INVESTMENT MANAGEMENT

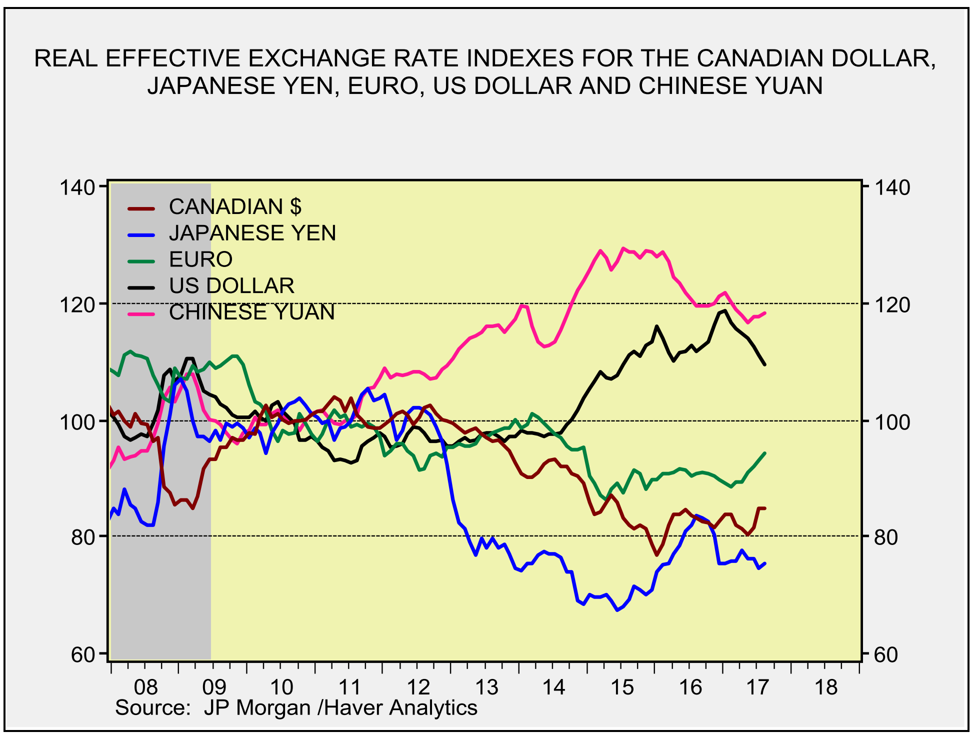
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: September 8, 2017—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were mixed, with the Shanghai composite relatively unchanged and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a lower open.

Market action is sluggish this morning; the big story is the continued weakness in the dollar. Here is what we are watching today:

The dollar in perspective: The EUR is threatening $1.210 and the greenback continues to slide despite dovish comments from ECB President Draghi yesterday. The chart below shows the real effective exchange rates for the USD, CAD, EUR, JPY and CNY.



Although the dollar is weakening, it is worth noting that it remains unusually strong against most major currencies except the CNY. If exchange rates are in the process of normalizing, the dollar still has a lot of room to decline. In the foreign economic sector, we note that both China and Germany had disappointing export numbers. Although it's probably too soon for the dollar's weakness to have a significant impact on trade, it is possible that we are seeing the early effects.

We also note reports that China is becoming “concerned” about currency strength. We remain dollar bears and expect greenback weakness to continue.

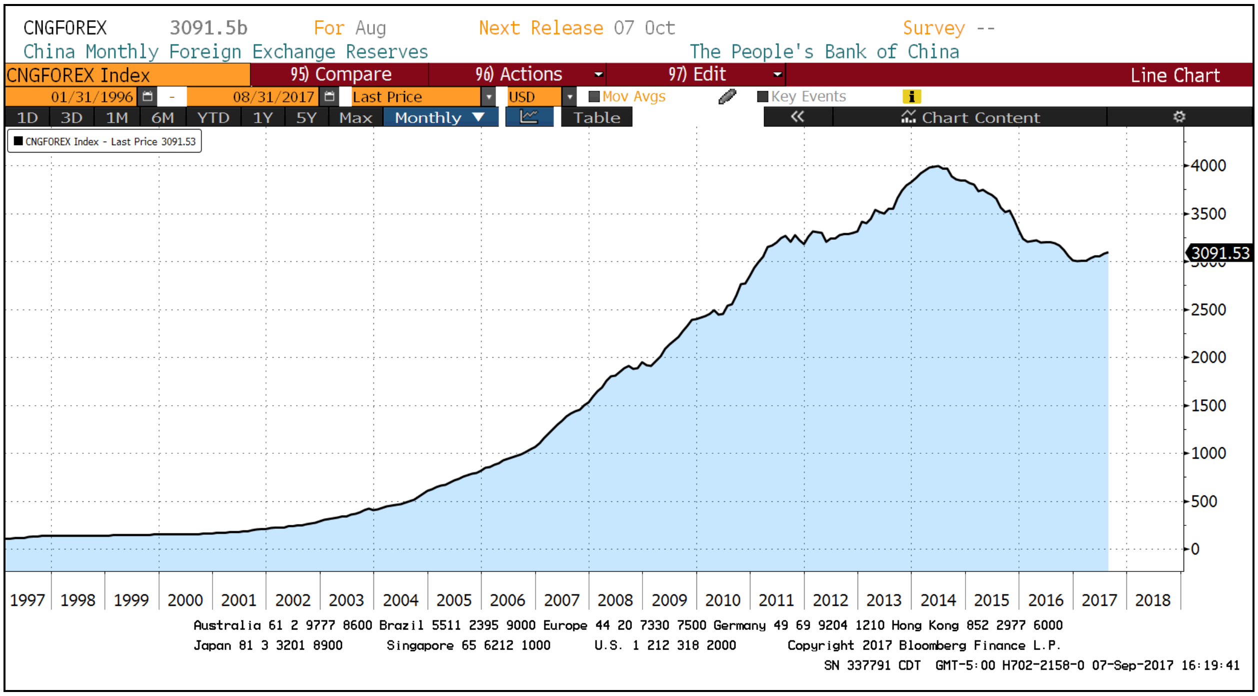
Nature bites: Hurricane Irma’s path has shifted westward and is now expected to move through the entire Florida peninsula into Georgia and end up as a depression in Tennessee by next Wednesday. Hurricane Jose looks like it will head into the Atlantic away from the U.S. mainland but is on target to hit Bermuda later next week. Finally, Katia is expected to make landfall near Veracruz tomorrow morning. Adding to Mexico’s woes, the country was hit with a major 8.1 (or, based on some reports, an 8.2) Richter scale earthquake yesterday evening. The epicenter was 60 miles from Mapastepec in the state of Chiapas. This is the most powerful earthquake to hit Mexico in over a century. Tsunami alerts were issued for Ecuador, Vanuatu and New Zealand. All these events will distort economic data for the next two to three quarters.

Warnings of a North Korean missile test: It’s a holiday in North Korea, commemorating the 69th anniversary of the founding of the Democratic People’s Republic of Korea (DPRK). South Korea is reporting that there are signs of another missile test. Worries about tests are boosting the JPY and gold this morning.

More on Washington: Yesterday, we detailed Trump’s triangulation with the Democrats. There are reports the president is working with lawmakers (mostly Democrats) to end debt ceiling votes. Debt ceiling votes began with WWI; before that, each act of government borrowing required an act of Congress. To handle the increased spending for the war, Congress set a limit for debt and allowed debt spending to occur until the limit was reached. Once reached, a new limit would have to be set. Note that the debt limit pays for spending that has already occurred. About the only impact the debt ceiling vote should have is to act as a reminder to lawmakers that debt is rising. However, it has become a tool of the party in opposition to use the leverage of shutting down the government to get its priorities passed. What is interesting about this potential change is that it is being pushed by a GOP president with Democrat Party support against the will of a significant faction of Congressional GOP members. We will see if the president can craft a workable legislative majority of Democrats and “Tuesday Group” Republicans to isolate the Freedom Caucus in order to pass other legislation.

Catalonia: Catalonia has voted to set a referendum on self-determination (or secession) for October 1, 2017. Madrid opposes the vote and will try to prevent it from occurring. It is possible the courts will prevent the referendum from being held, but even if it is held the Spanish government will likely choose to ignore it. There are various separatist movements in Europe. Scotland has been drifting toward leaving the U.K., and Czechoslovakia split into two states in 1993. This is a real problem for the EU; while EU elites try to unify Europe, states within Europe are facing pressure to split even further. This makes European unity an even more distant goal.

China’s foreign reserves: China’s foreign reserves rose $11 bn to $3.09 trillion.



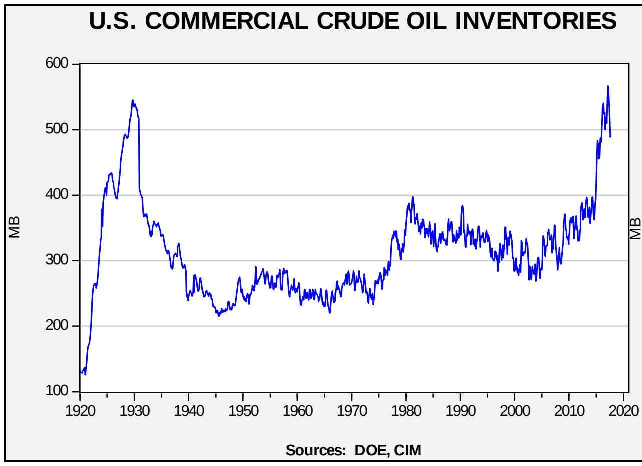
(Source: Bloomberg)

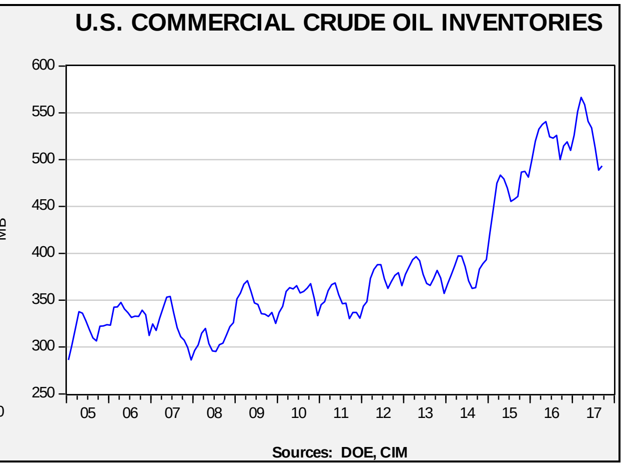
Although reserves remain well below their 2014 peak, they have recovered from the recent trough of $2.998 trillion. China has taken steps to slow outflows and, thus far, is having some success.

EU rules that nations must take refugees: The EU Court of Justice has ruled that nations must take their assigned quotas of refugees, rejecting actions brought by Slovakia and Hungary.[1] It remains to be seen if these two nations will be forced to take refugees; we actually doubt they will. Many nations in the EU passively rejected their obligations to take migrants coming from the Middle East and Africa. Hungary reacted angrily to the news and Poland may also face retribution from the EU for its rejection of some migrants. This is yet another example of the EU overriding national sovereignty in Europe and will raise political pressure for other nations to follow Britain's example. That's why Germany and France are adamant that the U.K. face significant penalties for Brexit to create an example of the cost of leaving the union.

Energy recap: U.S. crude oil inventories rose 4.6 mb compared to market expectations of a 2.5 mb increase.

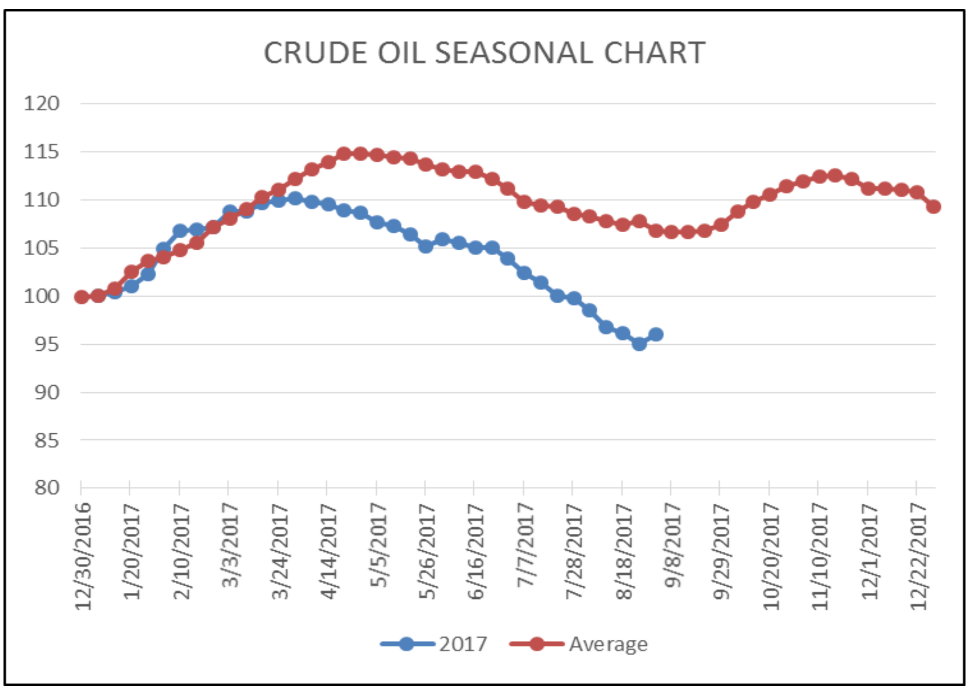
[1] https://www.nytimes.com/2017/09/06/world/europe/eu-migrants-hungary-slovakia.html?emc=edit_mbe_20170907&nl=morning-briefing-europe&nlid=5677267&te=1



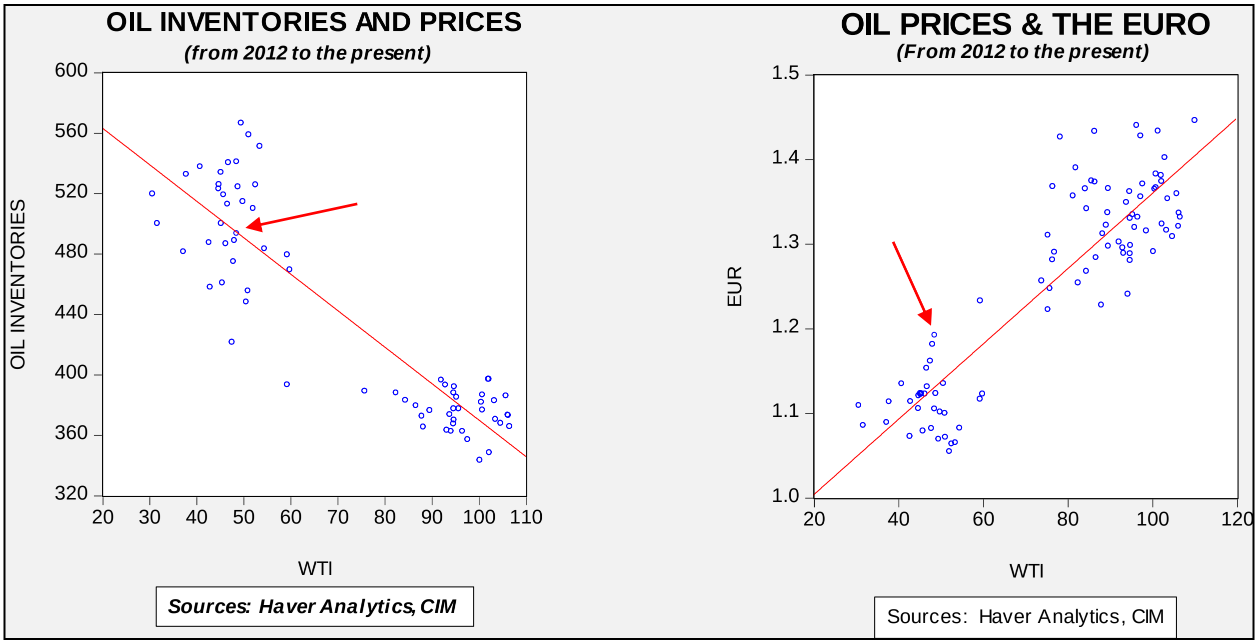


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but they have declined. Hurricane Harvey had a dramatic impact on the energy market data this week; the effects should continue for several more weeks.

As the seasonal chart below shows, inventories did turn higher this week but they were affected by the aforementioned hurricane. We are probably going to start the inventory rebuild period sooner than normal this year. Although oil imports did decline by nearly 0.9 mbpd and production fell by almost 0.8 mbpd, refinery capacity utilization dropped to 79.7% from 96.6%, or 3.2 mbpd. Media reports suggest that refineries are working hard to restart operations, but it will probably take a couple of months before the industry can achieve pre-Harvey refinery levels.

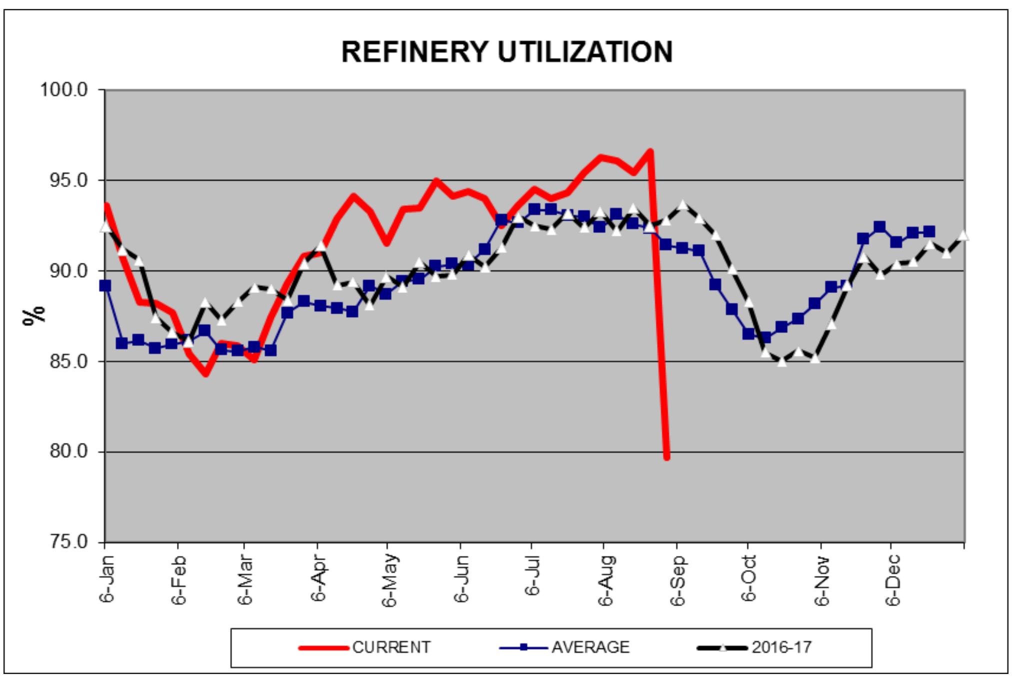


(Source: DOE, CIM)



Based on inventories alone, oil prices are undervalued with the fair value price of $53.39. Meanwhile, the EUR/WTI model generates a fair value of $66.68. Together (which is a more sound methodology), fair value is $62.16, meaning that current prices are well below fair value. Although the most bullish factor for oil is currently dollar weakness, the rapid decline in inventory levels is also supportive.

The drop in refinery operations is stunning.



(Source: DOE, CIM)

We do expect operations to recover in the coming weeks. Note that we are close to the onset of the maintenance season. As noted earlier, we do expect to see a recovery in the coming weeks but only to about 85% next month, with a gradual recovery to 90% by winter.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale Inventories	m/m	jul	0.4%	0.4%	**
10:00	Wholesale Trade Sales	m/m	jul	0.5%	0.7%	**
15:00	Consumer Credit	m/m	jul	$15.00 bn	$12.40 bn	**
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								
Japan	BoP Current Account Balance	m/m	jul	2.320 tn	0.934 tn	2.030 tn	**	Equity bullish, bond bearish
	BoP Current Account Adjusted	m/m	jul	2.032 tn	1.522 tn	1.652 tn	**	Equity bullish, bond bearish
	Trade Balance	m/m	jul	0.567 tn	0.519 tn	0.518 tn	**	Equity bullish, bond bearish
	GDP Annualized	m/m	2q	2.5%	4.0%	2.9%	***	Equity bullish, bond bearish
	GDP Private Consumption	m/m	2q	0.8%	0.9%	0.9%	**	Equity and bond neutral
	GDP Business Spending	m/m	2q	0.5%	2.4%	0.5%	**	Equity and bond neutral
	Bank Lending Incl Trust	m/m	aug	3.2%	3.3%		**	Equity and bond neutral
	Bank Lending Ex-Trust	m/m	aug	3.2%	3.4%	3.4%	**	Equity and bond neutral
	Bankruptcies	m/m	aug	-12.0%	0.3%		**	Equity and bond neutral
Australia	Home Loans	m/m	jul	2.9%	0.5%	1.0%	**	Equity bullish, bond bearish
	Investment Lending	m/m	jul	-3.9%	1.6%		**	Equity and bond neutral
	Owner-Occupier Loan Value	m/m	jul	0.9%	0.3%		**	Equity and bond neutral
New Zealand	Mfg Activity SA	q/q	2q	3.9%	2.8%		**	Equity and bond neutral
EUROPE								
Germany	Trade Balance	m/m	jul	19.5 bn	22.3 bn	21.0 bn	**	Equity bearish, bond bullish
	Exports	m/m	jul	0.2%	-2.8%	1.3%	**	Equity bearish, bond bullish
	Imports	m/m	juk	2.2%	-4.5%	2.8%	**	Equity and bond neutral
	Labor Costs	m/m	2q	2.3%	2.5%		**	Equity and bond neutral
	Current Account Balance	m/m	jul	19.4 bn	23.6 bn	20.8 bn	**	Equity bearish, bond bullish
France	Budget balance	m/m	jul	-83.8 bn	-62.3 bn		**	Equity and bond neutral
	Industrial Production	m/m	jul	3.7%	2.6%	3.6%	***	Equity and bond neutral
	Manufacturing Production	m/m	jul	3.9%	3.3%	4.2%	**	Equity bearish, bond bullish
UK	Industrial Production	y/y	jul	0.4%	0.3%		***	Equity and bond neutral
	Manufacturing Production	y/y	jul	1.9%	0.6%		**	Equity and bond neutral
	Construction Output	m/m	jul	-0.4%	0.9%		**	Equity and bond neutral
	Trade Balance	m/m	aug	-2872	-4564	-3250	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	aug	3.2%	3.2%	3.2%	***	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	jul	-3.5%	2.5%	-1.5%	**	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)	102	103	-1	Neutral
TED spread (bps)	30	29	1	Neutral
U.S. Libor/OIS spread (bps)	115	116	-1	Up
10-yr T-note (%)	2.03	2.04	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	22	22	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Neutral
pound	up			Down
franc	up			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	$54.65	$54.49	0.29%	Weather Conditions
WTI	$48.95	$49.09	-0.29%	
Natural Gas	$2.97	$2.98	-0.40%	
Crack Spread	$22.52	$22.42	0.41%	
12-mo strip crack	$19.53	$19.49	0.18%	
Ethanol rack	$1.69	$1.69	0.00%	
Metals				
Gold	$1,352.96	$1,349.22	0.28%	Market Uncertainty
Silver	$18.18	$18.13	0.30%	
Copper contract	$309.60	$314.35	-1.51%	
Grains				
Corn contract	$ 356.50	$ 355.25	0.35%	
Wheat contract	$ 438.00	$ 437.25	0.17%	
Soybeans contract	$ 972.00	$ 968.75	0.34%	
Shipping				
Baltic Dry Freight	1296	1250	46	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.6	2.5	2.1	
Gasoline (mb)	-3.2	-5.0	1.8	
Distillates (mb)	-1.4	-2.5	1.1	
Refinery run rates (%)	-16.90%	-7.00%	-9.90%	

Weather

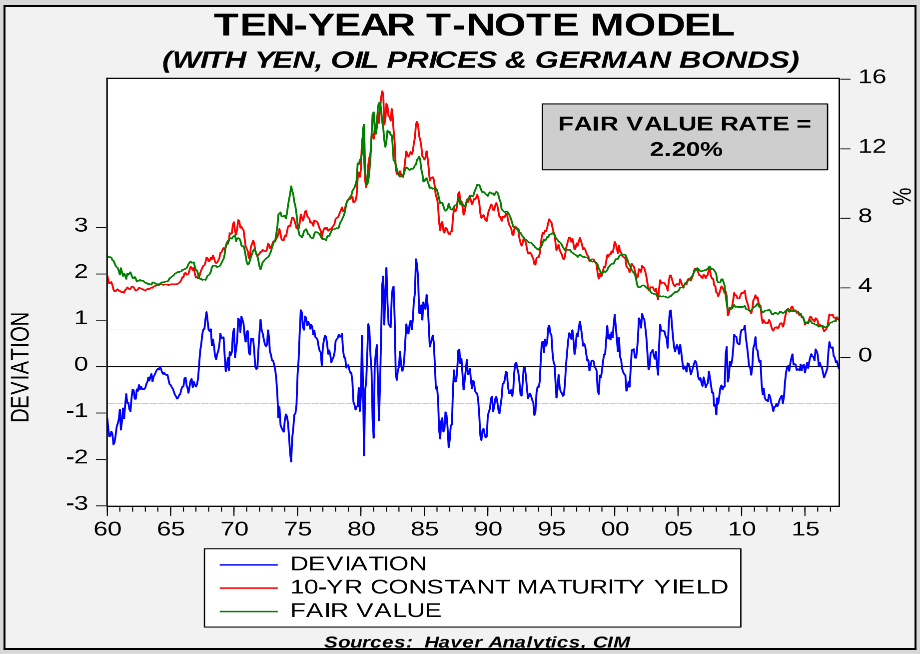
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler to normal temps in the southeastern region. Precipitation is expected for the Pacific region. Hurricane Irma is currently moving along the coast of Cuba and is expected to make landfall in Florida over the weekend. Hurricane Katia is moving along Mexico's Gulf Coast and is expected to disrupt oil shipments from Tuxpan, Veracruz. Hurricane Jose is headed toward the Leeward Islands.

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 8, 2017

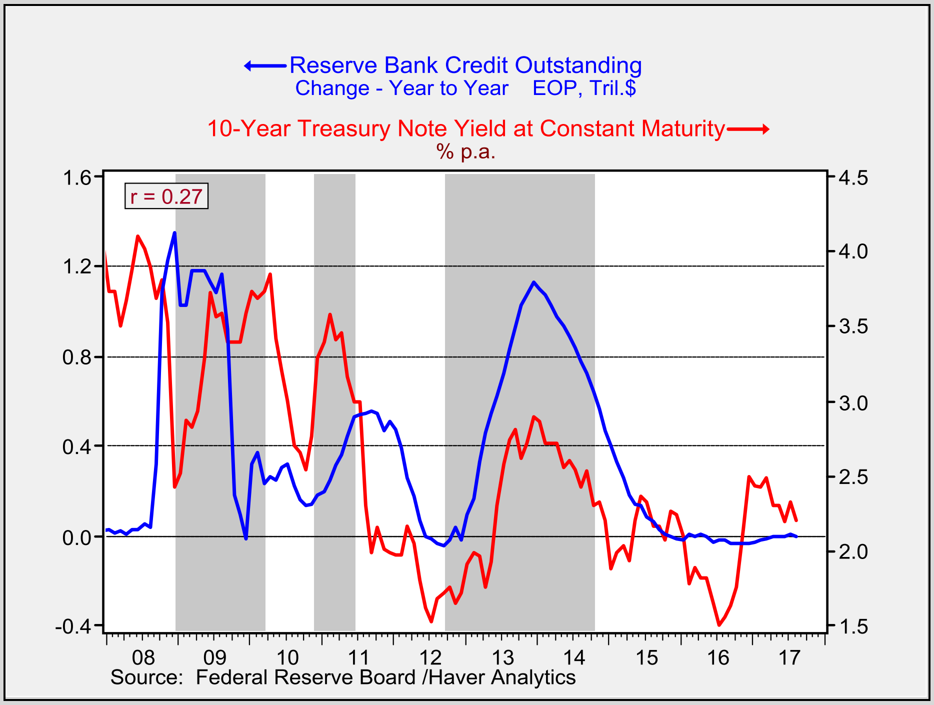
As the FOMC prepares to reduce its balance sheet, it's a good time to update our views on long-term interest rates. The chart below shows our current estimate of fair value for the 10-year Treasury.



The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The current yield is on fair value. Assuming the other variables remain steady, the current yield on the 10-year T-note is assuming the FOMC is going to hold rates steady for the foreseeable future.

Is this assumption on the policy rate reasonable? Currently, fed funds futures don't reach a 50% chance of a rate hike until the June 2018 meeting, and even by next December the odds of a rate increase are only 67%. We expect the Yellen FOMC to use balance sheet contraction to placate the hawks on the committee and thus avoid increases in fed funds until it becomes abundantly clear that inflation is rising.

One of the reasons for expanding the Fed's balance sheet was to lower long-term interest rates. In reality, the evidence of success is mixed.

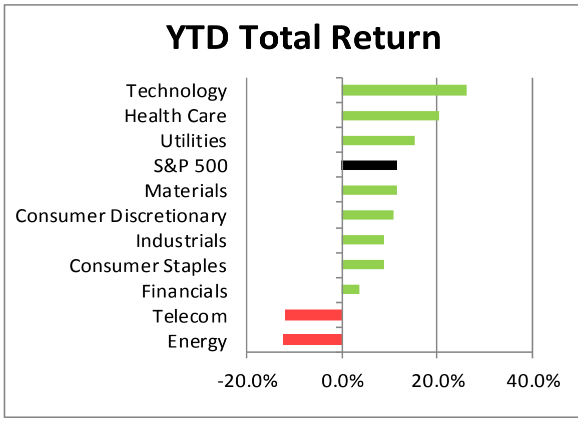


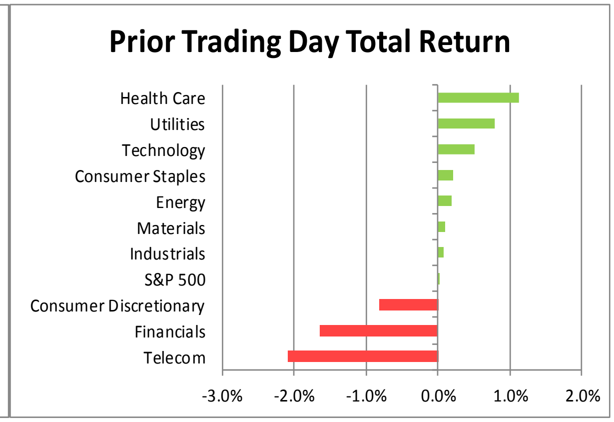
This chart shows the 10-year T-note yield with the yearly change in the balance sheet. The gray bars show official periods of QE. A zero reading indicates no change in the balance sheet compared to the prior year. Rates fell in QE1, at least initially, although they did rebound as the recession came to an end in mid-2009. However, rates generally rose in QE2 and QE3. Although the Fed was buying longer dated Treasuries, which reduced its supply, it appears the demand may have weakened on fears that QE would trigger inflation. Thus, a case could be made that reducing the balance sheet would have a similar effect and push rates lower.

Our base case is that reducing the balance sheet will have an asymmetric effect on markets; in other words, it won't have a significant impact on interest rates, unlike the apparent bearish impact that QE2 and QE3 had on long-term interest rates. This is because the FOMC is framing the reduction in the balance sheet as "normalization," whereas QE was designed to be stimulative. Thus, our analysis suggests that the most important impact of QE was psychological. However, it is possible that QE did more than just boost sentiment; if so, balance sheet normalization could be bullish for long-duration bonds.

Data Section

U.S. Equity Markets – (as of 9/7/2017 close)

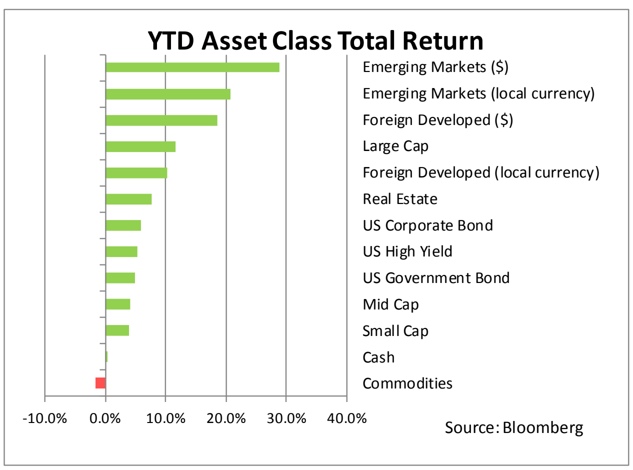




(Source: Bloomberg)

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 9/7/2017 close)

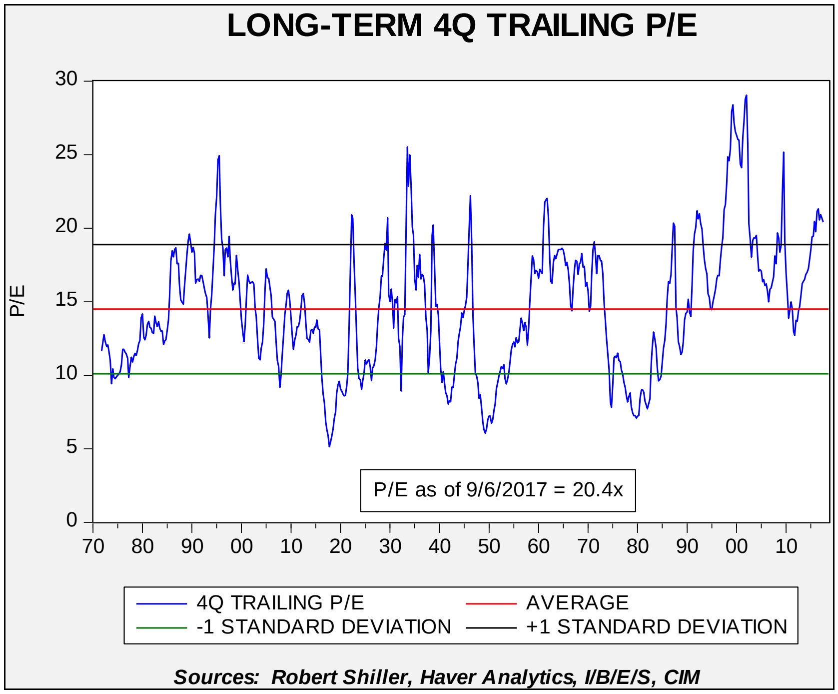


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 7, 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.