Daily Comment

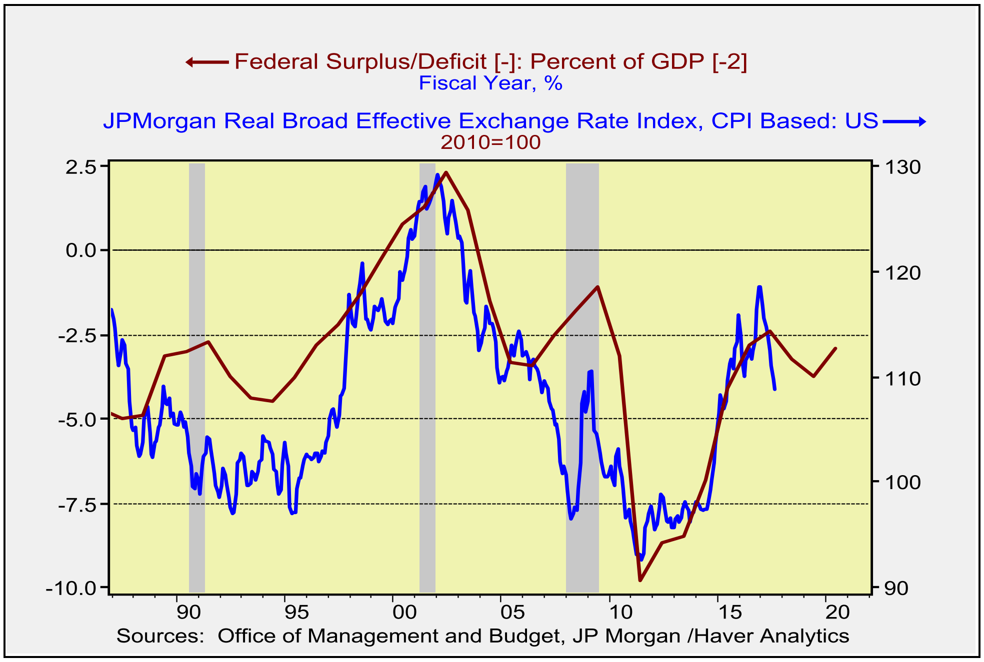
By Bill O'Grady and Thomas Wash

[Posted: October 30, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were down, with the Shanghai composite down 0.8% and the Shenzhen index down 1.7%. U.S. equity index futures are signaling a lower open. With 272 companies having reported, the S&P 500 Q3 earnings stand at $33.08, higher than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 76.5% of the companies reported earnings above forecast, while 14.0% reported earnings below forecast.

It was a heavy weekend of news. Let's dig in:

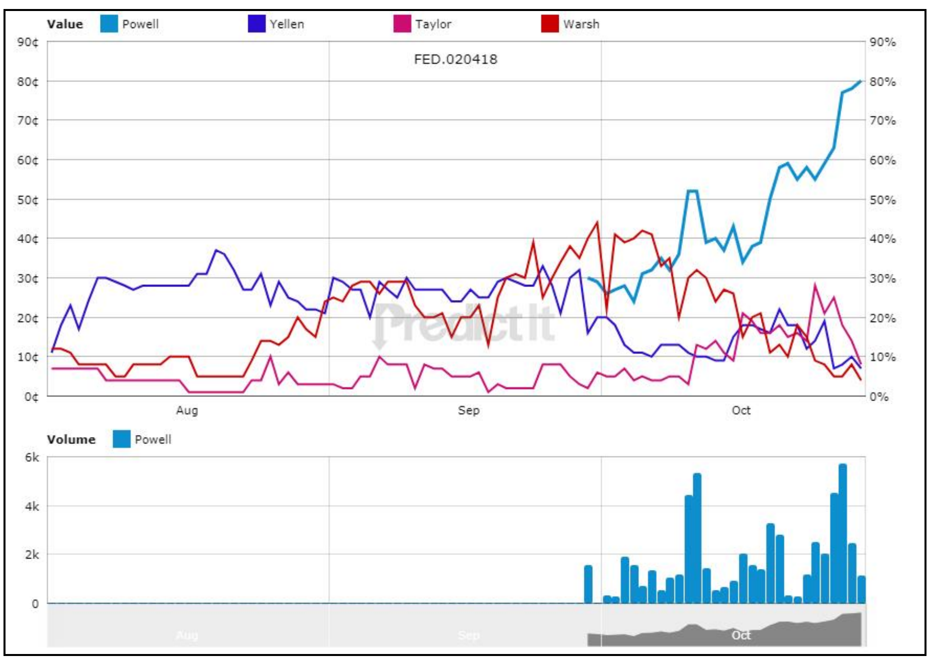
Manafort, Gates indicted: Paul Manafort and his former business associate, Rick Gates, were indicted this morning and told to surrender to the FBI. Latest reports indicate that Manafort and his former partner will face charges related to tax law, money laundering and disclosure of foreign lobbying. The media over the weekend was frothy over who might get indicted, but Manafort has been on the special council's radar for months. The fact that we didn't see anything beyond these two does suggest, at least for now, that the scope of the probe remains relatively narrow. Gates remained with the Trump campaign until after the election, but Manafort was relieved months before November. Because the indictments were narrow in scope, we doubt this news will have significant market impact, at least in the short run.

Realtor and home builders revolt! The National Association of Home Builders and the National Association of Realtors have officially come out in opposition to the GOP tax plan despite the fact that the deduction for state and local property taxes was retained in the proposed tax bill. The two groups wanted a homeowner tax credit in the bill as well, but bill writers scrapped the proposal. Losing these two groups weakens the possibility of passing a tax bill; there is a realtor in nearly every congressional district and they will flood the airwaves with critical ads in the coming weeks. It looks to us that if a bill is going to make it through the Senate, it will need to cut rates AND keep most deductions, meaning it will be a deficit builder. In the coming weeks, we will have more to say about the impact of a larger deficit on the economy and financial markets. In general, the risk of larger deficits is that it leads to higher inflation, but the effects are actually rather complicated. This chart offers one clue.



This chart shows that since the late 1980s, the fiscal account scaled to GDP tracks the dollar and leads the forex rate by two years. The correlation isn't perfect but it does suggest that if we are right and the deficit does widen then the dollar could be vulnerable to a broader decline, but not until 2019-20.

The Fed chair this week: The money is on Powell.



(Source: Predictit.org)

The betting site Predictit.org is indicating a more than 80% chance that Jerome Powell will be the next Fed chair. Again, we warn that the president is prone to change his mind and we may see a surprise. We also want to reiterate the message of this week's Asset Allocation Weekly (see below); the FOMC will be unusually hawkish next year regardless of who is chair.

Madrid takes control: Spain's public prosecutor has accused the entire former government of Catalonia of rebellion, sedition and embezzlement and the deposed Catalan leader, Carles Puigdemont, is calling for civil disobedience. The polling data doesn't really favor independence. In fact, there was a large anti-independence demonstration over the weekend in Barcelona. The risk is that Rajoy's crackdown will build sympathy for the independence movement and independence-supporting candidates will win when new elections are held in December. Again, if Rajoy wants to look at a successful playbook, the way Ottawa has dealt with Quebec Separatists is perhaps the best.

Barzani resigns: A few weeks ago, Iraqi Kurds voted for independence. Now, the man who led that vote, Masoud Barzani, has resigned as the Kurdish region's president. The move has clearly backfired as Iran, Turkey and Baghdad have moved to quash Kurdish independence. The U.S. has negotiated a ceasefire, but we are hearing that oil flows from the region have been halted.

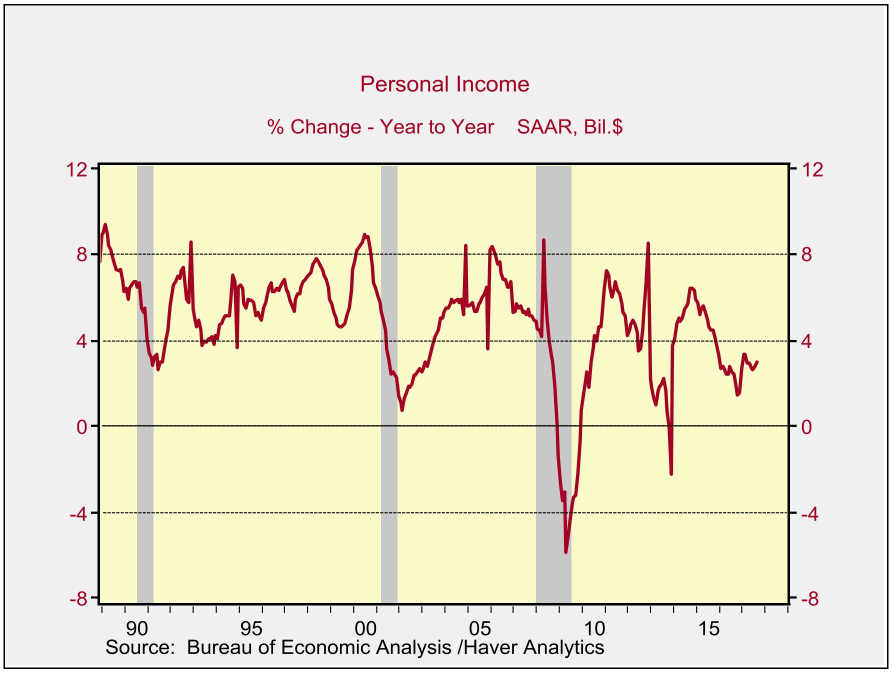
China breaks up plot to assassinate Kim Han-sol: [1] Kim Han-sol is the son of Kim Jong-nam, the older brother of Kim Jong-un. Earlier this year, the "Young General" apparently had his older brother assassinated.[2] According to reports, two agents of the DPRK are in custody in Beijing and are being interrogated. Kim Jong-un is likely worried that China might consider overthrowing him and put a relative in place to maintain the dynasty. Thus, the current DPRK leader has an incentive to kill any potential claimants to the throne.

U.S. Economic Releases

Personal income came in line with expectations, rising 0.4% from the prior month. Personal spending came in above expectations, rising 1.0% from the prior month compared to the forecast gain of 0.9%. Real personal spending came in above expectations, rising 0.6% from the prior month compared to the forecast gain of 0.5%.

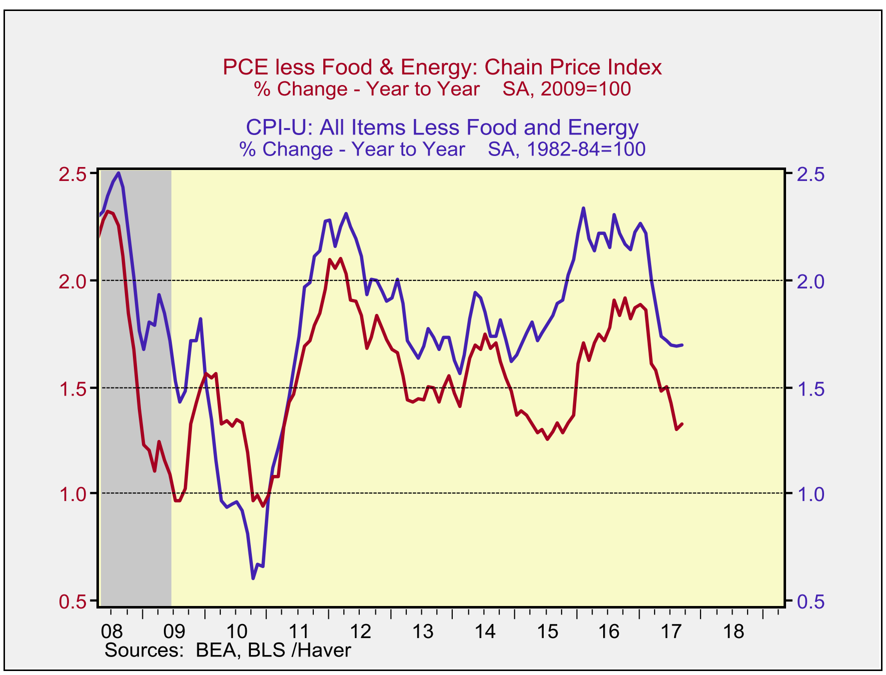
[1] https://www.bloomberg.com/news/articles/2017-10-30/china-breaks-up-plot-to-kill-kim-jong-un-s-nephew-report-says

[2] http://www.confluenceinvestment.com/wp-content/uploads/weekly_geopolitical_report_3_6_2017.pdf



The chart above shows the year-over-year change in personal income.

The PCE deflator came in line with expectations, rising 0.4% from the prior month. Additionally, core PCE came in line with expectations, rising 0.1% from the prior month.



The chart above shows the year-over-year change in core PCE and core CPI. Declining core CPI and PCE suggest that Fed tightening may have had an effect on inflation. If this pattern persists, we expect the Fed to reconsider its current pace of raising rates, especially since the effects of balance sheet contraction on the economy are unclear.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Dallas Fed Manufacturing Activity	m/m	oct	21.0	21.3	**
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	Retail Sales	m/m	sep	0.8%	-1.7%	0.8%	**	Equity and bond neutral
	Retail Trade	m/m	sep	2.2%	1.7%	2.3%	**	Equity and bond neutral
	Dept. Store, Supermarket Sales	m/m	sep	1.9%	0.6%	1.5%	***	Equity bullish, bond bearish
EUROPE								
Eurozone	Economic Confidence	m/m	oct	114.0	113.0	113.3	***	Equity bullish, bond bearish
	Business Climate Indicator	m/m	oct	1.44	1.34	1.40	**	Equity bullish, bond bearish
	Industrial Confidence	m/m	oct	7.9	6.6	7.1	***	Equity bullish, bond bearish
	Service Confidence	m/m	oct	16.2	15.3	15.0	***	Equity bullish, bond bearish
	Consumer Confidence	m/m	oct	-1.0	-1.0	-1.0	**	Equity and bond neutral
Germany	Retail Sales	y/y	oct	4.1%	2.8%	3.0%	***	Equity bullish, bond bearish
UK	Net Consumer Credit	m/m	sep	1.6 bn	1.6 bn	1.5 bn	**	Equity and bond neutral
	Net Lending Sec. on Dwellings	m/m	sep	3.8 bn	4.0 bn	4.0 bn	*	Equity and bond neutral
	Mortgage Approvals	m/m	sep	66.2k	66.6k	66.0k	**	Equity and bond neutral
	Money Supply M4	m/m	sep	-0.2%	0.9%		**	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	oct	109.8	105.8	106.5	***	Equity bullish, bond bearish
	Total Sight Deposits	m/m	oct	578.5 bn	578.6 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	oct	469.4 bn	468.7 bn		*	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)	138	138	0	Up
3-mo T-bill yield (bps)	108	108	0	Neutral
TED spread (bps)	30	30	0	Neutral
U.S. Libor/OIS spread (bps)	127	127	0	Up
10-yr T-note (%)	2.40	2.41	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	42	42	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			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	$60.56	$60.44	0.20%	Short Covering
WTI	$53.97	$53.90	0.13%	
Natural Gas	$2.97	$2.96	0.30%	
Crack Spread	$20.28	$20.27	0.07%	
12-mo strip crack	$20.95	$21.06	-0.54%	
Ethanol rack	$1.53	$1.53	-0.20%	
Metals				
Gold	$1,271.89	$1,273.35	-0.11%	Fed Expectataions
Silver	$16.76	$16.87	-0.61%	
Copper contract	$311.10	$310.35	0.24%	
Grains				
Corn contract	$ 349.00	$ 348.75	0.07%	
Wheat contract	$ 426.25	$ 427.25	-0.23%	
Soybeans contract	$ 992.25	$ 986.50	0.58%	
Shipping				
Baltic Dry Freight	1546	1555	-9	

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temps for the northwestern region, with warmer temps for the rest of the country. Precipitation is expected for most 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 27, 2017

It is expected that over the next two weeks President Trump is going to appoint a new Federal Reserve Open Market Committee (FOMC) chair and vice chair. In this report, we will build scenarios of how policy could change depending upon whom the president appoints.

This spreadsheet details our estimate of policy preference, with one being the most hawkish and five the most dovish.

		all	2017 FOMC	2018#1		2018#2		2018#3		2018#4
Yellen		3	3	3	Powell	3	Taylor	1	Yellen	3
Fischer		3	3	3	Taylor	1	Warsh	2	Taylor	1
Brainard		4	4	4	Brainard	4	Brainard	4	Brainard	4
Powell		3	3	3	vacant		Powell	3	Powell	3
Quarles		2	2	3	Quarles	2	Quarles	2	Quarles	2
vacant					vacant		vacant		vacant	
vacant					vacant		vacant		vacant	
Dudley		3	3	3	Dudley	3	Dudley	3	Dudley	3
Evans		4	4		Evans		Evans		Evans	
Bullard		5			Bullard		Bullard		Bullard	
George		1			George		George		George	
Mullinix		1		1	Mullinix	1	Mullinix	1	Mullinix	1
Bostic		3		3	Bostic	3	Bostic	3	Bostic	3
Williams		2		2	Williams	2	Williams	2	Williams	2
Mester		2		2	Mester	2	Mester	2	Mester	2
Rosengren		2			Rosengren		Rosengren		Rosengren	
Kashkari		5	5		Kashkari		Kashkari		Kashkari	
Kaplan		3	3		Kaplan		Kaplan		Kaplan	
Harker		2	2		Harker		Harker		Harker	
		2.82	3.20	2.70		2.33		2.30		2.40

(Sources: Federal Reserve, CIM)

The first column shows the members of the FOMC with the chair in green and vice chair in blue. We have Fischer still on the roster even though he is now leaving. The "all" column lists our estimates of policy bias. The Fed has eight permanent voters—the seven governors and the New York Federal Reserve Bank (FRB) president. The other 11 regional FRB presidents rotate into a voting position roughly every two to three years. The last row shows the average of our hawk/dove rankings. The current voting roster is more dovish than the FOMC as a whole. Scenario #1 assumes no changes to the chair and vice chair roles, although we know that Fischer is leaving so this scenario is purely hypothetical. This is to show that even with no changes at the governor level, next year's voting roster would have been markedly more hawkish regardless, with an average ranking of 2.70 compared to the current ranking of 3.20.

Scenario #2 assumes Jerome Powell, a current governor, is appointed to chair with John Taylor as vice chair. Powell's seat is assumed to remain vacant for the foreseeable future, which leads to an even more hawkish FOMC, with an average of 2.33.

Interestingly enough, the FOMC voters are just about as hawkish under the next most likely scenario, with John Taylor as chair and Kevin Warsh as vice chair (Powell remains as a governor). Finally, if Trump re-appoints Yellen but adds Taylor as vice chair, the average is 2.40; again, not a significant change in policy stance.

So, what is the most likely outcome? Currently, Powell is considered the front-runner[3] and would be the safest candidate. He is a moderate like Yellen and would probably maintain the current arc of policy. According to reports, President Trump had a good meeting with John Taylor and he might select him for vice chair. There is no indication at this point who would be selected to fill out the rest of the three open seats if Powell is appointed. It's possible that Kevin Warsh could be offered one as a consolation prize but, for now, we would not expect the remaining vacancies to be filled until much later in 2018.

The bottom line is that next year's FOMC will take on a decidedly more hawkish stance due mostly to the hawkish lineup of regional bank presidents. This is a factor that will affect our outlook for next year.

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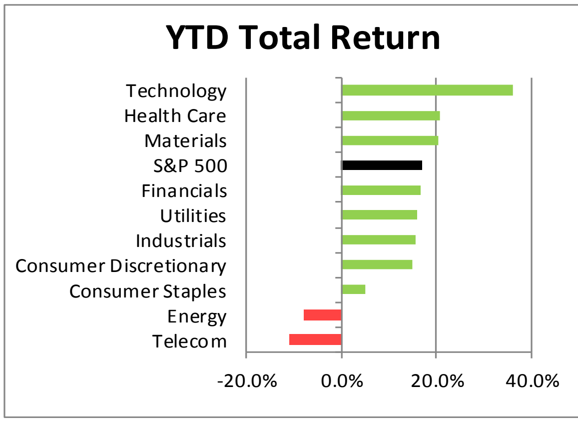
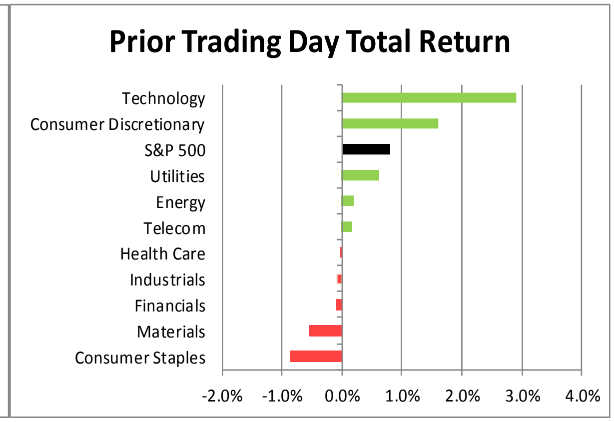
[3] https://www.predictit.org/Market/3306/Who-will-be-Senate-confirmed-Fed-Chair-on-February-4%2c-2018

Data Section

U.S. Equity Markets – (as of 10/27/2017 close)

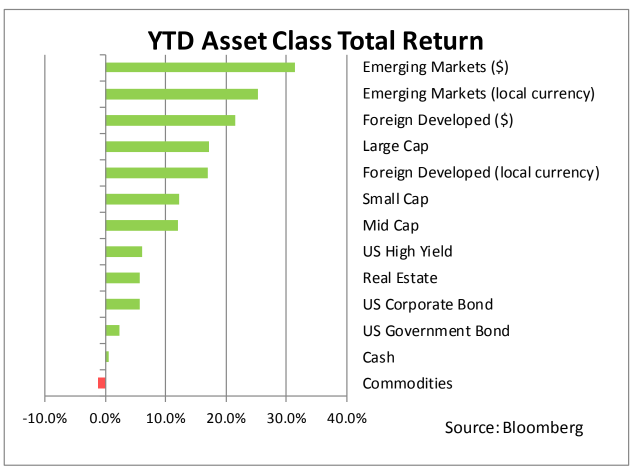




(Source: Bloomberg)

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 10/27/2017 close)

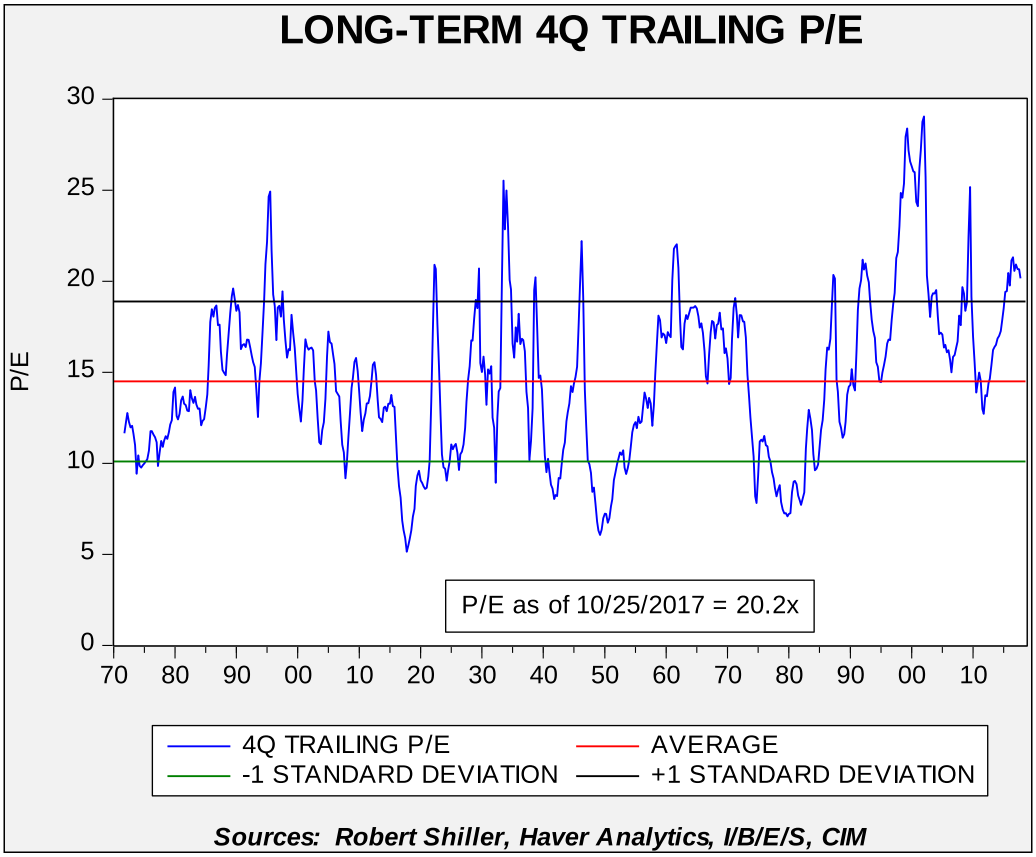


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[4] 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.

[4] 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.