Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 10, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.0% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.8%. U.S. equity index futures are signaling a higher open.

Although it was mostly quiet overnight, we are awaiting a potential declaration of independence from Catalonia. Here is what we are tracking this morning:

A declaration of independence? Catalan Leader Carles Puigdemont is expected to address the regional parliament in Barcelona at 11:00 EDT amid growing speculation that he will declare independence. According to reports, the Spanish national police are poised to arrest him if he follows through. However, there is a bit of nuance in the announcement. Puigdemont may make a declaration of independence but it may not be immediate or unilateral. That outcome would be crafted to avoid his arrest and open a dialogue with Madrid. Of course, that action would disappoint much of his separatist coalition. On the other hand, if he goes for a unilateral declaration of independence, the region could face a military crackdown. The risk of a hard response from Madrid is that it could trigger sympathy for independence. Reliable polling is rather scarce but the latest polls from July indicate 41% support for independence, with 49% opposing separation. We suspect these numbers are a reasonably accurate reflection of voter attitudes. If Rajoy simply allows for a broad vote without interference (last week's vote was boycotted by supporters of remaining in Spain), we suspect independence would lose. Apparently, Madrid feels uncomfortable with taking that chance. So far, problems in Spain have mainly been contained in Spanish financial assets. However, a breakaway problem in Spain could trigger similar movements elsewhere and lead to a collapse of the unity movement create by the European Union. If such a drive to self-determination gains momentum, the EUR could be undermined and depreciate.

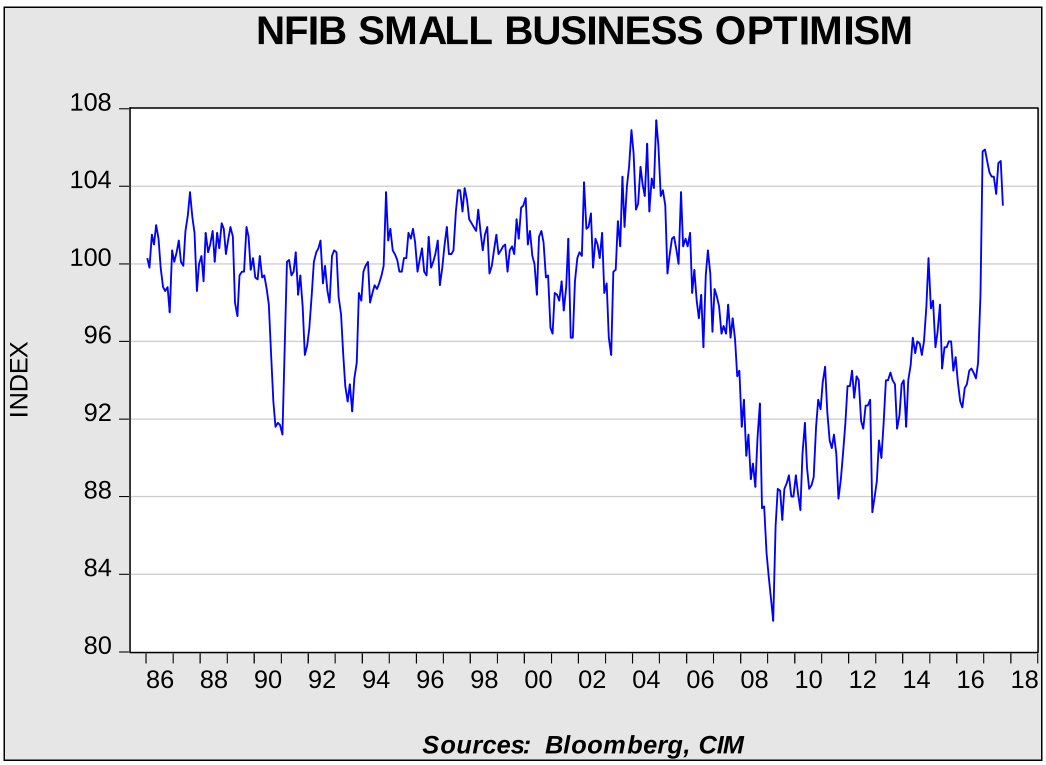
North Korean hack: Korean lawmakers said yesterday that there is evidence North Korea hacked into classified South Korean military documents which included the blueprint for leadership decapitation operations against Kim Jong-un. North Korea is known to have sophisticated cyberwar capabilities. They are believed to have hacked into Sony Pictures (SNE (ADR) $37.04) and recently have attempted to steal bitcoin from South Korean cryptocurrency exchanges.[1] This news should be treated with caution. Although it is quite possible that North Korea was able to steal this information, it is also possible that South Korea allowed the North to take the data as part of a disinformation campaign.

[1] https://www.ft.com/content/c245372a-a4e0-11e7-9e4f-7f5e6a7c98a2 (paywall)

Macron, Merkel disagree on EU reform: French President Macron has proposed reforms to the EU that include a unified fiscal budget and loose rules about debt restructuring. Germany, as expected, wants strict restructuring rules, which would likely lead to a greater divergence in Eurozone borrowing costs and reliance on individual nations to manage their fiscal affairs. Germany is a creditor state; it has no interest in making things easier for debtor nations. What the Germans fail to realize is that their pile of savings will do them little good if they can't find a place to loan and invest these funds. For now, both nations remain in their respective corners with little likelihood of massive changes along the lines of further unification of the EU.

U.S. Economic Releases

NFIB small business optimism came in below expectations at 103.0 compared to the forecast of 105.0. The drop in optimism can be attributed to Hurricanes Harvey and Irma that hit Texas and Florida in September. The damages caused by the hurricanes may have tempered growth expectations.



The table below shows the 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**
10:00	Neel Kashkari speaks at Townhall event in Grand Forks	President of the Federal Reserve Bank of Minneapolis
20:00	Robert Kaplan Speaks to Oil Group in Midland, Texas	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	BoP Current Account Balance	m/m	sep	2.380 tn	2.320 tn	2.223 tn	**	Equity bullish, bond bearish
	BoP Current Account Adjusted	y/y	aug	2.267 tn	2.033 tn	1.979 tn	**	Equity bullish, bond bearish
	Trade Balance	y/y	aug	318.7 bn	566.6 bn	264.9 bn	**	Equity and bond neutral
	Bankruptcies	m/m	sep	4.6%	-12.0%		**	Equity bearish, bond bullish
	Eco Watchers Survey Current	m/m	sep	51.3	49.7	50.2	**	Equity bullish, bond bearish
	Eco Watchers Survey Outlook	m/m	sep	51.0	51.1	50.5	**	Equity bullish, bond bearish
Australia	ANZ Roy Morgan Weekly Consumption	m/m	aug	113.8	113.4		**	Equity and bond neutral
	NAB Confidence Conditions	m/m	aug	14	15		**	Equity and bond neutral
	NAB Business Confidence	m/m	aug	7	5		**	Equity and bond neutral
New Zealand	Card Spending Retail	m/m	aug	0.1%	-0.2%	0.7%	**	Equity and bond neutral
	Card Spending Total	m/m	aug	-0.1%	0.6%		**	Equity and bond neutral
EUROPE								
Germany	Trade Balance	m/m	aug	20.0 bn	19.5 bn	19.5 bn	**	Equity and bond neutral
	Current Acount Balance	m/m	aug	17.8 bn	19.4 bn	17.0 bn	**	Equity and bond neutral
	Exports	m/m	aug	3.1%	0.2%	1.1%	**	Equity bullish, bond bearish
	Imports	m/m	aug	1.2%	2.2%	0.5%	**	Equity and bond neutral
France	Industrial Production	y/y	aug	1.1%	3.7%	1.5%	***	Equity and bond neutral
	Manufacturing Production	y/y	aug	1.1%	3.9%	2.7%	**	Equity and bond neutral
Italy	Industrial Production	y/y	aug	5.6%	4.4%	2.5%	***	Equity bullish, bond bearish
UK	Industrial Production	y/y	aug	1.6%	0.4%	0.9%	***	Equity bullish, bond bearish
	Manufacturing Production	m/m	aug	2.8%	1.9%	1.9%	**	Equity bullish, bond bearish
	Trade Balance	m/m	aug	-5626	-2872	-2800	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	sep	3.1%	3.2%	3.2%	***	Equity and bond neutral
AMERICAS								
Mexico	CPI	m/m	sep	6.4%	6.7%	6.5%	***	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)	104	105	-1	Neutral
TED spread (bps)	31	30	1	Neutral
U.S. Libor/OIS spread (bps)	122	122	0	Up
10-yr T-note (%)	2.35	2.36	-0.01	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	up			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	$56.33	$55.79	0.97%	Saudi Arabia reducing exports
WTI	$50.15	$49.58	1.15%	
Natural Gas	$2.86	$2.83	0.92%	
Crack Spread	$18.53	$18.38	0.82%	
12-mo strip crack	$19.36	$19.24	0.59%	
Ethanol rack	$1.59	$1.59	-0.26%	
Metals				
Gold	$1,291.09	$1,284.05	0.55%	Weaker dollar
Silver	$17.15	$16.97	1.07%	
Copper contract	$303.85	$303.10	0.25%	
Grains				
Corn contract	$ 348.75	$ 349.50	-0.21%	
Wheat contract	$ 434.50	$ 436.00	-0.34%	
Soybeans contract	$ 969.75	$ 966.75	0.31%	
Shipping				
Baltic Dry Freight	1411	1405	6	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.8		
Gasoline (mb)		0.0		
Distillates (mb)		-2.0		
Refinery run rates (%)		-0.50%		

Weather

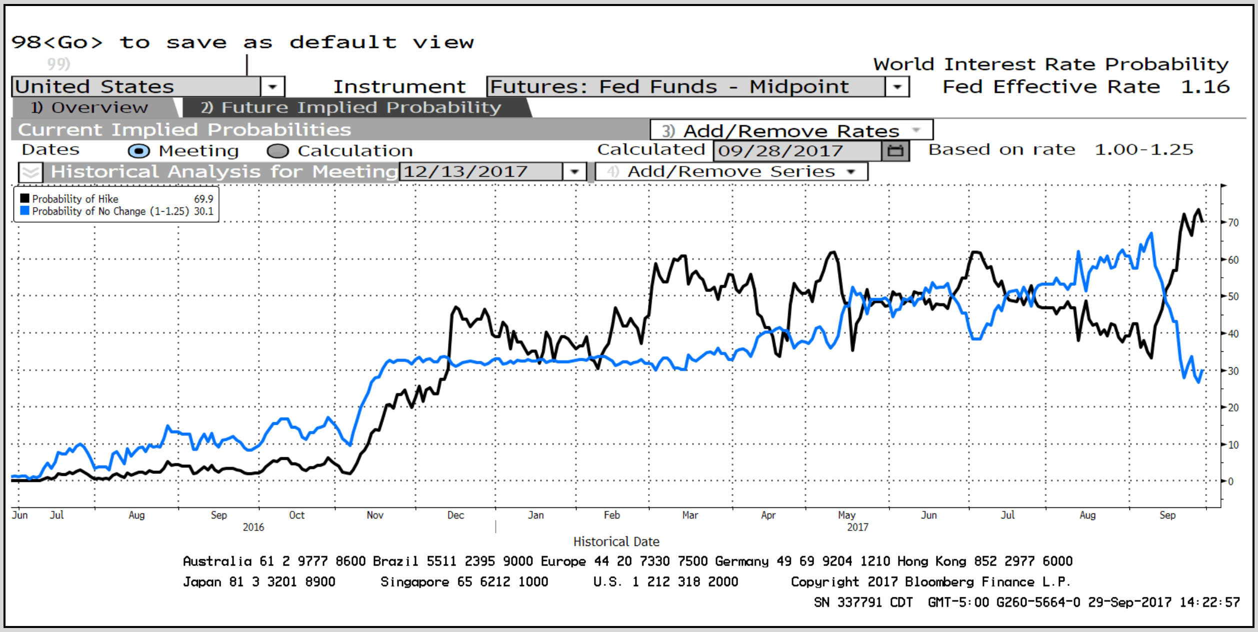
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. There are no tropical cyclone or disturbances approaching the Gulf of Mexico at this time.

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

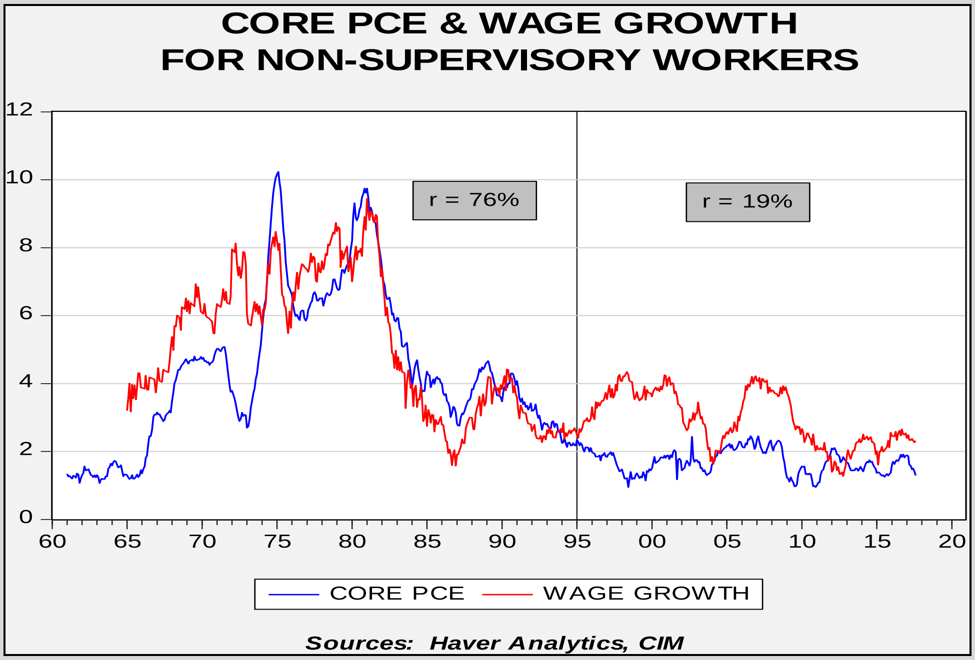
The latest FOMC meeting and subsequent comments from Chair Yellen have increased the likelihood of a December rate hike.



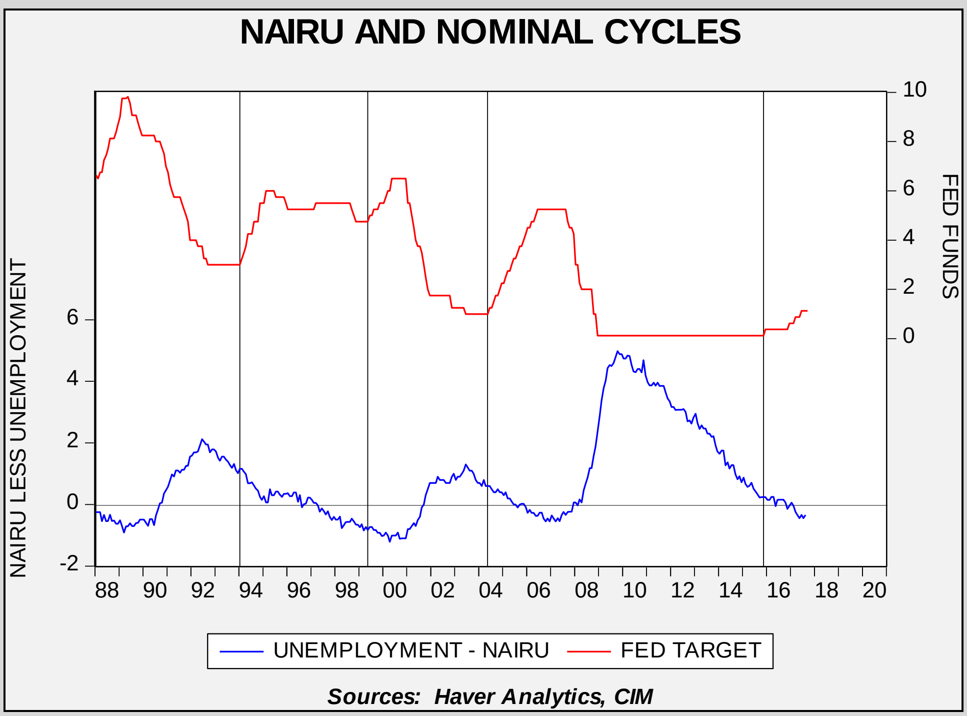
(Source: Bloomberg)

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.

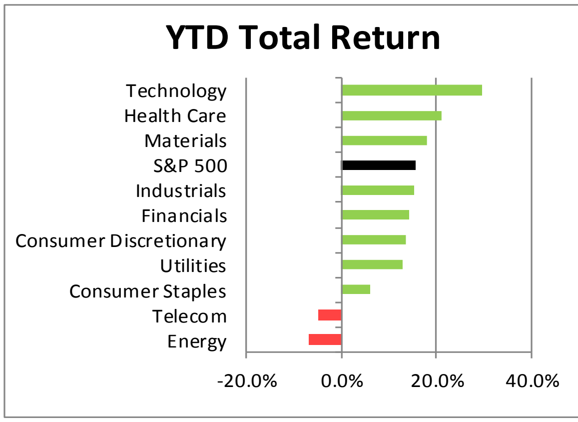


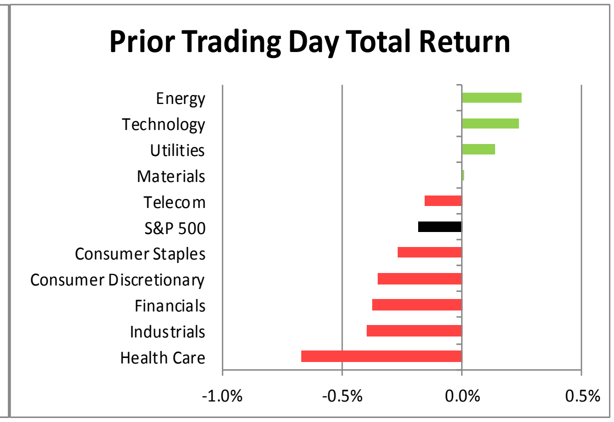
The key concept for the Phillips Curve is the Non-Accelerating Inflation Rate of Unemployment (NAIRU), which is the unemployment rate that is the lowest possible rate an economy can achieve without triggering inflation. The idea is that if unemployment falls below NAIRU, the labor markets become too 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 10/9/2017 close)

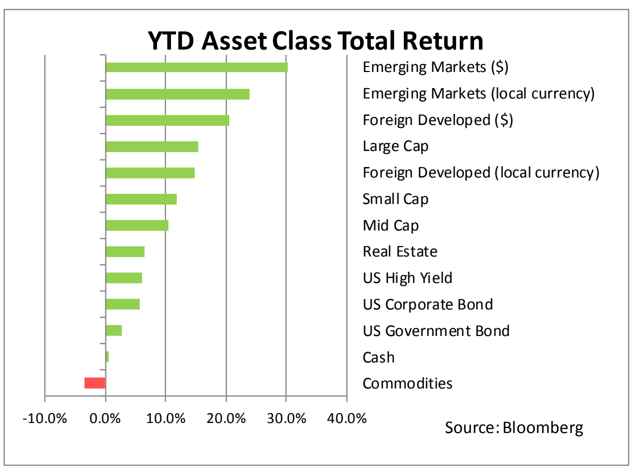




(Source: Bloomberg)

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 10/9/2017 close)

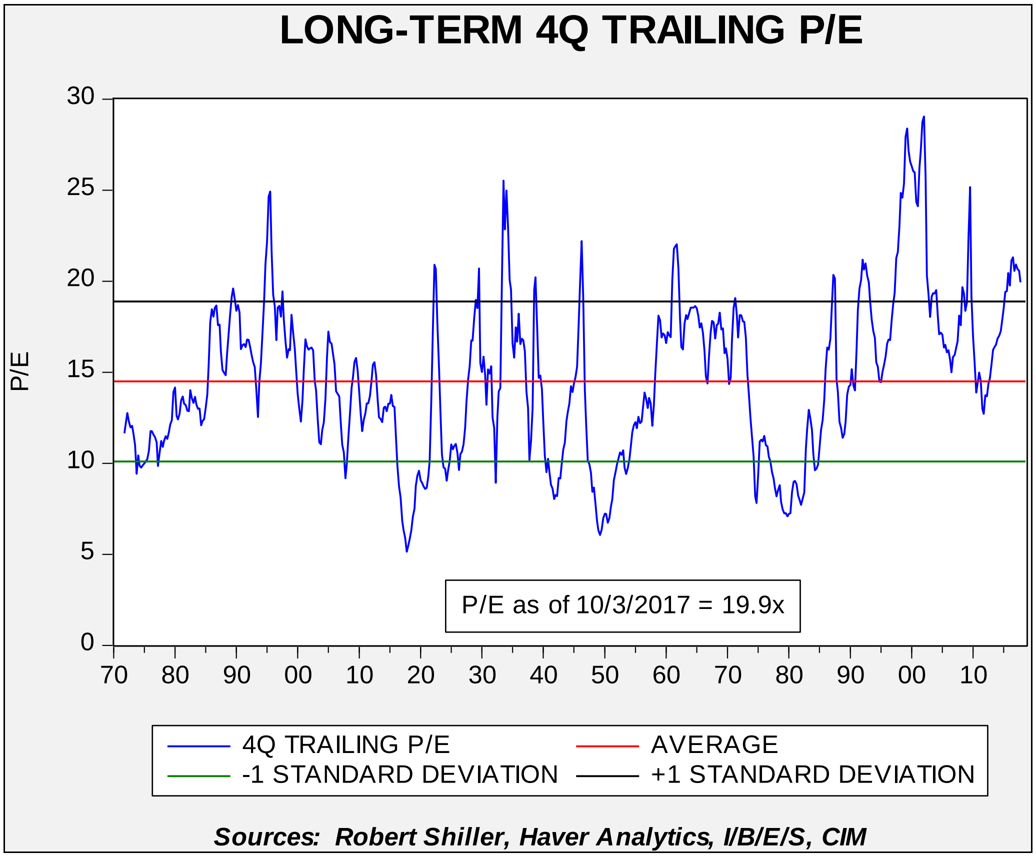


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

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[2] 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.