

**[Posted: March 7, 2016—9:30 AM EST]** Global equity markets are generally lower this morning. The EuroStoxx 50 is trading lower by 1.0% from the last close. In Asia, the MSCI Asia Apex 50 traded lower by 0.1% from the prior close. Chinese markets are actually higher, with the Shanghai composite up 0.8% and the Shenzhen index up 2.0%. U.S. equity futures are signaling a lower opening from the previous close. With 98.2% of the S&P 500 companies having reported, the Q4 adjusted earnings stand at \$29.81, higher than the \$28.95 forecast. Of the 491 companies that have reported, 69.0% beat expectations while 19.8% fell short.

There are two issues we want to discuss this morning, China and monetary policy as it relates to Friday's employment report.

**China:** The National People's Congress meetings began on Saturday and a clear signal is being sent—restructuring is being put on the back burner and the country is going for growth. The GDP target is being set at a range of 6.5% to 7.0%, which is overstating growth (most analysts put Chinese growth around 4.5%), but suggests that the Xi government continues to believe that its legitimacy (and the CPC's) rests on delivering strong growth. Both fiscal and monetary levers are being deployed, with a bigger focus on the former. The official deficit is forecast to rise to 3.0% of GDP from 2.3%; including off-balance sheet items, the actual deficit will likely rise to 4.5% from 3.9%. Tax cuts and deductions are being adjusted to support household consumption. Monetary policy will remain accommodative. Overall, it appears that China is using policy to boost growth. Ultimately, this will almost certainly mean higher levels of debt accumulation. This isn't a long-term solution and it suggests that Chairman Xi doesn't feel comfortable enough to lower growth to sustainable levels to curb debt expansion and shift the economy toward consumption and away from investment and exports.

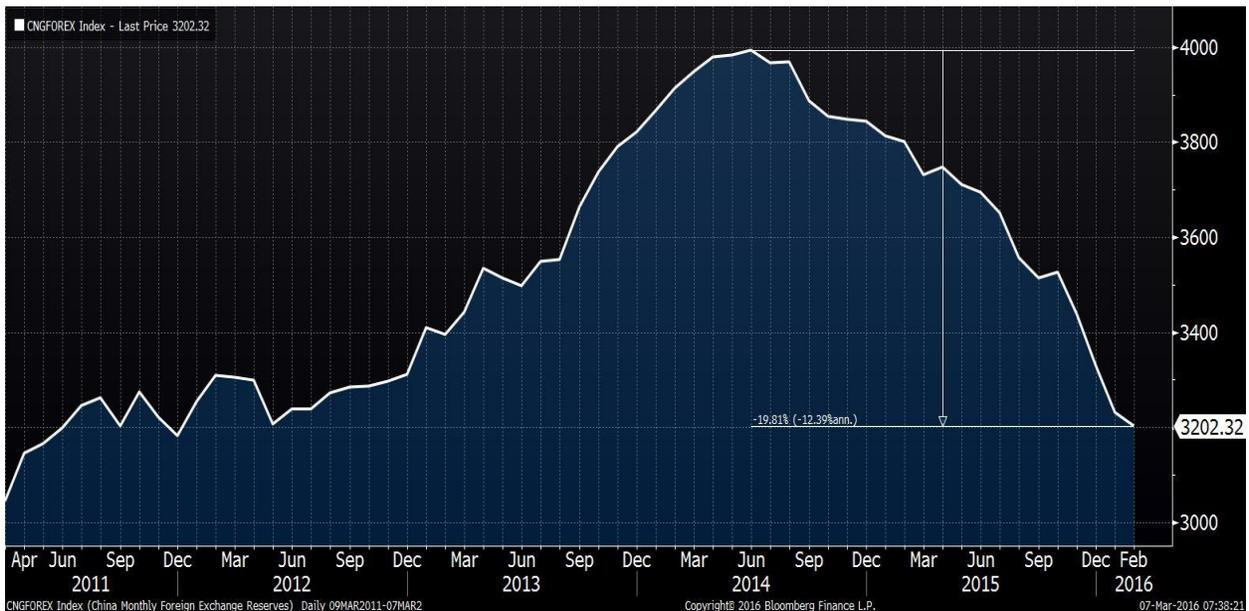
China's focus on growth may be placing a floor under commodity prices. Although the broad indices are not showing a major recovery, the CRB commodity index data suggests that prices are trying to bottom.



(Source: Bloomberg)

Over the past month, there has been a rebound in commodity prices. It's hard to make a case for returning to mid-2014 levels, which would likely take an OPEC agreement and a doubling of oil prices. However, if China is going to boost growth, investors may be willing to shift funds to commodities which, as the chart above shows, have been hit hard over the past 18 months.

China's foreign reserves fell further, to \$3.202 trillion, a bit better than expected. Forecasts were calling for \$3.19 trillion. Net capital outflows (gross outflows net of the trade surplus and currency adjustments) were probably around \$65 bn in February.

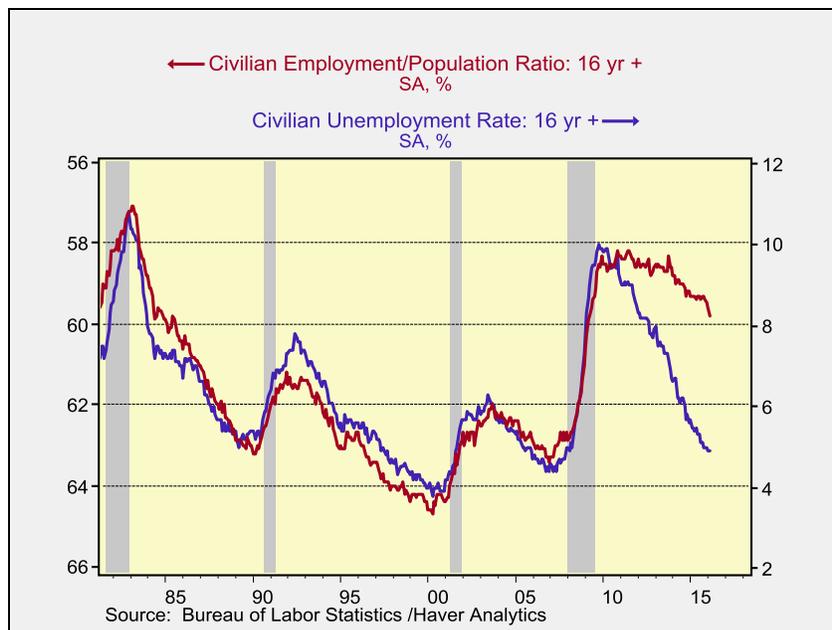


(Source: Bloomberg)

Since peaking in mid-2014, reserves are down 19.8%. The BIS reports that most of the outflows appear to be Chinese firms paying back dollar loans. If so, that is much less of a problem than capital flight. However, the real estate markets in British Columbia, California, New York and Australia do suggest that there is some degree of capital flight.

The bottom line is that if China is determined to grow by further debt expansion, it could be bullish in the short run for global growth, commodity prices and emerging markets. We don't think that this is a long-term solution. Eventually, China will run out of debt capacity, but that probably isn't an immediate concern and so we may see some growth acceleration as the year continues.

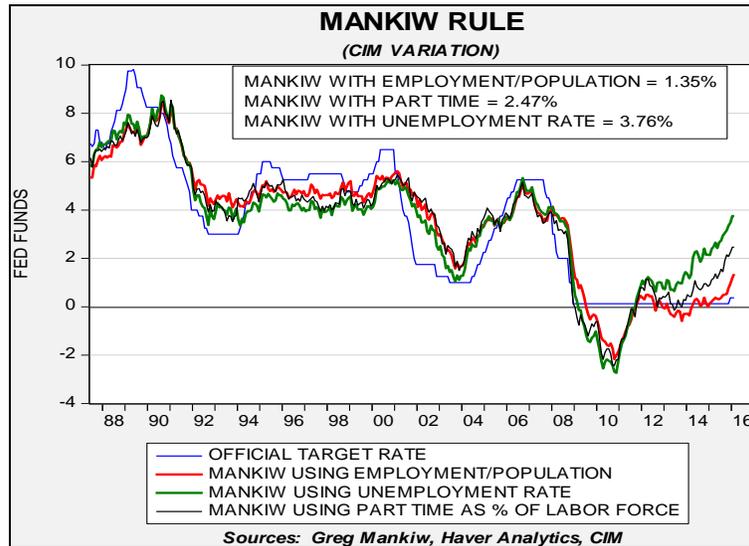
**Employment:** Friday's employment data was unusually strong as the labor force is showing signs of expanding.



Note how the gap between the employment/population ratio and the unemployment rate has narrowed. This trend suggests that formerly discouraged workers may be finding an attractive enough labor market to rejoin the workforce.

That improvement will likely spur the FOMC to return to tightening. Using the employment data and assuming that February core CPI will be in line with January, we can make a tentative update to our versions of the Mankiw rule model. This model attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate by 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, Mankiw used the unemployment rate as a proxy for economic slack. We have created three 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 and a third using involuntary part-time workers as a percentage of the total labor force.



Using the unemployment rate, the neutral rate is now up to 3.76%, suggesting the FOMC is well behind the curve. Using the employment/population ratio, the neutral rate is 1.35%, indicating that, even using the most dovish variation, the FOMC needs a rate hike of nearly 100 bps to achieve neutral policy. Finally, using involuntary part-time employment, the neutral rate is 2.47%. The lift in the employment/population ratio suggests the economy is heating up and that the Fed could move rates higher. Although wage growth was modest, that may be a quirk in the calculation. The reporting period fell before the 15th of February, which tends to underestimate growth; thus, don't be shocked by a reading of 2.6% or a bit higher in March.

If Fed tightening talk begins to surface, we would expect the dollar to rise and risk assets to suffer. That won't be a problem for the March meeting, but could become an issue later this spring. Currently, the financial markets are not prepared for a hike; fed funds futures estimate only a 44% likelihood of an increase at the June meeting and that is probably too low given the employment data.

## U.S. Economic Releases

There are no releases scheduled before we go to print. The table below shows the releases scheduled for the rest of the day.

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	Labor market conditions	m/m	Feb	1.0	0.4	*
3:00	Consumer credit	m/m	Jan	\$16.5 bn	\$21.3 bn	**
Fed Speakers and Events						
EST	Speaker or event	District or position				
12:00	Brainard	Fed governor				
2:00	Fischer	Fed vice chair				

## 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, with red indicating a concerning development, yellow indicating an emerging trend that we are following closely for possible complications and green indicating neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
<b>ASIA-PACIFIC</b>								
Japan	LEI	m/m	Jan	101.4	101.8	101.6	*	Equity bearish, bond bullish
	Coincident index	m/m	Jan	113.8	110.9	113.8	*	Equity and bond neutral
<b>EUROPE</b>								
Eurozone	Sentix investor confidence	m/m	Mar	5.5	6.0	8.3	**	Equity bearish, bond bullish
Germany	Factory orders	m/m	Jan	-0.1%	-0.2%	-0.3%	*	Equity and bond neutral
Italy	PPI	y/y	Jan	-3.0%	-3.9%		**	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
<b>3-mo Libor yield (bps)</b>	63	64	-1	Down
<b>3-mo T-bill yield (bps)</b>	27	26	1	Up
<b>TED spread (bps)</b>	36	37	-1	Down
<b>U.S. Libor/OIS spread (bps)</b>	41	41	0	Neutral
<b>10-yr T-note (%)</b>	1.90	1.87	0.03	Widening
<b>Euribor/OIS spread (bps)</b>	-22	-21	-1	Down
<b>EUR/USD 3-mo swap (bps)</b>	30	30	0	Neutral
<b>Currencies</b>	<b>Direction</b>			
dollar	up			Rising
euro	down			Falling
yen	up			Falling
franc	down			Falling

## 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	Cause/ Trend
<b>Energy markets</b>				
Brent	\$ 39.35	\$ 38.72	1.63%	Domestic rig count falls
WTI	\$ 36.54	\$ 35.92	1.73%	
Natural gas	\$ 1.65	\$ 1.67	-1.20%	Warmer weather forecast
Crack spread	\$ 17.78	\$ 17.64	0.82%	
12-mo strip crack	\$ 12.88	\$ 12.89	-0.12%	
Ethanol rack	\$ 1.50	\$ 1.50	0.00%	
<b>Metals</b>				
Gold	\$ 1,270.24	\$ 1,258.95	0.90%	Potential additional easing from the ECB
Silver	\$ 15.67	\$ 15.51	1.07%	
Copper contract	\$ 227.25	\$ 227.45	-0.09%	China growth concerns
<b>Grains</b>				
Corn contract	\$ 360.75	\$ 358.25	0.70%	
Wheat contract	\$ 465.50	\$ 460.75	1.03%	Dry weather in the U.S. Great Plains
Soybeans contract	\$ 882.75	\$ 878.50	0.48%	
<b>Shipping</b>				
Baltic Dry Freight	349	342	7	

## Weather

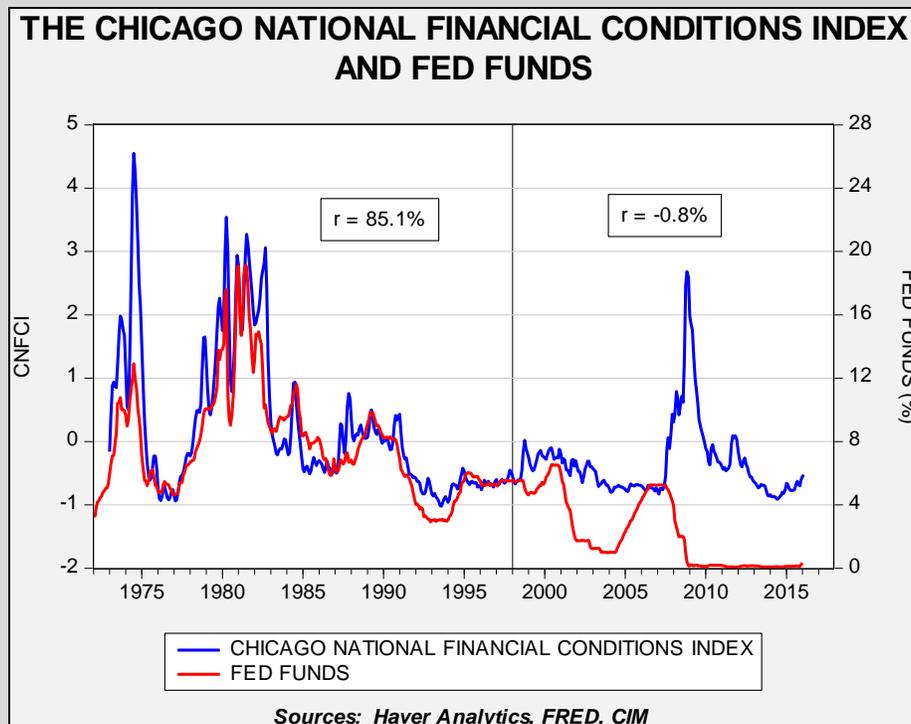
The 6-10 and 8-14 day forecasts indicate warmer and wetter than normal weather for the majority of the country.

## Weekly Asset Allocation Commentary

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 4, 2016

In the Saturday *NY Times* dated Feb. 27,<sup>1</sup> there was a story on the Federal Reserve’s monetary policy. The article discussed findings from a recent paper written jointly by several economists from the University of Chicago, Columbia University, Deutsche Bank, Morgan Stanley and JP Morgan. Although talking about the Fed isn’t a shock, the *NYT* article was very interesting in that it questioned the Fed’s transparency policy. As our regular readers know, we have also looked at the problem of Fed transparency and have concluded that it is probably a bad idea.



This chart shows the National Financial Conditions Index (CNFCI) from the Chicago FRB along with fed funds. The CNFCI is an index of financial stress; higher readings indicate rising stress. It is measured by the level of interest rates, credit spreads, volatility indices, etc. From 1973, when the index data begins, to 1998, the two series were highly correlated, at a positive 85.1%. Thus, when the Fed increased rates, stress rose and vice versa. However, since 1998, the two series have become almost completely uncorrelated, at a modest -0.8%.

<sup>1</sup> [http://www.nytimes.com/2016/02/27/business/economy/feds-transparency-may-give-investors-false-confidence-economists-say.html?\\_r=0](http://www.nytimes.com/2016/02/27/business/economy/feds-transparency-may-give-investors-false-confidence-economists-say.html?_r=0)

We view financial stress as a useful tool, rather than something to be avoided. In the earlier period, tightening policy was assisted by increasing financial stress. This made the tightening more effective. When the FOMC eased policy, the drop in stress tended to add further support to the economy. In our opinion, financial stress should be considered a tool for conducting policy, not a factor to be suppressed. Of course, that meant we had more periods of financial market volatility, but those situations could be addressed by lowering the policy rate.

The aforementioned paper notes that the U.S. central bank has become increasingly more transparent over time. Prior to 1994, the FOMC didn't issue public statements when it adjusted policy. Over time, this changed from issuing statements only to indicate a change in policy to issuing one with each meeting. Communication has steadily increased in other ways as well, with the Fed including economic projections every quarter, along with a "dots" chart to indicate the expected path of the policy interest rate.

It has been our contention that this transparency is counterproductive. By telegraphing policy aims, financial markets face less uncertainty and tend to increase leverage. This lift in leverage eventually creates fragile financial conditions and leads to severe market volatility. The paper argues that this problem isn't due to transparency per se, but due to the use of time-dependent policy guidance. In other words, by signaling that policy is expected to be on a certain path over time, investors become complacent and problems eventually develop. The steady rate hike cycle of 2004-06 is blamed for creating conditions that led to the 2008 financial crisis, and the policy language in 2011 that projected steady policy into 2013 led to expanding asset markets that have become vulnerable and dependent on continued accommodative monetary policy. Instead of using time-dependent guidance, the paper argues that policymakers should use data-dependent policy signals.

However, we fear that the authors have identified a difference without a real distinction. It is true that strictly holding to time-dependent policies can put policymakers into a difficult position. If they promise to engage in a policy stance that becomes difficult to maintain, they must either keep on an improper policy path or undermine their own credibility. However, data-dependence may not work any better. Since the Fed should be monitoring a wide set of data, signaling policy probably becomes too complex to communicate effectively. In addition, any perusal of the financial press shows that interviewers are obsessed about "when" policy will change. The financial media's focus on timing probably precludes any rational discussion about data-dependent policy. In fact, the paper argues that the FOMC often includes data-dependent language along with time-dependent comments; unfortunately, the media only talks about timing. Some analysts believe that this problem can be resolved with a policy rule, such as the Taylor and Mankiw Rules. The problem with these rigid rules is that policy rules may not be an improvement over discretionary policy if excluded variables (e.g., exchange rates, weather, political crises, etc.) have an impact on the economy and financial markets.

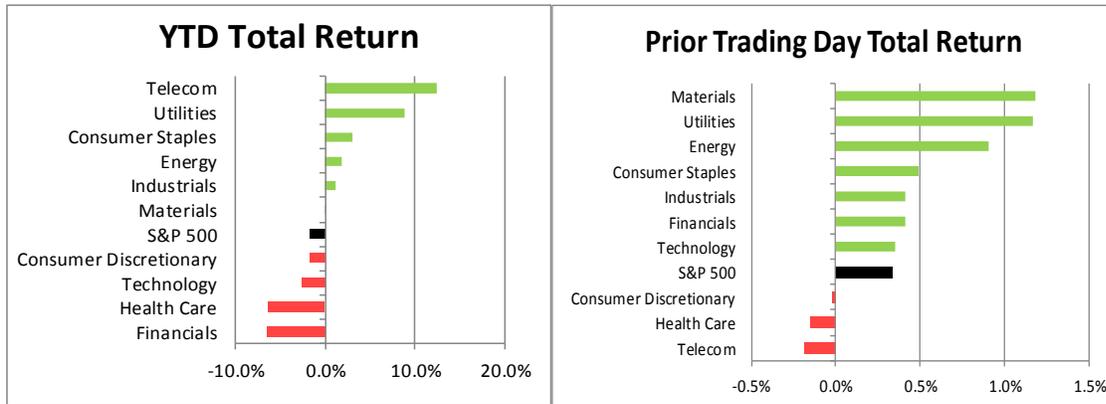
In our opinion, we have a rather simple choice. We can either have an opaque central bank with higher levels of financial stress but less vulnerability to excessive leverage and crises, or a transparent central bank where markets are stable for long periods of time, punctuated by occasional, but more severe, market crises. At present, policymakers have opted for the second option, although we suspect they have accepted this tradeoff without fully recognizing it.

Although we view the aforementioned paper as flawed, it may foster a discussion about this tradeoff and lead to better policy. Until the Fed's communication policy changes, our asset allocation process assumes that financial markets will continue the patterns seen since the late 1990s, which is extended periods of stability punctuated with episodes of high volatility.

*Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.*

**Data Section**

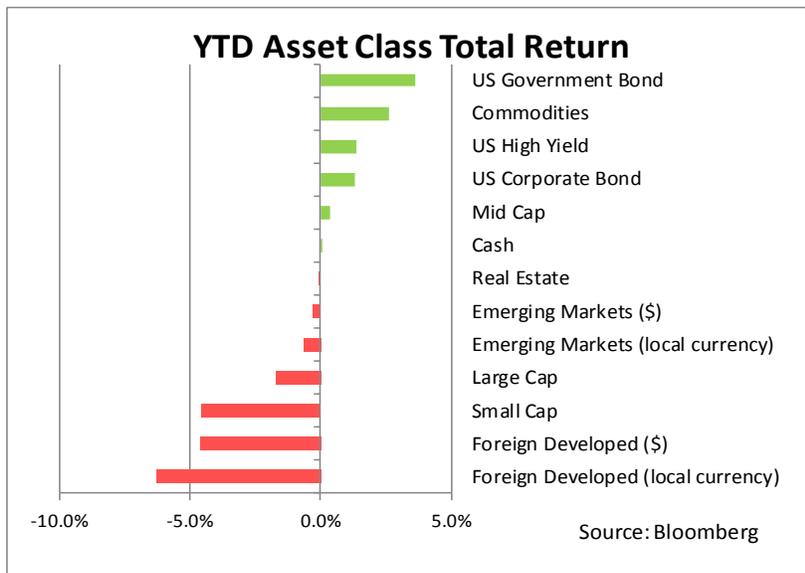
**U.S. Equity Markets – (as of 3/4/2016 close)**



(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. The sectors are ranked by total return, with green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

**Asset Class Performance – (as of 3/4/2016 close)**



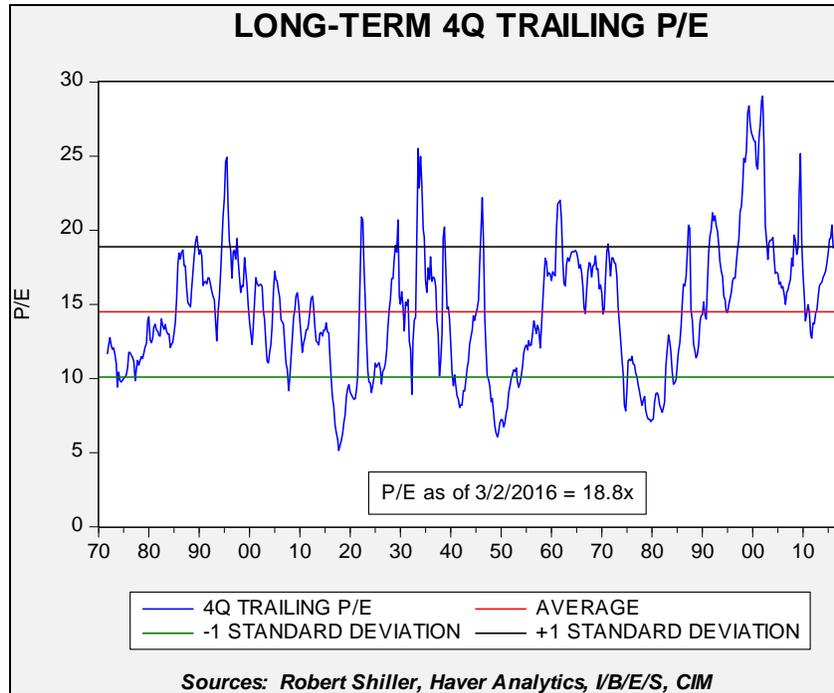
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Dow Jones-UBS Commodity Index).

## P/E Update

March 3, 2016



Based on our methodology,<sup>2</sup> the current P/E is 18.8x, up 1.2x from last week. The jump is due to a situation that has developed in recent quarters in which the Bloomberg numbers are significantly higher than the official data we receive from Haver Analytics. This situation has previously occurred during periods of weak economic growth. Haver releases an earnings number once 95% of the companies of the S&P 500 have reported and these may be adjusted in the coming weeks. For now, earnings have come in much weaker than expected. Based off the Haver numbers for 2015, operating earnings for the year were \$100.89; as reported, \$87.07.

*This report was prepared by Bill O'Grady and Kaisa Stucke of 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.*

<sup>2</sup> 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 two actual (Q2 and Q3) and two estimates (Q4 and 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.