Daily Comment

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[Posted: June 21, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.7% from the prior close. Chinese markets were up, with the Shanghai composite up 0.5% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a lower open.

In the overnight news:

MSCI opens up for China: The index producer has been reluctant to add domestic shares of Chinese companies due to numerous concerns, including capital controls, lack of accounting transparency, etc. This is something of a big deal, but also not. Chinese shares are already in the MSCI EM indices; in fact, China currently represents 28.6% of the index. However, the companies in this share of the index are internationally traded and generally follow Western accounting rules. The domestic "A-shares" will only add 0.7% of new Chinese shares to the index. So, in actual money terms, it's not a huge deal. However, it is another signal, similar to the CNY's inclusion in SDRs, that China is joining the major economies on an equal scale.

GOP holds two seats: In the sixth Georgia Congressional district, Karen Handel, a veteran Republican politician, fended off a well-funded[1] young Democrat named Jon Ossoff. Given that the GOP has held this seat for four decades, this was the expected outcome and the win wasn't huge—Handel won 51.9% to 48.1%. Meanwhile, in South Carolina, Republican Ralph Norman defeated Democrat Archie Parnell 51.1% to 47.9%, holding the seat vacated by Mick Mulvaney. The win was narrower than his predecessor's 20-point margin but still a comfortable win. Although the president remains a divisive figure, these two elections suggest that discomfort with the president probably isn't enough to change control of Congress. The problem for the Democrat Party is a path to increase popularity. The leadership, tied closely to parts of Wall Street and Silicon Valley, wants to run as center-left technocrats. The rest of the party wants to go hard left, becoming a "Corbyn/Sanders" party. We believe the broader issue is that we are seeing a restructuring of the coalitions that form both parties and therefore navigating the landscape will become increasingly difficult.

A Saudi shakeup: Saudi King Salman announced that Crown Prince Nayef was demoted and he has elevated his son, former Deputy Crown Prince Salman, to crown prince. Nayef will also lose his important power base of interior minister; this ministry oversees domestic security and counter-terrorism and was the base of power for the late King Abdallah. The new interior minister will be Prince Abdulaziz bin Saud bin Nayef, a nephew of the ousted crown prince. The decision was apparently approved by 31 of the 34 members of the Allegiance Council, which oversees succession.

[1] Total spending in this election topped $50 mm.

This decision has three elements of risk. First, CP Salman is very young and has conducted an aggressive foreign policy. He has managed the war in Yemen and is a hardliner with Iran. His appointment to next in line for the throne suggests that Saudi foreign policy will likely become increasingly bellicose. Second, the king's appointment of his son as successor raises the problem of primogeniture. The founder of Saudi Arabia, Ibn Saud, unified most of the Arabian Peninsula through war and marriage. At the time of his death, he reportedly had at least 44 sons, 22 wives and four known prominent concubines. His successor was his oldest son, Saud, who proved to be a feckless spendthrift and was ousted in a royal coup. Ibn Saud never made it completely clear how he wanted succession to occur. By appointing his oldest son, if the kingdom had followed primogeniture, Saud could have then selected his oldest son, leaving 43 sons of Ibn Saud out of kingly succession. The ouster of Saud instead created a system where the kingship would transfer to the sons of Ibn Saud. Although there are some available (albeit elderly) sons of Saud remaining, the royal family has agreed that the time has come for the grandsons of Ibn Saud to take control. That was the reason Nayef was made crown prince.[2] By selecting his son as the next crown prince, Salman has introduced the precedent of primogeniture. According to reports, the Allegiance Council considers this appointment as a "one-off" but, now that it has occurred, the precedent of the next king selecting one of his sons is in place. If such an event occurs, the potential for a civil war of sorts within the royal family increases. Third, why now? It is quite possible that the king's health is failing and he wanted to open the path of the throne to his favorite son before he died. King Salman is old (81 years) and there have been unconfirmed reports he suffers from dementia. If Salman passes soon, his controversial decision to elevate his son could become contentious.[3]

A century with Argentina: The South American country recently sold $2.75 bn of 100-year bonds with a coupon of 7.125%, giving it an annual yield of 7.9%. It had a bid/cover ratio of 3.5x. On the surface, this bond sale is amazing. Argentina has defaulted eight times since its independence in 1816. However, the risks may not be as large as they seem. First, the duration on a 100-year bond isn't significantly different from a 30-year bond. There will be very little principal paid for years. Second, given the high coupon, an initial investor recoups his investment in about 12 years. So, as long as Argentina doesn't default during that time, an investor should at least get paid back the initial stake. On the downside, it is dollar-denominated paper, which almost guarantees the bonds will face default at some point in the next century. However, we doubt any of today's buyers care; they are simply looking for a high coupon. This is one of the problems that comes with low policy rates; investors become tempted by debt that carries a higher yield with a high probability of default.

U.S. Economic Releases

MBA mortgage applications rose 0.6% from the prior week. Purchases fell by 1.0%, while refinancing rose by 2.1%. The average 30-year fixed rate mortgage remains unchanged from the prior week at 4.13%.

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

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[2] He had another attractive feature: no sons!

[3] For more background, see WGR, 1/20/15, Saudi Succession, and WGR, 5/11/15, The Next Generation.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Existing Home Sales	m/m	may	5.55 m	5.57 m	**
10:00	Existing Home Sales	m/m	may	-0.40%	-2.3%	**
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	All Industry Activity Index	m/m	may	2.1%	-0.6%	1.6%	**	Equity bullish, bond bearish
Australia	Westpac Leading Index	m/m	may	0.0%	-0.1%		**	Equity and bond neutral
	Skilled Vacancies	m/m	may	1.2%	0.1%		**	Equity and bond neutral
EUROPE								
UK	Public Finances	y/y	may	13.4 bn	-15.2 bn		**	Equity and bond neutral
	Central Government	y/y	may	10.5 bn	-15.2 bn		**	Equity and bond neutral
	Public Sector Net Borrowing	y/y	may	6.0 bn	9.6 bn	7.0 bn	**	Equity and bond neutral
	PSNB ex Banking Groups	y/y	may	6.7 bn	10.4 bn	6.8 bn	**	Equity and bond neutral
Switzerland	Money Supply M3	y/y	may	4.1%	3.0%		**	Equity and bond neutral
Russia	Unemployment Rate	m/m	may	5.2%	5.3%	5.2%	***	Equity and bond neutral
	Real Disposable Income	m/m	may	3.7%	2.5%	2.4%	**	Equity bullish, bond bearish
	Real Wages	y/y	may	3.7%	2.5%	2.4%	**	Equity bullish, bond bearish
	Retail Sales Real	y/y	may	0.7%	0.0%	0.5%	**	Equity bullish, bond bearish
AMERICAS								
Mexico	Aggregate Supply and Demand	q/q	1q	4.0%	1.9%	3.1%	**	Equity bullish, bond bearish

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)	128	127	1	Up
3-mo T-bill yield (bps)	99	100	-1	Neutral
TED spread (bps)	29	28	1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.15	2.16	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	33	33	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Neutral
pound	up			Down
franc	up			Down
Central Bank Action		**Prior**	**Expected**	
RBNZ Official Cash Rate		1.750%	1.750%	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	$45.95	$46.02	-0.15%	Long Liquidation
WTI	$43.49	$43.51	-0.05%	
Natural Gas	$2.94	$2.91	1.03%	
Crack Spread	$15.92	$15.85	0.46%	
12-mo strip crack	$14.56	$14.55	0.08%	
Ethanol rack	$1.68	$1.68	-0.20%	
Metals				
Gold	$1,246.10	$1,243.01	0.25%	Weaker Dollar
Silver	$16.48	$16.47	0.08%	
Copper contract	$258.20	$257.20	0.39%	
Grains				
Corn contract	$ 379.25	$ 378.00	0.33%	
Wheat contract	$ 483.25	$ 487.75	-0.92%	
Soybeans contract	$ 939.25	$ 938.75	0.05%	
Shipping				
Baltic Dry Freight	847	848	-1	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.2		
Gasoline (mb)		0.1		
Distillates (mb)		0.5		
Refinery run rates (%)		0.00%		
Natural gas (bcf)		55.0		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, except for the western region which shows warmer temps. Precipitation is expected for the southern region. Tropical Storm Cindy has been upgraded to Hurricane and is expected to make landfall on Thursday near the Texas/Louisiana border. This storm will likely cause some minor well closures in the GOM and will likely lead to some oil import disruptions as well. However, we do not expect it to have lasting effects on supplies.

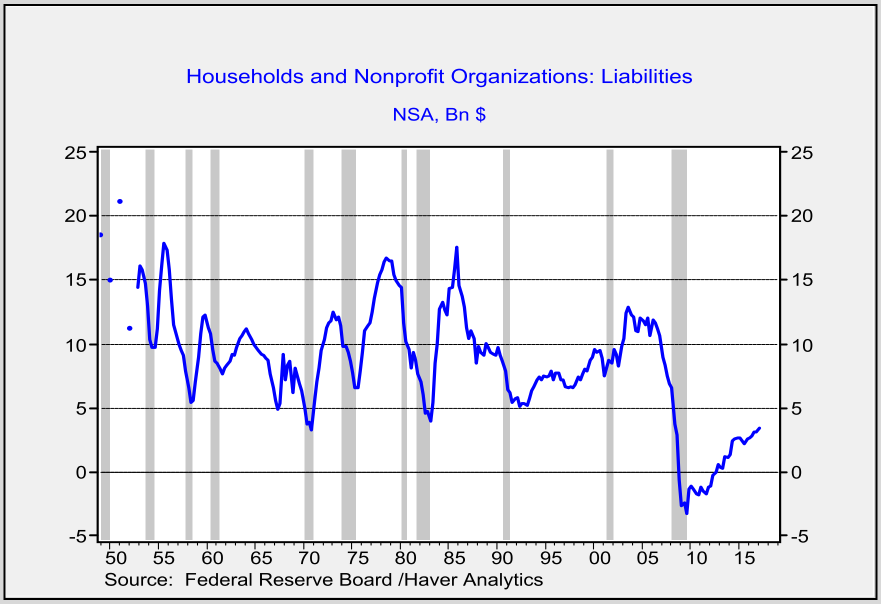
Asset Allocation Weekly Comment

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 16, 2017

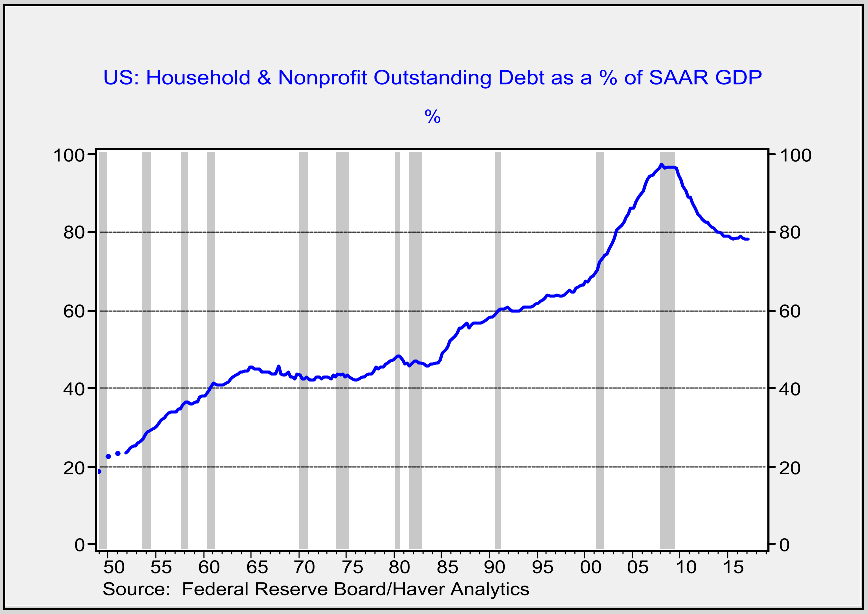
Last week, the Federal Reserve published its Financial Accounts of the United States report, more commonly called the "Flow of Funds" data. The report offers a plethora of insights into the economy. This week we want to examine the household debt situation.

In Q1, household debt reached $15.1 trillion, up 3.4% from the previous year.



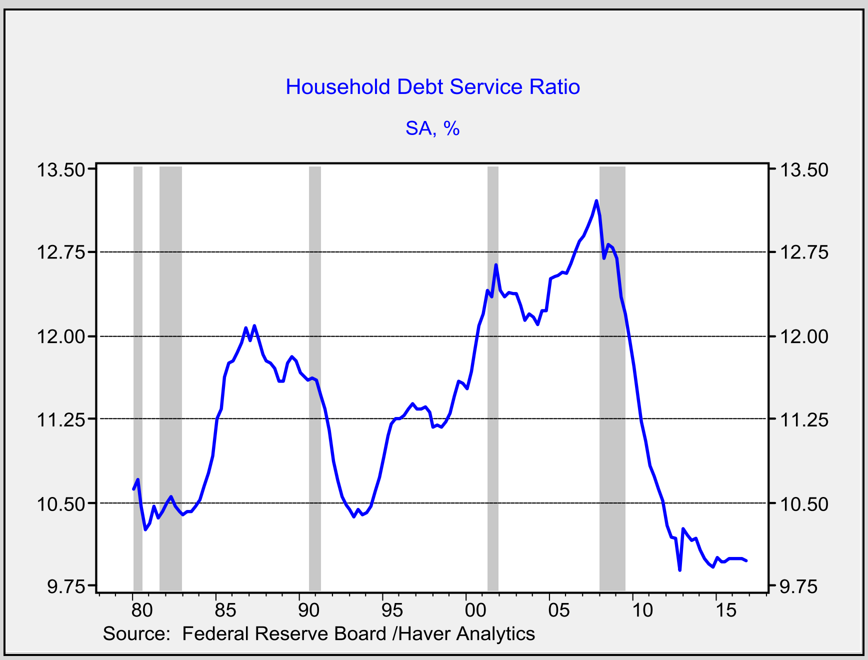
Although the growth in liabilities is positive for consumption, note that the current growth rate is well below the 9.8% average from 1946 through 2006. As we will show below, deleveraging continues but the pace has slowed dramatically. Still, part of the reason for sluggish growth is that households are simply not borrowing as quickly as what we have seen in the postwar period.

As noted, deleveraging has continued but the pace has slowed to a crawl.



Household debt (non-profit debt is not meaningful) is down to 78.2% of GDP after peaking at 97.7%. It is virtually impossible to determine the "correct" or sustainable level of debt, but a solid case can be made that any reading above 60% is probably not manageable over the long run. Of course, there are three ways this ratio can decline, falling levels of debt, rising real GDP relative to debt or rising inflation relative to debt. The lack of inflation has probably prevented an even larger drop in this ratio.

Low interest rates have reduced the servicing costs.

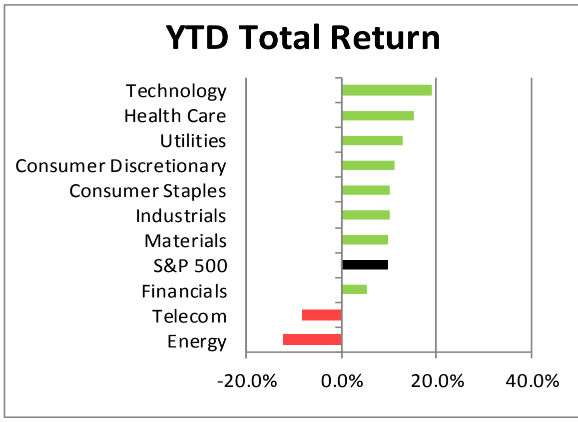


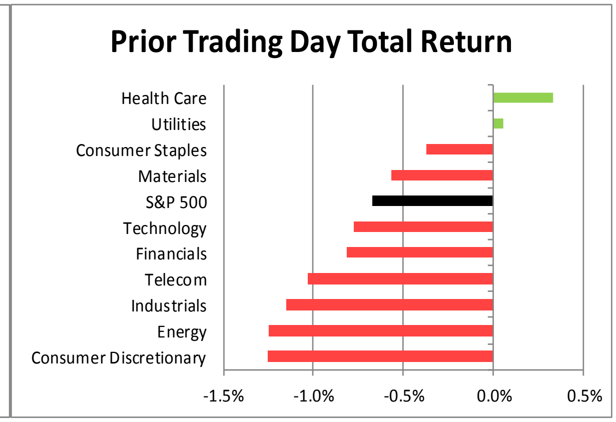
This chart shows household debt service costs as a percentage of after-tax income. Debt service costs rose steadily from 1993 into 2007. The combination of falling interest rates and the level of debt has led to a sharp drop in debt service costs. At these levels of debt service, one would expect that households would be encouraged to expand their debt levels. However, the "hangover" from the debt crisis has not yet diminished.

As long as households are reluctant to borrow, economic growth will remain slow and inflation low. This combination should lead to moderate policy tightening from the FOMC and an extended business cycle. If borrowing were to increase, these conditions might change but, for the foreseeable future, we expect borrowing to remain sluggish and economic growth to remain weak as well.

Data Section

U.S. Equity Markets – (as of 6/20/2017 close)

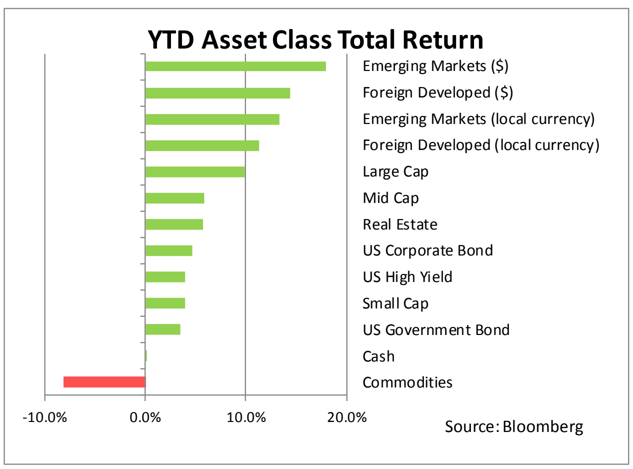




(Source: Bloomberg)

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 6/20/2017 close)

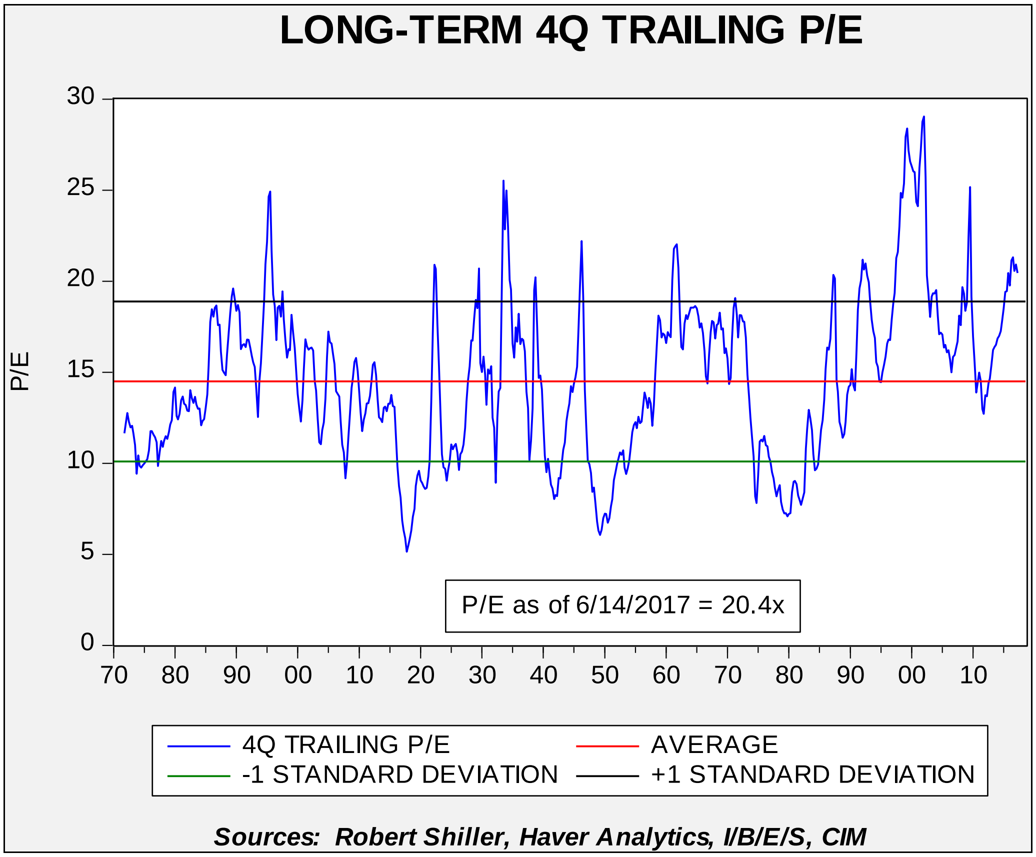


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[4] the current P/E is 20.4x, up 0.1x from last week.

[4] 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.