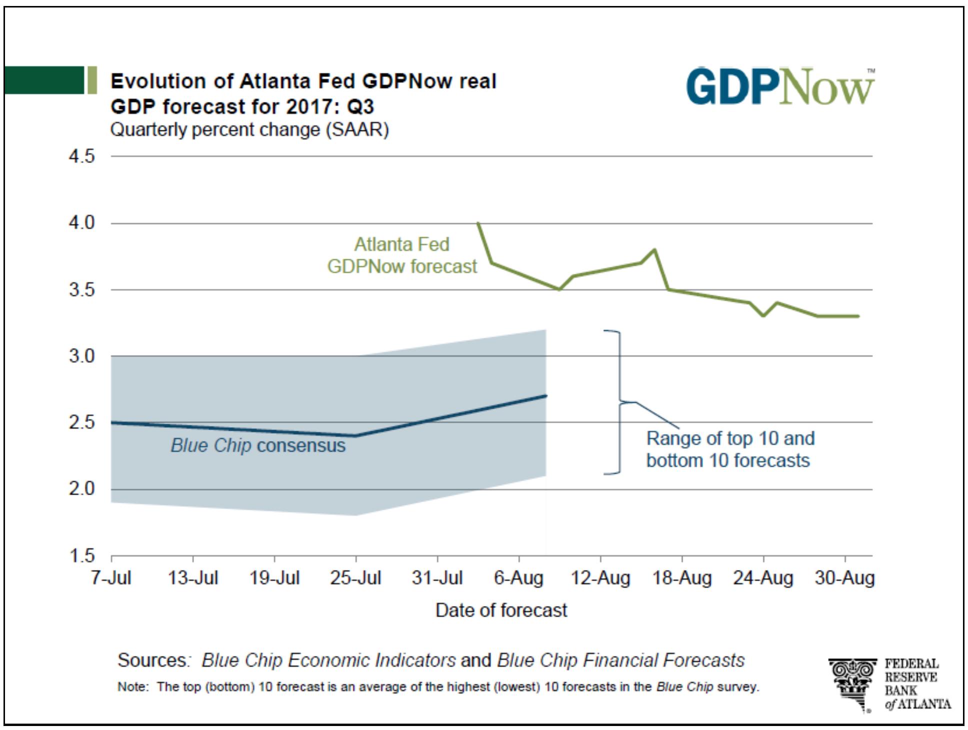
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: September 1, 2017—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.2% and the Shenzhen index up 0.6%. U.S. equity index futures are signaling a higher open.

Happy Employment Day! We recap the numbers below. Here is what we are watching today:

Q3 GDP looking strong: Q2 GDP was revised to 3.0%, and the Atlanta FRB is projecting a 3.3% growth rate for Q3. We present the relevant charts below.



The estimated growth rate is coming down but is still stronger than the consensus estimate. Below is the breakdown by contribution.

Atlanta Fed GDPNow forecasts for 2017: Q3, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
3-Aug	Initial nowcast	4.0	2.11	0.46	0.16	0.18	0.05	0.02	-0.08	1.13
4-Aug	Employment situation, Foreign trade	3.7	1.91	0.38	0.17	0.16	-0.04	0.01	-0.04	1.11
9-Aug	Wholesale trade	3.5	1.91	0.38	0.17	0.16	-0.04	0.01	-0.04	0.99
10-Aug	PPI, Monthly Treasury Statement	3.6	1.91	0.38	0.17	0.16	-0.04	0.04	-0.04	1.00
15-Aug	Retail trade, Import/Export prices	3.7	1.97	0.38	0.17	0.16	-0.02	0.04	-0.04	1.03
16-Aug	Housing starts	3.8	1.97	0.38	0.17	0.16	0.14	0.04	-0.04	1.03
17-Aug	Industrial production	3.5	1.94	0.35	0.17	0.06	0.13	0.04	-0.03	0.83
23-Aug	New-home sales/prices/costs	3.4	1.94	0.35	0.17	0.07	0.01	0.04	-0.03	0.83
24-Aug	Existing-home sales	3.3	1.94	0.35	0.17	0.07	-0.02	0.04	-0.03	0.83
25-Aug	Advance durable manufacturing	3.4	1.94	0.45	0.17	0.07	-0.02	0.04	-0.03	0.79
28-Aug	Advance Economic Indicators	3.3	1.94	0.45	0.17	0.07	-0.02	0.04	-0.14	0.82
31-Aug	GDP (8/30), Pers. income & outlays	3.3	1.97	0.34	0.21	0.08	-0.02	0.03	-0.22	0.93
Maximum forecast of real GDP growth										
3-Aug	Initial nowcast	4.0	2.11	0.46	0.16	0.18	0.05	0.02	-0.08	1.13
Minimum forecast of real GDP growth										
24-Aug	Existing-home sales	3.3	1.94	0.35	0.17	0.07	-0.02	0.04	-0.03	0.83

Note: CIPI is "change in private inventories." All numbers are percentage point contributions to GDP growth (SAAR). Table does not necessarily include all forecasts for the quarter; see tab "ContribHistory" in online excel file for entire history.

FEDERAL RESERVE BANK of ATLANTA

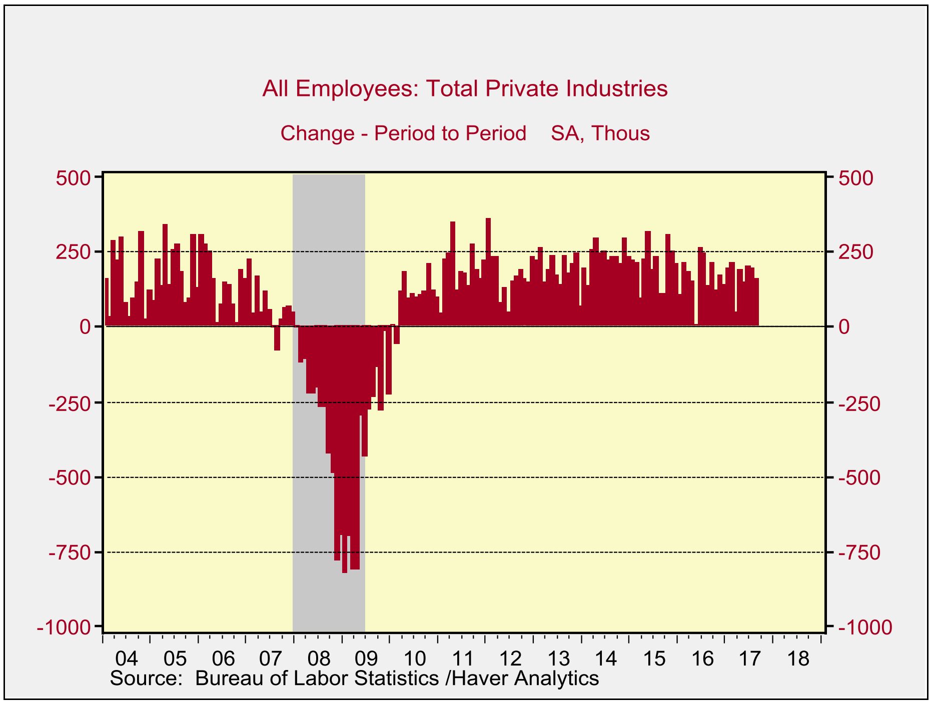
Consumption remains strong and inventories are expected to add a point to growth; in fact, inventories and PCE contribute most of the growth in the forecast, representing all but 40 bps of the expected increase. The data suggests a steadily improving economy. We will be watching to see the impact of Harvey in the coming weeks.

CPC meetings in October: The Communist Party of China (CPC) announced that its 19th Party Congress meetings will begin October 18. This is the meeting where Xi Jinping will announce his new Standing Committee, the body that is effectively his cabinet. In a Chinese leader's second term, he gets to select his own Standing Committee, whereas the Standing Committee is usually filled with allies of the previous leader in the initial election. So, unlike the U.S. system, the Chinese leader has ***more*** power in his second term. We will be watching closely for an "heir apparent"; if Xi fails to pick a Standing Committee member that looks like the next president, it is possible that Xi might try for a third term.

Kenya elections: Last night, Kenya's Supreme Court ruled that the results from last month's presidential election were invalid; as a result, new elections will take place within 60 days. The unprecedented ruling was a stunning blow to the incumbent, President Uhuru Kenyatta. The previous election's results showed that he had defeated his opponent, Raila Odinga, with 54% of the vote. Although it is likely that there were some forms of voter intimidation and voter fraud on both sides, which are fairly common in developing countries, we believe these irregularities are unlikely to explain the margin of victory. The decision is the first time in Kenya's history, as well as Africa, in which an election was overturned by the Supreme Court and is likely to raise tensions as the new election draws near. Trading on the Nairobi stock exchange was halted temporarily due to fears that political uncertainty could harm the economy.

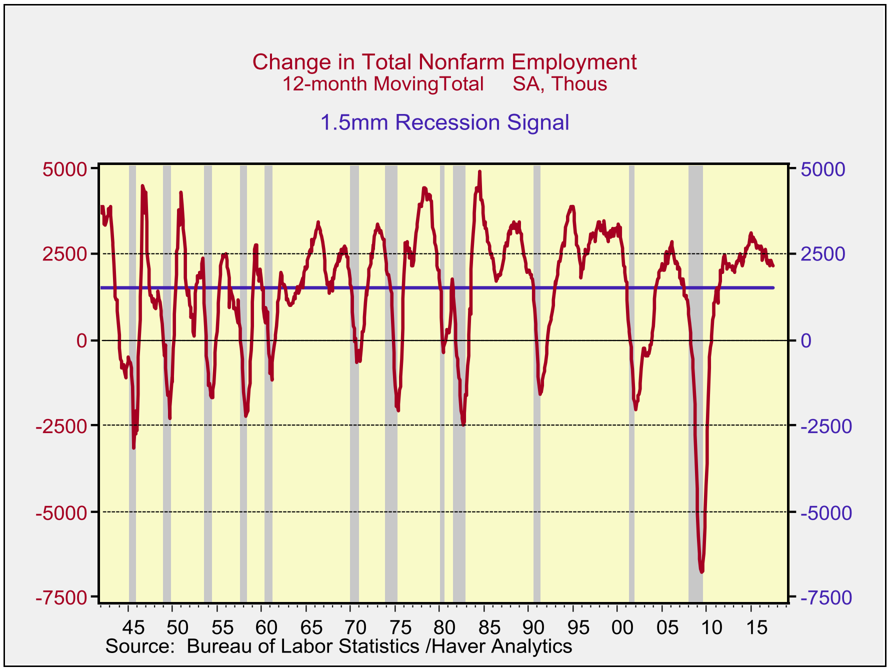
U.S. Economic Releases

The change in nonfarm payrolls for August came in below expectations at 156k compared to the forecast of 180k; the prior report was revised downward from 209k to 189k. The change in private payrolls came in below expectations at 165k compared to the forecast of 172k; the prior report was revised downward from 205k to 202k. The change in manufacturing payrolls came in above expectations at 36k compared to the forecast of 8k; the prior report was revised upward from 16k to 26k.

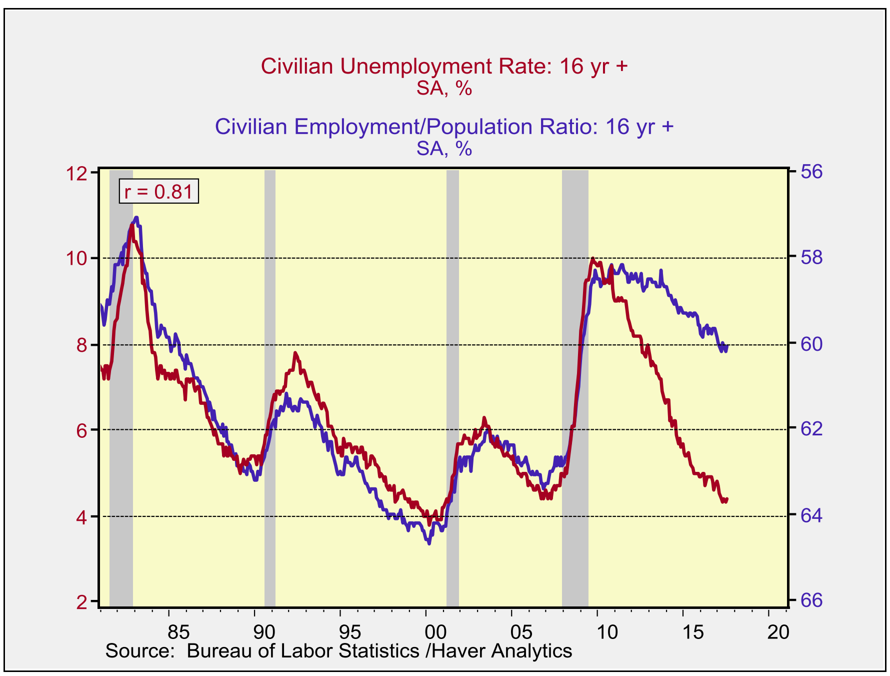


The chart above shows the change in total private employment. This chart suggests we are still in an economic expansion.

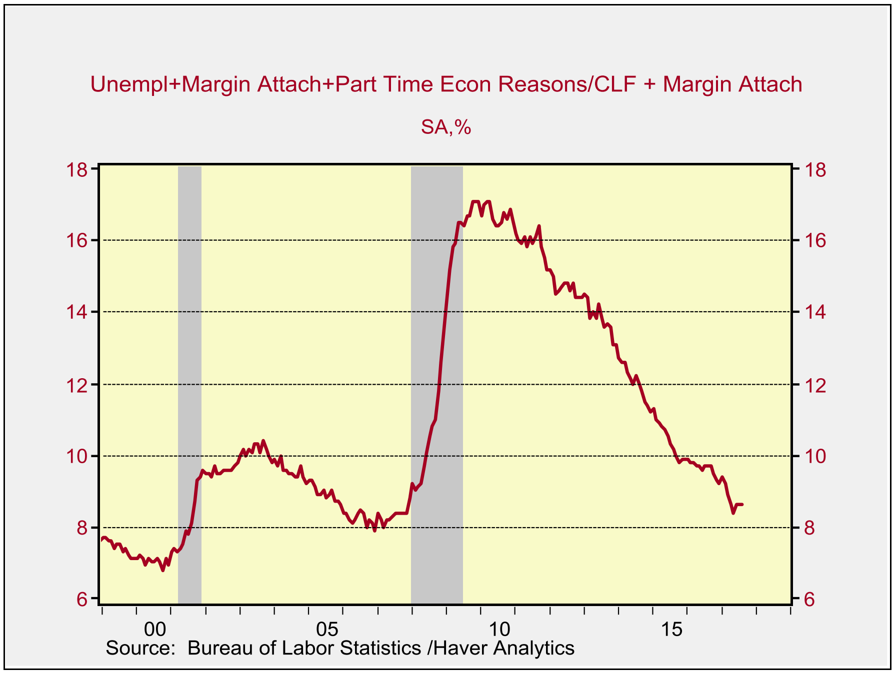
The chart below shows the 12-month moving total of the change in nonfarm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in above expectations at 4.4% compared to the forecast of 4.3%. The labor force participation and underemployment rates came in at 62.9% and 8.6%, respectively.

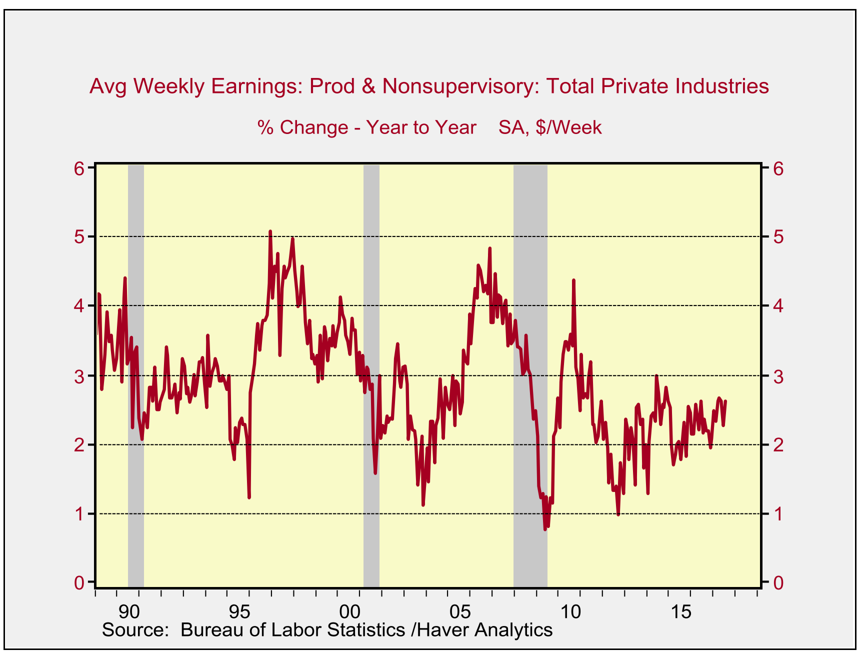


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables suggests that there is still slack within the labor market.



The chart above shows the underemployment rate, also referred to as the U-6 rate. This is the Federal Reserve's preferred gauge to measure slack in the labor market.

Average hourly earnings came in below expectations, rising 0.1% from the prior month compared to the forecast gain of 0.2%. On a yearly basis, wage growth remains subdued.



This chart shows the yearly growth in hourly earnings for all workers and non-supervisory workers. On an annual basis, wage growth came in at 2.5%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Chicago Purchasing Manager	m/m	aug	58.5	58.9	**
9:45	Bloomberg Consumer Comfort	m/m	aug		52.8	**
10:00	Pending Home Sales	m/m	jul	0.30%	1.5%	**
10:00	Pending Home Sales	y/y	jul	0.5%	0.7%	**
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	Caixin China PMI Mfg	m/m	aug	51.6	51.1	51.0	**	Equity bullish, bond bearish
Japan	Capital Spending	m/m	2q	1.5%	4.5%	7.9%	**	Equity bearish, bond bullish
	Capital Spending ex Software	m/m	2q	0.6%	5.2%	8.2%	**	Equity bearish, bond bullish
	Company Profits	m/m	2q	22.6%	26.6%		**	Equity and bond neutral
	Company Sales	m/m	2q	6.7%	5.6%		**	Equity and bond neutral
	Nikkei Japan PMI Mfg	m/m	aug	52.2	52.8		**	Equity and bond neutral
	Vehicle Sales	y/y	aug	4.7%	-1.1%		*	Equity and bond neutral
	Consumer Confidence	m/m	aug	43.3	43.8	43.5	**	Equity and bond neutral
India	GDP	y/y	2q	5.7%	6.1%	6.5%	***	Equity bearish, bond bullish
Australia	CBA Australia PMI Mfg	m/m	aug	53.5	54.4		**	Equity and bond neutral
	AiG Performance of Mfg Index	m/m	aug	59.8	56.0		**	Equity and bond neutral
	CoreLogic House Px	m/m	aug	0.1%	1.5%		**	Equity and bond neutral
New Zealand	Terms of Trade Index	q/q	2q	1.5%	5.1%	3.0%	*	Equity bearish, bond bullish
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	jul	57.4	57.4	57.4	**	Equity and bond neutral
Germany	Markit/ BME Germany Manufacturing	m/m	aug	59.3	59.4	59.4	**	Equity and bond neutral
France	Markit France Manufacturing	m/m	aug	55.8	55.8	55.8	**	Equity and bond neutral
Italy	Markit/ ADACI Italy Manufacturing	m/m	aug	56.3	55.1	55.3	**	Equity bullish, bond bearish
	GDP	m/m	2q	1.5%	1.5%	1.5%	***	Equity and bond neutral
UK	Markit UK PMI Manufacturing	m/m	aug	56.9	55.1	55.0	**	Equity bullish, bond bearish
Switzerland	Retail Sales Real	y/y	jul	-0.7%	1.5%		**	Equity and bond neutral
	PMI Manufacturing	y/y	aug	61.2	60.9	60.2	**	Equity bullish, bond bearish
Russia	Markit Russia PMI Mfg	y/y	aug	51.6	52.7	51.8	**	Equity and bond neutral
AMERICAS								
Brazil	GDP	m/m	jul	0.3%	-0.4%	0.0%	***	Equity bullish, bond bearish
Canada	MLI Leading Indicator	m/m	jun	0.2%	0.2%		**	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)	98	98	0	Neutral
TED spread (bps)	33	34	-1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.13	2.12	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	25	25	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	down			Neutral
pound	up			Down
franc	down			Down

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	$52.59	$52.86	-0.51%	Long Liquidation
WTI	$46.86	$47.23	-0.78%	
Natural Gas	$3.04	$3.04	-0.13%	
Crack Spread	$26.55	$26.97	-1.58%	
12-mo strip crack	$19.66	$19.98	-1.58%	
Ethanol rack	$1.69	$1.69	0.26%	
Metals				
Gold	$1,318.75	$1,321.43	-0.20%	
Silver	$17.54	$17.58	-0.25%	
Copper contract	$310.50	$309.85	0.21%	
Grains				
Corn contract	$ 358.75	$ 357.75	0.28%	
Wheat contract	$ 438.75	$ 434.50	0.98%	
Soybeans contract	$ 949.25	$ 945.25	0.42%	
Shipping				
Baltic Dry Freight	1184	1181	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.4	-2.0	-3.4	
Gasoline (mb)	0.0	-1.5	1.5	
Distillates (mb)	0.7	-0.4	1.1	
Refinery run rates (%)	1.20%	-0.80%	2.00%	
Natural gas (bcf)	30.0	34.0	-4.0	

Weather

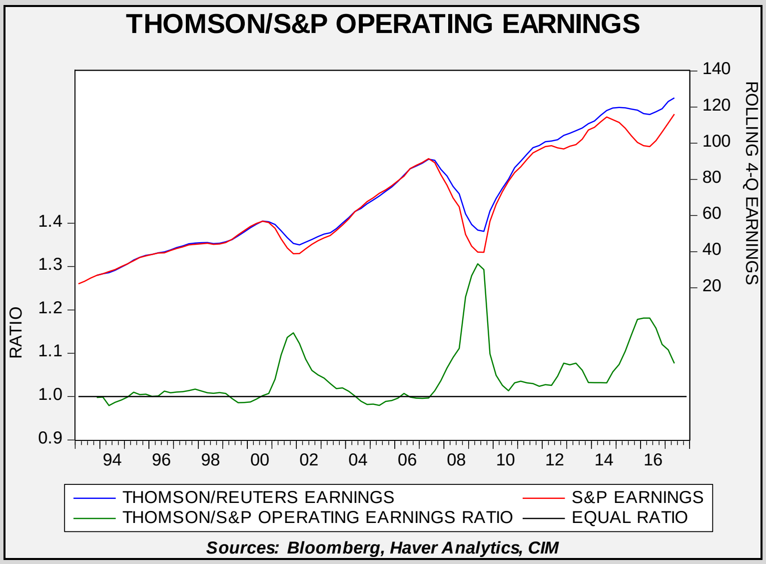
The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, with warmer to normal temps in the western region and precipitation expected for the East Coast. Tropical Depression Harvey has made its way to Tennessee and is expected to fully dissipate by the end of the day today.

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.

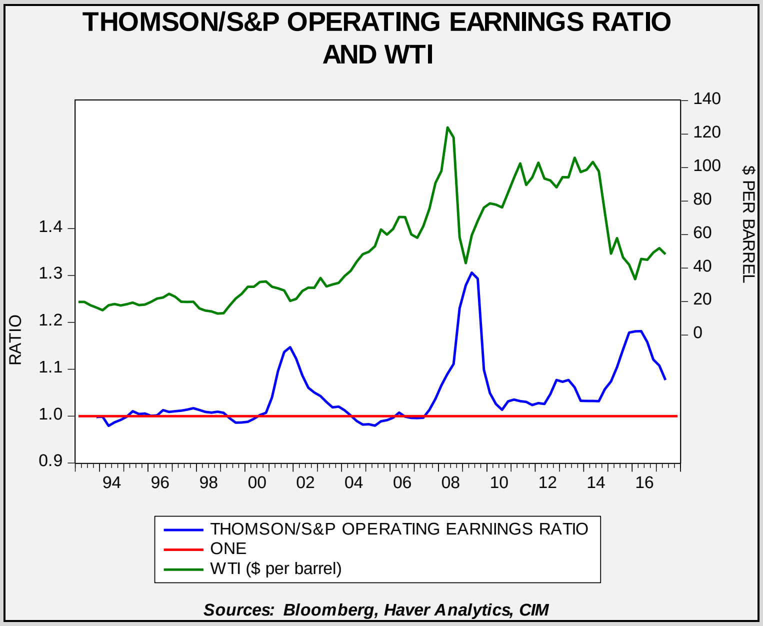
September 1, 2017

We have previously documented the difference between S&P 500 operating earnings reported by Thomson/Reuters and Standard and Poor's. Although both series purport to measure the same thing, there can be rather wide divergences. These exist due to differences in how unusual events are accounted for; we do often see long periods where the two series are identical but, in this bull market, the Thomson/Reuters data has tended to consistently exceed the S&P numbers.



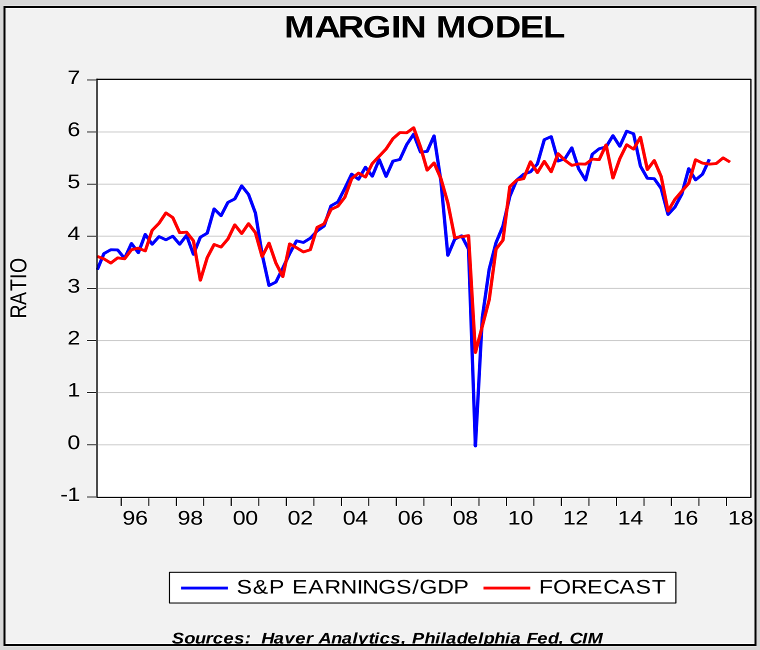
This chart shows the two series from 1994, with the lower line showing their ratio. The reason we monitor these divergences is that an elevated ratio has led to bear markets and recessions in two previous instances. Fortunately, the ratio is narrowing, although the difference in terms of the past four quarters is still notable, with Thomson/Reuters at $125.07 while the S&P is at $116.14.

One reason for the recent change in the ratio could be oil prices.



The drop in oil prices coincided with a widening of the ratio. Thus, it is possible that S&P treats the impact of falling oil prices on earnings differently than Thomson/Reuters. If oil prices remain elevated from recent lows, the spread between the two series should also narrow.

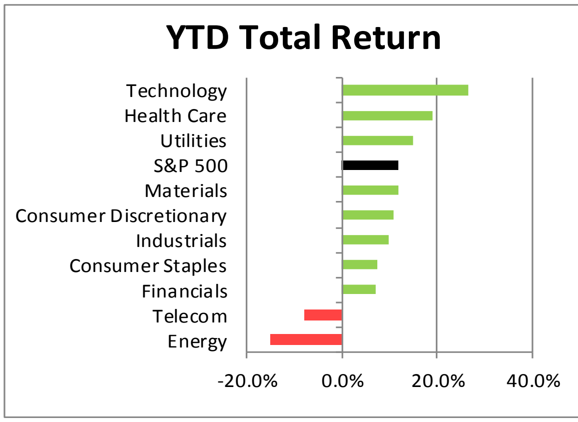
This year's earnings story continues to be the expansion of margins. Looking at S&P operating earnings compared to GDP, we have seen a solid recovery in margins. Our margin model has been projecting a recovery and stabilization around the level of 5.5% of GDP. If that is the case, the growth rate in earnings should slow to the pace of nominal GDP over the next few quarters.

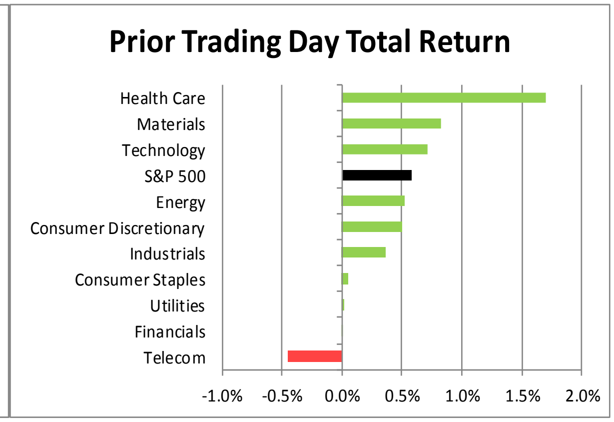


Based on our analysis, we are on pace for a year-end operating earnings number, basis Standard and Poor's, of $121.50, a 14.3% rise over this series report from last year. A similar growth number for Thomson/Reuters would put this year's earnings at $136.10 compared to the current expectation of $131.10. However, since the gap between the two earnings series is narrowing, current expectations are probably about right as that would be consistent with the current ratio. If the two narrow further, current expectations may be too high. Still, in any case, margins remain strong and should offer support for equities.

Data Section

U.S. Equity Markets – (as of 8/31/2017 close)

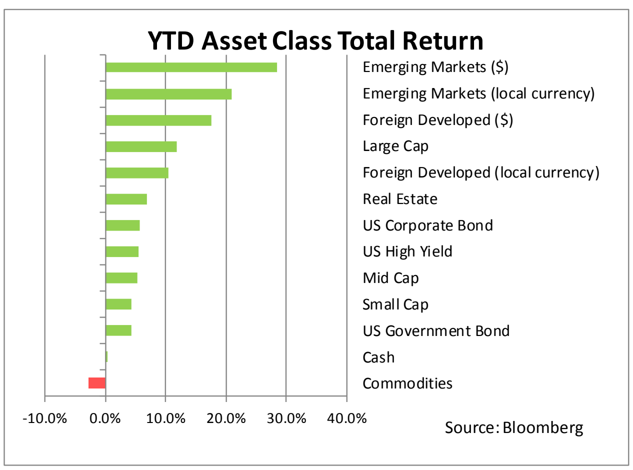




(Source: Bloomberg)

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 8/31/2017 close)

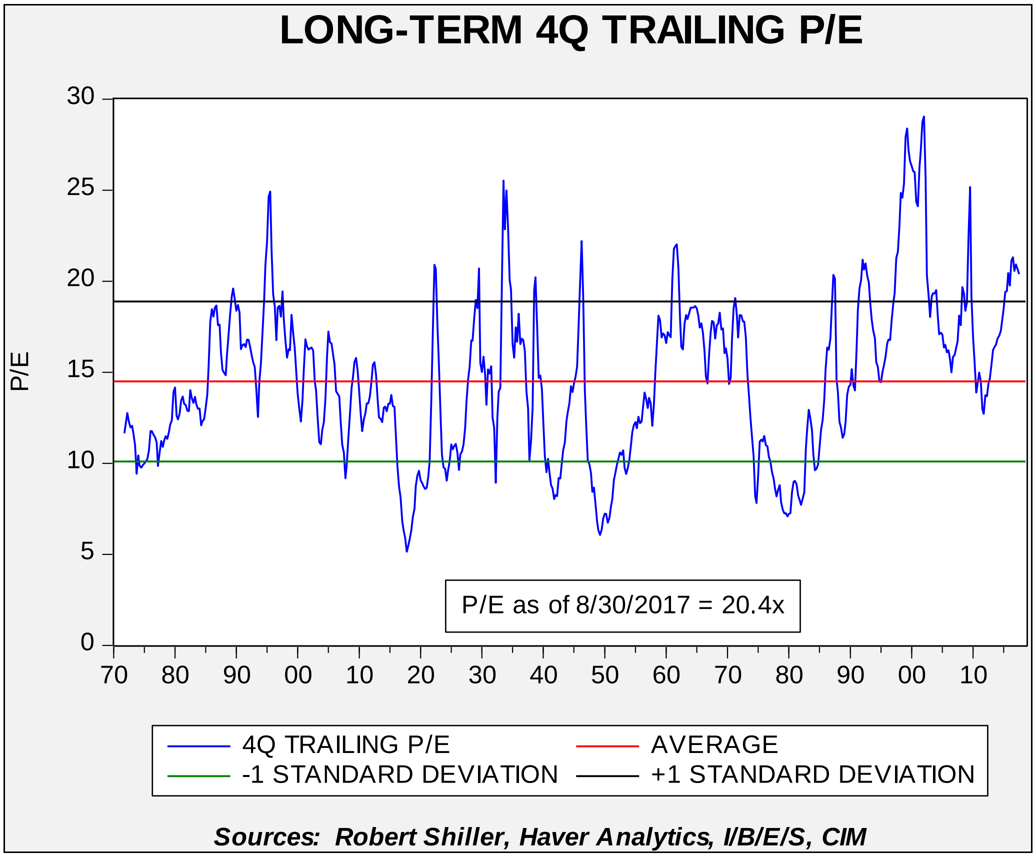


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 31, 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.

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[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.