[Posted: September 20, 2017—9:30 AM EDT] Global equity markets are mixed 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 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.

Markets are very quiet in front of the FOMC meeting. We get the results later today at 2:00 EDT, with a press conference about 30 minutes later. Here is what we are watching:

The UN speech: On the surface, the president's speech at the UN was more bellicose than we expected. The populist right was giddy; the centrist establishment was horrified. However, below the surface, we saw the speech as pure Andrew Jackson. As we have discussed before,[1] Jacksonian foreign policy rejects the globalist vision of policy, be it for the sake of business (Hamiltonian) or spreading American values (Wilsonian). Instead, it is based on supporting American sovereignty and supporting American interests first. At the same time, it is heavily invested in honor—the U.S. supports its allies but will react with overwhelming force against threats. Jacksonians reject the concept of limited war. This model of foreign policy, along with its more isolationist model, Jeffersonian policy, disappeared during the Cold War. It is clear the administration views North Korea and Iran as significant enemies. On the other hand, it seems willing to give more room to China and Russia. Although we expected a less aggressive speech, the content was no surprise. Thus, the potential for conflict in North Korea is elevated but, as we have noted before, there are no mobilization actions that one would expect if a conflict is imminent.

The Fed: Expectations are high for a beginning to the balance sheet runoff. We expect the Fed to stop reinvesting when bonds mature, initially allowing $5 bn per month to exit the balance sheet and eventually raising this to $50 bn. The dots plot will be of particular interest. Currently, fed funds futures put the odds of a December hike at virtually 50%. Thus, if the dots suggest the next rate hike isn't coming until 2018, we could see some dollar weakness develop. This topic will likely be addressed in the press conference if it isn't clear in the dots, which could lead to some volatility later in the day.

Another Russian bank in trouble: B&N Bank, one of the top five lenders in Russia, is reportedly in trouble and may need a bailout. This would be the second major bank in Russia in the past few months to require nationalization. Earlier, the Bank of Russia bailed out Bank Otkritie. To some extent, both banks have gotten into trouble by purchasing dodgy loans in smaller banks that were closed by the financial authorities. What is going on in Russia looks much like the Savings and Loan Crisis in the U.S. in the 1980s. The Bank of Russia is trying to

[1] See WGR, 4/4/2016, The Archetypes of American Foreign Policy: A Reprise.

consolidate the banking system and is encouraging larger banks to buy the smaller ones. However, the small banks apparently were in more trouble than they thought. We don't expect these bank failures to become systemic; instead, the Bank of Russia will simply nationalize these bad banks. The risk comes from the potential for a forced expansion of the money supply, which would lead to higher inflation.

Catalan independence vote: The *WSJ* reports that the Spanish police have arrested 13 officials associated with the planned October 1st referendum for Catalonia secession. The Spanish government has stated that the referendum is illegal and has vowed to stop it by any means necessary. The government's decision to crack down on officials will likely bolster support for the referendum within Catalonia. So far, the EU has refrained from intervening, apparently viewing it as an internal Spanish matter. However, the referendum can also be framed as a human rights issue and the EU's failure to mitigate the tensions between the Spanish government and Catalonia could possibly undermine its reputation as a defender of human rights. If the problem festers, it could have a bearish effect on the EUR.

U.S. Economic Releases

MBA mortgage applications fell 9.7% from the prior week. Purchases and refinancing fell 10.8% and 8.5%, respectively. The average 30-year fixed rate rose 1 bp from 4.03% to 4.04%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Existing Home Sales	m/m	aug	5.45 mn	5.44 mn	**
10:00	Existing Home Sales	m/m	aug	0.2%	-1.3%	**
Fed speakers or events						
EST	Speaker or event	District or position				
14:00	FOMC Rate Decision	Federal Reserve Board				

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								
Japan	Trade Balance	m/m	aug	113.6 bn	418.8 bn	104.4 bn	**	Equity bullish, bond bearish
	Trade Balance Adjusted	m/m	aug	367.3 bn	337.4 bn	404.5 bn	**	Equity and bond neutral
	Exports	y/y	aug	18.1%	13.4%	14.3%	**	Equity bullish, bond bearish
	Imports	y/y	aug	15.2%	16.3%	11.6%	**	Equity and bond neutral
	Convenience Store Sales	m/m	aug	-0.9%	0.0%		**	Equity and bond neutral
Australia	Westpac Leading Index	m/m	aug	-0.1%	0.1%		**	Equity and bond neutral
	Skilled Vacancies	m/m	aug	0.3%	0.8%		**	Equity and bond neutral
New Zealand	BoP Current Account Balance	m/m	aug	-0.618 bn	0.244 bn	-0.900 bn	**	Equity and bond neutral
	Current Account GDP Ratio	m/m	aug	-2.8%	-3.1%	-3.1%	**	Equity bullish, bond bearish
EUROPE								
Germany	PPI	y/y	aug	2.6%	2.3%	2.5%	**	Equity and bond neutral
UK	Retail Sales ex Auto Fuel	y/y	aug	2.8%	1.5%	1.4%	**	Equity bullish, bond bearish
	Retail Sales inc Auto Fuel	y/y	aug	2.4%	1.3%	1.1%	**	Equity bullish, bond bearish
Russia	Unemployment Rate	m/m	aug	4.9%	5.1%	5.1%	***	Equity and bond neutral
	Real Disposable Income	m/m	aug	-0.3%	-0.9%	0.0%	***	Equity bearish, bond bullish
	Real Wages	m/m	aug	3.7%	4.6%	3.8%	***	Equity and bond neutral
	Retail Sales Real	m/m	aug	1.9%	1.0%	1.1%	**	Equity bullish, bond bearish
AMERICAS								
Canada	Manufacturing Sales	m/m	jul	-2.6%	-1.8%	-1.9%	**	Equity bearish, bond bullish
Mexico	International Reserves Weekly	m/m	sep	$173.370 bn	$173.575 bn		**	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)	133	132	1	Up
3-mo T-bill yield (bps)	101	102	-1	Neutral
TED spread (bps)	31	31	0	Neutral
U.S. Libor/OIS spread (bps)	117	117	0	Up
10-yr T-note (%)	2.23	2.25	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	25	25	0	Up
Currencies	**Direction**			
dollar	down			Down
euro	down			Up
yen	up			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action		**Prior**	**Expected**	
FOMC Rate Decision Upper Bound		1.000%	1.250%	On forecast
FOMC Rate Decision Lower Bound		0.750%	1.000%	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	$55.83	$55.14	1.25%	Bullish API Report
WTI	$50.06	$49.48	1.17%	
Natural Gas	$3.13	$3.12	0.10%	
Crack Spread	$21.42	$21.68	-1.18%	
12-mo strip crack	$19.67	$19.77	-0.48%	
Ethanol rack	$1.69	$1.69	-0.06%	
Metals				
Gold	$1,314.45	$1,311.15	0.25%	
Silver	$17.36	$17.32	0.25%	
Copper contract	$298.30	$296.95	0.45%	
Grains				
Corn contract	$ 349.00	$ 348.25	0.22%	
Wheat contract	$ 444.25	$ 443.00	0.28%	
Soybeans contract	$ 968.75	$ 965.50	0.34%	
Shipping				
Baltic Dry Freight	1415	1398	17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-2.5		
Distillates (mb)		-1.7		
Refinery run rates (%)		5.00%		
Natural gas (bcf)		93.0		

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 western region. Hurricane Jose has been downgraded to a Tropical Storm and is expected to touch the East Coast on Thursday. Hurricane Maria has made landfall in Puerto Rico and is expected to touch down in the Dominican Republic on Thursday and move into the Atlantic Ocean afterward. At this time, Hurricane Maria is not a threat to the Gulf of Mexico.

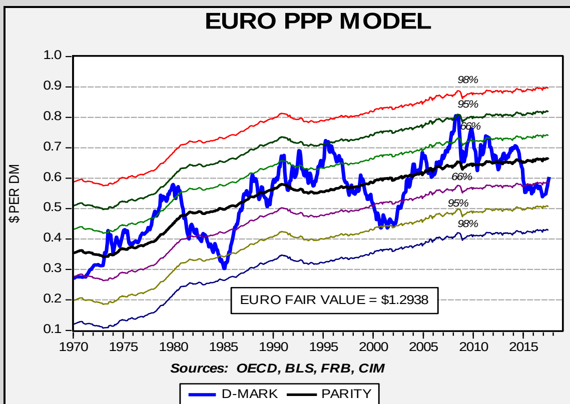
Asset Allocation Weekly Comment

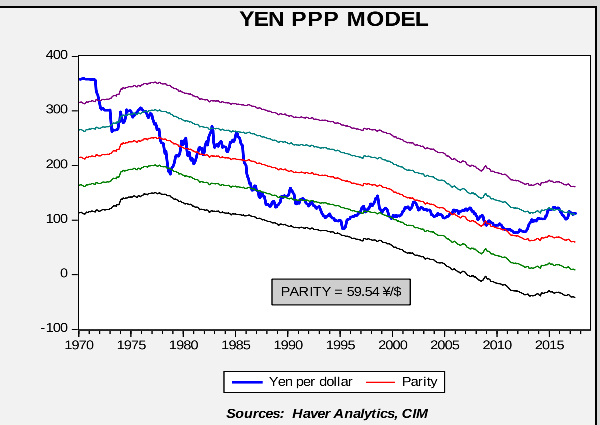
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

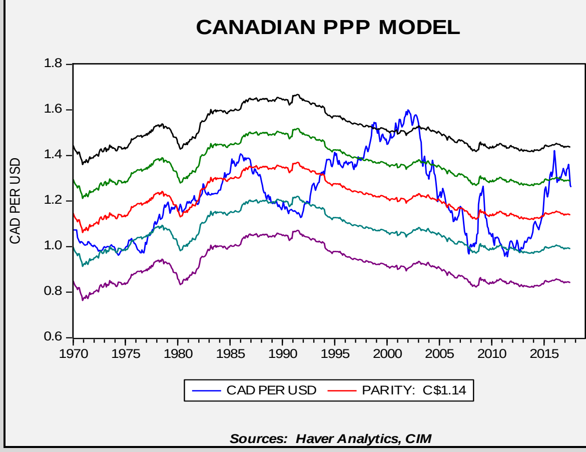
September 15, 2017

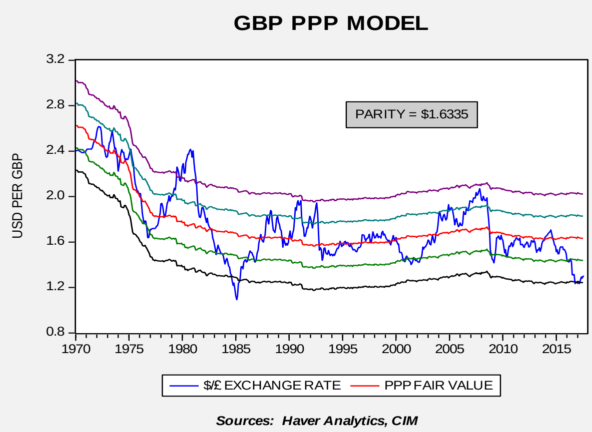
In our most recent asset allocation rebalancing, we added foreign allocations to our portfolios. Over the past few years, we had generally avoided allocations to non-U.S. markets in asset allocation portfolios due to two primary concerns. First, the dollar had been appreciating as a result of an improving 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.







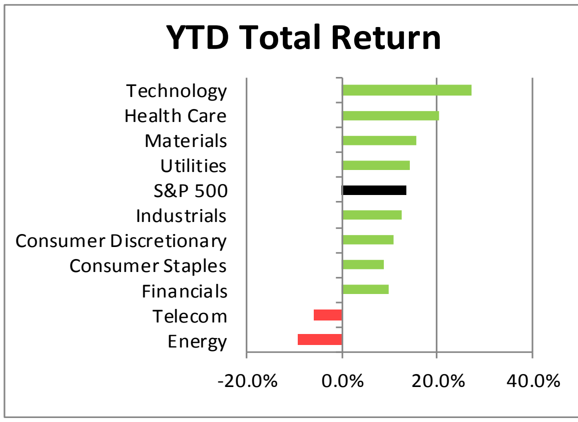


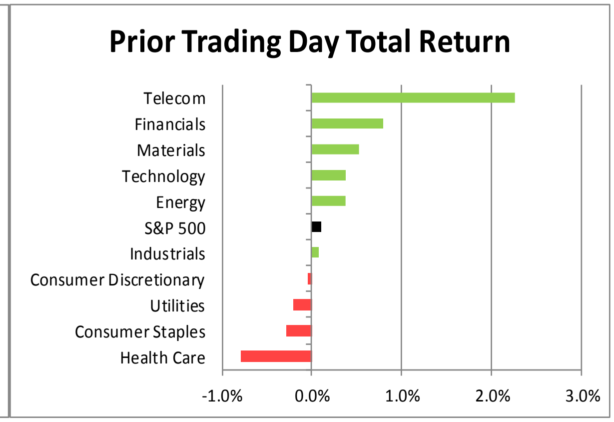
This chart shows four purchasing power parity models for the aforementioned currencies. In all four cases, the dollar was trading "rich" by more than one standard error, and nearly two standard errors from parity in two cases. Over the past two months, three of the four currencies have begun to appreciate 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 9/19/2017 close)

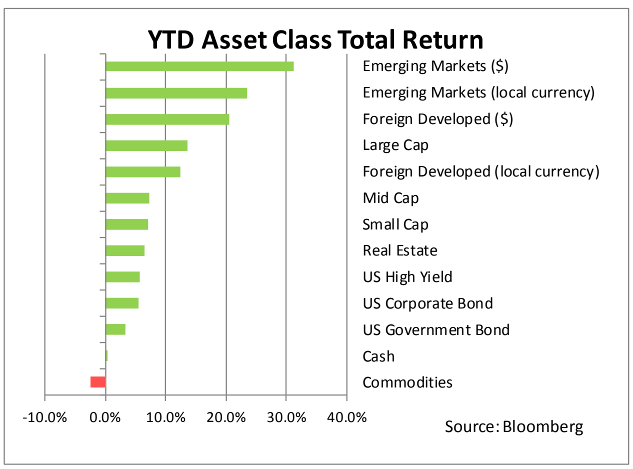




(Source: Bloomberg)

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 9/19/2017 close)

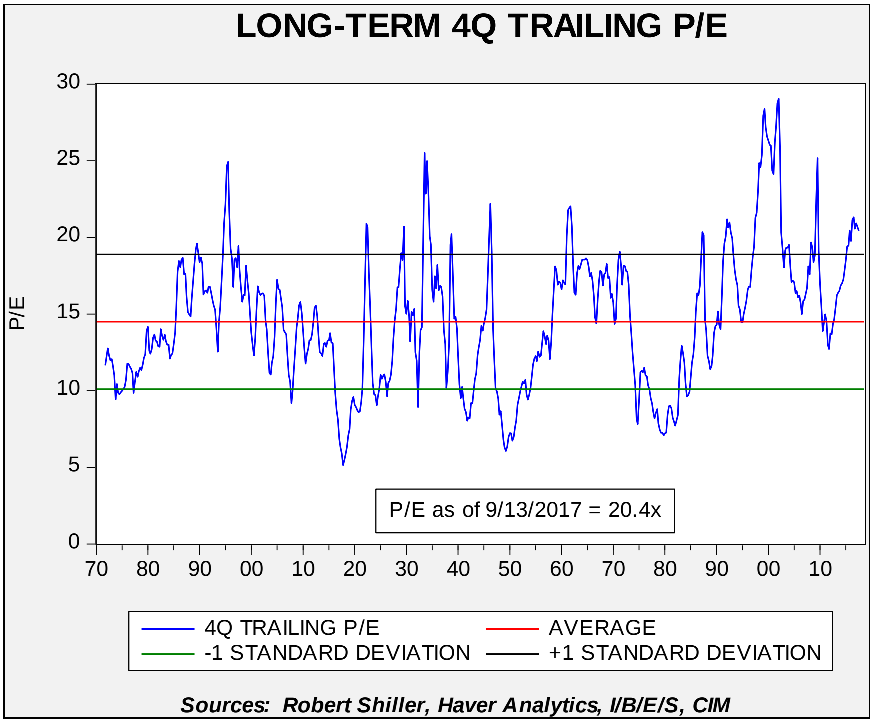


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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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[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.