Monday Morning Update October 30 2017

The Fed – expect zero changes and zero surprises at this Wednesday's FOMC meeting. But hopefully the Fed will comment on the balance-sheet reduction plan that is supposedly in place now. Expect a rate adjustment at the Dec 13th meeting (as of last Friday a 85% probability). Expect Trump to nominate someone other than Janet Yellen for the Chair of the Federal Reserve. Expect a continuation of the "gradual and transparent" approach to monetary policy, no matter who Trump selects. Expect a willingness for a little less regulation from the new Fed Chair. Expect the Fed's Dot Plots map to continue to suggest a more aggressive timeline for rate changes by the Fed than what Fed Funds and Eurodollar futures suggest. And watch the yield of the 2-year Treasury closely. With an historical spread between the yield of the 2-year versus the target Fed Funds at +/- 35 bps, the current yield of the Treasury confirms a move in December, and then potentially nothing well into 2018. Watch the yield of the 2-year closely.

Inflation – this week we have four important inflation indicators. The Fed's PCE is released on Monday. It will describe price changes for Personal Consumption Expenditures for the month of September. On Tuesday we will see data on the Employment Cost index (basic labor costs such as wages and benefits costs) and consumer inflation expectations for 12 months forward. And on Friday we will see new data on average hourly wages. A very important week for inflation data.

Treasuries – the yield on the 2-year Treasury moved higher all week, at least until midday on Friday. Then the yield dropped 5 bps. The downward move on Friday can be attributed to the uncertainty in Spain and the Catalonia sovereignty. And also news of a Muller indictment coming Monday morning. The yield on the 5-year traded sideways all week, and actually closed at its low yield of the week on Friday. The 10-year continues to be in a small "yield rally". Fixed income traders love Fibonacci numbers. And the 10-year closed right on top of a 2.42% Fibonacci target yield. A break above 2.42 % next week takes the 10-year to a 2.63%. If unable to break out above 2.42%, hello 2.35% again. Investors need to be able to withstand a move in yield on the 10-year to a 2.63%, whether it happens this week or before year-end.

The S&P 500 – The S&P closed at yet another new high, in search of the 2595 target oft mentioned here. Why does the S&P continue to defy fears of being overvalued ? Six simple reasons. (1) a continuation of good economic news (2) an acceptance of higher short-term interest rates as being a "good" instead of a "bad" (3) a continuation of QE by Draghi and the ECB (4) an expected continuation of QE in Japan (5) excellent 3rd quarter earnings from the S&P 500 companies that have reported so far (6) no "Trumps" this past week. What will keep the S&P moving higher into year end ? A belief in the continuation of the six simple reasons. The gap at 2365 mentioned here last week was successfully filled, and the S&P closed higher. The S&P does not look tired. The S&P is not cheap, but it is far from ridiculously expensive.

Crude Oil – Saudi Arabia did enough jaw-boning last week about its commitment to reduce production to help move prices higher on the week. Saudi needs higher oil prices as it readies to sell 5% of its oil business in an IPO. Oil closed on Friday at $53.90 a barrel for West Texas Intermediate. A price of $56 a barrel is an important level to cross, and stay above. But oil out 20 months is priced almost $3 below current prices. Having both Iraq and Iran still in the news has brought short-term support to crude prices. The rig count was lower again last week, and lower 6 of the past 7 weeks.

Municipals – Chicago Public Schools is getting ready to issue $1 billion of new debt, to be used primarily to refund floating rate debt. The State of Illinois issued almost $6 billion of bonds last week. Their spreads widened a little bit in order to get the huge size distributed. Illinois is trying to pass legislation requiring monthly financial reporting. There is no infrastructure spending bills before either the House or the Senate. Hurricane and Puerto Rico relief carries a higher priority than a dedicated infrastructure spending bill. And it is also difficult to try and get tax reform done with the left hand while the right hand is overtly increasing government spending on roads and bridges. A Federal bailout of both Puerto Rico and flood and hurricane victims will offer enough deficit spending to give relief to the muni market; this all means no increase in muni supply via public infrastructure spending. A limit on any new supply of muni bonds to potentially offset what may be a diminished appetite for tax exempt munis by corporations if their tax rates are reduced will help provide strong support to the muni market. Expect munis to move in tandem with Treasury yields going into year-end.

Corporates --- GE is expected to lose its “A” credit rating in the near future. Low inflation helps to keep High Yield corporate spreads from widening, so this week’s inflation data will be closely watched by the HY market. Investors and traders alike are trained to watch high yield spreads as a sign for a potential sell-off in equities. HY spreads are very tight, very very tight. But spreads on HY corporates would have to widen by at least 50-75 bps in a very short time span to upset the equity markets. It seem easy for HY spreads to tighten another 20-30 basis points before profit taking will set in again.

The US Dollar – Which one is the leader and which one is the follower ? Is the US Dollar’s move higher taking Treasury yields higher, or are the higher Treasury yields taking the USD higher ? A breakout of the USD to 96 (versus a basket of currencies) looks very possible. Draghi did what he could to make sure the Euro was weakening versus our US Dollar in his ECB meeting last week. The USD looks comfortable in its mini uptrend. A new floor for the USD may have been set at 92.50. Time will tell us.

Global Rate Policies – Draghi announced a two-fold strategy for the ECB. The amount of bonds being purchased by the ECB (their balance sheet is larger than the balance sheet of the Fed) will be cut in half each month, but the cut-off time to end this QE has been extended until at least Sept 2018. And the Negative Interest Rate Policy (NIRP) will stay in place well into 2018. The Bank of Japan is expected to keep their NIRP after their meeting concludes this week. The yield on the 10-yr UK bond is 1.35%. German 10-year is at .38%. Japan’s 10-year is at 6 basis points. China borrowed money at a spread of 15 bps over high grade corporates last week. These low rates abroad offer continued demand for US fixed income assets.

Consumer Sentiment – strong economic data released last week, and strong corporate earnings released these past 2 weeks will support high consumer and business confidence and optimism in the coming weeks. The Univ of Michigan sentiment data was very strong; its data on inflation expectations continued to show little concern higher prices are coming to America. The Conference Board reports its confidence readings this week. Expect more of the same. High stock prices, good economic growth, tax reform on the horizon all support high confidence and optimism levels ahead.