Monday Morning Update January 15, 2018

The Fed – Eight FOMC meetings a year. The first in 2018 is scheduled to end on January 31st. The second meeting will end on March 21st. Fed Funds futures suggest a 90% probability the Fed will adjust another 25 bps in its short-term rate at the March meeting. And then another 90% probability the Fed will adjust at the September meeting. Then stay at 1.75% - 2.00% well into 2019. Libor futures and Eurodollar futures suggest the same. Competitive money market funds could easily average between 1.25% - 1.50% this year. And one-year bonds could easily return 1.85% - 2.25% in 2018. Remember the Fed wants to move three times in 2018.

Inflation – the latest reading on wholesale prices suggests inflation pressures are moderating. December PPI had its first monthly decline in 17 months. The latest reading on retail prices show mixed findings. Goods prices are "less weak". Services prices are steady. Gasoline prices were down 3% in December. Always remember inflation trends tend to respond to changing economic conditions with a lag as long as 12-18 months. The Five Year Forward is barely below 2.0% (1.98% as of last Friday). The 5-Year Breakeven is at 1.94%. And the 10-year Breakeven continues to stay just above the all-important 2.0% level.

Treasuries – very strong demand this past week for 30-year Treasuries. The Chinese government denied rumors that China was curtailing its purchases of US Treasuries, maybe in an effort to fight back against tough trade talk by Trump. The federal deficit will grow by as much as $1.2 trillion this year, causing heavy increases in Treasury supply in 2018. The yield on the 2-year traded above 2.0% for the first time since 2008. The 10- year is approaching the all-important 2.63% yield; it could have traded above this level last week, but it couldn't find the strength. Controlled inflation data last week may have helped keep the yield below the 2.63% level.

The S&P 500 – It is a given that earnings will grow for at least the next 2 quarters. What is not a given is how the P/E will react to higher interest rates and higher inflation expectations. Abbey Joseph Cohen suggests that if both inflation and interest rates increase by 1%, the average P/E of the S&P 500 will drop by 3 points (from 18 to 15). Forward P/E's are high, but not ridiculously high, looking as far back as 1991. Easy earnings comparisons will be a thing of the past in the next 12-18 months. If revenues start to slow, profit margins can't be expected to expand. A significant question in 2018 is whether a lower corporate tax rate here in America will result in significant growth in US manufacturing.

Crude Oil – investors and traders witnessed an 8th consecutive weekly decline in crude oil stockpiles. The Int'l Energy Agency reported demand is increasing by more than 1 million barrels a day. Sanctions against Iran are set to expire. If sanctions are reinstated, supply will be removed from the markets. More and more strategists are suggesting $80 oil will happen this year. Demand increasing with stockpiles being drawn down support oil prices. The good news for consumers is gasoline inventories are growing. Oil closed at a 38-month high last Friday. If the "shorts" are out the market, oil may be near a short-term top.

Municipals – The month of January is expected to see a record low of issuance. December's deals pulled supply forward, causing less issuance in January. Tax-exempt closed end funds have had a difficult past 2 weeks, as 10-year yields are up, along with short-term yields, which are normally used to finance the leverage inherent in closed end funds. Foreign investors, who like the high quality of a municipal bond and a nice yield advantage over US Treasuries, should easily absorb any increase in supply in the taxable muni market. S&P put Cook County IL on watch list. And the State of New York will issue 30% less debt in 2018. Muni yields are following Treasury yields higher, which should make muni bond buyers happy.

Corporates --- Investors continue to show their confidence in High Yield corporate bonds. Lipper reported the largest inflow into HY funds last week, the biggest inflow since Dec 2016. Investors are willing to embrace risk at an appropriate yield/ spread. Skeptics agree there appears to be no catalyst that can disrupt the appetite seen for HY bonds. HY spreads traded to a 10-year low last week.

The US Dollar – four events are happening now. Central banks are starting to end their QE policies. Economies around the globe are growing. Deficits here in America are increasing. Central banks around the globe, including here in America are beginning to shrink their balance sheets. The US Dollar can weaken further in the 1st quarter, then look for the USD to trade sideways versus the Euro, Yen, and even the Pound for a while. The Euro will run into heavy resistance at 1.25 versus the USD.

Global Rate Policies – Japan has been targeting a rate on their 10-year bond at 0% -.05%. Japan has let this yield move above this band. Important ? The move on the Japanese 10-year is being watched as a potential clue that Japan is joining the UK and the ECB in a reduction of their respective QE policies. Germany reported GDP grew at 2.2% in 2017. The minutes of the ECB meeting in December suggested a move to further ease the ECB's QE policy may come in the 1st quarter. The minutes suggested Draghi and the ECB might be closer to changing its communications about its QE intentions. Canada's central bank meets this week. Expectations are for Canada to raise rates for the second time since September. Europe is showing signs of inflation. UK inflation data is out on Tuesday.

Consumer Sentiment – The data behind Small Business Optimism can be extrapolated to suggest small businesses expect the economy here to grow by at least 3.0% in 2018 and 2019. The markets will see data on homebuilders' sentiment this week. The Univ of Michigan will issue a preliminary look at its sentiment, expectations and inflation expectations on Friday.