Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: July 13, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.1% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.6% and the Shenzhen index remaining unchanged. U.S. equity index futures are signaling a lower open.

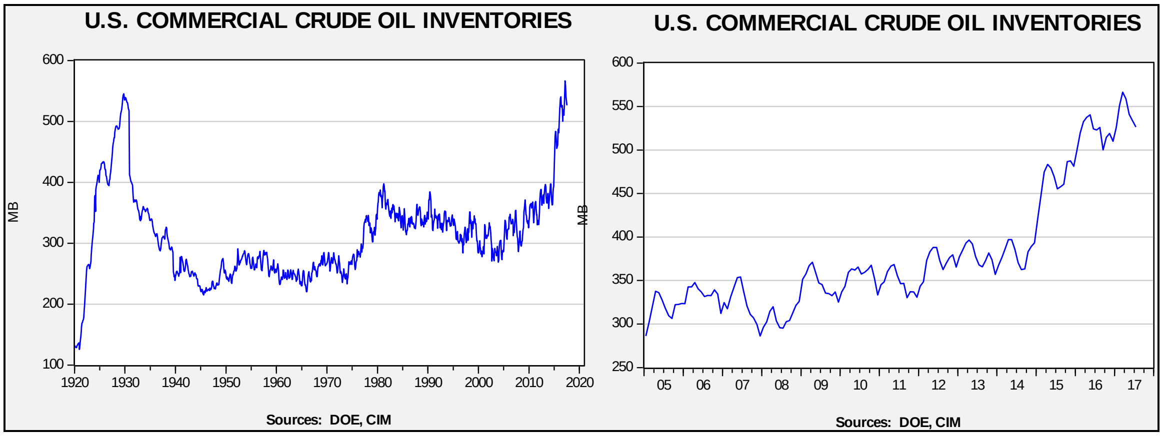
Here's what we are watching today:

Yellen, Round 2: There was nothing in Yellen's testimony that differed from her opening statement which the markets took as dovish. Our comments yesterday appear to be mostly confirmed; the FOMC is shifting to emphasizing balance sheet reduction and less focus on rate hikes, which is being taken as bullish by financial markets. Upon further reflection, the FOMC seems to be tying rate changes to inflation and balance sheet contraction to the economy. If this is the case and inflation remains below target but labor markets continue to be tight, balance sheet reduction could begin as early as autumn. If this impression is what the Chair wanted to signal, we shouldn't see any deviation from yesterday's discussion. On the other hand, if the market's impression was flawed, the Chair may signal otherwise. Although it's rare for this adjustment to occur, Chair Greenspan did make that change when he felt the markets overestimated his position. We don't expect that today.

IEA bearish: The IEA reported that OPEC compliance declined to 78% in June, down from a remarkable 95% in May. The violators were Algeria, Ecuador, Gabon, Iraq, the UAE and Venezuela. Saudi Arabia, Kuwait, Qatar and Angola remained compliant. Because of this increase in cheating, the IEA suggests rebalancing will be further delayed.

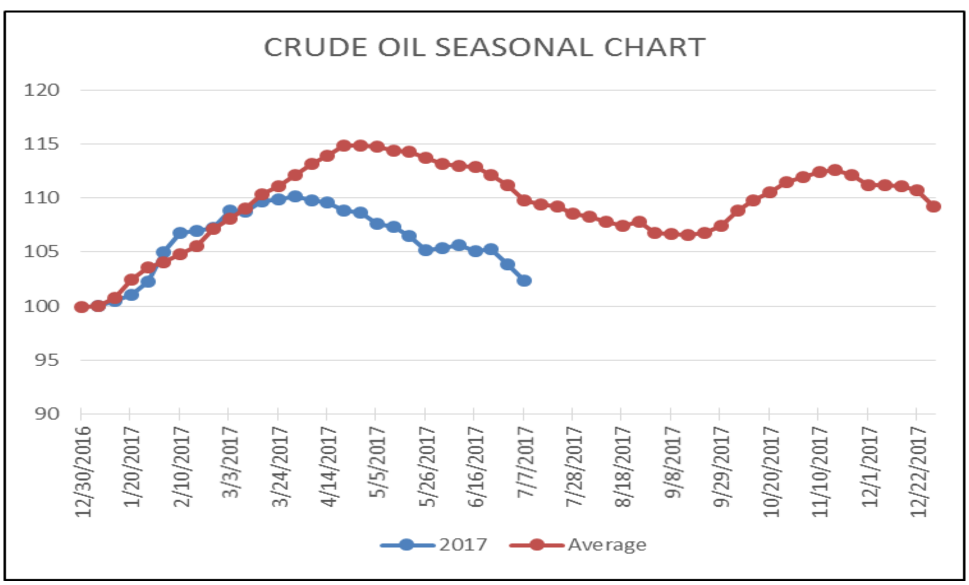
SOS Tillerson in the Gulf: The SOS left Qatar this morning on his way back to the U.S. after a tour of the region. Tillerson is trying to calm tensions between Qatar and the rest of the Gulf Cooperation Council (GCC) nations. We do note that Tillerson and Qatari officials signed an agreement on counterterrorism earlier in the week in a bid to respond to the GCC's claim that Qatar was soft on terrorism. The GCC indicated that the agreement "wasn't enough" which suggests terrorism has little to do with the current disagreement; we suspect this is mostly about Al Jazeera. The other GCC nations strongly dislike the news channel because it is an independent source of news that these nations can't control. It appears to us that the Saudis, after a warm set of meetings with President Trump, felt they had the backing of the White House to bring Qatar to heel. Although the president seems to have sided with the Saudis, Tillerson and the rest of the national security apparatus appear to want this issue smoothed over.

U.S. crude oil inventories fell 7.5 mb compared to market expectations called for a 2.9 mb draw.

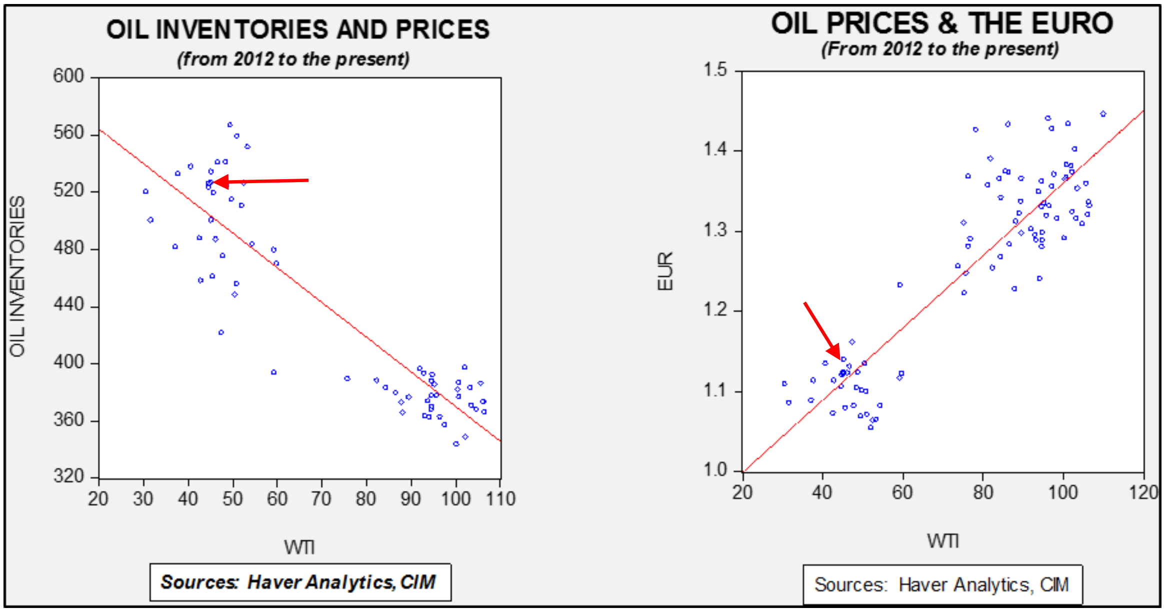


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventory remains historically high but inventories are declining. We also note that, as part of an Obama era agreement, there was a 3.1 mb sale of oil out of the Strategic Petroleum Reserve. This is part of a $375.4 mm sale (or 17.0 mb) done, in part, to pay for modernization of the SPR facilities. We note that sales have reached 16.2 mb this year, which likely means we should see these sales end in the very near future. International agreements require that OECD nations hold 90 days of imports in storage. Due to falling imports, the current coverage is near 140 days. Taking that into account, the draw would have been 10.7 mb, which is a significant decline in stockpiles.

As the seasonal chart below shows, inventories are well into the seasonal withdrawal period. This week we saw an acceleration in the decline. Some of this was likely due to weather disruptions caused by Hurricane Cindy. Still, we have already seen a larger than normal seasonal decline and the seasonal trough isn't usually hit until mid-September. Thus, we should see further stock withdraws over the next couple of months.



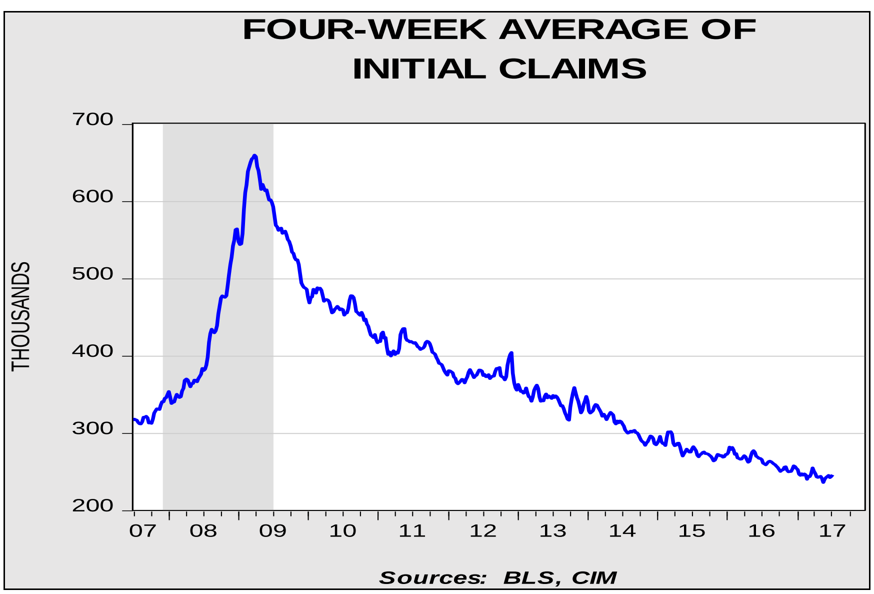
(Source: DOE, CIM)



Based on inventories alone, oil prices are overvalued with the fair value price of $43.84. Meanwhile, the EUR/WTI model generates a fair value of $55.83. Together (which is a more sound methodology) fair value is $51.89, meaning that current prices are well below fair value. Oil fundamentals are steadily improving and should be supportive for prices in the coming weeks.

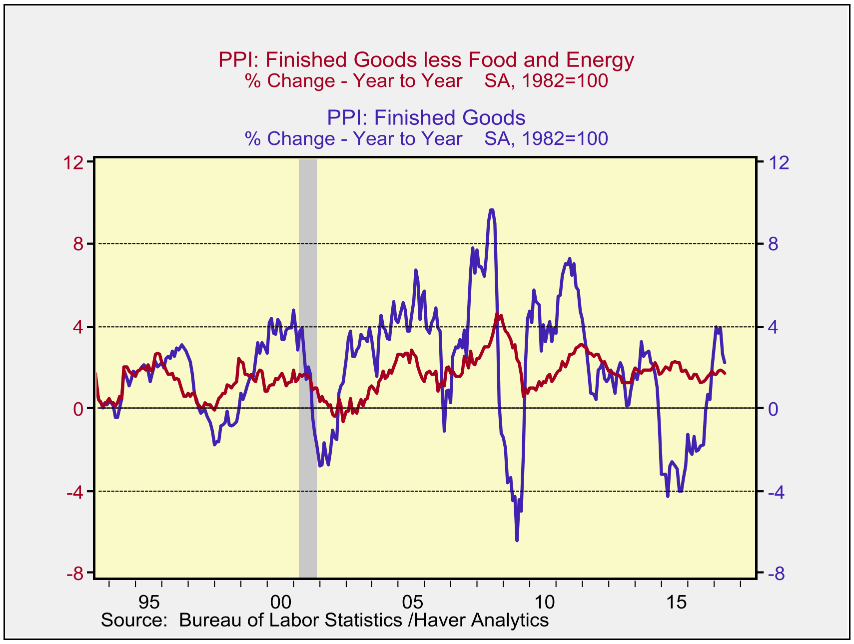
U.S. Economic Releases

Initial jobless claims came in above expectations at 247k compared to a forecast of 245k. The prior report was revised upward from 248k to 250k.



The chart above shows the four-week moving average for initial claims. The moving average rose by 1.75k to 245.5k, suggesting the labor market is still pretty strong.

Monthly PPI final demand came in above expectations at 0.1% compared to a forecast of unchanged. Monthly core PPI came in below expectations at 0.1% compared to a forecast of 0.2%. Monthly PPI excluding food and energy and trade came in line with the forecast at 0.2%.



The chart above shows the relationship between PPI finished goods and core PPI finished goods. Annually, headline PPI rose 2.2%, while core PPI rose 1.7%.

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	Bloomberg Consumer Comfort	m/m	jul		49.4	**
14:00	Monthly Budget Statement	m/m	jun	-$38.0 bn		**
Fed speakers or events						
EST	Speaker or event	District or position				
9:30	Janet Yellen Appears before Senate Banking Panel	Chairman of Board of Governors of Federal Reserve				
13:00	Lael Brainard Speaks in Cambridge, Massachussettes	Member of the Board of Governors				

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	Foreign Direct Invesment	y/y	jun	2.3%	-3.7%		**	Equity and bond neutral
	Exports	y/y	jun	11.3%	8.7%	8.9%	**	Equity bullish, bond bearish
	Imports	y/y	jun	17.2%	14.8%	14.5%	**	Equity and bond neutral
	Trade Balance	y/y	jun	$42.80 bn	$40.81 bn	$42.60 bn	**	Equity bullish, bond bearish
Japan	Tokyo Avg Office Vacancies	m/m	jun	3.26	3.41		**	Equity and bond neutral
Australia	Consumer Inflation Expectation	m/m	jul	4.4%	3.6%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	jul	-1.9%	3.1%		**	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	jun	1.6%	1.6%	1.6%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	jun	1.5%	1.5%	1.5%	**	Equity and bond neutral
France	CPI EU Harmonized	y/y	jun	0.8%	0.8%	0.8%	**	Equity and bond neutral
	CPI	y/y	jun	0.7%	0.7%	0.7%	***	Equity and bond neutral
Switzerland	Producer & Import Prices	y/y	jun	-0.1%	0.1%	0.0%	**	Equity bearish, bond bullish
Russia	Trade Balance	m/m	may	8.5 bn	8.0 bn	8.8 bn	**	Equity and bond neutral
	Exports	m/m	may	28.2 bn	26.1 bn	26.8 bn	**	Equity bullish, bond bearish
	Imports	m/m	may	19.7 bn	18.1 bn	18.0 bn	**	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	may	1.0%	-4.4%	0.3%	***	Equity and bond neutral
	Manufacturing Production	y/y	may	4.5%	-1.7%	5.0%	**	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)	130	130	0	Up
3-mo T-bill yield (bps)	103	103	0	Neutral
TED spread (bps)	28	28	0	Neutral
U.S. Libor/OIS spread (bps)	117	116	1	Up
10-yr T-note (%)	2.32	2.32	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	27	27	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	down			Up
yen	up			Neutral
pound	up			Down
franc	up			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	$47.36	$47.74	-0.80%	Bearish IEA
WTI	$45.17	$45.49	-0.70%	
Natural Gas	$2.98	$2.99	-0.13%	
Crack Spread	$17.48	$17.72	-1.38%	
12-mo strip crack	$15.37	$15.58	-1.37%	
Ethanol rack	$1.70	$1.70	-0.13%	
Metals				
Gold	$1,220.68	$1,220.51	0.01%	
Silver	$15.89	$15.92	-0.18%	
Copper contract	$269.25	$268.40	0.32%	
Grains				
Corn contract	$ 380.75	$ 385.50	-1.23%	Beaish USDA Report
Wheat contract	$ 524.25	$ 537.00	-2.37%	
Soybeans contract	$ 1,013.50	$ 1,034.00	-1.98%	
Shipping				
Baltic Dry Freight	859	830	29	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-7.6	-2.9	-4.7	
Gasoline (mb)	-1.6	-1.8	0.2	
Distillates (mb)	3.1	0.7	2.4	
Refinery run rates (%)	0.90%	0.40%	0.50%	

Weather

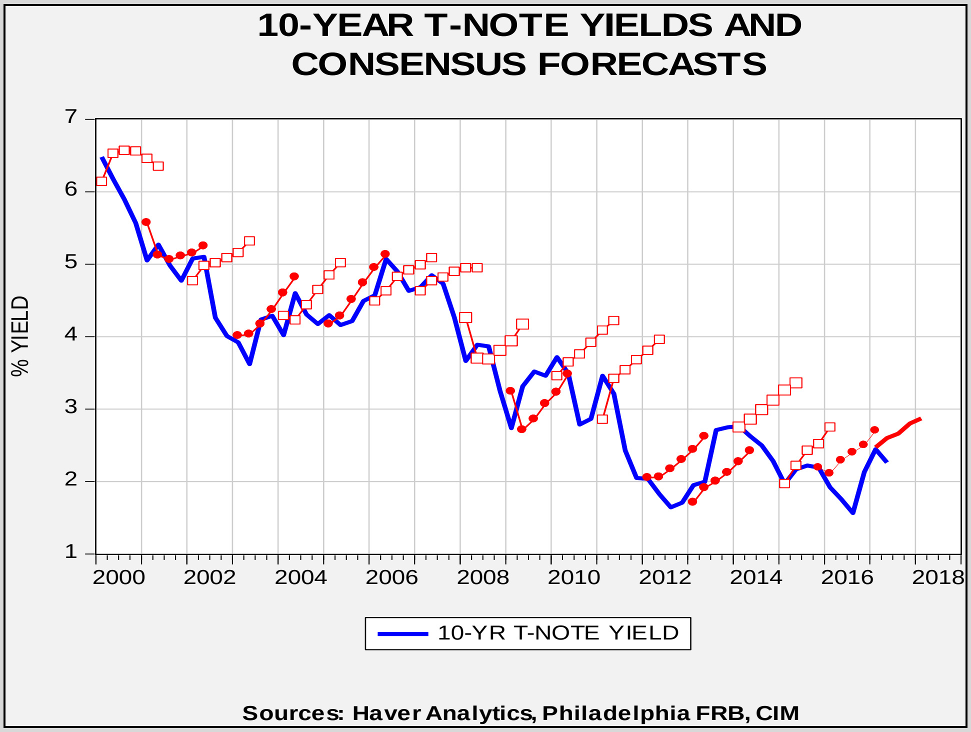
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for the southern and western regions. There is no tropical cyclone activity expected during the next 48 hours.

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.

July 7, 2017

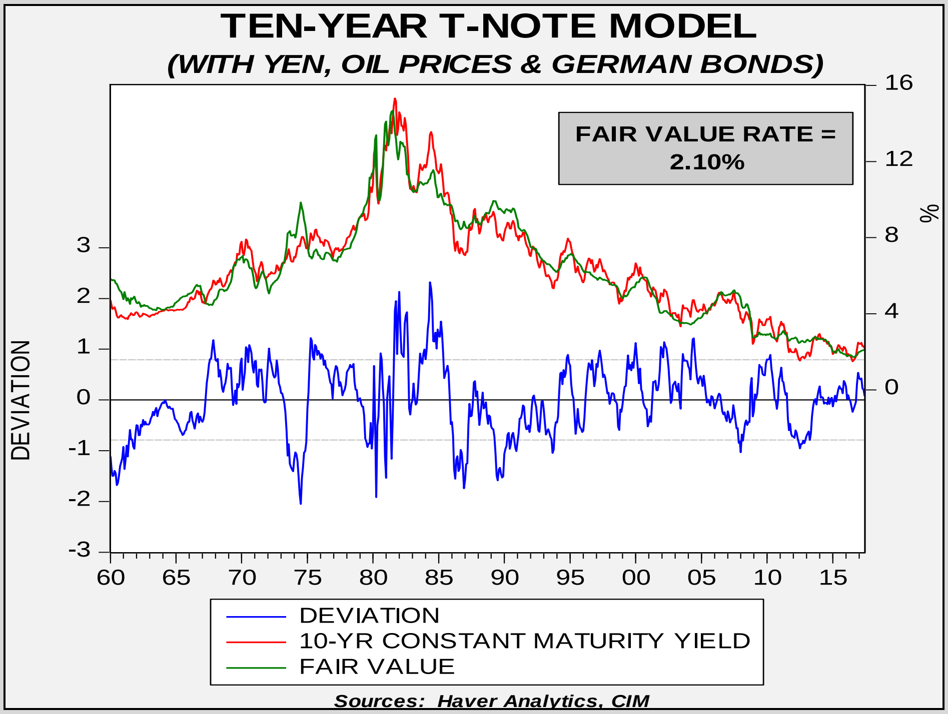
One of the relationships we persistently monitor is the expectations of 10-year Treasury yields compared to the actual level of yields. To do this, at the beginning of each year, we plot the rate forecasts from the Philadelphia FRB's Professional Forecaster Survey. The record of the forecasters has not been stellar.



The blue line on the chart shows the level of yield; the other lines show the consensus forecasts. The open boxes on the red lines are "misses" and the filled dots are "hits." The forecasters are wrong about 59% of the time.

What is interesting to us is not the error rates but the fact that the direction of the error is consistent; the forecasters expect higher rates. We suspect a major part of this was due to forecasters overestimating inflation. It has been our position that globalization and deregulation are responsible for low inflation, not monetary policy. We had little faith in central bank ability to cause inflation and so we have tended to be more dovish on long-term rates in our asset allocation portfolios.

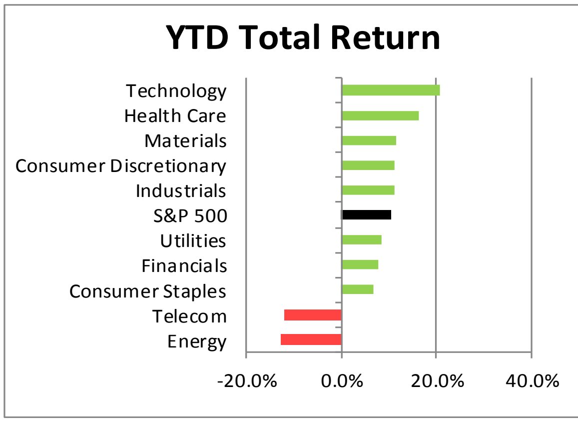
Still, we have noticed that the downtrend in rates has mostly ended in 2012, while rates have been rangebound for the past five years. Clearly, the forecasters are looking for an upside “breakout” in yields that has failed to materialize…so far.

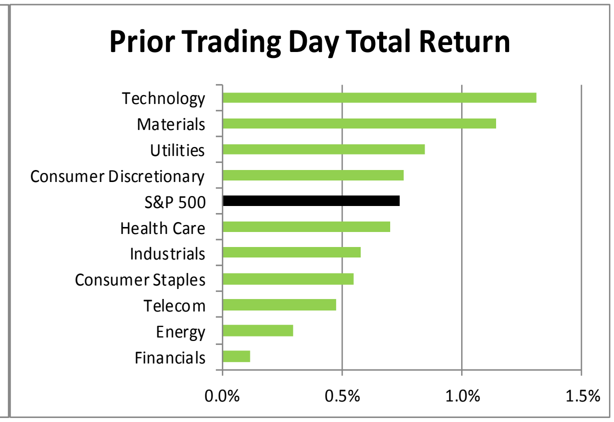


Our 10-year T-note yield model puts fair value at 2.10%; thus, current yields are a bit high. The model uses fed funds, long-term inflation trends, the yen/dollar exchange rate, oil prices and the yield on German bonds. What is troubling for us is that if we just use the first two variables of the model, the fair value yield jumps to 3.03%, which is in the neighborhood of the current Philadelphia FRB forecast. Simply put, international factors appear to be holding down fair value yields. A weaker yen, higher oil prices or rising German sovereign yields will likely have a negative effect on the fair value yield. Of the three, German yields are probably the most critical. If the Eurozone avoids financial and political problems, it appears the ECB is prepared to begin slowly withdrawing stimulus. If that’s the case, the forecasters may have a chance of being right this year.

Data Section

U.S. Equity Markets – (as of 7/12/2017 close)

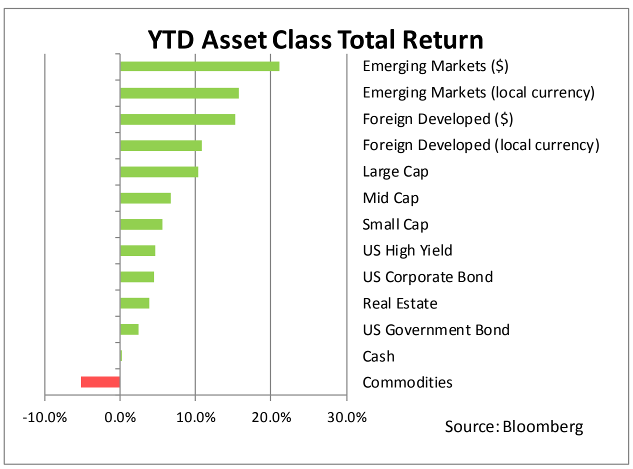




(Source: Bloomberg)

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 7/12/2017 close)

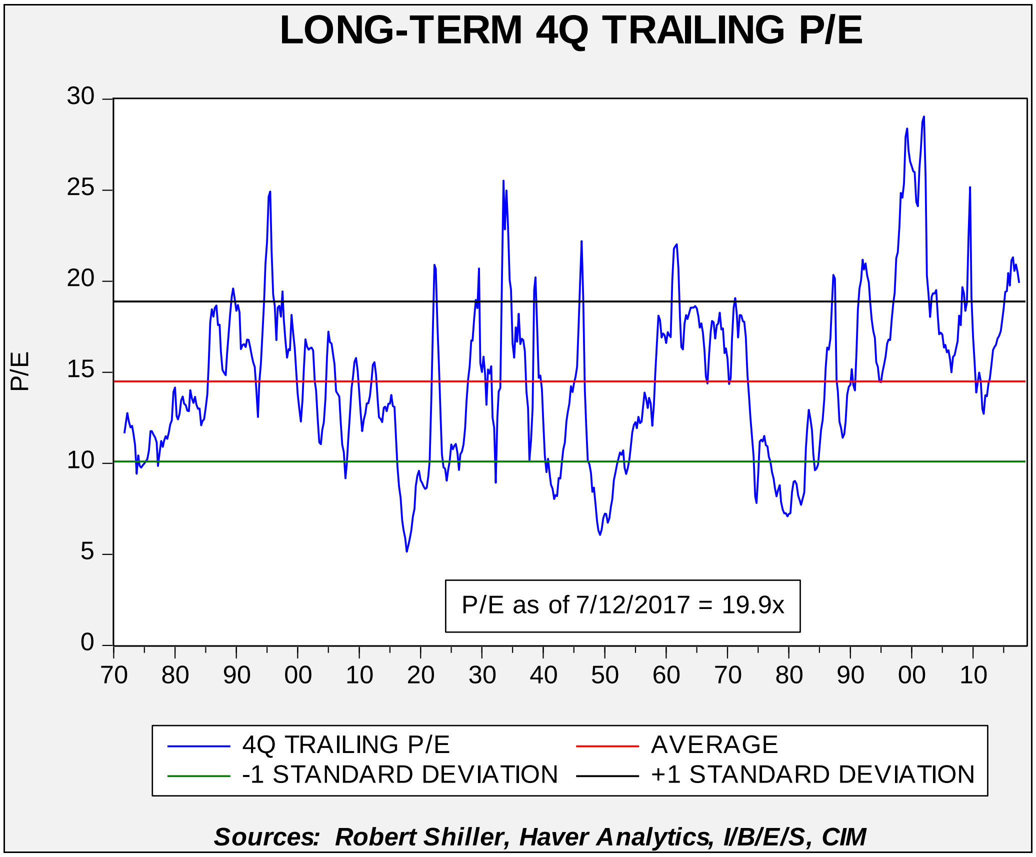


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 2017



Based on our methodology,[1] the current P/E is 19.9x, down 0.6x from last week. The drop is due to rolling to Q3.

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.