By Bill O'Grady and Thomas Wash

[Posted: October 18, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.3% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a higher open. With 48 companies having reported, the S&P 500 Q3 earnings stand at $32.45, slightly below the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 85.4% of the companies reported earnings above forecast, while 8.3% reported earnings below forecast.

Tax reform: Senate Republicans are moving closer to tax reform as 50 senators have agreed to begin debate on a budget resolution. In order for tax reform to happen, the Senate must first pass a budget appropriations bill. Currently, there appear to be a few holdouts that might prevent the budget resolution from passing through the Senate. Senator Rand Paul is the most vocal Republican holdout, stating that the bill fails to meet the budget cap requirement established in the 2011 Budget Control Act; Senator Bob Corker has also voiced similar concerns. In addition, there are still concerns about whether Senator Thad Cochran is healthy enough to vote as he has been recovering from an infection over the past few weeks. The GOP can only afford to lose two votes if they plan on passing a tax bill without help from the Democrats. That being said, there is growing speculation that tax reform will not get done by the end of the year. We continue to closely monitor this situation.

Return of the subsidies: Senators Lamar Alexander and Patty Murray reached a bipartisan deal that would fund healthcare subsidies for two years in exchange for giving states more regulatory flexibility with the law. Last week, Trump signed an executive order that would have ended subsidies that reimburse insurance companies for lowering deductibles, co-payments and other out-of-pocket costs for low income customers. At this moment, it is uncertain if it has enough support to become law; Senator McCain has expressed his support of the bill, while President Trump has backtracked on his initial support.[1] It is unclear whether Democrats are in favor of the bill, but it is widely perceived that Republicans will largely oppose it.

NAFTA stalemate: Renegotiations between the three-member trade alliance NAFTA ended at an impasse on Tuesday as Canada and Mexico were unwilling to give into U.S. trade demands. The countries will meet again next month for continued negotiations. During the negotiations, the U.S. asked for more flexibility to place import tariffs on certain goods such as automobiles, dairy and seasonal produce. The U.S. trade representative, Robert Lighthizer, told reporters that Canada and Mexico were being obstructionist and should be willing to "give up a little bit of

[1] http://thehill.com/homenews/administration/355985-trump-reverses-course-indicates-opposition-to-obamacare-deal

candy" in order to secure a deal. We believe that this administration is possibly positioning itself for an eventual withdrawal from NAFTA. Furthermore, the *Washington Post* reported[2] that Peter Navarro, director of the White House Office of Trade and Manufacturing Policy, circulated a memo alleging that manufacturing jobs lost through trade contribute to increased abortions, divorces and spousal abuse; there was no data supporting the claim in the memo. A withdrawal from NAFTA could be bearish for U.S. equities.

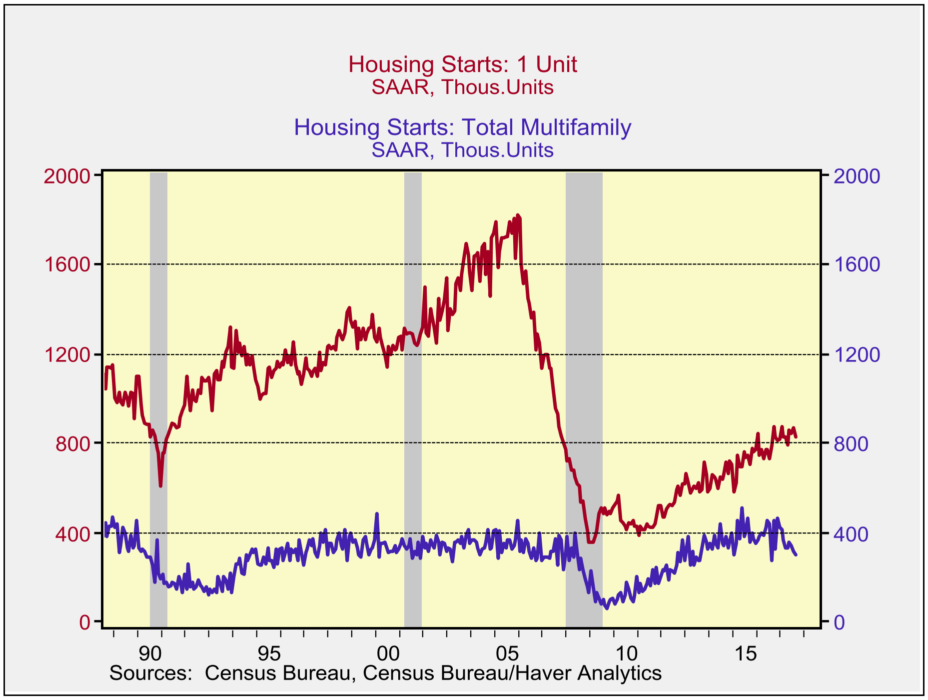
Raqqa falls, what's next? An American-backed militia, the Syrian Democratic Forces, claimed to have recaptured the northern Syrian city of Raqqa from the Islamic State. Raqqa is considered the capital for ISIS and its recapture represents a stunning blow to the dwindling group. The United States Central Command stopped short of claiming victory over ISIS, but has stated that the American-backed forces have wrested control away from ISIS. Despite the victory, there are concerns about how the U.S. plans to rebuild the areas formerly under ISIS control. Many fear that the defeat of ISIS could lead to a new power vacuum that could be filled by another militant group hostile to the U.S. As of right now, it appears that there are no detailed plans to rebuild the areas. President Trump's insistence that the U.S. will no longer participate in nation-building further complicates the issue. We will continue to monitor this situation.

U.S. Economic Releases

MBA mortgage applications rose 3.6% from the prior week. Purchases and refinancing rose 4.2% and 3.0%, respectively. The average 30-year fixed rate mortgage fell by 2 bps from 4.16% to 4.14%.

Housing starts came in below expectations at 1,127k compared to the forecast of 1,175k on an annualized basis. The prior month's report was revised upward from 1,180k to 1,183k. The monthly change in housing starts came in below expectations, falling 4.7% compared to the forecast loss of 0.4%. The prior report's loss was revised downward from 0.8% to 0.2%. Building permits came in below expectations at 1,215k compared to the forecast of 1,245k. The prior month's report was revised downward by 28k from 1,300k to 1,272k. The monthly change in building permits came in below expectations, falling 5.7% compared to the forecast loss of a 0.4% drop. The prior report's loss was revised downward from 0.4% to 0.2%.

[2] https://www.washingtonpost.com/news/business/wp/2017/10/17/internal-white-house-documents-allege-manufacturing-decline-increases-abortions-infertility-and-spousal-abuse/?utm_term=.3b993b21ad12



The chart above shows the level of multi-family and single-family housing starts. Multi-family starts and single-units have risen 6.8% and 5.9%, respectively.

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**
14:00	US Federal Reserve Releases Beige Book	Members 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								
Australia	Westpac Lending Index	m/m	sep	0.1%	-0.1%		**	Equity and bond neutral
EUROPE								
Eurozone	Construction Output	y/y	aug	1.6%	3.4%		**	Equity and bond neutral
UK	Claimant Count Rate	m/m	sep	2.3%	2.3%		**	Equity and bond neutral
	Jobless Claims Change	m/m	sep	1.7k	-2.8k		**	Equity and bond neutral
	Average Weekly Earnings 3m/3m	m/m	aug	2.2%	2.1%	2.1%	**	Equity bullish, bond bearish
	Weekly Earnings ex Bonus 3m/3m	m/m	aug	2.1%	2.1%	2.0%	**	Equity and bond neutral
	ILO Unemployment Rates 3m/3m	m/m	aug	4.3%	4.3%	4.3%	**	Equity and bond neutral
	Employment change 3m/3m	m/m	aug	94k	181k	148k	**	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	m/m	aug	-0.4%	0.4%	-0.3%	**	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	135	0	Up
3-mo T-bill yield (bps)	108	108	0	Neutral
TED spread (bps)	28	28	0	Neutral
U.S. Libor/OIS spread (bps)	124	124	0	Up
10-yr T-note (%)	2.33	2.30	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	39	39	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	$58.31	$57.88	0.74%	Bullish API
WTI	$52.08	$51.88	0.39%	
Natural Gas	$2.91	$2.96	-1.79%	
Crack Spread	$19.23	$19.10	0.70%	
12-mo strip crack	$19.91	$19.91	-0.02%	
Ethanol rack	$1.56	$1.56	-0.12%	
Metals				
Gold	$1,279.44	$1,285.12	-0.44%	Stronger Dollar
Silver	$16.95	$17.04	-0.54%	
Copper contract	$318.55	$319.55	-0.31%	
Grains				
Corn contract	$ 349.25	$ 350.00	-0.21%	
Wheat contract	$ 433.00	$ 434.75	-0.40%	
Soybeans contract	$ 983.50	$ 984.75	-0.13%	
Shipping				
Baltic Dry Freight	1552	1523	29	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-1.7		
Refinery run rates (%)		0.00%		
Natural gas (bcf)		61.0		

Weather

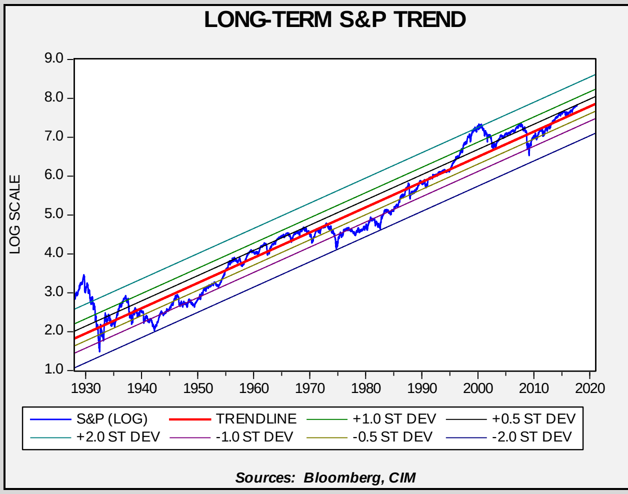
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. Precipitation is expected for the eastern region of the country. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

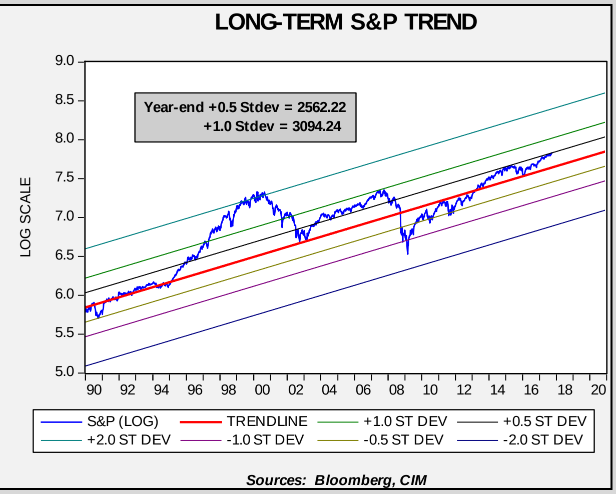
Asset Allocation Weekly Comment

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).

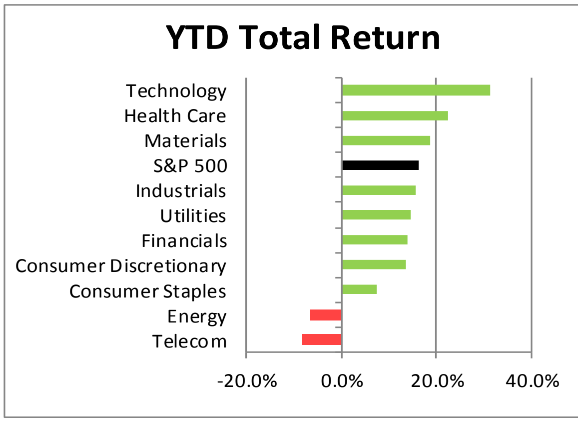
Equities clearly trend higher over time. The yearly trend shows an average return for the S&P 500 Index of just over 6%. However, as the charts show, there is a fair degree of variation over time. The trend data shows that two standard errors above the trend is a dangerous area. One standard error above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

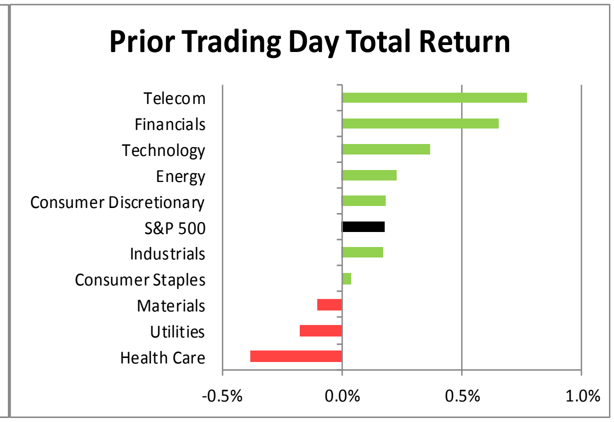
Simply put, barring a recession or geopolitical event, equities are not seriously extended on a trend basis. We also note that the last two bear markets dropped a full two standard errors from peak to trough. The bear market that began in 2000 fell from two standard errors above the trend to the trend 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 10/17/2017 close)

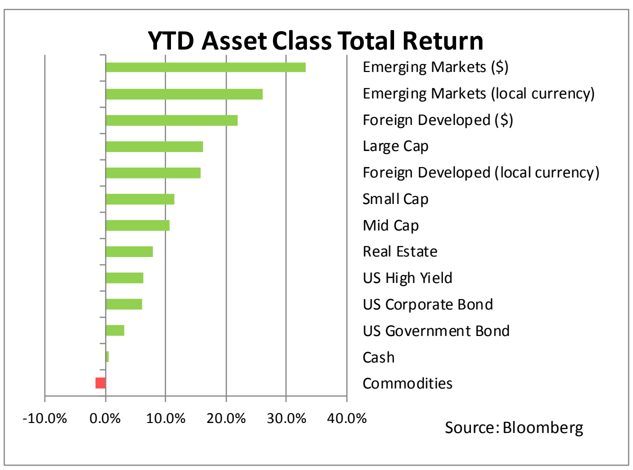




(Source: Bloomberg)

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 10/17/2017 close)

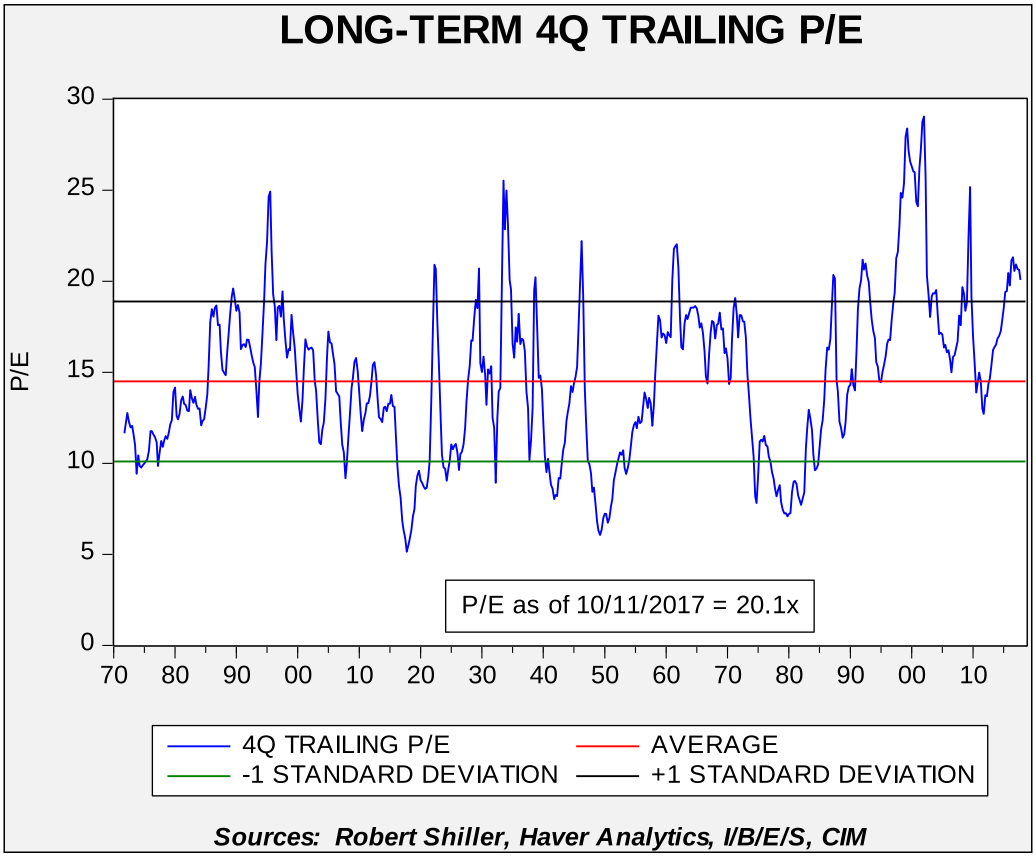


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.