Daiwa Capital Markets

U.S. Economic Comment

- Recent economic statistics: a muddled picture, but tilting on the positive side
- Support from commercial banks: helpful in promoting recovery

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The U.S. Economy in May

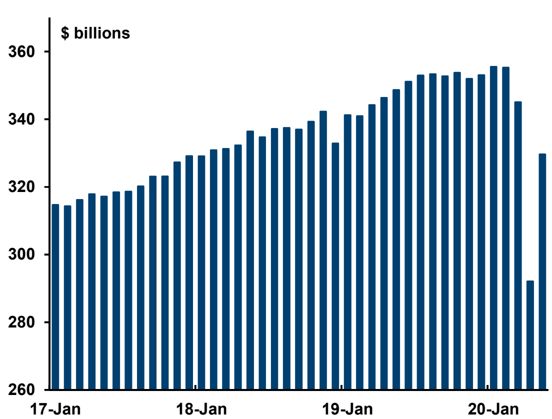
It seems reasonably safe to conclude that the U.S. economy bottomed in the spring, probably April, as the available statistics for May have generally shown improvement. However, wide variation in the data leaves the degree of improvement open to question. Some economic reports on the U.S. economy have been surprisingly robust, while others have increased modestly. The mixed results argue against a V-shaped recovery, but we would still look for a good bounce in Q3, as even the soft reports offered hints of firmer results in coming months.

A pronounced increase in payroll employment in May stirred thoughts of a quick recovery, and a vigorous advance in retail sales reinforced that view. Not only was the increase of 17.7 percent in retail activity impressive, but the breadth of the gain was striking as well, as all store categories posted sizeable gains. Many analysts focus on the so-called retail control, which is a set of store categories that correlate well with consumption figures that feed into the GDP report. This series rose 12.9 percent and retraced almost 60 percent of the ground lost in March and April (chart, left).

Other data published this week tilted on the soft side. The manufacturing component of industrial production, for example, rose 3.8 percent, a modest increase relative to the combined drop of 20 percent in March and April (chart, right). In addition, this advance was fueled by a jump of 120 percent in the auto industry, as assembly plants reopened after being largely closed during April. Excluding the auto sector, manufacturing production rose only 2.0 percent and regained only 11 percent of the deterioration in the prior two months.

While we were disappointed with the report on industrial production, we were mildly encouraged by the regional manufacturing indexes published by the Federal Reserve Banks of New York and Philadelphia. We typically do not give these measures much weight in assessing the economic environment because they often

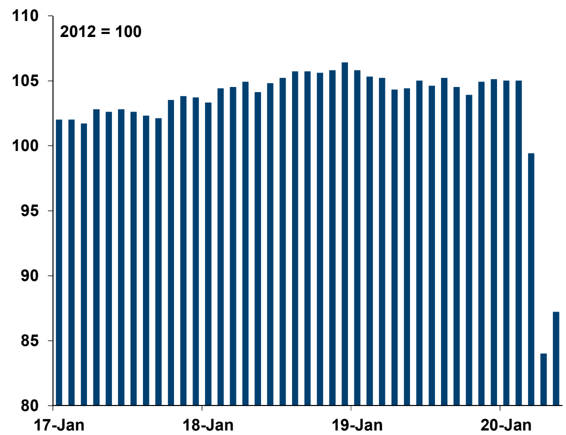
Retail Sales: Retail Control Group*



* The retail control group excludes sales at Motor Vehicle Dealers, Building Materials, Garden Equipment & Supply Dealers, and Gasoline Stations.

Source: U.S. Census Bureau via Haver Analytics

Industrial Production: Manufacturing



Source: Federal Reserve Board via Haver Analytics

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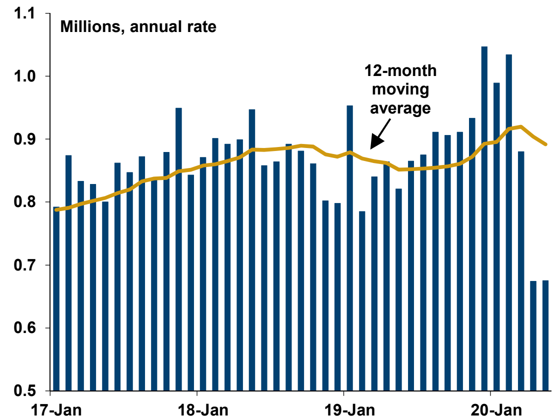
move erratically and don't correlate well with measures based on broader geographic areas. However, big moves sometimes have information value, and both jumped in June. The Empire index (NY) moved from -48.5 percent to -0.2 percent, while the Phily measure showed an even sharper change, jumping to +27.5 percent from -43.1 percent. (Both indexes can range from -100 to +100, with zero separating expansion and contraction.) The surges offer hope that production will be brisk in June.

Single-Family Housing Starts



Source: U.S. Census Bureau via Haver Analytics

We were distinctly surprised by housing starts in May, which rose 4.3 percent, well shy of the consensus estimate of a 23.5 percent gain. Moreover, the volatile multi-family sector accounted for most of the increase, and the gain of 15.0 percent might have contained an element of statistical noise rather than fundamental recovery; single-family starts were nearly unchanged (up 0.1 percent, chart).

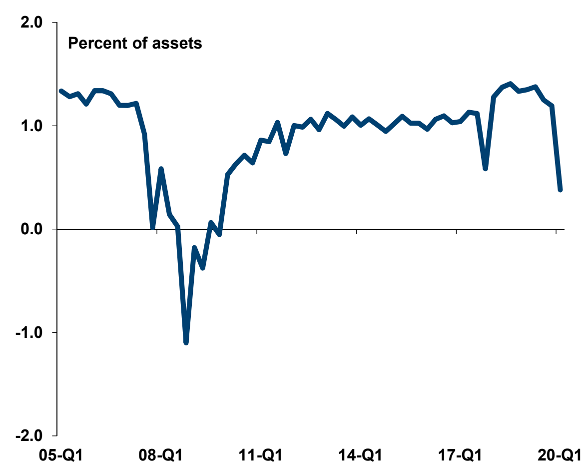
We suspect that results for housing starts in coming months will be notably better, as the May figures stand in contrast to noticeably firmer results for other housing-related indicators. Employment in the residential construction sector, for example, rose 226,000 in May and retraced one-half of the decline in the prior two months. Similarly, sentiment among construction companies brightened, as the index published by the National Association of Home Builders jumped 21 points to 58 percent (as in the ISM index, 50 percent separates expansion and contraction). Finally, building permits showed a solid gain in May (up 14.4 percent), opening the possibility of a brisk increase in June).

Perhaps the key lesson from the past few weeks is that we should not be surprised by surprising shifts in economic statistics. The unique economic setting is likely to lead to numerous deviations from normal patterns and relationships. Some reports will surprise on the upside while others will disappoint. Fortunately, the downside surprises in recent weeks have involved smaller-than-expected gains rather than additional retrenchment, and some offered hints of strong results in the months ahead. Thus, the dreadful second quarter will probably give way to a solid third quarter.

Support from Commercial Banks

The Federal Deposit Insurance Corporation (FDIC) this week released its quarterly banking report for Q1. The results were weak, as after-tax profits dropped to their lowest level since the early quarters of the latest expansion, when the industry was still struggling with fallout from the financial crisis. Measured as a share of average assets, as bank profits often are, returns in Q1 totaled 0.38 percent, down from an average of 1.29 percent in 2019 (chart).

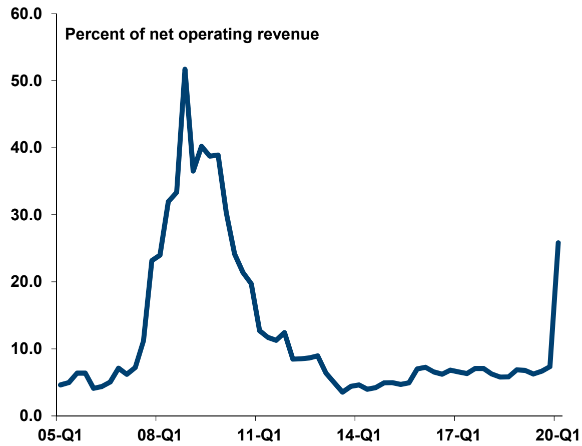
After-Tax Return on Assets



Source: Quarterly Banking Profile, Federal Deposit Insurance Corporation (FDIC)

Anyone closely associated with the banking industry no doubt viewed the results as disappointing, but from the perspective of the U.S. economy, there is a bright side: the soft profits indicate that a sizeable portion of the economic losses generated by the coronavirus will be absorbed by the banking industry, a financially strong sector that has the wherewithal to shoulder this burden. In effect, the banking industry is serving as a shock absorber.

Provisions for Loan Losses

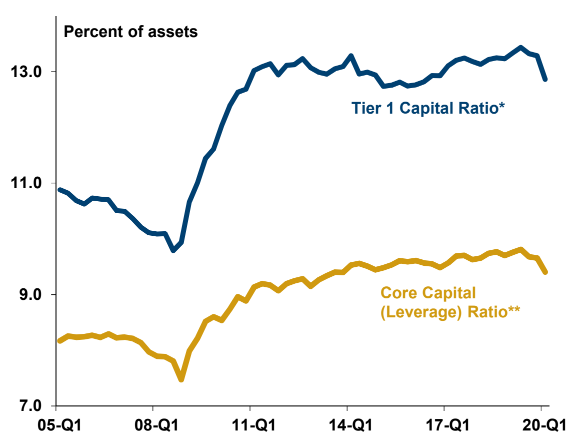


Source: Quarterly Banking Profile, Federal Deposit Insurance Corporation (FDIC)

A small portion of the weak earnings performance reflected a tightening in the net interest margin of banks and savings institutions, as the spread between interest income and expense tightened to 3.13 percentage points, down from an average of 3.36 percentage points last year. The majority of the deterioration was the result of a jump in provisions for loan losses, as FDIC-insured institutions braced for a wave of defaults generated by the pandemic. The dollar value of provisions for loan losses jumped 280 percent to $52.7 billion. Measured as a share of net operating revenue, provisions jumped to the highest level since the financial crisis (chart, above right).

While the hit to bank earnings in Q1 was sizeable, the damage to the fiscal health of the industry was not severe. Ratios of bank capital to assets eased because of soft earnings, but they remained close to the elevated readings seen in the past several years (chart, below left). Of course, Q1 might not be the end of the story. If the economy does not rebound quickly, loan defaults could exceed the totals assumed in first quarter earnings. The Federal Reserve later this month will release results from its stress tests, which could provide insights into the ability of banks to absorb additional losses. Whatever the stress tests might show, commercial banks are in a better position to shoulder losses than the individuals and businesses most affected by the coronavirus.

Capital Ratios of FDIC-Insured Institutions

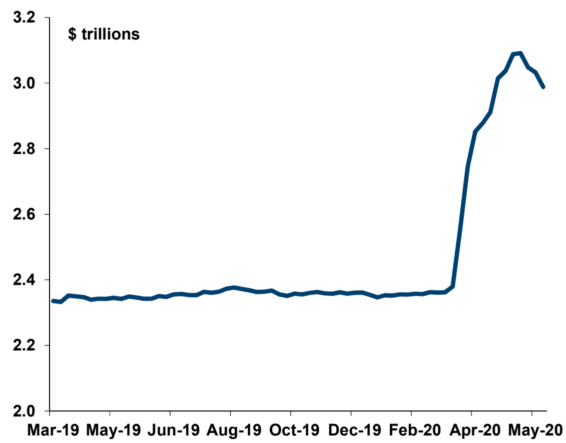


** Tier 1 capital as a share of risk-weighted assets. Tier 1 capital includes common equity plus noncumulative perpetual preferred stock plus minority interests in consolidated subsidiaries less goodwill and other ineligible intangible assets.*

*** Tier 1 capital as a share of average total assets minus ineligible intangibles.*

Source: Quarterly Banking Profile, Federal Deposit Insurance Corporation (FDIC)

Commercial & Industrial Loans



Source: Federal Reserve Board via Haver Analytics

Another figure involving commercial banks has shown another notable change indicating that the industry is playing a helpful role. Commercial and industrial loans (i.e. business loans) surged from mid-March to early May, posting annualized growth over this span of approximately 190 percent (chart; previous page, bottom right). The pickup was not necessarily voluntary, as most of the jump seemed to reflect businesses exercising lines of credit to ensure they would remain liquid in the uncertain environment; small businesses borrowing through the Paycheck Protection Program also played a role. Nevertheless, the jump in borrowing helped to maintain credit flows and provided some cushioning for the economy.

C&I loans have eased in recent weeks, but the dip is not necessarily troubling news for the economy. Some of the drop probably represents a shift of PPP loans from bank balance sheets to the Fed's credit facility. In addition, perhaps businesses did not need all the liquidity drawn from lines of credit, allowing them to repay portions of these loans.

Review

Week of June 15, 2020	Actual	Consensus	Comments
Retail Sales (May)	**17.7% Total, 12.4% Ex-Autos**	**8.4% Total, 5.5% Ex-Autos**	Retail sales surged in May, with the gain recouping 62% of the ground lost in the prior three months. Not only were sales strong, but the breadth of activity was impressive, as every major store category in the report posted an advance, with some moving close to their pre-virus ranges. Activity at building-supply stores moved substantially above its pre-virus range, and on-line sales remained red-hot, as nonstore retailers posted their third consecutive month of strong increases.
Industrial Production (May)	**1.4%**	**3.0%**	Despite a pickup, the industrial production report for May carried a soft tone. The increase of 3.8% in the manufacturing component trailed the expected gain of 5.0% and retraced only 15% of the ground lost in the prior two months. Mining activity fell 6.8% after a drop of 6.1% in April. Oil and natural gas extraction has been soft in response to low prices, but other areas in mining also have contracted. Utility output declined 2.3%, but the change reflected shifts in weather rather than economic fundamentals.
Housing Starts (May)	**0.974 Million (+4.3%)**	**1.100 Million (+23.5%)**	The increase in housing starts paled in comparison to the 23.5% gain expected by market analysts. Moreover, most of the advance occurred in the volatile multi-family sector and might have contained an element of statistical noise rather than fundamental recovery. Single-family starts barely moved (up 0.1%) and remained far below pre-virus norms.
Leading Indicators (May)	**2.8%**	**2.4%**	The index of leading economic indicators posted a solid increase in May, but the advance retraced only a portion of the virus-related swoon in March and April and left the index 10.9% below the cyclical high in January. A decline in initial claims for unemployment insurance made the largest positive contribution, with increases in the manufacturing workweek, building permits, and stock prices also contributing positively.
Current Account (20-Q1)	**-$104.2 Billion ($0.1 Billion Narrower Deficit)**	**-$102.9 Billion ($6.9 Billion Narrower Deficit)**	The trade deficit in Q1 improved by approximately $10 billion, but this shift was largely offset by slippage in income flows, which left the current account deficit little changed from the shortfall in the prior quarter. The deficit in Q4, though, was revised lower, now totaling $104.3 billion rather than $109.8 billion. The latest readings on the deficit are narrower than those in much of 2018 and 2019 (average of $126.7 from 2018-Q3 to 2019-Q3) but within the range seen from 2010 to early 2018.

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

Preview

Week of June 22, 2020	Projected	Comments
Existing Home Sales (May) (Monday)	**4.40 Million (+1.6%)**	An easing in lockdown restrictions could give a lift to housing activity, but soft results for pending home sales offer little hope for a big move.
New Home Sales (May) (Tuesday)	**0.640 Million (+2.7%)**	While activity in the market for existing homes does not appear to have surged, a pickup in mortgage applications suggests that sales of new homes could add to surprising gains in April.
Revised GDP (20-Q1) (Thursday)	**-5.0% (Unrevised)**	Firmer construction activity (both residential and business-related) should about offset lighter than previously believed inventory investment, leaving minimal revision to Q1 real GDP.
Durable Goods Orders (May) (Thursday)	**12.0%**	Although production grew only modestly in May, a jump in employment suggests that manufacturing activity is beginning to revive, which should involve a stirring in new orders. The reopening of the auto industry should be especially helpful, and the aircraft sector could do better than the net cancellations registered in March and April.
U.S. International Trade in Goods (May) (Thursday)	**-$68.0 Billion ($2.7 Billion Narrower Deficit)**	With economies around the world showing hints of improvement, trade flows should pickup after weak results in April. Exports seem to have more upside potential than imports, which should lead to a narrower deficit.
Personal Income, Consumption, Core Price Index (May) (Friday)	**-10.0%, 7.0%, 0.0%**	Strong employment growth in May should lead to a jump in wages and salaries, but a drop in transfer payments will provide a sizeable offset (unemployment benefits rose, but a dwindling of recovery rebate checks dominated). Rental income and investment income also are likely to be soft. On the spending side, a pickup in sales of new vehicles and strong retail activity should lead to a sharp gain. Soft demand in areas affected by the coronavirus will probably lead to modest price changes on average.
Revised Consumer Sentiment (June) (Friday)	**78.9 (Unrevised)**	While magnitudes of change in have varied greatly, most recent economic reports have had a positive tilt. Thus, the revised reading on consumer sentiment should be able to maintain the increase of 9.1% in the preliminary estimate for June.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June/July 2020

Monday	Tuesday	Wednesday	Thursday	Friday
15	16	17	18	19
	NFIB SMALL BUSINESS OPTIMISM INDEX Mar 96.4 Apr 90.9 May 94.4 **JOLTS DATA** Openings (000) Quit Rate Feb 7,004 2.3% Mar 6,011 1.8% Apr 5,046 1.4% **WHOLESALE TRADE** Inventories Sales Feb -0.7% -0.7% Mar -1.1% -5.1% Apr 0.3% -16.9% **FOMC MEETING**	**CPI** Total Core Mar -0.4% -0.1% Apr -0.8% -0.4% May -0.1% -0.1% **FEDERAL BUDGET** 2020 2019 Mar -$119.0B -$146.9B Apr -$738.0B $160.3B May -$398.8B -$207.8B **FOMC DECISION**	**UNEMPLOYMENT CLAIMS** Initial Continuing (Millions) May 16 2.446 20.841 May 23 2.123 21.268 May 30 1.897 20.929 June 06 1.542 N/A **PPI** Final Demand Core* Mar -0.2% -0.2% Apr -1.3% -0.9% May 0.4% 0.1%	**IMPORT/EXPORT PRICES** Non-fuel Imports Nonagri. Exports Mar 0.0% -1.4% Apr -0.5% -3.3% May 0.1% 0.6% **CONSUMER SENTIMENT** Apr 71.8 May 72.3 June 78.9
22	23	24	25	26
CHICAGO FED NATIONAL ACTIVITY INDEX (8:30) Monthly 3-Mo. Avg. Mar -4.97 -1.69 Apr -16.74 -7.22 May -- -- **EXISTING HOME SALES (10:00)** Mar 5.27 million Apr 4.33 million **May 4.40 million**	**NEW HOME SALES (10:00)** Mar 0.619 million Apr 0.623 million **May 0.640 million**	**FHFA HOME PRICE INDEX (9:00)** Feb 0.8% Mar 0.1% Apr --	**INITIAL CLAIMS (8:30)** **REVISED GDP (8:30)** GDP Chained Price 19-Q4 2.1% 1.3% 20-Q1(p) -5.0% 1.4% **20-Q1(r) -5.0% 1.4%** **DURABLE GOODS ORDERS (8:30)** Mar -16.7% Apr -17.7% **May 12.0%** **U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Mar -$64.9 billion Apr -$70.7 billion **May -$68.0 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale Retail Mar -1.1% 1.1% Apr 0.3% -3.7% May -- --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. Cons. Core Mar -2.2% -6.9% -0.1% Apr 10.5% -13.6% -0.4% **May -10.0% 7.0% 0.0%** **REVISED CONSUMER SENTIMENT (10:00)** Apr 71.8 May 72.3 June(p) 78.9
29	30	1	2	3
PENDING HOME SALES	**S&P CORELOGIC CASE-SHILLER HOME PRICE INDEX** **CHICAGO PURCHASING MANAGERS' INDEX** **CONSUMER CONFIDENCE**	**ADP EMPLOYMENT REPORT** **ISM MFG. INDEX** **CONSTRUCTION SPEND.** **FOMC MINUTES** **VEHICLE SALES**	**INITIAL CLAIMS** **EMPLOYMENT REPORT** **TRADE BALANCE** **FACTORY ORDERS**	***INDEPENDENCE DAY (OBSERVED)***
6	7	8	9	10
ISM NON-MFG INDEX	**JOB OPENINGS & LABOR TURNOVER SURVEY**	**CONSUMER CREDIT**	**INITIAL CLAIMS** **WHOLESALE TRADE**	**PPI**

Forecasts in Bold. (p) = preliminary (2nd estimate of GDP); (r) = revised (3rd estimate of GDP)

Treasury Financing

June/July 2020

Monday	Tuesday	Wednesday	Thursday	Friday
15	16	17	18	19
AUCTION RESULTS: Rate / Cover 13-week bills 0.175% 2.96 26-week bills 0.185% 2.93 **SETTLE:** $44 billion 3-year notes $29 billion 10-year notes $19 billion 30-year bonds	**AUCTION RESULTS:** Rate / Cover 42-day CMB 0.150% 2.82 119-day CMB 0.180% 3.37 52-week bills 0.200% 2.91 **ANNOUNCE:** $60 billion 4-week bills for auction on June 18 $55 billion 8-week bills for auction on June 18 $35 billion 105-day CMBs for auction on June 17 $40 billion 154-day CMBs for auction on June 17 **SETTLE:** $70 billion 4-week bills $60 billion 8-week bills $35 billion 105-day CMBs $40 billion 154-day CMBs	**AUCTION RESULTS:** Rate / Cover 105-day CMB 0.170% 3.25 154-day CMB 0.185% 3.22 20-yr bonds 1.314% 2.63	**AUCTION RESULTS:** Rate / Cover 4-week bills 0.125% 2.89 8-week bills 0.135% 2.92 5-year TIPS -0.766% 2.78 **ANNOUNCE:** $111 billion 13-,26-week bills for auction on June 22 $40 billion 42-day CMBs for auction on June 23 $40 billion 119-day CMBs for auction on June 23 $20 billion 273-day CMBs for auction on June 23 $20 billion 2-year FRNs for auction on June 24 $46 billion 2-year notes for auction on June 23 $47 billion 5-year notes for auction on June 24 $41 billion 7-year notes for auction on June 25 **SETTLE:** $114 billion 13-,26-week bills $34 billion 52-week bills $50 billion 42-day CMBs $40 billion 119-day CMBs	
22	23	24	25	26
AUCTION: $111 billion 13-,26-week bills	**AUCTION:** $40 billion 42-day CMBs $40 billion 119-day CMBs $20 billion 273-day CMBs $46 billion 2-year notes **ANNOUNCE:** $60 billion* 4-week bills for auction on June 25 $55 billion* 8-week bills for auction on June 25 **SETTLE:** $60 billion 4-week bills $55 billion 8-week bills $35 billion 105-day CMBs $40 billion 154-day CMBs	**AUCTION:** $20 billion 2-year FRNs $47 billion 5-year notes	**AUCTION:** $60 billion* 4-week bills $55 billion* 8-week bills $41 billion 7-year notes **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on June 29 **SETTLE:** $111 billion 13-,26-week bills $40 billion 42-day CMBs $40 billion 119-day CMBs $20 billion 273-day CMBs	**SETTLE:** $20 billion 2-year FRNs
29	30	1	2	3
AUCTION: $111 billion* 13-,26-week bills	**ANNOUNCE:** $60 billion* 4-week bills for auction on July 2 $55 billion* 8-week bills for auction on July 2 **SETTLE:** $60 billion* 4-week bills $55 billion* 8-week bills $17 billion 20-year bonds $15 billion 5-year TIPS $46 billion 2-year notes $47 billion 5-year notes $41 billion 7-year notes		**AUCTION:** $60 billion* 4-week bills $55 billion* 8-week bills **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on July 6 $46 billion* 3-year notes for auction on July 7 $29 billion* 10-year notes for auction on July 8 $19 billion* 30-year bonds for auction on July 9 **SETTLE:** $111 billion* 13-,26-week bills	***INDEPENDENCE DAY (OBSERVED)***
6	7	8	9	10
AUCTION: $111 billion* 13-,26-week bills	**AUCTION:** $46 billion* 3-year notes **ANNOUNCE:** $60 billion* 4-week bills for auction on July 9 $55 billion* 8-week bills for auction on July 9 **SETTLE:** $60 billion* 4-week bills $55 billion* 8-week bills	**AUCTION:** $29 billion* 10-year notes	**AUCTION:** $60 billion* 4-week bills $55 billion* 8-week bills $19 billion* 30-year bonds **ANNOUNCE:** $111 billion* 13-,26-week bills for auction on July 13 $34 billion* 52-week bills for auction on July 14 **SETTLE:** $111 billion* 13-,26-week bills	

**Estimate*