Daily Comment

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

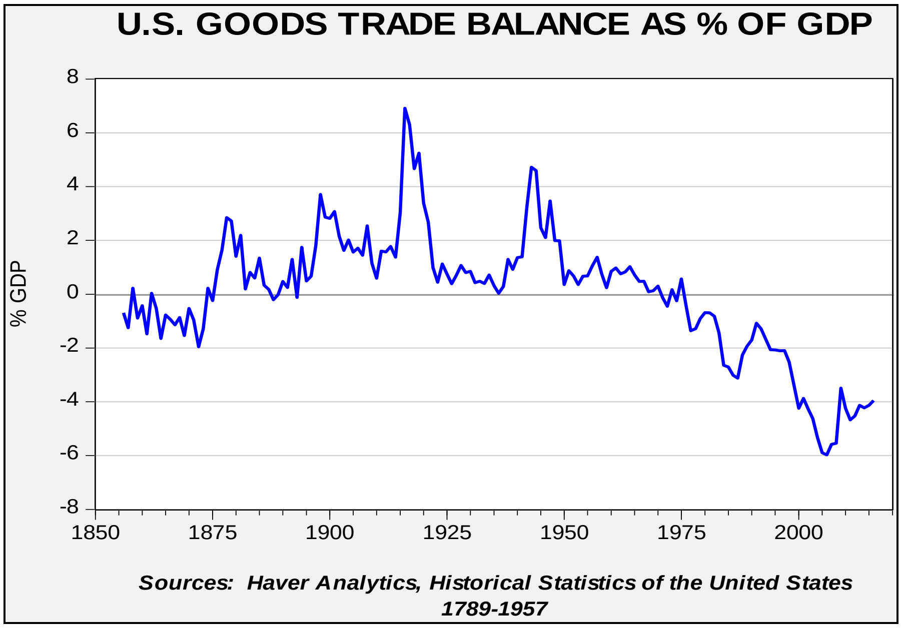
[Posted: June 2, 2017—9:30 AM EDT] Global equity markets are up this morning. The EuroStoxx 50 is up 1.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were up, with the Shanghai composite up 0.1% and the Shenzhen index up 0.9%. U.S. equity index futures are signaling a higher open.

The employment data, discussed at length below, was disappointing, with payrolls coming in weak. The bullish headline was that the unemployment rate fell to a new cycle low; in fact, a 16-year low. Sadly, that occurred because the labor force fell by a whopping 429k, offsetting a 233k decline in employment.

The president did remove the U.S. from the Paris Accord. There is much commentary on this issue. Our read is that the accord is mostly for show; there is no enforcement mechanism beyond international shaming and the goals are self-set. Anytime an agreement can have nearly all the nations of the world join is one that either (a) isn't going to change very much, or (b) is being enforced by the economic and military power of the hegemon. The Paris Accord falls under the first type.

However, the signaling is important. The U.S. is forgoing any element of leadership on climate change as the president makes it abundantly clear that his mantra of "America First" is, and remains, the key element of his administration. There is much punditry suggesting that this hands global leadership to China. If only…instead, this is further evidence that we are skidding rapidly to a "G-Zero" world in which there is no global leadership. Could China use this issue to expand its global influence? Perhaps. But the litmus test would be whether China is willing to cut its growth to 3% in order to take leadership on climate change. We strongly suspect that scenario isn't likely.

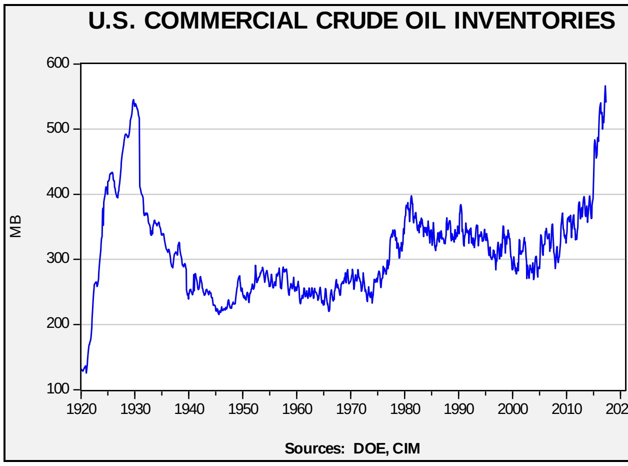
This is what global leadership looks like:

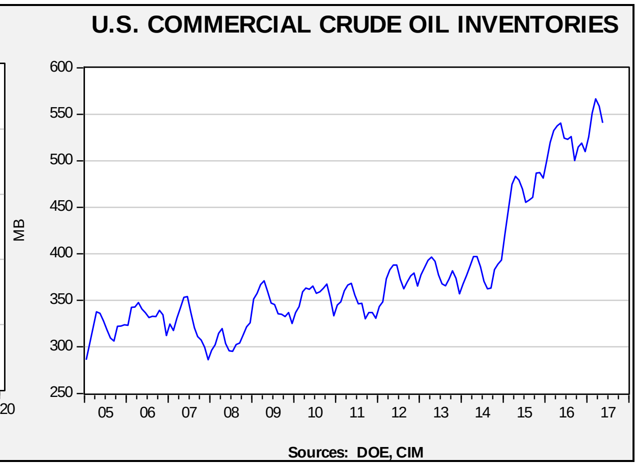


This chart shows the U.S. goods trade balance as a percentage of GDP, starting in 1860. Note that from the 1870s until the 1970s, the U.S. tended to run trade surpluses. But, as part of our superpower role, we have to provide dollars to the world for global trade, meaning that we will be required to expand our trade deficit in order to provide global liquidity. In the last decade, we ran a goods-trade deficit that reached 6% of GDP. This was done to accommodate China's development. Is there any other nation in the world willing to make such sacrifices for global growth? Is there any other nation willing to suffer the destruction of industries to global competition that is structured to generate trade surpluses at America's expense? Is China prepared to take similar actions to reduce carbon emissions?

For the foreseeable future, there is no obvious replacement to U.S. leadership. That's why Trump's decision is so unsettling. In reality, we expect businesses, along with state and local governments, to continue to take steps to reduce carbon emissions. As we noted yesterday, insurance companies and investors are demanding such changes from business. In addition, the chances of policy reversal in the next administration is likely. The key change here, as we noted above, is the signal that the U.S. is reducing its global responsibilities. For our regular readers, this comment isn't a shock; this is a theme we have been highlighting for years. But it is possible that historians years from now will cite this event as a bright line that signals the change in American policy. Just like the U.S. decision not to join the League of Nations, America is letting the rest of the world know that they will need to find their own way.

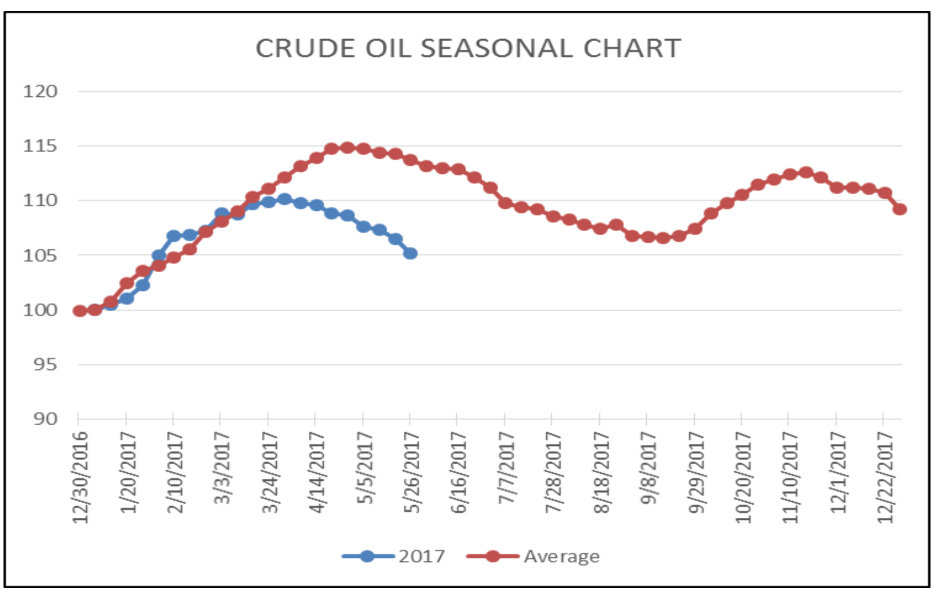
U.S. crude oil inventories fell 6.4 mb compared to market expectations of a 3.0 mb draw.



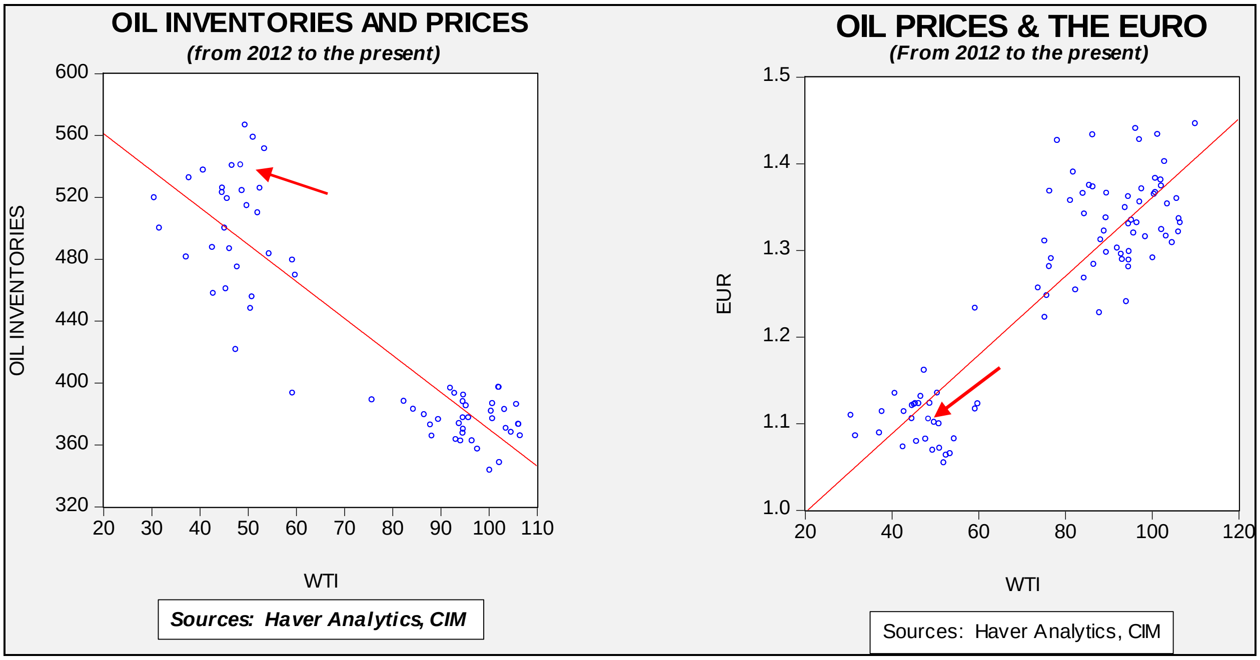


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but they are declining. We also note that, as part of an Obama era agreement, there was a 1.0 mb sale of oil out of the Strategic Petroleum Reserve. This is part of a $375.4 mm sale (or 8.0 mb) done, in part, to pay for modernization of the SPR facilities. 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 7.4 mb, which is a larger draw than forecast.

As the seasonal chart below shows, inventories are usually well into the seasonal withdrawal period. This year, that process began early. Although the actual level of stockpiles remains quite high, we are seeing stock declines at a rather rapid pace. Assuming a similar drop from this year's peak of 566.5 mb at the end of March, we will end up at 505 mb by late September. In fact, the current level of inventories has already declined more than the seasonal trough, which is supportive.



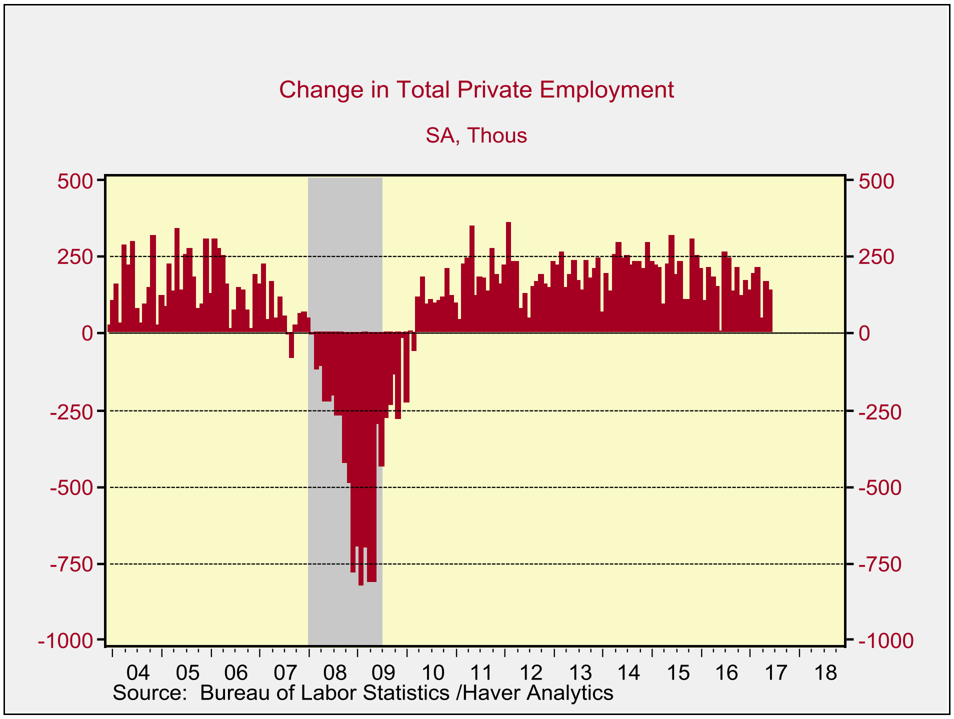
(Source: DOE, CIM)



Based on inventories alone, oil prices are overvalued with the fair value price of $37.69. Meanwhile, the EUR/WTI model generates a fair value of $48.80. Together (which is a more sound methodology), fair value is $45.14, meaning that current prices are above fair value but the deviation has been steadily closing in recent weeks. Using this model and assuming a steady €/$ exchange rate and a 505 mb trough in oil inventories, fair value for oil would be $47.25. Overall oil market sentiment has become rather bearish as a number of wirehouses have cut their price forecasts. Thus, a test of the lower end of the trading range, around $45, would not be a great surprise. However, we are seeing solid inventory liquidation and, if the dollar weakens, a recovery from these lower levels may be in the offing.

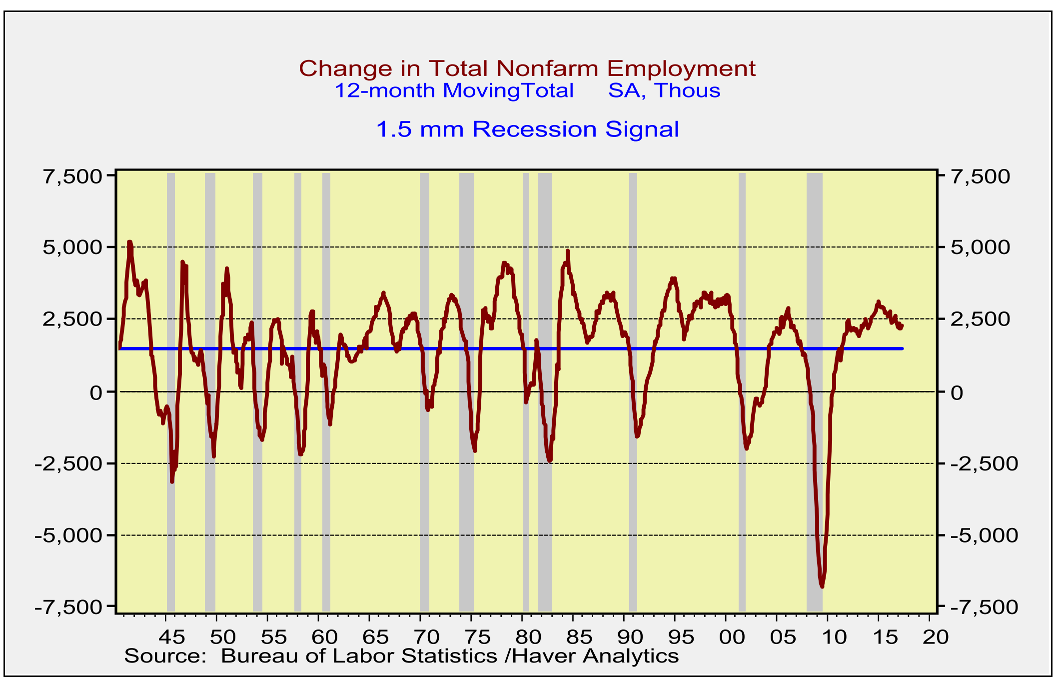
U.S. Economic Releases

The change in nonfarm payrolls came in below expectations at 138k compared to the forecast of 182k. The prior month's report was revised downward from 211k to 174k. The change in private payrolls came in below expectations at 147k compared to the forecast of 175k. The prior month's report was revised downward from 194k to 173k. The change in manufacturing payrolls came in below expectations at -1k compared to the forecast of 5k. The prior month's report was revised upward from 6k to 11k.

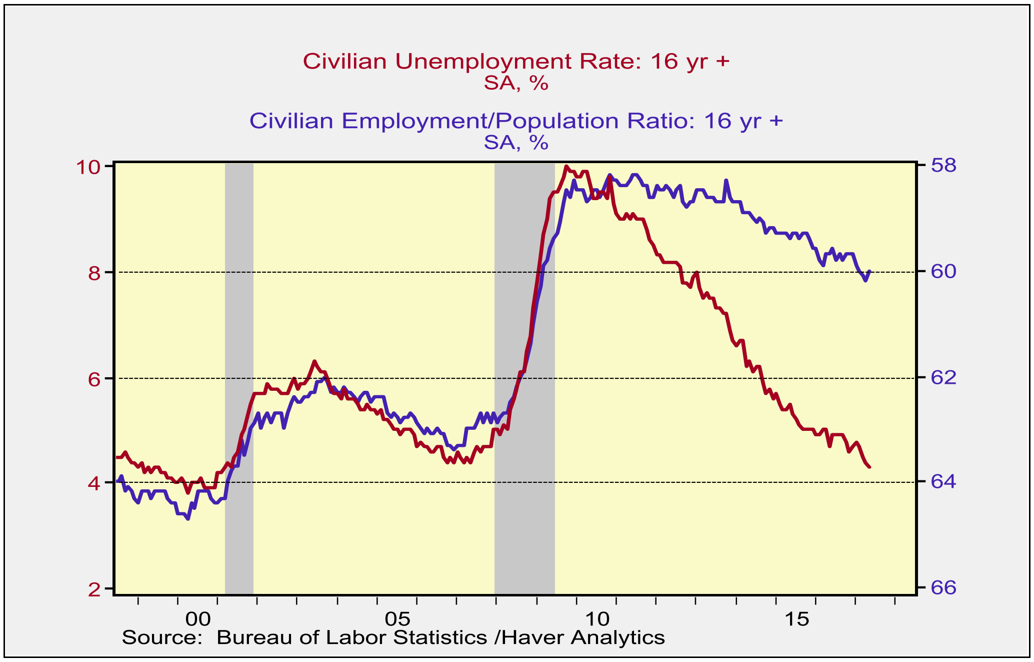


The chart above shows the change in total private employment. This chart suggests we are still in an economic expansion.

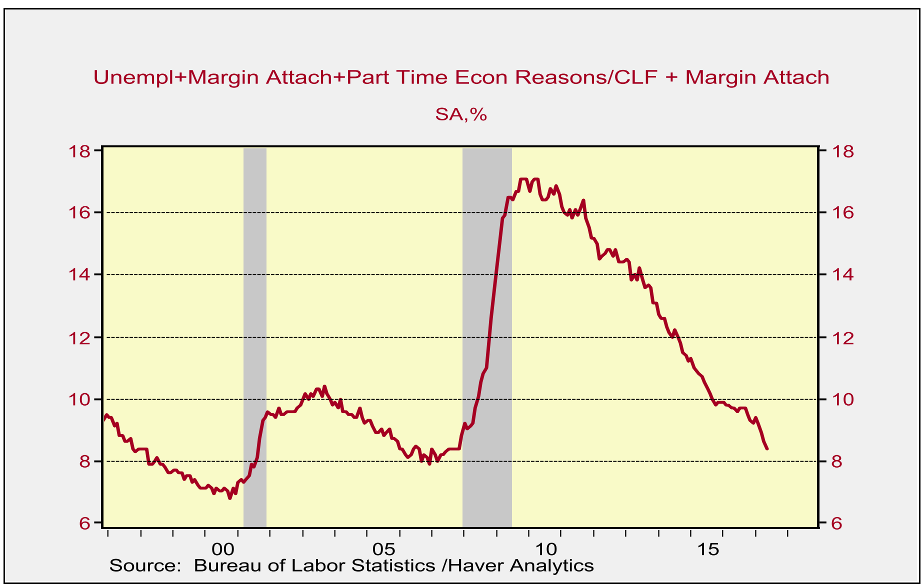
The chart below shows the 12-month moving average of the total change in nonfarm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in below forecast at 4.3% compared to the forecast of 4.4%. The labor force participation rate and the underemployment (U-6) rate came in at 62.7% and 8.4%, respectively.

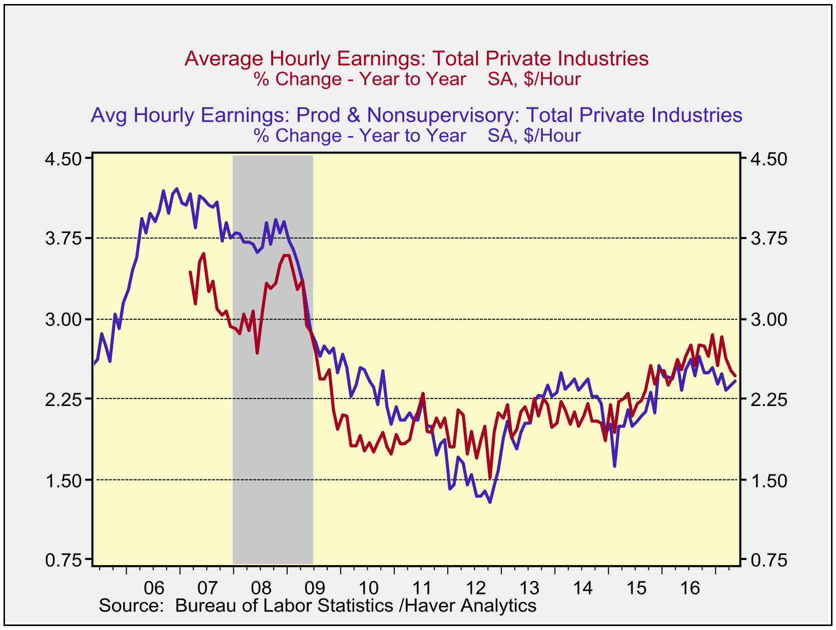


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables suggests that there is still slack within the labor market.



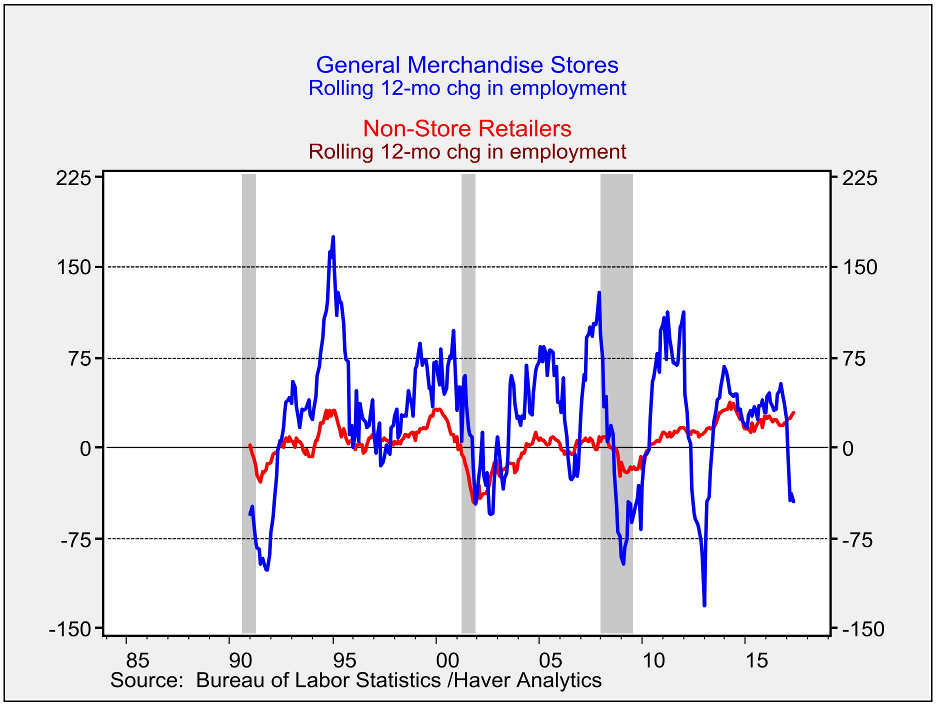
The chart above shows the underemployment rate, also referred to as the U-6 rate. There are some members of the FOMC, notably Robert Kaplan, president of the Dallas FRB, who are currently using this figure to gauge slack in the labor market. The decline in the U-6 rate suggests the labor market is strengthening. In fact, reaching 8% would likely turn Kaplan, a voter this year, more hawkish.

Average hourly earnings came in line with forecasts at a rise of 0.2% from the prior month. The prior month's gain was revised downward from 0.3% to 0.2%. Average weekly hours came in line at 34.4.

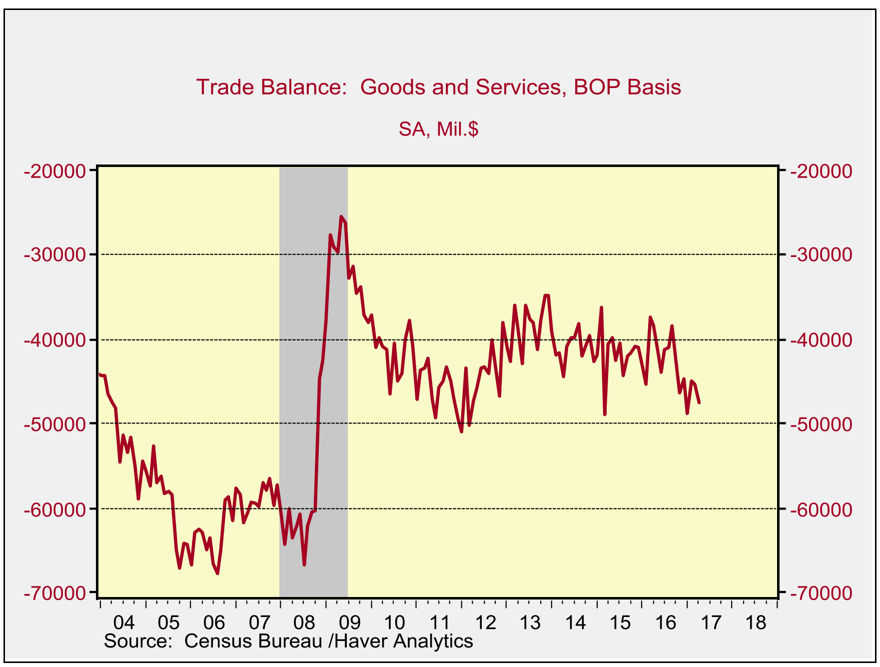


This chart shows the yearly growth in hourly earnings for all workers and non-supervisory workers. The two series narrowed as non-supervisory worker wage growth improved modestly, while overall private sector worker wage growth slowed.

The following is a bonus chart, showing the rolling 12-month total change of general merchandise store employment and non-store retailer employment. In other words, "brick and mortar" vs. "internet." Over the past year, general merchandise stores have cut their workforce by 45,600 jobs, while internet retailers have added 28,800 jobs.



The trade deficit came in wider than expected at $47.6 bn compared to the forecast of $46.1 bn. The prior report's deficit was revised wider from $43.67 bn to 45.3 bn.



The chart above shows the trade balance of goods and services. Generally, the trade balance has moved sideways over the past five years.

Despite the unemployment rate falling to its lowest rate in 16 years, the jobs numbers were disappointing. As noted above, the decline in the unemployment rate was due to a drop in the labor force. Wage growth remains stalled. Fed funds futures have reduced the odds of a 25 bps hike in June to 88.4%, down from 100% going into the release. Interestingly enough, the odds of an additional hike at the September meeting are only 35%. June might be the last hike of the year.

The dollar took a hit on the news and Treasuries rallied. Equity futures gave back some of their gains. Overall, the data was a disappointment.

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases						
	No economic releases today					
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
EST	**Speaker or event**	**District or position**				
12:45	Patrick Harker Speaks in New York	President of the Federal Reserve Bank of Philadelphia				
13:00	Robert Kaplan Speaks in College Station, Texas	President of the Federal Reserve Bank of Dallas				

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	Monetary Base	y/y	may	19.8%	19.4%		**	Equity and bond neutral
	Consumer Confidence Index	m/m	apr	43.6	43.2	43.5	**	Equity and bond neutral
Australia	HIA New Homes Sales	m/m	apr	0.8%	-1.1%		**	Equity and bond neutral
EUROPE								
Eurozone	PPI	y/y	may	4.3%	3.9%	4.5%	**	Equity and bond neutral
Italy	New Car Registration	y/y	may	8.2%	-4.6%		**	Equity and bond neutral
UK	Markit/CIPS UK Construction	m/m	may	56.0	53.1	52.6	**	Equity bullish, bond bearish
Russia	Money Supply Narrow Def	m/m	may	9.00t	9.10t		**	Equity and bond neutral
	Reserve Fund	m/m	may	$16.5 bn	$16.3 bn		**	Equity and bond neutral
	Wellbeing Fund	m/m	may	$74.2 bn	$73.6 bn		**	Equity and bond neutral
AMERICAS								
Brazil	Industrial Production	y/y	apr	-4.5%	1.1%	-5.5%	***	Equity and bond neutral
Canada	Labor Productivity	m/m	1q	1.4%	0.4%	1.2%	**	Equity bullish, bond bearish
	International Merchandise Trade	m/m	apr	-0.37 bn	-0.14 bn	-0.02 bn	**	Equity and bond neutral
Mexico	Vehicle Domestic Sales	m/m	may	122916	114477		**	Equity and bond neutral

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)	121	120	1	Up
3-mo T-bill yield (bps)	95	96	-1	Neutral
TED spread (bps)	26	24	2	Neutral
U.S. Libor/OIS spread (bps)	111	111	0	Up
10-yr T-note (%)	2.21	2.21	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	33	33	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	up			Down
yen	down			Down
pound	down			Neutral
franc	down			Neutral

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	$49.34	$50.63	-2.55%	Fears of oversupply
WTI	$47.13	$48.36	-2.54%	
Natural Gas	$3.00	$3.01	-0.43%	
Crack Spread	$17.34	$17.50	-0.93%	
12-mo strip crack	$14.87	$14.95	-0.56%	
Ethanol rack	$1.66	$1.66	-0.11%	
Metals				
Gold	$1,263.18	$1,265.96	-0.22%	Stronger Dollar
Silver	$17.21	$17.30	-0.52%	
Copper contract	$253.40	$258.75	-2.07%	
Grains				
Corn contract	$ 371.00	$ 370.50	0.13%	
Wheat contract	$ 429.25	$ 429.00	0.06%	
Soybeans contract	$ 914.25	$ 912.25	0.22%	
Shipping				
Baltic Dry Freight	850	878	-28	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.4	-3.0	-3.4	
Gasoline (mb)	-2.9	-1.5	-1.4	
Distillates (mb)	0.4	-0.7	1.0	
Refinery run rates (%)	1.50%	0.00%	1.5%	

Weather

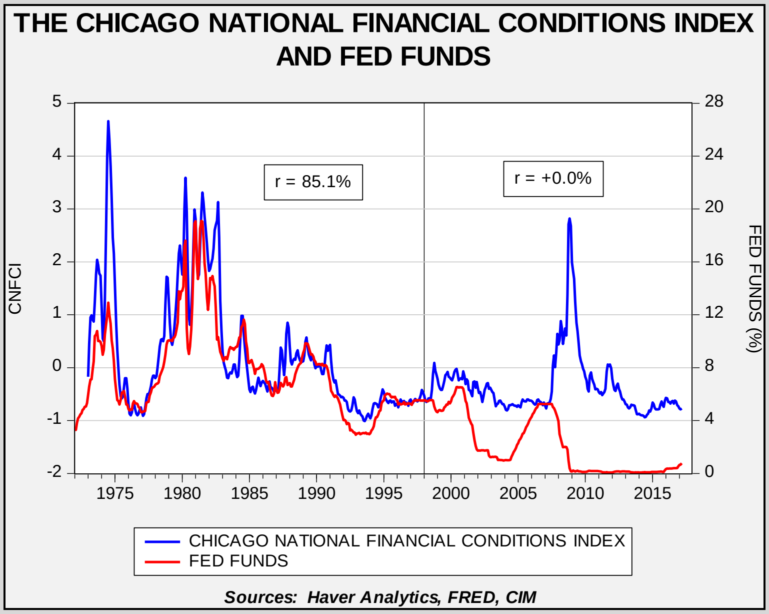
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the eastern region. Precipitation is expected for most of the country, excluding the northern region.

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 2, 2017

In the last FOMC minutes, policymakers signaled another hike at the upcoming June 14th meeting. We continue to closely monitor financial conditions but, so far, financial markets are rather sanguine about the impact of policy tightening.



The blue line on the chart shows the Chicago FRB Financial Conditions Index, which measures the level of stress in the financial system. It is constructed of 105 variables, including the level of interest rates, credit spreads, equity and debt market volatility, delinquencies, borrower and lender surveys, debt and equity issuance, debt levels, equity levels and various commodity prices (including gold). A rising line indicates increasing financial stress. The red line is the effective fed funds rate. Until 1998, the two series were positively and closely correlated. When the Fed raised rates, financial stress rose; when the Fed lowered rates, stress declined.

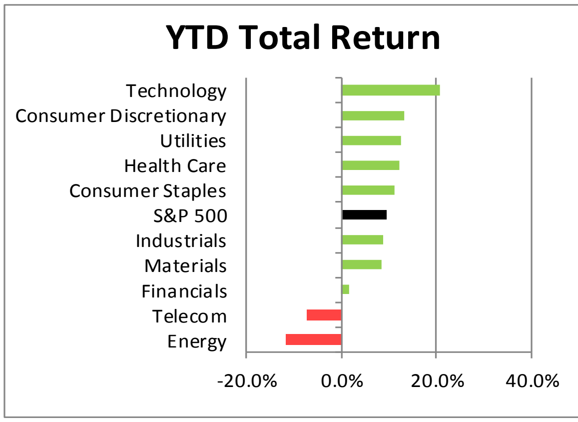
We believe there are two factors that changed this relationship. The first is policy transparency. Starting in the late 1980s, the Fed became increasingly transparent. For example, before 1988, the FOMC would meet but issue no statement about what it had decided to do. Investors and the financial system had to guess whether policy had been changed. Starting in 1988, the central bank began publishing its target rate. In the 1990s, it began issuing a statement when rates changed. Eventually, a statement followed all meetings. As the FOMC has become more transparent, the correlation between stress and the level of fed funds has changed. Essentially, the markets now know with a high degree of certainty when rate changes are likely. This is especially true of tightening. The FOMC appears to avoid making rate hikes that surprise the market.

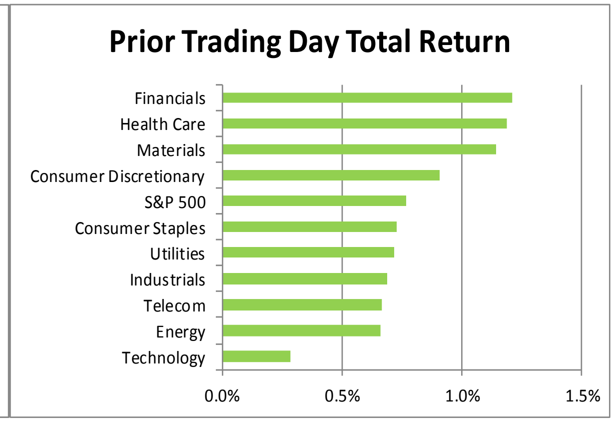
The second factor is financial system stability. From the Great Depression into the 1980s, policymakers put a high premium on system stability at the expense of efficiency. Bank failures were rare and there were a large number of rather small institutions. In addition, commercial banks were separated from investment banks. The drive to improve efficiency led to consolidation among commercial banks and a breakdown of the barriers between commercial and investment banks. Although this made the system more efficient, it also undermined stability. Thus, when raising rates, the Fed must pay close attention to system stability to prevent crises, which has tended to lead to gradual and measured policies; this behavior maintains stability…until it doesn't!

Essentially, policymakers and investors face the Minsky Paradox; the more stable markets become the more risks investors take, leading to conditions that cannot be sustained. Unfortunately, it's hard to know in advance when rate hikes become problematic. It is likely that as rates rise, factors that may have been manageable at lower rates become dangerous at higher rates. Those conditions can change faster than policymakers can likely react. For now, there isn't much evidence of trouble but the fact that policy is tightening raises the likelihood, however small, that problems could develop.

<u>Data Section</u>

U.S. Equity Markets – (as of 6/1/2017 close)

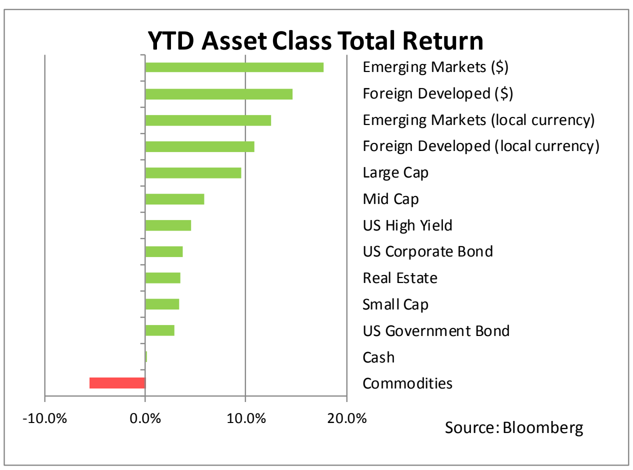




(Source: Bloomberg)

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 6/1/2017 close)

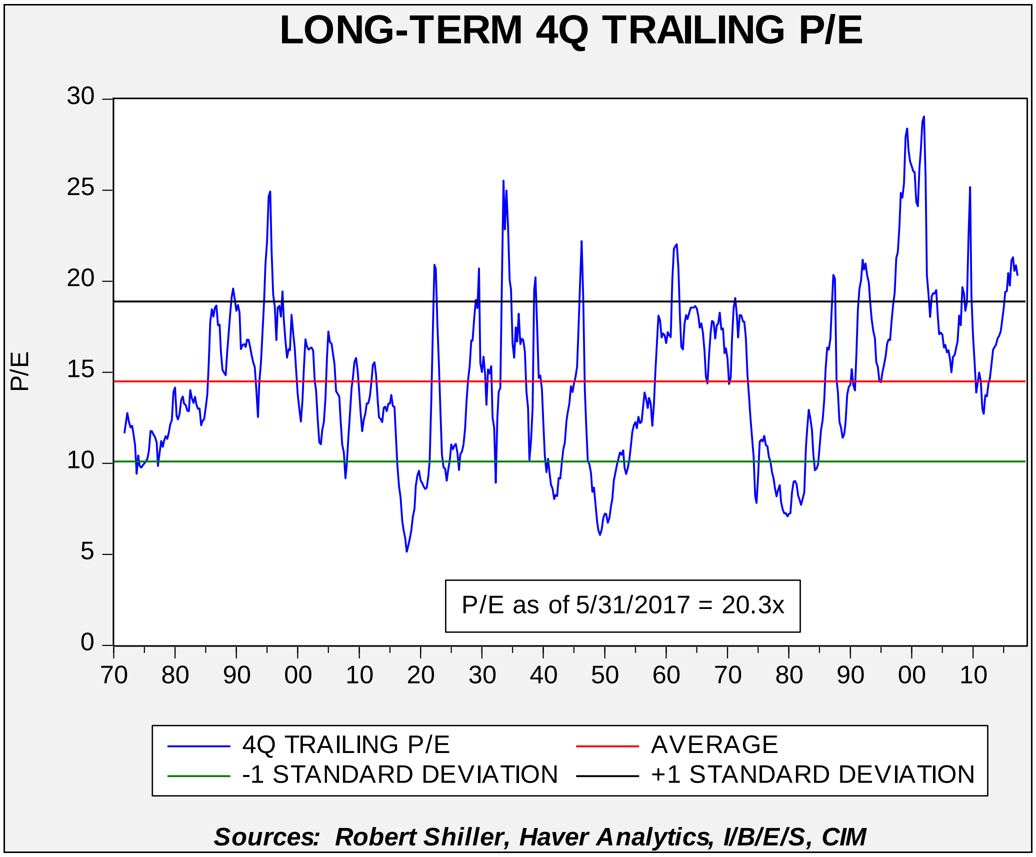


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 1, 2017



Based on our methodology,[1] the current P/E is 20.3x, unchanged from last week.

[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.