Daily Comment

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

[Posted: February 13, 2017—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.6% and the Shenzhen index down 0.7%. U.S. equity futures are signaling a higher open. With 357 companies having reported, the S&P 500 Q4 earnings stand at $31.69, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 66.9% of the companies reported earnings above forecast, while 20.7% reported earnings below forecast.

On Friday, Fed Governor Tarullo announced his retirement. Although his term ran until 2020, there was growing speculation he would leave. He has undertaken the role of lead regulator, a position that Dodd-Frank created but was never filled. It was expected that President Trump would fill the role and, when he did, Tarullo would resign. There are a number of names swirling around as replacements. David Nason, who was on Sec. Paulson's TARP team, is thought to be the front-runner. John Allison, former head of BB&T (BBT, 46.63), and Tom Hoenig, former KC Fed president and current FDIC chair, are also being considered. Based on our scoring, Tarullo is rated a "5,"[1] making him a hard dove. Although we don't know how Nason would vote, we would expect him to be a moderate, making him a "3." Hoenig and Allison would likely be hard hawks, or "ones." Tarullo's last meeting will be the March gathering, and his leaving changes the voting average from 3.5 to 3.3. Simply put, Tarullo's departure from the FOMC does make it a bit more hawkish. Potentially, President Trump could turn the board more hawkish when he fills this slot.

Interestingly enough, Scott Alvarez also announced his retirement last week from the position of general counsel of the Federal Reserve. His guidance has been to deregulate; we would look for Yellen to replace him with someone less inclined in this direction.

In addition to Tarullo's position, two open governor positions remain on the FOMC. The names being floated include John Taylor (yes, that John Taylor of the "Taylor Rule"), Kevin Warsh and Glenn Hubbard. Although Taylor appears hawkish, we suspect he would be more moderate in practice. We would rate him as a "2," or a moderate hawk. Warsh's positions are a bit less clear but we would probably rate him a "2" as well; he is less of an academic in terms of monetary policy and more of a regulatory expert. Hubbard is probably a "3"; he is a conservative economist but well regarded and cautious. Any two of these three would tend to move the FOMC in a more hawkish direction.

[1] We use a "1 to 5" scale, with 1 being the most hawkish and 5 the most dovish.

Chair Yellen begins her semi-annual report to Congress tomorrow. If the FOMC is considering a hike at the March meeting, we would expect her to begin preparing the markets for a move. Presently, the market only has around a 35% likelihood of a rate hike next month.

Treasury nominee Mnuchin appears likely to be confirmed this evening. Current speculation is that he is picking mostly establishment types for important deputy and undersecretary positions, including Jim Donovan, who was part of the Romney campaign and a former Goldman partner (GS, 242.72), and Justin Muzinich, former Morgan Stanley banker (MS, 44.70) and policy director for the Jeb Bush campaign. David Malpass looks poised to get a role at the Treasury as well.

In the populist/establishment box score, we note a long article in the *NYT* over the weekend on David Cohn, who is head of the National Economic Council and former Goldman Sachs COO. The report was favorable for Cohn, seeming to suggest he has a steadying influence. With Mnuchin's confirmation and his expected selections, the establishment is filling seats which should give them a bigger voice around Trump.

Finally, there are rumors swirling that Gen. Michael Flynn, current National Security Advisor, may be on his way out as it appears he may have discussed lifting sanctions on Russia after the election. Not only is this potentially illegal, he told VP Pence he didn't discuss sanctions and Pence relayed that report to the media. From a market perspective, this isn't necessarily a market mover. However, we mention it for two reasons. First, Flynn probably rests in the populist camp and is undoubtedly a Jacksonian. He is particularly negative on Iran and, if he is ousted, tensions with Iran may ease somewhat. Second, it should be remembered that President Trump ran a popular reality TV show where he fired people. It would not be out of character for him to move quickly against someone who has lost his favor. That could be true for the entire cabinet.

U.S. Economic Releases

There are no domestic releases or Fed events scheduled for the rest of the day.

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	GDP	q/q	4q	0.2%	0.3%	0.3%	***	Equity and bond neutral
	GDP Private Consumption	q/q	4q	0.0%	0.3%	0.0%	***	Equity and bond neutral
	GDP Business Spending	q/q	4q	0.9%	-0.4%	1.2%	***	Equity and bond neutral
India	CPI	y/y	jan	3.2%	3.4%	3.2%	***	Equity and bond neutral
Australia	Credit Card Balances	m/m	dec	A$52.8 bn	A$52.2 bn		**	Equity and bond neutral
	Credit Card Purchases	m/m	dec	A$27.7 bn	A$27.1 bn		**	Equity and bond neutral
New Zealand	Card Spending Retail	m/m	jan	2.7%	-0.1%	0.7%	**	Equity bullish, bond bearish
	Card Spending Total	m/m	jan	2.5%	0.0%		**	Equity and bond neutral
EUROPE								
Germany	Wholesale Price Index	y/y	jan	4.0%	2.8%		**	Equity and bond neutral
Switzerland	Total Sight Deposits CHF	m/m	feb	539.0 bn	535.2 bn		**	Equity and bond neutral
	Domestic Sight Deposits CHF	m/m	feb	464.5 bn	463.0 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)	104	103	1	Up
3-mo T-bill yield (bps)	53	53	0	Neutral
TED spread (bps)	51	51	0	Neutral
U.S. Libor/OIS spread (bps)	70	69	1	Neutral
10-yr T-note (%)	2.43	2.41	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	26	26	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	up			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	$56.42	$56.70	-0.49%	Long Liquidation
WTI	$53.64	$53.86	-0.41%	
Natural Gas	$2.96	$3.03	-2.37%	
Crack Spread	$13.74	$13.97	-1.65%	
12-mo strip crack	$15.65	$15.75	-0.63%	
Ethanol rack	$1.65	$1.64	0.32%	
Metals				
Gold	$1,229.59	$1,233.62	-0.33%	Stronger Dollar
Silver	$17.94	$17.95	-0.03%	
Copper contract	$278.75	$276.80	0.70%	
Grains				
Corn contract	$ 374.00	$ 374.50	-0.13%	
Wheat contract	$ 446.50	$ 449.00	-0.56%	
Soybeans contract	$ 1,052.75	$ 1,059.00	-0.59%	
Shipping				
Baltic Dry Freight	702	707	-5	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

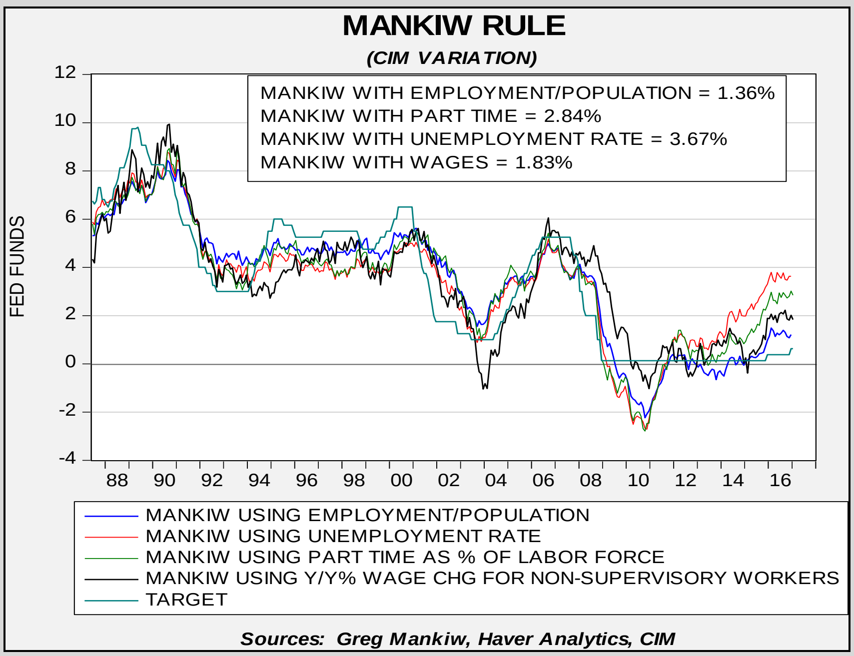
Asset Allocation Weekly Comment

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.

February 10, 2017

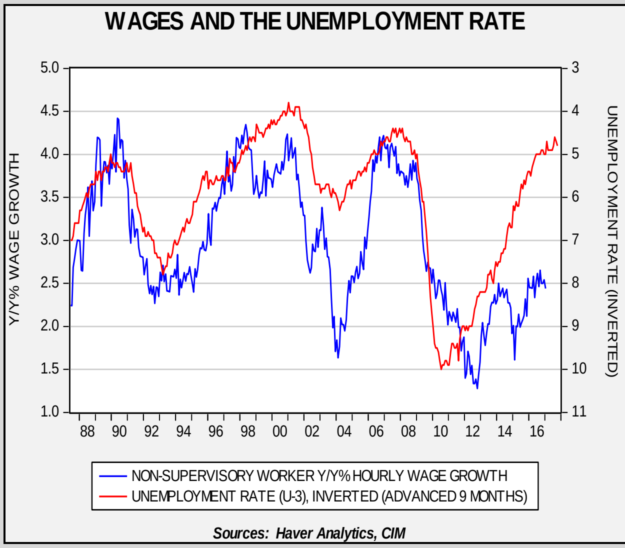
For better or worse, the Federal Reserve tends to conduct policy based on some variant of the Taylor Rule, which essentially means that the FED sets the policy interest rate based upon changes in the inflation rate and the level of slack in the economy. The rule suggests that if there is little available capacity in an economy, continued growth will lead to higher inflation, as such, tighter monetary policy is necessary to bring inflation back to target levels. On the other hand, if slack exists, rising growth is less of an inflation risk and the central bank can avoid rushing to raise interest rates.

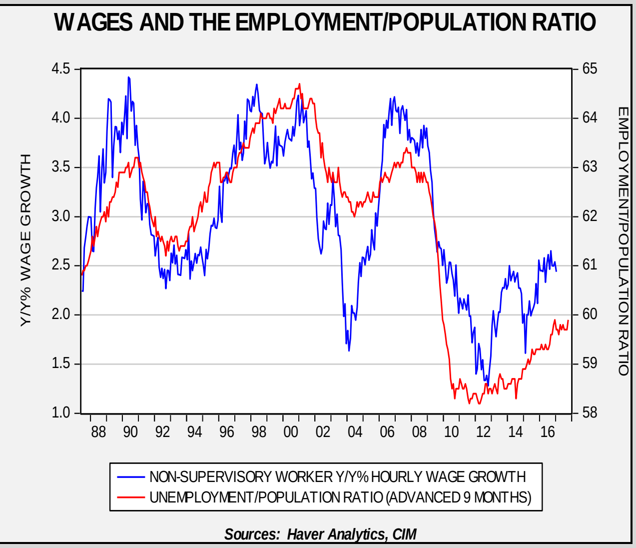
The hard part of this approach is measuring slack. Some models, including the one John Taylor created, use the difference between GDP and potential GDP to measure slack in the economy. The problem is that potential GDP can only be estimated, not measured. Greg Mankiw created an alternative to the Taylor Rule using the unemployment rate as a proxy for slack. We have expanded on Mankiw's original idea by creating three other variations, one that uses the employment/population ratio, another using involuntary part-time workers as a percentage of the total labor force and a third using yearly wage growth for non-supervisory workers.



Using the different variations, the FOMC is either modestly behind the curve (the employment/population ratio puts the neutral policy rate at 1.36%) or well behind the curve (the unemployment rate version puts the neutral policy rate at 3.67%). The question for policymakers, in particular, and economists and strategists, in general, is which variation best reflects the level of economic slack?

This pair of charts offers an insight into what may be the best answer.





The chart on the left shows the relationship of wages to the unemployment rate, while the chart on the right shows the relationship of wages to the employment/population ratio. From the late 1980s until the last recession, the two employment-related series generally tracked wages but they have diverged broadly in this recovery. One of the mysteries of the recovery is the weakness in wage growth despite the low unemployment rate. In fact, a simple model of the two suggests that wage growth should be 3.5% by Q3, well over the current 2.4%. However, relative to the employment/population ratio, wage growth should only be around the current level of 2.4% by September, which is equal to current wage growth.

In other words, the employment/population ratio appears to be, at present, a better indicator of slack. The low ratio suggests that the large number of those not working is somehow acting as a dampener on wages, meaning that, perhaps, the low ratio is either signaling to employers that they don't have to bid up wages to attract workers, or telling employees that there are enough people looking for jobs to prevent them from asking for higher pay.

We know that anecdotal evidence is mixed. Two articles from the *Wall Street Journal* show the divergence. One headline reads, "Skilled Workers are Scarce in a Tight Labor Market."[2] A second says, "Higher Jobless Rate Suggests Economy has Room to Run."[3] Although we are sympathetic to the former article, the data seem to confirm the latter one. In other words, there are regional and industry pockets where wages are being bid up due to the lack of workers. However, on a national level, that doesn't appear to be the case. There is evidence that labor

---

[2] https://www.wsj.com/articles/skilled-workers-are-scarce-in-tight-labor-market-1486047602 (paywall)
[3] https://www.wsj.com/articles/u-s-added-a-robust-227-000-jobs-in-january-1486128784 (paywall)

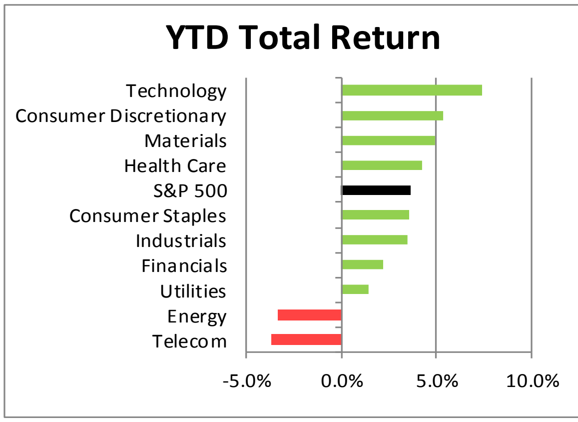
market mobility has declined[4] which may be leading to wider regional pay divergences, but overall the above analysis does tend to suggest that wage growth remains stifled and the employment/population ratio is probably a better measure of slack in the economy.

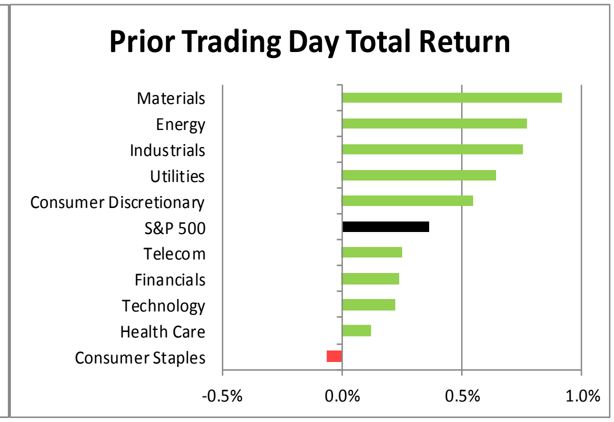
If this is the case, the Mankiw Rule version using the employment/population ratio is probably the guide to Fed policy. This would imply that the FOMC does need to raise rates if it desires a neutral policy, but not much more than the three hikes expected this year. Our analysis of the 10-year Treasury market suggests that, assuming current oil prices, inflation trends, German 10-year sovereign yields and the yen/dollar exchange rate, current yields have discounted a fed funds target of 1.75%. If the FOMC does not raise fed funds to that level, long-duration assets may become attractive as the year unfolds. Of course, part of the problem is that those other variables will likely not remain constant. For now, we maintain our mostly negative view toward long-duration fixed income but acknowledge that the FOMC may not lift rates to levels projected by the markets unless wage growth rises. In our estimation, for that to occur, the employment/population ratio must rise.

[4] http://equitablegrowth.org/equitablog/declining-u-s-labor-mobility-is-about-more-than-geography/

Data Section

U.S. Equity Markets – (as of 2/10/2017 close)

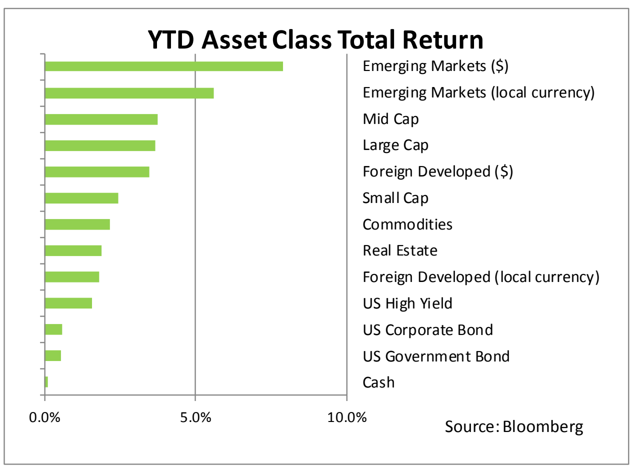




(Source: Bloomberg)

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. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 2/10/2017 close)

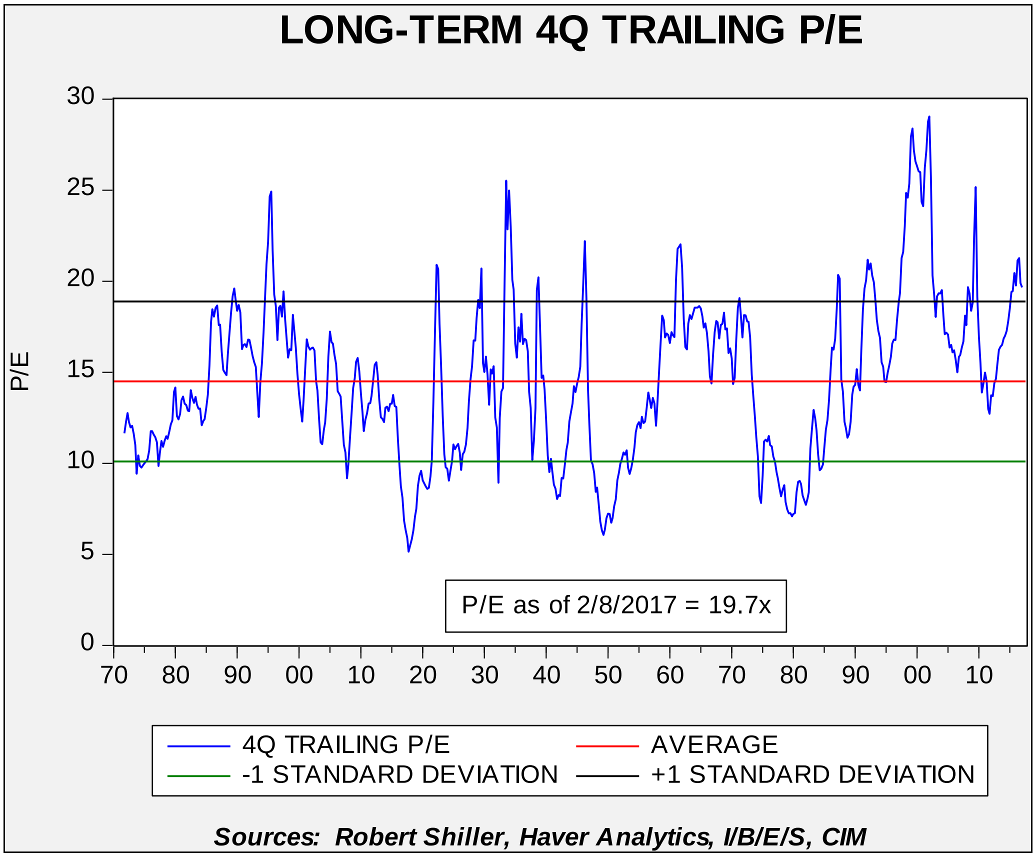


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Bloomberg total return Commodity Index).

P/E Update

February 9, 2017



Based on our methodology,[5] the current P/E is 19.7x, up 0.1x from last week. Falling Q1 earnings expectations led to the rise in the multiple.

---

[5] 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 (Q2 and Q3) and two estimates (Q4, Q1). 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.