Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 6, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed relatively unchanged from the prior close. Chinese markets were up, with the Shanghai composite up 0.5% and the Shenzhen index up 1.2%. U.S. equity index futures are signaling a lower open. With 382 companies having reported, the S&P 500 Q3 earnings stand at $33.30, higher than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 74.0% of the companies reported earnings above forecast, while 17.7% reported earnings below forecast.

Oh my, it was a very busy weekend for news. Let's dig in.

Saudi Arabia: The Kingdom of Saudi Arabia (KSA) was a hub of activity. There were a few items of note.

1. It appears that Crown Prince Muhammad bin Salman (MbS) has engineered a massive purge, arresting at least 17 prominent members of the Saudi security apparatus and important business figures.[1] Among the most important is Prince Miteb bin Abdullah, the son of the late King Abdullah and, until yesterday, the head of the Saudi National Guard. There are three major military/security agencies in the KSA. The regular military, the interior ministry and the National Guard. King Salman is generally in control of the first two, but the latter was under the authority of Prince Miteb. The National Guard has been in the Abdullah family for years; arresting Abdullah, along with other military leaders, consolidates MbS's power in the kingdom. Prince Waleed bin Ibrahim al-Ibrahim was also detained; a major global investor, he is often referred to as the "Buffett of Saudi Arabia." Major media leaders were arrested as were numerous military figures. This is a major action by MbS to consolidate power. The unknown here is whether this was a purge or a counter-coup. MbS has been moving quickly to consolidate power and this action is threatening lots of powerful people in the KSA. It would not be a surprise if there are plots to overthrow the king. However, whether there was nothing afoot or something brewing, the outcome is the same—King Salman has eliminated most of his rivals and can now smoothly abdicate for his son and crown prince, MbS. The official discussion was that the arrests were over "corruption" and were the actions of a newly created anti-corruption body. However, the fact that they could react this quickly does suggest that it's a cover for a purge. That's not to say there isn't corruption in the KSA; Transparency International[2] ranks the KSA at 62nd on its corruption scale out of 176 nations. That's in the "neighborhood" of Italy and

[1] https://en.wikipedia.org/wiki/2017_Saudi_Arabian_anti-corruption_arrests
[2] https://www.transparency.org/news/feature/corruption_perceptions_index_2016

Montenegro, meaning it's fairly corrupt but not all that bad for the region. Still, as we noted above, this appears to be more of a purge and anti-corruption is a tool.

2. A missile reportedly launched from Yemen was aimed at the Saudi Airport but was shot down by an anti-missile defense system, a Patriot. At first glance, this isn't a story that would be a huge shock. After all, the KSA is involved in a conflict in Yemen. On the other hand, it does appear to be a significant upgrade to the Houthi's arsenal. However, in light of the rest of the news, there is some speculation that this may have been a "false flag" operation. In other words, given that the Houthis are thought to be aligned with Iran, this launch could be *casus belli* for a conflict with Iran.
3. Lebanon's PM, Saad al-Hariri, abruptly resigned while visiting the KSA. Lebanon's political system is delicately balanced. There have always been constant tensions between Sunni, Shiites and Christians. As populations have changed, the country has been forced to adjust. The long civil war during the 1970s was in part due to the difficulties in adjusting to changes in socio-ethnic-religious allocations of power. At present, the Shiites are the most dominant group and Hezbollah the most potent military force. For the past few years, Hezbollah has been focused on the war in Syria. This has given Hariri political space to pass important legislation, including rules on oil and gas exploration. The fact that Hariri resigned in Riyadh (apparently after an assassination attempt) suggests the Saudis want a leader in Lebanon who will more strongly oppose Hezbollah. We note that Hezbollah's leader, Hassan Nasrallah, indicated that his group did not push for Hariri's removal and that the decision had been imposed by Riyadh. Hariri's departure will likely increase instability in Lebanon; Israel has, for the most part, been able to avoid the regional turmoil as Syria and Iraq deal with devolution. However, if tensions in Lebanon rise and Hezbollah tries to dominate, Israel may find itself pulled into a widening conflict.
4. There was a helicopter crash that reportedly killed Prince Mansour bin Muqrin, the deputy governor of the Asir province. He was the son of former Crown Prince Muqrin bin Abdulaziz, the last "king worthy" son of Ibn Saud, the founder of the KSA. According to reports, Prince Mansour was returning from an inspection tour of his province when his helicopter crashed. The cause of the crash has not been determined.[3]

So, what do we make of all this? The context of these events goes back to the end of WWII, when Franklin Roosevelt and Ibn Saud created a friendship agreement between the U.S. and the KSA. The U.S. didn't want Saudi oil falling into the hands of the British or the Soviets, and thus established relations with what is essentially a medieval kingdom. American policymakers knew that the states created by colonial powers in the Middle East were inherently unstable, where minority groups were given power in many cases to force the local leaders to rely on the colonial powers for support. When the colonialists departed, these nations devolved into authoritarian states often run by despots; although such leaders were antithetical to America's views on government, the U.S. maintained the borders in the region to prevent instability. That's why President George H.W. Bush built a coalition to remove Iraqi forces from Kuwait but didn't pursue these forces back to Baghdad or attempt to overthrow the Hussein regime. However, every president after Bush has undermined stability. President Clinton implemented harsh sanctions on Iraq and steadily weakened its economy. President George W. Bush invaded Iraq

[3] http://www.geographicguide.com/asia/maps/saudi-arabia.htm

and removed its leader, but was unable to build a working government to replace the tyrant. President Obama wanted to "pivot to Asia" which implied a "pivot from the Middle East." Adding to tensions was his support for the "Arab Spring" which has proven, in almost all cases, to lead to chaos. Because Obama wanted to reduce U.S. influence in the Middle East, he had to elevate a new regional hegemon. He chose Iran; the Iranian nuclear deal was, in part, a starting point to Iranian ascendency.[4] That decision, while defensible, was destined to be politically unpopular and President Obama lacked the political finesse to execute what would have been a difficult political feat. President Trump has returned to the American position of hostility toward Iran that occurred after the 1979 Iranian Revolution and hostage crisis. Current U.S. policy appears to support the ascendency of Saudi Arabia as the regional hegemon. And so, the events of this weekend should be seen in the context of the KSA taking steps to assume the regional hegemonic role. We doubt the KSA has the ability to execute this role but consolidating power, reforming the economy and modernizing social life in Saudi Arabia are probably necessary if MbS can transform the KSA into the dominant regional power.

The problem is that if the KSA can't perform the role, Iran, which views itself as the regional dominant power, will aggressively take steps to undermine the KSA in the region. The U.S. will need to decide if it will commit resources to the region when it faces a rapidly rising China in the Far East and a devolving EU in Europe. We fear the U.S. doesn't have the resources or the will to deal with a three-front world. The most likely outcome is that the U.S. allows the Middle East to devolve and focuses on Europe and the Far East (the Obama pivot). That means, at some point, a disruption of Middle East oil supplies and higher oil prices. In the past, fears of this outcome would have determined U.S. policy. However, shale oil and improving efficiency can allow the U.S. to focus outside the region.

Paradise Papers: We have links to the enormous data dump that exposed governments and individuals who have used offshore accounts to shelter wealth and income from taxes.[5] But, the key takeaway from the breadth of those revealed (the Queen? Really?! And Bono?) is that the populists have a point. Leaders across the establishment, whether center-left or center-right, have availed themselves of questionable to illegal means to avoid taxes. It smacks of Leona Helmsley's infamous line, "We don't pay taxes; only the little people pay taxes." Populist leaders around the world now have new fodder with which to attack the establishment.

Dudley to retire: NY FRB President Bill Dudley announced he plans to retire about mid-year 2018; he was scheduled to leave at year-end. The NY FRB president has unique powers on the FOMC. As true of all regional bank presidents, he is appointed by the board of directors of said bank. However, unlike other regional FRB presidents, the NY FRB president is a permanent

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[4] Although Iran remains wildly unpopular in the U.S., there are regional specialists who have argued that Iran is best suited for this role. The strongest argument is expressed by Robert Baer. Baer, R. (2008). *The Devil We Know: Dealing with the New Iranian Superpower*. New York, NY: Crown Publishers.

[5] https://www.bloomberg.com/news/articles/2017-11-05/panama-papers-redux-may-show-how-firms-wealthy-skirt-taxes ; http://www.bbc.com/news/uk-41876942?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top-stories ; https://www.icij.org/investigations/paradise-papers/explore-politicians-paradise-papers/ ; https://www.nytimes.com/2017/11/05/world/paradise-papers.html?emc=edit_mbe_20171106&nl=morning-briefing-europe&nlid=5677267&te=1

voter on the FOMC. In other words, he has the voting power of a governor without the Congressional appointment. This power is given to the NY FRB because of New York's predominant role in the U.S. financial system. Although Dudley has historically been a moderate (we rate him a "3" on our hawk/dove scale), he has evolved into a "Minskyist." We break the FOMC into three groups—Phillips Curve Disciples, Phillips Curve Heretics, and Minskyists. The disciples believe in the Phillips Curve and believe that tight labor markets require higher rates. The heretics believe the curve is no longer functional and believe the FOMC shouldn't raise rates until inflation exceeds the target. The Minskyists believe that lower rates trigger financial market distortions and thus call for higher rates to prevent asset bubbles. Thus, Dudley has become rather hawkish recently. The odds favor that Dudley will be replaced by a disciple simply because there are more of them around. That outcome may mean a somewhat less hawkish stance from the NY FRB.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows Fed events scheduled for the rest of the day.

Economic Releases		
	No economic releases today	
Fed speakers or events		
EST	**Speaker or event**	**District or position**
12:10	William Dudley speaks on Lessons from the Financial Crisis	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								
China	BoP Current Account Balance	q/q	3q	$37.1 bn	$50.9 bn		**	Equity and bond neutral
Japan	Nikkei Japan PMI Services	m/m	oct	53.4	51.0		**	Equity bullish, bond bearish
	Nikkei Japan PMI Composite	m/m	oct	53.4	51.7		**	Equity bullish, bond bearish
Australia	Melbourne Institute Inflation	m/m	oct	0.3%	0.3%		**	Equity and bond neutral
	ANZ Job Advertisements	m/m	oct	1.4%	0.0%		**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	sep	-0.3%	0.8%		**	Equity and bond neutral
	2yr Inflation Expectations	q/q	4q	2.0%	2.1%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Services PMI	m/m	oct	55.0	54.9	54.9	**	Equity and bond neutral
	Markit Eurozone Composite PMI	m/m	oct	56.0	55.9	55.9	**	Equity and bond neutral
	Sentix Investor Confidence	m/m	nov	34.0	29.7	31.0	**	Equity and bond neutral
	PPI	m/m	sep	0.6%	0.3%	0.4%	**	Equity bullish, bond bearish
Germany	Markit Germany Services	m/m	oct	54.7	55.2	55.2	**	Equity and bond neutral
	Markit/BME Germany Services	m/m	oct	56.6	56.9	56.9	**	Equity and bond neutral
	Factory Orders	m/m	sep	1.0%	3.6%	-1.1%	**	Equity bullish, bond bearish
France	Markit France PMI Composite	m/m	oct	57.3	57.5	57.5	**	Equity and bond neutral
	Markit France PMI Composite	m/m	oct	57.4	57.5	57.5	**	Equity and bond neutral
UK	New Car Registration	m/m	oct	-12.2%	-9.3%		**	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate	y/y	oct	6.3%	6.2%	6.2%	***	Equity and bond neutral
	Net Change in Employment	m/m	oct	35.3k	10.0k	15.0k	**	Equity and bond neutral
Brazil	Markit Brazil Services PMI	m/m	3q	49.5	51.7		**	Equity bearish, bond bullish
	Markit Brazil Composite PMI	m/m	aug	48.8	50.7		**	Equity bearish, bond bullish

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)	139	139	0	Up
3-mo T-bill yield (bps)	115	115	0	Neutral
TED spread (bps)	24	24	0	Neutral
U.S. Libor/OIS spread (bps)	130	129	1	Up
10-yr T-note (%)	2.32	2.33	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	43	43	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			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	$62.56	$62.07	0.79%	Uncertainty in Saudi Arabia
WTI	$56.02	$55.64	0.68%	
Natural Gas	$3.06	$2.98	2.45%	
Crack Spread	$20.73	$20.75	-0.06%	
12-mo strip crack	$21.15	$21.08	0.32%	
Ethanol rack	$1.56	$1.55	0.35%	
Metals				
Gold	$1,271.61	$1,269.91	0.13%	
Silver	$16.89	$16.84	0.27%	
Copper contract	$314.70	$311.75	0.95%	
Grains				
Corn contract	$ 349.50	$ 348.25	0.36%	
Wheat contract	$ 428.50	$ 425.75	0.65%	
Soybeans contract	$ 987.00	$ 986.75	0.03%	
Shipping				
Baltic Dry Freight	1482	1496	-14	

Weather

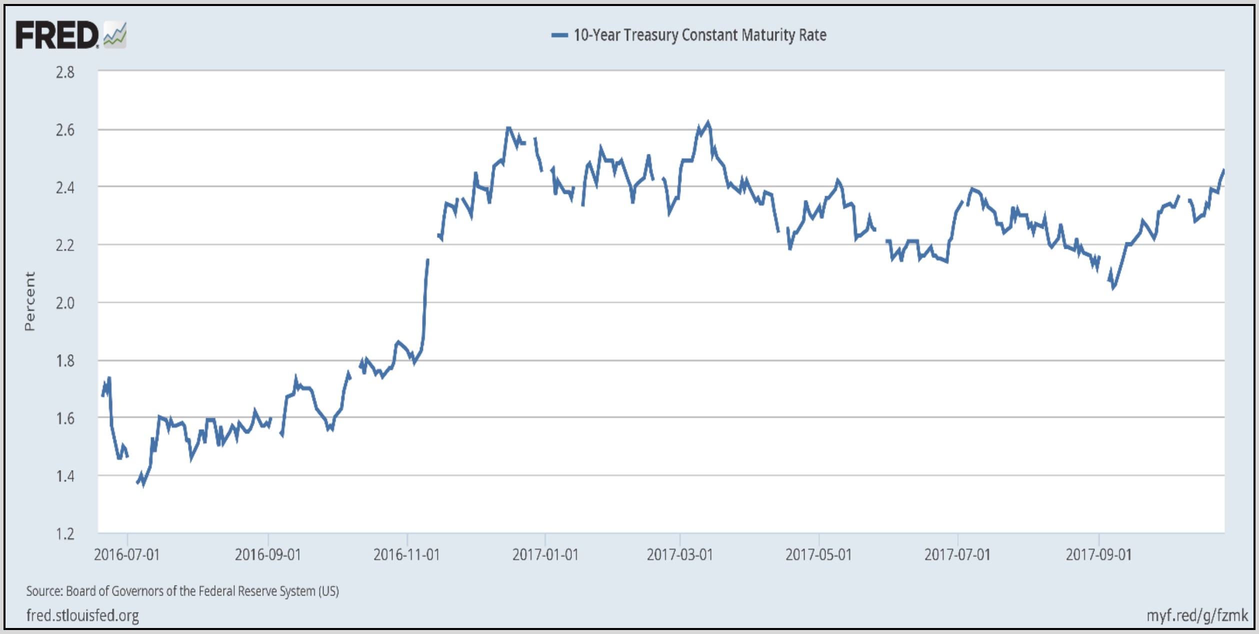
The 6-10 and 8-14 day forecasts show cooler to normal temps for the northern region, with warmer temps for the rest of the country.

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.

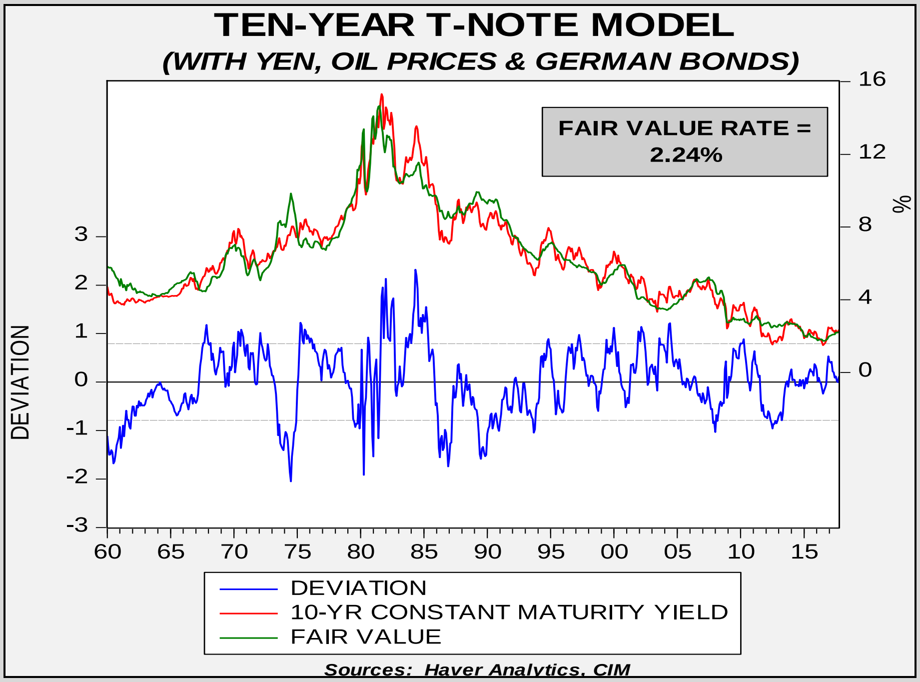
November 3, 2017

The 10-year Treasury yield has recently been trending upward.



Since early September, yields have risen from 2.06% to 2.46%. What's behind this rise and do we expect it to continue?

We use our 10-year T-note model for guidance. It estimates the fair value level of the 10-year T-note yield based on the long-term average of inflation, fed funds, German long-dated sovereign yields, the yen/dollar exchange rate and oil prices.



Based on these factors, the current fair value is 2.24%, a bit lower than the current yield. At the end of 2016, fair value was 1.96%, so the fair value rate has been moving higher. The primary reason has been a modest rise in German yields, rising fed funds and higher oil prices.

What do we see going forward? The two independent variables that have the most potential for pushing the fair value higher in the near term are fed funds and German yields. If the fed funds target rises to 2.25% by the end of next year and nothing else changes, the fair value yield would rise to 2.78%. If German bunds were to rise in yield to 0.75% at the same time, the fair value yield would rise to 2.80%. Thus, the primary worry is monetary policy. As we discussed last week, given the FOMC's voting roster next year, the FOMC will be unusually hawkish in 2018, so the odds of higher yields are rising.

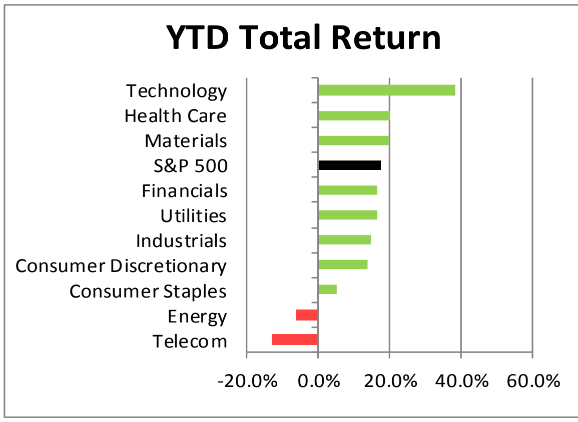
What about tax policy? Would larger deficits boost yields? The impact of deficits on interest rates is mixed. Perhaps the best way to think about this is with the savings identity.[6] The identity is: (private saving) + (public saving) + (foreign saving) = 0. In theory, if tax cuts result in a deficit of public saving, it must either be offset by rising private saving (saving>investment) or rising foreign saving (otherwise known as a current account deficit). If the public deficit is resolved by private saving, interest rates usually rise. But, if it is offset by foreign saving, domestic interest rates become a function of foreign interest rates. In other words, if foreign interest rates are low, domestic interest rates may not necessarily rise. In practice, large deficits usually occur during recessions and private saving is rising anyway as consumption falls. Thus, there will be talk about tax cuts boosting interest rates but the evidence isn't clear to support such statements.

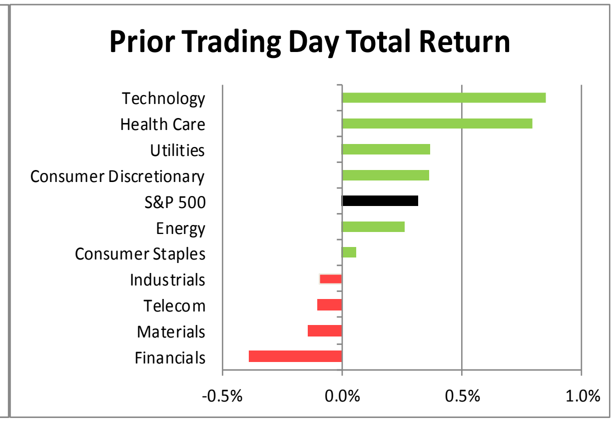
[6] For a deeper discussion, see WGRs from May 2017, Reflections on Trade: Parts I-IV.

The long-term risk for fixed income is inflation expectations. We use the 15-year average of CPI as a proxy for inflation expectations. Although we still expect inflation expectations to remain low, if populism leads to reregulation and/or deglobalization of the economy, inflation and expectations of future inflation would likely increase. If policymakers conclude that inequality must be reduced by restricting the introduction of new technology and restraining trade, greater inefficiencies will likely bring higher inflation. If such policies develop, we will become more defensive on fixed income.

<u>Data Section</u>

U.S. Equity Markets – (as of 11/3/2017 close)

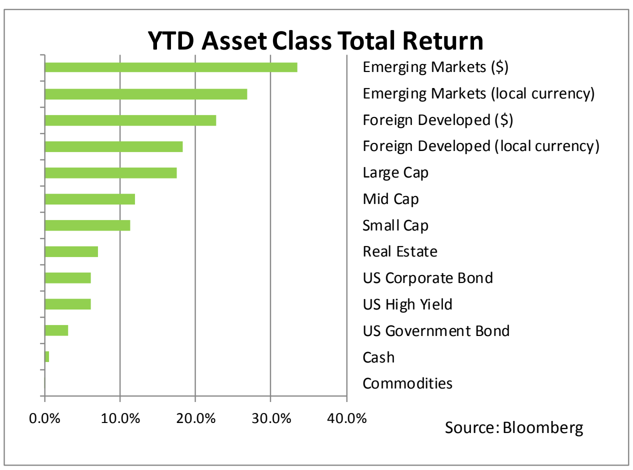




(Source: Bloomberg)

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 11/3/2017 close)

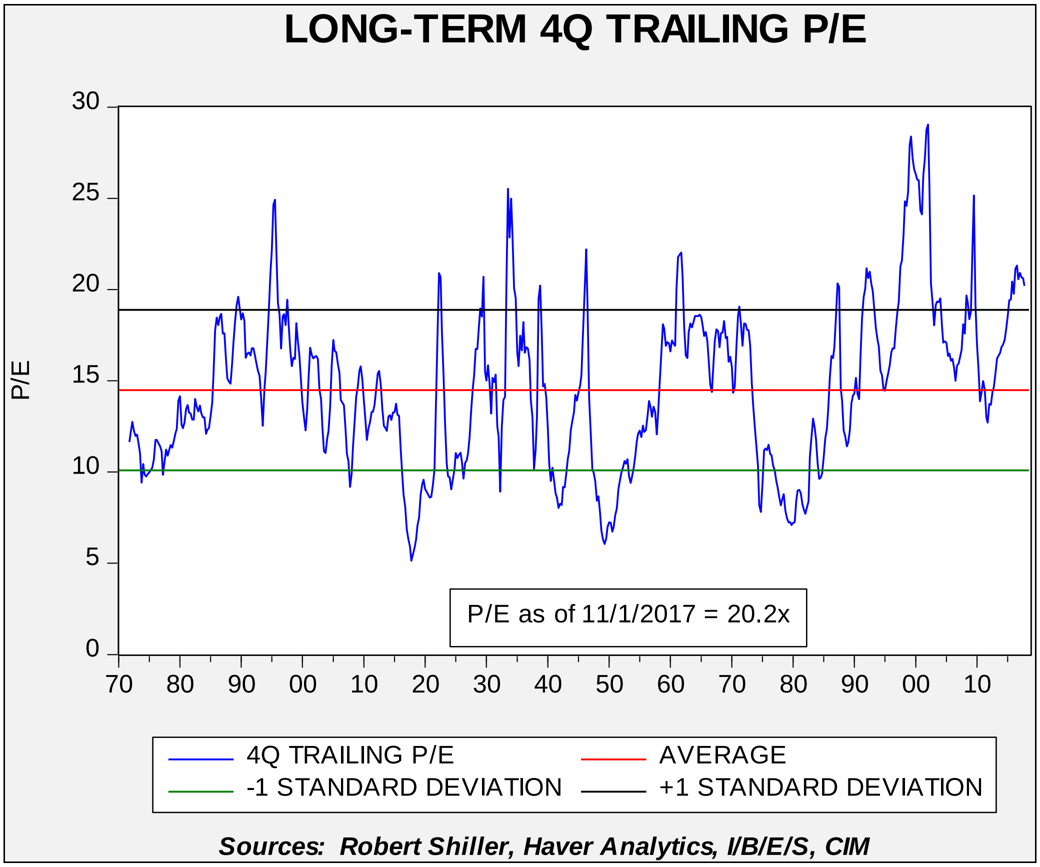


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[7] the current P/E is 20.2x, unchanged from last week.

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[7] 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.