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

[Posted: April 13, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were up, with the Shanghai composite up 0.1% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a lower open. With 25 companies having reported, the S&P 500 Q1 earnings stand at $27.58, lower than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 72.0% of the companies reported earnings above forecast, while 16.0% reported earnings below forecast.

In a wide-ranging interview, President Trump roiled the markets late yesterday by admitting that (a) China is not a currency manipulator; (b) the dollar is too strong; and (c) Chair Yellen might be invited to stay at the FOMC. Point (b) was the market-moving news; since Bob Rubin was Treasury Secretary during the Clinton administration, the White House has hewed to a "strong dollar" policy. Essentially, this policy was designed to end the practice of currency manipulation by the government. For the most part, the U.S. has allowed the dollar's level to be set by market forces.[1] Earlier, the Trump administration signaled that the Rubin dollar policy was coming to an end and active discussion of the dollar's level was possible. The president's position that the dollar is "too strong" suggests the administration would like to see it weaken.

This policy of "oral intervention" is often effective in the short run. Whether it has a long-term effect depends on two factors. First, is the jawboning followed up with policies that change the fundamentals for the exchange rate? And second, what is the valuation of the currency when the jawboning takes place? Currently, on a relative inflation basis, the dollar is expensive relative to the JPY and EUR. For the most part, the dollar's strength since 2014 has been a function of tighter monetary policy. In fact, based upon the current level of the two-year T-note, the EUR/USD rate should be closer to parity. It appears to us that the exchange rate markets are waiting to see how much more U.S. monetary policy tightens and whether other central banks are coming close to ending their overly easy policies. A president suggesting that he wants a weaker dollar does, at least in the near term, signal the potential for a weaker currency. However, we would also note that most presidents prefer dollar weakness on hopes it might boost growth. Even President Reagan, who supported dollar strength initially, reversed course on currency policy in his second term.

[1] U.S. dollar policy has always been an odd configuration; the Treasury has the mandate for policy but the most effective tools for short-term exchange rate management are interest rates, which are the purview of the Fed. The Treasury was mostly left with jawboning the markets, which isn't a good long-term strategy. Rubin decided that it made the most sense to say the U.S. wanted a strong dollar without defining what that meant. That decision has left subsequent Treasury Secretaries to maintain the language without content.

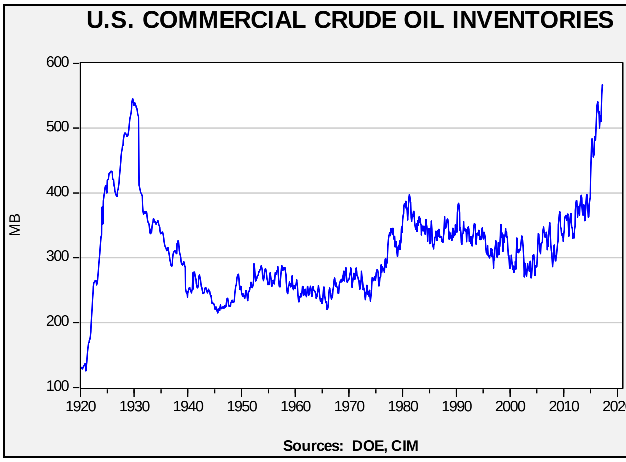
If the dollar is poised to fall, it would change our outlook for some markets. Emerging markets have been unusually strong relative to the dollar, which may suggest that investors in these markets anticipated a reversal in the greenback. Although dollar weakness is usually bullish for emerging markets, we would argue that much of that has already been discounted. Commodities usually benefit as well. As we note below, oil prices arguably have discounted some dollar weakness, too. A weaker dollar tends to support large caps relative to small caps and that trade may have some room to move further. But, it is too early to tell if yesterday's weakness will stick. After all, the FOMC is still expected to make at least two more hikes and the balance sheet will likely be trimmed, so a weaker dollar has to occur with tightening policy. That might be a struggle.

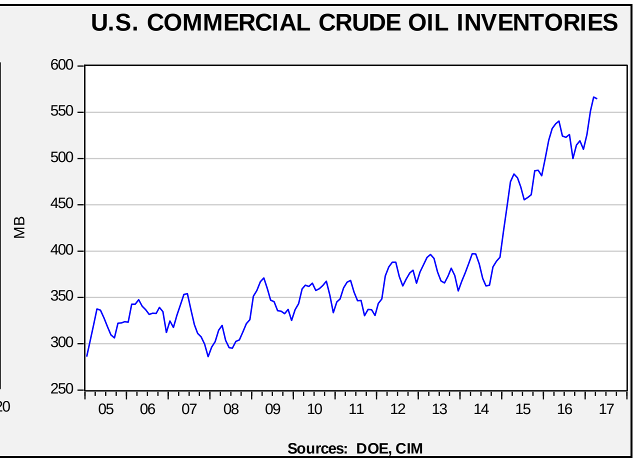
The interesting issue surrounding the decision not to name China a currency manipulator is that Trump actually has already received the key response to naming a nation a currency manipulator, namely, bilateral negotiations designed to reduce the trade imbalance. China does, in fact, manipulate its currency but in a way that is positive for U.S. trade; left to its own devices, the CNY would be much weaker. By getting trade talks without naming China a manipulator, which would have been difficult based on the Treasury Department's criteria, Trump has managed to get what he wanted anyway.

On the Yellen comment, we think it's best to frame it relative to what we see going on in the White House. Since the election, we have discussed this presidency as "Bannon v. Ryan." Bannon is losing ground fast. Jared Kushner appears to be the president's most trusted advisor, and he is steering Trump toward a conventional GOP establishment position. This not only excludes the populists but also the Freedom Caucus, which is pre-Rooseveltian. In other words, this is becoming a country club GOP administration. That being said, the other characteristic of this administration is that it consists of mostly tactics with little clear strategy. When the president cites "flexibility" we see the lack of clear goals.

If we are correct, it is good news for financial markets. The inflation-generating policies that the populists want would weigh on stocks and bonds. Instead, we will likely see "middle of the fairway" policies—the ACA mostly stays intact, modest tax cuts occur, trade impediments are mostly for show and the superpower role will remain intact. On the other hand, the populists aren't going away. If this is the correct assessment of the trend, it will open the door for either a right-wing populist to mount a GOP primary challenge or, more likely, a "Bernie-crat" challenge from the left. The latter assumes that the Democrat Party understands the populist-establishment dynamic, which is questionable. So, we will continue to watch this development closely, but this is what we are seeing.

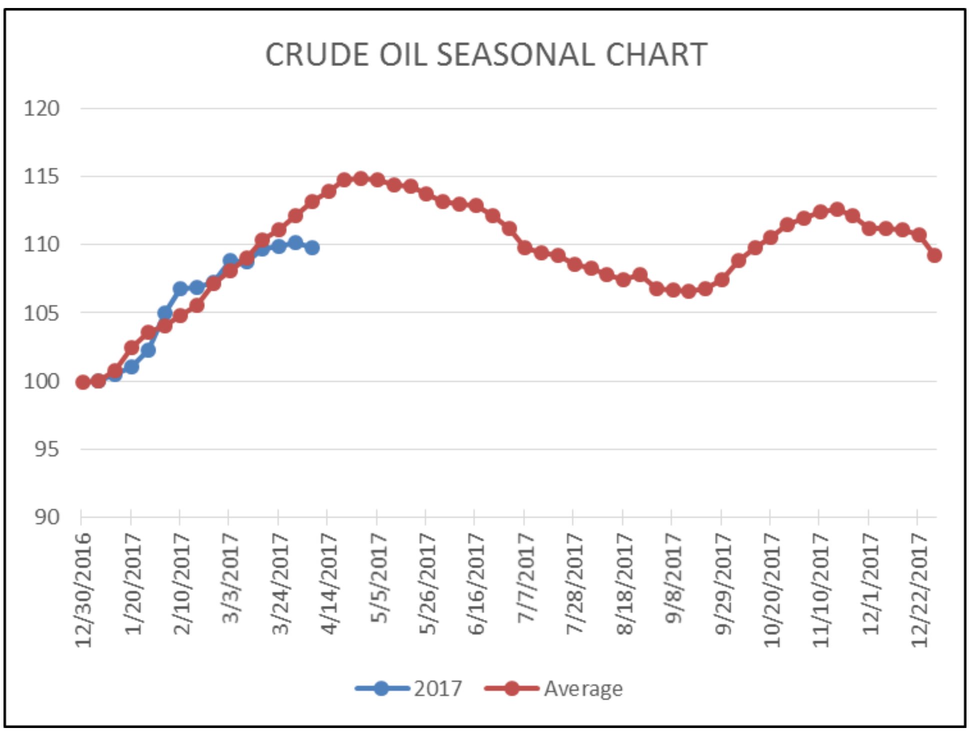
U.S. crude oil inventories fell 2.1 mb compared to market expectations of a 1.8 mb draw.



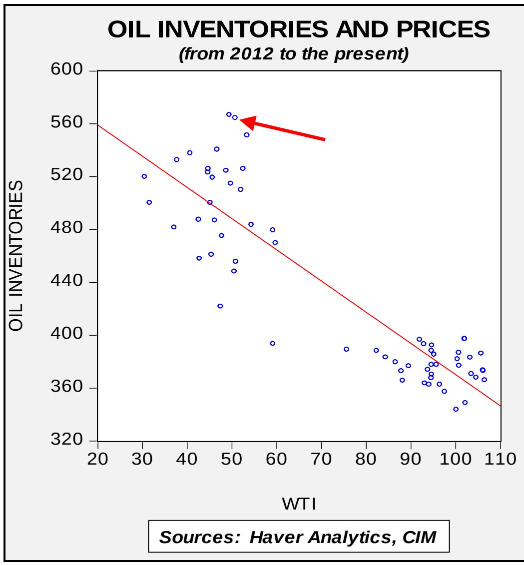


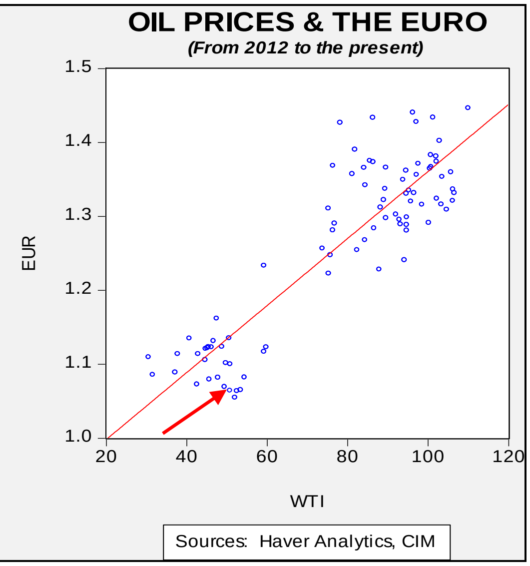
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high.

As the seasonal chart below shows, inventories usually increase for the next three weeks before rising refinery operations for the summer driving season lower stockpiles. This week's decline puts us further below normal. Although inventories remain high, this seasonal level is consistent with July, meaning that we may be on the way to an easing of the inventory overhang.



(Source: DOE, CIM)

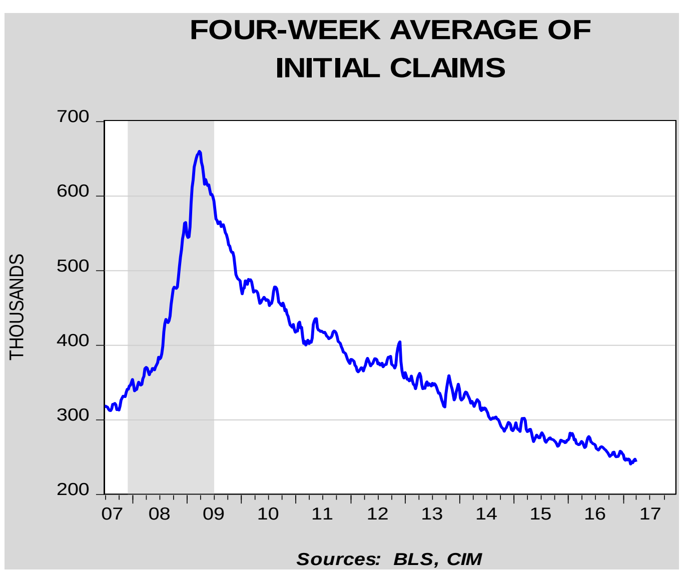




Based on inventories alone, oil prices are overvalued with the fair value price of $29.32. Meanwhile, the EUR/WTI model generates a fair value of $40.05. Together (which is a more sound methodology), fair value is $36.12, meaning that current prices are well above fair value. Like emerging markets, oil prices have discounted a lot of good news. Based on a €1.064 exchange rate, the current price has discounted oil inventories of 360 mb, over 200 mb below current levels. Assuming no change in inventories, the EUR would need to appreciate to €1.165. So, falling inventories and a weaker dollar has mostly been "baked in" at this point and may not lead to sharply higher oil prices.

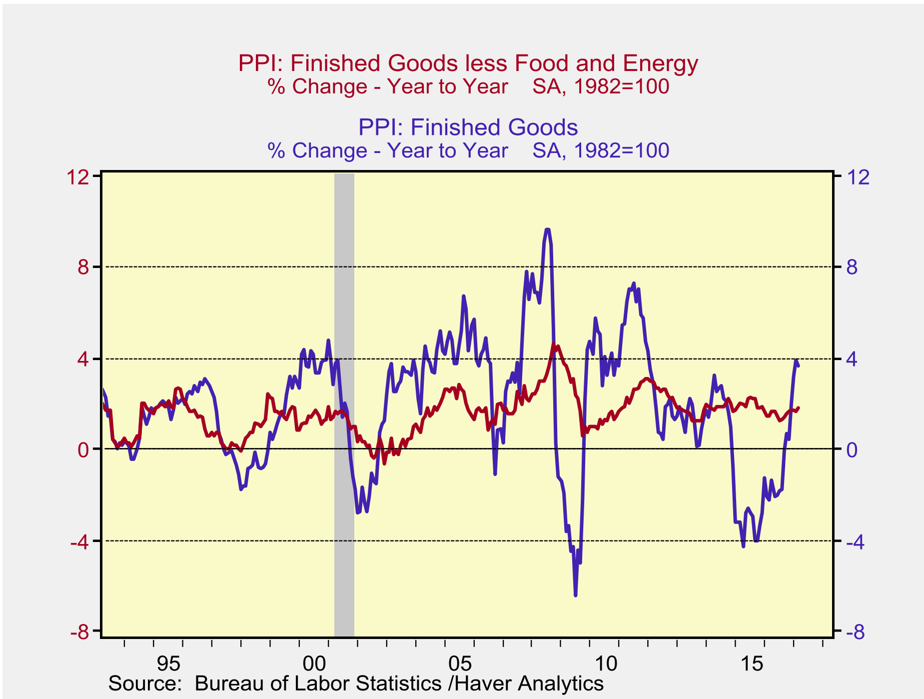
U.S. Economic Releases

Initial jobless claims came in below expectations at 234k compared to the forecast of 245k. The prior report was revised upward from 234k to 235k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 246.5k to 246.25k.

PPI final demand came in below expectations, falling 0.3% compared to the forecast of no change from the prior month. Core PPI remained unchanged compared to the forecast rise of 0.3% from the prior month.



The chart above shows the relationship between PPI final demand and core PPI. A relatively stagnant core PPI suggests that suppliers are still not facing any inflationary pressures. This could be attributed to a stronger dollar, which makes it easier to import inputs from abroad, or increased competition among intermediaries.

The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	apr		50.2	**
10:00	University of Michigan Sentimenet	m/m	apr	96.5	96.9	**
10:00	University of Michigan Current Conditions	m/m	apr	112.5	113.2	**
10:00	University of Michigan Expectations	m/m	apr	86.5	86.5	**
10:00	University of Michigan 1 yr Inflation	m/m	apr		2.5%	**
10:00	University of Michigan 5-10 yr Inflation	m/m	apr		2.4%	**
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								
China	Imports	y/y	mar	20.3%	38.1%	15.5%	**	Equity bearish, bond bullish
	Exports	y/y	mar	16.4%	-1.3%	4.3%	**	Equity bullish, bond bearish
	Trade Balance	y/y	mar	23.93b	-9.15b	12.50b	***	Equity bullish, bond bearish
	Foreign Direct Investment	y/y	mar	6.7%	9.2%	2.0%	*	Equity bullish, bond bearish
Japan	Japan Buying Foreign Bonds	y/y	apr	-2.1768t	1.0998t		**	Equity and bond neutral
	Japan Buying Foreign Stocks	y/y	apr	0.0829t	0.3354t		***	Equity and bond neutral
	Foreign Buying Japan Bonds	y/y	apr	0.5868t	0.8900t		***	Equity and bond neutral
	Foreign Buying Japan Stocks	y/y	apr	0.4410t	0.5845t		*	Equity and bond neutral
	M2	m/m	mar	4.3%	4.2%	4.2%	**	Equity and bond neutral
	Tokyo Avg Office Vacancies	m/m	mar	3.60	3.70		**	Equity and bond neutral
Australia	Unemployment Rate	m/m	mar	5.9%	5.9%	5.9%	*	Equity and bond neutral
	Consumer Inflation Expectations	y/y	apr	4.1%	4.0%		**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	mar	-10.7%	-14.2%			Equity and bond neutral
	BusinessNZ Manufacturing PMI	m/m	mar	57.8	55.2		**	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	mar	1.6%	1.6%	1.6%	***	Equity and bond neutral
France	CPI	y/y	mar	1.1%	1.1%	1.1%	***	Equity and bond neutral
UK	RICS Home Prices	m/m	mar	22.0%	24.0%	22.0%	**	Equity and bond neutral
Italy	CPI EU Harmonized	y/y	mar	1.4%	1.3%	1.3%	**	Equity and bond neutral
Switzerland	Producer & Import Prices	y/y	mar	1.3%	1.3%	0.9%	**	Equity and bond neutral
	Real Estate Index Family	y/y	1q	461.8	457.1		**	Equity and bond neutral
Russia	Budget Balance	y/y	mar	-274.2b	-147.8b	-278.0b	**	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)	116	116	0	Up
3-mo T-bill yield (bps)	79	79	0	Neutral
TED spread (bps)	37	36	1	Neutral
U.S. Libor/OIS spread (bps)	95	94	1	Up
10-yr T-note (%)	2.23	2.24	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	29	29	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	down			Neutral
yen	down			Down
pound	up			Down
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOC Rate Decision	0.500%	0.500%	0.500%	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	$55.96	$55.86	0.18%	Short Covering
WTI	$53.16	$53.11	0.09%	
Natural Gas	$3.17	$3.19	-0.53%	
Crack Spread	$18.67	$18.79	-0.63%	
12-mo strip crack	$15.45	$15.57	-0.73%	
Ethanol rack	$1.77	$1.76	0.38%	
Metals				
Gold	$1,286.90	$1,286.78	0.01%	
Silver	$18.55	$18.49	0.32%	
Copper contract	$256.85	$254.50	0.92%	
Grains				
Corn contract	$ 378.00	$ 376.00	0.53%	
Wheat contract	$ 448.25	$ 446.25	0.45%	
Soybeans contract	$ 957.25	$ 947.75	1.00%	
Shipping				
Baltic Dry Freight	1282	1262	20	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.2	-1.8	-0.4	
Gasoline (mb)	-3.0	-1.5	-1.5	
Distillates (mb)	-2.2	-1.0	-1.2	
Refinery run rates (%)	0.20%	0.50%	-0.30%	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the northwestern region. Precipitation is expected for most of the country.

<u>Asset Allocation Weekly Comment</u>

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.

April 13, 2017

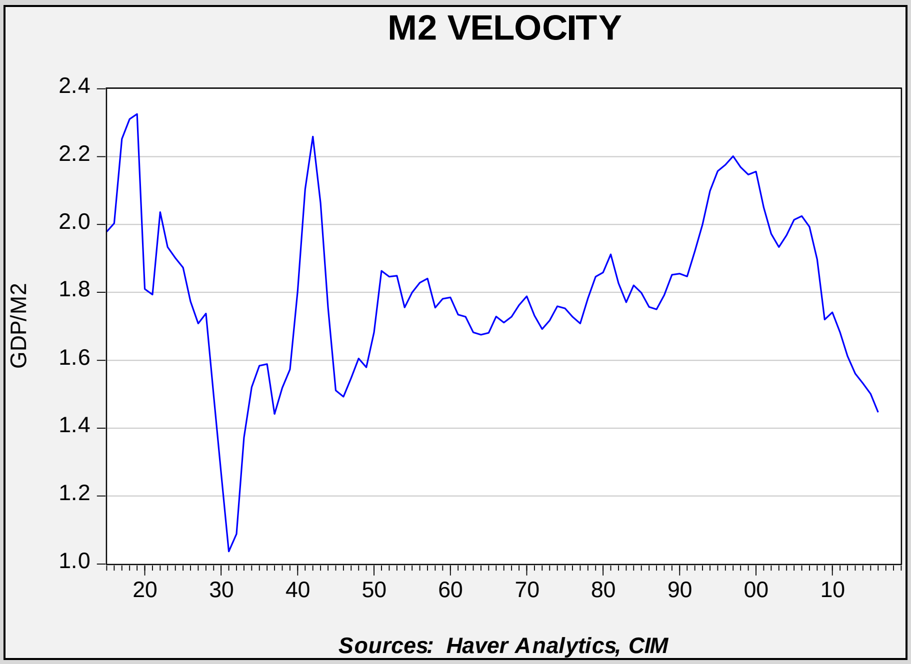
The most recent Federal Reserve minutes indicated that the U.S. central bank is preparing to reverse its experiment with quantitative easing (QE) by reducing the size of its balance sheet. Although the eventual desire to reduce the size of the balance sheet is no real surprise, the timing was unclear. It now appears that the FOMC will begin reducing the balance sheet by year's end. Over the next three weeks, we will look at the potential ramifications of reducing the Federal Reserve's balance sheet. This week we will examine the impact of QE on the economy. Next week, we will focus on the financial markets.

QE was a controversial policy; as policymakers explained it, there seemed to be two elements to the decision to expand the central bank's balance sheet. First, it wanted to boost the level of reserves and lower short-term interest rates to spur bank lending. Second, it wanted to lift the price level of financial assets to increase economic activity through the wealth effect. There were always a number of risks imbedded in the policy. First, if banks aggressively lent the money, the money supply would rise and lead to inflation. Second, the opposite effect could also occur; banks could simply sit on the excess reserves and hamper the stimulative effect of lending. Third, the wealth effect could exacerbate wealth inequality. Upper income households tend to hold more of their wealth in financial assets whereas lower income households usually hold the bulk of their assets in real estate and cash. By lowering bond yields and lifting price/earnings multiples, higher income families benefit. If home prices don't rise, or if lenders prevent cash-out refinancing, the policy's wealth impact would widen wealth gaps. Fourth, the support for financial asset markets could lead to valuation extremes and create fragile market conditions.

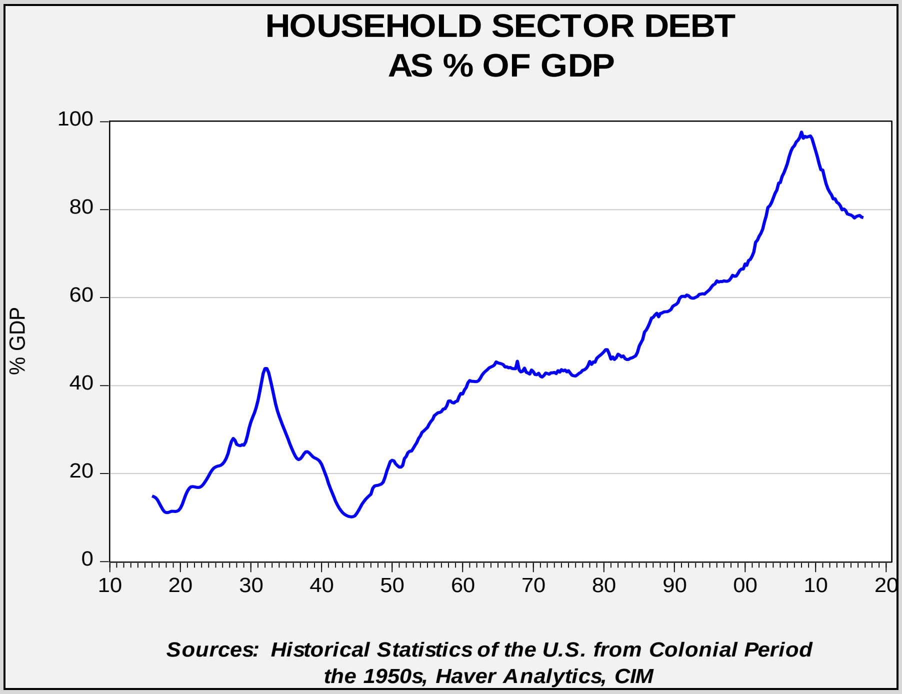
In practice, the effect from QE was rather mixed. We suspect that a whole generation of economists will write dissertations on the impact of QE. However, at this particular moment, we don't have the benefit of this analysis. Instead, we will have to focus on what effect the balance sheet reduction will have on the economy and financial markets. Over the past three decades, bear markets in equities are closely tied to economic recessions; in fact, the last major market decline absent of a recession was the 1987 crash. History also tells us that modern recessions occur for two reasons, a monetary policy mistake (policy is too tight) or a geopolitical event. Reducing the Fed's balance sheet, given the degree of uncertainty surrounding the impact of QE, raises the odds of a policy error.

The impact of QE on the economy: QE appears to have done little for the economy. Economic growth has been stagnant and it isn't obvious that low rates alone would not have yielded a similar outcome.

The fear among some analysts when QE was implemented was that it would spur inflation. This was based on Fisher's monetary identity, which is that money supply times velocity is equal to the price level times available supply, or MV=PQ. If Q, which represents the productive capacity of the economy, is fixed, and V is thought to be dependent upon the institutional arrangements for the circulation of money, and thus mostly fixed as well, raising M will only lead to higher P. If there is slack in the economy, Q could rise with steady prices, leading to higher real output. However, at full employment, inflation is the only result. In fact, what happened is that the reserves sat harmlessly on bank balance sheets, while the real economy grew slowly and velocity plunged. The chart below shows annual velocity of money (GDP/M2, or using the identity, V=PQ/M). Note that during the Great Depression, velocity plunged then as well. Economists during this period soured on monetary policy and mostly focused on fiscal policy. That shift of fiscal policy didn't occur during the 2008 Financial Crisis.



It is unclear why expanding the money supply failed to boost lending. However, deleveraging was common to both periods of low velocity.

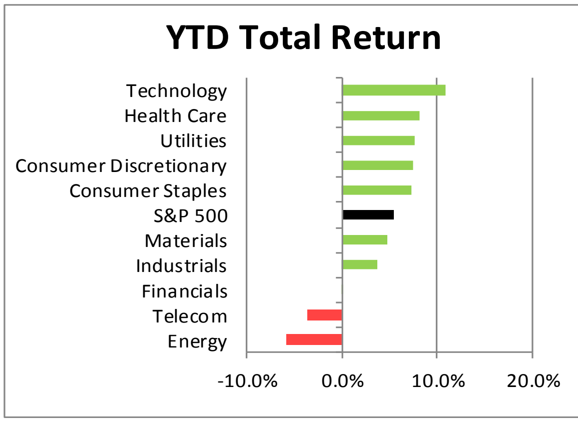


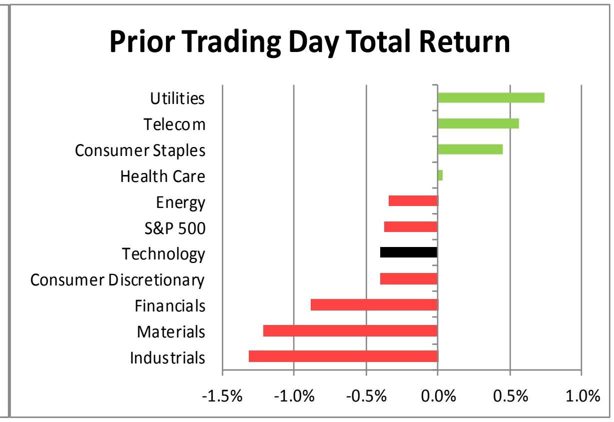
This chart shows household debt as a percentage of GDP. The plunge in the early 1930s coincides with a steady decline in household debt; the same is true now.[2] If there is a drop in demand for loans, injecting reserves into the banking system won't have much impact on the real economy. Conversely, shrinking the balance sheet should do nothing more than reduce the level of excess reserves on commercial bank balance sheets.

[2] It is interesting to note that velocity did rise in the early 1930s during the Great Depression. This was due to a horrific policy error where the Federal Reserve tightened policy into the teeth of the downturn, triggering a deeper drop in growth.

Data Section

U.S. Equity Markets – (as of 4/12/2017 close)

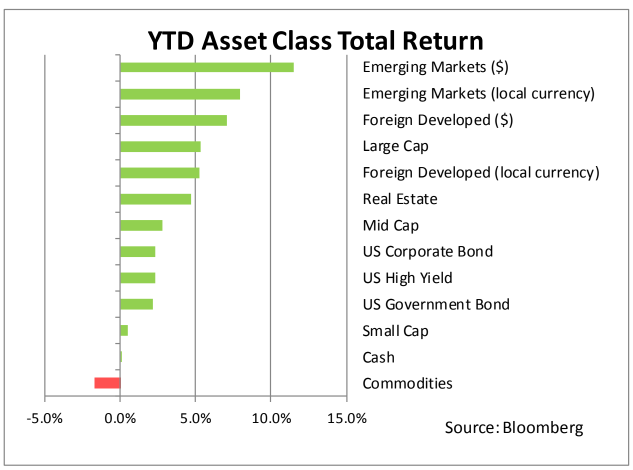




(Source: Bloomberg)

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 4/12/2017 close)

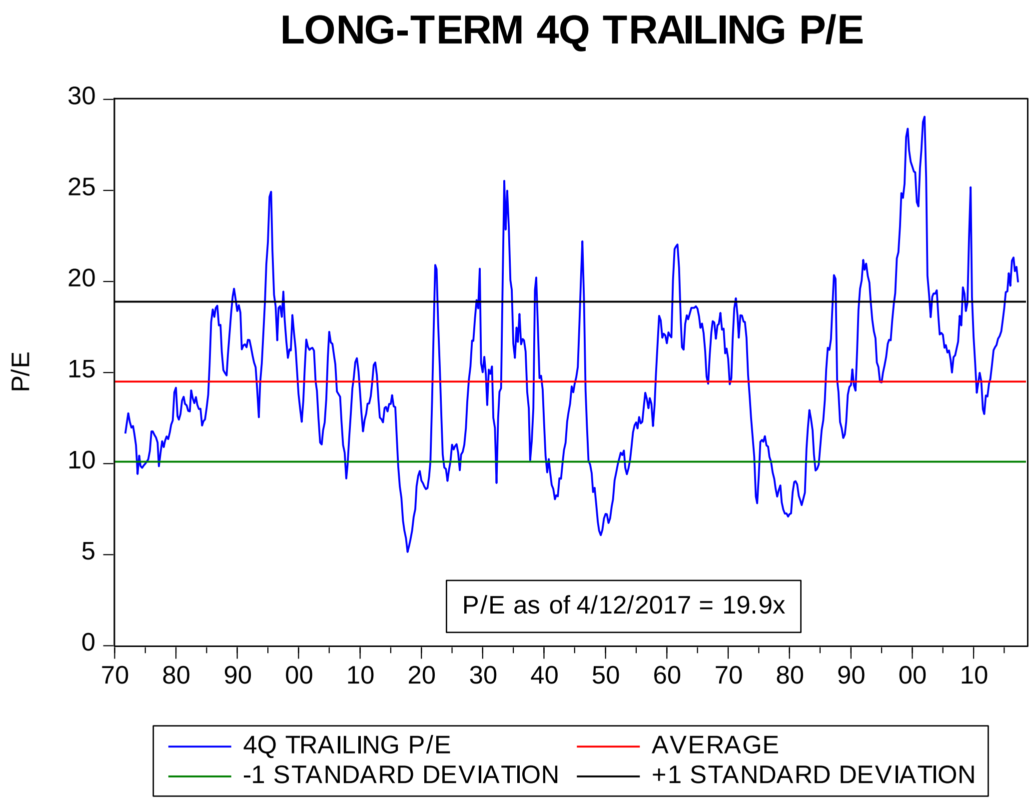


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 13, 2017



Sources: Robert Shiller, Haver Analytics, I/B/E/S, CIM

Based on our methodology,[3] the current P/E is 19.9x, down 0.1x from last week. Falling equity prices led to the modest decline in the multiple.

[3] 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 two actual quarters (Q3 and Q4) and two estimates (Q1 and Q2). 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.