Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: December 05, 2017—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is relatively unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.9% from the prior close. Chinese markets were down, with the Shanghai composite down 0.2% and the Shenzhen index down 1.9%. U.S. equity index futures are signaling a higher open.

Equity markets failed to hold yesterday's tax adjustment gains. We are mostly marking time this morning. Here is what we are watching:

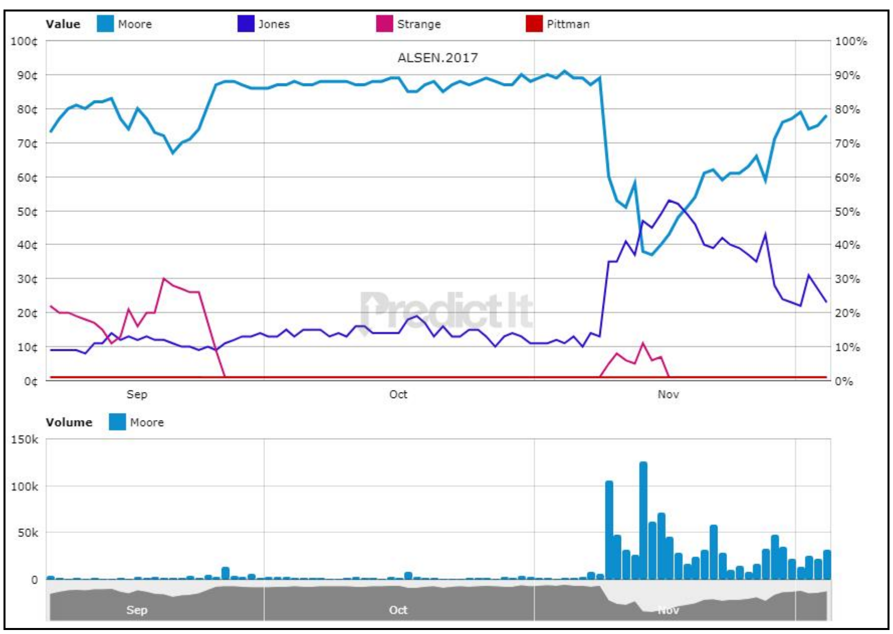
Brexit problems: As we noted yesterday, it appeared PM May had resolved the Northern Ireland/Ireland border problem. Her plan was to keep Northern Ireland in the EU Customs Union, thus creating a situation where there would be no hard border between Ireland and Northern Ireland. Under normal circumstances, that decision would have held. However, because of the Tories' poor performance in the spring elections, the government needed support from the Democratic Unionist Party (DUP), a Northern Ireland-based Unionist (Protestant) political party. The DUP opposes the action because it fears any legislation that makes it a special zone different from the rest of the United Kingdom will eventually lead to unification with Ireland. At the same time, there is great concern that a hard border between Northern Ireland and Ireland will lead to an increase in sectarian activity and put the Good Friday agreement that brought peace to Northern Ireland into question. If the DUP left the government, it is possible that the May government would fall and bring new elections. If so, a Corbyn-led Labour Party could win which would roil the U.K. economy. The other "can of worms" that has been opened is that Scotland and the City of London are suggesting that if Northern Ireland can stay in the Customs Union, they should be able to as well. Our basic position has been that the U.K. would come up with an agreement that would generally allow it to function outside the EU with close relations. This position is mostly based upon the idea that Germany wants as little disruption as possible. However, if the U.K. faces devolution pressure due to the differences between the "remain" and "leave" camps, then there is a question as to what the U.K. will look like when Brexit occurs.

Tax drama: In what should have been a procedural vote, the House, by a 222-192 margin, approved a motion to go to conference with the Senate. The drama came from the Freedom Caucus who were withholding support to gain control over spending that will be part of this week's expected continuing resolution to fund the government. At one point, the vote was tied. Although Speaker Ryan was eventually able to get his way and appoint conference negotiators, this event shows how fragile the political consensus is at this point and how subgroups and factions gain leverage under such conditions.

More tax drama: Part of the reason equity gains fizzled yesterday was the realization that the Senate version of the tax bill, the one most likely to be the actual finished product, included a corporate version of the Alternative Minimum Tax (AMT) that was not included in the House version. The corporate AMT wasn't much of an issue before; under a statutory rate of 35%, very few companies were caught by the AMT. However, with a statutory rate cut to 20%, suddenly a whole host of companies would find themselves subject to the AMT. Technology firms are most vulnerable to this change, which led to a selloff in that sector yesterday. Needless to say, the lobbyists are in full force to press against this measure but the revenue would need to be found somewhere else if the House version is adopted. We expect that it will, probably by a modest increase in the corporate rate. This sort of turmoil is inevitable as the "sausage is being made."[1]

Yemen: The ex-president of Yemen, Ali Abdullah Saleh, has been killed by Houthi forces in Yemen. Saleh was allied with the Houthis against the current (or what remains of the current) leadership in Yemen. But, Saleh turned against the Houthis, relying on various tribes to protect him; that was apparently a poor decision.[2] Saleh governed Yemen for nearly four decades, deftly managing tribal and sectarian differences to keep the country intact. However, his reaction to the Arab Spring led to his ouster. Instead of going quietly into exile, he formed an alliance with the Houthis to retake power. It is unclear if it was a faction of the Houthis that executed Saleh but it is probable that coalitions of tribes and sectarian groups are now in flux which will certainly lead to increased bloodshed but also may allow the GCC countries to make gains during this period of disunity among the opposition.

Alabama election: The GOP has decided to endorse Roy Moore for the Senate after President Trump made his support a formal endorsement as well. This chart probably explains why:



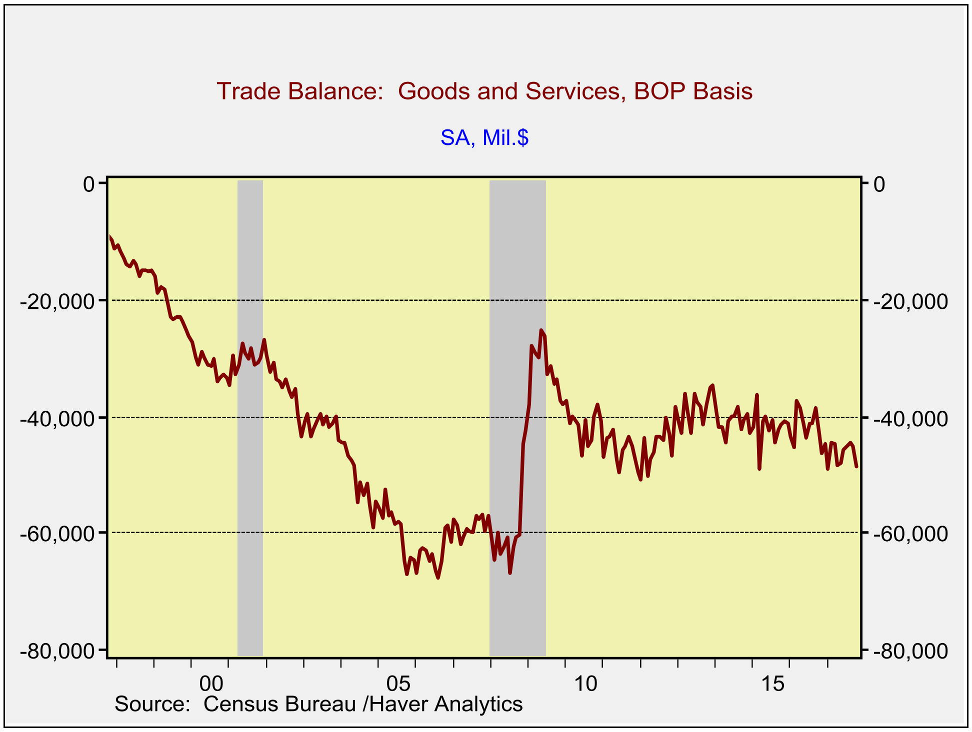
(Source: Predictit.org)

[1] Bismarck is usually attributed with the quote, "Laws are like sausages. It is better not to see them being made." However, it appears to have been originally coined by an American poet named John Godfrey Saxe.
[2] https://www.youtube.com/watch?v=VA7J0KkanzM

After seeing the bettors turn against Moore when the allegations surrounding his dating activity surfaced, his losses failed to hold. Current betting activity shows nearly 80% likelihood that Moore will prevail later this month.

U.S. Economic Releases

The trade deficit came in wider than expected at $48.7 bn compared to the forecast of $47.4 bn. The prior report's deficit was revised upward from $43.5 bn to $44.9 bn.



The chart above shows the level of the trade balance for goods and services. Over the past six years, the trade deficit has been volatile but has generally moved sideways.

The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Markit Services PMI	m/m	nov	54.7	55.3	**
10:00	ISM Non-Manufacturing	m/m	nov	59.0	60.1	**
Fed speakers or events						
No speakers or events scheduled						

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Caixin China PMI Composite	m/m	nov	50.8	51.0	50.9	**	Equity and bond neutral
	Caixin China Services PMI	m/m	nov	51.9	51.2		**	Equity and bond neutral
Japan	Nikkei Japan Services PMI	m/m	nov	51.2	53.4		**	Equity and bond neutral
	Nikkei Japan Composite PMI	y/y	oct	52.2	53.4		**	Equity and bond neutral
Australia	CBA Australia PMI Services	y/y	nov	54.0	53.0		**	Equity and bond neutral
	CBA Australia PMI Composite	m/m	nov	54.3	53.1		**	Equity and bond neutral
	BoP Current Account Balance	q/q	3q	-$A9.1 bn	-A$9.6 bn	-A$9.0 bn	**	Equity and bond neutral
India	Nikkei India PMI Services	q/q	oct	48.5	51.7		**	Equity and bond neutral
	Nikkei India PMI Composite	m/m	oct	50.3	51.3		**	Equity and bond neutral
Australia	CBA Australia PMI	m/m	oct	56.3	55.5		**	Equity and bond neutral
	AiG Performance of Services Index	m/m	oct	57.3	51.1		**	Equity and bond neutral
EUROPE								
Eurozone	Eurzone Services PMI	m/m	nov	56.2	56.2	56.2	**	Equity and bond neutral
	Eurozone Composite PMI	y/y	nov	57.5	57.5	57.5	**	Equity and bond neutral
	Retail Sales	y/y	oct	0.4%	3.7%	1.6%	**	Equity bearish, bond bullish
UK	UK Services PMI	m/m	nov	53.8	55.0	55.6	**	Equity and bond neutral
	UK Composite PMI	m/m	nov	54.9	55.8	55.8	**	Equity and bond neutral
Russia	Markit Russia PMI Services	m/m	dec	57.4	53.9	53.5	**	Equity bullish, bond bearish
	Markit Russia PMI Composite	y/y	nov	56.3	53.2		**	Equity bullish, bond bearish
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	dec	58.7	58.7		**	Equity and bond neutral
Brazil	Industrial Production	m/m	oct	0.2%	0.2%	0.2%	***	Equity and bond neutral
	Markit Brazil PMI Composite	y/y	nov	48.9	49.5		**	Equity bearish, bond bullish
	Markit Brazil PMI Services	y/y	nov	46.9	48.8		**	Equity bearish, bond bullish
Mexico	Leading Indicators	m/m	oct	-0.02	0.12		**	Equity bearish, bond bullish

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	149	149	0	Up
3-mo T-bill yield (bps)	128	127	1	Neutral
TED spread (bps)	22	22	0	Neutral
U.S. Libor/OIS spread (bps)	138	138	0	Up
10-yr T-note (%)	2.39	2.37	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	50	50	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	down			Up
yen	down			Neutral
pound	down			Neutral
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate	1.500%	1.500%	1.500%	On forecast

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$62.39	$62.45	-0.10%	
WTI	$57.24	$57.47	-0.40%	
Natural Gas	$2.93	$2.99	-1.78%	
Crack Spread	$16.89	$16.44	2.77%	
12-mo strip crack	$19.83	$19.56	1.36%	
Ethanol rack	$1.50	$1.50	-0.19%	
Metals				
Gold	$1,273.43	$1,276.18	-0.22%	
Silver	$16.27	$16.32	-0.34%	
Copper contract	$302.05	$309.00	-2.25%	
Grains				
Corn contract	$ 354.50	$ 353.50	0.28%	
Wheat contract	$ 434.50	$ 435.25	-0.17%	
Soybeans contract	$ 1,003.50	$ 998.50	0.50%	
Shipping				
Baltic Dry Freight	1662	1626	36	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		2.6		
Distillates (mb)		0.5		
Refinery run rates (%)		0.25%		

Weather

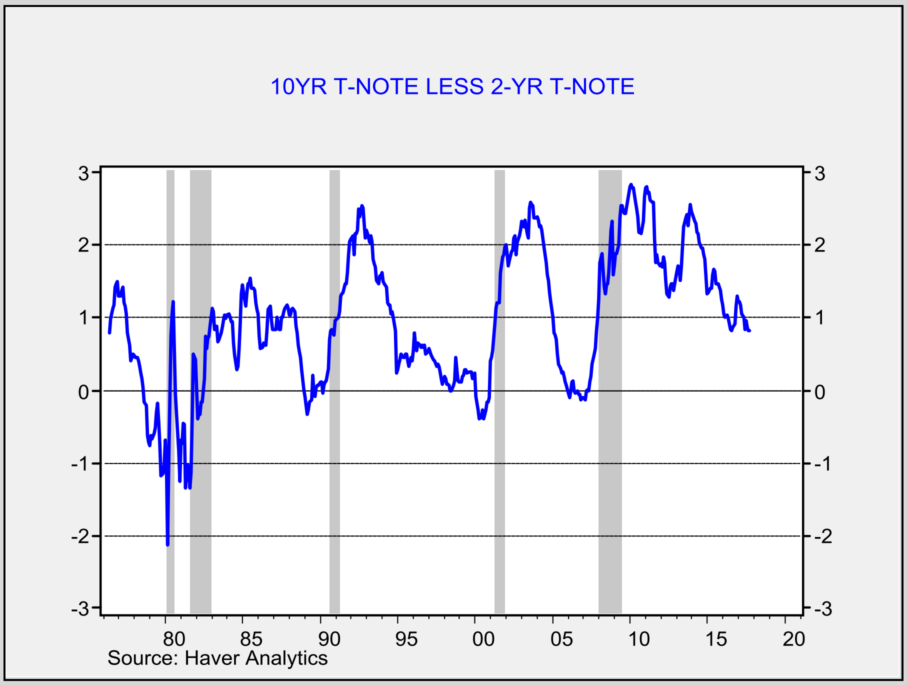
The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmer temps in the western region.

Asset Allocation Weekly Comment

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

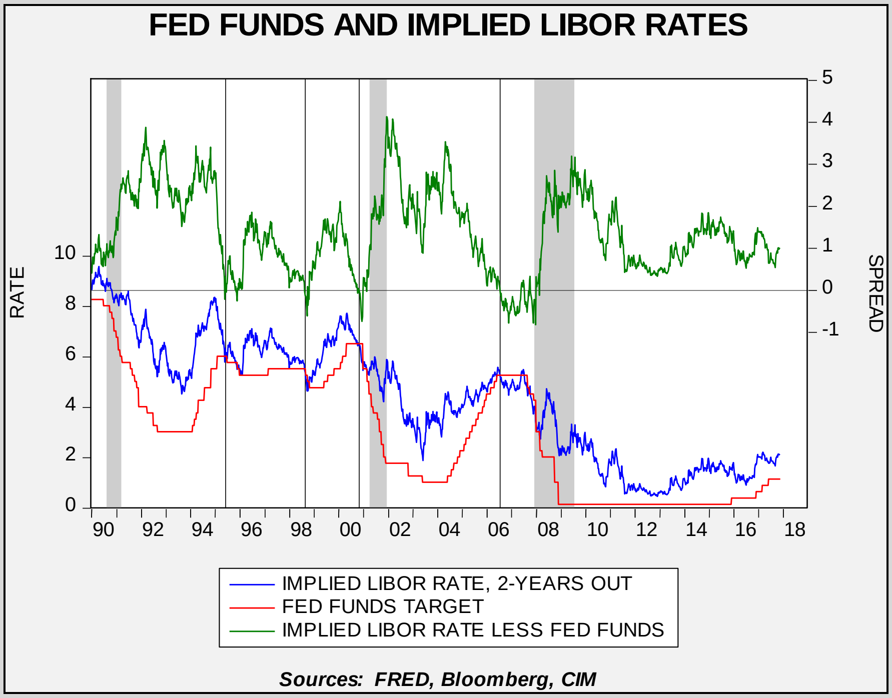
December 1, 2017

Given the length of the current expansion, there is growing concern about the economy's ability to avoid recession. So far, none of our indicators suggests the economy is near a downturn. Of all the indicators we monitor, the yield curve is the most reliable; however, there are potentially dozens of iterations of "the yield curve." The two-year/10-year T-note spread is used in the leading economic indicators.



The indicator is quite reliable with no real false positives. This is monthly data through October; currently, the spread is around 65 bps, meaning it is approaching inversion but still above zero, meaning the economy is probably still on pace to avoid recession over the next year.

Other calculations of the yield curve offer other insights. The spread between the implied three-month LIBOR rate from the Eurodollar futures market, two-year deferred, relative to fed funds offers insights into monetary policy. The Eurodollar futures market is where unhedged interest rate swaps are offset, so a rising implied rate on the deferred contracts suggests increased hedging activity and fears of rising rates. When those implied rates stop rising, it can offer a signal to policymakers that they have moved rates enough.

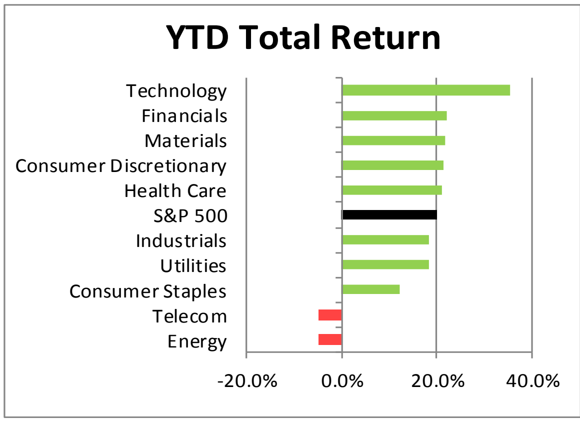


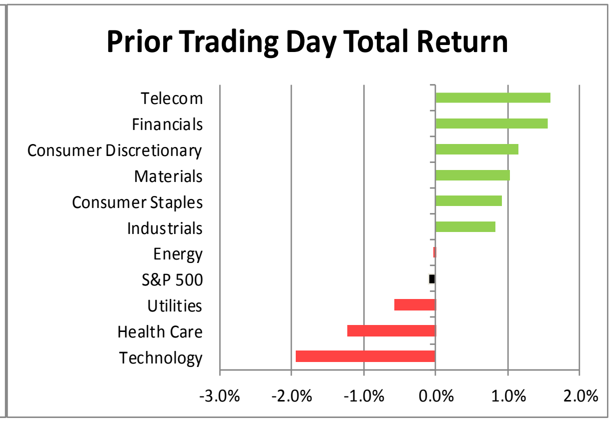
The lower two lines on the chart show the implied three-month LIBOR rate and the fed funds target. The upper line is the spread between the two rates. The important insight from this analysis is that the FOMC stops raising rates when the spread inverts. Chair Greenspan was able to prevent two recessions, one in 1994 and another in 1998, by rapidly cutting rates when the implied rate fell below the fed funds target. Although the FOMC did move rapidly in 2000, the rate cuts were not aggressive enough to prevent a recession. At the same time, the 2001 recession was rather mild. In the 2004-06 tightening cycle, the FOMC did stop raising rates once the spread inverted; however, the central bank kept rates elevated despite the inversion. As financial conditions deteriorated, the Federal Reserve moved to cut rates aggressively but this action was not enough to prevent the Global Financial Crisis.

So, what does this chart tell us now? As long as the spread isn't inverted, the FOMC will probably continue to raise rates. Note the reaction of implied LIBOR rates in 2016 after the December 2015 rate hike. As the implied LIBOR rate fell, the FOMC, which had been signaling higher rates for 2016, held rates steady until December and only raised rates as the implied LIBOR rate rose as well. Overall, this pattern suggests that the current spread will support a December rate hike. However, next year's rate moves should follow the implied LIBOR rate. If that rate fails to rise with policy tightening, we would expect the FOMC to slow the pace of increases next year.

Data Section

U.S. Equity Markets – (as of 12/4/2017 close)

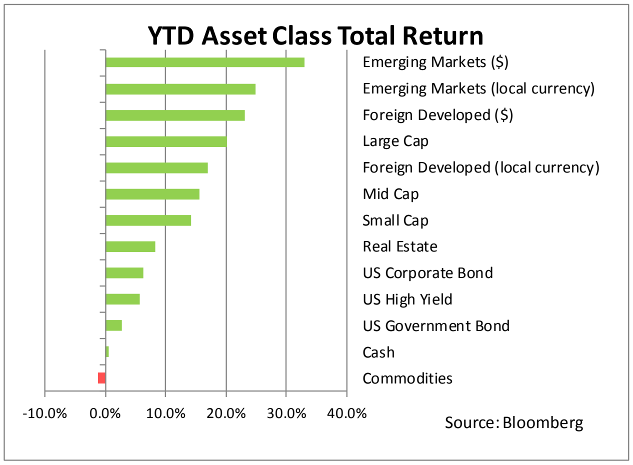




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 12/4/2017 close)

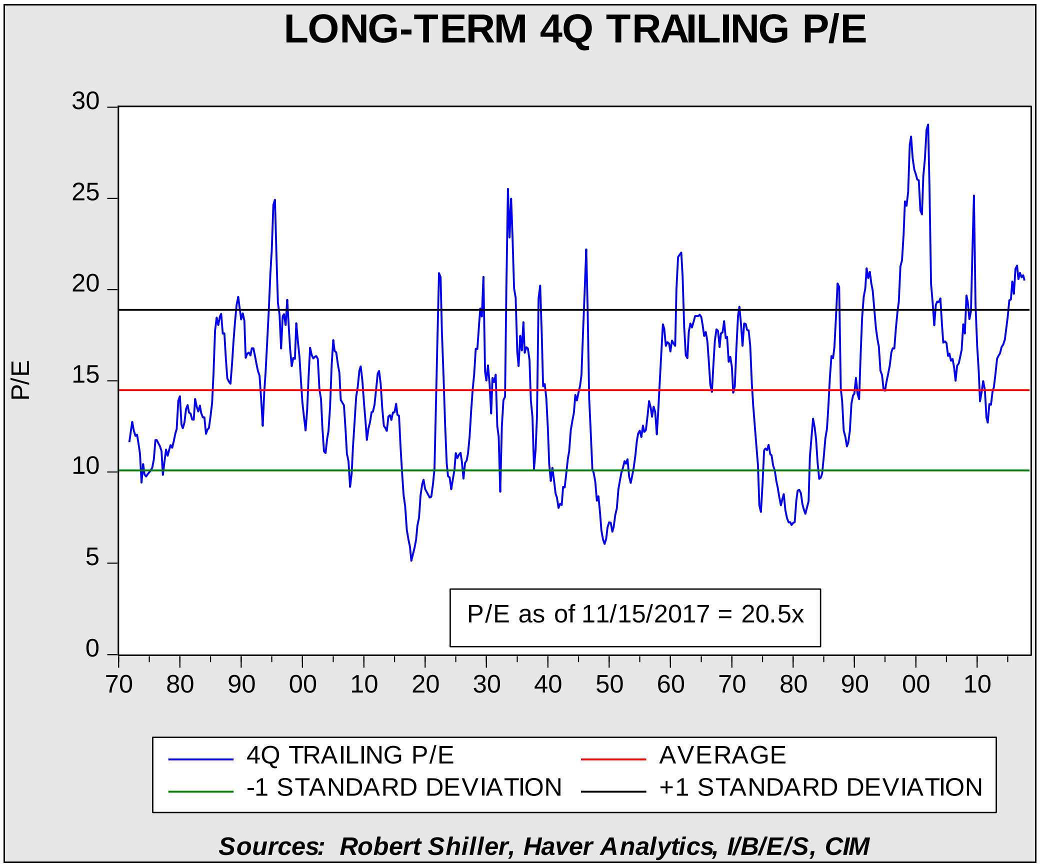


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index).

P/E Update

November 30, 2017



Based on our methodology,[3] the current P/E is 20.5x, up 0.1x from the last report. A rising S&P dampened the effects of rising earnings, causing a modest rise in the P/E this week.

[3] The above chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes three actual quarters (Q1, Q2 and Q3) and one estimate (Q4). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a very long-term dataset for P/E ratios.