Daily Comment

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

[Posted: January 11, 2017—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 up 0.7% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.8% and the Shenzhen index down 1.1%. U.S. equity futures are signaling a steady to lower open.

There was a lot of political and geopolitical news overnight. The most widely covered were reports that the Russians have compromising information about Donald Trump. The 32-page report, published last night by Buzzfeed, makes a series of allegations, suggesting that the president-elect engaged in salacious behavior in Moscow, Trump campaign officials made numerous contacts with Russian officials and the Wikileaks were used to divulge information about Hillary Clinton and members of her campaign for "plausible deniability."

It should be noted that these allegations circulated among the media well before the election. They didn't get a lot of traction because news organizations could not establish their veracity, but that doesn't mean there isn't an element of truth in them. Russia's two short-term goals are to get sanctions lifted and to rebuild influence in its near abroad. Although it isn't completely obvious that Trump would help in this area, Clinton was a known quantity and it was abundantly clear she would have bolstered NATO and pressed to keep sanctions in place. Thus, trying to support Trump and undermine Clinton was a reasonable policy for Russia.

One of the more interesting sidelights of this affair begs the questions of why is this material coming out now and why did the intelligence agencies allow it to come to light? It is plausible that the intelligence agencies are not happy with the incoming president and wanted to signal to him that they do have the ability to affect his presidency. Trump holds a press conference at 11:00 EST this morning. How he handles this issue will be worth monitoring.

Will this issue be enough to seriously undermine his presidency, leading to impeachment or resignation? Probably not, but it should be noted that it might compromise his leadership to some degree. It is important to remember that the establishment wings of both parties oppose many of Trump's campaign promises. Using this issue to prevent aggressive immigration reform or trade restrictions is not out of the realm of possibility.

At the same time, it should be remembered that foreign nations try to affect U.S. elections as a matter of course. The fact that the Russians were so obvious about it suggests either a rather profound degree of incompetence or an indication that Putin's personal loathing of Hillary Clinton got the best of him. We note Politico is reporting that Ukraine was engaged in measures to support Clinton because it wanted a friendly person in the White House. This support included reports that the country was investigating Paul Manafort for corruption in activities in

Ukraine. According to this source, Ukrainian officials are rapidly backtracking on these efforts in an attempt to build favor with the Trump White House.

China was in the news as well. The military sent a strategic bomber near the Spratly Islands. In addition, the Chinese Navy sent a flotilla of warships, including its lone carrier, the *Liaoning*, through the Taiwan Strait. This show of force led the Taiwan military to scramble jets and send its own navy to surveil the Chinese vessels as they moved through the area. China's actions triggered Japan and South Korea to scramble warplanes earlier this week. China's increased aggression is coming as the U.S. prepares to transfer power and as Chairman Xi (who is speaking at Davos next week, the first Chinese president to speak to this group) is laying the groundwork for his second term, which will begin in November.

On the topic of China, the under-the-fold story in today's *FT* reports that Chinese authorities are scrutinizing the bitcoin price surge. According to the story, Chinese bitcoin exchanges are monitored for large transactions. We suspect this is true. However, smaller deals are not closely watched and thus bitcoin may have become the portal of choice for less affluent households to diversify their holdings. Reuters is reporting that forex regulators are telling banks to keep their regulations surrounding capital exports secret and to let bank analysts know that any negative thoughts on the CNY should be "kept to themselves." SAFE, the Chinese regulator that manages forex, has been issuing oral regulations to conceal regulatory changes. This forces banks to refuse transfer business that they may have performed previously, but the banks have to do so without indicating why. These measures suggest that Chinese officials are very concerned about capital flight.

Finally, Bloomberg is reporting that Russia has started reducing oil production; as much as 148 kbpd of output may have been shut in. Russia is notorious for reneging on production cut agreements, so the fact that it appears to have started the process (the Russians have promised cuts of 300 kbpd over the next few months) is remarkable and bullish for crude oil.

U.S. Economic Releases

Today, MBA mortgage applications showed an increase of 5.8% from the prior week. Purchases and refinancing increased by 6.1% and 4.4%, respectively. The 30-year fixed rate fell 7 bps from 4.39% to 4.32%.

The table below lists the economic releases and Fed speakers scheduled for the rest of the day.

Economic Releases		
	No economic releases today	
Fed speakers or events		
13:20	William Dudley will Speaks on Bank Culture in New York	President of the Federal Reserve Bank of New York

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	Officials Reserve Assets	m/m	dec	$1216.9 bn	$1219.3 bn		**	Equity and bond neutral
	Leading Index CI	m/m	dec	102.7	100.8	102.6	**	Equity and bond neutral
	Coincident Index	m/m	dec	115.1	113.5	115.0	**	Equity and bond neutral
Australia	Job Vacancies	m/m	nov	2.2%	4.6%		**	Equity bearish, bond bullish
New Zealand	QV House Prices	y/y	dec	12.5%	12.4%		**	Equity and bond neutral
	ANZ Job Advertisements	m/m	dec	1.6%	2.9%		**	Equity and bond neutral
EUROPE								
UK	Trade Balance	m/m	nov	-£ 4,167.00	-£ 1,971.00	-£ 3,500.00	**	Equity bearish, bond bullish
	Manufacturing Production	m/m	nov	1.2%	-0.4%	0.4%	**	Equity bullish, bond bearish
	Construction Output	m/m	nov	1.5%	0.7%	2.0%	**	Equity and bond neutral
Russia	CPI	w/w	jan	0.3%	0.1%		***	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	nov	6.3%	7.0%	6.3%	***	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	Up
3-mo T-bill yield (bps)	50	50	0	Neutral
TED spread (bps)	51	51	0	Neutral
U.S. Libor/OIS spread (bps)	67	67	0	Neutral
10-yr T-note (%)	2.37	2.38	-0.01	Neutral
Euribor/OIS spread (bps)	-32	-32	0	Down
EUR/USD 3-mo swap (bps)	43	43	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	down			Down
franc	down			Neutral

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	$53.84	$53.64	0.37%	Short Covering
WTI	$50.97	$50.82	0.30%	
Natural Gas	$3.26	$3.28	-0.61%	
Crack Spread	$15.44	$15.05	2.63%	
12-mo strip crack	$15.84	$15.59	1.59%	
Ethanol rack	$1.66	$1.68	-0.77%	
Metals				
Gold	$1,188.63	$1,187.88	0.06%	
Silver	$16.74	$16.79	-0.26%	
Copper contract	$260.80	$261.25	-0.17%	
Grains				
Corn contract	$ 356.75	$ 358.25	-0.42%	
Wheat contract	$ 423.75	$ 426.75	-0.70%	
Soybeans contract	$ 1,010.75	$ 1,013.75	-0.30%	
Shipping				
Baltic Dry Freight	926	949	-23	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		2.5		
Distillates (mb)		3.0		
Refinery run rates (%)		-0.25%		
Natural gas (bcf)		-146.0		

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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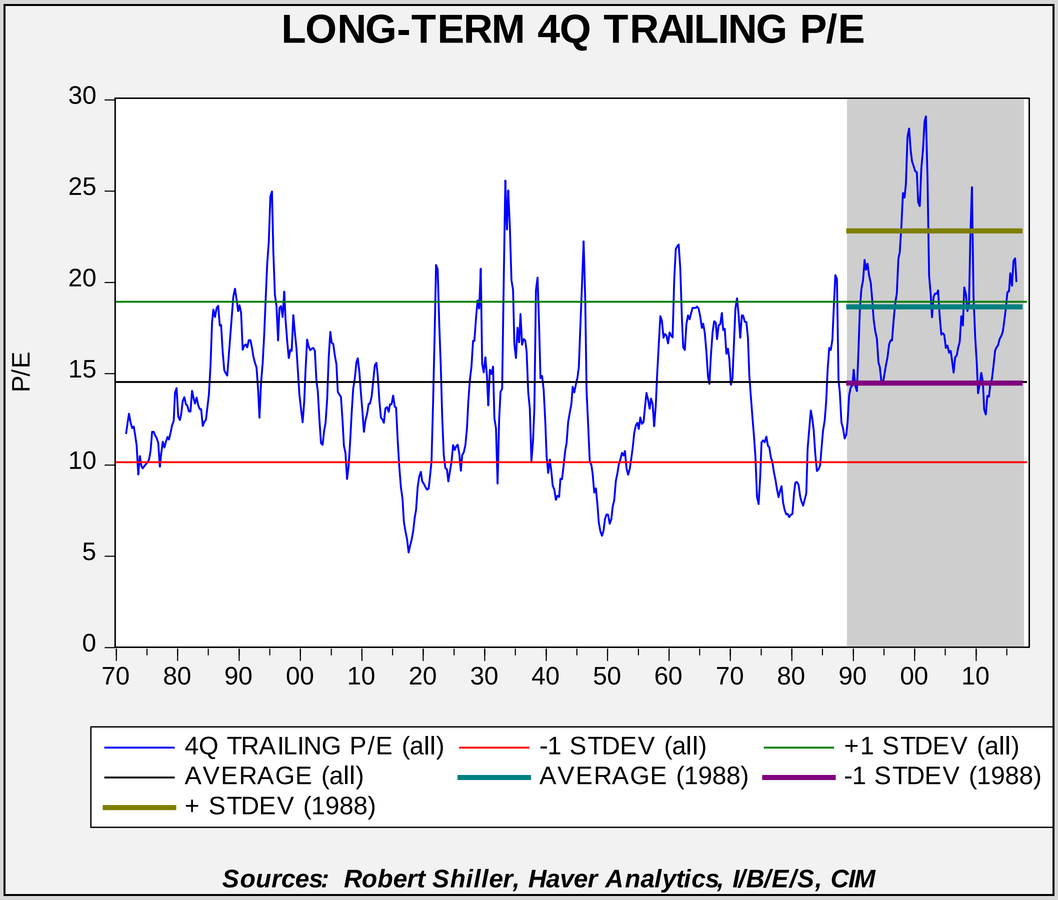
[6] Ibid, pp. 675-677.

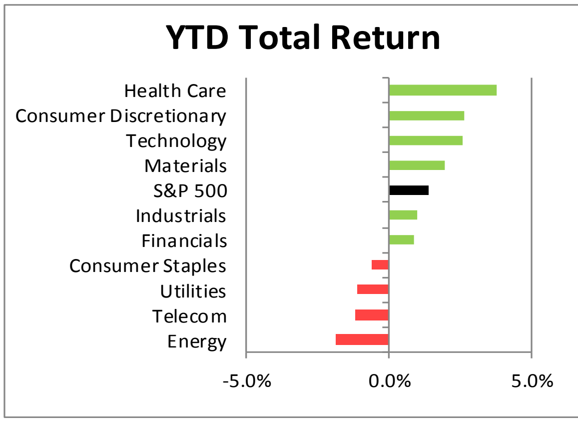
[7] Ibid, p. 435.

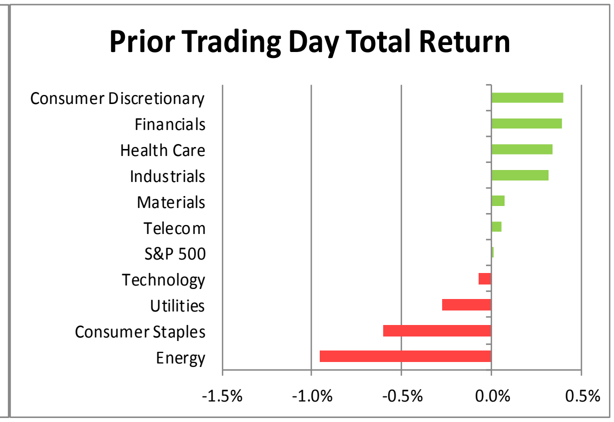


Our conclusions from Mallaby's work tend to confirm prior comments we have made about S&P 500 P/Es. This chart shows the trailing P/E for the S&P 500; for the current quarter, we use a mix of three quarters (Q1, Q2, Q3) and consensus forecasts for Q4. The area in gray, which encompasses the period from 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 1/10/2017 close)

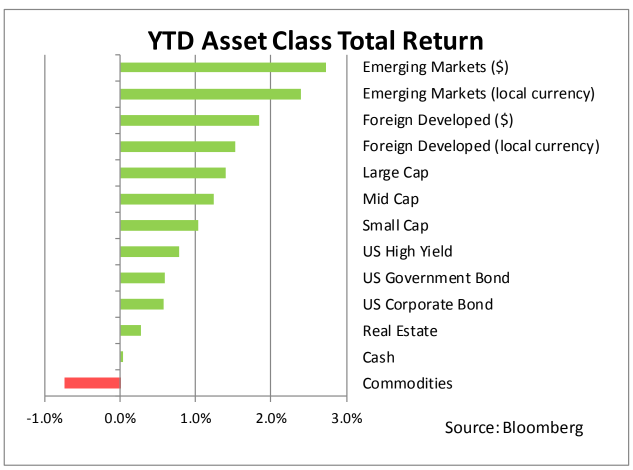




(Source: Bloomberg)

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 1/10/2017 close)



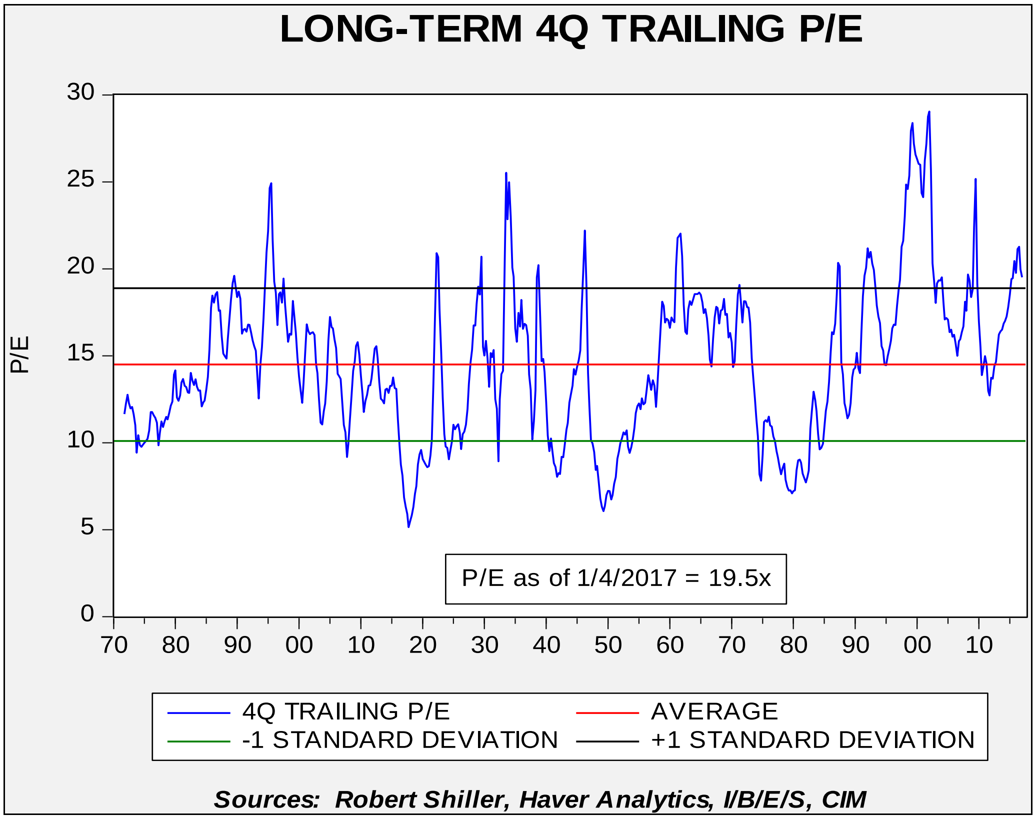
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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]

[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.

[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.