Monday Morning Update Feb 5, 2018

Sometimes you need to go back up to 30,000 feet and make sure you have a clear view on the general themes that exist in today's fixed income, equity and currency markets, especially after last week's moves in stocks and last month's moves in interest rates.

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 a pause for a while. But for yield 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 "calculate-able".
5. Quantitative Easing (QE) is declining on a global basis.
6. Rebalancing gets more significant as market values growth. Asset growth has made even a 5% rebalance between 2 major asset classes move markets over the short-term.
7. The markets smell a trade war. Trump and his Commerce Secretary, Wilbur Ross, seem to be protectionists. Equity markets do not like trade wars between large trading partners.
8. The weak US Dollar doesn't make sense to textbook strategists, with interest rates rising here in the USA.

The Fed – the new FOMC, with Jerome Powell at the helm, is expected to move three times for sure in 2018. Now a fourth move has over a 25% probability, according to both Fed Funds futures and Bloomberg calculations. The Fed will adjust its rate target by 25 bps in the 1st quarter, and then again in the 2nd quarter, and then again in the 3rd quarter; with a move in the 4th quarter ever more likely, as of last Friday. The growing likelihood of a 4th possible rate adjustment by the Fed has upset both short-term rates and longer term rates. Short-term rates will be at 2.00-2.25%, and more likely 2.25% - 2.50% at year-end 2018. The Fed will continue to be transparent in its intentions. The fourth move now in play makes traders wonder whether "4" moves qualifies as "gradual".

Inflation – it's been written here, maybe in ad nauseam, that inflation expectations are more important than actual inflation data. Data is old news. Expectations are forward looking, by definition. Of the 15 or so inflation reports each month, recently the most important ones are reports and tickers that track expectations for inflation. The Federal Reserve's Five Year Forward, Bloomberg's 5-year and 10-year Breakeven's, and the TIPs market all show the same change happening. Traders and investors, and finally consumers and businesses, are expecting inflation to move up, and move up well above a 2% target. It has been a very long time since inflation expectations were above the Fed's 2% target. It is my opinion the abrupt move higher in rates across the yield curve is due to the spike in inflation expectation readings. Until inflation expectations stop moving higher, Treasury yields across the yield curve will push higher.

Treasuries – equity markets would be okay with small and gradual moves in interest rates. But 35bps on the 10-year in three weeks is not gradual. And 20 bps higher in the 2-year in the past three weeks is not gradual. The yield curve has actually steepened the past 30 days, but this shift higher has not been picked up by analysts or journalists. The 10-yr got above the 2.45% level, and stayed above. The 10-year got above the 2.65% area, and stayed above. The 10-year is only a few bps away from the 3.03% key level. A stay above 3.03% level takes the 10-year yield to 3.35%. And a Fed Funds rate moving to 2.25% - 2.50% at year-end takes the 2-year to 2.50-2.75% this year. Income investors will be rewarded.

The S&P 500 – forget about the last few days. The S&P 500 was higher by 5.72% in January. The attempt to pinpoint the specific and exact cause of the +4% sell off last week will go on until we set new highs once again in the Dow and the S&P and Nasdaq. Then, no one will care why, except to be reminded that you have been told to buy any and all dips. Will this time be different ? For the next quarter or so, use $155 in earnings on the S&P 500. Put whatever P/E you want to use. Multiply the two. If your answer is higher than current levels on the S&P, stay long. If the current price on the S&P 500 is above your answer, reduce your position. Now, all you have to be is correct on the P/E. Missing it by 1% can be quite expensive, or quite rewarding. Traders and investors will look closer at what will move earnings in 2019. 2018 tax reform accretion to earnings will get little value in 2019.

Crude Oil – U.S. crude has traded in a $4 range the past 3 weeks. $66.60 is tough resistance. A move above $66.60, with staying power of a few days or a few weeks, will send oil to the mid $70's.

Municipals – demand emanating from coupon payments and maturities surpasses the available supply in the tax-exempt muni market so far in 2018. The lower tax benefit that corporations now receive on tax-exempt bonds, and the presumed reduction in demand from lower tax sensitive corporations, has not been felt at all in the muni market. And the taxable muni market has yet to see any increase in issuance as a result of tax law changes at year-end.

Corporates --- Investment Grade corporate spreads continue to tighten, offering some slight offset to higher rates in the Treasury market. High Yield spreads are still near their 10-year lows. IG spreads can easily tighten by another 25 bps in the 1st half. And HY spreads could move tighter by another 50-60 bps. The sell-off in equities last week didn't cause or move corporate spreads wider. Very important. This suggests the sell-off in equities was not fundamental in nature. A week of profit taking does not make for a sentiment shift in the value of equities.

The US Dollar – The USD is not weak; the Euro is strengthening, and its largest trading partner is the USA. So a movement in the Euro will always be compared against the US Dollar, even if the USA is doing all the right things to help a stronger dollar. Looking back 30 years, the USD has been below its current level versus a basket of currencies as recently as between 2008-2013, by almost 20%. So yes, the USD can weaken by another 15-20%. Until the Euro's strength reverses, the USD has to go lower. A weaker USD is a benefit to EM countries and their currencies. A weaker USD is a detriment to import prices, as a stronger import currency causes a higher price versus a weaker import currency.

Global Rate Policies – global sovereign yields are following our Treasury yields higher. The UK 10-year yield is higher by almost 40 bps so far this year. The German 10-year has seen its rate of return more than double the past 60 days. Italian sovereign debt has been quiet. Spanish yields are trying to move higher, in sympathy with a stronger Euro. The Japan 10-year is still above its target of 0% - 0.05%. The ECB does not meet again until early March. The UK's Bank of England meets this week. As does the central banks of India and Australia and Mexico. Canada and Japan meet next in March also.

Consumer Sentiment – sentiment indicators may not move higher, but they shouldn't move much lower, unless the sell-off in equities continues for another week or two. Lower corporate tax rates will keep small businesses optimistic. Consumer sentiment will stay high until home prices reverse their gains, or equity prices drop 5% in February.