Daily Comment

By Bill O'Grady and Thomas Wash

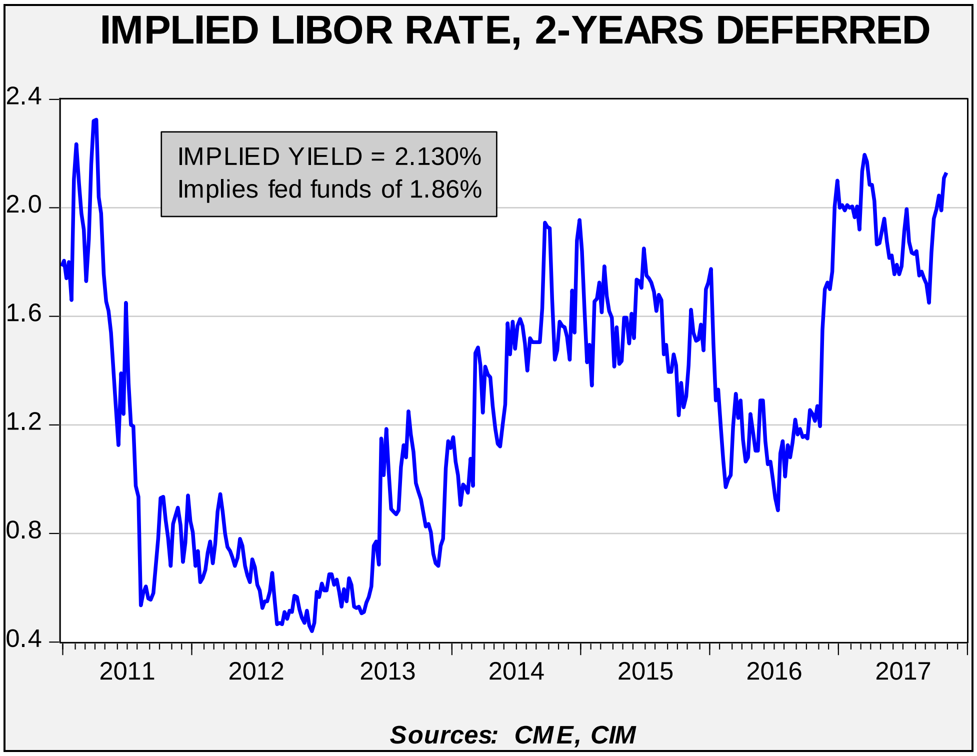
[Posted: October 26, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.3%. U.S. equity index futures are signaling a higher open. With 164 companies having reported, the S&P 500 Q3 earnings stand at $32.48, slightly higher than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 74.4% of the companies reported earnings above forecast, while 17.7% reported earnings below forecast.

It's a news-heavy morning. Here is what we are tracking:

Yellen out? Politico is reporting that the president has narrowed the field for Fed chair, eliminating Gary Cohn yesterday and also Yellen. Although the source from Politico, Ben White, is generally reliable, in the same report, a source suggests that the president changes his mind often and so no one may really be out. Still, Senate Republicans would like to have a Fed dominated by GOP members and therefore would prefer someone other than Yellen. It is worth noting that the president recently visited with Senate Republicans and thus may have been swayed. For the most part, we have seen this as a Powell/Taylor race for a while and, from our perspective, it's really about who gets what seat. Powell would be expected to be a continuation candidate; Taylor would likely be much more hawkish. We note that some have argued that, theoretically, Taylor could be dovish. The official Taylor Rule (different from the Mankiw Rule, which we detail often) is based on a formula that compares inflation to a target and GDP compared to potential GDP. If Taylor were to conclude that the Trump administration's deregulation and fiscal policies increase potential GDP, he could be dovish. This was the argument Greenspan made in the 1990s; he believed that the tech revolution would boost productivity enough to offset rising wages. Still, the Taylor Rule is widely calculated and if he were to manipulate the formula to justify current policy, the dream of "rules-based monetary policy" would be lost. Thus, it seems reasonable to expect that if Taylor is chair, he will be hawkish. The dollar rallied on the news.

ECB: The ECB generally did as expected; although rates remain unchanged, QE will be reduced from €60 bn per month to €30 bn per month, starting in January. It will be extended to September. In addition, the ECB will continue to reinvest maturing bonds, thus keeping the balance sheet level after QE ends. Although this outcome was in line with expectations, European bond yields fell and the EUR dropped. The ECB is intending to reduce accommodation but at a very slow pace.

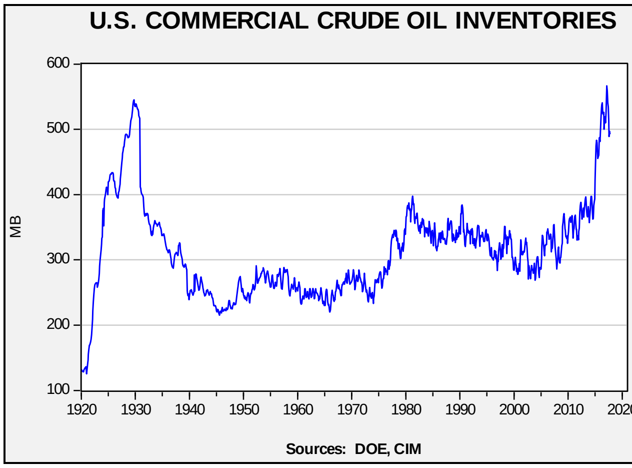
Interest rates: We have seen interest rates rise recently. It appears to us that the primary driver of this change has been expectations of tighter U.S. monetary policy. This is coming from two sources. First, the market is discounting that a new Fed chair will be more hawkish than Yellen. Second, even if Yellen remains, the roster of next year's FOMC will be decidedly more hawkish based on the policy stance of the regional presidents; this is the topic of tomorrow's Asset Allocation Weekly. We are seeing the deferred Eurodollar futures market implied yield rise to near-cycle highs.

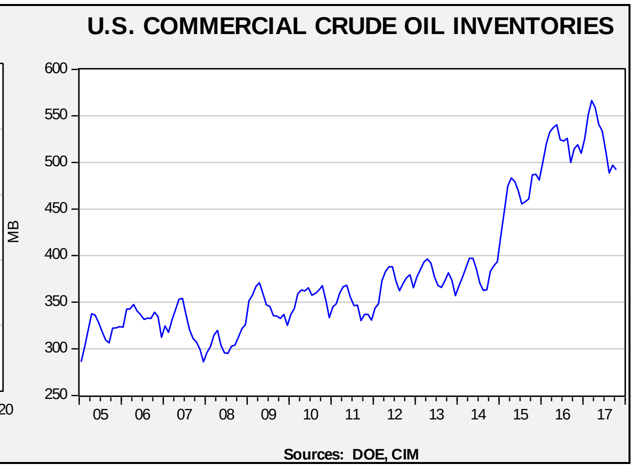


If Yellen is reappointed, which would be a modest surprise, we would look for a retreat in the above yield but probably not below this year's lows set in early September. This would put some downward pressure on the dollar and probably lower 10-year Treasury yields.

Catalonia to hold elections? The regional Catalan government is set to call elections in a bid to stall a takeover by Madrid. If calling elections doesn't placate Madrid, PM Rajoy will likely invoke Article 155 of the Spanish constitution, which allows the central government to take control of a province to maintain the governmental integrity of Spain. Tensions remain high but Rajoy should probably allow an election to go forward because there is a good chance voters will want to stay in Spain. This is the message that comes from Scotland and Quebec; areas may want autonomy but actually leaving is usually a minority idea in a region.

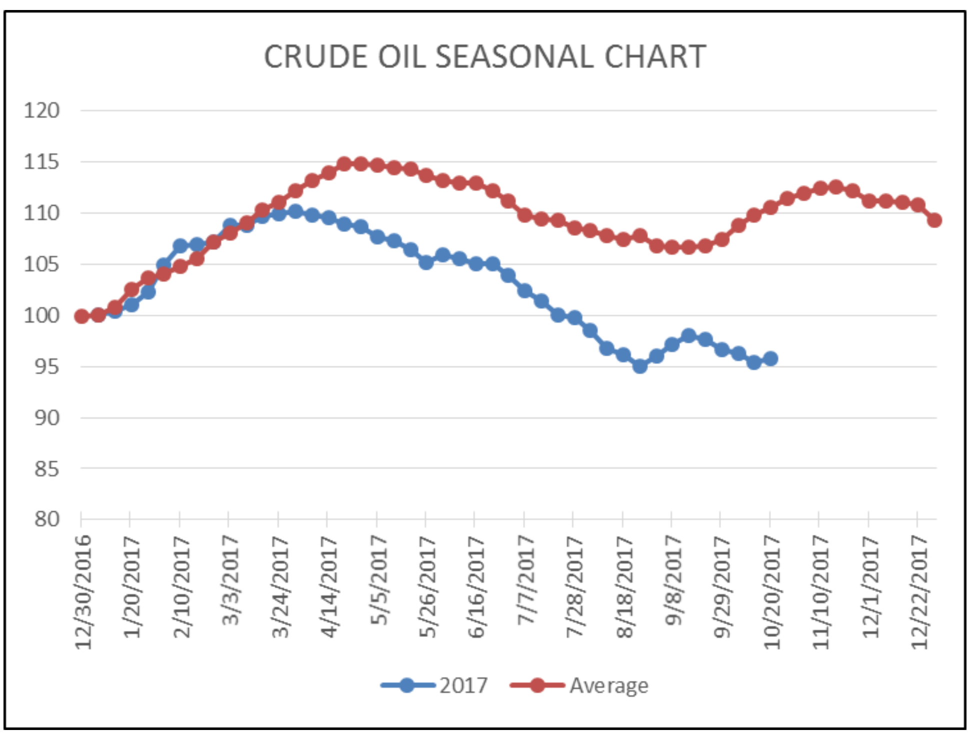
Energy recap: U.S. crude oil inventories rose 0.8 mb compared to market expectations of a 3.0 mb decline.



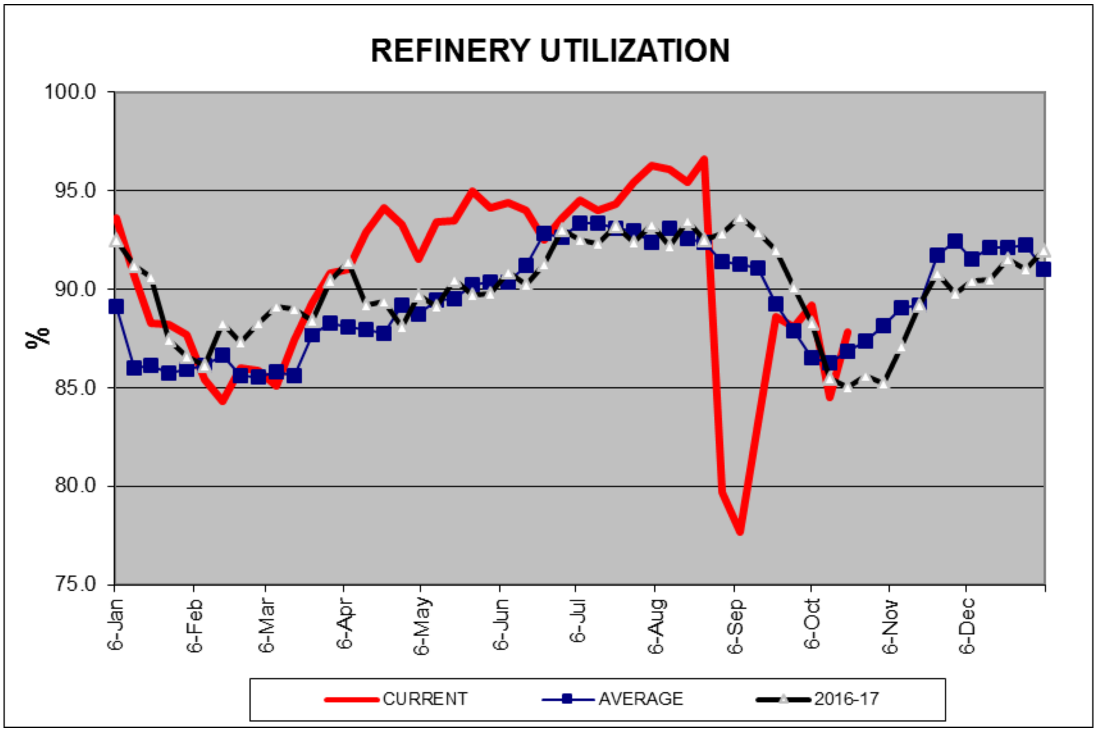


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined. The impact of Hurricane Harvey is diminishing as refinery operations recover. We also note the SPR fell by 0.3 mb, meaning the net build was 0.5 mb.

As the seasonal chart below shows, inventories rose modestly this week. It appears that we are "skipping" the usual autumn inventory rebuild period. We did see a strong recovery in production after a short hurricane disruption the previous week. Oil imports rebounded as well. Still, we usually see much higher inventory accumulation this time of year and so it should be supportive for prices if it remains slow.

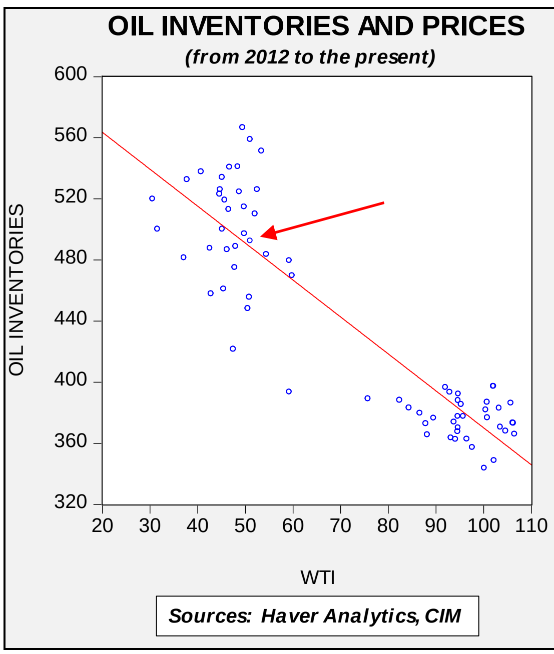


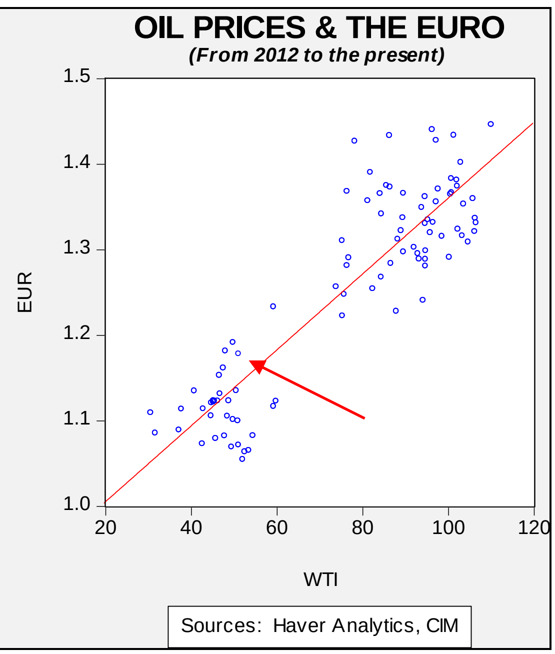
(Source: DOE, CIM)



(Source: DOE, CIM)

Refinery operations rebounded last week in line with seasonal norms. If this continues, and we expect it will, it should be bullish for oil prices.





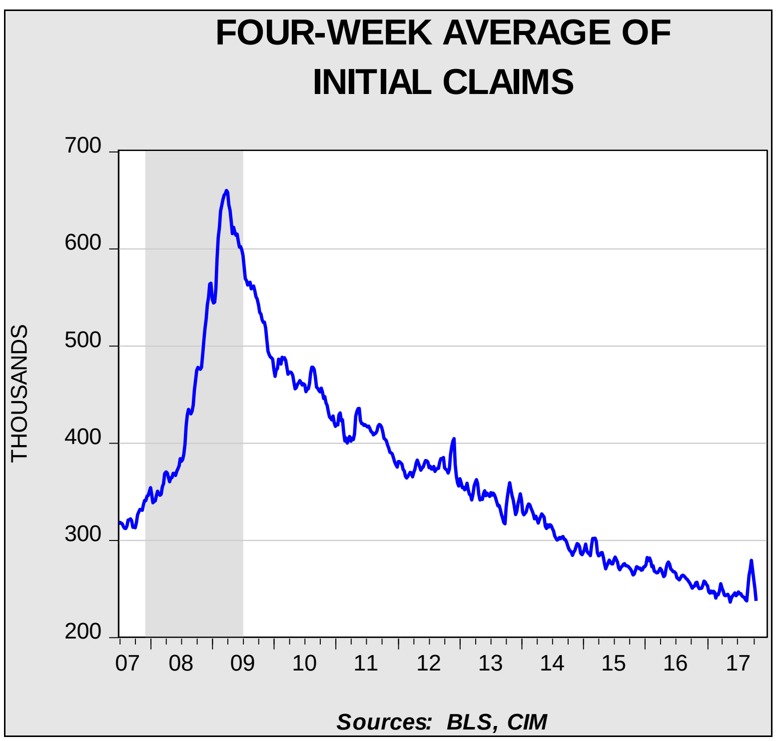
Based on inventories alone, oil prices are undervalued with the fair value price of $53.76. Meanwhile, the EUR/WTI model generates a fair value of $63.42. Together (which is a more sound methodology), fair value is $59.80, meaning that current prices remain below fair value.

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.

In other oil news, Saudi Arabia and Russia appear poised to extend output constraints through 2018. The official meeting is held on November 30. The kingdom has been vacillating on where, when and if on the IPO of Saudi Aramco. The leadership's concern appears to be tied to the disclosure rules that New York and London would require. The Royal Family essentially owns the state oil company and uses its revenue as the funding arm of the government. Going public wouldn't necessarily end that role but it would make the diversion public. The *FT* reports this morning that the Saudi Stock Exchange, the Tadawul, may be the sole listing venue for Saudi Aramco. We would assume that reporting requirements would be minimal. However, listing exclusively on the Tadawul would likely reduce the value of the firm due to the expected lack of transparency. On the other hand, it will allow the kingdom to raise funds in a manner it can control.

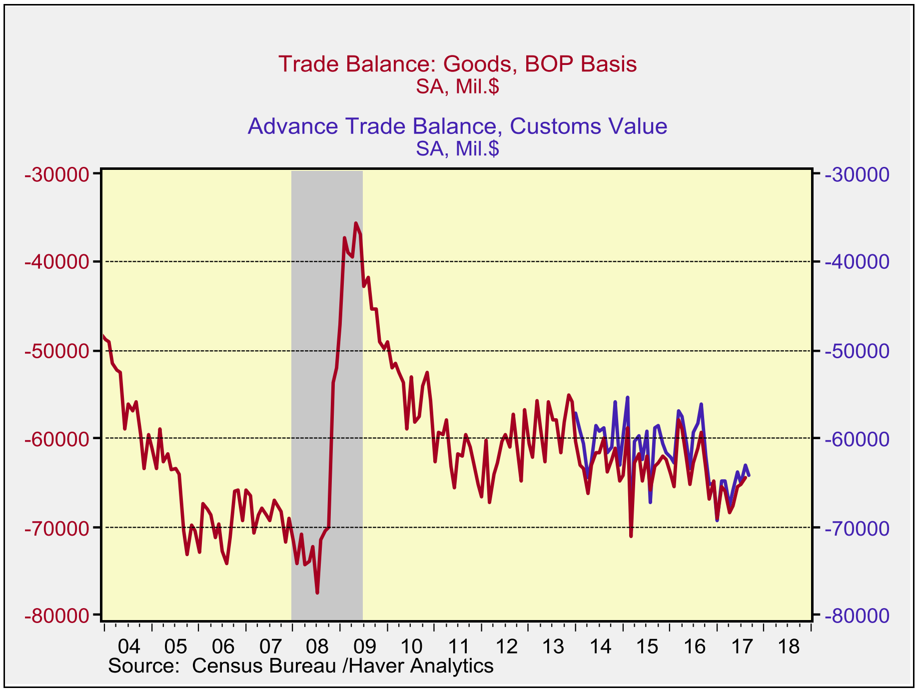
U.S. Economic Releases

Initial jobless claims came in below expectations at 233k compared to the forecast of 235k. The prior month's report was revised from 222k to 223k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 249.25k to 236.75k. As the data show, the impact of the hurricanes has mostly dissipated.

The advance goods trade deficit came in wider than expected at $64.1 bn compared to the forecast of $64.0 bn. The prior report was revised wider from $62.9 bn to $63.3 bn. Wholesale inventories came in below expectations at 0.3% compared to the forecast of 0.4%. The prior month's report was revised downward from 0.9% to 0.8%. Retail inventories rose 1.0% from the prior month. The prior month's report was revised downward from 0.7% to 0.6%.



The chart above shows the trade balance of goods and the advance trade balance.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	oct		51.1	**
10:00	Pending Home Sales	m/m	sep	0.4%	-2.6%	**
10:00	Pending Home Sales	y/y	sep	-4.2%	-3.1%	**
10:00	Kanss City Fed Manufacturing Index	m/m	oct	17	17	**
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								
Japan	Japan buying foreign bonds	m/m	oct	10.9 bn	269.7 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	oct	55.1 bn	153.7 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	oct	-410.3 bn	207.6 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	oct	686.0 bn	840.7 bn		*	Equity and bond neutral
	PPI Services	y/y	sep	0.9%	0.8%	0.8%	**	Equity and bond neutral
Australia	Import Price Index	q/q	3q	-1.6%	-0.1%	-1.5%	**	Equity bearish, bond bullish
	Export Price Index	q/q	3q	-3.0%	-5.7%	-4.0%	**	Equity and bond neutral
New Zealand	Trade Balance	m/m	sep	-1.143 bn	-1.235 bn	-0.900 bn	**	Equity bearish, bond bullish
	Exports	y/y	sep	3.78 bn	3.69 bn	3.90 bn	**	Equity bearish, bond bullish
	Imports	m/m	sep	4.92 bn	4.92 bn	4.88 bn	**	Equity bearish, bond bullish
EUROPE								
Eurozone	M3 Money Supply	y/y	sep	5.1%	5.0%	5.0%	**	Equity and bond neutral
Germany	GfK Consumer Confidence	m/m	nov	10.7	10.8	10.8	**	Equity and bond neutral
Italy	Economic Sentiment	m/m	oct	109.1	108.0		**	Equity and bond neutral
	Manufacturing Confidence	m/m	oct	111.0	110.4	110.0	**	Equity bullish, bond bearish
	Consumer Confidence	m/m	oct	116.1	115.5	114.9	***	Equity bullish, bond bearish
UK	CBI Retailing Reported Sales	m/m	oct	-36	42	14	**	Equity bearish, bond bullish
	CBI Total Dist. Reported Sales	m/m	oct	1	44		**	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	aug	-0.2%	0.4%	0.5%	**	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)	137	137	0	Up
3-mo T-bill yield (bps)	108	109	-1	Neutral
TED spread (bps)	29	28	1	Neutral
U.S. Libor/OIS spread (bps)	127	126	1	Up
10-yr T-note (%)	2.42	2.43	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	40	40	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action		**Prior**	**Expected**	
Selic Rate	7.500%	8.250%	7.500%	On forecast
ECB Main Refinancing Rate	0.000%	0.000%	0.000%	On forecast
ECB Marginal Lending Facility	0.250%	0.250%	0.250%	On forecast
ECB Deposit Facility Rate	-0.400%	-0.400%	-0.400%	On forecast
Bank of Canada Rate Decision	1.000%	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	$58.33	$58.44	-0.19%	Long liquidation
WTI	$52.17	$52.18	-0.02%	
Natural Gas	$2.88	$2.92	-1.51%	
Crack Spread	$20.18	$20.49	-1.49%	
12-mo strip crack	$20.66	$20.89	-1.12%	
Ethanol rack	$1.54	$1.54	-0.30%	
Metals				
Gold	$1,278.40	$1,277.53	0.07%	
Silver	$16.99	$16.95	0.21%	
Copper contract	$317.40	$318.30	-0.28%	
Grains				
Corn contract	$ 351.00	$ 351.00	0.00%	
Wheat contract	$ 436.25	$ 435.50	0.17%	
Soybeans contract	$ 987.50	$ 986.25	0.13%	
Shipping				
Baltic Dry Freight	1573	1588	-15	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	0.9	-3.0	3.9	
Gasoline (mb)	-5.5	-1.0	-4.5	
Distillates (mb)	-5.2	-0.5	-4.7	
Refinery run rates (%)	3.30%	1.45%	1.85%	
Natural gas (bcf)		63.0		

Weather

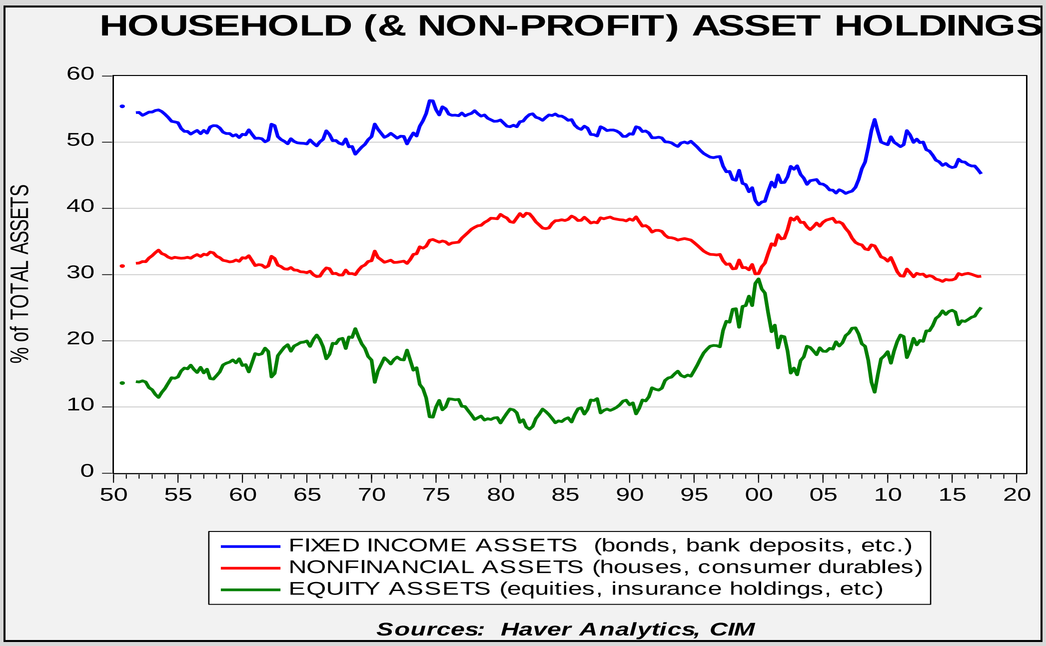
The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmer to normal temps expected for the western region. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

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.

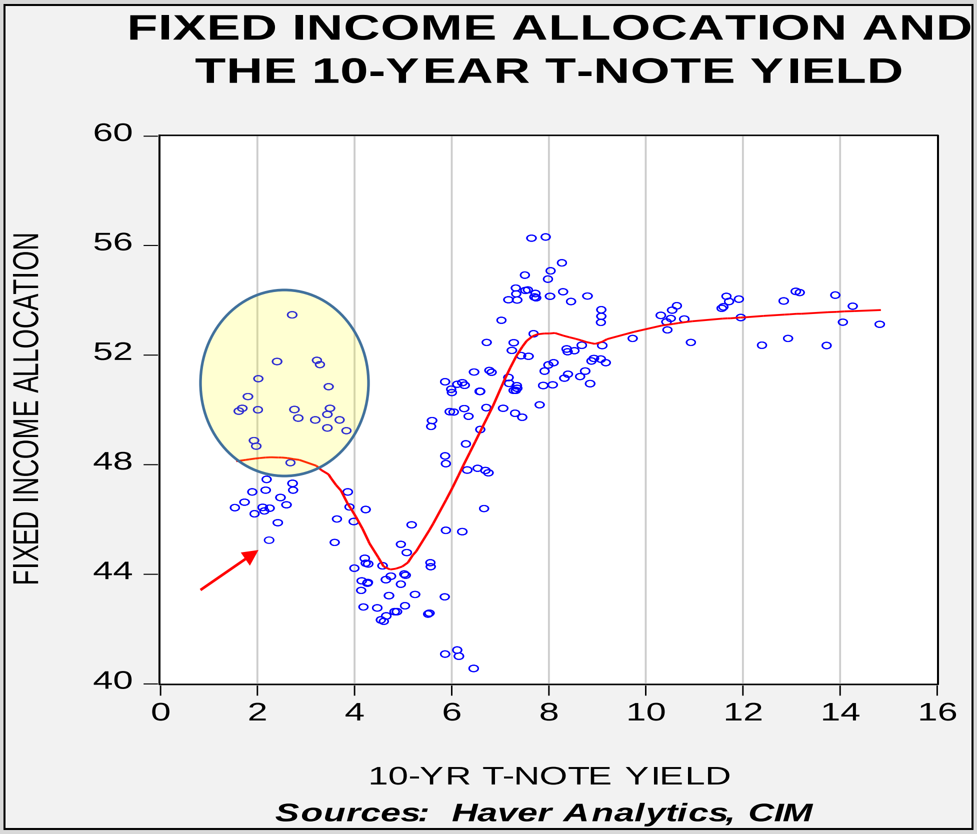
October 20, 2017

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%.

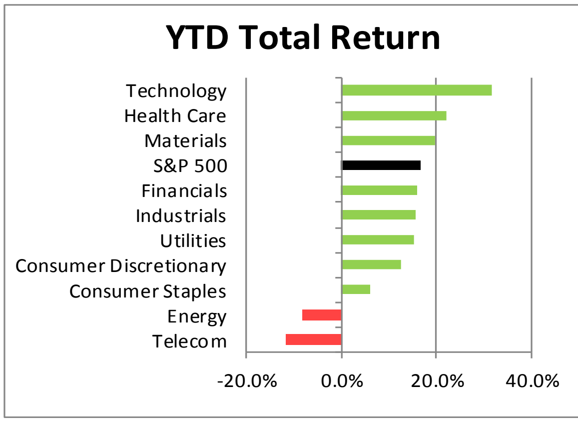


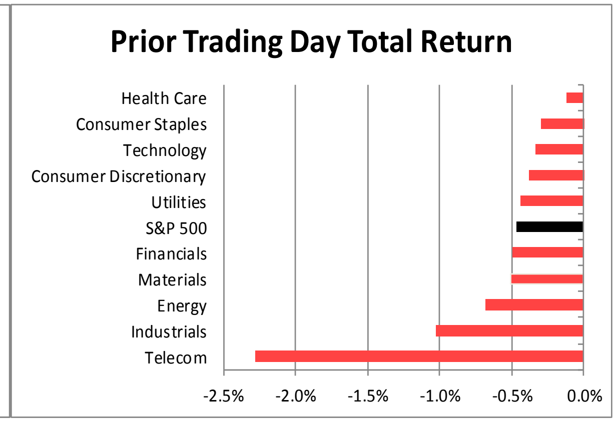
This chart shows a scatterplot of the percentage of total assets held in fixed income and the 10-year T-note yield. We have plotted a nearest neighbor fit study to the data. We have seen high fixed income levels along with low rates (shown in the circle), but these mostly occurred during the Great Financial 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 10/25/2017 close)

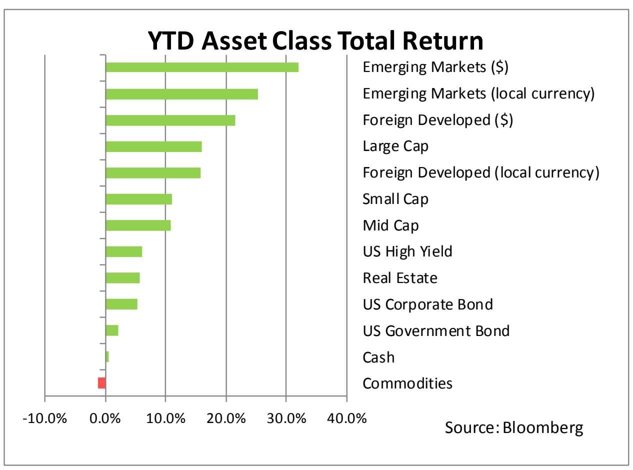




(Source: Bloomberg)

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 10/25/2017 close)

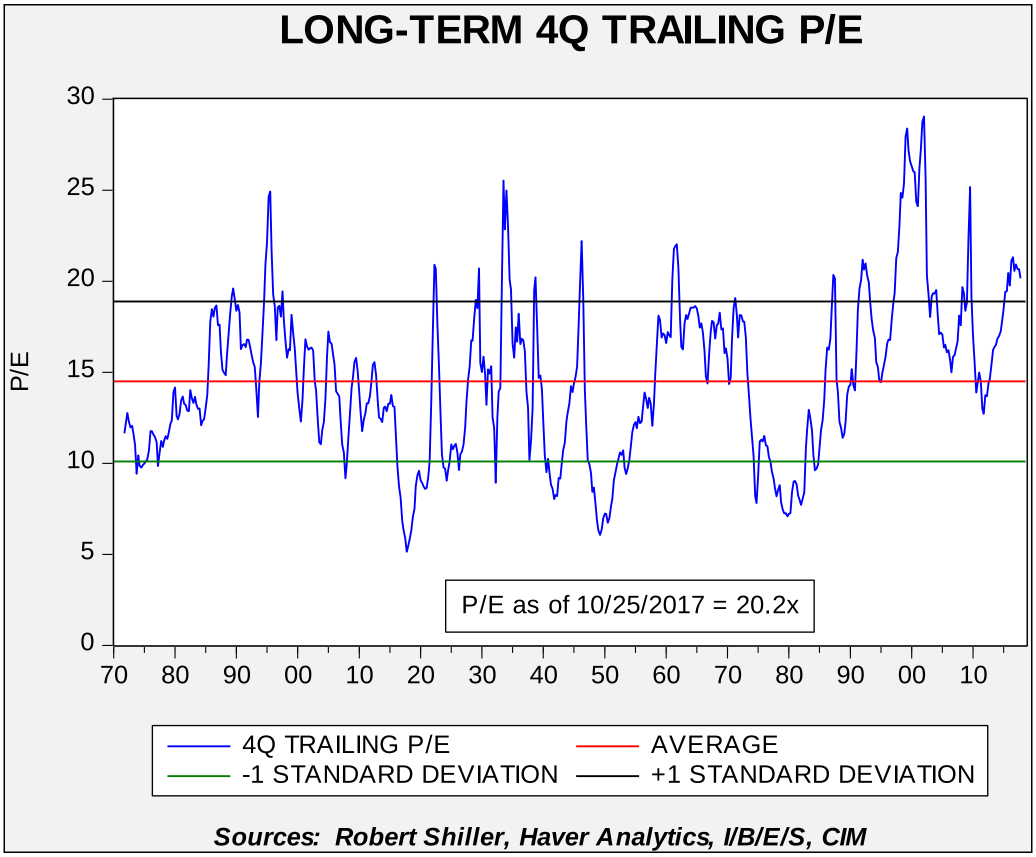


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2017



Based on our methodology,[1] the current P/E is 20.2x, up 0.1x from last week. Rising equity prices with mostly steady earnings led to the modest multiple expansion.

[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.