Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 29, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were relatively unchanged, with the Shanghai composite up 0.1% and the Shenzhen index unchanged. U.S. equity index futures are signaling a higher open.

Although yesterday was a news-heavy day, financial markets are relatively calm following North Korea's missile launch and an upward revision to GDP. Below are the stories we are following:

Nuclear North Korea: Yesterday, North Korea had its most successful missile launch and says it is capable of hitting anywhere on the U.S. mainland. Following the launch, North Korean Leader Kim Jong-un announced that his nuclear program is now complete. It is unclear how the United States plans to respond to the launch, but officials within the Trump administration have stated that the U.S. will continue its current policy of isolating North Korea and reaffirming its threat of possible military action. It has been suggested that China could be pressured into cutting off oil supply from North Korea. Although China's "technical difficulties" with its oil pipeline in 2003 forced North Korea to the negotiating table then, China's recent attempt at limiting oil supply to North Korea has failed to yield a similar result.[1] Nevertheless, while the recent missile launch has increased the likelihood of a potential preemptive strike by the U.S., markets have been relatively mum. We will continue to monitor the situation.

Possible trade war: It appears the warm relationship that had developed between President Trump and President Xi has finally cooled. Yesterday, the Trump administration initiated an investigation into imports of aluminum sheets from China, marking the first time since 1985 that the Commerce Department has initiated an investigation without a formal request. If the Commerce Department determines China has aided in unfair trade practices that have hurt the U.S. steel industry, it will instruct the U.S. Customs and Border Protection to collect duties from U.S. companies that purchase the steel.

Senate tax bill makes it out of committee: Yesterday, the Senate tax bill barely made it out of the committee after the two Republican holdouts were finally cajoled into voting for the bill. Concessions appear to have been made to Sen. Bob Corker (R-TN) to ensure the bill is more revenue-neutral, while Sen. Ron Johnson (R-WI) may have succumbed to pressure. The bill is expected to come to the Senate floor on Thursday, which would put it on track to meet the president's Christmas deadline. That being said, there is still speculation that there is not enough support among Senate Republicans, although there have been rumblings that at least two Senate

[1] https://www.economist.com/news/letters/21726670-populism-north-korea-childlessness-renewables-shipping-eurocrats-bullets-iceland-st

Democrats, Joe Manchin (D-WV) and Heide Heitkamp (D-ND), may support the bill. At this time, we believe it is a coin toss as to whether or not the bill is able to make it through the Senate this week.

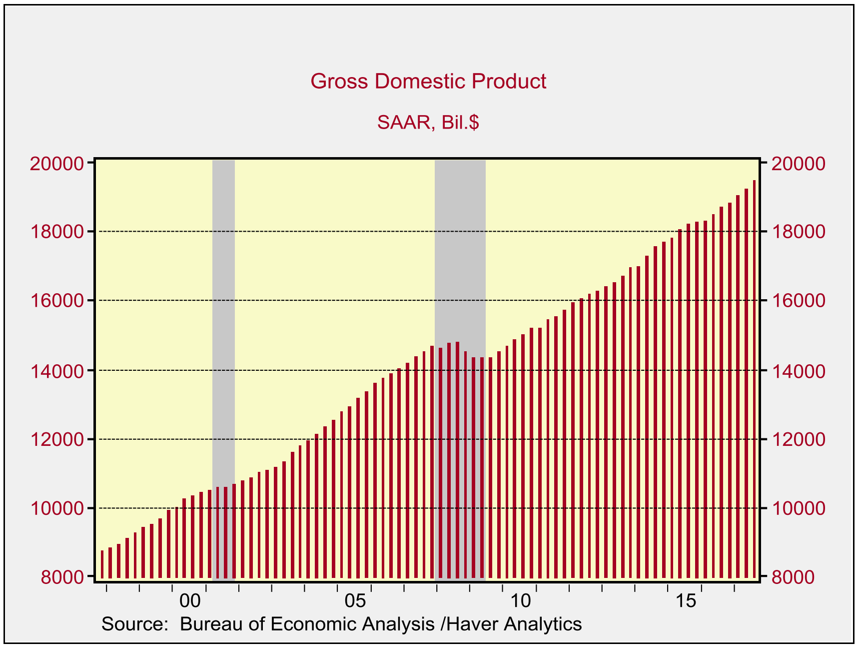
Government shutdown? Nancy Pelosi and Chuck Schumer skipped a bipartisan meeting with President Trump to discuss the government budget following comments the president made on Twitter. President Trump accused the two of being weak on illegal immigration and crime, in addition to wanting to raise taxes. The spat between the two sides has increased the likelihood of a government shutdown; the government is currently funded through December 8. Presently, there is not enough support among Republicans to secure funding, therefore the Democrats are using their leverage to gain assurances that the children in the DACA program will remain protected as well as secure financing for the Children's Health Insurance Program. It is unclear whether a budget deal is imminent and therefore it is likely that another stopgap spending bill will be passed to keep the government funded past next week.

EU/Brexit bill: It appears the EU and U.K. are close to coming to terms on a Brexit "divorce bill." It is believed the U.K. will pay a little under €50 bn to settle claims with the EU, whereas the estimated liabilities were €100 bn. After the agreement is finalized, the two sides will begin discussions on a free trade pact, a "hard" Irish border and the rights of EU citizens in the U.K.

U.S. Economic Releases

MBA mortgage applications fell 3.1% from the prior week. Purchases rose 1.8% from the prior week, while refinancing fell 7.7%. The 30-year fixed rate mortgage remained unchanged at 4.20% from the prior week.

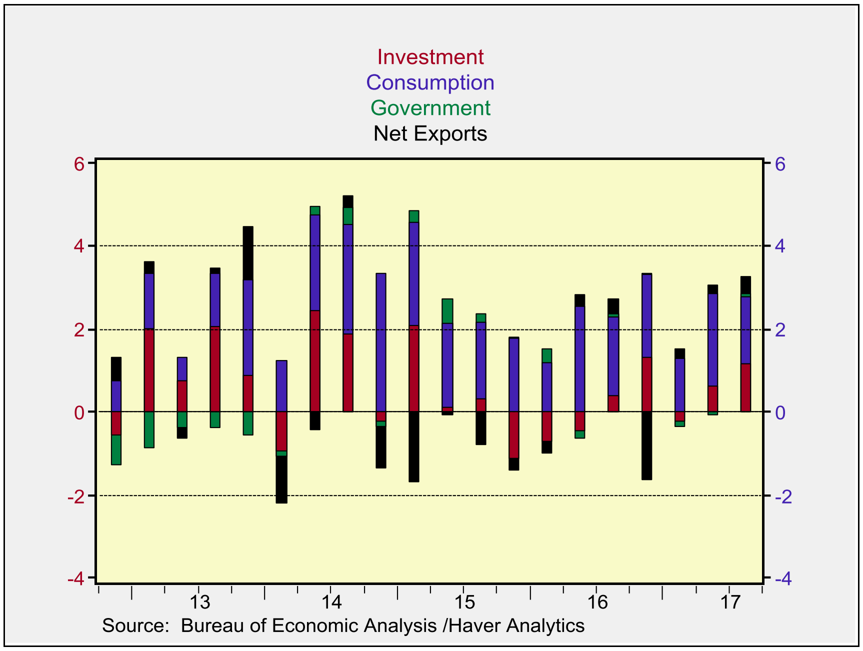
The second reading of Q3 GDP came in above expectations at 3.3% compared to the forecast of 3.2%. Personal consumption came in below expectations at 2.3% compared to the forecast of 2.5%. Core PCE came in above expectations at 1.4% from the prior quarter compared to the forecast of 1.3%. The GDP price index came in below expectations, rising 2.1% from the prior quarter compared to the forecast of 2.2%.



Despite tepid GDP growth over the past eight years, this period is now the third longest expansion in U.S. history.

	Q2 2017 Second Reading	Q3 2017 Prelim Reading	Difference
GDP	3.3%	3.0%	0.3%
Consumption	1.6%	1.6%	0.0%
Investment	1.2%	1.0%	0.2%
Inventories	0.8%	0.7%	0.1%
Net Exports	0.4%	0.4%	0.0%
Government	0.1%	0.0%	0.1%

The table above shows the contributions to GDP. The increase in GDP can be attributed to increases in investment and government spending.



This chart shows the contributions graphically.

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	Pending Home Sales	m/m	oct	1.0%	0.0%	**
10:00	Pending Home Sales	y/y	oct	3.0%	-5.4%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:00	Janet Yellen Appears before Joint Economic Committee	Chairman of Board of Governors of Federal Reserve				
12:45	John Williams speaks at Economic Forecast in Luncheon	President of the Federal Reserve Bank of San Francisco				
14:00	US Federal Reserve Releases Beige Book	Members of the Board of Governors				

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	Retail Sales	m/m	oct	0.0%	0.8%	0.2%	**	Equity bearish, bond bullish
	Retail Trade	y/y	oct	-0.2%	2.2%	0.2%	**	Equity bearish, bond bullish
	Dept. Store, Supermarket Sales	m/m	oct	-0.7%	1.9%	-0.8%	**	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	m/m	nov	114.6	114.0	114.6	**	Equity and bond neutral
	Business Climate Indicator	m/m	nov	1.49	1.44	1.51	**	Equity and bond neutral
	Industrial Confidence	m/m	nov	8.2	7.9	8.6	**	Equity and bond neutral
	Service Confidence	m/m	nov	16.3	16.2	16.7	**	Equity and bond neutral
	Consumer Confidence	m/m	nov	0.1	0.1	0.1	***	Equity and bond neutral
Germany	CPI	m/m	nov	1.8%	1.6%	1.7%	***	Equity and bond neutral
France	Consumer Spending	y/y	nov	-0.6%	2.8%	1.4%	**	Equity bearish, bond bullish
	GDP	y/y	3q	2.2%	2.2%	2.2%	***	Equity and bond neutral
Switzerland	UBS Consumption Indicator	m/m	oct	1.54	1.56		*	Equity and bond neutral
	Credit Suisse Survey Expectations	m/m	nov	40.7	32.0		**	Equity and bond neutral
AMERICAS								
Mexico	Unemployment rate	m/m	oct	3.5%	3.6%	3.4%	***	Equity and bond neutral
Canada	Industrial Product Price	m/m	oct	1.0%	-0.3%	0.5%	**	Equity bullish, bond bearish
	Raw Materiald Price Index	m/m	oct	3.8%	-0.1%	3.0%	**	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)	148	147	1	Up
3-mo T-bill yield (bps)	126	126	0	Neutral
TED spread (bps)	22	21	1	Neutral
U.S. Libor/OIS spread (bps)	136	136	0	Up
10-yr T-note (%)	2.35	2.33	0.02	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	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	$63.40	$63.61	-0.33%	Bearish API
WTI	$57.74	$57.99	-0.43%	
Natural Gas	$3.20	$3.13	2.17%	Weather
Crack Spread	$18.85	$18.87	-0.12%	
12-mo strip crack	$20.87	$20.88	-0.07%	
Ethanol rack	$1.53	$1.54	-0.35%	
Metals				
Gold	$1,294.75	$1,293.98	0.06%	
Silver	$16.86	$16.87	-0.03%	
Copper contract	$307.65	$309.85	-0.71%	
Grains				
Corn contract	$ 349.75	$ 349.75	0.00%	
Wheat contract	$ 431.00	$ 429.25	0.41%	
Soybeans contract	$ 990.00	$ 993.00	-0.30%	
Shipping				
Baltic Dry Freight	1506	1477	29	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.5		
Gasoline (mb)		1.0		
Distillates (mb)		0.5		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		-46.0		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmer temps in the western region. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

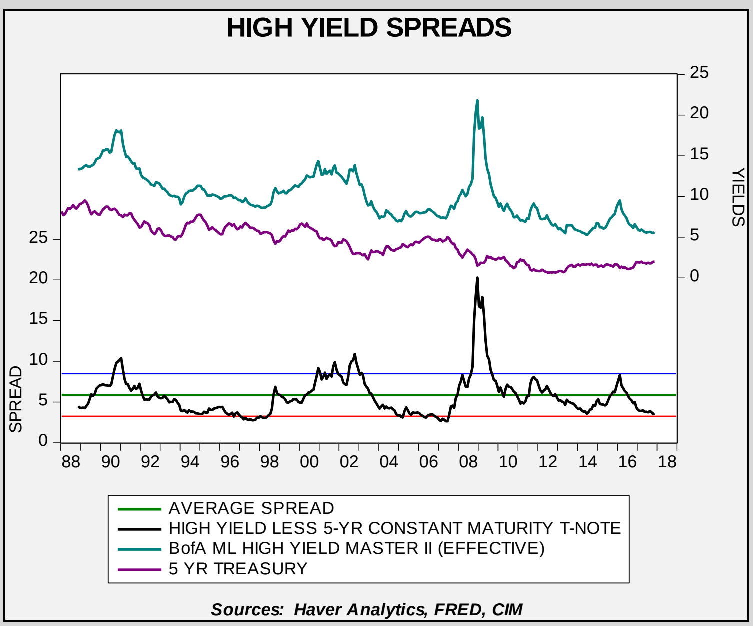
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.[2] 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.

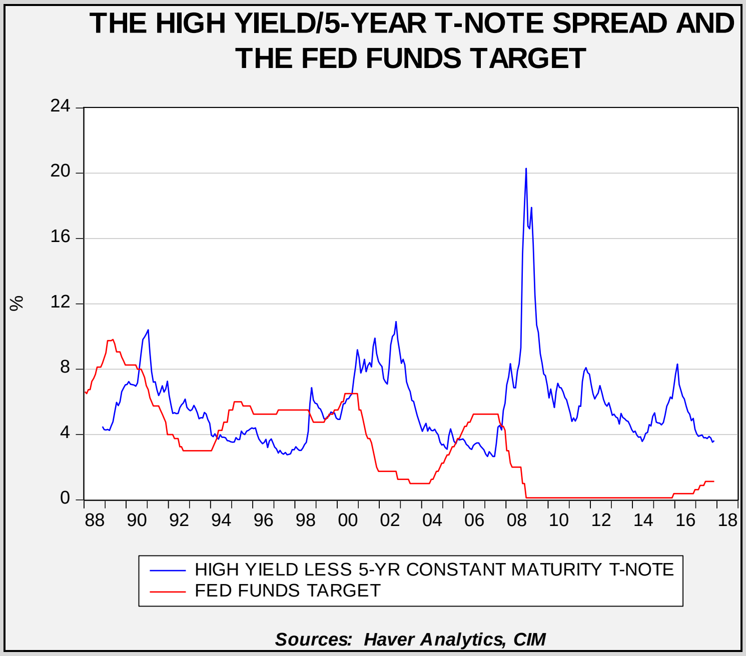


This chart shows the Merrill Lynch High Yield Master effective yield and the five-year T-note yield. The lower lines on the chart show the average spread and the standard deviation lines. The narrowing spread, by itself, doesn't necessarily signal an imminent

[2] 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.

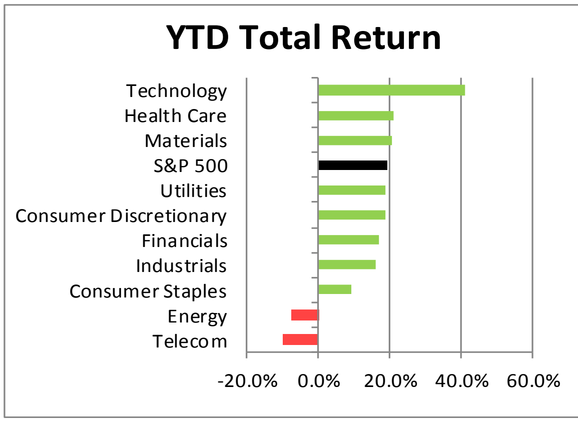


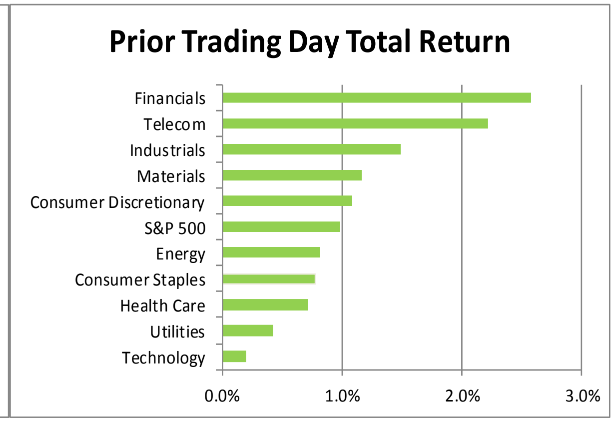
This chart shows the high-yield spread and the fed funds target. Major spikes in the spread are more likely after policy has already been tightened. In addition, the spread often continues to widen after policy easing has commenced. This pattern indicates that the spread is very sensitive to financial 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 11/28/2017 close)

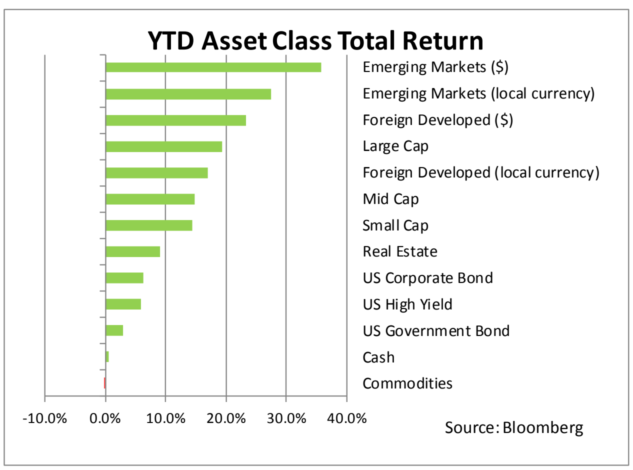




(Source: Bloomberg)

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 11/28/2017 close)

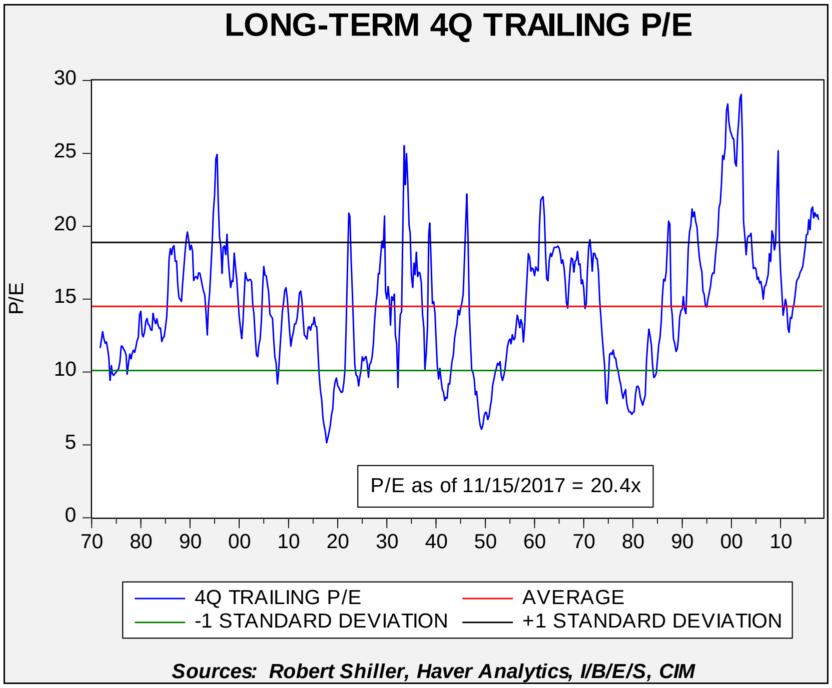


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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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[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 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.