Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: August 1, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were up, with the Shanghai composite up 0.6% and the Shenzhen index up 0.2%. U.S. equity index futures are signaling a higher open. With 292 companies having reported, the S&P 500 Q2 earnings stand at $32.19, higher than the $31.42 forecast for the quarter. The forecast reflects a 6.5% increase from Q2 2016 earnings. Thus far this quarter, 71.2% of the companies reported earnings above forecast, while 19.2% reported earnings below forecast.

Global equity markets are higher this morning on the second day of Gen. Kelly's tour as Chief of Staff (CoS). Here are the news items we are watching:

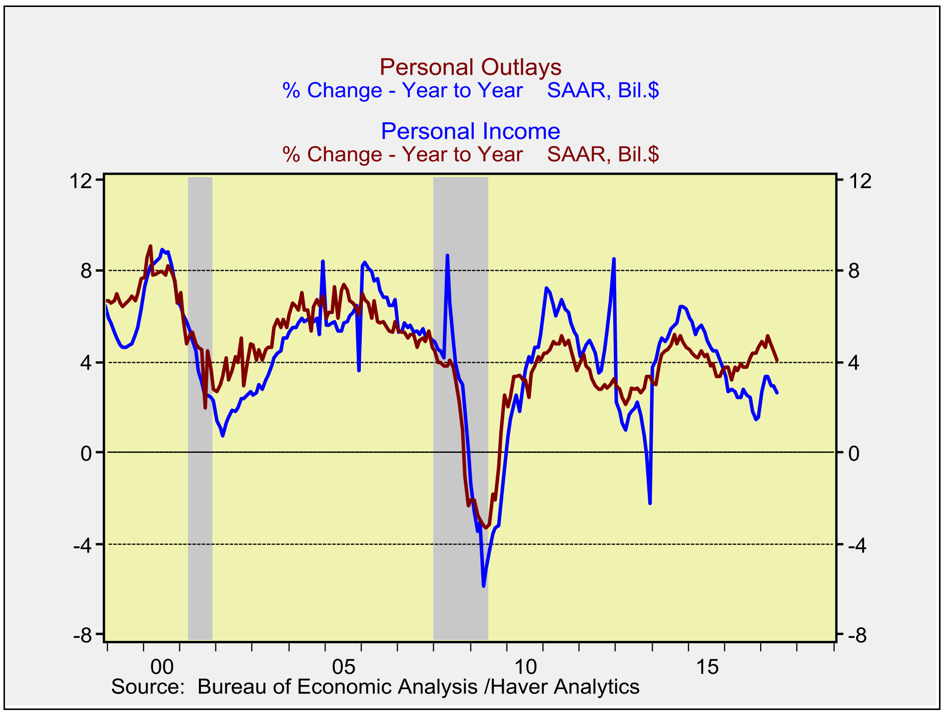
The "Mooch" is out: Anthony Scaramucci left his role as communications director. It isn't completely clear if he was fired or resigned but, in reality, CoS Kelly wanted him gone. This is a warning shot to the White House staff that a new regime is in place. Kelly has apparently moved to restrict access to the president and to better control the processes within the White House. This order is desperately needed. The U.S. is facing rapidly escalating challenges and a dysfunctional executive branch is not helpful. Kelly's appointment is potentially the first step toward bringing order. Sadly, a lot of political capital has been squandered and thus the administration's ability to meet its goals is reduced.

Stepping up tensions with Russia: VP Pence is traveling in the Russian "near abroad," speaking in Estonia and Georgia. He spoke in both places—in the latter, he offered U.S. support for adding Georgia to NATO, and in the former, he reassured leaders there that the U.S. is prepared to continue its defense via NATO and supports putting the Patriot missile system in the Baltic state. The Pentagon has proposed supplying Ukraine with anti-tank weapons, a move opposed by both France and Germany. The president would have to approve the arms sales to Ukraine; we expect he will. Pence's comments will escalate tensions with Russia, and it isn't obvious that the U.S. is prepared for conflict in Europe. Meanwhile, Russia is sending up to 100k troops to the eastern edge of NATO territory as part of military exercises.

Tensions rise in Venezuela: The Maduro government, in the wake of Sunday's election, has re-arrested two opposition leaders, Antonio Ledezma and Leopoldo Lopez. The U.S. has applied personal sanctions on President Maduro and other sanctions are being considered. Venezuela is moving rapidly to end democracy and install an authoritarian regime. The key question is, "Can the country afford it?" The Venezuelan economy is in shambles, with accelerating inflation and growing shortages of essential items. One problem that hasn't gotten much attention is increasing emigration. Until recently, most of those fleeing the country have been in the upper and upper-middle classes. Evidence of their flight can be found in Florida real estate.[1] The next wave will likely be less affluent Venezuelans fleeing malnutrition and political chaos. They will, at least initially, end up in neighboring countries but we wouldn't be surprised to see them eventually attempt to come to the U.S.

U.S. Economic Releases

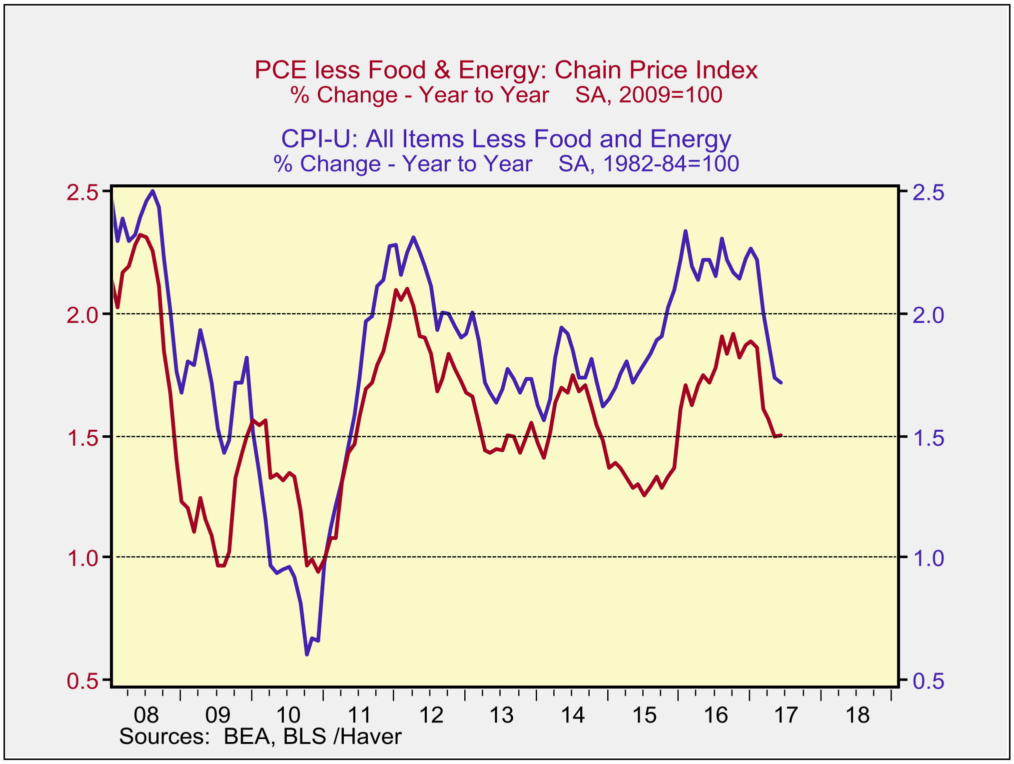
Personal income came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.4%. The prior month's gain was revised downward from 0.4% to 0.3%. Personal spending came in line with forecasts, rising 0.1% from the prior month. The prior month's gain was revised upward from 0.1% to 0.2%. Real personal spending came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.1%. The prior month's gain was revised upward from 0.1% to 0.2%.



The chart above shows the year-over-year change in consumer spending and personal income. Weakening personal income growth can have a constraining effect on demand, which can slow inflation.

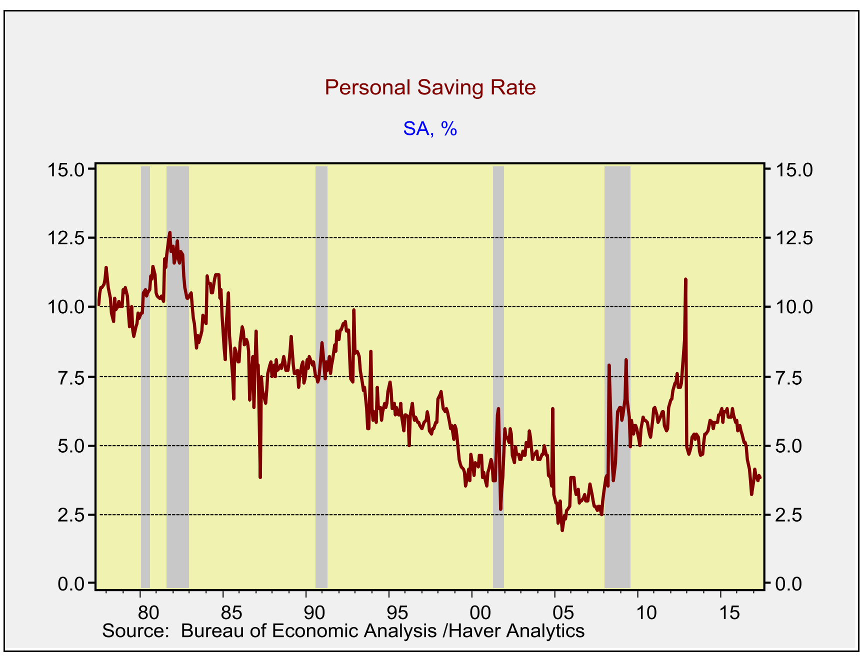
The PCE deflator was in line with forecasts, remaining unchanged from the prior month. Core PCE was also in line with expectations, rising 0.1% from the prior month.

[1] https://therealdeal.com/miami/2017/07/30/venezuelan-flight-capital-takes-multiple-routes-to-south-florida/



The chart above shows the year-over-year change for 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.

Finally, the savings rate remained mostly steady at 3.8% of after-tax income.



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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	jul	53.2	53.2	**
10:00	ISM Manfacturing Composite	m/m	jul	56.5	57.8	**
10:00	ISM Prices Paid	m/m	jul	55.8	55.0	**
10:00	ISM New Orders	m/m	jul		63.5	**
10:00	ISM Employments	m/m	jul		57.2	**
10:00	Construction Spending	m/m	jun	0.4%	0.0%	**
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	Caixin China PMI Mfg	m/m	jun	51.1	50.4	50.4	**	Equity bullish, bond bearish
Japan	Nikkei Japan PMI Mfg	m/m	jul	52.1	52.2		**	Equity and bond neutral
	Vehicle Sales	y/y	jul	-1.1%	9.7%		*	Equity and bond neutral
India	Nikkei India PMI mfg	y/y	jul	47.9	50.9		**	Equity and bond neutral
Australia	Commonwealth Bank Australia PMI	m/m	jul	54.4	56.2		**	Equity and bond neutral
	AiG Perf of Mfg Index	m/m	jul	118.4	115.1		**	Equity and bond neutral
	CoreLogic House Px	m/m	jul	1.5%	1.8%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	y/y	jul	56.6	56.8	56.8	**	Equity and bond neutral
	GDP	m/m	2q	2.1%	1.9%	2.1%	***	Equity and bond neutral
Germany	Markit/ BME Germany Manufacturing	m/m	jul	58.1	58.3	58.3	**	Equity and bond neutral
	Unemployment Change	m/m	jul	-9k	7k	-5k	**	Equity bullish, bond bearish
	Unemployment Claims Rate	m/m	jul	5.7%	5.7%	5.7%	***	Equity and bond neutral
France	Markit France Manufacturing PMI	m/m	jul	54.9	55.4	55.4	**	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing PMI	y/y	jul	55.1	55.2	55.0	**	Equity and bond neutral
UK	Nationwide House Px	y/y	jul	2.9%	3.1%	2.9%	*	Equity and bond neutral
	Markit UK PMI Manufacturing	y/y	jul	55.1	54.3	54.5	**	Equity bullish, bond bearish
Russia	Markit Russia PMI mfg	m/m	jul	52.7	50.3	51.0	**	Equity bullish, bond bearish
AMERICAS								
Mexico	GDP	y/y	2Q	1.8%	2.8%	1.8%	***	Equity and bond neutral
Brazil	Industrial Production	y/y	jun	0.5%	-0.3%	0.8%	***	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)	105	104	1	Neutral
TED spread (bps)	27	27	0	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.30	2.30	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	27	27	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	up			Down
franc	up			Down
Central Bank Action		**Prior**	**Expected**	
RBA Cash Rate Target	1.50%	1.50%	1.50%	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	$52.40	$52.72	-0.61%	Long Liquidation
WTI	$49.96	$50.17	-0.42%	
Natural Gas	$2.82	$2.79	0.89%	
Crack Spread	$20.12	$20.12	0.01%	
12-mo strip crack	$17.38	$17.52	-0.80%	
Ethanol rack	$1.70	$1.70	-0.03%	
Metals				
Gold	$1,266.74	$1,269.44	-0.21%	
Silver	$16.74	$16.83	-0.54%	
Copper contract	$288.20	$289.15	-0.33%	
Grains				
Corn contract	$ 382.25	$ 384.75	-0.65%	Weather Conditions
Wheat contract	$ 474.50	$ 474.50	0.00%	
Soybeans contract	$ 993.75	$ 1,007.25	-1.34%	
Shipping				
Baltic Dry Freight	946	933	13	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.3		
Gasoline (mb)		-1.9		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.00%		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, with warmer temperatures for the western region. Precipitation is expected for most of the country. TS Emily has slowed to a depression and is now moving along the eastern coasts, expected to dissipate by Thursday.

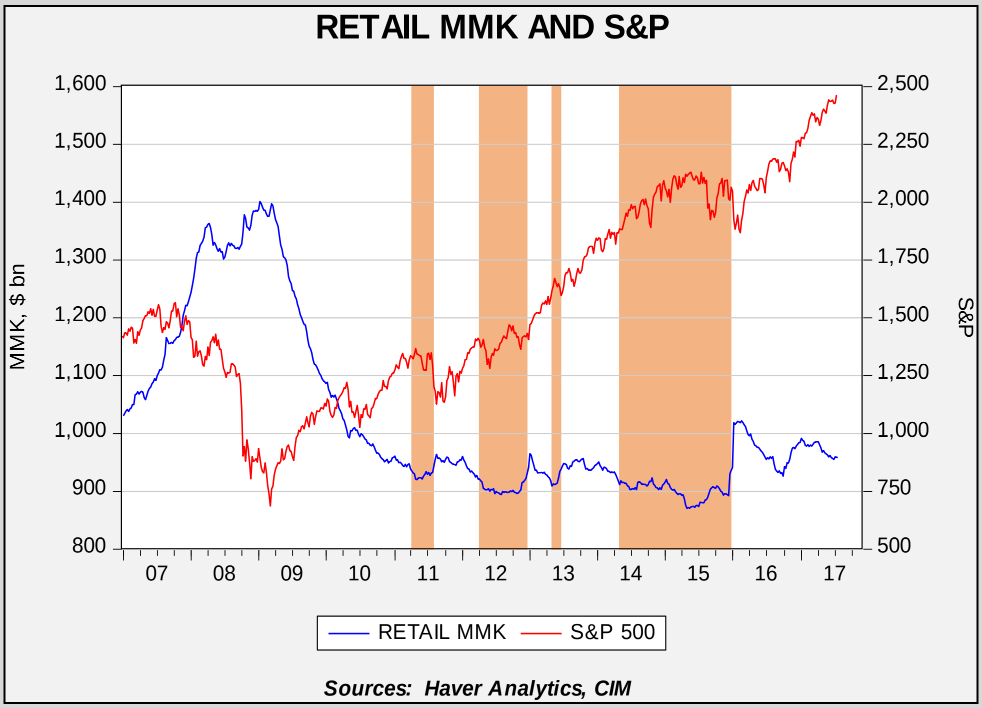
Asset Allocation Weekly Comment

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.

July 28, 2017

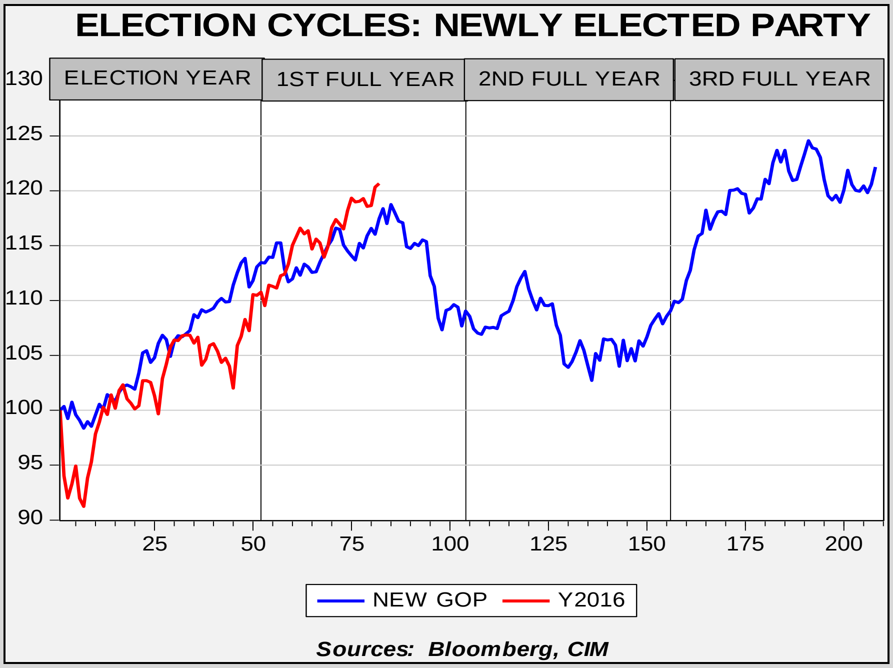
As the S&P 500 steadily rises to new highs, concerns about a correction will likely increase. Since 1987, major market pullbacks have been associated with recessions and there isn't much evidence to suggest the business cycle is set to turn. In the absence of a recession, we tend to look for factors that could trigger a market decline.

The first factor we are watching is liquidity.



This chart examines the S&P 500 on a weekly close basis compared to the level of retail money market funds. Since the Great Financial crisis, equity markets have tended to trend upward until money market fund levels fall to around $900 bn. These periods are shown in orange on the above chart. It appears that households are uncomfortable with cash levels much below this level and buying tends to "dry up" once money market assets fall to around $900 bn. Current cash levels appear ample which will probably support steady gains in equities.

Exogenous events are another factor. These can be political, social, geopolitical, etc. There is a myriad of potential events that could undermine investor sentiment, including instability in the Middle East, an escalation of tensions with North Korea, a debt ceiling crisis or disappointment on tax reform, to name a few. In terms of the usual political cycle, we are rapidly approaching a period where "disenchantment" sets in.

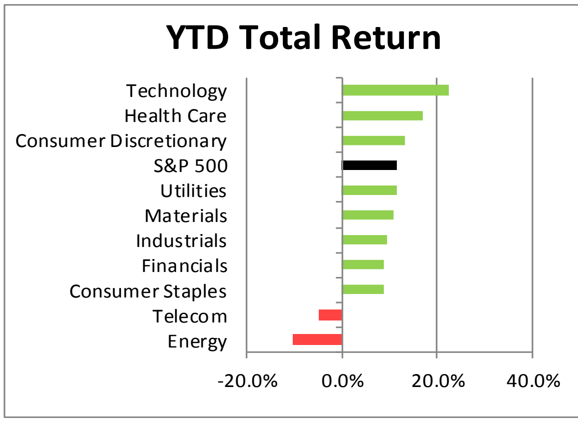


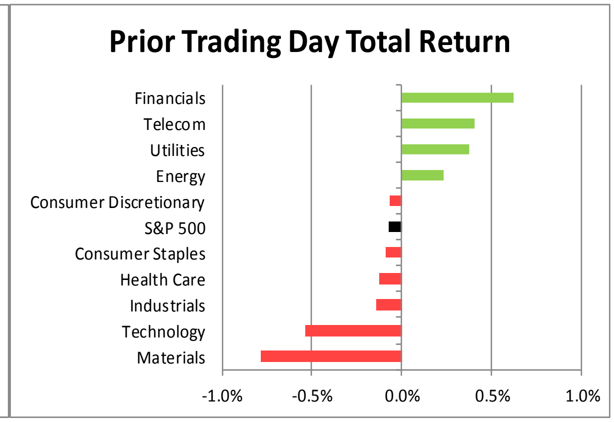
This chart shows the performance of the S&P 500 on a weekly close basis, indexed to the first weekly close of the election year. Our study begins in 1928. We have segregated new GOP administrations in the average and compared market action to the current administration. Although the fit isn't perfect, the general direction of the market under Trump is reasonably consistent with past incoming Republican presidents. If the pattern continues, this study would suggest a period of weakness is in the offing. We use these studies more for signals of trend, not necessarily as pure forecasts. And, because they are historical studies, their relevance is somewhat questionable in that the issues surrounding each administration are different. Still, the chart does suggest that a GOP win initially raises investor sentiment but this sentiment appears to deteriorate sometime in late summer of the first year in office, as the difficulties of legislating become more obvious. With the current turmoil in Washington, not to mention a broad set of geopolitical issues, a period of market turbulence would not be a shock.

Combining the two studies would suggest that there is enough available liquidity to prevent a significant pullback as suggested by the election year chart. We would not be surprised to see a few weeks of market consolidation, especially if tax reform talks stall or other issues arise. However, there is nothing in the data that suggests a recession is imminent and thus pullbacks in equities will probably be modest.

Data Section

U.S. Equity Markets – (as of 7/31/2017 close)

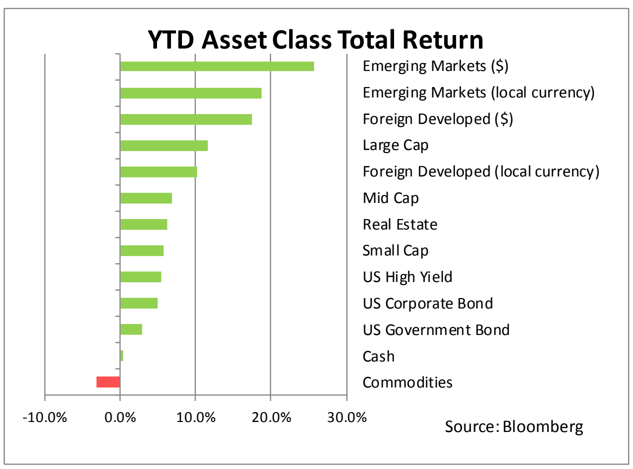




(Source: Bloomberg)

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 7/31/2017 close)

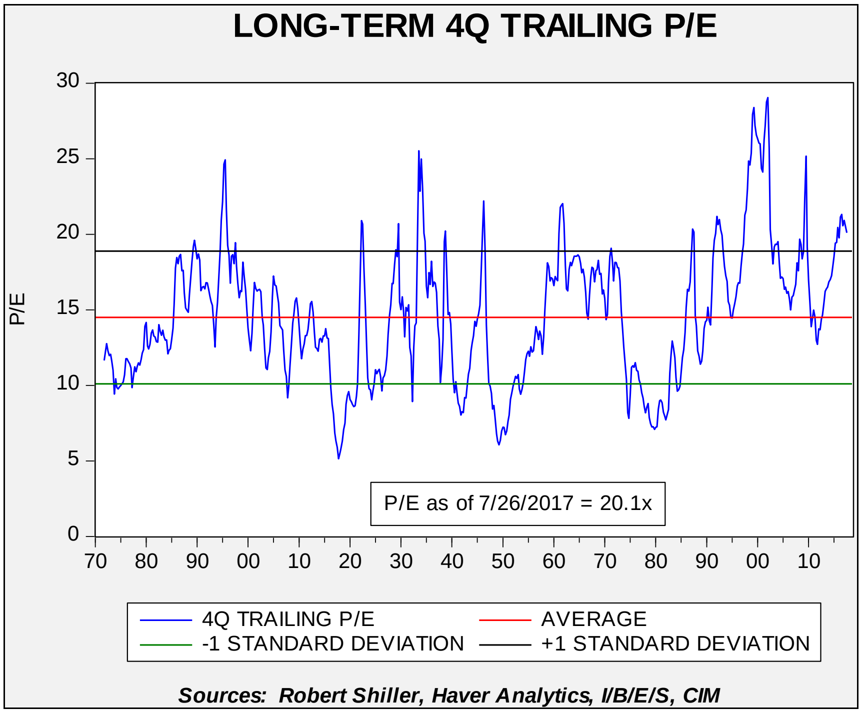


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 27, 2017



Based on our methodology,[2] the current P/E is 20.1x, up 0.1x from last week. The increase in the multiple is due to rising equity prices.

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.

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[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.