Monday Morning Update March 26, 2018

The Fed – Short-term rates are now set at 1.50% - 1.75%. One week T Bills yield a 1.65%. The Fed has six more meetings in 2018. If the Fed is no longer data dependent, and is now date dependent, meaning they move based on the dates of upcoming meetings regardless of economic and inflation data, you can plan the remaining rate adjustments based on when the Fed will have a press conference after their meetings. This puts the next rate adjustment at the June meeting (1.75% - 2.00%). Then a rate adjustment to a 2.00% - 2.25% rate target at the September meeting. The FOMC is now projecting (hoping) three rate adjustments in 2019, not two. If the Fed really is date dependent, and not data dependent, and if inflation expectations continue to roll over and move lower, the markets will have to deal with a yield curve that is at least 25 bps flatter than it is today.

Inflation – wage pressures remain tame. Inflation on consumer goods should be moving higher as the US Dollar has weakened against the Euro and the Yen. As should prices on services. Remember, the price of goods is normally a function of commodity prices and currencies. Higher prices for services lead to higher wage inflation more often than higher prices on goods. Services are harder to substitute than are goods when prices get elevated. The consumer has shown a definite willingness to say “no” on paying higher prices for most anything “discretionary”. The Fed’s Five Year Forward is in a downtrend now. Breakeven levels on inflation from one year out to 10 years out are all moving lower again. If inflation expectations continue their moves lower, long duration bonds will be back in high demand once again. Some would suggest they are already back in favor.

Treasuries – lots of attention as of late on Libor rates. Is the significant increase in Libor rates from three months out to one year a function of weakening credit conditions in the credit markets or a function of a strong demand for money ? Traders have to decide. One thing is for sure. Higher Libor rates means higher debt service for consumers, as much of the debt held by consumers is based on Libor, not Treasury yields or corporate bond yields. Income investors can get 85% of the yield of the 10-year Treasury in a 3-year maturity, with 67% less interest rate sensitivity. Income investors can get 92% of the yield of the 10-year Treasury with a 5-year bond, with 46% less interest rate sensitivity. A 10-year bond yields 92% of the yield of a 30-year bond, with 55% less interest rate sensitivity. Total return investors and traders don’t look at these comparisons; they rarely care about yields.

The S&P 500 – The S&P 500 continues to be unable to build any support around its 50-day moving average. And for the second time this year, the S&P has visited the 200-day moving average, with a beautiful bounce higher. Probabilities are increasing the Republicans will lose control of the House in the mid-term elections. Traders are seeing radically different assessments of the U.S. economy; the NY Fed is projecting GDP to grow 2.7% annualized in the 1st quarter. The St. Louis Fed is calling for a 3.8% GDP. And the Atlanta Fed suggests a 1.8% 1st qtr GDP. Brokerage firms are lowering their 1st qtr GDP forecasts. Retail sales have declined for three consecutive months. A continuing trend of lower consumer spending (70% of the economy here) makes it hard for inflation to increase. And a continuing trend for lower consumer spending makes it almost impossible for the GDP to grow more than 2.0% - 2.50% annually. Auto sales are not strengthening. Business investment (the “I” component in GDP = C + I + G + X) won’t grow if consumer spending isn’t growing. Lower tax rates do not equate to increases in business investment; lower tax rates are a one-time benefit to corporate earnings. The headline grabbing one-time bonuses being handed out by companies to advertise their altruistic behavior have yet to result in increased consumer spending. The P/E based on forward earnings estimates for the S&P is at a 2-year low, after last week's 6% collapse in the S&P. And … first qtr 2018 earnings will start to be reported in a couple of weeks. Oh Boy !! Expect (and hope for) a big bounce on Monday morning off the 200-day moving average.

Crude Oil – Saudi Arabia recommits to production limits. More sanctions against Iran are on the horizon. Libya and Nigeria continue to have disruptions in their oil production and pipeline delivery. Oil closed just shy of $66 a barrel for WTI crude. The new range for crude looks to be $59-$66.

Municipals – credit rating agencies are expected to get into the trade tariff wars by warning investors about the exposures various states and cities have to the trade issues at hand. Iowa and the tariff on pork as an example. Los Angeles and Houston ports with macro trade potentially declining. Illinois spreads are at 8-month wides, even though Illinois schools and their credit conditions are improving slightly. Rating agencies are also reexamining their reviews on the percentage of revenues needed to support pension obligations. States' revenues are not growing anywhere nearly as fast as the pension obligations; if investment returns are low single digit for 2018 and 2019, rating agencies will not be merciful on pension obligation bonds. Muni yields on maturities under 5 years are below corporate bond yields, for both 21% taxpayers and 35% taxpayers. In a rare move that received little press coverage, the State of Connecticut is covering upcoming debt service payments for the city of Hartford, allowing Hartford to avoid defaults and bankruptcy. San Francisco gets an upgrade to Aaa by Moody's, after it announced it expects budget deficits the next four years. This is a head-scratcher. S&P increased San Francisco's rating to AAA two weeks ago.

Corporates --- the cost of hedging is rising significantly for foreign investors. When you subtract the costs of hedging from the nominal yield, the "net" yield is barely above sovereign debt yields. This creates a real headwind for demand from non-U.S. investors. But income investors are safe. Economic growth is positive, not negative. Default rates are low; default rates are expected to decline in 2018, not increase. Price returns are negative, but buy-and-hold investors are safe. Total return investors are challenged. CCC-rated credits have the best total returns YTD; traditional fixed income investors should stay away from CCC-credits. Default rates are extremely high. And the issues tend to be randomly traded, and only traded within a small circle of traders. The HY market is a three-tiered market – BB credits, single-B credits and CCC credits. BB credits offer significantly higher safety with significantly lower default rates. B credits are borderline safe, from a buy-and-hold perspective. April has huge coupon payments, which will be reinvested back into corporates. This will help to offset the multi-week outflows from HY and IG bond funds. CCC credits have a positive YTD return of .47%, single B's have a negative .36% yield, and BBs have a negative 1.55% return YTD. Investment grade spreads have increased 20 bps since mid-February. So have HY spreads. Income investors should be rejoicing.

The US Dollar – A significantly weaker USD can result in higher inflation (due to our dependence on foreign goods) which can cause the Federal Reserve to move more times than current projections. A weaker USD does not necessarily justify higher P/E multiples on equities.

Global Rate Policies – China's central bank increased the cost of short-term loans to commercial lenders. Traders will have to decide if China is moving in step with the U.S. in its tightening policies, or reacting to promises made by the Chinese economic team put in place last week.

Consumer Sentiment – Small Business Optimism is at the highest levels since 1983. CEO optimism is at the highest level since this survey began in 2002. Consumer confidence continues to stay near long-term highs. But if higher confidence and optimism levels can't move GDP growth rates above 2.50%, the P/E on the S&P 500 is in real trouble.

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