Monday Morning Update July 10 2017

The Fed – Fed Chair Yellen has only 2 press conferences scheduled to take place after her four remaining FOMC meetings in 2017. Yellen will make a statement and then answer questions after both the September and December meetings. The July and November meetings will conclude with no Q&A from Yellen. So investors have to focus on where short-term rates are trading around the Sept and Dec dates. Fed Funds futures now suggest a 53% probability of a third normalization announced at the September meeting. December Fed futures suggest the move won't take place until after this meeting. One-month Eurodollar futures suggest a move in December is more likely than in September. And Eurodollar futures are only showing one rate normalization in all of 2018. But this can surely change quickly with central bank rhetoric. Yellen would not even think of raising rates and then not hold a press conference to explain her reasons. The upcoming July 26th meeting will give the Fed the platform to be more specific on the timing of its initial reduction in its balance sheet. A consensus has now been formed for the reduction in the Fed's balance to begin just after the Sept FOMC meeting, and a rate adjustment taking place in December.

Inflation – Investors will be following this week's release of PPI and CPI inflation data to see it if replicates the disinflation being felt in the Fed's PCE indicator. Core CPI is at 1.7% year-over-year. Core PPI is just over 2.0%. The Five Year Forward Inflation tracker is trying hard to move higher as improving growth in the Eurozone and China help support raw material prices. And with the weakness in the US Dollar, a lower USD allows for the importation of inflation. Our imports cost us more when the USD is weaker. A little inflation is a welcome friend, as long as the Fed doesn't move short-term rates so fast that the yield curve flattens another 25-50 bps. Small signs of slightly higher inflation expectations may be partly to blame for the increase in longer term Treasuries these past couple of weeks. Barron's wrote a strong article suggesting the demand picture for oil on a global scale is strong enough to overtake the daily production levels, allowing for crude prices to trade back up to $55 - $60 a barrel. A 20-30% increase in oil prices will definitely move inflation expectations higher.

Treasuries – The Treasury markets know one thing for certain. Central banks around the globe are done, or almost done, with their easy monetary policies. QE will be decreasing, not increasing. The markets now understand this. Hedge funds are rumored to be big sellers of long Treasury positions. Part of the selling comes as a sympathy trade from the two-week selloff in German Bunds and other Eurozone sovereign debt. The past trailing one-year high yield on the 2-year Treasury is 1.41%. It closed at 1.40% on Friday. The one-year high on the 5-year Treasury is 2.14%; it closed at 1.95% on Friday. The one-year high on the 10-year Treasury is 2.63%; it closed Friday at 2.39%. The one-year high on the 30-year is 3.21%; it closed at 2.93%. All 4 of these relative yields closed above their 50-day moving averages. The 50-day moving average is a critical "action-trigger" in the markets. A violation of a 50-day moving average, closing at or below this level for a few consecutive days, triggers high volume trading. It should be easy for the 5-year, 10-year and 30-year to test their 12-month high yields and still not be at danger-zone levels.

The S&P 500 – The S&P closed below its 50-day moving average twice last week. But it was able to close 11 points above this mark on Friday. And the S&P closed in positive territory ever so slightly for the week. This was good, based on the continued selloff in global sovereign debt for the second consecutive week. The equity markets heard that the manufacturing sector of the economy continues to chug along nicely. The services sector of the economy is also slowing growing. Equity investors saw a strong payroll report on Friday. But wages are not growing any faster than a 2.5% annual increase. The trade picture was better, offering a slight support to the "X" component of GDP. But construction spending was weak. Auto sales were weak, again. Factory orders were weak. Durable goods orders were weak. Data is suggesting a 1-2% economy, not a 2-3% economy. The Atlanta Fed's GDPNow continues to trend slightly lower with last week's data releases. But 2nd qtr GDP is expected to be much higher than the anemic 1st quarter growth rate of 1.4%. A headwind for a move higher in the S&P is the threat of continued higher rates and a slow down in the growth of both earnings and revenue. The S&P closed at a P/E multiple of 17.6x forward earnings. High, but not too high, unless the Fed rapidly changes short-term rates to much higher levels. And the chances of this are slim.

Crude Oil – Oil traded as high as $47.32 last week, and as low as $43.78 a barrel. Almost a 10% range. It closed near the low end of this range. You can sell oil today for $44.30 a barrel. You can sell oil for a $46.29 a barrel for settlement in one year. This is a 4.5% increase. You can sell at $47.21 a barrel for settlement in December 2018, for a 6.5% increase over today's price. Relatively stable prices for oil are now priced into the market. The rig count increased last week, after breaking a very long streak of increasing rig counts the previous week.

Municipals – The Illinois legislature overturned a veto by the Governor and passed a budget. S&P and Fitch said "thanks". Moody's now wants the limelight and they want to be the one who takes a State's general debt credit rating to junk for the first time in ratings history. Spreads on Illinois bonds tightened to their narrowest level in 3 months. High yield corporate investors have been buying this credit for the extremely wide spreads the bonds offer. Expect the direction and amount of changes in Treasury rates to carry over almost basis point for basis point to the muni market. July reinvestment continues to bring in buyers at higher yields.

Corporates --- The cost of buying insurance against default for both Investment Grade and High Yield credit continues to be quite low on a relative basis. Default insurance premiums on Assured Guaranty, a large insurer of both Puerto Rico debt and Illinois continues to soften, suggesting AGO's ability to absorb debt payments on defaulted bonds is quite strong. Spreads on IG debt closed at a 12-month low. And spreads on HY credit have stopped moving wider; they have been quite stable for the past 2 weeks. The increase in Treasury rates is not worrisome to the credit markets.

The US Dollar – Not even higher Treasury yields could move the USD higher once again last week, against a basket of foreign currencies. The USD is back to its lows set in late September/early October. A weaker dollar is actually negative for longer term Treasuries. A weak USD makes imports cost more. And higher prices causes Treasury yields to go higher.

Global Rate Policies – Fed Chair Yellen "testifies" to Congress on Wednesday about her outlook for economic growth and inflation and Fed policy. I have never understood why her dialogue with Congress is coined "testify". This makes her sound guilty of something. Maybe Congress feels more power over something they have zero control over. The Bank of Japan meets this Thursday. The ECB also meets this Thursday. Japan is less likely to suggest any immediate end to their easing monetary policies. And while Draghi's people tried to take back the interpretation of his earlier comments suggesting a more hawkish ECB, Draghi has certainly had time to recant the interpretation. He has not. Draghi is an experienced showman. He will tell his crowd whatever he wants them to hear. But yields in Germany, France and across the Eurozone continued their spike higher. The yield on the German 10-year closed at an 18-month high. The oldest bank in the world was bailed out by the Italian government last week. The one aspect holding back stronger growth in Europe is the weak banks in Italy, Spain and Portugal.

Consumer Sentiment – Investors will see the all-important Small Business Optimism report on Tuesday. But auto sales are not benefiting from high consumer optimism levels. Auto dealers are, once again, not listening to their customers. Consumers are happy to drive older cars. Usually a nice correlation btw auto sales and confidence. In this case maybe auto sales are a leading indicator.