Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: December 23, 2014—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.5% from yesterday's close. In Asia, the MSCI Asia Apex 50 was lower by 0.6% from the prior close. U.S. equity futures are signaling a higher opening from the prior close.

Note to readers: We will not publish on Friday, Dec. 26. The Daily Comment will return on Monday, Dec. 29.

Additional note: We published our 2015 Outlook[1] yesterday!

The RUB is continuing to rally this morning following PM Medvedev's decision to force state exporters to liquidate some of their forex holdings. By selling foreign currencies and buying RUB, these transactions will add about $1.0 bn per day to support the Russian currency for as long as the policy remains in place. At the same time, former Finance Minister Alexei Kudrin warned that Russia is on a path of economic crisis. Kudrin was a key advisor to Putin and considered a reformer. He argued for years that Russia needed to diversify its economy away from its dependence on energy and pressed for other liberalization policies as well. Although Putin listened, he sided with the hard liners and failed to follow Kudrin's recommendations.

The most critical worry is a bank run in Russia. If a run develops, the Russian economy and financial system could implode. The *NYT* reports that the Russian central bank moved to prop up a retail bank named Trust Bank by injecting $530 mn into the institution. So far, nothing has spread but depositor sentiment is key as to whether or not Putin can manage the economic downturn.

There were two news items of note from China. First, Bloomberg is reporting that China is becoming the rogue "lender of last resort." Yesterday, we noted that China informed Russia that it would consider expanding its $24 bn currency swap program to support the RUB. China has also provided $2.3 bn to Argentina as part of a currency swap and it lent $4.0 bn to Venezuela to support the country as oil prices plunge. All of these nations have been shut out of global capital markets; in the past, the U.S. would deal with such miscreants by ensuring that the only source of funding was the IMF, which would require austerity policies as the cost of access to capital. In effect, the IMF was a tool of American superpower projection. China is attempting to undermine this power by funding nations that either are (a) under sanction, or (b) have run afoul of the global financial system that the U.S. has constructed. China's actions, thus far, are not enough to represent a real alternative to the American system. However, it will be more difficult to force nations to comply with U.S. policy if China offers a substitute for global financial markets.

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[1] See Current Perspectives Report: Our Outlook for 2015 (12/22/14).

What bears watching are China's terms and how the country reacts when one of these nations inevitably defaults on a loan. China may find that the geopolitical power gains aren't worth the costs.

The other interesting news item relates to General Secretary Xi's continuing purge of former officials. The *NYT* reports that the CPC has opened an investigation of Ling Jihua, a top aide to former President Hu Jintao. Mr. Ling's star fell in 2012 when his son died in a car crash that also took the life of one of two female passengers. His son was driving a Ferrari at the time. According to reports, Ling paid the families of the two women large sums of hush money in an attempt to tame the scandal. Until the scandal, Ling directed the General Office of the CPC Central Committee, a key leadership position. He was demoted soon after. To some extent, Xi selected an easy target; most China watchers believe that Hu probably agreed to allow his former colleague to face charges. However, the fact that Hu could not protect Ling also suggests Hu has little influence or power over Xi, which means the latter has more latitude to take action compared to earlier successors of Deng who always had the former leader affecting decisions.

Finally, North Korea suffered a pervasive internet outage yesterday. It isn't clear if this outage came as retaliation from the U.S., if the system simply failed, or if North Korea took the system down itself to insulate it from outside attack. However, it is clear that cyberwarfare is becoming another tool that nations can use to project power.

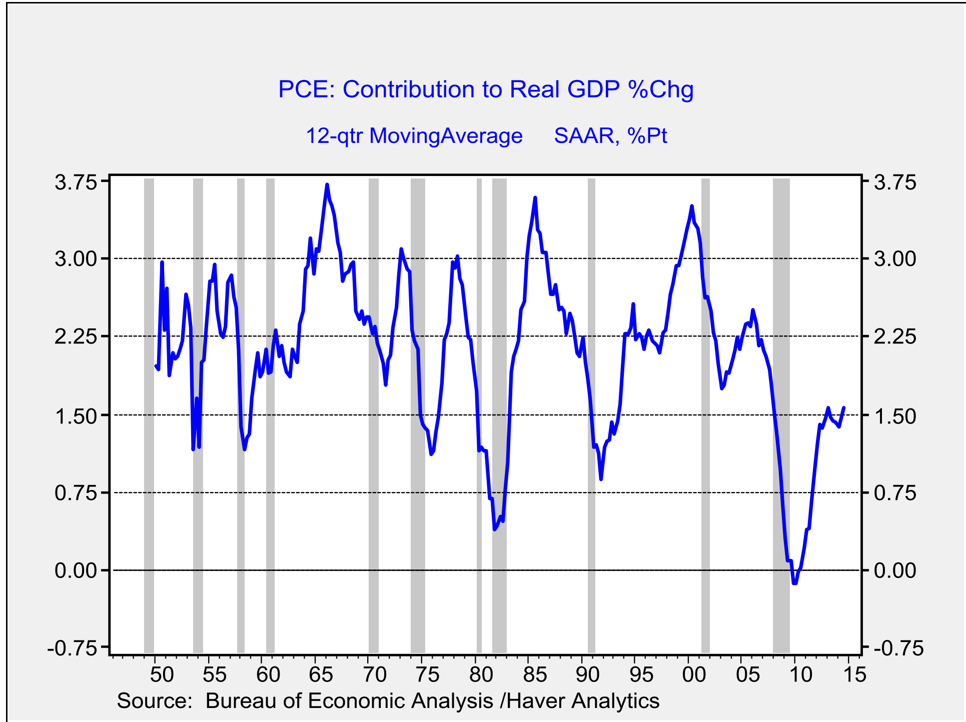
U.S. Economic Releases

The third look at Q3 GDP came in much better than forecast, at 5.0% compared to forecasts of 4.3%. This release is up from the second estimate of 3.9%. Personal consumption was much better than expected, rising 3.2%, higher than the 2.5% forecast and also up from the 2.2% from the second revision. Consumption of services was particularly strong. Private investment and government consumption were also revised modestly higher from prior estimates.

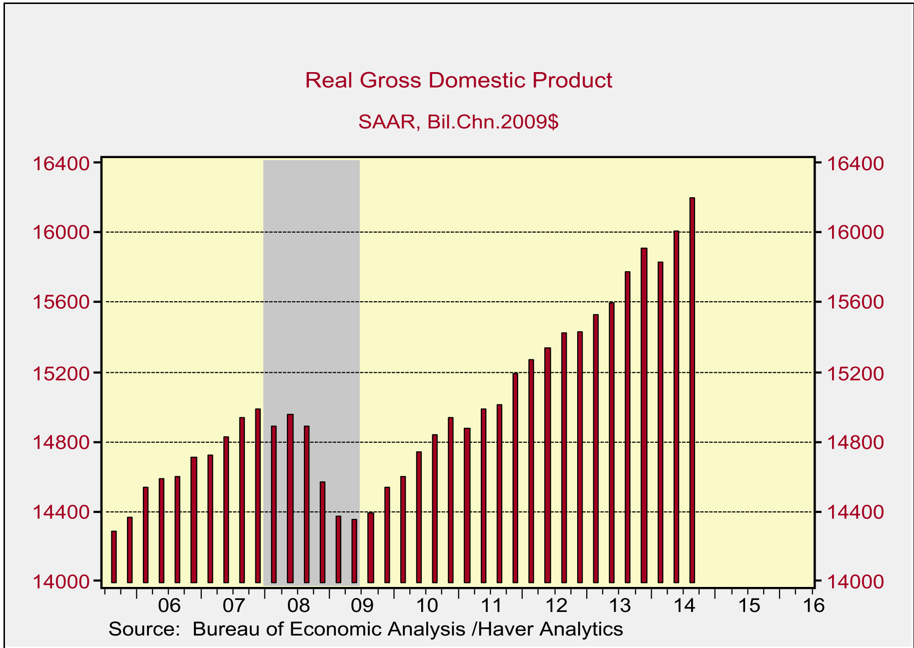
	December Q3 release	November Q3 release	Difference
GDP	5.0	3.9	1.1
Consumption	2.2	1.5	0.7
Investment	1.2	0.9	0.3
Inventories	0.0	-0.1	0.1
Net Exports	0.8	0.8	0.0
Government	0.8	0.7	0.1

This table shows the contribution to GDP from the four major sectors of the economy, plus the change in inventories for its signaling value. Consumption added 70 bps, investment added 30 bps and government added 10 bps to growth compared to the prior release. Net exports were unchanged. Inventories were lower than expected, which could mean that inventory levels were drawn down due to strong demand.

Even with the rise in consumption, the trend contribution from consumption remains weak.

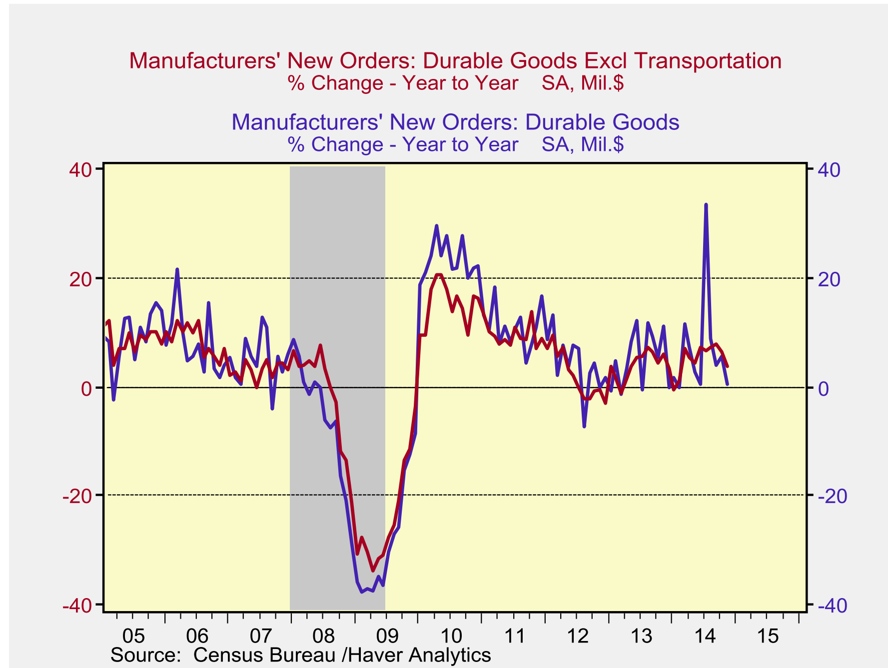


The chart below shows the real GDP levels. The economy is growing steadily, making new highs.



Durable goods orders disappointed. Orders fell 0.7% in November compared to expectations of a 3.0% increase. Orders ex-transportation declined 0.4% compared to a forecast increase of 1.0%. Defense orders were particularly weak, but a certain amount of volatility is expected from this sector as orders tend to be large. Transportation orders, in general, were weak, while

computers/electronics and metals also showed weakness. Capital goods orders, excluding defense and aircraft, a good proxy for business investment, was unchanged in November.



This chart shows the yearly change in the headline durable goods and the core durable goods orders. We are still seeing positive annual growth in durable orders, but the upward momentum is slowing.

Risk markets rebounded in the aftermath of these reports, mostly due to the better than expected GDP reading. Equities rose, while bonds trended lower.

At 9:55 EST, the December University of Michigan confidence indicator will be released, with a forecast level of 93.5, down from 93.8 the month before. At 10:00, the December Richmond Fed manufacturing index will be released, with a forecast level of 7, up from 4 the month before. Also at the same time, the November new home sales report will be released, with a forecast monthly increase of 0.4%. The personal income and spending report will also be published at 10:00, with 0.4% and 0.5% respective increases forecast. The November PCE deflator will also be released at the same time, with a forecast of 1.2% annually.

Foreign Economic News

In Asia, China's November LEI rose 0.9% from the month before, while the coincident indicator rose 0.1%.

In Europe, France's Q3 GDP rose 0.4% annually, on forecast, while November PPI fell 2.0% annually. Germany's October retail sales remained unchanged from the month before. The

U.K.'s Q3 GDP rose 2.6% annually, less than forecast, while the Q3 current account deficit widened to GBP 27.0 bn from GBP 24.3 bn the month before, wider than forecast.

Financial Markets

In the financial markets, three-month Libor yields were steady at 25 bps, and the three-month T-bill yields rose 1 bp to 4 bps, narrowing the TED spread to 21 bps. The U.S. Libor/OIS spread was stable at 13 bps. The 10-year Treasury yield was stable at 2.16%. The Euribor/OIS spread rose 1 bp to 10 bps and the EUR/USD three-month swap spread fell 1 bp to 14 bps. The dollar is trading higher along with the commodity currencies. The Treasury will auction $35 bn of five-year notes today and $29 bn of seven-year notes tomorrow.

Commodity Markets

Commodity markets are mixed this morning. Crude futures are trading higher on the domestic economic recovery. For this week's DOE inventory report, crude stocks are expected to fall 2.4 mb, gasoline stocks to accumulate 0.1 mb, distillates to draw down 1.4 mb and refinery runs to fall 0.1%. The nearby crack spread stands at $14.71, down $0.02 from the prior trading day, while the 12-month strip crack spread was $16.48, down $0.40 from the prior trading day. The ethanol rack prices fell two cents to $2.05. Precious metals are mixed, with gold lower on the higher dollar but silver modestly higher. Industrial metals are trading modestly lower. Grains are mixed, with wheat higher on talks of an increase in Russian wheat export taxes. The Baltic Dry Freight index was 794, lower by 11 points from the prior trading day.

Weather

The 6-10 and 8-14 day forecasts call for cooler and wetter than normal conditions for most of the country, except for the Southwest.

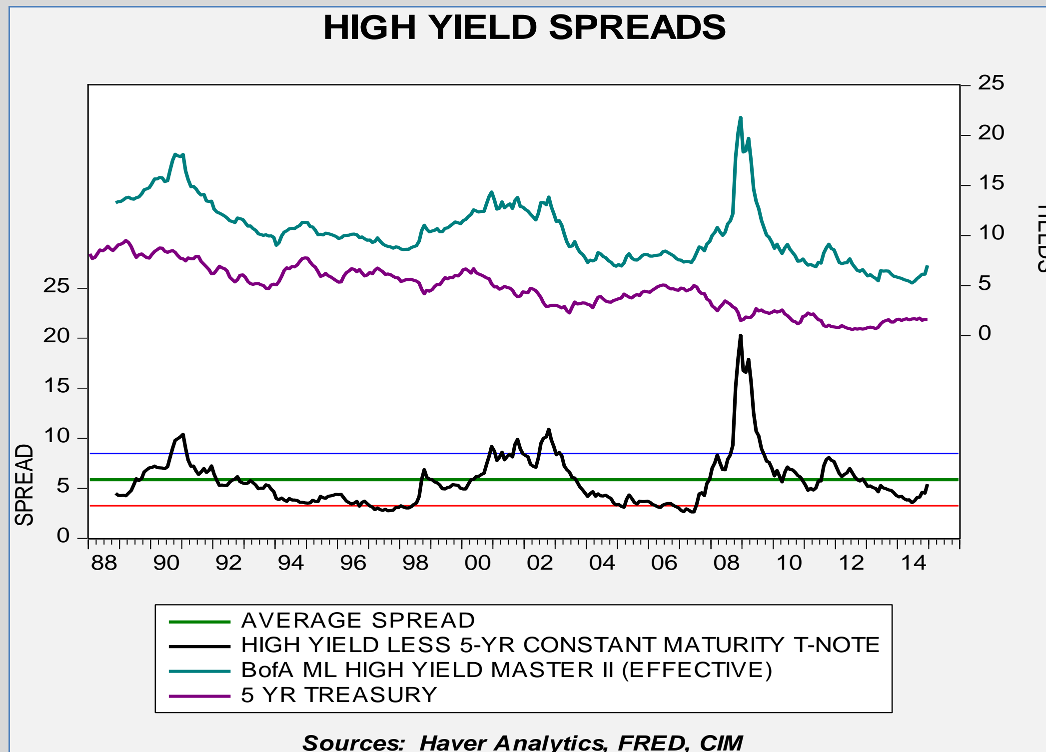
Weekly Asset Allocation Commentary

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. This year, we will start reporting asset allocation thoughts on a weekly basis, updating the piece every Friday. We hope you find this new addition useful.

December 19, 2014

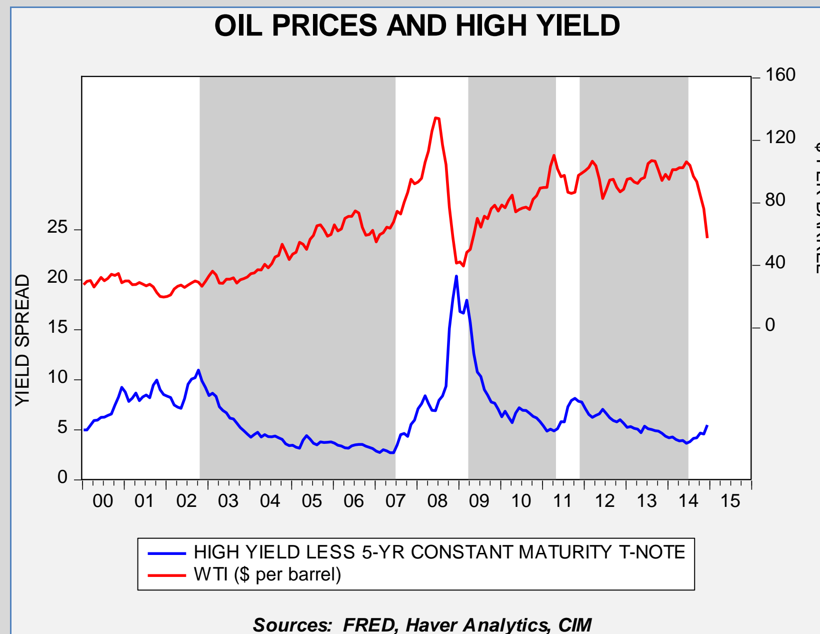
The next update for this section will be published on January 9, 2015.

The drop in oil prices has raised default fears among energy companies which comprise about 17% of the high yield market.



This chart shows the yields of the Merrill Lynch High Yield Master index and the five-year constant maturity Treasury. The lower lines on the chart show the spread between the two yields. As the spread line indicates, high yield spreads can deviate from average for significant periods, both above and below the mean. The most recent rise in yields has moved the spread above the lower standard deviation line to within 45 bps of average. In the past, yield spreads have held below average for extended periods. From 1993 to 1998 and from 2003 to 2007, the spread remained below average. The current spread dipped under average in late 2011, so we are nearly three years into a period of below-average spreads.

How do oil prices affect the high yield market? There is a modest direct correlation between rising oil prices and a narrowing of the yield spread.



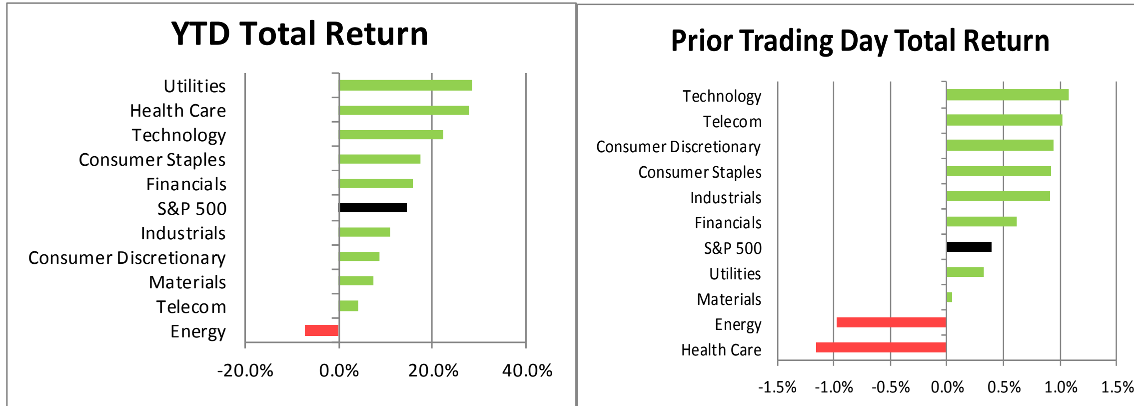
This chart shows the WTI barrel price of oil compared to the aforementioned high yield spread. We have put gray bars for three periods when oil prices were mostly rising or elevated; during these periods, the high yield spread mostly narrowed. This relationship actually held somewhat true from 2000 into late 2002 when a modest decline in oil prices fostered a widening high yield spread. However, this period did have a recession which usually leads to a widening high yield spread. The same case can be made for the other area in white, from mid-2007 into early 2009. In this period, sharply rising oil prices led to a widening yield spread; however, the recession officially began in December 2007 which was probably responsible for the rapid widening of the high yield spread. The recovery in oil prices coincided with the narrowing of the spread. Finally, the 2011 widening of the high yield spread was mostly due to a near default on Treasuries due to the budget standoff that raised recession concerns. At the same time, Europe was facing a Eurozone crisis and there were concerns that these issues would trigger a recession which led to both lower oil prices and a widening high yield spread.

The current situation appears to be mostly due to falling oil prices caused primarily by a market with excess supply. However, there are some legitimate business cycle concerns although they are confined to overseas economies. The Eurozone is teetering on deflation and probably recession, and Japan's economy remains sluggish despite historic stimulus programs. Oil producing nations, like Venezuela, Russia and Iran, are suffering greatly from the drop in oil prices and the latter two are struggling with sanctions as well. However, we do not expect weak overseas growth to trigger a recession in the U.S. unless the Federal Reserve makes an "unforced error" in monetary policy. Until the high yield market becomes convinced that the economy will avoid recession or oil prices recover, high yield will likely remain vulnerable to a widening to undervalued levels, one standard deviation above the mean. That level would imply a yield of 10.1%, more than 300 bps from current levels (assuming a steady five-year T-note yield). We do not anticipate a rise of this magnitude but would not suggest an overweight position in high yield until valuations weaken further.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

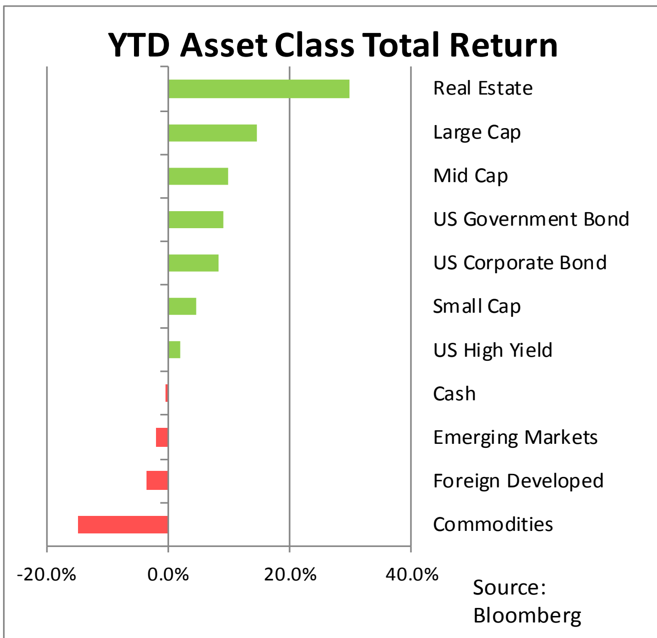
U.S. Equity Markets – (as of 12/22/2014 close)



(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. The sectors are ranked by total return, with green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 12/22/2014 close)

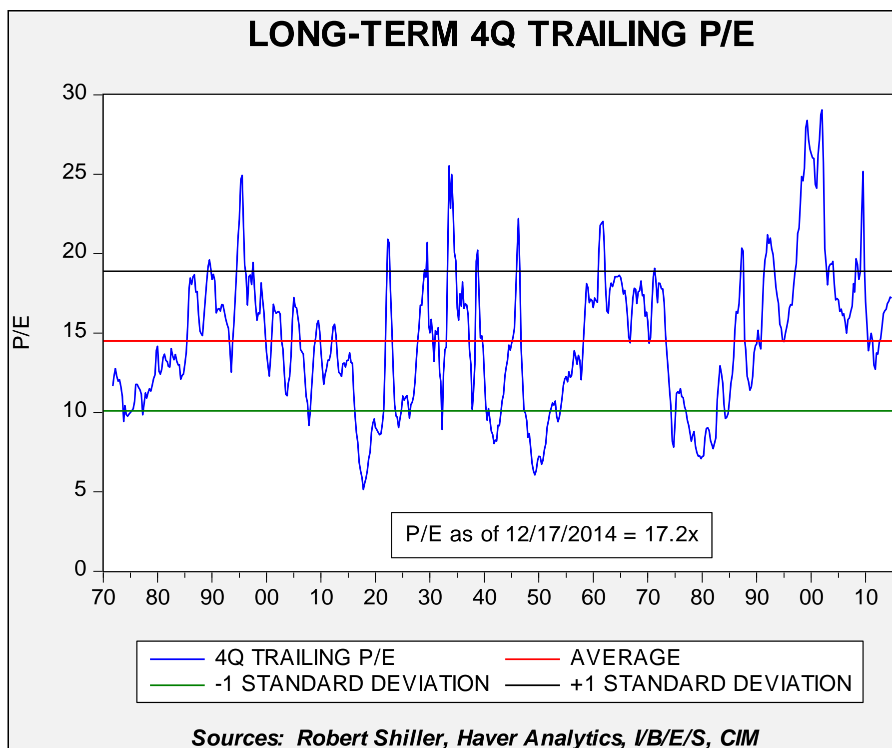


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 EAFA Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets 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 (Dow Jones-UBS Commodity Index).

P/E Update

December 18, 2014
The next update for this section will be published on January 8, 2015.



One of the new features we have added to the Daily Comment this year is the above chart, which 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 and last 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 (Q1, Q2 and Q3) and one estimate (Q4). 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.

Based on our methodology, the current P/E is 17.2x, up 0.1x from the last reading. The current reading is rising as earnings estimates fall. The level remains below clearly overvalued levels of 19.0x.

This report was prepared by Bill O'Grady and Kaisa Stucke of 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.