Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 17, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.2% and the Shenzhen index up 0.1%. U.S. equity index futures are signaling a lower open. With 34 companies having reported, the S&P 500 Q3 earnings stand at $32.38, lower than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 82.4% of the companies reported earnings above forecast, while 11.8% reported earnings below forecast.

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

Taylor to the Chair? John Taylor, the creator of the "Taylor Rule," visited President Trump yesterday and, according to news reports, the president was very impressed. Taylor is a well-respected economist with a good deal of government and academic experience. What makes him a bit of a surprise is that he is considered rather hawkish. When these reports emerged yesterday, the dollar rallied and Treasuries dipped. We would be surprised if Taylor gets the nod for chair, although it wouldn't be a shock to see him appointed to the FOMC. In general, Trump favors lower interest rates; Taylor is on the record calling for a 2% real fed funds rate, or, assuming 2% CPI, a 4% nominal fed funds rate. Eurodollar futures are nowhere near that level and so we would view Taylor as a bearish event for equities and Treasuries, and bullish for the greenback.

Friends Again! Yesterday, Senate Majority Whip McConnell and President Trump stood side-by-side in the rose garden in a sign of unity as they prepare to pass tax reform. It has been reported that the two had a falling out after the Senate failed to repeal Obamacare. This display of friendship should be taken with a grain of salt as there have been reports that officials in Trump's administration believe that Senate Republicans are an impediment to Trump's legislative agenda. It is also worth noting that while speaking on their improved relationship Trump mentioned that he would talk Steve Bannon out of setting up primary challenges to Senate Republicans; earlier this month, Bannon stated that he is willing to go to war with establishment Republicans. We would interpret this gesture as a final olive branch before Trump gives up on the GOP and tries to pass legislation on his own. We will continue to monitor this situation.

More Headaches for the Catalan President: Yesterday, Spain's high court sentenced the leaders of the Catalan National Assembly (ANC) and Omnium Cultural, Jordi Sanchez and Jordi Cuixart, to prison without bail pending an investigation of alleged sedition. The two men were accused of sedition due to their involvement in setting up massive protests to counter the Civil

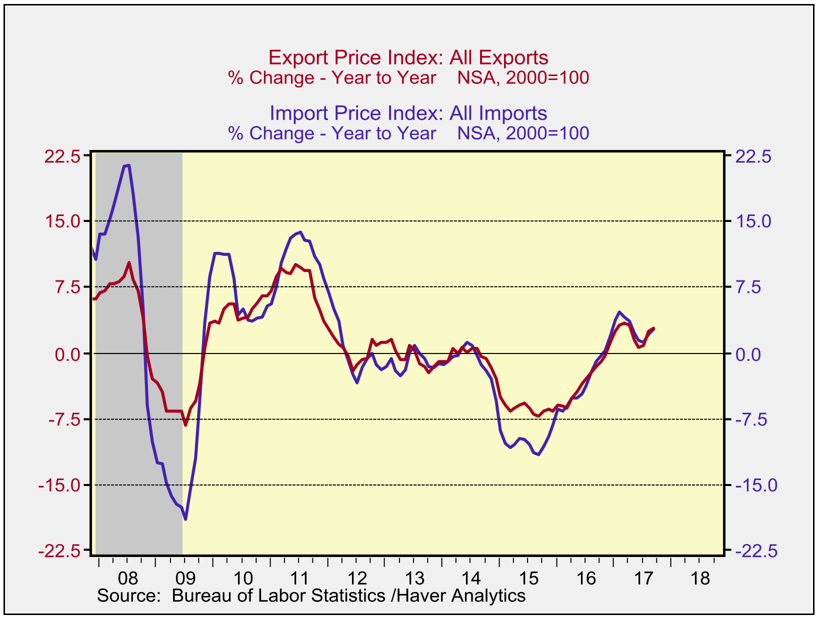
Guard's crackdown on the October 1st referendum. As the two men were escorted from the courthouse, they were given a hero's welcome from separatist supporters.

This event will likely put more pressure on Catalan President Carles Puigdemont to clarify his position on whether Catalonia has declared independence from Spain. Following the results of the referendum, Puigdemont stated that he has the mandate to declare independence but will suspend doing so in order to set up negotiations with the Spanish government. In response, the Spanish government has stated that it will not consider negotiating with Catalonia as long as it insists on becoming an independent state. In addition, Spain has given Puigdemont until Thursday to clarify his position or risk having his government dissolved. In rebuke of the Spanish government, the ANC sent a letter to Puigdemont urging him to immediately end the suspension of Catalan independence. Puigdeomnt appears to be in a lose-lose situation; if he formally declares independence he risks being removed from office, and if he does not declare independence he will likely lose the support of his base. Currently, Spanish equities are up but are trading slightly lower than last week.

So, you're saying there's a chance? Yesterday, CNN reported that a North Korean official stated that the region would only be willing to engage in diplomacy with the Trump administration if it has the capability to strike the East Coast of the U.S. Given all of its bluster, this statement represents a victory for SOS Rex Tillerson, who has maintained that sanctions will help bring North Korea to the negotiating table regarding its nuclear program. Over the past few weeks, SOS Tillerson and President Trump have offered differing strategies on how to deal with North Korea's nuclear program. Tillerson would prefer to curb the program through diplomacy, while the president has advocated for ending the program militarily. These comments could be a prelude to possible negotiations but we are not prepared to rule out the likelihood of a U.S. preliminary strike. We will continue to monitor this situation.

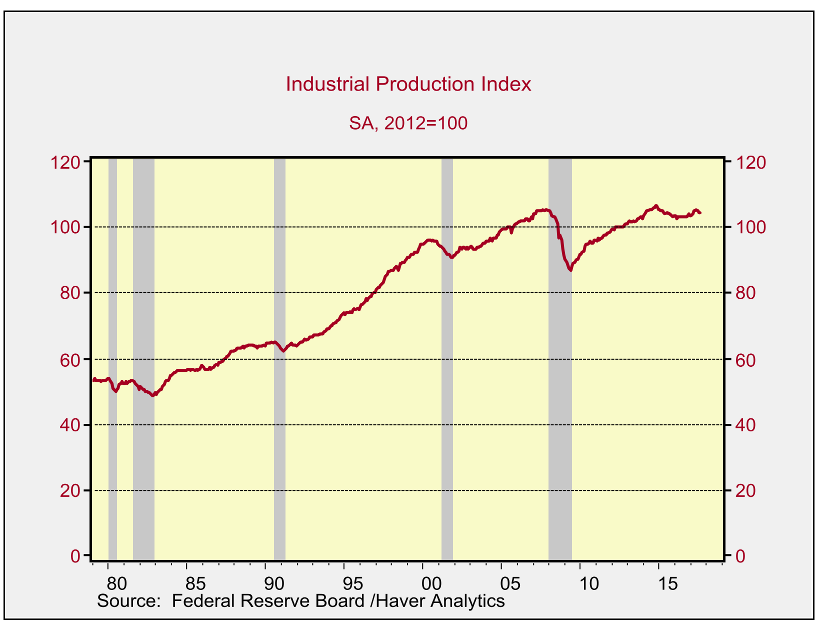
U.S. Economic Releases

The import price index came in above expectations, rising 0.7% from the prior month compared to the forecast gain of 0.6%. The import price index excluding petroleum came in above expectations, rising 0.3% from the prior month compared to the forecast rise of 0.2%. The export price index came in above expectations, rising 0.8% from the prior month compared to the forecast rise of 0.5%.



The chart above shows the year-over-year change in the import price index and export price index. The import price and export price indexes rose 2.7% and 2.9%, respectively. This report is somewhat uneventful and therefore unlikely to have an impact on the Fed's decision-making.

Industrial production came in line with expectations, rising 0.3% from the prior month; the prior report's loss was revised downward from 0.9% to 0.7%. Capacity utilization came in below expectations at 76.0% compared to the forecast of 76.2%; the prior month's report was revised downward from 76.1% to 75.8%. Manufacturing production came in below expectations, falling 0.1% from the prior month compared to the forecast gain of 0.2%.



The chart above shows the level of industrial production.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	NAHB Housing Market Index	m/m	sep	64	64	**
16:00	Total Net TIC Flows	m/m	sep		-$7.3 bn	**
16:00	Net Long-term TIC Flows	m/m	sep		$1.3 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
10:00	Patrick Harker Speaks on Equitable Transit	President of the Federal Reserve Bank of Philadelphia				

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								
Australia	ANZ Roy Morgan Weekly Consumption	y/y	sep	112.4	113.8		**	Equity and bond neutral
	New Motor Vehicle Sales	y/y	sep	-0.8%	1.7%		**	Equity and bond neutral
New Zealand	CPI	y/y	3q	1.9%	1.7%	1.8%	***	Equity bullish, bond bearish
	Non Resident Bond Holdings	y/y	sep	60.4%	61.2%		**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registraion	m/m	sep	-2.0%	5.6%		**	Equity and bond neutral
	CPI	y/y	sep	1.5%	1.5%	1.5%	***	Equity bullish, bond bearish
	CPI Core	m/m	sep	1.1%	1.1%	1.1%	***	Equity bullish, bond bearish
	ZEW Survey Expectations	m/m	oct	26.7	31.7		**	Equity and bond neutral
Germany	ZEW Survey Current Situation	m/m	oct	87.0	87.9	88.5	**	Equity and bond neutral
	ZEW Survey Expectations	m/m	oct	17.6	17.0	20.0	**	Equity and bond neutral
UK	CPI	y/y	sep	3.0%	2.9%	3.0%	***	Equity bullish, bond bearish
	CPI Core	y/y	sep	2.7%	2.7%	2.7%	***	Equity bullish, bond bearish
	RPI	y/y	sep	3.9%	3.9%	4.0%	**	Equity and bond neutral
	PPI Input	y/y	sep	8.4%	7.6%	8.2%	**	Equity and bond neutral
	PPI Output	y/y	sep	3.3%	3.4%	3.3%	**	Equity and bond neutral
	PPI Output Core	y/y	sep	2.5%	2.5%	2.6%	**	Equity and bond neutral
	House Price Index	y/y	aug	5.0%	5.1%	5.4%	**	Equity and bond neutral
Russia	Industrial Production	y/y	sep	0.9%	1.5%	1.5%	***	Equity bullish, bond bearish
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	sep	57.9	58.4		**	Equity and bond neutral
	Business Outlook Future Sales	q/q	3q	19.00	31.00		**	Equity and bond neutral
	BoC Senior Loan Office Survey	q/q	3q	-0.5	2.1		**	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)	104	105	-1	Neutral
TED spread (bps)	31	31	0	Neutral
U.S. Libor/OIS spread (bps)	123	123	0	Up
10-yr T-note (%)	2.31	2.30	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	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	$58.06	$57.82	0.42%	Kurdish Conflict
WTI	$52.11	$51.87	0.46%	
Natural Gas	$3.00	$2.95	1.80%	
Crack Spread	$18.99	$18.78	1.07%	
12-mo strip crack	$19.69	$19.51	0.89%	
Ethanol rack	$1.56	$1.57	-0.34%	
Metals				
Gold	$1,288.59	$1,295.79	-0.56%	Stronger Dollar
Silver	$17.10	$17.23	-0.75%	
Copper contract	$320.70	$323.90	-0.99%	
Grains				
Corn contract	$ 349.50	$ 350.50	-0.29%	
Wheat contract	$ 436.25	$ 436.50	-0.06%	
Soybeans contract	$ 986.50	$ 991.00	-0.45%	
Shipping				
Baltic Dry Freight	1523	1485	38	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-1.7		
Refinery run rates (%)		0.00%		

Weather

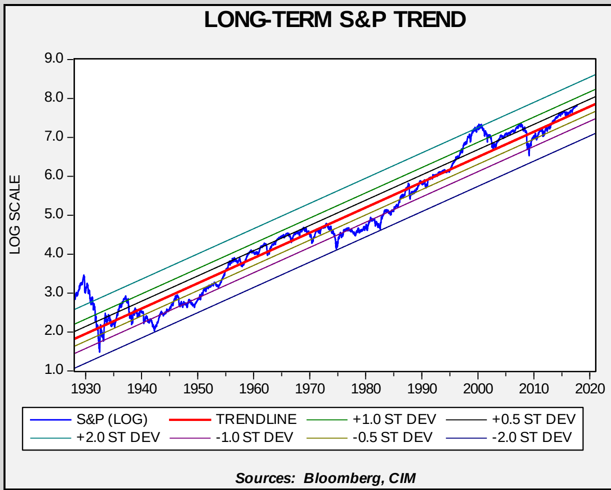
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. Precipitation is expected for the eastern region of the country. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

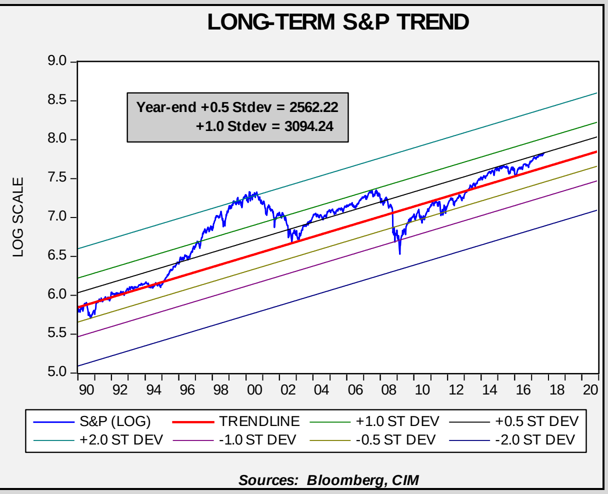
Asset Allocation Weekly Comment

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).

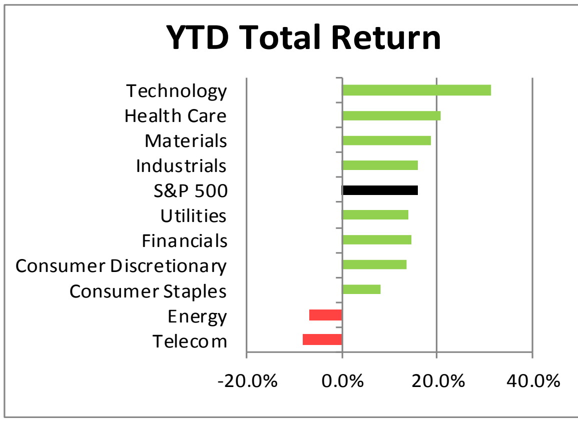
Equities clearly trend higher over time. The yearly trend shows an average return for the S&P 500 Index of just over 6%. However, as the charts show, there is a fair degree of variation over time. The trend data shows that two standard errors above the trend is a dangerous area. One standard error above 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%.

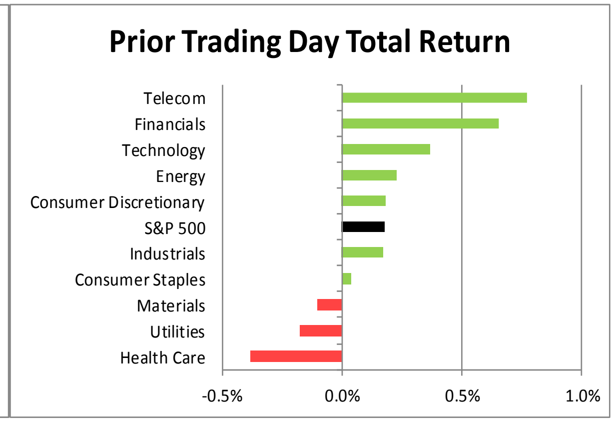
Simply put, barring a recession or geopolitical event, equities are not seriously extended on a trend basis. We also note that the last two bear markets dropped a full two standard errors from peak to trough. The bear market that began in 2000 fell from two standard errors above the trend to the trend 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 10/16/2017 close)

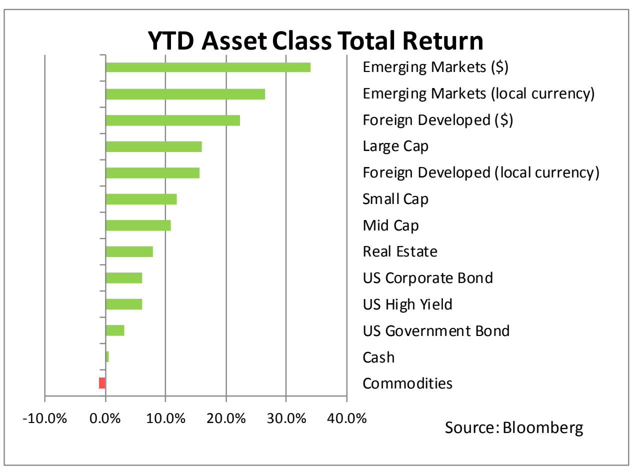




(Source: Bloomberg)

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 10/16/2017 close)

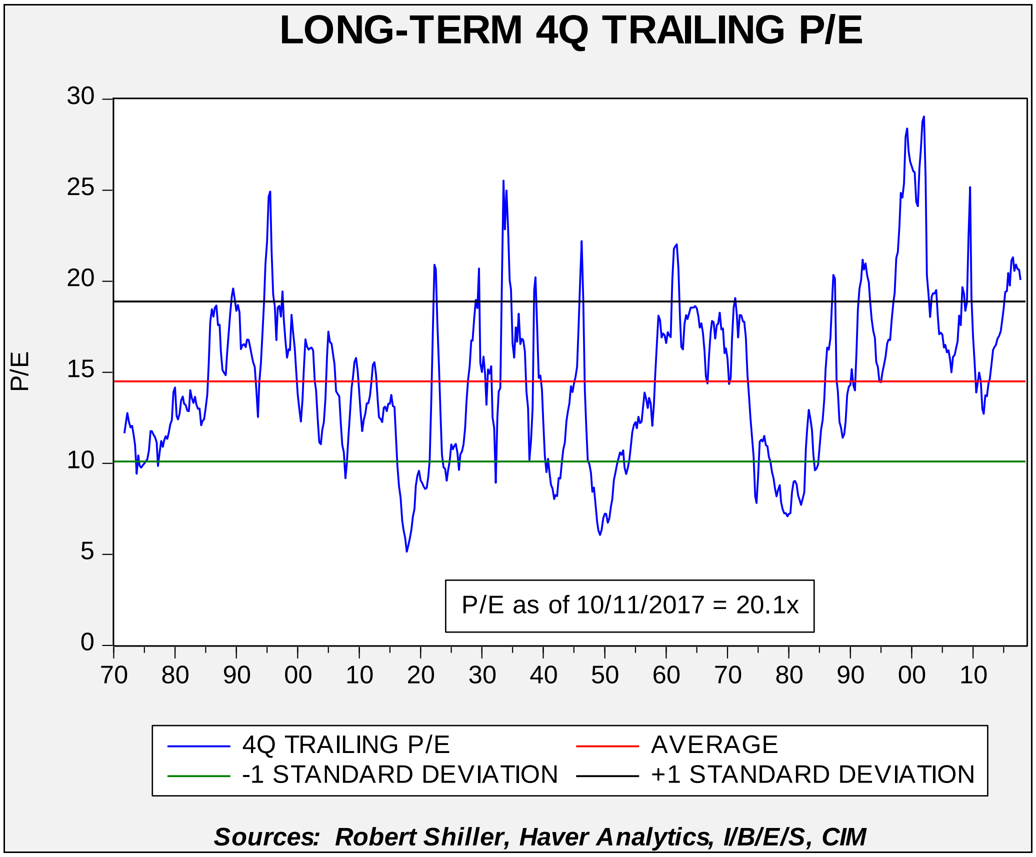


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] 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.

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[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.