Monday Morning Update December 4, 2017

The Fed – Soon to be ex-Chair Yellen expressed concerns about the market's low expectations for consumer price inflation in a speech she gave last week. No wonder the yield of the 10-year is not moving higher. Yellen also suggested further increases in the Fed's short-term interest rate targets will continue to be "data dependent". And after listening to the new incoming Fed Chair Jerome Powell's "interview" before the Senate, the Fed will continue to be transparent and gradual in its execution of monetary policy. There is no reason to believe Powell will bring with him different views from Yellen. The markets seem very comfortable with the Fed moving three times in 2018. Goldman wrote this past week they expect 4 moves by the Fed in 2018. If GDP is now running at a 3.00-3.50% annual rate of growth versus a 2.00-2.50% growth rate, Fed Funds at 1.50% seem way too low. The 2-year Treasury will confirm or reject Fed Funds futures prognostications, which are currently suggesting a move in March, and another move in either June or July.

Inflation – the Fed's preferred measure of inflation was updated last week. A move from 1.30% annually to 1.40% annually is a move in the right direction, but still a very, very long way from the Fed's target of 2.00%. What is so magical about a 2.00% number ? Why not 1.75% ? Why not 2.25 % ? Why 2.00% ? Maybe incoming Fed Cahir Powell can shed some light on this question.

Treasuries – another new 2017 closing high for the 2-year (1.77%). And the 5-year yield continues its uptrend that started in early September. Written here often has been a target of 2.15% on the 5-year. A close above 2.15% for a few days will set a new target of 2.75% in 2018. The 10-year Treasury continues to trade in a tight range of 2.30% - 2.40%. A closing yield of 2.36% on Friday allows the yield curve flattening trade to gain momentum. In the old days, a very flat yield curve suggested economic problems on the horizon. This no longer holds true. Significant rate differentials between the USA and abroad, and very low expectations for future inflation will support a flat yield curve without suggesting a recession is anywhere in sight. A Federal Reserve on track to move rates higher by 100 basis points in the next 12 months will put the 2-year at a 2.50%. A 2-year at 2.50% puts a 5-year Treasury at a 2.85% - 3.00%. And the 10-year Treasury could easily still be below 3.00%; maybe as low as a 2.75%.

The S&P 500 – The S&P closed up 1.5% last week. Expect to see a plethora of estimates of what a 20-23% corporate tax rate is worth for S&P earnings. Barron's wrote a 20% corporate tax rate is worth an increase of $10 a share in earnings. This figure seems to be the new consensus, so far. So take your P/E and multiply by $10 and you have the upside to the S&P. Forward P/E is currently 18. $10 multiplied by 18 equals 180 points higher for the S&P. The P/E on the S&P hasn't really moved much the past few months, but the S&P continues to move higher. So ….. earnings (projected earnings !!) are driving equities higher, not P/E expansion. Projected growth in earnings is pegged now at 10%. What if earnings only grow 5% next year, and not 10% ? Is a P/E of 18 justified because rates have been so low ? If yes, then what should the P/E be if rates are 100 bps higher ? Now that short rates are moving higher, and expected to move even higher next year, does this suggest P/E's have to move down ? If the equity markets are now earnings driven instead of interest rates driven, no problems on the horizon. The markets will tell us which driver is at the wheel.

Crude Oil – West Texas Intermediate crude closed at a 2-year high, closing at $58.36 on Friday. OPEC agreed to an extension in its "production reduction" agreement among OPEC producers to the end of 2018. Russian gave their verbal commitment to reducing production. Traders see less production from Iraq and Iran, as a result of pipeline shutdowns due to military and terrorist conflicts, not from any participation in the agreement. Production in the USA continues to increase. The 50-day moving average for WTI crude is $53.87. The price for oil in Sept 2019 is $53.27. Synchronized global economic growth is helping to support the continuation of the uptrend we have seen in oil prices since late June. The 2017 low of $42.53 on June 21 won't be tested anytime soon.

Municipals – Speculation continues about the effect on tax-exempt municipals in any tax reform bill signed by Trump. The Senate's version will carry more weight as their slim majority gives them more control over the final version of any tax bill. McConnell will not compromise on very much that is in the Senate's version. He is a bigger bully than Ryan. Expect advance refundings to be restricted, rather substantially, but not 100% eliminated. The advance refunding has been +/- 25-30% of the new issue market for the past few years. The assumption is any reduction in tax-exempt munis will shift the supply to the taxable market, where the interest income will be taxable, thus generating more revenue for the Federal government. Eliminating or reducing advance refunding is a pure revenue-raising play by Congress. Nothing more and nothing less. There is a good chance the elimination, or reduction of refunding bonds will force municipal issuers to the derivatives market to help offset the loss of tax-exempt financing. A very dangerous scenario. There is a good chance refundings will be limited to smaller issuers. There is a good chance some refundings will be limited to a certain time period around the call dates built into the structure as well. And there is a very good chance the status of AMT will be a bargaining chip against both eliminating private activity bonds and advance refunding bonds. But expect enough reduction in supply to support muni prices no matter what happens to interest rates. YTD new issue tax-exempt muni supply is 17% below last year's levels. A rush to issue tax-exempt debt before any tax changes get legislated has caused a back-up in muni yields of 15-20 bps in 10-year and longer bonds. Selling bonds into this year-end rush is ugly right now as dealers need to keep space on their shelves for new supply. The mark-up to the dealers on new issues is typically higher than the mark-up they get in the secondary market. One last comment on tax exempts. The prospectus for a municipal bond issue always comes with an unqualified opinion on the tax-exempt status of the bond. If legislation is muddled to where bond counsel can't write an unqualified opinion of the tax status of the interest income, the bond will not get issued because the investor will not buy the bond without this unqualified opinion by bond counsel. And, in an important event to watch, the State of Minnesota is playing games with appropriations on bonds issued to pay for lease payments on the new Senate office building. The bonds were issued as COP debt. COP debt service payments require a budget appropriation. If debt service appropriations for this COP is pulled from overall state budget appropriations, debt service payments for all COPs are in jeopardy. First pension problems, now State legislatures threatening not to fund COP debt service. What next ?

Corporates --- Investment Grade corporate bond yields are moving higher, but spreads are still in a downtrend. High Yield corporate bond yields are trying to move higher, and spreads are heading lower again, after a 50-bp spike in spreads during November. Total return investors will stay focused on spreads; income investors will stay focused on yield. The cost of buying insurance against corporate default is still very low, suggesting minimal debt service concerns. Credit rating agencies (Moody's and S&P) still have an incentive to downgrade their ratings instead of upgrading their ratings. Investors will always have to accept one of the key "bond investor's creed". Accept the fact that credit ratings can change, and accept the fact the change is normally down, not up. But a change in a credit rating does not necessarily mean an interruption in coupon payments or an interruption in principal payback. Default rates across the board are still extremely low (“triple C “ bonds don’t count in this comment).

The US Dollar – The USD was very quiet last week. It continues to track the direction of the 10-year Treasury, which was also quiet last week.

Global Rate Policies – using the 10-year as a proxy for rates, German yields set a new 1-year low on Friday (.30%). The UK gilt is at a 3-month low (1.23%). Japan wants their 10-yr as close to a 0% yield as possible; it closed at .03% on Friday. Canada’s yield is in a downtrend since peaking at a 2.13% in late September. China’s yield is off its 1-year high of 4.01%, but only by a few basis points. Spain’s 10-year yield is back to a 1-year low (1.41%). The same with Italy’s (1.71% close on Friday). The ECB meets on Dec 14th, along with the UK. The Bank of Japan meets on Dec 21. Draghi will continue his “whatever is necessary” blah blah blah rhetoric after his ECB meeting. The UK started its pullback on QE last month so expect nothing new from the Bank of England. Expect the significant rate differentials between global rates and the USA rates to continue into the 1st quarter 2018, supporting longer maturity Treasuries.

Consumer Sentiment – The consumer confidence index distributed by the Conference Board increased to the highest reading since Nov 2000. The present situation component increased, as did the expectations component. “Good” business conditions increased while “bad” business conditions decreased. The percentage of consumers expecting business conditions to improve increased. The percentage of consumers expecting business conditions to worsen decreased.