Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 9, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.3% from the prior close. Chinese markets were up, with the Shanghai composite up 0.8% and the Shenzhen index up 1.3%. U.S. equity index futures are signaling a higher open.

It's a slow news morning. Columbus Day is being celebrated, which means the Federal Government and Treasury market are closed. Equities are open. Here is what we are tracking this morning.

A Turkish spat: Turkish financial markets have been roiled this morning after both the U.S. and Turkey limited travel visas. The proximate cause was the arrest of a Turk employed by the U.S. Consulate. However, it is important to put this action into context. Turkey has been aggressively arresting Americans working or living in Turkey, claiming they were part of last year's coup. The key actor in this event is Fethullah Gulen, a Turkish Muslim leader living in Pennsylvania. Gulen has built a broad, and mostly moderate, Islamic movement in Turkey that was ultimately designed to undermine the secular Turkish state. President Erdogan and Gulen were initially allies but had a falling out in recent years. Erdogan believes Gulen was behind the 2016 coup attempt and wants the U.S. to extradite him for trial. So far, the U.S. has refused. Thus, Erdogan is arresting Americans or Turks working for Americans as a way to create "hostages" he can trade for Gulen. Worries about deteriorating relations are pushing the Turkish lira lower this morning. We expect tensions to remain elevated on this issue as we don't expect the U.S. to send Gulen to Turkey.

Pressure builds on North Korea: The *WSJ* reports that more than 20 nations have reduced operations with North Korea as the U.S. steps up economic and financial sanctions. Although the consensus of analysts is that North Korea will never relinquish its nuclear weapons program, President Trump has managed to unify nations against the regime. Economic pain may work to start talks; however, there is no clear roadmap as to what goals could be salvaged at this point. The stated position of the U.S. is that Pyongyang must give up its nuclear weapons, while North Korea's starting point is world recognition that it is a nuclear power. Clearly, these are not compatible goals. But, talks might yield a workable outcome short of war. One possibility is that North Korea gets to keep its nukes but allow supervision to ensure the program doesn't get larger, i.e., a freeze. For now, the president's comments suggest the march to war is more likely.

Counter-protests in Catalonia: Large rallies were held in Barcelona over the weekend where Catalonians who oppose independence called for the province to remain in Spain. Polls have suggested that the independence movement is a minority in the province and there is an argument that PM Rajoy overreacted; allowing the referendum to go forward and fail would have been a stronger outcome than using force to prevent it. Canada's experience with Quebec separatism bears this out. We have seen Spanish assets rally after initially declining on the idea that support for independence may not be enough for Catalonia to declare independence.

U.S. Economic Releases

There are no new economic releases or economic events scheduled for the rest of the day.

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	Foreign Reserves	m/m	sep	$3.109 tn	$3.092 tn	$3.100 tn	**	Equity bullish, bond bearish
	Caixin China PMI Composite	y/y	aug	51.4	52.4		**	Equity and bond neutral
	Caixin China PMI Services	y/y	aug	50.6	52.7		**	Equity and bond neutral
Australia	Foreign Reserves	m/m	sep	A$74.9 bn	A$76.3 bn		**	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	oct	29.7	28.2	28.5	**	Equity bullish, bond bearish
Germany	Industrial Production	m/m	aug	4.7%	4.0%	3.0%	***	Equity bullish, bond bearish
France	Bank of France Industry Sentiment	m/m	sep	104	105	104	**	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	sep	578.5	579.0 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	sep	472.9	473.0 bn		**	Equity and bond neutral
Russia	Light Vehicle Car Sales	y/y	sep	18.0%	17.0%	18.0%	**	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)	135	135	0	Up
3-mo T-bill yield (bps)	105	105	0	Neutral
TED spread (bps)	31	30	1	Neutral
U.S. Libor/OIS spread (bps)	122	121	1	Up
10-yr T-note (%)	2.36	2.36	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	40	40	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			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	$55.45	$55.62	-0.31%	Long Liquidation
WTI	$49.36	$49.29	0.14%	
Natural Gas	$2.88	$2.86	0.73%	
Crack Spread	$18.10	$18.76	-3.52%	
12-mo strip crack	$19.11	$19.35	-1.27%	
Ethanol rack	$1.60	$1.60	-0.38%	
Metals				
Gold	$1,282.75	$1,276.68	0.48%	Weaker Dollar
Silver	$16.93	$16.84	0.57%	
Copper contract	$302.50	$302.90	-0.13%	
Grains				
Corn contract	$ 349.50	$ 350.00	-0.14%	
Wheat contract	$ 440.50	$ 443.50	-0.68%	
Soybeans contract	$ 970.75	$ 972.25	-0.15%	
Shipping				
Baltic Dry Freight	1405	1382	23	

Weather

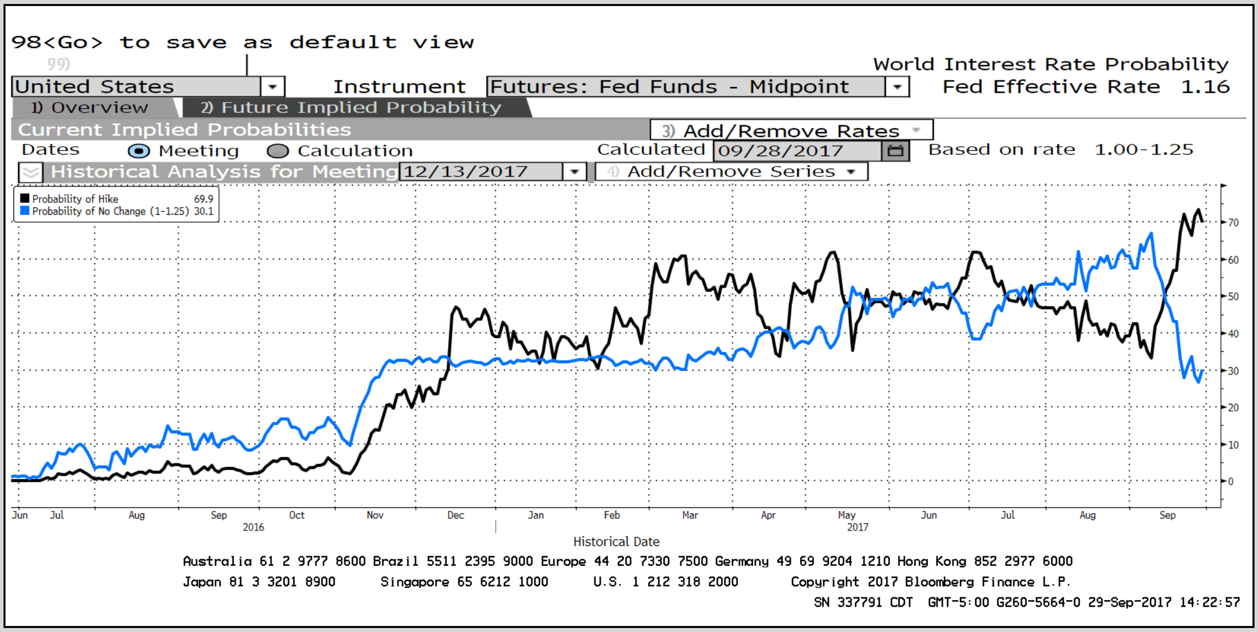
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. Tropical Storm Nate has slowed to a post-tropical cyclone and is currently moving across the Midwest.

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

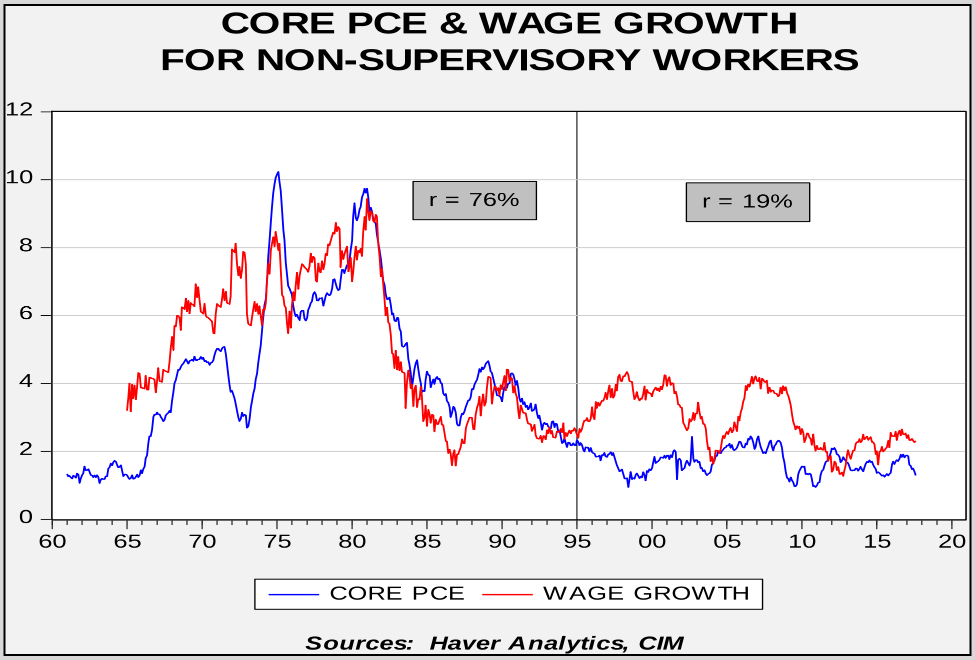
The latest FOMC meeting and subsequent comments from Chair Yellen have increased the likelihood of a December rate hike.



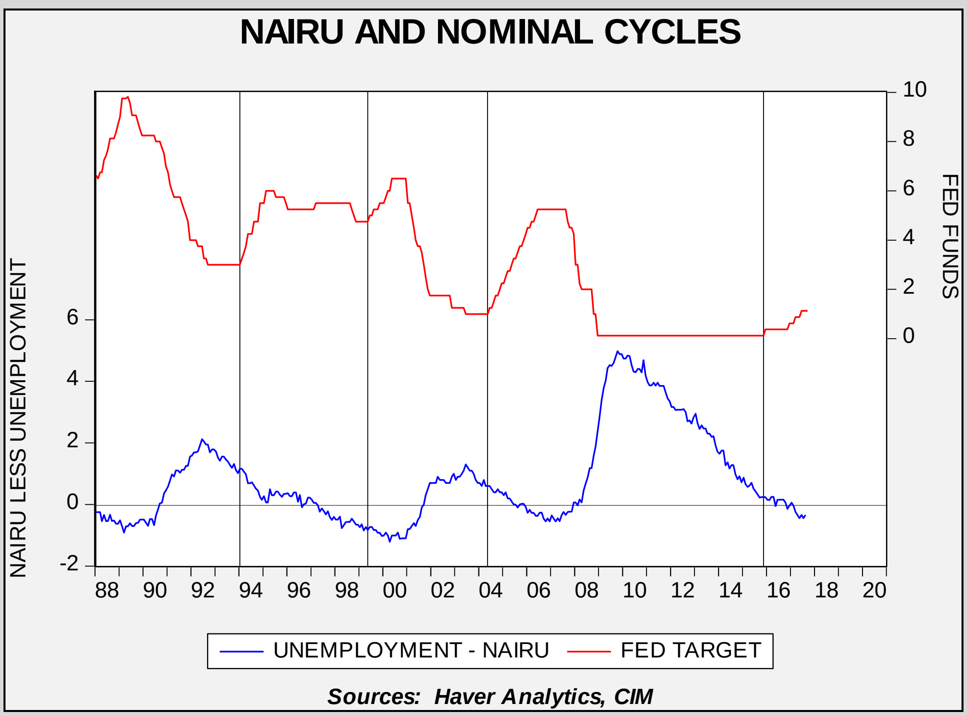
(Source: Bloomberg)

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.

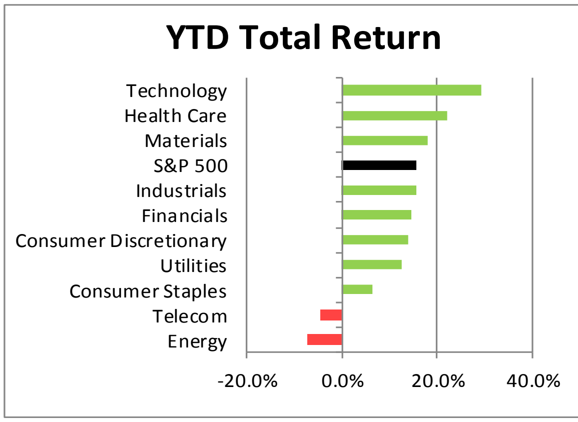


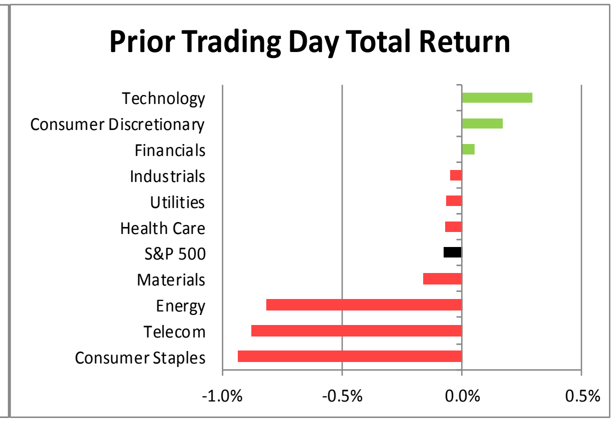
The key concept for the Phillips Curve is the Non-Accelerating Inflation Rate of Unemployment (NAIRU), which is the unemployment rate that is the lowest possible rate an economy can achieve without triggering inflation. The idea is that if unemployment falls below NAIRU, the labor markets become too 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 10/6/2017 close)

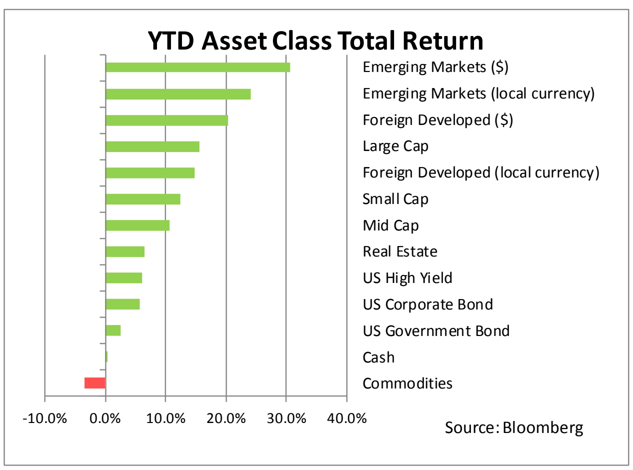




(Source: Bloomberg)

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 10/6/2017 close)

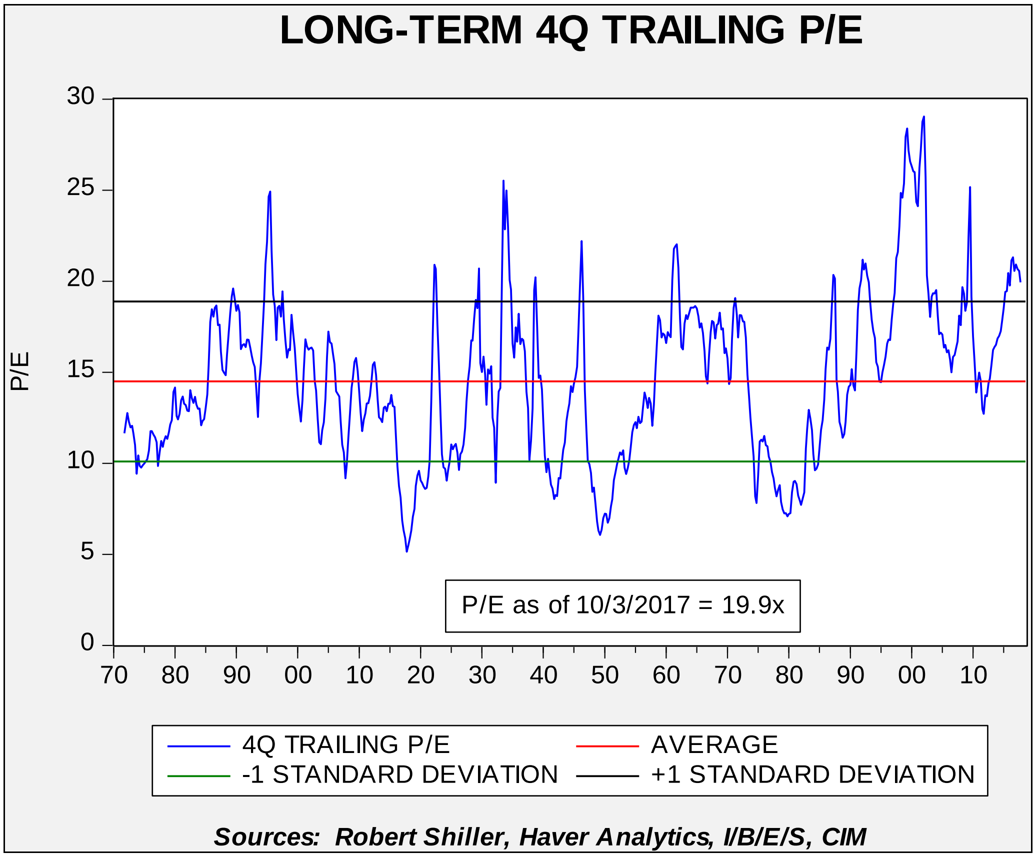


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.