Daiwa Capital Markets

U.S. Economic Comment

- Inflation constraints: productivity and import prices
- Federal budget update: 15 percent slippage in the first half of FY2019

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Productivity: Faster Growth?

The minutes from the March meeting of the Federal Open Market Committee indicated that policymakers had an extended discussion of factors that were restraining inflation. Some familiar explanations were mentioned, such as contained expectations of inflation, and still-ample slack in the labor market (i.e. the unemployment rate associated with full employment might be lower than previously believed). A few officials mentioned another factor: the possibility that productivity growth is beginning to quicken, which would allow businesses to absorb wage increases without raising prices or damaging profits.

While it has not attracted much attention in financial markets or the media, productivity growth has improved recently, increasing at an average annual rate of 2.2 percent in the past three quarters (chart). This pace is about double that in the past several years and close to the long-run average in the United States. (Productivity growth has waxed and waned over the decades, moving in a range of approximately one-to-four percent, with a long-run average of approximately two percent.)

The pickup is encouraging, but it is too soon to draw conclusions. Productivity moves erratically, and thus changes over short periods -- even as short as one year -- should be interpreted cautiously. For example, productivity had spurts similar to the current one in both 2012 and 2015 (2.0 percent and 1.9 percent, respectively), only to fade in subsequent quarters. A moving average of eight quarters provides a better view of underlying trends, and the average advance of 1.4 percent over this span is among the best of the past several years. However, it too was matched by a temporary surge in 2015 that was not sustained (see the line showing the eight-quarter moving average on the chart).

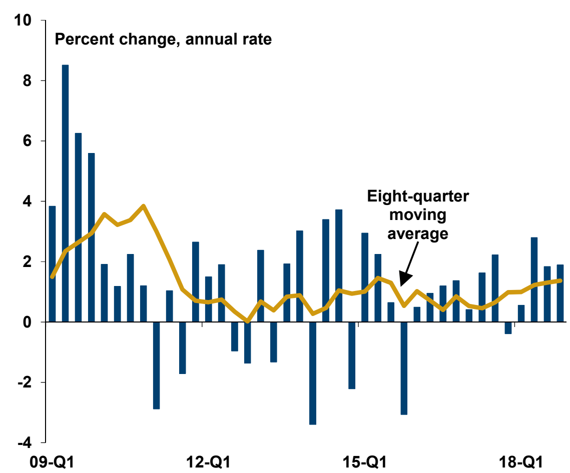
The Fed officials that mentioned the improvement in productivity did not seem to be adamant in the view that its underlying growth had picked up. They merely noted this recent development and saw a pickup as another factor than might restrain inflation. The report on productivity receives little attention in financial markets, but it warrants more scrutiny in the quarters ahead.

Import Prices

The FOMC discussion on inflation did not mention import prices as a constraint, but competition from abroad has almost certainly has been a factor limiting price pressure.

Import prices have fluctuated widely in the current expansion, advancing sharply in 2010-11, falling noticeably during 2015 and a portion of 2016, and rising moderately in 2017 and much of 2018. Much of the movement was driven by swings in the price of crude oil, but prices excluding petroleum and other fuels have followed a similar pattern (although with much smaller swings).

Nonfarm Productivity

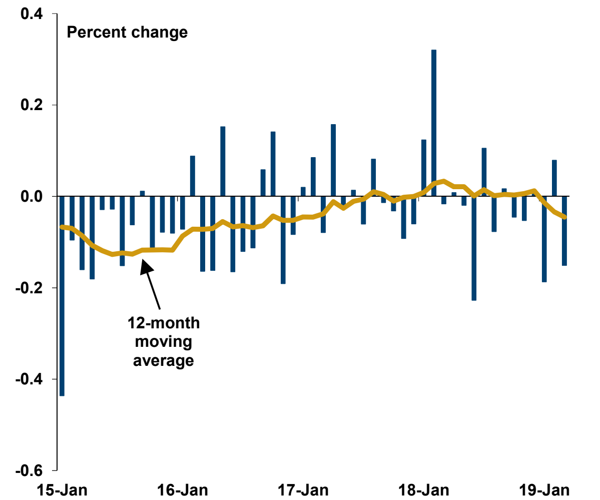


Source: Bureau of Labor Statistics via Haver Analytics

Prices of imports excluding fuels have softened recently, declining or showing no change in eight of the past 10 months. The year-over-year change totaled 0.8 percent in March, down from a recent peak of 2.0 percent in February of last year.

The series on import prices ex-fuels provides a good view on underlying trends, but it contains an element of noise from nonfuel commodity prices. We also monitor an index of finished-goods prices to eliminate noise from all commodity prices, and restraint here has been remarkable. Prices were declining on balance from 2015 through 2017, and they have not deviated sharply from zero since then. The year-over-year change has drifted into negative territory in recent months (chart). Many of the goods included in this measure will feed directly into U.S. price indexes, and they will provide competition to domestic producers even if the items do not enter directly. Either way, imports are helping to constrain inflation.

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 and Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

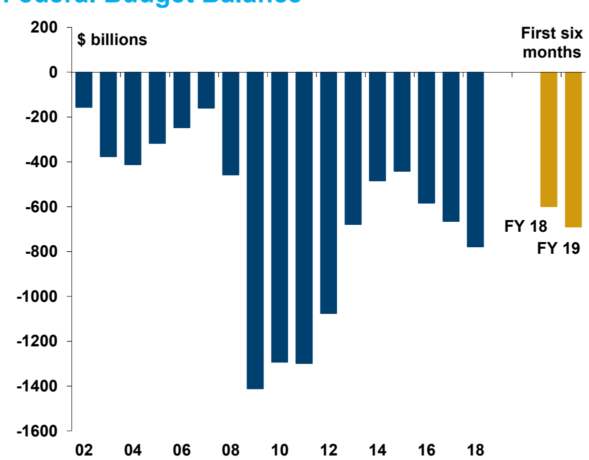
Federal Budget

The budget position of the federal government is not on the radar screen of many market participants (nor many politicians), but it should be. The budget deficits registered last year and expected this year are unusually wide for this stage of the business cycle, and the outlook is for additional slippage in the future. The wide gap cannibalizes funds that might flow to the private sector, and it will limit the ability of Congress to provide fiscal stimulus in the event of a downturn. The situation would be less-than-troubling if the deficit was fueling research or infrastructure investment, but that is not the case. As noted by William Gale, an economist at The Brookings Institution, net capital investment of the federal government has been close to zero for the past 25 years.

The Treasury Department this week published budget results for March, which marked the half-way point of the current fiscal year and represents a logical time for a review. The shortfall in the first half of fiscal year 2019 totaled $691 billion, up from $600 billion in the same period in the prior year (deterioration of 15.2 percent, chart). Federal revenues increased 0.7 percent in the first half of the fiscal year while outlays rose 4.9 percent.

The increase in revenue was paltry for an economy that grew in the neighborhood of five percent (nominal GDP), but the tax cut had a pronounced effect on the results. Withholding schedules for individual taxes were required to change by mid-February of last year, and thus the first 4½ months of the current year (October to mid-February), involved comparisons with higher tax rates and greater withholding. Year-over-year growth in March, which did not involve different withholding schedules, was

Federal Budget Balance*



** Fiscal year totals. The gold bars on the right show the deficits for the first six months of FY2018 and FY2019.*

Source: U.S. Treasury Department via Haver Analytics brisk at 8.5 percent. February also was strong with growth of 7.5 percent.

The tax cut, naturally, constrained individual and corporate receipts, which fell 1.7 percent and 13.5 percent, respectively. Remittances from the Federal Reserve also were weak, as the tightening of monetary policy led to higher payments of interest on bank reserves. In addition, the interest income of the Fed eased because of the shrinkage in its asset portfolio. The receipts side of the budget ledger had two bright spots: customs duties surged 78.9 percent because of tariffs, and excise taxes jumped 19.1 percent because of a new tax on providers of health insurance.

Outlays rose 4.9 percent, a less-than-alarming pace given the growth of the economy, but firm considering the elevated deficit in place. The major entitlement programs (Social Security, Medicare, other health-care programs) about matched the pace of overall spending (up 4.8 percent). Defense spending was strong (9.2 percent), reflecting generous provisions in the two-year budget agreement from last year. Interest expense jumped 14.8 percent despite low rates, as the growing volume of debt boosted interest obligations. There were two bright spots on the outlay side: Fannie Mae and Freddie Mac remitted $13 billion to the Treasury under its conservatorship agreement (recorded as a negative outlay), and spending by the Department of Homeland Security fell 27.3 percent primarily because natural disasters this year were fewer in number and less devastating than they were in FY2018.

We hesitate to call these budget results favorable, but they are better than expected at the start of the fiscal year. If spending growth stays at its current pace, and if revenues grow in line with nominal GDP (which we expect to grow approximately four percent), the deficit for the full fiscal year would total approximately $850 billion. This is a hefty total, but smaller than the $897 billion projected by the Congressional Budget Office in January.

Congress has started to consider the budget for fiscal 2020, which will probably involve contentious negotiations. The Budget Control Act of 2011 established spending caps for discretionary spending through 2021; Congress overrode the limits for 2018 and 2019 in last year's budget agreement (just as it did in 2013 and 2015), but the caps come back in place for the fiscal year beginning in October. As legislation now stands, Congress would need to cut spending to stay within the limits for FY2020, but few legislators seem willing to take such action. Additional spending will probably receive wide-spread support, although there is likely to be considerable disagreement on magnitudes and allocation of the additional funding.

Review

Week of April 8, 2019	Actual	Consensus	Comments
Factory Orders (February)	**-0.5%**	**-0.5%**	A drop in the volatile aircraft category (off 23.1%) accounted for much of the retreat in factory orders, but bookings in other durable-goods areas also were soft, as shown by a dip of 0.1% ex-transportation. Durable orders ex-trans have been approximately flat since last summer. Orders for nondurable goods provided a partial offset to the drop in durable bookings, but much of the 0.6% advance occurred in the petroleum and coal category (+2.8%), with higher prices most likely driving the increase. Nondurable orders ex-petrol and coal rose only 0.1%, and they too have shown little net growth since last summer.
CPI (March)	**0.4% Total; 0.1% Core**	**0.4% Total; 0.2% Core**	A jump of 3.5% in energy prices led the increase in the CPI in March. Food prices also contributed with an increase of 0.3%, continuing a faster pace that began late last year (3.5%, annual rate, in the past five months versus 1.2% in the 12 months before November). The core CPI rose 0.1% for the second consecutive month, but the change almost rounded up to 0.2% (+0.148%), and the latest month included an unusually sharp decline in the volatile apparel category (-1.9%, which subtracted 0.074 percentage point from monthly core inflation). The latest changes left the year-over-year increase in the headline index at 1.9%, up from 1.5% in February. The core component rose 2.0% in the past 12 months, down slightly from the prior month.
Federal Budget (March)	**$146.9 Billion Deficit**	**$181.0 Billion Deficit**	Federal revenues rose 8.5% in March from the same month last year. A drop in refunds contributed the reported growth in revenues, but most of the advance was the result of new inflows. Outlays declined 10.4% on a year-over-basis, but the drop was more the result of heavy spending last year rather than restraint this March (with spending last year driven by a calendar configuration that pulled April spending into March). The deficit for the first six months of FY2019 totaled $691 billion, a widening of $91 billion from the same period in the prior fiscal year.
PPI (March)	**0.6% Total; 0.0% Core***	**0.3% Total; 0.2% Core***	Energy prices rose sharply in March (5.6%), swamping a restrained reading on the core PPI (0.0%) and leading to a surprising jump in the headline index. Core goods prices rose 0.2%, but this change was offset by restrained readings in most service categories.
Consumer Sentiment (April)	**96.9 (-1.5%)**	**98.2 (-0.2%)**	Consumer sentiment slipped 1.9% in early April, dipping below the average 98.4 in 2018 but holding in the middle of the range of the past few years. The long-term inflation gauge published with the report declined two ticks to 2.3%, the lowest reading on record and suggestive of subdued views on inflation by consumers.

** The core PPI excludes food, energy, and trade services*

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

Preview

Week of April 15, 2019	Projected	Comments
Industrial Production (March) (Tuesday)	**0.1%**	The mining component of IP is likely to advance moderately, reflecting increases in the rotary rig count and hours worked in this sector. Colder-than-normal temperatures will probably lead to an increase in utility output. The manufacturing component will probably provide a partial offset to these gains, as a drop in employment in the factory sector points to a weak performance.
Trade Balance (February) (Wednesday)	**\$55.0 Billion Deficit (\$3.9 Billion Wider Deficit)**	Higher prices of crude oil will probably boost the value of imported petroleum products, and other import categories are likely to rebound from low-side readings in January. Higher prices also will boost the value of petroleum exports, but slow growth abroad will probably lead to limited growth in other areas.
Retail Sales (March) (Thursday)	**0.7% Total, 0.6% Ex-Autos**	A pickup in sales of new vehicles will probably boost the auto component of retail sales, while higher prices of gasoline are likely to inflate the value of activity at service stations. Elsewhere, with positive fundamentals for consumer spending, several areas are likely to rebound from lethargic results in the prior three months. Clothing stores, general merchandise stores, and miscellaneous outlets have notable upside potential.
Leading Indicators (March) (Thursday)	**0.3%**	Positive contributions from a decline in initial claims from unemployment insurance and increases in the ISM new orders index and stock prices suggest an advance in the index of leading economic indicators in March. The expected move offers a hint of improvement after a choppy month-to-month performance has left little net change in the index since the fourth quarter of last year.
Housing Starts (March) (Friday)	**1.180 Million (+1.5%)**	Firmer sales of new homes in January and February could stir new construction of single-family homes, although builders are likely to be cautious because of the potential for the rally in sales to fade. The volatile multi-family sector was close to its underlying average in February, but it still has upside potential to offset weak results in December and January.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

April/May 2019

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
FACTORY ORDERS Dec 0.1% Jan 0.0% Feb -0.5%	**NFIB SMALL BUSINESS OPTIMISM INDEX** Jan 101.2 Feb 101.7 Mar 101.8 **JOLTS DATA** Openings (000) Quit Rate Dec 7,479 2.3% Jan 7,625 2.3% Feb 7,087 2.3%	**CPI** Total Core Jan 0.0% 0.2% Feb 0.2% 0.1% Mar 0.4% 0.1% **FEDERAL BUDGET** 2019 2018 Jan $8.7B $49.2B Feb -$234.0B -$215.2B Mar -$146.9B -$208.7B **FOMC MINUTES**	**INITIAL CLAIMS** Mar 23 212,000 Mar 30 204,000 Apr 06 196,000 **PPI** Final Demand Core* Jan -0.1% 0.2% Feb 0.1% 0.1% Mar 0.6% 0.0%	**IMPORT/EXPORT PRICES** Non-fuel Imports Nonagri. Exports Jan -0.3% -0.4% Feb 0.2% 0.8% Mar -0.2% 0.7% **CONSUMER SENTIMENT** Feb 93.8 Mar 98.4 Apr 96.9
15	16	17	18	19
EMPIRE MFG (8:30) Feb 8.8 Mar 3.7 Apr -- **TIC DATA (4:00)** Total Net L-T Dec -$113.5B -$48.3B Jan -$143.7B -$7.2B Feb -- --	**IP & CAP-U (9:15)** IP Cap.Util. Jan -0.1% 79.2% Feb 0.0% 79.1% **Mar 0.1% 78.9%** **NAHB HOUSING INDEX (10:00)** Feb 62 Mar 62 Apr --	**TRADE BALANCE (8:30)** Dec -$59.9 billion Jan -$51.1 billion **Feb -$55.0 billion** **WHOLESALE TRADE (10:00)** Inventories Sales Dec 1.1% -0.9% Jan 1.2% 0.5% Feb -- -- **BEIGE BOOK (2:00)** **March Beige Book** “Economic activity continued to expand in late January and February, with ten Districts reporting slight-to-moderate growth, and Philadelphia and St. Louis reporting flat economic conditions.”	**INITIAL CLAIMS (8:30)** **RETAIL SALES (8:30)** Total Ex.Autos Jan 0.7% 1.4% Feb -0.2% -0.4% **Mar 0.7% 0.6%** **PHILLY FED INDEX (8:30)** Feb -4.1 Mar 13.7 Apr -- **LEADING INDICATORS (10:00)** Jan 0.0% Feb 0.2% **Mar 0.3%** **BUSINESS INVENTORIES (10:00)** Inventories Sales Dec 0.8% -0.9% Jan 0.8% 0.3% **Feb 0.3% 0.0%**	**HOUSING STARTS (8:30)** Jan 1.273 million Feb 1.162 million **Mar 1.180 million** ***(GOOD FRIDAY)***
22	23	24	25	26
CHICAGO FED NAT’L ACTIVITY INDEX **EXISTING HOME SALES**	**FHFA HOME PRICE INDEX** **NEW HOME SALES**		**INITIAL CLAIMS** **DURABLE GOODS ORDERS**	**GDP** **REVISED CONSUMER SENTIMENT**
29	30	1	2	3
PERSONAL INCOME, CONSUMPTION, PRICES	**EMPLOYMENT COST INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CHICAGO PURCHASING MANAGERS’ INDEX** **PENDING HOME SALES** **CONSUMER CONFIDENCE** **FOMC MEETING**	**ADP EMPLOYMENT REPORT** **ISM MFG INDEX** **CONSTRUCTION SPEND.** **FOMC DECISION** **POWELL PRESS CONFERENCE** **VEHICLE SALES**	**INITIAL CLAIMS** **PRODUCTIVITY & COSTS** **FACTORY ORDERS**	**EMPLOYMENT REPORT** **MERCHANDISE TRADE** **ADVANCE INVENTORY REPORT** **ISM NON-MFG INDEX**

Forecasts in Bold. * *The core PPI excludes food, energy, and trade services*

Treasury Financing

April/May 2019

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
AUCTION RESULTS: Rate Cover 13-week bills 2.375% 3.07 26-week bills 2.395% 3.14	**AUCTION RESULTS:** Rate Cover 3-year notes 2.301% 2.49 **ANNOUNCE:** $50 billion 4-week bills for auction on April 11 $35 billion 8-week bills for auction on April 11 **SETTLE:** $50 billion 4-week bills $35 billion 8-week bills	**AUCTION RESULTS:** Rate Cover 10-yr notes 2.466% 2.55	**AUCTION RESULTS:** Rate Cover 4-week bills 2.375% 2.88 8-week bills 2.375% 2.99 30-yr bonds 2.930% 2.25 **ANNOUNCE:** $78 billion 13-,26-week bills for auction on April 15 $17 billion 5-year TIPS for auction on April 18 **SETTLE:** $78 billion 13-,26-week bills	
15	16	17	18	19
AUCTION: $78 billion 13-,26-week bills **SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**ANNOUNCE:** $50 billion* 4-week bills for auction on April 18 $35 billion* 8-week bills for auction on April 18 **SETTLE:** $50 billion 4-week bills $35 billion 8-week bills		**AUCTION:** $50 billion* 4-week bills $35 billion* 8-week bills $17 billion 5-year TIPS **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on April 22 $26 billion* 52-week bills for auction on April 23 $20 billion* 2-year FRNs for auction on April 24 $40 billion* 2-year notes for auction on April 23 $41 billion* 5-year notes for auction on April 24 $32 billion* 7-year notes for auction on April 25 **SETTLE:** $78 billion 13-,26-week bills	
22	23	24	25	26
AUCTION: $78 billion* 13-,26-week bills	**AUCTION:** $26 billion* 52-week bills $40 billion* 2-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on April 25 $35 billion* 8-week bills for auction on April 25 **SETTLE:** $50 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $20 billion* 2-year FRNs $41 billion* 5-year notes	**AUCTION:** $50 billion* 4-week bills $35 billion* 8-week bills $32 billion* 7-year notes **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on April 29 **SETTLE:** $78 billion* 13-,26-week bills $26 billion* 52-week bills	
29	30	1	2	3
AUCTION: $78 billion* 13-,26-week bills	**ANNOUNCE:** $50 billion* 4-week bills for auction on May 2 $35 billion* 8-week bills for auction on May 2 **SETTLE:** $50 billion* 4-week bills $35 billion* 8-week bills $17 billion 5-year TIPS $20 billion* 2-year FRNs $40 billion* 2-year notes $41 billion* 5-year notes $32 billion* 7-year notes	**ANNOUNCE:** $38 billion* 3-year notes for auction on May 7 $27 billion* 10-year notes for auction on May 8 $19 billion* 30-year bonds for auction on May 9	**AUCTION:** $50 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on May 6 **SETTLE:** $78 billion* 13-,26-week bills	

*Estimate