Confluence INVESTMENT MANAGEMENT

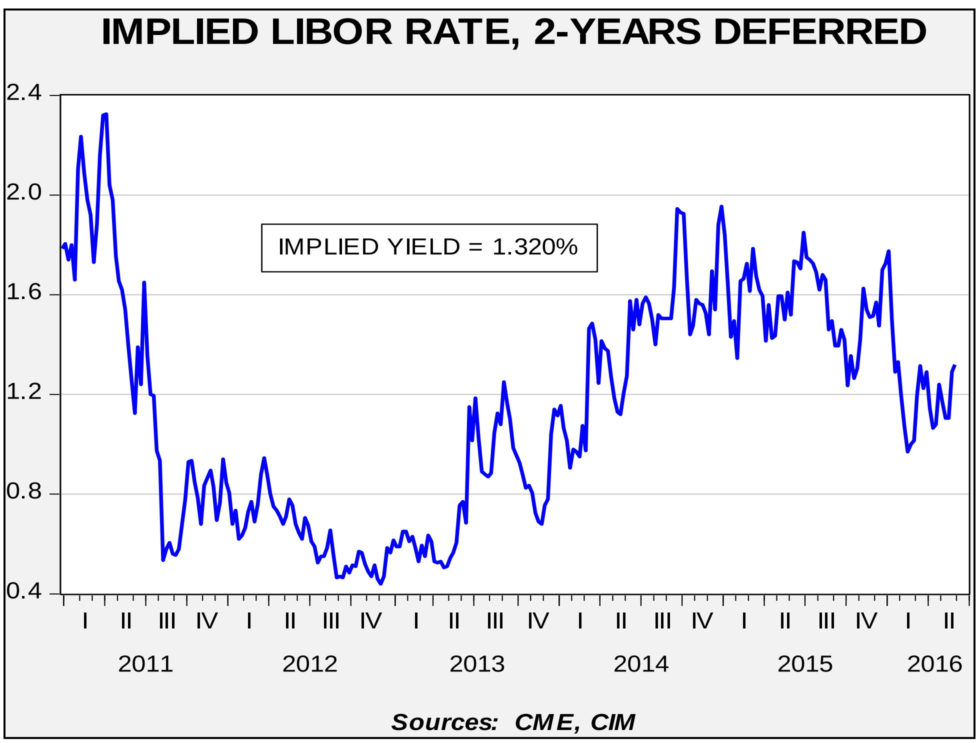
# Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

**[Posted: May 24, 2016—9:30 AM EDT]** Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 1.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.6% from the prior close. Chinese markets are also lower, with the Shanghai composite trading down 0.8% and the Shenzhen index lower by 0.9%. U.S. equity futures are signaling a higher opening from the previous close. With 95.6% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.76, more than the $26.66 forecast. Of the 478 companies that have reported, 72.2% had positive earnings surprises, while 20.3% had negative earnings surprises.

It's another quiet morning in front of Chair Yellen's speech on Friday. Yesterday, Dallas FRB President Harker added to voices calling for a rate hike this summer. Fed funds futures are putting the odds of a June hike at about 32%, but the odds are over 50% for July.

One of the comments we hear frequently is, "how can a mere 25 bps rate hike matter all that much?" By itself, the small rate hike really doesn't matter. The greater issue is the projection of future policy.



This chart shows the implied three-month LIBOR rate from the Eurodollar futures market. It is a reasonably good gauge of market expectations toward future short-term interest rates. Note how the implied rate was running around 40 bps when then-Fed Chair Bernanke began to talk about "tapering" the pace of the Fed's balance sheet expansion in Q2 2013. This decision marked, in our opinion, the beginning of the FOMC's tightening cycle. Implied rates rose nearly 160 bps. A 200 bps reading on three-month LIBOR is consistent with a fed funds target of 175 bps. As the FOMC raised the policy rate to a range of 25-50 bps last December, the implied LIBOR rate jumped about 50 bps. It is interesting now that, even with rate hike expectations rising, the implied LIBOR rate has not increased by a lot. The current reading discounts a fed funds target of roughly 100 bps two years from now.

If the implied LIBOR rate remains low, it would suggest that the market doesn't expect the Fed to raise rates very much and thus, the financial market impact from a summer rate hike probably won't be as bearish of an event as we saw in Q1. Of course, the tenor of the Eurodollar market could change over time. Nevertheless, based on what we know right now, the effect of a summer tightening probably won't be all that extreme. We will continue to closely monitor the deferred Eurodollar futures for clues about market expectations toward monetary policy.

The GBP is higher this morning after recent polls in the U.K. showed that the vote in favor of remaining in the EU holds a 13-point lead over those who support leaving. We generally expect the U.K. to remain in the EU. The economic benefits are high. However, one issue we are watching closely has to do with the reliability of polling. It is quite possible that voters polled may be lying about saying they will vote to remain. Why? Because establishment opinion clearly supports the campaign to stay and is painting those who want to leave as economically illiterate xenophobes. Admitting to a pollster that one is such a person might be hard. If the actual vote turns out to be much closer than these polls signal, it will offer us some insight into U.S. polling. More specifically, it may be difficult for voters to admit they support Donald Trump and thus polls may be underestimating his popularity. If the Brexit polling turns out to overestimate the support for remaining in the EU, then it may also be a harbinger of similar circumstances for Donald Trump.

The *WSJ* grabbed a major scoop yesterday when it ran a story suggesting that the Xi government is only giving lip service to the idea that financial markets are allowed to set exchange rates, and that stability is the primary goal of the regime, not clearing markets. According to the report, in early January, the PBOC jettisoned the market-based mechanism; this change was unannounced. Instead, the central bank now adjusts the CNY's daily value based on directives from Beijing. There is an old adage in economics that fixing one price forces other markets to experience higher volatility. Fixing the exchange rate gives the illusion of stability that should ease the incentive for capital flight. On the other hand, it makes China's export sector more vulnerable to Fed tightening; if the dollar rallies, the CNY will appreciate as well. It will also slow the drive to make the CNY a widely used reserve currency as history shows that fixed exchange rates eventually become unpegged, and the shifts tend to be violent when they lose their anchor. ***The fact that the* WSJ *nabbed this report is, in itself, an interesting part of the story too. It suggests the Xi government wants to signal to the world that it is re-pegging its currency and wants this information to be distributed by an unimpeachable source.***

## U.S. Economic Releases

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

| Economic releases | | | | | | |
|---|---|---|---|---|---|---|
| EST | Indicator | | | Expected | Prior | Rating |
| 10:00 | Richmond Fed manufacturing index | m/m | May | 8.0 | 14.0 | * |
| 10:00 | New home sales | m/m | Apr | 523k | 511k | * |

## 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 | Consumer sentiment (Westpac-MNI) | m/m | May | 114.2 | 117.8 | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Eurozone | ZEW survey of expectations | m/m | May | 16.8 | 21.5 | | * | Equity bearish, bond bullish |
| France | Business confidence | m/m | May | 102.0 | 101.0 | 101.0 | * | Equity bullish, bond bearish |
| | Manufacturing confidence | m/m | May | 104.0 | 105.0 | 104.0 | * | Equity and bond neutral |
| | Production outlook | m/m | May | 6.0 | -1.0 | | * | Equity bullish, bond bearish |
| Germany | GDP | y/y | Q1 | 1.3% | 1.3% | 1.3% | *** | Equity and bond neutral |
| | ZEW survey of expectations | m/m | May | 6.4 | 11.2 | 12.0 | * | Equity bearish, bond bullish |
| | ZEW survey of current situation | m/m | May | 53.1 | 47.7 | 49.0 | * | Equity bullish, bond bearish |
| Switzerland | Trade balance (CHF) | m/m | Apr | 2.5 bn | 2.2 bn | | ** | Equity bullish, bond bearish |
| | Exports (real) | m/m | Apr | 0.3% | -0.5% | | ** | Equity bullish, bond bearish |
| | Imports (real) | m/m | Apr | -3.1% | 8.6% | | ** | 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)** | 66 | 65 | 1 | Up |
| **3-mo T-bill yield (bps)** | 33 | 34 | -1 | Down |
| **TED spread (bps)** | 33 | 31 | 2 | Up |
| **U.S. Libor/OIS spread (bps)** | 46 | 45 | 1 | Up |
| **10-yr T-note (%)** | 1.84 | 1.84 | 0.00 | Neutral |
| **Euribor/OIS spread (bps)** | -26 | -26 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 28 | 27 | 1 | Up |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Falling |
| euro | down | | | Rising |
| yen | down | | | Rising |
| franc | down | | | Rising |

## 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 | $ 48.56 | $ 48.35 | 0.43% | Expectations of falling domestic inventories |
| WTI | $ 48.40 | $ 48.08 | 0.67% | |
| Natural gas | $ 2.08 | $ 2.06 | 1.31% | |
| Crack spread | $ 18.93 | $ 18.83 | 0.52% | |
| 12-mo strip crack | $ 14.74 | $ 14.74 | 0.03% | |
| Ethanol rack | $ 1.75 | $ 1.75 | 0.08% | |
| **Metals** | | | | |
| Gold | $ 1,238.89 | $ 1,249.13 | -0.82% | Fed outlook |
| Silver | $ 16.30 | $ 16.38 | -0.51% | |
| Copper contract | $ 207.45 | $ 205.50 | 0.95% | Expectations of supply constriction |
| **Grains** | | | | |
| Corn contract | $ 395.00 | $ 397.75 | -0.69% | |
| Wheat contract | $ 459.00 | $ 462.00 | -0.65% | |
| Soybeans contract | $ 1,045.25 | $ 1,058.50 | -1.25% | Profit taking |
| **Shipping** | | | | |
| Baltic Dry Freight | 624 | 625 | -1 | |
| **DOE inventory report expectations of weekly change** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -1.4 | | |
| Gasoline (mb) | | -1.6 | | |
| Distillates (mb) | | -1.1 | | |
| Refinery run rates (%) | | 0.6% | | |

## Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the eastern two-thirds of the country. Precipitation is forecast 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.*

May 20, 2016

As promised, this week we will discuss how President Trump's policies would likely affect the financial markets. It should be noted that Mr. Trump has not published any clear policy papers, so our descriptions are based on his public comments. Next week, we will discuss the expected policies and financial market effects from President Clinton.

Trump is a right-wing populist. This means we would expect him to support the following list of policies:

**Immigration:** Immigration is perhaps the most ancestrally common experience of most Americans. The acceptance of people from other places makes the U.S. unique. In the U.S., if you pass the citizenship exam and take the oath, you are an American. However, in most European nations, becoming a citizen does not make one "French" or "Italian." Despite this commonality of experience, immigrants have not always been welcomed. The "Know-Nothings" in the 1850s opposed the influx of Irish and German Catholics to America, fearing they would undermine American values. Often, lower skilled workers face competition from immigrants which drives down wages in certain parts of the job market. Compounding the problem is that approximately 10 to 12 million foreigners are in the U.S. illegally, signaling a lack of border control. The political establishment tends to turn a "blind eye" to illegal immigration; for the right-wing establishment, this form of immigration provides a steady supply of low wage workers. For the left-wing establishment, a "path to citizenship" would be expected to create new left-wing voters. Trump has appealed to right-wing populists who likely face, or perceive that they face, wage competition from illegal immigration. Thus, Mr. Trump's "build the wall" message raises the hopes of lower income workers that wages could rise.

**Defense:** Although Mr. Trump has campaigned on making a strong military, his positions are actually more nuanced than they first appear. Specifically, he has adopted positions similar to Sen. McCain (R-AZ) on many spending programs, which is to hold a skeptical eye toward spending programs. For example, Trump appears to oppose the F-35 and suggests that spending more on existing platforms makes better sense because of the inadequacies of the newer aircraft. This will infuriate the establishment on both wings who tend to support newer systems that bring money to their states and districts. Trump has promised to let the military choose what weapons it wants and threatens the infamous "military-industrial complex."

**Foreign Policy:** As noted last week, Trump is a classic Jacksonian based on the Meade archetypes. This characterization means he will run an isolationist foreign policy, although he will tend to overreact to perceived slights. In other words, he may allow Iraq to crumble and not oppose Japanese remilitarization. He has made it abundantly clear that he won't act as the "world's policeman." On the other hand, we would expect him to react strongly to Russian "buzzing" of U.S. Navy vessels or hostage-taking by terrorist groups. Postwar treaty organizations, like NATO, or other bodies like the U.N., will probably be ignored or allowed to deteriorate.

**Trade Policy:** Trump sees himself as a deal maker. He wants to renegotiate existing agreements and get better deals on pending ones. He has strongly opposed outsourcing and has threatened trade retaliation against China.

**Fiscal Policy:** Trump promises to maintain middle class entitlements, namely, Social Security and Medicare. He has promised to replace Obamacare but the details on its replacement are not clear. His tax policy would lead to significantly higher deficits, even when using "dynamic scoring," which accounts for the revenue impact of higher economic growth. His comments on Treasury debt have been interesting—he has suggested that Treasury debt could be restructured, but reversed himself when he apparently discovered that restructuring would not be necessary since the U.S. prints the money required to service the debt. Although it is difficult to determine with certainty, Trump could prove to be more amenable to heterodox economic policies, e.g., "helicopter money," if a recession were to develop. In any case, there is nothing to suggest that Trump is a deficit hawk.

The market impact of a Trump presidency could be significant; at the same time, it is always important to remember that the structure of the American government tends to restrain aggressive policy changes. Rahm Emanuel's famous quote of "you never let a serious crisis go to waste" reflects the structure of American government in that major changes usually only occur when conditions are bad enough to force the change. Newly elected, first-term presidents are at the peak of their political capital early in their terms; we expect President Trump's first priority will be immigration. Beyond that, he may find some support for his anti-trade policies and Congress can't force the president to intervene abroad.

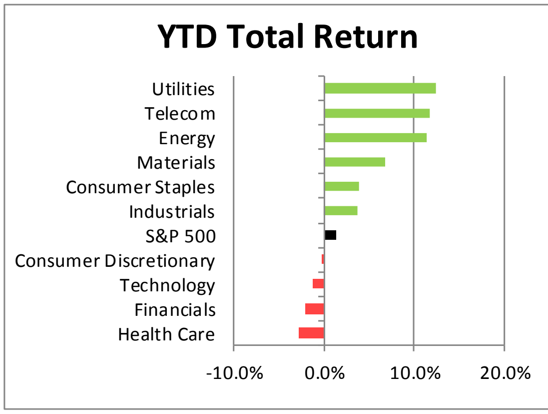
There are two key changes that we see from a Trump presidency. Domestically, Trump's policies are essentially reflationist. His opposition to globalization by interfering with trade and immigration will likely make the economy less efficient and lift price levels. For Trump's constituents, it's a mixed bag. Although higher prices will undermine their buying power, the likelihood of them getting jobs, at least at first, will rise. Eventually, those jobs may face automation pressures, but that will take some time. For the establishment, the outcome is unequivocally negative; rising inflation will raise interest rates, narrow profit margins and compress price/earnings multiples.

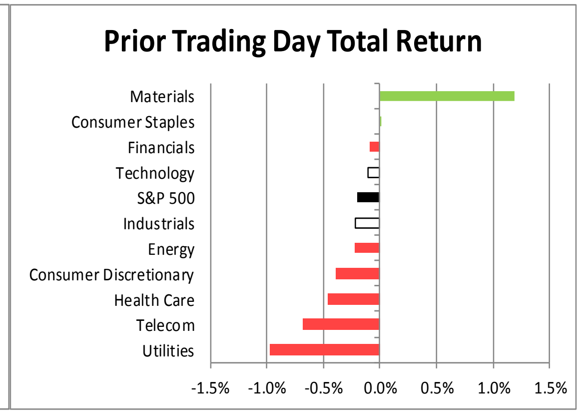
The second major change from a Trump presidency is the end of *Pax Americana*. As noted above, Trump has made it clear that he wants to end the U.S. role of world policeman. Without American leadership, the world will devolve into regional power centers with competing hegemonic powers; in other words, China will square off against Japan and India, Russia and Germany could be at odds again and Saudi Arabia and Turkey could line up against Iran. These policies will certainly lead to deglobalization and cut global supply chains, leading to less efficiency and exacerbating the already inflationist tendencies of Trump's immigration and trade policies.

In our asset allocation views, we have consistently held that inflation would remain low; we have tended to favor longer duration in fixed income and generally supported equities. A Trump presidency would likely be a harbinger of inflation which would lead us to adjust these positions. Rising inflation coupled with deregulated financial markets will almost certainly lead to higher long-term interest rates. Equity markets will face pressures as well. On the other hand, commodity prices will tend to rally if real interest rates turn negative. The impact on the dollar is more mixed. We really have no historical instance where the primary reserve currency is running protectionist trade policies. Because there is built-in demand for the reserve currency and protectionism blocks the traditional path for other countries to acquire the reserve currency, the dollar would become scarce. Paradoxically, Trump's policies could lead to a significantly stronger dollar as other nations take steps to reduce costs and the prices of their exports to offset tariffs and other trade barriers. Although it would seem that Trump's policies would spell the end of the dollar's reign as the primary reserve currency, there is no obvious replacement to the dollar. In addition, we would expect the Federal Reserve, assuming it remains independent, to raise rates to contain rising price levels, giving a further boost to the dollar. Although Congress will act as a restraint on Trump, as the current president has shown, some of these constraints can be evaded through regulatory policy and executive orders. ***Bottom line: a Trump presidency will likely bring higher inflation, reversing 36 years of disinflationary policies***.

## Data Section

**U.S. Equity Markets** – (as of 5/23/2016 close)

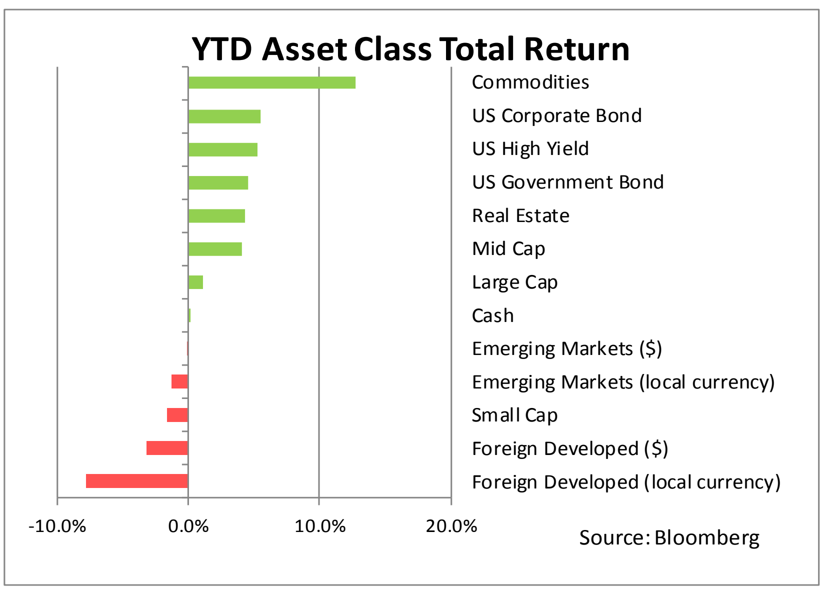



(Source: Bloomberg)

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 5/23/2016 close)

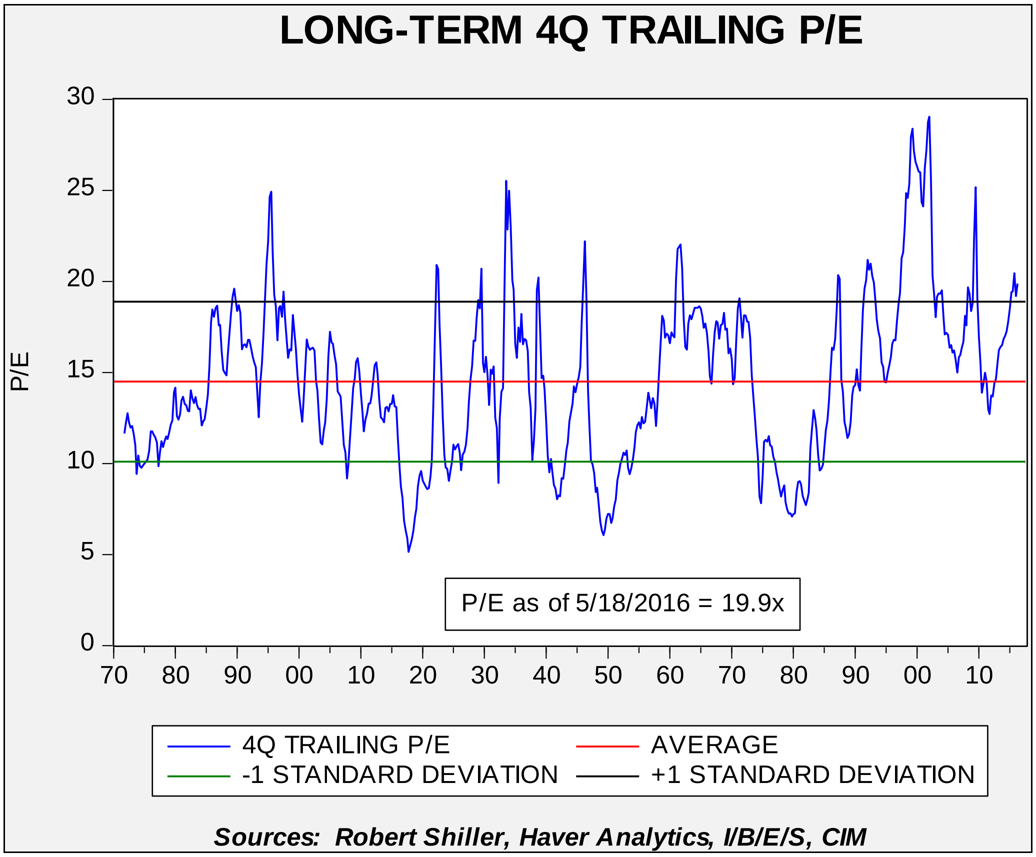



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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**

May 19, 2016




Based on our methodology,[1] the current P/E is 19.9x, down 0.1x from last week. The P/E eased due to a rise in earnings.

*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.*

[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 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 (Q3 and Q4) and two estimates (Q1 and Q2). 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.