Confluence Investment Management

Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 10, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.3% from the prior close. Chinese markets were up, with the Shanghai composite up 0.1% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a lower open. With 451 companies having reported, the S&P 500 Q3 earnings stand at $33.35, higher than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 73.4% of the companies reported earnings above forecast, while 18.0% reported earnings below forecast.

We are seeing further equity weakness this morning; interestingly, too, Treasury yields are rising. The asset market weakness doesn't appear to have a single cause, but rather a mix of factors has weakened investor sentiment. Here is what we are watching:

Who knew tax reform would be so hard? Although analysts persistently warned that tax reform would be difficult, investors seemed to be quite sanguine about the potential for change. The House and Senate have issued their bills and it's hard to see a path to compromise. The Senate wants to delay implementing the corporate tax changes for a year, which will infuriate the White House. After all, no president has an interest in boosting future growth which may only benefit a successor. In addition to that major discrepancy, the marginal rate structure is vastly different. And, the Senate bill does less to "broaden the base" by reducing tax expenditures. Given the political situation, the Senate bill will tend to be the blueprint because it will be much more difficult to move the bill through that body than the House. We have had strong doubts that a tax reform bill would get passed during this administration. Our position remains the same. It should also be noted that there will be winners and losers if a bill does get passed. Those hurt may be exactly the kind of households that would usually support Republicans.[1]

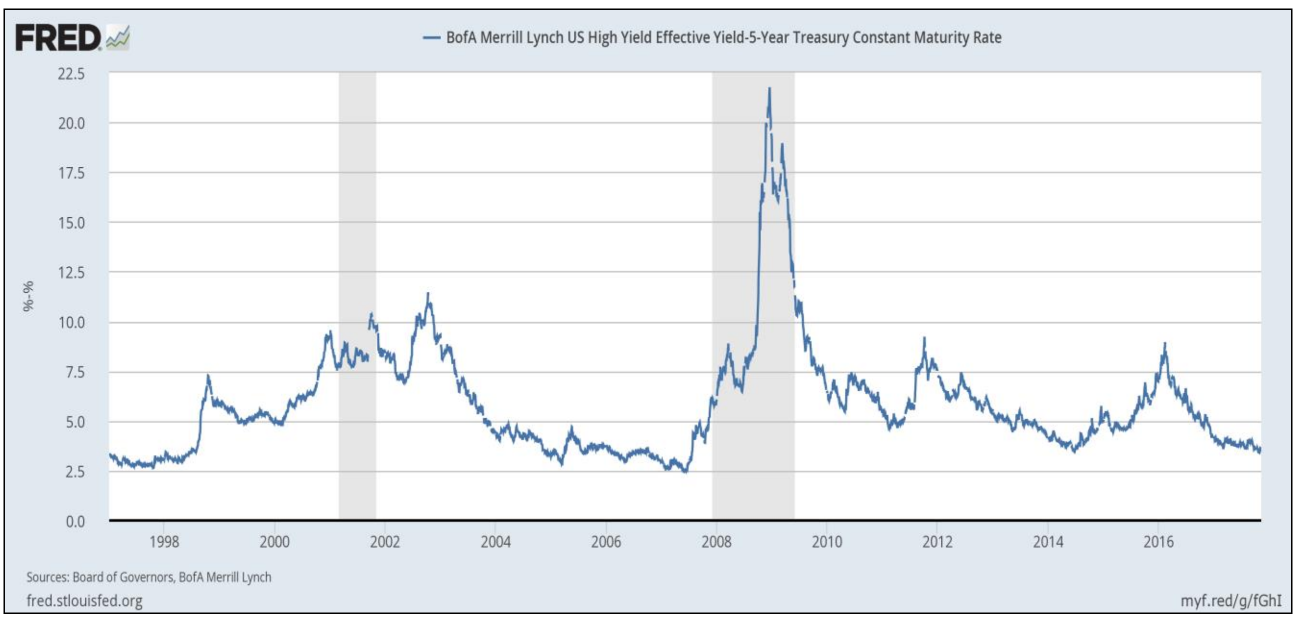
The populist president: President Trump gave an anti-trade speech in Asia overnight, bookended by President Xi offering a robust defense of globalization. The cover of this week's *Economist* is all about the U.S. stepping back from the world. This is a situation we have been discussing (and warning about) for the past eight years. Although there are lots of brave voices suggesting globalization can continue without the U.S., if it does, it won't look like the last century's globalization with the U.S. providing global security and the reserve currency for "free" to the world. Instead, we expect either an 18th century sort of colonization (the Eurozone as Germany's commonwealth, the "one belt, one road" as China's colonial drive) or a regionalization of power with no global power in place. At some point, financial markets will

[1] https://www.washingtonpost.com/business/economy/i-dont-feel-wealthy-the-upper-middle-class-is-worried-about-paying-for-the-tax-overhaul/2017/11/09/a5cf1acc-c55e-11e7-aae0-cb18a8c29c65_story.html?utm_term=.dfb78c5a42bd&wpisrc=nl_todayworld&wpmm=1

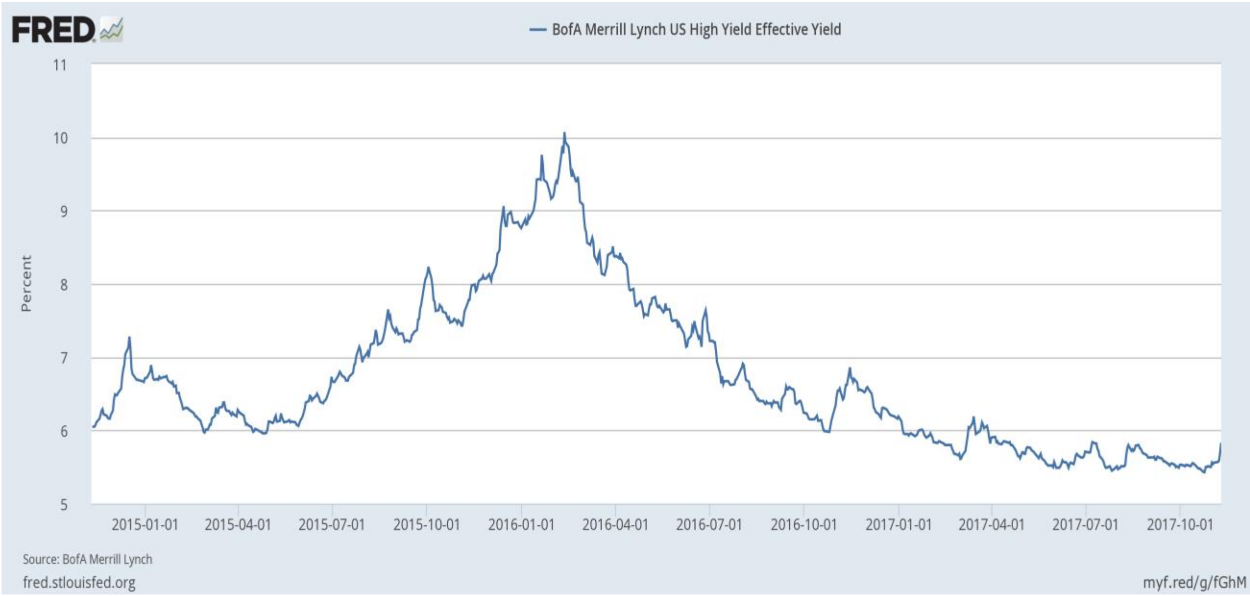
realize that a deglobalized world will not be good for business. Although we doubt this is the precise moment, the financial markets have mostly been ignoring the anti-trade, anti-immigrant policies of this administration. Perhaps some of that is being priced in.

The Roy Moore situation: Although we doubt the travails of Mr. Moore are significant to today's weakness, we see one important takeaway. The scandal and the reaction show, in bright lines, the split within the GOP. When the Senate majority leader calls on a candidate to withdraw from a race in a solid Republican state, it begs the question…what kind of relationship will the party leadership have with him if he wins the special election? The election will be held on December 12. Given the polarized nature of the electorate, unless further evidence emerges, we expect Moore to win. Predictit still gives him a 55% chance of winning; that is down from 60% but still looks rather safe. But, for McConnell, how reliable of a vote will Moore be going forward? Our position is that the underlying coalitions of both parties are in flux but they become much more apparent for the party in power because it has to govern. The ACA debacle and now the issue with tax reform are laying bare these divisions with the GOP. The Roy Moore situation does, too.

Junk takes a hit: High yield bonds have come under pressure in the past few days, mostly on disappointing earnings from firms that issue these instruments. Spreads have been narrowing for some time.



This chart shows the spread of high yield to the five-year Treasury. Note that the spread is in the lower range of history.



The rise in yields is seen at the right side of the graph. Will this continue? A move toward 6% would not be a shock, but to sustain rates higher than that level would require a rise in financial stress. So far, there isn't much evidence that stress is rising.

Don't forget December 8! On December 8, the borrowing capacity of the Treasury will be exhausted and a new debt limit will be required. Given that tax legislation is dominating the debate, Congress will scramble to make a deal to lift the debt ceiling; look for Democrat Party leaders to leverage this moment for their goals.

And, on other items:

China opens: In a surprise move, China announced today it will allow foreigners to purchase a majority stake in Chinese financial firms. This is a shocker, although in reality it will have less impact than it should. While there may be some interest from foreign firms in directly accessing the Chinese financial system, there is no consistent rule of law in China. A foreign firm could find itself the majority owner of a bank that the government forces to do things it doesn't want to do. So, optically, this is a big deal, but it won't have much effect if it isn't accompanied by a consistent regulatory environment.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	nov	100.9	100.7	**
10:00	U. of Michigan Current Conditions	m/m	nov	116.3	116.5	**
10:00	U. of Michigan Expectations	m/m	nov	91.0	90.5	**
10:00	U. of Michigan 1 yr Inflation	m/m	nov		2.4%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	nov		2.5%	**
Fed speakers or events						
EST	Speaker or event	District or position				
19:10	Patrick Harker Speaks in Tokyo on Balance Sheet Unwind	President of the Federal Reserve Bank of Philadelphia				

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	Money Stock M2	m/m	oct	4.1%	4.1%	4.1%	**	Equity and bond neutral
	Money Stock M3	m/m	oct	3.5%	3.4%	3.4%	**	Equity and bond neutral
	Tertiary Industry Industry	m/m	sep	-0.2%	-0.2%	-0.1%	**	Equity and bond neutral
India	Industrial Production	m/m	sep	3.8%	4.3%	3.8%	***	Equity and bond neutral
New Zealand	Card Spending Retail	m/m	oct	0.3%	0.1%	0.5%	**	Equity and bond neutral
	Card Spending Total	m/m	oct	0.4%	-0.1%		**	Equity and bond neutral
EUROPE								
France	Industrial Production	y/y	sep	3.2%	1.1%	3.1%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	sep	3.1%	1.1%	3.4%	**	Equity and bond neutral
	Wages	y/y	sep	0.3%	0.4%	0.3%	**	Equity and bond neutral
	Private Sector Payrolls	q/q	oct	0.2%	0.4%	0.3%	**	Equity and bond neutral
Italy	Industrial Production	y/y	sep	-1.3%	1.2%	-0.3%	***	Equity bearish, bond bullish
UK	Industrial Production	m/m	sep	2.5%	1.6%	1.9%	***	Equity bullish, bond bearish
	Manufacturing Production	m/m	sep	2.7%	2.8%	2.4%	**	Equity bullish, bond bearish
	Construction Output	m/m	sep	1.1%	3.5%	1.7%	**	Equity bearish, bond bullish
	Trade Balance	m/m	sep	-2754	-5626	-4300	**	Equity and bond neutral
Russia	Money Supply Narrow Def	m/m	nov	9.27 tn	9.25 tn		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	oct	6.4%	6.4%	6.3%	***	Equity and bond neutral
	CPI Core	m/m	oct	0.3%	0.3%	0.2%	***	Equity and bond neutral
Canada	New Housing Price Index	y/y	sep	3.8%	3.8%	3.8%	**	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)	141	140	1	Up
3-mo T-bill yield (bps)	121	121	0	Neutral
TED spread (bps)	20	20	0	Neutral
U.S. Libor/OIS spread (bps)	131	131	0	Up
10-yr T-note (%)	2.37	2.34	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	45	45	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	up			Up
yen	up			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action		**Prior**	**Expected**	
Overnight Rate	7.000%	7.000%	7.000%	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	$63.93	$63.93	0.00%	
WTI	$57.11	$57.17	-0.10%	
Natural Gas	$3.20	$3.20	-0.06%	
Crack Spread	$21.02	$21.04	-0.07%	
12-mo strip crack	$21.50	$21.54	-0.20%	
Ethanol rack	$1.55	$1.55	-0.05%	
Metals				
Gold	$1,284.79	$1,285.07	-0.02%	
Silver	$17.04	$17.00	0.21%	
Copper contract	$308.95	$308.60	0.11%	
Grains				
Corn contract	$ 341.25	$ 341.50	-0.07%	
Wheat contract	$ 428.00	$ 429.00	-0.23%	
Soybeans contract	$ 984.50	$ 985.00	-0.05%	
Shipping				
Baltic Dry Freight	1481	1486	-5	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.2	-2.5	4.7	
Gasoline (mb)	-3.3	-2.0	-1.4	
Distillates (mb)	-3.4	-1.2	-2.2	
Refinery run rates (%)	1.50%	0.45%	1.05%	
Natural gas (bcf)	14.0	17.0	-3.0	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country.

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.

November 10, 2017

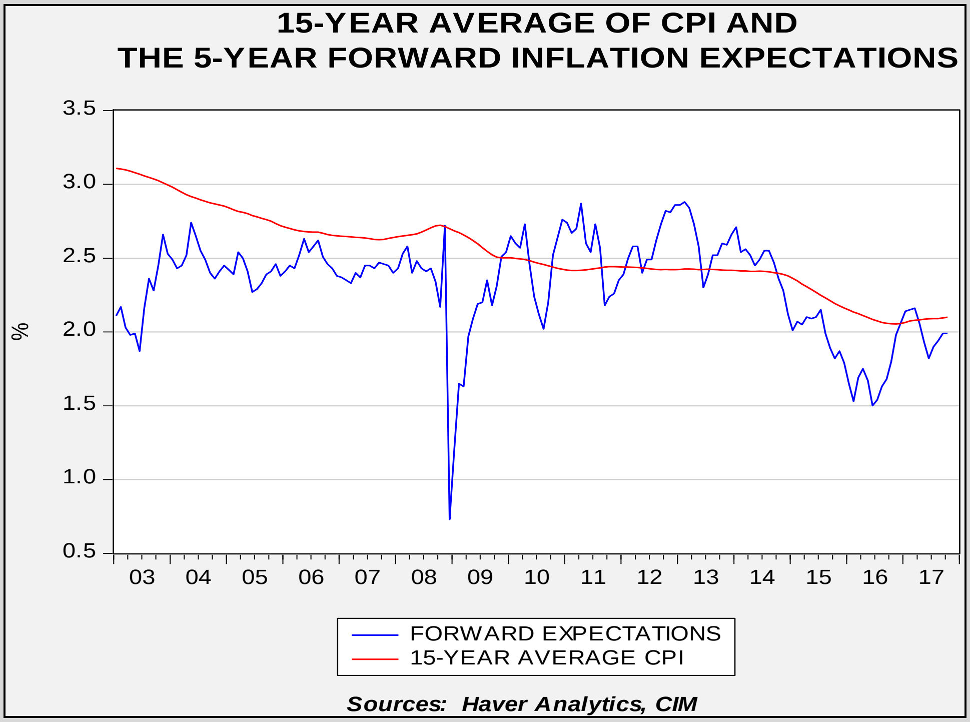
Last week, we discussed our views of the debt markets. However, one item we didn't examine was the dynamics of the yield curve. The U.S. Treasury market has both a domestic and an international component. While all sovereign debt markets have a domestic component, the international component is especially a factor for the U.S. because the dollar is the reserve currency. In our Treasury model, we use inflation expectations and fed funds for domestic elements. For foreign elements, we use the yen/dollar exchange rate, German bund yields and oil prices. Our model suggests that the dynamics of the yield curve are affected primarily by the domestic component.

Shifts in the yield curve are driven mostly by a combination of monetary policy and inflation expectations. As a general rule, short-duration instruments are more sensitive to monetary policy and less to inflation expectations. Long-duration instruments have the opposite characteristics. When we model the two-year Treasury and the 10-year Treasury, these characteristics are confirmed.

	2-Year	10-Year
Constant	-0.381	-0.576
Inflation	0.235	0.503
Fed funds	0.672	0.321
¥/$	0.005	0.009
German Bunds	0.153	0.317
WTI	-0.005	0.005

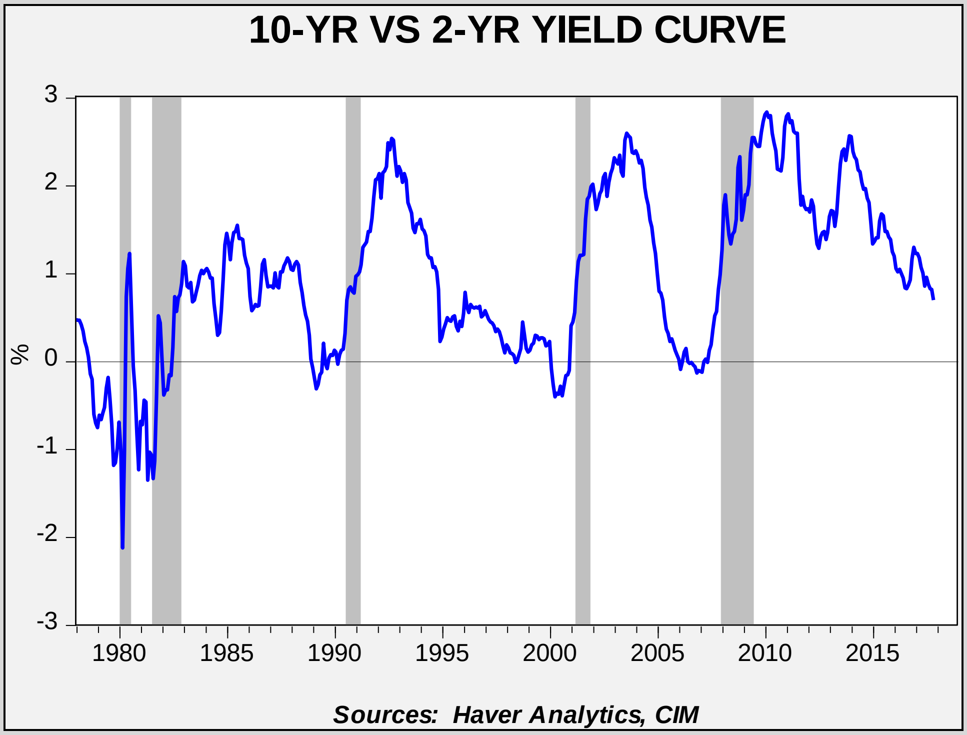
These are the coefficients of our Treasury model. The impact of the inflation variable has more than twice the impact on the 10-year Treasury compared to the two-year Treasury. At the same time, the impact of fed funds is more than twice as important to the two-year Treasury compared to the 10-year Treasury.

Our inflation variable is really about measuring inflation expectations. We use the 15-year moving average of the yearly change in CPI and developed this variable based on Milton Friedman's research. He postulated that inflation expectations are formed over a long period of time. This is our proxy for inflation expectations; although this moving average works reasonably well over time, we do realize that inflation expectations can have sudden shifts.



This chart shows the 15-year average of inflation compared to the implied five-year forward inflation rate from TIPS. Although the moving average isn't a perfect proxy for inflation expectations, it has worked as a measure of central tendency since 2009. And, since the instruments haven't been around for very long, it's difficult to know how the average compares over a longer time frame. But, for our purposes, it is a workable proxy.

When inflation expectations become volatile, policymakers describe these conditions as times when inflation expectations become "unanchored." These periods can make the conduct of monetary policy difficult. If inflation expectations rise, policymakers are likely to raise rates aggressively to contain those fears. At the same time, a decline in expectations can be just as problematic. If the FOMC is raising the target for fed funds while inflation expectations are falling, the yield curve will flatten. The FOMC would generally prefer a steeper yield curve. The Federal Reserve doesn't do a good job of explaining why it wants "higher inflation," which would seem to be a goal worth avoiding. What it really means is that it wants steady to modestly higher inflation expectations when it is raising the policy rate; otherwise, the yield curve will flatten and increase the likelihood of a recession.

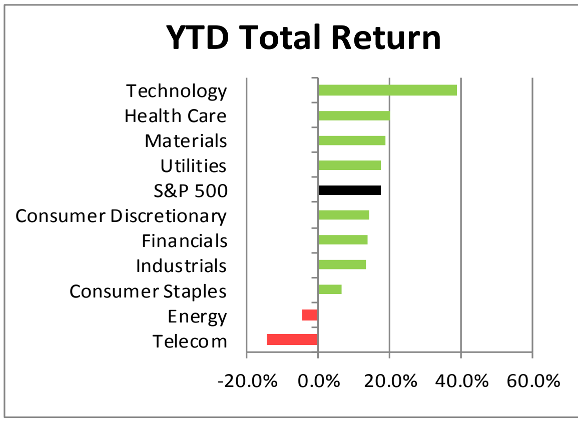


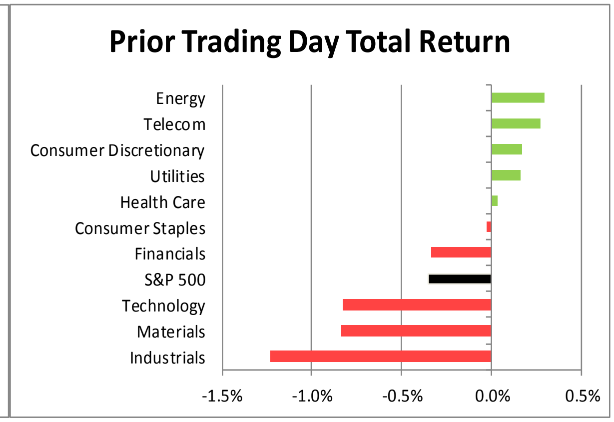
Currently, the two-year versus 10-year Treasury yield spread is above zero but the curve is clearly flattening. If the FOMC continues to tighten into stable (or perhaps falling) inflation expectations, the yield curve could invert and perhaps signal the end of this long business expansion.

The recent flattening of the yield curve suggests that inflation expectations are probably declining. If the Federal Reserve raises rates as much as planned and inflation expectations remain anchored at around 2%, we estimate the yield curve will fall under 50 bps. However, if inflation expectations decline, policymakers could overshoot rate hikes and increase the risk of recession. Our base case is that central bankers will remain cautious but it is a factor we will be watching closely next year, especially as the new composition of the Fed's Board of Governors becomes apparent.

Data Section

U.S. Equity Markets – (as of 11/9/2017 close)

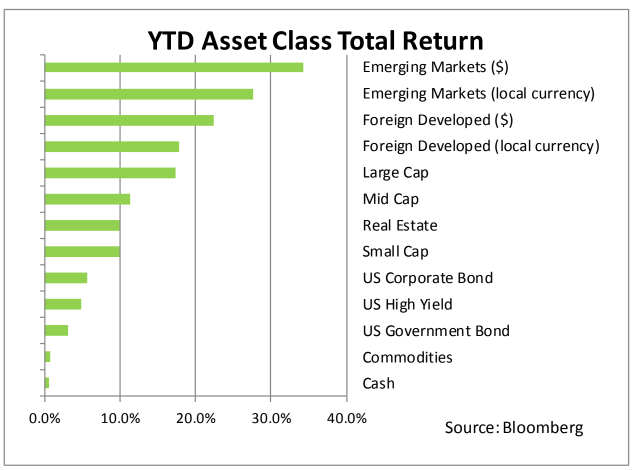




(Source: Bloomberg)

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 11/9/2017 close)

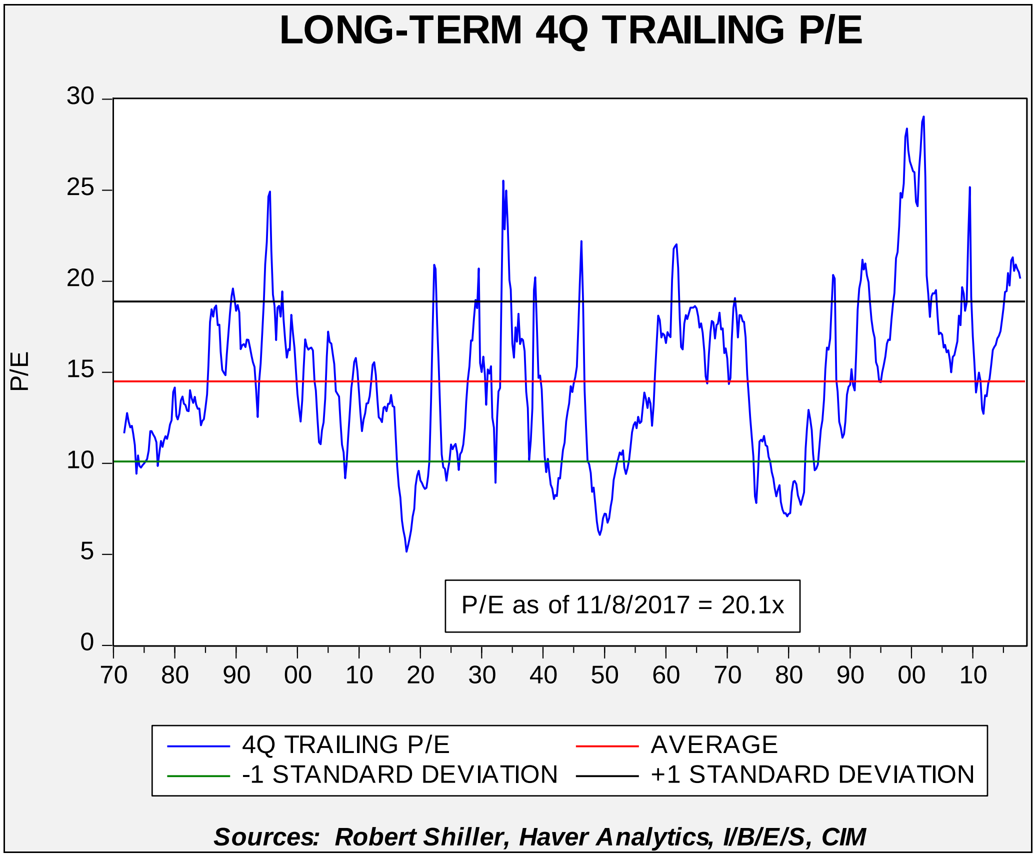


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2017



Based on our methodology,[2] the current P/E is 20.1x, down 0.1x from last week. Rising earnings offset the lift in the S&P, causing the modest decline in the P/E this week.

[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 two actual quarters (Q1 and Q2) and two estimates (Q3 and 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.