Daily Comment

By Bill O'Grady, Kaisa Stucke,
and Thomas Wash

[Posted: June 14, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.7% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a higher open.

There is breaking news at the time of this writing. A gunman shot at Congressional members and staffers at a baseball practice in suburban Virginia. The Congressional baseball game is one of the few bipartisan social events in Washington. Although the situation is evolving, early reports indicate at least five people were shot. The most notable is Steve Scalise (R-LA), the GOP House Whip, who was reportedly shot in the hip. Scalise is the third-highest ranking member of the House GOP leadership. His injuries are not considered life threatening. Although not confirmed at this time, there are reports the shooter was also shot and has been "neutralized" and is in custody.

Today is FOMC day. The Fed concludes its policy meeting with near certainty that the central bank will raise rates. This is a meeting with a press conference, new economic forecasts and a new dots plot. We don't expect the Fed to change the dots plot too much; if so, the last plot implied one more hike this year, assuming a 25 bps hike today. Although we don't expect details on shrinking the balance sheet today, we may hear more about that in the press conference. The FOMC is striving for transparency to preclude adverse market effects. Fed funds futures put the odds of a hike today at 92.7%. The odds of an additional hike in September are only 21.7% and, assuming no change until year's end, a December move is currently priced at 34.3%. In fact, we don't get a greater than 50% likelihood of a rate increase until the June 2018 meeting. Thus, anything suggesting a higher probability of a rate hike this year might be taken as hawkish.

CPI and retail sales for the U.S. came in soft (see below for details); the dollar rolled over on the news and interest rates declined. Gold prices also rose, but the yellow metal may also be reacting to the aforementioned shooting.

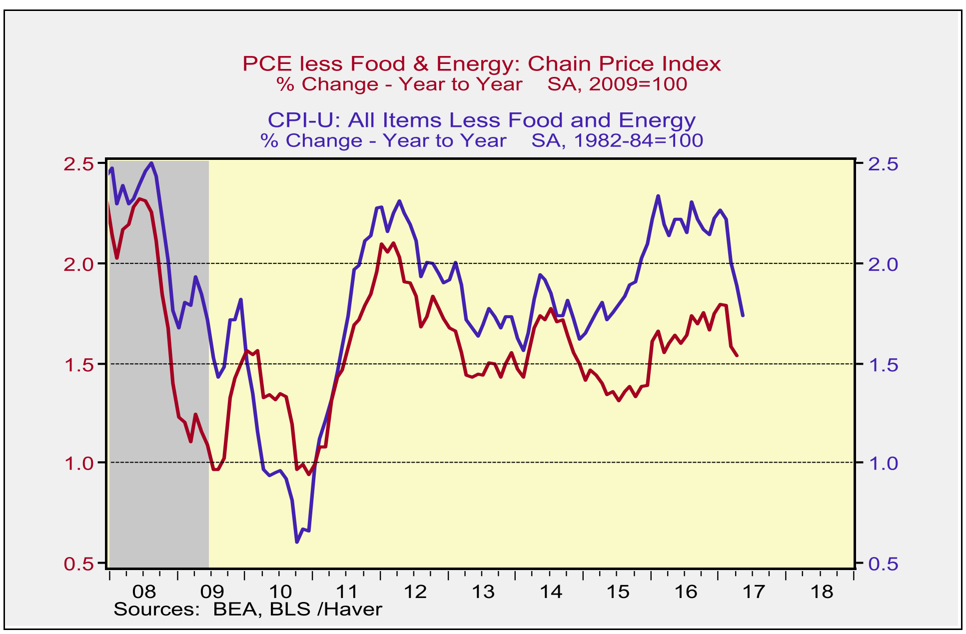
Oil prices are coming under pressure again this morning. The proximate cause was a report from the American Petroleum Institute (API) that crude oil inventories rose last week. The API report, based on a non-compulsory survey, comes out the evening before the official data from the DOE. The two series can disagree but inventory increases this time of year are unusual and thus bearish. However, on a longer term basis, the International Energy Agency (IEA), a division of the OECD, indicated today that the current inventory overhang will persist this year despite OPEC efforts to cut output. Rising production from Brazil, the U.S. and Canada are partially offsetting OPEC cuts. The IEA indicated that OECD stocks of oil rose 18.6 mb in April and are 292 mb above the five-year average. The IEA estimates that oil stocks won't fall to their five-year average until March 2018 and this only occurs if OPEC maintains its production constraint. Industry reports suggest that U.S. production growth will stall the closer oil prices get to $40; although such a drop is possible, we expect a weaker dollar to mitigate downside risk in oil prices. We will have our usual recap of the oil data in tomorrow's Daily Comment.

The debt ceiling is a looming threat; as we have noted in earlier reports, the Treasury is suggesting that the government will enter a partial shutdown by the first half of September without action taken to raise the debt ceiling. This issue has become an inter-party conflict within the GOP as the Freedom Caucus is proposing a $1.5 trillion increase in the ceiling, $1 trillion less than what the White House is requesting. The lower ceiling would lead to the exhaustion of borrowing capacity soon after the mid-terms. The White House would like to avoid further drama with a higher ceiling. We would expect a compromise, although the more entrenched positions become the longer we may go before a deal is reached. What is significant in this problem is that the battle is occurring within the GOP and highlights divisions within the party. The debt ceiling could be a further distraction from the president's agenda and consume precious political capital.

U.S. Economic Releases

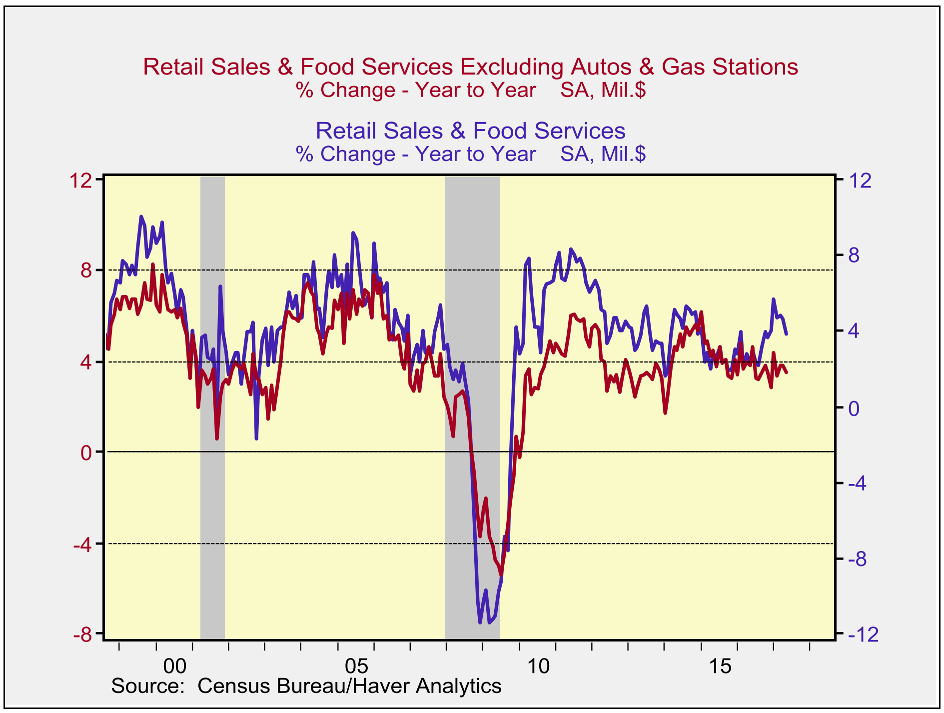
MBA mortgage applications rose 2.8% from the prior week. Purchases fell 2.8%, while refinancing rose 9.2% from the prior week. The average 30-year fixed rate mortgage fell by 1 bp to 4.13%.

Monthly CPI came in below expectations, falling 0.1% compared to the forecast of unchanged. Core CPI also came in below expectations, rising 0.1% compared to the forecast of a 0.2% rise from the prior month.



The chart above shows the year-over-year change in core CPI and core PCE. It appears that inflation has begun to slowdown. That being said, we still expect the Fed to raise rates in today's FOMC meeting.

Advance retail sales came in below expectations, falling 0.3% compared to the forecast of unchanged from the prior month. Retail sales excluding autos also came in below expectations, falling 0.3% compared to the forecast of a 0.1% rise. The prior report was revised upward from 0.3% to 0.4%. Core retail sales came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.3%. The prior report was revised upward from 0.3% to 0.5%. The retail sales control group came in below expectations, remaining unchanged from the prior month compared to the forecast of a 0.3% rise. The prior report was revised upward from 0.2% to 0.6%.



The chart above shows the annual change in retail sales and core retail sales. In general, retail sales fell to a 16-month low. The drop has been attributed to a lack of car and gasoline purchases. Although this report only represents one month of data, if the declines become a trend it will begin to draw concerns about the underlying strength of the economy.

Real average weekly earnings rose by 0.6% from the prior year, while real average hourly earnings also rose by 0.6% from the prior year. The prior report's gain was revised downward from 0.4% to 0.3%.

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	Business Inventories	m/m	apr	-0.2%	0.2%	**
Fed speakers or events						
14:00	FOMC Rate Decision	Members 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	Retail Sales	y/y	may	10.7%	10.7%	10.7%	**	Equity and bond neutral
	Fixed Assets ex Rural	y/y	may	8.6%	8.9%	8.8%	**	Equity and bond neutral
	Industrial Production	y/y	may	6.5%	6.5%	6.4%	***	Equity and bond neutral
Japan	Industrial Production	y/y	apr	5.7%	5.7%		***	Equity and bond neutral
	Capacity Utilization	m/m	apr	4.3%	-1.6%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	jun	112.9	112.9		**	Equity and bond neutral
	Westpac Consumer Confidence	m/m	jun	-1.8%	-1.1%		**	Equity and bond neutral
New Zealand	Reinz House Sales	m/m	may	-18.4%	-31.0%		**	Equity and bond neutral
	Food Prices	m/m	apr	2.4%	-0.8%		**	Equity and bond neutral
	BoP Current Account Balance	m/m	apr	0.244 bn	-2.335 bn	1.000 bn	**	Equity and bond neutral
	Current Account GDP Ratio YTD	q/q	1q	-3.1%	-2.7%	-2.7%	**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production	m/m	apr	1.4%	1.9%	1.4%	***	Equity and bond neutral
	Employment Change	q/q	1q	1.5%	1.1%		**	Equity and bond neutral
Germany	CPI	y/y	may	1.5%	1.5%	1.5%	***	Equity and bond neutral
UK	Claimant Count Rate	y/y	may	2.3%	2.3%		**	Equity and bond neutral
	Jobless Claims Change	y/y	may	7.3k	19.4k		**	Equity and bond neutral
	Average Weekly Earnings 3m/3m	y/y	may	2.1%	2.4%	2.4%	**	Equity and bond neutral
	Weekly Earnings ex Bonus	y/y	may	1.7%	2.1%	2.0%	**	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)	124	124	0	Up
3-mo T-bill yield (bps)	98	98	0	Neutral
TED spread (bps)	26	25	1	Neutral
U.S. Libor/OIS spread (bps)	115	115	0	Up
10-yr T-note (%)	2.20	2.21	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	33	33	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Down
yen	down			Down
pound	down			Neutral
franc	down			Neutral

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	$48.27	$48.72	-0.92%	Long Liquidation
WTI	$45.90	$46.46	-1.21%	
Natural Gas	$2.93	$2.97	-1.31%	
Crack Spread	$15.72	$15.79	-0.50%	
12-mo strip crack	$14.10	$14.11	-0.01%	
Ethanol rack	$1.68	$1.68	0.20%	
Metals				
Gold	$1,265.54	$1,266.55	-0.08%	Stronger Dollar
Silver	$16.95	$16.86	0.53%	
Copper contract	$258.75	$259.65	-0.35%	
Grains				
Corn contract	$ 383.25	$ 381.00	0.59%	
Wheat contract	$ 450.25	$ 445.00	1.18%	
Soybeans contract	$ 943.75	$ 939.00	0.51%	
Shipping				
Baltic Dry Freight	870	870	0	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		-1.2		
Distillates (mb)		0.5		
Refinery run rates (%)		0.00%		
Natural gas (bcf)		91.0		

Weather

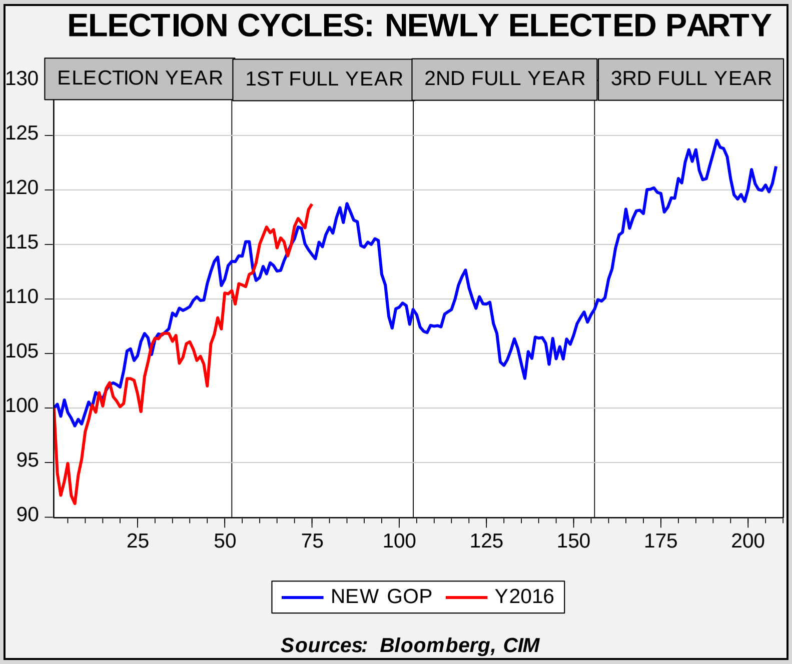
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country except for the northeastern region which shows cooler temps. Precipitation is expected for most of the eastern region.

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 9, 2017

We have been monitoring the S&P 500 performance relative to new GOP administrations. Based on the historical pattern, the market has reached the average peak level a few weeks early.



This chart shows the performance of the S&P 500 on a weekly close basis, indexed to the first Friday of the first trading week in the year of the election. We have averaged the first four years of a new GOP president. So far, this cycle's equity market has generally, though not perfectly, followed the average. Based on that pattern, the current level of the market is around the usual peak. Clearly, this election cycle could be different, but the average does suggest we could be poised for a period of weakness.

So, what might cause a pullback? Here are a few candidates:

A debt ceiling crisis: The Treasury indicates that the government may begin to shut down as early as August if the debt ceiling isn't lifted. With the GOP controlling Congress and the White House, raising the debt limit should be perfunctory. However, there are rumblings that the Freedom Caucus will demand spending cuts to agree to any debt limit increases. The Democrats, after watching President Obama deal with two government shutdowns and the sequester over the debt limit, are in no mood to work with the administration and may force the congressional leadership to deal with the Freedom Caucus. If another debt limit crisis triggers a new government shutdown and raises fears of a potential downgrade of Treasury debt, a pullback in equities would likely result.

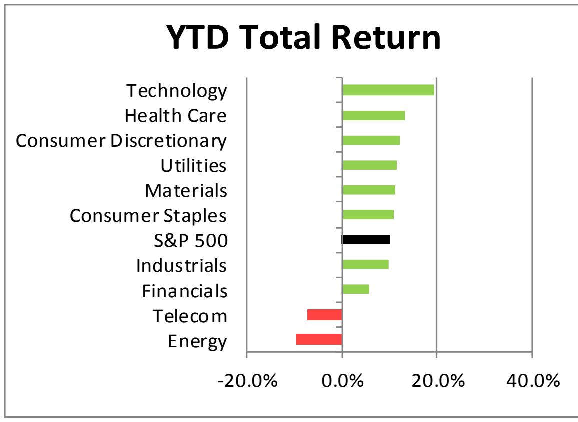
Winds of war on the Korean Peninsula: The U.S. will have three carrier groups in the East China Sea in the coming weeks. Although we doubt the Trump administration wants a war with North Korea, the U.S. is putting enough assets in the region to go to war if it so decides. A full-scale attack on North Korea would be a bloody affair; the Hermit Kingdom has been preparing for such an attack for years and even if its nuclear program isn't ready to deliver a weapon, its conventional forces will wreak havoc on the South. Even a hint of a conflict will likely prompt a pullback in risk assets.

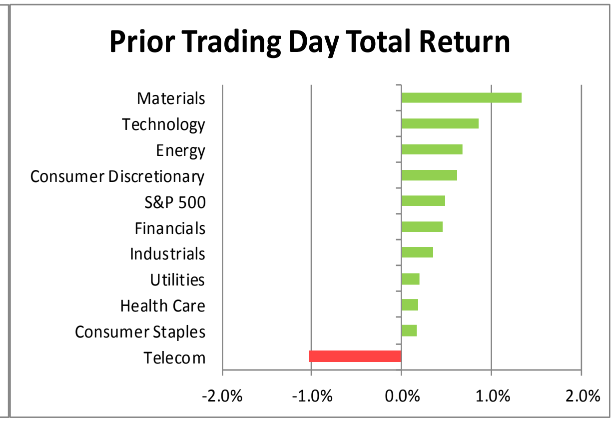
Monetary policy worries: The FOMC appears driven to raise the fed funds target rate. As we have noted before, there is a good deal of uncertainty surrounding the degree of slack that remains in the economy. The FOMC appears to be leaning toward the notion that the economy is getting close to capacity and further declines in unemployment will surely lead to inflation rising over target. Although financial markets didn't react well to the rate hike in December 2015, the subsequent increases have occurred without incident. Telegraphing the increases has reduced the risk to rate hikes but the odds of overtightening will increase if the Federal Reserve has miscalculated the level of slack in the economy. This potential concern, coupled with plans to begin reducing the size of the balance sheet later this year, could begin to undermine market sentiment.

We want to note that the average decline shown on the above graph is not a numerical forecast; we tend to view the direction as a more important indicator than level. It suggests that a period of equity market weakness is a growing possibility later this summer. What we don't see, at least so far, is evidence of anything more than a pullback. Recessions tend to be the primary factors that lead to bear markets. The economy is doing just fine; the yield curve hasn't inverted, the ISM manufacturing index is comfortably above 50 and there hasn't been any evidence in the labor markets to suggest a drop in economic growth. Thus, we may see a weak summer for stocks but nothing that would lead us to take a defensive position in the equity markets. Instead, a pullback will likely create an opportunity for investors.

Data Section

U.S. Equity Markets – (as of 6/13/2017 close)

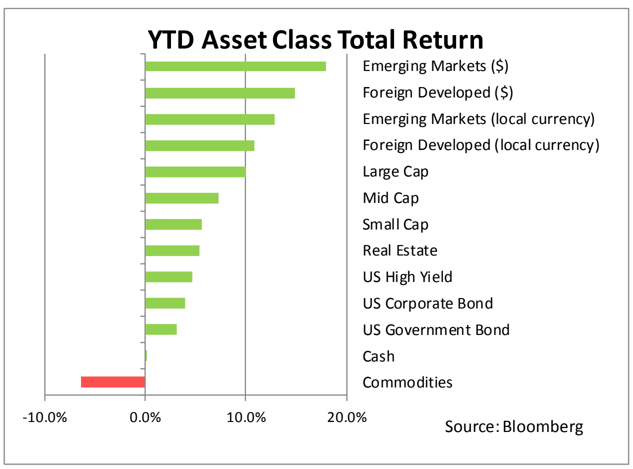




(Source: Bloomberg)

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 6/13/2017 close)

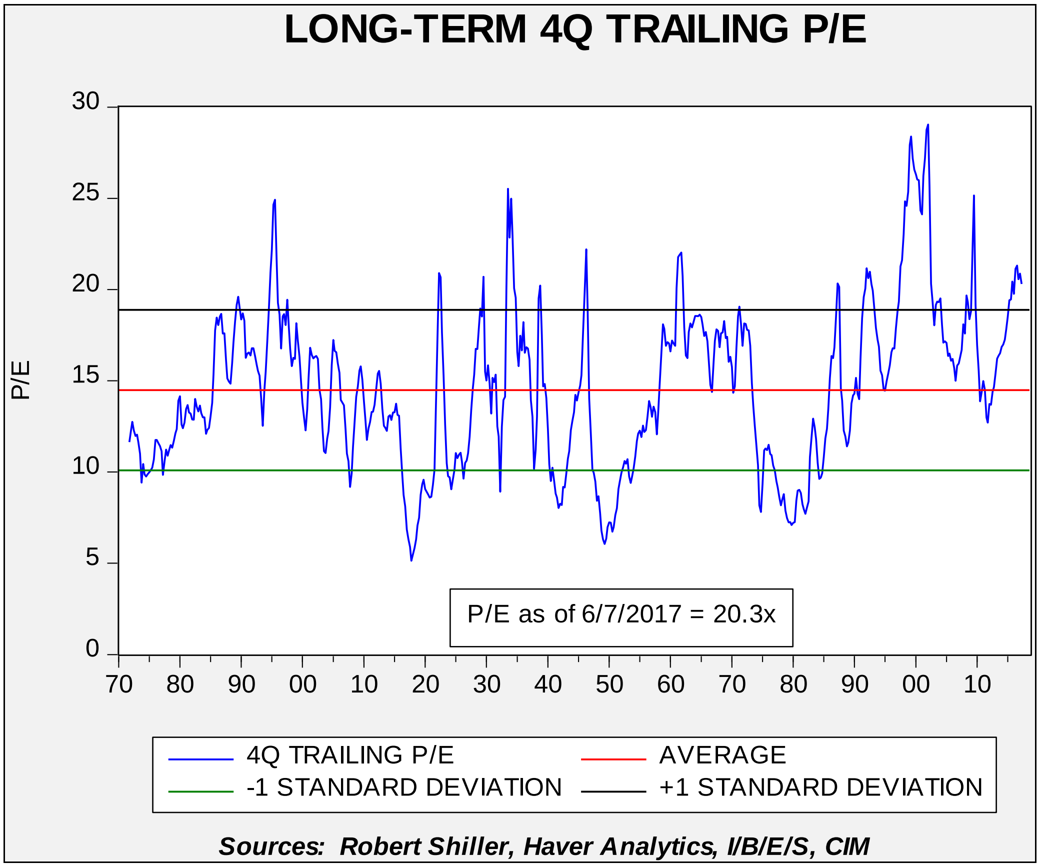


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 8, 2017



Based on our methodology,[1] the current P/E is 20.3x, unchanged from last week.

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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[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 three actual quarters (Q3, Q4 and Q1) and estimate (Q2). 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.