# Daily Comment

**By Bill O'Grady and Thomas Wash**

**[Posted: September 26, 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 down 0.6% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index relatively unchanged. U.S. equity index futures are signaling a flat open.

Financial markets are generally quiet this morning. Here are the news items we are watching:

**The German elections reverberate:** Although Merkel remains chancellor, the German political landscape is shifting radically. If the ruling coalition is made up of the CDU/CSU, FDP and the Greens, it will be the first three-party government in postwar German history. And, even putting this coalition together is problematic. The FDP would probably prefer to be in the opposition. How the Greens will operate in a conservative government will be interesting. The CDU/CSU is generally considered one party but it isn't; the CSU, mostly representing Bavaria, has more of a Catholic Church influence. Thus, it is more socially conservative than the CDU and tends to support social spending. The rise of the socially conservative AfD is putting pressure on the more conservative CSU to break with the CDU. If this were to occur, new elections would be difficult to avoid. The uncertainty surrounding the German government is putting pressure on the EUR this morning for the second consecutive day.

**The Kurds vote:** We won't get the official results from the Kurdish vote for a few days, but it seems highly improbable that the vote will not support independence. Neighboring nations are threatening the Kurds; Iraq and Turkey are holding military exercises near the Kurdish region and Iran has been making threatening comments. Turkey has also threatened to cut off Kurdish oil exports, which is one of the reasons oil prices have lifted. The Kurds want independence but it is obvious that the only way they can get it is to gain the protection of a local power. The more likely candidates would be Turkey or Iran. Usually, Turkey would oppose Kurdish statehood but having a state dependent on Turkey might be attractive.

**A declaration of war:** Financial markets were rattled by comments from North Korea's Foreign Minister Ri Su Yong, who indicated that President Trump's recent statements to the UN were a "declaration of war" and North Korea reserves the right to shoot down any foreign warplanes that venture near the country, even if they are over international airspace. Reuters is reporting that North Korea has boosted its air defenses on its eastern border.[1] This sort of talk is unsettling but it should be remembered that North Korea has a long history of provocations. These include the sinking of the ROKS Cheonan in 2010, the boarding and capture of the U.S.S. *Pueblo* in

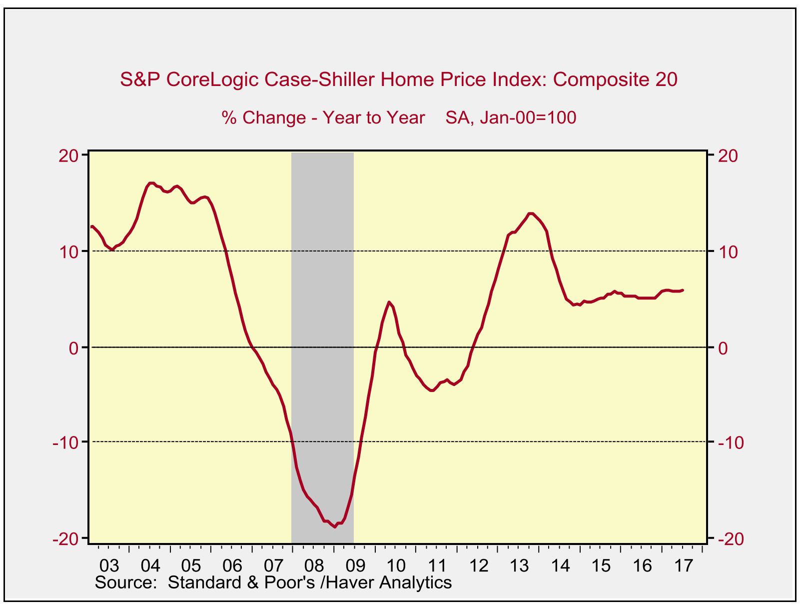
[1] http://www.reuters.com/article/us-northkorea-missiles/north-korea-bolsters-defenses-after-flight-by-u-s-bombers-as-rhetoric-escalates-idUSKCN1C026A?il=0

1968 and the 1976 "Axe Murder Incident" where North Korean troops attacked an American and South Korean tree trimming operation in the Demilitarized Zone, killing two U.S. soldiers. North Korea also downed a civilian aircraft, Korean Air Flight 858, in 1987. After the U.S. sanctioned Kim Jong-un in July 2016, the official news agency declared it as "an act of war." The same occurred after South Korea withdrew from a joint industrial complex in February 2016. The key point here is that provocative statements and actions are standard course for the DPRK; how the U.S. reacts is important, but North Korea declaring war isn't unusual.

**Yellen speaks:** As noted below, Chair Yellen speaks today. We will be watching to see if she adheres to the generally hawkish tone of the statement or if her own position is more dovish. We expect her to hold to the hawkish line, which may be dollar supportive.

**U.S. Economic Releases**

The S&P CoreLogic CS 20-city Home Price Index came in above expectations at 5.81% compared to the forecast rise of 5.70% from the prior year. The S&P CoreLogic CS U.S. Home Price Index rose by 5.94% from the prior year. The prior report was revised upward from 5.77% to 5.82%.




The chart above shows the year-over-year change in the S&P CoreLogic CS Home Price Index.

The table below shows the economic releases and Fed events scheduled for the rest of the day. We have a growing list of Fed speakers this week.

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 10:00 | New Home Sales | m/m | aug | 585k | 571k | ** |
| 10:00 | New Home Sales | m/m | aug | 2.5% | -9.4% | ** |
| 10:00 | Conference Board Consumer Confidence | m/m | sep | 120.0 | 122.9 | ** |
| 10:00 | Conference Board Present Situation | m/m | sep | | 151.2 | ** |
| 10:00 | Conference Board Expectations | m/m | sep | | 104.0 | ** |
| 10:00 | Richmond Fed Manufacturing Index | m/m | sep | 13 | 14 | ** |
| Fed speakers or events | | | | | | |
| EST | Speaker or event | District or position | | | | |
| 10:30 | Lael Brainard Speaks in Cambridge, Massachusetts | Member of the Board of Governors | | | | |
| 11:30 | Raphael Bostic Speaks to the Atlanta Press Club | President of the Federal Reserve Bank of Atlanta | | | | |
| 12:45 | Janet Yellen Appears before Senate Banking Panel | Chairman of Board of Governors of Federal Reserve | | | | |

## 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 | PPI Servuces | y/y | aug | 0.8% | 0.6% | 0.6% | ** | Equity bullish, bond bearish |
| Australia | ANZ Roy Morgan Weekly Consumption | m/m | jul | 114.1 | 114.8 | | ** | Equity and bond neutral |
| New Zealand | Trade Balance | m/m | aug | -1.235 bn | 0.085 bn | -0.825 bn | ** | Equity bearish, bond bullish |
| | Exports | m/m | aug | 3.69 bn | 4.63 bn | 4.05 bn | ** | Equity bearish, bond bullish |
| | Imports | y/y | aug | 4.92 bn | 4.55 bn | 4.80 bn | ** | Equity bearish, bond bullish |
| | Trade Balance 12 Mth YTD | m/m | aug | -3.20 bn | -3.21 bn | -2.91 bn | ** | Equity bearish, bond bullish |
| | ANZ Activity Outlook | m/m | aug | 29.6 | 38.2 | | ** | Equity and bond neutral |
| | ANZ Business Confidence | m/m | aug | 0.0 | 18.3 | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Germany | Import Price Index | y/y | aug | 2.1% | 1.9% | 2.1% | ** | Equity and bond neutral |
| France | Business Confidence | y/y | sep | 109 | 109 | 110 | ** | Equity and bond neutral |
| | Manufacturing Confidence | y/y | sep | 110 | 111 | 110 | ** | Equity and bond neutral |
| | Production Outlook Indicator | m/m | sep | 23 | 20 | | ** | Equity and bond neutral |
| | Own-Company Production | m/m | sep | 18 | 15 | | ** | Equity and bond neutral |
| UK | UK Finance Loans for Housing | m/m | aug | 41807 | 41587 | 41700 | ** | Equity bearish, bond bullish |
| AMERICAS | | | | | | | | |
| Mexico | Economic Activity | y/y | jul | 1.0% | 2.4% | 1.7% | ** | Equity bearish, bond bullish |
| Canada | Manufacturing Sales | m/m | jul | 58.9 | 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)** | 133 | 133 | 0 | Up |
| **3-mo T-bill yield (bps)** | 103 | 103 | 0 | Neutral |
| **TED spread (bps)** | 30 | 30 | 0 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 118 | 118 | 0 | Up |
| **10-yr T-note (%)** | 2.21 | 2.22 | -0.01 | Neutral |
| **Euribor/OIS spread (bps)** | -33 | -33 | 0 | Down |
| **EUR/USD 3-mo swap (bps)** | 33 | 33 | 0 | Up |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Down |
| euro | down | | | 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 | $58.67 | $59.02 | -0.59% | Long Liquidation |
| WTI | $52.06 | $52.22 | -0.31% | |
| Natural Gas | $2.94 | $2.92 | 0.79% | |
| Crack Spread | $20.14 | $20.36 | -1.11% | |
| 12-mo strip crack | $20.01 | $20.23 | -1.10% | |
| Ethanol rack | $1.68 | $1.68 | -0.04% | |
| **Metals** | | | | |
| Gold | $1,303.21 | $1,310.78 | -0.58% | Market Rebalancing |
| Silver | $17.03 | $17.18 | -0.86% | |
| Copper contract | $294.90 | $293.75 | 0.39% | |
| **Grains** | | | | |
| Corn contract | $ 353.25 | $ 353.75 | -0.14% | |
| Wheat contract | $ 455.25 | $ 454.00 | 0.28% | |
| Soybeans contract | $ 971.00 | $ 971.25 | -0.03% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1503 | 1502 | 1 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | 2.5 | | |
| Gasoline (mb) | | -1.5 | | |
| Distillates (mb) | | -2.1 | | |
| Refinery run rates (%) | | 2.75% | | |

## Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Hurricane Maria remains in the Atlantic Ocean and is expected to make landfall in North Carolina on Wednesday as 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 22, 2017

In a recent speech,[2] 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.

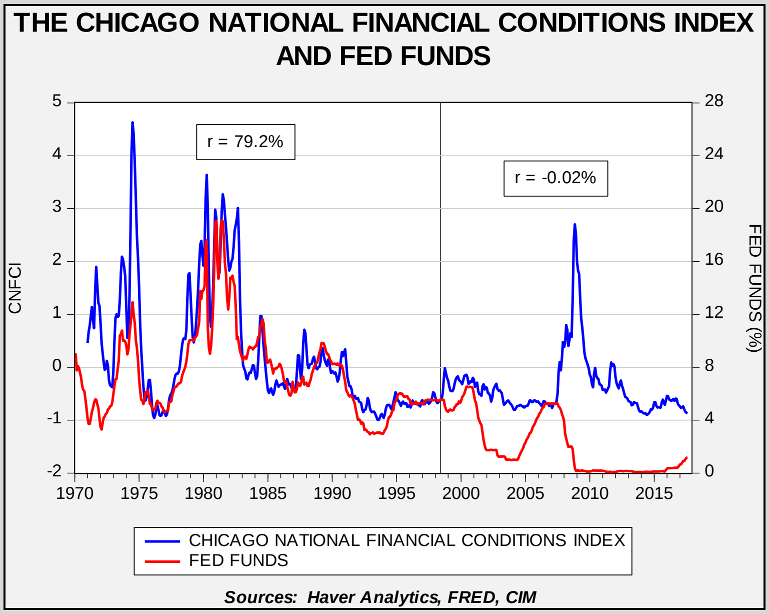
During financial crises, commercial banks face liquidity problems. Banks operate by maturity transformation. They take short-term loans (also known as deposits), repayable on demand, and transform them into less liquid but higher yielding loans. As long as depositors don't demand their money *en masse*, 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.[3]

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

[3] 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,[4] 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

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

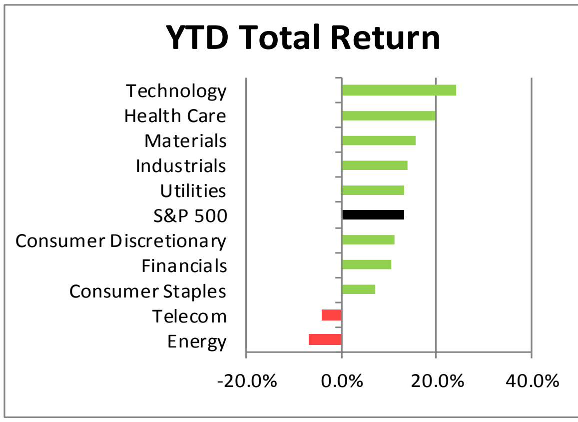
the FOMC would meet but issue no statement about what it had decided to do. Investors and the financial system had to guess whether policy had been changed. Starting in 1988, the central bank began publishing its target rate. In the 1990s, it began issuing a statement when rates changed. Eventually, 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.

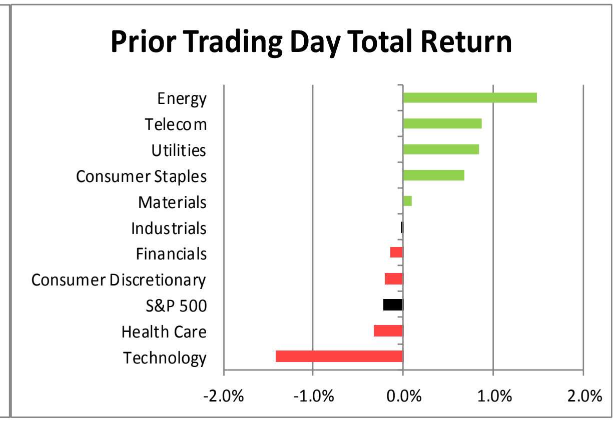
The second factor is financial system stability. From the Great Depression into the 1980s, policymakers put a high premium on system stability at the expense of efficiency. Bank failures were rare and there were a large number of rather small institutions. In addition, commercial banks were separated 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.

**<u>Data Section</u>**

**U.S. Equity Markets** – (as of 9/25/2017 close)

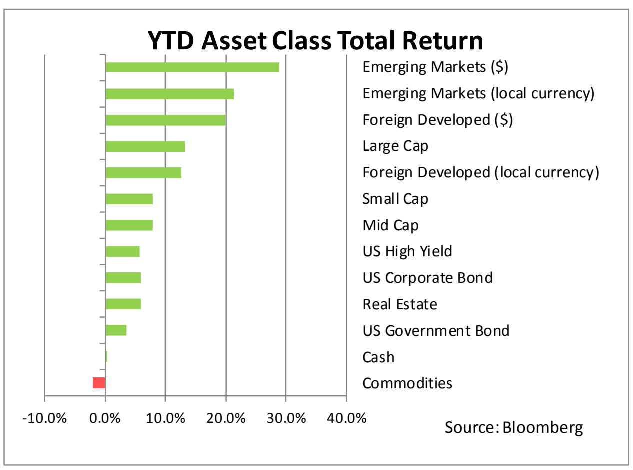



(Source: Bloomberg)

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 9/25/2017 close)

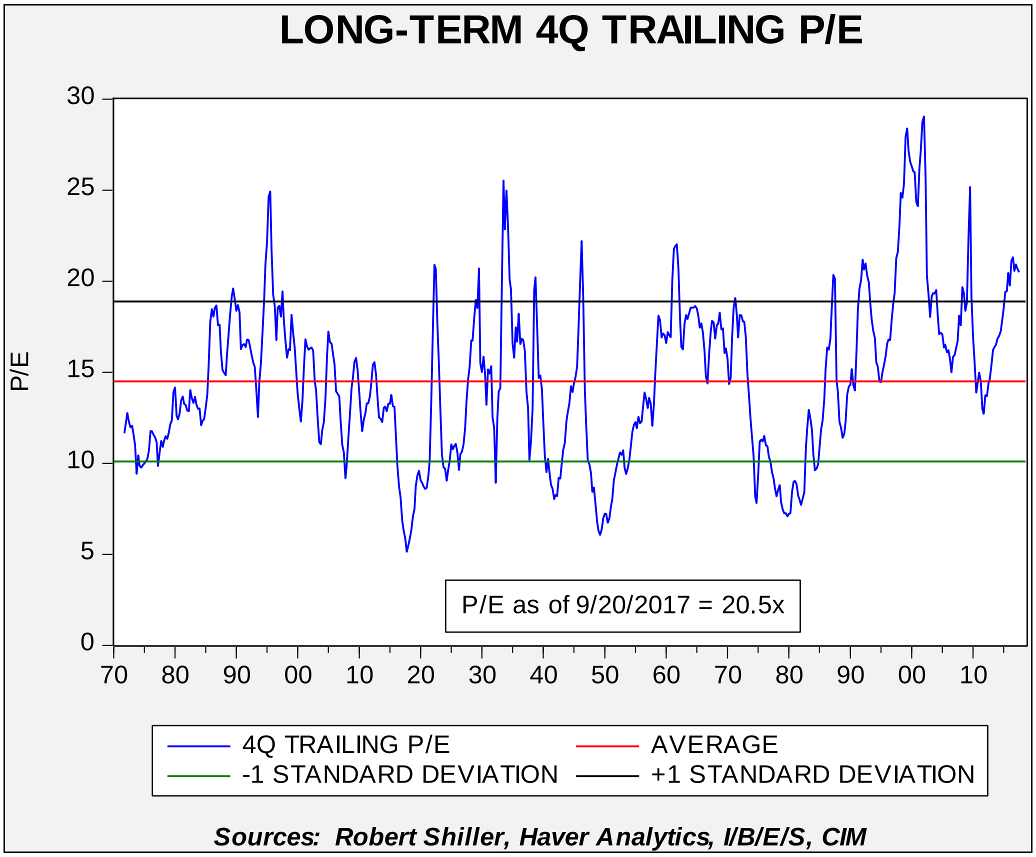



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[5] 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.*

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[5] 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.