has taken over. While this indicates that consumer industries face the most severe summer setbacks, significant spillover to other parts of the economy is highly likely as virus fears cause the Southeast and Gulf Coast in particular to pull back.

Meanwhile, the decline in the OpenTable index over the past month was larger in states that discontinued benefits early. This suggests that a month or two after states implemented benefit cuts, they may have done more to drive consumer spending lower amid reduced benefits than inspire a flood of worker re-entries into the labor market.

The Week Ahead in the Global Economy

U.S.

Things don't settle down next week. The key economic data will include the August Employment Situation, the ADP National Employment Report, vehicle sales, consumer confidence, both ISM surveys, the trade balance, and initial claims for unemployment insurance benefits. The early Bloomberg consensus for August nonfarm employment is a net 750,000 gain. This would be weaker than the 943,000 in July, which was inflated by seasonal adjustment issues around state and local government employment.

Our preliminary forecast for August employment is below the consensus as a number of the high-frequency and alternative labor market data we track have been soft recently, including Homebase. It is difficult to forecast monthly employment accurately now, because our models are based on the demand for labor, but supply is a key determinant currently and will be for the next few months. New data on construction spending, factory orders and vehicle sales could affect our high-frequency GDP model's tracking estimate of third-quarter GDP, which is currently 6.5% at an annualized rate.

Europe

Final GDP estimates for many European countries will lead next week's releases. Among the major economies, France's GDP likely rose 0.9% q/q and Italy's like jumped 2.7%. France's growth was held back in the second quarter due to its COVID-19 outbreak and relatively harsher health measures, and its significant auto and aerospace industries felt the pain of the global supply shortage of semiconductors. Italy's benefitted from relatively looser health measures and a larger than-expected rebound in tourism flows at the end of the quarter.

Meanwhile, we likely will see unemployment rates decrease in July. As economies and borders reopened, hiring in the services sector began to recover. The unemployment rate in the euro zone, therefore, is expected to have fallen to 7.5% in July from 7.7% in June. That said, there were likely some supply frictions, while uncertainty about the pandemic and still-recovering consumer spending softened demand for hiring.

As we will see, the business and consumer sentiment in the euro zone likely weakened in August. Concerns about COVID-19 variants, inflation and supply disruptions likely darkened the mood of businesses and households. Lower sentiment could cool spending in the final months of the year. But we are still expecting upbeat retail sales in July. The euro zone's retail index was likely up 0.8% m/m as consumers took advantage of summer sales.

Asia-Pacific

India's June quarter growth will be the highlight on the economic calendar. India's GDP is likely to have grown by 19% in yearly terms in the June quarter, as the low base effects from last year's restrictions-induced recession propped up the yearly growth estimate. Over the quarter, however, the economy is likely to have contracted by 12%, following a 3.7% pickup in the prior quarter. The significant second wave has triggered large-scale shutdowns, dealing a heavy blow to household consumption and undermining investment through most of April and May. Exports were relatively less impacted over this period and so a narrowed trade deficit, coupled with a quarterly increase in government spending, is likely to have provided some offset. But the sizeable shock to domestic demand will dominate and drive the quarterly decline.

Australia's GDP is likely to have grown by 0.3% in quarterly terms over the June quarter, following a 1.8% increase in the prior quarter, as the economy sustained the gains from the release of pent-up demand and an improving labour market. Some weakness in domestic demand induced by the lockdown in Victoria state through June nevertheless is expected to have weighed on the quarterly pickup.

China's manufacturing PMI is likely to have edged marginally lower to 50.1 in August from 50.3 in July, reflecting some moderation in production and possibly even new export orders, considering the prevailing Delta-led outbreaks in Asia. Japan's unemployment rate is likely to have risen to 3% in July from 2.9% in June, reflecting renewed weakness in services prospects from reinstated emergency measures.

Geopolitical Calendar

Date	Country	Event	Economic Importance	Financial Market Risk
5-Sep	Hong Kong	Legislative Council elections	Low	Medium
15-Sep to 15-Oct	Italy	Local elections	Low	Low
26-Sep	Germany	Federal elections	Medium	Medium
2-Oct	Brazil	Presidential and congressional elections	High	Medium
22-Oct	Japan	General elections	Medium	Medium
Oct/Nov	ASEAN	ASEAN summit	Low	Low
Nov	Asia-Pacific	Asia-Pacific Economic Cooperation forum	Medium	Low
Nov	G-20	G-20 Summit	Medium	Low
7-Nov	Nicaragua	Presidential, congressional elections	Low	Low
14-Nov	Argentina	Legislative elections	Medium	Low
21-Nov	Chile	Presidential elections	Low	Low
28-Nov	Honduras	Presidential, congressional and municipal elections	Low	Low
10-Apr	France	General elections	Medium	Medium
29-May	Colombia	Presidential elections	High	Low

Expect Fed to Announce Tapering Plan in September

BY RYAN SWEET

CREDIT SPREADS

Moody's long-term average corporate bond spread is 100 basis points, 4 bp wider than this time last week. This is below its high over the past 12 months of 138 bps and just above its lowest over the past year of 95 bps. This spread may be no wider than 118 bps by year-end 2021. The long-term average industrial corporate bond spread increased by 2 bp over the past week to 91 bps. This is only modestly above its low over the past 12 months of 86 bps and well below its high of 131 bps.

The long-term investment grade corporate bond spread was 133 basis points, compared with 130 bp last week. It remains well below its recent high of 194 bps. Its tightest over the past year was 129 bps. Investment-grade industrial corporate bond spreads widened from 134 bps to 138 bps.

The recent ICE BofA U.S. high-yield option adjusted bond spread of 322 basis points was 13 bps tighter than at this point last week. The high-yield option adjusted bond spread approximates what is suggested by the accompanying long-term Baa industrial company bond yield spread and roughly in line with that implied by a VIX of 17.6. The VIX has been bouncing around over the past few weeks and is now slightly below its historical average of around 19.

DEFAULTS

The global speculative-grade corporate default rate fell to 4.9% for the trailing 12 months ended in May, returning to where it stood a year earlier and down from 5.6% at the end of April. Among high-yield bond issuers, the U.S. default rate was 2.8% at the end of May when measured on a dollar-volume basis, down from 4.5% at the end of April. The decline reflects the exit of a few large defaults in 2020 from the trailing 12-month window.

According to the Moody's Credit Transition Model, the trailing 12-month global speculative-grade default rate will fall to 1.8% by the end of the year under the MIS baseline scenario and remain little change through May 2022. To derive default-rate forecasts, Moody's CTM uses inputs, including ratings and rating transitions, as well as assumed future paths of high-yield bond spreads and changes in unemployment rates.

In the Moody's Investors Service baseline scenario, the speculative-grade default rate will drop to 1.7% at the end of this year before creeping higher in April and May of next year, touching 1.9%. For Europe, the speculative-grade default rate will steadily decline over the next several months and end 2021 at 1.9%.

U.S. CORPORATE BOND ISSUANCE

First-quarter 2020's worldwide offerings of corporate bonds revealed annual advances of 14% for IG and 19% for high-yield, wherein US$-denominated offerings increased 45% for IG and grew 12% for high yield.

Second-quarter 2020's worldwide offerings of corporate bonds revealed annual surges of 69% for IG and 32% for high-yield, wherein US$-denominated offerings increased 142% for IG and grew 45% for high yield.

Third-quarter 2020's worldwide offerings of corporate bonds revealed an annual decline of 6% for IG and an annual advance of 44% for high-yield, wherein US$-denominated offerings increased 12% for IG and soared upward 56% for high yield.

Fourth-quarter 2020's worldwide offerings of corporate bonds revealed an annual decline of 3% for IG and an annual advance of 8% for high-yield, wherein US$-denominated offerings increased 16% for IG and 11% for high yield.

First-quarter 2021's worldwide offerings of corporate bonds revealed an annual decline of 4% for IG and an annual advance of 57% for high-yield, wherein US$-denominated offerings sank 9% for IG and advanced 64% for high yield.

Issuance weakened in the second quarter of 2021 as worldwide offerings of corporate bonds revealed a year-over-year decline of 35% for investment grade. High-yield issuance faired noticeably better in the second quarter.

U.S. dollar denominated investment-grade issuance was $10.5 billion in the week ended Wednesday, bringing the year-to-date total to $1.131 trillion. Issuance normally tails off right before the Labor Day holiday and this year is no exception. High-yield corporate bond issuance rose $5.6 billion, bringing the year-to-date total to $470.4 billion.

U.S. ECONOMIC OUTLOOK

U.S. federal lawmakers are feverishly working on another massive fiscal program, including a $550 billion bipartisan infrastructure deal and a $3.5 trillion package of spending and tax breaks to support a range of social investments.

The bipartisan infrastructure deal is small, as new outlays would average only 0.2% of annual GDP within the next decade. It would also include a potpourri of pay-fors. The most immediate impact of the deal would be to marginally reduce growth in 2022, since the pay-fors kick in right away while increased spending takes time to materialize because of lags in starting infrastructure projects. The apex in the boost to growth would come in 2023 when real GDP increases 2.9%, compared with 2.3% when assuming no further fiscal support is enacted. The deal creates close to 650,000 jobs at its peak impact in mid-decade, reducing the jobless rate a couple of tenths of a percentage point.

The $3.5 trillion package is much larger, as gross fiscal support would average 1% of annual GDP over the next decade. It is assumed to be mostly paid for by higher taxes on corporations and well-to-do households. The boost to growth under just the reconciliation package would occur quickly, with real GDP increasing 5.4% in 2022, compared with 4.3% if no further fiscal stimulus is passed. There are more than 2 million additional jobs by mid-decade and the jobless rate is at least 0.5 percentage point lower.

The August baseline forecast assumes that the $550 billion bipartisan infrastructure deal passes in its current form. This fall, Democrats will debate the $3.5 trillion package and seek to enact it through the budget reconciliation process, which requires only a simple Senate majority. Our base-case scenario is that moderate Democrats will roll back the scale of spending and tax breaks from $3.5 trillion to $3 trillion. All but $200 billion of the partisan reconciliation package will be financed by higher taxes on corporations and well-to-do households. Concerns around the deficit will be much more binding going forward than they have been in the past year. Under our current fiscal assumptions, the federal deficit will fall from 15% of GDP in fiscal 2020 to 12.8% and 5.8% in fiscal 2021 and 2022, respectively.

Tweaking GDP forecast

We lowered our forecast for GDP growth this year and next. We now expect real GDP to rise 6.3% this year, compared with 6.7% in the July baseline. Some of the downward revision is attributed to the data on second-quarter GDP, which came in weaker than in our prior baseline forecast. Another reason for the downward revision to our forecast for growth this year and next is we now anticipate a slower inventory rebuild because of supply chain issues. The number of days between a semiconductor order and shipment continues to climb. The Delta variant is hitting the Asia-Pacific region hard. This could also delay any improvement in global supply chains and might limit the amount of inventory that must be restocked in the U.S.

Real GDP is forecast to grow 4.5% in 2022, compared with 5% in the July baseline. We revised higher our forecast for GDP growth in 2023 by 0.3 of a percentage point to 2.6%. Our GDP forecasts are close to the Bloomberg consensus of 6.5% in 2021 and 4.2% in 2022. The consensus is for GDP to rise 2.3% in 2023.

Note: The August baseline forecast will incorporate the annual revisions to GDP that were released by the BEA with the advance estimate of second-quarter GDP.

Labor market recovery sticking to script

The July U.S. employment report was strong across the board, but labor supply constraints remain binding. There isn't any concrete evidence that states that ended expanded unemployment insurance benefits prematurely boosted the labor force.

Nonfarm employment rose by a net 943,000 in July, and the two-month net revision totaled 119,000. Seasonal adjustment issues with state and local government education juiced the headline. July is encouraging, but there is still a long way to go, as employment is down more than 8 million from where it would have been if the pandemic hadn't occurred. Private employment increased by 703,000 in July, and the underlying trend is running around 480,000 per month. Not seasonally adjusted, private employment rose 779,000, which is significantly stronger than in a typical July.

Given the incoming data, we nudged higher our forecast for average monthly job growth this year from 503,000 in the July baseline to 532,000 in the August baseline.

The unemployment rate fell more than expected in July, but we didn't alter the forecast. The unemployment rate is still expected to average 4.6% in the fourth quarter of this year and 3.5% in the final three months of next year. Both numbers are identical to the July baseline.

Inflation and the Fed

New historical data led us to revise higher our forecast for the core PCE deflator, as it's now expected to rise 3.5% on a year-ago basis in the fourth quarter of this year, compared with 3.2% in June. We look for inflation to moderate next year, with the core PCE deflator up 2.1% on a year-ago basis in the fourth quarter of 2022, identical to the July baseline.

There were no changes to our assumptions about monetary policy in the August baseline. We still look for the initial rate hike in the first quarter of 2023. Tapering will occur in January 2022 and will complete by the end of next year. We don't anticipate a repeat of the 2013 "taper tantrum," which occurred because markets tied the Fed's balance sheet and interest rate policies together. But taper-implied rates haven't risen, implying that markets now understand this.

Financial markets expect this tightening cycle to be gradual, pricing in about 125 basis points of tightening by the end of 2028. Also, in the next few years, the Fed is expected to become more aggressive than the Bank of England and European Central Bank but less than the Bank of Canada. It is difficult to see how the central bank could normalize rates in 2023 and subsequent years as slowly as the markets are pricing in with the economy expected to be at full employment and inflation firmly above its 2% through-the-business cycle target.

For another way to assess the amount of tightening this cycle, we turn to the inertial Taylor rule, one endorsed by Fed Vice Chairman Richard Clarida. This modification of the Taylor rule has a coefficient of zero on the unemployment gap, a 1.5 coefficient on the inflation gap, or the difference between core PCE inflation and the Fed's 2% longer-run objective. Clarida also used a neutral real-policy rate equal to his long-run expectation. We use this Taylor rule and a real-neutral real-policy rate of 0.5%. We include our baseline forecasts for the core PCE deflator, which has a significantly more aggressive tightening cycle than markets are betting on, with the target fed funds rate at 2.25% by the end of 2025, around 75 to 100 basis points more than what markets expect.

We cut our forecast for the 10-year U.S. Treasury in the third quarter and now have it averaging 1.4%, compared with 1.7% in the July baseline. The 10-year Treasury yield is now expected to average 1.7% in the fourth quarter of this year, 20 basis points lower than in the prior baseline. The August baseline for long-term rates converges to the July baseline in mid-2022.

We have revised higher the forecast for the Dow Jones Industrial Average because of how equity markets have performed since the July baseline, but the contours of the forecast haven't changed. The Dow is forecast to have peaked and will gradually decline during the next year. Risks are heavily weighted to the upside, but peak growth, inflation and Fed tapering could weigh on equity markets.

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THE LONG VIEW: EUROPE

Momentum Slows

BY KATRINA PIRNER and ROSS CIOFFI

The euro zone's IHS Markit Composite PMI fell to 59.5 in August after reaching 60.2 in July. As the reading is above 50, the euro zone economy is still in an expansionary phase, with activity slowing slightly from the previous month's 15-year record high. July's figure matched June's to register the joint-second-fastest expansion since 2006. Furthermore, the average for the third quarter is the highest in 21 years with activity in August unlikely to diverge significantly from this trend.

Notably, growth in the services sector outpaced the manufacturing sector for the first time in the COVID-19 recovery period. Specifically, the Flash Manufacturing PMI Output Index fell to 59.2 while the Flash Services PMI Activity Index declined to 59.7. That said, manufacturing output growth remains high by historic standards and opportunities for future growth in the services sector will be fewer with the majority of restrictions now lifted.

Meanwhile the U.K.'s Markit/CIPS Composite PMI Flash fell to 55.3 in August from 59.2. This marks a six-month low, with the sharp slowdown in output driven primarily by staff shortages and supply chain issues. The services PMI fell to 55.5 from 59.6 the previous month, suggesting a loss of momentum following the lifting of remaining restrictions in July. The manufacturing PMI saw a more modest dip of 0.3 point, coming in at 60.1. New orders growth eased slightly in August, with export sales helping to offset a slower recovering in domestic demand. However, this slowdown could prove temporary with business expectations hitting a three-month high in August.

Center-Left Comeback in Germany

In a surprise development, the German Social Democrats (SPD) have inched ahead of Angela Merkel's Christian Democratic Union (CDU) in the lead-up to the federal election on September 26. Over the last few months, Germany's parties have seen their fortunes shift, with the Greens having initially pulled ahead of the CDU, now relegated to third place. Armin Laschet, leader of the CDU, has seen his standing in the polls flounder after being captured laughing while touring a town devastated by last month's floods.

Although the SPD leans further left, their leader, Olaf Scholz, currently serves as finance minister and is viewed as more centrist than other members of his party. However, the policy positions of an SPD-led government will invariably depend on its coalition partners. We would expect an increase in investment, but the SPD's potential coalition partners differ regarding Germany's debt brake.

Germany's economy expanded between April and June, but the pace of improvement leaves something to be desired. With second-quarter growth clocking in at 1.6% q/q, real GDP remains 0.4% smaller than in the final quarter of 2020, just before COVID-19 sent the economy back into lockdown.

Household consumption and government spending helped boost second-quarter GDP. Increased vaccinations and the rollback of pandemic restrictions boosted consumption while government spending added 40 basis points to real GDP growth, financed by higher net borrowing levels. Conversely, investment spending and exports added little to growth in the second quarter as supply-chain disruptions, especially in Germany's key auto industry, held up activity.

Reprieve for U.K. manufacturers

The U.K. government has extended the deadline for manufacturers to adopt the post-Brexit "UKCA" safety and quality mark for their products to January 2023. Manufacturers had warned they were not yet ready to move away from the EU certification system and that sticking with the deadline could impede their reliance on foreign inputs. There have also been concerns as to whether the U.K. had built up the capacity to test products. Though the extension will provide U.K. manufacturers with much-needed breathing room, regulatory divergence means products bound for Northern Ireland will still require both certifications to meet the requirements of the Northern Ireland Protocol, which could result in shipment delays and added costs for producers.

Money growth still strong

M3 money growth in the euro zone slowed to 7.6% y/y in July from 8.3% in June. Although the growth rate of loans to households sped up to 4.2% y/y from 4%, the growth rate for nonfinancial corporate loans slowed to 1.7% from 1.8%. Monetary and fiscal policies have caused money supply to surge since the start of the pandemic, so a slowdown is natural now that the economy is recovering.

Japan's Recovery Postponed

BY STEFAN ANGRICK AND SHAHANA MUKHERJEE

Japan's economy continues to struggle halfway into the third quarter of 2021. A record number of COVID-19 infections has compelled the government to extend the ongoing state of emergency until mid-September and expand restrictions to more prefectures. Although GDP eked out some moderate growth in the second quarter, the outlook for labour demand and spending remains at risk considering the strong resurgences in the region.

Externally, too, the picture has clouded. Overseas demand remains solid overall thanks to continuing recoveries in Japan's main trading partners and global efforts to ramp up semiconductor production. This will support Japanese manufacturers. But the ongoing chip shortage and the virus resurgence across Asia will disrupt supply chains. The announcement by Japanese carmaker Toyota this week about plans to slash production sent equities tumbling and significantly clouded the near-term outlook for production and shipments.

Faster-than-expected vaccine rollout key to recovery

The silver lining is the vaccine rollout. While Japan still trails the G7, its vaccination campaign is the fastest of the group. Relative to population, Japan lags the U.S. and European Union by only a few weeks. Around 40% of the population has now been fully vaccinated, and more than 50% have received at least one dose. Higher vaccination rates will also allow for a more substantial rollback of restrictions, reflected in the government's recent announcement of a forthcoming exit strategy. At current rates, about 80% of the population will have been fully vaccinated by the middle of the fourth quarter.

Revisions reflect weak consumption, buoyant capex

Although we maintain our view that the road to recovery will be bumpy and prone to setbacks, the broader trajectory of the economy beyond the latest virus surge is gradually coming into view. This has prompted us to revise our medium- and long-term forecasts, with notable changes to GDP and its composition, and to monetary policy.

Our GDP forecasts now factor in a much slower recovery in consumption after the pandemic. The key reason is a weak consumer demand outlook, ongoing pressure on the labour market and disappointing wage growth. Although we look for a notable bounce in spending once the pandemic situation stabilises and pent-up demand is released, medium- to long-term growth will remain constrained unless more substantial wage growth materialises. In comparison, prospects for capital spending appear more positive, supported by favourable foreign demand, global efforts to ramp up semiconductor production, and efforts to upgrade ICT. Over the medium to longer term, demographic change will incentivise investment in labour-saving technology, while climate change and the government's pledge to decarbonise the economy will also be increasingly pertinent factors.

Reflecting these changes, we forecast the consumption share of GDP to decline while that of gross capital formation will increase, continuing broader trends observed in the data over the last decade. With global growth projected to outpace Japanese growth significantly, net exports are forecast to remain positive. Longer term, our GDP forecast now aligns much more closely with population projections, ensuring sensible productivity metrics.

On monetary policy, we expect the Bank of Japan to inch toward a moderately tighter policy stance as it recalibrates measures to ensure financial sustainability, barring a large shock to the economy or rapid appreciation of the yen. Conceivable changes are adjustments to forward guidance, the operational details of its asset purchases, or its reserve tiering system. The bank will also encourage super long-term bonds beyond 10 years maturity to drift higher, as reflected in our forecast. But more significant tightening, including a higher short-term policy rate and higher 10-year bond yield target, is unlikely so long as demand and inflation remain subdued.

RATINGS ROUND-UP

All Upgrades for Latest U.S. Changes

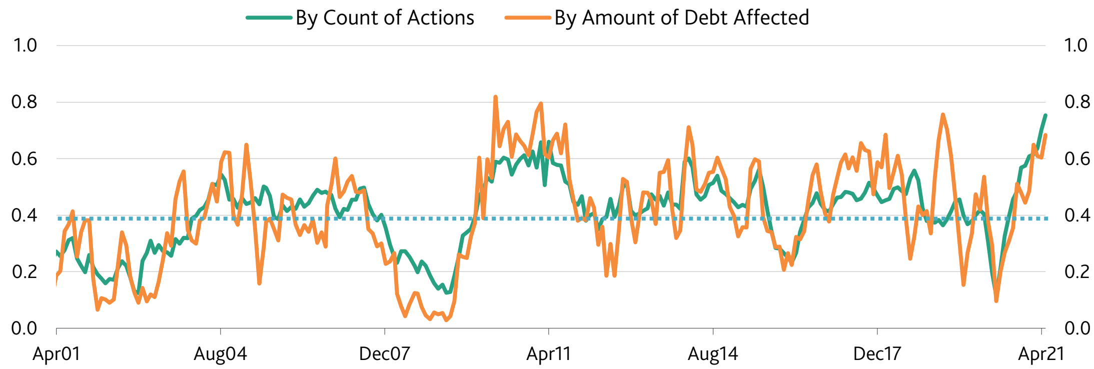
BY MICHAEL FERLEZ

U.S. rating activity was light in the latest period, with only four rating changes—all upgrades. Rating change activity was split across a diverse set of industries, with speculative-grade companies accounting for three of the four changes. The most notable change in terms of affected debt was Republic New York Corp., a subsidiary of HSBC Holdings plc. On August 18, Moody's Investors Service upgraded numerous ratings of HSBC USA Inc., HSBC USA, and HSBC Bank USA, N.A. These included the upgrade of Republic New York Corp.'s subordinate regular bond/debenture to A2 from A3, impacting $2.5 billion in outstanding debt. Last week's activity continues the months-long streak of positive rating changes. Through July, upgrades have accounted for over 70% of total rating changes and affected debt.

Western European rating change activity was also light last week with only one upgrade and one downgrade. The largest change in terms of affected debt was to Vedanta Resources Limited, which saw its senior unsecured notes rating upgraded to B3 from Caa1. In addition, Moody's Investors Service affirmed the company's Corporate Family Rating and upgraded unsecured notes issued by Vedanta Resources Finance II Plc—VRL's wholly owned subsidiary—and guaranteed by VRL. In total the upgrade affected $3.5 billion in debt.

RATINGS ROUND-UP

FIGURE 1
Rating Changes - US Corporate & Financial Institutions: Favorable as a % of Total Actions



* Trailing 3-month average

Source: Moody's

FIGURE 2
Rating Key

BCF	Bank Credit Facility Rating	MM	Money-Market
CFR	Corporate Family Rating	MTN	MTN Program Rating
CP	Commercial Paper Rating	Notes	Notes
FSR	Bank Financial Strength Rating	PDR	Probability of Default Rating
IFS	Insurance Financial Strength Rating	PS	Preferred Stock Rating
IR	Issuer Rating	SGLR	Speculative-Grade Liquidity Rating
JrSub	Junior Subordinated Rating	SLTD	Short- and Long-Term Deposit Rating
LGD	Loss Given Default Rating	SrSec	Senior Secured Rating
LTCF	Long-Term Corporate Family Rating	SrUnsec	Senior Unsecured Rating
LTD	Long-Term Deposit Rating	SrSub	Senior Subordinated
LTIR	Long-Term Issuer Rating	STD	Short-Term Deposit Rating

FIGURE 3
Rating Changes: Corporate & Financial Institutions - US

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/SG
8/18/2021	HSBC HOLDINGS PLC-REPUBLIC NEW YORK CORPORATION	Financial	Sub/PS/SrUnsec/MTN/ Sub	2,482.80	U	A3	A2	IG
8/19/2021	GRUPO FRIBOI-PILGRIM'S PRIDE CORPORATION	Industrial	SrSec/BCF	2,350.00	U	Ba2	Ba1	SG
8/19/2021	STRIPES US HOLDING, INC.-MATTRESS FIRM, INC.	Industrial	LTCFR/PDR/SrSec/BCF		U	B2	B1	SG
8/23/2021	OPPENHEIMER HOLDINGS, INC.	Financial	SrSec/LTCFR	125.00	U	B1	Ba3	SG

Source: Moody's

FIGURE 4

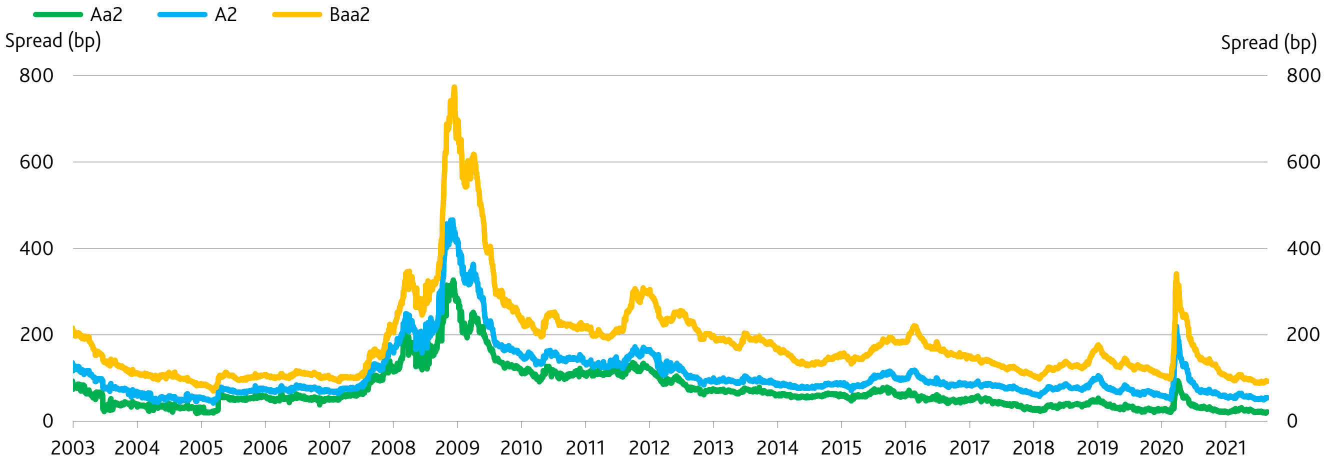
Rating Changes: Corporate & Financial Institutions - Europe

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG	Country
8/20/2021	PAO TMK-CHELPIPE FINANCE DAC	Industrial	SrUnsec	300.00	D	Ba3	B1	SG	IRELAND
8/23/2021	VEDANTA RESOURCES LIMITED	Industrial	SrUnsec	3,500.00	U	Caa1	B3	SG	UNITED KINGDOM

Source: Moody's

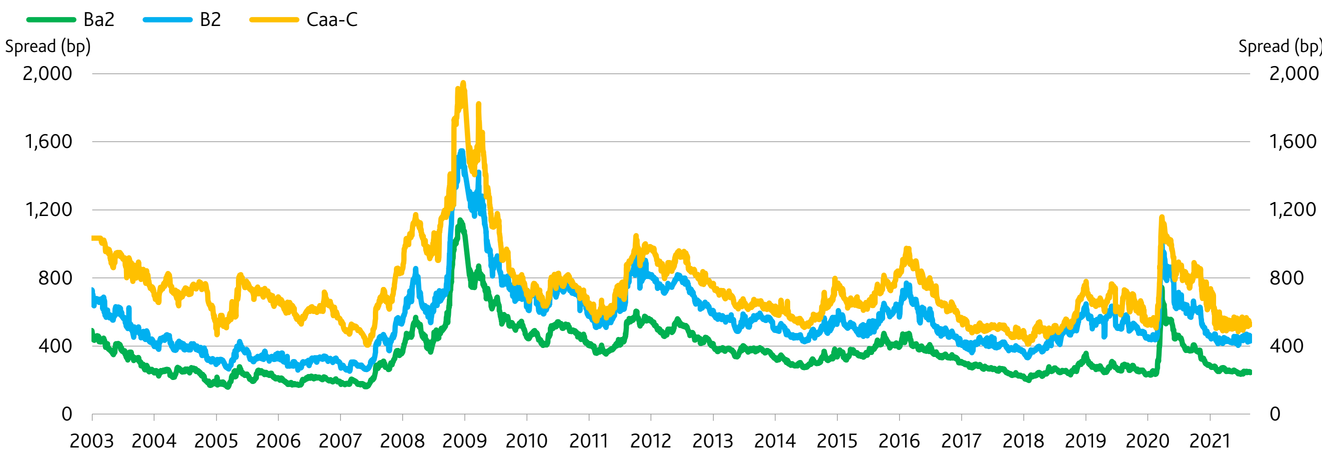
MARKET DATA

Figure 1: 5-Year Median Spreads-Global Data (High Grade)



Source: Moody's

Figure 2: 5-Year Median Spreads-Global Data (High Yield)



Source: Moody's

CDS MOVERS

Figure 3. CDS Movers - US (August 18, 2021 – August 25, 2021)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Aug. 25	Aug. 18	Senior Ratings
Air Products and Chemicals, Inc.	Aa2	A1	A2
Stanley Black & Decker, Inc.	Aa3	A2	Baa1
JPMorgan Chase & Co.	A3	Baa1	A2
Citigroup Inc.	Baa1	Baa2	A3
Wells Fargo & Company	A3	Baa1	A1
JPMorgan Chase Bank, N.A.	A2	A3	Aa2
Oracle Corporation	A1	A2	Baa2
Citibank, N.A.	Baa2	Baa3	Aa3
3M Company	Aa2	Aa3	A1
Amgen Inc.	Aa3	A1	Baa1

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Aug. 25	Aug. 18	Senior Ratings
Martin Marietta Materials, Inc.	Baa2	A3	Baa2
CenterPoint Energy, Inc.	Baa1	A3	Baa2
American Electric Power Company, Inc.	A2	A1	Baa2
Alliant Energy Corporation	A3	A2	Baa2
Vornado Realty L.P.	Ba2	Ba1	Baa2
United Airlines Holdings, Inc.	Caa3	Caa2	Ba3
Commercial Metals Company	Ba3	Ba2	Ba2
Domtar Corporation	B2	B1	Baa3
United States of America, Government of	Aaa	Aaa	Aaa
Goldman Sachs Group, Inc. (The)	Baa2	Baa2	A2

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Aug. 25	Aug. 18	Spread Diff
Talen Energy Supply, LLC	B3	6,134	4,133	2,001
Domtar Corporation	Baa3	302	247	55
CenterPoint Energy, Inc.	Baa2	51	40	11
Martin Marietta Materials, Inc.	Baa2	55	44	10
Vornado Realty L.P.	Baa2	138	131	7
Nissan Motor Acceptance Company LLC	Baa3	149	143	6
Mattel, Inc.	B1	191	185	6
Unisys Corporation	Caa1	227	221	6
Ford Motor Company	Ba2	192	187	5
SITE Centers Corp.	Baa3	123	118	5

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Aug. 25	Aug. 18	Spread Diff
Nabors Industries, Inc.	Caa2	962	1,049	-87
Rite Aid Corporation	Caa3	775	849	-74
Apache Corporation	Ba1	191	228	-36
Staples, Inc.	Caa1	955	991	-35
Murphy Oil Corporation	Ba3	314	348	-34
Pitney Bowes Inc.	B1	378	409	-32
Occidental Petroleum Corporation	Ba2	207	237	-29
Bath & Body Works, Inc.	Ba2	118	146	-28
Carnival Corporation	B2	399	426	-27
Royal Caribbean Cruises Ltd.	B2	389	416	-27

Source: Moody's, CMA

CDS Movers

Figure 4. CDS Movers - Europe (August 18, 2021 – August 25, 2021)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Aug. 25	Aug. 18	Senior Ratings
Intesa Sanpaolo S.p.A.	Baa1	Baa2	Baa1
HSBC Holdings plc	A3	Baa1	A3
Bayerische Motoren Werke Aktiengesellschaft	A1	A2	A2
E.ON SE	Aa3	A1	Baa2
Koninklijke KPN N.V.	Baa2	Baa3	Baa3
Adecco Group AG	A1	A2	Baa1
National Grid Gas plc	Aa3	A1	Baa1
Sappi Papier Holding GmbH	B3	Caa1	Ba2
adidas AG	Aa3	A1	A2
Iberdrola S.A.	A2	A3	Baa1

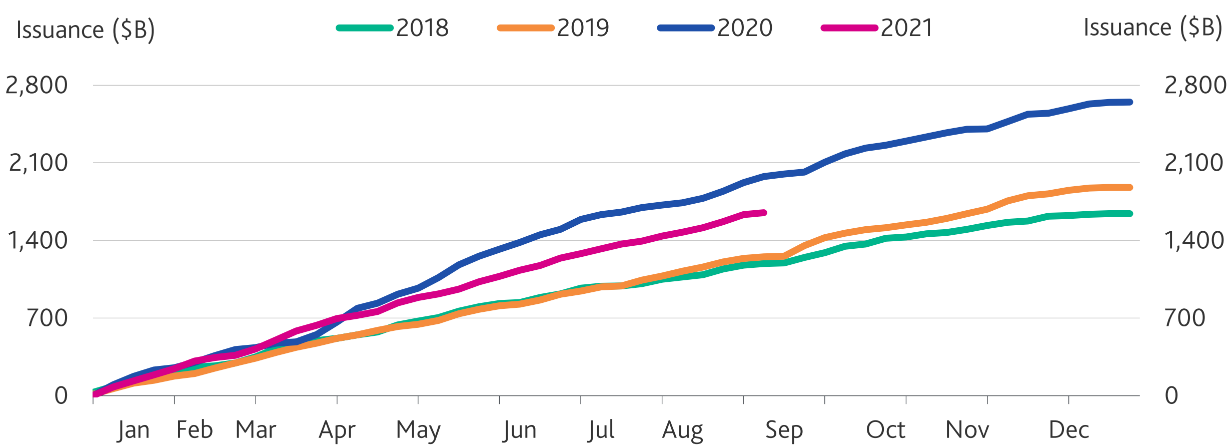
CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Aug. 25	Aug. 18	Senior Ratings
Orsted A/S	A1	Aa2	Baa1
CaixaBank, S.A.	A3	A2	Baa1
Dexia Credit Local	Baa3	Baa2	Baa3
BNP Paribas Fortis SA/NV	Aa2	Aa1	A2
Anglo American plc	Ba1	Baa3	Baa2
Unione di Banche Italiane S.p.A.	Baa3	Baa2	Baa3
Autoroutes du Sud de la France (ASF)	Aa3	Aa2	A3
Vattenfall AB	Aa2	Aa1	A3
Thales	A3	A2	A2
ASML Holding N.V.	Baa2	Baa1	A3

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Aug. 25	Aug. 18	Spread Diff
Boparan Finance plc	Caa1	949	929	19
Jaguar Land Rover Automotive Plc	B1	343	334	9
ASML Holding N.V.	A3	56	50	6
Piraeus Financial Holdings S.A.	Caa3	581	576	5
Norddeutsche Landesbank GZ	A3	77	73	4
National Bank of Greece S.A.	Caa1	206	202	4
Novo Banco, S.A.	Caa2	196	192	4
Smiths Group plc	Baa2	57	53	4
DZ BANK AG	Aa1	25	22	3
RCI Banque	Baa2	162	160	3

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Aug. 25	Aug. 18	Spread Diff
Vedanta Resources Limited	B3	707	769	-61
Novafives S.A.S.	Caa2	808	839	-32
Stena AB	Caa1	427	455	-28
Marks & Spencer p.l.c.	Ba1	150	173	-24
Sappi Papier Holding GmbH	Ba2	338	351	-13
Casino Guichard-Perrachon SA	Caa1	473	485	-12
Banco Sabadell, S.A.	Baa3	74	83	-9
Iceland Bondco plc	Caa2	424	433	-9
TUI AG	Caa1	689	698	-9
Telecom Italia S.p.A.	Ba2	151	159	-8

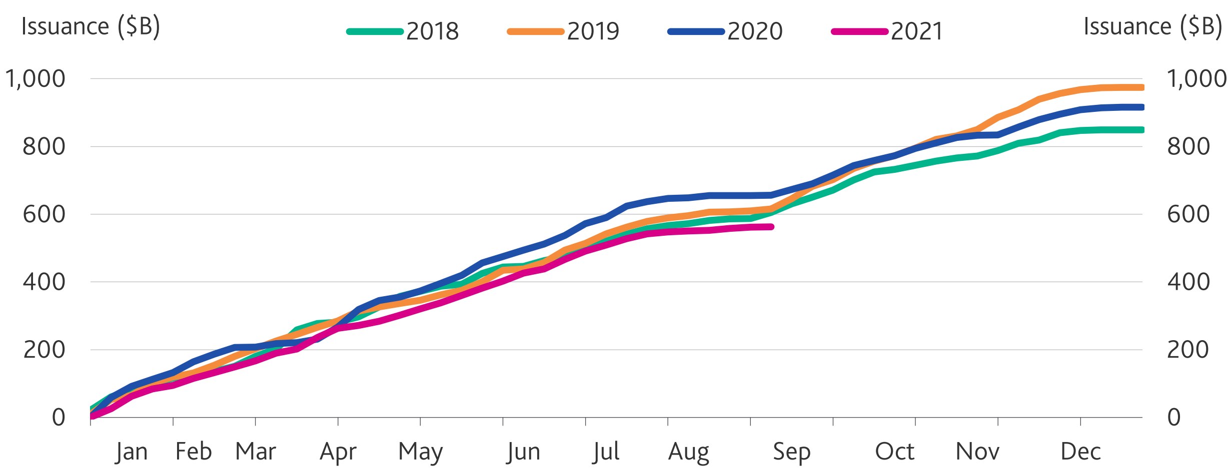
Source: Moody's, CMA

Figure 5. Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated



Source: Moody's / Dealogic

Figure 6. Market Cumulative Issuance - Corporate & Financial Institutions: Euro Denominated



Source: Moody's / Dealogic

Figure 7. Issuance: Corporate & Financial Institutions

	USD Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	10.475	5.625	17.260
Year-to-Date	1,131.580	470.372	1,650.033

	Euro Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	1.176	0.000	1.176
Year-to-Date	438.214	108.305	562.832

* Difference represents issuance with pending ratings.

Source: Moody's/ Dealogic

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