Daily Comment

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

[Posted: March 20, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.7% from the prior close. Chinese markets were up, with the Shanghai composite up 0.4% and the Shenzhen index up 0.3%. U.S. equity futures are signaling a lower open.

Although it has been a quiet morning, there was a lot of news over the weekend. Here's what we saw as noteworthy:

Mnuchin won't disavow protectionism: The G-20 communiqué usually includes language supporting free trade and opposing protectionism. Of course, in practice, there really is no nation that has completely open trade but some have more than others. Instead, free trade is seen as an ideal; something that one should aspire to but realize that one will always fall short. That wasn't the outcome among the finance ministers at this weekend's G-20 meeting in Baden-Baden. The new U.S. treasury secretary, Steven Mnuchin, would not support such language. Germany's finance minister, Wolfgang Schäuble, suggested that Mnuchin has "no mandate" to settle on what U.S. trade policy is all about. President Trump has made it clear that his administration intends to change America's trade policy. Since the end of WWII, the U.S. has steadily opened its markets to foreign nations as part of its reserve currency role. Foreign nations have obviously taken advantage of this, implementing export promotion policies to achieve developed nation status. Trump is suggesting that trade is the key factor behind the decline of the U.S. middle class and is determined to force nations to change their policies to boost American jobs.

Why did the U.S. engage in this policy? We believe for two reasons—to win the Cold War and promote global growth. We wanted to build the Free World and we did so by allowing foreign nations to trade with us. This gave other nations a steady source of demand; they created economies designed to export by suppressing domestic demand and restraining their currency's appreciation. The second reason is all about world growth in general, based on the idea that a world that trades with each other may be less likely to go to war. To provide the currency of choice for trade, the U.S. must run a trade deficit; a surplus acts as a global contraction of the money supply.

In our opinion, Trump represents a clear break in this policy. However, support for the financial side of American hegemony has been weakening for some time. Free trade deals have become politically difficult to pass through Congress. Even if Clinton had won the presidency, TPP and TTIP were dead. It's been so long since the U.S. has fought a world war that we have forgotten why these policies were put in place. This G-20 event is further evidence that change is underway.

***60 Minutes* takes on HB-1 visas:** Newsmagazine *60 Minutes* opened last night with a story about a group of IT workers in California who were replaced with foreigners on HB-1 visas and were given incentives to train their replacements. It's the kind of report that gets attention and is part of middle class angst over trade.

Was Tillerson "snuck" in China? While visiting China over the weekend, SOS Tillerson seemed to adopt language China has been supporting for some time. These statements included terms like "mutual respect" and "win-win" cooperation. This language issue is a classic example of strategic ambiguity. For most American ears, terms like mutual respect are benign. However, China interprets these as sphere of influence concepts. In other words, mutual respect means China won't interfere with U.S. relations in South and Central America and the U.S. will give China a free hand in the Far East. Did Tillerson understand China's take on this language? It's possible that given his newness to the job and the lack of support staff, he easily could be unaware. Or, he may be preparing the world for a removal of U.S. power and the creation of regional hegemonies. If we had to guess, we would go with Tillerson's inexperience as the explanation. The next point suggests why.

Trump is preparing to confront China on trade in early April: According to *Axios*,[1] Trump is planning to press Chairman Xi on trade policy with regard to autos. U.S. automakers face a 25% tariff when they try to import into China. In response, U.S. automakers build manufacturing in China but, to do so, they must undergo joint ventures with a Chinese firm that is, by law, the majority owner. Chinese automakers face a 2.5% tariff when exporting to the U.S. Why don't we see more Chinese cars in the U.S.? Mainly due to poor quality. Chinese manufacturers haven't mastered the techniques to meet Western quality standards. However, China has been eyeing the U.S. market for some time and we would expect quality to improve. According to *Axios*, Trump will make a series of demands that will include that China must build plants in the U.S. They can be fully owned by Chinese firms but only if the U.S. firms in China are relieved from the joint venture rule. In addition, profit repatriation will be limited. This gives a flavor for how the president may be looking to negotiate on trade.

Greece spinning toward another crisis: Eurozone finance ministers are meeting today to reiterate that the Tsipras government needs to comply with all the terms attached to emergency loans. Greece isn't really prepared to meet all the demands, which include highly unpopular pension reforms. Markets are ignoring this issue simply because Greece always seems to "blink." This is because there really is no solution to Greece's debt problem other than default and Grexit. Would a Greek exit be a big deal? By itself, probably not, but if Greece leaves the Eurozone and thrives, it will tempt other big economies to do the same which would spell the end of the single currency as we now know it.

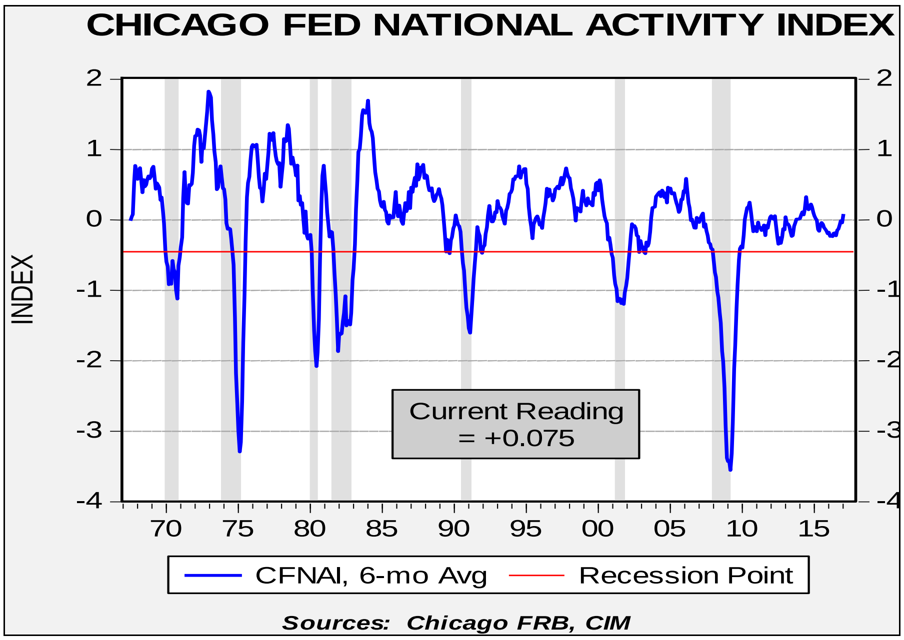
Article 50 on March 29: PM May has indicated she will begin the Brexit process by declaring Article 50 on March 29. Assuming rationality, Brexit should not be a crisis; Britain will need the

[1] https://www.axios.com/axios-sneak-peek-2319878918.html?utm_source=The+Sinocism+China+Newsletter&utm_campaign=e55d7dcd71-EMAIL_CAMPAIGN_2017_03_20&utm_medium=email&utm_term=0_171f237867-e55d7dcd71-29661833&mc_cid=e55d7dcd71&mc_eid=e77499fecc

EU for trade and the EU needs Britain for defense and financial services. However, the EU fears that if Britain gets too good of a deal then other nations may decide to exit as well. Although these fears are not unfounded, it should be noted that the U.K. is a special case; it's a big economy and it is well integrated into Europe. Striking a deal makes sense and one should emerge if emotions are managed.

U.S. Economic Releases

The Chicago Fed National Activity Index came in above expectations at 0.34 compared to the forecast of 0.03.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The current reading is 0.075, an increase from the last report of -0.10, suggesting an improving economy.

The table below shows the 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**
13:10	Charles Evans Speaks on Economy and Policy in New York	President of the Federal Reserve Bank of Chicago

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								
New Zealand	Westpac Consumer Confidence	q/q	1q	111.9	113.1		**	Equity and bond neutral
	Performance Services	m/m	feb	58.8	59.5		**	Equity and bond neutral
EUROPE								
Eurozone	Labor Costs	y/y	feb	1.6%	1.5%		**	Equity and bond neutral
Germany	PPI	y/y	feb	3.1%	2.4%	3.2%	**	Equity and bond neutral
Switzerland	Total Sight Deposits	q/q	mar	557.2b	555.4b		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	mar	470.9b	467.4b		**	Equity and bond neutral
AMERICAS								
Canada	Wholesale Trade Sales	m/m	jan	3.3%	0.7%	0.5%	**	Equity bullish, bond bearish

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)	115	115	0	Up
3-mo T-bill yield (bps)	72	72	0	Neutral
TED spread (bps)	44	43	1	Neutral
U.S. Libor/OIS spread (bps)	91	91	0	Up
10-yr T-note (%)	2.51	2.50	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	29	29	0	Up
Currencies	Direction			
dollar	down			Neutral
euro	up			Neutral
yen	down			Down
pound	down			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	$51.35	$51.76	-0.79%	Long liquidation
WTI	$48.18	$48.78	-1.23%	
Natural Gas	$2.93	$2.95	-0.61%	
Crack Spread	$17.46	$17.11	2.05%	
12-mo strip crack	$14.16	$14.03	0.95%	
Ethanol rack	$1.61	$1.62	-0.33%	
Metals				
Gold	$1,231.82	$1,229.26	0.21%	Weaker dollar
Silver	$17.40	$17.40	-0.01%	
Copper contract	$267.95	$269.15	-0.45%	
Grains				
Corn contract	$ 369.50	$ 367.50	0.54%	
Wheat contract	$ 439.00	$ 436.25	0.63%	
Soybeans contract	$ 1,005.50	$ 1,000.00	0.55%	
Shipping				
Baltic Dry Freight	1196	1172	24	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the northwestern region. Precipitation is expected for most of the country.

<u>Asset Allocation Weekly Comment</u>

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.

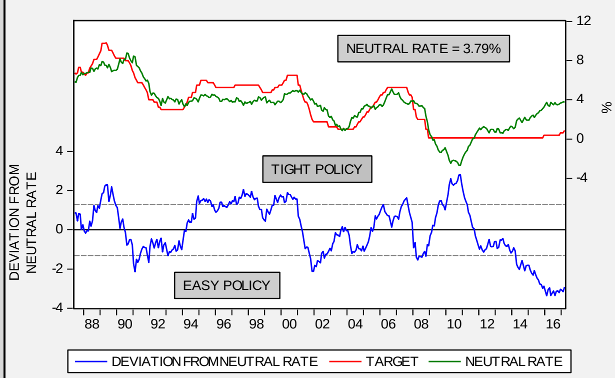
March 17, 2017

The FOMC has moved on rates; as expected, the Fed lifted its target fed funds rate to a range between 75 bps and 100 bps. The projections are for a 1.50% rate by the end of 2017 and a 2.25% rate by the end of 2018.

In this week's report, we want to examine the current neutral policy rates that are generated by our variations of the Mankiw Rule. The Mankiw Rule attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. The Mankiw Rule is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.

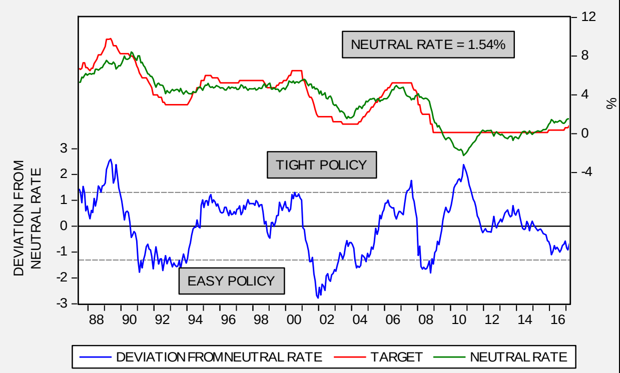
When we create each model, a deviation from the neutral rate is generated and this deviation is compared to the distribution of deviations. In general, one standard error should capture 66% of the deviation from forecast, assuming normally distributed deviations. When the deviation is inside of one standard error, it is generally within the acceptable range.

MANKIW USING THE U-3 UNEMPLOYMENT RATE



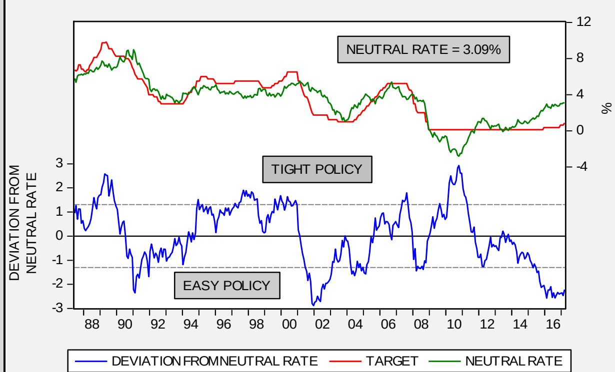
Sources: Haver Analytics, CIM

MANKIW USING THE EMPLOYMENT/ POPULATION RATIO



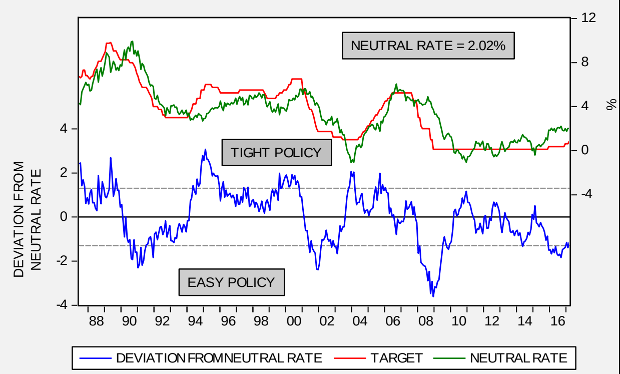
Sources: Haver Analytics, CIM

MANKIW USING INVOLUNTARY PART-TIME EMPLOYMENT AS % OF THE LABOR FORCE



Sources: Haver Analytics, CIM

MANKIW USING THE Y/Y% WAGE GROWTH FOR NON-SUPERVISORY WORKERS



Sources: Haver Analytics, CIM

The charts above show our four variations of the Mankiw Rule. We have published the neutral rates for each model on each chart. Two of the variations, using the unemployment rate and involuntary part-time employment, are well outside the lower standard error line, suggesting easy policy. However, the variations using the employment/population ratio and wage growth for non-supervisory workers is at or within one standard error, which indicates that policy is closer to neutral.

So, what does the FOMC think is the appropriate variation? Given their forecast of a 1.50% rate by year's end, we would argue that they are probably leaning toward the most dovish variation, the one using the employment/population ratio. As we argued earlier,[2] the employment/population ratio has been a better guide to wage growth than the unemployment rate. If this is correct, the longer term expectation for a policy rate of 2.25% is based on expectations that core CPI will rise or there will be continued improvement in the employment/population ratio. If neither occur, we could be at the terminal rate by year's end.

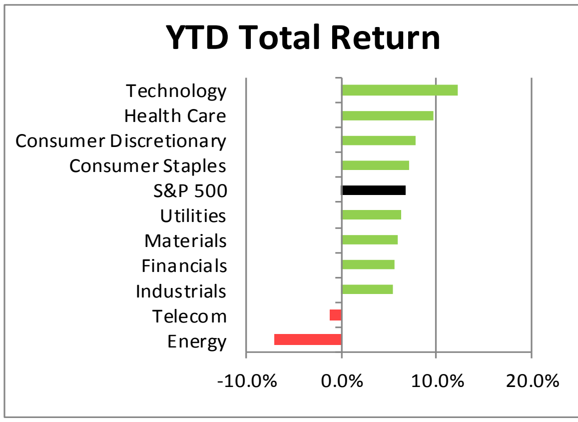
Overall, this means the FOMC, while raising rates, still has a mostly dovish bent. By choosing the most dovish variation of the Mankiw Rule, we are likely closer to the end of this rate cycle, assuming that core CPI remains mostly steady and the employment/population ratio doesn't

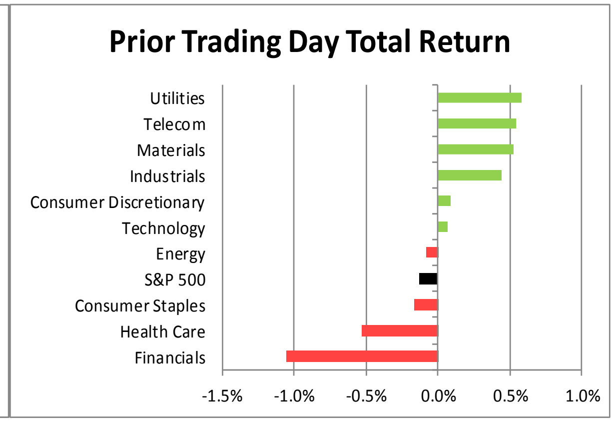
[2] See Asset Allocation Weekly, 2/10/2017.

unexpectedly rise. Such a stance is bullish for equities; however, it may be bearish for the dollar which may bring some adjustments to our current asset allocation mix.

Data Section

U.S. Equity Markets – (as of 3/17/2017 close)

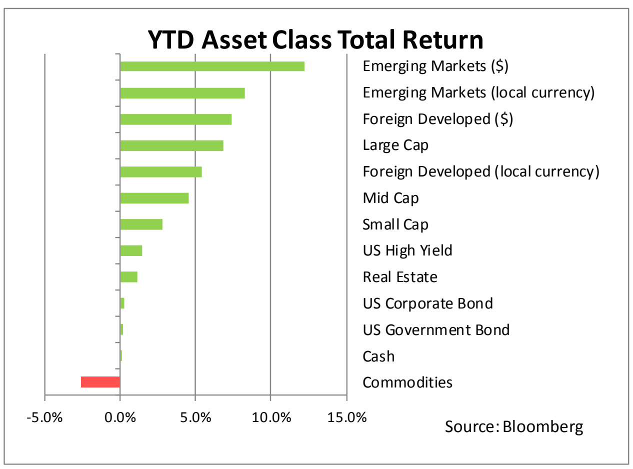




(Source: Bloomberg)

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 3/17/2017 close)

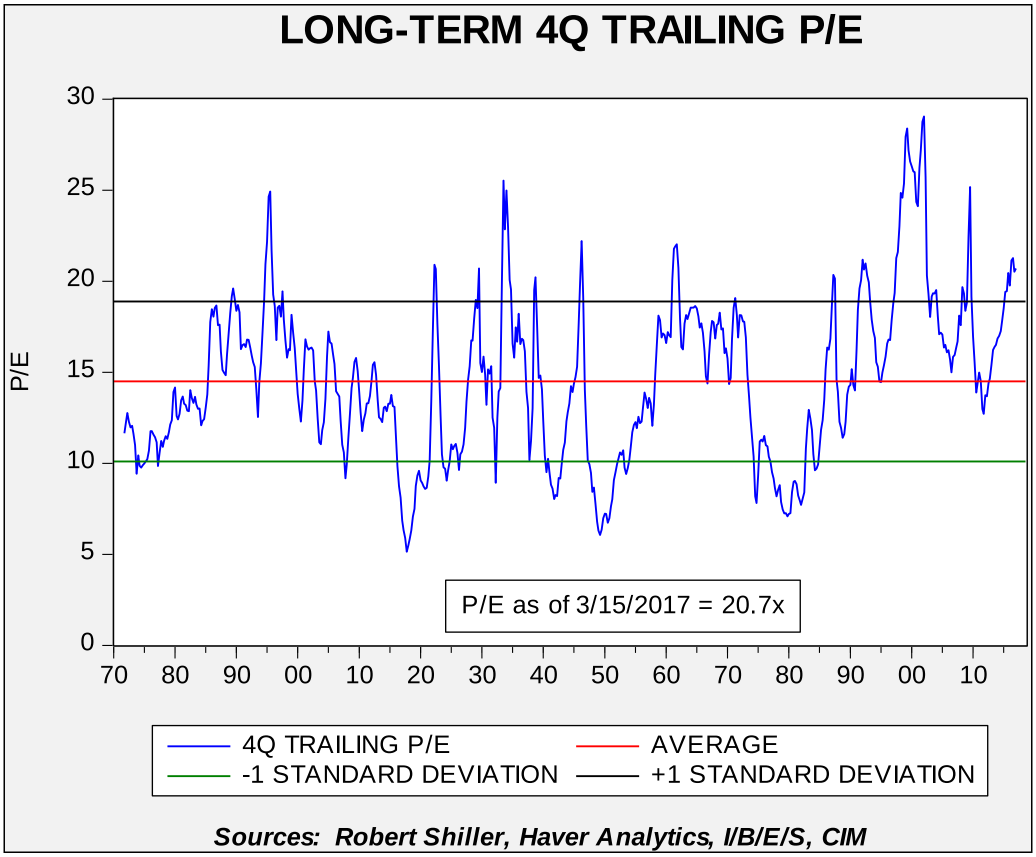


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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).

P/E Update

March 16, 2017



Based on our methodology,[3] the current P/E is 20.7x, up 0.2x from last week. Falling Q1 earnings coupled with market strength led to the rise in the multiple.

[3] 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.