Monday Morning Update October 16 2017

The Fed – the next FOMC meeting is 2 ½ weeks away. And then six weeks until the December action. Fed Funds futures signal December should be a done deal for the 3rd rate adjustment in 2017. So signals one-month Libor and three-month Eurodollar futures. Bloomberg calculates a slightly lower probability of a rate adjustment at the December meeting, based on weak inflation data released last Friday. But still a high probability (greater than 70%). Last week's inflation data will be a test to see if the Federal Reserve has replaced their "data dependency" with "gradual and transparent". The FOMC minutes from the September meeting were more dovish than hawkish, confusing the Treasury market.

Inflation – PPI was higher last month, but the markets quickly explained away the jump to supply chain pricing due to the hurricanes. CPI year-over-year was back above 2.00%, but core CPI (ex-food and energy) was down near a 2-year low. We will see import prices this week, with clues as to whether a weak US Dollar is causing the USA to import inflation from Europe and Asia. The Five Year Forward, the 5-year and 10-year inflation breakevens all traded sideways last week. Importantly, they did not move higher, and they did not move lower. But the Univ of Michigan inflation expectations indicator moved substantially lower. Copper is back up, near a one-year high. Wheat and corn still near a one-year low. A small spike higher for wholesale gasoline.

Treasuries – The yield on the 2-year traded up all week, then reversed itself on Friday after inflation data was released; it closed just under a 1.50% yield on Friday. The 5-year traded at lower yields all week. The same for the 10-year Treasury. The 10-year closed below 2.30% on Friday, which is quite worrisome. A combination of very weak consumer inflation data and a dovish slant to the FOMC minutes caused the yield curve (10-year versus 2-year) to flatten to less than 80 bps. Very strong demand for U.S. Treasuries and very strong demand for long duration Treasuries. The yield on the 30-year dropped by 9 bps last week, a huge move lower. The S&P didn't seem concerned.

The S&P 500 – 3rd quarter earnings began last week, and will continue for the next several weeks. This week we will see more than 10% of the S&P 500 report. Expectations are for 3rd quarter earnings to grow between 5-6%. So far the banks that have reported have shown nice loan growth, in both consumer loans and commercial loans. Retail sales were surprisingly strong last month. But if you look at a chart of retail sales data for the past 6 years, the retail sales numbers are always between +1% and -1%. Rarely above +1% and rarely below -1%. The Atlanta Fed's GDPNow still suggests a slower 3rd quarter than we saw in the 2nd quarter GDP data. Auto sales spikes higher, probably Harvey related. The S&P set another new intra-day high last week, on Friday, at 2557, closing at 2553. A target of 2595 seems easily attainable.

Crude Oil – West Texas Intermediate is still in its nice uptrend, which began on June 21st, when oil touched a low of $42.53 a barrel. Oil production was reported to be lower last week, as was the rig count. Oil closed comfortably above its 50-day moving average of $49.20 a barrel, closing at $51.45 on Friday. Oil trades at $52.26 in May 2018, then drops to $51.04 out to July 2019. Energy prices are pegged to be extremely stable for long time.

Municipals – Two-year to five-year munis still look very expensive, when compared to Treasury yields. 10-year munis still offer value, with "20-year callable in 8-10 years" bonds with tax-free yields between 2.70% - 2.80%. Money is still flowing into Illinois, Connecticut and New Jersey paper. Renewed doubt that we will see tax reform taking place in 2017, or even early 2018 continues to offer support, and demand for tax-advantaged bonds.

Corporate Spreads --- Investment Grade spreads traded in a 1 bp range last week. High Yield spreads traded sideways until Friday, when profit taking in HY corporates moved spreads a little wider, and off their one-year lows. Bond insurers are under the watchful eyes of credit analysts. The yield differential between HY bonds and IG bonds remain very low by historical standards.

The US Dollar – The US Dollar continued to trade above its 50-day moving average, but barely. And the Euro continued to trade below its 50-day moving average. The British Pound got some support from possibilities for an extension in the timeline for the Brexit initiative.

Global Rate Policies – it is doubtful Draghi and the ECB will start any reductions in its QE policies. And the press is trying to suggest the Bank of England should announce an ending, or at least a tapering, of its QE policy. A taper will always happen before an "end". China reports inflation data this week.

Consumer Sentiment – Small Business Optimism was lower with its last reading, but still very high. The Univ of Michigan data was very strong across all components. No wonder the S&P makes new highs all the time. Consumers think life is pretty good. Businesses think life is pretty good. And high optimism makes for new highs in equity prices.