Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 2, 2017—9:30 AM EDT] Global equity markets are down this morning. The EuroStoxx 50 is down 0.2% 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 0.4% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a lower open. With 327 companies having reported, the S&P 500 Q3 earnings stand at $33.15, higher than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 74.9% of the companies reported earnings above forecast, while 15.6% reported earnings below forecast.

The overnight news was relatively light, but here are the events we're keeping an eye on today:

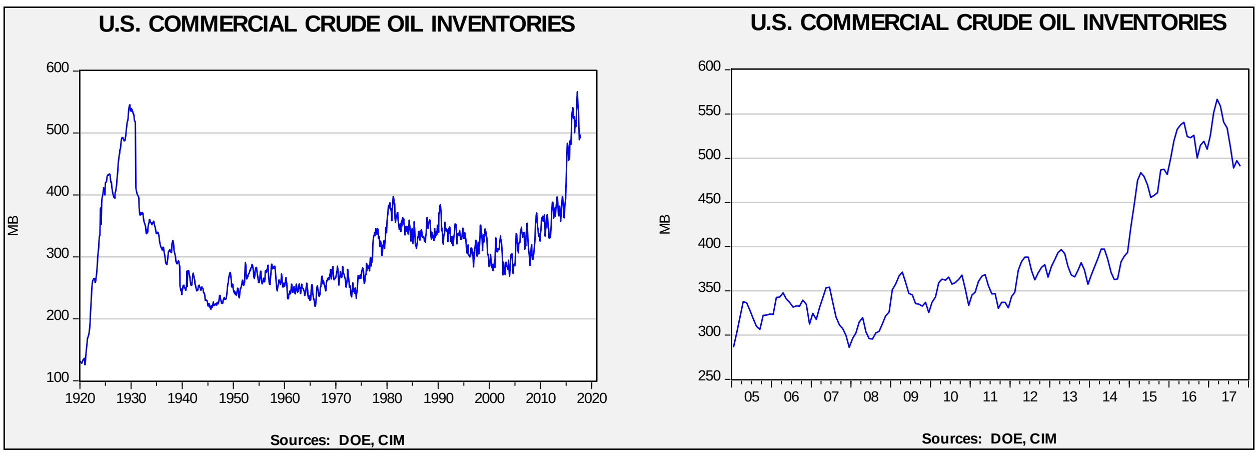
Changes at the Fed: Yesterday, the FOMC decided to maintain interest rates at their current levels but hinted at a possible rate increase in December. The Federal Reserve cited strong economic growth as the reason for further monetary tightening. Currently, the upper bound fed funds rate is 1.25%, which is relatively low compared to the neutral rate of 3.0%. As a result, we expect rate increases to continue into 2018.

In other Fed news, President Trump is expected to nominate Jerome Powell, a Federal Reserve governor, for the Federal Reserve chairman position. If confirmed, Powell would be replacing Janet Yellen after her term ends in February. He is not expected to have a tough time getting confirmed in the Senate as he has a good relationship with Republicans and Democrats alike. In 2011, Powell made a name for himself for his contribution in brokering a deal between the Obama administration and Congressional Republicans to raise the debt ceiling. Trump's selection of Powell would be considered a relatively safe choice as Powell has close ties with the Republican establishment. Powell's colleagues describe him as being neither dovish nor hawkish, but moderate. That being said, there are some Senate Republicans, including Vice President Mike Pence, who would prefer that President Trump select John Taylor, who is known to be hawkish. Accordingly, it is widely believed that he would maintain Yellen's approach of gradual interest rate rises.

Updates on tax reform: The tax reform package is expected to be revealed later today. Reports suggest that the House is struggling to come up with legislation that is palatable to all factions of the GOP and the White House. Recent attempts at proposal changes to make the bill more appealing have been complicated by the president's doggedness over key reforms. Trump has tweeted his disapproval of a possible phase-in period for corporate tax cuts, increased taxes on 401(k)s and retention of the Obamacare individual mandate. There are fears that Congress might replicate the failure of their Obamacare repeal if they insist on meeting all of Trumps demands. That being said, there have been a few concessions made as of late—it is believed the corporate tax rate will likely be temporary, the top individual tax rate will remain unchanged and mortgage rate deductions will be capped at $500,000. As of right now, we are not confident that tax reform will be complete before the end of the year. We will continue to monitor this situation.

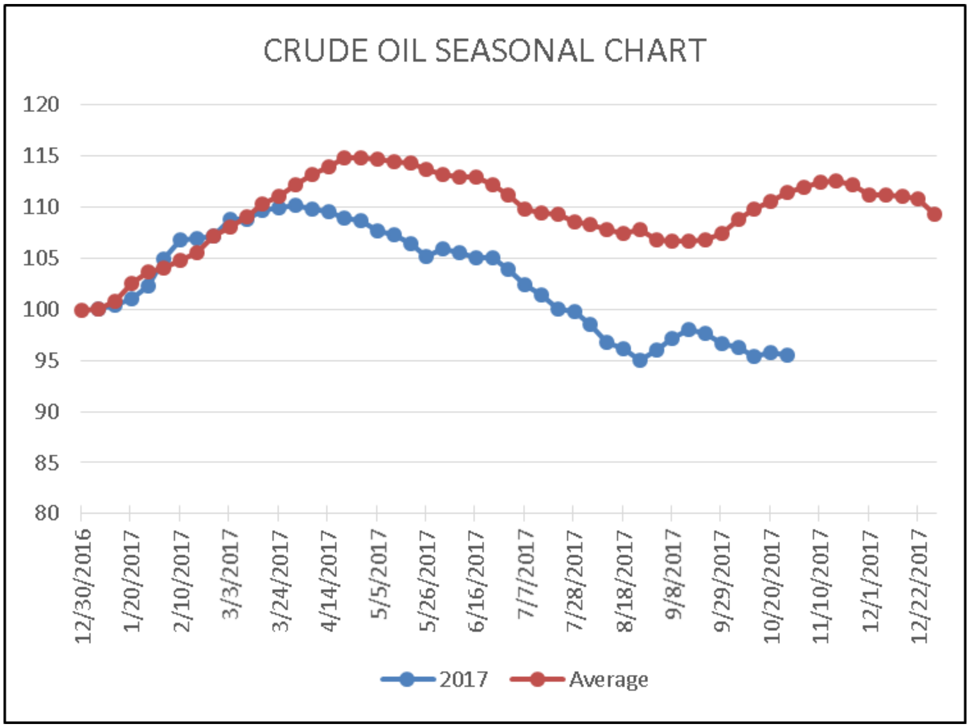
Rate hikes in the U.K.: Today, in a 7-2 vote, the Bank of England decided to raise its benchmark interest rate for the first time in a decade, while still maintaining its asset-buying program. The move is likely in response to elevated levels of inflation. Core CPI is 2.5%, which is higher than the 2.0% target set by the central bank. In addition, the BOE has signaled that it will likely raise interest rates two times before the year 2020. Even though the rate rise was expected, BOE policymakers have expressed concern as to the effect it might have on GDP, which has been relatively weak compared to some of its European peers.

Energy recap: U.S. crude oil inventories fell 2.4 mb compared to market expectations of a 2.1 mb draw.

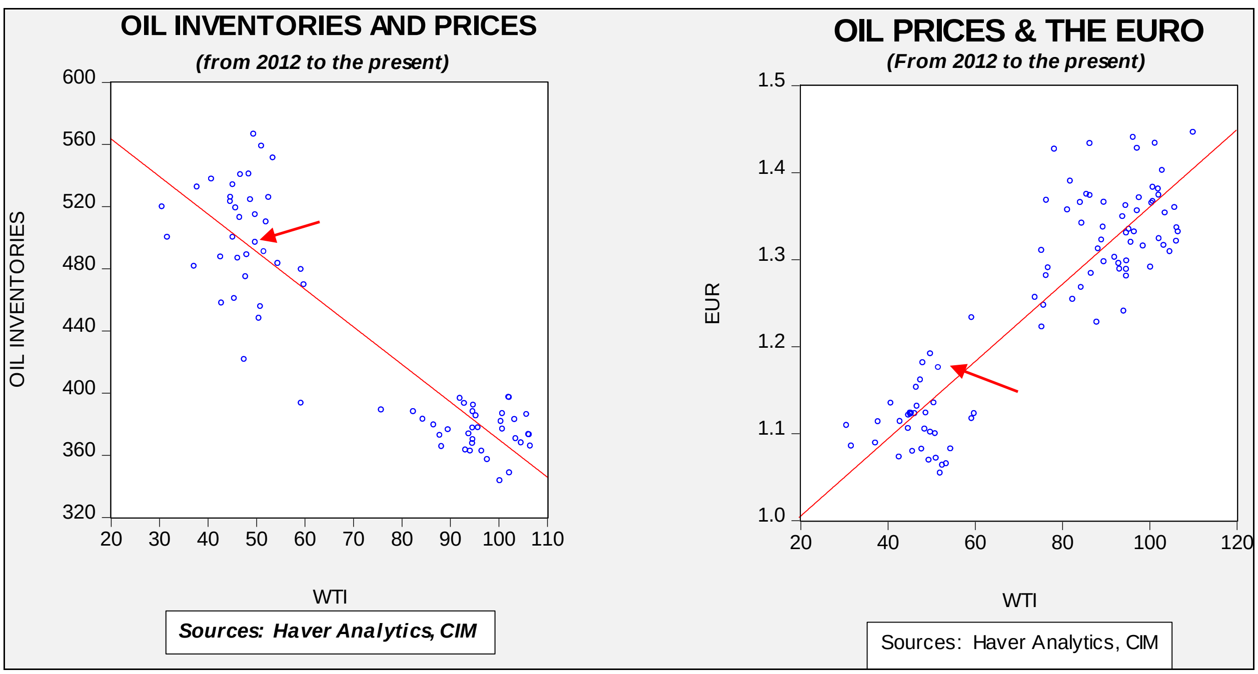


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have been declining. In fact, inventories are now at their lowest level since mid-2015. We also note that the SPR fell 0.8 mb, meaning total oil supplies fell 3.2 mb.

As the seasonal chart below shows, inventories are well into the autumn inventory build season but, so far, inventories have mostly been stable. As refinery runs pick up, further declines are likely. The real test will be in Q1 2018. As the chart below shows, inventories usually rise. Thus, oil prices could be well supported if inventories fail to increase.



(Source: DOE, CIM)

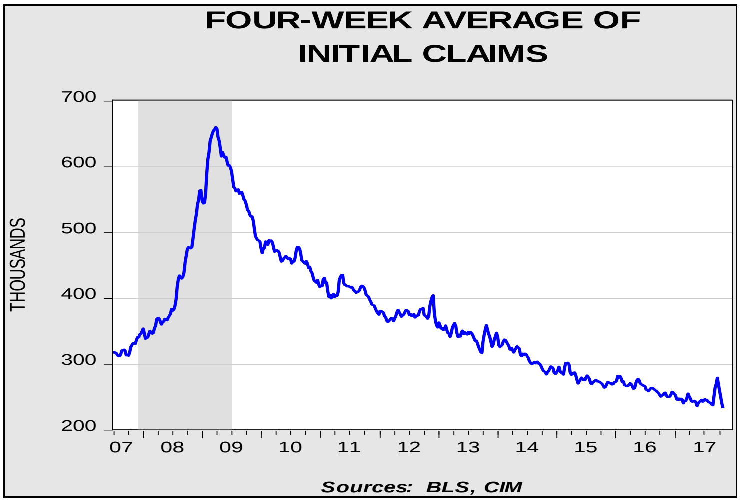


Based on inventories alone, oil prices are overvalued with the fair value price of $54.23. Meanwhile, the EUR/WTI model generates a fair value of $62.89. Together (which is a more sound methodology), fair value is $59.60, meaning that current prices are below fair value. Recent oil price strength has narrowed the degree of undervaluation.

U.S. Economic Releases

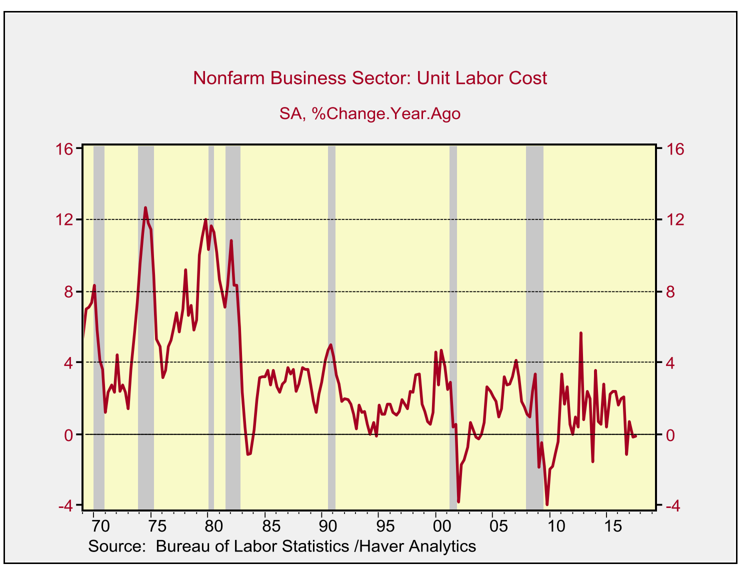
The October Challenger job cuts report fell by 3.0% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in below expectations at 229k compared to the forecast of 235k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 239.5k to 232.5k.

Nonfarm productivity came in above expectations, rising 3.0% from the prior quarter compared to the forecast gain of 2.6%. Unit labor costs came in above expectations, rising 0.5% from the prior quarter compared to the forecast gain of 0.4%. The chart below shows yearly changes in unit labor costs. The fact that unit labor costs, which are labor costs adjusted for productivity, are near zero explains why profit margins have improved recently.



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	Bloomberg Consumer Comfort	m/m	oct		51.0	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:20	William Dudley speaks at Alternative Reference Roundtable	President of the Federal Reserve Bank of New York				

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	Japan buying foreign bonds	m/m	sep	-1084 bn	10.9 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	sep	369.5 bn	55.1 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	sep	81.7 bn	-410.3 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	oct	697.0 bn	686.0 bn		*	Equity and bond neutral
	Monetary Base	y/y	oct	14.5%	15.6%		**	Equity and bond neutral
	Consumer Confidence	m/m	oct	44.5	43.9	43.6	**	Equity and bond neutral
Australia	Trade Balance	m/m	oct	A$1745 mn	A$989 mn	A$1200 mn	**	Equity bullish, bond bearish
	Building Approvals	m/m	oct	1.5%	0.4%	-1.0%	**	Equity bullish, bond bearish
New Zealand	ANZ Job Advertisements	m/m	sep	0.9%	0.4%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	oct	58.5	58.6	58.6	**	Equity and bond neutral
Germany	Markit Germany Manufacturing PMI	m/m	oct	60.6	60.5	60.5	**	Equity and bond neutral
	Unemployment Change	m/m	oct	-11k	-23k	-10k	***	Equity and bond neutral
	Unemployment Claims Rate	m/m	oct	5.6%	5.6%	5.6%	***	Equity and bond neutral
Italy	Markit/ ADACI Italy Manufacturing	m/m	oct	57.8	56.3	56.5	**	Equity bullish, bond bearish
France	Markit France Manufacturing	m/m	oct	56.1	56.7	56.7	**	Equity and bond neutral
UK	Markit/CIPS UK Construction PMI	m/m	oct	50.8	48.1	48.5	**	Equity bullish, bond bearish
Switzerland	SECO Consumer Confidence	m/m	oct	-2	-3	0	**	Equity and bond neutral
AMERICAS								
Mexico	Remittances Total	y/y	sep	$2.349 bn	$2.469 bn	$2.440 bn	**	Equity and bond neutral
	Markit Mexico Manufacturing PMI	m/m	oct	49.2	52.8		**	Equity and bond neutral
Canada	Markit Canada Manufacturing PMI	m/m	sep	54.3	55.0		**	Equity and bond neutral
Brazil	Industrial Production	y/y	aug	2.6%	4.0%	3.1%	***	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)	138	138	0	Up
3-mo T-bill yield (bps)	114	114	0	Neutral
TED spread (bps)	24	23	1	Neutral
U.S. Libor/OIS spread (bps)	129	128	1	Up
10-yr T-note (%)	2.37	2.37	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	43	43	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Neutral
pound	down			Neutral
franc	up			Neutral
Central Bank Action		**Prior**	**Expected**	
FOMC Rate Decision Upper Bound	1.250%	1.250%	1.250%	On forecast
FOMC Rate Decision Lower Bound	1.000%	1.000%	1.000%	On forecast
Bank of England Bank Rate	0.500%	0.250%	0.500%	On forecast
BOE Asset Purchase Target	435 bn	435 bn	435 bn	On forecast
BOE Corporate Bond Target	10 bn	10 bn	10 bn	On forecast

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	$60.24	$60.49	-0.41%	Long Liquidation
WTI	$54.30	$54.30	0.00%	
Natural Gas	$2.92	$2.89	0.86%	
Crack Spread	$20.39	$20.52	-0.63%	
12-mo strip crack	$20.94	$21.21	-1.27%	
Ethanol rack	$1.55	$1.55	0.20%	
Metals				
Gold	$1,276.69	$1,274.66	0.16%	Weaker Dollar
Silver	$17.11	$17.14	-0.19%	
Copper contract	$312.10	$314.25	-0.68%	
Grains				
Corn contract	$ 349.50	$ 348.25	0.36%	
Wheat contract	$ 421.50	$ 418.00	0.84%	
Soybeans contract	$ 994.50	$ 991.25	0.33%	
Shipping				
Baltic Dry Freight	1496	1522	-26	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.4	-2.1	-0.3	
Gasoline (mb)	-4.0	-1.3	-2.8	
Distillates (mb)	-0.3	-2.5	2.2	
Refinery run rates (%)	0.30%	0.70%	-0.40%	
Natural gas (bcf)		63.0		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temps for the northern region, with warmer temps for the rest of the country. 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.

October 27, 2017

It is expected that over the next two weeks President Trump is going to appoint a new Federal Reserve Open Market Committee (FOMC) chair and vice chair. In this report, we will build scenarios of how policy could change depending upon whom the president appoints.

This spreadsheet details our estimate of policy preference, with one being the most hawkish and five the most dovish.

	all	2017 FOMC	2018#1		2018#2		2018#3		2018#4
Yellen	3	3	3	Powell	3	Taylor	1	Yellen	3
Fischer	3	3	3	Taylor	1	Warsh	2	Taylor	1
Brainard	4	4	4	Brainard	4	Brainard	4	Brainard	4
Powell	3	3	3	vacant		Powell	3	Powell	3
Quarles	2	2	3	Quarles	2	Quarles	2	Quarles	2
vacant				vacant		vacant		vacant	
vacant				vacant		vacant		vacant	
Dudley	3	3	3	Dudley	3	Dudley	3	Dudley	3
Evans	4	4		Evans		Evans		Evans	
Bullard	5			Bullard		Bullard		Bullard	
George	1			George		George		George	
Mullinix	1		1	Mullinix	1	Mullinix	1	Mullinix	1
Bostic	3		3	Bostic	3	Bostic	3	Bostic	3
Williams	2		2	Williams	2	Williams	2	Williams	2
Mester	2		2	Mester	2	Mester	2	Mester	2
Rosengren	2			Rosengren		Rosengren		Rosengren	
Kashkari	5	5		Kashkari		Kashkari		Kashkari	
Kaplan	3	3		Kaplan		Kaplan		Kaplan	
Harker	2	2		Harker		Harker		Harker	
	2.82	3.20	2.70		2.33		2.30		2.40

(Sources: Federal Reserve, CIM)

The first column shows the members of the FOMC with the chair in green and vice chair in blue. We have Fischer still on the roster even though he is now leaving. The "all" column lists our estimates of policy bias. The Fed has eight permanent voters—the seven governors and the New York Federal Reserve Bank (FRB) president. The other 11 regional FRB presidents rotate into a voting position roughly every two to three years. The last row shows the average of our hawk/dove rankings. The current voting roster is more dovish than the FOMC as a whole. Scenario #1 assumes no changes to the chair and vice chair roles, although we know that Fischer is leaving so this scenario is purely hypothetical. This is to show that even with no changes at the governor level, next year's voting roster would have been markedly more hawkish regardless, with an average ranking of 2.70 compared to the current ranking of 3.20.

Scenario #2 assumes Jerome Powell, a current governor, is appointed to chair with John Taylor as vice chair. Powell's seat is assumed to remain vacant for the foreseeable future, which leads to an even more hawkish FOMC, with an average of 2.33.

Interestingly enough, the FOMC voters are just about as hawkish under the next most likely scenario, with John Taylor as chair and Kevin Warsh as vice chair (Powell remains as a governor). Finally, if Trump re-appoints Yellen but adds Taylor as vice chair, the average is 2.40; again, not a significant change in policy stance.

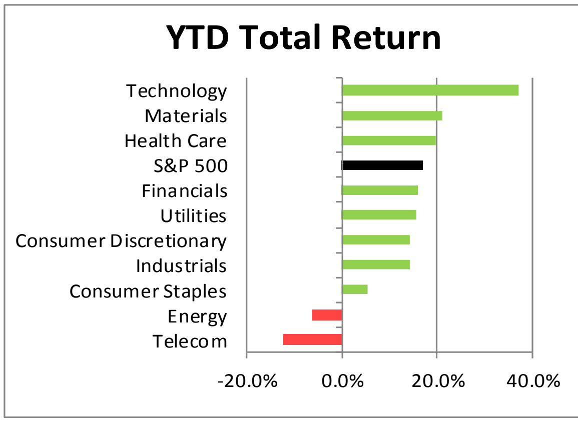
So, what is the most likely outcome? Currently, Powell is considered the front-runner[1] and would be the safest candidate. He is a moderate like Yellen and would probably maintain the current arc of policy. According to reports, President Trump had a good meeting with John Taylor and he might select him for vice chair. There is no indication at this point who would be selected to fill out the rest of the three open seats if Powell is appointed. It's possible that Kevin Warsh could be offered one as a consolation prize but, for now, we would not expect the remaining vacancies to be filled until much later in 2018.

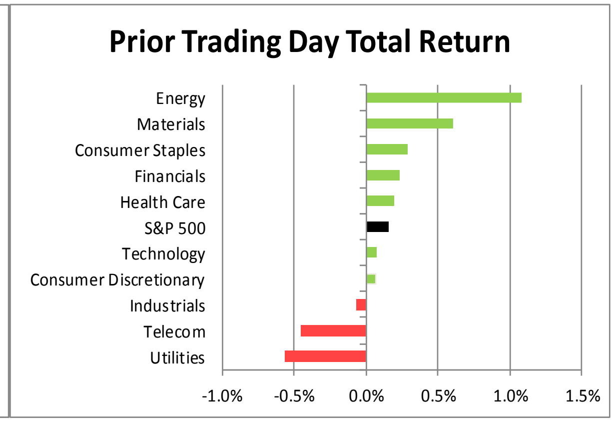
The bottom line is that next year's FOMC will take on a decidedly more hawkish stance due mostly to the hawkish lineup of regional bank presidents. This is a factor that will affect our outlook for next year.

[1] https://www.predictit.org/Market/3306/Who-will-be-Senate-confirmed-Fed-Chair-on-February-4%2c-2018

Data Section

U.S. Equity Markets – (as of 11/1/2017 close)

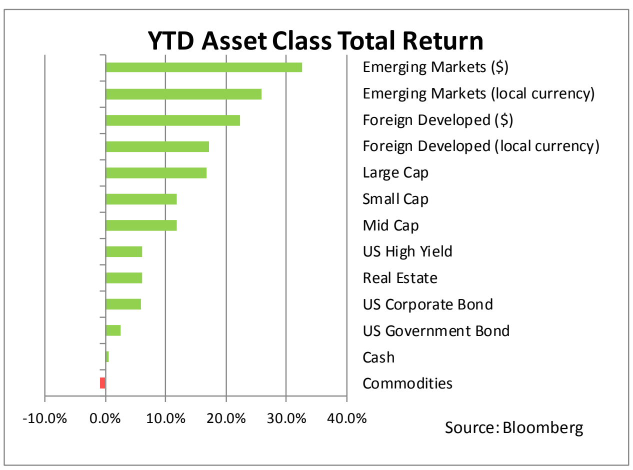




(Source: Bloomberg)

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 11/1/2017 close)

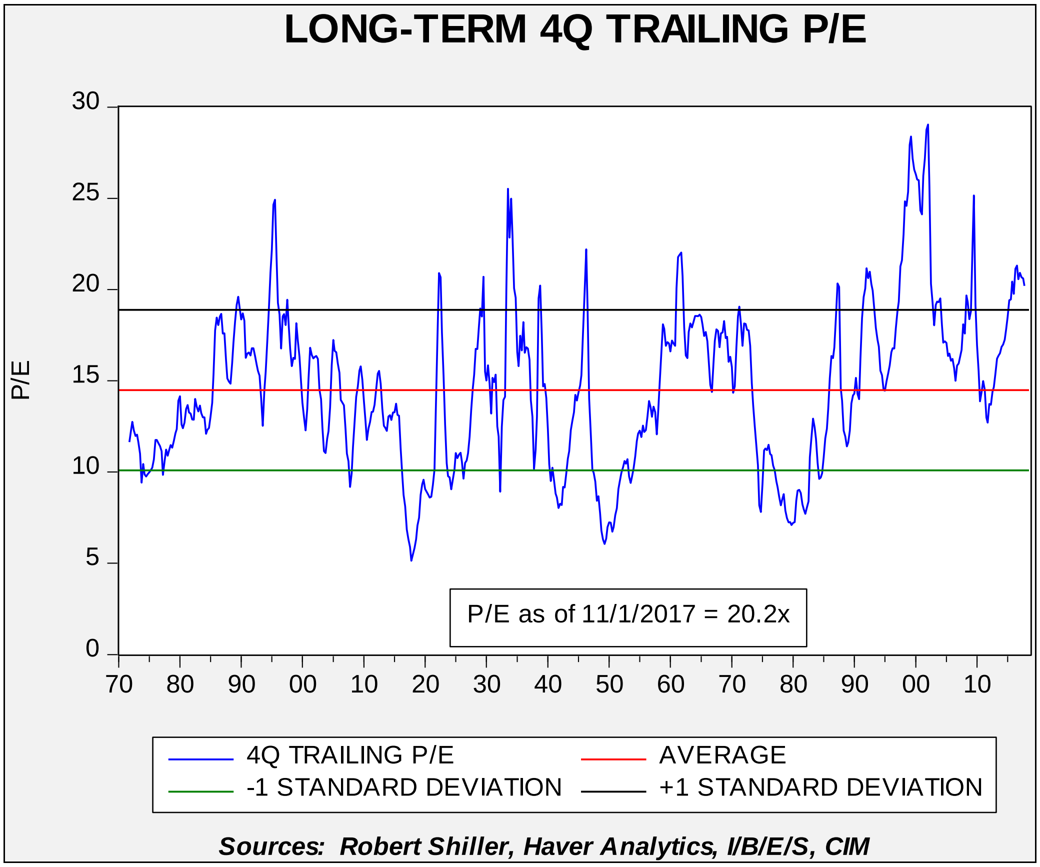


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2017



Based on our methodology,[2] the current P/E is 20.2x, unchanged from last 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 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.