Daiwa Capital Markets

U.S. Economic Comment

- The U.S. economic outlook: manufacturing matters
- The housing sector: can the good times last?

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Manufacturing: Highly Cyclical

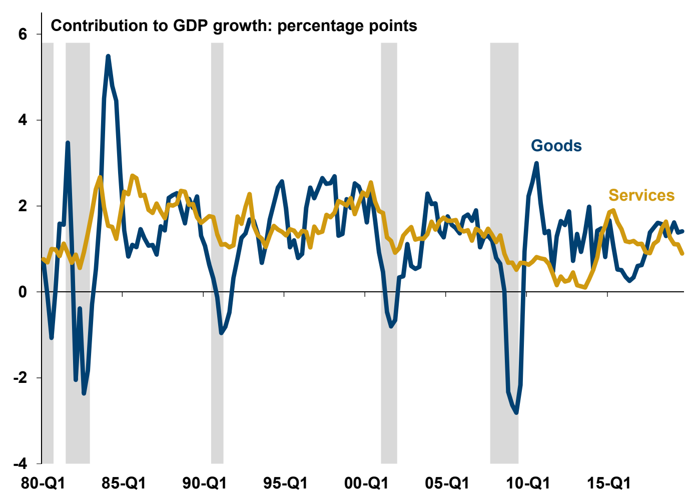
When the manufacturing sector of the economy began to soften earlier this year, some analysts downplayed the significance of the shift, arguing that factory output represents a small share of the economy and that continued growth in the service sector would keep overall activity on track. We do not subscribe to this view. While the manufacturing sector is indeed a small share of the economy -- only about 12 percent of GDP -- it is a highly cyclical area and it often calls the tune for the overall economy.

The strong influence of the manufacturing sector is apparent in the chart below, which shows the contribution over four quarters to GDP growth from manufacturing and service production. The service sector of the economy moves cyclically, but the swings are mild. The pace of growth slows during recessions, but it seldom moves into negative territory (the last instance of a four-quarter decline occurred in 1954). Service activity strengthens during expansion times, although surges are rare. Indeed, four-quarter contributions of more than two percentage points are uncommon; we have not seen any such advances in the past two expansions. The manufacturing sector, in contrast, often breaks through the two percent threshold, and more important, it tends to tumble during recessions. One could argue that it is the manufacturing sector that pulls the overall economy into recession.

Thus, we did not find much comfort earlier this year when service production seemed on track while manufacturing softened. If manufacturing activity had continued to retreat, the economy could have slid into recession. However, we have been heartened by the performance of the manufacturing sector in recent months. While this area is soft, it is not sliding lower, and some figures have suggested slight improvement.

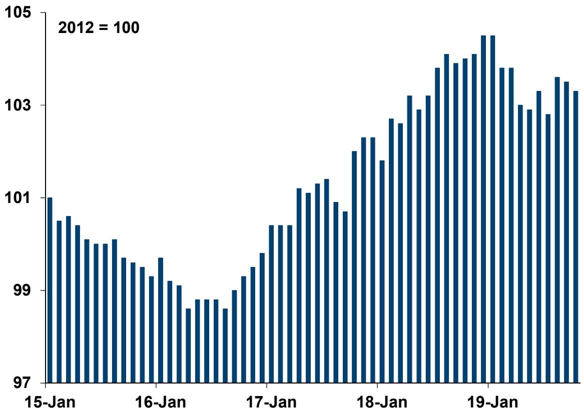
The manufacturing component of the industrial production index is perhaps the best indicator for gauging conditions in the factory sector, as it shows the amount of production taking place. This measure started to decline in February, and it took a notable drop in April and May (chart, next page; the chart shows manufacturing activity excluding motor vehicles and parts to eliminate the effects of the strike at General Motors). Some of the drop in the spring was the result of Boeing trimming the production of the 737 Max, but other areas also were weak. More than half of the 20 major industries included in the report reported declines in production during April and May. Since then, activity has recovered slightly; production is still noticeably below levels in late 2018, but it has tilted upward rather than continued to slide.

Contribution to Percent Change in GDP Growth*



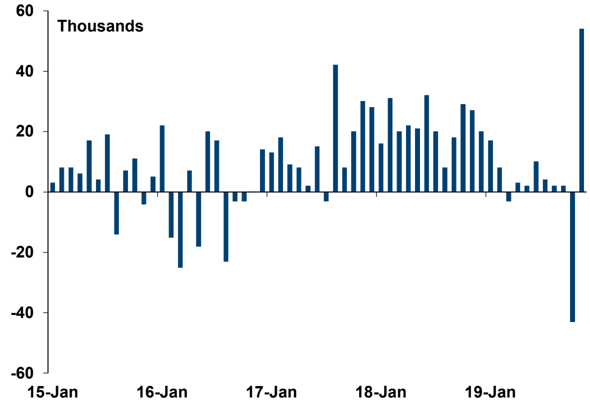
Four-quarter moving averages of the contributions of goods (blue line) and services (gold line) to GDP growth. The shaded areas indicate periods of recession in the U.S. economy.
Source: Bureau of Economic Analysis and National Bureau of Economic Research via Haver Analytics

Industrial Production: Manufacturing Ex. Autos



Source: Federal Reserve Board via Haver Analytics

Change in Manufacturing Payrolls



Source: Bureau of Labor Statistics via Haver Analytics

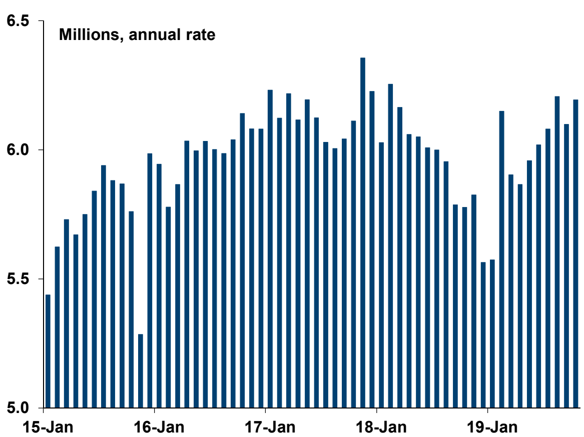
The employment statistics also support the view that manufacturing activity still has some life. Growth of factory employment has been slow, but firms have continued to hire workers (chart, above right). The strike-related swings in the past two months have netted to average job growth of 5,500 in October and November, results in line with the performance since the spring. Hiring is far from brisk, but it is not consistent with near-term recession.

Although the manufacturing sector is not faltering at this time, risks remain tilted in the downward direction. U.S. producers of goods could be badly damaged by an escalation in the trade war. In addition, slow growth abroad could be detrimental because of the possible weakening of exports. Careful monitoring is warranted, even if service activity remains on track.

Housing: On the Mend (For Now)

The housing industry has strengthened in recent months. Sales of both new and existing homes have increased sharply since the spring, with total activity moving to the top of the range from the current expansion (chart, left). The improvement in sales has stirred new construction, as single family housing starts also have moved to the upper portion of the recent range (chart, right). The residential construction

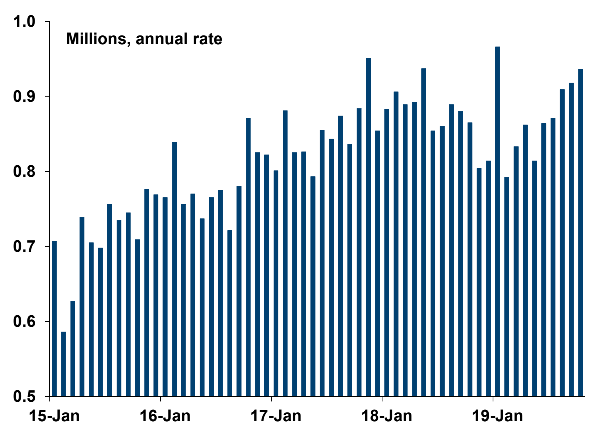
Total Home Sales*



* *Sales of existing and new homes.*

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

Single-Family Housing Starts



Source: U.S. Census Bureau via Haver Analytics component of GDP grew 5.1 percent in the third quarter, ending a string of six quarterly declines (and eight drops in the past nine quarters). Available data, while relating to only one month in the fourth quarter, point to another increase in residential construction.

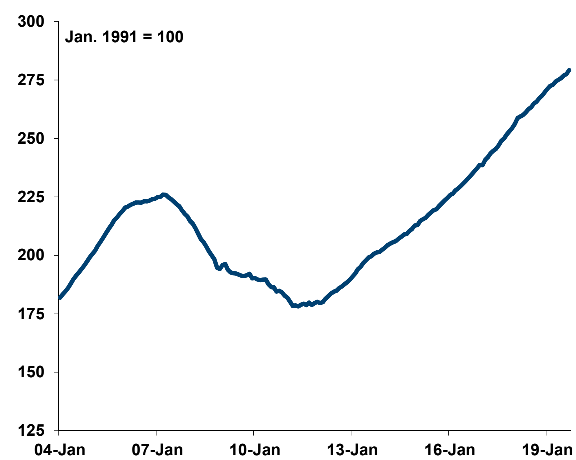
The recent pickup, no doubt, is related to the drop in interest rates that has unfolded in the past year. The rate on 30-year fixed-rate mortgages fell by approximately 145 basis points from mid-November last year to early September. Although rates have backed up about 20 basis points since the trough, the easy financial environment has boosted sales and starts.

The positive contribution from housing to economic growth is welcome, but we wonder about its staying power. If interest rates do not decline further, the effect of the drop in the past year is likely to begin fading before long. Without a push from low interest rates, the softening trends in sales and starts evident during most of 2018 could reassert themselves. We see several factors that could slow the momentum in housing activity.

Credit availability remains an issue, as lending standards remain tighter than historical norms, and many young buyers cannot clear today's hurdles because of burdens associated with student loans. Tight control of credit is evident in the growth of outstanding mortgage debt in the past few years, which has averaged approximately 2.5 percent, well shy of the average of five to six percent evident during the expansion in the 1990s (and nowhere near growth of 12 to 14 percent during the housing bubble, but we do not want to go there again).

We also see the pricing of homes as a constraint. Housing prices have increased steadily since finding a bottom in 2011, with average costs now well above peaks seen during the housing bubble (chart). Today's low level of interest rates will allow many to remain active in the market despite high prices, but some will be forced to withdraw. Even those who can afford to buy at current prices might hesitate. To the extent that they view housing as an investment, well-off buyers might be concerned about a price correction and decide to stay on the sidelines until prospects for appreciation seem brighter.

FHFA Home Price Index



Source: Federal Housing Finance Agency via Haver Analytics

The Tax Cuts and Jobs Act has not helped the housing market. Limits on the deduction of property taxes and mortgage interest have reduced the appeal of home ownership in high-cost and high-tax areas. We suspect that the softening in housing activity in 2018 was partly the result of the shift in tax provisions, and we doubt that the market has fully adjusted to the new environment.

Demographics, in a sense, might be working against continued growth in the housing market. The retirement of baby boomers is likely to diminish demand for traditional single-family homes in the suburbs and stir demand for multi-family units in center cities. That seems to have been the case in the past several years, as multi-family construction recovered rapidly during the early and mid-portions of the expansion and it has remained firm in the past few years. Single-family activity, in contrast, has lagged historical norms by a wide margin.

We welcome the recent recovery in housing, and we hope it lasts, but the market faces challenges once the push from low interest rates begins to fade.

Review

Week of Dec. 2, 2019	Actual	Consensus	Comments
ISM Manufacturing Index (November)	**48.1% (-0.2 Pct. Pt.)**	**49.2% (+0.9 Pct. Pt.)**	Although the decline in the ISM manufacturing index was small, it occurred from a low level and it marked the fourth consecutive reading below 50%. The new orders component, valuable because of its leading indicator properties, fell 1.9 percentage points to 47.2%. The latest observation matched the lowest since the recession. The employment index also disappointed with a drop of 1.1 percentage points to 46.6%, a reading in the low end of the range of the current expansion. The production index rose 2.9 percentage points, but this measure remained below the critical value of 50% (49.1%).
Construction Spending (October)	**-0.8%**	**0.4%**	All three major components contributed to the drop in construction activity in October. Private residential building slipped 0.9%. Single-family construction was firm, but multi-family activity and improvements to existing homes provided offsets. Private nonresidential construction fell 1.2%, marking the fifth decline in the past seven months. Government-related construction eased 0.2%, but the dip occurred from an elevated level and the performance thus far this year has been firm.
ISM Nonmanufacturing Index (November)	**53.9% (-0.8 Pct. Pt.)**	**54.5% (-0.2 Pct. Pt.)**	The November reading of the ISM nonmanufacturing index was in the low portion of the range from the past several years and it trailed the average of 58.9% from 2018 by a sizeable margin. The headline figure tilted to the disappointing side, but shifts in various components were less troubling. The new orders index increased 1.5 percentage points to 57.1%, still shy of the 2018 average of 61.3% but solid by historical standards. Businesses also hired actively, as the employment index rose 1.8 percentage points to 55.5%. The business activity index tumbled 5.4 percentage points to 51.6%, among the lowest readings since the early stages of the expansion, but given the solid performance in other key categories we suspect that this reading contained a dose of random volatility.
Trade Balance (October)	**-$47.2 Billion ($3.9 Billion Narrower Deficit)**	**-$48.5 Billion ($4.0 Billion Narrower Deficit)**	Both exports and imports fell in October, with a sharper change in imports (-1.7%) dominating a modest shift in exports (-0.2%), leaving an improvement in the monthly trade deficit. The modest change in exports reinforced the sideways trend that has been in place since mid-2018. Imports started to drift lower this year, with October adding an accent to the retreat. The sharp decline in imports (and narrowing in the trade deficit versus the Q3 average) suggests a contribution to GDP growth in Q4 of more than 1.0 pct. point. The large positive contribution, however, does not assure a firm showing for GDP growth, as weak imports could reflect softness on other components of GDP. In addition, the weak import figure could involve an element of statistical noise that will be reversed in coming months.

Review Continued

Week of Dec. 2, 2019	Actual	Consensus	Comments
Factory Orders (October)	**0.3%**	**0.3%**	The growth of new orders for durable goods (published last week) was revised 0.1 percentage point lower, now showing an increase of 0.5%. The latest reading, while positive, did not meaningfully alter the downward drift in the past year. Excluding the transportation component, which has weighed on bookings, durable orders have largely moved sideways this year. Orders for nondurable goods were unchanged in October. Bookings for petroleum and coal products rose 0.7% despite lower prices. Orders for nondurable goods other than petroleum and coal fell 0.1%, marking the second consecutive decline. Nondurable orders ex-petroleum started to firm in the spring and summer (up five consecutive months from April to August), but the recent drops have interrupted that rally.
Payroll Employment (November)	**266,000**	**180,000**	Nonfarm payrolls surged in November, with the results augmented by upward revisions of 41,000 in the prior two months. The results were partly influenced by a jump of 54,000 in the manufacturing sector, but a hefty advance was well anticipated because of workers at General Motors returning from their strike. The healthcare industry also stood out on the firm side (growth of 60,000 versus 45,000 in the prior 12 months). The unemployment rate moved one tick lower to 3.5%, although the shift was primarily a rounding issue rather than a substantive decline (3.535% versus 3.562% in October). Average hourly earnings rose 0.2%, but the figure almost rounded up to 0.3% (0.248%). In addition, growth in the prior month was revised upward by 0.1 percentage point (0.356% versus 0.213% as initially reported). Thus, wage developments titled on the firm side.
Consumer Sentiment (December)	**99.2 (+2.5%)**	**97.0 (+0.2%)**	The jump in consumer sentiment in December marked the fourth consecutive increase and pushed the measure to the upper portion of the range of the current expansion. Sentiment in December was firmer than the average of 96.0 for the year and 98.4 last year, but it remained below the peak of the expansion thus far (101.4 in March 2018). The long-term inflation measure published with the report declined two ticks to 2.3%, matching the low for the series and signaling restrained views on inflation by consumers.

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

Preview

Week of Dec. 9, 2019	Projected	Comments
Revised Nonfarm Productivity (2019-Q3) (Tuesday)	**-0.1% (0.2 Pct. Pt. Upward Revision)**	The upward adjustment to GDP growth in Q3 (2.1% versus the initial estimate of 1.9%) will probably feed through to productivity. The income portion of the GDP report raised the possibility of a downward revision in compensation per hour. This adjustment, along with the likely upward revision to productivity, should lead to slower growth in unit labor costs (3.1% versus the initial; estimate of 3.6%).
CPI (November) (Wednesday)	**0.2% Total, 0.2% Core**	Gasoline prices eased in November, but by less than seasonal norms, suggesting an increase after seasonal adjustment. Unusually soft readings for several items that restrained core prices in September and October are likely to give way to firmer increases in November (apparel, new motor vehicles, rents, alcoholic beverages).
Federal Budget (November) (Wednesday)	**$195.0 Billion Deficit**	Federal spending is likely to be noticeably firmer than the recent average because of a calendar configuration that pulled some outlays from December into November. Nevertheless, the deficit will probably narrow from the $205 billion shortfall in the same month last year, as available data suggest that federal revenues jumped in November after a soft showing in the prior month (up approximately 9.0% year-over-year in November versus down 2.8% in October).
PPI (November) (Thursday)	**0.0% Total, 0.1% Core***	Gasoline prices could inch upward after seasonal adjustment, but the increase could be offset by the food component, which should give back some of its surprising increase in October (up 1.3%). Elsewhere, prices of core goods should remain on their remarkably restrained path (nearly unchanged in the prior nine months). The volatile service sector always has the potential to surprise, but there are no obvious reasons to expect a sharp move in either direction.
Retail Sales (November) (Friday)	**0.6% Total, 0.7% Ex-Autos**	A pickup in sales of new motor vehicles should boost the auto component, and with fundamentals for consumer spending favorable, several categories that constrained activity in October should rebound in November (sales excluding autos and gasoline rose only 0.1% in October). A reportedly strong start to the holiday shopping season supports the view of a solid advance in November.

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

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

December 2019

Monday	Tuesday	Wednesday	Thursday	Friday
2	3	4	5	6
ISM INDEX Index Prices Sept 47.8 49.7 Oct 48.3 45.5 Nov 48.1 46.7 **CONSTRUCTION SPEND.** Aug 1.1% Sept -0.3% Oct -0.8%	**VEHICLE SALES** Sept 17.1 million Oct 16.5 million Nov 17.1 million	**ADP EMPLOYMENT REPORT** Private Payrolls Sept 124,000 Oct 121,000 Nov 67,000 **ISM NON-MFG INDEX** Index Prices Sept 52.6 60.0 Oct 54.7 56.6 Nov 53.9 58.5	**INITIAL CLAIMS** Nov 16 228,000 Nov 23 213,000 Nov 30 203,000 **TRADE BALANCE** Aug -$53.5 billion Sept -$51.1 billion Oct -$47.2 billion **FACTORY ORDERS** Aug -0.1% Sept -0.8% Oct 0.3%	**EMPLOYMENT REPORT** Payrolls Un. Rate Sept 193,000 3.5% Oct 156,000 3.6% Nov 266,000 3.5% **WHOLESALE TRADE** Inventories Sales Aug 0.1% -0.1% Sept -0.7% -0.1% Oct 0.1% -0.7% **CONSUMER SENTIMENT** Oct 95.5 Nov 96.8 Dec 99.2 **CONSUMER CREDIT** Aug $18.7 billion Sept $9.6 billion Oct $18.9 billion
9	10	11	12	13
	NFIB SMALL BUSINESS OPTIMISM INDEX (6:00) Sept 101.8 Oct 102.4 Nov -- **REVISED PRODUCTIVITY & COSTS (8:30)** Productivity Unit Labor Costs 19-Q2 2.5% 2.4% 19-Q3(p) -0.3% 3.6% **19-Q3(r) -0.1% 3.1%** **FOMC MEETING**	**CPI (8:30)** Total Core Sept 0.0% 0.1% Oct 0.4% 0.2% **Nov 0.2% 0.2%** **FEDERAL BUDGET (2:00)** 2019 2018 Sept $82.8B $119.1B Oct -$134.5B -$100.5B **Nov -$195.0B** -$204.9B **FOMC DECISION (2:00)** **POWELL PRESS CONFERENCE (2:30)**	**INITIAL CLAIMS (8:30)** **PPI (8:30)** Final Demand Core* Sept -0.3% 0.0% Oct 0.4% 0.1% **Nov 0.0% 0.1%**	**RETAIL SALES (8:30)** Total Ex.Autos Sept -0.3% -0.1% Oct 0.3% 0.2% **Nov 0.6% 0.7%** **IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports Nonagri. Exports Sept -0.1% -0.1% Oct -0.2% -0.3% Nov -- -- **BUSINESS INVENTORIES (10:00)** Inventories Sales Aug -0.1% 0.1% Sept -0.1% -0.3% **Oct 0.2% -0.1%**
16	17	18	19	20
EMPIRE MFG INDEX **NAHB HOUSING MARKET INDEX** **TIC DATA**	**HOUSING STARTS** **IP & CAP-U** **JOLTS DATA**		**INITIAL CLAIMS** **CURRENT ACCOUNT** **PHILLY FED INDEX** **EXISTING HOME SALES** **LEADING INDICATORS**	**REVISED GDP** **PERSONAL INCOME, CONSUMPTION, PRICES** **REVISED CONSUMER SENTIMENT**
23	24	25	26	27
CHICAGO FED NATIONAL ACTIVITY INDEX **NEW HOME SALES**	**DURABLE GOODS ORDERS**	***CHRISTMAS DAY***	**INITIAL CLAIMS**	

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

Forecasts in Bold. (p) = preliminary; (r) = revised

Treasury Financing

December 2019

Monday	Tuesday	Wednesday	Thursday	Friday
2	3	4	5	6
AUCTION RESULTS: Rate Cover 13-week bills 1.560% 3.03 26-week bills 1.565% 3.11 **SETTLE:** $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes	**AUCTION RESULTS:** Rate Cover 52-week bills 1.525% 3.39 **ANNOUNCE:** $40 billion 4-week bills for auction on December 5 $35 billion 8-week bills for auction on December 5 **SETTLE:** $45 billion 4-week bills $35 billion 8-week bills		**AUCTION RESULTS:** Rate Cover 4-week bills 1.500% 3.16 8-week bills 1.520% 3.18 **ANNOUNCE:** $78 billion 13-,26-week bills for auction on December 9 $38 billion 3-year notes for auction on December 9 $24 billion 10-year notes for auction on December 10 $16 billion 30-year bonds for auction on December 12 **SETTLE:** $78 billion 13-,26-week bills $26 billion 52-week bills	
9	10	11	12	13
AUCTION: $78 billion 13-,26-week bills $38 billion 3-year notes	**AUCTION:** $24 billion 10-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on December 12 $35 billion* 8-week bills for auction on December 12 **SETTLE:** $40 billion 4-week bills $35 billion 8-week bills		**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $16 billion 30-year bonds **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on December 16 $15 billion* 5-year TIPS for auction on December 19 **SETTLE:** $78 billion 13-,26-week bills	
16	17	18	19	20
AUCTION: $78 billion* 13-,26-week bills **SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**ANNOUNCE:** $40 billion* 4-week bills for auction on December 19 $35 billion* 8-week bills for auction on December 19 **SETTLE:** $40 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $15 billion* 5-year TIPS **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on December 23 $18 billion* 2-year FRNs for auction on December 24 $40 billion* 2-year notes for auction on December 23 $41 billion* 5-year notes for auction on December 24 $32 billion* 7-year notes for auction on December 26 **SETTLE:** $78 billion* 13-,26-week bills	
23	24	25	26	27
AUCTION: $78 billion* 13-,26-week bills $40 billion* 2-year notes	**AUCTION:** $18 billion* 2-year FRNs $41 billion* 5-year notes **ANNOUNCE:** $40 billion* 4-week bills for auction on December 26 $35 billion* 8-week bills for auction on December 26 **SETTLE:** $40 billion* 4-week bills $35 billion* 8-week bills	***CHRISTMAS DAY***	**AUCTION:** $40 billion* 4-week bills $35 billion* 8-week bills $32 billion* 7-year notes **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on December 30 $26 billion* 52-week bills for auction on December 30 **SETTLE:** $78 billion* 13-,26-week bills	

**Estimate*