THE National Investor

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INFLATION, YIELD CURVE AND MORE ON TAP FOR POWELL

INFLATION PERCOLATING

In the last week, we've learned that both producer (wholesale) and consumer costs have risen in the last 12 months at their fastest pace in six years. As you see above, the surge in these numbers from their weak oil-influenced bottom in the 2015-2016 time frame has been stark.

And these moves higher have been about more than recovering oil (indeed, *weak* natural gas prices have actually kept these overall numbers from being even worse.) With the supply shortage and high prices for housing in much of the country, *rents* have been rising sharply. Medical care likewise, as always. And in some key areas of the supply chain, costs are rising due to labor shortages; most of all in trucking, one of many industries where an aging skilled work force is not being replaced fast enough, leading to higher wages for those who *can* drive.

For consumers--though nobody seems in a panic yet, as evidenced by still-strong Summer gasoline demand--these and other rising costs have about canceled out wage gains and the effects of last year's tax cuts. **More worrisome *for the markets*, though, will be how many companies in this earnings season start to talk about hits to their numbers from rising costs (and the related stronger U.S. dollar.)** A few days ago WD-40 Company (NASD-WDFC) lowered its guidance for the rest of 2018 due to rising input costs. As I am finishing up this issue on Tuesday morning, consumer giant Johnson & Johnson (NYSE-JNJ) just lowered its numbers as well for future quarters, chiefly due to the strong dollar.

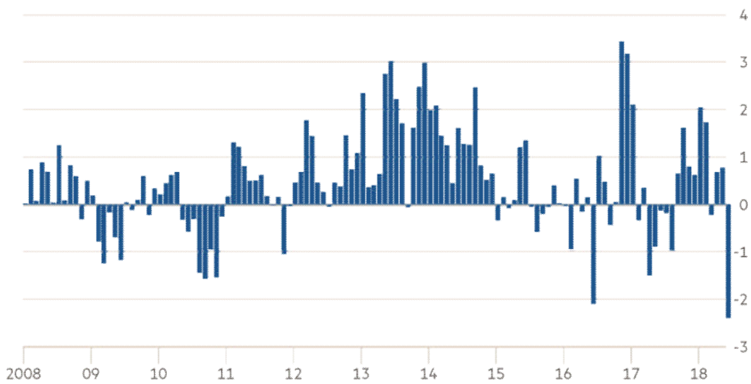
YIELD CURVE FLATTENS MORE

In recent days, that relentlessly-narrowing and widely-watched spread between 2-year Treasury notes and 10-year ones has narrowed to about 25 - 27 basis points. **That means, of course, that we're but one more Fed rate hike away from the curve being flat as a pancake.**

The more astonishing "half" of this formula of late has been the absolute refusal of the long end to sell off *at all* **despite the Japanese yen weakening** (which *should* have seen bonds weaken/rates rise along with the yen and the weakness in **gold**.) And at the same time, one would think that yields would tick back up a bit as stocks have moved higher anew. But no.

Investors bet on 10-year Treasury yields moving lower

10-year Treasury put volume minus 10-year Treasury call volume (number of contracts, m)



Negative suggests investors think yields will go lower
Source: CME Group
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One answer to this is that--even as they pile back in to the FAANG and some other big-cap areas of the stock market, **traders have simultaneously been betting on long-term rates moving *lower* still.** As you see at left, option traders have, net, made their biggest bets that long Treasury rates will go LOWER in a *very* long time.

The question is, why?

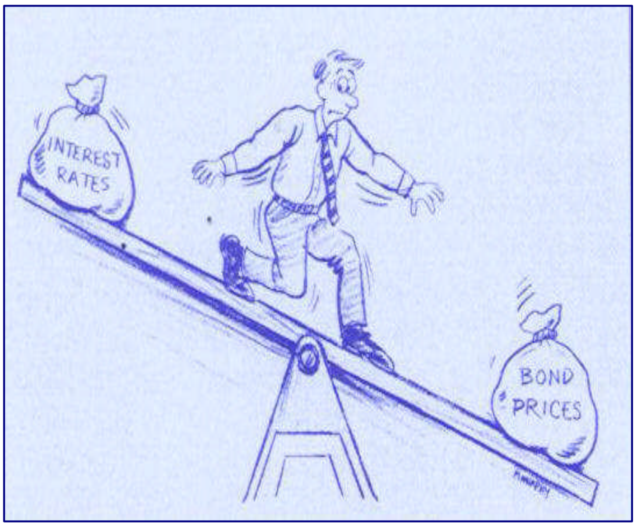
* A belief that the Fed is courting a recession by planning to keep its short-term rate hikes on course even after they do manage to invert the yield curve (as Fed Chairman Jerome Powell has intimated.)

* Worries that if the Fed doesn't slow the economy the evolving trade war *will*.

* An acknowledgement that -- contrary to the kind of nonsense I wrote about starting on the front page -- the appetite for Treasuries remains so strong that it just can't be fought via shorting them.

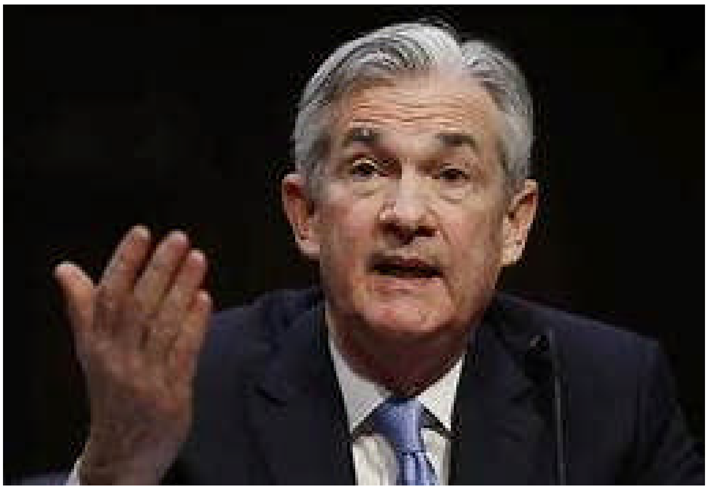
* A corollary to the above is that markets may sniff out enough potential near-term upheavals in China (whose currency may start to decline even more so, adding to demand for Uncle Sam's I.O.U.'s), Europe, Turkey, Argentina, India or (fill in the blank) and KNOW that trouble anywhere else will cause the dollar to rise more. . .and Treasury yields to fall as everyone rushes to buy them.

Still more amazing in all this is that Treasuries are holding up even as the pace of the Fed's balance sheet unwinding is picking up. How long that lasts, we don't know.



Clearly, though--with such heavy bets on Treasuries on the "long" side (again, this means trades based on the belief that Treasury *prices* will go higher and *yields* lower)--the risk is most likely of a sudden spurt higher for rates again one of the days. (**NOTE**: Keep in mind that with most any kind of bond/note, including Treasuries, prices and the current market yield move *inversely* to one another.) **That would be *most* likely to come about, I suspect, if peace does break out sooner rather than later where the trade wars are concerned.** But it might also happen if the recent inflation trends are extended more than still-complacent markets expect; and that--together with at least some remaining strength in economic growth--actually causes the Fed to accelerate things.

HOW WILL POWELL WEIGH IN ON ALL THIS...AND MORE?



As you receive this, Fed Chairman Jerome Powell (left) will be in the midst of his semi-annual testimony to Congress. Were there not the extenuating issues of the unfolding trade war and what that might do to the U.S. economy, the story of this Humphrey-Hawkins testimony would be simple: The economy is strong, inflation pressures are rising, markets are strong and liquid, so our path of normalization must be maintained, if not accelerated. *Case closed*.

What the markets WANT to hear is that Powell and Company will either slow down or suspend their rate hikes until we know how long the trade war will last. **But they aren't going to get that.** As he has already intimated, YES, the central bank will be watching for any actual damage to growth *or markets* if the trade war goes on. But it's not at a place *yet* to change course.

Where the economy is concerned, Powell has been its biggest cheerleader of late; or perhaps second only to the president who gave him this job. In fact, most of his comments suggest that he doesn't think we're anywhere near the end of the current expansion yet. He has pointed to *some* acceleration in loan growth (though that could get harmed as he inverts the yield curve), modest rises in wages, a strong labor market (if not downright *tight* in some ways, like trucking/transportation), a boost from tax cuts and more. Shortly he'll have a boffo number for Q2 G.D.P. growth to back him also. As one commentator summarized it, Powell thinks we're in "the sixth inning" still; and this will allow him to keep incrementally tightening policy.

Most of all--and as I have commented repeatedly--keep in mind that Powell indeed *does* have his eye on the markets; arguably, more so than on the economy. MUCH more so than any of his immediate predecessors, he makes no bones about that. Following the Fed's rate hike after its meeting last month, Powell said, in part, in his opening remarks, "We are aware that raising rates too slowly might raise the risk that monetary policy would need to tighten abruptly down the road in response to an unexpectedly sharp increase in inflation *or financial excesses,* jeopardizing the economic expansion." (*Emphasis* added.) These are comments--including "financial excesses"--that were an evolving theme even before Mrs. Yellen left, and which Powell has embraced. BOTTOM LINE, as I have oft pointed out: The Fed will continue its "normalization" until the markets get REALLY stressed. Or as Doubleline's Jeff Gundlach has famously put it, "until the Fed breaks something."

Again, if you haven't yet tired of it, the best and simplest analogy I can make is to a game of "Monetary Jenga."

I can't overstate the extent to which Powell is of a mind to keep the markets from getting too rambunctious; even in some areas to let some air back out. Tellingly, in response to a question during that post-F.O.M.C. presser last month, he laid this out by pointing out, "It's worth noting that the last two business cycles didn't end with high inflation. They ended with *financial instability,* so that's something we need to also keep our eye on." (*Emphasis* added.)

For now, as stated above, Powell has more than sufficient ammunition on pretty much every metric that matters to keep tightening. Hopefully (but I'm not holding my breath) the solons on Capitol Hill will ask less of their usual inane questions (Why don't you hire more women and minorities? Why don't YOU also have a Trump doll to stick pins in? Did *you* collude with Russia, too??) and *call him on his attitude on the markets.*

For me, I am especially interested in what he might have to say about emerging markets again. The last time I remember any comments from Powell, he portrayed a "let them eat cake" posture, seemingly unconcerned about the higher dollar--and for some countries the commensurate weakening of commodity prices--putting them in a pickle. India, Turkey and Argentina have been under MAJOR stress. China's yuan has been plunging even as the country has still *tried* to rein in some of its riskier credit growth. Rumors have increased that China may next resort to more of a *planned* devaluation if trade tensions don't subside.

So as I said on our first podcast of the week (you can listen to it if you haven't already, at http://www.kereport.com/2018/07/16/trumpputin-press-conference-recap-drop-oil/) thinly-traded markets (and Monday's yawner of a very narrow range) may move a LOT more depending on what we hear.

The above is excerpted from the July 16, 2018 Issue, the complete version of which has already been sent to Members.

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