Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: December 06, 2017—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.9% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.3% and the Shenzhen index up 0.7%. U.S. equity index futures are signaling a lower open.

Global equities continue to struggle this morning. Here is what we are watching:

Why the struggle in equities? There is a plethora of reasons why equities have started to tread water. The tax bill may fail. If it does pass, we could easily see a bout of profit-taking (buy rumor, sell fact). The next policy action from the Trump administration may be on trade. The combination of tax cuts (which raise the fiscal deficit) and trade restrictions (which would limit foreign saving from offsetting the fiscal deficit) would force domestic saving higher by either (a) cutting investment, or (b) forcing higher household and business saving, probably by boosting unemployment. That would weaken the economy and likely hurt earnings. The Fed may have too much credibility and the tax cuts may lead to faster monetary policy tightening and a stronger dollar. The fact that small caps seem to be holding up better than their larger brethren suggests the Fed concern may be playing a role; at the same time, small caps will probably benefit more from corporate tax cuts since they have not enjoyed the benefit of lobbying action to reduce their effective tax rates. The government may shut down. Chinese growth may slow next year. The bottom line is that we have seen a very strong equity market this year and a period of consolidation would make sense. And, the fact that there are so many "reasons" why equities are stalling suggests this is probably more of a consolidation than anything else. Why? Because the primary reason to worry about a bear market is either (a) recession, or (b) geopolitical event. Recession still appears to be a ways off. Geopolitical worries are a concern but we haven't had one, so far, that would put the economy at risk.

The Jerusalem issue: The Trump administration is moving to recognize Jerusalem as the capital of Israel. We don't have any strong feelings either way on the basis for this decision. However, it will complicate diplomacy in the region as the Arab states generally oppose the action. In other words, if the U.S. decides it wants to build an anti-Iranian coalition, this decision will make that harder. On the other hand, in the end, if the fear of Iran is great enough, it probably won't matter. At this point, our take is that it will foster lots of punditry but probably doesn't change much on the ground.

Bitcoin: We have been getting lots of questions on the cryptocurrency and it has been on a tear.

(Source: Bloomberg)

As the chart shows, the XBT/USD exchange rate is going parabolic. The debate around bitcoin, in particular, and cryptocurrencies, in general, is intense (Is it a real currency? Is it all a scam?). An issue we are monitoring related to bitcoin and cryptocurrencies is another cryptocurrency called "Tether" that uses the symbol "USDT." What does Tether do? Unlike other cryptocurrencies, it is pegged 1:1 to the USD. So, why does this exist? Tether is designed to allow a holder of a cryptocurrency to shift it to Tether which, according to reports, is easier than converting bitcoin to USD. The operators of Tether say that there is one USD backing each USDT. Currently, there is 814 mm USDT circulating, meaning that there should be $814 mm sitting in a bank somewhere—except that the managers of Tether have not allowed audits and Wells Fargo (WFC, 58.55) has ended its correspondent relationship with the manager. The manager of Tether has also decided to no longer do business in the U.S., although that might be hard to do given the proto-anonymous nature of cryptocurrencies. There is growing speculation that USDT is being created without a reserve backing (in other words, USDT is simply being "printed") and the manager is buying bitcoin with the inflows, further boosting the price of bitcoin.

So, what's the problem? Tether's contracts clearly indicate it is under no obligation to redeem USDT on demand (which, in theory, could eliminate the bank run problem). However, if the price of bitcoin were to fall rapidly for some reason (maybe because of the opening of futures contracts), then the backing of USDT, which may be bitcoin, would collapse. For most investors, this won't be a big deal. But, it should be a cautionary note for investors who are considering participating in the cryptocurrency space.[1]

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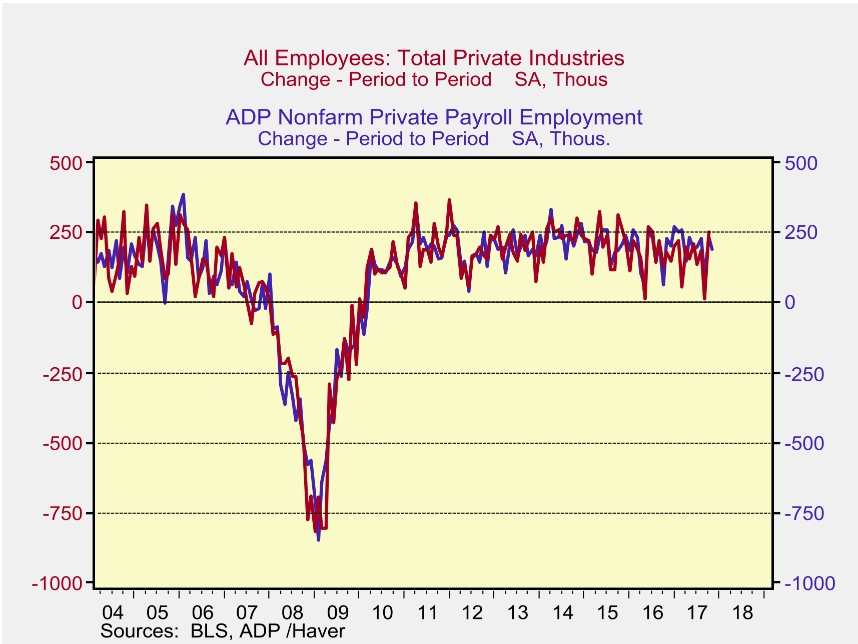
[1] See https://seekingalpha.com/article/4129543-bitcoin-one-way-go-true?page=2 and https://www.bloomberg.com/news/articles/2017-12-05/mystery-shrouds-tether-and-its-links-to-biggest-bitcoin-exchange for more details.

U.S. Economic Releases

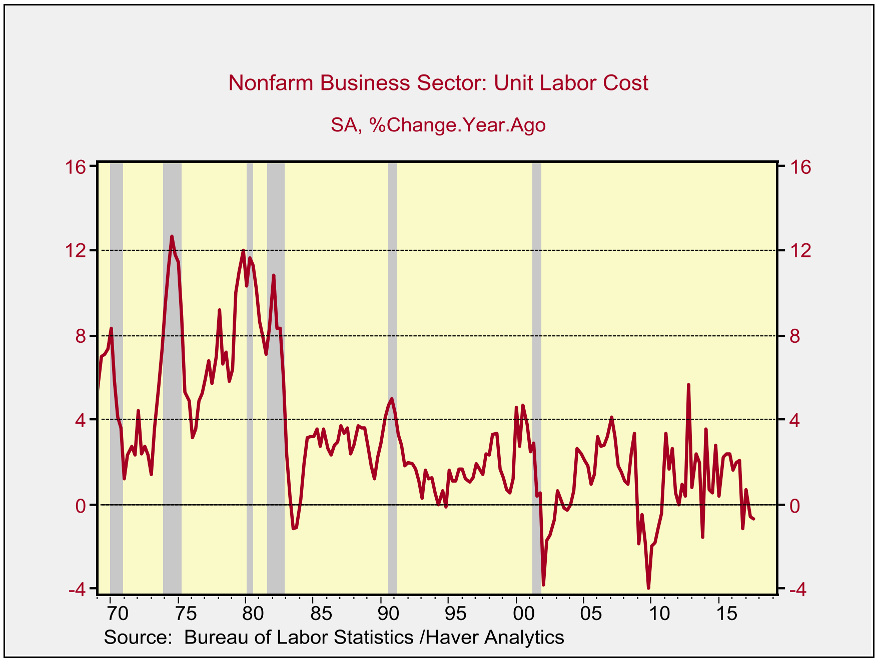
MBA mortgage applications rose 4.7% from the prior week. Purchases and refinancing rose 2.4% and 9.0%, respectively. The 30-year fixed rate mortgage fell by 1 bp from 4.20% to 4.19% from the prior week.

ADP employment change came in line with expectations at 190k.



The chart above shows the change in ADP employment and private payrolls. A high ADP employment change number signals a strong BLS non-farm payroll report for Friday.

Non-farm productivity came in below expectations, rising 3.0% from the prior quarter compared to the forecast gain of 3.3%. Unit labor costs came in below expectations, falling 0.7% from the prior quarter compared to the forecast gain of 0.2%. The chart below shows yearly changes in unit labor costs.



There are no economic releases or Fed events scheduled for the rest of the day.

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								
Australia	GDP	y/y	nov	2.8%	1.8%	3.0%	**	Equity and bond neutral
New Zealand	ANZ Job Advertisements	q/q	nov	-0.1%	0.9%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Retail PMI	m/m	sep	52.4	51.1		**	Equity and bond neutral
Germany	Factory Orders	m/m	oct	0.5%	1.0%	-0.2%	**	Equity bullish, bond bearish
	Markit Germany Construction	y/y	nov	53.1	53.3		**	Equity and bond neutral
	Markit Germany Retail PMI	y/y	nov	54.6	51.2		**	Equity and bond neutral
Italy	Markit Italy Retail PMI	m/m	nov	49.2	50.3		**	Equity and bond neutral
Switzerland	CPI	m/m	nov	0.8%	0.7%	0.8%	***	Equity and bond neutral
Russia	CPI	m/m	nov	2.5%	2.7%	2.5%	***	Equity and bond neutral
	CPI Core	m/m	oct	2.3%	2.5%	2.3%	***	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	m/m	sep	-2.6%	0.3%	-0.6%	**	Equity bearish, bond bullish
Canada	International Merchandise Trade	m/m	oct	-1.47 bn	-3.18 bn	-2.65 bn	**	Equity and bond neutral

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)	151	149	2	Up
3-mo T-bill yield (bps)	128	128	0	Neutral
TED spread (bps)	23	22	1	Neutral
U.S. Libor/OIS spread (bps)	139	138	1	Up
10-yr T-note (%)	2.34	2.35	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	52	52	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Repurchase Rate	6.00%	6.00%	6.00%	On forecast
RBI Reverse Repo Rate	5.75%	5.75%	5.75%	On forecast
RBI Cash Reserve Ratio	4.00%	4.00%	4.00%	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	$62.21	$62.86	-1.03%	Bearish API
WTI	$56.90	$57.62	-1.25%	
Natural Gas	$2.94	$2.91	1.00%	
Crack Spread	$17.02	$17.29	-1.54%	
12-mo strip crack	$19.76	$20.01	-1.28%	
Ethanol rack	$1.50	$1.50	0.00%	
Metals				
Gold	$1,267.52	$1,265.77	0.14%	
Silver	$16.11	$16.10	0.05%	
Copper contract	$297.70	$294.60	1.05%	
Grains				
Corn contract	$ 355.75	$ 353.75	0.57%	
Wheat contract	$ 432.50	$ 432.75	-0.06%	
Soybeans contract	$ 1,012.25	$ 1,008.50	0.37%	
Shipping				
Baltic Dry Freight	1666	1662	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		2.6		
Distillates (mb)		0.5		
Refinery run rates (%)		0.25%		
Natural gas (bcf)		-9.0		

Weather

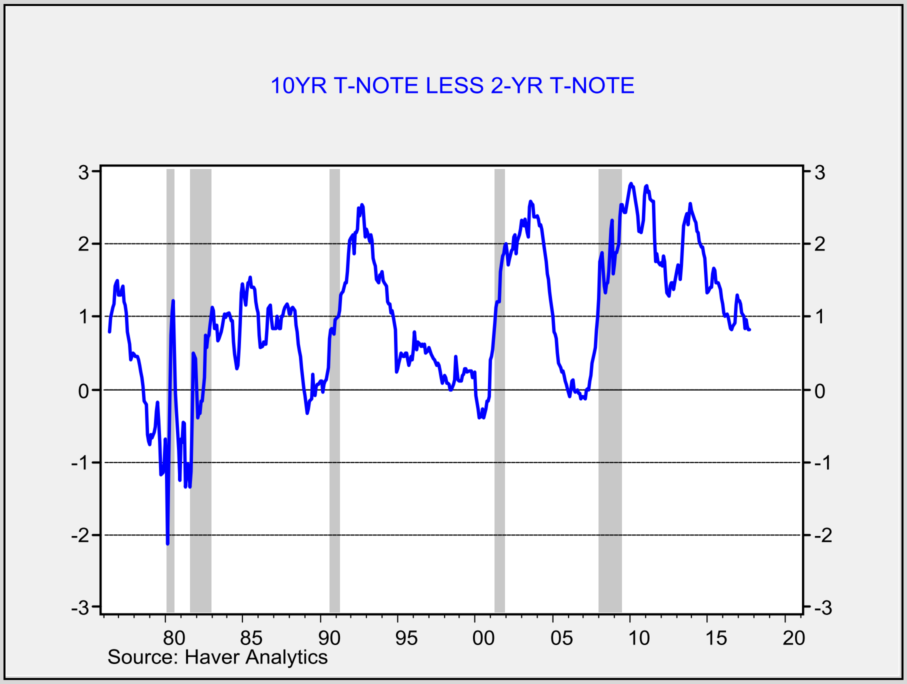
The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmer temps in the western region.

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.

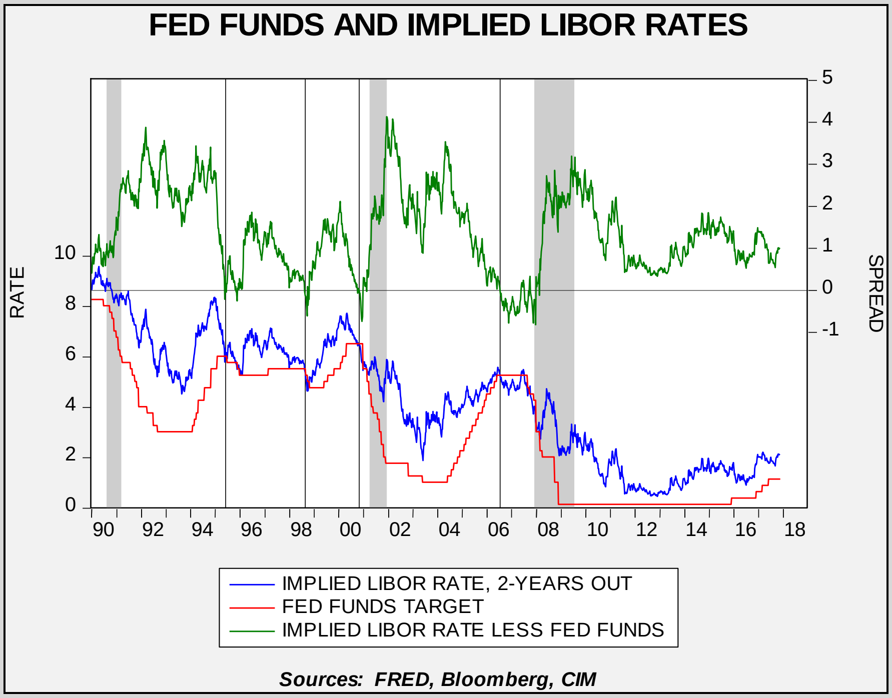
December 1, 2017

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.

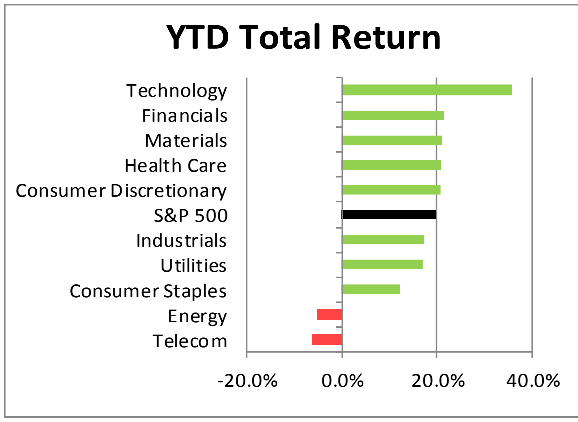


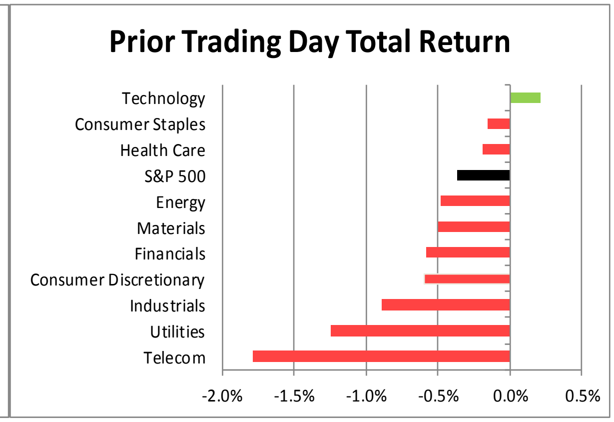
The lower two lines on the chart show the implied three-month LIBOR rate and the fed funds target. The upper line is the spread between the two rates. The important insight from this analysis is that the FOMC stops raising rates when the spread inverts. Chair Greenspan was able to prevent two recessions, 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 12/5/2017 close)

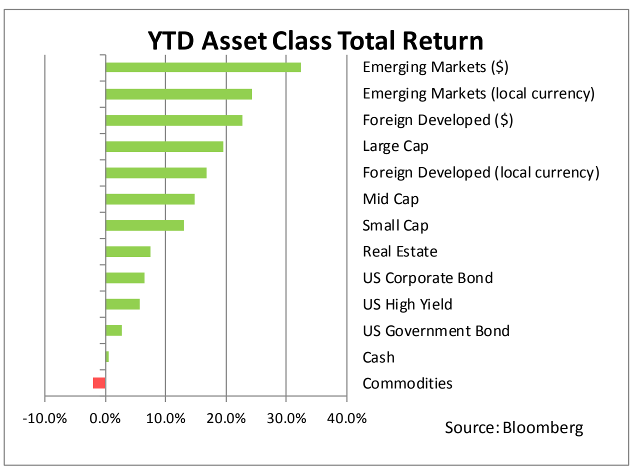




(Source: Bloomberg)

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 12/5/2017 close)

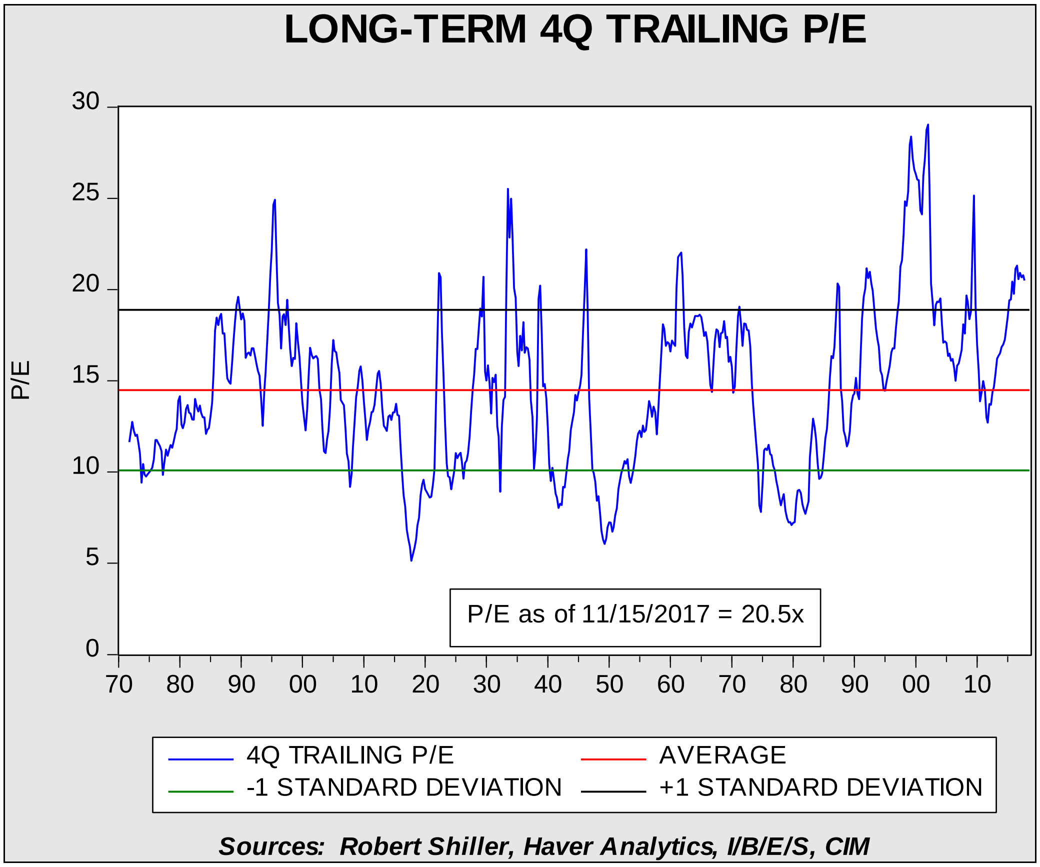


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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[2] 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.