Daiwa Capital Markets

U.S. Economic Comment

- Inflation: transitory factors still in play, but underlying pressure also limited
- Financial vulnerabilities: some risks, but the Fed views the system as resilient
- China: a difficult trading partner

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

Restrained Inflation: Part Transitory, Part Fundamental

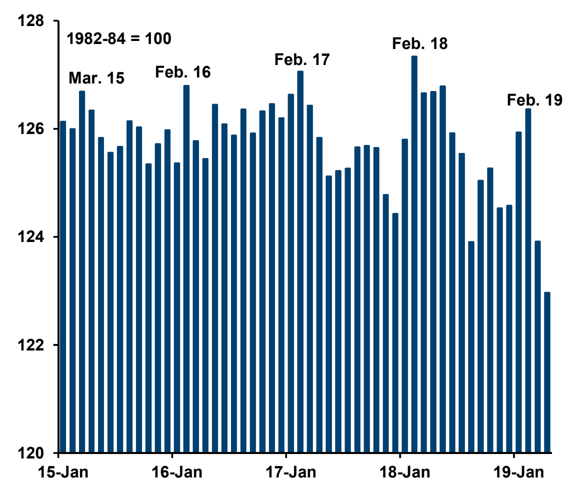
The consumer price index again surprised on the soft side, as increases of 0.3 percent and 0.1 percent in the headline and core measures trailed expectations by 0.1 percentage point. April marked the third consecutive month of restrained readings on the core CPI, with prices over this span increasing at an annual rate of only 1.6 percent. It is tempting to conclude that inflation is decelerating, but as Fed Chairman Jerome Powell noted in his May 1 press briefing, transitory factors seemed to be influencing the results. That seemed to be the case in the latest month as well, as the three transitory factors mentioned by Mr. Powell -- apparel prices, airfares, and charges for financial services -- fell again in April.

We would add another item to the list of transitory influences -- used car prices. These prices tend to follow their own cycle related to the ebb and flow of vehicles coming off of lease agreements; the macroeconomic environment seems to be a minor consideration. Used car prices are now in a downward phase, having declined for three consecutive months and in four of the past five (an average decline of 0.6 percent in the past five months).

The noise generated by apparel prices is apparent in the chart below, which shows the level of the index (view the vertical scale as indicating the price of a piece of clothing). Prices obviously fluctuate, jumping in some months only to be followed by discounting. Month-to-month percent changes in the past few years have ranged from -1.9 percent to 1.2 percent. We also suspect that faulty seasonal adjustment might be playing a role in recent monthly changes. Notice that apparel prices have jumped in February for four consecutive years only to be discounted later (a similar early-year jump occurred in March in 2015).

While transitory factors have played a role in restraining the CPI in recent months, fundamentals also seem to be at work. While apparel prices fluctuate sharply from month-to-month, notice too that prices have drifted downward on balance in the past two years, a surprising development for a fully employed economy growing at a rate faster than potential. Other items also have shown surprising restraint. The prices of recreation commodities (discretionary goods that should be sensitive to the economic environment) have been trending downward over the past few years; college text books, a hefty contributor to inflation in the past, drifted only modestly higher in 2017 and 2018 and have declined so far this year (although college tuition is still ramping ahead); the cost of medical care is rising at a more moderate pace than in the past, with some components (physicians services, for example) showing little inflation.

Consumer Price Index: Apparel



Source: Bureau of Labor Statistics via Haver Analytics

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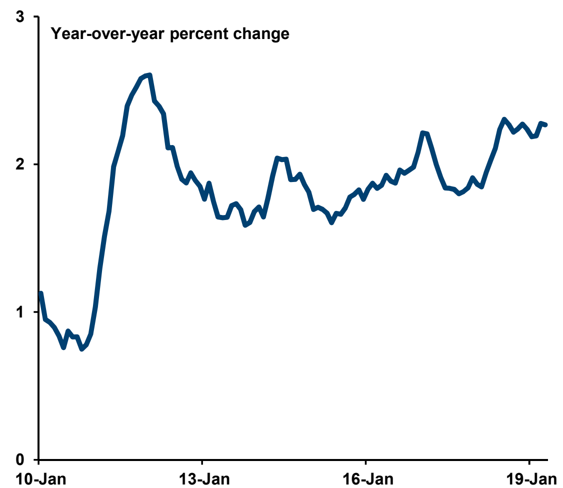
Chairman Powell highlighted stable inflation as measured by the Dallas Fed trimmed mean for the PCE price index as evidence supporting his view that transitory factors were a key consideration at this time. A measure based on the CPI published by the Cleveland Fed shows similar results, as year-over-year changes have been fluctuating in the neighborhood of 2 ¼ percent (chart).

Thus, the modest inflation rates seen in the past few months should not be viewed as signs of decelerating price pressure; transitory factors have had an influence. At the same time, inflation does not seem to be quickening despite a firm economic performance.

Trimmed-Mean CPI*



** The average inflation rate for the middle 84 percent of the distribution of price changes in the CPI. That is, the measure excludes eight percent of the items with the largest and smallest month-to-month price changes.*

Source: Federal Reserve Bank of Cleveland via Haver Analytics

The Fed: A Muddled Message on Inflation?

Some pundits in the past two weeks have criticized Fed Chairman Powell for sending mixed and confusing signals on the inflation environment. Specifically, at his press conference on March 20 he noted that slow inflation was one of the key challenges facing central bankers. He seemed to shift gears at the press briefing on May 1 when he argued that transitory factors were restraining inflation.

We are not puzzled by the apparent contradiction. The two views can be easily reconciled by noting that the Chairman was most likely focusing on two different time frames at these briefings. The statement in March is accurate if one focuses on the past several years, as inflation in the U.S. has generally been below target and it has been slow in most developed economies as well. The statement on May 1 was on the mark if one focuses on recent months, as the core CPI rose only marginally in the past three months, with transitory factors playing a role.

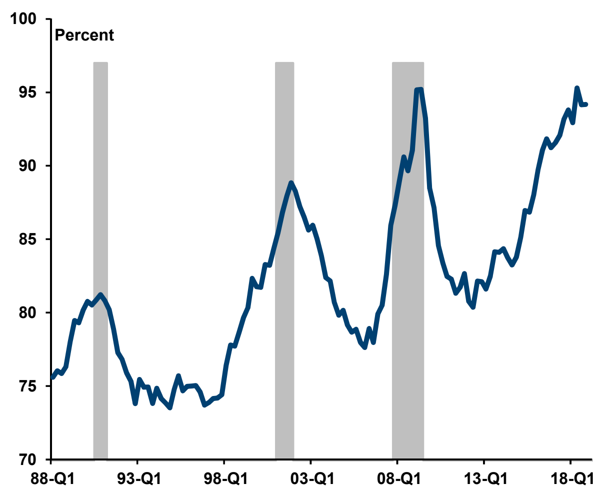
Financial Risks

The Federal Reserve has been monitoring the financial system more closely since the financial crisis, hoping to detect and prevent excessive risk taking that could generate a crisis. As part of this effort, the Board of Governors of the Fed has started to publish a semi-annual report on financial stability. Officials published the second edition of that report this past week. The Fed raised some concerns and noted some vulnerabilities, but in general the financial system was viewed as “resilient”.

The report focused most intently on heavy issuance of business-related debt, which has increased rapidly in the past several years, climbing close to previous peaks when measured relative to either GDP or corporate earnings (chart, next page, left). The current situation is not necessarily alarming, as interest rates are low and profits have been strong. Thus, corporations should be able to service their obligations with little difficulty.

However, the Fed report noted that much of the debt issuance in the past year was undertaken by firms with risky credit profiles. The junk bond market has been quiet, but the issuance of leveraged loans started to gain favor in 2017 and accelerated last year and remained firm in the first quarter (chart, next page, right). Not only has the volume of leveraged loans picked up, but the report noted that underwriting standards have eased, which opens the possibility of highly risky debt. Most leveraged loans are securitized and sold as collateralized loan obligations, which might lead one to be concerned about a repeat of problems associated with mortgage-backed securities during the financial crisis.

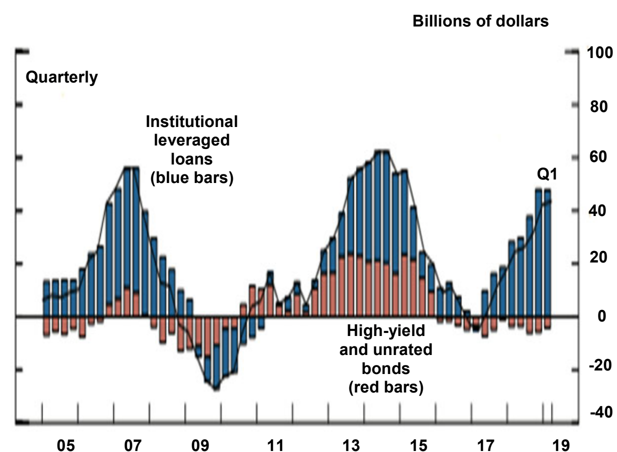
Ratio: Corporate Debt to Output*



* Corporate debt as a share of gross value added to GDP by nonfinancial corporations. The shaded areas show periods of recession in the United States.

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

Net Issuance of Risky Business Debt*



Source: Federal Reserve Board of Governors, Financial Stability Report

* Total net issuance of risky debt is the sum of the net issuance of speculative-grade and unrated bonds and leveraged loans. The data are four-quarter moving averages.

Fed sources: Mergent, Fixed Investment Securities Database (FISD); S&P Global, Leveraged Commentary & Data.

Business debt in general, and leveraged loans in particular, seem to represent a warning flag, but fallout thus far has been limited. Delinquency rates and defaults have been low.

The report also devoted considerable attention to asset values, and the Fed’s view was not especially favorable. Equity prices relative to forward earnings are in the upper end of their historical range, and credit spreads in the corporate bond market are tight. Prices of commercial real estate have surged in recent years, and capitalization rates on commercial properties (rental income relative to price) are low, suggesting a healthy dose of risk in investor portfolios. Prices of residential real estate also have increased noticeably in recent years and are historically high relative to rents (although the price-to-rent ratio is far below the peak during the housing bubble in 2006). The report stopped short of suggesting bubbles in any of these markets, but it certainly implied that downside risks were present.

The report covered two additional risk factors -- leverage in the financial sector and funding requirements -- and in these cases the outlook was favorable. Leverage in the banking system was seen as low -- that is, banks had raised new capital in the years following the crisis and they were now in comfortable positions. In addition, the loan performance at banks has been favorable, reducing the likelihood that capital would need to be tapped to absorb losses. Leverage among broker-dealers also was low by historical standards.

A breakdown in short-term funding markets was a major contributor to the turmoil that emerged during the financial crisis. Because of uncertainty about the loss exposure of leveraged investors, funding of these positions dried up during the crisis. The situation is now more comfortable because the volume of money-like runnable liabilities is much lower than it was in 2008. The situation in the banking industry is especially favorable, as liquid asset holdings are much larger than in the past, and short-term wholesale funding is close to historical lows when measured as a share of liabilities.

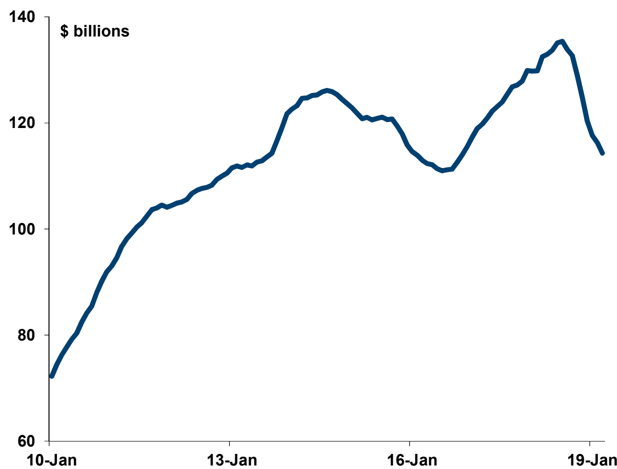
Trade with China

The U.S.-China trade war escalated this week, as China reportedly backed away from various provisions that had been agreed to, and the U.S. hiked tariffs in response. China most likely will take steps to retaliate for the hike in U.S. tariffs. There will be economic consequences, as the tariffs imposed last year already are hurting trade. Exports to and imports from China have both slipped in recent months (charts, next page).

The drop in U.S. exports has been large in percentage change terms, but it has been lighter than that in imports from China when measured in dollars. With the absolute change in imports exceeding that in exports, the trade deficit with China has narrowed, but only by a small amount.

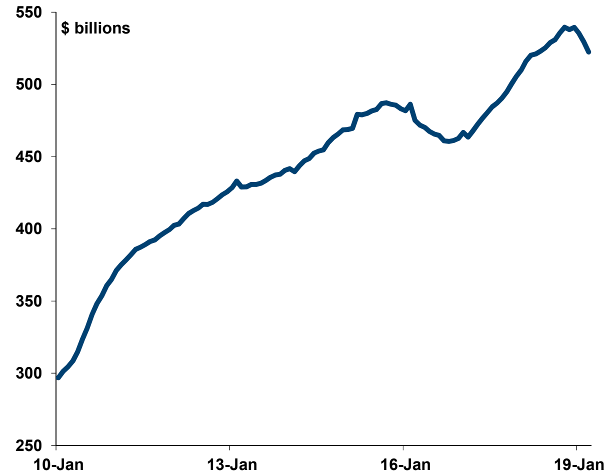
The reneging on commitments by China is not especially surprising, as China does not seem to give serious consideration to fair trade. For example, as shown in the left chart below, less than 10 percent of imported goods enter the country duty-free, a share well below the norm of other major traders. Similarly, actions taken by other countries against China for unfair trading practices far exceed the number for any other major country (chart, right). A tough stand against China's trade practices is easily justified.

U.S. Exports to China*



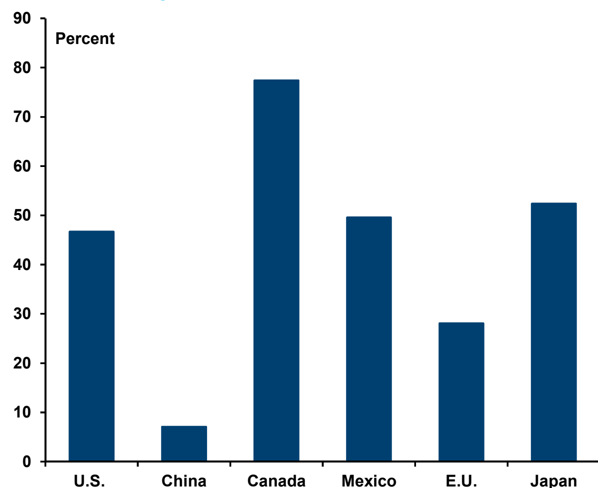
*   U.S. exports of goods to China. 12-month moving totals of not-seasonally-adjusted data.
Source: U.S. Census Bureau via Haver Analytics

U.S. Imports from China*



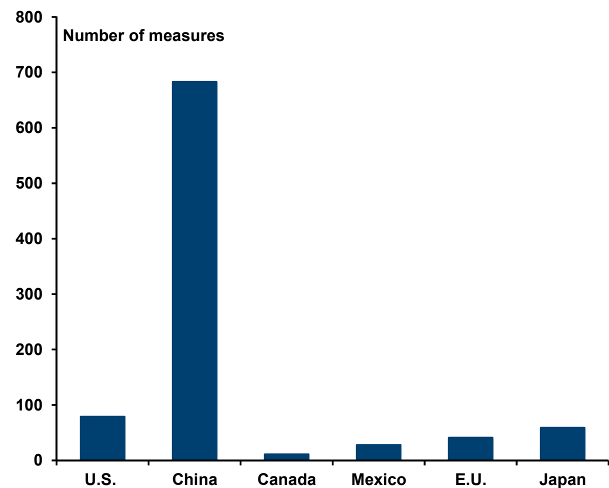
*   U.S. imports of goods from China. 12-month moving totals of not-seasonally-adjusted data.
Source: U.S. Census Bureau via Haver Analytics

Share of Duty-Free Imports



Source: World Trade Organization, World Tariff Profiles 2018

Non-Tariff Measures Against Exporting Countries*



*   Non-tariff measures include duties to counter the dumping of goods in the U.S. (i.e. selling goods in the U.S. at prices lower than those charged domestically) and duties that offset subsidies provided by foreign governments.
Source: World Trade Organization, World Tariff Profiles 2018

Review

Week of May 6, 2019	Actual	Consensus	Comments
Trade Balance (March)	**-\$50.0 billion (\$0.7 billion Wider Deficit)**	**-\$50.1 billion (\$0.7 billion Wider Deficit)**	Both exports and imports rose approximately 1.0% in March. The increase in exports marked the third consecutive gain after drifting lower during most of last year. Exports are now showing a slight increase from the year-ago level. Imports have been erratic in recent months, but they have declined since last fall. Imports are still above their year-ago level, but they have eased recently. The March results were close to the assumptions used in the initial estimate of Q1 GDP, and thus the trade figures are likely to have little influence on the upcoming revision to economic growth.
PPI (April)	**0.2% Total, 0.4% Core***	**0.3% Total, 0.2% Core***	Energy prices rose at the producer level, but the change was relatively light at 1.8% (compared to 2.9% in the CPI). Food prices dipped 0.2%, offsetting a similar-sized increase in March and leaving this component little changed for the third consecutive month. Prices excluding food and energy rose 0.1%, held down by a drop of 0.5% in the volatile trade-service category. Prices excluding food, energy, and trade services (the definition of core in the PPI) rose 0.4%. A jump in construction-related prices of 1.6% contributed importantly to the increase in the core component, as did an increase of 1.0% in prices of transportation and warehouse services.
CPI (April)	**0.3% Total, 0.1% Core***	**0.4% Total, 0.2% Core***	The energy component of the CPI rose 2.9% in April, led by a jump of 5.7% in gasoline prices that was partially offset by a drop of 0.8% in charges for natural gas. The food component settled to a degree after increasing sharply in the prior four months (-0.1% versus an average increase of 0.3% from December through March). The core component rose 0.1% for the third consecutive month, perhaps suggesting a deceleration in inflation. However, transitory factors seemed to play a role again in April, as both airfares and apparel prices (volatile items) fell again. The trimmed-mean and median CPIs published by the Cleveland Fed (measures of underlying inflation) rose 0.2% and 0.3%, respectively.
Federal Budget (April)	**\$160.3 Billion Surplus**	**\$160.5 Billion Surplus**	Federal revenues in April grew 4.9% from the same month last year despite a drop in payments from individuals to settle obligations from 2018. Taxes withheld from paychecks and collections of customs duties provided an offset. Federal outlays surged on a year-over-year basis, but the jump of 26.7% was a reflection of light outlays last April rather than enlarged expenditures this year. The latest results left the deficit in the first seven months of the fiscal year at \$530.9 billion, up from \$385.4 billion in the same period in FY2018.

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

Source: Bureau of Economic Analysis (Trade Balance); Bureau of Labor Statistics (PPI, CPI); U.S. Treasury Department (Federal Budget); Consensus forecasts are from Bloomberg

Preview

Week of May 13, 2019	Projected	Comments
Retail Sales (April) (Wednesday)	**0.3% Total, 0.7% Ex-Autos**	Higher prices of gasoline will probably inflate the value of sales at service stations, but a drop in sales of new motor vehicles is likely to provide a partial offset. Other areas are likely to advance on balance, but individuals probably spent only moderately after brisk activity in March (0.3% ex autos and gasoline).
Industrial Production (April) (Wednesday)	**0.0%**	Modest job growth in the factory sector suggests that the manufacturing component of industrial production rose only slightly. Mining activity was probably underwhelming as well, as the rotary rig count eased in April. The utility sector was probably the weakest of the three major areas, as warmer-than-normal temperatures probably led to a drop in demand for heating services.
Housing Starts (April) (Thursday)	**1.190 Million (+4.5%)**	A surge in sales of new homes in February and March probably led builders to pick up the pace of activity in the single-family sector. Multi-family starts in March were a touch below the recent average, and thus face mild upside potential.
Consumer Sentiment (May) (Friday)	**96.0 (-1.2%)**	The labor market is strong, but renewed escalation in the trade war and hesitation in the equity market could give individuals pause.
Leading Indicators (April) (Friday)	**0.2%**	With only the ISM new orders index making a negative contribution, improvement in consumer expectations and equity values in April should lead to a slight increase in the index of leading economic indicators.

Source: Forecasts provided by Daiwa Capital Markets America

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Economic Indicators

May 2019

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
	JOLTS DATA Openings (000) / Quit Rate Jan 7,625 2.3% Feb 7,142 2.3% Mar 7,488 2.3% **CONSUMER CREDIT** Jan $17.2 billion Feb $15.5 billion Mar $10.3 billion		**INITIAL CLAIMS** Apr 20 230,000 Apr 27 230,000 May 04 228,000 **TRADE BALANCE** Jan -$51.1 billion Feb -$49.3 billion Mar -$50.0 billion **PPI** Final Demand / Core* Feb 0.1% 0.1% Mar 0.6% 0.0% Apr 0.2% 0.4% **WHOLESALE TRADE** Inventories / Sales Jan 1.2% 0.5% Feb 0.4% 0.3% Mar -0.1% 2.3%	**CPI** Total / Core Feb 0.2% 0.1% Mar 0.4% 0.1% Apr 0.3% 0.1% **FEDERAL BUDGET** 2019 / 2018 Feb -$234.0B -$215.2B Mar -$146.9B -$208.7B Apr $160.3B $214.3B
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX (6:00) Feb 101.7 Mar 101.8 Apr -- **IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports / Nonagri. Exports Feb 0.2% 0.8% Mar -0.2% 0.7% Apr -- --	**RETAIL SALES (8:30)** Total / Ex.Autos Feb -0.2% -0.2% Mar 1.6% 1.2% **Apr 0.3% 0.7%** **EMPIRE MFG (8:30)** Mar 3.7 Apr 10.1 May -- **IP & CAP-U (9:15)** IP / Cap.Util. Feb 0.1% 79.0% Mar -0.1% 78.8% **Apr 0.0% 78.6%** **NAHB HOUSING INDEX (10:00)** Mar 62 Apr 63 May -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales Jan 0.9% 0.3% Feb 0.3% 0.2% **Mar 0.0% 1.5%** **TIC DATA (4:00)** Total / Net L-T Jan -$143.7 B -$7.2B Feb -$21.6B $51.9B Mar -- --	**INITIAL CLAIMS (8:30)** **HOUSING STARTS (8:30)** Feb 1.142 million Mar 1.139 million **Apr 1.190 million** **PHILLY FED INDEX (8:30)** Mar 13.7 Apr 8.5 May --	**CONSUMER SENTIMENT (10:00)** Mar 98.4 Apr 97.2 **May 96.0** **LEADING INDICATORS (10:00)** Feb 0.1% Mar 0.4% **Apr 0.2%**
20	21	22	23	24
CHICAGO FED NAT'L ACTIVITY INDEX	**EXISTING HOME SALES**	**FOMC MINUTES**	**INITIAL CLAIMS** **NEW HOME SALES**	**DURABLE GOODS ORDERS**
27	28	29	30	31
MEMORIAL DAY	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CONSUMER CONFIDENCE**		**INITIAL CLAIMS** **REVISED GDP** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, PRICE INDEXES** **CHICAGO PURCHASING MANAGERS' INDEX** **REVISED CONSUMER SENTIMENT**

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

Treasury Financing

May 2019

Monday	Tuesday	Wednesday	Thursday	Friday
6	7	8	9	10
AUCTION RESULTS: Rate Cover 13-week bills 2.380% 3.17 26-week bills 2.380% 3.21	**AUCTION RESULTS:** Rate Cover 3-year notes 2.248% 2.48 **ANNOUNCE:** $50 billion 4-week bills for auction on May 9 $35 billion 8-week bills for auction on May 9 **SETTLE:** $50 billion 4-week bills $35 billion 8-week bills $20 billion 37-day CMBs	**AUCTION RESULTS:** Rate Cover 10-yr notes 2.479% 2.17	**AUCTION RESULTS:** Rate Cover 4-week bills 2.385% 2.83 8-week bills 2.380% 3.05 30-yr bonds 2.892% 2.20 **ANNOUNCE:** $75 billion 13-,26-week bills for auction on May 13 **SETTLE:** $75 billion 13-,26-week bills	
13	14	15	16	17
AUCTION: $75 billion 13-,26-week bills	**ANNOUNCE:** $50 billion* 4-week bills for auction on May 16 $35 billion* 8-week bills for auction on May 16 **SETTLE:** $50 billion 4-week bills $35 billion 8-week bills	**SETTLE:** $38 billion 3-year notes $27 billion 10-year notes $19 billion 30-year bonds	**AUCTION:** $50 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $75 billion* 13-,26-week bills for auction on May 20 $26 billion* 52-week bills for auction on May 21 $11 billion* 10-year TIPS for auction on May 23 **SETTLE:** $75 billion 13-,26-week bills	
20	21	22	23	24
AUCTION: $75 billion* 13-,26-week bills	**AUCTION:** $26 billion* 52-week bills **ANNOUNCE:** $50 billion* 4-week bills for auction on May 23 $35 billion* 8-week bills for auction on May 23 **SETTLE:** $50 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $50 billion* 4-week bills $35 billion* 8-week bills $11 billion* 10-year TIPS **ANNOUNCE:** $75 billion* 13-,26-week bills for auction on May 28 $18 billion* 2-year FRNs for auction on May 29 $40 billion* 2-year notes for auction on May 28 $41 billion* 5-year notes for auction on May 28 $32 billion* 7-year notes for auction on May 29 **SETTLE:** $75 billion* 13-,26-week bills $26 billion* 52-week bills	
27	28	29	30	31
MEMORIAL DAY	**AUCTION:** $75 billion* 13-,26-week bills $40 billion* 2-year notes $41 billion* 5-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on May 30 $35 billion* 8-week bills for auction on May 30 **SETTLE:** $50 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $18 billion* 2-year FRNs $32 billion* 7-year notes	**AUCTION:** $50 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $75 billion* 13-,26-week bills for auction on June 3 **SETTLE:** $75 billion* 13-,26-week bills	**SETTLE:** $11 billion* 10-year TIPS $18 billion* 2-year FRNs $40 billion* 2-year notes $41 billion* 5-year notes $32 billion* 7-year notes

**Estimate*