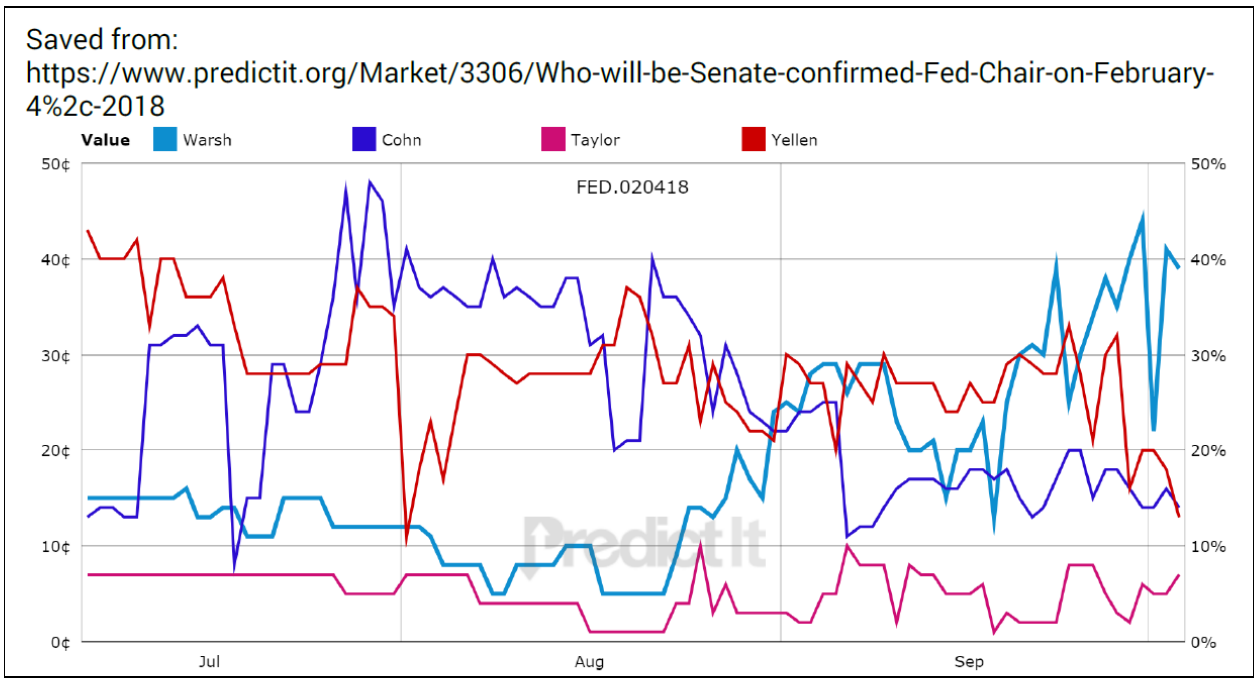
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 4, 2017—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were closed due to National Day. U.S. equity index futures are signaling a lower open.

Financial markets are very quiet again this morning in front of the employment data on Friday. Here is what we are watching this morning:

Fed chair decision: President Trump has distilled a short list for replacing (or, perhaps, reappointing) the position of Fed chair. Below is what the prediction markets are signaling.



(Source: www.predictit.org)

Bettors are putting their money on Warsh. He does meet many of the assumed criteria of the president. He is a Republican with private sector experience. He is young and well connected, coming from the elite establishment, and has been a Fed governor. He is not an economist. It is the latter point that gives most analysts and Fed watchers pause. He hasn't written much, but what he has published has been skewered.[1] In his defense, Chair Bernanke did speak well of Warsh but mostly in his work as a liaison between various parties during the Great Financial

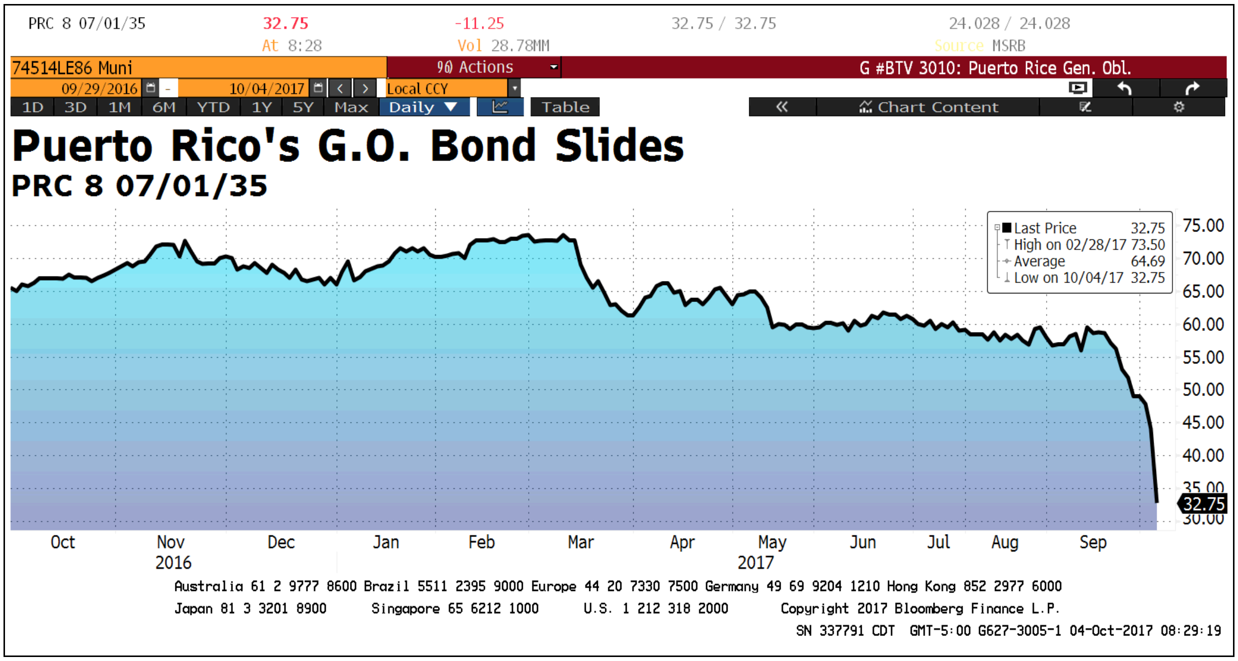
[1] http://economistsview.typepad.com/timduy/2017/01/was-kevin-warsh-really-a-fed-governor.html

Crisis. At the same time, Warsh might be the most compliant Fed chair Trump could appoint. Most of the other candidates would likely support Fed independence, but it is possible Warsh would be more inclined to please the White House. In watching the debate over who should be Fed chair and how that person would react in terms of policy, there have been persistent comments made that the combination of a new Fed chair and fiscal stimulation in the form of tax cuts could lead to a 1980s dollar bull market. That outcome is possible. However, there is another possibility that is almost never discussed, probably because most commentators were not even zygotes when that other outcome occurred, which is the combination of fiscal expansion and loose monetary policy, personified by Fed Chairs Arthur Burns and G. William Miller, that led to a significant dollar bear market. If Warsh is willing to be the most pliable chair, he could get Trump's nod. If Warsh doesn't win, we are leaning toward Jerome Powell, a current governor. He is a Republican but we would characterize him as a moderate on policy, sort of another Yellen.

The Iran deal: There are numerous reports this morning that Trump may not certify Iran's compliance to the nuclear deal. We do note that Gen. Mattis, his SOD, has indicated he believes Iran is complying. Part of the problem is that there has always been a lack of consensus about what the Iran deal means. On the surface, it is a limited pact that probably prevents Iran from developing a nuclear weapon—nothing more, or less. However, during the process of negotiating the deal, the Obama administration seemed to believe that it might be the first step in normalizing relations with Iran. This is hugely important.

Before the end of WWII, when President Roosevelt met with King Ibn Saud on the Bitter Lake aboard the U.S.S. *Quincy*, the U.S. established itself as the enforcer of stability in the Middle East. The U.S. has significant military assets in the region and has acted as "offshore rebalancer" to intervene in various conflicts to prevent any regional power from becoming dominant. This position ensured a free flow of oil from the region and denied the Soviets a warm water port. However, with the end of the Cold War and the onset of shale production, the U.S. has been reconsidering the balancer role. The whole concept of "pivoting" to the Far East required the U.S. to pivot away from the Middle East. Thus, if the U.S. isn't going to maintain that role, who should get it? The Obama administration seemed comfortable with giving that to Iran. Such a decision sent shock waves through the neo-conservative wing of the GOP who are focused on the security of Israel. And so, the election of Trump has led to a Sunni recovery in the region. At the same time, the Trump administration has essentially viewed the Iran nuclear deal with a broader mandate—that it should be designed to contain Iran and reduce its regional influence. Thus, rejecting the nuclear deal isn't just about the strict reading of the treaty; it's a reversal of unstated Obama-era policies to abandon the region to the tender mercies of the Persians. So, strictly speaking, Mattis is right…Iran is meeting its obligations. But to say that ignores the broader context, which is who will keep the Middle East stable?

Debt forgiveness for Puerto Rico? President Trump suggested that Puerto Rico's debt could be written off. Although we do expect a restructuring, the comments did surprise and Budget Director Mulvaney is trying to walk them back. We note that it seemed to have an impact on the island's debt prices. As the chart below shows, this representative GO bond has seen its prices fall by almost half since mid-September.

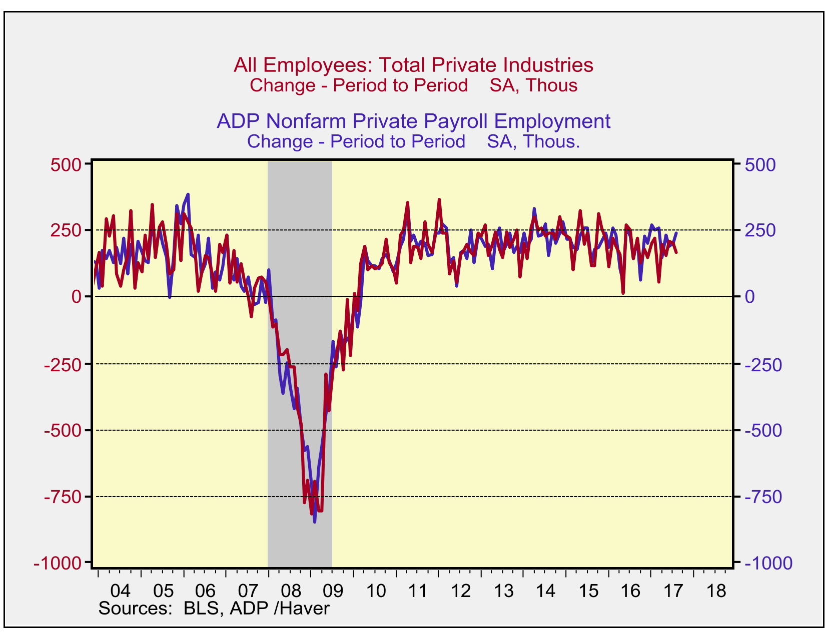


(Source: Bloomberg)

U.S. Economic Releases

MBA mortgage applications fell 0.4% from the prior week. Purchases rose 1.0%, while refinancing fell by 1.8% from the prior week. The 30-year fixed rate rose by 1 bp from 4.11% to 4.12%.

ADP employment change came in line with expectations at 135k. The prior report was revised downward from 237k to 228k.



The chart above shows the change in ADP employment and private payrolls. A low ADP employment change number signals a weak BLS non-farm payroll report for Friday.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Services PMI	m/m	sep	55.1	55.1	**
9:45	Markit US Composite PMI	m/m	sep		54.6	**
10:00	ISM Non-Manfacturing Composite	m/m	sep	55.5	55.3	**
Fed speakers or events						
15:15	Janet Yellen Appears before Senate Banking Panel	Chairman of Board of Governors of Federal Reserve				

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	Nikkei Japan PMI Services	y/y	sep	51.0	51.6		**	Equity and bond neutral
	Nikkei Japan PMI Composite	y/y	sep	51.7	51.9		**	Equity and bond neutral
India	Eight Infrastructure Industries	m/m	aug	4.9%	2.4%		**	Equity and bond neutral
Australia	CBA Australia PMI Services	m/m	sep	53.2	54.2		**	Equity and bond neutral
	CBA Australia PMI Composite	m/m	sep	53.1	54.1		**	Equity and bond neutral
	AiG Performance of Services Index	m/m	sep	52.1	53.0		**	Equity and bond neutral
New Zealand	ANZ Job Advertisments	m/m	sep	0.4%	1.0%		**	Equity and bond neutral
	ANZ Commodity Price	m/m	sep	0.8%	-0.8%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Services	m/m	sep	55.8	55.6	55.6	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	sep	56.7	56.7	56.7	**	Equity and bond neutral
	Retail Sales	y/y	sep	1.2%	2.6%	2.6%	**	Equity and bond neutral
Germany	Markit Germany Services PMI	m/m	sep	55.6	55.6	55.6	**	Equity and bond neutral
	Markit/ BME Germany Composite PMI	m/m	sep	57.7	57.8	57.8	**	Equity and bond neutral
France	Markit France Services PMI	m/m	sep	57.0	57.1	57.1	**	Equity and bond neutral
	Markit France Composite PMI	m/m	sep	57.1	57.2	57.2	**	Equity and bond neutral
Italy	Markit Italy Services PMI	m/m	sep	53.2	55.0	55.0	**	Equity bearish, bond bullish
	Markit Italy Composite PMI	m/m	sep	54.3	55.8	55.9	**	Equity bearish, bond bullish
UK	Markit UK Services PMI	m/m	sep	53.6	53.2	53.2	**	Equity and bond neutral
	Markit UK Composite PMI	m/m	sep	54.1	54.0	53.8	**	Equity and bond neutral
Russia	Markit Russia Services PMI	m/m	sep	55.2	54.2	54.3	**	Equity bullish, bond bearish
	Markit Russia Composite PMI	m/m	sep	54.8	54.2		**	Equity and bond neutral
AMERICAS								
Brazil	Industrial Production	y/y	aug	4.0%	2.5%	4.8%	***	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)	134	133	1	Up
3-mo T-bill yield (bps)	104	104	0	Neutral
TED spread (bps)	30	30	0	Neutral
U.S. Libor/OIS spread (bps)	120	120	0	Up
10-yr T-note (%)	2.30	2.32	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	36	36	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action		**Prior**	**Expected**	
RBI Repurchase Rate	6.000%	6.000%	6.000%	On forecast
RBI Reverse Repo Rate	5.750%	5.750%	5.750%	On forecast
RBI Cash Reserve Ratio	4.00%	4.00%	4.00%	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	$55.75	$56.00	-0.45%	Bearish API report
WTI	$50.23	$50.42	-0.38%	
Natural Gas	$2.91	$2.90	0.45%	
Crack Spread	$18.05	$17.92	0.69%	
12-mo strip crack	$19.16	$19.14	0.10%	
Ethanol rack	$1.63	$1.63	-0.18%	
Metals				
Gold	$1,281.39	$1,271.66	0.77%	Weaker dollar
Silver	$16.85	$16.64	1.30%	
Copper contract	$296.20	$296.35	-0.05%	
Grains				
Corn contract	$ 348.75	$ 349.50	-0.21%	
Wheat contract	$ 446.75	$ 448.00	-0.28%	
Soybeans contract	$ 955.50	$ 955.25	0.03%	
Shipping				
Baltic Dry Freight	1308	1328	-20	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.5		
Gasoline (mb)		1.0		
Distillates (mb)		-1.5		
Refinery run rates (%)		0.80%		
Natural gas (bcf)		55.0		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, with warmer to normal temps on the West Coast and in the eastern region. Precipitation is expected in the eastern region. There is a small tropical disturbance developing south of the Yucatan Peninsula; at this time, it is unclear as to whether it will develop into a tropical storm or hurricane.

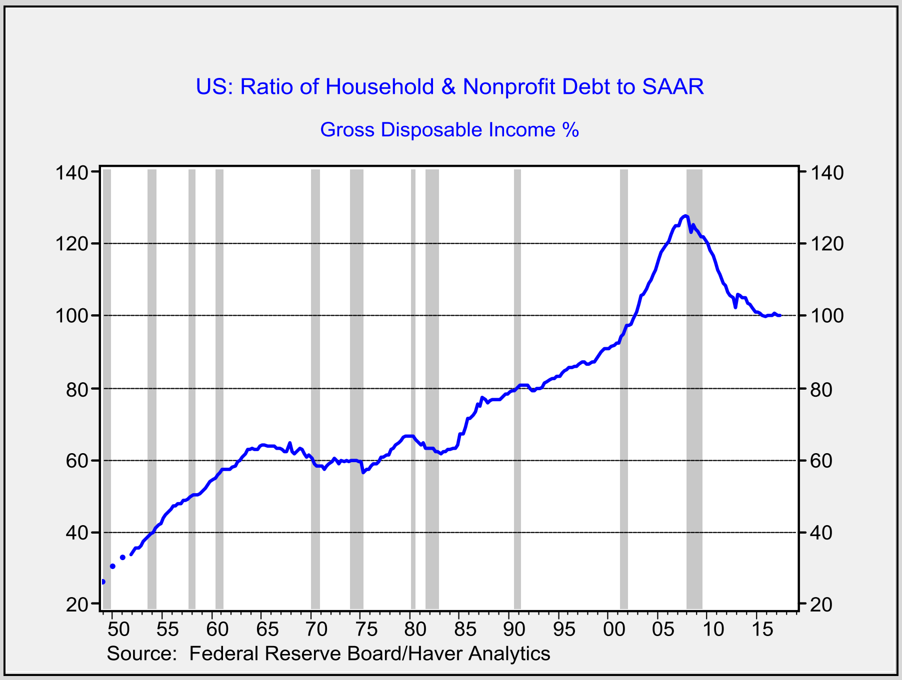
Asset Allocation Weekly Comment

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.

September 29, 2017

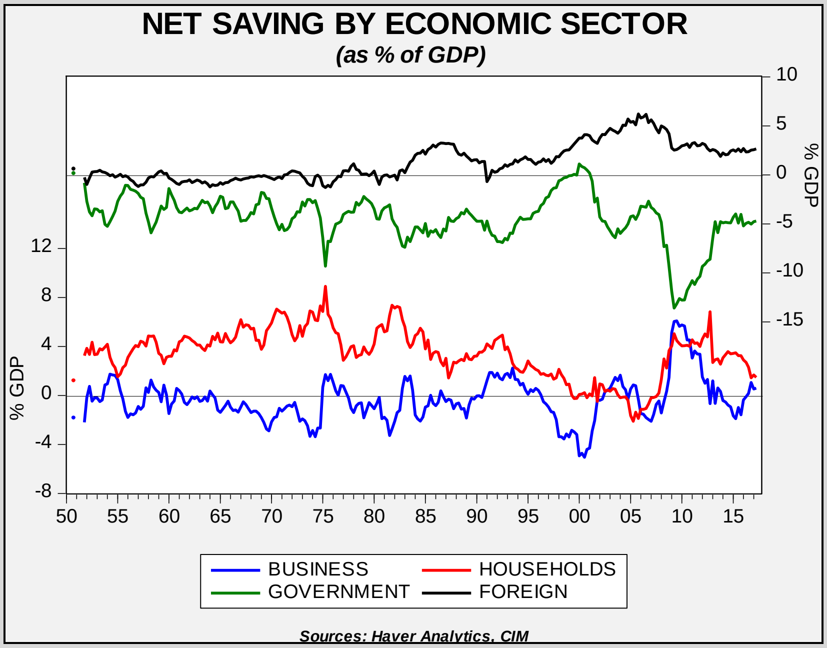
The Financial Accounts of the U.S. was released last week by the Federal Reserve. The report is a treasure trove of data about the economy. This report shows the flow of funds and the balance sheet of the American economy. Although there is much to look at, here are a few charts that show the underlying health of the economy and the financial system.

First, household debt relative to after-tax income has stabilized. Essentially, household deleveraging has come to an end but we are not seeing releveraging relative to income.



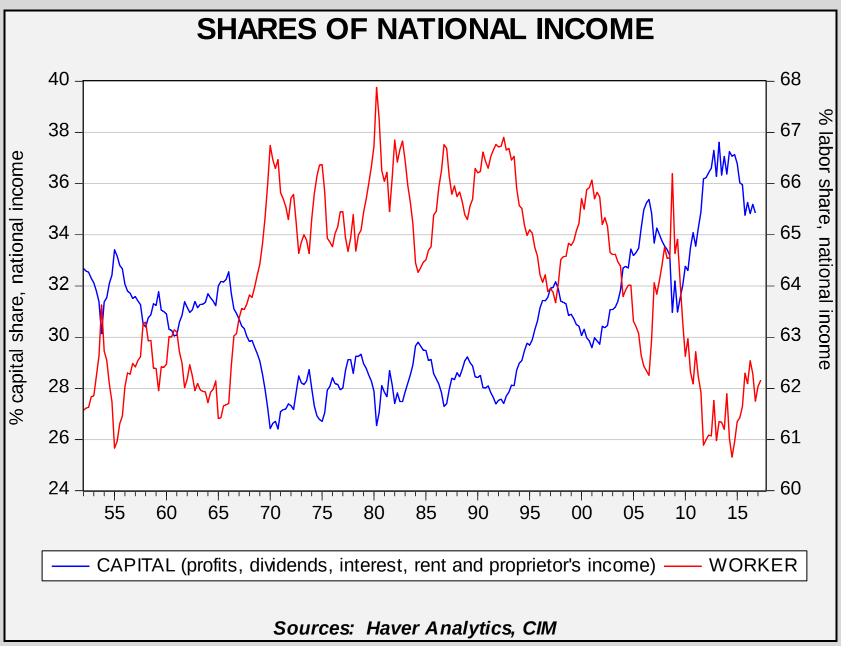
This is a "good news/bad news" situation. On the good side, the end of deleveraging will support stronger consumption. When households are trying to pay back debt, it acts as a dampener on economic growth. If households begin to add to debt relative to their incomes, growth accelerates.[2] The bad news is that the deleveraging has ended at historically high levels of debt. Although this level is probably manageable at current interest rates, spending may prove to be unusually sensitive to interest rates due to the current elevated levels of debt relative to income.

[2] Assuming, of course, that all the additional consumption would not be supplied by imports.



This chart is one we closely monitor; it is net saving by sector. Net saving in macroeconomics is much like a balance sheet—saving in one sector is always offset by dissaving in another and the sum of the four sectors always equals zero. What is most disturbing in the data is that household saving has declined and business saving has increased. In general, business saving funds investment; in a well-functioning economy, businesses should be dissavers. Rising business saving means less investment and the decline in household saving means that the household sector will become vulnerable to economic weakness.

The last chart of interest is the shares of national income. We divide national income into what is earned by labor compared to capital.

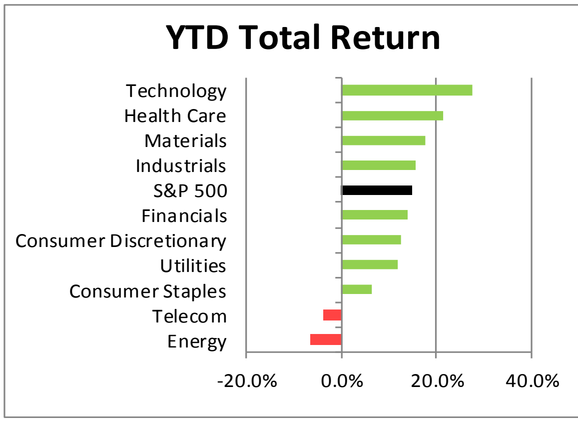


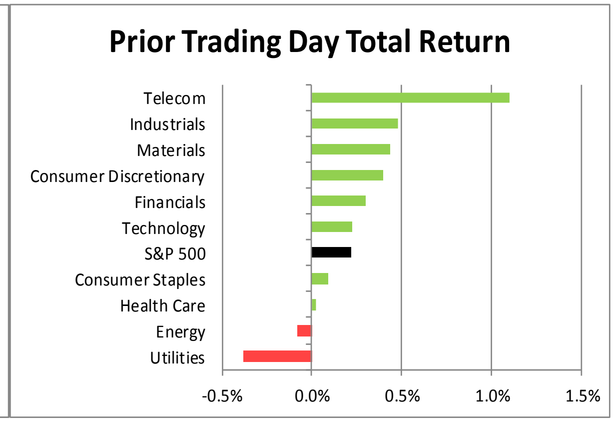
Since roughly 1990, the labor share has tended to decline and has made new lows in each business cycle. Capital income has performed in an opposite fashion. This growing divergence is part of the reason for the rise in populism. Even with the advanced age of the business cycle and low unemployment, the labor share remains low relative to history.

The Financial Accounts of the U.S. are showing that the expansion is getting a bit old. Although there is no evidence of a recession on the horizon, the weakness in household saving is a concern. The end of deleveraging does bode well for the economy in the short run but the continued high level of debt is a worry. Finally, the current political problems the country is facing will likely require a drop in the share of capital at some point. That will not be a favorable event for financial assets.

Data Section

U.S. Equity Markets – (as of 10/3/2017 close)

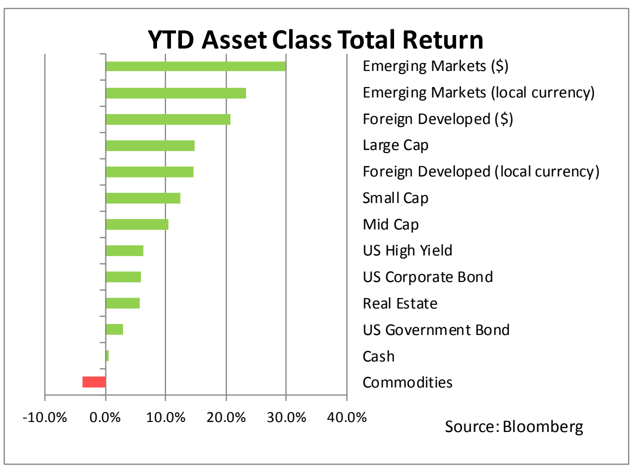




(Source: Bloomberg)

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 10/3/2017 close)

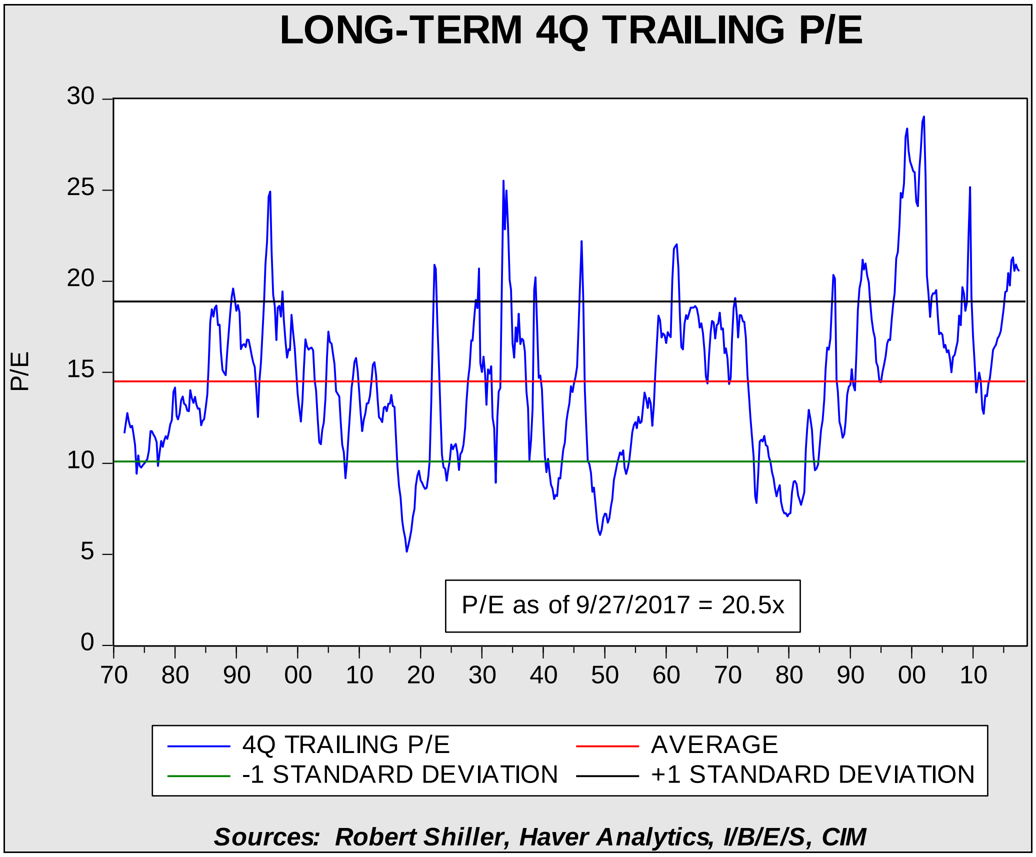


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 28, 2017



Based on our methodology,[3] the current P/E is 20.5x, 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 (Q4, Q1 and Q2) and one estimates (Q3). 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.