$666 BILLION FEDERAL BUDGET DEFICIT LAST YEAR, WITH TAX CUTS ON THE WAY; WHY NOT? THE NATIONAL DEBT IS ONLY $20 TRILLION

It’s hard to keep up with the latest thinking down in Washington when it comes to the budget and taxes. The stock market rallied on Friday in part because the Senate voted through (51-49) a budget resolution for fiscal year 2018 late on Thursday night. It includes $1.5 trillion for “comprehensive tax reform” over ten years. But it needs to be reconciled somehow with the House budget resolution which is deficit neutral. Meanwhile, on Friday, the actual Federal budget results for the final month of fiscal year 2017 (FY17) were released. The number is 6-6-6, setting the new Administration up for an ominous start when it comes to government spending: how much money will it take to make America great again. The budget deficit starting out is already at $666 billion in FY17.

If the eventual budget with tax cuts, corporate/individual, does indeed make its way to the President’s desk for signature, keep in mind consumers got a tax cut in 2011 and 2012 which was roughly the same dollar order of magnitude. We’ve done this experiment before. Payroll taxes withheld from worker paychecks that basically fund social security were cut from 6.2% to 4.2% putting as much as
$2,100 back in some top-of-the heap workers’ pockets, those making the maximum social security taxable earnings base of $106,800.

In total, the payroll tax holiday put about $110 billion back into consumer paychecks and the economy each of those two years, increasing the budget deficit. While it isn’t clear how or when the Senate and House will agree on a joint concurrent budget resolution, and we don’t know the breakdown of the Senate’s $1.5 trillion tax reform, we will assume for now they are going to give us tax cuts of $150 billion per year that increases the deficit. So about $110 billion of stimulus through payroll tax reductions back then in 2011 and 2012, and $150 billion proposed now. Will $150 billion of tax cuts per year help the economy grow at a faster 3% pace?

Well, it is hard to see what that “payroll tax holiday” fiscal stimulus did for the economy back then. Real GDP growth was 1.6% in 2011, 2.2% in 2012 and 1.7% in 2013. No growth jump-start. Millions of jobs were created, due more to natural economic forces and the passage of time we would guess, rather than to government intervention and stimulus, 1.571 million nonfarm payroll jobs created in 2011, 2.243 million more in 2012, and 2.206 million new jobs in 2013. In economics, someone got a Nobel Prize for saying that people will save any windfall gained from temporary...
tax cuts instead of spending it to help make the economy grow. Personal saving as a percent of disposable personal income indeed moved up from 5.6% in 2010 to 6.0% in 2011 and 7.6% in 2012 before dropping back to 5.0% in 2013.

Stay tuned. Story developing. Seems like the tax cuts are meant more philosophically to reduce the size of the Federal government, return the monies to the people, rather than to jumpstart growth and create jobs, jobs, jobs. But it’s early yet with virtually no details available. Hard to assess.

Mnuchin/Mulvaney statement on FY2017 Federal budget results

Growth in spending outpaced growth in tax receipts for the second year in a row as a result of historically subpar economic growth. Rising deficits show that smart spending restraint and pursuing policies that promote economic growth, like tax reform and reductions in regulatory burden, are critically necessary to promote long-term fiscal sustainability.

“Today’s budget results underscore the importance of achieving robust and sustained economic growth. Through a combination of tax reform and regulatory relief, this country can return to higher levels of GDP growth, helping to erase our fiscal deficit,” said Secretary Mnuchin. “The Administration’s pro-growth policies will create better, higher-paying jobs, make American businesses competitive again, and bring back cash from offshore to invest here at home. This will help place the nation on a path to improved fiscal health and create prosperity for generations to come.”

“These numbers should serve as a smoke alarm for Washington, a reminder that we need to grow our economy again and get our fiscal house in order. We can do that through smart spending restraint, tax reform, and cutting red tape,” said Director Mulvaney.
MARKETS OUTLOOK

10-year Treasury yields closed higher at 2.38% this week versus 2.27% last Friday. Stock market gains helped and odds of a December Fed rate hike rose to 80%. 10-yr yields were 2.35% by Wednesday on the 160 point rally in the Dow industrials, also following UK bond yields higher earlier on the better wage data there. Friday saw higher yields on the Senate vote on the budget resolution late Thursday night.

CORPORATE BONDS: KIA MOTORS, PACIFIC MUTUAL, TARGET

Corporate offerings were $20.4 billion in the October 20 week versus $33.0 billion in the October 13 week. On Wednesday, UnitedHealth Group sold $4.0 billion 3s/5s/10s/30s/FRNs. It priced $950 million 2.95% 10-yr (m-w +10bp) at 70 bps (A3/A+). The health care management company will use the proceeds to repay commercial paper and other debt. Corporate bonds (10-yr Industrials rated A2) were 78 bps above 10-yr Treasuries this week versus 79 bps last Friday.
OTHER ECONOMIC NEWS THIS WEEK

Unemployment claims at new 2017 low following hurricanes

Unemployment claims fell 22K to 222K in the October 14 week. Hurricane Harvey hit Texas in the September 2 week, and Hurricane Irma hit Florida in the September 16 week, but now claims have fallen surprisingly to the lowest level since the 1970s. This signals the labor market has moved beyond full employment.

Industrial production trend remains murky after hurricanes

Manufacturing industrial production rose 0.1% in September after falling the prior two months. The peak was in April this year where many industries saw greater output even if motor vehicles were a big part of that increase. Auto production is down sharply from April.

Industrial Production

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<td>2000 Nonfarm payroll jobs 112.2 min</td>
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Manufacturing payroll jobs

12.4 million +117K YOY
10.0% of Private Payroll Jobs
Another eco stat sunk by the storm

Breaking economy news. Housing starts fall 4.7% to 1.127 million in September and permits are down 4.5% to 1.215 million. While the construction of multifamily dwellings is way off this month and this year from the earlier construction boom in apartments, single family home construction is better than the headlines suggest with every area of the country seeing a surge of construction except for the storm battered South.

Net, net, residential housing construction is down but not out for this record-long recovery in home building in this economic cycle. It stands to reason that the recovery would be a long one from the severity of the deep downturn in construction seen during the housing bubble bust a decade ago.

But today’s report is really a tale of two housing markets. Multifamily construction had recovered already from the housing bubble dip in building during the recession. It was single-family home building that failed to return to anywhere near their housing bubble peaks. It is possible that homebuilders like everyone else are struggling to guess at what millennials want, and there does seem to be a tendency for the new generation to want homes with less square-footage and overall maintenance perhaps.

For whatever reason, the silver lining in today’s construction report is that momentum is building in single family construction that has been the weak link in overall investment spending that helps make the economy run. In today’s report, September single family home construction is at new highs this year in the West and in the Northeast, and rebounded strongly this month in the Midwest. Single family home construction tumbled in the South by 15.3% to 403 thousand which was to be expected after Hurricanes Harvey and Irma.

The housing market is down not out and the positive elements in today’s report suggest the Fed will keep to its schedule of gradual rate hikes later this year and next. The economy continues to defy expectations come whatever storm is thrown its way and it is time for the Fed to stop playing offense and instead return monetary policy back to normal. The economy is better than you think. Bet on it.
September existing home sales still calm before the storms

Breaking economy news. Existing home sales from the National Association of Realtors rose 0.7% to a 5.39 million annual rate of turnover in September. We guess this is a good rate of sales activity in a country with 326 million people. This September data and the results could weaken further in the months ahead as many existing home sales are recorded at the time the sales contract is closed, and therefore September data represents activity that could have occurred in July and August.

Sales were slightly better or unchanged in the Northeast, Midwest and West, while the biggest market down South declined slightly from 2.15 million in August to 2.13 million in September, 0.9%, hardly hurricane-sized declines… yet.

Realtors continue to complain that sales are held down by the lack of supply, and certainly California talks about housing shortages constantly in the local media. About 40% of sales nationwide are for homes from $100 to $250 thousand, and these are in short supply.

Net, net, the turnover of the existing home stock is sufficient to generate enough consumer spending to keep the economy growing at a 2% pace in the coming year as homebuyers redecorate and purchase appliances and furniture to fill their new homes. Maybe put a new car in the driveway, music to Detroit’s ears, unless they want more SUV sales. The Federal Reserve can continue to remove its stimulative policies left over from the recession with confidence knowing that the economy is strong enough to withstand a gradual pace of rate hikes. Even with the Fed lifting rates 100 bps the next year according to their forecasts, no private forecaster sees mortgage rates lifting higher than 5.25%. And 5.25% is not high enough to send homebuyers to the sidelines from the increase in borrowing costs.

The press release from the realtors did mention the potential negative effects of removing the deduction for state & local taxes or altering the mortgage interest deduction and what this could do to residential housing sales. They advise not to do it.

The economy remains stronger than you think for now assuming Congress does not make too many dramatic changes to the tax code, altering the way Americans have paid their taxes for decades. Consumers don’t like change, and the bigger the change, the worse it can be. We will still wonder why
tax cuts are necessary at this stage of the business cycle as every other Administration has not provided fiscal stimulus unless the economy was either in recession or perhaps still struggling immediately after the recession. Stay tuned. Story developing. The economy is great again already. Bet on it.
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