Daily Comment

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

[Posted: June 6, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.6%. U.S. equity index futures are signaling a lower open.

Although there has been some market uncertainty due to political risks in the U.S. and U.K., the overnight news was relatively quiet. Market jitters seem to be due to concerns that tax and healthcare reforms have stalled, doubts as to whether Theresa May will be able to pull off a decisive win in Thursday's election and the Middle East's isolation of Qatar.

Today, President Trump is meeting with congressional GOP members to get an update on healthcare and tax reform. Republicans have been reluctant to put the bill to a vote without receiving any support from Democrats. The Russian investigation and the travel ban have made Democrats hesitant to support any initiatives promoted by the Trump administration. It is believed that President Trump would like healthcare reform put to a vote by summer and tax reform by fall. Former FBI Director James Comey could possibly play a role in ensuring that Congress is able to meet this deadline, assuming his testimony doesn't further implicate President Trump in the Russian investigation. Congress has about 80 days left to pass legislation for this congressional session.

In the wake of the London Bridge attack, Theresa May has faced calls that she should resign as prime minister. While serving as home secretary, May agreed to cut the police budget by 18% which is believed to have contributed to a drastic reduction in the police force. Her opponents suggest that had the police budget not been cut, the attack could have been prevented. Although this assumption is probably baseless, it is likely to resonate with many Brexit supporters. May's fondness for ambivalence suggests that these critiques will force her to pivot toward a harder stance with the EU.[1] A hard Brexit would heighten uncertainty for businesses located in the U.K., hence we are bearish on the GBP. That being said, polls still suggest that May's party should win in Thursday's election.

Qatar remains at odds with its neighbors, but a bit more interesting information has emerged. According to the *FT*,[2] what has angered the rest of the Gulf Cooperation Council (GCC) states is that Qatar paid up to $1.0 bn to jihadist groups linked to al Qaeda and Iranian militants, in part to secure the release of a group of Royal Family falconers who were kidnapped in Iraq on a hunting trip. Qatar has been accused by the GCC of funding various militant groups, perhaps to ensure these groups don't attack Qatar. According to reports, these payoffs were so egregious that they

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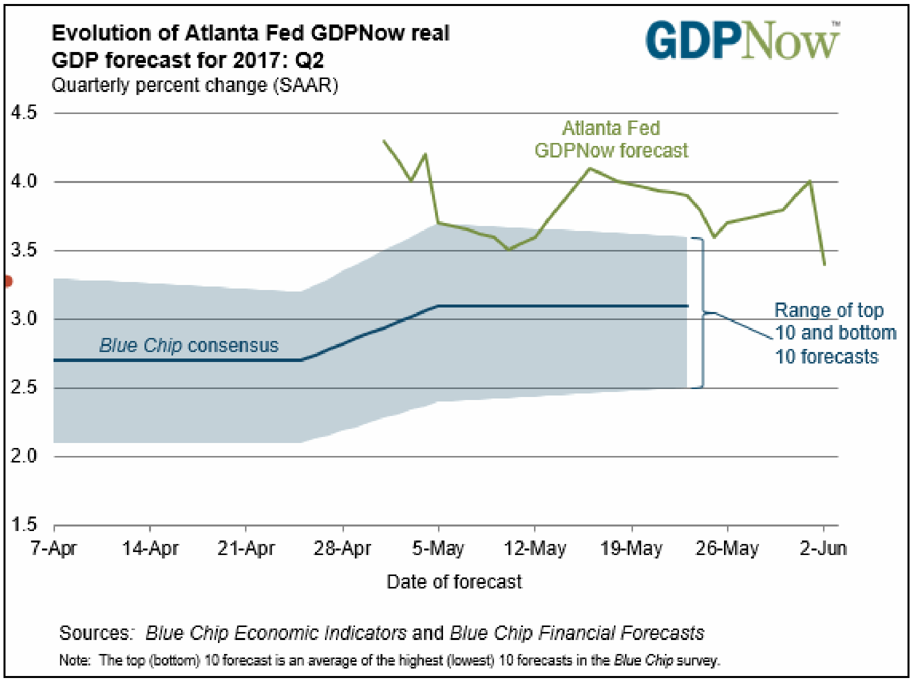
[1] *The Economist* has nicknamed her "Theresa Maybe."
[2] https://www.ft.com/content/dd033082-49e9-11e7-a3f4-c742b9791d43 (paywall)

prompted the recent harsh measures taken by the GCC. We suspect this will be a temporary event, but if the embargo evolves into a blockade, a military conflict could emerge. It will be interesting to see how Iran would manage such an event.

The Atlanta FRB GDPNow forecast is still indicating a strong Q2 GDP report.



(Source: Atlanta FRB)

The contributions to growth suggest that one percent of the growth is coming from inventory accumulation.

Atlanta Fed GDPNow forecasts for 2017: Q2, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
1-May	Initial nowcast	4.3	2.22	0.58	0.17	0.15	0.32	-0.01	-0.15	0.98
3-May	Auto sales, ISM Nonmanufacturing	4.0	2.07	0.51	0.17	0.16	0.32	-0.01	-0.15	0.97
4-May	Foreign trade, Manufacturing (M3)	4.2	2.08	0.47	0.17	0.16	0.32	-0.01	-0.15	1.14
5-May	Employment situation	3.7	1.85	0.34	0.17	0.13	0.23	0.02	-0.12	1.11
9-May	Wholesale trade	3.6	1.85	0.34	0.17	0.13	0.23	0.02	-0.12	0.99
10-May	Imp./Exp. prices, Treasury statement	3.5	1.85	0.34	0.17	0.13	0.23	-0.07	-0.11	0.98
12-May	Retail trade, Consumer Price Index	3.6	1.95	0.35	0.17	0.13	0.23	-0.07	-0.11	1.00
16-May	Housing starts, Industrial production	4.1	2.02	0.40	0.17	0.17	0.33	-0.07	-0.13	1.20
18-May	M3 Manufacturing revision	4.0	2.02	0.38	0.17	0.17	0.33	-0.07	-0.13	1.13
23-May	New home sales/costs	3.9	2.02	0.38	0.17	0.17	0.22	-0.07	-0.13	1.13
24-May	Existing-home sales	3.8	2.01	0.38	0.17	0.17	0.12	-0.07	-0.13	1.13
25-May	Advance economic indicators	3.6	2.01	0.39	0.17	0.17	0.12	-0.07	-0.18	0.94
26-May	GDP, Durable manufacturing	3.7	2.01	0.37	0.24	0.17	0.12	-0.06	-0.22	1.04
30-May	Pers. inc./outlays, NIPA Detail Tables	3.8	2.27	0.28	0.24	0.18	0.12	-0.06	-0.22	1.01
1-Jun	Construction spending, ISM Manuf.	4.0	2.45	0.37	0.24	0.10	0.17	-0.12	-0.24	1.02
2-Jun	Foreign trade, Employment	3.4	2.16	0.26	0.24	0.07	0.09	-0.17	-0.24	1.01
Maximum forecast of real GDP growth										
1-May	Initial nowcast	4.3	2.22	0.58	0.17	0.15	0.32	-0.01	-0.15	0.98
Minimum forecast of real GDP growth										
10-May	Imp./Exp. prices, Treasury statement	3.5	1.85	0.34	0.17	0.13	0.23	-0.07	-0.11	0.98

Note: CIPI is "change in private inventories." All numbers are percentage point contributions to GDP growth (SAAR). Table does not necessarily include all forecasts for the quarter; see tab "ContribHistory" in online excel file for entire history.

FEDERAL RESERVE BANK of ATLANTA

Consumption has remained rather steady and this forecast doesn't include the recent employment data. We are concerned about the softer residential investment and weak government spending but, overall, the data for Q2 suggests a good recovery, at least so far, and should lift H1 growth levels. At the same time, this solid data should support the FOMC in raising rates on the 14th. Fed funds futures put the odds of a rate hike at the next meeting at just above 90%. Interestingly, the odds of a hike in September remain around 35%, while we see a greater than 50% chance of a third hike this year at the December meeting.

U.S. Economic Releases

There were no new economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	JOLTS Job Openings	m/m	apr	5750	5743	**
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	Labor Cash Earnings	y/y	apr	0.5%	-0.4%	0.3%	**	Equity and bond neutral
	Real Cash Earnings	y/y	apr	0.0%	-0.8%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	apr	112.9	112.2		**	Equity and bond neutral
	BoP Current Account Balance	q/q	1q	-A$3.1 bn	-A$3.9 bn	-A$0.5 bn	**	Equity and bond neutral
	Net Exports of GDP	q/q	1q	-0.70	0.20	-0.40	**	Equity and bond neutral
New Zealand	Volume of All Buildings	q/q	1q	-3.5%	1.9%	0.3%	**	Equity and bond neutral
	ANZ Commodity Price	y/y	may	3.2%	-0.2%		**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	m/m	may	2.5%	2.3%	2.1%	**	Equity bullish, bond bearish
	Sentix Investor Confidence	m/m	jun	28.4	27.4	27.4	**	Equity and bond neutral
	Markit Eurozone Retail	m/m	may	52.0	52.7		**	Equity and bond neutral
Germany	Markit Germany Construction	m/m	may	55.3	54.6		**	Equity and bond neutral
	Markit Germany Retail PMI	m/m	may	55.0	56.2		**	Equity and bond neutral
UK	BRC Sales Like-For-Like	m/m	may	-0.4%	5.6%	-0.2%	**	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	jun	576.1 bn	576.0 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	jun	480.3 bn	489.3 bn		**	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Invesment	y/y	mar	3.9%	-3.1%	3.2%	**	Equity bullish, bond bearish
	Consumer Confidence Index	y/y	mar	86.8	83.8	84.6	**	Equity bullish, bond bearish
Canada	Bloomberg Nanos Confidence	m/m	jun	57.9	58.5		**	Equity and bond neutral
Brazil	Markit Brazil PMI Composite	m/m	may	50.4	50.4		**	Equity and bond neutral
	Markit Brazil PMI Services	m/m	may	50.3	49.2		**	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)	122	122	0	Up
3-mo T-bill yield (bps)	95	96	-1	Neutral
TED spread (bps)	28	26	2	Neutral
U.S. Libor/OIS spread (bps)	112	112	0	Up
10-yr T-note (%)	2.14	2.18	-0.04	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	32	32	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Down
yen	up			Down
pound	flat			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**		
RBA Cash Rate Target	1.5%	1.5%	1.5%	On forecast

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	$49.33	$49.47	-0.28%	Fears of oversupply
WTI	$47.26	$47.40	-0.30%	
Natural Gas	$3.01	$2.98	1.07%	
Crack Spread	$16.08	$16.10	-0.11%	
12-mo strip crack	$14.18	$14.20	-0.16%	
Ethanol rack	$1.68	$1.68	0.18%	
Metals				
Gold	$1,292.90	$1,279.80	1.02%	Market Uncertainty
Silver	$17.69	$17.55	0.83%	
Copper contract	$252.05	$255.75	-1.45%	
Grains				
Corn contract	$ 373.75	$ 373.00	0.20%	
Wheat contract	$ 433.50	$ 429.50	0.93%	
Soybeans contract	$ 925.00	$ 922.00	0.33%	
Shipping				
Baltic Dry Freight	821	830	-9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.5		
Gasoline (mb)		0.0		
Distillates (mb)		0.8		
Refinery run rates (%)		0.00%		

Weather

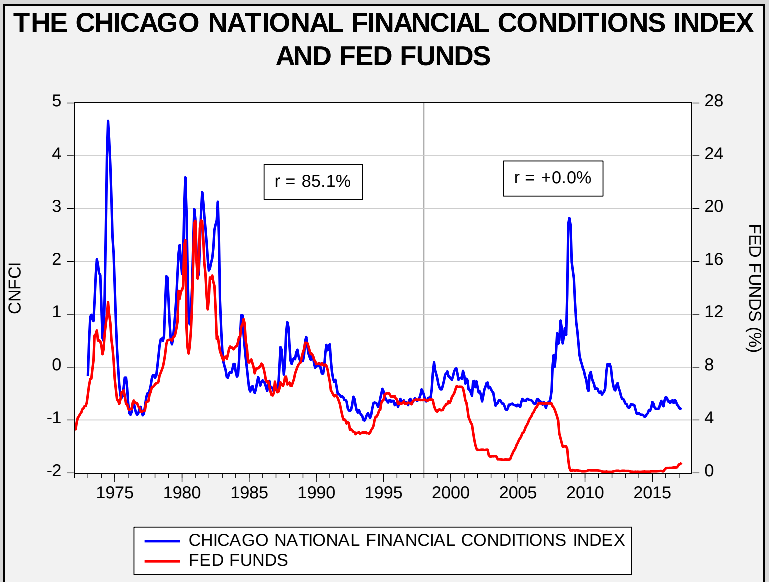
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the western region. Precipitation is expected for most of the northern region.

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.



Sources: Haver Analytics, FRED, CIM

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.

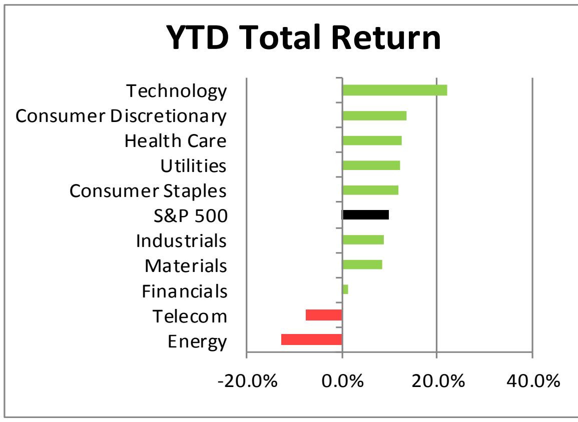
We believe there are two factors that changed this relationship. The first is policy transparency. Starting in the late 1980s, the Fed became increasingly transparent. For example, before 1988, the FOMC would meet but issue no statement about what it had decided to do. Investors and the financial system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

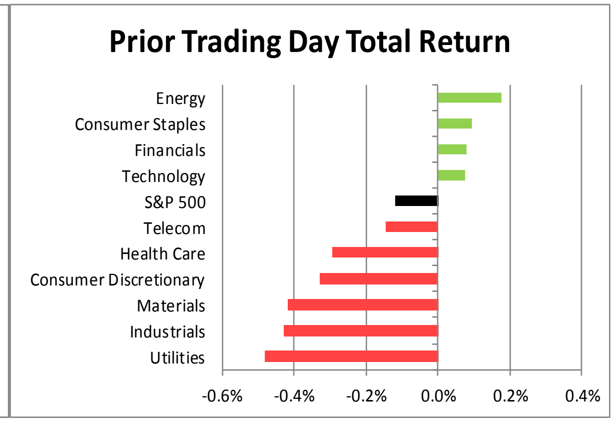
The second factor is financial system stability. From the Great Depression into the 1980s, policymakers put a high premium on system stability at the expense of efficiency. Bank failures were rare and there were a large number of rather small institutions. In addition, commercial banks were separated 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 6/5/2017 close)

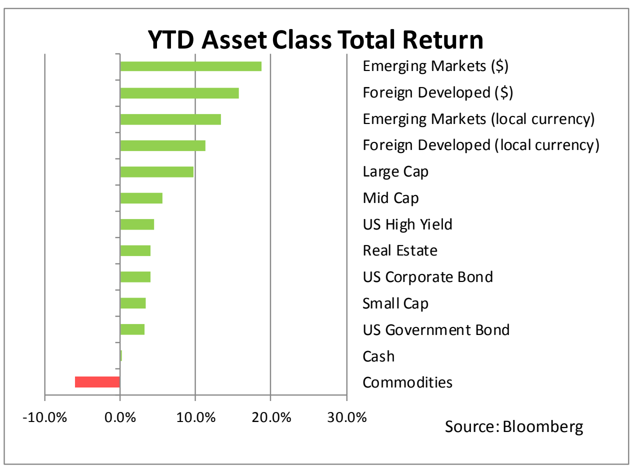




(Source: Bloomberg)

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 6/5/2017 close)

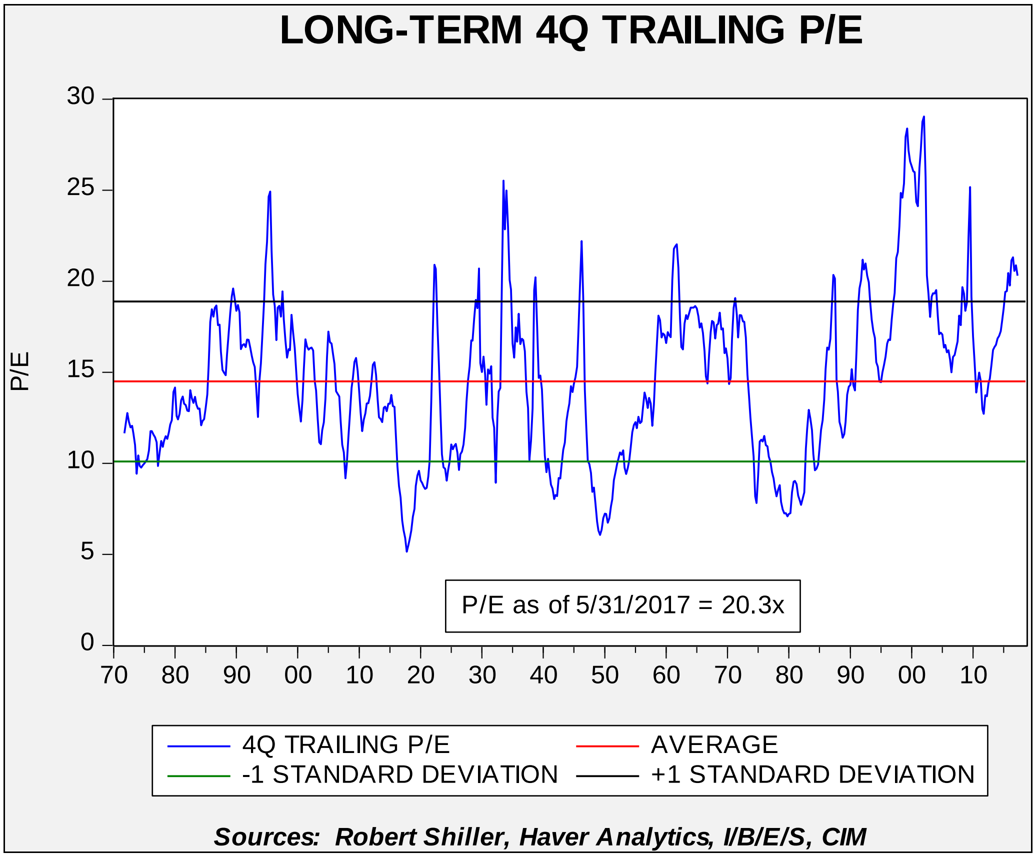


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.