Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: September 19, 2017—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is relatively unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets were down, with the Shanghai composite down 0.2% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a higher open.

Markets are very quiet in front of the FOMC meeting, which begins later this morning. President Trump offers formal remarks to the UN this morning, too. Here is what we are watching:

The Fed: As we noted yesterday, we look for the Fed to begin balance sheet reduction after this meeting with no change in the policy rate. In general, there is still a chance the FOMC raises rates in December. We actually doubt that will happen; if the dots chart agrees with our outlook, the dollar could take another leg lower.

Tropical situation: Hurricane Jose will brush Long Island and the northeastern shore but will generally spin out to sea. Hurricane Maria is currently a Category 5 storm; it is expected to weaken modestly to a Category 4 but will slam the U.S. Virgin Islands and Puerto Rico then veer northward. The consensus of computer models have it moving almost due north by the weekend, sparing Florida and probably most of the U.S. mainland. Of course, conditions can change but missing the U.S. Atlantic coast is favorable news. Sadly, the Caribbean islands, many of them still reeling from Hurricane Irma, are set for a second hit that will severely set back recovery efforts.

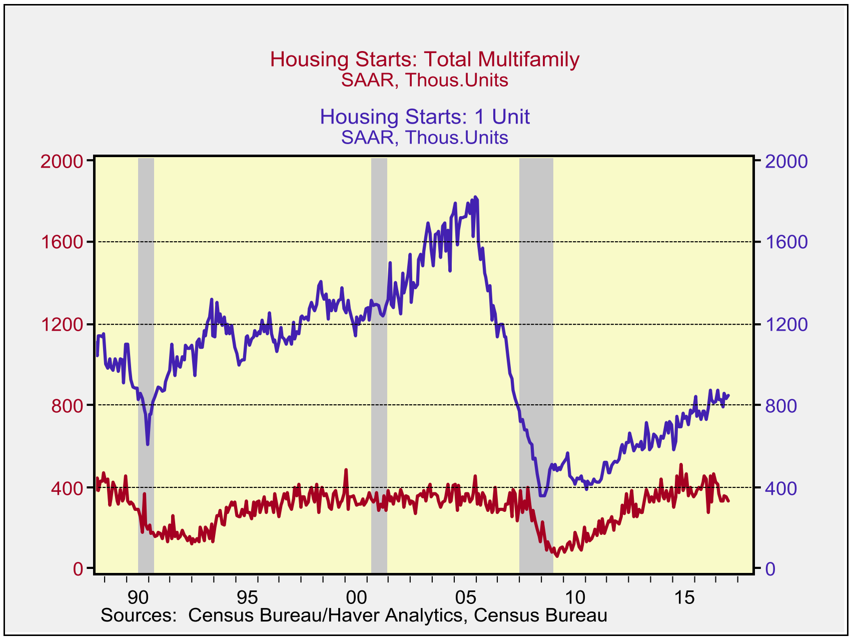
North Korea: This week's WGR, published yesterday afternoon, recaps the North Korean situation. SOD Mattis told Reuters today that the U.S. has military options that might spare Seoul from an artillery barrage but gave no details. Although it isn't obvious to us just what such options might entail, as we noted yesterday, there is no evidence of U.S. mobilization that would be expected to precede military action. Thus, for now, financial markets are mostly ignoring North Korea.

Bitcoin: We continue to monitor the cryptocurrency market. Currently, the behavior seems more akin to gold than a currency. For the most part, a currency fulfills three roles—store of value, a numeraire and a medium of exchange. Gold and cryptocurrencies meet only one of these roles, the store of value. There is limited ability to use either for exchange or pricing things (the numeraire function) because of the volatility. The chart below shows the recent price behavior of bitcoin against the dollar. As a thought experiment, imagine that one borrowed in bitcoin in early January when it was trading around $1k. Your debt service costs have soared ever since. China is moving to quash bitcoin; it has shut down commercial exchanges and is now acting to inhibit peer-to-peer trading. We don't expect the governments and the central banks to allow cryptocurrencies to undermine national currencies. After all, a currency is a symbol of national sovereignty. Thus, cryptocurrencies will likely be relegated to black market activities, allowing people to avoid capital controls and make cashless anonymous transactions.

(Source: Bloomberg)

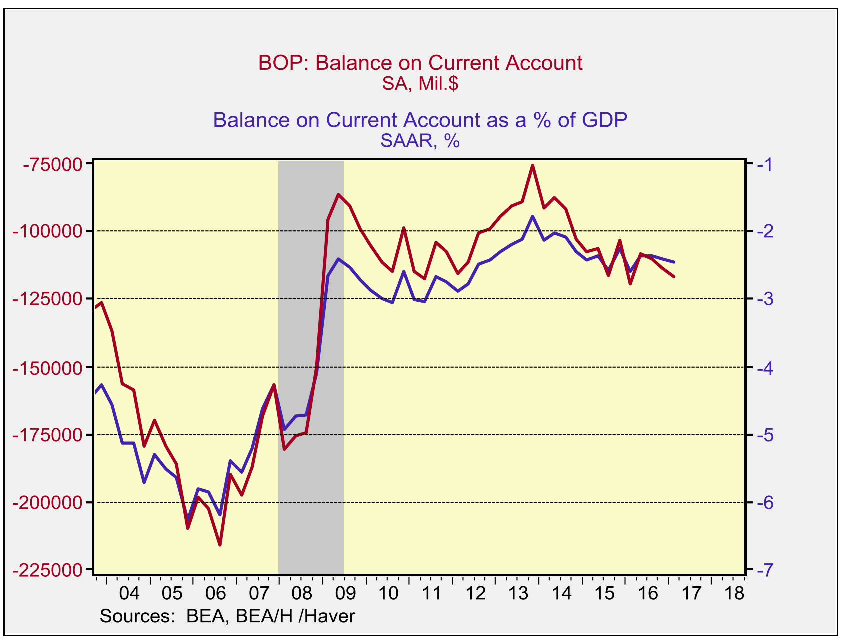
U.S. Economic Releases

Housing starts came in above expectations at 1,180k compared to the forecast of 1,174k on an annualized basis. The prior month's report was revised upward from 1,155k to 1,190k. The monthly change in housing starts came in below expectations, falling 0.8% compared to the forecast gain of 1.7%. The prior report's loss was revised downward from 4.1% to 3.5%. Building permits came in above expectations at 1,300k compared to the forecast of 1,220k. The prior month's report was revised upward by 7k from 1,223k to 1,230k. The monthly change in building permits came in above expectations, rising 5.7% compared to the forecast of a 0.8% drop. The prior report's loss was revised downward from 4.1% to 3.5%.



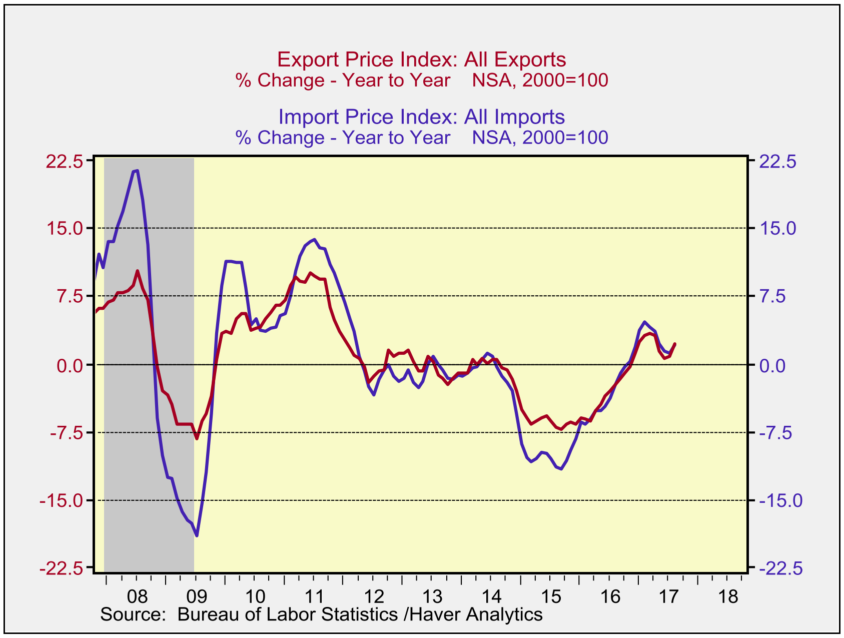
The chart above shows the level of multi-family and single-family housing starts. Multi-family starts have fallen 24.7% from the prior year, while single-units have risen 17.0%. Although the headline number suggests a weakening housing market, the fact that single-family starts have increased over last year is good news.

The current account deficit came in wider than expected at $123.1 bn compared to the forecast of $116.0 bn. The prior report's deficit was revised narrower from $116.8 bn to $113.5 bn.



The chart above shows the relationship between the balance on current account and the balance on current account as a percentage of GDP.

The import price index came in above expectations, rising 0.6% from the prior month compared to the forecast gain of 0.4%. The import price index excluding petroleum came in above expectations, rising 0.3% from the prior month compared to the forecast rise of 0.2%. The export price index came in above expectations, rising 0.6% from the prior month compared to the forecast rise of 0.2%.



The chart above shows the year-over-year change in the import price index and export price index. The import price and export price indexes rose 2.1% and 2.3%, respectively. This report is somewhat uneventful and therefore unlikely to have an impact on the Fed's decision-making.

There are no further economic releases or Fed events scheduled for the rest of the day.

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								
Australia	ANZ Roy Morgan Weekly Consumption	m/m	sep	114.8	109.8		**	Equity and bond neutral
	House Price Index	q/q	2q	10.2%	10.2%	9.2%	**	Equity bullish, bond bearish
New Zealand	Westpac Consumer Confidence	q/q	3q	112.4	113.4		**	Equity and bond neutral
EUROPE								
Eurozone	Current Account	y/y	jul	32.5 bn	28.1 bn		**	Equity and bond neutral
	Construction Output	y/y	jul	3.4%	3.4%		**	Equity and bond neutral
	ZEW Survey Expectations	y/y	sep	31.7	29.3		**	Equity and bond neutral
Germany	ZEW Survey Current Situation	y/y	sep	87.9	86.7	86.2	**	Equity bullish, bond bearish
	ZEW Survey Expectations	m/m	sep	17.0	10.0	12.0	**	Equity bullish, bond bearish
Italy	Current Account Balance	m/m	jul	8.625 bn	5.257 bn		**	Equity and bond neutral
AMERICAS								
Canada	Bloomber Nanos Confidence	y/y	jul	58.4	58.4		**	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	102	0	Neutral
TED spread (bps)	31	30	1	Neutral
U.S. Libor/OIS spread (bps)	117	117	0	Up
10-yr T-note (%)	2.22	2.23	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	24	24	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	down			Neutral
pound	down			Neutral
franc	up			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	$55.77	$55.48	0.52%	Short Covering
WTI	$50.35	$49.91	0.88%	
Natural Gas	$3.15	$3.15	0.00%	
Crack Spread	$21.36	$21.73	-1.67%	
12-mo strip crack	$19.63	$19.70	-0.37%	
Ethanol rack	$1.70	$1.70	0.04%	
Metals				
Gold	$1,308.63	$1,307.44	0.09%	
Silver	$17.17	$17.21	-0.21%	
Copper contract	$297.50	$296.90	0.20%	
Grains				
Corn contract	$ 352.50	$ 351.50	0.28%	
Wheat contract	$ 446.25	$ 443.50	0.62%	
Soybeans contract	$ 967.75	$ 967.75	0.00%	
Shipping				
Baltic Dry Freight	1398	1385	13	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-2.5		
Distillates (mb)		-1.7		
Refinery run rates (%)		5.00%		

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 western region. Hurricane Jose is still in the Atlantic Ocean but is expected to touch Massachusetts on Wednesday as a Tropical Storm. Hurricane Maria has strengthened into a Category 5 hurricane and is currently moving across the Caribbean islands.

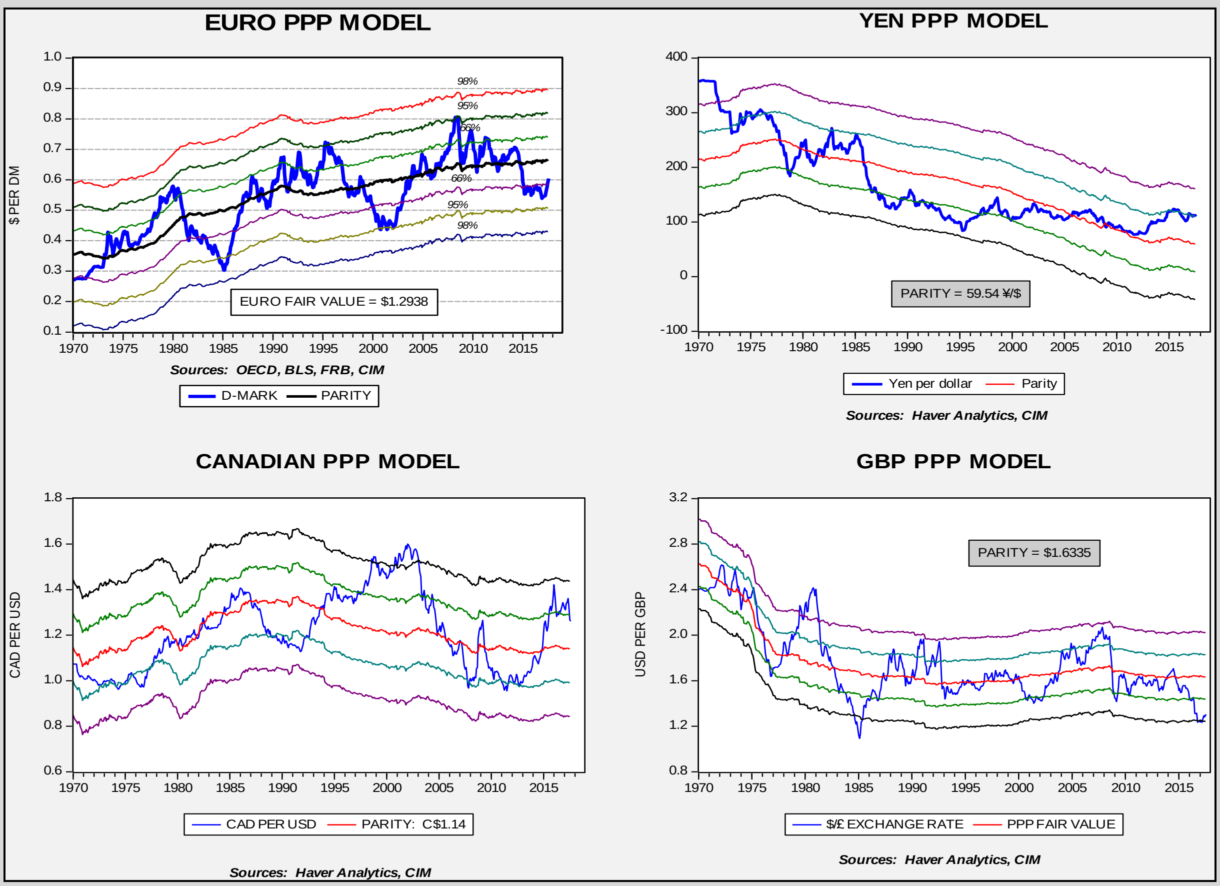
Asset Allocation Weekly Comment

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.

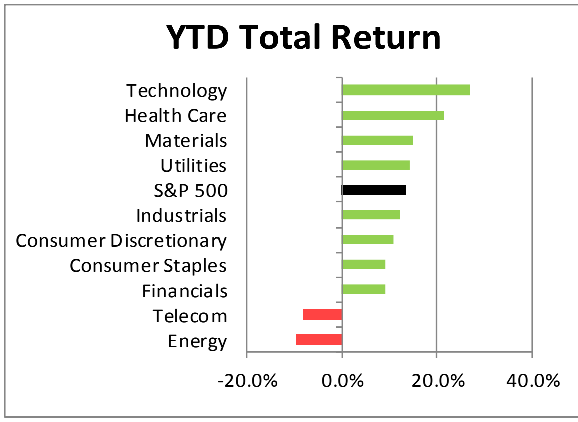


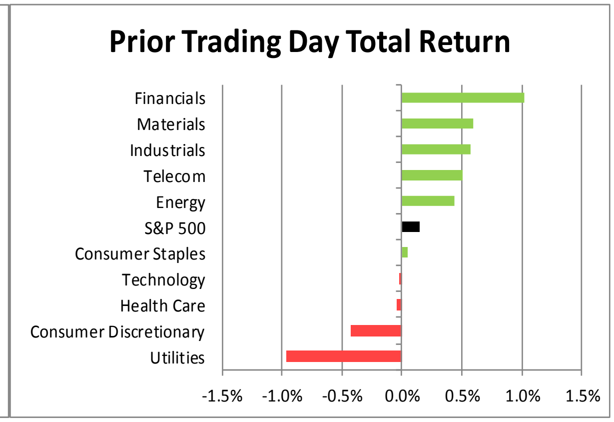
This chart shows four purchasing power parity models for the aforementioned currencies. In all four cases, the dollar was trading "rich" by more than one standard error, and nearly two standard errors from parity in two cases. Over the past two months, three of the four currencies have begun to appreciate 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 9/18/2017 close)

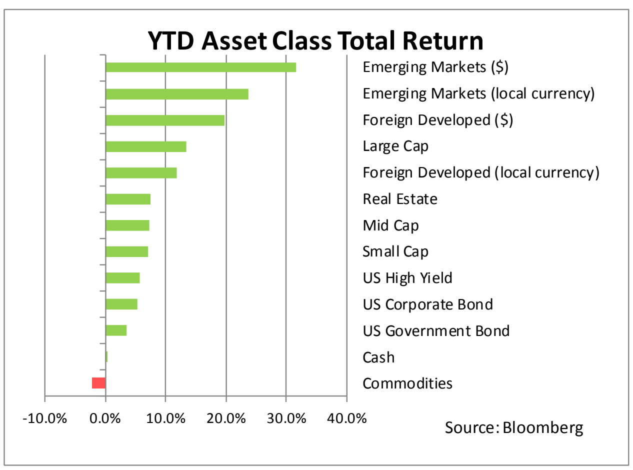




(Source: Bloomberg)

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 9/18/2017 close)

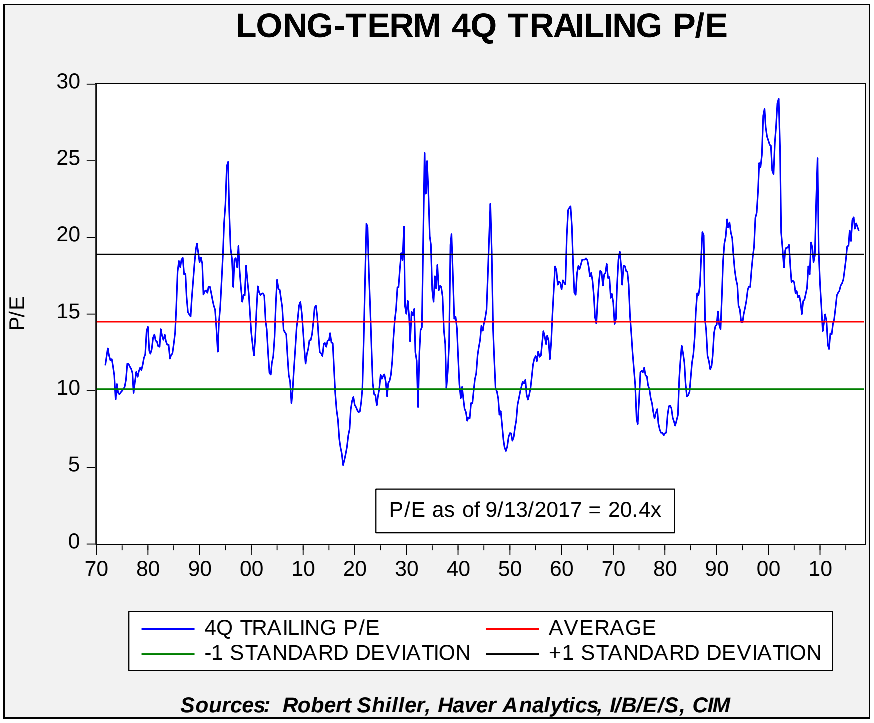


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] the current P/E is 20.4x, unchanged from last week.

[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.