Daiwa Capital Markets

U.S. Economic Comment

- Financial Markets: bracing for (but not quite expecting) recession

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

Financial Markets: Bracing for Recession

Financial markets were volatile this week, as market participants assessed the implications of the latest escalation in the U.S.-China trade dispute (China tolerating currency depreciation, and the US designating China as a currency manipulator). Investors sensed heightened risks of recession, as shown by marked declines in equity prices and interest rates (and by additional flattening in the yield curve). We, too, see a higher probability of recession, although we are hopeful that a downturn will be avoided. If a recession were to unfold, the likely trigger would be a step too far in trade warfare, and we suspect that leaders and negotiators know there are limits to their maneuvering. We view the markets as sending a similar signal: declines in interest rates and stock prices have not been pronounced enough to suggest that investors now expect a recession, but market participants certainly have become more concerned about the economic outlook.

Currencies

The foreign exchange market was the center of attention in the past week, as the Chinese currency weakened considerably, breaking through the psychologically important level of 7.0 yuan-per-dollar (chart, left). The jump could be viewed as a strategic move by China in the trade war, as officials lightened their previous efforts to contain market forces that were pushing the currency lower.

The Trump Administration certainly viewed the depreciation as a trade maneuver, as it prompted the Treasury Department (undoubtedly at the President's behest) to declare China a currency manipulator. The Treasury will now consult with the International Monetary Fund on possible remedies available to the United States, but the IMF is not likely to be sympathetic to the U.S. charge. The IMF will likely conclude that limited resistance to market forces pushing a currency lower falls well shy of manipulation.

Yuan/US$ Exchange Rate*

Weekly average data except for the last observation, which is a quote for August 9, 2019. Increases in this measure represent yuan depreciation (or dollar appreciation).

Source: Federal Reserve Board via Haver Analytics; Bloomberg

Nominal Broad Trade-Weighted Dollar Index*

Weekly average data. The reading for the week ended August 9, 2019 is an estimate by Daiwa Capital Markets America based on available currency spot quotes.

Source: Federal Reserve Board via Haver Analytics; Bloomberg; Daiwa Capital Markets America

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The currencies of other emerging markets followed the lead of the yuan and depreciated against the dollar. The moves were less than the Friday-to-Friday change of -1.7 percent for the Chinese currency, but some were still substantial (Indian rupee -1.6 percent, Brazilian real -1.4 percent, Korean won -1.1 percent, Mexican peso -0.7 percent). Some currencies appreciated relative to the U.S. dollar (Swedish krona 1.0 percent, Japanese yen 0.9 percent, Swiss franc 0.9 percent, euro 0.8 percent).

The mixed nature of the changes left the Federal Reserve's broad dollar index up moderately in the past week (0.4 percent; chart, p. 1, right). (The Federal Reserve publishes its index with a one-week lag. The increase of 0.4 percent is our estimate based on market quotes for the 26 currencies in the index.)

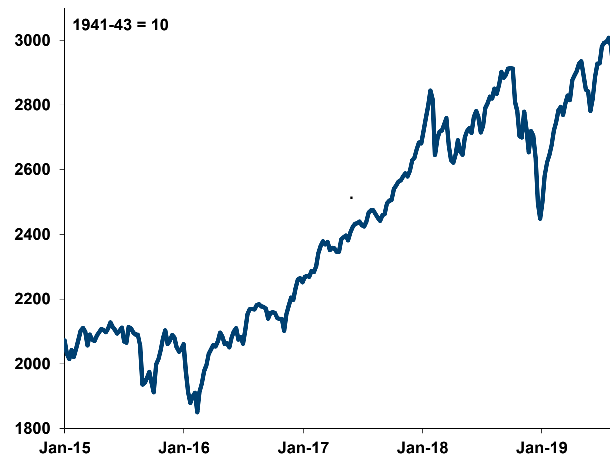
This appreciation of the dollar will leave U.S. firms less competitive than they would be otherwise, and thus the shift represents a challenge to economic growth. Currency values already represented a headwind in that the dollar index was above its two-year moving average. (Changes in currency values typically affect trade flows over a two-year period. Thus, the two-year average shows currency levels that have already influenced exports and imports. The gap between the current value of the index and the average provides insight into the influence of foreign exchange rates in the months ahead.) The latest change in the dollar index, while in the constraining direction, did not represent a meaningful change in the current gap. Indeed, the index and the gap remain within the recent range. Thus, the likely additional drag from recent changes in foreign exchange rates should not be severe -- certainly not enough to trigger thoughts of an export-led recession.

Equities

A swoon in the stock market on Monday (S&P 500 off 3.0 percent) added to a drop of 3.1 percent over the prior week, suggesting marked changes in the economic outlooks of equity investors. However, we found the movement over the balance of the week encouraging. Prices showed marked up and down movements, but they registered a net gain over the balance of the week that offset much of Monday's loss (chart).

The pronounced swings in share prices, in our view, suggest that the market is struggling to find an equilibrium. Investors have been thrown off course by the tariffs and currency maneuverings, and portfolio shifts by bulls and bears have yet to establish market-clearing levels. The net drop in the past two weeks indicates negative implications from the escalation of the trade dispute, but the retreat in total is not large by historical standards. Like the change in the dollar index, the slippage has not been large enough to stir thoughts of recession.

S&P 500 Index*



** Weekly average data except for the last observation, which is a quote for August 9, 2019.*

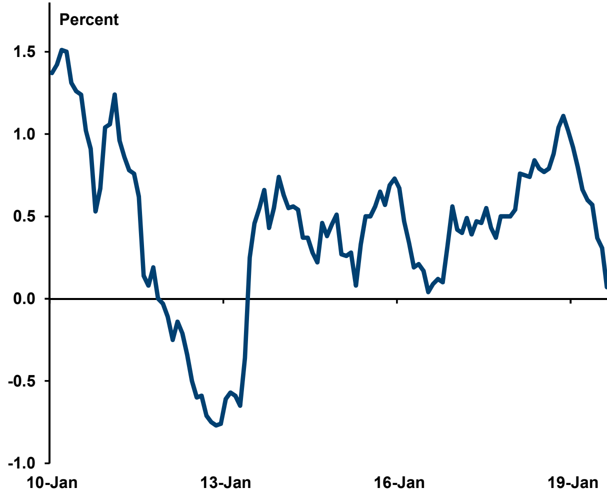
Source: Standard and Poor's via Haver Analytics; Bloomberg

Interest Rates

The retreat in long-term interest rates in the past several months has been striking. After falling approximately a percentage point from November through July, the rate on 10-year Treasury notes dropped almost 40 basis points in the past two weeks. The shift seems to represent a stronger recession signal than the drop in equity values does. Equity prices, while showing sharp swings, have advanced on balance this year. Interest rates, in contrast, have moved to the low portion of their range from the past several years.

Some of the drop in long-term interest rates seems to reflect an adjustment in inflation expectations, as break-even rates on Treasury inflation-protected securities (TIPS) have declined by approximately 40 basis points since last fall. Most of the drop in nominal rates, though, reflects a decline in real interest rates, signaling concern about the economic outlook. The yield on inflation-protected securities, which can be

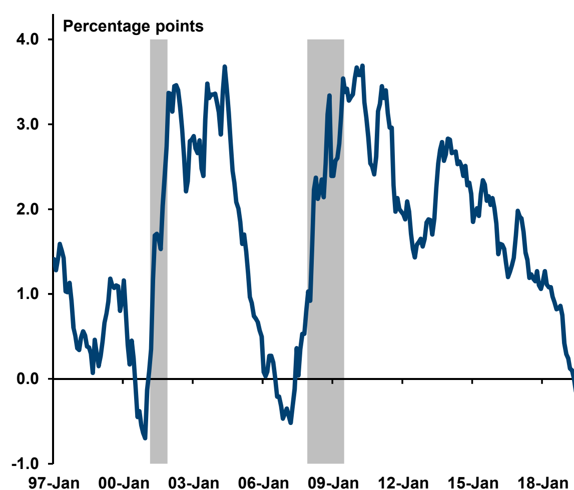
Real 10-Year Interest Rate*



The yield on 10-year Treasury inflation-protected securities (TIPS). Monthly average data except for the last observation, which is a quote for August 8, 2019.

Source: Federal Reserve Board via Haver Analytics

Yield Curve*



The 10-year Treasury rate less the three-month Treasury rate. Monthly average data except for the last observation, which is the spread for August 8, 2019. The shaded areas on the chart indicate periods of recession in the U.S. economy.

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

viewed as a real interest rate, has dropped approximately a full percentage point since last fall and currently is close to zero (chart, left). Still, the latest reading does not quite signal recession. The current level of the TIPS rate, while quite low, is still within the range seen throughout the current cycle and is well above the negative readings seen in 2012 and early 2013.

The yield curve continues to capture the attention of market participants. Recent changes in interest rates have deepened the inversion in the 10-year-to-3-month curve, with the latest spreads moving to approximately -35 basis points from an average of approximately -15 in June (chart, right). We would not dismiss the significance of the deepening in this spread, but we would maintain a healthy dose of skepticism. The quantitative easing programs of central banks have most likely influenced the behavior of long-term interest rates and the relationship between long-term and short-term yields. As a result, guidelines used in the past cannot be easily applied in the current setting. Thus, we would not conclude that a recession is imminent because of the current inversion. The fact that the inversion is less pronounced than in the prior two episodes (see chart) bolsters somewhat our confidence in this view.

Recession Probabilities

We do not view the latest shifts in financial variables as signaling recession, and economists in general share this view. Interestingly, three routine surveys of economists were published this week, with all asking about the probability of recession. None showed pronounced near-term risks.

The Wall Street Journal conducts a monthly survey of economists, which usually includes a question on the probability of a recession in the next 12 months. The latest canvas showed a mean expectation of 33.6 percent, up from 30.1 percent in July and 18.3 percent one year ago but still comfortably below 50 percent.

The Blue Chip Economic Indicators asks the question differently, requesting separate probabilities for a recession developing over the balance of this year and for one developing in 2020. The consensus in the August survey showed a 21.4 percent probability of a recession this year and a 36.6 percent probability for next year (similar to the WSJ probability of 33.6 percent). Some respondent were looking for a downturn next year, as the 10 most pessimistic forecasters showed an average probability of a recession in 2020 of 52.0 percent.

The survey of professional forecasters conducted by the Federal Reserve Bank of Philadelphia does not ask about recession explicitly; rather, it requests the probability of a negative reading on GDP growth in each of the next five quarters. The mean probability of a negative reading in the current quarter (2019-Q3) was 11.7 percent, and the probability gradually increased to 26.1 percent in 2020-Q3, a bit more optimistic than the other two surveys.

Review

Week of August 5, 2019	Actual	Consensus	Comments
ISM Nonmanufacturing Index (July)	**53.7% (-1.4 Pct. Pts.)**	**55.5% (+0.4 Pct. Pt.)**	The drop in the ISM nonmanufacturing index in July marked the seventh decline in the past 10 months, which left the measure 7.1 percentage points below the recent peak in September of last year. The level of the index continued to suggest growth, but the pace is likely to be well shy of brisk. The business activity component accounted for most of the drop in the headline index in July, as this measure fell 5.1 percentage points to 53.1%. The latest decline was among the largest of the current expansion, and the shift pushed the index below the range that had been in place in the past three years or so. The slow pace of business activity was probably influenced by soft order flows, as the new orders index dropped 1.7 percentage points to 54.1%. This measure was at the bottom of the range from the past several years. Although new orders and business activity were soft, firms continued to hire, as the employment index rose 1.2 percentage points to 56.2%.
PPI (July)	**0.2% Total, -0.1% Core***	**0.2% Total, 0.2% Core***	Energy prices jumped 2.3% in July, but the increase offset only part of a net decline of 4.1% in May and June combined. Food prices showed some pressure, as an increase of 0.2% followed a jump of 0.6% in June and was notably quicker than average monthly declines of 0.3% in the first five months of 2019. Prices of goods excluding food and energy rose 0.1% in July, but service prices slipped 0.1%. The latest results left the year-over-year change in the headline index at 1.7%, unchanged from the June reading and down from the recent peak of 3.4% in July 2018. The core index rose 1.7% in the past year, down from 2.1% in June and off the recent peak of 3.1% from September 2018.

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

Source: Institute for Supply Management (ISM Nonmanufacturing Index); Bureau of Labor Statistics (PPI); Consensus forecasts are from Bloomberg

Preview

Week of August 12, 2019	Projected	Comments
Federal Budget (July) (Monday)	**$120.0 Billion Deficit**	Available data suggest that federal revenues grew briskly in July (approximately 11% from the same month last year). The July results, if realized, will add an accent to the firm showing in the prior five months (6.6% revenue growth on average). Federal outlays also are likely to post a sharp year-over-year advance (possibly more than 20%), but most of the increase reflects a calendar configuration last year that moved some July spending into June. Expected outlays this July seem close to the recent average. The expected budget deficit in July would leave the shortfall at $867 billion in the first 10 months of the fiscal year, wider than the deficit of $684 billion in the same period in FY2018.
CPI (July) (Tuesday)	**0.3% Total, 0.2% Core**	Higher prices of gasoline probably pushed the energy component higher. In the core component, transitory restraints that led to increases of 0.1% from February through May are likely to have had little influence in July, which should leave a firmer increase, although one less pronounced than the jump of 0.3% in June.
Retail Sales (July) (Thursday)	**0.3% Total, 0.4% Ex-Autos**	A drop in sales of new motor vehicles is likely to constrain the auto component, while higher prices of gasoline should inflate the value of sales at service stations. In other areas, generally healthy financial positions of households and a strong labor market should fuel respectable growth.
Nonfarm Productivity (2019-Q2) (Thursday)	**1.4%**	Output grew only moderately in the second quarter (1.9% based on data in the GDP report), but that advance was achieved with a modest increase in labor input (estimated growth of 0.5%), implying a respectable gain in productivity. The expected increase in productivity trails the surge of 3.4% in Q1, but it represents an improvement from the average of 0.9% from 2010 through 2018.
Industrial Production (July) (Thursday)	**0.3%**	Employment in the manufacturing sector rose noticeably in July, but a shorter workweek represents an offsetting influence on output. The mining sector also is likely to post soft results, as both employment and the number of rotary rigs in operation fell in July. The utility sector probably registered a sharp gain in output, as the number of cooling-degree days was well above average for July.
Housing Starts (July) (Friday)	**1.230 Million (-1.8%)**	Sales of new homes, although not booming, have improved from the lows of late last year, which could stir single-family starts. The volatile multi-family sector, however, is likely to ease after high-side readings in the prior three months.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

August 2019

Monday	Tuesday	Wednesday	Thursday	Friday
5	6	7	8	9
ISM NON-MFG INDEX Index / Prices May 56.9 / 55.4 June 55.1 / 58.9 July 53.7 / 56.5	**JOLTS DATA** Openings (000) / Quit Rate Apr 7,372 / 2.3% May 7,384 / 2.3% June 7,348 / 2.3%	**CONSUMER CREDIT** Apr $17.5 billion May $17.8 billion June $14.6 billion	**INITIAL CLAIMS** July 20 207,000 July 27 217,000 Aug 03 209,000 **WHOLESALE TRADE** Inventories / Sales Apr 0.8% / -0.4% May 0.4% / -0.6% June 0.0% / -0.3%	**PPI** Final Demand / Core* May 0.1% / 0.4% June 0.1% / 0.0% July 0.2% / -0.1%
12	13	14	15	16
FEDERAL BUDGET (2:00) 2019 / 2018 May -$207.8B / -$146.8B June -$8.5B / -$74.9B **July -$120.0B** / -$76.9B	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** May 105.0 June 103.3 July -- **CPI (8:30)** Total / Core May 0.1% / 0.1% June 0.1% / 0.3% **July 0.3% / 0.2%**	**IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports / Nonagri. Exports May -0.3% / -0.2% June -0.3% / -1.1% July -- / --	**INITIAL CLAIMS (8:30)** **RETAIL SALES (8:30)** Total / Ex.Autos May 0.4% / 0.4% June 0.4% / 0.4% **July 0.3% / 0.4%** **PRODUCTIVITY & COSTS (8:30)** Productivity / Unit Labor Costs 18-Q4 1.3% / -0.4% 19-Q1 3.4% / -1.6% **19-Q2 1.4% / 3.0%** **EMPIRE MFG (8:30)** June -8.6 July 4.3 Aug -- **PHILLY FED INDEX (8:30)** June 0.3 July 21.8 Aug -- **IP & CAP-U (9:15)** IP / Cap.Util. May 0.4% / 78.1% June 0.0% / 77.9% **July 0.3% / 77.9%** **NAHB HOUSING INDEX (10:00)** June 64 July 65 Aug -- **BUSINESS INVENTORIES (10:00)** Inventories / Sales Apr 0.5% / -0.2% May 0.3% / -0.1% **June 0.0% / 0.2%** **TIC DATA (4:00)** Total / Net L-T Apr -$9.0B / $46.9B May $32.9B / $3.5B June -- / --	**HOUSING STARTS (8:30)** May 1.265 million June 1.253 million **July 1.230 million** **CONSUMER SENTIMENT (10:00)** June 98.2 July 98.4 **Aug 97.5**
19	20	21	22	23
		EXISTING HOME SALES **FOMC MINUTES**	**INITIAL CLAIMS** **LEADING INDICATORS**	**NEW HOME SALES**
26	27	28	29	30
DURABLE GOODS ORDERS **CHICAGO FED NAT'L ACTIVITY INDEX**	**FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CONSUMER CONFIDENCE**		**INITIAL CLAIMS** **REVISED Q2 GDP** **U.S. INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **PENDING HOME SALES**	**PERSONAL INCOME, CONSUMPTION, PRICES** **CHICAGO PURCHASING MANAGERS' INDEX** **REVISED CONSUMER SENTIMENT**

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

Treasury Financing

August 2019

<table>
<tr><th>Monday</th><th>Tuesday</th><th>Wednesday</th><th>Thursday</th><th>Friday</th></tr>
<tr><td>5</td><td>6</td><td>7</td><td>8</td><td>9</td></tr>
<tr>
<td>AUCTION RESULTS:
Rate Cover
13-week bills 1.990% 2.88
26-week bills 1.950% 2.31</td>
<td>AUCTION RESULTS:
Rate Cover
3-year notes 1.562% 2.41
ANNOUNCE:
$50 billion 4-week bills for auction on August 8
$40 billion 8-week bills for auction on August 8
SETTLE:
$35 billion 4-week bills
$35 billion 8-week bills</td>
<td>AUCTION RESULTS:
Rate Cover
10-yr notes 1.670% 2.20</td>
<td>AUCTION RESULTS:
Rate Cover
4-week bills 2.065% 2.64
8-week bills 2.050% 3.24
30-yr bonds 2.335% 2.34
ANNOUNCE:
$84 billion 13-,26-week bills for auction on August 12
$28 billion 52-week bills for auction on August 13
SETTLE:
$78 billion 13-,26-week bills</td>
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<tr><td>12</td><td>13</td><td>14</td><td>15</td><td>16</td></tr>
<tr>
<td>AUCTION:
$84 billion 13-,26-week bills</td>
<td>AUCTION:
$28 billion 52-week bills
ANNOUNCE:
$55 billion* 4-week bills for auction on August 15
$45 billion* 8-week bills for auction on August 15
SETTLE:
$50 billion 4-week bills
$40 billion 8-week bills</td>
<td></td>
<td>AUCTION:
$55 billion* 4-week bills
$45 billion* 8-week bills
ANNOUNCE:
$84 billion* 13-,26-week bills for auction on August 19
$7 billion* 30-year TIPS for auction on August 22
SETTLE:
$84 billion 13-,26-week bills
$28 billion 52-week bills
$38 billion 3-year notes
$27 billion 10-year notes
$19 billion 30-year bonds</td>
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<tr><td>19</td><td>20</td><td>21</td><td>22</td><td>23</td></tr>
<tr>
<td>AUCTION:
$84 billion* 13-,26-week bills</td>
<td>ANNOUNCE:
$55 billion* 4-week bills for auction on August 22
$45 billion* 8-week bills for auction on August 22
SETTLE:
$55 billion* 4-week bills
$45 billion* 8-week bills</td>
<td></td>
<td>AUCTION:
$55 billion* 4-week bills
$45 billion* 8-week bills
$7 billion* 30-year TIPS
ANNOUNCE:
$84 billion* 13-,26-week bills for auction on August 26
$18 billion* 2-year FRNs for auction on August 28
$40 billion* 2-year notes for auction on August 27
$41 billion* 5-year notes for auction on August 28
$32 billion* 7-year notes for auction on August 29
SETTLE:
$84 billion* 13-,26-week bills</td>
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<tr><td>26</td><td>27</td><td>28</td><td>29</td><td>30</td></tr>
<tr>
<td>AUCTION:
$84 billion* 13-,26-week bills</td>
<td>AUCTION:
$40 billion* 2-year notes
ANNOUNCE:
$55 billion* 4-week bills for auction on August 29
$45 billion* 8-week bills for auction on August 29
SETTLE:
$55 billion* 4-week bills
$45 billion* 8-week bills</td>
<td>AUCTION:
$18 billion* 2-year FRNs
$41 billion* 5-year notes</td>
<td>AUCTION:
$55 billion* 4-week bills
$45 billion* 8-week bills
$32 billion* 7-year notes
ANNOUNCE:
$84 billion* 13-,26-week bills for auction on September 3
SETTLE:
$84 billion* 13-,26-week bills</td>
<td>SETTLE:
$7 billion* 30-year TIPS
$18 billion* 2-year FRNs</td>
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**Estimate*