Daiwa Capital Markets

# U.S. Economic Comment

- State & local governments: a source of growth?
- PPI: a warning sign, or normal volatility?

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

## State and Local Governments: Not So Bad

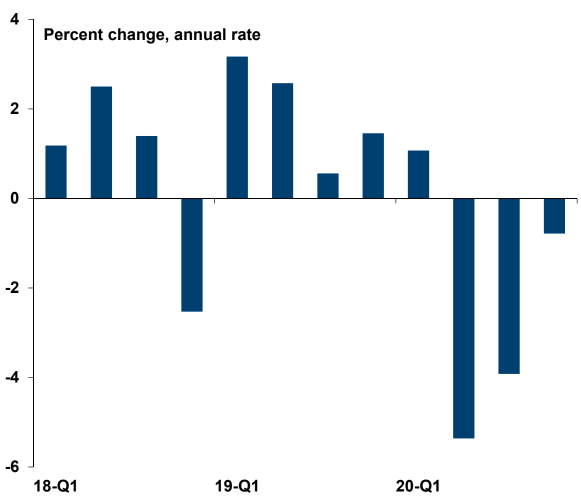
The favorable outlook for the U.S. economy this year largely rests on the expectation of strong consumer spending and brisk housing activity. Business spending on new equipment also has started to stir, and a buildup of unfilled orders for capital goods suggests that this area will remain active for a time. Two areas presumably showing little promise are net exports and spending by state and local governments. Results in these areas certainly have been soft recently, as international trade constrained growth in both the third and fourth quarters of 2020 (and Q1 is looking weak as well), while spending by state and local governments declined in the final three quarters of last year (chart, left).

Despite a poor performance last year, we see the potential for a positive surprise from state and local governments this year. It is not likely to be a boom sector, but we look for it to be in the plus column.

A negative outlook for spending by state and local governments would be based on the view that the pandemic has devastated tax revenues, which forced cuts last year and will constrain activity in coming quarters while financial positions are repaired. It turns out that damage to revenues was not severe. Data published by the Census Bureau show that receipts tumbled in the second quarter, but they rebounded in the third quarter and remained firm in Q4. For all of 2020, revenues grew 3.7 percent (chart, right). In terms of detail, sales taxes were weak, but not desperate (off 0.2 percent); property taxes, along with individual and corporate income taxes, increased.

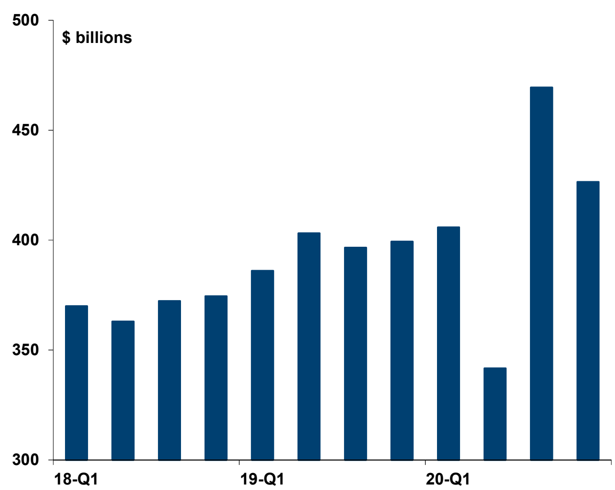
With revenues holding up well, activity among state and local governments is likely to revive. The picture is even brighter considering the support provided by the federal government. Congress approved $150 billion of direct aid through the CARES Act and $350 billion through the American Rescue Plan (the $1.9 trillion package approved in March). Congress also provided indirect assistance by appropriating funds for schools, transit systems, and vaccine distribution.

### State and Local Government Expenditures




*Source: Bureau of Economic Analysis via Haver Analytics*

### State and Local Government Tax Revenues




*Source: U.S. Census Bureau*

State and local governments have indeed become more active. Payrolls have increased 294,000 (1.6 percent) since the trough in May, and construction activity has increased since September (partly offset by a weather-related disruption in February). We are looking for total outlays by state and local governments to increase in the first quarter after three quarterly declines.

While the outlook seems favorable, one might have doubts because of the sharp adjustments made by state and local governments during the early stages of the pandemic and continued spending cuts in Q3 and Q4. We can offer two explanations for soft results thus far.

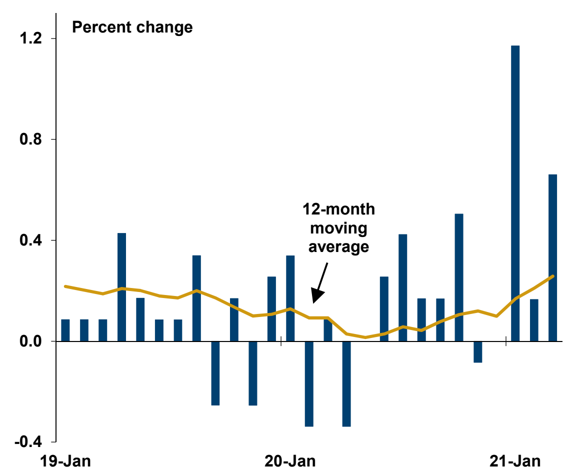
First, most of the drop in employment among state and local governments has occurred in educational services (70 percent of the total decline from the pre-pandemic peak in February 2020 through March 2021). Thus, it has been school closings driven by Covid rather than constrained revenues that have been holding back state and local governments. As schools return to in-class instruction, employment should improve considerably.

Second, like many other aspects of the virus, the effects on state and local governments have been uneven. Many states have continued to enjoy firm economic performances, while others have performed poorly. States that are heavily dependent on tourism or rely on sales taxes more than income taxes have indeed registered notable revenue shortfalls and have been forced to limit spending. Governments with steady or firmer revenue flows may have become cautious in their spending because of the uncertain environment. The combination of cuts by negatively affected states and cautious activity elsewhere would translate to weak activity in the aggregate.

## Producer Prices: Often Volatile

The producer price index for March provided a surprise with an increase of 1.0 percent overall and 0.7 percent excluding food and energy (versus consensus estimates of 0.5 percent and 0.2 percent, respectively). This is the second time in the past three months that prices other than food and energy have surged, with the changes pushing the year-over-year increase to 3.1 percent, the fastest advance since services were added to the index in late 2010 (chart). The aggressive fiscal and monetary policies now in place have stirred some thoughts of a pickup in inflation; perhaps the recent pressure on producer prices is a signal that problems are developing.

### PPI Excluding Food and Energy




*Source: Bureau of Labor Statistics via Haver Analytics*

In one sense, we view the PPI as valuable because it includes a broad array of goods and services – items purchased by consumers, businesses, governments, and foreign buyers (it includes prices of goods destined for export). Thus, it might provide a better sense of the overall inflation impulse than measures based only on prices paid by consumers. At the same time, the PPI tends to be erratic; it often swings widely from month-to-month or registers a few months of pressure that are later offset.

Because of the volatility and the often random nature of changes in the PPI, we tend to weigh it lightly in assessing the inflation environment. Recent changes have piqued our curiosity, but we would need to see corroborating evidence in other measures before we become concerned. Recent changes in the CPI certainly do not provide any suggestion of problems, as the core index has been flat or up only 0.1 percent in the past three months (March results published on April 13).

We doubt that Fed officials will be concerned about the recent jumps in producer prices. Public comments indicate that policymakers expect a pickup in inflation over the next several months and that they view the acceleration as likely transitory (an unwinding of price restraint generated by the pandemic and a temporary response to supply-chain disruptions). They are likely to dismiss any acceleration in inflation and argue that the underlying dynamics that have generated subdued inflation over the past several years will reassert themselves.

## The Biden Tax Proposal: Challenges Ahead

As we read the public commentary, the American Jobs Plan released on March 31 by President Biden has received a lukewarm reception. The President and his cabinet call the proposal an infrastructure plan, but many observers note that it is light on traditional infrastructure and loaded with projects that should be considered under the normal budget process (e.g. in-home health care, home restoration, job training). The tax portion of the proposal has received even less support. The business community has been deeply critical, and some Democratic members of Congress have expressed reservations.

The first available economic assessment will not help the prospects for passage. Economists at the University of Pennsylvania this week released results from the Penn Wharton model showing that the proposal would have a negative effect on the economy, leaving GDP 10 years from now 0.9 percent lower than it would be otherwise.

The contractionary effect occurs because spending provisions outweigh the tax increase, which will increase government debt, boost interest rates, and crowd out business investment spending. The increase in corporate taxes further depresses business investment, which leaves the nation with a lower capital stock and slower productivity growth. The slowdown in productivity, in turn, has a depressing effect on wages.

It is far too early to draw conclusions about the proposal and its effects on the economy, as the debate on the issues will most likely extend over several months, and the final legislation, if any, will probably be notably different than that offered by President Biden.

# Review

| Week of April 5, 2021 | Actual | Consensus | Comments |
|---|---|---|---|
| **ISM Services Index (March)** | **63.7% (+8.4 Pct. Pts.)** | **59.0% (+3.7 Pct. Pts.)** | The ISM services index surged to a record level in March, led by striking advances in the new orders and business activity components. The jumps of 15.3 percentage points to 67.2% for new orders, and 13.9 percentage points to 69.4% for business activity pushed both measures to new records. With orders and business activity strong, service firms also hired actively, with the employment index increasing 4.5 percentage points to 57.2%. The new reading was not a record, but it was in the upper portion of the historical range. |
| **Factory Orders (February)** | **-0.8%** | **-0.5%** | New orders for durable goods slipped 1.2% (revised lower from -1.1%; first published last week), but the decline occurred after advances in the previous nine months that had recouped all of the ground lost during the virus-led drop in the spring and it likely reflected adverse weather. Bookings in the nondurable area dipped 0.4%. Higher prices likely fueled the advance of 0.8% in orders for petroleum and coal products, but nondurable orders excluding petroleum and coal fell 0.6%, ending a string of nine consecutive monthly increases. Although results for February were weak, readings on manufacturing employment and the ISM index for March suggest an upcoming rebound in orders. |
| **Trade Balance (February)** | **-$71.1 Billion ($3.3 Billion Wider Deficit)** | **-$70.5 Billion ($2.3 Billion Wider Deficit)** | Exports and imports both broke from the upward trends that had developed in the past several months, with exports falling 2.6% and imports dipping 0.7% in February. Most of the widening in the deficit in February occurred in the goods sector, where the deficit widened by $2.8 billion. The change was even sharper after adjusting for price changes ($3.0 billion). The surplus in service trade slipped $0.5 billion, reestablishing a downward trend after slight improvement in the prior month. The trade results thus far in Q1 show a wider shortfall than the average in Q4, suggesting that net exports will make a negative contribution to GDP growth in the first quarter. |
| **PPI (March)** | **1.0% Total, 0.7% Ex. Food & Energy** | **0.5% Total, 0.2% Ex. Food & Energy** | Energy prices jumped 5.9% in March after averaging increases of 5.3% in the prior three months. Food prices also rose noticeably (0.5%), although the change trailed the average advance of 0.9% in the prior six months. Prices excluding food and energy are perhaps starting to stir, as the jump in March followed a surge of 1.2% in January. On a year-over-year basis, headline prices rose 4.2%, up from 2.8% in February and fastest pace since 2011. The PPI excluding food and energy increased 3.1% in the past year, the fastest year-over-year change since services were added to the index (PPI with goods and services available since November 2010). |

*Sources: Institute for Supply Management (ISM Services Index); U.S. Census Bureau (Factory Orders); Bureau of Economic Analysis (Trade Balance); Bureau of Labor Statistics (PPI); Consensus forecasts are from Bloomberg*

# Preview

| Week of April 12, 2021 | Projected | Comments |
|---|---|---|
| **Federal Budget (March) (Monday)** | **$650 Billion Deficit** | Federal revenues in March appear to have grown briskly relative to the same month last year, but outlays are likely to surge because of spending authorized by the American Rescue Plan. The expected shortfall would leave the deficit in the first six months of the current fiscal year at $1,697 billion, up from $743 billion during the same period in FY2020. |
| **CPI (March) (Tuesday)** | **0.4% Total, 0.2% Core** | Energy prices are likely to register their 10th consecutive increase, which would move the level of the index above readings around the turn of 2019-20. Food prices are likely to continue their upward drift (average increase of 0.1% in the past seven months). An easing in lockdown restrictions and the receipt of rebate checks are likely to stir consumer activity and boost the core component after three quiet months (flat or up 0.1% from December through February). |
| **Retail Sales (March) (Thursday)** | **4.5% Total, 4.0% Ex-Autos** | Households received most of the recovery rebate checks authorized by the American Rescue Plan during March, which should fuel active spending. Even without this federal push, activity would probably have picked up from weather-constrained results in February. |
| **Industrial Production (March) (Thursday)** | **2.0%** | A record reading on the ISM index and strong employment results in the factory sector suggest that the manufacturing component of industrial production will be strong. Similarly, a pickup in the rotary rig count and a solid gain in employment point to a rebound in mining activity from weather-constrained results in February. A drop in utility output because of warmer temperatures is likely to provide a partial offset to strength in manufacturing and mining. |
| **Housing Starts (March) (Friday)** | **1.580 Million (+11.2%)** | Underlying fundamentals for the housing sector are favorable, but weather probably dominated results in the past two months: depressing activity in February, when starts fell 10.3%, and triggering a rebound in March. |
| **Consumer Sentiment (April) (Friday)** | **89.0 (+4.1 Index Pts.)** | The receipt of recovery rebate checks seemed to boost spirits in the latter part of March, and there is likely to be some follow through in early April. Record readings on major stock indexes and improvement in the labor market also are likely to brighten moods. |

*Source: Forecasts provided by Daiwa Capital Markets America*

# Economic Indicators

## April 2021

### Monday 5

**ISM SERVICES INDEX**

| | Index | Prices |
|---|---|---|
| Jan | 58.7 | 64.2 |
| Feb | 55.3 | 71.8 |
| Mar | 63.7 | 74.0 |

**FACTORY ORDERS**

| | |
|---|---|
| Dec | 1.6% |
| Jan | 2.7% |
| Feb | -0.8% |

### Tuesday 6

**JOLTS DATA**

| | Openings (000) | Quit Rate |
|---|---|---|
| Dec | 6,752 | 2.4% |
| Jan | 7,099 | 2.3% |
| Feb | 7,367 | 2.3% |

### Wednesday 7

**TRADE BALANCE**

| | |
|---|---|
| Dec | -$67.0 billion |
| Jan | -$67.8 billion |
| Feb | -$71.1 billion |

**FOMC MINUTES**

**CONSUMER CREDIT**

| | |
|---|---|
| Dec | $9.1 billion |
| Jan | $0.1 billion |
| Feb | $27.6 billion |

### Thursday 8

**UNEMPLOYMENT CLAIMS**

| | Initial (Millions) | Continuing |
|---|---|---|
| Mar 13 | 0.765 | 3.841 |
| Mar 20 | 0.658 | 3.750 |
| Mar 27 | 0.728 | 3.734 |
| Apr 03 | 0.744 | N/A |

### Friday 9

**PPI**

| | Final Demand | Ex. Food & Energy |
|---|---|---|
| Jan | 1.3% | 1.2% |
| Feb | 0.5% | 0.2% |
| Mar | 1.0% | 0.7% |

**WHOLESALE TRADE**

| | Inventories | Sales |
|---|---|---|
| Dec | 0.3% | 1.4% |
| Jan | 1.4% | 4.4% |
| Feb | 0.6% | -0.8% |

### Monday 12

**FEDERAL BUDGET (2:00)**

| | 2021 | 2020 |
|---|---|---|
| Jan | -$162.8B | -$32.6B |
| Feb | -$310.9B | -$235.3B |
| **Mar** | **-$650.0B** | -$119.0B |

### Tuesday 13

**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)**

| | |
|---|---|
| Jan | 95.0 |
| Feb | 95.8 |
| Mar | -- |

**CPI (8:30)**

| | Total | Core |
|---|---|---|
| Jan | 0.3% | 0.0% |
| Feb | 0.4% | 0.1% |
| **Mar** | **0.4%** | **0.2%** |

### Wednesday 14

**IMPORT/EXPORT PRICES (8:30)**

| | Non-petrol. Imports | Nonagri. Exports |
|---|---|---|
| Jan | 0.9% | 2.2% |
| Feb | 0.5% | 1.5% |
| Mar | -- | -- |

**BEIGE BOOK (2:00)**

**March Beige Book**

"Economic activity expanded modestly from January to mid-February for most Federal Reserve Districts. Most businesses remain optimistic regarding the next 6-12 months as COVID-19 vaccines become more widely distributed."

### Thursday 15

**INITIAL CLAIMS (8:30)**

**RETAIL SALES (8:30)**

| | Total | Ex.Autos |
|---|---|---|
| Jan | 7.6% | 8.3% |
| Feb | -3.0% | -2.7% |
| **Mar** | **4.5%** | **4.0%** |

**EMPIRE MFG (8:30)**

| | |
|---|---|
| Feb | 12.1 |
| Mar | 17.4 |
| Apr | -- |

**PHILLY FED INDEX (8:30)**

| | |
|---|---|
| Feb | 23.1 |
| Mar | 51.8 |
| Apr | -- |

**IP & CAP-U (9:15)**

| | IP | Cap.Util. |
|---|---|---|
| Jan | 1.1% | 75.5% |
| Feb | -2.2% | 73.8% |
| **Mar** | **2.0%** | **75.3%** |

**NAHB HOUSING MARKET INDEX (10:00)**

| | |
|---|---|
| Feb | 84 |
| Mar | 82 |
| Apr | -- |

**BUSINESS INVENTORIES (10:00)**

| | Inventories | Sales |
|---|---|---|
| Dec | 0.7% | 0.9% |
| Jan | 0.5% | 4.5% |
| **Feb** | **0.5%** | **-2.0%** |

**TIC DATA (4:00)**

| | Total | Net L-T |
|---|---|---|
| Dec | $8.0B | $121.0B |
| Jan | $106.3B | $90.8B |
| Feb | -- | -- |

### Friday 16

**HOUSING STARTS (8:30)**

| | |
|---|---|
| Jan | 1.584 million |
| Feb | 1.421 million |
| **Mar** | **1.580 million** |

**CONSUMER SENTIMENT (10:00)**

| | |
|---|---|
| Feb | 76.8 |
| Mar | 84.9 |
| **Apr** | **89.0** |

### Monday 19

### Tuesday 20

### Wednesday 21

### Thursday 22

**INITIAL CLAIMS**

**CHICAGO FED NATIONAL ACTIVITY INDEX**

**EXISTING HOME SALES**

**LEADING INDICATORS**

### Friday 23

**NEW HOME SALES**

### Monday 26

**DURABLE GOODS ORDERS**

### Tuesday 27

**FHFA HOME PRICE INDEX**

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

**CONSUMER CONFIDENCE**

**FOMC MEETING**

### Wednesday 28

**U.S. INTERNATIONAL TRADE IN GOODS**

**ADVANCE INVENTORIES**

**FOMC DECISION**

### Thursday 29

**INITIAL CLAIMS**

**GDP**

**PENDING HOME SALES**

### Friday 30

**PERSONAL INCOME, CONSUMPTION & PRICES**

**EMPLOYMENT COST INDEX**

**MNI CHICAGO BUSINESS BAROMETER INDEX**

**REVISED CONSUMER SENTIMENT**

*Forecasts in Bold.*

# Treasury Financing

## April 2021

| Monday | Tuesday | Wednesday | Thursday | Friday |
|---|---|---|---|---|
| 5 | 6 | 7 | 8 | 9 |
| **AUCTION RESULTS:**<br>Rate / Cover<br>13-week bills 0.020% 3.00<br>26-week bills 0.035% 3.38 | **AUCTION RESULTS:**<br>Rate / Cover<br>6-week CMB 0.020% 3.50<br>**ANNOUNCE:**<br>$40 billion 4-week bills for auction on April 8<br>$40 billion 8-week bills for auction on April 8<br>$35 billion 17-week CMBs for auction on April 7<br>**SETTLE:**<br>$40 billion 4-week bills<br>$40 billion 8-week bills<br>$35 billion 17-week CMBs | **AUCTION RESULTS:**<br>Rate / Cover<br>17-week CMB 0.025% 4.06 | **AUCTION RESULTS:**<br>Rate / Cover<br>4-week bills 0.010% 3.72<br>8-week bills 0.010% 3.71<br>**ANNOUNCE:**<br>$111 billion 13-,26-week bills for auction on April 12<br>$58 billion 3-year notes for auction on April 12<br>$38 billion 10-year notes for auction on April 12<br>$24 billion 30-year bonds for auction on April 13<br>$40 billion 6-week CMBs for auction on April 13<br>**SETTLE:**<br>$111 billion 13-,26-week bills<br>$40 billion 6-week CMBs | |
| 12 | 13 | 14 | 15 | 16 |
| **AUCTION:**<br>$111 billion 13-,26-week bills<br>$58 billion 3-year notes<br>$38 billion 10-year notes | **AUCTION:**<br>$40 billion 6-week CMBs<br>$24 billion 30-year bonds<br>**ANNOUNCE:**<br>$40 billion* 4-week bills for auction on April 15<br>$40 billion* 8-week bills for auction on April 15<br>**SETTLE:**<br>$40 billion 4-week bills<br>$40 billion 8-week bills<br>$35 billion 17-week CMBs | | **AUCTION:**<br>$40 billion* 4-week bills<br>$40 billion* 8-week bills<br>**ANNOUNCE:**<br>$111 billion* 13-,26-week bills for auction April 19<br>$34 billion* 52-week bills for auction on April 20<br>$24 billion* 20-year bonds for auction on April 21<br>$19 billion* 5-year TIPS for auction on April 22<br>**SETTLE:**<br>$111 billion 13-,26-week bills<br>$58 billion 3-year notes<br>$38 billion 10-year notes<br>$24 billion 30-year bonds<br>$40 billion 6-week CMBs | |
| 19 | 20 | 21 | 22 | 23 |
| **AUCTION:**<br>$111 billion* 13-,26-week bills | **AUCTION:**<br>$34 billion* 52-week bills<br>**ANNOUNCE:**<br>$40 billion* 4-week bills for auction on April 22<br>$40 billion* 8-week bills for auction on April 22<br>**SETTLE:**<br>$40 billion* 4-week bills<br>$40 billion* 8-week bills | **AUCTION:**<br>$24 billion* 20-year bonds | **AUCTION:**<br>$40 billion* 4-week bills<br>$40 billion* 8-week bills<br>$19 billion* 5-year TIPS<br>**ANNOUNCE:**<br>$111 billion* 13-,26-week bills for auction on April 26<br>$28 billion* 2-year FRNs for auction on April 27<br>$60 billion* 2-year notes for auction on April 26<br>$61 billion* 5-year notes for auction on April 26<br>$62 billion* 7-year notes for auction on April 27<br>**SETTLE:**<br>$111 billion* 13-,26-week bills<br>$34 billion* 52-week bills | |
| 26 | 27 | 28 | 29 | 30 |
| **AUCTION:**<br>$111 billion* 13-,26-week bills<br>$60 billion* 2-year notes<br>$61 billion* 5-year notes | **AUCTION:**<br>$28 billion* 2-year FRNs<br>$62 billion* 7-year notes<br>**ANNOUNCE:**<br>$40 billion* 4-week bills for auction on April 29<br>$40 billion* 8-week bills for auction on April 29<br>**SETTLE:**<br>$40 billion* 4-week bills<br>$40 billion* 8-week bills | | **AUCTION:**<br>$40 billion* 4-week bills<br>$40 billion* 8-week bills<br>**ANNOUNCE:**<br>$111 billion* 13-,26-week bills for auction on May 3<br>**SETTLE:**<br>$111 billion* 13-,26-week bills | **SETTLE:**<br>$24 billion* 20-year bonds<br>$19 billion* 5-year TIPS<br>$28 billion* 2-year FRNs<br>$60 billion* 2-year notes<br>$61 billion* 5-year notes<br>$62 billion* 7-year notes |

*Estimate