Daily Market View

Thursday, December 14, 2017

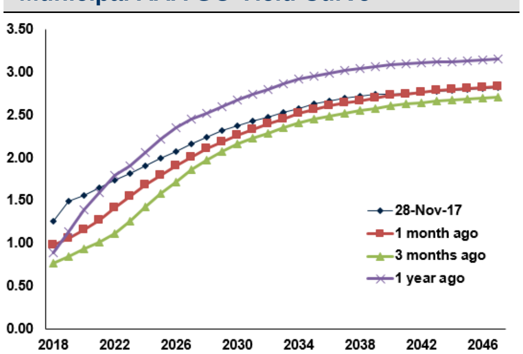
Portfolio Advisory Group – U.S. Fixed Income

Market Snapshot	7:30am CDT	Prior
30-year UST	2.74	2.73
10-year UST	2.37	2.34
5-year UST	2.14	2.11
2-year UST	1.81	1.78
6-Mo UST	1.47	1.46
3-Mo UST	1.31	1.30
10-year TIPS	0.47	0.46
10-year Corp	3.51	3.56
10-yr AAA Muni	2.03	2.07
3M LIBOR	1.57	1.57
Fed Funds	1.50	1.50
Prime Rate	4.25	4.25
CPI (YoY)	2.20	2.00
NASDAQ*	6,876	6,876
DJIA*	24,585	24,505
S&P 500*	2,663	2,664
Oil	$56.28	$56.60
Gold	$1,252.60	$1,245.40
Copper	$303.95	$302.95
Yen / US Dollar	¥112.78	¥112.54
Euro / $US	€ 1.1809	€ 1.1826
Link: Bloomberg Economic Calendar		

**Previous Day*

Client Friendly Publications	
Municipal Market Insight	December 2017
Credit Market Insight	November 2017
Global Insight Weekly	December 07, 2017
Global Insight Monthly	2018 Outlook

Municipal AAA GO Yield Curve



Source: RBC Wealth Management, MMD

Rates

To no one's surprise, Fed policy-makers raised their key benchmark rate by 25bps, meaning that the Fed met its annual rate hike forecast for the first time in the 6 year history of providing guidance, having now delivered three rate hikes this year to a new Fed Funds range of 1.25% - 1.50%. The statement language produced minimal changes but members noted that monetary policy will continue to support strong labor market conditions.

Inflation (core PCE) was left unchanged, with the Fed forecasting that the elusive 2% target will finally be achieved in 2019. The committee continues to cling to the belief that low inflation is still a result of transitory issues, but even so, pledged to monitor developments closely. Unemployment was revised lower with the 4% level being breached in 2018 (3.9%), and in our view this is a concession that the ultimate level of full employment will remain elusive. Finally, GDP was revised higher, a nod to the recent string of 3%+ quarterly growth numbers, but possibly also a recognition of the potential for a positive impact from tax reform. The Fed doesn't set policy in anticipation of fiscal policy developments, but in the post-meeting press conference, Fed Chair Yellen noted the "tax package could boost investment and consumer spending to some extent."

All in, the results of this meeting paint a picture of the Fed remaining on a gradual path to normalizing monetary policy. However, 2018 could be a pivotal year with significant turnover at the Fed, beginning at the top, and challenges on the inflationary front could move policy-makers to tap on the brakes. Our view is the Fed will be more inclined to slow the pace of tightening (two instead of three hikes next year) as they remain flummoxed by low inflation which will anchor long-term rates, and hence make them reluctant to raise rates at risk of intentionally inverting the yield curve.

At the surface, the Fed's 'dots' remained unchanged over the next two years, projecting 3 hikes in 2018 followed by 2 in 2019 though beneath the surface there was a subtle shift downwards. The average forecast for 2018 actually shifted lower to just 2.016% - barely forecasting a 3rd rate hike, which to us means that officials are primarily concerned about the inflation outlook given that they actually upgraded their growth outlook.

The only change to the 'dots' was seen in the 2020 forecast, which rose notably from 2.875% to 3.062%, putting the projected level at that point at a whole additional rate hike higher than the longer-run rate of 2.75%. In our view this is notable, as it means the Fed sees the economy running hot enough by 2020 to warrant further monetary policy tightening. More importantly for investors, however, this also likely means that the Fed is bullish on the intermediate-term trajectory of the U.S. economy, as the Fed would only continue to restrict policy if growth is operating in excess of its long-run potential.

Municipals

Munis posted strong gains (4-7bps) on limited offerings ahead of the Feds rate decision. The muni market may receive and early Christmas present on news private activity bonds may survive reconciliation.

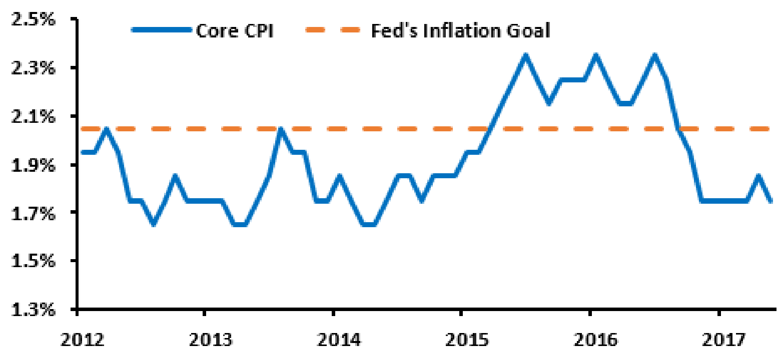
As expected, states have taken a cautious approach to budgeting for 2018 and we expect that trend to continue into FY2019 as revenue gains are expected to remain sluggish. States on average increased GO spending 2.3% with 26 states increasing spending below 2%.

Key U.S. Economic Data Releases

Event	Period	Survey	Actual	Prior	Our Thoughts
Import Price Index y/y	Nov.	3.2%	-	2.5%	Import prices are expected to spike due to the weakening of the dollar which is 8% lower than this time last year, thus making imported goods more expensive.
Retail Sales Ex Auto & Gas	Nov.	0.4%	-	0.3%	We wouldn't be surprised to see retail sales beat expectations as steady wage growth and survey based measures all indicate consumers are anticipating spending more this holiday season than last year.
Initial Jobless Claims	Dec. 9	236k	-	236k	Jobless claims are expected to hold steady for the first week of December as temporary hires in the retail sector typically remain employed through year end – leading to a seasonal 'spike' in claims.
Continuing Claims	Dec. 2	1,900k	-	1,908k	

Prior Session Highlights & Analysis

Event	Period	Survey	Actual	Prior
FOMC Rate Decision	Dec. 13	1.50%	1.50%	1.25%
CPI y/y	Nov.	2.2%	2.2%	2.0%
Core CPI y/y	Nov.	1.8%	1.7%	1.8%



Source: RBC Wealth Management, Bloomberg

Our Thoughts

A Work In Progress – Inflation Moves Away From Fed's 2.0% Target

Consumer price inflation came in at 2.2% as expected, but core CPI rose just 1.7% in the month of November, keeping the Fed still 30 bps away from its 2% target. The weak reading was weighed on by goods prices once again, which remains in a deflationary state, as well as declines in the cost of 'lodging away from home.'

The deceleration of shelter costs is one we see as being fairly consistent due to disruptive factors like Airbnb and Couchsurfing, as well as still strong demand in the housing market. The tepid inflation data is likely to keep the Fed on a gradual path, and confirms that we will need to see wages rise above the 2.5% pace in order to drive demand-pull inflation and force companies to pass costs on to customers.

RBC Capital Markets Weekly Dashboard

It seems any time the Fed tinkers with the language around the inflation narrative the market misinterprets it as a dovish development. This happened yet again at today's FOMC meeting. There was nothing in any of the changes on inflation that could be reasonably argued as dovish. Now, we will admit straight away that this is a splitting hairs conversation. After all with a new chair coming in and little change in the backdrop over the inter-meeting period, there was no reason for the Fed to make any material changes – so they didn't. But for arguments sake, we'll take the other side of the debate. As the exhibit below shows, at best the Fed just re-arranged some of the words around the inflation discussion – and critically the messaging was similar to the last statement.

In fact, it is easier to make the argument that the changes to the statement (inclusive of the Summary of Economic Projections) leaned toward the hawkish, what with the upgrade to the labor characterization, the nearly half-point increase in 2018 growth projections, a further improvement in the unemployment rate next year and the insertion of another hike in 2020 which lifted funds above their neutral estimate. But we would argue the most interesting part of this FOMC meeting was Yellen's response to the very last question of the press conference…

Fixed Income Dashboard

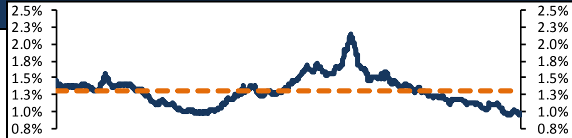
	High Yield Corp		Investment Grade Corp			Government Related			% of Curve
	B	BB	BBB	A	AA	AAA Munis	Agencies	Treasury	Captured
3M	2.97%	2.71%	1.95%	1.77%	1.66%	-	1.35%	1.31%	47.7%
6M	3.11	2.81	2.03	1.83	1.71	-	1.43	1.47	53.7%
1Y	3.37	2.99	2.17	1.95	1.82	1.25%	1.59	1.67	61.0%
2Y	3.97	3.40	2.43	2.18	2.04	1.47	1.81	1.81	65.9%
3Y	4.41	3.76	2.64	2.36	2.21	1.52	1.90	1.92	70.2%
4Y	4.76	4.06	2.81	2.49	2.34	1.57	1.87	2.03	74.1%
5Y	5.07	4.34	2.99	2.63	2.49	1.65	2.07	2.14	78.1%
7Y	5.61	4.85	3.31	2.89	2.62	1.80	2.36	2.20	80.1%
8Y	5.82	5.04	3.44	3.00	2.75	1.88	-	2.25	82.2%
9Y	6.01	5.20	3.56	3.10	2.86	1.96	-	2.31	84.3%
10Y	6.22	5.37	3.68	3.21	2.96	2.03	2.88	2.37	86.4%
15Y	7.13	6.05	4.12	3.64	3.06	2.38	-	2.46	89.8%
20Y	7.57	6.36	4.28	3.78	3.36	2.55	2.82	2.55	93.2%
25Y	7.89	6.29	4.24	3.78	3.52	2.64	2.89	2.65	96.6%
30Y	7.89	6.29	4.18	3.75	3.59	2.68	-	2.74	100.0%

Global Sovereign 10Y Yields

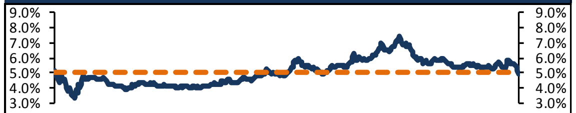
	Current	-1m	-6m
USA	2.37	2.37	2.13
Canada	1.86	1.95	1.49
Brazil	4.69	4.81	4.64
Mexico	3.60	3.65	3.50
UK	1.18	1.32	0.93
France	0.65	0.76	0.58
Germany	0.32	0.40	0.22
Italy	1.77	1.82	1.93
Spain	1.44	1.53	1.37
Portugal	1.80	1.96	2.82
Greece	4.08	5.04	5.74
Japan	0.04	0.05	0.06
Australia	2.55	2.66	2.40
Hong Kong	1.71	1.76	1.31
China	3.87	3.98	3.53

Credit Spreads (5-Years; Average: Orange line)

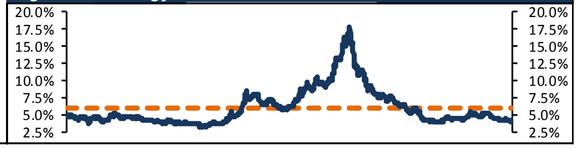
Investment Grade



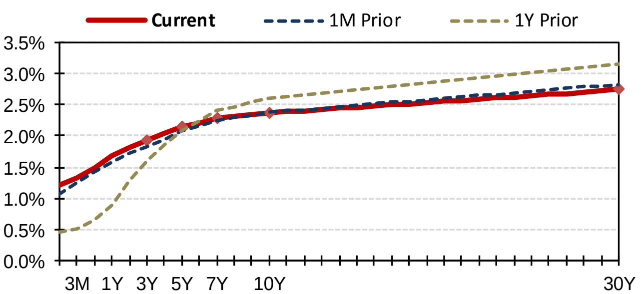
High Yield Ex-Energy



High Yield Energy



Treasury Yield Curve



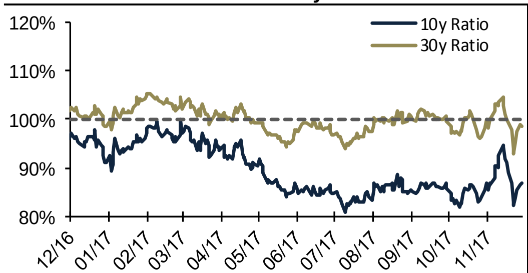
3-Month UST Curve Spread Trends

	Now	Avg
2s - 5s	Now 34	Avg 39
2s - 10s	Now 58	Avg 73
5s - 30s	Now 63	Avg 83
7s - 10s	9999999	Avg 14
10s - 30s	Now 39	Avg 49

Corporate Bonds

Corporate Bonds	Spread Performance			
	OAS	1w % Δ	1m % Δ	1y % Δ
Treasury Index	-	-	-	
Investment Grade	95	-0.9	-6.4	-26.21
AA	1	-1.9	-15.0	-33.77
A	1	-1.3	-7.5	-27.45
BBB	1	-0.8	-3.9	-21.02
Barclays US HY Index	350	0.6	-3.6	-13.15
S&P Pref. Stock Index	-	-	-	
Bank Loans (BKLN)	-	-	-	

10-Year & 30-Year Muni/Treasury Yield Ratios



GO Municipal Benchmark 10y Yields (%)

	Current	-1M	-6M
Composite	**2.03**	**2.03**	**1.84**
California	2.15	2.12	2.08
New York	2.07	2.19	2.07
Texas	2.16	2.15	2.04
Florida	2.20	2.14	1.99
Pennsylvania	2.55	2.47	2.38
Minnesota	2.13	2.08	1.97
Puerto Rico	13.86	11.77	11.53

Sector Performance

Sector Performance	Spread Performance			
	OAS	1w % Δ	1m % Δ	1y % Δ
Basic Materials	117	0.5	-4.5	-31.78
Communications	141	-0.9	-7.2	-14.76
Cons. Discretionary	93	-1.6	-7.1	-28.91
Cons. Staples	93	-1.7	-6.5	-23.51
Energy	124	0.0	-3.3	-19.62
Financials	73	-1.0	-6.5	-0.15
Health Care	91	-1.8	-8.2	-25.87
Industrials	79	-0.6	-5.7	-24.93
Technology	80	-2.9	-10.6	-28.69
Utilities	98	0.0	-4.1	-23.48

10-Year Yield Forecasts (%)

UNITED STATES	10-Year Yield Forecasts (%)					
Survey Month: December	4Q2017	1Q2018	2Q2018	3Q2018	4Q18	1Q19
RBC Capital Markets	**2.30**	**2.80**	**3.00**	**3.15**	**3.30**	**3.45**
Bloomberg Median	2.43	2.59	2.70	2.85	2.95	3.03
Bloomberg 1-Month Prior	*2.44*	*2.60*	*2.72*	*2.85*	*2.95*	*3.04*

CDS Price & Spread Levels

	Pre-Crisis Low	Current	-1M	-3M	-1Y
CDX Investment Grade	*30bps*	50.3	57.4	56.7	69.4
CDX High Yield	*191bps*	312.4	337.9	326.6	364.9

Portfolio Advisory Group – U.S. Fixed Income Strategies