# Daily Comment

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

**[Posted: June 28, 2017—9:30 AM EDT]** Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.9% from the prior close. Chinese markets were down, with the Shanghai composite down 0.6% and the Shenzhen index down 0.8%. U.S. equity index futures are signaling a higher open.

There was quite a bit of news from yesterday through this morning:

**ECB tells market "you misunderstand":** Yesterday, ECB President Draghi gave a speech that was taken to suggest that tapering was going to occur because the Eurozone economy is doing better. The EUR rallied and we had a significant rise in long duration yields in Europe and the U.S. The ECB took an unusual step to release a statement this morning indicating that the markets had misinterpreted Draghi's comments and policy tightening isn't imminent. The EUR, which was rising this morning, pulled back sharply (U.S. Treasuries have rallied, too). This will be an important test for the markets. If the markets believe that what Draghi said yesterday is true, then the ECB correction this morning should be treated the same way as intervention against the trend; it will be seen as a EUR buying opportunity by traders. If the ECB is successful in changing the narrative, the EUR's rally and Treasury weakness will stall. We tend to lean toward the former—that the EUR will likely continue to rally and Treasuries, which have been strong, could come under some pressure.

**Health care vote gets extended:** As the Senate GOP leadership unveiled its health care plan it became rather obvious that the vote would fail. Majority Leader McConnell had previously indicated that a vote, up or down, would be held by July 4th, prior to the recess. In something of a surprise, McConnell has decided to extend the debate on health care, suggesting he really wants a deal. Equity markets didn't like the shift at all. It appears that equity markets care little about health care reform but are very interested in tax reform. As long as Congress is focusing on health care, taxes are not being addressed and so extending the debate past the recess means that tax reform will be delayed. Even worse, political capital is being depleted on health care that could be used for tax reform. This is why we had the strong drop yesterday.

**A coup brewing in Venezuela?** A helicopter, which appears to have been commandeered by rogue elements of the military, flew toward Caracas and dropped two hand grenades on the Supreme Court (only one detonated) and then moved to the Interior Ministry building and opened fire on it. There are growing signs that elements of the military want to oust President Maduro and replace him with someone else. It is important to note here that this threat isn't coming from outside the ruling coalition but from within it. The elements of the military that participated in this action appear to be aligned with the Socialists but are disenchanted with Maduro and are especially incensed by his scheme to change the constitution. Recently, Maduro replaced the head of the country's Strategic Operational Command, firing Gen. Vladimir Padrino Lopez and replacing him with Adm. Regigio Ceballos Ichaso. Maduro should have a healthy fear of his military. The late Hugo Chavez, being an officer himself, had a certain degree of respect from the military; Maduro, a former bus driver, doesn't. It should also be recognized that we wouldn't anticipate a major policy shift if Maduro is replaced. The coup plotters appear to be leftists who simply want a different leader. However, if unrest rises, it could further reduce oil supplies and might be bullish for oil in the short run.

**China's new avenue for capital flight—tourists!** A recent study by the Federal Reserve[1] suggests that Chinese spending on tourism is much higher per capita than one usually observes. The anecdotal evidence is that Chinese tourists are using their foreign trips to purchase assets in foreign nations, evading Chinese capital controls. Below is a telling chart from the paper.

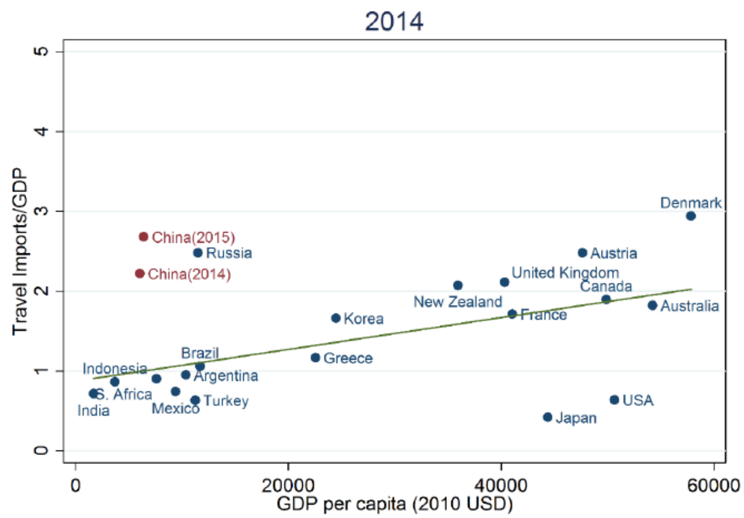



Figure 3b: Travel Imports (Percent of GDP) vs. GDP per capita, 2014

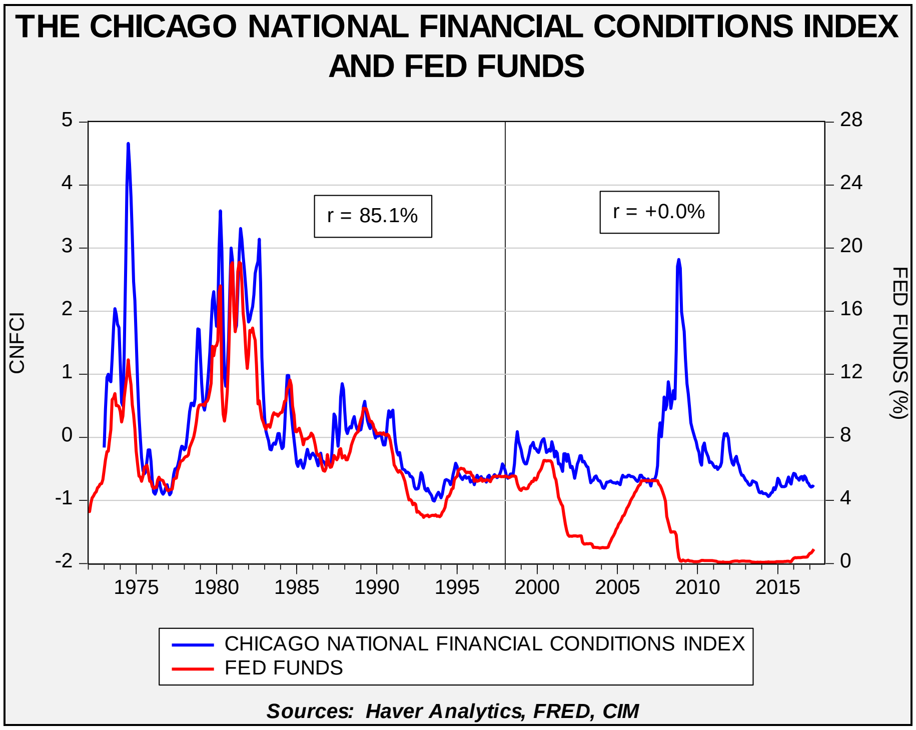
Source: United National World Tourism Organization and World Bank. Datapoint for 2015 for China was plotted with data for 2014 because cross country travel imports data was not available from source as of this writing.

(Source: Federal Reserve, page 49)

The regression line shows the normal spending one would expect given the level of per capita income. Although we don't show the chart here, in 2010, Chinese travel imports were on the regression line. The above chart shows that China's travel spending is near that of Denmark, which has a per capita GDP about 2.5x greater. Note that Russia, another nation plagued by capital flight, is in the same area of the graph as China. Besides the obvious conclusions drawn, that Chinese investors are clearly willing to take unusual steps to move funds out of the country, it also means that this spending is really capital account spending and the Chinese current account surplus is understated because tourist spending is considered a form of imports and thus is part of the current account.

[1] https://www.federalreserve.gov/econres/ifdp/files/ifdp1208.pdf

**Growing concern about financial stress (or the lack thereof):** NY FRB President Dudley, Chair Yellen and Vice Chair Fischer have all recently commented about the lack of financial stress in the system. We have discussed this issue consistently now for a few years.

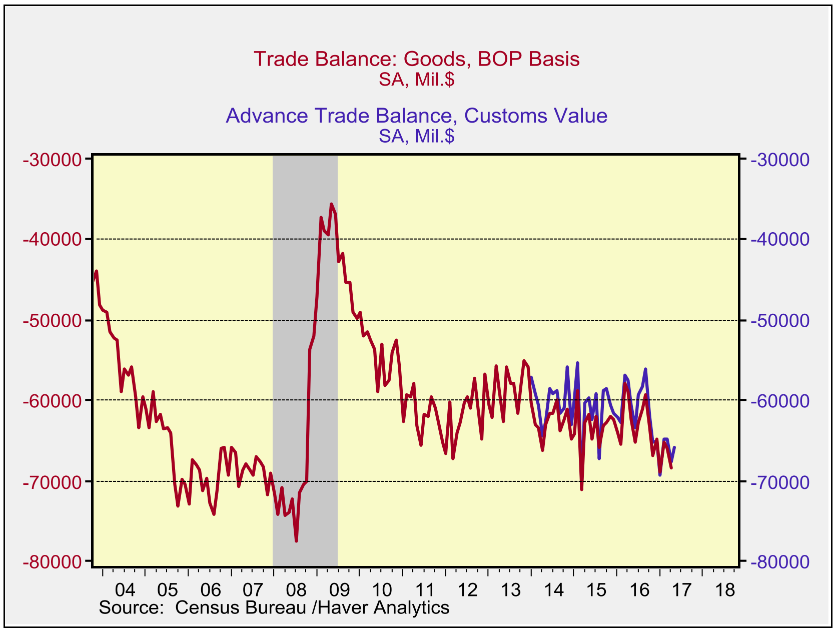



This chart shows the Chicago FRB index of financial conditions and fed funds. The conditions index is a measure of stress—the higher the index, the greater the level of stress. From the early 1970s into 1998, fed funds and the conditions index closely tracked each other; in fact, we would argue that stress acted as a force multiplier for policy. As the FOMC raised rates, stress rose, further contracting lending and signaling rising risk in the financial system. This led to slower growth. As the Fed cut rates, the opposite occurred. What changed? We think two things. First, as the Fed has become increasingly transparent, it has become easier for the financial markets to predict policy. In fact, the Fed seems to pride itself on not surprising the markets. Thus, there is little fear of policy even when rates are increased because the hikes can be discounted well in advance. Second, as the financial system has become more concentrated, the Fed is concerned that it has become more fragile. Thus, it works to contain financial stress (or keep financial conditions calm) as it feels it can't risk policy induced stress because it can't easily control the impact of stress. The data tend to bear this out. Once stress rose in 2008-09, it took years of low rates, forward guidance and QE to bring it down again. Recent comments from Yellen, et al. suggest that the FOMC would like to inject some stress into the financial system to prevent "irrational exuberance." The problem is that we fear they don't have the tools to contain it once introduced. The Fed is acting like a forest manager who never allows fires; eventually, a fire naturally occurs and there is so much built up tinder due to fire suppression that a major outburst becomes impossible to contain. Thus, we are leery of these recent comments because by the time stress begins to rise it may not be easily contained.

## U.S. Economic Releases

MBA mortgage applications fell 6.2% from the prior week. Purchases and refinancing fell 4.1% and 8.6%, respectively. The average 30-year fixed rate mortgage remains unchanged at 4.13%.

The advance goods trade deficit came in below expectations at $65.9 bn compared to the forecast of $66.0 bn. The prior report's deficit was revised downward from $67.6 bn to $67.1 bn.




The chart above shows the level of the trade balance for goods and the advance trade balance. Over the past three years, the trade deficit has been volatile but has generally moved sideways.

Wholesale inventories in May came in above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%. The prior report's loss was revised upward from 0.5% to 0.4%. Real inventories rose by 0.6%. The report's loss was revised upward from 0.3% to 0.2%.

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

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 10:00 | Pending Home Sales | m/m | jun | 1.0% | -1.3% | ** |
| 10:00 | Pending Home Sales NSA | y/y | jun | 0.5% | -5.4% | ** |
| 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 | Small Business Confidence | y/y | jun | 49.2 | 48.9 | 49.2 | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Germany | Import Price Index | y/y | may | 4.1% | 6.1% | 4.6% | ** | Equity bearish, bond bullish |
| | House Price Index | y/y | may | 0.6% | 1.7% | | ** | Equity and bond neutral |
| Italy | CPI NIC incl tobacco | y/y | jun | 1.2% | 1.6% | 1.4% | *** | Equity and bond neutral |
| | CPI EU Harmonized | y/y | jun | 1.2% | 1.6% | 1.4% | *** | Equity and bond neutral |
| | PPI | y/y | may | 3.1% | 4.4% | | ** | Equity and bond neutral |
| France | Consumer Confidence | m/m | jun | 108 | 102 | 103 | ** | Equity bullish, bond bearish |
| UK | Nationwide House Px | y/y | jun | 3.1% | 2.1% | 1.9% | * | Equity bullish, bond bearish |
| Switzerland | UBS Consumption Indicator | m/m | may | 1.39 | 1.48 | | ** | Equity bearish, bond bullish |
| | Credit Suisse Survey Expectations | m/m | jun | 20.7 | 30.8 | | ** | Equity bearish, bond bullish |
| AMERICAS | | | | | | | | |
| Brazil | Current Account Balance | m/m | may | $2.000 bn | $2.884 bn | $1.153 bn | ** | 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) | 99 | 99 | 0 | Neutral |
| TED spread (bps) | 31 | 31 | 0 | Neutral |
| U.S. Libor/OIS spread (bps) | 116 | 116 | 0 | Up |
| 10-yr T-note (%) | 2.24 | 2.21 | 0.03 | 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 | up | | | 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 | $46.61 | $46.65 | -0.09% | Bearish API |
| WTI | $44.09 | $44.24 | -0.34% | |
| Natural Gas | $3.07 | $3.04 | 0.92% | |
| Crack Spread | $16.16 | $16.28 | -0.72% | |
| 12-mo strip crack | $14.63 | $14.68 | -0.33% | |
| Ethanol rack | $1.67 | $1.67 | 0.08% | |
| **Metals** | | | | |
| Gold | $1,251.07 | $1,247.17 | 0.31% | Dollar weakness |
| Silver | $16.79 | $16.67 | 0.77% | |
| Copper contract | $266.50 | $266.15 | 0.13% | |
| **Grains** | | | | |
| Corn contract | $ 368.50 | $ 367.75 | 0.20% | |
| Wheat contract | $ 470.25 | $ 469.00 | 0.27% | |
| Soybeans contract | $ 918.75 | $ 917.50 | 0.14% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 903 | 884 | 19 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -2.3 | | |
| Gasoline (mb) | | 0.0 | | |
| Distillates (mb) | | 0.4 | | |
| Refinery run rates (%) | | -0.30% | | |
| Natural gas (bcf) | | 52.0 | | |

## Weather

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

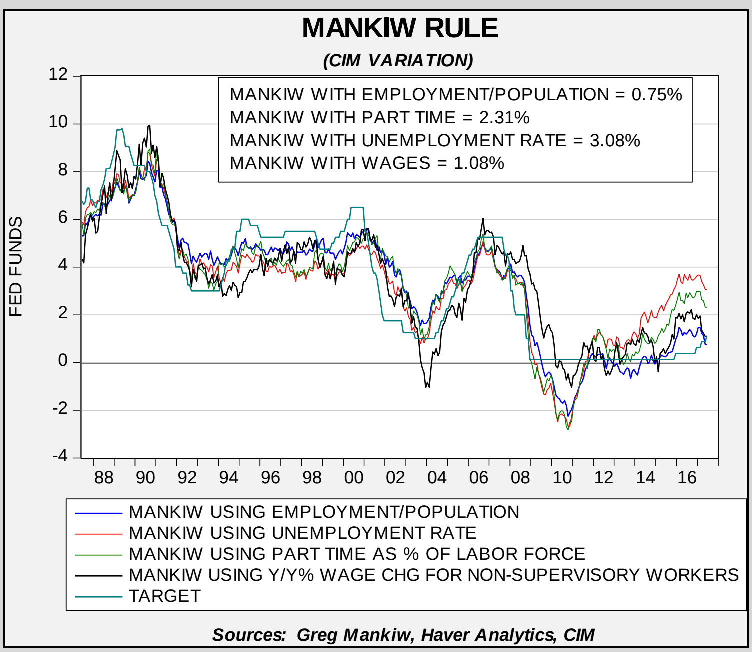
## Asset Allocation Weekly Comment

*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

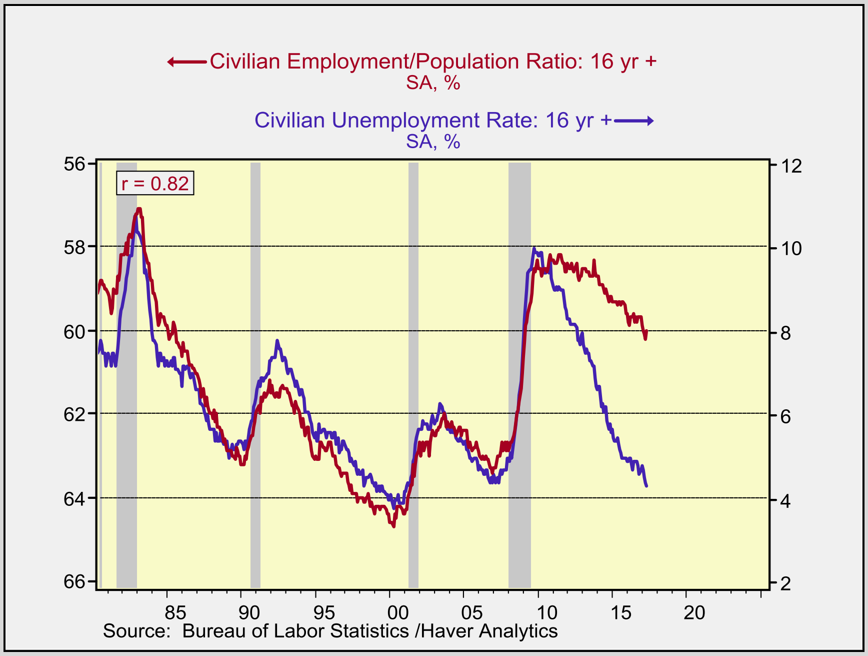
The FOMC did raise rates at the June meeting, which was fully expected. The dots chart suggested that we would see one more hike this year and three next year. In addition, the central bank gave some indication of how it would shrink its balance sheet. Although the statement didn't signal when the reduction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

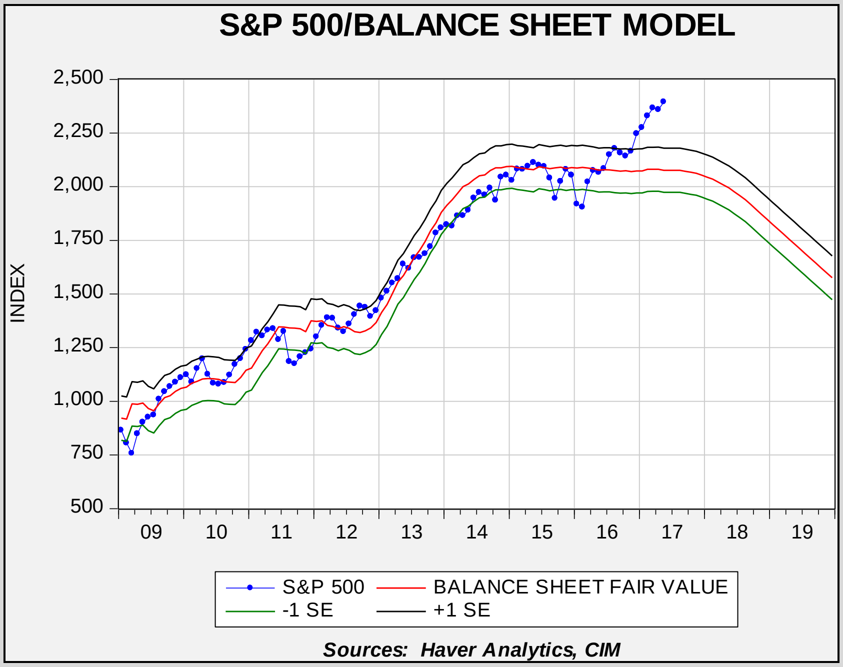



If the relationship between the unemployment rate and the employment/population ratio that existed from 1980 through 2010 had remained the same, the current unemployment rate would be closer to 7.5%. Using the above Mankiw Rule with a 7.5% unemployment rate and the current core inflation rate would generate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



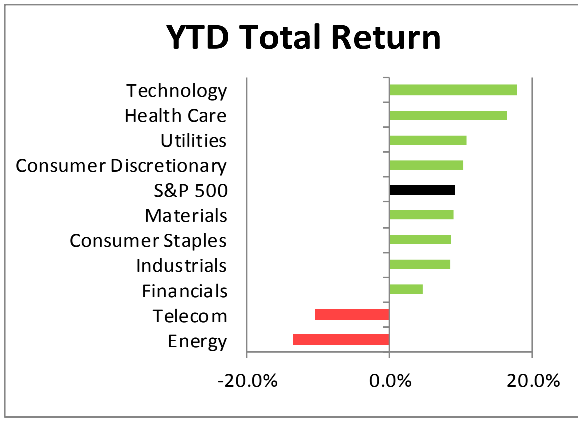

This chart forecasts the S&P 500 by using the size of the balance sheet. From 2009 into late last year, this equity index closely followed the balance sheet. After the election, equities shifted focus toward expectations of tax reform and fiscal expansion.

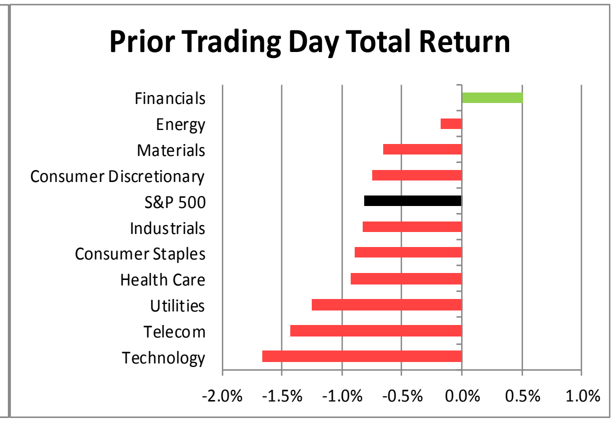
We have extended the forecast generated from the balance sheet using the FOMC's stated plan for reducing the balance sheet and assuming the reduction begins in September. The Fed intends to start slowly, only $10 bn per month, reaching $50 bn after a year. It is obvious that the balance sheet could become 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.

*Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.*

## Data Section

**U.S. Equity Markets** – (as of 6/27/2017 close)

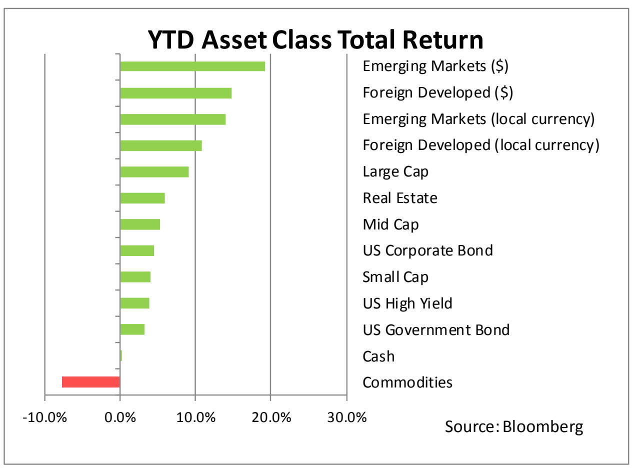



(Source: Bloomberg)

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 6/27/2017 close)

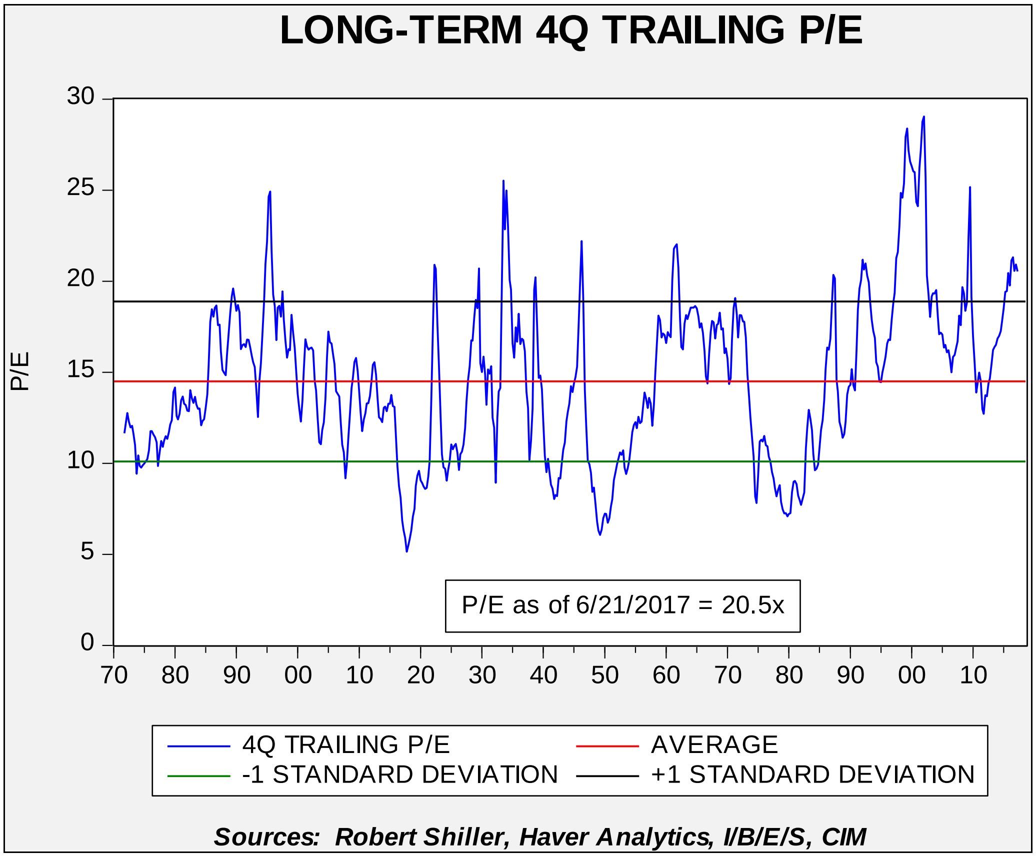



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.*

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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.