Daiwa Capital Markets

U.S. Economic Comment

- U.S. economy: coming into clearer focus

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

The U.S. Economy in Q2: A Tad Less Dreadful Than Previously Thought

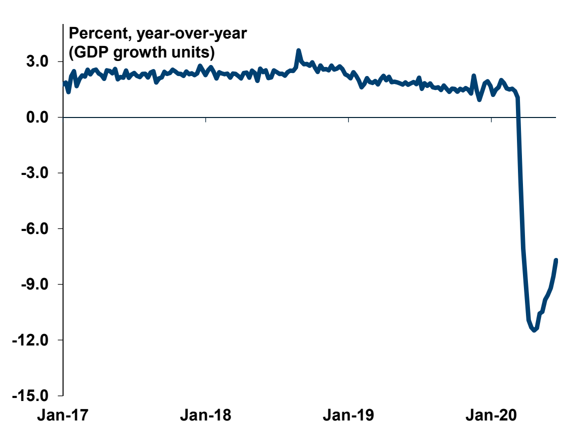
The economic data for April suggested a marked decline U.S. GDP in the second quarter, with many estimates showing a contraction in the neighborhood of 40 percent (annual rate). However, most economic reports picked up in May, and thus prospects for Q2 now seem less dire.

The improvement is evident in a monitoring tool constructed by the Federal Reserve Bank of New York, which suggested in late April that GDP in the latest four quarters was on track to contract 11.5 percent. With growth slightly negative from 2019-Q3 through 2020-Q1 (2.1 percent in the second half of last year and -5.0 percent in the first quarter of this year), that estimate implied a contraction of approximately 45 percent in Q2. That same gauge is now showing a four-quarter contraction of 7.7 percent, a tally that implies a drop of approximately 30 percent in the second quarter -- still terrible, but better than -45 percent (chart, left).

Another report released this week also suggested a marked turn during May. The National Activity Index published by the Federal Reserve Bank of Chicago can be viewed as a coincident indicator of economic activity. Unlike other gauges that have set ranges and logical interpretations (think ISM, with a range of 0 to 100 and 50 as the neutral point between expansion and contraction), the Chicago index has no fixed range and no definitive threshold indicating expansion or contraction. Rather, it is designed to have a value of zero when the economy is growing at its potential rate. Less than zero suggests growth slower than potential, with an outright decline in the economy probably occurring somewhere in the range of -0.7 to -1.0.

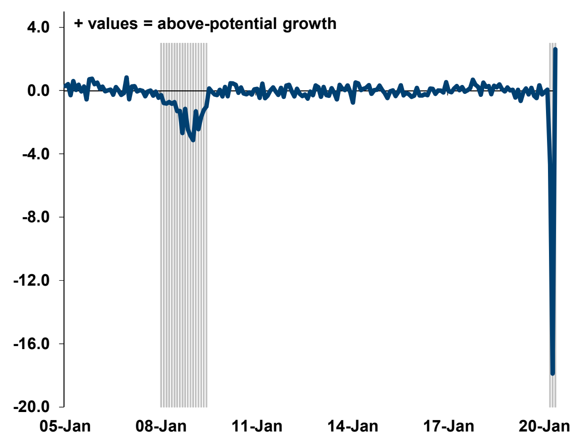
The Chicago index for April posted a shocking value of -17.89, far worse than the lows seen during prior recessions (-3.46 in 1974 and -3.13 during the financial crisis). The index, however, surged to 2.61 in May, the highest reading on record (chart, right). Analysts at the Chicago Fed suggest using a three-month moving average to smooth monthly swings. This metric had a value of -7.50 in April before inching up to -6.65 in May. Like the New York index, the three-month average of the Chicago measure is signaling a pronounced decline in Q2, but not as bad as suspected in April.

Weekly Economic Index



Source: Federal Reserve Bank of New York via Haver Analytics

National Activity Index*



** The shaded areas indicate periods of recession in the United States.*

Source: Federal Reserve Bank of Chicago and National Bureau of Economic Research via Haver Analytics

Sources of Weakness

Some of the economic reports published this week brought the second quarter into clearer focus. That is, they provided insights into which components of GDP were pushing the economy lower in Q2, and they provided clues into which sectors might lead the economy back onto a growth track in the third quarter.

Real consumer spending posted a record advance in May, but the gain of 8.1 percent represented only a partial offset to marked declines in the prior two months, leaving dim prospects for the second quarter. Even if spending in June were to match the jump in May, real outlays in Q2 would decline at an annual rate of approximately 32 percent, which would restrain GDP growth by more than 20 percentage points.

While consumer spending in Q2 will be dreadful, the outlook is not necessarily negative. The weakness in March and April was driven by stay-at-home restrictions rather than the lack of financial wherewithal. Interestingly, the income side of the GDP statistics (that is, a tally of the various types of income earned in the production process) showed that compensation of employees rose fractionally in the first quarter despite the drop of 5.0 percent in total output. The softness in Q1 was channeled to corporations in the form of lower profits (off 41 percent at an annual rate) rather than to individuals in the form of lower compensation.

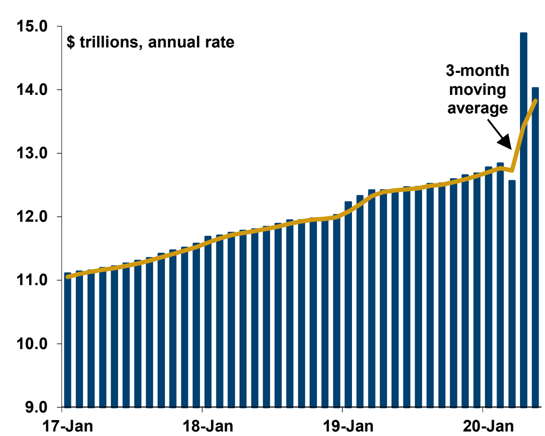
Consumers also were reasonably well insulated through the first two months of the second quarter. While wages and salaries have softened on balance, so-called transfer payments have thus far provided an offset. (Transfer payments are expenditures of the federal government for which no services are received in return. The most common forms of transfers are Social Security, Medicare and Medicaid, veterans' benefits, and unemployment benefits. The enhanced unemployment benefits and the recovery rebates approved by the CARES Act were the drivers behind the surge in transfer payments in April. Unemployment benefits remained elevated in May, but the aggregate value of rebate checks eased noticeably. Total transfer payments in May were still hefty, but less so than in April.)

The sum of wage income and transfer payments can provide insights into the spending power of individuals, and this gauge surged in April and remained elevated in May (chart, below). Results in the past two months indicate that the household sector in the aggregate was better off financially than it was before the outbreak of the virus.

Another element of the income and consumption report supported the view of a financially sound household sector. Specifically, rental income continued to grow over the past few months. The average advance of 0.1 percent in April and May trailed the 0.3 percent average registered last year, but it was in the plus column nonetheless. Many observers had expressed concern about individuals defaulting on rental payments while unemployed, but this does not appear to be a serious problem thus far.

If large segments of the economy were to reopen in the weeks ahead, the combination of pent-up demand and elevated income would most likely lead to a burst in consumer spending in the third quarter. Unfortunately, the pickup in the spread of the virus in the past few weeks suggests that reopening must proceed cautiously. Thus, there are downside risks. Still, we expect lockdowns to ease and for individuals to continue returning to work. Odds favor an advance in consumer spending in the third quarter.

Personal Income*



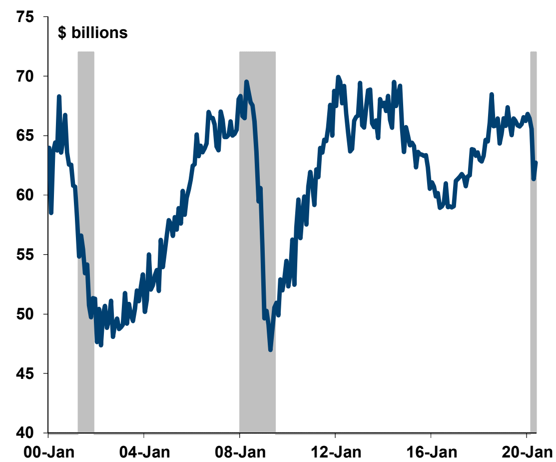
** The sum of the wages and salaries and personal current transfer receipts.*
Source: Bureau of Economic Analysis via Haver Analytics

Other Sectors

While consumer spending will account for most of the drop in Q2 GDP, this component will have plenty of company. Weak shipments of capital goods by domestic producers, along with a sharp decline in imports of equipment, suggest that business investment spending will decline sharply, probably by more than 30 percent.

Beyond Q2, uncertainty associated with the virus will act as a cloud over business investment, as will other issues, such as the presidential and congressional elections and trade wars. But again, pessimism is not necessarily warranted. We have been mildly encouraged by new orders for capital goods other than commercial aircraft. This measure softened in the spring, but it declined by less than many other economic indicators, and it rose 2.3 percent in May. It is still within the range of observations seen during the current expansion and well above levels seen in prior recessions (chart).

New Orders for Durable Goods*



** New bookings for nondefense capital goods excluding aircraft. The shaded areas indicate periods of recession in the United States.*

Source: U.S. Census Bureau and National Bureau of Economic Research via Haver Analytics

Inventory investment is likely to be quite weak in the second quarter, as the latest report on wholesale and retail inventories showed a record monthly decline in May after a sharp retreat in April. Figures in hand suggest that inventory investment will subtract more than 1.5 percentage points from GDP growth in the second quarter. After a cumulative drag of 3.5 percentage points in the prior four quarters, inventories are undoubtedly lean and rebuilding could provide a spark.

Construction activity might seem to be less sensitive to the virus than other sectors of the economy, but residential building will most likely be in the loss column in Q2. Housing starts softened in March before tumbling in April, and the pickup in May was feeble (single-family starts rose only 0.1 percent). However, sales of new homes have been firm in recent months, and sentiment among home builders has improved. Thus, after a likely drop in the second quarter, residential construction will probably improve in the summer months.

The international trade sector has been hit hard by the pandemic, as both exports and imports declined sharply in April and lost further ground in May. The retreat in exports has been sharper, and thus net exports seem on track to subtract two percentage points from GDP growth. The outlook in this sector is uncertain because it is not clear what developments might unfold in the trade wars. For this sector, we are tilting on the negative side. We suspect that U.S. growth will be firmer than that in most other nations, and thus imports are likely to outperform exports, leaving a drag on growth.

The unique situation in the U.S. (and global) economy leaves a great deal of uncertainty regarding the magnitudes of changes suggested above, but assuming the virus does not run wild, we would look for growth in the neighborhood of five percent in the third quarter and probably faster in the fourth.

Review

Week of June 22, 2020	Actual	Consensus	Comments
Existing Home Sales (May)	**3.91 Million (-9.7%)**	**4.09 Million (-5.6%)**	The drop in existing home sales in May marked the third consecutive decline and moved the activity to the low portion of the historical range. While recent results signaled notable weakness, some reason for optimism exists. Sales of existing homes are based on closed transactions rather than signed contracts. Closings in May would have been based on contracts signed in March and April, the period when lockdowns were widespread. Sales should pickup in coming months in response to the easing in restrictions.
New Home Sales (May)	**0.676 Million (+16.6%)**	**0.640 Million (+2.7%)**	The jump in new home sales in May occurred from downward revised levels in prior months (total sales in the past three months combined were 2.6% lower than previously believed), but the level of activity in May was still surprisingly firm. Sales in May were shy of the best readings of the past year and a bit below the average of 685,000 for 2019, but considering the virus-related constraints and uncertainties, the performance was quite good.
Revised GDP (20-Q1)	**-5.0% (Unrevised)**	**-5.0% (Unrevised)**	The contraction in real GDP in the first quarter was unrevised, but shifts among components occurred with the final publication. Business investment in new structures was stronger than previously believed (+2.6% rather than -3.9%), and government spending was a bit firmer as well. However, these improvements were offset by downward adjustments to inventory investment and residential construction.
Durable Goods Orders (May)	**15.8%**	**10.5%**	The increase in durable goods orders in May recouped approximately one-third of the pronounced slippage in the prior two months. Much of the improvement occurred in the transportation category, which posted growth of 80.7%, and like the headline figure, retraced one-third of the drop in the prior two months. Excluding the transportation category, new orders rose 4.0%, offsetting slightly more than 36% of the slide in March and April. New orders for nondefense capital goods ex-aircraft, a series that provides good insight into capital spending plans by businesses, rose 2.3% and offset approximately one-quarter of the slippage since January.
U.S. International Trade in Goods (May)	**-$74.3 Billion ($3.6 Billion Wider Deficit)**	**-$68.2 Billion ($2.5 Billion Narrower Deficit)**	The U.S. trade deficit widened noticeably for the second consecutive month, as both exports and imports continued to sink because of a slow global economic environment. Exports fell 5.8% in May after a plunge of 25.1% in April; imports slipped 1.2% after a decline of 13.6% in the prior month. The results for April and May left the deficit thus far in Q2 considerably wider than the average in Q1, setting the stage for a marked negative contribution of two percentage points to GDP growth in the second quarter.

Review Continued

Week of June 22, 2020	Actual	Consensus	Comments
Personal Income, Consumption, Core Price Index (May)	**-4.2%, 8.2%, 0.1%**	**-6.0%, 9.3%, 0.0%**	The drop in personal income in May was largely driven by government transfer payments, which fell from an elevated level in April associated with enhanced unemployment benefits and the issuance of recovery rebate payments. Unemployment benefits registered another sharp gain in May, but the aggregate value of rebate checks fell noticeably. Other income categories showed mixed results: wages and proprietors' income rose, while investment income fell. Spending rose sharply in May, but the jump occurred from a low level after the sharp declines in the prior two months, and outlays remained on track for a sharp contraction in Q2. The core PCE price index increased modestly after declines of 0.4% in April and 0.1% in March, which left the year-over-year advance unchanged at 1.0%.
Revised Consumer Sentiment (June)	**78.1 (-0.8 Index Pt. Revision)**	**79.2 (+0.3 Index Pt. Revision)**	Consumer sentiment was revised 1.0% lower in late June, likely reflecting the faster spread of the coronavirus in parts of the country after cases had slowed substantially in the Northeast. The final tally remained notably below the average of 96.0 in 2019, although it still far exceeded the low of 55.3 during the financial crisis.

Sources National Association of Realtors (Existing Home Sales); 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); University of Michigan Survey Research Center (Revised Consumer Sentiment); Consensus forecasts are from Bloomberg

Preview

Week of June 29, 2020	Projected	Comments
Conference Board Consumer Confidence (June) (Tuesday)	**88.0 (+1.4 Index Pts.)**	An easing in lockdown restrictions probably generated upbeat responses from individuals in the early part of June, but the pickup in the number of new Covid cases probably led to less favorable responses in the latter part of the month, leaving a small net increase in confidence.
ISM Manufacturing Index (June) (Wednesday)	**48.0 (+4.9 Pct. Pts.)**	A jump in factory employment and a firming in order flows for durable goods suggests some recovery in the manufacturing sector, a view supported by jumps in regional indexes published by Federal Reserve Banks. Although the index is likely to increase for the second consecutive month, still-cautious policies of manufacturers could keep the measure below the neutral level of 50%.
Construction Spending (May) (Wednesday)	**-2.0%**	Soft results for housing starts in March and April suggest that residential building will decline, and tight budgets because of the coronavirus probably forced state and local governments to trim construction activity. Business-related construction is probably not especially sensitive to the virus, but underlying trends have been soft.
Payroll Employment (June) (Thursday)	**2,500,000**	With essentially all key economic indicators showing improvement in May, businesses probably continued to recall workers or hire additional individuals in June. The recall of workers in service industries earning below-average wages could lead to a drop in average hourly earnings. The increase in employment will probably push the unemployment rate lower, but a reduction in the misreporting of employment status (fewer classified as employed but not at work and properly classified as on temporary layoff) could limit the size of the drop.
Trade Balance (May) (Thursday)	**-$53.0 Billion ($3.6 Billion Wider Deficit)**	The already reported widening of $3.6 billion in the goods trade deficit accounts for most of the expected slippage in the total trade imbalance, but a third consecutive narrowing in the service surplus could add to the shortfall as well.
Factory Orders (May) (Thursday)	**11.0%**	The already reported jump of 15.8% in bookings for durable goods is likely to account for most of the increase in total factory orders. Nondurable goods also are likely to contribute. The petroleum component could surge, reflecting both higher prices and more energy usage as the economy reopens. The improvement in economic activity in May also should lift orders for nondurable goods ex-petroleum.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

June/July 2020

Monday	Tuesday	Wednesday	Thursday	Friday
22	23	24	25	26
CHICAGO FED NATIONAL ACTIVITY INDEX Monthly 3-Mo. Avg. Mar -4.67 -1.57 Apr -17.89 -7.50 May 2.61 -6.65 **EXISTING HOME SALES** Mar 5.27 million Apr 4.33 million May 3.91 million	**NEW HOME SALES** Mar 0.612 million Apr 0.580 million May 0.676 million	**FHFA HOME PRICE INDEX** Feb 0.9% Mar 0.1% Apr 0.2%	**UNEMPLOYMENT CLAIMS** Initial Continuing (Millions) May 30 1.897 20.606 June 06 1.566 20.289 June 13 1.540 19.522 June 20 1.480 N/A **REVISED GDP** 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** Mar -16.7% Apr -18.1% May 15.8% **U.S. INTERNATIONAL TRADE IN GOODS** Mar -$64.9 billion Apr -$70.7 billion May -$74.3 billion **ADVANCE INVENTORIES REPORT** Wholesale Retail Mar -1.1% 1.1% Apr 0.2% -3.8% May -1.2% -6.1%	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX** Inc. Cons. Core Mar -2.2% -6.6% -0.1% Apr 10.8% -12.6% -0.4% May -4.2% 8.2% 0.1% **REVISED CONSUMER SENTIMENT** Apr 71.8 May 72.3 June 78.1
29	30	1	2	3
PENDING HOMES SALES (10:00) Mar -20.8% Apr -21.8% May --	**S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA NSA Feb 0.5% 0.5% Mar 0.5% 1.1% Apr -- -- **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index Prices Apr 35.4 48.4 May 32.3 53.8 **June 40.0 50.0** **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Apr 85.7 May 86.6 **June 88.0**	**ADP EMPLOYMENT REPORT (8:15)** Private Payrolls Apr -19,557,000 May -2,760,000 June -- **ISM INDEX (10:00)** Index Prices Apr 41.5 35.3 May 43.1 40.8 **June 48.0 45.0** **CONSTRUCTION SPEND. (10:00)** Mar 0.0% Apr -2.9% **May -2.0%** **FOMC MINUTES (2:00)** **VEHICLE SALES** Apr 8.7 million May 12.2 million **June 13.0 million**	**INITIAL CLAIMS (8:30)** **EMPLOYMENT REPORT (8:30)** Payrolls Un. Rate Apr -20,687,000 14.7% May 2,509,000 13.3% **June 2,500,000 12.5%** **TRADE BALANCE (8:30)** Mar -$42.3 billion Apr -$49.4 billion **May -$53.0 billion** **FACTORY ORDERS (10:00)** Mar -11.0% Apr -13.2% **May 11.0%**	***INDEPENDENCE DAY (OBSERVED)***
6	7	8	9	10
ISM NON-MFG INDEX	**JOB OPENINGS & LABOR TURNOVER SURVEY**	**CONSUMER CREDIT**	**INITIAL CLAIMS** **WHOLESALE TRADE**	**PPI**
13	14	15	16	17
FEDERAL BUDGET	**NFIB SMALL BUSINESS OPTIMISM INDEX** **CPI**	**IMPORT/EXPORT PRICES** **EMPIRE MFG INDEX** **IP & CAP-U** **BEIGE BOOK**	**INITIAL CLAIMS** **RETAIL SALES** **PHILLY FED INDEX** **BUSINESS INVENTORIES** **NAHB HOUSING INDEX** **TIC DATA**	**HOUSING STARTS** **CONSUMER SENTIMENT**

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
22	23	24	25	26
AUCTION RESULTS: Rate Cover 13-week bills 0.155% 2.69 26-week bills 0.175% 2.94	**AUCTION RESULTS:** Rate Cover 42-day CMB 0.125% 3.20 119-day CMB 0.155% 3.33 273-day CMB 0.180% 3.53 2-year notes 0.193% 2.46 **ANNOUNCE:** $50 billion 4-week bills for auction on June 25 $50 billion 8-week bills for auction on June 25 $30 billion 105-day CMBs for auction on June 24 $35 billion 154-day CMBs for auction on June 24 **SETTLE:** $60 billion 4-week bills $55 billion 8-week bills $35 billion 105-day CMBs $40 billion 154-day CMBs	**AUCTION RESULTS:** Margin Cover 2-year FRN 0.080% 3.16 Rate Cover 105-day CMB 0.150% 3.35 154-day CMB 0.165% 3.22 5-year notes 0.330% 2.58	**AUCTION RESULTS:** Rate Cover 4-week bills 0.110% 3.07 8-week bills 0.140% 2.72 7-year notes 0.511% 2.49 **ANNOUNCE:** $105 billion 13-,26-week bills for auction on June 29 $35 billion 42-day CMBs for auction on June 30 $35 billion 119-day CMBs for auction on June 30 **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: $105 billion 13-,26-week bills	**AUCTION:** $35 billion 42-day CMBs $35 billion 119-day CMBs **ANNOUNCE:** $50 billion* 4-week bills for auction on July 2 $50 billion* 8-week bills for auction on July 2 **SETTLE:** $50 billion 4-week bills $50 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 $30 billion 105-day CMBs $35 billion 154-day CMBs		**AUCTION:** $50 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $105 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:** $105 billion 13-,26-week bills $35 billion 42-day CMBs $35 billion 119-day CMBs	***INDEPENDENCE DAY (OBSERVED)***
6	7	8	9	10
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $46 billion* 3-year notes **ANNOUNCE:** $50 billion* 4-week bills for auction on July 9 $50 billion* 8-week bills for auction on July 9 **SETTLE:** $50 billion* 4-week bills $50 billion* 8-week bills	**AUCTION:** $29 billion* 10-year notes	**AUCTION:** $50 billion* 4-week bills $50 billion* 8-week bills $19 billion* 30-year bonds **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on July 13 $34 billion* 52-week bills for auction on July 14 **SETTLE:** $105 billion* 13-,26-week bills	
13	14	15	16	17
AUCTION: $105 billion* 13-,26-week bills	**AUCTION:** $34 billion* 52-week bills **ANNOUNCE:** $50 billion* 4-week bills for auction on July 16 $50 billion* 8-week bills for auction on July 16 **SETTLE:** $50 billion* 4-week bills $50 billion* 8-week bills	**SETTLE:** $46 billion* 3-year notes $29 billion* 10-year notes $19 billion* 30-year bonds	**AUCTION:** $50 billion* 4-week bills $50 billion* 8-week bills **ANNOUNCE:** $105 billion* 13-,26-week bills for auction on July 20 $17 billion* 20-year bonds for auction on July 22 $14 billion* 10-year TIPS for auction on July 23 **SETTLE:** $105 billion* 13-,26-week bills $34 billion* 52-week bills	

**Estimate*