Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: August 15, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.4% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a higher open. With 456 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, 72.6% of the companies reported earnings above forecast, while 18.2% reported earnings below forecast.

Markets are calming down. Here's what we are tracking this morning:

North Korea blinks: According to numerous reports, the military leadership of the Democratic People's Republic of Korea (DPRK) offered plans to Kim Jong-un for a missile test around the U.S. territory of Guam. After reviewing the plans, the "young marshal" decided to postpone any attacks. There has been a definite cooling of tensions since rhetoric intensified last week. As noted before, the U.S. military has not mobilized for an extended attack. U.S. military leaders have been stressing the need for diplomacy. South Korea's president indicated that "only the Republic of Korea (South Korea) can make the decision for military action on the Korean Peninsula."[1] Although President Moon is partially correct in his assessment, in that the U.S. can't dictate a ground war on the peninsula, an attack on Guam would lead to a U.S. response regardless of South Korea's position. Still, as tensions ease, we are seeing a reversal of risk trades—the dollar is higher, gold and Treasury prices are falling and equities are improving (today's retail sales data, shown below, have accelerated these trends).

The next North Korea? Iranian President Rouhani indicated today that his country could quit the nuclear deal "within hours" if new U.S. sanctions are imposed. Recently, the U.S. has applied unilateral sanctions on six Iranian companies for their work on Iran's ballistic missile program. The Trump administration argues that Iran's missile tests and development violate the 2015 nuclear deal; Iran denies that their conduct bars such activity. If relations between the U.S. and Iran continue to deteriorate and the nuclear deal ends, we expect Iran to rapidly move to build a deliverable weapon. This outcome would be quite negative. First, Israel will likely view this as an existential threat and could strike Iran with its own (so far undeclared) nuclear weapons. Second, even if military action doesn't occur, a nuclear Iran will very likely create a nuclear arms race in the region and, given the instability of these regimes, the chances increase for either a nuclear accident or a rogue government with a nuke. The Iran nuclear deal probably

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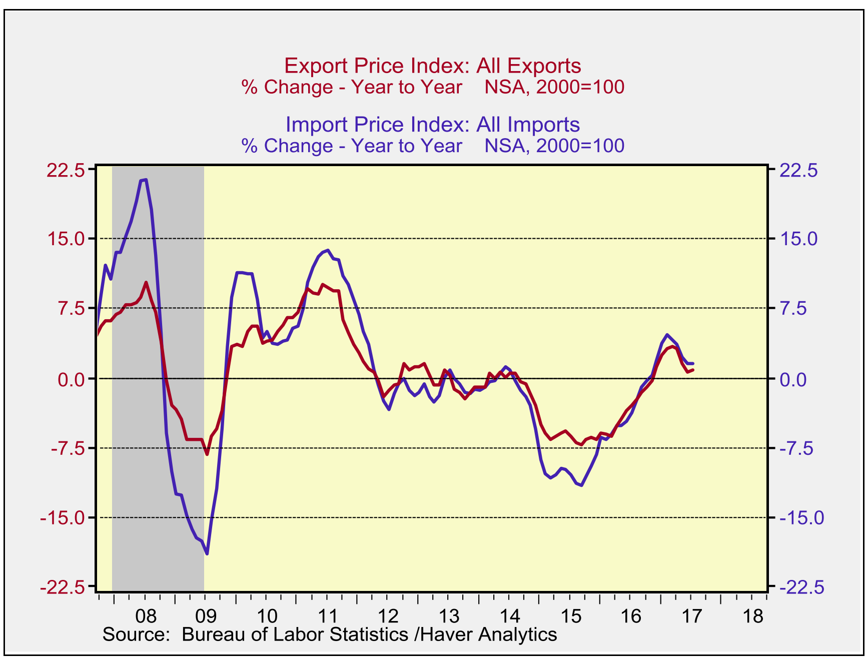
[1] https://www.ft.com/content/2de5c7ce-815f-11e7-a4ce-15b2513cb3ff?emailId=599271a28146910004bcb96f&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 (paywall)

was nothing more than “kicking the can down the road.” However, the end of “can kicking” has its own problems and it isn’t clear that the U.S. has the bandwidth to handle increasing problems in the Far East and the Middle East simultaneously. Additionally, we would fully expect the Putin regime to take advantage of American distraction if conditions in the Middle East deteriorate.

Germany signals to the ECB: German Finance Minister Schäuble indicated today that the European Central Bank’s ultra-loose monetary policy would come to an end in the “foreseeable future.” However, he also indicated that rates would remain low. Germany has not been comfortable with ECB monetary policy for some time and monetary policy is probably too loose given the strength of the economy. The EUR has been appreciating this year due to a combination of tighter ECB policy expectations, an overvalued dollar and disappointment that dollar bullish policies (e.g., border adjustment tax, infrastructure spending, etc.) expected when Trump was elected have failed to materialize. It should be noted that Schäuble’s comments were made at a campaign rally; Germany, a net saving nation, feels it is being unfairly penalized with low interest rates. So, his comments were well received.

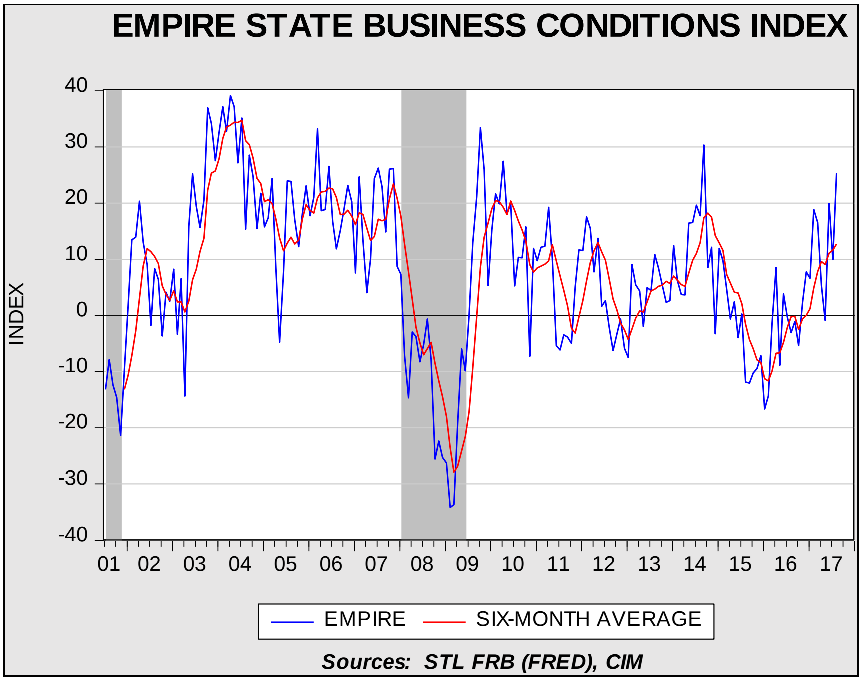
U.S. Economic Releases

The import price index came in line with expectations, rising 0.1% from the prior month. The import price index excluding petroleum came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.1%. The export price index came in above expectations, rising 0.4% from the prior month compared to the forecast rise of 0.2%.



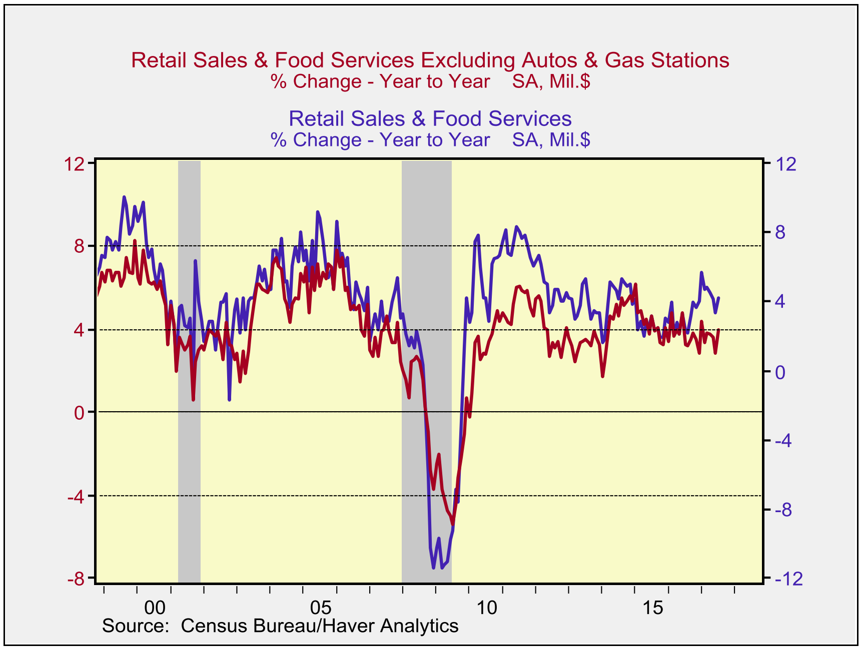
The chart above shows the year-over-year change in the import price index and export price index. The import price index and the export price index rose 1.5% and 0.8%, respectively. This report is somewhat uneventful and therefore unlikely to have an impact on Fed decision-making.

Empire manufacturing came in above expectations at 25.2 compared to the forecast of 10.0.



The chart above shows the six-month moving average of the Empire State Business Conditions Index.

Retail sales came in above expectations, rising 0.6% from the prior month compared to the forecast of a 0.3% rise. The prior report was revised upward from a fall of 0.2% to a rise of 0.3%. Retail sales excluding autos came in above expectations, rising 0.5% from the prior month compared to the forecast rise of 0.3%. The prior report was revised upward from a fall of 0.2% to a rise of 0.1%. Retail sales excluding auto and gas came in above expectations at 0.5% from the prior month compared to the forecast of 0.4%. The retail sales control group came in above expectations, rising 0.6% from the prior month compared to the forecast rise of 0.4%.



The chart above shows the year-over-year change in retail sales and core retail sales. The rise in retail sales suggests that the economy may be gaining momentum.

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

Economic Releases						
10:00	NAHB Housing Market Index	m/m	aug	64	64	**
10:00	Business Inventories	m/m	jun	0.4%	0.3%	**
16:00	Total Net TIC Flows	m/m	jun		$57.3 bn	**
16:00	Net Long-term TIC Flows	m/m	jun		$91.9 bn	**
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								
China	Money Supply M2	y/y	jul	9.2%	9.4%	9.5%	*	Equity and bond neutral
	Money Supply M1	y/y	jul	15.3%	15.0%	14.0%	*	Equity and bond neutral
	Money Supply M0	y/y	jul	6.1%	6.6%	6.5%	*	Equity and bond neutral
	New Yuan Loans	y/y	jul	0.826 tn	1.54 tn	0.800 tn	*	Equity and bond neutral
	Aggregate Financing	y/y	jul	1.22 tn	1.78 tn	1.00 tn	*	Equity and bond neutral
Japan	Tokyo Condominium Sales	y/y	jul	3.3%	-25.1%		*	Equity and bond neutral
	Industrial Production	y/y	jun	5.5%	4.9%		***	Equity and bond neutral
	Capacity Utilization	m/m	jun	2.1%	-4.1%		**	Equity and bond neutral
India	CPI	y/y	jul	2.4%	1.5%	2.1%	**	Equity bullish, bond bearish
	Trade Balance	m/m	jul	-$11.450 tn	-$12.960 tn	-$12.000 tn	**	Equity bullish, bond bearish
	Exports	y/y	jul	3.9%	4.4%		**	Equity and bond neutral
	Imports	y/y	jul	15.4%	19.0%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	aug	111.7	113.7		**	Equity and bond neutral
	New Motor Vehicle Sales	y/y	jul	1.8%	3.6%		*	Equity and bond neutral
EUROPE								
Germany	GDP	y/y	2q	2.1%	1.7%	1.9%	***	Equity bullish, bond bearish
UK	CPI	y/y	jul	2.6%	2.6%	2.7%	***	Equity and bond neutral
	CPI core	y/y	jul	2.4%	2.4%	2.5%	***	Equity and bond neutral
	RPI	y/y	jul	3.6%	3.5%	3.5%	**	Equity and bond neutral
	PPI Input	y/y	jul	6.5%	9.9%	6.9%	**	Equity and bond neutral
	PPI Output	y/y	jul	3.2%	3.3%	3.1%	**	Equity and bond neutral
	PPI Output Core	y/y	jul	2.4%	2.9%	2.5%	**	Equity and bond neutral
	House Price Index	y/y	jun	4.9%	4.7%	4.3%	**	Equity bullish, bond bearish
Switzerland	Producer & Import Prices	y/y	jul	-0.1%	-0.1%	0.0%	**	Equity and bond neutral
AMERICAS								
Canada	Teranet/ National Bank HPI	m/m	jul	14.2%	14.2%		**	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)	132	131	1	Up
3-mo T-bill yield (bps)	99	100	-1	Neutral
TED spread (bps)	32	31	1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.26	2.22	0.04	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	30	30	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	down			Down
franc	down			Down

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	$50.31	$50.73	-0.83%	Long Liquidation
WTI	$47.30	$47.59	-0.61%	
Natural Gas	$2.94	$2.96	-0.54%	
Crack Spread	$19.02	$19.04	-0.07%	
12-mo strip crack	$17.08	$17.15	-0.42%	
Ethanol rack	$1.73	$1.73	-0.12%	
Metals				
Gold	$1,273.85	$1,282.15	-0.65%	Stronger Dollar
Silver	$16.86	$17.08	-1.28%	
Copper contract	$290.65	$290.45	0.07%	
Grains				
Corn contract	$ 372.00	$ 376.25	-1.13%	Weather Conditions
Wheat contract	$ 462.25	$ 467.75	-1.18%	
Soybeans contract	$ 933.50	$ 938.25	-0.51%	
Shipping				
Baltic Dry Freight	1155	1138	17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.6		
Gasoline (mb)		-1.0		
Distillates (mb)		-0.3		
Refinery run rates (%)		-0.50%		

Weather

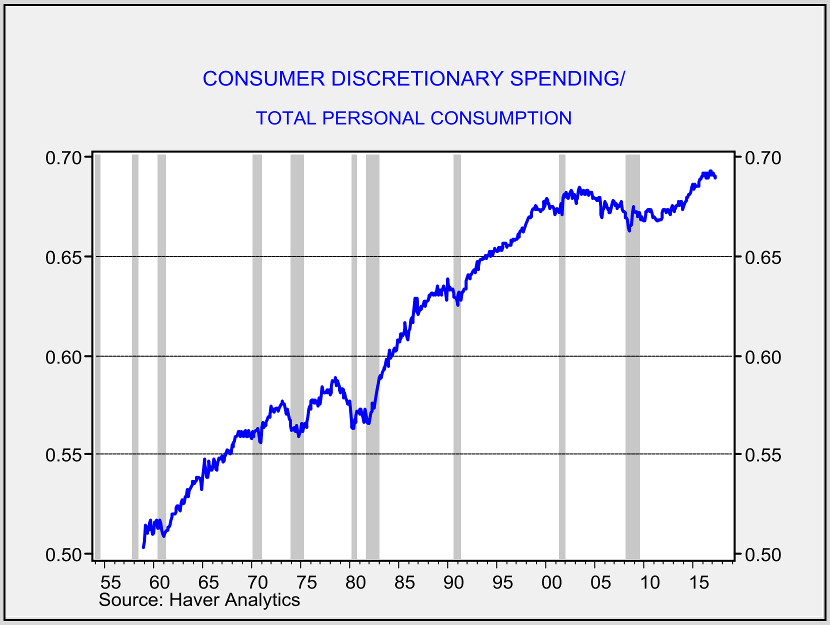
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temperatures expected for the northwestern regions. Precipitation is expected for the eastern half of the country. Tropical Storm Gert has strengthened into a hurricane and is moving along the Atlantic coast; it is not expected to make landfall.

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.

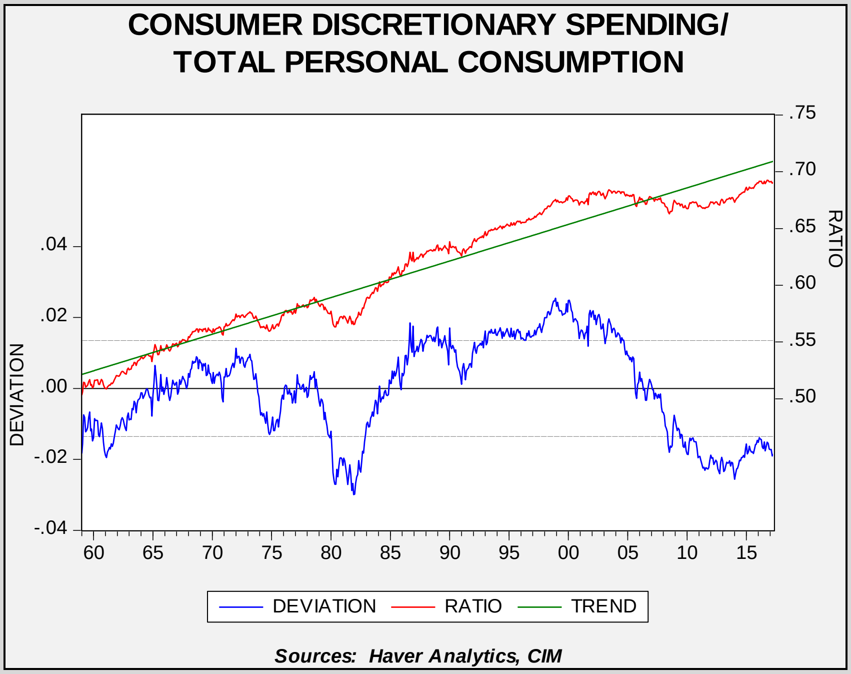
August 11, 2017

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.

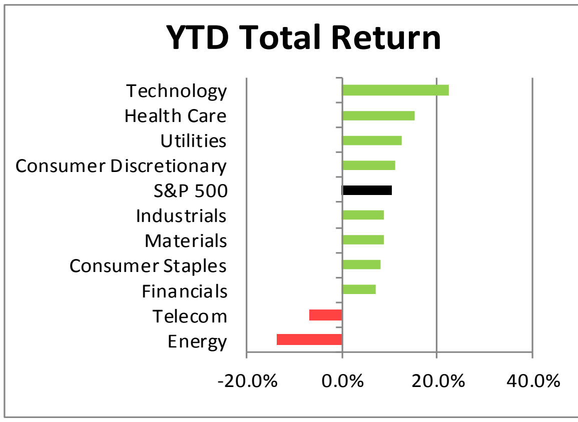
The most recent event has been the longest. The major recession of 2007-09 coupled with a slow recovery and stagnant income growth has led to a period where necessities are taking up a bigger share of spending relative to trend. It coincides with deep political divisions and a fear among many Americans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

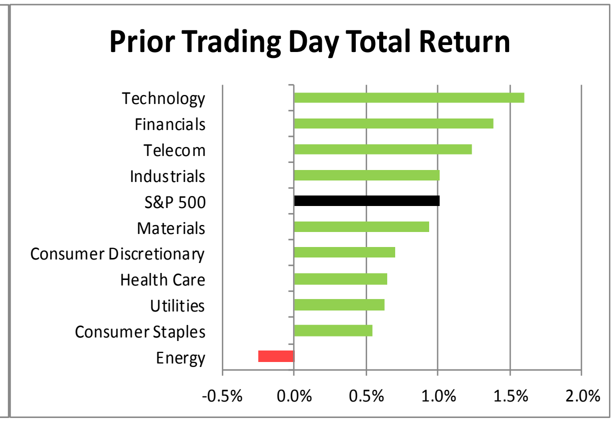
To some extent, this is an imperfect measure of sentiment. After all, the trend will eventually reach 100%, which would mean that spending on the four necessities would need to fall to zero (either we stop eating, wearing clothes, driving and living in homes or apartments) or the cost of these goods 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.

Data Section

U.S. Equity Markets – (as of 8/14/2017 close)

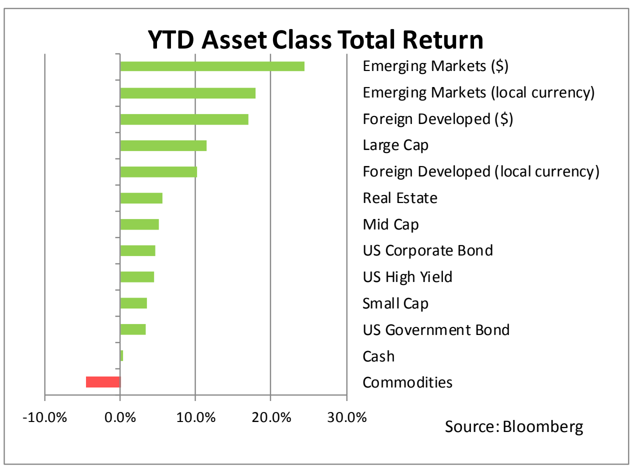




(Source: Bloomberg)

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 8/14/2017 close)

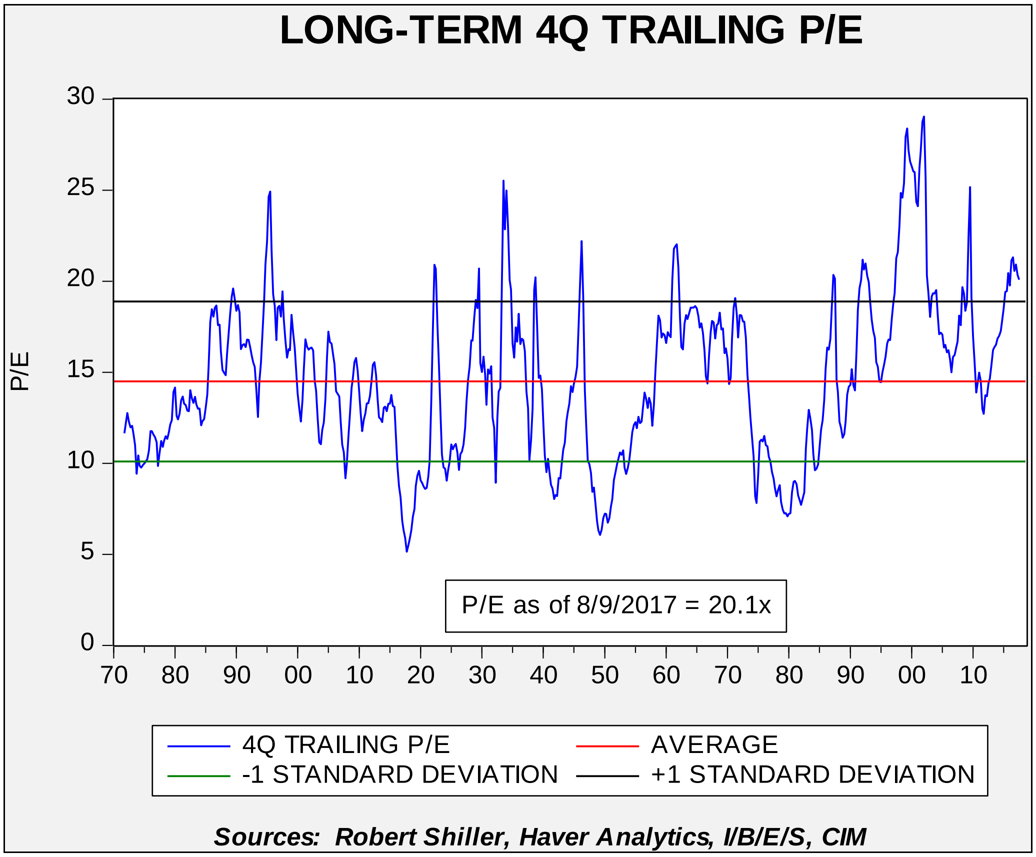


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[2] 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.