Monday Morning Update September 25 2017

The Fed – everything went as expected at the close of Wednesday's 2-day FOMC meeting. Yellen announced that Fed Funds would stay at 1.00%-1.25%. Yellen's statement suggests another rate adjustment is on the calendar for December, hopefully. Fed Funds futures increased to a 60+% probability of a rate adjustment in December after these comments. Libor futures and Eurodollar futures confirmed the increase in probability. Yellen and her team forecast three rate adjustments in 2018, two more in 2019, and only one in 2020. And the Fed will take a very gradual and very transparent approach to reducing its $4.5 trillion balance sheet. Starting next month, the Fed will reduce its balance sheet by $10 billion a month, $6 billion of Treasuries and $4 billion of mortgages (not a surprise). Every quarter, the Fed will increase this reduction by $10 billion. The limit is expected to be capped at $50 billion a month. A very gradual reduction. Very, very gradual, and outlined rather mathematically by Yellen. Of course all this can change if the Fed thinks a change in the monthly amounts is justified by economic data. Banks and REITs can easily absorb the newly released supply of mortgages. And global central banks, pension funds and fixed income ETFs can easily absorb the newly released supply of Treasuries. The Fed did reduce its long term forecast for short-term rates by 25 bps. And lastly, Yellen stated numerous times in both her statement and at the press conference after the meeting she is stupefied as to why inflation is not growing with unemployment so low. For the Chair of the Central Bank of the USA to openly admit, numerous times, that inflation statistics are baffling, with no understanding as to why key inflation metrics continue to trend lower is a scary admission. Maybe this helps to explain the weak US Dollar. The Central Bank of the USA does not understand one of its only two mandates.

Inflation – actual inflation versus expectations for inflation … the ultimate discussion as to which one moves rates more. Actual inflation data only confirms whether one's expectations for inflation are realistic or not, and accurate. Investors and traders will see the last look at the Fed's favorite inflation indicator this week as the PCE price index for the 2nd qtr is released on Thursday. Import prices were higher last month, completing the circle on how a weaker US Dollar results in higher import prices. Forward crude oil prices suggest little upside in oil prices for the foreseeable future from current levels. Copper looks like lower prices are more likely than higher prices going into year-end. Corn and wheat prices are still near their one-year lows. Wholesale gasoline prices are 15 cents a gallon below the peak seen just after Hurricane Harvey. Iron ore prices are in an ugly downtrend. Wage growth seems improbable much above the current 2.5% growth rate. And the major indicators used to measure expectations for higher inflation all continue to suggest a 2% inflation rate is a very long way off. Expectations are for core inflation to be below 2% (the Fed's target for inflation) for the next 5-10 years. Expectations drive interest rates. Actual inflation data helps to justify the direction.

Treasuries – Treasuries seemed to approve of the gradual and transparency story behind the much anticipated program outlined by the Fed to reduce its massive holdings of Treasuries and mortgages. The yields on the 2-year and 5-year Treasury "only" increased by 4-5 bps. after the Fed's meeting on Wednesday. The yield on the 10-year moved up "only" 3 bps. And the yield of the 30-year actually dropped 2 bps after the Fed's announcement. It has been written here that following the yield of the 2-year, and the 5-year, hold the clue as to the timing of the next Fed's rate adjustment. Month-to-date, Treasury yields are up, primarily in anticipation of the FOMC results. Now we have to watch for the next week or two to see how Treasuries react to the gradual approach by the Fed to reduce its bond holdings. A move to 1.60-1.70% on the 2-year will suggest a rate change will take place in December; it closed on Friday at 1.43%. The 5-year needs to stay below 2.14%; it closed Friday at a 1.86% yield. Inflation trends should keep the 10-year below 2.65%.

The S&P 500 – the S&P closed above 2500 on the week. The level of 2500 should now become the new floor as the S&P is still very capable of another 40-50 points higher before the next bout of consolidation occurs. Economic data released last week continues to suggest an economy growing faster than 2%. Investors and traders will see the last look at 2nd qtr GDP this week. And 3rd quarter GDP will look bumpy as the slowdowns caused by the recent hurricanes will certainly reduce output for a short while. But expectations for a rebound in growth in the 4th qtr and 1st qtr of 2018 will reflect much stronger Government spending. A busy week of economic data is ahead as we will see housing data, inflation data, manufacturing output data and key confidence indicators. Investors and traders will continue to expect some semblance of tax reform will happen just around the time earnings comparisons become more difficult, offering an offset to slower earnings growth. Investors should not expect continuous 10-12% growth rates in corporate earnings; they will need some form of "substitution" to keep P/E's high and equity prices setting new highs. Some form of tax reform can be this "substitution".

Crude Oil – Oil did manage to close above $50 a barrel last week as 85% of refineries are back on line. Oil futures, however, show little risk of oil moving up above $52 a barrel for the foreseeable future. OPEC and non-OPEC are trying to display a unified front in an attempt to extend the agreement calling for production cutbacks applicable to all oil producers. Stable oil prices will help to keep inflation data below the magic 2% inflation target.

Municipals – expectations are for Hartford CT to file for bankruptcy any day now. And the State of Connecticut is the next state to have a target on its back. Pennsylvania's general obligation bonds were downgraded last week, not unexpected. S&P Ratings suggested bond insurer Assured Guaranty will not suffer any credit rating downgrades as a result of damage caused by Harvey. It is too soon to see any claims from Irma or Jose. Yields on tax-exempt munis closed the week a couple of basis points higher, following the results seen in Treasuries at the close of the week. Relative to Treasury yields though, munis across the yield curve are at their most expensive levels in the past twelve months. If another ACA-repeal defeat happens this week, and if insurers will not be in the muni market raising liquidity to pay hurricane claims, muni yields will continue to attract buyers, even at these low relative levels. Yields don't stay low if there isn't a strong and constant demand for the bonds. And nothing on the horizon suggests the demand will not remain constant, and strong. If rates move 25-50 bps higher next year, new money will be invested at rates higher than are available today. This is not bad. Higher rates do not cause a delay in interest payments. Higher rates do not cause a delay in principal repayment. Higher rates give investors higher book yields.

Corporates --- Investment Grade spreads were stable last week. Spreads on High Yield corporate bonds moved lower, by 8 bps, which is a lot. These lower spreads offset the higher yields seen in Treasuries last week, keeping the yield on HY corporates unchanged on the week. The power of "spread tightening" was in full force last week. IG spreads want to retest their 12-month lows at +102 bps above Treasuries. And HY spreads look like they want to retest their 12-month low spread of +344 bps above Treasuries. Both IG and HY corporates still seem to justify allocations. Upgrades versus downgrades (credit rating changes by Moody's and S&P) suggest no credit black swans are on the horizon.

The US Dollar – a suggestion by the Federal Reserve of slightly higher yields in the near future let the USD move off a one-year low of 91.35 versus a basket of currencies. The Euro is taking a breather at just below 1.20 versus the USD. UK Prime Minister May continues her efforts to broker a smooth exit from the European zone, which is offering some support for the British Pound. Import prices showed a bump last month over the previous month. A few more months of import price data will need to be seen before we can conclude that the weaker US Dollar is resulting in the importation of inflation from overseas.

Global Rate Policies – the Bank of Japan met last week and opted to keep its negative interest rate policy in place. Japan continues the trend of central banks opining on how they would like to reduce their QE policies. The ECB, the Bank of England and the Bank of Japan will be watching the markets' reaction to the actual implementation of a balance sheet reduction initiative here in the US. German Chancellor Merkel is expected to win her election easily, offering consistency in policy and power in the Eurozone.

Consumer Sentiment – this week both investors and traders will see two widely followed confidence indicators. No reason to expect any significant weakness in the opinions on both current conditions, and future conditions.