

October Hike Probability Drops after Flurry of Friendly Data

Unexpected cooling of the Fed's preferred inflation measure and a surprisingly dovish comment from a prominent FOMC member, combined to reduce the likelihood of a pre-election rate hike this morning. The futures market is currently indicating a 34% probability of a quarter point increase at the next FOMC meeting on October 28, down from 70% on Monday. Unfortunately for bond investors, the rally was limited to the short end of the curve. *The beatings continue on the long end.*

The August Personal Consumption Expenditures (PCE) report reflected a change in methodology by the Bureau of Economic Analysis (BEA) resulting in a series of adjustments, but the magnitude of the downward revisions exceeded what economists were expecting. Core PCE was up just +0.2% for August, while July's increase was lowered to +0.1%. On a year-over-year basis in August, the core rate was +3.0%, comfortably below the +3.3% median forecast. *More importantly, the 3-month annualized core PCE pace was just +1.6%.*

This appears to be an indication that energy prices may not be seeping into core inflation to the degree analysts had expected, although this report is admittedly an outlier. It's also stale relative to other price measures. However, it does question how aggressively the Fed might need to tighten policy going forward, supporting a near-term policy pause.

In a speech yesterday, New York Fed President John Williams said another rate increase might be appropriate "late this year," but acknowledged "no need for urgency" after the quarter point move in September. As head of the New York Fed, Williams is a regular FOMC voter and influential committee member, assumed to carry considerable weight.

However, indications of improved economic growth won't help the hold-steady case as stronger demand typically puts upward pressure on prices, and a significant upward revision to second quarter GDP this morning is raising eyebrows. The final measure of Q2 GDP boosted the QoQ annualized growth rate from +1.5% to +2.2%. It's rare to see such a big final revision, especially when the median forecast had called for an *unchanged* reading. The primary driver was considerably stronger consumer spending. Stronger growth and an unfortunate rise in crude oil prices this morning probably account for much of the bond market sell-off.

The steady rise in bond yields is a concern as even yesterday's retreating crude prices didn't stop the long bond from bleeding. Yesterday, the 30-year Treasury yield rose to its highest level since June 2002. *This morning, it got worse.* Elevated inflation expectations are playing a role, along with strengthening GDP growth and a surge in debt issuance, but a more pressing concern may be that U.S. political leaders are doing little to address the nation's deteriorating fiscal condition. Investors are simply demanding a bigger risk premium.

Scott McIntyre, CFA
HilltopSecurities Asset Management
Co-Head of Investment Management
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

Greg Warner, CTP
HilltopSecurities Asset Management
Co-Head of Investment Management
Managing Director
512.481.2012
greg.warner@hilltopsecurities.com

Matt Harris, CFA
HilltopSecurities Asset Management
Senior Portfolio Advisor
Senior Vice President
512.340.1845
matt.harris@hilltopsecurities.com

Elevated inflation expectations are playing a role, along with strengthening GDP growth and a surge in debt issuance, but a more pressing concern may be that U.S. political leaders are doing little to address the nation's deteriorating fiscal condition. Investors are simply demanding a bigger risk premium.

Market Indications as of 11:46 A.M. Central Time

DOW	Down -38 to 51,312 (HIGH: 54,349)
NASDAQ	Up 262 to 27,059 (HIGH: 27,244)
S&P 500	Up 37 to 7,708 (HIGH: 7,799)
1-Yr T-bill	current yield 4.55%; opening yield 4.55%
2-Yr T-note	current yield 4.88%; opening yield 4.89%
3-Yr T-note	current yield 4.99%; opening yield 4.98%
5-Yr T-note	current yield 5.08%; opening yield 5.05%
10-Yr T-note	current yield 5.29%; opening yield 5.24%
30-Yr T-bond	current yield 5.64%; opening yield 5.57%

The paper/commentary was prepared by HilltopSecurities Asset Management (HSAM). It is intended for informational purposes only and does not constitute legal or investment advice, nor is it an offer or a solicitation of an offer to buy or sell any investment or other specific product. Information provided in this paper was obtained from sources that are believed to be reliable; however, it is not guaranteed to be correct, complete, or current, and is not intended to imply or establish standards of care applicable to any attorney or advisor in any particular circumstances. The statements within constitute the views of HTS and/or HSAM as of the date of the document and may differ from the views of other divisions/departments of Hilltop Securities Inc. and its affiliates. In addition, the views are subject to change without notice. This paper represents historical information only and is not an indication of future performance. Sources available upon request.

HilltopSecurities Asset Management is an SEC-registered investment advisor. Hilltop Securities Inc. is a registered broker-dealer, registered investment adviser and municipal advisor firm that does not provide tax or legal advice. HTS and HSAM are wholly owned subsidiaries of Hilltop Holdings, Inc. (NYSE: HTH) located at 717 N. Harwood St., Suite 3400, Dallas, Texas 75201, (214) 859-1800, 833-4HILLTOP.