U.S. Economic Comment

- Trade war: flirting with trouble
- Inflation developments: still restrained despite a jump in core CPI

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Powell's Concerns Are Becoming Evident

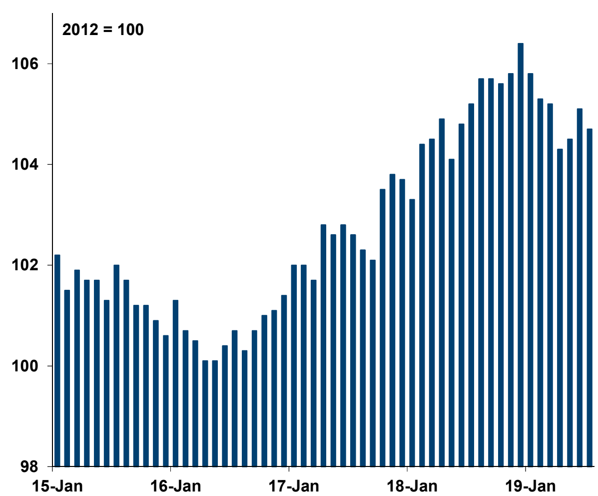
Fed Chairman Powell in his July 31 press conference justified the FOMC's rate cut by noting that headwinds had emerged because of uncertainty associated with the trade dispute and because of slow economic growth in foreign countries. He also noted that restrained inflation gave the Fed flexibility to support growth more aggressively. The latest week brought developments that suggested all three factors cited by Chairman Powell were coming into play: manufacturing activity has slowed and business executives seem to be rethinking investment plans because of the trade war, Q2 GDP growth slowed in several key countries, and inflation looks as though it will be contained for some time.

The trade dispute will have direct effects on economic activity by constraining exports and by disrupting supply lines that force production cuts or shifts to less efficient and more expensive alternatives. Such effects already have emerged, as the upward momentum in real exports of goods that was in place in 2017 and the early portion of 2018 has faded. Manufacturing activity has slowed in response, as production in the factory sector has declined in five of the past seven months and moved 1.6 percent below the peak in December of last year (chart). Some of this retreat could reflect an effort to slow the pace of inventory investment, which has been brisk in the past year, but we suspect the trade situation is playing a role as well.

The trade dispute also could have indirect effects on the economy if an uncertain business environment leads business executives to postpone or cancel investment projects. Indeed, this seemed to be a key concern of Chairman Powell. New orders for capital goods suggest that businesses have become cautious in undertaking capital spending programs, as bookings have shown essentially no net increase since last summer.

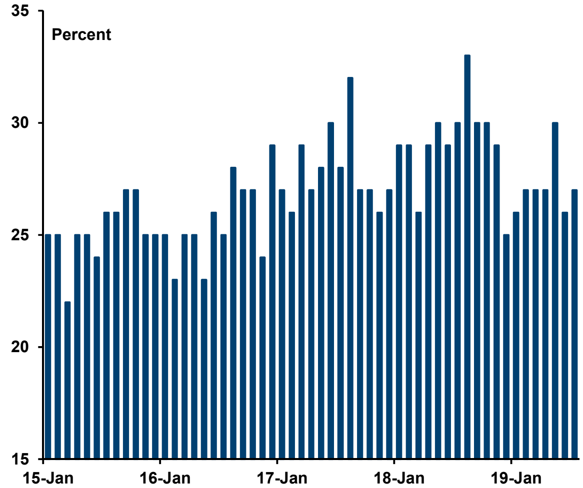
Surveys of business executives conducted by the Business Roundtable and the National Federation of Independent Business (trade associations for large enterprises and small businesses, respectively) show similar results. Executives showed keen interest in new investment outlays in early 2018, most likely because of incentives in the recent tax act. Since that time, however, spending plans have eased (charts, next page). Some of the easing might reflect a more careful consideration of the tax act and a realization that the new legislation was less of a boon than initially believed (effective tax rates have declined less than statutory rates have), but recent easing could well be influenced by concern about the trade war. The observations shown in the charts are dated in the sense that they preceded the recent escalation in the trade dispute. We suspect the next surveys will show less enthusiasm for capital spending.

Industrial Production: Manufacturing



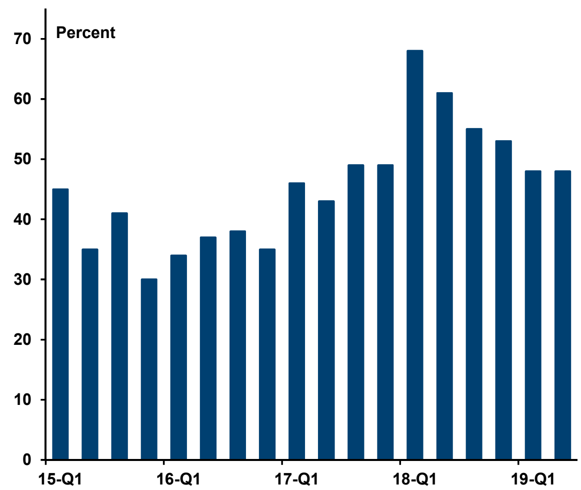
Source: Federal Reserve Board via Haver Analytics

Outlook for Capital Spending by Small Firms*



* Outlook for capital spending by small firms. The share of respondents planning capital expenditures in the next three to six months.
Source: National Federation of Independent Business via Haver Analytics

Outlook for Capital Spending by Large Firms*

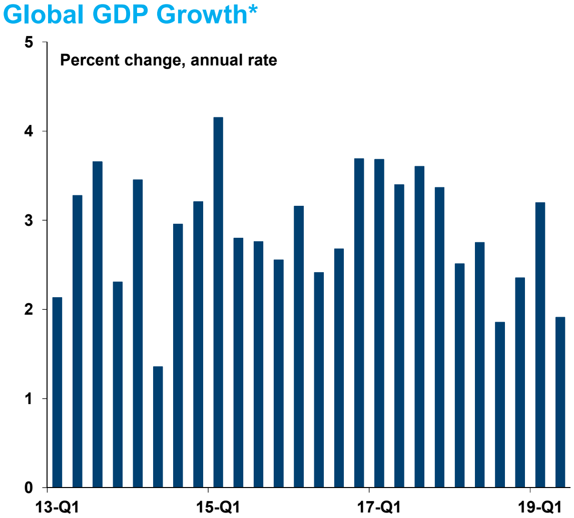


* Outlook for capital spending by large firms. The share of respondents planning to increase capital spending in the next six months.
Source: Business Roundtable via Haver Analytics

Mr. Powell also expressed concern about the global economic outlook in his latest press briefing, and the latest week brought notable developments on that front. China published a weak report on industrial production, as year-over-year growth continued along a downward trend that began in the spring of last year, shortly after tariffs became an issue. The latest annual growth rate of 4.8 percent was the slowest on record and trailed observations that had been in a range of six to seven percent. China also published soft results on consumer spending.

Germany perhaps captured more attention in financial markets with its release of second quarter GDP, which declined at an annual rate of 0.3 percent. Being a trade-sensitive economy, the contraction stoked concern about the effects of a trade war. Economic growth in other major countries was not as troubling as that for Germany, but still activity eased. The entire European Union, for example, grew 0.7 percent in the second quarter, less than half the pace registered in 2018. Japan performed well in Q2 with growth of 1.8 percent after a spurt of 2.8 percent in the first quarter (annual rates), much improved from 0.3 percent in 2018. Even with this solid performance in Japan, an average of key countries is showing an easing in the pace of growth (chart).

Global GDP Growth*



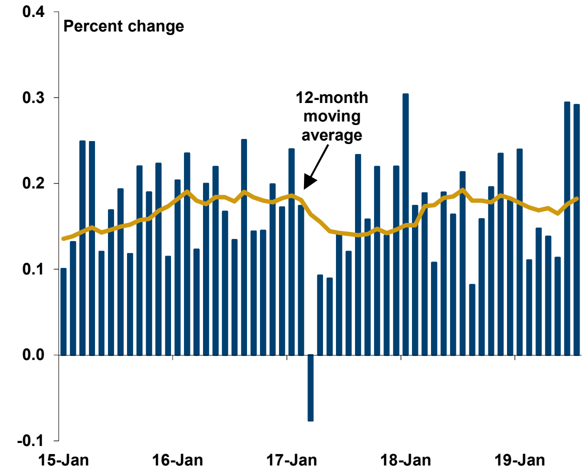
* Weighted average of GDP growth in the European Union (EU28), Japan, and China. Weights are based on U.S. exports to these areas.
Source: Cabinet Office of Japan, China National Bureau of Statistics, Statistical Office of the European Communities, and U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

The growth implications of the trade war are foremost on the minds of market participants, but inflation developments should be monitored closely as well, as the Fed will be focusing on both growth and inflation. The latest week brought three price-related reports; results were not uniformly soft, but the weight of the evidence, in our view, suggested contained inflation.

The CPI. The consumer price index appeared troubling on the surface, as the core index rose 0.3 percent for the second consecutive month. However, the increases followed four months of minimal inflation (0.1

percent every month from February to May). In addition, the pressure in June and July largely came in volatile areas that were subdued in prior months (apparel prices, airfares, hotel fees, prices of used cars). The sharp increases in these components merely moved them back in line with underlying trends, which was the case with core inflation as well. The year-over-year change in the core CPI totaled 2.2 percent, up slightly from 2.1 percent in June, but equal to several other readings in the past year and below the recent peak of 2.4 percent recorded last July (chart).

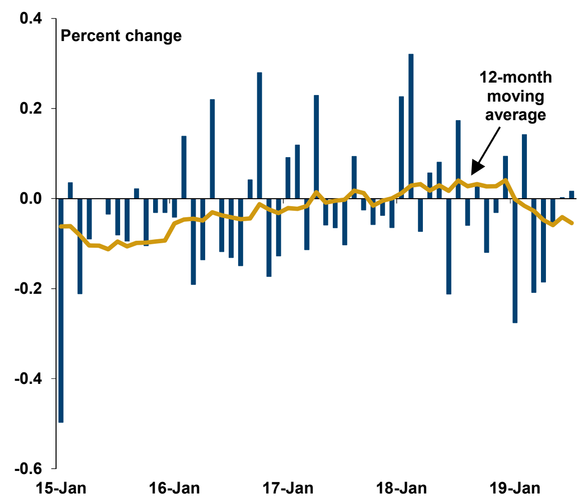
Core CPI



Source: Bureau of Labor Statistics via Haver Analytics

Import Prices. The latest week brought other developments supporting the view of contained inflation. Import prices remained subdued, as the prices of all goods imported into the U.S. rose only moderately in July (0.2 percent), which left the year-over-year change in negative territory (-1.8 percent). Excluding the volatile fuel component, prices eased 0.1 percent in July, leaving the year-over-year change at -1.3 percent. We like to monitor prices of imported consumer goods and motor vehicles, as they can enter directly into the CPI and PCE price index. In addition, they provide competition to domestic producers and limit pricing power. An index of these two items rose marginally in June and July (less than 0.1 percent in both months), but this measure had declined in seven of the 10 prior months and it was still down on a year-over-year basis (off 0.7 percent, chart). With the foreign exchange value of the dollar appreciating recently, this measure is likely to remain subdued for a time.

Import Prices: Autos & Consumer Goods*



* *A weighted average of prices of imported automobiles and consumer goods. Weights are derived from import shares into the United States.*
Source: Bureau of Labor Statistics and Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

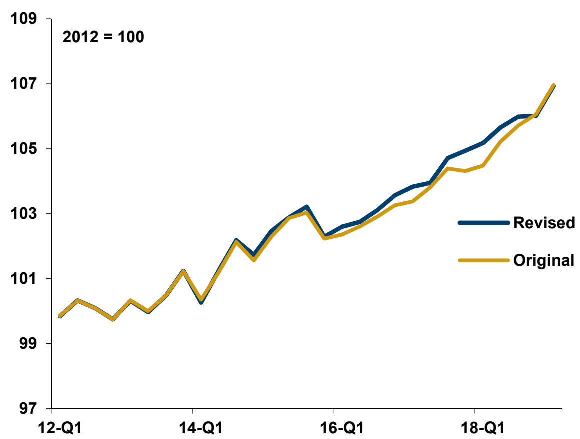
Prices of imported goods from China warrant close attention because of the trade dispute. These prices also were soft, declining 0.1 percent in July, which represented the 14th consecutive month of flat or negative readings. The decline in the past year totaled 1.6 percent (this price index excludes the effects of tariffs).

Productivity. With the economy now at full employment and with wages rising at a faster pace than in prior years, productivity growth will be a key variable determining the inflation outcome. If productivity growth were to be firm, producers could cover higher wages without raising the prices of their products, which would help to contain inflation.

Previous reports suggested that productivity was beginning to accelerate, as growth in the four quarters ending 2019-Q1 totaled 2.4 percent, notably faster than the average of approximately 0.7 percent from 2010 to 2017. However, the latest report on productivity included benchmark revisions to the prior five years, and the new figures showed less impressive results in the past year or so, with productivity growth totaling 1.7 percent rather than 2.4 percent in the year ending 2019-Q1. The new figures were not entirely disappointing, as results in earlier years were revised upward. In fact, the level of the productivity index in the first quarter was almost identical to the pre-revision estimate (chart, next page, left). The revised figures simply represent a new pattern: firmer results in earlier years but no spurt in the past year or so.

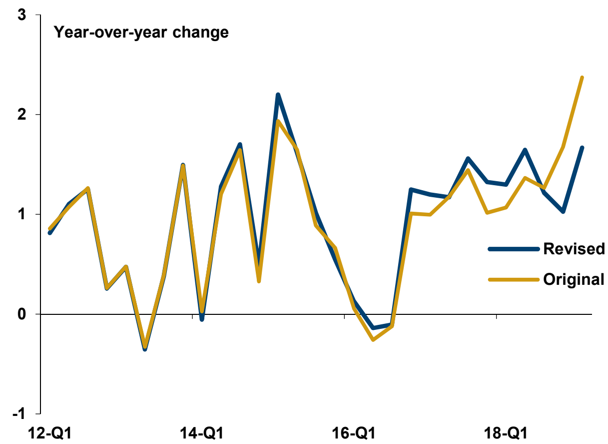
The growth rate of productivity also has taken on a new look. Previous data suggested that growth was beginning to accelerate -- more than two percent rather than one percent. The new figures show a steadier pace but at a firmer rate than previously believed (chart, right). With growth now apparently settling in at a rate of 1.5 to 2.0 percent rather than the sub-one-percent pace in the early portion of the expansion, productivity should help to contain inflation.

Nonfarm Productivity



Source: Bureau of Labor Statistics via Haver Analytics

Nonfarm Productivity



Source: Bureau of Labor Statistics via Haver Analytics

Review

Week of August 12, 2019	Actual	Consensus	Comments
Federal Budget (July)	**$119.7 Billion Deficit**	**$120.0 Billion Deficit**	Federal revenues jumped 11.6% year-over-year in July, adding to the recent solid performance in collections (6.7% revenue growth on average in the prior five months). Outlays also jumped (22.8% year-over-year), but much of the increase reflected a calendar configuration in the prior fiscal year that shifted some outlays from July into June. The shifts left the deficit for the first 10 months of FY2019 at $867 billion, $183 billion wider than the deficit in the same period in FY2018.
CPI (July)	**0.3% Total, 0.3% Core**	**0.3% Total, 0.2% Core**	Food prices were contained for the second consecutive month (less than 0.1% in both June and July), but energy prices jumped 1.3% and the core component exceeded expectations with its second consecutive increase of 0.3%. The increase in the core prices, while above the recent average, was not deeply troubling, as the increases followed changes of 0.1% in each of the prior four months. In addition, much of the upward pressure came in volatile areas that were soft in prior months (apparel, airfares, hotel charges, used motor vehicles). The latest changes left the year-over-year increase in the headline index at 1.8%, up from 1.6% in June, but within the recent range. The year-over-year change in the core index totaled 2.2%, up from 2.1% in June and matching the firmest reading of the year but still below the 2.4% registered last July.
Retail Sales (July)	**0.7% Total, 1.0% Ex-Autos**	**0.3% Total, 0.4% Ex-Autos**	The volatile components of the retail sales report moved in opposite directions in July (auto sales slipped 0.6%, whereas sales at gasoline stations posted a price-led jump of 1.8%). Other categories were generally firm as shown by an increase of 0.9% in sales excluding autos and gasoline. A surge of 2.8% in the nonstore category (mostly internet sales) influenced the results, but other areas also contributed; for example, activity at restaurants rose 1.1%, spending at general merchandise stores increased 0.6%, and sales at clothing stores advanced 0.8%.
Nonfarm Productivity (2019-Q2)	**2.3%**	**1.4%**	Moderate output growth (1.9%, annual rate) and a dip in labor input (-0.4%) translated to firm productivity growth in Q2. Compensation growth also increased, with the jump of 4.8% contributing to an advance of 2.4% in unit labor costs. The report included benchmark revisions to productivity. Productivity grew more slowly over the four quarters of last year than previously believed (1.0% rather than 1.7%), but results in prior years were revised upward and provided an offset to slower results last year. The net change in the prior several years was essentially zero.

Review Continued

Week of August 12, 2019	Actual	Consensus	Comments
Industrial Production (July)	**-0.2%**	**0.1%**	The disappointing results for industrial production were led by a decline of 0.4% in the cyclically sensitive manufacturing sector, with the latest result 1.6% below the recent peak in December 2018. Mining activity slipped 1.8%, continuing a choppy pattern that has left little net change in 2019 after surging higher in the prior few years. Utility output jumped 3.1%, but the increase followed a similar-sized decline in the prior month, and shifts in this area usually reflect weather rather than economic fundamentals.
Housing Starts (July)	**1.191 Million (-4.0%)**	**1.256 Million (0.2%)**	The drop in housing starts in July was joined by downward revisions in the prior two months equivalent to 0.5%. However, all of the weakness occurred in the volatile multi-family sector, where activity moved to the lower portion of the range of the past few years. Multi-family activity in June and July appears quite weak when viewed in isolation (off 16.2% in July after a drop of 16.4% in June), but activity had climbed to an unusually high level in May and a correction seemed in order. A pickup in multi-family permits in July (up 21.8%) supports the view that the July drop was indeed random volatility and could reverse in coming months. Single-family starts rose 1.3%, marking the fourth gain in the past five months and moving the level of activity in line with the averages in 2017 and 2018 after low-side readings around the turn of the year. An increase of 1.8% in single-family permits in July raises the possibility of further improvement in August.
Consumer Sentiment (August)	**92.1 (-6.4%)**	**97.0 (-1.4%)**	The drop of 6.4% in consumer sentiment was among the largest declines of the past few years. Both the current conditions and expectations components contributed to the drop, although the contribution from expectations was much larger (off 9.1% versus a decline of 3.0% for the current conditions component). The current level of the index has moved to the low portion of the range of the past few years. The observation from January of this year was slightly lower; otherwise, one has to go back to October 2016 to find a lower reading. It seems as though volatility in the equity market is influencing consumer moods, as the sharp drop in January followed the swoon in stock prices in December, and equity volatility seems to have had an effect again.

Source: U.S. Treasury Department (Federal Budget); Bureau of Labor Statistics (CPI, Nonfarm Productivity); U.S. Census Bureau (Retail Sales, Housing Starts); Federal Reserve Board (Industrial Production); Reuters/University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of August 19, 2019	Projected	Comments
Existing Home Sales (July) (Wednesday)	**5.38 Million (+2.1%)**	Low mortgage interest rates should stir housing demand, a view supported by solid growth in pending home sales in May and June. The expected reading for July is among the best of the past year (only 5.48 million in February was better), but it still lags the total of 5.531 million units in 2017, the best year for existing home sales in the current expansion.
Leading Indicators (July) (Thursday)	**0.5%**	With only three of the 10 components expected to make small negative contributions, the leading indicator index is likely to more than offset the published decrease of 0.3% in June. The net change in the past two months continues a choppy pattern since late last year that has left a modest net gain (up at an annual rate of 0.6% since September if the forecast proves accurate, versus average annual growth of 4.3% from December 2015 through September 2018).
New Home Sales (July) (Friday)	**0.650 Million (+0.6%)**	Low mortgage rates represent a positive factor in the new home market, although mediocre readings on buyer traffic and mortgage applications in July suggest the response was only moderate. Activity in the new home market has generally lagged that in the existing market in the current recovery. New home sales are still well below pre-housing-bubble norms, while sales of existing homes are in line with readings in the late 1990s and 2000.

Source: Forecasts provided by Daiwa Capital Markets America

Daiwa Capital Markets

Economic Indicators

August/September 2019

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
FEDERAL BUDGET 2019 2018 May -$207.8B -$146.8B June -$8.5B -$74.9B July -$119.7B -$76.9B	**NFIB SMALL BUSINESS OPTIMISM INDEX** May 105.0 June 103.3 July 104.7 **CPI** Total Core May 0.1% 0.1% June 0.1% 0.3% July 0.3% 0.3%	**IMPORT/EXPORT PRICES** Non-fuel Imports Nonagri. Exports May -0.3% -0.2% June -0.3% -1.0% July -0.1% 0.2%	**INITIAL CLAIMS** July 27 217,000 Aug 03 211,000 Aug 10 220,000 **RETAIL SALES** Total Ex.Autos May 0.5% 0.5% June 0.3% 0.3% July 0.7% 1.0% **PRODUCTIVITY & COSTS** Productivity Unit Labor Costs 18-Q4 0.1% 0.6% 19-Q1 3.5% 5.5% 19-Q2 2.3% 2.4% **EMPIRE MFG** June -8.6 July 4.3 Aug 4.8 **PHILLY FED INDEX** June 0.3 July 21.8 Aug 16.8 **IP & CAP-U** IP Cap.Util. May 0.2% 77.8% June 0.2% 77.8% July -0.2% 77.5% **NAHB HOUSING INDEX** June 64 July 65 Aug 66 **BUSINESS INVENTORIES** Inventories Sales Apr 0.5% -0.2% May 0.3% -0.1% June 0.0% 0.1% **TIC DATA** Total Net L-T Apr -$18.9B $46.8B May $37.6B $4.6B June $1.7B $99.1B	**HOUSING STARTS** May 1.264 million June 1.241 million July 1.191 million **CONSUMER SENTIMENT** June 98.2 July 98.4 Aug 92.1
19	20	21	22	23
		EXISTING HOME SALES (10:00) May 5.36 million June 5.27 million **July 5.38 million** **FOMC MINUTES (2:00)**	**INITIAL CLAIMS (8:30)** **LEADING INDICATORS (10:00)** May 0.0% June -0.3% **July 0.5%**	**NEW HOME SALES (10:00)** May 0.604 million June 0.646 million **July 0.650 million** **FED CHAIR POWELL'S SPEECH AT JACKSON HOLE CONFERENCE (10:00)**
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**
2	3	4	5	6
LABOR DAY	**ISM MFG INDEX** **CONSTRUCTION SPEND.**	**TRADE BALANCE** **BEIGE BOOK** **VEHICLE SALES**	**ADP EMPLOYMENT REPORT** **INITIAL CLAIMS** **REVISED PRODUCTIVITY & COSTS** **ISM NON-MFG INDEX** **FACTORY ORDERS**	**EMPLOYMENT REPORT**

Forecasts in Bold

Treasury Financing

August/September 2019

Monday	Tuesday	Wednesday	Thursday	Friday
12	13	14	15	16
AUCTION RESULTS: Rate Cover 13-week bills 1.960% 2.99 26-week bills 1.890% 3.06	**AUCTION RESULTS:** Rate Cover 52-week bills 1.800% 2.66 **ANNOUNCE:** $55 billion 4-week bills for auction on August 15 $40 billion 8-week bills for auction on August 15 **SETTLE:** $50 billion 4-week bills $40 billion 8-week bills		**AUCTION RESULTS:** Rate Cover 4-week bills 2.040% 2.47 8-week bills 1.950% 3.05 **ANNOUNCE:** $87 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	
19	20	21	22	23
AUCTION: $87 billion 13-,26-week bills	**ANNOUNCE:** $55 billion* 4-week bills for auction on August 22 $40 billion* 8-week bills for auction on August 22 **SETTLE:** $55 billion 4-week bills $40 billion 8-week bills		**AUCTION:** $55 billion* 4-week bills $40 billion* 8-week bills $7 billion 30-year TIPS **ANNOUNCE:** $87 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:** $87 billion 13-,26-week bills	
26	27	28	29	30
AUCTION: $87 billion* 13-,26-week bills	**AUCTION:** $40 billion* 2-year notes **ANNOUNCE:** $55 billion* 4-week bills for auction on August 29 $40 billion* 8-week bills for auction on August 29 **SETTLE:** $55 billion* 4-week bills $40 billion* 8-week bills	**AUCTION:** $18 billion* 2-year FRNs $41 billion* 5-year notes	**AUCTION:** $55 billion* 4-week bills $40 billion* 8-week bills $32 billion* 7-year notes **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on September 3 **SETTLE:** $87 billion* 13-,26-week bills	**SETTLE:** $7 billion 30-year TIPS $18 billion* 2-year FRNs
2	3	4	5	6
LABOR DAY	**AUCTION:** $87 billion* 13-,26-week bills **ANNOUNCE:** $55 billion* 4-week bills for auction on September 5 $40 billion* 8-week bills for auction on September 5 **SETTLE:** $55 billion* 4-week bills $40 billion* 8-week bills $40 billion* 2-year notes $41 billion* 5-year notes $32 billion* 7-year notes		**AUCTION:** $55 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on September 9 $28 billion* 52-week bills for auction on September 10 $38 billion* 3-year notes for auction on September 10 $24 billion* 10 year notes for auction on September 11 $16 billion* 30-year bonds for auction on September 12 **SETTLE:** $87 billion* 13-,26-week bills	

**Estimate*