Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: September 22, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.5% from the prior close. Chinese markets were down, with the Shanghai composite down 0.2% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a lower open.

There is much to discuss this morning. Let's get to it:

North Korea returns: After President Trump's speech to the UN we have been waiting for a response from the Kim regime. Overnight, we got our answer. The Young Marshal offered a rambling response to Trump but, more importantly, suggested he is considering a thermonuclear test in the waters of the Pacific Ocean. Non-underground testing of nuclear devices has become rare; the last one we could find was by China in 1980. Underwater testing was usually done to evaluate the impact on naval vessels; if the test occurs near the surface it can disperse significant amounts of nuclear fallout in the water and create radioactive steam. However, contamination is generally limited to the area around the blast. Still, such a test would be a major escalation of tensions. If the underwater test is a device offshore tethered to a barge (the usual method), it's a problem but not a red line. On the other hand, if the test is a warhead on a missile that is launched into the ocean and detonated, that would likely cross a red line and bring a military response from the U.S. The Trump administration has unveiled new financial sanctions that could potentially raise pressure on Chinese financial entities dealing with North Korea.

There is no doubt that tensions are escalating and the bellicose rhetoric is pushing both leaders into corners that will be difficult to walk back from without losing face. So far, financial markets are taking the news in stride. As we have seen recently, most of the impact has been in the forex markets; the dollar has declined,[1] Treasuries are modestly higher and equities are mixed. Although financial markets are concerned, there has been no discounting for war. If a conflict does break out, we would expect a much larger downturn in equities; the duration and depth would be dependent upon the level of intensity and the outcome of a conflict.

German elections: Germans go to the polls on Sunday. Current polling strongly suggests that Chancellor Merkel will remain in her role after the elections. The latest polls show Merkel's CDU/CSU holding a comfortable 14.5% lead over her nearest competitor, the Social Democrats (SPD). There are two unknowns in this election. First, Merkel will almost certainly need a coalition partner. The current government is a "grand coalition" of the CDU/CSU and the SPD. If the Free Democrats (FDP), a more libertarian party, get enough seats, you might see a

[1] One question we have been getting recently is, "Why is the JPY a flight to safety currency?" It's a good question. The best answer is that Japan, due to years of current account surpluses, has significant levels of overseas investments. When crises hit, Japanese investors pull some of their money home, causing a rally in the JPY.

CDU/CSU and FDP government. This has been a traditional alignment in Germany. A CDU/CSU and FDP coalition would probably take a harder line on the Eurozone issue as the FDP is much less enamored with the EU and the Eurozone. Currently, polling suggests another grand coalition, meaning the status quo continues. The second issue is the rise of the AfD, which is a right-wing populist party. It is polling close to 11%, meaning it will almost certainly gain representation in the Bundestag. No other party plans to join the AfD but its presence in the legislature will be a jarring development and highlights that, even in Germany, populism is gaining strength.

Kurdish referendum: On Monday, Iraqi Kurds are planning to hold a referendum on independence. The Iraqi government, the U.S., Iran and Turkey all oppose the move.[2] However, on the ground, the situation is more complicated. First, the Kurds themselves are not unified. The Syrian Kurds have closer relations with the Kurds in Turkey and are not all that close to the Iraqi Kurds. The Syrian/Turkish Kurds are aligned with a leftist (neo-Marxist) movement of the Kurdistan Workers Party (PKK). The Turkish government is much more concerned about a Kurdish state in Syria because it would have common cause with the Kurds in Turkey. On the other hand, the Iraqi Kurds have been useful to Turkey. A Kurdish state in Iraq would be deeply dependent on Turkey—oil pipelines from the Kurdish region transverse Turkey. About 90% of Iraqi Kurdistan's revenue comes from oil. In addition, a Kurdish state split from Iraq narrows the "Shiite Crescent" that gives Iran influence from Tehran to Lebanon and reduces Iraq significantly. Turkey isn't comfortable with a Kurdish state on its border but it could be useful. We expect the referendum to go forward and the vote to clearly favor independence. From there, the negotiations begin.

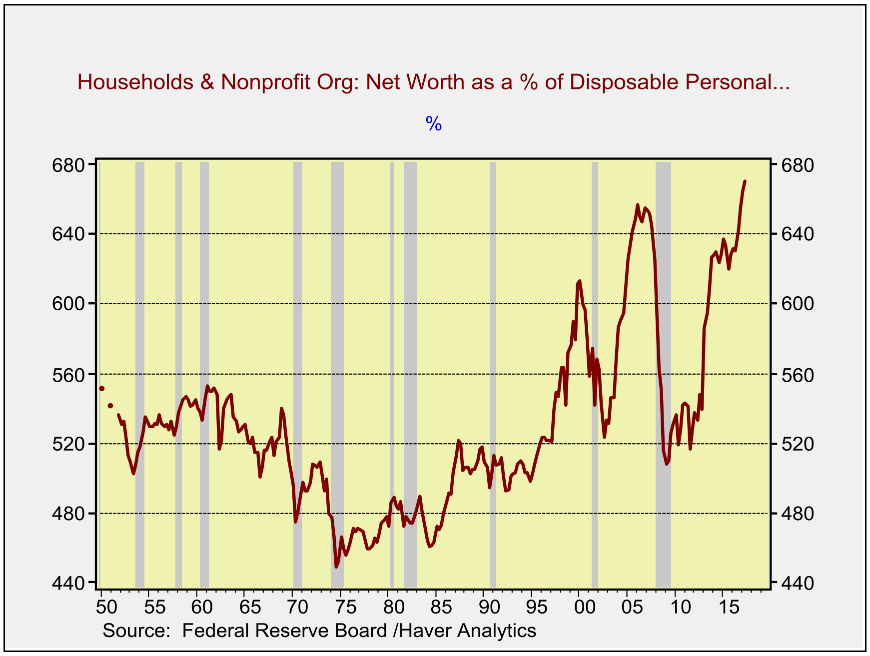
May speaks in Florence: PM May is giving a speech in Florence today. There is great anticipation over her comments because progress on Brexit has been slow and the clock is running. She is expected to allow the EU and the U.K. to split in about 18 months, but it is thought that she will ask for a two-year transition period to prevent a "regulatory cliff" and chaos. We doubt the EU will comply with her wishes; the EU wants to raise fears among others that leaving the EU is dangerous and costly. The downside for the EU is that hurting the U.K. will harm the EU as well. Moreover, the U.K. is arguably[3] the most competent military in Europe and NATO could become a less impressive force without full participation from the U.K. military.

The flow of funds: Yesterday, the Federal Reserve released the Financial Accounts of the U.S., which was formally known as the "flow of funds" report. It is a rich report with lots of interesting information. We will have more to detail on this report in an upcoming Asset Allocation Weekly, but one chart we will show today is household net worth as a percentage of after-tax income. As shown on the chart below, net worth has hit another new record, a reflection of elevated asset prices. As the history shows, elevated levels are followed by corrections, mostly due to weaker equity markets. Note that declines in the level of household net worth are closely tied to recessions. At this juncture, none of our recession indicators are

[2] The only regional power showing unabashed support is Israel.

[3] The French military is considered a close second.

suggesting that a recession is imminent. Thus, the chart confirms equity markets are elevated, but nothing more.



U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing	m/m	sep	53.0	52.8	**
9:45	Markit US Services	m/m	sep	55.7	56.0	**
9:45	Markit US Composite	m/m	sep		55.3	**
Fed speakers or events						
13:30	Robert Kaplan speaks at oil conference	President of the Federal Reserve Bank of Dallas				

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	Japan buying foreign bonds	m/m	aug	381.8 bn	198.7 bn		**	Equity and bond neutral
	Japan buying foreign stocks	m/m	aug	141.9 bn	306.1 bn		**	Equity and bond neutral
	Foreign buying Japan bonds	m/m	aug	-55.0 bn	555.8 bn		**	Equity and bond neutral
	Foreign buying Japan stocks	m/m	aug	-918.6 bn	-644.6 bn		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing PMI	y/y	sep	58.2	57.4	57.2	**	Equity bullish, bond bearish
	Markit Eurozone Services PMI	y/y	sep	55.6	54.7	54.8	**	Equity bullish, bond bearish
	Markit Eurozone Composite PMI	y/y	sep	56.7	55.7	55.6	**	Equity bullish, bond bearish
Germany	Markit/BME Germany Manufacturing PMI	y/y	sep	60.6	59.3	59.0	**	Equity bullish, bond bearish
	Markit Germany Services PMI	m/m	sep	55.6	53.5	53.7	**	Equity bullish, bond bearish
	Markit/BME Germany Composite PMI	m/m	sep	57.8	55.8	55.7	**	Equity bullish, bond bearish
France	GDP	y/y	2q	1.8%	1.7%	1.7%	***	Equity bullish, bond bearish
	Wages	q/q	2q	0.4%	0.4%	0.4%	**	Equity and bond neutral
	Markit France Manufacturing PMI	m/m	sep	56.0	55.8	55.5	**	Equity bullish, bond bearish
	Markit France Services PMI	m/m	sep	57.1	54.9	54.8	**	Equity bullish, bond bearish
	Markit France Composite PMI	m/m	sep	57.2	55.2	55.0	**	Equity bullish, bond bearish
AMERICAS								
Brazil	FGV Consumer Confidence	m/m	sep	82.3	80.9		**	Equity bullish, bond bearish

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	133	-1	Up
3-mo T-bill yield (bps)	100	102	-2	Neutral
TED spread (bps)	32	31	1	Neutral
U.S. Libor/OIS spread (bps)	118	118	0	Up
10-yr T-note (%)	2.25	2.28	-0.03	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	up			Up
yen	down			Neutral
pound	down			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	$56.39	$56.43	-0.07%	
WTI	$50.40	$50.55	-0.30%	
Natural Gas	$2.97	$2.95	0.71%	
Crack Spread	$19.95	$19.74	1.05%	
12-mo strip crack	$19.66	$19.57	0.46%	
Ethanol rack	$1.68	$1.68	-0.11%	
Metals				
Gold	$1,295.33	$1,291.20	0.32%	Weaker Dollar
Silver	$16.98	$16.96	0.10%	
Copper contract	$293.25	$293.45	-0.07%	
Grains				
Corn contract	$ 352.00	$ 350.25	0.50%	
Wheat contract	$ 454.25	$ 452.50	0.39%	
Soybeans contract	$ 979.25	$ 970.75	0.88%	
Shipping				
Baltic Dry Freight	1470	1449	21	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.6	3.0	1.6	
Gasoline (mb)	-2.1	-2.5	0.4	
Distillates (mb)	-5.7	-1.7	-4.0	
Refinery run rates (%)	5.50%	5.00%	0.50%	
Natural gas (bcf)	97.0	93.0	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 for the West Coast. Tropical Storm Jose has weakened into a post-tropical storm. Hurricane Maria has moved into the Atlantic Ocean.

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 22, 2017

In a recent speech,[4] New York FRB President Bill Dudley made the case that the FOMC should continue to reduce monetary stimulus even though inflation remains below target. His contention is that benign financial conditions in the face of tighter policy are creating distortions in financial markets, resulting in the need for additional policy tightening.

Congress has given the Federal Reserve dual mandates—full employment and low inflation. The Phillips Curve would suggest that meeting both is often impossible. The curve postulates that there is a tradeoff between inflation and unemployment, and so meeting one objective probably means missing the other. Since the 1970s, the Phillips Curve has become increasingly less reliable; globalization and deregulation have led to persistently falling price pressures. In other words, inflation is falling on its own, and thus monetary policy can mostly focus on full employment. Based on the current unemployment rate, it is likely that full employment has probably been achieved, although the persistence of weak wage growth would suggest that the Fed should be in no hurry to raise rates.

Although the FOMC has dual mandates, every central bank has the goal of financial stability. After all, the primary reason for creating a central bank is to build a system for a lender of last resort who will lend to financial institutions during liquidity crises. The Federal Reserve was created in 1913 in response to the Panic of 1907, which was single-handedly stopped by John Pierpont Morgan (yes, that J.P. Morgan). President Roosevelt, while relieved that private bankers were able to end the panic, was also worried that relying on this solution in the future was tempting fate. Thus, he started the debate on creating a U.S. central bank that resulted in the founding of the Federal Reserve six years later.

During financial crises, commercial banks face liquidity problems. Banks operate by maturity transformation. They take short-term loans (also known as deposits), repayable on demand, and transform them into less liquid but higher yielding loans. As long as depositors don't demand their money *en masse*, the system works well; cash becomes investable and helps build the economy by providing funds for investment. However, in a panic, banks may be forced to liquidate good loans to meet the demands from depositors. This selling can damage the financial system needlessly. The central bank is designed to lend against these loans so that banks can meet depositor demand and quell the panic.[5]

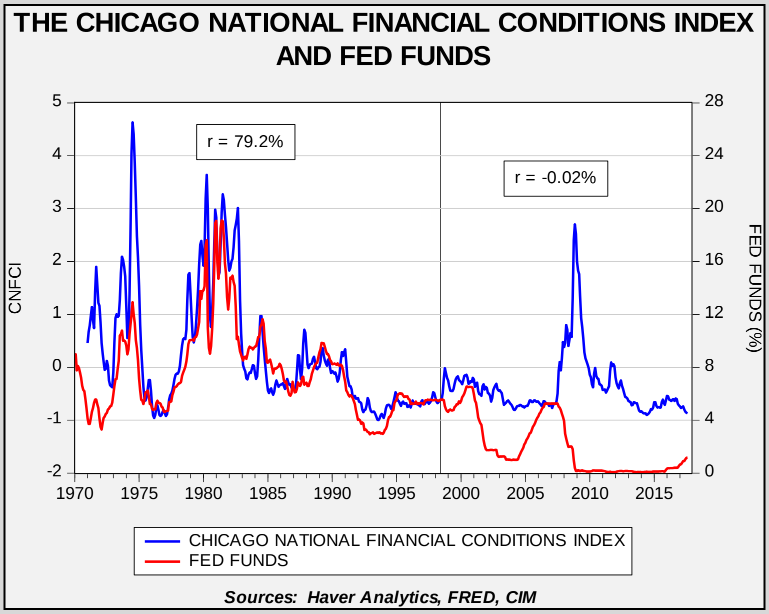
---

[4] https://www.newyorkfed.org/newsevents/speeches/2017/dud170907

[5] The problem for the central bank is determining if a commercial bank faces a solvency or a liquidity crisis. If the assets of the bank, its loans, are dodgy, the lending against them is probably a mistake and the bank should be liquidated. On the other hand, if the loans are of good quality, then lending against these loans is a sound way to contain a banking panic.

Essentially, one of the key roles of a central bank is crisis management. Thus, most central banks have regulatory power to prevent commercial banks from taking excessive risk. Reserve requirements, capital requirements, bank inspections, stress tests and the general level of interest rates are all used to reduce the likelihood of a panic. Creating an environment of healthy fear can curb bankers' "animal instincts" and prevent them from becoming overly optimistic and making aggressive loans. Unfortunately, if the Federal Reserve is successful in its Congressional mandates, it can prolong the business cycle. As Hyman Minsky noted,[6] the longer economic conditions appear calm, the greater the likelihood that investors, borrowers and lenders will be inclined to take more risk. The Minsky Instability Theory postulates that economic actors are more likely to create instability the longer conditions remain stable.

Dudley's comment about financial stability is worth examining. On the chart below, we overlay the Chicago FRB National Financial Conditions Index along with the fed funds rate.



The blue line on the chart shows the aforementioned Financial Conditions Index, which measures the level of stress in the financial system. It is constructed of 105 variables, including the level of interest rates, credit spreads, equity and debt market volatility, delinquencies, borrower and lender surveys, debt and equity issuance, debt levels, equity levels and various commodity prices (including gold). A rising line indicates increasing financial stress or deteriorating financial conditions. The red line is the effective fed funds rate. Until mid-1998, the two series were positively and closely correlated. When the Fed raised rates, financial stress rose; when the Fed lowered rates, stress declined. After 1998, the two series became virtually uncorrelated.

We believe there are two factors that changed this relationship. The first is policy transparency. Starting in the late 1980s, the Fed became increasingly transparent. For example, before 1988

---

[6] Minsky, H. (2008). *Stabilizing an Unstable Economy* (2nd ed.). New York, NY: McGraw-Hill (originally published 1986).

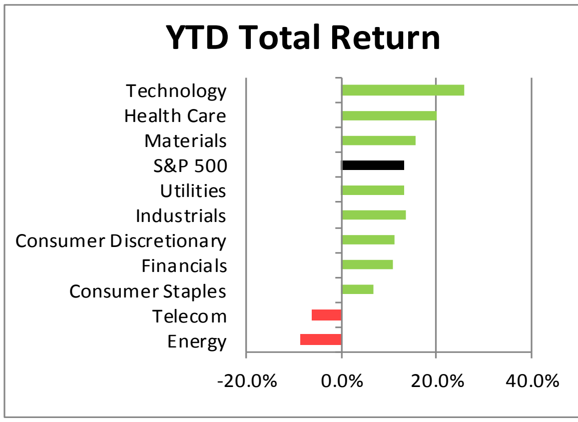
the FOMC would meet but issue no statement about what it had decided to do. Investors and the financial system had to guess whether policy had been changed. Starting in 1988, the central bank began publishing its target rate. In the 1990s, it began issuing a statement when rates changed. Eventually, a statement followed all meetings. As the FOMC has become more transparent, the correlation between stress and the level of fed funds has changed. Essentially, the markets now know with a high degree of certainty when rate changes are likely. This is especially true of tightening. The FOMC appears to avoid making rate hikes that surprise the market.

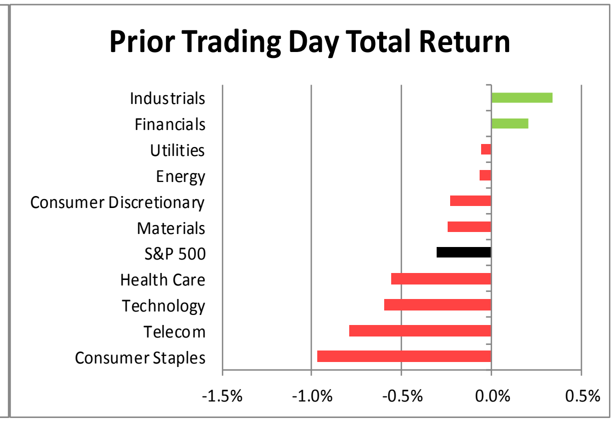
The second factor is financial system stability. From the Great Depression into the 1980s, policymakers put a high premium on system stability at the expense of efficiency. Bank failures were rare and there were a large number of rather small institutions. In addition, commercial banks were separated from investment banks. The drive to improve efficiency in the financial system led to consolidation among commercial banks and a breakdown of the barriers between commercial and investment banks. Although this made the system more efficient, it also undermined stability. Thus, when raising rates, the Fed must pay close attention to system stability to prevent crises, which has tended to lead to gradual and measured policies. This behavior maintains stability…until it doesn't!

It appears that Dudley would like to return to the pre-1998 period. We tend to agree with that sentiment. Monetary policy would be much more effective if financial stress moved directly with changes in policy rates. However, if our thesis that transparency and industry concentration led to the change in the relationship, it seems highly unlikely that policymakers would reverse those conditions. Instead, we now live with markets where policymakers have virtually no control over financial conditions; the longer conditions are quiet, the more emboldened investors, lenders and borrowers are likely to become. And, when financial conditions deteriorate, it seems to require extraordinary measures by central bankers to restore calm. This means that investors live in a world where financial conditions appear benign most of the time until they are not and then they become quite adverse. Monetary transparency has probably created distorted financial conditions where risks are hidden and thus encourage risky behavior, suggesting investors should exercise more caution than financial conditions currently signal.

Data Section

U.S. Equity Markets – (as of 9/21/2017 close)

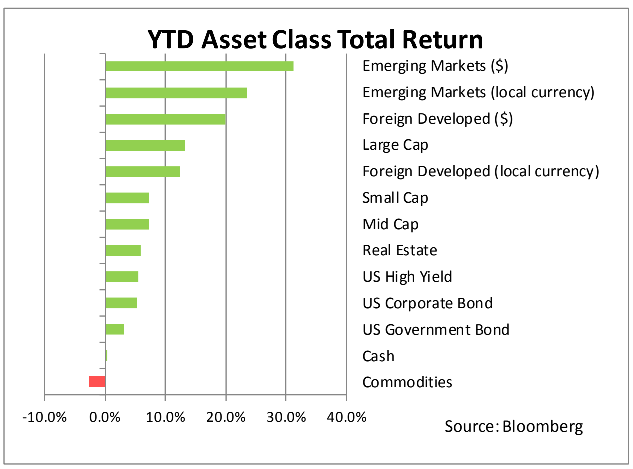




(Source: Bloomberg)

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 9/21/2017 close)

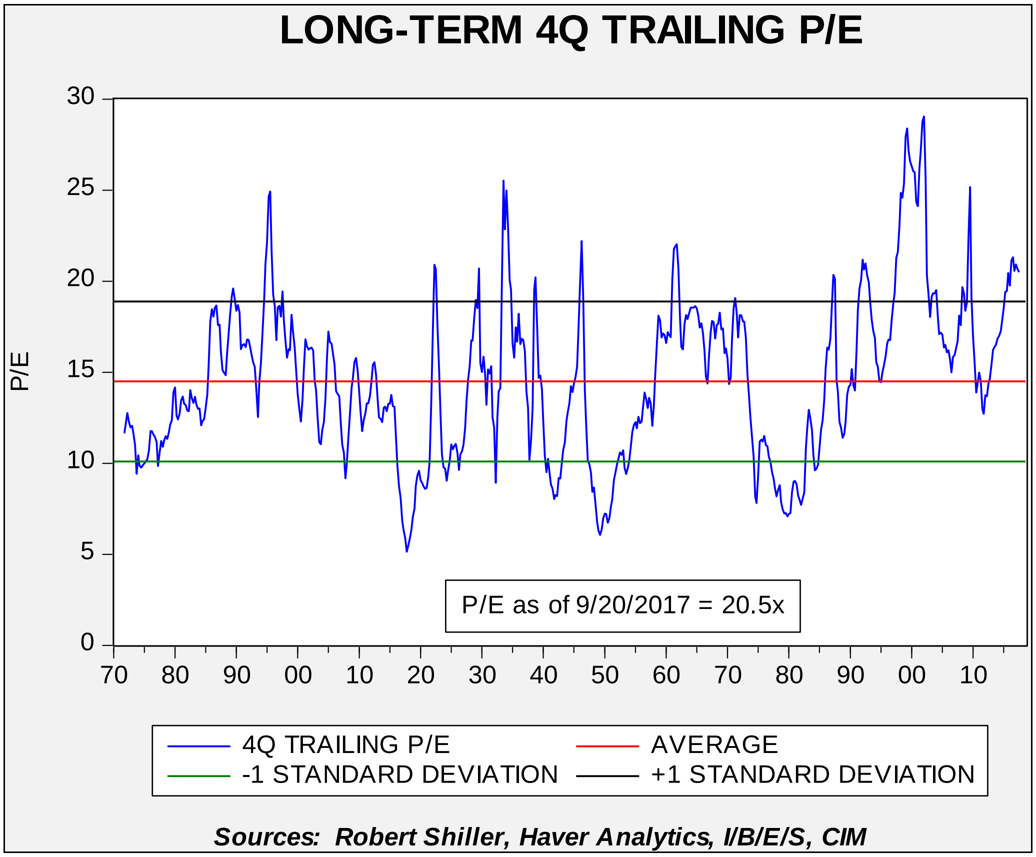


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2017



Based on our methodology,[7] the current P/E is 20.5x, up 0.1x 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.

---

[7] 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.