U.S. Economic Comment

- Inflation expectations: well anchored, especially among the young
- Holiday retail activity: disappointing
- The US-China trade agreement: interpretation, commitment are the keys
- New data lock-up provisions: probably workable

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

Inflation: Contained by Well-Anchored Expectations

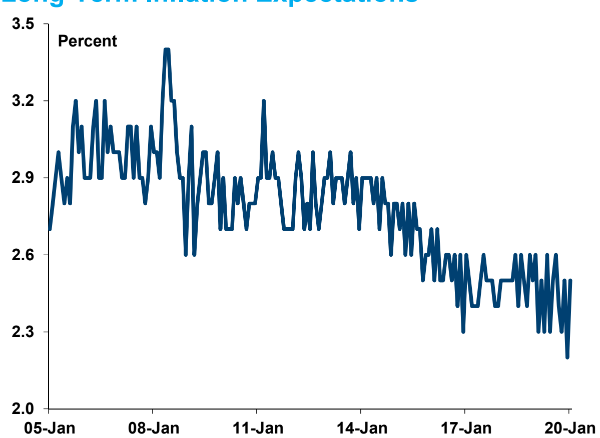
The consumer price index showed a spurt in the middle of last year, increasing 0.3 percent in June, July, and August. Otherwise, the measure was tame, posting increases of either 0.1 or 0.2 percent in the first five and the final four months of the year. The increase for all of 2019 totaled 2.3 percent for both the headline and core indexes, readings within the range of the current expansion.

The stable inflation rate is surprising in light of steady economic growth for more than 10 years and seemingly tight labor markets, but several explanations can be offered. The US seems to have an element of slack that can be tapped to meet demand. The capacity utilization rate in manufacturing is three percentage points below its long-run average, and prime-aged workers are entering the labor force at a brisk pace. Globalization and technology also are playing a role, as tighter linkages among nations effectively increases capacity and intensifies competition, while technological advances increase the flow of information, thereby enhancing price transparency and making consumers savvy shoppers.

Perhaps the most significant brake on inflation is well anchored inflation expectations. Consumers and business executives act on their expectations, and thus wage and price-setting decisions are heavily influenced by the inflation environment expected in the future. Thus, expected inflation is a key determinant of actual inflation, and essentially all measures of inflation expectations show well contained -- even receding -- expectations.

The University of Michigan Survey Research Center provides a useful measure of the views of individuals. The gauge of long-term expectations from UMich shows considerable month-to-month variation, but it also shows a clear downward trend in the past several years. We also monitor long-term expectations from the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, and it has shown a downward drift (charts).

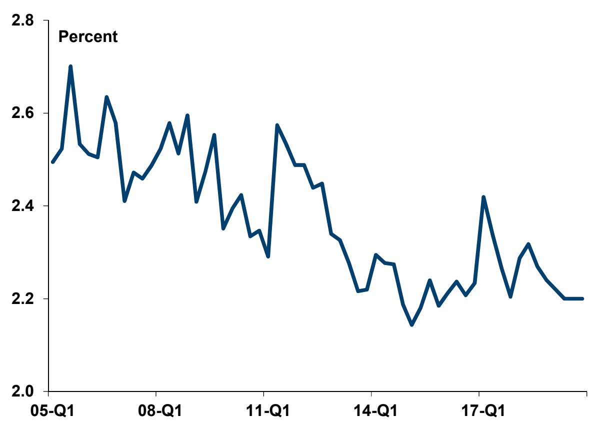
Long-Term Inflation Expectations*



* Survey respondents' expected annual change in prices over the next 5 to 10 years.

Sources: University of Michigan Survey of Consumers via Haver Analytics

Long-Term Inflation Expectations*

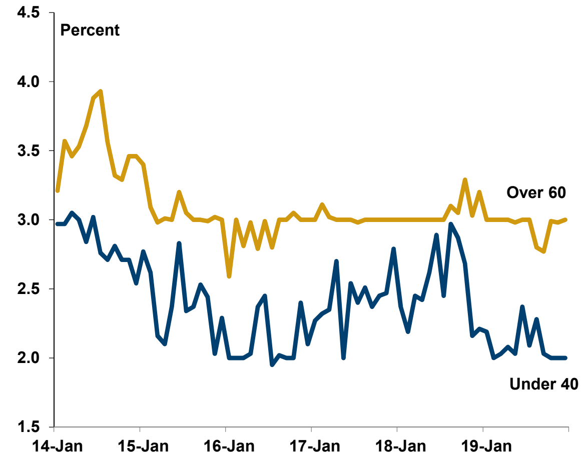


* The average rate of CPI inflation expected over the next 10 years. Mean estimate of survey participants.

Sources: Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia via Haver Analytics

These measures suggest that expectations represent an effective brake on actual inflation. Another bit of survey evidence suggests that the restraint from contained expectations has perhaps become more significant in recent years. The Federal Reserve Bank of New York began a survey of consumers in 2013, and its canvass includes a breakdown by age. Interestingly, young individuals (under 40 years) have lower expectations than those over 60 (chart). Such an outcome is understandable in that those under 40 years of age did not experience the double-digit inflation of the 1970s, while that episode has not vanished from the minds of older individuals. (The results for those in the 40-to-60-year range, unsurprisingly, was generally in the middle of these results.)

Inflation Expectations by Age*



** The median three-year ahead expected inflation rate by age group.*

Source: Survey of Consumer Expectations, Federal Reserve Bank of New York via Haver Analytics

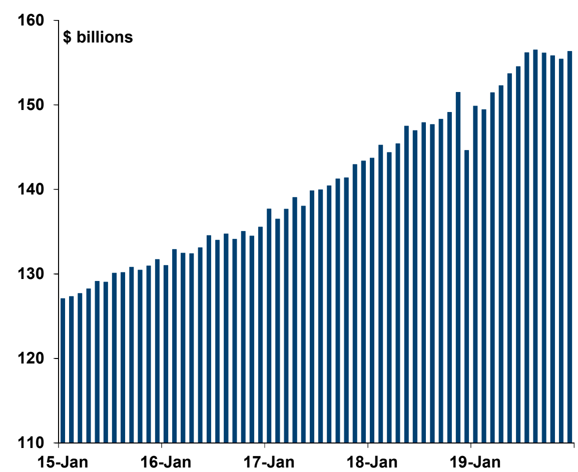
We suspect that those over 60 years old are playing a smaller role in the economy than those in the lower and middle age groups. Certainly, older individuals would be less active on the spending front, and they might be less aggressive in wage negotiations as well. Thus, the expectations of young (and middle-aged) individuals might be having more of an influence on actual inflation than an aggregate measure that includes older individuals. An aggregate measure of inflation expectations could well be understating the constraining influence of this factor.

Holiday Shopping: Disappointing

The strength of the holiday shopping season is often used as a metric for assessing the underlying strength of the household sector in particular and the economy in general. Unfortunately, real-time information is often sketchy, based on surveys or anecdotal information on foot traffic at malls. An accurate assessment is not possible until figures on retail sales for December become available in January.

Based on the recently released report on retail sales, we would rate activity this year as disappointing. We grouped together store types that would be expected to be active during the holiday season (electronic; sporting goods; clothing; general merchandise; and nonstore, i.e. on-line and catalogue). These stores in total posted an increase in sales of 0.2 percent on a month-to-month basis in December, an underwhelming change when viewed in isolation. Results could be viewed as troublesome when viewed from a longer perspective, as activity had declined in the prior three months. Given the declines, the level of sales in December trailed the peak in August by 0.5 percent (chart).

Retail Sales: Discretionary Stores*



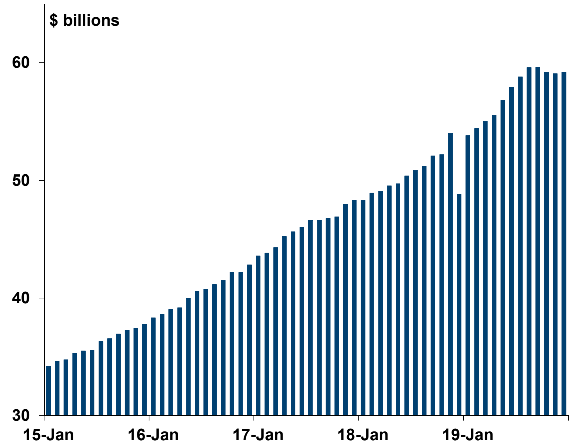
** Discretionary purchases include sales at electronics & appliance stores, clothing & accessory stores, sporting goods, hobby, book & music stores, general merchandise stores, and electronic shopping & mail order houses. Data on sales in the electronic shopping and mail order house category are published with a one-month lag. The estimate for December assumes growth equivalent that in the total nonstore retailers component, a category that includes both online sales and sales at fuel dealers.*

Source: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

Interestingly, a good portion of the disappointing results was the result of slow sales through internet and catalogue vendors. Sales increased in

December, but they were essentially flat in September and fell in October and November (chart). Sales in December were still 0.7 percent below the level in September. This area in recent years had typically registered monthly gains in a range of 0.5 to 1.0 percent. Recent results perhaps suggest that the structural shift toward on-line shopping activity is in its advanced stages.

Retail Sales: Nonstore (Online) Retailers*



Sales in the electronic shopping & mail order houses category of the retail sales report. Data in this category are published with a one-month lag. The reading for December is based on sales growth in the total nonstore retailers component, a category that includes both online sales and sales at fuel dealers.

Source: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

The Trade Agreement

Much of the press coverage of the trade agreement between the United States and China was less than flattering. A common theme was that the pact did not involve structural changes in the Chinese trading system, especially the reduction or elimination of subsidies to Chinese exporters. The *Financial Times* highlighted a wide gulf between the initial list of US demands in May 2018 and the provisions of the agreement. *The New York Times* left little doubt that it was unimpressed, as one of its lead articles noted: “It would be reasonable to look at the new trade agreement between the United States and China and say: All that…for this?”

We find this perspective curious. Negotiators were not seeking to achieve a broad agreement; the talks were billed as “phase one”, implying that it was a first step dealing with easy issues. We wonder why observers would have expected structural changes.

We were favorably surprised with the breadth of the agreement, as it involved more than the exchange of reduced tariffs by the US for the promise of more purchases of US goods and services by China. The agreement also contained provisions to enhance the protection of intellectual property and to prevent the forced transfer of US technology to Chinese firms. It also broadened the access of US firms to the financial services industry in China. Some critics note that China was already moving in these directions, but nevertheless the agreement could add momentum.

While we were pleasantly surprised by the progress achieved, we are skeptical about the success of the effort. We suspect that aspects of the agreement contain vague wording or phrasings that do not translate easily from English to Chinese or vice versa. We see a high probability that US and Chinese officials will have different interpretations of their obligations under the pact. We expect disputes to arise.

We also wonder about compliance. Even if US and Chinese officials agree on obligations, China could waver in response to protests or resistance from its constituents. The agreement contains a dispute resolution mechanism to push for compliance. However, after proceeding through several levels of authority without resolving a dispute, the agreement stipulates that the offended party can withdraw from the agreement. In other words, an exit door is unlocked and open.

We also are not optimistic about phase two. Phase one was supposedly the easy part of trade negotiations, but officials encountered notable difficulties. The challenges in phase two, where the US will be seeking fundamental changes in the Chinese trading system and economic structure, could well be insurmountable.

Data Releases

The Bureau of Labor Statistics this week announced new procedures for releasing its economic reports, which will become effective on March 1, 2020. Under current procedures, news reporters are allowed to review data releases in so-called lock-up rooms 30 minutes before the official release time. They can prepare reports on their lap-top computers to be released with the click of a mouse at the designated time.

Beginning March 1, the BLS will not allow electronic devices in the lock-up rooms. Reporters will still have access to reports 30 minutes before release time, but they can only take notes with pen and paper. Providing coverage in electronic format can occur only after reporters leave the lock-up room after the official release time.

The directive was issued by the Bureau of Labor Statistics, but other government agencies producing economic reports (the Bureau of Economic Analysis and the US Census Bureau) use the lock-up rooms of the BLS, and therefore they too will be using the new procedures.

We received several questions and numerous expressions of concern about the procedures. Traders and investors are worried about delayed and erratic release of the economic statistics. We suspect the fears are overdone. The old system will most likely die off, but close substitutes will emerge.

Lock-up rooms will be essentially useless without electronic devices, and thus wire services will no longer be the primary source for the initial read of the data. However, investors and traders can log on to the web sites of the releasing government agency and view an internet version of the report. This process will require numerous clicks on the reload icon near release time, and it will involve digging into the report to pull out figures of interest. This process will be slower and less convenient than the current process, but data will nevertheless be disseminated fairly quickly.

Government agencies also will be releasing information via twitter and email. We can envision interested parties monitoring all three sources of information (web sites, Twitter, email) and focusing on the quickest to post.

Economists and analysts also might begin playing a more prominent role. Databases are available that provide quick access to government statistics, with the full range of published figures usually available within a few minutes of release time (Haver Analytics, our source of information, is the most popular of these databases). These figures can quickly be converted to excel files and sent to interested parties.

Market participants will adapt.

Review

Week of Jan. 13, 2020	Actual	Consensus	Comments
Federal Budget (December)	**$13.3 Billion Deficit**	**$15.0 Billion Deficit**	Federal revenues rose 7.4% on a year-over-year basis, slower than the brisk pace of 9.3% in November but faster than average year-over-year growth of 4.9% in the first 10 months of calendar year 2019. Outlays rose 7.0% 2018 versus average growth of 9.4% in the prior 11 months. The deficit for first three months of FY2020 totaled $357 billion, $38 billion more than the same period in FY2019.
CPI (December)	**0.2% Total, 0.1% Core**	**0.3% Total, 0.2% Core**	Food prices rose 0.2% in December, close to the average increase of 0.15% in the first 11 months of 2019. Energy prices rose 1.4%, the third consecutive increase, but they have edged lower on balance since the fall of 2018. The restrained reading on the core CPI in part reflected soft results in areas that tend to be volatile (hotel fees, airfares, used car prices), but other areas suggested underlying restraint. For example, rental rates for primary residence rose 0.2% or less for the third time in the past five months (0.3% had been the norm). The latest result left the year-over-year increase in the headline index at 2.3%, the fastest pace of 2019 but slower than a recent peak of 2.9% in mid-2018. The year-over-year change in the core CPI totaled 2.3% in December, below the firmest readings in the current expansion (2.4% on three occasions).
PPI (December)	**0.1% Total, 0.1% Core***	**0.2% Total, 0.2% Core***	Food prices slipped 0.2% in December, returning to a soft track after a combined jump of 2.5% in the prior two months. Energy prices jumped 1.5%, but the trend for the year is still best described as flat. Core goods prices increased 0.1%, a restrained reading that essentially matched the average monthly change in the first 11 months of 2019. The year-over-year change in the headline index increased two ticks to 1.3%, quickening modestly from the November pace but off noticeably from the recent peak of 3.4% in July of 2018. The core PPI accelerated to 1.5% from 1.3% in the prior month, but it too remained off the recent high of 3.1% in September 2018.
Retail Sales (December)	**0.3% Total, 0.7% Ex-Autos**	**0.3% Total, 0.5% Ex-Autos**	The increase in headline retail sales in December was constrained by the volatile auto component (-1.3%). Activity elsewhere was strong with an increase of 0.7%, although some of the jump ex-autos was the result of strong activity at gasoline service stations (up 2.8%), which might have been influenced by price changes, which rose on a seasonally adjusted basis. Sales excluding autos and gasoline were respectable (up 0.5%), but the firm showing was nearly countered by downward revisions in the two prior months. The most interesting aspect of the report was a modest advance in the non-store area (+0.2%) after declines in the prior three months. The results perhaps suggest that the structural change in shopping patterns to online activity is now in its advanced stages.

Review Continued

Week of Jan. 13, 2020	Actual	Consensus	Comments
Housing Starts (December)	**1.608 Million (+16.9%)**	**1.380 Million (+1.1%)**	The surge in housing starts in December moved the level of activity far above other recent observations (and to the highest since 2006). In addition, the burst in starts occurred from upward revised levels in the prior two months, with activity in October and November combined 1.0% firmer than previously believed. Both single-family and multi-family activity contributed to the increase, with single-family starts jumping 11.2% and multi advancing 29.8%. Both components easily represented the strongest observations of the current expansion. While the latest reading was impressive, a decline of 3.9% in building permits suggests that activity could cool somewhat from the robust performance in December.
Industrial Production (December)	**-0.3%**	**-0.2%**	While industrial production fell overall in December, the composition of the report had a favorable tilt. All of the drop occurred in the utility component (-5.6%), where changes are nearly always a function of the weather. Activity in manufacturing and mining are driven more by economic fundamentals, and both of these components rose in December (up 0.2% and 1.3%, respectively). The increase in manufacturing occurred despite a drop of 4.6% in the motor vehicle industry, as 13 of the remaining 19 industries posted gains. Manufacturing activity lost ground in 2019, as the level of production in December was shy of readings in late 2018, but the downtrend was mild. Mining activity eased in the three months before December and it showed little net change in the early months of 2019. However, the pickup in December more than offset the dips from September to November and moved activity to a new record.
Consumer Sentiment (January)	**99.1 (-0.2 Index Pt.)**	**99.3 (Unchanged)**	Although consumer sentiment dipped in January, it remained in the upper portion of the range of the current expansion and was comparable to the better readings of the prior expansion.

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

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

Preview

Week of Jan. 20, 2020	Projected	Comments
Existing Home Sales (December) (Wednesday)	**5.40 Million (+0.9%)**	Low interest rates have led to a pickup in existing home sales after a slide in 2018, but a modest net change in recent months suggests that the lion's share of the boost has already been felt. The projection for December, while up on a moth-to-month basis, is within the range of recent observations.
Leading Indicators (December) (Thursday)	**-0.2%**	Negative contributions from initial claims for unemployment insurance, the ISM new orders index, and building permits are likely to more than offset positive contributions from consumer expectations, stock prices, and the leading credit index. If the projection proves accurate, December will mark the fifth consecutive month of flat or negative readings on the index. The measure showed only a mild upward drift in the 10 months before the recent softening.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

January/February 2020

Monday 13

FEDERAL BUDGET

	2019	2018
Oct	-$134.5B	-$100.5B
Nov	-$208.8B	-$204.9B
Dec	-$13.3B	-$13.5B

Tuesday 14

NFIB SMALL BUSINESS OPTIMISM INDEX

Oct	102.4
Nov	104.7
Dec	102.7

CPI

	Total	Core
Oct	0.4%	0.2%
Nov	0.3%	0.2%
Dec	0.2%	0.1%

Wednesday 15

PPI

	Final Demand	Core*
Oct	0.4%	0.1%
Nov	0.0%	0.0%
Dec	0.1%	0.1%

EMPIRE MFG

Nov	2.5
Dec	3.3
Jan	4.8

JANUARY BEIGE BOOK

"Economic activity generally continued to expand modestly in the final six weeks of 2019."

Thursday 16

INITIAL CLAIMS

Dec 28	223,000
Jan 04	214,000
Jan 11	204,000

RETAIL SALES

	Total	Ex.Autos
Oct	0.3%	0.2%
Nov	0.3%	0.1%
Dec	0.3%	0.7%

IMPORT/EXPORT PRICES

	Non-fuel Imports	Nonagri. Exports
Oct	-0.2%	-0.2%
Nov	-0.1%	0.0%
Dec	0.0%	-0.1%

PHILLY FED INDEX

Nov	8.4
Dec	2.4
Jan	17.0

BUSINESS INVENTORIES

	Inventories	Sales
Sept	-0.1%	-0.4%
Oct	0.1%	-0.2%
Nov	-0.2%	0.7%

NAHB HOUSING INDEX

Nov	71
Dec	76
Jan	75

TIC DATA

	Total	Net L-T
Sept	-$42.6B	$44.2B
Oct	-$62.0B	$31.5B
Nov	$73.1B	$22.9B

Friday 17

HOUSING STARTS

Oct	1.340 million
Nov	1.375 million
Dec	1.608 million

IP & CAP-U

	IP	Cap.Util.
Oct	-0.5%	76.9%
Nov	0.8%	77.4%
Dec	-0.3%	77.0%

CONSUMER SENTIMENT

Nov	96.8
Dec	99.3
Jan	99.1

JOLTS DATA

	Openings (000)	Quit Rate
Sept	7,032	2.3%
Oct	7,361	2.3%
Nov	6,800	2.3%

Monday 20

MARTIN LUTHER KING JR. DAY

Tuesday 21

Wednesday 22

CHICAGO FED NATIONAL ACTIVITY INDEX (8:30)

	Monthly	3-Mo. Avg.
Oct	-0.76	-0.35
Nov	0.56	-0.25
Dec	--	--

FHFA HOME PRICE INDEX (9:00)

Sept	0.7%
Oct	0.2%
Nov	--

EXISTING HOME SALES (10:00)

Oct	5.44 million
Nov	5.35 million
Dec	**5.40 million**

Thursday 23

INITIAL CLAIMS (8:30)

LEADING INDICATORS (10:00)

Oct	-0.2%
Nov	0.0%
Dec	**-0.2%**

Friday 24

Monday 27

NEW HOME SALES

Tuesday 28

DURABLE GOODS ORDERS

S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX

CONSUMER CONFIDENCE

FOMC MEETING

Wednesday 29

U.S. INTERNATIONAL TRADE IN GOODS

ADVANCE INVENTORIES

PENDING HOME SALES

FOMC DECISION

Thursday 30

INITIAL CLAIMS

Q4 GDP

Friday 31

PERSONAL INCOME, CONSUMPTION, PRICES

EMPLOYMENT COST INDEX

CHICAGO PURCHASING MANAGERS' INDEX

REVISED CONSUMER SENTIMENT

Monday 3

ISM INDEX

CONSTRUCTION SPEND.

VEHICLE SALES

Tuesday 4

FACTORY ORDERS

Wednesday 5

ADP EMPLOYMENT REPORT

TRADE BALANCE

ISM NON-MFG INDEX

Thursday 6

INITIAL CLAIMS

PRODUCTIVITY & COSTS

Friday 7

EMPLOYMENT REPORT

WHOLESALE TRADE

CONSUMER CREDIT

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

Treasury Financing

January/February 2020

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
AUCTION RESULTS: Rate Cover 13-week bills 1.530% 2.87 26-week bills 1.530% 2.98	**ANNOUNCE:** $35 billion 4-week bills for auction on January 16 $35 billion 8-week bills for auction on January 16 **SETTLE:** $35 billion 4-week bills $35 billion 8-week bills	**SETTLE:** $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds	**AUCTION RESULTS:** Rate Cover 4-week bills 1.505% 3.21 8-week bills 1.530% 3.20 **ANNOUNCE:** $78 billion 13-,26-week bills for auction on January 21 $14 billion 10-year TIPS for auction on January 23 **SETTLE:** $78 billion 13-,26-week bills	
20	21	22	23	24
MARTIN LUTHER KING JR. DAY	**AUCTION:** $78 billion 13-,26-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on January 23 $40 billion* 8-week bills for auction on January 23 **SETTLE:** $35 billion 4-week bills $35 billion 8-week bills		**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $14 billion 10-year TIPS **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on January 27 $26 billion* 52-week bills for auction on January 28 $20 billion* 2-year FRNs for auction on January 28 $40 billion* 2-year notes for auction on January 27 $41 billion* 5-year notes for auction on January 27 $32 billion* 7-year notes for auction on January 28 **SETTLE:** $78 billion 13-,26-week bills	
27	28	29	30	31
AUCTION: $78 billion* 13-,26-week bills $40 billion* 2-year notes $41 billion* 5-year notes	**AUCTION:** $26 billion* 52-week bills $20 billion* 2-year FRNs $32 billion* 7-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on January 30 $40 billion* 8-week bills for auction on January 30 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills		**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on February 3 **SETTLE:** $78 billion* 13-,26-week bills $26 billion* 52-week bills	**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
3	4	5	6	7
AUCTION: $78 billion* 13-,26-week bills	**ANNOUNCE:** $45 billion* 4-week bills for auction on February 6 $40 billion* 8-week bills for auction on February 6 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills	**ANNOUNCE:** $38 billion* 3-year notes for auction on February 11 $27 billion* 10-year notes for auction on February 12 $19 billion* 30-year bonds for auction on February 13	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills **ANNOUNCE:** $78 billion* 13-,26-week bills for auction on February 10 **SETTLE:** $78 billion* 13-,26-week bills	

*Estimate