Daiwa Capital Markets

U.S. Economic Comment

- Trade war: who has the edge? Who's winning?
- Forecast update: moderate growth in 2019; challenges in 2020

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U.S. versus China

Much of the U.S./China commentary this week involved relative advantages -- that is, who had the stronger negotiating position. Casual inspection of data might suggest that the Unites States has the upper hand. Specifically, China sells a huge volume of goods and services to U.S. consumers and businesses, while China represents a small export market for U.S. firms. The difference is striking, as Chinese exports to the United States represent approximately four percent of its GDP, while U.S. exports to China represent less than one percent of our GDP.

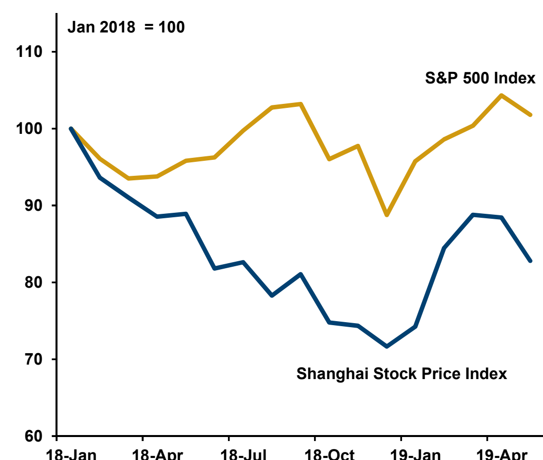
Recent movements in equity markets also hint at greater vulnerabilities in China. Share values in China fell throughout last year as trade issues moved to the forefront, while the market in the U.S. was firm until the retreat in December (chart). Markets in both countries tumbled after President Trump tweeted an escalation in the trade dispute on May 5, but the shift in China was noticeably larger (off 7.4 percent at the low versus a drop of 4.5 percent in the U.S.). Both markets have regained some ground, but the Shanghai composite index is still 6.4 percent below its May 3 level while the S&P 500 is down 2.5 percent.

Although the United States would seem to have the advantage in a trade dispute, the early returns have not been favorable. U.S. data show that both exports to and imports from China have declined, with imports showing a slightly larger change in dollar terms. However, because the value of imports far exceeds that for exports, the percentage change in imports is modest relative to that for exports (1.5 percent for imports versus 5.5 percent for exports; changes from recent peaks of 12-month averages; 12-month averages were used to smooth seasonal swings).

The negative effect on economic activity also seems more pronounced thus far in the United States. The manufacturing component of industrial production showed little net change in the closing months of last year, and it has declined in three of the first four months of this year (unchanged in the other month, chart, next page, left). Production in China, in contrast, has not missed a beat, as its production index has moved along a rather smooth upward trend (chart, next page, right; a spike in March most likely associated with noise related to the Chinese New Year).

The firm performance in China could begin to fade in the months ahead, as part of the resiliency seemed to reflect an effort to rush goods out of the country before tariffs took effect. With such front-loading, slower results could emerge in the months ahead. In this regard, the normal lull in imports from China that usually occurs in February and March was more pronounced than it was last year, with the two months combined falling more than 16 percent from the same period last year.

Stock Indexes*



** Both the Shanghai Stock Price Index and the S&P 500 Index are reindexed to equal 100 in January 2018. Monthly end-of-period data, except for the May 2019 observations which are quotes for May 17, 2019.*

Source: Shanghai Stock Exchange and Standard and Poor's via Haver Analytics; Bloomberg

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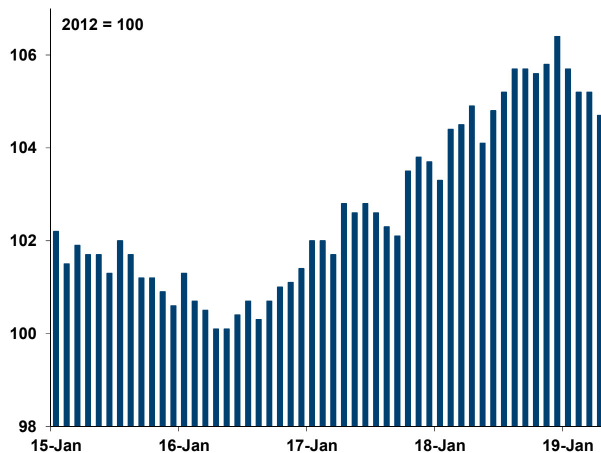
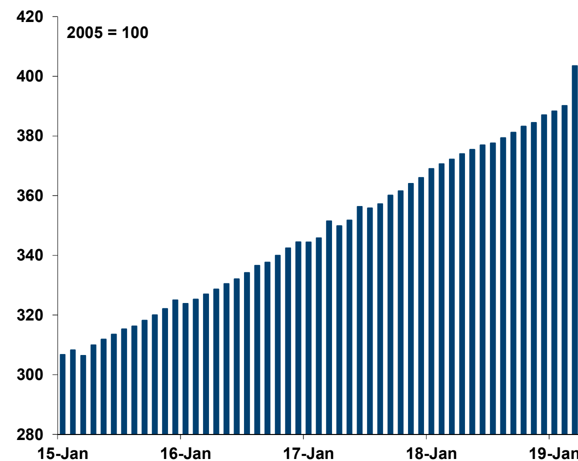


Source: Federal Reserve Board via Haver Analytics

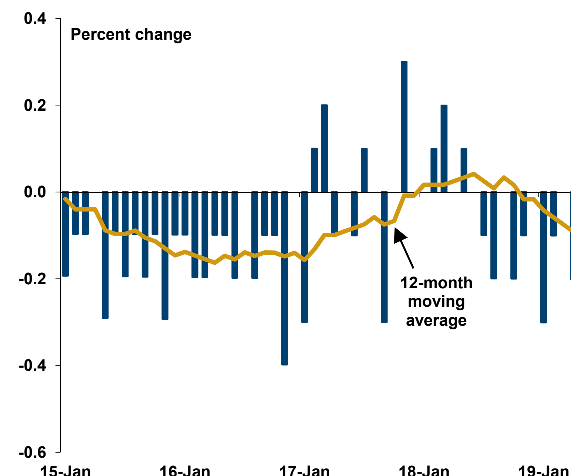


* *Excludes the construction sector*

Source: China National Bureau of Statistics via Haver Analytics

In addition, China might be losing some flexibility on pricing, which could dampen its competitive position in the United States. The yuan fell sharply last year after President Trump raised the issue of tariffs, with the currency depreciating almost 10 percent from April to late November. That depreciation allowed producers to trim prices on goods shipped to the U.S. throughout the second half of last year (chart; the price measure used in the chart is pre-tariff). The magnitude of the change has not been overwhelming (1.2 percent over this 10-month span), but this total most likely represents an average of larger changes on items subject to tariffs and smaller changes on non-tariff items.

Prices of goods imported from China provide some insight into the question of who bears the burden of the tariffs. President Trump claims that China is paying the tariffs, and the drop in prices provides an element of support for this view. Lower prices offset the effect of the tariffs to U.S. buyers at least partially, shifting the burden to Chinese producers in the form of lower profit margins (or a loss for the currency traders who suffered from the depreciation of the yuan). The magnitude of the price change, however, seems too small to offset tariffs of 10 or 25 percent, and thus the burden is falling mainly on U.S. entities. Distributers or retailers could absorb some of the cost in their profit margins; otherwise, the final purchasers -- consumers or businesses -- shoulder the burden.



Source: Bureau of Labor Statistics via Haver Analytics

Forecast Update

We hesitate to present a forecast for 2019 and 2020 because the economy's path will depend importantly on what unfolds in trade talks with China, and one can only guess about the outcome of those discussions. We assume that some type of face-saving agreement that avoids disruptions in trade will emerge. Many issues are likely to remain unresolved, but enough progress will be made to allow both sides to declare victory.

If negotiations break down and President Trump imposes tariffs on most goods from China (and perhaps on motor vehicles from Europe and Japan, although this decision has been pushed six-months down the road), economic growth undoubtedly would be slower than our current view. We can easily see a trade impasse

taking an additional one-half percentage point from economic growth, and we would not scoff at projections of much larger shortfalls.

The environment in a broad trade war, in a sense, would be similar to that during the financial crisis in 2008. An important dimension of that episode was uncertainty about linkages among market participants and exposure to losses associated with those linkages. This uncertainty led to a breakdown in market activity and economic retrenchment. Like traders and investors, businesses today have extensive and complex linkages with foreign counterparts. These linkages take the form of supply chains, and a serious trade war would most likely disrupt these links, forcing reductions in activity and shifts to less efficient operations. With supply chains far more developed than in the past, we cannot draw on history to assess the likely fallout. The global economy would be in uncharted territory.

If the trade dispute does not deteriorate further, we look for the economy to continue to expand over the balance of the year, although at a slower pace than registered in the past year or so. Consumer spending is likely to remain the most important engine of growth, fueled by a firm labor market and a healthy aggregate balance sheet. While the outlook is favorable, we see a deceleration in the pace of growth, partly reflecting a fading of the push from the tax cut and partly the result of a natural slowing in a mature expansion. Hints of an easing in the growth of consumer spending are already starting to appear. Sales of new motor vehicles have inched lower in recent months, and some of the recent reports on retail activity have been unimpressive.

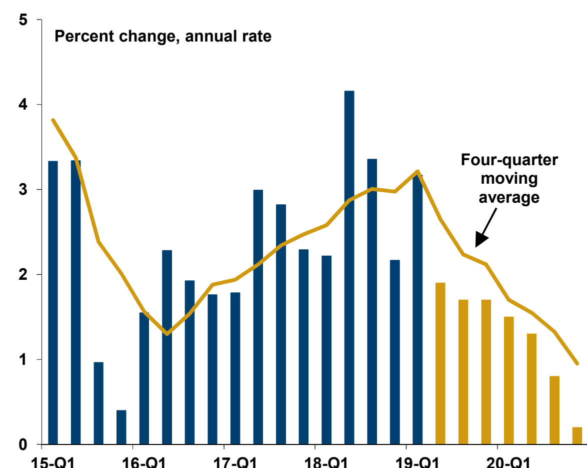
We also see business fixed investment in the plus column, but again the pace of growth is likely to be only moderate. The tax cut last year provides several incentives for capital spending (lower tax rates, accelerated depreciation, lessened need to book profits abroad), and they should be providing support this year. At the same time, the uncertainties regarding trade policy and the global economic outlook are likely to have a dampening effect on spending plans.

The housing sector is likely to be a soft spot, despite a recent pickup in home sales and housing starts in response to the drop in interest rates that occurred late last year. We view the recent pickup as a mere flurry, reflecting the actions of fence-sitters to take advantage of lower interest rates. With most measures of home prices above peaks before the housing bust, we see affordability as an issue that will constrain activity. Still-tight lending standards are a constraining factor as well.

Even if tariffs were not an issue, we would not have a favorable view on trade prospects. The foreign exchange value of the dollar is on the firm side, which will constrain exports and support imports. In addition, slow growth in the economies of some major trading partners is likely to limit trade flows as well.

These pluses and minuses should add to a reasonable performance over the balance of the year. Average growth of 1.8 percent in the final three quarters of 2019 is slower than the recent norm. However, this pace is in line with the economy's potential, and with the economy fully employed, it represents a fine showing. We expect a more notable slowing next year. The effects of the tax cut on consumer and business spending is likely to be largely gone, and the hints of hesitation that have appeared recently are likely to intensify. We also expect slow government spending. As laws currently stand, the federal government is required to

GDP Growth*



The readings from 2019-Q2 to 2020-Q4 (gold bars) are projections.

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

trim discretionary spending in fiscal year 2020. We suspect that Congress will decide to override current spending caps, but we look for a restrained increase because of wide budget deficits.

We are not concerned about an acceleration in inflation. An upward drift in wage growth presents upside risks, but productivity has stirred in recent quarters, which should allow businesses to absorb faster wage growth without changing prices appreciably. In addition, import prices have been well contained, which limits the pricing power of U.S. firms. Well anchored inflation expectations are perhaps the strongest argument in favor of limited inflation pressure.

With inflation not likely to stir, we expect the Fed to be on hold for the balance of the year. We look for the next change to be a cut next year as the economy slows. We look for Treasury rates to increase slightly from current levels over the balance of the year. Nervousness about a trade-related slowing in the economy has pushed interest rates lower in recent weeks, but these shifts should reverse if a trade war is averted.

U.S. Economic Outlook*

(Percent change annual rate, unless otherwise noted)

		2019				2020			
Item		**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
1	Gross Domestic Product	3.2	1.9	1.7	1.7	1.5	1.3	0.8	0.2
2	Personal Consumption Expenditures	1.2	3.0	2.5	2.2	1.8	1.5	1.1	0.5
3	Business Fixed Investment	2.7	3.0	3.7	3.7	3.6	2.6	0.7	-1.3
4	Residential Construction	-2.8	-1.0	-1.0	-2.0	-4.0	-2.0	-2.0	-2.0
5	Change in Business Inventories *(Contribution to growth)*	0.7	-0.6	-0.5	-0.2	-0.1	-0.1	-0.1	0.0
6	Government Spending	2.4	2.0	1.3	1.0	0.8	0.7	0.5	0.5
7	Net Exports *(Contribution to growth)*	1.0	-0.2	-0.2	-0.2	-0.1	0.0	0.0	0.0
	End of Period Figures: Inflation and Unemployment								
8	Core PCE Deflator *(Annual rate)*	1.3	1.7	2.0	2.1	2.1	2.0	2.0	1.9
9	Unemployment Rate	3.9	3.7	3.7	3.8	3.8	3.9	4.1	4.3
	Interest Rates								
10	Federal Funds Target (midpoint)	2.38	2.38	2.38	2.38	2.38	2.38	2.13	1.88
11	2-year Treasury	2.27	2.40	2.40	2.40	2.35	2.25	2.00	1.70
12	10-year Treasury	2.41	2.50	2.55	2.60	2.55	2.50	2.30	2.10
13	30-year Fixed-Rate Mortgages	4.06	4.40	4.45	4.55	4.60	4.55	4.40	4.20

** Data for 2019-Q1 are actuals.*
Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; Daiwa Capital Markets America

Review

Week of May 13, 2019	Actual	Consensus	Comments
Retail Sales (April)	**-0.2% Total, 0.1% Ex.-Autos**	**0.2% Total, 0.7% Ex.-Autos**	The two most volatile components of the retail sales report -- autos and gasoline -- had largely offsetting influences in April. The auto component fell 1.1% (most likely influenced by a drop in sales of new vehicles) while gasoline sales rose 1.8% (probably driven by higher prices). Key categories outside of the auto and gasoline components were weak, as sales ex-autos and ex-gas slipped 0.2%. A drop of 0.2% in the nonstore category (primarily internet and catalog) contributed importantly, as results deviated sharply from gains typically in the neighborhood of 1.0%. Sales at electronic and appliance stores and clothing stores also lacked vigor.
Industrial Production (April)	**-0.5%**	**0.0%**	A drop of 3.5% in the utility component led the decline in the industrial production index, but the soft result reflected decreased heating demand because of warmer-than-normal temperatures rather than economic fundamentals. A drop of 0.5% in the manufacturing component represented a more meaningful shift. The decline represented the third retreat in the past four months (no change in the other month), signaling a loss of momentum in this cyclically sensitive sector. The mining sector provided a positive surprise with an increase of 1.6%, which offset weakness in the prior three months.
Housing Starts (April)	**1.235 Million (+5.7%)**	**1.209 Million (+6.1%)**	The increase in housing starts in April was joined by upward revisions in the prior two months (1.6% firmer than previously believed). In addition, annual benchmark revisions involved modest upward adjustments in the prior few years. Both single-family and multi-family activity contributed to the latest monthly increase (+6.2 and +4.7 percent, respectively). The increase in single-family starts was welcome after generally soft results from November through March (except for a weather-related jump in January), but a downward trend in building permits accented by a drop of 4.2% in April suggests that the increase might be a temporary burst. The increase in multi-family starts pushed activity slightly above the average from last year but still well below the robust performances in 2015 and 2016.

Review Continued

Week of May 13, 2019	Actual	Consensus	Comments
Consumer Sentiment (May)	**102.4 (+5.4%)**	**97.2 (Unch.)**	The surprising jump in consumer sentiment was led by a surge of 9.8% in the expectations component. Both measures rose to their highest levels of the current expansion and were exceeded by only one observation in the previous expansion (numerous observations in the late 1990s and 2000 were higher). The current conditions index rose 0.1%, with the latest reading continuing a flat trend at an elevated level. The long-term inflation gauge published with the report increased three ticks to 2.6% from the lowest reading on record. This measure often swings widely from month-to-month, and we are inclined to view the increase as a random shift.
Leading Indicators (April)	**0.2%**	**0.2%**	Positive contributions from stock prices, consumer expectations, and the leading credit index nudged the index of leading economic indicators higher for the third consecutive month in April. The index had shown little net change from October through January, but the recent performance hints at a resumption of the previous upward trend.

Source: U.S. Census Bureau (Retail Sales, Housing Starts); Federal Reserve Board (Industrial Production); Reuters/University of Michigan Survey Research Center (Consumer Sentiment); The Conference Board (Leading Indicators); Consensus forecasts are from Bloomberg

Preview

Week of May 20, 2019	Projected	Comments
Existing Home Sales (April) (Tuesday)	**5.30 Million (+0.8%)**	After moving lower during most of 2018, sales of existing homes picked up in February and March in response to lower mortgage rates. The interest rate environment remained comfortable in April, which should hold sales close to the level in March. While sales have improved from results in late 2018, the expected reading in April remains shy of the average in the first half of last year (5.46 million).
New Home Sales (April) (Thursday)	**0.650 Million (-6.1%)**	Sales of new homes have jumped in the past few months in response to lower interest rates, with gains pushing activity in March into the upper reaches of the recent range. With the March level well above the average from last year, a correction seems likely.
Durable Goods Orders (April) (Friday)	**-2.0%**	Soft readings on manufacturing-related data (industrial production, employment, ISM) suggest that several industries are likely to post slow order flows. In addition, paltry bookings at Boeing are likely to leave a sharp drop in the volatile aircraft category.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

May/June 2019

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
	NFIB SMALL BUSINESS OPTIMISM INDEX Feb 101.7 Mar 101.8 Apr 103.5 **IMPORT/EXPORT PRICES** Non-fuel Imports / Nonagri. Exports Feb 0.1% 0.7% Mar -0.2% 0.7% Apr -0.1% 0.4%	**RETAIL SALES** Total / Ex.Autos Feb -0.3% -0.3% Mar 1.7% 1.3% Apr -0.2% 0.1% **EMPIRE MFG** Mar 3.7 Apr 10.1 May 17.8 **IP & CAP-U** IP / Cap.Util. Feb -0.5% 78.5% Mar 0.2% 78.5% Apr -0.5% 77.9% **NAHB HOUSING INDEX** Mar 62 Apr 63 May 66 **BUSINESS INVENTORIES** Inventories / Sales Jan 0.8% 0.4% Feb 0.3% 0.1% Mar 0.0% 1.5% **TIC DATA** Total / Net L-T Jan -$143.9B -$7.1B Feb -$21.5B $51.9B Mar -$8.1B -$28.4B	**INITIAL CLAIMS** Apr 27 230,000 May 04 228,000 May 11 212,000 **HOUSING STARTS** Feb 1.149 million Mar 1.168 million Apr 1.235 million **PHILLY FED INDEX** Mar 13.7 Apr 8.5 May 16.6	**CONSUMER SENTIMENT** Mar 98.4 Apr 97.2 May 102.4 **LEADING INDICATORS** Feb 0.2% Mar 0.3% Apr 0.2%
20	21	22	23	24
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Feb -0.31 -0.18 Mar -0.15 -0.24 Apr -- --	**EXISTING HOME SALES (10:00)** Feb 5.48 million Mar 5.21 million **Apr 5.30 million**	**FOMC MINUTES (2:00)**	**INITIAL CLAIMS (8:30)** **NEW HOME SALES (10:00)** Feb 0.662 million Mar 0.692 million **Apr 0.650 million**	**DURABLE GOODS ORDERS (8:30)** Feb -2.6% Mar 2.8% **Apr -2.0%**
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**
3	4	5	6	7
ISM INDEX **CONSTRUCTION SPEND.** **VEHICLE SALES**	**FACTORY ORDERS**	**ADP EMPLOYMENT REPORT** **ISM NON-MFG INDEX** **BEIGE BOOK**	**INITIAL CLAIMS** **TRADE BALANCE** **REVISED PRODUCTIVITY & COSTS**	**EMPLOYMENT REPORT** **WHOLESALE TRADE** **CONSUMER CREDIT**

Forecasts in Bold.

Treasury Financing

May/June 2019

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
AUCTION RESULTS: Rate / Cover 13-week bills 2.360% 3.52 26-week bills 2.355% 3.26	**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 RESULTS:** Rate / Cover 4-week bills 2.365% 2.85 8-week bills 2.355% 3.10 **ANNOUNCE:** $72 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: $72 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:** $72 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:** $72 billion 13-,26-week bills $26 billion 52-week bills	
27	28	29	30	31
MEMORIAL DAY	**AUCTION:** $72 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:** $72 billion* 13-,26-week bills for auction on June 3 **SETTLE:** $72 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
3	4	5	6	7
AUCTION: $72 billion* 13-,26-week bills	**ANNOUNCE:** $50 billion* 4-week bills for auction on June 6 $35 billion* 8-week bills for auction on June 6 **SETTLE:** $50 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $50 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on June 10 $38 billion* 3-year notes for auction on June 11 $24 billion* 10-year notes for auction on June 12 $16 billion* 30-year bonds for auction on June 13 **SETTLE:** $72 billion* 13-,26-week bills	

**Estimate*