Monday Morning Update September 11 2017

The Fed – the only newsworthy event last week was the announcement of the resignation of the Vice Chair of the Federal Reserve. Now Trump has another replacement to make inside the Fed. Both bond and stock markets seem to be more comfortable with the thought the Fed will not change its target for short-term rates until the later part of 2018. The decline in the yield of the 2-year Treasury helps to support this idea. The markets also seem okay with an announcement coming in two weeks of their plans to reduce the Fed's balance sheet. The Fed may be missing an opportunity to increase GDP by increasing the interest income available on savings and money market balances that can be a valuable source of spending and investment. Sitting for year and not changing the target for short term rates is worth about .3% to GDP growth.

Inflation – traders and investors will be watching both PPI and CPI data this week to see if it tells the same story the PCE data told us last week. Labor cost data will also be updated this week. If expectations come to fruition, the Fed will not see higher inflation trends in this week's reports, just more deflation.

Treasuries – The yields on the 2-year Treasury, the 5-year, the 10-year and the 30- year all moved lower last week. The 10-year yield touched 2.01% in overnight trading on Friday. Hurricane Harvey and Irma will certainly cause a slowdown in output for the weeks ahead. Florida Power & Light is reporting 70% of its customers are without power. Over 50% of Duke Energy's Florida customers are without power. Weeks, not days, may be the timeline to get production and spending back on tract. So traders and investors will find little reason to force yields significantly higher any time soon. The yield on the 2-year dropped 8 bps last week, a huge drop. N Korea tensions may be taking a backseat to continued disinflation signs and now, a slowdown in the US economy, until rebuilding begins.

The S&P 500 – the S&P closed down .6% last week, not bad considering a quiet week for earnings in the midst of more "missile promises" by N Korea, the shutdown of south Texas for a few days and the beginnings of a shutdown in south Florida. The equity markets will see new data on industrial production, durable goods and retail sales this week. Prior to Harvey and Irma, the economy seems capable of growing faster than 1.5%-2.0%. It also seems like a 2.0%-2.5% economy is now in place, versus the old 1.5%-2.0% economy we have lived with for a while. The "G" component of " Y = C + I + G + X " definition of the US economy will spike higher as the Federal government will have to dramatically increase their spending in the aftermath of the two recent hurricanes. It will also be interesting to see how earning expectations for the 4th quarter and 1st quarter 2019 start to materialize. Earnings forecast for the 3rd quarter are supportive for the S&P. But comparisons for the upcoming 4th qtr and 1st qtr 2018 earnings will have tough comparisons to deal with. Maybe corporate tax changes will offset some of the earnings comparisons difficulties that are just around the corner. Weaker earnings growth can be offset by some marginal tax reform at the corporate level, supporting equity prices.

Crude Oil – Oil closed just above its low price of the week. It tried hard to trade above $50 a barrel on Wednesday, Thursday, and Friday morning. But it sold off rather precipitously Friday afternoon as Irma headed towards Florida. I still think we will see $42-$44 prices for a longer period of time than we will see $50 a barrel for our West Texas Crude.

Municipals – the muni market will be watching to see if it has to deal with large sales from insurance companies. P&C insurance companies are known to carry large positions in tax advantaged municipals. They will certainly need to raise their cash balances to cover claims. And munis have historically offered the liquidity needed when insurance companies come knocking. Any sales will be absorbed rather easily as new supply is projected to be less than coupon payments and maturities for the balance of this year. Any slight increases in yield caused by the selling will be welcomed by retail investors.

Corporates --- Spreads widened last week, as they are supposed to do, when Treasury yields move a lot lower over the course of only a few days. High Yield spreads widened by 8 bps, closing at a spread of 381 bps over Treasuries. Investment grade spreads rose 3 bps on the week, offering an income advantage of 113 bps above Treasuries. The yield differential (spread) between HY and IG remains around +255 bps, with half the interest rate sensitivity in HY versus IG bonds, on a macro basis.

The US Dollar – yet another new 12-month low for the US Dollar. With the Federal Reserve looking more and more like they want to sit for a while, the USD has little fundamental reason to move higher. The Yen looks like a safe-haven currency, causing it to continue to strengthen versus both the USD and the Euro. The Euro looks like it could easily move higher to 1.25 versus the USD. And the British Pound could see 1.34 versus the USD in the coming weeks. A weak USD helps our equities.

Global Rate Policies – Draghi and his ECB teased traders and investors with his comments on what he sees as continued strength in the European economies. Draghi also suggested the ECB is beginning to think about talking about its plans to reduce their balance sheet. Draghi is good with his double talk. And his comments provide no justifications for the Euro to weaken in the immediate future. The Bank of England meets Thursday. They may be the next central bank to signal a stronger intent to start their QE pullback.

Consumer Sentiment – next week traders and investors will see an update on Small Business Optimism and updates from the Univ of Michigan, with respect to current conditions, consumer expectations, and expectations for inflation. These surveys were taken before the hurricanes from the last 2 weeks.