Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 21, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.7% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 0.8%. U.S. equity index futures are signaling a higher open.

Happy Thanksgiving week! We want to pass along a heads up that the Daily Comment will not be published this Friday, November 24. Although financial markets are quiet, there was a good bit of news. Here's what we are watching:

Merkel leans toward new elections: Yesterday, we laid out the four options for Germany, suggesting that new elections were the least market-friendly because this outcome raises uncertainty. Increasingly, it looks like Merkel is leaning toward new elections, unwilling to ask the SDP to join a grand coalition or form a minority government. Senior leaders within the CDU/CSU are giving the parties three weeks to form a government but are putting increasing pressure on the SDP to change its position. There are two reasons the SDP is reluctant to join Merkel to form a government. First, voters across Europe are shunning center-left parties for ignoring the needs of lower income citizens and opting for more market-friendly policies. The SDP took a drubbing in the polls and fears that joining Merkel again could lead to the end of the SDP as a functioning political party. Second, joining Merkel would raise the status of the AfD by making it the official opposition. There are hints that the SDP will join the CDU/CSU on one condition—Merkel steps down from the chancellor position. This is why Merkel is instead willing to take a shot at another round of elections. One important issue to remember is that Merkel has had a tendency to destroy junior partners in coalitions. The Free Democrats slipped badly after joining Merkel from 2009 to 2013. As noted above, the SDP has had a similar experience. If talks finally fail, the German president will hold votes in the Bundestag for chancellor; the first two rounds of votes require a majority in order to become chancellor. A third vote is held if a majority isn't reached, giving the chancellor post to the highest vote winner, which will almost certainly be Merkel. At this point, either Merkel can operate a minority government, piecing together votes to pass various measures, or the president can declare the government too unstable and call for new elections. We may be seeing the end of Merkel's political career. Political tumult in Europe's largest economy will tend to weigh on EUR sentiment. It may help PM May get a better deal on Brexit and will open up the chance for Macron to boost France's status within the EU and the Eurozone.

North Korea a state sponsor of terrorism: President Trump officially labeled North Korea as a state sponsor of terrorism yesterday, joining Iran, Syria and Sudan with this designation. The DPRK was initially put on the list in 1988 after its agents detonated a bomb on Korean Air Flight 858 in 1987. President George W. Bush removed North Korea from the list in 2008 in an attempt to improve relations during nuclear negotiations. For the most part, this won't make a huge difference; North Korea is already heavily sanctioned and anything that comes from this change won't be material. It is a global shaming for the DPRK and may increase Chinese pressure on Pyongyang. After all, a rising global power doesn't want to be seen supporting a designated terrorist state. The move was also welcomed in South Korea and Japan, which live in fear of North Korean terrorist behavior. On a related note, Kim Jong-un is disciplining the leadership of the nation's most powerful military organization. Although there is no information suggesting a purge of the military's leadership, they are being "punished." We suspect two issues here. First, Kim wants to put his own people in place and has been steadily removing his father's cronies; this action may be part of that. Second, Kim's father had increased the power of the military over the civilian structures of the government, including the party. Kim may be deciding that he wants to reverse that program. We watch this because unexpected outcomes are possible any time important parts of the North Korean government come under pressure.

Yellen out: Although it isn't a huge surprise, Chair Yellen made it official, saying she would not serve out her term as Fed governor when she steps down as chair in February. Her governor term lasts until 2024. This move is precedent at the Fed; when chair and vice chair terms expire in this particular office, they retire. This is done to allow the replacements to more easily conduct their policy. Imagine if Greenspan had stayed around as a governor after Bernanke became chair. Divisions and second-guessing, especially during the Great Financial Crisis, would have been a real problem. Thus, the president will have three governors in place after February—Brainard, Powell and Quarles. He can appoint four more governors and really put his stamp on the FOMC.

No to a major merger[1]: We rarely discuss company-specific issues. This is a macro publication and thus we don't comment on individual company issues unless they have a macro impact. The DOJ's decision to reject the AT&T (T, 34.64) and Time-Warner (TWX, 87.71) merger is one of those events. Since Reagan, the DOJ has generally been merger-supportive. Anti-trust legislation from the Progressive era of President Theodore Roosevelt to Reagan generally prohibited large combinations. Size was a key determining factor. The legal arguments tended to center on whether the combined firm dominated an industry. During the Reagan administration, anti-trust regulation shifted its focus to outcomes. If a monopolist did not abuse its pricing power, mergers were generally approved. A theory called "contestable markets" emerged, which suggested that mergers were usually approved even if an industry was concentrated so long as there was ease of entry so the oligopolist firms could not act with pricing power. The key determinant seemed to be how the firms in an industry treated consumers. If consumers didn't face higher prices after the union, the DOJ generally didn't object. Thus, "vertical" mergers, combining industries together, were usually approved whereas "horizontal" mergers, firms in the same industry, faced greater scrutiny. The aforementioned merger is considered vertical because one firm is in the distribution business while the other is in content.

What we may be seeing here is a change in precedent away from the Reagan model to the pre-Reagan model. In practice, firms have discovered that they can reach mammoth size if they don't adversely affect customers. Thus, labor tends to get hammered by companies. The whole move to the "gig" economy appears to simply be a way to push down labor costs. Mergers seem

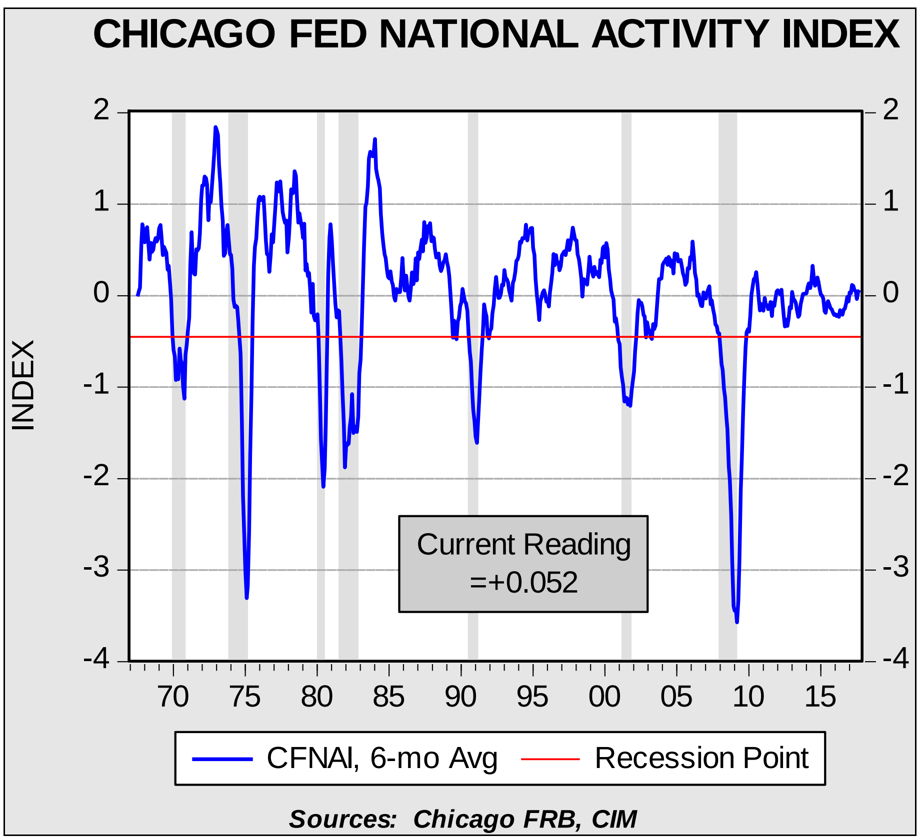
[1] A potential tongue twister…similar to https://www.youtube.com/watch?v=2OBZf0QdKdE

to do the same thing. The bigger firms become in an industry, the more they become monopsonists in the labor market for that industry. In other words, if there were only one tech firm, it could keep programmer wages low because there wouldn't be competition from other firms bidding up wages. If the Trump DOJ stands its ground on this merger, it could have a chilling effect on the mega-tech industry.[2]

DACA: Don't sleep on a December 8th shutdown. Democrat Party leaders are making DACA a key element in approving a continuing resolution to fund the government and perhaps raise the debt ceiling. With the GOP tied up with tax issues and the president generally open to the "dreamers," we expect Chuck and Nancy to use their leverage to try to get a win even if it leads to a government shutdown.

U.S. Economic Releases

The Chicago Fed National Activity Index came in above expectations at 0.65 compared to the forecast of 0.20. The prior report was revised upward from 0.17 to 0.36.



---

[2] See https://www.axios.com/the-ripple-effect-of-the-att-merger-lawsuit-2511164001.html and https://www.axios.com/the-facebook-whistleblower-wave-2511168571.html?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top-stories

The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The current reading is 0.052, an increase from the last report of 0.027. This is one of our favorite indicators and it shows an economy growing on trend.

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	Existing Home Sales	m/m	oct	5.40 mn	5.39 mn	**
10:00	Existing Home Sales	m/m	oct	0.2%	0.7%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
18:00	Janet Yellen Appears before Senate Banking Panel	Chairman of Board of Governors of Federal Reserve				

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	All Industry Activity Index	y/y	sep	-0.5%	0.1%	-0.4%	**	Equity and bond neutral
	Supermarket Sales	m/m	oct	-1.9%	-0.3%		*	Equity and bond neutral
	Nationwide Department Sales	m/m	oct	-1.8%	4.4%		*	Equity and bond neutral
	Tokyo Department Store Sales	m/m	oct	-0.3%	4.6%		*	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	nov	116.4	114.8		*	Equity and bond neutral
New Zealand	Credit Card Spending	m/m	oct	0.8%	0.7%		*	Equity and bond neutral
EUROPE								
UK	Public Finances	y/y	oct	-3.8 bn	11.2 bn		**	Equity bearish, bond bullish
	Central Government	m/m	sep	-6.7 bn	19.3 bn		**	Equity bearish, bond bullish
	Public Sector Net Borrowing	m/m	sep	7.5 bn	5.3 bn	6.5 bn	**	Equity and bond neutral
	PSNB ex Banking Groups	m/m	nov	8.0 bn	5.9 bn	7.1 bn	**	Equity and bond neutral
	CBI Trends Total Orders	m/m	sep	17	-2	3	*	Equity bullish, bond bearish
	CBI Trends Selling Prices	m/m	oct	17	18		*	Equity and bond neutral
Switzerland	Trade Balance	m/m	oct	2.33 bn	2.92 bn		**	Equity and bond neutral
	Exports Real	m/m	oct	-1.8%	-0.9%		**	Equity bearish, bond bullish
	Import Real	m/m	oct	-1.1%	-3.2%		**	Equity and bond neutral
Russia	Unemployment rate	m/m	oct	5.1%	5.0%	5.1%	***	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	y/y	nov	59.5	58.8		**	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)	144	144	0	Up
3-mo T-bill yield (bps)	126	125	1	Neutral
TED spread (bps)	18	18	0	Neutral
U.S. Libor/OIS spread (bps)	134	134	0	Up
10-yr T-note (%)	2.37	2.37	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	49	49	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Neutral
pound	up			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	$62.40	$62.22	0.29%	
WTI	$56.58	$56.42	0.28%	
Natural Gas	$3.03	$3.05	-0.62%	
Crack Spread	$19.46	$19.32	0.72%	
12-mo strip crack	$20.82	$20.73	0.43%	
Ethanol rack	$1.55	$1.55	-0.21%	
Metals				
Gold	$1,278.32	$1,276.92	0.11%	
Silver	$16.98	$16.91	0.42%	
Copper contract	$312.50	$311.55	0.30%	
Grains				
Corn contract	$ 355.25	$ 356.50	-0.35%	
Wheat contract	$ 438.50	$ 438.50	0.00%	
Soybeans contract	$ 988.50	$ 990.00	-0.15%	
Shipping				
Baltic Dry Freight	1385	1371	14	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		0.1		
Distillates (mb)		-1.0		
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

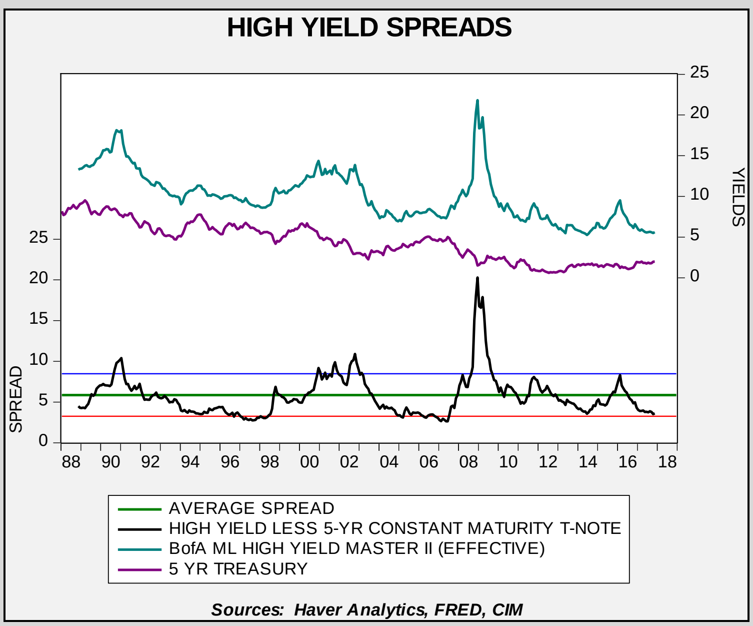
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

November 17, 2017

[Ed note: We will not publish an Asset Allocation Weekly Comment the week of November 24. The next comment will be published December 1.]

Over the past three weeks, we have seen a rise in the yields on high-yield bonds. The Merrill Lynch High Yield bond effective index is up 40 bps since late October.[3] There are a number of reasons for the sudden weakness. They are:

1. The tax bills in Congress may limit the deductibility of interest for corporations. Since many high-yield issuers are dependent on debt to fund their operations, a tax change could have an adverse effect on these companies and their high-yield issuance. At the same time, we remain pessimistic that major tax reform is likely and so the final version of any tax changes will likely be limited.
2. Telecom and health care sectors have suffered some weaker earnings growth. The failed merger talks between Sprint (S, $6.21) and T-Mobile (TMUS, $56.52) also dampened sentiment in the telecom sector. Since these sectors are important issuers of high-yield debt, their problems have raised concerns.
3. Spreads have narrowed significantly.

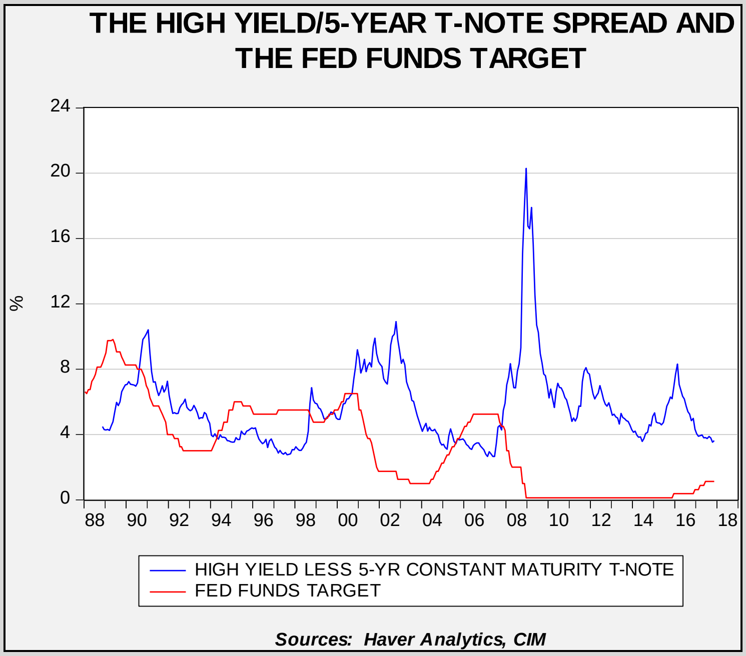


This chart shows the Merrill Lynch High Yield Master effective yield and the five-year T-note yield. The lower lines on the chart show the average spread and the standard deviation lines. The narrowing spread, by itself, doesn't necessarily signal an imminent

---
[3] https://fred.stlouisfed.org/series/BAMLH0A0HYM2EY

problem. As the above chart shows, spreads can remain at the lower deviation for an extended period of time. However, a spread at the lower deviation also suggests a market that is richly valued.

4. The relationship of high yield to monetary policy suggests that major reversals in the high-yield spread tend to occur well into a tightening cycle.

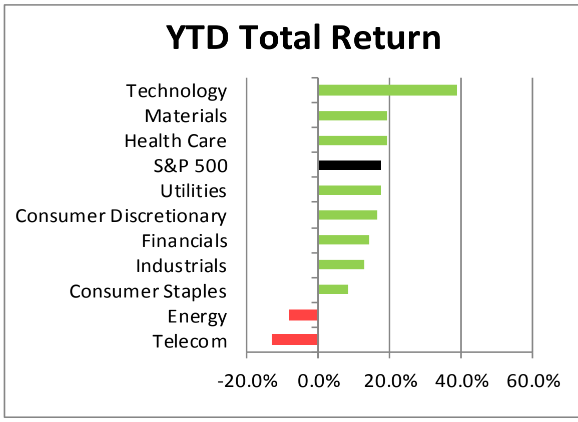


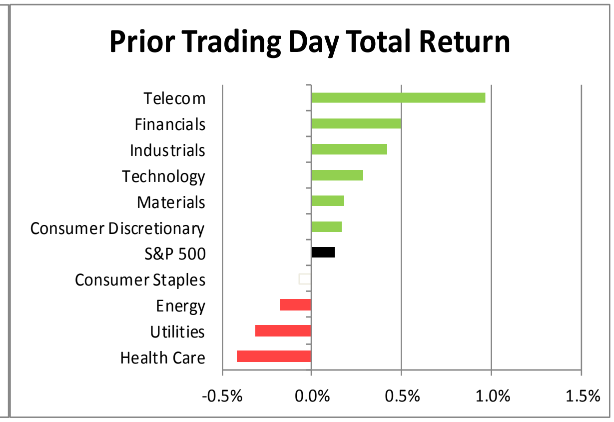
This chart shows the high-yield spread and the fed funds target. Major spikes in the spread are more likely after policy has already been tightened. In addition, the spread often continues to widen after policy easing has commenced. This pattern indicates that the spread is very sensitive to financial stress; in fact, most financial stress indices include both high-yield bonds and high-yield spreads in their construction.

Although there has been much press in the financial media on the recent backup in yields, the most recent change is barely visible on the spread. There isn't any obvious increase in financial stress, and monetary policy, while tightening, is not at a level that indicates it is near the end of the cycle nor is it at a level that should be causing stress. In our Asset Allocation portfolios, we have been reducing our exposure to high-yield bonds in the income-oriented programs due to high-yield spreads falling to the lower deviation. However, we don't expect that the recent rise in yields signifies the onset of a financial crisis. Obviously, we will continue to monitor the situation but, for now, we are comfortable with our current allocations to this asset class.

Data Section

U.S. Equity Markets – (as of 11/20/2017 close)

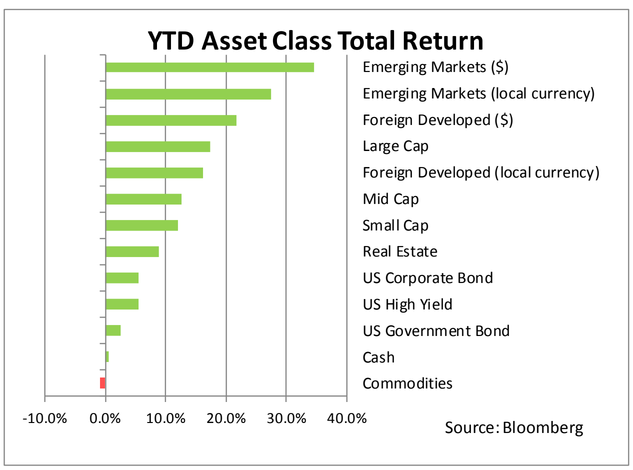




(Source: Bloomberg)

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 11/20/2017 close)

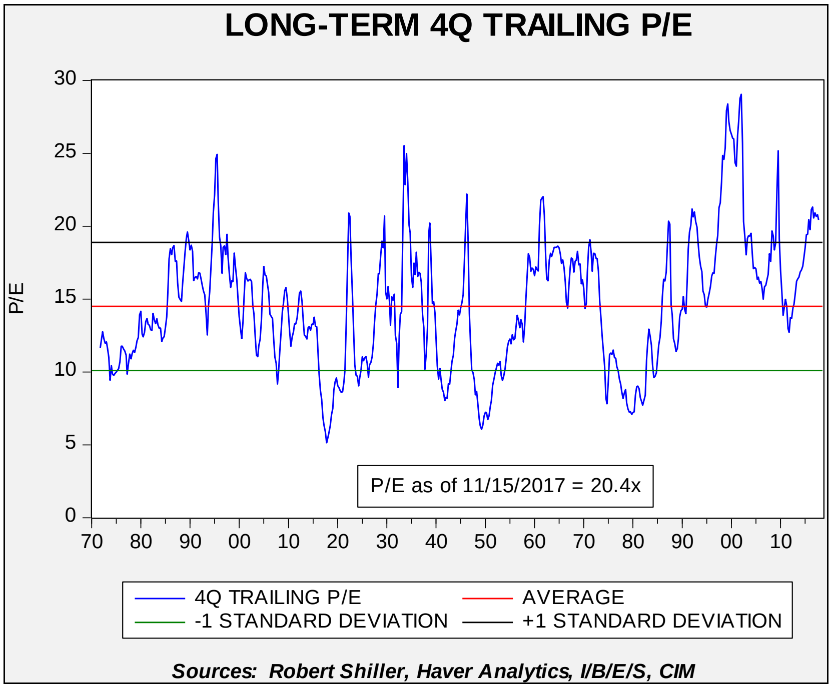


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2017



Based on our methodology,[4] the current P/E is 20.4x, up 0.3x from last week. This week, we received our first report for Q3 earnings from Haver Analytics, which provides the data for S&P operating earnings from Standard & Poor's. Shifting to this series caused the increase in the P/E this week.

---

[4] 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.