Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady, Kaisa Stucke, and Thomas Wash

[Posted: November 30, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.5% higher from the prior close. Chinese markets were lower, with the Shanghai composite down 1.0% and the Shenzhen index down 0.2%. U.S. equity futures are signaling a higher open. With 492 companies having reported, the S&P 500 Q3 earnings stand at $31.28, higher than the $29.23 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 72.7% of the companies reported earnings above forecast, while 20.6% reported earnings below forecast.

The big overnight news came from the OPEC meeting, where the latest is that the cartel has agreed to reduce production by a reported 1.2 mbpd. There are also reports that OPEC expects non-OPEC producers to cut output by an additional 0.6 mbpd. We still don't have details on the cuts. According to reports, it seems that the Saudis did "blink" in that they are apparently allowing Iran to operate without a quota. If this is the case, it is a major shift by the kingdom and suggests power is shifting to the Tehran-Baghdad-Moscow axis. Regarding the non-OPEC cuts, Russian cuts are said to be at least 0.2 mbpd to maybe 0.4 mbpd. However, we seriously doubt Russia will actually cut anything and we really don't expect other non-OPEC producers to do anything either.

(Source: Bloomberg)

This is a three-day tick chart for nearest oil futures. The jump today is obvious.

So, what happens now? Here are a few thoughts:

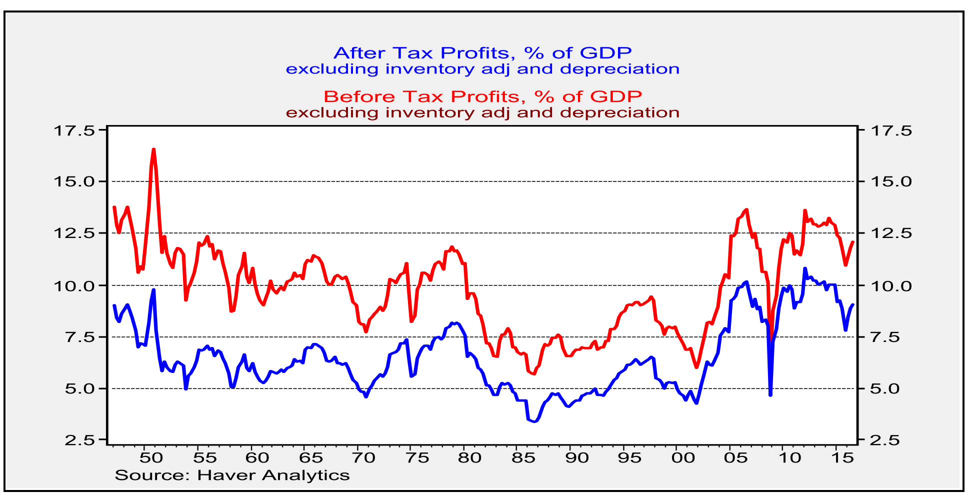
Financial markets, by design, discount the future. Using our inventory/dollar oil price model, assuming a €/$ exchange rate at today's levels of 1.0637 and oil prices of $48.20 (about where we are today), this price is discounting U.S. commercial crude stockpiles[1] of 421 mb, or a decline of about 100 mb from current levels. So, assuming 3.0 mb draw per week, it will take about 33 weeks to reach this level…or assuming 2.0 mb draw per week, we are about a year ahead of ourselves. This price reaction is probably overdone. Now, it is possible that the dollar could weaken. A euro at 1.1475 would justify current oil prices assuming constant inventory levels. However, for the near term, we would not expect the dollar to weaken.

We may see the Brent-WTI spread widen. Much of the OPEC supply is priced at Brent. However, higher oil prices will start to spur U.S. production which, at current spread levels, will tend to raise U.S. inventories. The WTI price will need to fall relative to Brent to support U.S. exports.

Rising U.S. oil production could be bearish for natural gas prices. As oil production rises in the U.S., associated natural gas output will rise, too. This factor will tend to boost natural gas supply and, in the absence of stronger demand, natural gas prices would be dampened.

Overall, we are somewhat surprised by the OPEC news, although the "devil remains in the details." In other words, until we see an actual roster of production quotas, this is all jawboning. The fact that the Saudis appear to have caved increases the likelihood of an agreement. As we discussed above, there is a lot of optimism already in the market that will require a significant decline in inventories. At the same time, the very fact that OPEC is trying to support prices is positive for oil and, at least for a while, traders will probably give the cartel the benefit of the doubt. Interestingly enough, OPEC cuts will probably give market share to non-OPEC output over time.

In yesterday's GDP data, we note that profit margins have improved.



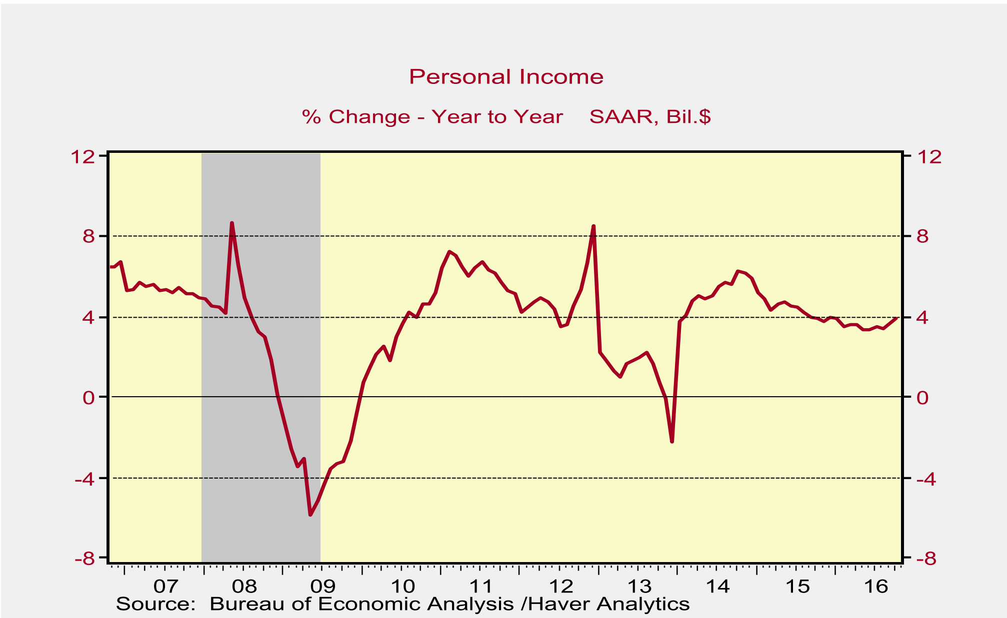
[1] Adding back in pipeline oil.

This chart shows corporate profits for the economy as a percentage of GDP on a before- and after-tax basis. Note that margins have rebounded over the past two quarters, which is something of a surprise. Since 1980, the spread between before- and after-tax profits have averaged about 2.6%. If tax reform is successful, this spread could narrow further and lift after-tax profits.

U.S. Economic Releases

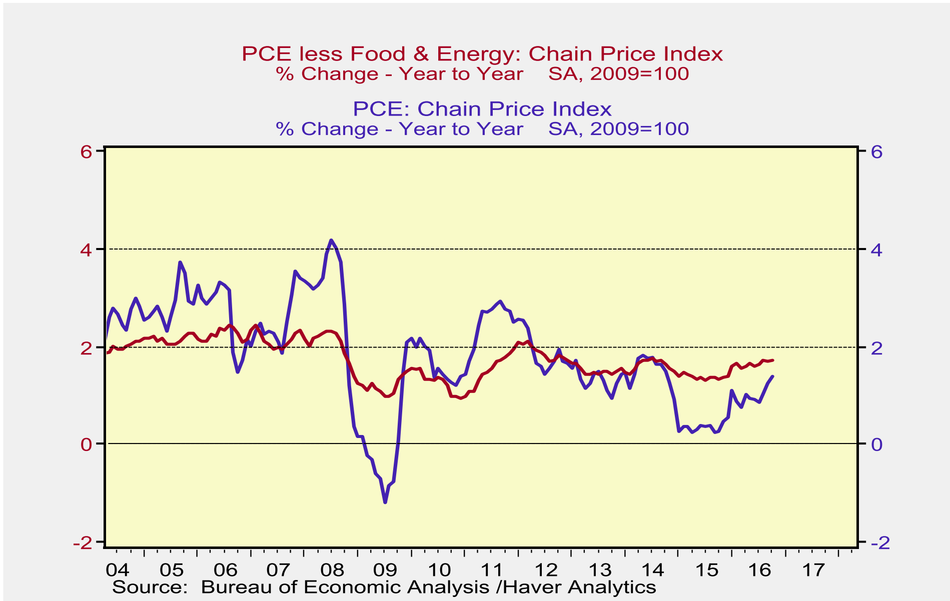
Today, the MBA mortgage applications showed a decrease of 9.4% from the prior week. Purchases declined by 0.2% and refinancing declined by 16.2%. The 30-year fixed rate mortgage increased from 4.16% to 4.23%.

Personal spending increased by 0.3%, below the forecast of a 0.5% increase. Personal income also increased by 0.6%, above the forecast of a 0.5% increase. The increase in wages shows that the economy is strengthening. Increasing wages should lead to more consumer spending, which is the primary driver of economic growth in the U.S. as consumers become more optimistic.



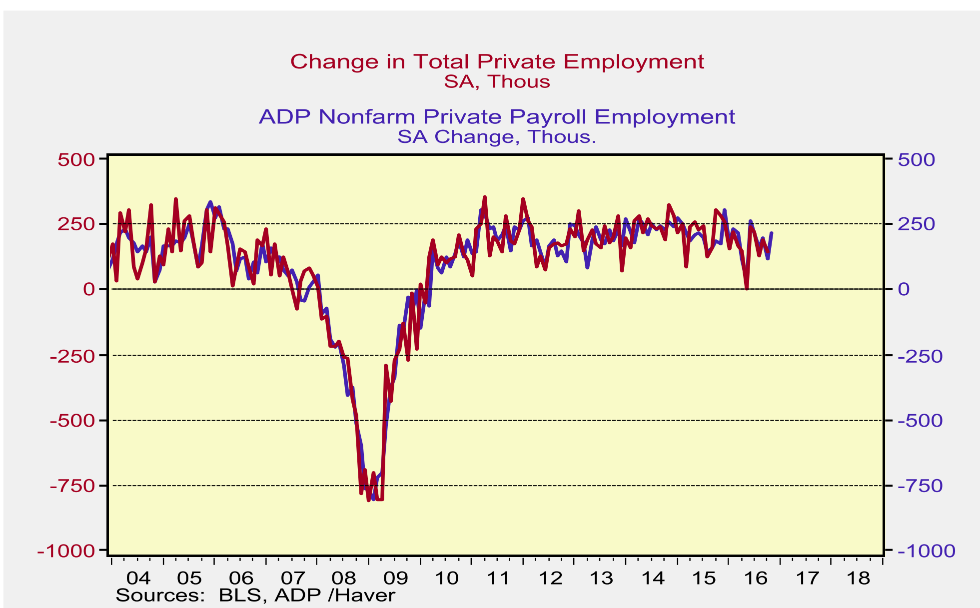
The chart above shows the year-on-year growth of personal income. The graph shows that income has begun to rebound.

The PCE deflator came in at 1.4% annually, slightly below market expectations. Core PCE came in at 1.7%, matching forecasts. Even though the PCE deflator is still below the Fed target, it is unlikely to alter expectations of a December hike.



The chart above shows the PCE deflator and the core price deflator. Although the PCE has not hit the Federal Reserve's target, it has been increasing in that direction. The PCE deflator is the primary tool used by the Federal Reserve to gauge inflation.

ADP employment change came in at 216k, above the forecast of 170k. The prior week's report was revised downward from 147k to 119k. November's number marks the largest increase in payrolls since June, which suggests the labor market is strengthening.



The chart above shows ADP private employment in relationship to the change in total private employment. The two variables are highly correlated, therefore the increase in ADP employment is a positive sign for private employment.

The table below lists the economic releases and Fed speakers scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Chicago Purchasing Manager	m/m	nov	50.6	52.5	**
10:00	Pending Home Sales	m/m	oct	0.1%	1.5%	**
Fed speakers or events						
EST	Speaker or event	District or position				
11:45	Jerome Powell Speaks in Washington	Member 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								
China	Westpac- MNI Consumer Sentiment	y/y	oct	114.9	117.1		**	Equity and bond neutral
Japan	Industrial Production	m/m	oct	0.1%	0.6%	0.0%	***	Equity and bond neutral
	Vehicle Production	m/m	oct	-3.9%	1.4%		**	Equity bearish, bond bullish
	Housing Starts	y/y	oct	13.7%	10.0%	11.0%	**	Equity bullish, bond bearish
	Construction Orders	y/y	oct	15.2%	16.3%		**	Equity and bond neutral
	Small Business Confidence	m/m	oct	48.3	48.3	48.0	**	Equity and bond neutral
Australia	Building Approvals	y/y	oct	-24.9%	2.0%	-8.7%	**	Equity bearish, bond bullish
	Private Sector Credit	y/y	nov	5.3%	5.4%	5.2%	**	Equity and bond neutral
New Zealand	ANZ Activity Outlook	y/y	oct	37.6	38.4		**	Equity and bond neutral
	ANZ Business Confidence	y/y	oct	20.5	24.5		**	Equity and bond neutral
	Money Supply M3	y/y	oct	7.1%	4.8%		**	Equity and bond neutral
EUROPE								
Eurozone	CPI Estimate	y/y	nov	0.6%	0.5%	0.6%	***	Equity and bond neutral
	CPI Core	y/y	nov	0.8%	0.8%	0.8%	***	Equity and bond neutral
Germany	Retail Sales	y/y	oct	-1.0%	0.4%	1.0%	**	Equity bearish, bond bullish
	Unemployment Claims Rate	y/y	nov	6.0%	6.0%	6.0%	***	Equity and bond neutral
France	PPI	y/y	oct	-0.9%	-1.7%		**	Equity and bond neutral
	CPI	y/y	nov	0.5%	0.4%	0.5%	***	Equity and bond neutral
Italy	CPI NIC incl tobacco	y/y	nov	-0.1%	0.0%	-0.2%	***	Equity and bond neutral
	PPI	y/y	oct	-0.7%	-0.8%		**	Equity and bond neutral
Switzerland	UBS Consumption Indicator	y/y	oct	1.49	1.59	1.55	**	Equity and bond neutral
	KOF Leading Indicator	y/y	nov	102.2	104.7	104.0	**	Equity and bond neutral
Russia	CPI Weekly YTD	y/y	nov	5.0%	4.9%		***	Equity and bond neutral
AMERICAS								
Canada	Quarterly GDP Annualized	q/q	3q	3.5%	-1.6%	3.4%	**	Equity and bond neutral
	Industrial Product Price	m/m	oct	0.7%	0.4%	0.6%	***	Equity and bond neutral
	Raw Materials Price	m/m	oct	3.3%	-0.1%	3.5%	**	Equity and bond neutral
Brazil	GDP	q/q	3q	-2.9%	-3.8%	-3.2%	***	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)	94	94	0	Neutral
3-mo T-bill yield (bps)	47	47	0	Neutral
TED spread (bps)	47	46	1	Up
U.S. Libor/OIS spread (bps)	61	60	1	Up
10-yr T-note (%)	2.35	2.29	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	60	61	-1	Down
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	down			Down
franc	down			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	$49.82	$46.38	7.42%	OPEC agreed to cut production by 1.2 million barrels
WTI	$48.37	$45.23	6.94%	
Natural Gas	$3.32	$3.32	0.27%	
Crack Spread	$13.94	$14.02	-0.58%	
12-mo strip crack	$15.24	$15.22	0.18%	
Ethanol rack	$1.75	$1.75	-0.34%	
Metals				
Gold	$1,183.77	$1,194.00	-0.86%	Stronger Dollar
Silver	$16.47	$16.61	-0.84%	
Copper contract	$262.95	$267.05	-1.54%	
Grains				
Corn contract	$ 356.00	$ 358.25	-0.63%	
Wheat contract	$ 413.50	$ 416.50	-0.72%	
Soybeans contract	$ 1,047.50	$ 1,056.00	-0.80%	
Shipping				
Baltic Dry Freight	1184	1181	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.2		
Gasoline (mb)		1.2		
Distillates (mb)		1.6		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		-53.0		

Weather

The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country. Precipitation is also expected for most of the country.

Asset Allocation Weekly Comment

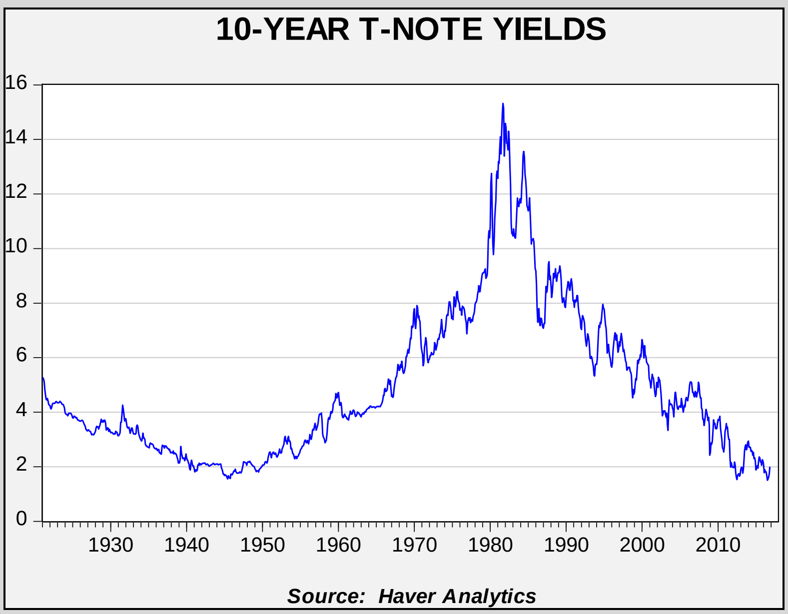
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

Due to the Thanksgiving holiday we will not be publishing a new Asset Allocation Weekly Comment this week. We will resume on Friday, December 2.

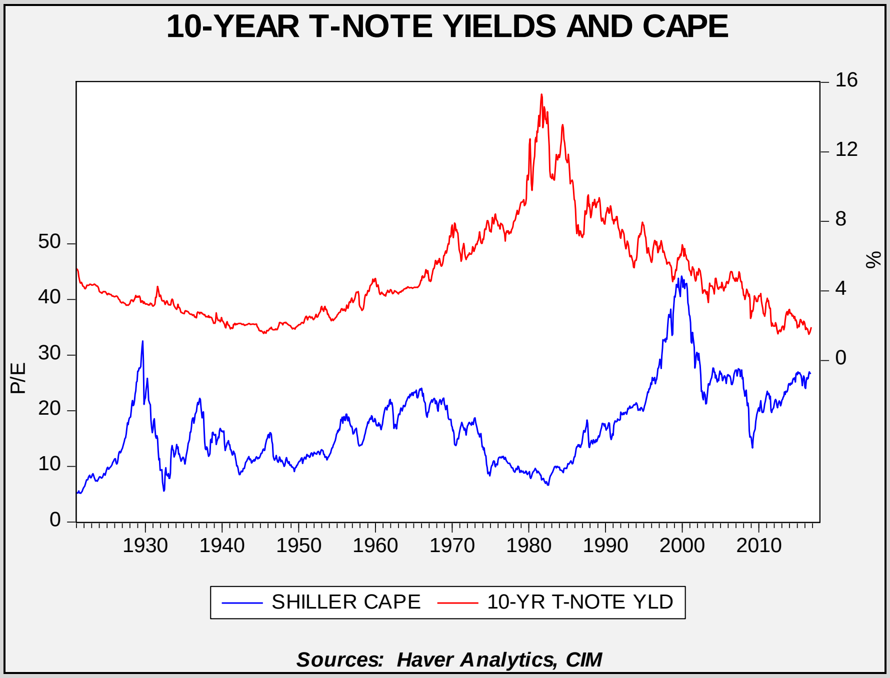
November 18, 2016

Trumponomics looks as if it will be a combination of fiscal stimulus, trade restrictions and deregulation. It looks very likely that environmental regulations will be reversed and there have been promises of financial deregulation as well. The first two will likely reflate the economy. Proposed deregulation may help hold down energy prices but financial services are not a major contributor to inflation (only about 0.24% in CPI) anyway.

With reflation on the horizon, we have seen a rise in the 10-year yield. Even though we would expect a retreat in yield during the next recession, it is likely that the secular bond bull market that began in the early 1980s is coming to a close.

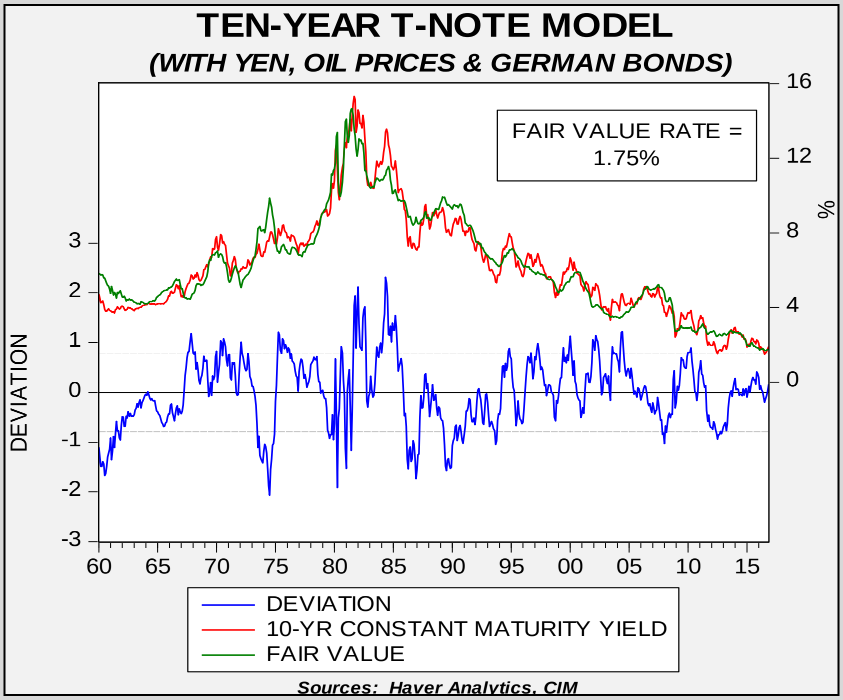


The chart above shows the 10-year T-note yield from 1921. Perhaps the most important issue to remember is that when the last secular bear market began after the lows were made in 1945, the next peak took 36 years. It took eight years before yields doubled. Although the regulatory environment is different, it takes a while for bond yields to reach really high levels. Still, the tailwind for financial assets that this bull market represents is noteworthy.



This chart shows the 10-year T-note yield and the cyclically adjusted price/earnings ratio (CAPE) that was developed by Robert Shiller. The CAPE deflates earnings and stock prices and then averages earnings over a decade, generating a P/E that is designed to capture the underlying trend in real earnings. Note that the P/E rose from 1950 to 1965 even though rates rose. However, as inflation steadily increased, interest rates and the P/E moved in opposite directions. Casual observation suggests that rates above 4% and rising lead to a lower multiple.

How high will interest rates rise? Our broad 10-year T-note model puts the fair value yield at 1.75%.

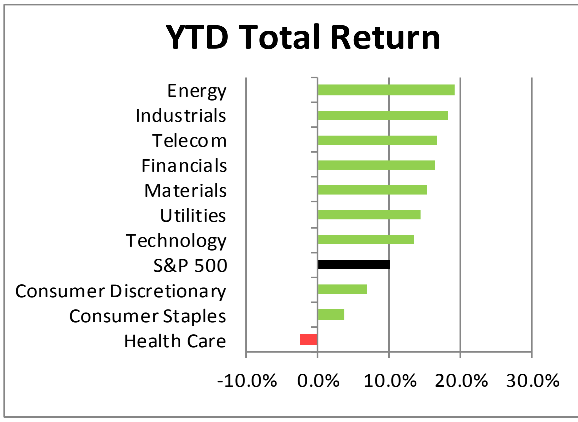


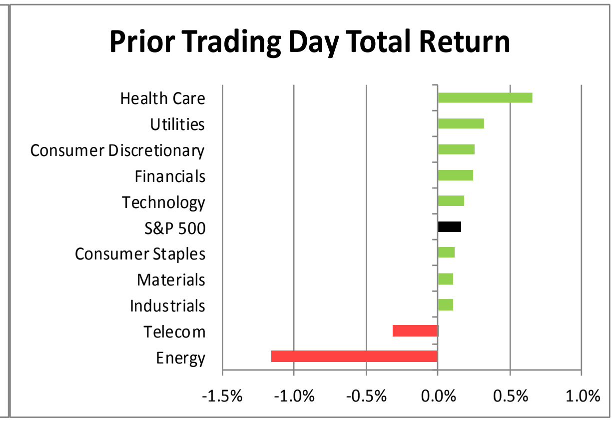
The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The most important variable keeping the fair value low are German bond yields; removing those from the model boosts the fair value yield to 2.42%. In a less globalized world, the impact of foreign rates might be reduced, so there is a concern the model is underestimating the fair value yield. However, as long as capital flows remain open, the impact of lower German yields should be a bullish factor for long-duration Treasuries. In addition, if we assume a 25 bps hike in fed funds next month, the fair value yield would increase to 1.84%.

Overall, a case can be made that the recent spike in long-duration yields is overdone, at least in the short run. On the other hand, as we discussed in the most recent WGR, if the U.S. retreats from the superpower role, inflation expectations will likely rise and weaken the case for holding long-duration instruments. We continue to closely monitor the fixed income markets but it does appear that the long bull market in Treasuries may be coming to an end.

Data Section

U.S. Equity Markets – (as of 11/29/2016 close)

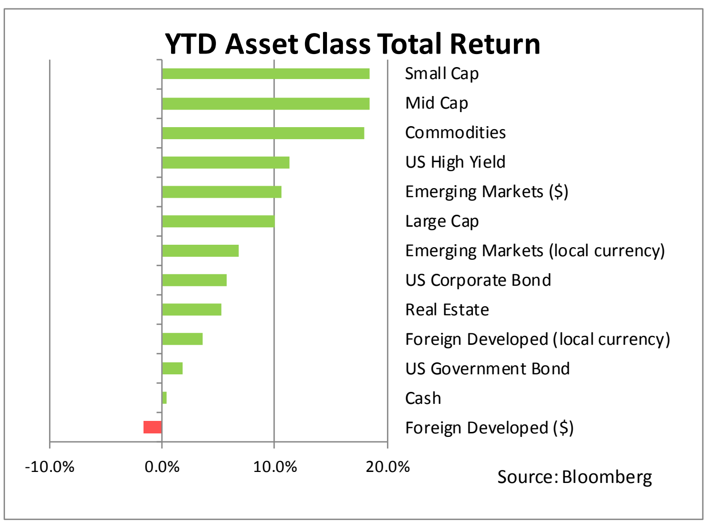




(Source: Bloomberg)

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 11/29/2016 close)



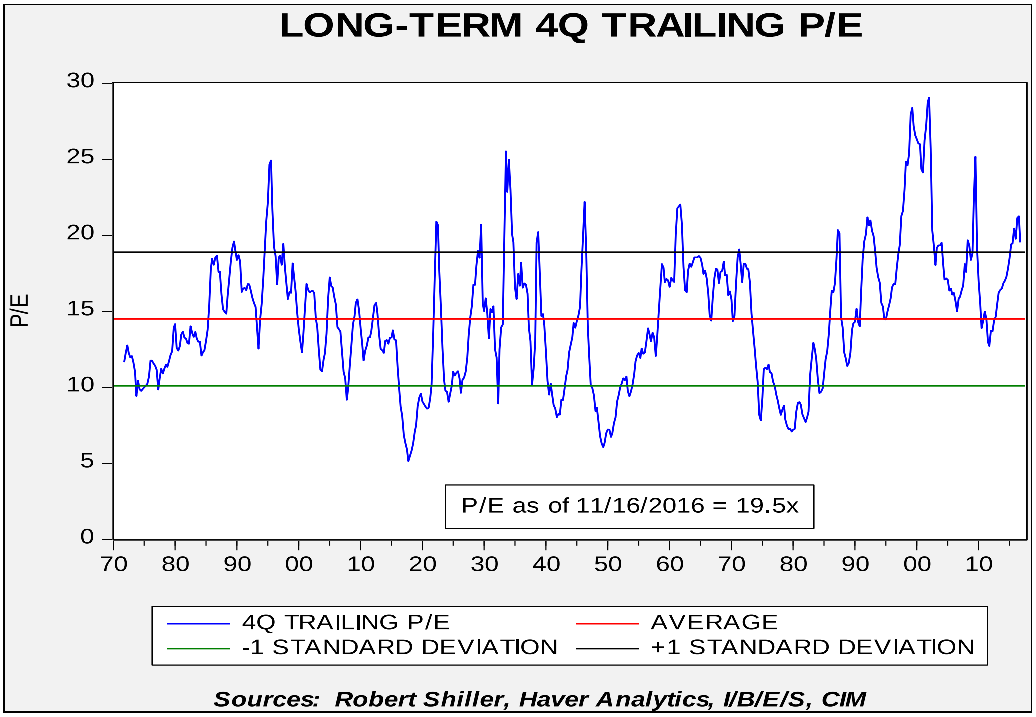
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Dow Jones-UBS Commodity Index).

P/E Update

Due to the Thanksgiving holiday we will not be updating the P/E chart this week. We will resume on Thursday, December 1.

November 17, 2016



Based on our methodology,[2] the current P/E is 19.5x, up 0.4x from last week. The rise in the P/E is due to the fact that we now have enough data that S&P has projected its earnings report for Q3. Although earnings are up strongly, the divergence we have noted in the past continues between Thomson-Reuters and S&P.

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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 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 the 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.