# Daily Comment

By Bill O'Grady and Thomas Wash

**[Posted: November 28, 2017—9:30 AM EDT]** Global equity markets are higher this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.3% and the Shenzhen index up 1.4%. U.S. equity index futures are signaling a higher open.

Financial markets are relatively quiet this morning. We are watching the following news events:

**Senate tax bill:** Today, the Senate's tax reform bill awaits approval from the Senate Budget Committee. Although approval from the committee is usually a formality, there is growing speculation that the bill might not achieve the majority votes needed to make it through. Senators Ron Johnson (R-WI) and Bob Corker (R-TN) have publicly come out against the bill in its current form. Sen. Johnson would like deeper tax cuts for pass-through businesses, while Sen. Corker would like to place a penalty provision in the bill that would raise taxes if economic growth fails to ensure the bill remains revenue-neutral. These demands seem steep given the political factions that exist within the Republican Party. The budget committee is split between 12 Republicans and 11 Democrats, so the bill needs support from both Republican senators as the Democrats have refused to support it. If this bill fails to make it out of committee, it will further delay tax reform.

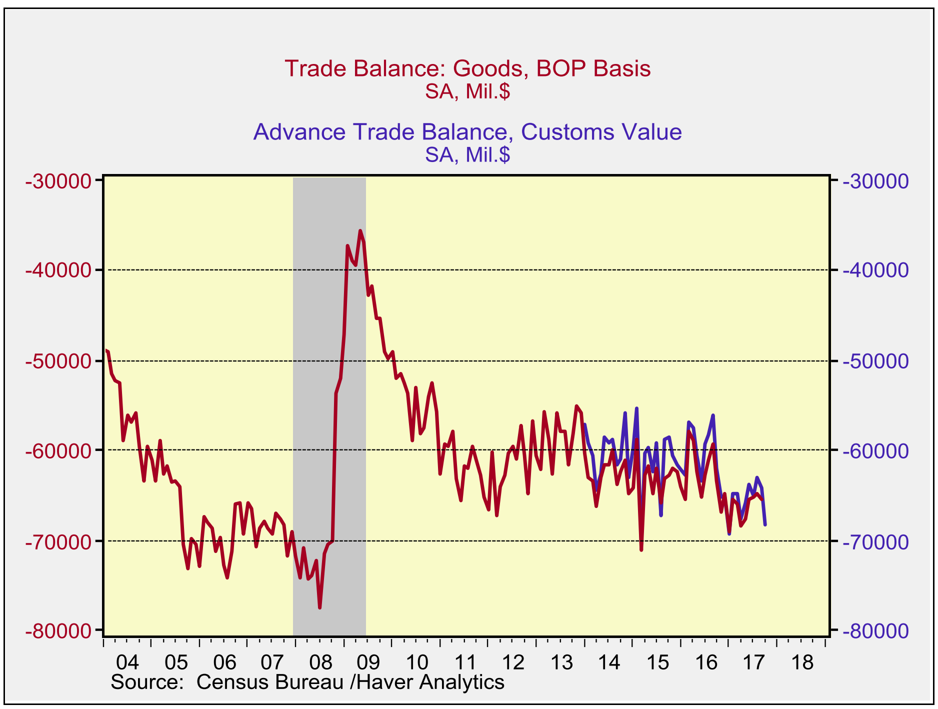
**Tension before coalition talks:** Yesterday, the European Commission voted to renew the license for the controversial weed killer glyphosate. Germany was not expected to support the renewal so the approval came as a surprise (Germany had abstained from the previous vote when the license was rejected). Upon approval of the license, France and Italy maintained they would continue to ban the use of glyphosate in their respective countries. Glyphosate is a substance used in weed killer that became controversial after a WHO report claimed the substance was "probably carcinogenic." The vote could complicate talks for a coalition government in Germany between the CDU/CSU and the SPD as the SPD has consistently supported the ban on glyphosate. Although this issue may have damaged trust between the sides, it appears that talks to form a coalition government will continue. So far, the euro has remained stable which suggests there is still optimism that a deal will be struck. We will continue to monitor the situation.

**The return of AMLO:** In Mexico, Andres Manuel Lopez Obrador (AMLO) is currently leading the polls for the presidential election planned for July 1, 2018. AMLO, a populist candidate with a loyal following, is expected to finish within the top two contenders for the third consecutive election. In the previous two elections, AMLO led in the polls early only to lose in the general election. A win by AMLO would increase the likelihood that Mexico will exit NAFTA as AMLO believes the agreement hurts Mexican farmers. That being said, it is widely believed the establishment parties, PAN and PRI, will do everything in their power to ensure AMLO does not win the presidency. These parties have recently seen a dip in support on corruption suspicions.

**Jerome Powell:** Later today, Fed chair nominee Jerome Powell is expected to meet with the Senate Banking Committee to begin his confirmation hearing. Prior to the hearing, he sent a statement to the committee in which he expressed broad support for Chair Yellen's agenda and signaled that he will continue down the path of gradual rate increases and shrinking the Fed balance sheet. He also mentioned that he would be open to considering "appropriate ways" to ease rules on banks. After making it through two confirmation hearings without resistance, Powell is expected to be confirmed, replacing Yellen when her term ends in February.

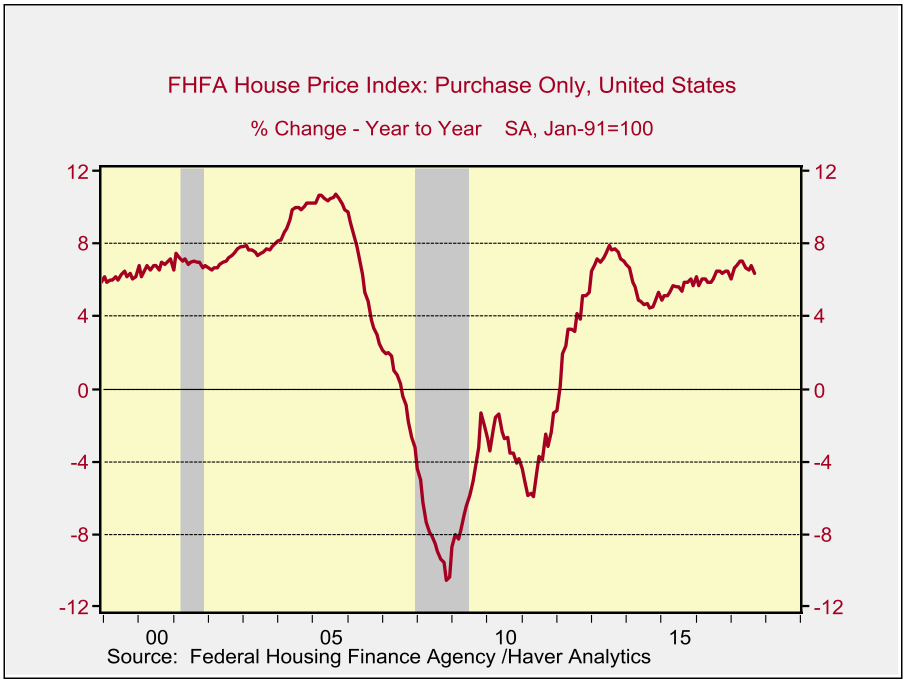
**U.S. Economic Releases**

The advance goods trade deficit came in wider than expected at $68.3 bn compared to the forecast of $64.9 bn. Wholesale inventories came in below expectations falling 0.4% compared to the forecast gain of 0.4%. The prior month's report was revised downward from 0.3% to 0.1%. Retail inventories fell 0.1% from the prior month. The prior month's loss was revised from 1.0% to 0.9%.



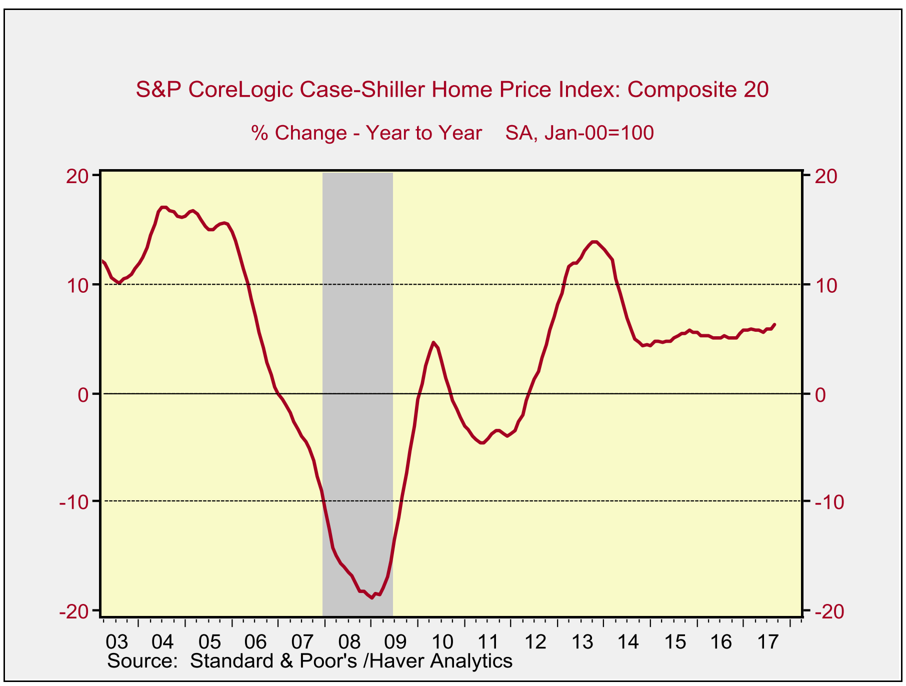

The chart above shows the trade balance of goods and the advance trade balance.

The FHFA House Price Index came in below expectations, rising 0.3% from the prior month compared to the forecast rise of 0.5%. The prior month's gain was revised upward from 0.7% to 0.8%. The house price index rose by 1.4% from the prior quarter. The prior report's gain was revised from 1.6% to 1.7%.




The chart above shows the year-over-year change in the FHFA House Price Index. Housing prices have risen 6.3% from the prior year.

The S&P CoreLogic CS 20-City Home Price Index came in above expectations at 6.19% compared to the forecast rise of 6.04% from the prior year. The prior report was revised downward from 5.92% to 5.82%. The S&P CoreLogic CS U.S. Home Price Index rose by 6.15% from the prior year. The prior report was revised downward from 6.07% to 5.95%.



The chart above shows the year-over-year change in the S&P CoreLogic CS Home Price Index. The relatively low supply of available homes has had a bullish effect on home prices.

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** | Conference Board Consumer Confidence | m/m | oct | 124.0 | 125.9 | ** |
| **10:00** | Conference Board Present Situation | m/m | oct | | 151.1 | ** |
| **10:00** | Conference Board Expectations | m/m | nov | | 109.1 | ** |
| **10:00** | Richmond Fed Manufacturing Activity | m/m | nov | 14 | 12 | ** |
| **Fed speakers or events** | | | | | | |
| **EST** | **Speaker or event** | **District or position** | | | | |
| **9:45** | Jerome Powell testifies at Confirmation Hearing | Member of the Board of Governors | | | | |
| **10:15** | Patrick Harker Speaks on Financial Safety | 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** | | | | | | | | |
| **Australia** | ANZ Roy Morgan Weekly Consumption | y/y | oct | 115.0 | 116.4 | | ** | Equity and bond neutral |
| **EUROPE** | | | | | | | | |
| **Eurozone** | M3 Money Supply | y/y | oct | 5.0% | 5.1% | 5.1% | ** | Equity and bond neutral |
| **Germany** | Import Price Index | y/y | oct | 2.6% | 3.0% | 2.5% | ** | Equity and bond neutral |
| | GfK Cpnsumer Confidence | m/m | dec | 10.7 | 10.7 | 10.7 | *** | Equity and bond neutral |
| **France** | Consumer Confidence | m/m | nov | 102 | 100 | 101 | *** | Equity and bond neutral |
| **AMERICAS** | | | | | | | | |
| **Mexico** | Trade Balance | m/m | oct | -2.066 bn | -1.886 bn | -0.912 bn | ** | Equity bearish, bond bullish |
| **Canada** | Bloomberg Nanos Confidence | w/w | nov | 58.7 | 59.5 | | ** | 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)** | 147 | 146 | 1 | Up |
| **3-mo T-bill yield (bps)** | 127 | 126 | 1 | Neutral |
| **TED spread (bps)** | 20 | 20 | 0 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 136 | 136 | 0 | Up |
| **10-yr T-note (%)** | 2.33 | 2.33 | 0.00 | Neutral |
| **Euribor/OIS spread (bps)** | -33 | -33 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 46 | 46 | 0 | Up |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Down |
| euro | down | | | Up |
| yen | down | | | Neutral |
| pound | down | | | 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 | $63.14 | $63.84 | -1.10% | Pessimism about Russian Commitment to OPEC deal |
| WTI | $57.52 | $58.11 | -1.02% | |
| Natural Gas | $2.97 | $2.93 | 1.57% | Weather |
| Crack Spread | $18.94 | $19.18 | -1.24% | |
| 12-mo strip crack | $20.69 | $20.99 | -1.45% | |
| Ethanol rack | $1.54 | $1.55 | -0.21% | |
| **Metals** | | | | |
| Gold | $1,294.87 | $1,294.52 | 0.03% | |
| Silver | $17.07 | $17.05 | 0.15% | |
| Copper contract | $310.15 | $315.75 | -1.77% | |
| **Grains** | | | | |
| Corn contract | $ 349.75 | $ 351.75 | -0.57% | |
| Wheat contract | $ 428.00 | $ 428.25 | -0.06% | |
| Soybeans contract | $ 992.00 | $ 996.00 | -0.40% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1477 | 1458 | 19 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -3.5 | | |
| Gasoline (mb) | | 1.0 | | |
| Distillates (mb) | | 0.5 | | |
| 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 in the western region. Precipitation is expected for most of the country.

**Asset Allocation Weekly Comment**

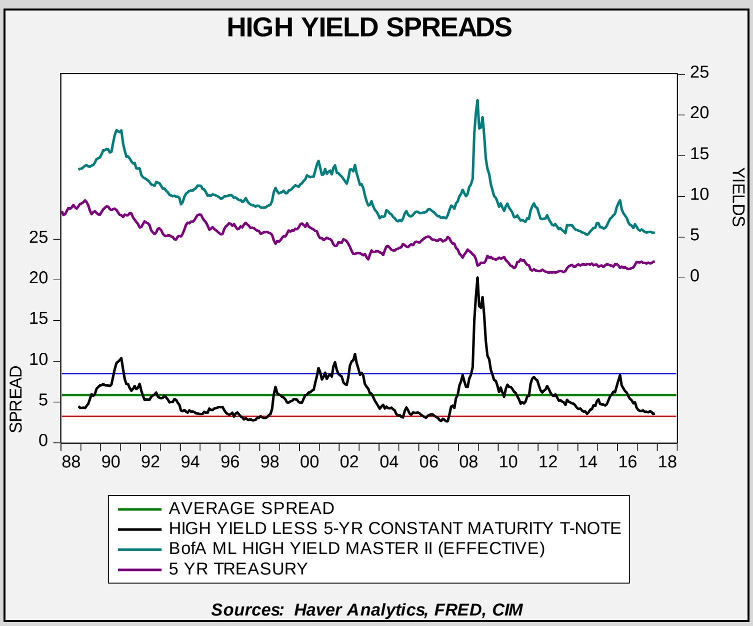
*Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.*

November 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.

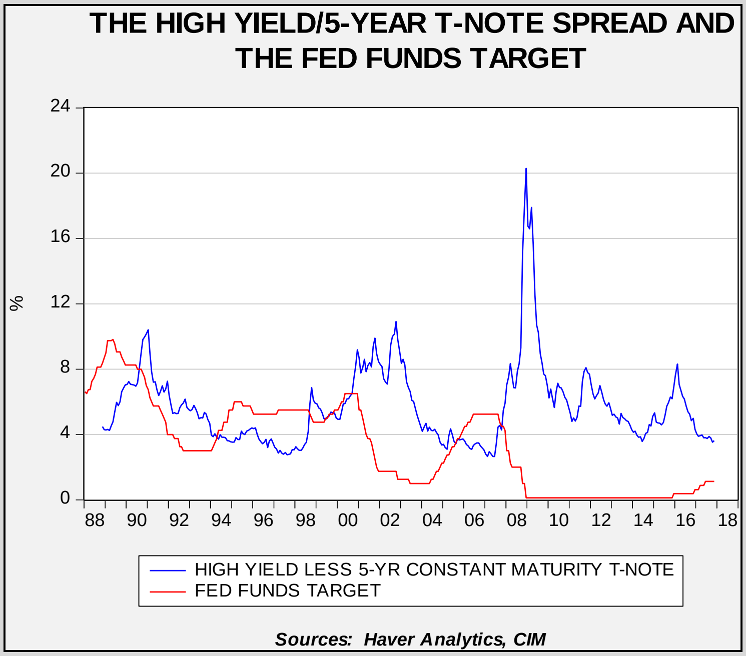



This chart shows the Merrill Lynch High Yield Master effective yield and the five-year T-note yield. The lower lines on the chart show the average spread and the standard deviation lines. The narrowing spread, by itself, doesn't necessarily signal an imminent

[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.

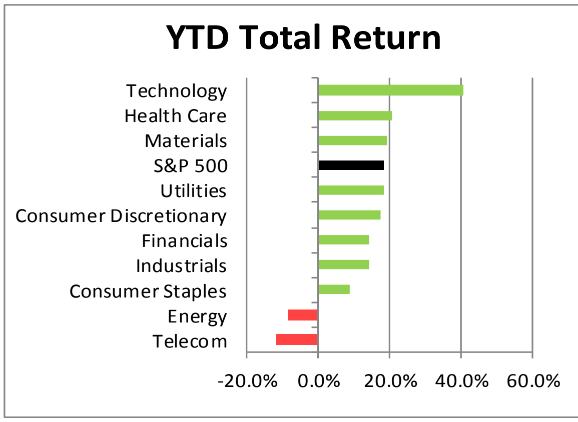


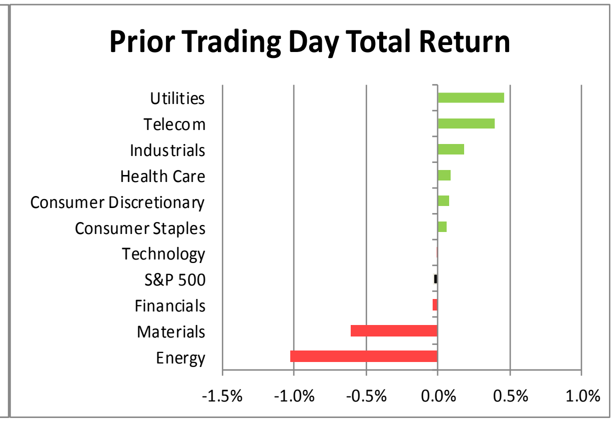

This chart shows the high-yield spread and the fed funds target. Major spikes in the spread are more likely after policy has already been tightened. In addition, the spread often continues to widen after policy easing has commenced. This pattern indicates that the spread is very sensitive to financial 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.

## Data Section

**U.S. Equity Markets** – (as of 11/27/2017 close)

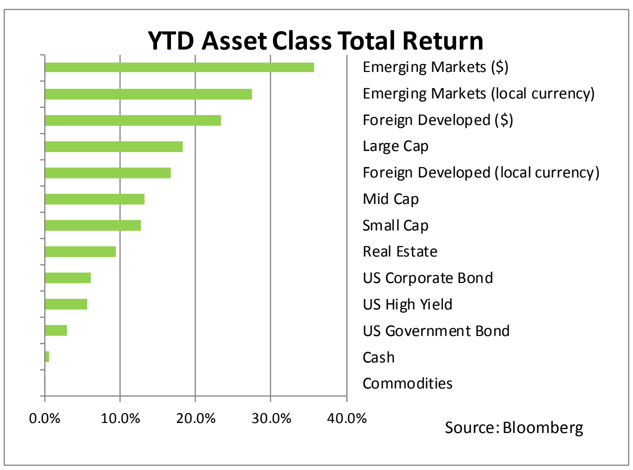



(Source: Bloomberg)

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 11/27/2017 close)

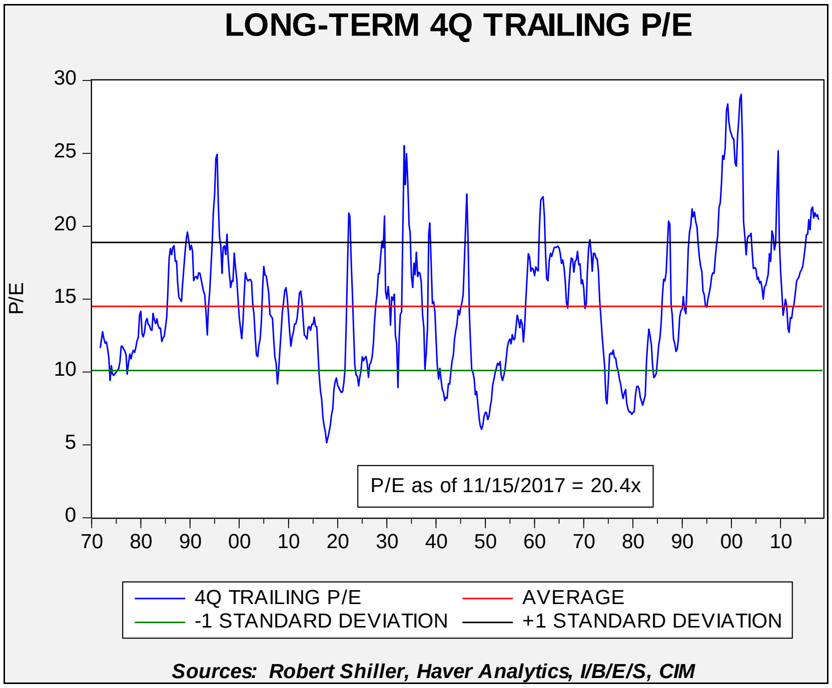



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.



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[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.