Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 25, 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 up 0.4% 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 lower open. With 119 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, 75.6% of the companies reported earnings above forecast, while 15.1% reported earnings below forecast.

Financial markets are a bit weaker this morning—equities are signaling a softer opening while Treasuries are continuing to take on water. There is a lot going on; this morning we are focused on the following issues.

Xi sets Standing Committee: The new Standing Committee of the Politburo is led by General Secretary Xi. Only LI Keqiang was retained from the last committee. The new members include Li Zhanshu, who was Xi's chief of staff and a close ally. He is considered an orthodox Marxist and will support Xi's attempts to rekindle Marxist indoctrination. Wang Yang is from the Youth League (the other main faction is represented by Xi—the "princelings," or sons of the early revolutionaries) and was a target of discrimination by the disgraced Bo Xilai. Wang Huning is a political theoretician who supports "neo-authoritarianism," a platform that best exemplifies Xi's governance. Zhao Leji is perhaps the most obscure of the new members who has mostly had a competent, but uninspiring, career. He replaces Xi loyalist Wang Qishan as head of the anti-corruption bureaucracy. Han Zheng was a municipal administrator in Shanghai and rounds out the group. Overall, there is no one on this roster who is a clear heir apparent for Xi, and none will be young enough in five years to serve a subsequent five years, a requirement for heir status. As we noted earlier this week, Xi will be required to give up the presidency in five years due to term limit law. However, he will very likely retain the position of general secretary. We would view the group as mostly loyalists but all appear competent. The fact that Xi didn't pack the committee with diehard loyalists suggests he feels very confident in his power.

Ships at sea: Although they are not in position to conduct operations against North Korea, the U.S. is moving two carrier strike groups (CSG), the CSG Nimitz and CSG Theodore Roosevelt, into the western Pacific. The Nimitz was in the Middle East (part of the U.S. 5th Fleet) but will be joining the 7th Fleet in the Pacific. Although not entirely necessary, the U.S. usually prefers to have three carrier groups in a region if it is considering military operations because three can conduct round the clock sorties on a target. We also note that North Korea has tested a solid fuel rocket engine; North Korea has tended to use liquid fuel missiles, which are easier to manage but are vulnerable to pre-emptive strikes during the fueling period. Going to solid fuel allows North Korea to launch missiles with less preparation, reducing the chances of a "left of launch" strike.

Meanwhile, NBC[1] is reporting that Joseph Yun, the top U.S. diplomat to North Korea, is warning members of Congress that North Korea refuses to engage in talks, apparently upset by President Trump's characterizations of Kim Jong-un. Yun suggested that diplomatic efforts are on their "last legs" and told lawmakers the White House is unresponsive to his worries. President Trump will make a visit to the region in early November, a 12-day trip. He is creating something of a stir by refusing to attend the East Asia Summit on November 14th; U.S. presidents usually attend such events as a show of Pacific leadership. Although the attendees of the summit will be disappointed, the other parts of the president's visit should indicate that the U.S. remains a Pacific power. We monitor the region closely; bringing three carrier groups together is a worrying development that may simply be a show of force. Nevertheless, having these assets in place does give the president a platform to launch a war with North Korea.

Iraqi Kurds: On the one hand, the Iraqi Kurdish government has offered to freeze progress toward independence in a bid to ease tensions. At the same time, Kurdish and Iraqi forces clashed yesterday. Both sides accused the other of an ambush, although it does appear the Kurds got the better of Iraqi forces.

Fed update: In a meeting with the GOP senators yesterday, the president had a show of hands for the Fed chair position. It appears that John Taylor was the preferred candidate, although Jerome Powell also received some votes. Yellen noticeably did not. However, we do note that President Trump may be Chair Yellen's strongest advocate,[2] if for no other reason than the equity markets would cheer the decision. President Trump has pointed to the strong equity markets as confirmation of his successful administration; if picking Taylor were to trigger a sell-off (and it very well could), then Trump would probably want to avoid this. We still think this is a race between Powell and Taylor, but reappointing Yellen does hold some positive features for the president.

GOP mutiny: Senators Flake and Corker have indicated they won't run for re-election and have come out with harsh criticisms of the president. Flake was almost certain to face defeat in the primary. The GOP is turning populist and establishment Republicans are being forced, at a minimum, to acquiesce to the president. For senators, especially, criticizing the president looks like a path to becoming a private citizen. The key unknown is how these senators will vote on taxes. Corker is a deficit hawk and Flake probably leans that way, and there is little chance the tax plan (it's no longer being called reform) will be revenue neutral. If Flake and Corker decide to vote against the plan, the GOP is at 50/50 in the Senate. Losing any other senators will doom the process. If tax cuts fail to materialize, the failure could have significantly adverse effects on the GOP at the mid-term elections.

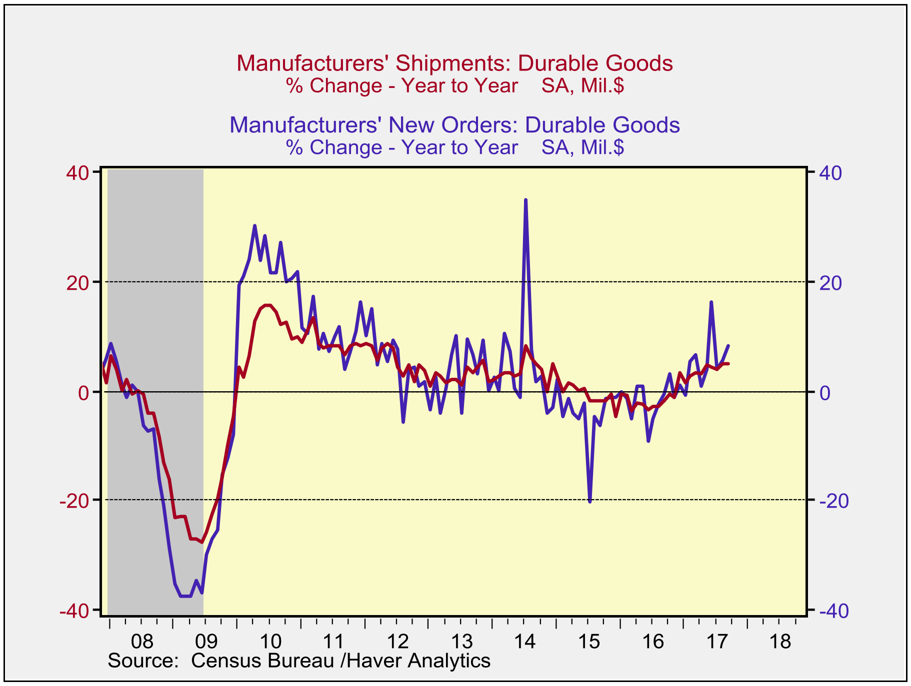
[1] https://www.nbcnews.com/news/north-korea/lack-talks-north-korea-sounds-alarms-capitol-hill-n813951?utm_source=Sailthru&utm_medium=email&utm_campaign=New%20Campaign&utm_term=%2ASituation%20Report

[2] https://www.bloomberg.com/news/articles/2017-10-24/yellen-is-said-to-find-unlikely-advocate-at-white-house-trump

U.S. Economic Releases

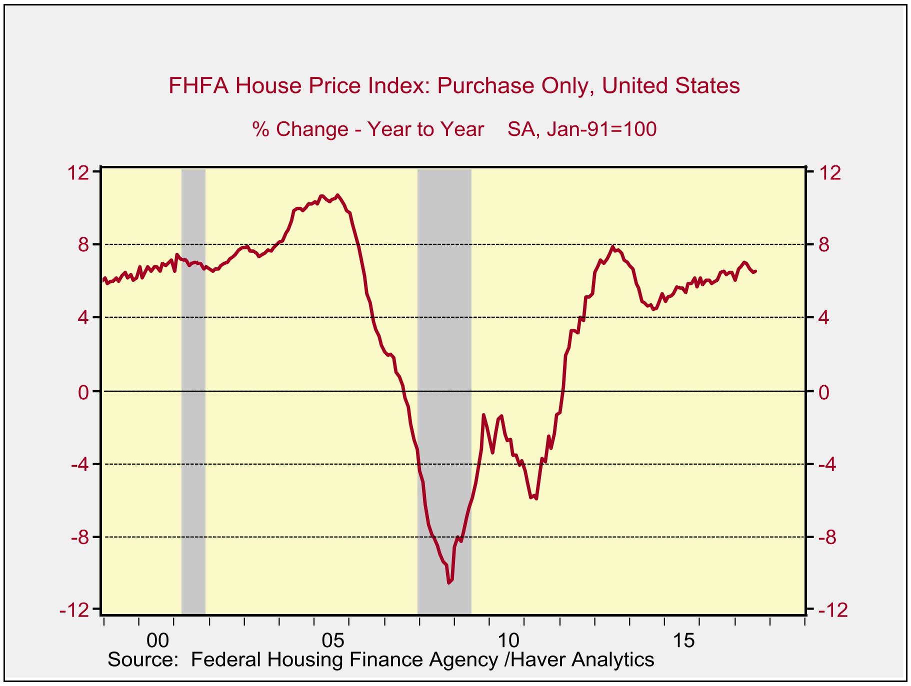
MBA mortgage applications fell 4.6% from the prior week. Purchases and refinancing fell 6.1% and 3.0%, respectively. The average 30-year fixed rate mortgage rose 4 bps from 4.14% to 4.18%.

September durable goods came in above expectations, rising 2.2% from the prior month compared to the forecast gain of 1.0%. Durables ex-transportation came in above expectations, rising 0.7% from the prior month compared to the forecast of 0.5%. The prior report's gain was revised upward from 0.5% to 0.7%. Capital goods orders non-defense ex-air came in above expectations, rising 1.3% from the prior month compared to the forecast gain of 0.3%. The prior month's gain was revised upward from 1.1% to 1.3%. Capital goods shipments non-defense ex-air came in above expectations at 0.7% from the prior month compared to the forecast rise of 0.1%. The prior report's gain was revised upward from 1.1% to 1.2%.



The chart above shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 8.3%, shipments rose by 5.0%, unfilled orders rose by 1.4% and inventories rose by 3.3%.

The FHFA House Price Index came in above expectations, rising 0.7% from the prior month compared to the forecast rise of 0.4%.



The chart above shows the year-over-year change in the FHFA House Price Index. Housing prices have risen 6.6% from the prior year.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	New Home Sales	m/m	sep	554k	560k	**
10:00	New Home Sales	m/m	sep	-1.1%	-3.4%	**
Fed speakers or events						
No speakers or events scheduled						

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	Skilled Vacancies	y/y	sep	0.0%	0.3%		**	Equity and bond neutral
	CPI	m/m	3Q	1.8%	0.2%	0.8%	***	Equity bullish, bond bearish
EUROPE								
Germany	IFO Business Climate	m/m	oct	116.7	115.2	115.1	**	Equity bullish, bond bearish
	IFO Expectations	m/m	oct	109.1	107.4	107.4	**	Equity bullish, bond bearish
	IFO Current Assessment	m/m	oct	124.8	123.6	123.5	**	Equity bullish, bond bearish
Italy	Industrial Orders	m/m	aug	8.7%	0.2%		**	Equity and bond neutral
	Industrial Sales	m/m	aug	12.2%	-0.3%		**	Equity and bond neutral
UK	UK Finance Loans for Housing	m/m	sep	41584	41807	41800	**	Equity and bond neutral
	GDP	y/y	3q	1.5%	1.5%	1.5%	***	Equity and bond neutral
	Index Services	m/m	aug	0.2%	-0.2%	0.3%	**	Equity and bond neutral
Switzerland	UBS Consumption Indicator	m/m	sep	1.56	1.53		**	Equity and bond neutral
	Credit Suisse Survey Expectations	m/m	oct	32.0	28.0		**	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity	y/y	aug	2.3%	1.0%	1.7%	**	Equity bullish, bond bearish

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)	137	136	1	Up
3-mo T-bill yield (bps)	110	110	0	Neutral
TED spread (bps)	27	27	0	Neutral
U.S. Libor/OIS spread (bps)	126	126	0	Up
10-yr T-note (%)	2.45	2.42	0.03	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	up			Up
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action		**Prior**	**Expected**	
Bank of Canada Rate Decision		1.000%	1.000%	On forecast

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	$58.37	$58.33	0.07%	
WTI	$52.34	$52.47	-0.25%	
Natural Gas	$2.95	$2.97	-0.81%	
Crack Spread	$20.23	$19.90	1.64%	
12-mo strip crack	$20.72	$20.66	0.29%	
Ethanol rack	$1.55	$1.55	-0.04%	
Metals				
Gold	$1,273.19	$1,276.58	-0.27%	
Silver	$16.87	$16.95	-0.44%	
Copper contract	$317.60	$319.80	-0.69%	
Grains				
Corn contract	$ 353.50	$ 352.75	0.21%	
Wheat contract	$ 439.50	$ 438.00	0.34%	
Soybeans contract	$ 992.50	$ 985.75	0.68%	
Shipping				
Baltic Dry Freight	1588	1586	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-0.5		
Refinery run rates (%)		1.45%		
Natural gas (bcf)		63.0		

Weather

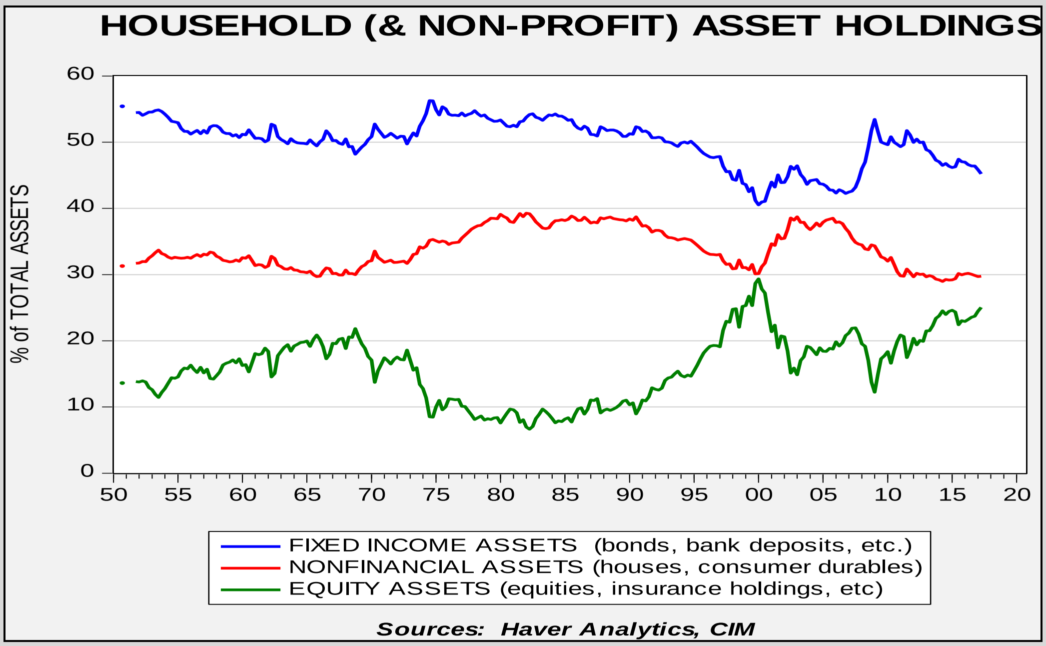
The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmer to normal temps expected for the western region. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

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.

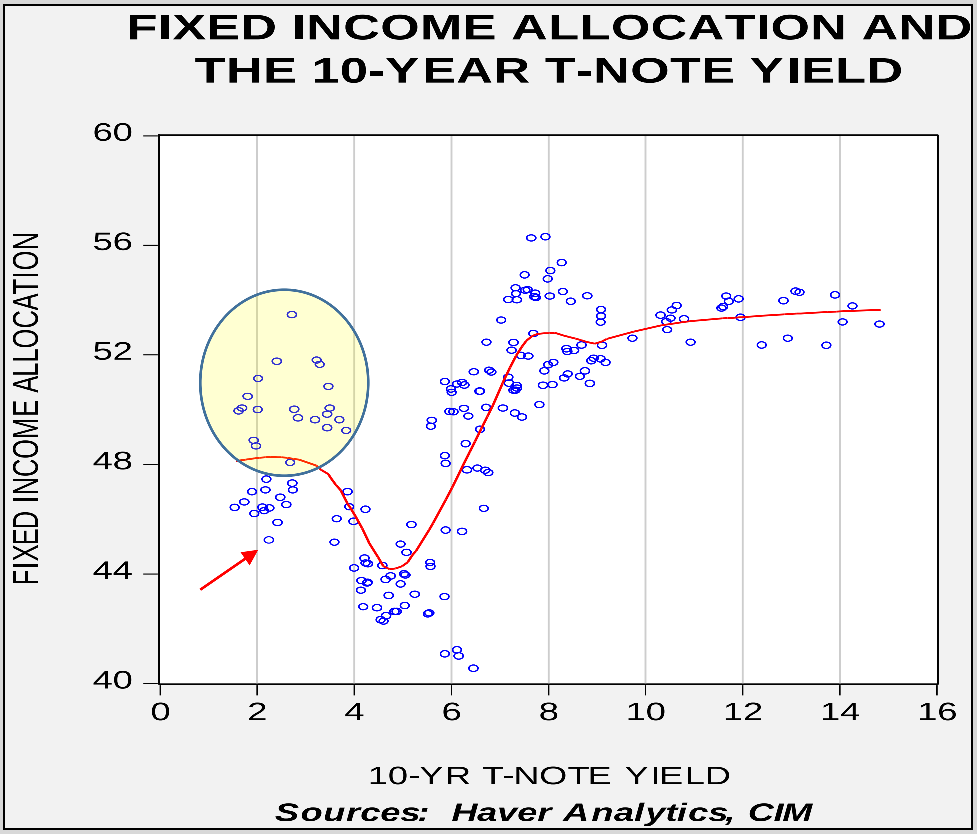
October 20, 2017

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%.

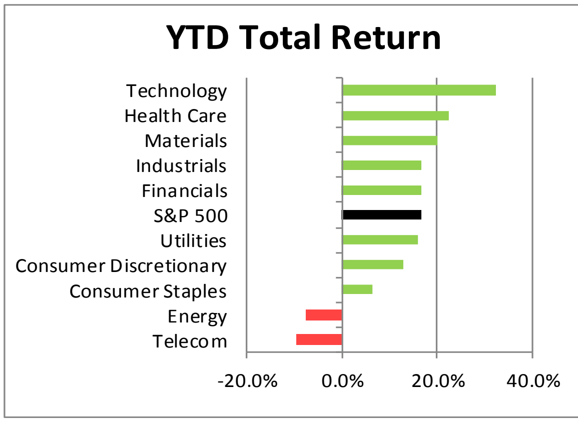


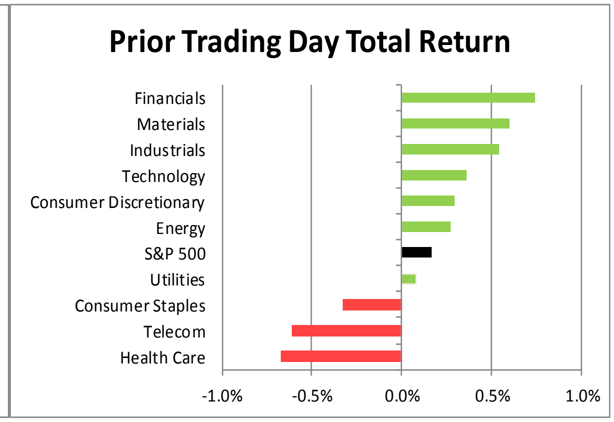
This chart shows a scatterplot of the percentage of total assets held in fixed income and the 10-year T-note yield. We have plotted a nearest neighbor fit study to the data. We have seen high fixed income levels along with low rates (shown in the circle), but these mostly occurred during the Great Financial 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 10/24/2017 close)

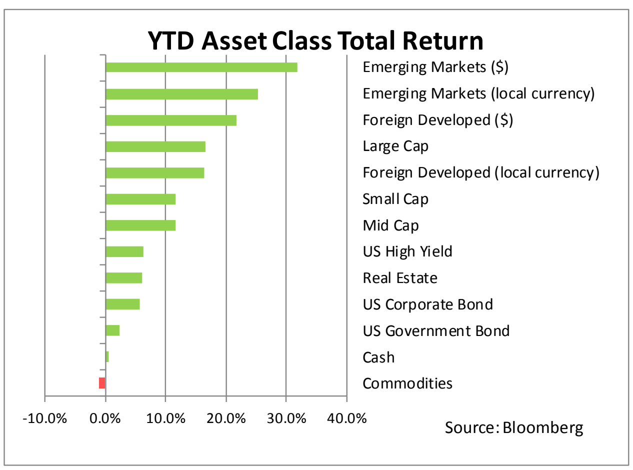




(Source: Bloomberg)

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 10/24/2017 close)

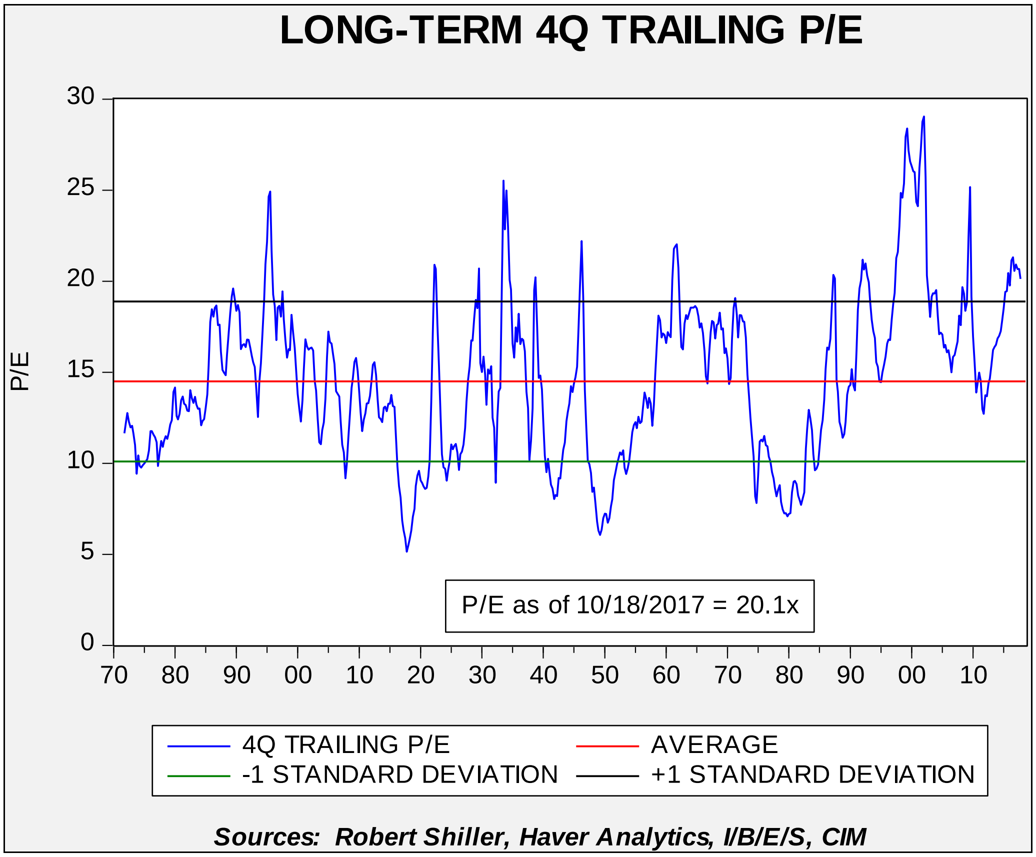


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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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[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.