Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: July 26, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.2% from the last close. In Asia, the MSCI Asia Apex 50 closed unchanged from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a higher open. With 144 companies having reported, the S&P 500 Q2 earnings stand at $31.85, higher than the $31.42 forecast for the quarter. The forecast reflects a 6.5% increase from Q2 2016 earnings. Thus far this quarter, 76.4% of the companies reported earnings above forecast, while 16.7% reported earnings below forecast.

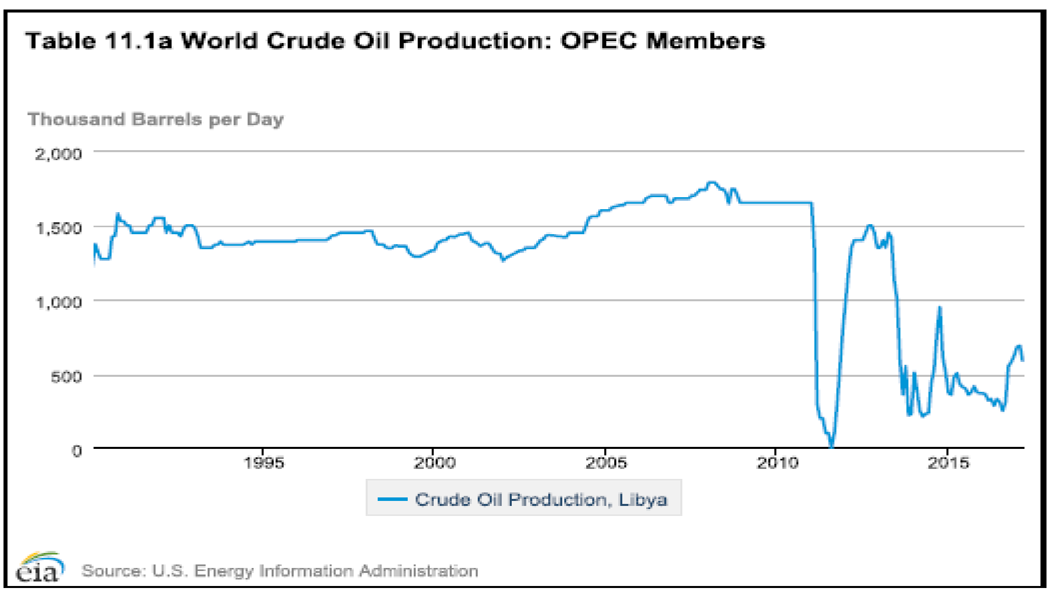
Good Wednesday morning! It's Fed day. Other than that, we continue to see the major U.S. equity indices quietly make new highs. Good earnings and nothing earthshattering coming from Washington are playing a role in lifting equity values. Here are the news items of interest today.

Fed day: There are two factors to watch for in today's statement. First, although we don't expect the FOMC to actually begin balance sheet contraction today, we do expect them to signal strongly that it will begin in September. Our take on balance sheet adjustment is that the doves on the committee are selling the hawks on the idea that reduction is tightening. In reality, it shouldn't be the case as most of the balance sheet sat innocently on commercial bank balance sheets as excess reserves. Thus, reducing those reserves a bit probably shouldn't affect the economy significantly. Therefore, if Chair Yellen can convince the hawks that balance sheet reduction is tightening, it should lead to fewer rate hikes. The problem for Yellen is the possibility that balance sheet cuts will actually act as a tightening by undermining investor confidence. We don't think this will be the outcome, but it is possible. Second, we will be watching for comments surrounding inflation. The FOMC has continually suggested that the weakness in inflation has been due to a succession of one-off events. We suspect this simply isn't the case; deregulation, globalization and the subsequent suppression of labor costs are keeping inflation down. What isn't part of this equation is monetary policy. Really, since probably the early 1990s, monetary factors have become mostly irrelevant to inflation (but not to asset prices). Unfortunately for the Fed, they have a mandate for inflation and probably have no tools to achieve that mandate, at least not under current conditions. Thus, if they admit that inflation remains low and perhaps for structural reasons, it begs the question as to why raise rates at all? The best answer is to prevent "irrational exuberance" in the asset markets. But, that means the Fed would be targeting equity values as policy, a "third rail" in the Fed's relations with Congress. To recap—we look for no rate change and no balance sheet reductions, but signaling for reductions to commence in September.

Trump ♥ Yellen? It has been widely expected that the president is planning to replace Chair Yellen in February, with Gary Cohn as the lead candidate. That is probably still the most likely outcome. However, Trump is, at heart, a soft money guy…he wants low rates and easy credit conditions. That is, by the way, a common position with presidents. Establishment Republicans represent the creditor class; they are hard money types. Thus, when one hears "rules-based policy," that really means, "higher interest rates, tight money." After all, for a creditor, easy money is an anathema. As a lender, I would get paid back in less valuable dollars. There may be one of two things going on here. First, Trump may be leaning toward replacing Priebus with Cohn, meaning that he may decide his next best alternative is Yellen. Second, Trump wants a soft money Cohn and is beginning the signaling process to let Cohn know that if he wants the chair job, he needs to be a soft money guy. Otherwise, he will stay with who he has now, a dove.

North Korea and ICBM: The *WP*[1] is reporting that North Korea could cross the ICBM threshold as early as next year, two years sooner than earlier estimates. There are still two hurdles North Korea faces to directly threaten the U.S. First, it must manage to build a warhead capable of reentry. The stresses of leaving space and entering the atmosphere are formidable but there are clear indications that the country is working on it. Second, North Korea hasn't proven it has built a miniaturized bomb that can be put on a missile. So far, all we have seen from the Hermit Kingdom are nuclear devices, which are essentially lab experiments. A missile-deliverable bomb may still take a while to achieve. But, it is clear that the U.S. is not saying anything to deter North Korea from its path toward directly threatening the U.S.

Macron mediates peace in Libya: Libya's two main rival leaders, Fayez al-Sarraj and Khalifa Haftar, have agreed to a ceasefire and promised to hold elections next year. The former is the UN-backed PM of the official government of Libya, while the latter is a military leader that controls much of the eastern part of the country. This action is important on a number of levels. First, peace coming to Libya would be a bearish factor for oil as we would expect Libyan oil production to recover.



[1] https://www.washingtonpost.com/world/national-security/north-korea-could-cross-icbm-threshold-next-year-us-officials-warn-in-new-assessment/2017/07/25/4107dc4a-70af-11e7-8f39-eeb7d3a2d304_story.html?utm_term=.59ce09a7c18c

Libyan production could reach its pre-crisis levels of 1.5 mbpd. Most recent production estimates are around 0.8 mbpd, so the additional oil would be difficult for the market to absorb. There are still issues to be resolved. Al-Sarraj is the UN-selected PM but has little power. Militias control much of western Libya's oil and may not be impressed with this deal. Second, peace in Libya might reduce the flow of refugees into Europe, which would be supportive for the European economy (at least in the short run). Italy is a bit miffed that Macron has acted as mediator. Libya was an Italian colony and it still believes it should have the most European influence in the country. Macron is showing, again, that he is a disruptive actor in Europe.

The EU acts against Poland: The EU is opening an investigation into Polish legislation that would change the court system. We doubt this will stop the ruling party in Poland from moving forward on this legislation but Poland could find itself increasingly isolated from the EU. In the end, after Brexit, that might not matter much.

Dovish talk from the Reserve Bank of Australia (RBA): The RBA Governor Lowe indicated today that, due to low inflation, he remains "comfortable" with low policy rates. The AUD has been strengthening recently on expectations of better growth, but continued low inflation readings will likely keep the RBA from raising rates in the near term. We do view the AUD as undervalued and would not expect the RBA statements to lead to a reversal in recent trends.

Iran vs. U.S.: The U.S.S. *Thunderbolt* fired two bursts of machine-gun fire at an Iranian naval vessel that approached at a very fast pace. The Iranian warship came within 150 yards of the U.S. ship before the American vessel opened fire. According to reports, these provocative acts have been increasing recently. We suspect the Iranians (and, for that matter, the Russians and the Chinese as well) are testing the new U.S. administration for its reaction to these provocations.

U.S. Economic Releases

MBA mortgage applications rose 0.4% from the prior week. Purchases fell by 2.2%, while refinancing rose by 3.4%. The average 30-year fixed rate rose 5 bps from 4.17% to 4.22%.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	New Home Sales	m/m	jun	615k	610k	**
10:00	New Home Sales	m/m	jun	0.8%	2.9%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	FOMC Rate Decision	Federal Reserve Board				

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	PPI Services	y/y	jun	0.8%	0.7%	0.8%	**	Equity and bond neutral
	Small Business Confidence	y/y	jul	50.0	49.2	49.8	**	Equity and bond neutral
Australia	Skilled Vacancies	y/y	jun	0.9%	1.2%		**	Equity and bond neutral
	CPI	y/y	may	1.9%	2.1%	2.2%	***	Equity bearish, bond bullish
New Zealand	Trade Balance NZD	y/y	jun	242 mn	103 mn	150 mn	**	Equity bullish, bond bearish
	Exports NZD	y/y	jun	4.70 bn	4.95 bn	4.60 bn	**	Equity bullish, bond bearish
	Imports NZD	y/y	jun	4.46 bn	4.85 bn	4.40 bn	**	Equity and bond neutral
EUROPE								
France	Consumer Confidence	m/m	jul	104	108	108	***	Equity and bond neutral
Italy	Economic Sentiment	m/m	jul	105.5	106.4		**	Equity and bond neutral
	Manufacturing Confidence	m/m	jul	107.7	107.3	107.0	**	Equity and bond neutral
	Consumer Confidence Index	y/y	jul	106.7	106.4	106.3	***	Equity and bond neutral
UK	BBA Loans for House Purchase	y/y	jun	40200	40347	40000	**	Equity and bond neutral
	GDP	y/y	2q	1.7%	2.0%	1.7%	***	Equity and bond neutral
	Index of Services	y/y	may	0.2%	0.2%	0.1%	**	Equity and bond neutral
Switzerland	UBS Consumption Indicator	m/m	jun	1.38	1.39		**	Equity and bond neutral
	Credit Suisse Survey Expectations	m/m	jul	34.7	20.7		**	Equity bullish, bond bearish
AMERICAS								
Mexico	Retail Sales	y/y	jul	4.1%	1.4%	3.5%	**	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)	114	114	0	Neutral
TED spread (bps)	17	17	0	Neutral
U.S. Libor/OIS spread (bps)	117	117	0	Up
10-yr T-note (%)	2.31	2.34	-0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	29	29	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	up			Up
yen	up			Neutral
pound	up			Down
franc	down			Down
Central Bank Action		**Prior**	**Expected**	
FOMC Rate Decision (Upper Bound)		1.250%	1.250%	On forecast
FOMC Rate Decision (Lower Bound)		1.000%	1.000%	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	$50.48	$50.20	0.56%	Bullish API
WTI	$48.28	$47.89	0.81%	
Natural Gas	$2.93	$2.94	-0.54%	
Crack Spread	$17.70	$18.15	-2.48%	
12-mo strip crack	$16.06	$16.34	-1.74%	
Ethanol rack	$1.68	$1.68	-0.13%	
Metals				
Gold	$1,247.97	$1,250.06	-0.17%	Strong Dollar
Silver	$16.46	$16.50	-0.22%	
Copper contract	$285.25	$284.65	0.21%	
Grains				
Corn contract	$ 382.25	$ 382.25	0.00%	
Wheat contract	$ 478.50	$ 474.00	0.95%	
Soybeans contract	$ 993.25	$ 992.75	0.05%	
Shipping				
Baltic Dry Freight	980	977	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.1		
Gasoline (mb)		-1.9		
Distillates (mb)		-0.8		
Refinery run rates (%)		0.00%		
Natural gas (bcf)		29.0		

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 along the southern region. There is a tropical formation off the coast of West Africa but it is unclear as to whether it will develop into a cyclone; we will continue to monitor.

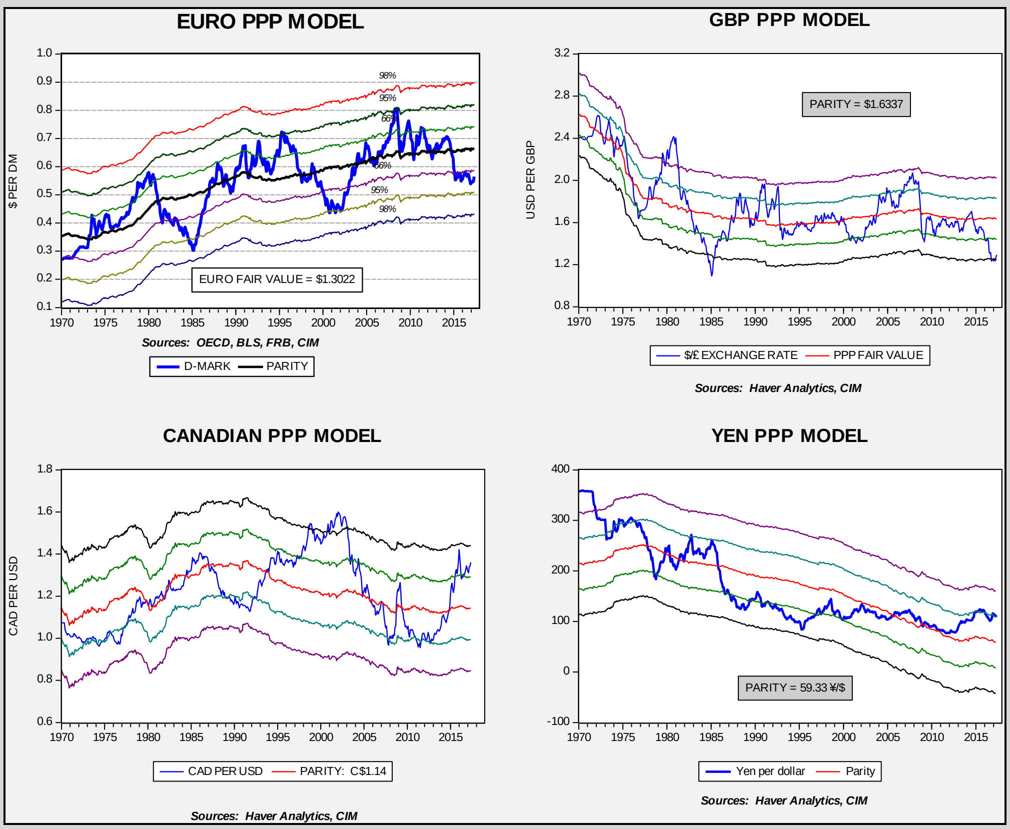
Asset Allocation Weekly Comment

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 21, 2017

In the past few years, we have generally avoided allocations to non-U.S. markets for our asset allocation portfolios due to two primary concerns. First, the dollar was rising as a result of an improving U.S. economy and policy divergences between the U.S. and the rest of the world. The Federal Reserve was raising rates and tapering its balance sheet while the majority of the other nations were still adding monetary stimulus. Second, we have had secular concerns about the stability and attractiveness of foreign investing in a world where the U.S. is seemingly reducing its hegemonic role.

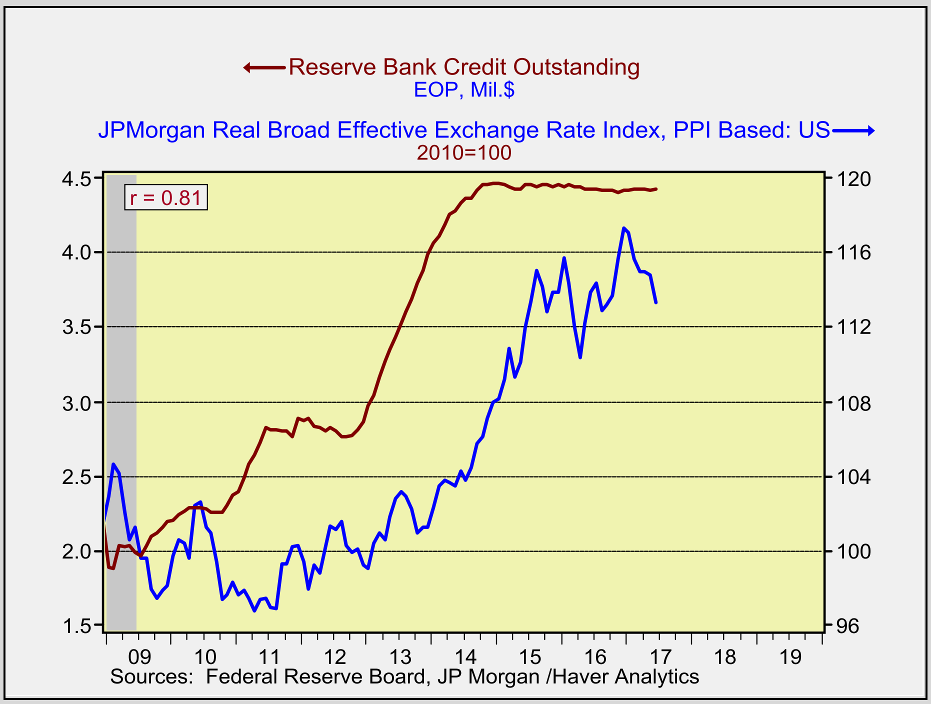
This quarter we have added foreign allocations into our portfolios. The primary reason is that we believe the dollar's bull market is probably coming to a close. On a relative valuation basis, the dollar has become rather expensive.



This chart shows four purchasing power parity models for the euro, yen, British pound and Canadian dollar. In all four cases, the dollar is trading "rich" by more than one standard error, and in two cases, nearly two standard errors from parity. Purchasing power parity uses relative inflation to value currencies. As the models show, currencies are rarely at parity. Although purchasing power parity is the oldest way to value currencies, it isn't the most accurate. However, it tends to be useful at extremes, and exchange rates tend to move around the parity measure. In other words, parity is something of an anchor around which the actual exchange rate vacillates.

History also suggests that exchange rates can diverge from parity for long periods of time, which usually means that a catalyst is required to move currencies from extremes of under-and over-valuation. For example, in the above euro and pound models, the deep undervaluation in the mid-1980s ended with the Plaza Accord. Yen overvaluation in the early 1990s was ended by the Halifax Accord. Changes in policy or governments can trigger an end to valuation extremes as well.

This leads us to two additional reasons for this repositioning. We believe there are two catalysts which will pressure the dollar in the coming quarters. First, the Federal Reserve appears to be hedging on future tightening. Although the dots charts still indicate rising rates, a number of FOMC members have raised worries about raising rates while inflation remains depressed. Chair Yellen appears to be offering a trade to the hawks on the committee; instead of raising rates, balance sheet reductions can act as policy tightening. It is possible reducing the balance sheet will be dollar bullish. However, that isn't supported by the data.

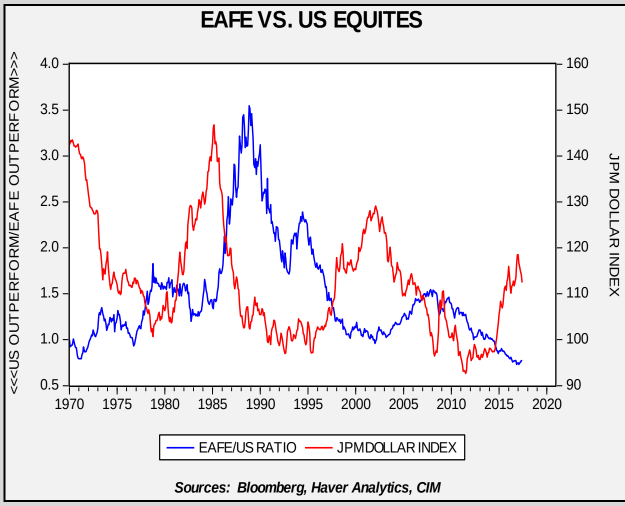


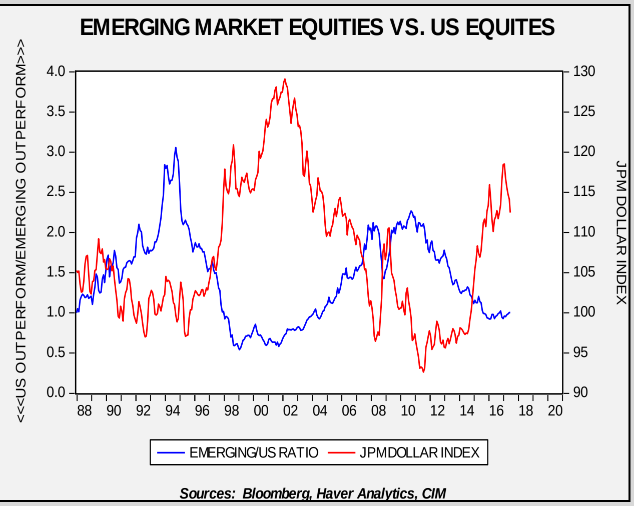
Although economic theory would suggest that boosting the size of the balance sheet should depreciate a currency, all else held equal, the pattern on the above chart developed likely because QE raised hopes of stronger growth. Our expectation is that reducing the balance sheet probably won't matter, but if the pattern is consistent, balance sheet reduction may actually be dollar-bearish. So, we expect the anticipated monetary policy trade of fewer rate hikes for balance sheet shrinkage to be bearish for the dollar.

The second catalyst is policy disappointment from the Trump administration. Earlier this year, we were worried about the dollar's overvaluation. And, proposed tax cuts and fiscal expansion from the Trump administration would have been dollar bullish, even at lofty valuations. However, the likelihood of major policy actions have declined and each month that passes without a policy adjustment means that political capital is being lost and it becomes less likely anything will pass. As disappointment grows, we would expect the dollar to retreat.

Although we retain our secular concerns about the stability and attractiveness of foreign investing in a world where the U.S. is seemingly reducing its hegemonic role, these concerns are overshadowed by the changing dynamics of monetary stimulus. Essentially, the near-term effects of policy and the exchange rate outweigh our secular concerns.

Finally, the issue of recent performance needs to be addressed. Both emerging and foreign developed equity markets have performed very well this year and there is a concern that we may be shifting too late into these asset classes. Although possible, if our expectations of a weaker dollar are accurate, history would suggest a longer period of foreign outperformance.

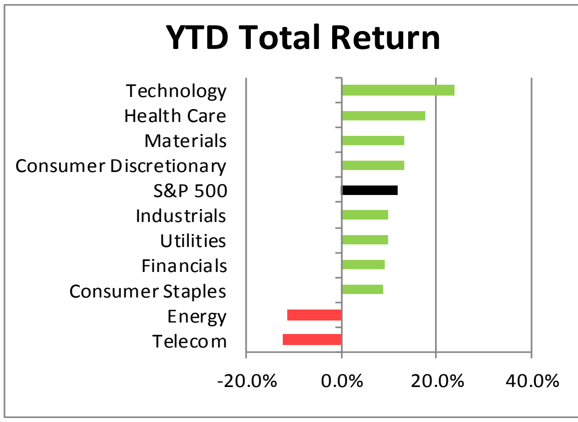


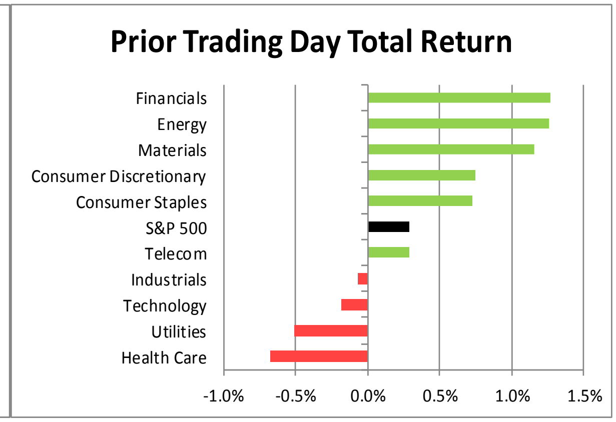


The red line on both charts shows the JP Morgan real dollar index. The blue line on the left chart is the ratio of dollar-denominated EAFE and the S&P; on the right chart, it's the dollar-denominated ratio of emerging markets and the S&P. Both have been rebased to their respective start periods. On both charts, a lower ratio indicates U.S. equity outperformance relative to foreign markets; a rising ratio shows the opposite. In both cases, periods of dollar strength coincide with domestic outperformance. Thus, even with good foreign performance this year, a weaker dollar may result in a longer period of foreign outperformance.

Data Section

U.S. Equity Markets – (as of 7/25/2017 close)

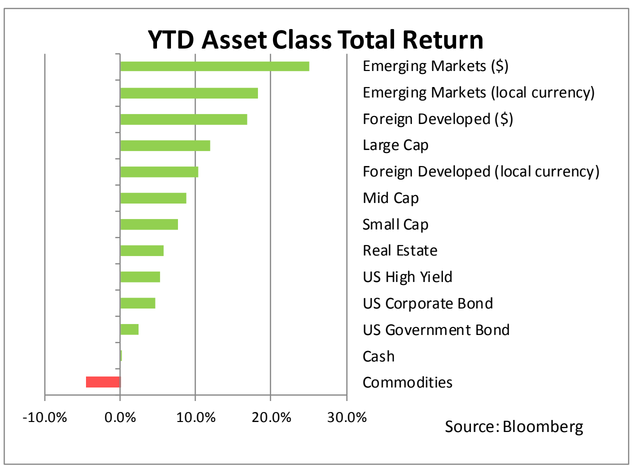




(Source: Bloomberg)

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 7/25/2017 close)

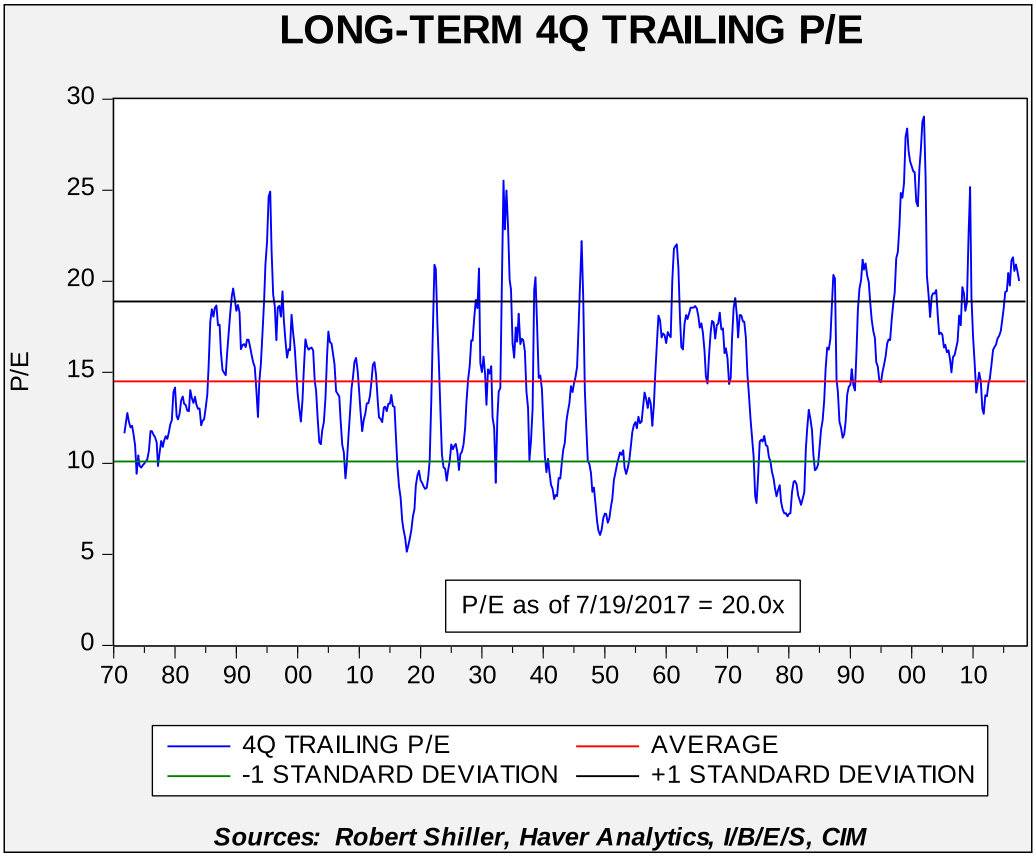


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2017



Based on our methodology,[2] the current P/E is 20.0x, up 0.1x from last week. The rise is due to rising equity prices as earning expectations are stable.

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.