Daiwa Capital Markets

U.S. Economic Comment

- The U.S. economy: still performing well, but decelerating

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Forecast Update

We typically wait until December to review and revise our economic outlook for the upcoming year, but recent developments suggest a favorable shift in prospects for the United States, leading us to reexamine a bit early. Trade tensions have eased to a degree, and recent employment data suggest good momentum in the labor market. Financial markets certainly are pricing in a firmer performance, as interest rates and stock prices have jumped and the slope of the yield curve has steepened.

We have tweaked our view in light of recent developments, but we have not made a pronounced adjustment. The U.S. economy, while currently performing well, also is showing an easing in momentum. The deceleration is most obvious in GDP growth: 2.9% last year, 2.5% in the first half of this year, and 1.9% in the third quarter. The labor market, too, has lost some of its edge, as average job growth of 167,000 so far this year lags the average of 223,000 in 2018. Given the age of the current expansion -- 10-plus years, the longest on record -- continued deceleration seems more likely than a reacceleration. We don't expect a recession to begin next year, but growth is likely to slow throughout 2020, barely staying positive by the fourth quarter (table, p. 4). Over the four quarters of next year, we see GDP growth totaling 1.3 percent, better than the 1.0 percent in our previous view, but not materially so.

Fed Chair Jerome Powell indicated in July that maintaining the expansion was the "overarching goal" of the Federal Open Market Committee, and thus we look for the Fed to provide additional support next year. The Fed will be on hold for a time, but we suspect that an easing in the rate of growth will prompt officials to trim interest rates further. Because of the near-term pause from the Fed, we are now looking for two rate cuts next year rather than three in our previous forecast.

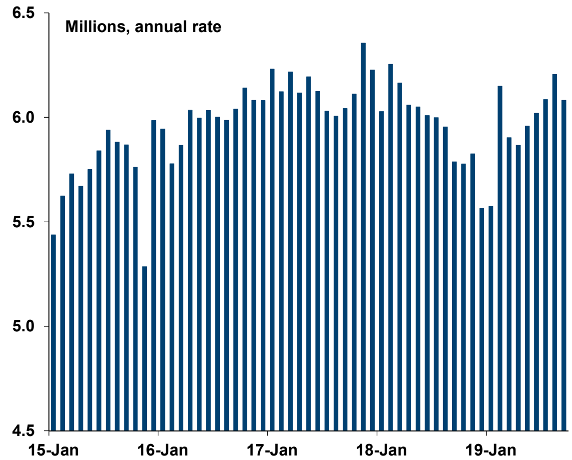
The Bright Spot

Optimistic views on the U.S. economy are largely based on continued support from the household sector in the form of both strong consumer spending and firm housing activity. There is much to be said for this view. Job growth, although slower than last year, remains brisk, and elevated job postings by businesses suggest that hiring will be well maintained. In addition, the aggregate financial position of the household sector is healthy, as individuals have used debt judiciously during the current expansion, while rising home values and stock prices have bolstered the asset side of the balance sheet.

At the same time, we are seeing signs that vigor has eased. Sales of new vehicles, for example, are drifting lower, with the annual sales pace so far this year totaling 16.9 million units, down from 17.2 million last year and a peak of 17.4 million in 2015 and 2016. In addition, measures of consumer attitudes have eased. The latest readings from the Conference Board and Reuters/University of Michigan are approximately three percent below their averages from last year. We were surprised by the soft tone to the Reuters/UMichigan index (published Friday), which increased only marginally in early November despite a surge in the stock market.

The housing market has performed well in recent months, with home sales (new and existing combined) moving back to the upper portions of the range in the past few years (chart, next page). Single-family housing starts also have picked up. This improvement is certainly welcome, but it also strikes us as feeble. The gains, no doubt, have been driven by the drop of approximately 125 basis points in mortgage rates since late last year, but this spark was not able to push activity to a new high for the current cycle. Moreover, the peak for the current cycle is not impressive from a historical perspective. We would not expect activity to move to the levels seen during the bubble, but this housing cycle has been soft relative to other expansions as well. We suspect that the push from low mortgage rates in the past year will begin to lose some of its force in the months ahead, which will probably renew the downward drift in sales and construction that was evident last year.

Total Home Sales*



Sales of existing and new homes.

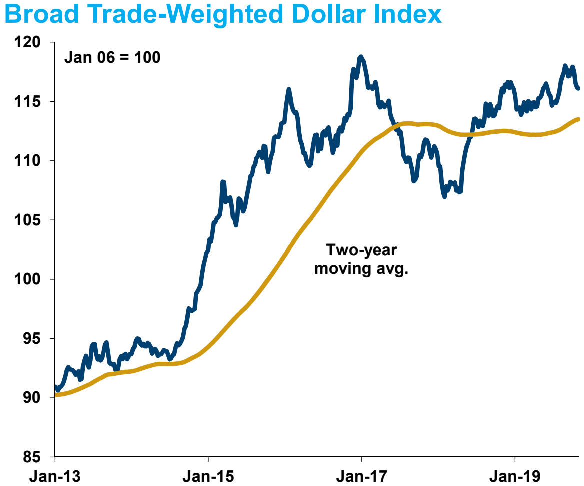
Source: National Association of Realtors and U.S. Census Bureau via Haver Analytics

Challenges

Net exports. Casual observation might suggest that the trade war and associated effects on exports and imports represents the greatest downside risk for the economy. However, the direct effect of tariffs on the pace of economic growth will probably be modest. Consumers and businesses can alter consumption patterns and supply chains to work around the costs generated by the duties, thereby limiting the economic damage. In this regard, estimates generated by the International Monetary Fund in its latest World Economic Outlook showed a small direct influence from tariffs, probably in the neighborhood of one-quarter percentage point for U.S. GDP growth. Indirect effects in the form of depressed capital spending because of uncertainty will add to the damage (discussed below).

Even in the absence of the trade dispute with China (and lesser spats with other areas such as Europe and Canada), the outlook for the trade sector was negative. Economic growth in some of the major trading partners of the U.S. is slowing, which naturally lessens demand for U.S. exports. In addition, the foreign exchange value of the dollar is on the firm side, dampening the competitiveness of U.S. producers. (Changes in exchange rates feed through to trade flows over a period of approximately two years. The current value of the dollar index published by the Federal Reserve is above its two-year moving average, signaling a constraining influence from the dollar's value in the months ahead; chart).

Broad Trade-Weighted Dollar Index



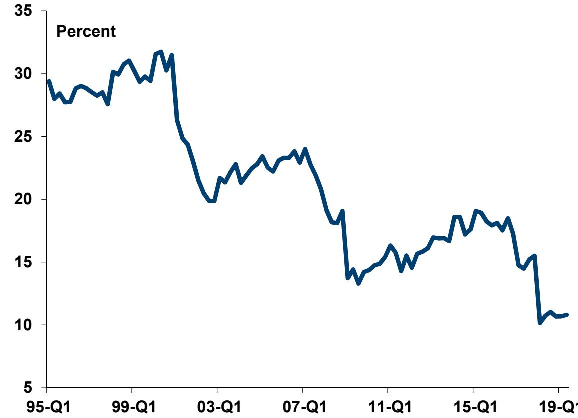
Source: Federal Reserve Board via Haver Analytics

Capital Expenditures. Investment spending has stood out on the soft side in the past two quarters, dropping 1.0 percent in Q2 and 3.0 percent in Q3. Some of the softness was the result of a cutback in drilling for oil and natural gas because of low prices, and a halt by Boeing in shipments of the 737 Max had an influence as well. However, other areas also were soft, with uncertainty probably the most important constraint. The trade war is an obvious source of uncertainty, but questions about the sustainability of the global expansion also have emerged, and the geopolitical environment is less than settled. Business executives are naturally hesitating.

Recent news regarding the trade war has been more favorable, with the U.S. and China working on "phase one" of a trade agreement, which might seem to brighten the outlook for capital spending next year. However, the presidential election might bring new forms of uncertainty. Specifically, if the far-left candidates begin to attract broad-based support, their anti-business platforms could intensify the reluctance of businesses to undertake investment projects. An Elizabeth Warren candidacy would be especially chilling for business investment, as would a Bernie Sanders candidacy.

The soft performance of capital spending might seem surprising in light of the Tax Cuts and Jobs Act of 2017, which was intended in part to boost investment spending. However, the investment implications of that act have been less forceful than members of Congress may have hoped. While the statutory tax rate for corporations was reduced substantially (from 35 percent to 21 percent) the decline in effective tax rates was much smaller. As shown in the chart to the right, an easing incorporate tax provisions in earlier years already had reduced effective corporate tax rates (effective rates defined as taxes paid as a share of income; GDP data). The new provisions trimmed effective rates, but the degree of change was not pronounced, and thus the boost to investment spending was moderate and short-lived.

Effective Corporate Tax Rate*



* *Taxes paid by corporations as a share of pretax income.*
Source: Bureau of Economic Analysis via Haver Analytics; Daiwa Capital Markets America

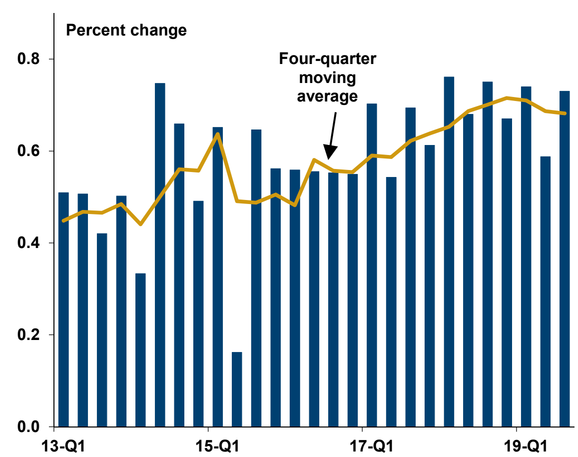
Inflation and Monetary Policy

Inflation is likely to remain contained. Upside risks exist because of tight labor markets and faster wage growth, but such risks do not seem overwhelming. Inflation expectations are well anchored, which will help constrain the demands of workers for pay hikes. In fact, the growth of the employment cost index -- probably the best available measure of labor compensation -- seems to be stabilizing (chart, below). The growth of average hourly earnings from the monthly employment report also has eased or settled (year-over-year growth has eased overall and stabilized for production workers).

Other factors also should help limit inflation pressures. Productivity growth has improved slightly in the past year or two, which will allow businesses to absorb higher wage costs without raising prices (although productivity in the third quarter was weak, which dampened the recent trend). In addition, prices of nonpetroleum imports have been soft, and are likely to remain so given the firmness of the U.S. currency.

Limited inflation pressure will allow the Federal Reserve to err on the side of accommodation. The Federal Open Market Committee will probably remain on the sidelines for the next several months. As noted by Chair Powell in his latest press conference, “monetary policy is in a good place”. However, if momentum begins to fade as we expect, the Fed will probably make an effort to sustain the expansion. Our current view involves two rate cuts next year (adjusted downward from our previous view of three cuts). We look for the changes to occur in the second and third quarters, although we remain open-minded on timing. We can easily envision the second quarter reduction being pushed back until after the presidential election.

Employment Cost Index



Source: Bureau of Labor Statistics via Haver Analytics

U.S. Economic Outlook*

Item		2019 Q1	2019 Q2	2019 Q3	2019 Q4	2020 Q1	2020 Q2	2020 Q3	2020 Q4
1	Gross Domestic Product	3.1	2.0	1.9	1.8	1.8	1.6	1.2	0.6
2	Personal Consumption Expenditures	1.1	4.6	2.9	2.3	2.2	1.9	1.6	1.0
3	Business Fixed Investment	4.4	-1.0	-3.0	0.5	3.0	2.8	1.3	-0.2
4	Residential Construction	-1.0	-3.0	5.1	4.0	3.0	0.0	-2.0	-2.5
5	Change in Business Inventories *(Contribution to growth)*	0.5	-0.9	-0.1	-0.1	-0.2	-0.1	0.0	0.0
6	Government Spending	2.9	4.8	2.0	1.4	1.0	0.8	0.7	0.4
7	Net Exports *(Contribution to growth)*	0.7	-0.7	-0.1	-0.1	-0.2	-0.1	-0.1	0.0
	End of Period Figures:								
	Inflation and Unemployment								
8	Core PCE Deflator *(Annual rate)*	1.1	1.9	2.2	2.1	2.1	2.0	2.0	1.9
9	Unemployment Rate	3.9	3.7	3.5	3.6	3.7	3.8	4.0	4.2
	Interest Rates								
10	Federal Funds Target (midpoint)	2.38	2.38	1.88	1.63	1.63	1.38	1.13	1.13
11	2-year Treasury	2.27	1.75	1.63	1.60	1.55	1.30	1.00	0.85
12	10-year Treasury	2.41	2.00	1.68	1.80	1.85	1.70	1.50	1.50
13	30-year Fixed-Rate Mortgages	4.06	3.73	3.64	3.85	3.90	3.80	3.70	3.80

** The readings for 2019-Q3 to 2020-Q4 are forecasts.*
Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; Daiwa Capital Markets America

Review

Week of Nov. 4, 2019	Actual	Consensus	Comments
Factory Orders (September)	**-0.6%**	**-0.5%**	New orders for durable goods fell 1.2% in September (published two weeks ago), with transportation-related orders weighing on the results (-2.8%). Results elsewhere also were soft, as bookings ex-transportation slipped 0.4%, giving a slight downward tilt to the previously flat trend. Nondurable bookings rose 0.1%. The advance reflected a price-led increase of 0.4% in petroleum and coal products. Bookings ex-petrol and coal were flat in September, but the latest reading did little damage to a rally that began in the spring.
Trade Balance (September)	**-$52.4 Billion ($2.5 Billion Narrower Deficit)**	**-$52.5 Billion ($2.5 Billion Narrower Deficit)**	While a narrowing in the trade deficit in September was welcome, the detail of the change was less encouraging, as the improvement was a "soft" one. That is, both exports and imports fell, but the drop in imports was larger (off 1.7% versus a decline of 0.9% for exports). Also, while the deficit was narrower than the one in August, it was a mid-range observation rather than a signal of an improving trend. The September trade results will feed into the revised reading for Q3 GDP, but the new figures suggest only a modest adjustment to net exports, one that likely will be lost with rounding.
ISM Nonmanufacturing Index (October)	**54.7% (+2.1 Pct. Pts.)**	**53.5% (+0.9 Pct. Pts.)**	Although the ISM nonmanufacturing index increased in October, the change was small and thus the measure remained in the low portion of the recent range. The latest reading trailed the average of 56.7% in the first half of the year and it was well below the average of 58.9% in 2018. The employment component accounted for much of the advance in the headline number (+3.3 percentage points to 53.7%), but the change occurred from a decidedly low level in September, and thus the new level was still uninspiring (among the lowest since mid-2017). The new orders index, valuable because of its leading indicator properties, rose moderately (1.9 percentage points to 55.6%). The pickup in order flows led to a similar-sized gain in the business activity index (+1.8 percentage points to 57.0%). Both of these measures, however, also remained in the low portions of their recent ranges.

Review Continued

Week of Nov. 4, 2019	Actual	Consensus	Comments
Nonfarm Productivity (2019-Q3)	**-0.3%**	**0.9%**	Growth of hours worked (+2.4%, annual rate) outpaced growth in output (2.1%) in Q3, leading to a modest decline in nonfarm productivity growth. In one sense, the slow results in Q3 are not shocking, as productivity growth often fluctuates widely from quarter to quarter. Thus, the series is best monitored with some long-term moving average (at least four quarters, eight is probably better). Before today's report, trend productivity growth seemed to be accelerating, with the eight-quarter average totaling 1.7% as of Q2, up from readings of approximately 1% in preceding years. The slow results in Q3 pushed the eight-quarter average to 1.3%, raising doubts about a meaningful pickup in productivity growth.
Consumer Sentiment (November)	**95.7 (+0.2%)**	**95.5 (Unchanged)**	Consumer sentiment inched higher in early November, but the index remained in the middle of the range of the past few years. An increase of 2.0% in the expectations component offset a similar-sized decline in the current conditions component, although both measures remained range-bound despite the shifts. The long-term inflation measure published with report increased one tick to 2.4%, a reading close to the record low of 2.3% seen in several recent months.

Source: U.S. Census Bureau (Factory Orders); Bureau of Economic Analysis (Trade Balance); Institute for Supply Management (ISM Nonmanufacturing Index); Bureau of Labor Statistics (Nonfarm Productivity); Reuters/University of Michigan Survey Research Center (Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of Nov. 11, 2019	Projected	Comments
CPI (October) (Wednesday)	**0.3% Total, 0.2% Core**	The food component will probably maintain the upward drift that has been in place since the spring, while the energy component will probably rise more than1%, led by gasoline prices. The core component has moved erratically this year: barely increasing in the spring before jumping from June to August only to slow again in September. We view these shifts as random volatility around an underlying trend of 0.2% per month.
Federal Budget (October) (Wednesday)	**$130.0 Billion Deficit**	After averaging year-over-year growth of more than 7% in the prior eight months, federal revenues appear to have dropped in October. With outlays likely to run close to the recent average, the soft revenue collections will leave noticeable slippage from the budget deficit of $100 billion in the same month last year.
PPI (October) (Thursday)	**0.3% Total, 0.2% Core***	Food prices are likely to remain on the flat trend that has been in place since January, but higher prices of gasoline will probably pressure the energy component. Core goods prices have been well contained recently, showing little net change since early in the year, and we have not seen any price quotes suggesting a break from this pattern. The volatile service component could jump after soft results in September, and construction prices tend to jump in the first month of a quarter.
Retail Sales (October) (Friday)	**0.2% Total, 0.3% Ex-Autos**	A drop in sales of new motor vehicles will probably constrain the auto component, but higher prices should inflate the gasoline component, and other areas are likely to post respectable growth in line with positive fundamentals for consumer spending (firm labor market and supportive financial conditions).
Industrial Production (October) (Friday)	**-0.4%**	An increase in manufacturing payrolls outside the auto industry suggests some stirring in the factory sector, but the strike at General Motors will weigh heavily in October, pushing the manufacturing component lower. Utility output is likely to be off as well, as heavier-than-normal air conditioning usage that boosted output in September is unlikely to be a factor in October. A modest increase in payrolls suggests that the mining sector could offset a small portion of the expected declines in manufacturing and utility output.

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

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

November 2019

Monday	Tuesday	Wednesday	Thursday	Friday
4	5	6	7	8
FACTORY ORDERS July 1.4% Aug -0.1% Sept -0.6%	**TRADE BALANCE** July -$54.0 billion Aug -$55.0 billion Sept -$52.5 billion **ISM NON-MFG INDEX** Index / Prices Aug 56.4 / 58.2 Sept 52.6 / 60.0 Oct 54.7 / 56.6 **JOLTS DATA** Openings (000) / Quit Rate July 7,174 / 2.4% Aug 7,301 / 2.4% Sept 7,024 / 2.3%	**PRODUCTIVITY & COSTS** Productivity / Unit Labor Costs 19-Q1 3.5% / 5.7% 19-Q2 2.5% / 2.4% 19-Q3 -0.3% / 3.6%	**INITIAL CLAIMS** Oct 19 213,000 Oct 26 219,000 Nov 02 211,000 **CONSUMER CREDIT** July $23.0 billion Aug $17.9 billion Sept $9.5 billion	**CONSUMER SENTIMENT** Sept 93.2 Oct 95.5 Nov 95.7 **WHOLESALE TRADE** Inventories / Sales Jul 0.2% / 0.2% Aug 0.1% / -0.1% Sept -0.4% / 0.0%
11	12	13	14	15
VETERANS DAY	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** Aug 103.1 Sept 101.8 Oct --	**CPI (8:30)** Total / Core Aug 0.1% / 0.3% Sept 0.0% / 0.1% **Oct 0.3% / 0.2%** **FEDERAL BUDGET (2:00)** 2019 / 2018 Aug -$200.3B / -$214.1B Sept $82.8B / $119.1B Oct **-$130.0B** / -$100.5B	**INITIAL CLAIMS (8:30)** **PPI (8:30)** Final Demand / Core* Aug 0.1% / 0.4% Sept -0.3% / 0.0% **Oct 0.3% / 0.2%**	**RETAIL SALES (8:30)** Total / Ex.Autos Aug 0.6% / 0.2% Sept -0.3% / -0.1% **Oct 0.2% / 0.3%** **IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports / Nonagri. Exports Aug 0.0% / -0.3% Sept -0.1% / -0.1% Oct -- / -- **EMPIRE MFG (8:30)** Sept 2.0 Oct 4.0 Nov -- **IP & CAP-U (9:15)** IP / Cap.Util. Aug 0.8% / 77.9% Sept -0.4% / 77.5% **Oct -0.4% / 77.0%** **BUSINESS INVENTORIES (10:00)** Inventories / Sales July 0.3% / 0.2% Aug -0.1% / 0.1% **Sept 0.1% / -0.2%**
18	19	20	21	22
NAHB HOUSING INDEX **TIC DATA**	**HOUSING STARTS**	**FOMC MINUTES**	**INITIAL CLAIMS** **PHILLY FED INDEX** **EXISTING HOME SALES** **LEADING INDICATORS**	**REVISED CONSUMER SENTIMENT**
25	26	27	28	29
CHICAGO FED NAT'L ACTIVITY INDEX	**INTERNATIONAL TRADE IN GOODS** **ADVANCE INVENTORIES** **FHFA HOME PRICE INDEX** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **NEW HOME SALES** **CONSUMER CONFIDENCE**	**INITIAL CLAIMS** **REVISED Q3 GDP** **DURABLE GOODS ORDERS** **CHICAGO PURCHASING MANAGERS' INDEX** **PERSONAL INCOME, CONSUMPTION, PRICES** **BEIGE BOOK**	***THANKSGIVING***	

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

Treasury Financing

November 2019

Monday	Tuesday	Wednesday	Thursday	Friday
4	5	6	7	8
AUCTION RESULTS: Rate Cover 13-week bills 1.520% 2.63 26-week bills 1.535% 2.69	**AUCTION RESULTS:** Rate Cover 52-week bills 1.565% 2.84 3-year notes 1.630% 2.60 **ANNOUNCE:** $55 billion 4-week bills for auction on November 7 $40 billion 8-week bills for auction on November 7 **SETTLE:** $55 billion 4-week bills $40 billion 8-week bills	**AUCTION RESULTS:** Rate Cover 10-yr notes 1.809% 2.49	**AUCTION RESULTS:** Rate Cover 4-week bills 1.535% 2.65 8-week bills 1.530% 2.81 30-yr bonds 2.430% 2.23 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on November 12 **SETTLE:** $87 billion 13-,26-week bills $28 billion 52-week bills	
11	12	13	14	15
11 *VETERANS DAY*	12 **AUCTION:** $87 billion 13-,26-week bills **ANNOUNCE:** $55 billion* 4-week bills for auction on November 14 $40 billion* 8-week bills for auction on November 14 **SETTLE:** $55 billion 4-week bills $40 billion 8-week bills		**AUCTION:** $55 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on November 18 $12 billion* 10-year TIPS for auction on November 21 **SETTLE:** $87 billion 13-,26-week bills	**SETTLE:** $38 billion 3-year notes $27 billion 10-year notes $19 billion 30-year bonds
18	19	20	21	22
AUCTION: $87 billion* 13-,26-week bills	**ANNOUNCE:** $55 billion* 4-week bills for auction on November 21 $40 billion* 8-week bills for auction on November 21 **SETTLE:** $55 billion* 4-week bills $40 billion* 8-week bills		**AUCTION:** $55 billion* 4-week bills $40 billion* 8-week bills $12 billion* 10-year TIPS **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on November 25 $18 billion* 2-year FRNs for auction on November 26 $40 billion* 2-year notes for auction on November 25 $41 billion* 5-year notes for auction on November 26 $32 billion* 7-year notes for auction on November 27 **SETTLE:** $87 billion* 13-,26-week bills	
25	26	27	28	29
AUCTION: $87 billion* 13-,26-week bills $40 billion* 2-year notes	**AUCTION:** $18 billion* 2-year FRNs $41 billion* 5-year notes **ANNOUNCE:** $55 billion* 4-week bills for auction on November 27 $40 billion* 8-week bills for auction on November 27 **SETTLE:** $55 billion* 4-week bills $40 billion* 8-week bills	**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 December 2 $28 billion* 52-week bills for auction on December 3	*THANKSGIVING*	**SETTLE:** $87 billion* 13-,26-week bills $18 billion* 2-year FRNs $12 billion* 10-year TIPS

*Estimate