Daiwa Capital Markets

U.S. Economic Comment

- Labor market indicators: mostly vigorous
- Currency values: a shift in the dollar's influence on growth & inflation
- Federal budget: slippage in FY2017; more deterioration likely in FY2018

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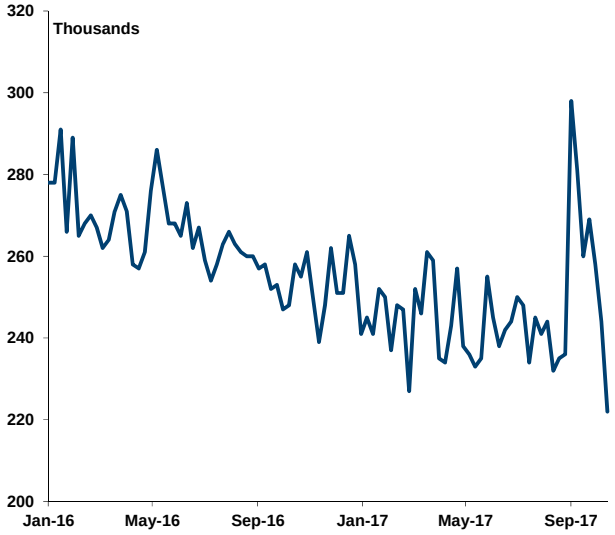
Labor Market: Look Beyond Nonfarm Payrolls

Most market participants focus on the monthly change in nonfarm payrolls to evaluate conditions in the labor market. The latest results -- a drop in employment, undoubtedly because of Hurricanes Harvey and Irma -- led investors and traders to ignore the data and may have diverted attention from other labor-market indicators. That would be unfortunate, as other employment-related statistics have been uniformly favorable, even vigorous.

Job growth as measured by the survey of households in the monthly employment report was certainly robust, showing a gain of 906,000. (This portion of the report would not be affected by the hurricanes, as individuals are counted as employed if they were not at work because of adverse weather.) This surge should be interpreted cautiously because the employment figures from the household survey are quite volatile, but the underlying average has been quite strong (202,000 in the past year and 224,000 in the past six months) and the marked upside move in September at the very least indicates that conditions are not slipping. In addition, the unemployment rate fell 0.2 percentage point in September, and the broad jobless rate (the U-6 measure) fell 0.3 percentage point. The unemployment rate can be viewed as a clean indicator -- that is, it shows little random volatility because statistical noise in employment and the size of the labor force tend to cancel in the calculation of the jobless rate. Thus, the drop in September signaled strength.

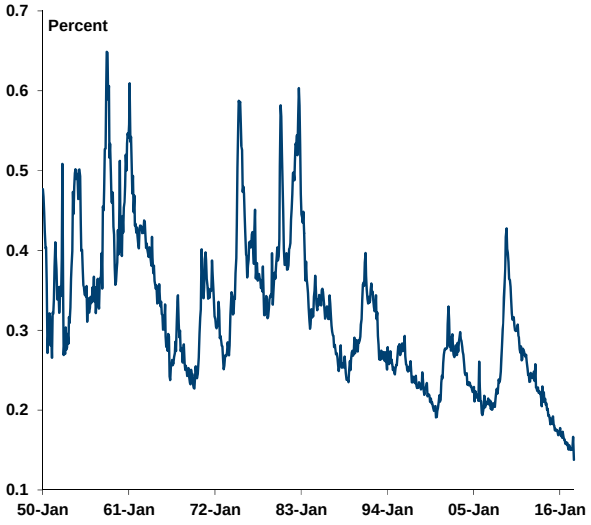
Recent readings on claims for unemployment insurance also have been impressive. Initial claims jumped in the weeks after Hurricane Harvey, but they settled quickly and moved to a new cyclical low in the latest week (chart, left). The rock bottom level of initial claims is best appreciated by taking a long-term perspective. Measured as a share of the labor force (to scale for the smaller size of the economy in years past), initial claims are far below previous cyclical troughs (chart, right). Continuing claims for unemployment insurance --

Initial Claims for Unemployment Insurance



Source: U.S. Department of Labor

Initial Claims for Unemployment Insurance*



** Initial claims for unemployment insurance as a share of the civilian labor force. The reading for October 2017 shows claims for the week of October 14 as a share of the labor force as of September 2017.*

Source: Bureau of Labor Statistics; U.S. Department of Labor

that is, the number of individuals receiving unemployment benefits -- also has been moving lower and is at a record low when measured as a share of the labor force. Interestingly, continuing claims did not rise in response to the hurricanes, as individuals most likely were able to return to their jobs before the normal lag of one to three weeks between the initial filing and the receipt of benefits. (Unemployment programs are run by state agencies, and lags vary by state.)

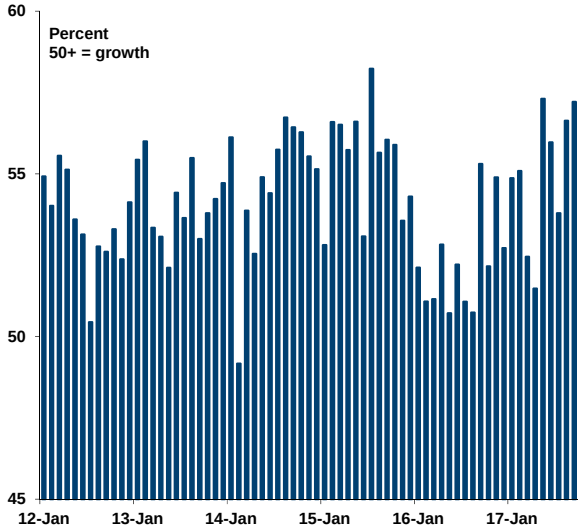
The limited number of layoffs in the economy also is evident in the JOLTs report (Job Openings and Labor Turnover), which shows the termination rate in the past year ranging from 1.0 percent to 1.2 percent of employment versus a range of 1.2 to 1.5 percent in the prior expansion.

The number of job openings published with the JOLTs report suggests that hiring will remain firm, as the latest observation was only modesty below the record in July and well above the peak in the previous expansion. That is, hiring will remain brisk if businesses can find qualified workers. The past few Beige Books of the Federal Reserve have noted difficulty in this regard, and recent monthly surveys of the National Federation of Independent Business have shown elevated readings on the share of businesses with few or no qualified applicants for job openings.

Other survey data also point to strong conditions in the labor market. The employment components of both ISM indexes have moved to the upper portions of their historical ranges, as shown by the reading of 57.2 percent in a composite measure (manufacturing and nonmanufacturing combined, chart). Regional measures of manufacturing conditions published by the Federal Reserve Banks of New York and Philadelphia also show strong employment conditions -- especially Phily, a new record by a wide margin. We do not put much weight on the regional measures because of their marked volatility, but neither do we ignore them, and in light of the other robust readings on the employment situation, they have a bit more credibility than usual.

Thus, the only soft reading on the labor market has been the change in nonfarm payrolls from the business survey, and this measure was no doubt influenced by the hurricanes. The preponderance of evidence shows a tight labor market.

ISM Composite Index: Employment*



* *A weighted average of the employment components of the ISM manufacturing and nonmanufacturing indexes. Weights are derived from GDP by industry data from the Bureau of Economic Analysis.*

Source: Institute for Supply Management; Daiwa Capital Markets America

The U.S. Dollar: Implications for Inflation and Growth

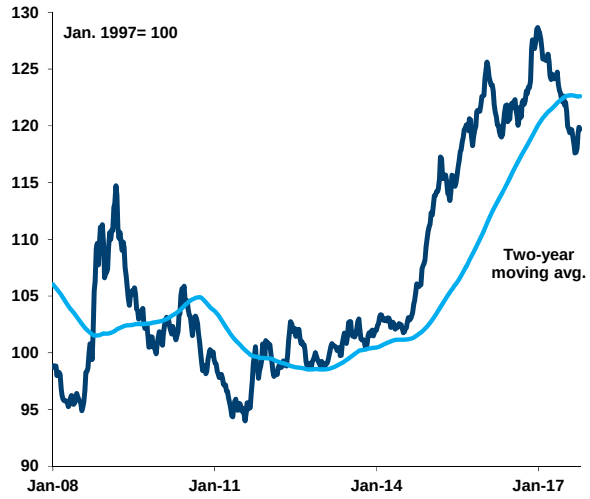
Although it has wiggled higher in the past four weeks, the foreign exchange value of the U.S. dollar as eased 8.5 percent against a basket of currencies since the recent peak in late December. The softening this year has pushed the trade-weighted index below its two-year moving average, a significant change because the lag between currency shifts and a change in trade flows is approximately two years (chart, next page). Thus, the current position of the dollar relative to this average suggests that the constraining effects of the dollar strength that began in mid-2014 should be largely absorbed; the exchange rate could now represent a tailwind for the U.S. economy.

Price movements suggest that such a change is underway. An index of prices for finished imported goods (capital goods, consumer goods, and motor vehicles) has increased in six of the past nine months and the year-over-year change has recently moved into positive territory, a marked change from price declines that

characterized the prior two years (chart, below left; we focus on the prices of finished goods because this eliminates the effect of commodity prices, which are highly volatile and often priced in dollars).

Fed Chair Janet Yellen has mentioned dollar strength and falling import prices as one of the transitory factors that has restrained inflation, and recent developments seem to support her view. Import prices that feed into domestic indexes (both the CPI and the PCE price index include prices of imports) will no longer be declining. In addition, competition from foreign producers will be less intense, which could allow domestic producers more flexibility to raise prices or to recapture market share in the U.S.

Broad Trade-Weighted Dollar Index

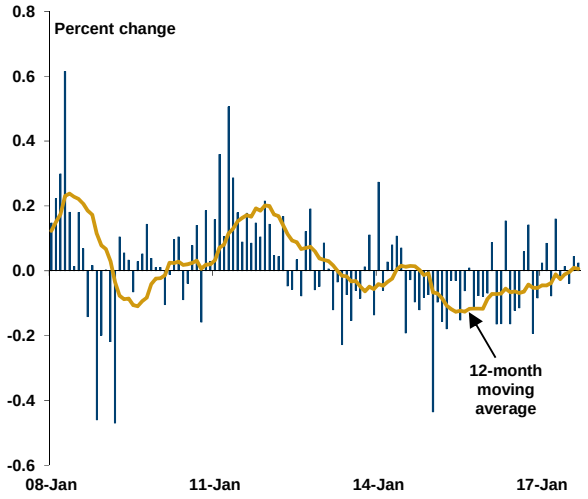


Source: Federal Reserve Board

The currency change also should boost the fortunes of U.S. producers in foreign economies. The softer currency could leave domestic firms in a stronger competitive position (price wise) in foreign countries; alternatively, they could raise prices in dollar terms (leaving little shift in foreign currency terms), which would widen profit margins.

U.S. executives seem to have decided to do a little of both. Real exports of goods grew briskly in the first half of the year (6.5 percent) and available data suggest a further advance in the third quarter. Thus, some firms seem to be pursuing market share. At the same time, others apparently are focused on profits, as prices of finished exported goods have increased every month since February (chart, below right). Either way -- market share or profits -- the currency shift has left U.S. firms in stronger international positions than they were in the prior two years.

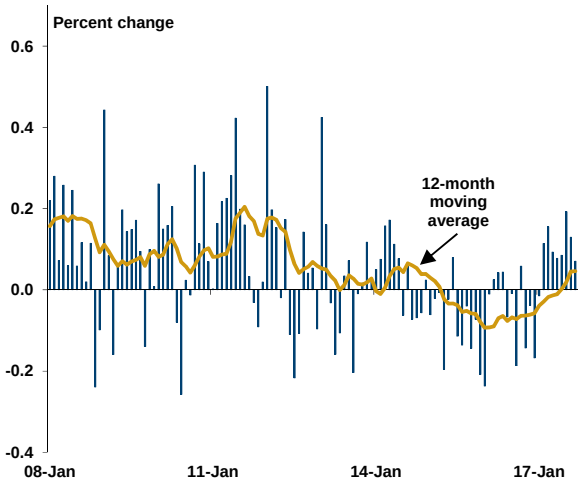
Key Import Prices*



** A weighted average index of capital goods, consumer goods, and automobile prices. Weights are derived from import shares into the United States.*

Source: Bureau of Labor Statistics; Bureau of Economic Analysis; Daiwa Capital Markets America

Key Export Prices*



** A weighted average index of capital goods, consumer goods, and automobile prices. Weights are derived from shares of U.S. exports.*

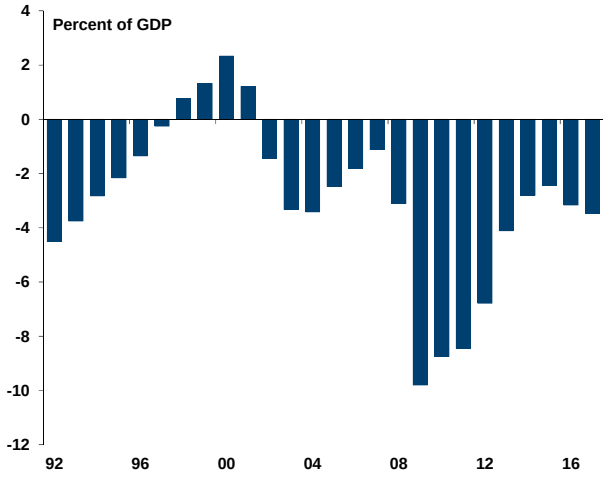
Source: Bureau of Labor Statistics; Bureau of Economic Analysis; Daiwa Capital Markets America

Federal Budget: FY2017 Results; a Plan for FY2018

The Treasury Department on Friday afternoon published budget results for the month of September, which completed fiscal year 2017. The government typically runs a surplus in September because of estimated tax payments by individuals and corporations. It did so again this year, although receipts were light (down 2.2 percent from the same month last year), and the monthly surplus of $8.0 billion was well shy of the average of $76 billion in the previous five Septembers.

The deficit for the full fiscal year totaled $665.7 billion (or 3.5 percent of GDP), up from $585.6 billion (3.2 percent of GDP) in fiscal year 2016 (chart).

U.S. Federal Budget Balance*



** The federal surplus/deficit as a share of nominal GDP. The reading for FY2017 includes an estimate of GDP based on available data.*

Source: U.S. Treasury Department; Bureau of Economic Analysis; Daiwa Capital Markets America

The weak revenue flows in September represented a continuation of soft results seen in most months in the past year, which left revenue growth of only 1.5 percent for the full fiscal year. Taxes paid by individuals were underwhelming with growth of 2.7 percent, but this performance was better than the decline of 2.0 percent in taxes paid by corporations. Remittances by the Federal Reserve plummeted 29.8 percent. Most of this retreat was the result of inflated payments in the prior year when the Fed was forced to transfer most of its accumulated capital to the Treasury to fund highway transportation projects. Remittances would have declined approximately 16 percent in the absence of this special factor, reflecting higher interest payments paid to depository institutions.

Total spending by the federal government rose by 3.3 percent, a reasonable pace in that it was slower than the increase in nominal GDP (estimated to be 3.8 percent, actual published on October 27). Outlays for the three major entitlement programs (Social Security, Medicare, and Medicaid) stayed within reasonable bounds with growth of 2.7 percent. A few areas showed rapid growth. Interest outlays jumped 9.2 percent, primarily because of a pickup in headline inflation and larger payments on inflation-protected securities. The government also increased the estimated subsidy cost associated with various loan programs (i.e. it recorded losses on defaulted loans), and subsidy costs for health-insurance premiums rose sharply.

The other news on the budget front involved the passage of a budget resolution by the Senate. The media widely reported the action as the adoption of a budget; actually, a budget resolution is merely an outline or plan for a budget. This resolution must now be reconciled with the plan adopted by the House of Representatives, and then various committees in Congress will begin filling in the details of the budget outline. There is still a ways to go before Congress has a budget for fiscal year 2018, which started on October. The government is currently operating under temporary budget authority, which expires December 8.

The budget resolution, along with other developments, suggests noticeable slippage in budget results for the current fiscal year. The government will be spending considerable amounts to recover from the hurricanes, and the budget resolution suggested that existing caps on defense spending might be breached. In addition, the resolution opened a door for net reductions in federal revenues associated with tax-reform legislation -- although we are not optimistic that Congress can assemble and pass a reform package that might become effective in the current fiscal year. More spending, possible tax reductions, wider budget deficits at a time of full employment -- not exactly sound fiscal policy.

Review

Week of October 16, 2017	Actual	Consensus	Comments
Industrial Production (September)	**0.3%**	**0.3%**	Manufacturing activity rose only slightly in September (0.1%) after declining in the prior two months (-0.2% in August and -0.4% in July). Hurricanes Harvey and Irma constrained activity in August and September, but softness in July indicated some retreat from firm results in the spring. However, the longer-term trend in manufacturing output was still upward and much improved from the flat performance in 2015-16. Mining activity has held up reasonably well. A hurricane-related dip in August was modest (-0.2%) and activity picked up in September (0.4%). Utility output fell sharply in August and recovered only a portion of the lost ground in September. However, shifts in the utility sector are nearly always driven by swings in temperatures rather than economic fundamentals.
Housing Starts (September)	**1.127 Million (-4.7%)**	**1.175 Million (-0.4%)**	Multi-family housing starts fell 5.1%, possibly influenced by the hurricanes but also reflecting an easing trend after a strong recovery in the prior six years. Single-family starts fell 4.6% in September, but all of the decline occurred in the South (off 15.3%), where Hurricanes Harvey and Irma most likely limited activity. The other three regions of the country all registered advances, with the combined increase totaling 8.4%. The decline in overall single-family starts in September dampened the upward trend, but the path excluding the South was noticeably firmer.
Leading Indicators (September)	**-0.2%**	**0.1%**	Only three of the 10 components of the leading indicator index fell in September (the manufacturing workweek, initial claims for unemployment insurance, building permits), and all three were probably influenced by the hurricanes (although the drop in building permits also reflected fundamental softening in multi-family activity). The index deviated from expectations because figures on permits were not available when analysts made projections.

Review Continued

Week of October 16, 2017	Actual	Consensus	Comments
Existing Home Sales (September)	**5.39 Million (0.7%)**	**5.30 Million (-0.9%)**	Existing home sales increased, but the pickup reversed only a small portion of the declines in the prior three months. The National Association of Realtors noted that Hurricanes Harvey and Irma played a role in restraining activity in August in September, as sales fell 0.9% in the South but rose 1.9% in the other three major regions. Officials noted again that limited inventories continued to restrict sales in many parts of the country.
Federal Budget (September)	**$8.0 Billion Surplus**	**$6.0 Billion Surplus**	The federal government typically runs a surplus in September because of heavy tax inflows associated with quarterly estimated payments by individuals and corporations. However, collections this year were light (off 2.2% from September 2016). In addition, the calendar configuration shifted some outlays from October into September, leaving an above-average pace of spending. Soft revenues and an added boost to outlays left the surplus well shy of the $76 billion average of the past five Septembers. The deficit for the full fiscal year totaled $665.7 billion versus $585.6 billion in FY2016.

Source: Federal Reserve Board (Industrial Production); U.S. Census Bureau (Housing Starts); The Conference Board (Leading Indicators); National Association of Realtors (Existing Home Sales); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of October 23, 2017	Projected	Comments
Durable Goods Orders (September) (Wednesday)	**2.0%**	Above-average order flows at Boeing probably led to a jump in the volatile aircraft component. Signs of improvement in the manufacturing sector (elevated readings on the ISM index, net gain in factory employment in recent months) suggest that other industries could contribute as well.
New Home Sales (September) (Wednesday)	**0.550 Million (-1.8%)**	A decline in buyer traffic in September and little movement in mortgage applications suggest that sales of new homes fell for the third consecutive month. The expected reading would leave the average in Q3 7.6% below the average in the first half of the year.
U.S. International Trade in Goods (September) (Thursday)	**-$63.0 Billion ($0.3 Billion Narrower Deficit)**	With the dollar now softer and with many foreign countries now showing firmer growth, exports are likely to rebound from declines in the prior two months. Imports of nonpetroleum goods also could rebound from their dip in August, and higher prices could push the value of imported crude oil higher, leaving a wider trade deficit.
GDP (2017-Q3) (Friday)	**2.8%**	The U.S. economy in Q3 appears to have grown faster than the 2.1% pace registered in the first half of the year, although almost a full percentage point of expected growth was driven by inventory investment (versus a drag of 0.7 percentage point from inventory investment in H1). Among other components, consumer spending and business investment in new equipment seemed to perform well, and available data suggest that net exports also made a positive contribution. Residential construction and government spending appear to have declined.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

October/November 2017

Monday	Tuesday	Wednesday	Thursday	Friday
16	17	18	19	20
EMPIRE MFG Aug 25.2 Sept 24.4 Oct 30.2	**IMPORT/EXPORT PRICES** Non-fuel Imports / Nonagri. Exports July -0.1% 0.3% Aug 0.3% 0.8% Sept 0.3% 1.0% **IP & CAP-U** IP / Cap.Util. July -0.1% 76.5% Aug -0.7% 75.8% Sept 0.3% 76.0% **NAHB HOUSING INDEX** Aug 67 Sept 64 Oct 68 **TIC DATA** Total / Net L-T June $7.3B $34.4B July -$7.3B $1.2B Aug $125.0B $67.2B	**HOUSING STARTS** July 1.185 million Aug 1.183 million Sept 1.127 million **BEIGE BOOK** "Reports from all 12 Federal Reserve Districts indicated that economic activity increased in September through early October, with the pace of growth split between modest and moderate."	**INITIAL CLAIMS** Sept 30 258,000 Oct 07 244,000 Oct 14 222,000 **PHILLY FED INDEX** Aug 18.9 Sept 23.8 Oct 27.9 **LEADING INDICATORS** July 0.3% Aug 0.4% Sept -0.2%	**EXISTING HOME SALES** July 5.44 million Aug 5.35 million Sept 5.39 million **FEDERAL BUDGET** 2017 / 2016 July -$42.9B -$112.8B Aug -$107.7B -$107.1B Sept $8.0B $33.4B
23	24	25	26	27
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. July 0.03 0.00 Aug -0.31 -0.04 Sept -- --		**DURABLE GOODS ORDERS (8:30)** July -6.8% Aug 2.0% **Sept 1.0%** **FHFA HOME PRICE INDEX (9:00)** June 0.1% July 0.2% Aug -- **NEW HOME SALES (10:00)** July 0.580 million Aug 0.560 million **Sept 0.550 million**	**INITIAL CLAIMS (8:30)** **U.S. INTERNATIONAL TRADE IN GOODS (8:30)** July -$63.8 billion Aug -$63.3 billion **Sept -$63.0 billion** **ADVANCE INVENTORIES (8:30)** Wholesale / Retail July 0.6% 0.0% Aug 0.9% 0.7% Sept -- -- **PENDING HOMES SALES (10:00)** July -0.8% Aug -2.6% Sept --	**Q3 GDP (8:30)** GDP / Chained Price 17-Q1 1.2% 2.0% 17-Q2 3.1% 1.0% **17-Q3 2.8% 1.4%** **REVISED CONSUMER SENTIMENT (10:00)** Aug 96.8 Sept 95.1 Oct (p) 101.1
30	31	1	2	3
PERSONAL INCOME & CONSUMPTION	**EMPLOYMENT COST INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CHICAGO PMI** **CONFERENCE BOARD CONSUMER CONFIDENCE** **FOMC MEETING**	**ADP EMPLOYMENT REPORT** **ISM MFG INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES** **FOMC DECISION**	**INITIAL CLAIMS** **PRODUCTIVITY & COSTS**	**EMPLOYMENT REPORT** **TRADE BALANCE** **ISM NON-MFG INDEX** **FACTORY ORDERS**
6	7	8	9	10
	JOLTS DATA **CONSUMER CREDIT**		**INITIAL CLAIMS** **WHOLESALE TRADE**	**CONSUMER SENTIMENT** **FEDERAL BUDGET**

Forecasts in Bold (p) = preliminary

Treasury Financing

October/November 2017

Monday	Tuesday	Wednesday	Thursday	Friday
16	17	18	19	20
AUCTION RESULTS: Rate Cover 3-mo bills 1.090% 3.19 6-mo bills 1.240% 3.35 **ANNOUNCE:** $40 billion 4-week bills for auction on October 17 **SETTLE:** $24 billion 3-year notes $20 billion 10-year notes $12 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 4-week bills 0.995% 3.24		**AUCTION RESULTS:** Rate Cover 30-yr TIPS 0.908% 2.64 **ANNOUNCE:** $78 billion 13-,26-week bills for auction on October 23 $15 billion 2-year FRNs for auction on October 25 $26 billion 2-year notes for auction on October 24 $34 billion 5-year notes for auction on October 25 $28 billion 7-year notes for auction on October 26 **SETTLE:** $78 billion 13-,26-week bills $40 billion* 4-week bills	
23	24	25	26	27
AUCTION: $78 billion 13-,26-week bills **ANNOUNCE:** $40 billion* 4-week bills for auction on October 24	**AUCTION:** $40 billion* 4-week bills $26 billion 2-year notes	**AUCTION:** $15 billion 2-year FRNs $34 billion 5-year notes	**AUCTION:** $28 billion 7-year notes **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on October 30 **SETTLE:** $78 billion 13-,26-week bills $40 billion* 4-week bills	
30	31	1	2	3
AUCTION: $78 billion* 13-,26-week bills **ANNOUNCE:** $40 billion* 4-week bills for auction on October 31	**AUCTION:** $40 billion* 4-week bills **SETTLE:** $5 billion 30-year TIPS $15 billion 2-year FRNs $26 billion 2-year notes $34 billion 5-year notes $28 billion 7-year notes	**ANNOUNCE:** $25 billion* 3-year notes for auction on November 7 $24 billion* 10-year notes for auction on November 8 $16 billion* 30-year bonds for auction on November 9	**ANNOUNCE:** $78 billion* 13-,26-week bills for auction on November 6 $20 billion* 52-week bills for auction on November 7 **SETTLE:** $78 billion* 13-,26-week bills $40 billion* 4-week bills	
6	7	8	9	10
AUCTION: $78 billion* 13-,26-week bills **ANNOUNCE:** $40 billion* 4-week bills for auction on November 7	**AUCTION:** $40 billion* 4-week bills $20 billion* 52-week bills $25 billion* 3-year notes	**AUCTION:** $24 billion* 10-year notes	**AUCTION:** $16 billion* 30-year bonds **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on November 13 $11 billion 10-year TIPS for auction on November 16 **SETTLE:** $78 billion* 13-,26-week bills $40 billion* 4-week bills $20 billion* 52-week bills	

**Estimate*