Financial Market Weekly

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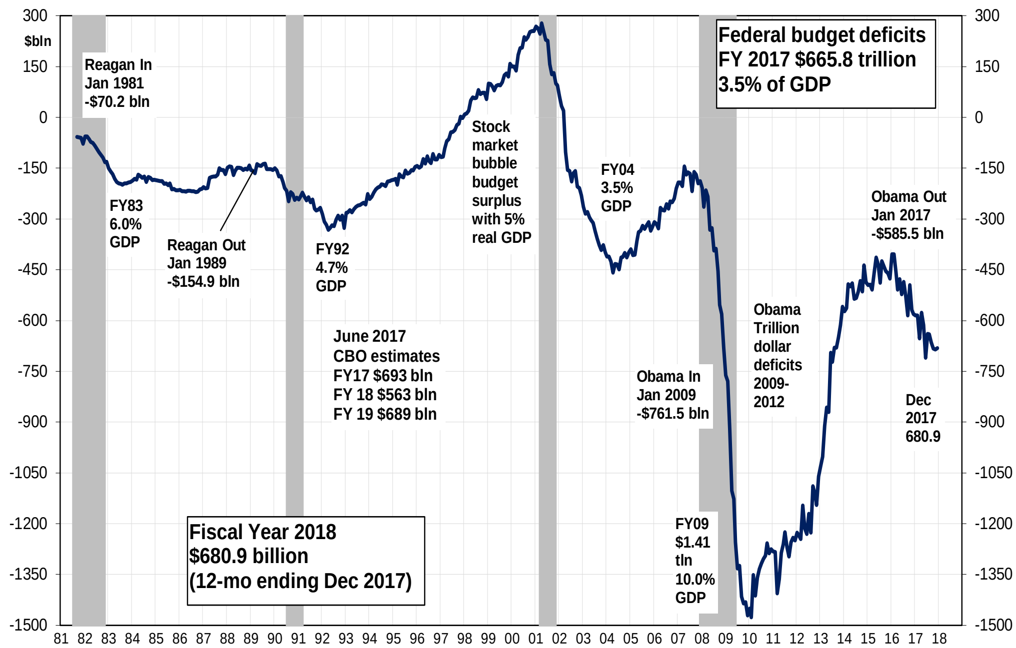
Q4 2017 FEDERAL BUDGET DEFICIT RESULTS

The first quarter of the Fiscal Year 2018 Federal budget is complete with Thursday's release of the December Monthly Treasury Statement. It's hard to get an exact read on where the budget deficit is going this year and next because the The Tax Cuts and Jobs Act hasn't hit the fan yet. This isn't your normal tax cut because of the radical changes made to both the individual and corporate tax code, where big changes mean it could be harder than normal to estimate tax collections in future years.

At the moment, on a 12-month sum basis, the Federal budget deficit is running $680.9 billion, but it looks like we will soon see a return of the Obama trillion dollar deficits from 2009 through 2012 that were meant to get the economy out of the recession rut. The Tax Cuts and Jobs Act is meant to do four things (pick all that apply): increase growth, create jobs, improve worker wages, and finally, if nothing else, the tax act will return the money back to the hard working American people.



In fiscal year 2018 ending in September, the deficit will swing out an extra $135.7 billion due to the tax act, then move above $200 billion for a few years according to Joint Committee on Taxation (JCT) estimates from the Congressional Budget Office (CBO) website. Specifically, the deficit widens $280 billion in 2019, $258 billion in 2020, and $221 billion in 2021, which should help our 3% Treasury bond yield forecast with more Treasury auctions on the way.

We are focusing on the revenue changes in the tax act over the next handful of years because the long-run numbers never seem to materialize according to the forecasts. But if you are worried about the National Debt, the ten-year changes from individual tax changes are $1.329 trillion, $644.1 billion for businesses, and International tax changes add back $324.4 billion… the grand total tax cuts changes over ten years is $1.649 trillion.

$1.649 trillion. Sounds like a big number that adds to America's National Debt. Relax. All is well. The tax act cuts spending too, by $194.1 billion over ten years, which brings the whole enchilada back down to $1.455 trillion. If you are still worried, don't be, they twisted some arms and made the JCT do some estimates of how much "speedier economic growth" would reduce the "$1.5 trillion" tax reform/stimulus price tag. Don't try this at home, but the JCT did some modeling and estimated the macroeconomic effects from the stimulus would bring in 384 billion over ten years. See there, the ultimate price tag is not $1.455 trillion but, 1.455 trillion minus 384 billion equals, $1.071 trillion. What's a trillion dollars over ten years? Not much. It's all good.

Tax Act to alter revenues over the next ten years

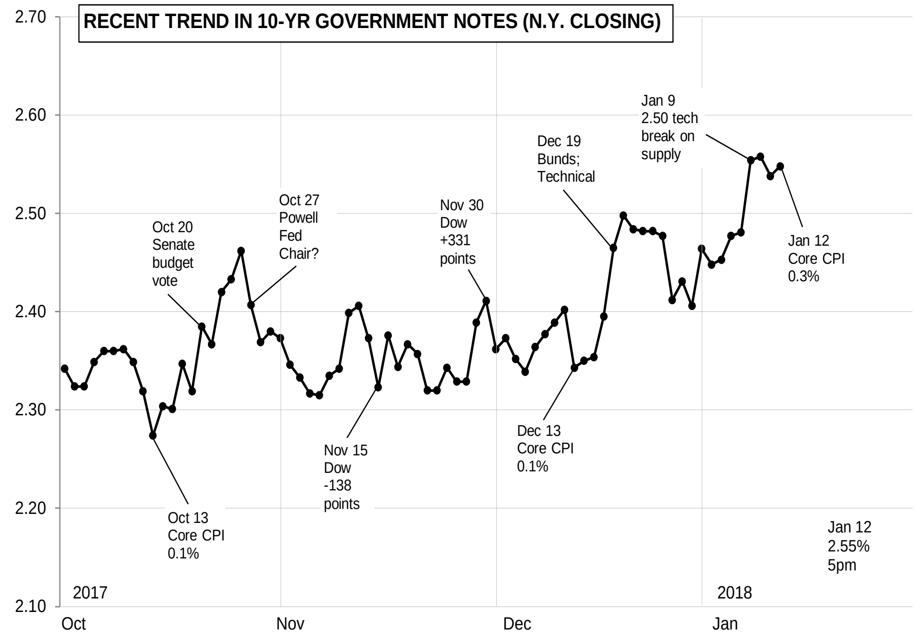
Tax Act changes $blns	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-2027
	-144.3	-270.9	-257.0	-234.8	-199.6	-163.9	-148.9	-146.4	-61.5	-19.8	-1,649.0
Individuals	-86.1	-182.0	-171.8	-172.2	-174.0	-169.9	-169.6	-170.9	-62.2	30.4	-1329.3
Businesses	-127.1	-131.5	-111.2	-90.6	-48.5	-16.5	-16.0	-24.2	-28.5	-49.5	-644.1
International	68.9	42.6	26.0	28.0	22.9	22.5	36.7	48.7	29.1	-0.8	324.4

Federal Government Spending ($bln) Where to cut?	1 Qtr FY18 Q4 17-Q4 17	1 Qtr FY17 Q4 16-Q4 16	Fiscal Year Changes	Fiscal Year % chg	Full Year FY 2017
TOTAL BUDGET OUTLAYS	994.467	950.607	43.860	4.6	3,980.605
Legislative	1.187	1.172	0.015	1.3	4.499
Judicial	1.978	1.862	0.116	6.2	7.566
Agriculture	51.913	49.319	2.594	5.3	127.563
Food Stamps	18.899	18.030	0.869	4.8	70.148
Child Nutrition	6.604	6.519	0.085	1.3	22.471
Commerce	1.563	2.209	-0.646	-29.2	10.304
Defense	158.556	149.392	9.164	6.1	568.905
Military Personnel	46.141	42.542	3.599	8.5	144.706
Operation Maintenance	60.334	59.965	0.369	0.6	245.186
Procurement	29.599	26.458	3.141	11.9	104.126
Research Development	18.421	16.552	1.869	11.3	68.126
Military Construction	1.904	1.703	0.201	11.8	6.673
Education	13.453	11.482	1.971	17.2	111.702
Office of Federal Student Aid	7.049	5.336	1.713	32.1	84.986
Energy	6.218	6.471	-0.253	-3.9	25.796
Health Human Services	257.238	257.956	-0.718	-0.3	1116.764
Medicare	154.324	150.786	3.538	2.3	708.299
Medicaid States Grants	94.753	96.411	-1.658	-1.7	374.681
Homeland Security	23.379	13.116	10.263	78.2	50.502
Housing Urban Development	10.829	10.958	-0.129	-1.2	55.474
Interior	3.894	3.144	0.750	23.9	12.141
Justice	8.680	7.372	1.308	17.7	30.977
Labor	5.573	5.828	-0.255	-4.4	40.120
State Unemployment Benefits	6.614	7.081	-0.467	-6.6	30.388
State	6.929	6.604	0.325	4.9	27.061
Transportation	18.657	19.350	-0.693	-3.6	79.440
FAA	3.809	3.778	0.031	0.8	15.866
Federal Highway Admin.	10.743	11.183	-0.440	-3.9	44.167
Treasury	159.731	150.945	8.786	5.8	546.434
TARP	0.730	0.961	-0.231	-24.0	4.146
IRS	14.457	13.543	0.914	6.7	139.539
Earned Income Credit	0.274	0.150	0.124	82.7	59.749
Child Tax Credit	0.122	0.081	0.041	50.6	19.408
Interest on Public Debt	146.253	139.126	7.127	5.1	456.955
Veterans Affairs	46.570	43.701	2.869	6.6	176.050
Corps of Engineers	1.604	1.727	-0.123	-7.1	6.453
Other Defense Civil Programs	16.780	14.663	2.117	14.4	58.695
Environmental Protection	2.408	2.406	0.002	0.1	8.088
Exec. Office of President	0.099	0.103	-0.004	-3.9	0.411
International Assistance	5.770	5.423	0.347	6.4	18.922
NASA	5.311	5.190	0.121	2.3	18.698
National Science Foundation	1.699	1.701	-0.002	-0.1	7.215
Personnel Management	23.924	23.667	0.257	1.1	95.461
Small Business Admin.	0.403	0.265	0.138	52.1	0.439
Social Security Admin.	253.274	245.408	7.866	3.2	1000.812
Retirement Benefits	202.356	194.758	7.598	3.9	791.098
Federal Disability Payments	35.302	35.377	-0.075	-0.2	142.957
Other Independent Agencies	1.525	4.237	-2.712	-64.0	11.660

MARKETS OUTLOOK

	29-Dec 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.74	2.90	3.00	3.10	3.30	3.40	3.50	3.60	3.70	3.80	3.80
10-Yr Note	2.41	2.50	2.70	2.80	3.00	3.20	3.30	3.40	3.50	3.70	3.70
5-Yr Note	2.21	2.20	2.40	2.60	2.80	3.00	3.15	3.30	3.40	3.60	3.60
2-Yr Note	1.89	1.95	2.20	2.45	2.65	2.85	3.10	3.30	3.40	3.60	3.80
3-month Libor	1.69	1.90	2.10	2.40	2.60	2.90	3.10	3.40	3.40	3.60	3.90
Fed Funds Rate	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75
2s/10s spread	52	55	50	35	35	35	20	10	10	10	(10)

Yields moved as high as 2.60% on Wednesday morning before the NY opening on a wild news story saying China would stop buying Treasuries. Yields retraced down to 2.52% after the China story died, and moved back up Friday as high as 2.59% on 0.3% core CPI before closing at 2.55%. Basically, this week's story is that yields broke longstanding 2.50% resistance on Tuesday ahead of the week's supply of 3s/10/30s from the Treasury and held the new higher level. Next resistance is 2.63%, the high yield for 2017 made in March last year.



FEDERAL RESERVE POLICY

The Fed meets January 30-31 to consider its monetary policy. Yellen's last one. No press conference, no expectation of policy changes. The March 21, 2018 meeting odds of a rate hike moved higher to 84% from 76% last week; most of the move came on Friday's 0.3% core CPI number. Philly Fed President Harker said just two rate hikes this year would be appropriate and Atlanta Fed President Bostic didn't sound in favor of "three or four moves per year." Bostic doesn't like low inflation and doesn't want the rate hikes to invert the yield curve. Old hand Boston Fed President Rosengren said later in the week, don't worry about the yield curve, keep going on rates, and outgoing New York Fed President Dudley said three rate hikes in 2018 was a reasonable starting point. Evans, Kashkari and Bullard also weighed in, but not sure any of them want to raise interest rates ever again anyway.

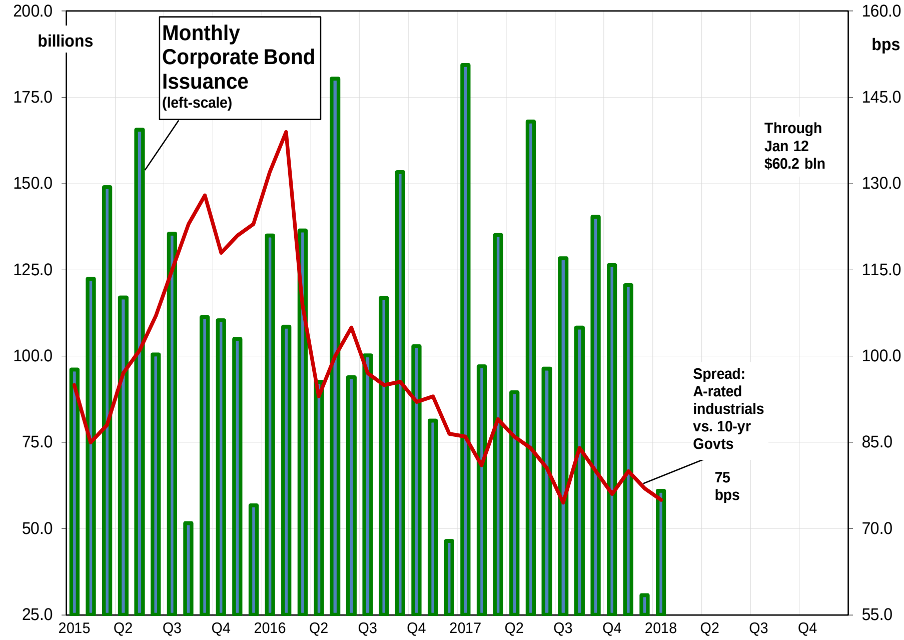
Selected Fed assets and liabilities

Fed H.4.1 statistical release billions, Wednesday data	10-Jan	3-Jan	27-Dec	20-Dec	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2448.209	2448.208	2454.219	2454.237	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1764.930	1764.929	1764.926	1775.451	0.000
Primary credit (Discount Window)	0.107	0.038	0.108	0.077	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	1.715	1.713	1.712	1.712	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	0.000
Central bank liquidity swaps	12.067	12.067	12.008	0.057	62.000
Federal Reserve Assets	4493.2	4490.9	4495.7	4494.7	961.7
3-month Libor %	1.71	1.70	1.69	1.66	2.82
Factors draining reserves					
Currency in circulation	1612.650	1618.531	1616.323	1607.915	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	57.954	131.622	147.749	127.582	0.000
Reserve Balances (Net Liquidity)	2257.894	2194.651	2176.452	2237.141	24.964
Treasuries within 15 days	3.098	3.098	17.504	17.504	14.955
Treasuries 16 to 90 days	107.658	107.658	79.555	79.556	31.549
Treasuries 91 days to 1 year	315.420	315.420	328.412	328.412	69.272
Treasuries over 1-yr to 5 years	1085.113	1085.113	1095.446	1095.449	170.807
Treasuries over 5-yrs to 10 years	314.035	314.035	310.412	310.416	91.863
Treasuries over 10-years	622.884	622.884	622.890	622.901	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

CORPORATE BONDS: TENCENT, TOYOTA, CROWN CASTLE, BROOKFIELD

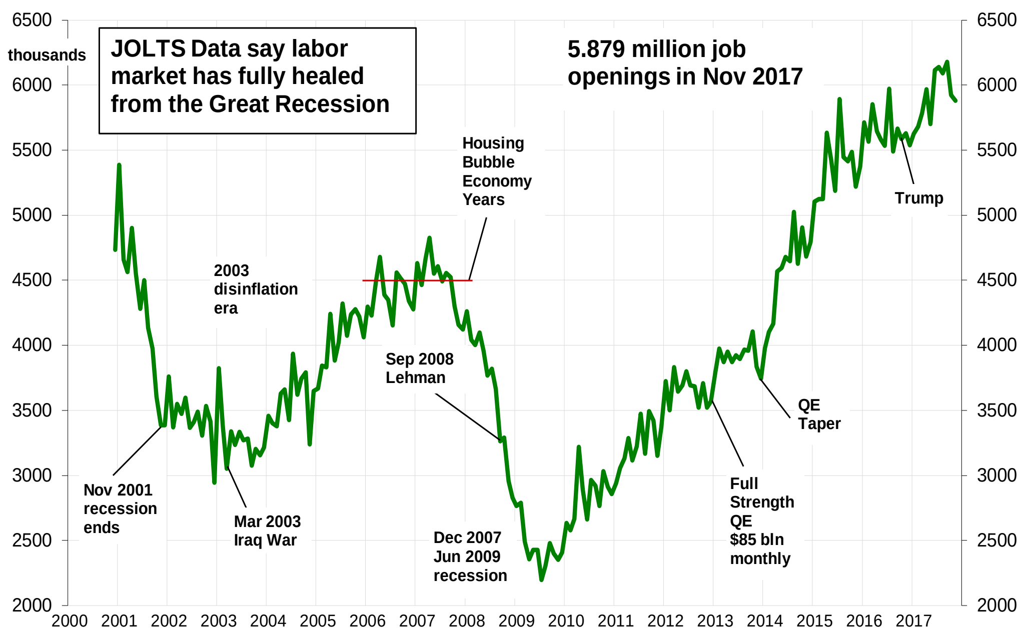
Corporate offerings were $32.3 billion in the January 12 week versus $28.5 billion in the January 5 week. On Tuesday, Sempra Energy sold $5.0 billion 2s/5s/10s/20s/30s/FRNs. It priced $1.0 billion 3.4% 10-yrs (m-w +15bp) at 93 bps (Baa1/BBB+). The energy services company (electricity, natural gas, pipelines) will use the proceeds to help fund its merger with Energy Future Holdings (Oncor). Corporate bonds (10-yr Industrials rated A2) were 75 bps above 10-yr Treasuries this week versus 78 bps last Friday.



OTHER ECONOMIC NEWS THIS WEEK

Workers seize the opportunity and send job openings tumbling (Tuesday)

Breaking economy news. The Jolts data, job openings and labor turnover, fell to 5.879 million in November from the 5.996 million level in October which was revised lower to 5.925 million. Nonfarm payroll jobs surged 252 thousand which helped send job postings to the lowest level in six months. The labor market continues to purr and match up buyers and sellers with new jobs. Workers are getting picked up by companies at a solid rate. The economy continues to operate a little past its peak after having reached full employment efficiency earlier this year. The unemployment rate is 4.1% and the Fed forecasts say full employment "unemployment" is 4.6%.



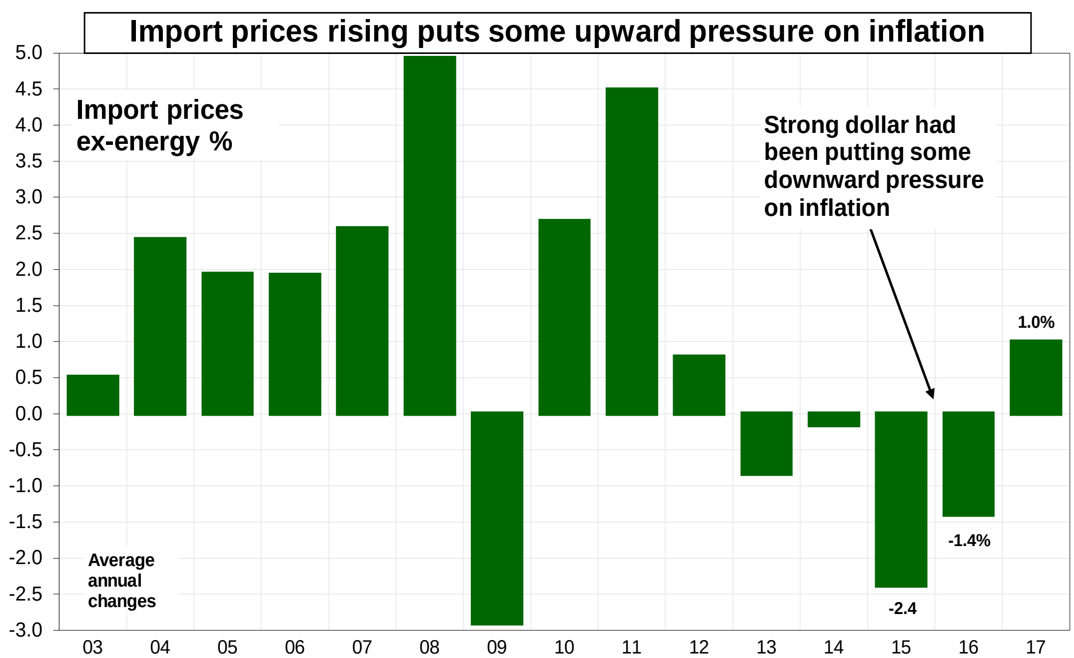
The quits rate, Fed Chair Yellen's favorite economic indicator, is showing worker confidence remains high at 3.2 million on a rounded basis for the third month in a row. You know the economy is strong if employees have the confidence to quit their jobs and strike out on their own in a new direction. More people are quitting now than they did in any month during the housing bubble economy years in the mid-2000s.

Net, net the labor market continues to churn at peak efficiency matching up workers with companies, helping the economy grow, and just because job openings are lower, don't assume the labor market isn't creating new jobs. There are still 5.879 million job openings in November which would make quite a dent in the nation's jobless rate if the openings could be matched up with the 6.616 million unemployed in November. Retail shops and stores are looking for 711 thousand workers nationwide so don't count this sector of the economy out yet. The economy is stronger than you think. Bet on it.

Import prices and other fake trading news today (Wednesday)

Breaking economy news. Import prices and a big market-mover of a news story on China saying they will sell Treasuries. Okay, maybe an exaggeration, just some muttering about how China finds Treasuries not quite as attractive as an investment. The story sent Dow futures down 100 points and 10-yr Treasuries up nearly to 2.60%. It all took place this morning before it was light out as we were riding the high-achiever early train into Manhattan making it difficult to understand what was going on.

China will stop buying Treasuries. Dream on. They can't not buy Treasuries. China has a massive trade surplus in dollars. If they sell their dollars they will wreck their trade advantage by strengthening their currency and price China exports out of world markets. The U.S. just saw this happen in 2015-16 where the strong dollar hurt manufacturers here and the world didn't want America's expensive export goods. As long as China has a trade surplus, and Trump's trade team is working furiously on this or maybe is just plain furious, as long as China has a trade surplus they have to put the dollars somewhere and Treasuries are the likely place for their billions/trillions of dollars to be.



Okay that's the fake news, what about the economic indicators. Import prices. Fed Chair Yellen has offered up the opinion that higher import prices due to the falling US dollar can help push up inflation. Fed officials are desperate for more inflation and will take it from any quarter.

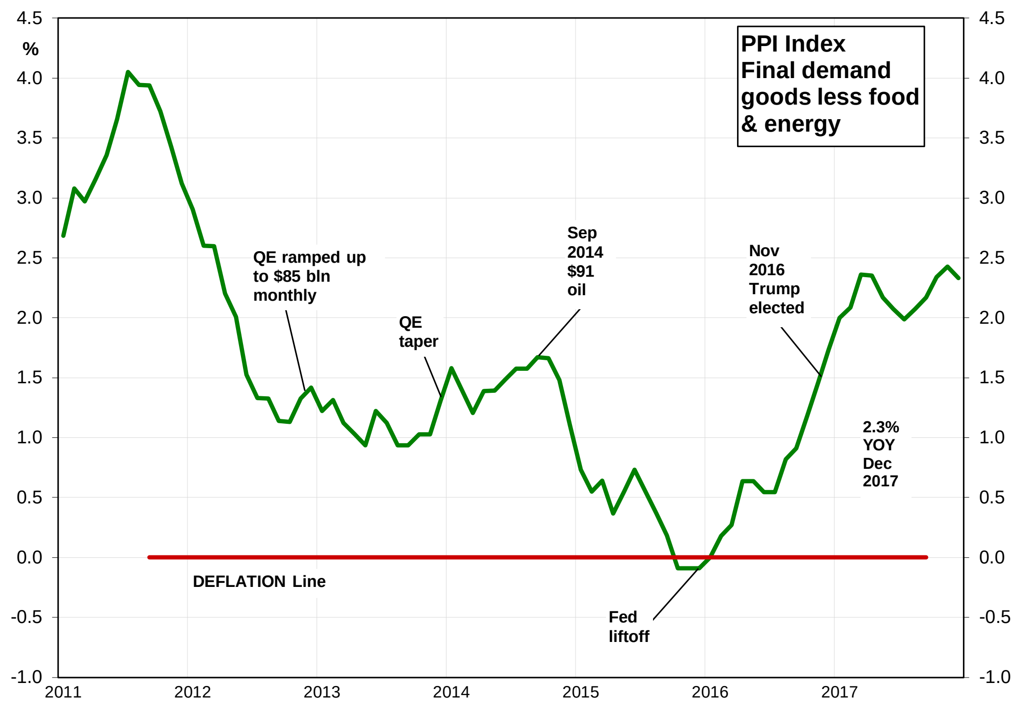
Well if they are looking for more inflation from fancy imported goods coming into the country, cheese and wine, and maybe a flood of autos from South Korea, Fed officials would be well advised to look elsewhere. Like under a rock maybe. Nonfuel import prices fell 0.1% in December after rising 0.1% in November and an unchanged 0.0 reading in October. No inflation help from imports.

Today's import price data will worry the Fed doves even more about too low inflation. Falling import prices are not the recipe for more inflation and three more rate hikes in 2018. Bet on it. Import prices rose just 1.0% last year which is better than the 1.4% decline in 2016, but not enough to move the needle on achieving the Fed's 2% inflation mandate. Stay tuned. Inflation story developing... slowly.

Stagflation with PPI falling 0.1% and jobless claims jumping to 261K (Thursday)

Breaking economy news. PPI inflation report and weekly jobless claims. It's winter outside and jobless claims soar at the turn of each year. Jobless claims rise 11K to 261K in the January 6 week, but weather is the likely culprit rather than jumping to the conclusion that companies are laying off workers suddenly after the economy slams on the breaks. Companies just got their tax cuts and many seem to be handing out one-time bonuses to workers not sacking them. Not seasonally adjusted, layoffs reached 351K which is pure winter weather related and the peak for the year. This is actually lower than last year's peak of 414K.

Producer prices fell 0.1% in December where 0.2% had been anticipated which was all the bond market heard. The decline was in final demand services however which fell 0.2% in December after rising 0.2% in November.



The traditional PPI which is final demand goods prices minus food and energy continue to rise which shows that the inflation story has a heartbeat even if the soulless bond market doesn't believe it. Humans don't trade bonds anymore anyway, machines have taken over the trading pits.

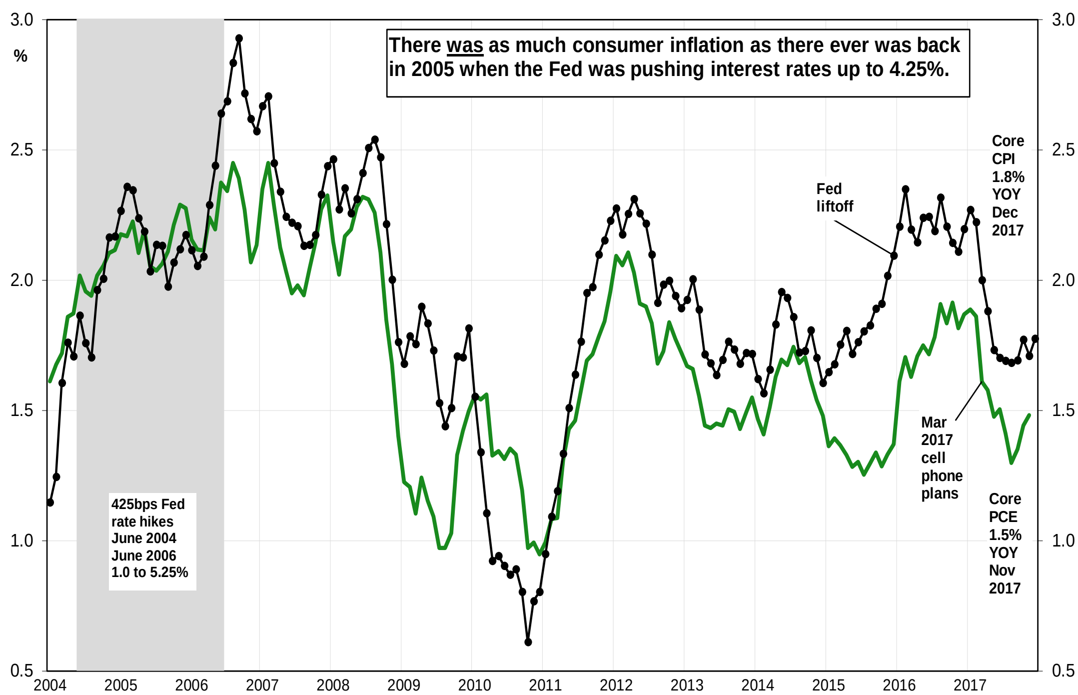
There's not no inflation that's for sure looking at these core prices of factory-produced goods rising 0.2% in December after increasing 0.3% in November. There have been either 0.2 or 0.3 percent monthly increases since August. Producers say inflation is back and we will see if consumers say the same thing in tomorrow's CPI inflation report.

Net, net, factories aren't producing as much inflation which is sure to bedevil the doves at the Federal Reserve who are worried about too low inflation. Today's data strike at the heart of the argument over whether Fed officials should let the economy run hot for a while longer with a shallower path of rate hikes in order to draw some of those left on the sidelines back into the labor market. Interesting that the "run hot" phrase originated with outgoing Fed Chair Yellen who quickly disowned it in front of Congress. She said no the Fed was going to raise rates because after reaching full employment, the economy generates price pressures where inflation can gain a foothold if policy officials aren't careful. We will see if the Fed under Powell continues with this textbook interpretation of monetary policy and continues to push up rates as the economy bumps up against its natural capacity limits. Stay tuned. Story developing.

Inflation's back and retail sales are strong--end of 2017 FINAL (Friday)

Breaking economy news. CPI inflation and retail sales for December. The Gods giveth and the Gods taketh away. Bonds rally on the 0.1% core CPI monthly numbers and sell off on the 0.3% prints. More core CPI inflation today, rising 0.3% for the month and 1.8% year-to-year. There is certainly inflation out there if Fed officials want to take the time to look for it. The bond market sees it. 10-yr yields were 2.54% before the CPI report and moved up to 2.59%. Back to trading the news!

Retail sales up 0.4% for both total sales and for retail sales minus autos, with upward revisions for both. Retail sales had a blistering fourth quarter pace of 11.3% at an annual rate. Stop talking about the poor 2% growth economy. We aren't sure who gets the credit for the strongest advance in consumer spending since 2010, but it is likely tied in part to the massive tax cuts from Washington and perhaps the Fed's easy money too-low interest rate policy for this stage of the business cycle with the economy in its ninth year of expansion from the end of the recession. The tax cut from Washington may just make this the longest economic expansion in modern economic history looking back to the 1970s. Even longer than the Clinton years as President.



Net, net, the economy is strengthening at the end of the year and generating more inflation pressures even before consumers see what is in their paychecks after the tax cuts within the next few weeks. The IRS has the new withholding tables ready to go and consumers aren't waiting. Retail sales at the nation's shops and malls had one of the best quarters on record as consumer confidence seemingly knows no bounds.

Taxpayers may not have wanted a tax cut according the polls but that isn't stopping them from spending it. More growth and more inflation with those tax cuts yet to kick in could push the economy into a new orbit. This has all the makings of a complete policy disaster for Fed officials who are reluctant to move interest rates to higher ground and temper the economy's strengthening momentum.

We expect today's economic reports of more spending and inflation will give policymakers the confidence to move rates higher at the first press conference meeting of the year under incoming Fed Chairman Powell's leadership. Fed funds futures odds of a March 21 rate hike moved up from 76% to 82% on this morning's retail sales and CPI news giving cover to the Fed's doves who are worried about too-low inflation.

Too-low inflation doesn't mean subpar economic growth that's for sure. Retail spending is on a tear. The market wants a rate hike to guard against an outbreak of inflation and we expect the new Federal Reserve under Powell will give it to them. The economy is stronger than you think. Bet on it.

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