Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 6, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3% from the prior close. Chinese markets were closed due to National Day. U.S. equity index futures are signaling a lower open.

Happy employment data day! We cover the release in detail below but the quick view is the report is mixed; payrolls actually declined but the unemployment rate did, too. The data was affected by weather events. The dollar rose on the news and Treasury yields rose as well, while equities eased modestly. Here is what we are watching this morning:

PM May is in trouble: The *FT* is reporting that up to 30 Tory MPs are pushing for PM May to resign. They are being led by Grant Shapps, a former party chairman. The broader party leadership is trying to suppress the rebellion, worried that the leadership challenge could lead to a no-confidence vote and new elections. If elections are held, it is quite possible that Labour could win. The GBP continues to slide on fears that political turmoil will stall potential rate hikes and the possibility of a Corbyn government.

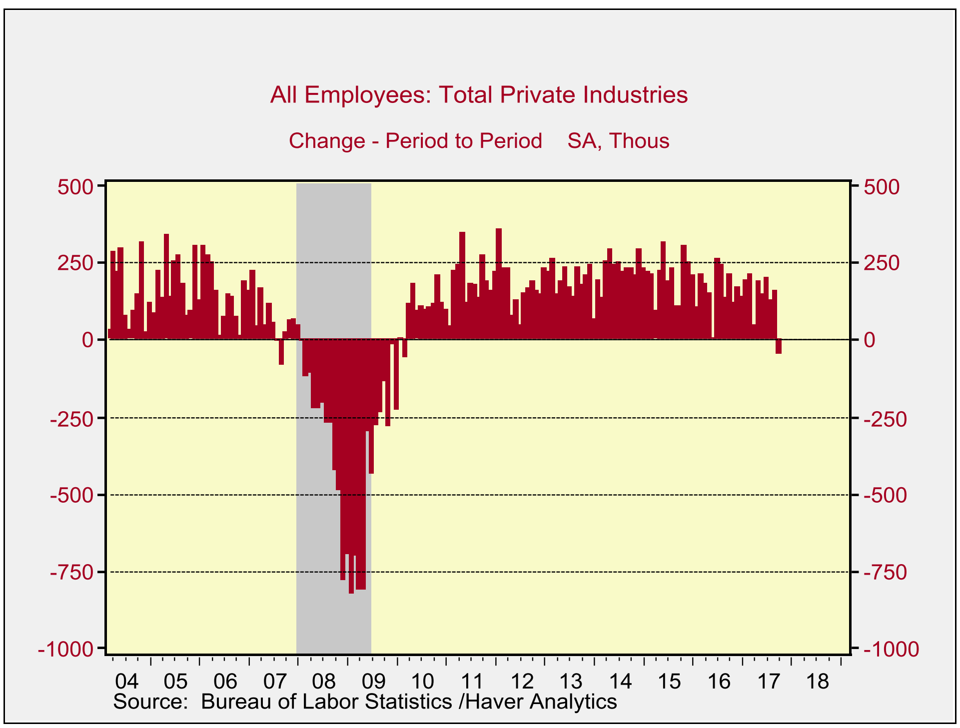
Madrid continues to tighten its grip on Catalonia: Spain's constitutional court has suggested Catalonia can't declare independence and the head of the province's police force has appeared in court under investigation for sedition. Some large businesses in Catalonia have indicated they would quit the province if independence is declared. In the end, independence usually requires applying one's claims through force. Catalonia doesn't have the military resources to separate. When a region finds itself in this situation, it usually petitions other nations to support its goal. For example, the emerging U.S. benefited greatly from French support during the American Revolution. The South may have been able to successfully secede if the British had come to its aid. We don't see any outside power willing to go to war with the rest of Spain to bolster Catalonian independence. The bigger problem is that Madrid will now have a restive province that will sullenly defy Spain at every turn. Madrid should have used the Canadian model; allow the vote to go on but shower Catalonia with "goodies" to sway the average voter that staying in Spain was a better deal. PM Rajoy is winning the battle but setting up for a long-term war that should have been avoided. This problem is weighing on the EUR.

Decertifying Iran: It appears the White House is planning to decertify the nuclear deal with Iran, forcing Congress to deal with the issue. However, it also appears that the president won't recommend new sanctions. This will allow the White House to express its displeasure with the Obama-era agreement without triggering a crisis. The president may not be able to avoid it. Once Congress gets control of the policy, there is no guarantee they won't push new sanctions to his desk, forcing him to either break the current deal or defy his own party. In addition, it is highly unlikely that Europe or Russia will cooperate on new sanctions, meaning the U.S. will be implementing the action unilaterally. About the only way the U.S. can make unilateral sanctions stick is if the American financial system is involved. Of course, if the nuclear deal ends, we would expect Iran to rapidly move to acquire a nuclear weapon which increases the potential of further destabilization in the Middle East. The White House is trying to weave a middle path—it wants to express its displeasure with Iran, which is a way to gain "points" politically without causing a crisis. It's a risky move because we doubt the president wants to go to war in the Middle East.

Quarles confirmed: The FOMC gained a new governor (finally!) as Randal Quarles was confirmed yesterday. He will take over Dan Tarullo's role as guiding bank regulation. Quarles is expected to be much more bank friendly, especially compared to Tarullo. As a voter, he will probably be moderate to hawkish.

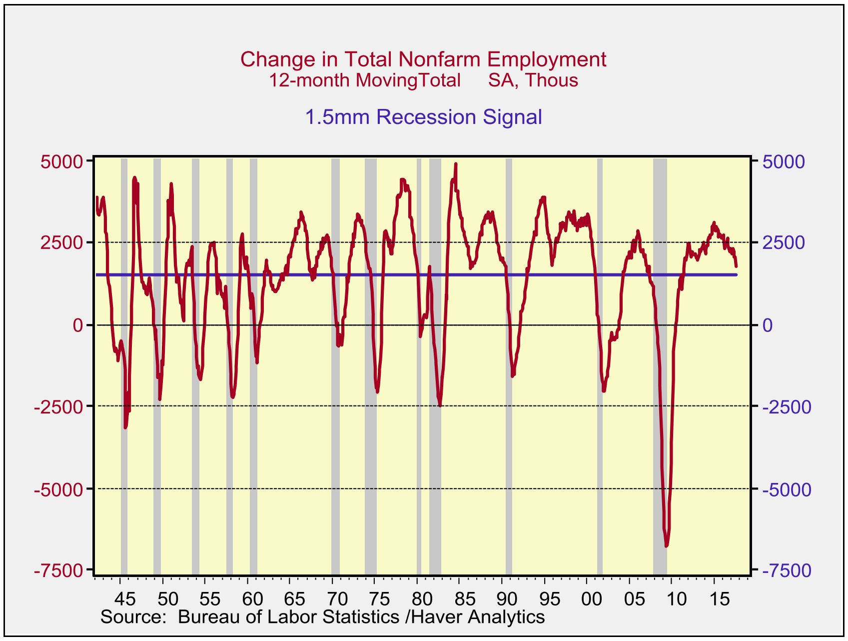
U.S. Economic Releases

The change in nonfarm payrolls for September came in below expectations at -33k compared to the forecast of 80k; the prior report was revised upward from 156k to 169k. The change in private payrolls came in above expectations at -40k compared to the forecast of 75k; the prior report was revised downward from 165k to 164k. The change in manufacturing payrolls came in above expectations at -1k compared to the forecast of 10k; the prior report was revised upward from 36k to 41k.

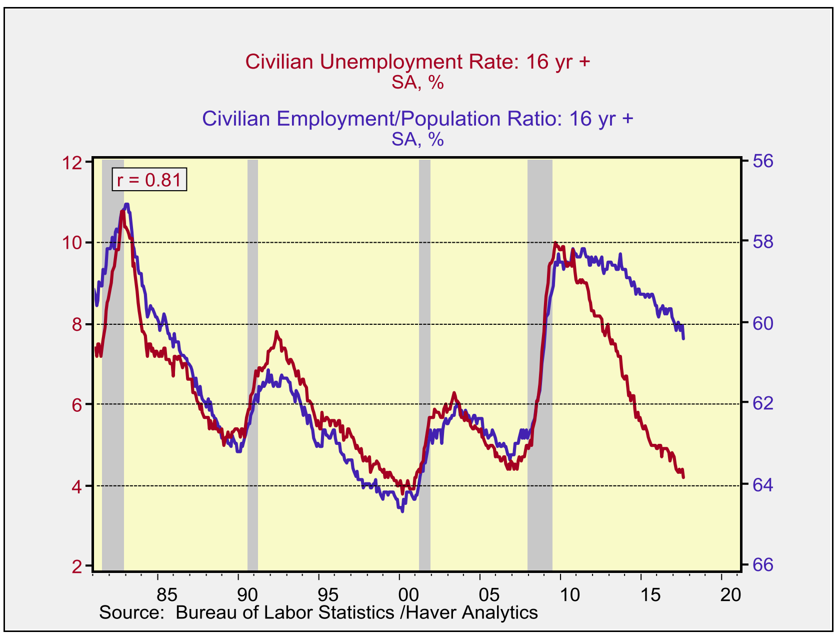


The chart above shows the change in total private employment. This chart suggests we are still in an economic expansion.

The chart below shows the 12-month moving total of the change in nonfarm payrolls; a dip under 1.5 mm signals recession.

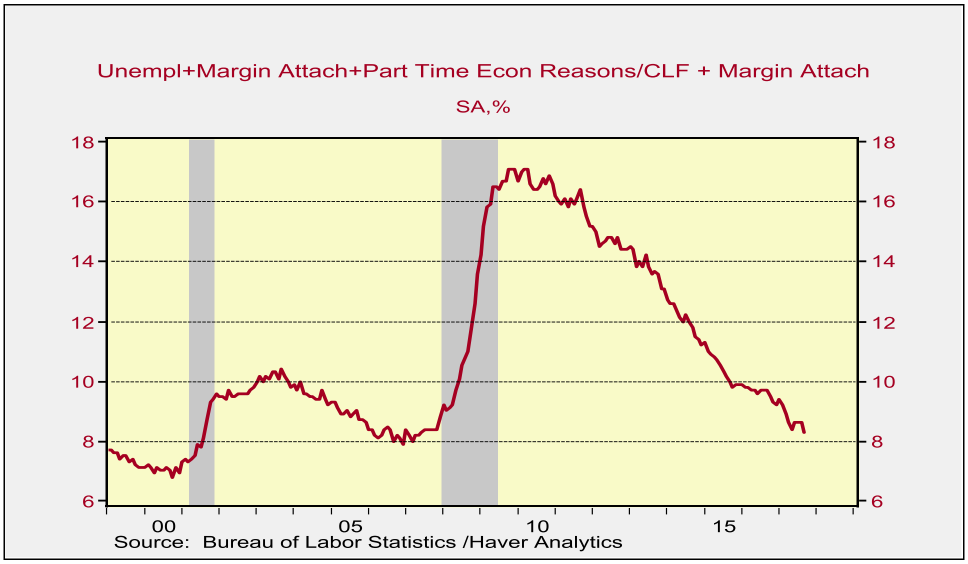


The unemployment rate came in below expectations at 4.2% compared to the forecast of 4.4%. The labor force participation and underemployment rates came in at 63.1% and 8.3%, respectively.

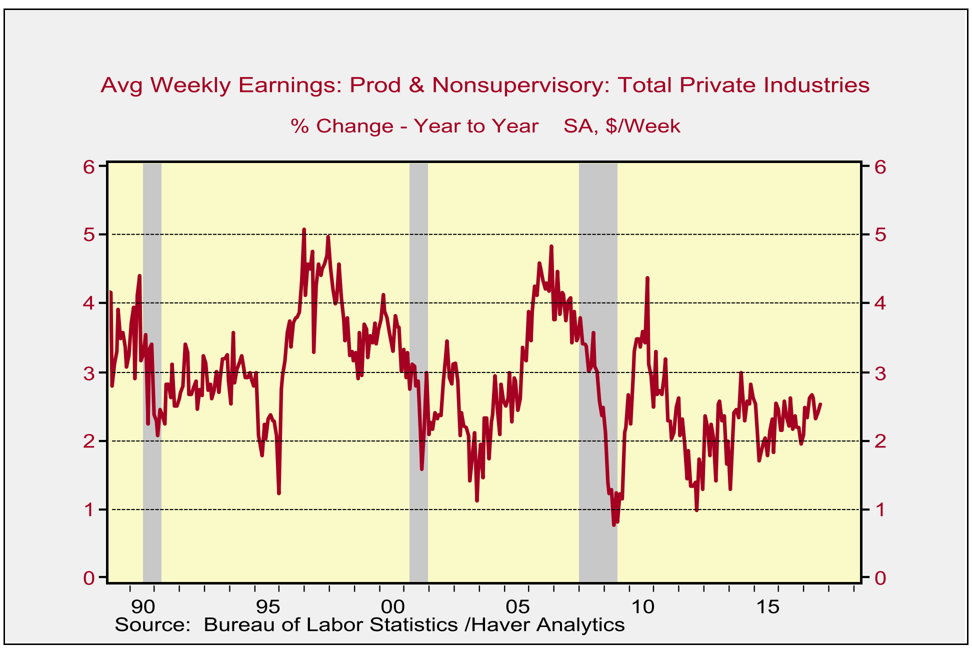


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables suggests there is still slack within the labor market.

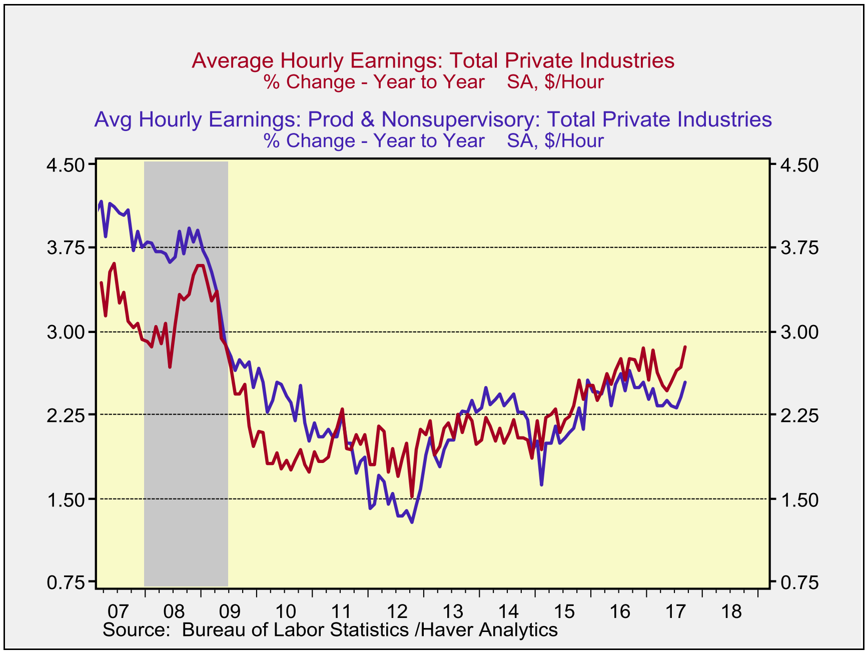
The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.



Average hourly earnings came in above expectations, rising 0.5% from the prior month compared to the forecast gain of 0.3%. On a yearly basis, wage growth remains subdued.

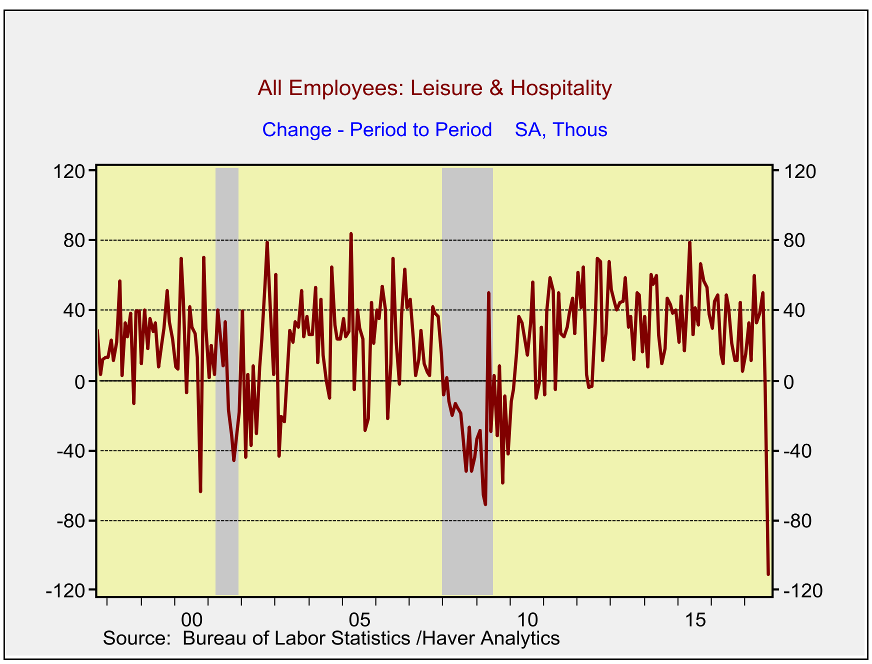


This chart shows the yearly growth in hourly earnings for all workers and non-supervisory workers. On an annual basis, wage growth came in at 2.5%. The financial media are abuzz with another wage measure, overall average wages, which rose to 2.9%.



The non-supervisory number is a better measure of wage growth for lower income households and, although higher, it is still well below previous cycle levels.

We would strongly recommend exercising caution with this data. The divergence between the payroll and household surveys, a product of weather distortions, makes the numbers suspect. Note this chart:



Leisure and hospitality payrolls plunged 111k, most likely because vacation areas closed during the hurricanes. These workers tend to be poorly paid; meanwhile, utility workers, who were called upon to work overtime, are paid much more and very easily could be part of the reason for the jump in wages.

The bottom line: This data is distorted and we will have a much better feel for it after a couple of months.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale Trade Sales	m/m	aug	0.0%	0.1%	**
10:00	Wholesale Inventories	m/m	aug	1.0%	1.0%	**
15:00	Consumer Credit	m/m	aug	$15.54 bn	$18.49 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
12:15	William Dudley will Speak at Press Briefing in New York	President of the Federal Reserve Bank of New York				
12:45	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								
Japan	Official Reserve Assets	m/m	sep	$1.266 tn	$1.268 tn		**	Equity and bond neutral
	Labor Cash Earnings	y/y	aug	0.9%	-0.3%	0.5%	**	Equity bullish, bond bearish
	Real Cash Earnings	y/y	aug	0.1%	-0.8%	0.1%	**	Equity and bond neutral
	Leading Index CI	m/m	aug	106.8	105.2	107.1	**	Equity and bond neutral
	Coincident Index	m/m	aug	117.6	115.7	117.5	**	Equity and bond neutral
Australia	AiG Performance of Services Index	m/m	sep	54.7	55.3		**	Equity and bond neutral
EUROPE								
Germany	Factory Orders	m/m	aug	3.6%	-0.7%	0.7%	**	Equity bullish, bond bearish
France	Trade Balance	m/m	aug	4.514 bn	-5.968 bn	5.400 bn	**	Equity and bond neutral
	Current Account Balance	m/m	aug	-1.5 bn	-4.2 bn		**	Equity and bond neutral
Italy	Retail Sales	y/y	sep	-0.5%	0.0%	0.8%	**	Equity bearish, bond bullish
UK	Halifax House Prices	m/m	sep	0.5%	0.3%	0.5%	**	Equity and bond neutral
	Unit Labor Costs	y/y	2q	1.6%	2.1%		**	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	sep	724.4 bn	716.7 bn		**	Equity and bond neutral
Russia	CPI	y/y	sep	3.0%	3.3%	3.1%	**	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence Index	m/m	sep	89.2	88.5	86.0	**	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)	135	134	1	Up
3-mo T-bill yield (bps)	104	105	-1	Neutral
TED spread (bps)	30	30	0	Neutral
U.S. Libor/OIS spread (bps)	121	121	0	Up
10-yr T-note (%)	2.37	2.35	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	32	32	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	$56.78	$57.00	-0.39%	Long Liquidation
WTI	$50.30	$50.79	-0.96%	
Natural Gas	$2.92	$2.92	-0.27%	
Crack Spread	$19.88	$19.34	2.79%	
12-mo strip crack	$19.97	$19.72	1.27%	
Ethanol rack	$1.61	$1.61	0.04%	
Metals				
Gold	$1,268.59	$1,268.22	0.03%	
Silver	$16.61	$16.60	0.09%	
Copper contract	$304.15	$304.65	-0.16%	
Grains				
Corn contract	$ 349.00	$ 349.50	-0.14%	
Wheat contract	$ 440.00	$ 440.75	-0.17%	
Soybeans contract	$ 967.25	$ 968.25	-0.10%	
Shipping				
Baltic Dry Freight	1382	1320	62	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.0	-0.5	-5.5	
Gasoline (mb)	1.6	1.0	0.6	
Distillates (mb)	-2.6	-1.5	-1.1	
Refinery run rates (%)	-0.50%	0.80%	-1.30%	
Natural gas (bcf)	42.0	55.0	-13.0	

Weather

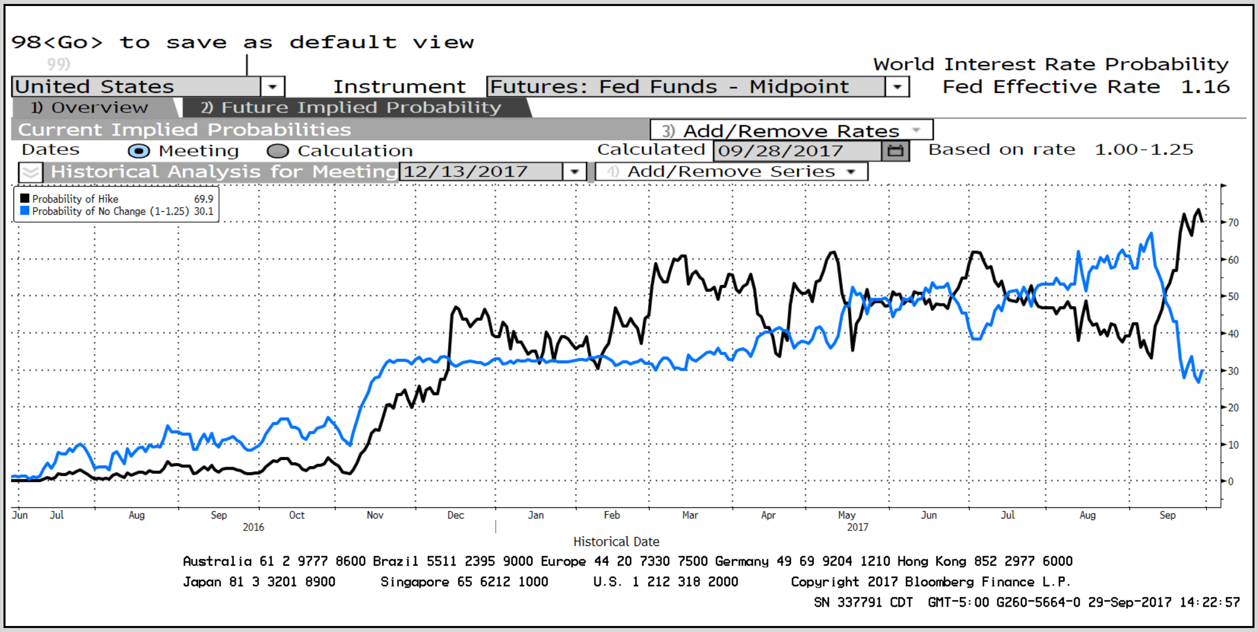
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. Tropical Storm Nate has moved just below the Yucatan Peninsula and is expected to strengthen into a hurricane. In response to the storm, oil refiners in the Gulf of Mexico have already begun shutting down operations.

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 6, 2017

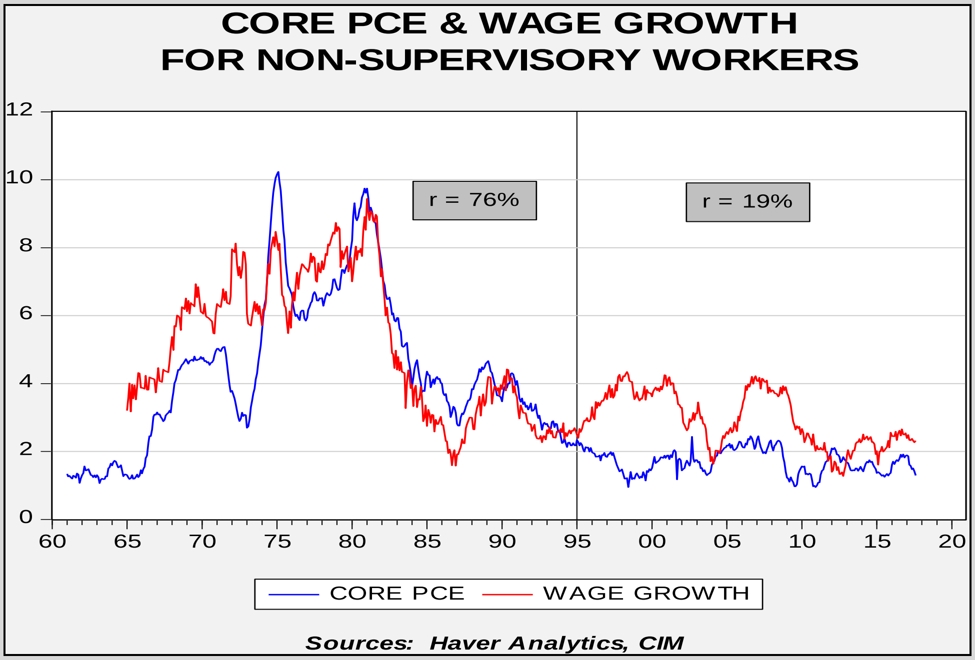
The latest FOMC meeting and subsequent comments from Chair Yellen have increased the likelihood of a December rate hike.



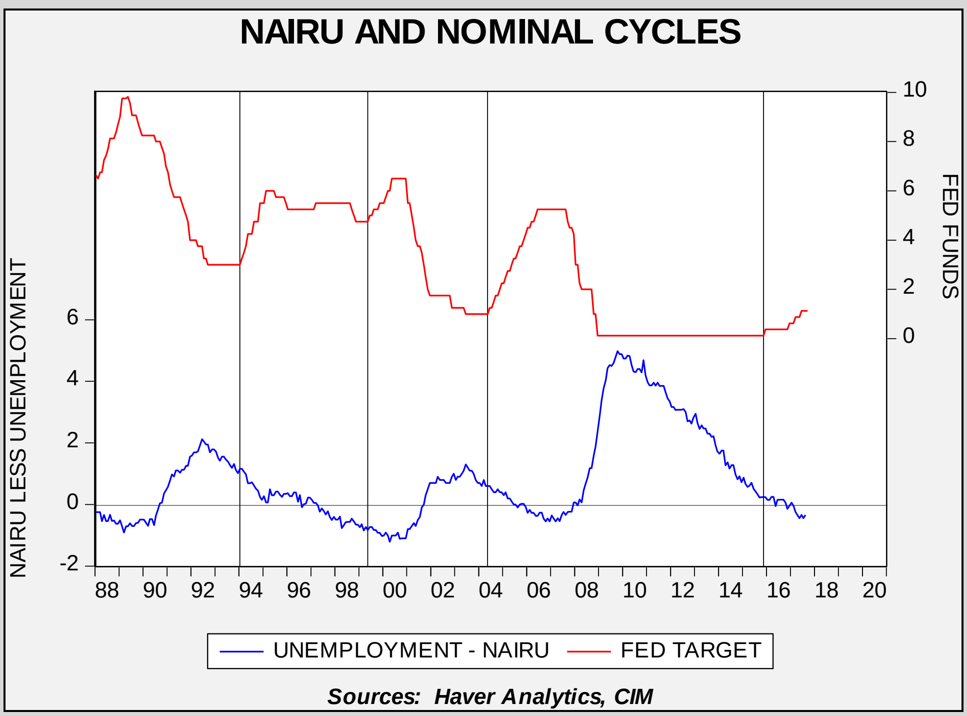
(Source: Bloomberg)

This chart shows the implied likelihood of a rate hike compared to steady policy from fed funds futures for the December meeting. In early December, the projected odds of a hike were just above 30%; those odds have recently jumped to over 70%. Although the core personal consumption deflator remains well under 2%, which is considered the target of the central bank, Chair Yellen indicated that tight labor markets raise the chances that inflation might rise quickly and force the Fed to boost rates sharply, potentially triggering a recession. By raising rates when inflation is below the inflation target, the FOMC hopes to avoid a rapid increase in rates.

Most members of the FOMC base their policy decisions on the Phillips Curve, which postulates that there is a relationship between unemployment and wages, and if the latter rises, inflation tends to follow. This idea has become increasingly controversial as the relationship between wages and inflation has weakened over the past two decades.



This chart shows the yearly change in core PCE and wage growth for non-supervisory workers. Note that the correlation broke down after 1995. We believe this is because the full impact of deregulation and globalization has put a lid on inflation and thus wage changes have less impact on price levels.

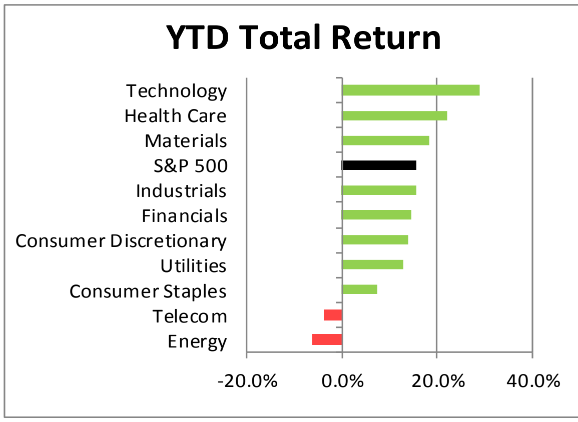


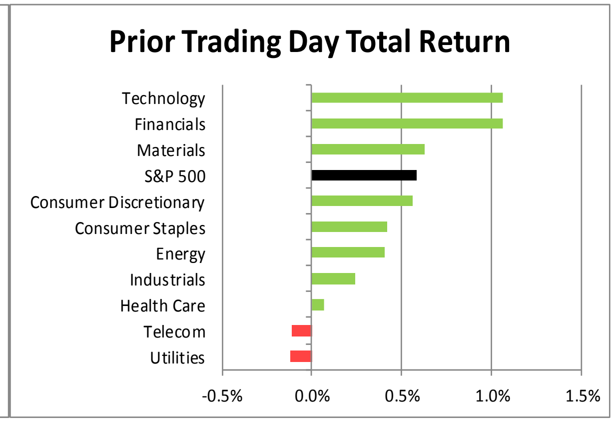
The key concept for the Phillips Curve is the Non-Accelerating Inflation Rate of Unemployment (NAIRU), which is the unemployment rate that is the lowest possible rate an economy can achieve without triggering inflation. The idea is that if unemployment falls below NAIRU, the labor markets become too tight, triggering excessive wage growth and inflation. The above chart shows the Greenspan-Bernanke-Yellen Federal Reserve. We have put vertical lines where tightening cycles began. Note that Greenspan began two tightening cycles while the unemployment rate was above NAIRU (1994, 2004) but waited to raise rates until 1998 when the unemployment rate was well below NAIRU. The latter tightening cycle was a rather famous one; Greenspan held that rising productivity would keep inflation under control and thus waited to raise rates. Notably, Janet Yellen, a Fed governor at the time, lobbied hard for raising rates sooner due to the drop in unemployment.

The current tightening cycle began with the unemployment rate very close to NAIRU, which is consistent with Chair Yellen's thinking on inflation. So far, wage growth has remained subdued. Since the early 1980s, wage growth has usually exceeded 4% when the unemployment rate falls below NAIRU. It is currently 2.3%. It is unclear why wage growth is so weak relative to what appears to be a tight labor market. ***That is what makes boosting the policy rate risky.*** Since the meeting, we have seen the dollar strengthen and bond yields rise. However, the odds of a policy mistake, though currently low, are rising. This is an issue we will be monitoring closely in the coming months, especially as the president chooses not only a new Fed chair but also a vice chair and two other open governor positions.

Data Section

U.S. Equity Markets – (as of 10/5/2017 close)

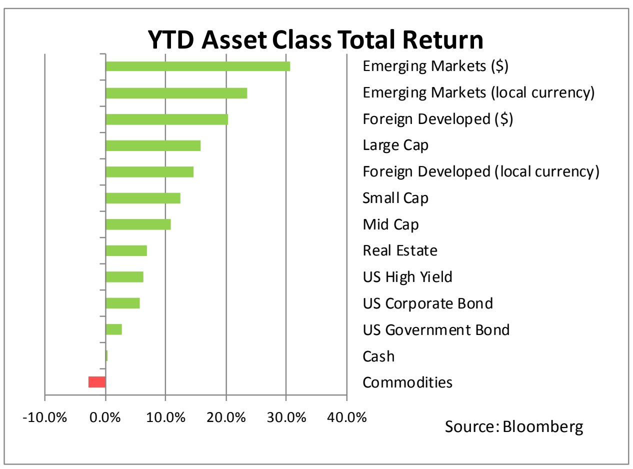




(Source: Bloomberg)

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 10/5/2017 close)

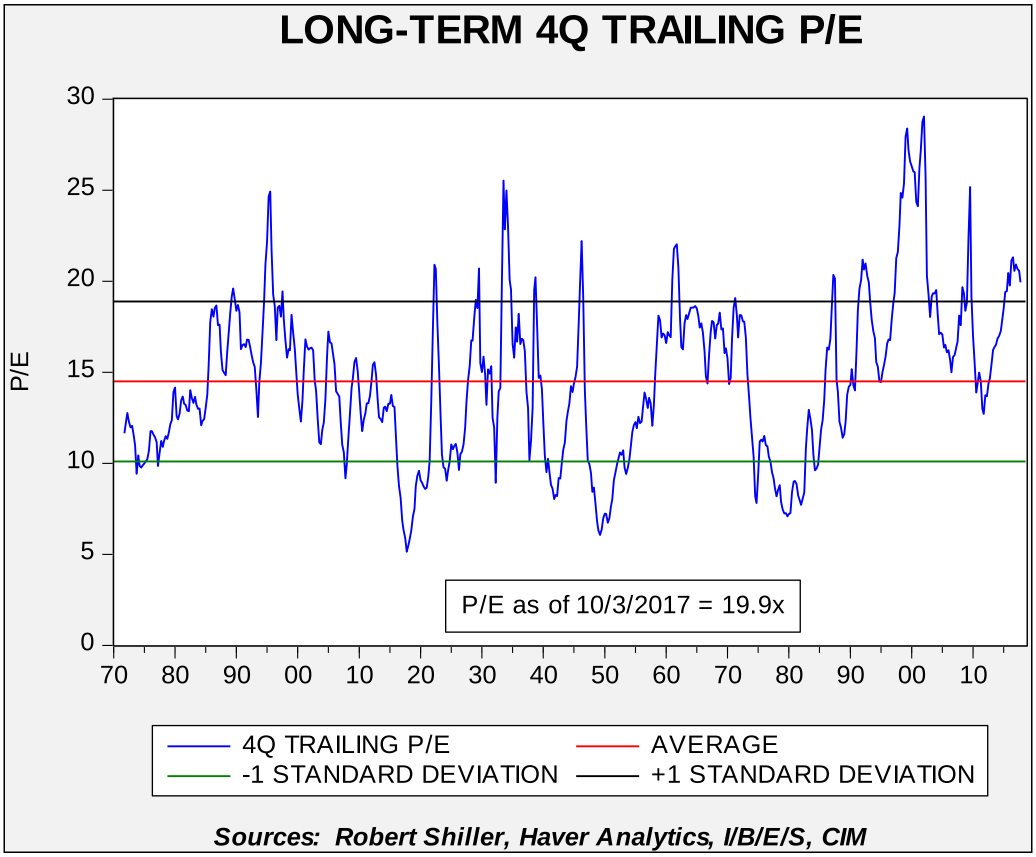


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 4, 2017



Based on our methodology,[1] the current P/E is 19.9x down 0.6x from last week. The drop in the P/E is because we have rolled into Q4 and are working with higher earnings estimates for Q4.

[1] 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.