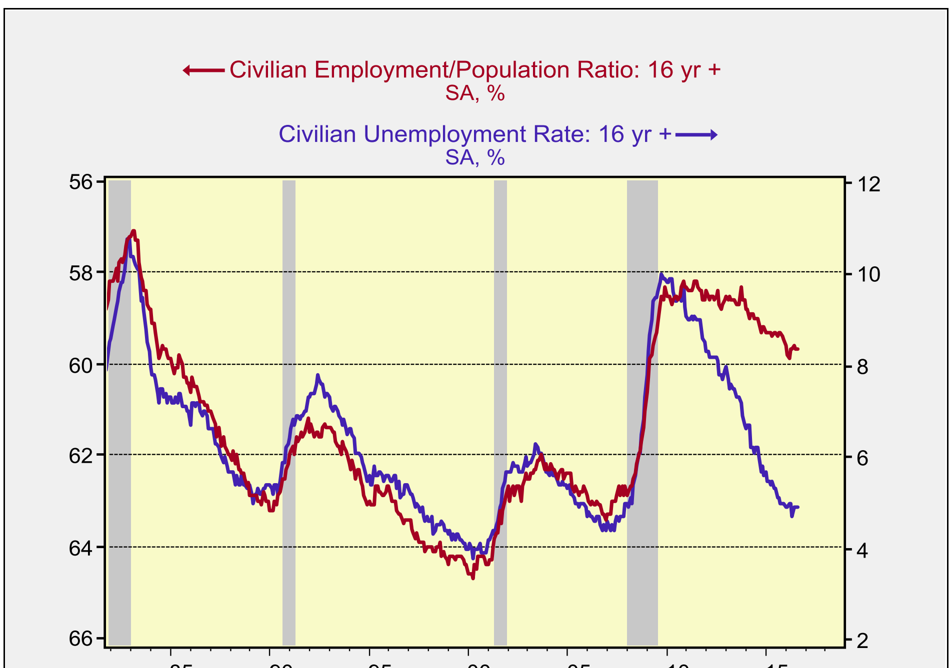
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 12, 2016—9:30 AM EDT] Global equity markets are sharply lower this morning. The EuroStoxx 50 is trading lower by 2.1% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 3.1% from the prior close. Chinese markets were also lower, with the Shanghai composite moving down by 1.9% and the Shenzhen index lower by 2.9%. U.S. equity futures are signaling a lower opening from the previous close.

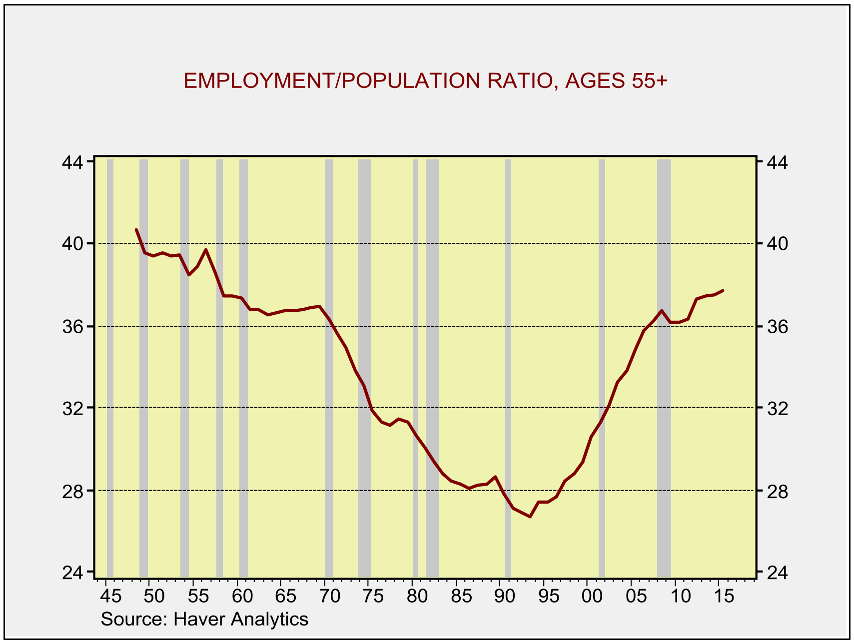
Although Friday's sell-off in equities was impressive, the financial chatter over the weekend was almost non-existent. U.S. equity markets have been extended for some time and, so far, investors took Friday in stride. The proximate cause for the drop was a renewed fear of Fed tightening. Boston FRB President Rosengren, previously a reliable dove, said on Friday that a rate hike is "justified" due to the growing tightness of the labor market. We have said much over the past few years on the issue of the labor market. This chart, which should be familiar to our readers, is probably the best way to show the uncertainty.

This chart shows the difference between the unemployment rate and the employment/population ratio. The two series tracked each other closely from 1980 into the financial crisis. Since then, they have diverged significantly. Some of the weakness in the employment/population ratio is due to demographics; as the baby boom generation heads to retirement, the ratio should ease.



Source: Bureau of Labor Statistics /Haver Analytics

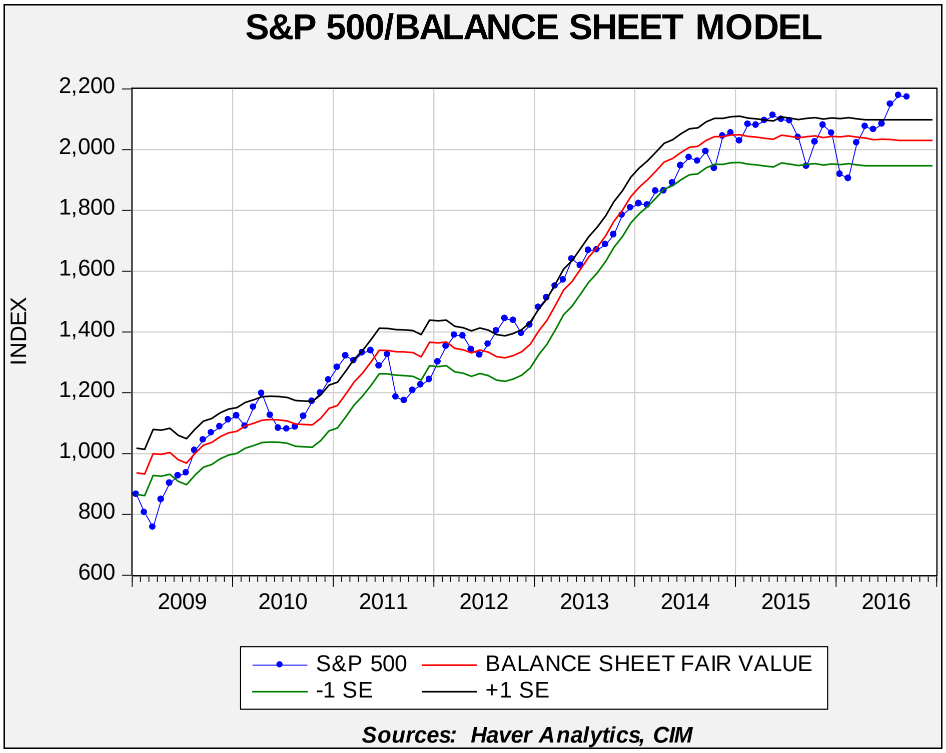
However, there are two problems with this explanation. First, the millennial generation, which is also large, is entering its working years and should offset some of the retirements. Second, the baby boomers are working longer.



The markets correctly worry that the Fed might tighten into an economy with ample slack and clearly low inflation. Thus, a hike may be a mistake.

There may be a bigger issue, however. This most recent weakness has hit both long-duration bonds and stocks and seemed to follow after the ECB made no policy adjustments. There is a worry that central banks may be concluding that there isn't much more they can do to boost economic growth without participation from fiscal policy. And, since the odds of expanding fiscal policy are remote, we may be moving to a market situation where further monetary stimulus isn't coming. A case can be made that monetary policy has been majorly supportive for equity markets.

The good news is that it's doubtful the Fed will be contracting its balance sheet anytime soon. The bad news is that we may be moving back to mid-range, which, from this point, will be a notable pullback in equity values. The chart below shows an S&P index model, using the Fed's balance sheet as the explanatory variable. The last time we had a market this expensive to the model was in 2012 when the market was anticipating QE. Fair value for this model is 2030 on the S&P. Although a drop to that level would not be catastrophic, it would represent about an 8% decline from current levels.



Governor Brainard, a reliable dove, is expected to speak early this afternoon. She may ease fears of policy tightening. Currently, the fed funds futures market places only about a 15% chance of a rate hike on the 21st of this month but the odds are around 60% for December.

There were three other news items from the weekend that caught our attention.

What is the state of Sen. Clinton's health? For the most part, these discussions have been only held among right-wing pundits and bloggers. The mainstream media has either ignored the controversy or ridiculed it. That stance may have changed after Sen. Clinton was removed from a 9/11 ceremony complaining of light-headedness. The video of her entourage taking her away did not look good. Later in the day, the campaign admitted the senator had pneumonia but mainstream commentators were sounding concern. This election season has been one of the oddest in our memory. The weekend events simply added to the controversy. So far, financial markets have not been affected but we would not be surprised to see some volatility tied to the election as we get closer to November.

Is Kim Jong-un crazy? The general consensus is no. If one looks at it from the viewpoint of the dynasty, acquiring nuclear weapons is completely rational. For most of the Cold War, North Korea was protected by the Soviet Union and its economy was mostly on par with the South. But, its economy lost its funding from the U.S.S.R. with the fall of the Soviet Union, and South Korea's economy was booming during the late Cold War years, clearly overtaking the North. The Kims found themselves isolated. They also could not help but notice that the U.S. had overturned various regimes in nations such as Libya, Iraq and Afghanistan, and President Bush had included North Korea in his "axis of evil." So, how does a state keep from getting invaded?

Get a nuclear weapon. Dictators around the world believe that Muammar Gaddafi made a strategic error by ending Libya's nuclear program. It should be noted that getting a nuke won't improve North Korea's economy or allow it to take over the South. All nuclear powers realize that the bomb is only a defensive weapon; even if North Korea attacked the U.S., it would face certain annihilation. It doesn't appear that is what the Kims have in mind. Thus, we suspect North Korea will become a nuclear power that can deliver a warhead. The U.S. won't like it but there isn't much we can do about it. In fact, only one power on Earth can, and that's China. Until China decides North Korea is too big of a liability it will refrain from acting against the regime. This morning, Chinese officials criticized the U.S. for "creating" the situation on the Korean peninsula. After all, the U.S. is the global hegemon. It has a duty to fix such things. The only way China may conclude it has to curb the Kim regime is if South Korea and Japan decide to build their own nuclear deterrents. The U.S. has worked to prevent that from occurring, but that doesn't mean we can continue to prevent it.

U.S. Economic Releases

There are no releases scheduled before we go to print. The table below shows the releases and Fed speakers scheduled for the rest of the day.

Economic releases		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
1:00	Kashkari	Minneapolis FRB President
1:15	Brainard	Governor

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.

ASIA-PACIFIC								
China	CPI	y/y	Aug	1.3%	1.8%	1.7%	***	Equity neutral and bond bearish
India	CPI	y/y	Aug	5.1%	6.1%	5.2%	**	Equity and bond neutral
	Industrial production	y/y	Jul	-2.4%	2.1%	1.4%	***	Equity bearish, bond bullish
Japan	Machine tool orders	y/y	Jul	5.2%	-0.9%	0.3%	**	Equity bullish, bond bearish
	PPI	y/y	Aug	-3.6%	-3.9%	-3.4%	**	Equity and bond neutral
EUROPE								
Italy	Unemployment rate	m/m	Q2	11.5%	11.6%	11.5%	**	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)	85	85	0	Up
3-mo T-bill yield (bps)	34	33	1	Neutral
TED spread (bps)	52	51	1	Neutral
U.S. Libor/OIS spread (bps)	45	45	0	Neutral
10-yr T-note (%)	1.69	1.68	0.01	Widening
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	28	28	0	Neutral
Currencies	**Direction**			
dollar	up			Up
euro	down			Neutral
yen	up			Down
pound	down			Down
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	$47.10	$48.01	-1.90%	
WTI	$44.96	$45.88	-2.01%	
Natural Gas	$2.87	$2.80	2.43%	
Crack Spread	$12.79	$12.26	4.32%	
12-mo strip crack	$13.47	$13.31	1.17%	
Ethanol rack	$1.62	$1.62	0.00%	
Metals				
Gold	$1,327.82	$1,327.83	0.00%	Higher interest rates
Silver	$18.85	$19.05	-1.03%	
Copper contract	$208.10	$209.25	-0.55%	Chinese copper imports decline
Grains				
Corn contract	$ 340.00	$ 341.00	-0.29%	
Wheat contract	$ 402.50	$ 403.50	-0.25%	
Soybeans contract	$ 974.25	$ 980.25	-0.61%	
Shipping				
Baltic Dry Freight	804	792	12	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for all of the country except the southwestern region. Precipitation is forecast for the eastern two-thirds of the country. A small low pressure area has developed near the Bahamas. It has a low chance of development. In the mid-Atlantic, about 800 miles east-northeast of the Leeward Islands, a cell with a much better chance of development is circulating. We note that the average peak in tropical storm development is September 10, so we should see fewer storms as the weeks pass.

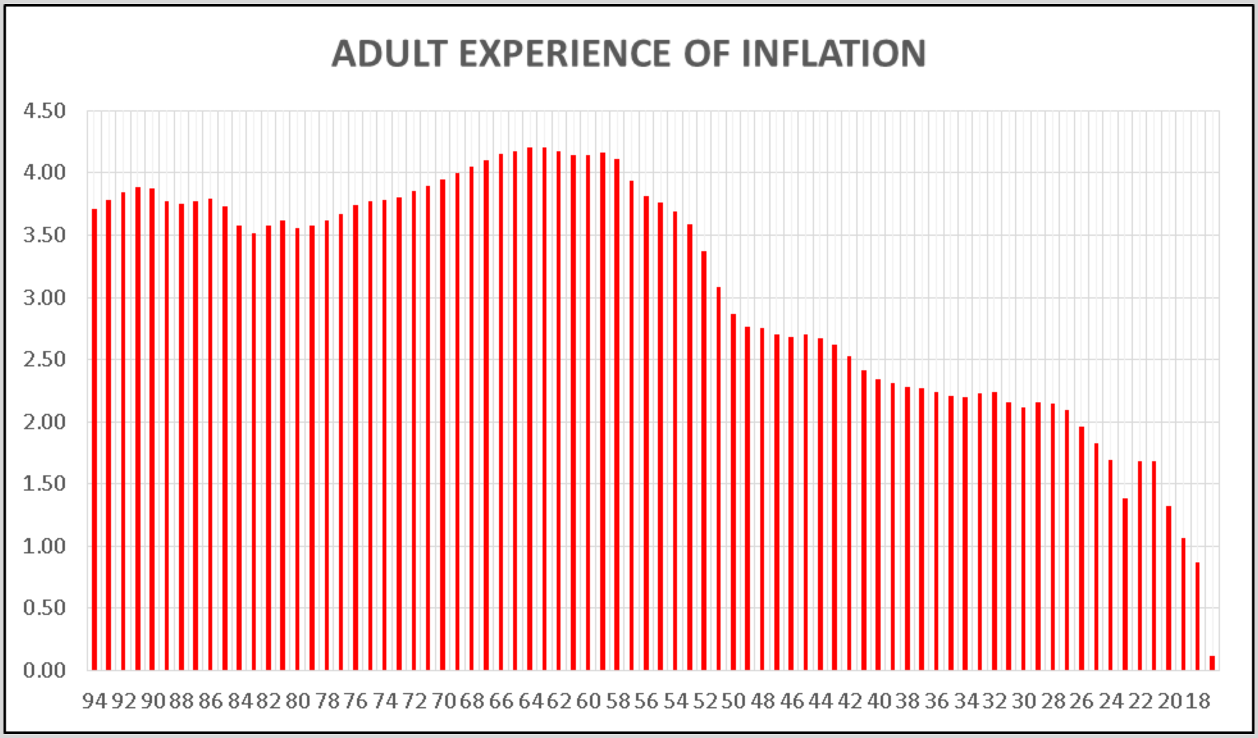
Asset Allocation Weekly Comment

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 9, 2016

Milton Friedman postulated that inflation expectations are established through a lifetime of experience. To some extent, the issue of inflation expectations is similar to other market gauges in our lives, such as the level of financial markets, interest rates and home prices. What we have experienced is considered as "normal" in our lives. Behavioral economists call this anchoring; it's where we believe levels "should be" based on our experience.

To get a feeling for this, we calculated the adult experience of inflation, looking at ages 16 to 94.



(Sources: Haver Analytics, CIM)

We have presented the "lifetime" experience of inflation on several occasions in the past. However, on this chart, we omit the data related to the first 16 years of an individual's life on the assumption that children are less aware of inflation than adults. The difference is interesting. Essentially, Americans with the highest experience of inflation are in their late 50s and early 60s. By age 50, which is 34 years of inflation experience, the average inflation experience falls below 3%. And, by age 26, the average falls under 2%.

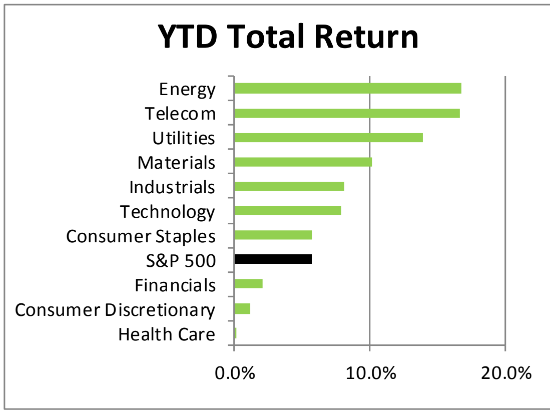
It makes sense that current policymakers are concerned about inflation. Vice Chairman Stanley Fischer is 73, while the youngest member of the FOMC, Neil Kashkari, is 43.[1] The allocation of hawks and doves doesn't seem to follow an age pattern. In fact, the most important factor to determine policy stance is permanent voting members versus rotating voter members. The NY FRB president and the five governors, all permanent voting members, are moderates to doves. All the hawks are other regional FRB presidents who are rotating voters. But, the fact that the "dots" chart mostly shows high future rate levels does suggest that nearly all the FOMC members expect some degree of normalization. This is consistent with the adult inflation experience for the ages of the members.

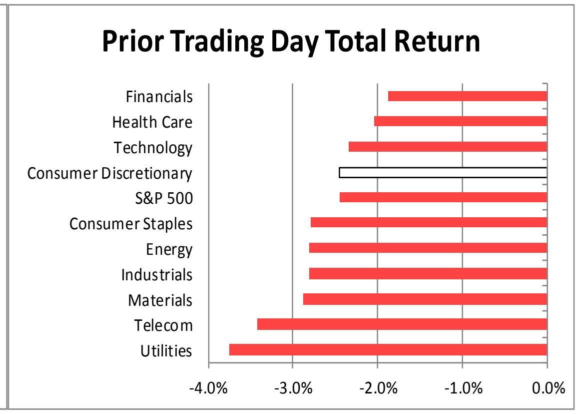
The other factor this chart highlights is the expectations of investors. Older investors are likely more concerned about inflation because they have experienced it. As time wears on, the odds of inflation-inducing policy become lower because fears of it should decline. However, we would not expect this to become an issue for at least another decade. Thus, fears of rising long-term rates and duration risk are probably overestimated, for now.

[1] The current age breakdown for FOMC voting and alternate members is as follows: ages 40-44: 1 member, ages 45-49: 0 members, ages 50-54: 3 members, ages 55-59: 5 members, ages 60-64: 4 members, ages 65-69: 0 members, ages 70-74: 2 members.

Data Section

U.S. Equity Markets – (as of 9/9/2016 close)

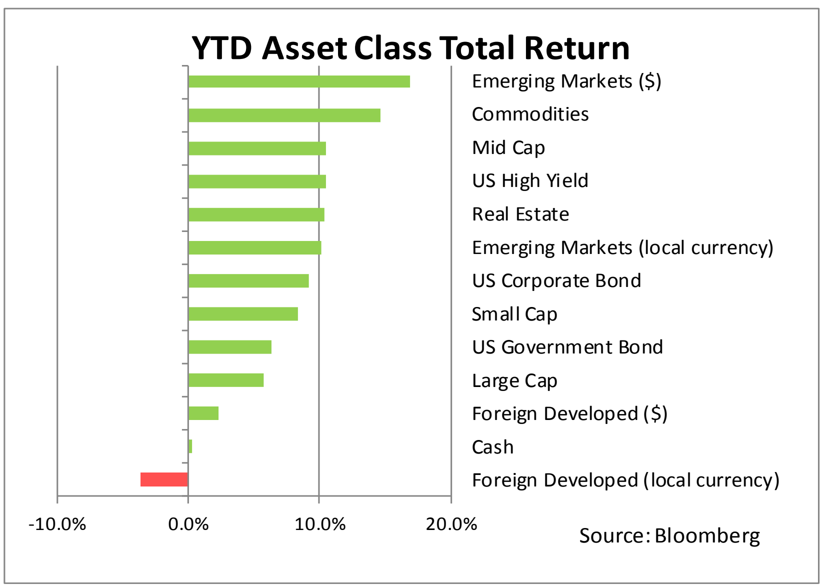




(Source: Bloomberg)

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 9/9/2016 close)

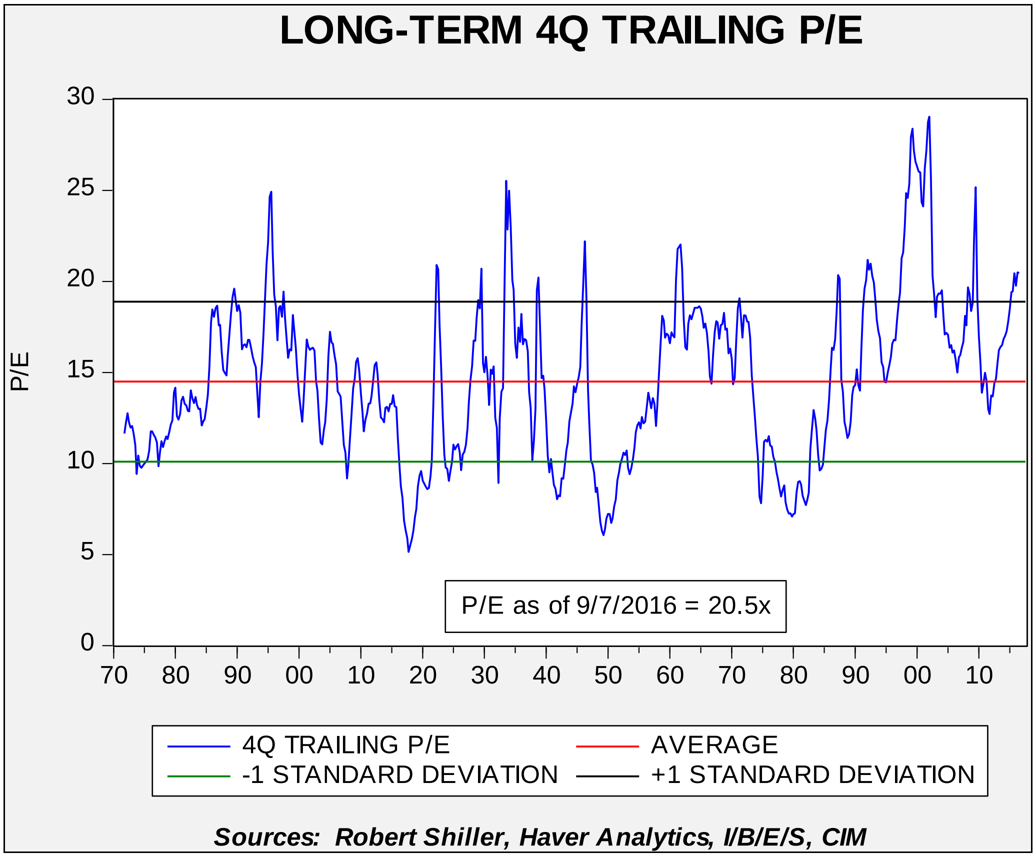


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 8, 2016



Based on our methodology,[2] the current P/E is 20.5x, down 0.5x from last week. A rise in Q2 S&P earnings led to the improvement in the P/E.

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.

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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 two actual (Q4 and Q1) and two estimate (Q2 and 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.