Daily Comment

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and Thomas Wash

[Posted: June 23, 2017—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed unchanged from the prior close. Chinese markets were down, with the Shanghai composite down 0.3% and the Shenzhen index down 0.5%. U.S. equity index futures are signaling a lower open.

News flow overnight was rather slow. This is typical of summer. The Senate is working on its version of health care and, no surprise, is dealing with the same problems the House faced—to make the bill palatable to moderates, it fails to garner votes from the hard right. Senate Majority Leader McConnell can only lose two GOP senators to pass the bill and most counts suggest he has four 'no' votes. Of course, negotiations continue and there is a chance something might get done. However, we are not convinced that McConnell is all that driven to execute a deal and would much rather move on to tax reform. If this is the case, he will be less likely to use his political capital to pass health care legislation in order to conserve it for tax changes. If the Senate health care bill fails to pass, it might actually be bullish for equities because it would raise hopes of tax changes this year.

The Gulf Cooperation Council (GCC), the representative body for the Arab Peninsula nations, has given Qatar its list of demands. They include closing Al Jazzera, reducing ties to Iran and closing a Turkish military base in the country. The other GCC nations want reparations for unspecified damages inflicted by Qatar over the years. We assume these would include security and social spending costs that came from Qatar's support of the Muslim Brotherhood. Qatar has indicated it won't negotiate while under a blockade; the GCC has given Qatar 10 days to comply, although no consequences have been signaled if Qatar doesn't acquiesce. We would not expect Qatar to comply. Turkey is increasing support and we would expect Iran to do so as well. The Trump administration appears divided, with the president offering support for Saudi Arabia's hardline position while Secretary of State Tillerson has pushed the parties to end the tensions. Although this issue hasn't had any real market effects, we are watching for signs of escalation which would be bullish for oil prices.

St. Louis FRB President Bullard made comments yesterday suggesting that the path of interest rate hikes is probably not justified, although he fully supports reducing the balance sheet. Bullard has become something of a renegade on the FOMC, arguing that monetary policy operates in a "paradigm" that keeps rates within a certain range and these rates should stay within that range until the paradigm changes. We believe that monetary policy is at a crossroads of sorts; the FOMC essentially uses the Phillips Curve to formulate policy and it doesn't necessarily have a good measure of economic slack, a key component of Phillips Curve analysis. Bullard, Kashkari and Evans are questioning the path of rate hikes, which would suggest they believe more slack exists. Currently, Evans and Kashkari are voting members of the committee;

next year, none of these three will vote, which may give a more hawkish bias to the FOMC. Of course, by next year, we may have five new governors so the path of policy could change significantly. If Cohn and other establishment figures within the Trump administration are influential in filling current and future vacancies, monetary policy could tighten faster next year.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing	m/m	jun	52.7	53.0	**
9:45	Markit US Services	m/m	jun	53.5	53.6	**
9:45	Markit US Composite	m/m	jun		53.6	**
10:00	New Home Sales	m/m	may	590k	569k	**
10:00	New Home Sales	m/m	may	3.7%	-11.4%	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:40	Loretta Mester speaks on Money and Monetary Policy	President of the Federal Reserve Bank of Cleveland				
14:15	Jerome Powell speaks before Senate Banking Committee	Member 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								
Japan	Nikkei Japan PMI Mfg	m/m	jun	52.0	53.1		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	jun	57.3	57.0	56.8	**	Equity bullish, bond bearish
	Markit Eurozone Services	m/m	jun	54.7	56.3	56.1	**	Equity bearish, bond bullish
	Markit Eurozone Composite	m/m	jun	55.7	56.8	56.6	**	Equity bearish, bond bullish
Germany	Markit/ BME Germany Manufacturing	m/m	jun	59.3	59.5	59.0	**	Equity and bond neutral
	Markit Germany Services PMI	m/m	jun	53.7	55.4	55.4	**	Equity bearish, bond bullish
	Markit/ BME Germany Composite	m/m	jun	56.1	57.4	57.2	**	Equity bearish, bond bullish
France	GDP	y/y	1q	1.1%	1.0%	1.0%	***	Equity and bond neutral
	Markit France Manufacturing	m/m	jun	55.0	53.8	54.0	**	Equity and bond neutral
	Markit France Services	m/m	jun	55.3	57.2	57.0	**	Equity bearish, bond bullish
	Markit France Composite	m/m	jun	55.3	56.9	56.7	**	Equity bearish, bond bullish
Italy	Industrial Orders	y/y	apr	-2.2%	9.2%		**	Equity and bond neutral
	Industrial Sales	y/y	apr	4.0%	7.2%		**	Equity and bond neutral
Russia	Money Supply Narrow Def	y/y	jun	9.19 tn	9.12 tn		**	Equity and bond neutral
AMERICAS								
Canada	Retail Sales	m/m	apr	0.8%	0.7%	0.3%	**	Equity bullish, bond bearish
	Retail Sales ex Auto	m/m	apr	1.5%	-0.2%	0.7%	**	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)	129	129	0	Up
3-mo T-bill yield (bps)	94	94	0	Neutral
TED spread (bps)	35	35	0	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.15	2.15	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	30	30	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Neutral
pound	up			Down
franc	down			Down
Central Bank Action		**Prior**	**Expected**	
Mexico Overnight Rate	7.000%	6.750%	7.000%	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	$45.29	$45.22	0.15%	Short Covering
WTI	$42.82	$42.74	0.19%	
Natural Gas	$2.91	$2.89	0.59%	
Crack Spread	$16.31	$16.43	-0.71%	
12-mo strip crack	$14.70	$14.78	-0.53%	
Ethanol rack	$1.66	$1.67	-0.17%	
Metals				
Gold	$1,257.84	$1,250.51	0.59%	Weaker Dollar
Silver	$16.77	$16.56	1.32%	
Copper contract	$264.40	$261.00	1.30%	
Grains				
Corn contract	$ 371.50	$ 370.75	0.20%	
Wheat contract	$ 476.50	$ 475.25	0.26%	
Soybeans contract	$ 915.50	$ 913.25	0.25%	
Shipping				
Baltic Dry Freight	855	844	11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.5	-1.2	-1.3	
Gasoline (mb)	-0.6	0.1	-0.7	
Distillates (mb)	1.1	0.5	0.6	
Refinery run rates (%)	-0.40%	0.00%	-0.4%	
Natural gas (bcf)	61	55.0	6.0	

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 northern region. TD Cindy is now in central Arkansas and will soon lose its tropical status later today.

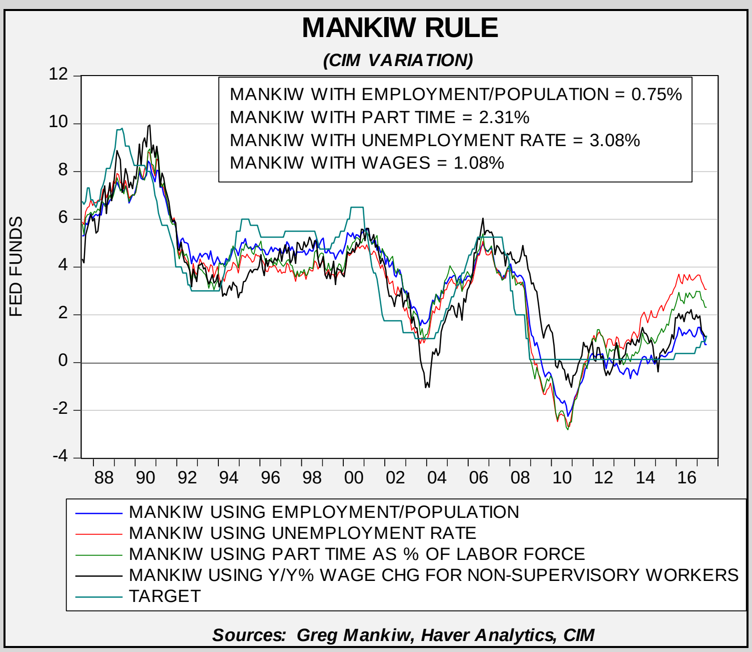
Asset Allocation Weekly Comment

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 23, 2017

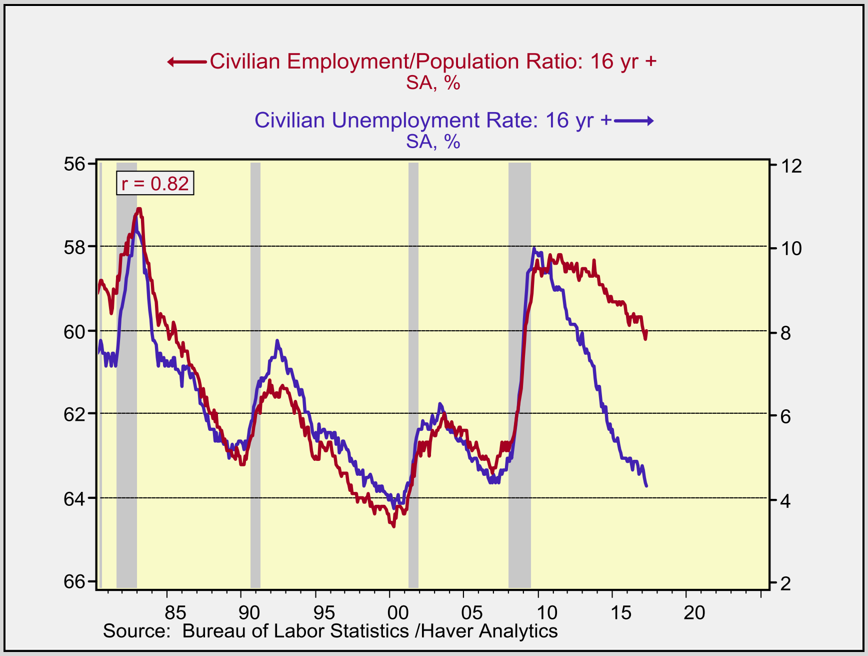
The FOMC did raise rates at the June meeting, which was fully expected. The dots chart suggested that we would see one more hike this year and three next year. In addition, the central bank gave some indication of how it would shrink its balance sheet. Although the statement didn't signal when the reduction would begin, Chair Yellen indicated in the press conference that it would begin before year's end and seemed to hint it may start much sooner than the market expects.

In this report, we want to examine two concerns we have about the path of policy tightening. The first concern is the level of the policy rate. To measure the impact of the policy rate, we use the Mankiw Rule. 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 estimated at 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 has been mixed during this recovery. The unemployment rate has fallen sharply, but other measures, most notably the employment/population ratio, have fallen much more slowly.

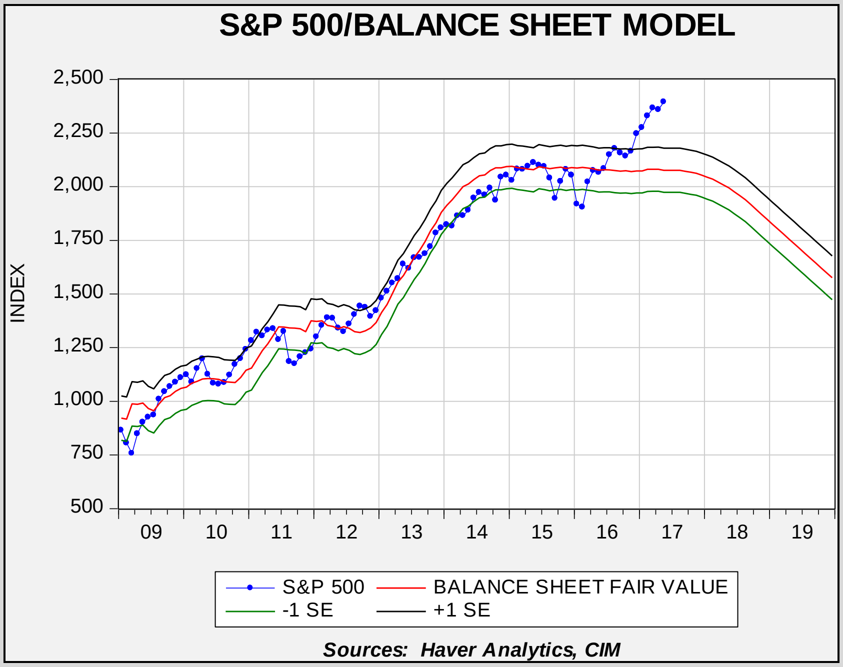


If the relationship between the unemployment rate and the employment/population ratio that existed from 1980 through 2010 had remained the same, the current unemployment rate would be closer to 7.5%. Using the above Mankiw Rule with a 7.5% unemployment rate and the current core inflation rate would generate a neutral policy rate of -0.61%! In other words, not only would the FOMC not be tightening, but cutting the balance sheet wouldn't be considered either.

The conventional wisdom is that the employment/population ratio is being affected by retirements and thus the labor market slack isn't as great as that indicator would suggest. However, we note that wage growth is much more consistent with the employment/population ratio than the unemployment rate. Thus, there is a legitimate worry that the Fed may overtighten and put the economy at risk. Currently, the financial markets only expect one more tightening over the next two years; if the dots plot is the path of policy, the odds of a recession will rise.

If the employment/population ratio is the accurate measure of slack, we are already 37 bps above neutral. Policy would be tight at 100 bps. Thus, we are two to three hikes from putting the economy at risk. Of course, the ratio could improve or inflation could rise, but without those events occurring, the risk to the economy from tighter monetary policy is rising.

The second concern is the balance sheet. The actual effect of QE on the economy is difficult to determine. We tend to think that the most likely impact was that the balance sheet expansion confirmed that the Fed was determined to execute an easy policy even with the policy rate at zero. The level of the balance sheet appears to have had a strong effect on investor sentiment.

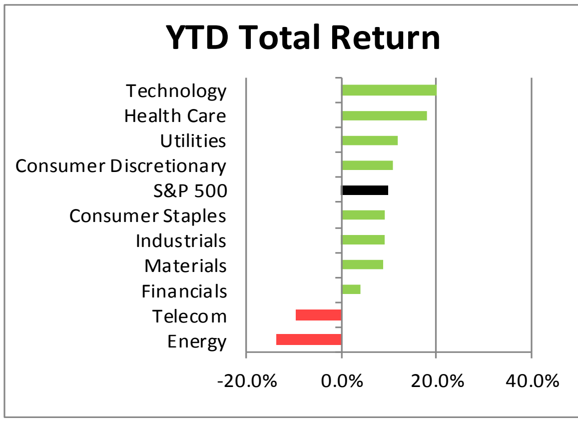


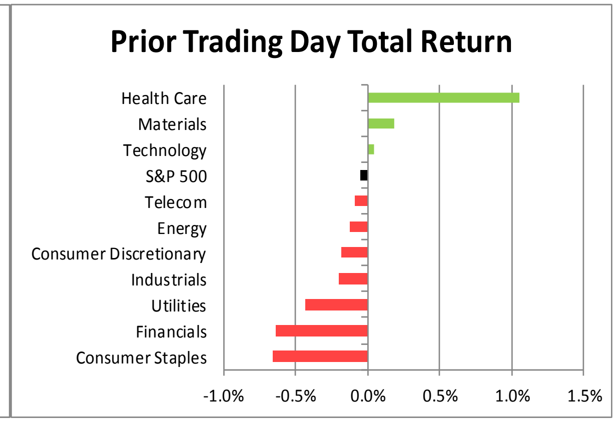
This chart forecasts the S&P 500 by using the size of the balance sheet. From 2009 into late last year, this equity index closely followed the balance sheet. After the election, equities shifted focus toward expectations of tax reform and fiscal expansion.

We have extended the forecast generated from the balance sheet using the FOMC's stated plan for reducing the balance sheet and assuming the reduction begins in September. The Fed intends to start slowly, only $10 bn per month, reaching $50 bn after a year. It is obvious that the balance sheet could become a headwind by 2018. This above chart isn't our forecast for equities but it does suggest that the combination of rate hikes and balance sheet reductions is signaling that monetary policy will tend to become a headwind for equities. If the Trump administration fails to move forward with tax reform or infrastructure spending, equity markets will be vulnerable to a correction.

Data Section

U.S. Equity Markets – (as of 6/22/2017 close)

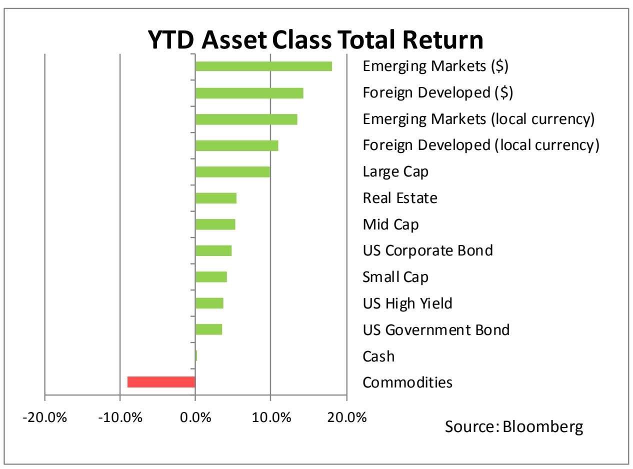




(Source: Bloomberg)

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 6/22/2017 close)

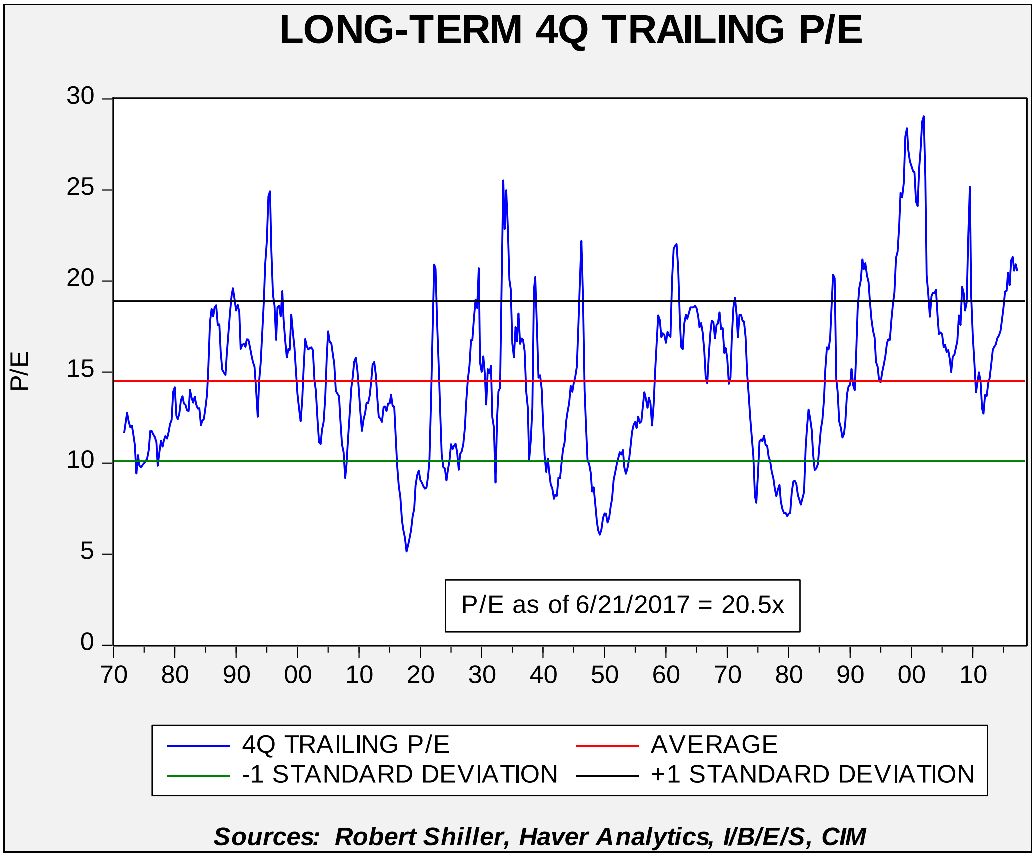


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 22, 2017



Based on our methodology,[1] the current P/E is 20.5x, up 0.1x 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.