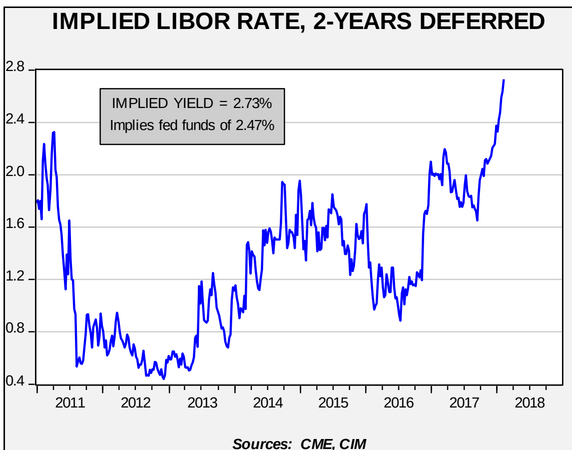
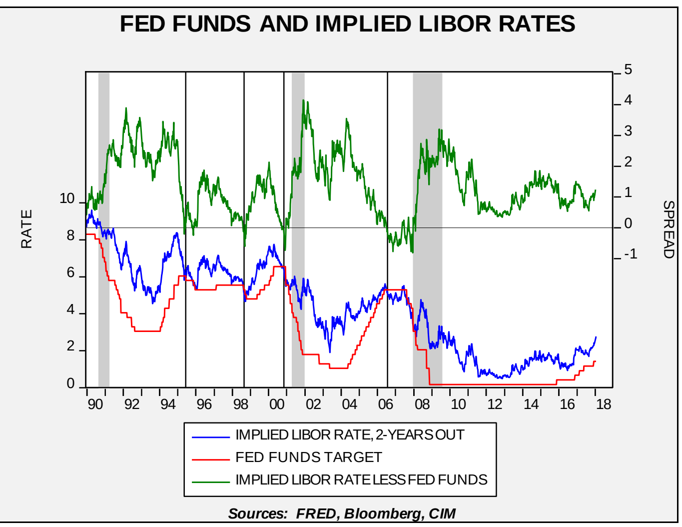
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: February 1, 2018—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.3% from the prior close. Chinese markets were down, with the Shanghai composite down 1.0% and the Shenzhen index down 3.0%. U.S. equity index futures are signaling a higher open. With 185 companies having reported, the S&P 500 Q4 earnings stand at $35.47, higher than the $34.84 forecast for the quarter. The forecast reflects a 10.7% increase from Q4 2016 earnings and a 4.2% increase from Q3 2017. Thus far this quarter, 78.4% of the companies reported earnings above forecast, while 13.0% reported earnings below forecast.

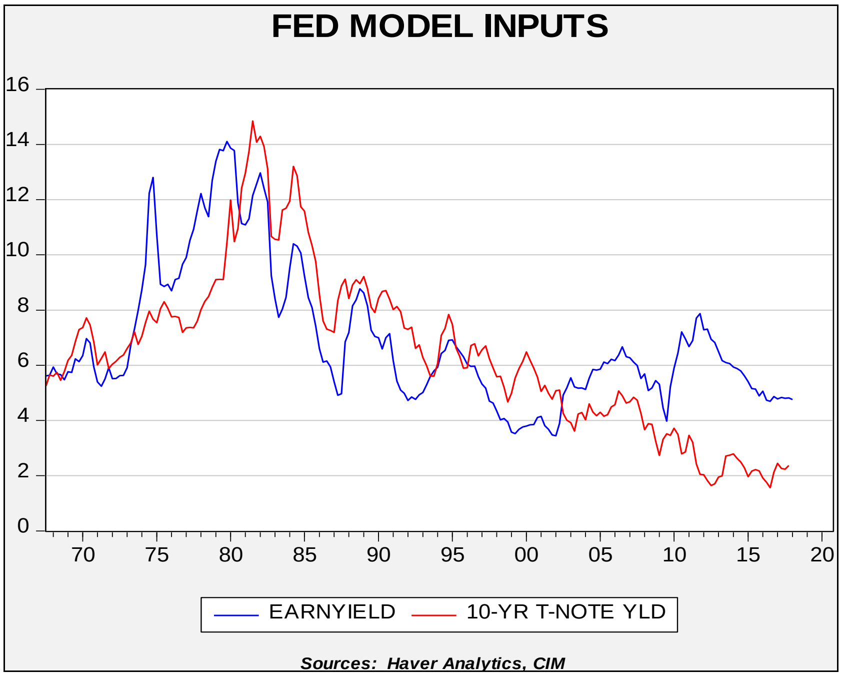
The FOMC: The FOMC did what we expected; it held rates steady but prepared the market for new rate hikes. We currently expect three hikes this year but, given the overall hawkishness of the 2018 voters, we cannot rule out four hikes, especially if the economy continues on its current course. Financial markets are preparing for additional hikes.





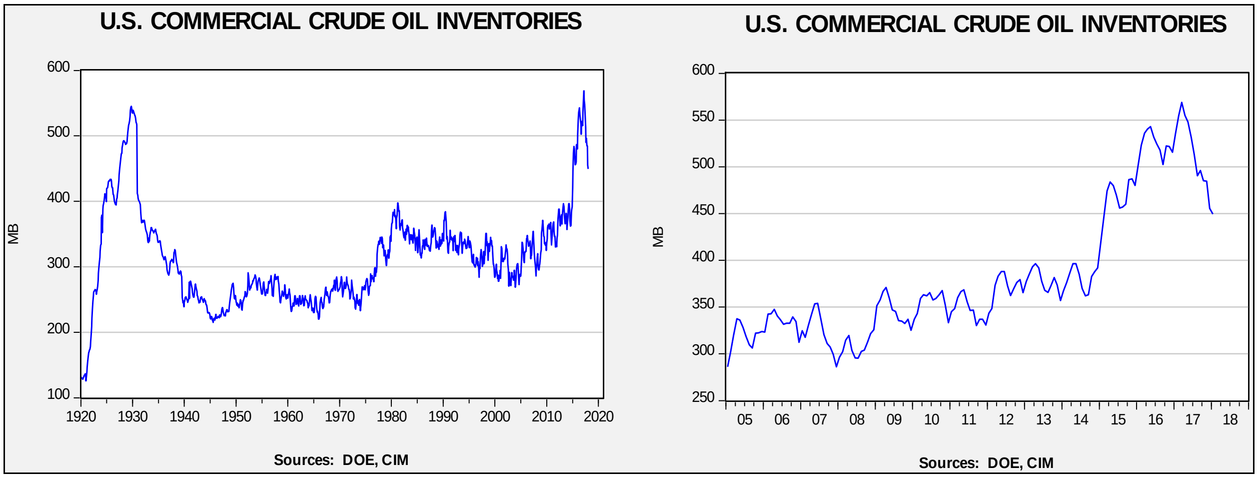
The chart on the left shows the implied three-month LIBOR rate from the Eurodollar futures market, two years deferred. In other words, it is the market's projection of three-month LIBOR rates in Q1 2020. Since September 2017, this rate has moved higher at a solid pace and now has reached its highest level in nearly eight years. The Eurodollars are now projecting a fed funds rate of nearly 2.50% in two years. The chart on the right shows the aforementioned implied LIBOR rate with the fed funds target. The upper line on the chart shows the spread between the two rates. During tightening cycles, the FOMC tends to raise rates until the spread becomes negative (shown by vertical lines on the chart). The fact that the spread is widening despite tighter policy suggests we are likely moving into an accelerating phase of tightening.

T-notes approach 2.75%: The 10-year T-note yield has moved toward 2.75% this morning as the prospect of tighter monetary policy, rising European yields and higher oil prices have boosted yields. Although the rise in Treasury yields is a potential threat to the equity markets, in reality, we would need to see much higher yields for it to become a significant risk for stocks.



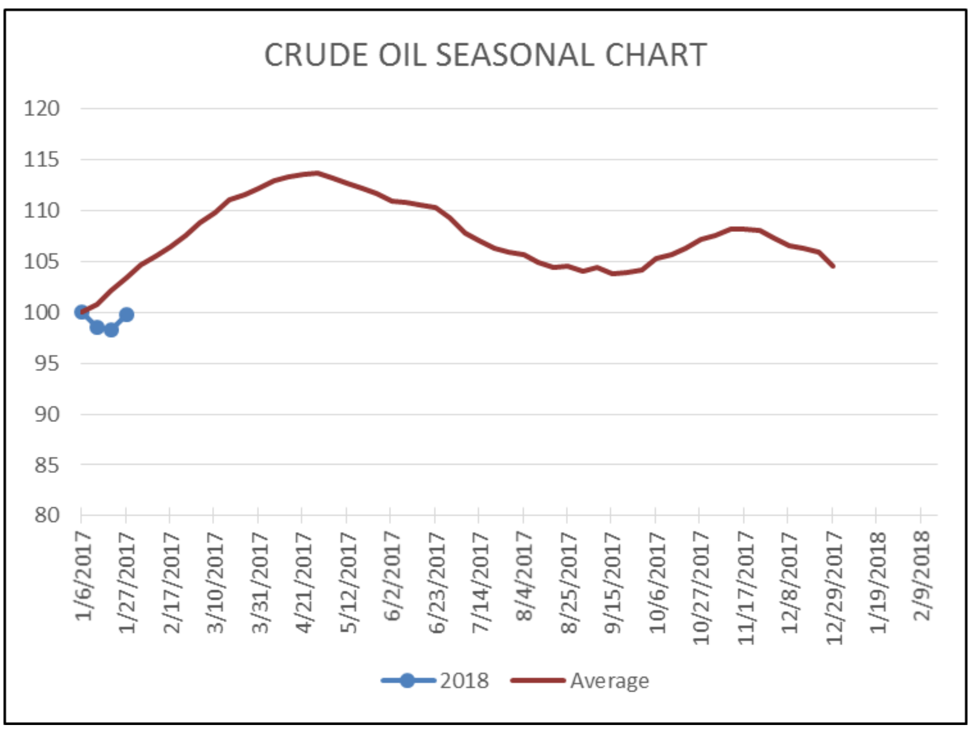
This chart shows the 10-year T-note yield and the S&P 500 earnings yield, the inverse of the P/E. For the P/E, we use the four-quarter trailing methodology, described in our weekly P/E chart. Although the so-called "Fed Model" has been around for a long time, in its raw form, it isn't all that good of a predictor. During much of the 1980s, the earnings yield was below the 10-year yield, which is odd. Still, for most of this century, the earnings yield has been higher than the T-note yield. Regressing the two suggests that the current level is about at fair value; to get to where equites are expensive, the 10-year would need to reach around 4.25%. Of course, given the relative "looseness" of this relationship, we would expect a negative reaction from equities before then but this chart does suggest that it will take a larger move in rates to adversely impact equities.

Energy recap: U.S. crude oil inventories rose 6.8 mb compared to market expectations of a 3.0 mb build.



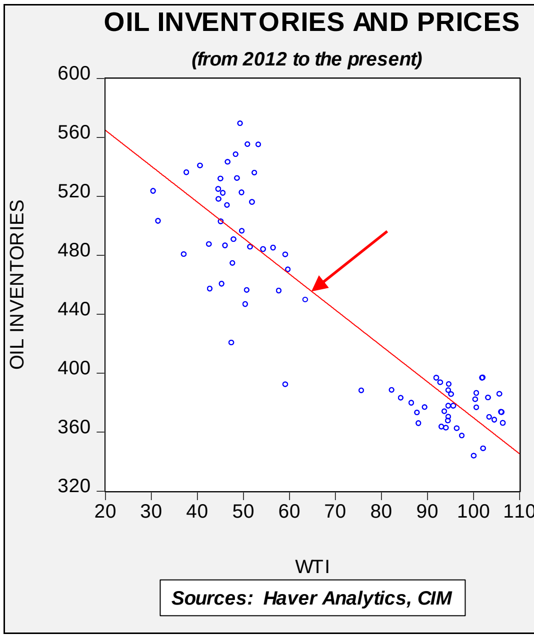
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider the overhang closed if stocks fell under 400 mb.

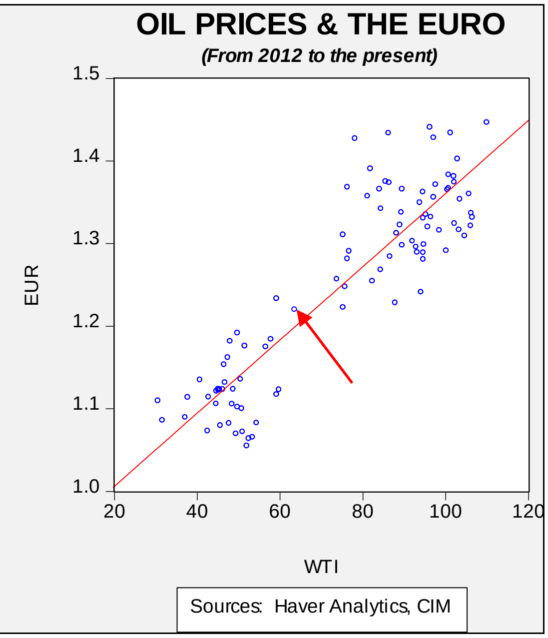
As the seasonal chart below shows, inventories are usually rising this time of year. This week, we finally saw an increase as refinery operations declined.



(Source: DOE, CIM)

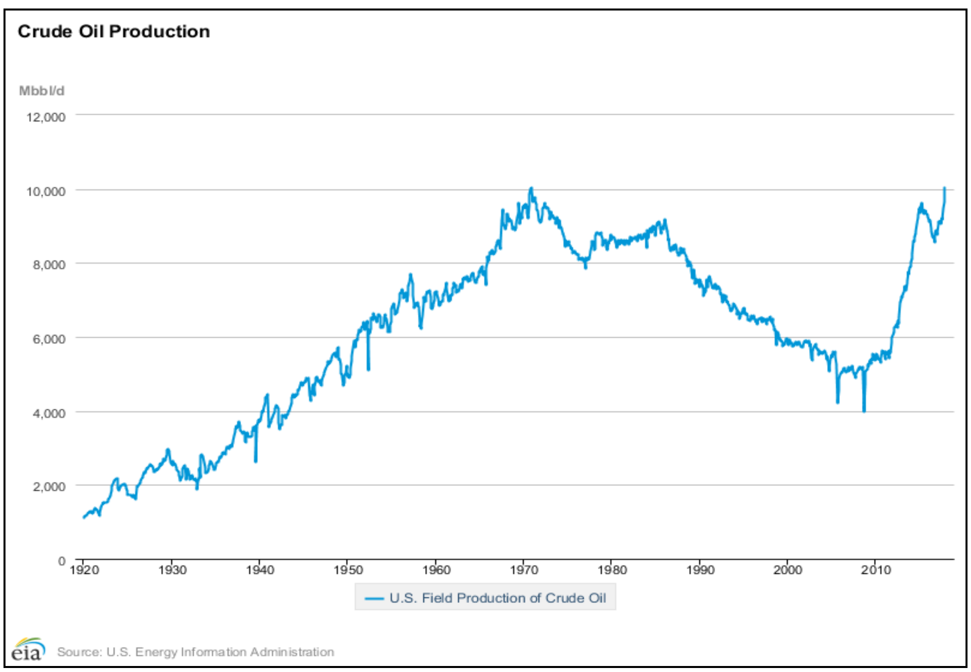
The rise is more normal and we would expect steady increases in stockpiles in the coming weeks until the refinery maintenance season comes to a close.





Based on inventories alone, oil prices are undervalued with the fair value price of $68.12. Meanwhile, the EUR/WTI model generates a fair value of $72.21. Together (which is a more sound methodology), fair value is $70.95, meaning that current prices, while elevated, are below fair value. The weak dollar and falling oil inventories are bullish for oil prices and suggest there is more upside, especially if inventories fail to rise in their normal seasonal fashion.

Yesterday, the DOE announced that official November U.S. oil production reached 10.0 mbpd for the first time since the early 1970s.

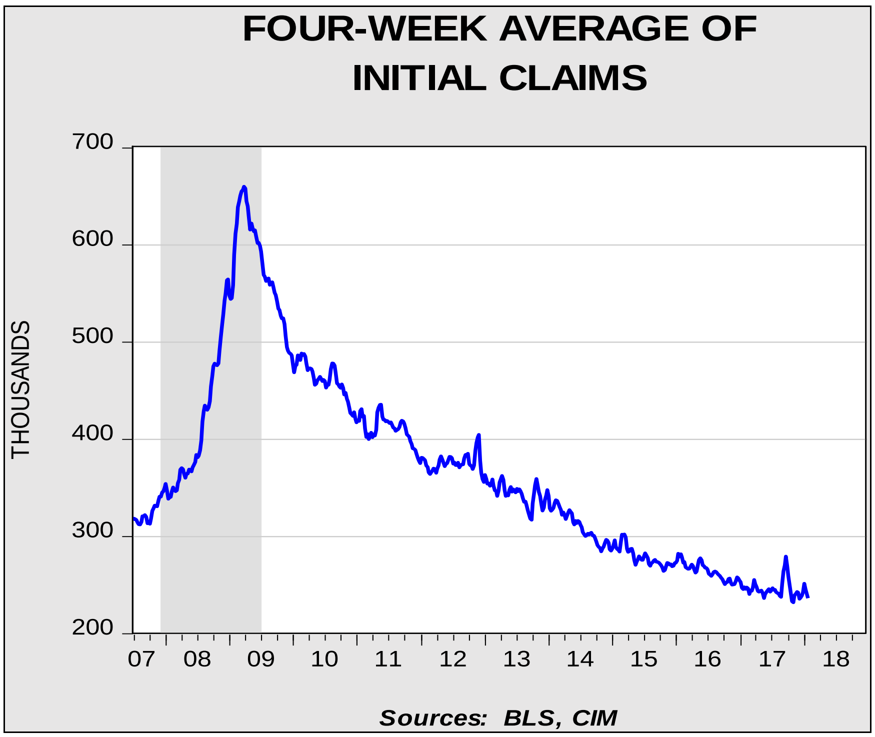


Although this news wasn't an enormous surprise, it is still remarkable. It is interesting to note that the U.S. was producing just over 5.0 mbpd at the turn of the decade. Essentially, U.S. oil output has doubled in eight years.

U.S. Economic Releases

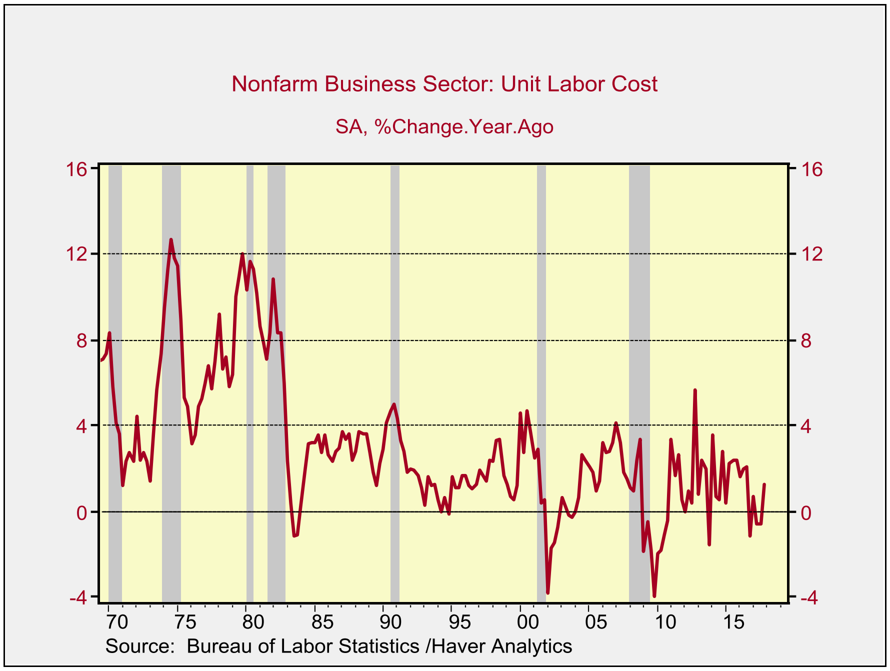
The January Challenger job cuts report fell by 2.8% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in below expectations at 230k compared to the forecast of 235k. The previous report was revised downward from 233k to 231k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average dropped from 240.5k to 235.5k.

Nonfarm productivity came in below expectations, falling 0.1% from the prior quarter compared to the forecast gain of 0.7%. The prior report was revised downward from 3.0% to 2.7%. Unit labor costs came in above expectations, rising 2.0% from the prior quarter compared to the forecast gain of 0.9%. The chart below shows yearly changes in unit labor costs.



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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	jan		53.7	**
9:45	Markit US Manufacturing PMI	m/m	jan	55.5	55.5	**
10:00	Construction Spending	y/y	dec	0.4%	0.8%	**
10:00	ISM Manufacturing	m/m	jan	58.6	59.7	**
10:00	ISM Prices Paid	m/m	jan		57.0	**
10:00	ISM New Orders	m/m	jan	68.8	69.0	**
10:00	ISM Employment	m/m	jan		69.4	**
	Wards Total Vehicle Sales	m/m	jan	13.45 mn	13.72 mn	**
	Wards Domestic Vehicle Sales	m/m	jan	17.20 mn	17.76 mn	**
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								
China	Caixin China PMI Mfg	m/m	jan	51.5	51.5	51.5	**	Equity and bond neutral
Japan	Japan buying foreign bonds	m/m	jan	¥41.1 bn	¥411.1 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	jan	¥374.5 bn	¥379.8 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	jan	-¥253.6 bn	-¥413.4 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	jan	-¥300.5 bn	¥148.2 bn		*	Equity and bond neutral
India	Nikkei India PMI Mfg	m/m	jan	52.4	54.7		**	Equity and bond neutral
	Fiscal Deficit INR Core	m/m	dec	8844	86784		**	Equity and bond neutral
Australia	CBA Australia PMI	m/m	jan	55.4	57.1		**	Equity and bond neutral
	AiG Performance of Mfg Index	m/m	jan	58.7	56.2		**	Equity bullish, bond bearish
	CoreLogic House Px	m/m	jan	-0.5%	-0.4%		**	Equity and bond neutral
	Import Price Index	q/q	4q	2.0%	-1.6%	1.5%	*	Equity and bond neutral
	Export Price Index	q/q	4q	2.8%	-3.0%	2.0%	*	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	jan	59.6	59.6	59.6	**	Equity and bond neutral
Germany	Markit/ BME Germany Manufacturing	m/m	jan	61.1	61.2	61.2	**	Equity and bond neutral
Italy	Markit/ ADACI Italy Manufacturing	m/m	jan	59.0	57.4	57.4	**	Equity bullish, bond bearish
France	Markit France Manufacturing	m/m	jan	58.4	58.1	58.1	**	Equity bullish, bond bearish
U.K.	Markit UK PMI Manufacturing	m/m	jan	55.3	56.3	56.5	**	Equity and bond neutral
Switzerland	SECO Consumer Confidence	m/m	jan	5	-2	2	***	Equity bullish, bond bearish
	Retail Sales Real	y/y	dec	0.6%	-0.2%		**	Equity and bond neutral
	PMI Manufacturing	m/m	dec	65.3	65.2	64.2	**	Equity bullish, bond bearish
Russia	Markit Russia PMI Manufacturing	m/m	jan	52.1	52.0	52.1	**	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	nov	3.5%	3.4%	3.4%	***	Equity bullish, bond bearish
Brazil	Industrial Production	y/y	dec	4.3%	4.7%	3.4%	***	Equity bullish, bond bearish

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)	177	177	0	Up
3-mo T-bill yield (bps)	143	143	0	Neutral
TED spread (bps)	35	34	1	Neutral
U.S. Libor/OIS spread (bps)	154	153	1	Up
10-yr T-note (%)	2.75	2.71	0.04	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	34	32	2	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	down			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Upper Bound)	1.500%	1.500%	1.500%	On forecast
FOMC Rate Decision (Lower Bound)	1.250%	1.250%	1.250%	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	$69.42	$68.89	0.77%	
WTI	$65.20	$64.73	0.73%	
Natural Gas	$2.94	$3.00	-1.80%	
Crack Spread	$17.20	$17.22	-0.12%	
12-mo strip crack	$19.42	$19.43	-0.06%	
Ethanol rack	$1.46	$1.46	0.44%	
Metals				
Gold	$1,338.49	$1,345.14	-0.49%	
Silver	$17.19	$17.35	-0.89%	
Copper contract	$319.10	$319.55	-0.14%	
Grains				
Corn contract	$ 360.25	$ 361.50	-0.35%	
Wheat contract	$ 446.00	$ 451.75	-1.27%	
Soybeans contract	$ 989.00	$ 995.75	-0.68%	
Shipping				
Baltic Dry Freight	1152	1191	-39	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	6.8	0.8	6.0	
Gasoline (mb)	-2.0	2.0	-4.0	
Distillates (mb)	-1.9	-0.5	-1.4	
Refinery run rates (%)	-2.80%	-0.45%	-2.35%	
Natural gas (bcf)		-288.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer temperatures for the western region, with cooler to normal temperatures for the rest 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.

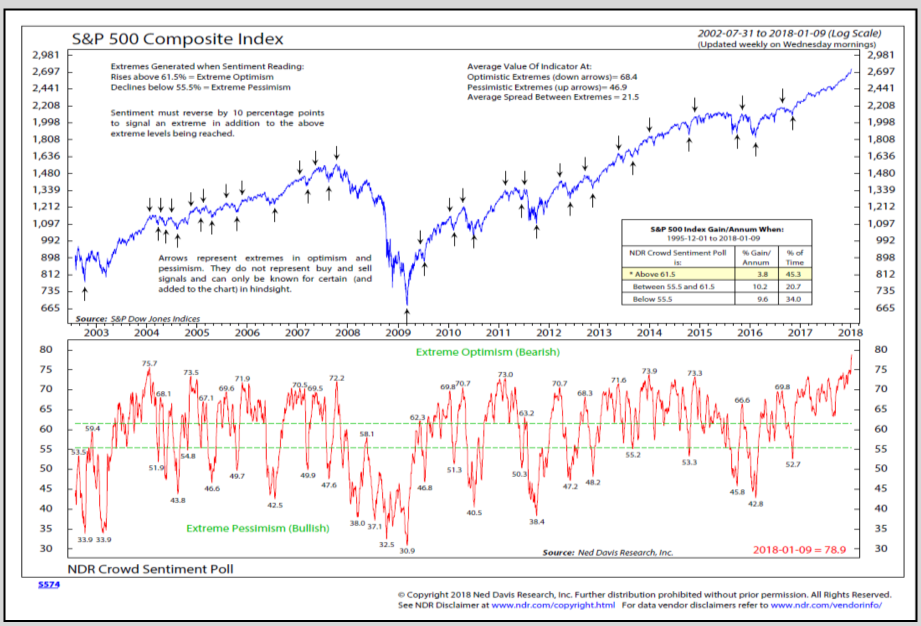
January 26, 2018

Equity markets have been steadily rising, with the major indices making a series of new all-time highs. The recent impetus to equities has been the tax law. As we detailed in our recent addendum to our 2018 Outlook,[1] the tax bill will shift about 1.3% of GDP to after-tax corporate profits. This development led us to raise our forecast for the S&P 500 to 3056.12 for 2018. At the same time, we realize bear markets do happen. So, what do we think as the market keeps trending higher?

In our 2018 Outlook[2] we detailed our views on the economy and how the economy affects equity markets. In summary, since 1987, each bear market in equities has coincided with economic recession. There is no evidence at present that a recession is looming in the near future; however, we do pay very close attention to the two major causes, geopolitical events and monetary policy mistakes, and will try to warn readers if we see anything looming.

This report, instead, is going to focus on short-term market factors. The steady rise in equities fosters both fear and greed. Here are some of the factors we are watching:

First, investor sentiment is elevated. The American Association of Individual Investor Sentiment Index is elevated; in fact, the ratio of bulls/bears is 5.25, wider than before the 1987 crash. Another sentiment indicator we monitor, from Ned Davis, tells a similar story.



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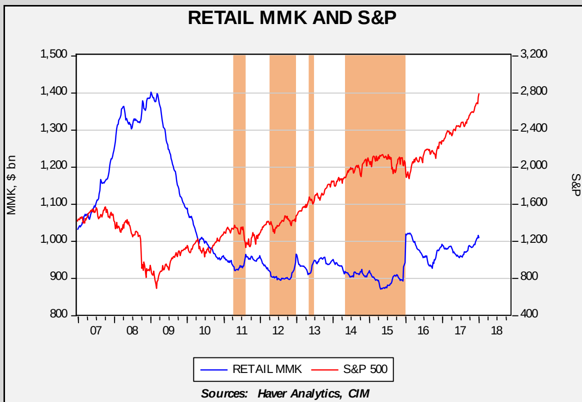
[1] See 2018 Outlook: Addendum, 1/4/18.

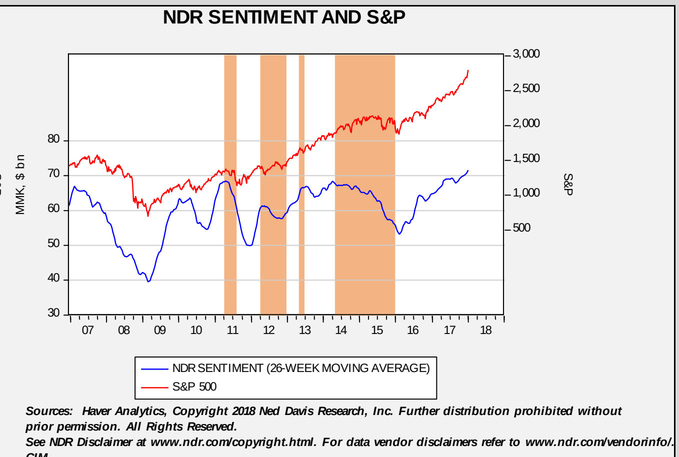
[2] See 2018 Outlook, 11/30/17.

The theory behind these sentiment indicators is “contrarianism.” Contrarianism is based on the idea that what the crowd believes is probably either (a) wrong, or (b) already discounted by the market. In other words, once investors become extremely bullish, not only does the price probably contain that sentiment, but high sentiment means there probably isn’t more upside left. Another variation of this theory can be seen in famous magazine covers, like *The Economist* predicting $5 crude oil in the late 1990s very close to the bottom around $10 per barrel.

Still, it is evident from the above chart that sentiment alone isn’t reliable. After all, Ned Davis uses a reading above 61.5 as an indicator of elevated sentiment; based on this figure, sentiment has been elevated since last November’s election with no significant declines in equity prices.

Second, another factor we monitor is the level of money market funds held by retail households. Since the recovery began in 2009, equity markets have tended to do well as long as money market funds exceed $920 bn. But, if money market funds fall below this level, equity markets seem to stall, most likely due to the lack of liquidity. The combination of liquidity and sentiment appears to offer better insights into market behavior than just sentiment alone.





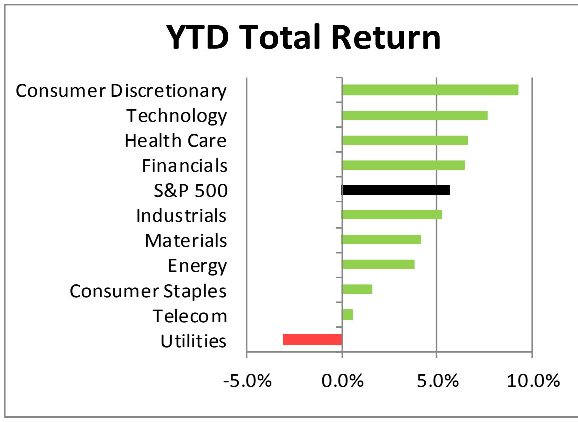
The chart on the left shows household money market funds. We have placed orange shading on periods when money market funds fell below $920 bn. Note how equity markets tended to stall once liquidity became tight. On the right, we use the same shading (indicating a low level of available liquidity) and the 26-week moving average of the NDR Sentiment Indicator. This shows that high levels of sentiment with ample cash levels tend to support high equity prices, whereas a reading over 60 on the sentiment index and low cash levels tend to lead to a flat to weaker market.

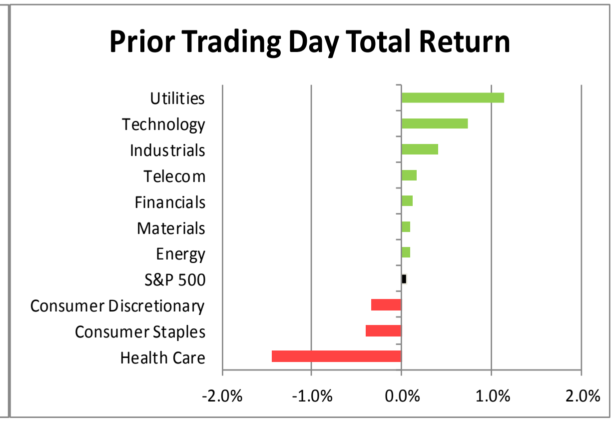
What is salient about the current situation is the combination of elevated sentiment and ample liquidity. Although it is possible that short-term interest rates have risen to a level where investors find them attractive, we rather doubt that’s the case. Over the past few years, elevated levels of cash usually indicate the potential for increased allocation to equities. High money market balances, coupled with elevated levels of investor sentiment, probably signal higher equity values.

That being said, concern about the elevated level of equities is not without merit. There is no doubt we are in the "late innings" of this bull market. After all, the current expansion will soon be the second longest on record. Although expansions don't die of old age, rising geopolitical tensions and expectations of tighter monetary policy do suggest this bull market may be measured in quarters, not years. At the same time, the combination of strong sentiment and high liquidity suggests that further upside is likely and it is probably premature for investors to become overly defensive.

Data Section

U.S. Equity Markets – (as of 1/31/2018 close)

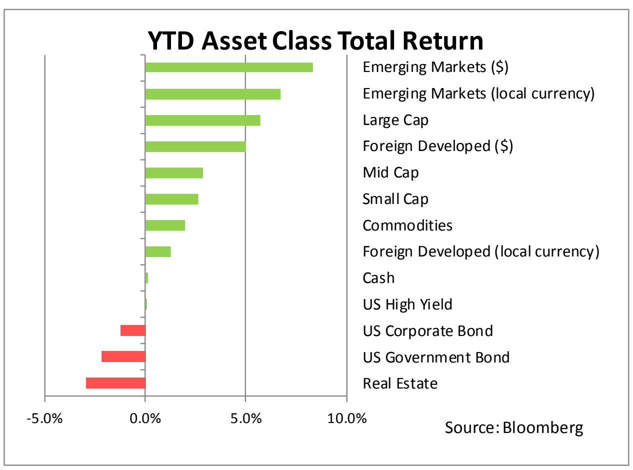




(Source: Bloomberg)

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 1/31/2018 close)

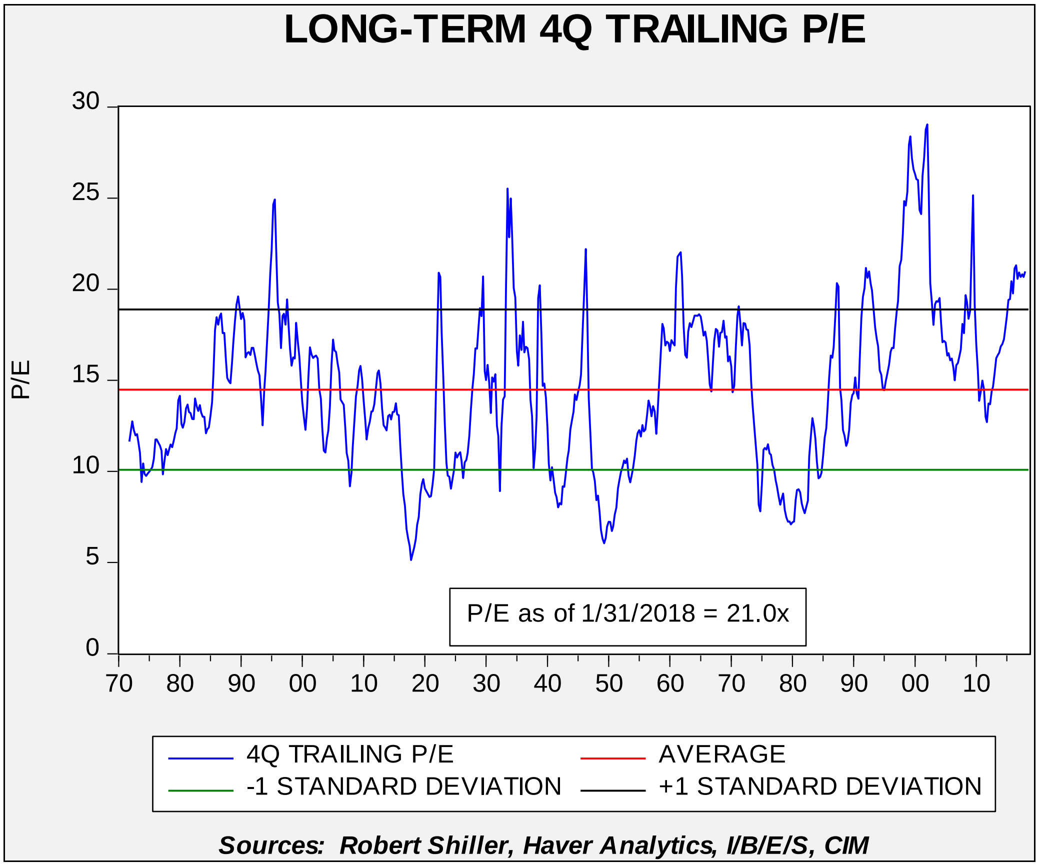


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 1, 2018



Based on our methodology,[3] the current P/E is 21.0x, unchanged from last week.

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.

[3] 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 quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q2 and Q3) and two estimates (Q4 and 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.