Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: December 08, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.2% from the prior close. Chinese markets were up, with the Shanghai composite up 0.6% and the Shenzhen index up 1.2%. U.S. equity index futures are signaling a higher open.

It's employment data day! We detail the data below but the short answer is that the numbers are good for capital—employment rose faster than forecast while wage growth came in weaker than expected. The lack of wage growth should bring some degree of pause on the part of the FOMC. Here are other items we are watching this morning:

Brexit goes forward: Britain and the EU reached a deal on exit terms, giving special rights to the four million EU expats in the U.K. and an exit fee of €40 bn to €60 bn. The sticky problem of the border in Ireland was resolved; although the DUP did go along, in reality, it appears that Northern Ireland will, in terms of regulation, be a de facto member of the EU. The U.K. did get some relief over EU jurisdiction. Overall, it looks like PM May got a deal because she acquiesced at every level with the EU. From here, negotiations will move on to trade. Although this is a significant development, it appears the markets fully anticipated this outcome as the GBP is essentially flat.

Basel bank accords: Although the deal took almost two years longer than planned, the Basel III accords have been approved. These rules apply to bank capital in 27 nations plus the entire EU. The goal is to create uniform bank capital rules across the developed world to prevent financial contagion. The disagreement was mostly U.S. versus EU; the former wanted stricter regulations because America's financial structure makes businesses less dependent on banks and more on capital markets. If the EU were forced to follow U.S. rules, the EU financial markets would need massive restructuring. EU bank equities are up 3% on the news.

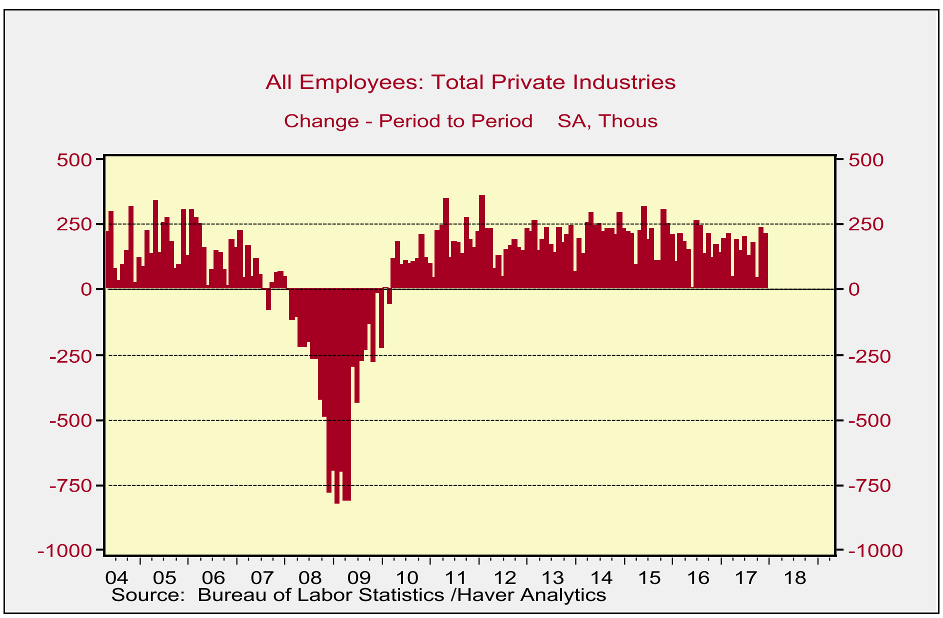
Continuing resolution: It looks like a short-term deal was struck to keep the government functioning but it will only last until around Christmas. The sticking points are familiar—Democrats want an immigration break for dreamers and social spending equal to defense spending. The GOP wants no immigration deal and only spending on defense. This impasse looks difficult to resolve but the most likely outcome is higher spending and deficits.

A questionable invitation: Greece and Turkey are historical enemies. For the first time in 65 years, the Turkish president visited Greece. It may be an equal period of time before such an event happens again. Turkish President Erdogan opened discussions by calling for a reworking of the 1923 Treaty of Lausanne, the treaty that established the border between the two nations. Greece has no interest in adjusting the deal. Erdogan also accused his hosts of discriminating against Muslim Turks who live in Greece. Criticism of the aforementioned treaty and support of the Muslim Turkish minority are a page out of the authoritarians' playbook; see Hitler's absorption of the Sudetenland in 1939. Erdogan also indicated that the division in Cyprus is due to Greek intransigence. Needless to say, hopes for some sort of improvement in relations looks like a long shot.

German coalition negotiations: Martin Schulz, the leader of the SDP in Germany, is in talks with the CDU/CSU to create a new grand coalition in Germany. If these talks fail, Germany will likely need new elections, which would be unprecedented in the postwar experience. Schulz gave a rousing speech that called for a "United States of Europe" by 2025;[1] this would signal a dramatic reversal in the CDU/CSU's platform, which is cautious over further European integration. German conservatives are worried that further integration would entail Eurobonds (an EU bond backed by the full faith and credit of all EU members, meaning Germans would guarantee the debt of the other 26 members' spending) and a unified fiscal budget. Schulz is laying down his markers for forming a government with Merkel. If he holds to this position, it seems highly unlikely that Merkel can form a government.

U.S. Economic Releases

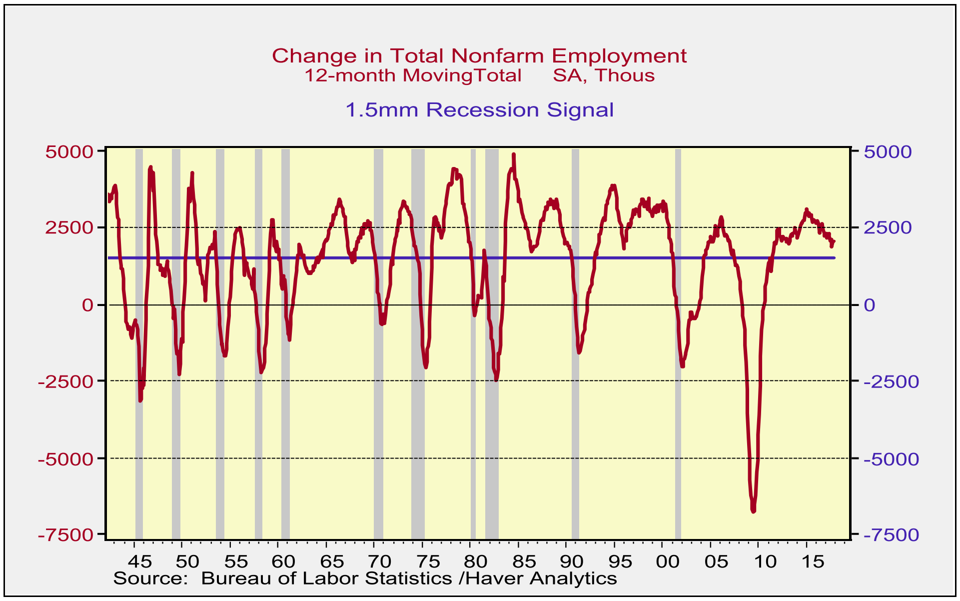
The change in non-farm payrolls for November came in above expectations at 228k compared to the forecast of 195k; the net revisions from the prior two reports is +3k. The change in private payrolls came in above expectations at 221k compared to the forecast of 195k. The change in manufacturing payrolls also came in above expectations at 31k compared to the forecast of 15k; the prior report was revised downward from 24k to 23k.



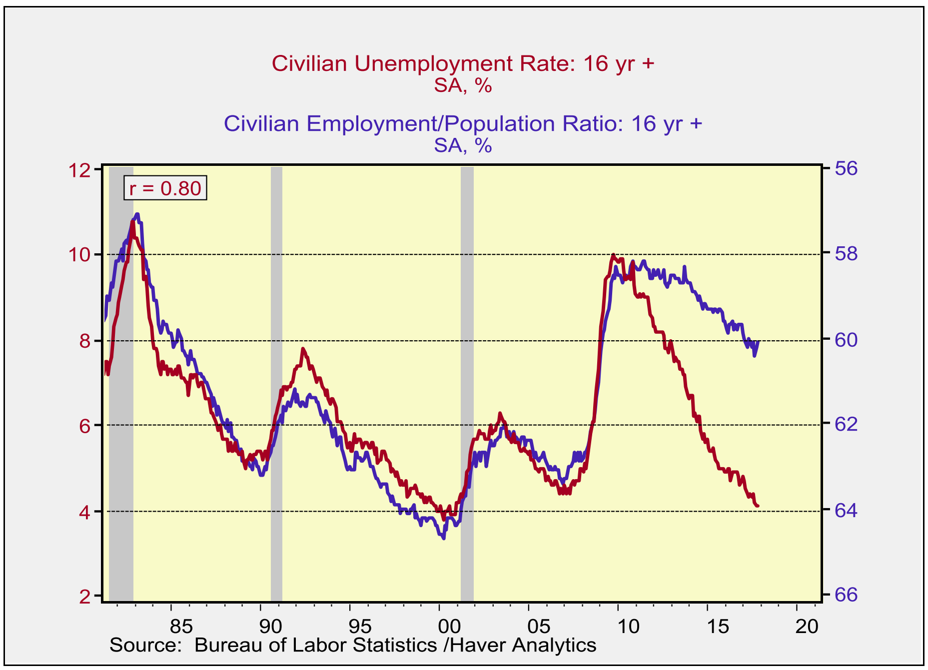
The chart above shows the change in total private employment. This chart suggests we are still in an economic expansion.

[1] https://www.youtube.com/watch?v=9HVejEB5uVk

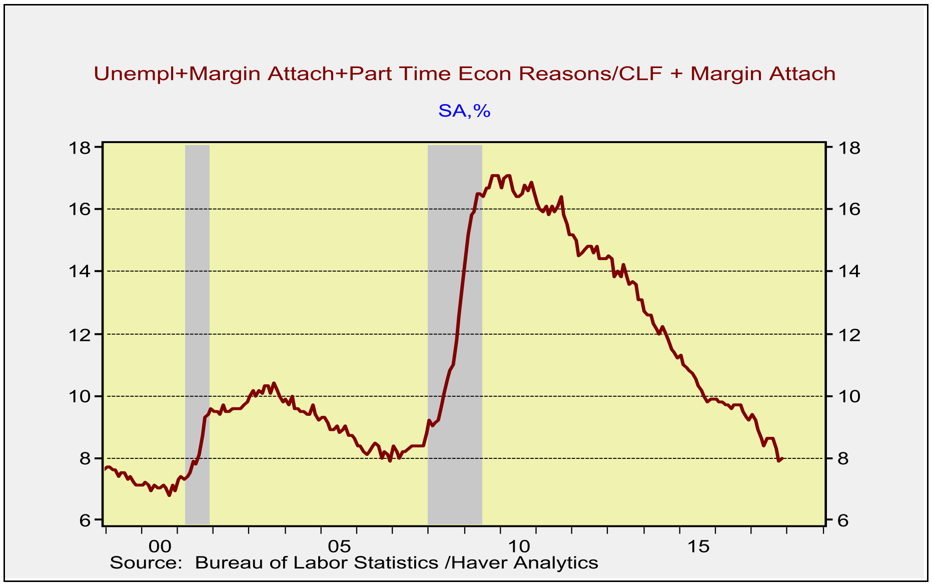
The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in line with expectations at 4.1%. The labor force participation rate came in at 62.7%, steady from the previous month, while the U-6 unemployment rate rose 0.1% to 8.0%.

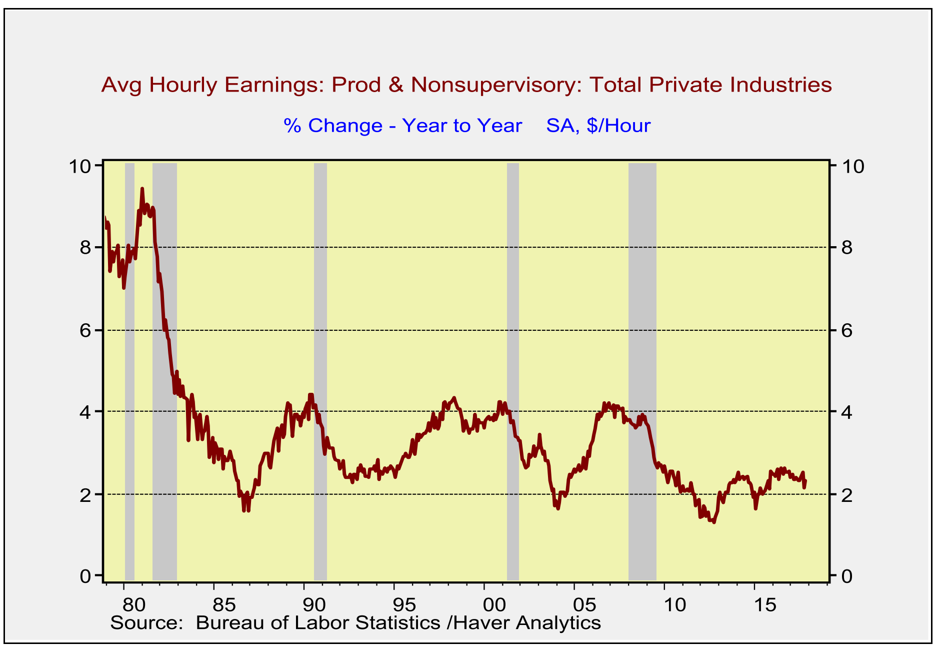


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.



The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.

Average hourly earnings came in below expectations, rising 0.2% from the prior month compared to the forecast gain of 0.3%.



The above chart above shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and nonsupervisory employees rose 2.3%. Wage growth remains subdued even with an historically low unemployment rate.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Wholesale Trade Sales	m/m	oct	-0.4%	-0.4%	**
10:00	Wholesale Inventories	m/m	oct	0.3%	1.3%	**
15:00	U. of Michigan Sentiment	m/m	dec	99.0	98.5	**
10:00	U. of Michigan Current Conditions	m/m	dec	114.3	113.5	**
10:00	U. of Michigan Expectations	m/m	dec	90.5	88.9	**
10:00	U. of Michigan 1 yr Inflation	m/m	dec		2.5%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	dec		2.4%	**
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	Trade Balance	m/m	nov	$40.21 bn	$38.17 tn	$35.00 tn	**	Equity bullish, bond bearish
Japan	BoP Current Account Balance	m/m	nov	¥2.441 tn	¥2.271 tn	¥1.721 tn	**	Equity bullish, bond bearish
	Trade Balance	m/m	nov	¥430.2 bn	¥852.2 bn	¥418.1 bn	**	Equity and bond neutral
	GDP	y/y	nov	0.6%	0.3%	0.4%	***	Equity bullish, bond bearish
Australia	Home Loans	m/m	oct	-0.6%	-2.3%	-2.0%	*	Equity bearish, bond bullish
	Investment Lending	m/m	oct	1.6%	-6.2%		*	Equity and bond neutral
	Own-Occupier Loan Value	m/m	oct	0.0%	-2.1%		*	Equity and bond neutral
New Zealand	Mfg Activity Volume	q/q	3q	0.3%	1.0%		**	Equity and bond neutral
EUROPE								
Germany	Trade Balance	q/q	oct	18.9 bn	24.1 bn	21.9 bn	**	Equity bearish, bond bullish
	Current Account Balance	q/q	oct	18.1 bn	25.4 bn	20.0 bn	**	Equity bearish, bond bullish
	Labor Costs	q/q	3q	0.7%	0.3%		**	Equity and bond neutral
France	Budget Balance	y/y	oct	-77.1 bn	-76.3 bn		**	Equity and bond neutral
	Industrial Production	m/m	oct	1.9%	0.6%	-0.1%	***	Equity bullish, bond bearish
	Manufacturing Production	m/m	oct	6.9%	3.1%		**	Equity and bond neutral
UK	Industrial Production	m/m	oct	0.0%	0.7%	0.0%	***	Equity and bond neutral
	Manufacturing Production	m/m	oct	3.9%	0.7%	0.0%	**	Equity bullish, bond bearish
	Construction Output	y/y	oct	-0.2%	1.1%	1.8%	**	Equity bearish, bond bullish
	Trade Balance	m/m	oct	-£1405	-£2754	-£3000	**	Equity bullish, bond bearish
Russia	Money Supply Narrow Def	m/m	dec	9.20 tn	9.28 tn		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	m/m	nov	6.6%	6.4%	6.6%	***	Equity and bond neutral
Canada	Building Permits	m/m	oct	63.0	63.8	62.5	**	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)	152	152	0	Up
3-mo T-bill yield (bps)	126	126	0	Neutral
TED spread (bps)	26	25	1	Neutral
U.S. Libor/OIS spread (bps)	139	139	0	Up
10-yr T-note (%)	2.38	2.36	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	63	63	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Neutral
pound	down			Neutral
franc	down			Neutral

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	$63.16	$62.20	1.54%	Increase in Demand
WTI	$57.61	$56.69	1.62%	
Natural Gas	$2.81	$2.76	1.77%	
Crack Spread	$17.36	$17.47	-0.61%	
12-mo strip crack	$19.83	$19.91	-0.40%	
Ethanol rack	$1.47	$1.48	-0.30%	
Metals				
Gold	$1,247.47	$1,247.22	0.02%	
Silver	$15.83	$15.73	0.64%	
Copper contract	$297.80	$296.45	0.46%	
Grains				
Corn contract	$ 353.25	$ 351.50	0.50%	
Wheat contract	$ 423.25	$ 421.50	0.42%	
Soybeans contract	$ 995.50	$ 992.00	0.35%	
Shipping				
Baltic Dry Freight	1679	1670	9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.6	-2.5	-3.1	
Gasoline (mb)	6.8	2.6	4.2	
Distillates (mb)	1.7	0.5	1.2	
Refinery run rates (%)	1.20%	0.25%	1.0%	
Natural gas (bcf)	2.0	-9.0	11.0	

Weather

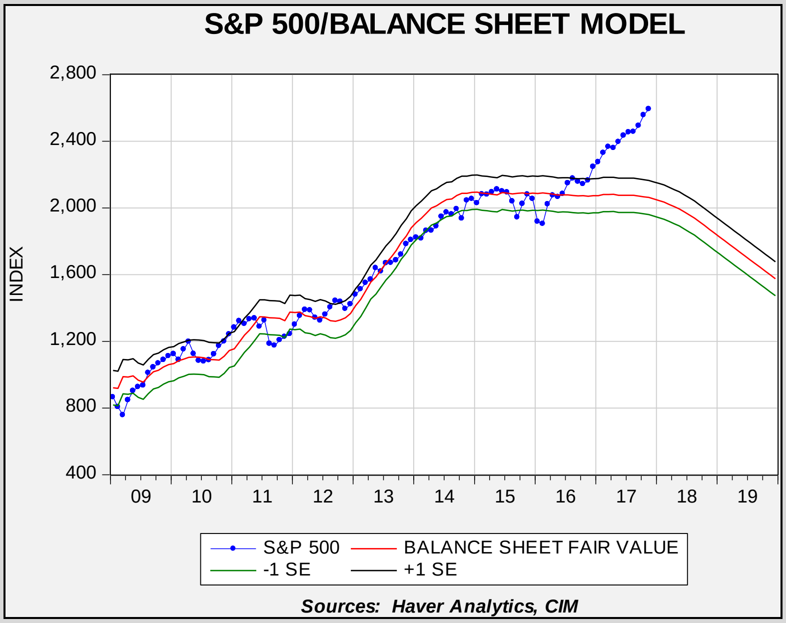
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country, with cooler temps in the western region.

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 8, 2017

We have received a number of requests to update our S&P 500/Fed balance sheet model.



This chart shows the results from our S&P 500/Fed balance sheet model. We have projected the model's forecast using the expected path of balance sheet reduction. It shows that the equity index tended to follow monetary policy from the end of the recession in mid-2009 until the election of President Trump. Since the election, the index has far outperformed what the balance sheet model projects for fair value.

This model was always problematic, potentially a classic example of data mining. The problem of data mining and the current discussion of "big data" get at the philosophical problem of "how do we know?"[2] Our basic procedure when looking at correlations is to try to formulate a theoretical reason for why the correlation should exist. Simply finding correlations, otherwise called data mining, is fraught with risk. Some correlations are spurious—they develop almost by accident and fade over time. Others are true as far as they go but can lead one to draw inappropriate conclusions.

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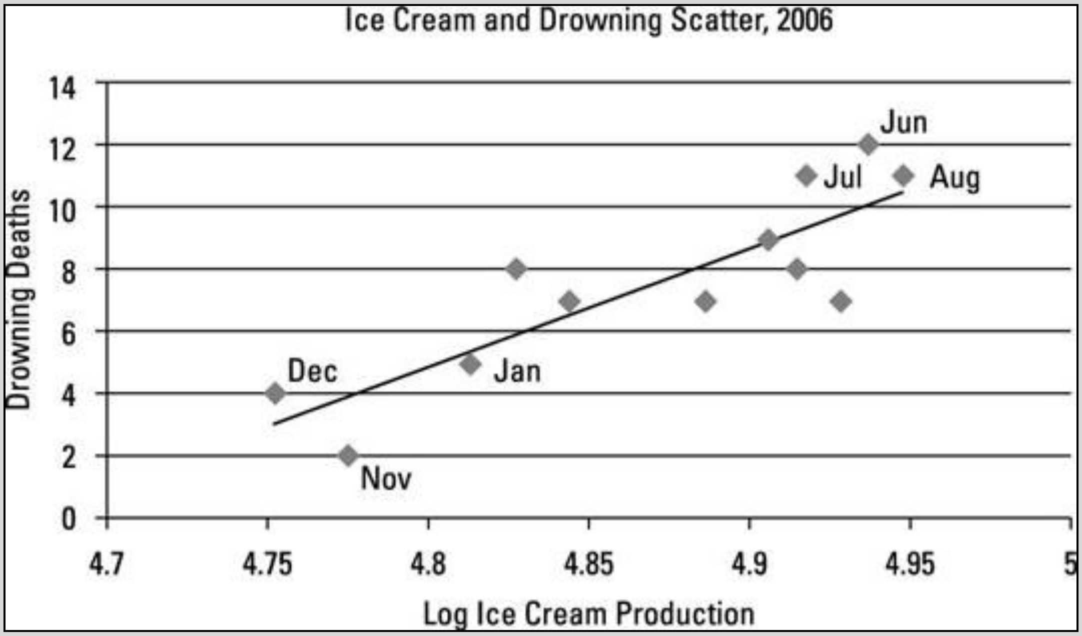
[2] We discussed this issue at length in the summer of 2016. See WGRs, Thinking about Thinking: Part 1, 8/15/16; and Part II, 8/22/16.

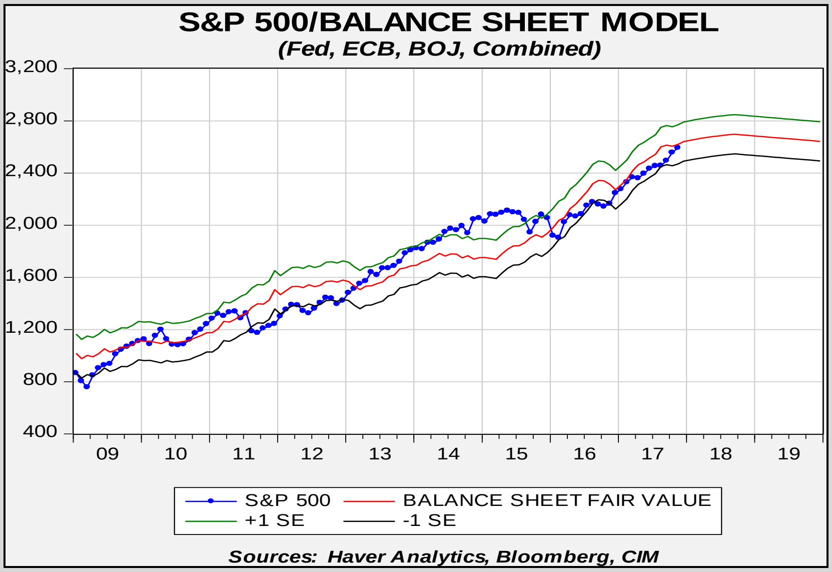


(Source: Dummies.com)

This chart shows the relationship between ice cream consumption and drowning in 2006. The relationship of these two variables is a common pedagogical tool when teaching statistics. It is clear that a relationship exists between these two variables. However, they share a common factor that is the likely cause of the correlation—summer! If a policymaker neglected to take the seasonal factor into account, a case could be made for a tax on ice cream in a bid to reduce drownings. It is almost certain such a policy would fail.

We have concluded that the most likely reason the Fed's balance sheet was related to the S&P 500 was because it showed that the U.S. central bank still had effective tools to stimulate economic growth. In other words, QE was mostly a confidence builder. It appears that Trump's promises of deregulation and tax cuts have replaced QE in supporting investor confidence and thus, the relationship has broken down between the Federal Reserve's balance sheet and the S&P 500.

However, we would be remiss if we didn't examine another element of the balance sheet relationship. With globalized financial markets, it is also possible that the behavior of foreign central banks affects U.S. equities as well. Combining the exchange rate-adjusted balance sheets of the European Central Bank (ECB), the Bank of Japan (BOJ) and the Federal Reserve, with projections based on policy guidance, yields the following model.

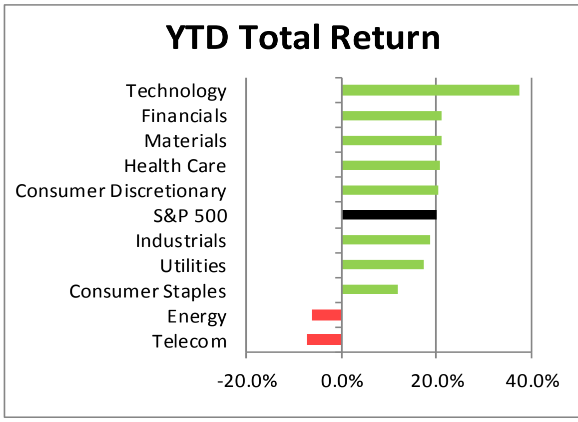


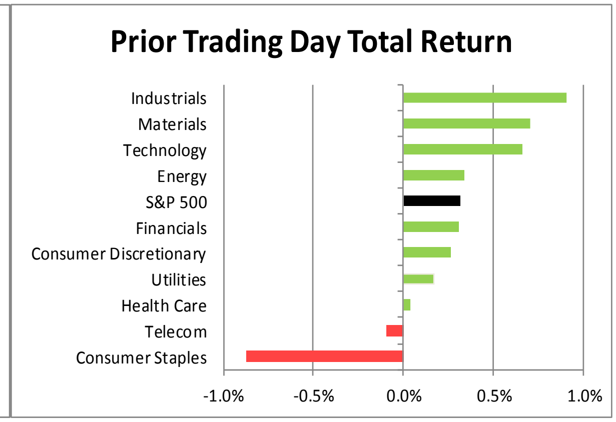
The BOJ's balance sheet path is more difficult to project because Japan is now fixing the 10-year JGB interest rate and adjusting the balance sheet accordingly. We have developed a projection but with less confidence than our estimates for the Fed and the ECB. We are also assuming mostly steady exchange rates. This model shows that the rise in the S&P 500 can be explained by the combined effects of balance sheet expansion from the Federal Reserve, the BOJ and the ECB. It also suggests the upside is likely limited because the ECB will begin tapering next year and is projected to stop expanding its balance sheet by the end of Q3 2018.

Thus, one possibility is that continued balance sheet expansion by the BOJ and ECB has supported equities, offsetting the lack of Federal Reserve expansion. If this is the case, then ECB tapering and the end of its expansion and the uncertainty surrounding BOJ expansion may become significant headwinds next year. However, as noted above, we believe QE was mostly a confidence booster; there is little evidence it had much of an impact on the economy. At present, tax cuts and deregulation have lifted investor sentiment and supported higher equity prices. However, we will be watching to see whether the slow end of unconventional monetary policy abroad has an impact on equities next year.

<u>Data Section</u>

U.S. Equity Markets – (as of 12/7/2017 close)

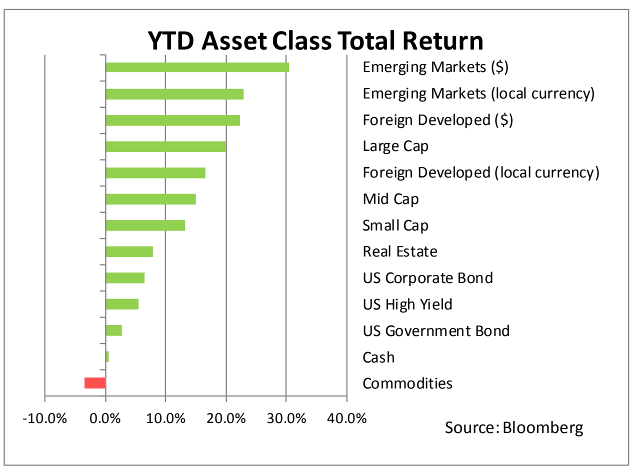




(Source: Bloomberg)

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 12/7/2017 close)

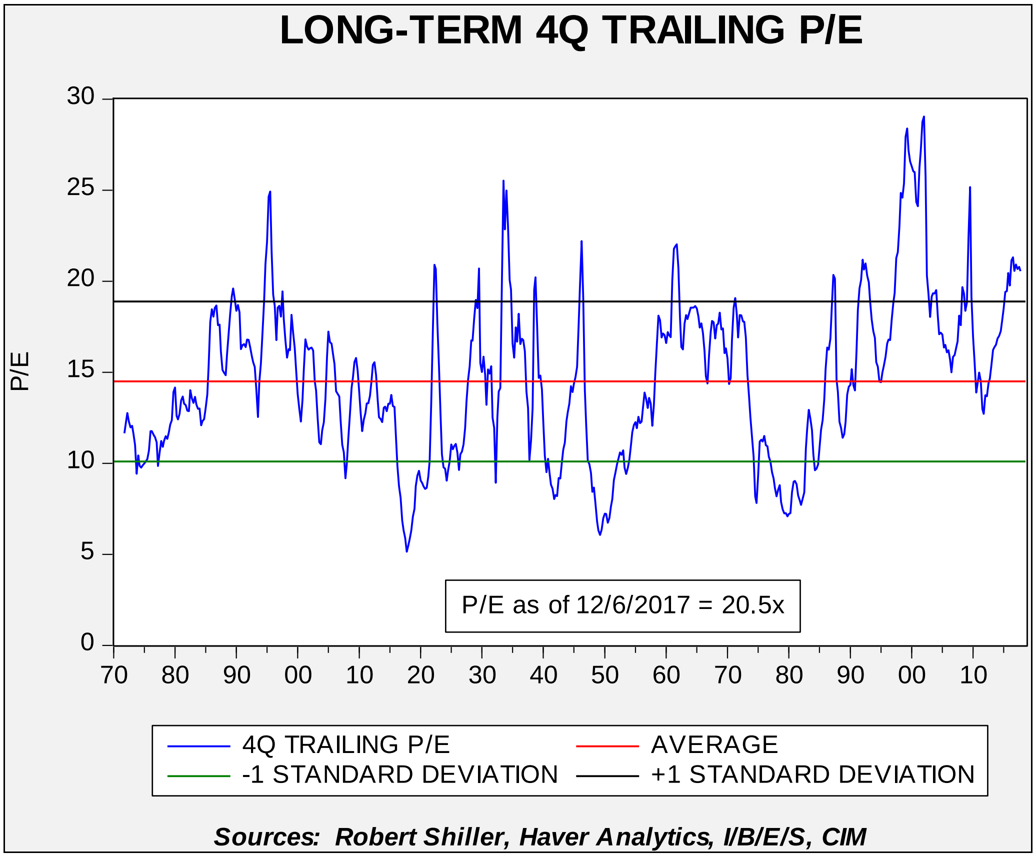


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 7, 2017



Based on our methodology,[3] the current P/E is 20.5x, unchanged from last 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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[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.