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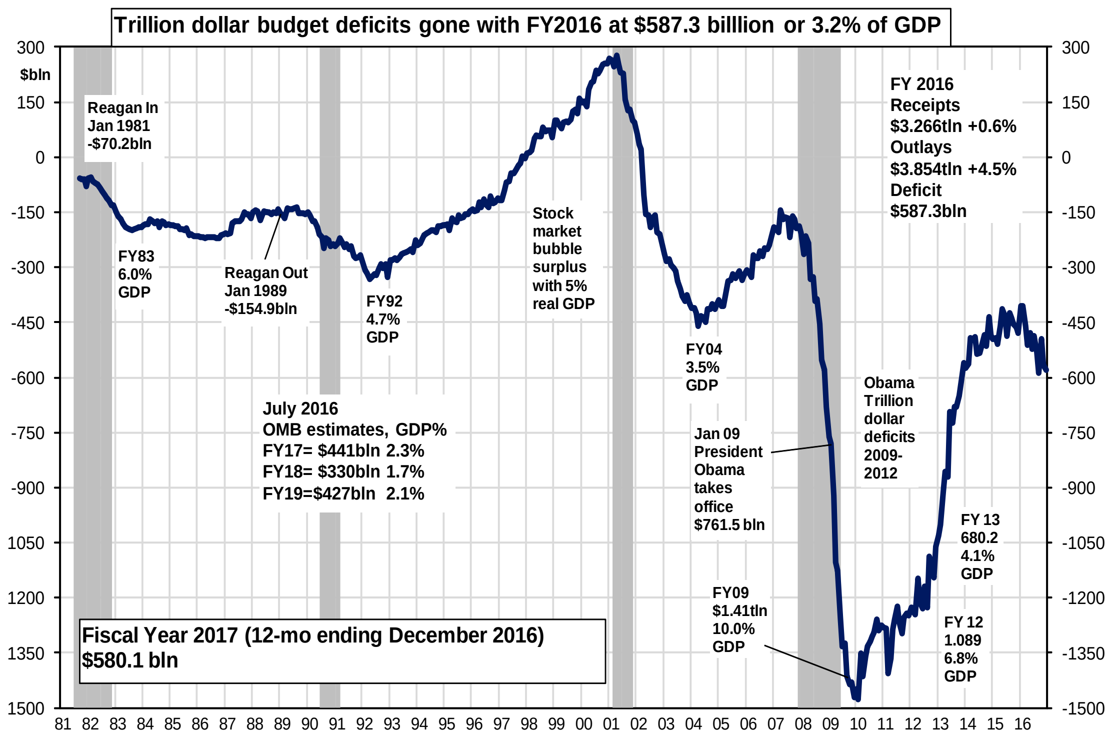
FEDERAL BUDGET DEFICIT: ALL IS QUIET BEFORE THE STORM



The last budget estimates from the outgoing Obama administration were for lower deficits the next three fiscal years ending Septembers always. It's all quiet for now but Team Trump storms into Washington later this month with new ideas on tax cuts and infrastructure spending. It is unclear where the deficit goes as deficits don't match with the Republican congress' long-held core values like a smaller government and revenue-neutral spending, if any Federal government spending must be done at all.

The budget deficit was $438 billion in FY15 and swung out to $587 billion in FY16. Part of the increase was "technical" benefits payment-timing issues ($40 billion), but outlays did rise 4.5%, while revenues rose just 0.6%. Revenues caught our eye. It is a progressive personal income tax system, and with personal incomes rising, why didn't taxpayers get kicked up into higher income brackets and pay more taxes? Nonwithheld income taxes fell $20 billion; the stock market was flat in 2015. In addition, corporate taxes are down about $40 billion; less profit in the second half of the year (oil & gas?) and partly tax law changes accelerating deductions for investment.

Lots of talk in Presidential campaign about getting corporations to pay more… not a lot of there there.

Corporate Taxes fiscal years $billions and percent changes										
2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
353.9	370.2	304.3	138.2	191.4	181.1	242.3	273.5	320.7	343.8	299.6
27.2	4.6	-17.8	-54.6	38.5	-5.4	33.8	12.9	17.3	7.2	-12.9

That was the past, so what about the future? The future is always uncertain and now the coming changes in Washington make it more so. The White House Office of Management and Budget (OMB) did its midsession review last summer and looks for FY deficits of $441 billion in 2017, $330 billion in 2018, and $427 billion in 2019. Not a lot of Federal deficit spending with the deficit remaining below the 3% of nominal GDP threshold level below which Bernanke said the government's red ink had just minimal impact on the economy.

As far as reviewing spending trends in the first three months of FY2017, no single category stands out. Total spending is down 3.3% in Q4 2017 versus Q4 2016-the first three months of these two fiscal years. Spending is down 3.3% or $32.1 billion so far this year due to timing differences on benefit payments due to posting dates falling on a weekend. Spending is actually about $50 to 60 billion higher.

There is not a lot to go on yet when it comes to assessing Team Trump's spending and tax cut ideas. There are no concrete proposals to analyze. More deficit spending might help push growth to 3-4 percent GDP, one of Trump's campaign promises. More deficit spending might push up interest rates. Our forecast for higher bond yields could use a boost itself. The Congressional Budget Office (CBO) did a long term outlook with economic assumptions back in August 2016. And brave enough to put out another Budget and Economic Outlook on Tuesday, January 24, just days after Trump's inauguration. Maybe he'll say something in his address to the Nation.

Federal Government Spending ($bln)			Fiscal	Fiscal	
Where to cut?	1 Qtr FY17	1 Qtr FY16	Year	Year	Full Year
	Q4 16-Q4 16	Q4 15-Q4 15	Changes	% chg	FY 2016
TOTAL BUDGET OUTLAYS	949.130	981.196	-32.066	-3.3	3,854.100
Legislative	1.172	1.115	0.057	5.1	4.344
Judicial	1.862	1.897	-0.035	-1.8	7.497
Agriculture	49.319	47.707	1.612	3.4	138.162
Food Stamps	18.030	18.922	-0.892	-4.7	73.081
Child Nutrition	6.519	6.410	0.109	1.7	21.978
Commerce	2.209	2.174	0.035	1.6	9.162
Defense	149.392	153.206	-3.814	-2.5	565.364
Military Personnel	42.542	49.412	-6.870	-13.9	147.905
Operation Maintenance	59.965	57.315	2.650	4.6	243.200
Procurement	26.458	27.600	-1.142	-4.1	102.651
Research Development	16.552	15.236	1.316	8.6	64.873
Military Construction	1.703	2.173	-0.470	-21.6	6.677
Education	11.482	14.032	-2.550	-18.2	76.981
Office of Federal Student Aid	5.336	5.759	-0.423	-7.3	42.796
Energy	6.471	6.331	0.140	2.2	25.852
Health Human Services	257.956	265.769	-7.813	-2.9	1102.965
Medicare	150.786	167.718	-16.932	-10.1	698.609
Medicaid States Grants	96.411	91.388	5.023	5.5	368.280
Homeland Security	13.116	11.053	2.063	18.7	45.195
Housing Urban Development	10.958	10.175	0.783	7.7	26.393
Interior	3.144	2.634	0.510	19.4	12.584
Justice	7.372	6.232	1.140	18.3	29.523
Labor	5.828	5.704	0.124	2.2	41.371
State Unemployment Benefits	7.081	7.406	-0.325	-4.4	32.178
State	6.603	6.968	-0.365	-5.2	29.448
Transportation	19.350	18.622	0.728	3.9	78.419
FAA	3.778	3.753	0.025	0.7	15.560
Federal Highway Admin.	11.183	10.091	1.092	10.8	114.055
Treasury	150.945	138.118	12.827	9.3	526.116
TARP	0.961	1.031	-0.070	-6.8	4.961
IRS	13.543	12.517	1.026	8.2	133.126
Earned Income Credit	0.150	0.054	0.096	177.8	60.580
Child Tax Credit	0.081	0.061	0.020	32.8	20.188
Interest on Public Debt	139.126	123.860	15.266	12.3	429.963
Veterans Affairs	43.701	48.465	-4.764	-9.8	174.018
Corps of Engineers	1.727	1.347	0.380	28.2	6.388
Other Defense Civil Programs	14.663	20.592	-5.929	-28.8	64.505
Environmental Protection	2.406	2.477	-0.071	-2.9	8.729
Exec. Office of President	0.103	0.100	0.003	3.0	0.395
International Assistance	5.405	4.407	0.998	22.6	16.241
NASA	5.190	5.143	0.047	0.9	18.829
National Science Foundation	1.701	1.589	0.112	7.0	6.904
Personnel Management	23.667	22.558	1.109	4.9	91.316
Small Business Admin.	0.265	0.208	0.057	27.4	-0.444
Social Security Admin.	245.408	269.566	-24.158	-9.0	976.783
Retirement Benefits	194.758	208.002	-13.244	-6.4	762.126
Federal Disability Payments	35.923	42.360	-6.437	-15.2	143.130
Other Independent Agencies	2.778	6.471	-3.693	-57.1	13.162

Anyway the CBO last August was looking for sharply higher interest rates when making their budget forecasts years (and years) into the future. 10-yr Treasury yields would not go above 3% until Q4 2019 when it averages 3.1% and 3-month Treasury bills (the Fed funds rate, close enough for government work) will average 2.2% in Q4 2019. Not high enough on the rates forecast for us, but okay. They do "see" 10-yr yields averaging 3.6% from the years 2022 to 2026 if you can wait for that. Here is their reasoning.

> "That projected rise in interest rates reflects the expectation that both foreign and domestic economic growth will improve, which should result in higher interest rates abroad as well as in the United States. In addition, CBO expects the "term premium"—the extra return paid to bondholders for risk associated with holding long-term Treasury securities—to increase from historically low levels. In CBO's estimation, the term premium has remained low, in part, because of low foreign interest rates, heightened concern about global economic growth, and increased demand for Treasury securities as a hedge against possible adverse economic outcomes." Not a lot here to "Bet on it!" but okay, thanks.

Speaking of interest rates, here is our current forecast. We show rates rising. But basically there is no interest rate "forecast." How could there be after the Bernanke/Yellen Fed has left rates at zero since December 2008. The interest rate "cycle" is broken. Our "interest rate forecast" is based on this Fed or the next Fed under Donald Trump returning interest rates to normal levels. Normal? Normal is about 4% for the Fed funds rate. Once it gets there we can start "forecasting" rates again.

	30-Dec 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Bond	3.07	3.10	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.20	4.30
10-Yr Note	2.45	2.40	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	4.00	4.10
5-Yr Note	1.93	2.00	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.80	4.00
2-Yr Note	1.19	1.60	1.80	2.00	2.20	2.50	2.75	2.85	3.10	3.30	3.50	3.50	3.70
3-month Libor	1.00	1.25	1.50	1.70	1.95	2.20	2.45	2.70	2.95	3.20	3.45	3.45	3.70
Federal Fund Rate	0.75	1.00	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	126	80	70	70	80	70	65	65	60	50	40	50	40
Libor/funds spread	25	25	25	20	20	20	20	20	20	20	20	20	20

The trend in 10-yr Treasury yields has been relatively lifeless so far in 2017 after falling the day before the Friday, January 6 payroll jobs report with its "better" wage data (2.9%, just not for working people). On Thursday, January 5 the 153K ADP jobs report did not suggest a big number on Friday, the dollar and stocks fell, and the technicals did not look good on the charts. Yields closed this week at 2.40%, after falling at the start of the week on Monday with a $2 drop in crude oil (to $51.96 only). The retail sales and PPI inflation reports brought out sellers with 10-yr yields rising from 2.33 to 2.38% five minutes after the 8:30am New York time release of the economic news.

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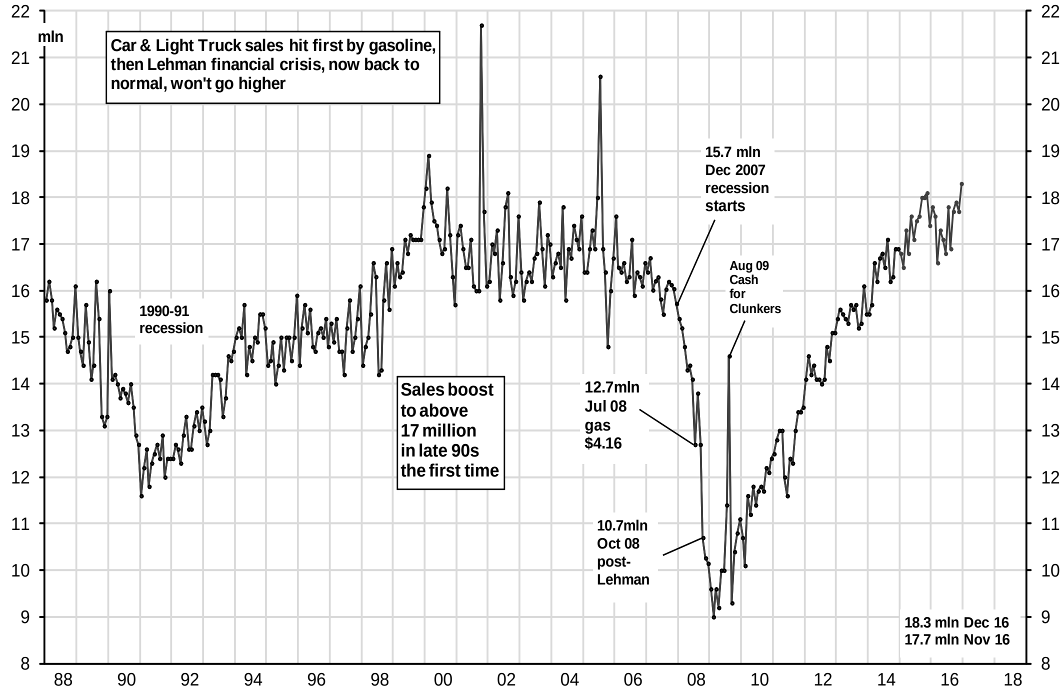
Other News This Week

Consumer hits the car lots in December while inflation shoots higher

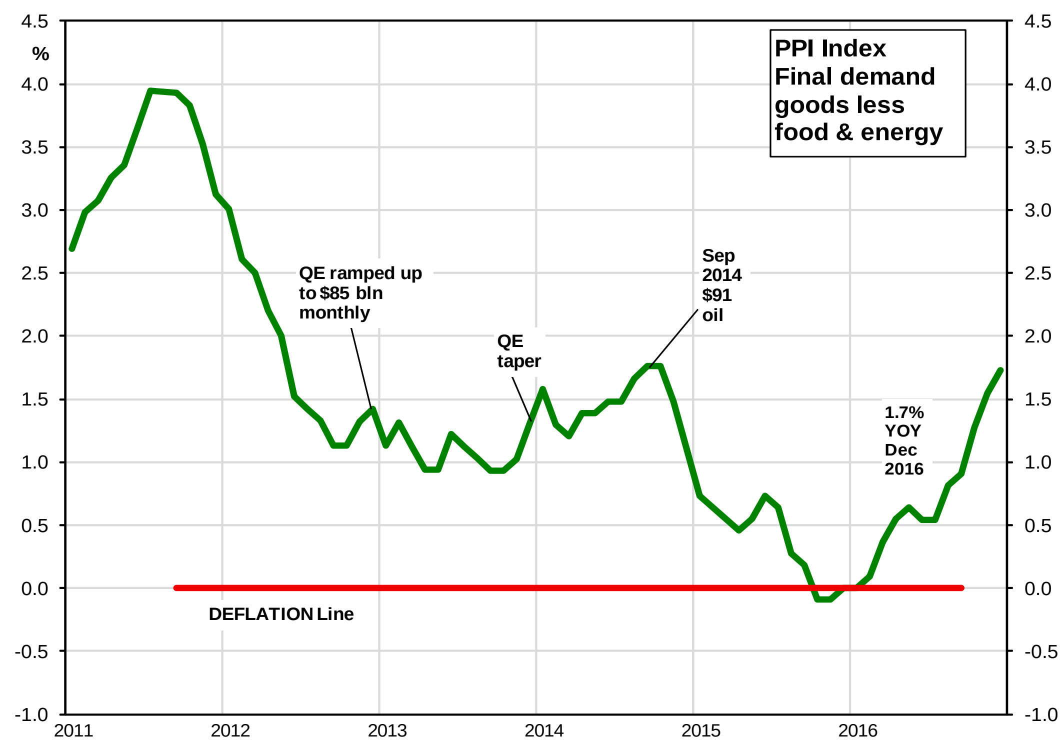
Breaking economy news.

Retail sales and Producer Prices (PPI). We don't know about PPI anymore, but retail sales are still the second most important economic statistic of the month after the employment report, and yet we did not read many stories on this important economic news in the newspapers the next morning.



Retail sales rose 0.6% in December as car buyers were out in force. Gas prices are up with energy overall during the Trump rally but that did nothing to kill the consumer's thirst for great big SUVs, those thinly disguised trucks parked in the way at the supermarket. We already know car & light truck sales rose 3.1% to 18.3 million in December, a record high for this long expansion from recession now in its eighth year. (Year number nine starts this summer in July at your local picture theatre.)

If there's growth, there must eventually be inflation. Final demand PPI goods prices ex-food and energy have risen steadily since July and kicked it up a notch the final two months of the year, +0.2% in November and +0.3% in December. Inflation is arising.



Net, net, consumers still got it and they're spending it, even though it is more at the car lot than at the shopping malls this month. Whenever we hear the lament about the low turnover and subpar let's make America great again growth, we always point people to retail sales at the cash register with sales up 4.4% the last year. This is growth, count it, retailers are. Ka-ching noises coming from their cash registers opening and closing, opening and closing. Sure, some of it is lazy, Internet sales made on smart phones from people's couches rising 10.4% in 2016, but bricks-and-mortar shops are not dead yet.

Meanwhile, as the economic expansion hits full maturity, inflation is picking up at the lowest production level for goods. Final demand goods prices ex-food and energy are now up 1.7% the last 12-months which is the highest in two years. Even Fed officials can see where inflation is headed. We expect Fed officials to keep with their promise to raise rates two or three times this year. This is not the picture of an economy that requires the support of the central bank's policymakers. The economy is stronger than you think. Bet on it.

Analyst Certification

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