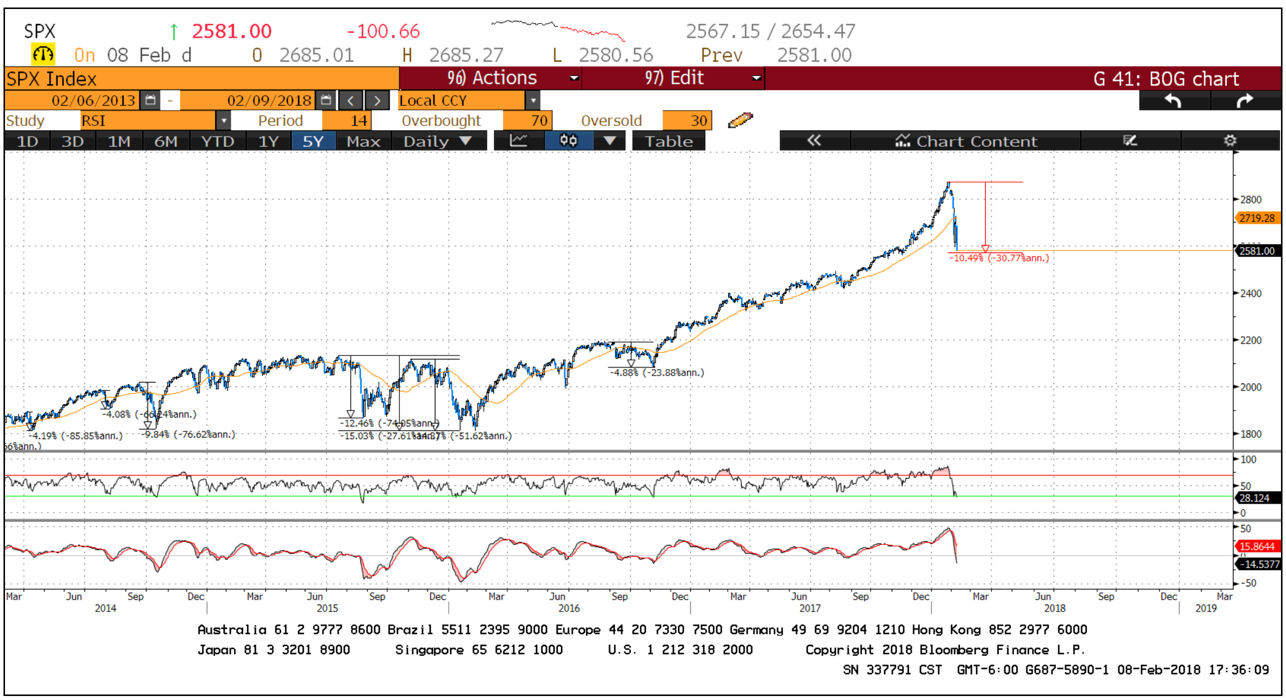
Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: February 9, 2018—9:30 AM EST] Global equity markets are down this morning. The EuroStoxx 50 is down 1.8% from the last close. In Asia, the MSCI Asia Apex 50 closed down 2.4% from the prior close. Chinese markets were down, with the Shanghai composite down 4.1% and the Shenzhen index down 3.2%. U.S. equity index futures are signaling a lower open. With 322 companies having reported, the S&P 500 Q4 earnings stand at $35.88, 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, 77.3% of the companies reported earnings above forecast, while 14.3% reported earnings below forecast.

Looking for something to read? In our travels we are often asked about books we recommend. As a result, we have created [The Reading List](). The list is a group of books, separated by category, that we believe are interesting and insightful. Each book on the list has an associated review to help you decide if you want to read it. We will be adding to the list over time. Books marked with a "" are ones we consider classics and come highly recommended.*

It's official! We are in a correction. The S&P 500 has now declined just over 10% on an intraday high-to-low basis.



(Source: Bloomberg)

Do we have more downside from here? Probably not materially, although we expect more grinding around current levels before we head back higher. Next week's CPI data will be important. If inflation does appear to be accelerating, it may trigger another downleg. Overall, the economy is still doing fine; the drop in equities might affect sentiment but it's important to remember that nearly 85% of equities are held by households in the top 10% of income brackets. In other words, the real losses are concentrated at the top end of the income scale so, for most Americans, the gyrations in equities are not a materially negative factor.

What are we paying attention to? It is clear in the data that the last major equity market decline in the absence of recession occurred in 1987. This begs the question, "Is this another 1987 event?" At present, we don't think so but, if it is going to be that kind of event, the trigger would probably be the use of volatility products. In 1987, portfolio insurance led to a selling effect that exacerbated the downdraft. Volatility trading won't necessarily involve the same methods, but it could lead to similar results.

We have been getting questions on the volatility trade and note there is some confusion on how it works. It's important to note that betting on volatility is just that—it's essentially trying to predict when the "freight train" is coming while others pick up nickels from the tracks. To get an idea of this, we refer to the prospectus for the VXX (55.24), which says (on pages 13-14):

> *The long-term expected value of your ETN is zero. If you hold your ETN as a long-term investment, it is likely you will lose all or a substantial portion of your investment.*

The reason is the roll yield. The long volatility products are long the front contract of the VIX futures when the term structure of the VIX futures are normally in contango, meaning the deferred futures price is above the nearest price. When the nearest contract expires, the VXX manager buys the next nearest contract ***at a higher price.*** If nothing happens, that contract will decline to where the previous contract expired, meaning the value of the positon will decline. Over the long term, that means steady losses for the holder of long volatility. So, the inverse position in volatility is in the opposite position. Their position gains over time. The anti-vol trade is really more of a roll yield position and less of a position on volatility. Now, when policymakers are dampening volatility with accommodative and transparent monetary policy, the periods lengthen between volatility spikes (when the VXX pays off, or, when the "freight train" arrives), making the anti-vol positions quite profitable.

What led to the collapse of the anti-vol ETP was not just the jump in volatility but the fact that the volatility futures term structure flipped from contango to backward. In other words, the nearest futures contract rose relative to the deferred contracts. This means that losses were being accumulated on the roll yield and on the outright short position against volatility, which pushed prices down to points where some (but not all) ETN managers, to protect losses, exercised the call provision of the note and closed their products.

The unknown is how widespread was anti-vol positioning, who was in it and how much leverage was being deployed? A casual look at the holders of XIV (0.00), the primary inverse ETN, shows a number of banks and broker dealers that were probably holding these for customers.

But, a large number of hedge funds are also represented and that is where the concern lies. The fact that we are seeing selloffs in the last hour of trading may be a signal that these entities are still trying to build liquidity. We don't think the current event is going to be another 1987 situation, but we are watching the volatility issue closely because that is the most likely source if this does turn out to be a similar occurrence.

Is there a Powell put? At present, if there is one, we are far from its strike price. Various Fed speakers have been out in recent days and none seem overly concerned about the decline in equities, and fed fund futures are still projecting the odds of a March rate hike at around 85%.

A budget: The president signed the Senate budget deal that was passed early this morning by the House and Senate. We did have a filibuster in the Senate that delayed the passage but we felt confident it would pass. The good news is that we have now removed the budget drama from the markets for a couple of years. What we have to deal with is the additional fiscal stimulus coming from the tax bill and this new spending. We expect much of the expansion to boost imports, meaning the national growth effect will not be all that impressive but it is quite good for the global economy.

U.S. Economic Releases

There were no new economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale Inventories	m/m	dec	0.2%	0.2%	**
10:00	Wholesale Trade Sales	m/m	dec	0.4%	1.5%	**
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	PPI	m/m	jan	4.3%	4.9%	4.3%	**	Equity and bond neutral
	CPI	m/m	dec	1.5%	1.8%	1.9%	***	Equity bearish, bond bullish
Japan	Money Stock M2	m/m	jan	3.4%	3.6%	3.6%	**	Equity and bond neutral
	Money Stock M3	m/m	jan	2.9%	3.1%	3.1%	**	Equity and bond neutral
	Tertiary Industry Index	m/m	dec	-0.2%	1.1%	0.2%	**	Equity bearish, bond bullish
Australia	Home Loans	m/m	dec	-2.3%	2.1%	-1.0%	**	Equity bearish, bond bullish
	Investment Lending	m/m	dec	-2.6%	1.5%		**	Equity and bond neutral
New Zealand	QV House Prices	y/y	jan	6.4%	6.6%		***	Equity and bond neutral
EUROPE								
France	Industrial Production	m/m	dec	0.5%	-0.5%	0.1%	***	Equity bullish, bond bearish
	Manufacturing Production	m/m	dec	4.7%	3.0%	3.4%	**	Equity bullish, bond bearish
Italy	Industrial Production	m/m	dec	4.9%	2.2%	1.9%	***	Equity bullish, bond bearish
U.K.	Trade Balance	m/m	dec	-4896	-2804	-2400	**	Equity bearish, bond bullish
	Industrial Production	m/m	dec	-1.3%	0.4%	-0.9%	***	Equity bearish, bond bullish
	Manufacturing Production	m/m	dec	0.3%	0.4%	0.3%	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	jan	3.3%	3.3%	3.4%	***	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	dec	5.6%	6.8%	5.5%	***	Equity and bond neutral
Canada	Housing Starts	m/m	jan	216.2k	217.0k	210.0k	**	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)	180	179	1	Up
3-mo T-bill yield (bps)	152	152	0	Neutral
TED spread (bps)	28	27	1	Neutral
U.S. Libor/OIS spread (bps)	154	154	0	Up
10-yr T-note (%)	2.84	2.82	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	39	33	6	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Banco de Mexico Overnight Rate	7.500%	7.500%	7.500%	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	$64.35	$64.81	-0.71%	
WTI	$60.48	$61.15	-1.10%	
Natural Gas	$2.64	$2.70	-2.19%	
Crack Spread	$15.39	$15.17	1.46%	
12-mo strip crack	$18.19	$18.08	0.64%	
Ethanol rack	$1.49	$1.49	-0.06%	
Metals				
Gold	$1,310.65	$1,318.39	-0.59%	Stronger dollar
Silver	$16.31	$16.37	-0.35%	
Copper contract	$307.80	$308.75	-0.31%	
Grains				
Corn contract	$ 365.50	$ 365.25	0.07%	
Wheat contract	$ 457.50	$ 460.50	-0.65%	
Soybeans contract	$ 985.75	$ 983.00	0.28%	
Shipping				
Baltic Dry Freight	1097	1095	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.9	3.0	-1.1	
Gasoline (mb)	3.4	1.0	2.4	
Distillates (mb)	3.9	-1.5	5.4	
Refinery run rates (%)	4.40%	-0.40%	4.8%	
Natural gas (bcf)	-119.0	-111.0	-8.0	

Weather

The 6-10 and 8-14 day forecasts call for cooler to normal temperatures for the northern region, with warmer temperatures for the rest of the country. Precipitation is expected for most of the country.

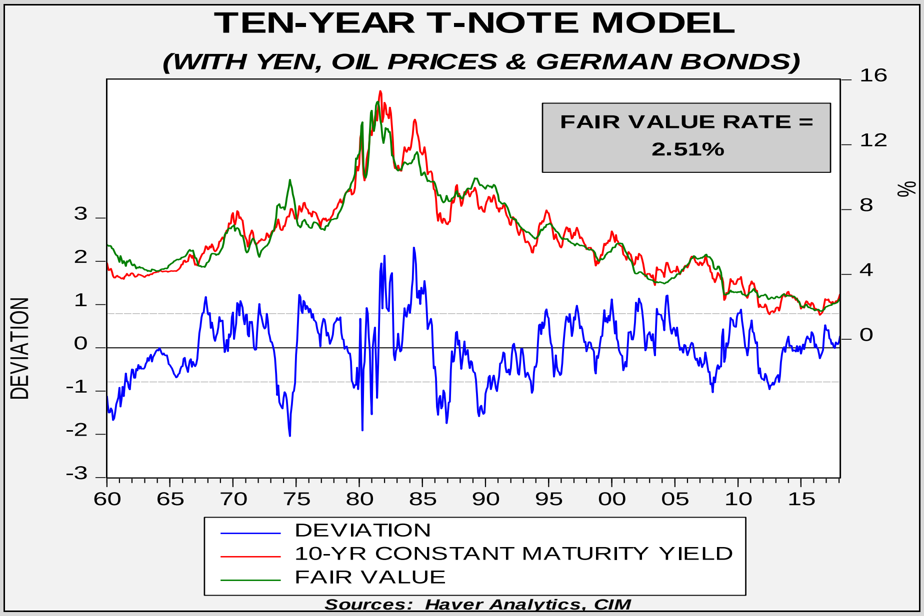
Asset Allocation Weekly Comment

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 9, 2018

The continued rise in long-term interest rates is clearly grabbing the attention of financial markets. Stronger than expected wage growth was the proximate cause of the recent lift in yields. Although overall wages rose 2.9%, wages for production and non-supervisory workers grew only 2.4%. Still, it is clear that fears of inflation stemming from an accelerating economy and concerns about monetary policy tightening are leading to rising interest rates.

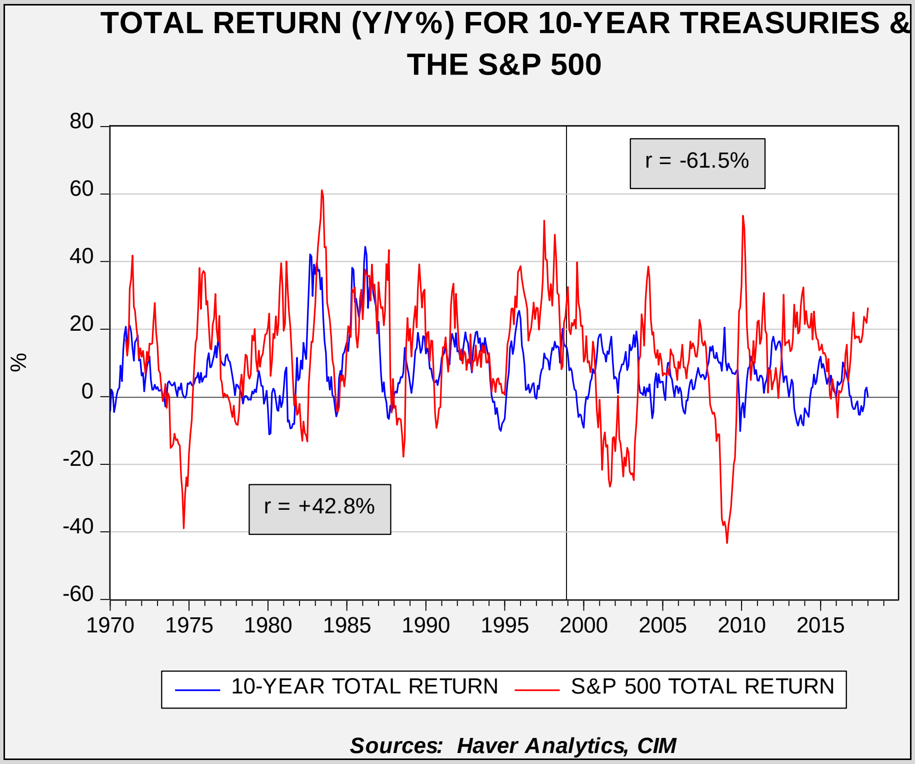
Here is our updated 10-year T-note model.



The model's core variables are fed funds and the 15-year moving average of inflation, which we use as a proxy for inflation expectations. The other three variables are the yen, oil prices and German long-duration sovereign yields. The current yield on the 10-year T-note, which is in the 2.80% range, is running above fair value. The standard error for this model, shown on the lower part of the graph as the parallel lines running along the midpoint of the standard error, is ±70 bps. Thus, reaching a level that would signal excessively high yields would be 3.20%.

Complicating this case is the fact that the FOMC is expected to raise rates at least three times this year, and perhaps four, German yields are rising and oil prices have increased as well. To project the potential lift in yields, we made some projections. Assuming the FOMC moves the upper end of the target rate to 2.25%, with nothing else changing, fair value for the 10-year T-note will reach 2.825%. The recent lift in 10-year T-note yields appears to be mostly discounting tighter monetary policy. If oil prices reach $75 per barrel, the fair value yield would hit 2.90%, and if German yields rise to 1.00%, we would see 2.95%. This suggests to us that a reasonable projection of variables likely takes us to a 3.00% 10-year T-note in the coming months. In other words, it appears the 10-year T-note yield is mostly about discounting tighter monetary policy.

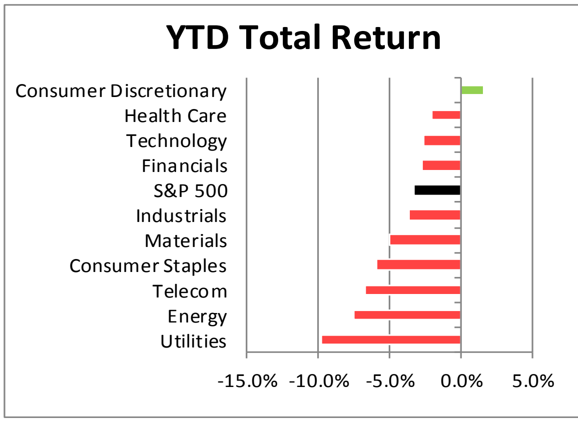
One other factor worth mentioning is that bond and stock prices have been positively correlated recently. Under these circumstances, the effectiveness of bonds as a portfolio diversification tool is reduced.

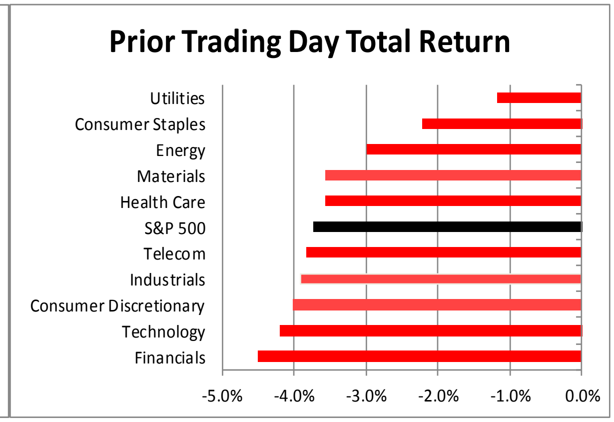


It's interesting that the returns were positively correlated from 1970 to 1998. What caused the reversal? Most likely it's a function of the steady decline in interest rates from their high peak in the early 1980s to normal levels by the late 1990s. In other words, falling yields were the norm during that two-decade period and, as rates fell, it supported rising P/E multiples. After rates normalized by the end of the 1990s, the ordinary inverse relationship between equities and bond prices emerged. Although the short-term price action between bonds and equities is a concern, we doubt it will be maintained. Since the shift in the correlation occurred in the late 1990s, we have seen two periods when the one-year rolling correlation became positive, 2007 and 2015. Neither event lasted very long nor did it undermine the longer term diversification that longer duration bonds offered. We suspect the current positively correlated event is due to an overbought correction in equities and a bond market discounting tighter monetary policy (as noted above). Thus, we view this as a temporary event.

Data Section

U.S. Equity Markets – (as of 2/8/2018 close)

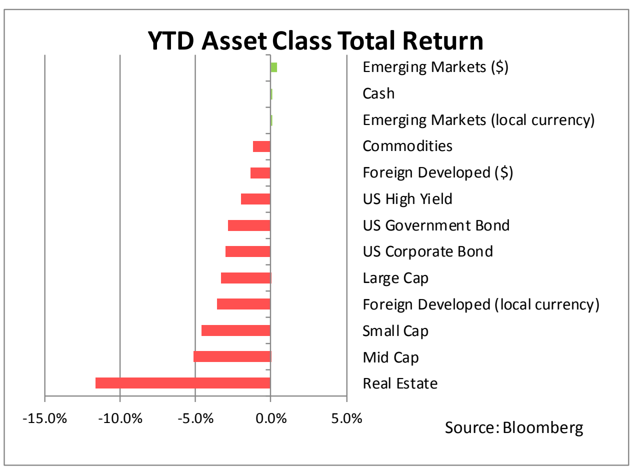




(Source: Bloomberg)

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 2/8/2018 close)

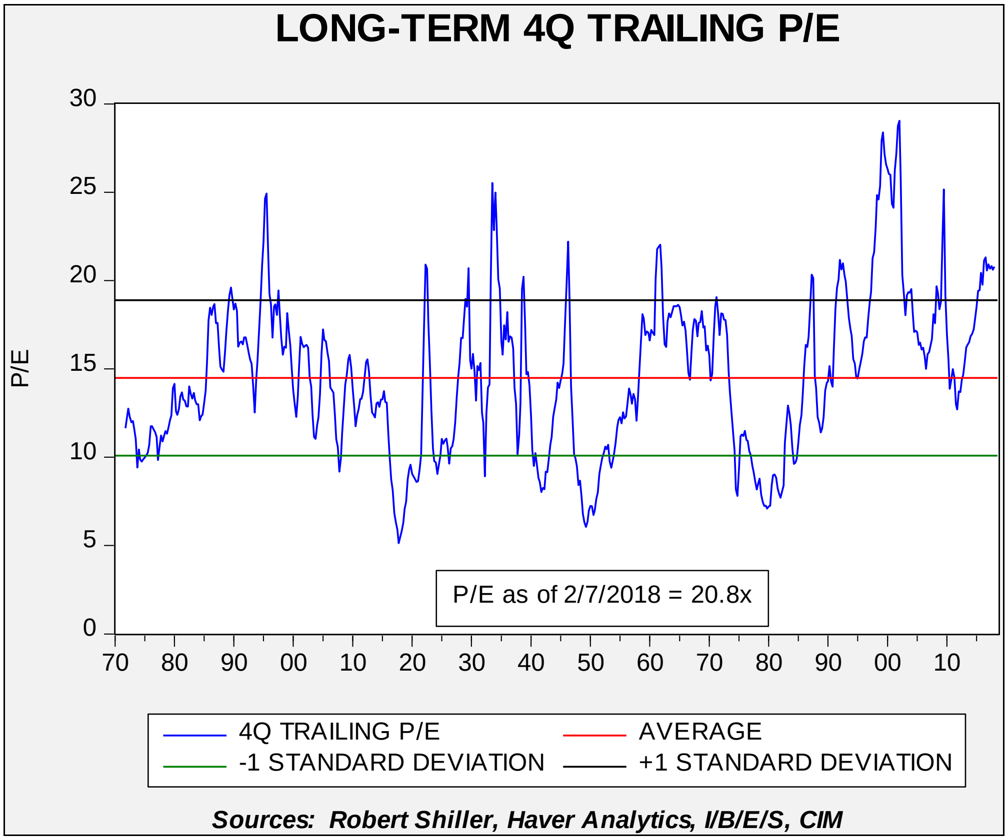


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 8, 2018



Based on our methodology,[1] the current P/E is 20.8, down 0.2x from last week. Rising earnings and falling equity prices led to the modest decline in the multiple.

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.

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[1] 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.