Monday Morning Update October 23 2017

The Fed – the probability for a December rate adjustment is now up to 83%. Yellen spoke at a conference this past week and said nothing to change this timeline. But Fed Funds futures still suggests only a 42% chance one rate increase will take place in 2018, and not until mid-year. Either Fed Funds futures can't be considered a reliable forecasting tool this far out in the future, or the market feels whoever the new Fed Chair will be won't be aggressive in raising rates next year. 3-month, 6-month and 12-month LIBOR are all slowly creeping higher, suggesting 2018 is in play for at least one more adjustment. Trump has committed he will announce his nomination for the Fed Chair before Nov 3rd. The chances of his pick being Yellen are quite small. And another week without comments on the balance sheet reduction initiative. Has it started yet ? The Fed is not talking.

Inflation – Import prices were up from the previous month, but so were export prices so not much can be understood on the inflation front from this data. The Five Year Forward continues to move sideways, under 2.00%, and under 1.8%. The Ten Year Forward continues its move sideways, also under 2.00%, and under 1.9%. Only a 10 bp difference in expected inflation 5-10 years out. Corn and wheat set a new 12-month low. Copper stayed high. Wholesale gasoline higher last week. Iron ore lower on the week.

Treasuries – Why is the yield on the 10-year Treasury moving higher ? Fears of inflation ? Fears of stronger economic growth ? The 2-year yield is moving higher as a December rate adjustment is just around the corner. But why the 10-year ? It is all about the "risk on" trade. All is quiet in North Korea. Tax reform is a small step closer after Thursday's Senate vote on a budget resolution. Equities continue to move higher, corporate spreads continue to move lower, and REITs and MLPs continue to pay out high dividends. No need to own Treasuries in this past week's markets. It would be hard to blame the rise in yields to current inflation data or forward inflation expectations. The Federal Government did report an increase in the deficit for last fiscal year. And Treasury traders and investors expect an even larger budget deficit next year. But "risk on" is moving Treasury yields higher. I think. New floor for the 2-yr is at 1.45%. New floor for the 5-year is at 1.89%. New floor on 10-year is 2.27%.

The S&P 500 – The S&P saw a slight upward bias going into Thursday afternoon. Then late Thursday the Senate passed a budget resolution bill. On Friday morning, the S&P "gapped higher" on the opening and never looked back. Month-to-date, the S&P is up 2.3%. For the year, the S&P is up 16.88%. The target often mentioned here of 2595 may look too low. Almost 20% of the S&P 500 has reported 3rd quarter earnings so far. Revenue is higher, and earnings are higher. The S&P is now at a forward P/E of 18. Very high. But interest rates are still very low, allowing for the market to go higher, pushed in part by higher P/E's. Next Friday investors and traders will see a guess on 3rd qtr GDP. Atlanta Fed's GDPNow has the 3rd qtr GDP at 2.7%. The "gap" on the chart from last Friday's strong opening gives us a downside target. The S&P 500 will trade down to 2562 sometime in the near future. Buyers will step in when the gap is filled on the charts, sending prices back up again.

Crude Oil – for the week, West Texas crude traded within a $1.80 a barrel, high to low. Oil seems to be fairly priced, based on renewed conflict with both Iraq and Iran. A year-to-date high of $57.54, and a YTD low of $43.08 in 2017. Half way price is $50.25, which is more or less the recent average price that oil has traded. The rig count was lower again last week, the lowest level in 5 months. Demand is weak, so rigs aren't needed. The peak price for crude for the next 2 years in the futures market is only $52.30

a barrel for April 2018 delivery. Oil closed at $51.84 on Friday. The price in Aug 2019 is only $50.69 a barrel.

Municipals – The ratio between 2-year muni yields and 2-year Treasury yields is extremely low. So is the 5-year ratio. The 10-year muni is now expensive versus a Treasury. Tight muni ratios, and absolute prices show no fear of tax reform, and lower tax rates. But Thursday's vote by the Senate on a budget resolution may take a few days to affect muni prices and subsequent yields.

Corporates --- Investment Grade spreads traded to a new 1-year low, and to a new 5-year low last week. The lowest spread recorded was almost 30 years ago, at a spread of 54 bps to Treasuries. I doubt we will get this tight for IG corporate bonds. The High Yield market saw its spreads move to a 1-year low as well last week; and within 7 basis points of its 5–year low of +323 bps to Treasuries. The HY spread was as tight as +235 bps 23 years ago. It seems easy for HY spreads to tighten another 20-30 basis points before profit taking will set in again.

The US Dollar – The US Dollar traded in a tight range last week, once again above its 50-day moving average. The USD was at a high of 103.30 in late December 2016, and was at a low of 91.35 in early September. We may have seen a breakout to the upside, from a 9-month downtrend, when the USD closed above 92.50. It has stayed above 92.50 for almost a month now. A new floor for the USD may have been set. Time will tell us.

Global Rate Policies – Draghi loves a big audience. Draghi knows how to warm up a big audience. Draghi knows how to bring an audience to the edge of its chairs. Thursday, the ECB will have its meeting. The markets seem comfortable with the notion of a reduction in the QE policy Draghi and his ECB has designed. A weaker Euro, simply as a result of a stronger USD, will only help with Europe's growth by making its exports cheaper than goods and services from the USA. So any move Draghi makes will be designed not to increase the Euro versus other currencies. It is doubtful the situation in Spain will affect an announcement from the ECB. The downdraft in Spanish sovereign debt means little to Draghi.

Consumer Sentiment – Homebuilder's sentiment latest read was very strong, again. The housing data doesn't look that great, but homebuilders' optimism remains high. Homebuilders are getting as much as is available within the current income demographics. But signs of a new target market for owning a home, the millennials, offer a new source for cautious optimism for the housing industry.