Monday Morning Update April 16, 2018

The Fed – Short-term rates are now set at 1.50% - 1.75%. The FOMC has a commitment to raise rates at least two more times in 2018. They will not miss the opportunity to explain their actions via a press conference. The FOMC will have a press conference after their June, September and December meetings (each is a two-day meeting). The markets expect Fed Funds to be targeted at 1.75%-2.00% after the June meeting. Then the target will be set at 2.00%-2.25% after the Sept meeting. The minutes from the March meeting suggests the possibility of short-term rates at 2.25% - 2.50% after the December meeting. Chairman Powell prefers 3 rate moves in 2018; many of his voting colleagues favor four moves this year. Savers and cash balances will see yields close to 2% by the end of the year in a 1-day maturity savings account. Zero risk, daily liquidity, and a 2% return might look fantastic.

Inflation – traders and investors saw consumer price data last week. Prices on both consumer goods and services were slightly higher on a year-over-year basis. Price pressures on food are muted. Gasoline prices were reported to be weaker. Prices on consumer services are up 2.90% YOY, versus goods prices down -.3% YOY. The negative .3% was better than the previous negative .5%, so this counts as prices going up. The Fed's key inflation indicator is running about a half percent below the CPI data. Wholesale prices showed costs in the production pipeline are firming. The Five Year Forward is still moving lower, suggesting inflation is not a concern at all in the next 5 years. The Ten Year Forward is back trying to move higher. Not sure why it is moving in the opposite direction of the Five Year. Maybe just trading noise and hedge rebalancing.

Treasuries – the Forward Rate Curve suggests Treasury yields may be near their peaks for the immediate future. Total return portfolios are still afraid of adding duration in a market where the Fed is in play. If the Forward Curve is telling us the truth, longer duration will be rewarding.

The S&P 500 – economic growth is stable, and hopefully accelerating. If no acceleration is seen in GDP in the 2nd quarter versus both the 1st qtr, and also going back to the 4th qtr 2017, the S&P will find it difficult to get out of the 2600-2700 trading range it is stuck in (the S&P is stuck between its 50-day moving average and its 200-day moving average). The upcoming quarter needs to see a strong increase in GDP from its 2.50%-3.00% track record. The equity markets need to see consumers act on what is presumed to be pent-up demand. Retails sales data will be updated today; retail sales have been down for three consecutive months. If 70% of the economy is not growing, neither will GDP from current levels.

Crude Oil – With West Texas crude now trading at 40-month high, targets as high as $80 a barrel are being thrown around. Saudi Arabia's commitment to production limits, more sanctions against Iran, disruptions in oil production in Nigeria, Libya and Venezuela have offset a ramp up in the rig count. Traders are waiting to see if $64-$66 is the new floor for the next few months; $64-$66 a barrel was the ceiling for the past 3 ½ years.

Municipals – spreads on Illinois State GO bonds are back above +210 bps. State budget deficits, and pension liabilities are back in the headlines for Illinois, as the Republican Governor seeks reelection in November. Spreads were +290 bps over the muni curve in 2017. They traded as low at +170 in late 2017. Muni ratios are expected to fall in the 2nd quarter, as fund flows are expected to keep taxexempt munis in high demand. High Yield munis are at their lowest yields in five years. The appetite for risk in municipals bonds is also very healthy.

Corporates – the appetite for risk remains high, as evidenced by the performance of corporate spreads. The credit market shows little concern about stumbling stock prices and heightened geopolitical tensions. Spreads in the HY market have tightened almost every day the past 2 weeks. The CCC-tranche of HY debt is at the lowest yields in a couple of months. Higher oil prices are historically good for the HY market. Almost 75% of the new issues are bonds rated in the B/CCC category, where default rates are at uncomfortable levels for income investors. Credit default swaps are still extremely low, on a relative basis, supporting the projections of lower default rates in 2018 and 2019. Investment grade corporates continue to churn out competitive yields and virtually zero default risk.

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. Keep in mind currency moves tend to impact import prices with a multi-month lag. The lag can be as long as six months. A weaker USD will reduce the deflation that has been seen in goods prices, but only after several months. A weaker USD should result in a move from deflation in consumer goods to inflation in consumer goods. Any strengthening of the USD would relax inflation fears that have been building since the USD moved lower versus major trading partners in 2017.

Global Rate Policies – Members of the ECB are talking to the press, suggesting an increase in the ECB's rate target may be coming in May. Draghi has not condoned these comments. The ECB is watching the change in monetary policy here in the USA, with the markets' reactions. But what we are doing here will not heavily influence Draghi to change his policy of extreme accommodation anytime soon.

Consumer Sentiment – Small Business Optimism remains among the highest in survey history; it has pulled back from a 35-year high in February, but still remains very high. Consumer sentiment remains elevated by historical standards. Lower tax withholding rates and one-time bonuses, coupled with favorable employment conditions will keep consumer sentiment relatively high for the foreseeable future.