Monday Morning Update Feb 12, 2018

General themes in the market to keep in mind.

1. Inflation expectations are increasing, and increasing at a faster pace. To some, at an alarmingly faster pace.
2. U.S. deficits are increasing, maybe by as much as $1 trillion just in 2018 alone. More Treasury supply coming at a time when central banks are buying less every month.
3. Asset allocation models heavily favor equities over fixed income.
4. 2018 will be a true test of an investor's desire for income versus total return. A total return strategy, which cares little if any about yield or income, has a high probability of delivering negative total return across all maturity bands this year. HY corporates and HY munis may have the only chance of delivering positive total returns in the first half of 2018, if the rate increases along the yield curve don't slow down and take pause for a while. But for income investors, three or four moves by the Fed this year and hopefully three next year still allows yield investors to benefit by buying bonds longer than 1-year in maturity. The Fed has a maximum target for their monetary policy strategy; the downside to bonds is easily "calculateable".
5. Quantitative Easing (QE) is declining on a global basis.
6. Rebalancing gets more significant as market values growth. Asset growth has made even as small as a 5% rebalance between 2 major asset classes move markets over the short-term.

The Fed – the second FOMC meeting in 2018 is still quite a few weeks away. It is probably no coincidence that the sell-off in equities has prompted a change in trader's opinions on the upcoming Fed rate adjustments. A move in March to a target of 1.50% - 1.75% is still highly probable (87%). A second move in the 2nd quarter is now less than a 50/50 chance. A third move to a target of 2.00% - 2.25% is now only a 22% probability. The fourth move, which came into play in Fed Funds futures just a few weeks ago, is now is off the table. Treasury rates will settle down once the markets perceive a fourth move won't happen in 2018. And if the chances for a third move dwindle more, 5-10 year rates may have hit a short-term top.

Inflation – all eyes will be on this week's reports on wholesale inflation and consumer inflation. After the past week's violent response to the average hourly earnings data in January's employment report, traders will be wondering if inflation may actually be a concern in the months ahead. The Fed's Five Year Forward was up again last week, closing at a 2.19% guess for inflation. The NY Fed reports a growing fear of higher inflation. Ten-year TIPS suggests inflation is running at a 2.10%. Five-year TIPS suggest inflation is running at a 2.00% clip. Oil, copper and wholesale gasoline prices were all lower last week.

Treasuries – all eyes were watching the yield on the 10-year last week. Little attention was given to the 2-year Treasury last week; its yield dropped 7 basis points. Very important. The yield on the 5-year dropped 4 basis points. The yield on the 10-year was well behaved; it rose by 1 basis point last week. The yield of the 30-year was up 7 basis points. Very weak auction results for both the 10-year and the 30-year Treasury last week. It is safe to say any flight to quality from the massive ups and downs in equities the past 6 days only showed up in short Treasury yields. Somewhat surprising.

The S&P 500 – investors now have learned the hard way that traders have created a relative value correlation between a change in this thing called “volatility” and equity valuations. When volatility changes, equity valuations have to change. And traders are defining equity valuations at the P/E. The multiple being paid for the S&P 500 has dropped from 18.8 times forward earnings to only 16.8 times forward earnings. Now investors will have to see what happens if the P/E only goes back to a 17-handle versus an 18-handle. Earnings forecasts are not being reduced. The valuation changed because the level of “volatility” in the market changed. Earnings of $155 a share, and a P/E of 17 puts the S&P at 2625. A multiple (P/E) of 18 puts the S&P at 2790. The S&P closed at 2620 last Friday. At every single “huge” price spike of a few hundred points or so in a couple of minutes the past few days, there was not one single headline that coincided with any of these “huge” spikes both up and down. Not one single headline. Algorithmic trading is very powerful. The 50-day moving average is now at 2719. The S&P did a beautiful job of hitting the 200-day moving average and bouncing higher. Dilly Dilly !

Crude Oil – U.S. crude had traded in a $4 range for several weeks, up until last week. West Texas crude prices dropped 10% last week. The level we referenced at $66.60 did prove to be very tough resistance. Prices dropped $6 last week, and closed below the 50-day moving average for the first time in six months. Production here in the US is exploding. The rig count has increased by 50 rigs the past 6 weeks. It seems that at least here in the USA, higher prices are bringing back drilling, putting over-supply concerns back in focus. It had been “demand” getting all the headlines. Now “supply” gets the headlines. Oil trades at $52.83 a barrel for Nov 2019 delivery. It closed Friday at $59.20.

Municipals – corporations now paying a maximum 21% Federal tax rate will want to own corporate bonds and taxable municipal bonds with maturities less than 5 years in lieu of tax-exempt munis. The after-tax yields are higher in corporates and taxable munis. In the 7-10 year maturity range, investors can selectively buy tax-exempt munis at around 25-40 bps above taxables on a taxable equivalent basis. It used to be a whole bunch more advantage for corporations. The muni market is still trying to digest the tax reform specifics that directly affect the municipal financing portion of capital markets. Demand from coupon payments and maturities are outpacing the supply of new issues. This supply/demand imbalance should continue for awhile.

Corporates --- High Yield corporates have held up remarkably well the past few days. Spreads are only slightly above 10-year lows. The tightness in spreads helps to suggest the massive sell-off in equities was not based on any one fundamental news story. High Yield spreads have widened 50 bps from their lows; in the past “crisis”, spreads widened by well over 100 bps. Current spreads on HY bonds still offer value, based on very low default rate history. The current spread on HY is only 10 bps above its one-year average spread. This bodes well for a spike in equities. Investment Grade corporates are doing what they should be doing, if the sell-off in equities was something other than fundamentals-based. Spreads on IG have barely budged, and are also sitting near long-term lows. Corporate bonds are telling traders and investors the financial strength of the corporate debt markets is fantastic.

The US Dollar – The USD showed a bit of strength last week. But the markets are not expecting this bout of strength to last. The USD looks like it wants to go lower versus the Euro. The Euro Zone is growing at a faster rate of change than the USA; (we were already growing slowly when the Euro Zone wasn’t growing at all; they are catching up). And our deficits are growing larger every day with Trump’s successes. The USD does not like growing deficits. The BP is up to 1.38 versus the USD; it traded briefly at 1.42.

Global Rate Policies – The Bank of England left policy unchanged, but signaled hawkish language after their meeting. German rates were higher last week, but Japan's rates were lower. Canadian rates are at one-year highs. As are the UK's and Mexico. Global sovereign interest rates are reacting to a change in the value of currencies and a reduction beginning in the QE policies around the globe.

Consumer Sentiment – traders will have to wait a few weeks to see if any of the equity moves have caused changes in sentiment and optimism data. If the sell-off is almost over, any decreases would be expected to be minimal. Equity prices and the unemployment rate are the drivers right now for sentiment and optimism data.