U.S. Economic Comment

- Clues and insights into second quarter growth in the U.S. economy
- Deflation risks: not inconsequential

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

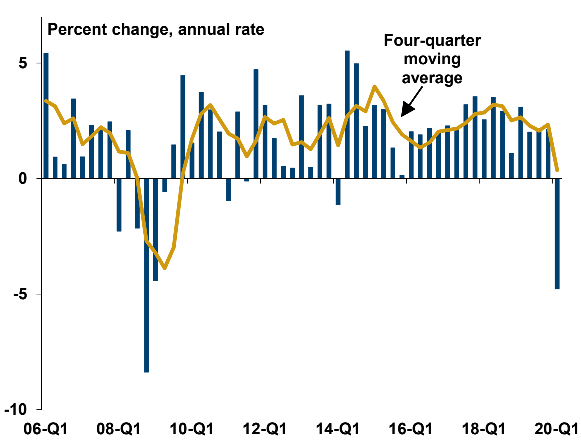
Insights into Q2

The coronavirus hit the global economy hard in the first quarter, as it triggered declines in GDP of 36.5 percent in China and 14.4 percent in the euro area (quarter-to-quarter changes at compound annual rates). The U.S. economy fared better, but it too slowed noticeably, with the drop of 4.8 percent similar to those registered during the financial crisis (chart, left). China is likely to improve in Q2, but the downturns in the euro area and the U.S. will probably deepen. For the United States, some of the recent economic reports provide insights into the vulnerable areas and offer clues into the magnitudes of the declines that might be expected.

Consumer spending led the decline in U.S. GDP during the first quarter, and it most likely will be a weak sector in the second quarter as well. The monthly report on income and consumption for March showed that consumer spending ended the first quarter on a soft note (chart, right), and often the jumping off point in one quarter provides clues for results in the next quarter. In this instance, the sharp decline in March will require a huge increase at some point in the next three months to merely stay even with the average in the first quarter. If such an increase is not forthcoming, the second quarter will show a decline.

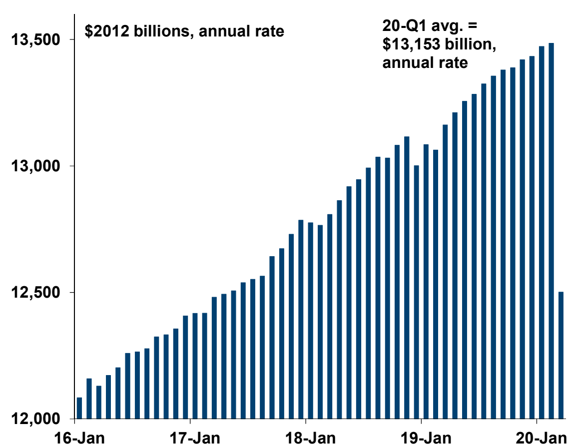
Given that lockdowns in most U.S. locales are still in place, an offsetting increase to March weakness is not likely to occur in coming months; in fact, further downward adjustments are likely to occur given that shutdowns did not intensify until the latter part of March. An optimistic view might be that real consumer spending over the next three months holds steady at the March level. If so, the average for Q2 would trail that for Q1, generating a drop of 18.4 percent in the consumption component of GDP, far weaker than the existing record quarterly drop of 11.5 percent back in 1950.

GDP Growth



Sources: Bureau of Economic Analysis via Haver Analytics

Real Consumer Spending

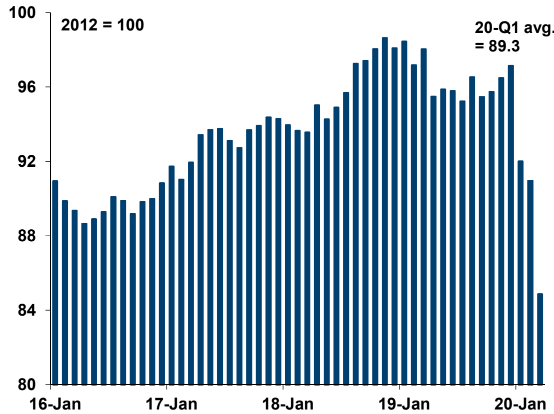


Source: Bureau of Economic Analysis via Haver Analytics

This report is issued by Daiwa Securities Group Inc. through its relevant group companies. Daiwa Securities Group Inc. is the global brand name of Daiwa Securities Co. Ltd., Tokyo ("Daiwa Securities") and its subsidiaries worldwide that are authorized to do business within their respective jurisdictions. These include: Daiwa Capital Markets Hong Kong Ltd. (Hong Kong), regulated by the Hong Kong Securities and Futures Commission, Daiwa Capital Markets Europe Limited (London), regulated by the Financial Conduct Authority and a member of the London Stock Exchange, and Daiwa Capital Markets America Inc. (New York), a U.S. brokerdealer registered with the U.S. Securities and Exchange Commission, a futures commission merchant regulated by the U.S. Commodity Futures Trading Commission, and a primary dealer in U.S. government securities. The data contained in this report were taken from statistical services, reports in our possession, and from other sources believed to be reliable. The opinions and estimates expressed are our own, and we make no representation or guarantee either as to accuracy, completeness or as to the existence of other facts or interpretations that might be significant.

Business investment spending also was weak in the first quarter, dropping 8.6 percent and marking the fourth consecutive quarterly decline. It is difficult to be optimistic about the second quarter, as "jumping-off" calculations like those for consumer spending indicate additional declines. Specifically, the industrial production report showed that the combined output in the machinery and aerospace (i.e. airline) sectors in March was 18.3 percent (annual rate) below the average in the first quarter (chart).

Industrial Production: Aerospace & Machinery*



** A weighted average of the the aerospace and other miscellaneous transportation equipment index and the machinery index from the industrial production report. Weights are calculated from industry weights as of 2019.*

Source: Federal Reserve Board via Haver Analytics; Daiwa Capital Markets America

Residential construction was a bright spot for the United States in the first quarter, advancing at an annual rate of 21.0 percent. One might hope for a repeat in the second quarter to offset a portion of the likely plunges in consumer and business spending. However, this area also seems vulnerable, as housing starts plunged in March, with new building 52.7 percent (annual rate) shy of the level in the first quarter. Continued work on homes started before March will probably temper the annual rate of decline, but the drop in starts suggests a new, cautious attitude in the home building industry that will probably translate to a retreating sector rather than an advancing one.

Claims for unemployment insurance provide the most telling evidence that economic activity will plummet in the second quarter. Initial claims have totaled 27.9 million in the past six weeks (not seasonally adjusted, which is the proper way to view claims in this instance because the boost to claims provided by seasonal adjustment at this time of the year -- an additional 2.4 million -- is a statistical construct, not individuals losing jobs). If employment declines sharply, presumably production or output would follow the lead and decline by a similar magnitude. Using the same percentage change formula used to calculate GDP growth, a drop of 27 million in payroll employment from the Q1 average translates to an annual decline of 55.5 percent.

Such a decline might seem implausible, but a new indicator from the Federal Reserve Bank of New York also leads to a striking conclusion. This measure, the Weekly Economic Index, uses high-frequency (i.e. weekly) data to estimate the year-over-year growth of GDP. This measure is currently showing a contraction of 11.6 percent. Such a pace is tame compared to figures cited above, but it reflects year-over-year growth, which is influenced by results in the prior three quarters. The prior three quarters showed a modest net decline in GDP (up 2.1 percent in both 2019-Q3 and Q4 and down 4.8 percent in 2020-Q1). To average -11.6 percent in the past four quarters, Q2 would need to decline at an annual rate of approximately 46 percent.

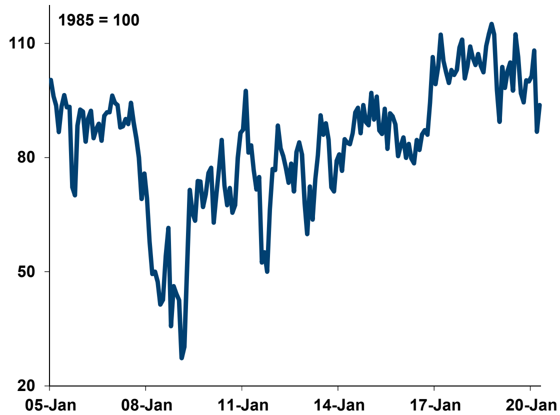
The picture could brighten if the lockdown eases in May and June and the economy begins to revive as a result, but the evidence in hand suggests pronounced weakness.

Deflation Probabilities: Low, but Not Zero

Chair Powell was asked at his press briefing this week about the possibility of extreme economic weakness leading to deflation. He indicated that well-anchored inflation expectations were likely to prevent such a development, and we view this as a strong argument. We would add that the downturn, while deep, might not be long lasting. If the virus dissipates during the spring and summer, and if a second round does not begin in the fall, we would expect the economy to be on a recovery track before the end of the year.

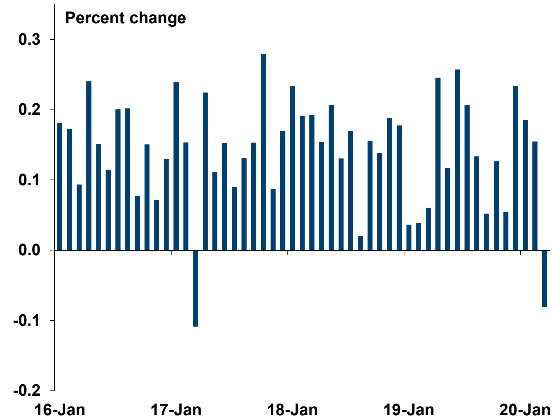
Individuals also appear hopeful that the recession will be brief, as the recent sharp decline in the Conference Board's measure of consumer confidence was concentrated in the current conditions component; the expectations component eased only modestly (chart, next page, left). Expectations of inflation are not likely to deteriorate meaningfully as long as individuals remain confident about the economy's future.

Consumer Expectations



Sources: The Conference Board via Haver Analytics

Core PCE Price Index



PCE = personal consumption expenditures
Source: Bureau of Economic Analysis via Haver Analytics

While the likelihood of deflation emerging seems limited, we should not dismiss the possibility, and we should recognize that the downturn will most likely slow the rate of inflation. The March report on income, consumption, and prices showed that inflation was responding to the easing in the economy, as the core price index for personal consumption expenditures posted a rare decline (chart, right). Only two other drops have occurred since the recession, and one of them was driven by what might be viewed as a special factor (a dramatic reduction in cell phone charges in March 2017 as several providers began to offer unlimited data plans).

Moreover, the softness in prices during March occurred in areas severely affected by the virus. Prices of transportation services, most likely driven by airfares, fell 2.2 percent; prices of food services and accommodation, i.e. restaurant meals and hotel stays, fell 0.6 percent, as did prices of recreation goods. A slow pace of sales led to a drop of 0.4 percent in prices of motor vehicles, and weak demand was probably a major factor in the drop of 2.2 percent in clothing prices.

The drop in the price of crude oil this year adds to the downside pressure on prices. Energy-related goods (gasoline, heating oil) have already declined in price, and they are likely to fall further. Other items that involve heavy energy inputs (e.g. airfares) are likely to decline as well. In addition, lower energy prices could affect the psychology of individuals and business executives that eventually leads to a drop in inflation expectations. Such risks are not pronounced, as individuals realize that energy prices are volatile and that recent softness could well be temporary, but if softness persists, perceptions and expectations could change.

We agree with Chair Powell that deflation risks are low, but at the same time, declining prices represent another downside risk that warrants monitoring.

Review

Week of April 27, 2020	Actual	Consensus	Comments
U.S. International Trade in Goods (March)	**-$64.2 Billion ($4.3 Billion Wider Deficit)**	**-$55.0 Billion ($4.9 Billion Narrower Deficit)**	Both exports and imports lost ground in March, with exports showing the larger decline (off 6.7% versus a drop of 2.4% for imports). Slippage on both sides of the trade ledger were not surprising, as trade flows have been slowing in response to trade disputes and the weakening in global economies, but the larger drop in exports represented a break from the recent tendency for imports to show more pronounced weakness.
Consumer Confidence (April)	**86.9 (-31.9 Index Pts.)**	**87.0 (-33.0 Index Pts.)**	The plunge of 26.9% in the Conference Board's measure of consumer confidence followed a drop of 10.4% in March. The combined shift was among the sharpest retreats in the history of the series (only April/May 1980, when credit controls pushed the economy into recession, was sharper). The decline, though, occurred from an elevated level, and thus the latest reading did not indicate desperate conditions. Indeed, the measure was still above readings in the first five years of the latest expansion and above several in the prior expansion (2002-07).
GDP (2020-Q1)	**-4.8%**	**-4.0%**	Consumer spending and business fixed investment led the drop in Q1 GDP, with declines of 7.6% and 8.6%, respectively. Two areas stood out on the firm side: residential construction jumped at an annual rate of 21.0%, and net exports made a positive contribution to GDP growth of 1.3 percentage points, although it was a "weak" positive contribution, as both exports and imports declined (off 8.7% and 15.3%, respectively), with the sharper decline in imports leading to the positive contribution.
Personal Income, Consumption, Core Prices (March)	**-2.0%, -7.5%, -0.1%**	**-1.7%, -5.1%, -0.1%**	Economic disruptions from the coronavirus weighed heavily on personal income and consumption in March. On the income side, a decline of 3.1% in wages and salaries was joined by a drop of 6.4% in nonfarm proprietors' income as stay-at-home orders limited business activity. Nominal spending was bleak as well. Outlays for durable goods plunged 15.1% and spending on services fell 9.5%. Spending on nondurable items rose 3.1%, with the majority of the increase reflecting a jump of 19.8% in outlays for food as people prepared to hunker down. The dip in the core PCE price index was led by items influenced by the coronavirus (airfares, hotel charges, food services -- i.e. food away from home -- and motor vehicles).
Employment Cost Index (2020-Q1)	**0.8%**	**0.6%**	The increase in the employment cost index matched the firmest of the latest expansion and exceeded that average of 0.7% from 2019. Wages led the advance with a jump of 0.9% while benefits lagged with an increase of only 0.4%. Gains in benefits in the past two years have been generally lighter than those for wages, but the gap in Q1 was larger than the recent norm.

Review Continued

Week of April 27, 2020	Actual	Consensus	Comments
ISM Manufacturing Index (April)	**41.5% (-7.6 Pct. Pts.)**	**36.0% (-13.1 Pct. Pts.)**	The moderate decline in the ISM manufacturing index in April was influenced by a jump of 11.0 percentage points in the supplier delivery component to 76.0%. This index increases as delivery times slow. In this instance, the delivery lags were most likely associated with disrupted supply chains because of shutdowns. Thus, the firm reading is best viewed as a distortion. The three components providing the best insight into current conditions -- new orders, production, and employment -- all collapsed to levels in the range of 27% to 28%.
Construction Spending (March)	**0.9%**	**-3.5%**	Construction activity in March seemed little affected by the coronavirus. Private residential activity led the advance with an increase of 2.3%. Construction of new homes eased 1.3%, but the drop was offset by a jump of 10.2% in home improvements. Government-related construction rose 1.6%, continuing on its upward trend. Private nonresidential construction fell 1.3%, but it remained within the recent range of observations and continued to move along a flat trend.

Sources U.S. Census Bureau (U.S. International Trade in Goods, Construction Spending); The Conference Board (Consumer Confidence); Bureau of Economic Analysis (GDP, Personal Income, Consumption, Prices); Bureau of Labor Statistics (Employment Cost Index); Institute for Supply Management (ISM Manufacturing Index); Consensus forecasts are from Bloomberg

Preview

Week of May 4, 2020	Projected	Comments
Factory Orders (March) (Monday)	**-10.0%**	Lower prices will probably lead to a decline in orders for petroleum products, while an easing in manufacturing activity will probably lead to soft results for nondurable goods other than petroleum. The expected retreat of 5.5% in nondurable orders will join the already reported decline of 14.4% in durable bookings. (The drop in durable orders was concentrated in the volatile transportation category; durable orders ex-transportation fell only 0.2%.)
Trade Balance (March) (Tuesday)	**-$44.5 Billion ($4.6 Billion Wider Deficit)**	The already reported widening in the goods trade deficit will probably account for most to the expected slippage in the total trade balance, but a smaller surplus in trade services could contribute as well. The coronavirus probably led to a slowdown in trade services, especially travel and tourism, which will probably constrain U.S. exports more so than imports.
ISM Nonmanufacturing Index (April) (Tuesday)	**40.0% (-12.5 Pct. Pts.)**	Although the ISM nonmanufacturing index in March fell to the low end of the range from the past 10 years, it was still above a level that would suggest recession. It will probably move into alignment with most other economic indicators signaling a marked downturn.
Nonfarm Productivity (2020-Q1) (Thursday)	**-5.5%**	GDP fell in Q1 despite a slight increase in total hours worked, a combination that points to a sharp retreat in productivity.
Nonfarm Payrolls (April) (Friday)	**-25,000,000**	The surge in claims for unemployment benefits indicates that payroll employment will register a mind-boggling decline, although the magnitude of the change involves a bit of uncertainty. Claims could be understating the loss of jobs because of backlogs at state employment offices; alternatively, they could lead to overestimates of payroll cuts if the Paycheck Protection Program led to worker recalls. We assume the two sources of error will be about offsetting. The jump in the number of individuals receiving unemployment points to a jobless rate of approximately 18%.

Source: *Forecasts provided by Daiwa Capital Markets America*

Economic Indicators

April/May 2020

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	29	30	1
	U.S. INTERNATIONAL TRADE IN GOODS Jan -$66.0 billion Feb -$59.9 billion Mar -$64.2 billion **ADVANCE INVENTORIES REPORT** Wholesale Retail Jan -0.6% 0.0% Feb -0.6% -0.4% Mar -1.0% 0.9% **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX** SA NSA Dec 0.4% 0.0% Jan 0.4% 0.0% Feb 0.4% 0.5% **CONFERENCE BOARD CONSUMER CONFIDENCE** Feb 132.6 Mar 118.8 Apr 86.9 **FOMC MEETING**	**GDP** GDP Chained Price 19-Q3 2.1% 1.8% 19-Q4 2.1% 1.3% 20-Q1 -4.8% 1.3% **PENDING HOMES SALES** Jan 5.3% Feb 2.3% Mar -20.8% **FOMC DECISION**	**UNEMPLOYMENT CLAIMS** Initial Continuing (Millions) Apr 04 6.615 11.914 Apr 11 5.237 15.818 Apr 18 4.442 17.992 Apr 25 3.839 N/A **PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. Cons. Core Jan 0.5% 0.4% 0.2% Feb 0.6% 0.2% 0.2% Ma -2.0% -7.5% -0.1% **EMPLOYMENT COST INDEX** Comp. Wages 19-Q3 0.7% 0.8% 19-Q4 0.7% 0.7% 20-Q1 0.8% 0.9% **CHICAGO PURCHASING MANAGERS' INDEX** Index Prices Feb 49.0 52.9 Mar 47.8 56.7 Apr 35.4 48.4	**ISM INDEX** Index Prices Feb 50.1 45.9 Mar 49.1 37.4 Apr 41.5 35.3 **CONSTRUCTION SPEND.** Jan 2.6% Feb -2.5% Mar 0.9% **VEHICLE SALES** Feb 16.7 million Mar 11.4 million **Apr 8.6 million**
4	5	6	7	8
FACTORY ORDERS (10:00) Jan -0.5% Feb -0.1% **Mar -10.0%**	**TRADE BALANCE (8:30)** Jan -$45.5 billion Feb -$39.9 billion **Mar -$44.5 billion** **ISM NON-MFG INDEX (10:00)** Index Prices Feb 57.3 50.8 Mar 52.5 50.0 **Apr 40.0 48.0**	**ADP EMPLOYMENT REPORT (8:15)** Private Payrolls Feb 179,000 Mar -27,000 Apr --	**INITIAL CLAIMS (8:30)** **PRODUCTIVITY & COSTS (8:30)** Productivity Unit Labor Costs 19-Q3 -0.3% 0.2% 19-Q4 1.2% 0.9% **20-Q1 -5.5% 6.0%** **CONSUMER CREDIT (3:00)** Jan $12.1 billion Feb $22.3 billion Mar --	**EMPLOYMENT REPORT (8:30)** Payrolls Un. Rate Feb 275,000 3.5% Mar -701,000 4.4% **Apr -25,000,000 18.0%** **WHOLESALE TRADE (10:00)** Inventories Sales Jan -0.6% 1.3% Feb -0.6% -0.8% **Mar -1.0% -3.0%**
11	12	13	14	15
	NFIB SMALL BUSINESS OPTIMISM INDEX **CPI** **FEDERAL BUDGET**	**PPI**	**INITIAL CLAIMS** **IMPORT/EXPORT PRICES**	**RETAIL SALES** **EMPIRE MFG. INDEX** **IP & CAP-U** **BUSINESS INVENTORIES** **JOLTS DATA** **CONSUMER SENTIMENT** **TIC DATA**
18	19	20	21	22
NAHB HOUSING INDEX	**HOUSING STARTS**	**FOMC MINUTES**	**INITIAL CLAIMS** **PHILLY FED INDEX** **EXISTING HOME SALES** **LEADING INDICATORS**	

Forecasts in Bold.

Treasury Financing

April/May 2020

Monday	Tuesday	Wednesday	Thursday	Friday
27	28	29	30	1
AUCTION RESULTS: Rate Cover 13-week bills 0.120% 3.04 26-week bills 0.150% 3.25 2-year notes 0.229% 3.10 5-year notes 0.394% 2.74	**AUCTION RESULTS:** Spread Cover 2-year FRNs 0.114% 3.02 Rate Cover 7-year notes 0.525% 2.56 43-day CMB 0.085% 3.22 **ANNOUNCE:** $90 billion 4-week bills for auction on April 30 $70 billion 8-week bills for auction on April 30 $30 billion 103-day CMBs for auction on April 29 $30 billion 154-day CMBs for auction on April 30 **SETTLE:** $90 billion 4-week bills $70 billion 8-week bills $30 billion 154-day CMBs	**AUCTION RESULTS:** Rate Cover 273-day CMB 0.165% 2.98 119-day CMB 0.110% 3.50 103-day CMB 0.115% 3.05 **SETTLE:** $55 billion 43-day CMBs	**AUCTION RESULTS:** Rate Cover 4-week bills 0.095% 2.75 8-week bills 0.095% 3.07 154-day CMB 0.140% 2.90 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on May 4 $30 billion 105-day CMBs for auction on May 4 $65 billion 42-day CMBs for auction on May 5 $30 billion 119-day CMBs for auction on May 5 **SETTLE:** $105 billion 13-,26-week bills $22 billion 2-year FRNs $17 billion 5-year TIPS $42 billion 2-year notes $43 billion 5-year notes $35 billion 7-year notes $30 billion 103-day CMBs $25 billion 119-day CMBs $25 billion 273-day CMBs	
4	5	6	7	8
AUCTION: $111 billion 13-,26-week bills $30 billion 105-day CMBs	**AUCTION:** $65 billion 42-day CMBs $30 billion 119-day CMBs **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 $30 billion 154-day CMBs $30 billion 105-day CMBs	**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:** $111 billion* 13-,26-week bills for auction on May 11 **SETTLE:** $111 billion 13-,26-week bills $65 billion 42-day CMBs $30 billion 119-day CMBs	
11	12	13	14	15
AUCTION: $111 billion* 13-,26-week bills $42 billion* 3-year notes	**AUCTION:** $29 billion* 10-year notes **ANNOUNCE:** $90 billion* 4-week bills for auction on May 14 $70 billion* 8-week bills for auction on May 14 **SETTLE:** $90 billion* 4-week bills $70 billion* 8-week bills	**AUCTION:** $20 billion* 30-year bonds	**AUCTION:** $90 billion* 4-week bills $70 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on May 18 $30 billion* 52-week bills for auction on May 19 $13 billion* 10-year TIPS for auction on May 21 **SETTLE:** $111 billion* 13-,26-week bills	**SETTLE:** $42 billion* 3-year notes $29 billion* 10-year notes $20 billion* 30-year bonds
18	19	20	21	22
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $30 billion* 52-week bills announce: $90 billion* 4-week bills for auction on May 21 $70 billion* 8-week bills for auction on May 21 **SETTLE:** $90 billion* 4-week bills $70 billion* 8-week bills		**AUCTION:** $90 billion* 4-week bills $70 billion* 8-week bills $13 billion* 10-year TIPS **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on May 26 $20 billion* 2-year FRNs for auction on May 27 $44 billion* 2-yer notes for auction on May 26 $45 billion* 5-year notes for auction on May 27 $37 billion* 7-year notes for auction on May 28 **SETTLE:** $111 billion* 13-,26-week bills $30 billion* 52-week bills	

**Estimate*