Daily Comment

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

[Posted: May 11, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.8% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.3% and the Shenzhen index down 0.8%. U.S. equity index futures are signaling a lower open. With 451 companies having reported, the S&P 500 Q1 earnings stand at $30.70, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 73.2% of the companies reported earnings above forecast, while 20.4% reported earnings below forecast.

Media attention remains on the Comey firing. On this issue, there are three stories we view as notable this morning.

Deputy AG Rosenstein threatened to resign: The *WP*[1] is reporting that the deputy AG threatened to resign as the narrative emerging from the White House was that the president was simply following the recommendations of the DOJ. This highlights an emerging characteristic of this presidency. When things go well, the president takes full credit. When something goes wrong, an underling is blamed. It's a far cry from President Truman's "the buck stops here."[2] All presidents demand some degree of loyalty. The same is true of all leaders. An organization will struggle to perform its mission without some level of loyalty. However, it cannot be the primary virtue because it can lead to abuses; loyalty to the organization becomes an excuse for the end justifying the means.[3] President Trump appears to put great emphasis on loyalty and the decision to fire Comey is creating a narrative that the primary reason was concern that Comey was not loyal and could not be controlled by the White House.[4]

The optics of meeting with Russian officials looks like an "own goal": The White House did not allow the U.S. press to cover Trump's meeting with Russian Foreign Minister Lavrov and Russian Ambassador to the U.S. Sergei Kislyak. However, the Russian media apparently did get a photo of the president and the two Russian officials. Under normal circumstances, such meetings are not news—presidents meet with foreign officials as part of the job. However, the timing of this one is unfortunate.

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[1] https://www.washingtonpost.com/politics/how-trumps-anger-and-impatience-prompted-him-to-fire-the-fbi-director/2017/05/10/d9642334-359c-11e7-b373-418f6849a004_story.html?utm_campaign=newsletter_axiosam&utm_medium=email&utm_source=newsletter&utm_term=.64858ef5cc41

[2] https://qph.ec.quoracdn.net/main-qimg-edc462fee894f545efa2db00e65b86c9-c

[3] One of the best works on balancing loyalty in an organization comes from Herbert Simon. See: Simon, H.A. (1945). *Administrative Behavior*. New York, NY: The Free Press.

[4] https://www.nytimes.com/2017/05/10/us/politics/how-trump-decided-to-fire-james-comey.html?_r=0

(Source: AP via the Russian Foreign Ministry)

Polls are slipping: Quinnipiac released a poll[5] yesterday showing rising disfavor with the president. This isn't exactly news in that Trump hasn't usually polled all that well. However, one of the characteristics of the Quinnipiac polls is that they ask the same questions over a number of weeks so one can observe trends. Here are a few interesting observations. In handling the job as president, "strongly disapprove" has moved from 40% to 51% since late January. The "favorable/unfavorable" responses have seen favorable deteriorate from 44% in late November to 35% now and unfavorable rise from 46% to 58%. The "honest/dishonest" responses have dropped honest from 42% to 33% (November to now), while dishonest has risen from 52% to 61%. On the question of leadership as "good/bad," good has declined from 56% to 41% (November to now), and bad has risen 38% to 56%. Perhaps the most troubling were the responses to whether "Donald Trump cares about Americans"; yes has fallen from 51% to 38% (November to now), while no has risen from 45% to 59%. Why does this matter? The ability to get legislation through Congress needs presidential leadership. If members of Congress begin to view the president as a political liability, it becomes difficult to move legislation through Congress. President Obama faced similar issues at the midterms of 2014; Democrat candidates didn't want him campaigning with them.[6] It's also noteworthy that the Obama administration was unable to move major legislation through Congress after 2014 in part due to his unpopularity. ***The more unpopular Trump becomes, the quicker his political capital will be depleted.*** That means tax reform, infrastructure spending, etc. will not move forward.

Meanwhile, the Fed appears on a path toward at least two more rate hikes this year. Boston Fed President Rosengren, a reliable dove, indicated yesterday that he ***sees three more hikes this year***.

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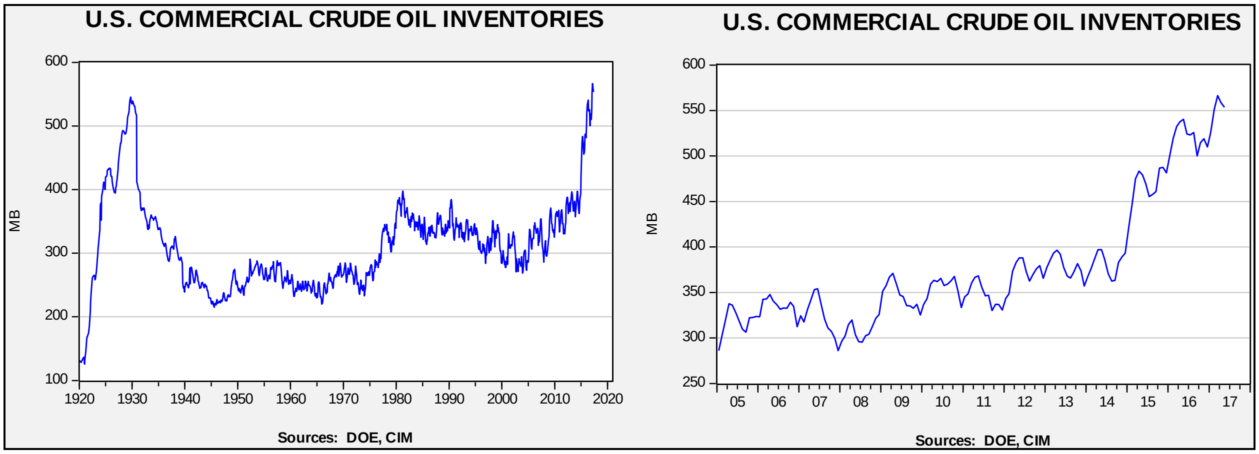
[5] https://poll.qu.edu/national/release-detail?ReleaseID=2456
[6] http://time.com/3507165/alison-grimes-barack-obama-midterm-elections/

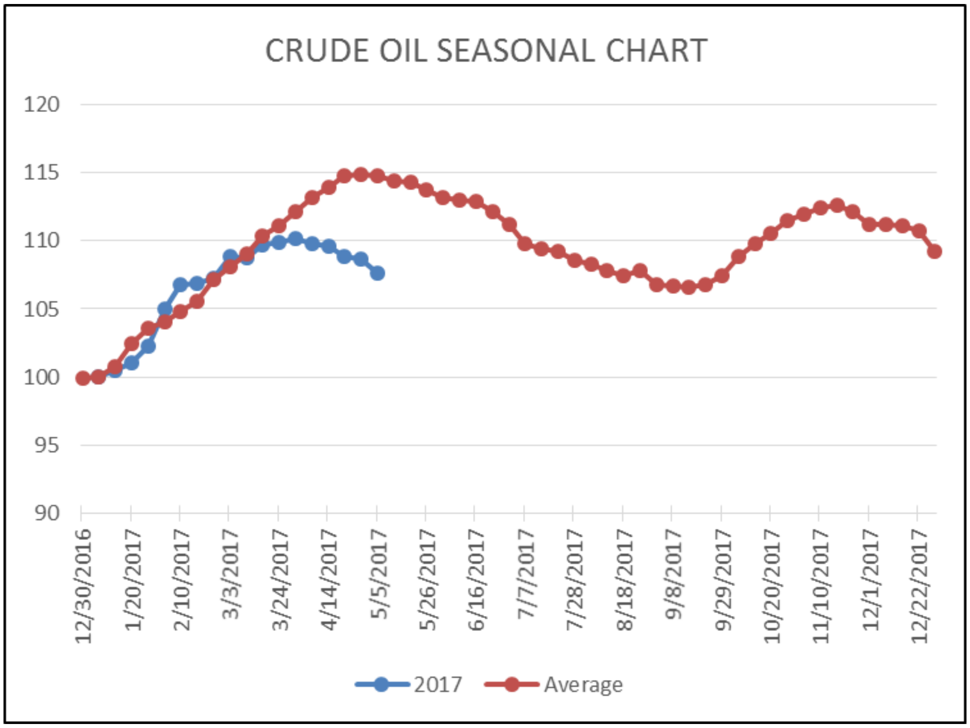
The financial markets haven't discounted tightening of this magnitude so this could become a risk factor as the year wears on.

U.S. crude oil inventories fell 5.3 mb compared to market expectations of a 2.2 mb draw.

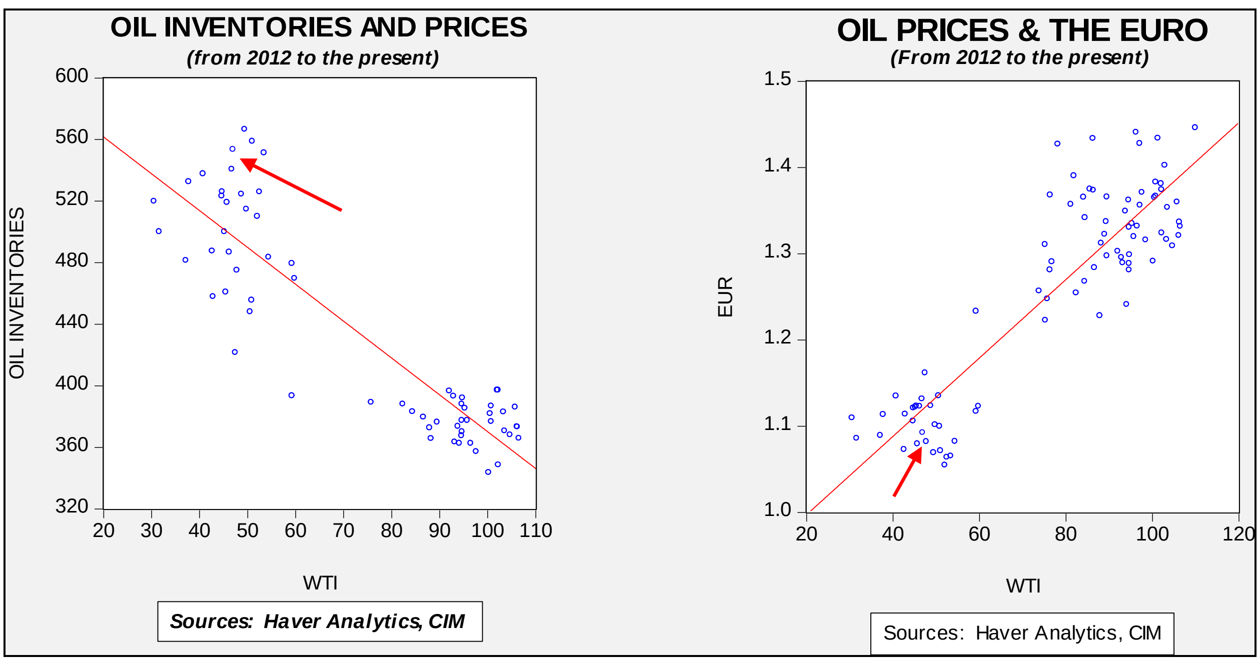


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but the seasonal withdrawal phase has begun. We also note that, as part of an Obama era agreement, there was a 0.5 mb sale of oil out of the Strategic Petroleum Reserve. This was 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 5.8 mb, which is even more below expectations.

As the seasonal chart below shows, inventories usually are at their seasonal peak and begin falling about now. This year, the seasonal decline has started early. Although inventories remain high, this seasonal level is consistent with July, meaning that we may be on the way to an easing of the inventory overhang. Last year, we saw a roughly 45 mb draw from the April peak. Assuming a similar drop from this year's peak of 566.5 mb at the end of March, we will end up at 520 mb by late September.



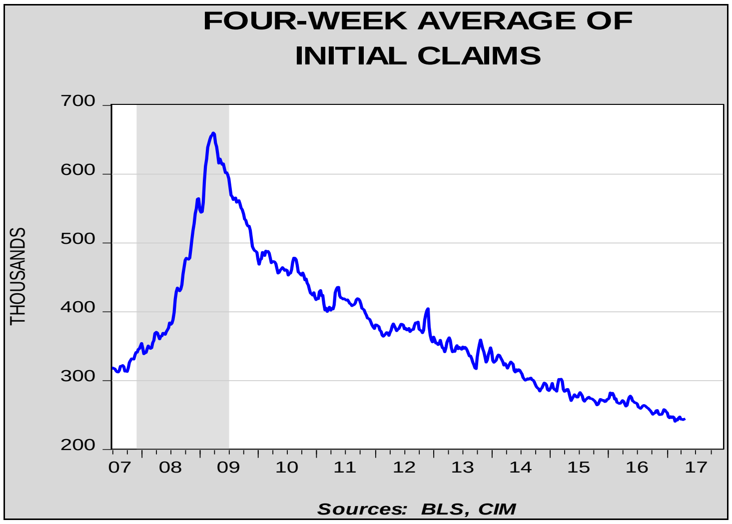
(Source: DOE, CIM)



Based on inventories alone, oil prices are overvalued with the fair value price of $33.71. Meanwhile, the EUR/WTI model generates a fair value of $46.04. Together (which is a more sound methodology), fair value is $42.04, meaning that current prices are above fair value but the deviation has been steadily closing in recent weeks. We note that OPEC looks like it will keep production cuts in place into next year, which probably keeps oil in a range of $55 to $45, basis WTI.

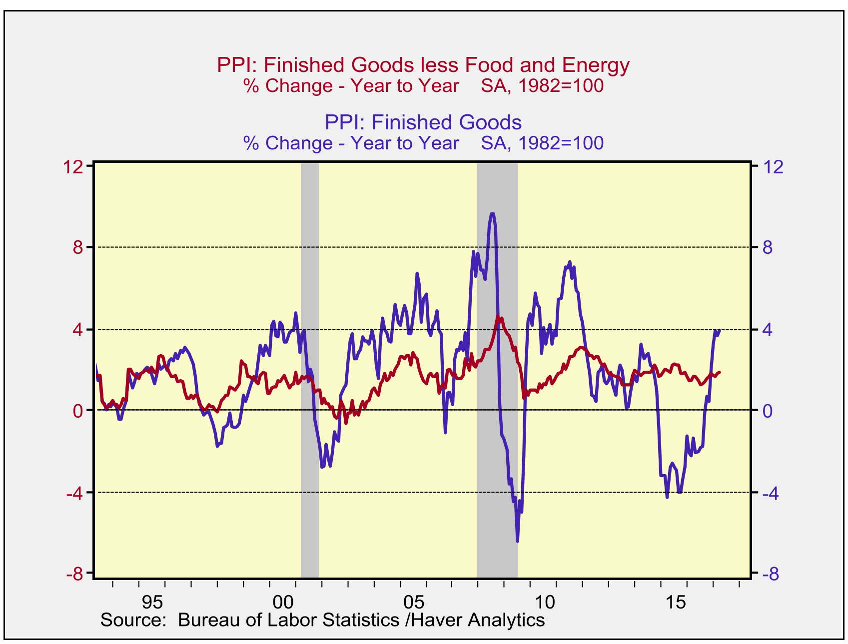
U.S. Economic Releases

Initial jobless claims came in below expectations at 236k compared to the forecast of 245k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 243.0k to 243.5k.

PPI final demand came in above expectations, rising 0.6% from the prior month compared to the forecast of 0.2%. Core PPI remained rose 0.4% compared to the forecast rise of 0.2% from the prior month.



The chart above shows the relationship between PPI final demand and core PPI. Annually, the headline prices rose 2.5%, while core PPI rose 1.9%. Core PPI remains stagnant at around 2.0% for the past decade. This may suggest that suppliers are not facing any inflationary pressures. This could be attributed to increased competition among intermediaries; dollar strength probably plays a role as well.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	may		50.9	**
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	BoP Current Account Balance	m/m	mar	2.9077 tn	2.8136 tn	2.5930 tn	**	Equity bullish, bond bearish
	Trade Balance	m/m	mar	0.8655 tn	1.0768 tn	0.8550 tn	**	Equity and bond neutral
	Bank Lending incl Trusts	m/m	apr	3.0%	3.0%		**	Equity and bond neutral
	Bank Lending ex- Trusts	m/m	apr	3.0%	3.0%		**	Equity and bond neutral
	Tokyo Avg Office Vacancies	m/m	mar	3.39	3.60		**	Equity and bond neutral
	Bankruptcies	y/y	apr	-2.2%	5.4%		**	Equity and bond neutral
New Zealand	Food Prices	m/m	apr	-0.8%	-0.3%		**	Equity and bond neutral
EUROPE								
Germany	Wholesale Price Index	m/m	apr	0.3%	0.0%		**	Equity bullish, bond bearish
UK	Industrial Production	m/m	mar	-0.5%	-0.7%	-0.4%	**	Equity bearish, bond bullish
	Manufacturing Production	m/m	mar	-0.6%	-0.1%	-0.2%	**	Equity bearish, bond bullish
	Construction Output	m/m	mar	-0.7%	-1.7%	0.4%	**	Equity bearish, bond bullish
	Trade Balance	y/y	apr	-4.900	-3.663	-3.000	**	Equity bearish, bond bullish
	NIESR GDP Estimate	y/y	apr	0.2%	0.5%	0.4%	**	Equity bearish, bond bullish
Switzerland	CPI	y/y	apr	0.4%	0.6%	0.5%	***	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	mar	-4.0%	-3.2%	-1.8%	**	Equity bearish, bond bullish
Mexico	Nominal Wages	m/m	apr	3.9%	4.7%		**	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)	118	118	0	Up
3-mo T-bill yield (bps)	87	88	-1	Neutral
TED spread (bps)	31	31	0	Neutral
U.S. Libor/OIS spread (bps)	104	104	0	Up
10-yr T-note (%)	2.39	2.41	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	31	31	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Down
yen	up			Down
pound	down			Neutral
franc	up			Neutral
Central Bank Action	**Current**	**Prior**		
RBNZ Official Cash Rate	1.750%	1.750%	1.750%	On forecast
Bank of England Bank Rate	0.250%	0.250%	0.250%	On forecast
BOE Asset Purchase Target	435 bn	435 bn	435 bn	On forecast
BOE Corporate Bond Target	10 bn	10 bn	10 bn	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	$50.86	$50.22	1.27%	Fall in US Inventories
WTI	$47.95	$47.33	1.31%	
Natural Gas	$3.31	$3.29	0.49%	
Crack Spread	$16.65	$16.43	1.29%	
12-mo strip crack	$13.84	$13.67	1.30%	
Ethanol rack	$1.63	$1.63	-0.12%	
Metals				
Gold	$1,223.75	$1,219.10	0.38%	
Silver	$16.35	$16.20	0.96%	
Copper contract	$253.70	$249.45	1.70%	
Grains				
Corn contract	$ 373.00	$ 373.75	-0.20%	
Wheat contract	$ 433.25	$ 431.75	0.35%	
Soybeans contract	$ 973.50	$ 970.25	0.33%	
Shipping				
Baltic Dry Freight	1005	1007	-2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.2	-2.0	-3.2	
Gasoline (mb)	-0.2	0.4	-0.5	
Distillates (mb)	-1.6	-0.8	-0.8	
Refinery run rates (%)	-1.80%	-0.30%	-1.5%	
Natural gas (bcf)		55.0		

Weather

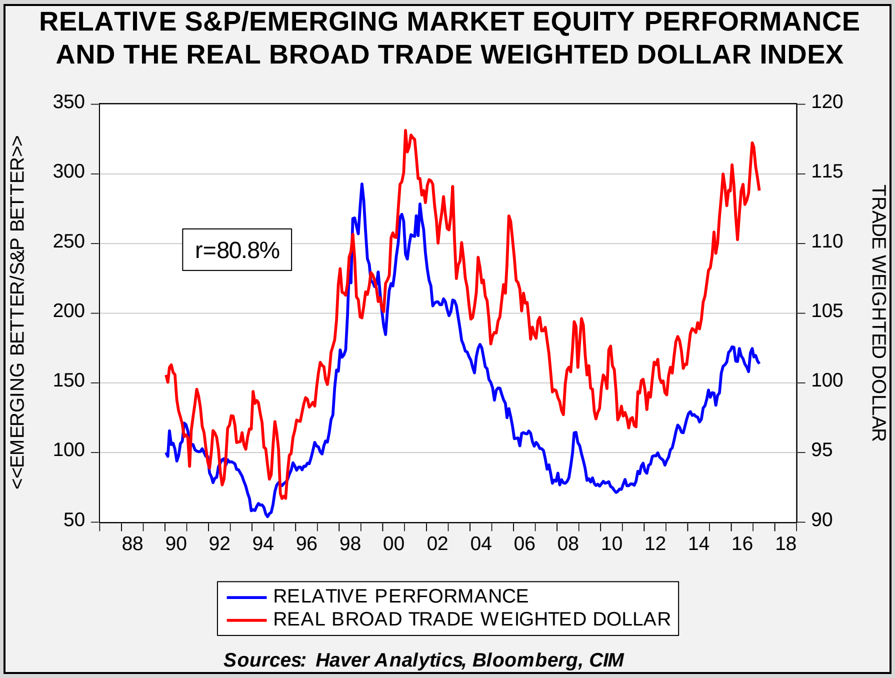
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the western region. Precipitation is expected for most of the western region.

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.

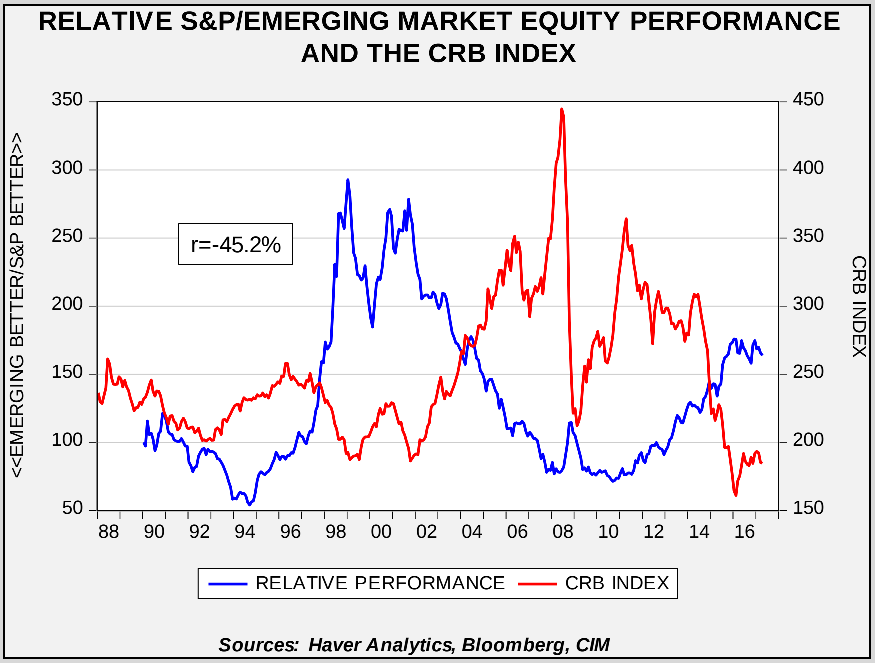
May 5, 2017

In our most recent quarterly asset allocation meetings, our analysis determined that emerging markets would not be added to the portfolios. Since this asset class has been this year's best performer, some explanation is in order. One of the primary reasons we have refrained from adding emerging markets is the dollar's strength.

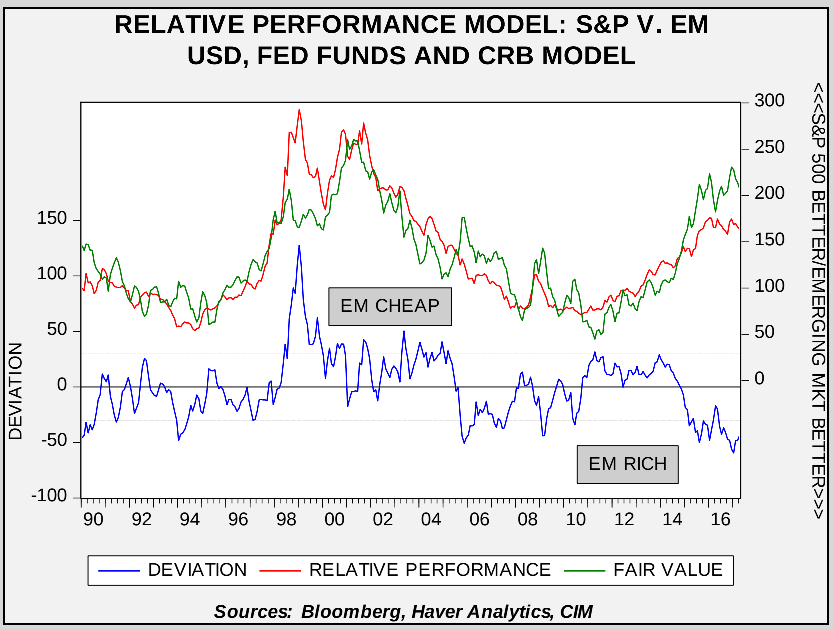


The blue line on this chart looks at the relative performance of emerging markets to the S&P 500. When the line is rising, the S&P is outperforming emerging markets. The red line is the JPM real dollar index. The two series are positively correlated at 80.8%, meaning that a stronger dollar tends to reflect the S&P 500 outperforming the emerging markets. This correlation has weakened modestly recently, but is still quite elevated.

The second reason we have been reluctant to add emerging markets is because the relative outperformance is occurring with weaker commodity prices.



Although the correlation isn't as strong as with the dollar, rising commodity prices tends to coincide with stronger relative emerging market performance. Although commodities are off their lows, they remain depressed. Thus, the current level of commodity prices seems to support weaker relative emerging market equities.

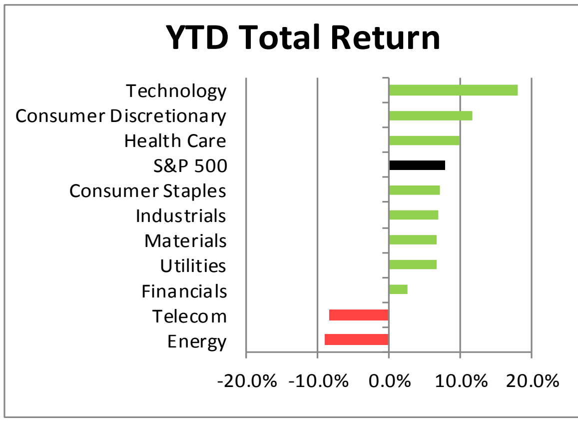


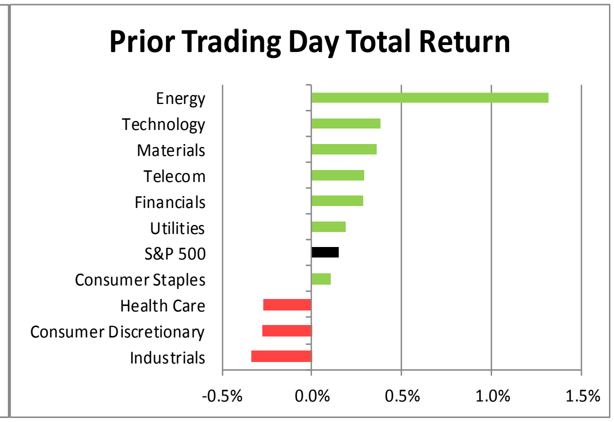
This chart shows a model of the emerging market/S&P 500 relative performance regressed against the JPM dollar index, the CRB index and fed funds (advanced six months). Currently, the model is suggesting that emerging market equities are overvalued relative to the S&P against these three independent variables.

Despite this overvaluation, it is possible that the strong relative performance of emerging markets is anticipating a recovery in commodities, a slowing of monetary policy tightening or a weaker dollar. The dollar lifted on expectations of tighter policy and if the FOMC does not raise rates as much as expected or if foreign central banks reverse their current easy policy stances, then the dollar could weaken. However, this model suggests that emerging market equities have already discounted that outcome. Thus, we are concerned that emerging market equities may be ahead of the fundamentals. If this is true, the current strong performance of emerging markets could stall even with dollar weakness, rising commodities or a stall in Fed tightening. And, if the dollar rises, commodities fall further or the FOMC raises rates according to the "dots plot," emerging markets could be quite vulnerable. For now, we believe the risks exceed the potential return from these levels.

Data Section

U.S. Equity Markets – (as of 5/10/2017 close)

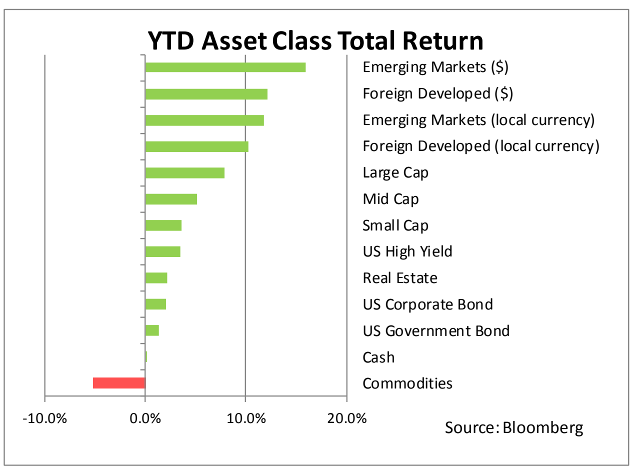




(Source: Bloomberg)

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 5/10/2017 close)

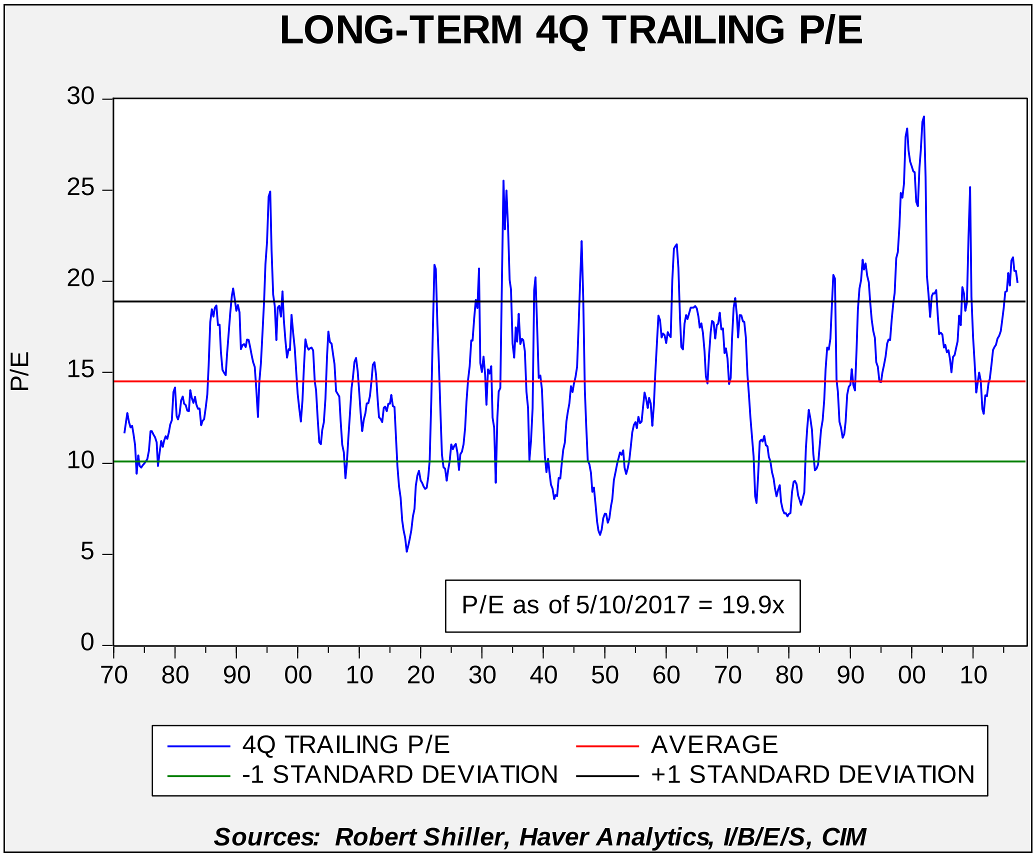


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 11, 2017



Based on our methodology,[7] the current P/E is 19.9x, down 0.1x from last week. The decline in the multiple has mostly come from the continued rise in operating earnings.

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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 two actual quarters (Q3 and Q4) and two estimates (Q1 and 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.