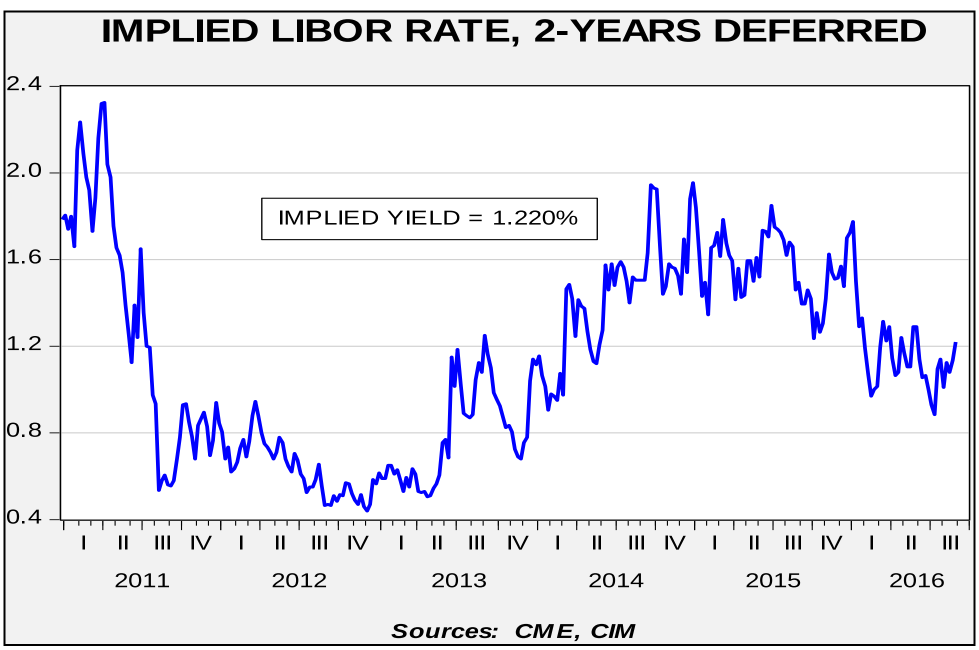
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: August 29, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.2% from the prior close. Chinese markets were higher to sideways, with the Shanghai composite roughly unchanged and the Shenzhen index trading higher by 0.2%. U.S. equity futures are signaling a higher opening from the previous close. With 493 companies having reported, the S&P 500 Q2 earnings stand at $29.47, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 72.1% of companies reported earnings above forecast, while 17.3% reported earnings below forecast.

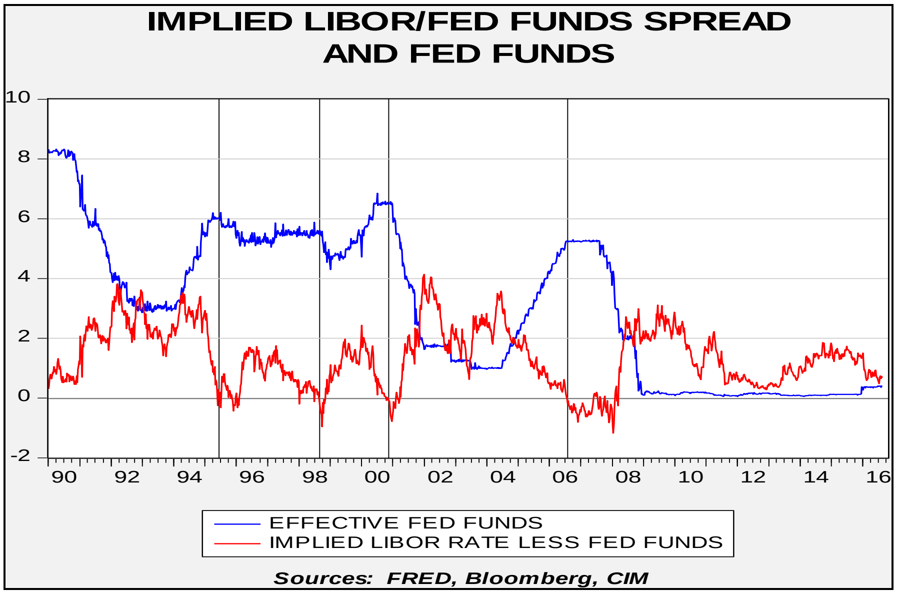
The long anticipated Jackson Hole conference came and went. Chair Yellen's speech was initially taken as dovish, but comments from Vice Chair Fischer sent financial and commodity markets into a significant reversal when he indicated that two hikes may be possible this year. We see the change in fed funds futures. The market had the odds of a September rate hike at nearly zero after Brexit. They are now at 44% with a 67% likelihood in December. Yellen did note that the labor market is approaching the U.S. central bank's target but also seemed to imply the Fed has time to wait before moving rates higher. Fischer's comments changed the tone of the meeting, turning it into a hawkish event.

In watching the market reaction, we note that there are clear worries about a near-term hike; however, expectations for the terminal rate remain low.



This chart shows the implied three-month LIBOR rate from the two-year deferred Eurodollars. When Ben Bernanke opened the topic of tapering in May 2013, rates started a steady climb, reaching nearly 2% by H2 2014. However, the projected LIBOR rate has steadily declined following last December's rate hike. We believe this indicates the markets are expecting a lower fed funds rate in the future.

Here's another way of looking at the data.



This chart shows the weekly effective fed funds rate with the spread between the two-year deferred three-month Eurodollar futures and fed funds. Note that the FOMC usually stops raising rates when the spread reaches zero. The current spread has narrowed from nearly 190 bps in late 2014 to the current 68 bps. That means if the implied LIBOR rate remains steady, we are probably looking at ***two to three hikes in total***.

Tighter policy will have an impact on the financial and commodity markets. We are already seeing an upward move in the Treasury curve, although it is also flattening. Gold and other commodity prices, along with emerging markets, are weakening. The dollar is strengthening. Equities are holding up fairly well, but the short-term uptrend has stalled.

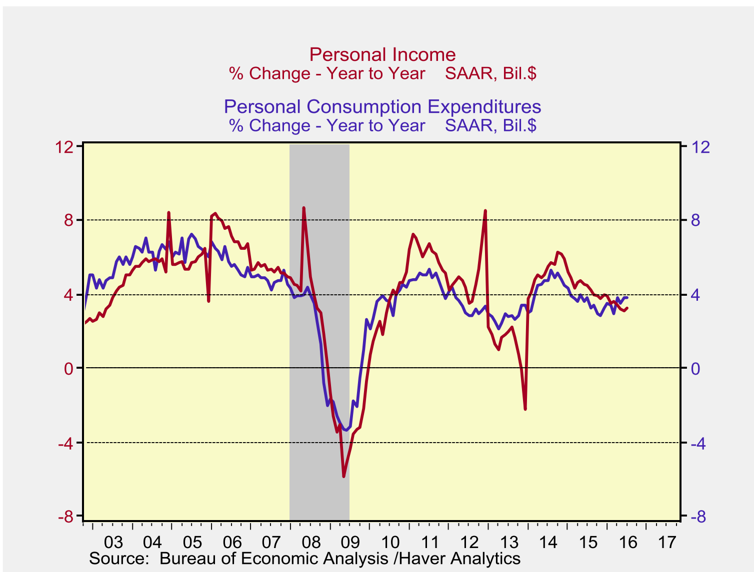
We note that BOJ Governor Kuroda was at Jackson Hole suggesting that more stimulus is coming. Although there are grave doubts as to what the BOJ has left in terms of policy support, direct financing of fiscal spending is possible. And, the BOJ could implement QE by purchasing U.S. Treasuries, although that would cause a firestorm of protests.

Canadian PM Trudeau is heading to China to talk trade with General Secretary Xi. Saturday's *NYT* discussed at length comments from Chinese nationals and Canadians of Chinese descent who face public criticism and worse for pointing out human rights problems in China. According to reports, the Xi regime is putting pressure on Western governments to restrict criticism. We also note that some activists have faced cyber-attacks and threats of physical harm. Canada, like the U.S. and Australia, has been a prime destination for Chinese capital flight. However, if Canada begins to muzzle Chinese political dissent in a bid to gain export markets, we would look for the Chinese (and their capital) to look for other places where their free speech will be protected.

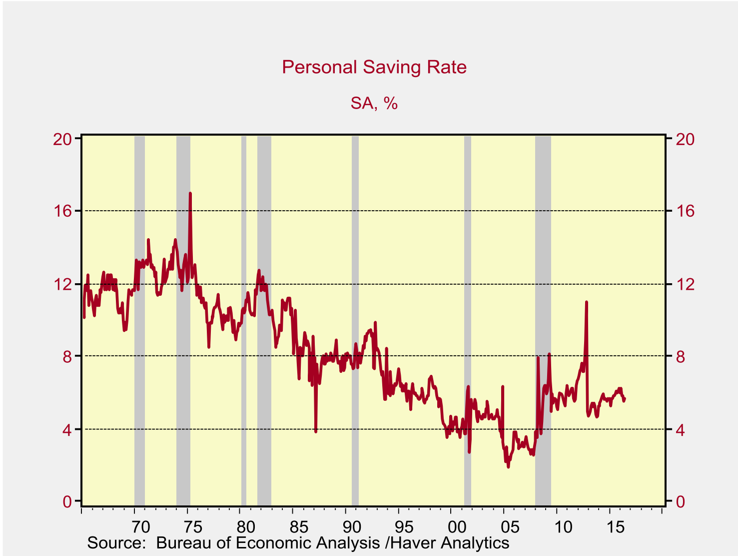
The German economy minister, Sigmar Gabriel, said over the weekend that the Trans-Atlantic Trade and Investment Partnership, or TTIP, is dead. Gabriel noted that after 14 rounds of talks, not one item of the 27 chapters of the proposed trade agreement was accepted by both sides. TPP is barely viable; both U.S. presidential candidates have disavowed it and its only chance is to be passed in the lame duck session after the November elections but before inauguration. Even then, the odds are long. Retreating from these trade deals will have important geopolitical ramifications but, in the current political environment, free trade has lost its allure.

U.S. Economic Releases

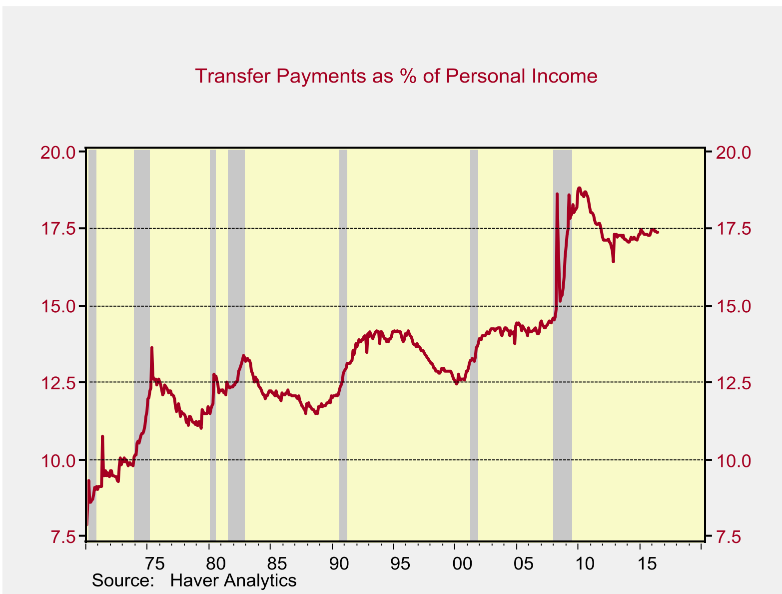
Personal income and spending both came in on forecast in July. Income rose 0.4%, while spending rose 0.3%. The chart below shows the annual change in personal income and expenditures. Although incomes are rising, the pace of gains is generally slowing.



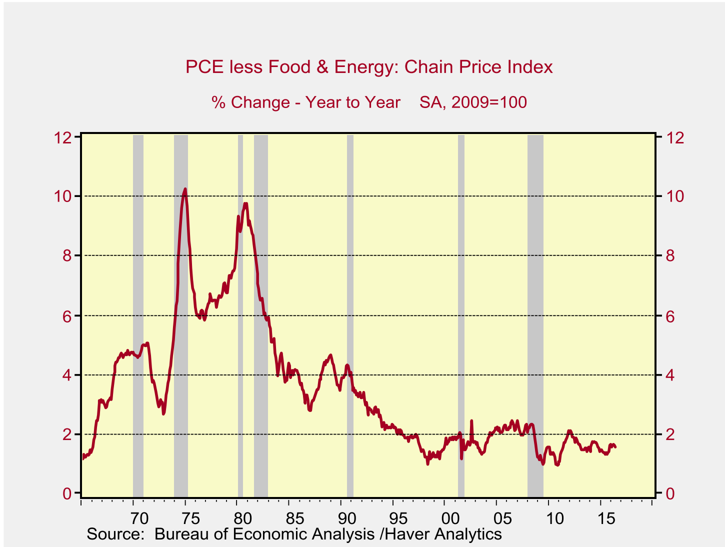
The personal savings rate, shown in the chart below, remained unchanged at 5.7%.



Transfer payments as a percentage of income also remained unchanged at 17.4%. The metric has remained range-bound over the past two years.



The headline PCE deflator rose 0.8% annually, on forecast. The core PCE deflator rose 1.6% annually, a little more than the 1.5% increase forecast. The core PCE is shown in the chart below and is a favorite inflation measure of the FOMC. Overall, inflation pressures remain mild.



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

Economic releases						
EDT	Indicator			Expected	Prior	Rating
10:30	Dallas Fed manufacturing activity indicator	m/m	Aug	-3.9	-1.3	**

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								
Australia	New home sales	m/m	Jul	-9.7%	8.2%		*	Equity bearish, bond bullish
China	Industrial profits	y/y	Jul	11.0%	5.1%		**	Equity bullish, bond bullish
India	CPI	y/y	Jul	0.5%	0.7%	0.7%	***	Equity bearish, bond bullish
EUROPE								
Italy	Consumer confidence	y/y	Aug	109.2	111.2	110.3	**	Equity and bond neutral
	Manufacturing confidence	y/y	Aug	101.1	102.9	102.5	**	Equity bearish, bond bullish
	Economic sentiment	y/y	Aug	99.4	103.0		**	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)	83	83	0	Neutral
3-mo T-bill yield (bps)	32	31	1	Up
TED spread (bps)	52	52	0	Neutral
U.S. Libor/OIS spread (bps)	47	46	1	Up
10-yr T-note (%)	1.60	1.63	-0.03	Narrowing
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	42	40	2	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Neutral
yen	down			Up
pound	down			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	$49.19	$49.92	-1.46%	Falling alongside other risk markets, OPEC production freeze doubts
WTI	$46.96	$47.64	-1.43%	
Natural Gas	$2.85	$2.87	-0.73%	
Crack Spread	$13.26	$13.51	-1.84%	
12-mo strip crack	$13.66	$13.69	-0.25%	
Ethanol rack	$1.57	$1.57	0.00%	
Metals				
Gold	$1,320.92	$1,321.18	-0.02%	Higher dollar
Silver	$18.60	$18.66	-0.29%	
Copper contract	$207.90	$208.45	-0.26%	Ample global supplies
Grains				
Corn contract	$ 323.75	$ 325.00	-0.38%	
Wheat contract	$ 399.00	$ 407.50	-2.09%	
Soybeans contract	$ 963.00	$ 967.25	-0.44%	
Shipping				
Baltic Dry Freight	720	718	2	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for the eastern two-thirds of the country. Precipitation is forecast in the north and the west. Hurricane Gaston is expected to slow as it moves over cooler waters and dissipate by the end of the week. Two disturbances are located in the Gulf of Mexico. Tropical Depression Nine is in the southeast corner of the GOM and is expected to turn north and make landfall in Florida. Another small disturbance is in the northwest corner of the GOM. This activity has a low chance of becoming a cyclone over the next two days. Tropical Depression Eight is moving along the Eastern Seaboard.

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

As we noted last week, equity markets are trading at the upper end of the range defined by the relationship between the Federal Reserve's balance sheet and equities. To some extent, the level of the relationship is somewhat less important than what the expanded balance sheet signals, which is that monetary policy remains accommodative. In our AAW from June 24, 2016, we discussed St. Louis FRB President Jim Bullard's paper on monetary regimes. Bullard is projecting only one rate hike of 25 to 50 bps over the next two years unless economic conditions change, a position for which he has taken some criticism. However, we note that a recent paper by San Francisco FRB President Williams suggests that the neutral real interest rate has probably declined to near zero, meaning that if inflation is 2%, the target rate for fed funds that would be neither stimulative nor restrictive would be 2% as well. To stimulate growth, the policy rate would need to be below 2%, suggesting little room to raise rates. Although various U.S. central bank officials keep suggesting that every meeting is "live," meaning a rate change could occur, the reality is that there appears to be a distinct intellectual trend toward the idea that the slow growth the economy is facing is more than just temporary headwinds. In fact, Ben Bernanke recently blogged that the FOMC does appear to be shifting its perspective on the economy in a dovish direction.[1]

There is increasing attention on fiscal policy. We note that both presidential candidates are calling for increases in infrastructure spending. Our review of economic literature shows little consensus on the multiplier effect of government investment spending; there is no doubt, however, that the state of U.S. roads would be improved by repairs. On the other hand, it isn't obvious what sort of investment the government could make that would equate to the building of the interstate highway system or the dam building of the Great Depression. If the Federal Reserve and the government coordinated stimulus through direct funding ("helicopter money"), the effect could be substantial, although its most important impact might be in currency depreciation.[2]

What this all means is that the financial markets, which have been projecting significantly less tightening than the "dots" chart has been signaling, are probably correct. Interest rates will likely remain low and the terminal rate will probably come nowhere close to what we saw prior to the 2008 Financial Crisis. This situation puts policymakers in a difficult position. In both the U.S. and in Europe, there is great reluctance for fiscal expansion. Most of the policymakers came of age during the high inflation years of the 1970s and early 1980s and are quite skeptical of government spending. If a recession were to develop, the Federal Reserve would find itself at the zero bound rather quickly. At that point, all monetary policy could offer is either QE4 or

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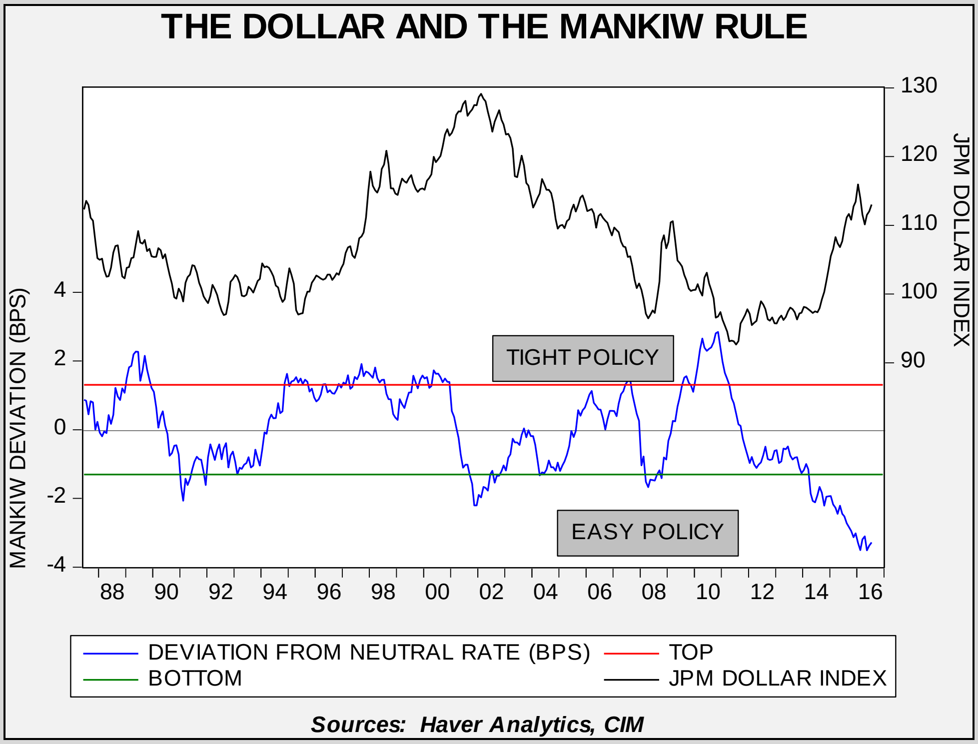
[1] https://www.brookings.edu/blog/ben-bernanke/2016/08/08/the-feds-shifting-perspective-on-the-economy-and-its-implications-for-monetary-policy/

[2] See WGR: The Geopolitics of Helicopter Money, Part I (5/2/16), Part II (5/9/16), and Part III (5/16/16).

negative nominal rates. The former might help equities but foreign experience with negative nominal rates has been quite disappointing.

So far, policymakers in the major economies have avoided competitive currency depreciation. However, a move to such policies will become increasingly tempting as other tools fail to deliver growth. This was the pattern seen during the 1930s.

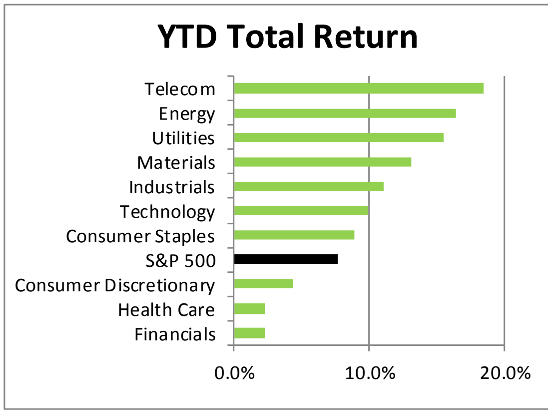


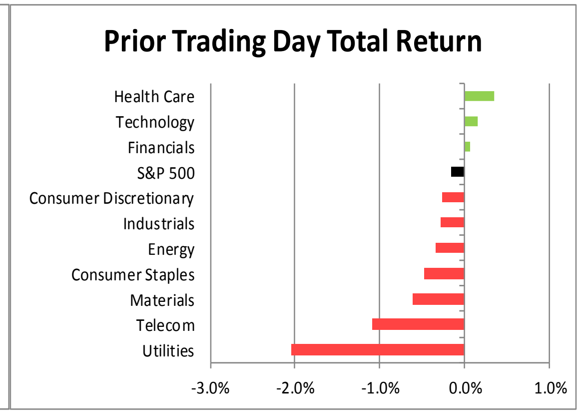
This chart shows the deviation from the Mankiw Rule model, using core CPI and the unemployment rate along with the dollar index. In the past, the FOMC paid little attention to the dollar in setting policy. However, commentary from the Fed minutes suggests "international" concerns are being discussed at length. We suspect that the dollar (using the JPM effective exchange rate as a proxy) would need to fall before the FOMC would consider raising rates.

This means that, despite protests to the contrary, the FOMC probably won't raise rates for a while unless (a) the dollar weakens, (b) core inflation unexpectedly rises, or (c) unemployment falls further. The risk of a rate hike is that it would push the dollar higher and tighten policy more than the FOMC would want. This puts the Fed in something of a quandary. They would like to have a higher rate in place, if for nothing more than to give them room to lower rates into the next downturn. However, due to the uncertainty surrounding the reaction of the dollar, we expect monetary policy to remain on hold into 2017, assuming the three conditions noted at the top of this paragraph don't arise. If that is the case, equity values should remain supported.

Data Section

U.S. Equity Markets – (as of 8/26/2016 close)

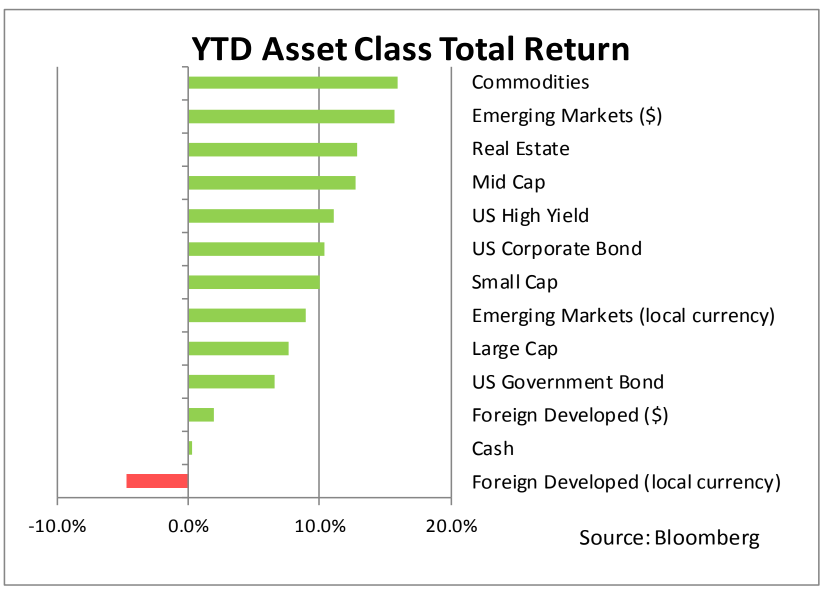




(Source: Bloomberg)

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 8/26/2016 close)

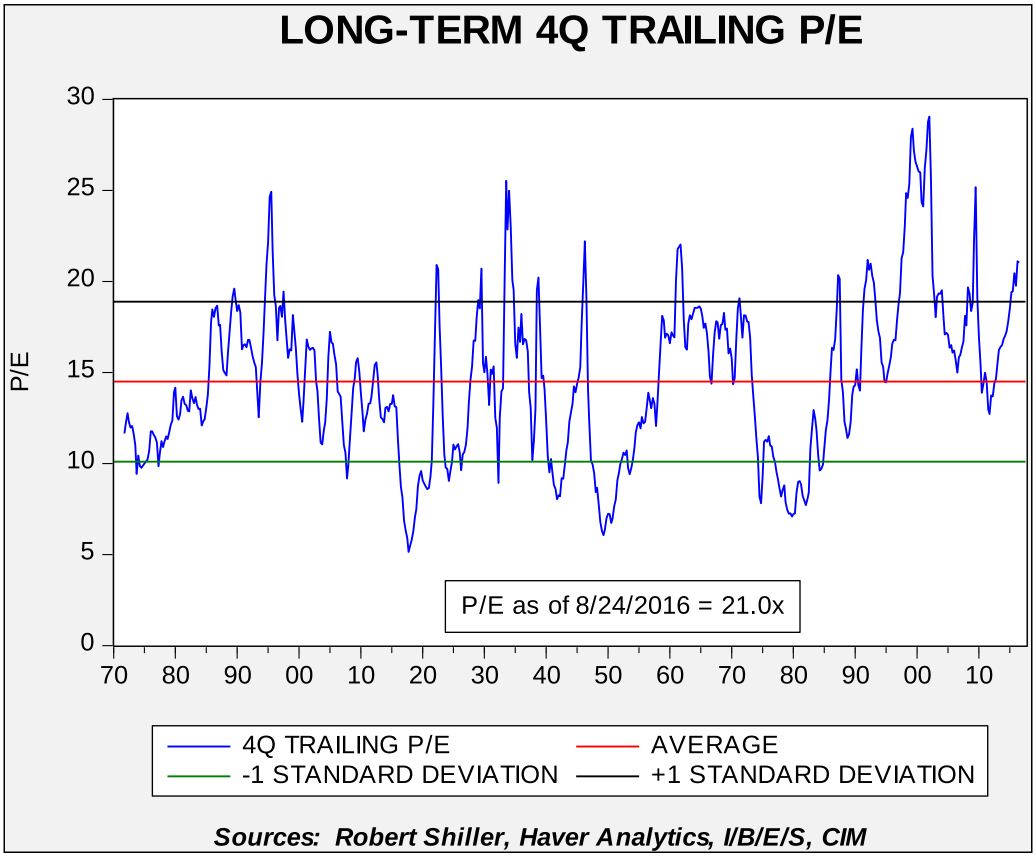


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2016



Based on our methodology,[3] the current P/E is 21.0x, unchanged from last week.

This report was prepared by Bill O'Grady and Kaisa Stucke of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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[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 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.