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Yields, the Dollar, and Stocks Continue the post-Trump Rally

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Last Friday the yield on the benchmark ten-year US Treasury reached an 11-month high of 2.15%. This morning the yield scaled 2.34% although it has now dropped back to 2.29%. On the stock front, equities are still pressing forward, which the S&P 500 a fraction of a percent away from its all-time high, but the broader Russell 3000, which includes surging small stocks, did reach a new high yesterday. One of the factor lifting small stocks is that they are heavily weighted with financials which have surged since the Trump election and most small companies are more domestic and are not adversely impacted by the dollar, which has strengthened to a 14-year high.

Almost all forecasters have now come to the conclusion which we reached weeks ago that a December rate hike is a certainty. The big question is: How many hikes in 2017? No one, including the Fed knows at this time. But the behavior of the long bond informs the Fed's policy, and if yields continue to rise, so will the funds rate. To be sure, a sharp rise in the dollar will keep the Fed from tightening too rapidly, but as long as commodity prices and yield spreads remain stable, the direction of rates is clearly upward.

The pre-Trump economic data this week was on the strong side. Retail sales surprised on the upside and weekly jobless claims sunk to the 43-year low. And there was good news on the inflation front, as producer prices were much softer than expected and the core CPI also rose less than expected. These reports pushed GDP growth up a bit, with Q3 growth now looking at a bit over 3% (compared to 2.9% in the advance report). I would not quite call this the "Goldilocks" economy of low inflation and rapid economic growth, but clearly the data do not point to any slowdown in the near term.

This Tuesday I was able to interview Sebastian Mallaby, author of the new biography of Alan Greenspan entitled *The Man Who Knew*. Joining me was Peter Conti-Brown, a professor of legal studies at Wharton who also authored a book about the Federal Reserve. We spoke of the possible successor to Janet Yellen. Both agreed that my leading candidate, Professor John Taylor of Stanford, author the eponymous monetary policy rule which has been so favored by the Republicans, would likely be the best choice. But they regarded him as too much of an interest rate hawk. Given the Trump's desire to stimulate the economy with infrastructure spending, he may need an advocate of lower interest rates in the driver's seat. Although it would be difficult to keep a liberal Democrat like Yellen at the helm (although the financial markets would be comfortable with this), Taylor might not be Trump's man. Fortunately, he need not make that decision for a year.
