"Monday Morning" Update Feb 19, 2018

The Fed – Bloomberg continues to calculate a rate adjustment in March, a second rate adjustment in the second quarter, and a third adjustment in the fourth quarter. But the chances for a third move in 2018 are now down to only a 33% probability. One-month Libor and Three-Month Eurodollar futures point to the same time line, and probabilities. Short-term rates should be at 1.63% at the end of March, at a 1.88% at the end of August, and a good chance of being at a 2.13% at year-end 2018. If the Fed was not in a rate-adjusting mood, the yield on the 2-year would not have risen 12 bps in a week (last week), especially with the carnage in the equity markets.

Inflation – news on consumer prices and wholesale prices did offer investors an opportunity to opine about inflation trends. The higher inflation readings in wholesale prices (PPI) were dismissed. Our economy has shifted from a goods-based economy to a services-driven economy. And wholesale prices measured by the PPI are focused on prices for goods, not services. The consumer price data (CPI) supported a continuing theme. Consumer prices are accelerating. Up 4.4% on an annual basis the past 3 months. Year-over-year prices are up over the magical 2% Fed target; YOY CPI is running at 2.1%. Consumer prices ex-food and energy are up 2.9% on a YOY basis the past three months. A weaker US Dollar causes higher import prices; sometime in 2018 higher import prices will have to show up in CPI data.

Treasuries – the yield on the 2-year increased 12 bps last week. This is a bunch. The yield on the 10-year increased only 2 bps last week. A 2.19% yield on the 2-year clearly suggests two moves by the Fed. Another 15 bps move higher on the 2-year by the end of March will confirm a third move is in play for 2018. The 10 bp flattening in the yield curve last week bears watching. The curve had steepened 25 bps the past 2 months. The yield of the 2-year Treasury has tracked the upper Bollinger Band for the past 6 months. This trend should continue for a while, until the Fed is out of play.

The S&P 500 – not a single new or radically different economic or political event last week, and the S&P was up more than 4%. Volatility is significantly lower. The S&P closed above its 50-day moving average. The S&P needs to build support at the 50-day average before it can set new highs. All eyes are on 2725 for the S&P. If the S&P can't stay above 2725, we will retest the 2581 low from Feb 8th.

Crude Oil – oil traded in a tight range last week, and it traded higher all week. Again, $66.60 continues to be a ceiling. And it looks like $55-$56 is a floor. Stable energy prices ahead.

Municipals – the muni market has been benefiting from the equity volatility the past two weeks. The muni market now attracts "low risk parking vehicle" money when volatility in equities occurs. The money rarely stays for very long. The markets witnessed outflows for the first time in six weeks. Yield buyers flocked to Pennsylvania tobacco settlement bonds. Muni yields were up by 1-3 bps last week. And yields are up 8 bps in the 10-yr for the month, while 2-year muni yields are actually down 2 bps MTD. YTD yields out 10 years are up 45 bps, with shorter maturity yields up 25 bps YTD. Income investors should be happy when their coupon payments and maturities get reinvested back into tax-exempts.

Corporates --- supply is expected to be plentiful in 2018 as companies are expected to continue to use leverage to finance their M&A activities. This resultant increase in leverage will benefit shareholders, not bondholders. High Yield default rates are expected to be 2.6% for Dec 2017. This default rate would be the third consecutive year of a decrease. HY mutual funds have seen 4 consecutive weeks of outflows. But buyers seemed to reappear on Thursday and Friday. Spreads on HY corps are still only 35 bps above their 10 ½-year lows. The corporate bond market has held up very, very well the past 2 weeks. The 240 bps in extra yields HY gives investors over Investment Grade corporates looks like free money in this market.

The US Dollar – The USD resumed its weakness last week. The U.S. trade deficit is increasing. The U.S. budget deficit is increasing. A currency never likes deficits, let alone dual deficits.

Global Rate Policies – It you were looking across all the central banks around the globe 6 months ago, you would not have seen any central bank with any intention to tighten monetary policy. Now, the U.S., Canada, Mexico, the UK, China and Korea are all in a tightening mode these days. Short-term rates are still negative in Europe and Japan. But longer term-rates have risen along with rates in the U.S.

Consumer Sentiment – Small Business Optimism was reported to be very strong in January. The Univ. of Michigan's preliminary look at consumer sentiment, business expectations and inflation expectations showed one small surprise. Consumer sentiment is still strong. Business expectations are very strong. And surprisingly inflation expectations did not increase from the last report.

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