Monday Morning Update January 8, 2018

The Fed – The Federal Reserve starts 2018 with its target for short-term rates at 1.25% - 1.50%. The midpoint to be used for comparisons will probably be 1.42%, statistically well above the average of the range. Fed Funds futures suggest +25 bps in the target to take place at either the March or the May meeting. Then, a second +25 bp bump at the September meeting. Bloomberg suggests only a 50% probability of a second bump in 2018. The Fed plans on bumping short-term rates three times in 2018. 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 1.85% - 2.25% in 2018.

Inflation – Investors and traders will get both PPI and CPI data this week. The Fed's preferred inflation gauge closed 2017 at a 1.40% rate of inflation. The key indicator to watch in the first part of 2018 is the data describing expectations for inflation. The Fed's Five Year Forward broke out of a 6-month range, and closed Friday at a 1.96%, 20 bps higher going into 2018. The 5 Year Breakeven has spiked 15 bps higher. The 10-year Treasury trading at a 2.48% yield instead of a 2.25% acknowledges the increase in inflation expectations. PPI starts the year at a 3.1%. CPI starts the year at a 2.2%. Core CPI, ex-food and energy, starts the year at a 1.70%.

Treasuries – the yield on the 2-year moved higher yet again last week, closing at a 1.96%. It should be a slow grind higher to a 2.50% yield; a yield of 2.75% would be the maximum for 2018. The yield on the 5-year had a steady grind higher last week, closing at a 2.29%. Expect a slow grind to 2.75% if the 2-year moves to a 2.50%. The yield on the 10-year bumped up against a 2.48% once again last week. The 10-year yield can't get to 3.0% until it gets past a 2.65% yield. And it can't get past 2.65% until it gets past 2.48%. The 10-yr minus 2-yr curve can flatten another 20-25 bps in 2018. Since there is no recession in sight and since the economy is expected to be growing by at least by 3.0% - 3.5% during the next couple of quarters, 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 – The economy is growing, but without huge demands for a larger workforce. The economy here has seen employment grow for some 87 consecutive months. The monthly growth in payrolls is enough to support a modern economy growing around 3.0% a year. The S&P closed up 2.6% in the first week of 2018. I wish I could take an annualized return of the first week's gain and relax for the next 51 weeks. Retail sales data will be reported this week. And 4th quarter earnings start to get reported on Friday. The S&P is clearly in an uptrend. When it does close above two standard deviations, and it happens often, the S&P relaxes long enough to resume the uptrend. No recession anywhere on the horizon, so no reason not to be fully invested in the S&P 500 in 2018.

Crude Oil – Tensions in Iran, and reports showing more crude oil coming out of storage, continue to keep oil prices above $60 a barrel. The price of crude in Oct 2019 is $56.01. Friday's close was $61.60 a barrel. The High Yield corporate bond market absolutely loves higher oil prices, as long as the higher price is a result of economic growth and not geopolitical supply disruptions. Famed strategist Byron Wein suggested we would see $80 oil in 2018. At $80 a barrel, High Yield spreads would drop 75-100 bps.

Municipals – The yield curve in the muni market is flattening just like the Treasury yield curve. Demand for tax-exempt munis will exceed the supply in the first half of 2018. Default rates will continue to be very low. Sectors such as hospital bonds and airport bonds will continue to offer low tax-rate banks and insurance companies value versus Corporates in early 2018. It is too early to see if the taxable muni market will see any resurgence in issuance due to the elimination of advance refunding bonds. BBB tax exempts and High Yield tax-exempts will do well in 2018.

Corporates --- Steady global economies, declining default rates, strong steady oil prices, and powerful equity markets helped to send High Yield spreads much lower last week, taking their yields down as well. The Covenant Stress index slipped last month, which suggests there are a low number of issuers violating financial loan maintenance covenants. Investors continue to scramble for yield. With declining default rates, and a declining Covenant Stress index, spreads of +325bps may be low, but they could move as low as +250 bps in 2018. Yields are very attractive, considering these positive credit indicators. Investment Grade spreads will follow HY spreads in 2018. Appetite for yield will outweigh the stress on financials for many HY issuers losing significant deductions from their interest expense.

The US Dollar – the USD had its weakest year since 2003 last year. A weaker USD logically makes emerging market and developed nation currencies stronger, versus the USD. Stronger currencies many times help to keep monetary policy at bay. With the Euro at a 3-year high versus the US Dollar, any continued drop in the USD would normally have implications for the ECB and Draghi. Draghi has supported currency interventions to stem spikes in the Euro. Travelling to Europe from the U.S. is 10% more expensive now versus just a few months ago.

Global Rate Policies – the yield on the UK’s 10-year is trying to move lower. The German 10-year has run into resistance at a .50% yield. The Italian 10-year is 40 bps higher off its low yields in 2017. Japan will continue its target of 0% for their sovereign 10-year bond. Canada’s 10-year yield is at a 12-month high. The ECB’s reduction in QE will be monitored closely in the debt markets in early 2018.

Consumer Sentiment - No reason to expect any significant weakness in consumer sentiment data in the first part of 2018. Businesses are not giving consumers any reasons to stay away from buying “things”. And consumers spend money nonchalantly on “services” when money feels available and prices seem reasonable and sometimes cheap. The markets will analyze Small Business Optimism data that will be released on Tuesday.