U.S. Economic Comment

- U.S. manufacturing: a cyclically sensitive sector remains firm
- The government shutdown: getting more serious, but still not a recession trigger

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U.S. Manufacturing: On Track

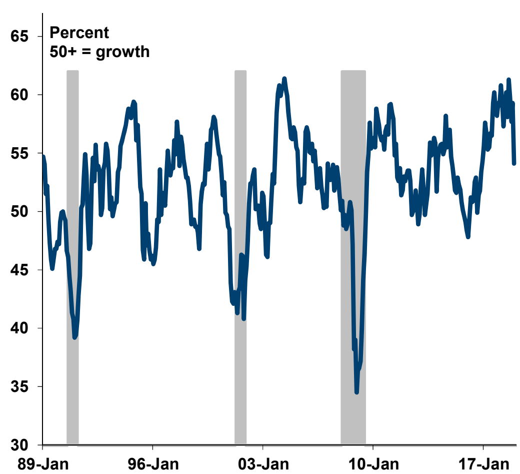
Some analysts pay little heed to the manufacturing sector, believing that it has evolved into an inconsequential segment of the economy. In fact, it should be monitored closely. Although employment and output in the factory sector have trended sharply lower as shares of the totals, manufacturing is still a highly cyclical sector of the economy, and thus it provides keen insights into shifting economic trends. Given the economic and financial uncertainties that have emerged in recent months, and with some observers beginning to talk of recession, manufacturing-related statistics warrant careful consideration.

Some recent reports suggest cause for concern. The ISM manufacturing index, for example, tumbled in December, dropping 5.2 percentage points. The index remained above the critical value of 50 percent (54.1 percent), but the magnitude of the change was large enough to stir thoughts of a faltering manufacturing sector. Indeed, the decline was larger than all but one of the many retreats seen during the Great Recession.

We find the ISM index useful and interesting, but we also interpret it cautiously, as sharp swings and false signals are common. The current expansion, for example, has registered two noticeable downward trends that did not result in a recession. Most other expansions also have involved apparent soft patches that never developed into genuine weakness (chart, left).

Other measures provide sharper insights into developments in the manufacturing sector. The manufacturing component of the index of industrial production sometimes moves randomly, but it shows considerably less month-to-month volatility than the ISM index does, and it tends to move in step with the overall economy. It does not lead the overall business cycle, but it provides a good read on current conditions and generates few false signals (chart, right).

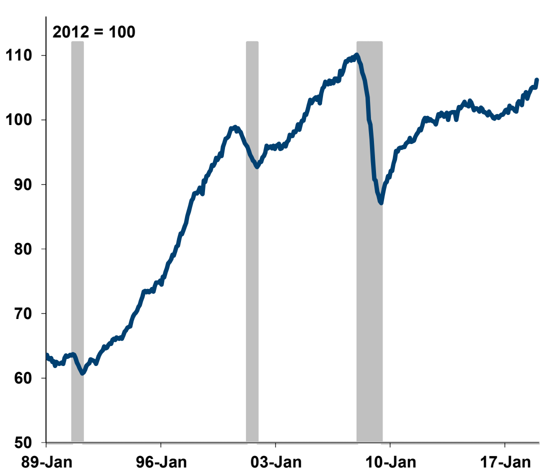
ISM Manufacturing Index*



The shaded areas indicate periods of recession in the United States.

Source: Institute for Supply Management and National Bureau of Economic Research via Haver Analytics

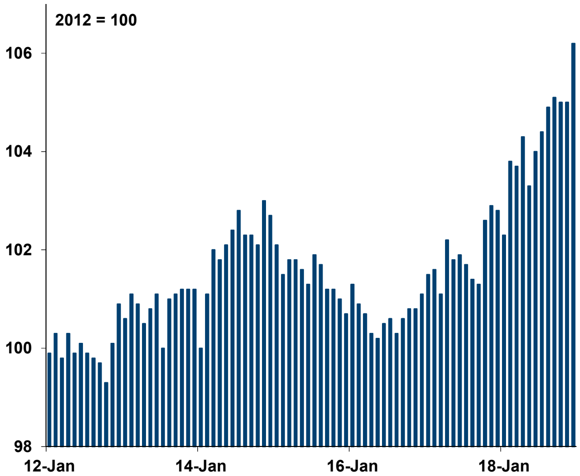
Industrial Production: Manufacturing*



The shaded areas indicate periods of recession in the United States.

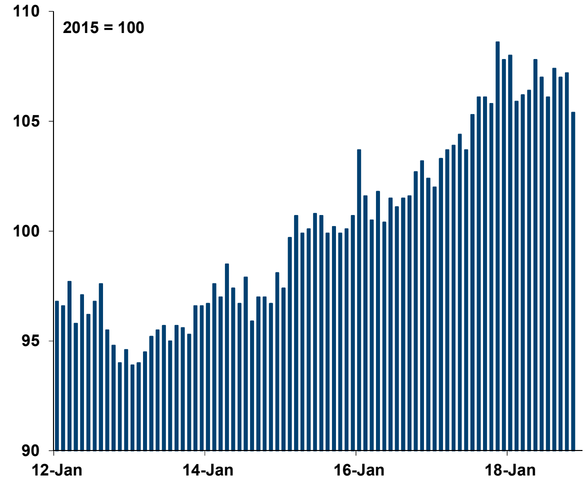
Source: Federal Reserve Board and National Bureau of Economic Research via Haver Analytics

U.S. Industrial Production: Manufacturing



Source: Federal Reserve Board via Haver Analytics

Euro Area Industrial Production: Manufacturing*



** A weighted average index of member states' industrial production. The index shown includes 19 euro area member countries.*

Source: Statistical Office of the European Communities (Eurostat)via Haver Analytics

An up-close look at the manufacturing component of industrial production offers encouragement regarding the current state of the economy. Activity jumped 1.1 percent in December, considerably larger than our expectation of a 0.5 or 0.6 percent advance. In addition, results in the prior few months showed a slight net upward revision. The latest changes pushed production far above the apparent underlying trend (chart, left). Some of the increase might have reflected catchup for modest changes in the prior two months; alternatively, the change could have involved a dose of upside random volatility. Still, the latest data lead us to conclude that the manufacturing sector is performing well; at the very least, it is not signaling recession.

Other direct measures of manufacturing activity, such as employment, also suggest that this cyclical sector remains on track. Employment in the manufacturing sector has increased for 17 consecutive months and in 25 of the past 26 months. The monthly increases in factory employment in the past three months were among the largest during this string.

Much of the concern about continued growth in the United States relates to developments abroad, with activity in Europe and China showing signs of softening. The easing trends are apparent in the industrial production indexes in these economies, although they are not suggestive of recession. The aggregate index of the 19 countries in the euro area registered brisk growth in 2017 and the first month of 2018, but since then the measure has drifted downward on balance (chart, right; data available only through November). The index for China is continuing to advance, although the pace of growth has eased slightly (0.4 percent per month through the first 11 months of 2018 versus averages of 0.5 percent in each of the prior three years and much faster -- often in excess of 1.0 percent per month -- in years before 2015).

The Government Shutdown

The financial press this week carried several stories noting that the fallout from the government shutdown is intensifying, with some commentary raising the possibility of recession. We agree with the view that the consequences will deepen as the shutdown lengthens. Changes in behavior would be modest if the shutdown were brief, perhaps even stimulative if furloughed workers saw the closure as free vacation time with no loss of wages. However, as paychecks are missed, spending cuts will be unavoidable in many cases, and such declines could generate second and third round effects.

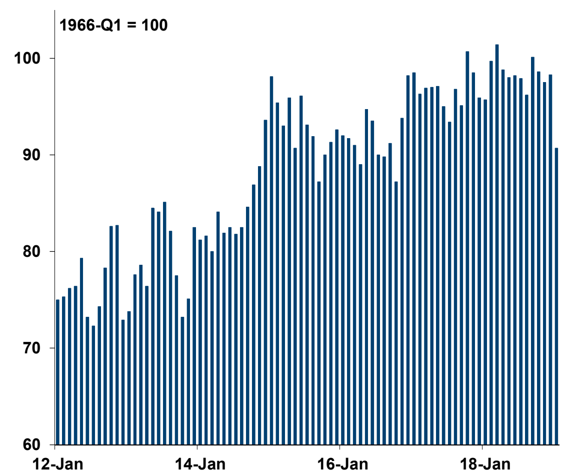
Still, we view talk of recession as premature. This shutdown is a partial one, and therefore the economic impact will be limited. More than 70 percent of federal employees are on the job and receiving pay; many others are working without pay and therefore providing services that allow normal functioning of the economy. Furloughed workers represent less than 15 percent of federal employment.

Many observers this week highlighted the large number of contract workers for the federal government, noting that this group was not assured of receiving lost pay. This is an important consideration, but the impact is difficult to gauge. Those billing hourly will certainly lose, but many of these contracts are with sizeable consulting companies and based on fixed fees that presumably will be honored by the government.

Kevin Hassett, the Chair of President Trump's Council of Economic Advisers, this week noted that the shutdown would subtract 0.13 percentage point from GDP growth for each week of closure (revised from his previous view of 0.1 percentage point for every two weeks of closure). If the government were to remain closed for the balance of the quarter, this new estimate would leave GDP growth in Q1 approximately 1.5 percentage points lighter than it would be otherwise (assuming modest effects in the early weeks of the shutdown). This effect is sizeable, but not recessionary in an economy with underlying growth of more than two percent. (Also, we doubt that the shutdown will last the balance of the quarter. Once disruptions become more obvious, we suspect that President Trump and members of Congress will compromise.

We do not see the direct effects of the shutdown as carrying recession risks, but we wonder about indirect effects. Specifically, if the rancor in Washington were to shake the confidence of consumers or business executives, their resulting change in behavior could alter the path of the economy. In this regard, the consumer sentiment index in early January showed a notable drop, moving out of the range from the past two years (chart). If the slippage was tied to the government shutdown, it will perhaps recover when issues are resolved. If the drop is related to other factors, such as the stock market adjustment, the recent improvement in equity values should be helpful. However, as it stands, the drop is troubling.

Consumer Sentiment



Source: Reuters/University of Michigan Survey Research Center via Haver Analytics

Unemployment Claims. Government workers are eligible to receive unemployment benefits when they are furloughed (but not when they are deemed essential and are working without pay). The number of government workers filing for benefits is not included with the headline figure for claims published every week; the government tally is published separately with a one-week lag. The number of federal workers filing an initial claim in the first two weeks of the shutdown totaled 15,000. This total seems paltry compared with the 380,000 furloughed workers. However, incentives to file are not strong, as any benefits received must be repaid if workers receive back pay. The historical experience would lead workers to expect back pay, and eventual payment was assured this week when President Trump signed legislation promising to cover wages missed during the shutdown.

The Employment Report. The legislation signed this week assuring back pay altered the outlook for the monthly employment report. If not assured of receiving back pay, furloughed federal workers would not be viewed as employed, and the job tally would be 380,000 lighter than it would be otherwise. However, because the government will pay workers for the shutdown period, the Labor Department will view them as on a payroll and therefore employed. Thus, the January estimate of nonfarm payrolls will not be affected by the shutdown. The unemployment rate, in contrast, is likely to show some influence. Government workers included in the household survey are likely to indicate that they are on temporary layoff, which would place them among the unemployed and push the jobless rate higher.

Review

Week of Jan. 14, 2019	Actual	Consensus	Comments
PPI (December)	**-0.2% Total, 0.0% Core***	**-0.1% Total, 0.2% Core***	Food prices surged in December (2.6%) after hefty increases in the prior two months (average of 1.2%). The changes followed net declines in the spring and summer, but the pronounced increases were enough to push the level of the food index to the upper portion of the range in the current cycle. The energy component, in contrast, fell 5.4%, led by sharply lower prices of gasoline. Prices excluding energy also contributed to the soft reading in the headline index. Some of the restraint reflected random volatility in in the noisy service category (down 0.1% after an average increase of 0.5% in the prior two months), but goods prices excluding food and energy also were contained, increasing only 0.1%. The headline index rose 2.5% on a year-over-year basis, down from a recent peak of 3.4% in July. The PPI definition of core prices (ex food, energy, trade services) rose 2.8% in the past year, below readings of 3.0% in July and August, but firm by recent standards.
Industrial Production (December)	**0.3%**	**0.2%**	Manufacturing activity led the increase in industrial production in December with a surge of 1.1% that pushed the component notably above the underlying trend. An above-trend advance in motor vehicle production (+4.7%) accounted for much of the surge, but production ex-vehicles (+0.8%) also was firm. Mining activity (+1.0%) rose for the second consecutive month despite depressed energy prices. Utility output fell 6.3%, but the change reflected shifts in weather rather than economic fundamentals.
Consumer Sentiment (January)	**90.7 (-7.6 Index. Pts.)**	**96.8 (-1.5 Index. Pts.)**	The volatility in stock prices in recent months (despite the rally in late December and early January) and steady flow of negative news relating to the government shutdown likely weighed on the minds of consumers in early January, as the Reuters/Michigan measure of attitudes moved sharply below the average of 98.4 in 2018 and posted its worst reading since October 2016. The expectations component registered the sharper decline (-10.0%), moving to the bottom of the range of the past few years. The current conditions component slipped 5.3%, with the decline doing less damage to the underlying trend. The long-term inflation gauge published with the report increased one tick to 2.6%, a reading at the top of the range of the past few years but subdued from a longer-term perspective.

**The PPI definition of core is total excluding food, energy, and trade services.*

Source: Bureau of Labor Statistics (PPI); Federal Reserve Board (Industrial Production); Reuters/University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Jan. 21, 2019	Projected	Comments
Existing Home Sales (December) (Tuesday)	**5.33 Million (+0.2%)**	The drop in interest rates that has unfolded since early November could stir sales in January, but slow buyer traffic suggests that any gain will be small.
Leading Indicators (December) (Thursday)	**-0.1%**	Declines in stock prices and the ISM new orders index will probably offset positive contributions from unemployment claims, the leading credit index, and consumer expectations, leaving a modest drop in the headline index. The expected dip represents the second retreat in the past three months, but the net change has been modest.
Durable Goods Orders (December) (Friday) (Possibly Postponed)	**0.4%**	This report will most likely be postponed because of the government shutdown. We suspect that uncertainties associated with the government shutdown, trade policies, and financial volatility led business executives to order cautiously.
New Home Sales (December) (Friday) (Possibly Postponed)	**0.575 Million (+5.7% versus October)**	The December report, like the one for November, will probably be postponed because of the government shutdown. The observation for October was quite weak (9.0% below the average in the third quarter, which had already softened from results earlier in the year). We expect some rebound in response to lower interest rates, but low readings on home builder sentiment suggest that the pickup will be modest.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2019

Monday	Tuesday	Wednesday	Thursday	Friday
14	15	16	17	18
	PPI Final Demand / Core* Oct 0.6% 0.2% Nov 0.1% 0.3% Dec -0.2% 0.0% **EMPIRE MFG** Nov 21.4 Dec 11.5 Jan 3.9	**RETAIL SALES (POSTPONED)** Total / Ex.Autos Oct 1.1% 1.0% Nov 0.2% 0.2% **Dec 0.2% 0.2%** **IMPORT/EXPORT PRICES** Non-fuel Imports / Nonagri. Exports Oct 0.1% 0.5% Nov -0.3% -1.0% Dec 0.0% -1.1% **BUSINESS INVENTORIES (POSTPONED)** Inventories / Sales Sept 0.5% 0.3% Oct 0.6% 0.3% Nov -- -- **NAHB HOUSING INDEX** Nov 60 Dec 56 Jan 58 **BEIGE BOOK** "Economic activity increased in most of the U.S., with eight of twelve Federal Reserve Districts reporting modest to moderate growth." **TIC DATA (POSTPONED)** Total / Net L-T Sept -$29.2B $30.8B Oct $42.0B $31.3B Nov -- --	**INITIAL CLAIMS** Dec 29 233,000 Jan 05 216,000 Jan 12 213,000 **HOUSING STARTS (POSTPONED)** Oct 1.217 million Nov 1.256 million **Dec 1.220 million** **PHILLY FED INDEX** Nov 11.9 Dec 9.1 Jan 17.0	**IP & CAP-U** IP / Cap.Util. Oct 0.2% 78.4% Nov 0.4% 78.6% Dec 0.3% 78.7% **CONSUMER SENTIMENT** Nov 97.5 Dec 98.3 Jan 90.7
21	22	23	24	25
MARTIN LUTHER KING DAY	**EXISTING HOME SALES (10:00)** Oct 5.22 million Nov 5.32 million **Dec 5.33 million**	**FHFA HOME PRICE INDEX (9:00)** Sept 0.2% Oct 0.3% Nov --	**INITIAL CLAIMS (8:30)** **LEADING INDICATORS (10:00)** Oct -0.3% Nov 0.2% **Dec -0.1%**	**DURABLE GOODS ORDERS (8:30) (POSSIBLY POSTPONED)** Oct -4.3% Nov 0.8% **Dec 0.4%** **NEW HOME SALES (10:00) (POSSIBLY POSTPONED)** Oct 0.544 million Nov -- **Dec 0.575 million**
28	29	30	31	1
CHICAGO FED NAT'L ACTIVITY INDEX	U.S. INTERNATIONAL TRADE IN GOODS ADVANCE INVENTORIES S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX CONSUMER CONFIDENCE FOMC MEETING	ADP EMPLOYMENT REPORT GDP PENDING HOME SALES FOMC DECISION POWELL PRESS CONFERENCE	INITIAL CLAIMS PERSONAL INCOME, CONSUMPTION, PRICE INDEX EMPLOYMENT COST INDEX CHICAGO PMI	EMPLOYMENT REPORT ISM MFG. INDEX CONSTRUCTION SPEND. REVISED CONSUMER SENTIMENT VEHICLE SALES
4	5	6	7	8
FACTORY ORDERS	TRADE BALANCE ISM NON-MFG INDEX	PRODUCTIVITY & COSTS	INITIAL CLAIMS CONSUMER CREDIT	WHOLESALE TRADE

**The PPI definition of core is total excluding food, energy, and trade services.*

Forecasts in Bold

Treasury Financing

January/February 2019

Monday	Tuesday	Wednesday	Thursday	Friday
14	15	16	17	18
AUCTION RESULTS: Rate Cover 13-week bills 2.405% 2.90 26-week bills 2.460% 3.22	**ANNOUNCE:** $40 billion 4-week bills for auction on January 17 $30 billion 8-week bills for auction on January 17 **SETTLE:** $40 billion 4-week bills $30 billion 8-week bills $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds		**AUCTION RESULTS:** Rate Cover 4-week bills 2.370% 3.05 8-week bills 2.365% 3.47 10-year TIPS 0.919% 2.42 **ANNOUNCE:** $81 billion 13-,26-week bills for auction on January 22 **SETTLE:** $75 billion 13-,26-week bills	
21	22	23	24	25
MARTIN LUTHER KING DAY	**AUCTION:** $81 billion 13-,26-week bills **ANNOUNCE:** $40 billion* 4-week bills for auction on January 24 $30 billion* 8-week bills for auction on January 24 **SETTLE:** $40 billion 4-week bills $30 billion 8-week bills		**AUCTION:** $40 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $81 billion* 13-,26-week bills for auction on January 28 $26 billion* 52-week bills for auction on January 29 $20 billion* 2-year FRNs for auction on January 29 $40 billion* 2-year notes for auction on January 28 $41 billion* 5-year notes for auction on January 28 $32 billion* 7-year notes for auction on January 29 **SETTLE:** $81 billion 13-,26-week bills	
28	29	30	31	1
AUCTION: $81 billion* 13-,26-week bills $40 billion* 2-year notes $41 billion* 5-year notes	**AUCTION:** $26 billion* 52-week bills $20 billion* 2-year FRNs $32 billion* 7-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on January 31 $30 billion* 8-week bills for auction on January 31 **SETTLE:** $40 billion* 4-week bills $30 billion* 8-week bills	**ANNOUNCE:** $38 billion* 3-year notes for auction on February 5 $27 billion* 10-year notes for auction on February 6 $19 billion* 30-year bonds for auction on February 7	**AUCTION:** $40 billion* 4-week bills $30 billion* 8-week bills **ANNOUNCE:** $85 billion* 13-,26-week bills for auction on February 4 **SETTLE:** $13 billion 10-year TIPS $81 billion* 13-,26-week bills $26 billion* 52-week bills $20 billion* 2-year FRNs $40 billion* 2-year notes $41 billion* 5-year notes $32 billion* 7-year notes	
4	5	6	7	8
AUCTION: $85 billion* 13-,26-week bills	**AUCTION:** $38 billion* 3-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on February 7 $30 billion* 8-week bills for a auction on February 7 **SETTLE:** $40 billion* 4-week bills $30 billion* 8-week bills	**AUCTION:** $27 billion* 10-year notes	**AUCTION:** $40 billion* 4-week bills $30 billion* 8-week bills $19 billion* 30-year bonds **ANNOUNCE:** $85 billion* 13-,26-week bills for auction on February 11 $9 billion* 30-year TIPS for auction on February 14 **SETTLE:** $85 billion* 13-,26-week bills	

**Estimate*