Financial Market Weekly

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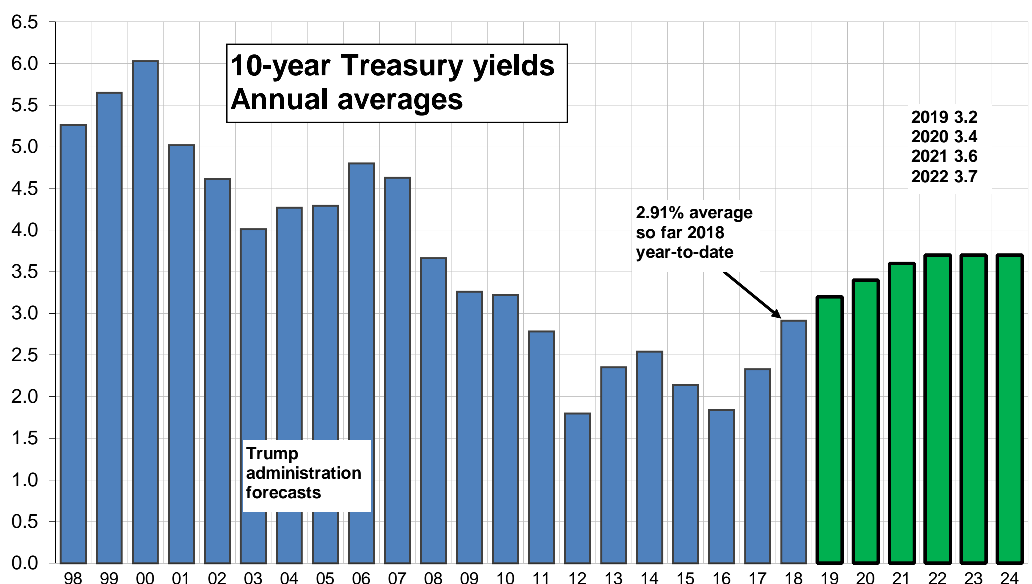
ALL THE PRESIDENT'S MEN LOOK FOR HIGHER INTEREST RATES

Our hands are tied. The die is cast. There can be no other forecast. Interest rates are going up. Or at least they were. The Fed may well be loco for raising interest rates, but pockets deep within the Trump administration are singing the same tune.

The OMB mid-session budget review this summer has bond yields going to 3.7% even though it looks like the Fed hikes the interest rate it controls (2.25% currently) only another 75 bps to 3.0%. And then quits. The OMB forecast is 3-month Treasury bills go to 3.0 to 3.1% and then that's it. Essentially, the Trump administration doesn't see the Fed taking the punch bowl away and raising interest rates above 3.0% neutral levels for the economy.



	10-yr Treasury Yield	Core PCE	Real Yield bps
2002	4.61	1.7	291
2003	4.01	1.4	261
2004	4.27	2.0	227
2005	4.29	2.1	219
2006	4.80	2.3	250
2007	4.63	2.2	243
2008	3.66	2.0	166
2009	3.26	1.2	206
2010	3.22	1.4	182
2011	2.78	1.6	118
2012	1.80	1.9	-10
2013	2.35	1.5	85
2014	2.54	1.6	94
2015	2.14	1.3	84
2016	1.84	1.7	14
2017	2.33	1.6	73
2018	2.87	1.9	97

2018-to September

The bond market doesn't think there is inflation, either do Fed officials, especially when measured against core personal consumption expenditures (PCE) deflator "inflation." Since 2011, bond yields have never ventured more than 100 bps higher against core PCE inflation. This means if core PCE inflation goes back to 2.3% in the housing bubble economy years, then 10-yr Treasury yields, what? Go maybe to 3.3% on bonds' inflation value.

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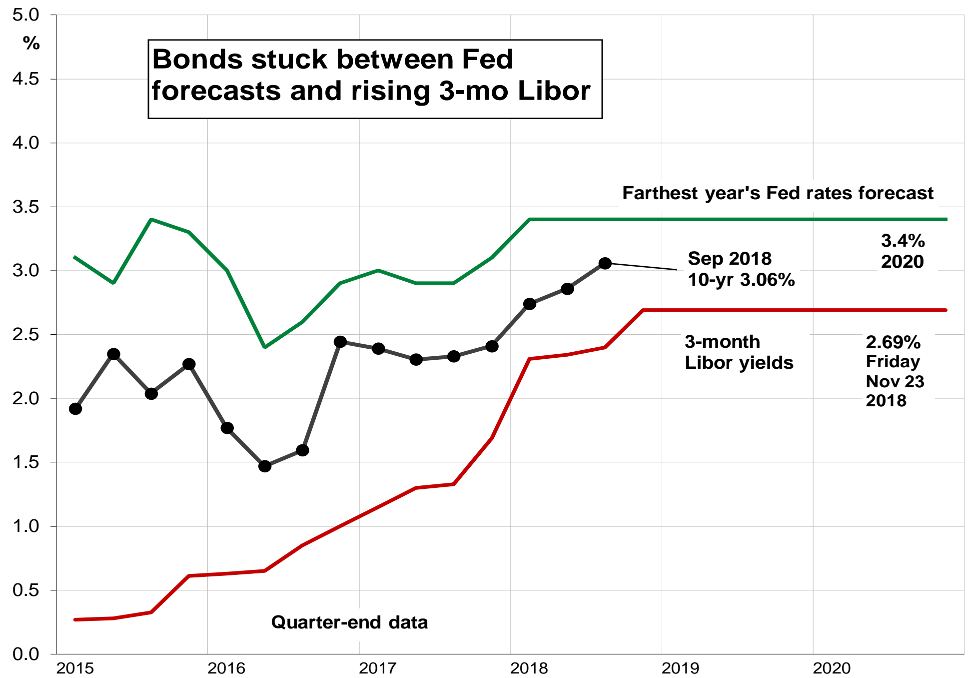
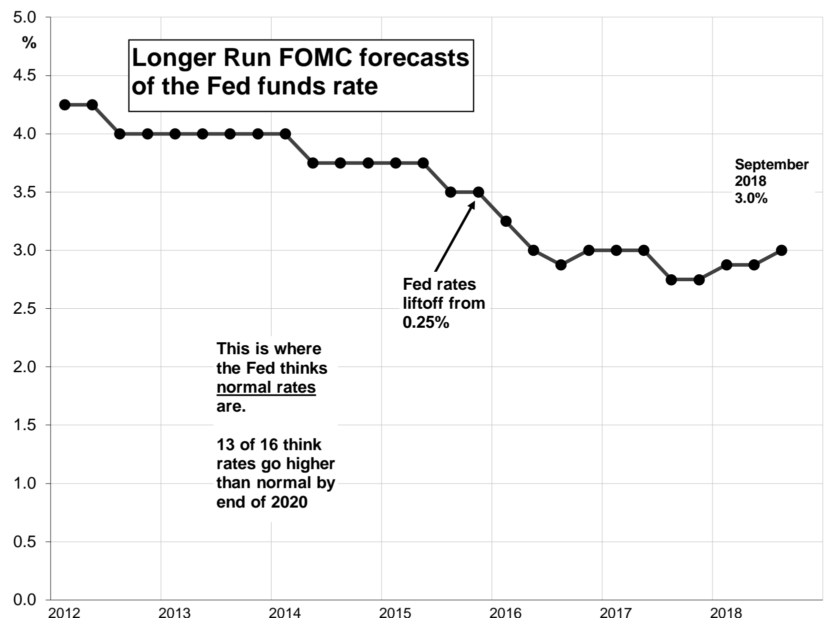
Bond yield forecasts are also capped if you will by the Fed's own forecasts. (1) They only anticipate having to raise rates to 3.4% at the end of 2020 (at the September meeting they forecast 3.4% again at the end of 2021. (2) They have moved down the forecast of "neutral" rates for the economy currently 3%. Back when they first started these rate forecasts in 2012, they thought neutral rates for the economy were 4.25%. We don't feel comfortable forecasting 10-yr Treasury yields rising much above 3% neutral levels. Guess we have gotten used to the discomfort given our forecast on page 3 always of this report looks for 4% 10-y yields. We think the economy can get used to higher yields. 4% neutral seems appropriate: neutral as in it doesn't speed up or slow down economic growth. Recently however, the economy may be starting to stumble a little with the trade wars as well as a sharp rise in mortgage rates which is slowing the housing sector. And falling oil prices don't help a rising bond yield forecast. Generally, we would treat higher interest rates like higher gasoline prices a decade or more ago: the economy can get used to the level. There is a lot of supply relative to demand that could still push up 10-yr yields. We will know more in the next six to nine months. The Trump administration looks for a $1.1 trillion deficit in fiscal year 2019, and $360 billion of securities from the Fed's balance sheet wind down also have to be bought by the public. Foreign demand is minimal relative to what they bought during the trillion dollar Obama deficit years a decade ago.



Why aren't bond yields higher already? Doesn't help the Fed thinks the economy can't handle higher rates.

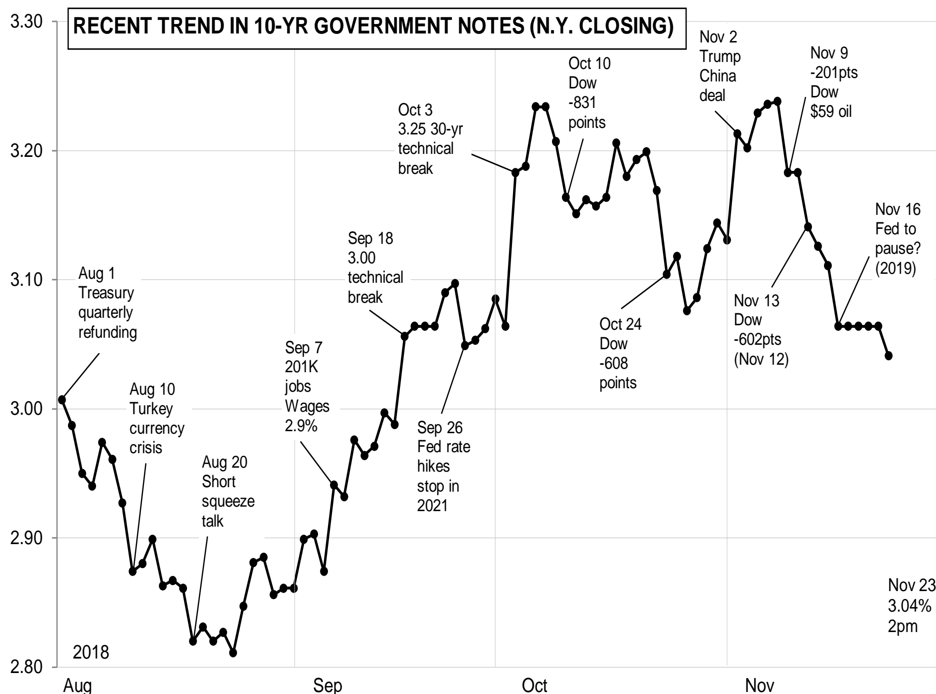


Federal Budget Deficits fiscal years ending September $bln	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
OMB (FY19 Budget mid-session review)	458	1,412	1,294	1299	1086	679	484	438	584	665	779	1085
Fed QE Purchases of Govts		293	7	600	0	414	387	13	2	2	-152	-43
Treasuries Held in Custody fgn central banks	256	624	392	212	193	38	89	-20	-185	232	19	-17
Foreign private purchases Govts (TIC)	252	267	579	320	218	53	178	210	85	143	149	-21
Commercial Bank holdings Treasuries	1	50	103	-17	23	-36	186	64	62	0	22	na

MARKETS OUTLOOK

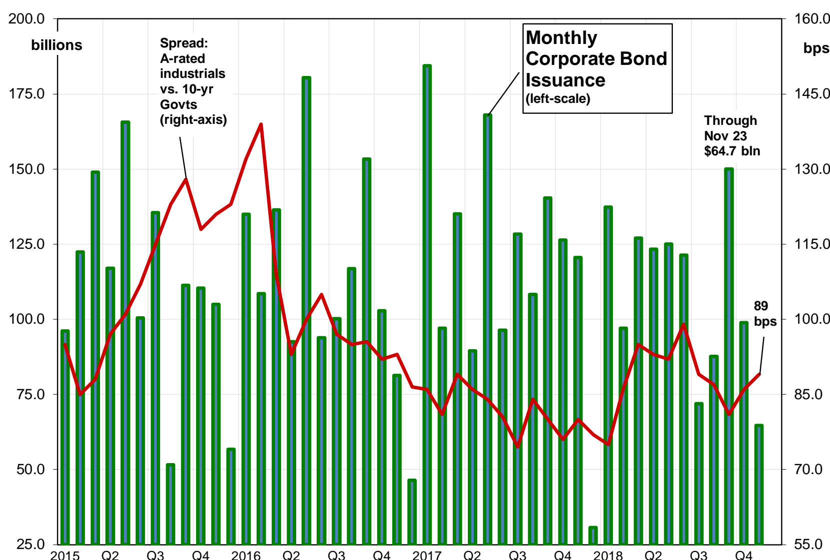
	28-Sep 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
30-Yr Treasury	3.21	3.25	3.40	3.45	3.65	3.60	3.80	3.85	3.85	3.95	3.95
10-Yr Note	3.06	3.10	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95	3.95
5-Yr Note	2.95	3.00	3.10	3.20	3.40	3.45	3.65	3.75	3.80	3.95	3.95
2-Yr Note	2.82	2.90	3.00	3.15	3.40	3.40	3.60	3.75	3.80	4.00	4.00
3-month Libor	2.40	2.70	2.95	3.20	3.45	3.45	3.70	3.90	3.90	4.20	4.15
Fed Funds Rate	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00	4.00
2s/10s spread	24	20	20	15	10	10	10	5	0	(5)	(5)
Libor/funds spd	15	20	20	20	20	20	20	15	15	20	15

Not much happened before Thanksgiving Day with 10-yr yields closing unchanged each day from Friday's 3.06% close. This despite the Dow industrials stocks crashing 395 points Monday and 551 points on Tuesday. Crude oil prices may have finally had a downward impact on bond yields by Friday as these were as low as $50.15 on Friday versus the $56.46 close on Friday, November 16. The bond rally made a new high on Friday, barely above Tuesday though. The rally runs out of steam if the Fed keeps moving rates up is the problem. Three-month Libor is already 2.69% Friday and the Fed funds rate won't be 2.5% until December 19. Market odds of a December hike are 76%. Three months further out (not as "reliable"), odds of a 25 bps rate hike to 2.75% (2.95 Libor?) on March 21, 2019 are only 28%.



CORPORATE BONDS: TAKEDA PHARMACEUTICAL, WEC ENERGY, GATX

Corporate offerings were $8.0 billion in the November 23 week versus $19.5 billion in the November 16 week. On Monday, Takeda Pharmaceutical sold $5.5 billion 2s/3s/5s/10s. It priced a $1.75 billion 5.0% 10-yr (m-w +30bp) at 200 bps (A2/A-). The pharmaceutical company will use the proceeds as financing for its Shire acquisition. Corporate bond yields (10-yr Industrials rated A2) were 89 bps above 10-yr Treasuries this week versus 88 bps last Friday.



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FEDERAL RESERVE POLICY

The Fed meets December 18-19 to consider its monetary policy. Our recommendation would be to raise rates to 2.5%, and then tell markets you will take another look at what needs to be done at the June 2019 meeting. Hit the pause button. Mortgage rates have risen too quickly from 3.5% to almost 5% and may be having a negative effect on the economy. Fed policy restraint can be thought of in terms of level and speed. 2.5% will not be very high historically, but the speed, a rate hike every quarter starting December 2016 except one; may constitute "tightening" of a sort.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	21-Nov	14-Nov	7-Nov	31-Oct	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2253.085	2270.420	2270.436	2270.399	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1661.830	1670.825	1668.989	1668.989	0.000
Primary credit (Discount Window)	0.015	0.110	0.016	0.061	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	0.007	0.007	0.007	0.007	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	
Central bank liquidity swaps	0.058	0.047	0.079	0.080	62.000
Federal Reserve Assets	4154.1	4193.6	4189.8	4186.8	961.7
3-month Libor %	2.68	2.63	2.60	2.56	2.82
Factors draining reserves					
Currency in circulation	1706.046	1702.792	1699.134	1696.031	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	16.205	0.660	1.875	4.815	0.000
Reserve Balances (Net Liquidity)	1757.502	1799.528	1828.825	1771.541	24.964
Treasuries within 15 days	24.916	34.304	34.357	34.357	14.955
Treasuries 16 to 90 days	78.011	59.403	59.402	45.211	31.549
Treasuries 91 days to 1 year	306.254	310.003	310.003	324.193	69.272
Treasuries over 1-yr to 5 years	961.676	993.899	985.378	985.372	170.807
Treasuries over 5-yrs to 10 years	263.716	255.606	264.108	264.095	91.863
Treasuries over 10-years	618.512	617.206	617.188	617.170	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

The Fed still maintains their policy adjustments for interest rates (upward of course, despite Trump telling reporters he wanted lower interest rates on Tuesday) are dependent on the economy. Still? Really? It may sound like we are talking out of both sides of our mouth, but monetary policy would not be in this condition if they had raised interest rates earlier, instead of leaving them down at zero for so long, that the public (including Trump) thinks any rate hikes are bad. We could have sworn that Yellen once said interest rates should be normal when the economy is, and instead interest rates are still short of 3% normal. [Full disclosure: The Fed once thought normal was 4.25%, and also the votes on the FOMC for normal are mixed: 3 say 2.5%, 4 say 2.75% and 6 members say 3.0%.]

Fed Individual Forecasts					
Fed funds rate by year-end					Longer
Votes	2018 End	2019 End	2020 End	2021 End	run
1	2.125	2.125	2.125	2.125	2.500
2	2.125	2.375	2.625	2.625	2.500
3	2.125	2.625	2.875	2.875	2.500
4	2.125	2.875	3.125	2.875	2.750
5	2.375	2.875	3.125	2.875	2.750
6	2.375	2.875	3.125	3.000	2.750
7	2.375	2.875	3.125	3.125	2.750
8	2.375	3.125	3.375	3.375	3.000
9	2.375	3.125	3.375	3.375	3.000
10	2.375	3.125	3.625	3.375	3.000
11	2.375	3.125	3.625	3.375	3.000
12	2.375	3.375	3.625	3.500	3.000
13	2.375	3.375	3.625	3.625	3.000
14	2.375	3.375	3.625	3.625	3.250
15	2.375	3.375	3.625	3.875	3.500
16	2.375	3.625	3.875	4.125	
17					
Median	2.375	3.125	3.375	3.375	3.000
Meeting	Sep 2018	Sep 2018	Sep 2018	Sep 2018	Sep 2018

Anyway, if they are still data dependent, the most important economic variable is the 3.7% unemployment rate. Unemployment claims this week are rising and this suggests unemployment will not decline further for now, which could take away some of the urgency to keep on the current path after a rate hike to 2.5% in December. Economic growth is important, maybe more for optics (why would you hike rates with growth slowing and the President yelling), as the Fed forecasts look for higher interest rates despite their growth forecasts slowing to 2.5% in 2019 and 2.0% in 2020, when the Fed funds rate is supposed to end the year at 3.5%.

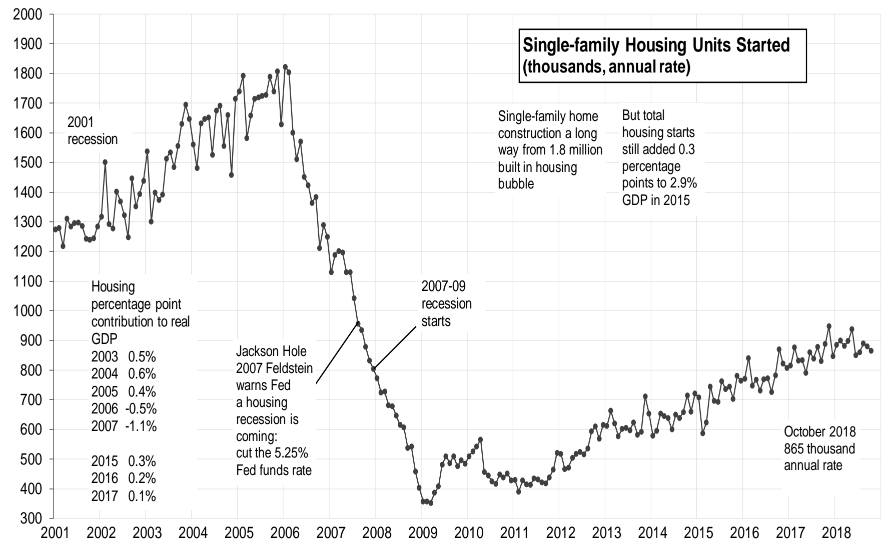
Year-ends for Interest Rates				
Percent %	2018	2019	2020	2021
Eurodollar futures	2.77	3.055	3.045	3.025
Fed's Sept forecast	2.5	3.25	3.5	3.5

Eurodollar futures price where 3-month Libor will be in the future.
Friday, November 23, 2018 3-month Libor 2.69%

OTHER ECONOMIC NEWS THIS WEEK

Single-family home construction a no-show since Trump elected (Tuesday)

Breaking economy news. Housing starts rose 1.5% to 1.228 million in October. Single-family home starts fell 1.8% to 865 thousand however. Single-family home starts dropped 4.0% in the South which is the biggest market for home building in the U.S. and this may be in part due to recent hurricanes including Hurricane Michael making landfall on October 10 in the Florida Panhandle.



Net, net, homebuilders are getting increasingly wary and their confidence is flagging as new home sales continue to sputter. Single-family home construction is down everywhere except in the Northeast (+14.8%) where only about 10% of construction occurs nationwide. Whether true or not, homebuilders are increasingly concerned that skyrocketing mortgage rates are driving buyers out of the market. Surveys cite a reduction in homebuyer foot traffic when it comes to looking over properties for sale.

The Tax Cuts and Jobs Act did lead to an increase in investment spending for companies, but there is no new investment spending in residential housing construction. We forecast that new home construction will not pick up again with mortgage rates near 5%. Homebuyers are facing sticker shock as home prices move out of sight and they can't afford the higher borrowing costs either.

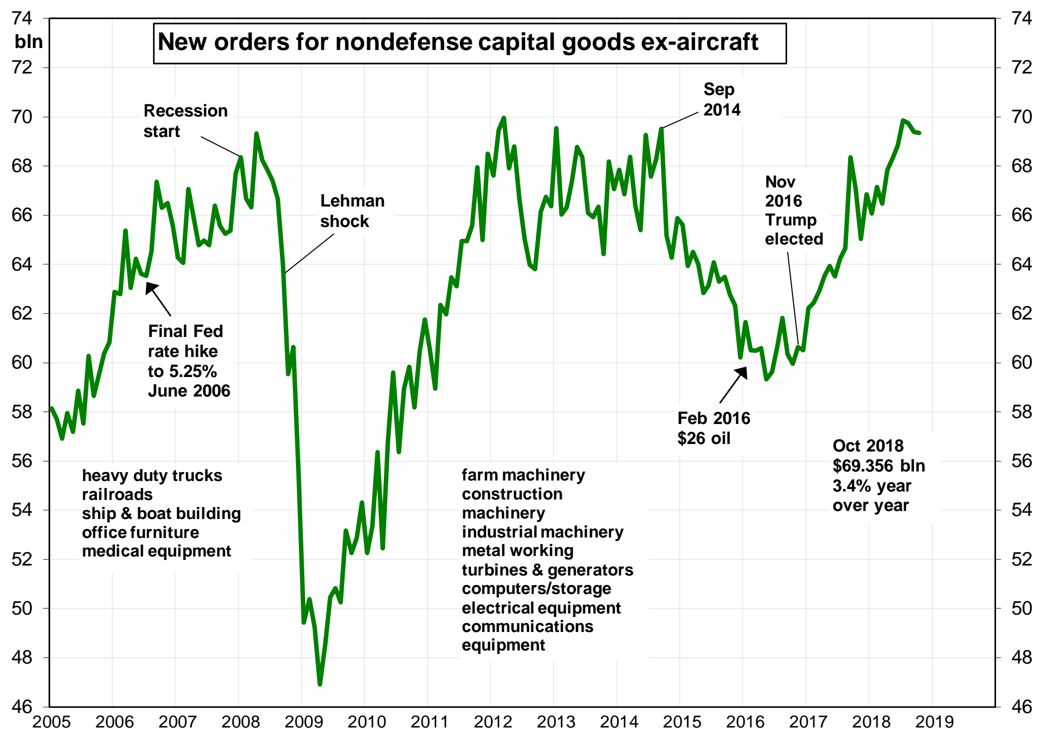
Housing Starts Total, Single-Family, Multi-Family

	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Oct 18	1228	865	363	87	70	210	127	596	427	335	241
Sep 18	1210	881	329	132	61	158	129	569	445	351	246
Oct 17	1265	888	377	145	64	200	144	617	475	303	205
% Chgs											
Oct/Sep	1.5	-1.8	…	-34.1	14.8	32.9	-1.6	4.7	-4.0	-4.6	-2.0
Oct/Oct	-2.9	-2.6	…	-40.0	9.4	5.0	-11.8	-3.4	-10.1	10.6	17.6

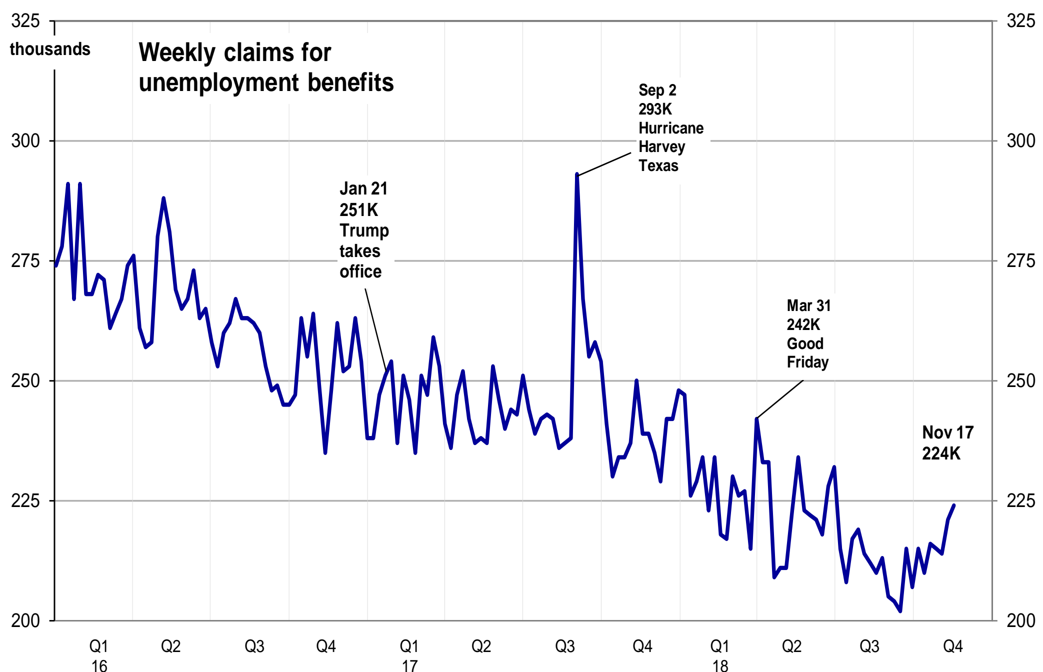
Interest rate sensitive sectors of the economy like autos and home sales are going nowhere. Maybe Trump has a point that the Fed's rate hikes are undoing the good that his administration has done for the economy. The market might agree. The Fed is looking for three rate hikes next year, and in the last few weeks the market has taken at least one of those rate hikes off the table. Eurodollar futures are barely pricing in two rate hikes next year to 3.0%. The odds of a fourth rate hike this year to 2.5% on December 19 remains the same at 72% this morning however.

Stay tuned. Story developing. For the Fed maybe it is indeed a bridge too far. Market chatter has the Fed pausing its rate hikes soon. This started with Fed Chair Powell last week in Dallas "they need to be thinking how much higher to go on rates," he said, and continued with NY Fed President Williams saying rates would go somewhat higher yesterday. NEC head Kudlow says the U.S. economy is roaring in headlines this morning, but homebuilding remains quiet as a mouse.

Equipment orders stumble, job layoffs are up... uh-oh (Wednesday)



Breaking economy news. Durable goods orders and shipments for October, and a surprising rising trend in unemployment claims the last two weeks ending at 224K in the November 17 week. Maybe the Fed should back off. Fed officials just can't win with the President on their case and now the markets and market players are saying the Fed should pause those gradual rate hikes. Job losses are up since September, maybe something is going on with the economy. The stock market seems to think the 2019 economic outlook is nothing to write home about. No economic growth, no profits, after the Tax Cuts and Jobs Act boost to the corporate bottom line goes away next year. Still waiting on those 1040 tax forms for individuals that the IRS is about to put out so we can check our own tax bill next April. Waiting, waiting, waiting.



Durable goods orders plummeted 4.4% in October, but the drop was caused by a reversal in transportation equipment following strong gains in August and September. Our monthly proxy for business capex is nondefense capital goods orders ex-aircraft which were unchanged in October, but these orders are actually down 0.5% from where we thought, after accounting for a downward revision to September. October orders for business equipment suggest the trade wars or stock market turmoil is dampening the confidence of companies, and business investment will not be a significant driver of GDP growth in the fourth quarter. We are keeping our forecast at 3.0% real GDP

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for now in the fourth quarter but the risks are plainly on the downside. If the President is thinking of cutting a deal with China at G20 in Buenos Aires, now would be the time. The economy and stock markets could use a jolt of certainty right now. Good news, not fake news.

Net, net, there is nothing to be thankful for this year with the latest batch of economic data on job losses and sputtering equipment order books for companies. The economy may have seen its best day already for growth and prosperity back a couple of months ago in late summer. Winter is coming for the economic outlook where business investment spending looks to be topping out, and companies have let a few workers go. Holiday sales at retailers may be the best in a decade yet retailer stock shares are in freefall. Stay tuned. Story developing. Something is going on out there.

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