Daily Comment

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

[Posted: February 2, 2017—9:30 AM EST] Global equity markets are down this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1% from the prior close. Chinese markets are closed today for New Year. U.S. equity futures are signaling a lower open. With 219 companies having reported, the S&P 500 Q4 earnings stand at $31.39, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 64.4% of the companies reported earnings above forecast, while 22.4% reported earnings below forecast.

There's a lot going on this Groundhog Day,[1] so let's get started:

The Fed: The FOMC meeting was a clear non-event. Almost none of the language changed and the new committee didn't give us any hints that it is prepared to raise rates any faster than what the market currently expects. This suggests that, at least officially, the Fed is comfortable with its current views and positions on the economy and sees no reason to change its policy trajectory. Informally, it probably means that Chair Yellen isn't prepared to get the attention of the White House until she is really comfortable with her policy decision. ***The lack of tightening signals led the dollar lower which has continued this morning.*** Chair Yellen does give her semi-annual testimony to Congress on February 14-15 and that may offer better insights into the Fed's thinking.

The BOE: The BOE also left policy unchanged even though inflation and growth have been improving in the U.K. The bank appears worried about a drag on growth from Brexit and thus is keeping policy easy. However, inflationary pressures coming from the weaker GBP may eventually lead the BOE to begin raising rates or reducing QE.

An Iranian "red line"? National Security Advisor Flynn spoke to the press yesterday indicating that the administration is "officially putting Iran on notice" over its recent missile test. According to reports, the administration is considering "a large number of options"; there was no indication whether military action is being considered or ruled out. The test does not violate the nuclear deal which, by itself, does not include provisions on missile tests. However, the test likely defies the U.N. Security Council Resolution 2231, which does not allow Iran to test any missile capable of transporting a nuclear warhead. This recent test is at least the second; the last one was thought to have occurred in July. The Trump administration is signaling it won't be as tolerant as the Obama administration on these issues and the diplomatic agreements. The key unknown is whether this issue will escalate. If fears of a shooting war rise, gold, oil and Treasuries are the most likely beneficiaries. Given the strong tone of the objection coming from

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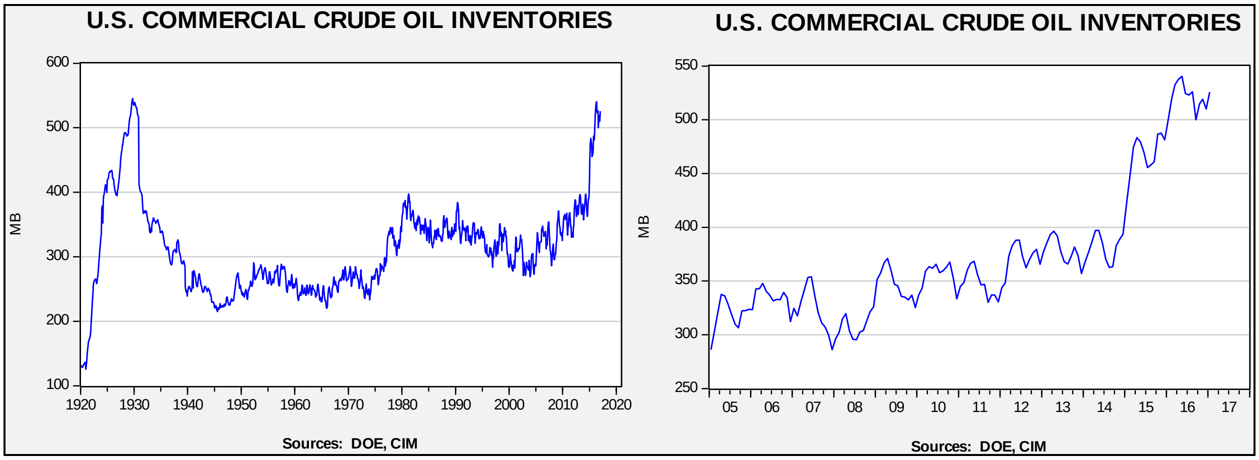
[1] Test your *Groundhog Day* movie skills with this quiz! http://www.stltoday.com/news/multimedia/groundhog-day-movie-quiz/html_b728cd22-4db4-11e1-8e5c-001a4bcf6878.html

the Trump administration, some sort of response is required. Otherwise, it could fall into the same trap the previous administration found itself in with Syria when a "red line" was violated but the Obama government failed to respond. This lack of response arguably reduced U.S. influence not only in the Middle East but in other areas as well.

Who is leaking these transcripts? The comments from two seemingly contentious phone calls by President Trump, one to Australian PM Turnbull and the other to Mexican President Nieto, have turned up in the press. In the former, the two leaders argued about a refugee agreement made between the Obama administration and Turnbull which would allow 1,250 refugees who are stuck on the islands of Nauru and Manus. Many of these souls are from the seven nations subject to restrictions by the recent executive order. President Trump was apparently upset by the deal and is indicating that these refugees will, at a minimum, be facing "extreme vetting." Second, a transcript from a call with Presidents Trump and Nieto seemed to imply that the former is considering sending U.S. troops into Mexico to attack "tough hombres." We wonder how these transcripts are being leaked. Is this being done deliberately by the White House to signal potential policy actions? Or does the administration have a "mole" trying to expose the new government? This is an issue we will continue to monitor.

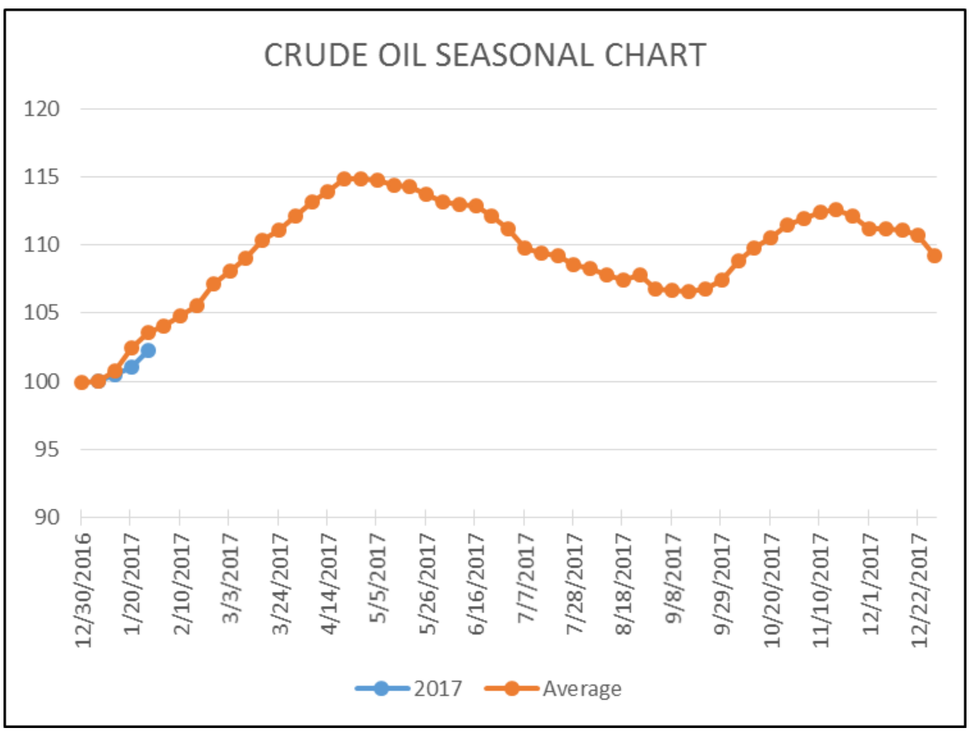
The French elections: Wikileaks has dumped 3,630 documents from the conservative (center-right) candidate François Fillon. So far, nothing too salacious has been uncovered but there are fears that the group, led by Julian Assange, is trying to affect the outcome of the French election. As we noted earlier, Fillon could be facing an investigation over allegations that he paid his wife to work as an administrator when in fact she did nothing. Nepotism is not illegal in France but paying people not to work apparently does violate the law. There are growing calls for Fillon to step down and allow another conservative to run in his place. His polling numbers are falling and, if the election were held today, there is a chance that the two largest vote winners would be the National Front's Le Pen and Emmanuel Macron, who is running as an independent. There are worries that such an outcome would favor Le Pen, since Macron would not have a party apparatus supporting his bid for the presidency. The fear in France is that the Kremlin, through Assange, is trying to put another Russian-friendly leader in a major Western government. Le Pen has been a supporter of Russia, suggesting the Russian annexation of the Crimea was "legal." Le Pen has indicated she would likely favor "Frexit" and would almost certainly try to leave the Eurozone.

U.S. crude oil inventories rose 6.5 mb compared to market expectations of a 3.0 mb build.

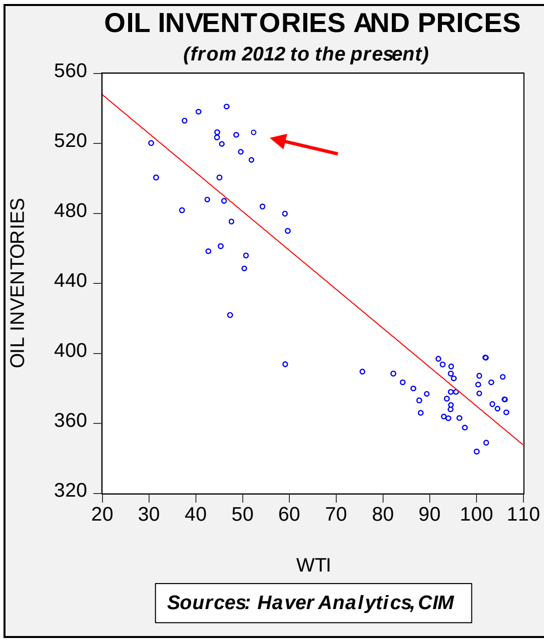


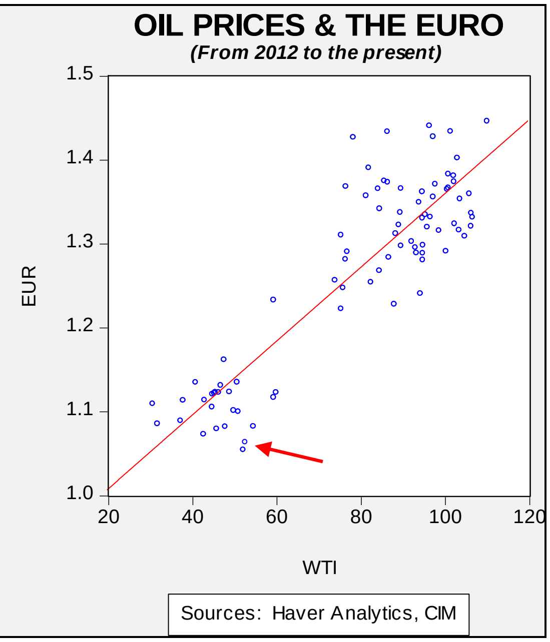
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, inventories remain elevated.

As the seasonal chart below shows, inventories usually increase into April before rising refinery operations for the summer driving season lower stockpiles. So far this year, inventories are rising a bit slower 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)





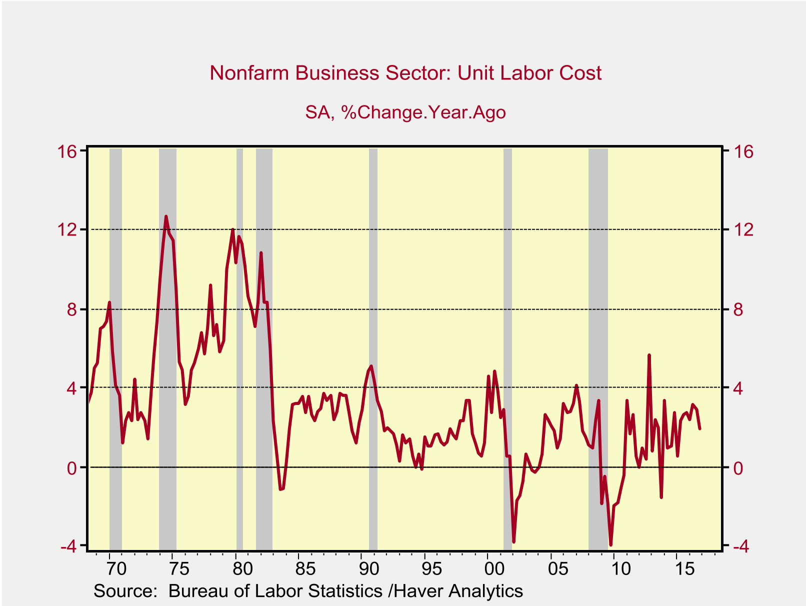
Based on inventories alone, oil prices are overvalued with the fair value price of $37.72. Meanwhile, the EUR/WTI model generates a fair value of $38.19. Together (which is a more sound methodology), fair value is $36.19, meaning that current prices are well above fair value.[2] OPEC has managed to lift prices but maintaining these levels will be a challenge given the dollar's strength and the continued elevated levels of inventorie. In fact, we need to see oil inventory accumulation fall well short of the usual seasonal pattern or oil prices will be vulnerable to a late Q1 drop.

U.S. Economic Releases

The Challenger job cuts index fell 38.8% 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. This index, with the exception of last month, has decreased steadily over the past six months, which suggests that the labor market is strengthening. If this trend continues we expect the Fed to continue its plan to raise rates.

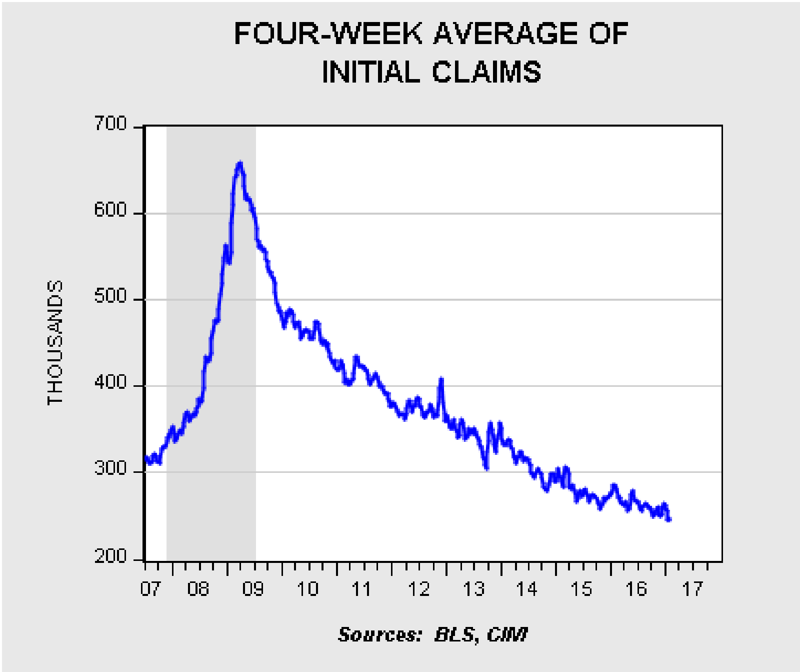
Nonfarm productivity rose 1.3% for Q4 compared to the forecast of 1.0%. The prior report was revised upward from a rise of 3.1% to 3.5%. Unit labor costs rose 1.7% compared to the forecast of 1.9%. The prior report was revised downward from a rise of 0.7% to 0.2%.

[2] The forecast that uses both independent variables is lower than the two separate models because the €/$ exchange rate and oil inventories are highly inversely correlated at -89%. In theory, it appears that some investors may be using oil inventories as a way to protect against dollar weakness.



The chart above shows the annual change in unit labor costs.

Initial jobless claims came in below expectations at 246k compared to the forecast of 250k. The prior week's report was revised upward from 259k to 260k. This is the 99th consecutive week that initial jobless claims have come in below 300k, the longest streak since 1970. The data suggests that the labor market is still strong.



The chart above shows the four-week moving average for initial jobless claims. The four-week moving average rose slightly from 245.75k to 248k.

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

Economic Releases						
9:45	Bloomberg Consumer Comfort	m/m	jan		45.2	**
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								
Japan	Monetary Base	y/y	jan	22.6%	23.1%		**	Equity and bond neutral
	Consumer Confidence	y/y	jan	43.2	43.1	43.4	**	Equity and bond neutral
	Japan Buying Foreign Bonds	y/y	jan	-1.3593 tn	-0.5390 tn		**	Equity and bond neutral
	Japan Buying Foreign Stocks	y/y	jan	124.9 bn	-19.1 bn		**	Equity and bond neutral
	Foreign Buying Japan Bonds	y/y	jan	446.2 bn	-168.5 bn		**	Equity and bond neutral
	Foreign Buying Japan Stocks	y/y	jan	-143.9 bn	-376.1 bn		**	Equity and bond neutral
Australia	Trade Balance	y/y	dec	$3.511 bn	$1.243 bn	$2.000 bn	**	Equity bullish, bond bearish
	Building Approvals	y/y	dec	-11.4%	-4.8%	-10.8%	**	Equity bearish, bond bullish
New Zealand	ANZ Job Advertisments	m/m	jan	-0.2%	1.6%		**	Equity and bond neutral
EUROPE								
Eurozone	PPI	y/y	dec	1.6%	0.1%	1.2%	**	Equity and bond neutral
U.K.	Markit/ CIPS UK Construction	y/y	jan	52.2	54.2	53.8	**	Equity and bond neutral
Switzerland	Retail Sales	y/y	dec	-3.5%	0.9%	-0.7%	**	Equity and bond neutral
Russia	Gold and Forex Reserve	y/y	jan	392.5 bn	385.9 bn		**	Equity and bond neutral
	Reserve Fund	y/y	jan	$16.2 bn	$16.0 bn		**	Equity and bond neutral
	Wellbeing Fund	y/y	jan	$72.5 bn	$71.9 bn		**	Equity and bond neutral
AMERICAS								
Mexico	Vehicle Domestic Sales	y/y	jan	123,260	192,567		**	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)	103	103	0	Up
3-mo T-bill yield (bps)	50	50	0	Neutral
TED spread (bps)	54	54	0	Neutral
U.S. Libor/OIS spread (bps)	69	68	1	Neutral
10-yr T-note (%)	2.46	2.47	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	30	30	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**	
FOMC Rate Decision (Upper Bound)	0.75%	0.75%	0.75%	On forecast
FOMC Rate Decision (Lower Bound)	0.50%	0.50%	0.50%	On forecast
Bank of Englan Bank Rate	0.25%	0.25%	0.25%	On forecast
BOE Asset Purchase Target	435 bn	435 bn	435 bn	On forecast
BOE Corporate Bond Target	10 bn	10 bn	10 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	$57.09	$56.80	0.51%	Short Covering
WTI	$54.03	$53.88	0.28%	
Natural Gas	$3.13	$3.17	-1.29%	
Crack Spread	$13.56	$13.77	-1.57%	
12-mo strip crack	$15.46	$15.51	-0.37%	
Ethanol rack	$1.57	$1.57	0.04%	
Metals				
Gold	$1,220.88	$1,209.84	0.91%	Weaker Dollar
Silver	$17.67	$17.55	0.73%	
Copper contract	$269.95	$271.15	-0.44%	
Grains				
Corn contract	$ 366.75	$ 368.25	-0.41%	
Wheat contract	$ 431.50	$ 433.75	-0.52%	
Soybeans contract	$ 1,034.25	$ 1,036.75	-0.24%	
Shipping				
Baltic Dry Freight	786	800	-14	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	6.5	3.0	3.5	
Gasoline (mb)	3.9	1.5	2.4	
Distillates (mb)	1.6	-0.5	2.1	
Refinery run rates (%)	-0.10%	-0.10%	0.0%	
Natural gas (bcf)		-77.0		

Weather

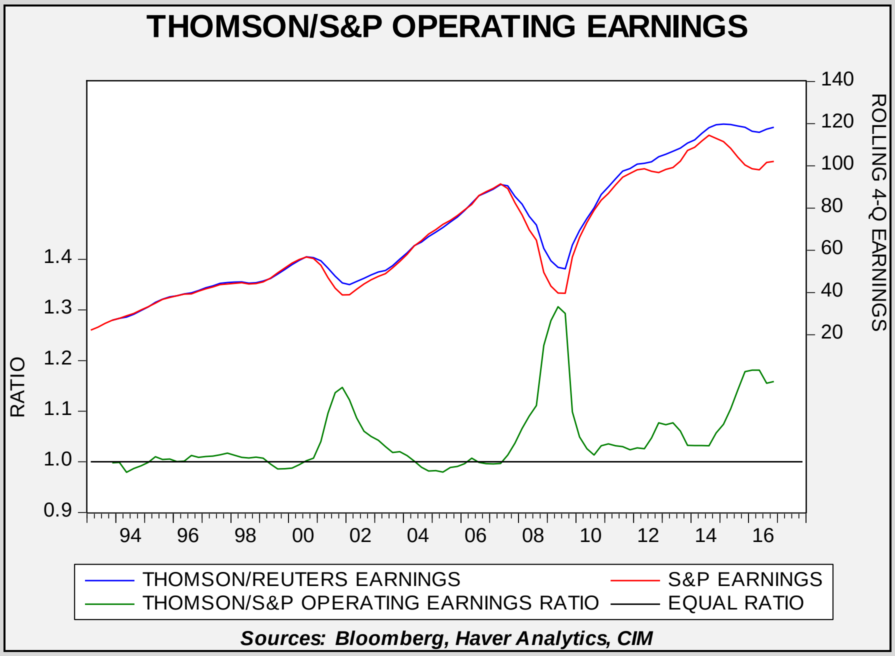
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country except the southwestern region.

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.

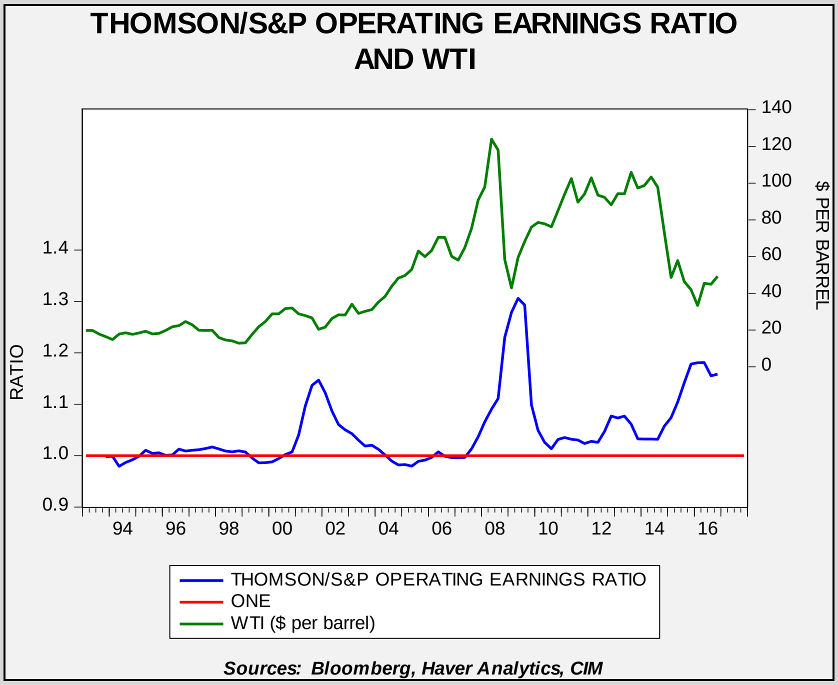
January 27, 2017

The consensus estimate for Q4 2016 S&P 500 operating earnings growth is 3.2%, which translates into a forecast of $118.35 per share for the S&P 500, using Thomson/Reuters data. Using a similar growth rate, the Standard and Poor's calculation of operating earnings generates annual earnings of $102.16. Simply put, these two sources currently have a rather wide divergence.



This chart shows the two series from 1994, with the lower line showing their ratio. The official explanation for the divergence is that S&P earnings are closer to Generally Accepted Accounting Principles (GAAP), which usually don't include "unusual items." The Thomson/Reuters earnings data excludes more of these non-recurring costs, resulting in higher operating earnings.

What concerns us about the current divergence is that two of the past divergences occurred during recessions. Thus, it is possible that the recent event is signaling that a downturn could be coming. However, we have also noted that another factor may help explain the widening—oil prices.



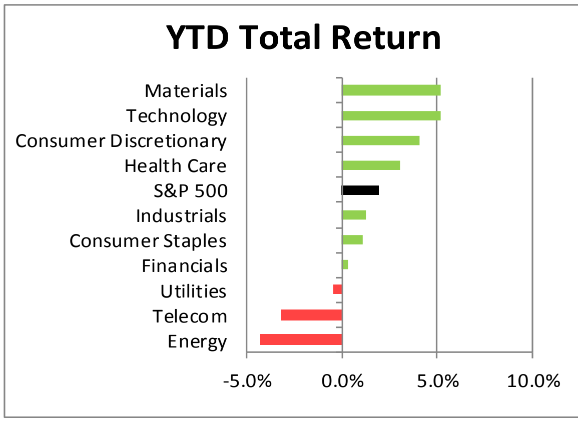
This chart overlays the ratio of the two earnings series with oil prices. Note that the three major divergences coincide with significant declines in oil prices. It is not unusual for recessions to bring lower oil prices; however, oil prices can fall for other reasons, as we have seen since 2014. This means that with the recovery in oil prices, we could very well see a narrowing of the ratio between the two series.

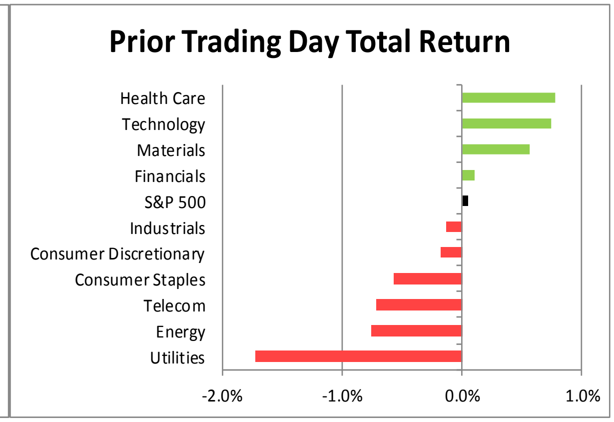
To the extent that the markets usually focus on the Thomson/Reuters data, a narrowing of the ratio won't matter too much. The growth in earnings as reported by S&P could be quite robust next year whereas the growth already estimated by I/B/E/S[3] of about 10.6%, while impressive, won't be as strong as S&P if the ratio approaches one. That would entail a greater than 29% rise in what S&P reports. Still, convergence of the two series does give us more confidence in the veracity of the earnings data.

[3] A part of Thomson/Reuters.

Data Section

U.S. Equity Markets – (as of 2/1/2017 close)

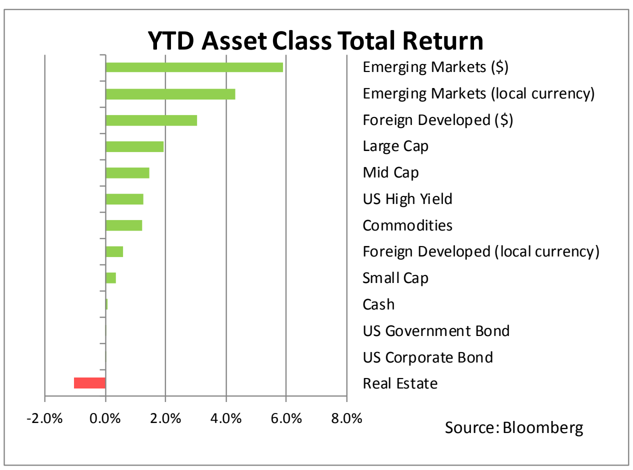




(Source: Bloomberg)

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 2/1/2017 close)

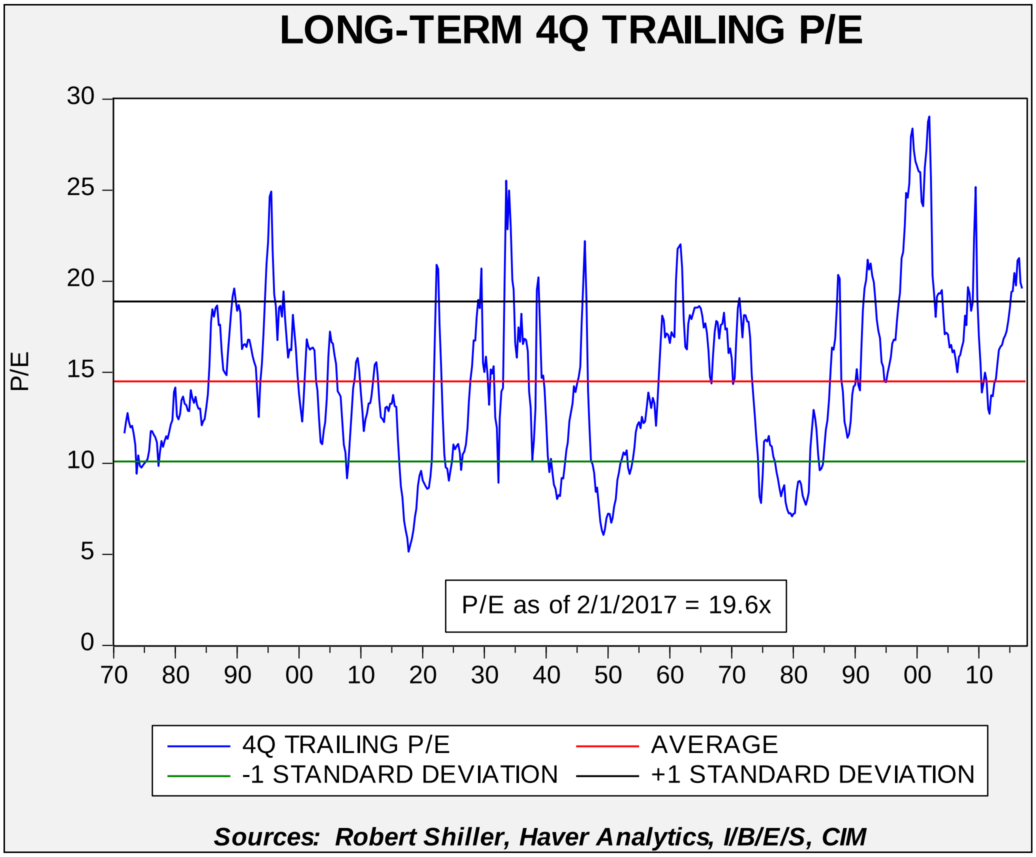


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2017



Based on our methodology,[4] the current P/E is 19.6x, unchanged from our last report.

[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.