Monday Morning Update November 20, 2017

The Fed – The last meeting of the year for the Fed and Chair Janet Yellen is only 2 ½ weeks away. The markets still price in a 90% probability of a move in short-term rates to 1.25% - 1.50% on Dec 13th. And the markets still expect a 50/50 chance of a move to 1.50% - 1.75% in either late March or early May 2018. Fed Funds futures suggest the move to 1.50% - 1.75% won't happen until the Sept 2018 FOMC meeting. A disconnect continues between the FOMC's Dots Plot map and Fed Funds futures and Libor futures. The minutes from the November FOMC meeting will be released on Wednesday. Important.

Inflation – there are two sides of inflation – price inflation and wage inflation. And there are two views on inflation – current inflation and expectations for future inflation. Both consumer price inflation and producer price inflation (wholesale inflation) were updated last week. Consumer prices are still increasing at a rate below the Federal Reserve's 2.0% target. And wholesale prices still reflect supply-chain replacement needs from the hurricanes (we need to include the California wild fires as well in this replacement story). Core CPI is still very near the lows of 2014 (1.6%), and way off the highs from 2016 (2.3%). As a reminder, the Federal Reserve's preferred measure of inflation is still very near a 5-year low, at a 1.30%. We saw an update on wage inflation last week; average weekly earnings are not moving higher.

Treasuries – the yield on the 2-year Treasury continues to move higher; the yield was up another 6 bps last week, closing at 1.72%. The yield on the 2-year is at an 8-year high. The next target is way up at a 2.60%. To justify a 2.60% yield on the 2-year, Fed Funds would have to be at 2.00% - 2.25%, and rising. The yield curve (10-year versus 2-year yield) continues to flatten, closing at +62 bps last Friday. The duration of the 10-year is 4.5x the duration of the 2-year, with only a 62 bp yield pick-up. Justifying a move out the yield curve needs to be played against where you expect cash yields to be. The move lower on the 10-year is a function of both low inflation readings and huge income benefits over European, UK and Japanese sovereign yields. Total return performance on fixed income will take a back seat to income pick-up over cash and cash equivalents in 2018. Remember, bonds are assets built to deliver predictable and uninterrupted income streams that are used to buy other asset classes. Bonds are not supposed to offer 5-10% capital gains coming from price appreciation. The reduction of the Fed's balance sheet, which started last month, has had no measurable effect on Treasury yields.

The S&P 500 – you would have thought the equity market was in a huge powerful significant correction if you were watching CNBC and listening to its anchors Monday-Wednesday of last week. The S&P closed down .13% for the week. Rounding makes the move lower insignificant. The S&P is only a half percent below its all-time closing high. Once again, buyers came in and bought dips last week. The House passing its tax reform bill helped. The Senate releasing its version of tax reform helped last week. It's not the details on the tax reform as much as it is the expectation that something will go to Trump for his signature. The S&P got ever so close to its 50-day moving average last week, but it never violated the price support. Very important. The Russell 2000 closed 1.2% higher on the week, giving support to the High Yield corporate bond market. Third quarter earnings are almost behind us. Investors and traders are already calculating growth rates on revenue and earnings per share for the next 2 quarters. And all eyes will be on holiday spending and comparisons between online consumer spending and bricks-and-mortar consumer spending. Expect the S&P 500 to hit 2750 in 2018, and quite possibly in the 1st half of 2018. A short week with the Thanksgiving holiday so trading volume should be very low.

Crude Oil – The battle is back in oil prices. Is the outlook for heavy supply going to outweigh the outlook for demand increasing? If demand is increasing by 500,000 barrels a day, but both current supply and "immediately available supply" is expected to overwhelm any increase in global demand, then prices for West Texas Intermediate crude and Brent crude will stay in a tight range near recent levels. Geopolitical events tend to only cause spikes; and these spikes tend to correct back to the previous trading range. WTI price per barrel was basically unchanged last week. Any price above $54 a barrel is a gift for producers. Any price below $52 a barrel is a gift for consumers (and also long Treasury bond holders). Both production and inventories were higher last week. As was the rig count here in the USA. Oil closed at $56.41 a barrel last Friday. Oil futures have returned to a "backwardation" pricing ladder, meaning farther out prices are lower than current prices. You can "sell today at a high price and buy back tomorrow at a lower price". Oil priced for sale and delivery in Aug 2019 is at $52.65 a barrel, $4 dollars lower than today. Hard to see how oil prices will cause the inflation needle to move higher.

Municipals – muni research last week focused on the supply that will leave the tax-exempt side of the muni market, based on components of both the House and the Senate's tax bills. Expect one "sector of muni supply" to get eliminated. Maybe two. Eliminating tax-exempt financing for football stadiums seems like an easy reform both sides of the aisle can agree on. Eliminating AMT seems like an easy reform both sides of the aisle can agree on. Forcing not-for-profit hospitals, airports, higher education institutions to move their financing needs to the taxable market (assume +50-100 bps bump in interest expense from a move to taxable from tax exempt for issuers) makes zero sense, if infrastructure spending is important. And eliminating the ability to refinance debt for State and local municipalities would be harmful to the balance sheet of municipalities. Any drop in the corporate tax rate will be easily absorbed by a constant demand for municipals by individuals. The chances of the top tax rate for individuals being reducing by any meaningful amount are slim. It is hard for a municipal issuer to come to market "quickly". But expect a fast track of new issuance between now and year-end for those "sectors of supply" most affected by the tax bills in the House and Senate. Muni buyers may see some higher yields in order to get the deals done before year-end.

Corporates --- It may not matter which one leads the other. Does the price trend in the Russell 2000 affect the spread direction in High Yield corporates, or are spread changes in HY corporates a canary in the coalmine for the direction of small cap stocks ? The Russell 2000 closed up 1.2% last week. The proxy for the HY corporate market, HYG (an ETF) closed up by .4%. Selling has been heavy in HY mutual funds and especially heavy in High Yield ETFs. But it seems the sectors hardest hit are the sectors that will be harmed the most by the proposed reduction in the ability to deduct interest expense; coincidently these sectors have arguably the weakest pricing power (telecoms and retail). The yield on the HY index approached 6% last week. If investors can earn 6% a year, with very low default probabilities, and with cash yielding way below 2% for the foreseeable future, seems like relatively easy money. The average spread for HY corporates the past 12 months is +375 bps to Treasuries; Friday's close was +362. The average yield for HY corporates the past 12 months is 5.73%; Friday's closing yield was 5.81%.

The US Dollar – the USD weakened last week. It is moving in the same direction as long-term Treasury yields. The Euro moved higher on the week versus the USD, helping to take Euro equities lower. PM May continues to get poor scores on her Brexit project.

Global Rate Policies – The yields on the 10-year UK sovereign, the 10-year German bund, the Japanese 10-year, and China's 10-year all moved lower last week. China injected significant liquidity into their markets last Monday, helping to send China rates lower. Their interest rates have soared this year. The yield differentials between U.S. bonds and global bonds will remain for a very long time.

Consumer Sentiment – Small Business Optimism showed continued strength when reported last week. Retails sales were okay. Business inventories seem manageable. Equity prices are high, and in upward trends. A USA economy growing at a 2.5% - 3.0% rate, versus at 1.5% - 2.0% supports high optimism readings across all sectors. Don't expect this to change anytime soon. Lots of economic data this week, but don't expect a lot of decision makers to be around to act on any of it.

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