Monday Morning Comment Feb 26 2018

Something interesting happened last Friday. The S&P 500 was up 1.6% and the yield on the 10-year was down 5 basis points on the day. The yield on the 2-year was up 5 bps last week. The yield on the 5-year was down 2 bps. The yield on the 10-year was down 1 basis point. Very interesting.

The S&P closed above the famous 50-day moving average on Friday, with conviction some say. It needs to close above, and stay above, and retest a few times; this will help to set this level as the new floor before we can revisit the high of 2873 set on Jan 26th, and move on up to 3000.

The path of short term rates seems very clear. The Federal Reserve raises its one-day maturity rate by 75 basis points in 2018. This puts the yield on the 2-year at a 2.75%. This then puts the yield on the 5-year at 3.10%. Bond investors buy bonds for income. Income is going higher. Bond investors will be rewarded with higher investment income versus what has been available for the past year or two.

So, where does this put the yield on the 10-year ?

Much harder to get right. Traders will be watching (1) appetite at Treasury auctions with increasing size coming at every auction for as far as the eye can see (2) inflation expectations indicators … forward looking not backward looking (3) commitment by UK and the ECB to continue their reduction in QE (4) the charts. Support and resistance. Moving averages. Relative Strength Indicators. Geeky stuff. But the charts on the 10-year carry a lot of weight on trading desks. A wide range is expected. Probably not below 2.65% for the foreseeable future. And hopefully no higher than 3.25%. It closed on Friday at a 2.85% yield.

Equity investors are now being told earnings on the S&P will go up from current earnings of $155 a share to $172 a share. An 11% increase expected for earnings. If the P/E stays the same, the S&P has another 11% increase coming. If the P/E drops by a factor of 1, the S&P is fully valued at somewhere between 2750 and 2925. The S&P closed at 2747 on Friday.