U.S. Economic Comment

- Inflation: tame in March, but still trending higher
- Budget deficit: troubling on the surface; worse than it looks

Michael Moran
Daiwa Capital Markets America
212-612-6392
michael.moran@us.daiwacm.com

Inflation Developments

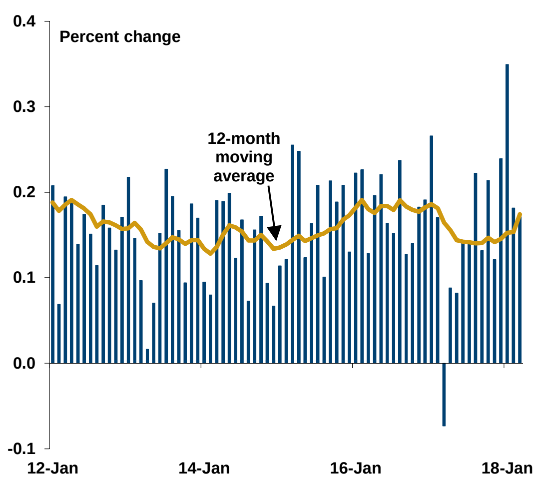
Various inflation measures showed marked signs of quickening in the first two months of the year, but results for March settled somewhat. The easing was not sharp enough to challenge the view of most Fed officials that inflation will be moving higher this year, but the new figures suggested a gradual acceleration rather than a surge.

The core consumer price index in March posted a "soft" increase of 0.2 percent. That is, the published change rounded up to that total (0.176) and trailed the average increase of 0.266 percent in the first two months of the year (chart, left). The easing was broadly based rather than reflective of special circumstances in a few components.

The new report also reinforced some longer-term trends that suggested inflation is not likely to get out of hand. For example, rent of primary residence, which is heavily weighted in the CPI and had been consistently increasing slightly more than 0.3 percent per month, has increased less than 0.3 percent in eight of the past 15 months. Recent shifts have pushed the 12-month change from a recent peak of 3.9 percent in December 2016 to 3.6 percent in March (chart, right). College tuition also has shifted gears. Annual inflation rates of four to six percent had been the norm in the early part of the expansion (faster in prior years -- as much as 10 percent at times), but the year-over-year change began to decelerate in 2014 and has gradually eased to an average of approximately 2.0 percent so far this year (only 1.7 percent in March).

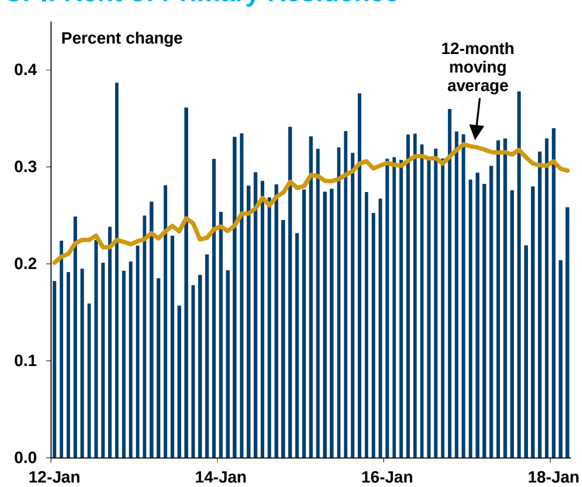
Despite the easing in March, the CPI has firmed on balance in recent months. The core component rose at a monthly average pace of 0.113 percent from February through September of last year, but it has picked up to a pace of 0.213 percent in the past six months and 0.236 percent in the past three. The year-over-year change totaled 2.1 percent in March, back to the lower portion of the range in place before transitory factors slowed the annual inflation rate. The most pronounced of the transitory factors (the drop in cell phone charges) dropped out of the year-over-year calculation in March and led to a noticeable pickup.

Core CPI



Source: Bureau of Labor Statistics via Haver Analytics

CPI: Rent of Primary Residence

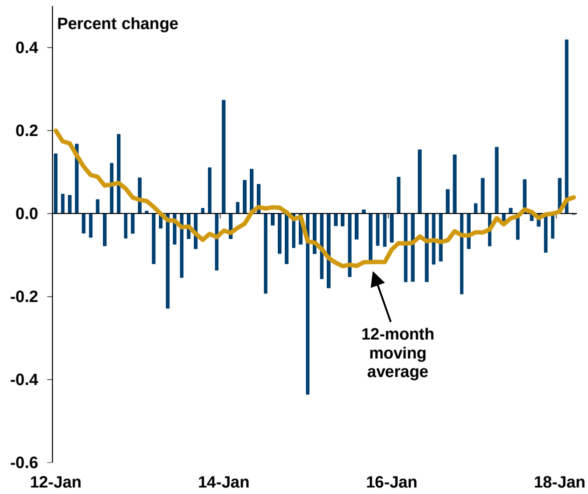


Source: Bureau of Labor Statistics via Haver Analytics

Import prices do not seem to be monitored closely by market participants, but they deserve close attention. Many items purchased from foreign countries feed directly into domestic price measures, and imports affect the competitive environment in the U.S., which can influence the pricing power of U.S. firms.

Import prices helped to restrain inflation from late 2014 through much of last year, but with the foreign exchange value of the dollar peaking in late 2016 and moving lower in the past year, the trend is now changing. We monitor a price index for finished imported goods to eliminate the volatility generated by commodity prices, and the year-over-year change in this measure has moved into positive territory recently after declining from 2015 through the first half of last year (chart).

Key Import Prices*



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

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

This measure rose moderately in January and surged in February, raising the possibility of an abrupt turn, but it showed no change in the latest month. We view recent shifts as representing either random volatility or seasonal movements (these series are not seasonally adjusted), but the trend is upward. With the lagged effects of past dollar strength largely faded, and with the softening in the dollar in the past year now playing a larger role, we suspect that import prices will continue to increase on balance.

Fed officials have expressed increasing confidence in recent months that inflation will return to target in the foreseeable future. We suspect that the turn in import prices has helped to build that confidence.

The Budget Outlook

The Congressional Budget Office this week released new estimates of the federal budget position for the next 10 years that incorporates the effects of the Tax Cut and Jobs Act and the Bipartisan Budget Act. As widely expected, the projections showed marked deterioration in the budget deficit, although the new estimates were a tad less disturbing than we thought possible. For example, we suspected the shortfall in the current fiscal year would be in the neighborhood of $850 billion, while the CBO is expecting $804 billion; we looked for a deficit noticeably in excess of $1.0 trillion next year, but CBO pegs the shortfall at $981 (although the federal government breaks the trillion-dollar mark in 2020 and remains above this threshold through the forecast horizon). The previous projections of the CBO (June 2017) saw a deficit of $563 billion for the current fiscal year and $689 billion for FY 2019.

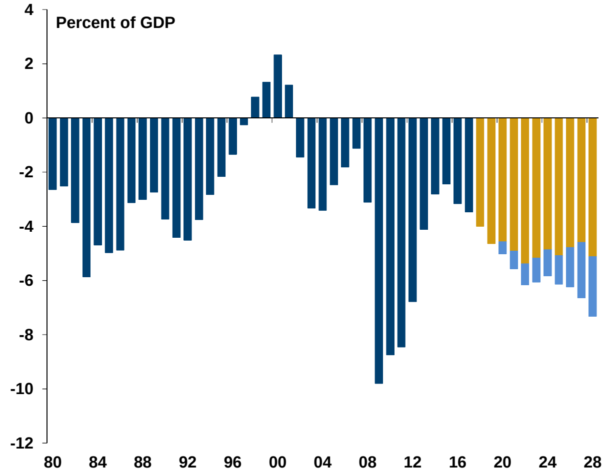
The government's budget balance is best viewed as a percentage of GDP, as this allows for more meaningful historical comparisons. The CBO's calculations show the deficit totaling 4.0 percent of GDP in the current fiscal year and 4.6 percent next year (up from 2.8 percent and 3.3 percent in June). The projected deficit reaches its widest point in 2022 at 5.4 percent of GDP (chart, next page, gold portions of bars).

Such magnitudes are troubling. To put the estimates into perspective, note that only five fiscal years in modern history (1960 to the present) have generated wider shortfalls than the 5.4 percent in 2022. Four of these occurred from 2009-12, when the combination of the deep recession and countercyclical fiscal stimulus led to deficits ranging from 6.8 to 9.8 percent of GDP -- clearly a unique situation. The other instance occurred in 1982, when the Reagan tax cuts and defense rebuild led to a shortfall of 5.9 percent of GDP.

Such an outcome was widely viewed as intolerable, and pressure for more disciplined fiscal policy led President Reagan to accept upward adjustments to the tax code in the three years from 1982 to 1984.

The published deficit projections of the CBO are disconcerting as they stand, but they probably understate the deficits that could emerge. The CBO is required to base its projections on the current law, but Congress can alter existing law, and it might be tempted to adopt some changes that lead to wider deficits in the future. For example, most of the new provisions in the personal tax code are scheduled to expire after 2025, which would involve tax increases for many. However, several legislators have indicated that Congress will give serious consideration to extending the benefits provided by the new tax act. Similarly, the new budget bill eliminated spending caps for 2018 and 2019 that were established by the Budget Control Act of 2011, but it retained caps for 2020 and 2021. Thus, as the law stands, the spending programs subject to limits will face budget cuts in 2020, but we suspect that Congress will be reluctant to allow a sizeable drop in spending.

Federal Budget Balance*



** The federal budget balance as a share of nominal GDP. The forecasts (2018-2028) are by the Congressional Budget Office. The gold portion of the bars shows the baseline forecasts of the CBO, which is based on current law. The darker portion is an alternative projection based on the assumption that Congress extends tax breaks scheduled to expire and that it does not return to spending caps in 2020 that were lifted in 2018 and 2019.*

Source: U.S. Treasury Department via Have Analytics; Congressional Budget Office via Haver Analytics; Daiwa Capital Markets America

The CBO has provided an alternative budget projection that extends tax breaks that are scheduled to expire and that allows spending to grow with inflation rather than to retreat to levels required by caps established by earlier laws. It also made an adjustment that would reduce the budget deficit from the baseline estimate: the alternative CBO projection set outlays for disaster relief at their historical average rather than maintain the level in the current year, which is being boosted by spending for Hurricanes Harvey, Irma, and Maria, and by wildfires in California. The blue portions of the bars on the chart show the increment to the deficit from the alternative set of assumptions. The deficit based on this view reaches 6.2 percent of GDP in 2022 and increases further to 7.3 percent of GDP in 2028.

Some observers might be willing to tolerate wide budget deficits because the fiscal impulse could perhaps quicken the pace of economic growth or extend the duration of the current expansion. However, we do not expect a pronounced effect on the rate of growth because the stimulus is being applied to a fully employed economy. In such an environment, the resources to fuel growth are not available; some type of offsetting market adjustment is likely to occur that will keep economic growth close to its recent pace.

Textbook economics suggests two obvious potential offsets. First, wide budget deficits could push interest rates higher, which would crowd out private spending. Alternatively, foreign investment could flow into the United States, which would limit the upward pressure on interest rates, but the investment flow would boost the foreign exchange value of the dollar and slow economic growth through the trade sector (fewer exports and more imports).

We would not expect a complete offset to the recent fiscal actions from such market changes. Offsets could unfold slowly, and the economy for short periods can strain resources and grow faster than potential. More important, the tax changes authorized by Congress will most likely have some supply-side effects. That is, lower marginal tax rates could pull some individuals into the workforce or induce others to work longer hours. Similarly, lower corporate tax rates and more generous depreciation provisions could stir investment spending and boost productivity.

The CBO has allowed for such effects, as it sees a short-term jump in economic growth to 3.3 percent this calendar year before easing to 2.4 percent in 2019 and 1.8 percent in 2020. CBO also has built in supply-side effects, as it sees potential GDP growth averaging 2.0 percent from 2018 to 2022; last year, it saw potential growth of 1.7 percent over this time span. Despite the supply side effects, the outlook for the deficit relative to GDP has worsened.

Does it Matter?

Some observers might argue that the wide budget deficits will not be harmful to the economy. The Treasury Department has easily financed deficits thus far at historically low interest rates, suggesting that the nation has room to run an easy fiscal policy. In this market friendly environment, some feel that the government should be more active in spending on infrastructure or social programs. We disagree. Deficits of the magnitude in store have the potential to generate funding problems in the future; even if funding difficulties do not arise, deficits will have a long-term corrosive effect on the economy.

One problem will arise because of surging interest expense. Federal debt already has climbed to elevated levels relative to GDP, and the CBO projections have it close to 100 percent in the future (over 100 percent by the alternative forecast). The elevated level of debt, combined with higher interest rates in the future, will lead to a compounding effect on interest expense that will force reductions in other spending areas. Observers already rail about the paucity of infrastructure spending, but the tightness in such budgets will probably intensify in the future.

Moreover, the market changes and spending offsets noted above (higher interest rates and a firmer dollar; reduced investment spending and deteriorating trade deficit) also will be detrimental. Reduced investment spending will constrain productivity and lock the nation into slow underlying growth. The widening in the trade deficit is likely to exacerbate other problems that receive attention today: a shrinking manufacturing sector, a dwindling middle class, and an increase in income inequality.

The outlook is troubling as it stands, but nevertheless we can perhaps end on an optimistic note. Like the experience in 1982, we are hopeful that Congress will eventually recognize that deficits in excess of five percent of GDP in non-recession years will not serve the nation or the economy well. We hope that some action will be taken down the road -- either some type of tax increase or spending cut.

Review

Week of April 9, 2018	Actual	Consensus	Comments
PPI (March)	**0.3% Total, 0.3% Core**	**0.1% Total, 0.2% Core**	An unusual jump in food prices (2.2% versus average monthly increases of less than 0.1% in the prior 12 months) offset a decline of 2.1% in energy prices. Prices excluding food and energy rose briskly, with prices of both goods and services increasing 0.3%. The headline PPI rose 3.0% year-over-year, up two ticks from the February reading and at the top of the range of the past few years. The core PPI advanced 2.7% year-over- year, the fastest increase since November 2011.
CPI (March)	**-0.1% Total, 0.2% Core**	**0.0% Total, 0.2% Core**	A subdued increase in the food component (0.1%) and a drop of 2.8% in the energy component restrained the headline CPI. The increase in the core component was in line with other recent observations, but close inspection shows that it tilted on the soft side (0.176% versus averages of 0.257% and 0.206% in the prior three and six months). However, the increase was still firm enough to support the view that restrained inflation in mid-2017 was influenced by transitory factors. The most pronounced of those transitory factors (the drop in cell phone charges) dropped out of the year-over-year change this month, which led to a pickup in the 12-month inflation rate (2.1% for the core index in March versus 1.8% in the prior three months and 1.7% from May to November of last year).
Federal Budget (March)	**$208.7 Billion Deficit**	**$186.0 Billion Deficit**	Federal revenues in March fell 2.7% from the same month last year despite a drop of 13.5% in refunds. Part of the softness reflected the fact that this March had fewer business days than the previous March did, but the new withholding schedules associated with the tax cuts also played a major role. Federal outlays were heavy in March, totaling 25.1% more than the average in the first five months of the year. Much of the surge was the result of the calendar configuration that pulled some outlays scheduled for April into March. However, spending was still 6.8% stronger than March last year, which had the same calendar quirk. The budget deficit in the first half of the fiscal year totaled $599.7 billion, up $72.9 billion from the same period in FY2017.
Consumer Sentiment (April)	**97.8 (-3.6 Index Pts.)**	**100.4 (-1.0 Index Pt.)**	The sharper-than-expected decline in consumer sentiment occurred from the best reading of the expansion, and thus it remained in the upper end of the range of the past few years. Both current conditions (-5.1%) and expectations (-2.3%) contributed to the slippage in early April.

Source: Bureau of Labor Statistics (PPI, CPI); U.S. Treasury Department (Federal Budget); Reuters/University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of April 16, 2018	Projected	Comments
Retail Sales (March) (Monday)	**0.4% Total, 0.3% Ex-Autos**	A jump in sales of new motor vehicles in March suggests that the auto component of the retail report will recoup some of the ground lost in the prior four months (down in all four months, with an average change of -0.8%). With firm fundamentals for consumer spending, sales ex-autos also should improve from soft readings in the prior three months (average increase of 0.1%, although the sluggish performance followed a strong November).
Housing Starts (March) (Tuesday)	**1.245 Million (+0.7%)**	Sales of new homes have been less than vigorous in recent months, but they have probably been firm enough to spur a small increase in single-family starts. The volatile multi-family sector should pick up from its below-average reading in February. Winter storms in the Northeast pose a downside risk to the forecast.
Industrial Production (March) (Tuesday)	**-0.5%**	Cooler-than-normal temperatures probably led to an increase in utility output, but the manufacturing and mining sectors will probably give back some of their outsized gains in February. These areas are performing well, but the increases in February of 1.3% and 3.5%, respectively, probably overstate the underlying strength.
Leading Indicators (March) (Thursday)	**0.2%**	Positive contributions from the slope of the yield curve, the ISM orders index, and consumer expectations should offset small negative contributions from the manufacturing workweek and initial claims for unemployment insurance. The expected reading, if realized, would mark the 17th consecutive increase and leave the measure 6.4 percent above the peak in the previous expansion.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

April/May 2018

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
CBO BUDGET ESTIMATES	**NFIB SMALL BUSINESS OPTIMISM INDEX** Jan 106.9 Feb 107.6 Mar 104.7 **PPI** Final Demand / Core Jan 0.4% / 0.4% Feb 0.2% / 0.2% Mar 0.3% / 0.3% **WHOLESALE TRADE** Inventories / Sales Dec 0.7% / 0.8% Jan 0.9% / -1.5% Feb 1.0% / 1.0%	**CPI** Total / Core Jan 0.5% / 0.3% Feb 0.2% / 0.2% Mar -0.1% / 0.2% **FEDERAL BUDGET** 2018 / 2017 Jan $49.2B / $51.3B Feb -$215.2B / -$192.0B Mar -$208.7B / -$176.2B **FOMC MINUTES**	**INITIAL CLAIMS** Mar 24 218,000 Mar 31 242,000 Apr 07 233,000 **IMPORT/EXPORT PRICES** Non-fuel Imports / Nonagri. Exports Jan 0.5% / 0.9% Feb 0.5% / 0.2% Mar 0.2% / -0.1%	**JOLTS DATA** Openings (000) / Quit Rate Dec 5,667 / 2.3% Jan 6,228 / 2.2% Feb 6,052 / 2.2% **CONSUMER SENTIMENT** Feb 99.7 Mar 101.4 Apr 97.8
16	17	18	19	20
RETAIL SALES (8:30) Total / Ex.Autos Jan -0.1% / 0.1% Feb -0.1% / 0.2% **Mar 0.4% / 0.3%** **EMPIRE MFG (8:30)** Feb 13.1 Mar 22.5 Apr -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales Dec 0.6% / 0.5% Jan 0.7% / -0.3% **Feb 0.6% / 0.4%** **NAHB HOUSING INDEX (10:00)** Feb 71 Mar 70 Apr -- **TIC DATA (4:00)** Total / Net L-T Dec -$122.5B / $23.3B Jan $119.7B / $62.1B Feb -- / --	**HOUSING STARTS (8:30)** Jan 1.329 million Feb 1.236 million **Mar 1.245 million** **IP & CAP-U (9:15)** IP / Cap.Util. Jan -0.2% / 77.0% Feb 0.9% / 77.7% **Mar -0.5% / 77.1%**	**BEIGE BOOK (2:00)** **March Beige Book** “Economic activity expanded at a modest to moderate pace across the 12 Federal Reserve Districts in January and February.”	**INITIAL CLAIMS (8:30)** **PHILLY FED INDEX (8:30)** Feb 25.8 Mar 22.3 Apr -- **LEADING INDICATORS (10:00)** Jan 0.8% Feb 0.6% **Mar 0.2%**	
23	24	25	26	27
CHICAGO FED NAT’L ACTIVITY INDEX **EXISTING HOME SALES**	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **NEW HOME SALES** **CONSUMER CONFIDENCE**		**INITIAL CLAIMS** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **DURABLE GOODS ORDERS**	**EMPLOYMENT COST INDEX** **Q1 GDP** **REVISED CONSUMER SENTIMENT**
30	1	2	3	4
PERSONAL INCOME, CONSUMPTION, CORE PRICE INDEX **CHICAGO PURCHASING MANAGERS’ INDEX** **PENDING HOME SALES**	**ISM MFG INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES** **FOMC MEETING**	**ADP EMPLOYMENT REPORT** **FOMC DECISION**	**INITIAL CLAIMS** **PRODUCTIVITY & COSTS** **TRADE BALANCE** **ISM NON-MFG INDEX** **FACTORY ORDERS**	**EMPLOYMENT REPORT**

Forecasts in Bold

Treasury Financing

April/May 2018

Monday	Tuesday	Wednesday	Thursday	Friday
9	10	11	12	13
AUCTION RESULTS: Rate / Cover 3-mo bills 1.715% 2.92 6-mo bills 1.880% 3.04 **ANNOUNCE:** $45 billion 4-week bills for auction on April 10	**AUCTION RESULTS:** Rate / Cover 4-week bills 1.620% 3.25 3-year notes 2.450% 2.85	**AUCTION RESULTS:** Rate / Cover 10-yr notes 2.795% 2.46	**AUCTION RESULTS:** Rate / Cover 30-yr bonds 3.044% 2.41 **ANNOUNCE:** $90 billion 13-,26-week bills for auction on April 16 $16 billion 5-year TIPS for auction on April 19 **SETTLE:** $90 billion 13-,26-week bills $45 billion 4-week bills	
16	17	18	19	20
AUCTION: $90 billion 13-,26-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on April 17 **SETTLE:** $30 billion 3-year notes $21 billion 10-year notes $13 billion 30-year bonds	**AUCTION:** $45 billion* 4-week bills		**AUCTION:** $16 billion 5-year TIPS **ANNOUNCE:** $90 billion* 13-,26-week bills for auction on April 23 $24 billion* 52-week bills for auction on April 24 $17 billion* 2-year FRNs for auction on April 25 $32 billion* 2-year notes for auction on April 24 $35 billion* 5-year notes for auction on April 25 $29 billion* 7-year notes for auction on April 26 **SETTLE:** $90 billion 13-,26-week bills $45 billion* 4-week bills	
23	24	25	26	27
AUCTION: $90 billion* 13-,26-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on April 24	**AUCTION:** $45 billion* 4-week bills $24 billion* 52-week bills $32 billion* 2-year notes	**AUCTION:** $17 billion* 2-year FRNs $35 billion* 5-year notes	**AUCTION:** $29 billion* 7-year notes **ANNOUNCE:** $90 billion* 13-,26-week bills for auction on April 30 **SETTLE:** $90 billion* 13-,26-week bills $45 billion* 4-week bills $24 billion* 52-week bills	
30	1	2	3	4
AUCTION: $90 billion* 13-,26-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on May 1 **SETTLE:** $16 billion 5-year TIPS $17 billion* 2-year FRNs $32 billion* 2-year notes $35 billion* 5-year notes $29 billion* 7-year notes	**AUCTION:** $45 billion* 4-week bills	**ANNOUNCE:** $31 billion* 3-year notes for auction on May 8 $25 billion* 10-year notes for auction on May 9 $17 billion* 30-year bonds for auction on May 10	**ANNOUNCE:** $90 billion* 13-,26-week bills for auction on May 7 **SETTLE:** $90 billion* 13-,26-week bills $45 billion* 4-week bills	

**Estimate*