Financial Market Weekly

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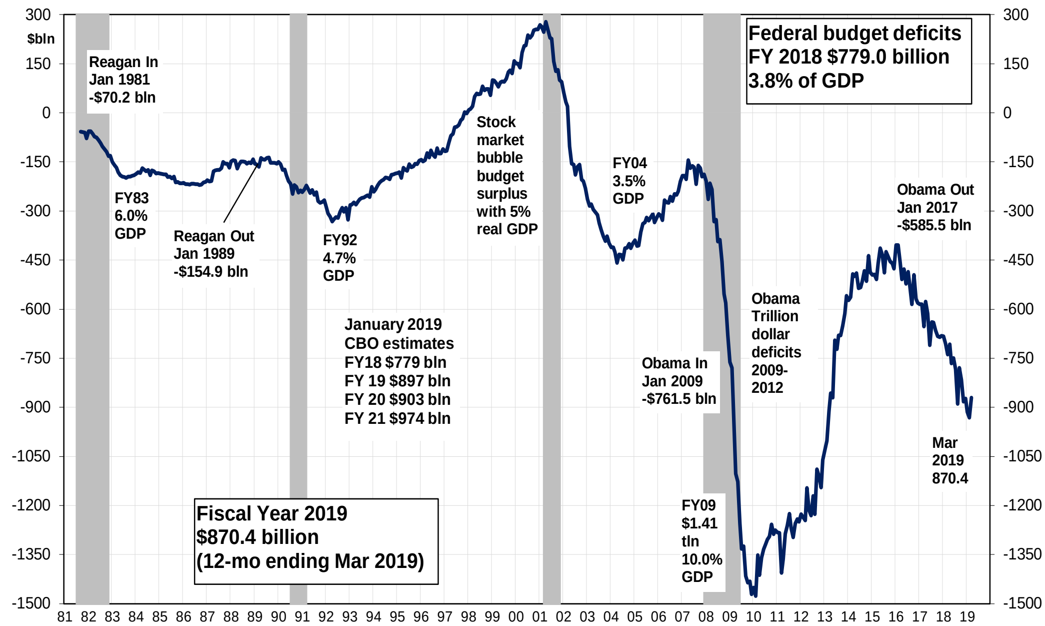
FEDERAL BUDGET DEFICIT MAY BE NEARING PEAK AT $1 TRILLION

Halfway through fiscal year (FY) 2019, the Federal budget deficit is running $870.4 billion on a 12-month trailing sum basis. The Treasury must auction $870.4 billion in securities to the market to pay for the deficit. Add to this financing demand, and potentially higher bond yields to entice investors to buy the extra



President's 2020 Federal Budget			
FY20/FY19 Baseline estimates			
$ chg	$ billions	2020	2019
173	Outlays	4,709	4,536
(19)	Discretionary	1,340	1,359
(3)	Defense	671	674
(16)	Nondefense	669	685
104	Mandatory	2,887	2,783
61	Social Security	1,102	1,041
57	Medicare	702	645
7	Medicaid	426	419
(21)	Other	657	678
88	Net interest	482	394
205	Revenues	3,643	3,438
124	Individual income taxes	1,822	1,698
40	Corporate income tax	256	216
	Social program taxes		
38	Social Security Payroll	949	911
13	Medicare Payroll	289	276
2	Unemployed insurance	46	44
9	Excise taxes	108	99
-	Estate and gift taxes	19	19
(21)	Customs duties	48	69
-	Fed earnings	49	49
(31)	Deficit	1,067	1,098

securities, the $360 billion annual wind down of the Fed's Treasury securities on its balance sheet, and the result could have meant higher bond yields. Didn't happen, and now the Fed's wind down of its balance sheet ends in September. Because the Fed gradually worked up to a $360 billion annual wind down rate, the extra supply of Treasuries needed to be auctioned has been relatively modest: a $312 billion runoff from the end of October 2017 to the latest April 17, 2019 bank reporting week. The Trump administration budget for FY2020 released in March this year estimates the FY2019 budget deficit will be $1.098 trillion with six months left to go. The Congressional Budget Office (CBO) in a January report is only estimating $897 billion. The effect of the Tax Cuts and Jobs Act signed in December 2017 has been modest so far and will grow larger in the second half of FY2019. In the first six months of FY2019 (Oct-Mar), individual income taxes are only $12 billion less than the prior year, corporate income taxes are $11 billion less than the prior year.

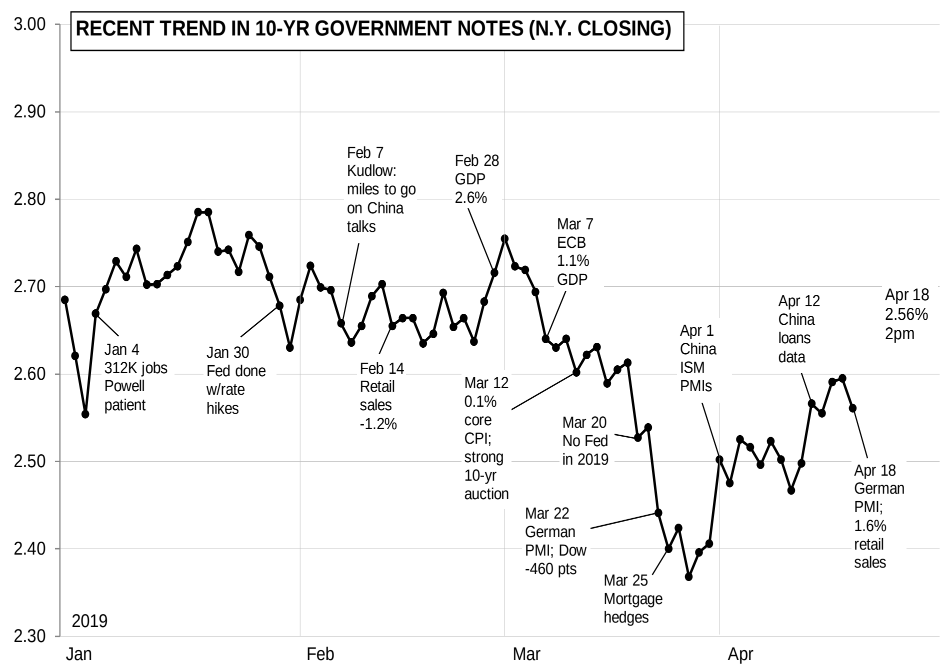
Federal Government Spending ($bln)			Fiscal	Fiscal	
Where to cut?	2 Qtrs FY19	2 Qtrs FY18	Year	Year	Full Year
	Q4 18-Q1 19	Q4 17-Q1 18	Changes	% chg	FY 2018
TOTAL BUDGET OUTLAYS	2,198.468	2,096.705	101.763	4.9	4,107.741
Legislative	2.422	2.349	0.073	3.1	4.670
Judicial	3.940	3.847	0.093	2.4	7.779
Agriculture	85.639	82.744	2.895	3.5	136.713
Food Stamps	32.640	35.734	-3.094	-8.7	68.493
Child Nutrition	13.121	12.971	0.150	1.2	22.829
Commerce	5.978	3.867	2.111	54.6	8.562
Defense	325.518	298.111	27.407	9.2	600.706
Military Personnel	84.324	79.879	4.445	5.6	145.827
Operation Maintenance	130.018	122.408	7.610	6.2	256.663
Procurement	59.888	55.739	4.149	7.4	112.667
Research Development	43.987	34.913	9.074	26.0	76.975
Military Construction	3.825	3.391	0.434	12.8	6.723
Education	40.685	37.818	2.867	7.6	63.707
Office of Federal Student Aid	21.224	20.906	0.318	1.5	45.917
Energy	13.634	12.587	1.047	8.3	26.481
Health Human Services	583.491	563.898	19.593	3.5	1120.500
Medicare	373.155	357.933	15.222	4.3	711.499
Medicaid States Grants	197.951	192.724	5.227	2.7	389.157
Homeland Security	29.625	40.777	-11.152	-27.3	68.374
Housing Urban Development	22.504	21.533	0.971	4.5	54.665
Interior	6.551	7.124	-0.573	-8.0	13.210
Justice	17.129	17.633	-0.504	-2.9	34.521
Labor	16.988	20.312	-3.324	-16.4	39.638
State Unemployment Benefits	14.533	15.462	-0.929	-6.0	28.135
State	14.114	12.756	1.358	10.6	26.385
Transportation	34.964	34.527	0.437	1.3	78.494
FAA	7.951	7.774	0.177	2.3	15.999
Federal Highway Admin.	19.194	18.786	0.408	2.2	45.604
Treasury	358.325	342.241	16.084	4.7	629.448
TARP	0.709	1.218	-0.509	-41.8	2.226
IRS	110.114	98.392	11.722	11.9	145.209
Earned Income Credit	49.022	49.468	-0.446	-0.9	58.640
Child Tax Credit	24.138	15.819	8.319	52.6	18.597
Interest on Public Debt	259.687	240.522	19.165	8.0	521.553
Veterans Affairs	96.633	92.948	3.685	4.0	178.509
Corps of Engineers	3.429	3.395	0.034	1.0	5.082
Other Defense Civil Programs	32.599	31.962	0.637	2.0	55.368
Environmental Protection	4.415	4.264	0.151	3.5	8.085
Exec. Office of President	0.195	0.187	0.008	4.3	0.382
International Assistance	6.598	7.506	-0.908	-12.1	21.632
NASA	9.740	9.632	0.108	1.1	19.754
National Science Foundation	3.358	3.332	0.026	0.8	7.166
Personnel Management	50.851	48.591	2.260	4.7	98.802
Small Business Admin.	-0.096	-0.719	0.623	--	0.046
Social Security Admin.	540.426	513.221	27.205	5.3	1039.902
Retirement Benefits	436.576	410.346	26.230	6.4	833.038
Federal Disability Payments	72.159	71.523	0.636	0.9	143.731
Other Independent Agencies	12.625	3.076	9.549	310.4	7.770

As far as FY2020 starting in October, the President's budget in March is looking for a $1.067 trillion deficit. Congress won't listen and will do its own budget of course. Late as usual. Spending decisions are limited because so much of the outlays are mandatory, social security benefits, Medicare spending, etc. One issue is the Budget Control Act of 2011 that established limits on discretionary budget authority. Congress lifted the spending limits with legislation in early 2018 for two years. But without a new agreement, CBO estimates defense spending will drop $54 billion (roughly 8.5%) starting October 1, and discretionary nondefense spending will drop $36 billion (about 6%). The original legislation authorizing about $150 billion more spending in early 2018 was one of the reasons (along with the Tax Cuts and Jobs Act) the Fed under Yellen lifted their forecasts for the economic growth and interest rates. Now government spending could fall back about $90 billion. Stay tuned. Story developing. At the moment, the risk of higher rates from greater deficit spending and quantitative tightening looks to be off the table.

MARKETS OUTLOOK

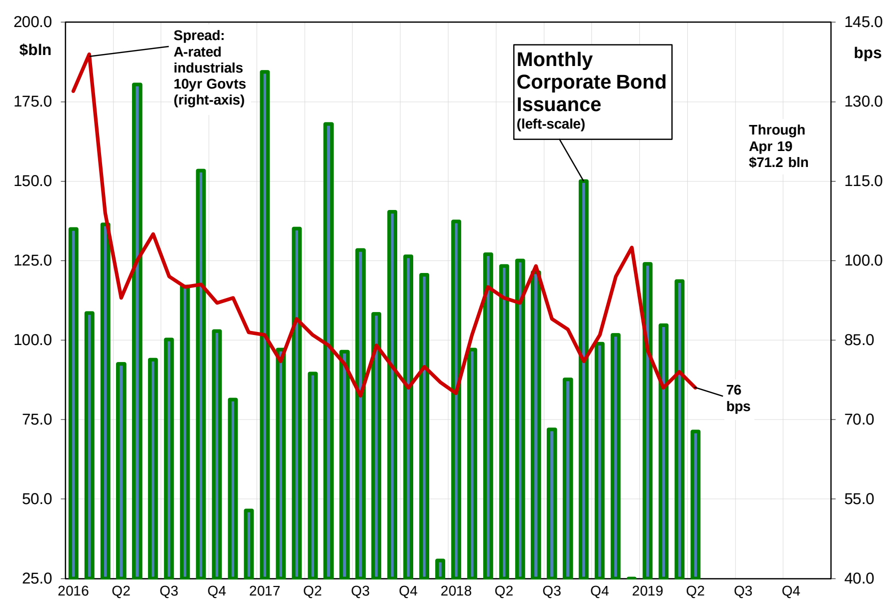
	29-Mar 2018	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	3.00	3.00	3.10	3.10	3.25	3.20	3.20
10-Yr Note	2.41	2.60	2.70	2.90	2.90	3.10	3.10	3.10
5-Yr Note	2.23	2.45	2.60	2.80	2.80	3.05	3.05	3.05
2-Yr Note	2.26	2.45	2.50	2.70	2.70	2.90	2.95	3.00
3-month Libor	2.60	2.60	2.60	2.90	2.90	3.10	3.10	3.10
Fed Funds Rate	2.50	2.50	2.50	2.75	2.75	3.00	3.00	3.00
2s/10s spread	15	15	20	20	20	20	15	10

The bond market closed early at 2pm EDT on Thursday before the long holiday weekend. 2.56% was the close of the week with yields as high as 2.61% on Wednesday. Bond yields tried a repeat of last month's trade, falling to 2.55% on Thursday at 330am EDT with Bunds after the release of weaker German manufacturing PMI data. Last month's data on March 22 brought US bond yields down, inverted the 3-mo/10-yr Treasury yield curve and frightened the stock market to death with the Dow industrials dropping 460 points. Markets can relax because the 3-mo/10-yr yield curve is not inverted anymore, no longer signaling a recession. Whew, for a minute there…



CORPORATES: SEVERAL BANKS, AMERICA MOVIL, WALMART, BLACKROCK

Corporate offerings were $21.9 billion in the April 19 week versus $24.4 billion in the April 12 week. On Tuesday, Walmart sold $4.0 billion 5s/7s/10s. It priced a $1.25 billion 3.25% 10-yr (m-w +10bp) at 67 bps (Aa2/AA). The world's largest retailer will use the proceeds for general corporate purposes, including repayment, refinancing, or replacing maturing debt. Corporate bond yields (10-yr Industrials rated A2) were 76 bps above 10-yr Treasuries this week versus 74 bps last Friday.



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FEDERAL RESERVE POLICY

The Fed meets April 30 - May 1 to consider its monetary policy. We are seeing better economic data, the stock market (S&P 500) closed up 15.9% year-to-date on Friday. We can't remember a time the Fed cut rates with stocks up so much, but the President and his Men want one or two or three rate cuts. [Sorry, this is what we wrote last week. Still true though.] A lot of Fed speakers this week. Not sure it matters when the White House wants a couple of rate cuts. Dallas Fed President Kaplan on Thursday said political considerations play no role in setting policy. Sure. Chicago Fed President Evans, St. Louis Fed President Bullard, Atlanta Fed President Bostic, Philadelphia Fed President Harker, Boston Fed President Rosengren all got some news headlines as well. Seventeen members of the Federal Open Market Committee and the President has proposed a couple more members. You wonder how they can come to a decision with so many in the room making policy. We guess they read what each other say and a middle ground consensus emerges somehow. They all seem to be of the same basic view at the moment forgetting that at the March meeting 11 said no rate hikes this year and 6 voted for rate hikes in 2019. Inflation is below the 2% target (CPI inflation won't be for long with crude oil moving up). The Fed funds rate of 2.5% is at neutral or darn near. No recession. We are preserving our optionality, rates could go up or down. On and on the Fed chatter goes. No decision on rates is expected to be announced on May 1 certainly.

Selected Fed assets and liabilities

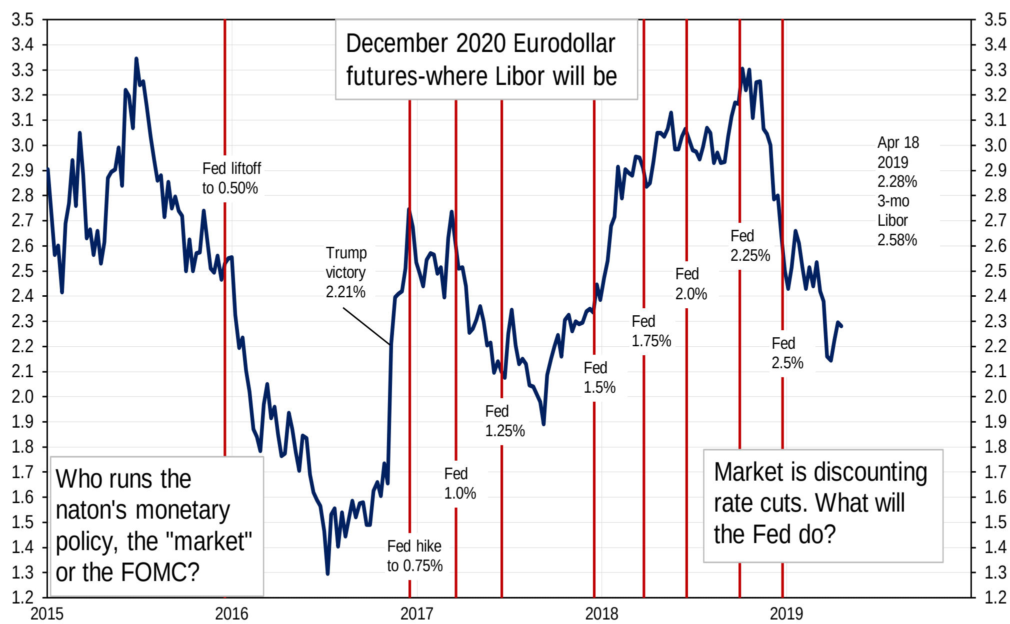
Fed H.4.1 statistical release billions, Wednesday data	17-Apr	10-Apr	3-Apr	27-Mar	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2153.409	2153.443	2153.308	2175.596	479.782
Federal agency debt securities	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	1587.938	1592.912	1592.723	1592.723	0.000
Primary credit (Discount Window)	0.005	0.010	0.003	0.021	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)	0.000	0.000	0.000	0.000	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	0.055	0.055	1.365	0.066	62.000
Federal Reserve Assets	3979.7	3984.7	3983.2	4003.4	961.7
3-month Libor %	2.59	2.60	2.60	2.60	2.82
Factors draining reserves					
Currency in circulation	1728.061	1728.355	1727.490	1723.754	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.015	56.676	0.016	0.166	0.000
Reserve Balances (Net Liquidity)	1524.297	1646.560	1630.987	1632.788	24.964
Treasuries within 15 days	31.746	0.180	0.180	22.379	14.955
Treasuries 16 to 90 days	82.182	111.741	111.741	90.458	31.549
Treasuries 91 days to 1 year	263.734	265.651	265.650	270.528	69.272
Treasuries over 1-yr to 5 years	908.683	908.927	908.908	922.088	170.807
Treasuries over 5-yrs to 10 years	249.260	249.207	249.157	252.513	91.863
Treasuries over 10-years	617.804	617.738	617.673	617.630	101.337

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

Odds of Rate Cuts
Fed funds futures

Th4-18-2019	
12%	2.25% June
34%	2.25% September
62%	2.25% December

Odds at June, September, December Fed meetings



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OTHER ECONOMIC NEWS THIS WEEK

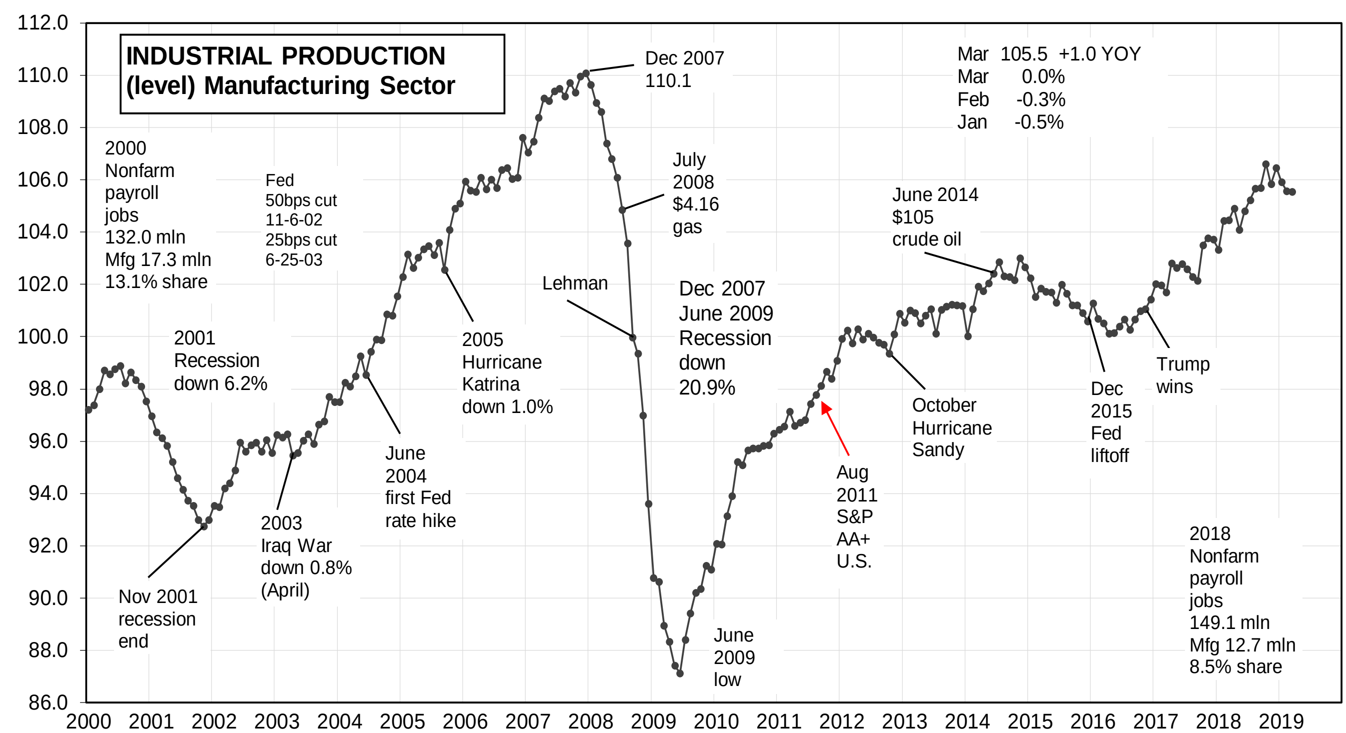
Big fat zero for factory production in March (Tuesday)

Breaking economy news. March industrial production fell 0.1% in March and has slowed to 2.8% the last year. Manufacturing production was unchanged in March and has risen 1.0% over the last 12 months. Mining production is doing the heavy lifting up 10.5% the last year, but even this category including oil & gas drilling activity has fallen in the first quarter.

Percent changes			Industrial Production March 2019		
Jan	Feb	Mar	YOY		Weight
-0.3	0.1	-0.1	2.8	Total Index	100.0
-0.5	-0.3	0.0	1.0	Manufacturing	75.1
-0.2	0.0	-0.8	10.5	Mining	14.6
0.6	3.7	0.2	3.8	Utilities	10.4
			Manufacturing payroll jobs 12.8 million +209K YOY 10.0% of Private Payroll Jobs		

Net, net, manufacturing production has pivoted to the downside in the first quarter of the year showing the revival in factories and output is sputtering for the first time since the Trump economics team took office. The trade war and America First policies have not brought factories back home yet. With one of the engines for economic growth falling away it will be harder than ever for Trump's economists to get the economy to fly 3 percent on a sustainable basis despite one of the biggest tax cuts in history.

We still expect real GDP output in the first quarter to hit 1.5%, but much of the increase will come from a temporary build-up of inventories rather than factories producing more goods. There's going to be even more pressure from the White House for the Federal Reserve to reverse a couple of its rate hikes from late last year to stoke the fires of growth going into the 2020 elections. Stay tuned. Story developing.



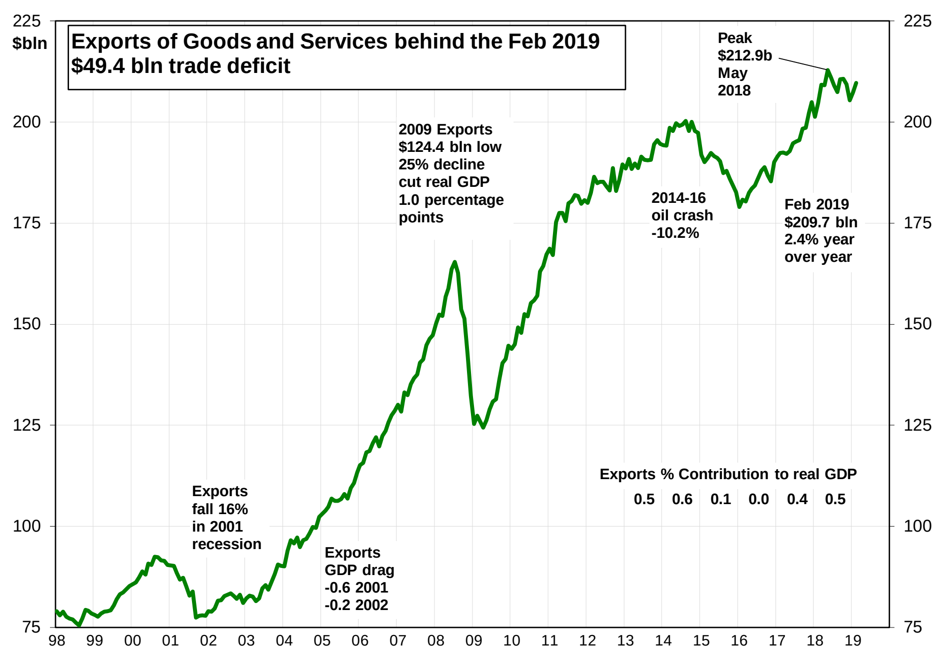
Trade war having some effect on narrowing the trade deficit (Wednesday)

Breaking economy news. The trade deficit narrowed to $49.4 billion in February from $51.1 billion in January. Civilian aircraft exports were stronger than expected, rising $5.8 billion in February, which was part of the reason for the narrowing deficit in February. The average trade deficit so far in Q1 2019, with January/February data and March left to go, is $50.3 billion down from $55.7 billion in Q4 2018, so trade is adding to GDP this quarter. Q1 2019 real GDP is due Friday, April 26 and we still expect 1.5% down from 2.2% in Q4 2018.

Net, net, many down in Washington would like to think the trade wars and tariffs are having some impact on the imports of goods, although it is early in the year when seasonal trends tend to make the data volatile. The facts are that imports of goods in the first two months of 2019 are $418.8 billion which is not much of a difference from $418.7 billion in the first two months of 2018. For the trade between nations in goods where the data are not seasonally adjusted, we couldn't help noticing that US exports to Europe (EU) are up, and US exports to China are down. What can we sell the world? The biggest increases this year are oil, aircraft and engines, pharmaceutical drugs, soybeans.

U.S. Goods Imports
2019 Year-to-date Totals
(through February)

$ Millions	2019	2018	Change	% Change
Total	418,769	418,694	75	0.0
Foods, feeds, beverages	24,322	24,392	-70	-0.3
Fish and shellfish	3,469	3,733	-264	-7.1
Fruits, frozen juices	3,241	3,256	-15	-0.5
Other foods	3,038	2,827	211	7.5
Vegetables	2,239	2,193	46	2.1
Industrial supplies/materials	86,317	94,132	-7,815	-8.3
Crude oil	19,104	26,101	-6,997	-26.8
(Crude oil price $barrel)	53.18	62.96	-9.78	-15.5
Industrial supplies, other	6,555	6,308	247	3.9
Petroleum products, other	5,582	5,553	29	0.5
Chemicals-organic	4,642	4,759	-117	-2.5
Capital goods, ex-auto	114,225	113,336	889	0.8
Computers	13,004	12,543	461	3.7
Telecommunications equip.	10,467	12,647	-2,180	-17.2
Computer accessories	9,486	11,036	-1,550	-14.0
Industrial machines, other	10,336	9,858	478	4.8
Automotive vehicles, parts	63,854	61,781	2,073	3.4
Passenger cars	30,545	30,084	461	1.5
Other parts and accessories	19,264	18,843	421	2.2
Trucks, buses	6,724	5,450	1,274	23.4
Engines, engine parts	4,878	5,126	-248	-4.8
Consumer goods	111,893	108,862	3,031	2.8
Pharmaceutical prepartions	22,263	22,004	259	1.2
Cell phones	19,779	19,008	771	4.1
Apparel, textiles, nonwool/cotton	9,137	8,474	663	7.8
Apparel, household goods-cotton	7,713	7,451	262	3.5
Other goods	18,157	16,191	1,966	12.1



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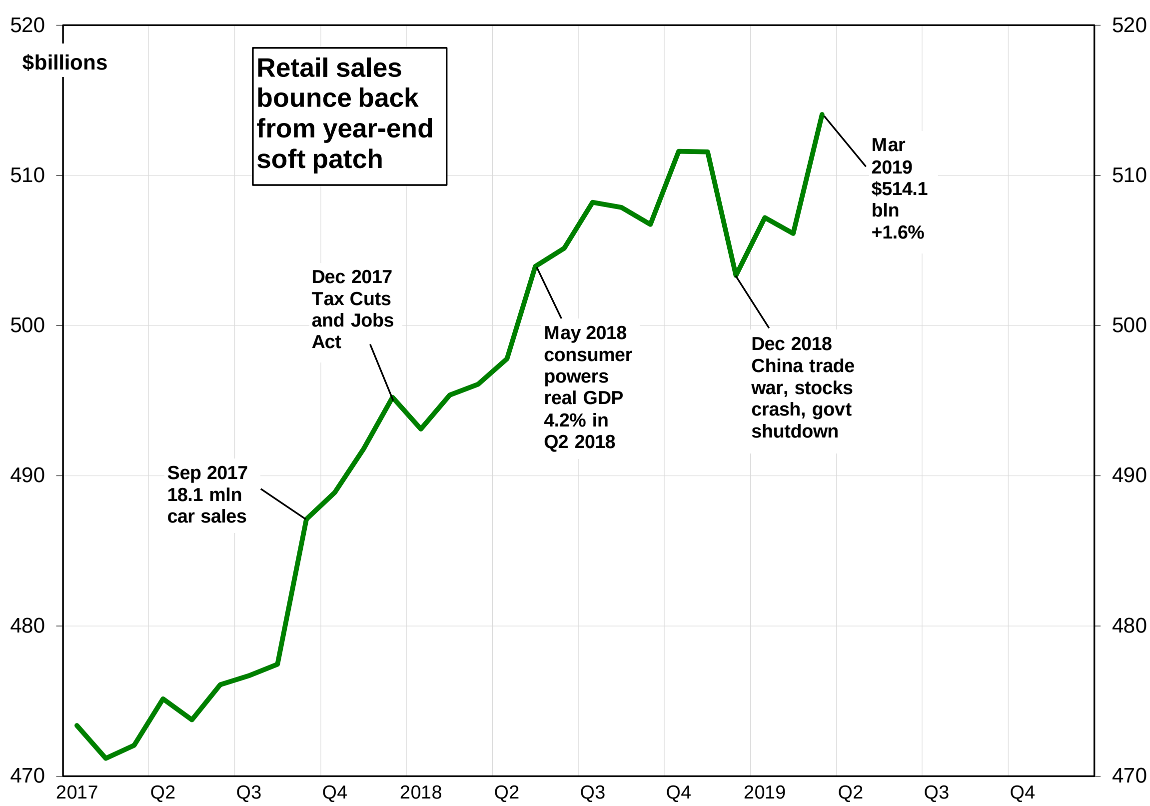
Retail sales rebound from December blues; jobless claims still falling (Thursday)

Breaking economy news. Weekly jobless claims and March retail sales. Jobless claims fell to a new all-time low (since 1969) this week. 192 thousand applied for unemployment benefits in the April 13 week because they had been sacked by their companies which is lower than 197 thousand claimants in the April 6 week. Jobless claims falling showing the economy was improving was one reason why the Fed under the command of Ben Bernanke lifted rates from 4.5 percent to the 5.25 percent peak from March to June 2006. The 5.25% level was thought to be too tight, although if it was restrictive enough to bring down the economy, it took a year and a half as the economy did not turn down and go negative until January 2008.

The Fed can't do everything with that interest rate they control. Although Fed officials may be slapping each other on their backs, high-fives around the room, thinking that retail sales rebounded, and consumers returned to the shops and the malls in March after the Fed shelved the remaining rate hikes in 2019 and stopped quantitative tightening (QT). Fed policy did it. Made retail sales jump. Hooray. Retail sales jumped 1.6% in March to a new record high. We already knew that car and light truck sales jumped 6.1% in March to 17.5 million at an annual rate after weakness of 16.5 million in February and 16.7 million in January. All the other categories of retail spending were up in March except for a 0.3% decline in "sporting goods." This category is down 9.7% the last year and includes sporting goods, hobby, musical instrument and book store sales. Americans aren't spending on hobbies anymore apparently. Stay tuned. Story developing. The economy is in better shape than the fixed income markets think.



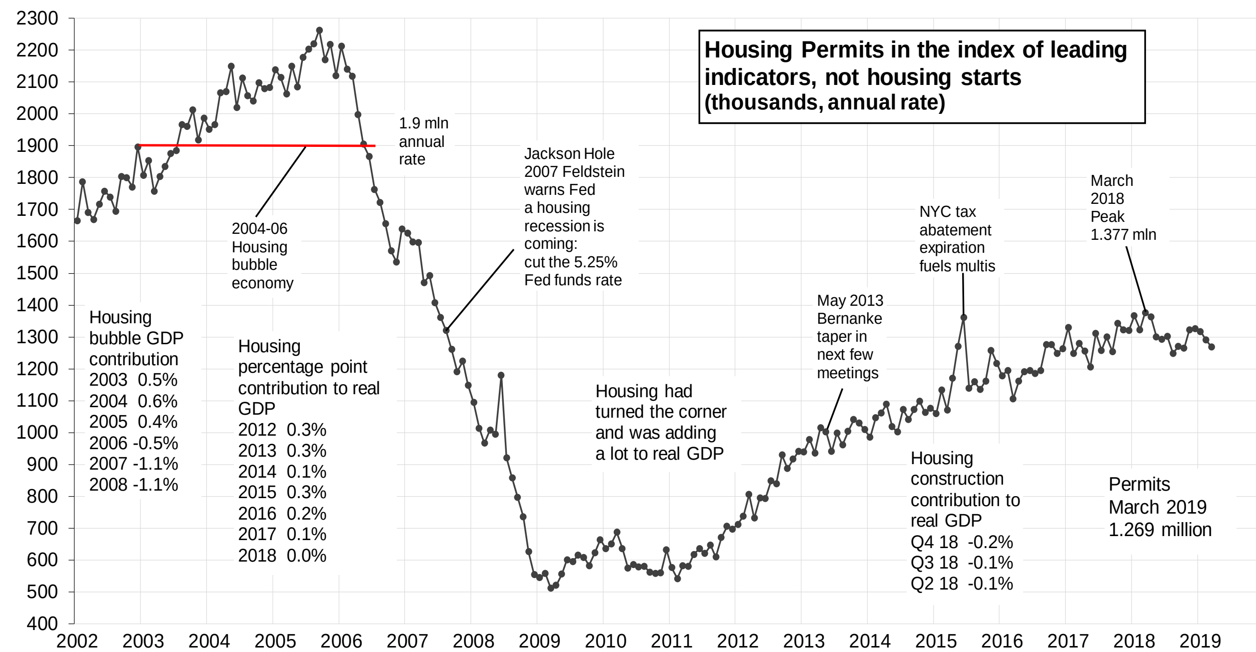
Housing starts and permits are adding nothing to economic growth this year (Friday)

Housing starts more volatile than new permits, both down from early 2018 peak

Breaking economy news. Markets are closed, both stocks and bonds, and it is just as well as the residential housing construction data are adding little to economic growth. Housing starts fell 0.3% to 1.139 million at an annual rate in March. Housing permits fell 1.7% to 1.269 million at an annual rate in March. The trend in starts exhibits much more volatility than permits, and both are down from the peaks in activity registered a year ago in early 2018.

Housing starts fell in all regions of the country except for the West, where starts jumped 31.4% to 318 thousand. Single family housing starts out West rose 13.9% to 189 thousand, but are down 21.6% from year earlier levels. The recent drop in mortgage rates from 4.94% in mid-November to 4.17% this week has not lit a fire of enthusiasm under home builders plans for future construction.

Net, net, residential housing construction remains cool and is unlikely to add much to economic growth this year. Waiting for construction activity to pick up after a sharp drop in mortgage rates is like waiting for Godot. It is hard to know what is ailing the home construction industry. There is a shortage of affordable housing with the emphasis on affordable. It is looking increasingly like the reports from homebuilders are true. New affordable homes cannot be built because the cost of materials, land, labor, are all too high. Stay tuned. Story developing. Residential housing construction has not added to real GDP growth since 2017 and is unlikely to add to the economy the rest of this year as well. The housing bubble collapse over a decade ago drove many builders out of the market permanently. It could be another decade before housing starts get anywhere near the peak of over 2 million per year back in 2005 before the housing crash.



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