What Caught Our Eye This Week

It is hard to get through a day this week without seeing a headline about a new high for bitcoin, a cryptocurrency or virtual currency. Bitcoin began the year below $1,000 and briefly topped $19,000 this week resulting in a rally of over 1,500%. This Sunday, the first of three companies, Cboe Global Market’s Inc, will offer bitcoin derivatives. CME Group Inc. begins on December 18 and Nasdaq Inc. will offer futures trading in 2018. This seems to be a primary reason for the rapid increase in the price of bitcoin and should produce more two-way traffic (buyers & sellers) which in turn could reduce the volatility. It will allow holders of bitcoin to hedge their risk. The new products are subject to the Commodity Futures Trading Commission Oversight (CFTC), and at some point, U.S. regulators such as the SEC, the IRS, and the Treasury Department’s FinCEN, which tracks illicit payments, could also get involved. These agencies do not agree on how to categorize bitcoin. CFTC says it is a commodity. The IRS says it is property. The SEC says it is a security. FinCEN refers to bitcoin as a “money-like instrument”.

Economy

The most anticipated report this week was the nonfarm payrolls report, which was released on Friday. This report showed payrolls increasing by 228,000 in November, which was above the consensus forecast of 200,000. The unemployment rate remained at 4.1%, and the U-6 measure of unemployment increased to 8.0%. Average hourly earnings increased 0.2% and are now up 2.5% year-over-year. Examining the different employment sectors, manufacturing added 31,000 jobs, healthcare added 30,000, and professional and business services added 46,000. The labor force participation rate remained at 62.7%, which is still low by historical standards. In other news this week the ISM nonmanufacturing index showed a decrease to 57.4 from 60.1 in October. The new orders index dropped to 58.7 and the business activity index declined to 61.4. Overall 16 of 18 industries reported growth for the month. On Wednesday we were pleased to see nonfarm productivity growth remain at 3.0% for the third quarter. Unit labor costs declined by 0.2% and are down 0.7% year-over-year. Productivity has now increased by 1.5% over the past year, and by a 0.8% rate over the last five years. Finally initial jobless claims declined by 2,000 to 236,000 during the week ending December 2nd. The four week moving average is now at 242,000.

Fixed Income/Credit Market

The annual year end in municipal supply has done little to deter bond prices from rising this week. Typically, the added supply puts downward pressure on municipal bond prices and investors can capitalize on the increased yield opportunities, which happen in late November. However, the continuing flattening of the yield curve and potential tax policy changes that may limit future supply have facilitated increased demand. On Thursday, Bloomberg reported that trading in the muni market totaled $21.3B, the highest trading level in nearly three years and up 29% from a week earlier. Month-over-month, the benchmark Bloomberg AAA 2-year and 30-year spread has decreased 50 basis points (bps) to close Thursday at 110 bps. Across the U.S., the visible 30-day supply is approximately $27.1B while the amount of debt expected to retire is $23.6B. Furthermore, municipalities have issued $35.4B in debt the past thirty days with the expectation that December’s issuance might rival 1985’s monthly record of $54.7B.

Equities

This past weekend the U.S. Senate passed a major tax bill showing advanced progress in tax reform that drove equities higher on Monday’s open. Monday’s positive momentum quickly reversed as the technology sector continued to sell off eliminating last Friday’s late recovery. The market continued to sell off following news that the U.S. embassy in Tel Aviv, Israel would be relocated to Jerusalem sparking unrest across the Middle East. Equities in Asia sold off, which extended to European markets as well as the U.S. Domestic equities turned positive Thursday led by the Technology sector and continued to rise on Friday following better than expected employment data. The Financial sector had another strong week gaining 1.5% as investors anticipate the Fed will raise rates next week. The Telecom sector was the worst performing sector declining 2.3% as forward earnings projections are muted.

S&P 500

Our View

The FOMC meets this upcoming week and the markets are pricing in an extremely high probability that they will lift the Fed funds rate another 25 basis points. If the FOMC does hike rates on December 13th, it will be the third rate hike of the year and will take the Fed funds rate to between 1.25 to 1.50%. It is interesting to note that according to the FOMC’s most recent statement, both headline and core “inflation measures have declined this year and are running below 2%.” So, why is the FOMC raising interest rates while inflation resides below its 2% target? The answer may reside in the fact that the Fed’s preferred inflation measure (personal consumption expenditures or PCE) does not take into consideration real and financial asset prices and relies mainly on a dynamic consumption bucket. Moreover, the staff at the New York Fed has developed a new inflation gauge that now incorporates asset values along with a consumption bucket, which shows that inflation is actually up roughly 3% on an annual basis as of October. If this new inflation gauge does measure inflation more accurately than PCE, then the Fed may have more data to support further interest rate hikes.