Financial Market Weekly

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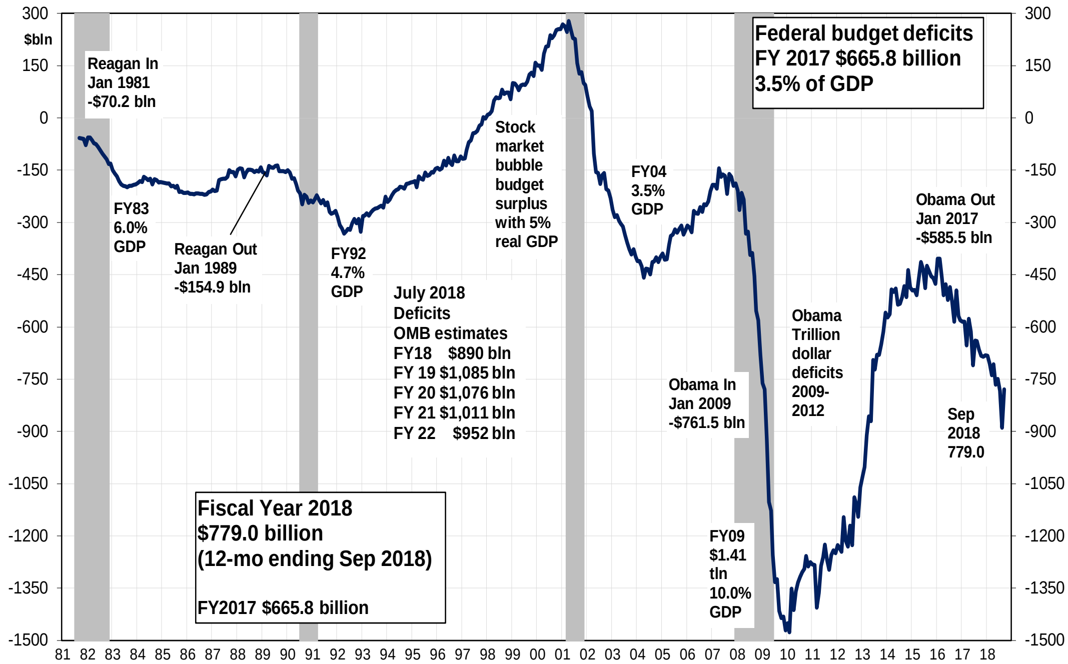
FEDERAL BUDGET DEFICIT $779 BILLION FY2018 ON ITS WAY TO $1.1 TRILLION FY2019



Last year is over, this year has just begun if you are the Federal government. The budget deficit was $779 billion in FY2018 ending September, and next year it will be $1.1 trillion according to the Office of Management and Budget's (OMB) Mid-Session Review done in July this year. The Obama trillion dollar deficits are back. The deficits were above $1 trillion for four years from 2009 to 2012 both because of the recession, and engineered purposely in order to fight the recession. Maybe Treasury yields overshoot on the added supply, especially with foreigners no longer buying our debt like they did a decade ago, yields overshooting where the Fed thinks it is going on interest rates in 2020-3.5%.

The Republicans now are looking for ways to cut the deficit after voting through the massive tax cuts last December. Senate Majority Leader O'Connell said this week "entitlements" were the key. Not sure how they are going to do this with 10,000 poor & angry baby boomers retiring every day.

Federal Government: Where's the Money Coming From?

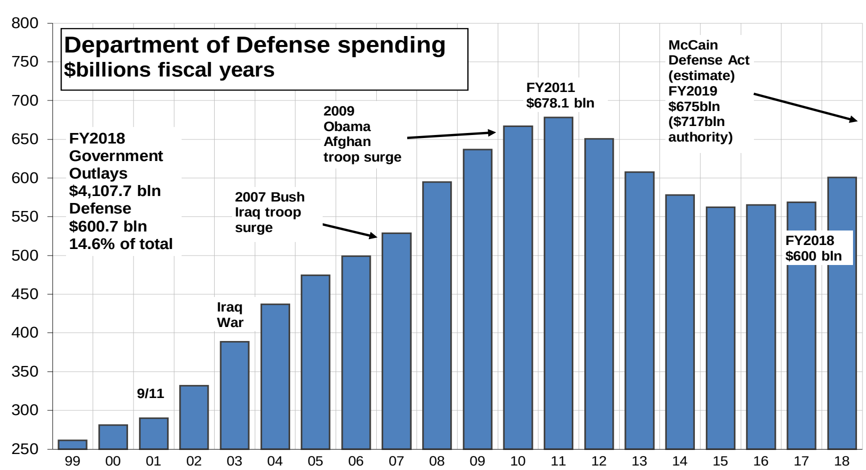
FY18/FY17 % change	Fiscal Years $billons	Sep 2018	Sep 2017	Sep 2016	Sep 2015
0.4	Budget Receipts	3,328.7	3,314.9	3,266.8	3,248.7
6.1	Income taxes	1,683.5	1,587.1	1,546.1	1,540.8
-31.1	Corporation taxes	204.7	297.0	299.5	343.8
0.8	Social retirement taxes	1,121.1	1,111.9	1,062.3	1,010.4
-1.7	Unemployment insurance	45.0	45.8	48.8	51.2
13.4	Excise taxes	95.0	83.8	95.0	98.3
0.9	Estate and Gift Taxes	23.0	22.8	21.4	19.2
19.4	Customs Duties	41.3	34.6	34.8	35.0
-12.8	Miscellaneous	115.0	131.9	158.7	149.9

They are banking on what little entitlements they are supposed to get. President Trump told his cabinet this week that they could save 5% on budget outlays, going from Federal Agency to Agency looking for wasteful spending things to cut. The Tax Cuts and Jobs Act hasn't paid for itself with faster economic growth, and more tax collections yet. Corporate income taxes fell 31.1% or $92.3 billion in FY2018 to $204.7 billion. Income taxes are up 6.1% in FY2018 to $1.683 trillion. We will let you know our forecast for FY2019 individual income taxes once we figure out what we might personally owe Uncle Sam. Secretary Mnuchin's Treasury Department says the Tax Cuts and Jobs Act is delivering results for the American people, but it also encourages, which sounds like cautions, taxpayers to check their withholding amounts. To us this means not all are going to be winners when the tax bill comes due on April 15, 2019, especially those in states like California and New York.

Federal spending rose another 3.2% or $127.0 billion in FY2018 to $4.107 trillion. Disaster relief was part of the spending increase (up $12.4 billion to $21.2 billion) as was defense spending +$31.8 billion to $600.7 billion). Defense spending was at an all-time high in FY2011, before coming down to the recent low in FY2015 because we were no longer at war. Now it has gone back up because.

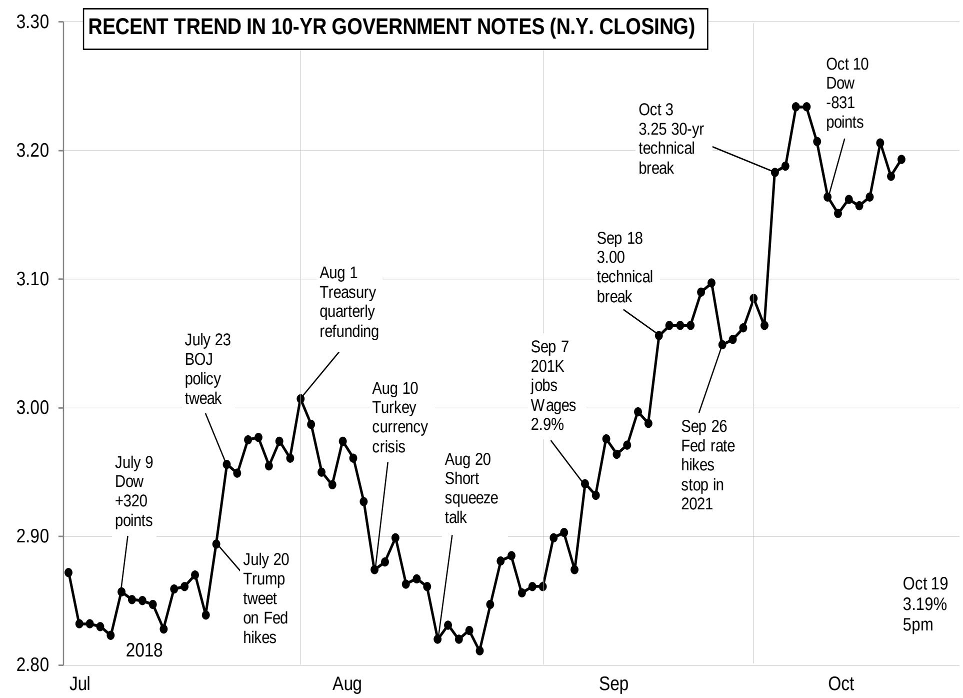
That's what is going up for Federal government spending. Other things that ~~cannot be~~ better not be cut are Social Security retirement benefits adding $41.9 billion more this year (baby boom will be "gone" by the year 2050). Interest on the public debt added $64.6 billion more. That's the Fed's fault.

Federal Government Spending ($bln) **Where to cut?**	4 Qtrs FY18 Q4 17-Q3 18	4 Qtrs FY17 Q4 16-Q3 17	Fiscal Year Changes	Fiscal Year % chg
TOTAL BUDGET OUTLAYS	4,107.741	3,980.720	127.021	3.2
Legislative	4.670	4.499	0.171	3.8
Judicial	7.779	7.566	0.213	2.8
Agriculture	136.713	127.563	9.150	7.2
Food Stamps	68.493	70.148	-1.655	-2.4
Child Nutrition	22.829	22.471	0.358	1.6
Commerce	8.562	10.304	-1.742	-16.9
Defense	600.706	568.905	31.801	5.6
Military Personnel	145.827	144.706	1.121	0.8
Operation Maintenance	256.663	245.186	11.477	4.7
Procurement	112.667	104.126	8.541	8.2
Research Development	76.975	68.126	8.849	13.0
Military Construction	6.723	6.673	0.050	0.7
Education	63.707	111.702	-47.995	-43.0
Office of Federal Student Aid	45.917	84.986	-39.069	-46.0
Energy	26.481	25.796	0.685	2.7
Health Human Services	1120.500	1116.764	3.736	0.3
Medicare	711.499	708.299	3.200	0.5
Medicaid States Grants	389.157	374.681	14.476	3.9
Homeland Security	68.374	50.502	17.872	35.4
Housing Urban Development	54.665	55.623	-0.958	-1.7
Interior	13.210	12.141	1.069	8.8
Justice	34.521	30.977	3.544	11.4
Labor	39.638	40.120	-0.482	-1.2
State Unemployment Benefits	28.135	30.388	-2.253	-7.4
State	26.385	27.061	-0.676	-2.5
Transportation	78.494	79.440	-0.946	-1.2
FAA	15.999	15.866	0.133	0.8
Federal Highway Admin.	45.604	44.167	1.437	3.3
Treasury	629.448	546.400	83.048	15.2
TARP	2.226	4.146	-1.920	-46.3
IRS	145.209	139.539	5.670	4.1
Earned Income Credit	58.640	59.749	-1.109	-1.9
Child Tax Credit	18.597	19.408	-0.811	-4.2
Interest on Public Debt	521.553	456.955	64.598	14.1
Veterans Affairs	178.509	176.050	2.459	1.4
Corps of Engineers	5.082	6.453	-1.371	-21.2
Other Defense Civil Programs	55.368	58.695	-3.327	-5.7
Environmental Protection	8.085	8.088	-0.003	0.0
Exec. Office of President	0.382	0.411	-0.029	-7.1
International Assistance	21.632	18.922	2.710	14.3
NASA	19.754	18.698	1.056	5.6
National Science Foundation	7.166	7.215	-0.049	-0.7
Personnel Management	98.802	95.461	3.341	3.5
Small Business Admin.	0.046	0.439	-0.393	--
Social Security Admin.	1039.902	1000.812	39.090	3.9
Retirement Benefits	833.038	791.098	41.940	5.3
Federal Disability Payments	143.731	142.957	0.774	0.5
Other Independent Agencies	7.770	11.660	-3.890	-33.4



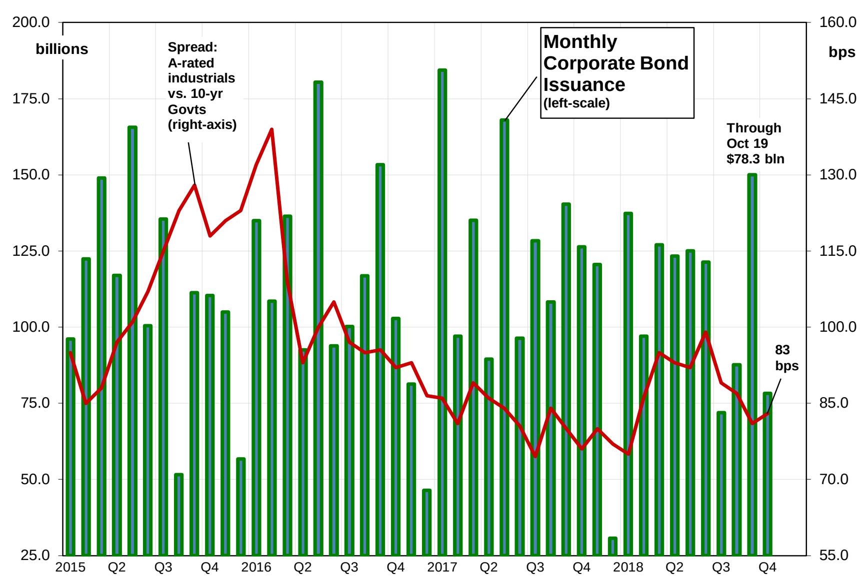
MARKETS OUTLOOK

	28-Sep 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
30-Yr Treasury	3.21	3.25	3.40	3.45	3.65	3.60	3.80	3.85	3.85	3.95	3.95
10-Yr Note	3.06	3.10	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95	3.95
5-Yr Note	2.95	3.00	3.10	3.20	3.40	3.45	3.65	3.75	3.80	3.95	3.95
2-Yr Note	2.82	2.90	3.00	3.15	3.40	3.40	3.60	3.75	3.80	4.00	4.00
3-month Libor	2.40	2.70	2.95	3.20	3.45	3.45	3.70	3.90	3.90	4.20	4.15
Fed Funds Rate	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00	4.00
2s/10s spread	24	20	20	15	10	10	10	5	0	(5)	(5)
Libor/funds spd	15	20	20	20	20	20	20	15	15	20	15



Bond yields were little changed at 3.19% on Friday versus 3.16% last Friday. The stock market losses last week and uncertain stocks recovery this week seems to have taken some wind out of the sails of the bond yield rally. The 10-yr yield high this year was 3.26% on October 9. The technical trend in yields remains higher though. A major catalyst for higher yields is supply: more Treasury auctions. The Administration's Federal budget estimate for fiscal year 2019 starting October 1 is $1.1 trillion, and add an extra $360 billion on top of that for the Fed's balance sheet wind down, also starting in the October 1 year. It will take four years to bring the Fed balance sheet down slowly to normal.

CORPORATE BONDS: FEDEX, PROGRESSIVE CORP, PEMEX, UBER



Corporate offerings were $24.1 billion in the October 19 week versus $6.8 billion in the October 12 week. On Monday, Conagra Brands sold $7.0 billion 3s/5.5s/7s/10s/20s/30s/FRNs. It priced a $1.3 billion 4.85% 10-yr (m-w +30bp) at 170 bps (Baa3/BBB). The branded food company (Reddi-wip, Slim Jim, Hunt's) will use the proceeds to finance in part its merger with Pinnacle Foods. Corporate bond yields (10-yr Industrials rated A2) were 83 bps above 10-yr Treasuries this week versus 80 bps last Friday.

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FEDERAL RESERVE POLICY

The Fed meets November 7-8 to consider its monetary policy. (That's right: Fed decision announced 2pm EST Thursday, November 8… not a Wednesday.) Twelve of sixteen Fed officials see a fourth rate hike this year to 2.5%. In December.

Next year, 4 out of 16 Fed officials see three rate hikes to 3.25%, 7 see two or fewer rate hikes, and 5 see more than three hikes. The Committee seems less certain on the path of rates in 2019 as there are different opinions about where neutral rates for the economy are. President Trump sees no rate hikes next year.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	17-Oct	10-Oct	3-Oct	26-Sep	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2294.245	2294.227	2294.210	2313.208	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1680.109	1681.778	1681.775	1681.763	0.000
Primary credit (Discount Window)	0.010	0.013	0.064	0.064	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)	0.007	0.007	0.007	0.007	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	
Central bank liquidity swaps	0.089	0.090	0.151	0.090	62.000
Federal Reserve Assets	4223.2	4224.6	4222.4	4240.4	961.7
3-month Libor %	2.45	2.43	2.41	2.39	2.82
Factors draining reserves					
Currency in circulation	1691.479	1692.975	1689.897	1686.023	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.174	2.390	2.954	5.625	0.000
Reserve Balances (Net Liquidity)	1831.618	1878.887	1837.587	1837.874	24.964
Treasuries within 15 days	23.833	0.026	0.026	19.033	14.955
Treasuries 16 to 90 days	79.615	101.337	101.337	83.128	31.549
Treasuries 91 days to 1 year	308.510	310.595	310.595	315.819	69.272
Treasuries over 1-yr to 5 years	999.357	999.355	999.352	1010.629	170.807
Treasuries over 5-yrs to 10 years	265.775	265.769	265.763	267.467	91.863
Treasuries over 10-years	617.154	617.146	617.137	617.133	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

The September 25-26 Fed meeting minutes were released on Wednesday, three weeks after the meeting as is usual. Bond yields moved four basis points higher on the news (to 3.21%) as the headlines noted a number of Fed officials wanted to move rates above neutral levels at some point. Not exactly new news as the median Fed forecasts in the table below show a Fed funds rate of 3.25% at the end of next year and 3.5% at the end of 2020. The actual quote from the Fed meeting minutes was a "few participants" said policy would need to be modestly restrictive for a time and "a number" said it would be necessary to raise the Fed funds rate temporarily above neutral, and "a couple of participants" did not favor a restrictive policy stance unless there were signs of an overheating economy and rising inflation. Clear enough for now. The meeting was September 25-26 though before Dow industrials fell 831 points on Wednesday, October 10, and 545 points more on Thursday October 11.

Fed Individual Forecasts					
Fed funds rate by year-end					Longer
Votes	2018 End	2019 End	2020 End	2021 End	run
1	2.125	2.125	2.125	2.125	2.500
2	2.125	2.375	2.625	2.625	2.500
3	2.125	2.625	2.875	2.875	2.500
4	2.125	2.875	3.125	2.875	2.750
5	2.375	2.875	3.125	2.875	2.750
6	2.375	2.875	3.125	3.000	2.750
7	2.375	2.875	3.125	3.125	2.750
8	2.375	3.125	3.375	3.375	3.000
9	2.375	3.125	3.375	3.375	3.000
10	2.375	3.125	3.625	3.375	3.000
11	2.375	3.125	3.625	3.375	3.000
12	2.375	3.375	3.625	3.500	3.000
13	2.375	3.375	3.625	3.625	3.000
14	2.375	3.375	3.625	3.625	3.250
15	2.375	3.375	3.625	3.875	3.500
16	2.375	3.625	3.875	4.125	
17					
Median	2.375	3.125	3.375	3.375	3.000
Meeting	Sep 2018	Sep 2018	Sep 2018	Sep 2018	Sep 2018

Year-ends for Interest Rates				
Percent %	2018	2019	2020	2021
Eurodollar futures	2.77	3.275	3.3	3.255
Fed's Sept forecast	2.5	3.25	3.5	3.5
Eurodollar futures price where 3-month Libor will be in the future.				
Friday, October 19, 2018 3-month Libor 2.48 %				

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OTHER ECONOMIC NEWS THIS WEEK

The tax cut well's gone dry for consumers: spells growth slowdown in 2019 (Monday)

Breaking economy news. The monthly retail sales report, the second most important economic report for the month in the old days when markets used to trade the news. Retail sales rose just 0.1% in September (0.1 for the second month in a row) and it was all autos as retail sales ex-autos fell 0.1% in September. We already had the data in hand saying car & light truck sales jumped 4.8% to 17.4 million at an annual rate in September from 16.6 million in August.

To be sure, the softer tone in the retail spending report mirrors the hurricane-dampening effect seen in the monthly employment report with a sharp 1.8% drop in spending at eating & drinking places. We will see if consumers return to the bars and restaurants in the next few months as the storms clear or whether there is something darker behind the drop in their spending. Spending at eating & drinking places is almost 12% of total consumer purchases.

Retail spending, actual dollars, each month

	$million	% to	Percent Changes %		
	Sep 2018	Total	Sep	Aug	Year/year
Total Retail Sales	509,041	100.0	0.1	0.1	4.7
Motor vehicles/parts	102,937	20.2	0.8	-0.5	1.1
Furniture/furnishings	10,276	2.0	1.1	-0.8	4.3
Electronics/appliances	8,460	1.7	0.9	0.6	5.8
Building materials/garden	32,891	6.5	0.1	0.8	1.5
Food & beverage	62,159	12.2	0.2	-0.3	2.9
Health/personal care	29,264	5.7	-0.3	0.5	4.1
Gasoline stations	43,640	8.6	-0.8	1.1	11.4
Clothing/accessories	22,913	4.5	0.5	-2.8	4.6
Sporting goods, books	6,659	1.3	0.7	-0.5	-3.8
General merchandise	60,294	11.8	0.3	0.1	3.6
Department stores	12,360	2.4	-0.8	-0.9	-1.5
Miscellaneous retailers	10,910	2.1	0.1	2.7	2.9
Eating & drinking places	60,575	11.9	-1.8	0.3	7.1
Nonstore retailers (internet)	58,063	11.4	1.1	0.5	11.4

We believe it is still true that Republicans gave the American people the Tax Cuts and Jobs Act, but now consumers have spent every last dollar they were given, leaving nothing for a rainy day and nothing left to power economic growth next year.

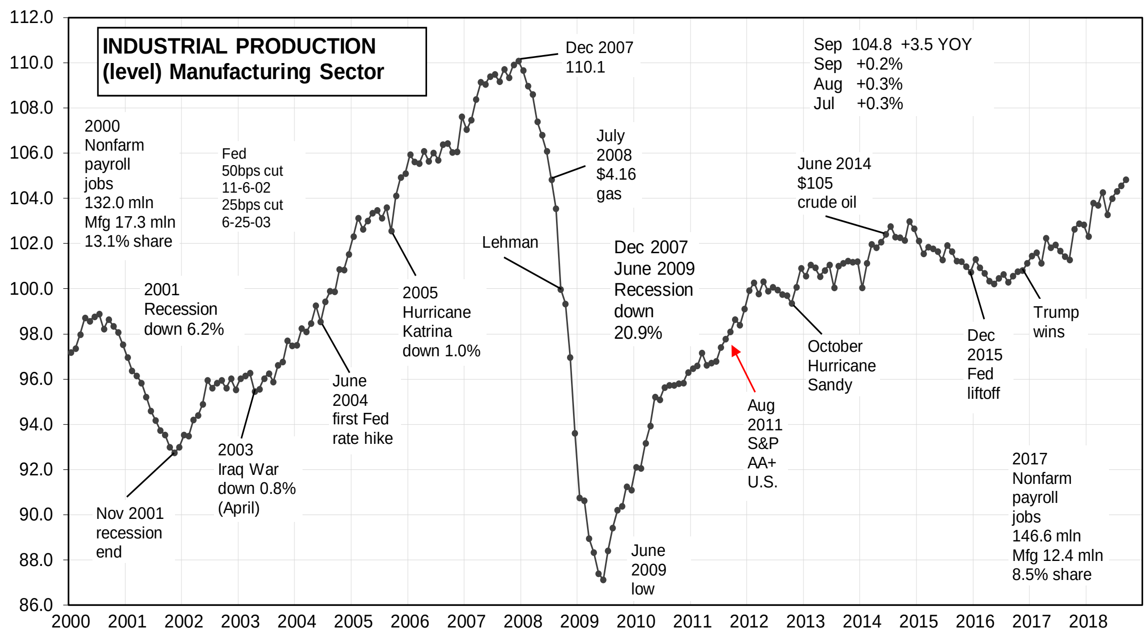
Net, net, nothing lasts forever, trees grow to the sky, but the economy moves up and down. The consumer seems to have lost their footing at the end of the third quarter which doesn't bode well for the final quarter of 2018. Simply put, it looks like the consumer has spent all their tax cuts monies and are more concerned about the the Trump administration's trade war with the world. There is no forward momentum for the economy from the consumer in September, and this could cause economists to mark down their estimates for GDP growth as we head into the November elections. That 4.2% real GDP report in the second quarter is a one-off, with growth perhaps 3.0% in the third quarter now, and real economic growth in the fourth quarter looking weak at barely 2.0%.

There may be a technical reason for the soft tone of retail spending today given the outsized drop, possibly storm-related, for expenditures at restaurants and bars, but the handwriting for the economy is on the wall. The bump in consumer spending from the Tax Cuts and Jobs Act is just as temporary as the hurricane effect. Tax cuts boost spending for one year at most. Mainstream Republican economists have always maintained that tax cuts don't work because consumers save it. Despite all the hoopla being made by politicians reminding voters about the historic tax cuts, most Americans are in the dark about the final tax bill this year because the tax forms have not been made available yet to the tax-prep software companies. There could be a rude awakening for many taxpayers when they find out their withholding rates were reduced, but they will actually end up owing more next April.

Manufacturing industrial production up 3.5% the last year (Tuesday)

Breaking economy news. The Fed's own manufactured statistic, industrial production is out. Can't have a recession unless factories stop producing more goods, and that is not the case. Industrial production is up 5.1% in September from last year levels, helped along by a 13.4% rise in oil & gas drilling which at some point will slow. So-called Mining production is about 14% of total production.

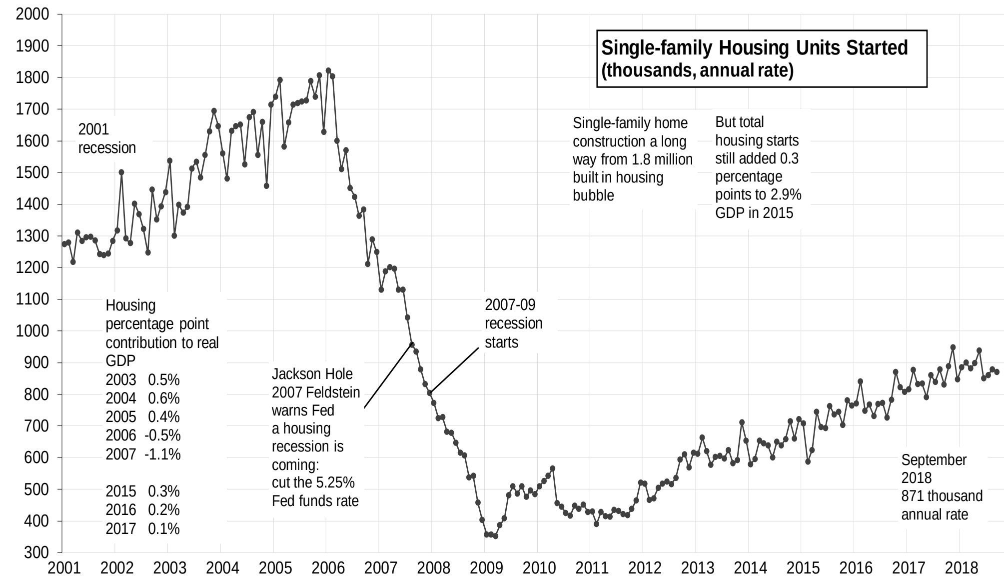
Net, net, factory output is surprisingly firm for this late in an economic expansion and shows the supply chain is not totally disrupted by the import tariffs put on during the trade war. U.S. factories continue to get the inputs they need to build the products that consumers and other businesses rely on.



There are a lot of recession forecasts from economists out there on the horizon, but as long as industrial production is increasing, the downside risks to the economy will be held at bay. Factory output declines in every recession on record, and right now it is purring along quite well thank you. There may not be that many factories coming back to America from overseas, but output from existing manufacturing plants is humming and should keep the broader economy on track to shatter records for longevity left over from the Clinton years in the 1990s. Manufacturing production is up a strong 3.5% in the last twelve months which is the strongest output seen from manufacturers since 2010 when output bounced back 5.2% following the recession. Stay tuned. Story developing. The economy cannot be going off the rails yet as long as companies are able to get the supply chain goods they need to ramp up industrial production. Bet on it.

Percent changes			Industrial Production September 2018		
July	Aug	Sep	YOY		Weight
0.3	0.4	0.3	5.1	Total Index	100.0
0.3	0.3	0.2	3.5	Manufacturing	75.5
0.8	0.4	0.5	13.4	Mining	14.1
0.0	1.1	0.0	5.4	Utilities	10.4
			Manufacturing payroll jobs 12.7 million +278K YOY 10.0% of Private Payroll Jobs		

Housing starts down but not out (Wednesday)



Breaking economy news. Residential housing construction fell 5.3% in September to 1.201 million at an annual rate. Construction fell sharply in June this year and hasn't managed much of a comeback the last three months. The news is not quite so bad looking at the details although we don't recommend doing so this month because it is an overly complicated story. Single family home sales are the trend we are most interested in as construction of these units is the proverbial canary in the coal mine warning for the economic outlook. Interest rate sensitive sectors of the economy are first to feel the wrath of higher rates from the Federal Reserve. Not a lot of weakness in single-family home starts this month at 871 thousand down 0.9% from August; it is still up 4.8% from last year. Single family homes down 6.7% in the Northeast, 6.8% in the South, but up 10.2% in the Midwest and 7.0% in the West. Multifamily starts showed big swings in both directions according to the geographical breakdown which is hard to explain, so we won't. Single family is what we are most interested in.

Homebuilders are not certain if they build it that Millennials will come. The single family home market has been starved for buyers and it still faces demographic headwinds where the population aged 25-54 is relatively stagnant. It is also true homebuilders cannot build homes that are affordable for cash-strapped Millennials struggling to pay off their student loans with their lackluster starter-salary wages. Home prices have reached levels that are unaffordable for most Americans.

Net, net, residential housing construction weakness this month is no smoking gun for the economic outlook ahead. Housing has not peaked for this cycle because the Fed's higher interest rates are starting to bite. Single family home construction has lagged in this long economic expansion with builders starting 871 thousand homes in September about half the housing bubble pace of 1.8 million started in early 2006 before the bubble burst. The construction trend cannot be over before it recovers even halfway can it? Anyone, anyone? Stay tuned. Story developing.

Housing Starts Total, Single-Family, Multi-Family

	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Sep 18	1201	871	330	120	56	160	130	567	441	354	244
Aug 18	1268	879	389	93	60	186	118	657	473	332	228
Sep 17	1158	831	327	101	75	186	126	543	410	328	220
% Chgs											
Sep/Aug	-5.3	-0.9	…	29.0	-6.7	-14.0	10.2	-13.7	-6.8	6.6	7.0
Sep/Sep	3.7	4.8	…	18.8	-25.3	-14.0	3.2	4.4	7.6	7.9	10.9

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