Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: August 23, 2017—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.1% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a lower open.

Trump attacks Washington and the media: President Trump made his first major speech on immigration yesterday in Phoenix, Arizona, during which he placated his base by threatening to shut down the government if the border wall isn't funded, alluding to a withdrawal from NAFTA and attacking the media. His speech will likely heighten tensions within the GOP as it appears the president is willing to protect his base at all costs even if it means challenging members of his own party. In recent weeks, Republicans have become increasingly concerned with the president's handling of domestic events and many have expressed reservations about funding a border wall due to the impact it may have on the national debt. His threat to shut down the government appears to be a rebuke of Mitch McConnell, who stated earlier this month that there was a zero percent chance of that happening. Trump's speech will likely increase the rift in his relationship with McConnell, which reports suggest was caused by the failure to repeal Obamacare.

Soft power diplomacy: Trump's foreign policy shift seems to have taken root with increased actions against China, Russia and Egypt. Yesterday, the *WSJ* reported that the U.S. Treasury has expanded its sanctions to firms in Russia and China due to their involvement in Pyongyang's nuclear and ballistic missile program. The escalation of sanctions is aimed at forcing North Korea to the negotiating table. Additionally, the *Washington Post* reported that the State Department is going to withhold $195 million in military aid from Egypt and has also withdrawn $96 million in other aid due to human rights violations in the country. The shift in diplomacy reinforces speculation that the military establishment's influence has grown in the Trump administration; as a result, we expect the president's foreign policy to resemble those of his predecessors, President Obama and President Bush.

Yesterday's market action: The dollar rallied as did equities. For the past several months, the dollar has tended to weaken during periods of U.S. political dissention and strengthen on evidence of policy stability. Dollar sensitivity to political uncertainty is rather unusual.

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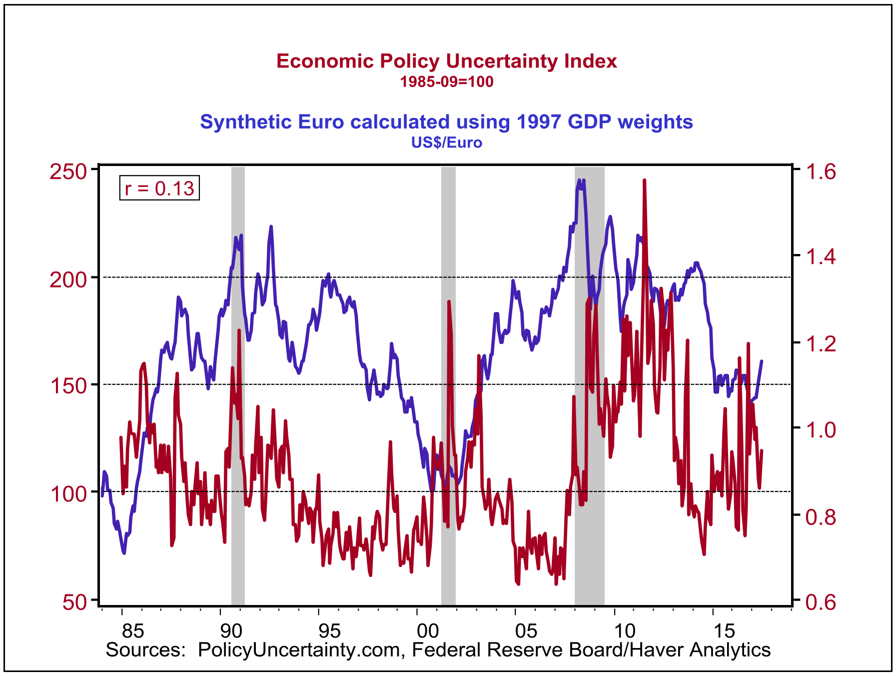


This chart shows the economic policy uncertainty index compared to the EUR. The two series are essentially uncorrelated. The behavior we saw yesterday has been something we have noted recently. Investors have generally not been willing to sell equities in the face of turmoil but have sold the dollar instead. Both the dollar and equities rallied strongly after President Trump's disciplined and well delivered speech on Monday regarding the war in Afghanistan. However, we noted lots of commentary suggesting that the president has moved on from populism, citing the speech and Steve Bannon's exit from the White House. However, the president seems to have a "soft spot" for populist ideas. Simply put, although it is possible that the president has moved to become an establishment Republican, it's unlikely that he has changed. Thus, the potential for more market uncertainty remains.

The Navy puzzle: The U.S. Navy has been hit with a series of mishaps this year. In January, the U.S.S. *Antietam* ran aground near Yokosuka, Japan. In May, the U.S.S. *Lake Champlain* hit a South Korean fishing vessel. In June, the U.S.S. *Fitzgerald* hit a container ship, and this week, the U.S.S. *John S. McCain* struck an oil tanker. The Navy is reviewing the situation. Bloomberg[1] notes that one possibility is that the Navy is trying to do too much without enough resources. From 1998 to 2015, the Navy shrunk by 20% to 271 vessels. The demand for the Navy's services may simply exceed the number of ships available to perform the work safely. However, there is another theory circulating that is much more ominous. On June 22nd, the Global Positioning Satellite system was manipulated; 20 vessels on the Black Sea reported a location 20 miles inland, near an airport. This was the first confirmed instance of GPS "spoofing." Although the Navy uses encrypted GPS and should be protected, commercial vessels are not and thus could be vulnerable to manipulation. There is some evidence that Russia

[1] https://www.bloomberg.com/news/articles/2017-08-22/why-do-u-s-navy-ships-keep-crashing

may be behind this GPS spoofing; it would be consistent with Russia's "hybrid war" concept and shows how a nation with much less economic power can "punch above its weight."[2]

U.S. Economic Releases

MBA mortgage applications fell 0.5% from the prior week. Purchases fell by 1.5%, while refinancing rose by 0.3%. The average 30-year fixed rate mortgage remained unchanged from the prior week at 4.12%.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing PMI	m/m	aug	53.5	53.3	**
9:45	Markit US Services PMI	m/m	aug	55.0	54.7	**
9:45	Markit US Composite PMI	m/m	aug		54.6	**
10:00	New Home Sales	m/m	jul	610k	610k	**
10:00	New Home Sales	m/m	jul	0.0%	0.8%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
13:05	Robert Kaplan Speaks to Oil Group in Midland, Texas	President of the Federal Reserve Bank of Dallas				

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.

[2] https://www.newscientist.com/article/2143499-ships-fooled-in-gps-spoofing-attack-suggest-russian-cyberweapon/ and http://www.mcclatchydc.com/news/nation-world/national/national-security/article168470432.html

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Machine Tool Orders	y/y	jul	28.0%	26.3%		*	Equity and bond neutral
	Nikkei Japan PMI Mfg	m/m	aug	52.8	52.1		**	Equity and bond neutral
Australia	Skilled Vacancies	m/m	jul	0.8%	0.9%		*	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	aug	57.4	56.6	56.3	**	Equity bullish, bond bearish
	Markit Eurozone Services PMI	m/m	aug	54.9	55.4	55.4	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	aug	55.8	55.7	55.5	**	Equity bullish, bond bearish
Germany	Markit/ BME Germany Manufacturing	m/m	aug	59.4	58.1	57.6	**	Equity bullish, bond bearish
	Markit Germany Services	m/m	aug	53.4	53.1	53.3	**	Equity and bond neutral
	Markit/ BME Germany Composite	m/m	aug	55.7	54.7	54.7	**	Equity bullish, bond bearish
France	Markit France Manufacturing PMI	m/m	aug	55.8	54.9	54.5	**	Equity bullish, bond bearish
	Markit France Services PMI	m/m	aug	55.5	56.0	55.8	**	Equity and bond neutral
	Markit France Composite	m/m	aug	55.6	55.6	55.4	**	Equity and bond neutral
AMERICAS								
Mexico	GDP	y/y	2q	1.8%	1.8%	1.8%	***	Equity and bond neutral
	Economic Activity	y/y	2q	2.4%	3.1%	2.3%	**	Equity and bond neutral
Canada	Retail Sales	m/m	jun	0.1%	0.6%	0.2%	**	Equity and bond neutral
	Retail Sales ex Auto	m/m	jun	0.7%	-0.1%	0.1%	**	Equity bullish, bond bearish

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)	99	99	0	Neutral
TED spread (bps)	33	33	0	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.21	2.21	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	26	26	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			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	$51.66	$51.87	-0.40%	Bearish API data
WTI	$47.73	$47.83	-0.21%	
Natural Gas	$2.91	$2.94	-1.02%	
Crack Spread	$16.45	$16.56	-0.69%	
12-mo strip crack	$17.20	$17.23	-0.16%	
Ethanol rack	$1.69	$1.69	-0.16%	
Metals				
Gold	$1,288.12	$1,285.08	0.24%	Weaker dollar
Silver	$17.06	$16.98	0.43%	
Copper contract	$300.70	$300.75	-0.02%	
Grains				
Corn contract	$ 360.25	$ 360.00	0.07%	
Wheat contract	$ 430.25	$ 429.00	0.29%	
Soybeans contract	$ 943.00	$ 937.50	0.59%	
Shipping				
Baltic Dry Freight	1249	1266	-17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.5		
Gasoline (mb)		-1.0		
Distillates (mb)		0.0		
Refinery run rates (%)		-0.25%		
Natural gas (bcf)		46.0		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country. Precipitation is expected for most of the country. Currently, there is a high likelihood of a tropical depression developing within the next 48 hours in the Gulf of Mexico, which could possibly strengthen into a tropical storm within the next five days. If this storm becomes serious, it could lead to the disruption of oil and gas production. Currently, the storm is located over the Bay of Campeche and could possibly reach the northwestern coast by Friday; we will continue to monitor this situation.

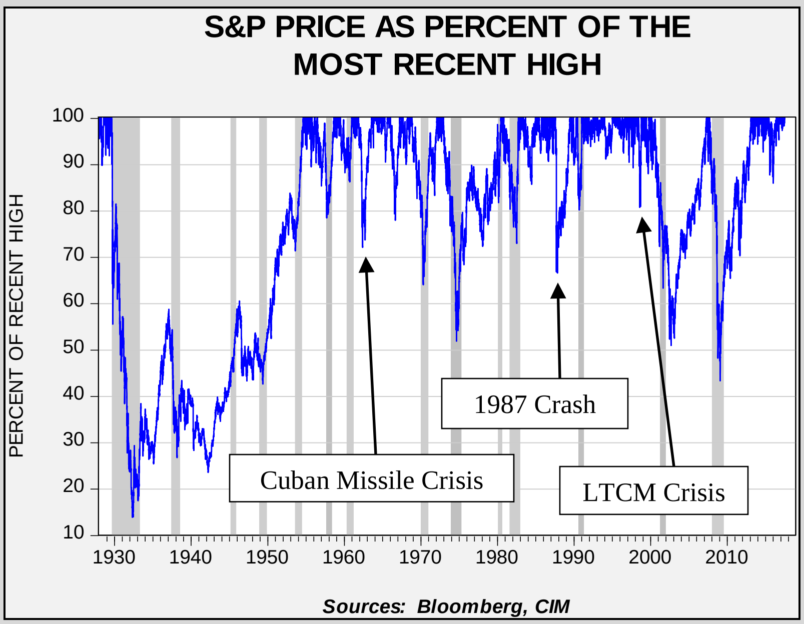
Asset Allocation Weekly Comment

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 18, 2017

A number of market commentators have suggested current conditions are similar to 1987. Complacency, shown by the low level of volatility and an elevated P/E, is rampant. On the other hand, there is no evidence a recession is looming and, although monetary policy is tightening, the Federal Reserve has been raising rates at a slow pace and financial conditions remain at low stress levels.

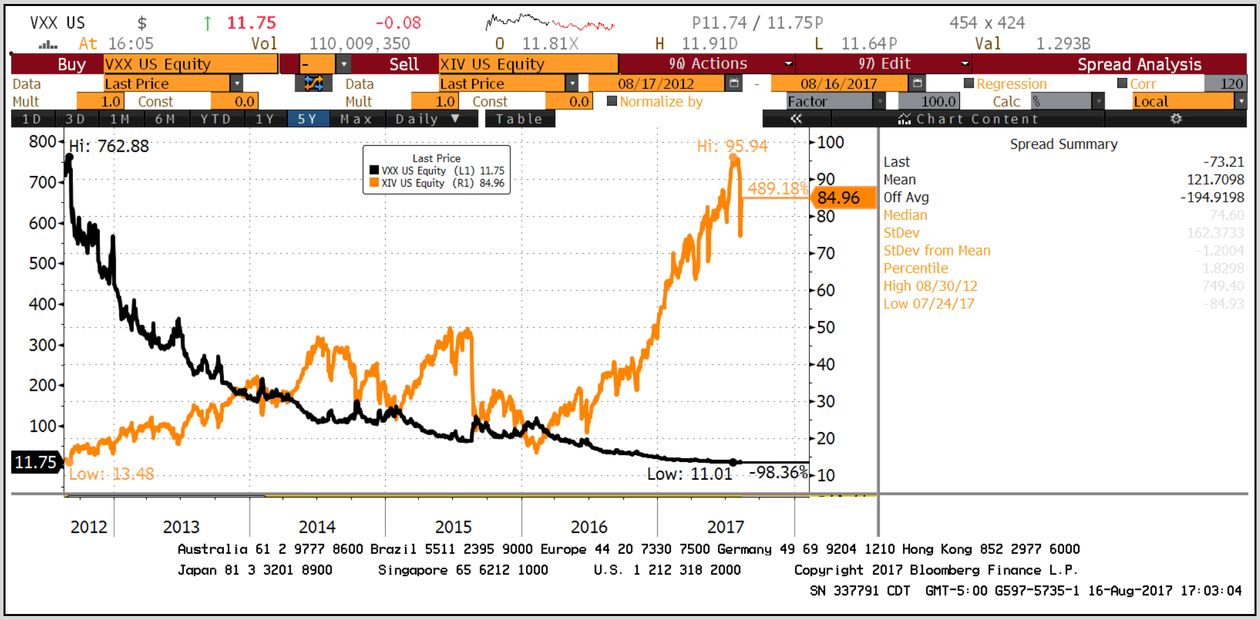
This chart can help us examine the potential for a correction.



To create this chart, we looked at the daily close for the S&P 500 Index starting on the first trading day of 1928. Each subsequent close is measured against the most recent closing high. A reading of 100% means a new high has been attained. Recessions, shown by the gray bars, tend to have a negative impact on equities; the effect was most obvious during the Great Depression. We have also noted a few events of interest on the chart.

There are currently two areas of concern. The first is that the North Korean situation could escalate; clearly, if we have a military event that includes nuclear weapons, then we are in uncharted territory and none of the above history is relevant. However, we do have the Cuban Missile Crisis as an analogue. From the S&P 500's recent closing high of 2490, a repeat of that crisis would trigger a pullback to 1785. Although that would be sizeable, note that the market recovered quickly. At present, tensions have cooled and we don't expect a military event in the near future.

The second area of concern is tied to market complacency. Market volatility has been very low and investors have been shorting volatility successfully for some time.



(Source: Bloomberg)

This chart shows the VIX ETF (VXX, 11.75) and the inverse VIX (XIV, 84.96). This five-year chart shows that those who have been long volatility have suffered steady losses, while those short volatility have generally done well. However, the gains on being short volatility have accelerated over the past two years. There have been reports that portfolio managers have been using short volatility in a fashion similar to portfolio insurance in the 1980s. Portfolio insurance was one of the causal factors of the 1987 Stock Market Crash, shown on the above chart. Short volatility has become a crowded trade. If investors reverse these positions quickly, it could create conditions similar to 1987. A repeat of that outcome yields an S&P of 1636.

It is important to note that in both the 1962 and 1987 events, the economy avoided recession and equities recovered quickly. Clearly, past performance doesn't guarantee future outcomes, but as long as a market correction event isn't driven by a recession then we would expect the decline to be short-term in nature.

Recently, we introduced an economic data/S&P indicator.[3] It does not suggest a recession-driven market drop is imminent.

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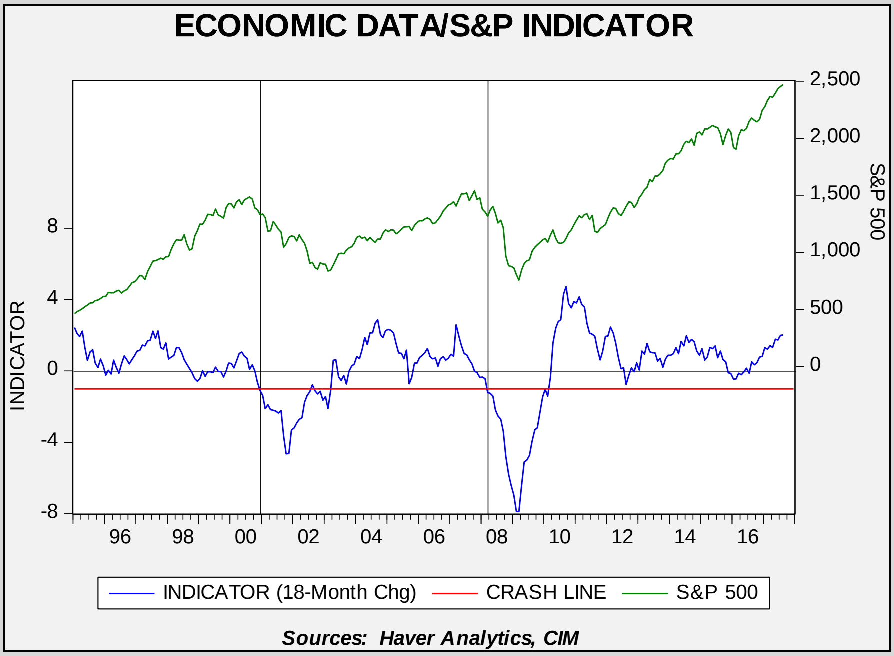
[3] See Asset Allocation Weekly, 6/30/17.

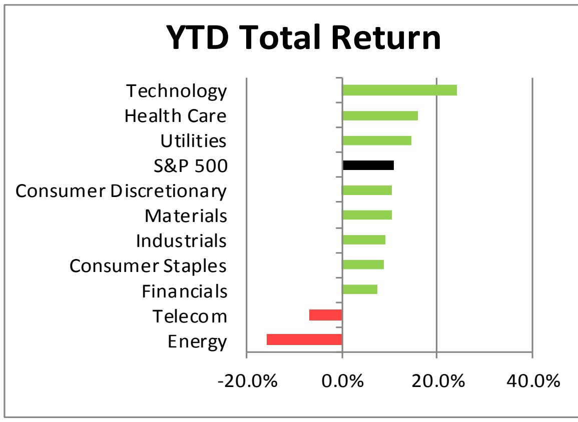


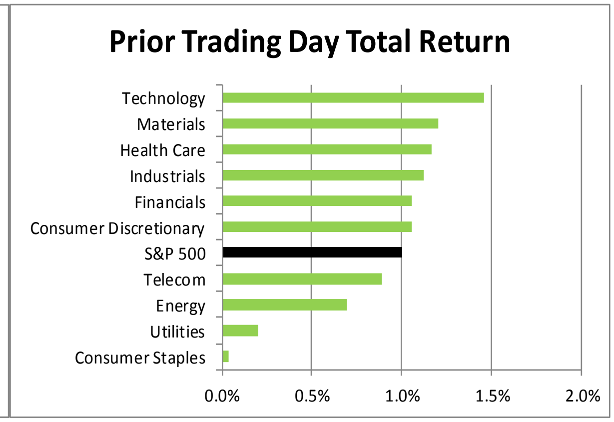
The green line is the monthly average for the S&P 500; the blue line is an indicator built of three economic numbers—initial claims, the CRB commodity index and the Conference Board's Consumer Confidence data. We have standardized the economic data and created an indicator, shown on the bottom of the graph. In general, a positive reading is normally bullish for equities. We have placed vertical lines on the chart to indicate when the indicator turned negative with persistence. These are usually periods of falling equities. This model would tend to suggest that a pullback caused by economic weakness isn't in the offing, and so an event-driven pullback, though potentially painful, would probably be short-term in nature.

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 8/22/2017 close)

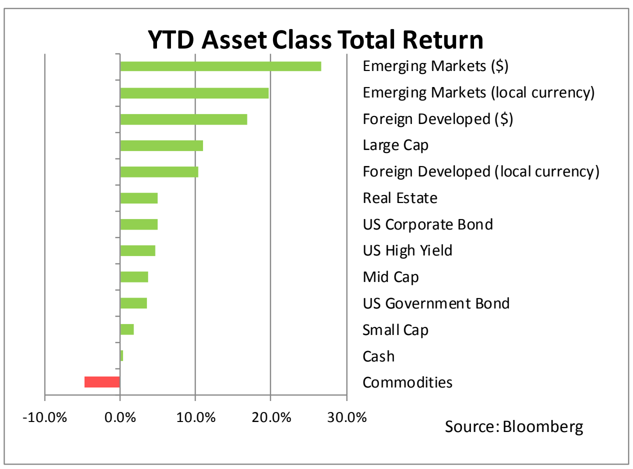




(Source: Bloomberg)

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 8/22/2017 close)

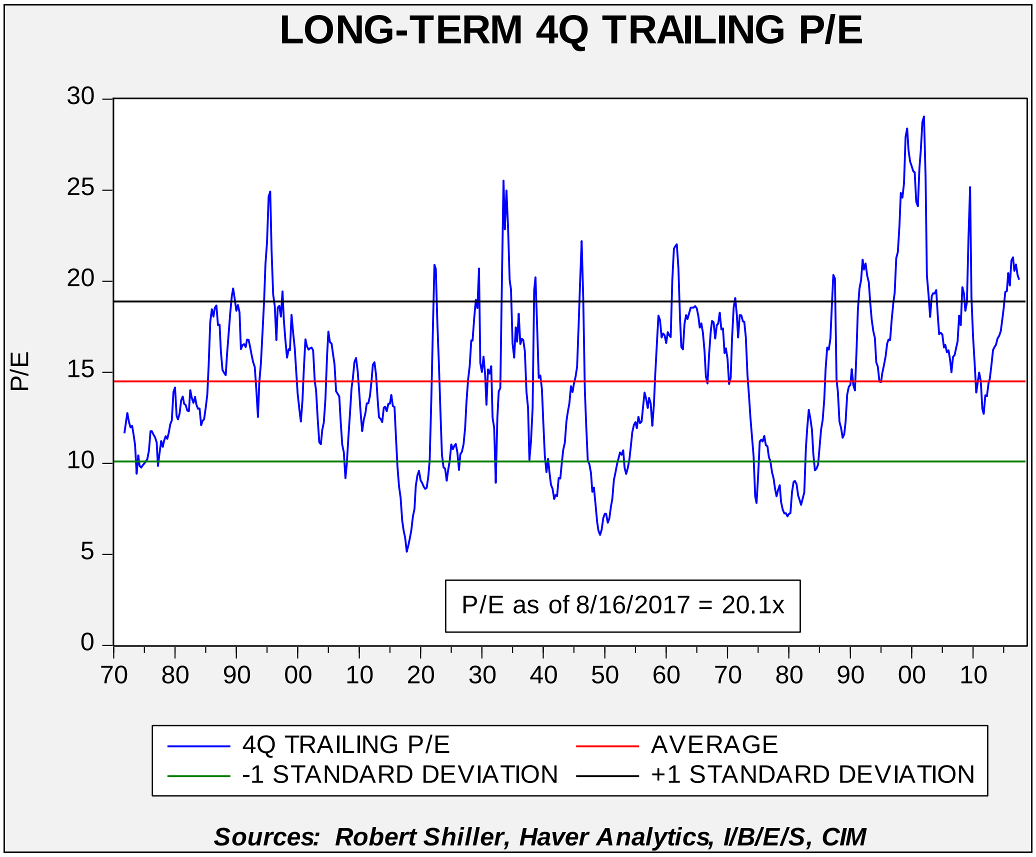


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 17, 2017



Based on our methodology,[4] 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.

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[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 (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.