Confluence Investment Management

Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: November 9, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.4% and the Shenzhen index up 0.7%. U.S. equity index futures are signaling a lower open. With 436 companies having reported, the S&P 500 Q3 earnings stand at $33.35, higher than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 74.3% of the companies reported earnings above forecast, while 17.4% reported earnings below forecast.

We are seeing some equity weakness this morning. There isn't anything specific weighing on the market other than what looks like profit taking. Here's the news we are watching this morning:

President Trump in China: The president received $250 bn in trade deals and promised investments. He will call this a win. China, on the other hand, made no promises of structural change in the trade relationship that would be necessary for a sustained decline in the trade account. China has created a situation of persistent oversaving; this was done to build China's investment base. Although this investment-led development was successful (and has been used at some point by every nation that has achieved developed status), a point is reached where the investment infrastructure is adequate and restructuring the economy away from suppressing consumption is necessary. We actually think that process is already underway. The aggressive consolidation of power in China by Chairman Xi will give him the wherewithal to restructure the economy. How will that look? One way, and, in our opinion, the best way, would be to sell off part of the state-owned enterprises to households at discount prices. This would boost household wealth and lift spending. Another way would be to put in social safety nets, like social security and deposit insurance. But, doing this will directly harm the wealthy and powerful in China; that's why Xi had to implement the purges he did in his first term. ***If Xi makes these moves, the Chinese external accounts will move from surplus to at least balanced, if not deficit.*** However, Xi cannot be seen as doing this because of demands by the U.S. And so, in place of real reform, which may be coming, Xi gave "baubles" to President Trump so Xi can reform at his own pace.

China and North Korea: There's not much new here. U.S. policy continues to hold that North Korea is China's problem to solve when China has no interest in solving it. China would be more worried if the U.S. engaged in direct negotiations with Pyongyang. As we noted recently,[1] China and North Korea are not really allies. A North Korea aligned with the U.S. would give Beijing its worst nightmare—a hostile power on its border.

[1] See WGRs: North Korea and China: A Difficult History, Part I (10/16/17); Part 2 (10/23/17); and Part III (10/30/17).

More trouble for May: PM May has lost her second minister in a week. Priti Patel, May's international development secretary, resigned after it was revealed she held up to a dozen unauthorized meetings with Israeli officials during a summer vacation. This follows on the heels of the resignation of May's defense minister, Michael Fallon, on charges of "inappropriate conduct." The GBP has been struggling on fears that May's government will fall and new elections will be held. The weakness of May's position has undermined her ability to negotiate Brexit, which has also pressured the currency.

Saudi crackdown continues: Bloomberg[2] is reporting that the wealthy in Saudi Arabia are fearful of additional asset freezes and are trying to move money out of the country. Although bitcoin reportedly jumped yesterday after a plan was shelved that would have created an offshoot of the popular cryptocurrency,[3] we suspect Saudi capital flight might be behind the rally and may support further upside to bitcoin. Cryptocurrencies have proven effective in evading capital controls and bitcoin could have another leg up if Saudi subjects begin to use the tool to move money away from the kingdom.

(Source: Bloomberg)

This is a year-to-date chart on the XBT/USD exchange rate.

Venezuela may avoid default…for now: Russia has apparently agreed to restructure $3.0 bn of Venezuelan debt it holds. This isn't anything new; over the past three years, Moscow has given the country $10 bn of assistance. In return, Rosneft (MCX: ROSN 334.10) was given 49% of CITGO, which is PDVSA's refining arm in the U.S. Russia is using Caracas's woes to gain

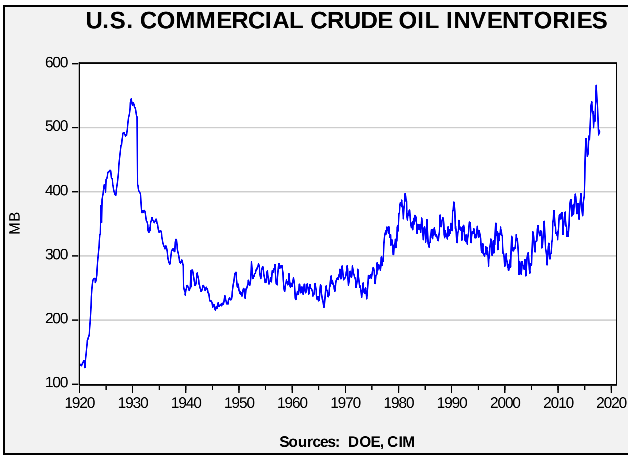
2 https://www.bloomberg.com/news/articles/2017-11-09/saudi-billionaires-are-said-to-move-funds-to-escape-asset-freeze

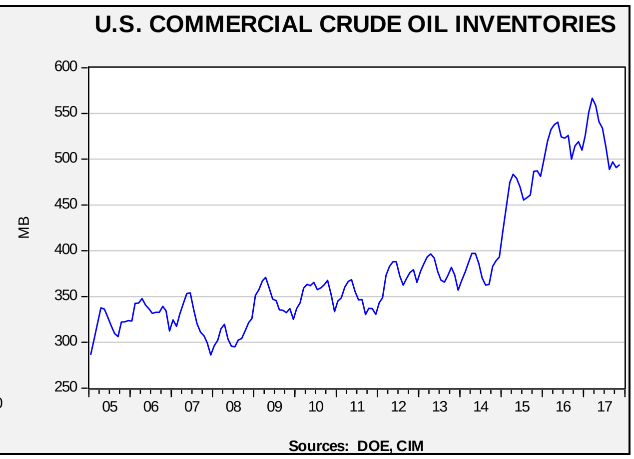
3 https://www.bloomberg.com/news/articles/2017-11-08/bitcoin-surges-to-record-on-speculation-possible-split-avoided

further control of Venezuela and will likely try to use this foothold in the Western Hemisphere to weaken U.S. influence in the region. Still, it appears highly unlikely that Venezuela will avoid restructuring its debt.

Merkel is struggling: Chancellor Merkel has been trying to cobble together a coalition after her party's weak showing in the September elections. She has attempted a "Jamaica" coalition, consisting of her conservative CDU/CSU party, the Free Democrats, a libertarian-leaning party, and the Greens, the environmental party (the party colors are green for the Greens, yellow for the Free Democrats and black for the CDU/CSU, the Jamaican flag colors). These parties are not natural allies, but political leaders fear that another election may lead to further gains for the AfD. This weakness in Germany comes at a time of a growing global power vacuum and raises the dangers for further drift in Europe. At the same time, distraction in Germany may lead Merkel to be soft on Brexit negotiations, which would benefit the U.K.

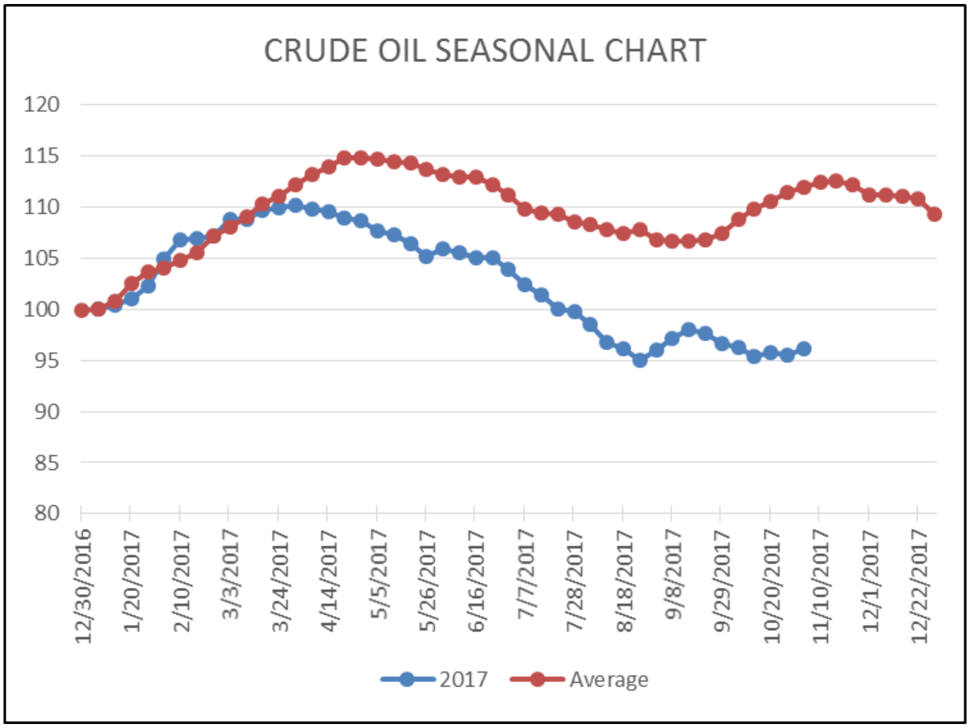
Energy recap: U.S. crude oil inventories rose 2.2 mb compared to market expectations of a 2.5 mb rise.



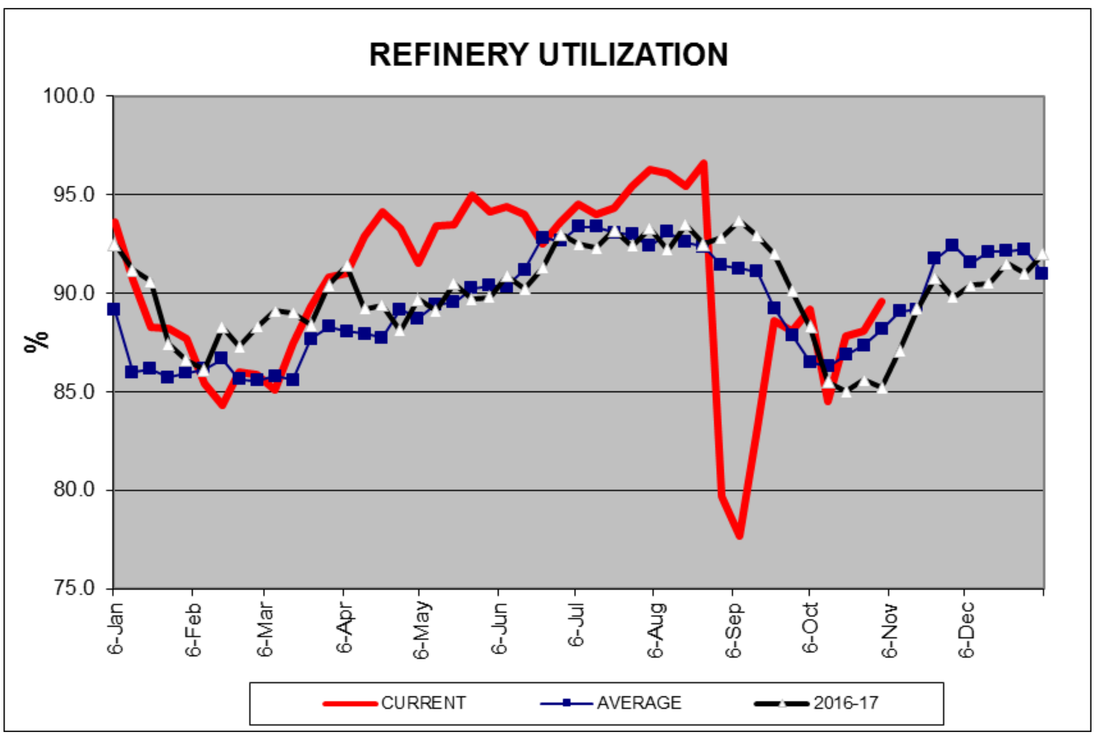


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly this year. We also note the SPR fell by 0.7 mb, meaning the net build was 1.5 mb.

As the seasonal chart below shows, inventories rose modestly this week. It appears that we are "skipping" the usual autumn inventory rebuild period. Usually, inventories would peak in two weeks. After that, stockpiles would decline into year's end and then start their largest build from early January into early April.

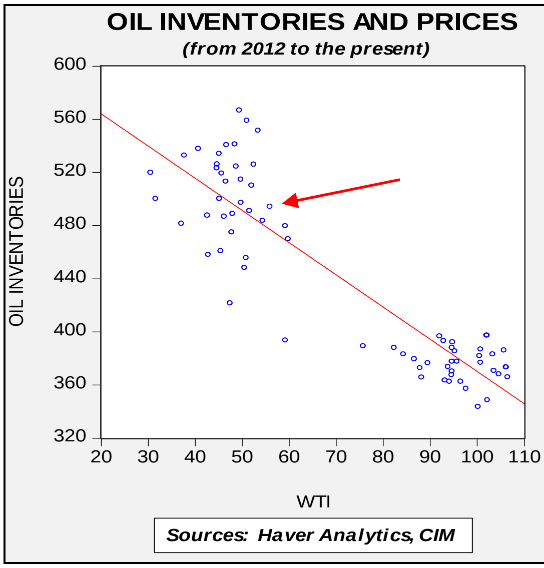


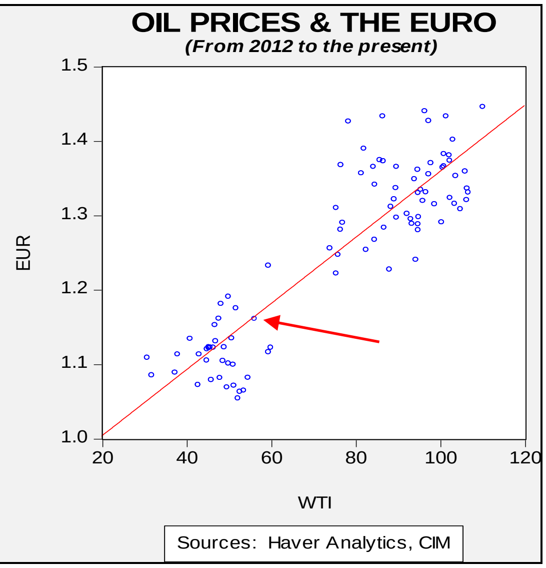
(Source: DOE, CIM)



(Source: DOE, CIM)

Refinery operations continued to rise last week, in line with seasonal norms. If this continues, and we expect it will, it should be bullish for oil prices.

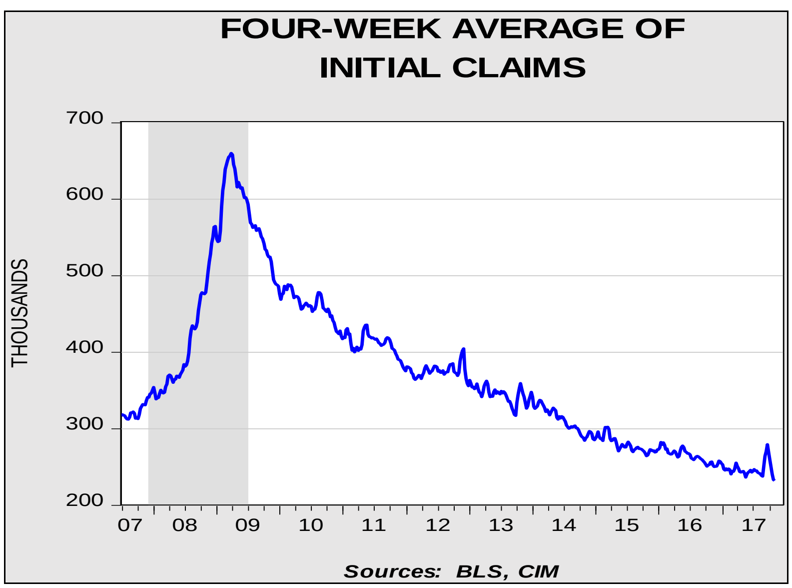




Based on inventories alone, oil prices are undervalued with the fair value price of $53.22. Meanwhile, the EUR/WTI model generates a fair value of $59.70. Together (which is a more sound methodology), fair value is $56.99, meaning that current prices are very close to fair value. Dollar strength and the rise in oil prices have mostly addressed the recent undervaluation. Oil prices should continue to benefit from turmoil in the Middle East, but we would look for a period of consolidation in prices unless geopolitical conditions deteriorate significantly.

U.S. Economic Releases

Initial jobless claims came in below expectations at 239k compared to the forecast of 232k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 232.50k to 231.25k.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	nov		51.7	**
10:00	Wholesale Trade Sales	m/m	sep	0.9%	1.7%	**
10:00	Wholesale Inventories	m/m	sep	0.3%	0.3%	**
Fed speakers or events						
	No speakers or events scheduled					

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	CPI	y/y	oct	1.8%	1.6%	1.8%	***	Equity and bond neutral
	PPI	y/y	oct	6.9%	6.9%	6.6%	**	Equity and bond neutral
Japan	Japan buying foreign bonds	m/m	oct	-0.730 tn	1.084 tn		**	Equity and bond neutral
	Japan buying foreign stocks	m/m	oct	-0.170 tn	0.370 tn		**	Equity and bond neutral
	Foreign buying Japan bonds	m/m	oct	0.094 tn	0.082 tn		**	Equity and bond neutral
	Foreign buying Japan stocks	m/m	oct	-0.012 tn	0.697 tn		**	Equity and bond neutral
	Core Machine Orders	m/m	oct	8.1%	3.4%	-2.0%	*	Equity bullish, bond bearish
	BoP Current Account Balance	m/m	oct	2.271 tn	2.380 tn	2.363 tn	**	Equity and bond neutral
	Trade Balance BoP	m/m	oct	0.852 tn	0.319 tn	0.833 tn	**	Equity bullish, bond bearish
Australia	Home Loans	m/m	oct	-2.3%	1.0%	2.0%	*	Equity bearish, bond bullish
	Investment Lending	m/m	sep	-6.2%	4.3%		**	Equity and bond neutral
	Owner-Occupier Loan Value	m/m	sep	-2.1%	0.9%		**	Equity and bond neutral
EUROPE								
Germany	Trade Balance	m/m	sep	24.1 bn	20.0 bn	22.3 bn	**	Equity bullish, bond bearish
	Current Account Balance	m/m	sep	25.4 bn	17.8 bn	23.5 bn	**	Equity bullish, bond bearish
	Exports	y/y	sep	-0.4%	3.1%	-1.3%	**	Equity and bond neutral
	Imports	m/m	oct	-1.0%	1.2%	0.3%	**	Equity and bond neutral
France	Bank of France Industry Sentiment	m/m	oct	106	104	105	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	oct	3.0%	3.0%	3.0%	***	Equity and bond neutral
AMERICAS								
Canada	House Starts	m/m	oct	222.8k	217.1k	211.0k	**	Equity bullish, bond bearish
	Building Permits	m/m	sep	3.8%	-5.5%	1.0%	**	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)	140	140	0	Up
3-mo T-bill yield (bps)	120	121	-1	Neutral
TED spread (bps)	20	19	1	Neutral
U.S. Libor/OIS spread (bps)	131	131	0	Up
10-yr T-note (%)	2.33	2.32	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	46	46	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action		**Prior**	**Expected**	
RBNZ Cash Rate Target	1.750%	1.750%	1.750%	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	$63.49	$63.49	0.00%	
WTI	$56.89	$56.81	0.14%	
Natural Gas	$3.17	$3.18	-0.03%	
Crack Spread	$21.22	$21.09	0.61%	
12-mo strip crack	$21.46	$21.48	-0.09%	
Ethanol rack	$1.56	$1.56	-0.38%	
Metals				
Gold	$1,287.18	$1,281.36	0.45%	
Silver	$17.11	$17.04	0.42%	
Copper contract	$308.05	$309.95	-0.61%	
Grains				
Corn contract	$ 348.75	$ 348.25	0.14%	
Wheat contract	$ 427.00	$ 426.75	0.06%	
Soybeans contract	$ 1,002.25	$ 998.50	0.38%	
Shipping				
Baltic Dry Freight	1486	1477	9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.2	-2.5	4.7	
Gasoline (mb)	-3.3	-2.0	-1.4	
Distillates (mb)	-3.4	-1.2	-2.2	
Refinery run rates (%)	1.50%	0.45%	1.05%	
Natural gas (bcf)		17.0		

Weather

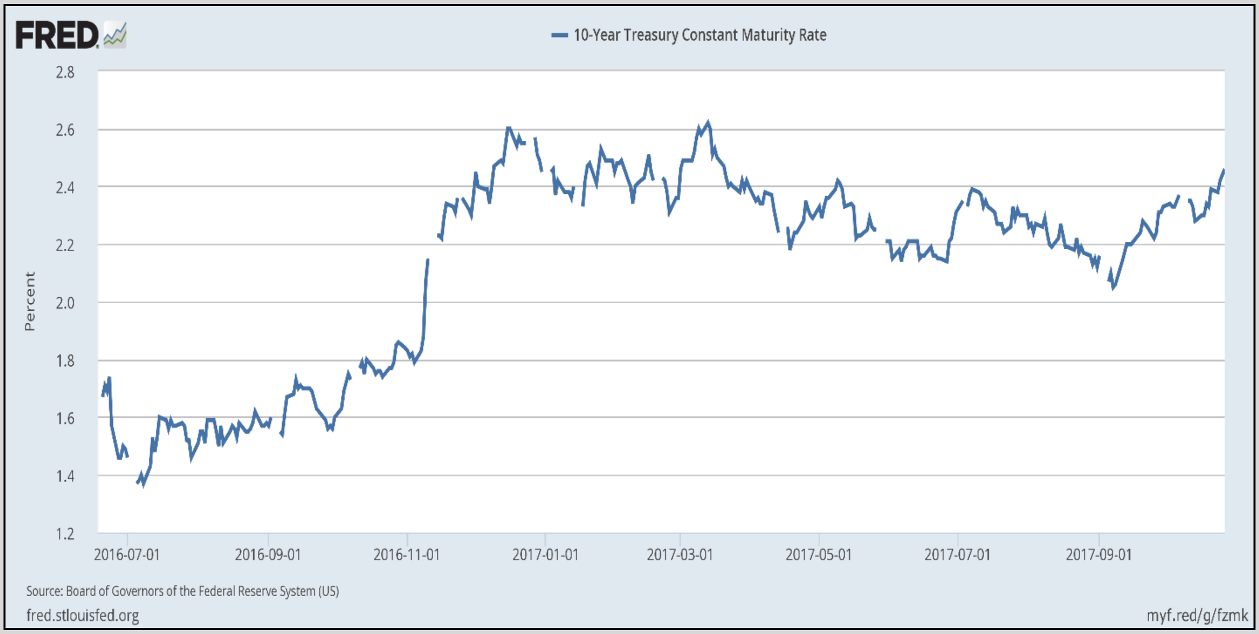
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country.

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.

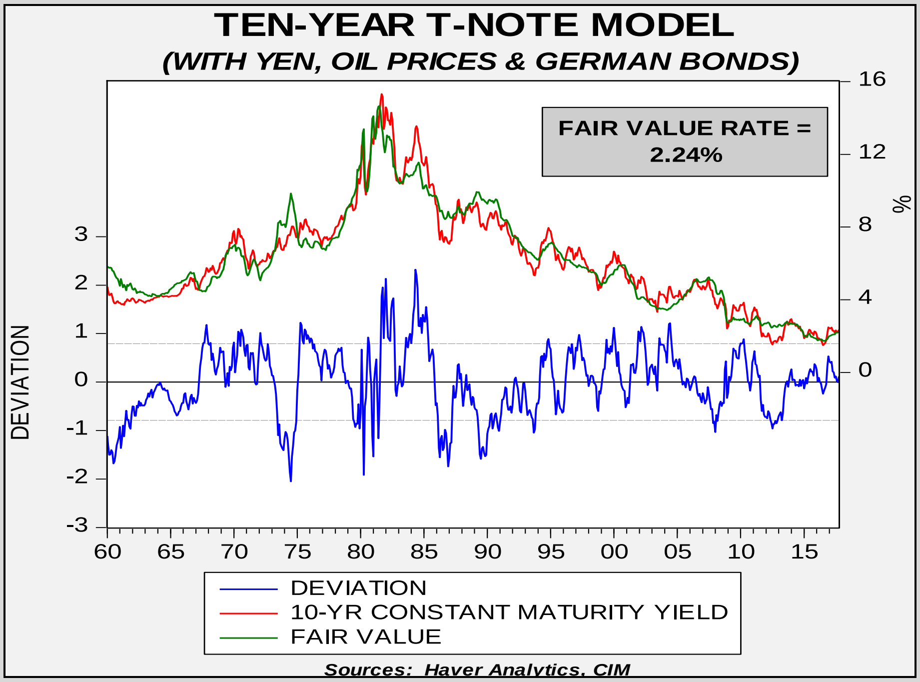
November 3, 2017

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.[4] 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.

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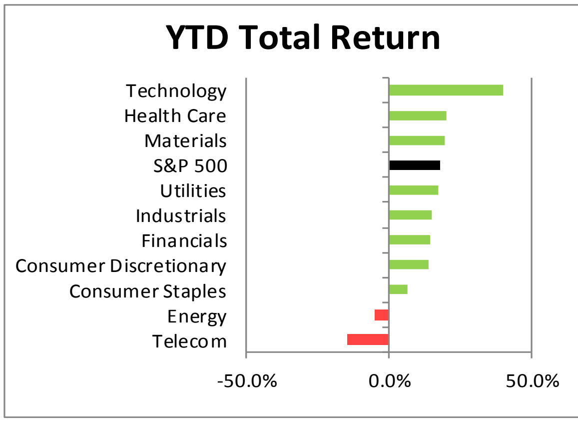
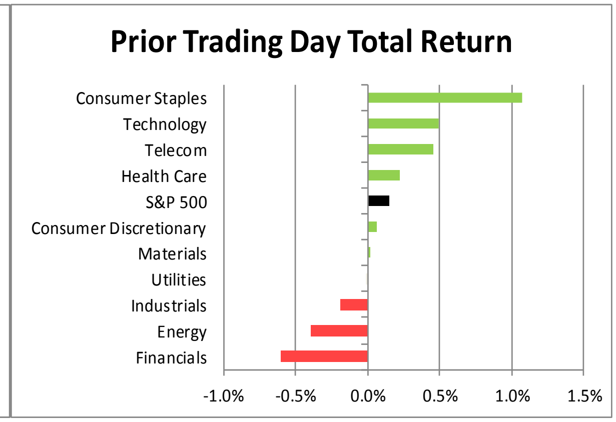
[4] For a deeper discussion, see WGRs from May 2017, Reflections on Trade: Parts I-IV.

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.

Data Section

U.S. Equity Markets – (as of 11/8/2017 close)

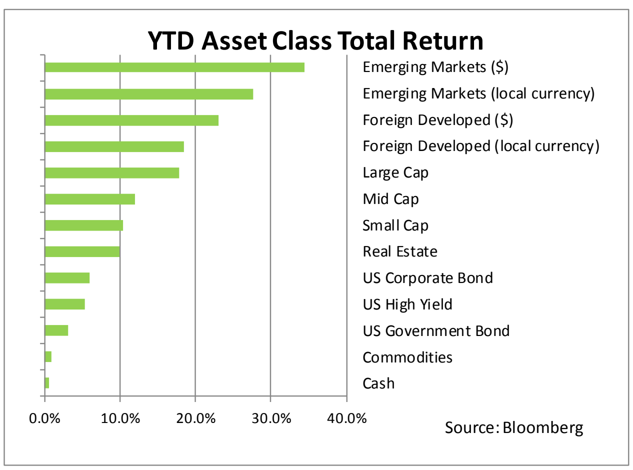




(Source: Bloomberg)

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 11/8/2017 close)

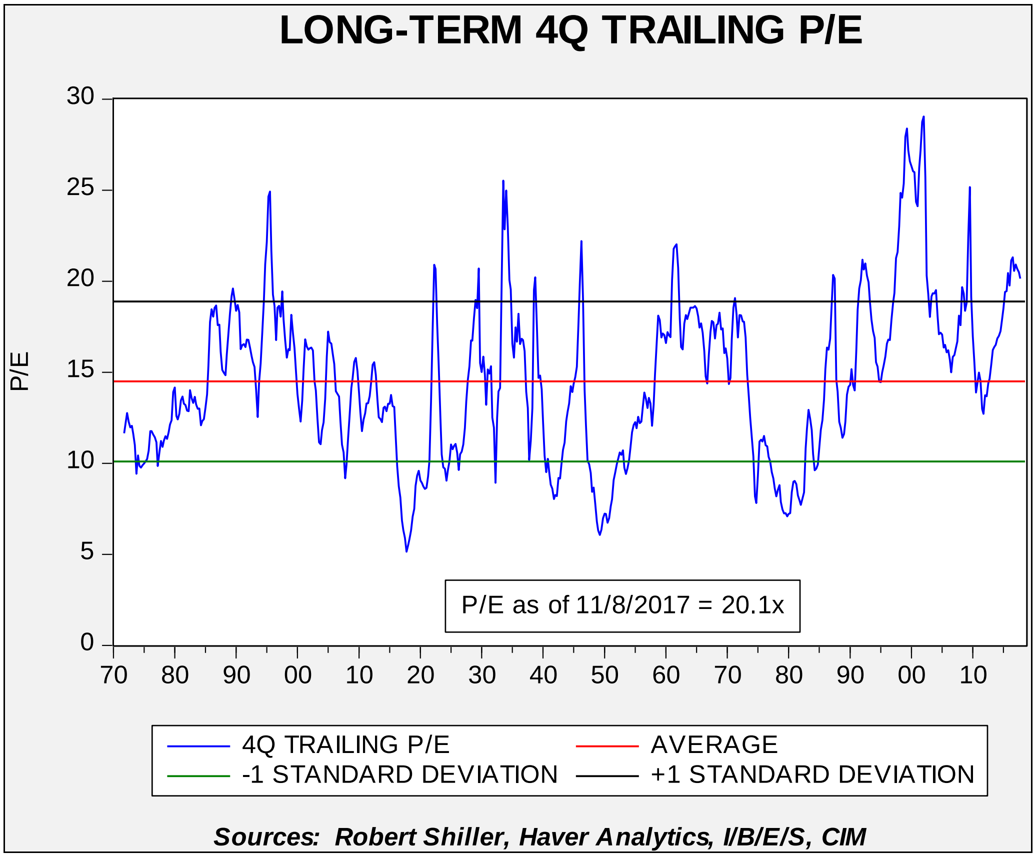


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2017



Based on our methodology,[5] the current P/E is 20.1x, down 0.1x from last week. Rising earnings offset the lift in the S&P, causing the modest decline in the P/E this week.

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[5] 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.