Monday Morning Update September 18 2017

The Fed – sometime between 2:00 pm and 2:15 pm on Wednesday, the FOMC should announce they are not instituting another round of rate normalization. Their target for short-term rates will remain at 1.00% - 1.25%, until December, and potentially well into 2018. Another rate normalization in December is still projected at only a 45% - 50% probability, according to virtually all tools for predictions. The FOMC should be announcing their first step in their plan to reduce their $4.5 trillion balance sheet. The initial reaction to this announcement will be closely watched in Libor rates and Treasury rates. It is pure, 100% speculation, to have any opinion on how Libor and Treasuries will react. But the measured move (the change in respective interest rates/yields) will show how concerned traders and investors are with the initial description of the first step the Fed plans to take. The Fed will see three more inflation reports before the December meeting, as an aside.

Inflation – CPI was a little stronger, and PPI was a little weaker, as reported last week. CPI's above-expectations number can point to rent and gasoline as the cause for the higher inflation reading. Food and airfares were down last month. PPI showed steady and predictive production costs, with little reason for a change in this trend. The CPI and PPI data will not sway the Federal Reserve at this week's FOMC meeting. Remember, inflation comes in three forms. Commodities inflation, wages inflation and labor cost inflation. Commodities are not showing any concerns on a macro basis (lumber prices will move higher as the rebuilding from hurricanes will force up demand, but grain prices continue to look weak; lots of offsets exist). Wages are stubbornly stuck at a low growth rate. And labor costs are also stubbornly stuck, when you include wages in the cost of benefits. What continues to be most important to the markets is that expectations for inflation continue to be quite low, for as far out as 10 years. Short horizon expectations are no different than long horizon expectations; expectations for prices trending higher are just non-existent in all inflation data.

Treasuries – The yields on the 2-year Treasury, the 5-year, the 10-year and the 30- year all moved in the exact opposite direction from the previous week. The 2-year is back up near its 12-month high. The 5-year may easily retest the 1.90% yield not seen since early July. The 10-year yield needs to get above 2.22% before it can revisit the magic 2.40% ceiling that has been in place since mid-May. An increase of 20 bps on the yield of the 10-year last week is healthy. We did not want to see a "1% handle" on the 10 year. Housing data to be released this week will probably not move the Treasury market much. Treasuries should be narrowly traded until Wednesday's FOMC meeting concludes. Watch the 2-year closely. A move above 1.40% towards 1.50% - 1.60% will suggest the Fed is in play in December.

The S&P 500 – the S&P closed up 1.6% last week, at another new closing high. Damage from Irma was much less than expected. The Federal Reserve is expected to stay quiet with its rate normalization plans. Earnings expectations are still strong. And P/E's for forward earnings are not ridiculously high. A move to 2545-2555 is easily in reach. And potentially before the month of September is over.

Crude Oil – Oil closed up 5% last week. Crude saw the magic $50 level briefly last week, but couldn't close above $50 on Friday. Refineries will be ramping up as much as possible, so demand is back in full force. OPEC and non-OPEC members meet this Friday; certainly they will discuss extending the production reduction agreement that is set to expire in the first quarter of 2018. Once the euphoria of the refiners being back in the market for crude subsides, prices should settle back under $50, and realistically back under $45 a barrel. China is supposedly slowing down again, under their own measurement. There is a very good chance the renewed demand for crude is not coming from a opinion of better global economic growth; this "theme" is already included in a $45 a barrel price.

Municipals – Barron's is "all-in" on the tax-exempt muni market for the foreseeable future. The writer in Barron's agrees with what has previously been written here that any change in the maximum individual tax rate agreed to by both the Trump administration and Congress will still keep the top bracket high enough to cause minimal repricing of muni yields and their accompanying price. Barron's notes that since the largest investor class in tax-exempt munis is individuals, their theme/opinion was devoted to retail investors. Any corporate tax rate reductions will certainly cause some repricing of municipals as banks and insurance companies are significant buyers of individual tax-free bonds; they will still allocate capital to tax-free munis, just at a different taxable equivalent yield on their books. But assuming a corporate tax rate reduction doesn't take the rate below 25%, a repricing of munis will only be a result of a tax rate change, not a change in quality or concerns that coupon and maturity payments will not be made on time. Neither situation will result from a change in a corporate tax rate. Preferreds and corporate bonds that benefit from the DRD and QDI tax benefit will see repricing as well. But an investor and a trader will also see zero change in the quality or coupon and maturity features of the security.

Corporates --- Treasury yields went up last week, so spreads on corporates should have moved lower. This is assuming the yields of governments went up because the economy looks better after Irma, and not because the credit quality of the US government is deteriorating. Spreads did move lower last week in High Yield corporates. Investment grade corporate spreads also tightened last week. Both reacted as they should have reacted. The credit market continues to see fears of recession as completely beyond any visible horizon. The yield differential between HY and IG corporates moved lower, but at +/- 240 bps income advantage currently, HY still warrants an allocation.

The US Dollar – with Treasury yields moving higher last week, one would have hoped that the US Dollar strengthened. The 1% move higher late Wednesday/ and early Thursday didn't last thru the end of the week. And the USD closed basically unchanged, to ever so slightly stronger last week. If Trump's team has their way, the USD will move another 5% lover in the coming months. And with Yellen not expected to change short-term rates for at least a couple of months more, no real reason why the USD should strengthen against the Euro, the Yen or the Pound.

Global Rate Policies – Draghi speaks at a conference on Friday. It would be rare for him to miss an opportunity to opine with his random thoughts about monetary policy inside the ECB. Bank of England met and stayed the course. They made wistful and dreamy comments suggesting they, too, wanted to start their ending of QE and the beginnings of balance sheet reductions. Wishful thinking and just rhetoric.

Consumer Sentiment – the results from the Univ of Michigan survey last week showed no surprises; current conditions look good, expectations on the business climate are positive and expectations for higher inflation are muted. With Irma damage less than expected, and new highs across the equity indices, no reason to assume consumer surveys to be anything different than positive.