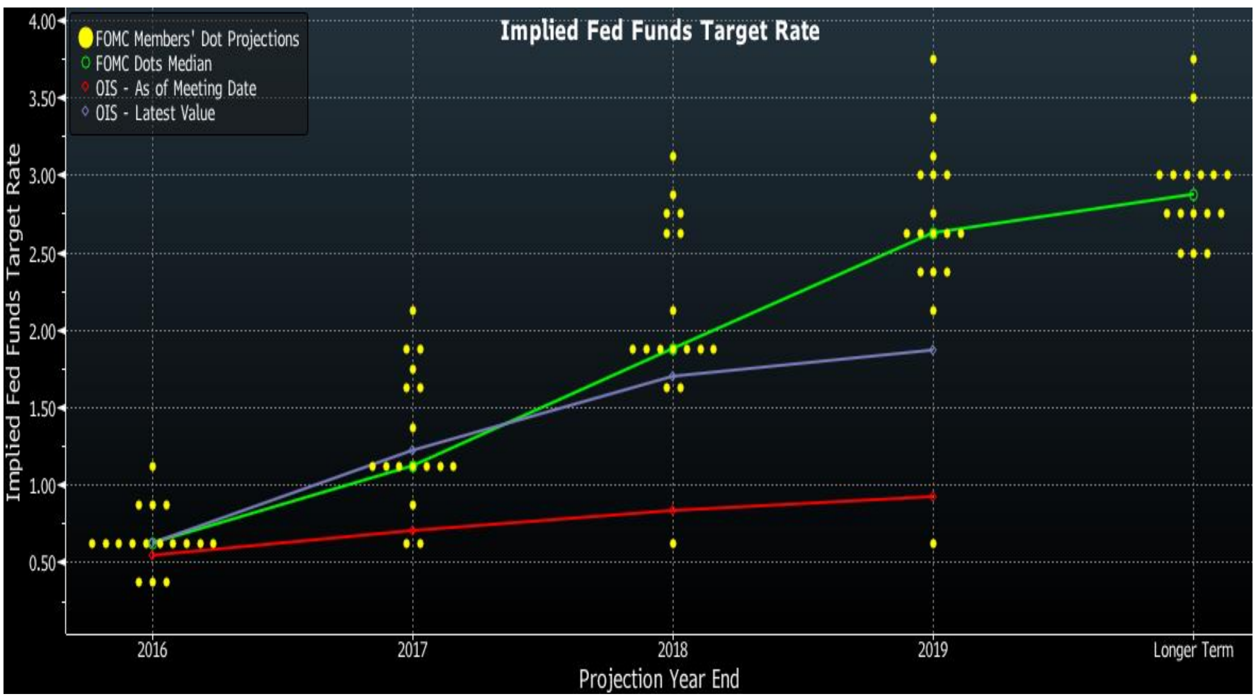
By Bill O'Grady, Kaisa Stucke,
and Thomas Wash

[Posted: December 15, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed 1.5% lower from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.7% and the Shenzhen index higher by 0.7%. U.S. equity futures are signaling a steady to lower open.

The Fed gave us a modest hawkish surprise, calling for three rate hikes in 2017 rather than two. That was taken as bearish by the financial markets yesterday with Treasury yields rising, equities declining and the dollar rising. U.S. equities are mostly flat this morning, but the dollar is sharply higher and Treasury yields are continuing to rise.

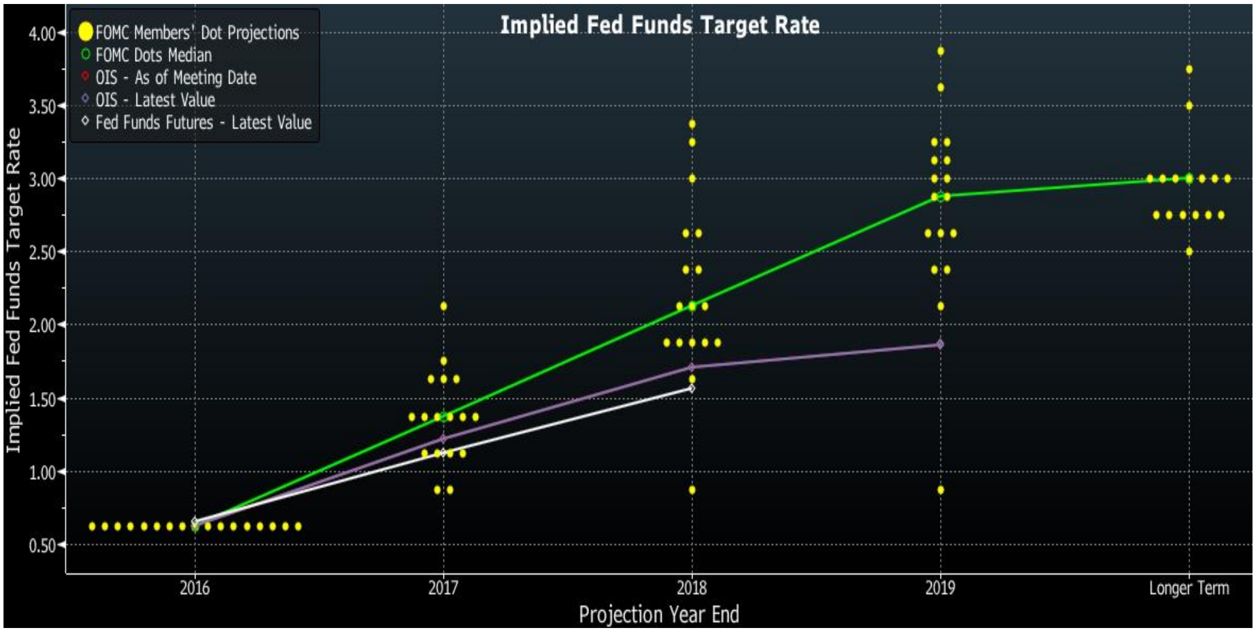
Here is the dots plot from September.



(Source: Bloomberg)

Note the purple line, which is the LIBOR-OIS curve from yesterday. It has jumped from where it was on the meeting date in September, shown by the red line.

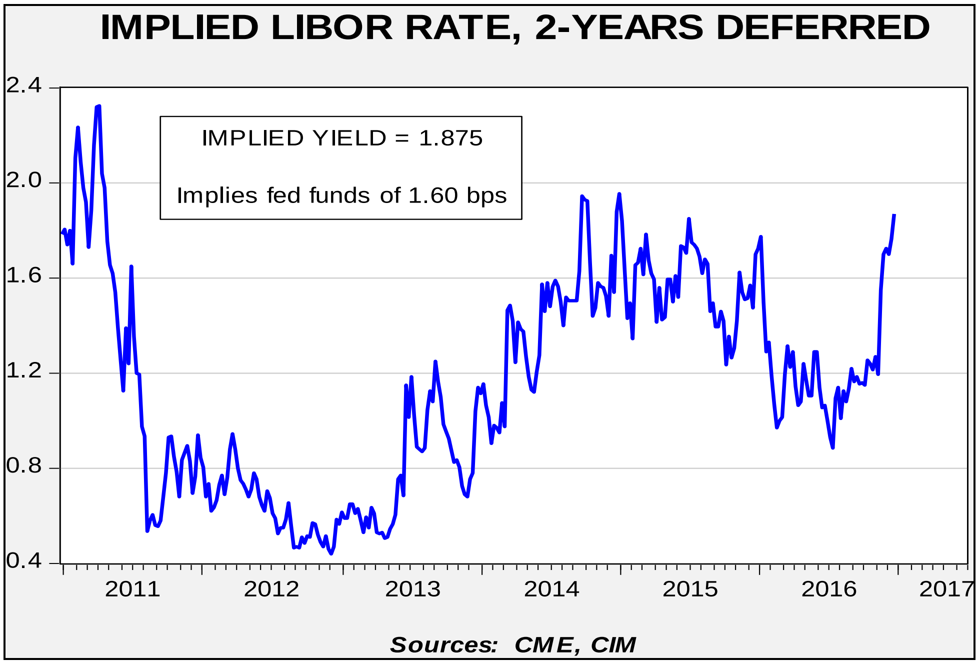
Now, the current dots plot.



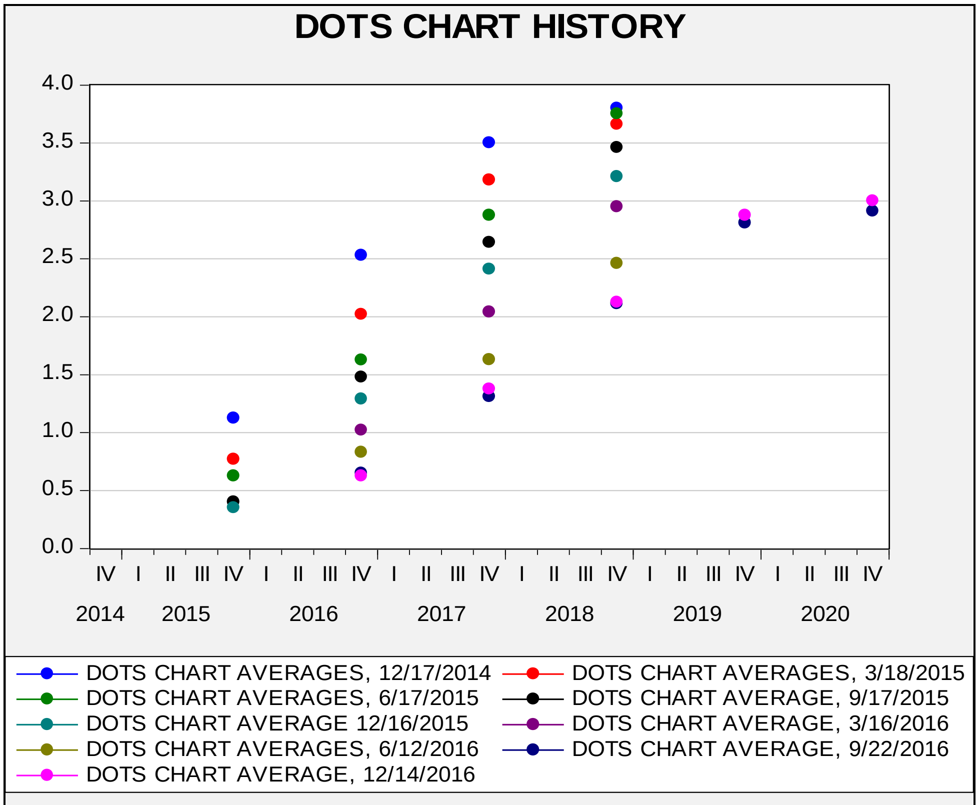
(Source: Bloomberg)

For 2017, the median forecast is currently 1.375%, up from 1.125% in September. For 2018, the median is up to 2.125% from 1.875%. Two participants see no change next year but one of those is probably St. Louis FRB President Bullard, who has decided not to participate in the dots procedure. Although the market expectations continue to lag, we did see the LIBOR-OIS rate rise to 1.25% from 0.875% in September.

This can be seen in the deferred Eurodollar futures.



The jump in yields since Trump's election has been striking. We are approaching the highest level of implied rates since the "taper tantrum." This rise triggered the onset of the dollar rally in mid-2014 and we note that the dollar has been rising since the election.

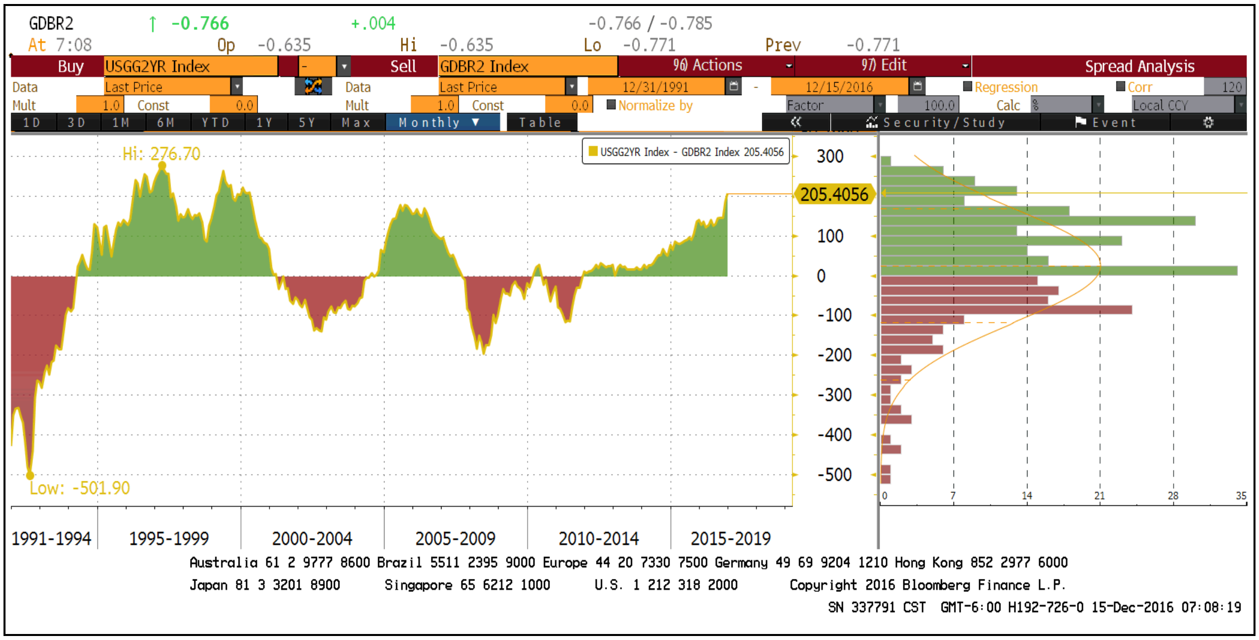


Sources: Federal Reserve, CIM

The fuchsia dots represent yesterday's report. It is important to note that the dots have stopped their steady progression to lower levels. For better or worse, the path of policy expectations from the dots suggests that the FOMC is becoming comfortable with this path of hikes.

So, unexpectedly, the FOMC was hawkish yesterday. It is projecting three hikes in 2017 and 2018. As the dots chart history shows, what tends to occur is that rate forecasts fall as time passes. That pattern appears to have stopped. Normalization of monetary policy appears to be accelerating. Adding to the hawkish tone was a warning of sorts from Chair Yellen who, in the press conference, downplayed the need for fiscal stimulus, a key element of the Trump platform. Thus, if Trump is able to push through a significant stimulus package, it is possible the FOMC could become even more hawkish.

Although the reaction in Treasuries is remarkable, the dollar's rally is equally impressive. Here is one of the key reasons why.



(Source: Bloomberg)

This chart shows the spread between the U.S. and German two-year sovereigns. The spread has widened to its highest level since the late 1990s. By 2000-01, the €/$ exchange rate had fallen well below parity. If this rate spread persists, the dollar will rise further and act as a policy tightening.

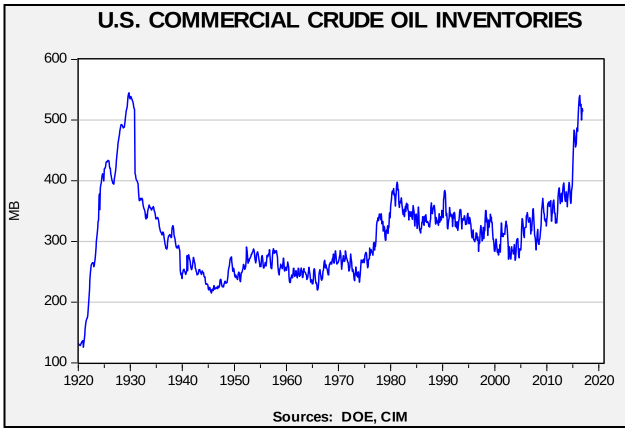
We have been closely monitoring the evolution of the incoming Trump presidency to see which constituent group he will favor. Colloquially, we have framed this as Bannon v. Ryan, although Chief of Staff Preibus is a key player as well. Preibus did an interview with conservative radio host Hugh Hewitt yesterday where he suggested that Trump's primary agenda will be to change the Affordable Care Act (ACA) and tax cuts. Politico reported that a "surprising" number of Democratic lawmakers are "open" to replacing the ACA, probably because so many Democratic Party senators are up for re-election in 2018. At the midterms, 25 Democrats are facing re-election and 10 of those states were won by Trump.

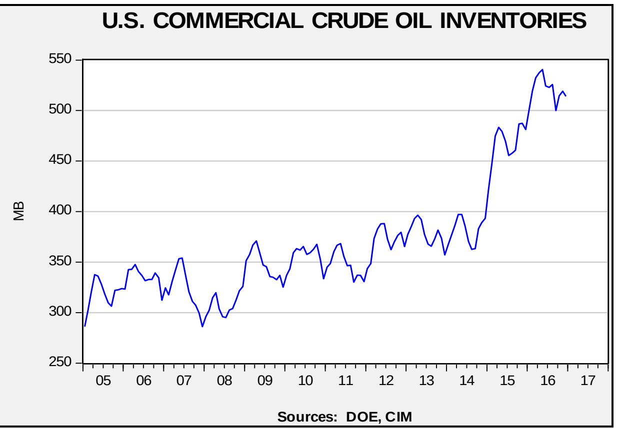
What appears to be shaping up is that the GOP establishment is planning to radically change the ACA in return for tax cuts, assuming that Obamacare will be popular with right-wing populists. This has the potential to be a major mistake. Although the ACA isn't popular, it may not be for the reasons the establishment thinks. The establishment seems to believe the unpopularity is because of the government's interference in medical care; more likely, it's because the ACA didn't produce what populist America really wanted, which is unlimited free health care. Gutting the ACA and leaving lower income Americans without health care could prove to be a disaster for the GOP. And, tax cuts won't really help the bottom 80%.

We want to stress that President-elect Trump is capable of aggressive shifts in policy. He could surprise the establishment and press for trade restrictions and infrastructure spending after all, but pushing a populist agenda with the cabinet he has constructed so far may be difficult. If he disappoints the populists, 2020 could be another change election.

In our recently published [2017 Geopolitical Outlook] we warned of a series of elections in Europe that could lead to further populist power in the region. Another may be brewing. Greece is in the midst of an impasse with its creditors and the European Stability Mechanism leadership has frozen its payments on a €86 bn support package. The Tsipras government implemented a series of social spending measures and, in response, the EU has suspended support. If the economy collapses, we could see snap elections and perhaps the decision by Greece to exit the Eurozone.

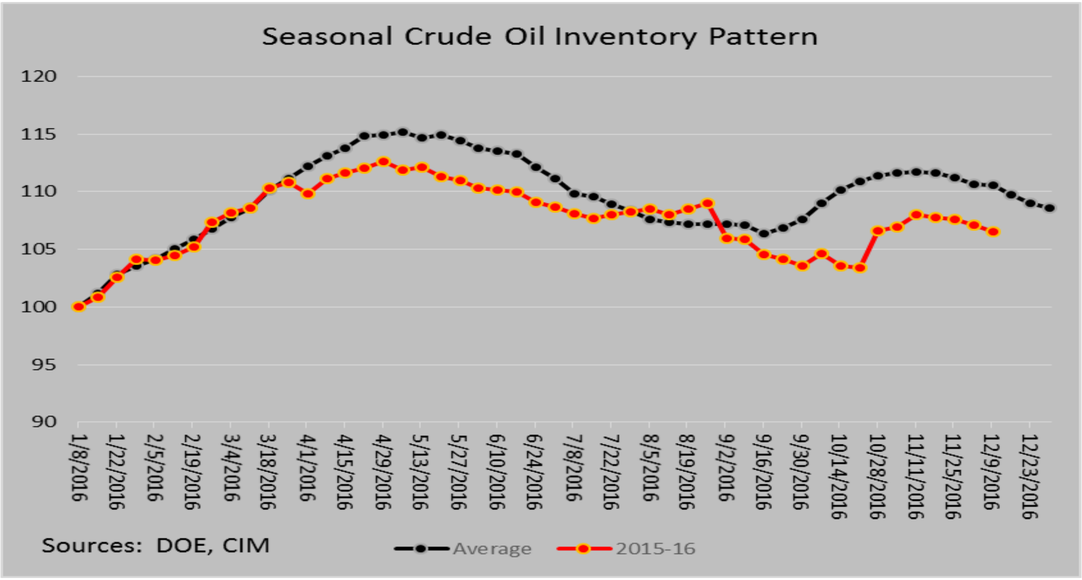
U.S. crude oil inventories fell 2.4 mb compared to market expectations of a 1.5 mb draw.

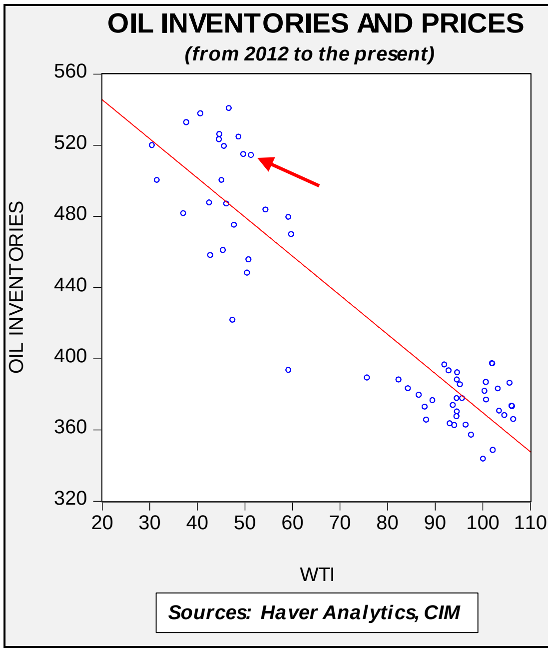


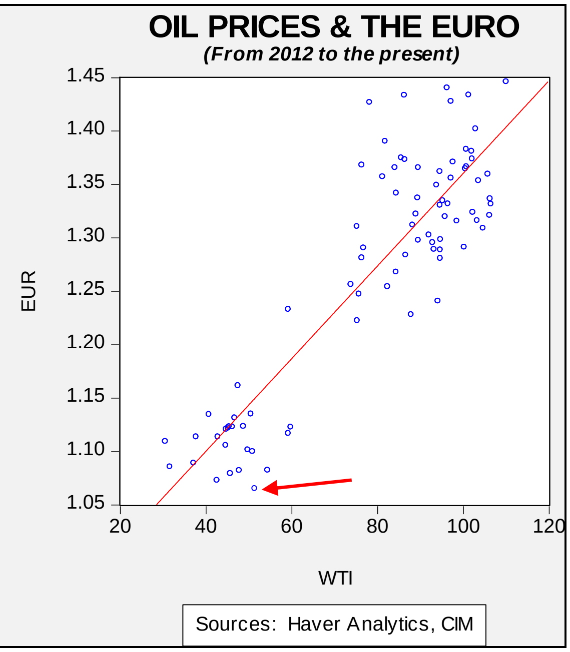


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, inventories remain elevated.

The annual seasonal pattern suggests inventories should decline into year's end. This week's data is consistent with that relationship.





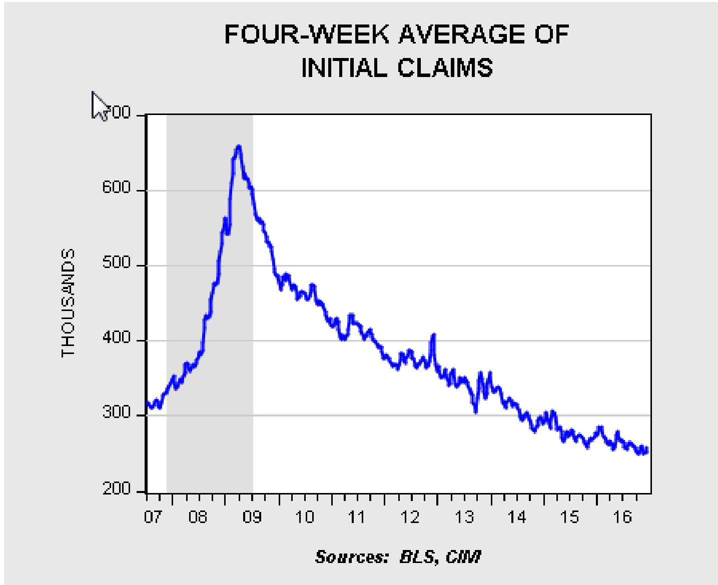


Based on inventories alone, oil prices are overvalued with the fair value price of $41.25. Meanwhile, the EUR/WTI model generates a fair value of $36.82. Together (which is a more sound methodology), fair value is $37.49, meaning that current prices are well above fair value.[1] OPEC has managed to lift prices but maintaining these levels will be a challenge given the dollar's strength and the continued elevated levels of inventory.

U.S. Economic Releases

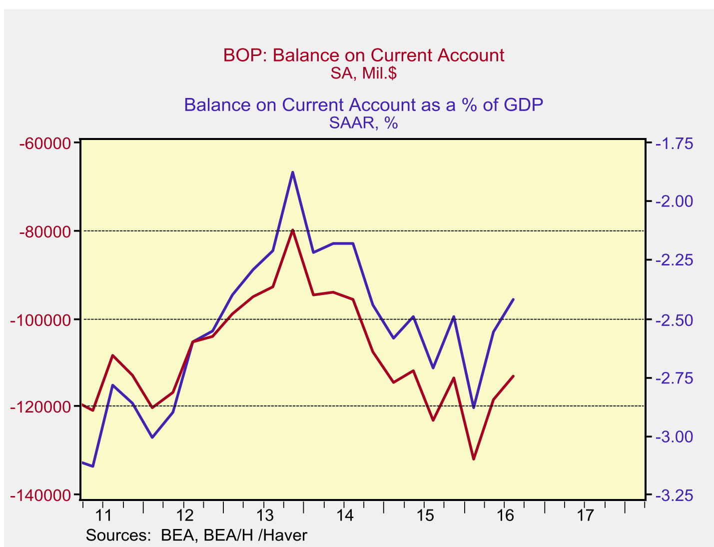
Initial jobless claims came in below forecast at 254k compared to the forecast of 255k. This marks the 93rd straight week of claims below 300k, supporting the notion that the labor market is relatively strong.

[1] The reason the combined model is calculating a fair value price below the individual models for the euro and oil stocks is due to the fact that the euro and oil stocks are collinear. In other words, the euro and oil stocks are correlated at -88.8%, meaning a weaker euro usually means higher oil stocks. The fact that oil inventories are falling into a weakening euro is unusual.



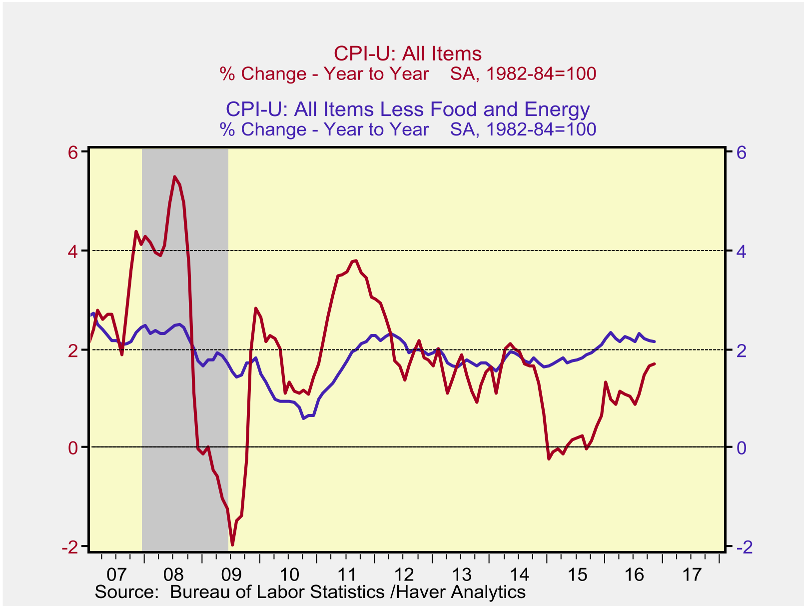
The chart above shows the four-week moving average of initial claims. The four-week moving average rose from 252.5 to 257.75. Initial jobless claims seem to be following a downward trend.

The current account balance came in wider than expected at a deficit of $113 bn, while the forecast had called for a deficit of $111.6 bn. The prior report was revised narrower from a deficit of $119.9 bn to a deficit of $118.3 bn.



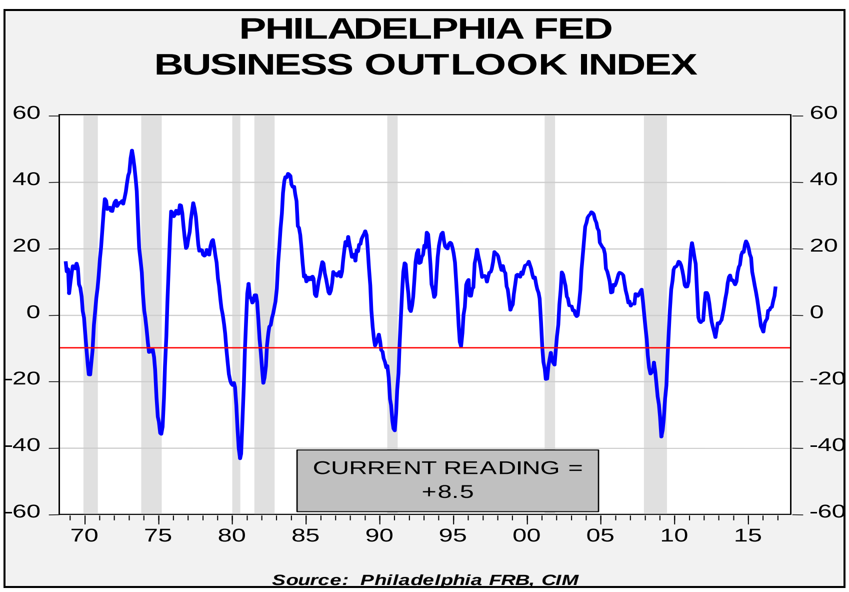
The chart above shows the relationship between the balance on current account and the balance on current account as a percentage of GDP. The increase shows that the U.S. trade deficit is narrowing. We do not expect this trend to hold as the dollar becomes stronger.

CPI came in on forecast for November, rising 0.2% from the month before. Core inflation also came in on forecast at 0.2%

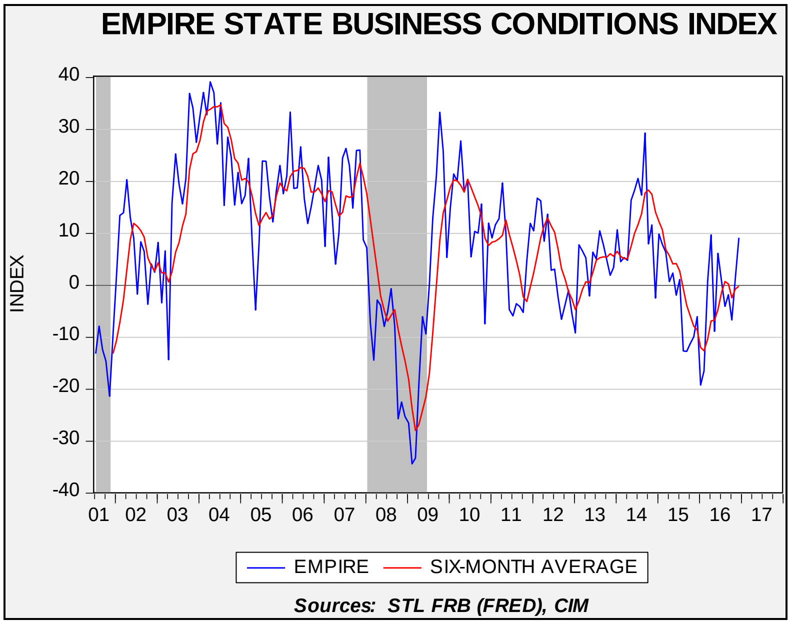


The chart above shows the annual change in headline consumer inflation and core inflation. Headline inflation rose 1.7% annually, on forecast. Core prices rose 2.1% annually, slightly less than the 2.2% increase expected.

The December Philadelphia FRB Business Outlook Survey came in stronger than expected at 21.5 compared to expectations of 9.1. The chart below shows the data, smoothed with a six-month moving average. Any reading above zero suggests expansion. We are seeing steady improvement in the Northeast's economy and no sign of recession.



The Empire State manufacturing index for December showed similar improvement, coming in at 9.0 compared to expectations of 4.0.



The six-month average has recovered to positive levels, which does suggest an improving New York economy. Both the Philadelphia FRB and Empire State data suggest an improving economy. Real average weekly earnings showed an increase of 0.5%.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Confidence	m/m	dec		45.1	**
9:45	Markit US Manufacturing PMI	m/m	dec	54.5	54.1	**
10:00	NAHB Housing Market Index	m/m	dec	63	63	**
16:00	Total Net TIC Flows	m/m	dec		-$152.9 bn	**
16:00	Net Long-term TIC Flows	m/m	dec		-$26.2 bn	**

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	Nikkei Japan PMI Mfg	y/y	dec	51.9	51.3		**	Equity and bond neutral
	Machine Tool Orders	y/y	nov	-5.6%	-5.6%		**	Equity and bond neutral
India	Trade Balance	m/m	nov	-$13.01 bn	-$10.16 bn	-$10.5 bn	**	Equity bearish, bond bullish
	Imports	m/m	nov	10.4%	8.1%		**	Equity bearish, bond bullish
	Exports	m/m	nov	2.3%	9.6%		**	Equity bearish, bond bullish
New Zealand	BusinessNZ Manufacturing PMI	y/y	nov	54.4	55.2		**	Equity and bond neutral
	Value of All Buildings	q/q	3q	1.4%	5.5%	2.1%	*	Equity and bond neutral
Australia	Consumer Inflation Expectation	m/m	nov	3.4%	3.2%		**	Equity and bond neutral
	Employment Change	m/m	nov	39.1k	9.8k	17.5k	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	nov	5.7%	5.6%	5.6%	***	Equity and bond neutral
	Participation Rate	m/m	nov	64.6%	64.4%	64.5%	**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	y/y	dec	54.9	53.7	53.7	**	Equity bullish, bond bearish
	Markit Eurozone Services	y/y	dec	53.1	53.8	53.8	**	Equity and bond neutral
	Markit Eurozone Composite	y/y	dec	53.9	53.9	53.9	**	Equity and bond neutral
Germany	Markit Germany Manufacturing	y/y	nov	55.5	54.3	54.5	**	Equity and bond neutral
	Markit Germany Services	y/y	nov	53.8	55.1	54.9	**	Equity and bond neutral
	Markit Germany Composite	y/y	oct	54.8	55.0	54.9	**	Equity and bond neutral
France	Markit France Manufacturing	y/y	oct	53.5	51.7	51.8	**	Equity bullish, bond bearish
	Markit France Services	m/m	nov	52.6	51.6	51.9	**	Equity and bond neutral
	Markit France Composite	y/y	nov	52.8	51.4	51.6	**	Equity and bond neutral
UK	Retail Sales	y/y	nov	6.6%	7.6%	6.0%	**	Equity and bond neutral
	Retail Sales ex Auto Fuel	y/y	nov	5.9%	7.6%	6.0%	**	Equity and bond neutral
Italy	General Government Debt	y/y	oct	2.224 tn	2.212 tn		**	Equity and bond neutral
Russia	Industrial Production	y/y	nov	2.7%	-0.2%	0.3%	***	Equity bullish, bond bearish
	PPI	y/y	nov	4.3%	3.1%	3.9%	**	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	y/y	oct	-5.3%	-3.7%	-5.5%	**	Equity and bond neutral
Canada	Manufacturing Sales	y/y	oct	-0.8%	0.3%	0.4%	**	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)	96	96	0	Neutral
3-mo T-bill yield (bps)	51	53	-2	Down
TED spread (bps)	45	43	2	Up
U.S. Libor/OIS spread (bps)	66	66	0	Neutral
10-yr T-note (%)	2.61	2.57	0	Neutral
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	56	51	5	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	down			Up
franc	down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Federal Funds Upper Bound	0.75%	0.50%	0.75%	On forecast
FOMC Federal Funds Lower Bound	0.50%	0.25%	0.50%	On forecast
RBA FX Transactions Other	$34 mn	$26 mn		On forecast
RBA FX Transactions Market	$503 mn	$439 mn		On forecast
RBA FX Transactions Government	$549 mn	-$450 mn		On forecast
Bank of Englan Bank Rate	0.25%	0.25%	0.25%	On forecast
BOE Asset Purchase Target	435 bn	435 bn	435 bn	On forecast
BOE Corporate Bon Target	10 bn	10 bn	10 bn	On forecast
SNB 3-Month Libor Lower Target	-1.25%	-1.25%	-1.25%	On forecast
SNB 3-Month Libor Upper Target	-0.25%	-0.25%	-0.25%	On forecast
SNB 3-Sight Deposit Interest Rates	-0.75%	-0.75%	-0.75%	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	$54.10	$53.90	0.37%	Falling Crude inventories
WTI	$50.95	$51.04	-0.18%	
Natural Gas	$3.49	$3.54	-1.47%	
Crack Spread	$14.97	$14.90	0.48%	
12-mo strip crack	$16.17	$16.22	-0.29%	
Ethanol rack	$1.90	$1.92	-0.67%	
Metals				
Gold	$1,127.77	$1,142.95	-1.33%	Federal Reserve decision to raise rates
Silver	$16.07	$16.84	-4.55%	
Copper contract	$258.05	$260.45	-0.92%	
Grains				
Corn contract	$ 360.25	$ 362.00	-0.48%	
Wheat contract	$ 415.00	$ 418.00	-0.72%	
Soybeans contract	$ 1,021.75	$ 1,023.75	-0.20%	
Shipping				
Baltic Dry Freight	1003	1052	-49	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.6	-1.5	-1.1	
Gasoline (mb)	0.5	2.0	-1.5	
Distillates (mb)	-0.8	1.0	-1.8	
Refinery run rates (%)	0.1%	0.5%	-0.4%	
Natural gas (bcf)		-134.0		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, while the eastern region is expected to see warmer temps. Precipitation is also expected for the northwestern and eastern regions.

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.

December 9, 2016

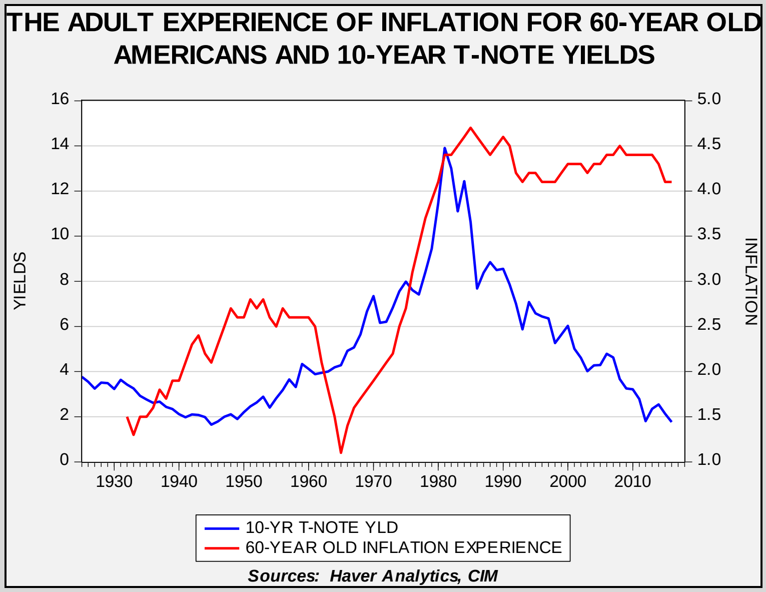
The rapid rise in longer duration Treasury yields since the presidential election has been surprising. As of December 8, the 10-year T-note yield was approximately 2.40%. Although President-elect Trump's policies will probably be inflationary, it is still unclear how much of his arguably vague plans will get passed. It is possible the FOMC will become more hawkish and we have seen some increase in rate hike expectations.[2] Still, our 10-year T-note model is putting the fair value yield at 1.85%. Assuming fed funds at 1.25% still only raises the 10-year rate to 2.20%. Taking oil to $60 and assuming the 1.25% fed funds only raises the fair value yield to 2.27%. Only when assuming steady oil, fed funds at 1.25% and German bunds at 1.25% (up from the current 33 bps) does the yield even reach 2.40%. The current spike in yields can be best justified by assuming a significant jump in inflation expectations.

In our yield model we use the 15-year average of CPI as a proxy for inflation expectations. This assumption comes from the work of Milton Friedman, who postulated that inflation expectations are derived over a long-term time frame. We realize our calculation is a proxy but have refrained from using more market-based expectations because of their lack of predictability. If one assumes that nominal rates are the sum of the expectations of real rates plus inflation forecasts, inflation forecasts are very important to predicting nominal interest rates.

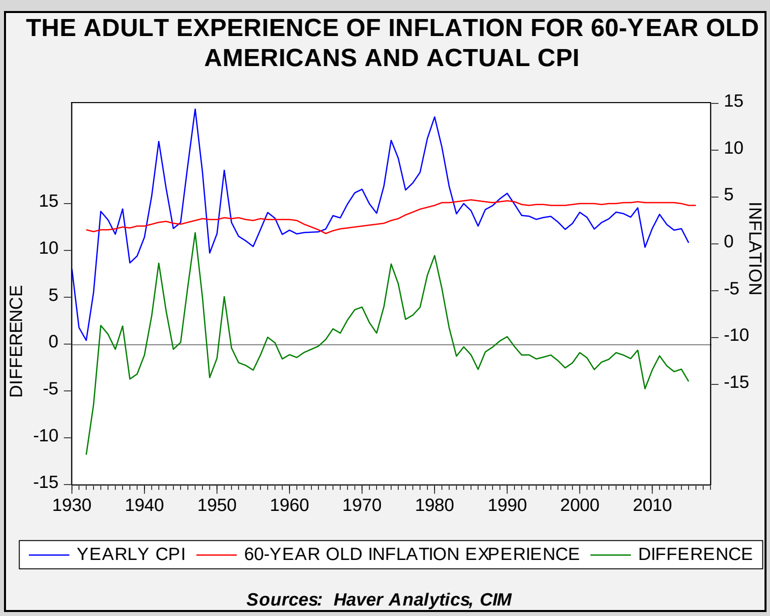
If the lifetime experience of inflation is important, then what is the most important age? We estimate that 60 is a reasonable age; the average age of the Senate is 61 years, the current FOMC average is 62 and the average age of an S&P 500 CEO is 57.[3] Simply put, it's around the age of 60 that people come into power in politics and business. We believe that their personal experiences color the expectations of any investor and so using 60 as an influential age makes sense.

[2] For example, the two-year deferred Eurodollar futures, which measure three-month LIBOR two years into the future, have jumped nearly 50 bps since the election.

[3] http://fortune.com/2015/12/13/oldest-ceos-fortune-500/



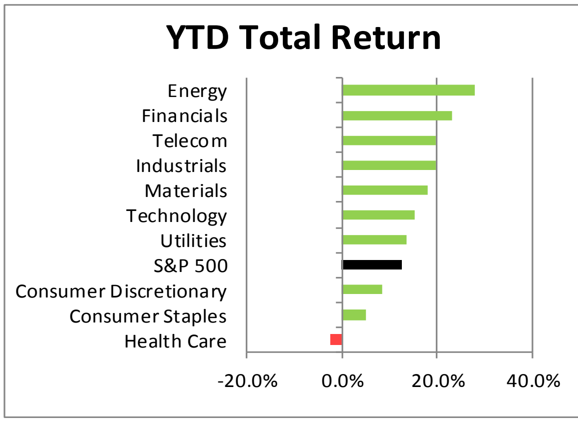
This chart shows the adult experience of inflation for a person turning 60 from 1932 to the present. To reflect the adult experience, we use the average annual change in CPI from ages 16 to 60. Note that inflation experience rose into the late 1940s and stabilized into 1960, when it fell sharply. This was the generation that entered adulthood during the Great Depression. It is interesting to note that as rates began to rise in the mid-1960s, the inflation experience steadily rose as well. Essentially, the rise in rates coincided with the rise in inflation experience. However, after peaking in 1981, bond yields began a steady drop into the current year despite the relatively high level of inflation experience. On the other hand, T-note yields exceeded the inflation experience of 60-year-olds in absolute terms until 2002.

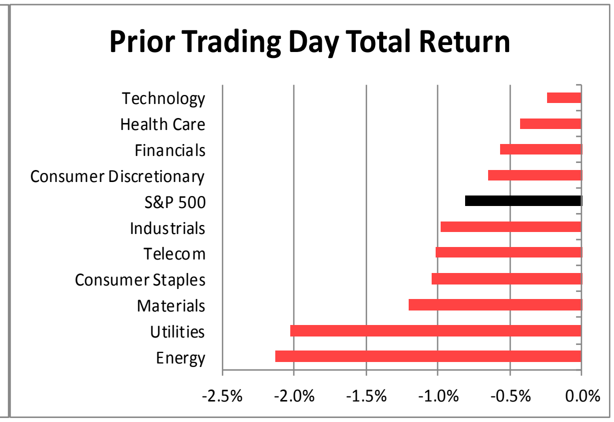


This chart shows the actual inflation rate compared to an average 60-year-old's adult experience of inflation. In general, bull markets in bonds tend to occur when the actual inflation rate is persistently below the average rate. Bear markets happen when the opposite condition is in place. Currently, the actual inflation rate is still well below the average rate, suggesting that the bull market in bonds should have more time to run. However, our worry is that the average 60-year-old is unusually sensitive to inflation fears and thus may overreact to the incoming president's policies. In other words, inflation expectations may become unanchored rather quickly, forcing the Federal Reserve to turn unexpectedly hawkish. Thus, we are taking a more cautious stance on fixed income into 2017, expecting higher yields and greater duration risk. At the same time, we will be closely monitoring the economy in light of less accommodative monetary policy. Most recessions occur because the Fed tightens too much. We don't expect that to become a problem until late next year or early 2018 if the Fed continues to raise rates. So, for the upcoming year, we expect a weak fixed income environment.

Data Section

U.S. Equity Markets – (as of 12/14/2016 close)

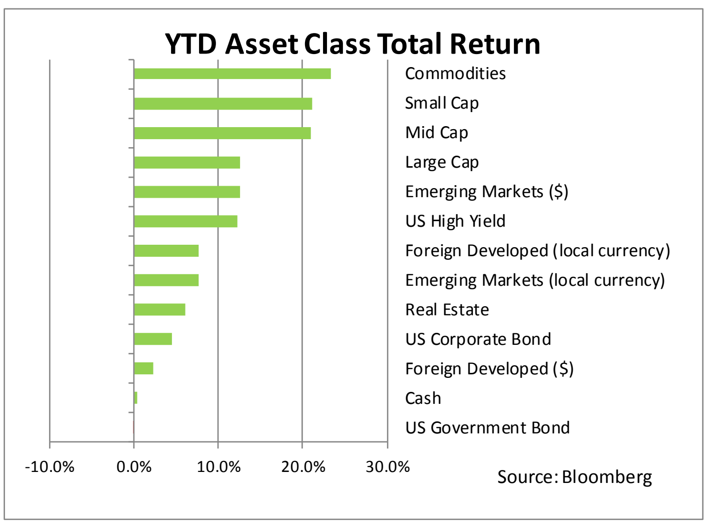




(Source: Bloomberg)

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 12/14/2016 close)

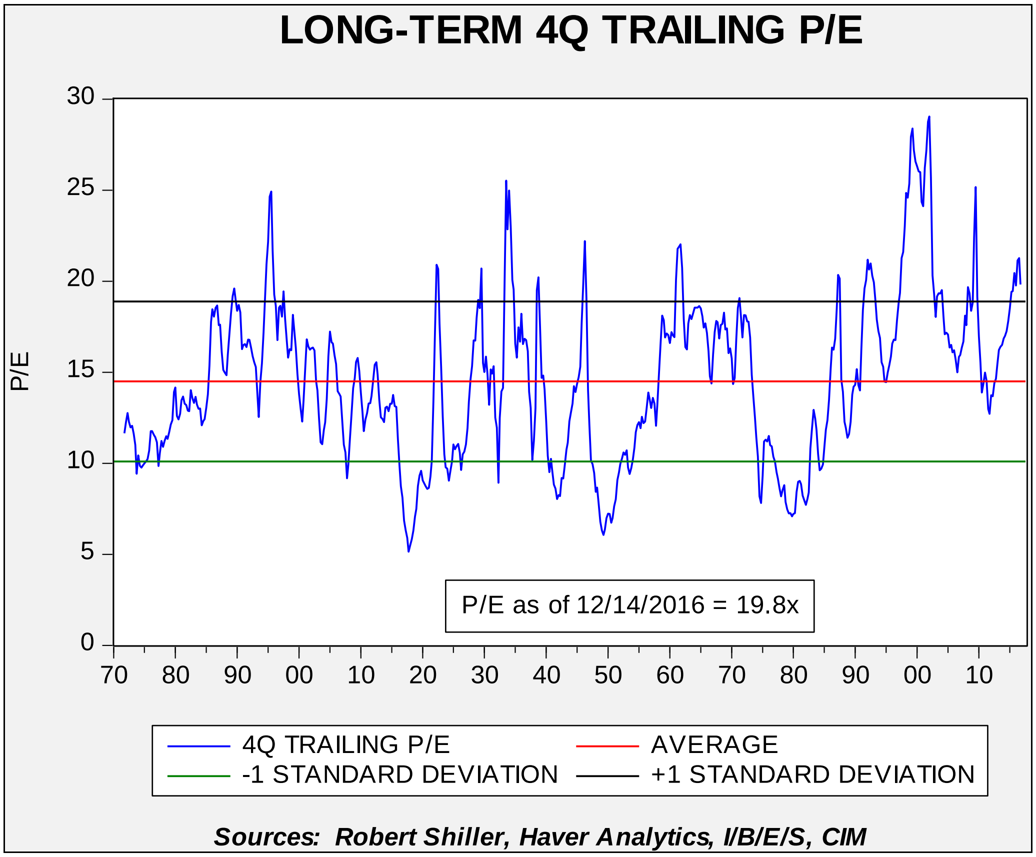


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 15, 2016



Based on our methodology,[4] the current P/E is 19.8x, up 0.1x from last week. Rising equity values led to the rise in the P/E.

[4] 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 the actual (Q1,Q2 and Q3) and one estimate (Q4). 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.