Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: September 15, 2017—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a lower open.

Hawkish comments from the BOE continue to lift the GBP. Here is what we are watching today:

North Korea launches (yawn): As expected, North Korea launched a missile that passed over the Japanese island of Hokkaido. The missile appears to be an intermediate-range ballistic missile, not an ICBM. This missile's distance exceeded the recent one over Japan and shows North Korea can now threaten Guam. Market reaction thus far has been enlightening. The usual flight to safety trade is long JPY, Treasuries and gold. All are lower today. Geopolitical tensions exhibit a pattern in markets over time. Unless conditions escalate significantly, each event has less impact with repetition. We have seen this pattern with terrorist events and now we are seeing it with missile launches. It does not appear that Kim Jong-un is taking into account Western financial market behavior with his provocations but, if he did, this one would be rather disappointing.

Terrorist attack in the London Underground: There was a terrorist attack in a London subway platform this morning. It appears to be an improvised explosive device that injured 22 people, none seriously. There was no obvious market impact, although follow-on attacks after these events do occasionally occur. We will continue to monitor the news flow.

Venezuela suspends dollar auctions, prices oil in EUR: Venezuelan President Maduro has indicated that his nation, in a bid to dilute the impact of U.S. sanctions, will be invoicing oil in EUR going forward. Iraq did something similar under Saddam Hussein. This scheme probably won't work well for Caracas. The U.S. is a major trading partner with Venezuela and forcing U.S. firms to use EUR will simply discourage American buyers further. In addition, having EUR will increase the cost of servicing dollar-denominated debt, in that it will take another step in translation to adjust the debt. This move smacks of desperation.

The return of the Italian lira? Three of Italy's largest political parties are calling for a dual currency to trade alongside the EUR. The Five Star Movement, the Northern League and Silvio Berlusconi's Forza Italia have all proposed introducing a new currency following the election scheduled for next year. Italian lawmakers are using this as a threat to Brussels to allow Italy to violate the fiscal spending rules. In the last ECB press conference, Draghi shot down this idea, saying that there is only one legal tender in the Eurozone, the EUR. If Italy were to exit the Eurozone, it would be a serious blow to European unity, perhaps a bigger problem than Brexit.

Although we have been bullish the EUR, this position would need to be reevaluated if this parallel currency movement gains momentum.

Bitcoin tumbles: China has outlawed cryptocurrency exchanges and various financial leaders in the U.S. have said derogatory things about these currencies. Bitcoin, the predominant cryptocurrency, has fallen over 30% recently. The sharp decline is an indication of the ephemeral nature of cryptocurrencies.

(Source: Bloomberg)

Saudi news: There were a few items of interest emerging from Saudi Arabia. First, Sputnik (admittedly, not the most reliable of sources) is saying the kingdom is looking for a vendor to build nuclear reactors for electrical power. The report indicates that no U.S. firms will be asked to bid on the project (which seems odd, given the warm relations the president seems to have with the king). The worry, of course, is that this plan will eventually lead to the kingdom getting nuclear weapons. Second, the crown prince appears to be behind a series of arrests designed to stifle dissent. According to reports, a number of clerics have been arrested.[1] We have been hearing rumors that the royal family is working to curtail the influence of the clerical establishment in a bid to loosen Saudi Arabia's rather stodgy social scene. In addition to clerics, others have been arrested as well, including a member of the royal family. The *NYT* reports that

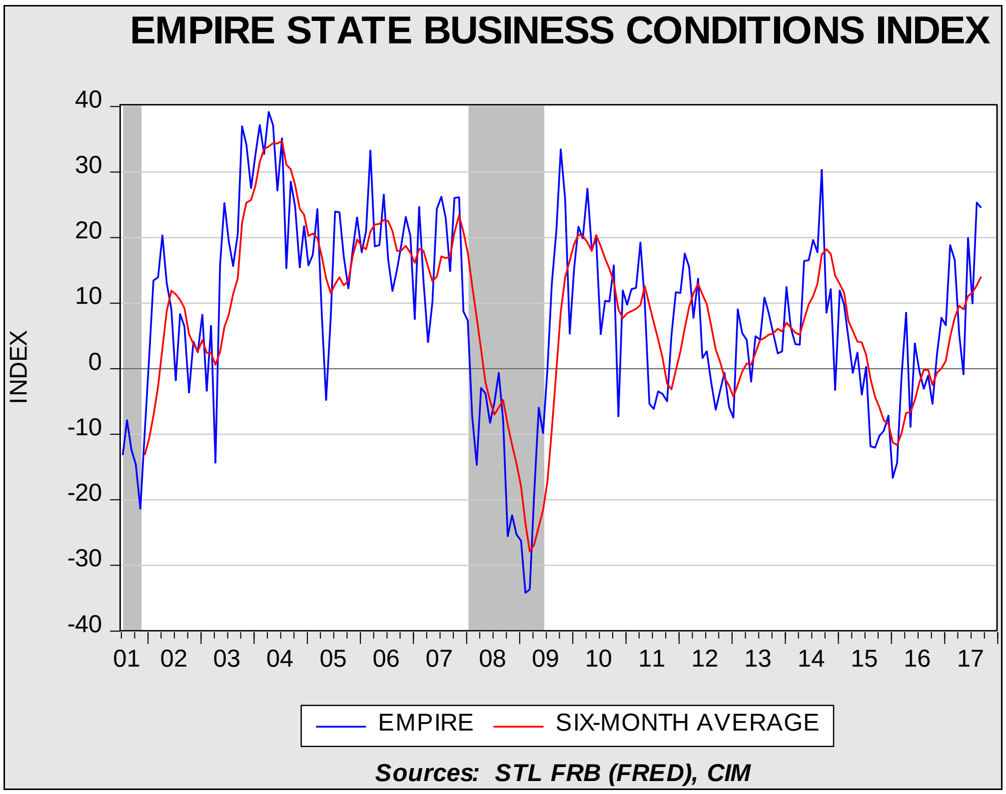
[1] https://www.thenational.ae/opinion/new-saudi-policy-will-ensure-clerics-fall-in-line-1.628123

Jamal Khashoggi, a long-tenured journalist and commentator, has moved to the U.S., fearing arrest.[2]

Iran deal approved: Yesterday, we noted that President Trump had to renew the Iran deal, which was expiring. Although there is growing concern he will end the deal, he did approve it yesterday but is indicating that he intends to curtail Iran's influence in the region.

U.S. Economic Releases

Empire manufacturing came in above expectations at 24.4 compared to the forecast of 18.0.



The chart above shows the six-month moving average of the Empire State Business Conditions Index.

Retail sales advance came in below expectations, falling 0.2% from the prior month compared to the forecast gain of 0.1%; the prior month's gain was revised downward from 0.6% to 0.3%. Retails sales ex-auto came in below expectations, rising 0.2% from the prior month compared to the forecast gain of 0.5%; the prior month's gain was revised downward from 0.5% to 0.4%. Retail sales ex-auto and gas came in below expectations, falling 0.1% from the prior month compared to the forecast gain of 0.3%. The retails sales control group came in above expectations, falling 0.2% from the prior month compared to the forecast gain of 0.2%.

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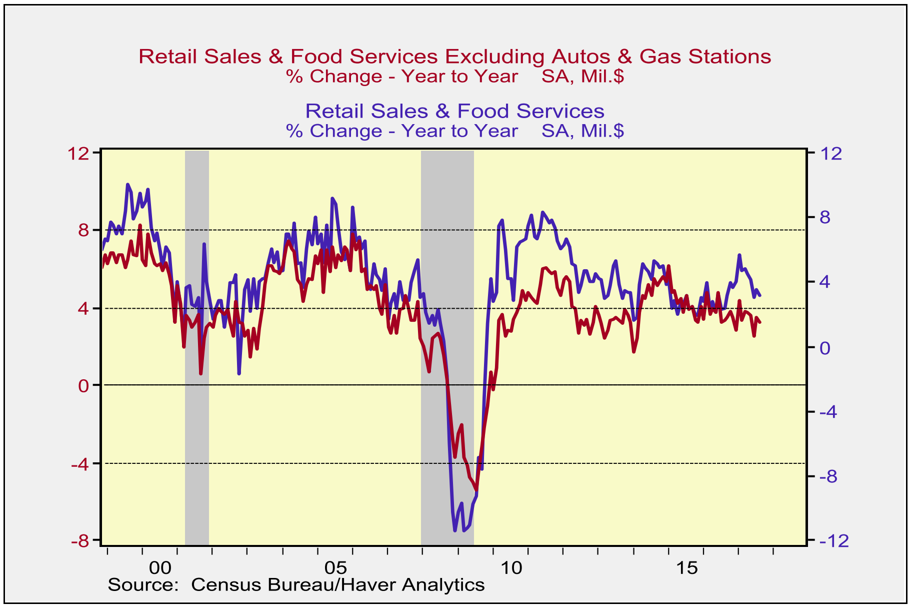
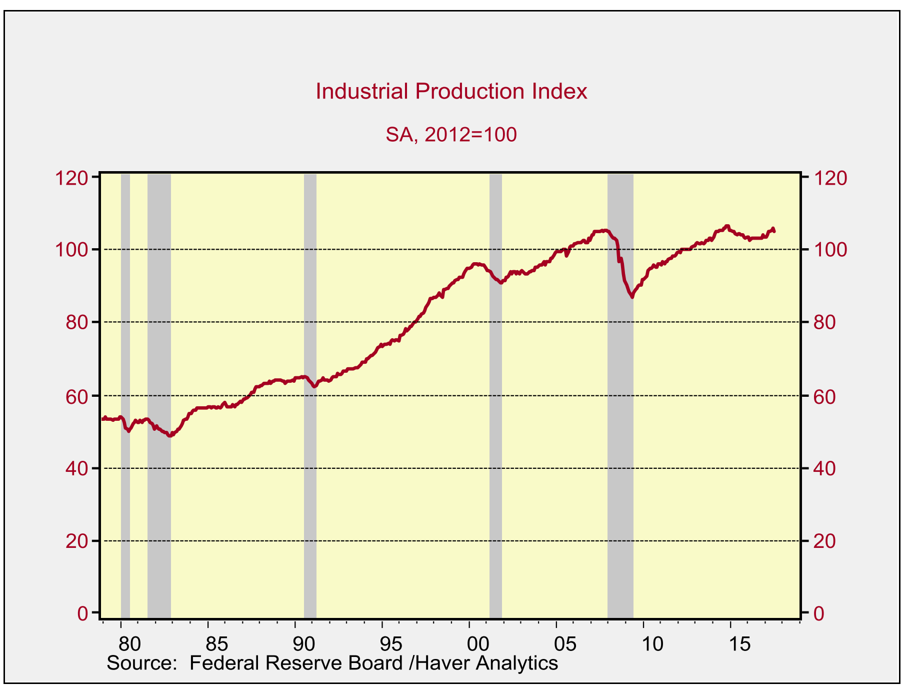
[2] https://www.nytimes.com/2017/09/14/world/middleeast/saudi-arabia-clerics.html?emc=edit_mbe_20170915&nl=morning-briefing-europe&nlid=5677267&te=1



The chart above shows the year-over-year change in retail sales and core retail sales. The fall in retail sales could be related to weakness in consumption and Hurricane Harvey.

Industrial production came in below expectations, falling 0.9% from the prior month compared to the forecast gain of 0.1%; the prior report was revised downward from 0.4% to 0.2%. Capacity utilization came in below expectations at 76.1% compared to the forecast of 76.7%; the prior month's report was revised upward from 76.7% to 76.9%. Manufacturing production came in below expectations, falling from the prior month compared to the forecast gain of 0.3%.



The chart above shows the level of change for industrial production.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	sep	95.0	67	**
10:00	U. of Michigan Current Conditions	m/m	sep	108.0	110.9	**
10:00	U. of Michigan Expectations	m/m	sep	83.0	87.7	**
10:00	U. of Michigan 1 Yr Inflatoin	m/m	sep		2.6%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	sep		2.5%	**
10:00	Business Inventories	m/m	jul	0.2%	0.5%	**
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	Money Supply M2	y/y	aug	8.9%	9.2%	9.1%	**	Equity and bond neutral
	New Yuan Loans	y/y	aug	1090.0 bn	825.5 bn	950.0 bn	**	Equity and bond neutral
	Aggregate Financing	y/y	aug	1480.0 bn	1220.0 bn	1280.0 bn	**	Equity and bond neutral
	Money Supply M1	m/m	aug	14.0%	15.3%	14.8%	**	Equity and bond neutral
	Money Supply M0	m/m	aug	6.5%	6.1%	6.0%	**	Equity and bond neutral
India	Wholesale Prices	y/y	aug	3.2%	1.9%	3.2%	**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	aug	-20.0%	-24.5%		**	Equity and bond neutral
	BusinessNZ Manufacturing PMI	m/m	aug	57.9	55.4		**	Equity and bond neutral
	Non Resident Bond Holdings	m/m	aug	61.2%	61.7%		**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	y/y	jul	18.6 bn	22.3 bn	20.3 bn	**	Equity bearish, bond bullish
	Labour Costs	y/y	2q	1.8%	1.5%		**	Equity and bond neutral
Italy	General Government Debt	y/y	jul	2300.0 bn	2281.4 bn		**	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	jul	3.1%	3.0%	3.2%	**	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)	132	132	0	Up
3-mo T-bill yield (bps)	102	103	-1	Neutral
TED spread (bps)	30	29	1	Neutral
U.S. Libor/OIS spread (bps)	117	116	1	Up
10-yr T-note (%)	2.20	2.19	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	23	23	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	down			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action		**Prior**	**Expected**	
Russia Key Rate	8.500%	9.000%	8.500%	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	$55.54	$55.47	0.13%	Short Covering
WTI	$49.93	$49.89	0.08%	
Natural Gas	$3.05	$3.07	-0.72%	
Crack Spread	$21.00	$20.60	1.95%	
12-mo strip crack	$19.57	$19.50	0.32%	
Ethanol rack	$1.69	$1.70	-0.12%	
Metals				
Gold	$1,323.55	$1,329.74	-0.47%	North Korean Apathy
Silver	$17.71	$17.80	-0.49%	
Copper contract	$295.75	$295.75	0.00%	
Grains				
Corn contract	$ 352.75	$ 354.25	-0.42%	
Wheat contract	$ 441.25	$ 443.00	-0.40%	
Soybeans contract	$ 972.50	$ 976.00	-0.36%	
Shipping				
Baltic Dry Freight	1361	1337	24	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.9	4.8	1.1	
Gasoline (mb)	-8.4	-3.0	-5.4	
Distillates (mb)	-3.2	-2.4	-0.8	
Refinery run rates (%)	-2.00%	4.65%	-6.65%	
Natural gas (bcf)	91.0	80.0	11.0	

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. Hurricane Jose is still in the Atlantic Ocean but has been downgraded to a tropical storm.

Asset Allocation Weekly Comment

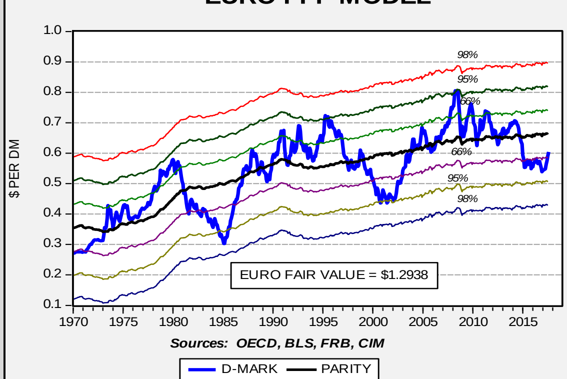
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

September 15, 2017

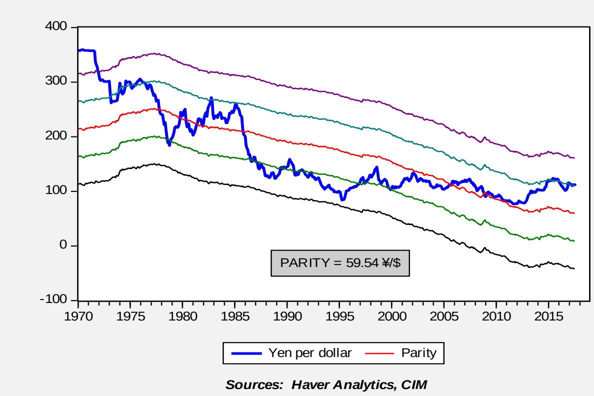
In our most recent asset allocation rebalancing, we added foreign allocations to our portfolios. Over the past few years, we had generally avoided allocations to non-U.S. markets in asset allocation portfolios due to two primary concerns. First, the dollar had been appreciating as a result of an improving U.S. economy and policy divergences between the U.S. and the rest of the world. The Federal Reserve was raising rates and tapering its balance sheet while the majority of other nations were still adding monetary stimulus. Second, we have had secular concerns about the stability and attractiveness of foreign investing in a world where the U.S. is seemingly reducing its hegemonic role.

We previously noted that the dollar was deeply undervalued on a purchasing power parity basis and vulnerable to depreciation. The catalysts for dollar weakness appear to be coming from two sources. First, the FOMC is moving very slowly to tighten policy while the rest of the world's central banks are finally withdrawing policy stimulus. Second, uncertainty surrounding American governance appears to be undermining investor confidence and leading to dollar selling. In this week's report, we wanted to update the valuation levels for the dollar against the yen, euro, Canadian dollar and British pound.

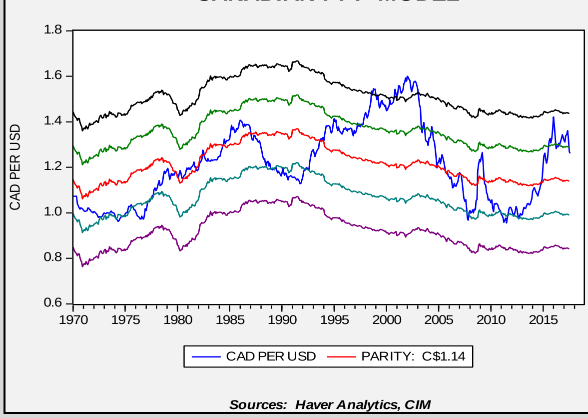
EURO PPP MODEL



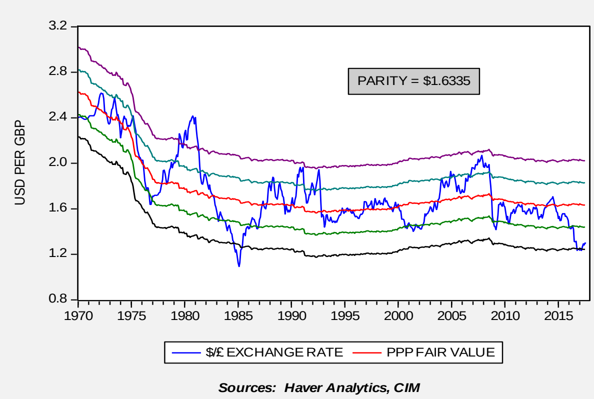
YEN PPP MODEL



CANADIAN PPP MODEL



GBP PPP MODEL

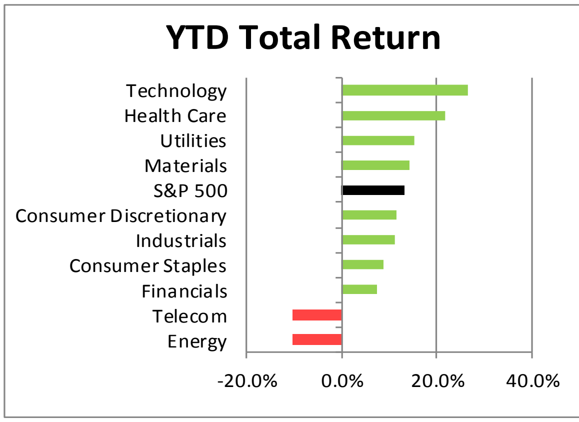


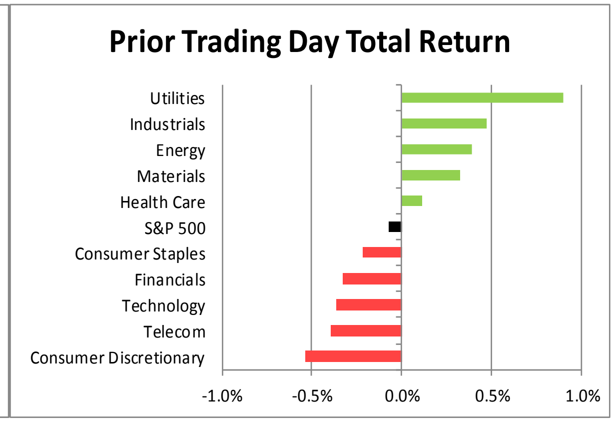
This chart shows four purchasing power parity models for the aforementioned currencies. In all four cases, the dollar was trading "rich" by more than one standard error, and nearly two standard errors from parity in two cases. Over the past two months, three of the four currencies have begun to appreciate and are indicating some modest improvement in valuation. However, these models all suggest that the dollar is still overvalued and thus, even with the recent depreciation, the greenback is still overvalued. Hence, the narrative that a weaker dollar should support further gains in overseas assets remains viable. If history is any guide, we are still in the early stages of a dollar reversal that should remain in place for the foreseeable future.

At the same time, the secular concerns about the impact of the withdrawal of U.S. hegemony will likely be a bearish factor for overseas investments. For now, we expect the dollar's weakness to overshadow concerns over global stability. But, as some point, possibly in the next couple of years, the dollar will be closer to fair value and the case for foreign investment will be more difficult to justify.

Data Section

U.S. Equity Markets – (as of 9/14/2017 close)

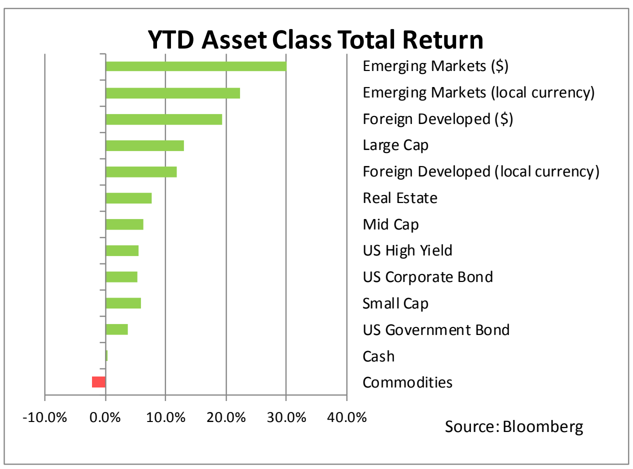




(Source: Bloomberg)

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 9/14/2017 close)

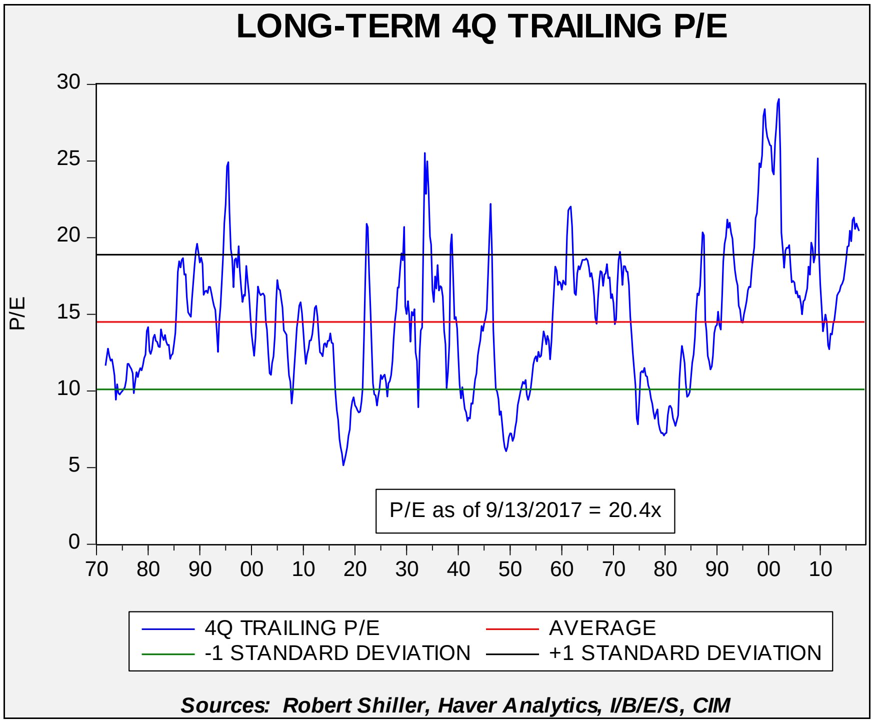


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2017



Based on our methodology,[3] the current P/E is 20.4x, unchanged from last week.

[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.