Financial Market Weekly

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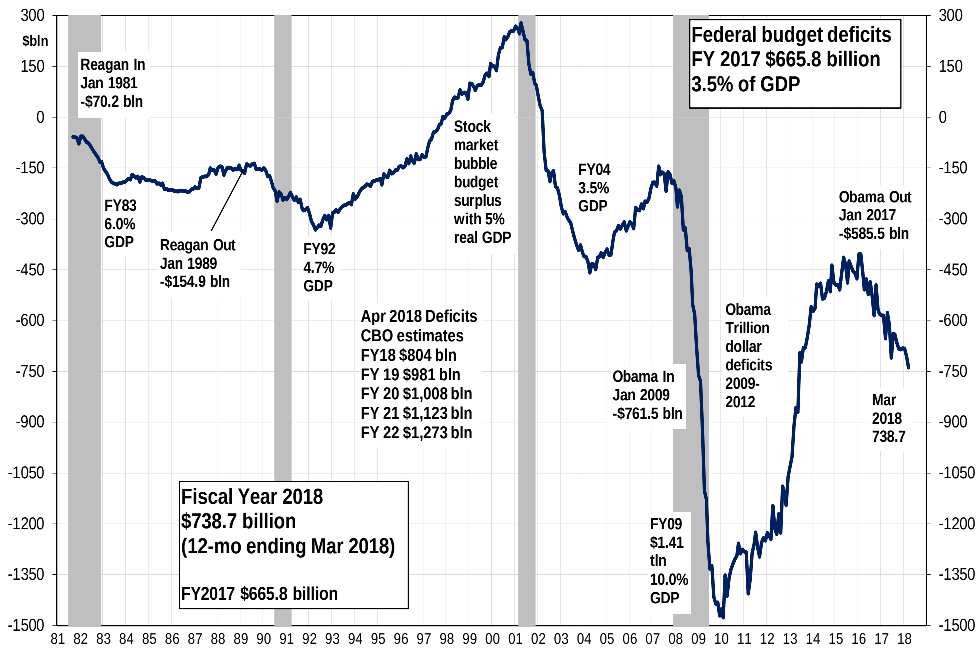
TREASURY BUDGET DEFICIT GOING TO $1.2 TRILLION ON OCTOBER 1



That was going to be our headline this week before the Congressional Budget Office (CBO) poured rain on our parade with their 2018-2028 Federal Budget Outlook this week. They estimate the FY2019 deficit will be just $981 billion. The Federal budget deficit was $665.8 billion in FY17, or 3.5% of nominal GDP, and it is running $738.7 billion "call it" in FY2018 on a 12-month trailing sum basis ending in March 2018. March 2018 data was released on Wednesday this week so we are doing our usual quarterly update on the Federal budget.

We were thinking the Federal budget deficit would be $1.2 trillion in the year starting October 1, and we were not a lone wolf forecaster on this. The tax act and spending accord were going to add close to $400 billion in deficit spending we thought. A looming $1.2 trillion Federal budget deficit and full-implementation wind down of the Fed's Treasury holdings on their balance sheet that was to start October 1 at a $360 billion annual rate. We thought the greater supply of bonds being auctioned by the US Treasury, $1.2 trillion budget deficit + .360 trillion balance sheet unwind, would push 10-yr Treasury yields to 3.5% by the end of calendar year 2019. It's tricky of course because supply doesn't

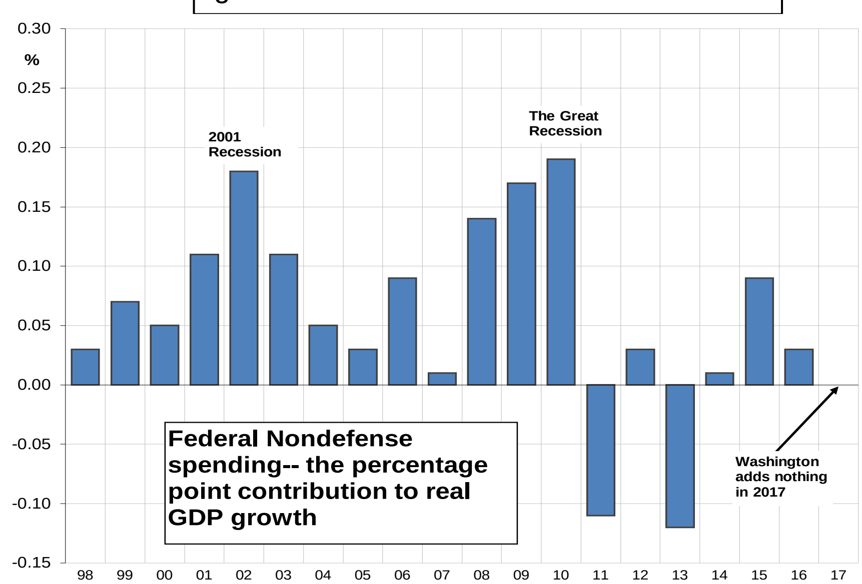
Percentage point contribution to Real GDP growth from Total Federal Government spending (Defense + Nondefense)																			
Fiscal	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
GDP effect	0.1	0.0	0.2	0.5	0.5	0.3	0.1	0.2	0.1	0.5	0.4	0.4	-0.2	-0.2	-0.5	-0.2	0.0	0.0	0.0

always matter. There was an even larger Federal budget deficit of $1.41 trillion which was 10% of GDP in FY2009, and perhaps 10-yr Treasury yields rebounded from 2.2% at the end of 2008, yields brought lower after Lehman and the final Fed rate cut to zero (0.25), to 3.8% at the end of 2009 on the supply deluge perhaps. Ten percent of current nominal GDP today would be a Federal budget deficit of $1.9 trillion. It's bad now, but not as bad as back then, in terms of supply, though you have to keep in mind that world demand for Treasuries was enormous during the financial crisis and recession. Foreigners have been buying fewer Treasuries at recent auctions.

Federal government spending is rising 4.8%, or nearly $97 billion higher in the first six months of FY 2018 than in FY 2017. Total spending was $2.096 trillion in the first half of FY 2018. Homeland Security is up with the FEMA disaster relief. Social security retirement benefits are up 4.7% to $410.3 billion. Interest on the public debt rose 7.9% to $240.5 billion. More spending is on the way, but nondefense Federal spending has not added that much to GDP growth historically, even during the last two recessions. In fact half of the 0.4 percentage point contribution to econmic growth in 2009 and 2010 was due to greater defense spending. The CBO 2018-2028 outlook shares the same view as Fed officials that fiscal stimulus will have its greatest impact on 2018 growth and will not add to the economy forever. CBO GDP forecasts are 3.3% in 2018, 2.4% in 2019 and a lowly 1.8% in 2020, when Trump says GDP will first hit 3% and stay at 3% forever and ever.

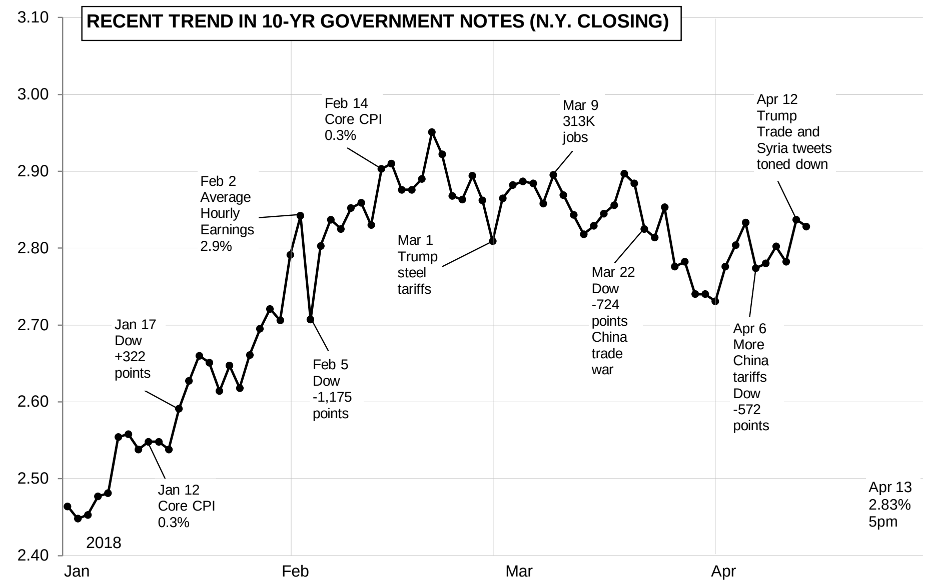
Federal Government Spending ($bln) **Where to cut?**	2 Qtrs FY18 Q4 17-Q1 18	2 Qtrs FY17 Q4 16-Q1 17	Fiscal Year Changes	Fiscal Year % chg	Full Year FY 2017
TOTAL BUDGET OUTLAYS	2,096.713	1,999.992	96.721	4.8	3,980.605
Legislative	2.357	2.303	0.054	2.3	4.499
Judicial	3.847	3.754	0.093	2.5	7.566
Agriculture	82.744	81.028	1.716	2.1	127.563
Food Stamps	35.734	35.506	0.228	0.6	70.148
Child Nutrition	12.971	12.791	0.180	1.4	22.471
Commerce	3.867	5.657	-1.790	-31.6	10.304
Defense	298.111	285.620	12.491	4.4	568.905
Military Personnel	79.879	76.401	3.478	4.6	144.706
Operation Maintenance	122.408	118.906	3.502	2.9	245.186
Procurement	55.739	52.546	3.193	6.1	104.126
Research Development	34.913	32.161	2.752	8.6	68.126
Military Construction	3.391	3.258	0.133	4.1	6.673
Education	37.818	34.580	3.238	9.4	111.702
Office of Federal Student Aid	20.906	16.630	4.276	25.7	84.986
Energy	12.587	12.866	-0.279	-2.2	25.796
Health Human Services	563.898	554.307	9.591	1.7	1116.764
Medicare	357.933	346.665	11.268	3.3	708.299
Medicaid States Grants	192.724	190.840	1.884	1.0	374.681
Homeland Security	40.777	25.375	15.402	60.7	50.502
Housing Urban Development	21.533	18.739	2.794	14.9	55.474
Interior	7.124	5.396	1.728	32.0	12.141
Justice	17.633	15.304	2.329	15.2	30.977
Labor	20.312	20.773	-0.461	-2.2	40.120
State Unemployment Benefits	15.642	16.480	-0.838	-5.1	30.388
State	12.756	12.783	-0.027	-0.2	27.061
Transportation	34.527	35.628	-1.101	-3.1	79.440
FAA	7.774	7.779	-0.005	-0.1	15.866
Federal Highway Admin.	18.786	18.961	-0.175	-0.9	44.167
Treasury	342.241	310.627	31.614	10.2	546.434
TARP	1.218	1.869	-0.651	-34.8	4.146
IRS	98.392	97.886	0.506	0.5	139.539
Earned Income Credit	49.468	50.947	-1.479	-2.9	59.749
Child Tax Credit	15.819	16.734	-0.915	-5.5	19.408
Interest on Public Debt	240.522	222.961	17.561	7.9	456.955
Veterans Affairs	92.948	85.880	7.068	8.2	176.050
Corps of Engineers	3.395	3.468	-0.073	-2.1	6.453
Other Defense Civil Programs	31.962	29.557	2.405	8.1	58.695
Environmental Protection	4.264	4.415	-0.151	-3.4	8.088
Exec. Office of President	0.187	0.197	-0.010	-5.1	0.411
International Assistance	7.506	11.998	-4.492	-37.4	18.922
NASA	9.632	9.389	0.243	2.6	18.698
National Science Foundation	3.332	3.348	-0.016	-0.5	7.215
Personnel Management	48.591	47.793	0.798	1.7	95.461
Small Business Admin.	-0.719	0.505	-1.224	--	--
Social Security Admin.	513.221	493.964	19.257	3.9	1000.812
Retirement Benefits	410.346	391.760	18.586	4.7	791.098
Federal Disability Payments	71.523	71.218	0.305	0.4	142.957
Other Independent Agencies	3.076	6.491	-3.415	-52.6	11.660

The President and Congress did not add that much government spending to GDP growth in the last two recessions.



MARKETS OUTLOOK

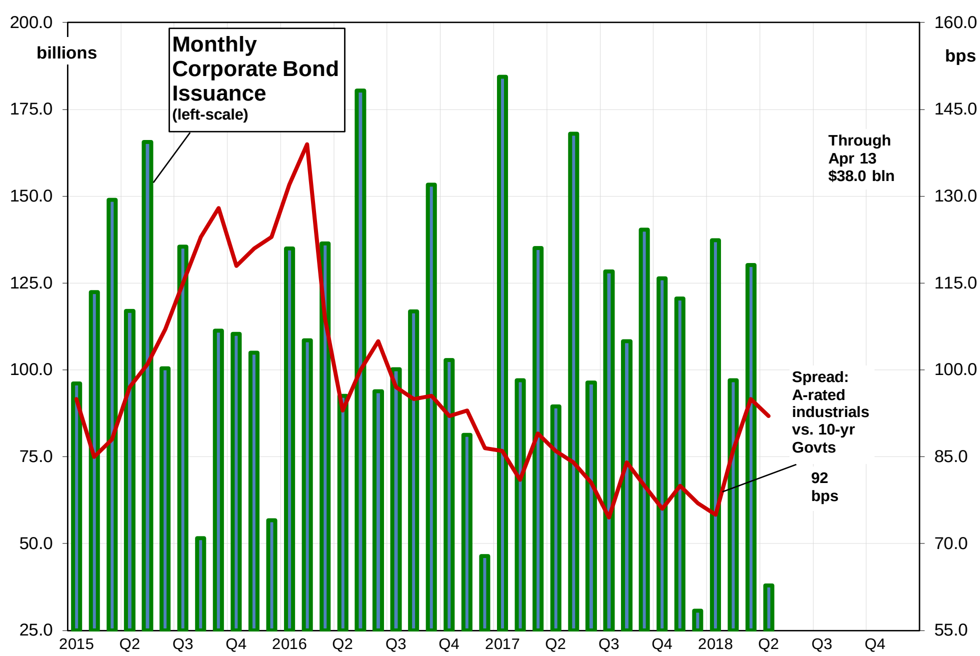
	29-Mar 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.97	3.10	3.10	3.20	3.35	3.45	3.60	3.55	3.75	3.75	3.90	4.00
10-Yr Note	2.74	2.80	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.70	3.90	4.00
5-Yr Note	2.56	2.60	2.70	2.80	3.05	3.15	3.40	3.45	3.65	3.65	3.90	4.00
2-Yr Note	2.27	2.40	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.80	4.00	4.20
3-month Libor	2.31	2.30	2.55	2.80	3.05	3.30	3.55	3.55	3.70	3.95	3.95	4.20
Fed Funds Rate	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00
2s/10s spread	47	40	35	20	20	15	10	10	10	(10)	(10)	(20)



The 10-yr Treasury yield closed at 2.83% this week, 6 bps higher. It was a quiet week until Wednesday around 7am NY time when Trump tweeted Russia get ready, bombs are coming to Syria which brought Dow futures down a couple hundred points and 10-yr Treasury yields fell to the 2.75% lows for the week. The final tick down on Wednesday may have been on the 0.1 decline in headline CPI instead of the 0.0 consensus. Headline CPI inflation won't be down for long with crude oil prices rising. Yields then rebounded to 2.84% on Thursday as the Trump trade rhetoric was toned down (the US might even join TPP) and Dow industrials rallied 293 points.

CORPORATES: TOYOTA MOTOR CREDIT, CH ROBINSON WORLDWIDE

Corporate offerings were $12.0 billion in the April 13 week versus $25.9 billion in the April 6 week. On Thursday, Fairfax Financial priced a $600 million 4.85% 10-yr (m-w +30bp) at 205 bps (Baa3/BBB-). The property and casualty insurance company will use the proceeds to repay/refinance its debt. Corporate bonds (10-yr Industrials rated A2) were 92 bps above 10-yr Treasuries this week versus 94 bps last Friday.



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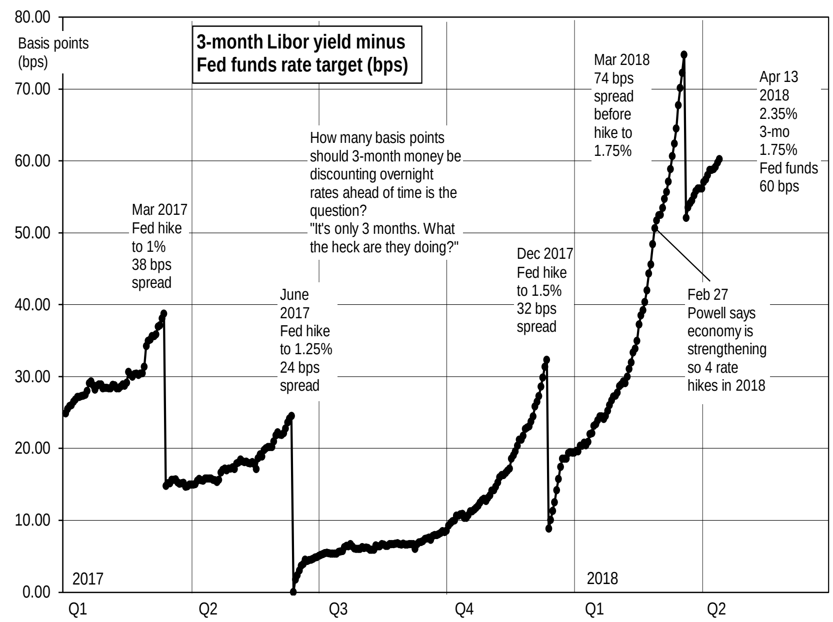
FEDERAL RESERVE POLICY

The Fed meets May 1-2 to consider its monetary policy. There is no press conference and no chance of anything happening. Two more rate hikes this year according to the median Fed forecast (7 of 15 say 3 more hikes this year), which meetings will they choose, June, September, or December? For the June 12-13 meeting, the rate hike odds are 86%. Three-month Libor is 2.35%, 60 bps above the 1.75% Fed funds rate, and already discounting a 25 bps Fed rate hike on June 13.



The stale Fed meeting minutes from three weeks ago when they sat around a table and decided to raise interest rates by 25 bps to 1.75% were released Wednesday, April 11 at 2pm EDT. It is still a close call on whether they come with 2 or 3 more rate hikes in 2018. The median forecast in March was for two more rate hikes, although the vote was close with 7 out of 15 thinking that three more rate hikes were necessary. They all agreed that a stronger economic outlook over the last few months, basically due to the fiscal stimulus, meant a gradual pace of rate hikes, it is just that there is not a strong consensus on whether two or three more rate hikes will be required this year.

The bottom line is there is no meaningful information in the actual minutes that adds to our understanding of what they are planning to do. There can't be because the future is too uncertain. And uncertainty has skyrocketed since their decision on March 21 to hike rates with the Dow Jones industrials falling over 1,300 points at the worst point on trade war fears.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	11-Apr	4-Apr	28-Mar	21-Mar	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2413.060	2413.031	2424.883	2424.723	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1754.369	1754.368	1754.368	1763.171	0.000
Primary credit (Discount Window)	0.000	0.002	0.002	0.000	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)	1.709	1.709	1.709	1.708	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	0.079	5.011	0.079	0.077	62.000
Federal Reserve Assets	4431.2	4433.4	4439.3	4448.7	961.7
3-month Libor %	2.34	2.32	2.30	2.27	2.82
Factors draining reserves					
Currency in circulation	1640.817	1640.597	1636.934	1634.754	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	2.361	4.570	17.898	20.586	0.000
Reserve Balances (Net Liquidity)	2128.844	2098.731	2119.605	2135.068	24.964
Treasuries within 15 days	0.229	0.229	31.201	31.201	14.955
Treasuries 16 to 90 days	119.506	119.506	89.281	89.280	31.549
Treasuries 91 days to 1 year	290.370	290.367	298.438	298.434	69.272
Treasuries over 1-yr to 5 years	1080.029	1080.010	1081.513	1081.492	170.807
Treasuries over 5-yrs to 10 years	296.322	296.395	298.012	297.970	91.863
Treasuries over 10-years	626.605	626.525	626.439	626.346	101.337

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

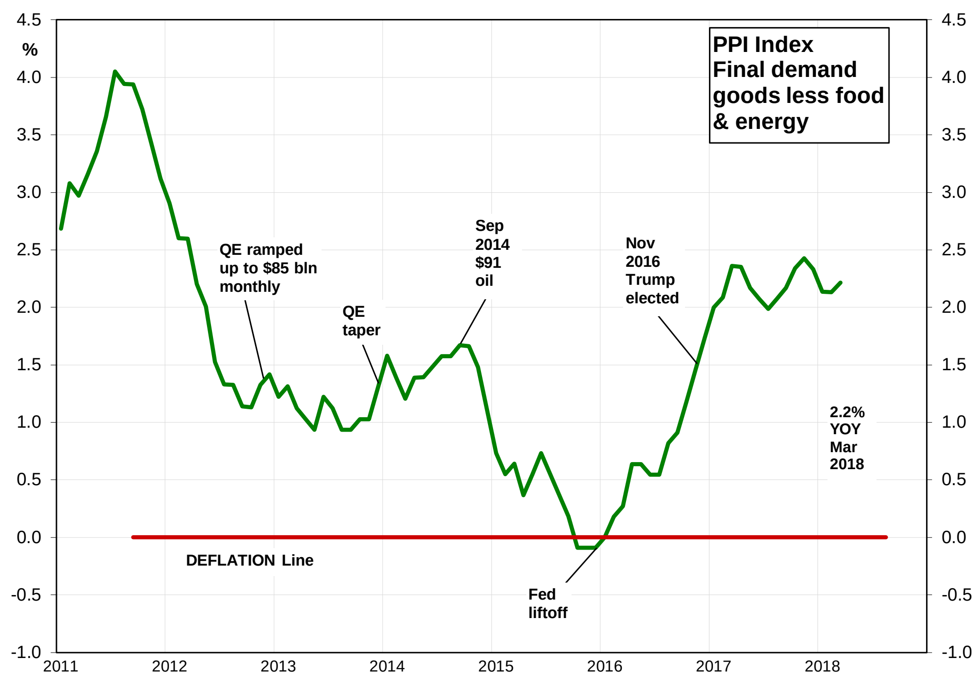
The only smoking gun if there was one in the minutes is that "some" participants say they might have to eventually change their statement language to tell the markets that policy will eventually move from being accommodative to moving to neutral or even further, a higher Fed funds rate might be required which would be a restraining factor for economic growth. There it is. The first acknowledgement that they might have to tighten monetary policy, take away the punch bowl, raise interest rates high enough to slow the economy down. This is all premature however, as just some participants are saying this.

To conclude, the Fed remains on a gradual path for raising interest rates and this outlook was not altered despite the volatility in the stock market. Fed officials curiously dismissed the market turbulence and stated flat out that financial market conditions remained accommodative. Maybe someone should check that. The Fed funds rate is accommodative, but someone deflated a lot of air out of the stock market bubble and that means financial market conditions have tightened. The public is plainly worried by the stock market correction and time will tell whether they can get over their anxiety and start spending their tax cuts dollars again. March Retail Sales is due out Monday, April 16. Let's wait and see. We are a little concerned that markets are expecting too much economic growth the next few years, where the truth is most economists just see a one-year pop in economic growth in 2018 and then see economic growth slowing back down dramatically in 2019. The historical record shows fiscal stimulus does not add as much growth to the economy as the initial forecasts predict.

OTHER ECONOMIC NEWS THIS WEEK

Producers have lit the fuse for higher inflation and the clock is ticking (Tuesday)

Breaking economy news. Producer prices for March. PPI as it used to be known until the BLS makeover that added services prices to the Producer Price Index (PPI) of commodities. Total final demand PPI as they call it is on a tear this year rising 0.4% in January, 0.2% in February, and 0.3% in March. Final demand PPI less food and energy, and the more volatile trade services component, has increased 0.4% each month this year and is rising 2.9% the last twelve months, hotter than the 1.8% year-on-year reading a year ago in March 2017. Things are looking up for inflation this year, and the bond markets, bracing for higher yields, are nervously waiting for the Fed's economic staff to brief Fed Chair Powell with this latest development.



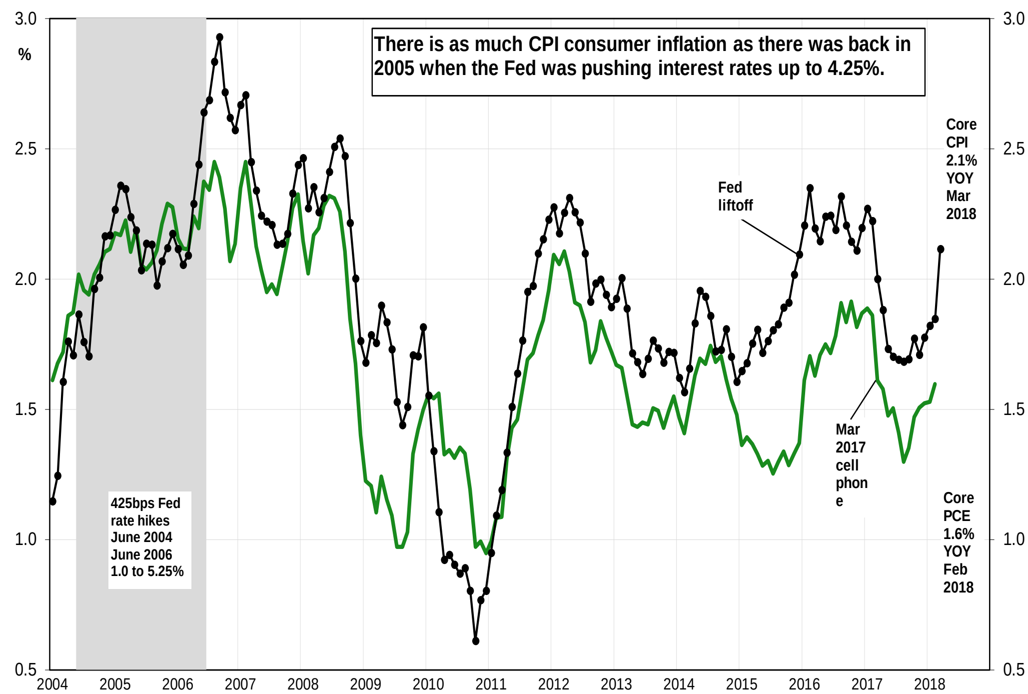
Net, net, the economy is generating some heat with inflation at the producer level picking up. Will it lead to more consumer inflation? Commodities are 25% of core CPI purchases. CPI is due out tomorrow and core CPI is expected to move up from 1.8 to 2.1 percent, when the free cell phone plan data effect, depressing CPI inflation a year ago, drops out of the year-on-year data.

Time will tell if the fuse is lit and the clock is ticking for higher inflation that prompts a faster path for interest rate hikes from Fed officials seeking to thread the needle and balance supply and demand pressures in this long-dated economic expansion. Policy is always a balance between too hot and too cold and right now the Fed's policy is running the economy a little on the hot side.

Commodity prices are rising at a fast clip, but whether goods prices spill over to the services sector remains an open question. Merchants are not seeing the need to pass through higher commodity priced inflation to their own services at the moment, but that can change in a heartbeat if the Federal Reserve allows the economy to heat up too much by dragging their feet and keeping interest rates too low for too long. The Fed funds rate setting is currently stimulative for the economy at 1.75% and the market is rightly discounting another rate hike at the Federal Reserve's next actionable meeting in June. Stay tuned. Story developing.

Inflation is up, mostly on something that happened a year ago (Wednesday)

Breaking economy news. Headline CPI inflation fell a surprising 0.1% in March, mostly due to the 4.9% fall in the price of gasoline. The surprise comes in knowing gasoline prices fell barely 1% nationwide by 3 cents from $2.72 in February to $2.69 in March. Seasonal factors are exaggerating the decline. Headline CPI inflation is still running 2.4% year-on-year though, faster than the Fed's inflation target.



If you want to watch the inflation trend, you have to watch core prices, CPI less food and energy prices. Core CPI inflation rose 0.2% in March and because it fell 0.1% in March 2017, due to the free cell phone data quality adjustment to prices, core CPI inflation year-to-year rose three-tenths to 2.1% in March from 1.8% in February. Whether anything matters here for the Fed's gradual rate hike path, two more coming this year, is questionable. Even noneconomist Fed Chair Powell has pointed to the cell phone data plan effect; not a surprise.

So core CPI inflation is up, and we will find out if core PCE inflation rises three-tenths as well from 1.6% to 1.9%, a tenth away from the Fed's 2% objective, on Monday, April 30. Markets are bracing for it. Just kidding, we don't know if it is spring break week or what but nothing is going on in the bond market. Bonds are rallying this morning, not on CPI inflation, but they are down a few bps in yield on the tweets meant for Russia saying bombs are headed for Syria. Get ready to duck.

Net, net, inflation is warming up partly with the strengthening economic conditions with fiscal stimulus being added late in the economic cycle. But part of the hotter inflation really stems from a statistical quirk from the free cell phone data plans put into effect by wireless companies a year ago. Core CPI fell 0.1% in March 2017, deflation! You know the last time core CPI fell in any month? January 2010. You know the last time prior to January 2010 that core CPI fell? Never. Or at least we looked back to 1990 and didn't see any monthly decline.

Core CPI Inflation monthly and year-on-year changes

2018	% chg	YOY	2017	% chg	YOY
Dec			Dec	0.2	1.8
Nov			Nov	0.1	1.7
Oct			Oct	0.2	1.8
Sep			Sep	0.1	1.7
Aug			Aug	0.2	1.7
Jul			Jul	0.1	1.7
Jun			Jun	0.1	1.7
May			May	0.1	1.7
Apr			Apr	0.1	1.9
Mar	0.2	2.1	Mar	-0.1	2.0
Feb	0.2	1.8	Feb	0.2	2.2
Jan	0.3	1.8	Jan	0.3	2.3

The million dollar question for those Fed rate hike bets depends on whether inflation is heating up. Never mind that one of Fed Chair Powell's Number 2s, John Williams, incoming NY Fed President, thinks inflation can rise above 2% without the Fed needing to do anything about it. To judge whether inflation is heating up we need to see more 0.2 monthly prints in core CPI. This year is starting out inflationary with 0.3 in January, 0.2 in February and now in March. But 2017 was a different story with one 0.3, and just four 0.2 percent monthly changes. It is early in 2018 to judge whether the economy is running hot or not with those massive tax cuts for corporations and individuals.

The key to core CPI inflation is partly medical care and drugs. Medical care services are still running slower at 2.1% year-to-year despite the 0.5% jump today in March. Medical care commodities, your meds, are also just rising slower at just 1.4% year-to-year.

Shelter costs are going up rising 0.4% in March and 3.3% year-to-year, but this isn't enough to push core CPI that much faster. Stay tuned. Inflation is heating up today on a statistical anomaly based on ancient history, but this tells us little on whether inflation pressures are building and will present a problem for Fed officials in the future. At the moment, it is not looking like the Fed needs to raise interest rates that high above the 2-7/8 percent neutral level of interest rates for the economy because while the inflation genie is out of his bottle, he is not up to any mischief yet. Our conclusion is that a worrisome inflation outbreak does not appear imminent based on today's report.

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