Daily Comment

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[Posted: December 23, 2016—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.5% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.9% and the Shenzhen index down 1.1%. U.S. equity futures are signaling a flat to lower open.

(Note to readers: We are suspending the Daily Comment next week, starting on Tuesday, December 27. We will restart the report on Tuesday, January 3. From all of us at Confluence Investment Management, we wish you a warm and blessed holiday season!)

Happy Festivus!

Although market activity is quiet, there were a number of new items of note. First, the lead suspect in the Berlin Christmas terrorist event was shot and killed in Milan this morning. Anis Amri, a Tunisian national that was slated for deportation, is thought to have driven the truck used in the attack. According to reports, Amri was traveling by train from France to Italy when he was approached during an ID check. Amri apparently pulled a gun from his backpack and opened fire on security officers who returned fire and killed him. On the one hand, the fact he was tracked down in less than a week suggests security forces were generally on top of the situation. On the other hand, the fact Amri passed through at least three borders since the attack (Germany, France and Italy) will raise calls for better frontier security. Of course, this would undermine Schengen Area policy which allows for free movement within the EU.

It appears that two hijackers have taken control of a Libyan airliner that was forced to land in Malta this morning. The Afriqiyah Airways plane with 111 passengers (and seven crew members) is on the ground in Malta. The two hijackers have threatened to blow up the aircraft. Latest reports suggest the hijackers have released at least 65 passengers with unconfirmed reports that all 111 are now off the plane. It is unclear what the hijackers want.

Two notable news items emerged from China. First, the lead story in today's *FT* reports that Chinese officials are not happy with the appointment of Peter Navarro to a newly created trade policy office. Navarro, a Harvard economist and professor at UC-Irvine, holds positions that are strongly anti-Chinese. One pattern we are seeing from China is that they are reacting quickly to any actions by the president-elect they view as unfriendly. Navarro's appointment is a win for the populists in the Trump government. Second, General-Secretary Xi hinted today that he is open to growth falling below 6.5%; ***Xi suggested that slower growth is acceptable as long as employment stays firm*** (which is, of course, the rub). In general, China can engineer any level of growth it wants as long as it has the capacity to expand its debt. However, with its total debt at 250% of GDP and rising rapidly, Xi may be simply acknowledging that the only way to slow the growth of debt is by reducing GDP growth. If China takes these steps, it will reduce global growth. On the other hand, it will reduce the likelihood of a debt crisis.

On this topic of China, we have noted a rather interesting set of recent trends.

(Source: Bloomberg)

This chart shows the XBT(bitcoin)/USD exchange rate compared to gold (using GLD as the gold proxy). Although it is not unprecedented to see the two instruments not move in tandem, they mostly do because they both represent non-liability backed currencies with limited application. Sovereign money is a medium of exchange, commonly used unit of account and store of value. Gold is mostly just the latter while bitcoin is limited in the first characteristic and mostly acts as the third. Recently, while gold is falling due to the dollar's strength, bitcoin has been on a tear.

The most likely reason for bitcoin's strength is that it is being used to facilitate capital flight from China. The chart below shows that the XBT/USD exchange rate and the CNY/USD exchange rate have closely tracked each other since 2015. In other words, the weaker the CNY, the faster XBT rises. Since bitcoin transactions are anonymous and electronic, they are a better vehicle than gold for moving money out the country.

(Source: Bloomberg)

U.S. Economic Releases

There are no economic releases before we publish. The table below lists the economic releases and Fed speakers scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	New home sales	m/m	Nov	575k	563k	**
10:00	University of Michigan Sentiment	m/m	Nov	112.1	112.1	***
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								
EUROPE								
France	GDP	q/q	Q3	1.0%	1.1%	1.1%	***	Equity and bond neutral
	Consumer spending	y/y	Nov	3.3%	1.5%	2.4%	*	Equity bullish, bond bearish
Germany	GfK Consumer Confidence	m/m	Jan	9.9	9.9	9.8	**	Equity and bond neutral
Switzerland	Leading Indicator	m/m	Dec	102.2	102.2	103.0	*	Equity bearish, bond bullish
U.K.	GDP	y/y	Q3	2.2%	2.3%	2.3%	***	Equity and bond neutral
	Current Account	q/q	Q3	-£25.2	-£28.7	-£28.2	*	Equity bullish, bond bearish
AMERICAS								
Canada	GDP	y/y	Oct	1.5%	1.9%	1.8%	***	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)	100	100	0	Up
3-mo T-bill yield (bps)	49	50	-1	Neutral
TED spread (bps)	51	50	1	Neutral
U.S. Libor/OIS spread (bps)	66	65	1	Up
10-yr T-note (%)	2.54	2.55	0	Up
Euribor/OIS spread (bps)	-32	-32	0	Down
EUR/USD 3-mo swap (bps)	58	58	0	Neutral
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	up			Down
pound	down			Down
franc	up			Down

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	$54.55	$55.05	-0.91%	Long liquidation/profit taking
WTI	$52.47	$52.95	-0.91%	
Natural Gas	$3.56	$3.54	0.71%	
Crack Spread	$15.75	$15.90	-0.92%	
12-mo strip crack	$16.53	$16.55	-0.10%	
Ethanol rack	$1.86	$1.85	0.05%	
Metals				
Gold	$1,130.94	$1,128.38	0.23%	dollar pause
Silver	$15.79	$15.79	-0.04%	
Copper contract	$249.65	$249.95	-0.12%	
Grains				
Corn contract	$ 346.50	$ 347.25	-0.22%	
Wheat contract	$ 397.00	$ 397.00	0.00%	
Soybeans contract	$ 1,004.75	$ 1,004.00	0.07%	
Shipping				
Baltic Dry Freight	928	926	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.3	-2.5	4.8	
Gasoline (mb)	-1.3	1.3	-2.6	
Distillates (mb)	-2.4	-1.8	-0.7	
Refinery run rates (%)	1.0%	0.3%	0.7%	
Natural gas (bcf)	-209.00	-206.0	-3.0	

Weather

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

Asset Allocation Weekly Comment

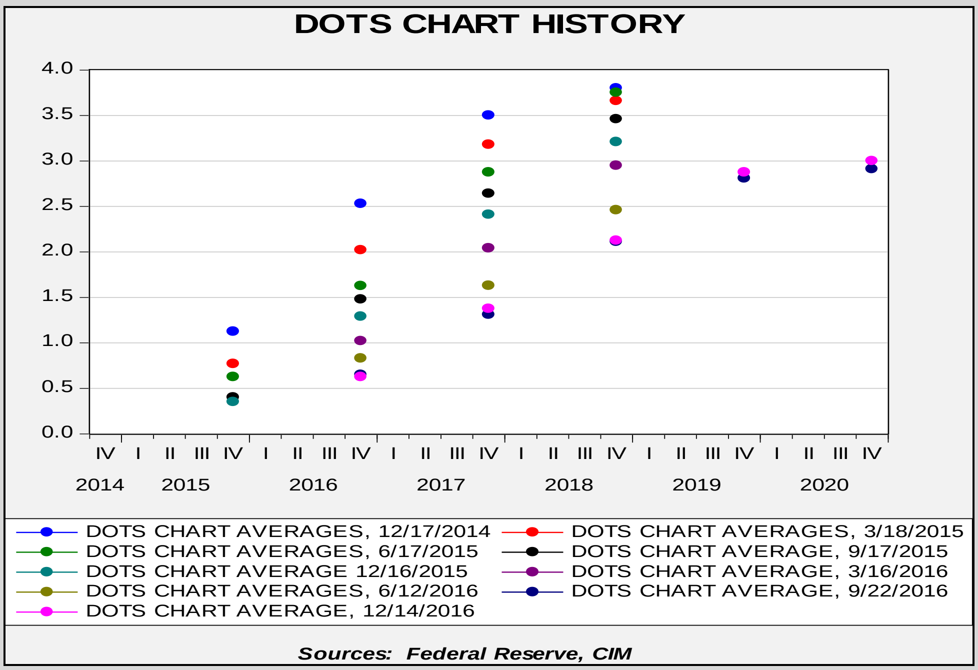
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

December 23, 2016

Due to the upcoming holidays, the next edition of this report will be published on January 6, 2017.

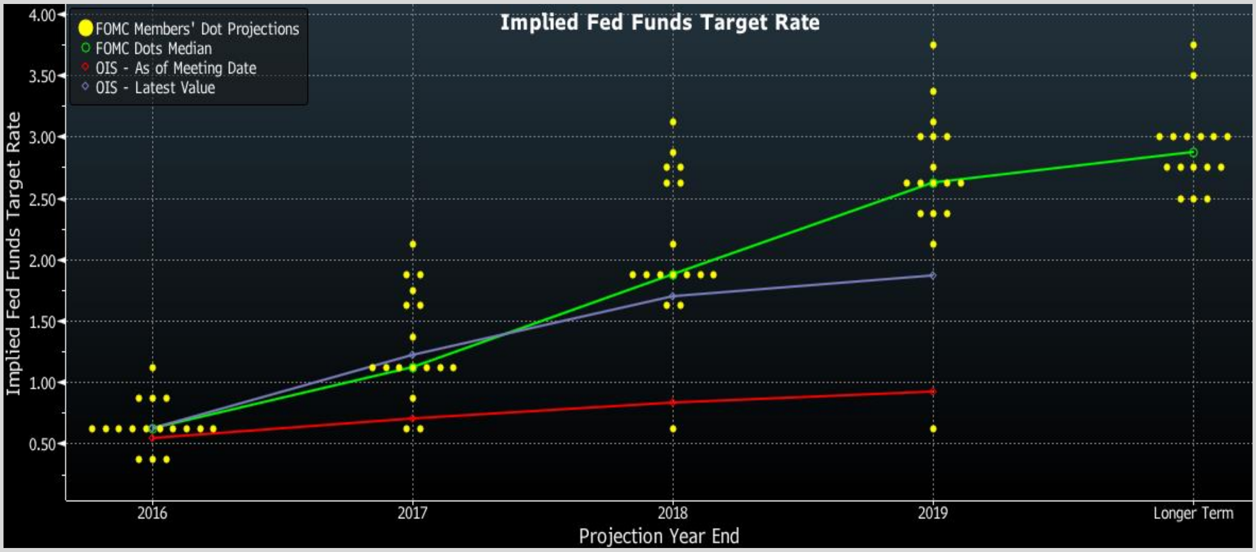
The Fed gave us a modest hawkish surprise last week, calling for three rate hikes in 2017 rather than two. The news has boosted Treasury yields and lifted the dollar. Equities mostly absorbed the news without incident.

Here is a chart of the FOMC's average dots over the past two years.



The fuchsia dots represent the most recent meeting. The dots have stopped their steady progression toward 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.

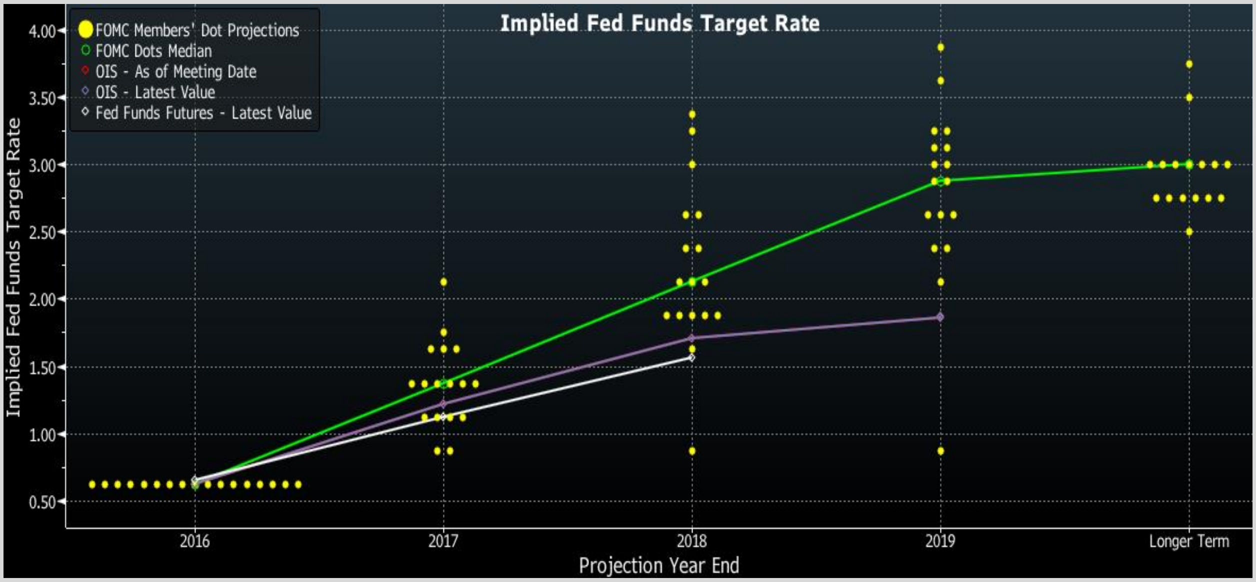
Here is the dots plot from September.



(Source: Bloomberg)

Note the purple line, which is the LIBOR-OIS curve from the meeting day. It has jumped from where it was on the meeting date in September, shown by the red line. For the past few years, the FOMC dots have tended to decline toward the market. The rise in the LIBOR-OIS curve suggests that process is reversing.

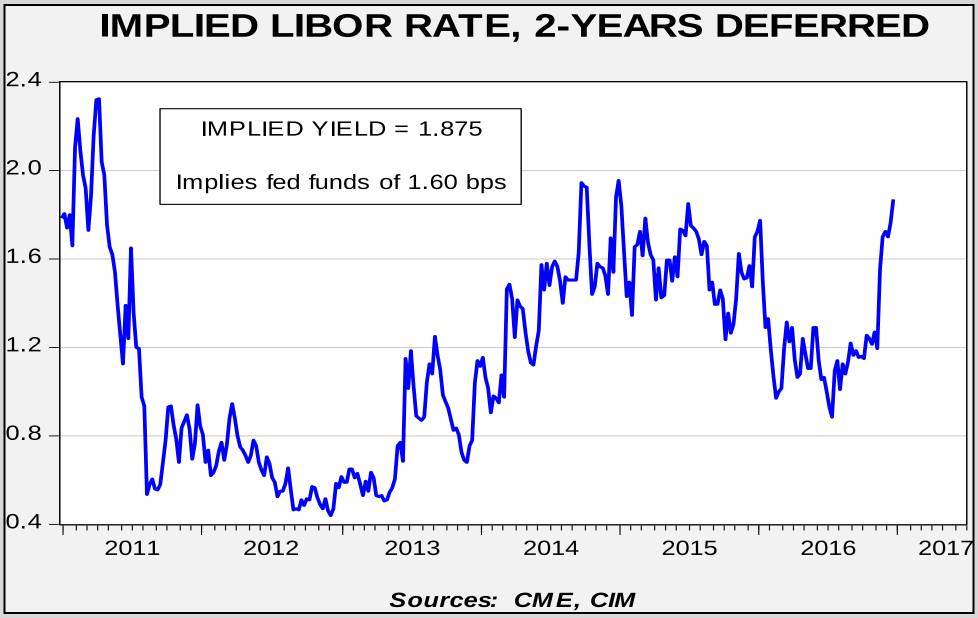
This is the new dots plot, released at the December meeting.



(Source: Bloomberg)

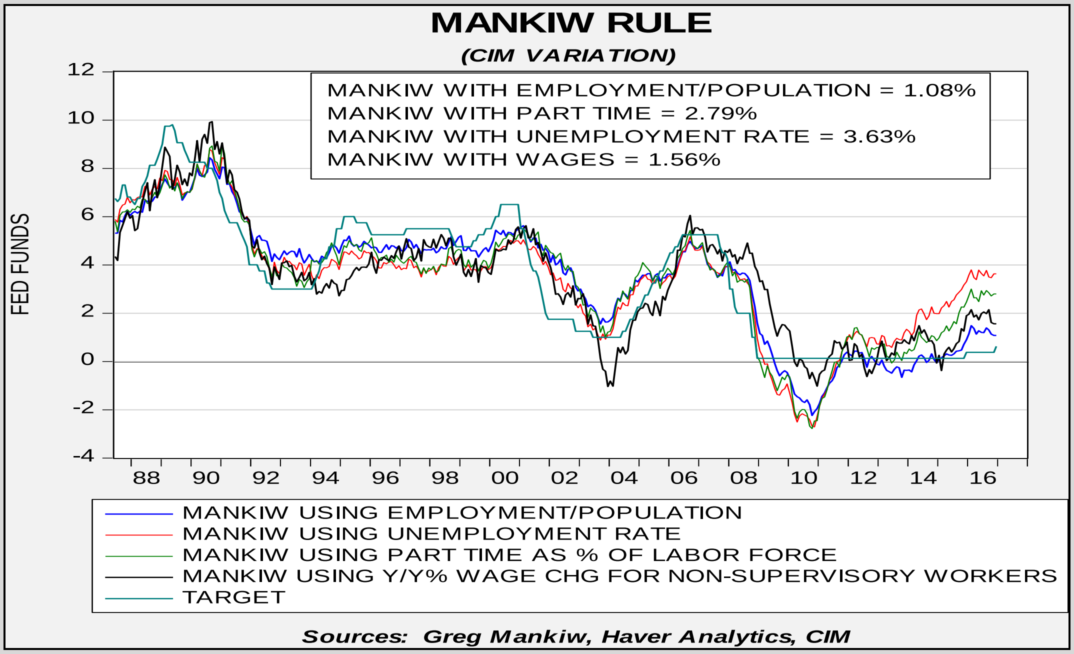
For 2017, the median forecast is currently 1.375%, up from 1.125% in September. For 2018, the median is up to 2.125% from 1.875%. Two participants see no change next year but one of those is probably St. Louis FRB President Bullard, who has decided not to participate in the dots procedure. Although market 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.

To get some sense of where policy is in relation to the neutral rate, we use the Mankiw rule model, incorporating the recent rate changes by the FOMC. 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 using 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.

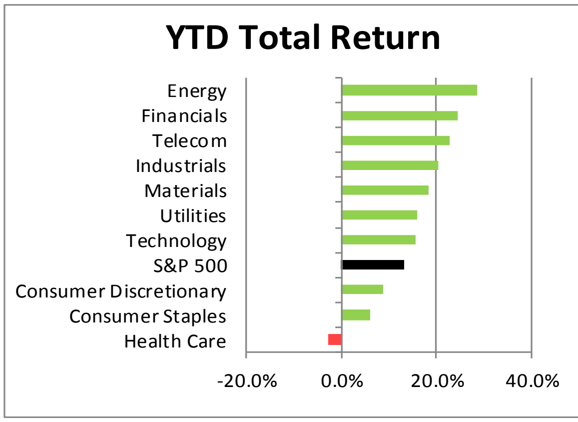


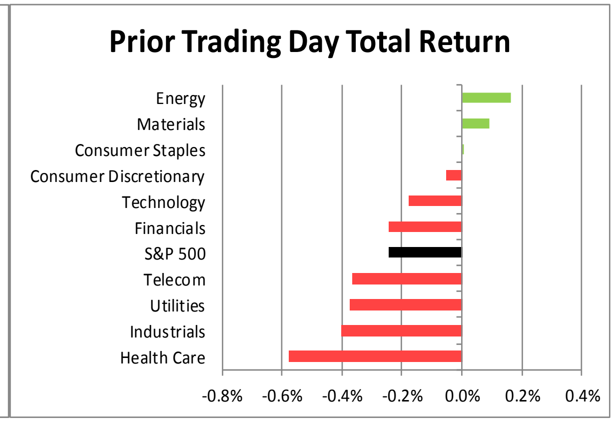
Using the unemployment rate, the neutral rate is now 3.63%. Using the employment/population ratio, the neutral rate is 1.08%. Using involuntary part-time employment, the neutral rate is 2.79%. And finally, the wage growth model puts the neutral rate at 1.56%.

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 which one 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 and most of the doves probably believe 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. However, 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 assumption would change if the incoming President Trump puts up trade barriers. Thus, the path of monetary policy could be a risk factor in the upcoming year.

Data Section

U.S. Equity Markets – (as of 12/22/2016 close)

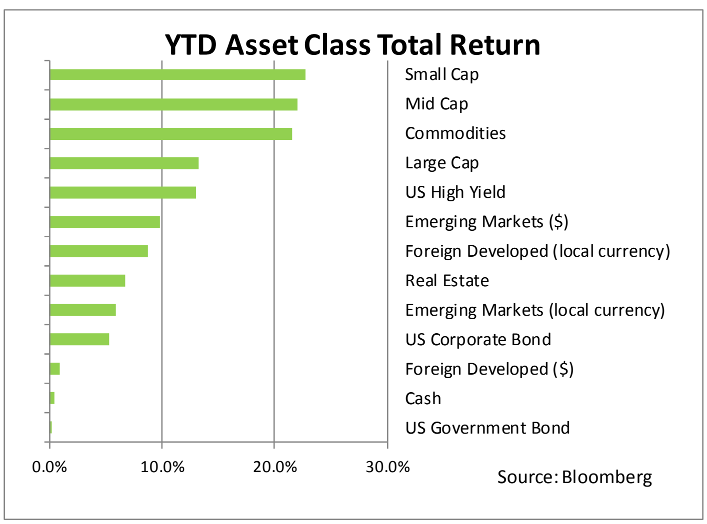




(Source: Bloomberg)

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 12/22/2016 close)

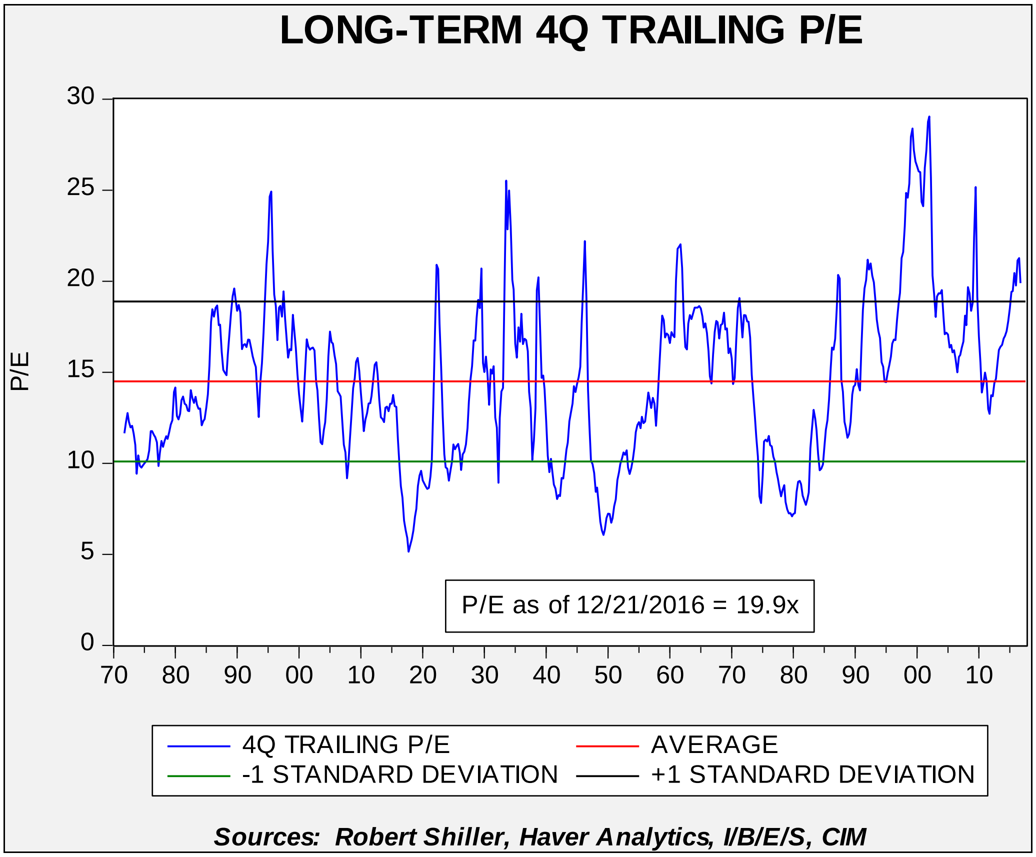


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 22, 2016



Based on our methodology,[1] the current P/E is 19.9x, 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.