One of the triggers for higher bond yields was more supply, but so far, the Federal budget deficit is taking its sweet time in climbing towards the trillion dollar mark. The Congressional Budget Office (CBO) recently adjusted the Fiscal Year (FY) 2019 budget deficit estimate to $973 billion for the year that begins in October. This was to cause a perfect storm in the Treasury markets that was to send bond yields soaring. In addition to financing the $973 billion of red ink from Washington, the Treasury would also have to sell the bonds coming off the Fed’s balance sheet. The unwinding of the Fed’s Treasury holdings will start a $360 billion annual rate of reduction beginning in October. Investors would have to absorb $1.333 trillion (973+360) more paper beginning October 1 this year.

We thought the budget deficit could widen more quickly after the massive tax cuts which robs the government of revenue. Massive isn’t an exaggeration. In the first 9 months of FY2018, corporate taxes fell 27.6% to $161.7 billion from $223.3 billion in the comparable period of FY2017. And the deficit is also supposed to move higher after the President signed the bipartisan budget agreement in February this year. The agreement breaks the 2011 “sequester” budget law which capped spending and lets Congress spend roughly $300 billion more over the next two years. But so far, Federal outlays through June 2018 are running $3.147 trillion, an increase of $117.0 billion or 3.9%.
Federal government spending is $117.0 greater in FY2018, but part of the increase is due to mandated programs that cannot be altered where social security retirement benefits are up $30.1 billion this year, although disability benefits have stopped rising and were roughly unchanged at $107.7 billion. Interest on the public debt is $38.0 billion higher. Interest on the public debt is $413.7 billion in FY2018 year-to-date which is a 13.1% share of $3.147 trillion of total budget outlays, a share that is going to go higher over the next few decades.

Other Federal spending programs in the news. Defense spending up 5.8% or $24.8 billion to $449.7 billion even if the country is not at war. Our Veterans, discussed during the election campaign, saw an increase of $7.6 billion to $138.5 billion. Medicare and Medicaid are still rising up 4.6 and 3.7 percent, respectively. Executive Office of the President is down 9.4% to $289 million this year.

On a 12-month trailing sum “annual” basis, Federal spending is $4.097 trillion in June 2018, which is 2.9% higher than FY2017 spending of $3.98 trillion, and almost matches 2017’s 3.3% spending increase. Federal outlays looked flat from 2011 to 2014 before picking up again. If you have any ideas on what Federal programs can be cut back, write your Congressional representative.
MARKETS OUTLOOK

We haven’t missed much with 10-yr yields still at 2.83%, same as the day we left. No change in yields this week either even with the Treasury selling $69 billion 3s/10s/30s, and with Dow stocks climbing over 500 points. Another trade war salvo, the U.S. list of $200 billion China imports subject to tariffs, on Tuesday evening, dropped stocks 219 points Wednesday, before climbing higher. We moved the interest rate forecast forward another quarter, time marches on. The curve inverts in Q4 2020, an event that has many Fed members afraid of their own shadows, afraid their interest rate hikes will invert the curve and cause a recession. We agree with Powell-curve inversion is meaningless.

CORPORATES: OFFERINGS DOMINATED BY BANKS; HONDA, TOYOTA

Corporate offerings were $13.8 billion in the July 13 week versus zero in the July 6 week. On Tuesday, PacifiCorp priced a $600 million 4.125% 30-yr (m-w +20bp) at 117 bps (A1/A+). The Oregon-based electric utility will use the proceeds to repay 5.65% bonds due in July. Corporate bonds (10-yr Industrials rated A2) were 96 bps above 10-yr Treasuries this week versus 99 bps last Friday.
FEDERAL RESERVE POLICY

The Fed meets July 31-August 1 to consider its monetary policy. It isn’t a live meeting where anything could possibly happen because there is no press conference, but next summer it will be Live! when Chair Powell starts his eight times a year press conferences in January. It’s going to be a lot of Powell all the time next year. When you are only thinking of moving rates 3 or 4 times a year, there is no reason to have eight formal meetings, let alone hold a press conference to explain to the public what you didn’t do. Move rates up to 3% and then stop and take a closer look would be our advice. We realize there won’t be as many votes to raise rates above 3%, take the punch bowl away from the economy, unless core PCE is above 2.2% and heading higher. Monetary policy is on autopilot the next four rate hikes. The odds of a 25 bps rate hike to 2.25% in September closed the week at 86%.

OTHER ECONOMIC NEWS THIS WEEK

Core CPI inflation of 2.3% as high now as it was in 2006 when Fed pushed rates to 5.25% (Thursday)

Breaking economy news. Another tick higher for core CPI inflation to 2.3%. Consumer inflation for core goods and services as measured by CPI is now as high as it was when the Fed last had an inflation scare in 2006 and pushed the Fed funds rate to its 5.25% peak. The Fed funds rate is 2.0% today. How times change. Core CPI inflation moved up a “rounded” tenth to 2.3% in June (2.24 to 2.26 percent year-year actually). Both core consumer inflation measures are at 2% or above now. May core PCE inflation moved up to the Fed’s 2.0% target in a report out on Friday, June 29. Inflation is moving up but it is hard to forecast core PCE inflation moving higher than 2.2% on a sustained basis.
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