Daily Comment

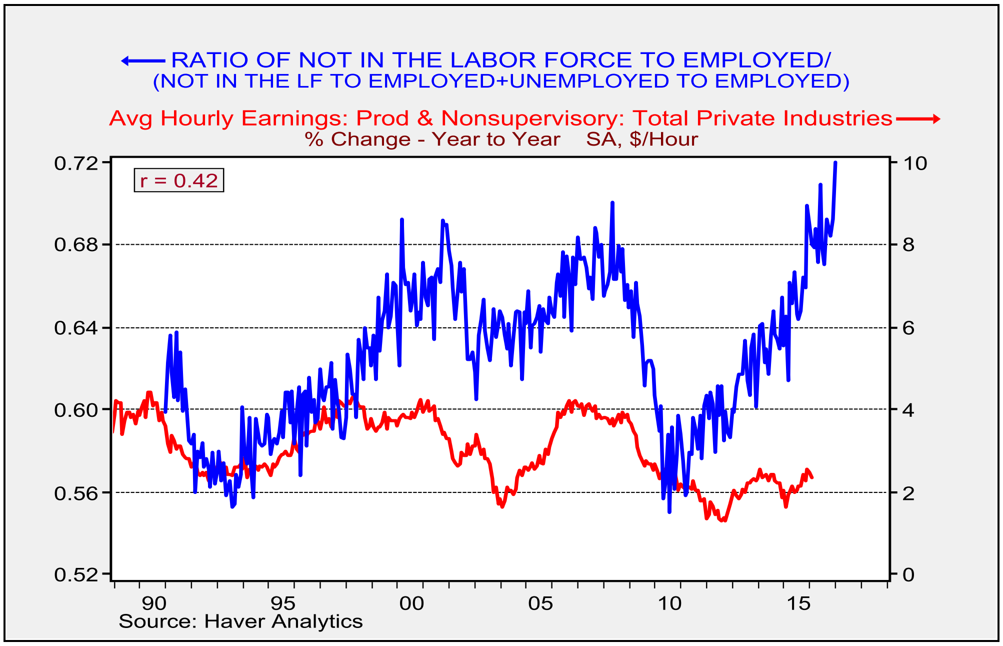
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: March 8, 2016—9:30 AM EST] Global equity markets are generally lower this morning, outside of China. The EuroStoxx 50 is trading lower by 0.1% from the last close. In Asia, the MSCI Asia Apex 50 traded lower by 0.8% from the prior close. Chinese markets are actually higher, with the Shanghai composite up 0.1% and the Shenzhen index up 0.5%. U.S. equity futures are signaling a lower opening from the previous close. With 98.4% of the S&P 500 companies having reported, the Q4 adjusted earnings stand at $29.81, higher than the $28.95 forecast. Of the 492 companies that have reported, 69.2% beat expectations while 19.6% fell short.

Global equity markets are taking a breather today after an impressive rally. Commodity prices have been rallying as well. As noted below, China's trade data came in a bit sloppy, with exports down 25.4% from last year. However, all Chinese data is difficult to read in the first two months of the year due to variations in when the Chinese New Year holiday begins. For example, last year the holiday came late and firms tended to increase exports before the holiday, making this year's comparison difficult. If this is the reason, March exports should show a strong yearly rebound. Imports were down 13.8% from last year. Commodity import volumes did show some improvement, which likely reflects the Chinese position that raw material prices are attractive. That sentiment partly accounts for the recent rebound in commodity prices.

As we warned yesterday, the Fed hawks are surfacing. Vice Chairman Fischer suggested the U.S. is starting to see the "first stirrings" of inflation. He also made a spirited defense of the Phillips Curve, suggesting that it isn't dead, just flat. In other words, the relationship between inflation and employment still stands but has become less sensitive over time.

The following is another interesting labor market chart.



This chart shows the ratio of workers who used to be outside the labor force but are now employed divided by the sum of these same workers plus workers who were already in the labor force and are now employed. When the ratio rises, more workers are being employed from outside the labor force. To be in the labor force, one must either be working or looking for work; the latter are the officially "unemployed." Once someone stops working *and* looking for work, they officially leave the labor force. The above data shows an unusually high degree of workers who were not in the labor force entering employment. In the past, when this ratio hit about 0.68, wage growth was averaging about 4% per year. So far, despite these flows from discouraged workers to employment, wage growth has remained soft. In other words, firms have been able to draw workers from the pool of discouraged workers without lifting wages. There is a plethora of explanations why wage growth has been sluggish. In fact, the San Francisco FRB recently published a study[1] suggesting that retiring baby boomers may be to blame. As older workers retire, presumably at near-peak wage levels, they are replaced with new workers making less money. The paper argues that the sluggishness of wage growth may not be due to slack but due to a generational shift, and so the labor market is actually rather tight. Although we suspect there are other explanations as well, this one does solve a couple of mysteries. First, if depressed wage growth is due to this generational shift, it would also explain why productivity is so weak. The newer workers are less trained than the retiring baby boomers they are replacing, thus dragging down productivity. Second, it would explain Fischer's "flat" Phillips Curve theory in that wage growth is weak because this generational shift is to blame.

Overall, the FOMC is navigating an environment of rather difficult structural divergences. For the most part, the committee does seem aware of how treacherous it is and so we expect the Fed

[1] http://www.frbsf.org/economic-research/publications/economic-letter/2016/march/slow-wage-growth-and-the-labor-market/?utm_source=frbsf-home-economic-letter-title&utm_medium=frbsf&utm_campaign=economic-letter

to maintain a bias toward tightening but move very cautiously in an attempt to avoid a policy mistake.

U.S. Economic Releases

The NFIB small business optimism deteriorated in February, falling to 92.9 from 93.9 the month before, also weaker than the 94.0 level forecast.

There are no releases 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, 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
ASIA-PACIFIC								
China	Trade balance	m/m	Feb	$32.6 bn	$63.3 bn	$51.0 bn	**	Equity bearish, bond bullish
	Exports	y/y	Feb	-25.4%	-11.2%	-14.5%	**	Equity bearish, bond bullish
	Imports	y/y	Feb	-13.8%	-18.8%	-12.0%	**	Equity bullish, bond bearish
	Foreign reserves	m/m	Feb	$3.2 tn	$3.2 tn	$3.2 tn	**	Equity and bond neutral
Japan	GDP	y/y	Q4	-1.1%	-1.4%	-1.5%	***	Equity bullish, bond bearish
	Trade balance	m/m	Jan	-¥411.0 bn	¥188.7 bn	-¥530.0 bn	**	Equity bullish, bond bearish
	Current account balance	m/m	Jan	¥1.5 tn	¥1.7 tn	¥1.7 tn	**	Equity bearish, bond bullish
EUROPE								
Eurozone	GDP	y/y	Q4	1.6%	1.5%	1.5%	***	Equity bullish, bond bearish
France	Trade balance	m/m	Jan	-€3.7 bn	-€3.7 bn	-€4.1 bn	**	Equity bullish, bond bearish
	Current account balance	m/m	Jan	-€1.4 bn	-€0.4 bn		**	Equity bearish, bond bullish
Germany	Industrial production	y/y	Jan	2.2%	-1.3%	-1.6%	***	Equity bullish, bond bearish
Switzerland	Unemployment rate	m/m	Feb	3.4%	3.4%	3.4%	***	Equity and bond neutral
	CPI	y/y	Feb	-0.8%	-1.3%	-1.1%	***	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)	63	64	-1	Down
3-mo T-bill yield (bps)	30	30	0	Neutral
TED spread (bps)	33	34	-1	Down
U.S. Libor/OIS spread (bps)	40	41	-1	Down
10-yr T-note (%)	1.85	1.91	-0.06	Narrowing
Euribor/OIS spread (bps)	-22	-22	0	Neutral
EUR/USD 3-mo swap (bps)	27	29	-2	Down
Currencies	**Direction**			
dollar	up			Rising
euro	up			Falling
yen	up			Falling
franc	up			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
Energy markets				
Brent	$ 41.26	$ 40.84	1.03%	Domestic rig count falls
WTI	$ 38.17	$ 37.90	0.71%	
Natural gas	$ 1.73	$ 1.69	2.31%	Warmer weather forecast
Crack spread	$ 18.67	$ 18.21	2.50%	
12-mo strip crack	$ 13.66	$ 13.41	1.85%	
Ethanol rack	$ 1.50	$ 1.50	0.01%	
Metals				
Gold	$ 1,274.89	$ 1,267.33	0.60%	Investment demand
Silver	$ 15.62	$ 15.64	-0.16%	
Copper contract	$ 224.60	$ 228.35	-1.64%	China growth concerns
Grains				
Corn contract	$ 357.50	$ 359.00	-0.42%	
Wheat contract	$ 459.50	$ 462.75	-0.70%	Oversupply concerns
Soybeans contract	$ 877.75	$ 881.75	-0.45%	
Shipping				
Baltic Dry Freight	354	349	5	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.6		
Gasoline (mb)		-1.4		
Distillates (mb)		0.3		
Refinery run rates (%)		-0.1%		
Natural gas (bcf)		-44.0		

Weather

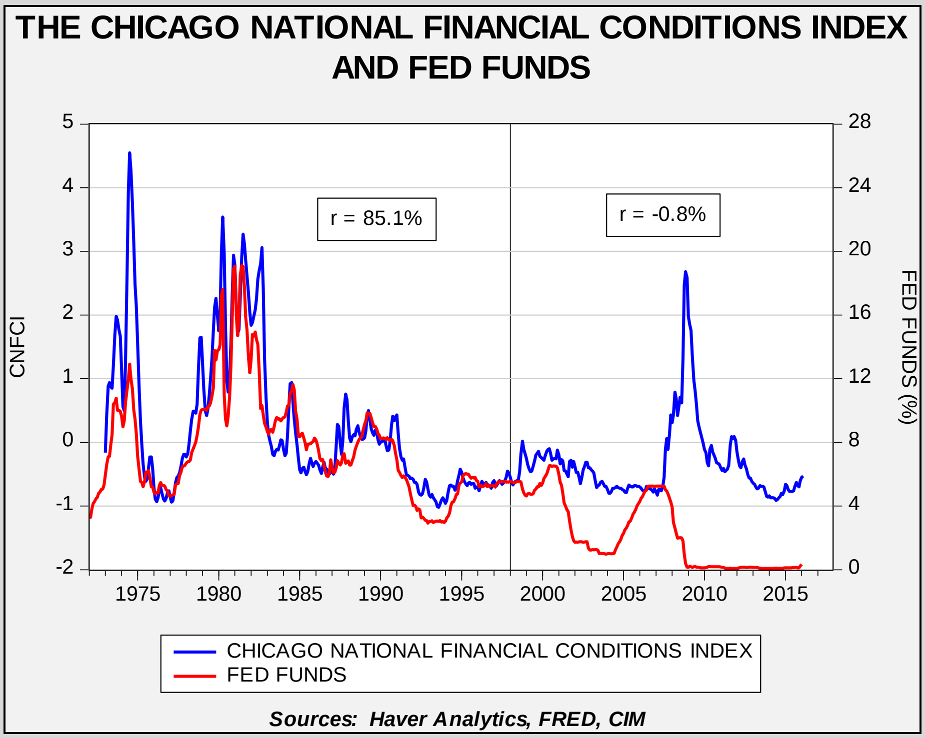
The 6-10 and 8-14 day forecasts indicate warmer and wetter than normal weather for the majority of the country.

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,[2] 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%.

[2] 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.

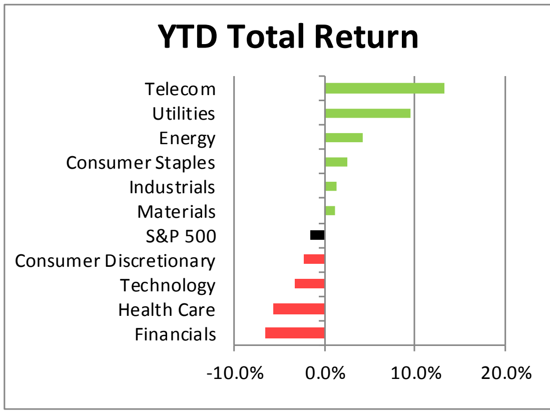
However, we fear that the authors have identified a difference without a real distinction. It is true that strictly holding to time-dependent policies can put policymakers into a difficult position. If they promise to engage in a policy stance that becomes difficult to maintain, they must either keep 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.

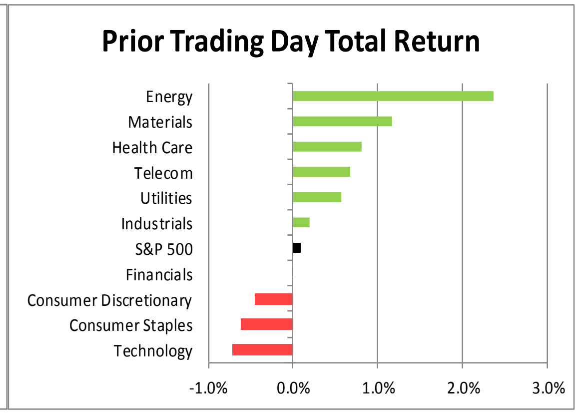
In our opinion, we have a rather simple choice. We can either have an opaque central bank with higher levels of financial stress but less vulnerability to excessive leverage and crises, or a transparent central bank where markets are stable for long periods of time, punctuated by occasional, but more 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.

Data Section

U.S. Equity Markets – (as of 3/7/2016 close)

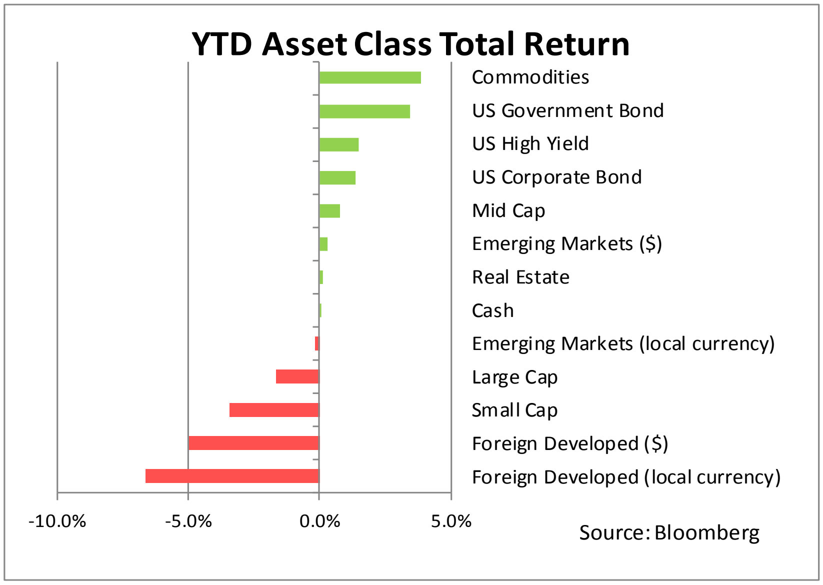




(Source: Bloomberg)

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 3/7/2016 close)

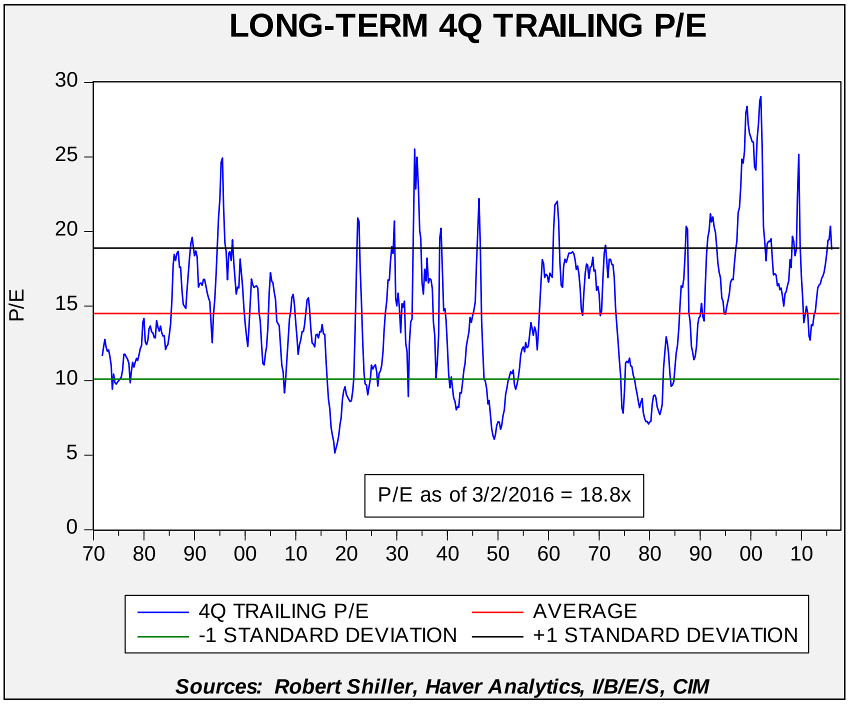


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

[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 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.