CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

December 14, 2018

The November Retail Sales Report is out this morning and results were strong, and combined with upward revisions to October will likely push fourth quarter GDP estimates higher. The so-called Control Group (a direct GDP input comprising sales ex-food, gas, building materials and auto dealers) posted a solid 0.9% gain and was the highest monthly gain in a year. Overall sales were up 0.2% versus 0.1% expected and 1.1% in October as the decrease in gas prices during the month affected sales totals that are not price adjusted. To wit, sales ex-autos & gas were up 0.5% versus 0.4% expected and 0.7% the prior month. Adding to the solid report, nine of thirteen categories posted monthly gains. The report, and October revisions, will cause fourth quarter GDP estimates to increase from the current 2.6% range. Consumer consumption was expected to average 2.8% this quarter which is off the 3.8% and 3.6% second and third quarter gains, but the retail numbers and revisions should boost that estimate as well. So, while consumption will still be off the torrid pace of the spring and summer, the consumer looks to be logging solid enough results in the fourth quarter such that the Fed may stick with its three-hikes-in-2019 scenario. More on that below.

With the November Retail Sales Report out of the way the field is mostly clear for the FOMC rate decision next Wednesday. We say mostly because there are a couple housing reports that will arrive before the meeting and are expected to indicate either continued softening or status quo moderation. Either way, the housing reports won't deter a rate hike at the meeting but any pronounced weakness may put more pressure on the 2019 rate-hiking forecasts. That being said, the fact the retail sales numbers were solid probably keeps the Fed on course for at least two forecasted rate hikes next year if not sticking to the current three hike forecast.

The updated rate forecasts will be the key element from the meeting and if we've learned anything from this Fed, both under Yellen and now Powell, it's approach to policy is gradualist in nature. Since the September rate hike and forecasts, the increase in market volatility has led to tighter financial conditions. In addition, the increase in trade angst, Brexit troubles, and other increased geopolitical risks have added to global uncertainty. Finally, the interest sensitive sectors—housing and autos—have exhibited weakening, partially as a consequence of the eight rates hikes to date, not to mention the $50 billion per month rolling-off the Fed's balance sheet. That being said, we think the Fed will wax positive over the economic outlook but recognize the headwinds that have developed since September. But given the labor market strength, and ongoing strength in the consumer (see today's retail sales numbers), we think they stick with the three-hikes in 2019 forecast. If further volatility and weakening occurs in early 2019, the March meeting seems the spot to ratchet back the forecast to two hikes. We think the single rate hike in 2020 in the September forecast remains but again further weakness in early 2019 would spell the end for that planned hike in the March or later forecasts. Thus, we think the Fed will project getting to 3% on the funds rate over the next two years but that could end the rate-hiking cycle.

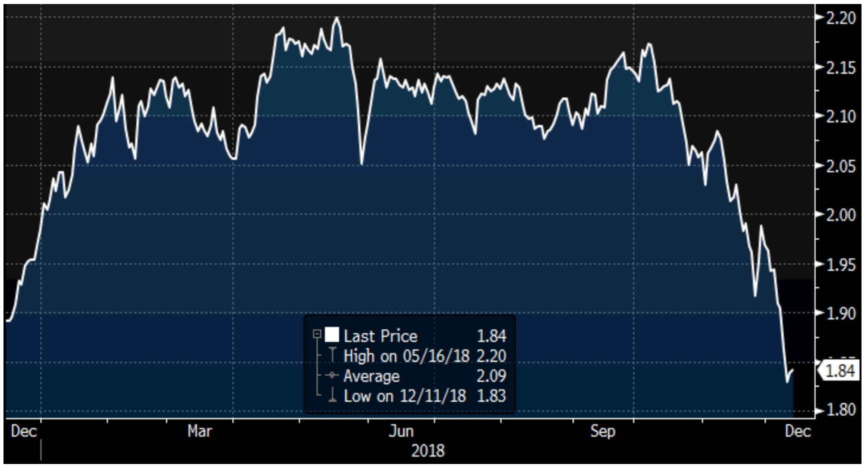
While the futures market has only 10bps of rate hikes priced in for next year, expecting the Fed to cut their 2019 forecast from three hikes to less than one is frankly asking too much from this gradualist Fed, at least while job and economic numbers are still solid. Thus, we think the front-end of the curve runs the risk of some selling as a consequence of the Fed's updated forecasts next week with the 2yr-10yr spread perhaps flattening to new cycle lows (i.e., <10bps).

Meanwhile, some of the geopolitical headwinds were laid bare over the past two days as UK Prime Minister Theresa May survived a no-confidence vote over her handling of Brexit but that successful vote only brings into sharp relief the difficulty her government will have in getting a deal approved by the March 29th deadline. Failure to secure an agreement could lead to a "hard Brexit" in which the UK leaves the EU with no grace period and no legal arrangements in place to smooth the ongoing cross-border commerce with ports of entry likely becoming centers of bottlenecks with shortages of all types.

Members of Parliament are discovering that any Brexit deal involves bad choices. Either Britain pays an economic price for leaving the EU, or Britain stays inside the EU customs arrangement but without a real voice or vote in helping shape those arrangements. In the plan May brought to Parliament she opted for the second alternative as the lesser of two bad options that would impact the average citizen's wallet the least. That deal, however, struck legislators as an affront to UK prestige and sovereignty. It's still anyone's guess how this is eventually resolved so expect the issue to continue to shamble along into the first quarter with the attendant economic uncertainty being dragged along for the ride.

Apart from the Brexit mess the ECB held its policy meeting yesterday with Mario Draghi saying that euro-area risks are worsening even as he called a halt at year-end to the ECB's QE bond-buying program (reinvestment of maturing bonds, however, will continue). He also remarked that while risks are "broadly balanced" they are now "moving to the downside." The change in language was also reflected in downgraded growth and inflation forecasts. The Brexit issue is no doubt front and center for the ECB but also the threat of tariffs on German car sales into the US is weighing on sentiment and the Italian economy (close to recession) and budget problem are also high on the list of concerns. Thus, it looks like rate hikes will not be a feature of ECB policy until late 2019 and that should continue to aid the bid in Treasuries.

10-Year Inflation Breakeven Rates Falling



This week's CPI release was mostly as-expected with core CPI climbing a tenth to 2.2%, but despite that the market is expecting inflation to moderate, and if that does come to pass it will complicate the Fed's desire to hike in 2019. The graph shows the TIPs 10-year breakeven inflation expectation (the rate that TIPs buyers expect to receive as inflation compensation over a 10-year period) and you can clearly see the decline in those expectations since early October. The softening in interest-rate sensitive sectors, the gathering global headwinds, and continued dollar strength have TIPs investors betting that inflation will recede. If correct, that will keep a lid on nominal yields as well.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	2.40%	UNCH	1 Mo LIBOR	2.44%	+0.06%	FF Target Rate	2.00%-2.25%	3 Year	2.854%
6 Month	2.54%	UNCH	3 Mo LIBOR	2.78%	+0.01%	Prime Rate	5.25%	5 Year	2.836%
2 Year	2.74%	-0.02%	6 Mo LIBOR	2.89%	UNCH			10 Year	2.921%
10 Year	2.89%	-0.01%	12 Mo LIBOR	3.10%	-0.02%				