Daily Comment

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[Posted: June 26, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 1.0% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.9% from the prior close. Chinese markets were up, with the Shanghai composite up 0.9% and the Shenzhen index up 1.4%. U.S. equity index futures are signaling a higher open.

Here's a recap of the weekend news:

Italy bails out two banks: Veneto Banca and Banca Popolare di Vicenza were declared failed by the ECB on Friday. Over the weekend, the Italian government bailed out the banks, shielding senior bondholders from losses. EU rules are designed to force private investors to bear the first losses and so shareholders, junior bondholders and senior bondholders bear losses in that order. Italy was able to inject public (taxpayer) money into the two banks before the bondholders faced losses by invoking the "public interest" loophole in the regulation—essentially, if a Eurozone government decides that following the normal liquidation procedure would lead to undue economic stress. The Italian government sold the two banks to Intesa Sanpaolo, another Italian bank. To transact the deal, the buying bank received €4.8 bn and also received €12.0 bn in additional guarantees. It should be noted that these two banks are rather small—they only hold 2% of Italian bank deposits. Of course, if the Italian government is willing to go to the mat for two small banks, it suggests that larger banks will almost certainly be bailed out, too. The EU did approve the bailout but to not do so would have created a political crisis between the EU and Italy, and the fear was that it might trigger a broader run if the two banks failed. The real takeaway from this bailout is that the EU is rather powerless to stop a national authority from bailing out a bank, short of the ECB refusing to act as lender of last resort. The bigger risk for the EU is that other nations will flout the bailout rules too and further weaken the Eurozone banking system.

Qatar rejects ultimatum: Qatar, faced with a set of demands from the GCC to end the blockade, rejected the ultimatum. It is not clear what the "or else" will be from the GCC. Qatar still has a strong ally in Turkey, which could be using the dispute to undermine Saudi Arabia's push to dominate the Sunni world. Although President Trump has supported the GCC against Qatar, Secretary of State Tillerson has been much more critical of the GCC and has been pushing for reconciliation. In fact, Tillerson has canceled a trip to Mexico this week to work on this situation from Washington.

Saudi security forces thwart an attack on Mecca: The *NYT* reports that Saudi security forces have prevented an attack on Mecca. The sponsor of the attack wasn't announced but apparently there were three militants. Two were met in Jidda and one near the Grand Mosque. The latter was a suicide bomber who detonated his weapon, wounding 11 people. A successful attack on one of Islam's most holy places would be a "black eye" for the kingdom, which gains part of its legitimacy from protecting the holy sites.

Crackdown on the crocodiles: Chairman Xi is going after a number of the large conglomerates in China, sometimes called "crocodiles." The official reason seems to be that these companies are rather leveraged and there are concerns that they could trigger a financial crisis if lending isn't curbed. However, it should be noted that all these firms are aggressive foreign investors and Xi may be going after them in order to contain capital flight. And, like any purge in China, there is likely an element of political control as well. This may be akin to Putin's aggression against the oligarchs in Russia.

A rogue order hits gold: Gold prices are sharply lower this morning, much weaker than the action in the dollar would support. Bloomberg[1] reports that at 9:00 am London time (4:00 am EDT), a massive 1.8 mm ounce order hit the Comex, leading to an 18,149 contract order. An hour later, the trade was 2,334 contracts. This has the classic look of a "fat finger" order, a mistake. However, in a world of trading algorithms, this order could have been triggered by a computer with little human oversight. Although these algorithms make the markets more efficient, they do create vulnerabilities to large market moves that may be unrelated to news or market conditions.

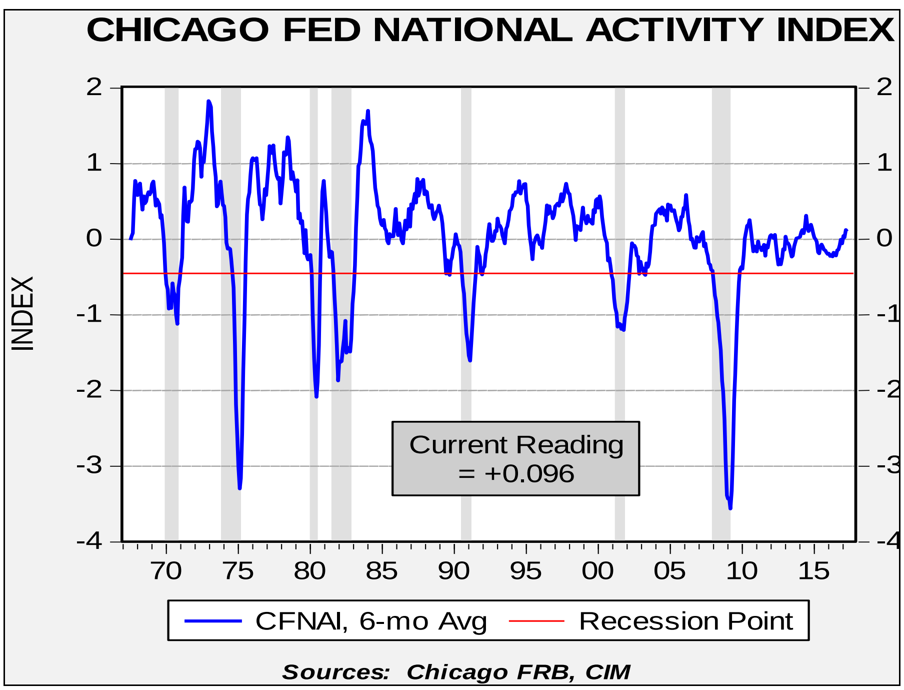
U.S. Economic Releases

May durable goods orders came in below expectations, falling 1.1% from the prior month compared to the forecast fall of 0.6%. The prior month's loss was revised downward from 0.8% to 0.9%. Durable goods excluding transportation came in below expectations, rising 0.1% from the prior month compared to the forecast rise of 0.4%. Capital goods orders nondefense excluding air came in below expectations, falling 0.2% from the prior month compared to the forecast rise of 0.4%. The prior month's gain was revised upward from 0.1% to 0.2%. Capital goods shipments nondefense excluding air came in below expectations, falling 0.2% from the prior month compared to the forecast rise of 0.1%.

[1] https://www.bloomberg.com/news/articles/2017-06-26/gold-plunges-as-1-8-million-ounces-traded-in-a-new-york-minute?cmpid=socialflow-twitter-business&utm_content=business&utm_campaign=socialflow-organic&utm_source=twitter&utm_medium=social

The chart above shows the annual change in durable goods orders and shipments. Annually, new orders rose by 2.7%, shipments rose by 4.0%, unfilled orders fell by 1.7% and inventories rose by 1.6%.

The Chicago National Activity Index came in below expectations at -0.26 compared to the forecast of 0.20. The prior report was revised upward from 0.49 to 0.57.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The current reading is 0.096, a drop from the last report of 0.14.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:30	Dallas Fed Manufacturing Activity	m/m	jun	16.0	17.2	**
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	PPI Services	y/y	may	0.7%	0.7%	0.7%	**	Equity and bond neutral
	Leading Index CI	m/m	apr	104.2	104.5		**	Equity and bond neutral
	Coinceident Index	m/m	apr	117.1	117.7		**	Equity and bond neutral
EUROPE								
Germany	IFO Business Climate	m/m	jun	115.1	114.6	114.5	**	Equity and bond neutral
	IFO Expectations	m/m	jun	106.8	106.5	106.4	**	Equity and bond neutral
	IFO Current Assessment	m/m	jun	124.1	123.2	123.2	**	Equity and bond neutral
UK	BBA Loans for House Purchase	m/m	may	40347	40750	40250	*	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	jun	578.2	577.4 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	jun	491.2 bn	482.0 bn		*	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	apr	1.3%	1.6%	1.5%	***	Equity and bond neutral
Mexico	Retail Sales	m/m	apr	1.2%	-1.3%	0.8%	**	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	130	-1	Up
3-mo T-bill yield (bps)	95	94	1	Neutral
TED spread (bps)	35	36	-1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.15	2.14	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	30	30	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	up			Down
franc	down			Down

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	$45.58	$45.54	0.09%	Short Covering
WTI	$43.11	$43.01	0.23%	
Natural Gas	$2.99	$2.93	1.91%	
Crack Spread	$16.22	$16.12	0.62%	
12-mo strip crack	$14.63	$14.51	0.81%	
Ethanol rack	$1.67	$1.67	0.08%	
Metals				
Gold	$1,241.38	$1,256.71	-1.22%	Stronger Dollar
Silver	$16.51	$16.71	-1.22%	
Copper contract	$263.65	$263.45	0.08%	
Grains				
Corn contract	$ 368.25	$ 365.50	0.75%	
Wheat contract	$ 467.75	$ 473.50	-1.21%	
Soybeans contract	$ 916.00	$ 911.00	0.55%	
Shipping				
Baltic Dry Freight	870	855	15	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for the northern region. There is no tropical cyclone activity expected for the next 48 hours.

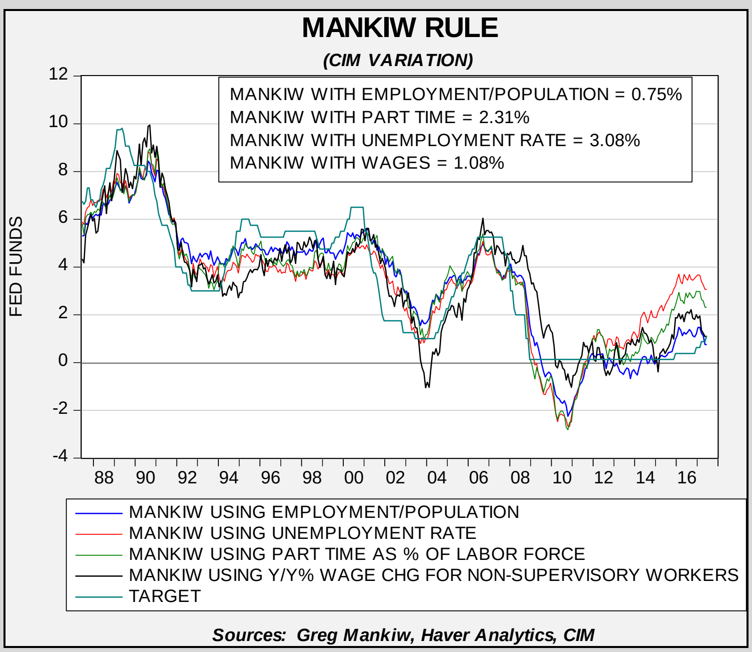
Asset Allocation Weekly Comment

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

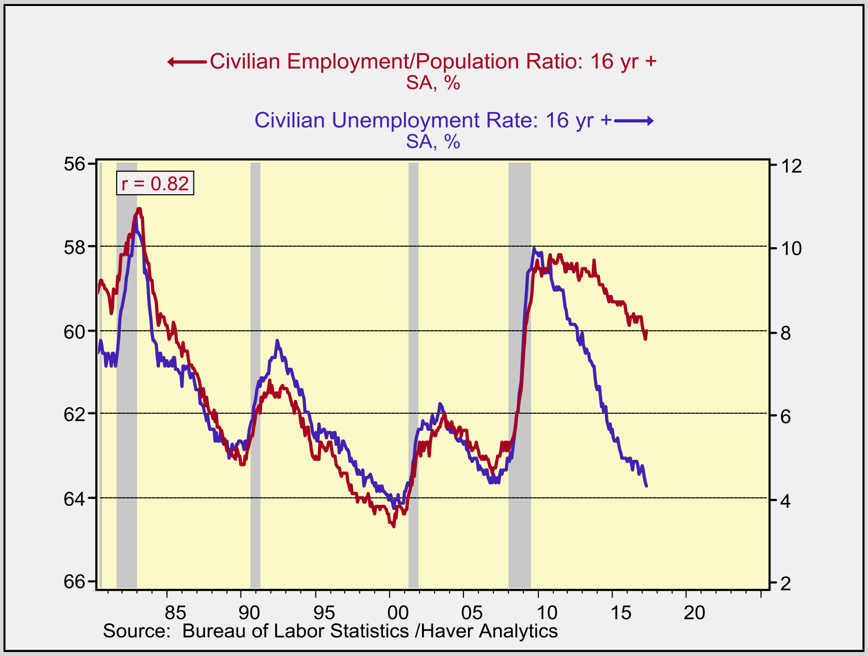
The FOMC did raise rates at the June meeting, which was fully expected. The dots chart suggested that we would see one more hike this year and three next year. In addition, the central bank gave some indication of how it would shrink its balance sheet. Although the statement didn't signal when the reduction 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.

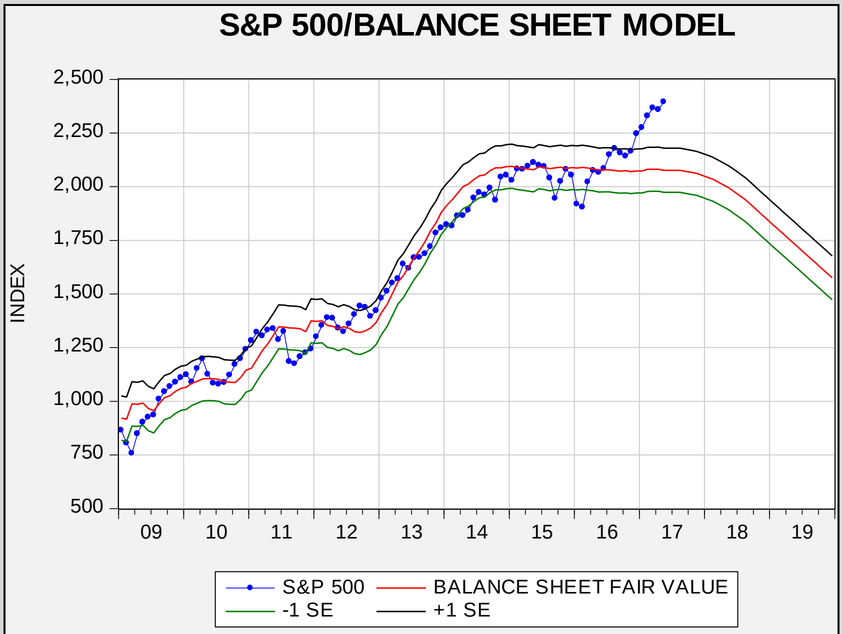


If the relationship between the unemployment rate and the employment/population ratio that existed from 1980 through 2010 had remained the same, the current unemployment rate would be closer to 7.5%. Using the above Mankiw Rule with a 7.5% unemployment rate and the current core inflation rate would generate 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.



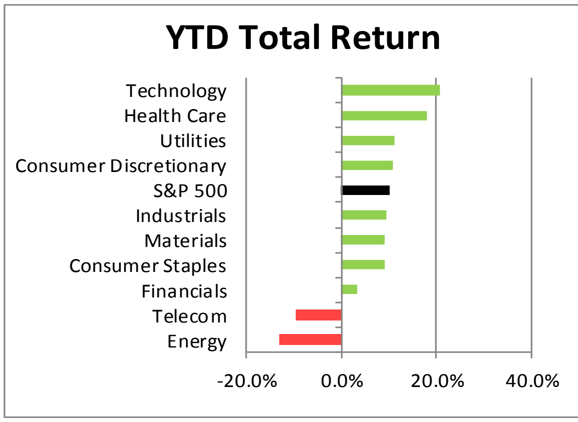
Sources: Haver Analytics, CIM

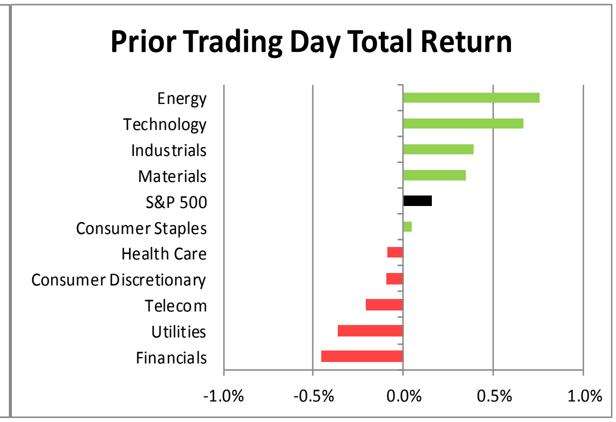
This chart forecasts the S&P 500 by using the size of the balance sheet. From 2009 into late last year, this equity index closely followed the balance sheet. After the election, equities shifted focus toward expectations of tax reform and fiscal expansion.

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 6/23/2017 close)

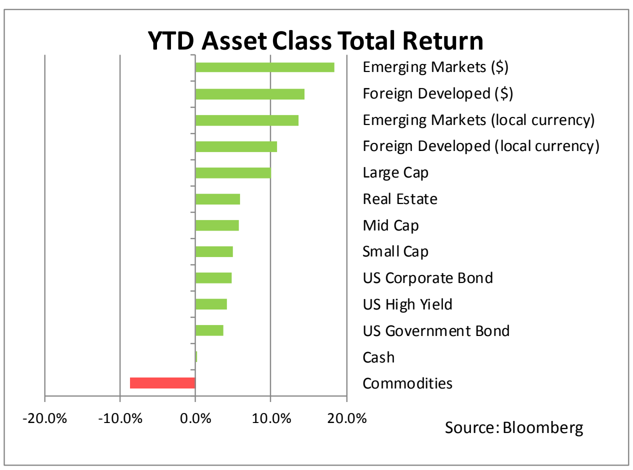




(Source: Bloomberg)

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 6/23/2017 close)

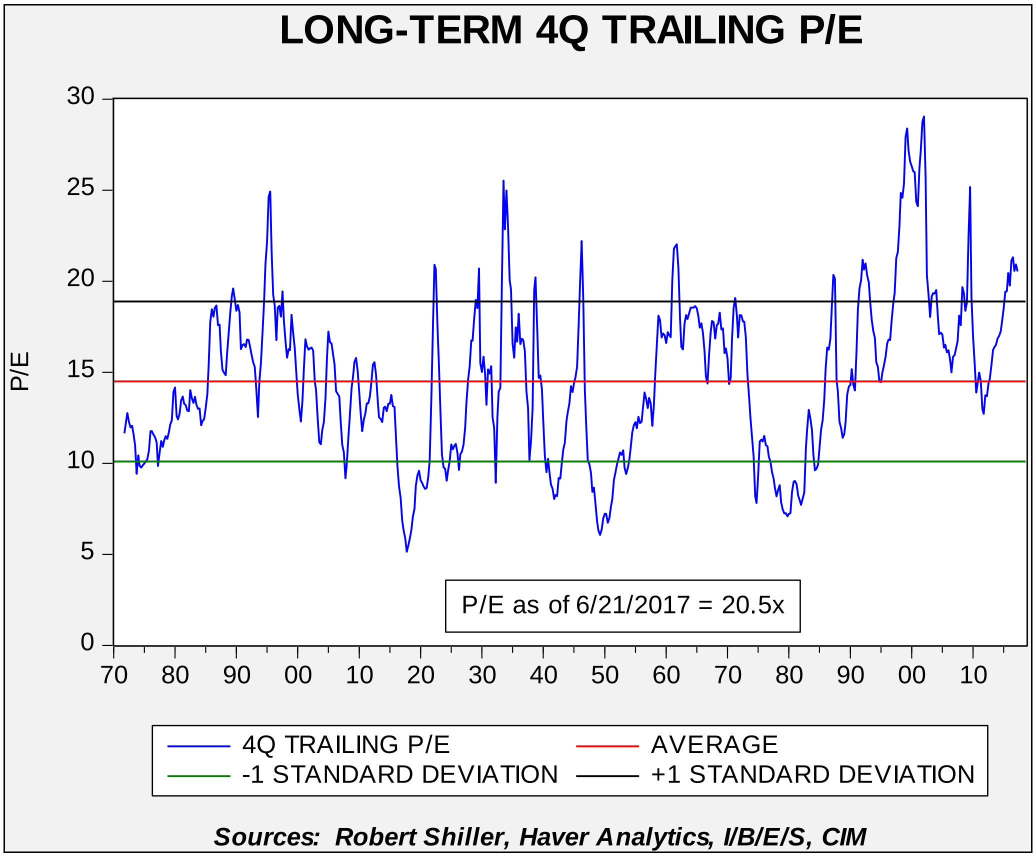


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[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.