Confluence Investment Management

Daily Comment

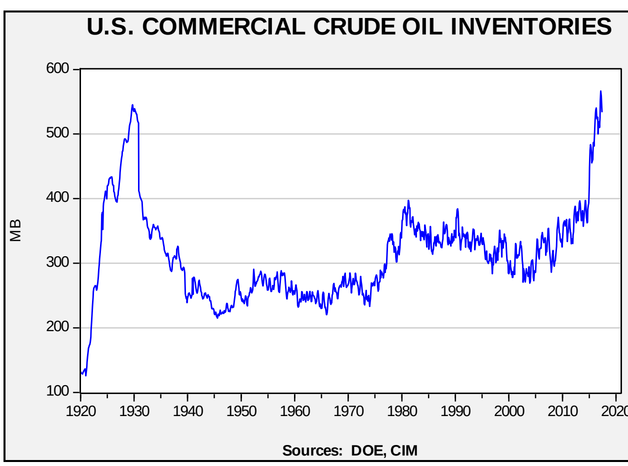
By Bill O'Grady and Thomas Wash

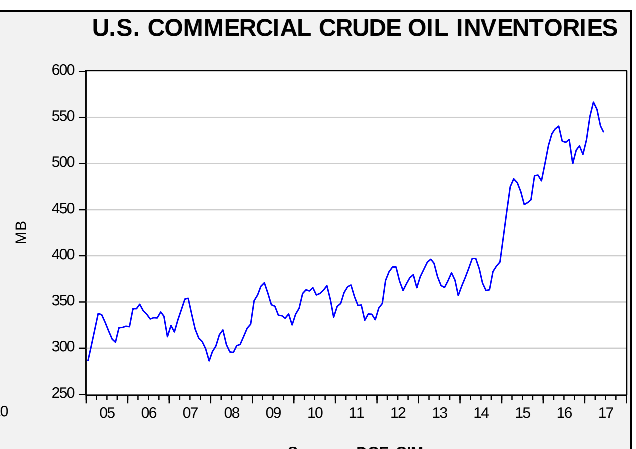
[Posted: July 7, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets were up, with the Shanghai composite up 0.2% and the Shenzhen index up 0.2%. U.S. equity index futures are signaling a higher open.

Happy employment day! The employment data is covered in detail below but the snapshot of the data is supportive. Payrolls rose 222k compared to forecasts of 178k; we also saw a 47k upward revision, making the report robust. The unemployment rate came in at 4.4% versus expectations of 4.3%, mostly due to a rise in the labor force and increased participation. Wage growth remains sluggish at 2.5%.

There is not much new to report on the G-20. We expect a contentious meeting where the differences between the emerging American policy of exiting the hegemonic role collide with the rest of the world's terror at realizing the U.S. world order of the past 72 years is coming to a close. It should be noted that this retreat has been underway since 2008 and President Trump is merely making the case more clearly, but the American public, painfully aware of the costs of hegemony but inured to the benefits, has simply had enough of supporting the world. We note that Japan and the EU have apparently negotiated a new trade deal. This will be interesting to watch—how does a trade deal work between two parties that are running export-promoting policies? In addition, trade rests on the U.S. providing global security. Who will guarantee the sea lanes between Japan and Europe? China? Overall, we don't expect much out of the G-20 other than clarity that the world is changing rapidly.

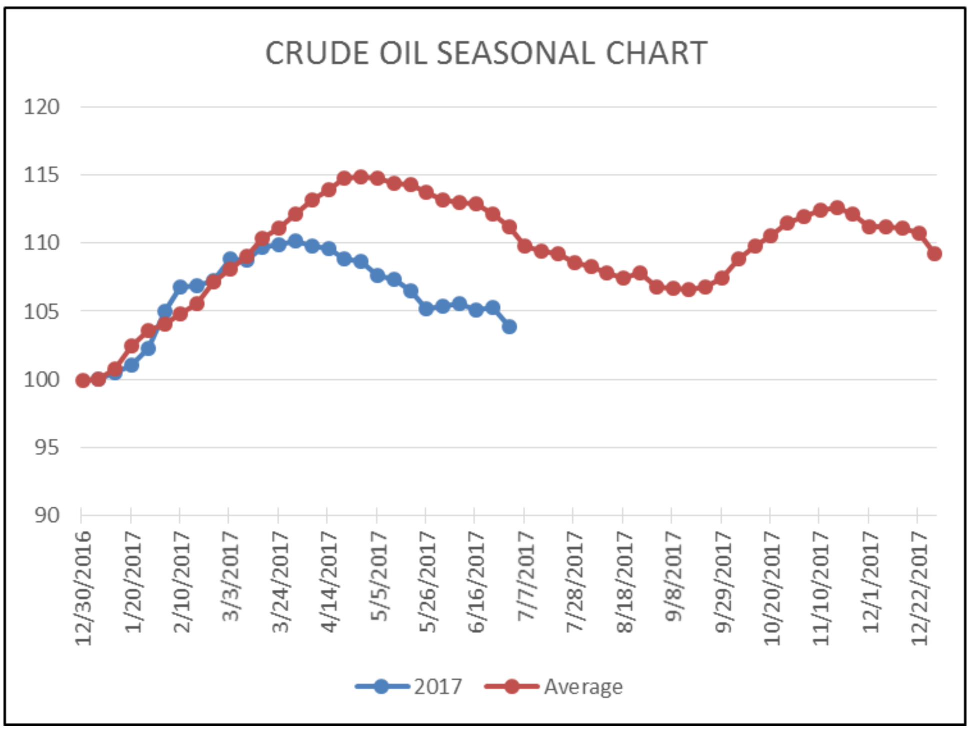
U.S. crude oil inventories fell 6.3 mb compared to market expectations of a 2.5 mb draw.



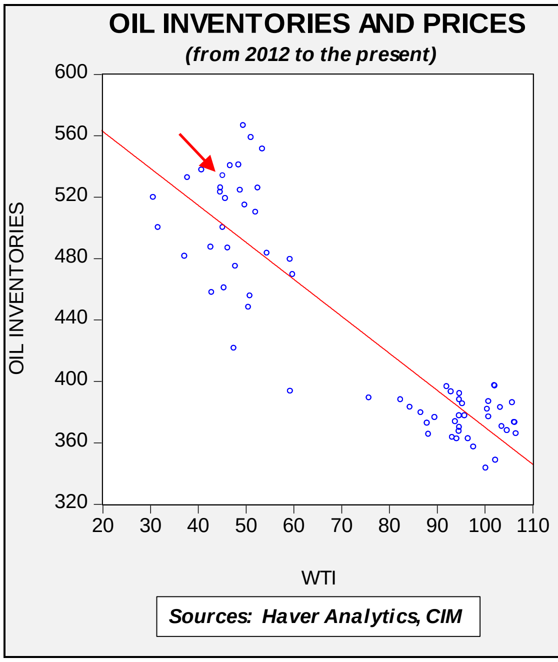


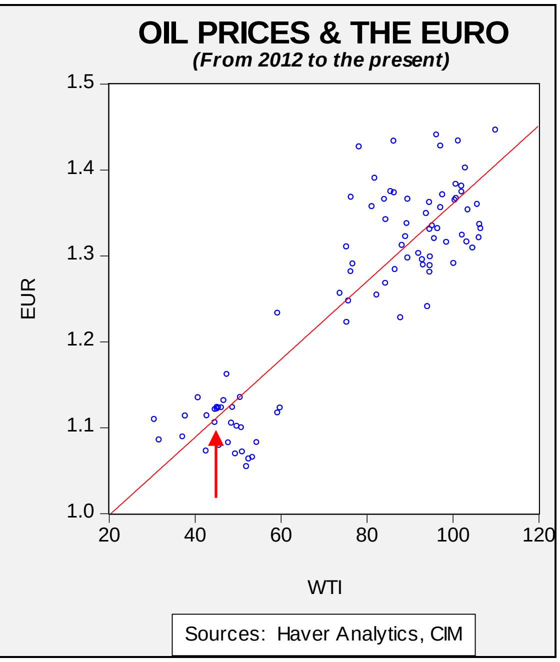
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but they are declining. We also note that, as part of an Obama era agreement, there was a 1.4 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 13.1 mb this year, which likely means we should see these sales end in the coming weeks. 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 6.7 mb, which is an even more impressive draw.

As the seasonal chart below shows, inventories are usually 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 withdrawals over the next couple of months.



(Source: DOE, CIM)

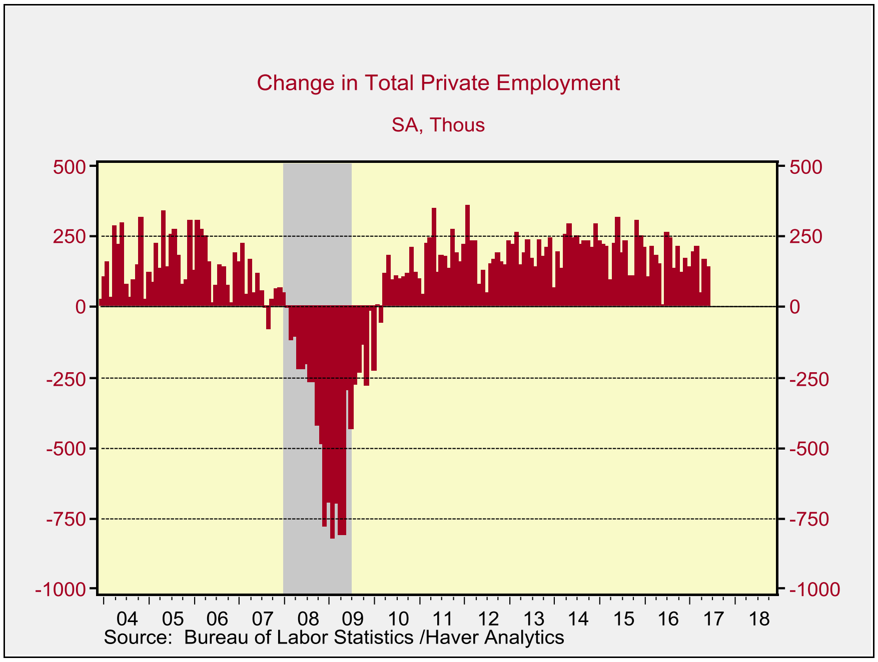




Based on inventories alone, oil prices are overvalued with the fair value price of $40.27. Meanwhile, the EUR/WTI model generates a fair value of $52.55. Together (which is a more sound methodology), fair value is $48.61, meaning that current prices are well below fair value. Currently, prices are below our expected trading range; we view oil prices as attractive on a short-term trading basis. Yesterday's DOE data was bullish. The drop in prices is therefore a worry because markets that fail to positively react to bullish data usually face further selling. We do expect oil prices to rise in the coming weeks, simply because the fundamentals are supportive.

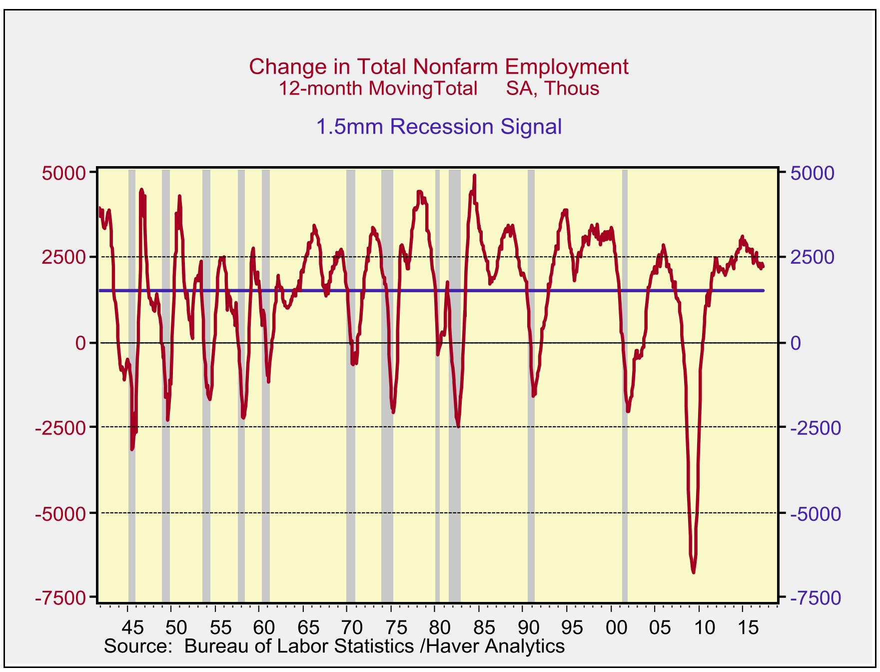
U.S. Economic Releases

The change in nonfarm payrolls came in above expectations at 222k compared to the forecast of 178k. The prior month's report was revised upward from 138k to 152k. The change in private payrolls came in above expectations at 187k compared to the forecast of 170k. The prior month's report was revised upward from 147k to 159k. The change in manufacturing payrolls came in below expectations at 1k compared to the forecast of 5k. The prior month's report was revised downward from -1k to -2k.

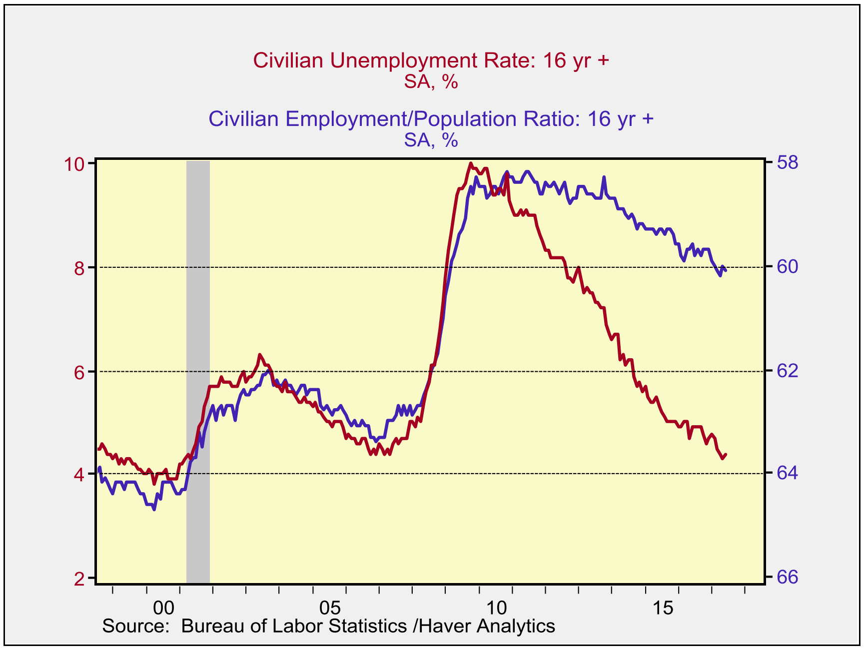


The chart above shows the change in total private employment. This chart suggests we are still in an economic expansion.

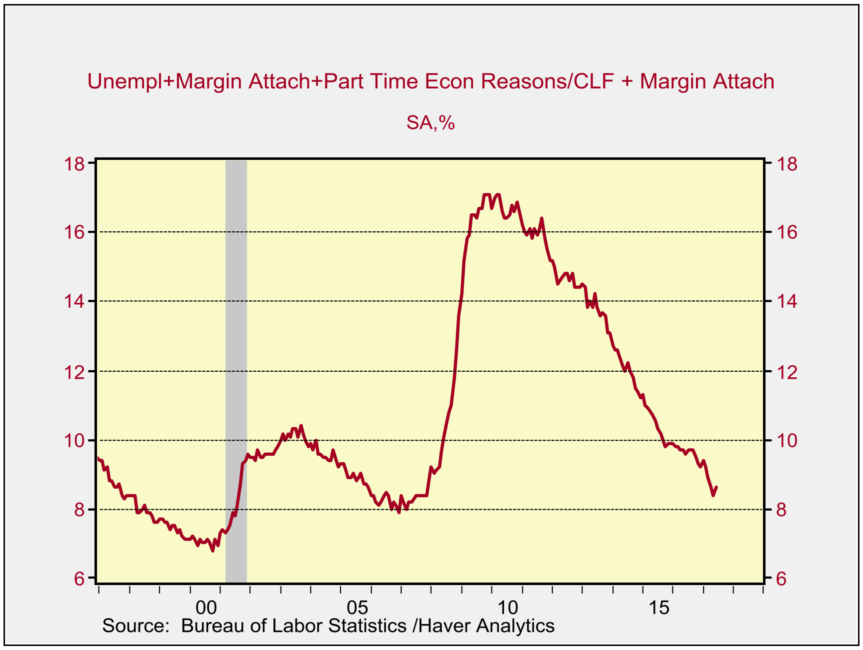
The chart below shows the 12-month moving total of the change in nonfarm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in above forecast at 4.4% compared to the forecast of 4.3%. The labor force participation rate rose 0.1% and the underemployment (U-6) rate rose 0.2%; the levels of these two numbers came in at 62.8% and 8.6%, respectively.

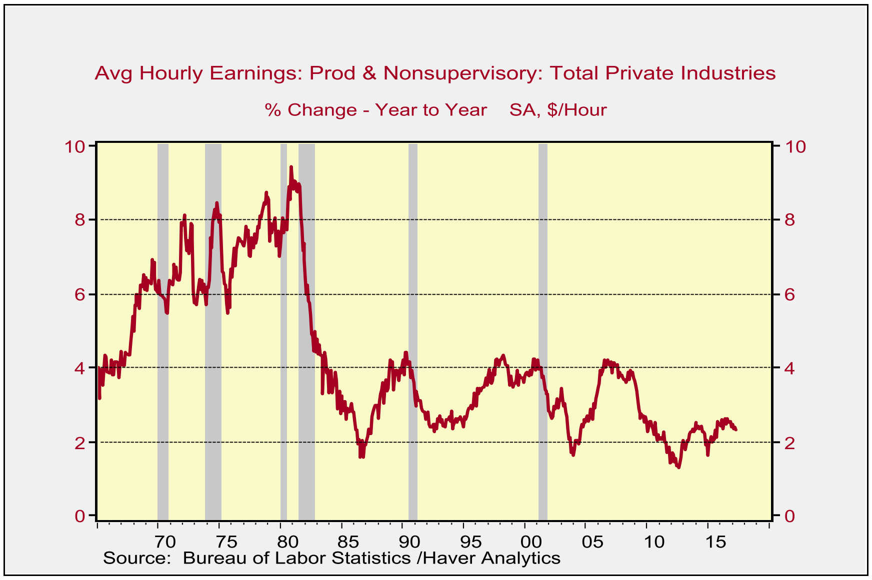


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables suggests that there is still slack within the labor market.



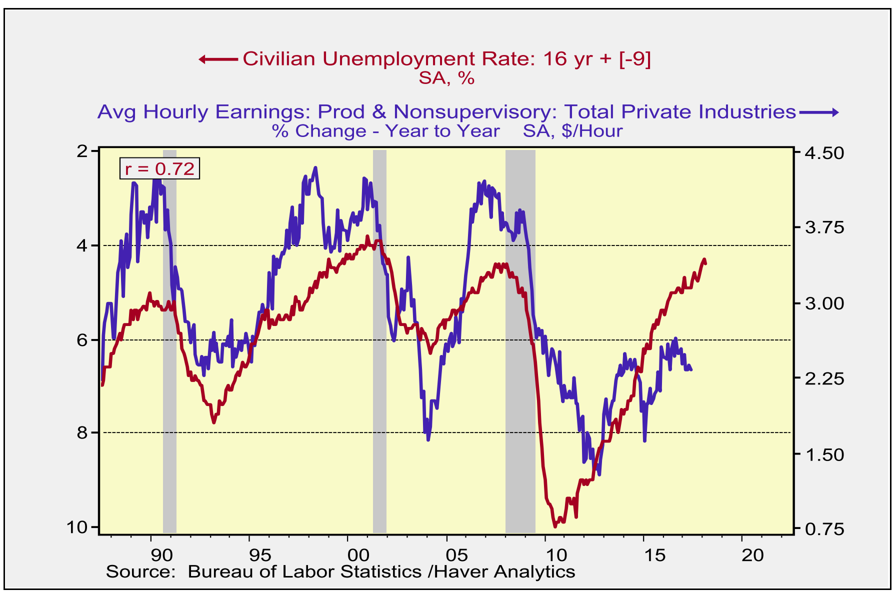
The chart above shows the underemployment rate, also referred to as the U-6 rate.

Average hourly earnings came in below expectations, rising 0.2% from the prior month compared to the forecast of 0.3%. The prior month's gain was revised downward from 0.2% to 0.1%. Average weekly hours came in above expectations at 34.5 compared to the forecast of 34.4.



This chart shows the yearly growth in hourly earnings for all workers and non-supervisory workers. On an annual basis, wage growth came in at 2.3%, down from 2.4% last month.

Overall, the data show healthy job growth while the mystery of low wages continues.



This chart shows the unemployment rate on an inverted scale with wage growth for non-supervisory workers. In the last three business cycles, unemployment at these levels has generated wage growth of around 4%. The lack of wage growth has been attributed to lots of factors (retiring high wage baby boomers are being replaced by lower wage millennials, for example), but we view this as evidence that slack remains in the labor market. Thus, the FOMC should tread lightly with policy tightening.

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								
China	Foreign Reserves	m/m	jun	$3.0610 tn	$3.0536 tn	$3.0620 tn	**	Equity and bond neutral
Japan	Leading Index	m/m	may	104.7	104.2	104.5	**	Equity and bond neutral
	Official Reserve Assets	m/m	jun	$1.2498 tn	$1.2519 tn	$1.2572 tn	**	Equity and bond neutral
	Labor Cash Earnings	y/y	may	0.7%	0.5%	0.4%	**	Equity bullish, bond bearish
	Real Cash Earnings	y/y	may	0.1%	0.0%	-0.1%	**	Equity bullish, bond bearish
	Coincident Index	m/m	may	115.5	117.1	115.5	**	Equity and bond neutral
Australia	Foreign Reserves	m/m	jun	A$84.1 bn	A$88.5 bn		**	Equity and bond neutral
	AiG Perf of Construction Index	m/m	jun	56.0	56.7		**	Equity and bond neutral
EUROPE								
Germany	Industrial Production	m/m	may	1.2%	0.8%	0.2%	**	Equity bullish, bond bearish
France	Trade Balance	m/m	may	-4.886 bn	-5.535 bn	-5.100 bn	**	Equity bullish, bond bearish
	Current Account Balance	m/m	may	-2.300 bn	-3.100 bn		**	Equity and bond neutral
	Budget Balance	m/m	may	-66.4 bn	-57.9 bn		**	Equity and bond neutral
	Industrial Production	m/m	may	1.9%	-0.5%	0.6%	**	Equity bullish, bond bearish
	Manufacturing Production	m/m	may	2.0%	-1.2%	0.6%	**	Equity bullish, bond bearish
Italy	Retail Sales	m/m	may	-0.1%	-0.1%	0.3%	*	Equity bearish, bond bullish
UK	Halifax House Prices	m/m	jun	-1.0%	0.4%	0.2%	**	Equity bearish, bond bullish
	Industrial Production	m/m	may	-0.1%	0.2%	0.4%	**	Equity bearish, bond bullish
	Manufacturing Production	m/m	may	-0.2%	0.2%	0.5%	**	Equity bearish, bond bullish
	Construction Output	m/m	may	-1.2%	-1.6%	0.7%	**	Equity bearish, bond bullish
	Trade Balance	m/m	may	-3073	-2050	-2500	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	jun	3.0%	3.1%	3.0%	**	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)	102	102	0	Neutral
TED spread (bps)	29	28	1	Neutral
U.S. Libor/OIS spread (bps)	117	117	0	Up
10-yr T-note (%)	2.38	2.37	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	27	27	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			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	$46.74	$48.11	-2.85%	Russian refusal to make concessions on output cuts
WTI	$44.18	$45.52	-2.94%	
Natural Gas	$2.93	$2.89	1.56%	
Crack Spread	$17.66	$18.03	-2.06%	
12-mo strip crack	$15.65	$16.02	-2.32%	
Ethanol rack	$1.67	$1.68	-0.32%	
Metals				
Gold	$1,222.83	$1,225.22	-0.20%	Stronger dollar
Silver	$15.88	$16.05	-1.03%	
Copper contract	$265.20	$266.15	-0.36%	
Grains				
Corn contract	$ 390.00	$ 390.50	-0.13%	
Wheat contract	$ 533.00	$ 539.00	-1.11%	
Soybeans contract	$ 997.00	$ 999.25	-0.23%	
Shipping				
Baltic Dry Freight	829	847	-18	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.3	-2.5	-3.8	
Gasoline (mb)	-3.7	-2.0	-1.7	
Distillates (mb)	-1.9	0.0	-1.9	
Refinery run rates (%)	1.10%	0.65%	0.5%	

Weather

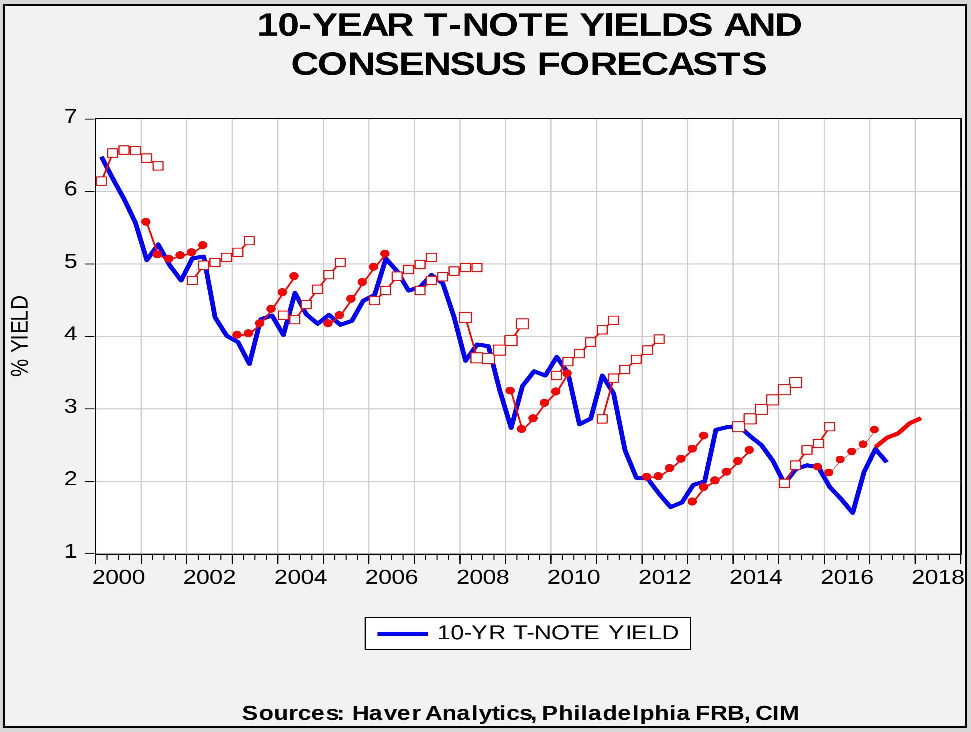
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for the eastern region. The tropical cyclone developing in the south Atlantic has formed into a depression, but at this time it is unlikely to make its way to the Gulf of Mexico. Current 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.

July 7, 2017

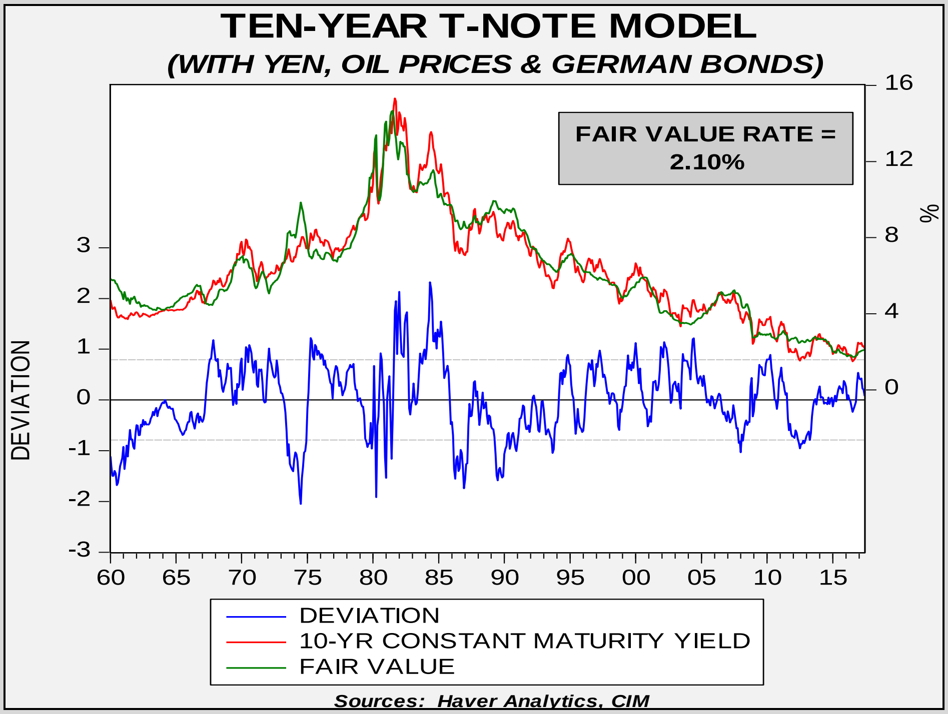
One of the relationships we persistently monitor is the expectations of 10-year Treasury yields compared to the actual level of yields. To do this, at the beginning of each year, we plot the rate forecasts from the Philadelphia FRB's Professional Forecaster Survey. The record of the forecasters has not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

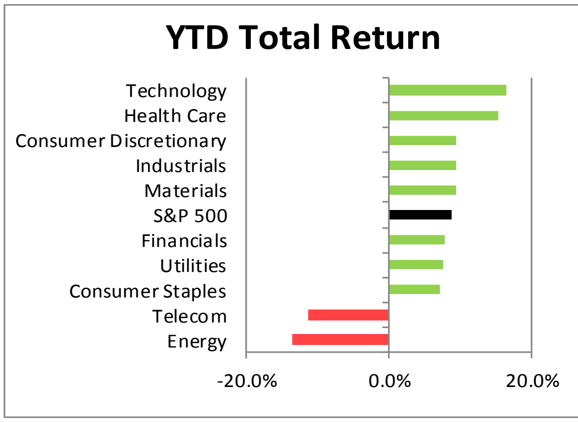
Still, we have noticed that the downtrend in rates has mostly ended in 2012, while rates have been rangebound for the past five years. Clearly, the forecasters are looking for an upside "breakout" in yields that has failed to materialize…so far.

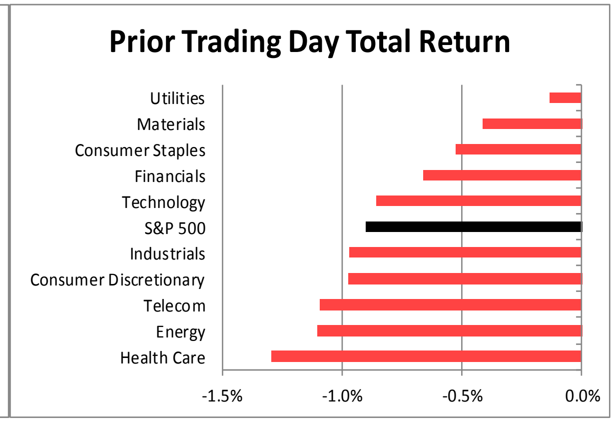


Our 10-year T-note yield model puts fair value at 2.10%; thus, current yields are a bit high. The model uses fed funds, long-term inflation trends, the yen/dollar exchange rate, oil prices and the yield on German bonds. What is troubling for us is that if we just use the first two variables of the model, 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.

<u>Data Section</u>

U.S. Equity Markets – (as of 7/6/2017 close)

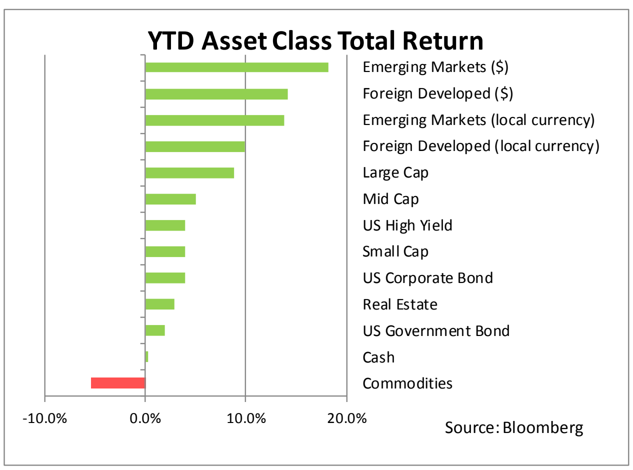




(Source: Bloomberg)

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 7/6/2017 close)

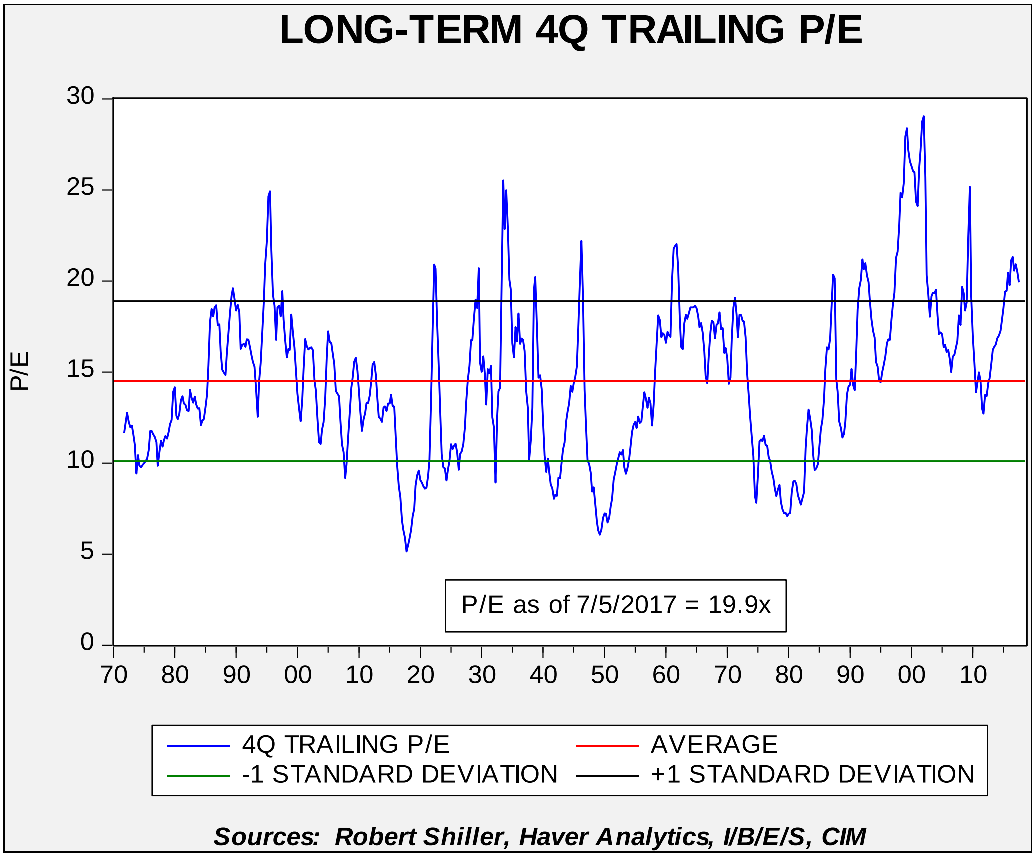


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

[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.