Daily Comment

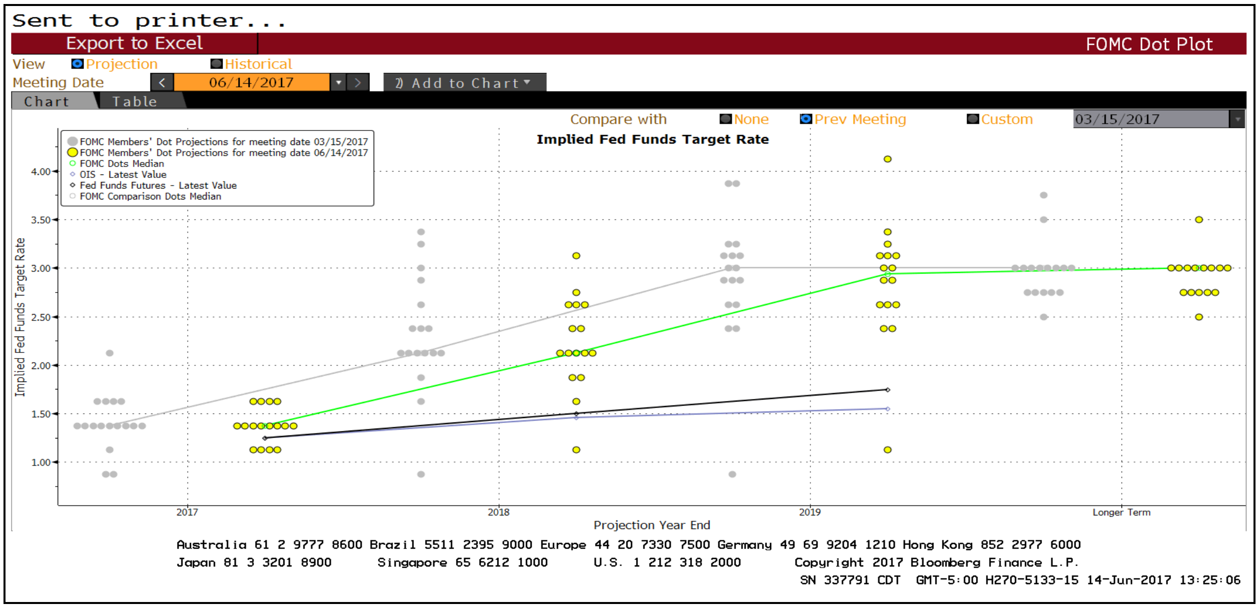
By Bill O'Grady, Kaisa Stucke, and Thomas Wash

[Posted: June 15, 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 0.8% from the prior close. Chinese markets were up, with the Shanghai composite up 0.1% and the Shenzhen index up 0.9%. U.S. equity index futures are signaling a higher open.

There were three items dominating the overnight news. First, the shooting at the GOP baseball practice yesterday continues to reverberate. We will have more to say about this event in the future but it is further evidence of deep divisions within American society that show no signs of improving. Second, the BOE followed script and held policy steady. However, the vote was 5-3, with the dissenters calling for rate hikes. The strength of dissent caught the markets by surprise; the GBP rallied off its lows (the dollar has been stronger today) and Gilt yields jumped. Financial markets in Britain have been leaning toward rate cuts. The high level of dissent suggests that cuts will be difficult. Third, we are seeing further fallout from yesterday's FOMC meeting; the dollar is up, gold and equities are lower and Treasury yields, which fell yesterday, are recovering a bit this morning.

The FOMC did as expected, raising rates by 25 bps. The comments about the economy remain upbeat but the lack of inflation was noted. The big news was that the balance sheet reduction is expected to start later this year, perhaps as soon as September. At some point this year, which remains unspecified, the Fed will begin allowing the balance sheet to decline by $10 bn per month, increasing by the same amount every three months until it reaches a maximum decline rate of $50 bn per month within five quarters. There will be a 60/40 split on Treasury and mortgages, respectively. We do have concerns about the balance sheet; in theory, since most of QE has been sitting innocuously on commercial bank balance sheets, removing it shouldn't be a big deal. In reality, we simply don't know how the market will react. If the behavior is symmetrical, it should "double down" on the idea that the Fed is tightening policy. There was one dissenter, Minneapolis FRB President Kashkari, who wanted to maintain the current rate.

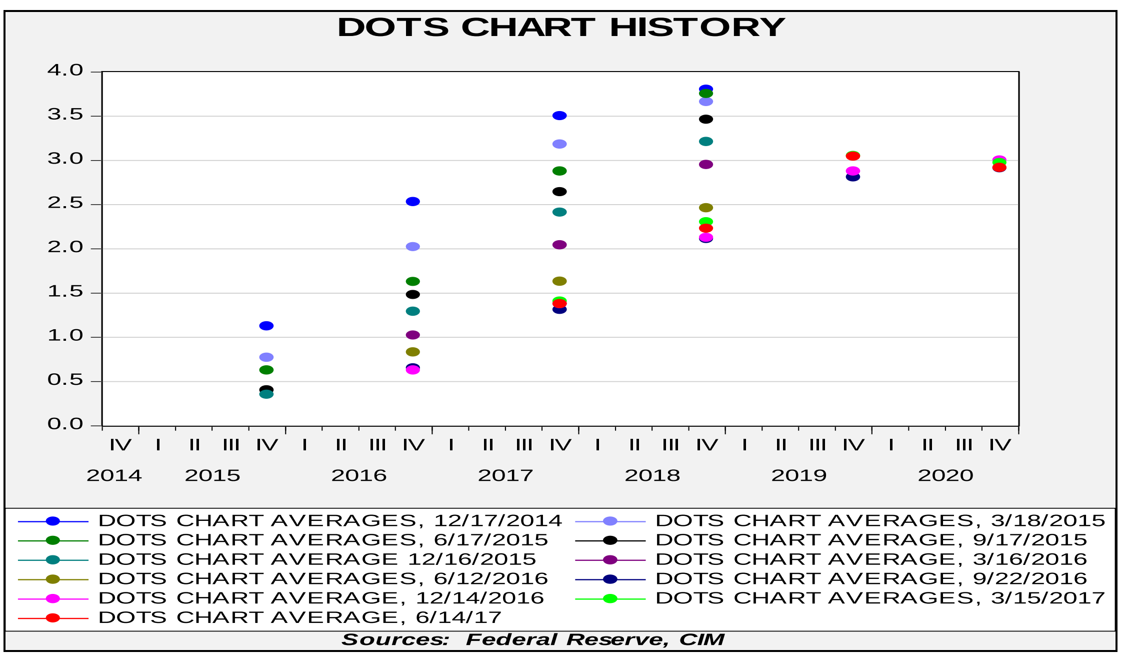
Here are some relevant charts:



(Source: Bloomberg)

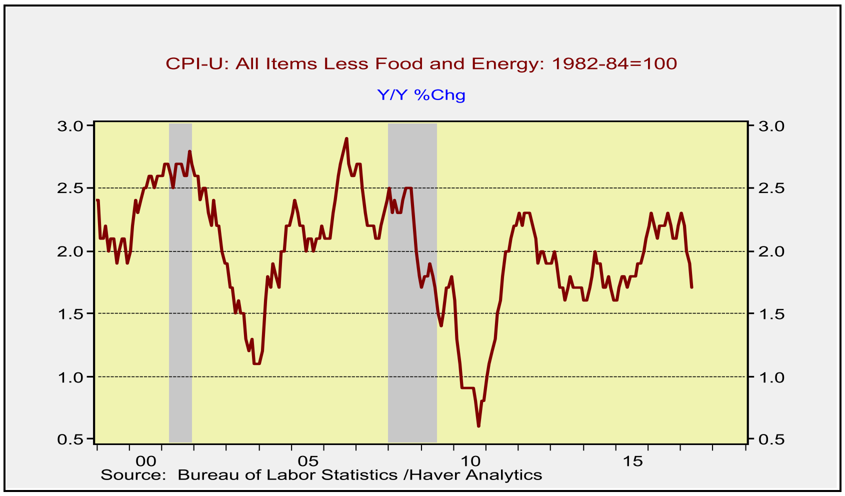
This shows the dispersion of the dots chart. The green line plots the median from yesterday's meeting, while the gray shows the previous meeting. There wasn't any change for the next two years but a modest decline in 2019. The median does suggest a 2.25% peak rate for next year, with only one more hike forecast this year and at least three hikes would be scheduled for next year. The market doesn't expect this pace of hikes.

Here is our average dots chart:

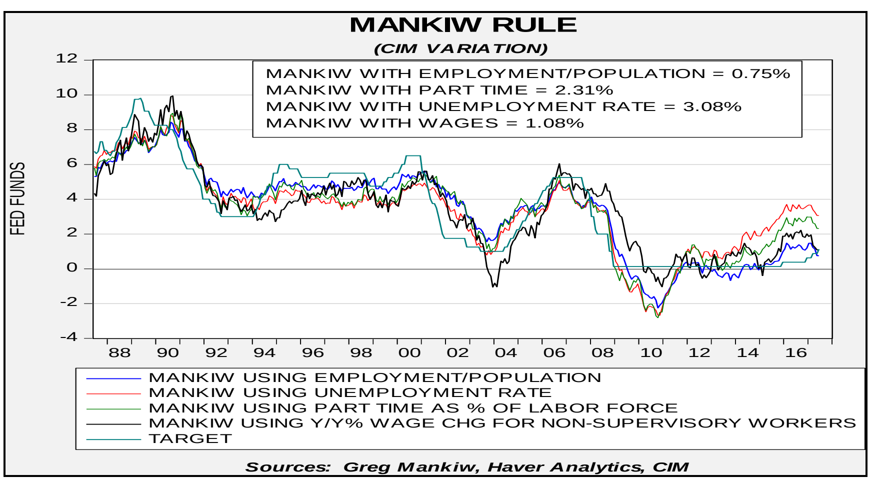


The most recent dot is in red. The average suggests very little change in projections from the FOMC. The history of the dots chart is one of a steady decline in projections. However, for the past several quarters, there has been a stabilization of expectations, suggesting the FOMC is becoming comfortable with its policy path.

With the release of the CPI data and yesterday's FOMC action, we can upgrade the Mankiw Rule models. The dip in the core CPI rate (see below) did affect the Mankiw Rule model results.



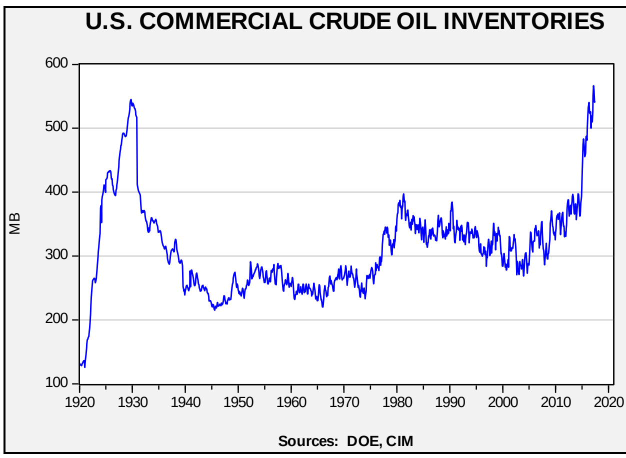
The Mankiw Rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.

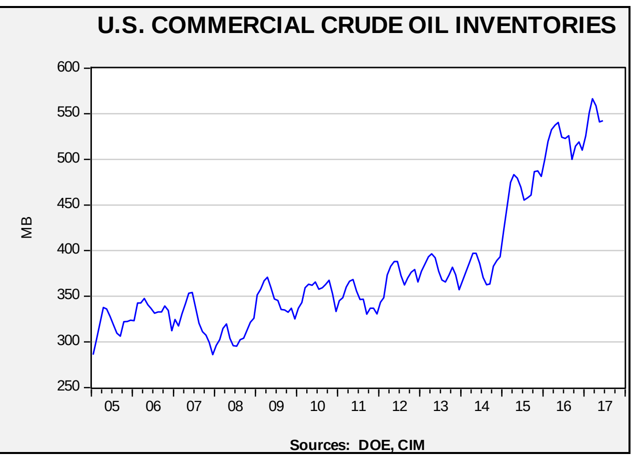


Using the unemployment rate, the neutral rate is now 3.08%. Using the employment/population ratio, the neutral rate is 0.75%. Using involuntary part-time employment, the neutral rate is 2.31%. Using wage growth for non-supervisory workers, the neutral rate is 1.08%. The labor data is mixed, with the employment/population ratio falling and wage growth stagnant, while the unemployment rate fell and involuntary part-time employment was steady. The drop in core CPI has led to lower Mankiw neutral rate estimates across the board.

To a great extent, the issue for policymakers remains the proper measure of slack. The danger for the financial markets is if the proper measure is wage growth or the employment/population ratio but policymakers believe slack is best measured by involuntary part-time employment or the unemployment rate. If that is their measure, policymakers will likely overtighten and prompt a recession. For the past couple of years, this issue has been mostly academic. Regardless of the measurement of slack, policy was generally accommodative. Now, using either wage growth or the employment/population ratio, monetary policy has achieved neutrality. If rates are raised as projected by the dots chart, assuming no change in inflation, the policy rate will reach a level consistent with tight policy with another two rate increases. Thus, we are now entering a more dangerous period for the economy where a policy mistake will matter.

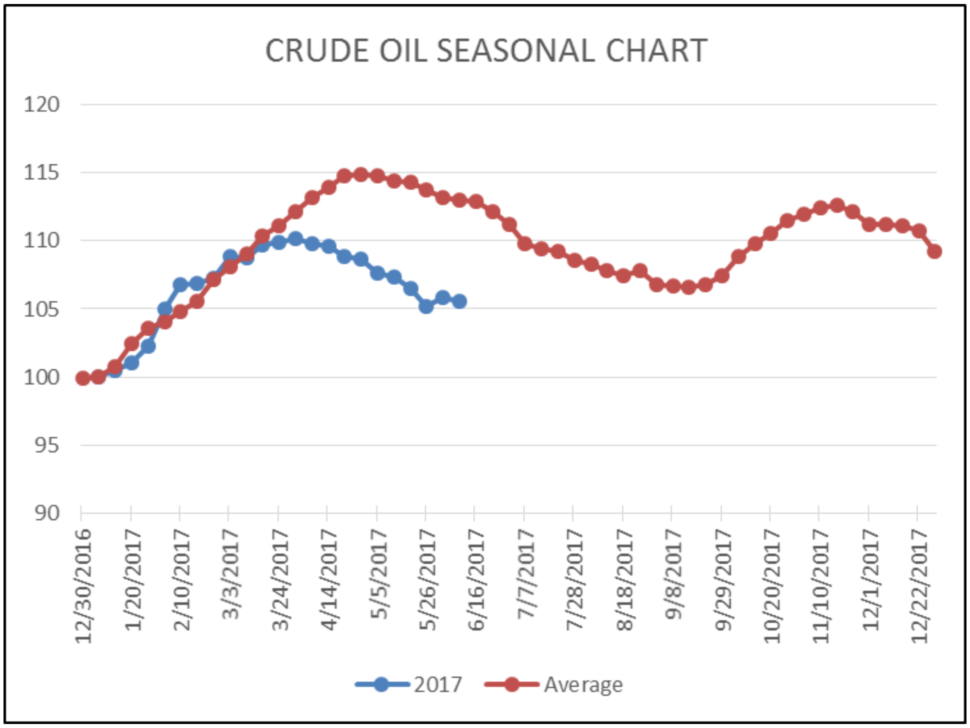
U.S. crude oil inventories fell 1.7 mb compared to market expectations of a 2.3 mb draw.



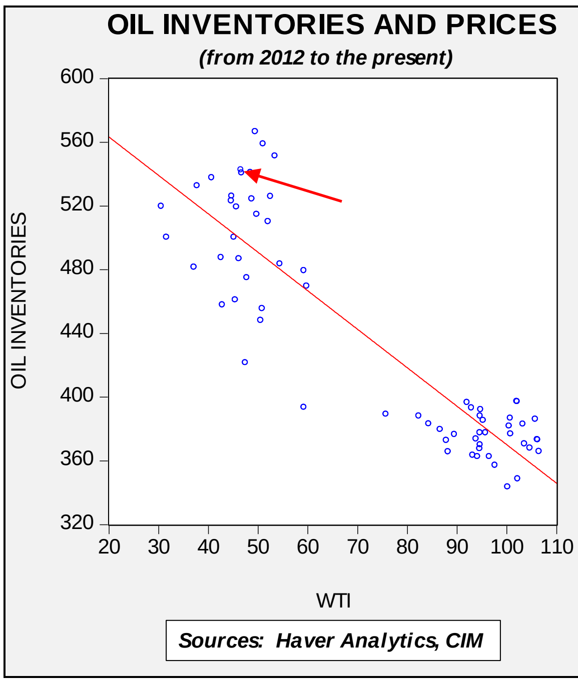


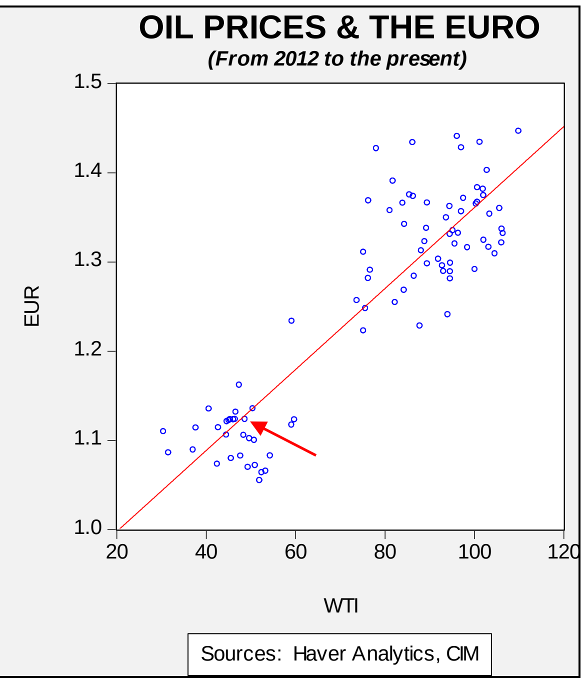
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but they are declining. We also note that, as part of an Obama era agreement, there was a 0.4 mb sale of oil out of the Strategic Petroleum Reserve. This is part of a $375.4 mm sale (or 8.0 mb) done, in part, to pay for modernization of the SPR facilities. 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 2.1 mb, which is near forecast.

As the seasonal chart below shows, inventories are usually well into the seasonal withdrawal period. This year, that process began early. Although the actual level of stockpiles remains quite high, we have seen rather sharp stock declines until the past two weeks. We would expect the draws to increase as the recent rise in imports should fade.



(Source: DOE, CIM)





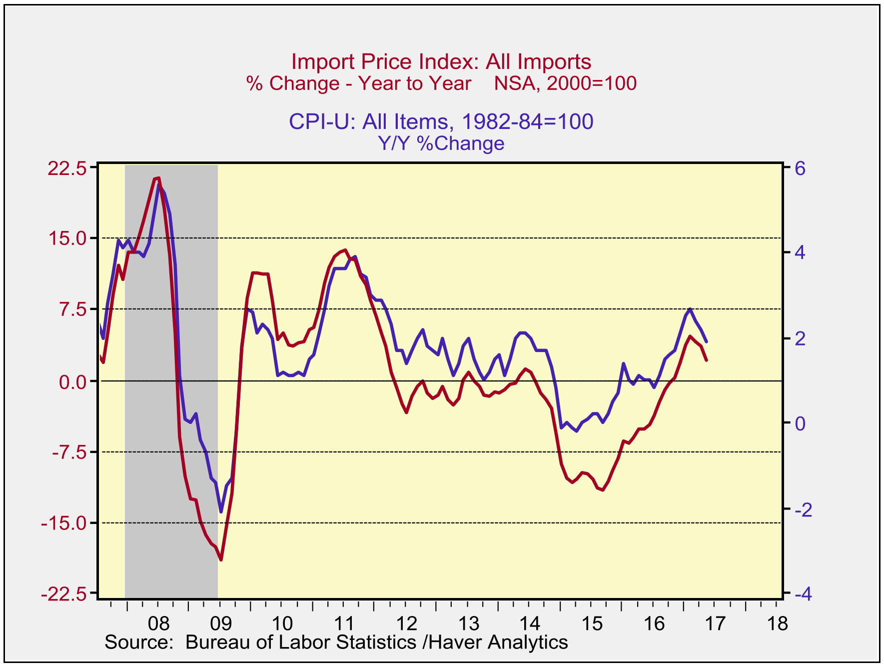
Based on inventories alone, oil prices are overvalued with the fair value price of $37.65. Meanwhile, the EUR/WTI model generates a fair value of $52.56. Together (which is a more sound methodology), fair value is $48.00, meaning that current prices are well below fair value. Currently, prices are below our expected trading range; we view oil prices as attractive on a short-term trading basis.

(Source: Bloomberg)

This chart shows the nearest WTI futures price. We have drawn a box between $45 and $55 per barrel. Note that since early October, nearly all prices fall within this range. This range has developed because OPEC's cuts are being offset by rising U.S., Canadian and Brazilian output, leaving a mostly balanced market. As the chart shows, prices at this level have been attractive entry points. Of course, the risk is that we are seeing a downside breakout but we view further weakness as unlikely without strong evidence of OPEC cheating. Thus, a recovery should develop in the coming weeks.

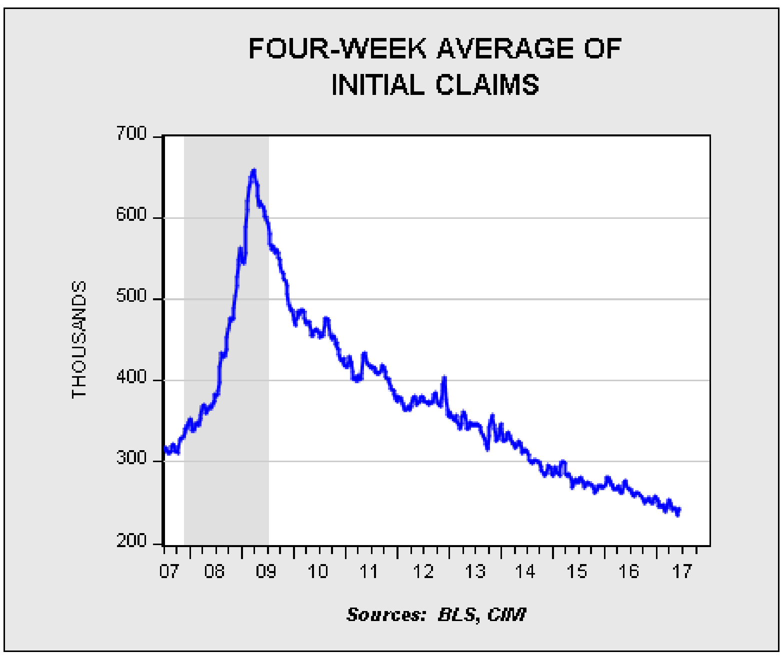
U.S. Economic Releases

The monthly import price index came in below expectations, falling 0.3% compared to the forecast drop of 0.1%. The prior month's gain was revised downward from 0.5% to 0.2%. The core import price index remained unchanged, while the prior report's gain was revised downward from 0.4% to 0.3%. The export price index came in below expectations, falling 0.7% compared to the forecast rise of 0.2%.



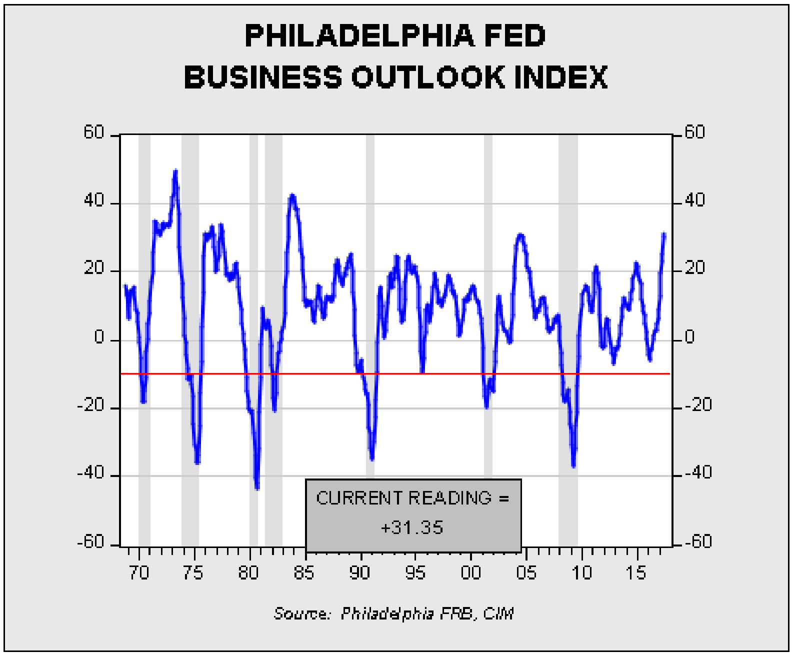
The chart above shows the year-over-year change in the import price index and CPI. The drop in the import price index is consistent with the drop we saw in yesterday's CPI report.

Initial jobless claims came in below expectations at 237k compared to the forecast of 241k.



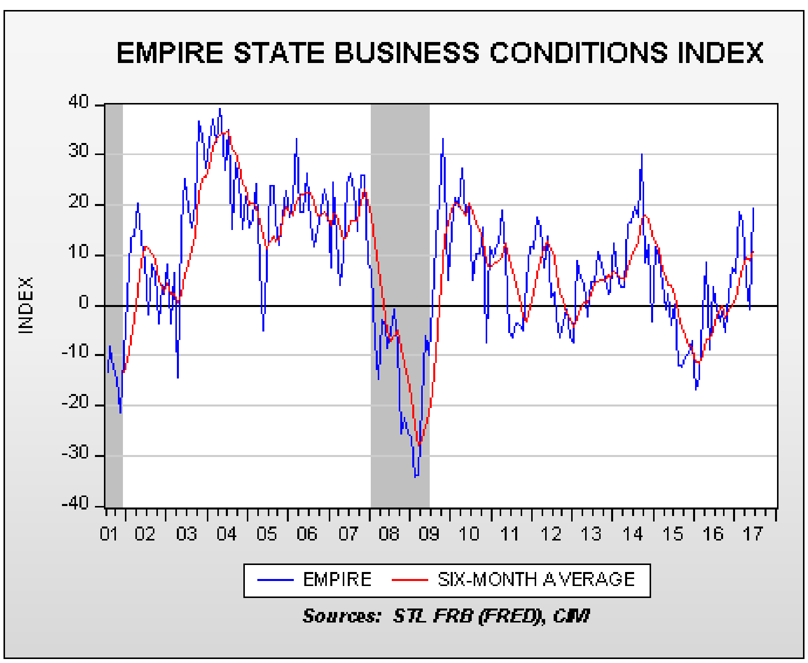
The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose from 242k to 243k.

The Philadelphia Fed business outlook came in above expectations at 27.6 compared to the forecast of 24.9.



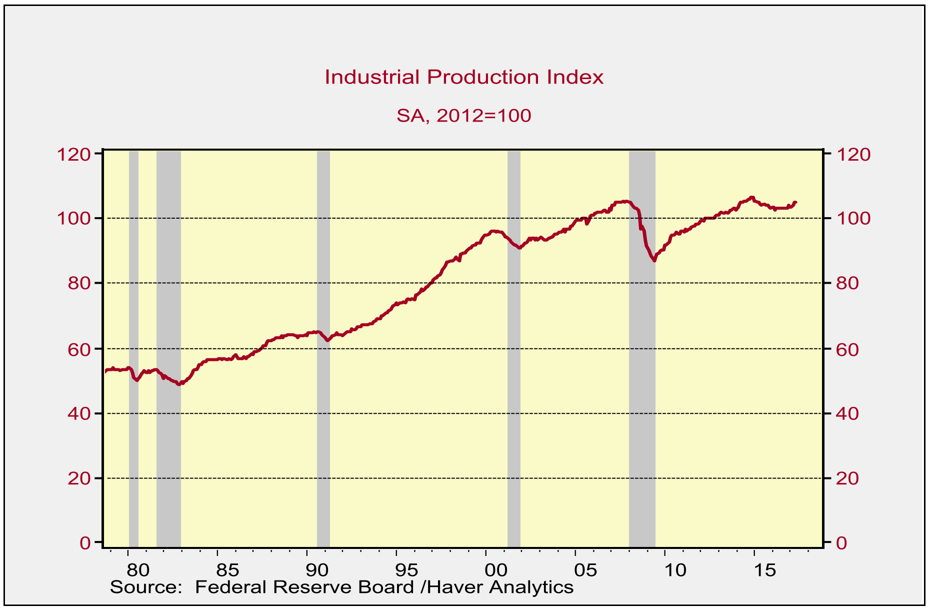
We smooth the data with a six-month average. The current reading is at a new cycle high for the current expansion. Although this is a sentiment number, it does suggest strong confidence in the Philadelphia FRB district.

Empire manufacturing came in above expectations at 19.8 compared to the forecast of 5.0.



The chart above shows the six-month moving average of the Empire State Business Conditions Index.

Industrial production came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.2%. Capacity utilization came in below expectations at 76.6% compared to the forecast of 76.8%. Manufacturing production came in below expectations, falling 0.4% from the prior month compared to the forecast rise of 0.1%.



The chart above shows the industrial production index over the past 30 years. Recently, industrial production has been stagnant, which could suggest that manufacturers are experiencing reduced exporting power as a result of the stronger dollar.

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

Economic Releases							
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	jun		49.9	**
10:00	NAHB Housing Market Index	m/m	jun	70	70	**
16:00	Total Net TIC Flows	m/m	apr		-$0.7 bn	**
16:00	Net Long-term TIC Flows	m/m	apr		$59.8 bn	**
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								
Japan	Japan Buying Foreign Bonds	m/m	jun	526.6 bn	-350.4 bn		*	Equity and bond neutral
	Japan Buying Foreign Stocks	m/m	jun	50.4 bn	443.7 bn		*	Equity and bond neutral
	Foreign Buying Japan Bonds	m/m	jun	309.6 bn	484.5 bn		*	Equity and bond neutral
	Foreign Buying Japan Stocks	m/m	jun	-143.1 bn	543.3 bn		*	Equity and bond neutral
Australia	Consumer Inflation Expectations	m/m	may	3.6%	4.0%		**	Equity and bond neutral
	Employment Change	m/m	may	42.0k	37.4k	10.0k	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	may	5.5%	5.7%	5.7%	***	Equity bullish, bond bearish
	Full Time Employment Change	m/m	may	52.1k	-11.6k		**	Equity and bond neutral
	Part Time Employment Change	m/m	may	-10.1k	49.0k		**	Equity and bond neutral
	Participation Rate	m/m	may	64.9%	64.8%	64.8%	**	Equity bullish, bond bearish
New Zealand	GDP	y/y	1q	2.5%	2.7%	2.7%	***	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	m/m	apr	19.0 bn	23.1 bn	22.0 bn	**	Equity and bond neutral
Italy	CPI EU Harmonized	y/y	may	1.6%	1.5%	1.5%	***	Equity and bond neutral
	General Government Debt	y/y	apr	2.2704 tn	2.2603 tn		**	Equity and bond neutral
France	CPI	y/y	may	0.8%	0.8%	0.8%	***	Equity and bond neutral
UK	Retail Sales ex Auto Fuel	y/y	may	0.6%	4.5%	1.9%	**	Equity bearish, bond bullish
	Retail Sales inc Auto Fuel	y/y	may	0.9%	4.0%	1.6%	**	Equity bearish, bond bullish
Switzerland	Producer & Import Prices	y/y	may	0.1%	0.8%	0.2%	**	Equity and bond neutral
AMERICAS								
Mexico	Teranet/ National Bank HPI	y/y	may	13.9%	13.4%		**	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)	125	124	1	Up
3-mo T-bill yield (bps)	98	99	-1	Neutral
TED spread (bps)	27	25	2	Neutral
U.S. Libor/OIS spread (bps)	115	115	0	Up
10-yr T-note (%)	2.15	2.13	0.02	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	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	0.250%	0.250%	0.250%	On forecast
BOE Asset Purchase Target	435 bn	435 bn	435 bn	On forecast
BOE Corporate Bond Target	10 bn	10 bn	10 bn	On forecast
FOMC Rate Decision Upper Bound	1.250%	1.000%	1.250%	On forecast
FOMC Rate Decision Lower Bound	1.000%	0.750%	1.000%	On forecast
SNB Deposit Interest Rate	-0.750%	-0.750%	-0.750%	On forecast
SNB 3-Month Libor Upper Bound	-0.250%	-0.250%	-0.250%	On forecast
SNB 3-Month Libor Lower Bound	-1.250%	-1.250%	-1.250%	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	$46.89	$47.00	-0.23%	Long Liquidation
WTI	$44.54	$44.73	-0.42%	
Natural Gas	$2.95	$2.93	0.44%	
Crack Spread	$14.91	$15.13	-1.45%	
12-mo strip crack	$13.81	$13.88	-0.50%	
Ethanol rack	$1.68	$1.68	-0.03%	
Metals				
Gold	$1,255.30	$1,260.86	-0.44%	Stronger Dollar; Rise in Fed Funds Rate
Silver	$16.79	$16.90	-0.65%	
Copper contract	$256.75	$257.35	-0.23%	
Grains				
Corn contract	$ 375.25	$ 377.00	-0.46%	
Wheat contract	$ 441.75	$ 443.00	-0.28%	
Soybeans contract	$ 934.25	$ 939.00	-0.51%	
Shipping				
Baltic Dry Freight	865	870	-5	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.7	-2.3	0.6	
Gasoline (mb)	2.1	-1.2	3.2	
Distillates (mb)	0.3	0.5	-0.2	
Refinery run rates (%)	0.30%	0.00%	0.3%	

Weather

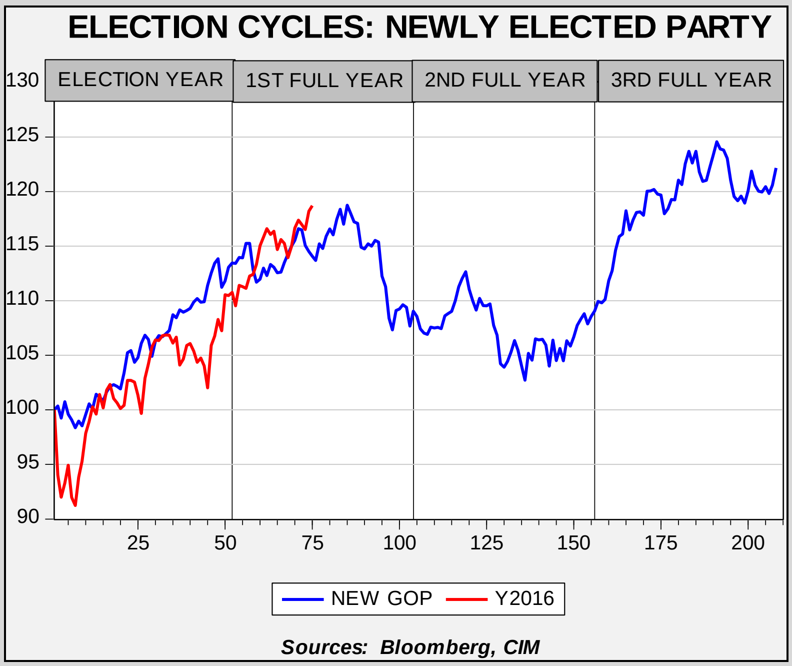
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, except for the northern region which shows cooler temps. Precipitation is expected for most of the eastern region.

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.

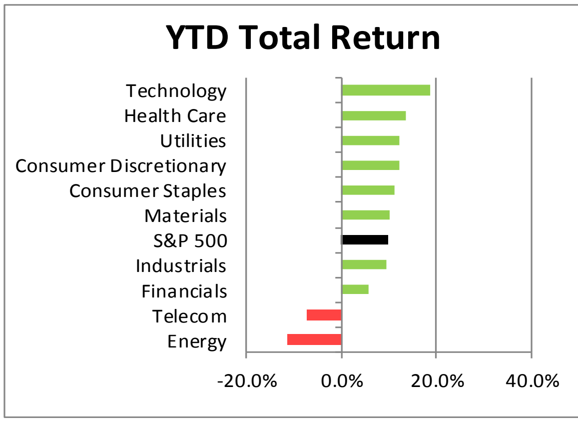
Winds of war on the Korean Peninsula: The U.S. will have three carrier groups in the East China Sea in the coming weeks. Although we doubt the Trump administration wants a war with North Korea, the U.S. is putting enough assets in the region to go to war if it so decides. A full-scale attack on North 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.

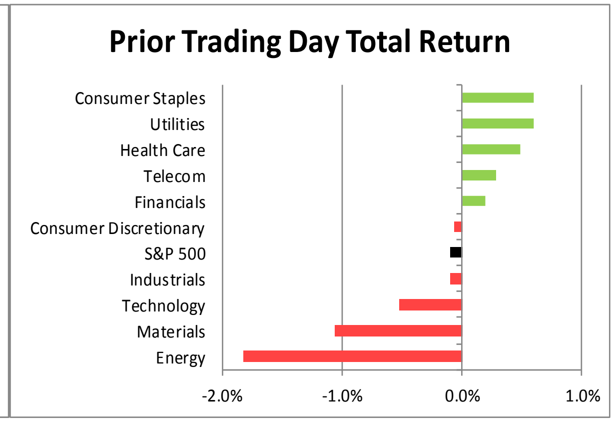
Monetary policy worries: The FOMC appears driven to raise the fed funds target rate. As we have noted before, there is a good deal of uncertainty surrounding the degree of slack that remains in the economy. The FOMC appears to be leaning toward the notion that the economy is getting close to capacity 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 6/14/2017 close)

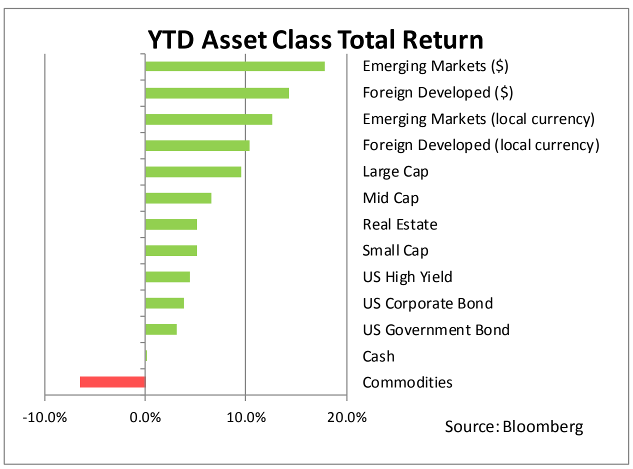




(Source: Bloomberg)

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 6/14/2017 close)

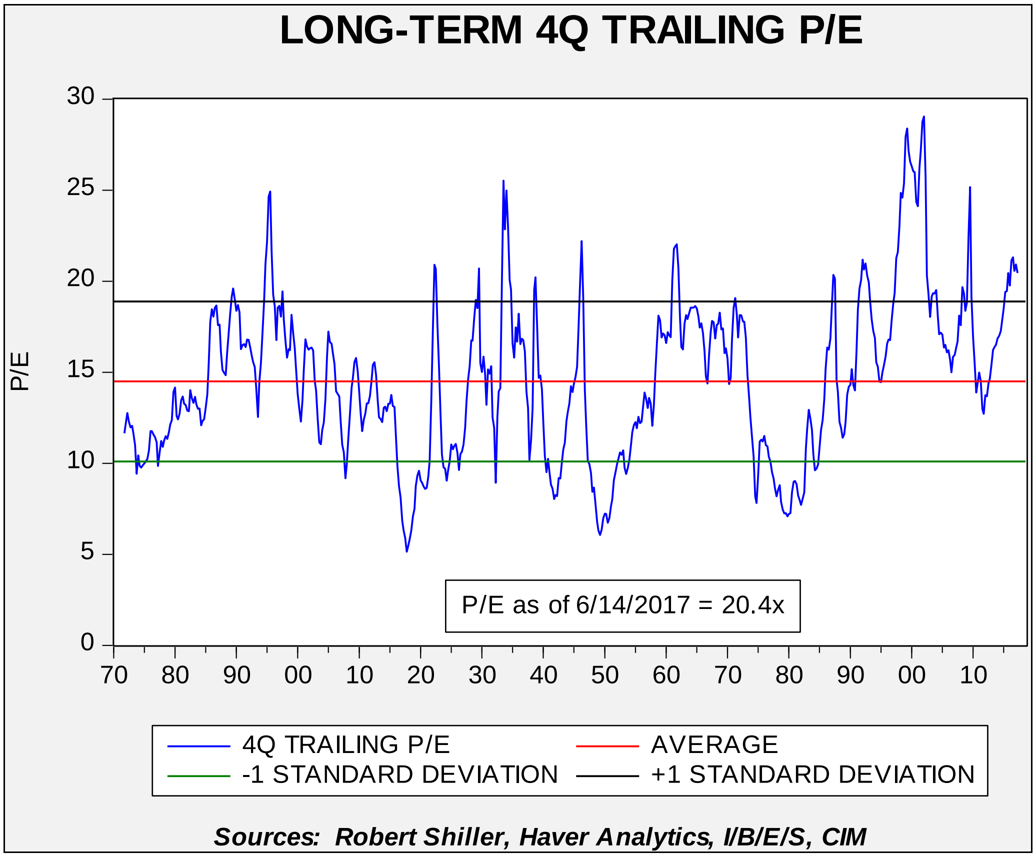


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2017



Based on our methodology,[1] the current P/E is 20.4x, up 0.1x from last week.

[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.