Monday Morning Update November 6, 2017

The Fed – The markets (stocks and bonds) showed approval of Trump's nomination of Jay Powell as the next Fed Chair. Last Friday's employment report and economic data from last week gives the Fed zero reason to change their December rate adjustment timeline. Barron's is now writing about something that has been written here often --- Fed Funds futures only suggest one rate adjustment in all of 2018, versus the Fed's desire to adjust 3 times in 2018. The Federal Reserve under Powell will take note of this discrepancy. Watch closely the move in 3-month, 6-month and 12-month Libor rates over the course of the next few months.

Inflation – a bad week for investors and traders praying for higher inflation. The PCE price index showed no increase in "core" prices from the previous month. Average hourly earnings were unchanged this past month, and reversed an unusually large increase in wages that was reported last month. The Conference Board's inflation expectations were lower. And the Fed's Five Year Forward inflation indicator showed no changes. No wonder 5-year to 30-year Treasury yields all moved lower last week.

Treasuries – the yield on the 2-year Treasury hit 1.63% last week, and closed above a 1.60% yield. This move confirms the market's expectation of a rate adjustment at the December 12th-13th FOMC meeting. The yield on the 5-year Treasury moved lower all week, as did the yield on the 10-year and the 30-year. Weak inflation data moved Treasury yields lower, as would be expected. The 10-year was unable to break out above the 2.42% level mentioned here last week; it did as expected and moved back down toward 2.35%. It closed at a 2.33% yield. The yield on the 2-year is up 80 bps in the past 12 months (keep in mind Fed Funds are up 75 bps). The 5-year yield is up 71 bps. The 10-year yield is up 50 bps. And the 30-year yield is up only 21 bps. A flattening yield curve is normally not good. But there is still an 80 bp yield differential between the 10-year and the 2-year. Enough to support higher equity prices for a while.

The S&P 500 – equities across the board moved higher last week, with new closing highs for the Dow, the S&P 500 and Nasdaq. The House released its tax reform proposal. A proposed cut in the corporate tax rate to something near 20-25% would result in an increase in earnings for the S&P of between $5-10 a share. With a multiple of 17, this is worth between 85 and 170 points on the S&P. In a couple of weeks, the focus will move to forecasts and expectations for 4th quarter earnings and earnings for 1st quarter 2018. Investors and traders alike know a correction is coming. The true unknown is how big the sell-off will be, and for how long the sell off will continue. Selloffs will be bought, until short term rates move too high, too fast, and a recession nears. Both seem to be a long way off. This week is a very slow week for economic data.

Crude Oil – both West Texas Intermediate and Brent crude had an upward bias in price all week. WTI had a new 12-month closing high, at $55.71 a barrel. Saudi Arabia took a page out of Draghi's playbook and made it clear last week they will do whatever it takes to keep oil prices higher, at least until it prices its IPO of Aramco. Higher oil prices since June has not resulted in any increases in production. Very unusual. The rig count was lower again, now for 5 consecutive weeks.

Municipals – the House's tax reform plan affects the municipal bond market. The House proposes to keep the 39.6% tax bracket for individuals. It limits the tax-exempt status of certain types of muni bonds. It limits refunding capabilities for municipalities. All of the above are subject to change before Trump signs any tax change legislation. Spreads on Connecticut GO's moved to a 3-month low, confirming a zero probability of default, and the insatiable appetite for tax advantaged income.

Corporates --- Barron's suggests it may be time to take profits in High Yield corporates, as spreads are extremely tight relative to historical standards. For total return asset-allocation managers, spreads matter. But for the vast majority of HY buyers, default probabilities matter more. And default rates are expected to stay low for quite some time. The House's tax reform plan may limit some types of corporate bond issuance. A reduction in the interest expense deduction is on the table. Any reduction in the deduction allowed for interest expense, coupled with the reduction in the corporate tax rate makes the cost of debt higher. And if repatriation is signed into legislation, cash from overseas will be used to raise dividends and extend stock buybacks, not debt via the new issue market. Less supply, and global economic growth should keep spreads relatively tight.

The US Dollar – has the USD decoupled from the direction of Treasury yields ? Or is it just tracking the direction of the yield of the 2-year Treasury ? The USD has been in a nice little uptrend since early September. The Bank of England's rate announcement did nothing to provide support to the British Pound last week.

Global Rate Policies – The Bank of England announced it is raising rates for the first time in 10 years. Their short-term rate will move from .25% to .50%. And the yield of their 10-year moved lower on the news, suggesting uncertainty in Britain's negotiations of the terms and the cost of a Brexit. The German 10-year moved lower last week. As did the yield on Spain, Italy and Canada's 10-year sovereign debt. Global deflation is still more of a likely event than global inflation, according to longer maturity sovereign bonds.

Consumer Sentiment – The Conference Board reported even higher consumer confidence, and lower inflation expectations. This week the Univ of Michigan reports its findings on consumer sentiment and inflation expectations.