U.S. Economic Comment

- Corporate tax reform: lower rates for most; modest changes for large firms
- FOMC preview: another rate hike despite slow inflation

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Corporate Tax Reform

Initially, we were not deeply impressed with the proposed changes to the corporate tax code. The bills passed in the House of Representatives and the Senate involve large reductions in the statutory tax rates (20 percent rather than 35 percent), but because of extensive loopholes, the effective corporate tax rate was already low. The Statistics of Income published by the Internal Revenue Service, the most detailed information on taxes paid, showed an effective tax rate of 23.3 percent in 2013 (latest available). A shift from 23.3 percent to 20 percent does not seem like a bold move.

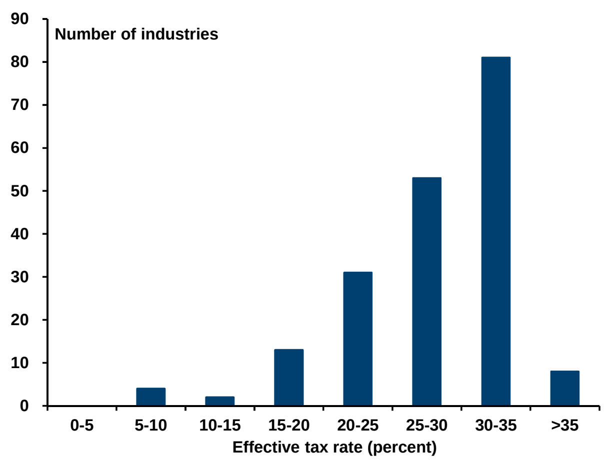
However, from other perspectives, the change is sizeable. Estimates by the Joint Committee on Taxation show that both the House and Senate bills involve average annual net tax cuts of approximately $70 billion over the next ten years, an amount that equates to approximately 25 percent of corporate tax receipts for fiscal year 2017. The maximum corporate benefit in any single year totals $131.6 billion (Senate bill in fiscal year 2019), which represents 40 percent of FY2017 corporate tax payments. It is hard to imagine an individual or business that would not be ecstatic with a one-time reduction of 40 percent and an average reduction of 25 percent in their tax bills.

The aggregate effective tax rate faced by corporations is low at 23.3 percent, but a review of tax rates by industry shows a skewed distribution around this average. The Statistics of Income mentioned above provides profits and taxes by industry, and results show that almost half of the industries listed faced effective tax rates of 30 percent or more in 2013 (latest available), and nearly three-quarters paid effective rates of 25 percent or more (chart). (The chart shows some firms paying more than the 35 percent statutory rate. The amounts paid to the Treasury can include items other than ordinary profit taxes, such as recapture taxes, excessive net passive income taxes, and a host of esoteric items.)

An average tax rate of less than 25 percent implies that the firms in the lower effective brackets are large enterprises that capture most of the benefits from loopholes allowed by Congress. The skew in the distribution supports the view that large corporations have been able to exercise market power and tilt the tax code in their favor. Accusations of crony capitalism are not unfounded.

The bills now before Congress, if passed, will close many of the loopholes, and large corporations with low effective tax rates will see little benefit and some could be facing larger tax bills. The closing of loopholes will not be inconsequential. The estimates from the Joint Committee on Taxation show that the combined effects of lower tax rates and generous depreciation provisions would generate average tax savings of approximately $141 billion per year for the next 10 years, but the average net tax cut totals only $68 billion per year, implying net tightening of $73 billion in other elements of the corporate tax code.

Effective Corporate Tax Rates by Industry*



* *Income tax after credits as a share of income subject to tax. Latest data available are from 2013.*

Source: Internal Revenue Service, Statistics of Income

The skew in effective tax rates raises doubts about the effect of tax reform on business investment spending. Firms in industries paying more than 25 percent of their profits in taxes will have incentive to invest and grow, but the tax environment for larger firms below the 25 percent effective rate is not likely to improve meaningfully, nor would their investment plans. The number of firms in the low brackets is small relative to those in the upper brackets, but their size is substantial and their behavior is likely to dominate the pace of investment spending that unfolds.

In this regard, the financial press a few weeks ago reported on a Q&A session with business executives held by Gary Cohn, a Trump advisor and one of the architects of the tax proposals. Mr. Cohn asked for a show of hands from executives that would increase investment spending in response to tax reform. Few hands were raised. The audience was most likely individuals from the larger firms that already face low effective tax rates and have little to gain from tax reform.

Much of the commentary in the economic and financial media has focused on the ultimate beneficiaries of corporate tax reform. Corporations are not breathing entities; the benefits of lower corporate tax rates will be passed on to individuals in three groups: shareholders in the form of larger dividends or higher equity values, employees in the form of more jobs or higher wages, and other households in the form of lower prices for the products of corporations.

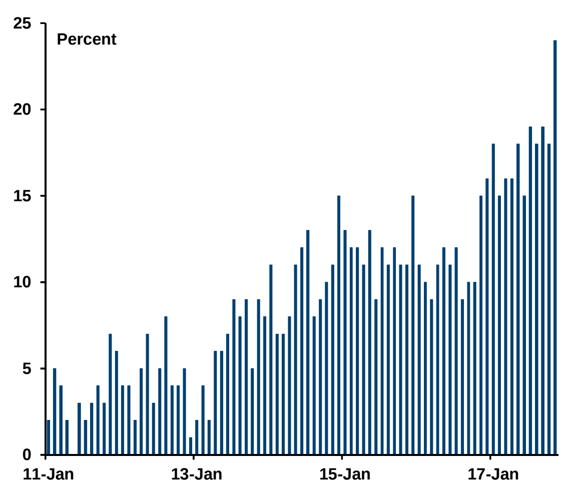
The academic literature shows mixed results on the likely distribution of the benefits, but the evidence tilts in favor of shareholders. In the current instance, however, the outcome could favor employees or other households. If the benefits of lower tax rates accrue to smaller corporations in the high effective tax brackets, their more limited market power might lead to benefits flowing to workers or other households.

It will be interesting.

FOMC Preview

We suspect that several Fed officials will argue strongly for steady monetary policy at the December 12-13 meeting of the Federal Open Market Committee, citing tame inflation and contained inflation expectations as reasons for patience. However, with the economy performing well and inflation showing hints of picking up, officials will most likely raise rates for the third time this year and for the fifth time in the current cycle.

Small Business Economic Trends: Hiring Plans*



The share of firms planning to increase employment
Source: National Federation of Independent Business

Recent economic statistics have been generally firm, consistent with GDP growth of approximately 2.5 percent in Q4, a fine performance after growth in excess of three percent in the second and third quarters. Labor market data have been even more impressive. Average job growth of 170,000 in the past three months (long enough to smooth the distortions associated with hurricanes) is nearly identical to the average of 175,000 in the 12 months before September. In addition, unemployment has continued to decline. Conditions in the labor market are likely to remain brisk, as the report on Job Openings and Labor Turnover shows a near-record level of job postings. Similarly, the latest survey from the National Federation of Independent Business showed a surge in the number of firms that plan to increase employment (chart). This series has shown spikes in the past, but few of the magnitude seen in November.

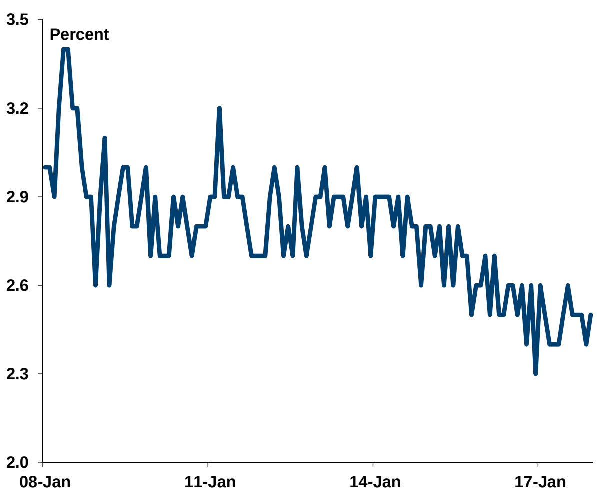
Some Fed officials also are likely to note the highly accommodative nature of broad financial conditions. Low long-term Treasury rates and tight credit spreads, along with elevated stock prices and a tame foreign exchange value of the dollar, make for a highly friendly financial environment. The exuberance and degree of risk taking now evident is likely to fuel concern about financial instability and support the case for additional firming in policy. The remarkable surge in the value of Bitcoin will most likely add to concern about financial exuberance.

Fed officials on the dovish side of the spectrum no doubt agree with the favorable assessment of the economy, and they certainly are aware of conditions in financial markets. However, they believe that tame inflation and a possible easing in inflation expectations argue for a gradual pace of adjustment. Various measures of inflation expectations provide the strongest support for their view, as both survey-based and market-based gauges have eased in recent years. The survey of consumers from Reuters and the University of Michigan Survey Research Center shows a downward drift since 2014 in long-term expected inflation. Break-even rates on inflation-protected securities have shown considerable volatility, but they too are notably lower than pre-2014 readings (charts).

Inflation-related arguments for steady policy, while still compelling, are less forceful than they were a short time ago. The core components of both the consumer price index and the price index for personal consumption expenditures have picked up in recent months. The changes have been modest, but they support the view that at least some of the easing in inflation in the spring and summer was the result of transitory factors.

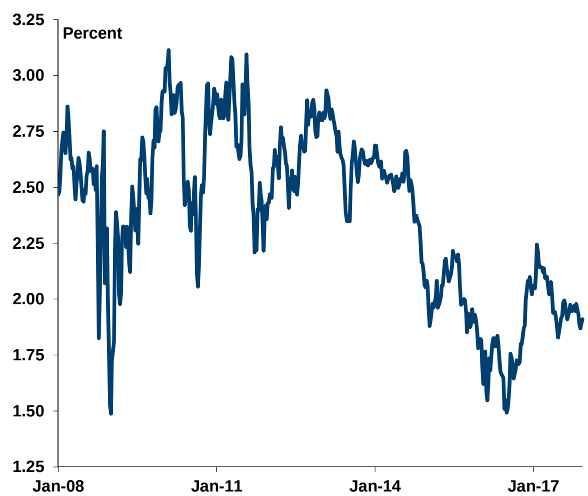
A more telling signal on the inflation front is found in a new measure developed by the Federal Reserve Bank of New York: the so-called underlying inflation gauge (UIG). This measure is generated by a statistical technique that uses a long list of economic indicators to determine the common factors that are driving the key variable of interest -- inflation in this case. The measure has a better record than the core CPI in predicting the actual movement in inflation, and its distinct upward trend supports the view that tight labor markets and faster-than-potential economic growth will begin to fuel price pressure (chart, next page).

Long-Term Inflation Expectations*



Inflation expectations for the next 5 to 10 years.
Source: University of Michigan Survey of Consumers

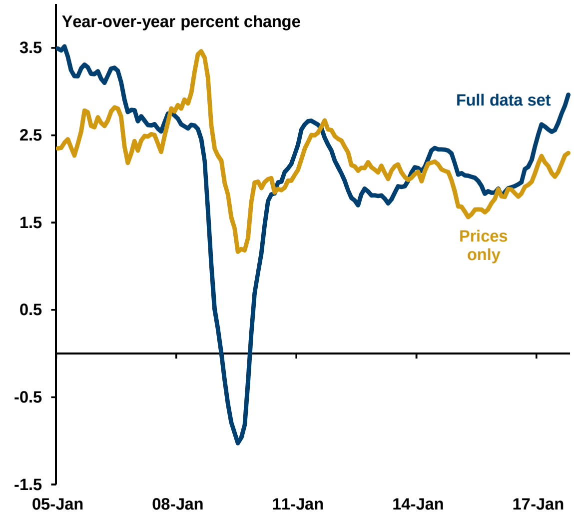
TIPS Spread (Five-Year, Five-Year Forward)*



** The five-year forward nominal Treasury rate less the five-year forward TIPS rate. The forward rates are the expected five-year interest rates five years from now. The forward rates are derived from spot rates for five-year and 10-year securities. Weekly data, except for the last observation, which is a reading for December 8, 2017.*
Source: Bloomberg

Fed governors and reserve bank presidents will provide new economic forecasts at this meeting, including a new set of dot plots. We would not be surprised to see an upward adjustment in the median forecast for GDP growth and a downward revision to the expected unemployment rate. The firm performance of the economy in recent months would argue for such changes, and the increased likelihood of fiscal stimulus in the form of tax cuts supports the case for revisions as well. Ordinarily, we look for dot plots to show tighter distributions of expected interest rates as time passes, but uncertainty about potential tax cuts and the appropriate response of monetary policy could lead to a wider distribution of views.

NY Fed Underlying inflation Gauge (UIG)



Source: Federal Reserve Bank of New York

Chair Yellen will give her final press briefing on Wednesday. We look for reporters to go easy on Ms. Yellen, offering lots of (deserved) praise and thank yous. If reporters probe into substance, they will probably push for justification of tighter policy in a low-inflation environment. Reporters also are likely to ask about the implications of tax cuts for monetary policy. She can easily duck this question by saying that Fed officials will wait to see the final bill before making assessments of the economic impact.

Review

Week of Dec. 4, 2017	Actual	Consensus	Comments
Factory Orders (October)`	**-0.1%**	**-0.4%**	A drop of 16.2% in bookings for aircraft pulled the durable component lower (-0.8%, revised up from -1.2% published on November 22) but orders excluding transportation increased for the fourth consecutive month (+0.9%), reinforcing their upward trend. Bookings for nondurable goods rose 0.7%, as higher prices likely influenced the jump of 2.6% in the petroleum and coal category. Nondurable bookings ex-petroleum rose 0.2% in October, but they have shown little net change in the past four months after trending upward during 2016 and the first half of this year.
Trade Balance (October)	**-$48.7 Billion ($3.8 Billion Wider Deficit)**	**-$47.5 Billion ($4.0 Billion Wider Deficit)**	An increase of 1.6% in imports and little change in exports led to a noticeable widening in the monthly trade deficit in October. The latest month-to-month change was largely expected after the report on goods trade (published November 28) suggested notable slippage, but downward revisions in the services category for April through September provided a downside surprise and left the magnitude of the October deficit larger than expected. The shift in the trade deficit in the latest month raises the prospect of a negative contribution from net exports to GDP growth in the fourth quarter. If results for November and December were to match those of October, net exports would subtract almost one percentage point from GDP growth.
ISM Nonmanufacturing Index (November)	**57.4% (-2.7 Percentage Points)**	**59.0% (-1.1 Percentage Points)**	The decline in the ISM nonmanufacturing index occurred from an elevated level in October, and thus the level of the index remained in the upper portion of the range of the past two years. The new orders index posted the largest change, dropping 4.1 percentage points to 58.7%, better than the average of 57.5% in 2016, but off from the average of 60.0% in H1 of 2017. Production and employment also slipped, but remained firm (-0.8 percentage point to 61.4% and -2.2 percentage points to 55.3%, respectively). The supplier delivery index fell sharply (off 4.0 percentage points to 54.0%). However, this component was due for a correction after unusually strong readings in September and October (probably hurricane-related).

Review Continued

Week of Dec. 4, 2017	Actual	Consensus	Comments
Revised Nonfarm Productivity (2017-Q3)	**3.0% (Unrevised)**	**3.3% (+0.3 Percentage Point Revision)**	Output in the nonfarm sector rose more than previously estimated (4.1%, annual rate versus 3.8% first reported), but hours worked also rose more than believed, leaving no revision from the initial estimate of productivity growth. The latest increase in productivity represented the fifth consecutive advance and was among the best readings of the current expansion, perhaps suggesting an improvement in the underlying trend. Compensation per hour was revised lower (+2.7% versus +3.5%), leading to a downward revision to unit labor costs.
Payroll Employment (November)	**228,000**	**195,000**	The increase in nonfarm payrolls in November was joined by a modest upward revision of 3,000 in the prior two months. The gain may have contained an element of upside noise associated with recovery from the hurricanes, but solid gains in cyclically sensitive industries (manufacturing and construction) suggested that underlying conditions were strong. The unemployment rate was reported as unchanged at 4.1%, but it inched higher if calculated with more precision (4.118% versus 4.065% in October), reflecting an increase in the size of the labor force (148,000) that outpaced an advance of 57,000 in employment as measured by the household survey. Average hourly earnings rose 0.2%, a bit disappointing after a drop of 0.1% in the prior month. The latest change left the year-over-year increase at 2.5%, up two ticks from the October result but still within the range of the past two years.
Consumer Sentiment (December)	**96.8 (-1.7 Index Points)**	**99.0 (+0.5 Index Point)**	Back-to-back declines in consumer sentiment (-3.9% in the past two months) pushed the measure from its cyclical high in October to the middle of the range from this year. However, attitudes have been positive this year, and thus the new reading still remained firm by historical standards. All of the decline in December came in the expectations component (-4.8%), pushing it to the middle of the recent range. The current conditions component rose 2.1%, just shy of the best reading of the current expansion. The long-term inflation gauge published with report rose 0.1 percentage point to 2.5%, a reading in the low portion of the historical range.

Source: U.S. Census Bureau (Factory Orders); Bureau of Economic Analysis (Trade Balance); Institute for Supply Management (ISM Nonmanufacturing Index); Bureau of Labor Statistics (Revised Nonfarm Productivity, Payroll Employment); Reuters/University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Dec. 11, 2017	Projected	Comments
PPI (November) (Tuesday)	**0.2% Total, 0.1% Core**	The energy component of the PPI is likely to jump because of higher gasoline prices, but the core component could be restrained by a cooling in services prices after surges in the prior two months.
Federal Budget (November) (Tuesday)	**$135.0 Billion Deficit**	Available data suggests that federal revenues in November rose approximately 5% from the same month last year, better than the advance of 1.5% in FY2017. Outlays are likely to be firmer than the recent average, partly reflecting hefty spending for disaster relief. Federal interest payments also were firm. All told, the deficit is likely to show only modest improvement from the shortfall of $137 billion in November 2016.
CPI (November) (Wednesday)	**0.4% Total, 0.2% Core**	Higher prices of gasoline are likely to account for much of the expected increase in the headline consumer price index, but the core component is likely to contribute as well with its third increase of 0.2% in the past four months. Reduced price competition from imported goods and a fading of transitory factors that were present in the spring and summer seem to be influencing prices excluding food and energy.
Retail Sales (November) (Thursday)	**0.1% Total, 0.5% Ex. Autos**	Higher prices of gasoline are likely to inflate reported activity at service stations, but slower vehicle sales after a hurricane-related spurt in October are likely to provide an offset. Several areas outside of autos and gasoline could pause after strong results in October; food, clothing, and furniture stores seem vulnerable in this regard. Activity at building-supply stores also could ease after a surge in September that was most likely related to hurricane recovery.
Industrial Production (November) (Friday)	**0.5%**	Firm job growth in the factory sector suggests that the manufacturing component of industrial production will register a solid gain. The production index from the ISM report also bodes well for manufacturing activity. Higher prices of crude oil could stir activity in the mining sector.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

December 2017

Monday	Tuesday	Wednesday	Thursday	Friday
4	5	6	7	8
FACTORY ORDERS Aug 1.2% Sept 1.7% Oct -0.1%	**TRADE BALANCE** Aug -\$44.3 billion Sept -\$44.9 billion Oct -\$48.7 billion **ISM NON-MFG INDEX** Index / Prices Sept 59.8 / 66.3 Oct 60.1 / 62.7 Nov 57.4 / 60.7	**ADP EMPLOYMENT REPORT** Private Payrolls Sept 96,000 Oct 235,000 Nov 190,000 **REVISED PRODUCTIVITY & COSTS** Productivity / Unit Labor Costs 17-Q2 1.5% / -1.2% 17-Q3(p) 3.0% / 0.5% 17-Q3(r) 3.0% / -0.2%	**INITIAL CLAIMS** Nov 18 240,000 Nov 25 238,000 Dec 02 236,000 **CONSUMER CREDIT** Aug \$11.4 billion Sept \$19.2 billion Oct \$20.5 billion	**EMPLOYMENT REPORT** Payrolls / Un. Rate Sept 38,000 / 4.2% Oct 244,000 / 4.1% Nov 228,000 / 4.1% **WHOLESALE TRADE** Inventories / Sales Aug 0.8% / 1.9% Sept 0.1% / 1.4% Oct -0.5% / 0.7% **CONSUMER SENTIMENT** Oct 100.7 Nov 98.5 Dec 96.8
11	12	13	14	15
JOLTS DATA (10:00) Openings (000) / Quit Rate Aug 6,090 / 2.1% Sept 6,093 / 2.2% Oct -- / --	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** Sept 103.0 Oct 103.8 Nov -- **PPI (8:30)** Final Demand / Core Sept 0.4% / 0.4% Oct 0.4% / 0.4% **Nov** **0.2%** / **0.1%** **FEDERAL BUDGET (2:00)** 2017 / 2016 Sept \$8.0B / \$33.4B Oct -\$63.2B / -\$45.8B **Nov** **-\$135.0B** / -\$136.7B **FOMC MEETING**	**CPI (8:30)** Total / Core Sept 0.5% / 0.1% Oct 0.1% / 0.2% **Nov** **0.4%** / **0.2%** **FOMC ANNOUNCEMENT (2:00)** **YELLEN PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **RETAIL SALES (8:30)** Total / Ex.Autos Sept 1.9% / 1.2% Oct 0.2% / 0.1% **Nov** **0.1%** / **0.5%** **IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports / Nonagri. Exports Sept 0.3% / 0.9% Oct 0.2% / -0.3% Nov -- / -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales Aug 0.6% / 0.8% Sept 0.0% / 1.5% **Oct** **-0.1%** / **0.5%**	**EMPIRE MFG (8:30)** Oct 30.2 Nov 19.4 Dec -- **IP & CAP-U (9:15)** IP / Cap.Util. Sept 0.4% / 76.4% Oct 0.9% / 77.0% **Nov** **0.5%** / **77.3%** **TIC DATA (4:00)** Total / Net L-T Aug \$130.2B / \$73.2B Sept -\$51.3B / \$80.9B Oct -- / --
18	19	20	21	22
NAHB HOUSING MARKET INDEX	**HOUSING STARTS** **CURRENT ACCOUNT**	**EXISTING HOME SALES**	**INITIAL CLAIMS** **REVISED GDP** **PHILLY FED INDEX** **CHICAGO FED NAT'L ACTIVITY INDEX** **FHFA HOME PRICE INDEX** **LEADING INDICATORS**	**PERSONAL INCOME, CONSUMPTION, CORE PRICE INDEX** **DURABLE GOODS ORDERS** **NEW HOME SALES** **REVISED CONSUMER SENTIMENT**
25	26	27	28	29
CHRISTMAS DAY	**S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX**	**CONSUMER CONFIDENCE** **PENDING HOME SALES**	**INITIAL CLAIMS** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **CHICAGO PURCHASING MANAGERS' INDEX**	

Forecasts in Bold (p) = preliminary; (r) = revised

Treasury Financing

December 2017

<table>
<tr><th>Monday</th><th>Tuesday</th><th>Wednesday</th><th>Thursday</th><th>Friday</th></tr>
<tr><td>4</td><td>5</td><td>6</td><td>7</td><td>8</td></tr>
<tr><td>AUCTION RESULTS:
Rate Cover
3-mo bills 1.290% 3.09
6-mo bills 1.450% 3.30
ANNOUNCE:
$35 billion 4-week bills for auction on December 5</td><td>AUCTION RESULTS:
Rate Cover
4-week bills 1.180% 3.10
52-week bills 1.650% 3.44</td><td></td><td>ANNOUNCE:
$84 billion 13-,26-week bills for auction on December 11
$24 billion 3-year notes for auction on December 11
$20 billion 10-year notes for auction on December 11
$12 billion 30-year bonds for auction on December 12
SETTLE:
$78 billion 13-,26-week bills
$35 billion 4-week bills
$20 billion 52-week bills</td><td>ANNOUNCE:
$9 billion 41-day CMBs for auction on December 8
AUCTION RESULTS:
Rate Cover
41-day CMB 1.170% 4.01
SETTLE:
$9 billion 41-day CMBs</td></tr>
<tr><td>11</td><td>12</td><td>13</td><td>14</td><td>15</td></tr>
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ANNOUNCE:
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$45 billion* 4-week bills
$12 billion 30-year bonds</td><td></td><td>ANNOUNCE:
$84 billion* 13-,26-week bills for auction on December 18
$14 billion* 5-year TIPS for auction on December 21
SETTLE:
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$12 billion 30-year bonds</td></tr>
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<tr><td>AUCTION:
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ANNOUNCE:
$45 billion* 4-week bills for auction on December 19</td><td>AUCTION:
$45 billion* 4-week bills</td><td></td><td>AUCTION:
$14 billion* 5-year TIPS
ANNOUNCE:
$45 billion* 4-week bills for auction on December 26
$84 billion* 13-,26-week bills for auction on December 26
$13 billion* 2-year FRNs for auction on December 27
$26 billion* 2-year notes for auction on December 26
$34 billion* 5-year notes for auction on December 27
$28 billion* 7-year notes for auction on December 28
SETTLE:
$84 billion* 13-,26-week bills
$45 billion* 4-week bills</td><td></td></tr>
<tr><td>25</td><td>26</td><td>27</td><td>28</td><td>29</td></tr>
<tr><td>CHRISTMAS DAY</td><td>AUCTION:
$45 billion* 4-week bills
$84 billion* 13-,26-week bills
$26 billion* 2-year notes</td><td>AUCTION:
$13 billion* 2-year FRNs
$34 billion* 5-year notes</td><td>AUCTION:
$28 billion* 7-year notes
ANNOUNCE:
$45 billion* 4-week bills for auction on January 2
$84 billion* 13-,26-week bills for auction on January 2
$20 billion* 52-week bills for auction on January 2
SETTLE:
$84 billion* 13-,26-week bills
$45 billion* 4-week bills</td><td>SETTLE:
$14 billion* 5-year TIPS
$13 billion* 2-year FRNs</td></tr>
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**Estimate*