By Bill O'Grady and Thomas Wash

[Posted: December 15, 2017—9:30 AM EDT] Global equity markets are mixed to lower this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.7% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.8% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a higher open.

Tax bill update: Although the conference committee has finished its work, it's going to be something of a nail-biter to passage. Sen. Rubio (R-FL) has indicated he will vote against the current version unless the child tax credit is increased. It is unclear if Sen. Corker (R-TN) will oppose this measure as he did when the Senate version was passed. Sen. Flake (R-AZ) may not be on board and Sen. Lee (R-UT) has now indicated concerns. In addition, Sen. McCain (R-AZ) is in the hospital due to complications tied to his cancer treatment and Sen. Cochran (R-MI) has been undergoing treatment for a variety of maladies and has missed a few votes recently. VP Pence has changed his travel plans; he was scheduled to visit the Middle East but is staying around in case his vote is needed to break a tie. Although the financial markets appear confident that a bill will pass, the chances for delay are probably higher than acknowledged. If the votes aren't there, negotiators could wait until next year but the GOP's loss of Alabama earlier this week would further complicate passage. This isn't a done deal yet and if the bill fails we would expect a pullback in equities.

EU agrees on Brexit: The EU has confirmed that "sufficient progress" has been made on Brexit talks to proceed to the next stage of negotiations. This news should be considered a boost for PM May, although the praise she was given by EU leaders may make her less popular at home. Interestingly enough, the GBP has been steadily weakening on this news which isn't what we expected. It is possible this outcome was already discounted and with that confirmation we are seeing liquidation (buy rumor, sell fact). If this is the case, the weakness should be short-lived.

A Chinese satellite ground station in North America: China has quietly built a satellite ground station in Nuuk, Greenland, which is on the southwestern coast of the large island.[1] China is building an alternative to the U.S. GPS system called "Beidou." Although both are used by civilians, the primary reason for their existence is for military purposes. The new station will be used for gathering military data. China has designs on the Arctic; as the polar caps melt, it allows for faster shipping over the pole and China clearly doesn't want to be dependent upon Canadian and U.S. forces for navigation. China has promised Greenland, Denmark and the Faroes "full access" to the data, but we have serious doubts that sensitive information will be shared.

[1] https://tools.wmflabs.org/geohack/geohack.php?pagename=Nuuk&params=64_10_30_N_51_44_20_W_region:GL_type:city

It should be noted that China has been investing in Greenland for some time; Jiangxi Copper (SHA, CNY 16.97) has had an exploratory project there since 2009. However, it wasn't until 2013 that Western media realized this investment had occurred. Anne-Marie Brady, a leading expert on Chinese polar aspirations, says that China tends to domestically boast of its Arctic activities but downplays them to the foreign press. This sort of encroachment shows China's increasing reach and also America's diminishing influence.

The curious case of EUR/USD basis swaps: Recently, the swap rate between the EUR and USD over three months has widened significantly.

(Source: Bloomberg)

This chart shows the swap rate between euros and dollars for three months. These swaps are generally used to hedge against currency moves. Thus, if European borrowers need dollars, they issue dollar-denominated commercial paper. The buyer who buys the paper now has dollar risk. The swap eliminates that currency risk. The borrower servicing the debt in dollars may decide to also hedge. The sudden shift is probably due to two factors. First, if there is a dearth of dollars at year-end, when some buyers want to hedge, it can drive up the rate (negatively widening the swap). Note that there were squeezes in 2011, 2015 and 2016, although the current one is much stronger than the last two, which suggests something is in play other than seasonal factors. The second reason this may be happening is that U.S. firms with dollars offshore may have been the usual buyer of this dollar-denominated paper. They would have less need to hedge and thus could absorb the paper without pressuring the swap rate. But, if those firms are expecting a repatriation holiday from the tax bill, they may be reluctant buyers and thus there is a dollar-funding squeeze.

Interestingly enough, for European buyers, U.S. 10-year T-notes are now carrying a negative yield if the paper is fully hedged. If they borrow U.S. dollar three-month LIBOR at +1.61%, plus local LIBOR (-39 bps) plus the EUR/USD swap rate, the hedged rate is around -63 bps.

We watch this rate because it can signal financial stress. As the chart above shows, in 2008, the spread widened dramatically as global borrowers tried to secure dollars. Paradoxically, the Treasury downgrade in 2011 caused similar worries. We think the current widening is probably due to seasonal factors and tax concerns, but we will continue to monitor markets to see if there is some other factor affecting the swap rate.

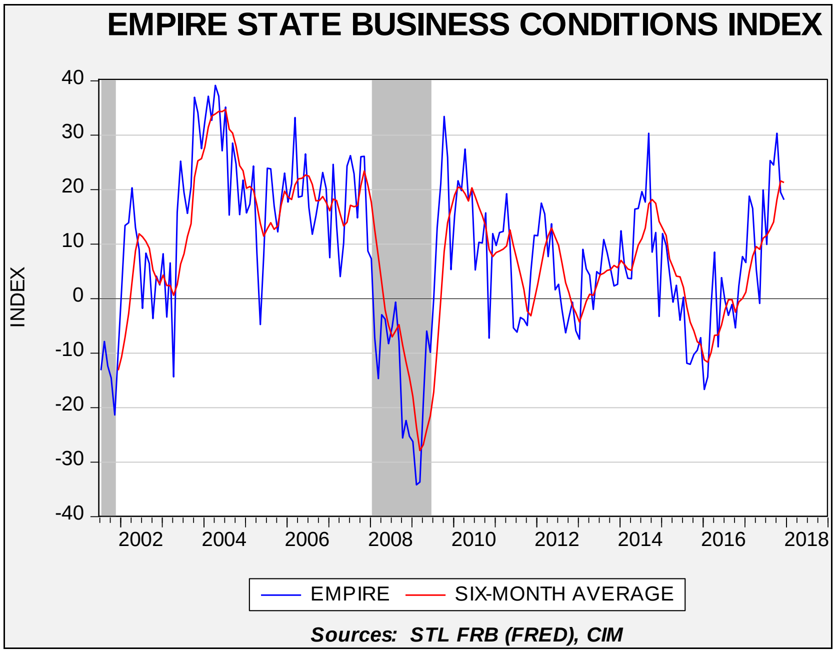
Another North Korean execution: It has been confirmed that Vice Marshall Hwang Pyong-so, a senior DPRK military figure, has been executed. He was in charge of the General Political Bureau, which oversees the military. South Korean intelligence indicates the bureau is under "audit"; Hwang was said to have been punished for an "impure attitude" toward the Kim regime. What is important here is that there could be growing dissent between Kim and the military. It should be noted that Kim's father, Kim Jong-il, strongly supported the military. His successor son has been trying to rebalance the relationship to boost the civilian economy, which could be leading to tensions within the regime.

In addition, it should be remembered that military leaders everywhere are acutely aware of the weaknesses and limitations of their forces. There is a natural tendency for military leaders to overestimate the strength of an opponent. On the other hand, civilian leaders, charged with selling military action to the populous, tend to overestimate their own forces and underestimate the enemy. Very few civilian leaders indicate at the onset of war that the conflict will be long and bloody with an indeterminate outcome. That's why PM Churchill's promise of "blood, sweat and tears" was so remarkable. Instead, civilian leaders typically promise quick and painless victories. It is quite possible that the North Korean military views Kim Jong-un's actions as impetuous[2] and was trying to encourage him to lower the tone of his rhetoric or maybe even entertain talks with the U.S. Kim may be trying to rid the military of these "impure thoughts" because he doesn't trust them or because he doesn't want to hear words of caution. At the same time, this execution may signal internal dissent within North Korea. If Kim continues to march toward a conflict, especially if there is another nuclear test, the military may decide a coup is in order.

U.S. Economic Releases

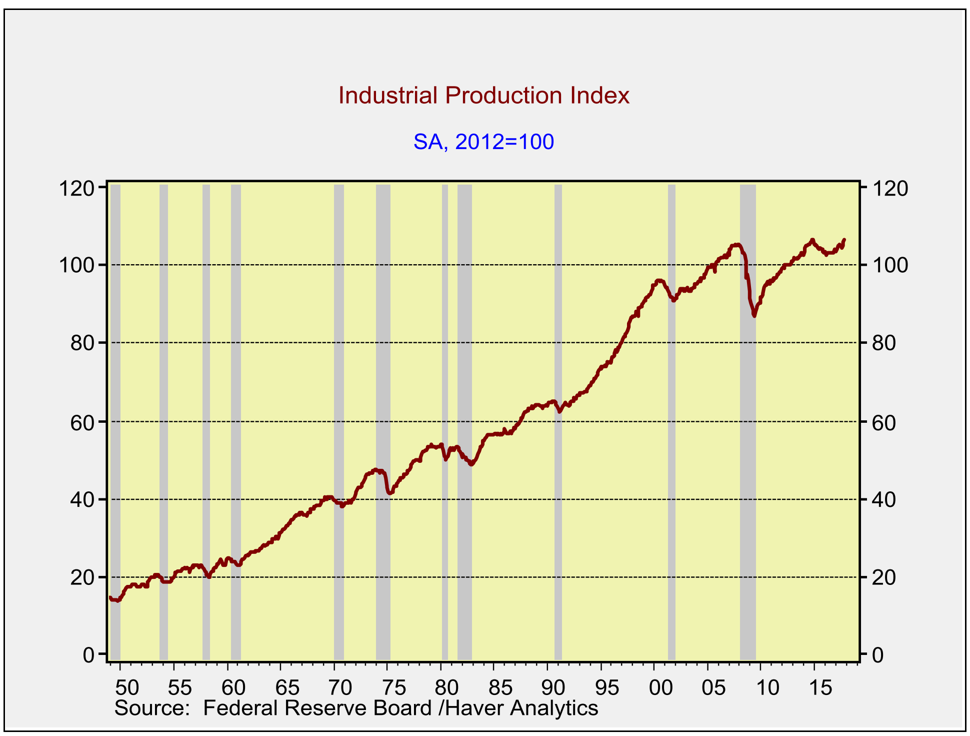
The Empire State manufacturing index for December came in a bit weaker than forecast, at 18.0 versus expectations of 18.7. This reading is down from the 19.4 reported in November.

[2] This trait may run in the family. See WGRs: North Korea and China: A Difficult History, Part 1, 10/16/17; Part II, 10/23/17; and Part III, 10/30/17. Note how Chinese military leaders viewed the military "prowess" of the current leader's grandfather, Kim Il-sung.



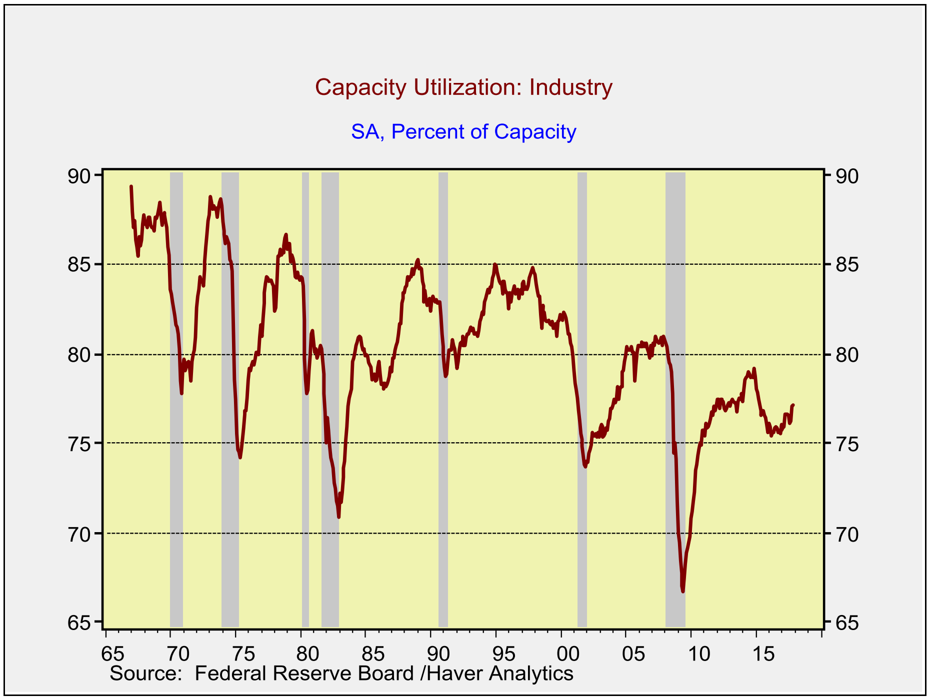
The index remains elevated and suggests an expanding economy for New York.

November industrial production rose 0.2% compared to forecasts of a 0.3% rise. However, the prior month was revised to 1.2% from 0.9%, more than offsetting the less than expected increase.



Although the pace of increases in industrial production is slowing, it should be noted that the current reading is a new all-time high for this index.

Capacity utilization came in at 77.1%; market expectations were 77.2%, but the prior month was revised to +1.4% from +1.3%, suggesting the data is near expectations.



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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
15:00	Total net TIC flows	m/m	oct		$-51.3 bn	**
	Net long-term TIC flows	m/m	oct		$80.9 bn	**
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								
Japan	Tankan Large mfg	q/q	Q4	25.0	22.0	24.0	***	Equity bullish, bond bearish
	Tankan Small mfg	q/q	Q4	15.0	10.0	11.0	*	Equity and bond neutral
India	Trade Balance	m/m	nov	-$13.8	$14.0 bn	$13.3 bn	**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	m/m	oct	€19.0 bn	€25.0 bn	€24.3 bn	*	Equity bearish, bond bullish
France	Wages	q/q	Q3	0.3%	0.3%	0.3%	*	Equity and bond neutral
AMERICAS								
Canada	Manufacturing sales	m/m	oct		0.5%	1.0%	**	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)	159	157	2	Up
3-mo T-bill yield (bps)	128	128	0	Neutral
TED spread (bps)	31	29	2	Neutral
U.S. Libor/OIS spread (bps)	141	141	0	Up
10-yr T-note (%)	2.36	2.35	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	106	78	28	Up
Currencies	**Direction**			
dollar	up			Down
euro	up			Up
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia	7.775%	8.250%	8.000%	Easing
Bank of Mexico	7.250%	7.000%	7.250%	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	$63.37	$63.31	0.09%	
WTI	$57.23	$57.04	0.33%	
Natural Gas	$2.70	$2.68	0.41%	Colder forecast
Crack Spread	$16.63	$16.48	0.94%	
12-mo strip crack	$19.74	$19.54	1.03%	
Ethanol rack	$1.43	$1.43	-0.22%	
Metals				
Gold	$1,260.72	$1,252.96	0.62%	Dovish Fed
Silver	$16.06	$15.89	1.07%	
Copper contract	$308.65	$307.25	0.46%	
Grains				
Corn contract	$ 349.00	$ 348.50	0.14%	
Wheat contract	$ 418.75	$ 418.25	0.12%	
Soybeans contract	$ 983.00	$ 978.75	0.43%	
Shipping				
Baltic Dry Freight	1668	1730	-62	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.1	-2.9	-2.2	
Gasoline (mb)	5.7	2.0	3.7	
Distillates (mb)	-1.4	1.0	-2.4	
Refinery run rates (%)	-0.40%	0.00%	-0.4%	
Natural gas (bcf)	-69.0	-56.0	-13	

Weather

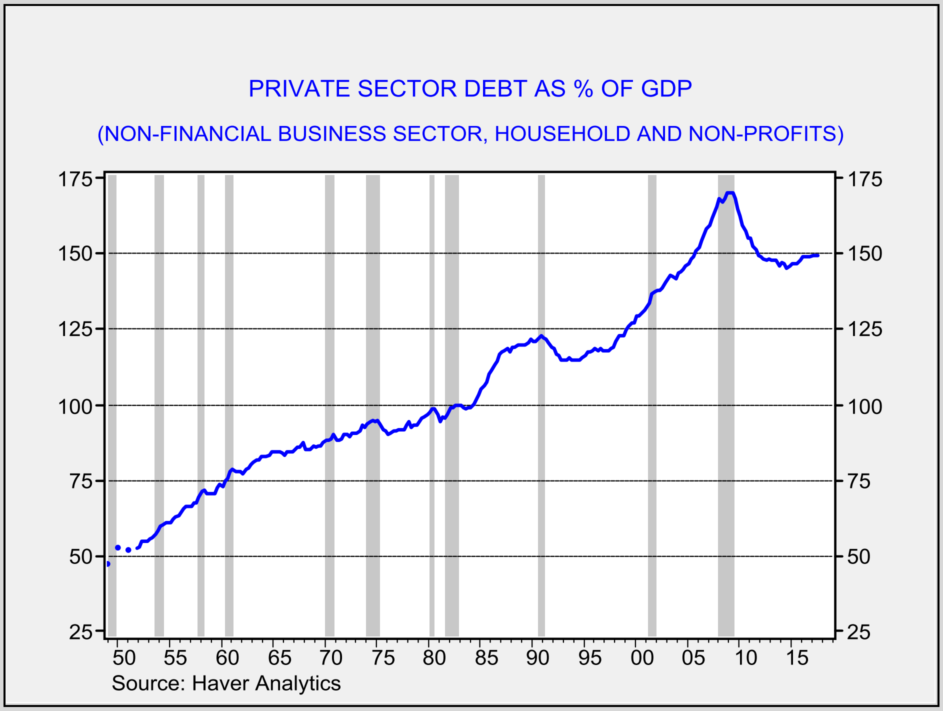
The 6-10 and 8-14 day forecasts are calling for a definitive cooling trend that should last into New Year's.

<u>Asset Allocation Weekly Comment</u>

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.

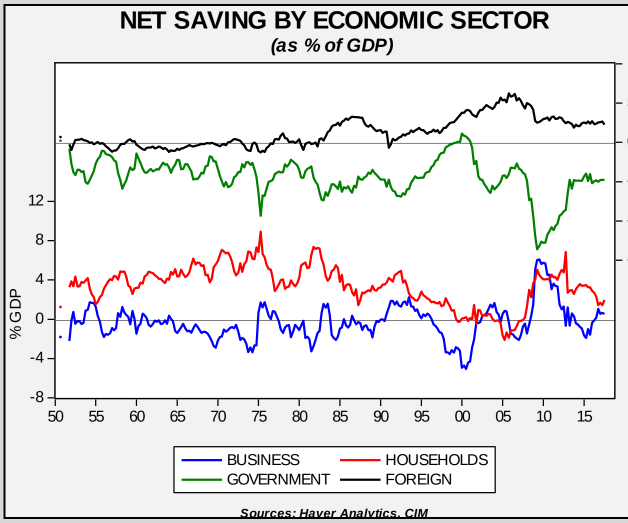
December 15, 2017

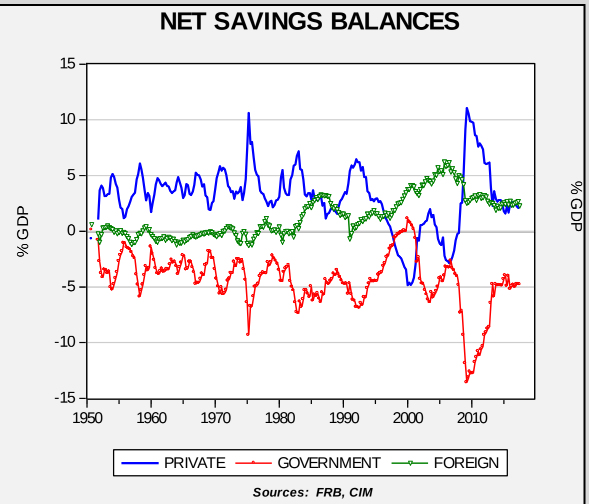
Last week, the Federal Reserve released its Financial Accounts of the United States, formerly called the Flow of Funds report. It is a broad set of data that covers many aspects of the economy. Here we present some key charts from the report.



This chart shows key private sector debt as a percentage of GDP. We exclude the financial sector to avoid double counting. We consider private sector debt more important to the economy for two reasons. First, business sector investment is funded with debt and household sentiment is also tied to debt. Leverage will boost growth, while deleveraging weighs on growth. The other important factor is that private sector debt has different capacity constraints than public sector debt. Private sector debt has to be serviced from income or revenue; the private sector cannot print its own money to service its debt. The public sector can not only print money to service its debt, but it can use coercion to force compliance. That is why government debt is a profoundly different risk to the economy; a large deficit is mostly an inflation risk, not a default risk. When the private sector deleverages, it must either write down the debt (harming creditors) or create increased saving (harming debtors). The current expansion is long in duration but growth has lagged previous growth periods in part because of deleveraging. The above data suggests that the private sector has mostly stopped reducing debt relative to the economy but isn't releveraging, which would tend to increase growth.

The other chart we closely watch is net saving by sector.

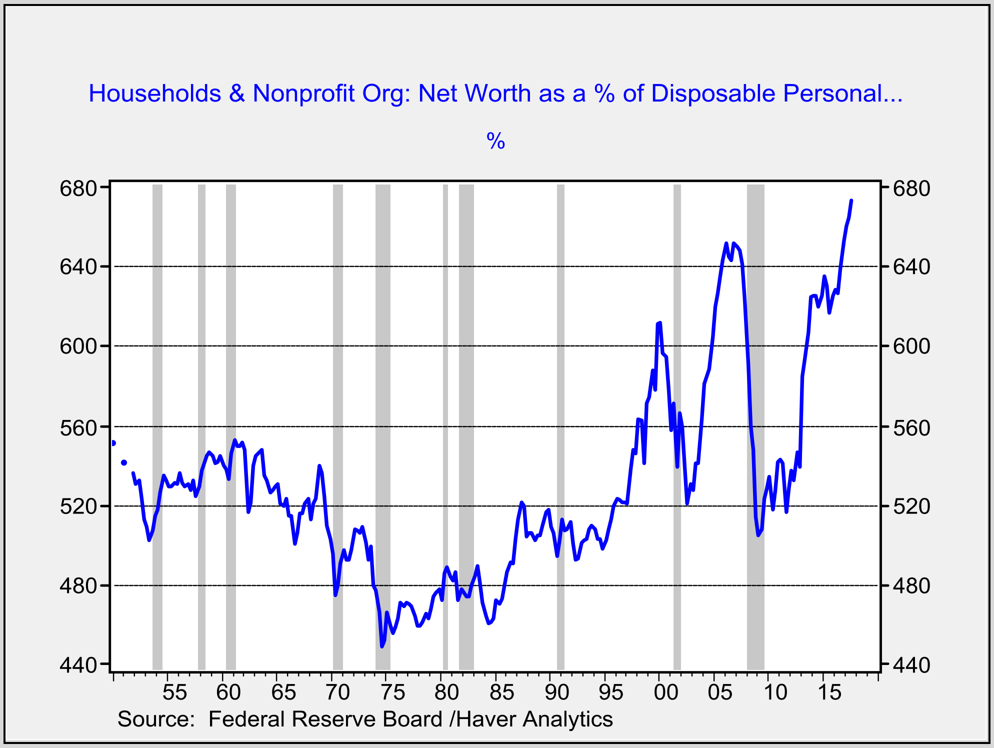




The chart on the left shows net saving by the four sectors of the economy—business, households (which represent the domestic private sector), government and the foreign sector. They have been scaled to GDP. Business saving is revenue less investment. Household saving is income less consumption. The government sector is the fiscal balance and foreign saving is the inverse of the current account. For macroeconomic accounting, the four act like a balance sheet—the net sum always equals zero. For the past few quarters, saving by sector has been mostly steady. The combination of domestic private sector saving and foreign saving has been balancing the government's deficit. That is best observed on the chart on the right side.

One of the less discussed ramifications of the current tax bill is that it is expected to raise the government's deficit; in other words, government dissaving must rise. This must be offset by either rising domestic private sector saving or foreign saving (in other words, a rising trade deficit). One of the other policy goals of the Trump administration is to lower the trade deficit but the tax bill may actually foster a wider deficit. At the same time, if the administration meets that goal, domestic private sector inflation must rise. If it is to come from the business sector, investment must fall without a significant rise in business revenue. Of course, rising business investment is a key goal of the tax bill. The other way saving could rise is from higher household saving, but that would likely come from lower consumption which would weaken growth. That's why getting a revenue-neutral tax bill was so important. If the tax bill were revenue-neutral and simply improved efficiency through tax reform, investment could rise and perhaps be funded without a drop in business saving due to higher revenue.

Finally, net worth of households has reached a new record high.

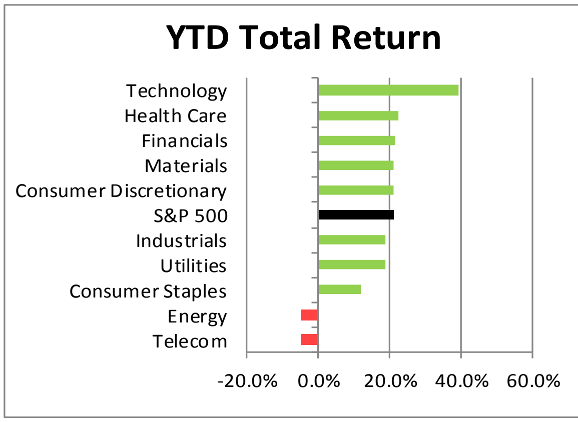


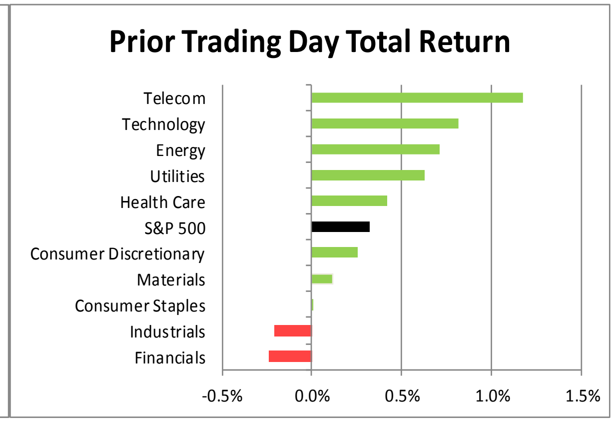
Household net worth is now 673.0% of after-tax income, a new record. The current level reflects rising equity markets and improved housing prices. The chart does indicate that this number tends to fall rather abruptly during recessions. As we noted in our 2018 Outlook, we do not expect a recession next year so this ratio probably has further to rise.

Overall, the Financial Accounts of the United States paints a picture of stability and slow healing. Saving and debt are stabilizing and net worth is rising. We will be watching how the tax bill affect this stability in the coming months.

Data Section

U.S. Equity Markets – (as of 12/14/2017 close)

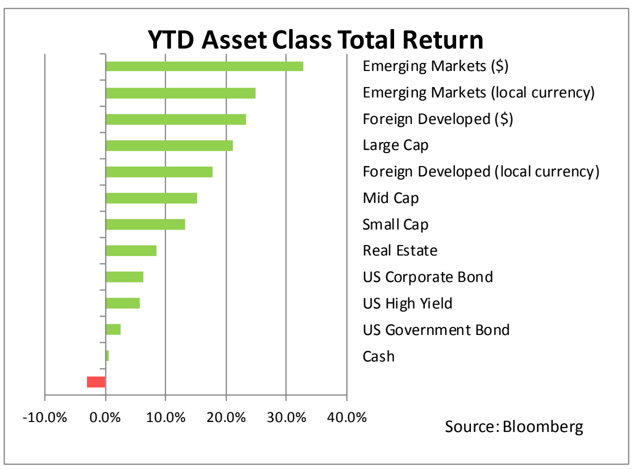




(Source: Bloomberg)

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 12/14/2017 close)

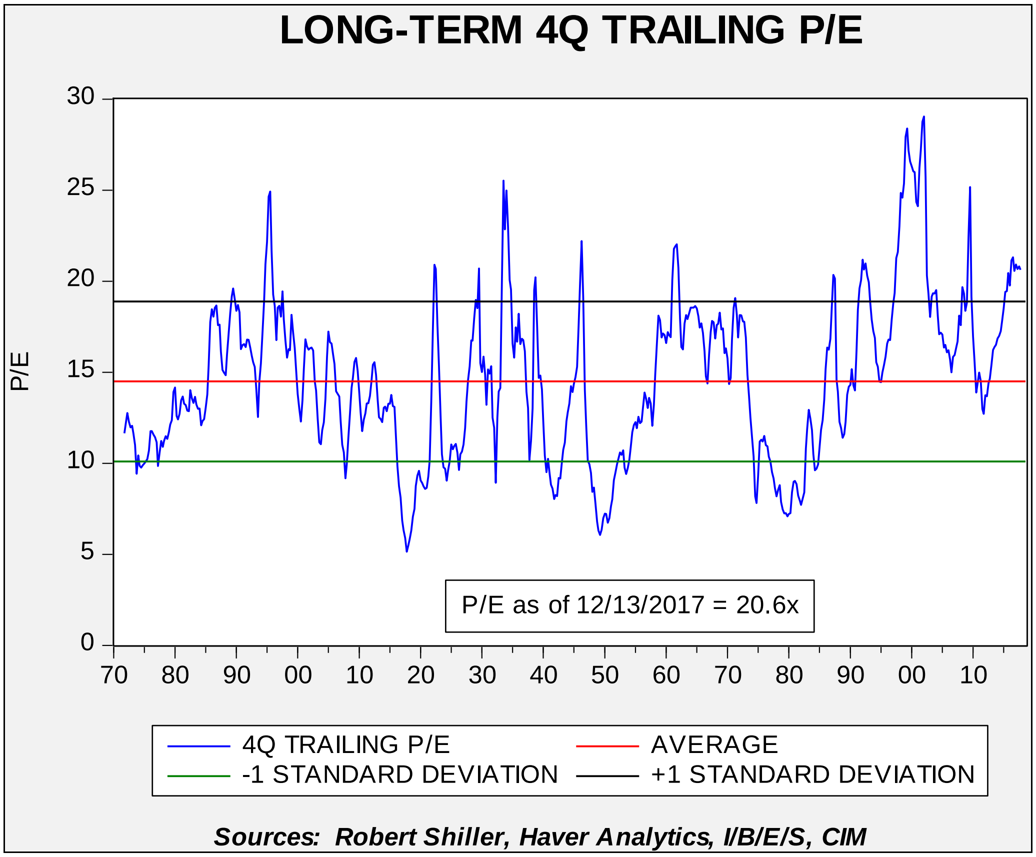


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2017



Based on our methodology,[3] the current P/E is 20.6x, up 0.1x from last week. The rise in the ratio is mostly due to the rise in the index.

---

[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.