Daily Comment

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

[Posted: February 16, 2017—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were up, with the Shanghai composite up 0.6% and the Shenzhen index also up 0.6%. U.S. equity futures are signaling a lower open. With 374 companies having reported, the S&P 500 Q4 earnings stand at $31.37, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 66.8% of the companies reported earnings above forecast, while 21.4% reported earnings below forecast.

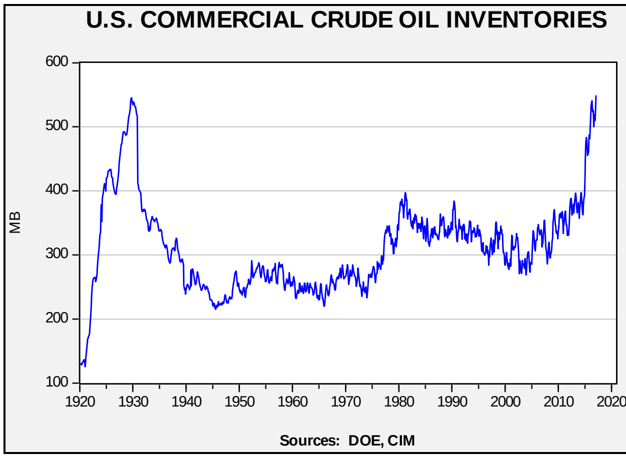
We are seeing a bit of weakness this morning in equities but this looks mostly like a normal market pause. The dollar is lower despite growing talk that the Fed is moving to raise rates. Not only did Chair Yellen signal that hikes are coming, but Boston FRB President Rosengren, a long-time dove, is calling for three hikes this year. The most likely reason for the dollar weakness is that Chair Yellen expressed opposition to the border adjustment tax. The opposition to this tax is growing and there is rising speculation that corporate tax reform won't include this provision. If true, that removes an element of dollar support.

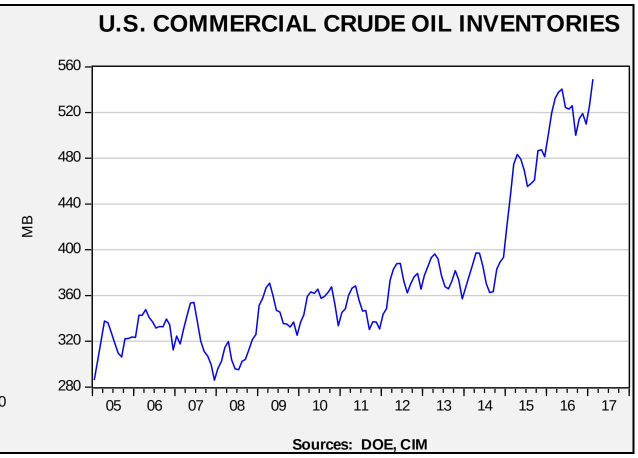
The turmoil coming out of Washington is relentless. Vociferous leaks continue out of the intelligence apparatus, the White House appears in disarray and Congress looks to begin investigations. All these things would seem to undermine confidence for investors, consumers and businesses. However, that couldn't be further from what we are seeing. The economic data is improving and the survey data is strengthening. Today's evidence comes from the business outlook survey from the Philadelphia FRB (see below). The numbers were more than double the forecast and the trend in the data suggests growing optimism.

Some of this improvement appears to be simply organic. After nearly eight years of slow growth, we are finally starting to see some animal spirits return to the economy and markets. At the same time, hopes for regulatory relief and fiscal stimulus are supporting sentiment. Progress on these fronts may slow if the president becomes mired in scandal and investigations. On the other hand, Congressional Republicans may simply forge ahead with traditional GOP policy positions, which should be supportive for equities.

We are closely monitoring the issues and concerns coming out of D.C. We do think they are important but, for now, they are not enough to derail an improving economy and earnings. As long as the political problems don't affect the economy, earnings and the progress of favorable policy, these issues are noise.

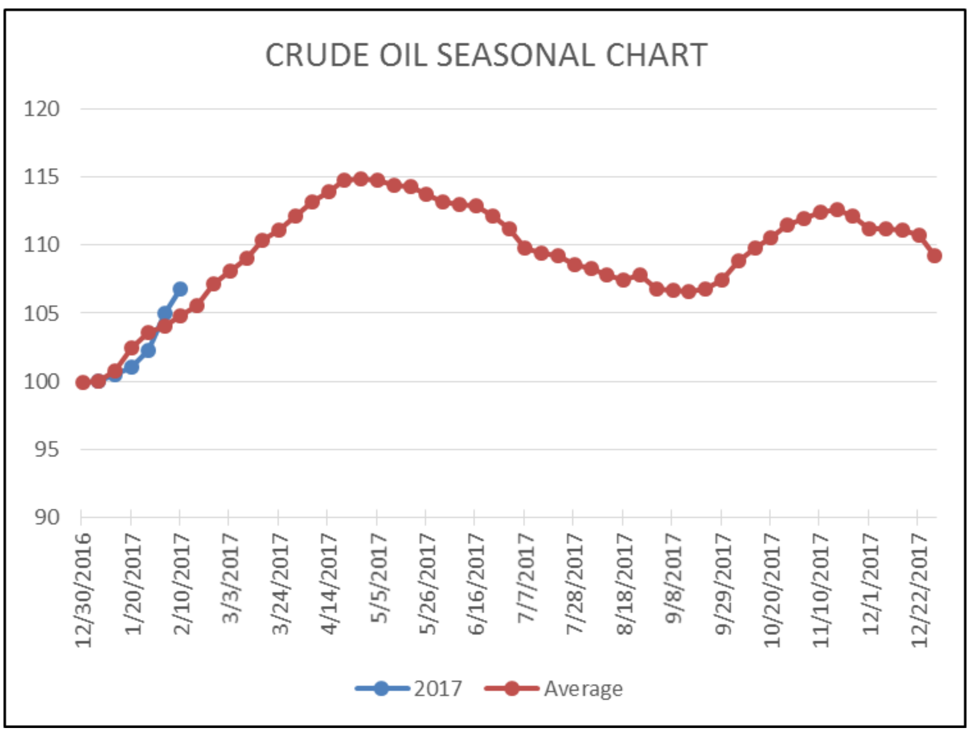
U.S. crude oil inventories rose 9.5 mb compared to market expectations of a 2.5 mb build.



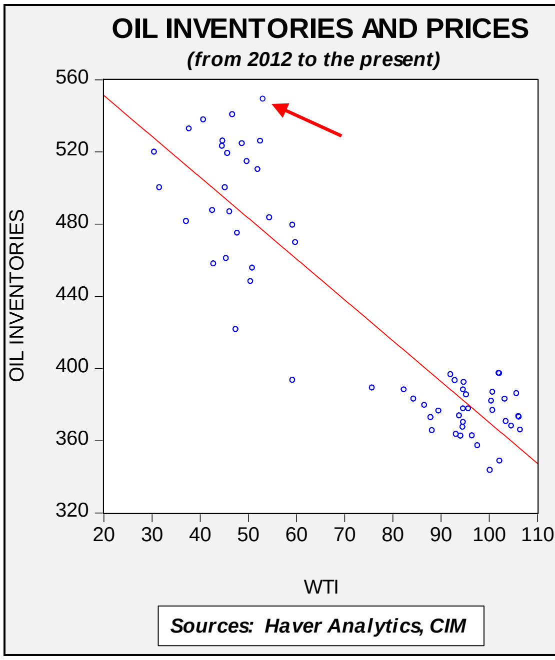


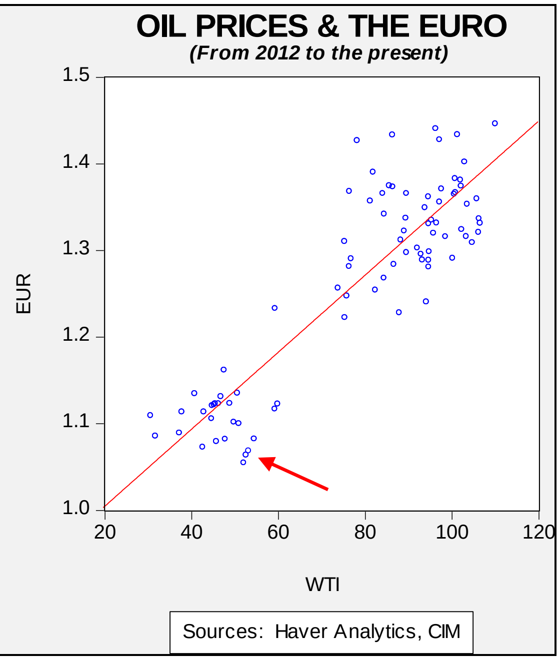
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, inventories remain elevated.

As the seasonal chart below shows, inventories usually rise into April before increasing refinery operations for the summer driving season lower stockpiles. Over the past two weeks, inventories have risen much faster than normal. A normal seasonal build would lead inventories to peak in late April at 590 mb, which would be well above the previous record and would be a bearish factor for prices.



(Source: DOE, CIM)

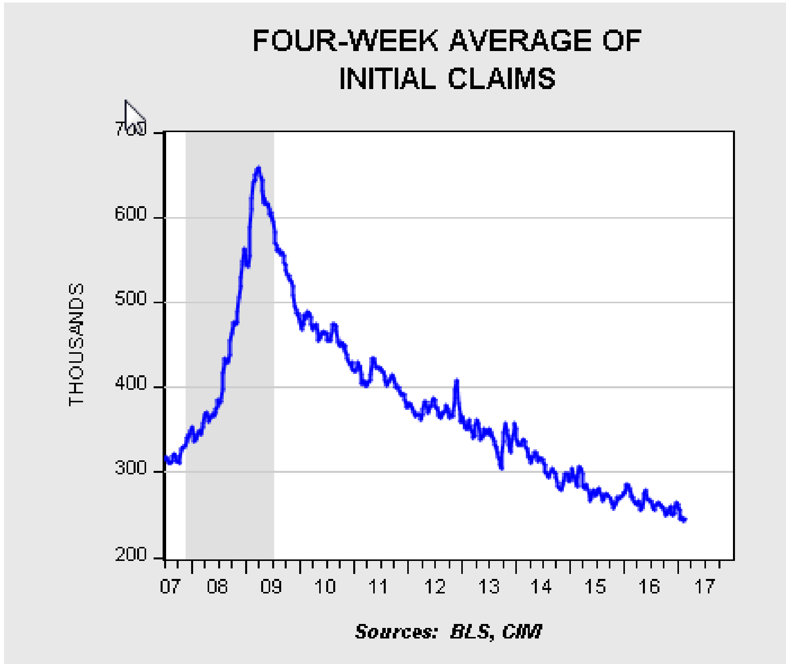




Based on inventories alone, oil prices are overvalued with the fair value price of \$30.86. Meanwhile, the EUR/WTI model generates a fair value of \$39.98. Together (which is a more sound methodology), fair value is \$35.50, meaning that current prices are well above fair value. So far, the oil markets continue to ignore the bearish rise in oil inventories. Today's *FT* has a good analysis of the intraday price action surrounding the inventory data release. The pattern is mostly that prices initially decline on bearish data but recover as the day progresses. Traders interviewed say that the intraday recovery appears to be driven by a sizable buyer determined to "buy the dips." In an electronic trading environment (as opposed to the old open outcry), it is almost impossible to figure out the identity of this buyer. We suspect it is probably a hedge fund building a bullish position in oil and views each decline as a buying opportunity. However, the article notes that there is speculation that OPEC may be the buyer. The bullish argument rests on the idea that when the seasonal drawdown starts in mid-April, it will be robust enough to justify these prices. Our analysis would suggest this outcome will be hard to achieve. But, for now, the old adage holds that prices that rise in the face of bearish data are bull markets.

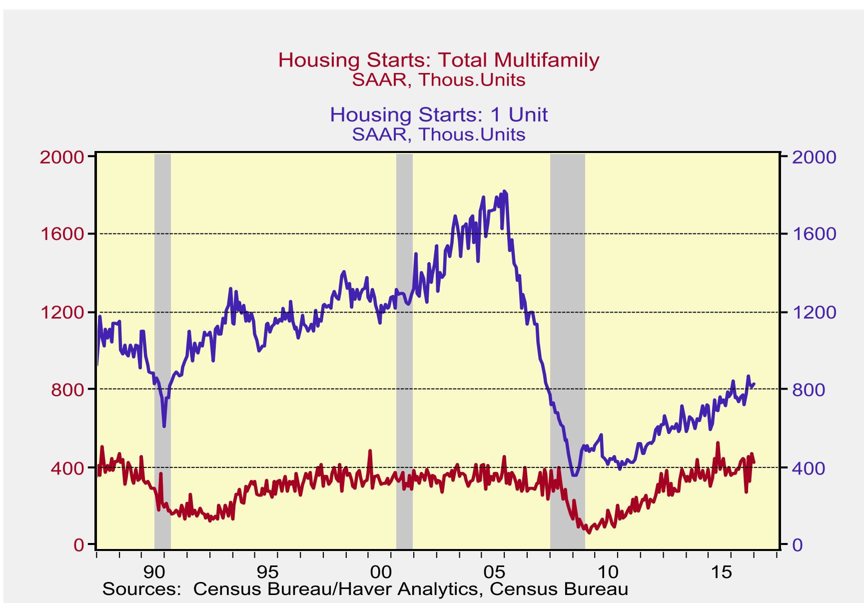
U.S. Economic Releases

Initial jobless claims came in below expectations at 239k compared to the forecast of 245k. This report marks the 101st week of jobless claims below 300k, the longest stretch since 1970.



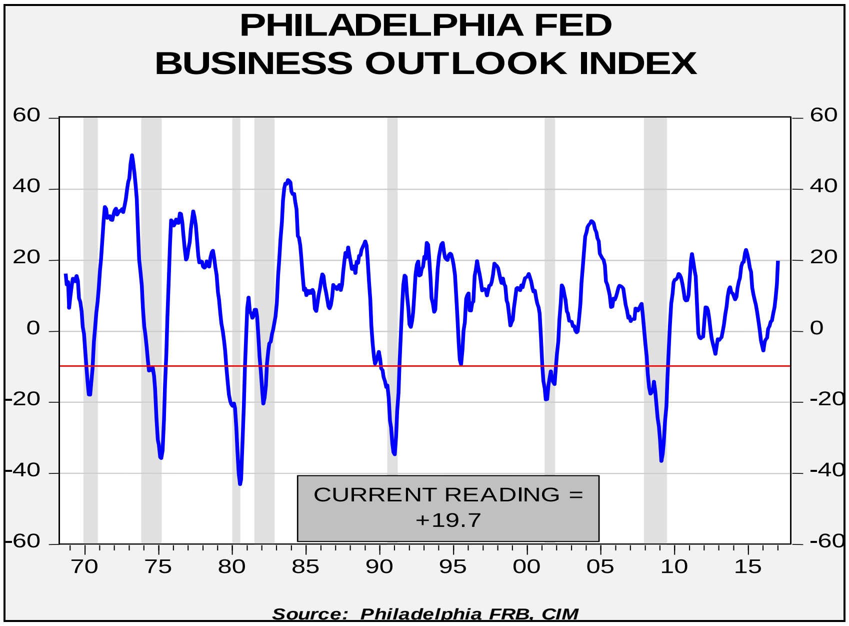
The chart above shows the four-week moving average of jobless claims. The four-week moving average rose 0.5k to 244.75k.

Housing starts came in below expectations, falling 2.6% from the prior month compared to the forecast of unchanged. Building permits came in above expectations at 4.6% compared to the forecast rise of 0.2%. The prior report was revised upward from a fall of 0.2% to a rise of 1.3%.



The chart above shows single- and multi-family starts. Single-family starts are up 7.2% from last year and multi-family starts are up 19.1% over the same time period.

The Philadelphia FRB Business Outlook Index soared this month, rising to 43.3, well above January's 23.6 and far above expectations of 18.0.



We smooth the data with a six-month moving average. Any reading below zero is a concern but a recession isn't consistently signaled until the level of -10 is broken. Clearly, that isn't a problem now. The current reading is challenging the two cycle highs in this expansion and, given the averaging process, we will likely see new cycle highs in the coming months. Although this is survey data, it is consistent with small business sentiment and strong consumer confidence. The survey data points to a rapidly improving economy which should be bullish for equities and the dollar and bearish for long duration fixed income.

The table below shows the domestic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	feb		47.2	**
9:45	Bloomberg Economic Expectations	m/m	feb		56.0	**

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								
China	Foreign Direct Investment	y/y	jan	-9.2%	5.7%	1.4%	**	Equity bearish, bond bullish
Japan	Japan Buying Foreign Bonds	y/y	feb	-297.4 bn	-126.6bn		**	Equity and bond neutral
	Japan Buying Foreign Stocks	y/y	feb	-96.7 bn	332.8 bn		**	Equity and bond neutral
	Foreign Buying Japan Bonds	y/y	feb	-99.2 bn	239.8 bn		**	Equity and bond neutral
	Foreign Buying Japan Stocks	y/y	feb	175.6 bn	-248.0 bn		**	Equity and bond neutral
	Machine Tool Orders	y/y	jan	3.5%	3.5%		**	Equity and bond neutral
Australia	Consumer Inflation Expectations	m/m	jan	4.1%	4.3%		**	Equity and bond neutral
	Employment Change	y/y	jan	10.0k	13.5k	10.0k	**	Equity and bond neutral
	Unemployment Rate	m/m	jan	5.8%	5.8%	5.8%	**	Equity and bond neutral
	Participation Rate	m/m	jan	64.7%	64.7%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	feb	127.4	128.7		**	Equity and bond neutral
	Non Resident Bond Holdings	m/m	feb	62.5%	63.2%		**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registration	y/y	jan	10.2%	3.0%		**	Equity and bond neutral
Italy	Trade Balance	y/y	dec	.124 bn	.235 bn		**	Equity bearish, bond bullish
France	ILO Unemployment Rate	y/y	4q	10.0%	10.0%	9.8%	**	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	m/m	dec	-1.8%	-2.0%	-1.7%	**	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	104	0	Up
3-mo T-bill yield (bps)	52	53	-1	Neutral
TED spread (bps)	52	51	1	Neutral
U.S. Libor/OIS spread (bps)	72	73	-1	Neutral
10-yr T-note (%)	2.48	2.49	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	27	27	0	Neutral
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Down
pound	up			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Transacions Government	-A$588 bn	-A$1.827 bn		On forecast
RBA Transacions Market	A$557 bn	A$1.799 bn		On forecast
RBA Transacions Other	A$0.046 bn	A$0.024 bn		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	$56.10	$55.75	0.63%	Saudi Arabia suggests further output cuts
WTI	$53.39	$53.11	0.53%	
Natural Gas	$2.92	$2.93	-0.14%	
Crack Spread	$13.06	$13.06	0.02%	
12-mo strip crack	$15.52	$15.55	-0.23%	
Ethanol rack	$1.62	$1.62	0.01%	
Metals				
Gold	$1,237.39	$1,233.70	0.30%	Weaker Dollar
Silver	$18.05	$17.99	0.37%	
Copper contract	$275.50	$276.15	-0.24%	
Grains				
Corn contract	$ 384.75	$ 386.00	-0.32%	
Wheat contract	$ 467.50	$ 468.25	-0.16%	
Soybeans contract	$ 1,066.75	$ 1,071.75	-0.47%	
Shipping				
Baltic Dry Freight	688	685	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	9.5	3.5	6.0	
Gasoline (mb)	2.8	0.6	2.3	
Distillates (mb)	0.7	0.8	-0.1	
Refinery run rates (%)	-2.30%	0.00%	-2.3%	
Natural gas (bcf)		-128.0		

Weather

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

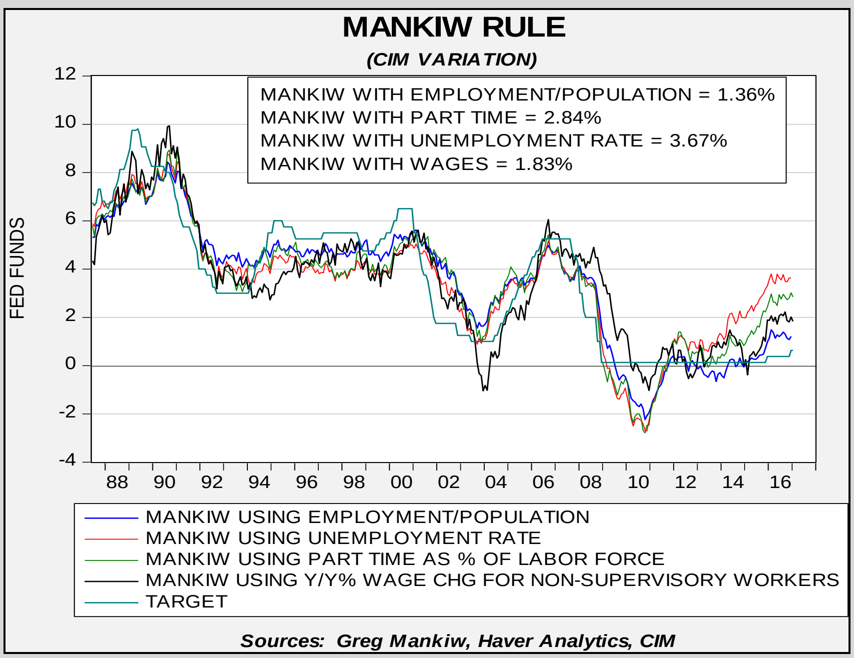
Asset Allocation Weekly Comment

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

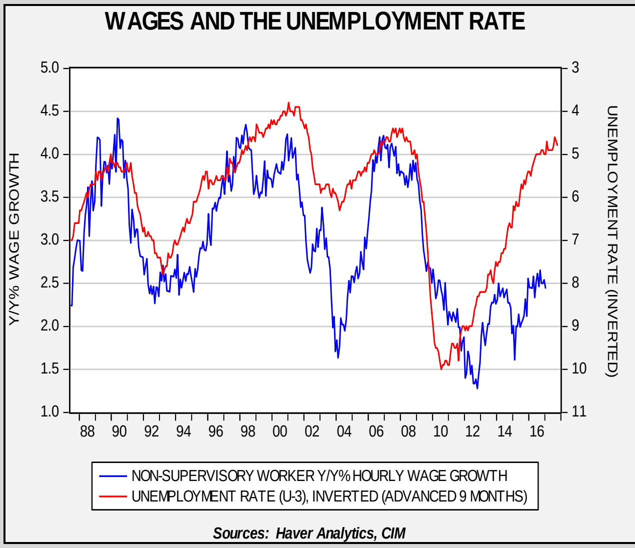
For better or worse, the Federal Reserve tends to conduct policy based on some variant of the Taylor Rule, which essentially means that the FED sets the policy interest rate based upon changes in the inflation rate and the level of slack in the economy. The rule suggests that if there is little available 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.

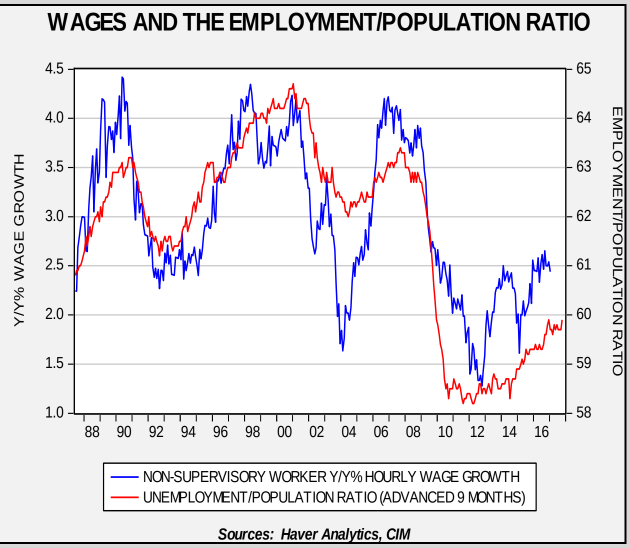
The hard part of this approach is measuring slack. Some models, including the one John Taylor created, use the difference between GDP and potential GDP to measure slack in the economy. The problem is that potential GDP can only be estimated, not measured. Greg Mankiw created an alternative to the Taylor 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."[1] A second says, "Higher Jobless Rate Suggests Economy has Room to Run."[2] 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

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

market mobility has declined[3] 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.

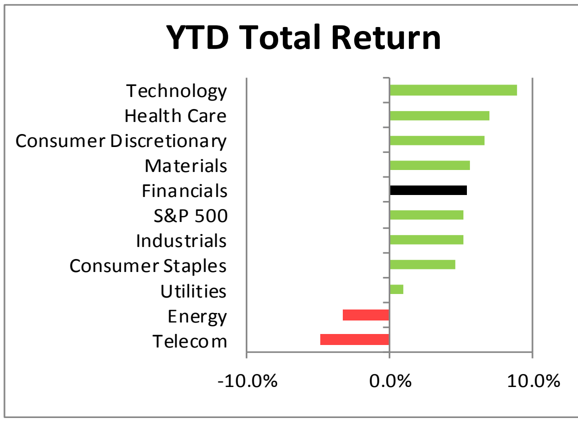
If this is the case, the Mankiw Rule version using the employment/population ratio is probably the guide to Fed policy. This would imply that the FOMC does need to raise rates if it desires a neutral policy, but not much more than the three hikes expected this year. Our analysis of the 10-year Treasury 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.

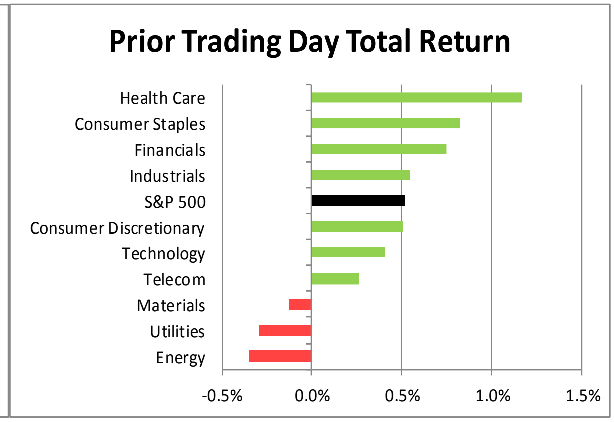
Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors 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.

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

Data Section

U.S. Equity Markets – (as of 2/15/2017 close)

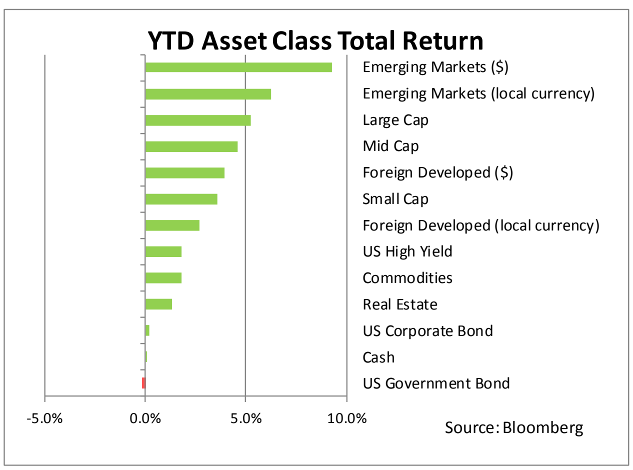




(Source: Bloomberg)

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 2/15/2017 close)

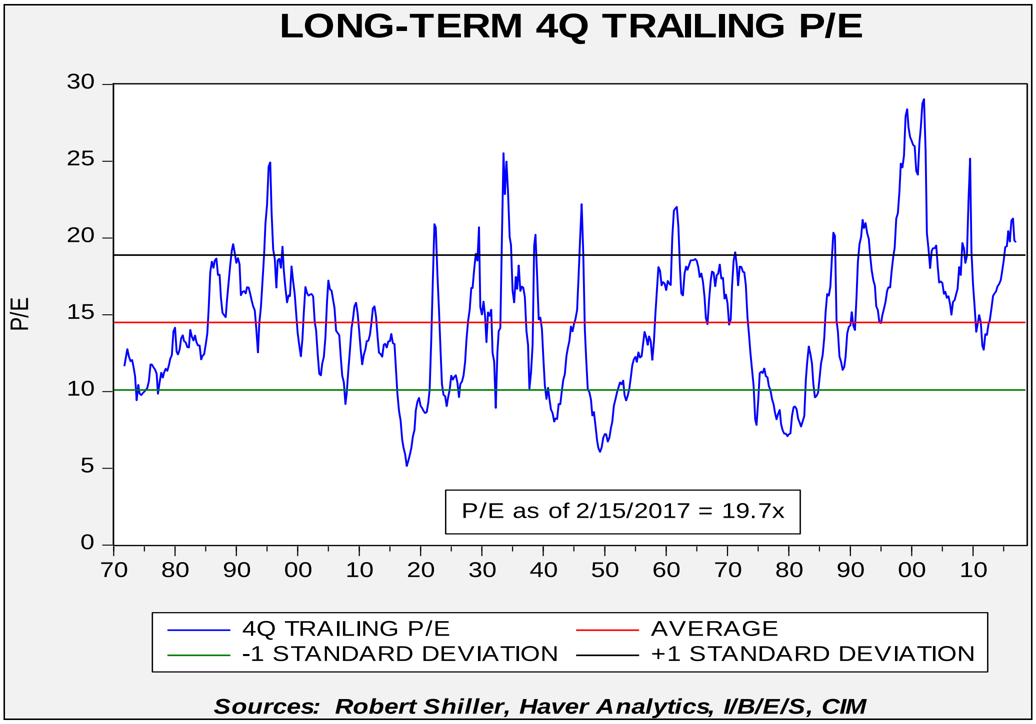


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2017



Based on our methodology,[4] the current P/E is 19.7x, unchanged from last week. Rising Q4 earnings offset the rise in equity prices, keeping the multiple steady.

This report was prepared by 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.

[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 (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.