Confluence Investment Management

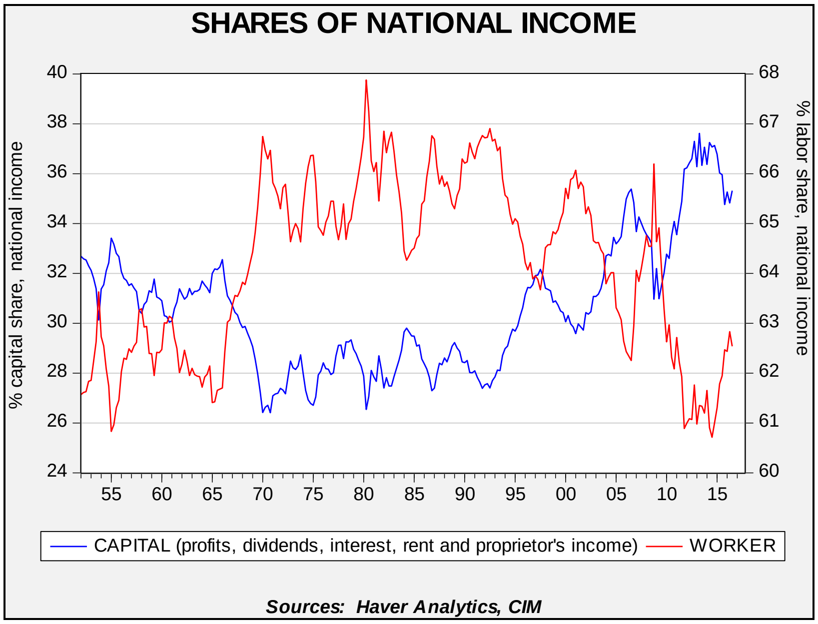
# *Daily Comment*

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

**[Posted: January 12, 2017—9:30 AM EST]** Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.6% and the Shenzhen index down 0.9%. U.S. equity futures are signaling a lower open.

The primary market theme this morning appears to be a broad reversal of the so-called "Trump trades" that have dominated the markets since the election. We are seeing weaker equities globally and the dollar is weaker, while Treasuries and gold are doing better. There are two factors that need to be separated from these markets moves. First, a portion of this action is simply normal market adjustment. The trend in the Trump trades has been pronounced and relentless. Some market reversals for profit taking and position squaring make sense. Second, one must determine where the interpretation of the Trump trades may have been in error. The idea is that reversals that are merely "a pause to refresh" should be viewed as positioning opportunities. Reversals based on mistakes may have more "legs."

For example, it's hard to see how trade restrictions will be bullish for bonds or stocks. Deglobalization will tend to be inflationary, leading the Fed to raise rates and generally leaning against profit margins and growth. Thus, the rise in bond yields make sense; the broad rally in equities less so. This doesn't mean that certain parts of the equity markets won't do well. Financials will be supported by regulatory relief and rising rates. Energy should receive regulatory relief and the Ryan tax plan may tax oil imports, giving more support for domestic small cap equities. Small and mid-cap stocks, due to their lower exposure to overseas markets, should outperform large caps. However, populist policies favor equality over efficiency, which isn't good for capital because it favors labor. Thus, Trump's policies may prove to be less supportive for the broad equity market, and consequently the fall in bond yields probably wouldn't last and any weakness that develops in energy or financials may be a buying opportunity.

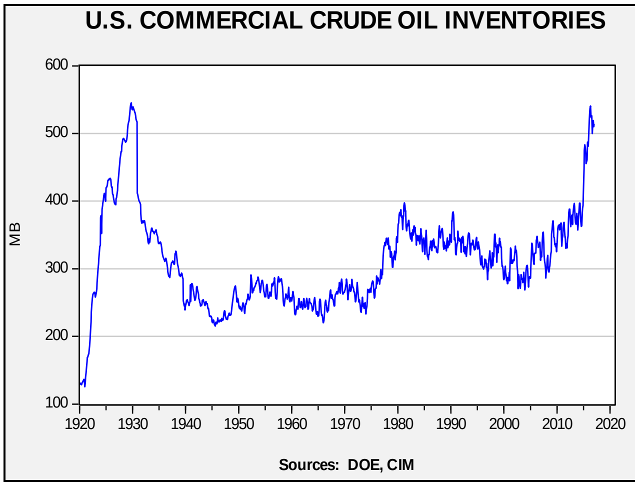


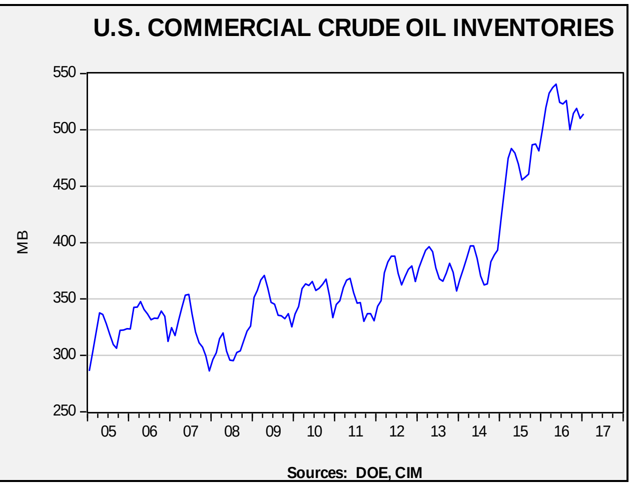

This chart shows the distribution of national income to capital and labor (the numbers don't exactly add to 100 because we don't include government's share of national income). From the late 1960s into the early 1990s, labor's share averaged around 66% and capital about 28%. Since the early 1990s, capital has been gaining share in each expansion cycle of the business cycle. The current average share of labor in this expansion is around 61.5% compared to 36% for capital. The deteriorating position of labor is probably behind the rise of populism.

Trump's policies against trade are, in part, a bid to improve the labor share at the expense of capital. These measures may not help all that much because, in a floating exchange rate environment, the dollar will likely rise to offset many of these measures. This morning, for example, we are seeing a sharp drop in the dollar; although the dollar is technically overbought and due for correction, we expect Trump's tax and trade policies to lead to dollar strength. About the only way that the dollar's rise can be stopped is if the Federal Reserve is badgered into holding rates steady. We would not expect this outcome; thus, we see the dollar's weakness as a technical correction, not a longer term change in trend.

Finally, as a side note, the Italian Constitutional Court rejected a request for a referendum on Renzi's labor market reform. This union-led request, if allowed, would have probably triggered new elections. By rejecting the bid, the odds of an Italian election this year are reduced.

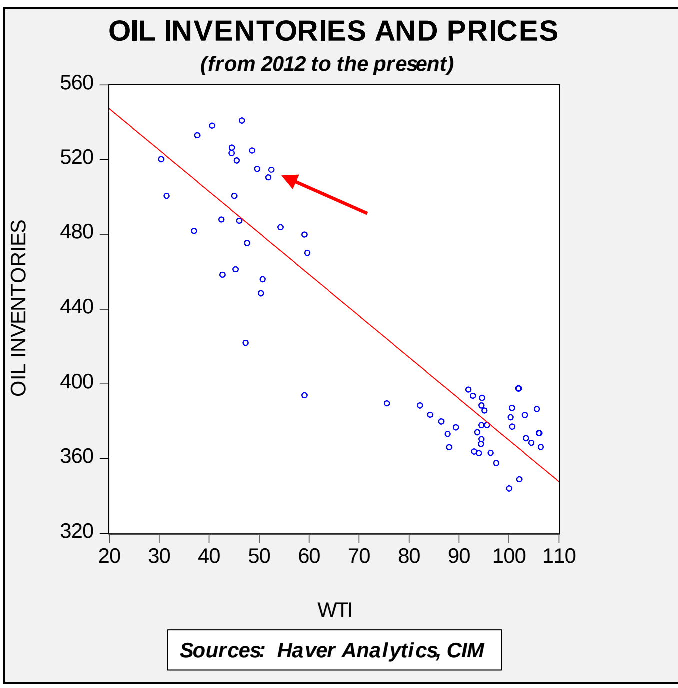
U.S. crude oil inventories rose 4.1 mb compared to market expectations of a 2.0 mb build.

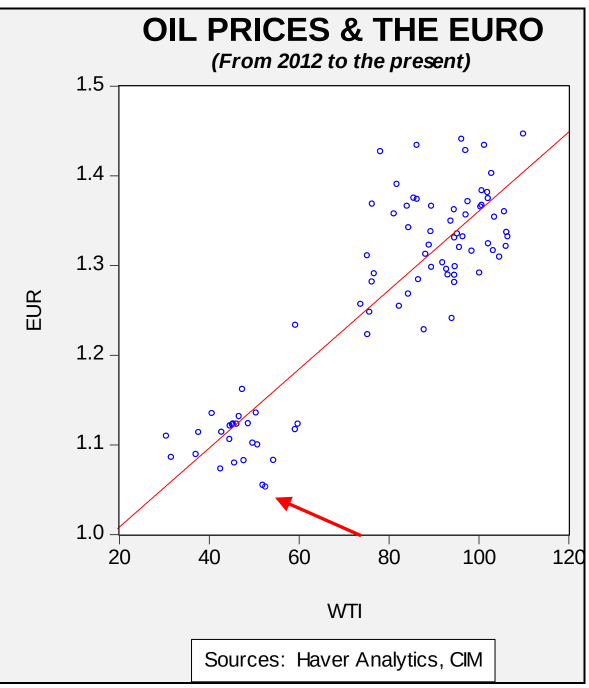



This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, inventories remain elevated.

We won't publish the annual seasonal pattern chart this week because, by design, the first week isn't meaningful. It will return next week. We do note that the build is rather large this week which suggests OPEC cuts have not affected U.S. supply. Of course, now that the cartel is officially reducing production, we should see a slower than normal build in the coming week.



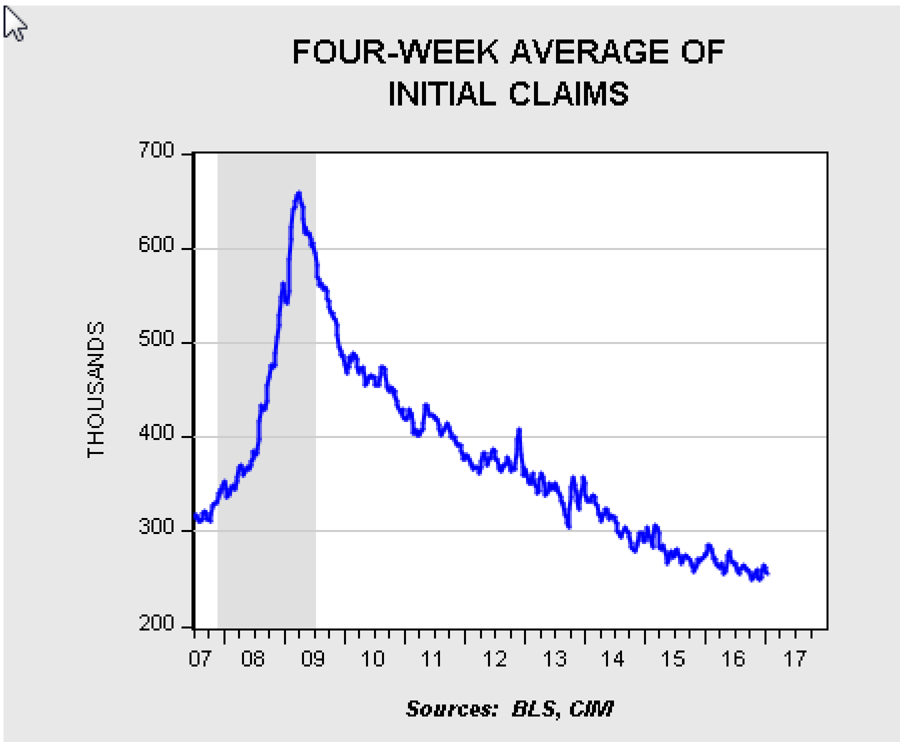




Based on inventories alone, oil prices are overvalued with the fair value price of $41.79. Meanwhile, the EUR/WTI model generates a fair value of $35.94. Together (which is a more sound methodology), fair value is $36.05, meaning that current prices are well above fair value.

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 inventories.

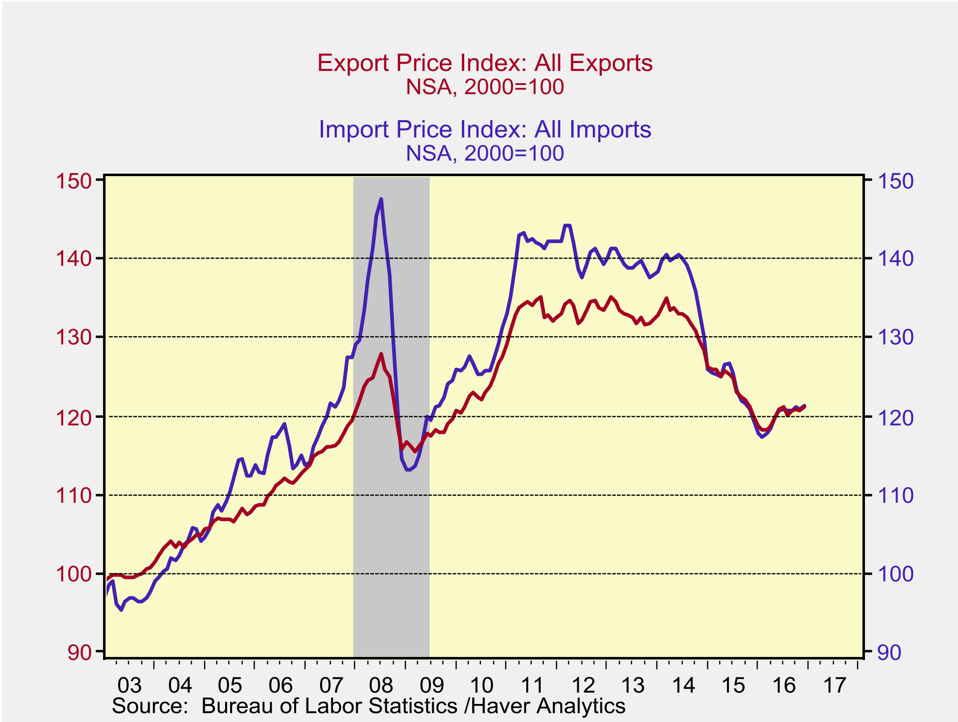
**U.S. Economic Releases**

Today, initial jobless claims rose 247k, below the forecast of 255k. Last week's report was revised up 2k from 235k to 237k. This is the 96th consecutive week that initial jobless claims came in below 300k, the longest streak since 1970. This data suggests that the labor market is still pretty strong.




The chart above shows the four-week moving average for initial jobless claims. The four-week moving average fell 1.75k from 257.25k to 255.5k.

The import price index rose 0.4% from the prior year, below the forecast of 0.7%. The prior report was revised upward from a drop of 0.3% to a drop of 0.2%. The rise in import prices is likely due to rising oil prices. The core import price index fell by 0.2%. This drop in the core can be attributed to a stronger dollar.




The chart above shows the relationship between the export price index and import price index. These variables should give an indication of the competitiveness of American goods in comparison to foreign goods. As the dollar has become stronger, imported goods have become relatively cheaper compared to exports. This index can give insight into how President-elect Trump's policies will affect U.S. companies abroad.

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

| **Economic Releases** | | | | | | |
|---|---|---|---|---|---|---|
| **EDT** | **Indicator** | | | **Expected** | **Prior** | **Rating** |
| **9:45** | Bloomberg Consumer Comfort | m/m | Jan | | 45.5 | ** |
| **14:00** | Monthly Budget Statement | m/m | dec | -$26.0 bn | -$136.7 bn | ** |
| **Fed speakers or events** | | | | | | |
| **EST** | **Speaker or event** | **District or position** | | | | |
| **14:00** | Robert Kaplan Speaks in Chicago | President of the Federal Reserve Bank of Dallas | | | | |
| **14:00** | Janet Yellen town hall meeting with educators | Chairman of Board of Governors of Federal Reserve | | | | |

## 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 | BoP Current Accounts | m/m | nov | 1415.5 bn | 1719.9 bn | 1460.0 bn | ** | Equity bearish, bond bullish |
| | Bank Lending | m/m | nov | 2.6% | 2.4% | | ** | Equity and bond neutral |
| | Tokyo Average Office Vacancies | m/m | dec | 3.61 | 3.75 | | ** | Equity and bond neutral |
| | Eco Watchers Survey Current | m/m | dec | 51.4 | 52.5 | | ** | Equity and bond neutral |
| India | CPI | y/y | dec | 3.4% | 3.6% | 3.5% | *** | Equity and bond neutral |
| | Industrial Production | y/y | nov | 5.7% | -1.9% | 1.5% | *** | Equity bullish, bond bearish |
| Australia | Credit Card Balances | y/y | nov | $52.5 bn | $51.4 bn | | ** | Equity and bond neutral |
| | Credit Card Purchases | y/y | nov | $27.1 bn | $25.6 bn | | ** | Equity and bond neutral |
| New Zealand | ANZ Truckometer Heavy | m/m | dec | -0.1% | 4.0% | | * | Equity bearish, bond bullish |
| | ANZ Commodity Price | m/m | dec | 0.7% | 2.7% | | * | Equity bearish, bond bullish |
| EUROPE | | | | | | | | |
| Eurozone | Industrial Production | m/m | nov | 1.5% | -0.1% | 0.6% | *** | Equity bullish, bond bearish |
| Germany | GDP | y/y | 2016 | 1.9% | 1.7% | 1.8% | *** | Equity and bond neutral |
| | Budget Maastricht % of GDP | y/y | 2016 | 0.6% | 0.5% | 0.6% | ** | Equity and bond neutral |
| France | CPI | m/m | nov | 0.6% | 0.3% | 0.3% | ** | Equity bullish, bond bearish |
| Italy | Industrial Production | y/y | nov | 3.2% | 1.3% | 1.9% | ** | Equity bullish, bond bearish |
| Russia | Gold and Forex Reserve | w/w | jan | 377.7 bn | 379.1 bn | | * | Equity and bond neutral |
| | Light Vehicle Car Sales | q/q | 4q | -1.0% | 1.0% | 0.0% | * | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Mexico | Industrial Production | y/y | nov | 1.3% | -1.4% | 0.5% | *** | Equity bullish, bond bearish |
| | Manufacturing Production | y/y | nov | 4.3% | -0.6% | 2.7% | ** | Equity bullish, bond bearish |
| Canada | New Housing Price Index | m/m | nov | 0.2% | 0.4% | 0.3% | ** | Equity and bond neutral |
| | Teranet/National Bank HPI | y/y | dec | 12.3% | 11.9% | | ** | 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)** | 102 | 101 | 1 | Up |
| **3-mo T-bill yield (bps)** | 50 | 50 | 0 | Neutral |
| **TED spread (bps)** | 52 | 51 | 1 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 67 | 67 | 0 | Neutral |
| **10-yr T-note (%)** | 2.33 | 2.37 | -0.04 | Neutral |
| **Euribor/OIS spread (bps)** | -33 | -32 | -1 | Down |
| **EUR/USD 3-mo swap (bps)** | 42 | 42 | 0 | Neutral |
| **Currencies** | **Direction** | | | |
| dollar | down | | | Neutral |
| euro | up | | | Neutral |
| yen | up | | | Down |
| pound | up | | | Down |
| franc | down | | | Neutral |
| **Central Bank Action** | **Current** | **Prior** | **Expected** | |
| Selic Rate | 13.00% | 13.75% | 13.25% | Below 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 | $55.80 | $55.10 | 1.27% | Russia and Saudi Arabia cuts to output |
| WTI | $52.83 | $52.25 | 1.11% | |
| Natural Gas | $3.32 | $3.22 | 2.88% | |
| Crack Spread | $15.72 | $15.49 | 1.49% | |
| 12-mo strip crack | $16.13 | $15.90 | 1.44% | |
| Ethanol rack | $1.64 | $1.65 | -0.62% | |
| **Metals** | | | | |
| Gold | $1,205.62 | $1,191.62 | 1.17% | Weaker Dollar |
| Silver | $16.94 | $16.73 | 1.22% | |
| Copper contract | $263.15 | $261.05 | 0.80% | |
| **Grains** | | | | |
| Corn contract | $ 356.00 | $ 357.25 | -0.35% | |
| Wheat contract | $ 416.50 | $ 418.75 | -0.54% | |
| Soybeans contract | $ 1,012.00 | $ 1,011.50 | 0.05% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 894 | 926 | -32 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | 4.1 | 2.0 | 2.1 | |
| Gasoline (mb) | 5.0 | 2.5 | 2.5 | |
| Distillates (mb) | 8.4 | 3.0 | 5.4 | |
| Refinery run rates (%) | 1.6% | -0.25% | 1.9% | |
| Natural gas (bcf) | | -146.0 | | |

## Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. 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.

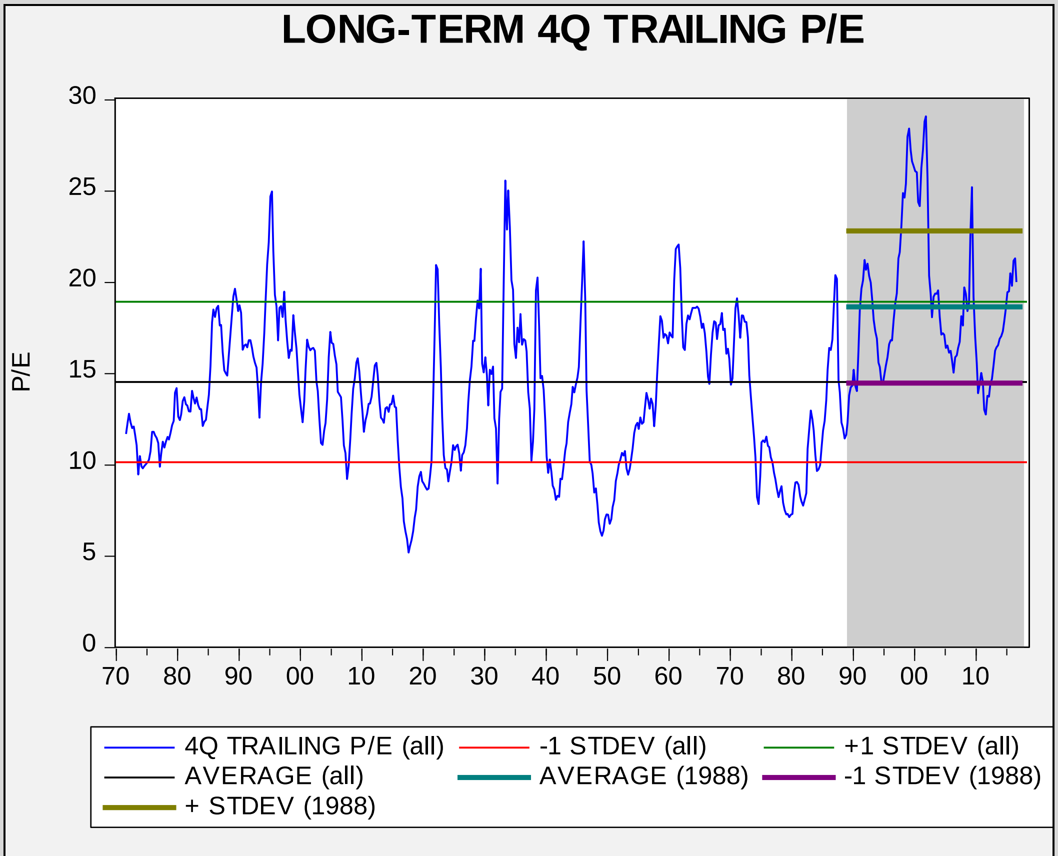
[5] Ibid, p. 430. James Carville's famous quote about reincarnating as the bond market.

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).

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

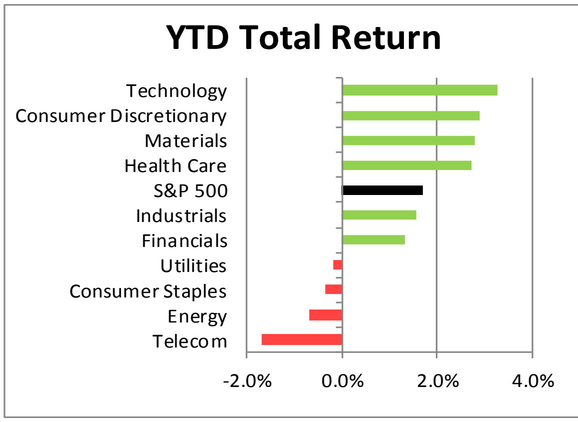


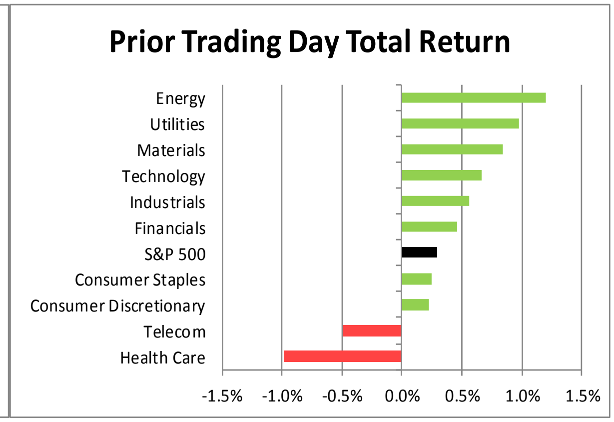

***Sources: Robert Shiller, Haver Analytics, I/B/E/S, CIM***

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 1/11/2017 close)

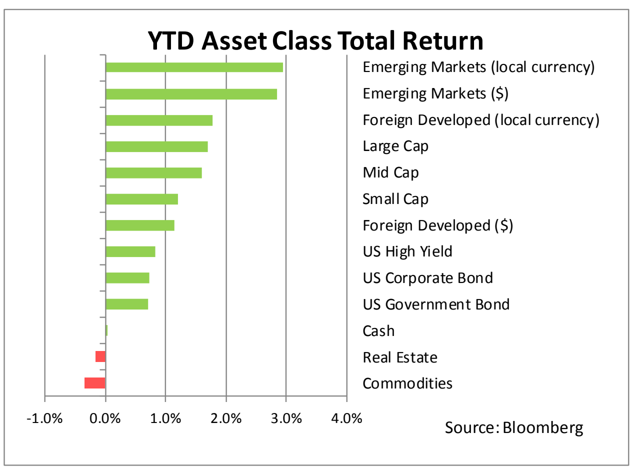



(Source: Bloomberg)

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 1/11/2017 close)



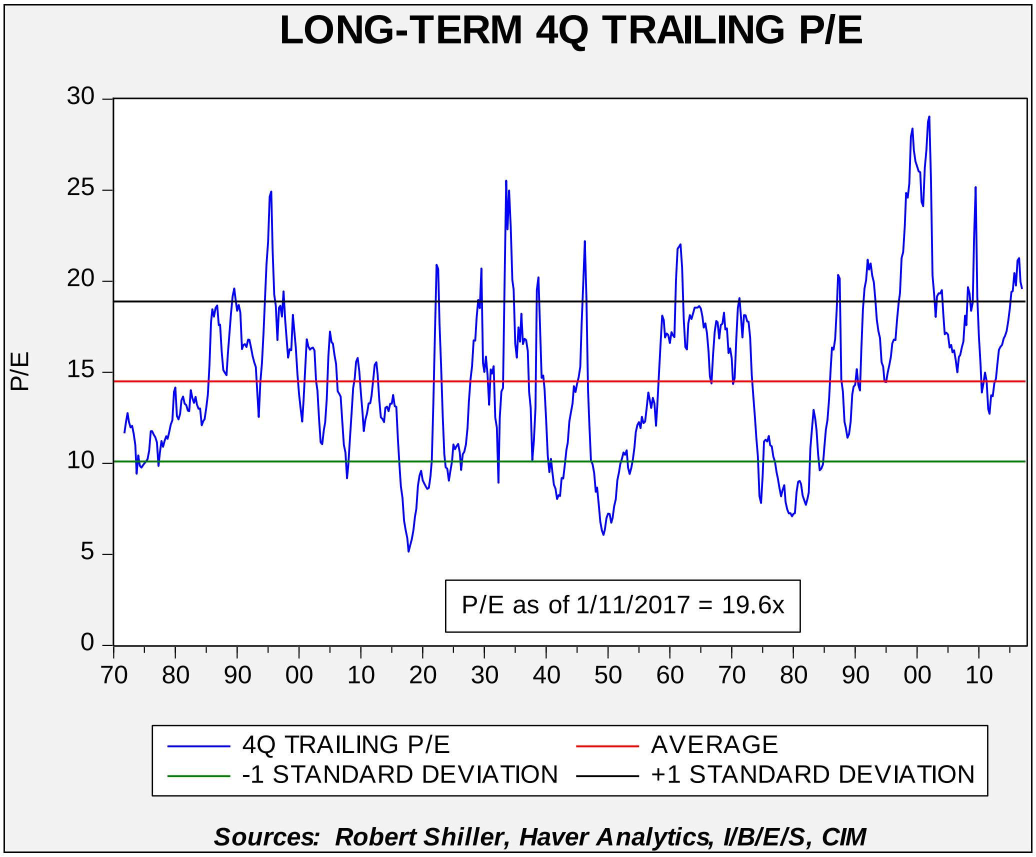

This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 12, 2017




Based on our methodology,[9] the current P/E is 19.6x, up 0.1x from our last report. Rising equity values coupled with a modest decline in earnings expectations led to the rise 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.*

[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.