Daiwa Capital Markets

U.S. Economic Comment

- Monetary policy: no change in our view of steady policy this year, cuts next year

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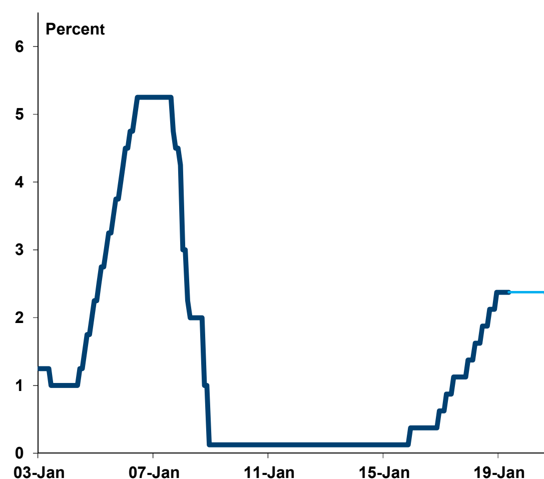
Monetary Policy

Expectations for monetary policy have shifted dramatically in recent weeks, with market participants now looking for multiple cuts in the federal funds rate this year. We are not jumping on this bandwagon. While we expect the next change in monetary policy to involve a cut in rates, we do not see that happening until next year. Our current view has the cuts occurring in the second half of next year (chart). We may need to pull those shifts forward to the first half, but we are sticking to changes in 2020 rather than 2019.

We are not mystified by the swing in market sentiment. The Fed most likely will err on the side of accommodation in order to preserve the expansion, and we have seen hints of slower economic growth. Thus, it is natural to begin thinking of easier monetary policy. At the same time, we believe the market response has been excessive. While there are several reasons to expect the next change in policy to involve a cut in rates -- such as trade disruptions, slow economic growth, contained inflation, and tighter financial conditions -- the case for any one of these is not strong at this time. Consider each in turn.

Fed Funds Target Rate*



** The midpoint of the federal funds target rate. The thin line is a forecast.*
Source: Federal Open Market Committee via Haver Analytics; Daiwa Capital Markets America

Trade Disruptions

The biggest shift in market sentiment occurred after the threat of President Trump to impose tariffs on imports from Mexico. This action could carry severe consequences for the U.S. economy because of extensive supply chains linking economic activity in the two countries. However, the President's actions in the days and weeks ahead are far from clear. We suspect that the President's statements contain a strong element of bluster, and thus his actions are not likely to be forceful. In addition, officials in Mexico seem willing to take some action to stem immigration flows, which could allow Mr. Trump to declare a cease fire on this front.

Tariff actions taken thus far seem to have had some constraining influence on trade flows, as both exports and imports have shifted from upward trends to sideways movement (charts, next page). Slower economic growth and currency changes have probably influenced trade flows as well, but with much of the deceleration driven by trade with China (nominal exports off 17 percent from their recent peak and imports down 3.8 percent), tariffs seem to be playing a leading role.

Trade has slowed in response to tariffs, but shifts thus far do not seem strong enough to suggest that a meaningful slowdown is developing. The absence of export growth will dampen the overall expansion, but this is less drastic than the consequences of an outright decline. The softening in imports might lead to more activity in the domestic market and thus provide a boost to growth. In fact, net exports contributed substantially to GDP growth in Q1, and data for April raised the possibility of a small boost in Q2.

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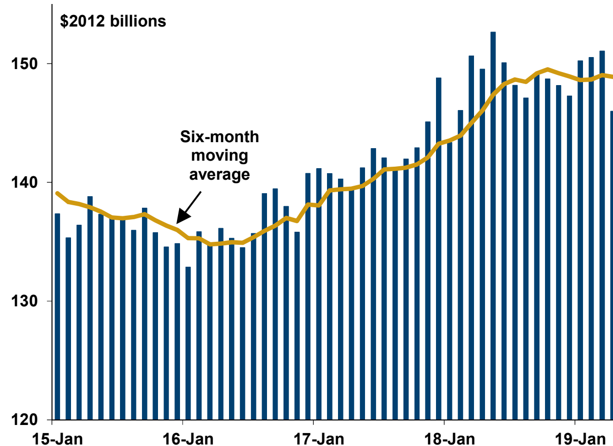
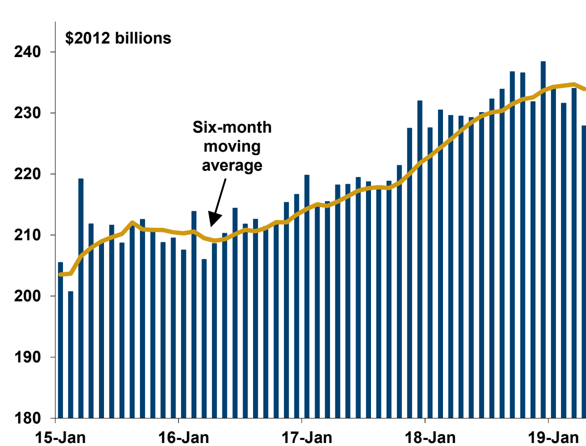
Real Exports of Goods



Source: Bureau of Economic Analysis via Haver Analytics

Real Imports of Goods



Source: Bureau of Economic Analysis via Haver Analytics

Economic Growth

Growth in the U.S. is clearly slowing from the pace of approximately three percent in 2018. Activity in Q1 remained firm at 3.1 percent, but a good portion of this expansion was the result of inventory investment (0.6 percentage point), which is likely to be temporary. Also, net exports added a full percentage point, which is not likely to be repeated. Final domestic demand (GDP less inventory investment and net exports, perhaps a better gauge of the underlying trend at this time) grew 1.5 percent in the first quarter. Another measure of aggregate output -- gross domestic income -- grew 1.4 percent in the first three months of the year. This measure in theory should match the growth of GDP, but the two often differ because of measurement errors and differing data sources. The slower pace of GDI leads one to wonder about an overstatement of activity as measured by GDP.

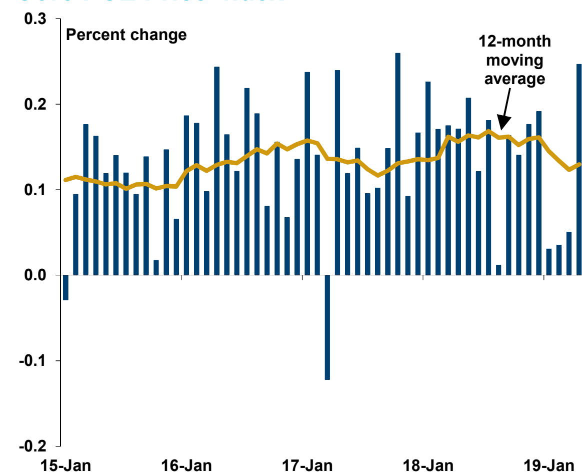
Data so far in the second quarter are pointing to GDP growth of 1.5 to 2.0 percent, and we expect a similar pace in the second half of the year. This performance pales in comparison to growth last year, but it is not recession-like. In fact, this pace is in line with the potential growth rate of the economy, and at a time of full employment, this is a satisfactory pace.

John Williams of the New York Fed argued in a recent speech that benchmarks for evaluating the economy's performance should be adjusted because of structural changes that have occurred. Specifically, slower growth of productivity and the working-age population limit the potential of the U.S. economy and thus slower paces of growth than in the past should be expected. Mary Daly of the San Francisco Fed made similar comments this week by noting that growth has moved in line with a natural pace. Thus, economic growth is slowing, but not to such a degree that it warrants easier monetary policy.

Inflation

Many observers point to the slow rate of inflation as a reason to ease monetary policy, and inflation has indeed been contained. The core price index for personal consumption expenditures (PCE) has been below the Fed's target of 2.0 percent in most years since 2010 and rose at an annual rate of only 1.0

Core PCE Price Index



PCE = personal consumption expenditures
Source: Bureau of Economic Analysis via Haver Analytics

percent in the first quarter. However, Chairman Powell and others have argued that restraint in early 2019 was largely the result of transitory factors.

The April results for the PCE price index support the view of Mr. Powell, as the core index posted one of its sharpest increases of the past few years (chart, prior page). Moreover, the pickup occurred in areas highlighted by Chairman Powell as likely to be temporary (airfares and charges for financial services). We do not mean to suggest that inflation is about to jump; in fact, we expect inflation to remain subdued and we suspect that Fed officials will tolerate some breach of the two-percent target. But the inflation results in early 2019 do not suggest a need for lower interest rates at this time.

Financial Conditions

The equity market wavered again in May, with the S&P 500 declining almost seven percent. The drop seemed tied to perceived recession risks by investors, and the drop itself could trigger a downturn through negative wealth effects on consumer spending or through cost of capital constraints on business investment. Thus, the Fed might have contemplated easier policy because of the shift in financial conditions.

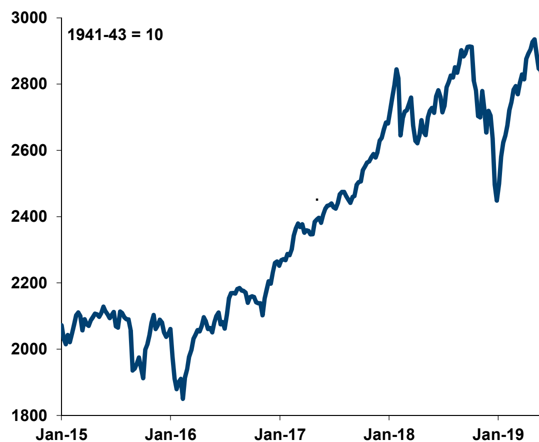
However, the market has bounced back this week, recouping much of the ground lost during May). Even before the rebound, the argument for altering monetary policy in response to the equity market was weak. The drop in May, while noticeable, was far less pronounced than the adjustment last fall (chart, left). The cumulative decline of almost 20 percent from early October to the end of the year caught the Fed's attention and played a role in the Fed's pivot toward its patient posture. The latest move was a different order of magnitude and thus less likely to prompt a reaction from the Fed.

The situation with credit spreads is similar. Spreads drifted upward during the first three quarters of last year and they took a noticeable step higher in the closing months of 2018 (chart, right). However, spreads remained below levels earlier in the expansion and were far below levels that would be expected as a recession approached.

Summary: Policy on Hold

We are sympathetic to the view that the Fed will strive the keep the economy on track and that it will err on the side of accommodation. However, we do not look for the Fed to act rashly. It will need a convincing case before rates are lowered, and the arguments are not compelling at this time. If President Trump in fact moves aggressively on tariffs and the economy slips in response, we will look for a bold move from the Fed. But a tweet from a volatile president does not warrant an adjustment.

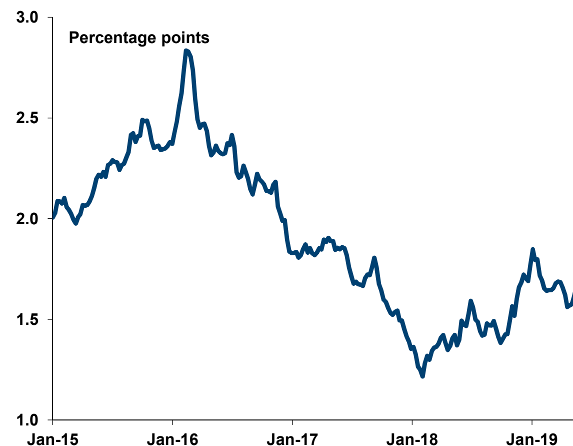
S&P 500 Index*



Weekly average data, except for the last observation which is a closing quote for June 7, 2019.

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

Corporate Credit Spread*



An index of A-rated corporate bond yields less the 10-year Treasury rate. Weekly average data, except for the last observation which is the spread for June 6, 2019.

Source: Bank of America Merrill Lynch via Haver Analytics

Review

Week of June 3, 2019	Actual	Consensus	Comments
ISM Manufacturing Index (May)	**52.1 (-0.7 Pct. Pt.)**	**53.0 (+0.2 Pct. Pt.)**	The ISM manufacturing index, which has been moving irregularly lower since last summer, fell again in May. The decline left the index well shy of the average of 58.8% in 2018 and at its lowest level since October 2016. The drop in May was led by the supplier delivery and inventory components (-2.6 pct. pts. and -2.0 pct. pts., respectively). We view these measures as less important than the new orders, production, and employment components. These key components also were unimpressive: production slipped 1.0 pct. pt. to 51.3%, while new orders and employment remained at low levels (up 1.0 pct. pt. to 52.7% and up 1.3 pct. pts to 53.7%, respectively).
Construction Spending (April)	**0.0%**	**0.4%**	The flat reading on construction activity was not deeply disappointing because results in the prior two months were revised upward, with the adjustments pushing the level of activity in March 1.3% above the previous tally. Government-related construction was strong in April (up 4.8% after a cumulative jump of 10.5% in the prior three months), but a drop of 1.7% in the private sector provided an offset. Private residential construction continued its downward drift (off 0.6%). Business related activity dropped 2.9%, offsetting gains in the prior four months and leaving a flat trend since last summer.
Factory Orders (April)	**-0.8%**	**-1.0%**	Much of the decline in factory orders in April reflected the already-reported drop of 2.1% in bookings for durable goods, with the weakness in durables stemming primarily from slippage in transportation-related orders (both aircraft and motor vehicles). Durable orders ex-transportation showed no change, continuing the slow performance that began in the middle of last year. New orders for nondurable goods rose 0.5%, but much of this advance occurred in the petroleum and coal category (+2.0%), which was probably driven by higher prices rather than firmer volumes. Nondurable bookings ex-petroleum and coal edged 0.1% higher from a downwardly revised level, continuing the sideways trend in place since August.
ISM Nonmanufacturing Index (May)	**56.9 (+1.4 Pct. Pts.)**	**55.4 (-0.1 Pct. Pt.)**	The increase in the ISM nonmanufacturing index in May left the measure shy of the average of 58.9% in 2018, but it was encouraging nonetheless, as it exceeded expectations and suggested that the economy was not flagging. The employment index led the advance with a jump of 4.4 pct. pts., a change that pushed the measure to the upper end of its recent range. The business activity component also was firm with an increase of 1.7 pct. pts., which compared favorably with the average from last year. The new orders index rose 0.5 pct. pt. to 58.6%. The level of the orders index was respectable from a longer-term perspective, but it lagged the average of 61.3% in 2018.

Review Continued

Week of June 3, 2019	Actual	Consensus	Comments
Trade Balance (April)	**-$50.8 Billion ($1.1 Billion Narrower Deficit)**	**-$50.7 Billion ($0.7 Billion Wider Deficit)**	The trade report was encouraging in that the deficit narrowed slightly from the results in the prior month and from the average in the first quarter, raising the possibility of a positive contribution to GDP growth in Q2. The boost to growth would be small -- perhaps ¼ pct. pt. -- but any boost in a difficult trade environment would be welcome. While the deficit narrowed in April, it was a “soft” improvement; that is, both exports and imports fell, with imports showing the larger change. A slower pace of economic growth, both in the U.S. and abroad, is probably having some influence on the results, but disruptions associated with trade tensions are probably having an effect as well.
Revised Nonfarm Productivity (2019-Q1)	**3.4% (-0.2 Pct. Pt. Revision)**	**3.5% (-0.1 Pct. Pt. Revision)**	A downward nudge to output growth in Q1 led to a slightly smaller advance in productivity, although the increase was still among the best of the current expansion and joined with other recent firm readings to suggest that productivity growth is beginning to accelerate. The more notable revision to the data was a disappointing adjustment to the growth of compensation per hour, which was revised three pct. pts. lower in Q3 (0.9% rather than 3.9%) and 0.8 pct. pt. lower in Q1 (1.8% versus 2.6%). This slower pace, along with the favorable results on productivity, has led to declines in unit labor costs in three of the past four quarters with a net drop of 0.8% over this span.
Payroll Employment (May)	**75,000**	**175,000**	Modest job growth in May was joined by downward revisions of 75,000 in the prior two months, effectively leaving no net job growth. The net flat reading on monthly job growth might seem to signal economic difficulties, but the results were not deeply troubling, as the average advance in payrolls of 151,000 in the past three months was still respectable. The unemployment rate held steady at 3.6%, but it ticked higher if rounded to more than one decimal point (3.620% versus 3.585% in April). The size of the labor force rose 176,000, exceeding employment growth of 113,000 as reported in the household survey and leading to the wiggle higher in unemployment. Average hourly earnings rose 0.2%. The monthly change left the year-over-year advance at 3.1%, down from 3.2% in the prior two months and a recent cyclical high of 3.4% in February.

Source: Institute for Supply Management (ISM Manufacturing Index, ISM Nonmanufacturing Index); U.S. Census Bureau (Construction Spending, Factory Orders); Bureau of Economic Analysis (Trade Balance); Bureau of Labor Statistics (Revised Nonfarm Productivity, Payroll Employment); Consensus forecasts are from Bloomberg

Preview

Week of June 10, 2019	Projected	Comments
PPI (May) (Tuesday)	**0.2% Total, 0.2% Core***	Gasoline prices rose in May, but by no more than seasonal norms, and thus the energy component of the PPI is likely to be calm. Food prices were rising noticeably for a time, but they have settled in the past few months. Prices of goods other than food and energy have generally been contained (up an average of 0.1% in the past six months) and are likely to stay within the recent range. Prices of services often move erratically and carry the potential for surprises.
CPI (May) (Wednesday)	**0.2% Total, 0.2% Core**	Energy prices should settle after sharp increases in the prior two months, as available data suggest changes in line with normal seasonal movement. Food prices settled in April after upward pressure from November through March. In the core component, an unwinding of the transitory factors that restrained inflation in the early months of the year will probably lead to an increase of 0.2%.
Federal Budget (May) (Wednesday)	**$200.0 Billion Deficit**	Available data suggest firm growth in revenues (up approximately 5% from the same month last year), but outlays are likely to be hefty as well, partly because of a calendar configuration that puled some spending from June into May. If the forecast proves accurate, the budget deficit in the first eight months of the year will total $731 billion, up from $532 billion in the same period in fiscal year 2018.
Retail Sales (May) (Friday)	**0.4% Total, 0.0% Ex-Autos**	A jump in sales of new vehicles should boost the auto component of the retail report, but slow results at service stations because of lower gasoline prices (after seasonal adjustment) is likely to provide a partial offset. Spending elsewhere is likely to be moderate given slow job growth in the latest month. The unsettled equity market also might give some individuals pause.
Industrial Production (May) (Friday)	**0.0%**	The manufacturing component of the industrial production report will probably join the string of other statistics showing slow activity in the factory sector (employment, orders, ISM). A pickup in utility output because of above-average temperatures at the start of the cooling season could give a lift to the headline figure, but a drop in the rotary-rig count raises the possibility of an offset in the mining sector.
Consumer Sentiment (June) (Friday)	**99.0 (-1.0%)**	Hesitation in the equity market and a steady flow of news on trade tensions are likely to dampen moods of consumers.

** The core PPI excludes food, energy, and trade services.*
Source: Forecasts provided by Daiwa Capital Markets America

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Economic Indicators

June 2019

Monday	Tuesday	Wednesday	Thursday	Friday
3	4	5	6	7
ISM INDEX Index / Prices Mar 55.3 54.3 Apr 52.8 50.0 May 52.1 53.2 **CONSTRUCTION SPEND.** Feb 1.0% Mar 0.1% Apr 0.0% **VEHICLE SALES** Mar 17.3 million Apr 16.3 million May 17.3 million	**FACTORY ORDERS** Feb -1.0% Mar 1.3% Apr -0.8%	**ADP EMPLOYMENT REPORT** Private Payrolls Mar 158,000 Apr 271,000 May 27,000 **ISM NON-MFG INDEX** Index / Prices Mar 56.1 58.7 Apr 55.5 55.7 May 56.9 55.4 **BEIGE BOOK** "Overall Economic Activity Economic activity expanded at a modest pace overall from April through mid-May..."	**INITIAL CLAIMS** May 18 212,000 May 25 218,000 April 01 218,000 **TRADE BALANCE** Feb -$50.0 billion Mar -$51.9 billion Apr -$50.8 billion **REVISED PRODUCTIVITY & COSTS** Productivity / Unit Labor Costs 18-Q4 1.3% -0.4% 19-Q1(p) 3.6% -0.9% 19-Q1(r) 3.4% -1.6%	**EMPLOYMENT REPORT** Payrolls / Un. Rate Mar 153,000 3.8% Apr 224,000 3.6% May 75,000 3.6% **WHOLESALE TRADE** Inventories / Sales Feb 0.4% 0.3% Mar 0.0% 1.8% Apr 0.8% -0.4% **CONSUMER CREDIT** Feb $15.4 billion Mar $11.0 billion Apr $17.4 billion
10	11	12	13	14
JOLTS DATA (10:00) Openings (000) / Quit Rate Feb 7,142 2.3% Mar 7,488 2.3% Apr -- --	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** Mar 101.8 Apr 103.5 May -- **PPI (8:30)** Final Demand / Core* Mar 0.6% 0.0% Apr 0.2% 0.4% **May 0.2% 0.2%**	**CPI (8:30)** Total / Core Mar 0.4% 0.1% Apr 0.3% 0.1% **May 0.2% 0.2%** **FEDERAL BUDGET (2:00)** 2019 / 2018 Mar -$146.9B -$208.7B Apr $160.3B $214.3B **May -$200.0B** -$146.8B	**INITIAL CLAIMS (8:30)** **IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports / Nonagri. Exports Mar -0.2% 0.7% Apr -0.1% 0.4% May -- --	**RETAIL SALES (8:30)** Total / Ex.Autos Mar 1.7% 1.3% Apr -0.2% 0.1% **May 0.4% 0.0%** **IP & CAP-U (9:15)** IP / Cap.Util. Mar 0.2% 78.5% Apr -0.5% 77.9% **May 0.0% 77.7%** **CONSUMER SENTIMENT (10:00)** Apr 97.2 May 100.0 **June 99.0** **BUSINESS INVENTORIES (10:00)** Inventories / Sales Feb 0.3% 0.1% Mar 0.0% 1.2% **Apr 0.5% -0.4%**
17	18	19	20	21
EMPIRE MFG **NAHB HOUSING INDEX** **TIC DATA**	**HOUSING STARTS** **FOMC MEETING**	**FOMC DECISION** **POWELL PRESS CONFERENCE**	**INITIAL CLAIMS** **CURRENT ACCOUNT** **PHILLY FED INDEX** **LEADING INDICATORS**	**EXISTING HOME SALES**
24	25	26	27	28
CHICAGO FED NAT'L ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **NEW HOME SALES** **CONSUMER CONFIDENCE**	**DURABLE GOODS ORDERS** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES**	**INITIAL CLAIMS** **REVISED GDP** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, PRICES** **CHICAGO PURCHASING MANAGERS' INDEX** **REVISED CONSUMER SENTIMENT**

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

Forecasts in Bold. (p) = preliminary; (r) = revised

Treasury Financing

June 2019

Monday	Tuesday	Wednesday	Thursday	Friday
3	4	5	6	7
AUCTION RESULTS: Rate Cover 13-week bills 2.300% 2.59 26-week bills 2.255% 2.70	**ANNOUNCE:** $40 billion 4-week bills for auction on June 6 $35 billion 8-week bills for auction on June 6 **SETTLE:** $40 billion 4-week bills $35 billion 8-week bills		**AUCTION RESULTS:** Rate Cover 4-week bills 2.290% 2.75 8-week bills 2.300% 2.73 **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	
10	11	12	13	14
AUCTION: $72 billion 13-,26-week bills	**AUCTION:** $38 billion 3-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on June 13 $35 billion* 8-week bills for auction on June 13 **SETTLE:** $40 billion 4-week bills $35 billion 8-week bills	**AUCTION:** $24 billion 10-year notes	**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $16 billion 30-year bonds **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on June 17 $26 billion* 52-week bills for auction on June 18 $15 billion* 5-year TIPS for auction on June 20 **SETTLE:** $72 billion 13-,26-week bills	
17	18	19	20	21
AUCTION: $72 billion* 13-,26-week bills **SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**AUCTION:** $26 billion* 52-week bills **ANNOUNCE:** $40 billion* 4-week bills for auction on June 20 $35 billion* 8-week bills for auction on June 20 **SETTLE:** $40 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $15 billion* 5-year TIPS **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on June 24 $18 billion* 2-year FRNs for auction on June 26 $40 billion* 2-year notes for auction on June 25 $41 billion* 5-year notes for auction on June 26 $32 billion* 7-year notes for auction on June 27 **SETTLE:** $72 billion* 13-,26-week bills $26 billion* 52-week bills	
24	25	26	27	28
AUCTION: $72 billion* 13-,26-week bills	**AUCTION:** $40 billion* 2-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on June 27 $35 billion* 8-week bills for auction on June 27 **SETTLE:** $40 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $18 billion* 2-year FRNs $41 billion* 5-year notes	**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $32 billion* 7-year notes **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on July 1 **SETTLE:** $72 billion* 13-,26-week bills	**SETTLE:** $15 billion* 5-year TIPS $18 billion* 2-year FRNs

**Estimate*