Monday Morning Update October 2 2017

The Fed – Fed Chair Yellen followed up her latest FOMC meeting with a speech last week where she all but guaranteed a rate adjustment will take place in December. The Federal Reserve is no longer data dependent. If the Fed were still data dependent, the recent inflation readings and the forward inflation indicators would keep the Fed on hold. Yellen's Fed is committed to a transparent, and gradual, move towards a neutral short-term rate target of 2.75%. She is okay that it will take well into the later part of 2019-early part of 2020 to get to this target. Fed Funds futures will move when Yellen announces further intentions via her full transparency. But Yellen is only around until early next year. Trump and his team met this week to discuss potential candidates to nominate for the "maturing" term of Chair Yellen. If Yellen is committed to raising short-term rates, her likelihood of being reappointed is slim. Trump needs low rates as he wants to increase U.S. borrowings. The Fed is scheduled to start reducing its balance sheet this month. Raising rates and reducing the balance sheet at the same time, even by tiny measures, may cause short-maturity Treasury yields to spike. December Fed Funds futures reflect a 70% probability of a third rate adjustment for 2017. Eurodollar futures only suggest a 60% chance. Savers will be rewarded in 2018 with cash balances invested in money market funds and very short maturity bonds. Short-term rates should move higher in 2018, very slow, very gradual, but higher.

Inflation – housing prices continued their trend of increasing across the country at a 5+% annualized rate of growth. The last look at the price index for the 2nd quarter showed lethargic pricing pressures. Forward breakeven indicators continue to suggest seeing a 2.00% inflation rate is still a ways out. Oil moved marginally higher last week. Copper stayed weak. Grains remained weak. Wholesale gasoline prices fell some more. Iron ore fell some more last week.

Treasuries – Last week was to be an important week to see how Treasuries would react to the FOMC's announcement on rates and balance sheets. But Trump brought to market his tax reform initiative on Wednesday, so Treasuries had this to react to instead (or in addition to). The yield on the 2-year Treasury closed higher by 5 bps on the week, closing at a 1.49% yield. The 5-year yield closed higher by 8 bps on the week, at a 1.94%. The yield on the 10-year closed up by 8 bps on the week, at a 2.33%. We will continue to watch the targets mentioned here last week. A move to 1.60-1.70% on the 2-year in October will suggest a rate change will take place in December. The 5-year needs to stay below 2.14%. Inflation trends should keep the 10-year below 2.65%.

The S&P 500 – we all saw the final read on 2nd quarter GDP last week. The economy grew at a 3.1% annual rate in the 2nd qtr. No way will we see back-to-back 3% GDPs when the 3rd quarter results start to be released. The Atlanta Fed's GDPNow is well below its earlier prediction for the 3rd quarter, and well below a 3% growth rate. Tax reform details released midweek by Trump helped the S&P to another new closing high. The S&P didn't hit 2545-2550 in September, but it should easily hit this target in the month of October. Confidence is high, interest rates are still low, earnings are positive, and the market continues to not be ridiculously high in its valuation. The S&P has closed above 2500 for 9 of the past 11 sessions, building a nice new floor. The employment report on Friday should offer continued support to the S&P.

Crude Oil – Oil closed up a dollar on the week. Full tilt at the refineries helped this past week's move higher. And so did more press releases from the OPEC meeting suggesting better chances for an extension of the production agreement that is being violated by all parties. The rig count in the U.S. was a little higher last week. All eyes are watching $54 a barrel. The chances look slim that crude can move that high in the near term, but stranger things have happened. Not sure if the increase in yield on the 10-year last week had anything to do with the price increase in oil. Probably not, as any sustained move higher in oil is seen as a small probability, using forward pricing as the tool for measurement.

Municipals – the City of Hartford CT met with bond insurers this week to discuss debt restructuring. The City of Chicago is looking to securitize its sales tax to refinance some of its debt. The cost savings easily justifies the issuance of a specially structured bankruptcy remote first lien on Chicago sales tax. Right now 6% of revenue is used to service Chicago's debt. This refinancing could lower that to a 5% level. South Carolina utilities sold their Toshiba settlement to Citibank for an 8.5% haircut to get cash now to protect the credit ratings on their outstanding nuclear plant debt. Trump's tax proposal announced this week says nothing about muni tax exemption; the topic is not mentioned or referenced at all, suggesting no change will take place to the tax-exempt income offered by tax-exempt municipals. Muni yields increased lockstep with Treasury yields last week, keeping the relative value ratio at 12-month lows. And a top tax rate of 35%, in lieu of a 39.6% tax rate, will keep muni demand strong and constant. Even with a lower corporate tax rate possible, demand for munis will continue to be strong, and maybe with higher income returns for investors.

Corporates --- both Investment Grade and High Yield corporate spreads tightened last week. IG spreads closed 5 bps tighter, a big move. High Yield spreads tightened by 9 bps last week, bigger than big. There is enough momentum to keep both IG and HY spreads moving to new lows. Rarely in the past 5 years have HY spreads stayed below +350 bps versus Treasuries for very long. Not sure if this time will be any different.

The US Dollar – The US Dollar closed above its 50-day moving average for the first time in a very long time. It seems to be moving in tandem with December Fed Funds futures. The Euro is back under 1.18 versus the USD. It closed below its 50-day moving average for the first time in a very long time.

Global Rate Policies – a quiet week for global rate policies. Draghi will be watching the markets' reaction the USA's initial foray into balance sheet reducing.

Consumer Sentiment – The Conference Board reported continued strength in its consumer confidence surveys, and also with current and forward conditions. New highs were not reported, but readings stay very high on an absolute basis. The Univ of Michigan survey showed the same results.