Confluence Investment Management

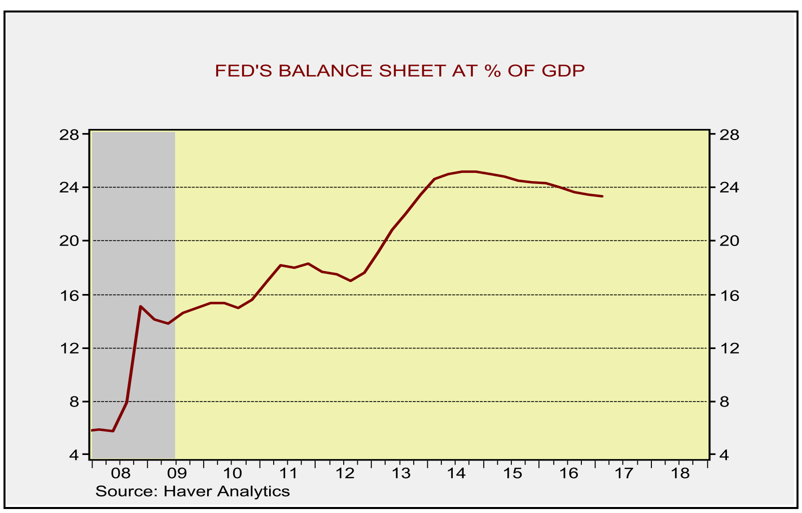
# Daily Comment

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

**[Posted: May 25, 2017—9:30 AM EDT]** Global equity markets are generally higher this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.0% from the prior close. Chinese markets were up, with the Shanghai composite up 1.4% and the Shenzhen index up 0.7%. U.S. equity index futures are signaling a higher open. With 482 companies having reported, the S&P 500 Q1 earnings stand at $30.79, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 73.4% of the companies reported earnings above forecast, while 20.3% reported earnings below forecast.

The FOMC minutes held no surprises—barring a sudden downturn in the data, the next rate hike will come on June 14. Dallas FRB President Kaplan gave a speech in Toronto yesterday and indicated that he expects two more rate hikes this year; thus, if they do move next month, as expected, there would only be one more hike this year. As we have noted in the past, the key issue for policymakers is the correct measure of economic slack. If it's the unemployment rate, the Fed needs to raise rates into the 4% range to achieve neutrality. If it's the employment/population ratio or wage growth for non-supervisory workers, then the fed funds target is near neutral now.

In terms of the expected balance sheet reduction, the FOMC is considering a plan that would set limits on the amount of bonds that would be allowed to "roll off" each month. If there were more bonds that reached maturity than the limit, those would be reinvested. Over time, the limits would be raised to allow for more bonds to roll off. This appears to be a very gradual approach likely designed to reduce potential market volatility. We expect more details to emerge as we approach year's end.

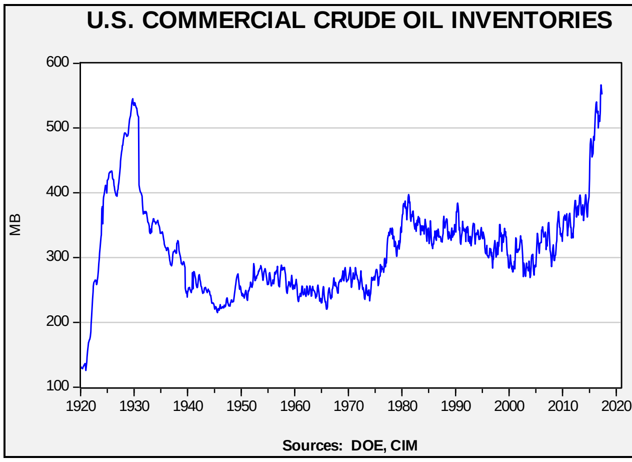


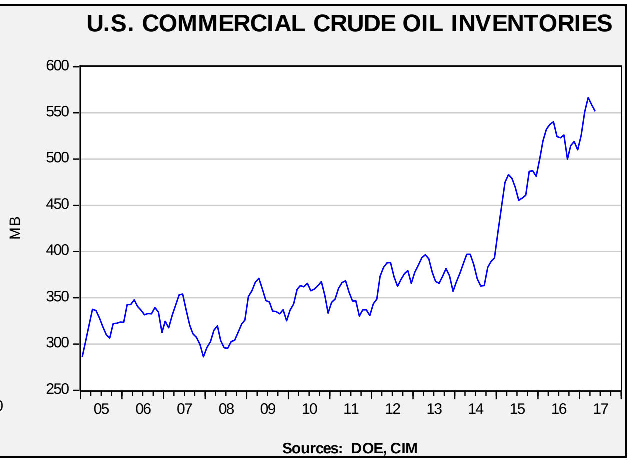
Although we don't have any details yet, we are assuming that the Fed is probably going to target a balance sheet roughly around 10% to 12% of GDP. We expect that, at most, the Fed would reduce the balance sheet by about $50 bn per month; with 4% nominal GDP growth (growth has been around 3.7% since 2011), the balance sheet will stabilize around 2021 at around $3.6 trillion.

U.K. PM May is reportedly "furious" at information leaked to the U.S. press about the recent terrorist bombing in Manchester. The *NYT* published pictures of evidence that seem to show a well-crafted bomb. The bomb suggests a broader conspiracy; so far, seven people have been detained, including the bomber's brother and father. According to reports, May intends to confront President Trump on the leaks and then return to Britain, returning early from the G-7 meeting. The most recent polls show a widening of the Tories' lead, to 14% from 9% prior to the terrorist event. PM May was Home Secretary under PM Cameron and is considered strong on security.

Oil prices have slumped this morning despite OPEC agreeing to a nine-month extension of its current output agreement. The market narrative is that oil prices are lower on disappointment that new cuts were not announced. We doubt that's the case. This look more like classic "buy rumor, sell fact" market action. Overall, the extension is supportive for oil prices but the recent rally has put oil prices in the middle of our expected range, meaning some price consolidation is plausible.

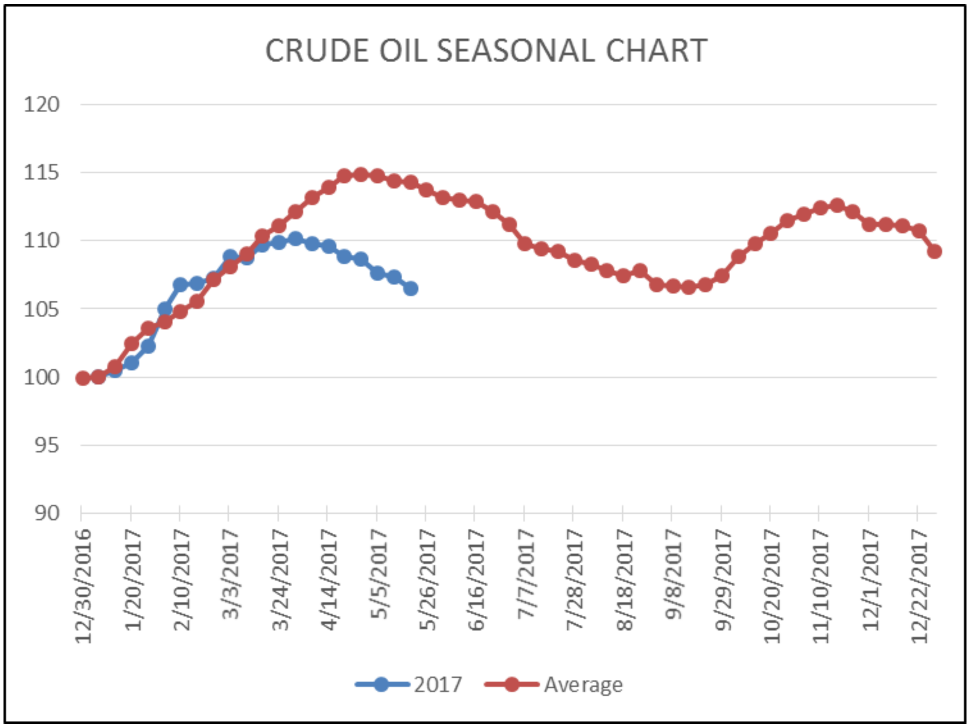
U.S. crude oil inventories fell 4.5 mb compared to market expectations of a 2.0 mb draw.



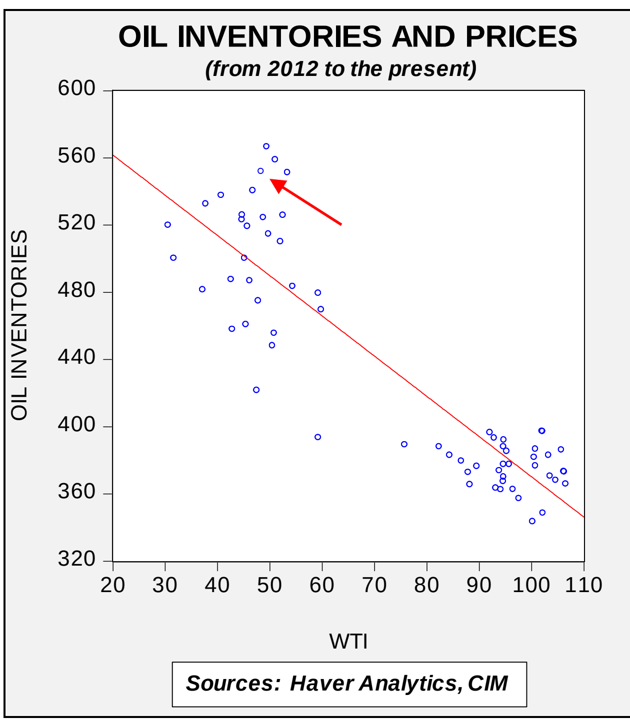



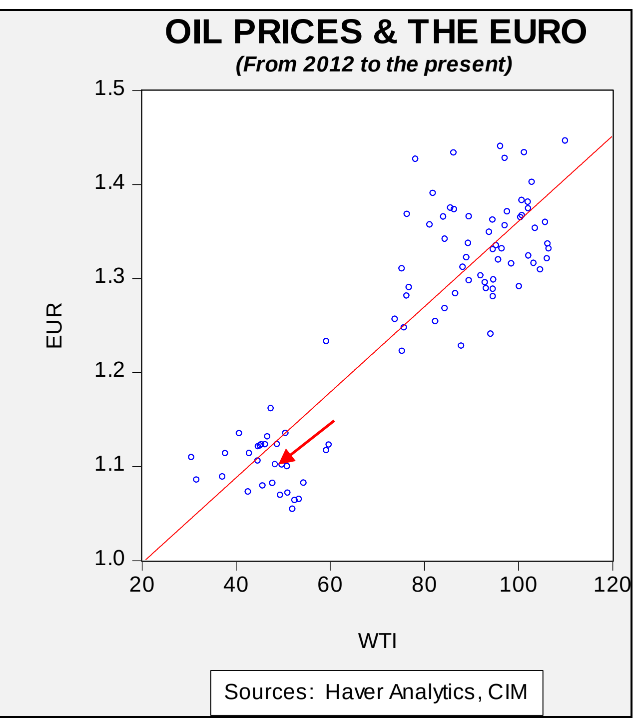

This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but they are declining. We also note that, as part of an Obama era agreement, there was a 0.4 mb sale of oil out of the Strategic Petroleum Reserve. This is part of a $375.4 mm sale (or 8.0 mb) done, in part, to pay for modernization of the SPR facilities. International agreements require that OECD nations hold 90 days of imports in storage. Due to falling imports, the current coverage is near 140 days. Taking that into account, the draw would have been 4.9 mb, which is well below expectations.

As the seasonal chart below shows, inventories are usually just starting their seasonal withdrawal period. This year, that process began early. Although the actual level of stockpiles remains quite high, we are seeing stock declines at a rather rapid pace. Assuming a similar drop from this year's peak of 566.5 mb at the end of March, we will end up at 510 mb by late September.




(Source: DOE, CIM)

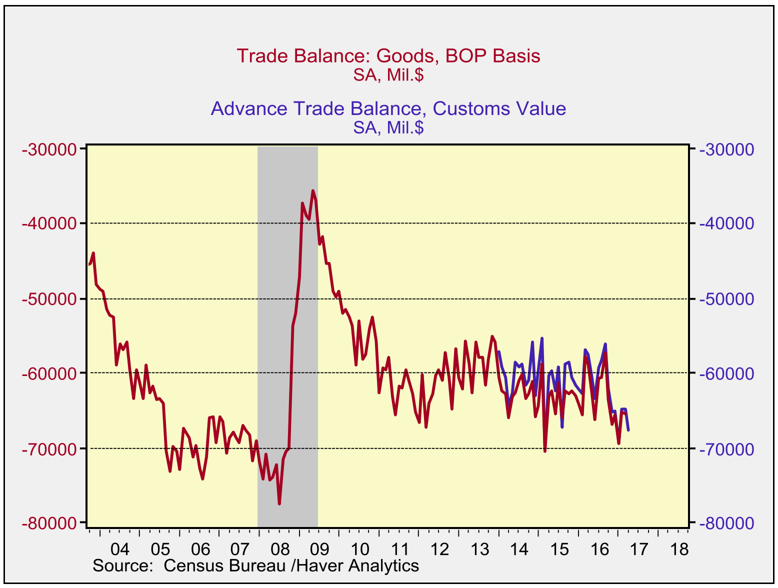


Based on inventories alone, oil prices are overvalued with the fair value price of $34.32. Meanwhile, the EUR/WTI model generates a fair value of $48.17. Together (which is a more sound methodology), fair value is $43.87, meaning that current prices are above fair value but the deviation has been steadily closing in recent weeks. We note that OPEC looks like it will keep production cuts in place into next year, which probably keeps oil in a range of $55 to $45, basis WTI.

**U.S. Economic Releases**

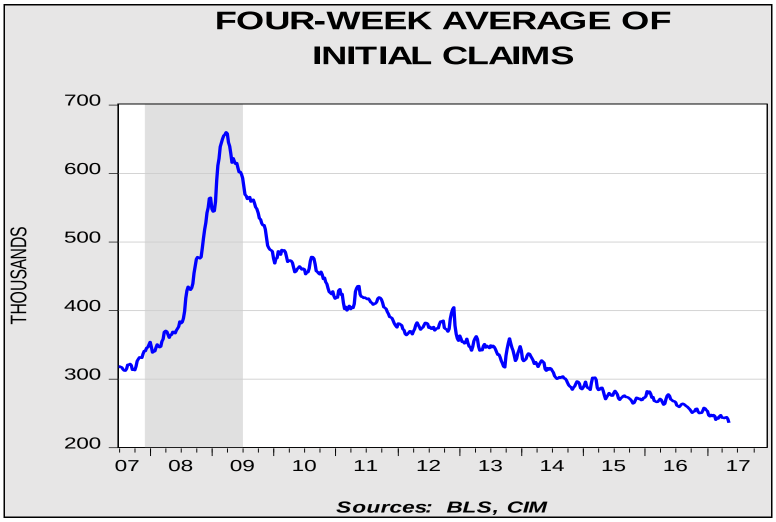
The advance goods trade deficit came in above expectations at $67.6 bn compared to the forecast of $64.5 bn. The prior report's deficit was revised upward from 64.8 bn to 65.1 bn.




The chart above shows the level of the trade balance for goods and the advance trade balance. Over the past three years, the trade deficit has been volatile but has generally moved sideways.

Wholesale inventories came in below expectations at -0.3% compared to the forecast of 0.2%. The prior report's gain was revised downward from 0.2% to 0.1%. Real inventories fell by 0.3%. The report's gain was revised downward from 0.4% to 0.3%.

Initial jobless claims came in below expectations at 232k compared to the forecast of 238k.




The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 241k to 235.25k.

The table below shows the economic releases and Fed events scheduled for the rest of the day.

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| **EDT** | **Indicator** | | | **Expected** | **Prior** | **Rating** |
| **9:45** | Bloomber Consumer Comfort | m/m | may | | 50.2 | ** |
| **11:00** | Kansas City Fed Manf. Activity | m/m | may | 10 | 7 | ** |
| **Fed speakers or events** | | | | | | |
| **EST** | **Speaker or event** | **District or position** | | | | |
| **10:00** | Lael Brainard Speaks on Role of Inclusion in Economy | Member of the Board of Governors | | | | |
| **22:00** | James Bullard Speaks in Washington | President of the Federal Reserve Bank of St. Louis | | | | |

## 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 | Swift Global Payments | y/y | apr | 1.6% | 1.8% | | ** | Equity and bond neutral |
| Japan | Japan Buying Foreign Bonds | y/y | apr | 0.7785 tn | 1.8212 tn | | ** | Equity and bond neutral |
| | Japan Buying Foreign Stocks | m/m | mar | -.0261 tn | 0.2734 tn | | ** | Equity and bond neutral |
| | Foreign Buying Japan Bonds | m/m | mar | 0.5631 tn | 0.3954 tn | | ** | Equity and bond neutral |
| | Foreign Buying Japan Stocks | m/m | apr | -.0264 tn | 0.3722 tn | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Italy | Industrial Orders | y/y | mar | 9.2% | 7.8% | | ** | Equity and bond neutral |
| | Industrial Sales | y/y | mar | 7.2% | 4.6% | | ** | Equity and bond neutral |
| France | Total Jobseekers | m/m | apr | 3.4718 mn | 3.5081 mn | 3.4680 mn | ** | Equity and bond neutral |
| UK | BBA Loans for House Purchase | m/m | apr | 40750 | 41061 | 40800 | ** | Equity and bond neutral |
| | GDP | y/y | 1q | 2.0% | 2.1% | 2.1% | ** | Equity and bond neutral |
| | Index Services | m/m | mar | 0.2% | 0.2% | 0.0% | ** | Equity and bond neutral |
| | Total Business Investment | y/y | 1q | 0.8% | -0.9% | | ** | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Brazil | Federal Debt Total | m/m | apr | 3.245 tn | 3.234 bn | | ** | 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)** | 119 | 119 | 0 | Up |
| **3-mo T-bill yield (bps)** | 91 | 91 | 0 | Neutral |
| **TED spread (bps)** | 28 | 28 | 0 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 108 | 106 | 2 | Up |
| **10-yr T-note (%)** | 2.25 | 2.25 | 0.00 | Neutral |
| **Euribor/OIS spread (bps)** | -33 | -33 | 0 | Down |
| **EUR/USD 3-mo swap (bps)** | 33 | 33 | 0 | Up |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Neutral |
| euro | down | | | Down |
| yen | down | | | Down |
| pound | down | | | Neutral |
| franc | down | | | Neutral |
| **Central Bank Action** | **Current** | **Prior** | | |
| Bank of Canada Rate Decision | 0.500% | 0.500% | 0.500% | On forecast |

## 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 | $53.37 | $53.96 | -1.09% | Long Liquidation Post-OPEC |
| WTI | $50.71 | $51.36 | -1.27% | |
| Natural Gas | $3.21 | $3.21 | 0.03% | |
| Crack Spread | $17.48 | $17.32 | 0.87% | |
| 12-mo strip crack | $15.35 | $15.24 | 0.68% | |
| Ethanol rack | $1.61 | $1.61 | 0.19% | |
| **Metals** | | | | |
| Gold | $1,257.86 | $1,258.73 | -0.07% | |
| Silver | $17.20 | $17.23 | -0.21% | |
| Copper contract | $258.05 | $258.35 | -0.12% | |
| **Grains** | | | | |
| Corn contract | $ 372.75 | $ 371.25 | 0.40% | |
| Wheat contract | $ 434.00 | $ 432.50 | 0.35% | |
| Soybeans contract | $ 950.25 | $ 948.25 | 0.21% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 934 | 949 | -15 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | -4.4 | -2.0 | -2.4 | |
| Gasoline (mb) | -0.8 | -0.8 | 0.0 | |
| Distillates (mb) | -0.5 | -1.0 | 0.5 | |
| Refinery run rates (%) | -0.10% | 0.00% | -0.1% | |
| Natural gas (bcf) | | 72.0 | | |

## Weather

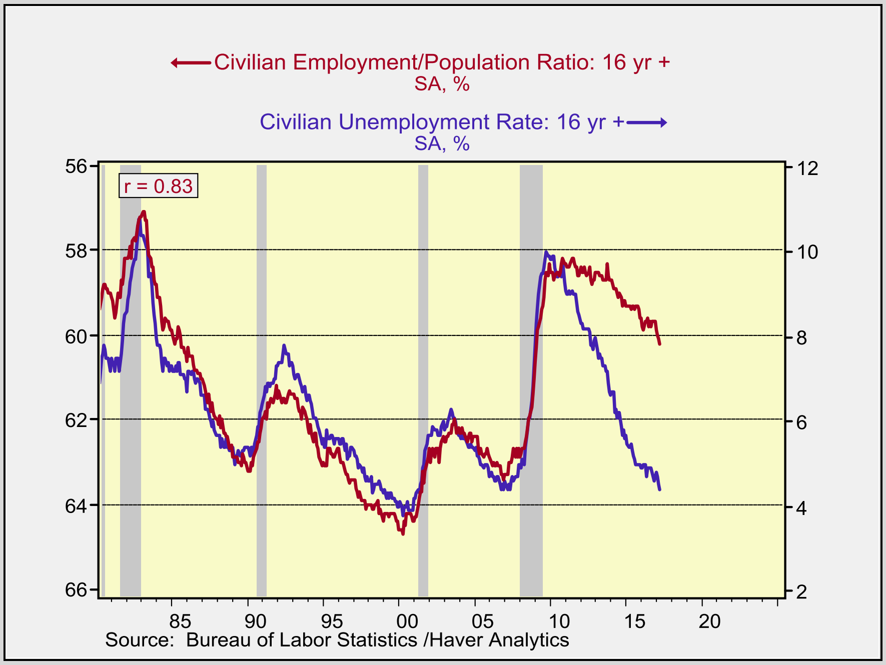
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the central region. Precipitation is expected for most of the country.

**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.*

May 19, 2017

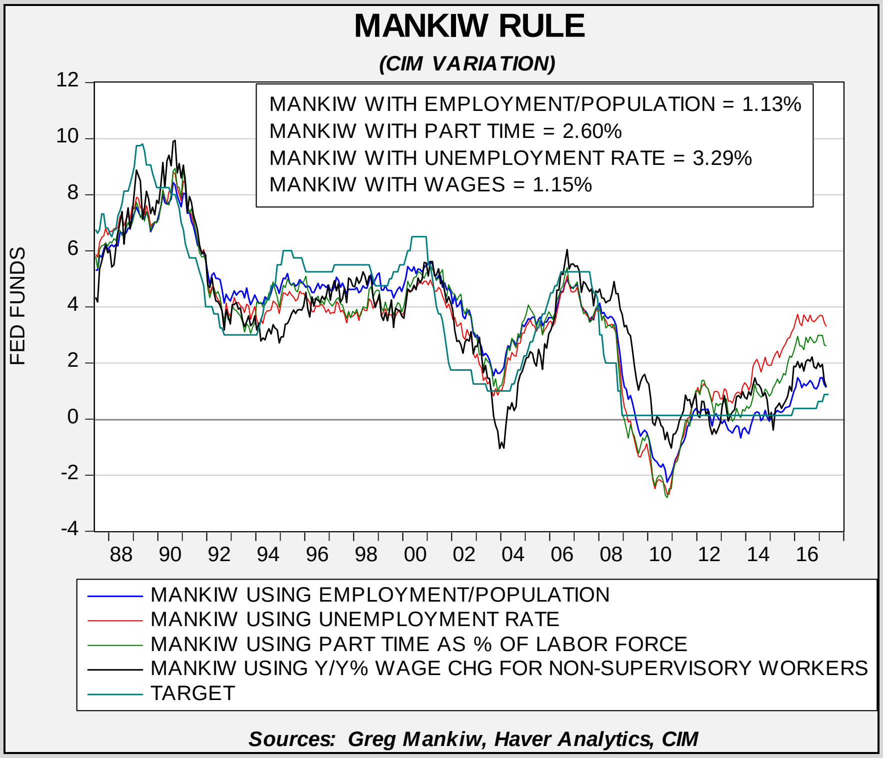
One of the significant "known/unknowns" is the true condition of the labor market. The below chart highlights the issue.




The blue line is the unemployment rate, while the red line is the employment/population ratio (scale inverted). From 1980 until 2010, these two series closely tracked each other. During the period since the last recession, the two have clearly diverged. The current unemployment rate is 4.4%; if the relationship from 1980 to 2010 had held constant, the unemployment rate would be approximately 7.5%.

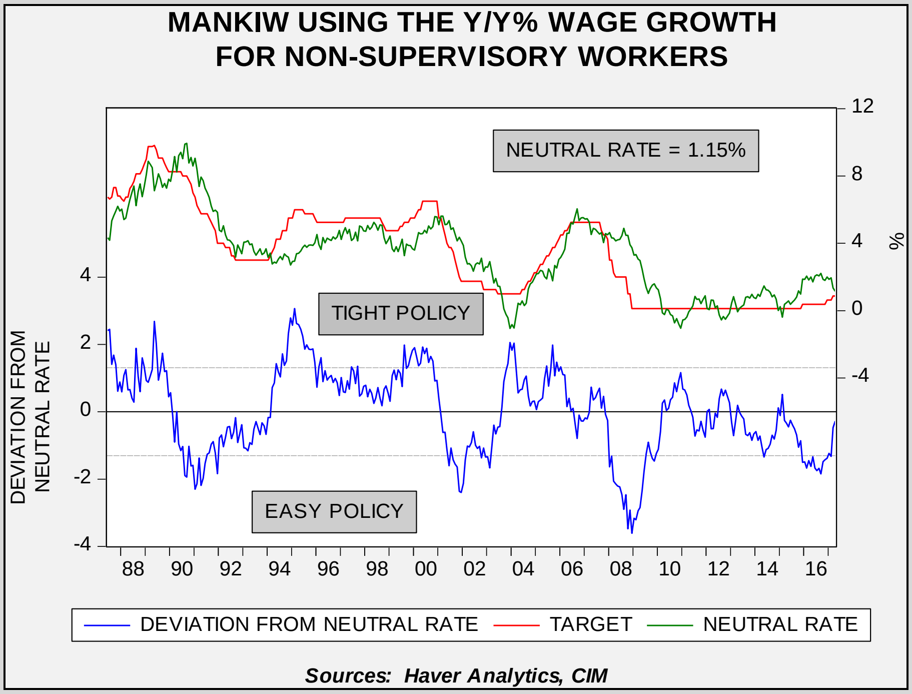
For policymakers, the problem is determining which measure of the labor market best characterizes the degree of slack in the economy. If the employment/population ratio is correct, then ample slack exists and policymakers should keep policy accommodative. If the unemployment rate is the better measure, then labor markets are tight and the FOMC needs to be raising rates.

To determine the degree of accommodation, we use four variations of the Mankiw Rule. The Mankiw Rule models attempt 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 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.




Using the unemployment rate, the neutral rate is now 3.29%. Using the employment/population ratio, the neutral rate is 1.13%. Using involuntary part-time employment, the neutral rate is 2.60%. Using wage growth for non-supervisory workers, the neutral rate is 1.15%. Note that for two of the variations, wage growth and the employment/population ratio, the FOMC is already near the neutral rate. The fact that policymakers appear driven to lift rates further suggests they believe that some other measure is a proper measure of slack.

Since the Great Financial Crisis, it has been unclear which measure of employment accurately characterizes the labor market. Because the Fed had been conducting very easy monetary policy, the debate was mostly academic; that isn't the case anymore. If the most accurate measure is actually the employment/population ratio or wage growth, but the Fed thinks either the unemployment rate or involuntary part-time employment is the correct indicator of slack, then policymakers could run the risk of overtightening and potentially risking a recession.



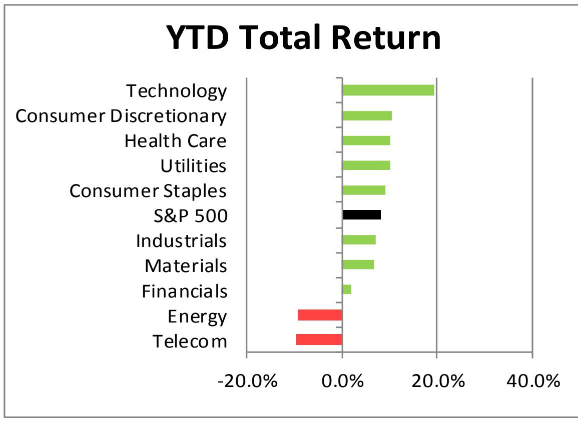

This chart shows the issue; this is the Mankiw model variation using wage growth. The lower line on the chart shows the deviation from the neutral rate as projected by the model. When the rate is below zero, policy is leaning toward accommodative. Note the parallel lines on the lower part of the chart; these lines measure a standard error on either side of the neutral rate. When the deviation is within the parallel lines, it suggests policy is mostly neutral. Thus, based on wage growth, we are close enough to neutral policy that the Fed could stand pat until either wage growth accelerates or core CPI rises.

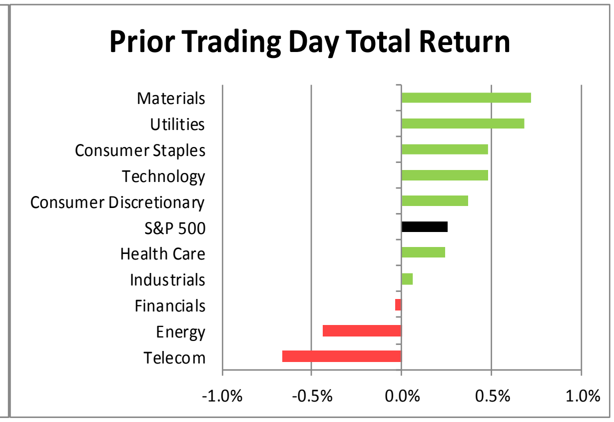
Thus, the coming months will be key. If this model is the most accurate measure of slack then the Fed needs, at most, one more hike. Policy would be tight at a fed funds target of 2.40%, so there is some margin for error. Based on the dots chart, we would be at this level by the end of next year. Simply put, we could be approaching a period where monetary policy shifts to a headwind.

The path of monetary policy has been a key element in the asset allocation committee's analysis of the economy and markets. We are moving into a more critical phase where the potential for a policy error is rising. By year's end, we could have a fed funds rate that would be modestly higher than neutral using at least two of the four variations of the Mankiw Rule model. That would increase the potential for a recession which we would expect to have a negative impact on equity markets. Thus, this is an issue we will be closely monitoring into the second half of 2017.

## Data Section

**U.S. Equity Markets** – (as of 5/24/2017 close)

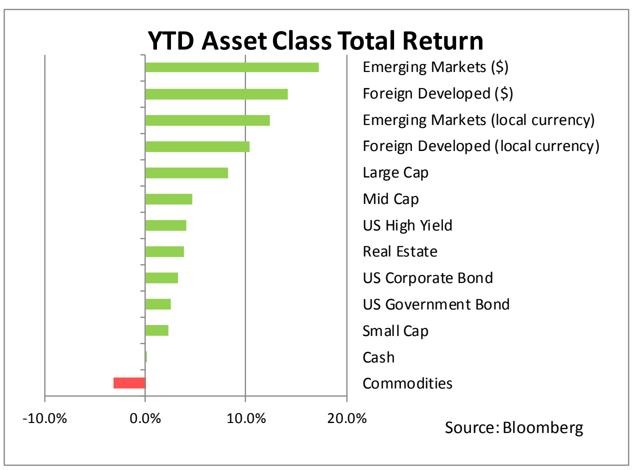



(Source: Bloomberg)

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 5/24/2017 close)

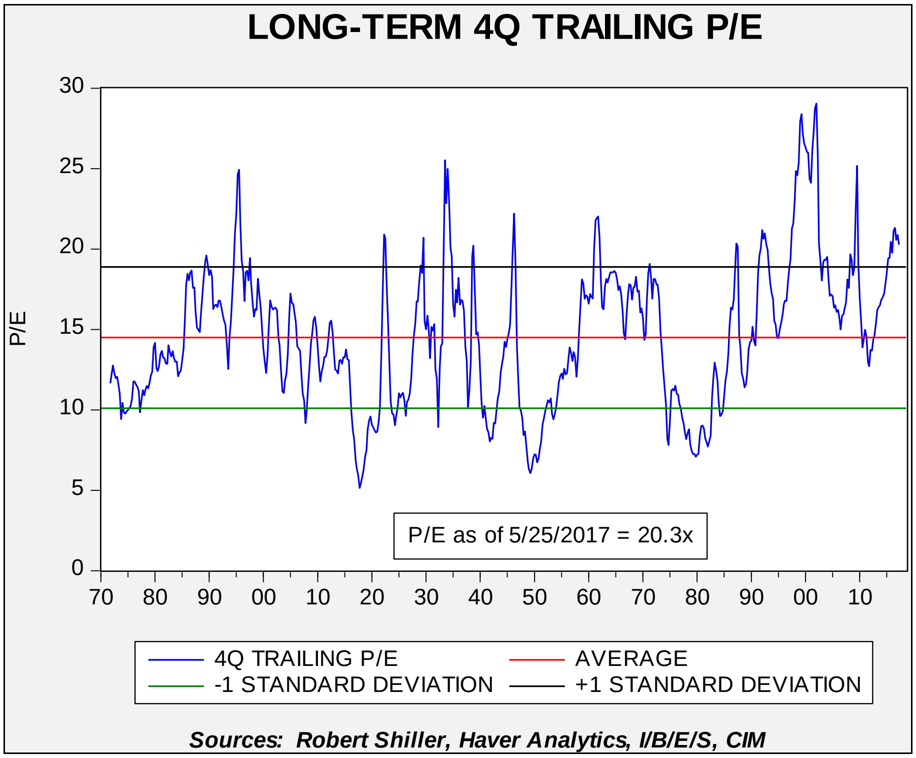



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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**

May 25, 2017




Based on our methodology,[1] the current P/E is 20.3x, up 0.4x from last week. The reason for the rise is that, for Q1, we have moved from I/B/E/S estimates to actual operating earnings from S&P. Operating earnings from the former have been persistently higher than the official data from S&P. The long expanse of our data is from S&P and so, to be consistent, we use it when available. From last year, S&P operating earnings are up 21.2%, a strong recovery.



[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 three actual quarters (Q3, Q4 and Q1) and estimate (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.