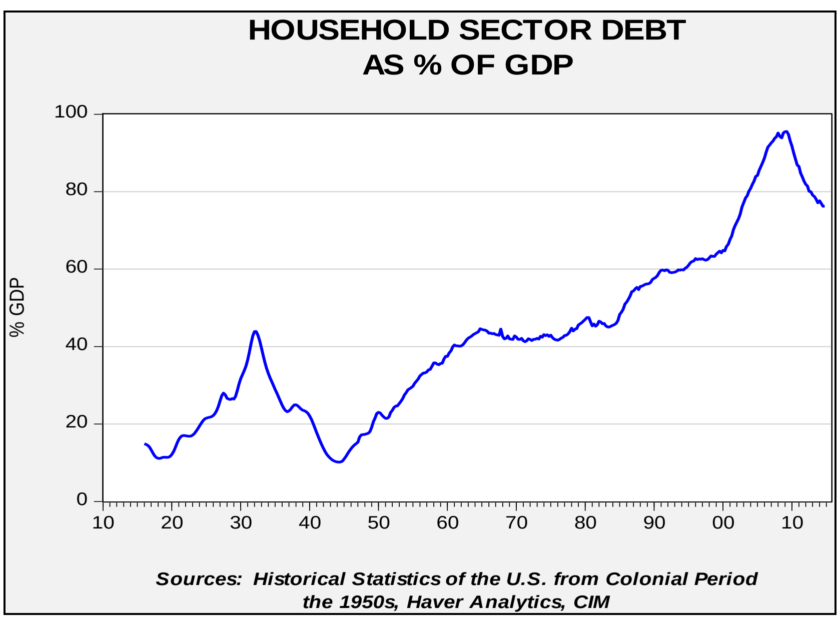
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: August 23, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 0.4% from the prior close. Chinese markets were also higher, with the Shanghai composite up 0.2% and the Shenzhen index trading higher by 0.3%. U.S. equity futures are signaling a higher opening from the previous close. With 480 companies having reported, the S&P 500 Q2 earnings stand at $29.44, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 72.2% of companies reported earnings above forecast, while 17.1% reported earnings below forecast.

It was another quiet overnight session, typical of late summer. The flash PMI data came in fairly strong (details below), easing some concerns about the economy post-Brexit. However, until Britain actually leaves the EU, it is almost impossible to determine what the actual impact will be, simply because we don't know the terms of the exit.

The real story this week is Fed Chair Yellen's Jackson Hole speech on Friday. As best we can tell, the Fed and the world's other industrialized central banks are starting to realize that the economy isn't normalizing as they had projected it would since 2009. El-Erian's "new normal" has come to pass, meaning that we live in a world of low growth and low inflation. We believe there are multiple reasons for low inflation and persistently slow growth. The primary culprit is the level of household debt; we are in a period of deleveraging, which tends to foster slow economic growth as household are less likely to borrow.

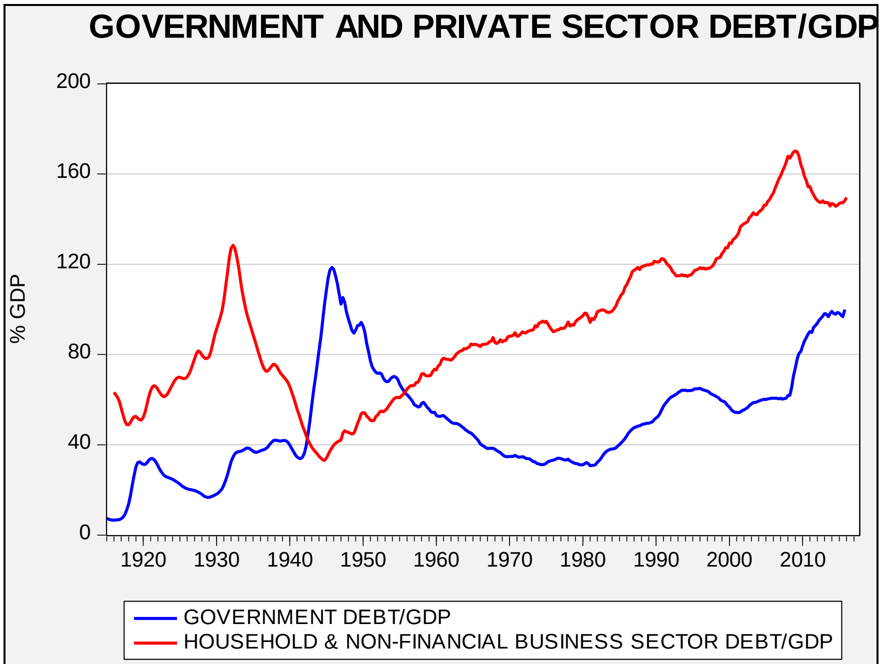


The key to a debt problem is resolution; society has to decide how to assign the bad debt losses. There are essentially three ways to address a bad debt problem. The debtors can shoulder the burden and are forced to cut their spending and increase their savings to service the debt. The creditors can carry the burden through repudiation or restructuring. Lastly, a third party can settle the debt and favor either side; in other words, if the outside party buys the debt at full face value, then the creditors are saved (of course, the debtors are too) and the third party bears the burden. Or, the outside party can buy the debt at a discount and force the creditor to bear some of the losses.

Such negotiations are political in nature. In Europe, for example, the debtors have carried nearly all the burden, which is why the economies of Greece, Spain, et al. have been so weak. In the U.S., the debtors have shouldered most of the burden. We note that during the Dodd-Frank negotiations, Senator Frank toyed with mortgage "cram downs" which would have forced principal losses on creditors. That didn't happen. However, the creditors have not gotten away without pain. The Federal Reserve is allocating some of the cost of restructuring to creditors in the form of financial repression. By holding interest rates at very low levels, debtors can more easily refinance their debt, which is a form of credit restructuring. Creditors are also being forced to fund lesser quality debt in the desperate search for yield.

The missing element of financial repression has been the lack of inflation. Central banks seem to remain under the sway of monetarism, which postulates that the central bank can create any inflation it wants by expanding its balance sheet. This has proven to be untrue. In our opinion, inflation comes from the intersection of aggregate supply and aggregate demand and the aggregate supply curve is nearly horizontal in a globalized and deregulated world, meaning that rising demand won't necessarily lead to higher price levels. Without rising inflation, it is hard to enforce financial repression in a manner that would rapidly address the debt overhang. Think of the above chart, which is a ratio of debt and GDP; rising inflation would lift nominal GDP (the denominator) and consequently lower the ratio, if debt merely stays the same. The fastest way to lift nominal GDP is with higher price levels.

Needless to say, this solution isn't making either side very happy. It is worth noting that when we had this problem in the 1930s the solution was WWII. The government acted as the third party, taking on massive debt via war spending which allowed the private sector (households and businesses) to effect a debt swap, shifting their debt to the government. The chart below shows how that worked.



Sources: Historical Statistics of the U.S. from Colonial Period to the 1950s, Haver Analytics, CIM

In the most recent debt cycle, we have seen a smaller version of the post-1930 debt swap but, frankly, the government didn't increase debt enough. Political constraints prevented that from occurring. Consequently, the swap was never fully executed and now, with increased business borrowing, progress on deleveraging has stalled prematurely.

So, what is the answer? There are really two paths to take. The first is to take another swing at expanding government debt through fiscal spending. Although there is a rising drumbeat for such policies, they are only attractive in the abstract. Politically, you have to pick winners and losers if fiscal spending is going to expand. Given the degree of political gridlock, it has been virtually impossible to come up with mutually agreeable spending. The other path would be to bring inflation by reversing globalization and deregulation, the policies of Donald Trump and Bernie Sanders. In the end, neither choice is particularly attractive, so we continue to muddle through with slow growth and low inflation. Until there is some political resolution of this issue, we expect more of the same.

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						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	**Manufacturing PMI (Markit)**	m/m	Aug	52.6	52.9	**
10:00	**Richmond Fed manufacturing index**	m/m	Aug	6.0	10.0	*
10:00	**New home sales**	m/m	Jul	-2.0%	3.5%	**

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, with red indicating a concerning development, yellow indicating an emerging trend that we are following closely for possible complications and green indicating 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	Overall business condition	m/m	Aug	54.3	55.5		**	Equity and bond neutral
Japan	Manufacturing PMI (Nikkei)	m/m	Aug	49.6	49.3		**	Equity and bond neutral
EUROPE								
Eurozone	Manufacturing PMI (Markit)	m/m	Aug	51.8	52.0	52.0	**	Equity and bond neutral
	Services PMI (Markit)	m/m	Aug	53.1	52.9	52.9	*	Equity bullish, bond bearish
	Composite PMI (Markit)	m/m	Aug	53.3	53.2	53.1	*	Equity bullish, bond bearish
France	Manufacturing PMI (Markit)	m/m	Aug	48.5	48.6	48.8	**	Equity bearish, bond bullish
	Services PMI (Markit)	m/m	Aug	52.0	50.5	50.5	*	Equity bullish, bond bearish
	Composite PMI (Markit)	m/m	Aug	51.6	50.1	50.4	*	Equity bullish, bond bearish
Germany	Manufacturing PMI (Markit)	m/m	Aug	53.6	53.8	53.6	**	Equity and bond neutral
	Services PMI (Markit)	m/m	Aug	53.3	54.4	54.4	*	Equity bearish, bond bullish
	Composite PMI (Markit)	m/m	Aug	54.4	55.3	55.1	*	Equity bearish, bond bullish
Switzerland	Trade balance (CHF)	m/m	Jul	2.9 bn	3.5 bn		**	Equity and bond neutral
	Exports	m/m	Jul	5.5%	-4.0%		**	Equity bullish, bond bearish
	Imports	m/m	Jul	9.2%	-4.0%		**	Equity bearish, bond bullish

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)	82	81	1	Up
3-mo T-bill yield (bps)	29	29	0	Neutral
TED spread (bps)	53	52	1	Widening
U.S. Libor/OIS spread (bps)	43	43	0	Neutral
10-yr T-note (%)	1.55	1.54	0.01	Up
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	38	37	1	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Neutral
yen	up			Up
franc	up			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	$48.75	$49.16	-0.83%	Awaiting domestic inventory data
WTI	$47.01	$47.41	-0.84%	
Natural Gas	$2.72	$2.68	1.42%	
Crack Spread	$12.77	$12.99	-1.66%	
12-mo strip crack	$13.32	$13.56	-1.81%	
Ethanol rack	$1.59	$1.60	-0.03%	
Metals				
Gold	$1,343.86	$1,339.09	0.36%	Lower dollar, awaiting Yellen speech on Friday
Silver	$19.05	$18.91	0.73%	
Copper contract	$214.15	$215.20	-0.49%	Ample global inventories
Grains				
Corn contract	$ 339.50	$ 342.50	-0.88%	Domestic crop tour results expected to come in strong
Wheat contract	$ 431.75	$ 435.25	-0.80%	
Soybeans contract	$ 1,013.50	$ 1,015.75	-0.22%	
Shipping				
Baltic Dry Freight	687	683	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.7		
Gasoline (mb)		-1.3		
Distillates (mb)		0.1		
Refinery run rates (%)		-0.6%		
Natural gas (bcf)		22.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer and wetter than forecast conditions for the eastern two-thirds of the country. Tropical Depression Fiona has moved into the mid-Atlantic but remains “remarkably resilient.” It is not expected to affect anything but open Atlantic shipping. This activity is expected to slow as it moves northwest. Another large low-pressure area has moved east of the Leeward Islands. This activity has a medium chance of becoming a cyclone over the next two days. Tropical Storm Gaston has formed in the eastern Atlantic, but is expected to slow as it moves northwest over cooler waters.

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.

August 19, 2016

U.S. equity markets are showing impressive strength.

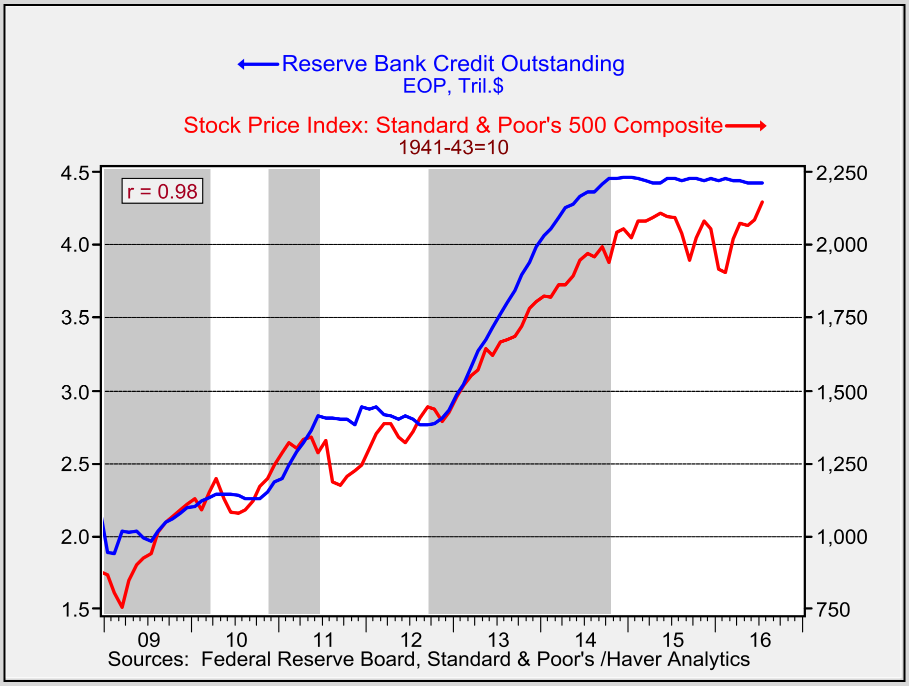
(Source: Bloomberg)

This chart shows the S&P 500 Index along with the 200-day moving average. The white horizontal line shows recent highs; note that the S&P 500 has recently moved above these highs. Technically, this is a "breakout" and suggests the market will likely move higher.

Still, this rally has occurred with slowing earnings growth. Although S&P 500 operating earnings are coming in better than expected, they are still down about 2% from last year.[1] Rising equity prices with falling earnings implies a rising P/E (confirmed below). Without an increase in future earnings, equity markets are becoming increasingly pricey.

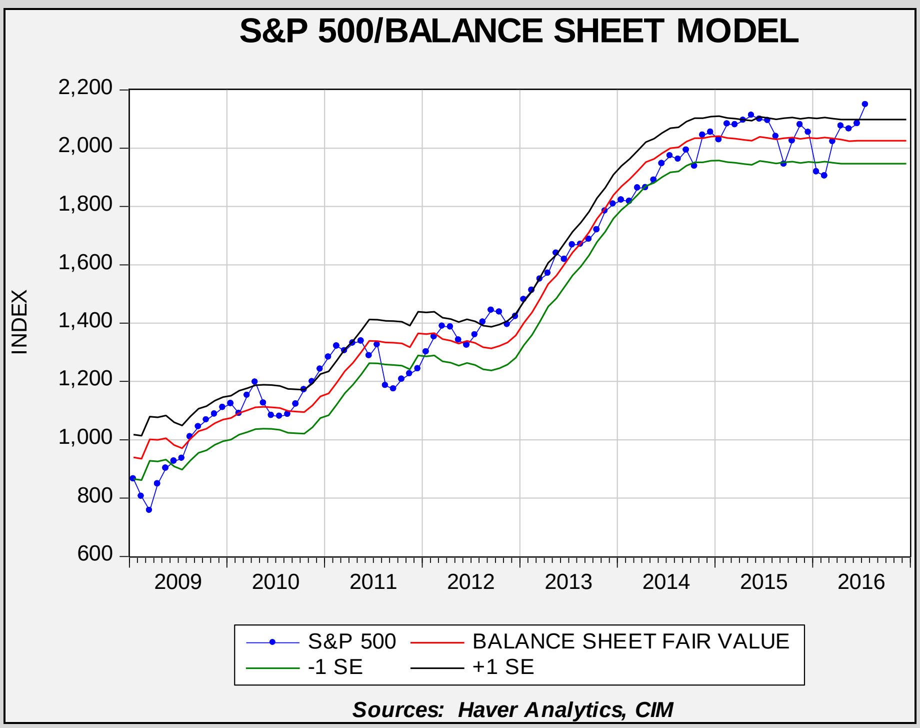
One of our more reliable indicators during this cyclical bull market has been the relationship between the S&P 500 and the Federal Reserve's balance sheet.

[1] Using Thompson-Reuters' calculation of operating earnings.



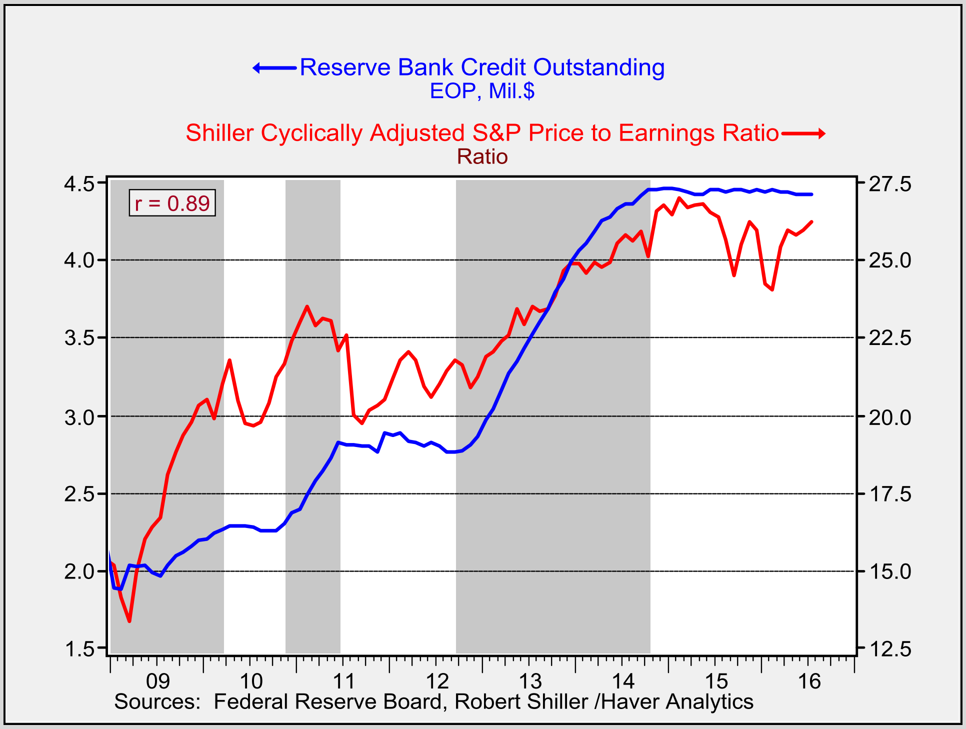
This chart shows the size of the Fed's balance sheet along with the S&P 500 Index. Periods of quantitative easing (QE) are shown in gray. Note that since the recovery began in 2009, equity values tended to rise during and in anticipation of a balance sheet expansion and move sideways during periods where the balance sheet remained steady.

This chart shows a regression of the relationship.



This chart shows the fair value for the S&P 500, based on the Fed's balance sheet, along with standard error bands. Over the past seven years, the upper standard error band has been a signal that markets are overvalued; dips to the lower standard error bank suggest a more favorably valued equity market.

We are currently well above one standard error which raises three possibilities. The first is that equities are overvalued and primed for a pullback (fair value is 2,025 and the lower standard error line is 1,947). The second is that the relationship was always spurious and the recent rise is uncorrelated. The third is that there are other variables that are now more important which can justify the recent rise. We disagree with the second possibility because the relationship between the Fed's balance sheet and the Shiller P/E is also quite strong, suggesting that unconventional monetary policy boosted investor sentiment and supported a higher P/E.



This chart shows the relationship of P/E ratios and the balance sheet; note that the P/E rises sharply during periods of QE. We believe this relationship offers support for the notion that unconventional monetary policy lifted investor sentiment and P/E ratios remained steady in its absence.

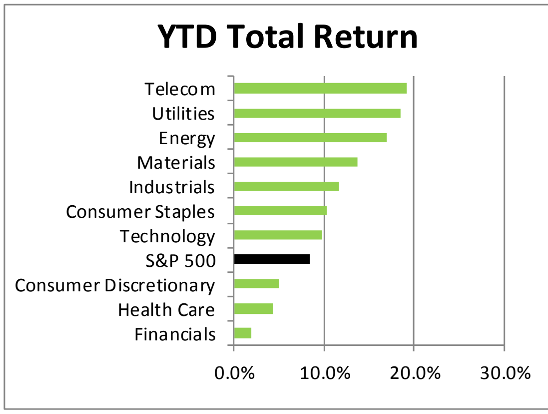
However, the third possibility does remain—there are new factors that are boosting equities. We note the equity markets rallied on Friday's strong employment data. However, the historical record on the relationship of employment and equities is mixed. Clearly, an improving labor market signals that a recession isn't imminent. But, when the labor market becomes very strong, it often triggers tighter monetary policy. At present, the financial markets do not expect tighter policy until December at the earliest. Thus, at least in the short run, the equity markets may be in a "sweet spot" where better growth may lift top line revenues without triggering tighter policy.

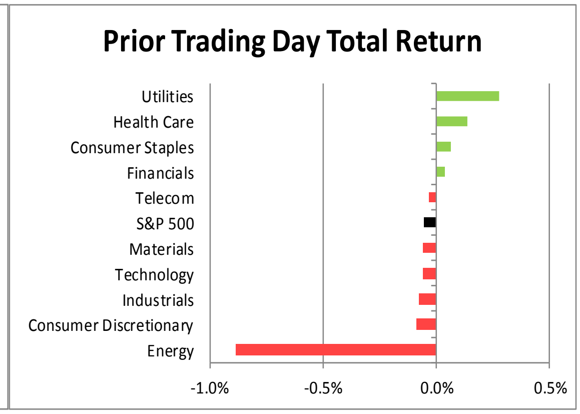
However, these favorable conditions may not last. Therefore, our base case is that equities are fully valued but a correction may not be imminent.

At the same time, equities are not cheap and could be vulnerable to exogenous issues, such as the U.S. presidential elections and terrorism. As a result, we would not be surprised to see a modest correction in the coming months but, as long as a recession is avoided (which we expect), a major pullback isn't likely.

Data Section

U.S. Equity Markets – (as of 8/22/2016 close)

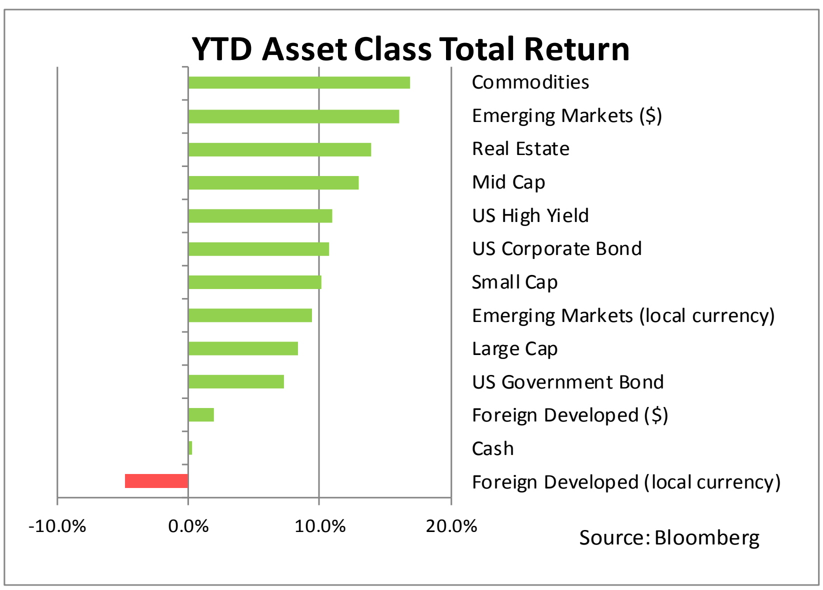




(Source: Bloomberg)

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 8/22/2016 close)

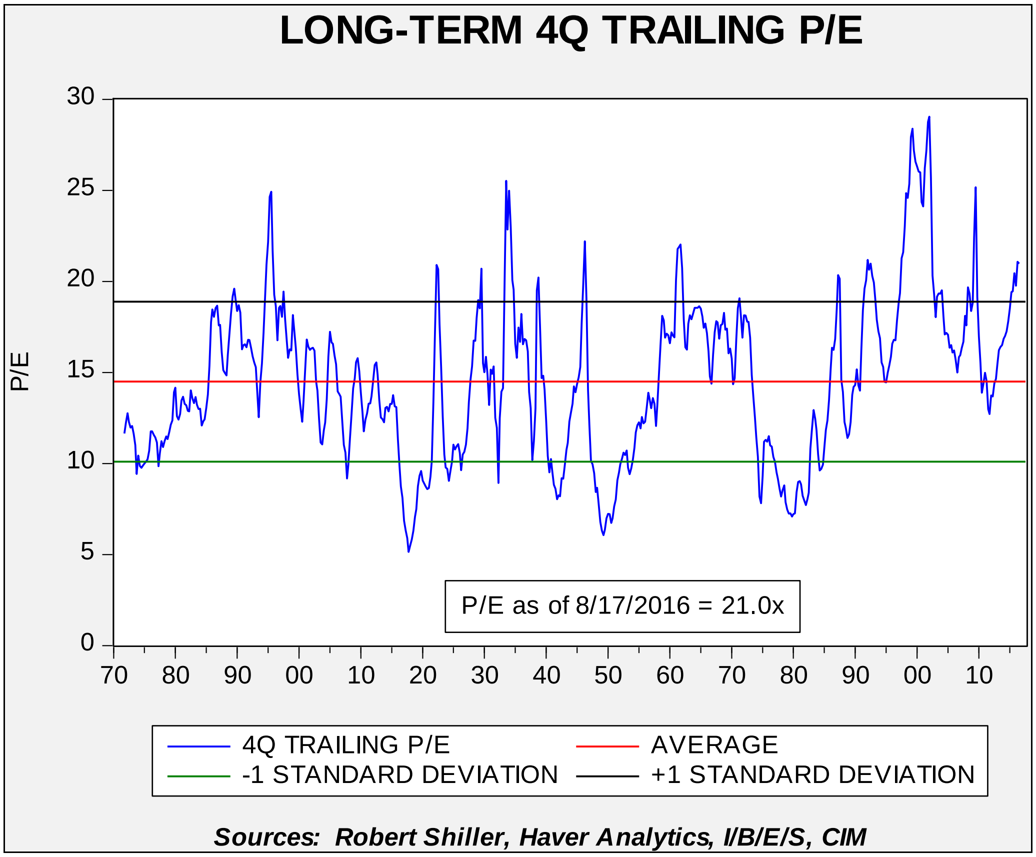


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 18, 2016

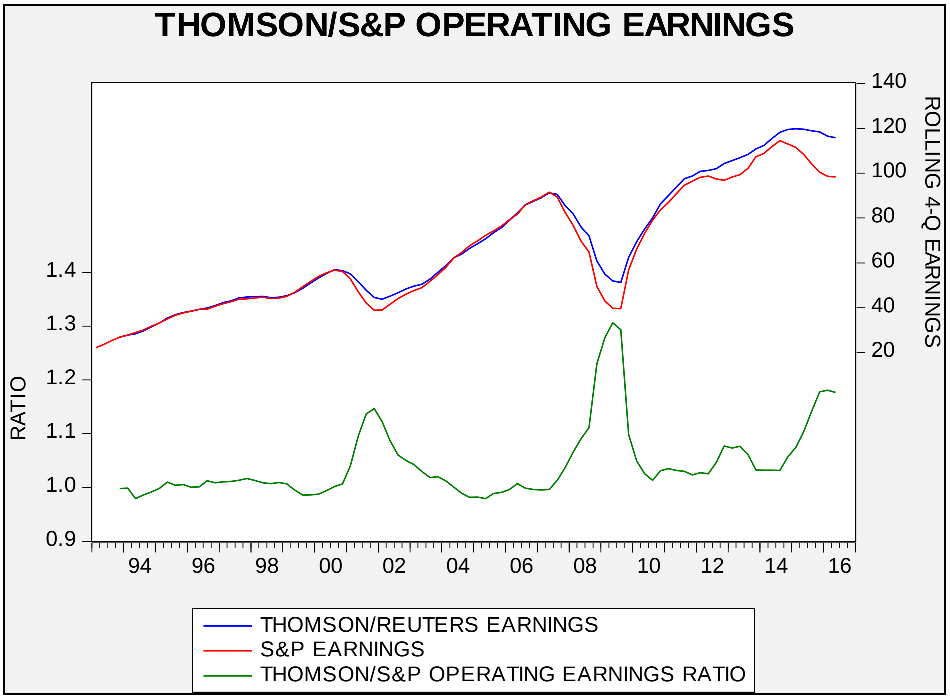


Based on our methodology,[2] the current P/E is 21.0x, up 0.6x from last week.

Every week we update the rolling P/E for the S&P 500. Our source for the history of operating earnings comes from S&P. However, Thomson/Reuters also provides operating earnings data and I/B/E/S earnings estimates also come for the same source. As noted in the footnote below, we calculate the P/E using history and expectations. Once the number of companies reporting

[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.

exceeds 90%, Haver Analytics, our primary data aggregator, provides an estimate for the latest quarter from S&P. This has resulted in a sharp jump in the P/E to 21.0x because we are now including two quarters of actuals and one quarter of estimates from S&P and one quarter of estimates from I/B/E/S. As we noted earlier this year in an AAW, we are seeing a sharp divergence between these two data sources.



Most of the time, the two series track closely but they usually diverge during recessions or periods of economic stress. The lower line on this chart shows the current ratio between the two, which is quite elevated. This is something of a warning sign for equities; in the past, a ratio this high tended to signal a significant pullback in equities. On a rolling four-quarter basis, through Q2, Thomson-Reuters reports earnings of $115.76; S&P reports $98.36. We tend to trust S&P more but the common discussion in the financial media uses Thomson-Reuters. Investors should be aware of the current divergence. It does appear that the two series eventually equalize and most of the movement comes from the S&P source. However, in the two prior periods when the ratio was this elevated, the improvement also came with a bear market in stocks.

The bottom line is that the strength we are seeing in equities is mostly coming from multiple expansion and using Thomson-Reuters' data may underestimate the degree of reliance on multiple growth. As long as Fed policy remains accommodative, the likelihood of equity weakness is low, but it also suggests that conditions are becoming increasingly vulnerable to modest changes in policy.