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RJO Previews and Perspectives for Wednesday, Jan 17

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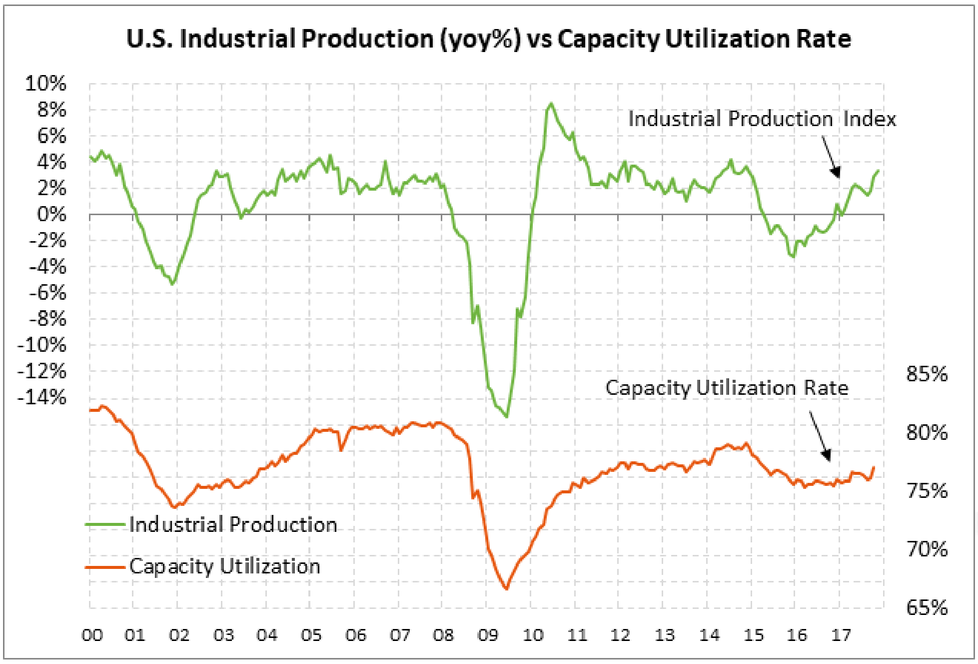
U.S. industrial production expected to show a solid increase -- The market consensus is for today's Dec industrial production report to show a solid increase of +0.4%, adding to Nov's increase of +0.2%. Excluding the mining and utility sectors, today's Dec manufacturing production report is expected to show an increase of +0.3%, adding to Nov's report of +0.2%. The industrial production series is finally returning to normal after the hurricanes in Aug/Sep caused weak reports in Aug/Sep that were offset by a large +1.2% rise in October.

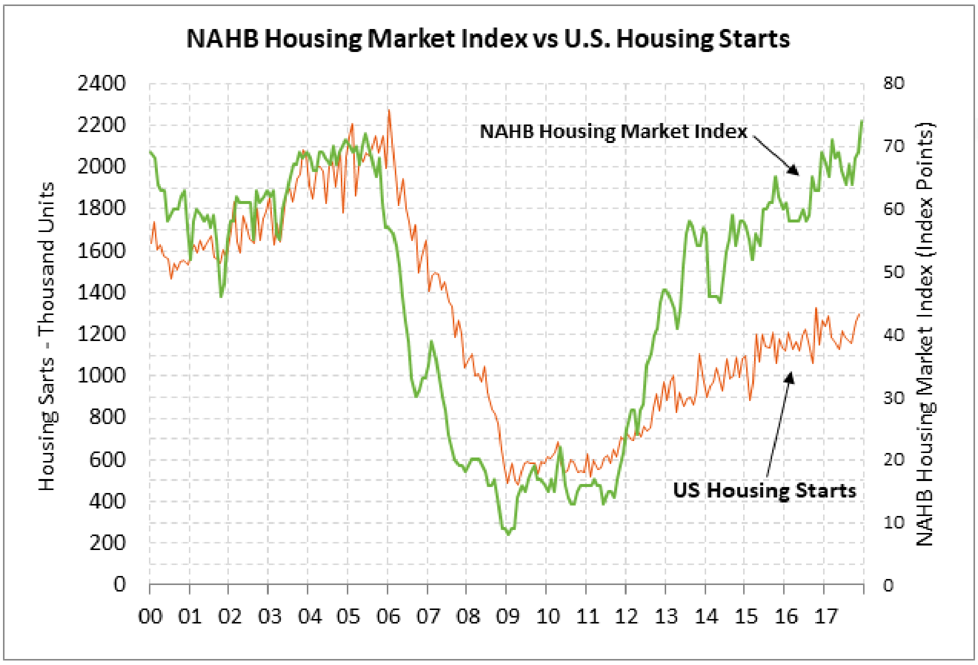
U.S. industrial production should see strength in early 2018 due to strong global economic growth combined with an increase in U.S. capital spending tied to December's tax-cut bill. The tax bill allows the full expensing of equipment purchases and also frees up after-tax cash that corporations can use for expansion. The new 3-year low in the dollar index is also a supportive factor for the U.S. manufacturing sector since the weak dollar should stimulate the exports of U.S. manufactured goods.



NAHB index expected to show that U.S. home builder confidence remains very strong -- The market consensus is for today's Jan NAHB housing market index to show a -2 point drop to 72, reversing part of December's +5 point surge to 74. The index in December posted a 18-1/2 year high of 74, indicating the strongest confidence among U.S. home builders since 1999.

Strong U.S. home builder confidence is based on (1) very strong new home sales (10-1/2 year high of 733,000 units in November), (2) strong Nov new home prices of $248,000 (-6% below the record high of $263,300 posted in June 2017), (3) the tight supply of new homes on the market of 4.6 months (tighter than the long-term average of 6.1 months), and (4) strong consumer confidence and spending in general.

December's new tax-cut bill should boost new home sales in early 2018 to the extent that consumers have more cash in their pockets. However, the bill's limit on the deductibility of mortgage interest is likely to hurt the sales and the prices of more expensive homes with larger mortgage payments. There is also some concern about reduced home affordability since mortgage rates are likely to rise this year with the Fed's expectation for three rate hikes in 2018.

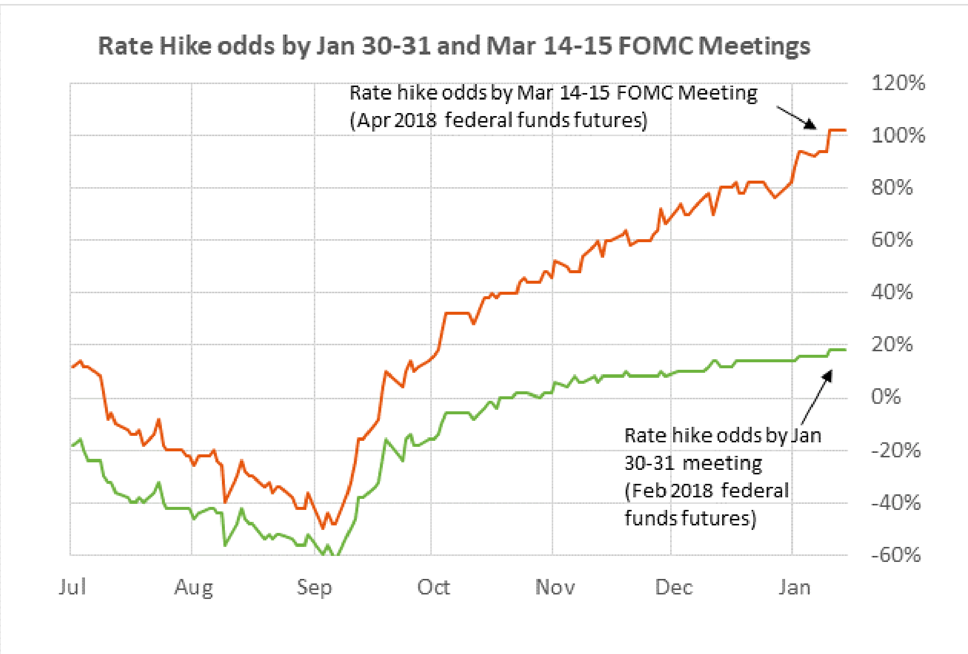


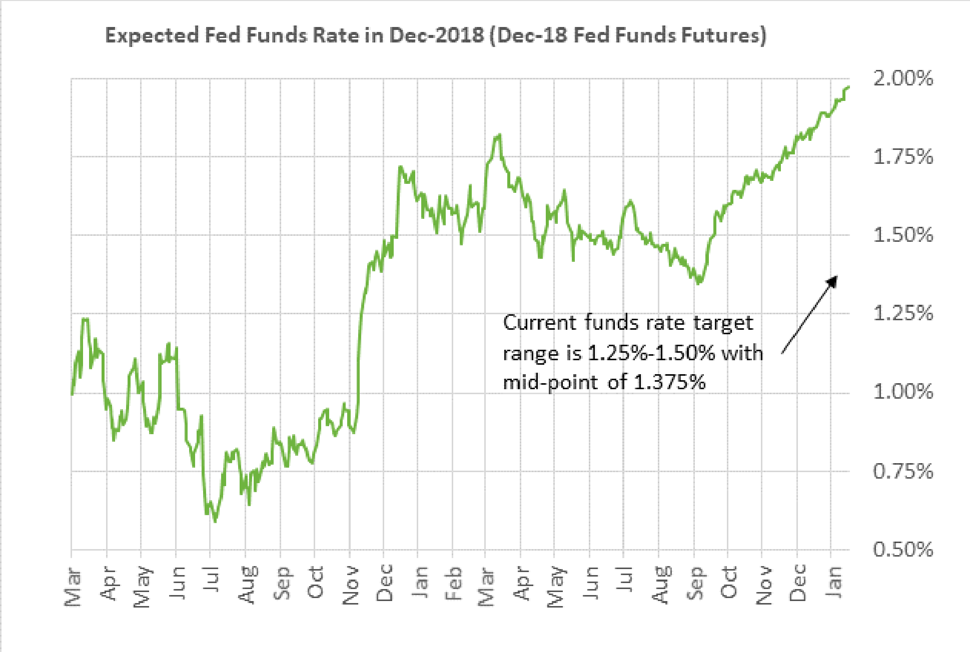
Fed Beige Book -- The Fed today will release its Beige Book report ahead of the next FOMC meeting in two weeks on Jan 30-31. Today's report should be positive due to the post-hurricane recovery in affected areas and due to a strong holiday shopping season. The last Beige Book, released on November 29, said that the U.S. economic activity "continued to increase at a modest to moderate pace in October and mid-November."

The federal funds futures market is discounting only a minor 18% chance that the FOMC at its meeting on Jan 30-31 will raise its funds rate target by +25 bp. However, the market is discounting a 100% chance for that +25 bp rate hike at the following meeting on March 20-21.

Market expectations for the Fed's overall rate hike in 2018 have risen substantially in recent months to the current high of +58.5 bp. That is much higher than market expectations as of last summer for no rate hikes in 2018, but is still more dovish than the Fed-dot forecast for three rate hikes in 2018 totaling +75 bp.

We continue to believe that the Fed will make good on its forecast for three rate hikes in 2018 due to the strong economy, frothy asset markets, and the likelihood of higher inflation. We believe the FOMC is on a mission to do away with a negative real federal funds rate by boosting the funds rate above its 2.00% inflation target. Three FOMC rate hikes this year would leave the funds rate target at 2.00%-2.25%, thus producing a modestly positive real federal funds rate (depending on inflation expectations at the time). After the funds rate is back at a positive real level, then the FOMC can take its time in deciding when to push the funds rate up to its eventual target in the 2.75%-3.00% area.

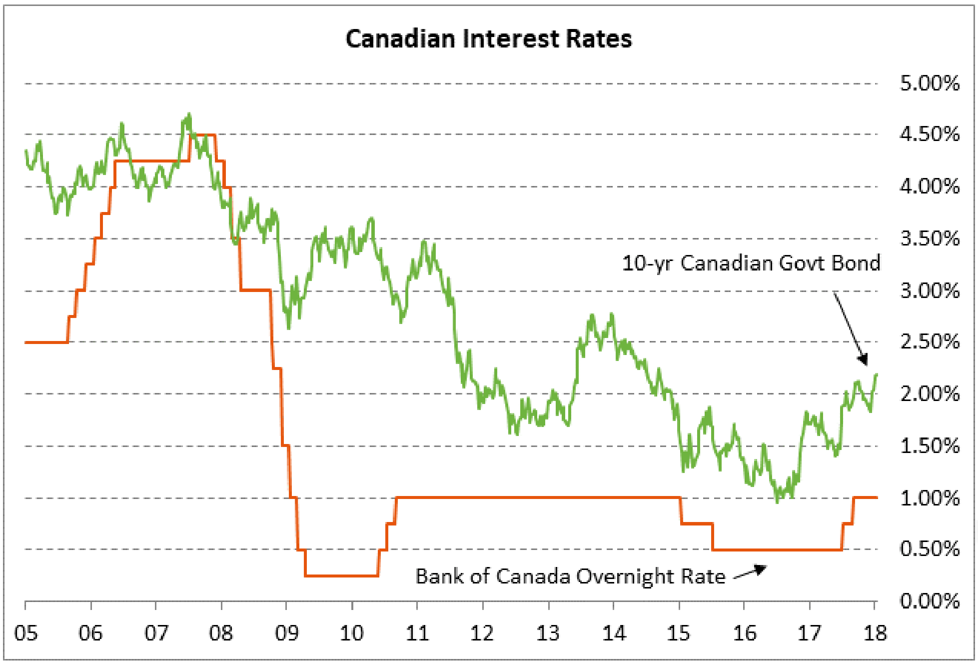




House is preparing to vote on another short-term CR -- House Republican leaders are considering another short-term continuing resolution (CR) that would last until Feb 16. That would give Republicans and Democrats more time to try to reach an agreement on funding levels and DACA. On the other hand, Democrats could force a government shutdown at midnight this Friday if they decide to go to the mat now over DACA. However, as long as there is some forward progress towards on bipartisan DACA agreement, it would be in the interests of Democrats to agree to a 1-month CR, thus relieving them of shouldering blame for a government shut-down that might not even be successful in the end of achieving a DACA agreement.

Bank of Canada expected to raise rates today -- The market consensus is that the Bank of Canada at its policy meeting today will raise its overnight rate by +25 bp to 1.25%. The odds for a rate hike today are above 90% based on overnight index swap pricing. In addition, a survey by Bloomberg found that 26 of 27 economists surveyed are forecasting a +25 bp rate hike today.

The market is expecting a rate hike today based on the strong Canadian economy, where the unemployment rate recently fell to a 40-year low. The Bank of Canada has already raised its policy rate twice in the second half of 2017 from 0.50% to 1.00%, reversing the -50 bp rate hike implemented in 2015 due to the plunge in oil prices. However, there is a chance that the Bank of Canada today may instead leave rates unchanged if it is particularly concerned about an economic shock if President Trump makes good on his threat to pull the U.S. out of NAFTA.



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