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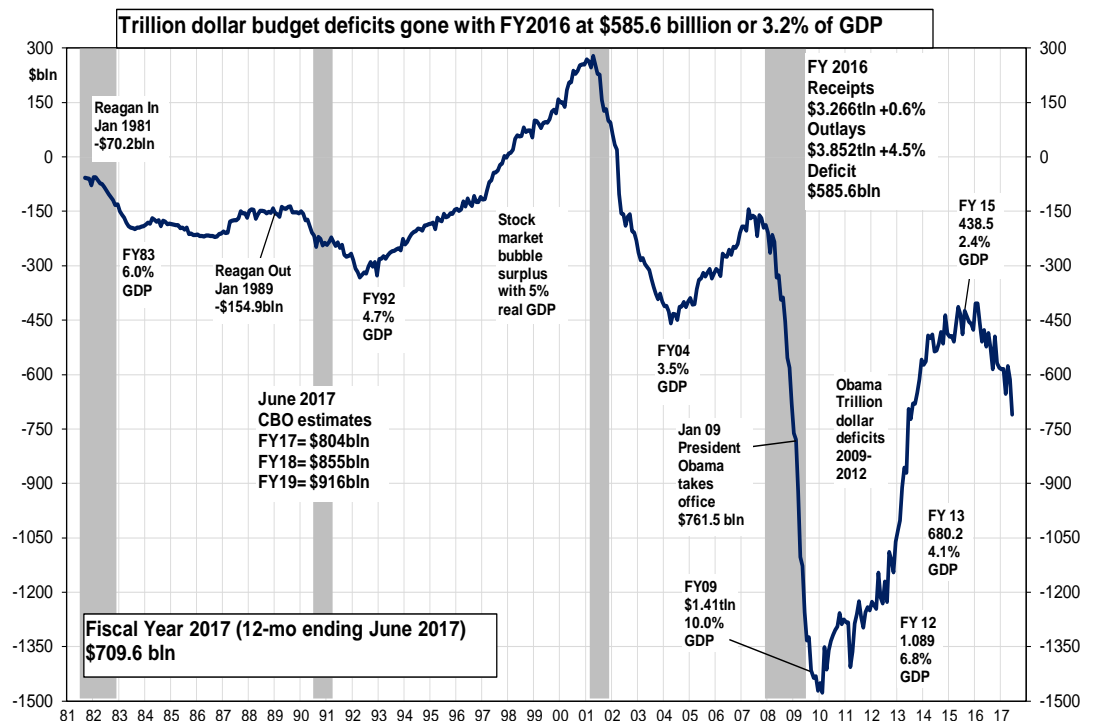
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READY OR NOT, THE FEDERAL BUDGET DEFICIT IS WIDENING IN THE FIRST “SIX MONTHS” OF THE TRUMP ADMINISTRATION

There’s not much in the way of concrete proposals on taxes or infrastructure spending, but the Federal budget deficit is widening anyway, ready or not. Something is going on and it isn’t revenue-neutral.

In the 12 months ending June 2017, the Federal budget deficit is running \$709.6 billion. It was \$438.5 billion two years ago in Fiscal Year (FY) 2015,

but the latest CBO forecast has it widening to \$804 billion in FY 2017 that ends a few months from now in September. The \$804 billion Federal budget deficit CBO forecast for FY 2017 is \$365.5 billion greater than it was two years. And you can add the \$360 billion Fed balance sheet unwind of Treasury securities (annually), once it gets going at full speed a year after being formally announced, to the “deficit” amount that the Treasury will have to fund by selling bonds to the market... so it looks like trillion-dollar deficits are back, last seen in the Obama recession years of 2009 through 2012. We will see if more supply can help push 10-yr yields up to our 3% forecast because Fed policy certainly is not going to do it before the end of 2019 unless the incoming Fed Chairman strikes a new course and steers the current crop of FOMC members back to normal.



The deficit is widening this year even before we get to those tax policy changes and infrastructure spending promised during the election. In FY 2017 Federal outlays are up 6% from last year while receipts are lagging in rising just 2% from last year. Individual tax collections are up, corporate taxes are unchanged, and Fed remittances to the Treasury are down. As far as Federal spending, social security is up 3% this year, Medicare +4%, Medicaid +2%, and interest on the public debt up 13%. Spending is also up on the accounting for loan guarantees and subsidies for both the Department of Education and the Department of Housing and Urban Development.

Yellen gave a reminder this week on just why it will be difficult for Congress to advance new legislation on taxes and infrastructure unless it is somehow rendered revenue-neutral as many members in Congress are reluctant to add to the "\$20 trillion" National Debt. On Wednesday in questioning before the House, Representative Pearce (R-NM) had a long question on the national debt... "We're already running deficits, which means we have to print the money every year on which to operate, and it seems like -- that -- that the people in charge of the system would be talking about

it and -- and postulating and telling us, "Hey, this is kind of serious. Why don't we all work together and start figuring out what we can do to live within our means, to just make sure that we're not paying triple and quadruple what other people are paying for debt?"

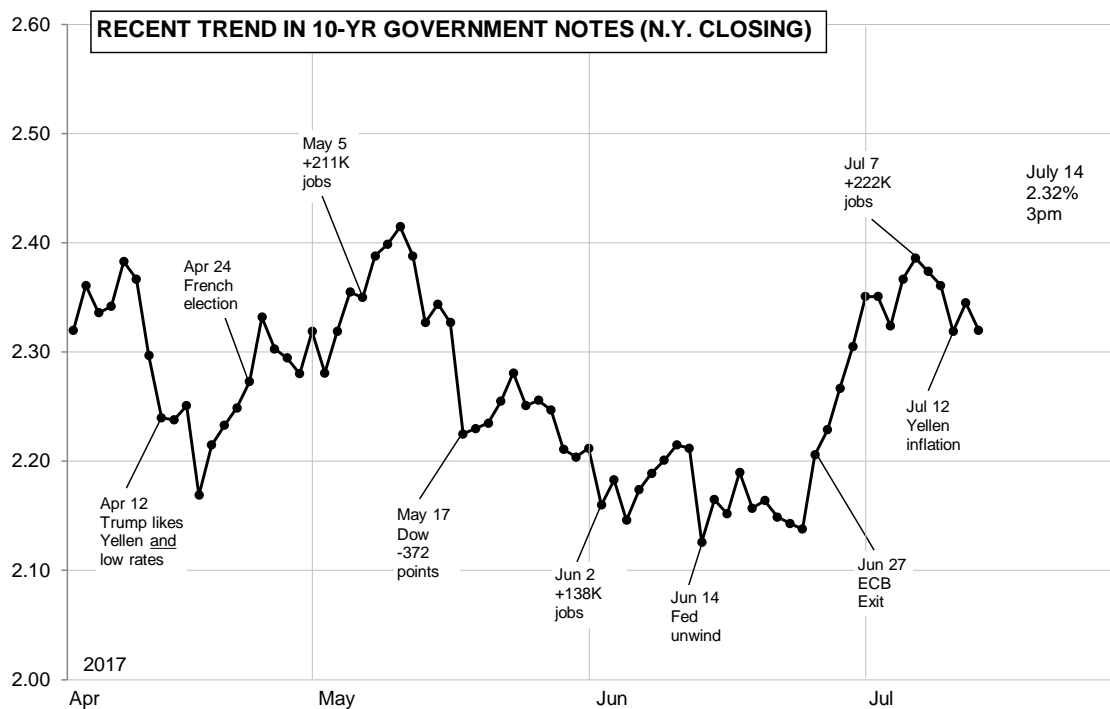
Federal Government Spending (\$bln)	Fiscal		Fiscal	Fiscal	Full Year
Where to cut?	3 Qtrs FY17	3 Qtrs FY16	Year	Year	Full Year
	Q4 16-Q2 17	Q4 15-Q2 16	Changes	% chg	FY 2016
TOTAL BUDGET OUTLAYS	3,030.903	2,867.988	162.915	5.7	3,854.100
Legislative	3.371	3.217	0.154	4.8	4.344
Judicial	5.703	5.484	0.219	4.0	7.497
Agriculture	109.787	110.490	-0.703	-0.6	138.162
Food Stamps	52.750	55.110	-2.360	-4.3	73.081
Child Nutrition	19.460	18.940	18.940	2.7	21.978
Commerce	7.859	6.677	1.182	17.7	9.162
Defense	424.935	417.270	7.665	1.8	565.364
Military Personnel	109.546	109.784	-0.238	-0.2	147.905
Operation Maintenance	181.669	178.562	3.107	1.7	243.200
Procurement	78.343	75.999	2.344	3.1	102.651
Research Development	48.780	47.652	1.128	2.4	64.873
Military Construction	5.144	5.160	-0.016	-0.3	6.677
Education	90.206	59.457	30.749	51.7	76.981
Office of Federal Student Aid	66.671	32.134	34.537	107.5	42.796
Energy	18.798	19.064	-0.266	-1.4	25.852
Health Human Services	823.914	792.492	31.422	4.0	1102.965
Medicare	521.392	496.888	24.504	4.9	698.609
Medicaid States Grants	278.161	271.858	6.303	2.3	368.280
Homeland Security	35.304	32.081	3.223	10.0	45.195
Housing Urban Development	49.498	20.169	29.329	145.4	26.393
Interior	8.396	9.035	-0.639	-7.1	12.584
Justice	23.367	21.479	1.888	8.8	29.523
Labor	31.251	31.872	-0.621	-1.9	41.371
State Unemployment Benefits	23.880	25.259	-1.379	-5.5	32.178
State	19.162	18.487	0.675	3.7	29.448
Transportation	55.771	53.407	2.364	4.4	78.419
FAA	11.546	11.305	0.241	2.1	15.560
Federal Highway Admin.	29.749	98.982	-69.233	-69.9	114.055
Treasury	485.732	466.452	19.280	4.1	526.116
TARP	3.371	4.011	-0.640	-16.0	4.961
IRS	123.423	119.957	3.466	2.9	133.126
Earned Income Credit	58.976	60.041	-1.065	-1.8	60.580
Child Tax Credit	19.107	19.926	-0.819	-4.1	20.188
Interest on Public Debt	375.632	345.780	29.852	8.6	429.963
Veterans Affairs	130.970	123.908	7.062	5.7	174.018
Corps of Engineers	5.006	4.543	0.463	10.2	6.388
Other Defense Civil Programs	43.308	45.685	-2.377	-5.2	64.505
Environmental Protection	6.285	6.668	-0.383	-5.7	8.729
Exec. Office of President	0.319	0.288	0.031	10.8	0.395
International Assistance	14.930	13.388	1.542	11.5	16.241
NASA	14.157	13.926	0.231	1.7	18.829
National Science Foundation	3.348	3.187	0.161	5.1	6.904
Personnel Management	71.283	68.302	2.981	4.4	91.316
Small Business Admin.	0.184	-0.735	0.919	----	-0.444
Social Security Admin.	748.951	728.096	20.855	2.9	976.783
Retirement Benefits	590.587	569.238	21.349	3.8	762.126
Federal Disability Payments	107.192	107.432	-0.240	-0.2	143.130
Other Independent Agencies	8.105	6.575	1.530	23.3	13.162

YELLEN: Well, let me state, in the strongest possible terms, I agree that what you're showing here represents a trend that, given current spending and taxation decisions, is going to lead to an unsustainable debt situation with rising interest rates and declining investment in the United States that will further harm productivity growth and living standards. I believe a key thing that Congress should be taking into account in designing fiscal policy is the need to achieve sustainability of this debt path over time. This is something I'm not just saying today, but have been emphasizing for some time in my testimony.

MARKETS OUTLOOK

	30-Jun 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Treasury	2.83	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10
10-Yr Note	2.30	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90
5-Yr Note	1.89	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70
2-Yr Note	1.38	1.60	1.85	2.10	2.40	2.60	2.85	3.10	3.35	3.35	3.60
3-month Libor	1.30	1.65	1.90	2.20	2.45	2.70	2.95	3.20	3.45	3.35	3.70
Fed Funds Rate	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50
2s/10s spread	92	90	85	90	80	80	65	60	45	55	30
Libor/funds spd	5	15	15	20	20	20	20	20	20	10	20

Yields lifted last week on growing talk that the European Central Bank and Bank of England would soon change their focus to the time when it would no longer be necessary to provide the current level of monetary accommodation. This week the focus shifted back to the U.S. with yields falling a little on the idea that inflation might remain short of target for a longer time and hence delay a rate hike or two. Delaying returning interest rates to normal levels when the economy is at full employment has to be a new one in the history of Federal Reserve policymaking, meaning we cannot recall any Fed seeking to push up inflation ever. CPI inflation was less than expected on Friday, and this brought down 10-yr yields from 2.33% at the 830am EDT release time down as low as 2.28% for a time.



FEDERAL RESERVE POLICY

The Fed meets July 25-26 to consider its monetary policy. We are not expecting anything to happen, although Yellen did tell Congress on Wednesday the balance sheet unwind's official starting announcement would take place "relatively soon." Wouldn't that be a kick in the head if they announced it on July 26? The market at the moment is expecting the balance sheet announcement in September and for the final of the Fed's forecasted three rate hikes this year to take place in December (raising the Fed funds rate 25 bps to 1.50% in case you forgot). Our official forecast looks for four rate hikes this year, because it's the right thing for them to do, but pay no attention to the advice from that man behind the curtain.

There was more chirping this week from some Fed officials saying they wanted assurance that inflation was actually headed back up closer to their 2% target. We guess these Fed members were not listening when Yellen told Congress she expected inflation to move higher and the latest downdraft she repeated again: inflation has come off a little because of "quality adjustments" where your cell phone bill gives you more data and drug prices fell as well. We still cannot believe some on the Committee won't raise rates with inflation at this level. They will when they get new leadership maybe. Low inflation seems irrelevant to us when it comes to an assessment of current business and economic conditions because interest rates (1.25%) are so low relative to normal 3% levels. Yellen took a stab at the dangers, the specter, of too low inflation (sounds like a James Bond film) in a question from Senator Menendez (D-NJ), but her whole response was pretty unconvincing; risk of undershooting 2% somehow increases the risk of deflation we guess is the point. All of this handwringing over not-enough inflation took place

Selected Fed assets and liabilities					Sep 10
billions, Wednesday data					2008**
	12-Jul	5-Jul	28-Jun	21-Jun	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2465.121	2465.096	2465.046	2464.958	479.782
Federal agency debt securities	8.097	8.097	8.097	8.097	0.000
Mortgage-backed securities	1770.281	1770.281	1770.280	1781.099	0.000
Primary credit (Discount Window)	0.001	0.001	0.084	0.009	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	0.000
Maiden Lane (Bear)	1.709	1.709	1.709	1.709	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
<u>Central bank liquidity swaps</u>	0.055	3.070	0.035	0.042	62.000
Federal Reserve Assets	4513.4	4513.8	4509.6	4520.9	961.7
3-month Libor %	1.30	1.30	1.30	1.29	2.82
Factors draining reserves					
Currency in circulation	1564.816	1565.957	1559.134	1555.694	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	179.172	240.029	263.669	198.769	0.000
Reserve Balances (Net Liquidity)	2238.951	2169.650	2118.108	2164.616	24.964
Treasuries within 15 days	1.278	1.278	12.885	12.885	14.955
Treasuries 16 to 90 days	44.593	44.593	34.924	34.923	31.549
Treasuries 91 days to 1 year	275.578	275.577	256.069	256.067	69.272
Treasuries over 1-yr to 5 years	1152.805	1152.801	1174.374	1174.361	170.807
Treasuries over 5-yr to 10 years	357.263	357.258	353.845	353.826	91.863
Treasuries over 10-years	633.604	633.589	632.949	632.897	101.337

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

MENENDEZ: Then let me ask you, finally, how does -- we see high -- rising levels of household debt, widening inequality, a neutral interest rate at historically low levels, and -- and, to me, it's critical that the Fed have the ability to respond in the event of another economic decline.

How does below-target inflation impact household debt? And what signs do you see of inflation coming close to the Fed's 2 percent target, let alone exceeding it by dangerous amounts?

YELLEN: So, as I said, I think the risks, with respect to inflation, are two-sided. But we're very aware of the fact that inflation has been running below our 2 percent objective, now, for many years, and we're very focused on trying to bring inflation up to our 2 percent objective. That's a symmetric objective and not a ceiling.

We know from periods in which we've had deflation, which -- of course, we don't have in this country, but that's something that has a very adverse effect on debtors, and can leave debtors drowned in debt. Now, we don't have a situation nearly that serious, but it is important, when we have a 2 percent inflation objective, to make sure that we achieve it. And we're focused on doing that.

before Friday's CPI inflation data... even if CPI is not the Fed's targeted inflation measure.

What follows is our real-time comment on [Yellen's HH testimony statement at 830am on Wednesday, July 12](#) that somehow moved the markets. (Glad something could move 10-yr Treasury yields however briefly, the auctions of \$24 billion 3-yrs Tuesday, \$20 billion 10-yrs Wednesday, and \$12 billion 30-yrs on Thursday did little.) We would emphasize that Yellen saw three risks to the outlook, inflation running under the 2% target, fiscal policy out of Washington, and world economic growth. The risks ahead from all three are equally balanced to the upside and to the downside. All the market heard was that inflation might delay a rate hike, partly because some FOMC members are saying as much.

Yellen to markets: damn the low inflation full speed ahead

Breaking economy news. Yellen's semiannual monetary policy report testimony. Gradual rate hikes are still needed despite low inflation that has some Fed officials on the Federal Open Market Committee worried. Bonds are rallying however on a Bloomberg news headline upon the 830am release of her statement *YELLEN SAYS INFLATION RESPONSE TO ECONOMY IS KEY UNCERTAINTY which makes it sound like more rate hikes are not necessarily forthcoming. We don't think this is Yellen's view on the path of rates going forward and it is unlikely to be the view of the next Federal Reserve Chairman either. Low inflation is a foolish worry of only a few of the hobgoblins of little minds at the Fed. The majority still favors one more rate hike this year, three more in 2018, and three more beyond that in 2019. Yellen is starting to look more like a Hawk now that the Doves have found in inflation a new reason to delay rate hikes.

The Bloomberg headline is from the three uncertainties Yellen outlined regarding the current economic outlook. Will inflation pick up in response the tightening labor market? What will be the effect on the economy from possible fiscal policy changes ahead? What are the prospects for world economic growth? Taken altogether these uncertainties pose equal odds that the economy will run faster or slower she said, so the Bloomberg headline is misleading in that it exaggerates the risks to the Fed's plan for a gradual pace of interest rate hikes. False news.

Low inflation is not a concern for companies and consumers in the economy anyway and Fed officials are wrong in trying to divert our focus to it. They are exaggerating the powers of their own limited policy measures by delaying the return of interest rates to normal neutral levels. Leaving interest rates down at these lower levels will not bring about faster inflation. Inflation will move up at the same speed regardless of whether the Fed funds rate is 1.25% or 3.0%.

Net, net, Yellen's testimony leaves our base case for policy unchanged where the balance sheet wind down is announced at the September meeting and the final Fed rate hike this year is delayed until the December meeting. There is no smoking gun in the statement itself about the timing of the balance sheet reduction announcement, but with the complete operational details of the process being announced in June, it makes little sense to delay the plan's actual implementation. We still don't know what will be the ultimate effects of the balance sheet reduction on the economy and markets, but traders and investors seem to embrace Yellen's characterization of the wind down for now as

something that will run silently in the background without having a major effect on market yields or liquidity. Time will tell if this is true.

For the moment, the economic outlook looks solid and there is little need for the Fed to deviate from its gradual pace of rate hikes over the next two and a half years. That is the message of Yellen's statement today. It's full speed ahead for the normalization of monetary policy Yellen said today with no need to delay it with the economy recovering nicely from the recession and financial crisis. The economy no longer requires the full support of the Federal Reserve. The economy is better than you think. Bet on it.

OTHER ECONOMIC NEWS THIS WEEK

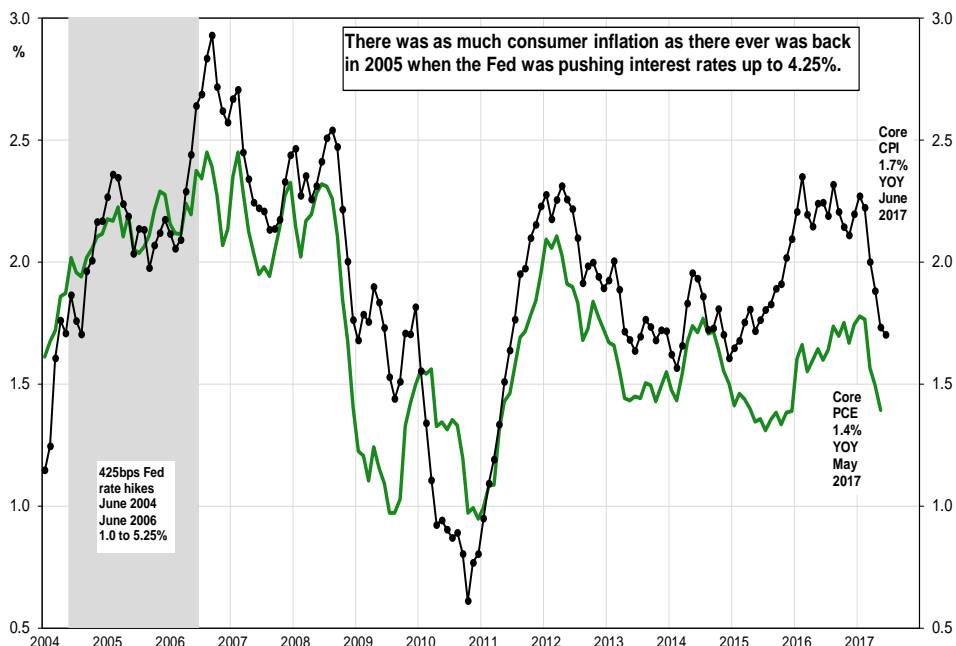
June gloom for retail sales, core CPI up just a tick, running less than 2% annual rate

Breaking economy news. Retail sales and CPI inflation, keeping in mind the Fed likes PCE inflation.

What on earth has happened to consumer spending? Retail sales are plainly sputtering looking at ex-auto sales which have fallen for two months in a row. Heck, the ol' reliable recession indicator signal was triggered when retail sales fell for three consecutive months. Two in a row, say it isn't so. Part of the story is slower inflation because real consumer spending that goes into GDP is actually moderate in the second quarter through May and rising 2.7% which is a solid rate of advance.

Retail sales down 0.1% in May and now down 0.2% in June, these are headline retail sales including autos as well. This soft patch economic data is all the market needed with 10-yr yields coming down, down, down. Yields rose last week on ECB tapering or QE exit or whatever Draghi is considering doing, and

yields are falling back this week on Yellen's testimony that they are carefully watching inflation (now another reason for them to stop raising rates) and weaker retail sales and cooler CPI inflation today. 10-yr Treasury yields were 2.33% before the retail sales news and are 2.28% a half hour later. At least the market is trading, just not our way.



Looking at the overall spending categories to see what was behind the 0.2% drop for total retail sales in June, food and beverage sales down 0.4%, the clothes on your back down 0.1%, sporting goods, hobby, book and music stores -0.6%, eating and drinking down 0.6% and a huge 3.1% monthly drop in miscellaneous retail sales.

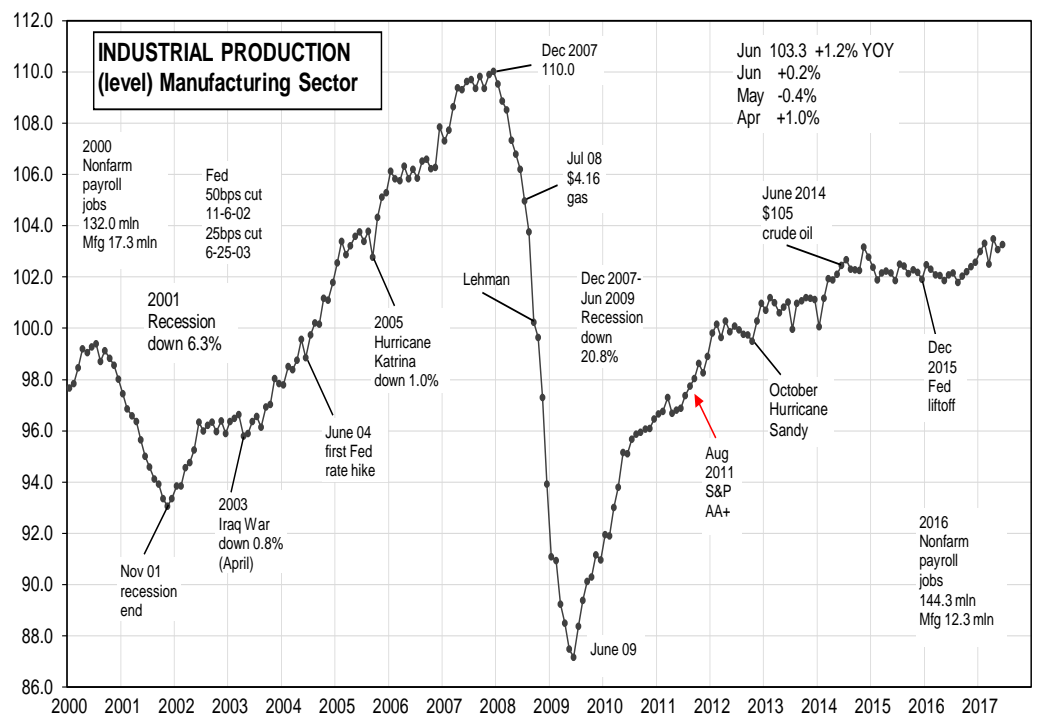
Meanwhile headline CPI inflation in June is down to just 1.6% which counts as a distinct cooling trend from the warmer reading of 2.7% in February this winter. Prices were hotter in February than they are now at the start of the summer. Go figure. Core CPI inflation which for Yellen tells her which way the wind blows on the price trend rose just 0.1% this month and 1.7% year-to-year. Monthly core inflation has risen 0.1% in each of the last three months which is no way to get to the Fed's 2% objective. Prices for new and used car and light trucks are down, air fares, wireless cell phone plans, household furnishings, recreation and clothing all down... these declines seem to be holding core inflation to just a modest overall rise of 0.1% this month.

Net, net, the economy is facing a gloomy start this summer with slower spending at shops and malls and not enough inflation to meet the Fed's objective. Economic activity is plainly subdued which may put the domestic U.S. economy back on the Fed's watch carefully list. Yellen's testimony cited just three risks to the outlook, inflation under target, world economic growth and Washington fiscal policies, but maybe the darkening economic skies right here in the good old USA need to be monitored as well. The Fed can continue with its gradual pace of rate hikes, but the emphasis is going to be more on the cautious side of gradual until retail sales show a little more oomph hopefully later on this summer.

What can we tell you?

Consumers are at the beach already this year at the start of the summer sitting on their wallets and causing growth to stall. The Trump administration's 3% GDP target looks in danger if they can't get the consumer off the beaches and back in the game.

The only good news today released later at 915am EDT was the Fed's own industrial



production report that rose 0.4% in June. Mining is back and rising 1.6% this month while manufacturing production was up 0.2%. Industrial output is expanding even if a lot of the activity is in the recovering oil & gas drilling sector. Factories are not coming back yet from overseas, it's mostly production in the energy sector. Rising industrial production was not enough good news on the economy to turn the day's bond rally around however.

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