Monday Morning Update December 11, 2017

The Fed – short-term rates will make their final adjustments after Yellen concludes her FOMC meeting on Wednesday. Yellen will raise the Fed's target for short rates to 1.25% - 1.50%. And just as important will be the Fed's update on its forecasts for economic growth and its target path for interest rates for the next couple of years. Fed Funds futures suggest a move at the May 2nd meeting, and then nothing until Mar 2019. Bloomberg suggests a 65-68% probability of either the Mar 21st meeting or the May 2nd meeting for the first move in 2018. Six weeks in timing difference is not important. Bloomberg also suggests only one rate adjustment in 2018; Bloomberg is reporting only a 38% chance of a 2nd move in 2018. The Fed still wants three. A huge disconnect. The 2-yr Treasury will be the signal on the market's acceptance of multiple rate adjustments in the coming year.

Inflation – investors and traders saw some data on wage inflation last week. Average hourly earnings are stuck at a growth rate of 2.5% above last year's wages. The Employment Cost Index, which includes total compensation and costs of benefits, is showing a much higher growth rate, in excess of 3%. The Fed's preferred gauge of inflation is only showing inflation at a 1.4% annual rate. For whatever reason, the Fed's target is 2.0%. This week investors and traders will see updates on wholesale prices and consumer prices. The Conference Board's inflation expectations 12-months forward, is still trending lower. Five Year Forward, Ten Year Forward, and both 5-yr and 10-yr Break-evens are consistently below 2.0%. But the NY Fed has its own inflation gauge now, and it is showing inflation running well above 2%, and trending higher. Chair Powell has some data choices to consider in 2018.

Treasuries – the yield on the 2-yr Treasury continues to move higher. Three reasons. First, the federal deficit is increasing, so more supply of Treasuries will have to come onto the market. Second, the Fed and the Treasury have shown an interest to increase supply at the short end, where it is currently cheaper to borrow than at the longer end (the yield curve is positively sloped.). And last, the 2-year believes the Fed can and wants to take short-term rates higher by another 75 bps from the Dec 13th level, in 2018. The 30-year yield is supported by the demand for long duration, credit-proof assets priced and traded in US Dollars. The huge rate differential between the USA and global bonds has the ability to move the yield curve flatter by another 25-30 basis points, without any talk of recession being warranted. A Federal Reserve on track to move rates higher by 100 basis points in the next 12 months will force the 2-year to a 2.50% yield. A 2-year at 2.50% puts a 5-year Treasury at a 2.85% - 3.00% yield. And the 10-year Treasury could easily still be below 3.00%; maybe as low as a 2.75%.

The S&P 500 – the S&P closed up .35% last week. Last Monday, it traded as high as 2665. Our 2675 target on the S&P got here a lot faster than had been anticipated. With global growth continuing to advance, and with a US Dollar that is moving in sync with the yield of the 10-yr Treasury, a target of 2800 on the S&P 500 is easily attainable in 2018. The key to 2018 for the S&P 500 is the P/E. Where will the P/E be in 6 months ? In 12 months ? Earnings will be growing in 2018. Dividends will be growing in 2018. Can the P/E keep from shrinking, with interest rates maybe being 100bps higher at this time next year ? This week we see data on retail sales. The fundamentals behind the EPS's and the P/E's look good. The technicals behind the EPS's and the P/E's look good. Capital goes where it is treated well. The S&P 500 will continue to treat capital well. The S&P can easily move higher. The growth rate of P/E's in the first half of 2018 will need to be closely compared to the price change of the S&P to determine what percentage of the S&P's price change is coming from an expansion of the P/E and what percentage is coming from earnings expectations. Very important.

Crude Oil – mixed reactions to the supply statistics and the demand statistics was cause for some price volatility last week. A high of $58.88 a barrel, and a low of $55.82 a barrel for last week. Prices out 18 months are three and a half dollars lower than today's price. The 50-day moving average of WTI crude is $54.40 a barrel. Rig count is at a 3-month high. Supply is not going away. And demand is not shrinking. Oil closed at $57.34 on Friday.

Municipals – huge supply last week, and yields in the muni market collapsed. But only the yields if you were a buyer. Sellers continued to have tough times getting bids anywhere near where the custodians are pricing bonds. Dealers continue to favor their capital in the new issue market, not the secondary market. The yield on the 10-yr muni curve dropped by 25 bps last week. And this was with the yield on the 10-year Treasury only down by 3 bps. Non-USA investors are increasing their allocations to muni bonds. The tax status means nothing to them. Just the much higher yield compared to yields in their sovereign bonds, coupled with high credit quality and extremely low default rates. Maturities and coupon payments for the next 2 months will be almost double the expected supply coming to market.

Corporates --- investors continue to return to the High Yield market. Corporate default rates are declining. Covenant stress indices suggest a low risk of issuers violating their financial maintenance covenants. Both IG spreads and HY spreads can move lower. Steady stock prices, a steady economy, rising oil prices and declining default rates all support both HY spreads and IG spreads moving lower, or at least not moving significantly higher anytime soon. Tighter spreads on corporates maturing within 5 years will help to offset higher yields, for the total return investor. Income investors have to choose between buying a 1-year bond and rolling it for a couple of years, or buying a 2-year maturity and sitting back. Or buy a 5-year maturity, regardless of where you think rates will be a year or two from now.

The US Dollar – the USD finally moved higher last week. Probably not because fundamentals suggested a move higher was warranted. Just a bounce off the 93.00 level on the charts. Increasing federal deficits are normally not good for a country's currency value. The British Pound was trying to set a 12-mth high versus the USD, but reversed course and started a move back down under 1.34 versus the USD. The Euro is sitting on top of its 50-day moving average.

Global Rate Policies – the USA has embarked on a tighter monetary policy, pulling liquidity out of the system (theoretically; the deficit is increasing, offsetting any decrease in the balance sheet). The ECB has suggested it may start its tighter monetary policy in late 2018. Japan wants to continue to create a 0% - .10% yield on its long rate (the 10-yr). Bank of England started its tighter monetary policy, but will continue to tighten very slowly. The ECB meets on Thursday. The Bank of England also meets on Thursday. Japan's central bank meets on Dec 21st. Global sovereign 10-year yields were all lower last week. Central bank buying dominates.

Consumer Sentiment – an update on Small Business Optimism is released on Tuesday. Univ of Michigan reported last week that consumer sentiment cooled for a second month. But consumer sentiment (consumer is 68% of GDP here in the USA) is still strong, and at appropriate measures based on a steady economy with low reported unemployment. Year-ahead inflation expectations did increase to the highest level since April 2016.

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