U.S. Economic Comment

- The budget agreement: fiscal discipline & responsibility has disappeared
- FOMC preview: rate cut all but certain as Fed tests policy guidelines

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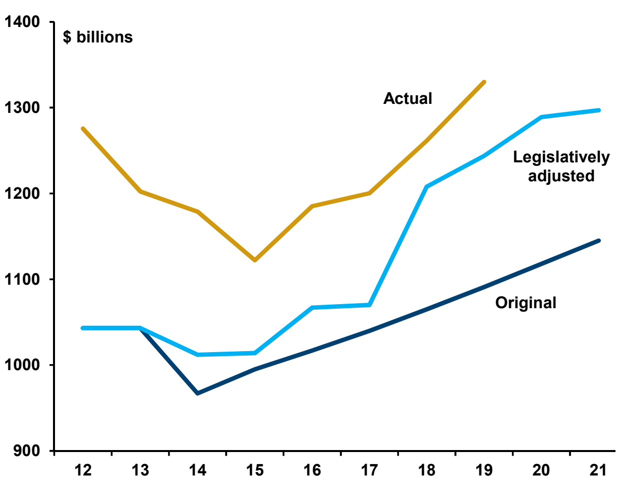
Federal Budget, Fiscal Years 2020 & 2021

Key members of Congress and the Trump Administration this week agreed on the broad terms for federal discretionary spending in the coming two fiscal years. Their agreement also includes a suspension of the debt ceiling through the end of July 2021. The good news, assuming the measures are adopted by Congress and signed by the President, is that the deal removes the possibility of a government shutdown at the start of the new fiscal year in October. In addition, the Treasury auction schedule will not be disrupted when the effective debt ceiling is reached in the fall. (The federal government has already reached its technical debt limit, but the Treasury Department is using so-called extraordinary measures -- i.e. accounting gimmicks -- to continue selling marketable securities. Without legislative action on the debt ceiling, the Treasury would exhaust its slight-of-hand measures in September or October.)

The troubling news is that the agreement essentially confirms that budget discipline (responsibility is perhaps a better term) has become a minor consideration in Washington. For the second time in two years, legislators have authorized increases in discretionary spending when the budget deficit was already well above historical norms when measured as a share of GDP. Outsized deficits at a time of full employment deepen the disconcerting aspects of current fiscal policy.

The charts below show the nature of the shift away from budget control in the past two years. Following several years of rapid spending growth in the early 2000s, first to conduct the war in Iraq and then to spur the economy during the Great Recession, Congress passed the Budget Control Act of 2011 to push the federal government toward a sustainable fiscal path. To this end, the legislation established limits on discretionary spending for fiscal years 2012 to 2021.

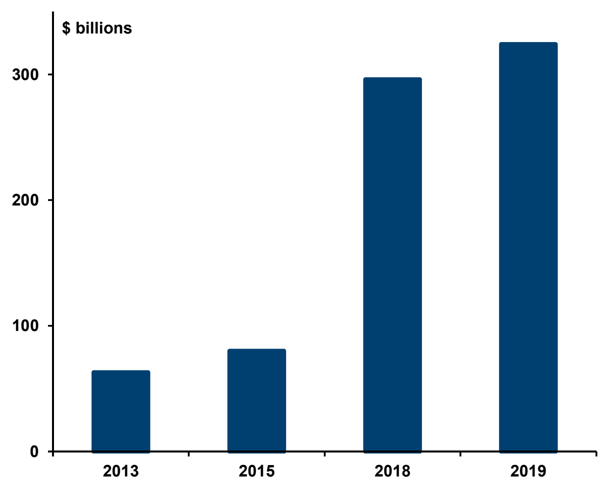
Caps on Federal Discretionary Spending*



The original caps include a downward adjustment to the amounts quoted in the Budget Control Act of 2011 (BCA). These adjustments were triggered by the failure of Congress to comply with a provision of the BCA to adopt $1.2 trillion of deficit reduction over a 10-year period. Actual spending exceeds caps because the BCA allows outlays to cover overseas military operations, emergencies, natural disasters, and efforts to prevent fraud and abuse of federal programs.

Source: Congressional Budget Office

Adjustments to Spending Caps*



The chart shows increases in spending caps authorized by budget agreements in 2013, 2015, and 2018. The last bar shows the combined increases in caps for fiscal years 2020 and 2021 now under consideration in Congress.

Source: Congressional Budget Office

Actual discretionary spending has consistently exceeded the caps, but that does not necessarily suggest a lack of fiscal discipline. The Budget Control Act allows Congress to spend beyond the caps for so-called overseas contingency operations (i.e. military activity), emergencies, natural disasters, and program-integrity initiatives (expenditures to prevent fraud and abuse of federal programs). Of course, superfluous outlays may have crept into federal spending under these exceptions, which would violate the spirit of the law.

More serious breaches, changing the letter of the law, began in 2013, when Congress passed the first of three legislative measures that overrode the caps (middle line in the left chart). The first upward adjustment was modest at $63 billion spread over two years, but the change signaled that Congress viewed the caps as a guideline rather than a serious constraint. An adjustment two years later was slightly larger at $80 billion spread over two years, and then the dam burst in 2018. The budget agreement that year involved an adjustment of $296 billion spread over fiscal years 2018 and 2019. The legislation now under consideration represents a fourth legislative action and will be the largest of the bunch: $324 billion according to the Congressional Budget Office -- $171 billion for FY2020 and $153 billion for FY2021 (chart; p.1, right).

The adjustment to the spending cap is large, but it will not involve a heavy dose of fiscal stimulus. In the absence of legislative action, the existing cap for 2020 would have required a cut in discretionary spending of $126 billion. Thus, the main effect of the new budget act is avoidance of fiscal tightening. Spending will still grow, but the new cap is "only" $45 billion (3.6 percent) above the cap for 2019. (The CBO's estimate of $171 billion for FY2020 reflects the elimination of the $126 billion cut plus the addition of $45 billion of new spending). The new cap for 2021, in turn, is only $9 billion above the adjusted 2020 cap. In addition to the adjustment of the caps, the amount of discretionary spending in the next two years will depend upon the exceptions allowed by the Budget Control Act (overseas military operations, emergencies, natural disasters, program-integrity initiatives). These items, of course, are volatile and largely unpredictable.

FOMC: Testing Limits

Public comments from Chairman Powell and other Fed officials have left little doubt that the Federal Open Market Committee will cut interest rates on July 31; it would be shocking if the Fed did not alter policy. An element of uncertainty regarding the magnitude of the change remains in place -- 25 or 50 basis points. Firm tones to several recent economic reports (employment, retail sales, CPI, durable goods orders) led us to favor a cut of 25 basis points.

Fed officials are likely to discuss the possibility of an early end to its effort to normalize the balance sheet -- that is to end redemptions of Treasury and mortgage-backed securities immediately rather than in October. We do not have strong views on this issue, and we do not view the decision as important. The effort will end shortly in any event, and the volume of redemptions in the next two months is small relative to the amount redeemed in previous months and relative to the amount purchased during QE. (The Fed plans to redeem $28 billion of Treasury securities in the next two months combined, less than the $30 billion that was being redeemed in a single month before May.)

Why Ease?

We view this policy change as interesting and important because it suggests the Fed might be making fundamental changes in its approach to monetary policy. That is, its reaction function might be undergoing changes.

In setting the stage for the rate cut, Chairman Powell highlighted crosscurrents that had emerged from the trade dispute with China and slow global economic growth. The emphasis on global growth caught our attention. While the Fed has always kept an eye on global economic conditions, domestic considerations were the primary drivers of policy changes. Fed Chairs in the past have noted that foreign central banks have the tools to address stabilization issues in their countries, and those tools should be used rather than to expect the Fed to cushion their economies. Altering U.S. policy because of foreign economic conditions suggests a break from this traditional view. It seems that foreign conditions now represent a new argument in the Fed's reaction function, or at least one with a larger coefficient than in the past.

A rate cut at this time seems curious in light of the recent performance of the U.S. economy. Just a few months ago, the Fed seemed quite comfortable in its policy stance. Several officials noted that the economy "was in a good place" and thus they planned to be "patient" in adjusting policy. John Williams of the New York Fed was perhaps the most explicit, arguing that monetary policy is where it should be -- a neutral interest rate setting at a time when the economy was fully employed and growing at a rate close to its potential.

The sudden shift to easing mode might suggest that the Fed is abandoning some of the models and structural relationships that guided policy in the past. Alternatively, while policymakers might be using the same models, they might now be more willing to experiment and to test previous views on critical values of key variables. For example, officials might have become less confident that an unemployment rate below 4.2 percent carries inflation risks. (4.2 percent is the median long-run rate in the FOMC's Summary of Economic Projections.) Lacking confidence in the value of the natural rate of unemployment, officials might be willing to experiment by seeking a lower jobless rate and observing the response of wage growth and inflation. Similarly, officials might be more open to the view that neutral rates are lower than they previously believed, which would open a door to easier policy.

In short, the Fed might be starting to embrace some of the challenges to traditional guides to monetary policy. They might not fully subscribe to alternative views on full employment and the level of neutral interest rates, but in light of contained inflation, they are perhaps willing to experiment and test previous thresholds that guided policy. If the Fed is indeed experimenting and testing its limits, we could be seeing more rate cuts in the months ahead.

Review

Week of July 22, 2019	Actual	Consensus	Comments
Existing Home Sales (June)	**5.27 Million (-1.7%)**	**5.32 Million (-0.4%)**	Mixed results on sales of existing homes in recent months (off in June after an upwardly revised jump of 2.9% in May) left the level of activity above readings around the turn of the year, but below levels seen in 2017 and the first half of 2018. The National Association of Realtors again cited tight inventories as a factor hampering sales. It also raised the possibility that a reduction in tax incentives might be constraining sales, although officials indicated that it was too soon to discern the effect of the tax act.
New Home Sales (June)	**0.646 Million (7.0%)**	**0.658 Million (5.1%)**	Sales of new homes rose briskly in June, although the change occurred from downwardly revised levels in the prior three months. The combined changes left sales in the upper portion of the range from the past few years, although several months in the current cycle showed firmer activity. Sales have responded positively to lower interest rates, but the market is not booming.
Durable Goods Orders (June)	**2.0%**	**0.7%**	The increase in durable goods orders in June occurred from a downwardly revised level in May, but the new data should still be viewed positively, as the latest change dampened the downward drift that began earlier this year. Part of the advance was the result of a jump of 16.9% in orders for aircraft, but other areas also were firm, as shown by an increase of 1.2% in durable orders excluding transportation. The gain ex-transportation offset the downward drift in the prior several months and pushed the level of orders to a new cyclical high. In addition, orders for nondefense capital goods excluding aircraft, which provide insight into capital spending plans by businesses, increased 1.9%, also rising to a new high for the current cycle.

Review Continued

Week of July 22, 2019	Actual	Consensus	Comments
U.S. International Trade in Goods (June)	**-$74.2 Billion ($0.9 Billion Narrower Deficit)**	**-$72.5 Billion ($2.5 Billion Narrower Deficit)**	Both exports and imports of goods fell in June (off 2.7% and 2.2%, respectively). The dollar value of the change in imports was larger, and thus the trade deficit in goods narrowed slightly in the latest month. The declines in exports and imports were not surprising, as both had jumped in May and seemed out of line with the softening trends that began in early-to-mid 2018. Although the trade deficit improved on a month-to-month basis, the average shortfall in Q2 was still wider than that in Q1, which left a negative contribution of 0.65 percentage point to GDP growth from net exports.
GDP (2019-Q2)	**2.1%**	**1.8%**	Consumer spending was quite strong in the second quarter (4.3%), and government spending provided good support as well (federal 7.9%; state and local 3.2%). Other components were soft, as business fixed investment slipped 0.6% and residential construction fell 1.6%. Inventory investment and net exports were decidedly soft, subtracting 0.86 and 0.65 percentage point, respectively, from GDP growth. The report included benchmark revisions to the previous five years. The new data showed that growth in 2018 when measured on a Q4-to-Q4 basis was lighter than previously believed (2.5% versus 3.0%), but activity in the prior four years was firmer than previously believed. All told, the level of GDP at the end of the revision period was little changed from the previous estimate.

Source: National Association of Realtors (Existing Home Sales); U.S. Census Bureau (New Home Sales, Durable Goods Orders, U.S. International Trade in Goods); Bureau of Economic Analysis (GDP); Consensus forecasts are from Bloomberg

Preview

Week of July 29, 2019	Projected	Comments
Personal Income, Consumption, Core Prices (June) (Tuesday)	**0.5%, 0.4%, 0.2%**	Strong job growth in June (224,000) should lead to a firm advance in wages and salaries; investment income should provide support as well. On the spending side, an easing in sales of new vehicles will probably leave little growth in outlays for durable goods, but a strong report on retail sales suggests that expenditures on nondurable goods were brisk. Results for the CPI suggest an above-average reading on the core PCE price index.
Consumer Confidence (July) (Tuesday)	**124.0 (+2.1%)**	With the equity market close to a record level and the labor market strong, the confidence index should rebound from a low-side reading in June.
Employment Cost Index (2019-Q2) (Wednesday)	**0.7%**	The range-bound nature of growth in average hourly earnings in recent months suggests that the employment cost index will remain close to its average of 0.7% in the past year.
ISM Manufacturing Index (July) (Thursday)	**53.0% (+1.3 Pct. Pts.)**	The manufacturing sector showed signs of life in June (a gain in employment and an increase in production), which should lead to a pickup in the ISM index.
Construction Spending (June) (Thursday)	**-0.5%**	Although multi-family housing is doing reasonably well, single-family activity has responded only modestly to lower interest rates, and thus private residential construction is likely to continue the downward drift that began last year. Business-related activity has been flat in recent months, and it is likely to remain contained because of uncertainty on the trade front. Government construction is likely to cool after a blistering advance in the first four months of the year.
Payroll Employment (July) (Friday)	**150,000**	Elevated job postings and minimal claims for unemployment insurance suggest that job growth will be firm on average, but July could show below-average results after a surge in June. The labor force is likely to increase by less than the jump of 335,000 in June, and thus the employment gain should be strong enough to push the jobless rate one tick lower to 3.6%. The growth of average hourly earnings is likely to match the recent average of 0.2%.
Trade Balance (June) (Friday)	**-$54.5 Billion ($1 Billion Narrower Deficit)**	The surplus in service trade typically shows modest month-to-month changes; thus, the already reported narrowing of $0.9 billion in the goods trade deficit is likely to account for most of the change in the overall trade deficit.
Factory Orders (June) (Friday)	**1.0%**	We look for orders for nondurable goods to decline slightly, as a price-led drop in the petroleum and coal category offsets a slight gain in other categories. The expected drop in the nondurable area will provide a partial offset to the already reported increase of 2.0% in durable bookings.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

July/August 2019

Monday 22

CHICAGO FED NATIONAL ACTIVITY INDEX

	Monthly	3-Mo. Avg.
Apr	-0.73	-0.47
May	-0.03	-0.27
June	-0.02	-0.26

Tuesday 23

FHFA HOME PRICE INDEX

Mar	0.2%
Apr	0.4%
May	0.1%

EXISTING HOME SALES

Apr	5.21 million
May	5.36 million
June	5.27 million

Wednesday 24

NEW HOME SALES

Apr	0.658 million
May	0.604 million
June	0.646 million

Thursday 25

INITIAL CLAIMS

July 06	208,000
July 13	216,000
July 20	206,000

DURABLE GOODS ORDERS

Apr	-2.8%
May	-2.3%
June	2.0%

U.S. INTERNATIONAL TRADE IN GOODS

Apr	-$70.9 billion
May	-$75.0 billion
June	-$74.2 billion

ADVANCE INVENTORIES REPORT

	Wholesale	Retail
Apr	0.8%	0.6%
May	0.4%	0.3%
June	0.2%	-0.1%

Friday 26

GDP

	GDP	Chained Price
18-Q4	1.1%	1.6%
19-Q1	3.1%	1.1%
19-Q2	2.1%	2.4%

Monday 29

Tuesday 30

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)

	Inc.	Cons.	Core
Apr	0.5%	0.6%	0.2%
May	0.5%	0.4%	0.2%
June	**0.5%**	**0.4%**	**0.2%**

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)

	SA	NSA
Mar	0.3%	0.7%
Apr	0.0%	0.8%
May	--	--

PENDING HOMES SALES (10:00)

Apr	-1.5%
May	1.1%
June	--

CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)

May	131.3
June	121.5
July	**124.0**

FOMC MEETING

Wednesday 31

ADP EMPLOYMENT REPORT (8:15)

	Private Payrolls
May	41,000
June	102,000
July	--

EMPLOYMENT COST INDEX (8:30)

	Comp.	Wages
18-Q4	0.7%	0.7%
19-Q1	0.7%	0.7%
19-Q2	**0.7%**	**0.7%**

CHICAGO PURCHASING MANAGERS' INDEX (9:45)

	Index	Prices
May	54.2	53.8
June	49.7	56.4
July	--	--

FOMC DECISION (2:00)

POWELL PRESS CONFERENCE (2:30)

Thursday 1

INITIAL CLAIMS (8:30)

ISM INDEX (10:00)

	Index	Prices
May	52.1	53.2
June	51.7	47.9
July	**53.0**	**50.0**

CONSTRUCTION SPEND. (10:00)

Apr	0.4%
May	-0.8%
June	**-0.5%**

VEHICLE SALES

May	17.4 million
June	17.3 million
July	**17.0 million**

Friday 2

EMPLOYMENT REPORT (8:30)

	Payrolls	Un. Rate
May	72,000	3.6%
June	224,000	3.7%
July	**150,000**	**3.6%**

TRADE BALANCE (8:30)

Apr	-$51.2 billion
May	-$55.5 billion
June	**-$54.5 billion**

FACTORY ORDERS (10:00)

Apr	-1.2%
May	-0.7%
June	**1.0%**

CONSUMER SENTIMENT (10:00)

May	100.0
June	98.2
July(p)	98.4

Monday 5

ISM NON-MFG INDEX

Tuesday 6

JOLTS DATA

Wednesday 7

CONSUMER CREDIT

Thursday 8

INITIAL CLAIMS

WHOLESALE TRADE

Friday 9

PPI

Monday 12

FEDERAL BUDGET

Tuesday 13

NFIB SMALL BUSINESS OPTIMISM INDEX

CPI

Wednesday 14

IMPORT/EXPORT PRICES

Thursday 15

INITIAL CLAIMS

RETAIL SALES

PRODUCTIVITY & COSTS

EMPIRE MFG INDEX

PHILLY FED INDEX

IP & CAP-U

NAHB HOUSING INDEX

BUSINESS INVENTORIES

TIC DATA

Friday 16

HOUSING STARTS

CONSUMER SENTIMENT

Forecasts in Bold (p) = preliminary

Daiwa Capital Markets

Treasury Financing

July/August 2019

Monday	Tuesday	Wednesday	Thursday	Friday
22	23	24	25	26
AUCTION RESULTS: Rate / Cover 13-week bills 2.040% 2.96 26-week bills 2.010% 2.69	**AUCTION RESULTS:** Rate / Cover 2-year notes 1.825% 2.50 **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 RESULTS:** Spread / Cover 2-year FRNs 0.220% 2.73 Rate / Cover 5-year notes 1.824% 2.26	**AUCTION RESULTS:** Rate / Cover 4-week bills 2.110% 2.91 8-week bills 2.140% 2.77 7-year notes 1.967% 2.27 **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	
5	6	7	8	9
AUCTION: $72 billion* 13-,26-week bills	**AUCTION:** $38 billion* 3-year notes **ANNOUNCE:** $35 billion* 4-week bills for auction on August 8 $35 billion* 8-week bills for auction on August 8 **SETTLE:** $35 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $27 billion* 10-year notes	**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills $19 billion* 30-year bonds **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on August 12 $26 billion* 52-week bills for auction on August 13 **SETTLE:** $72 billion* 13-,26-week bills	
12	13	14	15	16
AUCTION: $72 billion* 13-,26-week bills	**AUCTION:** $26 billion* 52-week bills **ANNOUNCE:** $35 billion* 4-week bills for auction on August 15 $35 billion* 8-week bills for auction on August 15 **SETTLE:** $35 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $35 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on August 19 $6 billion* 30-year TIPS for auction on August 22 **SETTLE:** $72 billion* 13-,26-week bills $26 billion* 52-week bills $38 billion* 3-year notes $27 billion* 10-year notes $19 billion* 30-year bonds	

**Estimate*