Week In Review

November 30, 2018

The Fed

Fed Chair Jerome Powell spoke at the Economic Club of New York this week. Among his many remarks, the markets appeared to key in on one line in particular. Chairman Powell stated, "Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy…" The markets interpreted this sentence as a signal of a more dovish Fed. After all, in October Powell had said that rates are "a long way from neutral."

Our Take: Cooler heads prevail. A less reactive reading of the Chairman's remarks point to a less dramatic view. He stated that rates are near the broad range of estimates (currently 2.5%-3.5%), which is not necessarily the same as near the neutral rate. Add to that the fact that the Fed has recently stated its willingness to raise rates past neutral, and we could still be a long way from the end of Fed rate hikes. A bigger takeaway from Powell's speech could be that we are nearing new territory. With rates near zero, it was clear the direction the Fed needed to go. The only question was timing. Now that rates are near the broad range of neutral, the Fed's future rate decisions become less clear. Although another rate hike at the December meeting remains likely, we may see less clarity on policy guidance from the Fed going forward.

Oil

Oil prices tumbled below $60/bbl in London and below $51/bbl for WTI. These price declines are in response to concerns about growing supply and wavering demand. Thus far, Russia has not committed to supporting OPEC calls for production cuts to maintain support for oil prices.

Our Take: The growth in U.S. shale production and the lower prices at which this production is economic has placed downward pressure on the price of oil that OPEC and Russia can sustain without ceding significant market share.

Italy

Salvini and DeMaio stated that Italy would be willing to alter the overall 2019 budget deficit, but both stated that tax cuts, a citizens' income, and reversal of pension reforms are not up for discussion. Spreads on Italian government bonds relative to Bunds narrowed in response. Italian economic activity shrank from the second to the third quarter, and this casts greater doubt on the growth assumptions in the 2019 budget.

Our Take: Changing the optics of the headline deficit number may have some political appeal, but ultimately Italy cannot afford to implement the populist coalition's promised measures while keeping Italian government debt on a stable or declining trajectory as demanded by the EU. Unless the Italian politicians have a significant change of position on the promised measures, Italy and the EU are still going to be heading towards a confrontation over fiscal policy. In such a confrontation, the EU and ECB would need to be willing to let Italy default or leave the euro, or else accept that member states will not be subject to restrictions on fiscal policy.

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Municipals

December new municipal sales are forecasted to be $24.2 billion according to a Citigroup report released this week. This is significantly less than the December 2017 issuance, which reached $58.1 billion.

Our Take: 2018 issuance has lagged the 2017 levels, which was expected. State and local governments rushed to market at the end of 2017 to access the municipal bond market before possible tax code changes occurred.

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