Financial Market Weekly

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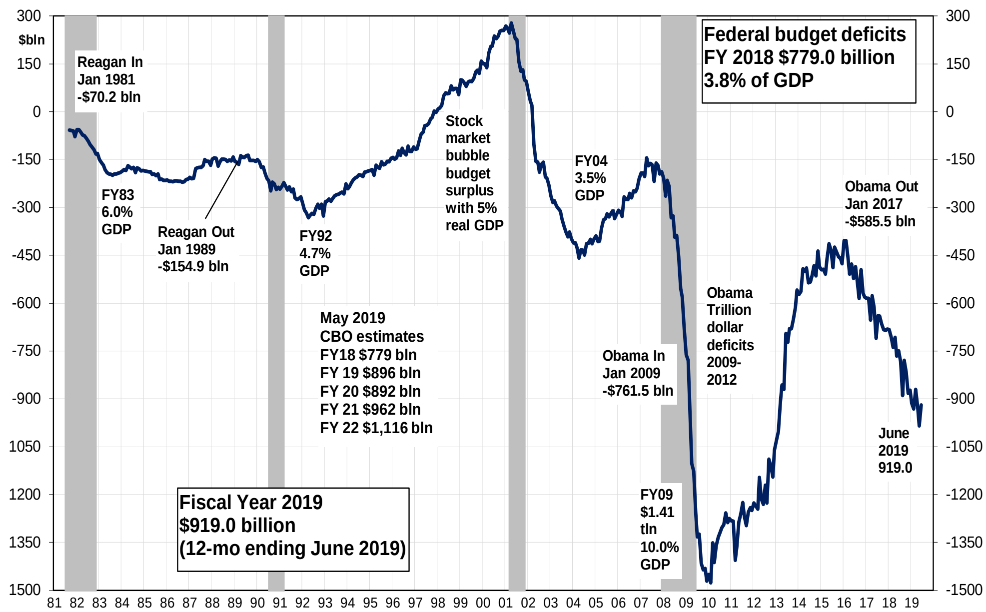
FEDERAL BUDGET DEFICIT SEAS ARE CALM FOR NOW… JUST UNDER $1 TRILLION



12 o'clock and all is well. More debt does not appear to be hurting the yields in the debt market. More supply, more Treasury auctions, hasn't led to higher bond yields. Another economic law to be repealed just like the Phillips curve where low unemployment isn't leading to more inflation. When Obama left and Trump entered in January 2017, the deficit was running $585.5 billion and now in the 12-months ending June 2019 the Federal budget deficit is $919.0 billion. 10-yr Treasury yields were 2.43% in January 2017 and averaged 2.07% in June 2019. Yields are falling not rising.

Midsession Federal Budget Review			
FY20/FY19			
$ chg	$ billions	2019	2020
(161)	Outlays	4,478	4,639
13	Discretionary	1,358	1,345
16	Defense	680	664
(4)	Nondefense	678	682
(128)	Mandatory	2,744	2,872
(56)	Social Security	1,038	1,094
(58)	Medicare	644	702
(16)	Medicaid	406	422
2	Other	656	654
(45)	Net interest	377	422
(156)	Revenues	3,473	3,629
(84)	Individual income taxes	1,719	1,803
(32)	Corporate income tax	221	253
	Social program taxes		
(32)	Social Security Payroll	914	946
(9)	Medicare Payroll	278	287
(3)	Unemployed insurance	43	46
(10)	Excise taxes	98	108
(2)	Estate and gift taxes	17	19
18	Customs duties	82	64
-	Fed earnings	49	49
(4)	Deficit	1,006	1,010

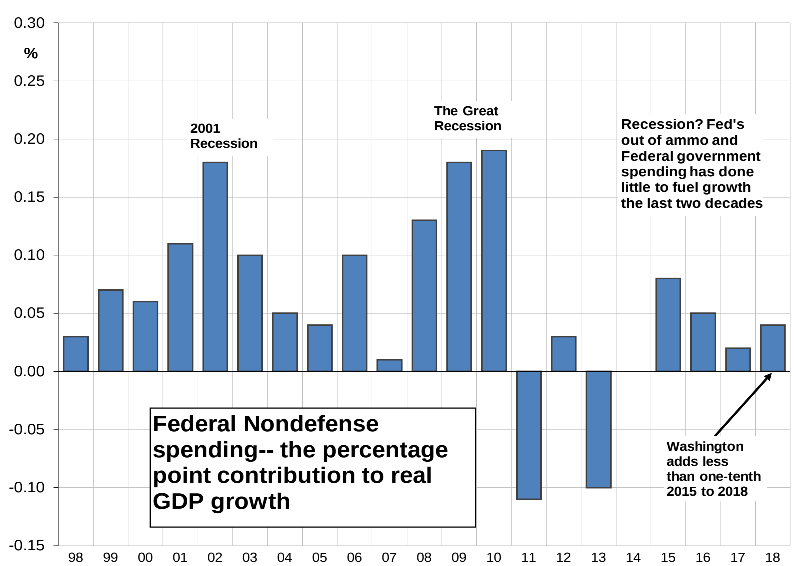
The Congressional Budget Office (CBO) forecast based on current law sees the deficit ending fiscal year (FY) 2019 at $896 billion and not much change in FY 2020 at $892 billion. The White House Office of Management and Budget (OMB) released their midsession review of the budget this week and the baseline estimate for the deficit is $1.006 trillion in 2019 and $1.010 trillion in 2020. Government spending or outlays are seen rising 3.6% to $4.639 trillion next year due to mandatory programs.

These baseline OMB estimates use their economic forecasts which see real GDP running 3% or higher from 2019 through 2024. It looks like the Fed will not change rates given the 2020 average 3-month Treasury bill yield of 2.4% and 10-yr Treasury yield averaging 2.8% next year. These are White House budget estimates of course and congress will have their say hopefully soon as FY 2020 starts October 1.

Government spending in the first three quarters of FY 2019 is 6.6% higher, $208.0 billion more than a year ago. Defense was $38.0 billion of it. Education is $39.7 billion of the increase though it has been volatile based on the finance accounting of student loans. Housing and Urban Development fell $28.4 billion on finance accounting issues with Fannie/Freddie. Homeland Security is down $11.2 billion on less FEMA disaster relief. Mandatory programs like Medicare up $36.5 billion this year and Medicaid up $13.5 billion. Interest on the public debt is up $43.2 billion and going higher until the Fed helps out by cutting interest rates.

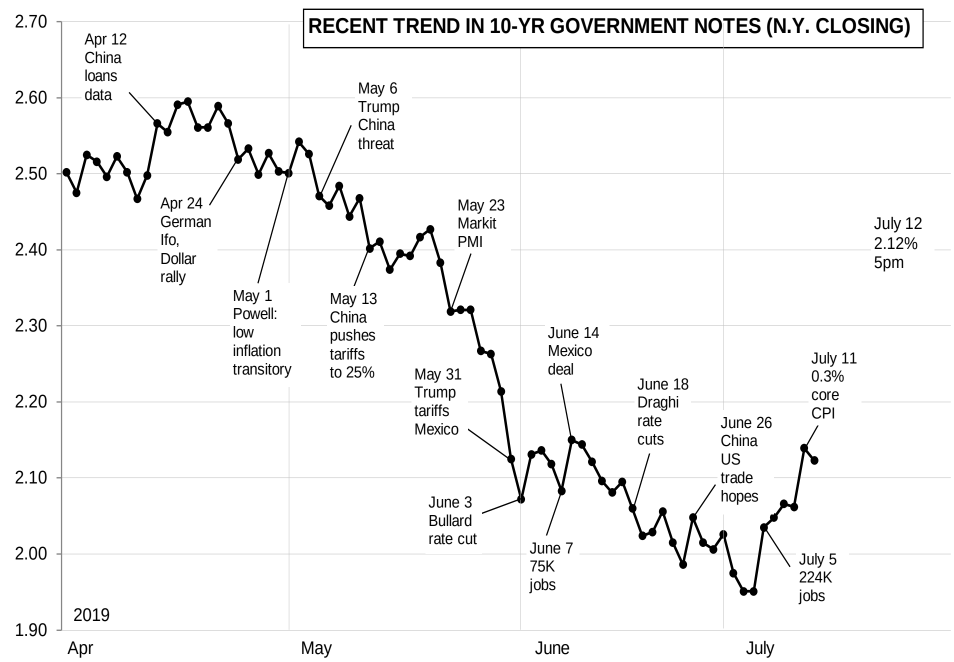
Powell said Wednesday that fiscal policy was powerful, "you need fiscal policy to really lift the economy," but the effect of Federal government spending on real GDP from nondefense programs has not been that large in recent years. The Obama years' fiscal stimulus on the spending side added barely 0.2 percentage points to real GDP in 2009 and again in 2010, during the recession. In conclusion, the budget deficit is holding near $1 trillion and is unlikely to boost economic growth even if congress votes for and the president approves additional spending. $1 trillion can be financed without pushing rates higher.

Federal Government Spending ($bln) **Where to cut?**	3 Qtrs FY19 Q4 18-Q2 19	3 Qtrs FY18 Q4 17-Q2 18	Fiscal Year Changes	Fiscal Year % chg	Full Year FY 2018
TOTAL BUDGET OUTLAYS	3,355.970	3,147.904	208.066	6.6	4,107.741
Legislative	3.635	3.463	0.172	5.0	4.670
Judicial	5.957	5.821	0.136	2.3	7.779
Agriculture	115.093	111.770	3.323	3.0	136.713
Commodity Credit Corporation	17.314	12.110	5.204	43.0	18.611
Food Stamps	47.735	52.191	-4.456	-8.5	68.493
Child Nutrition	19.999	19.834	0.165	0.8	22.829
Commerce	8.574	6.284	2.290	36.4	8.562
Defense	487.770	449.710	38.060	8.5	600.706
Military Personnel	119.707	113.736	5.971	5.2	145.827
Operation Maintenance	199.412	188.603	10.809	5.7	256.663
Procurement	91.103	83.458	7.645	9.2	112.667
Research Development	67.664	56.408	11.256	20.0	76.975
Military Construction	5.761	5.057	0.704	13.9	6.723
Education	86.430	46.704	39.726	85.1	63.707
Office of Federal Student Aid	59.529	33.988	25.541	75.1	45.917
Energy	20.745	19.342	1.403	7.3	26.481
Health Human Services	901.867	851.089	50.778	6.0	1120.500
Medicare	582.003	545.448	36.555	6.7	711.499
Medicaid States Grants	301.941	288.412	13.529	4.7	389.157
Homeland Security	42.619	53.838	-11.219	-20.8	68.374
Housing Urban Development	17.324	45.815	-28.491	-62.2	54.665
Interior	10.052	10.543	-0.491	-4.7	13.210
Justice	25.992	26.462	-0.470	-1.8	34.521
Labor	26.936	29.807	-2.871	-9.6	39.638
State Unemployment Benefits	20.989	21.978	-0.989	-4.5	28.135
State	20.540	18.978	1.562	8.2	26.385
Transportation	54.977	52.547	2.430	4.6	78.494
FAA	11.875	11.540	0.335	2.9	15.999
Federal Highway Admin.	29.941	29.207	0.734	2.5	45.604
Treasury	585.807	542.581	43.226	8.0	629.448
TARP	1.127	1.696	-0.569	-33.5	2.226
IRS	143.927	125.525	18.402	14.7	145.209
Earned Income Credit	58.152	57.861	0.291	0.5	58.640
Child Tax Credit	28.263	18.298	9.965	54.5	18.597
Interest on Public Debt	456.868	413.656	43.212	10.4	521.553
Veterans Affairs	148.948	138.546	10.402	7.5	178.509
Corps of Engineers	4.796	4.280	0.516	12.1	5.082
Other Defense Civil Programs	45.411	45.199	0.212	0.5	55.368
Environmental Protection	6.265	6.134	0.131	2.1	8.085
Exec. Office of President	0.298	0.289	0.009	3.1	0.382
International Assistance	19.589	15.753	3.836	24.4	21.632
NASA	14.744	14.755	-0.011	-0.1	19.754
National Science Foundation	5.081	5.041	0.040	0.8	7.166
Personnel Management	76.876	73.288	3.588	4.9	98.802
Small Business Admin.	0.170	-0.322	0.492	--	0.046
Social Security Admin.	822.993	780.732	42.261	5.4	1039.902
Retirement Benefits	661.347	620.717	40.630	6.5	833.038
Federal Disability Payments	108.821	107.733	1.088	1.0	143.731
Other Independent Agencies	14.892	3.137	11.755	374.7	7.770



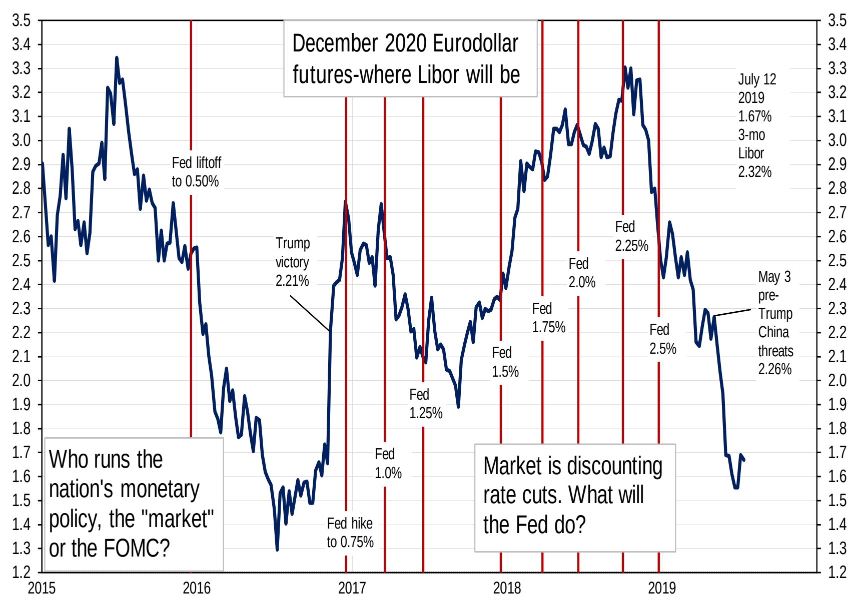
MARKETS OUTLOOK

	29-Mar 2019	28-Jun 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	2.53	2.25	2.30	2.40	2.50	2.50	2.70
10-Yr Note	2.41	2.01	1.75	1.80	2.00	2.10	2.20	2.40
5-Yr Note	2.23	1.77	1.50	1.55	1.80	1.90	2.00	2.20
2-Yr Note	2.26	1.76	1.50	1.60	1.70	1.80	2.00	2.20
3-month Libor	2.60	2.32	2.00	2.00	2.00	2.00	2.00	2.00
Fed Funds Rate	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00
2s/10s spread	15	25	25	20	30	30	20	20



10-year Treasury yields closed last week at 2.04% and moved higher to 2.12% at Friday's close. Yields drifted higher early in the week, and then jumped 9 bps on Thursday as high as 2.15% after the June 0.3% rise in core CPI inflation. Core inflation had been just 0.1% each month from February to May. Much of the rise was due to Used car and trucks +1.6%, and Apparel 1.1%, transitory increases that won't last. We expect 10-yr yields to hang out here well under the 2.5% Fed funds rate waiting on the next two Fed decision dates: July 31 and September 18.

FEDERAL RESERVE POLICY



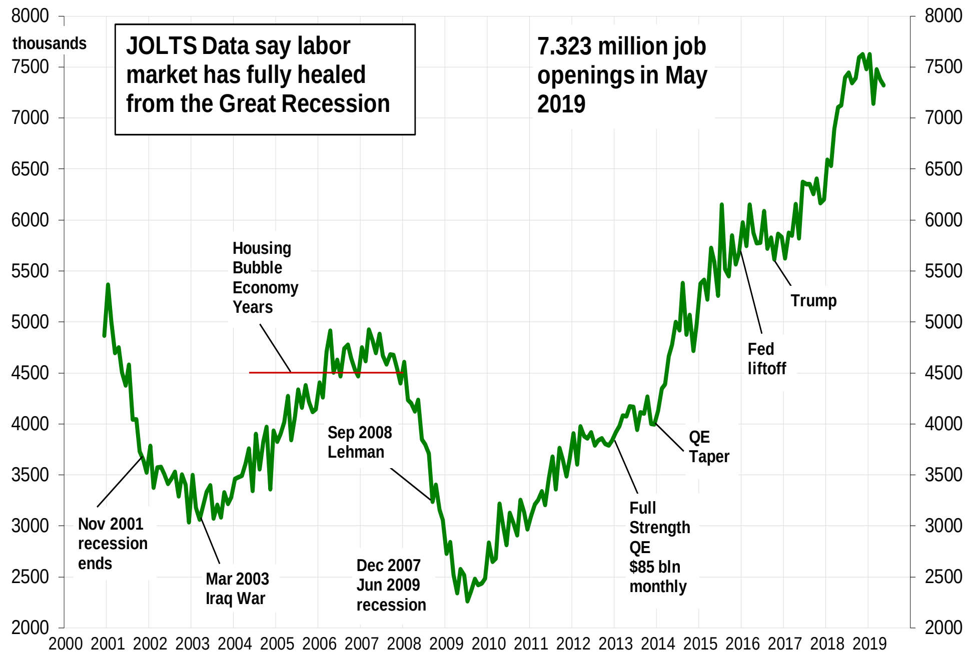
The Fed meets July 30-31 to consider its monetary policy. 224K jobs in June as reported Friday, July 5, so no recession, no need for rate cuts. Powell suggested otherwise in two days of testimony this week, Wednesday before the House and Thursday before the Senate. He told Carolyn Maloney (D-NY) the June jobs report did not change his outlook on whether a rate cut was appropriate in the near term. There were 9 of 17 votes at the June meeting for no rate cuts this year, some of these Fed officials have said as much publicly, but Powell is steering the committee toward rate cuts. The daily effective Fed funds rate was 2.40% on Thursday, and October Fed funds futures were 1.91% Friday, 49 bps lower, consistent with two rate cuts over the next two meetings.

OTHER ECONOMIC NEWS THIS WEEK

Job openings plunge to 7.323 million in May as China trade war escalates (Tuesday)

Breaking economy news. Job openings plunge to 7.323 million in May as the US trade war with China escalated sharply. 49 thousand fewer jobs out there than the 7.372 million in April. Blame the ongoing economic war with China and tumbling stock market after the latest escalation of the China-US trade war when Trump tweeted on May 5th he would lift tariffs on $200 billion of China imports from a manageable 10% to a costly 25% because China broke the deal. The record for job openings remains 7.626 million in November 2018.

Forget our sensational headline seeking clicks and readership. Any way you want to cut it, 7.323 million or 7.626 million there's still a heckuva lot of jobs out there. There's no way we can level the playing field and bring factories back to the USA because there is simply no one available to work in them and produce the goods that Americans want. In fact, job openings in US manufacturing rose to a new all-time record of 509 thousand in May. We can't make America great again if we can't make it in America and we can't make it in America if there is no one to roll up their sleeves and work in the factories that make the things consumers buy.



Net, net, the labor market remains as strong as it ever was with more for-hire signs out there and not enough workers to fill them. There is a lot of talk about recession coming in the next year and those forecasts may yet prove to be correct simply because the country is running out of labor. The labor pool is running dry with the number of unemployed dwindling and those working part-time being content and are unwilling to be hired on the full-time basis that many companies demand. Stay tuned. Story developing. Economics 101 teaches us that growing economies need capital and labor to keep going, and right now there is plenty of money and capital available, but there just aren't enough workers. Bet on it.

Inflation pressures building in tight labor market conditions (Thursday)

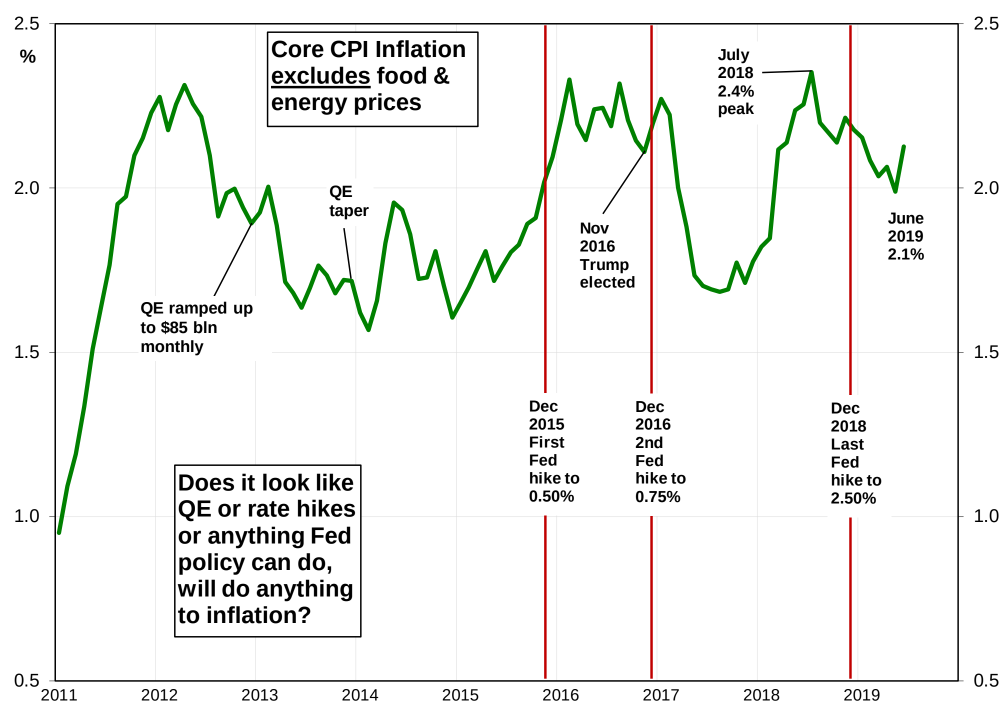
Breaking economy news. Weekly jobless claims tumbled 13 thousand to 209 thousand in the July 6 week that included the July 4th holiday of course. Core inflation jumped by 0.3% in June after a long string of 0.1% monthly increases. Fourth months with little inflation to see. But now the long inflation drought is over and the markets better take heed as the need for the Fed to take out an insurance policy and cut interest rates just in case looks completely unnecessary. Buying an insurance policy makes Fed officials look like a bunch of Chicken Little's warning the markets the sky is falling. There's uncertainty, but the sky is not falling. The economy has entered its tenth year of expansion and all is well. The trade headwinds are not pushing inflation down that much we know.

Net, net, it is too early to say the Phillips Curve is dead as the tightest labor market in decades is keeping deflation pressures at bay. There is no sign of economic weakness anywhere in today's economic reports on jobless benefits and CPI inflation. Taking out a little insurance and cutting interest rates looks less necessary with inflation seeing a spark of life and companies keeping a firm grip on their workforces. With a tight labor market, the direction of inflation is up not down and Fed officials would be well advised to check their compasses to see where the economy is actually heading. Finish the job and return monetary policy to normal would be our advice after seeing today's data.

Fed officials who are concerned about inflation being too low will take some comfort from today's report showing core inflation pressures have rebounded after months of being stuck in a soft patch.

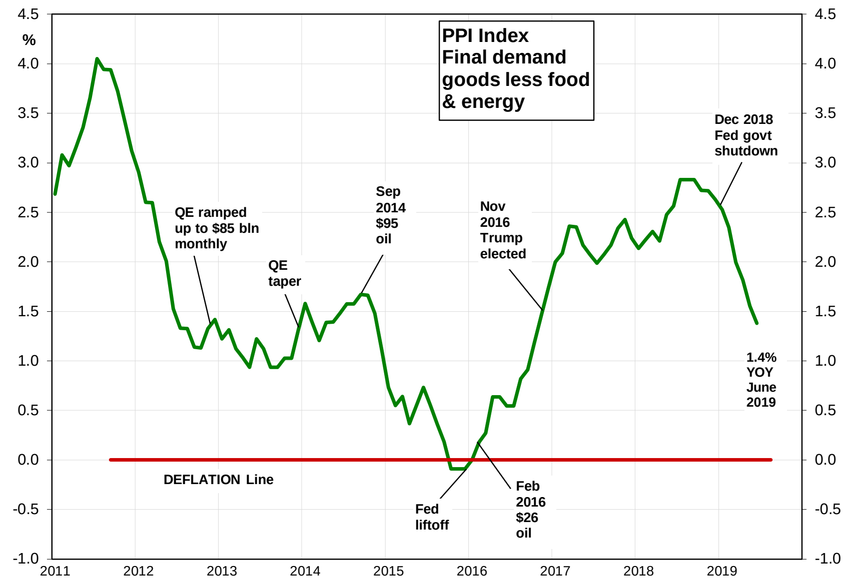
Inflation pressures continue to build in one of the tightest labor markets the country has ever seen and this argues against aggressive monetary stimulus from the central bank. Fed officials are unlikely to cut interest rates more than one or two times this year no matter how badly the Trump economics team wants even more stimulus to stoke the economy's engines of growth going into next year's presidential election.

There is no recession anywhere on the horizon after today's economic data with plummeting jobless claims and a sharp one-month jump in core consumer inflation. The economy's better than you think. Bet on it.



False alarm: zero inflation at the producer level as trade war throttles up (Friday)

Breaking economy news. PPI inflation once the hottest economic number on the planet where bond market vigilantes saw rising inflation and sold bonds like crazy before heading for the hills. More inflation, higher bond yields. Life was so much simpler then. Bond market vigilantes have turned into bond market junkies who see deflation everywhere dragging the economy down, and rush out to buy more bonds every time yields back up 10 or 20 basis points higher. Bond yields are in a near-death plunge over the cliff to negative yields around the globe. And who can blame them? Fed officials are worried inflation is too low, one of the economic challenges of our times as Powell was directed to say following a pointed question to him recently. Indeed.



No inflation today. Manufacturers exporting their goods to the world are so far down in the dumps that they cannot even think of raising prices and risk losing out on market share. World trade has imploded and these America First protectionist policies from the Trump administration may yet bring world economic growth to a screeching halt. The Lehman bankruptcy last did it in 2009, maybe the trade war will do it in 2020 if not sooner.

Get on with it. Okay, PPI total final demand inflation rose 0.1% in June. We are most interested in the index that shows demand for basic commodities used in industry. The June ISM manufacturing survey says prices are declining, and not quite but close to it according to today's PPI report. Final demand goods prices less food and energy have been unchanged for three straight months, 0.0 percent in April, in May, and in June. Industrial inflation by this measure had been rising 2.8 percent year-on-year last September before cooling down to just 1.4% on a year-year basis. It is looking increasingly like those final couple of Fed rate hikes in September and December last year really took the wind out of inflation's sails. Cooling inflation is another reason why Fed officials are likely to take some risk off the table for the economy by reducing interest rates a couple of times before the end of the year.

Net, net, the prices of core goods that companies pay to produce their products are seeing no lift from the tariffs that the Trump administration has put in place. That's not good news as prices for core producer goods are lifeless which speaks volumes to the weakening demand seen in the manufacturing sector this year. Production is down, and somehow orders for new equipment remain near all-time highs, but orders can be cancelled which may yet prove to be the case as manufacturing is clearly hurting due to the reduction in world trade from America's trade war escalating rapidly around the globe.

Bringing factories and jobs back to the USA may have been a good campaign pledge back in 2012 with an unemployment rate of 7 or 8 percent when the president first thought of running for the highest office in the land. But continuing this trade war and putting on sanctions and tariffs will only hurt the

US economy today and not lead to any more jobs as the country is at full employment. Stay tuned. Story developing.

Analyst Certification

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