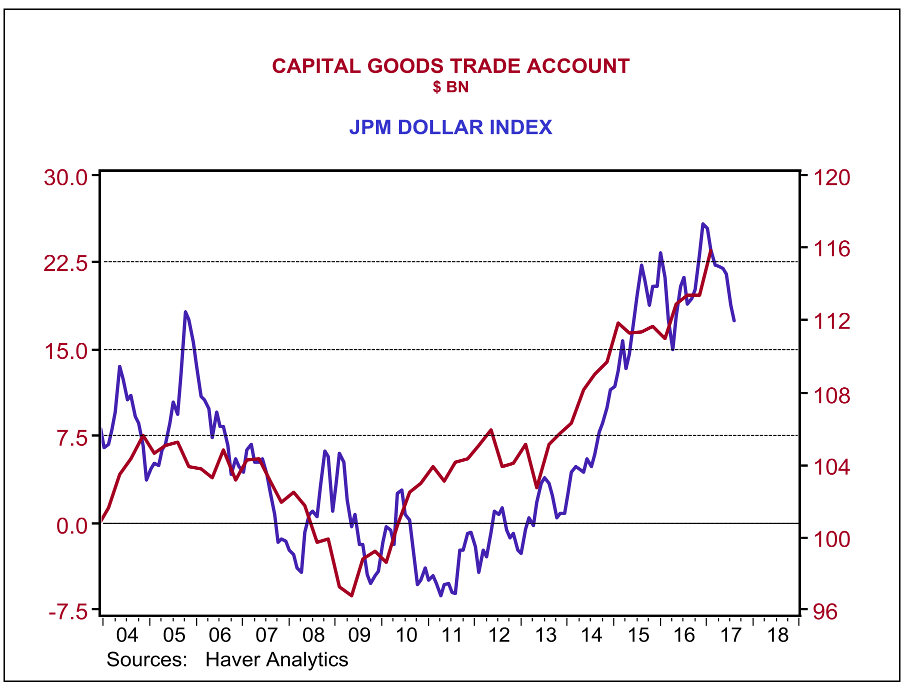
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: September 12, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a higher open.

Yesterday's market action was consistent with a sharp reversal in the recent risk trade. Amidst concerns about North Korea, the debt ceiling, trends in Washington, hurricane problems, etc., we saw Treasuries and gold rally, the dollar stumble and equities tread water. Those positions reversed yesterday with the dollar and equities rising strongly while the dollar dipped and Treasury yields rose. We are seeing some follow through overnight. It should be noted that renewed tensions with North Korea could bring a return of the aforementioned flight to safety trade. Here are some other items we are watching:

Capital goods balance and the dollar: We took a look at the capital goods trade balance; capital goods are goods designed for investment, e.g., machinery, rolling stock, etc. Over the past 12 years, dollar strength has led to a rising capital goods deficit.



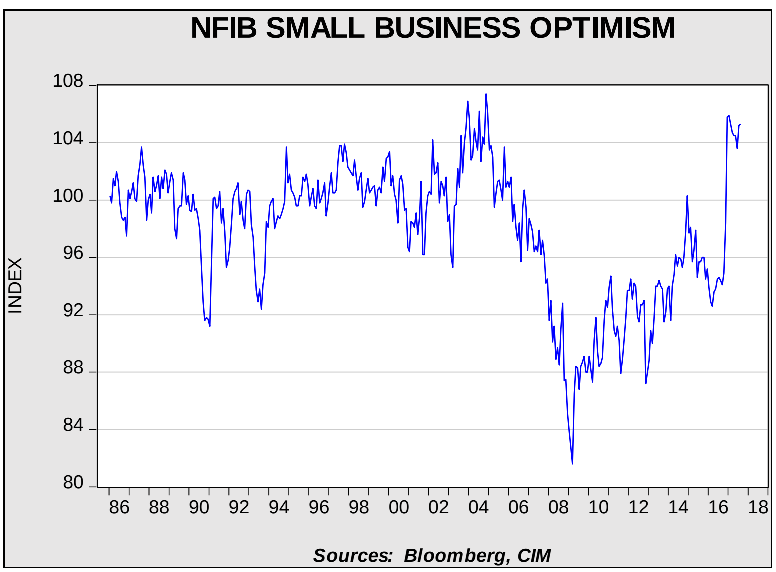
Recent dollar weakness may slow the rising deficit, but a significant narrowing of this deficit would likely require further weakness in the dollar.

North Korea: As expected, the UNSC did approve additional sanctions on North Korea. However, these new sanctions are much less than the U.S. wanted. Given that China and Russia have veto power on the Security Council, getting any significant sanctions through the U.N. will be difficult. We do note that most major Chinese banks announced they will not open new bank accounts with North Korean ties. This action might be signaling that the Xi regime does not want to give into U.S. demands via the U.N. but wants to show its displeasure with the Kim regime over its behavior.

La Diada de Catalunya (Day of Catalonia): Yesterday, pro-independence supporters celebrated Catalonia's national day by gathering in the streets of Barcelona in support of Catalonia's independence referendum scheduled for October 1st. Last week, the Catalan regional government passed through legislation that would allow its citizens to decide whether to leave or remain as a part of Spain. The Spanish government has denounced the referendum as illegal and is looking for ways to stop the vote from happening. An independent Catalonia could potentially cause headaches for the European Union as there are no guidelines on how to deal with a breakaway state. In the past, the European Union has sought to quash separatist movements by stating that any breakaway state would have to leave and reapply. Currently, polls shows that the remain camp is ahead 49.4% to 41.1%. Although the vote is non-binding, a vote to leave Spain would embolden the separatists as they await the outcome of Brexit negotiations. If the U.K. is able to strike a decent deal with the European Union upon its exit, then separatists will likely argue that Catalonia could negotiate a similar arrangement.

U.S. Economic Releases

The NFIB Small Business Optimism Index came in above expectations at 105.3 compared to the forecast of 104.8.



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	jul	6000	6163	**
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	Manpower Survey	q/q	4q	9.0%	5.0%		**	Equity and bond neutral
Japan	Manpower Survey	q/q	4q	23.0	24.0		**	Equity and bond neutral
India	Manpower Survey	q/q	4q	20.0%	15.0%		**	Equity and bond neutral
Australia	Manpower Survey	m/m	4q	11.0%	7.0%		**	Equity and bond neutral
	NAB Business Confidence	m/m	aug	15	15		**	Equity and bond neutral
	NAB Business Confidence	m/m	aug	5	12		**	Equity and bond neutral
	Credit Card Purchases	m/m	jul	A$35.6 bn	A$26.7 bn		**	Equity and bond neutral
	Credit Card Balances	m/m	jul	A$51.3 bn	A$52.4 bn		**	Equity and bond neutral
New Zealand	ANZ Truckometer Heavy	m/m	aug	6.2%	-5.5%		**	Equity and bond neutral
	Manpower Survey	q/q	4q	12.0%	12.0%		**	Equity and bond neutral
EUROPE								
France	Total Payrolls	q/q	2q	0.3%	0.3%	0.4%	**	Equity and bond neutral
	Private Sector Payrolls	q/q	2q	0.4%	0.5%		**	Equity and bond neutral
Italy	Unemployment Rate Quarterly	q/q	2q	11.2%	11.6%	11.3%	**	Equity bullish, bond bearish
UK	CPI	y/y	aug	2.9%	2.6%	2.8%	**	Equity bullish, bond bearish
	RPI	y/y	aug	3.9%	3.6%	3.7%	**	Equity bullish, bond bearish
	PPI Input	y/y	aug	7.6%	6.5%	7.3%	**	Equity bullish, bond bearish
	PPI Output	y/y	aug	3.4%	3.2%	3.1%	**	Equity bullish, bond bearish
	PPI Output Core	y/y	aug	2.5%	2.4%	2.3%	**	Equity bullish, bond bearish
	House Price Index	y/y	aug	5.1%	4.9%	4.8%	**	Equity bullish, bond bearish
Russia	GDP	y/y	2q	2.5%	2.5%	2.5%	**	Equity and bond neutral
AMERICAS								
Canada	Bloomber Nanos Confidence	m/m	aug	58.4	58.9		**	Equity and bond neutral
Mexico	Industrial Production	y/y	jul	-1.6%	-0.3%	-0.2%	**	Equity bearish, bond bullish
Brazil	Trade Balance Weekly	m/m	sep	$1190 mn	$187 mn		**	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	104	-2	Neutral
TED spread (bps)	29	28	1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.15	2.13	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	23	23	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	$53.98	$53.84	0.26%	Short covering
WTI	$48.13	$48.07	0.12%	
Natural Gas	$2.94	$2.95	-0.27%	
Crack Spread	$22.42	$22.09	1.46%	
12-mo strip crack	$19.62	$19.62	0.00%	
Ethanol rack	$1.70	$1.70	0.12%	
Metals				
Gold	$1,323.74	$1,327.54	-0.29%	Stronger Dollar
Silver	$17.75	$17.81	-0.32%	
Copper contract	$303.35	$306.60	-1.06%	
Grains				
Corn contract	$ 355.25	$ 357.50	-0.63%	
Wheat contract	$ 433.75	$ 434.75	-0.23%	
Soybeans contract	$ 957.75	$ 960.00	-0.23%	
Shipping				
Baltic Dry Freight	1355	1332	23	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		4.8		
Gasoline (mb)		-3.0		
Distillates (mb)		-2.4		
Refinery run rates (%)		4.65%		

Weather

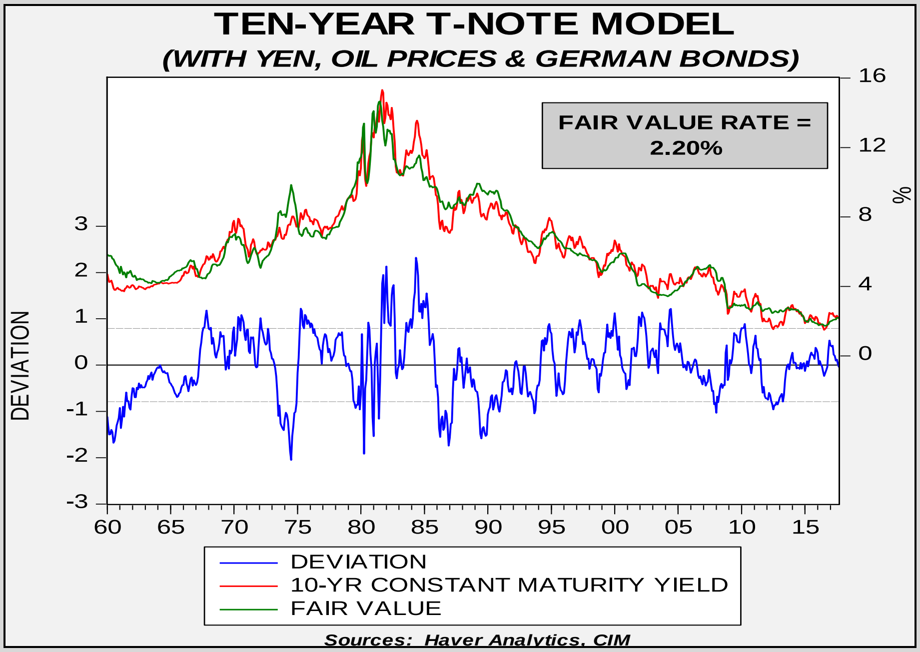
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler to normal temps in the northwestern region. Precipitation is expected for most of the country. Hurricane Irma has been downgraded to a post-tropical cyclone and is moving along the border of Georgia and Alabama. Hurricane Jose is still in the Atlantic Ocean and is expected to move toward the East Coast.

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

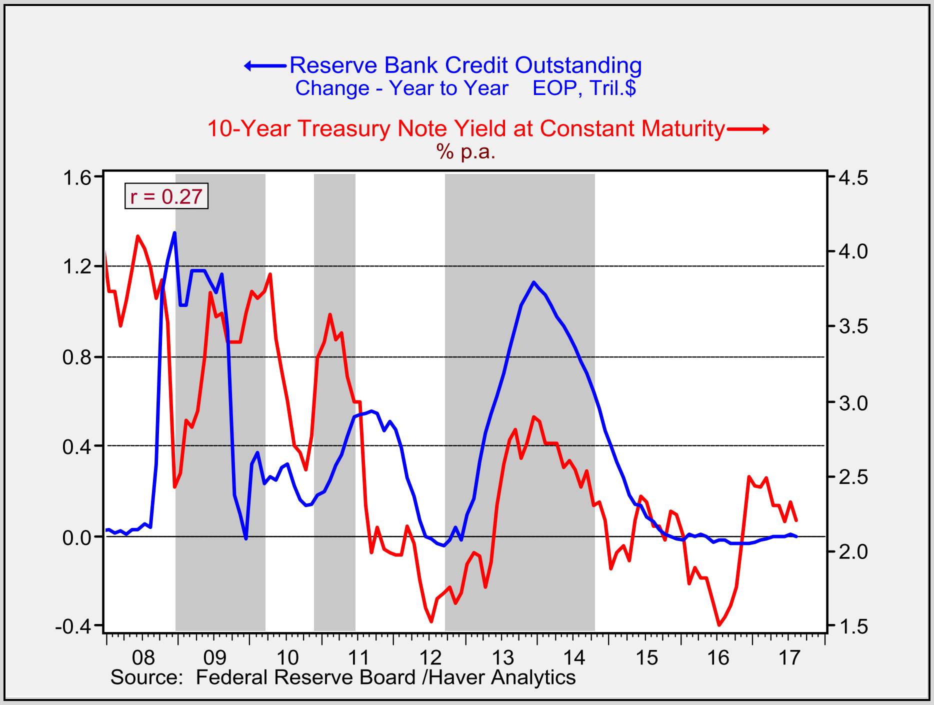
As the FOMC prepares to reduce its balance sheet, it's a good time to update our views on long-term interest rates. The chart below shows our current estimate of fair value for the 10-year Treasury.



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.

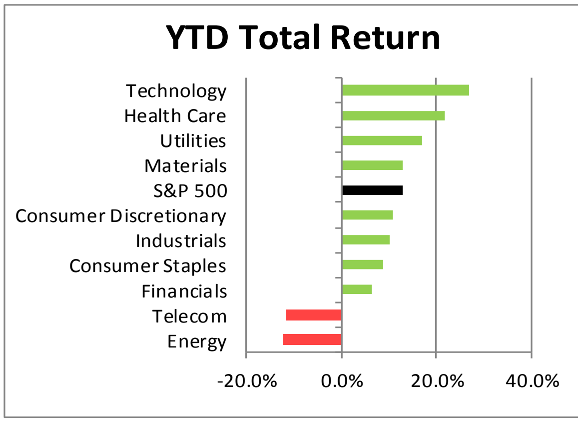


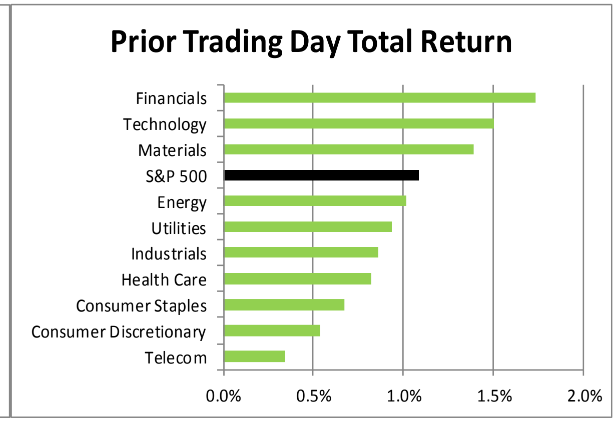
This chart shows the 10-year T-note yield with the yearly change in the balance sheet. The gray bars show official periods of QE. A zero reading indicates no change in the balance sheet compared to the prior year. Rates fell in QE1, at least initially, although they did rebound as the recession came 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 9/11/2017 close)

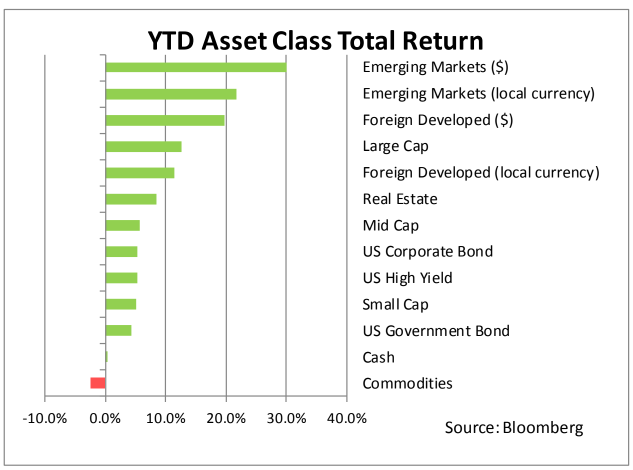




(Source: Bloomberg)

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 9/11/2017 close)

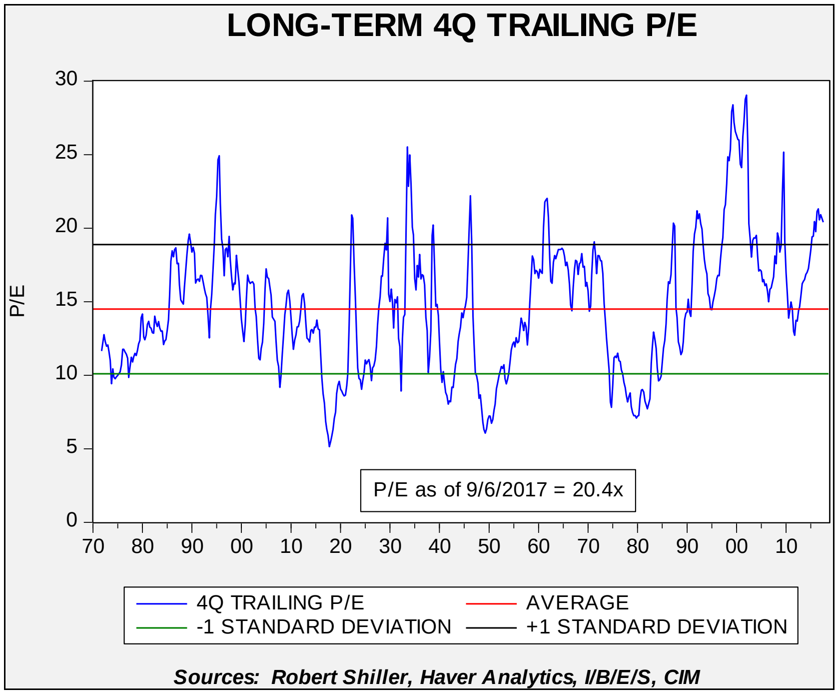


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] the current P/E is 20.4x, 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.

[1] 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.