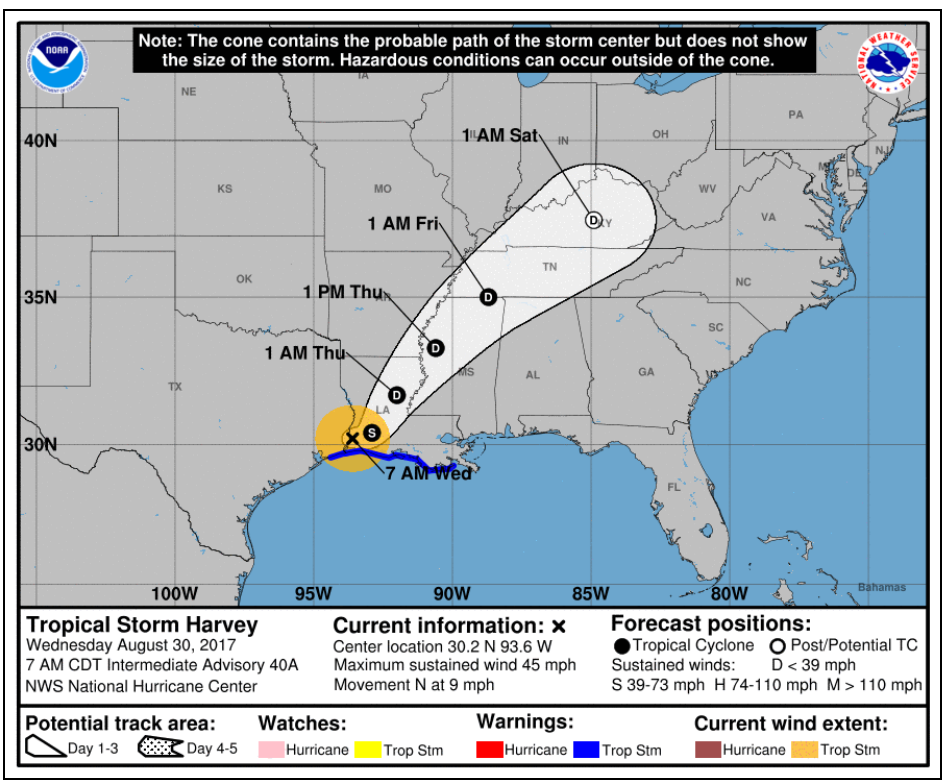
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: August 30, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.8% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.1% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a higher open.

Happy GDP day! We cover the GDP data below, but the report showed 3.0% annualized growth. Interest rates have ticked higher and the dollar is recovering from yesterday's weakness. Here is what we are following this morning:

Harvey hits Louisiana: After slamming Texas with massive rains, TS Harvey moved back over the Gulf of Mexico (GOM) and has made a second landfall just east of the Texas/Louisiana border.



(Source: National Hurricane Center)

The market most sensitive to the storm in the short run has been energy. This morning, the massive Motiva 600 kbpd refinery announced it would shut down due to flooding. Gasoline futures jumped about four cents per gallon on the news but have settled back. Crude oil prices continue to slide on fears that depressed refining activity will lower demand; in addition, the Texas coast is the exporting hub for U.S. crude oil so we would expect a decline for a while. We are probably on the "backside" of this crisis, but the rebuilding will be slow and it is likely the damage from Harvey will be extensive.

On the other hand, the need for emergency rescue spending may end the drama around the debt ceiling. Texas is a red state and the GOP would usually want to exercise caution on spending, worried that lawmakers would try to sneak pet spending projects into an emergency bill. If the Texas contingent puts forth a clean aid bill, it could create conditions of bipartisanship and lead to an easy debt ceiling vote. If so, this outcome would reduce the potential for a government shutdown later next month. After all, shutting down FEMA in the middle of a massive recovery effort would be a huge unforced error.

North Korea update: Kim Jong-un renewed his threats on Guam, suggesting the missile test over Japan was a test for attacking the U.S. base on the U.S. territory. Meanwhile, President Trump did say that "all options are on the table" with North Korea. In the midst of all this noise we are trying to figure out if there is a "signal" from this mess. Although Japan was angry with the violation of its airspace, it didn't attempt to shoot down the missile. There are three potential reasons. First, perhaps Japan has little faith in its anti-missile defenses and didn't want to shoot at the North Korean missile for fear the impotence of the defense system would be revealed. Although possibly true, if Japan actually believed it was under attack, an unreliable system is better than none. Thus, the lack of Japanese response to the overflight suggests something else. A second explanation is that Japan knew in advance that the missile was unarmed. There have been reports of backchannel discussions with North Korea[1]; it is quite possible that interested parties were told in advance of the launch. If Japan thought this missile was the opening salvo of a nuclear or chemical attack, it would make sense to use its anti-missile defense even if it is rather unreliable. On the other hand, if one knew in advance that this wasn't an actual attack, revealing the unreliability of the anti-missile defense wouldn't make much sense. Third, reactions from South Korea and the U.S. suggest that North Korea had made it clear that this missile launch wasn't a preemptive strike, which would add to evidence that this launch was indicated in advance among these backchannel contacts.

This doesn't mean war is more or less imminent. The fact that the sides are talking is better than if they were not, but nothing has really changed. North Korea's ultimate goal is peninsula unification under Pyongyang's rule. In its estimation, the primary obstacle to this goal is the U.S. Thus, the goal is to either talk the U.S. out of the region or make the U.S. look ineffective as a defender. The flaw in the discussion is that North Korea may not be strong enough militarily to defeat South Korea. Authoritarian regimes consistently underestimate the fighting resolve of democracies; they observe the divisions that naturally occur in the democratic process and "see" weakness. At the same time, North Korea's actions may not be helping its goal; there are reports that National Security Advisor McMaster and his South Korean counterparts are considering the movement of U.S. strategic assets to South Korea. This would include the

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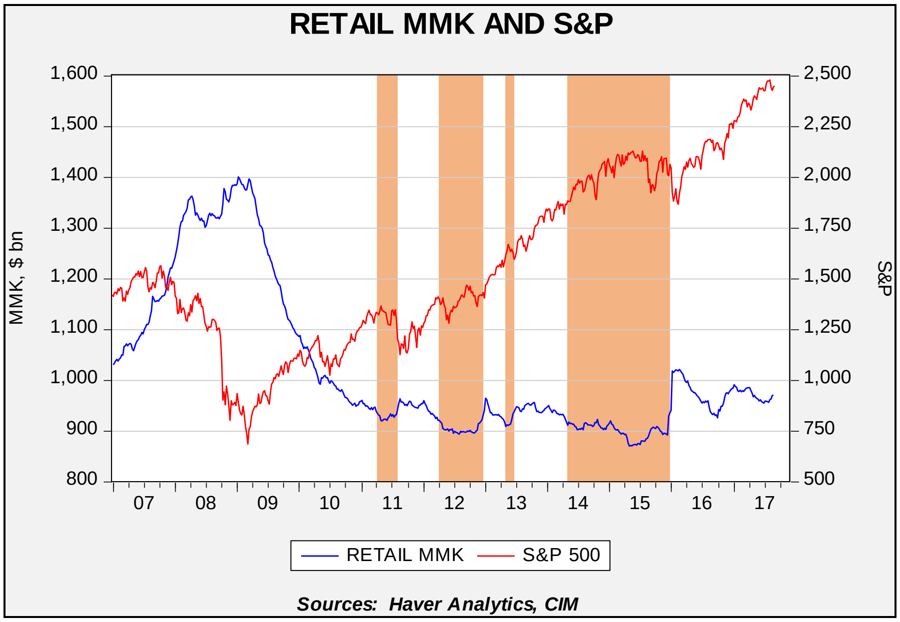
[1] http://nypost.com/2017/08/11/white-house-has-quietly-engaged-in-back-channel-talks-with-north-korea/

basing of B-1, B-52 and F-35 warplanes that are not currently on South Korean soil. The U.S. is considering short-range ballistic missiles in South Korea as well.

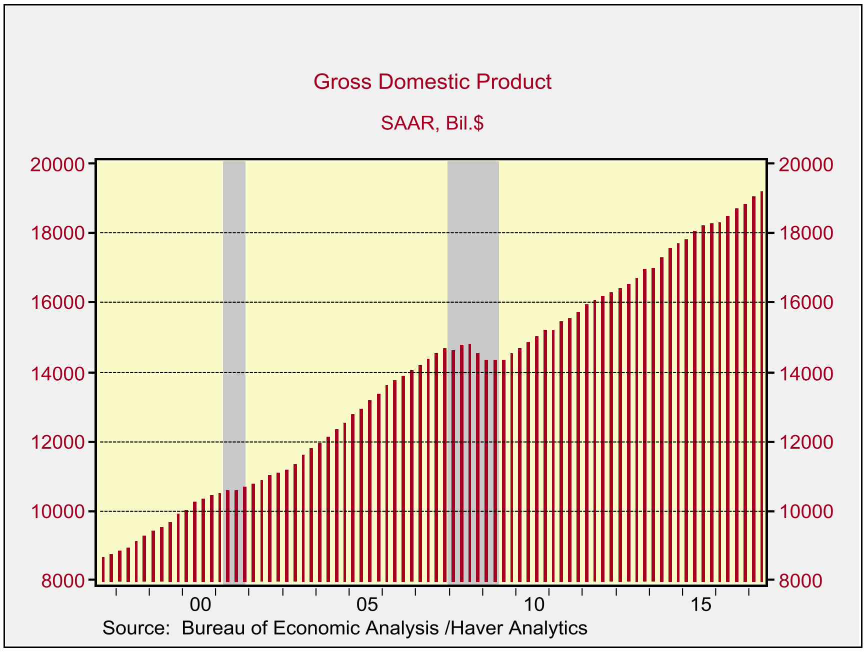
Market action: One characteristic we have noted is that there is enough liquidity in the financial markets that equity pullbacks tend to be shallow and short. We saw some of that yesterday; although the market opened lower, it moved higher throughout the day as the North Korean situation didn't deteriorate further. To measure liquidity, we have been using retail money market funds (MMK).



This chart shows the level of retail money market funds and the S&P 500; we have placed orange bars on the chart to show periods when the level of money market funds approached $900 bn. At that point, equities have tended to weaken; in our opinion, this is because buying power is depleted. Current liquidity levels are high enough to put power behind the "buy the dip" mentality we have been seeing in stocks for a while. Barring a recession or some other factor that increases the demand for liquidity (war would do it, by the way), we expect this pattern to continue.

U.S. Economic Releases

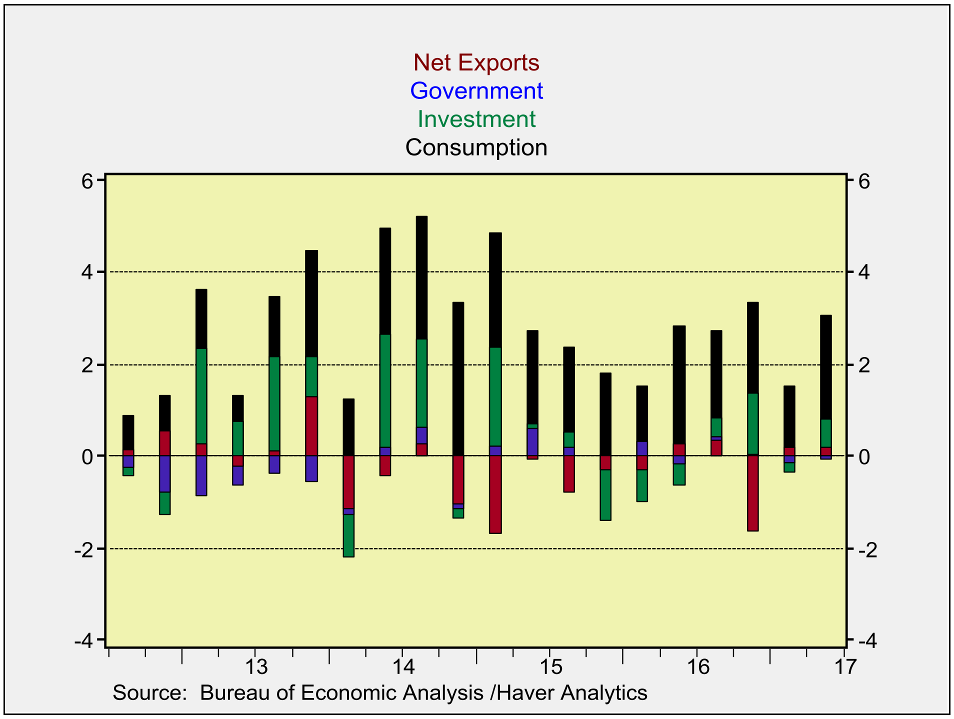
The second revision to Q2 GDP came in above expectations at 3.0% compared to the forecast of 2.6%. Personal consumption came in above expectations at 3.3% compared to the forecast of 3.0%. Core PCE came in line with expectations, rising 0.9% from the prior quarter. The GDP price index was in line with expectations at 1.0%.



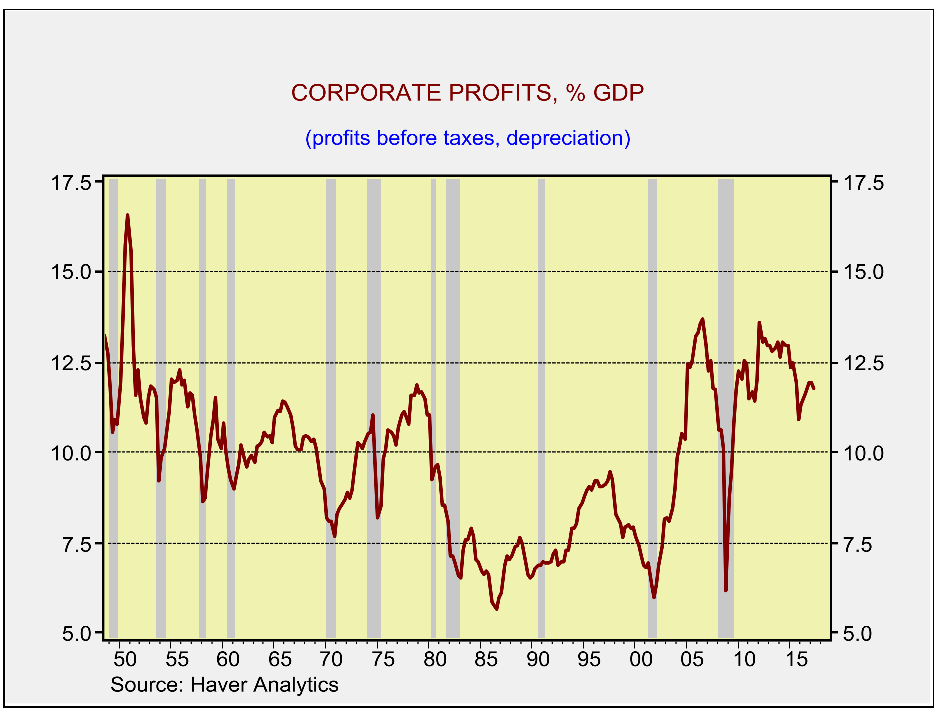
Despite tepid GDP growth over the past eight years, this period is now the third longest expansion in U.S. history.

	Q2 2017 Second Reading	Q2 2017 Prelim Reading	Difference
GDP	3.0%	2.6%	0.4%
Consumption	2.3%	1.9%	0.4%
Investment	0.6%	0.3%	0.3%
Inventories	0.0%	-0.2%	0.2%
Net Exports	0.2%	0.2%	0.0%
Government	-0.1%	0.1%	-0.2%

The table above shows the contributions to GDP. The acceleration in GDP can be attributed to a huge increase in consumption and an increase in investment spending. The chart below shows the contribution breakdown.



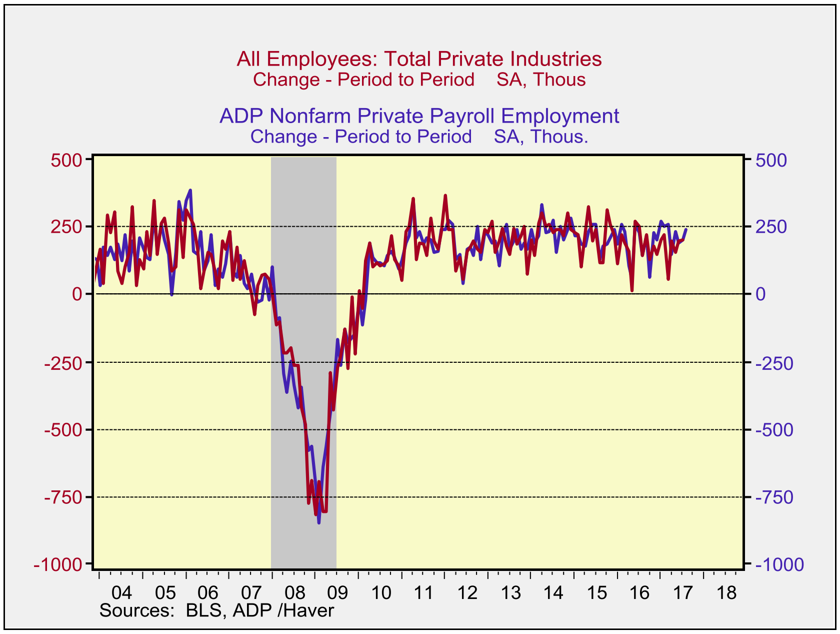
In the second revision, the Bureau of Economic Analysis provides profit data.



Profits as a percentage of GDP fell to 11.8% from 11.9%; they remain elevated on a historical basis.

MBA mortgage applications fell 2.3% from the prior week. Purchases and refinancing fell 2.7% and 2.0%, respectively. The average 30-year fixed rate fell by 1 bp from the prior week to 4.11%.

August ADP employment change came in above expectations at 237k compared to the forecast of 187k. The prior month's report was revised upward from 185k to 237k.



The chart above shows the period-to-period change in ADP employment change and nonfarm payrolls. Generally, a good ADP report suggests that nonfarm payrolls will also be good.

There are no economic releases or Fed events scheduled for the rest of the day.

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	Retail Sales	m/m	jul	1.1%	0.2%	0.3%	**	Equity bullish, bond bearish
	Retail Trade	y/y	jul	1.9%	2.1%	1.0%	**	Equity bullish, bond bearish
	Department Store, Supermarket Sales	m/m	jul	-0.2%	0.2%	-0.2%	**	Equity and bond neutral
Australia	Construction Work Done	y/y	2q	9.3%	-0.7%	1.0%	**	Equity bullish, bond bearish
	Building Approvals	m/m	jul	-13.9%	-2.3%	-16.6%	**	Equity and bond neutral
New Zealand	Building Permits	y/y	jul	-0.7%	-1.0%		**	Equity and bond neutral
EUROPE								
Eurozone	Economic Climate Indicator	m/m	aug	2.1	2.2		**	Equity and bond neutral
	Economic Confidence	m/m	aug	111.9	111.2	111.3	**	Equity and bond neutral
	Business Climate Indicator	m/m	aug	1.09	1.05	1.05	**	Equity bullish, bond bearish
	Industrial Confidence	m/m	aug	5.1	4.5	4.7	**	Equity bullish, bond bearish
	Services Confidence	m/m	aug	14.9	14.1	13.9	**	Equity bullish, bond bearish
	Consumer Confidence	m/m	aug	-1.5	-1.5	-1.5	***	Equity and bond neutral
Germany	CPI	y/y	aug	1.8%	1.7%	1.8%	***	Equity and bond neutral
UK	Net Consumer Credit	y/y	jul	1.2 bn	1.5 bn	1.5 bn	**	Equity bearish, bond bullish
	Net Lending Sec. on Dwellings	y/y	jul	3.6 bn	4.1 bn	3.8 bn	**	Equity bearish, bond bullish
	Mortgage Approvals	y/y	jul	68.7 k	64.7 k	65.5 k	**	Equity and bond neutral
Switzerland	KOF Leading Indicator	y/y	aug	104.1	106.8	107.0	**	Equity bearish, bond bullish
	UBS Consumption Indicator	m/m	jul	1.38	1.38		**	Equity and bond neutral
	CredIt Suisse Survey Expectations	m/m	aug	25.0	34.7		**	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)	132	132	0	Up
3-mo T-bill yield (bps)	101	100	1	Neutral
TED spread (bps)	31	32	-1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.14	2.13	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	28	28	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	up			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	$51.69	$52.00	-0.60%	
WTI	$46.11	$46.44	-0.71%	
Natural Gas	$2.96	$2.98	-0.94%	
Crack Spread	$23.72	$21.57	9.95%	
12-mo strip crack	$19.23	$18.94	1.50%	
Ethanol rack	$1.68	$1.68	-0.06%	
Metals				
Gold	$1,309.79	$1,309.23	0.04%	
Silver	$17.40	$17.38	0.13%	
Copper contract	$309.60	$310.45	-0.27%	
Grains				
Corn contract	$ 349.25	$ 348.75	0.14%	
Wheat contract	$ 432.25	$ 429.75	0.58%	
Soybeans contract	$ 938.00	$ 937.25	0.08%	
Shipping				
Baltic Dry Freight	1203	1209	-6	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-1.5		
Distillates (mb)		-0.4		
Refinery run rates (%)		-0.80%		
Natural gas (bcf)		34.0		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, and warmer to normal temperatures for the western region of the country. Precipitation is expected for the eastern region of the country. Tropical Storm Harvey has made landfall in Louisiana and is expected to weaken into a Tropical Depression.

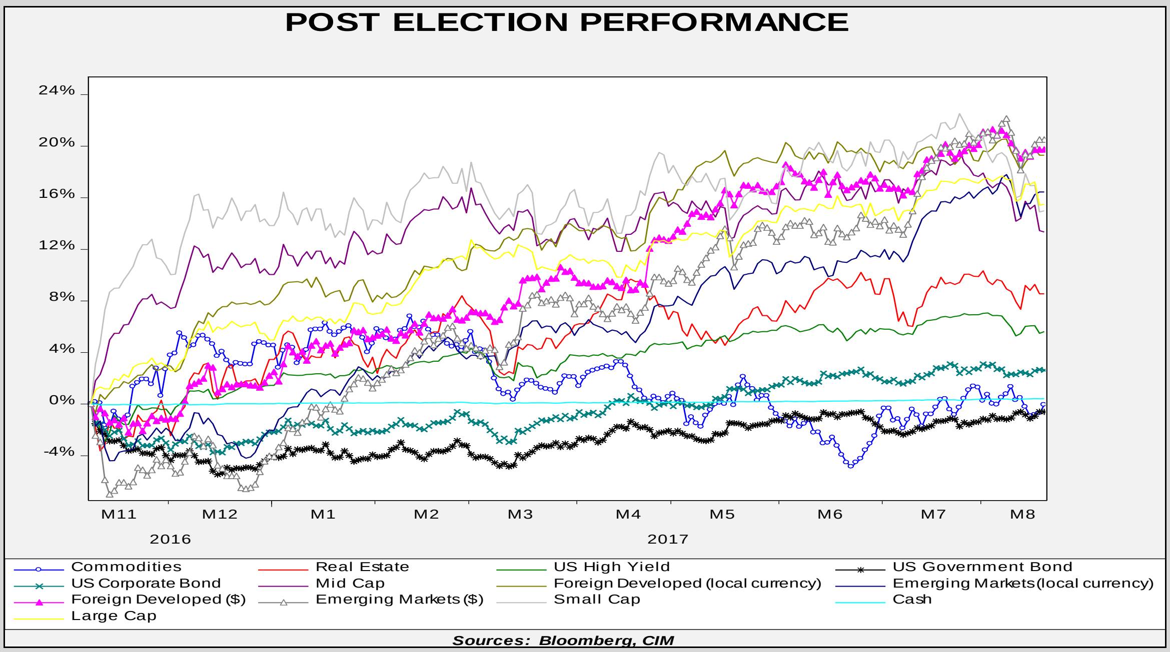
Asset Allocation Weekly Comment

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 25, 2017

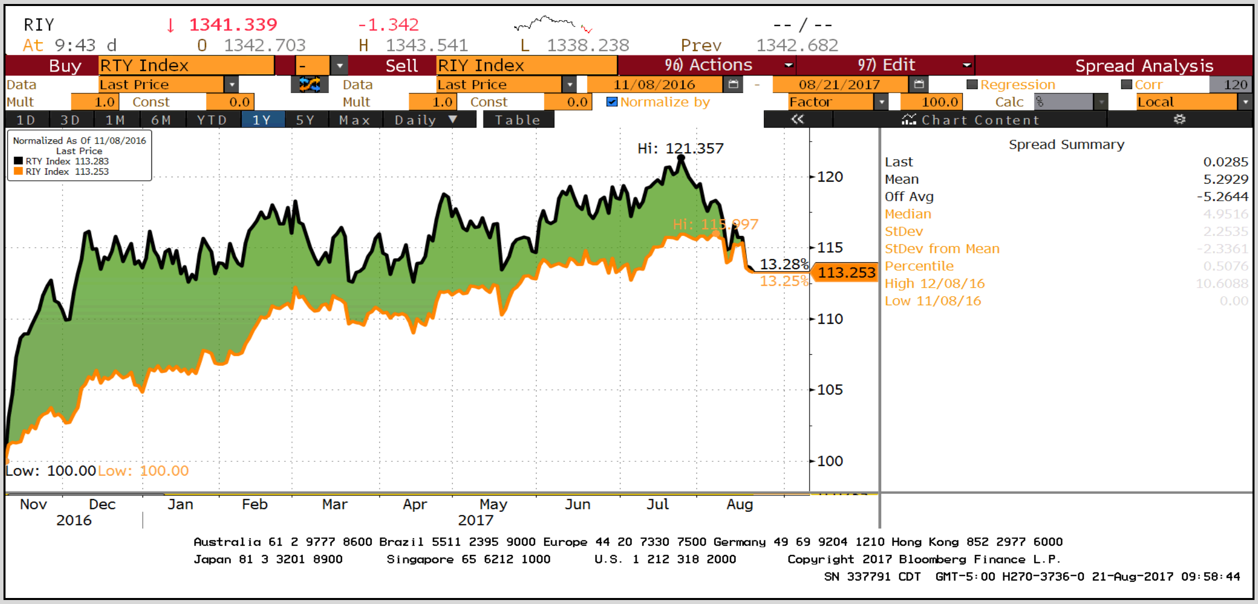
When President Trump was elected, there were expectations that fiscal policy would become more stimulative, which would lead to faster growth, tighter monetary policy and dollar strength. There were also promises of regulatory relief. In November, soon after the election, financial markets, exercising their usual pattern of discounting the future, immediately began to react to these expectations. This week, we want to look at how these expectations have fared thus far.

We begin by looking at the 12 asset classes that we monitor in our Daily Comment to see how they have performed. We indexed the data to the close on Election Day.



The best performing asset classes have been emerging market and foreign developed equities, denominated in dollars. U.S. large caps have generally performed in line with both of these asset classes in local currency terms, but dollar weakness has led to foreign outperformance. The weakest performing asset classes have been U.S. government bonds and commodities. Bonds have steadily recovered from the December lows as Trump's policy agenda continues to stall.

A couple of individual charts are worth noting. First, small cap stocks, which jumped after the election, have begun to roll over. The Affordable Care Act weighed heavily on smaller firms and hopes of a repeal likely boosted small cap stocks due to expectations of easing regulatory burdens.



(Source: Bloomberg)

This chart shows the relative performance of the Russell 2000 and the Russell 1000 Indexes, or small cap versus large cap stocks, indexed to Election Day. After a strong rally following the election, small cap stocks have clearly weakened. We suspect much of this is due to disappointment with the path of policy.

The other item we want to highlight is the path of the dollar.

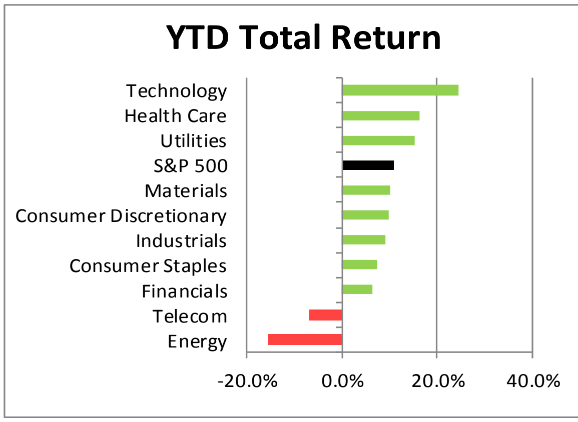
(Source: Bloomberg)

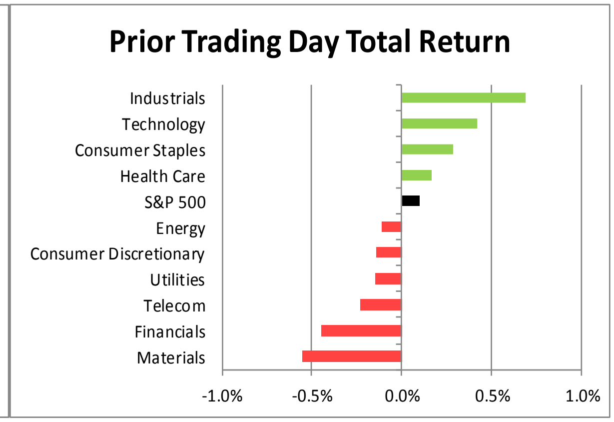
This chart shows the G-10 dollar index, again from Election Day to the present. The dollar rose after the election and peaked about 4% from Election Day. As the Trump agenda has stalled, the dollar has come under pressure and has fallen about 5% below the level seen at the election. If the full GOP agenda had been legislated, it would have been dollar bullish. Fiscal stimulus, including tax cuts and infrastructure spending, would have boosted demand and likely prompted monetary policy tightening from the FOMC. At the same time, the border adjustment tax, which would have acted as a tax on imports and a subsidy on exports, would have also boosted the dollar. Sluggish economic growth and the Republicans' inability to pass legislation, along with low inflation, have slowed the pace of monetary policy tightening. The dollar has weakened, in part due to fiscal policy disappointment and the use of short dollar positions to protect against the erratic behavior of the Trump government.

Perhaps the bigger surprise has been the relatively weak performance of commodities despite dollar depreciation. There is growing evidence that commodity price performance is becoming more sensitive to China. This year, the Chinese economy has been a bit choppy due to policy uncertainty surrounding October's Communist Party meetings, which will select the personnel for Chairman Xi's second term. Thus, we will be watching to see what Chairman Xi focuses on for his second term. Will he try to address China's debt problem through slower growth and a bias toward the household sector, or will he go for growth? If he picks the latter, commodities will benefit. If not, they will likely languish. Slowing the rise in debt is probably the right choice over the long run; however, it is a risky proposition in the short run. Thus, the safer bet is that he will continue to keep growth elevated which will lead to higher levels of debt.

Data Section

U.S. Equity Markets – (as of 8/29/2017 close)

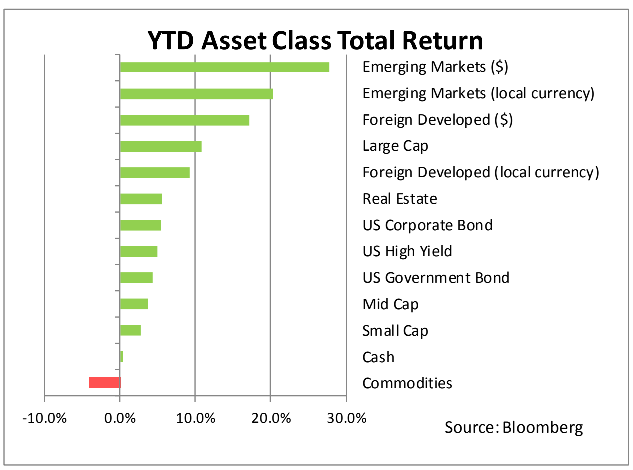




(Source: Bloomberg)

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 8/29/2017 close)

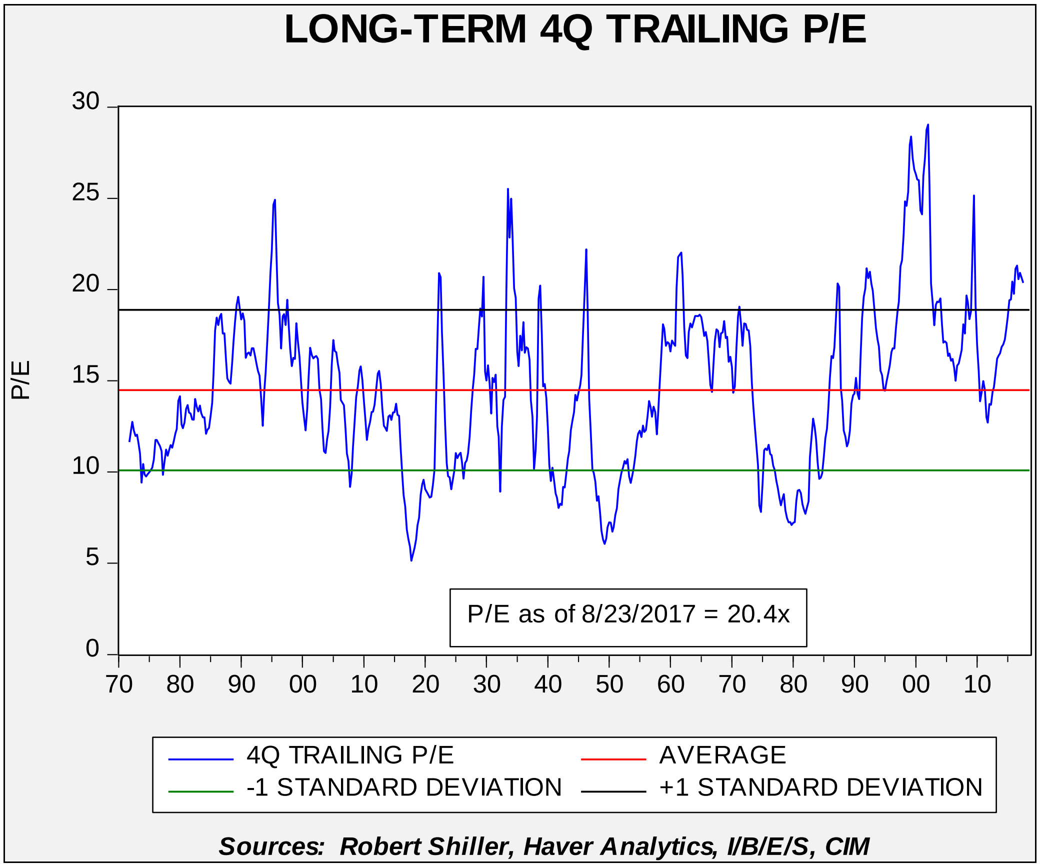


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2017



Based on our methodology,[2] the current P/E is 20.4x, up 0.3x from last week. We now have official S&P data for Q2; Thompson/Reuters operating earnings numbers tend to run higher than S&P and so the P/E ticks higher when the official numbers are reported.

[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 three actual quarters (Q4, Q1 and Q2) and one estimates (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.