U.S. Economic Comment

- U.S. economy: early reports for Q3 suggest a solid bounce
- The Fed's new strategy: no surprise on inflation targeting…
  …but a new perspective on the labor market

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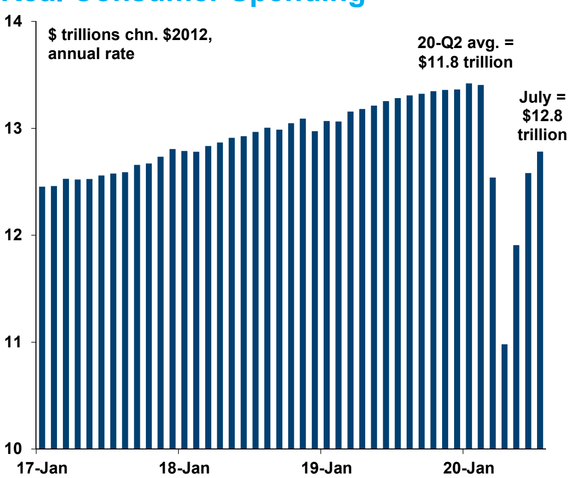
Early Insights into Q3 Economic Growth

Revised GDP statistics for the second quarter confirmed that the U.S. economy registered a dreadful performance in the spring (-31.7 percent, annual rate, not materially different than the initial estimate of -32.9 percent). Given that the downturn was driven by the pandemic rather than economic excesses or imbalances, one might expect a brief downturn and a solid rebound. Early data for the third quarter support this view, as several economic reports point to economic growth in excess of 20 percent in Q3.

Consumer spending stands out as a strong sector, as activity started to revive in May and has continued into July. Spending is still noticeably below pre-virus levels, but given that Covid is still an issue and some restrictions remain in place, the pickup is encouraging. The growth of consumer spending in Q3 certainly will be brisk, as expenditures of $12.8 trillion in July were already well ahead of the $11.8 trillion average for Q2. Even if spending were to stall in August and September, the growth of consumer spending in the GDP accounts would total approximately 35 percent. (The GDP statistics use compound annual rates for its growth measures.)

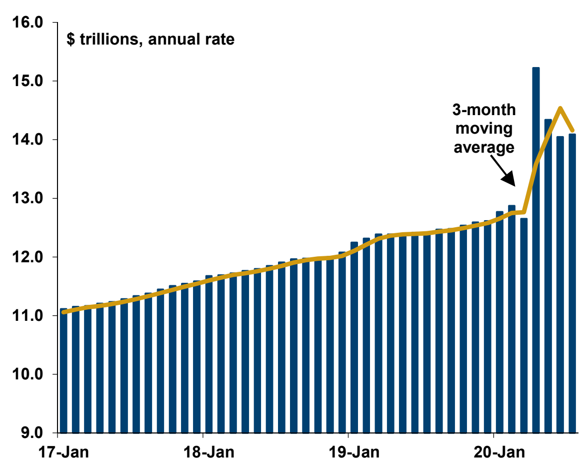
The brisk pickup in consumer activity in the past few months no doubt was influenced by heavy government support, as recovery rebate checks and enhanced unemployment benefits have kept the household sector financially flush in the aggregate. Indeed, the sum of wages and transfer payments (government support) has jumped far above the previous underlying trend (chart, right). If Congress does not provide more support, the measure shown in the chart will fade, as enhanced unemployment benefits have already expired and rebate checks are a mere trickle in July and will slow more in the months ahead. However, the spread of the virus is easing, which should allow for more workers to return to their jobs and lead to a pickup in wage income.

Real Consumer Spending



Source: Bureau of Economic Analysis via Haver Analytics

Personal Income*

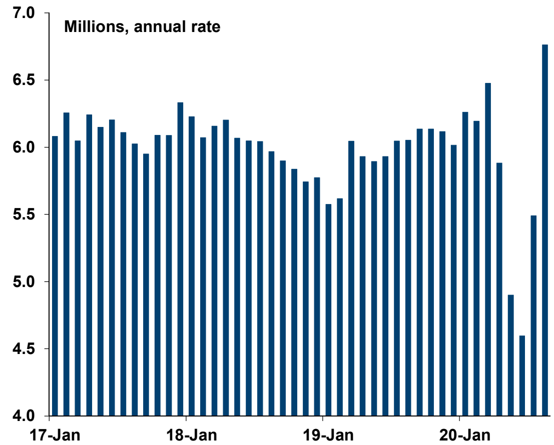


** The sum of the Wages and Salaries and Personal Current Transfer Receipts components of personal income.*

Source: Bureau of Economic Analysis via Haver Analytics

Individuals also are providing support through the housing market, as sales of both new and existing homes have surged recently, with both moving above levels in place before the onset of the pandemic (chart). The pickup could be more than a flurry, as pending home sales in July posted a solid gain from an already firm level. The number of pending sales is at a level last seen in 2005, when the housing market was experiencing a bubble. The pace of sales seems to be stirring new construction, as housing starts were firm in July and the builder sentiment index published by the National Association of Home Builders matched its historical record in August.

Total Home Sales*



** Sales of new and existing homes*

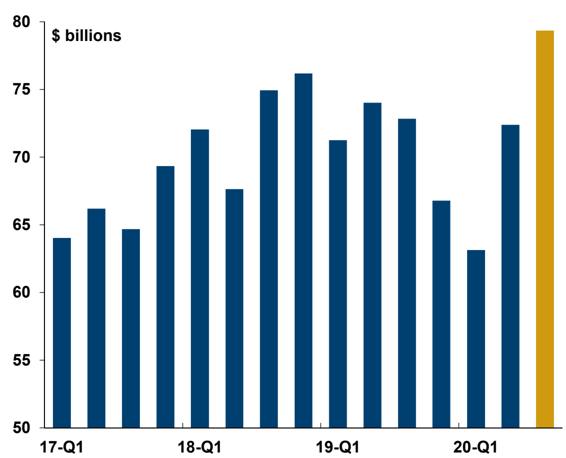
Source: National Association of Realtors and U.S. Census Bureau via Haver Analytics

We look for the business sector to be cautious in the months ahead because of uncertainty associated with both the pandemic and the election outcomes. However, we are likely to see some pickup in spending from the notably low levels seen in the spring. Outlays for new equipment are likely to jump in the third quarter, as shipments of nondefense capital goods other than aircraft have picked up in the past two months, retracing 88 percent of the ground lost during the spring. New orders for capital goods other than aircraft also have picked up, which offers hope for some support beyond Q3, but we would not look for strong activity. Certainly, we will not get support from the airline industry, as the commercial aircraft component of the durable goods report has registered negative order flows (i.e. net cancellations) in four of the past five months.

Businesses are likely to be a factor on the inventory front in the months ahead. Inventories have declined sharply in the past year, initially because of cautious management and more recently because of supply chain disruptions associated with the pandemic. However, trends may be shifting. Retailers showed an abrupt change in July, as they boosted stocks by 1.2 percent versus an average monthly decline of 4.2 percent in Q2. Wholesalers trimmed inventories again in July, but the drawdown of 0.1 percent was lighter than the average decline of 0.7 percent in the second quarter. We will receive information on inventories at the manufacturing level with the report on factory orders next week.

The international trade sector is perhaps going against the grain by restraining activity during the summer months. Both exports and imports have increased sharply in June and July, but imports have dominated and the nominal trade deficit in goods has widened as a result (chart). Strong imports are a constraint in that the revival in domestic demand in the U.S. is satisfied by foreign-produced goods rather than domestic ones. The initial results on trade are a bit discouraging, but we are keeping an open mind, as these results do not include trade in services and they are not adjusted for inflation. Thus, the picture could change as more data become available.

Nominal Goods Trade Deficit*



** Quarterly averages of monthly data. The reading for 2020-Q3 (gold bar) is the monthly deficit for July 2020.*

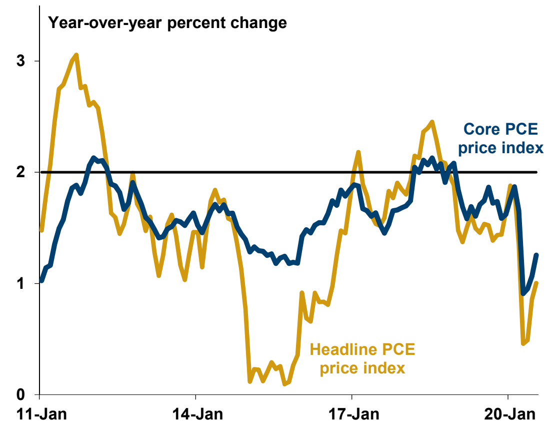
Source: U.S. Census Bureau via Haver Analytics; Daiwa Capital Markets America

Even with a drag from net exports, GDP growth in Q3 is likely to be quite firm, most likely in excess of 20 percent with a reading near 30 percent possible. The result is encouraging, but it would not lead us to begin suggesting V-shaped recovery, as challenges exist beyond Q3, such as waning fiscal stimulus. However, with the number of new Covid-19 cases trending downward, the economy should remain on a growth track.

The Fed's Strategic Framework

We were not deeply moved by the Fed's new plan for targeting inflation (pursuing average inflation of two percent in a flexible manner), as the change was largely in line with expectations and it is not materially different than the procedure now in place. Fed officials have emphasized in the past few years that their inflation target is "symmetrical," implying that above-target inflation could be tolerated at times. Thus, targeting average inflation and pursuing a symmetrical target could be viewed as nearly identical strategies.

PCE Price Indexes*



PCE = personal consumption expenditures

** The horizontal line at two percent is the inflation target of the Federal Reserve.*

Source: Bureau of Economic Analysis via Haver Analytics; Federal Open Market Committee

The new strategy, as outlined by Chair Powell, also was underwhelming because of its vague nature. Fed officials will allow (even pursue) inflation above two percent because of the sub-two-percent experience of the past several years (chart). However, it is not clear how much above two percent officials will tolerate and for how long. In addition, Chair Powell noted that policy decisions would not be based on a single variable or a simple formula; officials will take into account a "broad array of considerations", but he did not specify what might be considered. It seems as though the Fed will be looking at everything and exercising a good bit of judgment, just as it has always done in the past. Nothing new here.

We were more taken by the shift related to the Fed's mandate to achieve maximum employment. Under the new strategy, the Fed will seek "to mitigate **shortfalls** of employment from the Committee's assessment of its maximum level." Previously, officials sought to minimize **deviations** of employment from the perceived maximum. This change is notable and marks a pronounced shift from traditional decision making at the Fed.

The wording -- shortfalls rather than deviations -- indicates that officials will not be concerned about tight labor markets, low unemployment, and possible upward pressure on wage growth or inflation; they will allow labor markets to run hot.

The shift in view largely reflects the recent cyclical experience, where changes in unemployment (both upside during the financial crisis and downside during the latest expansion) had little apparent influence on wage and price pressure. Thus, officials now see little reason to resist strong labor markets. They will ignore "deviations" on the upside.

This shift also is interesting because it represents the abandonment of an economic hypothesis that served as one of the key principles guiding monetary policy in the past several decades. Specifically, most Fed officials in the past embraced the so-called Phillips curve, a view positing that inflation and unemployment are inversely related (low unemployment drove inflation higher and vice versa). Officials recognized that the relationship had weakened in recent years, but they still held to the view that low unemployment mattered from an inflation perspective. Now, that view has been placed in the dust bin. Chair Powell essentially pronounced the Phillips curve dead.

We also sense that the new view on the labor market reflects the acceptance by the Fed of an implicit mandate to reduce income and wealth inequality. Fed Chairs in recent years have been badgered about inequality in their Congressional testimonies, and as a result, they have most likely become sensitive to the issue. Increased interest in inequality has become apparent in various Fed reports, which now often comment on economic trends by income class or by racial and ethnic group. Chair Powell has noted frequently that one of the prime lessons from the *Fed Listens* tour is that tight labor markets have benefitted groups and regions that had been falling behind. Thus, while not stated explicitly in the new strategic statement or mandated by Congress, we believe the Fed sees itself as playing a role in reducing income inequality.

Review

Week of August 24, 2020	Actual	Consensus	Comments
Consumer Confidence (August)	**84.8 (-6.9 Index Pts.)**	**93.0 (+0.4 Index Pt.)**	The decline in the Conference Board's measure of consumer confidence in August pushed the index below the previous Covid-related low in April (85.7). The current index level is still respectable in that it is above lows seen in previous recessions (e.g. 25.3 in February 2009 and 55.1 in January 1991), but it is far below the average of 131.5 in January/February.
New Home Sales (July)	**0.901 Million (+13.9%)**	**0.790 Million (+1.8%)**	New home sales jumped from an upward revised level in June, with the combined changes pushing the July reading 16.4% above the pre-virus peak in January. The July total was still below elevated readings from 2003 to 2006, when the market was experiencing bubble-like conditions, but the latest result compares favorably to other previous periods of firm activity.
Durable Goods Orders (July)	**11.2%**	**4.8%**	Durable goods orders advanced for the third consecutive month in July, with the combined results recouping 80% of the ground lost in March and April. Orders excluding transportation rose 2.4% and have now retraced 90% of the ground lost from February through April. Bookings for nondefense capital goods ex. aircraft, which provides insights into capital spending plans by businesses, rose 0.8% and is now within the range before the onset of the pandemic.
Revised GDP (20-Q2)	**-31.7% (+1.2 Pct. Pts. Revision)**	**-32.5% (+0.4 Pct. Pt. Revision)**	The U.S. economy in Q2 was not as soft as previously believed, but the upward adjustment was minuscule relative to the magnitude of the contraction. The revision was broadly based, as all major components showed better results. However, the revisions to components were small.
Personal Income, Consumption, Core Price Index (July)	**0.4%, 1.9%, 0.3%**	**-0.2%, 1.6%, 0.5%**	With payrolls increasing in July, wages and salaries rose 1.4%. The advance in wages was joined by an increase of 1.3% in rental income after declines in the prior three months. A drop of 1.7% in transfer payments represented further unwinding of a stimulus-related spurt in April, but the level of support from the government remained elevated. Consumer spending rose 1.6% after adjusting for inflation. Even if real spending were to remain flat in August and September, the results imply consumer spending growth in Q3 of approximately 35% (annual rate). The core PCE price index rose two ticks on a year-over-year basis in July. The pace quickened from the recent low of 0.9% in April but trailed the 1.9% print in February.
U.S. International Trade in Goods (July)	**-$79.3 Billion ($8.3 Billion Wider Deficit)**	**-$72.0 Billion ($1.0 Billion Wider Deficit)**	Exports and imports of goods both jumped 11.8% in July, but the dollar volume of imports exceeded that of exports and led to a notable widening in the monthly trade deficit. Back-to-back increases in both exports and imports in the past two months are notable in that they may signal a stirring in global economic activity, but trade volumes still lag those prior to the onset of the virus. Also, the data on goods flows suggest a negative contribution to GDP growth from net exports in Q3. However, real goods flows are not yet available for July (published next week along with data on nominal services flows), and results for August and September could change the picture appreciably.

Source: The Conference Board (Consumer Confidence); U.S. Census Bureau (New Home Sales, Durable Goods Orders, U.S. International Trade in Goods); Bureau of Economic Analysis (Revised GDP, Personal Income, Consumption, and Core Price Index); Consensus forecasts are from Bloomberg

Preview

Week of August 31, 2020	Projected	Comments
ISM Manufacturing Index (August) (Tuesday)	**55.0% (+0.8 Pct. Pt.)**	Strong orders for durable goods in July and a pickup in factory production suggest that manufacturing activity is recovering, which should allow the ISM index to remain close to its solid reading in July. The results for July and August represent the best since early 2019, although they lag the average of 58.9 for 2018. In terms of components, the above-60 observations for new orders and production could ease to a degree, but the sub-50 reading on employment has upside potential.
Construction Spending (July) (Tuesday)	**0.0%**	Strong housing starts in July suggest that private residential building will pick up after declining in the prior four months. However, business-related activity is likely to remain subdued because of cautious behavior by executives during the pandemic. Tight budgets could constrain the activity of state and local governments.
Factory Orders (July) (Wednesday)	**6.2%**	The already reported increase of 11.2% in orders for durable goods accounts for most of the expected increase in total factory bookings, but the nondurable area also is likely to contribute with a projected increase of 1.5%. Part of the advance in nondurable orders is likely to reflect higher prices of petroleum products, but further recovery in nondurable bookings other than petroleum should play a role as well. The increase in durable orders was led by the transportation category (brisk bookings for autos, defense aircraft, and miscellaneous items that offset net cancellations for commercial aircraft). Durable orders ex-transportation rose 2.4%.
Trade Balance (July) (Thursday)	**-$58.8 Billion ($8.1 Billion Wider Deficit)**	Exports and imports are rebounding from marked slippage that occurred from March through May, which should give a lift to the surplus in trade services. However, the monthly deficit in goods trade widened noticeably in July (slippage of $8.3 billion; published August 28), which is likely to swamp the expected improvement in service trade. The slippage in goods trade reflected solid performances for both exports and imports, but imports carried the day and led to a wider deficit.
ISM Nonmanufacturing Index (August) (Thursday)	**57.0% (-1.1 Pct. Pts.)**	Surges in the nonmanufacturing index in June and July pushed the measure above the pre-virus high in February. However, the service sectors of the economy are still struggling with the virus, and thus the ISM index may have gotten ahead of underlying conditions, raising the possibility of a correction in August. The above-60 readings on the new orders and business activity components seem to have downside potential.
Payroll Employment (August) (Friday)	**1,400,000**	Initial claims for unemployment insurance remain elevated, but they have eased since the survey week in July. In addition, a drop in the number of individuals receiving unemployment benefits indicates that workers are being recalled at a faster pace than others are being let go. Thus, nonfarm payrolls should show another firm increase, which should be sufficient to push the unemployment rate lower for the fourth consecutive month. Average hourly earnings could dip as the recall of lower-paid workers pushes the measure back toward its pre-virus level.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

August/September 2020

Monday 24

CHICAGO FED NATIONAL ACTIVITY INDEX

	Monthly	3-Mo. Avg.
May	4.24	-6.00
June	5.33	-2.78
July	1.18	3.59

Tuesday 25

FHFA HOME PRICE INDEX

Apr	0.1%
May	-0.2%
June	0.9%

S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX

	SA	NSA
Apr	0.3%	0.8%
May	0.0%	0.3%
June	0.0%	0.2%

CONFERENCE BOARD CONSUMER CONFIDENCE

June	98.3
July	91.7
Aug	84.8

NEW HOME SALES

May	0.687 million
June	0.791 million
July	0.901 million

Wednesday 26

DURABLE GOODS ORDERS

May	15.0%
June	7.7%
July	11.2%

Thursday 27

UNEMPLOYMENT CLAIMS

(Millions)	Initial	Continuing
Aug 01	1.191	15.480
Aug 08	0.971	14.758
Aug 15	1.104	14.535
Aug 22	1.006	N/A

REVISED GDP

	GDP	Chained Price
20-Q1	-5.0%	1.4%
20-Q2(a)	-32.9%	-1.8%
20-Q2(p)	-31.7%	-2.0%

PENDING HOMES SALES

May	44.3%
June	15.8%
July	5.9%

Friday 28

PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX

	Inc.	Cons.	Core
May	-4.2%	8.6%	0.2%
June	-1.0%	6.2%	0.3%
July	0.4%	1.9%	0.3%

U.S. INTERNATIONAL TRADE IN GOODS

May	-$75.4 billion
June	-$71.0 billion
July	-$79.3 billion

ADVANCE INVENTORIES

	Wholesale	Retail
May	-1.2%	-6.2%
June	-1.3%	-2.7%
July	-0.1%	1.2%

CHICAGO PURCHASING MANAGERS' INDEX

	Index	Prices
June	36.6	55.2
July	51.9	56.9
Aug	51.2	55.0

REVISED CONSUMER SENTIMENT

June	71.8
July	72.5
Aug	74.1

Monday 31

Tuesday 1

ISM INDEX (10:00)

	Index	Prices
June	52.6	51.3
July	54.2	53.2
Aug	**55.0**	**53.0**

CONSTRUCTION SPEND. (10:00)

May	-1.7%
June	-0.7%
July	**0.0%**

VEHICLE SALES

June	13.1 million
July	14.5 million
Aug	**14.8 million**

Wednesday 2

ADP EMPLOYMENT REPORT (8:15)

	Private Payrolls
June	4,314,000
July	167,000
Aug	--

FACTORY ORDERS (10:00)

May	7.7%
June	6.3%
July	**6.2%**

BEIGE BOOK (2:00)

July 2020 Beige Book

"Economic activity increased in almost all Districts, but remained well below where it was prior to the COVID-19 pandemic."

Thursday 3

INITIAL CLAIMS (8:30)

TRADE BALANCE (8:30)

May	-$54.8 billion
June	-$50.7 billion
July	**-$58.8 billion**

REVISED PRODUCTIVITY & COSTS (8:30)

	Productivity	Unit Labor Costs
20-Q1	-0.3%	9.8%
20-Q2(p)	7.3%	12.2%
20-Q2(r)	**10.4%**	**9.2%**

ISM NON-MFG INDEX (10:00)

	Index	Prices
June	57.1	62.4
July	58.1	57.6
Aug	**57.0**	**57.0**

Friday 4

EMPLOYMENT REPORT (8:30)

	Payrolls	Un. Rate
June	4,791,000	11.1%
July	1,763,000	10.2%
Aug	**1,400,000**	**9.8%**

Monday 7

LABOR DAY

Tuesday 8

NFIB SMALL BUSINESS OPTIMISM INDEX

CONSUMER CREDIT

Wednesday 9

JOLTS DATA

Thursday 10

INITIAL CLAIMS

PPI

WHOLESALE TRADE

Friday 11

CPI

FEDERAL BUDGET

Monday 14

Tuesday 15

EMPIRE MFG INDEX

IMPORT/EXPORT PRICES

IP & CAP-U

FOMC MEETING

Wednesday 16

RETAIL SALES

BUSINESS INVENTORIES

NAHB HOUSING MARKET INDEX

FOMC DECISION

TIC DATA

Thursday 17

INITIAL CLAIMS

HOUSING STARTS

PHILLY FED INDEX

Friday 18

CURRENT ACCOUNT

LEADING INDICATORS

CONSUMER SENTIMENT

Forecasts in Bold. a = advance (1st estimate of GDP); (p) = preliminary (2nd estimate of GDP); (r) = revised

Treasury Financing

August/September 2020

Monday	Tuesday	Wednesday	Thursday	Friday
24	25	26	27	28
AUCTION RESULTS: Rate Cover 13-week bills 0.100% 2.57 26-week bills 0.120% 2.92	**AUCTION RESULTS:** Rate Cover 2-year notes 0.155% 2.78 42-day CMB 0.085% 3.39 119-day CMB 0.110% 3.05 **ANNOUNCE:** $30 billion 4-week bills for auction on August 27 $35 billion 8-week bills for auction on August 27 $25 billion 105-day CMBs for auction on August 26 $30 billion 154-day CMBs for auction on August 26 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs	**AUCTION RESULTS:** Margin Cover 2-year FRN 0.055% 2.85 Rate Cover 105-day CMB 0.100% 3.68 154-day CMB 0.110% 3.67 5-year notes 0.298% 2.71	**AUCTION RESULTS:** Rate Cover 4-week bills 0.080% 2.93 8-week bills 0.090% 2.93 7-year notes 0.519% 2.47 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on August 31 $30 billion 42-day CMBs for auction on September 1 $30 billion 119-day CMBs for auction on September 1 **SETTLE:** $105 billion 13-,26-week bills $30 billion 42-day CMBs $30 billion 119-day CMBs	**SETTLE:** $22 billion 2-year FRNs
31	1	2	3	4
AUCTION: $105 billion 13-,26-week bills **SETTLE:** $25 billion 20-year bonds $7 billion 30-year TIPS $50 billion 2-year notes $51 billion 5-year notes $47 billion 7-year notes	**AUCTION:** $30 billion 42-day CMBs $30 billion 119-day CMBs **ANNOUNCE:** $30 billion* 4-week bills for auction on September 3 $35 billion* 8-week bills for auction on September 3 **SETTLE:** $30 billion 4-week bills $35 billion 8-week bills $25 billion 105-day CMBs $30 billion 154-day CMBs		**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on September 8 $34 billion* 52-week bills for auction on September 8 $50 billion* 3-year notes for auction on September 8 $35 billion* 10-year notes for auction on September 9 $23 billion* 30-year bonds for auction on September 10 **SETTLE:** $105 billion 13-,26-week bills $30 billion 42-day CMBs $30 billion 119-day CMBs	
7	8	9	10	11
LABOR DAY	**AUCTION:** $105 billion* 13-,26-week bills $34 billion* 52-week bills $50 billion* 3-year notes **ANNOUNCE:** $30 billion* 4-week bills for auction on September 10 $35 billion* 8-week bills for auction on September 10 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $35 billion* 10-year notes	**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $23 billion* 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on September 14 $22 billion* 20-year bonds for auction on September 15 $12 billion* 10-year TIPS for auction on September 17 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills	
14	15	16	17	18
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $22 billion* 20-year bonds **ANNOUNCE:** $30 billion* 4-week bills for auction on September 17 $35 billion* 8-week bills for auction on September 17 **SETTLE:** $30 billion* 4-week bills $35 billion* 8-week bills $50 billion* 3-year notes $35 billion* 10-year notes $23 billion* 30-year bonds		**AUCTION:** $30 billion* 4-week bills $35 billion* 8-week bills $12 billion* 10-year TIPS **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on September 21 $22 billion* 2-year FRNs for auction on September 23 $52 billion* 2-year notes for auction on September 22 $53 billion* 5-year notes for auction on September 23 $50 billion* 7-year notes for auction on September 24 **SETTLE:** $105 billion* 13-,26-week bills	

*Estimate