

Monday Morning UpdateDecember 18, 2017

The Fed – Yellen and her FOMC followed thru with the markets' expectations for the path for short-term rates. The target rate is now at 1.25% - 1.50%. The Fed intends to make three rate adjustments in 2018. This will put the short-term rate target at 2.00% - 2.25% in Dec 2018. And the Fed intends to make the target 2.50% - 2.75% in 2019. Fed Funds futures, Libor futures and Eurodollar futures still only suggest two rate adjustments in 2018. The Fed is committed to move short-term rates higher, regardless of the gap between actual inflation and their target goal for inflation. There is nothing to suggest incoming Fed Chairman Powell has any different intentions from what the DOT Plot map suggests for 2018 and 2019.

Inflation – inflation readings are becoming a bifurcated market. Wholesale prices on a year-over-year basis are moving higher at the fastest pace since 2012. And it is not just energy prices causing wholesale prices to rise; prices for both discretionary goods and services are moving higher. Wholesale prices are up 3.1% versus last year; core wholesale prices, ex-food and energy, are up 2.4% over the past 12 months. But consumer prices are not advancing anywhere near the pace of wholesale prices. Core CPI was reported lower than expectations when retail price inflation details came out last Wednesday. And retail prices are up only 1.7% over the past 12 months, down from a 1.8% reading the previous month. The Fed's preferred inflation gauge will be updated this Friday. Last release showed inflation at 1.4%.

Treasuries – the yield on the 2-yr Treasury hit a 1.84% last week, closing in on the yield of the S&P 500. The 2-year Treasury is poised to see a yield of 2.50% in 2018. The 5-year hit a yield of 2.20% last week; the 5-year is poised to see a 2.85% yield in 2018. The 10-year moved lower last week, keeping the flattening yield curve trade in play. Weak consumer prices reported last week, and the ECB's commitment to keep a negative interest rate policy continues to give strong support to the 10-year Treasury. The yield differential between 10-year Treasuries and 2-year Treasuries closed Friday at 52 bps. This yield differential could easily be at only +25 bps in the first half of 2018.

The S&P 500 – The S&P is enamored with the view from 30,000 feet. Global economic growth is increasing, not decreasing. Long-term interest rates are very stable. Equity investors and traders, small cap and large cap, domestic and international, are impressed with their immunity to Twitter Tweets from Trump. Equity traders and investors are not afraid of three rate adjustments by the Fed in 2018. P/E's are not expected to drop by more than a factor of one in 2018 ( from an 18 P/E to a 17 P/E ). Lower corporate tax rates will be accretive to earnings in 2018 and 2019. If the S&P 500 can reach 2800 by the first quarter of 2018, 2875 would be the next target. The S&P closed at a new high last Friday, as did the Dow and Nasdaq. Until recession fears come to the forefront, equity prices should move higher. This week, data on housing starts, building permits, existing home sales, and the final report on 3<sup>rd</sup> qtr GDP will be released in a very light week for trading. 4th qtr GDP is expected to be higher than 3<sup>rd</sup> quarter.

Crude Oil – the disruption caused from the pipeline incident in the North Sea continued to support oil prices last week. WTI crude closed near its average price on the week. The rig count was lower by one rig last week; on the year the rig count is up by almost 50%. Support for crude is at \$55 a barrel. Oil closed last Friday at \$57.36 a barrel; prices for delivery in Sept 2019 closed at \$52.88 last week.

Municipals – unless something has changed over the weekend, advance refundings are gone as outlined in the new tax plan. But private activity bonds stay. All in all, the tax plan expected to be signed by Trump this week is very positive for the tax-exempt muni market in 2018. The cut in corporate tax rates, applicable to banks and insurance companies who have been constant buyers of tax exempt munis, would normally cause less demand for tax exempt bonds. But a top individual tax rate of 37%, coupled with huge maturities and coupon payments in 2018 will support the tax-exempt muni market. The real uncertainty is the potential shift to the taxable market by traditional tax-exempt issuers, either via taxable municipals or corporate bonds, and the resulting net effect on rates. Rating agencies will take a negative view on those municipal issuers who actively have used advanced refundings to refinance their outstanding debt.

Corporates --- The High Yield corporate bond market is assumed to be harmed from a component in the final tax plan that reduces the deductibility of interest expenses for corporate debt issuers. But spreads on HY debt last week showed no worries. The spread on HY corps are almost 20 bps below their 12-month average. Investment Grade spreads want to make a new 12-month low; no reason to suggest spreads won't move lower going into 2018. Corporate traders and investors have yet to decide on the importance of dramatic increases in income tax expenses on earnings for those companies planning on repatriating cash back to the USA.

The US Dollar – the USD closed right on top of its 50-day moving average last week. The US Dollar is basically off 10% from its 12-month high of 103.30 versus a basket of currencies. The S&P 500 has definitely benefitted from the weakness in the Dollar. Expect the correlation between the path of the 10-year Treasury yield and the USD to continue. The Euro is bouncing around between 1.16 and 1.19 versus the USD. The British Pound has to deal with another setback for PM May; Parliament now has the final say over Brexit terms negotiated by PM May.

Global Rate Policies – the ECB met last Thursday and retained their negative interest rate policy. The ECB is forecasting stronger economic growth in the Eurozone for the next 3 years; economic growth is now forecast at 2.3% GDP in 2018, versus a 1.8% growth rate forecast earlier in the year. Draghi stated rather emphatically rates in the Eurozone would “remain at their present levels for an extended period of time”. Draghi also stated an “ample degree of stimulus remains necessary”. Low inflation continues to confound Draghi and his policy makers. The Bank of England met last week, keeping their rates unchanged ( the BoE raised rates last month for the first time in ten years ). Central banks in both Sweden and Switzerland met and kept their NIRP. China raised their short-term rates last week, in a further attempt to stem the flight of capital from China to other countries. The Bank of Japan meets Thursday.

Consumer Sentiment – Small Business Optimism reported extremely strong results last week. Expectations for lower tax rates, expectations for a continuation in global economic growth, expectations for low long term rates and expectations for benign inflation, with respect to both wages and input prices suggest optimism levels will continue to impress investors and traders in 2018. Homebuilders' sentiment data will be released this week.