Daily Comment

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

[Posted: April 24, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 3.92% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were down, with the Shanghai composite down 1.4% and the Shenzhen index down 2.4%. U.S. equity index futures are signaling a higher open. With 96 companies having reported, the S&P 500 Q1 earnings stand at $29.85, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 75.0% of the companies reported earnings above forecast, while 17.7% reported earnings below forecast.

Financial markets breathed a great sigh of relief as the first round of the French presidential election went about as expected. Macron and Le Pen will square off on May 7th to decide the presidency. Current polls show Macron with a commanding lead, generally 20 points or more. Although we have seen electoral surprises recently, they have all been within the margin of error. For Le Pen to make up 20 to 25 points would require a significant event, e.g., major terrorist attack, political scandal of epic proportions or campaign error that seriously undermines Macron's character.[1] Although we do expect Macron to win, we also expect a tighter vote than the current polls suggest. Macron has no real party and so he will not have the usual "get out the vote" apparatus in place. It's important to note that nearly 40% of the first round votes went center-right and far-left; it isn't inconceivable that turnout could be low. Current polling suggests that Le Pen will only gather a small part of Mélenchon's 19%, with the majority going with Macron and a rather large number spoiling their ballots by abstaining. Most of Fillon's voters will end up with Macron as well.

Although Macron will keep France in the EU and the Eurozone, which is a market-friendly outcome compared to Le Pen, he is far from an ideal candidate. First, he has no party; there is no framework in the Fifth Republic for when a president has no representation in the Assembly. He will be forced to select a PM that will be acceptable to whichever party wins in the June legislative elections. Thus far, we haven't seen any reliable polling for the legislative elections but, given the collapse of the center-left in this election, the most likely outcome will be a center-right domination of the Assembly. Macron can probably function with that outcome. Second, Macron is a political novice. French voters wanted change in this election, something we saw in the U.S. (arguably since 2008) and with Brexit. Assuming a Macron win, it is simply unknown whether France is in competent hands.

Therefore, we believe the worst outcome has been avoided but this outcome isn't necessarily good for financial markets because it is further evidence that the center-left and center-right coalitions that have mostly ruled the West since WWII are struggling to maintain their hold on

[1] https://www.youtube.com/watch?v=yTO5AYl1zCs

power. The strong rally we are seeing in equities (with one exception, discussed below) along with the drop in gold, the JPY and Treasuries is consistent with "risk on." However, much of this rally is probably due to investors reversing positions designed to protect themselves from a negative outcome in these elections. If that is all it is, the rise should mostly be contained within the next few days.

The one interesting divergence from the global equity rally is China. The Shanghai Composite has been stumbling recently in what seems to be caused by growing worries of rising interest rates.

(Source: Bloomberg)

Note that Chinese equities have been coming under pressure over the past two weeks. The drop coincides with rising interest rates.

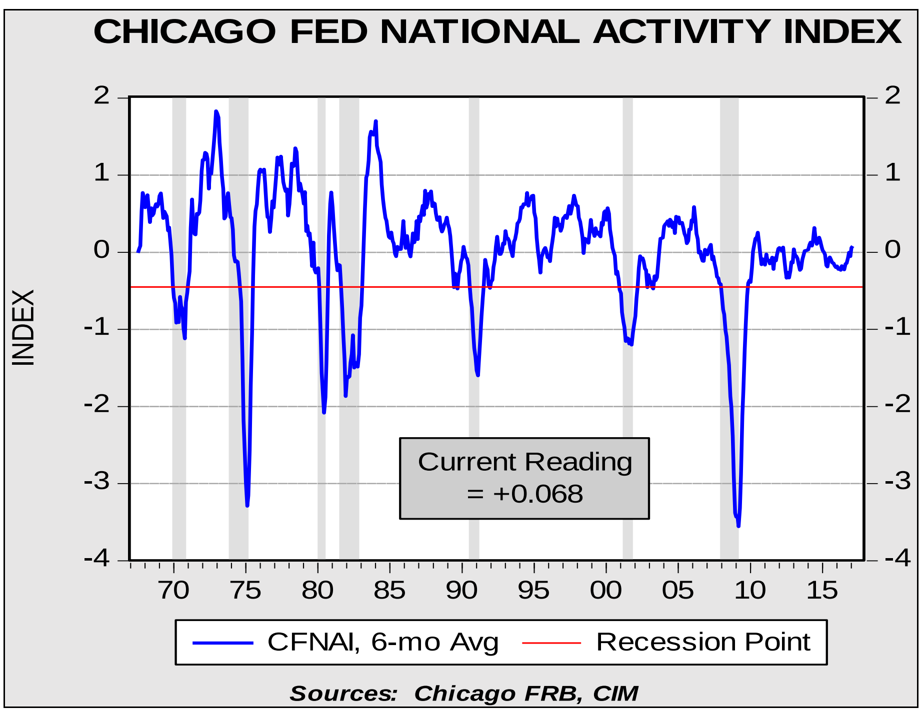
(Source: Bloomberg)

The Xi government is worried about the high levels of Chinese debt and reports of rising non-performing loans. As the PBOC clamps down on lending, rates are rising which appears to be pressuring equities lower. The Xi government is working to maintain stability and growth as the CPC conference that will elect him to a second term convenes in October. Thus, we don't expect the regime to allow for a major market drop or a financial crisis to develop…at least if it can control such things. So far, the drop in Chinese equities appears to be nothing more than a normal market retracement, but more significant declines may be forthcoming if we break the 3100 level on the Shanghai Composite.

Finally, President Trump surprised his aides by indicating that a tax proposal will be outlined on Wednesday. We don't expect anything other than the broadest of brush strokes but this announcement does suggest he is trying to make a splash around his first 100-day mark. We also don't expect a government shutdown on Saturday, although we have to say that negotiations don't seem to be going well. The opposition isn't planning on voting for a border wall and the GOP may reduce funding for the ACA's subsidies so the potential for a closure is in place. We believe the president doesn't want a shutdown this early on his watch so he will likely stand down, but anything is possible given the mercurial nature of Mr. Trump. We continue to watch the markets but clearly today there are no concerns about a government closure.

U.S. Economic Releases

The Chicago Fed National Activity Index came in below expectations at 0.08 compared to the forecast of 0.50.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The current reading is 0.068, a modest rise from the last report of 0.048. Currently, the index is on trend.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:30	Dallas Fed Manf. Activity	m/m	mar	17.0	16.9	**
Fed speakers or events						
EST	Speaker or event	District or position				
11:30	Neel Kashkari speaks at UCLA	President of the Federal Reserve Bank of Minneapolis				
15:15	Neel Kashkari participate in Q&A at Claremont McKenna	President of the Federal Reserve Bank of Minneapolis				

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								
Japan	Supermarket Sales	y/y	mar	-1.8%	-3.3%		**	Equity and bond neutral
	Leading Index CI	y/y	feb	104.8	104.4		**	Equity and bond neutral
	Coincident Index	y/y	feb	115.3	115.5		**	Equity and bond neutral
EUROPE								
Eurozone	Government Debt to GDP	y/y	2016	89.2%	90.4%		**	Equity and bond neutral
Germany	IFO Business Climate	m/m	apr	112.9	112.3	112.4	**	Equity and bond neutral
	IFO Expectations	m/m	apr	105.2	105.7	105.9	**	Equity and bond neutral
	IFO Current Assessment	m/m	apr	121.1	119.3	119.2	**	Equity and bond neutral
UK	CBI Business Optimsim	m/m	apr	1	15	12	**	Equity bearish, bond bullish
	CBI Trends Total Orders	y/y	apr	4	8	6	**	Equity bearish, bond bullish
	CBI Trends Selling Prices	y/y	apr	29	29	27	**	Equity and bond neutral
Switzerland	Total Sight Deposits	y/y	apr	569.1 bn	567.1 bn		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	apr	480.6 bn	480.6 bn		**	Equity and bond neutral
AMERICAS								
Canada	Wholesale Trade Sales	m/m	feb	-0.2%	3.3%	-1.0%	**	Equity and bond neutral
Mexico	Unemployment Rate	y/y	mar	3.5%	3.4%	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)	116	115	1	Up
3-mo T-bill yield (bps)	78	76	2	Neutral
TED spread (bps)	38	39	-1	Neutral
U.S. Libor/OIS spread (bps)	97	95	2	Up
10-yr T-note (%)	2.31	2.25	0.06	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	33	33	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			Down
pound	up			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	$52.32	$51.96	0.69%	Short Covering
WTI	$49.98	$49.62	0.73%	
Natural Gas	$3.12	$3.10	0.52%	
Crack Spread	$18.18	$18.28	-0.55%	
12-mo strip crack	$14.94	$15.03	-0.59%	
Ethanol rack	$1.76	$1.76	0.06%	
Metals				
Gold	$1,270.87	$1,284.44	-1.06%	Bullish Equities due to French Election
Silver	$17.81	$17.93	-0.66%	
Copper contract	$256.30	$255.10	0.47%	
Grains				
Corn contract	$ 365.75	$ 363.75	0.55%	
Wheat contract	$ 424.25	$ 421.00	0.77%	
Soybeans contract	$ 968.00	$ 960.75	0.75%	
Shipping				
Baltic Dry Freight	1195	1243	-48	

Weather

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

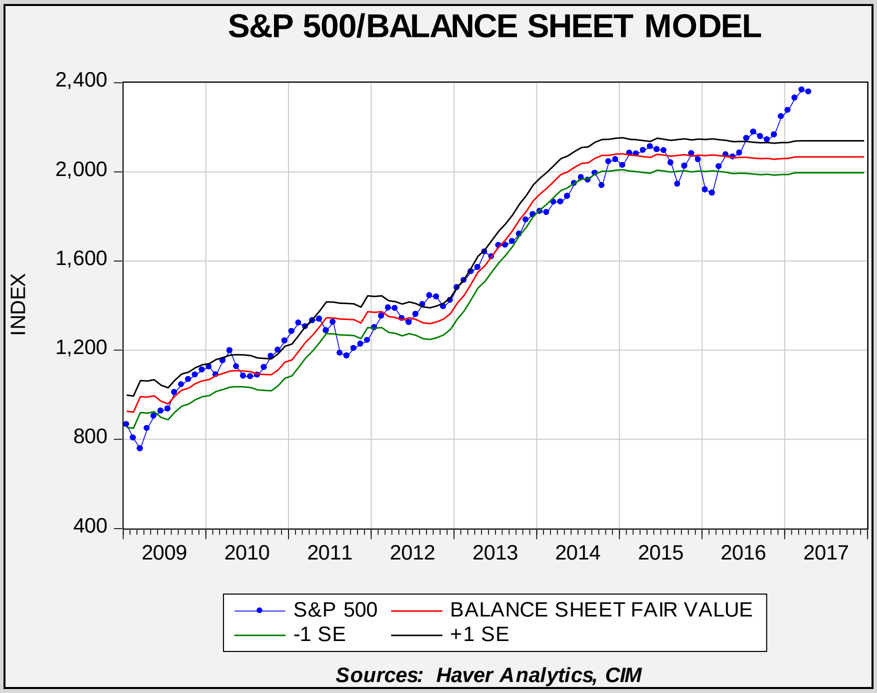
Asset Allocation Weekly Comment

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.

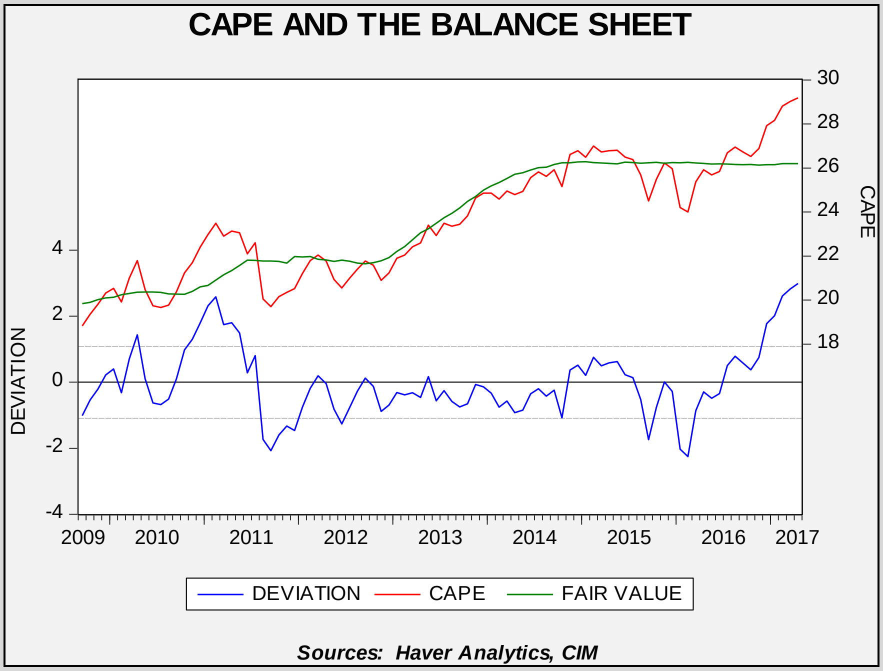
April 21, 2017

Last week, we discussed the impact of reducing the size of the Federal Reserve's balance sheet on the economy. This week we will discuss the effects of QE on financial markets.

The relationship between the balance sheet and equities seems rather straightforward; expanding the balance sheet appears to be clearly supportive for equities.



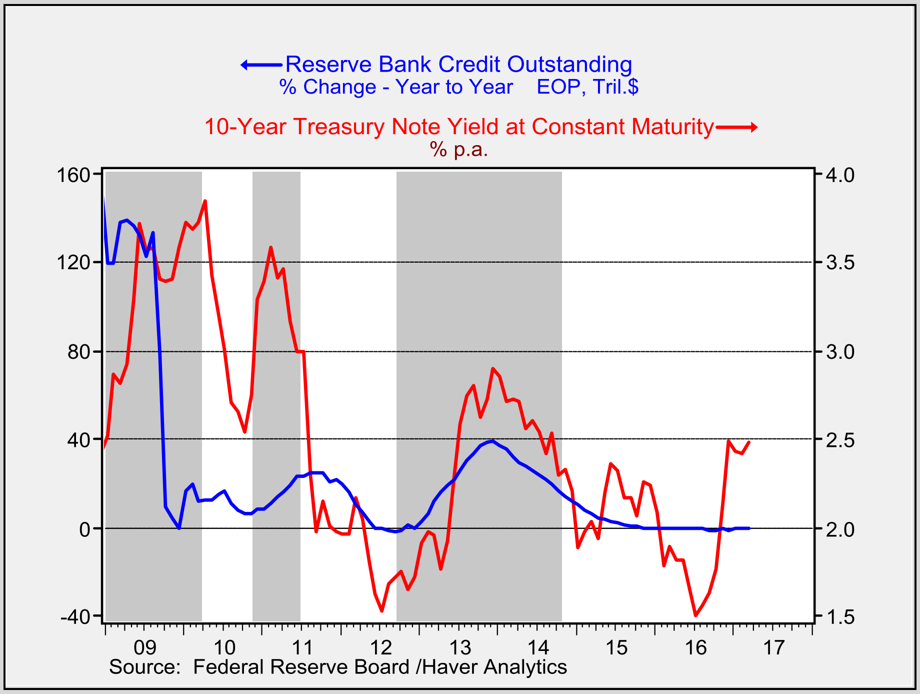
This chart shows the S&P 500 Index regressed against the Fed's balance sheet. From 2009 until last year, this equity index closely tracked the level of the balance sheet. Equities have lifted above the forecast level of the balance sheet recently. If the relationship holds, equities are vulnerable to a large decline. On the other hand, there is no evidence to suggest that bank reserves somehow found their way into the equity market. Comparing the Shiller P/E (CAPE) suggests that the effect of QE was probably psychological; after fed funds reached the zero bound, QE signaled to investors that policy was still easy.



This chart regresses the CAPE against the Fed's balance sheet; the CAPE's behavior is similar to that of the overall equity market. After the election, the market has mostly risen on multiple expansion, rising well above the model's fair value.

It should be noted that low interest rates could have a similar effect. However, the fact that equities and the P/E seemed to track the balance sheet does suggest that QE had an impact on market psychology.

The impact on bonds is rather interesting.



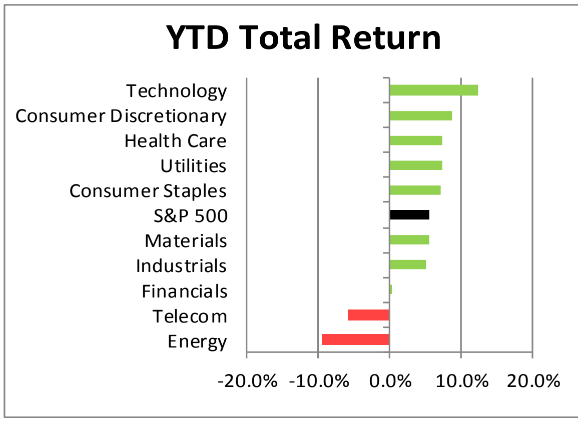
The gray bars show periods when QE was implemented. Especially after QE 1, periods of QE tended to coincide with rising rates. When QE was ending (shown by the decline in the yearly growth rate of the balance sheet), rates tended to decline. Despite the FOMC bond buying, rates rose mostly on fears of inflation. Once QE ended, those fears eased and bond yields declined. The most recent rise is likely due to expectations of fiscal stimulus that will boost growth and potentially raise inflation.

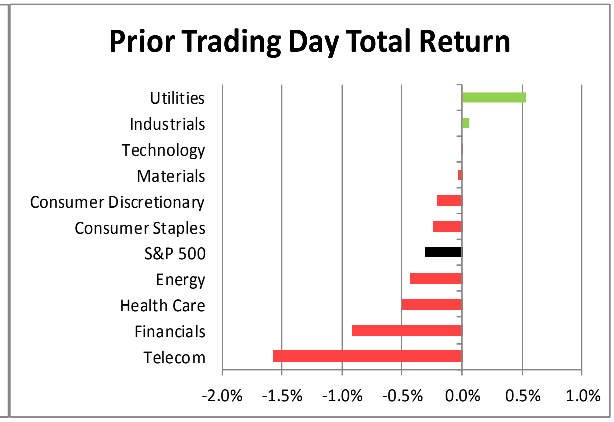
If the Fed's expanding balance sheet was a supportive psychological factor for bonds and stocks, will the contraction have the opposite impact? Simply put, we don't know. If the economy and earnings are improving, the drop in the balance sheet probably won't matter. Unfortunately, if the economy disappoints, cutting the balance sheet could have a bearish impact on these assets.

Next week we will examine the impact of the Fed's balance sheet on monetary policy.

<u>**Data Section**</u>

U.S. Equity Markets – (as of 4/21/2017 close)

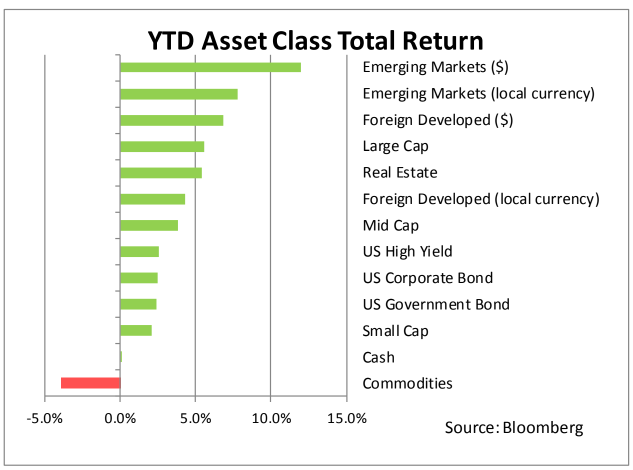




(Source: Bloomberg)

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 4/21/2017 close)

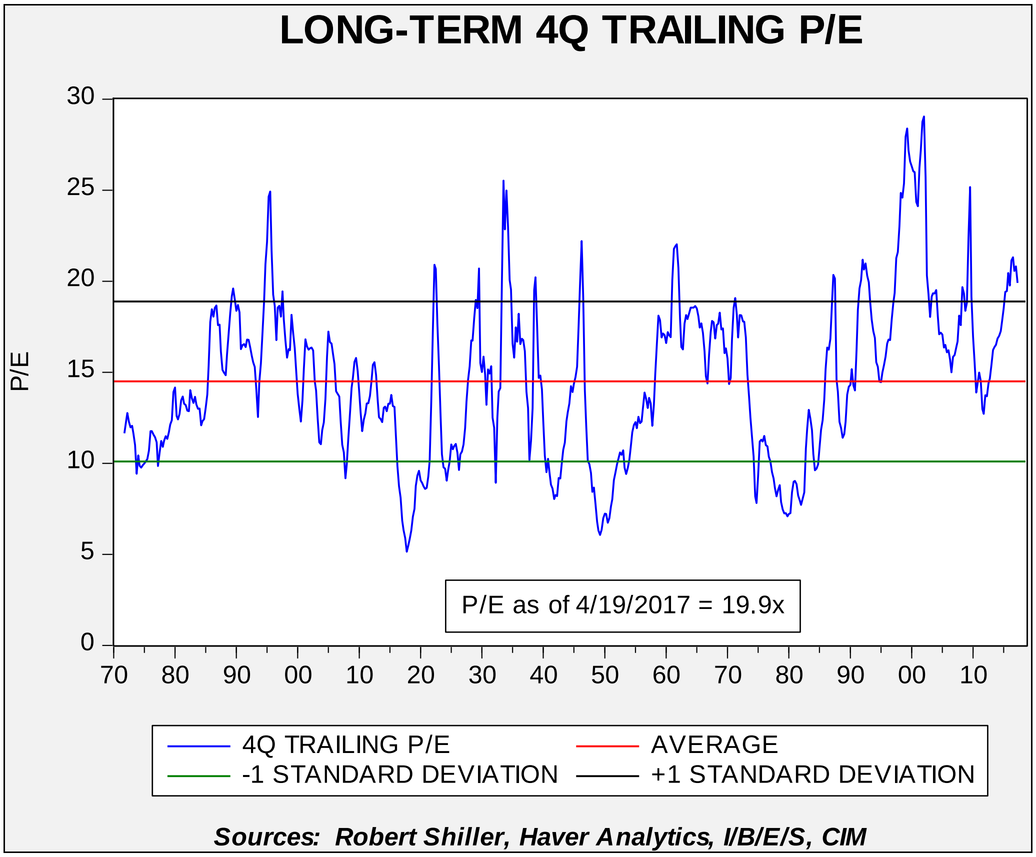


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

---

[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.