Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 2, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is relatively unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.7%. U.S. equity index futures are signaling a higher open.

It was a violent weekend. Here is what we are watching:

The mess in Catalonia: Catalonia did hold an independence referendum over the weekend in the midst of a strong central government crackdown. Latest media reports suggest over 760 people were injured in clashes with central government riot police. The vote overwhelmingly supported independence (over 90%) but that was mostly the result of anti-independence groups telling their supporters not to vote. We are seeing a weaker EUR this morning, due in part to the chaos caused by this vote. It gets even more complicated; PM Rajoy leads a conservative minority government that governs with occasional support from the liberal and center-left parties. The opposition will be less likely to cooperate with Rajoy in the aftermath of his heavy-handed response. So, it is quite possible the government will fall because of this event and Spain could be looking at new elections.

A massacre in Las Vegas: In a shooting somewhat reminiscent of the University of Texas massacre in 1966,[1] Stephen Paddock, a local resident, began shooting randomly from the 32nd floor of a local casino/hotel into a crowded music festival. At the time of this writing, 50 people have died and over 400 are injured. Although this event probably won't have a major market impact, it is a horrific event and our thoughts and prayers go out to the victims.

"Save your energy, Rex": The Sunday *NYT* reported[2] that the U.S. was in direct communication with North Korea, raising hopes that negotiations were actually making progress. There have been reports for months that the U.S. was engaged in backchannel talks with North Korean officials; for the Secretary of State to openly reveal that such talks were underway was a hopeful sign. However, in a series of tweets, President Trump essentially undercut any discussions. How could any North Korean negotiator take Tillerson's promises with any degree of certainty? We do note that there is a North Korean holiday coming on October 10th and there are expectations that the Kim regime will use the event to launch another missile test. Trump's comments raise the likelihood that a conflict occurs. We still believe the odds remain low (>15%), but they are increasing.

---

[1] https://en.wikipedia.org/wiki/University_of_Texas_tower_shooting
[2] https://www.nytimes.com/2017/09/30/world/asia/us-north-korea-tillerson.html

Fed talk: President Trump is turning his attention to the three (and soon to be four) open Fed governor positions. Current Governors Jerome Powell and Kevin Warsh are said to be the leading candidates for Fed Chair. Powell is a moderate on policy. Warsh's public statements have been hawkish but he isn't an economist and our read is that he is more of a political operator than an independent voice on policy. Thus, if the president wants a dove, Warsh can do that. There are reports that Warsh may favor increased political oversight of the Fed; although central bank independence is accepted wisdom, in reality, independence is a function of anti-inflation policy. For years, central banks were expected to accommodate fiscal policy and all central banks serve at the pleasure of some political master. But, if we start to see a retreat from independence, the chances of reflation rise.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing PMI	m/m	sep	53.0	53.0	**
10:00	ISM Manufacturing	m/m	sep	58.1	58.8	**
10:00	ISM Prices Paid	m/m	sep	63.0	62.0	**
10:00	ISM New Orders	m/m	sep		60.3	**
10:00	ISM Employment	m/m	sep		59.9	**
10:00	Construction Spending	m/m	aug	0.4%	-0.6%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	Robert Kaplan speaks in El Paso	President of the Federal Reserve Bank of Dallas				

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	Manufacturing PMI	m/m	sep	52.4	51.7	51.6	**	Equity bullish, bond bearish
	Non-manufacturing PMI	m/m	sep	55.4	53.4		**	Equity and bond neutral
	Caixin China PMI Mfg	m/m	sep	51.0	51.6	51.5	**	Equity and bond neutral
India	Nikkei India PMI Mfg	m/m	sep	20149	63211		**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	y/y	aug	9.1%	9.1%	9.0%	***	Equity and bond neutral
	Markit Eurozone Manufacturing	m/m	sep	58.1	58.2	58.2	**	Equity and bond neutral
Germany	Markit/ BME Germany Manufacturing	m/m	sep	60.6	60.6	60.6	**	Equity and bond neutral
Italy	Markit/ ADACI Italy Manufacturing	m/m	sep	56.3	56.3	56.8	**	Equity and bond neutral
	Unemployment Rate	m/m	aug	11.2%	11.3%	11.2%	***	Equity and bond neutral
France	Markit France Manufacturing PMI	m/m	sep	56.1	56.0	56.0	**	Equity bullish, bond bearish
UK	Markit UK PMI Manufacturing	m/m	sep	55.9	56.9	56.2	**	Equity and bond neutral
Switzerland	Retail Sales Real	y/y	aug	-0.2%	-0.7%		**	Equity and bond neutral
	PMI Manufacturing	m/m	sep	61.7	61.2	60.5	**	Equity bullish, bond bearish
	Total Sight Deposits	m/m	sep	579.0 bn	579.3 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	sep	473.0 bn	476.2 bn		**	Equity and bond neutral
Russia	Markit Russia PMI Mfg	m/m	sep	51.9	51.6	52.1	**	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)	133	134	-1	Up
3-mo T-bill yield (bps)	103	103	0	Neutral
TED spread (bps)	31	30	1	Neutral
U.S. Libor/OIS spread (bps)	120	119	1	Up
10-yr T-note (%)	2.34	2.33	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	40	40	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	$55.81	$56.79	-1.73%	Decline in Seasonal Demand
WTI	$50.59	$51.67	-2.09%	
Natural Gas	$2.99	$3.01	-0.57%	
Crack Spread	$18.11	$18.11	-0.01%	
12-mo strip crack	$18.95	$19.04	-0.47%	
Ethanol rack	$1.65	$1.65	-0.12%	
Metals				
Gold	$1,272.46	$1,279.75	-0.57%	Stronger Dollar
Silver	$16.58	$16.66	-0.46%	
Copper contract	$295.65	$295.50	0.05%	
Grains				
Corn contract	$ 354.00	$ 355.25	-0.35%	
Wheat contract	$ 443.00	$ 448.25	-1.17%	
Soybeans contract	$ 963.25	$ 968.25	-0.52%	
Shipping				
Baltic Dry Freight	1356	1391	-35	

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, with warmer to normal temps in the western region and precipitation expected in the eastern region. There is no tropical cyclone activity expected over the next 48 hours.

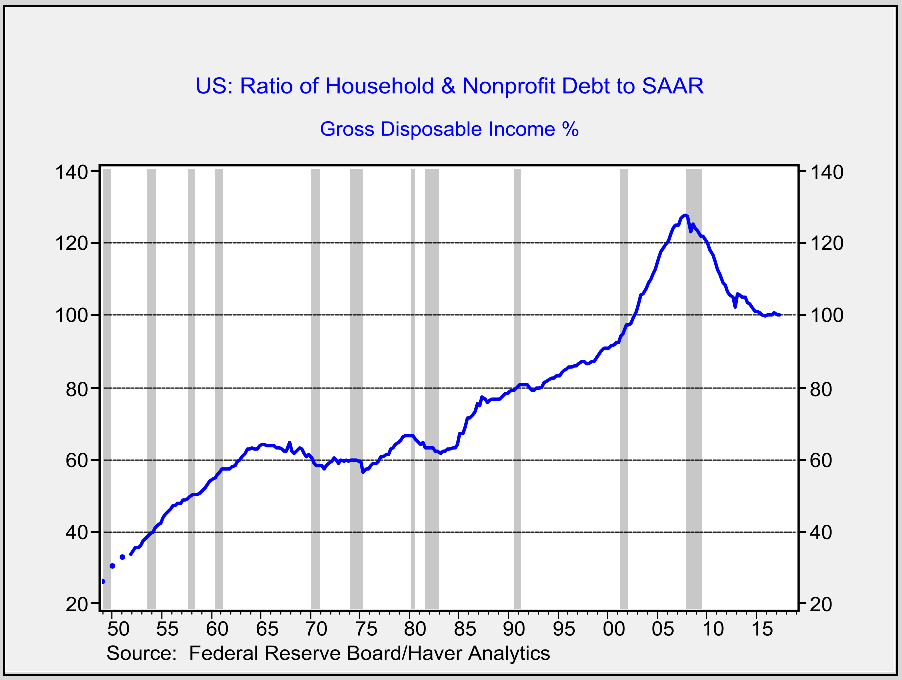
Asset Allocation Weekly Comment

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.

September 29, 2017

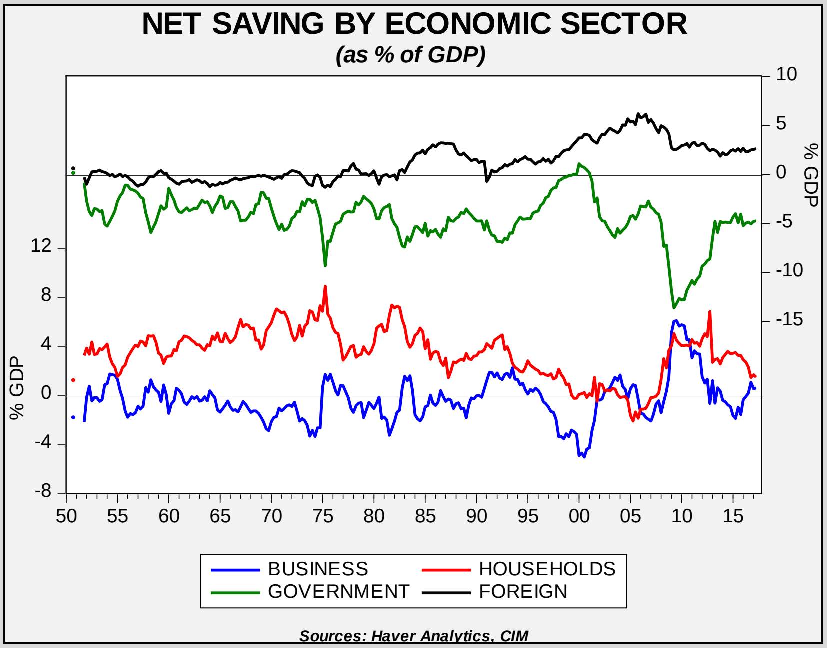
The Financial Accounts of the U.S. was released last week by the Federal Reserve. The report is a treasure trove of data about the economy. This report shows the flow of funds and the balance sheet of the American economy. Although there is much to look at, here are a few charts that show the underlying health of the economy and the financial system.

First, household debt relative to after-tax income has stabilized. Essentially, household deleveraging has come to an end but we are not seeing releveraging relative to income.



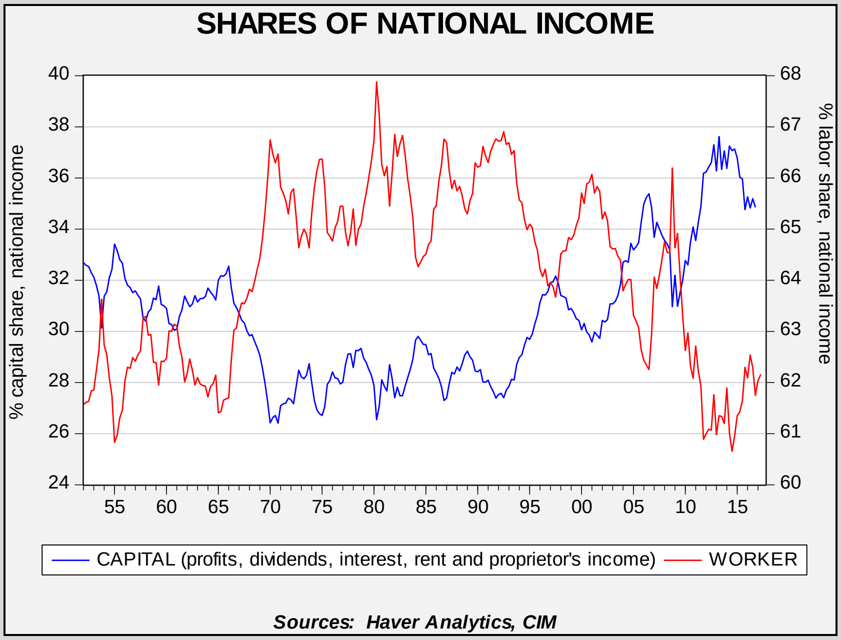
This is a "good news/bad news" situation. On the good side, the end of deleveraging will support stronger consumption. When households are trying to pay back debt, it acts as a dampener on economic growth. If households begin to add to debt relative to their incomes, growth accelerates.[3] The bad news is that the deleveraging has ended at historically high levels of debt. Although this level is probably manageable at current interest rates, spending may prove to be unusually sensitive to interest rates due to the current elevated levels of debt relative to income.

[3] Assuming, of course, that all the additional consumption would not be supplied by imports.



This chart is one we closely monitor; it is net saving by sector. Net saving in macroeconomics is much like a balance sheet—saving in one sector is always offset by dissaving in another and the sum of the four sectors always equals zero. What is most disturbing in the data is that household saving has declined and business saving has increased. In general, business saving funds investment; in a well-functioning economy, businesses should be dissavers. Rising business saving means less investment and the decline in household saving means that the household sector will become vulnerable to economic weakness.

The last chart of interest is the shares of national income. We divide national income into what is earned by labor compared to capital.

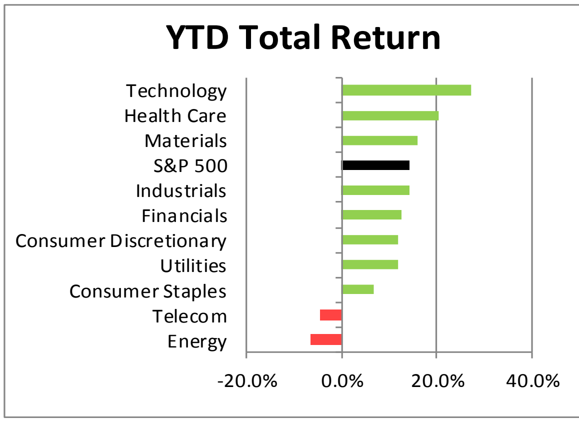


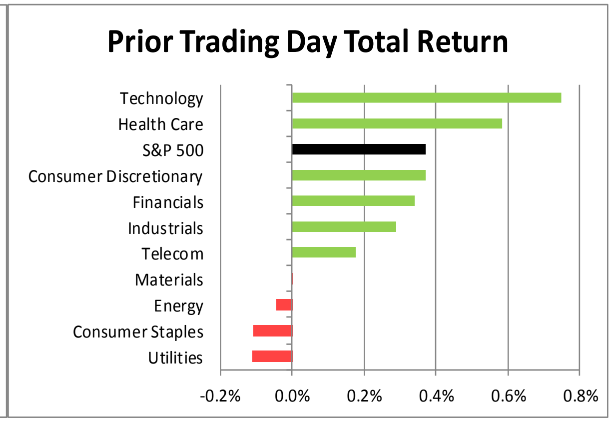
Since roughly 1990, the labor share has tended to decline and has made new lows in each business cycle. Capital income has performed in an opposite fashion. This growing divergence is part of the reason for the rise in populism. Even with the advanced age of the business cycle and low unemployment, the labor share remains low relative to history.

The Financial Accounts of the U.S. are showing that the expansion is getting a bit old. Although there is no evidence of a recession on the horizon, the weakness in household saving is a concern. The end of deleveraging does bode well for the economy in the short run but the continued high level of debt is a worry. Finally, the current political problems the country is facing will likely require a drop in the share of capital at some point. That will not be a favorable event for financial assets.

Data Section

U.S. Equity Markets – (as of 9/29/2017 close)

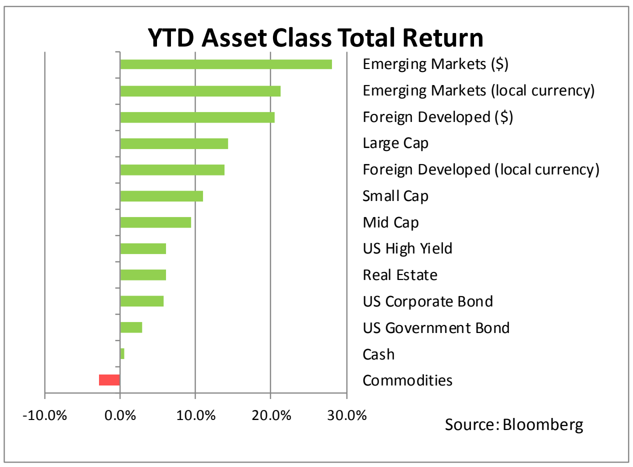




(Source: Bloomberg)

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 9/29/2017 close)

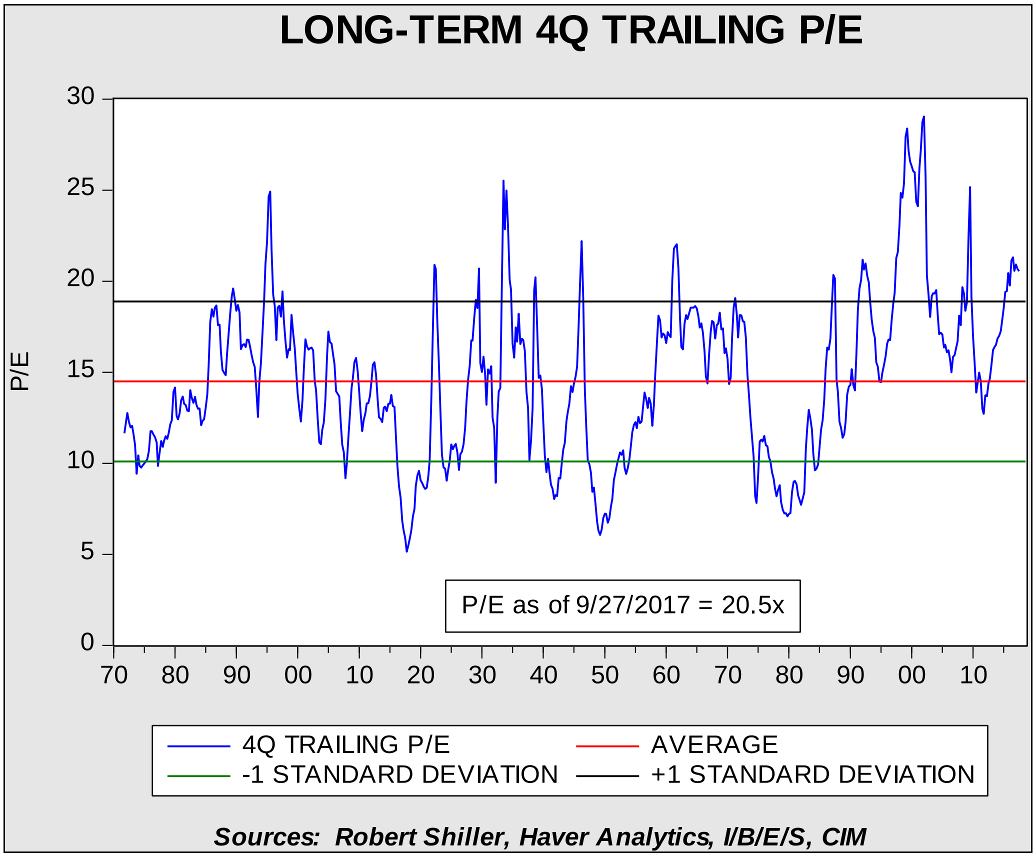


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 28, 2017



Based on our methodology,[4] the current P/E is 20.5x, unchanged from last week.

---

[4] 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 (Q4, Q1 and Q2) and one estimates (Q3). 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.