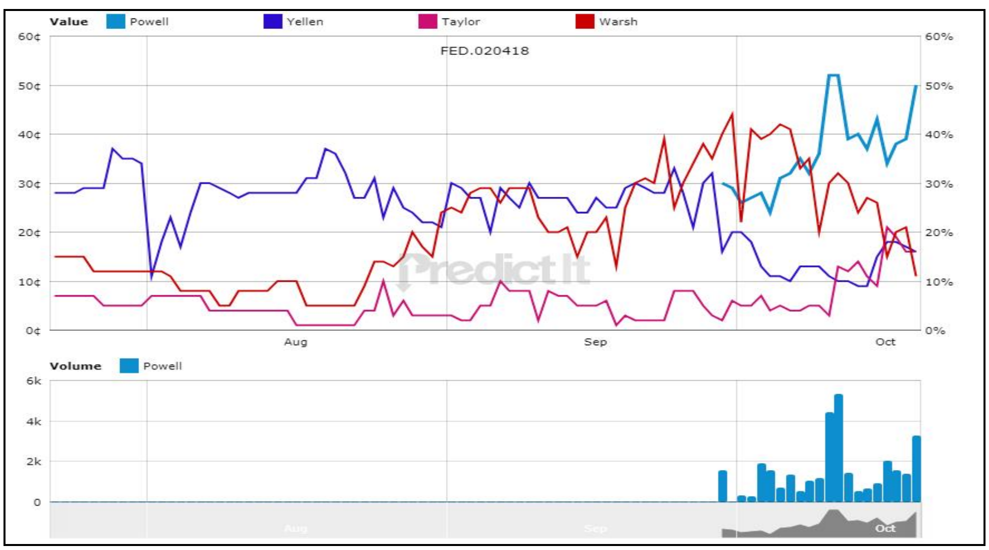
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 20, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.1% 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. With 78 companies having reported, the S&P 500 Q3 earnings stand at $32.45, just lower than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 78.2% of the companies reported earnings above forecast, while 12.8% reported earnings below forecast.

Risk-on returned to the financial markets this morning, with the dollar and equities higher and Treasuries and gold lower. The possibility that John Taylor could be the next Fed chair along with hopes of tax reform are boosting risk assets this morning.

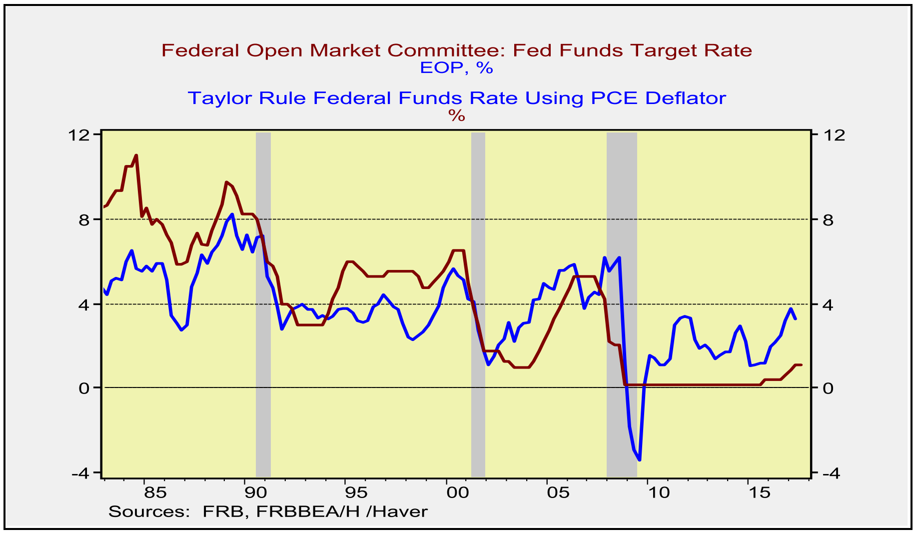
Chair talk: There are a series of dueling stories in the media this morning on who the president will select for the Fed chair position. The current conventional wisdom suggests that Powell is the front-runner, while John Taylor is running second. Below is the latest on the topic from PredictIt, the decision-betting site.



(Source: Predictit.org)

Warsh was the front-runner until about two weeks ago; since then, his star has fallen rather quickly. Powell makes sense as a chair. He favors deregulation and is considered a moderate on policy. However, he does not fit the "shake things up" framework of the president, so a surprise is possible.

Here is the history of the target and the Taylor Rule, calculated using core PCE:



There has been an interesting trend in the relationship of the rule to the policy rate. From 1983 to 2000, the policy rate target exceeded the Taylor Rule by an average of 178 bps. Since 2000, it has averaged -136 bps. The current Taylor Rule rate would be 3.25%, roughly the level of the Mankiw Rule using involuntary part-time employment. Greenspan mostly exceeded the Taylor Rule rate until the 2000 tech crash. He and Bernanke clearly lagged the rule rate during the last tightening cycle. Note that the FOMC moved much more quickly to lower rates during the last recession than did the Taylor Rule. In fact, it's rather clear the FOMC performed better than the Taylor Rule during the downturn by acting faster to cut rates, recognizing the gravity of the situation. If one reads the meeting transcripts from 2008, there was a growing call to ***raise*** rates in August 2008. We suspect the Taylor Rule was one of the reasons why some hawks were leaning in that direction. In hindsight, that increase would have been toxic.

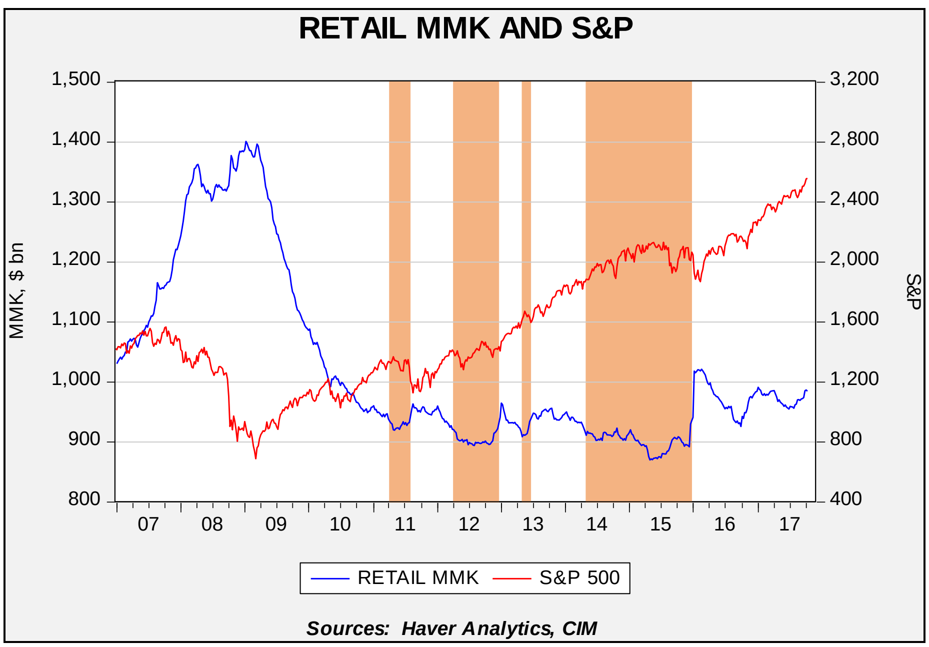
We are leaning toward Powell but it should be noted that the other open governor spots are important, too. If Taylor and Warsh are offered governor positions as a consolation prize, Powell's ability to manage to a consensus will be significantly undermined.

A budget deal: By a 51-49 vote, the Senate passed a fiscal 2018 budget resolution and the House has agreed to accept. The vote was nearly by party line, with Rand Paul (R-KY) the only Republican voting against the measure. The resolution is important because now that one is in place Congress can consider tax law changes without fear of filibuster in the Senate. Although this is a first step toward tax reform, it is a rather small one; tax reform remains a difficult task.

More non-centrist political developments: If polls are accurate, the next PM of the Czech Republic will be Andrej Babis, a right-wing populist businessman. Although the overall economic data from the country is rather good, rising inequality and political corruption is lending support to Babis. He has run on an anti-corruption, anti-EU and anti-immigrant platform. If elections pan out as expected, another EU government will have moved to the political fringe. Meanwhile, in New Zealand, Jacinda Ardern, aged 37, will be the next PM; she is the leader of the hard-left Labour Party and another young figure at the helm of an important Western government. She was able to gain power after the New Zealand Party, a party dedicated to providing government funding to the elderly, joined Arden to form a majority coalition. Arden's platform calls for social spending but is also anti-immigrant and wants to ban foreigners from buying property.[1] Like many nations in the region, New Zealand has been favored by foreign capital flight. In the election, the center-right (and former government leader) National Party received 56 seats, Labour won 46, the New Zealand Party won nine and the Greens eight. The Greens didn't join the coalition but agreed to caucus with it, giving it a majority. The NZD dropped 2% yesterday on the news.

Merkel gives May a lifeline: Chancellor Merkel welcomed PM May's initial offer of £20 bn and a transition deal on the EU's terms to facilitate a smooth Brexit. Although the hardliners in the EU want something closer to £60 bn or more, Merkel's reaction probably means that a less onerous package can be negotiated. The GBP rose on the news.

Retail MMK update: Yesterday's market action in equities was consistent with recent patterns, which is that each pullback has been shallow and met with almost immediate buying. Thus, pullbacks have been consistently unsustainable. We attribute that characteristic to high levels of cash among investors waiting for the opportunity to invest. As a result, small market declines are seen as rare opportunities for purchasing. We have noted that the level of retail money market holdings has been a fairly good indicator of buying power.

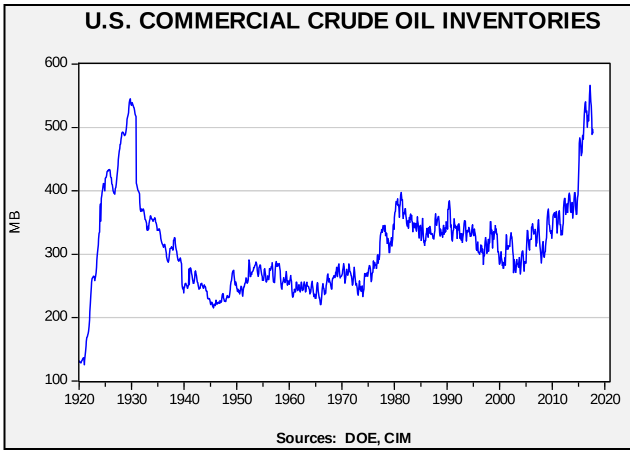


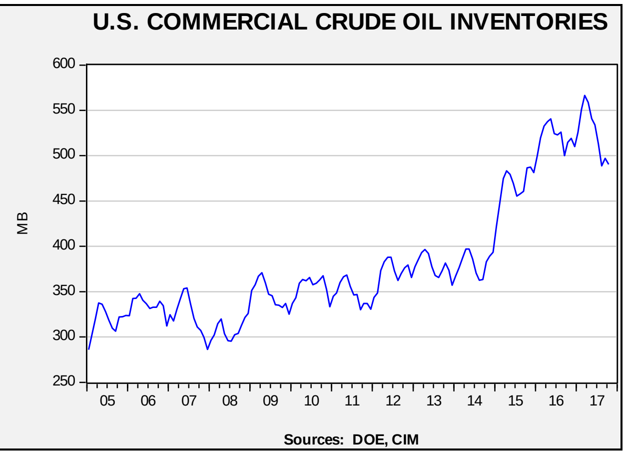
This chart shows the weekly Friday close for the S&P 500 along with the level of retail money market funds. We have applied areas to the chart in orange—these represent periods when money market levels fell below $920 bn. In general, when money market funds held by retail

[1] We suspect terror has just erupted in Silicon Valley!

fall to "low" levels, which we define as $920 bn, equity markets tend to decline or stall. We believe this occurs due to the lack of "fuel" for new buying. Current levels are near $985 bn, meaning there is ample cash for buying and thus, barring a geopolitical event, elevated levels of liquidity would be consistent with shallow pullbacks and a "buy the dip" mentality, exhibited yesterday.

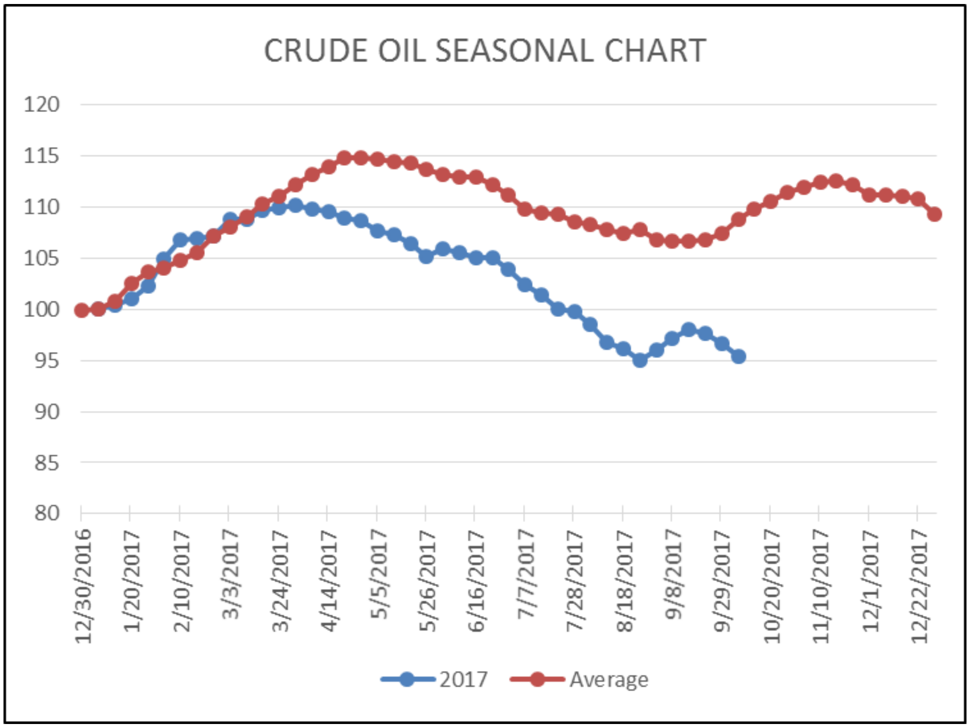
Energy recap: U.S. crude oil inventories fell 5.7 mb compared to market expectations of a 3.0 mb decline.



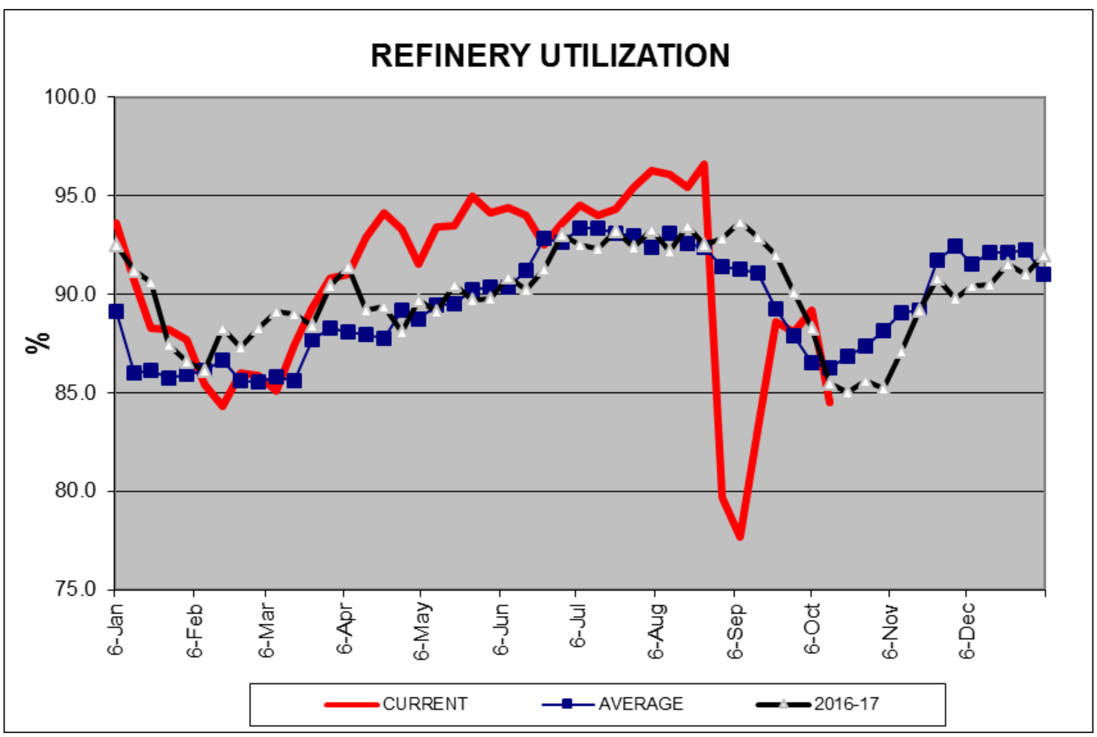


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined. The impact of Hurricane Harvey is diminishing as refinery operations recover. We also note the SPR fell by 0.7 mb, meaning the total draw was 6.4 mb.

As the seasonal chart below shows, inventories fell this week. It appears we have started the inventory rebuild period sooner than normal this year due to the hurricanes. However, inventories have declined over the past three weeks, which is a surprise based on the seasonal pattern. Crude oil inventories usually rise into mid-November, so if this decline phase continues it should be supportive for crude oil prices.

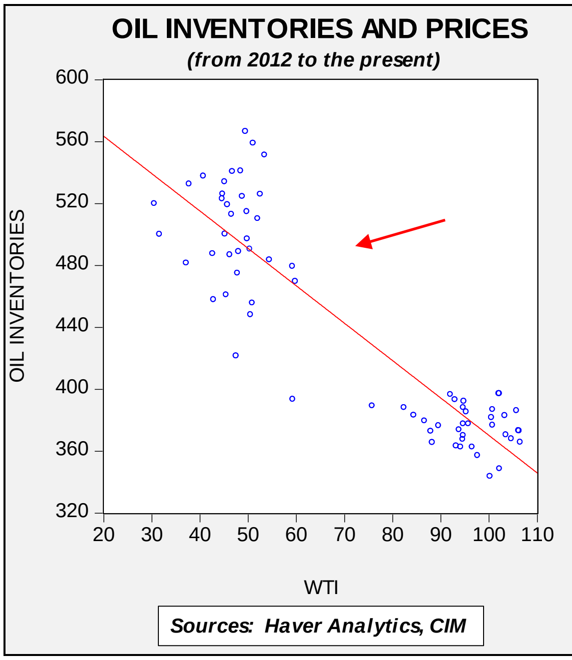


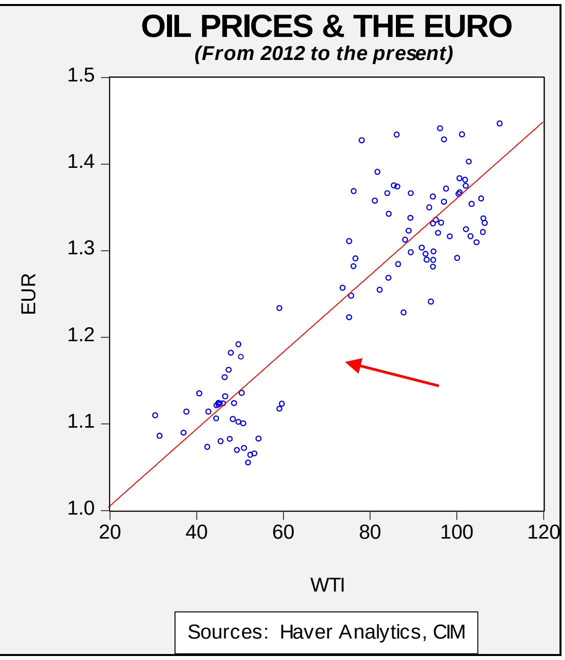
(Source: DOE, CIM)



(Source: DOE, CIM)

Refinery operations fell sharply last week in line with seasonal norms. This week usually represents the low in seasonal refinery activity, meaning that demand should rise on a seasonal basis going forward. What was interesting this week was that U.S. production appears to have declined by 1.1 mbpd. It isn't obvious why this would have occurred and so we will be watching to see if this is a one-week event or part of a larger drop in oil production. If production remains low, it is also a bullish factor for prices.





Based on inventories alone, oil prices are undervalued with the fair value price of $54.33. Meanwhile, the EUR/WTI model generates a fair value of $63.44. Together (which is a more sound methodology), fair value is $60.01, meaning that current prices remain below fair value. For the past few months, the oil market has not fully accounted for dollar weakness. However, now the markets are not even taking tightening inventories into account. In general, without the expected seasonal lift in crude oil inventories, oil prices at current levels are attractive.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. 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	Existing Home Sales	m/m	sep	5.30 mn	5.35 mn	**
10:00	Existing Home Sales	m/m	sep	-0.9%	-1.7%	**
Fed speakers or events						
EST	Speaker or event	District or position				
14:00	Loretta Mester speaks to Community Banking Conference	President of the Federal Reserve Bank of Cleveland				
19:30	Janet Yellen Appears before Senate Banking Panel	Chairman of Board of Governors of Federal Reserve				

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	Convenience Store Sales	y/y	sep	0.0%	-0.9%		**	Equity and bond neutral
EUROPE								
UK	Public Finances	y/y	sep	11.2 bn	0.0 bn		**	Equity and bond neutral
	Central Government NCR	y/y	sep	19.3 bn	1.1 bn		**	Equity and bond neutral
	Public Sector New Borrowing	m/m	sep	5.3 bn	5.1 bn	5.7 bn	**	Equity and bond neutral
	PSNB ex Banking Groups	m/m	sep	5.9 bn	5.7 bn	6.1 bn	**	Equity and bond neutral
Russia	Money Supply Narrow Def	m/m	sep	9.39 tn	9.29 tn		**	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)	136	136	0	Up
3-mo T-bill yield (bps)	107	107	0	Neutral
TED spread (bps)	30	29	1	Neutral
U.S. Libor/OIS spread (bps)	125	124	1	Up
10-yr T-note (%)	2.36	2.32	0.04	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	down			Neutral
franc	up			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	$56.84	$57.23	-0.68%	Long Liquidation
WTI	$50.84	$51.29	-0.88%	
Natural Gas	$2.90	$2.87	1.01%	
Crack Spread	$19.60	$19.64	-0.18%	
12-mo strip crack	$19.95	$20.02	-0.35%	
Ethanol rack	$1.54	$1.55	-0.35%	
Metals				
Gold	$1,282.54	$1,290.13	-0.59%	Stronger Dollar
Silver	$17.11	$17.25	-0.82%	
Copper contract	$319.40	$316.75	0.84%	
Grains				
Corn contract	$ 348.50	$ 349.00	-0.14%	
Wheat contract	$ 433.75	$ 432.75	0.23%	
Soybeans contract	$ 989.25	$ 986.50	0.28%	
Shipping				
Baltic Dry Freight	1582	1566	16	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.7	-3.0	-2.7	
Gasoline (mb)	0.9	-1.0	1.9	
Distillates (mb)	0.5	-1.7	2.2	
Refinery run rates (%)	-4.70%	0.00%	-4.70%	
Natural gas (bcf)	51.0	61.0	-10.0	

Weather

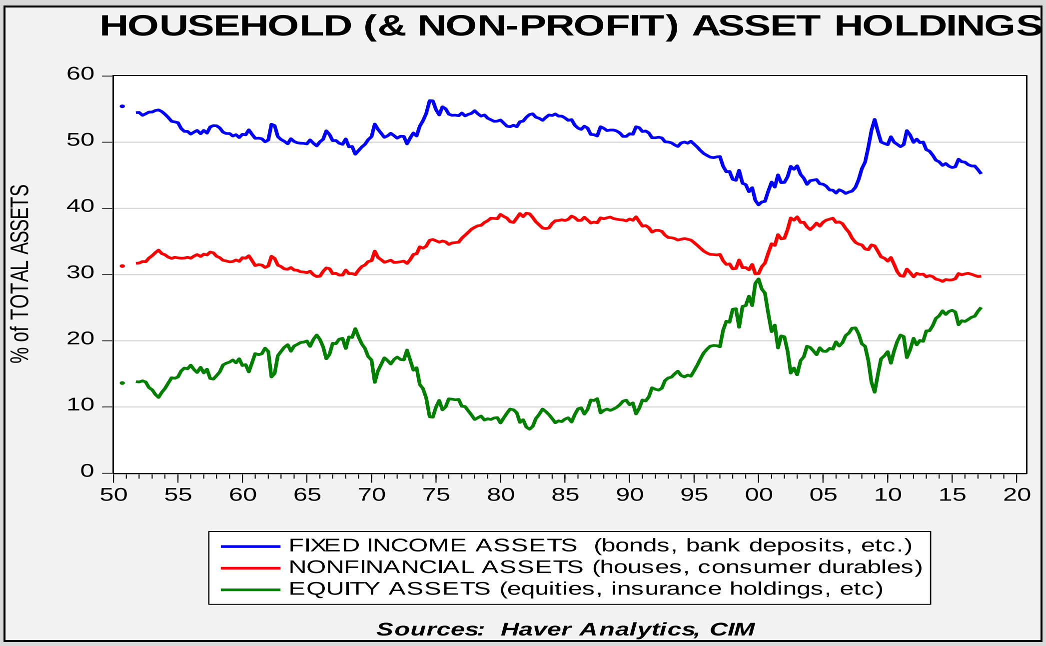
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country, with cooler to normal temps expected for the eastern region. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

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.

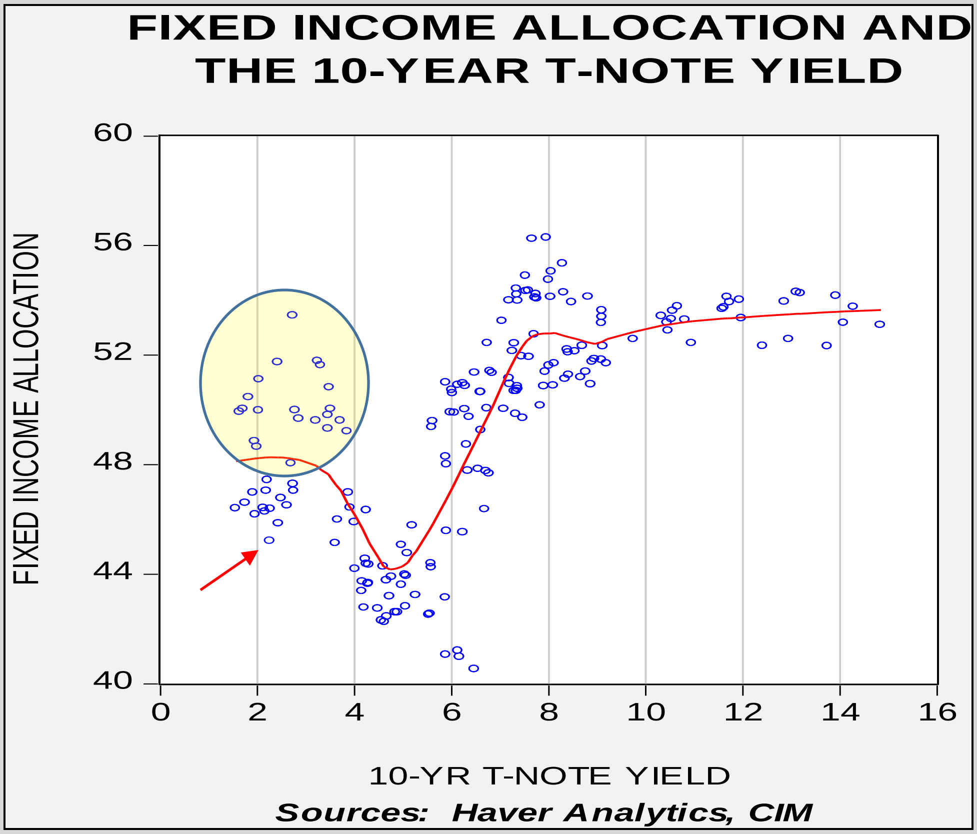
October 20, 2017

The Financial Accounts of the United States (formerly known as the Flow of Funds Report) is published by the Federal Reserve and provides data on the level of financial assets and liabilities by sector. Using this data, we can approximate the average asset allocation of American households over different periods. This accounting of assets is broad; for example, the equity portion includes equities held in defined benefit plans and insurance policies. In addition, the Federal Reserve includes non-profits in its data. In our view, non-profits are not material to the overall calculations.



The data goes back to the 1950s. On average, 50% of household assets are held in some sort of fixed income, while equity assets average 16% and non-financial assets average 34%. A casual observation of the data suggests that allocations to fixed income and non-financial assets (likely housing) are favored during periods of high levels of inflation and elevated nominal interest rates. On the other hand, equity allocations are higher during periods of low inflation and low nominal interest rates. The allocation to non-financial assets rose sharply after 2000 as part of the housing bubble. After the Great Financial Crisis, non-financial asset holdings declined; initially, fixed income rose and equities fell, but since 2010, that trend has steadily reversed as equities have taken a large share of assets.

Some of the gains in the various asset classes have come from price appreciation and other parts from reallocation of assets. It isn't completely obvious how much is coming from which part, although in future reports we will examine this issue more fully. However, the chart does suggest that equities have benefited from being "the only game in town." Historically low interest rates and the aftermath of the housing crisis have undermined allocations to fixed income and housing. Historical patterns suggest that allocations to fixed income don't increase until 10-year Treasury rates exceed 6%.

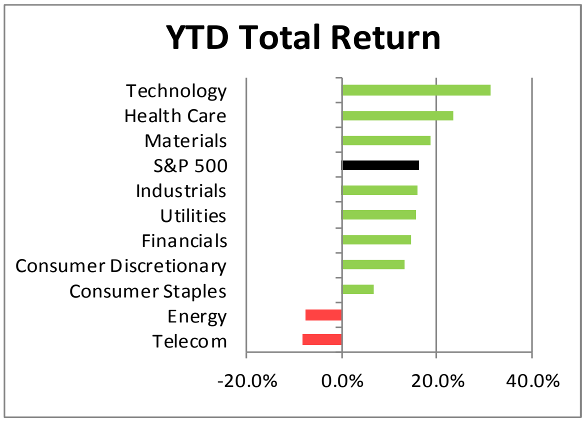


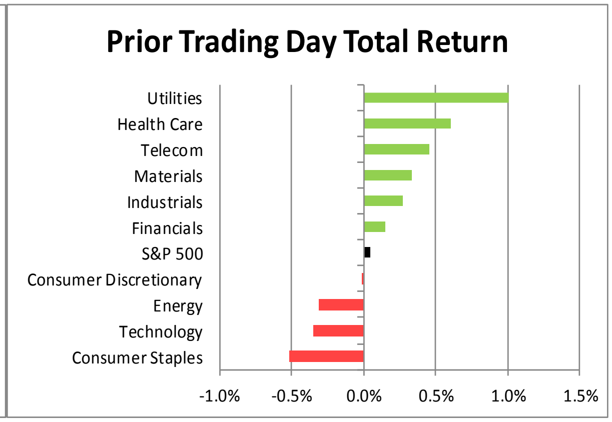
This chart shows a scatterplot of the percentage of total assets held in fixed income and the 10-year T-note yield. We have plotted a nearest neighbor fit study to the data. We have seen high fixed income levels along with low rates (shown in the circle), but these mostly occurred during the Great Financial Crisis. Although the current level of fixed income is low (shown by the arrow), a consistent rise above 50% generally has been seen with interest rates in excess of 6%. Thus, history suggests that it would take a more significant rise in interest rates to trigger a flight to fixed income.

Of course, recessions or geopolitical events could trigger a move out of equities. At 25%, the current allocation to equities is elevated. This level is similar to where it was in Q3 1999 and not far from the peak of 27% in Q1 2000. At the same time, the liquidity does need another place to go. After the 2000 tech crash, the primary beneficiary was housing. We don't expect that pattern to repeat itself. Thus, without an event to scare households out of equities or a sizeable rise in interest rates, equities should maintain their favored status for the time being.

Data Section

U.S. Equity Markets – (as of 10/19/2017 close)

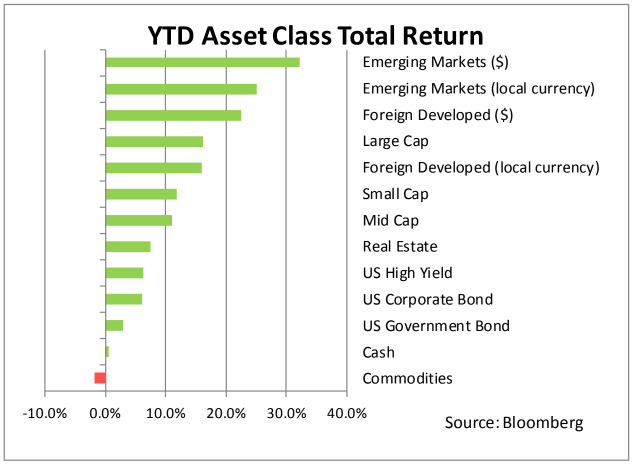




(Source: Bloomberg)

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 10/19/2017 close)

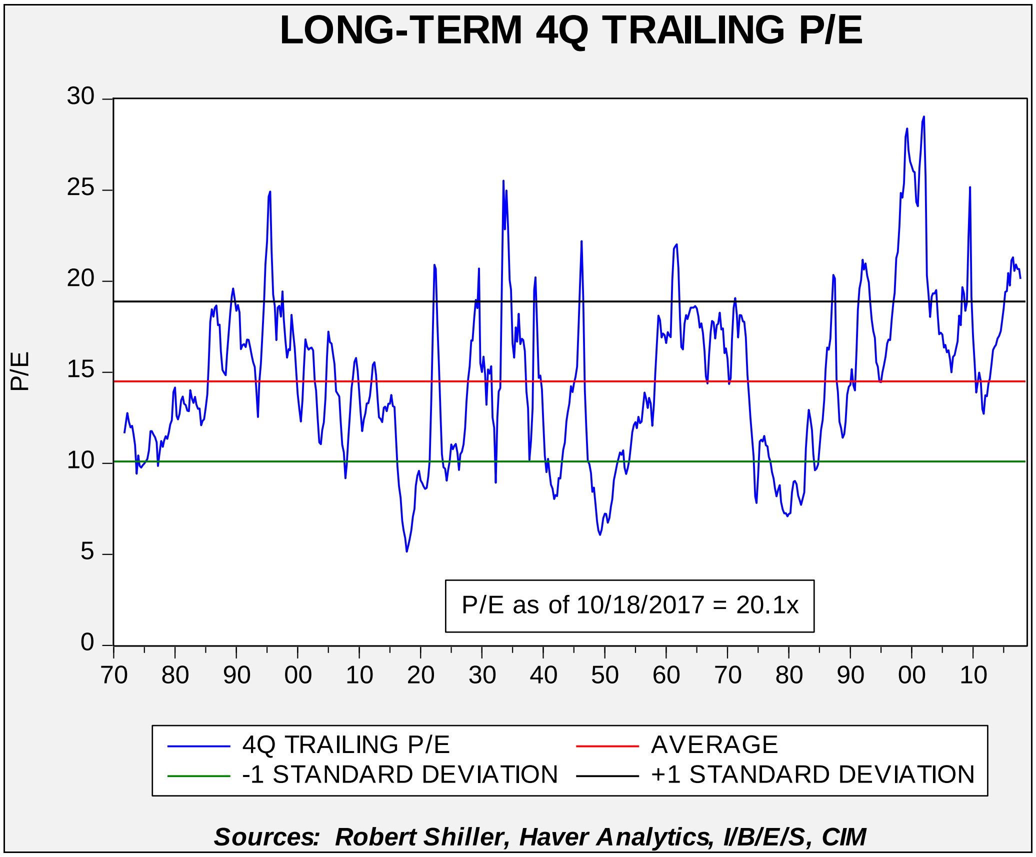


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2017



Based on our methodology,[2] the current P/E is 20.1x, unchanged from last week.

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.

---

[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.