Daily Comment

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

[Posted: June 1, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 1.9%. U.S. equity index futures are signaling a higher open.

There were a couple of political items of note. First, the White House announced the president will hold a Rose Garden gathering to announce his decision on the Paris Climate Accord. Reports suggest he will take the U.S. out of the agreement, although there are conflicting news items indicating he hasn't completely made up his mind quite yet. Although there is much concern in the media about the action, we view it as mostly symbolic. First, these major accords rarely meet their promises. The ones that do are narrowly structured; for instance, the Montreal Protocol on CFCs worked because it was a specific gas and substitutes were available. The Paris Climate Accord is much more general, thus we always expected widespread failure in reaching the stated goals. Second, it seems to us that the private sector is already moving on this issue of reducing carbon emissions and government action may not matter all that much. Insurers' decisions to not cover risks affected by climate and firms needing to make long-term investment decisions that might be affected by a post-Trump reversal of environmental rules are not going to change based on what the president says later today. In other words, a utility looking at a 30-year investment in generating capacity will probably still lean toward natural gas instead of coal, not knowing how regulation may change in the future. Third, natural market forces lowering the costs of alternatives may make leaving the accord moot.

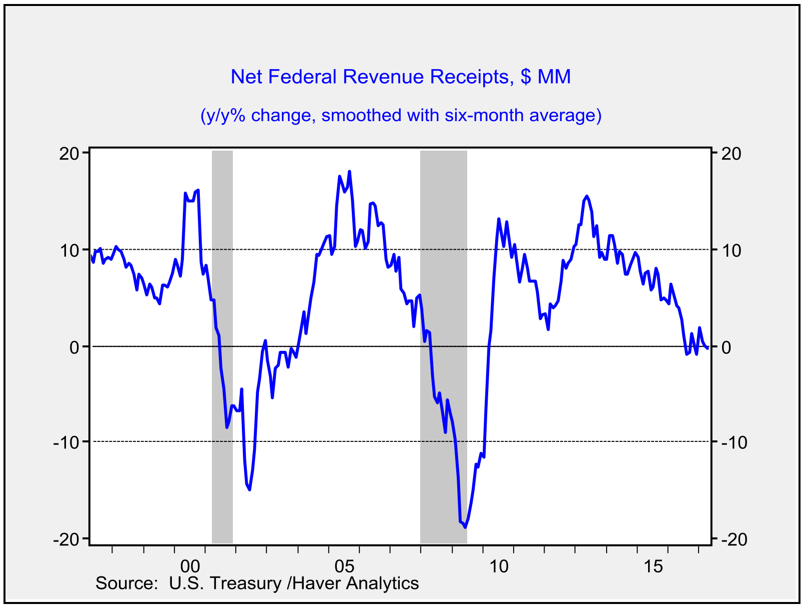
And, lest we forget, President Trump is mercurial; he may decide to stay in the accord. We are expecting to hear from the White House at 3:00 EDT. If the announcement is delayed, it may indicate how torn the president is over this decision.

PM May decided to skip a live debate yesterday evening, continuing a pattern where she is refusing to directly engage the other candidates. Instead, she sent Home Secretary Rudd to represent her. This was probably a bad move. The lesser parties severely criticized the PM while Labour Party Leader Corbyn scored points by staying measured and avoiding direct attacks on May. Polls continue to tighten, with the Tories' lead falling to a mere 3%. We are in the area of the margin of error; if the Conservatives lose, it will be bearish for the GBP and other U.K. financial assets.

One of the issues we are monitoring is the debt ceiling. The debt ceiling is the limit on national debt that can be issued by the Treasury. As a refresher, the debt ceiling was first created in 1917 during WWI. Prior to the Second Liberty Bond Act of 1917, Congress had to approve the debt every time the government borrowed money for a specific appropriation. War borrowing made this practice impractical so the new law set a limit on debt the Treasury could issue and Congress must lift the limit in order to issue more debt once the initial limit is reached. It should be noted that the appropriations and budget are separate from the debt ceiling issue. In effect, the debt issued is to fund government appropriations that have already occurred.

After a couple of incidents when the debt ceiling was reached, Congress passed the "Gephardt Rule," which said that the debt ceiling would be automatically raised when a budget was passed. This rule was repealed in 1995; since then, we have had periodic debt limit crises that have led to government shutdowns. The first occurred in 1995-96. The most famous incident occurred in the summer of 2011 which resulted in a downgrade of U.S. Treasury debt by S&P. The sequester process emerged from this event. Another shutdown occurred in 2013. We have been currently working under a suspended debt ceiling that expired in March.

It initially appeared that the debt ceiling would become an issue in Q4, but the Trump administration has indicated that the Treasury will reach the current limit by August.



This chart shows the yearly change in net Federal receipts, smoothed with a six-month moving average. Falling receipts is a concern; the past two recessions coincided with a sharp decline in revenue likely caused by falling incomes and profits. The current problem is partially due to some taxpayers delaying asset sales in hopes of lower capital gains rates in the future.[1]

The GOP membership appears divided on the debt ceiling issue. The Freedom Caucus is hinting that it may call for spending cuts to approve a rise in the debt limit. Other members of the GOP, including the treasury secretary, are pressing for a "clean" rise in the debt limit. The GOP leadership may be forced to woo Democrat Party votes in order to avoid default, but it is unknown what demands they will make on the White House and the establishment GOP for their votes. We would not be surprised to see demands related to health care, for example.

[1] https://www.bloomberg.com/politics/articles/2017-05-31/rich-americans-may-hasten-a-trump-headache-raising-debt-limit

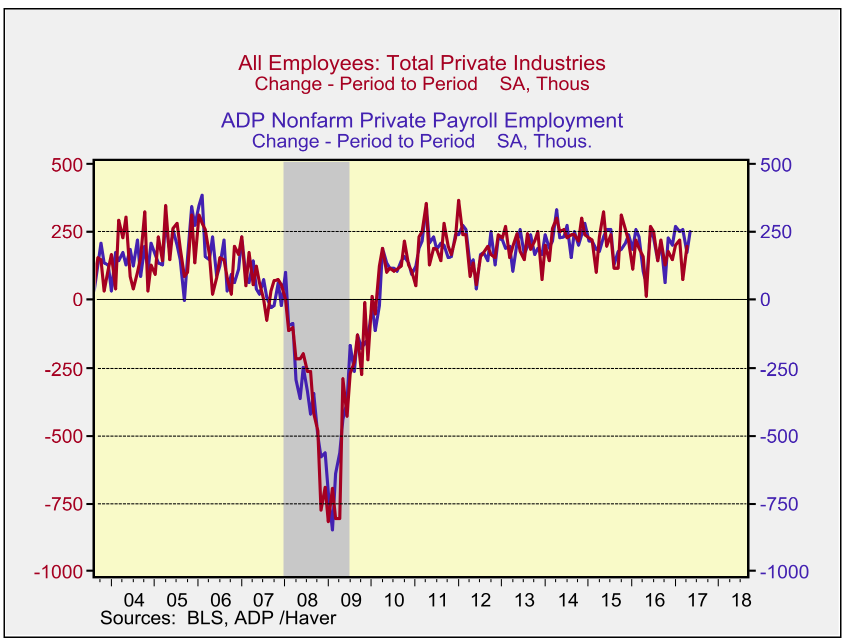
Given the disarray within the Republican Party in Congress, we are worried that threats of default and a government shutdown are rising. At best, this issue will begin to distract the administration and Congress from other pressing issues, such as health care, tax reform, etc. At worst, we could face another government shutdown and the threat of another downgrade. We will continue to monitor this issue as the summer unfolds.

The *FT* is reporting that EU officials are looking into a process where sovereign debt across the Eurozone would be "bundled" into a new financial instrument and sold to investors. Although officials in Brussels have been careful not to characterize this new instrument as a Eurobond, it could be an intermediate step toward the creation of such an instrument. In theory, German, Italian, Spanish and other nation bonds would be bundled into an instrument; this process could modestly raise German borrowing costs but lower costs elsewhere. We would look for Germany to oppose the measure but France and the southern tier nations to actively support the idea.

U.S. Economic Releases

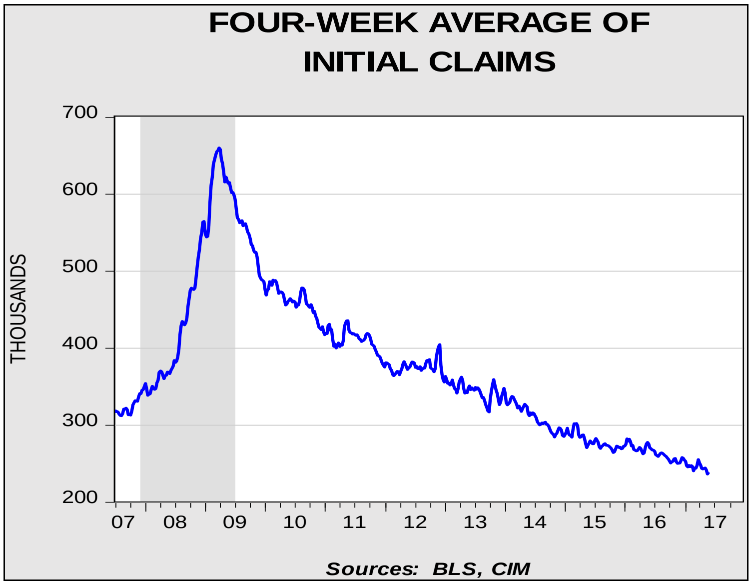
The March Challenger job cuts report rose by 71.4% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

The ADP employment change came in above expectations at 253k compared to the forecast of 180k. The prior report was revised downward from 177k to 173k.



The chart above shows the period change of nonfarm payrolls and ADP employment change. A strong ADP employment change number signals a good BLS non-farm payroll report for Friday, suggesting the labor market is still strengthening.

Initial jobless claims came in worse than expectations at 248k compared to the forecast of 238k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose from 235.5k to 238k.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	april	52.5	52.5	**
9:45	Bloomberg Consumer Comfort	m/m	may		49.7	**
10:00	ISM Manufacturing	m/m	may	54.8	54.8	**
10:00	ISM Prices Paid	m/m	may	67.0	68.5	**
10:00	ISM New Orders	m/m	mar		57.5	**
10:00	ISM Employment	m/m	may		52.0	**
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	Caixin China PMI Manufacturing	m/m	may	49.6	50.3	50.1	**	Equity bearish, bond bullish
Japan	Housing Starts	m/m	apr	1.9%	0.2%	-1.5%	**	Equity bullish, bond bearish
	Construction Orders	m/m	apr	1.1%	-0.2%		**	Equity and bond neutral
	Small Business Confidence	m/m	apr	48.9	48.6		**	Equity and bond neutral
	Capital Spending	q/q	1q	4.5%	3.8%	4.0%	**	Equity bullish, bond bearish
	Company Profits	q/q	1q	26.6%	16.9%		**	Equity and bond neutral
	Company Sales	q/q	1q	5.6%	2.0%		**	Equity and bond neutral
	Loans & Discount Corp	m/m	apr	3.7%	3.2%		**	Equity and bond neutral
India	Nikkei India PMI Mfg	m/m	may	51.6	52.5		**	Equity and bond neutral
Australia	Private Capital Expenditure	m/m	1q	0.3%	-2.1%	0.5%	**	Equity and bond neutral
	Retail Sales	m/m	apr	1.0%	-0.1%	0.3%	**	Equity bullish, bond bearish
	CoreLogic House Px	m/m	apr	-1.1%	0.1%		**	Equity and bond neutral
New Zealand	QV House Prices	y/y	may	9.7%	11.1%		**	Equity and bond neutral
	Terms of Trade Index	q/q	1q	5.1%	5.7%	3.9%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	may	57.0	57.0	57.0	**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	m/m	may	59.5	59.4	59.4	**	Equity and bond neutral
France	Markit France Manufacturing	m/m	may	53.8	54.0	54.0	**	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing	m/m	may	55.1	56.2	56.0	**	Equity and bond neutral
	GDP	y/y	1q	1.2%	0.8%	0.8%	***	Equity and bond neutral
UK	Nationwide House Px	m/m	may	-0.2%	-0.4%	-0.2%	**	Equity and bond neutral
	Markit UK PMI Manufacturing	m/m	may	56.7	57.3	56.5	**	Equity and bond neutral
Switzerland	GDP	y/y	1q	1.1%	0.6%	1.3%	***	Equity and bond neutral
	Retail Sales	y/y	apr	-1.2%	2.1%		**	Equity and bond neutral
	PMI Manufacturing	m/m	may	55.6	57.4	57.8	**	Equity and bond neutral
Russia	Markit Russia PMI Mfg	m/m	may	52.4	50.8	50.8	**	Equity bullish, bond bearish
AMERICAS								
Brazil	GDP	y/y	1q	-0.4%	-2.5%	-0.4%	***	Equity and bond neutral
Canada	MLI Leading Indicator	m/m	apr	0.4%	0.5%		**	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)	120	120	0	Up
3-mo T-bill yield (bps)	96	96	0	Neutral
TED spread (bps)	25	24	1	Neutral
U.S. Libor/OIS spread (bps)	111	110	1	Up
10-yr T-note (%)	2.22	2.20	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	34	34	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Down
yen	down			Down
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**		
Selic Rate	10.250%	11.250%	10.250%	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	$50.51	$50.76	-0.49%	Long Liquidation
WTI	$48.23	$48.32	-0.19%	
Natural Gas	$3.11	$3.07	1.37%	
Crack Spread	$17.83	$17.63	1.10%	
12-mo strip crack	$15.20	$15.21	-0.07%	
Ethanol rack	$1.66	$1.65	0.30%	
Metals				
Gold	$1,267.17	$1,268.92	-0.14%	Stronger Dollar
Silver	$17.15	$17.33	-1.00%	
Copper contract	$256.75	$258.00	-0.48%	
Grains				
Corn contract	$ 373.00	$ 372.00	0.27%	
Wheat contract	$ 429.25	$ 429.25	0.00%	
Soybeans contract	$ 918.00	$ 916.00	0.22%	
Shipping				
Baltic Dry Freight	878	900	-22	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-1.5		
Distillates (mb)		-0.7		
Refinery run rates (%)		0.00%		
Natural gas (bcf)		77		

Weather

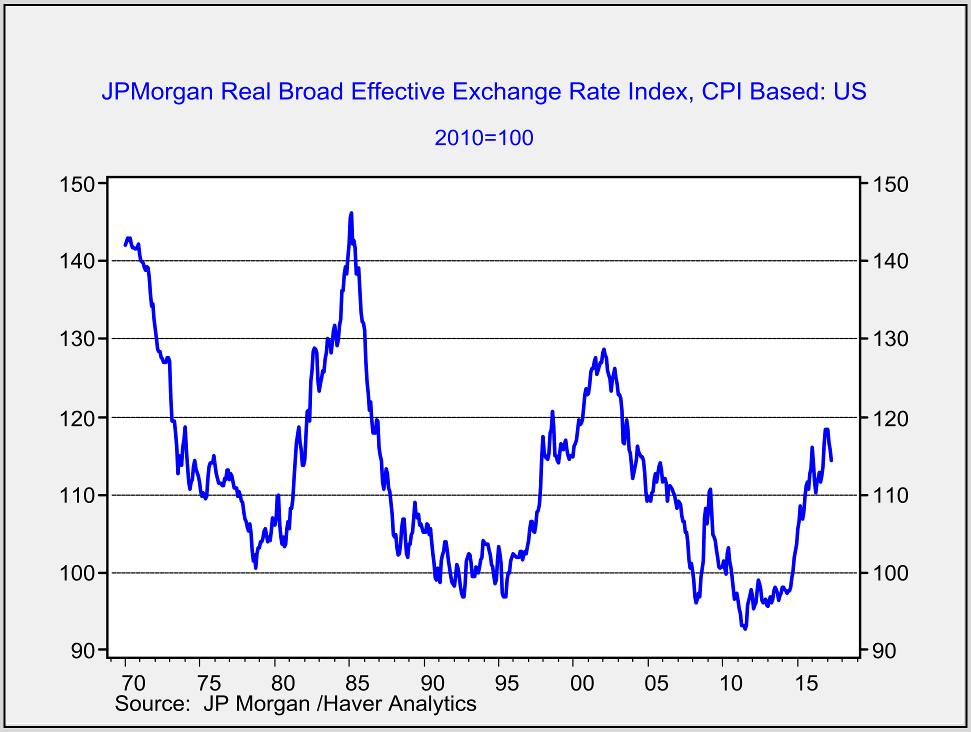
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the eastern region. Precipitation is expected for most of the country, excluding the northern region.

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.

May 26, 2017

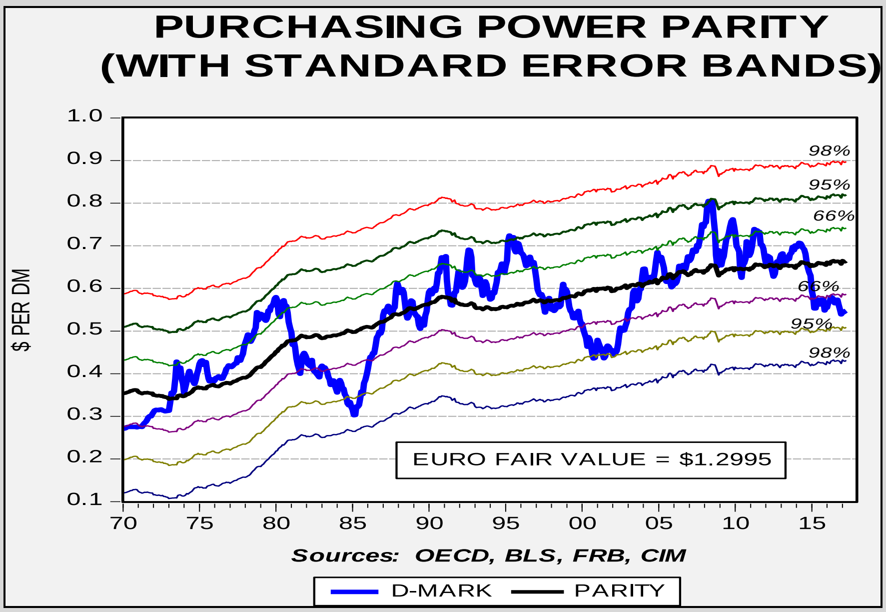
The dollar is in its third major bull market since currencies began floating in 1971.



This chart shows the JPM dollar index which adjusts for relative inflation and trade. The previous two bull markets exhibited greater strength than the current one. Because of the dollar's reserve currency role, there will always be an underlying demand for dollars for foreign reserve purposes. Thus, U.S. policymakers can run fiscal deficits and tax policies that penalize saving (for example, we tax income instead of consumption) and not suffer from foreign exchange crises. At the same time, dollar strength can act as a drag on the economy; it tends to make imports more attractive and can undermine the competitiveness of domestic firms.

The previous two dollar rallies were tied to specific fundamental factors. The 1978-85 bull market was mostly attributable to the Volcker Federal Reserve. Paul Volcker instituted monetary policy based on money supply growth instead of interest rate targets. This allowed interest rates to rise to extraordinary levels (fed funds peaked at 19.1% in June 1981) and made the dollar very attractive. The 1995-2002 bull market was mostly caused by productivity gains, although fiscal surpluses likely contributed as well. Technology investment began to boost the economy in the latter half of the 1990s and made the U.S. an attractive investment venue. The surplus reduced available Treasuries and made it difficult to build reserves without bidding the dollar higher. The current bull market is similar to the Volcker bull market in that it appears to be mostly due to monetary policy. The Federal Reserve began to reverse its unconventional monetary policy measures before the other major G-7 economies, boosting the greenback.

Valuing currencies is difficult as it is generally true that the currency markets focus on different factors over time. There are periods when relative inflation is dominant. During other periods, the external accounts drive the exchange rates, while other times interest rate differentials are key. The valuation model with the longest history is purchasing power parity, which is based on relative inflation rates. The thesis is that the exchange rate should act to balance prices between nations and so a country with higher inflation relative to another should have a weaker exchange rate to unify prices across countries. In practice, we find that not all goods are tradeable, inflation indices are not the same across countries and relative pricing parity models don't account for capital flows. Although parity models often deviate from fair value, they can be useful when parity reaches an extreme.



This chart shows the German/U.S. parity model, which uses CPI from Germany and the U.S. to establish parity. Currently, the exchange rate is nearly two standard errors below parity, meaning the D-mark (or the euro) is undervalued relative to the dollar. As the chart shows, the exchange rate rarely stays around purchasing power parity. However, when it reaches the two-standard error level in either direction, it usually means the exchange rate will eventually reverse. It isn't uncommon for the exchange rate to remain over or undervalued for a long period of time. However, we eventually do see a reversal from extreme levels. Usually, there is a catalyst that brings an adjustment to valuation. In 1985, it was the Plaza Accord which was specifically designed to weaken the dollar. The end of the second bull market was likely due to the end of the tech bubble in equities and the Bush tax cuts, which reduced the fiscal surplus.

It appears we are seeing two catalysts that may be signaling the end of this dollar bull market.

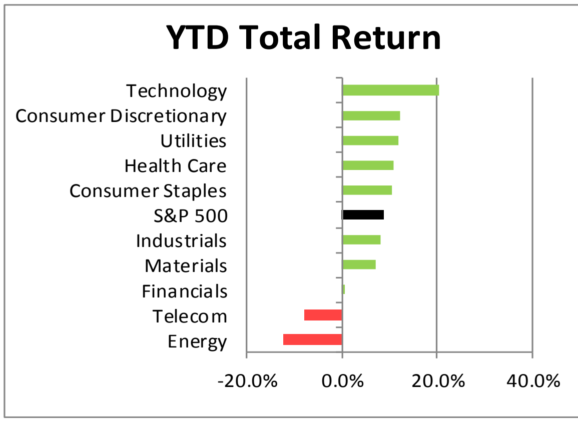
The reversal of monetary policy: The dollar initially rallied on the divergence of monetary policy. The Federal Reserve was ending QE and beginning to raise rates, while the Bank of Japan (BOJ) was expanding QE and the European Central Bank (ECB) was implementing QE and experimenting with negative interest rates. This kicked off the current dollar bull market that began in mid-2014. Although the FOMC is planning to raise rates further that action has been well telegraphed. At the same time, it appears the ECB is poised to raise rates and end its QE program. And, European economic growth has been strengthening, which will likely accelerate policy tightening. Even the BOJ is considering easing some of its support. Given the degree of dollar overvaluation, foreign policy tightening will likely weaken the dollar in the coming months.

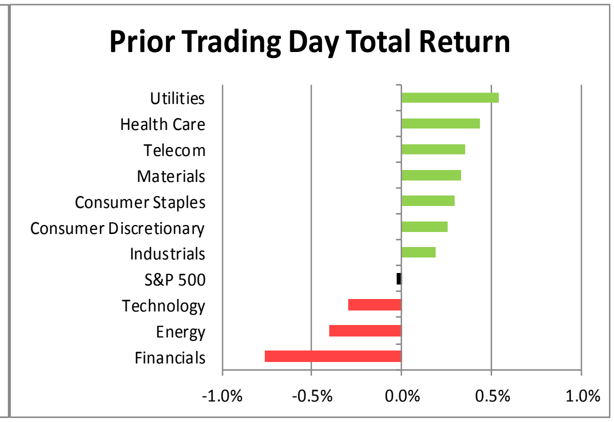
Political turmoil is favoring foreign currencies: There is no lack of political turmoil in the developed countries. We have had two major elections in Europe thus far, with upcoming German elections in the fall and Italian elections expected in February. Brexit continues to roil Europe. Tensions are rising in the Far East as North Korea continues to test missiles and threaten its neighbors. When President Trump won the election in November, the dollar rose on expectations of trade restrictions, tax reform that would support repatriation and infrastructure spending which would boost growth. As the Trump administration has gotten sidetracked on other issues, these expectations have dwindled. Even though political risk remains high throughout the developed markets, the high dollar valuation and disappointment surrounding the president's policies appear to be undermining the dollar.

If the dollar's bull market is coming to a close, what can we expect? First, it gives a tailwind to foreign investment. Emerging markets, which have been strong this year, would likely receive further support if the dollar begins to weaken. Second, commodities would benefit. For example, our oil inventory/EUR model for oil prices indicates that a €1.30 would generate a fair value for oil near $78 per barrel, even with the current elevated level of inventories. Gold prices are traditionally supported by dollar weakness as well. The asset allocation committee will be weighing the likelihood of dollar weakness and take appropriate measures in the coming months.

<u>**Data Section**</u>

U.S. Equity Markets – (as of 5/31/2017 close)

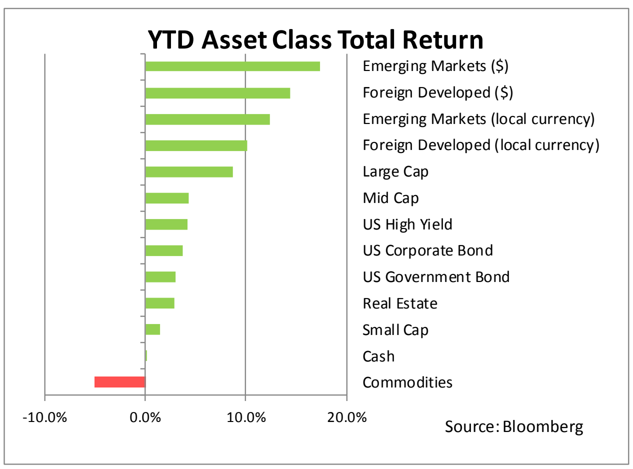




(Source: Bloomberg)

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 5/31/2017 close)

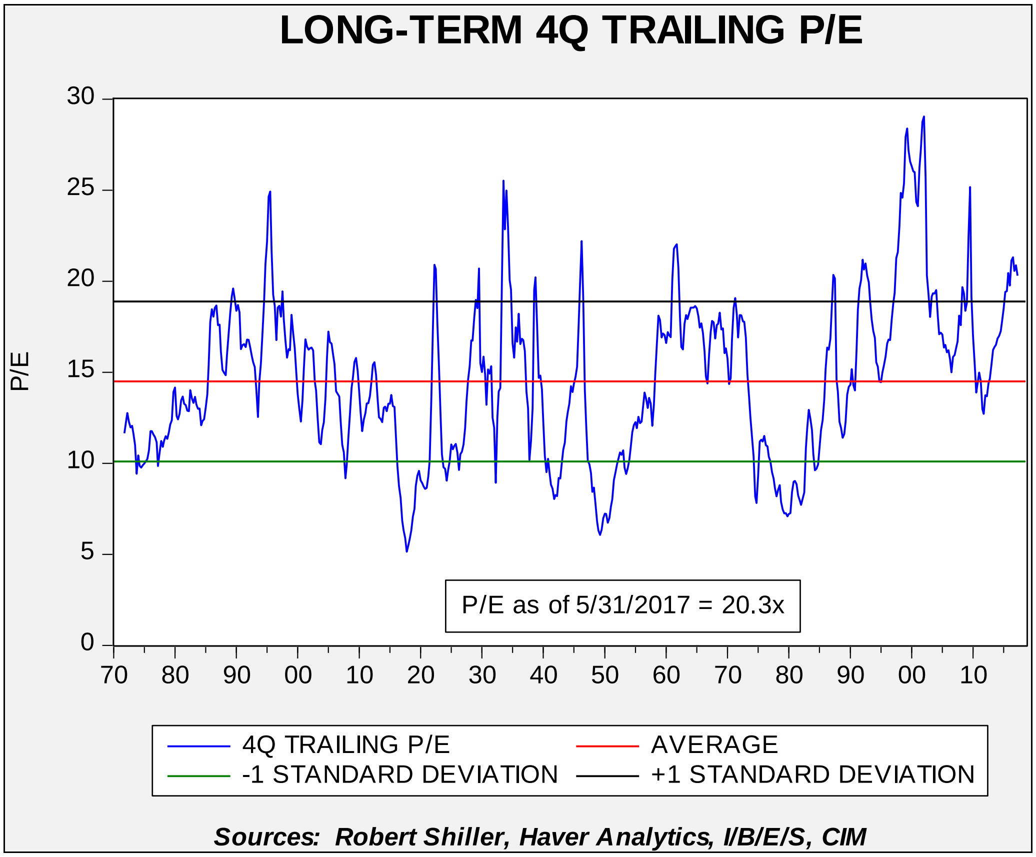


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 1, 2017



Based on our methodology,[2] 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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[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 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.