

[Posted: August 11, 2017—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.8% from the prior close. Chinese markets were down, with the Shanghai composite down 1.6% and the Shenzhen index down 1.6%. U.S. equity index futures are signaling a lower open. With 455 companies having reported, the S&P 500 Q2 earnings stand at \$32.63, higher than the \$31.42 forecast for the quarter. The forecast reflects a 6.5% increase from Q2 2016 earnings. Thus far this quarter, 72.7% of the companies reported earnings above forecast, while 18.2% reported earnings below forecast.

Commentary from the White House remains belligerent, but U.S. equity futures appear to be stabilizing. Here is what we are watching:

U.S. v. North Korea: In a press event yesterday, President Trump doubled down on his bellicose rhetoric against North Korea. He added to it this morning, saying the U.S. has prepared “military solutions” that are “locked and loaded.” Although we are sure some plans are in place, we also note that there are no carrier groups in theater; the U.S.S. *Carl Vinson* and the U.S.S. *Theodore Roosevelt* are both in training exercises off the U.S. West Coast. The U.S.S. *Nimitz*, which was in the Far East in the spring, is now in the Persian Gulf. We estimate that two of these vessels could be near North Korea in two to three weeks. We also note that “non-essential diplomatic and military personnel” in South Korea have not been ordered to leave. If a major military operation is to be executed, we would expect two and preferably three carriers in the Far East and non-essential personnel to be evacuated. Thus, any military operations that could be executed now would be air attacks from Guam, Japan and South Korea. Although potent, attacks from these sources would be limited.

We were actually more interested in comments from SOD Mattis yesterday, who warned North Korea to “cease any consideration of actions that would lead to the end of its regime and destruction of its people.” Although Mattis is still pressing for a diplomatic solution to the current problems with North Korea, this warning should be taken seriously; attacking the U.S. will lead to an overwhelming response that will likely lead to the end of the Kim regime. Essentially, Mattis is suggesting that a military strike on the U.S. could trigger a devastating response.

We still think the odds of an actual conflict are low, but the risk is rising. It will be interesting to see how financial markets handle today’s market close. Does a trader want to go home for the weekend with a levered long position in equities?

The problem of positioning: As we have noted before, the Federal Reserve appears to be attempting to manage financial conditions as an unofficial third mandate. All the financial

conditions indices we monitor remain at low levels (although they will tick up next week). We have serious doubts as to policymakers' abilities to manage financial stress, but it does appear that low interest rates and perhaps an enlarged balance sheet have given investors comfort. In response to the third mandate, investors have been increasingly shorting volatility. The position has worked.



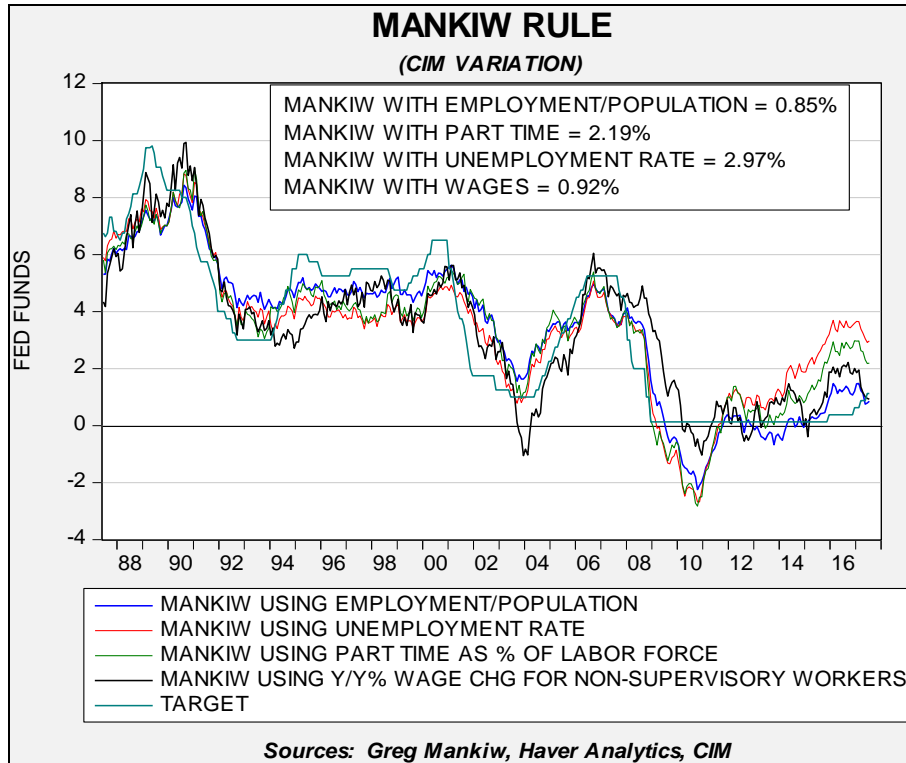
(Source: Bloomberg)

This chart overlays the VIX ETF (VXX, 13.29) and the inverse VIX ETF (XIV, 78.18). Over the past five years, holders of the VXX have suffered huge losses, while holders of the XIV have done well, especially since mid-2016. Obviously, yesterday we did see a spike in volatility and the XIV dropped sharply. Our concern is that investors have taken the “don’t fight the Fed” advice with regard to the third mandate and have increasingly shorted volatility. The problem is that the Fed doesn’t have direct control over financial stress. Thus, this positioning by investors aligns with the goals of policymakers; sadly, policymakers lack the tools to enforce their goals. Shorting volatility is a bit like “pocketing nickels in front of freight trains.” The position works well most of the time but, when it doesn’t, the reversals can be significant. Our worry is that if investors decide to abandon these short volatility positions, it could lead to selling pressure in the equity markets as money managers who target volatility will be forced to reduce share levels as volatility rises.

With the release of the CPI data and yesterday’s FOMC action, we can upgrade the Mankiw models. The dip in the core CPI rate (see below) did affect the Mankiw Rule model results.

The Mankiw rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw’s model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the

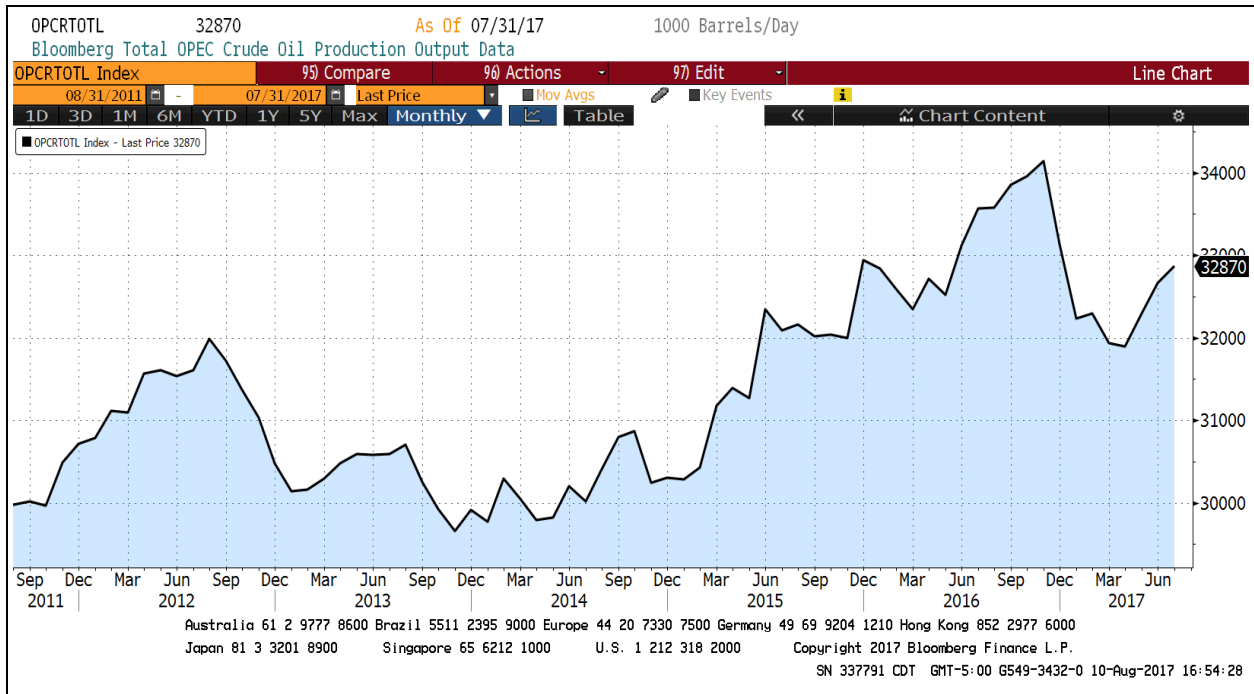
unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.



Using the unemployment rate, the neutral rate is now 2.97%. Using the employment/population ratio, the neutral rate is 0.85%. Using involuntary part-time employment, the neutral rate is 2.19%. Using wage growth for non-supervisory workers, the neutral rate is 0.92%. There wasn't much change from last month; two of the models, the employment/population ratio and non-supervisory wage growth, are suggesting the Fed has achieved neutral policy. The other two remain elevated and indicate that 200 bps of tightening are necessary to achieve neutral.

To a great extent, the issue for policymakers remains the proper measure of slack. The danger for the financial markets is that the proper measure is either wage growth or the employment/population ratio but policymakers believe slack is best measured by either involuntary part-time employment or the unemployment rate. If one of the latter two is their measure, policymakers will likely overtighten and prompt a recession. Since inflation remains tame, it probably makes sense for the Fed to hold steady for a while to see if inflation does accelerate. That's what we expect the FOMC to do; so does the market. Fed funds futures are not looking for another rate hike until mid-2018, which is why the dollar is weakening. As long as inflation remains tame, the pace of hikes will remain slow.

OPEC woes: As we noted yesterday, U.S. commercial crude inventories contracted sharply and have fallen rather impressively this summer. However, oil prices remain stalled on worries that OPEC output discipline is weakening. The data support that concern.



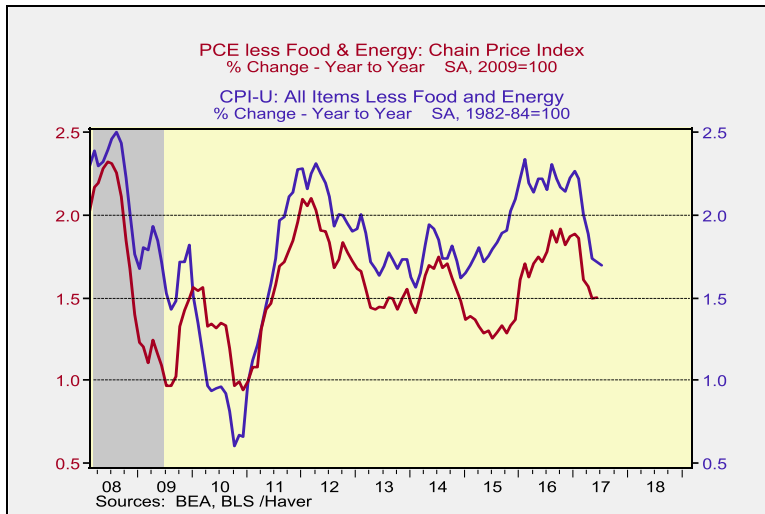
(Source: Bloomberg)

This chart shows the Bloomberg estimate of OPEC production, which is consistent with other sources of this data. Since March, OPEC output has jumped almost 0.9 mbpd, with much of that coming from states that were not given quotas, such as Nigeria and Libya. Saudi Arabia needs to press the other members to bring this production down if it wants oil prices to rise further.

Grain woes: Grain prices plunged yesterday after the USDA lifted production and ending inventory estimates for corn and soybeans. The government also lowered its estimates for prices and farm incomes. Higher inventories and lower prices will put economic pressure on the agriculture sector and give some leverage to China in trade talks. After all, the economic pressures in the farm belt would be exacerbated if China were to retaliate against American farm products due to trade restrictions it faces from the U.S.

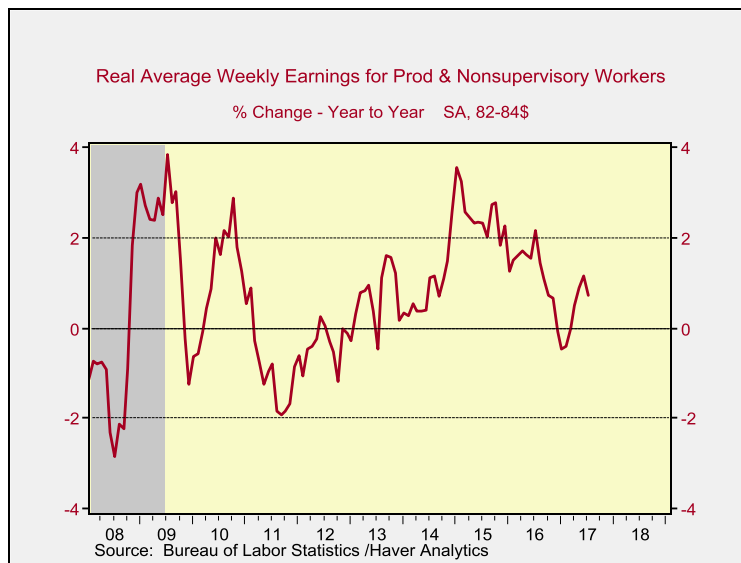
U.S. Economic Releases

CPI came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%. Core CPI came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%.



The chart above shows the year-over-year change in core CPI and core PCE. It is worth noting that even though CPI is the most commonly used inflation gauge, the Fed's preferred measure is the PCE. Declining CPI suggests that inflation is weakening; if PCE were to follow this trend in its upcoming report, we believe the Fed would reconsider the pace of rate hikes.

Real average weekly earnings rose by 1.1% from the prior year. The prior report was revised upward from 1.1% to 1.2%. Real average hourly earnings rose by 0.7% from the prior year. The prior report was revised upward from 0.8% to 0.9%.



The chart above shows the year-over-year change in real average weekly earnings for production and non-supervisory workers. A decline in earnings suggests that there is still slack in the labor market.

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	Speaker or event	District or position
11:30	Neel Kashkari speaks at Minneapolis	President of the Federal Reserve Bank of Minneapolis

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								
India	Local Car Sales	m/m	jul	192773	136895		**	Equity and bond neutral
	Industrial Production	y/y	jun	-0.1%	1.7%	0.1%	***	Equity bearish, bond bullish
New Zealand	REINZ House Sales	y/y	jul	-24.5%	-24.7%		**	Equity and bond neutral
	BusinessNZ Manufacturing PMI	y/y	jul	55.4	56.2		**	Equity and bond neutral
	Food Prices	m/m	jun	-0.2%	0.2%		**	Equity and bond neutral
EUROPE								
Germany	Wholesale Price Index	y/y	jul	2.2%	2.5%		**	Equity and bond neutral
	CPI	y/y	jul	1.7%	1.7%	1.7%	***	Equity and bond neutral
Italy	CPI EU Harmonized	y/y	jul	1.2%	1.2%	1.2%	***	Equity and bond neutral
France	CPI	y/y	jul	0.7%	0.7%	0.7%	***	Equity and bond neutral
	Wages	q/q	2q	0.4%	0.6%		**	Equity and bond neutral
AMERICAS								
Canada	New Housing Price Index	m/m	jun	0.2%	0.7%	0.5%	**	Equity bearish, bond bullish
Mexico	Nominal Wages	m/m	jul	5.8%	5.2%		***	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)	131	131	0	Up
3-mo T-bill yield (bps)	101	102	-1	Neutral
TED spread (bps)	30	29	1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.20	2.20	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	26	26	0	Up
Currencies	Direction			
dollar	up			Neutral
euro	down			Up
yen	up			Neutral
pound	up			Down
franc	up			Down
Central Bank Action		Prior	Expected	
Overnight Rate	7.000%	7.000%	7.000%	On forecast
RBNZ Official Rate	1.750%	1.750%	1.750%	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	\$51.66	\$51.90	-0.46%	Bearish IEA report
WTI	\$48.30	\$48.59	-0.60%	
Natural Gas	\$2.98	\$2.99	-0.20%	
Crack Spread	\$19.23	\$19.13	0.55%	
12-mo strip crack	\$17.34	\$17.37	-0.18%	
Ethanol rack	\$1.72	\$1.72	-0.20%	
Metals				
Gold	\$1,287.15	\$1,286.53	0.05%	
Silver	\$17.10	\$17.12	-0.13%	
Copper contract	\$289.20	\$290.30	-0.38%	
Grains				
Corn contract	\$ 371.75	\$ 371.00	0.20%	
Wheat contract	\$ 467.25	\$ 468.75	-0.32%	
Soybeans contract	\$ 942.75	\$ 940.25	0.27%	
Shipping				
Baltic Dry Freight	1092	1050	42	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)	-6.5	-2.1	-4.4	
Gasoline (mb)	3.4	-1.8	5.2	
Distillates (mb)	-1.7	0.5	-2.2	
Refinery run rates (%)	0.90%	0.50%	0.40%	
Natural gas (bcf)	28.0	36.0	-8.0	

Weather

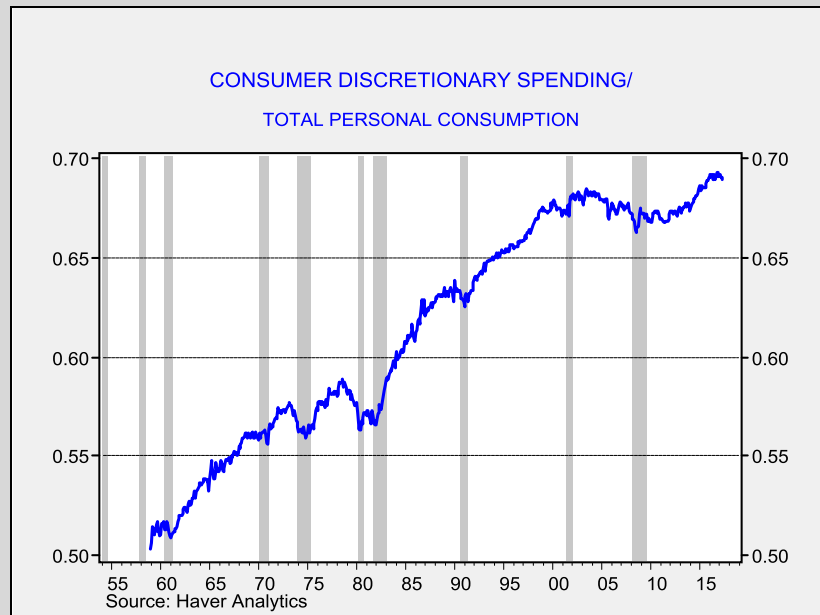
The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, with warmer temperatures expected for the western and southern regions. Precipitation is expected for the eastern half of the country. There is a slight chance of cyclone formation off the coast of Florida, although nothing appears imminent over the next 48 hours.

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.

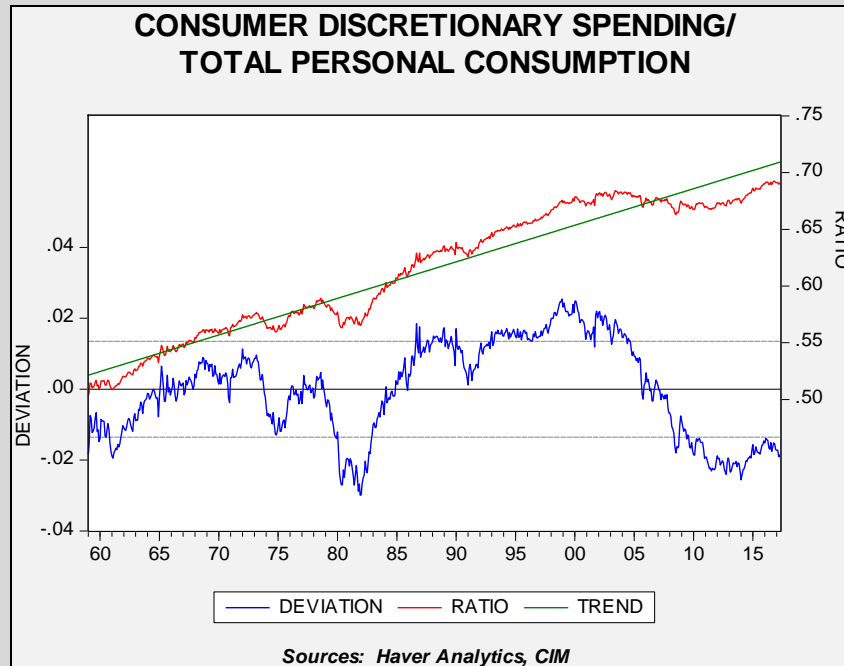
August 11, 2017

Although measuring “malaise” is more art than science, overall feelings of wellbeing or the lack thereof affect markets, politics, etc. One less common way to measure this is the ratio between discretionary spending compared to overall spending. Discretionary spending is defined as total spending less what is spent on food, clothing, energy and housing. In other words, if a household is able to spend more on other items besides these goods, one would expect “happier” people. Spending more on necessities, on the other hand, can make households feel as if they “can’t get ahead.”



This chart shows the ratio of consumer discretionary spending to total personal consumption. A higher ratio means that households are spending more on discretionary items and less on food, clothing, gas, heat and rent. Although the ratio has generally increased since the late 1950s, there have been two periods when the pace of improvement slowed, in the 1970s and since 2000.

To better analyze the behavior of this ratio, we regressed the ratio against a time trend.



There have been four periods when this ratio was significantly below trend. The first was in the early 1960s. John F. Kennedy’s presidential campaign promised to get America moving again after the somnolent 1950s. The second occurred during the deep 1973-75 recession, which coincided with the first energy crisis. The third occurred during the late 1970s into the early 1980s; this period featured a “double dip” recession and another energy crisis. The 1970s also had major political problems, including the Nixon resignation and the difficult presidency of Jimmy Carter.

The most recent event has been the longest. The major recession of 2007-09 coupled with a slow recovery and stagnant income growth has led to a period where necessities are taking up a bigger share of spending relative to trend. It coincides with deep political divisions and a fear among many Americans that stagnation is never-ending.

To some extent, this is an imperfect measure of sentiment. After all, the trend will eventually reach 100%, which would mean that spending on the four necessities would need to fall to zero (either we stop eating, wearing clothes, driving and living in homes or apartments) or the cost of these goods would approach zero. Neither scenario is likely. Still, the fact that spending on necessities is higher than trend relative to other spending has proven, historically, to signal social and political problems. As one who lived through President Carter’s “malaise” speech, the feeling in the late 1970s was rather bleak. Ronald Reagan’s optimism was key to lifting the country out of this funk. The fall in inflation that allowed households to spend less on necessities did the rest.

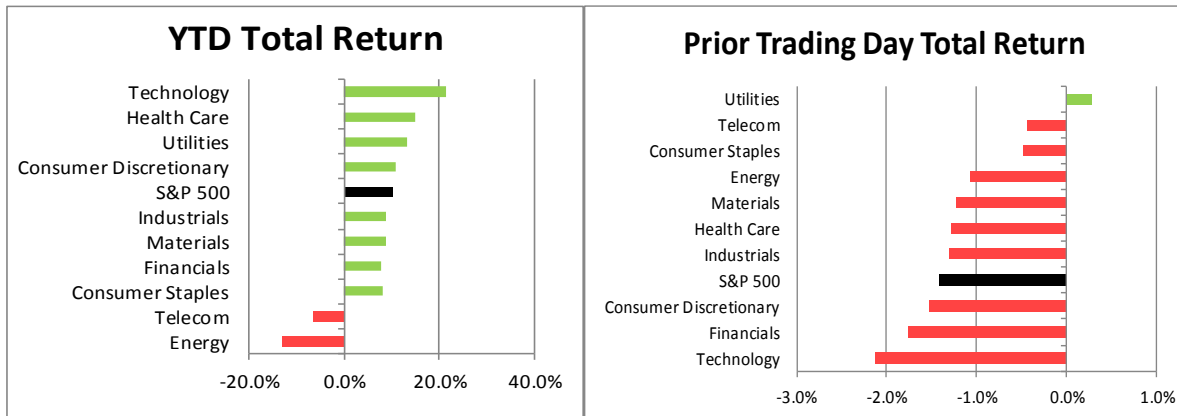
So far, this period of below-trend spending on discretionary goods has not adversely affected financial markets. However, it is clearly having an impact on the current political situation and, at some point, it could affect market confidence. We monitor these conditions closely and are somewhat heartened by the recent improvement in this ratio. However, this time around, falling

prices for energy and food probably won't be enough to raise this ratio. Rising wages for the bulk of American households is probably the only way to lift this ratio back to trend.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

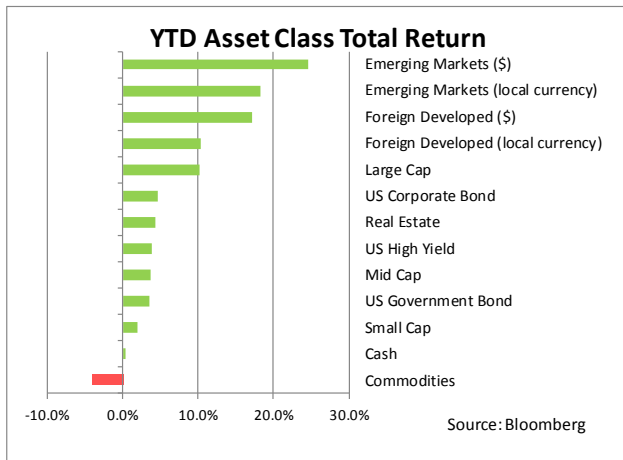
U.S. Equity Markets – (as of 8/10/2017 close)



(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 8/10/2017 close)



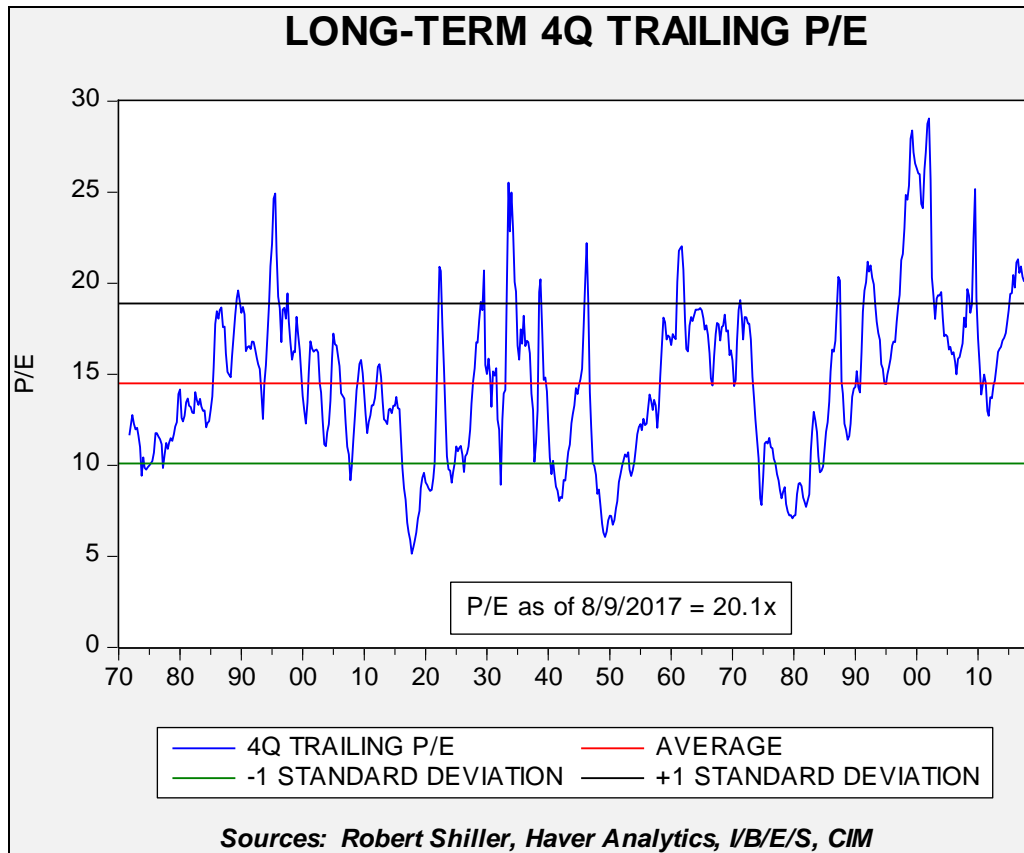
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 10, 2017



Based on our methodology,¹ 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.

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 (Q4, Q1) and two estimates (Q2, Q3). 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.