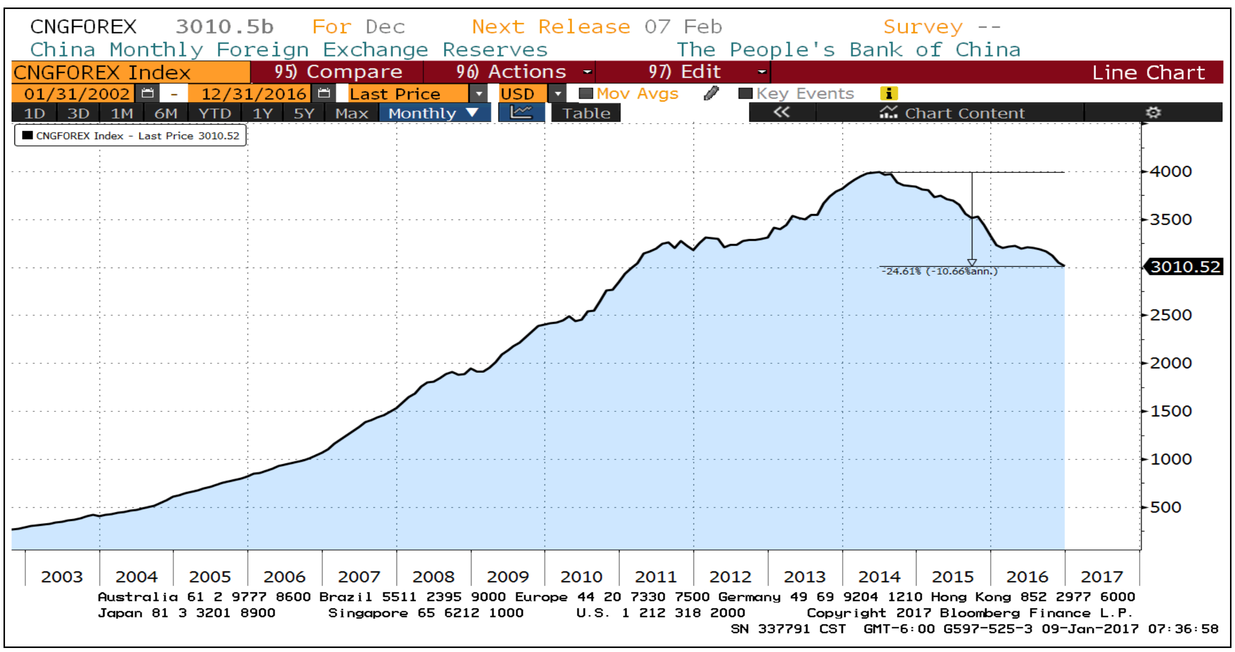
Daily Comment

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

[Posted: January 09, 2017—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 0.3%. U.S. equity futures are signaling a lower open.

It was a rather quiet weekend. We are seeing a drop in oil prices this morning attributed to reports that production in Northern Iraq, which is under Kurdish control, may be rising. It was never certain whether the Kurds would cooperate and the worry is that if one major producing nation cheats then the rest of the cartel may also defect from the agreement.

On Saturday, China released its foreign reserves data. Reserves dropped by $41 bn, near forecast.



(Source: Bloomberg)

Since peaking in June 2014, China's foreign reserves have declined by nearly 25%, or about 10.7% annually. Although the level of reserves is still high, the drop since the peak is approaching $1.0 trillion, a massive amount. There are reports that the PBOC has been meeting with bitcoin firms in China; currently, the discussions appear to be about curbing advertising. If this is the case, it would suggest that Chinese officials, at least for now, will tolerate "insider" use of bitcoin but are interested in discouraging it from becoming a mass product. We suspect that officials realize that shutting down bitcoin would be difficult because it is most likely being utilized by CPC members for capital flight. Thus, controlling it and keeping it from the commoners makes sense.

In other news, PM May's comments about restricting immigration sent the GBP lower this morning. Although the pound remains at historically cheap levels, worries about a "hard Brexit" continue to weigh on the currency. Reuters is reporting that leftist parties in Germany, namely, the Social Democrats (SDP), the hard-left Die Linke and the Greens, are considering a coalition. This party mix actually now controls more seats in the Bundestag and could rule. However, the SDP, which is center-left, does not agree with the pacifist Die Linke, which wants to pull out of NATO. We suspect the SDP will remain in a grand coalition with Chancellor Merkel's CDU-CSU but is using this threat to gain more influence in the autumn elections. This suggests to us that Merkel will retain power but be a weaker leader. Finally, Ayatollah Ali Akbar Hashemi Rafsanjani died over the weekend. Rafsanjani was an influential Iranian political figure who held numerous positions since the revolution, including president. He was powerful enough to act as a counterweight to the conservative mullahs; his passing creates something of a power vacuum that will likely be filled by the conservatives.

U.S. Economic Releases

There were no domestic releases prior to this publication. The table below lists the economic releases and Fed speakers scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
14:00	Consumer Credit	m/m	nov	$18.225 bn	$16.019 bn	**
Fed speakers or events						
	No speakers or events scheduled					
EST	Speaker or event	District or position				
14:45	Eric Rosengren Speaks in Hartford, Connecticut	President of the Federal Reserve Bank of Boston				
9:15	Dennis Lockhart Speaks to the Rotary Club of Atlanta	President of the Federal Reserve of Atlanta				

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 Reserves	m/m	dec	3010.5 bn	$3051.6 bn	$3010.0 bn	**	Equity and bond neutral
Australia	AiG Perf of Construction Index	m/m	nov	47.0	46.6		**	Equity and bond neutral
	Building Approvals	y/y	nov	-4.8%	-24.9%	-5.7%	**	Equity and bond neutral
	ANZ Job Advertisements	m/m	dec	-1.9%	1.7%		**	Equity and bond neutral
	Foreign Reserves	m/m	dec	76.1 bn	$69.9 bn		**	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	jan	18.2	10.0	12.8	**	Equity bullish, bond bearish
Germany	Industrial Production	y/y	nov	2.2%	1.2%	1.9%	***	Equity bullish, bond bearish
	Trade Balance	m/m	nov	22.6 bn	19.3 bn	20.3 bn	**	Equity bullish, bond bearish
	Exports	m/m	nov	3.9%	0.5%	0.5%	**	Equity bullish, bond bearish
	Imports	m/m	nov	3.5%	1.3%	1.1%	**	Equity and bond neutral
France	Bank of France Business Sentiment	y/y	dec	102	101	101	**	Equity and bond neutral
Italy	Unemployment Rate	y/y	nov	11.9%	11.6%	11.6%	***	Equity and bond neutral
U.K.	Halifax House Prices	m/m	dec	1.7%	0.2%	0.3%	**	Equity bullish, bond bearish
Switzerland	Retail Sales	y/y	nov	0.9%	-0.5%		**	Equity bullish, bond bearish
	Total Sight Deposits	m/m	jan	529.7 bn	529.0 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	jan	467.6 bn	466.3 bn		**	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)	101	101	0	Neutral
3-mo T-bill yield (bps)	51	51	0	Neutral
TED spread (bps)	51	50	1	Widening
U.S. Libor/OIS spread (bps)	68	67	1	Widening
10-yr T-note (%)	2.39	2.42	-0.03	Tightening
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	46	46	0	Neutral
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	down			Down
franc	up			up

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	$55.98	$57.10	-1.96%	Increase in US Production
WTI	$52.92	$53.99	-1.98%	
Natural Gas	$3.23	$3.29	-1.77%	
Crack Spread	$15.41	$15.61	-1.24%	
12-mo strip crack	$15.96	$16.22	-1.58%	
Ethanol rack	$1.72	$1.72	-0.19%	
Metals				
Gold	$1,179.18	$1,172.63	0.56%	
Silver	$16.52	$16.49	0.15%	
Copper contract	$253.05	$254.60	-0.61%	
Grains				
Corn contract	$ 359.25	$ 358.00	0.35%	
Wheat contract	$ 427.50	$ 423.25	1.00%	
Soybeans contract	$ 995.25	$ 994.75	0.05%	
Shipping				
Baltic Dry Freight	963	983	-20	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. The warming trend has pressured natural gas prices recently. Precipitation is also 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.

January 6, 2017

Over the holiday, I had the pleasure of reading Sebastian Mallaby's recent biography of Alan Greenspan.[1] The book was thoroughly researched and well-written, and I recommend it to our readers, albeit with fair warning—it's long and the endnotes are critical to fully understanding the points of the work.

Here are the key points of the book.

All presidential administrations want easy money: Truman implored William Martin to accommodate the Korean War spending, intimating that not doing so was supporting communism. Nixon leaked a rumor (perhaps an early form of "false news") that his Fed Chair, Arthur Burns, wanted a pay raise. The report infuriated Congress and put Burns on the defensive. Nixon let Burns know that he would set the record straight in return for easy money.[2] Nixon got his wish. Ford wanted accommodative policy. Reagan consistently complained about Volcker's tight policy and believed a return to the gold standard would be a painless way to weaken inflation expectations.[3] George H.W. Bush felt Greenspan's tight money cost him the election.[4] Bill Clinton generally avoided publicly criticizing the Fed but was worried that high bond yields would kill the economy.[5] The goal of any president is to stay in power; having the unfortunate circumstance of a recession occurring into an election year is a career-ending event. Thus, wanting the central bank to support the economy into the election is a desire of all presidents.

Financial crises are inevitable—so are government bailouts: Greenspan was a devotee of Ayn Rand and a member of her "Collective." He opposed government support for bad behavior. However, his youthful position changed as he entered government. The political and economic fallout of letting large and connected financial firms fail was simply too costly. Although the heavily regulated and geographically dispersed financial system avoided crises from 1945 to the early 1970s, it was also an era of higher rates and a less efficient financial system. For example, the ratio of prime lending rates to fed funds in the 1950s to the late 1960s was 1.57x; that fell to 1.18x from the 1970s to the late 1980s. However, improved financial market efficiency came at the cost of financial system problems. What the book makes clear is that regulators won't prevent crises and no regulator has determined a level of capital that will, either. The only way to reduce the frequency of financial crises and bailouts is through policies that make the financial system less efficient. During good times, the majority of people want the financial system to

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[1] Mallaby, S. (2016). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York, NY: Penguin Press.
[2] Ibid. Greenspan disputed Mallaby's claim that the former was responsible for letting Burns know how he could get the rumor squelched, pp. 141-144. Mallaby stands by his position.
[3] Ibid, p. 267.
[4] Ibid, p. 569. Dick Darman, Bush's budget director, suggested Greenspan may be similar to Norman Bates, p. 415.
[5] Ibid, p. 430. James Carville's famous quote about reincarnating as the bond market.

accommodate their borrowing desires. Thus, they support imprudent lending that inevitably leads to financial crises. Pressing policies that impede lending are unpopular and are only considered in the aftermath of financial events. Over time, these measures will be diluted and repealed. Greenspan supported the repeal of Glass-Steagall and opposed the CFTC's attempt to gain regulatory control over the swaps market. Although these measures might have reduced the magnitude of the 2008 Financial Crisis, the bipartisan support for Fannie Mae and Freddie Mac (both bodies opposed by Greenspan) made the mortgage crisis unavoidable. Greenspan believed that it was better to allow the bubble to inflate and clean up the "debris" in its wake. That isn't an optimum policy but probably the only one that is politically feasible.[6]

Inflation targeting leads to asset inflation: As early as 1993, Lawrence Lindsey, a Fed governor, pointed out to the FOMC that focusing solely on inflation control has the potential side effect of creating asset bubbles.[7] Lindsey observed that inflation was falling due to globalization (and not due to Fed policy). We would add deregulation as well. If inflation is low, the central bank could be lured into keeping policy accommodative, potentially leading to asset bubbles in equities, housing and fixed income. Greenspan mostly ignored Lindsey's concerns; Mallaby speculates that the Fed Chair realized that keeping goods prices in check was politically acceptable but restricting wealth would not be tolerated. Essentially, if some future Fed chair wants to tighten policy ostensibly to deflate an asset bubble, he will have to come up with an inflation narrative to do so. Consequently, monetary policy in an era of globalization and deregulation will tend to support asset prices and increase the odds of asset bubbles.

What do these insights tell us? In a world that is globalized and deregulated, financial markets will have a bullish bias because monetary policy will be persistently accommodative. If President-elect Trump signals an end to globalization and perhaps the unencumbered introduction of new technology, inflation targeting will become less friendly to financial markets. Still, there is no evidence to suggest that the Fed will no longer face pressure from the White House for easy money, not rescue financial markets from volatility or ever target asset prices in setting policy (at least consistently and overtly).

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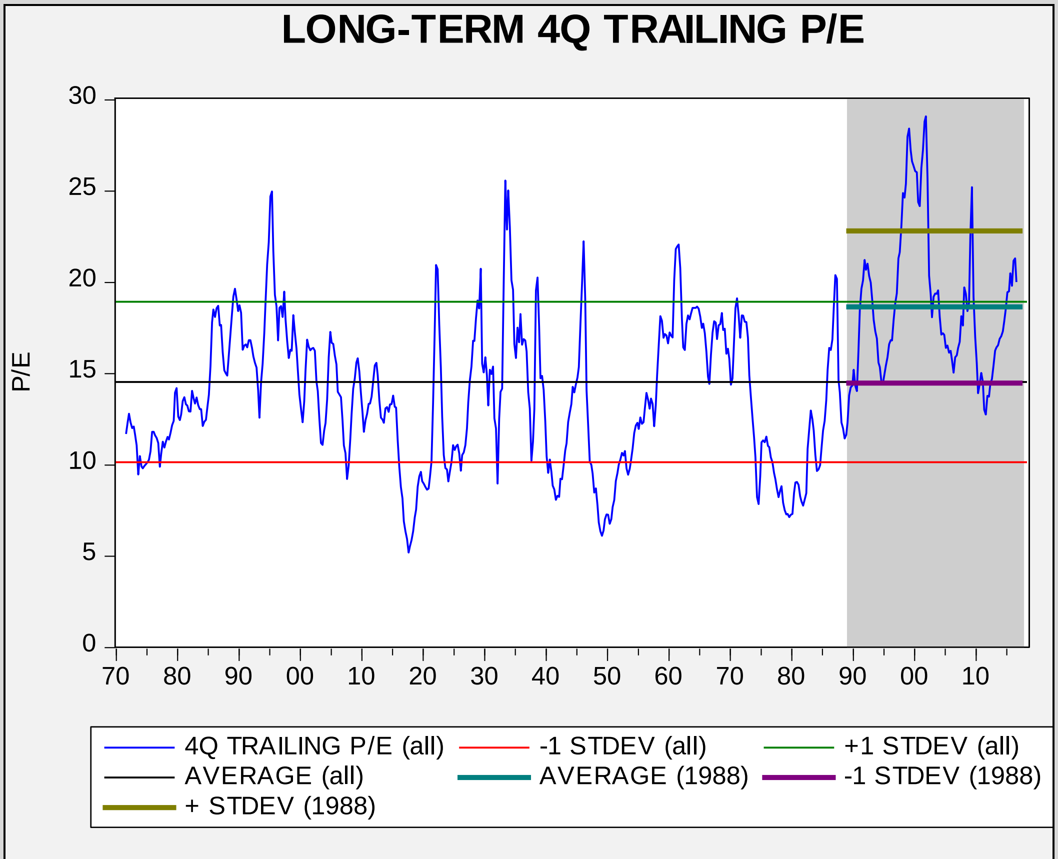
[6] Ibid, pp. 675-677.
[7] Ibid, p. 435.

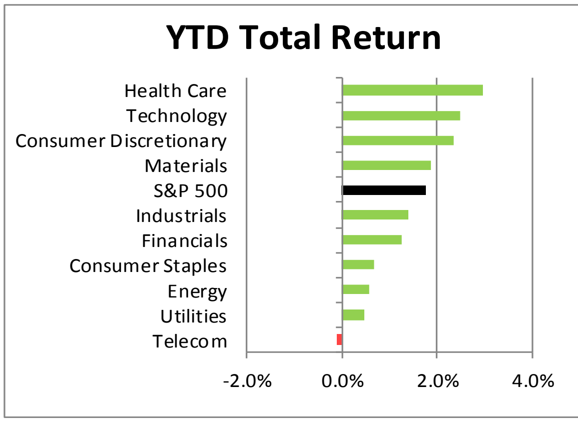


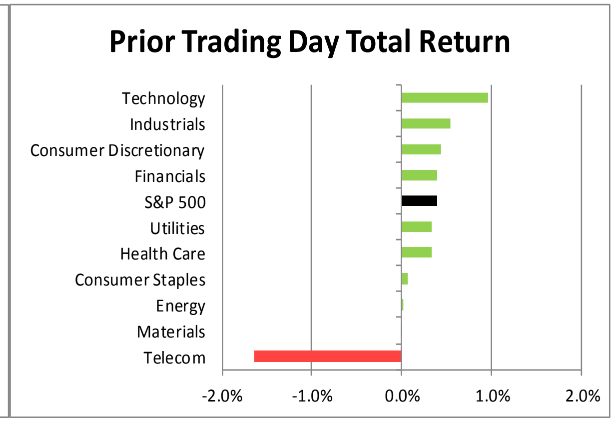
Sources: Robert Shiller, Haver Analytics, I/B/E/S, CIM

Our conclusions from Mallaby's work tend to confirm prior comments we have made about S&P 500 P/Es. This chart shows the trailing P/E for the S&P 500; for the current quarter, we use a mix of three quarters (Q1, Q2, Q3) and consensus forecasts for Q4. The area in gray, which encompasses the period from 1988 to the present, has seen an upward shift in the P/E. Essentially, the lows recorded in this period are closer to the average observed over the entire time frame. Investors appear to have shifted their risk tolerance and are willing to "pay up" for earnings. Part of the reason why this shift occurred could be contained in the above analysis of monetary policy. The combination of expectations of central bank "rescues" from market turbulence and policy accommodation stemming from inflation targeting in a globalized economic environment may have given investors more "courage" about accepting a higher earnings multiple than seen in the past. Thus, the current P/E, though historically elevated, may not be all that risky…as long as the monetary policy environment doesn't change.

Data Section

U.S. Equity Markets – (as of 1/6/2017 close)

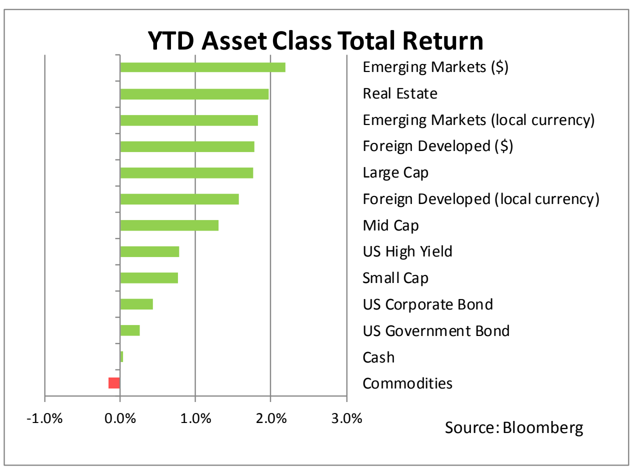




(Source: Bloomberg)

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 1/6/2017 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).[8]

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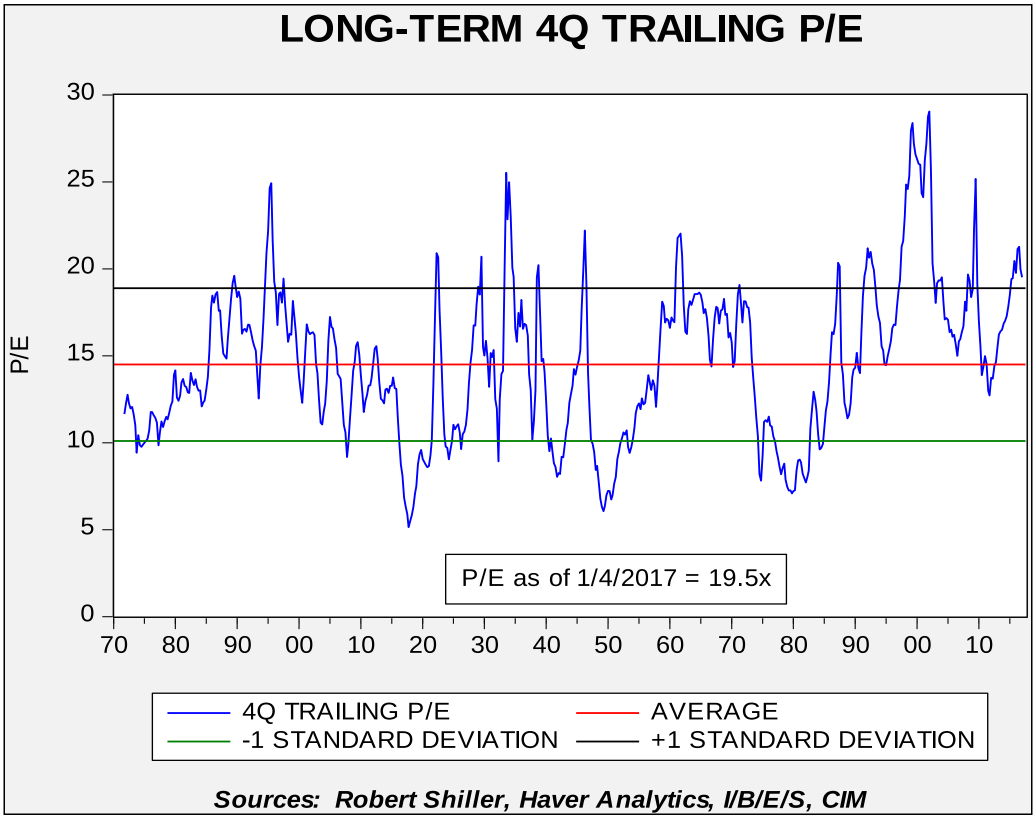
[8] We note that Bloomberg is no longer supporting the DJ commodity index and so we are substituting this one. The sharply negative swing in the index is partially due to changing the index but also due to today's weakness and the small number of data points available in the new year.

P/E Update

January 5, 2017



Based on our methodology,[9] the current P/E is 19.5x, down 0.4x from our last report, which covered Q4. This report covers Q1. Better earnings expectations have led to a drop in the P/E.

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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[9] 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.