Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 22, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.6% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a higher open.

As a reminder, we will not publish the Daily Comment this Friday, November 24. Financial markets are quiet, but here are the news items we are watching:

Yield curve flattening: Yesterday, the U.S. yield curve flattened to its lowest point since November 2007; as a result, there have been growing concerns of an impending economic slowdown. The yield curve is one of the most widely used financial indicators in determining the health of the U.S. economy. An upward sloping yield curve signals that the economy is in good shape, whereas a flattening yield curve signals a possible slowdown and a downward sloping yield curve signals a possible recession. Furthermore, a change in the yield curve does not necessarily signal a change in the economy but rather it could reflect current monetary policy. As the Fed raises short-term interest rates, the market adjusts long-term interest rates based on inflation expectations.

That being said, we believe the flattening of the yield curve is the result of a combination of the Fed raising short-term rates and falling inflation expectations. After the election, inflation fears rose, which led to a rise in long-term interest rates. Inflation expectations have fallen as post-election inflation fears proved to be unfounded.

(Source: Bloomberg)

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The chart above shows the spread between the two-year and 10-year Treasuries from June 2016 to the present. After Trump won the presidency there was a spike in the spread between the two- and 10-year Treasuries, but it has seen a steady decline since. A flattening yield curve suggests the Fed should be cautious with rate hikes next year as its actions could lead to an inverted yield curve. This sentiment is mirrored by Chicago FRB President Charles Evans, who expressed his hesitancy last month for supporting rate hikes if inflation expectations do not pick up.

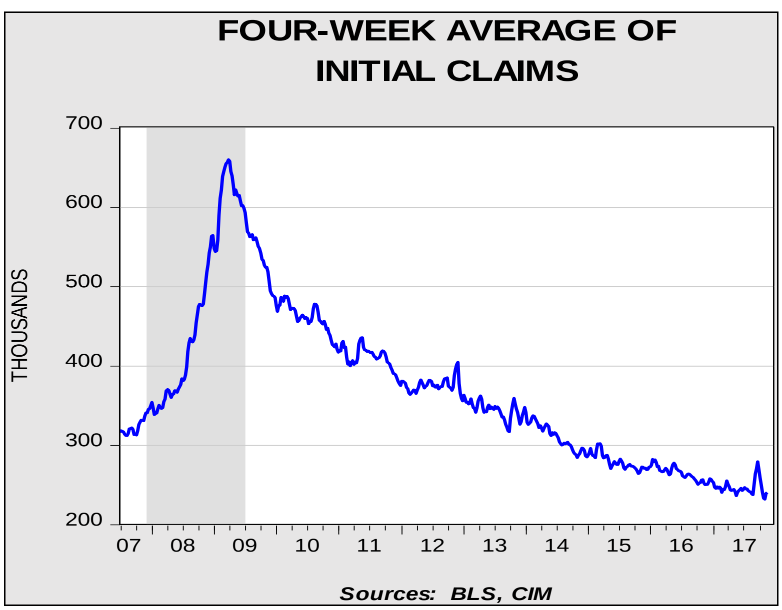
Mugabe out: After 37 years of rule in Zimbabwe, Robert Mugabe has formally resigned from office and will be replaced his former Vice President Emmerson Mnangagwa. Mugabe's peaceful departure is a positive sign for the region as it paves the way for new elections next summer. The change of power was likely supported by China, which has stood by Mugabe since he came to power in 1980. It has been reported that China became increasingly skeptical of Mugabe as he grew more unpopular among members of his own party.

Tensions rising in North Korea: Yesterday, North Korea escalated tensions with South Korea and the U.S. Last week, a North Korean border guard chased and shot a defector in the demilitarized zone that separates the two Koreas; this incident was a violation of the ceasefire agreement between the two countries. In addition, North Korea has denounced the U.S. decision to re-designate the country as a state sponsor of terrorism. The increased provocation is not likely to lead to war anytime soon, but we will continue to monitor the situation.

U.S. Economic Releases

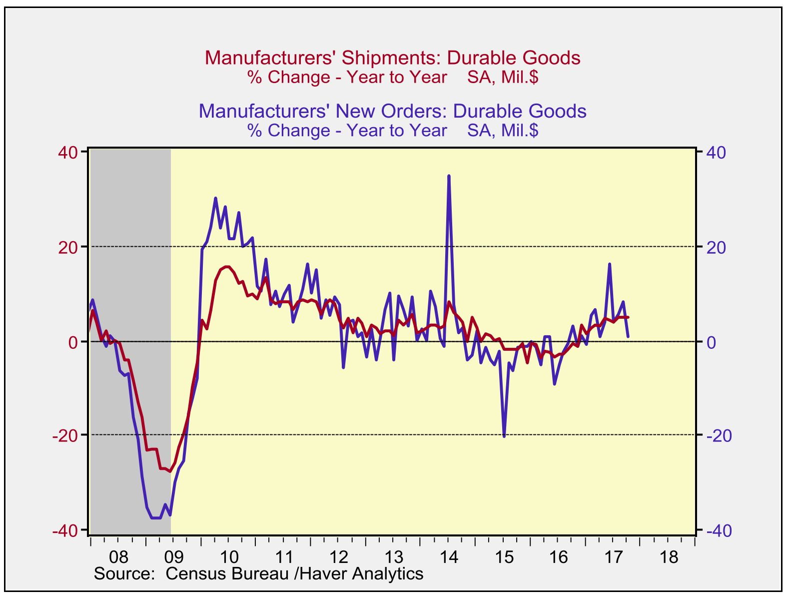
MBA mortgage applications rose 0.1% from the prior week. Purchases rose 5.3% from the prior week, while refinancing fell 4.8%. The 30-year fixed rate mortgage rose 2 bps from the prior week from 4.18% to 4.20%.

Initial jobless claims came in below expectations at 239k compared to the forecast of 240k. The prior week's report was revised upward from 249k to 252k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose from 238.5 to 239.75.

October durable goods came in below expectations, falling 1.2% from the prior month compared to the forecast gain of 0.3%. The prior report's gain was revised upward from 2.0% to 2.2%. Durables ex-transportation came in below expectations, rising 0.4% from the prior month compared to the forecast rise of 0.5%. The prior report's gain was revised upward from 0.7% to 1.1%. Capital goods orders non-defense ex-air came in below expectations, falling 0.5% from the prior month compared to the forecast gain of 0.5%. The prior month's gain was revised upward from 1.7% to 2.1%. Capital goods shipments non-defense ex-air came in above expectations at 0.4% from the prior month compared to the forecast rise of 0.3%. The prior report's gain was revised upward from 0.9% to 1.2%.



The chart above shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 1.0%, shipments rose by 5.1%, unfilled orders rose by 0.6% and inventories rose by 3.6%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomber Consumer Comfort	m/m	oct		52.1	**
10:00	U. of Michigan Sentiment	m/m	nov	98.0	97.8	**
10:00	U. of Michigan Current Conditions	m/m	nov		113.6	**
10:00	U. of Michigan Expectations	m/m	nov		87.6	**
10:00	U. of Michigan 1 yr Inflation	m/m	nov		2.6%	**
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				
14:00	FOMC Meeting Minutes	Federal Reserve Board				

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								
Australia	Westpac Leading Index	y/y	sep	0.1%	0.1%		**	Equity and bond neutral
	Skilled Vacancies	m/m	oct	0.5%	0.0%		**	Equity and bond neutral
	Construction Work Done	m/m	oct	15.7%	9.3%	-2.3%	**	Equity bullish, bond bearish
New Zealand	Net Migration	m/m	oct	5580	5190		**	Equity and bond neutral
AMERICAS								
Canada	Wholesale Trade Sales	y/y	sep	-1.2%	0.5%	0.6%	**	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)	145	144	1	Up
3-mo T-bill yield (bps)	126	126	0	Neutral
TED spread (bps)	18	18	0	Neutral
U.S. Libor/OIS spread (bps)	135	134	1	Up
10-yr T-note (%)	2.37	2.36	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	50	50	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Neutral
pound	up			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	$63.16	$62.57	0.94%	Bullish API Report
WTI	$57.82	$56.83	1.74%	
Natural Gas	$3.01	$3.02	-0.40%	
Crack Spread	$19.01	$19.72	-3.61%	
12-mo strip crack	$20.74	$21.11	-1.75%	
Ethanol rack	$1.54	$1.54	-0.03%	
Metals				
Gold	$1,284.33	$1,280.61	0.29%	Weaker Dollar
Silver	$16.99	$16.96	0.16%	
Copper contract	$314.65	$315.05	-0.13%	
Grains				
Corn contract	$ 356.75	$ 356.25	0.14%	
Wheat contract	$ 443.00	$ 441.25	0.40%	
Soybeans contract	$ 993.75	$ 989.00	0.48%	
Shipping				
Baltic Dry Freight	1396	1385	11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		0.1		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		-55.0		

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

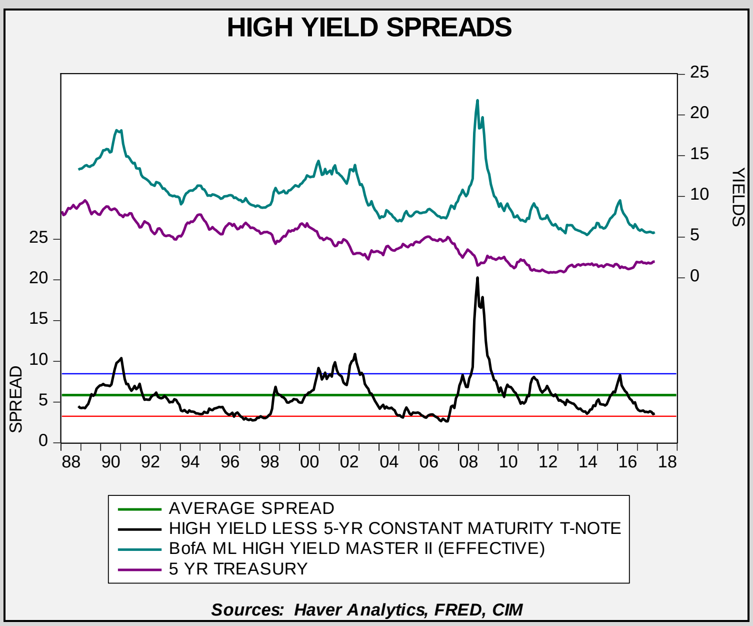
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.[1] 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.

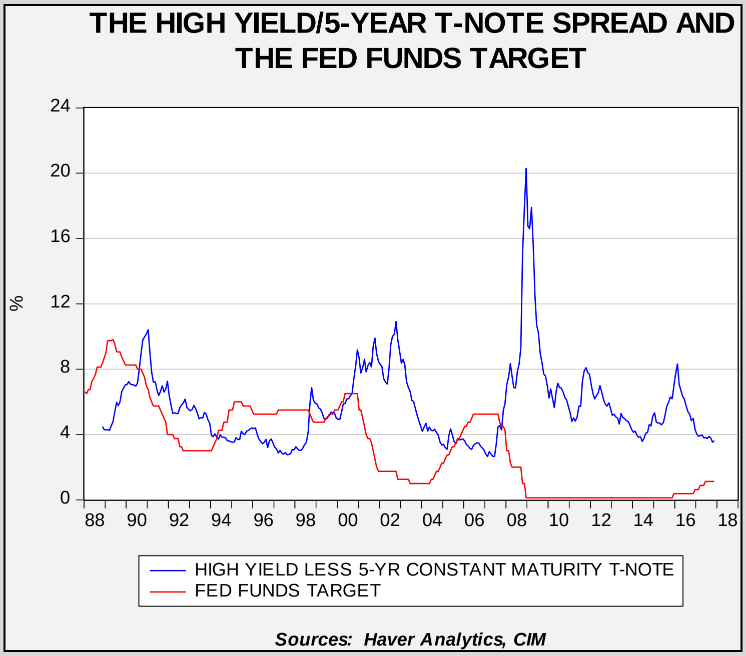


This chart shows the Merrill Lynch High Yield Master effective yield and the five-year T-note yield. The lower lines on the chart show the average spread and the standard deviation lines. The narrowing spread, by itself, doesn't necessarily signal an imminent

[1] 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.



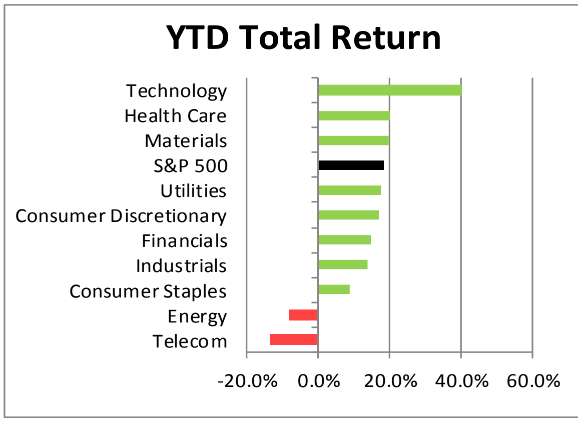
This chart shows the high-yield spread and the fed funds target. Major spikes in the spread are more likely after policy has already been tightened. In addition, the spread often continues to widen after policy easing has commenced. This pattern indicates that the spread is very sensitive to financial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

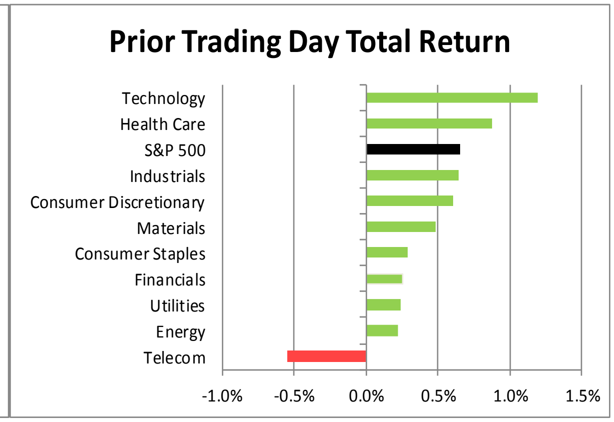
Although there has been much press in the financial media on the recent backup in yields, the most recent change is barely visible on the spread. There isn't any obvious increase in financial stress, and monetary policy, while tightening, is not at a level that indicates it is near the end of the cycle 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.

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 11/21/2017 close)

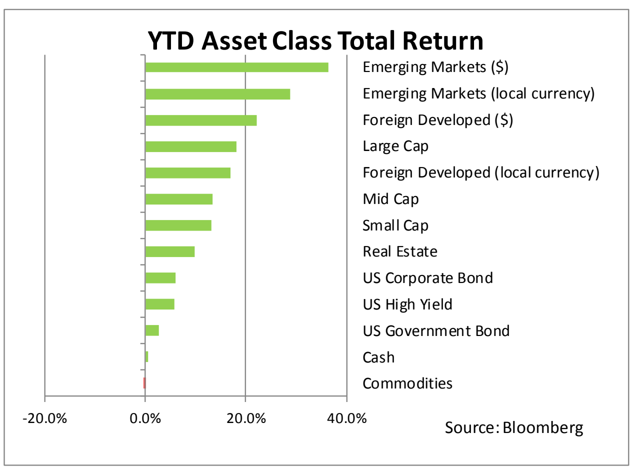




(Source: Bloomberg)

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 11/21/2017 close)

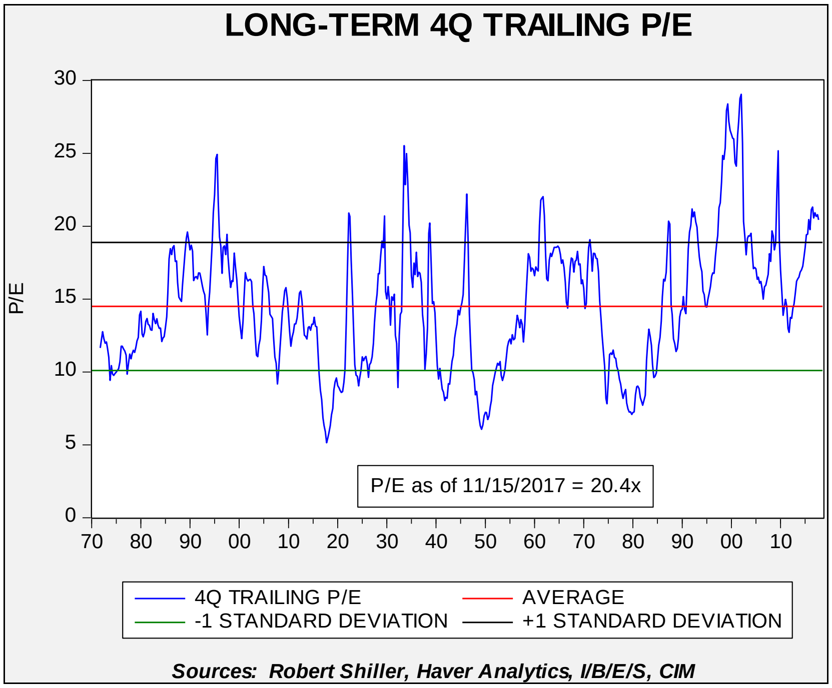


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[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 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.