Daily Comment

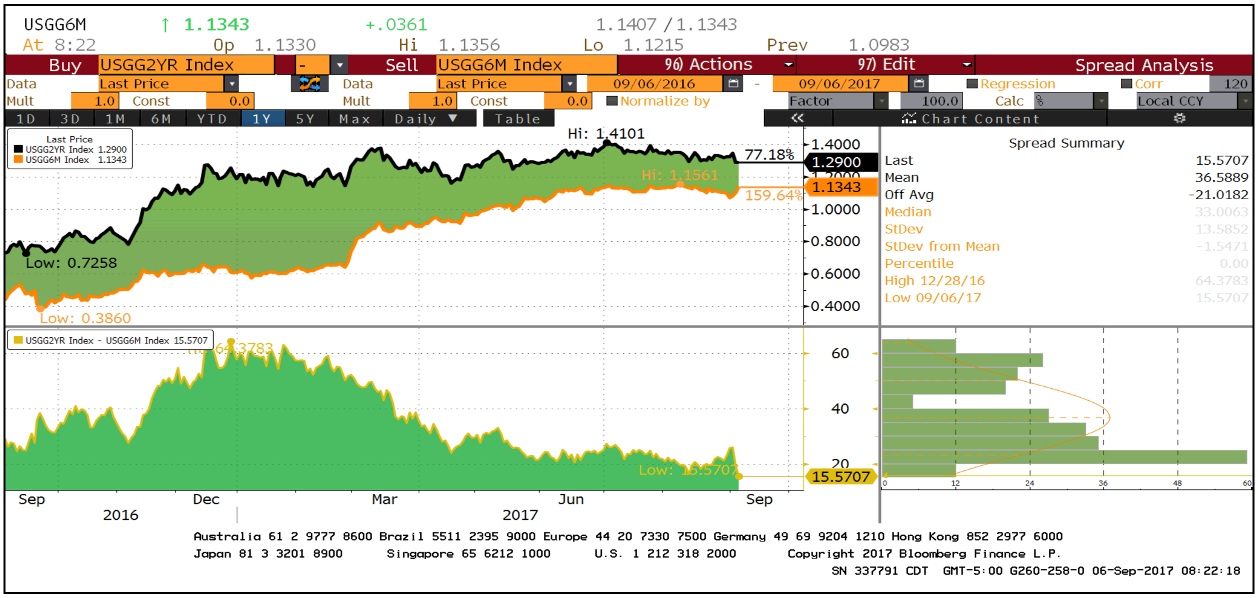
By Bill O'Grady and Thomas Wash

[Posted: September 6, 2017—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is relatively unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite unchanged and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a higher open.

Financial markets are easing off the flight from risk exhibited yesterday. There wasn't a lot of breaking news overnight, but there are currently several significant news items. Here's a recap:

Hurricane Irma: There are three tropical events in the Atlantic but Irma is the current focus of attention. It is a massive Category 5 storm that is presently hitting the Caribbean islands. Yesterday, a majority of the computer models were showing the storm taking a northward hook into Florida by the weekend, but there were a couple of models that suggested the turn may occur late enough for the storm to enter the Gulf of Mexico. If the path continued west, Texas and Louisiana might be hit again by a major storm. However, there is universal agreement among the models this morning that Irma is going to move straight up the Florida peninsula by Monday. The cold front that moved across St. Louis on Monday will steer the storm northward. As we have covered energy since 1989, we do know that computer models are not perfect; if the cold front stalls, a more western drift is possible. But, for now, it appears that the Sunshine State will be the target on the U.S. mainland.

This will be the second major storm to strike the U.S. this hurricane season. The need for emergency government spending should end any uncertainty surrounding the debt ceiling passage, at least in the short run. However, this issue may return by late December. Interestingly enough, financial markets are not convinced that the hurricanes will force a debt ceiling reconciliation.



(Source: Bloomberg)

This chart shows the six-month T-bill rate along with the two-year T-note rate. Note that the spread has significantly narrowed recently as bill rates increased while two-year rates fell. We suspect that fears of a short-term disruption related to the debt ceiling are boosting bill yields, while the feared negative impact on the economy weighs on the potential for future Fed rate hikes, easing the note rate. We would expect this spread to widen again if our analysis is correct and the hurricanes force a clean debt ceiling rise.

When doves cry: Fed Governor Brainard and Minneapolis FRB President Kashkari gave talks yesterday. Both are doves; the latter has dissented from recent rate hikes and the former has expressed deep caution about moving rates higher too quickly. Kashkari said yesterday that the recent hikes may have already adversely affected the economy. We find this argument difficult to support; GDP growth is running around 3% and the current Atlanta FRB GDPNow forecast for Q3 GDP is 3.2%, incorporating the somewhat weaker than expected employment data. Maybe Kashkari will be right in the future but, for now, the impact of recent hikes doesn't appear onerous. Brainard's comments appear to be on more solid theoretical footing. She suggests that current low inflation isn't just a series of idiosyncratic events but is, in fact, structural in nature. In other words, inflation is coming down on a secular basis, and running monetary policy on the premise that price levels will normalize will likely lead to overly tight policy and invite a recession. Essentially, Brainard is arguing that ***inflation expectations are becoming unanchored to the downside*** and that monetary policy should take this idea into account and perhaps lean against this trend.[1] Our economic work suggests that the central bank has little impact on inflation; instead, inflation is the intersection of aggregate supply and demand. And, in a globalized and deregulated world, the aggregate supply curve is nearly

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[1] We recently discussed the issue of weak wage growth and noted that while nominal wage growth is running well below where it historically should be based on labor market conditions, real wage growth is actually consistent with current labor market conditions. http://www.confluenceinvestment.com/asset-allocation-weekly-july-14-2017/

horizontal, meaning that increased demand has little impact on inflation. However, the central bank does have an impact on inflation expectations; if it appears too accommodative, it can spook businesses and households into precautionary spending. Simply put, if a household or business fears future price increases, it "saves" by holding inventory, further boosting price levels. The central bank isn't the only factor in inflation expectations, though. One's experience of inflation over a 10- to 20-year time frame also affects inflation expectations. Essentially, the Fed now has the opposite problem it faced in the 1970s. At that time, inflation expectations were elevated and the Volcker Fed had to act aggressively to convince households and firms that it would take steps to bring down inflation. Now, expectations of continued low inflation have become so entrenched that the Fed faces the need to convince economic actors that it won't snuff out the economy prematurely.

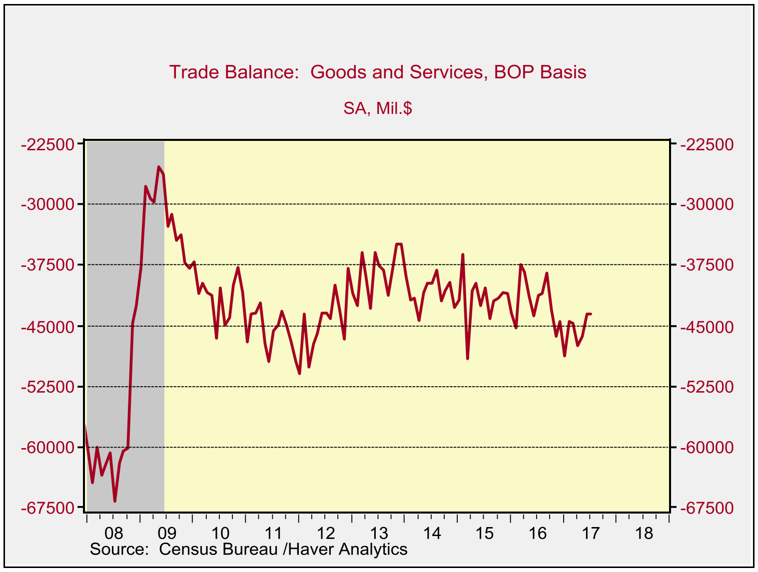
The key question is whether or not Brainard's position will sway her fellow FOMC members. It's probably unlikely. Although it's too simplistic to say that age affects the process of monetary policy, in fact, a significant number of influential members, including the chair and vice chair, came of age during the 1970s and are probably affected by that experience. It is no coincidence that Brainard and Kashkari are among the youngest members of the FOMC. Perhaps the only way the Fed becomes comfortable with persistently easy policy is through generational change. It is true that policy has been persistently accommodative, but it is also true that the preponderance of policymakers at the Fed appear to view current policy as an emergency measure and not a structural shift. Brainard is arguing for a structural shift. We doubt her argument will carry the day at the current Fed but it may in the future.

DACA: We haven't commented on this issue yet because our focus is on financial markets. However, now that action is being taken, this issue will begin to affect the financial markets. DACA now becomes another distraction for a Congress that has lots of them. So, instead of working on tax reform or infrastructure spending or a budget, Congress will have to deal with this issue. Given the deeply divided nature of Congress, it is hard to see how they can address such a contentious problem and thus working on DACA will delay other agenda items.

U.S. Economic Releases

The MBA mortgage applications index fell 3.3% from the prior week. Purchases and refinancing rose 1.4% and 5.1%, respectively. The average 30-year fixed rate fell by 5 bps from 4.11% to 4.06%.

The trade deficit came in narrower than expected at $43.7 bn compared to the forecast of $44.7 bn. The prior report was revised downward from $43.6 bn to $43.5 bn.



The chart above shows the level of the trade balance for goods and services. Over the past six years, the trade deficit has been volatile but has generally moved sideways.

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 Services	m/m	jul	56.9	56.9	**
9:45	Markit US Composite	m/m	jul		56.0	**
9:45	ISM Non-Manufacturing Composite	m/m	jul	55.6	53.9	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	US Federal Reserve Releases Beige Book	Members of the Board of Governors				

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	Labor Cash Earnings	y/y	jul	-0.3%	-0.4%	0.5%	**	Equity bearish, bond bullish
	Real Cash Earnings	y/y	jul	-0.8%	-0.8%	0.0%	**	Equity bearish, bond bullish
Australia	GDP	y/y	2q	1.8%	1.7%	1.9%	**	Equity and bond neutral
New Zealand	ANZ Job Advertisements	m/m	aug	1.0%	-1.0%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Retail	m/m	aug	50.8	51.0		**	Equity and bond neutral
Germany	Factory Orders	m/m	aug	5.0%	5.1%	5.8%	**	Equity bearish, bond bullish
	Markit Germany Construction	m/m	jul	54.9	55.8		**	Equity and bond neutral
	Markit Germany Retail	m/m	aug	53.0	50.7		**	Equity and bond neutral
France	Markit France Composite	m/m	aug	50.4	54.1		**	Equity and bond neutral
Italy	Retail Sales	y/y	jul	0.0%	1.5%	1.2%	**	Equity bearish, bond bullish
	Markit Italy Retail	m/m	aug	48.0	47.3		**	Equity bearish, bond bullish

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	101	1	Neutral
TED spread (bps)	30	31	-1	Neutral
U.S. Libor/OIS spread (bps)	116	116	0	Up
10-yr T-note (%)	2.07	2.06	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	25	25	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	up			Up
yen	down			Neutral
pound	up			Down
franc	down			Down
Central Bank Action		**Prior**	**Expected**	
Selic Rate		9.250%	8.250%	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	$54.10	$53.38	1.35%	Weather Conditions
WTI	$49.09	$48.66	0.88%	
Natural Gas	$2.97	$2.97	0.07%	
Crack Spread	$22.52	$23.39	-3.71%	
12-mo strip crack	$19.11	$19.19	-0.42%	
Ethanol rack	$1.69	$1.69	-0.04%	
Metals				
Gold	$1,339.41	$1,339.71	-0.02%	
Silver	$17.97	$17.89	0.44%	
Copper contract	$314.20	$312.80	0.45%	
Grains				
Corn contract	$ 356.50	$ 358.50	-0.56%	
Wheat contract	$ 440.25	$ 443.00	-0.62%	
Soybeans contract	$ 966.00	$ 968.50	-0.26%	
Shipping				
Baltic Dry Freight	1215	1187	28	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.5		
Gasoline (mb)		-5.0		
Distillates (mb)		-2.5		
Refinery run rates (%)		-7.00%		

Weather

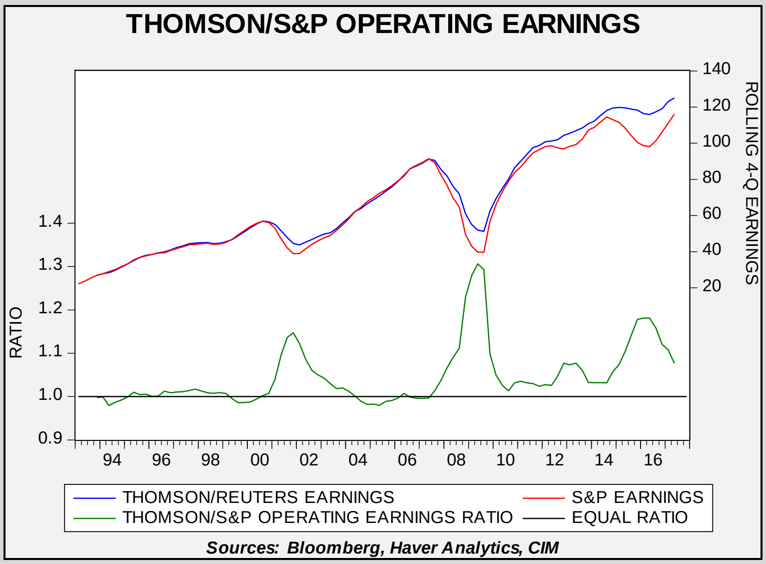
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler to normal temps in the western region. Precipitation is expected for the East Coast. Hurricane Irma has made landfall in the Caribbean Islands and is expected to make its way to Florida by Monday. Tropical Storm Katia has formed in the Gulf of Mexico and is gaining strength near the Yucatan Peninsula. Tropical Storm Jose has formed in the central Atlantic Ocean and is expected to strengthen into a hurricane. At this time, it is unclear as to whether any of these tropical disturbances will have an impact on the production and shipment from refineries located in the Gulf of Mexico; we will continue to monitor this situation.

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.

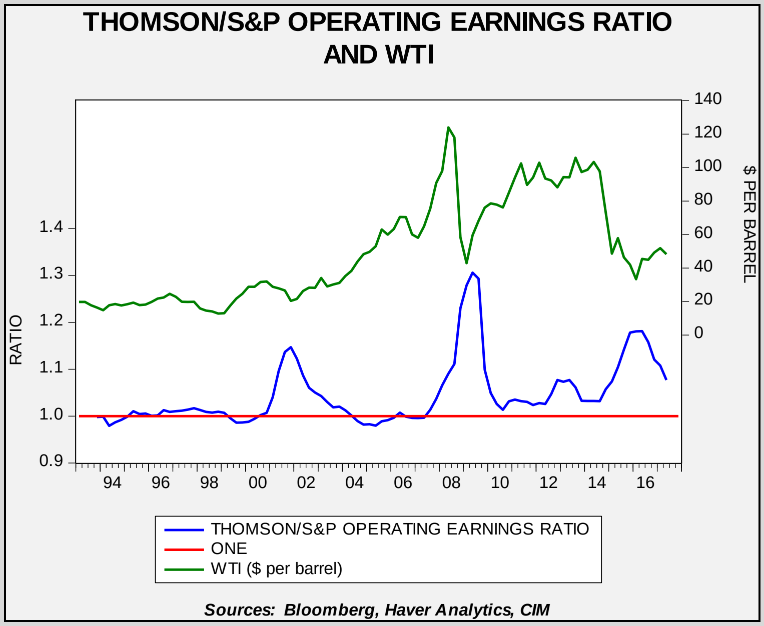
September 1, 2017

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.



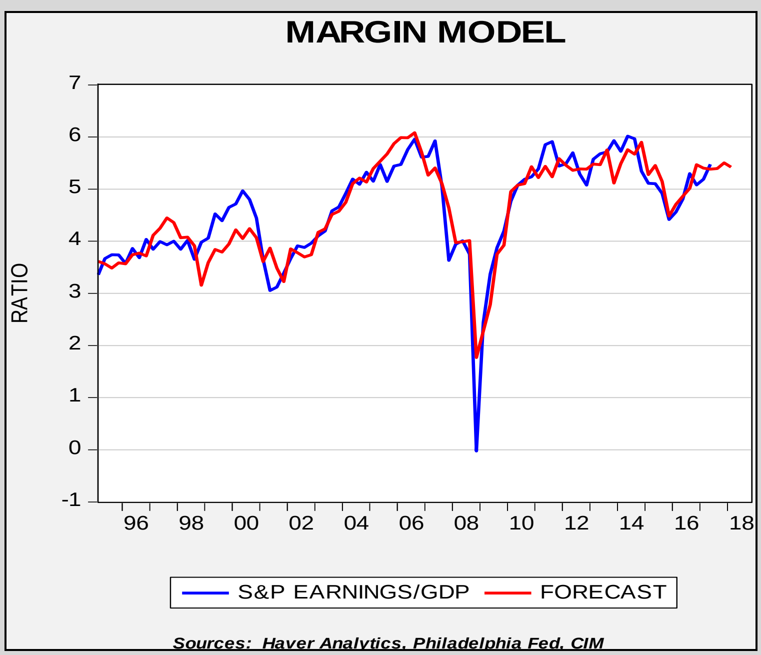
This chart shows the two series from 1994, with the lower line showing their ratio. The reason we monitor these divergences is that an elevated ratio has led to bear markets and recessions in two previous instances. Fortunately, the ratio is narrowing, although the difference in terms of the past four 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.

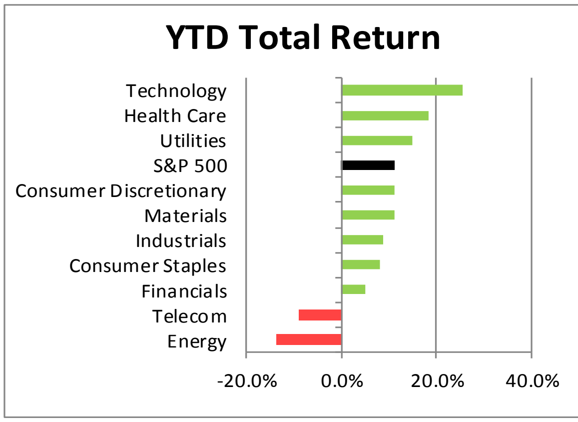
This year's earnings story continues to be the expansion of margins. Looking at S&P operating earnings compared to GDP, we have seen a solid recovery in margins. Our margin model has been projecting a recovery and stabilization around the level of 5.5% of GDP. If that is the case, the growth rate in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

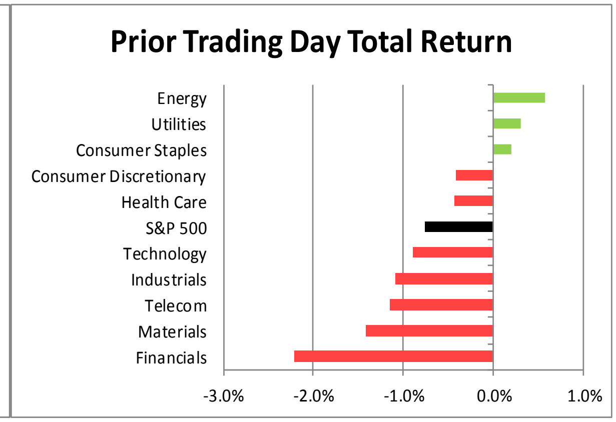


Based on our analysis, we are on pace for a year-end operating earnings number, basis Standard and Poor's, of $121.50, a 14.3% rise over this series report from last year. A similar growth number for Thomson/Reuters would put this year's earnings at $136.10 compared to the current expectation of $131.10. 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 9/5/2017 close)

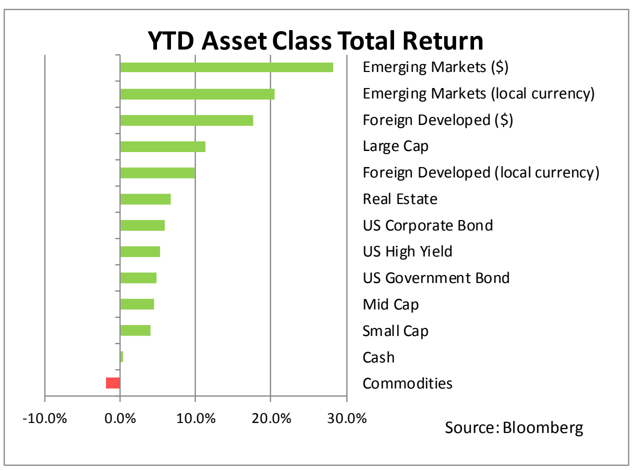




(Source: Bloomberg)

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 9/5/2017 close)

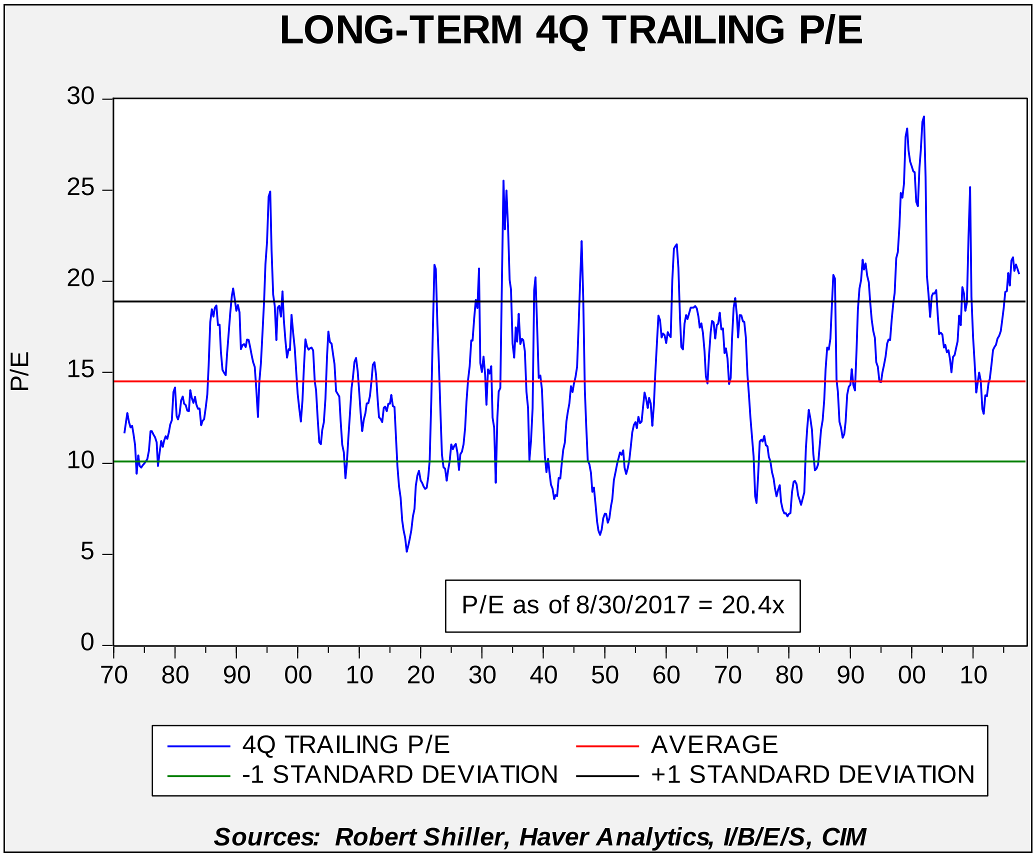


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

[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.