Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 16, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is relatively unchanged 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 0.4% and the Shenzhen index down 1.5%. U.S. equity index futures are signaling a higher open. With 32 companies having reported, the S&P 500 Q3 earnings stand at $32.40, lower than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 84.4% of the companies reported earnings above forecast, while 9.4% reported earnings below forecast.

Although U.S. financial markets are quiet, there is a lot going on. Here's what we are watching this morning:

War in Iraq? Iraqi troops have taken a refinery and captured oil fields surrounding the city of Kirkuk. So far, only Iraqi regular army troops have been involved; the Iranian-dominated Iraqi Shiite militias have reportedly not been part of the action. Kurdish Peshmerga forces have withdrawn, avoiding a fight with Iraqi forces. Reuters[1] is reporting that General Qassem Soleimani, a key leader of the Iranian Republican Guard Corps (IRGC), has arrived in Kurdistan for talks. Soleimani is a somewhat shadowy figure in the IRGC but is considered to be the mastermind behind many of Iran's tactics in the region. His presence there suggests Tehran is trying to contain the situation and prevent a wider war. To some extent, the tensions in Kurdistan are part of the collapse of IS. There is a power vacuum in western Iraq and eastern Syria; IS was the first to fill it, but it won't be the last, and the process of determining who is in control will likely be difficult and lead to constant conflict. Oil prices lifted on the news.

A deadline for Catalonia: Catalan leaders are trying to support indigenous independence while avoiding a violent crackdown from Madrid. PM Rajoy has given Catalonia until Thursday to say, yes or no, whether independence was declared. If it was, look for a violent reaction from Spain. EU Commission President Juncker indicated today that he regrets that both parties in Spain didn't heed his advice to talk sooner but said the EU would not mediate the crisis. Catalan leaders are stuck; if they back down from independence, they will likely lose their positions and more radical elements could replace them. If they declare independence, they will meet an ugly, aggressive response from Rajoy. So far, the EUR and Spanish debt have shown little signs of stress.

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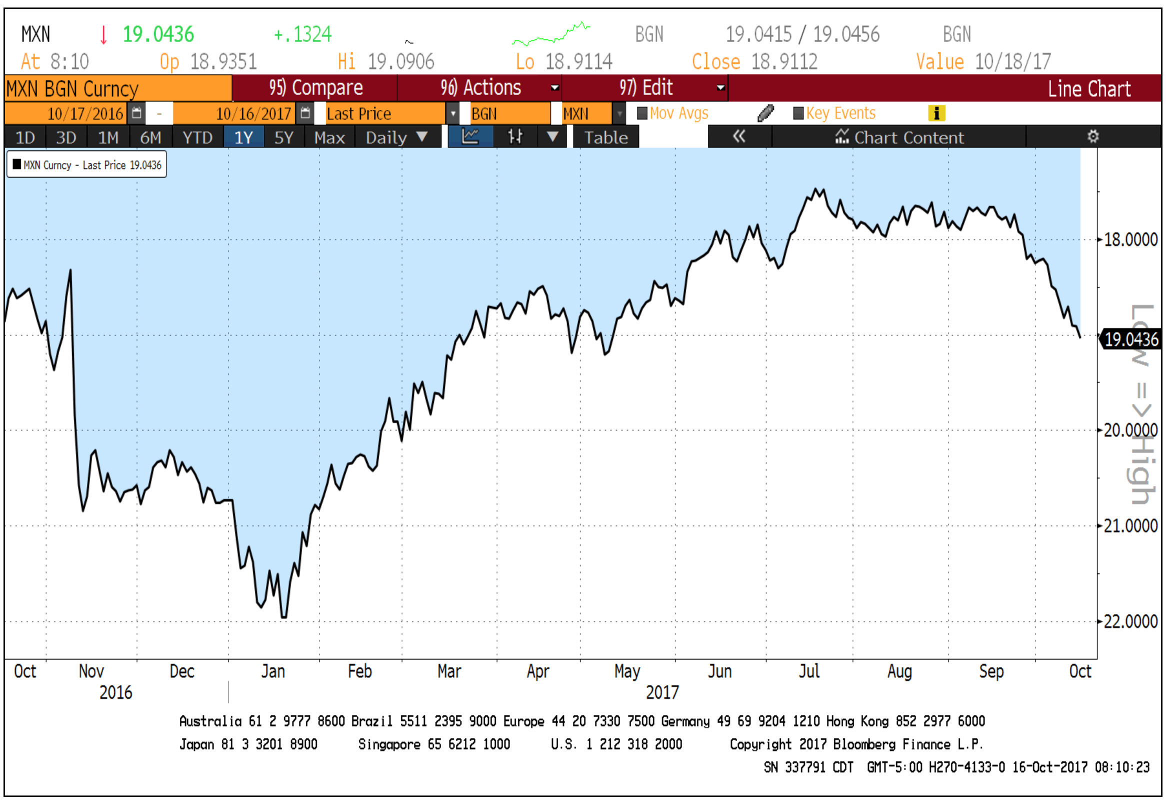
[1] http://www.reuters.com/article/us-global-oil/oil-rises-as-fighting-escalates-in-iraqs-oil-rich-kirkuk-idUSKBN1CL01M?utm_source=Sailthru&utm_medium=email&utm_campaign=New%20Campaign&utm_term=%2ASituation%20Report

Austria moves right: As we noted last Friday, the Austrian vote went as expected, with the center-right People's Party winning a plurality, making Sebastian Kurz the youngest leader of a major nation in the world. Kurz has moved the previously staid People's Party into a more populist, right-wing party and has energized it with social media. He ran on an anti-immigration platform and will likely team up with the right-wing, populist Freedom Party. Although the general trend has been for populists to underperform in elections this year, as seen in France and the Netherlands, they have clearly done better in Germany and Austria. Populism remains a potent force in the West.

NAFTA worries: There are growing worries that the Trump administration will scuttle the agreement. There is talk of higher content rules for products (which would reduce imports of parts from Mexico and Canada) and sunset rules that would require renegotiation every five years. The former might be workable but the latter essentially kills the deal. Trade law changes business infrastructure; if it is open to major changes every five years then firms won't make the investments into international supply chains and will simply produce more at home. Worries are starting to show up in the forex markets.



(Source: Bloomberg)

Concerns are clearly reflected in the MXN/USD (Mexican peso) exchange rate. This is the number of MXN per USD on an inverted scale. The MXN fell sharply after the election of President Trump but then the currency recovered on hopes that Trump, for all his rhetoric, would turn out to be a typical free-trade Republican. Note that the MXN has been weakening steadily since the middle of last month, reflecting worries about NAFTA. A somewhat less clear picture emerges on the CAD/USD (Canadian dollar) exchange rate.

(Source: Bloomberg)

Although the CAD didn't weaken after the election (it was already quite weak), it rallied from May to September after the Bank of Canada raised rates. We have seen the currency weaken as NAFTA talks have deteriorated.

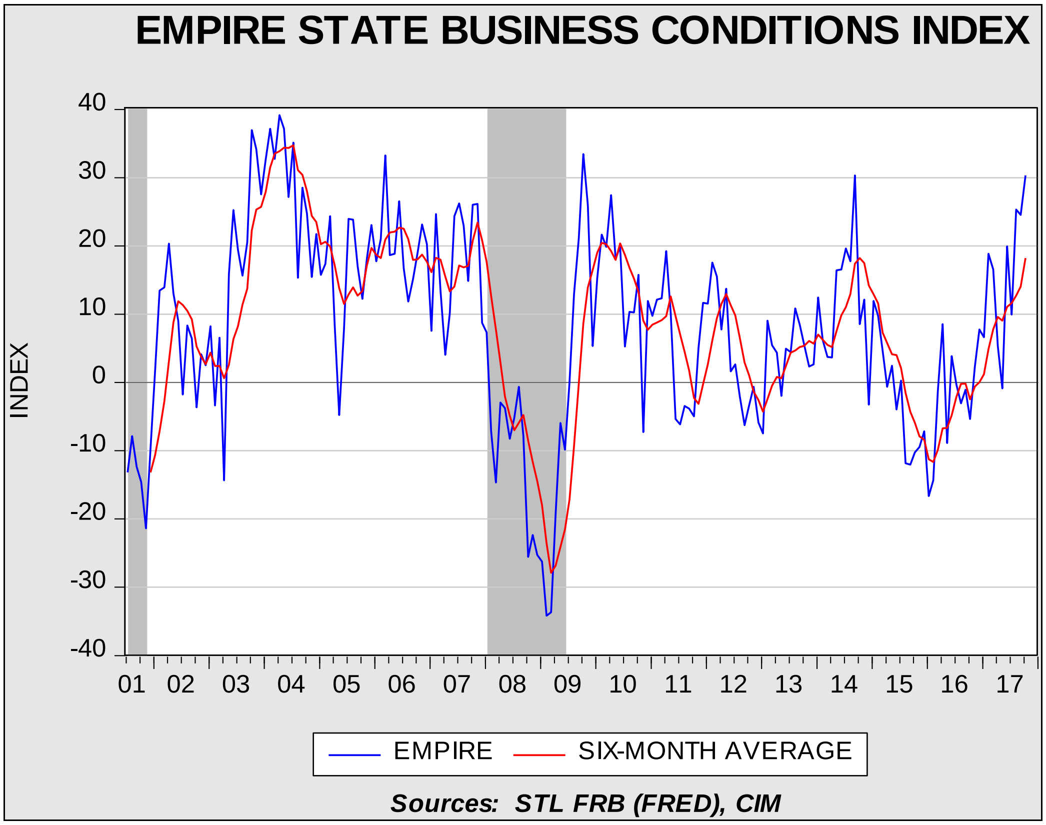
Yellen at the G-30: The G-30 is a group of finance officials from the industrialized nations. They met last weekend as part of the IMF meetings. Yellen reiterated her defense of the Phillips Curve and indicated that rates would continue to rise.

A worry for Turkey? A series of wiretaps suggests that PM (now President) Erdogan may have facilitated a violation of sanctions on Iran with gold for natural gas swaps in 2013.[2] The Turkish president has called the transcripts and tapes a fabrication but U.S. prosecutors think Turkey may have violated international sanctions on Iran. This case is damaging already strained relations with Turkey.

[2] https://www.nytimes.com/2017/10/14/world/europe/turkey-new-york-case.html?emc=edit_mbe_20171016&nl=morning-briefing-europe&nlid=5677267&te=1

U.S. Economic Releases

Empire manufacturing came in above expectations at 30.2 compared to the forecast of 20.4.



The chart above shows the six-month moving average of the Empire State Business Conditions Index. The strong move in the index suggests an improving economic situation in New York and is usually a precursor to the more widely followed Philadelphia FRB Business Index.

There are no economic releases or Fed 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	Money Supply M2	y/y	sep	9.2%	8.9%	8.9%	**	Equity and bond neutral
	Money Supply M1	y/y	sep	14.0%	14.0%	13.5%	**	Equity and bond neutral
	Money Supply M0	y/y	sep	7.2%	6.5%	6.6%	**	Equity and bond neutral
	New Yuan Loans	y/y	sep	1.270 tn	1.090 tn	1.200 tn	**	Equity and bond neutral
	Aggregate Financing	y/y	sep	1.820 tn	1.480 tn	1.573 tn	**	Equity and bond neutral
Japan	Tokyo Condominium Sales	m/m	sep	-13.0%	6.9%		**	Equity and bond neutral
	Industrial Production	m/m	sep	5.3%	5.4%		***	Equity and bond neutral
	Capacity Utilization	m/m	sep	3.3%	-1.8%		**	Equity and bond neutral
India	Wholesale Prices	y/y	sep	2.6%	3.2%	3.3%	**	Equity and bond neutral
New Zealand	Performance Services Index	m/m	sep	56.0	57.3		**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	m/m	aug	21.6 bn	18.6 bn	20.2 bn	**	Equity bullish, bond bearish
Germany	Wholesale Price Index	y/y	sep	3.4%	3.2%		**	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	oct	578.5 bn	578.5 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	oct	471.3 bn	472.9 bn		**	Equity and bond neutral
	Real Estate Index Family House	m/m	aug	464.5	462.3		**	Equity and bond neutral
AMERICAS								
Canada	Existing Home Sales	m/m	sep	2.1%	1.3%		**	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	136	-1	Up
3-mo T-bill yield (bps)	105	105	0	Neutral
TED spread (bps)	30	31	-1	Neutral
U.S. Libor/OIS spread (bps)	123	122	1	Up
10-yr T-note (%)	2.28	2.27	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	41	41	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			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	$58.02	$57.17	1.49%	Kurdish Conflict
WTI	$52.17	$51.45	1.40%	
Natural Gas	$2.95	$3.00	-1.60%	
Crack Spread	$19.14	$19.18	-0.18%	
12-mo strip crack	$19.63	$19.68	-0.26%	
Ethanol rack	$1.57	$1.58	-0.20%	
Metals				
Gold	$1,305.92	$1,303.82	0.16%	Eurozone Uncertainty
Silver	$17.44	$17.42	0.14%	
Copper contract	$321.75	$313.35	2.68%	
Grains				
Corn contract	$ 351.75	$ 352.75	-0.28%	
Wheat contract	$ 440.25	$ 439.50	0.17%	
Soybeans contract	$ 994.75	$ 1,000.25	-0.55%	
Shipping				
Baltic Dry Freight	1485	1458	27	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.7	-0.8	-2.0	
Gasoline (mb)	2.5	0.0	2.5	
Distillates (mb)	-1.5	-2.0	0.5	
Refinery run rates (%)	1.10%	-0.50%	1.60%	
Natural gas (bcf)	87.0	84.0	3.0	

Weather

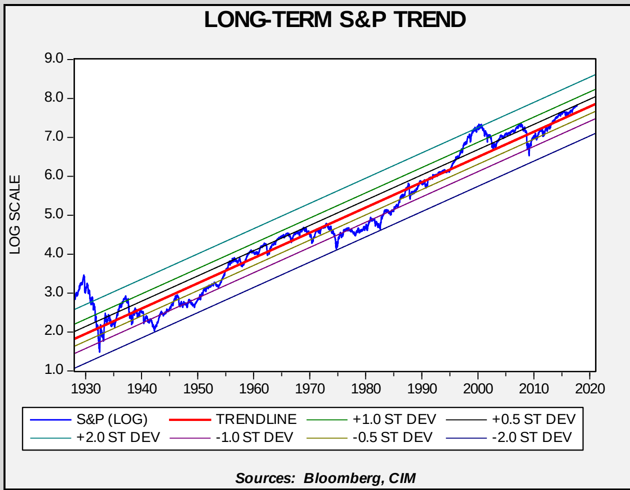
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. Precipitation is expected for the eastern region of the country. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

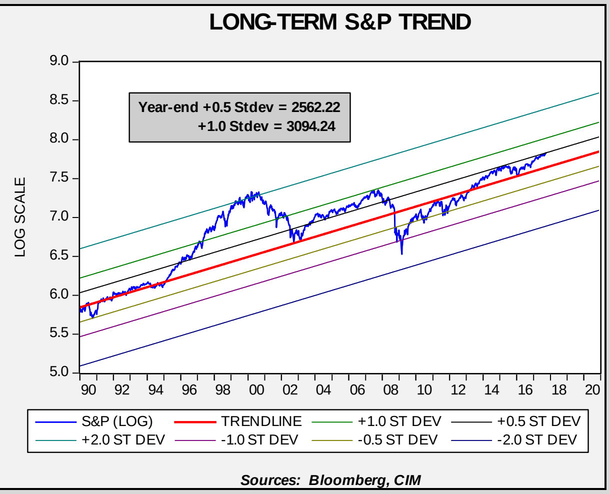
Asset Allocation Weekly Comment

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 13, 2017

With the S&P making new highs almost daily, it is probably a good time to look at long-term trends to build some parameters.





This is a simple trend chart of the S&P 500 Index. We have log-transformed the weekly Friday closes of the index data and regressed it against a time trend. The chart on the left shows the index from 1929 while the chart on the right shows the index from 1990 (same regression trend lines for both charts).

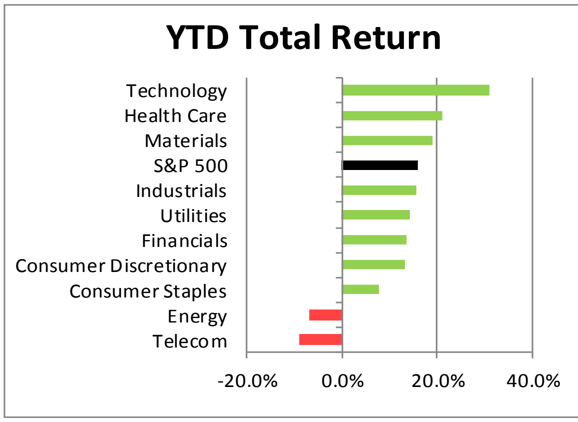
Equities clearly trend higher over time. The yearly trend shows an average return for the S&P 500 Index of just over 6%. However, as the charts show, there is a fair degree of variation over time. The trend data shows that two standard errors above the trend is a dangerous area. One standard error above the trend is a concern. We are currently just below one-half standard error above the trend. That level by itself isn't a big worry. In the 1950s into the early 1970s, we saw the index vacillate between the trend and one standard error above trend. These are not inconsequential market moves; in the current context, the trend line for the S&P 500 Index is 2090.26, meaning a pullback from current levels to the trend line would be a decline of about 17.6%.

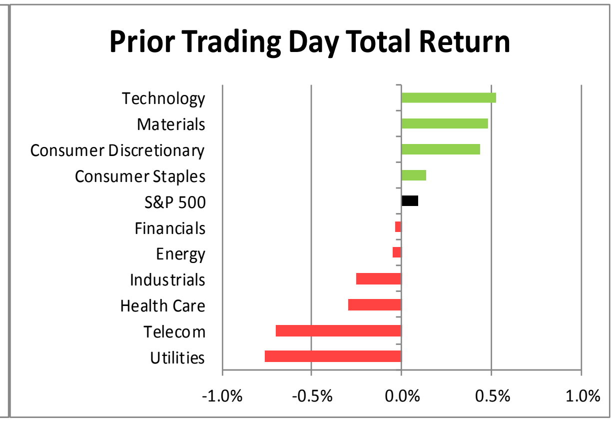
Simply put, barring a recession or geopolitical event, equities are not seriously extended on a trend basis. We also note that the last two bear markets dropped a full two standard errors from peak to trough. The bear market that began in 2000 fell from two standard errors above the trend to the trend line (the bold red line on the chart), and the 2008 bear market ran from one standard error above the trend to one standard error below. Thus, a recession-triggered bear market would be a significant market event.

So, what does this tell us? Although there is a rather elevated sense of concern among investors, overall, the path of least resistance is to grind higher. Equities are not cheap but alternatives are even more expensive. The other insight this research offers is that a "melt-up" would take us well above 3000. If investors were to become "irrationally exuberant" we would expect a move to this level. At this point, there appears to be enough caution to prevent that from occurring. However, if a dovish Fed chair is nominated or a major tax cut appears likely to pass, a rise to these levels might be triggered. A recession is a clear worry; falling to one standard error below the trend line, which would be a drop of lesser magnitude than normal, would be to 1454.81 by year's end. Obviously, because the trend line moves higher over time, the longer it takes to have a correction, the higher the expected bottom. For now, equities, based on this analysis, are not at levels that would usually signal a major bear market. At the same time, this doesn't mean that there are no risks. It just means that, in terms of trend, we are not at extremes.

Data Section

U.S. Equity Markets – (as of 10/13/2017 close)

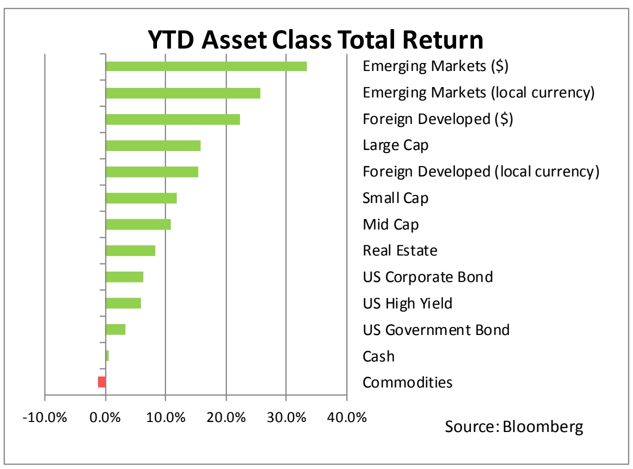




(Source: Bloomberg)

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 10/13/2017 close)

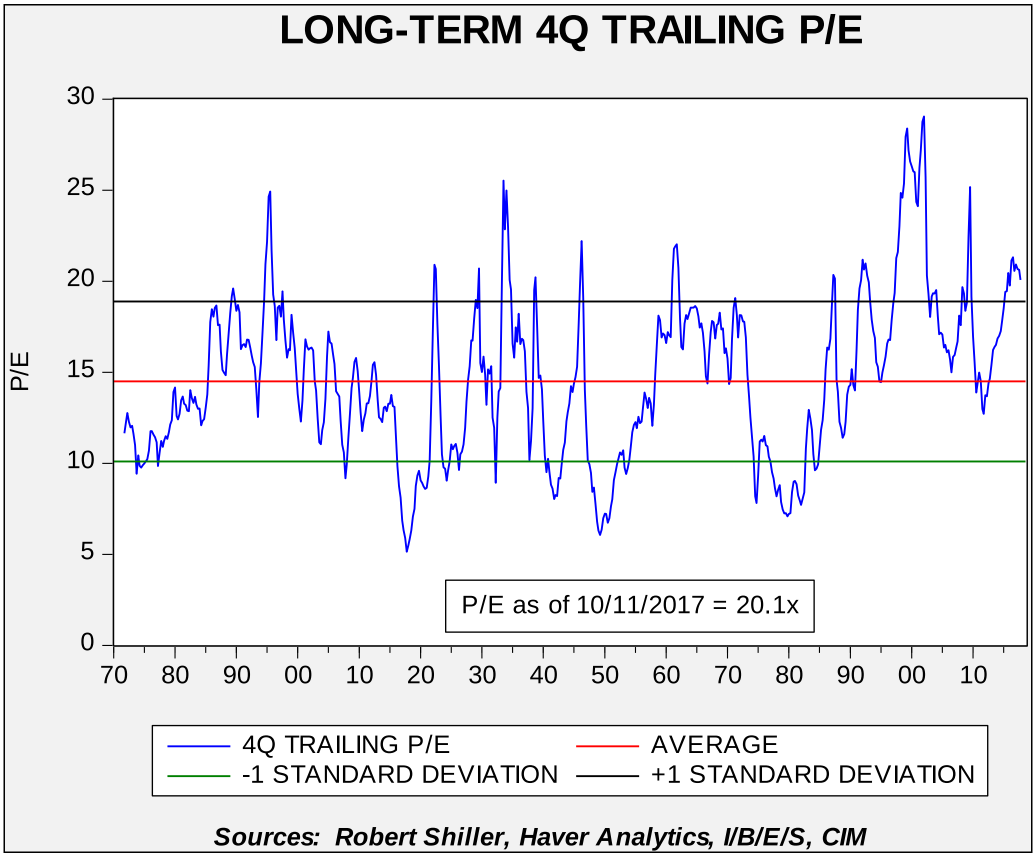


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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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[3] 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.