Daiwa Capital Markets

U.S. Economic Comment

- Recent economic statistics: Retail Sales & IP push Q1 GDP into negative territory
- Thoughts on Q2: dreadful
- Bank capital: a shock absorber

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Troubling Economic Statistics

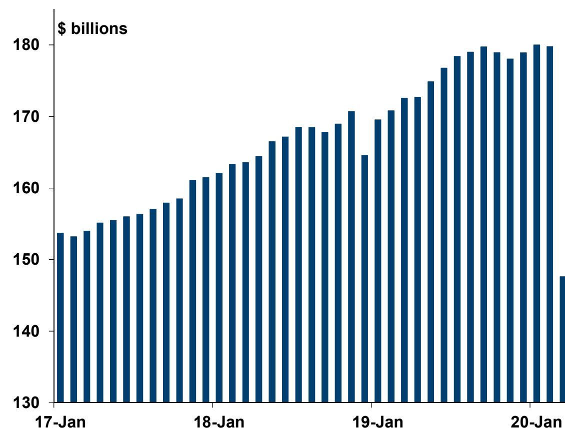
The U.S. economy performed well in the first two months of the year, with early-year data leading us to expect GDP growth of approximately two percent in the first quarter. However, the good times unraveled with the emergence of the coronavirus. Claims for unemployment insurance offered the first indication that the economic fallout from the virus was severe, and reports this week on retail sales and industrial production provided further evidence of desperate conditions. These figures feed more naturally into estimates of GDP growth than the claims data do, and the results were weak enough to trigger thoughts of a decline in the first quarter.

Some retailers registered strong results in March as individuals stocked up on essential items in the early stages of the virus crisis (food stores, pharmacies, big-box outlets). On-line vendors also had a strong month. However, most other areas posted dismal results as stay-at-home restrictions and income concerns because of layoffs limited activity. Sales at retailers dealing primarily with discretionary items were especially weak (restaurants, auto dealers, clothing stores, furniture stores; chart, left).

Data on consumer spending through February were already showing some slowing in the pace of activity, but the picture darkened in March. We now see a potential decline of five percent in real consumer outlays in the GDP accounts, a marked contrast to average growth of 2.7 percent over the four quarters of 2019.

Industrial production had been soft in the past year or so, declining slightly from late 2018 through February, but conditions worsened considerably in March. Mining activity fell only moderately despite negative incentives for drilling from low oil prices, but production in the manufacturing sector fell off a cliff (chart, right). Data for January and February were pointing to an approximately flat performance for the

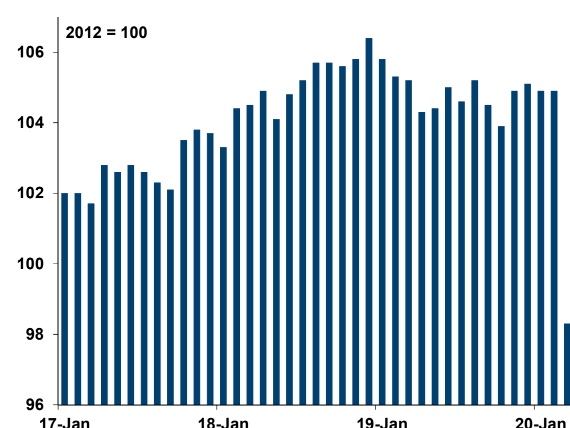
Retail Sales: Discretionary Stores*



** The discretionary stores grouping includes sales from the following types of stores: furniture and home furnishing; electronics and appliance; clothing and accessory; sporting goods, hobby, book, and music; food services and drinking places; and nonstore retailers, which include online sales as well as sales by fuel oil dealers. These stores deal primarily with items whose purchase could be postponed.*

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

Industrial Production: Manufacturing



Source: Federal Reserve Board via Haver Analytics

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factory sector in the first quarter, but the reading for March brought the average in Q1 well below that in the fourth quarter. Using the same compound annual growth formula as that for GDP, manufacturing production tumbled 7.2 percent in the first quarter.

These weak results lead us to look for a decline in GDP of approximately two percent in the first quarter (annual rate; some upcoming reports could alter the picture, such as durable goods orders on April 24 and inventory and trade statistics on April 28). Consumer spending and business fixed investment will probably be notably weak, but residential construction could provide a partial offset, and a drop in imports could absorb some of the weakness in consumption and investment.

Speculation on Q2

Whatever the pace of growth in early 2020, the first quarter is history. The important issue at this time is the degree of softness in the second quarter. Interestingly, the industrial production report provides a hint of what might be expected in the spring quarter, and the outlook is not pleasant.

Because the first quarter ended on a soft note, prospects for the average volume of industrial production in the second quarter are not favorable. That is, a sizeable a jump in activity is necessary to pull the second quarter average equal to or above the average in the first quarter, and such a jump seems unlikely given the influence of the coronavirus. Thus, manufacturing activity seems on track for another retreat in Q2, and the drop could be large. If manufacturing production merely held steady at the March level over the next three months, which seems optimistic at this point, production in the second quarter would register a decline of 22 percent (annual rate). Obviously, if production slips, the contraction will be sharper.

The current setting for industrial production suggests marked decline in the second quarter, but manufacturing activity represents only 11 percent of the economy. Overall activity could follow a different path. However, a broader perspective based on employment statistics also suggests a shocking decline in the second quarter.

The monthly employment report allows one to calculate the total number of hours worked in a typical week; it's a simple calculation: the number of workers times the length of the average workweek. Logic suggests that output will correlate highly with this measure. In fact, however, the statistical fit is loose because the employment figures do not include self-employed individuals or farm workers. In addition, productivity, which can fluctuate widely, adds noise to the relationship between hours and output. Nevertheless, total worktime can provide an inkling of what to expect for output and GDP growth. Unemployment claims indicate that employment (and hence worktime) will decline significantly in the second quarter, and one can outline various scenarios to get a sense of the magnitude of the decline that might be in store for GDP.

The first row of the table to the right uses figures from the monthly employment reports to calculate the number of hours worked in the first quarter (average payroll totals times the length of the average workweek). The next three rows show possibilities for the second quarter, with employment totals falling by 10, 15, and 20 million from the average in the first quarter. The table also assumes that the length of the average workweek will shorten because of reduced hours for those who remain employed.

Each scenario shows a dramatic decline in hours worked that translates to shocking annual rates of decline (26 to 47 percent, column 4).

Speculation on Q2 Growth

	Payroll Employment (Millions)	Workweek (Hours)	Total Hours	Growth (Annual Rate)
20-Q1	152.2	34.3	5,220.5	1.1%
		Hypothetical		
20-Q2	142.0	34.1	4,842.2	-26.0%
	137.0	33.9	4,644.3	-37.4%
	132.0	33.7	4,448.4	-47.3%

Sources: Bureau of Labor Statistics; Daiwa Capital Markets America

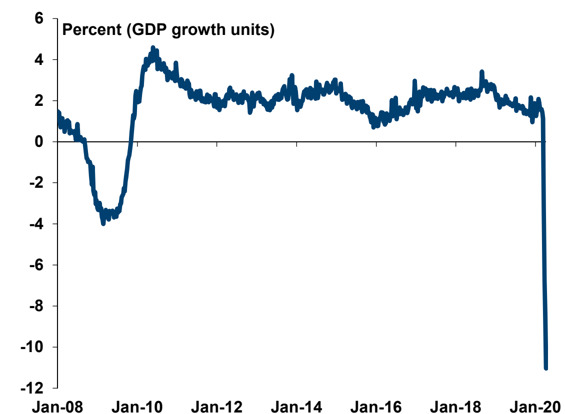
For purposes of comparison, the worst quarter for the U.S. economy since quarterly tabulations began in 1947 was the drop of 10.0 percent in 1958-Q1. The worst performance during the financial crisis was a decline of 8.4 percent in 2008-Q4.

NY Fed High-Frequency View

Economists at the Federal Reserve Bank of New York have developed a new index of economic activity based on high-frequency (i.e. weekly) data. The measure allows the Fed to monitor the effects of the coronavirus without the delays associated with monthly or quarter data, and it is constructed to have an intuitive and easy-to-understand interpretation. That is, the published index shows "GDP growth units" -- the year-over-year growth rate for GDP suggested by recent weekly data.

The latest observation shows a contraction of approximately 11 percent (chart). This pace seems tame compared with the dire figures suggested above, but in fact it is consistent. The year-over-year change in the Fed index includes the effect of 2.1 percent growth in the second half of 2019. A drop of 11 percent in the Fed index after two quarters of growth at 2.1 percent implies a contraction of 24 percent in the first half of this year (+2.1 and -24 average to -11). The decline of 24 percent will not be evenly split between the first and second quarters – the second will be far weaker. If the economy contracted two percent in the first quarter, the Fed index in this instance implies a contraction of 46 percent in the second quarter.

Weekly Economic Index (WEI)*



** The WEI is an index of real economic activity using timely and relevant high-frequency data. It represents the common component of ten different daily and weekly series covering consumer behavior, the labor market, and production. The WEI is scaled to the four-quarter GDP growth rate; for example, if the WEI reads -2 percent and the current level of the WEI persists for an entire quarter, we would expect, on average, GDP that quarter to be 2 percent lower than a year previously.*

Source: Federal Reserve Bank of New York, Weekly Economic Index, https://www.newyorkfed.org/research/policy/weekly-economic-index.

We would not oversell these figures as predictions of economic growth in the second quarter; conditions could improve. Elements of the CARES Act (especially the Paycheck Protection Program) could lead to the recall of individuals to their jobs, or the economy could begin to reopen in May or June. It is too early in Q2 to make firm predictions. Nevertheless, the information in hand suggests the outcome will be decidedly weak.

A Shock Absorber

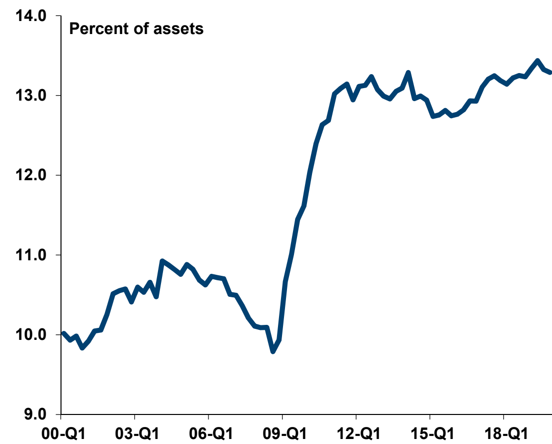
Commercial banks in the U.S. this week began releasing earnings reports for the first quarter, and results were generally soft because of heightened provisions for loan losses. That is, banks took charges for defaults expected to emerge in coming months. The press coverage of the earnings reports had a negative tone, and certainly the news was not good, but we see a silver lining in such developments. Specifically, the loan loss provisions signal that some of the economic stress associated with the coronavirus is being shifted to a sector that has the wherewithal to absorb the damage.

The wave of legislative and regulatory changes that followed the financial crisis greatly increased the capital requirements of depository institutions, and commercial banks and savings institutions have indeed boosted their capital cushions. The so-called tier-one capital ratio at commercial banks has climbed from readings in a range of 10 to 11 percent before the crisis to readings centered on 13 percent more recently (chart). The elevated capital position will allow most lenders to absorb losses generated by the coronavirus without threatening their survival. The missed payments or outright defaults will ease some of the financial burden on borrowers.

We do not mean to sound unconcerned about the situation. To the contrary, the jump in loan loss provisions shows that the coronavirus has inflicted severe economic damage and has generated costs that

must be absorbed somewhere. Borrowers missing payments or defaulting are no doubt under severe financial stress; bankruptcies will be involved. Also, those closely tied to lending institutions will pay a price; stockholders of commercial banks will bear a burden in the form of reduced dividends or weaker stock prices, and employees might absorb some of the loss in the form of reduced bonuses. The losses are real, but tilting the burden to healthy financial institutions will help to limit the damage to the overall economy and perhaps to the social fabric of the country.

Tier 1 Capital Ratio*



** The chart shows tier 1 capital as a share of risk-weighted assets. Tier 1 capital includes common equity plus noncumulative perpetual preferred stock plus minority interests in consolidated subsidiaries less goodwill and other ineligible intangible assets.*

Source: Federal Deposit Insurance Corporation (FDIC)

Review

Week of April 13, 2020	Actual	Consensus	Comments
Retail Sales (March)	**-8.7% Total, -4.5% Ex-Autos**	**-8.0% Total, -5.0% Ex-Autos**	Some areas in the retail sector registered strong results in March, as individuals ramped up purchases of essential items in the early stages of the virus crisis (food stores, pharmacies, big-box retailers). On-line vendors also had a strong month. However, the report was dominated by pronounced weakness in other areas because of stay-at-home restrictions associated with the coronavirus. As might be expected, results were especially weak at establishments dealing primarily with discretionary items (restaurants, auto dealers, clothing stores, furniture stores, sporting-goods stores). The decline eclipsed the previous record retreat of 6.5% in January 1987.
Industrial Production (March)	**-5.4%**	**-4.0%**	Outright closures of some factories and supply-chain disruptions at others led to a marked decline in manufacturing activity (-6.3%). Mining activity performed reasonably well considering the constraining effects of low oil prices on drilling activity (-2.0%). Warmer-than-normal temperatures led to a drop inutility output. The decline in overall IP was not a record, but it was the weakest in 74 years (January 1946).
Housing Starts (March)	**1.216 Million (-22.3%)**	**1.300 Million (-18.7%)**	Both single-family and multi-family activity contributed to the decline in March, with single-family activity dropping 17.5% and multi-family retreating 31.7%. The decline in the single-family sector occurred from elevated readings in the prior three months, and the new level was still respectable by standards of the prior few years. Starts in the multi-family sector fell noticeably below the he average from last year, but they were in line with results in prior years.
Leading Indicators (March)	**-6.7%**	**-7.2%**	The stunning increases in claims for unemployment insurance in the latter part of March accounted for much of the tumble in the leading indicator index, but stock prices, building permits, the ISM orders index, and the length of the factory workweek also made noticeable negative contributions. The decline easily a represented a new record, far exceeding the drop of -3.4% in October 2008.

Sources: U.S. Census Bureau (Retail Sales, Housing Starts); Federal Reserve Board (Industrial Production); The Conference Board (Leading Indicators); Consensus forecasts are from Bloomberg

Preview

Week of April 20, 2020	Projected	Comments
Existing Home Sales (March) (Tuesday)	**5.40 Million (-6.4%)**	Stay-at-home restrictions associated with the coronavirus will most likely constrain home sales. However, sales of existing homes are based on closings, and many closings tied to contracts in January and February could have been completed in March. Thus the drop in sales is likely to be moderate rather than pronounced.
New Home Sales (March) (Thursday)	**0.650 Million (-15.0%)**	In contrast to sales of existing homes, sales of new homes are based on contracts signed. Social-distancing restrictions associated with the coronavirus most likely limited buyer traffic through new homes and inhibited the signing of contracts.
Durable Goods Orders (March) (Friday)	**-15.0%**	Closures of businesses and uncertainty in the economic outlook undoubtedly hampered order flows. Guidance from the ISM indexes and the optimism index of the National Federation of Independent Business suggest a double-digit retreat.
Revised Consumer Sentiment (April) (Friday)	**65.0 (-6.0 Index Pt. Revision)**	The reading for the sentiment index in early April probably captured most of the effect of the corona virus. However, frustrations generated by business and personal lockdowns create the potential for a downward revision.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

April/May 2020

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
	IMPORT/EXPORT PRICES Non-fuel Imports / Nonagri. Exports Jan 0.3% 0.6% Feb 0.3% -1.1% Mar 0.0% -1.5%	**RETAIL SALES** Total / Ex.Autos Jan 0.8% 0.7% Feb -0.4% -0.4% Mar -8.7% -4.5% **EMPIRE MFG** Feb 12.9 Mar -21.5 Apr -78.2 **IP & CAP-U** IP / Cap.Util. Jan -0.5% 76.7% Feb 0.5% 77.0% Mar -5.4% 72.7% **BUSINESS INVENTORIES** Inventories / Sales Dec 0.1% 0.0% Jan -0.3% 0.5% Feb -0.4% -0.5% **NAHB HOUSING INDEX** Feb 74 Mar 72 Apr 30 **APRIL BEIGE BOOK** "Economic activity contracted sharply and abruptly across all regions in the United States as a result of the COVID-19 pandemic." **TIC DATA** Total / Net L-T Dec $78.9B 85.6B Jan $127.3B $21.8B Feb -$13.4B $49.4B	**UNEMPLOYMENT CLAIMS** Initial / Continuing (Millions) Mar 21 3.307 3.059 Mar 28 6.867 7.446 Apr 04 6.615 11.976 Apr 11 5.245 N/A **HOUSING STARTS** Jan 1.619 million Feb 1.564 million Mar 1.216 million **PHILLY FED INDEX** Feb 36.7 Mar -12.7 Apr -56.6	**LEADING INDICATORS** Jan 0.4% Feb -0.2% Mar -6.7%
20	21	22	23	24
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly / 3-Mo. Avg. Jan -0.33 -0.11 Feb 0.16 -0.21 Mar -- --	**EXISTING HOME SALES (10:00)** Jan 5.42 million Feb 5.77 million **Mar 5.40 million**	**FHFA HOME PRICE INDEX (9:00)** Dec 0.7% Jan 0.3% Feb --	**INITIAL CLAIMS (8:30)** **NEW HOME SALES (10:00)** Jan 0.800 million Feb 0.765 million **Mar 0.650 million**	**DURABLE GOODS ORDERS (8:30)** Jan 0.1% Feb 1.2% **Mar -15.0%** **REVISED CONSUMER SENTIMENT (10:00)** Feb 101.0 Mar 89.1 Apr(p) 71.0 **Apr(r) 65.0**
27	28	29	30	1
	U.S. INTERNATIONAL TRADE IN GOODS **ADVANCE INVENTORIES** **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** **CONSUMER CONFIDENCE** **FOMC MEETING**	**Q1 GDP** **PENDING HOME SALES** **FOMC DECISION**	**INITIAL CLAIMS** **PERSONAL INCOME, CONSUMPTION, PRICE INDEXES** **EMPLOYMENT COST INDEX** **CHICAGO PURCHASING MANAGERS' INDEX**	**ISM MANUFACTURING INDEX** **CONSTRUCTION SPEND.** **VEHICLE SALES**
4	5	6	7	8
FACTORY ORDERS	**TRADE BALANCE** **ISM NON-MFG INDEX**	**ADP EMPLOYMENT REPORT**	**INITIAL CLAIMS** **PRODUCTIVITY & COSTS** **CONSUMER CREDIT**	**EMPLOYMENT REPORT** **WHOLESALE TRADE**

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

Treasury Financing

April/May 2020

Monday	Tuesday	Wednesday	Thursday	Friday
13	14	15	16	17
AUCTION RESULTS: Rate / Cover 13-week bills 0.280% 3.10 26-week bills 0.290% 3.08 69-day CMB 0.270% 3.22	**AUCTION RESULTS:** Rate / Cover 43-day CMB 0.190% 3.12 119-day CMB 0.220% 4.13 **ANNOUNCE:** $90 billion 4-week bills for auction on April 16 $70 billion 8-week bills for auction on April 16 $30 billion 103-day CMBs for auction on April 15 $30 billion 154-day CMBs for auction on April 15 **SETTLE:** $90 billion 4-week bills $70 billion 8-week bills $40 billion 154-day CMBs	**AUCTION RESULTS:** Rate / Cover 103-day CMB 0.165% 3.32 154-day CMB 0.190% 3.14 **SETTLE:** $40 billion 3-year notes $25 billion 10-year notes $17 billion 30-year bonds $35 billion 69-day CMBs $65 billion 43-day CMBs	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.150% 2.90 8-week bills 0.150% 3.03 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on April 20 $28 billion 52-week bills for auction on April 21 $17 billion 5-year TIPS for auction on April 23 $65 billion 43-day CMBs for auction on April 20 $25 billion 119-day CMBs for auction on April 21 **SETTLE:** $105 billion 13-,26-week bills $25 billion 119-day CMBs $30 billion 103-day CMBs	
20	21	22	23	24
AUCTION: $105 billion 13-,26-week bills $65 billion 43-day CMBs	**AUCTION:** $28 billion 52-week bills $25 billion 119-day CMBs **ANNOUNCE:** $90 billion* 4-week bills for auction on April 23 $70 billion* 8-week bills for auction on April 23 **SETTLE:** $90 billion 4-week bills $70 billion 8-week bills $30 billion 154-day CMBs	**SETTLE:** $65 billion 43-day CMBs	**AUCTION:** $90 billion* 4-week bills $70 billion* 8-week bills $17 billion 5-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on April 27 $21 billion* 2-year FRNs for auction on April 28 $42 billion* 2-year notes for auction on April 27 $43 billion* 5-year notes for auction on April 27 $33 billion* 7-year notes for auction on April 28 **SETTLE:** $105 billion 13-,26-week bills $28 billion 52-week bills $25 billion 119-day CMBs	
27	28	29	30	1
AUCTION: $105 billion* 13-,26-week bills $42 billion* 2-year notes $43 billion* 5-year notes	**AUCTION:** $21 billion* 2-year FRNs $33 billion* 7-year notes **ANNOUNCE:** $90 billion* 4-week bills for auction on April 30 $70 billion* 8-week bills for auction on April 30 **SETTLE:** $90 billion* 4-week bills $70 billion* 8-week bills		**AUCTION:** $90 billion* 4-week bills $70 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on May 4 **SETTLE:** $105 billion* 13-,26-week bills $21 billion* 2-year FRNs $17 billion 5-year TIPS $42 billion* 2-year notes $43 billion* 5-year notes $33 billion* 7-year notes	
4	5	6	7	8
AUCTION: $105 billion* 13-,26-week bills	**ANNOUNCE:** $90 billion* 4-week bills for auction on May 7 $70 billion* 8-week bills for auction on May 7 **SETTLE:** $90 billion* 4-week bills $70 billion* 8-week bills	**ANNOUNCE MID-QTR REFUNDING:** $42 billion* 3-year notes for auction on May 11 $29 billion* 10-year notes for auction on May 12 $20 billion* 30-year bonds for auction on May 13	**AUCTION:** $90 billion* 4-week bills $70 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on May 11 **SETTLE:** $105 billion* 13-,26-week bills	

*Estimate