Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 31, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% 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 0.1% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a lower open. With 277 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, 76.2% of the companies reported earnings above forecast, while 14.4% reported earnings below forecast.

Happy Halloween!

Financial and commodity markets are quiet this morning, awaiting the president's pick for Fed chair (Powell is the consensus selection), the president's trip to Asia and Friday's employment report. Here is what we are watching this morning:

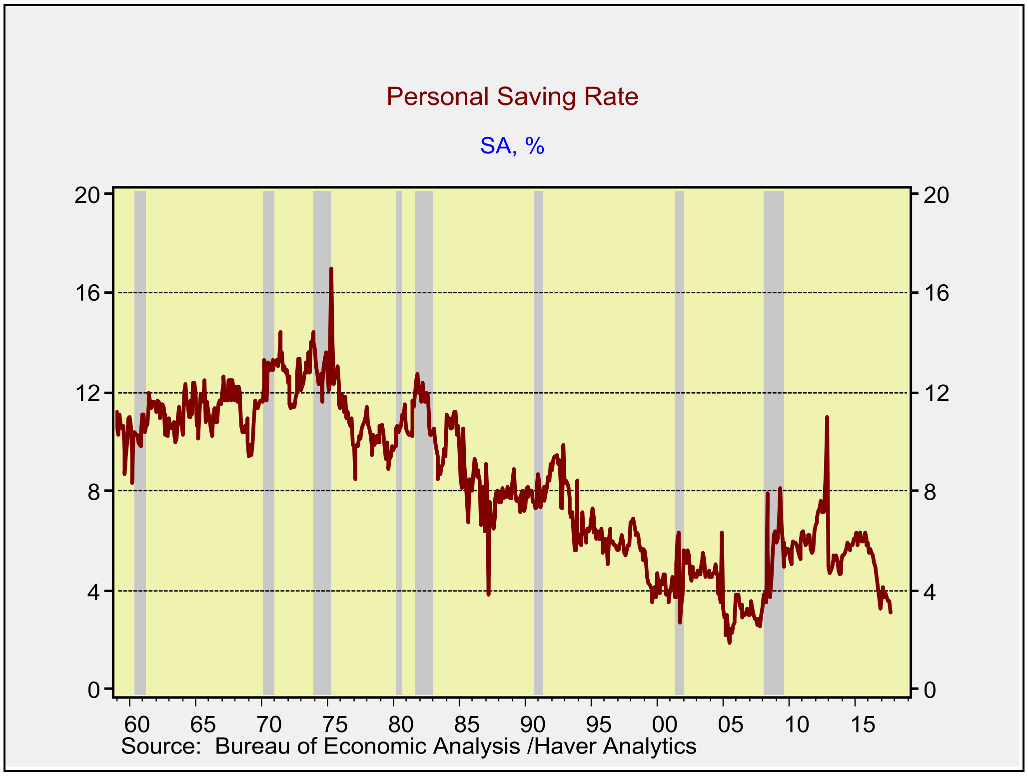
The indictments: Although the indictments dominated the news flow yesterday, we still view this as a long process. The primary concern is that the issue will become a larger distraction for the White House and make tax cuts more difficult. The tax changes are already quite difficult. Yesterday, we saw a trial balloon of phasing in corporate tax changes over five years. That landed with a "thud" and was probably behind the Treasury rally seen yesterday. Tax writers are fiddling with such ideas because it is becoming difficult to even come close to neutrality. If the president moves to fire Mueller, it may trigger a constitutional crisis and that could have a detrimental impact on equity markets. We don't expect that outcome but the odds are rising from a low level. The House is expected to offer a tax bill perhaps as early as tomorrow.

South Korea and China make up: When the U.S. put the THAAD anti-missile system in South Korea, China went "ballistic"[1] and pulled diplomats from Seoul. Apparently, China has decided that the system isn't that big of a threat after all. We suspect that the threat has nothing to do with it. Instead, China is probably trying to woo South Korea away from the U.S. by giving in on this missile system. If a conflict is going to occur in North Korea, the U.S. will base some operations in South Korea. If the Moon government, who leans dovish anyway, wants to avoid war on the peninsula, getting China to pressure Pyongyang makes sense. And, if China wants to reduce the chances of war, influencing South Korea to oppose U.S. military actions would make sense. We note that the U.S. will have three carrier strike groups in the area soon and, for the first time, has sent a squadron of 12 F-35A fighters to the Kadena AFB in Japan. Although we haven't seen the strongest precursor for war (removing American civilians from South Korea

[1] See what we did there?

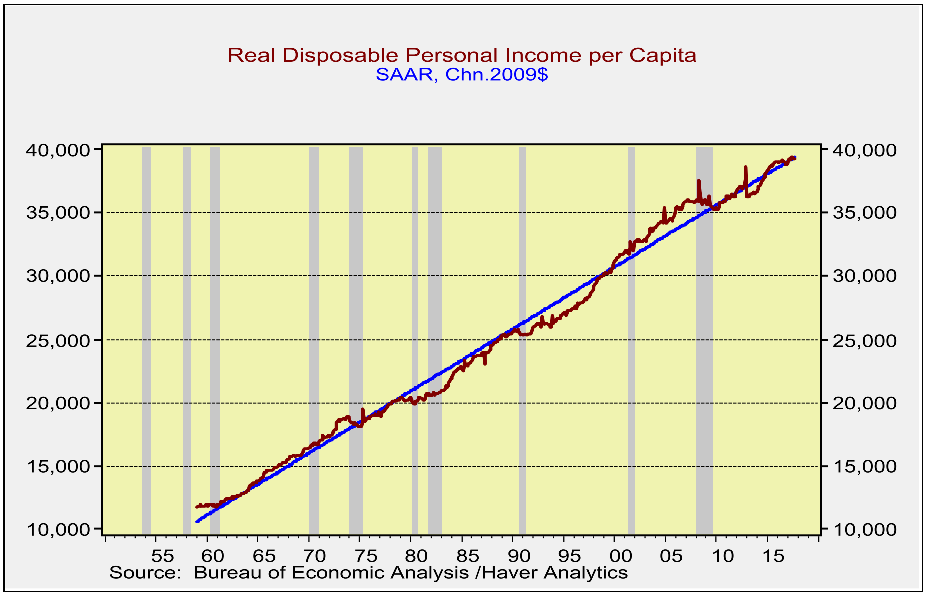
would be the clearest signal of an imminent attack), the U.S. is clearly moving military assets into place for a conflict.

A couple of thoughts about the PCE data: In reviewing the personal consumption data, a couple of concerns emerged. First, the saving rate is rolling over.



We have also seen a stall in deleveraging at the household level. This is a "good news, bad news" situation. The good news is that, at least in the short run, households are feeling more confident and are willing to spend down saving to make purchases. We may be reaching the limits on how much more saving can fund consumption, and if consumption is going to rise in the absence of wage growth then debt will need to rise. Taking on leverage with debt at current levels is probably self-limiting as well.

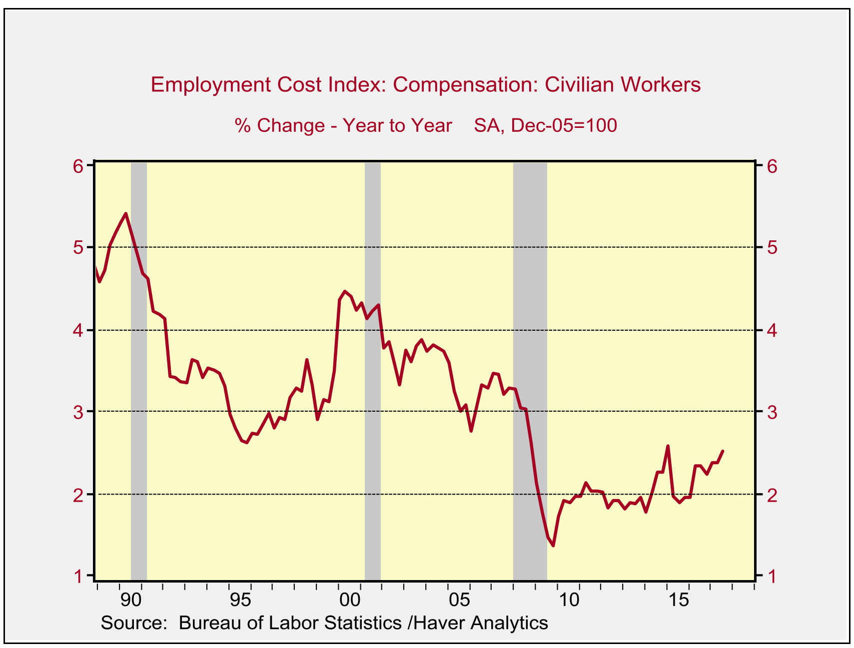
Second, we are seeing inflation-adjusted per capita income stall.



This chart shows real per capita income against trend. It peaked in May and fell below trend in August. The downtrend accelerated in September. Although this number isn't necessarily a good indicator of the business cycle, it should affect consumption. Both these numbers suggest that the 3% GDP growth we are seeing is probably not sustainable.

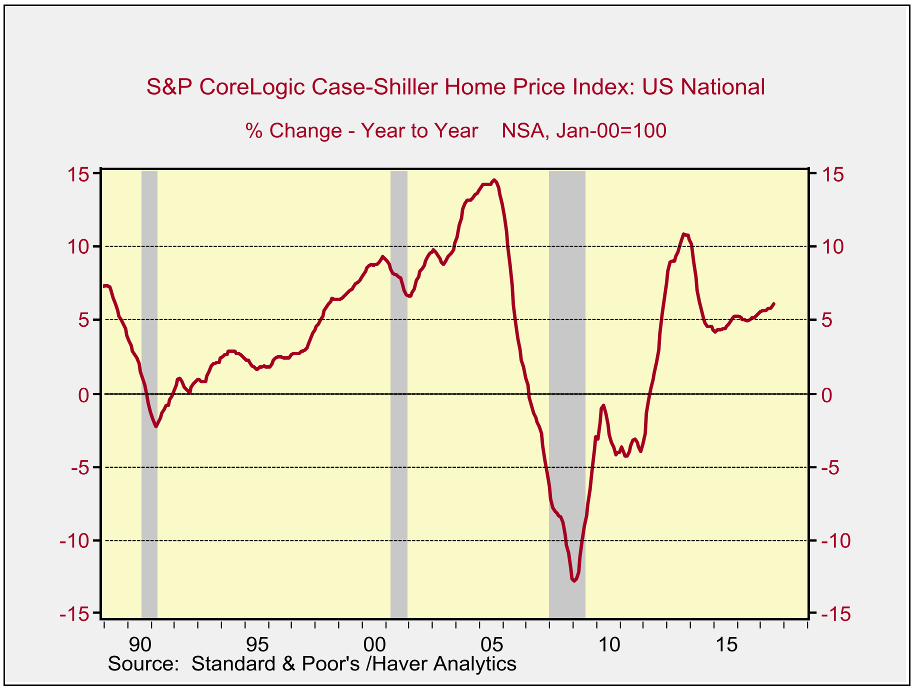
U.S. Economic Releases

The employment cost index for Q3 came in line with the forecast at a 0.7% rise from the prior quarter.



The chart above shows the year-over-year change of the employment cost index, which rose 2.5% from the prior year. Since the financial crisis, the ECI has been relatively weak, remaining below its historical average of 3.0% for over a decade. An ECI approaching its historical average would confirm that the labor market is tightening, lifting the likelihood of higher inflation.

The S&P CoreLogic CS 20-City Home Price Index came in below expectations at 5.92% compared to the forecast rise of 5.93% from the prior year. The prior report was revised upward from 5.81% to 5.83%. The S&P CoreLogic CS U.S. Home Price Index rose by 6.07% from the prior year. The prior report was revised downward from 5.94% to 5.88%.



The chart above shows the year-over-year change in the S&P CoreLogic CS Home Price Index. The relatively low supply of available homes have had a bullish effect on home prices.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Chicago Purchasing Manager	m/m	oct	60.2	65.2	**
10:00	Conference Board Consumer Confidence	m/m	oct	121.3	119.8	**
10:00	Conference Board Present Situation	m/m	oct		146.1	**
10:00	Conference Board Expectations	m/m	oct		102.2	**
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	Jobless Rate	m/m	sep	2.8%	2.8%	2.8%	**	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	sep	1.52	1.53	1.52	**	Equity and bond neutral
	Overall Household Spending	m/m	sep	-0.3%	0.6%	0.6%	**	Equity bearish, bond bullish
	Industrial Production	y/y	sep	2.5%	5.3%	2.0%	**	Equity and bond neutral
	Vehicle Production	y/y	sep	1.7%	5.6%		**	Equity and bond neutral
India	Fiscal Deficit INR Core	y/y	sep	-26107	20149		**	Equity and bond neutral
	Eight Infrastucture Industries	y/y	sep	5.2%	4.9%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	oct	113.4	113.3		**	Equity and bond neutral
	HIA New Home Sales	m/m	sep	-6.1%	9.1%		**	Equity and bond neutral
	Private Sector Credit	m/m	sep	0.3%	0.5%	0.5%	**	Equity bearish, bond bullish
New Zealand	Building Permits	m/m	sep	-2.3%	10.2%		**	Equity and bond neutral
	ANZ Activity Outlook	m/m	oct	22.2	29.6		**	Equity and bond neutral
	ANZ Business Confidence	m/m	oct	-10.1	0.0		**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	sep	8.9%	9.1%	9.0%	***	Equity bullish, bond bearish
	GDP	q/q	oct	0.6%	0.6%	0.5%	***	Equity and bond neutral
	CPI Estimate	y/y	oct	1.4%	1.5%	1.5%	***	Equity and bond neutral
	CPI Core	y/y	oct	0.9%	1.1%	1.1%	***	Equity and bond neutral
France	GDP	q/q	oct	0.5%	0.5%	0.5%	***	Equity and bond neutral
	CPI	m/m	oct	1.1%	1.0%	1.0%	***	Equity and bond neutral
	PPI	m/m	oct	2.1%	2.0%		**	Equity and bond neutral
	Consumer Spending	m/m	sep	2.8%	1.2%	1.9%	**	Equity bullish, bond bearish
Italy	Unemployment Rate	m/m	sep	11.1%	11.2%	11.1%	***	Equity and bond neutral
	CPI incl. tobacco	m/m	oct	-0.2%	-0.3%	0.1%	***	Equity bearish, bond bullish
	CPI EU Harmonized	m/m	oct	0.0%	1.8%	0.2%	***	Equity bearish, bond bullish
	PPI	m/m	sep	2.0%	0.5%		*	Equity and bond neutral
AMERICAS								
Brazil	Net Debt % GDP	m/m	sep	50.9%	50.2%	50.8%	**	Equity and bond neutral
	Primary Budget Balance	m/m	sep	-21.3 bn	-9.5 bn	-23.4 bn	**	Equity and bond neutral
	Nominal Budget Balance	m/m	sep	-53.3 bn	-45.5 bn	-55.8 bn	**	Equity and bond neutral
	CNI Consumer Confidence	m/m	oct	101.2	98.5		**	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	m/m	oct	57.6	57.7		**	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)	112	111	1	Neutral
TED spread (bps)	27	27	0	Neutral
U.S. Libor/OIS spread (bps)	127	127	0	Up
10-yr T-note (%)	2.38	2.37	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	42	42	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action		**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	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	$60.77	$60.90	-0.21%	Short Covering
WTI	$54.05	$54.15	-0.18%	
Natural Gas	$2.96	$2.97	-0.27%	
Crack Spread	$20.05	$20.09	-0.16%	
12-mo strip crack	$21.07	$21.05	0.09%	
Ethanol rack	$1.54	$1.54	0.21%	
Metals				
Gold	$1,273.56	$1,276.29	-0.21%	Fed Expectataions
Silver	$16.83	$16.86	-0.13%	
Copper contract	$311.10	$311.20	-0.03%	
Grains				
Corn contract	$ 348.75	$ 348.75	0.00%	
Wheat contract	$ 424.75	$ 424.75	0.00%	
Soybeans contract	$ 985.75	$ 984.50	0.13%	
Shipping				
Baltic Dry Freight	1534	1546	-12	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.1		
Gasoline (mb)		-1.3		
Distillates (mb)		-2.5		
Refinery run rates (%)		0.70%		

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. The traditional hurricane season ends today so we will cease our regular coverage until June 1, 2018.

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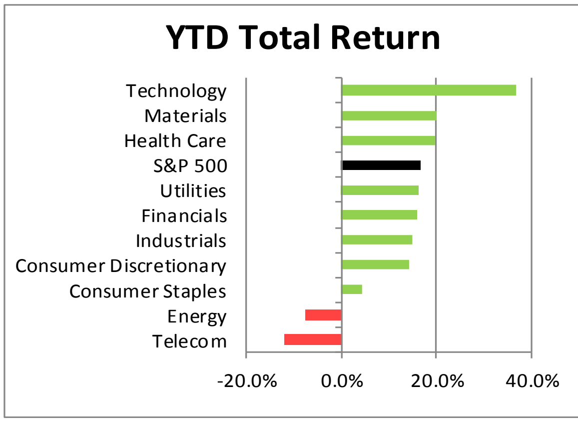
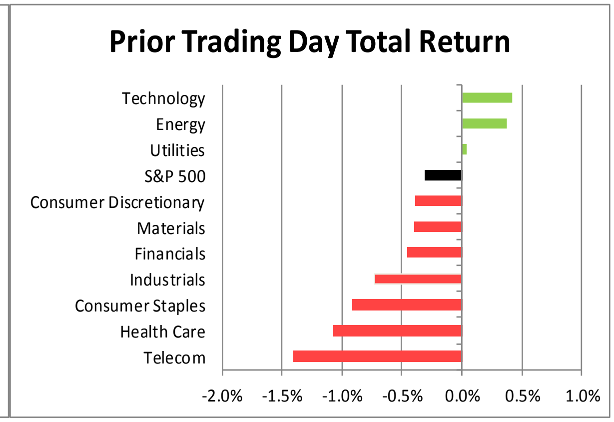
[2] https://www.predictit.org/Market/3306/Who-will-be-Senate-confirmed-Fed-Chair-on-February-4%2c-2018

Data Section

U.S. Equity Markets – (as of 10/30/2017 close)

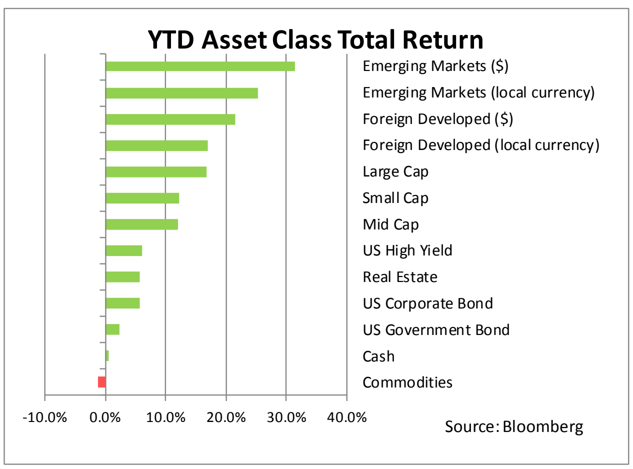




(Source: Bloomberg)

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 10/30/2017 close)

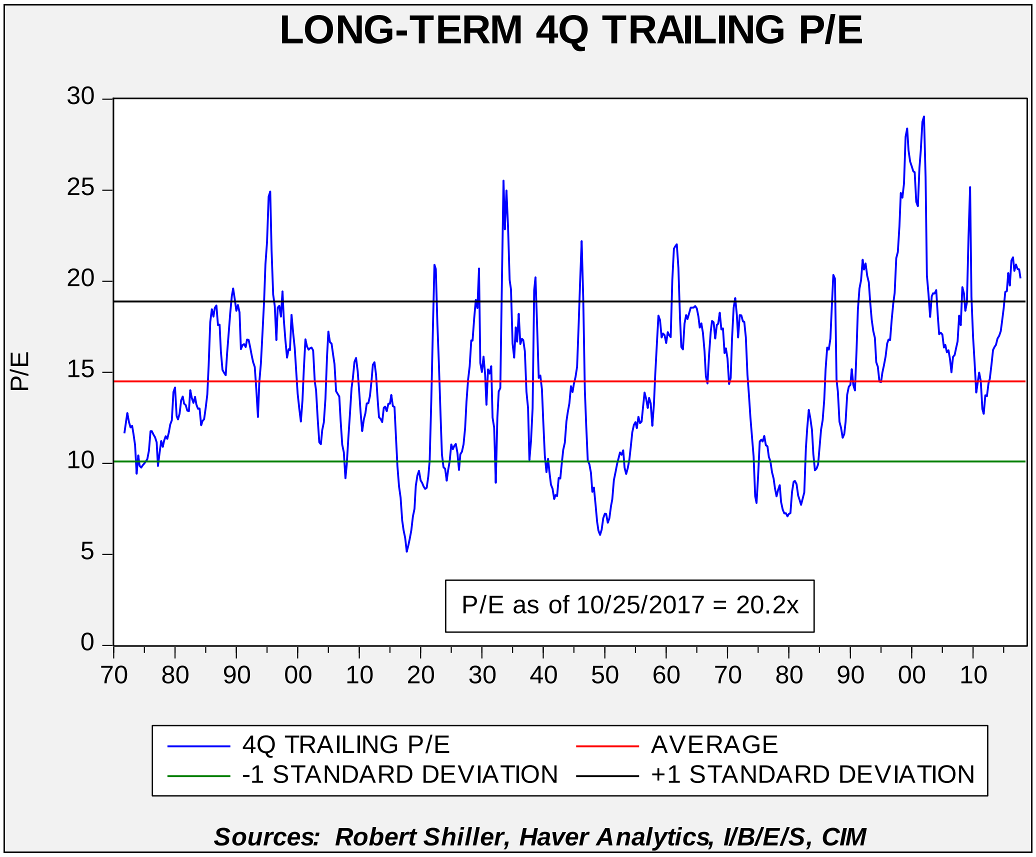


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

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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.