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Scott J. Brown, Ph.D., (727) 567-2603, Scott.J.Brown@RaymondJames.com

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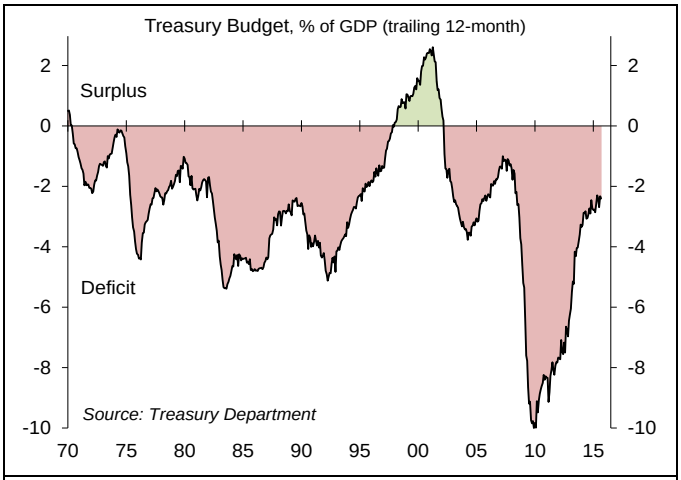
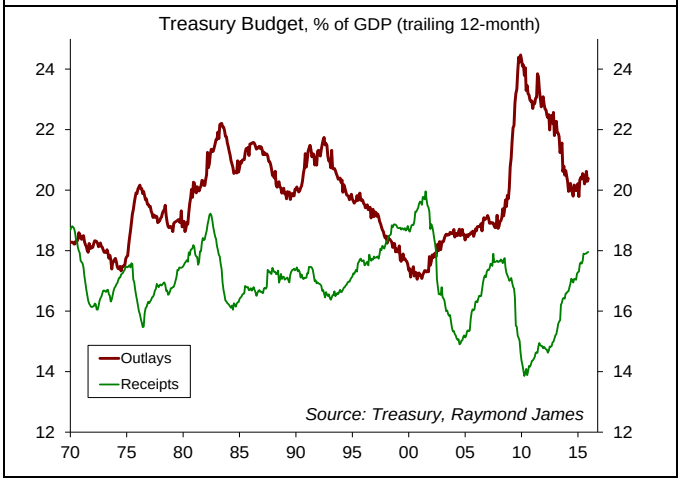
Weekly Market Monitor

The Budget and the Debt Ceiling

Treasury reported a $439 billion budget deficit for the fiscal year ending in September. That sounds like a lot, but it's 2.4% of GDP, below the average of the last few decades. However, that's nothing to celebrate, as the retirement of the baby-boom generation will boost entitlement spending in the decades to come. There's plenty of time to solve that problem, but the federal debt ceiling is a more immediate concern. Congress has just two weeks to work out a deal.

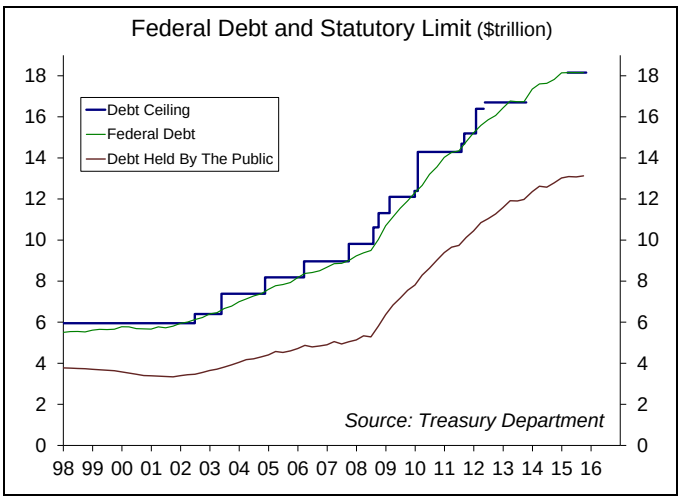
The deficit ballooned to $1.4 trillion (10% of GDP) in FY09, reflecting the severity of the recession. Revenues dried up, and recession-related spending (unemployment benefits, food stamps) surged. As the economy recovered, spending retreated and revenues recovered (although not entirely – the economy remains below its potential). We did have some fiscal stimulus at the beginning of the recovery, about $831 billion spread out, mostly in 2009 to 2011. That was small compared to the magnitude of the decline in GDP (and more than 40% of the stimulus was ineffective tax cuts in the first two years).





Medicare and Social Security are accounting for an increasing share of federal outlays. Nondefense discretionary spending (outlays less defense, entitlements, and interest) is now about 3.3% of GDP, but is projected to fall steadily over time (so contrary to popular misconceptions, if you exclude entitlements, there's not a whole lot of the budget to cut). Medicare is the bigger problem, reflecting healthcare cost inflation on top of the demographic issues. The government will eventually have to face the necessity of cutting entitlements, raising taxes, or borrowing more (or, most likely, some combination of these).

Under the Constitution, (Article 1, Section 8), only Congress can authorize federal borrowing. The federal debt is simply the sum of past budget deficits. Congress established the debt ceiling in 1917 as a means of preventing President Wilson from spending too much on World War I. We haven't been able to get rid of it since, even though it may be at odds with the annual budget set by Congress. Often, one party will try to use the debt ceiling to extract something that it wants from the other side. This is politics. Senator Obama voted against raising the debt ceiling. Many Republicans had no problem raising the debt ceiling several times during the previous administration.



In 2011, a debt ceiling crisis led to a downgrade of U.S. debt. That downgrade did not have much of an impact on Treasury bond yields, which declined. However, the uncertainty did contribute to a 2000-point drop in the Dow.

The debt ceiling had been suspended, but went back into effect in mid-March. Treasury has extraordinary measures (borrowing from certain government retirement funds) to artificially stay below the limit, but now projects November 3 to be the "drop dead" date for raising the debt ceiling. House Speaker Boehner, who resigned effective October 30, can still work with House Democrats to come up with a compromise, but we are running out of time quickly and need to see some action.

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	Treasury Yields								Dollar				Equities		
	13-wk	26-wk	52-wk	2-yr	3-yr	5-yr	10-yr	30-yr	$/Euro	$/BP	JY/$	CD/$	NASD	SPX	DJIA
9/18/15	0.00	0.10	0.35	0.69	0.97	1.45	2.13	2.93	1.136	1.557	119.85	1.315	4827.23	1958.03	16384.58
10/09/15	0.01	0.07	0.28	0.65	0.96	1.41	2.12	2.94	1.136	1.532	120.30	1.295	4830.47	2014.89	17084.49
10/16/15	0.01	0.08	0.22	0.61	0.90	1.35	2.03	2.88	1.135	1.544	119.49	1.291	4886.69	2033.08	17215.84

Recent Economic Data and Outlook

Two Fed Governors suggested that it might be appropriate to delay the initial increase in short-term interest rates, and the week's economic data reports supported that sentiment.

Treasury reported a $439 billion **Budget Deficit** for fiscal 2015 (2.4% of GDP), down from $483 billion in FY14 (2.8% of GDP). Revenues rose 7.6%, while outlays rose 5.2% (Defense -2.3%, Medicare +6.7%, Social Security +5.1%, interest -2.0%).

In a letter to Congressional leaders, Treasury Secretary Lew said that the drop dead date for avoiding the **Debt Ceiling** is November 3, two days earlier that previously estimated.

The **Beige Book** noted that reports from the 12 Federal Reserve districts *"pointed to continued modest expansion in economic activity"* from mid-August to early October. Consumer spending grew *"moderately,"* while manufacturing *"turned in a mixed but generally weak performance."* Labor markets tightened in most districts. Wage growth was *"mostly subdued,"* with *"scattered reports of increased wage pressures."* Prices were *"fairly stable."*

Retail Sales edged up 0.1% in September (+2.4% y/y), reflecting a 1.7% increase in autos (+8.8% y/y) and a 3.2% drop in gasoline (-19.7% y/y). Ex-autos, building materials, and gasoline, sales rose 0.1% (+3.7% y/y) – a 4.5% annual rate in 3Q15 (vs. +5.1% in 2Q15). Sales at restaurants and bars rose 0.7% (+7.9% y/y)

Business Inventories were essentially flat for a second consecutive month in August. We're still missing September data and adjusting for price changes can be tricky, but it appears likely that slower inventories will subtract significantly from 3Q15 GDP growth (advance estimate due October 29).

Industrial Production fell 0.2% in September (+0.4% y/y), with an upward revision (smaller decline) for August. Oil and gas drilling fell 4.0% (-55.6% y/y). Manufacturing output fell 0.1% (+1.6% y/y), following -0.3% in August and +1.1% in July, with some strength in autos (+0.2%, up 9.4% y/y). Ex-autos, factory output edged down 0.1% (+0.8% y/y). Capacity utilization dropped to 77.5% (from 77.8% in August and 78.5% a year ago).

The **Consumer Price Index** fell 0.2% in September (-0.0% y/y). Food at home rose 0.3% (+0.8% y/y), while food away from home rose 0.5% (+2.9% y/y). Gasoline fell 9.0% (-29.6% y/y). Ex-food & energy, the CPI rose 0.2% (+1.9%), reflecting a 0.3% rise in shelter costs (+3.2% y/y). Ex-food, energy, and shelter, the CPI rose 0.1% (+1.0% y/y). The 3Q15-over-3Q14 increase in the CPI-W was zero, so there will be no cost-of-living adjustment for Social Security in January (sorry, Grammy).

Real Hourly Earnings rose 0.1% in September (+2.2% y/y).

The **Producer Price Index** fell 0.5% in September (-1.1% y/y), reflecting a 0.8% decline in food (-2.9% y/y) and a 16.6% decline in gasoline (-42.8% y/y). Gauges for the earlier stages of production showed negative pipeline pressures.

The Fed's two main regional manufacturing surveys remained weak in October. The **Empire State Manufacturing Index** rose to -11.4, vs. September's -14.7, while the **Philadelphia Fed Index** rose to -4.5, vs. -6.0 in September. Both surveys showed declines in orders, production, and employment.

The Index of **Small Business Optimism** edged up to 96.1 in September, vs. 95.9 in August. It was 95.3 a year ago.

Economic Outlook (4Q15): about a 2.0% to 2.5% annual rate, following growth of around 1.0% to 1.5% in 3Q15 (held back by wider trade deficit and an inventory correction).

Employment: The pace of job growth has slowed somewhat, but job losses remain limited and new hiring remains good.

Consumers: Average wage growth has remained lackluster, but strong y/y job growth and lower gasoline prices have been supportive for spending. Credit is still relatively tight, but should become gradually easier over time.

Manufacturing: Strength in autos, but soft otherwise -- likely reflecting the impact of the stronger dollar and slower global growth. Domestic orders have improved relative to 2Q15.

Housing/Construction: Home sales and construction activity are increasing. Mortgage credit is getting somewhat easier.

Prices: Overall consumer price inflation has been very low, but should pick up after energy prices stabilize. There is downward price pressure in commodities and imports. Wage pressures are generally mild. Inflation expectations remain well-anchored.

Interest Rates: Fed officials believe that conditions are likely to warrant an initial increase in short-term rates later this year (or early 2016), but the more important question is the pace of tightening after the initial hike (expected to be very gradual).

This Week:					*forecast*	last	last –1	comments
Sunday	10/18	22:00	China GDP					below 7% target?
Monday	10/19	10:00	Homebuilder Sentiment	Oct	***64***	62	61	trending higher
Tuesday	10/20	8:30	**Building Permits, mln**	Sep	***1.185***	1.161	1.130	likely to have improved
			% change		***+2.1***	+2.7	-15.5	a strong trend in single-family
			Housing Starts		***1.160***	1.126	1.161	seen rebounding
			% change		***+3.0***	-3.0	-4.1	watch for revisions
Wednesday	10/21	10:00	BOC Policy Decision					no change
Thursday	10/22	7:45	ECB Policy Decision					no change, but any hints of more QE?
		8:30	Jobless Claims, 0th.	10/17	***270***	255	262	likely to rebound, still a low trend
		10:00	**Existing Home Sales, mln**	Sep	***5.50***	5.31	5.58	should have picked up
			% change		***+3.6***	-4.8	+1.8	
		10:00	Leading Econ Indicators	Sep	***-0.1%***	+0.1%	0.0%	S&P500, factory workweek to subtract
		1:00	TIPS Auction					$7 billion in re-opened 30-year TIPS
Friday	10/23	9:45	Markit US Manf PMI (flash)	Oct	***NF***	53.0	53.0	not market-moving
Next Week:								
Monday	10/26	10:00	**New Home Sales, th.**	Sep	***570***	552	522	trending higher
			% change		***+3.3***	+5.7	+12.0	but a lot of month-to-month noise
Tuesday	10/27	8:30	**Durable Goods Orders**	Sep	***-0.3%***	-2.3%	+1.9%	lower aircraft orders
			ex-transportation		***+0.2%***	-0.2%	+0.4%	perhaps a modest rebound
			nondef cap gds ex-aircraft		***+0.3%***	-1.3%	+0.8%	choppy
		10:00	**CB Consumer Confidence**	Oct	***102.8***	103.0	101.3	seen little changed
		1:00	Treasury Note Auction					2-year notes
Wednesday	10/28	8:30	**Goods Trade Balance, $bln**	Sep	***-63.4***	-67.2	-59.1	seen moderating following sharp move
		11:30	FRN Auction					2-year floating rate notes
		1:00	Treasury Note Auction					5-year notes
		2:00	**FOMC Policy Decision**					no change, no strong hints on December
Thursday	10/29	8:30	Jobless Claims, 0th.	10/24	***270***	***270***	255	still a low trend
		8:30	**Real GDP (advance est.)**	3Q15	***1.4%***	3.9%	0.6%	big drags from inventories & net exports
			Private Domestic Final Sales		***3.7%***	3.9%	2.0%	strong underlying domestic demand
		10:00	Pending Home Sales Index	Sep	***+1.2%***	-1.4%	+0.5%	likely to rebound
		1:00	Treasury Note Auction					7-year notes
Friday	10/30	8:30	Personal Income	Sep	***+0.2%***	+0.3%	+0.5%	softer wage growth
			Personal Spending		***+0.2%***	+0.4%	+0.4%	lower gasoline prices vs. auto strength
			PCE Price Index ex-f&e		***+0.1%***	+0.1%	+0.1%	mild core inflation
		8:30	**Employment Cost Index**	3Q15	***+0.4%***	+0.2%	+0.7%	still a lackluster trend
		9:45	Chicago PMI	Oct	***49.0***	48.7	54.4	still a bit soft
		10:00	UM Consumer Sentiment	Oct	***92.6***	87.2	91.9	92.1 at mid-month

This Week…

The economic calendar thins out. Residential construction data, still a long way from "normal," are likely to have remained relatively strong in September. Earnings reports are expected to be the main driver of the stock market and the bond market is likely to look to equities for direction.

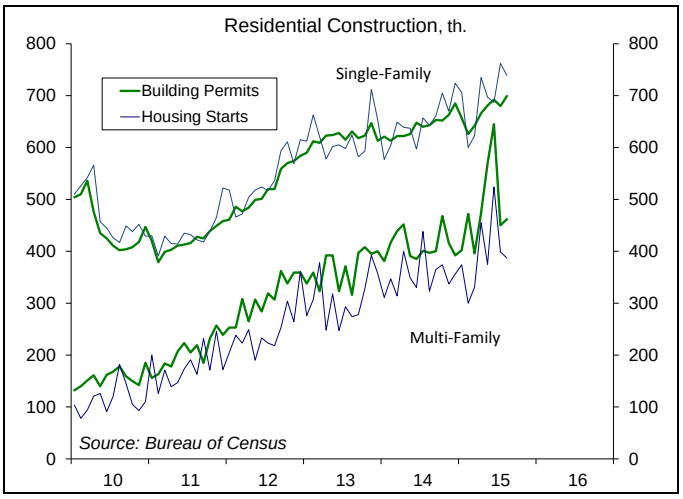
Sunday

China GDP (3Q15) – The government has a 7% target and (no surprise) managed to hit it in 1Q15 and 2Q15. Third quarter figures are eagerly anticipated. However, does anybody really believe these numbers? Market participants are now wondering whether the government will admit that the economy is slowing (pretty evident from the sharp drop in imports) and possibly revise its growth target.

Monday

Homebuilder Sentiment (October) – The National Association of Home Builders' Housing Market Index is likely to have improved further in October, reflecting improved fundamentals of the housing sector (strong job growth, easier mortgage credit). Still, there is a fair amount of noise from month to month.

Tuesday



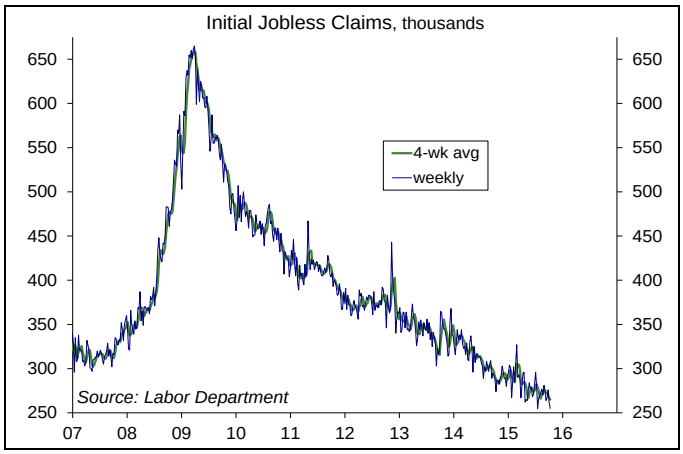
Building Permits, Housing Starts (September) – Multi-family activity, normally volatile, was boosted a few months ago by an expiring tax credit in New York. Single-family activity has improved, but remains well below a "normal" level. In other words, the housing recovery still has a way to go. The financial markets often react to the headline figure on starts, but the number of single-family permits is the most reliable element of the report and should show relative strength.

Wednesday

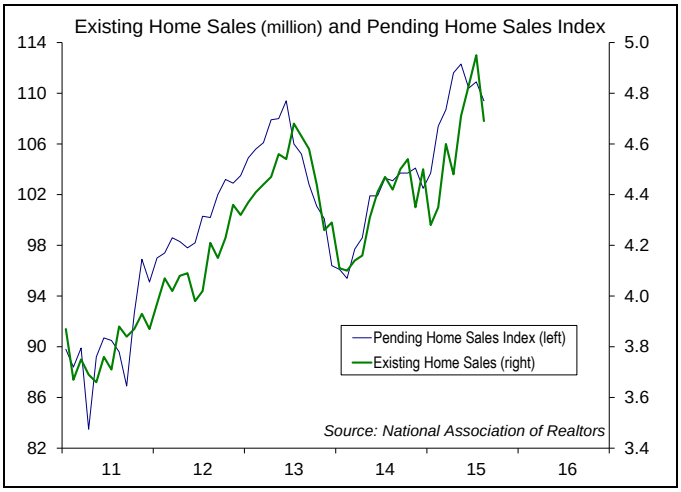
Bank of Canada Policy Decision – The drop in energy prices has had a big impact on the energy sector (exploration and revenues), but the weaker currency has made other exports more competitive. For monetary policy, it's wait-and-see in the near term, but the BOC will eventually follow (with some lag) the U.S. Federal Reserve in raising short-term rates.

Thursday

Jobless Claims (week ending October 17) – Initial claims for unemployment benefits are often a bit choppy during this time of year (due to difficulties in the seasonal adjustment), but the underlying trend has remained very low, consistent with a further tightening of overall labor market conditions.



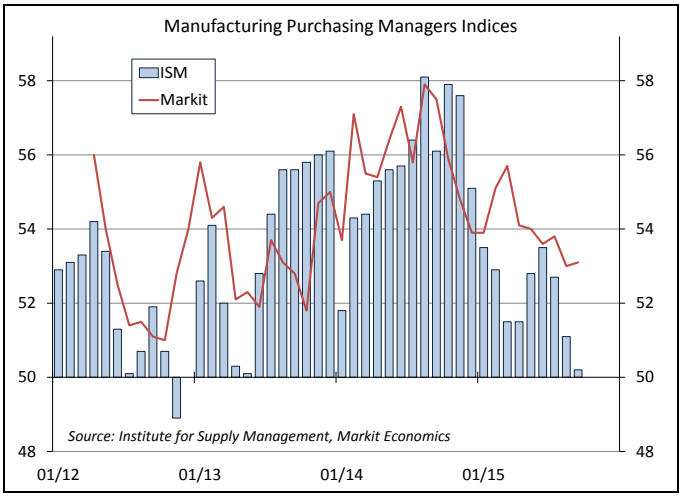
Existing Home Sales (September) – Despite the "softer" payroll growth in September, job gains over the last couple of years have been very strong and should support housing demand. Mortgage rates are still relatively low.



Leading Economic Indicators (September) – Components were mixed (we're still missing building permits). The yield curve and the drop in jobless claims will make positive contributions. The stock market and the factory workweek will subtract.

Friday

Markit U.S. Manufacturing PMI (October, flash estimate) – This gauge really hasn't caught on with U.S. investors. It has only a loose correlation with the more-important ISM data.



Next Week …

The economic calendar picks back up, with an expected focus on the advance GDP estimate. The third quarter was a mixed bag, with domestic strength offset by large (and uncertain) drags from foreign trade and inventories. Durable goods shipments and inventories and the September trade data on goods may help to refine forecasts a bit. Financial market participants typically focus on the headline number, but one should really keep an eye on Private Domestic Final Sales. The Fed policy meeting is expected to result in no change. There is no Yellen press conference. All we'll get is the policy statement, and investors will be looking for clues about whether the Fed will move in December or in early 2016. The Employment Cost Index, a key measure of inflation pressure, should remain on a relatively lackluster trend.

Coming Events and Data Releases

November 1	Daylight Savings Time ends
November 2	ISM Manufacturing Index (October)
November 4	ISM Non-Manufacturing Index (October)
November 6	Employment Report (October)
November 11	Veteran's Day (bond market closed)
November 13	Retail Sales (October)
November 26	Thanksgiving (markets closed)
December 16	FOMC Policy Decision, Yellen press conference
January 27	FOMC Policy Decision (no press conference)
March 16	FOMC Policy Decision, Yellen press conference