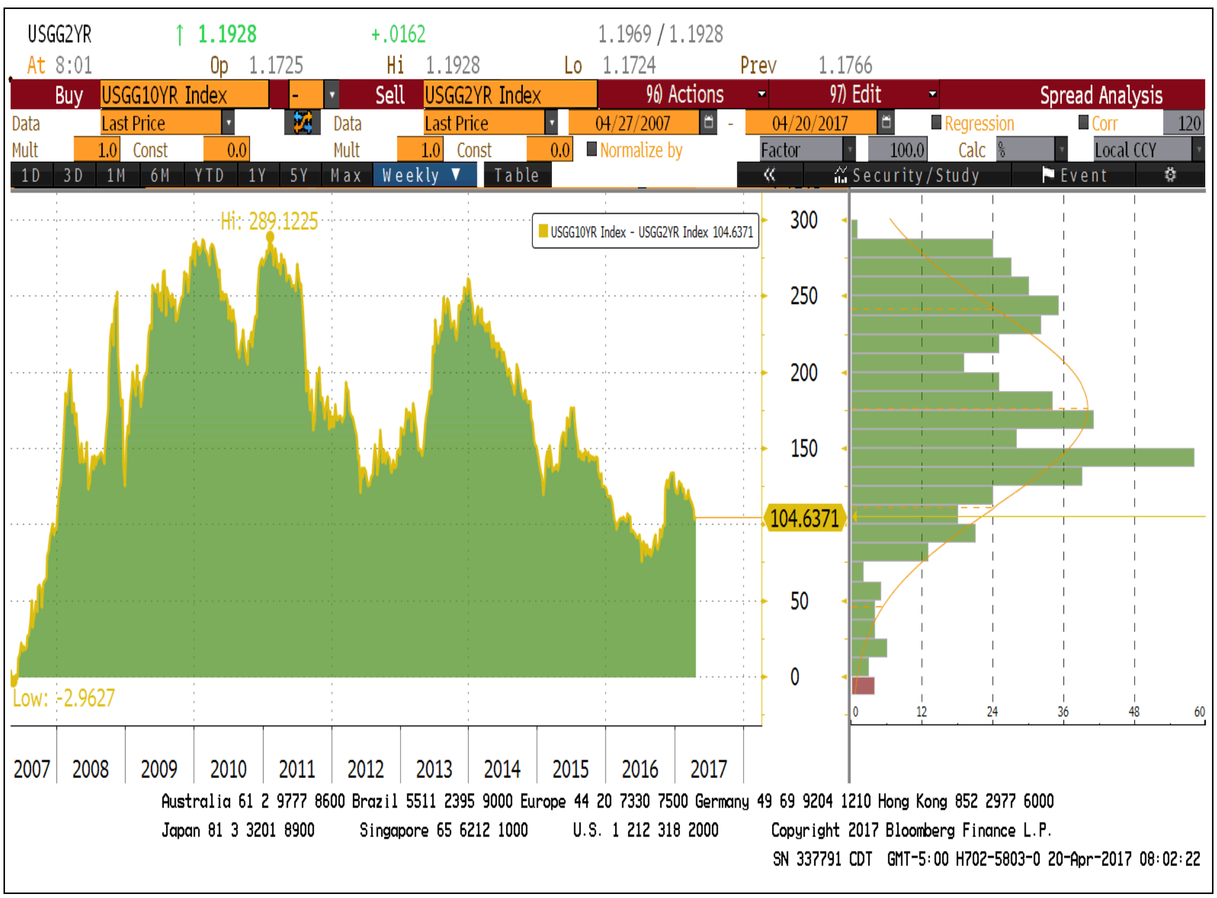
Daily Comment

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

[Posted: April 20, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.8% from the prior close. Chinese markets were mixed, with the Shanghai composite remaining unchanged and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a lower open. With 66 companies having reported, the S&P 500 Q1 earnings stand at $29.83, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 77.3% of the companies reported earnings above forecast, while 18.2% reported earnings below forecast.

The euphoria surrounding the election of President Trump appears to be waning. Although the sentiment polls remain elevated, we note the fixed income markets are clearly showing some jitters.

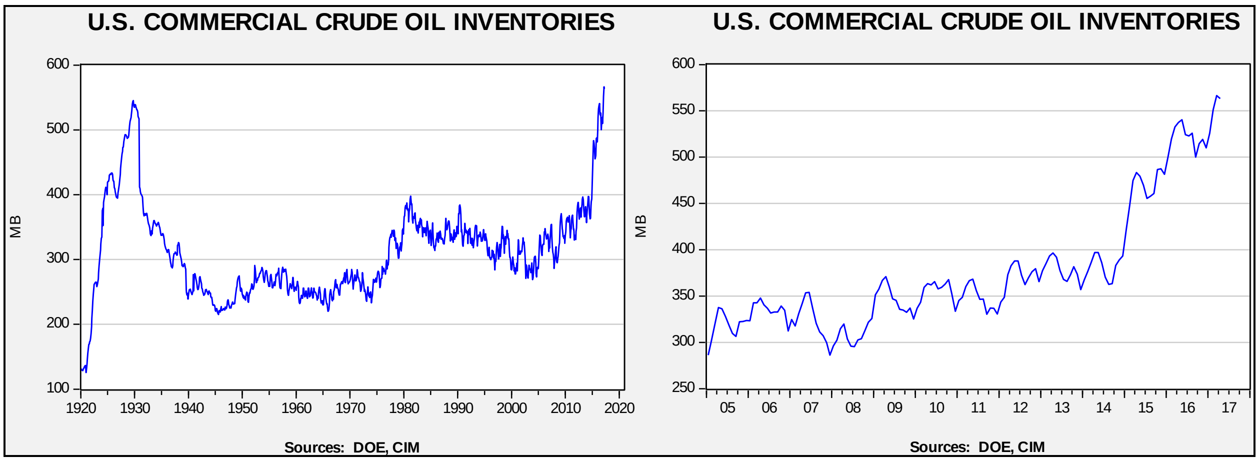


(Source: Bloomberg)

This chart shows the two-year/10-year Treasury spread. Although the curve is steeper than it was prior to the election, it has been flattening rather rapidly recently. If this isn't arrested soon, worries over the economy will increase and likely weigh on risk assets.

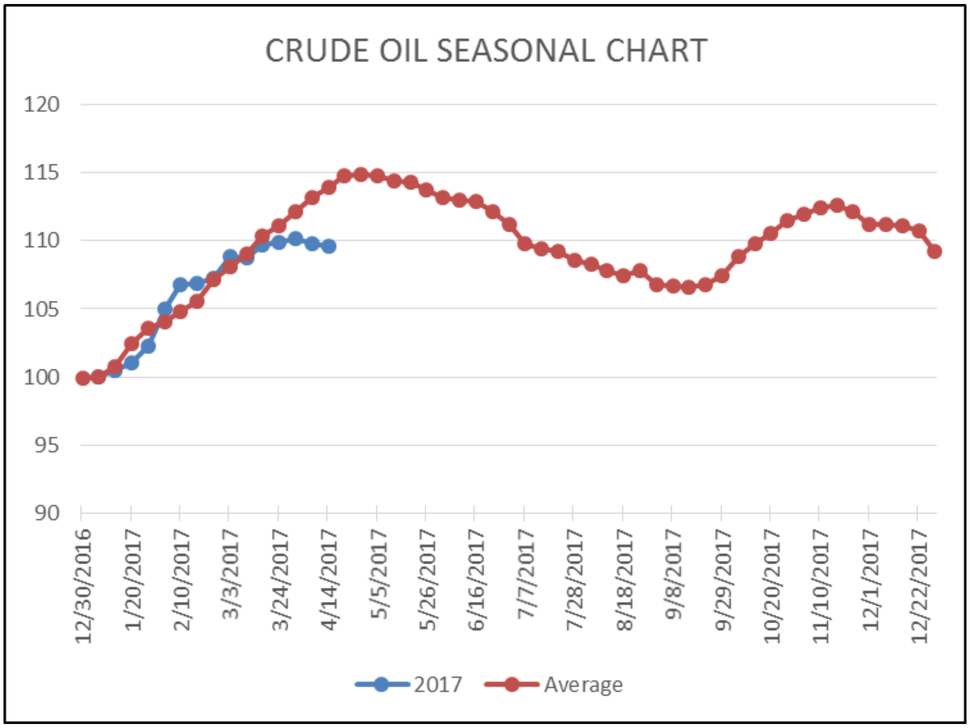
There were massive protests in Venezuela yesterday as those opposed to President Maduro braved security officials and the irregular Maduro forces armed by the president to call for elections and democratic reforms. At least seven people died. More rallies are expected today. Oil production appears to be down to 2.0 mbpd; the country was traditionally a 3.0 mbpd producer. Unrest there is a minor, but supportive factor, for crude oil prices.

U.S. crude oil inventories fell 1.0 mb compared to market expectations of a 1.7 mb draw.

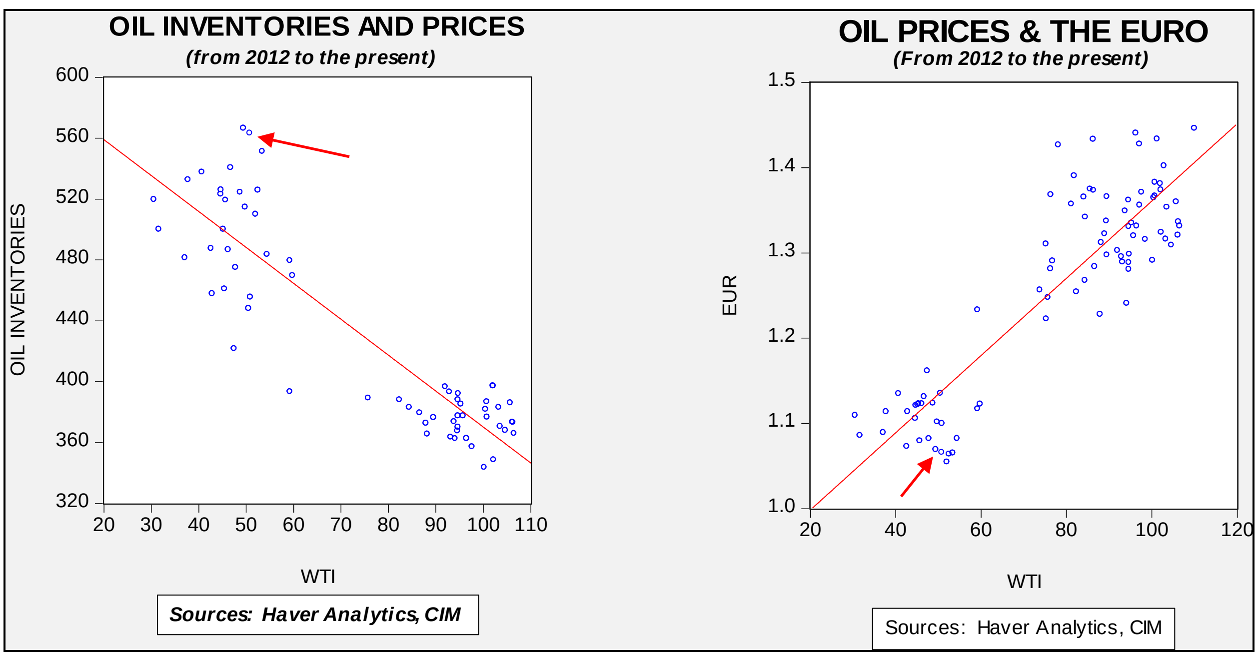


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high.

As the seasonal chart below shows, inventories are near their seasonal peak and should begin falling as rising refinery operations 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.

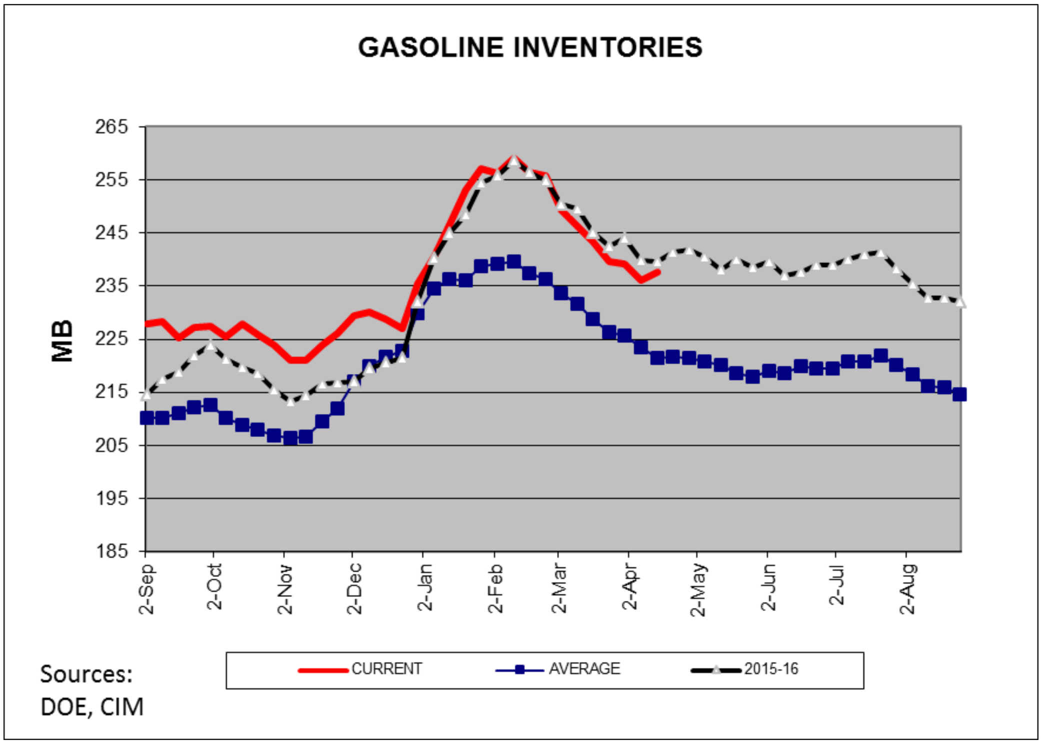


(Source: DOE, CIM)



Based on inventories alone, oil prices are overvalued with the fair value price of $29.65. Meanwhile, the EUR/WTI model generates a fair value of $40.35. Together (which is a more sound methodology), fair value is $36.43, meaning that current prices are well above fair value.

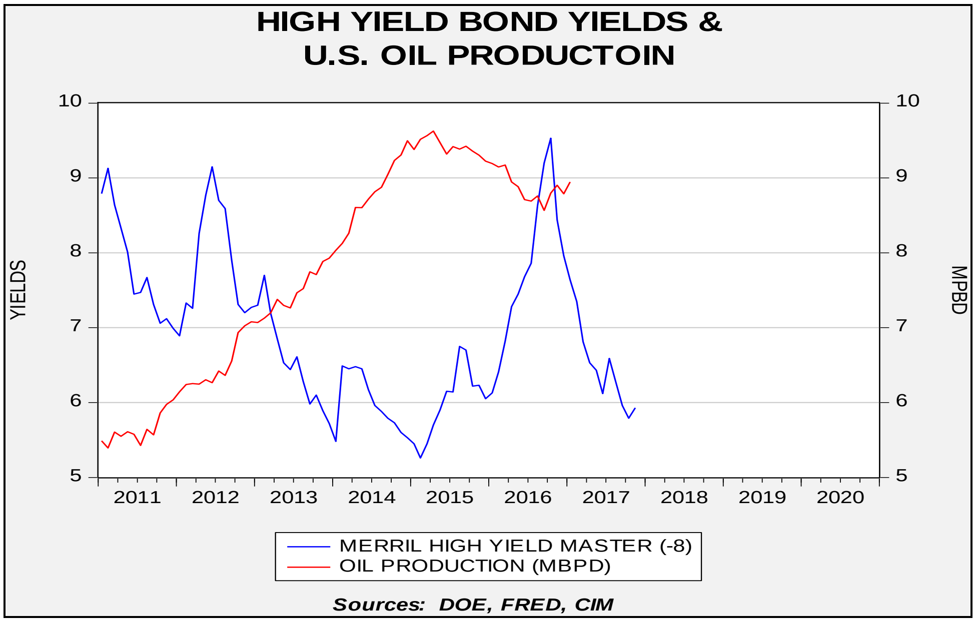
Yesterday, oil prices fell sharply, with the rise in gasoline inventories cited as the catalyst. Although gasoline inventories usually decline from their February peaks, the pace of the decline is reaching its nadir and stockpiles normally stabilize through the summer.



This chart shows gasoline inventories. The five-year average shows the seasonal pattern; however, this year's data is closely tracking last year. If this pattern continues, we will see mostly steady inventory levels until late July. That isn't necessarily bad news for oil prices but it isn't supportive, either.

Saudi Arabia is pressing OPEC to extend its production cuts and there are reports that the cartel is going along with it. This is the factor keeping prices higher. At the same time, rising U.S. production is taking share away from OPEC. As we have stated before, the oil market is being supported by what we would describe as epic "window dressing" in front of the Saudi Aramco IPO next year.

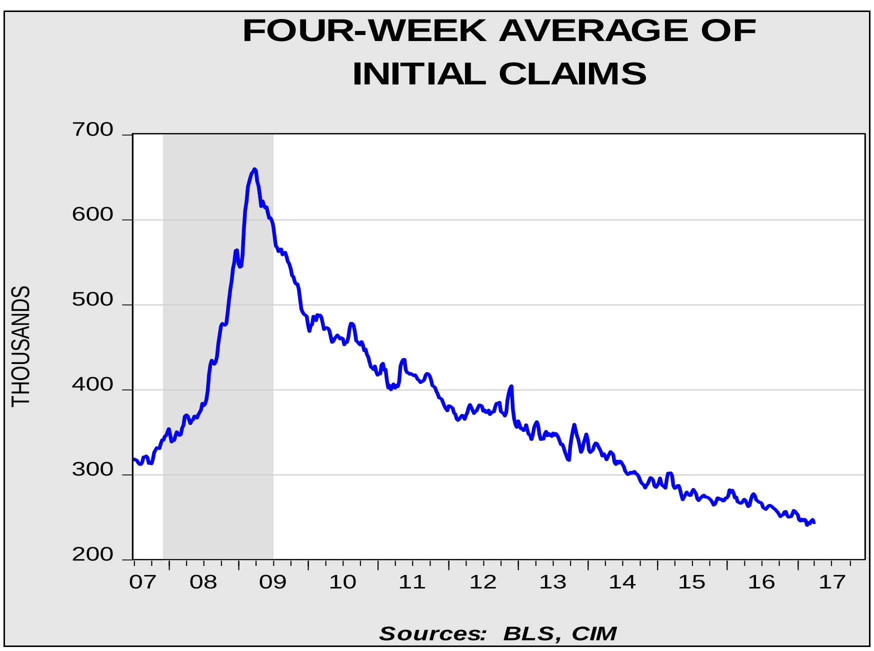
A secondary factor helping U.S. oil production, beyond OPEC propping up oil prices, is lower yields on junk bonds.



Since 2011, the correlation is a respectable -55% between the two series, with yields leading production by eight months. Obviously, oil prices play a larger role but the combination of higher oil prices and a favorable financing environment will tend to support higher U.S. production. Although higher U.S. output may be modestly negative for oil prices, it is supportive for U.S.-oriented oil producers…at least until the Saudis decide to retake market share.

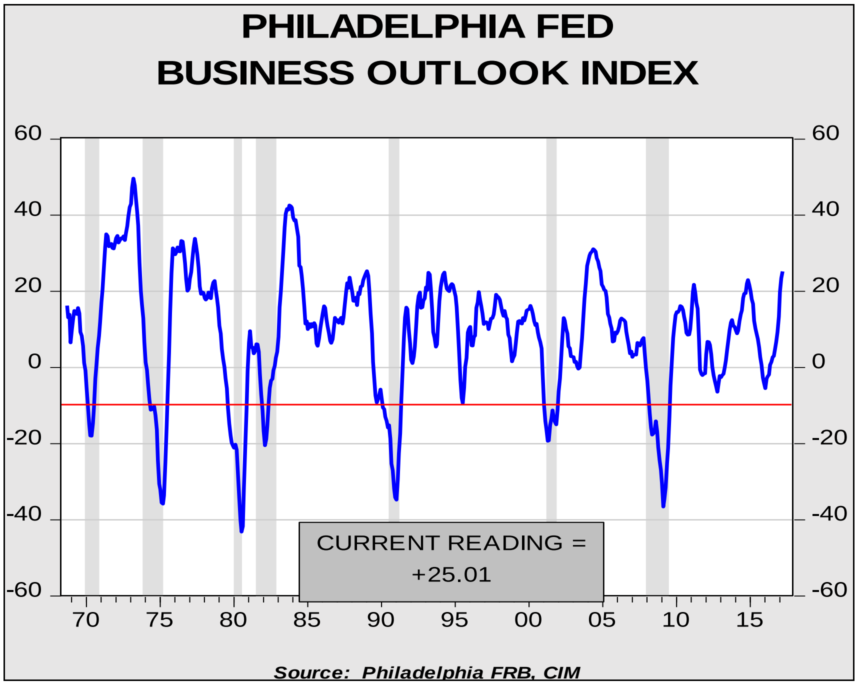
U.S. Economic Releases

Initial jobless claims came in above expectations at 244k compared to the forecast of 240k.



The chart above shows the four-week moving average of jobless claims. The four-week moving average rose 0.25k to 243k.

The Philadelphia FRB outlook came in below expectations at 22.0 compared to the forecast of 25.5.



We smooth the data with a six-month average. The current reading is at a new cycle high for the current expansion. Although this is a sentiment number, it does suggest strong confidence in the Philadelphia FRB district.

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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	apr		51.0	**
9:45	Bloomberg Economic Expectataions	m/m	apr		54.0	**
10:00	Leading Index	m/m	mar	0.2%	0.6%	**
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	FX Net Settlement- Clients CNY	y/y	mar	-48.3 bn	-69.2 bn		**	Equity and bond neutral
Japan	Trade Balance	y/y	mar	614.7 bn	813.4 bn	608.0 bn	**	Equity and bond neutral
	Exports	y/y	mar	12.0%	11.3%	6.2%	**	Equity bullish, bond bearish
	Imports	m/m	mar	15.8%	1.2%	10.0%	**	Equity bearish, bond bullish
	Japan Buying Foreign Bonds	y/y	mar	-0.7962 tn	-2.1768 tn		*	Equity and bond neutral
	Japan Buying Foreign Stocks	y/y	mar	-0.2317 tn	-0.0829 tn		*	Equity and bond neutral
	Foreign Buying Japan Bonds	y/y	mar	0.4105 tn	0.5868 tn		*	Equity and bond neutral
	Foreign Buying Japan Stocks	y/y	mar	0.3152 tn	0.4410 tn		*	Equity and bond neutral
Australia	NAB Business Confidence	y/y	1q	6	5		*	Equity and bond neutral
New Zealand	CPI	y/y	1q	2.2%	1.3%	2.0%	***	Equity and bond neutral
EUROPE								
Eurozone	Construction Output	y/y	feb	7.1%	-6.2%		*	Equity and bond neutral
Germany	PPI	y/y	mar	3.1%	3.1%	3.2%	**	Equity and bond neutral
Russia	PPI	y/y	mar	11.3%	15.1%	12.5%	**	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)	116	116	0	Up
3-mo T-bill yield (bps)	78	79	-1	Neutral
TED spread (bps)	38	37	1	Neutral
U.S. Libor/OIS spread (bps)	96	95	1	Up
10-yr T-note (%)	2.23	2.22	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	up			Neutral
yen	down			Down
pound	up			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA FX Transacions Government	-A$1265 mn	-A$333 mn		On forecast
RBA FX Transacions Market	A1248 mn	A$282 mn		On forecast
RBA Transacions Other	A$14 mn	A$60 mn		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	$53.38	$52.93	0.85%	Oil producers agree to extend output cuts
WTI	$50.89	$50.44	0.89%	
Natural Gas	$3.21	$3.19	0.72%	
Crack Spread	$18.26	$18.15	0.62%	
12-mo strip crack	$15.12	$15.10	0.14%	
Ethanol rack	$1.76	$1.76	-0.20%	
Metals				
Gold	$1,278.96	$1,280.21	-0.10%	Stronger Dollar
Silver	$18.19	$18.15	0.27%	
Copper contract	$256.20	$254.90	0.51%	
Grains				
Corn contract	$ 370.00	$ 368.25	0.48%	
Wheat contract	$ 435.50	$ 434.50	0.23%	
Soybeans contract	$ 963.75	$ 960.50	0.34%	
Shipping				
Baltic Dry Freight	1278	1294	-16	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.0	-1.7	0.7	
Gasoline (mb)	1.5	-2.0	3.5	
Distillates (mb)	-2.0	-1.0	-1.0	
Refinery run rates (%)	0.20%	0.10%	0.10%	
Natural gas (bcf)	10.0	46.0	-36.0	

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.

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.

April 13, 2017

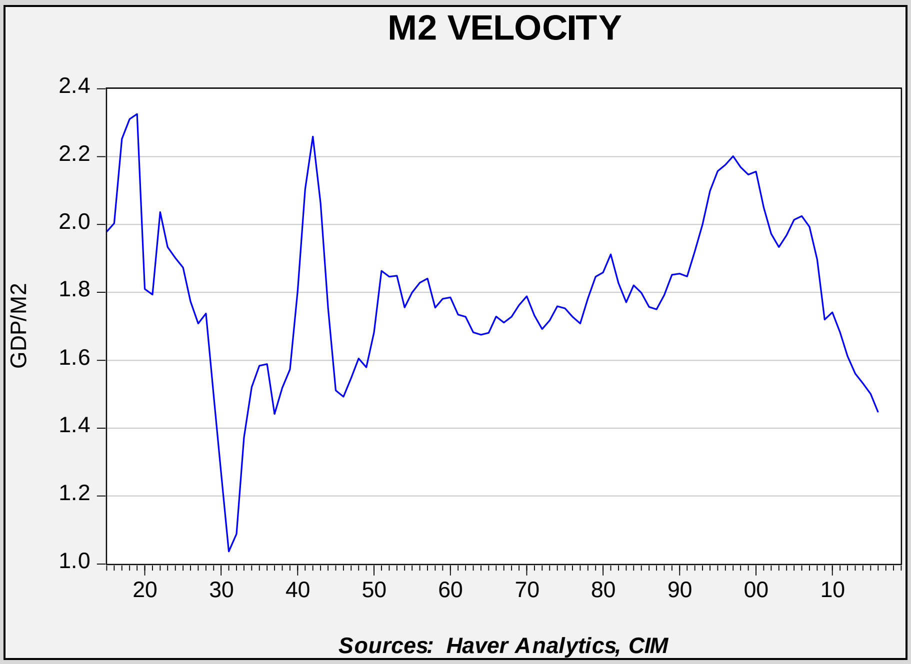
The most recent Federal Reserve minutes indicated that the U.S. central bank is preparing to reverse its experiment with quantitative easing (QE) by reducing the size of its balance sheet. Although the eventual desire to reduce the size of the balance sheet is no real surprise, the timing was unclear. 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.

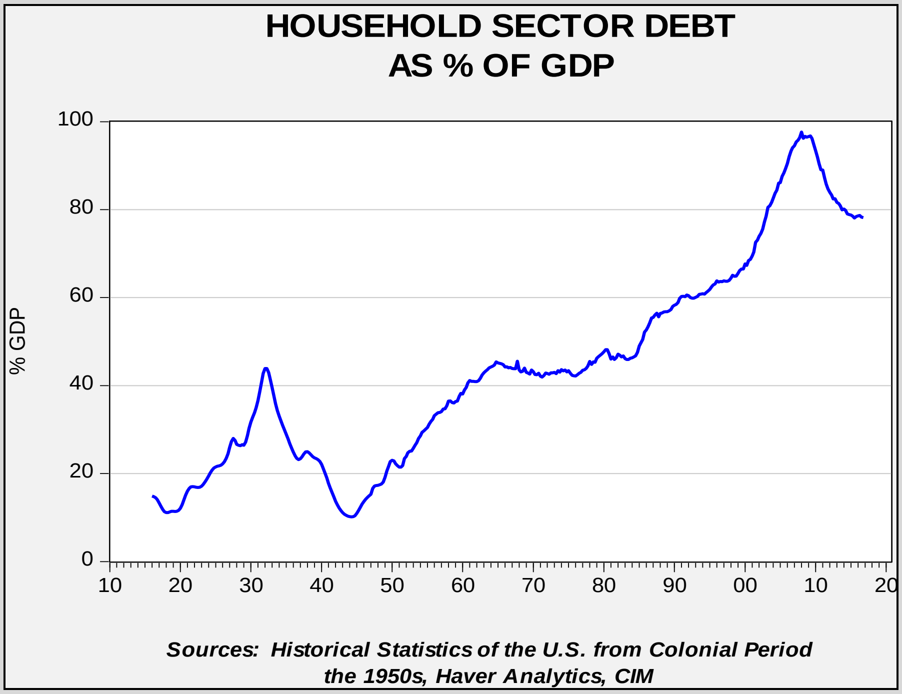
In practice, the effect from QE was rather mixed. We suspect that a whole generation of economists will write dissertations on the impact of QE. However, at this particular moment, we don't have the benefit of this analysis. Instead, we will have to focus on what effect the balance sheet reduction will 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.



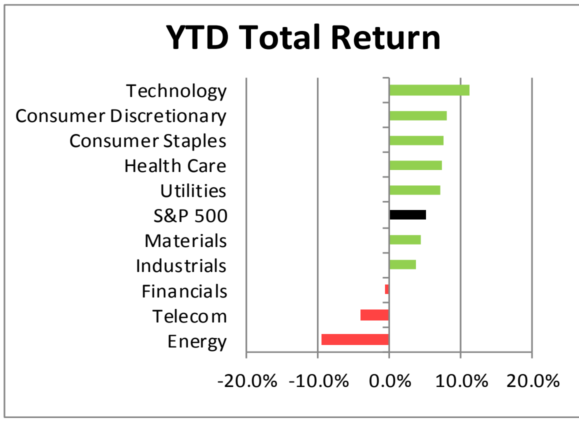
This chart shows household debt as a percentage of GDP. The plunge in the early 1930s coincides with a steady decline in household debt; the same is true now.[1] If there is a drop in demand for loans, injecting reserves into the banking system won't have much impact on the real economy. Conversely, shrinking the balance sheet should do nothing more than reduce the level of excess reserves on commercial bank balance sheets.

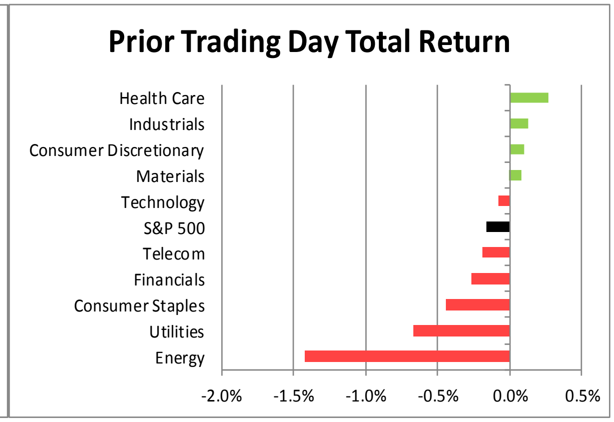
Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors 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.

[1] 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 4/19/2017 close)

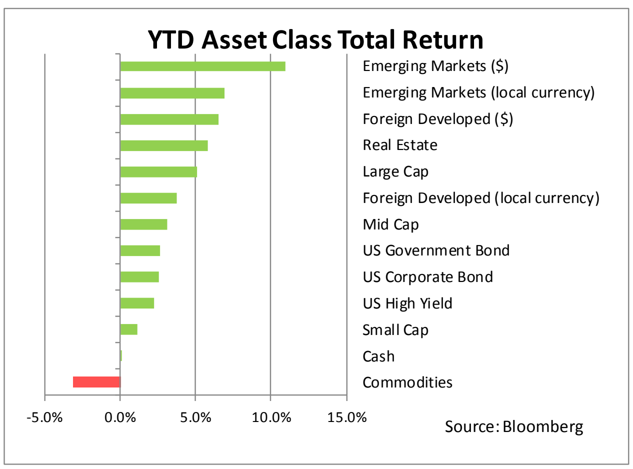




(Source: Bloomberg)

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 4/19/2017 close)

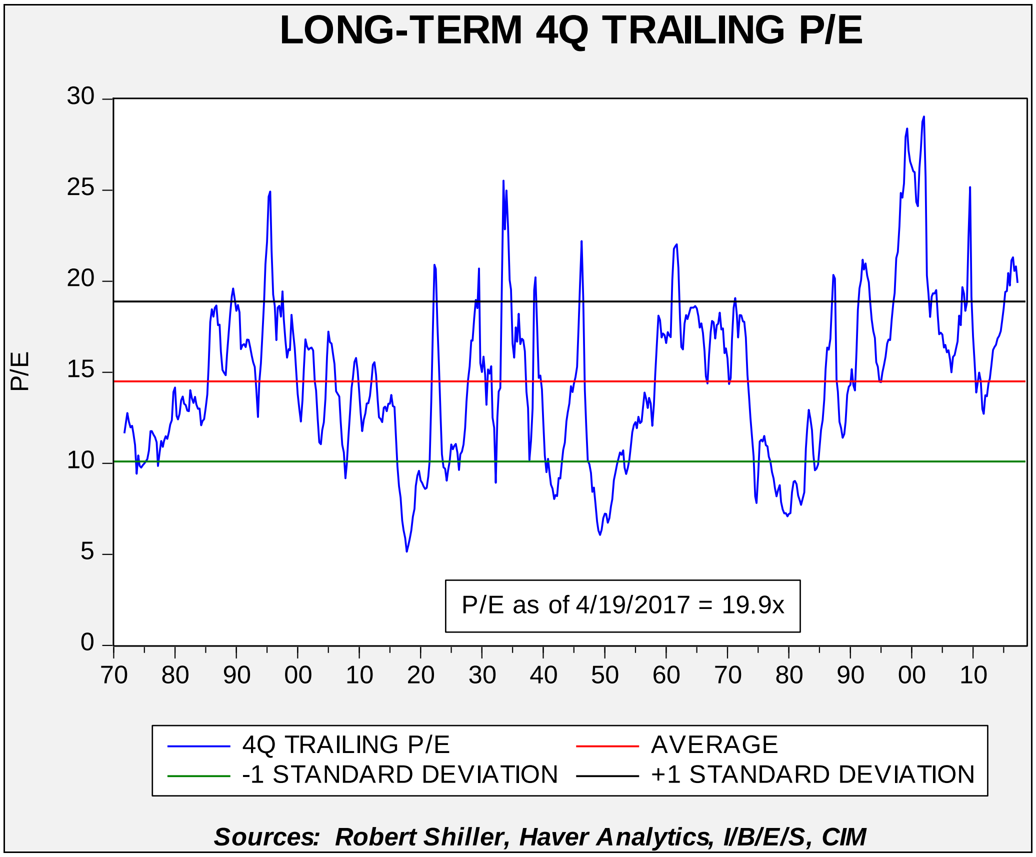


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2017



Based on our methodology,[2] the current P/E is 19.9x, unchanged from last week.

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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 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.