Financial Markets This Week

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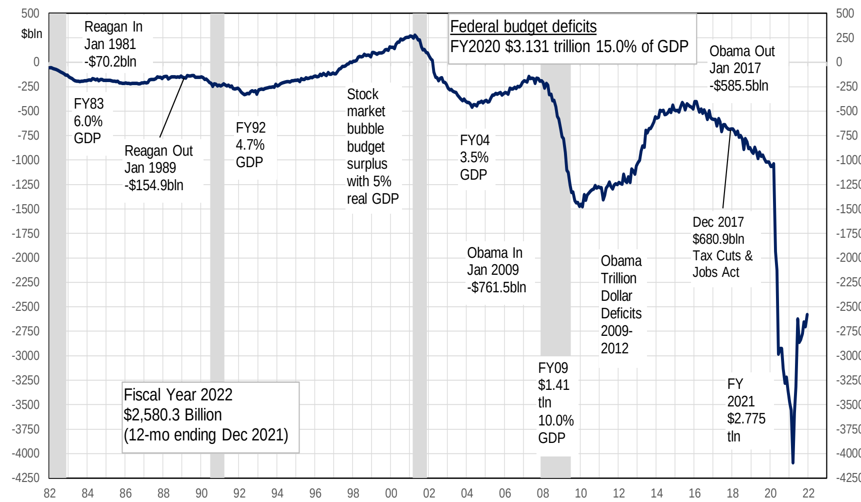
FEDERAL BUDGET DEFICIT RED INK BACK TO $1 TRILLION THIS YEAR MAYBE



The economy is normalizing, maybe the Federal budget deficit will as well. Wages are up, tax collections as well of course, if only Congress holds the line on spending. There were a lot of complaints from all sides about the trillion dollar Federal budget deficits from 2009 to 2012 during the Obama years: deficits weren't big enough to get the economy moving again, lackluster growth and joblessness persisted etc. There was less criticism of the Federal deficit spending during the pandemic, at least initially. The Federal deficit was already sliding back to $1 trillion during the best economy in fifty years in the 2019 fiscal year (FY) ending in September. The budget-busting Tax Cuts and Jobs Act in December 2017 helped that trillion dollar deficit along. What happened in FY2020 was off the charts with a Federal deficit of $3.131 trillion: which wasn't all spending of course as the recession dropped tax revenues dramatically with unemployment approaching 20% briefly in April 2020. Deficit spending is good in recessions according to economic theory as it makes up for the loss of private spending. The Federal government is thought to have not spent enough in the 2007-09 Great Recession although the biggest deficit of $1.41 trillion in FY2009 was 10.0% of GDP. A decade later the FY2020 $3.131 trillion deficit was 15.0% of GDP. In comparison to way back in the Reagan years, the FY1983 deficit was 6.0% of GDP. Which points out who pays for Washington's red ink spending? The U.S. Treasury doesn't have the cash to fund the spending of Congress, so they have to raise the cash by selling bonds to the public… except, except this time around when the Federal Reserve's emergency QE stimulus was there to pick up the slack. Although the Fed eventually slowed its monthly QE Treasury purchases to $80 billion per month, they bought more than that in the early days of the pandemic including a stunning $993 billion in the month of April 2020. The $3.1 trillion Federal deficit sounds bad in FY 2020, but the Federal Reserve brought it down to size for the good of the country by purchasing $2.3 trillion of it that year. For the life of us, we cannot understand why they are in a hurry to reverse these purchases so quickly in this economic cycle even if the downturn of two months was much shorter than the 18 month Great Recession in 2007-09. The public will have to buy the bonds the Fed no longer wants to hold on its balance sheet and more U.S. Treasury auctions could push up 10-year Treasury yields and, more importantly for the economy, mortgage rates. Seems like an unnecessary risk to the economy, and overshoot of Fed tightening in addition to the three Fed funds rate increases they are forecasting this year.

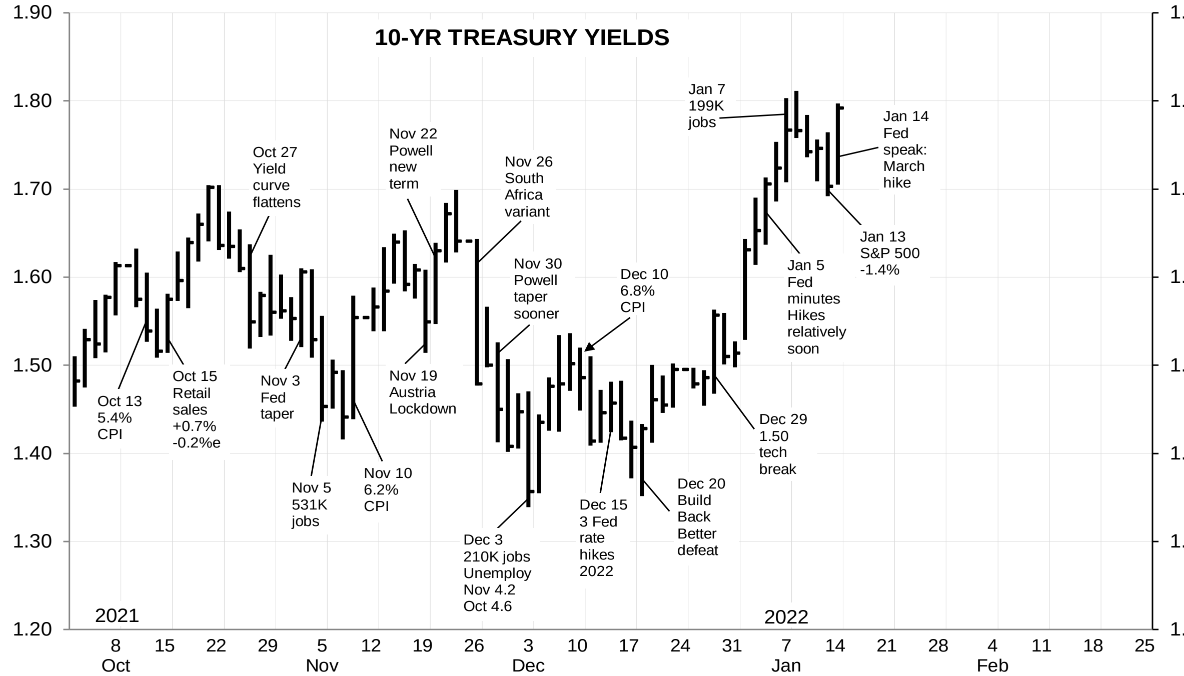
But we wanted to look at the Federal budget deficit trend in the final calendar quarter of 2021 after getting the December monthly Treasury statement on Wednesday this week. After pandemic budget deficits of $3.131 trillion in FY2020, and $2.775 trillion in FY2021, the deficit is coming down closer to $1 trillion this year. The Office of Management and Budget put out a mid-session review August 27, 2021 and looks for a $1.542 deficit. The CBO's Nonpartisan Analysis for the U.S. Congress thought $1.153 billion. FY2021 had $570 billion of Economic Impact Payments ($600 and $1400 checks) that are going away. Unemployment benefits paid in FY2021 were nearly $400 billion and this year might be just $40 billion. That takes a trillion off FY2022 without even thinking about it; the kind of back of the sandwich wrap trading desktop research we specialize in. Fed has stopped buying, so deficit reduction is good.

Federal Government Spending ($bln) **Where to cut?**	1 Qtr FY22 Q4 21-Q4 21	1 Qtr FY21 Q4 20-Q4 20	Fiscal Year Changes	Fiscal Year % chg	Full Year FY 2021
TOTAL BUDGET OUTLAYS	1,429.567	1,376.268	53.299	3.9	6,821.532
Legislative	1.483	1.388	0.095	6.8	5.263
Judicial	2.199	2.150	0.049	2.3	8.310
Agriculture	74.455	72.069	2.386	3.3	235.193
Commodity Credit Corporation	8.182	12.348	-4.166	-33.7	10.548
Food Stamps	42.244	27.084	15.160	56.0	134.527
Child Nutrition	11.001	5.719	5.282	92.4	25.798
Commerce	3.755	5.177	-1.422	-27.5	13.134
Defense	197.226	195.059	2.167	1.1	717.585
Military Personnel	60.808	59.957	0.851	1.4	172.580
Operation Maintenance	67.923	70.174	-2.251	-3.2	286.181
Procurement	38.257	32.679	5.578	17.1	141.446
Research Development	27.295	26.645	0.650	2.4	105.665
Military Construction	2.512	2.620	-0.108	-4.1	9.147
Education	39.159	21.481	17.678	82.3	260.452
Office of Federal Student Aid	7.842	8.125	-0.283	-3.5	170.400
Energy	8.594	8.947	-0.353	-3.9	33.694
Health Human Services	389.573	356.639	32.934	9.2	1466.673
Medicare	220.212	211.291	8.921	4.2	875.361
Medicaid States Grants	137.268	123.491	13.777	11.2	520.588
Homeland Security	21.368	27.641	-6.273	-22.7	91.069
Housing Urban Development	12.725	11.658	1.067	9.2	35.083
Interior	3.825	3.768	0.057	1.5	15.788
Justice	9.313	9.040	0.273	3.0	39.261
Labor	13.280	79.632	-66.352	-83.3	404.771
State Unemployment Benefits	222.335	195.977	26.358	13.4	222.335
Fed Additional Unemployment	8.520	69.792	-61.272	-87.8	162.697
State	8.306	8.641	-0.335	-3.9	35.814
Transportation	25.115	25.613	-0.498	-1.9	104.936
FAA	6.109	20.396	-14.287	-70.0	37.022
Federal Highway Admin.	129.431	25.663	103.768	404.3	61.218
Treasury	248.519	167.540	80.979	48.3	1633.747
TARP	0.027	0.116	-0.089	-76.7	0.370
Coronavirus Relief Fund	2.295	0.000	2.295	--	243.460
IRS	85.440	28.728	56.712	--	817.462
Earned Income Credit	1.153	1.364	-0.211	-15.5	60.757
Child Tax Credit	47.812	0.699	47.113	--	78.959
Economic Impact Payments	3.600	0.000	3.600	--	570.000
Interest on Public Debt	152.397	132.444	19.953	15.1	562.388
Veterans Affairs	72.787	66.820	5.967	8.9	233.781
Corps of Engineers	2.376	2.554	-0.178	-7.0	7.936
Other Defense Civil Programs	21.154	22.773	-1.619	-7.1	58.085
Environmental Protection	2.535	2.186	0.349	16.0	8.309
Exec. Office of President	0.114	0.111	0.003	2.7	0.427
International Assistance	4.349	5.074	-0.725	-14.3	20.047
NASA	6.329	6.214	0.115	1.9	22.249
National Science Foundation	1.854	1.682	0.172	10.2	7.354
Personnel Management	27.733	26.499	1.234	4.7	108.552
Small Business Admin.	10.386	3.741	6.645	--	322.721
Social Security Admin.	306.748	321.748	-15.000	-4.7	1192.453
Retirement Benefits	251.581	259.861	-8.280	-3.2	982.673
Federal Disability Payments	34.417	41.210	-6.793	-16.5	140.774
Other Independent Agencies	9.224	5.474	3.750	68.5	13.554

Selected Pandemic Fiscal Stimulus

$Billions	Oct	Nov	2020 Dec	2021 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	FY2021 end Sep	Oct	Nov	2021 Dec
Unemployment compensation	33.566	25.892	27.703	33.812	43.977	49.080	37.488	35.007	38.752	27.341	29.057	13.595	4.715	3.448	3.125
State	23.041	22.083	24.669	18.619	21.322	23.441	17.477	16.437	18.684	13.293	14.484	8.785	2.958	2.976	2.585
Federal additional	3.242	2.642	2.236	15.002	22.516	25.200	19.944	18.523	20.027	14.028	14.552	4.788	1.745	0.464	0.532
FEMA Lost Wages	7.283	1.167	0.798	0.191	0.139	0.439	0.067	0.047	0.041	0.020	0.021	0.022	0.012	0.008	0.008
Economic Impact Payments	--	--	--	139.000	8.000	339.000	58.000	11.000	5.000	4.000	3.000	3.000	3.000	1.700	-0.746
Food Stamps	8.991	9.107	8.986	8.430	9.105	10.932	10.642	11.463	14.537	13.843	14.777	13.615	13.381	14.528	14.335

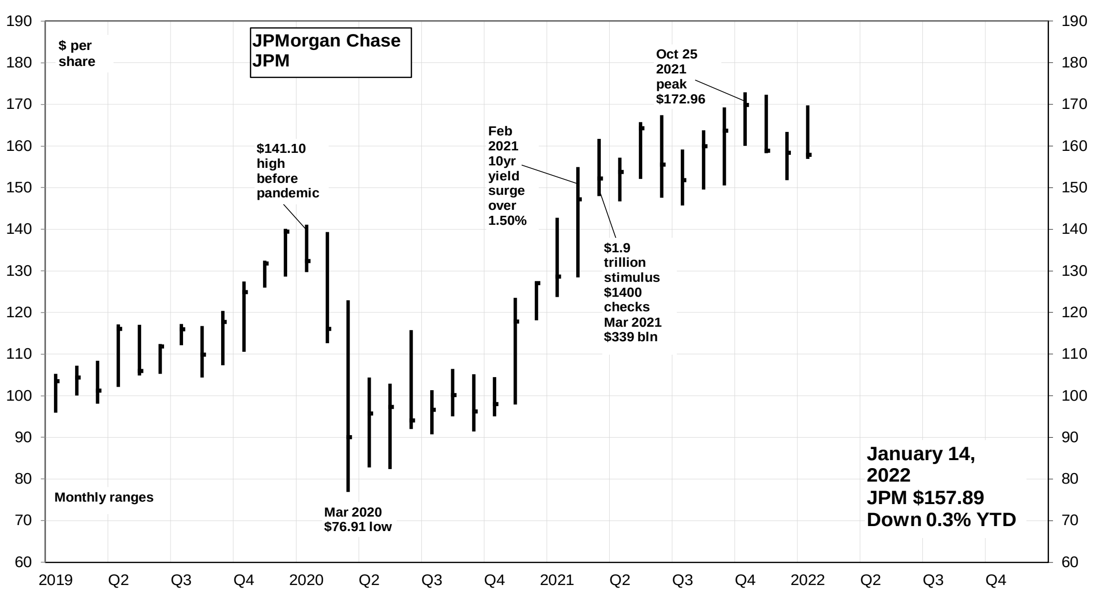
INTEREST RATES



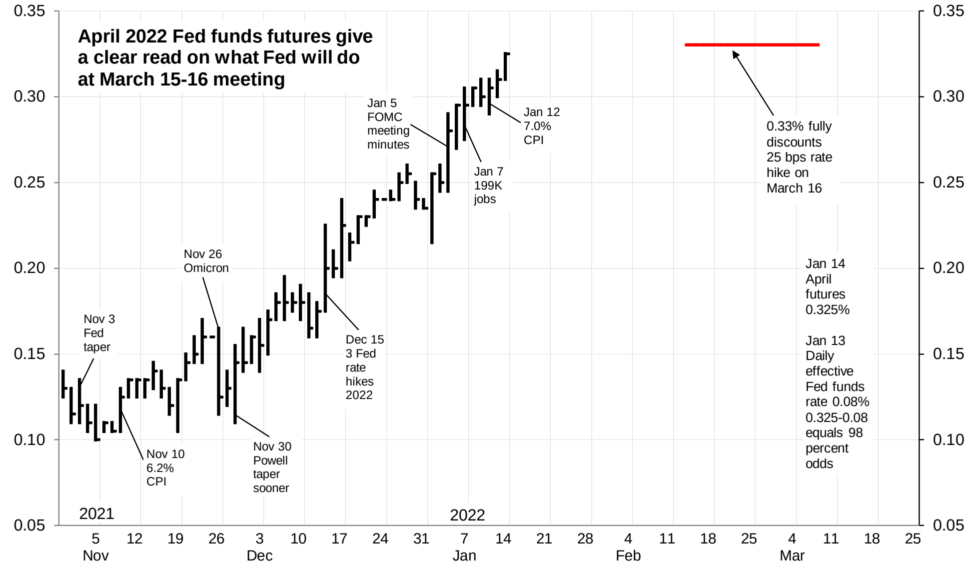
Let's see. CPI inflation 7.0% worst since 1982 this week. Bonds closed at 1.75% the day of the news. Before that, 6.8% CPI on December 10, bonds closed 1.49%. Before that, November 10 CPI 6.2%, bonds closed 1.55%. Before that, October 13 CPI 5.4%, bonds closed 1.54%. Bonds not exactly scared of inflation. Makes you wonder what will happen to yields when CPI inflation comes down to 3 or 4 percent. For all the talk of inflation and the need to address it, the Fed forecasts only see a 2.25% Fed funds rate in 2024. Unless they revise that higher, 10-year Treasury yields will have trouble moving as high as they did the last time around in 2018: 3.26%.

JPMorgan drops Friday after earnings, 9th largest company in S&P 500

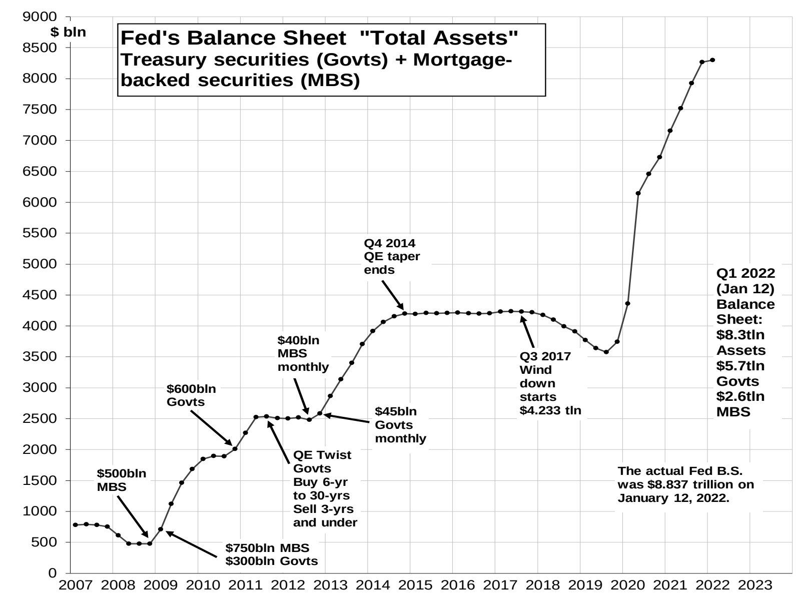
JPMorgan stock tumbled 6.1% on Friday helping to drag the Dow Industrials down 0.6% with the S&P 500 and Nasdaq higher. Last quarter, bank earnings in general were a major reason stocks recovered further from the lows on October 14. JPM closed $161.00 on October 13, 2021 after its last earnings call. Now however expenses (wages) are rising and it expects more headwinds in the next year or two. CEO Jamie Dimon said there could be more than 4 Fed rate hikes, perhaps six or seven.



FEDERAL RESERVE POLICY



The Fed meets on January 25-26, 2022 to consider its monetary policy. The economic data this week didn't hold back Fed officials on the need to normalize policy. They put on a united front and this may have helped drive bond yields higher on Friday. Overseas markets were impressed with the Vice Chair Senate confirmation hearing statements from Fed governor Brainard who in past years was often seen as a champion of the maximum employment mandate at the expense of inflation. Not true now, although it must be hard to speak to both sides of the aisle. She was asked by Senator Tina Smith (D-MN) what higher interest rates will do to employment. Brainard replied, "I believe we'll be able to see inflation coming back down to target while the employment picture continues to clear." 1:57 Great. You can have your cake and eat it too. Fine with us. Everyone used to think monetary policy was accommodative until the Fed funds rate reached 2.5% neutral, normal levels. Fed rate hike odds for March were 98% Friday versus 86% last week.

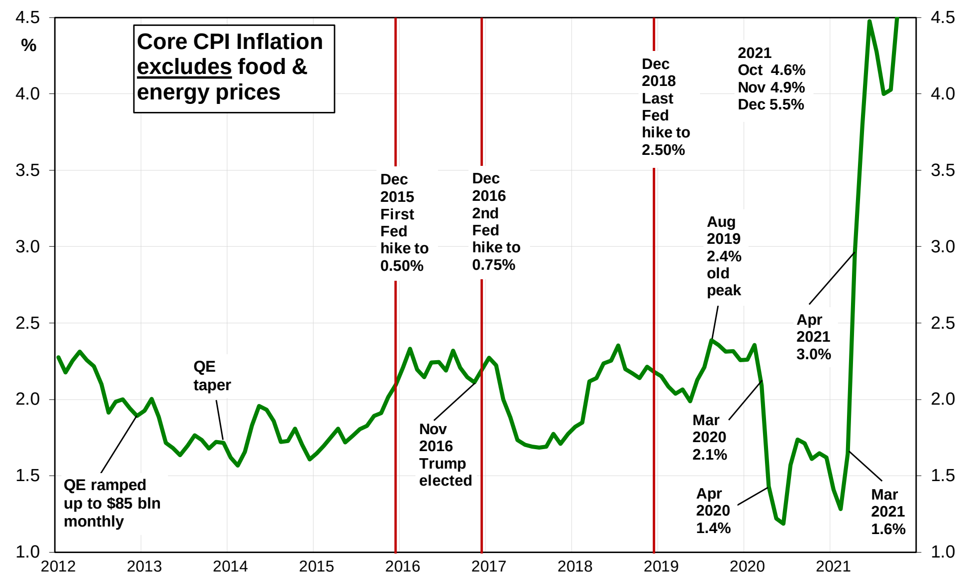


We remain interested in the QT Quantitative Tightening angle, and are still somewhat baffled about the need to bring the balance sheet down so quickly. No one knows what the balance sheet is doing right now at its enormous size even if Powell's December press conference statement has him saying, "Even after our balance sheet stops expanding, our holdings of securities will continue to foster accommodative financial conditions." Okay. We think New York Fed President Williams on Friday let the cat out of the bag. Maybe the Fed's rate hikes this year will flatten the yield curve and keep 10-year Treasury yields from rising high enough to restrictive levels that slow economic demand. So as a countermeasure, the Fed can let its holdings of U.S. government securities roll off its balance sheet which means the Treasury has to auction more Treasuries to the market and the increase in supply pushes bond yields higher. We will see what happens. The QT Treasury security redemptions were relatively modest the last time around from Q4 2017 to Q3 2019, about $390 billion, but it was generally a period of rising interest rates until the December 2018 stock crash; maybe some economic models think QT helped move bond yields higher.

OTHER ECONOMIC NEWS

CPI inflation the worst since 1982 says it all (Wednesday)

Breaking economy news. CPI inflation rose 0.5% in December to a new high year-year rate of 7.0%. Even an optimist wouldn't view today's report as good news even if the one-month change is better than 0.8% in November and 0.9% in October. The bottle is broken and the inflation genie is out. We just had Powell's Senate testimony for a second term as Fed Chair yesterday where he said he is humble and well he should be for unleashing the worst inflation seen in America since the 1980s. The Fed took their eye off the ball and this is what we got. The highest inflation since 1982 before Volcker the lion-tamer brought inflation to its knees. Core CPI inflation 0.6% in October, 0.5% in November, 0.6% in December shows there is no sign that the worst days of this unprecedented inflation outbreak is behind us. Even the price of clothing is up 1.7% in December and 5.8% above last year levels even with millions of workers still at home laboring away in their underwear. How could that be? Services prices ex-energy are up 3.7% the last year and you can use this as an indicator of where inflation will cool once the commodity price hikes stop.



Net, net, the nation is unlikely to see another year of inflation like it did in 2021 as the price increases were fed by Fed emergency stimulus and over-the-top fiscal stimulus that drove demand for store-bought goods to unforeseen heights. The danger is just how entrenched inflation has become in society and the warning signs are clearly there with services prices going up in unison with consumer goods even with the service sector of the economy not back to pre-pandemic levels.

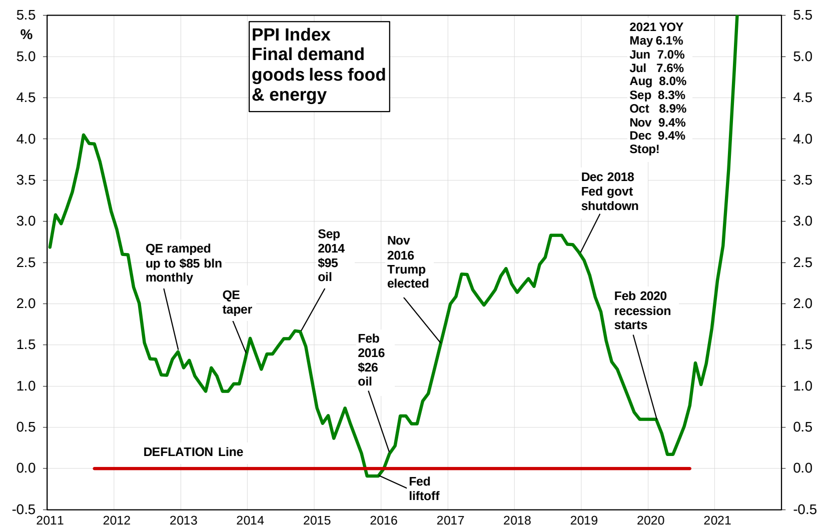
The lesson of history is once inflation starts it is difficult to slow price increases back down. We don't believe Fed officials have the tools to bring inflation back down to levels that the public no longer notices. CPI inflation was 7.0% in 2021, and we won't see that again, but 3 or 4 percent inflation in 2022 will be nothing to cheer as it eats away at the purchasing power of people's savings, especially the elderly that can least afford to speculate in the stock market. We don't see any good outcomes here. Commodity prices like oil and gasoline can't go up forever, but once the inflation genie is out of the bottle, it is nearly impossible to stop the damage these price increases inflict on the economy. The Fed hasn't engineered a soft landing for the economy with its interest rate hikes before. We are doomed. The mistake of fighting joblessness for too long has already been made. Bet on it.

		Monthly Percent Changes			YOY %
Weight	CPI inflation	Oct 2021	Nov 2021	Dec 2021	Dec 2021
100.0	Total	0.9	0.8	0.5	7.0
13.990	Food	0.9	0.7	0.5	6.3
6.269	Food away from home	0.8	0.6	0.6	6.0
7.542	Energy	4.8	3.5	-0.4	29.3
78.468	Ex-food & energy	0.6	0.5	0.6	5.5
3.884	New vehicles	1.4	1.1	1.0	11.8
3.419	Used cars/trucks	2.5	2.5	3.5	37.3
2.669	Clothing	0.0	1.3	1.7	5.8
1.487	Medical care goods	0.6	0.1	0.0	0.4
32.393	Shelter	0.5	0.5	0.4	4.1
23.509	Owner equiv. rent	0.4	0.4	0.4	3.8
5.046	Transportation	0.4	0.7	-0.3	4.2
6.987	Medical care services	0.5	0.3	0.3	2.5

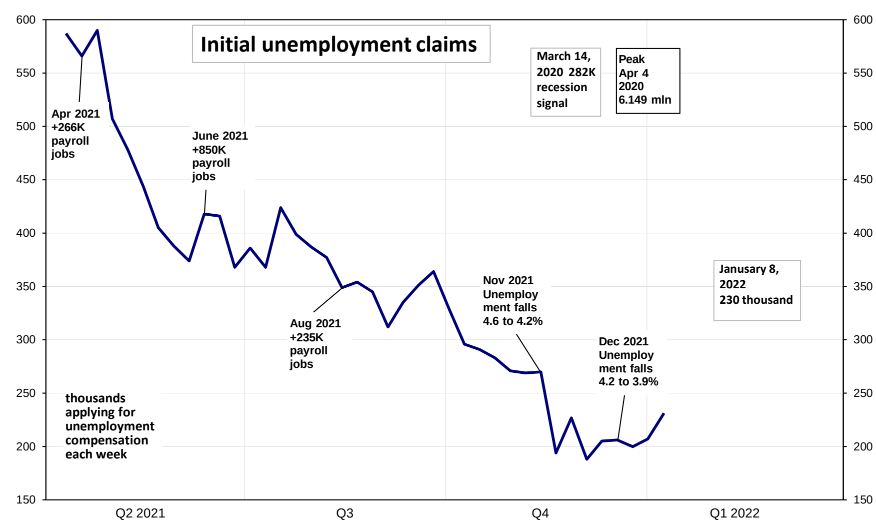
Omicron slowing demand is good for the inflation fight even if temporary (Thursday)

Breaking economy news. Producer inflation and weekly jobless claims. Jobless claims are the highest since mid-November, and keeping in mind the first Omicron case was not discovered until December 1, the meteoric spread of the virus the last few weeks may have led to forced layoffs at some firms. It's hard to tell as the seasonal factors find it difficult to adjust the weekly layoffs in winter. Jobless claims jumped 23K to 230K in the January 8 week. It is possible that Omicron's spread has pushed back on the very strong demand pressures the economy has seen which would be just what the doctor ordered for policymakers trying to slow the worst inflation outbreak since the 1980s. Omicron slowing demand in the economy is good for the inflation fight even if the virus shows signs of peaking.

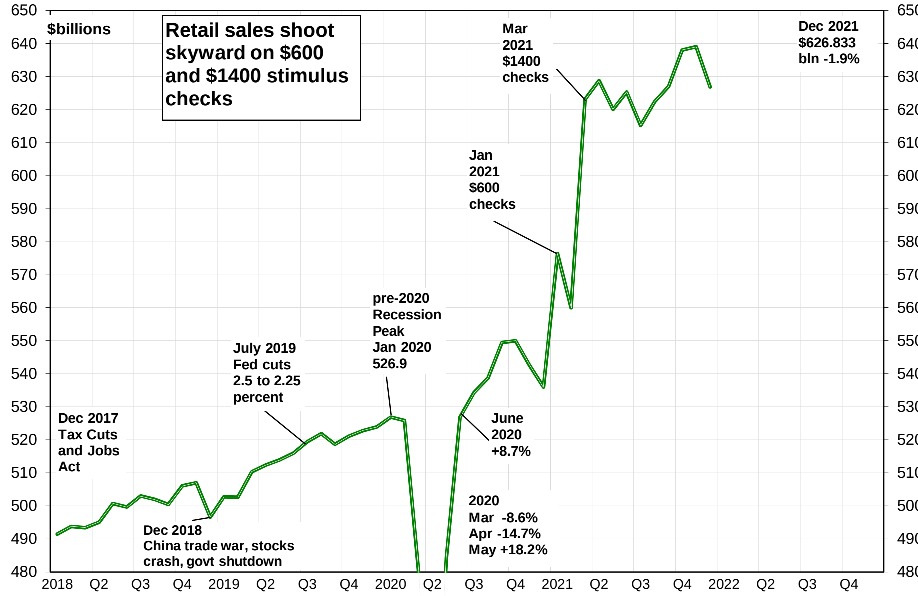
Producer price inflation headlines sounded like improvement, but drawing back the curtain, the drop in PPI final demand goods prices was all due to food and energy and of course energy prices are now higher in January looking at crude oil futures at $82.28 this morning. December Final demand goods less food and energy inflation held at 9.4% year-on-year the same as in November. Consumer inflation is running 7.0% higher in December than it was a year earlier. If there's one thing consumers and producers can agree on there's too much inflation out there in the country.



Net, net, it's not just a matter of logistics, or lack of workers or supply chain disruptions anymore, producers across a wide range of product lines and industries are raising prices because the market lets them. It is the strength in the demand for their products that is allowing them to lift prices to never before seen levels. If Washington wants to stop inflation in its tracks it is going to have to figure out how to cool the economic boom that shows no sign of ending anytime soon. Every inflation period in history has gone from bad to worse and right now inflation is bad but worse times may still lie ahead. One thing for sure is that any company that cannot raise prices, those businesses will be left behind in the dust and may even face bankruptcy as their costs spiral out of control.



Retail sales flop in December even before Omicron case counts build (Friday)



Breaking economy news. Retail sales dropped 1.9% in December, more than expected, if expectations play any role anymore in a world filled with surprises in the aftermath of the pandemic. We will see what the retailers say in their earnings reports, but the holiday season doesn't look as bright and cheery as anecdotal reports had said, even allowing for some early sales in November due to fear of understocked store shelves. Furniture down 5.5%, Electronics and appliances -2.9%, clothing -3.1%, and the Sporting goods, hobby, musical instruments, book stores category down 4.3%. Even all the purchases we made from the couch in December on our cell phone for holiday presents couldn't stop internet sales (nonstore retailers) plummeting 8.7% in December. Must be something wrong with seasonal factors. But the number is the number and right now the retail sales flop in December is going to cool the forecasts for real GDP in Q1 2022. Retail sales jumped 8.7% in Q4 2021 on an annualized basis and now are starting out Q1 2022 from December's level down 4.8% in the hole. This is quite a reversal of fortune for the consumer who is clearly tiring and it is not all certain that the lack of wind in their sales is due to social distancing caused by the emergence of the Omicron variant. Retail sales were a flop in December even before the Omicron case counts started to build.

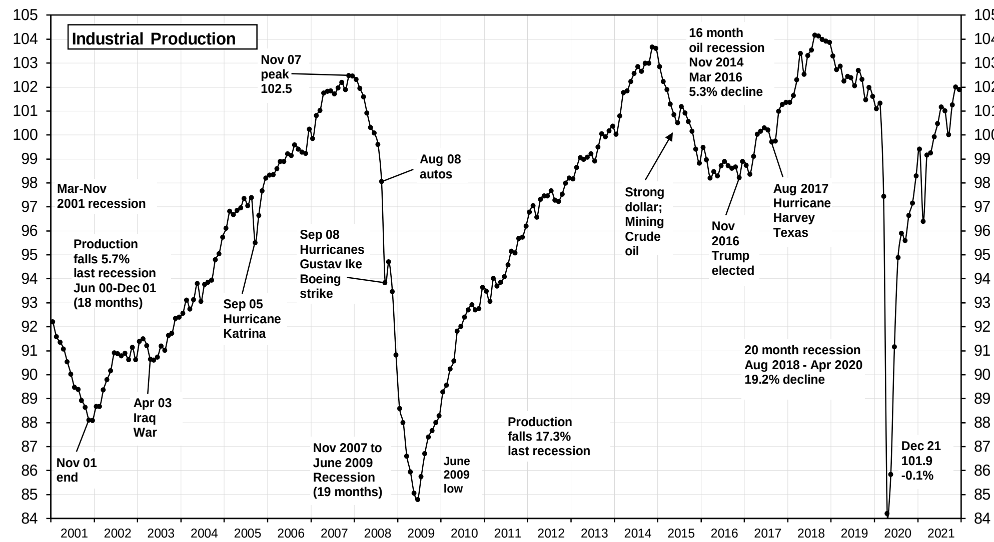
Retail spending, actual dollars, each month

	$million Dec 2021	% to Total	Percent Changes % Dec	Nov	Year/year
Total Retail Sales	626,833	100.0	-1.9	0.2	16.9
Motor vehicles/parts	126,267	20.1	-0.4	0.2	10.2
Furniture/furnishings	11,795	1.9	-5.5	0.5	11.1
Electronics/appliances	7,398	1.2	-2.9	-9.7	14.6
Building materials/garden	41,740	6.7	0.9	2.2	12.5
Food & beverage	77,353	12.3	-0.5	0.4	8.4
Health/personal care	32,371	5.2	0.5	0.9	8.4
Gasoline stations	54,662	8.7	-0.7	2.2	41.0
Clothing/accessories	26,061	4.2	-3.1	1.2	29.5
Sporting goods, books	9,140	1.5	-4.3	2.1	18.1
General merchandise	69,639	11.1	-1.5	-1.2	14.6
Department stores	10,930	1.7	-7.0	-5.5	22.5
Miscellaneous retailers	15,280	2.4	1.8	0.7	20.6
Nonstore retailers (internet)	82,596	13.2	-8.7	-1.5	10.7
Eating & drinking places	72,531	11.6	-0.8	0.6	41.3

Net, net, if the consumer is still in the driver's seat powering the economy forward, the outlook for 2022 is in big trouble with retail sales dropping in December the most since February. And February's decline was technical after the Federal government's first $600 dollar checks were spent. The economy's car is literally out of gas with filling station sales down 0.7% this month. If the Federal Reserve is truly going to bring the hammer down hard on the economy with the first rate hike just a couple of months away, then a 2022 slowdown in growth is looking more and more likely. For the first time since this strong economic recovery began, we have to scale back our optimism as the central bank's war on inflation has just begun. Stay tuned. Watch here where the world goes next.

Factory production setback in December too (Friday)

Breaking economy news. Industrial production fell 0.1% in December. The Federal Reserve's own statistic compiled since 1919 and very important in their monetary policy deliberations so maybe that March interest rate hike is not a done deal. Well, maybe not. Mining activity rescued the entire index from falling further. The total index is up 3.7% the last 12 months which shows you this is real activity as opposed to the unreal retail sales report out earlier today at 830am ET where sales were still up 16.9% this year thanks in part to the 7.0% rise in CPI inflation, both on the same year-year basis.



Manufacturing was down 0.3% in December and not sure whether that was Omicron or supply shortages related. But motor vehicles and parts did fall 1.3%, although manufacturing production without motor vehicles was still down 0.2%. Not the end of the world for factory production, but manufacturing industrial production is still 1.8% below the best economy in fifty years before the pandemic, in this case August 2018 was the peak.

Net, net, signs of an economic slowdown at the end of last year are everywhere with declines reported in retail sales and factory production. Time will tell if this slowdown spreads further in the first quarter and leads to a scaling back of Fed offiicials' plans to throw three rate hikes at the economy in 2022 to do the same thing-slow the economy's demand boom. Factory production had a setback in December and we can't even blame the weather as the report said warmer-than-normal temperatures reduced demand for heating. Stay tuned. Watch here where the world goes next.

Percent changes			Industrial Production Dec 2021		
Oct	Nov	Dec	YOY		Weight
1.2	0.7	-0.1	3.7	Total Index	100.0
1.4	0.6	-0.3	3.5	Manufacturing	75.9
4.3	0.5	2.0	11.0	Mining	12.2
-3.4	1.9	-1.5	-3.4	Utilities	11.9
			Manufacturing payroll jobs		
			12.6 million +349K YOY		
			9.9% of Private Payroll Jobs		

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