Monday Morning Update January 1, 2018

The Fed – The Federal Reserve meets eight times every year. The 2018 FOMC will continue on a path of transparency, with gradual adjustments. In 2018, the Fed has intentions to raise its target short-term rate three times. Three adjustments with only eight meetings to choose from. The Fed wants to see its target rate at 2.00% -2.25% by December 2018. January will be a quiet month. An increase of 25bps should come in March, with a second bump of 25 bps in June. This leaves the last 25 bp bump taking place in the 4th quarter, if it happens at all. Fed Funds futures still suggests two bumps, not three this year. If the Fed changes its intentions for 2018, it won't be a surprise. They will communicate the change via speeches, press conferences after its meetings, and via its Dots Plot map. Will the FOMC adjust to Fed Funds futures, or will Fed Funds futures adjust to the Fed's intentions ? The good news for investors in 2018 will be the ability to earn a nominal rate of return on cash and cash equivalents. Competitive money market funds could easily average between 1.25% - 1.50% this year. And one-year bonds could easily return 1.75% - 2.25% in 2018.

Inflation – The Fed seems intent on keeping with its 2% inflation goal. The Central Banks of Europe and Japan also like a 2% inflation target. Even though inflation has been recorded to be well below 2% for a few years now, what is magical about 2% ? Why not set a target of 1.75% ? Why not 1.50% and call it a success ? Why not 2.5% as a target ? Wage inflation will grind higher in 2018, but should stay below a 3% average growth rate in 2018. Prices for goods should remain soft, with e-commerce and price comparison-shopping the trend. Prices for services should grind sideways to slightly higher this year as labor cost increases will be partially offset with an expanding global trading pattern, with lesser players buying market share with low prices. The Fed's preferred inflation gauge starts the year at a 1.50%. Inflation expectations did take a jump and a spike higher the past 2 weeks. This is critical to monitor in the weeks ahead. CPI starts the year at a 2.2%. Core CPI, ex-food and energy, starts the year at a 1.70%. Inflation is arguably the most important indicator to watch in 2018. Expectations are for sub-2% inflation. If expectations for inflation move higher, and stay higher, bonds will take notice and reprice. Higher inflation gives the Fed justification for three moves in 2018.

Treasuries – if the Fed follows thru on its intentions, expect the annual return (the yield) of the 2-year to move towards 2.50% - 2.75% by the end of 2018. Then, expect the 5-year Treasury to deliver an annual return (yield) of 2.75% - 3.00%. The wild card is the yield on the 10-year in 2018. The 10-year Treasury traded between a 2.20% to 2.49% yield 82% of the trading days in 2017. Expect the same stable trading in 2018 for the 10-year, but at 25 bps higher yields. The intentions of the Fed, plus the expectation for the yield of the 10-year in 2018, makes for a flatter yield curve in 2018, but not necessarily an inverted yield curve. The 10-yr minus 2-yr curve can flatten by another 20-25 bps. Since there is no recession in sight, and since the economy is expected to be growing by at least by 3.0% - 3.5%, the markets will not be spooked by a continued flattening of the Treasury yield curve. Concerned, but not spooked. If the 10-year stays under a 2.75% yield in 2018, the Fed only moves twice. Inflation expectations will move the 10-year in early 2018.

The S&P 500 – A USA economy only growing 2.0% a year is behind us. A USA economy only growing 2.5% a year is behind us. We are now in an economy that will grow more than 3.0% a year, easily, for the next 18 months. If Trump and his team pull off a $Trillion infrastructure deal in 2018, then a 4% GDP is a layup. The S&P will continue to be enamored with the view from 30,000 feet. Global economic growth is increasing, not decreasing. This is very important. Long-term interest rates are very stable. Tax reform will be quite beneficial to the EPS reports (Earnings Per Share) of the S&P 500, the Dow, and definitely Nasdaq. Taxes needed to pay for cash repatriated will only be a footnote in companies' earnings releases in the 1st and 2nd quarter of 2018. If earnings can grow $8-$12 a share, and the price investors and traders willing to pay for these earnings remains stable, the S&P 500 can easily hit 3000 in the next 12 months. This would only be a 12% move higher; modest but very acceptable. No recession anywhere on the horizon, so no reason not to be fully invested in the S&P 500 in 2018.

Crude Oil – crude closed above $60 a barrel for the first time since June 2015. Supply disruptions, both terrorist and non-terrorist related, and noticeable decreases in inventories have provided strong support for oil prices. So has short covering. A significant portion of the move to $60 a barrel is a result of short covering when crude stayed above $55 a barrel. Synchronized global expansion makes a strong case for crude to average $55 a barrel in 2018. Energy inflation should be muted in 2018, after a significant rise in 2017. Prices for delivery in Sept 2019 are $55.48 a barrel. Oil closed at $60.42 in 2017.

Municipals – lots of window dressing, tax harvesting and supply anomalies made the muni market hard to understand the last two weeks of 2017. Demand from maturities, demand from coupon payments received, and a top tax rate of 37% for individuals will support tax-exempt munis in the first half of 2018. The assumed reduction in demand from banks and insurance companies as a result of a lower corporate tax rate will not be felt very much in early 2018. Expected demand versus expected supply for the tax-exempt market in 2018. Taxable municipal bonds may resurface as a more mainstream investment option as a result of the elimination of advance refunding. The elimination from the tax-exempt market will move some supply to the taxable market, even though it will be more expensive for the issuers of the bonds. Investors should have more choices in 2018 between corporate bonds and taxable municipal bonds. Taxable municipals will offer yields 50-150 bps higher than Treasuries as you move along the yield curve in 2018. High yield taxable munis should offer yields in excess of 200bps of Treasuries. If banks and insurance companies want to stay invested in tax-exempt munis, they will migrate to BBB's and High Yield munis to benefit from a low default/high preference income asset. Default rates for municipal bonds are expected to be extremely low again in 2018.

Corporates --- Investors will want to shift their focus from total return to income-per-year return in 2018 for corporate bonds. Higher Treasury yields and stable spreads will cause minor drops in market prices in 2018. The price drops will not be credit based, just change in interest rate based. Investment Grade corporate spreads don't have to widen in 2018; fundamentals look great for debt servicing. And easy, unlimited access to capital markets to roll over maturities will continue in 2018. High Yield spreads should offer stable yield pick-up versus Treasuries in 2018. The range could easily be between 340 bps and 390 bps versus Treasuries. Spreads that widen on corporate issuers who get nicked from a reduction in the deduction allowed for interest expenses will be bought quickly by yield investors. Total return traders and investors will purchase any widening of more than 50 bps in the HY sector. Default rates are expected to be quite low again in 2018 for both IG and HY corporate bonds. Moody's and S&P will continue to downgrade more ratings than they upgrade. But spreads will not be adversely affected from the rating agencies' actions.

The US Dollar – the USD moved decidedly lower the last two weeks in 2017. USA equities enjoy the weakness in the USD. Emerging markets' currencies enjoy the weakening USD, as a weak Dollar makes it easier for them to service their debt, since their debt is mostly denominated in US Dollars. Commodity prices enjoy a weak US Dollar, as does the economies of the emerging market countries that supply the commodities. The focus early on in 2018 will be whether the correlation between the yield of the 10-yr Treasury and the value of the US Dollar continues. The yield of the 10-year has moved +/- 10 bps higher with the USD moving 2% lower during the same time frame at the end of 2017.

Global Rate Policies – the ECB and Mario Draghi will watch the results experienced in the U.S. before it continues on a path of reducing its own QE policy. The rate differential between global 2-year rates and U.S. 2-year Treasuries will remain huge in 2018. The rate differentials in the 5-year sovereign maturity bucket between the U.S and the globe will remain huge in 2018. The same can be said for the 10-year. The test for equities and bonds will be if and when more central banks than just the USA is active in raising short term rates in 2018 and 2019.

Consumer Sentiment – Wage growth north of 2.5%, equity prices moving higher, unemployment rates very low, new cars in a lot of garages, millennials moving out of their parent's house into their own little houses and gasoline prices a non-event in the world of budgets allows for high optimism to continue in 2018. New highs don't need to be set every month on both consumer and business optimism and confidence surveys. Just no discernible weakness. No reason to expect weakness in the first half of 2018.