Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: September 11, 2017—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.8%. U.S. equity index futures are signaling a higher open.

Sixteen years ago, the U.S. suffered its worst terrorist attack in its history. The nation was changed in numerous ways, both large and small. Every time we fly commercial we are reminded that our safety was compromised. The country is still trying to unwind two wars related to the attack. On the other hand, the fears that the U.S. would suffer a subsequent similar attack have not come to fruition. This is due, in part, to America's security and intelligence apparatus. It is also due to the likely fact that 9/11 was something of a long shot by al Qaeda that worked much better than expected. In any case, we still remember those directly affected by the event and keep them in our prayers.

Risk-on has returned to the financial markets. Here is what we are watching today:

A quiet Korean Peninsula: Although there was great fear that Kim Jong-un would test another ICBM, nothing occurred over the weekend. It's possible that, despite Saturday being a major holiday in the DPRK, there are backchannel discussions going on and the lack of launch is a good faith effort. Or, it may mean Kim simply decided to enjoy the weekend. Meanwhile, the UNSC is working on some rather meek sanctions that probably won't matter much. We would not be surprised to see the U.S. apply unilateral financial sanctions on North Korea, but it won't be possible to put a direct oil embargo on North Korea because China won't cooperate. At the same time, the *NYT* reports that the trade imbalance between North Korea and China is widening.[1] It isn't clear what currency China uses when it settles trade with North Korea. Nobody wants the North Korean won and so we suspect North Korea simply builds arrears in CNY. Eventually, either trade will stop because firms will no longer want to accept IOUs from the DPRK or the Chinese government will swap the IOUs to pay the firms and settle the debt. Simply put, Chinese trade with North Korea could become more like aid, something we doubt China will continue with indefinitely.

TS Irma: Hurricane Irma, which has been downgraded to a tropical storm, is now at the bend of the Florida panhandle. Although it led to devastation in the Caribbean, the impact on Florida, though significant, has been less than anticipated. It is rapidly turning into a rain event for

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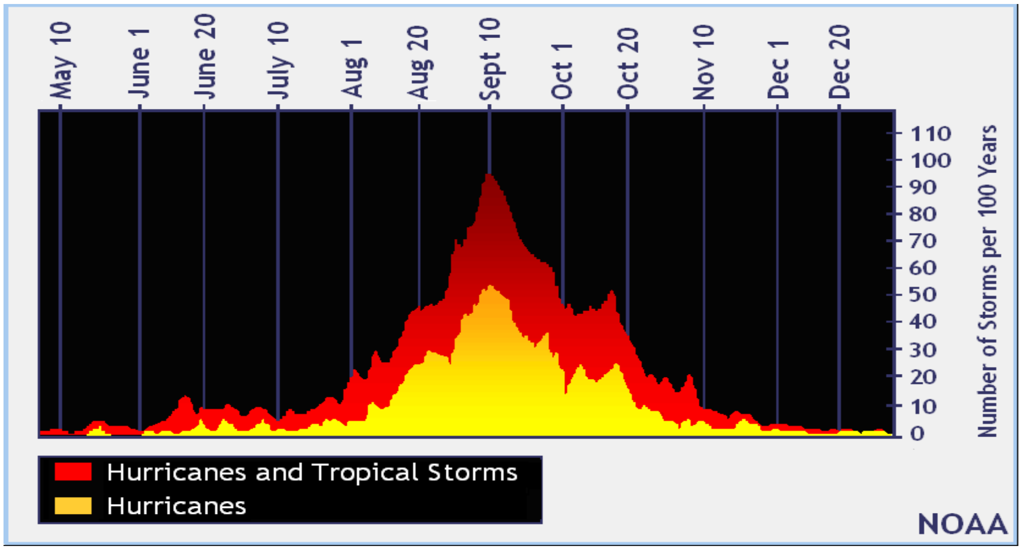
[1] https://www.nytimes.com/2017/09/08/business/north-korea-china-trade.html?emc=edit_tnt_20170908&nlid=18733852&tntemail0=y&utm_source=The+Sinocism+China+Newsletter&utm_campaign=9f544c05c1-EMAIL_CAMPAIGN_2017_09_10&utm_medium=email&utm_term=0_171f237867-9f544c05c1-29661833&mc_cid=9f544c05c1&mc_eid=e77499fecc

Georgia and Alabama. Hurricane Jose looks like it is going to circle itself in the Atlantic. We will continue to monitor the storm but, for now, it doesn't appear to be a threat to the U.S. On average, hurricane season peaks on Sept. 10th, so activity should steadily decline going forward.



China continues to clamp down on cryptocurrencies: China has shut down all virtual trading platforms as it takes steps to rein in cryptocurrencies. These electronic currencies are useful in skirting capital controls, something the Xi administration has been tightening over the past couple of years. Although XBT/USD rates remain elevated, the exchange rate is weakening, probably due to China's restrictions on the use of cryptocurrencies.

(Source: Bloomberg)

U.S. Economic Releases

There were no new economic releases or Fed events scheduled for today.

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	CPI	y/y	aug	1.8%	1.4%	1.6%	***	Equity bullish, bond bearish
	PPI	y/y	aug	6.3%	5.5%	5.7%	**	Equity bullish, bond bearish
Japan	Machine Orders	y/y	jul	8.0%	-1.9%	4.1%	**	Equity bullish, bond bearish
	Money Stock M2	m/m	aug	4.0%	4.0%	4.1%	**	Equity and bond neutral
	Money Stock M3	m/m	aug	4.0%	3.4%	3.4%	**	Equity and bond neutral
	Tertiary Industry Index	m/m	jul	0.1%	0.0%	0.1%	**	Equity and bond neutral
New Zealand	Card Spending Retail	m/m	aug	-0.2%	-0.5%	0.5%	*	Equity bearish, bond bullish
	Card Spending Total	m/m	aug	0.6%	-0.7%		*	Equity and bond neutral
EUROPE								
France	Bank of France Industry Sentiment	m/m	aug	104	105	106	**	Equity and bond neutral
Italy	Industrial Production	y/y	jul	4.4%	5.3%	3.7%	***	Equity bullish, bond bearish
Switzerland	Total Sight Deposits	m/m	sep	579.0 bn	579.2 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	sep	471.5 bn	468.5 bn		**	Equity and bond neutral
AMERICAS								
Canada	Unemployment Rate	m/m	aug	6.2%	6.3%	6.3%	***	Equity and bond neutral
	Capacity Utilization	m/m	2q	85.0%	83.3%	85.0%	**	Equity and bond neutral
	Net Change in Employment	m/m	aug	22.2k	10.9k	15.0k	**	Equity and bond neutral
	Participation Rate	m/m	aug	65.7	65.7		**	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)	131	132	-1	Up
3-mo T-bill yield (bps)	102	103	-1	Neutral
TED spread (bps)	29	29	0	Neutral
U.S. Libor/OIS spread (bps)	116	115	1	Up
10-yr T-note (%)	2.10	2.05	0.05	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	22	22	0	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Neutral
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	$53.63	$53.78	-0.28%	
WTI	$47.82	$47.48	0.72%	
Natural Gas	$2.91	$2.89	0.66%	
Crack Spread	$22.15	$23.29	-4.90%	
12-mo strip crack	$19.32	$19.90	-2.89%	
Ethanol rack	$1.69	$1.69	-0.01%	
Metals				
Gold	$1,336.19	$1,346.59	-0.77%	Stronger Dollar
Silver	$17.80	$17.97	-0.94%	
Copper contract	$307.65	$304.15	1.15%	
Grains				
Corn contract	$ 355.00	$ 356.75	-0.49%	
Wheat contract	$ 433.50	$ 437.75	-0.97%	
Soybeans contract	$ 964.00	$ 962.00	0.21%	
Shipping				
Baltic Dry Freight	1332	1296	36	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.6	2.5	2.1	
Gasoline (mb)	-3.2	-5.0	1.8	
Distillates (mb)	-1.4	-2.5	1.1	
Refinery run rates (%)	-16.90%	-7.00%	-9.90%	
Natural gas (bcf)	65.0	64.0	1.0	

Weather

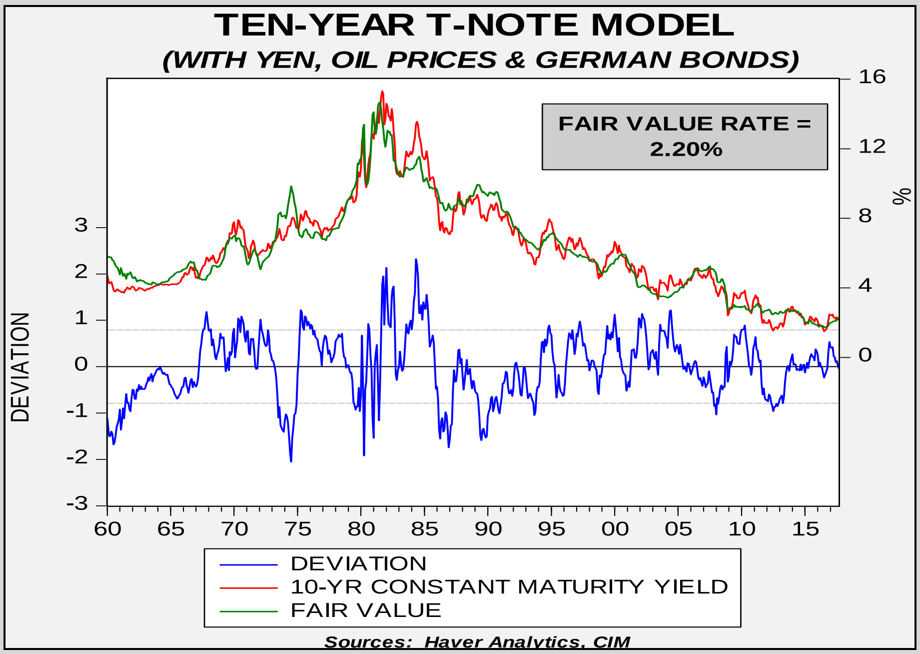
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler to normal temps in the northwestern region. Precipitation is expected for most of the country. Hurricane Irma is currently moving across the Florida peninsula and has been downgraded to a category 1. Hurricane Katia has dissipated, and Hurricane Jose has moved away from the Caribbean islands and into the Atlantic Ocean.

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 8, 2017

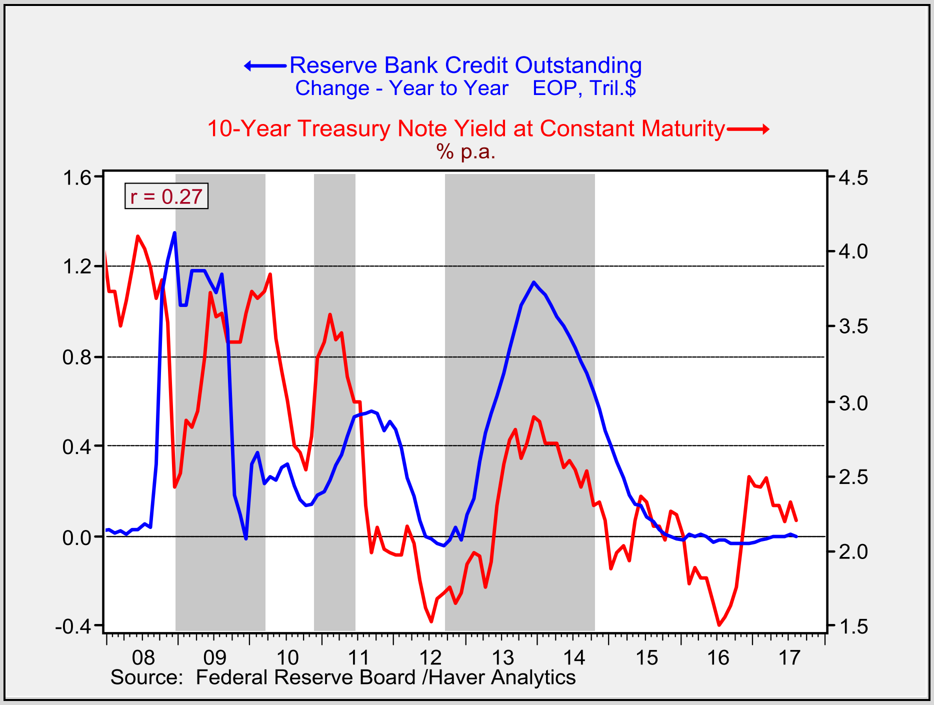
As the FOMC prepares to reduce its balance sheet, it's a good time to update our views on long-term interest rates. The chart below shows our current estimate of fair value for the 10-year Treasury.



The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The current yield is on fair value. Assuming the other variables remain steady, the current yield on the 10-year T-note is assuming the FOMC is going to hold rates steady for the foreseeable future.

Is this assumption on the policy rate reasonable? Currently, fed funds futures don't reach a 50% chance of a rate hike until the June 2018 meeting, and even by next December the odds of a rate increase are only 67%. We expect the Yellen FOMC to use balance sheet contraction to placate the hawks on the committee and thus avoid increases in fed funds until it becomes abundantly clear that inflation is rising.

One of the reasons for expanding the Fed's balance sheet was to lower long-term interest rates. In reality, the evidence of success is mixed.

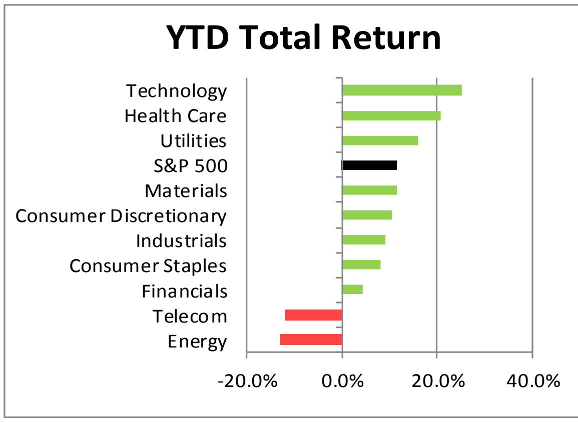


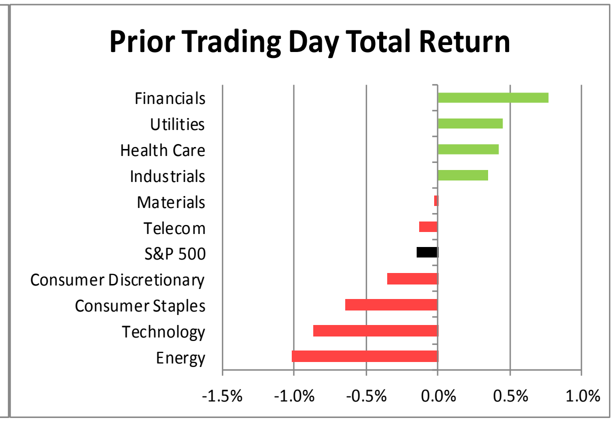
This chart shows the 10-year T-note yield with the yearly change in the balance sheet. The gray bars show official periods of QE. A zero reading indicates no change in the balance sheet compared to the prior year. Rates fell in QE1, at least initially, although they did rebound as the recession came to an end in mid-2009. However, rates generally rose in QE2 and QE3. Although the Fed was buying longer dated Treasuries, which reduced its supply, it appears the demand may have weakened on fears that QE would trigger inflation. Thus, a case could be made that reducing the balance sheet would have a similar effect and push rates lower.

Our base case is that reducing the balance sheet will have an asymmetric effect on markets; in other words, it won't have a significant impact on interest rates, unlike the apparent bearish impact that QE2 and QE3 had on long-term interest rates. This is because the FOMC is framing the reduction in the balance sheet as "normalization," whereas QE was designed to be stimulative. Thus, our analysis suggests that the most important impact of QE was psychological. However, it is possible that QE did more than just boost sentiment; if so, balance sheet normalization could be bullish for long-duration bonds.

Data Section

U.S. Equity Markets – (as of 9/8/2017 close)

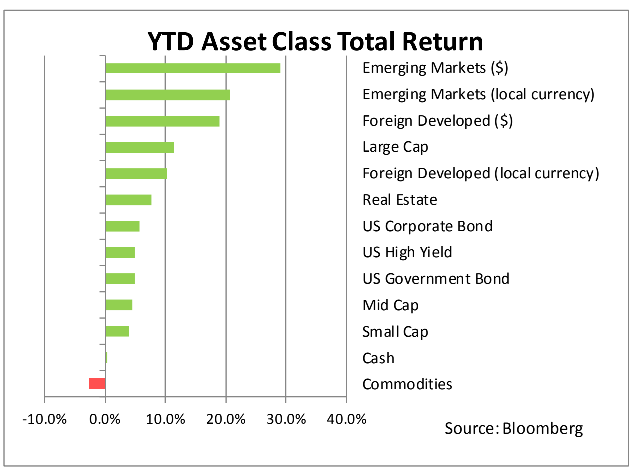




(Source: Bloomberg)

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 9/8/2017 close)

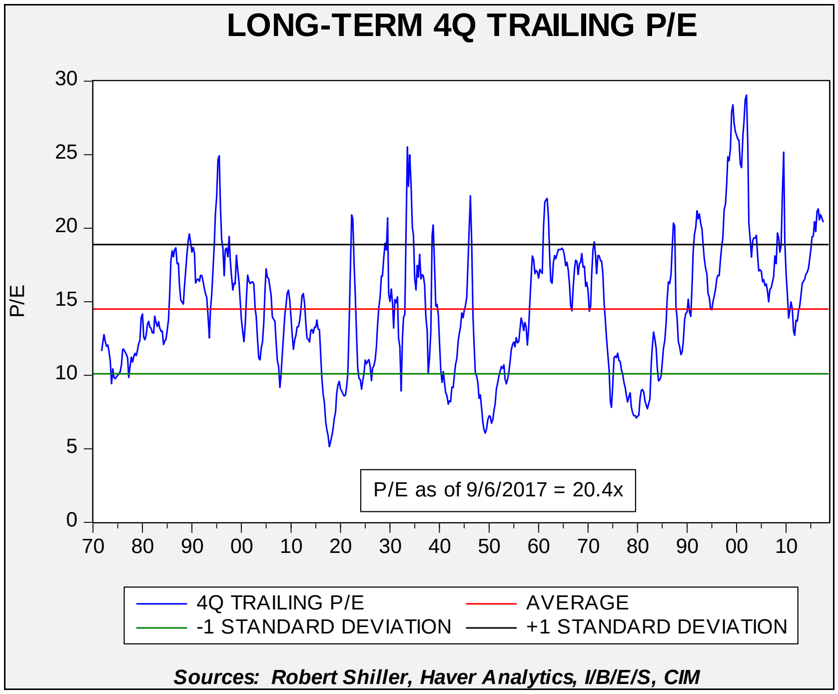


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 7, 2017



Based on our methodology,[2] the current P/E is 20.4x, unchanged from last week.

[2] 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.