U.S. Economic Comment

- Capital spending: key source of downside risk
- Federal budget update: firm revenue growth in past several months,
  But outlays also growing briskly

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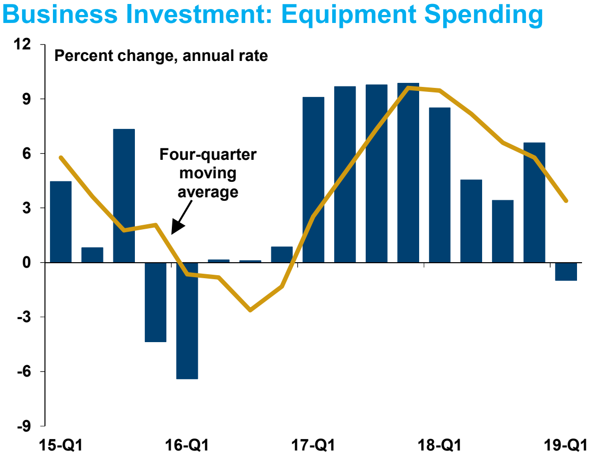
Business Investment:

Fed Chairman Jerome Powell did not make an effort in his Congressional testimony this week to dampen market expectations for a rate cut at the July FOMC meeting, and thus he seems likely to ease monetary policy this month. The Chairman's testimony, as well as the minutes from the June meeting of the Federal Open Market Committee, indicated that policymakers viewed the economy as performing well, but they have become concerned about downside risks generated by trade tensions and slow economic growth abroad. Muted inflation also is a factor behind the Fed's dovish shift.

If downside risks were to materialize, they most likely would take the form of reduced capital spending by business firms. Trade tensions could disrupt supply chains and reduce export demand, and uncertainty about such developments could lead business executives to delay spending decisions. Even before these risks emerged, investment was not on a firm trajectory. Businesses are actively spending on software and research and development, but they are limiting construction activity and outlays for new equipment. Indeed, outlays for new equipment fell in the first quarter after mediocre results in the prior three quarters (chart, left). In addition, recent figures on shipments of capital goods, as well as exports and imports of capital goods, suggest slow activity again in Q2. New and unfilled orders for capital goods do not offer much hope for revival in the second half (chart, right).

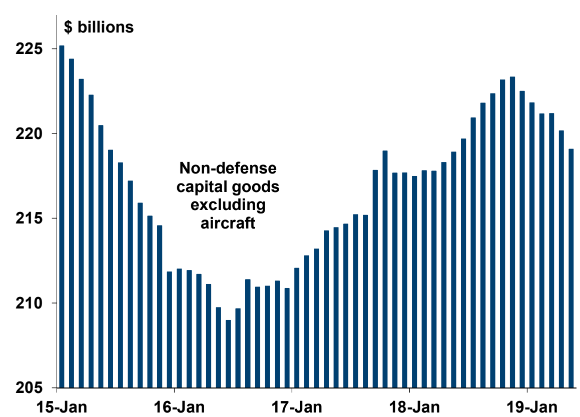
Chairman Powell also referred to surveys of business attitudes and capital spending plans to suggest the potential for further slowing in capital spending. Several measures are available and they tell similar stories: executives are less optimistic than they were during much of 2018, although attitudes are still elevated relative to historical standards. The top charts on the next page are from the Business Roundtable, a group of executives from large businesses. The overall business outlook index has declined for five consecutive quarters from an elevated level in early 2018, but it still is within the recent range. Similarly, plans for capital spending are off their recent high, but they remain in the upper portion of the range from the past few years. The middle charts are from the National Federation of Independent Business, which represents small firms. Here too, optimism and spending plans have eased, but they remain in line with observations before 2018. The charts lead us to conclude that businesses have become cautious, although they are not in full-fledged retreat.

Business Investment: Equipment Spending



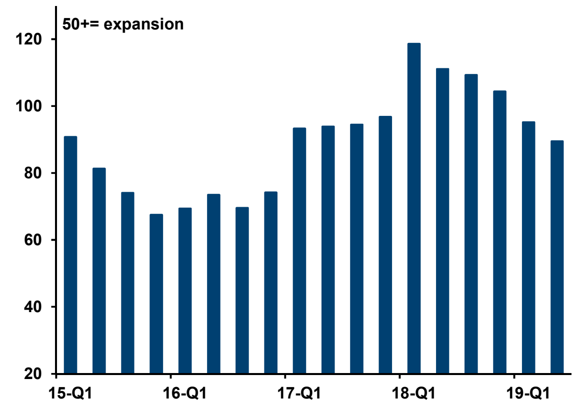
Source: Bureau of Economic Analysis via Haver Analytics

Unfilled Orders for Durable Goods



Source: U.S. Census Bureau via Haver Analytics

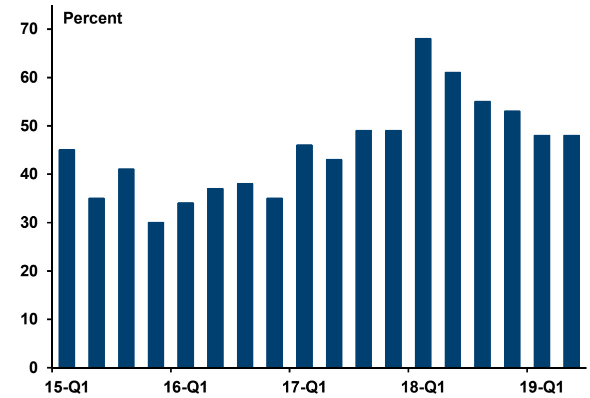
CEO Economic Outlook Survey*



* A composite measure based on expected sales, planned capital spending, and intentions for hiring. The series is constructed to range from -50 to +150 with the value 50 separating expansion from contraction.

Source: Business Roundtable via Haver Analytics

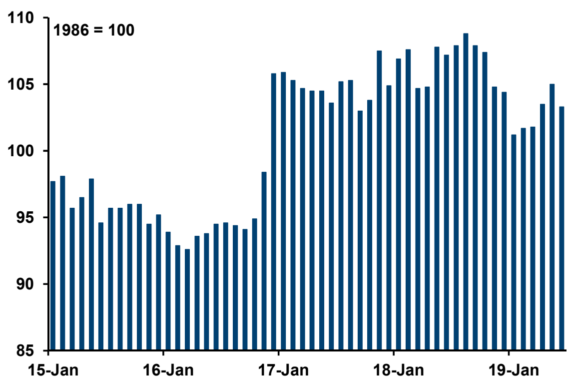
Outlook for Capital Spending*



* Outlook for capital spending by large firms. The share of respondents planning to increase capital spending in the next six months.

Source: Business Roundtable via Haver Analytics

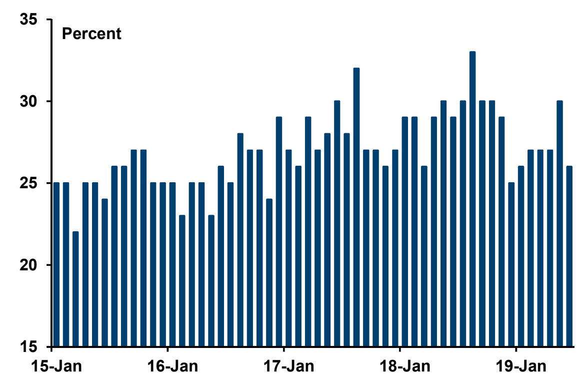
Small Business Optimism Index*



* A composite series based on 10 components, including expectations for sales, employment, capital spending, earnings.

Source: National Federation of Independent Business via Haver Analytics

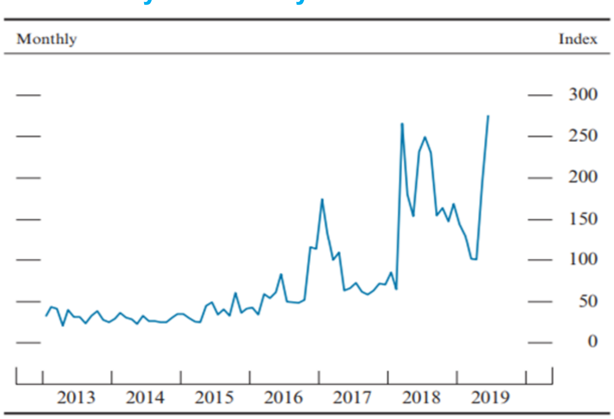
Outlook for Capital Spending*



* The share of respondents planning capital expenditures in the next three to six months.

Source: National Federation of Independent Business via Haver Analytics

Trade Policy Uncertainty*

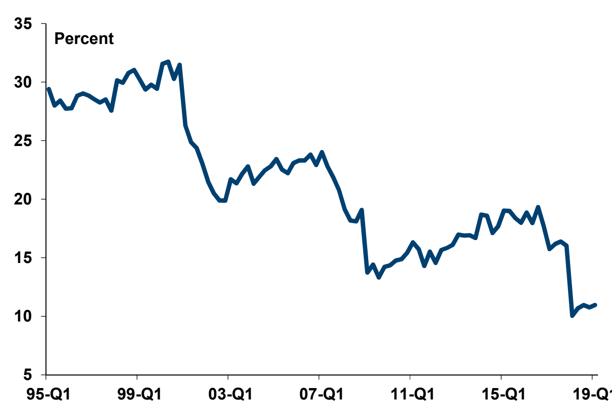


* The data extend through June 2019. At an index value of 100, one percent of news articles contain references to trade policy uncertainty.

Source: Federal Reserve Board of Governors, Monetary Policy Report: July 2019

Fed sources: Dario Caldara, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (2019), "The Economic Effects of Trade Policy Uncertainty," manuscript presented at the 91st meeting of the Carnegie-Rochester-NYU Conference on Public Policy, held at New York University, New York, April 12-13.

Effective Corporate Tax Rate*



* Taxes paid by corporations as a share of pre-tax income, based on data from the National Income and Product Accounts.

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

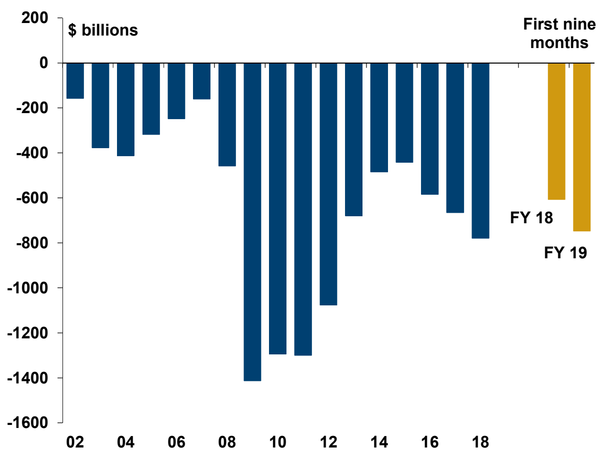
Chairman Powell suggested that uncertainty generated by trade disputes was the driving force behind the easing in confidence and spending plans. The full report on monetary policy that accompanied his testimony contained a chart supporting this view, as an uncertainty index tied to trade was elevated much of last year and it jumped to a new high recently (chart, p. 2, bottom left).

We also wonder about the influence of the Tax Cut and Jobs Act on business attitudes toward investment. The legislation contained several provisions that should encourage investment (lower tax rates, full expensing of equipment outlays, incentives to repatriate foreign earnings) but it also eliminated or limited various deductions. The effective tax rate paid by corporations (taxes paid as a share of profits) provides a convenient summary of the net effect of all the business provisions, and the measure shows that the spur to investment spending might be less than envisioned. While the statutory tax rate fell 14 percentage points (35 percent to 21 percent), the effective rate has declined only five percentage points (15 percent to 10 percent; chart, p. 2, bottom right). Business executives were most likely enthused with the passage of the tax act, but their views might have softened after careful analysis of the provisions and their net effect.

Budget Update

The federal government completed the first three quarters of its fiscal year in June, and the budget results for the latest month (deficit of $8.5 billion) left the cumulative shortfall thus far in the fiscal year at $747.1 billion, compared with $607.1 billion in the same period in FY2018 (chart). Revenue growth has been uninspiring so far this year, totaling only 2.7 percent. However, the overall advance reflects a decline of 1.7 percent in the first four months of the fiscal year and growth of 6.2 percent in the past five months. The slow results in the first four months of the fiscal year were the result of diminished withholding and estimated payments because of the Tax Cuts and Jobs Act. That Act is now more than one-year old, and thus year-over-year comparisons are no longer influenced by the lower tax rates.

Federal Budget Deficit*



** Fiscal year basis. The blue bars show the federal budget deficits for full fiscal years 2002-2018. The gold bars to the right show the deficits for the first nine months of FY2018 and FY2019.*

Source: U.S. Treasury Department via Haver Analytics

Individual tax receipts have declined so far in the current year (off 0.3 percent), but all of the drop occurred in the early months of the year. Receipts from individuals grew 6.2 percent in the past five months. Corporate collections have increased 1.6 percent in the first nine months of the year, with a drop of more than 20 percent in the first four months and a slightly larger increase in the past five. Excise tax collections, although a small share of the total, have increased 12.9 percent this year, reflecting a new tax on providers of health insurance. Customs duties have been strong because of the various tariffs imposed by the Trump Administration (up 78.2 percent). On the soft side, remittances from the Federal Reserve have declined 27.9 percent, reflecting both a smaller portfolio of securities and larger payments for interest on reserves.

Outlay growth totaled 6.6 percent in the first nine months of the fiscal year, noticeably faster than rates ranging from 3.2 to 4.5 percent in the prior three fiscal years. Retiring baby boomers played a role, as outlays for Social Security and Medicare rose 5.6 and 6.4 percent, respectively. The two-year budget deal made in early 2018 also boosted outlays, as higher caps on spending led to a jump of 8.4 percent in defense expenditures. The Tax Cuts and Jobs Act had an influence, as refundable portions of the earned income and child tax credits rose briskly. The Department of Education registered a shocking advance in spending (85.1 percent), with most of the shift reflecting a revision to estimated losses on student loans. Net interest on the public debt jumped 16.4 percent, reflecting both a larger pool of outstanding debt and higher interest rates.

There were some favorable developments on the outlay side of the budget. Spending by the Department of Homeland Security fell by 20.8 percent, although the drop was the result of good luck rather than fiscal discipline (fewer natural disasters). The Department of Housing and Urban Development reported a decline of 62.1 percent, primarily reflecting a favorable reestimate on losses from housing-related loans. Fannie Mae and Freddie Mac remitted more to the Treasury Department than they did last year, with this category increasing by $11.8 billion or 156.4 percent (these payments are treated as negative outlays; items other than Fannie and Freddie remittances are also included in this category).

Assuming that revenues and outlays continue to grow at their recent paces, the deficit in the final quarter of the fiscal year would total approximately $200 billion, which would leave the full year deficit in the neighborhood of $950 billion. Such a shortfall would probably translate to 4.5 percent of GDP, up from 3.9 percent in the prior fiscal year and a cyclical low of 2.4 percent in FY2015. The Congressional Budget Office currently expects the deficit in FY2020 to approximately match that in 2019, but that projection is based on the assumption that Congress adheres to spending caps currently in place. Legislators most likely will waive those caps, which will probably result in further deficit widening next year.

Review

Week of July 8, 2019	Actual	Consensus	Comments
CPI (June)	**0.1% Total, 0.3% Core**	**0.0% Total, 0.2% Core**	The increase in the core CPI exceeded expectations, but the jump was not especially troublesome as it followed changes of only 0.1% in the prior four months. The cumulative shift in the first half of the year totaled 2.1% (annual rate), the same as the change in the past 12 months. In addition, some of the increase could be viewed as random volatility, as a portion of the pressure occurred in the volatile apparel and used-vehicle categories. Energy prices fell 2.3% in June after a dip in May, keeping the level of the energy index below readings from last fall. Food prices were unchanged in June after increasing only marginally on average in the prior two months. With the prices of food and energy contained, the headline CPI rose 1.6% in the past year, a reading in the middle of the range from the current expansion.
Federal Budget (June)	**$8.5 billion Deficit**	**$7.9 billion Deficit**	Revenue growth in recent months has been on a firm track after easing last year because of the Tax Cuts and Jobs Act. Year-over-year growth in June totaled 5.6%, slower than the average increase of 7.0% in the prior four months, but better than the average drop of 1.4% in calendar-year 2018. Outlays were restrained in June, trailing the average in the current fiscal year by 9.1%. Part of the softness reflected a calendar configuration that shifted some spending from June into May, but light months for Medicare and defense spending also contributed. The deficit for the first nine months of the fiscal year totaled $747.1 billion, wider than the shortfall of $607.1 billion in the same period in FY2018.
PPI (June)	**0.1% Total, 0.0% Core***	**0.0% Total, 0.2% Core***	Food prices provided an upside surprise with a jump of 0.6%, but the pressure was concentrated in foods for export. Prices of finished consumer foods rose 0.2%, which represented only a partial offset to declines in the prior two months. Energy prices fell 3.1%, in line with expectations. Prices of goods excluding food and energy were unchanged in June, while prices of services jumped 0.4%. The pressure in the service area was led by a surge of 1.3% in the cost of trade services, which is excluded from the PPI definition of core prices, and thus the core index was unchanged. The latest results left the year-over-year change in the headline index at 1.7%, down from a recent peak of 3.3% in June 2018 and the slowest rate since November 2016. The core index rose 2.1% in the past year, up slightly from the prior month but still noticeably below the 3.1% reading in September of last year.

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

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

Preview

Week of July 15, 2019	Projected	Comments
Retail Sales (June) (Tuesday)	**0.1% Total, 0.4% Ex-Autos**	Lower prices should lead to a drop in the gasoline component, which is likely to constrain the headline measure. Elsewhere, solid fundamentals for consumer spending (firm job market, healthy balance sheets) are likely to lead to respectable growth.
Industrial Production (June) (Tuesday)	**0.2%**	A pickup in employment in the factory sector, along with a longer workweek, suggest that the manufacturing component advanced for the second consecutive month after declining or showing no change in the first four months of the year. A dip in the rotary-rig count suggests only a modest productivity-led increase in mining. Risks are tilted toward the downside in the utility sector, as temperatures shifted from slightly above normal in May to slightly below in June, which could lessen the usage of air conditioning.
Housing Starts (June) (Wednesday)	**1.260 Million (-0.7%)**	A favorable interest rate environment is likely to encourage the construction of single-family homes, but a correction in the volatile multi-family sector after a firm reading in May could push total starts lower.
Leading Indicators (June) (Thursday)	**0.0%**	Small positive contributions from the leading credit index, the manufacturing workweek, stock prices, and consumer expectations are likely to be offset by negative contributions from the ISM new orders index, initial unemployment claims, and the slope of the yield curve. Our calculations show no change in the index, although it could round down to -0.1%. Also, building permits (released July 17) represent a wild card.
Consumer Sentiment (July) (Friday)	**99.0 (+0.8%)**	With the stock market up, energy prices down, and the labor market retaining a favorable tone, the sentiment index could inch higher from its firm reading in June.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July/August 2019

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
CONSUMER CREDIT Mar $11.0 billion Apr $17.5 billion May $17.1 billion	**NFIB SMALL BUSINESS OPTIMISM INDEX** Apr 103.5 May 105.0 June 103.3 **JOLTS DATA** Openings (000) Quit Rate Mar 7,474 2.3% Apr 7,372 2.3% May 7,323 2.3%	**WHOLESALE TRADE** Inventories Sales Mar 0.0% 1.8% Apr 0.8% -0.4% May 0.4% 0.1% **POWELL SEMI-ANNUAL MONETARY POLICY TESTIMONY (HOUSE)** **FOMC MINUTES**	**INITIAL CLAIMS** June 22 229,000 June 29 222,000 July 06 209,000 **CPI** Total Core Apr 0.3% 0.1% May 0.1% 0.1% June 0.1% 0.3% **FEDERAL BUDGET** 2019 2018 Apr $160.3B $214.3B May -$207.8B -$146.8B June -$8.5B -$74.9B **POWELL SEMI-ANNUAL MONETARY POLICY TESTIMONY (SENATE)**	**PPI** Final Demand Core* Apr 0.2% 0.4% May 0.1% 0.4% June 0.1% 0.0%
15	16	17	18	19
EMPIRE MFG (8:30) May 17.8 June -8.6 July --	**RETAIL SALES (8:30)** Total Ex.Autos Apr 0.3% 0.5% May 0.5% 0.5% **June 0.1% 0.4%** **IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports Nonagri. Exports Apr -0.1% 0.2% May -0.3% -0.2% June -- -- **IP & CAP-U (9:15)** IP Cap.Util. Apr -0.4% 77.9% May 0.4% 78.1% **June 0.2% 78.1%** **NAHB HOUSING INDEX (10:00)** May 66 June 64 July -- **BUSINESS INVENTORIES (10:00)** Inventories Sales Mar 0.0% 1.3% Apr 0.6% -0.3% **May 0.3% 0.2%** **TIC DATA (4:00)** Total Net L-TI Mar -$5.6B -$25.9B Apr -$7.8B $46.9B May -- --	**HOUSING STARTS (8:30)** Apr 1.281 million May 1.269 million **June 1.260 million** **BEIGE BOOK (2:00)** **June 2019 Beige Book** "Economic activity expanded at a modest pace overall from April through mid-May, a slight improvement over the previous period."	**INITIAL CLAIMS (8:30)** **PHILLY FED INDEX (8:30)** May 16.6 June 0.3 July -- **LEADING INDICATORS (10:00)** Apr 0.1% May 0.0% **June 0.0%**	**CONSUMER SENTIMENT (10:00)** May 100.0 June 98.2 **July 99.0**
22	23	24	25	26
CHICAGO FED NAT'L ACTIVITY INDEX	**FHFA HOME PRICE INDEX** **EXISTING HOME SALES**	**NEW HOME SALES**	**INITIAL CLAIMS** **DURABLE GOODS ORDERS** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES**	**Q2 GDP**
29	30	31	1	2
	PERSONAL INCOME, CONSUMPTION, PRICES **S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **PENDING HOME SALES** **CONSUMER CONFIDENCE** **FOMC MEETING**	**ADP EMPLOYMENT REPORT** **EMPLOYMENT COST INDEX** **FOMC DECISION** **POWELL PRESS CONFERENCE**	**INITIAL CLAIMS** **ISM INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES**	**EMPLOYMENT REPORT** **TRADE BALANCE** **FACTORY ORDERS** **REVISED CONSUMER SENTIMENT**

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

Daiwa Capital Markets

Treasury Financing

July/August 2019

Monday	Tuesday	Wednesday	Thursday	Friday
8	9	10	11	12
AUCTION RESULTS: Rate / Cover 13-week bills 2.210% 2.59 26-week bills 2.075% 2.95	**AUCTION RESULTS:** Rate / Cover 3-year notes 1.857% 2.39 **ANNOUNCE:** $35 billion 4-week bills for auction on July 11 $35 billion 8-week bills for auction on July 11 **SETTLE:** $40 billion 4-week bills $35 billion 8-week bills	**AUCTION RESULTS:** Rate / Cover 10-yr notes 2.064% 2.41	**AUCTION RESULTS:** Rate / Cover 4-week bills 2.135% 3.04 8-week bills 2.130% 2.99 30-yr bonds 2.644% 2.13 **ANNOUNCE:** $72 billion 13-,26-week bills for auction on July 15 $26 billion 52-week bills for auction on July 16 $14 billion 10-year TIPS for auction on July 18 **SETTLE:** $72 billion 13-,26-week bills	
15	16	17	18	19
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:** $35 billion* 4-week bills for auction on July 18 $35 billion* 8-week bills for auction on July 18 **SETTLE:** $35 billion 4-week bills $35 billion 8-week bills		**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills $14 billion 10-year TIPS **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on July 22 $20 billion* 2-year FRNs for auction on July 24 $40 billion* 2-year notes for auction on July 23 $41 billion* 5-year notes for auction on July 24 $32 billion* 7-year notes for auction on July 25 **SETTLE:** $72 billion 13-,26-week bills $26 billion 52-week bills	
22	23	24	25	26
AUCTION: $72 billion* 13-,26-week bills	**AUCTION:** $40 billion* 2-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on July 25 $35 billion* 8-week bills for auction on July 25 **SETTLE:** $35 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $20 billion* 2-year FRNs $41 billion* 5-year notes	**AUCTION:** $35 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 29 **SETTLE:** $72 billion* 13-,26-week bills	
29	30	31	1	2
AUCTION: $72 billion* 13-,26-week bills	**ANNOUNCE:** $35 billion* 4-week bills for auction on August 1 $35 billion* 8-week bills for auction on August 1 **SETTLE:** $35 billion* 4-week bills $35 billion* 8-week bills	**ANNOUNCE:** $38 billion* 3-year notes for auction on August 6 $27 billion* 10-year notes for auction on August 7 $19 billion* 30-year bonds for auction on August 8 **SETTLE:** $14 billion 10-year TIPS $20 billion* 2-year FRNs $40 billion* 2-year notes $41 billion* 5-year notes $32 billion* 7-year notes	**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on August 5 **SETTLE:** $72 billion* 13-,26-week bills	

**Estimate*