Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 23, 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 down 0.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.1% and the Shenzhen index up 0.6%. U.S. equity index futures are signaling a higher open. With 86 companies having reported, the S&P 500 Q3 earnings stand at $32.26, lower than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 75.9% of the companies reported earnings above forecast, while 13.8% reported earnings below forecast.

There was (and is) lots of news. Let's dig in:

Abe in a landslide: PM Abe's gamble to call early elections looks like a winner. The LDP and the rest of Abe's ruling coalition will take 313 seats, giving him a "supermajority" of more than 310 seats, which is the level that will allow him to make changes to the constitution. Japanese equities rose on the news and the JPY declined modestly (it has been weaker on expectations that Abe would prevail and thus Abenomics would continue). However, on the economic front, we don't see much more from Abenomics. The "three arrows" were really all about a weaker JPY; that has been achieved and it's probably not possible to weaken the currency much further without prompting a negative reaction from Washington. BOJ Governor Kuroda will probably get reappointed. We look for Abe's focus to shift toward adjusting the constitution to allow Japan to project military power. As U.S. isolationism develops, this is a necessary step to deal with a growing Chinese threat.

Xi and the Party Congress: Today, we expect Chairman Xi to reveal the new members of the Standing Committee of the Politburo, the most powerful body in China. But, for now, the real story is that Xi is ending Deng's foreign policy. The PRC's foreign policy has evolved, starting with Mao, who was essentially isolationist. He turned the nation inward to stabilize the persistent tensions between the insular interior and the cosmopolitan coasts. This led to unity and income equality with weak economic growth. Deng allowed the coasts to flourish to lift the economy at the expense of regional divergence and rising income inequality. Deng called for China to avoid projecting power globally to allow for uninterrupted economic development. Because the economic development was based on export promotion, workable relations with the U.S. were imperative. The 2008 Great Financial Crisis and uncertainty about the U.S. role in the world has led Chinese leaders to sense a vacuum, and Xi has indicated over this Congress that he wants China to fill it. China is facing the problems of the late stages of a "high growth/low cost nation," which are unbalanced development (too much productive capacity with inadequate household share of GDP) and too much debt. Xi is making it clear he intends to follow imperialism to resolve this problem, the paths the British and the Dutch took when they faced this point in their development. The problem for China is that it doesn't have the military power to pull this off; thus, it must try to develop economic colonies under the protection of the U.S. military. When Japan faced this issue in the 1930s, it invaded China and eventually bombed Pearl Harbor.[1] An assertive China is going to be a growing problem for global stability.

Spain: PM Rajoy appears poised to take direct control of Catalonia. If the current provincial leadership declares independence, they may all end up in jail. Rajoy has the state apparatus to take control; what he doesn't have is the political legitimacy to enforce his will. In other words, he will find that it's one thing to establish control but it's another to maintain it. Rajoy will face overt and covert opposition to taking away Catalan autonomy and disruption will prove to be costly given that the province represents 20% of Spain's GDP.

Another populist win: As we noted last week, the Czech Republic has elected a populist slate of candidates, with the Ano Party winning nearly 30% of the vote, almost 20 points higher than the closest rival. The Social Democrats, the center-left, saw their support collapse from 20.5% to 7.3%. It should be noted that the next largest parties in this vote lean Euro-skeptic, suggesting that the EU is becoming rather unpopular. Along with recent elections in Austria and the rise of the AfD in Germany, we are seeing a nationalist, anti-immigrant surge in Europe. Meanwhile, we note that Lombardy and Veneto, regions in Italy, have voted for more autonomy from Rome. Although neither are pushing for independence, Europe appears to be moving away from centralization, which has been the primary trend in Europe since WWII.

Iran: SOS Tillerson has warned European firms that doing business with Iran might be risky as new U.S. sanctions are being considered.[2] This move by the Trump administration comes with evidence that the Iranian government has used the removal of sanctions to undermine the economic power of the Iranian Republican Guard Corps (IRGC).[3] During sanctions, the IRGC took over large swaths of the economy to maintain growth and evade sanctions. This allowed the IRGC to develop power independently of the clerical government. President Rouhani and the Ayatollah Khamenei have been trying to weaken the IRGC's economic power to prevent them from becoming a political threat. If the Trump administration puts sanctions back in place, Iran will have no recourse other than to allow the IRGC to resume its activities.

Jimmy to the rescue? In a curious op-ed in the *NYT*, Maureen Dowd interviewed former President Jimmy Carter. The interview was wide-ranging but a couple of items stick out. First, the former president would be willing to help negotiate with the North Koreans. He is credited with the 1994 Agreed Framework, which diffused a crisis over North Korea's nuclear program, although we now know Pyongyang simply moved to another method to attain a nuclear weapon. Still, Carter did likely prevent a war on the peninsula. Essentially, it appears Carter is sending a signal to the Trump administration that he is available. We note Carter said some rather flattering things about the president and also that he didn't vote for Mrs. Clinton during the primary (he voted for Sen. Sanders). Second, there is a clear element of animosity in his tone toward the Clintons and Obama. We are not sure what exactly is going on there but Carter may

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[1] https://www.youtube.com/watch?v=yKHUGvde7KU

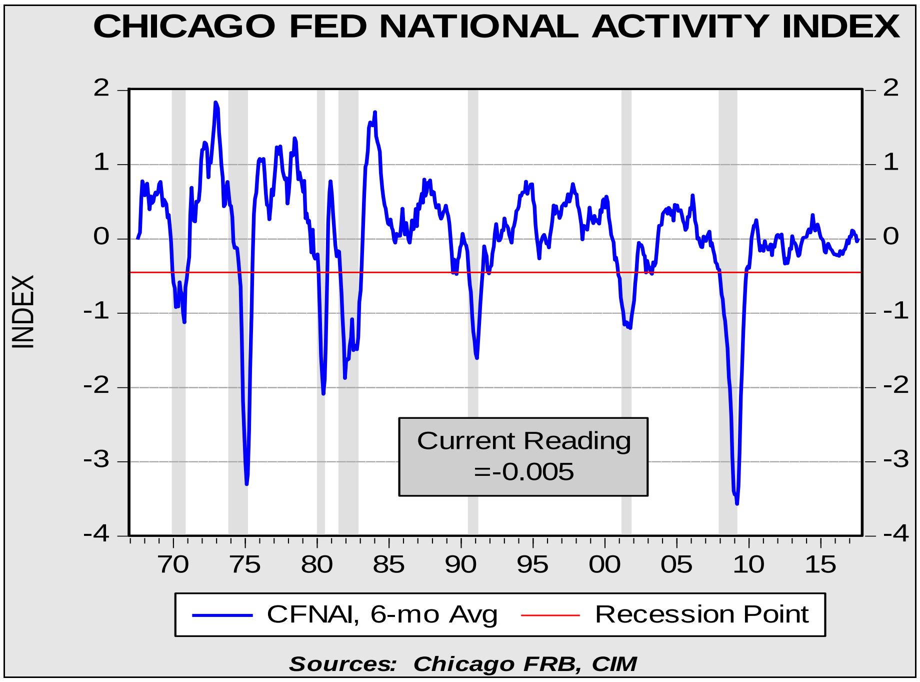
[2] https://www.nytimes.com/2017/10/22/world/middleeast/tillerson-iran-europe.html?emc=edit_mbe_20171023&nl=morning-briefing-europe&nlid=5677267&te=1

[3] https://www.nytimes.com/2017/10/21/world/middleeast/iran-revolutionary-guards.html

be one to watch. Trump likes unconventional "out of the box" surprises. Nothing would be closer to an unexpected outcome than sending Carter to North Korea. This is happening as we are hearing reports that the U.S. is considering the involuntary call-up of reserve pilots.[4]

U.S. Economic Releases

The Chicago Fed National Activity Index came in above expectations at 0.17 compared to the forecast of -0.10. The prior report was revised lower from -0.31 to -0.37.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The current reading is -0.005, an increase from the last report of -0.048. This is one of our favorite indicators and it shows an economy growing on trend.

As we have noted before, the current tightening cycle is occurring with rather lackluster growth. This is unusual and suggests the Fed believes it is behind the curve and is thus trying to move policy to neutral.

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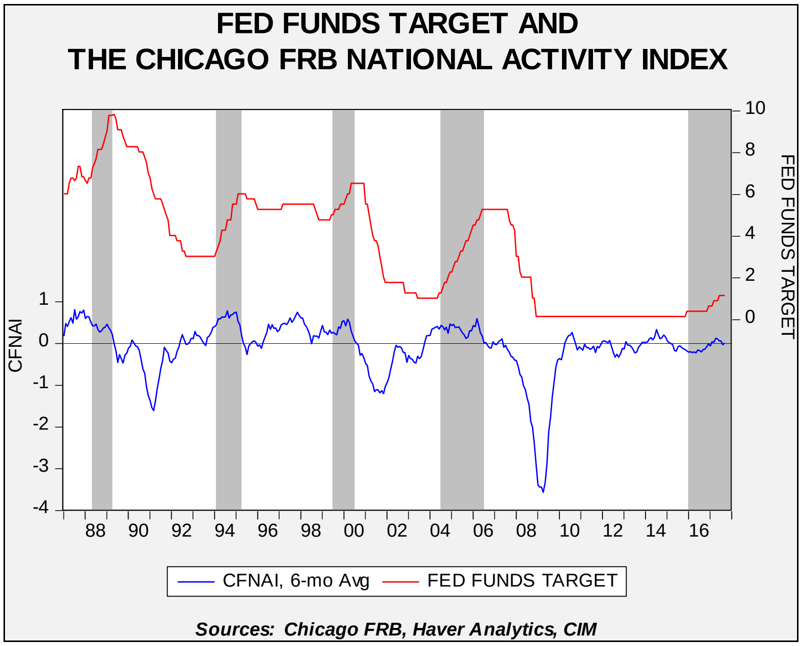
[4] http://www.foxnews.com/politics/2017/10/21/air-force-could-recall-up-to-1000-retired-pilots-after-trump-order.html?utm_source=Sailthru&utm_medium=email&utm_campaign=New%20Campaign&utm_term=%2ASituation%20Report and http://www.defenseone.com/threats/2017/10/exclusive-us-preparing-put-nuclear-bombers-back-24-hour-alert/141957/?utm_source=Sailthru&utm_medium=email&utm_campaign=New%20Campaign&utm_term=%2ASituation%20Report



There are no other 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								
Japan	Leading Index CI	y/y	3q	107.2	106.8		**	Equity and bond neutral
	Coincident Index	y/y	sep	117.7	117.6		**	Equity and bond neutral
	Nationwide Dept Sales	y/y	sep	4.4%	2.0%		**	Equity and bond neutral
	Tokyo Dept Store Sales	y/y	sep	4.6%	3.6%		**	Equity and bond neutral
EUROPE								
Eurozone	Govt Debt/ GDP Ratio	y/y	2016	88.9%	89.2%		**	Equity and bond neutral
UK	CBI Business Optimism	m/m	sep	-11	5		**	Equity and bond neutral
	CBI Trends Total Orders	m/m	sep	-2	7	9	**	Equity and bond neutral
	CBI Trends Selling Prices	m/m	sep	18	18		**	Equity and bond neutral
Switzerland	Money Supply M3	y/y	sep	4.4%	4.0%		*	Equity and bond neutral
	Total Sight Deposits	y/y	oct	578.6 bn	578.5 bn		*	Equity and bond neutral
	Domestic Sight Deposits	y/y	oct	468.7 bn	471.3 bn		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	sep	1.6%	1.4%	1.7%	***	Equity and bond neutral
	Retail Sales	m/m	aug	-0.3%	0.4%	0.5%	**	Equity bearish, bond bullish

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)	108	109	-1	Neutral
TED spread (bps)	28	28	0	Neutral
U.S. Libor/OIS spread (bps)	125	125	0	Up
10-yr T-note (%)	2.39	2.39	0.00	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	$57.78	$57.75	0.05%	Short Covering
WTI	$52.13	$51.84	0.56%	
Natural Gas	$2.99	$2.92	2.57%	
Crack Spread	$19.38	$19.45	-0.39%	
12-mo strip crack	$20.28	$20.39	-0.50%	
Ethanol rack	$1.53	$1.54	-0.16%	
Metals				
Gold	$1,275.93	$1,280.47	-0.35%	Stronger Dollar
Silver	$16.98	$17.03	-0.26%	
Copper contract	$317.25	$316.55	0.22%	
Grains				
Corn contract	$ 345.00	$ 344.50	0.15%	
Wheat contract	$ 426.00	$ 426.00	0.00%	
Soybeans contract	$ 989.75	$ 989.25	0.05%	
Shipping				
Baltic Dry Freight	1578	1582	-4	

Weather

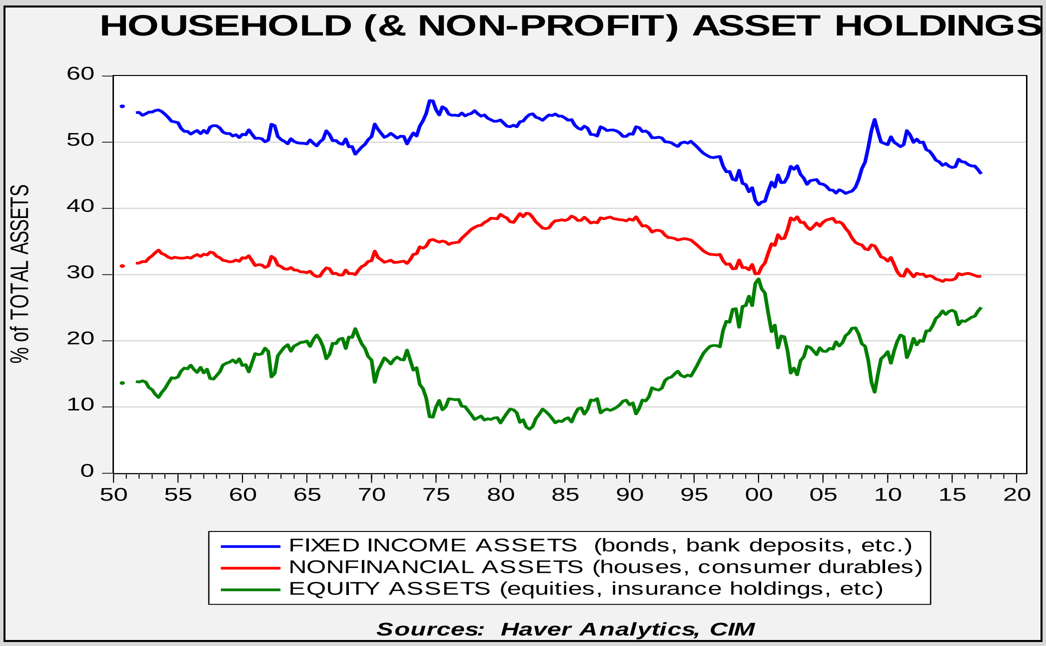
The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmer to normal temps expected for the western region. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

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.

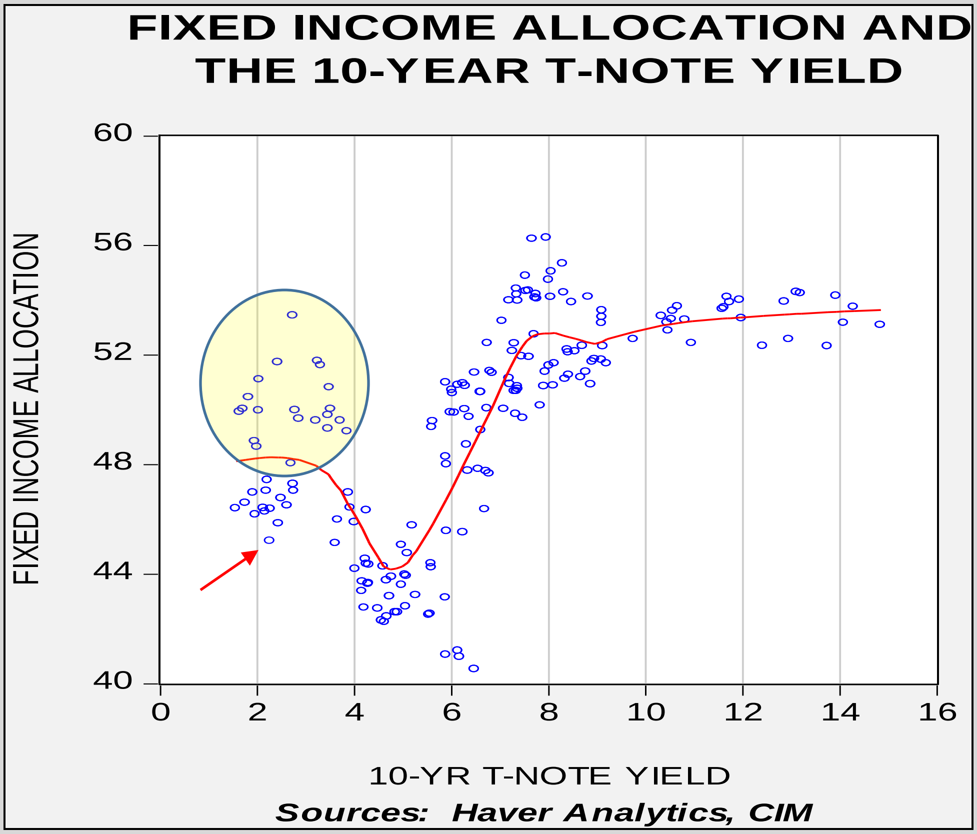
October 20, 2017

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%.

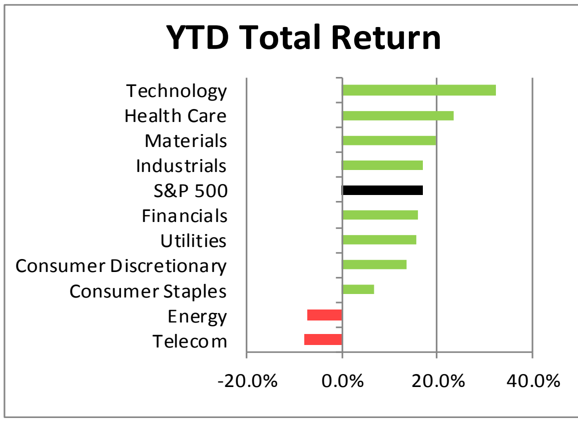


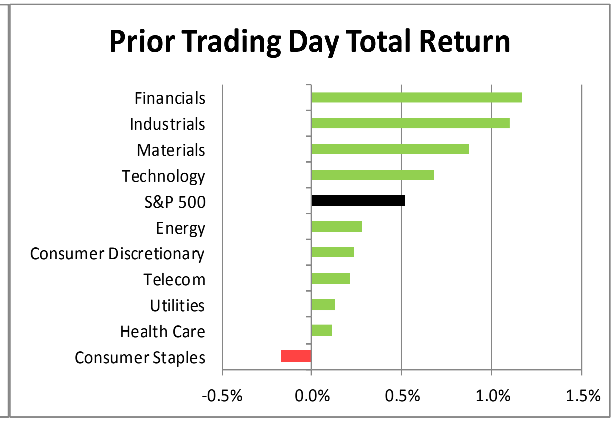
This chart shows a scatterplot of the percentage of total assets held in fixed income and the 10-year T-note yield. We have plotted a nearest neighbor fit study to the data. We have seen high fixed income levels along with low rates (shown in the circle), but these mostly occurred during the Great Financial 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 10/20/2017 close)

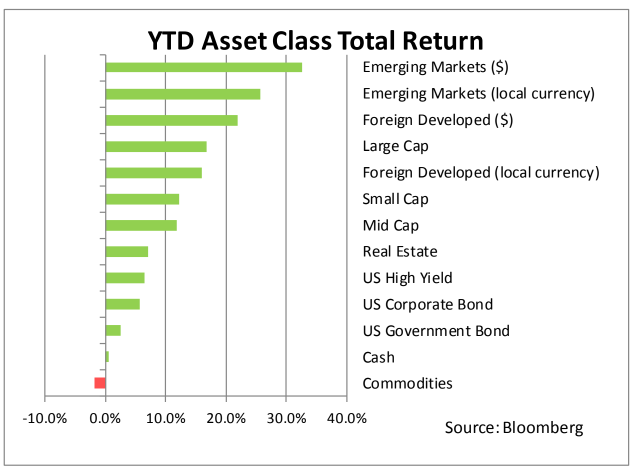




(Source: Bloomberg)

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 10/20/2017 close)

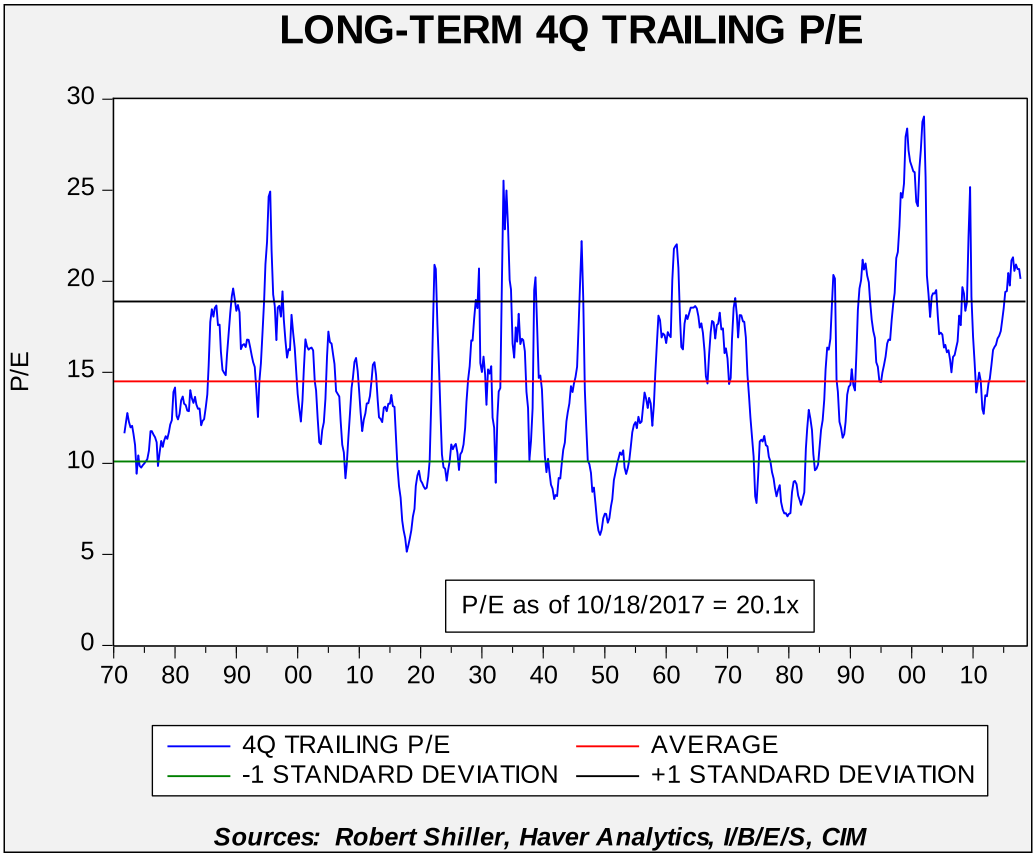


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[5] 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.

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[5] 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.