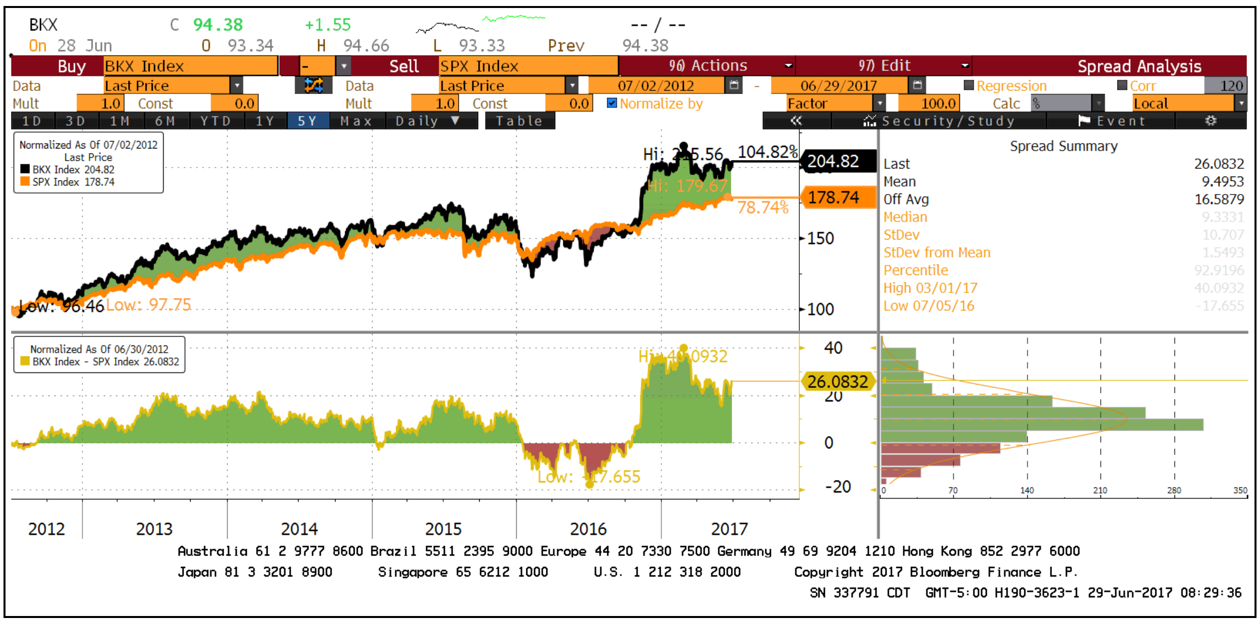
Daily Comment

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

[Posted: June 29, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were up, with the Shanghai composite up 0.5% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a higher open.

Here are some of the items we are tracking this morning:

Fed stress tests give banks a green light: The banks performed well on the Federal Reserve stress tests, opening the sector to increasing dividends and stock buybacks. Bank stocks lifted the broader indices yesterday and this trend will likely continue.



(Source: Bloomberg)

This chart shows the KBW Bank Index relative to the S&P 500. Note that bank stocks jumped after the elections but have been consolidating for the past couple of months. The stress test results will likely lead to another leg higher in these equities.

On the other hand, central banks are turning hawkish: In central bank meetings in Portugal, ECB officials hinted that tapering of their QE is in the offing, while the BOC and BOE both indicated that policy is set to tighten. This policy change is significant because the equity bull market that began in March 2009 has enjoyed the backdrop of supportive monetary policy. We are starting to see a backup in long duration Treasury yields (which is actually bullish for banks) and the dollar is weakening as other central banks signal a withdrawal of stimulus. We are probably embarking on a new phase in this cycle that carries new risks. Although policy tightening doesn't necessarily signal the bull market is in trouble, policy will likely become a headwind in the near future and will no longer be a tailwind.

The South Korean president visits: Moon Jae-in visits the White House today amid reports[1] that the U.S. is preparing contingency plans that include military action if North Korea shows it has built a nuclear warhead[2] and/or has created an ICBM that can reach the U.S. mainland. As we have recently discussed, a war on the Korean peninsula would be, to quote SOD Mattis, "catastrophic."[3] Moon will likely try to buy time because, in a war, his capital will be a primary target for North Korea's massed artillery.

The fate of the former crown prince: The *NYT* reports[4] that the recently demoted Prince Mohammed bin Nayef is under house arrest, confined to his palace. This report has been denied by the kingdom but the story is being widely reported in the regional media; the Iranian news agency FARS reports [5] that five other Saudi princes are also being confined to quarters. Although none of this is definitive, if true, it would suggest that King Salman's decision to elevate his son to crown prince has caused consternation among the royal family. If this conflict escalates, it would be a potentially bullish event for crude oil because we doubt unrest will be contained in the kingdom.

Kurdish and Turkish forces fired on each other: There are reports that Kurdish YPG militias, one of the most effective fighting forces against IS, have also been engaging in skirmishes with Turkish forces.[6] Turkey fears Kurdish nationalism because it could undermine the territorial integrity of Turkey itself. The Kurds are considered to be the largest ethnic group in the world without a state; they have wanted a Kurdish state for well over a century. One of our worries is that the fall of IS will simply lead to a series of wars as various actors attempt to control swaths of what used to be Iraq and Syria.

A militant Germany: Chancellor Merkel gave a remarkably critical speech today, criticizing the rise of protectionism and weakening international cooperation, laying the blame squarely on President Trump. Her and her country's discomfort with the change in U.S. policy is completely understandable—Germany prospered under *Pax Americana* because it no longer had to fear

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[1] http://www.cnn.com/2017/06/28/politics/north-korea-trump-military-options/index.html?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top-stories

[2] A warhead can be placed on a missile, survive launch and re-entry and detonate. A device is a non-deliverable nuclear appliance that can explode and is used for testing and development. So far, North Korea has proved it can do the latter but not the former.

[3] See our recent two-part WGR series on The Second Korean War: Part I, 6/19/17; and Part II, 6/26/17.

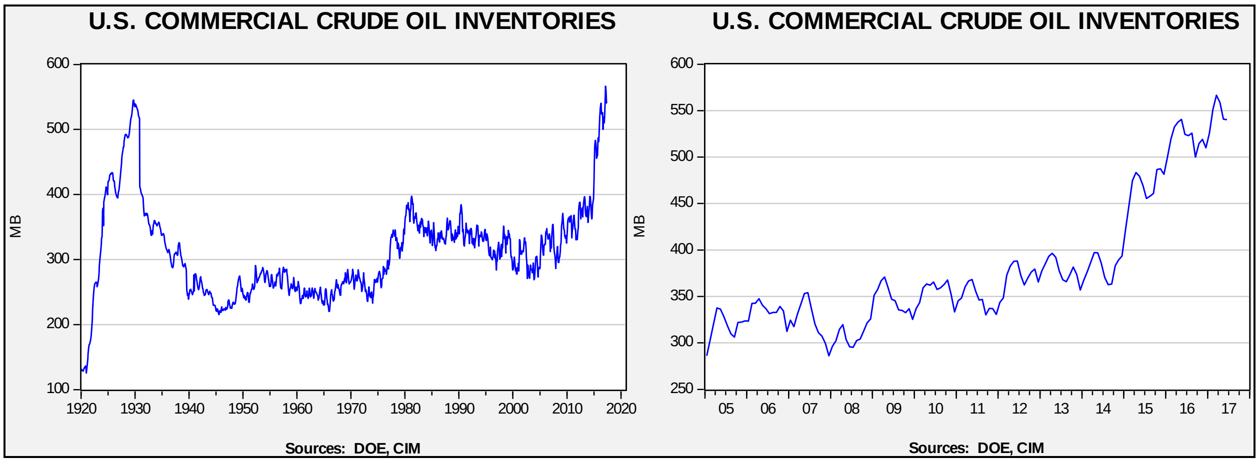
[4] https://www.nytimes.com/2017/06/28/world/middleeast/deposed-saudi-prince-mohammed-bin-nayef.html?emc=edit_mbe_20170629&nl=morning-briefing-europe&nlid=5677267&te=1

[5] http://en.farsnews.com/newstext.aspx?nn=13960407000220

[6] http://www.reuters.com/article/us-mideast-crisis-syria-turkey-idUSKBN19K0ZJ?feedType=RSS&feedName=worldNews&utm_source=Sailthru&utm_medium=email&utm_campaign=New%20Campaign&utm_term=%2ASituation%20Report

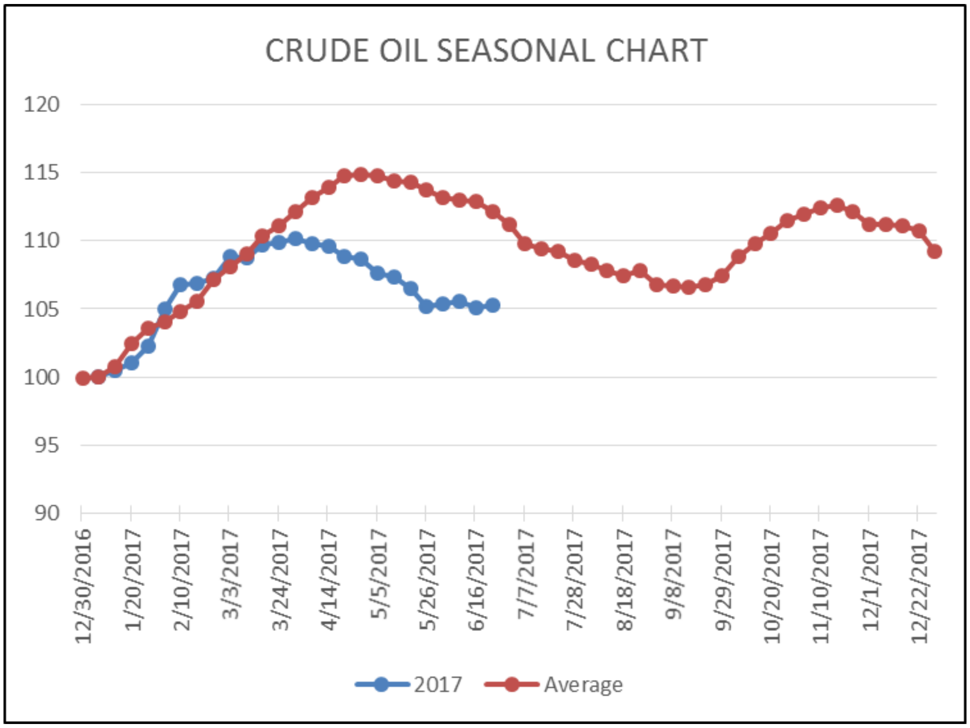
invasion from its neighbors. The U.S. guaranteed it wouldn't happen. She is also correct that isolationism and protectionism won't solve the world's problems; however, if the U.S. has decided it's getting out of the hegemony business, these positions may not help the world but they just might help the bottom 80% of the American household income distribution. What will become worrisome is if Germany, sensing the vacuum, begins to reassert itself on the regional and world stage. It will raise fears across Europe of the pre-1945 world in which the German problem was the key problem of Europe. America's hegemonic behavior since WWII has allowed the rest of the world to focus on their own issues and simply follow U.S. foreign policy. Those conditions would change if the U.S. withdraws from the world and Merkel's comments reflect the unease this change is triggering.

U.S. crude oil inventories rose 0.1 mb compared to market expectations of a 2.3 mb draw.

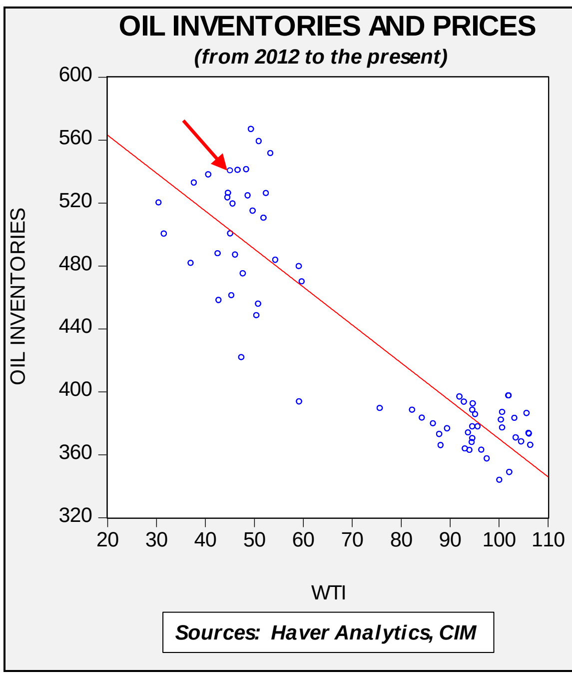


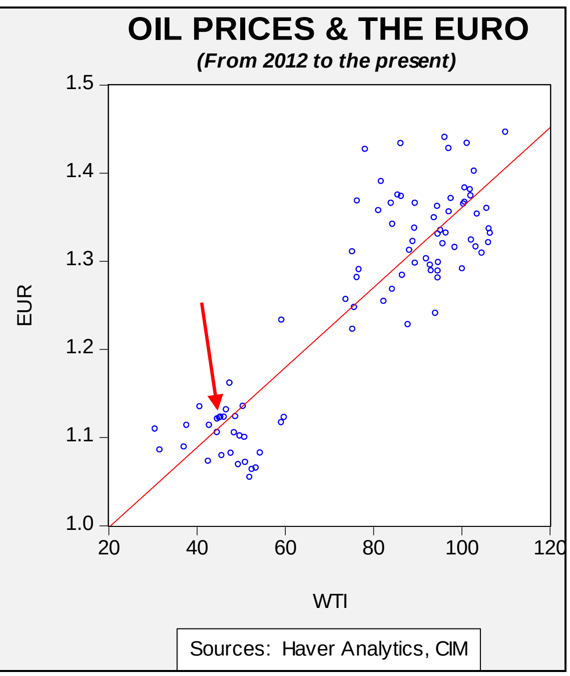
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but they are declining. We also note that, as part of an Obama era agreement, there was a 1.4 mb sale of oil out of the Strategic Petroleum Reserve. This is part of a $375.4 mm sale (or 17.0 mb) done, in part, to pay for modernization of the SPR facilities. We note that sales have reached 12.7 mb this year, which likely means we should see these sales end in the coming weeks. International agreements require that OECD nations hold 90 days of imports in storage. Due to falling imports, the current coverage is near 140 days. Taking that into account, the draw would have been 1.3 mb, which is less than forecast.

As the seasonal chart below shows, inventories are usually well into the seasonal withdrawal period. The typical decline has stalled; although currently below the usual September trough, the slowdown in withdrawals has been a bearish factor for oil prices. If we take the SPR sale into account, the decline has been more in line with normal seasonal withdrawals and therefore we can conclude that the SPR sale has played a role in pushing oil prices lower.



(Source: DOE, CIM)

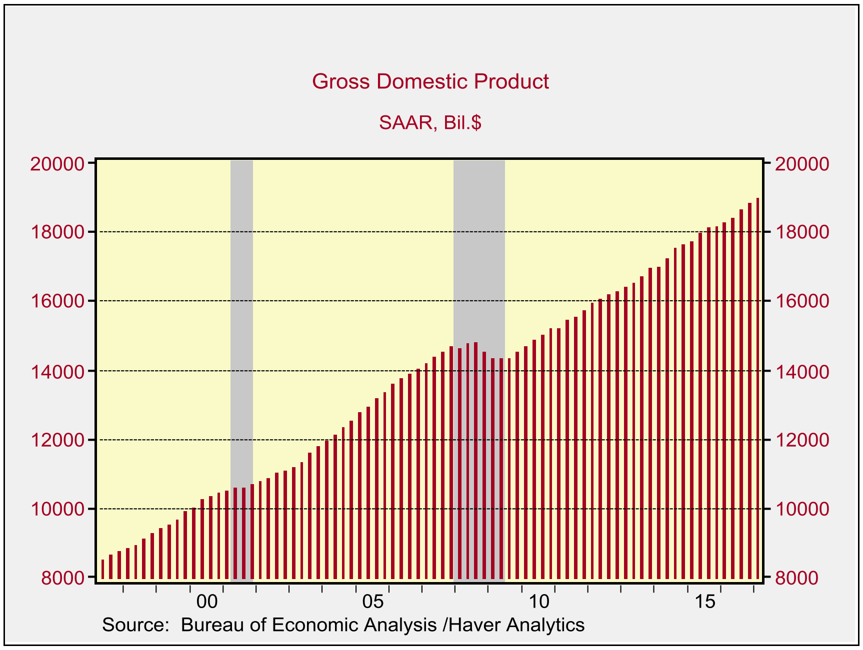




Based on inventories alone, oil prices are overvalued with the fair value price of $38.30. Meanwhile, the EUR/WTI model generates a fair value of $52.23. Together (which is a more sound methodology), fair value is $47.86, meaning that current prices are well below fair value. Currently, prices are below our expected trading range; we view oil prices as attractive on a short-term trading basis.

U.S. Economic Releases

The third GDP Q1 reading came in above expectations at 1.4% compared to the forecast of 1.2%. Personal consumption came in above expectations at 1.1% compared to the forecast of 0.6%. Core PCE came in below expectations at 2.0% compared to the forecast of 2.1%. The GDP price index came in below expectations at 1.9% compared to the forecast rise of 2.2%.

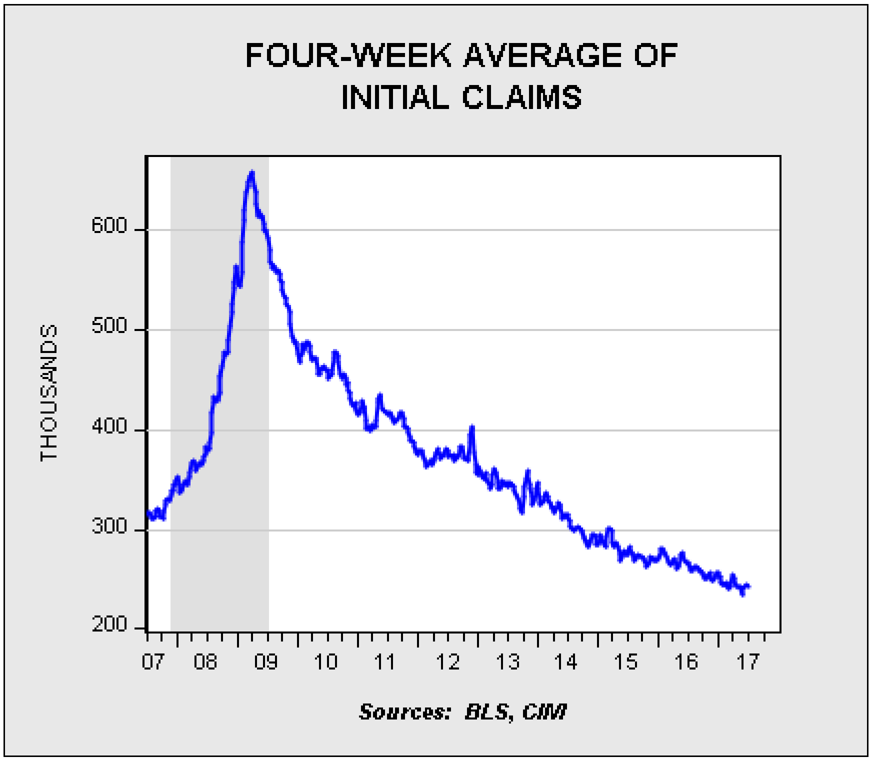


Despite tepid GDP growth throughout the last eight years, this period is now the third longest expansion in U.S. history.

	Q1 2017 Third Reading	Q1 2017 Second Reading	Difference
GDP	1.4%	1.2%	0.2%
Consumption	0.8%	0.4%	0.3%
Investment	0.6%	0.8%	-0.2%
Inventories	-1.1%	-1.1%	0.0%
Net Exports	0.2%	0.1%	0.1%
Government	-0.2%	-0.2%	0.0%

The table above shows the contributions to GDP. The upward revision in the GDP can be attributed to higher than estimated consumption and exports, as well as a lower than expected rise in investment. Despite the revision, GDP is still considered feeble. This report is unlikely to play a significant role in determining whether the Fed decides to delay rate hikes.

Initial jobless claims came in above expectations at 244k compared to the forecast of 240k. The prior report was revised upward from 241k to 242k.



The chart above shows the four-week moving average for initial claims. The moving average fell by 2.75k from 245k to 242.25k, suggesting the labor market is still pretty strong.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Bloomberg Consumer Comfort	m/m	jun		49.4	**
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)	130	129	1	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 (%)	2.28	2.23	0.05	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	29	29	0	Up
Currencies	Direction			
dollar	down			Neutral
euro	up			Up
yen	down			Neutral
pound	up			Down
franc	up			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	$47.86	$47.31	1.16%	Weaker Dollar
WTI	$45.29	$44.74	1.23%	
Natural Gas	$3.10	$3.09	0.26%	
Crack Spread	$16.75	$16.66	0.50%	
12-mo strip crack	$15.00	$14.90	0.68%	
Ethanol rack	$1.67	$1.67	0.04%	
Metals				
Gold	$1,244.64	$1,249.27	-0.37%	
Silver	$16.78	$16.81	-0.17%	
Copper contract	$269.35	$267.60	0.65%	
Grains				
Corn contract	$ 367.50	$ 366.25	0.34%	
Wheat contract	$ 482.00	$ 473.00	1.90%	
Soybeans contract	$ 927.25	$ 921.75	0.60%	
Shipping				
Baltic Dry Freight	929	903	26	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	0.1	-2.3	2.4	
Gasoline (mb)	-0.9	0.0	-0.9	
Distillates (mb)	-0.2	0.4	-0.6	
Refinery run rates (%)	-1.50%	-0.30%	-1.2%	
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.

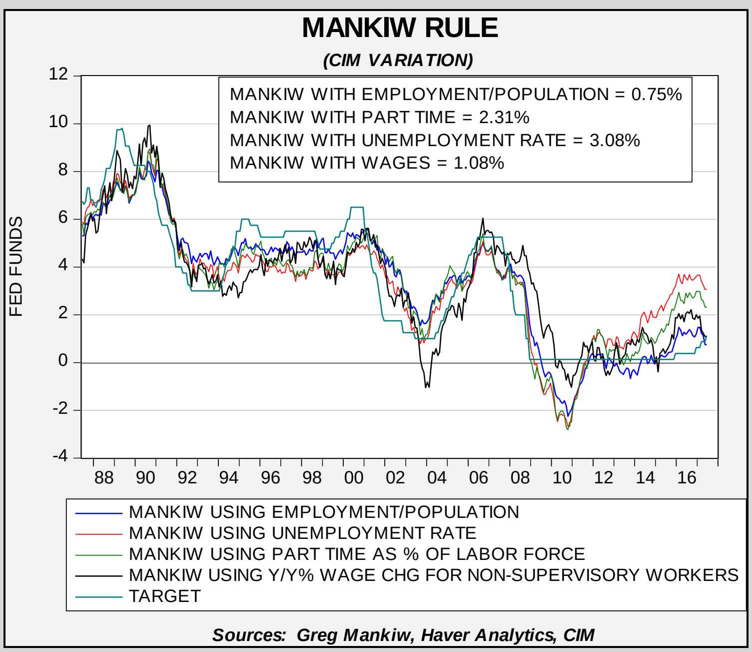
Asset Allocation Weekly Comment

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

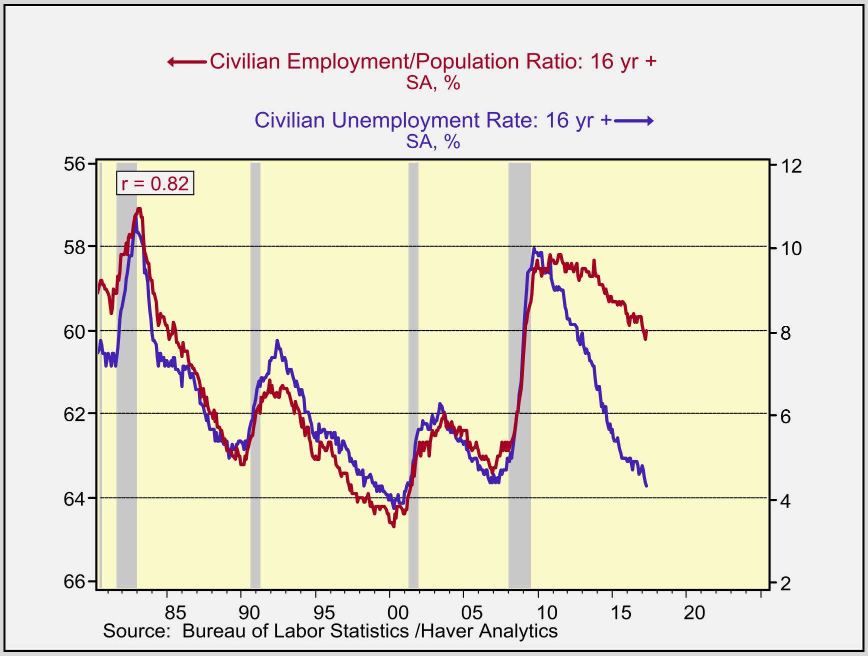
The FOMC did raise rates at the June meeting, which was fully expected. The dots chart suggested that we would see one more hike this year and three next year. In addition, the central bank gave some indication of how it would shrink its balance sheet. Although the statement didn't signal when the reduction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

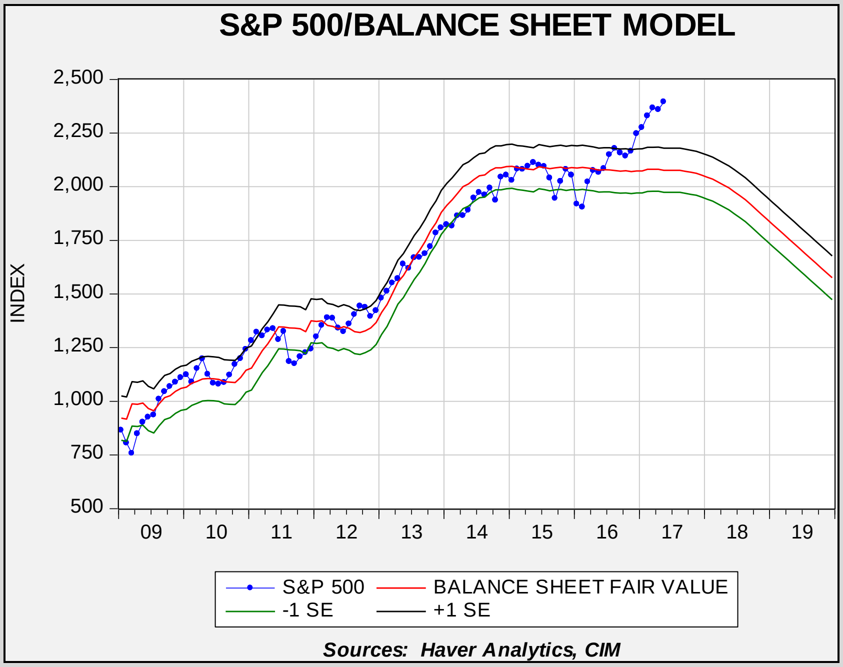


If the relationship between the unemployment rate and the employment/population ratio that existed from 1980 through 2010 had remained the same, the current unemployment rate would be closer to 7.5%. Using the above Mankiw Rule with a 7.5% unemployment rate and the current core inflation rate would generate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



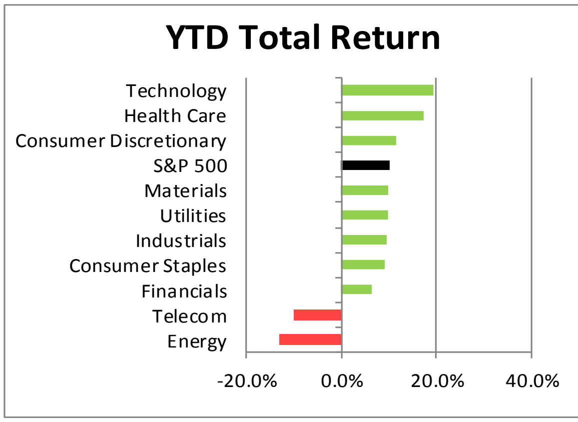
This chart forecasts the S&P 500 by using the size of the balance sheet. From 2009 into late last year, this equity index closely followed the balance sheet. After the election, equities shifted focus toward expectations of tax reform and fiscal expansion.

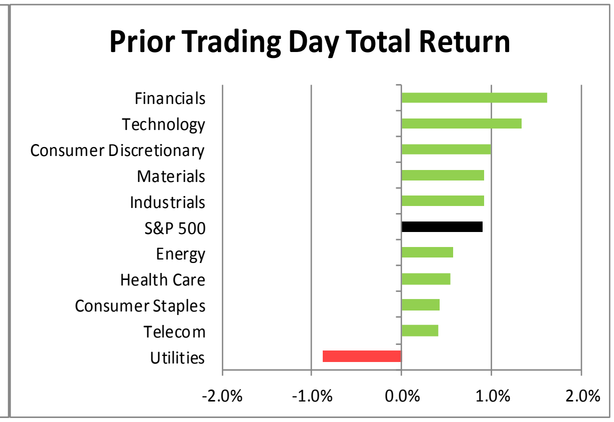
We have extended the forecast generated from the balance sheet using the FOMC's stated plan for reducing the balance sheet and assuming the reduction begins in September. The Fed intends to start slowly, only $10 bn per month, reaching $50 bn after a year. It is obvious that the balance sheet could become 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 6/28/2017 close)

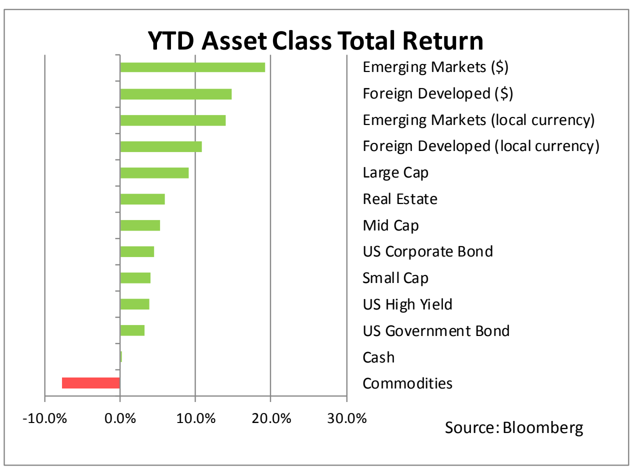




(Source: Bloomberg)

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 6/28/2017 close)

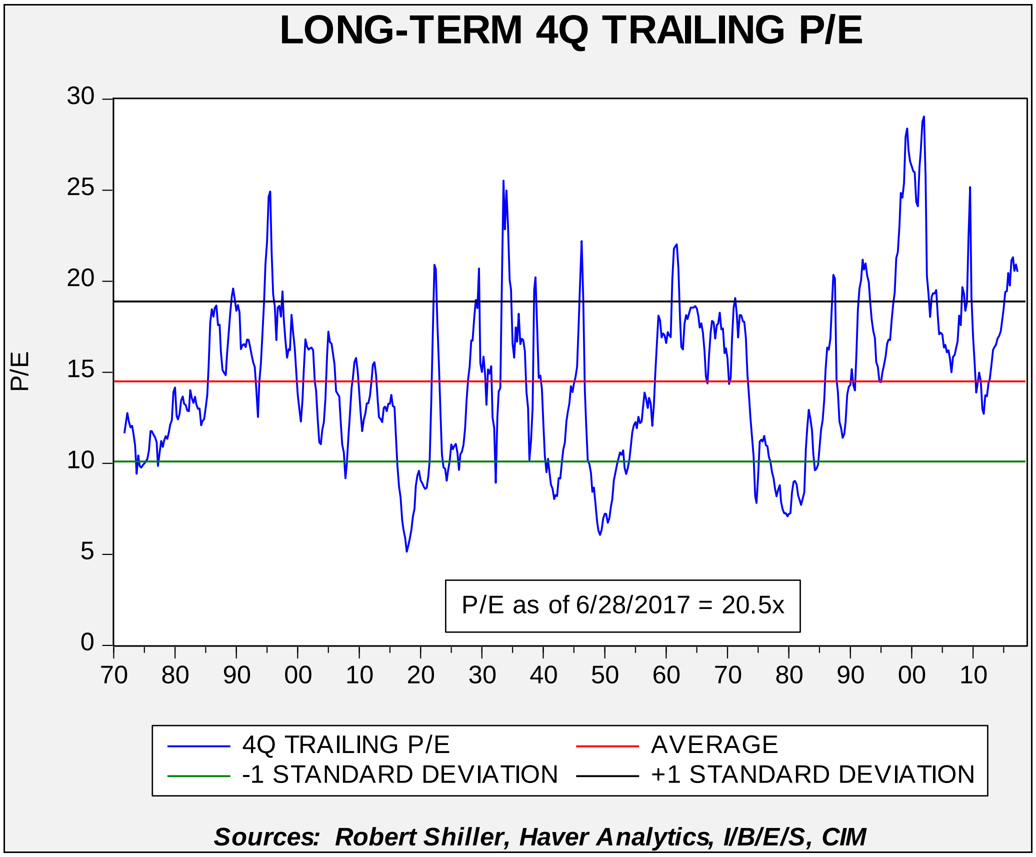


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 29, 2017



Based on our methodology,[7] 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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[7] 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.