



**ABOUT
BILL SULLIVAN**

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

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JVB FINANCIAL

Weekly Commentary by Bill Sullivan, JVB Chief Economist

November 2, 2009

Tax collections in October remained very weak

When examining the Treasury's Daily Statement for input on the Federal Budget, recognition has to be given to the fact that the available data can be distorted to some extent by ongoing shifts in the configuration of the calendar. An extra business day, for instance, can affect the volume of tax receipts or expenditures that are recorded in a given month versus previous years. Notwithstanding this caveat, it is quite apparent that another huge deficit was registered during October, 2009, the first month of the new fiscal year. Especially noteworthy in our judgment was the continued weakness in revenue inflows, a development that seemingly challenges the notion that a full-fledged economic recovery process is now underway.

The continued shortfall in tax collections is evident when a year-over-year comparison in key categories is made. As an example, the Treasury received \$12.0 billion in non-withheld payments from individuals last month, down \$3.0 billion or 20% versus October, 2008, when the year-over-year decline was just 10%. While October is not a major installment month for most business firms, corporate receipts were still surprisingly weak as the fiscal year got underway. To provide perspective, corporations paid \$7.5 billion to the Treasury last month, down 22.7% from the inflows during October, 2008, and 31.8% from the payments received in October, 2007. Similarly, customs duties are off 18.7% on a year-over-year basis, perhaps hinting at a global trade revival that is far less robust than many observers currently envision.

Conceivably, the most problematic performance vis-à-vis the economy was the huge drop in payroll tax receipts during October. Indeed, the Treasury collected just \$124.7 billion in withheld income and Social Security taxes, down \$17.8 billion or 12.5% versus the inflows recorded for October, 2008. The payroll receipts category, needless to say, is extraordinarily sensitive to changes in labor force activity. Clearly, the number of workers on payrolls, the length of the workweek as well as the prevailing hourly wage combine to shape the actual earnings that workers realize during a specific period. The tax payments on that income are effectively a measure of prevailing employment conditions. In that regard, the October decline is a worrisome development as the drop-off represents an acceleration of the recent pattern. Specifically, during the third quarter of 2009, the year-over-year contraction in payroll tax receipts was 9.3% or visibly under the decline that was recorded last month. Admittedly, the employment report for October, 2009 that will be released by the Department of Labor on Friday may not show the same degree of weakness that the tax collection experience would suggest as the seasonal adjustment process could alter the outcome. Nonetheless, the implication of the payroll tax receipt data is quite straight forward: hiring remains very soft and take home pay continues to languish.

The slump in revenues is being juxtaposed against very strong spending, creating the potential for another year of record red ink for the Federal budget. As

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has been the case for some time, the early surge in outlays for fiscal year 2010 has been dominated by entitlement programs. Medicare spending for October tallied \$57.8 billion, up 10.7% on an annual basis. Social Security benefits last month totaled \$46.7 billion, up 11.4% from October, 2008. Grants for Health and Human Services doubled on a year-over-year basis, registering \$14.0 billion for the full month of October. Other notable increases were evident for the Education Department, Unemployment Insurance and Military Active Duty pay. Augmenting the trend toward wider deficits early in the new fiscal year is the large jump in refund payments being made by the Internal Revenue Service to individual taxpayers and businesses. According to the Treasury's Daily Statement, individuals received \$11.3 billion in refunds last month, up a hefty 36% versus year ago readings. Even more dramatic has been the increase in corporate refund payments which hit nearly \$16.1 billion for October, 2009, up 46.4% as compared to the opening month of FY 2009. The tremendous increase in refunds indicates that many households and corporations may have inadvertently overpaid their taxes and are now eligible for some repayment. The pattern could also be an indication that key sources of income such as worker pay and company profits may have been overstated by the traditional measures that the Government publishes.

If the mismatch between tax receipts and spending that was in place during October were to persist, upward revisions to deficits for future fiscal years would seem inevitable before too long. Obviously, such an outlook would indicate an ever rising supply of new issue Treasury debt well into the future. The prospect

of a historically large calendar of offerings bolsters the risk of higher yields on Government securities as time goes by. But, as investors have repeatedly learned, supply is a residual influence on interest rates. Many other forces such as the preference for safety, the demand for credit from private borrowers and the portfolio practices of foreign central banks play significant roles in shaping yield levels. Moreover, acknowledgement has to be given to the fact that the maintenance of record budget shortfalls is related in part to the sluggish economy that is curtailing income and profit growth. In that regard, the inflationary implications of upcoming deficits may prove negligible, another force that could help dampen interest rate pressures over the period ahead. ■

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November 2, 2009*

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