Daily Comment

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

[Posted: January 17, 2017—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.8% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.2% and the Shenzhen index up 1.2%. U.S. equity futures are signaling a lower open.

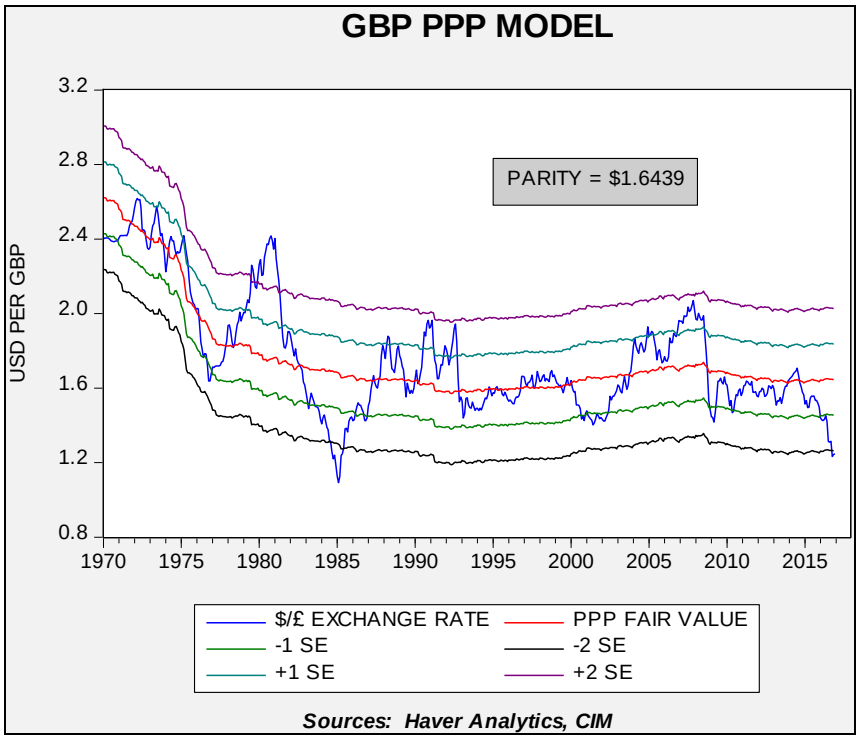
The big news item over the long weekend was U.K. PM May's indication that she is leaning toward what is being called a "hard Brexit." In general, a "soft Brexit" would mean the U.K. leaves the EU but the terms are such that not much changes. In other words, financial institutions in London could still easily access EU markets and there would be a mostly unimpeded flow of EU member citizens across the U.K. border. A "hard Brexit" is quite different—there would be a return to a stringent U.K. border and the free movement of EU members would no longer be in place. If this is the U.K.'s definition of Brexit, the EU will almost certainly put up trade barriers on the U.K. and financial institutions in London will probably need to shift into one of the EU financial centers.

The U.K. establishment supported the Remain campaign. With Brexit, they were leaning toward the soft option. But May, reflecting the goals of the core Leave constituency, wants the hard option, which means the reestablishment of secure borders. The EU likely won't tolerate that decision and will treat the U.K. as an outside power, meaning new trade deals will need to be created. May has also made clear that she is preparing to leave the EU whether or not there is a trade deal in place with the EU bloc. Despite her apparent leaning toward a hard Brexit, she has stated that any deal made between the EU and the U.K. will need approval from both houses of Parliament.

The GBP slid on the news over the weekend, falling below $1.200 on fears that a hard Brexit will weaken the U.K. economy, but has since rallied due to the level of clarity provided. We have seen a reversal in the pound this morning, which is likely due to short covering. Although fears of a hard Brexit are reasonable, there is evidence that supports the notion that the financial markets, especially the exchange rate, have already discounted much of these concerns. The chart below shows a simple purchasing power parity model of the USD/GBP relationship. Purchasing power parity is a way of valuing exchange rates. Also known as the "law of one price," it assumes that the exchange rate will adjust to differences in prices between two nations. Thus, if the cost of living is higher in one nation compared to another, the former will have a weaker exchange rate to ensure the costs of goods between the two nations are equal. In practice, the method is far from perfect. To work perfectly, all goods would need to be equivalent between nations and shipping costs would be zero. Some goods are simply impossible to trade; they are either services that can't be exported (e.g., haircuts), or impractical for trade (e.g., cooked to order meals). To calculate parity, we create a ratio of CPI between the U.K. and the U.S. This clearly isn't a perfect match; the inflation indexes between the two

nations have different baskets with different weights, reflecting the buying patterns in each nation.

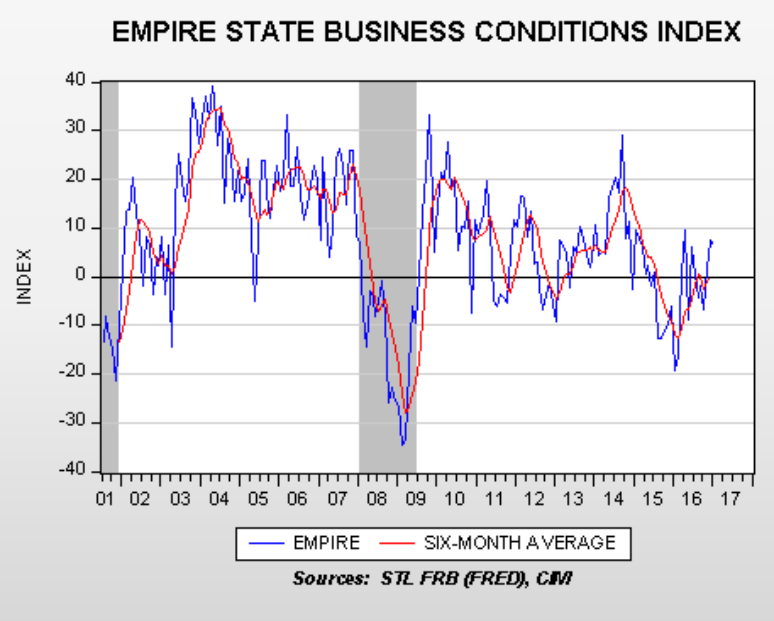
Keeping these weaknesses in mind, we have found that parity models are useful at extremes.



Note on this chart that when the exchange rate's deviations near or exceed two standard errors, a reversal often occurs. This doesn't mean that the pound won't remain weak in the near term; given worries about Brexit, we would not be surprised to see additional declines. However, it should be noted that this is the weakest the GBP has been against the dollar since the Volcker dollar in the mid-1980s. We would not be surprised to see the GBP recover soon after Article 50 is declared later this quarter.

U.S. Economic Releases

Today, the January Empire State manufacturing index came in at 6.5, below the forecast of 8.5. The prior report was revised downward from 9.0 to 7.6.



The chart above shows the six-month moving average of the Empire State Business Conditions Index. This moving average shows that the manufacturing sector in New York is approaching full recovery.

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		
EST	**Speaker or event**	**District or position**
18:00	John Williams Speaks in Sacramento	President of the Federal Reserve Bank of San Francisco

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	Machine Tool Orders	y/y	dec	4.4%	-5.6%		**	Equity bullish, bond bearish
	Industrial Production	m/m	nov	1.5%	1.5%		***	Equity and bond neutral
	Capacity Utilization	m/m	nov	3.0%	1.4%		**	Equity bullish, bond bearish
India	Wholesale Prices	y/y	dec	3.4%	3.2%	3.5%	**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	y/y	jan	119.3	120.1		**	Equity and bond neutral
	Home Loans	m/m	nov	0.9%	-0.8%	0.3%	**	Equity bullish, bond bearish
	Owner-Occupier Loan Value	m/m	nov	0.4%	-0.8%		**	Equity bullish, bond bearish
	Investment Lending	m/m	nov	4.9%	0.7%		**	Equity bullish, bond bearish
	New Motor Vehicle Sales	m/m	dec	0.3%	-0.6%		*	Equity bullish, bond bearish
New Zealand	REINZ House Sales	y/y	dec	-10.7%	-6.0%		**	Equity bearish, bond bullish
EUROPE								
Eurozone	Trade Balance	m/m	nov	22.7 bn	19.7 bn	20.8 bn	**	Equity bullish, bond bearish
	EU27 New Car Registration	m/m	dec	3.0%	5.8%		*	Equity and bond neutral
Germany	ZEW Survey Expectations	m/m	jan	16.6	13.8	18.4	*	Equity and bond neutral
France	Budget Balance YTD	m/m	nov	-93.3 bn	-85.5 bn		*	Equity bearish, bond bullish
Italy	Trade Balance	m/m	nov	.235 bn	.452 bn		**	Equity bearish, bond bullish
U.K.	CPI	y/y	dec	1.6%	1.2%	1.4%	**	Equity and bond neutral
	RPI	y/y	dec	2.5%	2.2%	2.5%	**	Equity and bond neutral
	PPI Input	y/y	dec	15.8%	12.9%	15.5%	**	Equity and bond neutral
	PPI Output	y/y	dec	2.7%	2.3%	2.9%	**	Equity and bond neutral
	House Price Index	y/y	dec	6.7%	6.9%	6.1%	**	Equity and bond neutral
Russia	Official Reserves Assets	m/m	dec	377.7 bn	385.3 bn	380.5 bn	**	Equity and bond neutral
	Trade Balance	m/m	nov	9.1 bn	6.6 bn	7.3 bn	**	Equity bullish, bond bearish
	Exports	m/m	nov	26.6 bn	24.9 bn	24.9 bn	**	Equity bullish, bond bearish
	Imports	m/m	nov	17.5 bn	18.3 bn	17.5 bn	**	Equity and bond neutral
AMERICAS								
Mexico	Formal Job Creation Total	m/m	dec	-319.2k	137.9k		**	Equity bearish, bond bullish
Brazil	Trade Balance Weekly	w/w	jan	120 m	222 m		**	Equity bearish, bond bullish

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	102	0	Up
3-mo T-bill yield (bps)	51	52	-1	Neutral
TED spread (bps)	51	50	1	Neutral
U.S. Libor/OIS spread (bps)	68	68	0	Neutral
10-yr T-note (%)	2.34	2.40	-0.06	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	43	43	0	Neutral
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Down
pound	up			Down
franc	up			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	$55.45	$56.01	-1.00%	Long Liquidation
WTI	$52.44	$53.01	-1.08%	
Natural Gas	$3.35	$3.39	-0.97%	
Crack Spread	$15.66	$15.55	0.70%	
12-mo strip crack	$16.00	$15.90	0.66%	
Ethanol rack	$1.63	$1.63	-0.31%	
Metals				
Gold	$1,197.81	$1,195.43	0.20%	Weaker Dollar, Waning Optimism for President Elect
Silver	$16.79	$16.78	0.04%	
Copper contract	$264.90	$267.15	-0.84%	
Grains				
Corn contract	$ 357.00	$ 358.25	-0.35%	
Wheat contract	$ 425.25	$ 426.25	-0.23%	
Soybeans contract	$ 1,034.75	$ 1,040.25	-0.53%	
Shipping				
Baltic Dry Freight	892	894	-2	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country and cooler weather for the western region. 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 13, 2017

Last week, we reviewed Sebastian Mallaby's recent biography of Alan Greenspan.[1] This week, we will focus on the issue of financial crises and financial stability. As noted in last week's review, the financial system has evolved from a disjointed and diffuse system where banks could not establish themselves across state lines to one of increasing interconnectedness and concentration. Although this has made the financial system more efficient, it has also made it less robust. Simply put, we have created a "too big to fail" problem that means that the Federal Reserve must stand ready to intervene and support failed financial firms to prevent a broader systemic meltdown. This factor, coupled with inflation targeting, means that policy will tend to produce rising financial asset markets that are prone to infrequent large bear markets. The analogy we have used in the past is similar to a forestry policy that will not tolerate any forest fires. By preventing small fires, excessive underbrush grows, creating conditions that allow for extreme fire events that are difficult to control. By constantly rescuing smaller financial firms, policymakers encourage excessive risk which leads to unstable financial markets.

If FOMC officials are convinced that regulators and financial policymakers will not address the "too big to fail" issue effectively (and we tend to believe they won't[2]), then in reality the Federal Reserve has three mandates—full employment, controlled inflation and financial stability. Currently, the FOMC uses monetary policy to address the first two mandates and relies on regulation to manage financial stability. The track record for regulation is poor—even Vice Chair Fischer noted that so called "macro-prudential regulations" don't work all that well, based off his experience as head of the Bank of Israel.[3] Regulatory capture, the phenomenon where regulators are co-opted by those they regulate, is well-documented. The only effective policy available to manage financial stability is monetary policy—raising or lowering interest rates. However, it is very difficult for a central banker to raise interest rates because the equity P/E is too high or bond yields are too low; in fact, as we noted last week, it's a good way for a central bank to see its independence stripped.

We have previously discussed the disconnect that has developed between financial stress and monetary policy.

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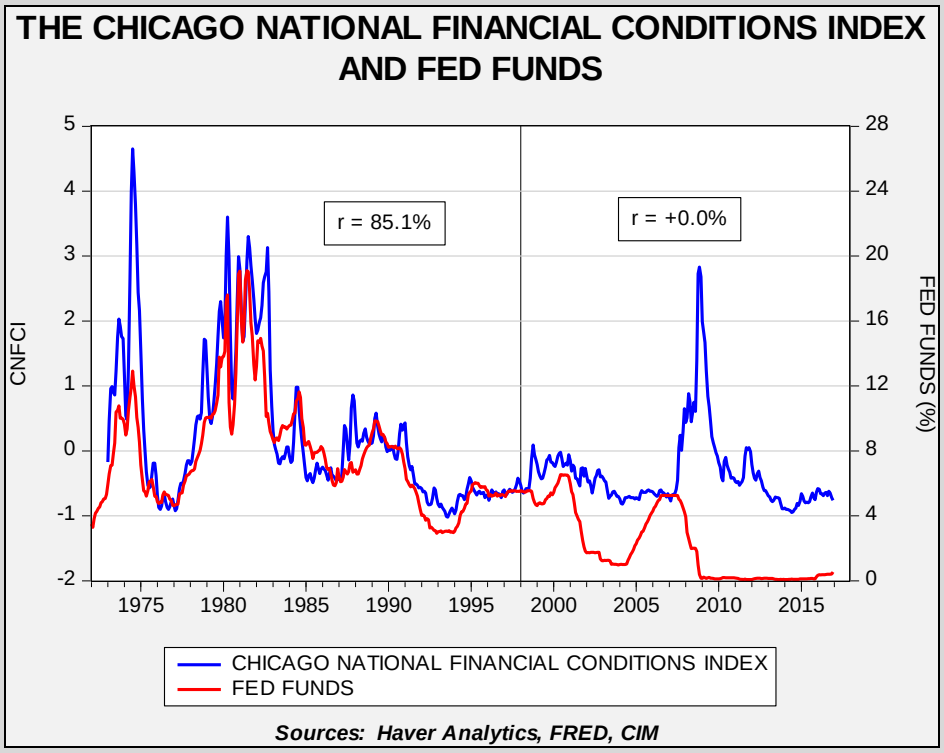
[1] Mallaby, S. (2016). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York, NY: Penguin Press.

[2] There is an effective measure to address financial stability. It requires banks to hold more capital. That position is profoundly unpopular with banks because capital is something of a "dead weight" to the balance sheet. For a good introduction to this issue, we recommend the following podcast: http://www.npr.org/sections/money/2016/12/27/507125309/episode-744-the-last-bank-bailout

[3] https://www.federalreserve.gov/newsevents/speech/fischer20140710a.htm



This chart shows the Chicago FRB's Financial Conditions Index ("CFRBFCI") and the rate of fed funds. The CFRBFCI is a measure of financial stress—it has 105 variables that include interest rates, borrowing levels, outstanding debt, credit spreads, credit surveys and money supply among many other factors. In general, a rising number suggests worsening financial conditions and a reading above zero indicates worse than average financial conditions. From 1973, when the index was first created, until the end of 1997, the CFRBFCI and the level of fed funds were closely correlated, at +85.1%. When the Fed raised rates, financial conditions generally worsened and vice versa. Essentially, this relationship acted as a "force multiplier" for monetary policy. When the Fed raised rates, worsening financial conditions acted to depress the economy; when the Fed cut rates, improving financial conditions boosted growth. However, since 1998, the two have become completely uncorrelated. When the FOMC raised rates from 2004 to 2006, financial stress didn't rise; when the financial crisis hit in 2008, the sharp drop in rates was slow to lower stress. In fact, it wasn't until April 2013 before financial stress fell to pre-crisis levels.

We have puzzled over this change for some time. Mallaby's biography of Greenspan offers one possible explanation. In 1998, during the Long-Term Capital Management meltdown and Asian Economic Crisis, the FOMC, pressed by Greenspan, cut rates 25 bps at three consecutive meetings (Sept. through Nov.). These cuts occurred in an environment of steadily falling unemployment. Simply put, the FOMC cut rates as financial stress rose even though the case for lowering rates was difficult to justify given the state of the economy. It appeared that investors concluded a policy asymmetry was in place—policymakers would cut rates if financial stress rose but would refrain from raising rates if stress was low. In other words, the "Greenspan put" on financial markets was in place.

This leads to a rather uncomfortable problem. If monetary policymakers are concerned that the financial system is fragile and cannot cope with much financial stress and they also conclude that regulators will never address this fragility due to regulatory capture, then they will be reluctant to raise rates and will only do so by clearly telegraphing their plans to avoid creating financial stress. There are four conclusions to draw from this problem. First, since the Fed will continue to target inflation, which is mostly held in check by globalization and deregulation (characterized mostly as the unfettered introduction of technological change), there will be a tendency for asset prices to reach unsustainable levels. Second, given the impotence of financial regulation, the FOMC will unofficially target the suppression of financial stress, also fostering higher financial asset prices. Third, investors will realize that the policy of suppressing financial stress will allow them to take on more risk.[4] Fourth, monetary policy will be only modestly effective in reducing financial stress when the inevitable drop in asset values eventually occurs.

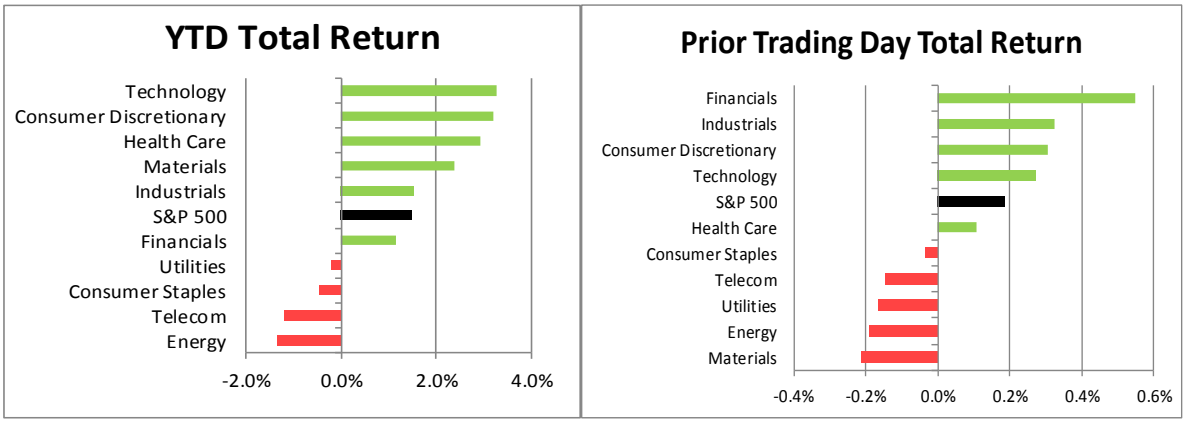
For investors, this policy situation creates a condition where one should remain invested in riskier assets until extremes in valuation are achieved.[5] History does suggest financial problems tend to occur during recessions, which is another factor we closely monitor. Overall, though, the central bank appears to be conducting policy in such a manner that supports asset prices and this is expected to continue for the foreseeable future.

[4] The problem discussed by Hyman Minsky. Minsky, H. (2008). *Stabilizing an Unstable Economy*. New York, NY: McGraw-Hill (First edition published 1986, Yale University Press).

[5] See Asset Allocation Weekly, 12/16/2016, for thoughts on equity levels.

Data Section

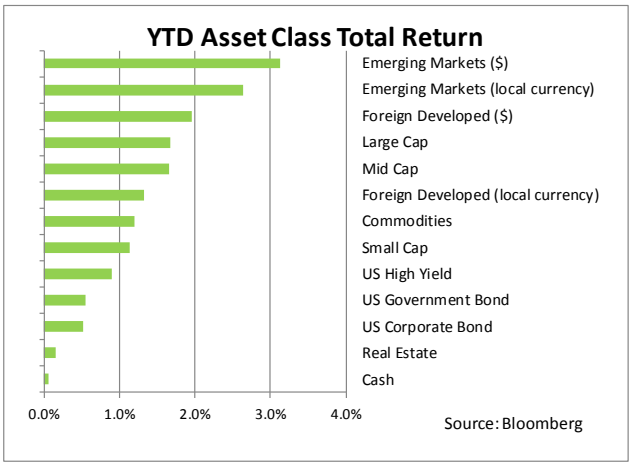
U.S. Equity Markets – (as of 1/13/2017 close)



(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 1/13/2017 close)



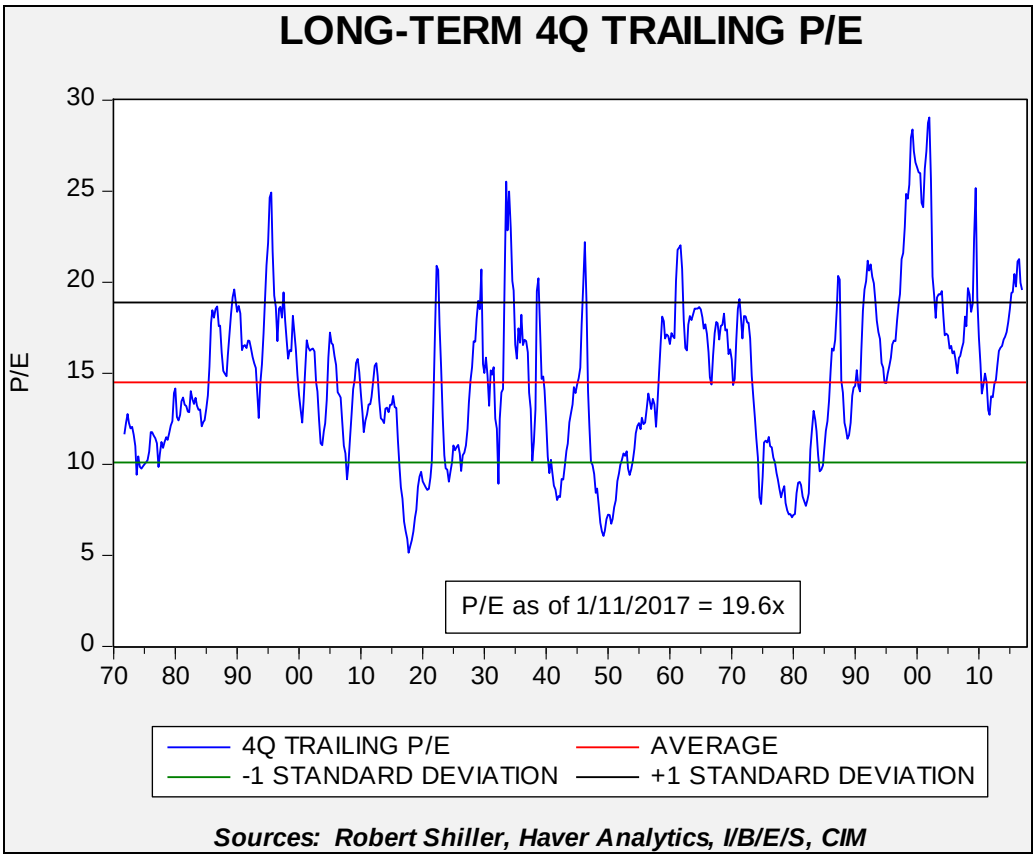
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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).[6]

[6] 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,[7] 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.

[7] 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.