Daily Comment

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

[Posted: February 9, 2017—9:30 AM EST] Global equity markets are up this morning. The EuroStoxx 50 is up 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3% from the prior close. Chinese markets were up, with the Shanghai composite up 0.5% and the Shenzhen index up 0.7%. U.S. equity futures are signaling a higher open. With 326 companies having reported, the S&P 500 Q4 earnings stand at $31.68, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 67.2% of the companies reported earnings above forecast, while 20.2% reported earnings below forecast.

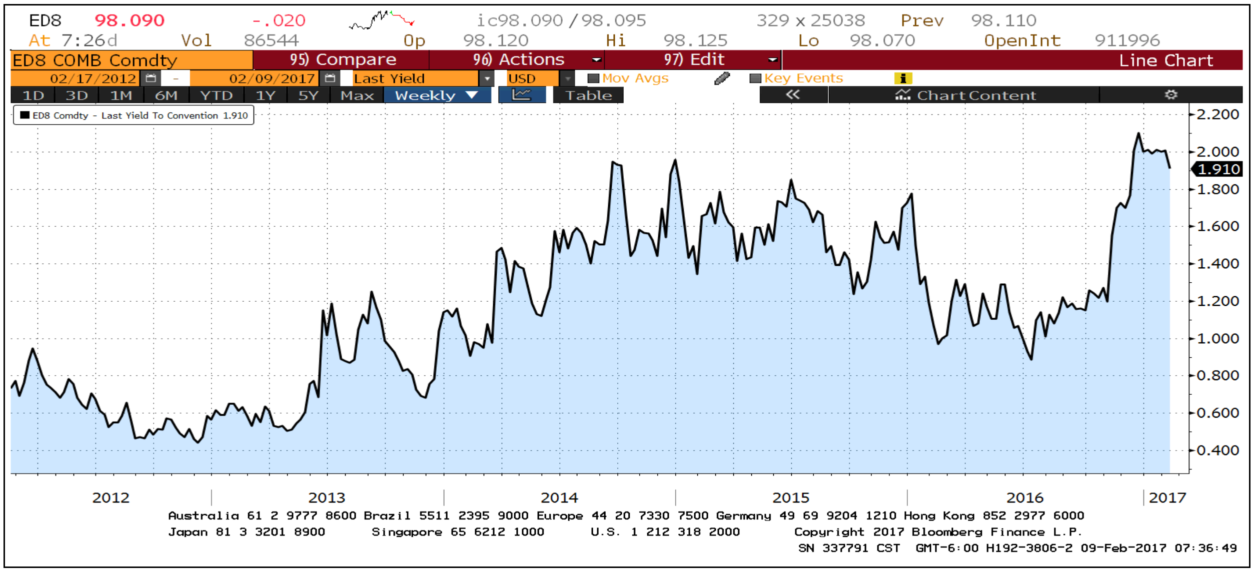
One of the political factors we watch with a new president is the management of political capital. Political capital is essentially the goodwill, the mandate, which comes from winning an election. Although not a hard and fast figure, it does appear to exist, can be depleted and has a "sell-by date." In general, by the 18th month of the first term, the capital is exhausted even if it isn't spent. By that time, Congress is gearing up for the midterm elections and the president's goals and aspirations become secondary to the desire for reelection.

Essentially, it's all about first understanding the strength of the mandate and "spending" it wisely. In my recollection, no president is perfect in this area. In the sweep of the moment, it's easy for a president to think he can do more than he is actually able and to get distracted by side issues that consume more time, effort and political capital than the issues warrant. It's also critically important for a president to understand the environment. All Democratic Party presidents pine for the expansion of health care; Republicans for entitlement changes. Attempting to achieve these changes tends to consume a lot of political capital and it's hard to get much else accomplished.

President Trump is something of an enigma. It is difficult to measure how much political capital he has given the size of his popular vote. At the same time, he is so unconventional that he may have more than normal. However, history would suggest his capital isn't infinite and it probably remains perishable. This means that we have to closely watch the allocation of political capital to policy and personnel.

After the November election, both the right-wing populists and the center-right establishment had their wish lists and both seemed to believe most of their goals would be fulfilled. Financial markets clearly believed that tax reform and rate reductions were coming and regulatory rollbacks were likely. Equity markets rallied, interest rates rose and the dollar jumped. At the same time, the right-wing populists were expecting immigration reform, infrastructure spending and trade restrictions. Trump is clearly trying to satisfy both constituencies while also trying to fill positions to build an administration. Our concern is that he is experiencing a significant "capital burn." At some point, he is going to have to start choosing his battles more carefully to conserve his political capital and accomplish his goals. We suspect this is going to require some degree of discipline that, at this juncture, seems to be lacking. Without discipline, he stands to disappoint both wings of his constituency due to ineffective management and opposition from Democrats.

Here is an indicator that may offer some insight into the concept of political capital.

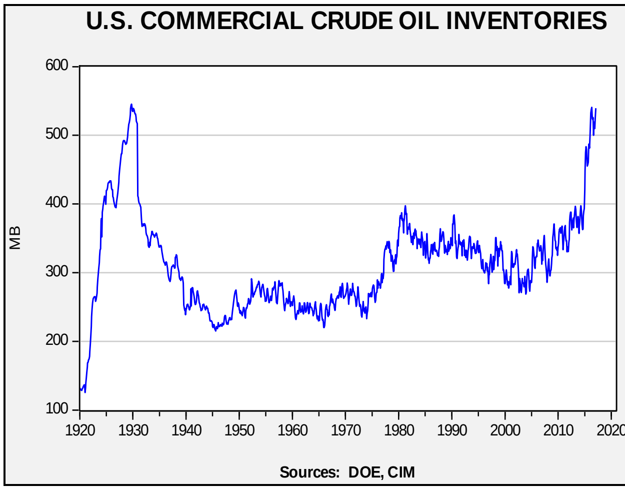


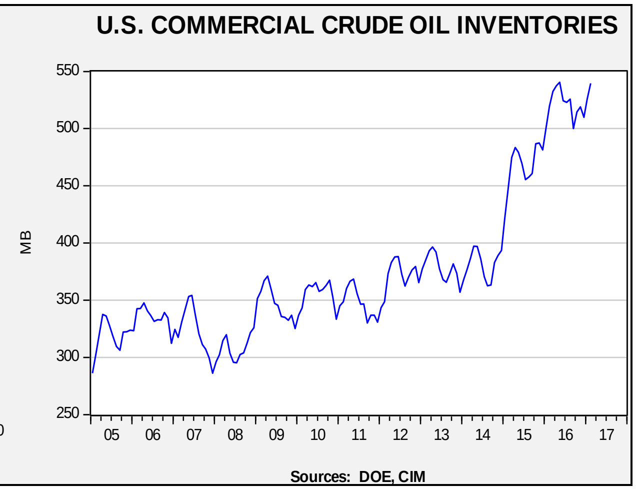
(Source: Bloomberg)

This chart shows the implied yield from the Eurodollar futures contract, two years advanced. Essentially, it's the market's estimate of what three-month LIBOR will be in two years. Note that the yield soared after the election, jumping nearly 90 bps in the first few weeks after November 9. We believe the rate jumped on expectations that Trump's fiscal stimulus would boost the economy and lead to tighter monetary policy. However, we are starting to see the implied rate pull back, suggesting the financial markets are reassessing just how much he will be able to accomplish.

If our analysis is correct, the implied rate should rise if Trump's policy goals begin to accelerate. This is especially true if tax cuts and fiscal spending are implemented. That would also lift long-duration Treasury yields and the dollar. However, if the implied yield continues to fall, it would suggest the financial markets are discounting less stimulus and slower policy tightening. This could lead to lower long-duration Treasury yields and dollar weakness.

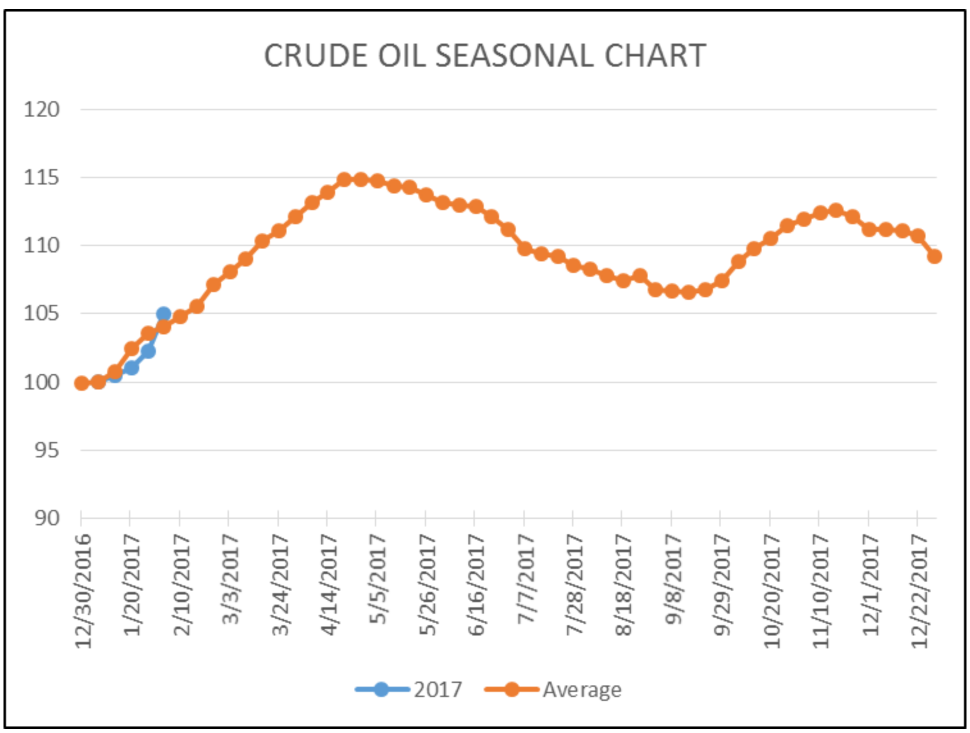
U.S. crude oil inventories rose 13.8 mb compared to market expectations of a 2.5 mb build.



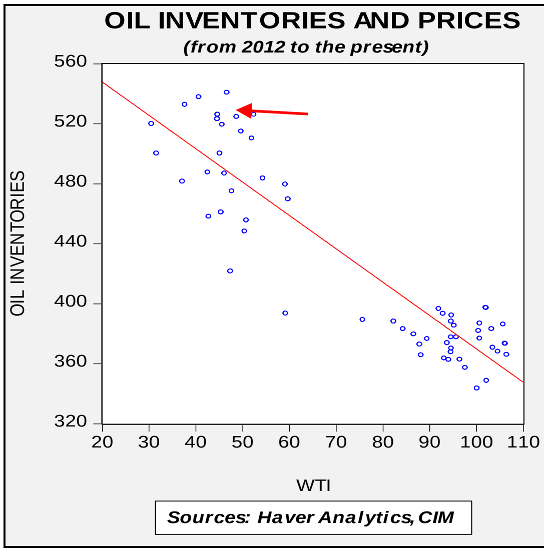


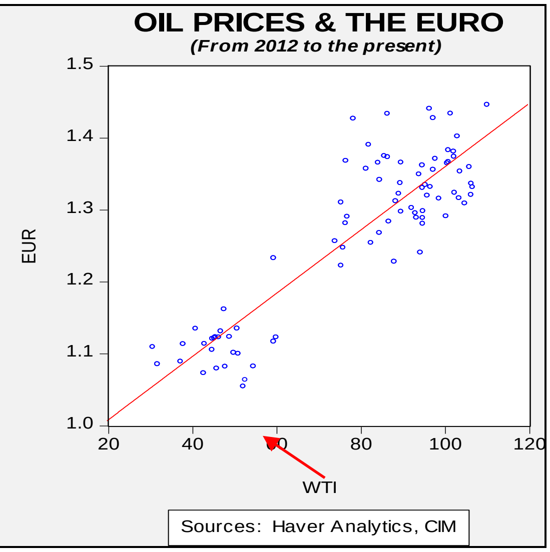
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, inventories remain elevated.

As the seasonal chart below shows, inventories usually rise into April before increasing refinery operations for the summer driving season lower stockpiles. After last week's data, inventories are rising 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)

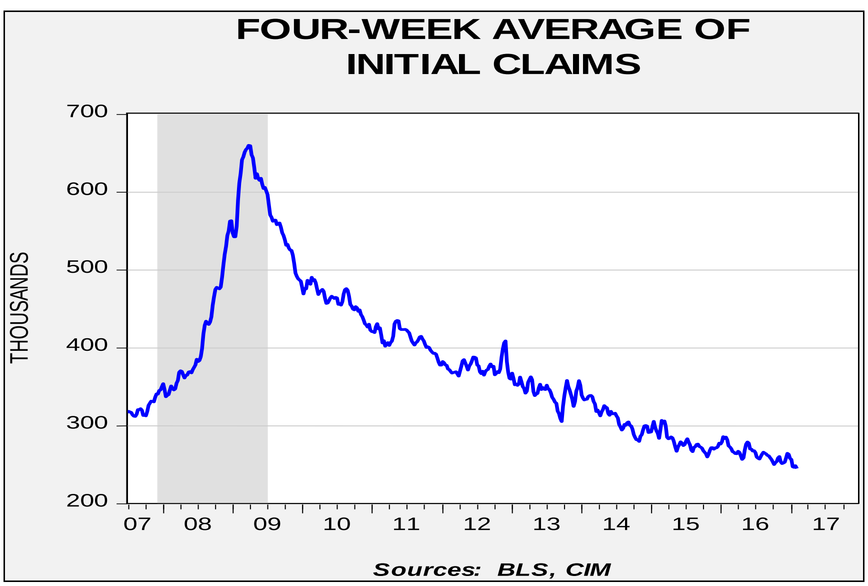




Based on inventories alone, oil prices are overvalued with the fair value price of $33.96. Meanwhile, the EUR/WTI model generates a fair value of $41.13. Together (which is a more sound methodology), fair value is $37.24, meaning that current prices are well above fair value. So far, the oil markets continue to give great benefit of the doubt as to OPEC's ability to improve market fundamentals. For now, since inventories usually rise this time of year anyway, the concern over the supply overhang is lessened. However, as the seasonal chart suggests, oil prices could be vulnerable to a setback if stockpiles fail to rapidly decline in the summer. In the meantime, it will be difficult to make a case for oil price strength barring a major dollar correction.

U.S. Economic Releases

Initial jobless claims came in below expectations at 243k compared to the forecast of 246k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell 3.75k to 244.25k.

Here are the domestic releases and Fed events scheduled for the rest of the day.

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	dec		46.6	**
10:00	Wholesale Trade Sales	m/m	dec		0.4%	**
15:00	Wholesale Inventories	m/m	dec	1.00%	1.00%	**
Fed speakers or events						
13:10	Charles Evans Speaks on Economy and Policy in Chicago	President of the Federal Reserve Bank of Chicago				

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	BoP Current Account Balance	y/y	4q	$37.6 bn	$69.3 bn		**	Equity bearish, bond bullish
Japan	BoP Current Account Balance	y/y	dec	1.1112 tn	1.4155 tn	1.1833 tn	**	Equity bearish, bond bullish
	Trade Balance BoP Basis	y/y	dec	806.8 bn	313.4 bn	738.9 bn	**	Equity bullish, bond bearish
	Bank Lending Incl Trusts	y/y	jan	2.6%	2.6%		**	Equity and bond neutral
	Bankruptcies	y/y	jan	-10.4%	1.6%		**	Equity bullish, bond bearish
	Eco Watchers Survey Current	m/m	jan	49.8	51.4	51.8	**	Equity bearish, bond bullish
	Eco Watchers Survey Outlook	m/m	jan	49.4	50.9	51.5	**	Equity bearish, bond bullish
New Zealand	ANZ Truckometer Heavy	m/m	jan	-0.8%	-0.1%		**	Equity and bond neutral
EUROPE								
France	Bank of France Business Sentiment	y/y	jan	101	102	103	**	Equity and bond neutral
Russia	Light Vehicle Car Sales	y/y	dec	-5.0%	-1.0%	0.0%	**	Equity and bond neutral
	CPI	w/w	feb	0.1%	0.1%		**	Equity and bond neutral
AMERICAS								
Mexico	Vehicle Sales AMIA	m/m	jan	278542	242495		**	Equity and bond neutral
	Vehicle Exports AMIA	m/m	jan	211682	216645		**	Equity and bond neutral
Canada	Housing Starts	m/m	jan	207.4k	207.0k	197.3k	**	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)	104	104	0	Up
3-mo T-bill yield (bps)	53	53	0	Neutral
TED spread (bps)	51	51	0	Neutral
U.S. Libor/OIS spread (bps)	69	68	1	Neutral
10-yr T-note (%)	2.35	2.32	0.03	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
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	1.75%	1.75%	1.75%	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	$55.55	$55.12	0.78%	Short Covering
WTI	$52.76	$52.34	0.80%	
Natural Gas	$3.17	$3.13	1.34%	
Crack Spread	$14.13	$14.04	0.63%	
12-mo strip crack	$15.75	$15.77	-0.14%	
Ethanol rack	$1.64	$1.63	0.71%	
Metals				
Gold	$1,239.80	$1,241.53	-0.14%	Stronger Dollar
Silver	$17.77	$17.78	-0.02%	
Copper contract	$266.80	$266.65	0.06%	
Grains				
Corn contract	$ 369.50	$ 370.75	-0.34%	
Wheat contract	$ 430.50	$ 432.50	-0.46%	
Soybeans contract	$ 1,053.25	$ 1,058.75	-0.52%	
Shipping				
Baltic Dry Freight	702	714	-12	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	13.8	2.5	11.3	
Gasoline (mb)	-0.9	1.5	-2.4	
Distillates (mb)	0.0	0.5	-0.5	
Refinery run rates (%)	-0.50%	-0.20%	-0.3%	
Natural gas (bcf)		-156.0		

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 western region.

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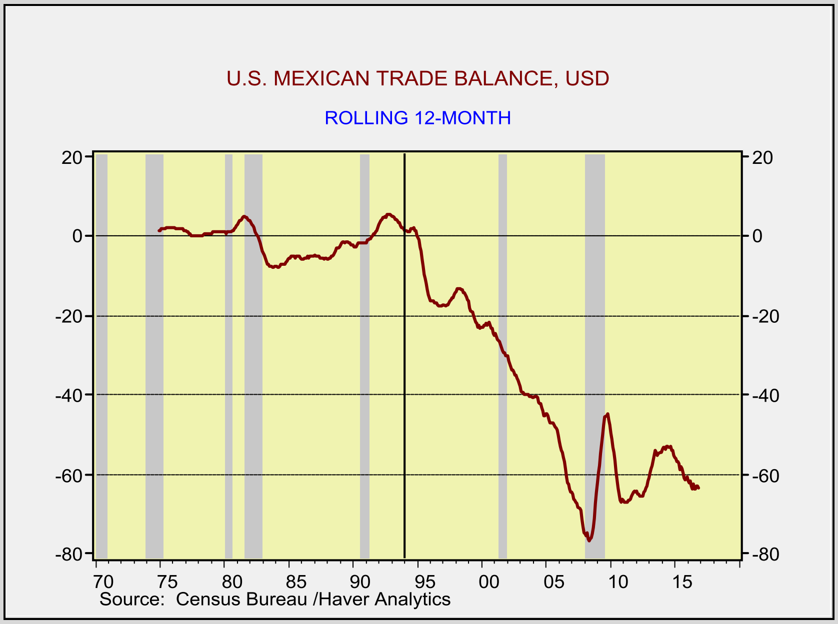
Asset Allocation Weekly Comment

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.

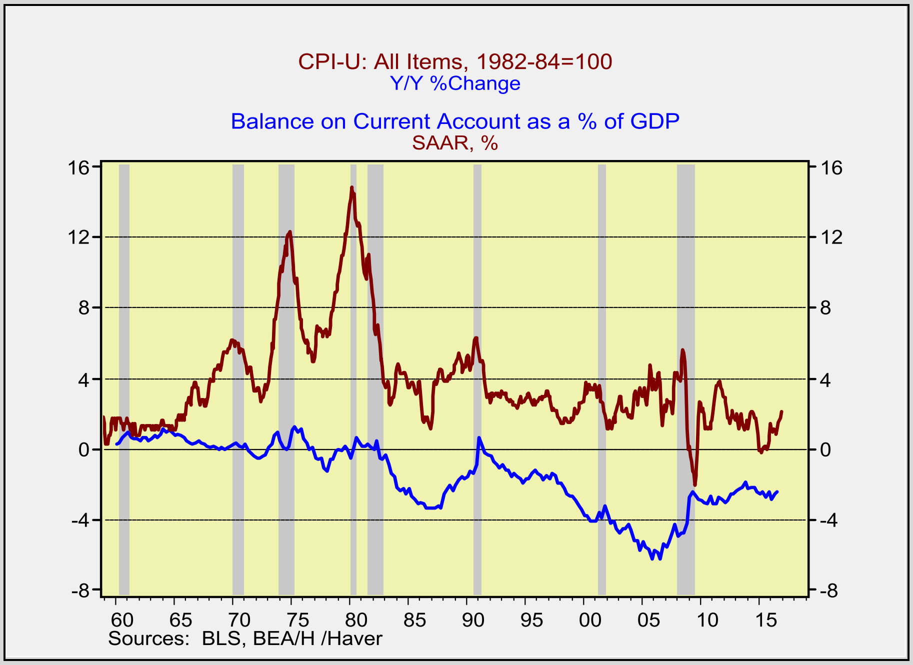
February 3, 2017

Although our current allocation models exclude emerging markets, we still monitor various emerging market nations for potential opportunities. A country that has been in the news recently is Mexico. President Trump has been targeting Mexico and the North American Free Trade Agreement (NAFTA) for Mexico's persistent trade surpluses with the U.S.



This chart shows the rolling 12-month trade account with Mexico; the vertical line on the chart shows the month when NAFTA was enacted. As the chart clearly shows, the trade deficit with Mexico has widened significantly, although it is interesting to note that it hasn't worsened since the last recession.

Trade deficits act as a drag on GDP; the tradeoff is microeconomic. Imports tend to improve the competitiveness of an economy.



Until the 1980s, the U.S. tended to run modest current account surpluses.[1] Note that inflation steadily declined after 1980. From 1960 to 1980, inflation averaged 5.1%. From 1980 to the present, it has averaged 3.3%, and since 1990, 2.1%. Competition from foreign trade forces domestic firms to be more competitive and cost efficient. At the same time, since the U.S. provides the reserve currency, there is an incentive for other nations to implement policies designed to run trade surpluses with the U.S. in order to acquire dollars. These policies tend to suppress domestic consumption and expand investment, with the global effect of boosting growth through trade.

The peso/dollar exchange rate has a strong impact on the performance of investments into Mexico. Currently, our model of the exchange rate suggests the peso is deeply undervalued.

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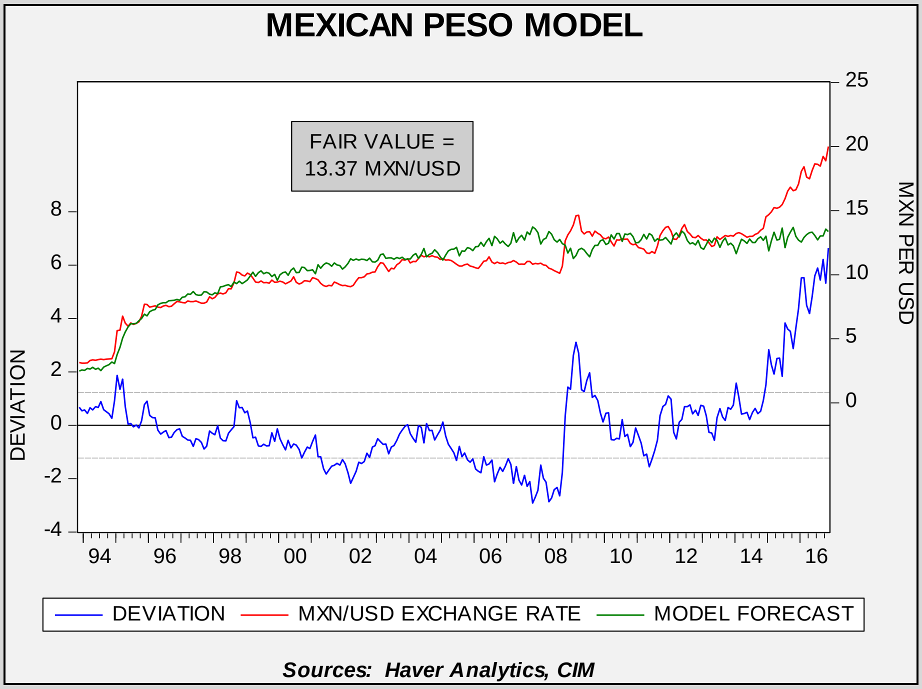
[1] The current account is the merchandise trade account plus private and public transfers and remittances.



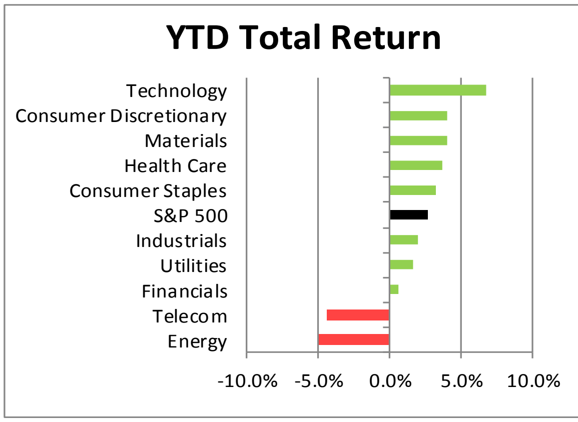
This model uses relative inflation and the trade account as independent variables. It suggests the peso is 33% undervalued relative to the dollar. Note that this undervaluation began in mid-2014 as the dollar began to rise across most currencies due to expectations of U.S. monetary policy tightening. The peso weakened further due to the election of Donald Trump, who promised to build a wall across the southern border of the U.S.

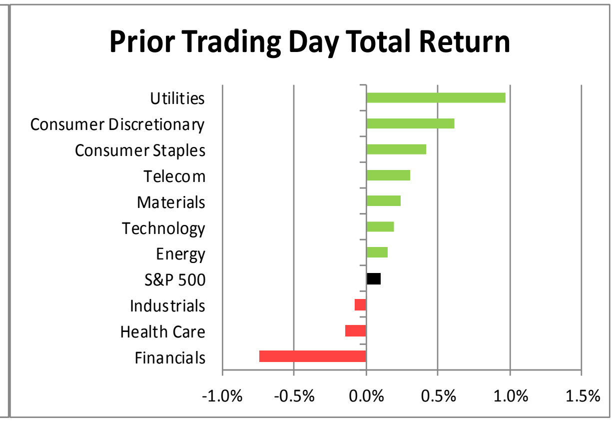
The weak peso has had an effect on Mexican equity values; in peso terms, the MSCI Mexico Index is up 10.1% since mid-2014, an annual gain of 3.8%. In U.S. dollar terms, it is down 28.1%, or -12.0% annualized.

Although the peso is quite competitive with the U.S. at current levels, the degree of political risk is so elevated at present that we are not ready to allocate to Mexican equity markets. However, at some point, the currency should stabilize and offer an opportunity for our asset allocation accounts. Until then, we continue to closely monitor this market.

Data Section

U.S. Equity Markets – (as of 2/8/2017 close)

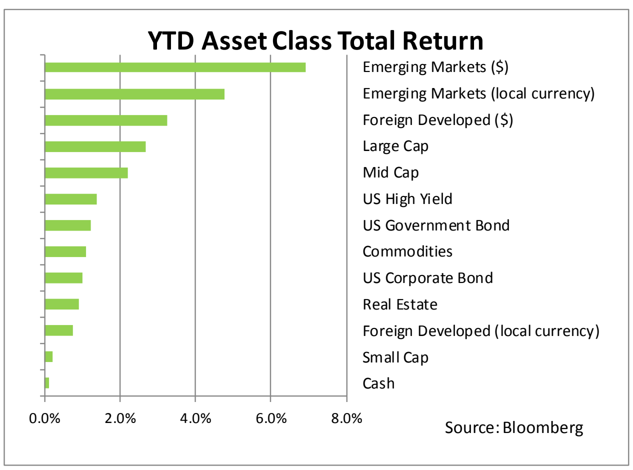




(Source: Bloomberg)

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 2/8/2017 close)

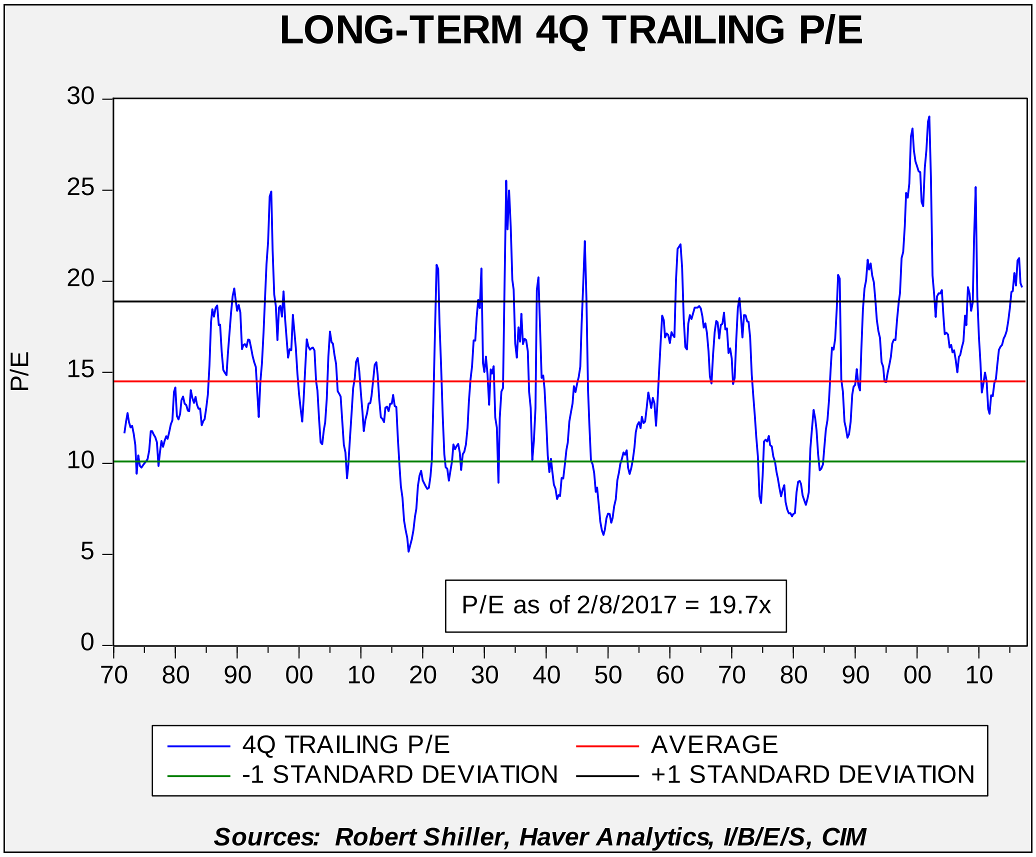


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

[2] 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.