Daily Comment

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

[Posted: May 2, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.0% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.4% and the Shenzhen index unchanged. U.S. equity index futures are signaling a lower open. With 303 companies having reported, the S&P 500 Q1 earnings stand at $30.43, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 76.2% of the companies reported earnings above forecast, while 16.5% reported earnings below forecast.

May Day is over and markets have reopened. There wasn't any market-moving news overnight, although there were some interesting items that provide some background for issues that will concern us in the coming months. Here is a roundup:

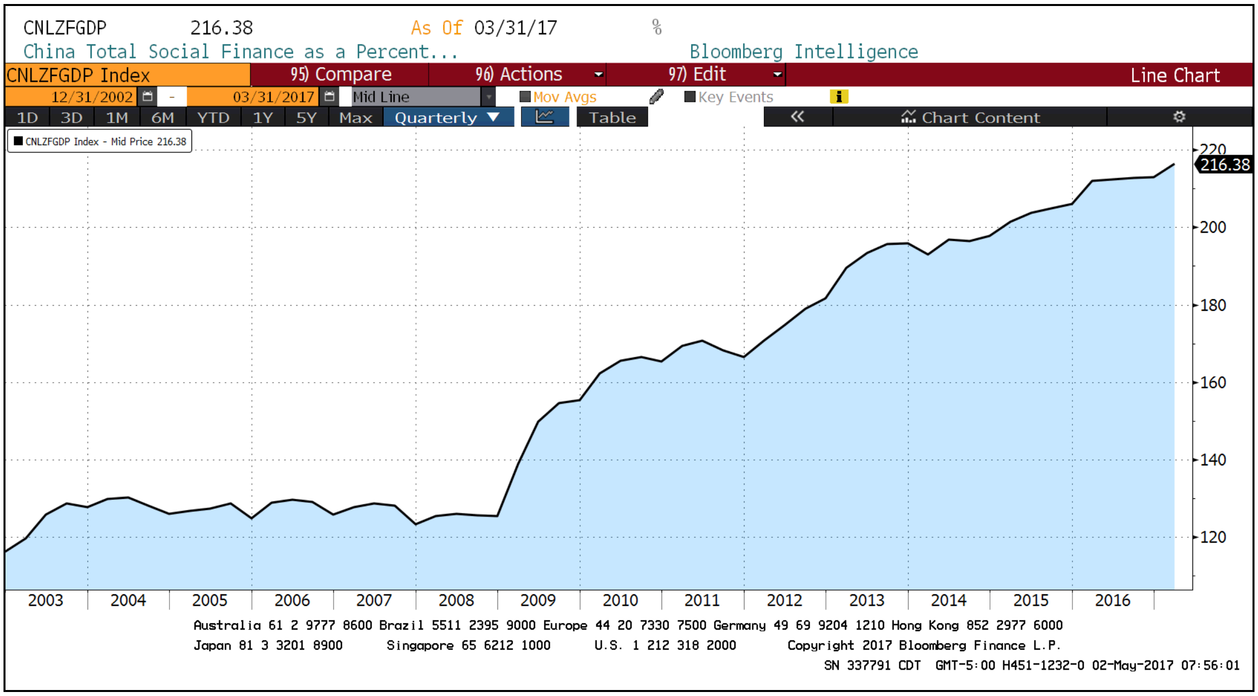
China's credit slowdown: Yesterday, we noted that China was lifting interest rates. The rise in rates is part of a pattern we have seen since the Great Financial Crisis. In this week's WGR, we began a series on trade and introduced the balance identity, which is that the private investment/savings balance (I-S) plus the government balance (G-Tx) equals the trade balance (X-M). The formal equation is as follows:

$$(I\text{-}S) + (G\text{-}Tx) = (M\text{-}X)$$

China's development suppresses consumption. This builds saving which is used to create productive capacity through investment. Much of the saving went to boosting investment but China ran a trade surplus when I<S, as the above identity would suggest. After the Great Financial Crisis, global demand wasn't strong enough to maintain China's policy structure. To compensate, China boosted investment further and increased borrowing to pay for it. We believe China has a serious problem with malinvestment and the cure is to reduce S by boosting consumption. However, that would require a change in the structure of the economy that would harm the currently rich and powerful in China. So, in the short term, China is simply recycling the excess saving at home by boosting capacity and likely creating unnecessary investment.[1] In the longer run, the Asian Infrastructure Investment Bank and the "one belt, one road" expansion plan that Chairman Xi is promoting are likely attempts to create neo-colonial economic conditions in Asia that would allow China's current development model to continue. ***The simple fact is that China can have any growth level it likes as long as it has debt capacity.*** The problem with debt capacity is that it is virtually impossible to determine in advance. In other words, when creditors won't accept your debt at any price, you have achieved debt capacity. On

[1] This article highlights the issue. See: https://www.wsj.com/articles/china-looks-to-export-auto-overcapacity-on-slow-growth-world-1493627132.

occasion, we see Chinese leaders recoil from the rising debt levels and try to curtail borrowing. This leads to slower growth, which is also unacceptable, and thus borrowing resumes.



(Source: Bloomberg)

This chart shows total social financing as a percentage of GDP; this debt is private sector only (household and corporate). It is currently 216.4% of GDP. Although U.S. debt is larger, at 232.5%, the growth rate is far less. Since 2008, private sector debt/GDP is up 72.8% in China, while U.S. private sector debt/GDP has fallen 20.8% over the same time frame. For safety, China should curtail its debt growth; however, it has to be willing to accept slower growth, which is clearly unpopular.

The two Trumps: We have argued that the president has two parts of the GOP coalition he needs to address. The populist faction, represented by Steve Bannon, wants immigration restrictions, trade impediments, job support and regulatory protection. The establishment wing, represented currently by Gary Cohn,[2] wants traditional GOP goals such as open trade and borders, smaller government and less regulation. Clearly, the goals of these two groups are not compatible. The president has been managing these two factions by vacillating policy "balloons" between the two groups. So, yesterday, the president suggested he might support a large bank breakup proposal, perhaps a return of Glass-Steagall. This would be something of an anathema to much of the establishment GOP. He also floated a gasoline tax hike to pay for infrastructure, which might find support among the establishment but is opposed by the populists. We do think that the president is mostly non-ideological. He wants to "get things done" and be considered a "winner" and thus he is willing to support different policies to achieve

[2] Although many others could fit this characterization, including Speaker Ryan.

his goals. It's unclear how this will work out, but investors should remember that this is a president who doesn't appear to value consistency.

The Greeks get a deal: Greece's creditors and the government reached a preliminary deal today that will allow the disbursement of €7.0 bn in funds to Athens. In return, Greece will make further reforms to its labor and energy markets, along with pension cuts and tax increases. It isn't obvious to us that the Tsipras government can survive getting these changes through the Greek parliament. However, there are vague promises that creditors may consider debt relief if Greece accepts the deal. The IMF wants to see debt forgiven, arguing that Greece won't be able to pay back its current burden. Germany is willing to "extend and pretend" for longer. We doubt any debt relief comes until after the German elections in September. The good news for investors is that Greece won't trigger a Eurozone crisis.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
	Wards Total Vehicle Sales	m/m	apr	17.13 mn	16.53 mn	**
	Wards Domestic Vehicle Sales	m/m	apr	13.30 mn	12.97 mn	**
Fed speakers or events						
	No speakers or events scheduled					

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	Caixin China PMI Mfg	m/m	apr	50.3	51.2	51.3	**	Equity and bond neutral
Japan	Monetary Base	y/y	apr	19.8%	20.3%		**	Equity and bond neutral
	Nikkei Japan PMI Services	m/m	apr	52.2	52.9		**	Equity and bond neutral
	Nikkei Japan PMI Composite	y/y	apr	52.6	52.9		**	Equity and bond neutral
India	Nikkei India PMI Mfg	m/m	apr	52.5	52.5		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	apr	111.3	111.2		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	y/y	apr	56.7	56.8	56.8	**	Equity and bond neutral
	Unemployment Rate	y/y	apr	9.5%	9.5%	9.4%	***	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	y/y	mar	58.2	58.2	58.2	**	Equity and bond neutral
France	Markit France Manufacturing	y/y	apr	55.1	55.1	55.1	**	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing	y/y	apr	56.2	55.7	56.0	**	Equity and bond neutral
	Unemployment Rate	y/y	apr	11.7%	11.5%	11.5%	***	Equity and bond neutral
UK	Markit UK PMI Manufacturing	y/y	apr	57.3	54.2	54.0	**	Equity bullish, bond bearish
Switzerland	PMI Manufacturing	y/y	apr	57.4	58.6	58.2	**	Equity and bond neutral
	Total Sight Deposits	y/y	apr	571.4 bn	569.1 bn		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	apr	479.5 bn	480.6 bn		**	Equity and bond neutral
Russia	Markit Russia PMI Mfg	y/y	1q	50.8	52.4	52.6	**	Equity bearish, bond bullish

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)	117	117	0	Up
3-mo T-bill yield (bps)	83	83	0	Neutral
TED spread (bps)	35	34	1	Neutral
U.S. Libor/OIS spread (bps)	100	99	1	Up
10-yr T-note (%)	2.33	2.32	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	34	34	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Neutral
yen	down			Down
pound	down			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**		
RBA Cash Rate	1.500%	1.500%	1.500%	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	$51.99	$51.52	0.91%	Short Covering
WTI	$49.17	$48.84	0.68%	
Natural Gas	$3.22	$3.22	0.28%	
Crack Spread	$15.28	$14.75	3.57%	
12-mo strip crack	$13.36	$12.98	2.96%	
Ethanol rack	$1.73	$1.73	0.20%	
Metals				
Gold	$1,255.85	$1,256.58	-0.06%	
Silver	$16.93	$16.86	0.44%	
Copper contract	$262.85	$266.05	-1.20%	
Grains				
Corn contract	$ 376.25	$ 377.50	-0.33%	
Wheat contract	$ 459.00	$ 456.00	0.66%	
Soybeans contract	$ 976.50	$ 970.25	0.64%	
Shipping				
Baltic Dry Freight	1109	1134	-25	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.3		
Gasoline (mb)		1.0		
Distillates (mb)		1.5		
Refinery run rates (%)		-0.10%		

Weather

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

Asset Allocation Weekly Comment

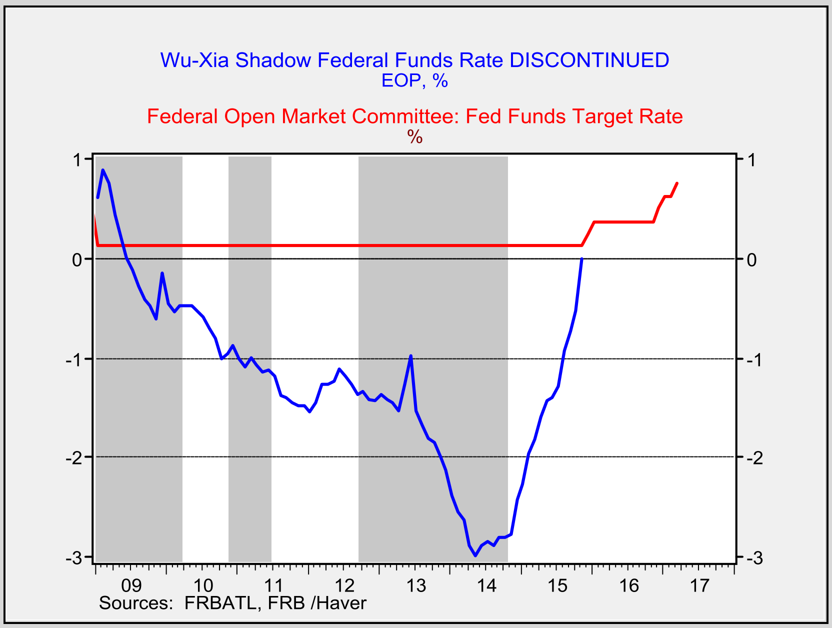
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

April 28, 2017

Last week, we discussed the impact of reducing the size of the Federal Reserve's balance sheet on stocks and bonds. This week we will discuss the effects of QE on monetary policy.

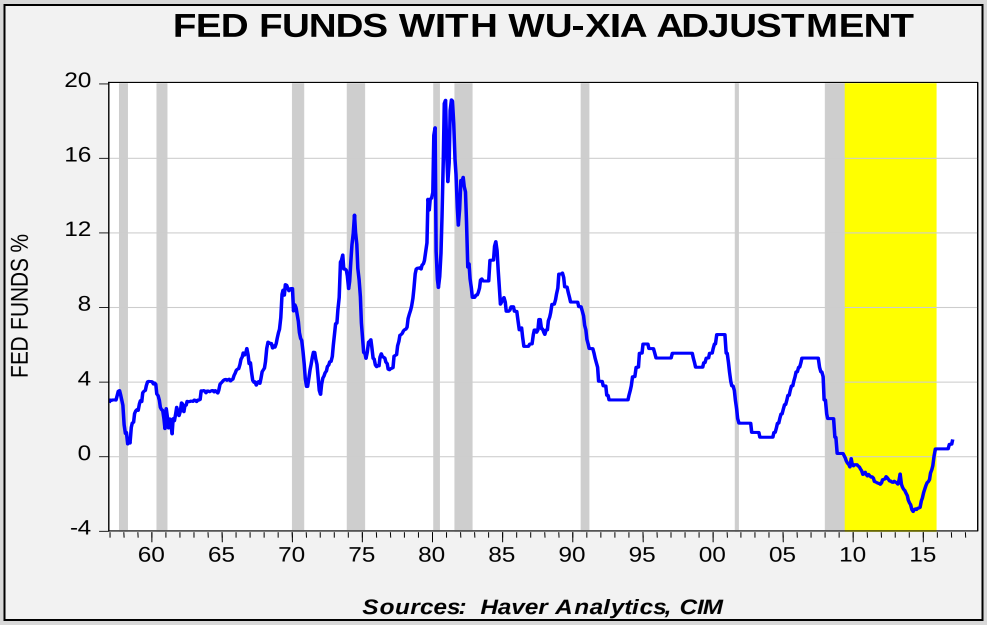
The FOMC dropped rates to near zero by January 2009. Although European central banks (including the ECB) have since taken policy rates below zero, in 2009, the "zero lower bound" was considered to be the lowest rates could fall. Thus, when the Fed wanted to stimulate further, it felt it could not lower rates below zero. The U.S. central bank was left with nothing but unconventional policy. The two policy tools employed at this point were forward guidance and QE. The former was a clear signal from the Fed that rates would be kept low for the foreseeable future. The latter was the expansion of the balance sheet.

The problem was that it was difficult to determine how much stimulus these tools generated. One attempt to answer this question came from the Atlanta FRB. To estimate the impact of unconventional policy, Wu and Xia used the yield curve to measure the impact on borrowing rates.



Based on their analysis, QE and forward guidance were the equivalent of negative nominal rates of nearly -3.0%. As tapering set in, the "shadow" rate rose rapidly. The bank has discontinued calculating the rate, suggesting that once the fed funds target rate leaves the zero floor, the applicability of the shadow rate is reduced. Essentially, they argue that once rates lift off the zero bound, the shadow fed funds rate is no longer applicable.

Using the shadow rate as a guide, we can get a feel for how much policy has tightened relative to earlier cycles.



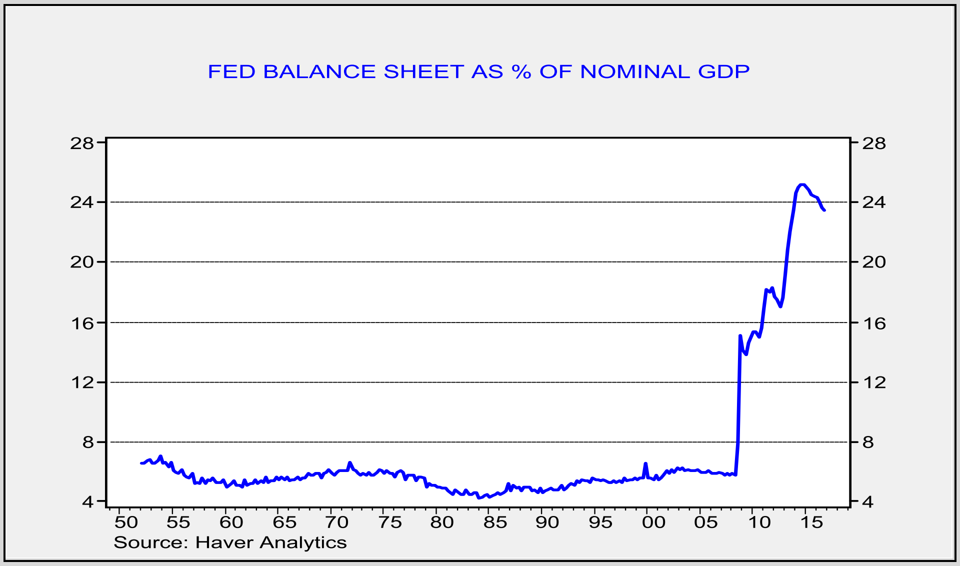
This chart shows the effective fed funds rate from 1957 to 1982, the estimated and actual target from 1982 to 2009, the shadow rate (shaded in yellow on the chart) from 2009 to 2015 and a return to the target rate after 2015. We have then calculated the trough and peak in fed funds tied to the end of each expansion from 1960 through 2008 along with the current cycle using the shadow rate.

Trough Rate (bps)	Trough Month	Peak Rate (bps)	Peak Month	Rate Change	Months Peak to Trough
63	May-58	400	Nov-59	337	18
379	Jul-67	900	Oct-69	521	27
329	Feb-72	1078	Sep-73	749	19
461	Jan-77	1378	Dec-79	917	35
961	Aug-80	1910	Jun-81	949	10
587	Dec-86	981	May-89	394	29
475	May-99	650	Dec-00	175	19
100	Apr-05	525	Jul-08	425	40
-289	Aug-14	87.5	Mar-17	376.5	31
Average				558.375	24.8625

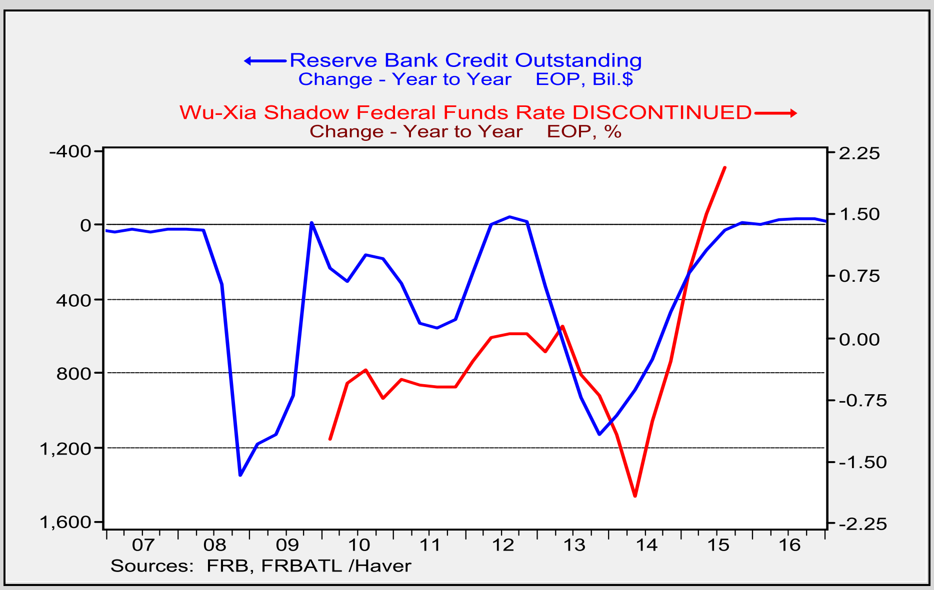
(Source: Haver Analytics, CIM)

We have highlighted the current cycle in yellow and excluded it from the average. To reach the average level that has preceded recessions in the past, the FOMC will need to make around seven more rate hikes of 25 bps. Excluding the Volcker money-targeting regime years would reduce the average by roughly 125 bps, meaning that the Yellen Fed will be flirting with recession with only two more rate hikes.

We are quite concerned about this situation because of an unresolved policy debate. It is unclear if QE stimulation is a function of the ***level*** or the ***change*** in the balance sheet. If it's the level, the balance sheet is quite large; however, if it's the change that matters, then reducing the balance sheet could create unanticipated risks for the economy and markets.



The balance sheet, scaled to GDP, is off its all-time highs but, at 23.4%, is well above the pre-QE level of 5.8%. If level is the key determinant of stimulus, then the FOMC can reduce the balance sheet substantially. On the other hand, the Wu-Xia shadow rate seems to follow the yearly changes in the balance sheet.



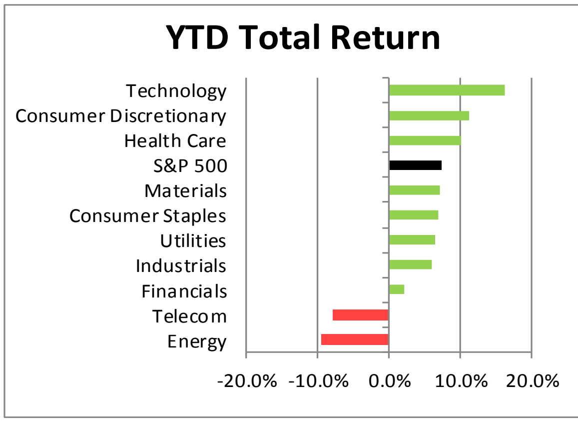
Comments from Fed officials clearly signal that policymakers believe the level is the key indicator of stimulus; last week's report, which compared equity markets to the level of the balance sheet, would support that contention. However, as the above chart suggests, a case can be made that the change in the balance sheet has an impact as well.

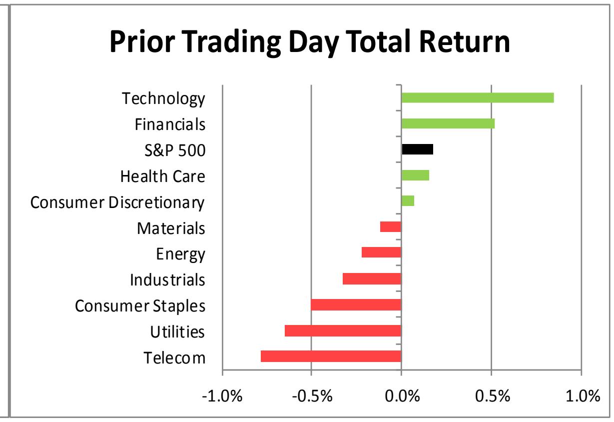
By 2018, it is quite possible the FOMC will have raised rates by another 50 bps and will have started the process of reducing the balance sheet. The latter policy could tighten monetary policy by an unknown amount. And, as we noted above, excluding the early Volcker years, two rate hikes may be getting us closer to recession levels than generally believed if the shadow rate accurately represents the actual trough in the policy rate. It should be remembered that forward guidance was part of the policy as well. Simply indicating that hikes will occur in the future affects financial markets today. Although this isn't an immediate concern, it appears we are gliding into a period of enhanced risk by autumn. Adding to this issue is that both Chair Yellen and Vice Chair Fischer are expected to leave the FOMC in January. Depending on who President Trump appoints, we could have a change in the policy stance of the central bank.

We will be watching financial markets closely in the coming months to see how these issues we have raised over the past three weeks will affect the economy and financial markets. Our concern is that policymakers and markets have never experienced a sustained drop in the Fed's balance sheet; it may be innocuous or it may be a problem. History will be of only modest use and thus the potential for a mistake will be elevated.

Data Section

U.S. Equity Markets – (as of 5/1/2017 close)

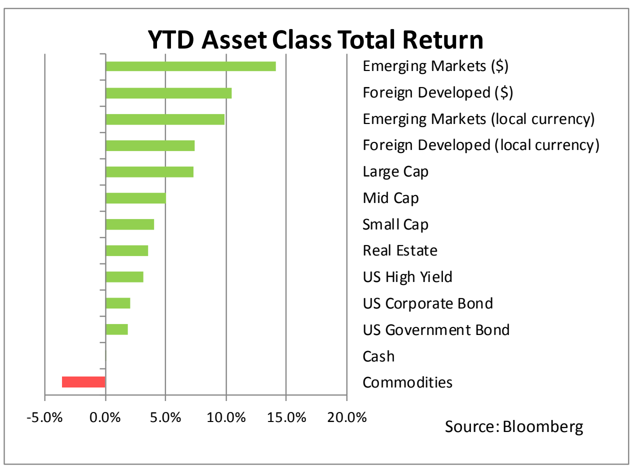




(Source: Bloomberg)

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 5/1/2017 close)

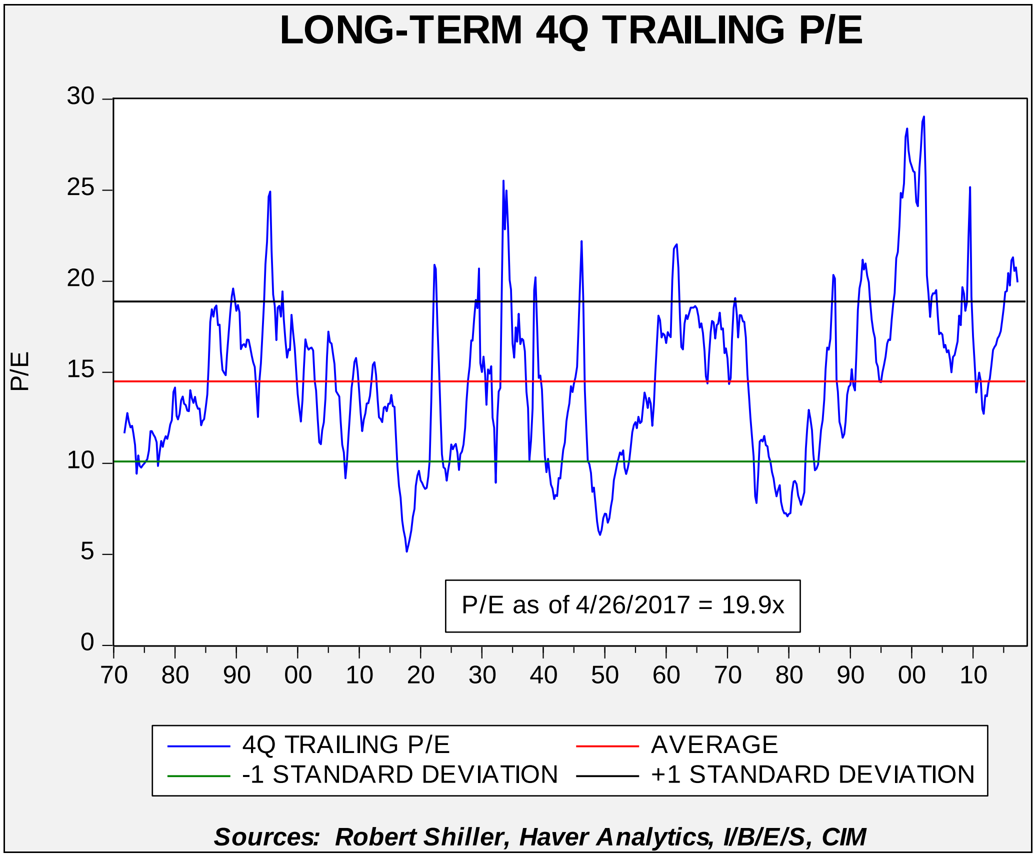


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 27, 2017



Based on our methodology,[3] the current P/E is 19.9x, unchanged from last week.

This report was prepared by 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.

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[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 two actual quarters (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.