Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 14, 2017—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 1.0%. U.S. equity index futures are signaling a lower open. With 458 companies having reported, the S&P 500 Q3 earnings stand at $33.37, higher than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 73.6% of the companies reported earnings above forecast, while 17.9% reported earnings below forecast.

It was a very quiet overnight session. Better Eurozone growth has lifted the EUR, while global equity markets continue to struggle in what looks to us like profit taking. PPI (see below) did come in higher than forecast; shorter duration Treasury yields rose. Here is what we are watching this morning:

May will allow Parliament to have a say on Brexit: Initially, PM May was not going to allow MPs to add amendments to the Brexit bill. However, in her politically weakened position she has bowed to pressure, primarily from pro-EU MPs, to have a full vote and allow amendments to be voted on as well. It isn't clear how this will play out. Although the May government insists the vote can't halt Brexit, it does seem possible that Parliament could scuttle Brexit. May's plan is to offer two separate bills, one that is an actual vote on Brexit and another that votes on the specifics of the process, with the hopes that party discipline will ensure Brexit occurs and then allow "meaningful but essentially meaningless" votes on the second bill. If May had a strong majority government and Tories feared her, this would probably work. However, this isn't the case. If Parliament votes to defeat the Brexit bill, it isn't obvious what would happen. The EU is committed to the U.K.'s exit from the organization and Parliament's inability to pass a bill shouldn't prevent the EU from expelling Britain. The exit was officially triggered last year. Brexit without a plan leads to a chaotic situation. On the other hand, we would not be shocked if Parliament blocks Brexit and the EU (read: Merkel) allows the U.K. to stay in the EU fold. In any case, this is turning into a mess; at the same time, the GBP would likely soar if the U.K. ends up staying in the EU.

Venezuela in default: S&P has confirmed that Venezuela missed two interest payments within the 30-day grace period on its sovereign debt, on issues maturing in 2019 and 2024. This rating agency is the first to declare the nation in default. The rating on these two particular bonds is now "D," down from "CC," and the long-term foreign currency sovereign credit rating is now "SD," or selective default, down from "CC." Although Venezuela's default was really just a matter of time, there isn't an obvious path of restructuring. We will be closely watching how Caracas handles its debt to China; we suspect it will default on that debt last, but eventually it will likely default on that debt, too. Complicating matters for bondholders is that Venezuela does have assets outside the country that could be seized by creditors (CITGO, for example). We do note that the International Swaps and Derivatives Association has delayed a decision on default; if this group agrees with S&P, it would likely trigger the payment of credit default swaps.

Another governor? There are reports the president is considering nominating Michelle Bowman, a state bank commissioner from Kansas. She was formerly a banker with Farmers and Drovers[1] Bank in Council Grove, KS, with about seven years of banking and bank regulatory experience. She has a BA from Kansas University[2] and a JD from Washburn University in Topeka, KS. She does have rather extensive experience in Washington. She worked with Sen. Dole and was counsel to the House Committee on Transportation and Infrastructure and the Committee on Government Reform and Oversight. She was also attached to FEMA and was deputy assistant to Homeland Security Secretary Tom Ridge. One of the governor slots is reserved for a community banker; it has been difficult to fill this position because state regulators are usually not well liked by bankers and most community bankers don't want to leave their posts for a government job. Although her banking experience is a bit light, her Washington experience will probably allow her to be easily confirmed. Historically, this position tends to vote with the chair and its primary contribution is to offer "ground level" information from the small banking sector to the FOMC.

IEA bullish on shale: In its most recent report, the IEA projects strong shale growth in the U.S., leading to total liquids production of 13 mbpd by 2025. The Paris-based group projects that the U.S. will account for 80% of the increase in global oil and liquids supply over that time frame. Interestingly enough, recent reports from the maturing oil shale fields in Texas paint a much less favorable supply story. The EIA (the U.S. data arm of the DOE) says that December U.S. shale production will rise to 6.1 mbpd, a new high. However, the EIA also reports that the legacy decline rate has reached 83.3%, meaning that 83.3% of gross new production is offsetting declines in older wells. In May, this number was 70.5, indicating that production growth is slowing. Industry reports suggest that increasing proppants and longer well laterals in the Permian basin aren't boosting output. The bottom line is that macro energy analysis appears to be holding that growth will continue at almost a linear pace, whereas the micro reports suggest that if such growth is going to occur it will likely require higher prices.

U.S. Economic Releases

NFIB small business optimism came in below expectations at 103.8 compared to the forecast of 104.0.

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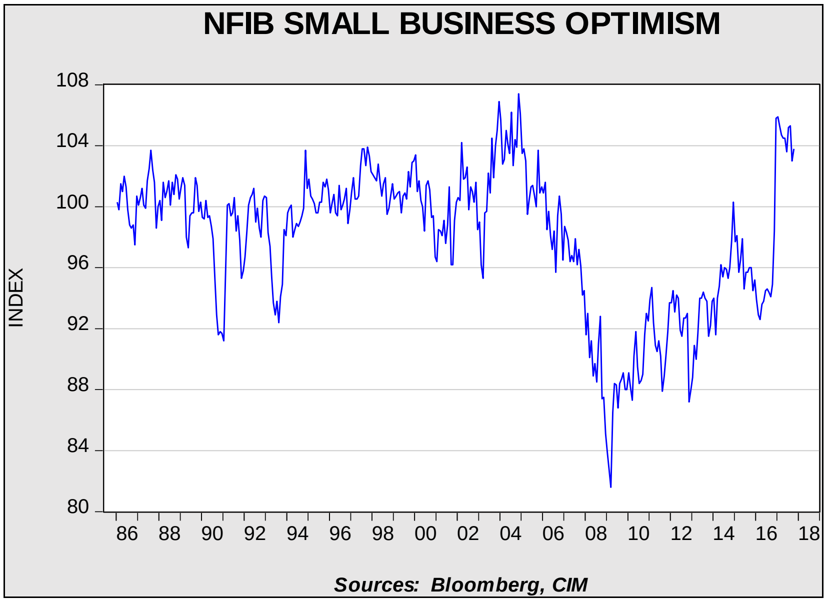
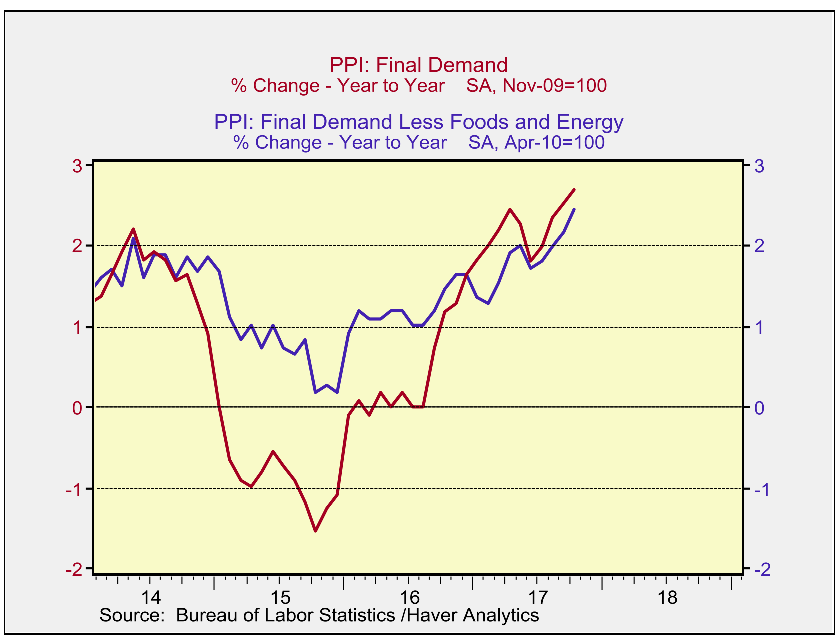
[1] A drover is a person who moves animals over long distances.

[2] Go Jayhawks!



Small business optimism remains elevated.

PPI final demand came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.1%. PPI excluding food and energy rose by 0.4% from the prior month compared to the forecast gain of 0.2%. Core PPI came in line with forecasts, rising 0.2% from the prior month.



The chart above shows the relationship between PPI final demand and PPI excluding food and energy. Annually, headline PPI and PPI excluding food and energy rose 2.8% and 2.4%, respectively. We note the relationship of PPI to CPI isn't all that strong so the impact on overall inflation is not significant.

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
13:05	Raphael Bostic Speaks on Economic Outlook	President of the Federal Reserve Bank of Atlanta

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	Fixed Assets Ex Rural	y/y	oct	7.3%	7.5%	7.3%	**	Equity and bond neutral
	Retail Sales	y/y	oct	10.0%	10.3%	10.5%	***	Equity bearish, bond bullish
	Foreign Direct Investment	y/y	oct	5.0%	17.3%		**	Equity and bond neutral
	Industrial Production	y/y	oct	6.7%	6.7%	6.7%	***	Equity and bond neutral
India	Wholesale Prices	m/m	oct	3.6%	2.6%	3.0%	**	Equity bullish, bond bearish
	Trade Balance	m/m	oct	-14.018 bn	-8.984 bn	-10.500 bn	**	Equity bearish, bond bullish
	Exports	m/m	sep	-1.1%	25.7%		**	Equity and bond neutral
	Imports	m/m	sep	7.6%	18.1%		***	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	oct	114.8	112.6		**	Equity and bond neutral
	NAB Business Conditions	m/m	oct	21	14		**	Equity and bond neutral
	NAB Business Confidence	m/m	oct	8	7		**	Equity and bond neutral
EUROPE								
Europe	Industrial Production	y/y	sep	3.3%	3.8%	3.2%	***	Equity and bond neutral
	ZEW Survey Expectations	y/y	nov	30.9	26.7		**	Equity and bond neutral
	GDP	y/y	3q	2.5%	2.5%	2.5%	***	Equity and bond neutral
Germany	GDP	q/q	3q	2.3%	0.8%	2.0%	***	Equity bullish, bond bearish
	CPI	y/y	oct	1.6%	1.6%	1.6%	***	Equity and bond neutral
	ZEW Current Sitaution	m/m	nov	88.8	87.0	88.0	**	Equity bullish, bond bearish
	ZEW Current Expectations	m/m	nov	18.7	17.6	19.5	**	Equity and bond neutral
Italy	GDP	m/m	sep	1.8%	1.5%	1.7%	**	Equity bullish, bond bearish
	CPI	m/m	sep	1.1%	1.1%	1.1%	**	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	oct	6.4%	3.6%	5.9%	**	Equity bullish, bond bearish

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	141	0	Up
3-mo T-bill yield (bps)	121	121	0	Neutral
TED spread (bps)	20	20	0	Neutral
U.S. Libor/OIS spread (bps)	132	131	1	Up
10-yr T-note (%)	2.39	2.41	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	49	49	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Neutral
pound	down			Neutral
franc	up			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	$62.85	$63.16	-0.49%	
WTI	$56.51	$56.76	-0.44%	
Natural Gas	$3.12	$3.17	-1.64%	
Crack Spread	$20.28	$20.49	-1.04%	
12-mo strip crack	$21.16	$21.32	-0.72%	
Ethanol rack	$1.55	$1.56	-0.13%	
Metals				
Gold	$1,275.31	$1,278.31	-0.23%	
Silver	$16.98	$17.06	-0.46%	
Copper contract	$310.65	$311.65	-0.32%	
Grains				
Corn contract	$ 341.75	$ 342.25	-0.15%	
Wheat contract	$ 441.25	$ 443.25	-0.45%	
Soybeans contract	$ 975.25	$ 974.25	0.10%	
Shipping				
Baltic Dry Freight	1445	1464	-19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.2		
Gasoline (mb)		-1.5		
Distillates (mb)		-1.8		
Refinery run rates (%)		0.50%		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country, with cooler temps on the East Coast.

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

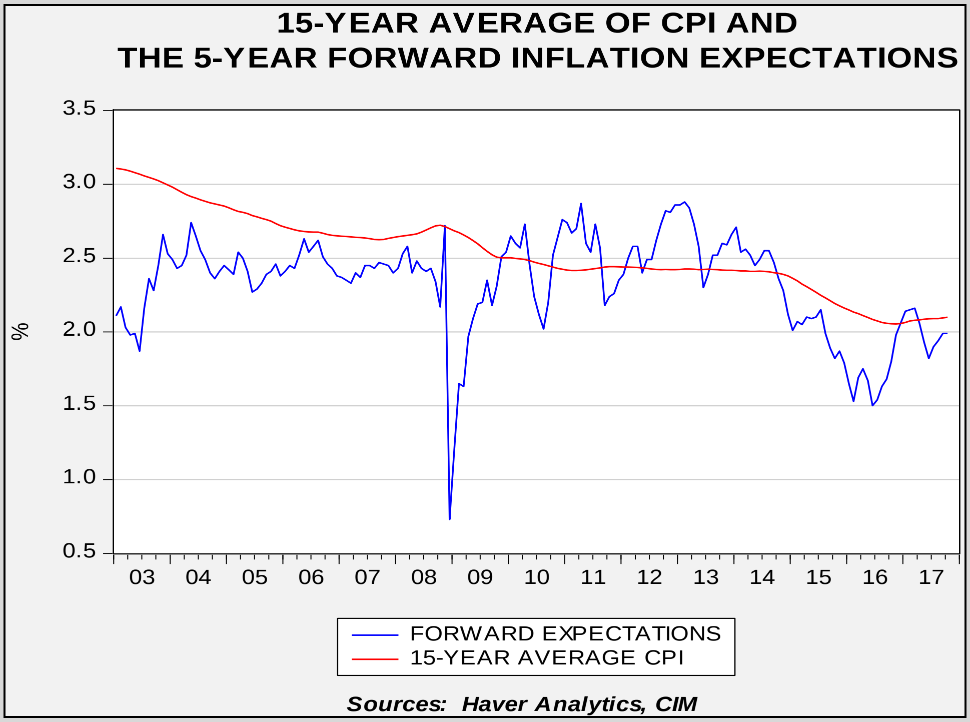
Last week, we discussed our views of the debt markets. However, one item we didn't examine was the dynamics of the yield curve. The U.S. Treasury market has both a domestic and an international component. While all sovereign debt markets have a domestic component, the international component is especially 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

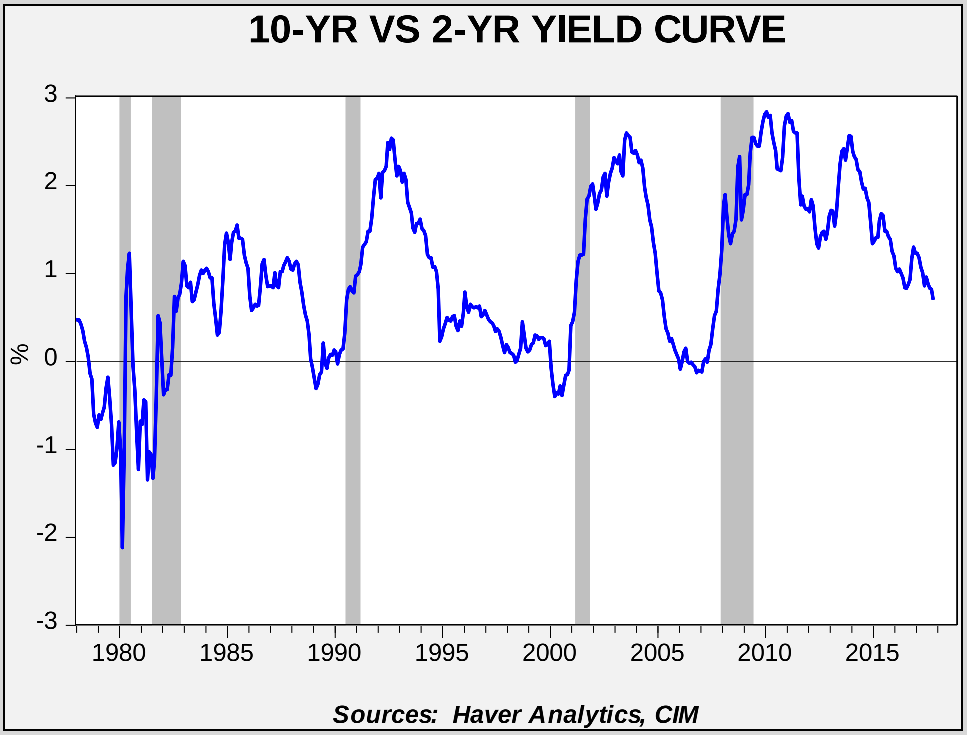
These are the coefficients of our Treasury model. The impact of the inflation variable has more than twice the impact on the 10-year Treasury compared to the two-year Treasury. At the same time, the impact of fed funds is more than twice as important to the two-year Treasury compared to the 10-year Treasury.

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.



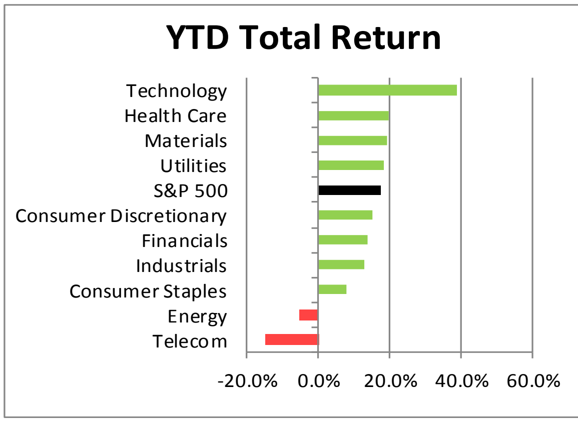
Currently, the two-year versus 10-year Treasury yield spread is above zero but the curve is clearly flattening. If the FOMC continues to tighten into stable (or perhaps falling) inflation expectations, the yield curve could invert and perhaps signal the end of this long business expansion.

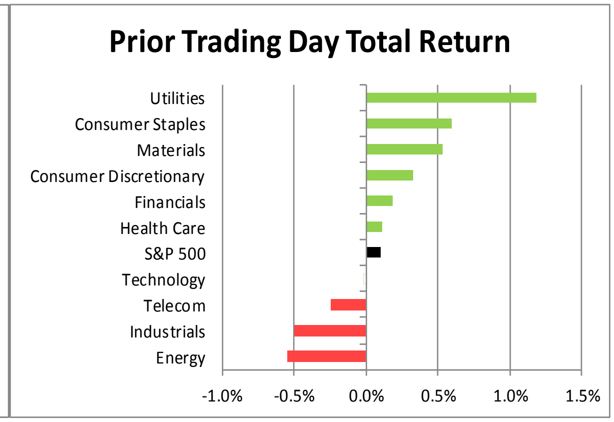
The recent flattening of the yield curve suggests that inflation expectations are probably declining. If the Federal Reserve raises rates as much as planned and inflation expectations remain anchored at around 2%, we estimate the yield curve will fall under 50 bps. However, if inflation expectations 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.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 11/13/2017 close)

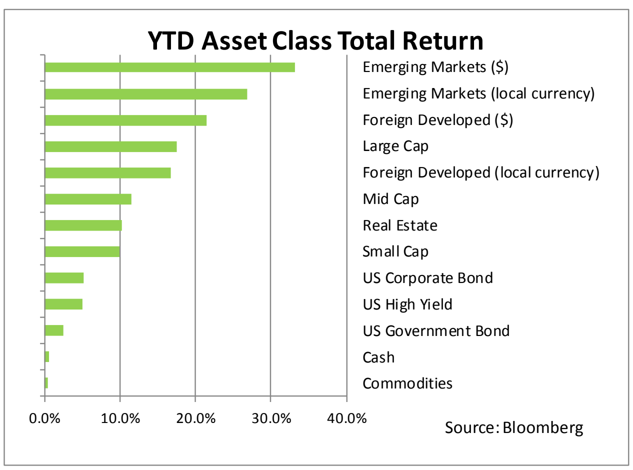




(Source: Bloomberg)

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 11/13/2017 close)

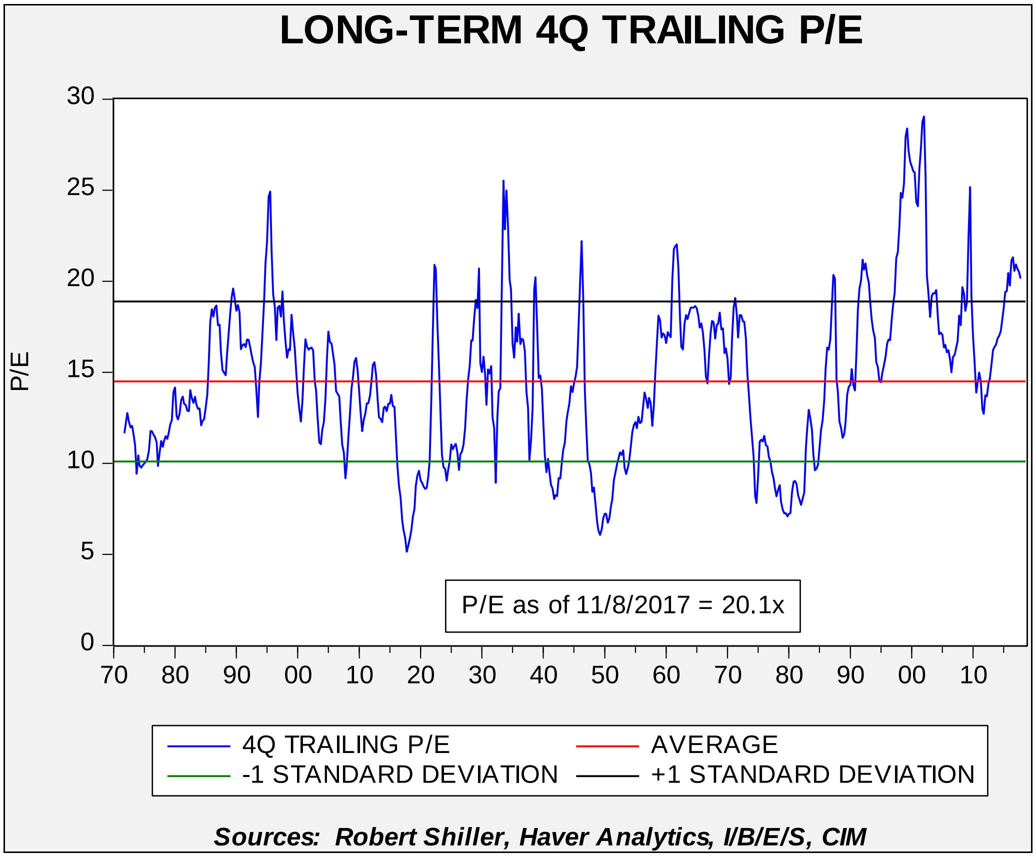


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

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 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.