Daily Comment

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

[Posted: January 18, 2017—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index down 0.5%. U.S. equity futures are signaling a higher open.

President-elect Trump caused a stir yesterday when he suggested that he doesn't want a strong dollar. Some of the commentary we saw suggested that this is nearly "unprecedented." That's not really the case. Since the dollar began floating under Nixon, presidents have, on occasion, discussed the dollar or had key cabinet members, normally the treasury secretary, try to "jawbone" the dollar. Nixon was comfortable with dollar weakness. His treasury secretary, John Connally, told European leaders soon after the collapse of Bretton Woods that the dollar is "our currency but it's your problem." President Reagan initially cheered the stronger dollar as he saw it as confirmation of his policies and he wanted to contain inflation. However, by his second term, he became concerned about the dollar's impact on manufacturing so he had his treasury secretary, Jim Baker, organize the Plaza Accord, which was a joint effort by the G-5 to weaken the dollar. In 1987, after the dollar had declined, Baker, angry at Germany over its policies, threatened to push the dollar lower. Some have suggested this was a contributing factor to the 1987 Stock Market Crash. President Clinton's first treasury secretary, Lloyd Bentsen, openly called for a stronger yen.

The "modern" policy on the dollar was developed by Clinton's second treasury secretary, Bob Rubin. Rubin simply said that the U.S. should always support a "strong dollar," irrespective of how it is actually trading, and at the same time let markets set the exchange rate. This policy really had no content in terms of the level of the exchange rate. What it did do was take the exchange rate out of policy discussion and end the practice of using oral intervention to move exchange rates. Early in President George W. Bush's administration, his treasury secretary, Paul O'Neil, suggested the dollar was too strong. The currency plunged and he was forced to backtrack into the Rubin policy, suggesting that if U.S. currency policy changed, he would "rent out Yankee Stadium" to let everyone know.

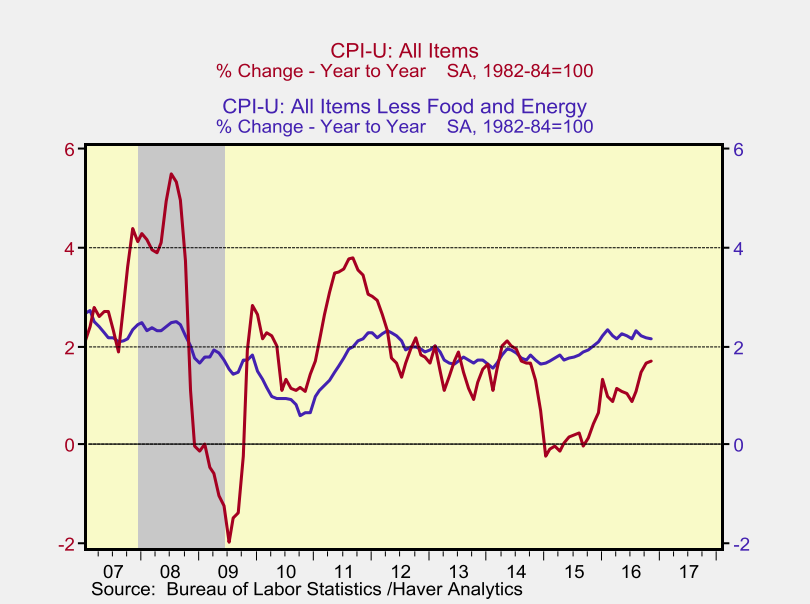
Since O'Neil's comment, every subsequent treasury secretary has fallen back on the Rubin dollar policy. Trump's comments could be signaling that the Rubin policy may be coming to a close. If the incoming president decides to start commenting on the level of the dollar, instead of making innocuous comments about the "strong dollar," it will lead to much higher exchange rate volatility. It may encourage other nations to make similar comments. The benefit of Rubin's policy was that it toned down the rhetoric in the currency markets. If the policy is being jettisoned, volatility will tend to rise.

At the same time, it is important to note that Trump's policies appear to be quite bullish. Tariffs implemented by the reserve currency nation tend to strengthen its currency because it reduces the supply available on world markets. If the border adjustments are part of corporate tax reform, that is dollar bullish. If tax reform encourages repatriation of corporate liquidity held overseas, that is dollar bullish. And, if infrastructure spending and tax cuts boost the economy, it will likely lead to tighter monetary policy (this may be the most interesting issue to watch this year) and, again, a stronger dollar. Simply put, Trump may try to talk the dollar down but his policies will tend to move the dollar in the opposite direction.

U.S. Economic Releases

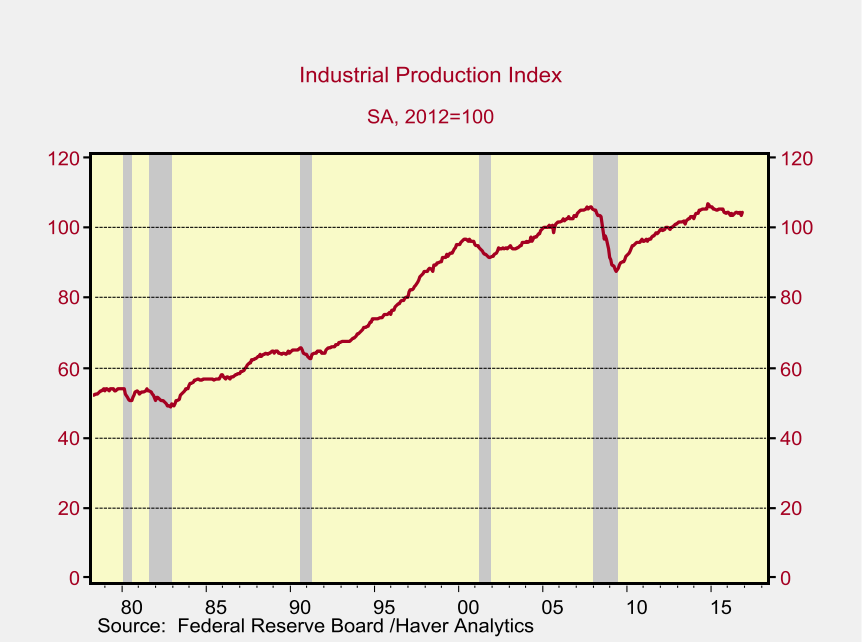
MBA mortgage applications rose by 0.8% from the prior week. Purchases fell by 5.2% and refinancing rose by 6.8%. The 30-year fixed rate mortgage fell by 5 bps from 4.32% to 4.27%.

CPI came in on forecast for December, rising 0.3% from the month before. Core inflation also came in on forecast at 0.2%



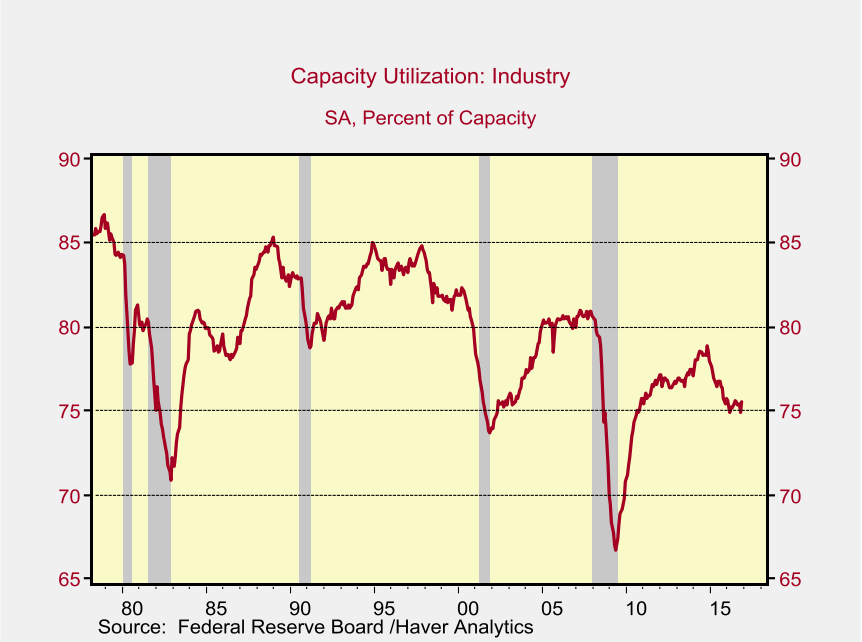
The chart above shows the annual change in headline consumer inflation and core inflation. Headline inflation and core inflation rose annually by 2.1% and 2.2%, respectively, on forecast.

Industrial production rose by 0.8%, higher than the forecast rise of 0.6%. The prior month's report was revised slightly downward from a decline of 0.4% to a decline of 0.7%. This is the strongest rise in two years.



The chart above shows the industrial production index over the past 30 years. Recently, industrial production has been stagnant, which could suggest that manufacturers are experiencing reduced exporting power as a result of the stronger dollar.

Capacity utilization came in slightly stronger than expected at 75.5% compared to the forecast of 75.4%. The prior month's report was revised downward from 75.0% to 74.9%.



The chart above shows capacity utilization over the past 30 years. Recently, capacity utilization has been weak due to lower than expected economic activity.

Manufacturing production rose 0.2% monthly, below the forecast of 0.4%.

Real average weekly earnings rose by 0.2%. The prior report was revised downward from 0.5% to 0.2%. Real average hourly earnings rose by 0.8%.

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

Economic Releases						
10:00	NAHB House Market Index	m/m	jan	69	70	**
16:00	Total Net TIC Flows	m/m	nov		$18.8 bn	**
16:00	Net Long-Term TIC Flows	m/m	nov		$9.4 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
9:00	Robert Kaplan Speaks in Chicago	President of the Federal Reserve Bank of Dallas				
11:00	Neel Kashkari Speaks in Eau Claire, Wisconsin	President of the Federal Reserve Bank of Minneapolis				
15:00	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								
Australia	Westpac Consumer Confidence	m/m	jan	0.1%	-3.9%		**	Equity bullish, bond bearish
New Zealand	Non Resident Bond Holdings	m/m	dec	63.2%	63.6%		*	Equity and bond neutral
EUROPE								
Eurozone	Construction Output	y/y	nov	0.0%	2.2%		**	Equity bearish, bond bullish
	CPI	y/y	dec	1.1%	1.1%	1.1%	***	Equity and bond neutral
Germany	CPI	y/y	dec	1.7%	1.7%	1.7%	***	Equity and bond neutral
U.K.	Claimant Count Rate	m/m	nov	2.3%	2.3%	2.3%	*	Equity and bond neutral
	Jobless Claims	m/m	nov	-10.1k	2.4k	5.0k	**	Equity bullish, bond bearish
	Average Weekly Earnings	y/y	dec	2.8%	2.5%	2.6%	**	Equity and bond neutral
	ILO Unemployment Rate	y/y	dec	4.8%	4.8%	4.8%	**	Equity and bond neutral
Russia	CPI	w/w	jan	0.1%	0.3%		***	Equity and bond neutral
AMERICAS								
Brazil	CNI Industrial Confidence	w/w	jan	50.1	48.0		**	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	102	0	Up
3-mo T-bill yield (bps)	53	53	0	Neutral
TED spread (bps)	50	50	0	Neutral
U.S. Libor/OIS spread (bps)	68	67	1	Neutral
10-yr T-note (%)	2.36	2.33	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	40	40	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	down			Down
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate		0.50%	0.50%	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	$54.69	$55.47	-1.41%	Long Liquidation
WTI	$51.66	$52.48	-1.56%	
Natural Gas	$3.37	$3.41	-1.32%	
Crack Spread	$15.45	$15.41	0.21%	
12-mo strip crack	$16.14	$16.17	-0.17%	
Ethanol rack	$1.62	$1.61	0.24%	
Metals				
Gold	$1,212.64	$1,217.07	-0.36%	Stronger Dollar
Silver	$17.12	$17.20	-0.47%	
Copper contract	$261.20	$262.50	-0.50%	
Grains				
Corn contract	$ 366.00	$ 365.50	0.14%	
Wheat contract	$ 433.75	$ 433.50	0.06%	
Soybeans contract	$ 1,066.50	$ 1,069.25	-0.26%	
Shipping				
Baltic Dry Freight	922	925	-3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		2.3		
Distillates (mb)		0.3		
Refinery run rates (%)		-0.60%		

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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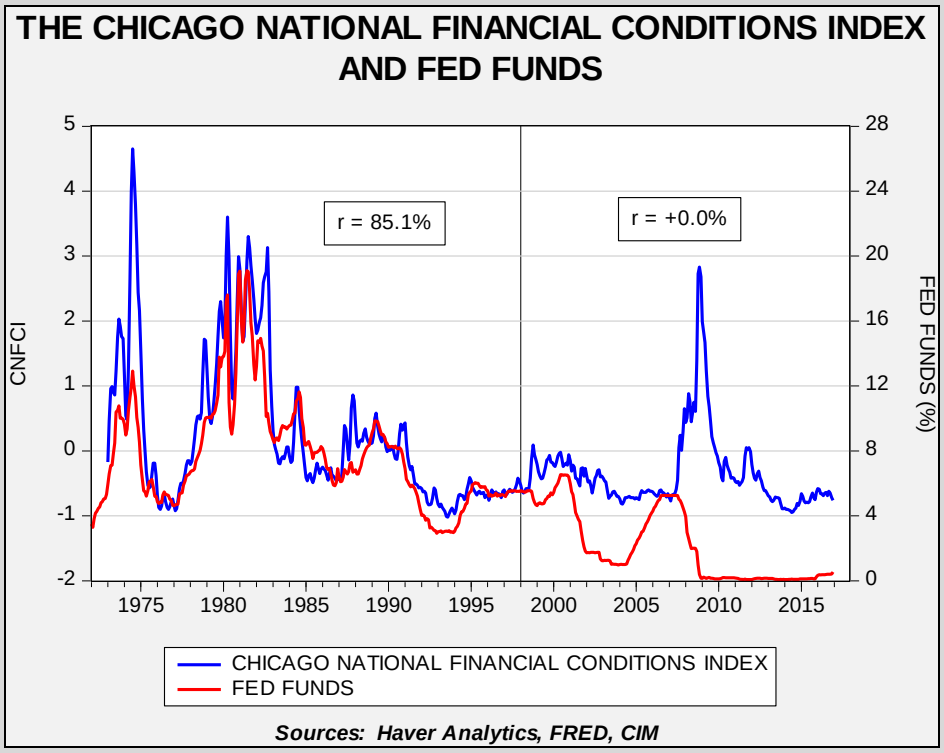
[1] Mallaby, S. (2016). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York, NY: Penguin Press.
[2] There is an effective measure to address financial stability. It requires banks to hold more capital. That position is profoundly unpopular with banks because capital is something of a "dead 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.

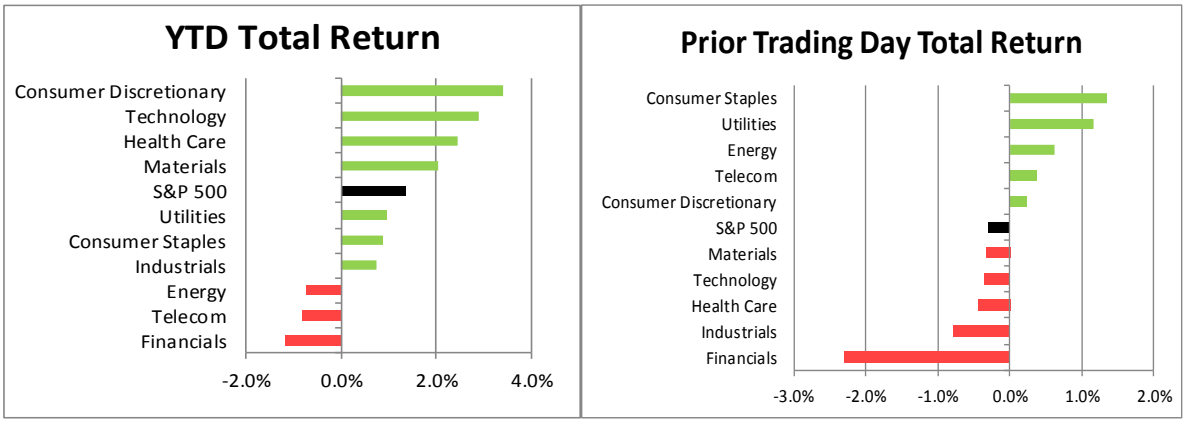
For investors, this policy situation creates a condition where one should remain invested in riskier assets until extremes in valuation are achieved.[5] History does suggest financial problems tend to occur during recessions, which is another factor we closely monitor. Overall, though, the central bank 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

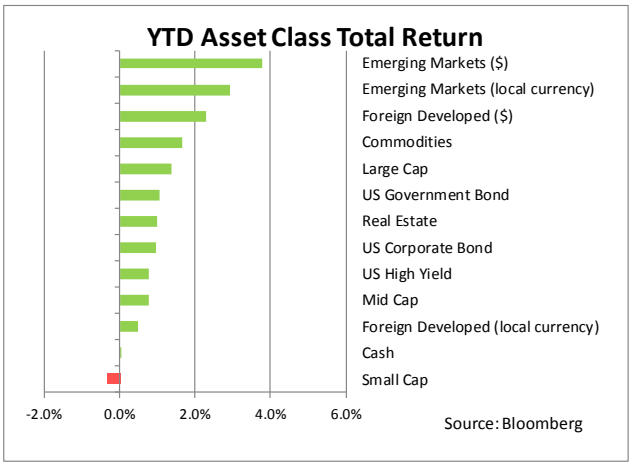
U.S. Equity Markets – (as of 1/17/2017 close)



(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 1/17/2017 close)



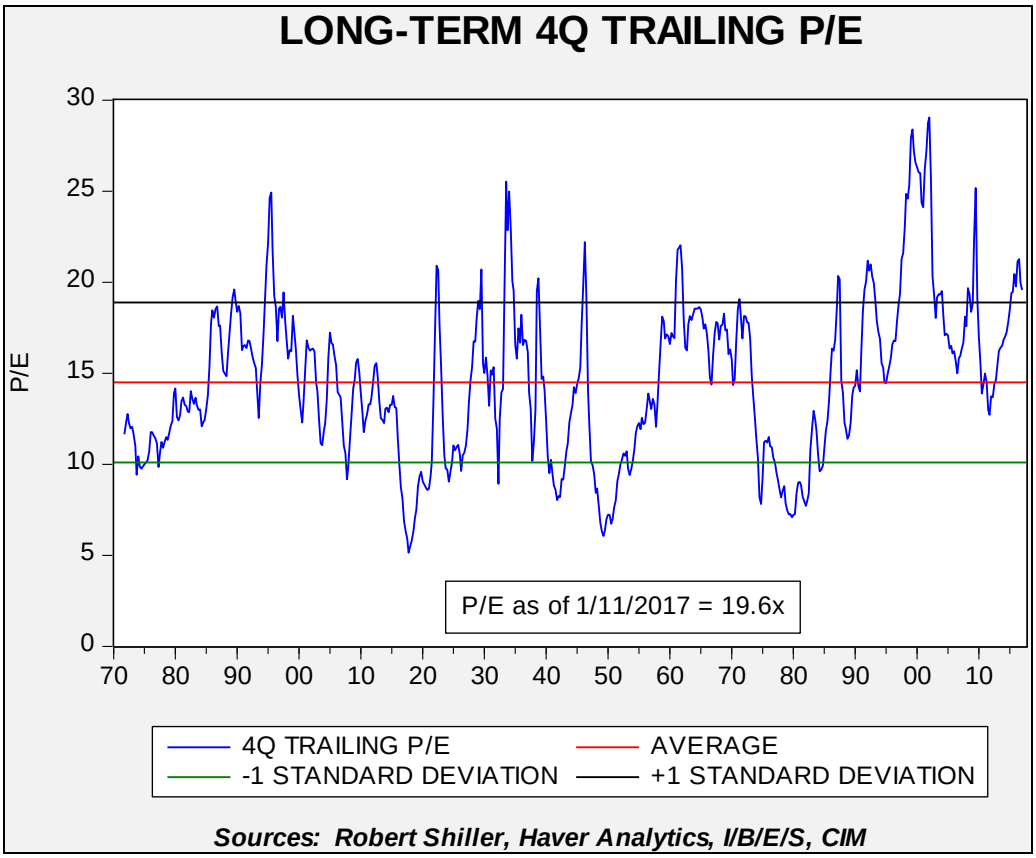
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.