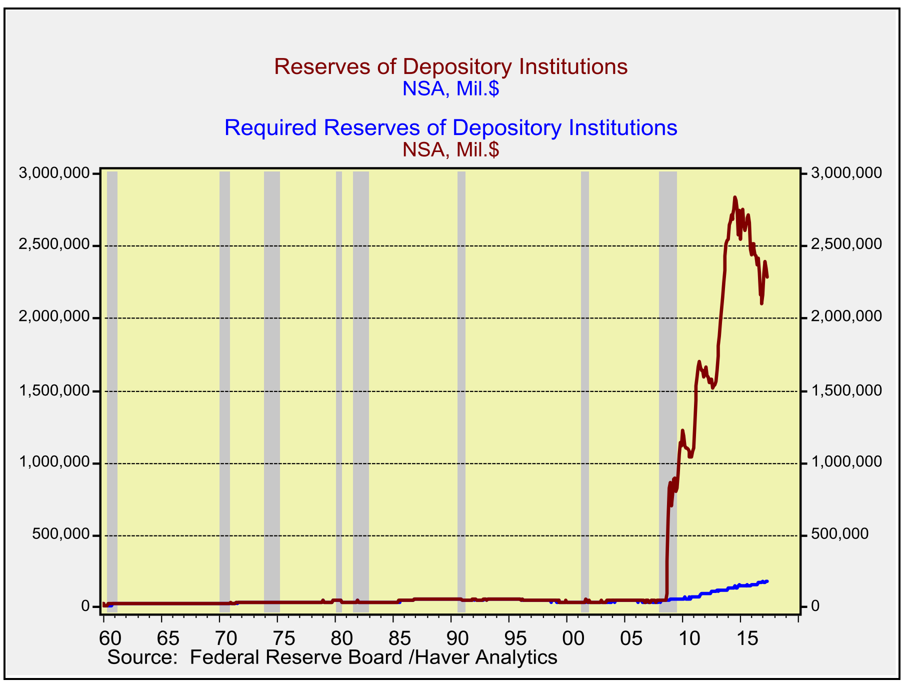
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: July 6, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 1.0% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets were up, with the Shanghai composite up 0.2% and the Shenzhen index up 0.1%. U.S. equity index futures are signaling a lower open.

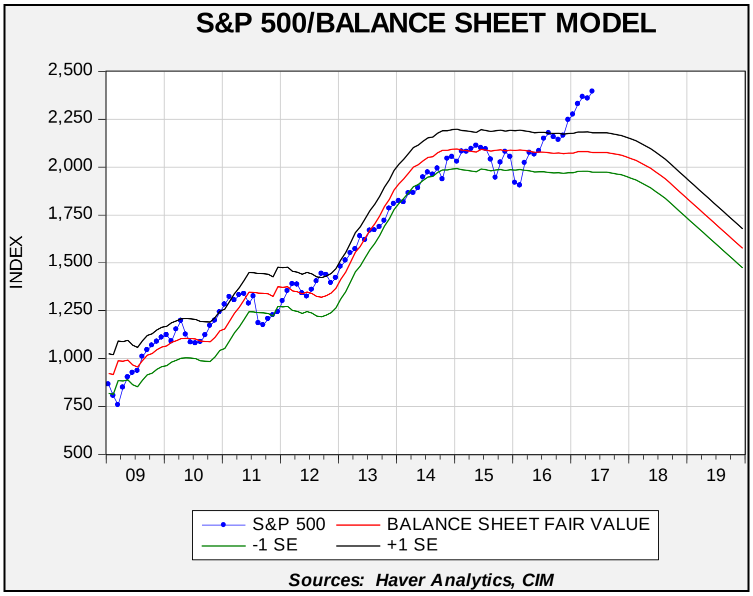
It's a fairly quiet morning, typical of mid-summer. Here are the issues we are watching:

Fed minutes: Most of the media recaps focused on the reduction of the balance sheet. As we have noted in the past, in theory, this action shouldn't be a big deal. Most of QE ended up sitting harmlessly in the banks as excess reserves. Simply put, the funds from QE were injected into the banking system and then simply sat. Thus, taking them away shouldn't have much of an impact.



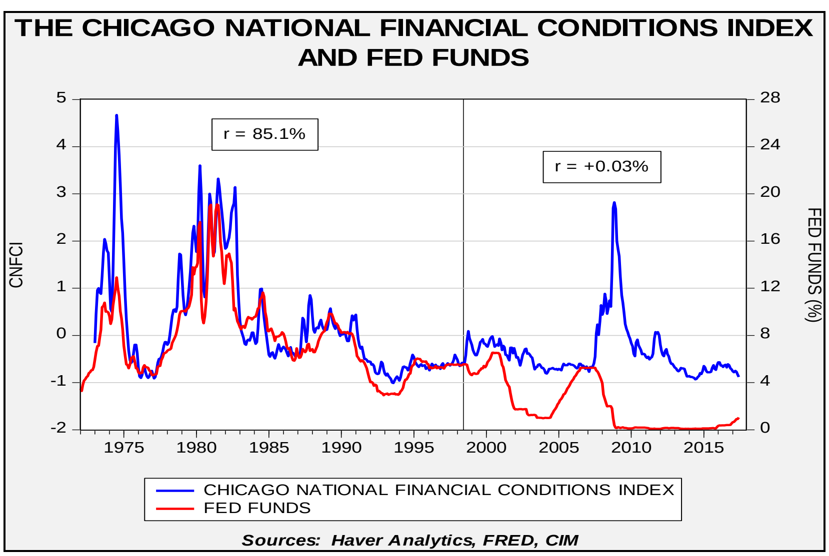
As this chart shows, excess reserves are almost 13x more than required reserves. Since tapering began, the level of excess reserves has started to decline but still remains high. Therefore, removing some of these reserves probably won't prevent loans from being given.

The bigger concern is the psychological impact of shrinking the balance sheet.



This is a chart we have shown for a while with a new twist; we assume the Fed will begin its process of reducing the balance sheet in September and follow the plans previously released. Obviously, if the balance sheet affected equity markets in a mechanical fashion, a bear market is looming. We don't think this is the case. We believe that the impact of QE on equities was to reassure investors that the Fed wasn't lacking tools to stimulate the economy. If investors are confident about continued economic growth, the impact of balance sheet contraction shouldn't be a big deal. However, since we have never seen anything like this before, it is difficult to quantify the risk factor.

Buried in the minutes were concerns expressed about the "increased risk tolerance" of investors as a reason for tighter policy. As we have noted before, the Fed has lost control of financial conditions. Until the late 1990s, the Fed could affect financial stress via changes in fed funds. That relationship broke down in the late 1990s.



This chart shows the relationship of the Chicago FRB Financial Conditions Index and fed funds. The blue line measures financial stress, with a higher number indicating elevated stress. Note that the two series were tightly correlated from 1973 into 1998. Since then, the two have become almost completely independent. We believe that the primary reason for the breakdown is transparency; from the late 1980s to the present, the Fed has become increasingly transparent and the more the Fed telegraphed its policy actions, the less policy activity affected stress. Thus, when financial conditions deteriorated in 2007-10, the policy rate fell to zero and had to be held there before stress declined. We note that NY FRB President Dudley suggested in a recent speech that the FOMC should be raising rates due to low levels of financial stress. This could be considered a type of "controlled burn" by the Fed. What is interesting is that if the relationship between fed funds and the above stress index had remained consistent since the 1973-98 period, then financial stress would be almost twice as low! Thus, if the FOMC raises rates to lift stress, it will almost certainly overtighten. This says nothing about the policy nightmare the Fed would face if it made the P/E a policy goal.

The takeaway from the minutes is that the FOMC is on a path of policy tightening and risks will rise over time.

The G-20: This promises to be a contentious meeting. Merkel and Trump are not getting along. The presidents of Russia and the U.S. will meet for the first time. There is talk of trade wars over steel tariffs. Given that expectations for this meeting are already low, it is hard to imagine there will be a disappointment. Normally, G-20 meetings are snoozers. We do expect some friction given all the tensions in the world, but the most likely outcome is that the meeting "won't be that bad," mostly because our expectations are so depressed.

North Korea: There isn't much new to report. The UNSC took up the issue yesterday. As expected, Russia and China were reluctant to press hard on North Korea. The U.S. is making military threats but there isn't much evidence of mobilization. As we have noted before, there are no good outcomes with North Korea.

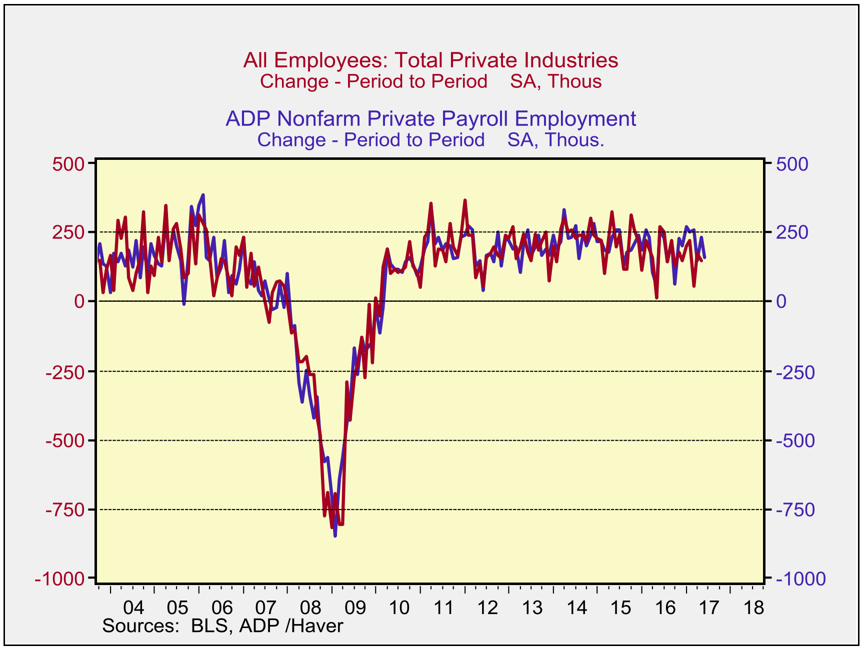
Employment day tomorrow: Current forecasts call for non-farm payrolls to rise 177k, with an unemployment rate of 4.3% and average hourly earnings rising 2.6%.

U.S. Economic Releases

MBA mortgage applications rose 1.4% from the prior week. Purchases rose 3.1%, while refinancing fell 0.4% from the prior week. The average 30-year fixed rate mortgage rose 7 bps from 4.13% to 4.20%.

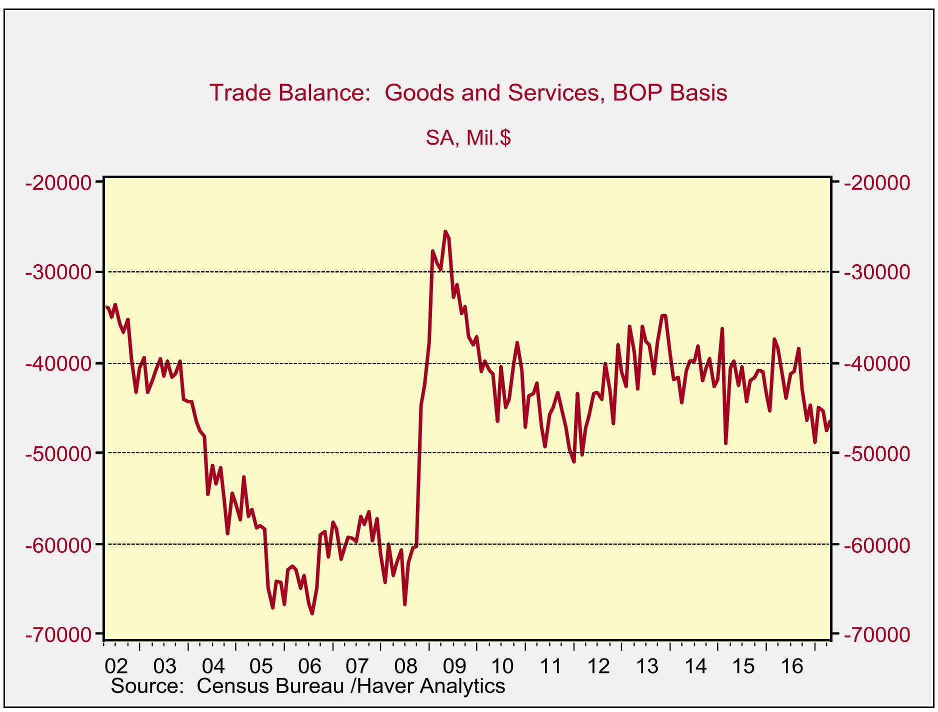
The June Challenger job cuts report fell by 19.3% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

The ADP employment change came in below expectations at 158k compared to the forecast of 188k. The prior report was revised downward from 253k to 230k.



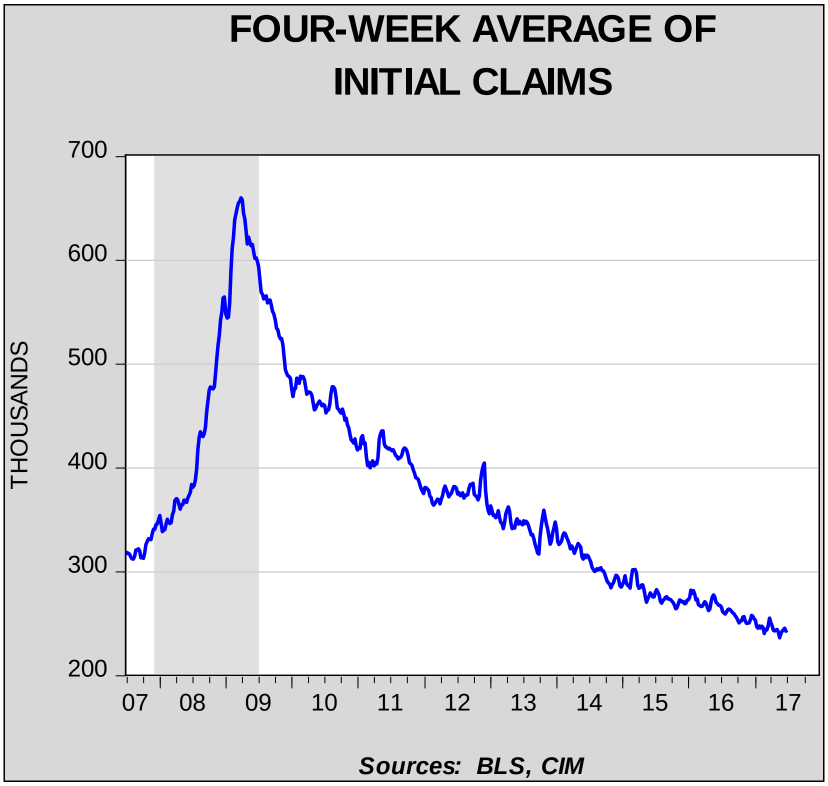
The chart above shows the period change of nonfarm payrolls and ADP employment change.

The U.S. goods and services trade deficit came in above expectations at $46.5 bn compared to the forecast of $46.3 bn.



The chart above shows the level of the trade balance for goods and services. Over the past six years, the trade deficit has been volatile but has generally moved sideways. That being said, recent trade data has come in relatively low over the past three months.

Initial jobless claims came in above expectations at 248k compared to the forecast of 243k.



The chart above shows the four-week moving average for initial claims. The moving average rose by 0.75k to 242.75k, suggesting the labor market is still pretty strong.

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 Services	m/m	jun	53.0	53.0	**
9:45	Bloomberg Consumer Comfort	m/m	jun		48.6	**
9:45	Markit US Composite	m/m	jun		53.0	**
10:00	ISM Non-Manfacturing Composite	m/m	jun	56.5	56.9	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:00	Stanley Fischer speaks in New York	Vice Chairman of Board of Governors of Federal Reserve				
19:30	John Williams speaks in Santa Cruz	President of the Federal Reserve Bank of San Francisco				

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	Japan Buying Foreign Bonds	m/m	jun	0.7728 bn	0.3218 bn		*	Equity and bond neutral
	Japan Buying Foreign Stocks	m/m	jun	0.1497 bn	0.3661 bn		*	Equity and bond neutral
	Japan Buying Japan Bonds	m/m	jun	0.0758 bn	-1.4639 bn		*	Equity and bond neutral
	Japan Buying Japan Stocks	m/m	jun	0.014 bn	-0.0263 bn		*	Equity and bond neutral
Australia	Trade Balance	m/m	may	A$2.471 bn	A$0.555 bn	A$1.000 bn	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Retail	m/m	jun	53.2	52.0		**	Equity and bond neutral
Germany	Factory Orders	m/m	may	1.0%	-2.1%	1.9%	**	Equity and bond neutral
	Markit Germany Construction PMI	m/m	jun	55.1	55.3		**	Equity and bond neutral
	Markit Germany Retail PMI	m/m	jun	54.5	55.0		**	Equity and bond neutral
France	Markit France Retail PMI	m/m	jun	56.3	53.3		**	Equity bullish, bond bearish
Italy	Markit Italy Retail PMI	m/m	jun	47.1	45.5		**	Equity and bond neutral
Switzerland	CPI	y/y	jun	0.2%	0.5%	0.3%	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Consumer Confidence Index	m/m	jun	87.2	86.8	88.0	**	Equity and bond neutral
	Gross Fixed Investment	m/m	apr	-8.6%	3.9%	-5.9%	**	Equity bearish, bond bullish

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	27	1	Neutral
U.S. Libor/OIS spread (bps)	117	117	0	Up
10-yr T-note (%)	2.36	2.32	0.04	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	up			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	$48.37	$47.79	1.21%	Bullish API
WTI	$45.71	$45.13	1.29%	
Natural Gas	$2.89	$2.84	1.58%	
Crack Spread	$17.72	$17.64	0.48%	
12-mo strip crack	$15.79	$15.81	-0.12%	
Ethanol rack	$1.68	$1.68	-0.12%	
Metals				
Gold	$1,223.41	$1,227.04	-0.30%	
Silver	$16.00	$16.09	-0.57%	
Copper contract	$266.20	$266.00	0.08%	
Grains				
Corn contract	$ 385.00	$ 392.00	-1.79%	
Wheat contract	$ 541.00	$ 560.00	-3.39%	
Soybeans contract	$ 988.25	$ 994.25	-0.60%	
Shipping				
Baltic Dry Freight	847	871	-24	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		-2.0		
Distillates (mb)		0.0		
Refinery run rates (%)		0.65%		
Natural gas (bcf)		66.0		

Weather

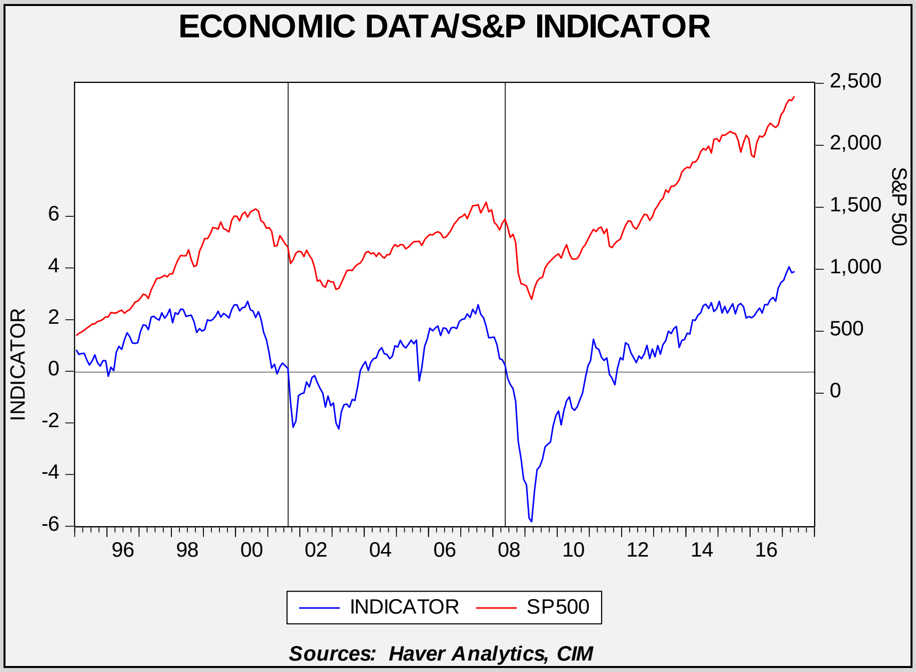
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for the eastern region. The tropical cyclone developing in the south Atlantic has formed into a depression, but at this time it is unlikely to make its way to the Gulf of Mexico. Current forecasts expect the event to remain a depression into Saturday when it will be some 400 miles north of Puerto Rico.

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.

June 30, 2017

For equity investors, there is always a concern about the major market declines; being able to reduce market exposure prior to crashes like the ones in 2000 or 2008 is always desirable. Although large declines have occurred outside of economic recessions, they have become increasingly rare. The last major market pullback absent a recession was the 1987 crash. Thus, an indicator that can use high frequency economic data (data that is available on a weekly basis) and relate it to equities should have some value.



This chart shows one of our recent efforts. The upper line is the monthly average for the S&P 500; the lower 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[1] the economic data and created an indicator, shown on the bottom of the graph. In general, a positive reading is generally 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.

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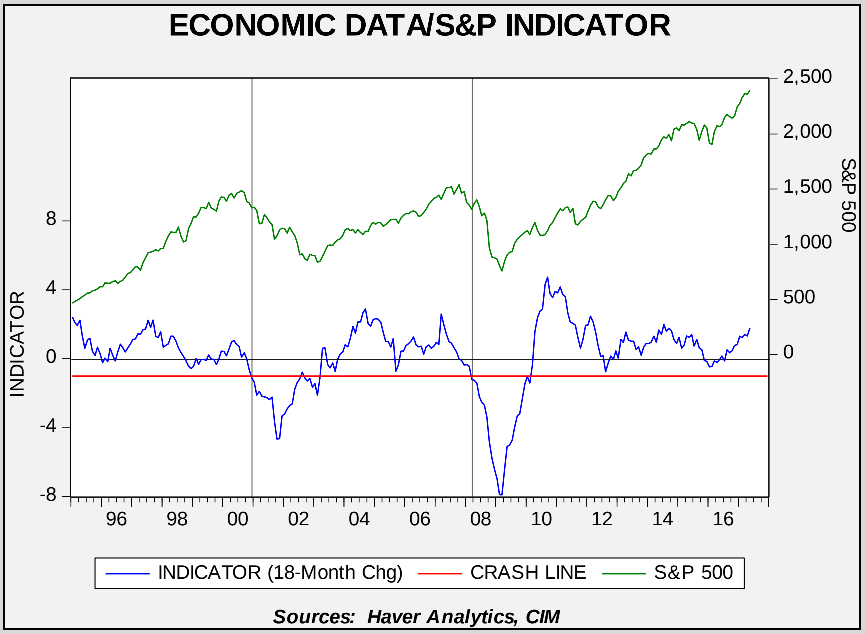
[1] Standardizing entails subtracting the raw data by its average and dividing by its standard deviation. The resulting number is then adjusted by how far it is from average and how far it is from its normal deviation. Standardizing allows one to combine unlike indicators and essentially balance their relative effect. In this case, the formula is Indicator = (standardized CRB + standardized Consumer Confidence) – standardized Initial Claims. We subtract the claims data because lower claims indicates a stronger economy. Subtracting that number thus allows the indicator to rise when economic data are improving and vice versa.

Although useful, it is clear that the indicator is somewhat "late" in that the equity decline is well underway by the time it becomes negative. That would suggest that a momentum number based off the economic indicator might be helpful.



To achieve this, we calculated the 18-month change in the above indicator and set a "crash line" at -1.0. The adjustment improves the indicator's value, indicating an investor should reduce equity exposure sooner than the unchanged index would suggest. At the same time, using a -1.0 reading eliminated the false exit signals.

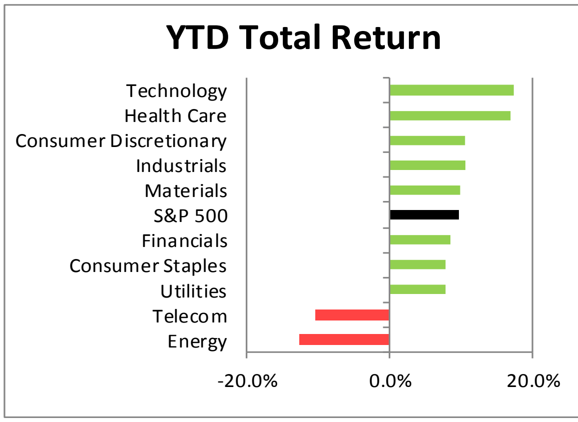
There is an element of "data mining" here and we would not recommend using this indicator as a "precision instrument." However, it does show that these three standardized data points are fairly good coincident indicators of the economy and, using an 18-month change and a filter, do offer reasonably good warnings when one should reduce exposure and when a market pullback is a mere correction.

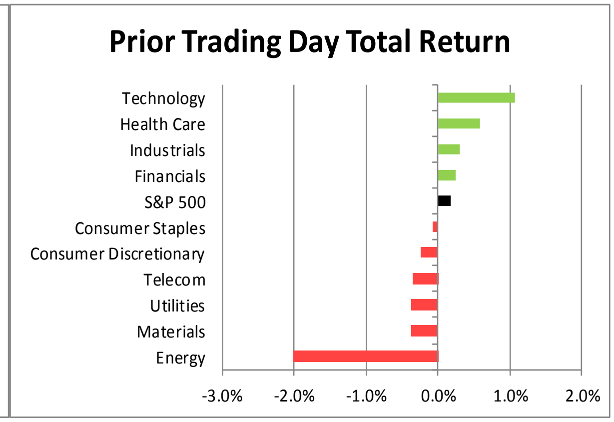
We use the period since 1997 because it makes the data easier to observe. But, we did look at data from 1980 and the performance is similar. As we would expect, the indicator did not help at all during the 1987 crash, confirming that its usefulness is as a gauge of the interaction between equities and the economy, not as a pure market indicator.

What is it telling us now? The economy is doing well enough that market declines will probably not be more than normal pullbacks. Of course, this sort of indicator won't necessarily be helpful if a geopolitical event triggers a major market decline. But, the most common cause of bear markets in equities are recessions. For now, that doesn't appear to be on the horizon.

Data Section

U.S. Equity Markets – (as of 7/5/2017 close)

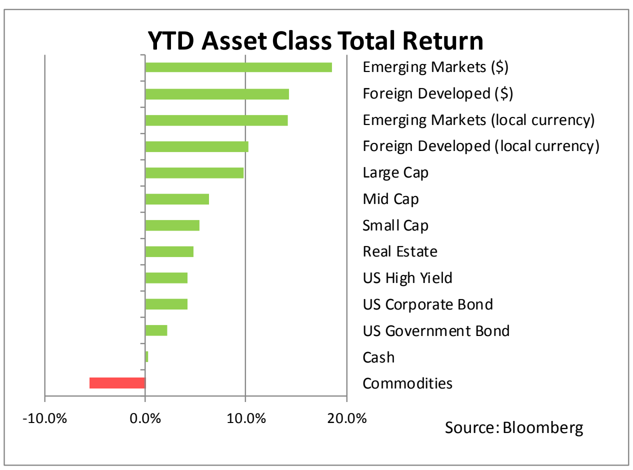




(Source: Bloomberg)

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 7/5/2017 close)

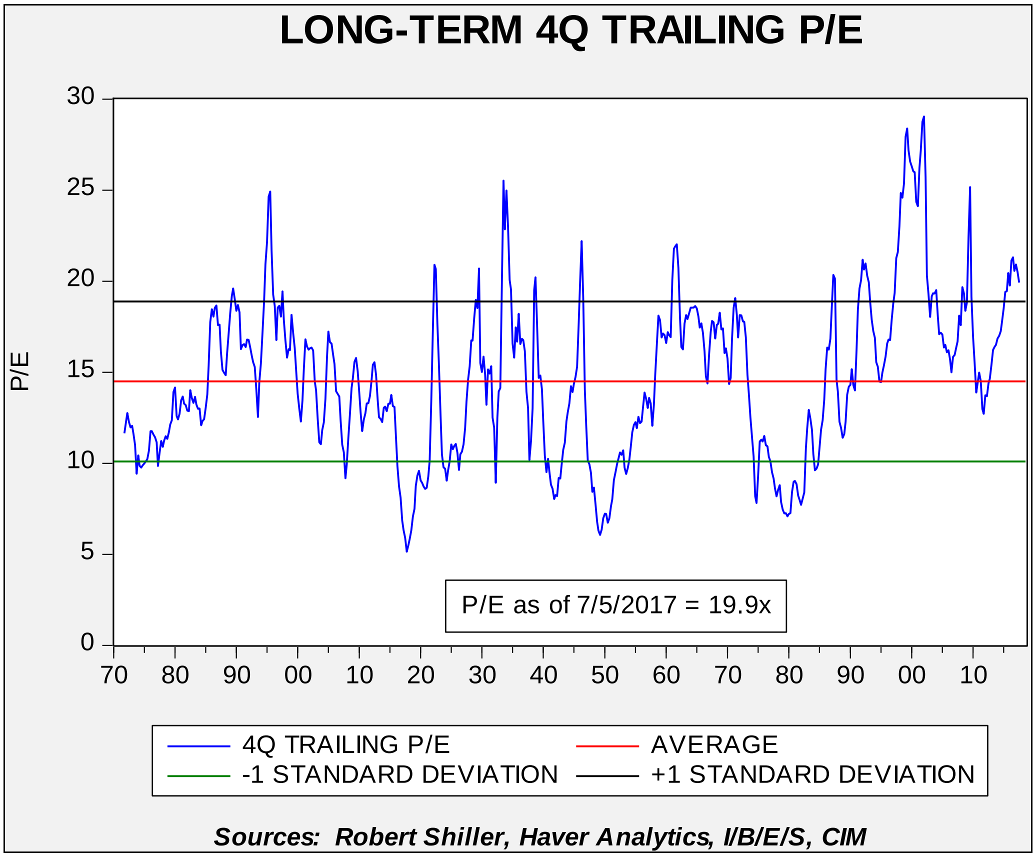


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 6, 2017



Based on our methodology,[2] 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.

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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.