Daily Comment

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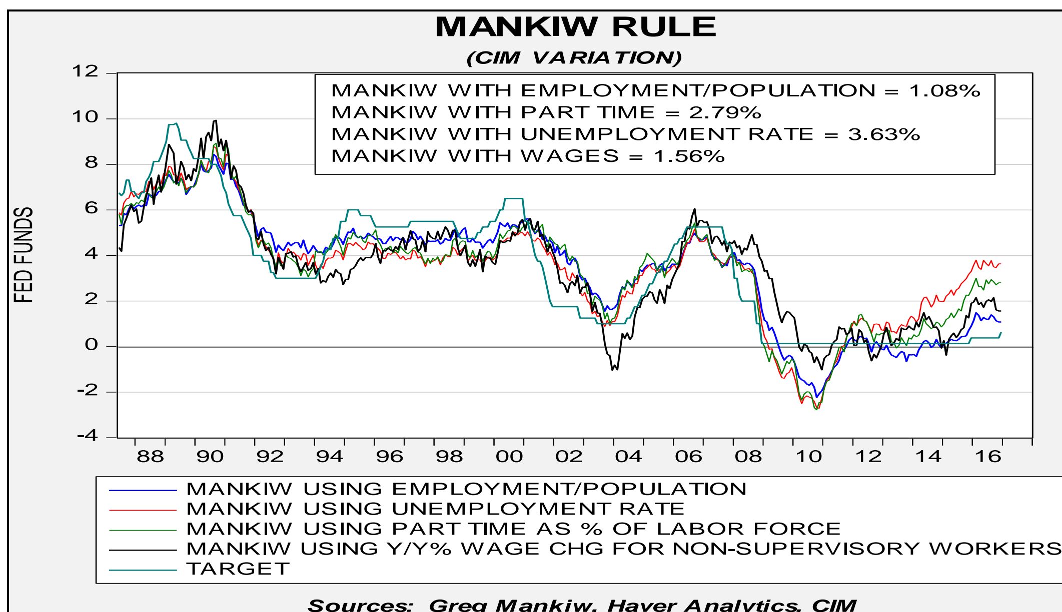
and Thomas Wash

[Posted: December 16, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.1% lower from the prior close. Chinese markets were up, with the Shanghai composite up 0.2% and the Shenzhen index higher by 1.0%. U.S. equity futures are signaling a steady to higher open.

With the release of CPI data, we can update our versions of the Mankiw rule model, incorporating the recent rate changes by the FOMC (we assume December's data will be close to November's releases). This model attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate by core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.

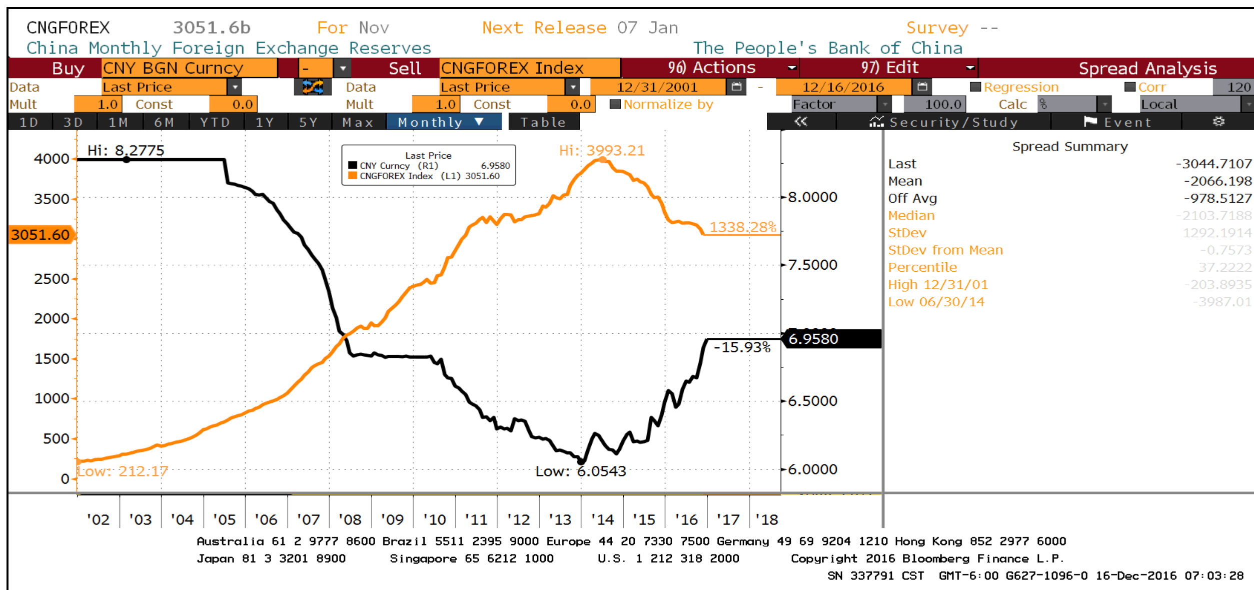


Using the unemployment rate, the neutral rate is now 3.63%. This rate rose 13 bps due to the drop in the unemployment rate, offsetting a modest decline in core CPI. Using the employment/population ratio, the neutral rate is 1.08%, down 5 bps. Using involuntary part-time

employment, the neutral rate is 2.79%, up 6 bps due to the decline in this measure of employment (fewer workers were forced to accept part-time employment when they preferred full-time employment). And, for the new model, the neutral rate is 1.56, down 15 bps on continued sluggish wage growth. What is interesting is that the model rate fell for the employment/population variant and for the wage growth measure as well. On the other hand, the variants using involuntary part-time employment and the unemployment rate have increased.

It is still uncertain which of these variants best reflects slack (or lack thereof) in the economy. Although we tend to think that wage growth or the employment/population ratio is the best measure of slack, the key is what policymakers view as the most consistent with measuring slack. At this point, we don't know, although we think the hawks are probably relying on the unemployment rate variant while the chair probably believes the involuntary part-time employment variant is the best measure. The involuntary part-time employment variant is most consistent with six rate hikes over the next 24 months. That path would bring the policy rate near neutral; however, if they are wrong and, for example, the employment/population ratio is actually correct, then policy will be overly restrictive (assuming that ratio doesn't improve dramatically). Thus, the FOMC is moving rates higher in a slow fashion to allow them time to adjust if it turns out there is more slack (reflected by the lower neutral rate variants) than some data would suggest. Of course, by going slow, assuming the higher neutral rate variants are correct, the Fed could keep policy overly accommodative longer than it should. As long as the economy remains globalized and deregulated enough to allow for the nearly unfettered introduction of new technology, being late isn't all that risky. That's why the incoming President Trump and his potential to put up trade barriers is a key issue for policymakers.

The CNY continues to weaken. This is consistent with the steady decline in foreign reserves.

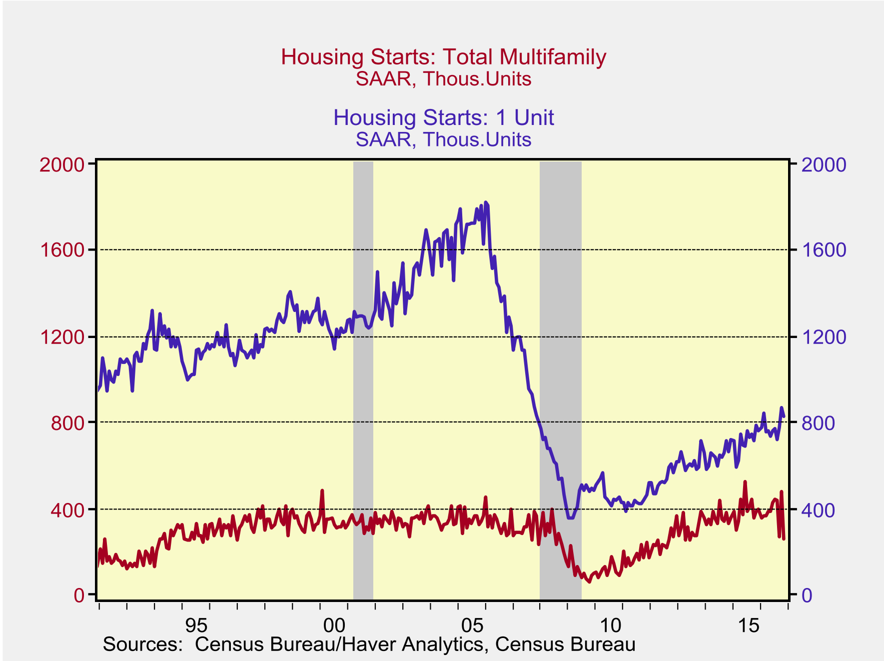


(Source: Bloomberg)

This chart shows the CNY/USD (black line) and the level of reserves (gold line). The former is in CNY per USD, meaning the lower the value the stronger the Chinese currency. Since reserves are calculated in dollars, to the extent that China holds reserves in other currencies a stronger dollar will lead to falling reserves. The key unknown in this graph is which variable is independent; is the CNY weakening due to falling reserves or are reserves declining because of currency weakness? In reality, the relationship is "reflexive," a concept discussed often by George Soros. Simply put, the direction of causality changes over time. At present, we believe that reserves are leaving China because citizens are, for a number of reasons, wanting to invest overseas. This is putting downward pressure on the CNY. We know the PBOC is propping up the CNY, likely fearing that it may encourage faster capital flight if the depreciation accelerates (thus, the reflexive nature of the problem). We see the CNY's weakness as inevitable; U.S. monetary policy by itself will probably lead to that outcome. However, political uncertainty in China is likely playing a role in capital flight, creating a negative feedback loop. The main concern is whether it could trigger a financial crisis if reserves continue to leave China. That is one of the key risks for 2017.

U.S. Economic Releases

Today, housing starts came in below market expectations, falling 18.7% compared to the forecast drop of 7.0%. The lower reading can be attributed to a drop in multi-family home construction. Building permits also saw a steeper than expected decline, falling 4.7% compared to the forecast drop of 1.6%.



The chart above shows single- and multi-family starts. Single-family starts are down 4.1% and multi-family starts are down 45.1%. The sudden drop in housing starts can be attributed to volatility within the housing market due to changes in weather. October was relatively warm and as a result saw an unusual spike in housing starts, while November saw temperatures closer to

normal, leading to less housing construction activity. However, the large percentage declines mostly reflect unusually strong October numbers. If we smooth the overall starts numbers with a three-month moving average, the monthly decline in November was a much more manageable 2.1%.

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

Fed speakers or events		
EST	Speaker or event	District or position
12:30	Jeffrey Lacker Speaks in Charlotte	President of the Federal Reserve Bank of Richmond

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								
New Zealand	ANZ Consumer Confidence Index	m/m	dec	124.5	127.2		**	Equity and bond neutral
	Non Redent Bond Holdings	m/m	dec	63.6%	63.9%		*	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	nov	0.6%	0.6%	0.6%	***	Equity and bond neutral
	CPI Core	y/y	nov	0.8%	0.8%	0.8%	***	Equity and bond neutral
	Trade Balance	y/y	oct	20.1 bn	26.5 bn	29.0 bn	**	Equity bearish, bond bullish
France	Wages	q/q	3q	0.2%	0.2%	0.2%	**	Equity and bond neutral
	Business Confidence	m/m	dec	105	102	102	**	Equity bullish, bond bearish
	Manufacturing Confidence	y/y	dec	106	103	103	**	Equity bullish, bond bearish
	Production Outlook Indicator	y/y	dec	6	3	4	**	Equity bullish, bond bearish
	Own-Company Production Outlook	y/y	dec	8	7	8	**	Equity and bond neutral
Italy	Trade Balance	y/y	oct	4.299 bn	3.67 bn		**	Equity bullish, bond bearish
UK	CBI Trends Total Orders	y/y	dec	0	-3	-5	***	Equity and bond neutral
	CBI Trends Selling Prices	y/y	dec	26	19	20	**	Equity bullish, bond bearish
AMERICAS								
Canada	International Securities Transactions	y/y	oct	15.75 bn	11.77 bn		**	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)	99	97	2	Up
3-mo T-bill yield (bps)	49	49	0	Neutral
TED spread (bps)	50	48	2	Up
U.S. Libor/OIS spread (bps)	65	65	0	Neutral
10-yr T-note (%)	2.59	2.60	0	Neutral
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	55	55	0	Neutral
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	up			Down
pound	up			Up
franc	up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Russia Key Rate	10.00%	10.00%	10.00%	On forecast
Mexico Overnight Rate	5.75%	5.25%	5.50%	Above 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	$54.31	$54.02	0.54%	Falling Crude inventories
WTI	$51.08	$50.90	0.35%	
Natural Gas	$3.39	$3.43	-1.31%	
Crack Spread	$15.28	$15.27	0.09%	
12-mo strip crack	$16.36	$16.43	-0.45%	
Ethanol rack	$1.89	$1.90	-0.59%	
Metals				
Gold	$1,133.50	$1,128.50	0.44%	Depreciating dollar
Silver	$16.07	$15.97	0.60%	
Copper contract	$257.15	$260.05	-1.12%	
Grains				
Corn contract	$ 357.50	$ 356.50	0.28%	
Wheat contract	$ 408.25	$ 409.25	-0.24%	
Soybeans contract	$ 1,032.25	$ 1,029.00	0.32%	
Shipping				
Baltic Dry Freight	966	1003	-37	
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)	-147	-134.0	-13	

Weather

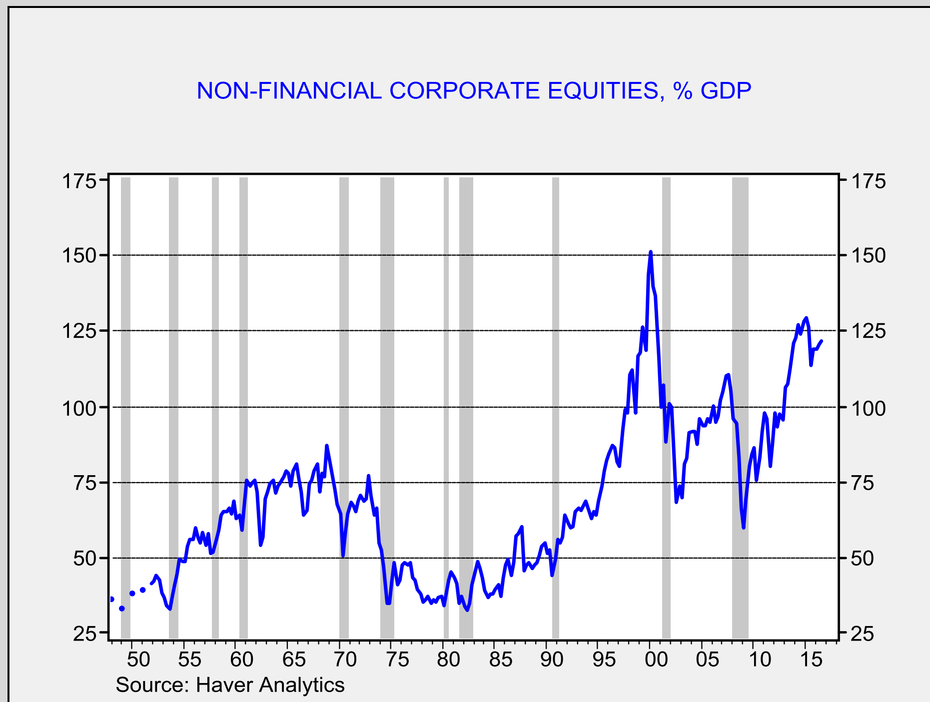
The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, while the eastern region is expected to see warmer temps. Precipitation is also expected for most of the country.

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.

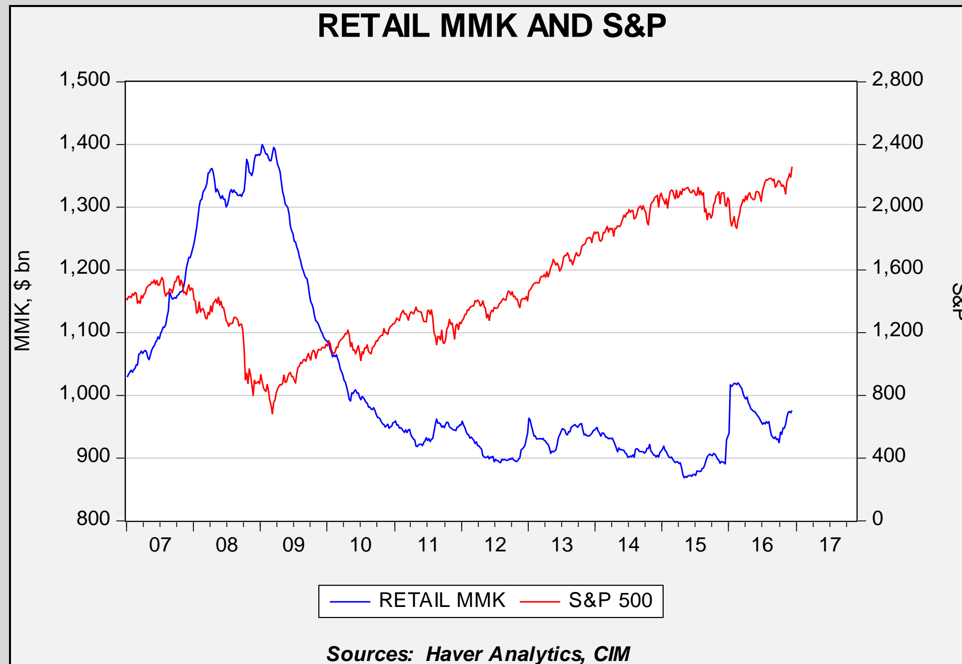
December 16, 2016

Equity markets are expensive by numerous measures and have become even more extended in the wake of the "Trump Rally." As noted in our weekly P/E update (found in the last section of the Daily Comment), our four-quarter measure of the P/E is elevated. Another well-known derivation of the "Buffet Indicator" has also reached lofty levels.



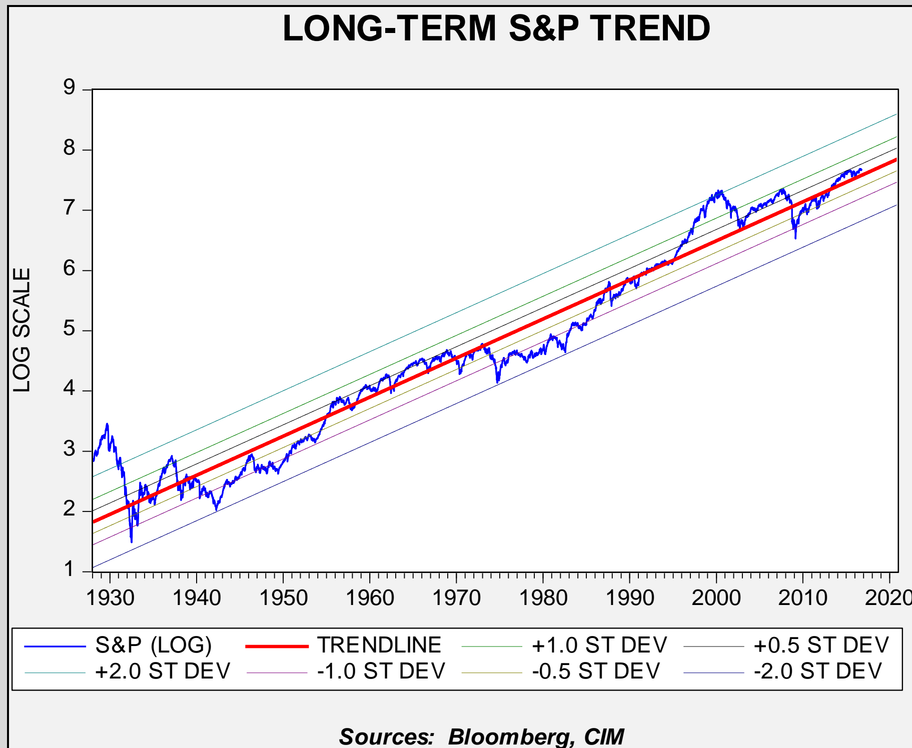
This ratio divides the market value of equities outstanding from the Federal Reserve's Financial Accounts of the U.S. by GDP. Although the ratio is off its recent highs, it is still at the upper end of its historical range.

At the same time, the optimism isn't unfounded. Proposals for corporate tax reform could bring repatriation of the more than $2.0 trillion of corporate cash parked overseas. Tax cuts would boost after-tax earnings. The "E" part of the P/E could rise, making the market less expensive. Another factor to note is that investor cash levels remain elevated.



This chart shows the level of retail money market funds relative to the S&P 500. Since 2011, equities have tended to trend higher when money market fund levels exceed $920 bn. Once money market holdings fall below that level, equities have tended to stall. It appears that investors were building cash in front of the election but, so far, retail investors are not aggressively entering the equity markets. The weekly mutual fund flows suggest that investors are selling out of bonds which probably accounts for the recent rise in money market funds; to date, there isn't any evidence in the same data that equity mutual fund buying is increasing. This data would suggest that there is ample fuel for further gains in equities.

So, if equities are rich but could work higher, how high is high?



On this chart, we log-transform the weekly close of the S&P 500 starting in 1928. The red line is the long-term trend. We have regressed the trend line against the weekly close and have calculated the standard deviation at the ½ level, one deviation and two deviations from trend. Only twice in the past 88 years has the index exceeded two standard deviations to the upside and it has only touched that level on the downside three times. We are currently below ½ deviation on the upside, suggesting that, on a long-term trend basis, equities are not all that extended.

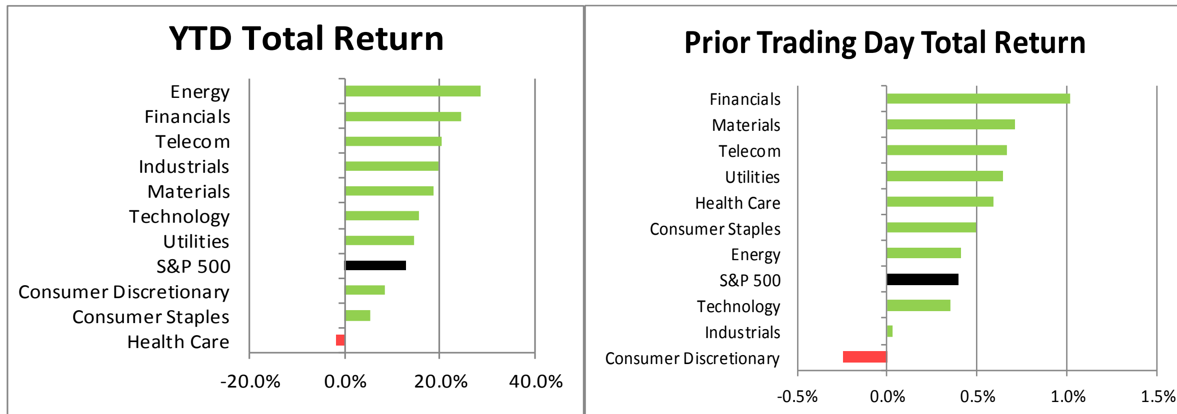
If we reach +½ standard deviation by mid-2017, the S&P 500 would reach 2480.70; the year-end reading would be 2562.22 by the same measure. By comparison, reading the +one standard deviation line would put the index at 2995.80 by June 2017, and 3094.24 by year's end. We are not anticipating a rise to +one standard deviation next year but a rise to the +½ level isn't out of the question.

We still don't know what the specific policies will be of the incoming Trump administration. Tax policy is complicated and there is always the potential for mistakes. The current euphoria surrounding other policies will probably fade over time. And, although the above analysis suggests that equity markets are sporting high valuations, cash levels are high and current equity levels, while above trend, haven't reached levels of concern. Thus, for the time being, the path of least resistance for equities is probably higher.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

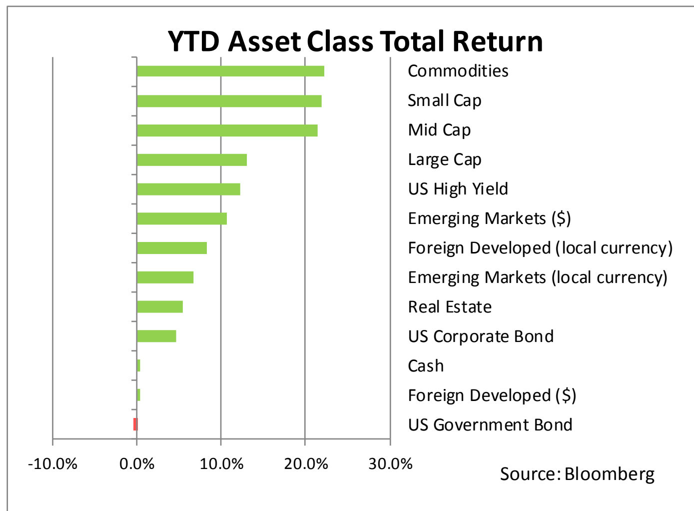
U.S. Equity Markets – (as of 12/15/2016 close)



(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 12/15/2016 close)

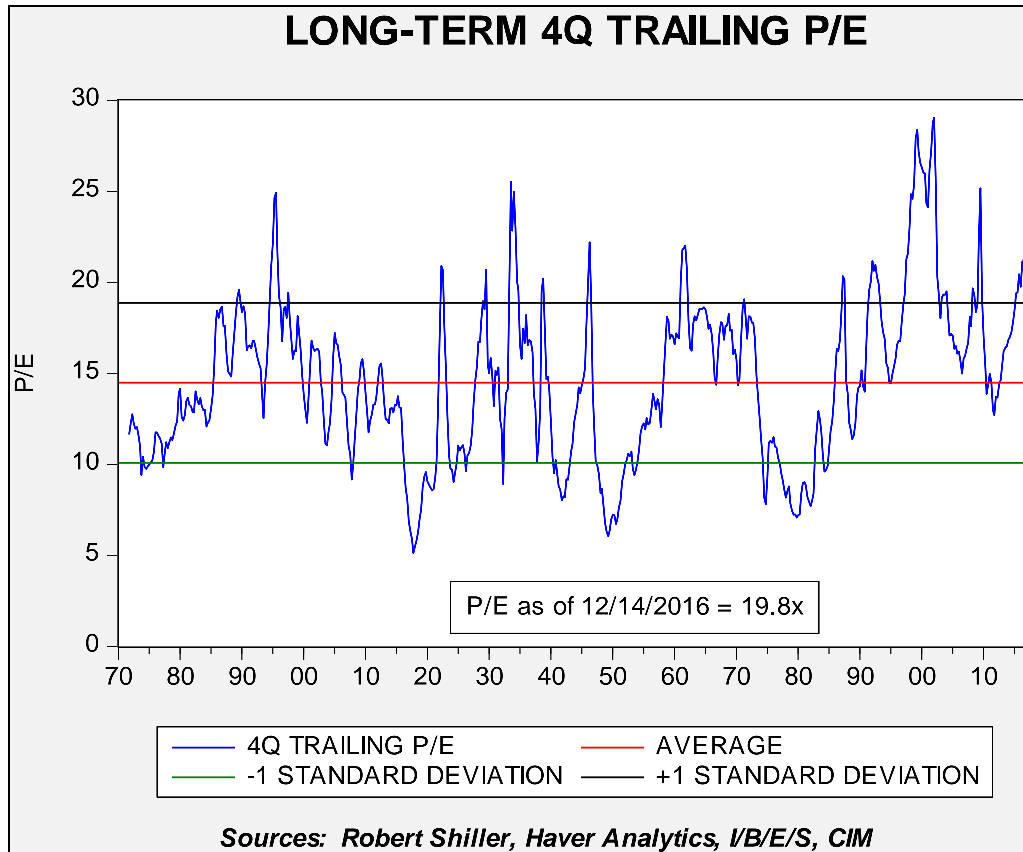


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

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[1] 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.