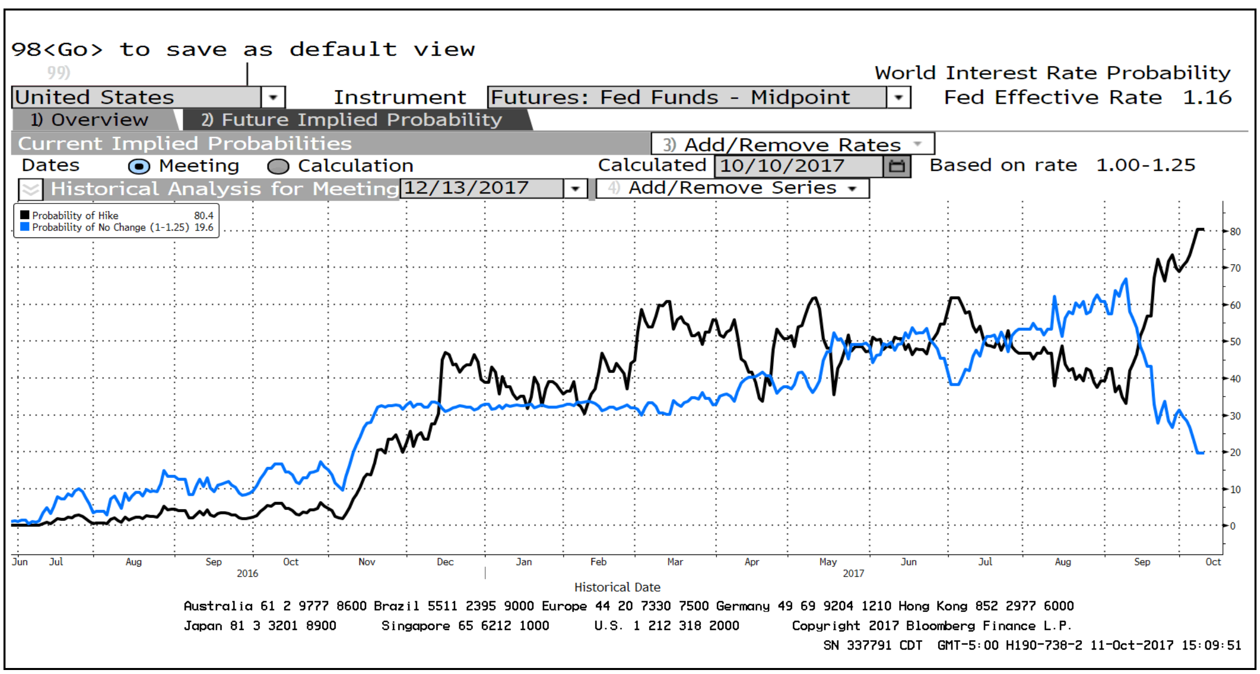
# Daily Comment

By Bill O'Grady and Thomas Wash

**[Posted: October 12, 2017—9:30 AM EDT]** Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were down, with the Shanghai composite down 0.1% and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a lower open. With 26 companies having reported, the S&P 500 Q3 earnings stand at $32.37, lower than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 84.7% of the companies reported earnings above forecast, while 7.7% reported earnings below forecast.

**Fed minutes:** The Fed minutes didn't have a lot of surprises; we would characterize them as modestly dovish. Going off the terms used, "several" members were uncertain about inflation and wanted more data to improve their confidence, while "a few" believed that additional increases should be delayed. On the other hand, "many" thought another increase in the target before year's end was warranted. That would suggest a rate hike in December is probably likely, but the decision may not be as unanimous as the market seems to think. Here are the current odds of a December hike in fed funds futures.




(Source: Bloomberg)

Current expectations call for an 80% probability of a December hike. The odds didn't decline after the minutes were released.

**The Chair race:** Politico[1] is reporting that Treasury Secretary Mnuchin is promoting Jerome Powell for the Fed chair job. The secretary has worked with him on issues in the past and sees him as a safe pick that he will have some influence over. At this point, we believe the two front-runners are Powell and Kevin Warsh and, of these two, we would wager that Warsh gets the nod. However, Mr. Trump has a history of surprises. Although his name isn't on any lists, we would not be shocked to see the president appoint an überdove like Minneapolis FRB President Kashkari. Kashkari is a Republican, which would make him acceptable to the GOP establishment. President Trump has also indicated he prefers low interest rates. We think Warsh is the front-runner because he will likely be beholden to the White House. The president's comments suggest he may be more Nixonian in his stance toward the U.S. central bank and, if so, it would be dollar bearish.

**Brexit talks stall:** EU Chief Negotiator Barnier indicated this morning that the two sides have not made any "great steps forward" and that talks are "deadlocked." Britain wants talks to shift to trade, but the EU wants the U.K. to inform the EU what it intends to pay to honor its EU commitments as the price of exit. Naturally, the May government has no interest in spelling out the costs but it appears that the EU won't negotiate on trade until the U.K. makes an offer. Although talks are not doomed, there was some market impact from the announcement of a deadlock.

(Source: Bloomberg)

The GBP tumbled on the deadlock news but has started to recover.

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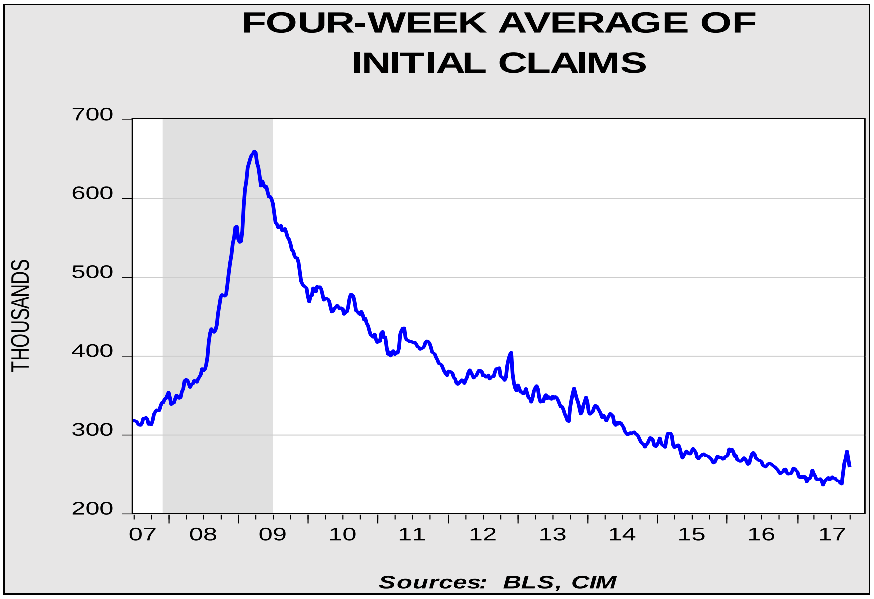
[1] http://www.politico.com/story/2017/10/11/jerome-powell-federal-reserve-chair-243679

**Is NAFTA in trouble?** Although negotiations continue, reports indicate that talks are contentious and negotiators are struggling to save the agreement. The impact of a repeal would be significant. U.S. agricultural exports would be harmed; Mexican tariffs on agricultural goods are steep and thus U.S. exports of grain and meat would likely decline. U.S. manufacturing is deeply integrated with Canada and Mexico, so production dislocations could be significant if trade flows are disrupted. For example, if trade barriers prevent auto parts from flowing across borders, auto production could cease for a period until new arrangements are created. More than 310 state and local Chambers of Commerce have sent letters to the White House urging the president to keep the U.S. in NAFTA. On the other hand, leaders of the AFL-CIO are supportive of the president's efforts. Although we generally expect inflation to remain low, our position is that mild inflation is mostly a function of globalization and deregulation. If either is disrupted, supply constraints and higher prices will result. If such an outcome accelerates, it will have a significantly negative effect on financial markets. Inflation lifts interest rates and lowers P/Es. It is quite possible that NAFTA falls and is followed up with bilateral agreements that mimic NAFTA. However, the shift would not be frictionless and, in the interim, an inflation scare could prompt tighter monetary policy and increase the odds of recession. We are watching this issue closely.

**Austrian elections:** If current polls are correct, Austrian voters are going to side with the center-right People's Party and its young leader, Sebastian Kurz. At 31, he would be the youngest head of government in the world. Usually, Austrian governments are grand coalitions of center-left and center-right parties. However, Kurz is expected to form a government with the xenophobic Freedom Party. Kurz has tried to limit the number of asylum seekers in Austria, opposing the German refugee policy. The anti-immigrant policy has been popular; when Kurz became party leader, People's Party polling rose 10%. One of the other interesting elements of this election is that consultants for the Social Democrats apparently made fake Facebook (FB, 172.74) pages that purported to be from racist groups suggesting Kurz planned to open Austria's borders at the behest of George Soros. The campaign appears to be rather nasty by European standards but, in the end, Austria appears to be turning rightward which will raise worries for Germany and France.

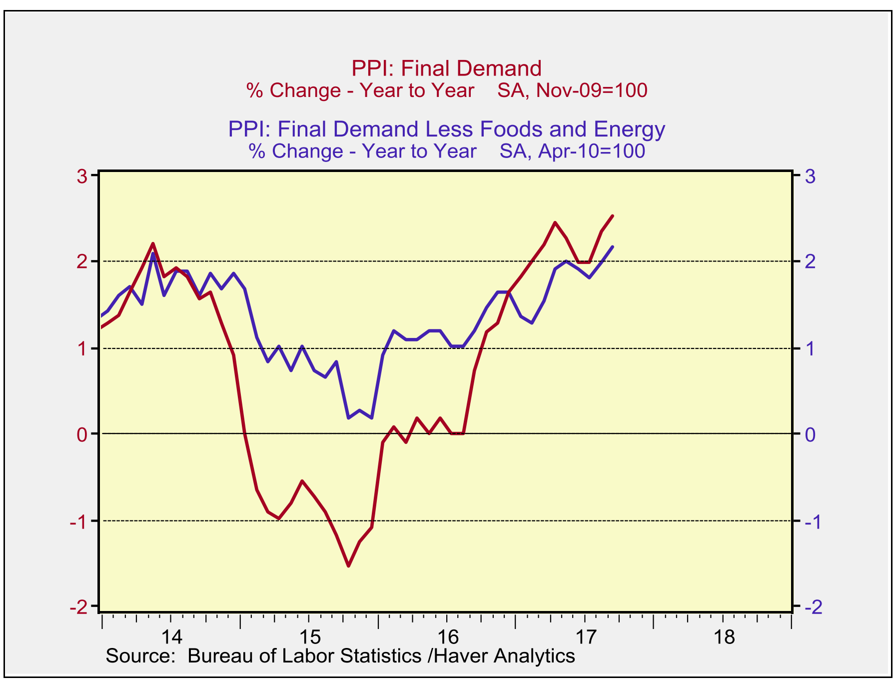
**U.S. Economic Releases**

Initial jobless claims came in below expectations at 243k compared to the forecast of 250k. The prior month's report was revised downward from 260k to 258k. Initial claims were distorted by the hurricanes but claims are falling to pre-hurricane levels as the effect dwindles.




The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 268.5k to 258.25k.

PPI final demand came in line with forecasts, rising 0.4% from the prior month. PPI excluding food and energy rose by 0.4% from the prior month compared to the forecast gain of 0.2%. Core PPI came in line with forecasts, rising 0.2% from the prior month.




The chart above shows the relationship between PPI final demand and PPI excluding food and energy. Annually, headline PPI and PPI excluding food and energy rose 2.6% and 2.2%, respectively.

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

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 9:45 | Bloomberg Consumer Comfort | m/m | oct | | 49.9 | ** |
| 10:00 | Monthly Budget Statement | m/m | sep | $6.0 bn | $33.4 bn | ** |
| Fed speakers or events | | | | | | |
| EST | Speaker or event | District or position | | | | |
| 14:15 | Jerome Powell speaks before Senate Banking Committee | Member of the Board of Governors | | | | |
| 14:00 | Lael Brainard Speaks in Cambridge, Massachusetts | Member of the Board of Governors | | | | |

## 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 | PPI | y/y | sep | 3.0% | 2.9% | 3.0% | ** | Equity and bond neutral |
| | Back Lending Incl Trusts | y/y | sep | 3.0% | 3.2% | | ** | Equity and bond neutral |
| | Back Lending Ex- Trusts | y/y | sep | 3.0% | 3.2% | | ** | Equity and bond neutral |
| | Tokyo Average Office Vacancies | m/m | sep | 3.17 | 3.35 | | ** | Equity and bond neutral |
| | Tertiary Industry Index | m/m | aug | -0.2% | 0.1% | 0.1% | ** | Equity bearish, bond bullish |
| Australia | Consumer Inflation Expectation | m/m | sep | 4.3% | 3.8% | | ** | Equity and bond neutral |
| | Home Loans | m/m | aug | 1.0% | 2.9% | 0.5% | ** | Equity bullish, bond bearish |
| | Investment Lending | m/m | aug | 4.3% | -3.9% | | ** | Equity and bond neutral |
| | Owner-Occupier Loan Value | m/m | aug | 0.9% | 0.9% | | ** | Equity and bond neutral |
| | Credit Card Purchases | m/m | aug | A$26.9 bn | A$25.6 bn | | ** | Equity and bond neutral |
| | Credit Card Balances | m/m | aug | A$51.3 bn | A51.3 bn | | ** | Equity and bond neutral |
| New Zealand | REINZ House Sales | y/y | sep | -26.2% | -20.0% | | ** | Equity and bond neutral |
| | Food Prices | m/m | sep | -0.2% | 0.6% | | ** | Equity and bond neutral |
| | ANZ Consumer Confidence | m/m | oct | 126.3 | 129.9 | | ** | Equity and bond neutral |
| | ANZ Consumer Confidence | m/m | oct | -2.8% | 2.9% | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Eurozone | Industrial Production | m/m | sep | 3.8% | 3.2% | 2.6% | *** | Equity bullish, bond bearish |
| France | CPI | y/y | sep | 1.0% | 1.0% | 1.0% | *** | Equity and bond neutral |
| | CPI ex-Tobacco | m/m | sep | 101.30 | 101.47 | 101.32 | *** | Equity and bond neutral |
| UK | RICS House Price Balance | m/m | sep | 6.0% | 6.0% | 4.0% | ** | 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)** | 136 | 136 | 0 | Up |
| **3-mo T-bill yield (bps)** | 106 | 107 | -1 | Neutral |
| **TED spread (bps)** | 29 | 28 | 1 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 122 | 122 | 0 | Up |
| **10-yr T-note (%)** | 2.33 | 2.35 | -0.02 | Neutral |
| **Euribor/OIS spread (bps)** | -33 | -33 | 0 | Down |
| **EUR/USD 3-mo swap (bps)** | 42 | 42 | 0 | Up |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Down |
| euro | up | | | Up |
| yen | up | | | 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 | $56.26 | $56.94 | -1.19% | Bearish API |
| WTI | $50.52 | $51.30 | -1.52% | |
| Natural Gas | $2.90 | $2.89 | 0.42% | |
| Crack Spread | $18.80 | $18.76 | 0.20% | |
| 12-mo strip crack | $19.27 | $19.42 | -0.74% | |
| Ethanol rack | $1.58 | $1.58 | -0.28% | |
| **Metals** | | | | |
| Gold | $1,296.26 | $1,291.72 | 0.35% | Brexit Uncertainty |
| Silver | $17.24 | $17.18 | 0.36% | |
| Copper contract | $311.40 | $309.55 | 0.60% | |
| **Grains** | | | | |
| Corn contract | $ 346.25 | $ 346.00 | 0.07% | |
| Wheat contract | $ 434.50 | $ 433.25 | 0.29% | |
| Soybeans contract | $ 968.25 | $ 965.25 | 0.31% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1433 | 1418 | 15 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -0.8 | | |
| Gasoline (mb) | | 0.0 | | |
| Distillates (mb) | | -2.0 | | |
| Refinery run rates (%) | | -0.50% | | |
| Natural gas (bcf) | | 84.0 | | |

## Weather

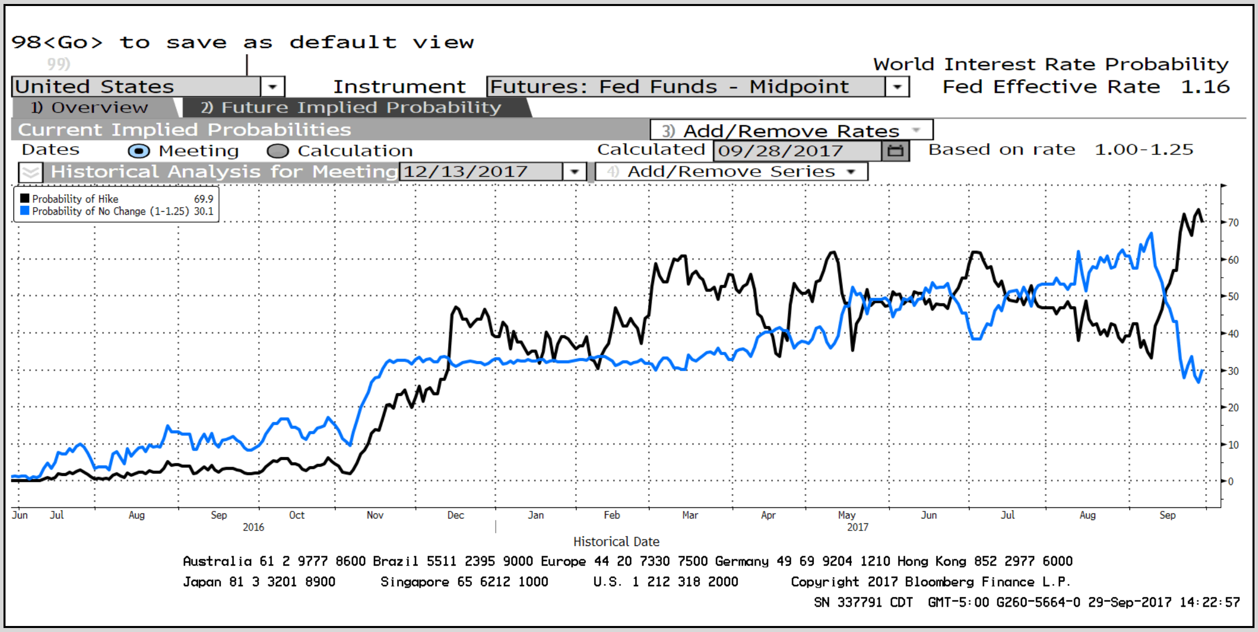
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

## 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

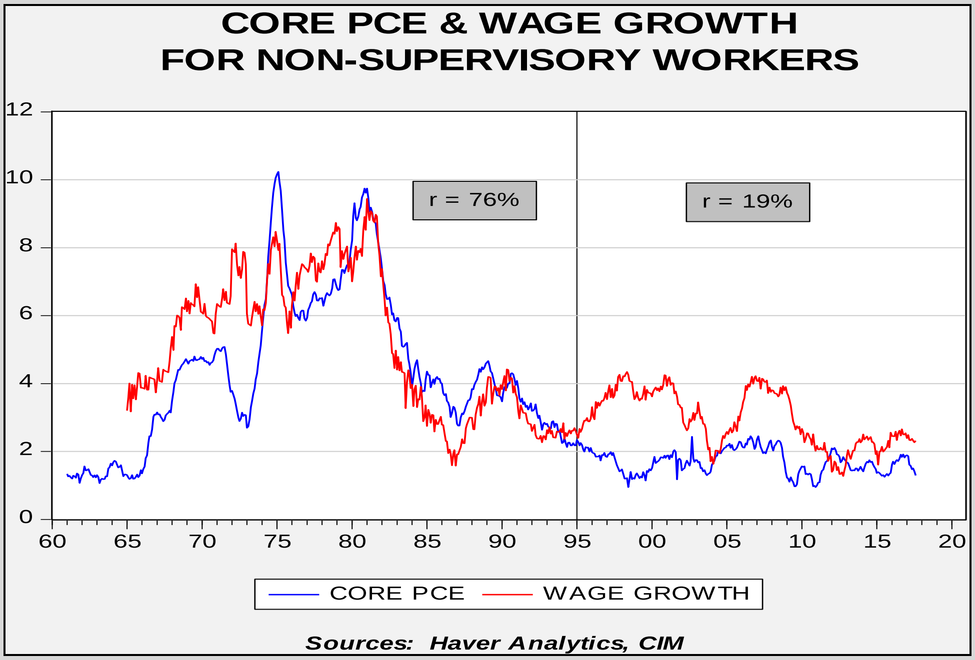
The latest FOMC meeting and subsequent comments from Chair Yellen have increased the likelihood of a December rate hike.



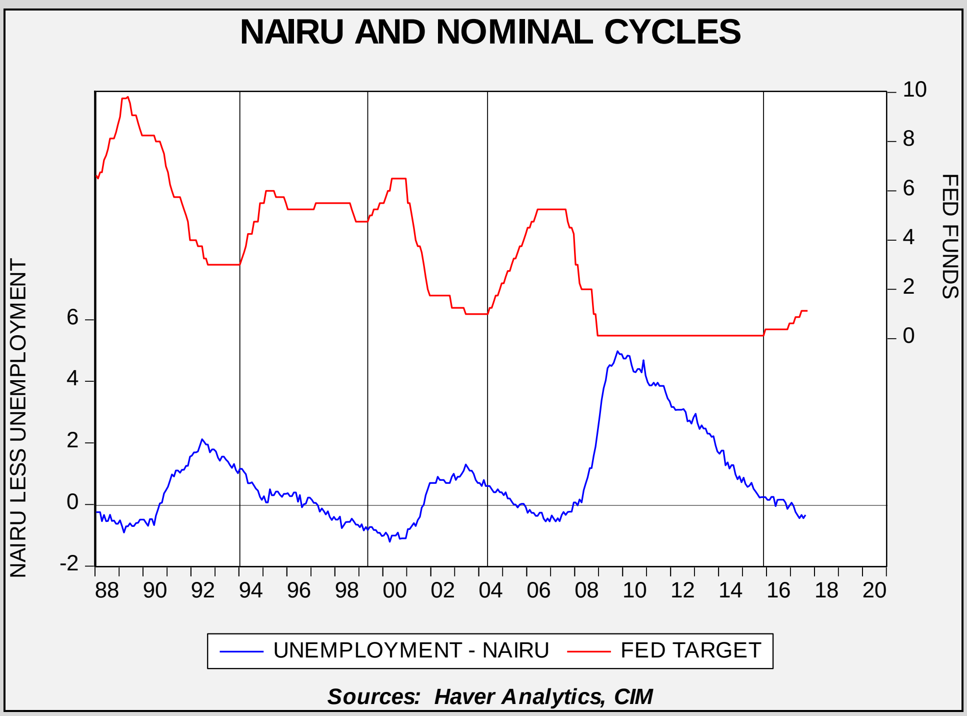
(Source: Bloomberg)

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.



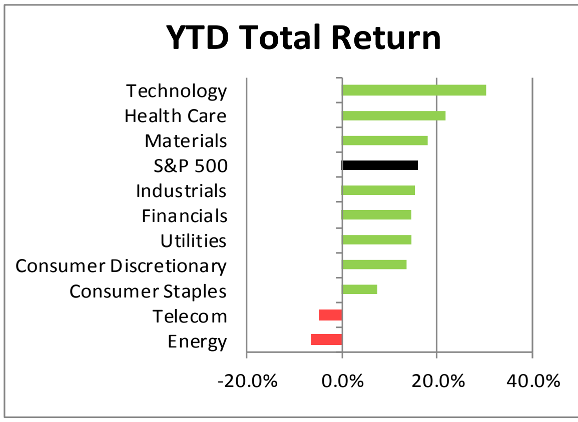

The key concept for the Phillips Curve is the Non-Accelerating Inflation Rate of Unemployment (NAIRU), which is the unemployment rate that is the lowest possible rate an economy can achieve without triggering inflation. The idea is that if unemployment falls below NAIRU, the labor markets become too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

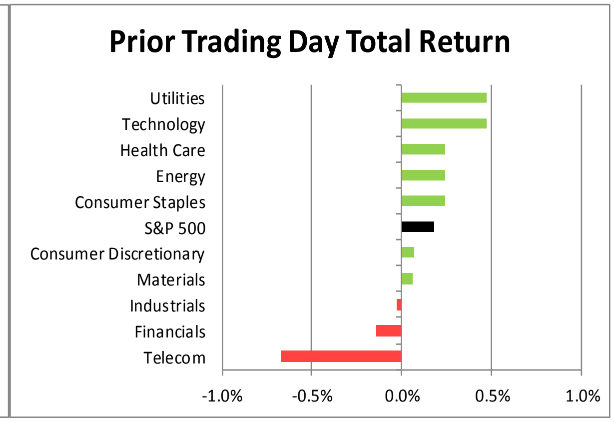
The current tightening cycle began with the unemployment rate very close to NAIRU, which is consistent with Chair Yellen's thinking on inflation. So far, wage growth has remained subdued. Since the early 1980s, wage growth has usually exceeded 4% when the unemployment rate falls below NAIRU. It is currently 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.

*Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.*

## Data Section

**U.S. Equity Markets** – (as of 10/11/2017 close)

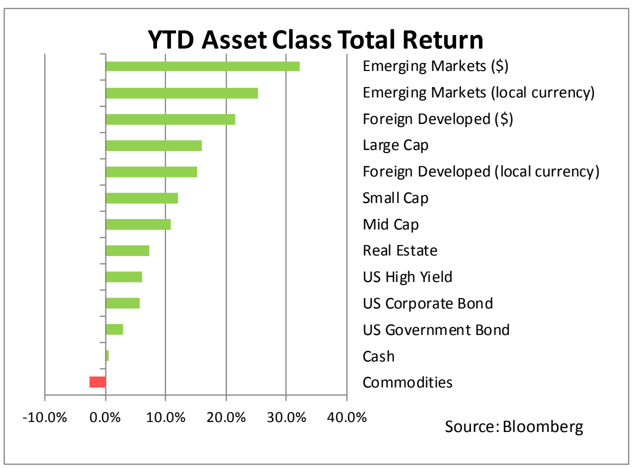



(Source: Bloomberg)

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 10/11/2017 close)

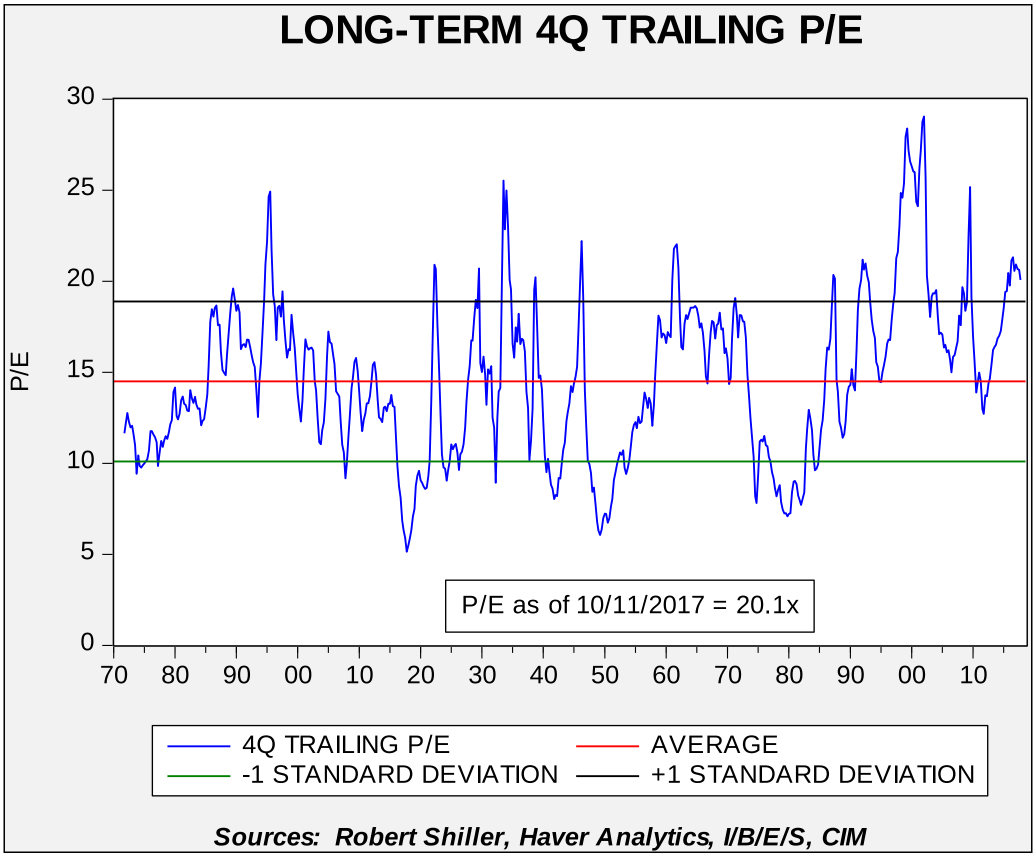



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 12, 2017




Based on our methodology,[2] the current P/E is 20.1x, up 0.2x from last week. The rise in the P/E is due to a reduction in Q3 earnings expectations (which fluctuate during the quarter) and rising levels of the S&P 500 index.

*This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.*

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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.