Daily Comment

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

[Posted: June 5, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.1% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.5% and the Shenzhen index up 0.7%. U.S. equity index futures are signaling a lower open.

Although financial markets are quiet, there is a lot happening in the news. Here is what we saw as important:

President Trump ready with two Fed governor nominations: The president, according to numerous media reports, is prepared to fill two of the current three vacancies on the FOMC. Randal Quarles, a former Treasury official, is said to be the selection to replace Tarullo, who was acting as the governor with the regulation mandate. His public statements suggest he would likely roll back regulations on the banks and his appointment would be welcomed by the financial services industry. The other selection is Marvin Goodfriend, an economics professor at Carnegie Mellon; he has broad experience working as a researcher in monetary policy. Media reports touted comments he has made critical of QE and his support of a "rules-based" policy for setting rates as evidence that he would be a hawkish "offset" to Yellen. However, deeper research suggests this is a facile analysis of his broader work. Goodfriend opposed QE mainly because he was much more supportive of negative interest rates. Of course, the major problem with negative rates is that they create a positive return for cash. Thus, negative rates should trigger massive cash hoarding if the rates become negative enough. His solution to this problem would be to devalue cash by having the central bank no longer exchange 1:1 currency for reserves. In other words, the value of cash held would be allowed to adjust as well. We remain unsure how this would work in practice but suffice it to say that to suggest Goodfriend is a hawk is probably a misjudgment. In fact, his views appear radical enough to suggest we may be installing the next Kocherlakota.

Terror attacks in London: Again, the U.K. was the target of another attack over the weekend. IS has claimed responsibility but we don't yet know how involved the group was in the attack. It isn't clear why London was the target unless terrorists groups want to undermine the May administration. Although these attacks are clearly not on the scale of 9/11, they are effective insofar as they terrorize. Thus far, these attacks have had little effect on financial markets and, in fact, the more often they occur, the more markets become inured to them.

Thursday is a big day: On Thursday, former FBI Director Comey is expected to testify before Congress, the British hold elections and the ECB holds its regular meetings. The Comey testimony runs the risk of further distracting the administration from tax reform, health care, etc. In the U.K., the polling spread remains in the single digits, with the latest poll showing the Conservatives holding a 7% lead, although some polling from late last week showed the race as a dead heat. We still expect the Tories to win but a narrow victory would defeat May's reason for calling snap elections, which was to build a larger mandate to negotiate Brexit. Finally, the ECB may begin hinting about tapering and rate increases. If so, the EUR may get a boost.

The PRI in Mexico squeaks out a win: A quick vote count in the state of Mexico gives the governorship to Alfredo del Mazo, the candidate of the ruling PRI. The last count shows the PRI up 32.3% to 31.3%. This election was seen as a harbinger for next year's national elections. The PRI has ruled the state of Mexico for 88 years and so a loss here would suggest that the leftists under Andres Manuel Lopez Obrador[1] might win the presidency. We caution that this final vote hasn't been tabulated so the PRI may still lose this state.

Qatar isolated: Bahrain, Saudi Arabia, Egypt and the UAE, among others, have severed diplomatic ties to Qatar. Diplomats are being sent home. The severing nations are angry with Qatar for their supposed ties to Iran and its support of the Muslim Brotherhood. Less than two weeks after the president's visit to Saudi Arabia, the anticipated coalition against Iran and terrorism appears to be fracturing. We note the U.S. operates out of the Al Udild Air Base in Qatar; the base is used for air operations against IS. So far, we don't know if operations will be disrupted due to this diplomatic spat. Religious authorities in Saudi Arabia are accusing the leadership of Qatar of religious illegitimacy. Conspicuous in its absence is Pakistan. The Pakistanis have been cool to the Saudis' tensions with Iran and any sort of conflict with Iran would be problematic without Pakistan's support. Overall, we have seen such tensions before, although not to this degree; in fact, the actions being implemented are commonly part of war. Thus, this is an issue that bears watching.

The Israelis do have "the bomb": There was a report in the weekend *NYT*[2] that Israel was planning to detonate a demonstration nuke in the Sinai in 1967 if its forces were being overwhelmed. This was to serve as a warning to the Arab states that the costs would be catastrophic if they tried to make good on their promise to "push Israel into the sea." The plan was never executed because the IDF won a quick victory in the 1967 Six-Day War. On the 50-year anniversary of this conflict, the report reveals what Israel has refused to acknowledge, which is that it is a nuclear power.

The White House is pushing infrastructure: The White House seems to be preparing to unveil a plan to rebuild U.S. infrastructure this week. It appears to rely heavily on local direction and money, with only modest federal involvement and funding. Needless to say, state and local governments are less than impressed. The idea of state and local government funding is a pre-1930s conception; it only works if the projects generate enough cash to service the debt drawn to pay for them. Thus, toll roads and other service fees are required to build projects. Although such constraints should lead to better projects, the public has gotten used to federal funding and it would be a shock to force car owners to rent or buy electronic pass units to drive around. We note that the president is expected to unveil a partial privatization of the air traffic control system today.

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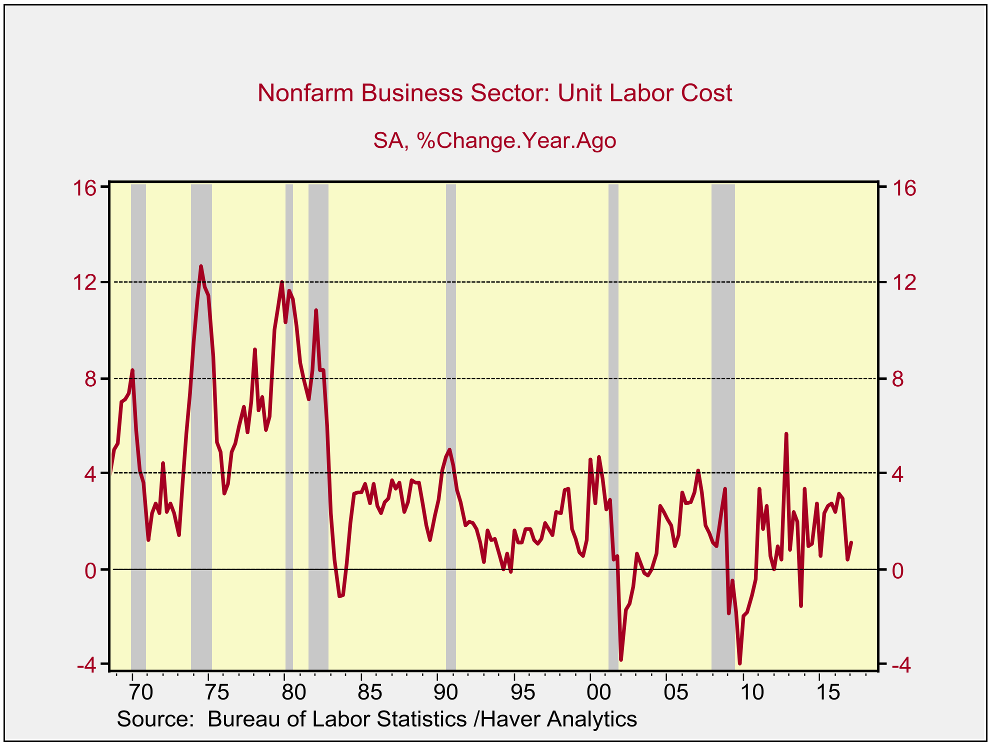
[1] See WGRs: The Rise of AMLO: Part I, 3/13/17, and Part II, 3/20/17

[2] https://www.nytimes.com/2017/06/03/world/middleeast/1967-arab-israeli-war-nuclear-warning.html?emc=edit_mbe_20170605&nl=morning-briefing-europe&nlid=5677267&te=1

U.S. Economic Releases

The revised Q1 nonfarm productivity data came in above expectations, remaining unchanged from the prior quarter. Forecasts showed an upward revision from -0.6% to -0.1%. The revised Q1 unit labor costs came in below expectations at 2.2%, and forecasts showed a downward revision from 3.0% to 2.4%.



The chart above shows the year-over-year change of unit labor costs. The yearly change in unit labor costs was only 1.1%, which suggests that wages may be subdued. During a period of full employment, we expect unit labor costs to go up as a tightening labor market should increase the demand for labor. This report could possibly dampen the Fed's economic outlook.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Composite	m/m	may	54.0	54.0	**
9:45	Markit US Services	m/m	may		53.9	**
10:00	ISM Non-Manufacturing	m/m	may	57.1	57.5	**
10:00	Labor Market Conditions Index	m/m	may	3.0	3.5	**
10:00	Factory Orders	m/m	apr	-0.2%	0.2%	**
10:00	Factory Orders ex Trans	m/m	apr		-0.3%	**
10:00	Durable Good Orders	m/m	apr	-0.6%	-0.7%	**
10:00	Durables ex Transportation	m/m	apr	-0.2%	-0.4%	**
10:00	Capital Goods Orders Nondef ex Air	m/m	apr	0.1%	0.0%	**
10:00	Capital Goods Ship Nondef ex Air	m/m	apr		-0.1%	**
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								
China	Caixin China PMI Composite	m/m	may	51.5	51.2		**	Equity and bond neutral
	Caixin China PMI Services	m/m	may	52.8	51.5		**	Equity and bond neutral
Japan	Nikkei Japan PMI Services	y/y	may	53.0	52.2		**	Equity and bond neutral
	Nikkei Japan PMI Composite	m/m	apr	53.4	52.6		**	Equity and bond neutral
India	Nikkei India PMI Services	m/m	apr	52.2	50.2		**	Equity and bond neutral
	Nikkei India PMI Composite	q/q	1q	52.5	51.3		**	Equity and bond neutral
Australia	AiG Perf of Services Index	m/m	may	51.5	53.0		**	Equity and bond neutral
	Melbourne Institute Inflation	y/y	may	0.0%	2.6%		**	Equity and bond neutral
	Inventories	q/q	1q	1.2%	0.3%	0.5%	**	Equity bullish, bond bearish
	Company Operating Profits	m/m	may	6.0%	20.1%	5.0%	**	Equity and bond neutral
	ANZ Job Advertisements	m/m	apr	0.4%	1.4%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Composite	m/m	may	56.8	56.8	56.8	**	Equity and bond neutral
	Markit Eurozone Services	m/m	may	56.3	56.2	56.2	**	Equity and bond neutral
Germany	Markit Germany Services PMI	m/m	may	55.4	55.2	55.2	**	Equity and bond neutral
	Markit/BME Germany PMI	m/m	may	57.4	57.3	57.3	**	Equity and bond neutral
France	Markit France Composite	m/m	may	57.2	58.0	58.0	**	Equity and bond neutral
	Markit France Services	m/m	may	56.9	57.6	57.6	**	Equity and bond neutral
Italy	Markit/ ADACI Italy Services	m/m	may	55.1	56.2	55.3	**	Equity and bond neutral
	Markit/ ADACI Italy Composite	m/m	may	55.2	56.8	55.7	**	Equity and bond neutral
UK	New Car Registration	y/y	may	-8.5%	19.8%		**	Equity and bond neutral
	Markit/ CIPS UK Services	m/m	may	53.8	55.8	55.0	**	Equity and bond neutral
	Markit/ CIPS UK Composite	m/m	may	54.4	56.2	55.5	**	Equity and bond neutral
	Official Reserves Changes	m/m	may	$1.115 bn	$1.362 bn		**	Equity and bond neutral
Russia	Markit Russia Composite	m/m	may	56.3	56.1	55.6	**	Equity bullish, bond bearish
	Markit Russia Services	m/m	may	56.0	55.3		**	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)	122	122	0	Up
3-mo T-bill yield (bps)	96	96	0	Neutral
TED spread (bps)	27	26	1	Neutral
U.S. Libor/OIS spread (bps)	112	112	0	Up
10-yr T-note (%)	2.17	2.16	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	32	32	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Down
yen	down			Down
pound	up			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	$49.55	$49.95	-0.80%	Fears of oversupply
WTI	$47.34	$47.66	-0.67%	
Natural Gas	$3.00	$3.00	0.13%	
Crack Spread	$17.05	$17.29	-1.35%	
12-mo strip crack	$14.69	$14.86	-1.15%	
Ethanol rack	$1.68	$1.67	0.52%	
Metals				
Gold	$1,280.49	$1,279.17	0.10%	
Silver	$17.54	$17.56	-0.07%	
Copper contract	$254.60	$257.45	-1.11%	
Grains				
Corn contract	$ 372.50	$ 372.75	-0.07%	
Wheat contract	$ 428.75	$ 429.50	-0.17%	
Soybeans contract	$ 920.25	$ 921.25	-0.11%	
Shipping				
Baltic Dry Freight	830	850	-20	
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%	
Natural gas (bcf)	81.0	77.0	4.0	

Weather

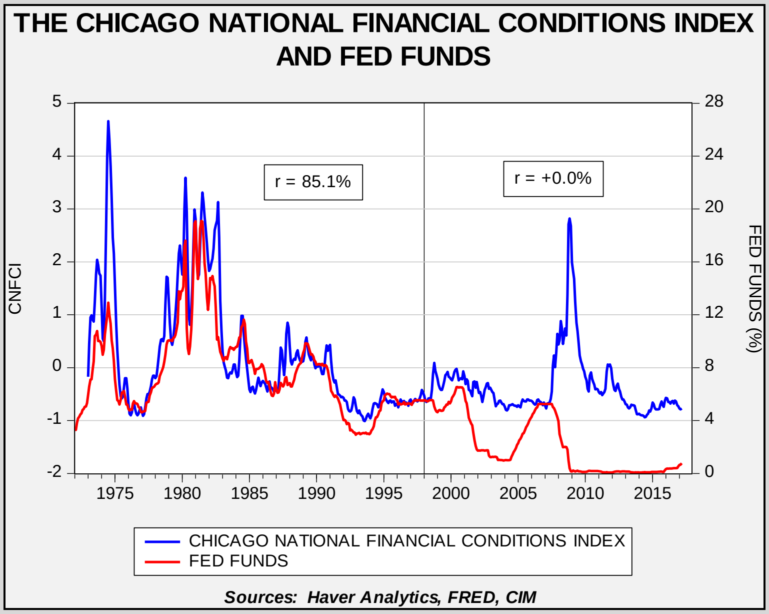
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the western region. Precipitation is expected for most of the northern region.

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.

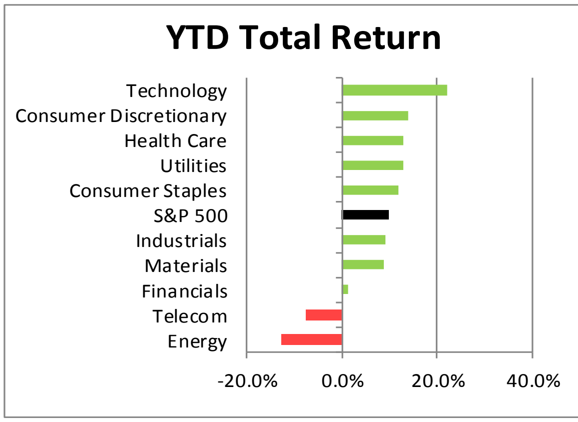
We believe there are two factors that changed this relationship. The first is policy transparency. Starting in the late 1980s, the Fed became increasingly transparent. For example, before 1988, the FOMC would meet but issue no statement about what it had decided to do. Investors and the financial system 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.

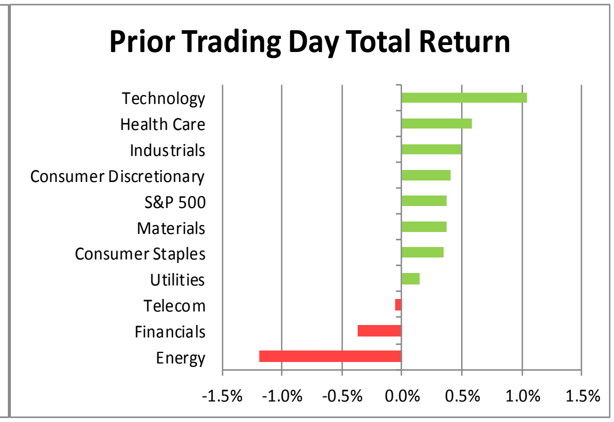
The second factor is financial system stability. From the Great Depression into the 1980s, policymakers put a high premium on system stability at the expense of efficiency. Bank failures were rare and there were a large number of rather small institutions. In addition, commercial banks were separated 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.

Data Section

U.S. Equity Markets – (as of 6/2/2017 close)

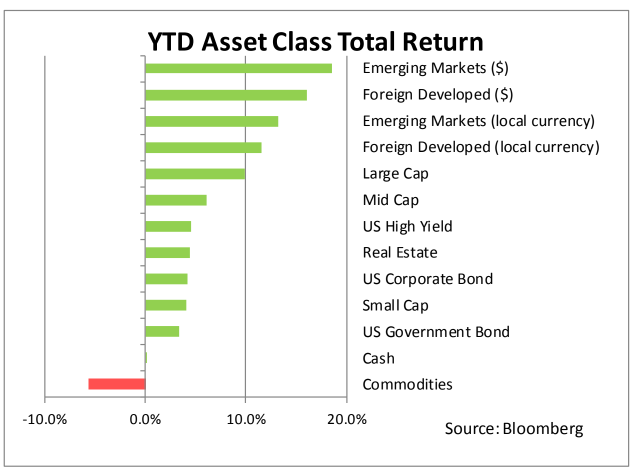




(Source: Bloomberg)

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 6/2/2017 close)

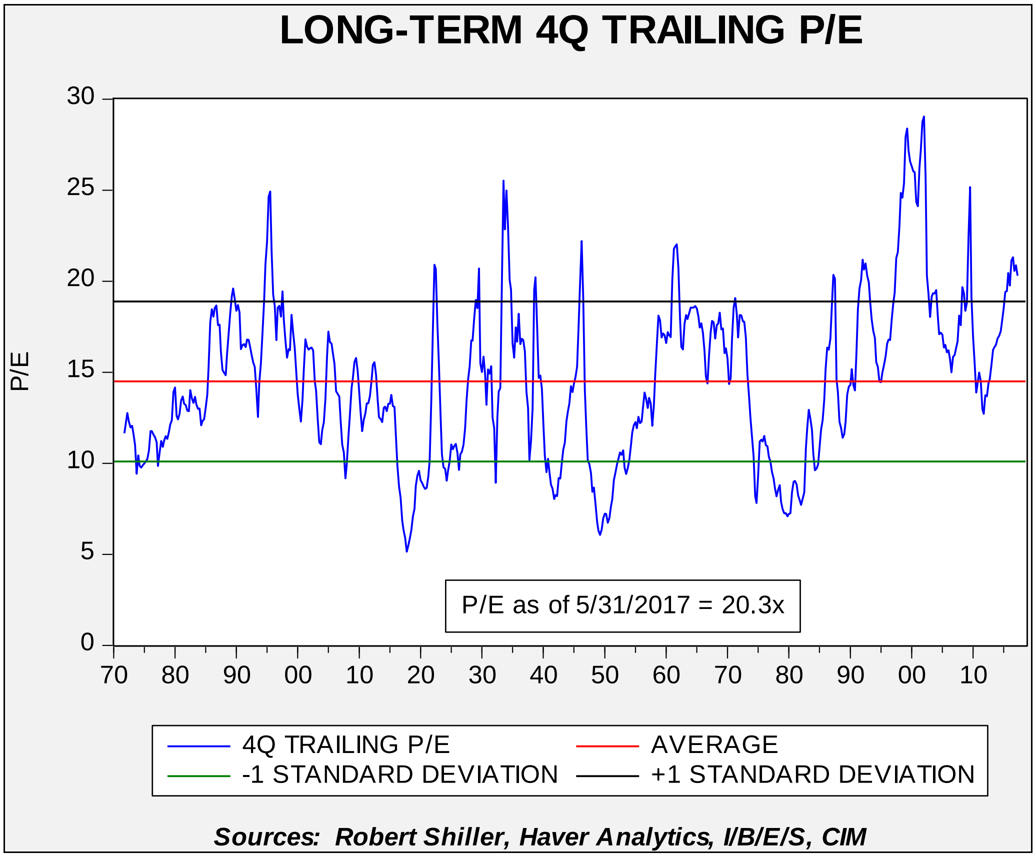


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] the current P/E is 20.3x, unchanged 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.

[3] 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.