Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: July 31, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.9% from the prior close. Chinese markets were up, with the Shanghai composite up 0.6% and the Shenzhen index also up 0.6%. U.S. equity index futures are signaling a higher open. With 286 companies having reported, the S&P 500 Q2 earnings stand at $32.20, higher than the $31.42 forecast for the quarter. The forecast reflects a 6.5% increase from Q2 2016 earnings. Thus far this quarter, 71.7% of the companies reported earnings above forecast, while 18.9% reported earnings below forecast.

Happy St. Ignatius of Loyola Day! The weekend was news heavy—here's what we are watching this morning.

A new Chief of Staff: Reince Priebus was removed from the Chief of Staff position at the White House late Friday. Although it does appear he resigned the day before, his removal played out on national TV with him standing in the rain on the tarmac in Washington. Gen. John F. Kelly moved from DHS to the Chief of Staff role and begins his job in earnest today. There is much being discussed about the problems Kelly will face in trying to streamline the Byzantine organizational structure of the Trump White House. From a market perspective, probably the most important signal this appointment sends is that Gary Cohn is the frontrunner for Fed Chair. There was speculation that Cohn could become Chief of Staff if (or when) Priebus was removed. Of course, if Cohn took that job, it reduced the chances that he would take the FOMC role. With Kelly's appointment, Cohn remains in the running. Although we think odds still favor Cohn getting the Fed Chair position, it wouldn't shock us if Trump decides to keep Yellen in place. Yellen is a dove and Cohn would probably be more hawkish. In addition, it should be noted that Priebus's exit from the White House reduces establishment GOP influence. The establishment GOP generally favors higher rates—establishment Republicans tend to be creditors who like low inflation, a strong dollar and higher interest rates. Trump has made it clear he isn't a hawk on monetary policy and thus may find Yellen is a better fit for his policy goals. We still think odds favor Cohn to replace Yellen but the likelihood isn't overwhelming.

On to taxes…maybe? Congressional Republicans have signaled that with the failure to repeal Obamacare the agenda will move to tax reform. However, the president continues to urge lawmakers to pass a repeal measure. Each day that tax reform (or cuts) are delayed means more political capital is lost and reduces the odds that anything gets accomplished. Lurking in the background is the debt ceiling. The Freedom Caucus is apparently planning to trade spending cuts for permission to raise the limit; this may mean we could see a shutdown develop by late September or early October.

Another North Korean missile test: North Korea successfully launched another ICBM and, by all accounts, this one could reach the continental U.S. and maybe all the way to the Midwest. The U.S. response was multipronged. First, American B-1 bombers flew over South Korea, accompanied by South Korean F-16s. Second, the South Koreans requested and the U.S. approved longer range missiles in South Korea. Third, the U.S. is strongly considering additional sanctions against China to encourage China to pressure Pyongyang to restrain its behavior. The North Korean problem is a major concern of ours as the U.S. is rapidly facing a binary choice of either accepting North Korea as a nuclear state or fighting a very costly war on the Korean peninsula. Although the more likely outcome is the former, President Trump is capable of aggressive action.

The Russians toss U.S. diplomats: Russia didn't initially respond to the Obama administration's decision to remove some Russian diplomats and close two Russian facilities but, in light of recent sanctions, the Kremlin his decided to send 755 U.S. diplomatic personnel home. Despite attempts by the president to improve relations, it appears that the trend of a new cold war with Russia has resumed.

The mess in Venezuela: The Venezuelan government held an election on Sunday to select a constituent assembly to create a new constitution. The vote was rigged by design; voters only got to select the members of the assembly, not decide whether the constitution should be rewritten. The government claims eight million Venezuelans voted, but independent observers think it was about half that level at best. It is unclear where we go from here. The Trump administration has threatened sanctions if the elections were held. We are waiting to see what the U.S. will implement. At a minimum, we expect the administration to restrict access to the U.S. financial system. At worst, the U.S. could ban Venezuelan exports. Given that Venezuelan crude oil is heavy and sour, there are few outlets for its oil. China and Russia are especially nervous because they are significant creditors to the regime. If the government falls, the incoming government may repudiate the debt. We are seeing signs that the economic situation is becoming untenable. Venezuela is having difficulty generating inflation because it can't print enough banknotes. The country imports its currency from foreign printers and, since they haven't been paid, new currency isn't coming in which is stabilizing prices. In addition, the market for dollars has seized up in Venezuela as those holding greenbacks are hoarding them and won't trade them at any price. If Venezuela collapses, it may be short-term bullish for crude oil.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Chicago Purchasing Manager	m/m	jul	60.0	65.7	**
10:00	Pending Home Sales	m/m	jun	1.0%	-0.8%	**
10:00	Pending Home Sales NSA	m/m	jun		0.5%	**
10:30	Dallas Fed Manf. Activity	m/m	jul	13.0	15.0	**
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	Manufacturing PMI	y/y	jun	51.4	51.7	51.5	**	Equity and bond neutral
	Non-manufacturing PMI	y/y	jun	54.5	54.9		**	Equity and bond neutral
Japan	Industrial Production	y/y	jun	4.9%	6.5%	4.8%	***	Equity bearish, bond bullish
	Loans & Discounts Corp	y/y	jun	4.1%	3.9%		**	Equity and bond neutral
	Vehicle Production	y/y	jun	6.9%	5.5%		**	Equity and bond neutral
India	Fiscal Deficit INR Core	m/m	jun	68324	167739		**	Equity and bond neutral
	Eight Infrastructure	m/m	jun	0.4%	3.6%		**	Equity and bond neutral
Australia	Melbourne Institute Inflation	y/y	jun	2.7%	2.3%		**	Equity and bond neutral
	HIA New Home Sales	y/y	jun	-6.9%	1.1%		**	Equity and bond neutral
	Private Sector Credit	y/y	jun	5.4%	5.0%	5.2%	**	Equity and bond neutral
New Zealand	Building Permits	m/m	jun	-1.0%	7.0%		**	Equity and bond neutral
	ANZ Activity Outlook	m/m	jul	40.3	42.8		**	Equity and bond neutral
	ANZ Business Confidence	m/m	jul	19.2	24.8		**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	jun	9.1%	9.3%	9.2%	***	Equity and bond neutral
	CPI Estimate	m/m	jul	1.3%	1.3%	1.3%	***	Equity and bond neutral
	CPI Core	m/m	jul	1.2%	1.1%	1.1%	***	Equity and bond neutral
Germany	Retail Sales	y/y	jun	1.5%	4.8%	2.7%	**	Equity bearish, bond bullish
Italy	Unemployment Rate	m/m	jul	11.1%	11.3%	11.2%	***	Equity and bond neutral
	CPI NIC inc. tobacco	y/y	jul	1.1%	1.2%	1.0%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	jul	1.2%	1.2%	1.2%	***	Equity and bond neutral
	PPI	y/y	jun	3.1%	3.1%		**	Equity and bond neutral
UK	Net Consumer Credit	y/y	jun	1.5 bn	1.7 bn	1.5 bn	*	Equity and bond neutral
	Net Lending Sec. on Dwellings	y/y	jun	4.1 bn	3.5 bn	3.4 bn	*	Equity and bond neutral
	Mortgage Approvals	y/y	jun	64.7k	65.2k	65.0k	*	Equity and bond neutral
	Money Supply M4	m/m	jun	-0.2%	-0.1%		**	Equity and bond neutral
Switzerland	Total Sight Deposits	y/y	jul	579.1 bn	579.1 bn		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	jul	478.9 bn	475.4 bn		**	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)	106	106	0	Neutral
TED spread (bps)	25	25	0	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.29	2.29	0.00	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	down			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	$52.49	$52.52	-0.06%	Long Liquidation
WTI	$49.67	$49.71	-0.08%	
Natural Gas	$2.84	$2.94	-3.43%	
Crack Spread	$19.92	$19.45	2.43%	
12-mo strip crack	$17.20	$17.07	0.76%	
Ethanol rack	$1.70	$1.70	0.11%	
Metals				
Gold	$1,268.99	$1,269.64	-0.05%	
Silver	$16.85	$16.76	0.56%	
Copper contract	$289.75	$287.50	0.78%	
Grains				
Corn contract	$ 383.00	$ 388.00	-1.29%	Weather Conditions
Wheat contract	$ 476.00	$ 481.00	-1.04%	
Soybeans contract	$ 1,001.00	$ 1,013.00	-1.18%	
Shipping				
Baltic Dry Freight	933	942	-9	

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. Tropical Storm Emily has entered the Gulf of Mexico and is currently positioned off the coast of Florida. TS Emily is slowing and is expected to dissipate by Thursday, hence it is unlikely to cause any major disruptions in the production or shipping of oil in the Gulf of Mexico.

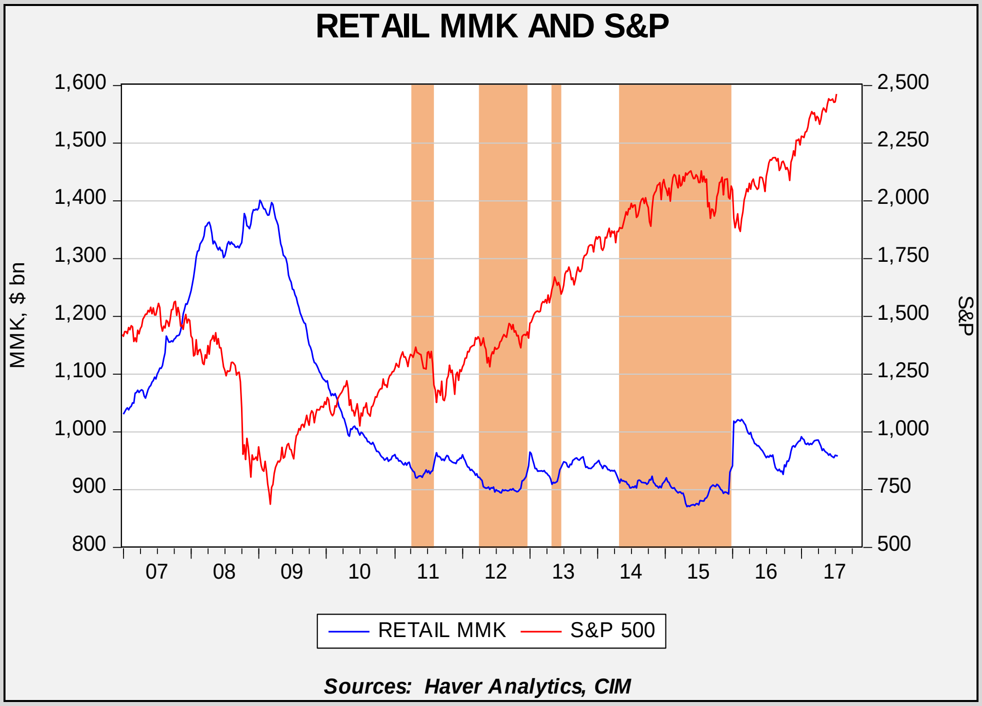
Asset Allocation Weekly Comment

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

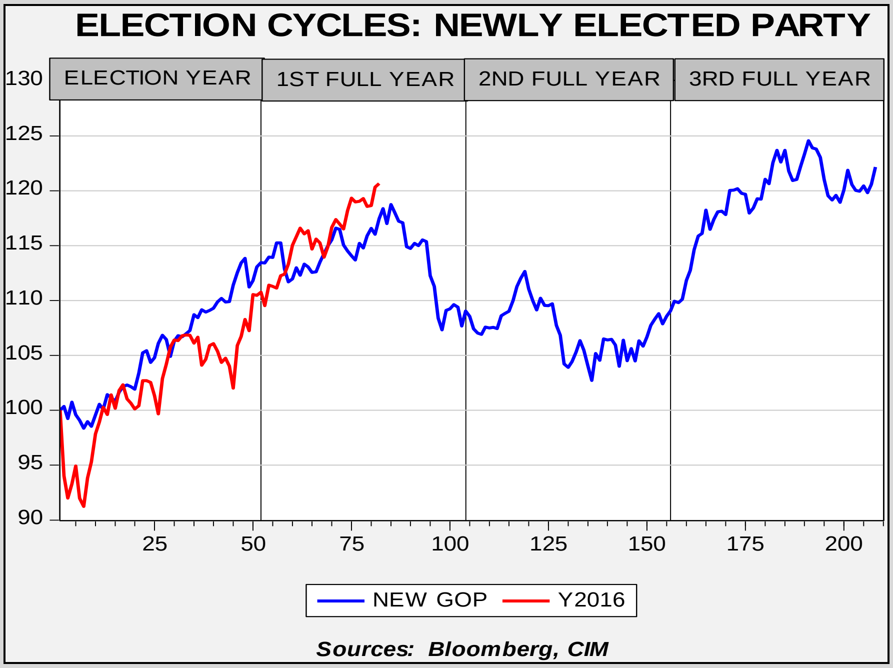
As the S&P 500 steadily rises to new highs, concerns about a correction will likely increase. Since 1987, major market pullbacks have been associated with recessions and there isn't much evidence to suggest the business cycle is set to turn. In the absence of a recession, we tend to look for factors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

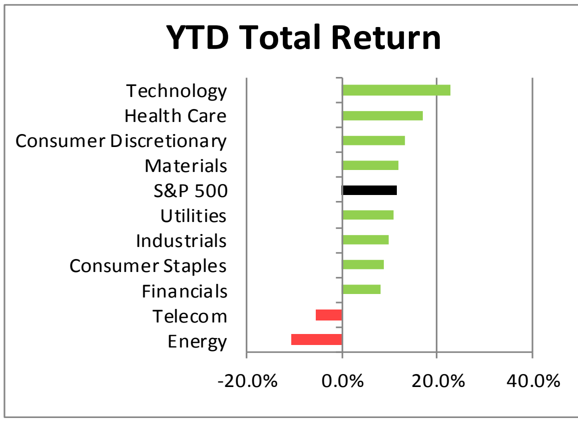


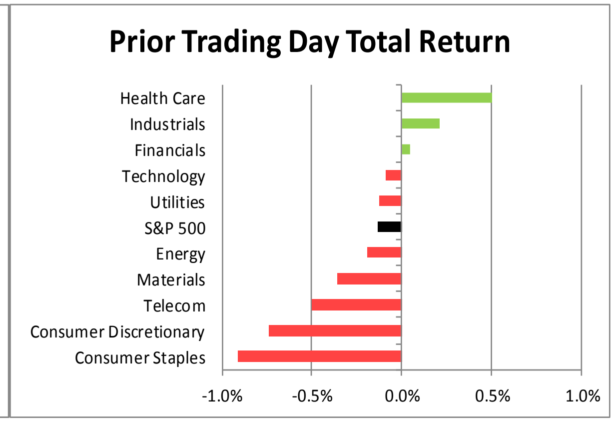
This chart shows the performance of the S&P 500 on a weekly close basis, indexed to the first weekly close of the election year. Our study begins in 1928. We have segregated new GOP administrations in the average and compared market action to the current administration. Although the fit isn't perfect, 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 7/28/2017 close)

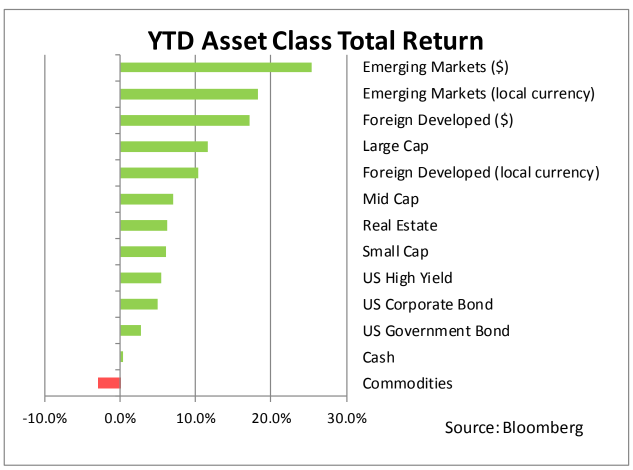




(Source: Bloomberg)

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 7/28/2017 close)

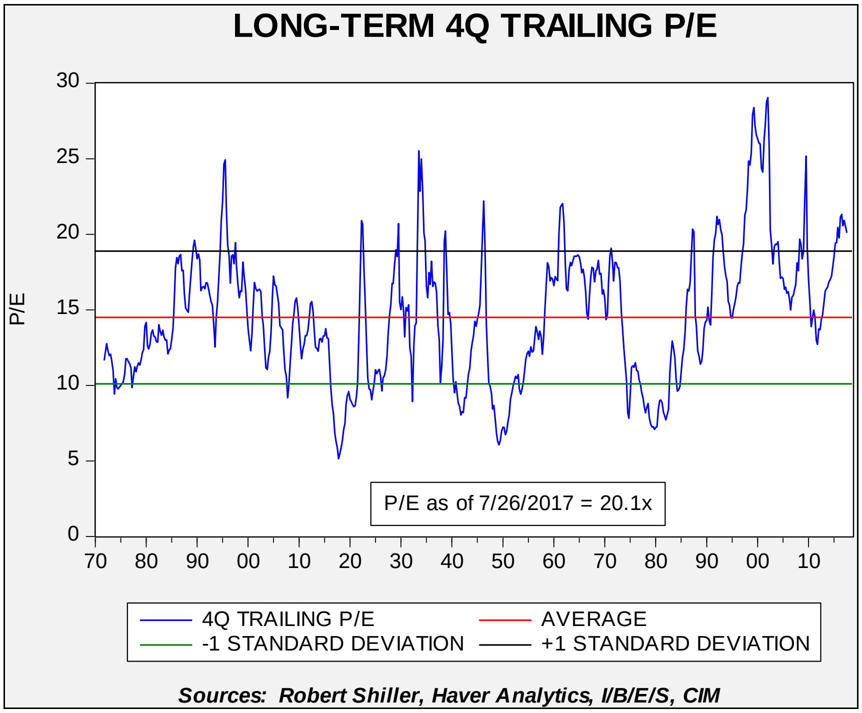


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

[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.