Daily Comment

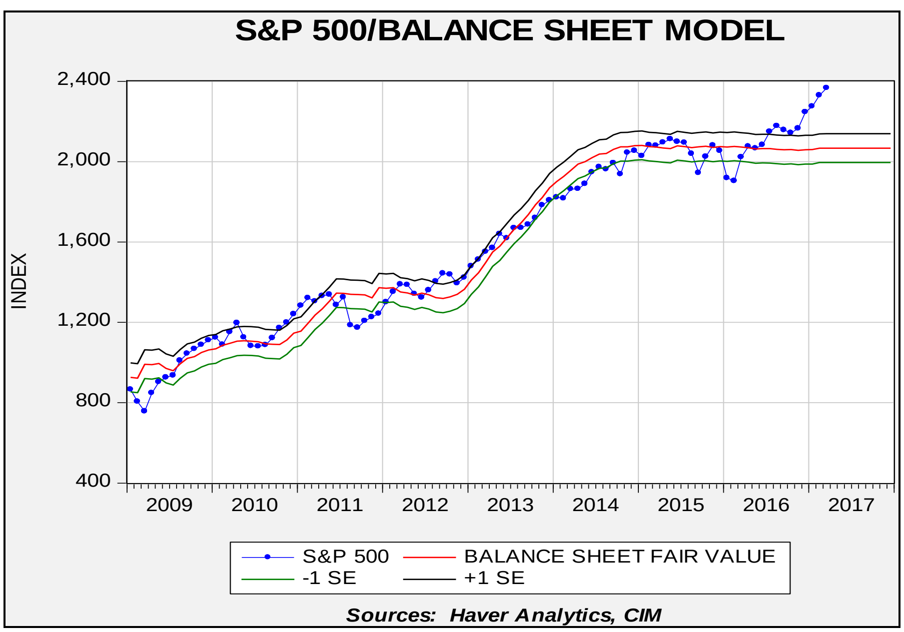
By Bill O'Grady, Kaisa Stucke, and Thomas Wash

[Posted: April 6, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.7% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index also up 0.3%. U.S. equity futures are signaling a higher open.

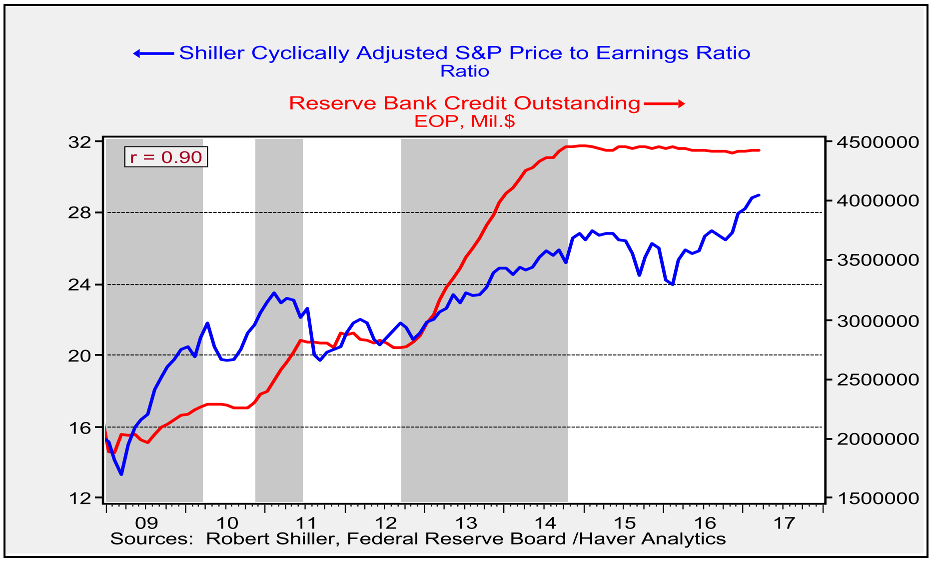
Most of the time, Fed minutes are snoozers. On the other hand, there is often real action within the FOMC. The full meeting transcripts are published with a five-year lag and they show verbal sniping and open disagreement. By contrast, the minutes are sanitized with code words like "some members" or "many members" to give hints at the degree of support or opposition. Most of the time, the minutes are nothing more than a longer version of the statement.

However, that was not the case yesterday. The FOMC made its clearest signal yet that it intends to shrink the balance sheet. The general expectation was that the Fed would allow the balance sheet to slowly unwind by not buying bonds when paper matures. However, that doesn't seem to be what the FOMC is saying; instead, it appears to be looking to actively reduce the size of the balance sheet.

This is a big topic that will require deeper analysis. To be completely clear, no one knows for sure exactly how the balance sheet expansion affected the economy and the markets. We can look at market effects, but we can't tell for sure why those factors worked the way they did. We can make a very good case that QE was good for stocks.

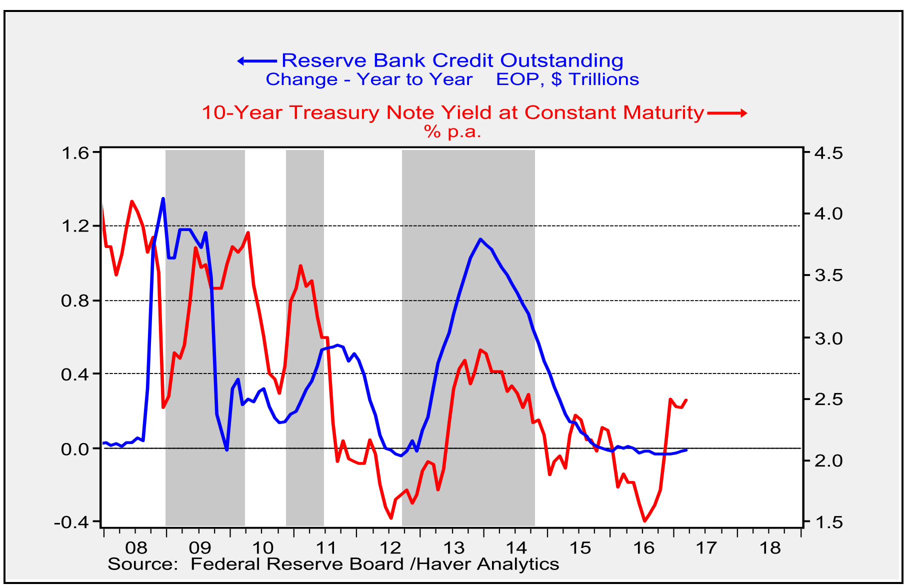


The chart above shows the S&P 500 regressed against the Fed's balance sheet. From 2009 until the middle of last year, the model did a good job of projecting the path of equities. Since the Trump election, equities have moved sharply higher. Our position was that the actual effect of QE was to boost equity market sentiment.



The chart above shows the Shiller CAPE and the balance sheet. Periods of QE are shown in gray. Note that the P/E tended to rise when the balance sheet expanded. Obviously, the most recent lift isn't being caused by policy but by the election.

Perhaps the most underappreciated element of QE was the impact on long-duration interest rates. One of the reasons for implementing QE was to lower long-term interest rates. However, the evidence suggests the impact was just the opposite of what policymakers expected.



This chart shows the yearly change in the size of the balance sheet along with the yield on the 10-year Treasury. Note that, especially with QE2 and QE3, yields tended to rise during periods of balance sheet expansion. Although the common expectation is that yields will rise once the reversal begins, in fact, we would be more inclined to expect bond prices to rise. Why did bond yields rise during QE when the Fed was buying longer dated paper? Most likely, investors feared the goal of policy was reflation; rising inflation is always negative for bond prices and those fears overwhelmed the impact of reduced supply.

However, we are cautious about drawing too many conclusions from these patterns. We have no experience with cutting the size of a balance sheet this large. On the one hand, it shouldn't make much difference. The rise in the balance sheet did nothing more than bloat the banking system with reserves that, for the most part, have not been lent. Reducing excess bank reserves shouldn't be a big deal. On the other hand, QE and the balance sheet were symbols of Fed policy support. The psychological impact could be quite negative. We will have more to say on this going forward, but our initial read is that balance sheet reduction could be bearish for equities and bullish for bonds. Then again, the impact may not be large and could be overwhelmed by other issues, such as tax changes, geopolitical events, etc.

In other news, the China/U.S. summit begins later today. We would not expect much to happen here as the Chinese leader needs a "no drama" meeting. The Czech Republic ended its peg with the EUR; since mid-2015 the Czech central bank has pegged the koruna/euro rate at 27.0313. It has rallied about 0.5% on news that the Czech government will allow its currency to strengthen.

Stephen Bannon, special advisor to the president, was pulled off the National Security Council yesterday in a clear win for the establishment. Our read is that the key power broker is Jared Kushner and there have been rumors that Bannon and Kushner's relationship has cooled in recent months. Some reports suggest Bannon was prepared to resign but the Mercers pressed him to stay. Gary Cohn, the White House economic advisor, apparently asked some senators about Glass-Steagall in a private meeting. According to Bloomberg,[1] Cohn expressed support for bringing the separation of investment and commercial banking back to the financial system. This is a bit of a shock coming from Cohn but it may be a trial balloon to see if Congress would support such a measure. Bannon's fall from grace is a blow to the populists, while Glass-Steagall would be a win for this group.

Overall, in our establishment/populism "meter" the former is gaining strength. If the establishment gains power, financial markets will favor this outcome. However, populism isn't going away and moving in this direction leaves President Trump vulnerable to a challenge from a leftish populist in 2020…if and only if the Democrat Party sees the opening.

U.S. crude oil inventories rose 1.6 mb compared to market expectations of a 1.5 mb draw.

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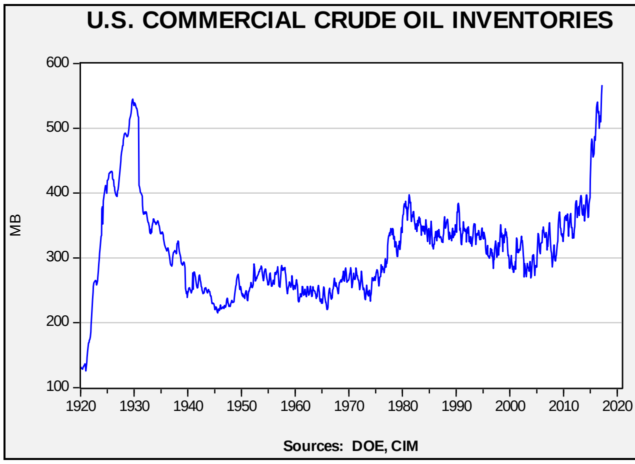
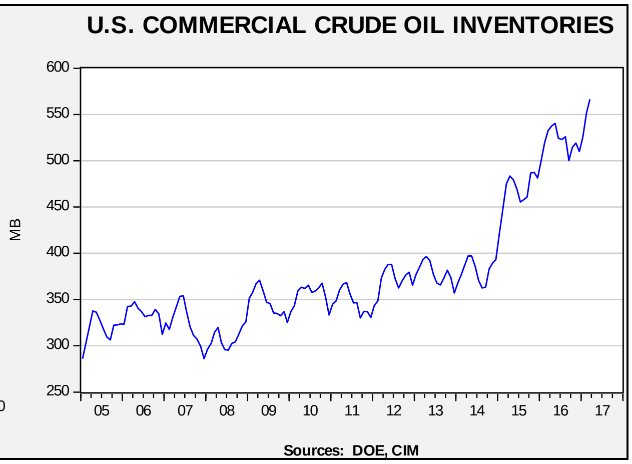
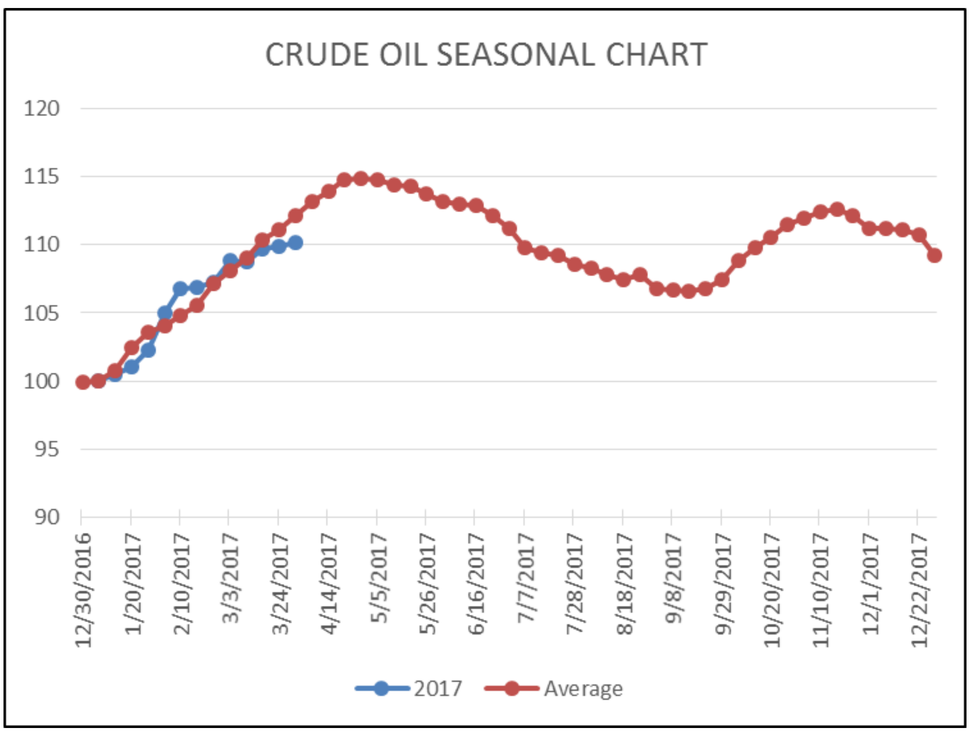
[1] https://www.bloomberg.com/news/articles/2017-04-06/cohn-said-to-back-wall-street-split-of-lending-investment-banks



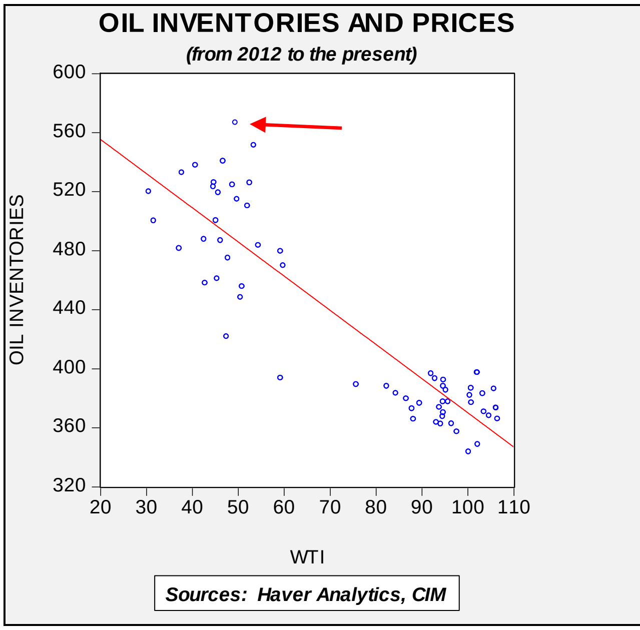


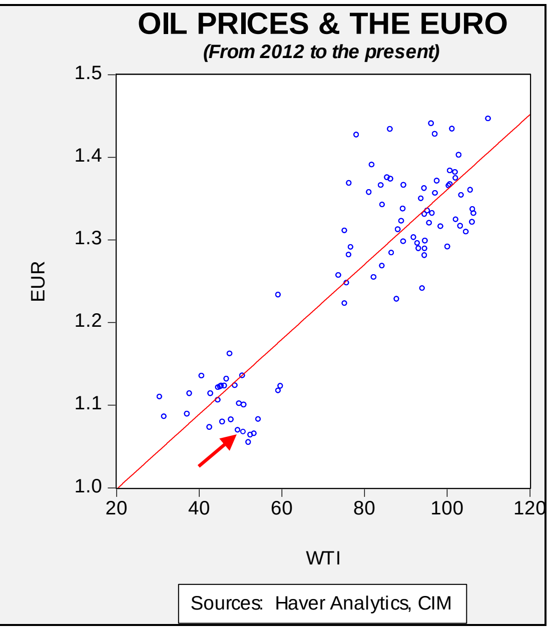
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, inventories remain elevated.

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 smaller than seasonal rise puts us further below normal. Although inventories remain high, this seasonal level is consistent with early July, meaning that we may be on the way to an easing of the inventory overhang.



(Source: DOE, CIM)



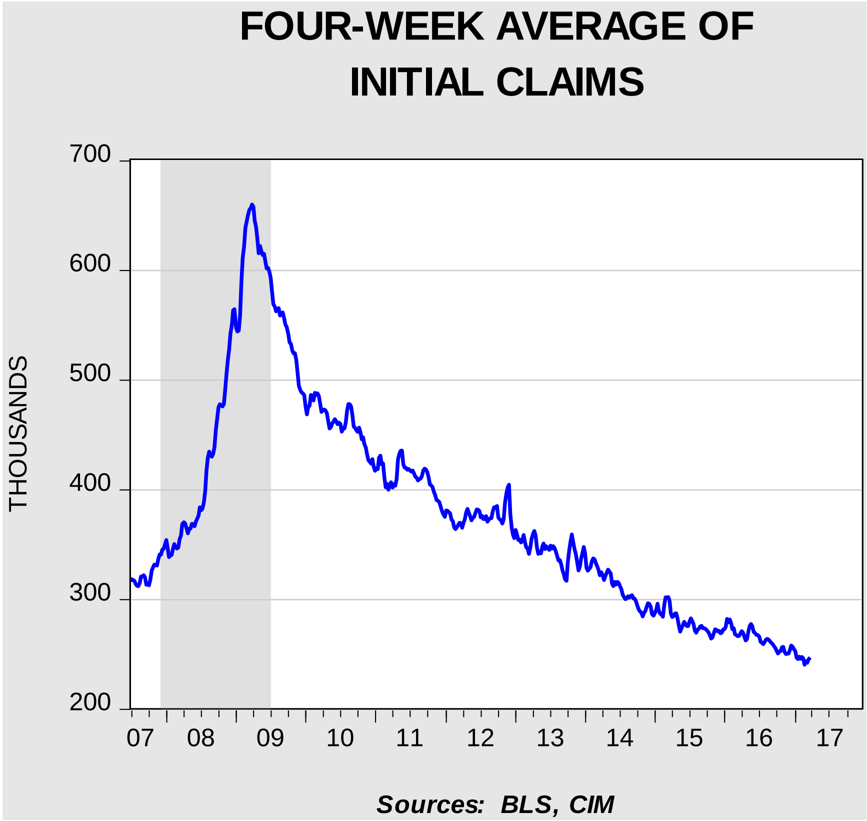


Based on inventories alone, oil prices are overvalued with the fair value price of $26.81. Meanwhile, the EUR/WTI model generates a fair value of $40.66. Together (which is a more sound methodology), fair value is $35.36, meaning that current prices are well above fair value. The data indicate that the bullish case for oil mostly rests on a weaker dollar. If the dollar continues to soften, coupled with the usual seasonal decline in oil inventories, our models will raise the fair value level. That isn't necessarily bullish for oil prices but it does remove a potentially bearish factor. Simply put, current oil prices have already factored in a drop in inventories and likely a weaker dollar.

U.S. Economic Releases

The March Challenger job cuts report fell by 2.0% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in above expectations at 234k compared to the forecast of 250k. The prior report was revised upward from 258k to 259k. There may be a seasonal component to the decline; spring break in a number of school systems may have led laid-off workers to delay claiming insurance until they returned from vacation.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose from 244.5k to 246.25k.

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		49.7	**
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	Caixin China PMI Composite	m/m	mar	52.1	52.6		**	Equity and bond neutral
	Caixin China PMI Services	m/m	mar	52.2	52.6		**	Equity and bond neutral
Japan	Japan Buying Foreign Bonds	m/m	mar	1.0998t	-0.1516t		**	Equity and bond neutral
	Foreign Buying Japan Stocks	m/m	mar	0.8900t	-1.9237t		**	Equity and bond neutral
	Foreign Buying Japan Bonds	m/m	mar	0.5845t	-0.7543t		**	Equity and bond neutral
	Japan Buying Foreign Stocks	m/m	mar	0.3354t	-0.2940t		**	Equity and bond neutral
	Consumer Confidence Index	m/m	mar	43.9	43.1	43.4	**	Equity and bond neutral
India	Nikkei India PMI Services	m/m	mar	51.5	50.3		**	Equity bullish, bond bearish
	Nikkei India PMI Composite	m/m	mar	52.3	50.7		**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Retail	m/m	mar	49.5	49.9		**	Equity and bond neutral
Germany	Factory Orders	m/m	mar	3.4%	-7.4%	4.0%	**	Equity and bond neutral
	Markit Germany Construction PMI	m/m	mar	56.4	54.1		**	Equity and bond neutral
	Markit Germany Retail PMI	m/m	mar	52.5	51.2		**	Equity and bond neutral
France	Markit France Retail PMI	m/m	mar	49.4	51.7		**	Equity bearish, bond bullish
Italy	Markit Italy Retail PMI	m/m	feb	45.1	45.5		**	Equity and bond neutral
Switzerland	CPI	y/y	mar	0.6%	0.6%	0.5%	***	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	feb	-2.5%	5.4%	1.3%	**	Equity bearish, bond bullish
Mexico	Consumer Confidence Index	m/m	mar	81.0	75.7	79.0	**	Equity bullish, bond bearish

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)	115	115	0	Up
3-mo T-bill yield (bps)	79	79	0	Neutral
TED spread (bps)	36	36	0	Neutral
U.S. Libor/OIS spread (bps)	94	94	0	Up
10-yr T-note (%)	2.36	2.34	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	22	22	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	up			Neutral
yen	down			Down
pound	down			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Repurchase Rate	6.250%	6.250%	6.250%	On forecast
RBI Reverse Repurchase Rate	6.000%	5.750%	5.750%	Above Forecast
RBI Cash Reserve Ratio	4.00%	4.00%	4.00%	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	$54.75	$54.36	0.72%	Short Covering
WTI	$51.44	$51.15	0.57%	
Natural Gas	$3.26	$3.27	-0.15%	
Crack Spread	$19.29	$19.33	-0.20%	
12-mo strip crack	$15.47	$15.57	-0.62%	
Ethanol rack	$1.73	$1.73	0.12%	
Metals				
Gold	$1,252.35	$1,255.76	-0.27%	Stronger Dollar
Silver	$18.24	$18.31	-0.42%	
Copper contract	$267.80	$268.00	-0.07%	
Grains				
Corn contract	$ 364.75	$ 364.75	0.00%	
Wheat contract	$ 429.75	$ 429.75	0.00%	
Soybeans contract	$ 945.50	$ 944.25	0.13%	
Shipping				
Baltic Dry Freight	1223	1255	-32	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.6	-1.5	3.1	
Gasoline (mb)	-0.6	-1.5	0.9	
Distillates (mb)	-0.5	-1.0	0.5	
Refinery run rates (%)	1.50%	0.50%	1.00%	
Natural gas (bcf)		9		

Weather

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

Asset Allocation Weekly Comment

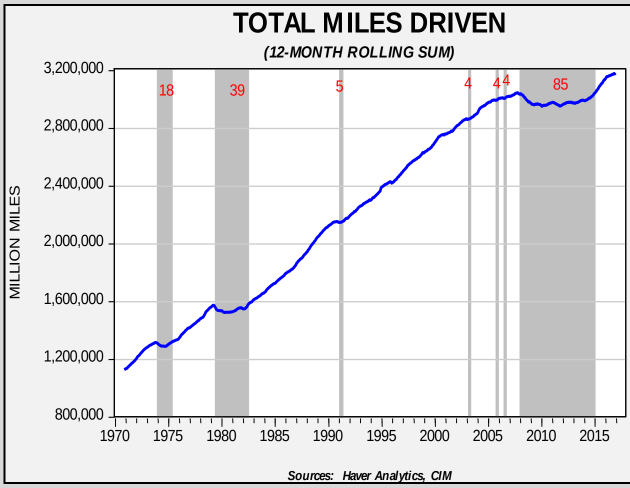
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

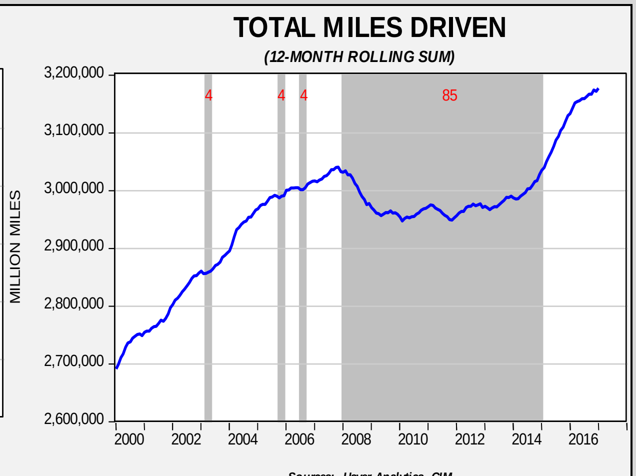
March 31, 2017

Historically, recessions tend to come from three sources—overly tight monetary policy, geopolitical events and inventory overhangs. The latter has mostly become irrelevant due to improved inventory management, leaving overly tight monetary policy and geopolitical events as the typical causes of downturns. As our regular readers know, we monitor both quite closely.

One of the problems with monetary policy is determining "tightness." Although we have a plethora of models that attempt to calculate the "neutral rate" for fed funds, in reality, the correct neutral rate changes over time due to economic conditions. Again, we usually focus on inflation and the most visible data, such as the employment report and GDP, to gauge the health of the economy. However, we also monitor more obscure numbers which may offer insights into the economy that are not being picked up by the bigger and more common reports.

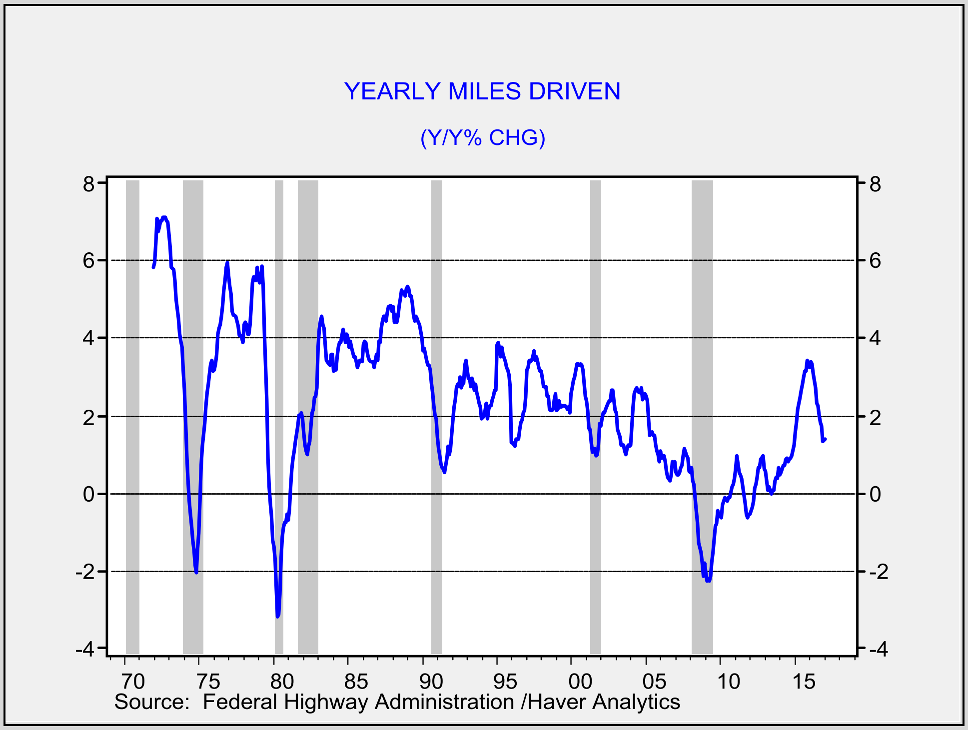
One of these lesser watched metrics tracks vehicle miles driven. The Federal Highway Administration measures how many miles are being driven by all vehicles, including commercial vehicles and passenger cars and trucks. We have found that miles driven are sensitive to economic activity and oil prices.





These charts show the same data on different time scales. The left chart shows the rolling 12-month data on vehicle miles driven since the early 1970s. The gray bars indicate periods when the monthly total is not a new peak. Once a new peak is reached, the gray bar ends. Although there have been short-term declines from the peak, there were three significant events seen in 1973-75, 1979-82 and 2007-2014. All three of these events occurred during deep recessions that coincided with high oil prices. The chart on the right shows the data since 2000. Note that we finally reached a new peak in early 2015, just over seven years after the previous high in late 2007.

As the chart on the right shows, in 2014, miles driven began to accelerate, suggesting the economy was improving. However, since Q2 2016, the growth rate in miles driven has started to stall. Although it is still making new highs, the slowdown does raise concerns.



This chart shows the annual change in the 12-month rolling total for vehicle miles driven. Until 2012, negative readings coincided with recessions but only severe ones that also suffered from high oil prices. However, even the 1990-91 downturn, which was part of the oil spike caused by the Iraqi invasion of Kuwait, did not bring a negative reading to this number.

There is a structural trend in the data as well. Note that the level of driving seems to grow at a slower pace during each expansion. The expansion after the 1973-75 recession was 3.8%; the expansion after the 1980-82 recession was 4.1%. However, the subsequent growth rate after the 1990-91 recession was 2.5% and after the 2001 recession was 1.3%. In this expansion, the average growth rate in miles driven is a mere 0.8%. Why are fewer miles being driven? We suspect a number of factors are at work. To some extent, the law of large numbers is having an effect. There are simply constraints to driving that are probably leading to slower growth, namely, road infrastructure and the amount of the population that can afford to own a car. The aging baby boom population is being replaced by Americans who seem to drive less.[2] The advent of social media may reduce the need to drive; baby boomers used to "cruise" to meet friends. The internet allows gatherings to occur without leaving home.

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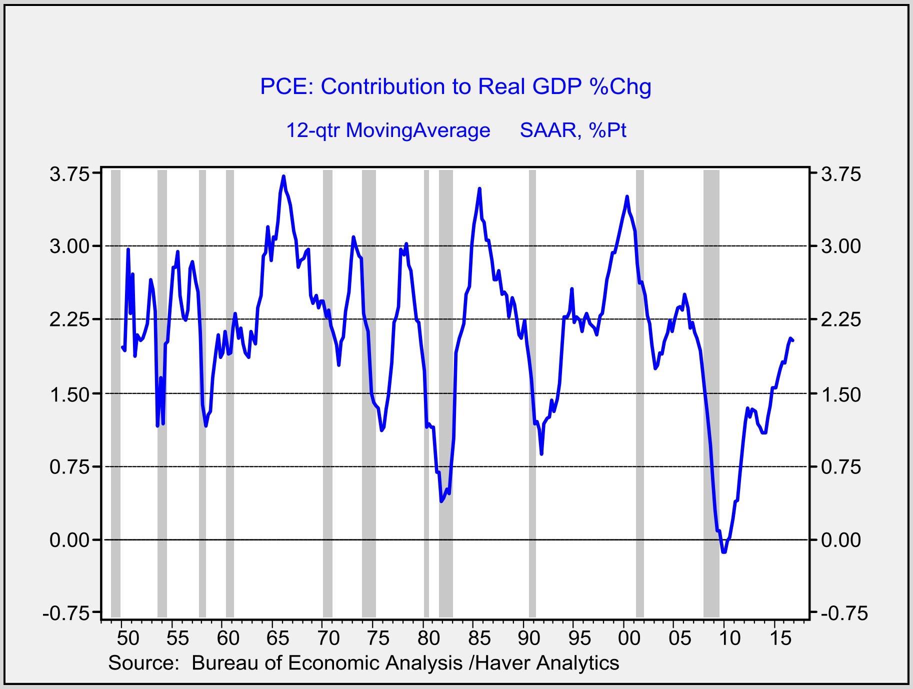
[2] https://www.washingtonpost.com/news/wonk/wp/2014/10/14/the-many-reasons-millennials-are-shunning-cars/?utm_term=.3061591ca7d9

Still, the jump in the data from 2014 into early 2016 and the subsequent slowdown do concern us. This drop could be an early warning that consumers are retrenching; the lack of wage growth may be weighing on household spending. We note that consumption trends are showing slowing growth.

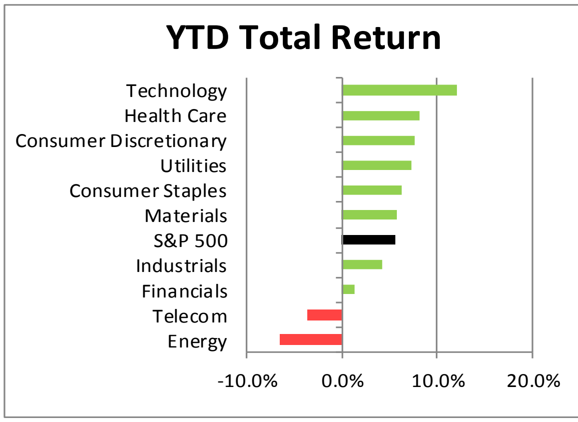


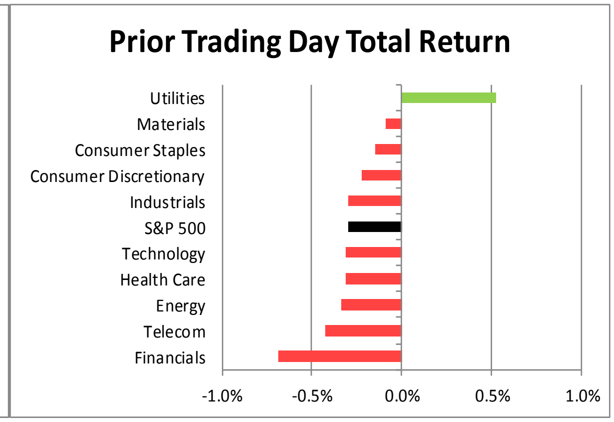
This chart shows the three-year moving average of the contribution to GDP coming from household consumption. The sharp decline in the last recession shows how damaging the last recession was to the household sector. Although the recovery has been robust, the level of growth remains well below previous cycles. In addition, for the past three quarters, the trend contribution level has been stuck at 2%. If this reading fails to accelerate, it would suggest growth will remain slow.

Thus, the miles driven number does suggest some softening in the economy. The slowdown isn't serious enough to signal an imminent recession, but it should give policymakers pause on moving aggressively on interest rates. If monetary policy remains accommodative, the bullish environment for equities should remain in place.

Data Section

U.S. Equity Markets – (as of 4/5/2017 close)

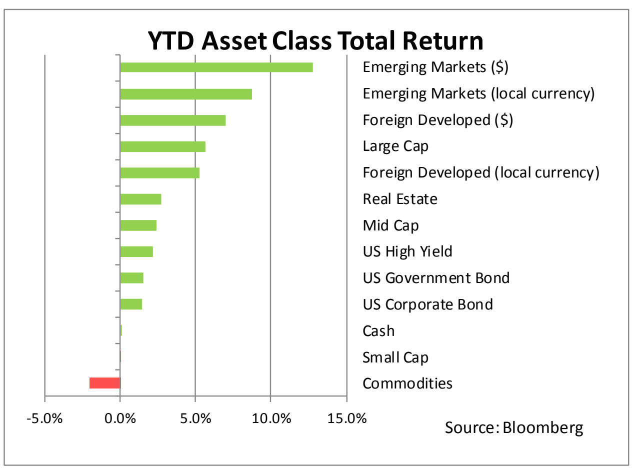




(Source: Bloomberg)

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 4/5/2017 close)

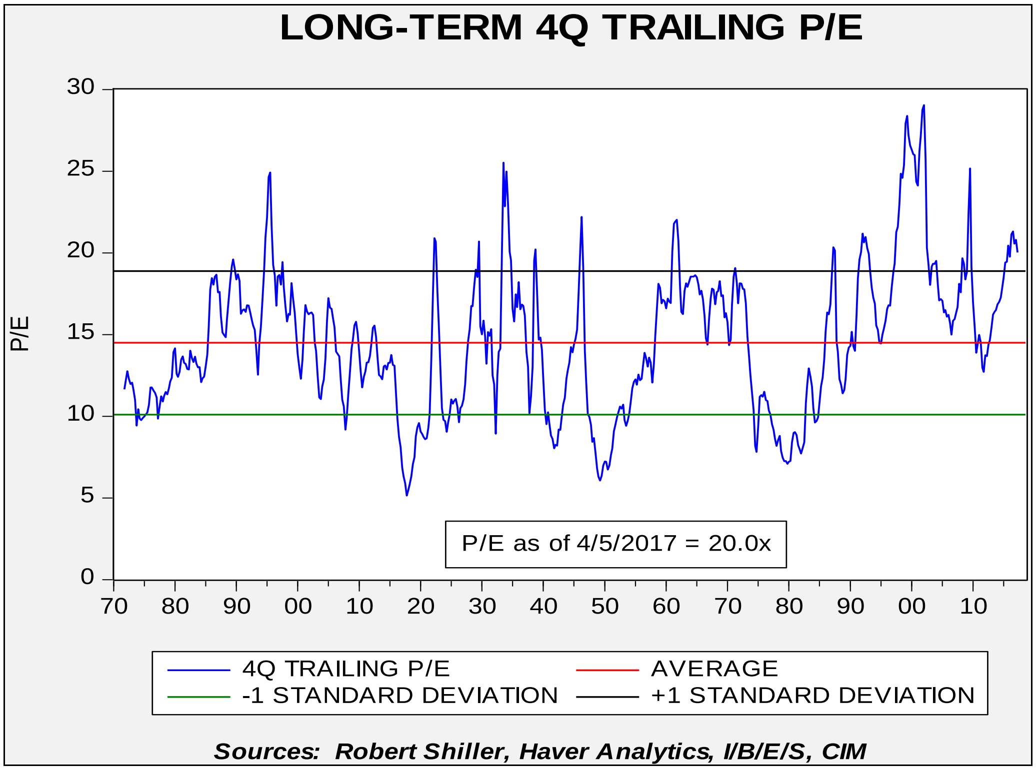


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 6, 2017



Based on our methodology,[3] the current P/E is 20.0x, down 0.8x from last week. We are now into Q2 which means we added expectations for the current quarter to our calculation. Those earnings estimates led to the 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.