Daily Comment

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

[Posted: March 14, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index down 0.1%. U.S. equity futures are signaling a lower open.

The two big news items since yesterday morning are from the U.K. and the CBO. In the U.K., PM May won her battle for a clean Brexit bill, meaning that Article 50 can be declared soon. We look for the declaration to come by month's end. From the time of the declaration, negotiations have a two-year deadline, although there is a chance that the EU and Britain could decide to extend talks for another two years. The GBP did slump on the news, which is more of a knee-jerk reaction given that this outcome was well expected.

Nicola Sturgeon, the leader of the Scottish National Party, is demanding a new referendum on Scottish independence, which was mostly expected. There is some speculation that PM May is delaying the announcement of Article 50 until the end of March in response to Sturgeon's call for another referendum. Speculation had been high that May would announce as soon as today. If Scotland tries to separate from the U.K. during the country's negotiations to exit the EU, it will weaken the U.K.'s bargaining position. May wants to establish a favorable trade deal with the EU but, if Scotland exits, the EU will have less incentive to deal with the remaining elements of the U.K. and will probably force the country to accept WTO rules.

Also from the U.K. this morning, Charlotte Hogg resigned from the BOE after it was disclosed that she failed to tell regulators that her brother worked for Barclays (BCS, $11.12). She was appointed by the current governor, Mark Carney; because she came from industry instead of academia, she mostly deferred to Carney in voting. This means that Carney will lose a reliable ally in conducting policy. Given that recent decisions by the BOE have been non-controversial, in that voting hasn't been close, we expect her exit to leave policy unaffected. However, it does undermine the reputation of Governor Carney.

The CBO scored the new health care bill and it showed an increase in the number of uninsured but a reduction in spending. These characteristics will probably allow the bill to pass in the House but we see a much more difficult time in the Senate. We are seeing the usual railing against the CBO for its analysis. Our take is that the body isn't always right but it is generally fair. One of our concerns is that the president is spending political capital on this issue which will make tax reform more difficult; the longer the health care issue consumes Congress, the less time there is for other legislation.

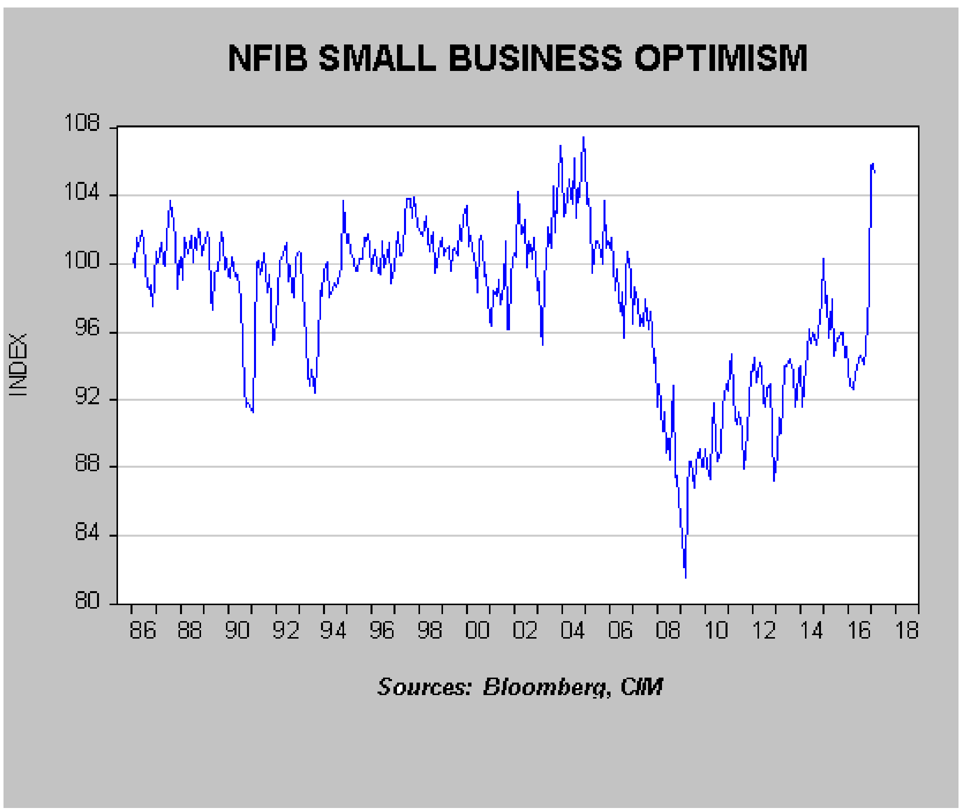
Reuters is reporting that Japan is sending its largest warship, the *Izumo* helicopter carrier, to a port tour across Southeast Asia starting in May. The ship was commissioned two years ago.

Stops include Indonesia, the Philippines and Sri Lanka. It will eventually join the U.S. and India for naval exercises in the Indian Ocean in July. The vessel will be moving through waters claimed by the PRC; although this could be controversial, we don't expect China to act aggressively against the *Izumo*. Still, this is a show of force and does signal that Japan could have significant offensive capabilities if it decided to take such a role.

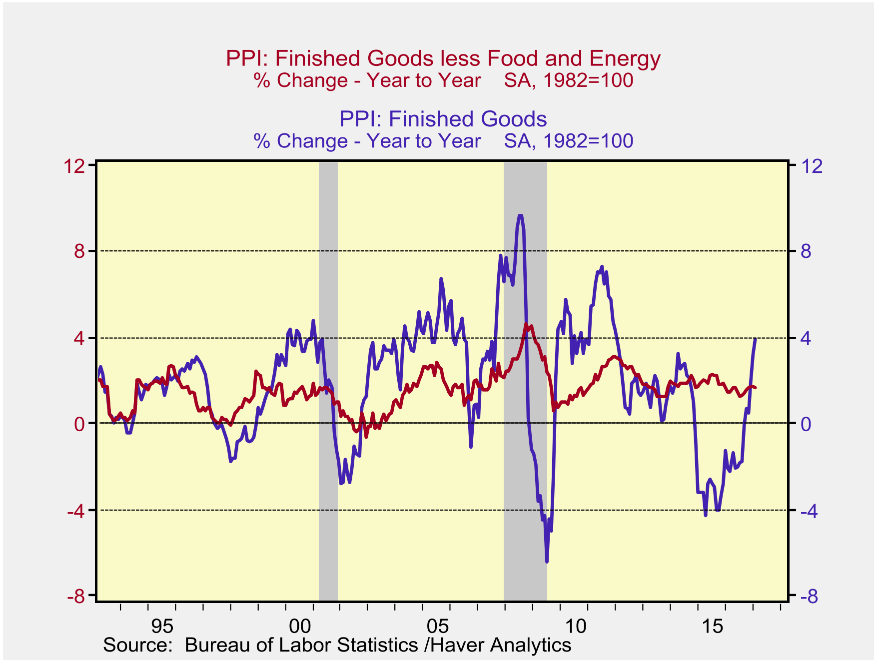
Finally, we are expecting a nor'easter for the Northeast and parts of the Mid-Atlantic states. Chancellor Merkel has canceled her trip due to the weather event. The FOMC is still meeting but some of the members may participate by teleconference. Major snow events in New York have disrupted financial markets in the past. We don't expect too many problems but investors should be aware that New York may be less active today.

U.S. Economic Releases

The NFIB came in slightly below forecast at 105.3 compared to the forecast of 105.6. Hopes of less regulation and tax cuts have boosted small business optimism.



PPI final demand came in above expectations at 0.3% compared to the forecast of 0.1%. Core PPI came in above expectations at 0.3% compared to the forecast 0.2%.



The chart above shows the relationship between PPI final demand and core PPI. The upward trend in PPI suggests that the costs of producing goods are increasing. A rising PPI is bearish for exports as domestic firms may be reluctant to sell overseas due to narrower margins.

There are no economic releases or Fed events scheduled for the rest of the day.

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	Manpower Survey	m/m	2q	4.0%	4.0%		**	Equity and bond neutral
	Retail Sales	m/m	feb	9.5%	10.4%	10.6%	**	Equity and bond neutral
	Fixed Assets Ex Rural	m/m	feb	8.9%	8.1%	8.3%	**	Equity and bond neutral
	Industrial Production	m/m	feb	6.3%	6.0%	6.2%	***	Equity and bond neutral
Japan	Manpower Survey	m/m	2q	23.0	23.0		**	Equity and bond neutral
India	Manpower Survey	m/m	2q	18.0%	21.0%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	feb	113.1	113.9		**	Equity and bond neutral
	NAB Business Conditions	m/m	jan	9	16		**	Equity and bond neutral
	NAB Business Confidence	m/m	feb	7	10		**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production	y/y	feb	0.9%	-1.6%	1.3%	***	Equity and bond neutral
Germany	CPI	y/y	feb	2.2%	2.2%	2.2%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	jan	0.7%	0.7%	0.7%	**	Equity and bond neutral
	ZEW Survey Current Situation	m/m	jan	77.3	76.4	78.0	**	Equity and bond neutral
	Zew Survey Current Expectations	m/m	jan	12.8	10.4	13.0	**	Equity and bond neutral
AMERICAS								
Mexico	ANTAD Same-Store Sales	y/y	feb	2.7%	4.1%	3.0%	**	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	m/m	mar	58.2	57.4		**	Equity and bond neutral
Brazil	Trade Balance Weekly	m/m	feb	$1.725b	$0.697b		**	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)	112	112	0	Up
3-mo T-bill yield (bps)	76	75	1	Neutral
TED spread (bps)	37	37	0	Neutral
U.S. Libor/OIS spread (bps)	90	90	0	Up
10-yr T-note (%)	2.62	2.63	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	21	21	0	Up
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	$51.72	$51.35	0.72%	Short Covering
WTI	$48.69	$48.40	0.60%	
Natural Gas	$3.05	$3.04	0.20%	
Crack Spread	$16.96	$16.87	0.53%	
12-mo strip crack	$14.00	$13.90	0.76%	
Ethanol rack	$1.60	$1.59	0.67%	
Metals				
Gold	$1,205.27	$1,204.30	0.08%	Market Uncertainty
Silver	$17.02	$16.98	0.26%	
Copper contract	$262.55	$262.55	0.00%	
Grains				
Corn contract	$ 360.25	$ 361.00	-0.21%	
Wheat contract	$ 430.00	$ 430.50	-0.12%	
Soybeans contract	$ 1,001.50	$ 1,006.00	-0.45%	
Shipping				
Baltic Dry Freight	1099	1086	13	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-2.0		
Distillates (mb)		-1.3		
Refinery run rates (%)		0.30%		

Weather

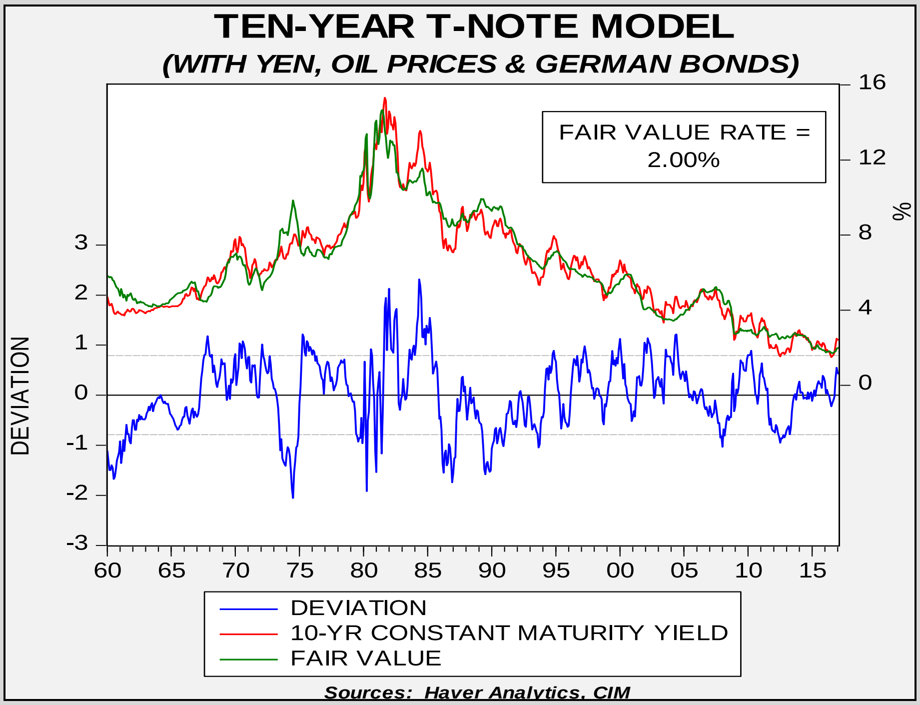
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

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.

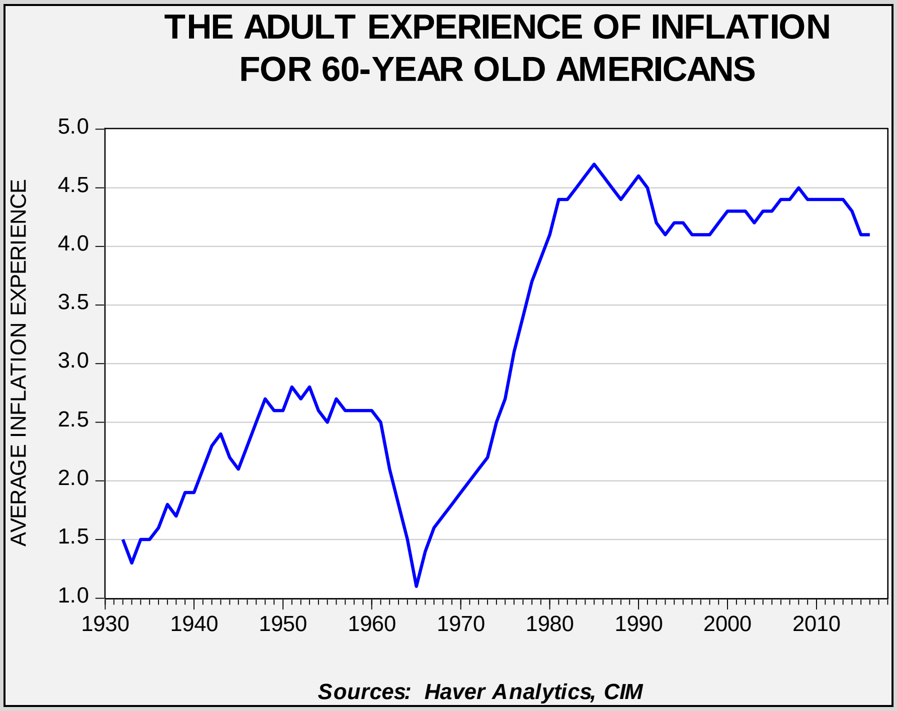
March 10, 2017

As the FOMC prepares to raise interest rates, it's a good time to update our views on long-term interest rates. The chart below shows our current estimate of fair value for the 10-year Treasury.



The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The current yield is about 42 bps above fair value; we move above one standard error of fair value at a 10-year yield of 2.70%. Assuming the other variables remain steady, the current yield on the 10-year T-note has discounted fed funds of 1.80%, suggesting that a series of rate hikes is already in the market.

The factor that could lead to a bigger bear market in long-duration fixed income would be a change in inflation expectations. Our inflation proxy estimates inflation expectations of 2.1%, which is roughly in line with the implied 10-year inflation rate from the TIPS spread. Our worry about inflation expectations is that older investors could ratchet higher if the new administration's policies raise inflation concerns.

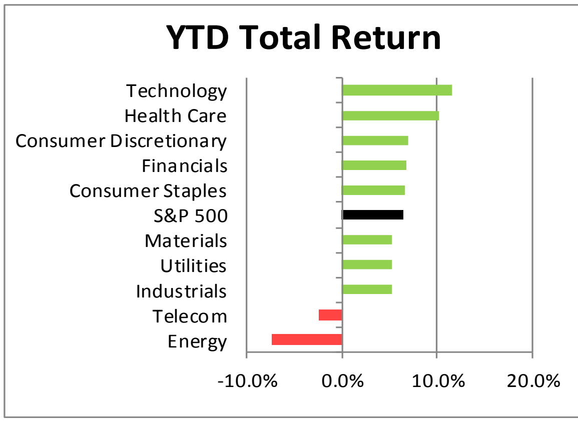


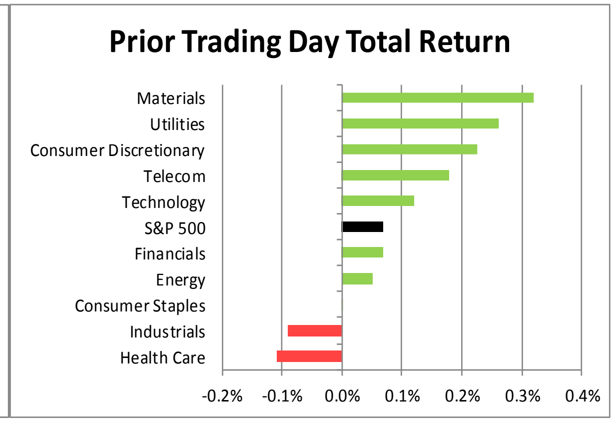
This chart shows the average adult (ages 16 to 60) experience of inflation for 60-year-olds. It's currently 4.2%. It should be noted that younger Americans have, on average, experienced lower levels of inflation; the inflation experience of the current 50-year-old cohort is only 2.8%. We expect older investors to favor fixed income to preserve capital and replace wages in retirement. We also assume that fixed income investors are sensitive to inflation and base their inflation expectations on long-run inflation experiences. Thus, if new government policies on trade and infrastructure spending raise fears of inflation, older Americans may be more prone to "inflation panic" and demand higher rates. Over the next 18 months, that is probably the greatest risk to long-duration fixed income.

For now, we remain cautious on long rates and have tended to favor credit risk over duration risk in fixed income. However, if inflation expectations remain anchored (and tighter monetary policy should assist in this effort), then long-duration fixed income assets could become more attractive as the Fed's tightening cycle continues.

Data Section

U.S. Equity Markets – (as of 3/13/2017 close)

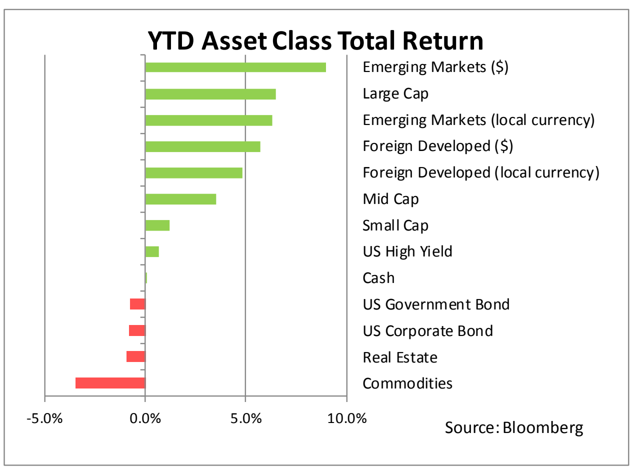




(Source: Bloomberg)

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 3/13/2017 close)

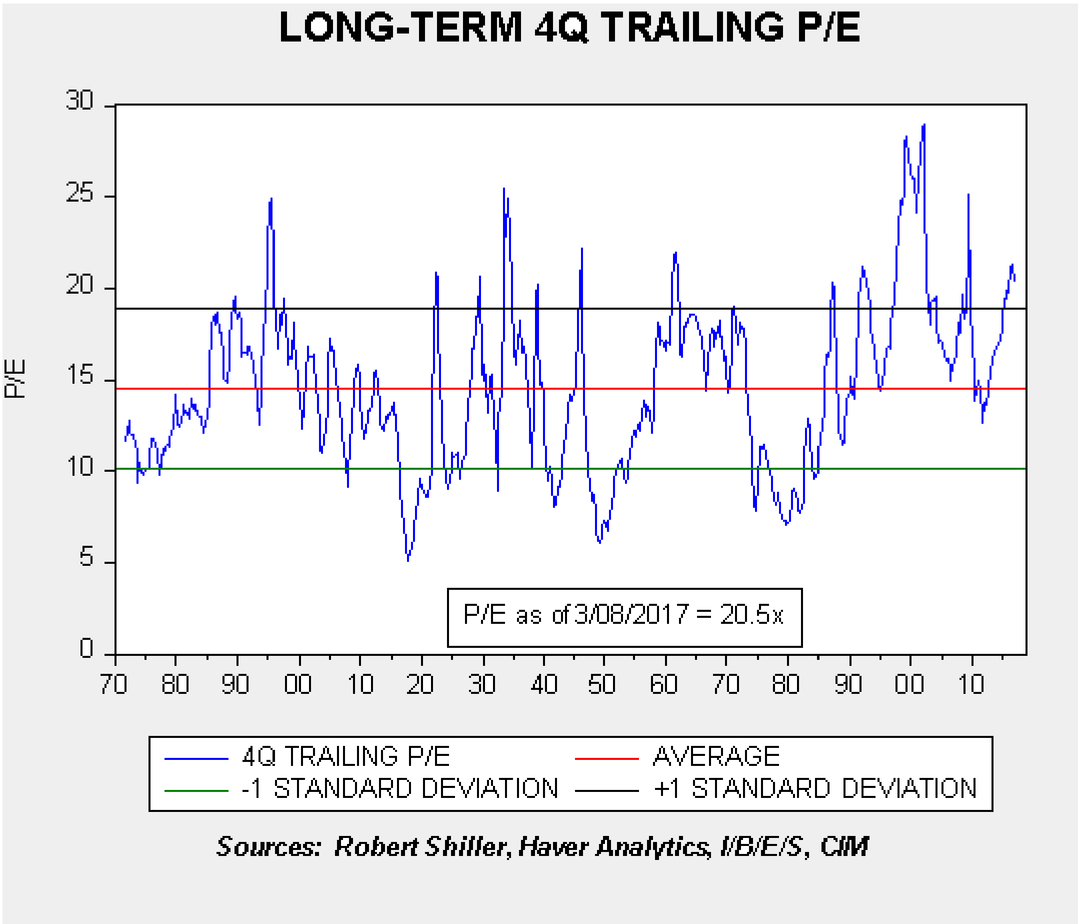


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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).

P/E Update

March 9, 2017



Based on our methodology,[1] the current P/E is 20.5x, relatively unchanged from last week. Falling Q1 earnings were balanced by a rising S&P 500.

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[1] 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 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, Q3 and Q4) and one estimate (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.