Daily Comment

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

[Posted: May 4, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.3% and the Shenzhen index also down 0.3%. U.S. equity index futures are signaling a higher open. With 379 companies having reported, the S&P 500 Q1 earnings stand at $30.62, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 73.6% of the companies reported earnings above forecast, while 20.1% reported earnings below forecast.

The Federal Reserve did just about what we expected; it did acknowledge Q1 economic weakness but expressed no serious concern about slowdown, suggesting that it isn't all that concerned about future growth. We note that fed funds futures are placing the odds of a 25 bps rate hike at the June meeting at 90%, up from the low 81% level before the meeting statement. As long as economic data remains stable, it looks like a second hike is coming in June.

The House is planning to vote on a replacement bill for the ACA; the vote is expected to be close. Usually, the leadership of the House won't bring an important bill to a vote if they are not reasonably confident of the outcome. If the bill passes, it probably won't become law in its current form as it is highly unlikely the Senate will pass it without major changes. However, if it fails to pass the House, it will be a defeat of sorts for the White House and perhaps raise concerns that the president is incapable of shepherding anything through Congress. That outcome might undermine hopes of infrastructure spending and tax cuts.

SOS Tillerson gave a speech yesterday at the State Department laying out the administration's vision for foreign policy. He suggested that the U.S. has been "too accommodating" to emerging nations and allies and "things have gotten out of balance." We can see the logic of this statement. The U.S. has been unusually generous for a hegemon on two fronts. First, for the most part, we have single-handedly enforced peace in the world's three "hot zones" of Europe, the Far East and the Middle East by putting troops and bases in these regions. More importantly, we have taken over the security of Europe and Japan, removing the long-standing tensions that led to two world wars in Europe and the constant tensions between China and Japan. We essentially did the same thing in the Middle East. This policy has been quite costly in terms of "blood and treasure," although we would argue that the costs were worth it since we didn't fight WWIII. However, without question, much of the world has enjoyed a "free ride" at the expense of American taxpayers and soldiers.

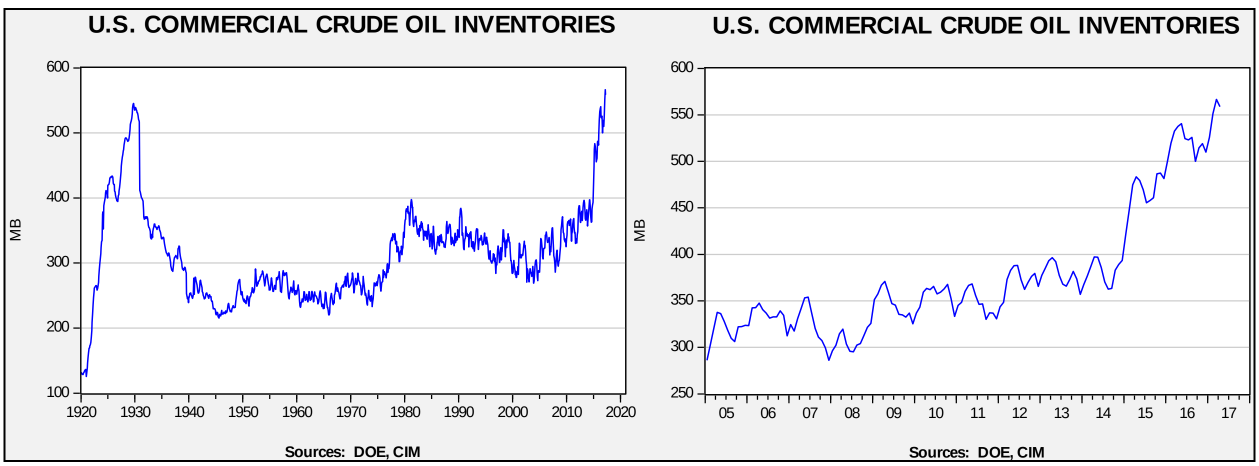
Second, the other element of hegemony has been to provide the reserve currency, which has led to persistent trade deficits and allowed a model of development designed to boost investment and exports, funded by domestic saving. This topic is under discussion currently in our four-part

Weekly Geopolitical Report series. By being the global importer of last resort, we have bolstered global growth. However, the cost to Americans has been a gutting of the middle class that has become clearly evident in the political turmoil observed over the past three elections.

What Tillerson didn't do was explain how the "rebalancing" is going to occur. Would it be through a reduction of the trade deficit by forcing foreign firms to source production in the U.S., sort of a "tribute" paid to America for access to the dollar? Would it be by forcing allies to pay more for their own defense? If allies pay more, can we still control them? What if Germany rearms and decides to collect bad Greek debt by taking a few islands?

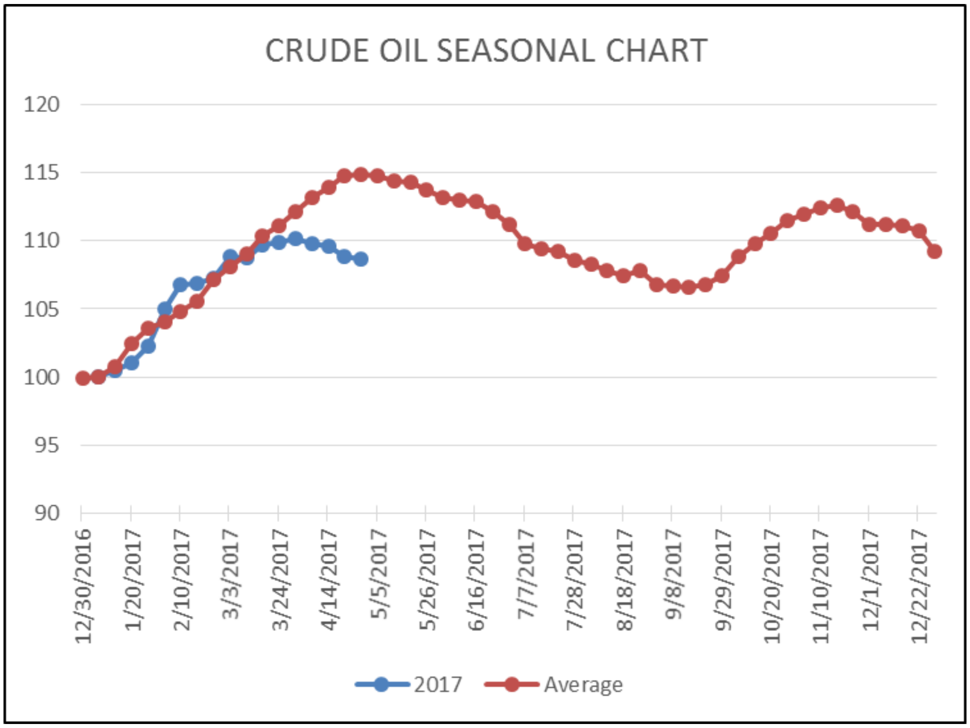
We can see the need for changes to American hegemonic policy. However, a clear path isn't obvious; in fact, it's fraught with risk. We are already seeing the results of "thawing" the frozen conflict in the Middle East. The territorial integrities of both Syria and Iraq are mostly broken and we don't know what will replace them. Islamic State was the first attempt; that wasn't such a great outcome. An adjustment is necessary. We believe the policies used since WWII have probably become politically impossible to maintain, but it isn't known what can effectively replace those policies. Until they are replaced, uncertainty will remain elevated.

U.S. crude oil inventories fell 0.9 mb compared to market expectations of a 3.3 mb draw.

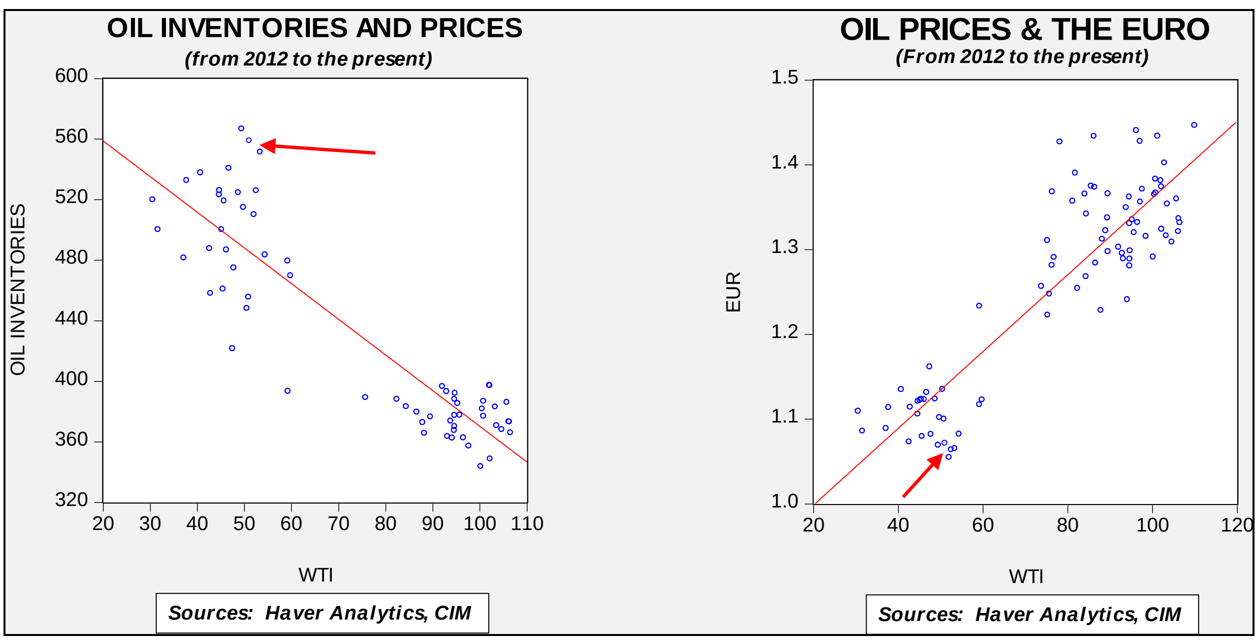


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have started the seasonal withdrawal phase. We also note that, as part of an Obama-era agreement, there was a 1.5 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' worth of imports in storage. Due to falling imports, the current coverage is near 140 days. Taking that into account, the draw would have been 2.4 mb, roughly in line with expectations.

As the seasonal chart below shows, inventories are near their seasonal peak and should begin falling as rising refinery operations lower stockpiles. This week's decline rise puts us further below normal. Although inventories remain high, this seasonal level is consistent with July, meaning that we may be on the way to an easing of the inventory overhang. Last year, we saw a 45 mb draw from the April peak. Assuming a similar drop from this year's peak of 566.5 mb at the end of March, we will end up at 520 mb by late September. Assuming a $1.09 EUR and using the model discussed below, fair value is $44.15 for oil prices. Thus, we would need to see a much larger drop to justify current prices.



(Source: DOE, CIM)

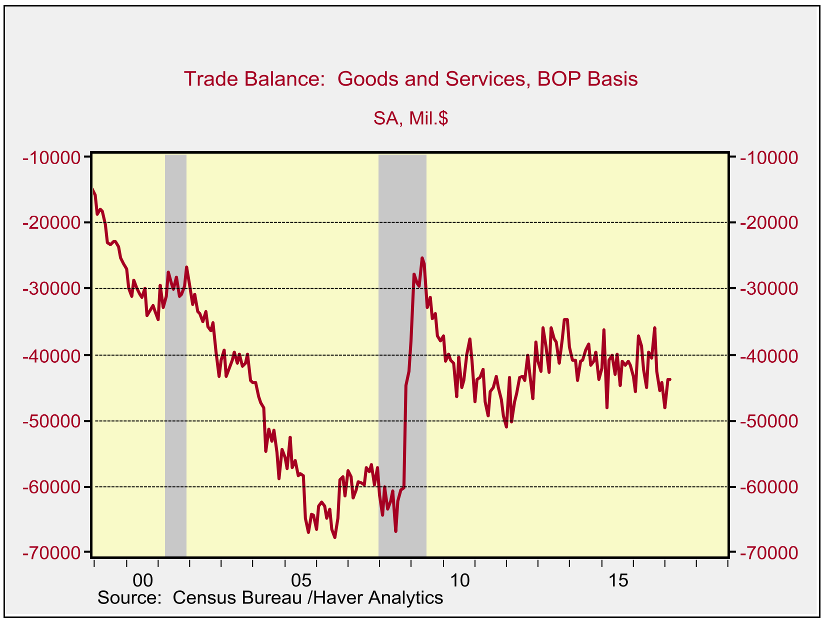


Based on inventories alone, oil prices are overvalued with the fair value price of $31.03. Meanwhile, the EUR/WTI model generates a fair value of $41.57. Together (which is a more sound methodology), fair value is $37.68, meaning that current prices are well above fair value. To a great extent, it appears that the oil market has already discounted a drop in inventory levels and a weaker dollar.

U.S. Economic Releases

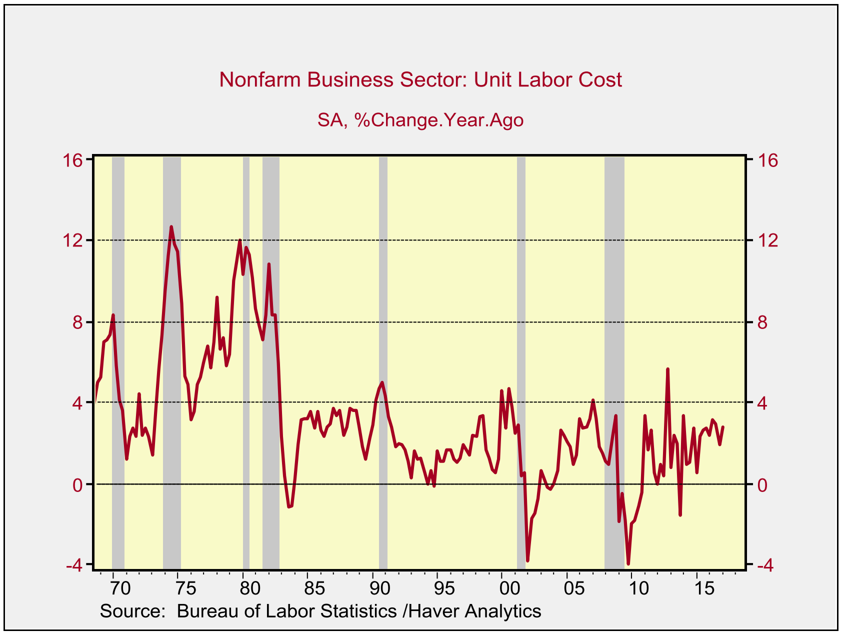
The March Challenger job cuts report fell by 42.0% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

The trade deficit came in narrower than expected at $43.7 bn compared to the forecast of $44.5 bn. The prior report's deficit was revised wider from $43.6 bn to $43.8 bn.

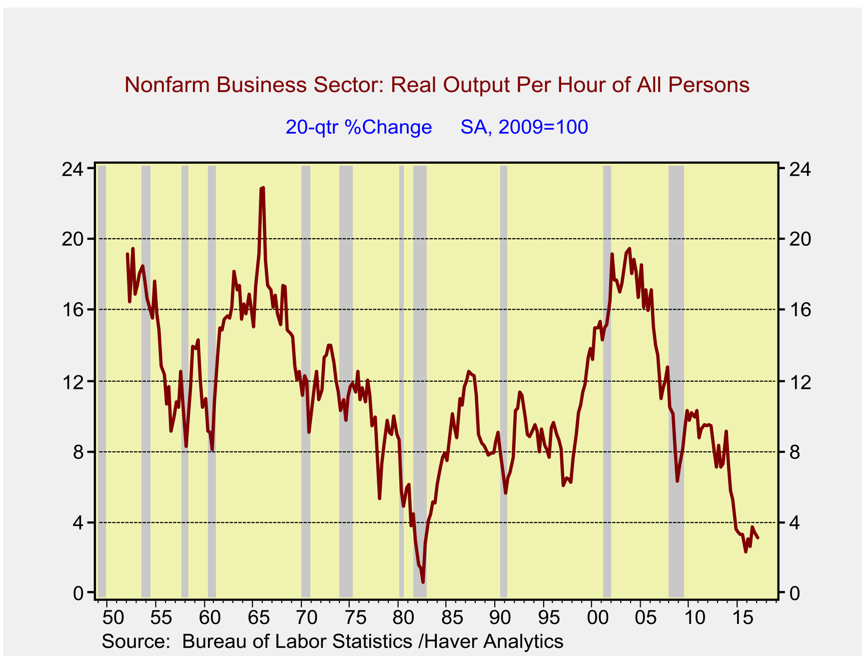


The chart above shows the trade balance of goods and services. Generally, the trade balance has moved sideways over the past five years.

Non-farm productivity came in below forecast, falling 0.6% compared to the forecast fall of 0.1%. The prior report was revised upward from 1.3% to 1.8%. Unit labor costs came in above forecasts at 3.0% compared to the forecast of 2.7%. The prior report was revised downward from 1.7% to 1.3%.

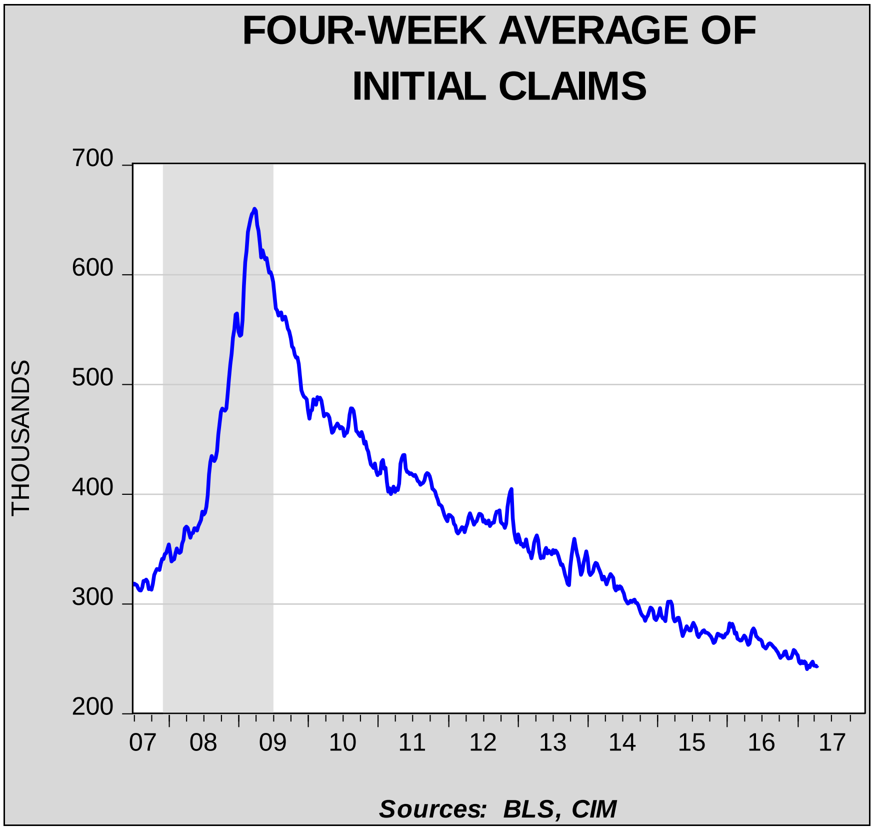


The chart above shows the annual change in unit labor costs.



The chart above shows the five-year change in productivity. What we like about this chart is that it shows the longer term trends in productivity and, clearly, things are not good. This is the lowest trend in productivity since the early 1980s when we were in the depths of the second-worst postwar recession. Weak productivity means that firms must hire more workers (or have them work more hours) to expand production. Weak productivity remains a mystery; economists tend to treat productivity as the residual from what can be explained by capital and labor inputs. The combination of weak productivity and high margins can only be resolved in two ways, low wages and/or weak material prices. We have seen a bit of both. Raising productivity allows both labor and capital to reap growing compensation; unfortunately, no one really has a good idea about how to boost it.

Initial jobless claims came in below expectations at 238k compared to the forecast of 248k.



Sources: BLS, CIM

The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose to 243k from 242.25k.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	apr		50.8	**
10:00	Factory Orders	m/m	mar	0.4%	1.0%	**
10:00	Factory Orders ex Trans	y/y	mar		0.4%	**
10:00	Durable Goods Orders	m/m	mar	0.7%	0.7%	**
10:00	Durable ex Transportation	m/m	mar		-0.2%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	mar		0.2%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	mar		0.4%	**
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 Composite	m/m	apr	51.2	52.1		**	Equity and bond neutral
	Caixin China PMI Services	m/m	apr	51.5	52.2		**	Equity and bond neutral
India	Nikkei India PMI Services	m/m	apr	50.2	51.5		**	Equity and bond neutral
	Nikkei India PMI Composite	m/m	apr	51.3	52.3		**	Equity and bond neutral
Australia	HIA New Home Sales	m/m	mar	-1.1%	0.2%		**	Equity bearish, bond bullish
	Trade Balance	m/m	mar	A$3.107 bn	A$3.574 bn	A$3.250 bn	**	Equity and bond neutral
New Zealand	ANZ Job Advertisements	m/m	apr	2.8%	1.6%		**	Equity and bond neutral
	ANZ Commodity Price	m/m	apr	-0.2%	0.4%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Services	m/m	apr	56.4	56.2	56.2	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	apr	56.8	56.7	56.7	**	Equity and bond neutral
	Retail Sales	m/m	mar	0.3%	0.7%	0.1%	**	Equity bullish, bond bearish
Germany	Markit Germany Services PMI	m/m	apr	55.4	54.7	54.7	**	Equity and bond neutral
	Markit/ BME Germany Composite PMI	m/m	apr	56.7	56.3	56.3	**	Equity and bond neutral
France	Markit France Services PMI	m/m	apr	56.7	57.7	57.7	**	Equity and bond neutral
	Markit France Composite PMI	m/m	apr	56.6	57.4	57.4	**	Equity and bond neutral
Italy	Markit/ADACI Italy Services PMI	m/m	apr	56.2	52.9	53.6	**	Equity bullish, bond bearish
	Markit/ADACI Italy Composite PMI	m/m	apr	56.8	54.2	54.6	**	Equity bullish, bond bearish
UK	New Car Registration	m/m	apr	-19.8%	8.4%		**	Equity and bond neutral
	Markit/CIPS UK Services PMI	m/m	apr	55.8	55.0	54.5	**	Equity bullish, bond bearish
	Markit/CIPS UK Composite PMI	m/m	apr	56.2	54.9	54.5	**	Equity bullish, bond bearish
Switzerland	SECO Consumer Confidence	y/y	apr	-8	-3	3	**	Equity and bond neutral
Russia	Markit Russia PMI Services	m/m	apr	56.1	56.6	56.2	**	Equity and bond neutral
	Markit Russia PMI Composite	m/m	apr	55.3	56.3		**	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)	85	85	0	Neutral
TED spread (bps)	33	32	1	Neutral
U.S. Libor/OIS spread (bps)	101	101	0	Up
10-yr T-note (%)	2.34	2.32	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	32	32	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			Down
pound	up			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**		
FOMC Rate Decision (Upper Bound)	1.000%	1.000%	1.000%	On forecast
FOMC Rate Decision (Lower Bound)	0.750%	0.750%	0.750%	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	$50.18	$50.79	-1.20%	Inventories higher than expected
WTI	$47.24	$47.82	-1.21%	
Natural Gas	$3.22	$3.23	-0.19%	
Crack Spread	$15.29	$15.76	-2.98%	
12-mo strip crack	$13.17	$13.44	-2.00%	
Ethanol rack	$1.70	$1.71	-0.50%	
Metals				
Gold	$1,234.09	$1,238.17	-0.33%	
Silver	$16.49	$16.47	0.11%	
Copper contract	$252.65	$254.35	-0.67%	
Grains				
Corn contract	$ 372.25	$ 374.75	-0.67%	
Wheat contract	$ 450.00	$ 454.00	-0.88%	
Soybeans contract	$ 971.50	$ 975.25	-0.38%	
Shipping				
Baltic Dry Freight	1034	1073	-39	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.9	-3.3	2.3	
Gasoline (mb)	0.2	1.0	-0.8	
Distillates (mb)	2.0	1.5	0.5	
Refinery run rates (%)	-0.30%	-0.10%	-0.2%	
Natural gas (bcf)		60.0		

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 northwestern and central region. Precipitation is expected for most of the western region of the country.

<u>Asset Allocation Weekly Comment</u>

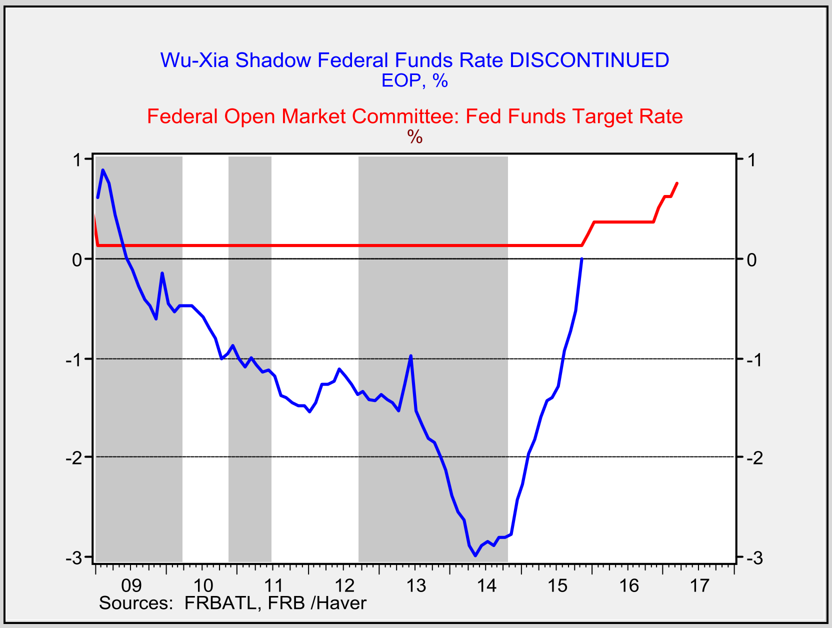
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

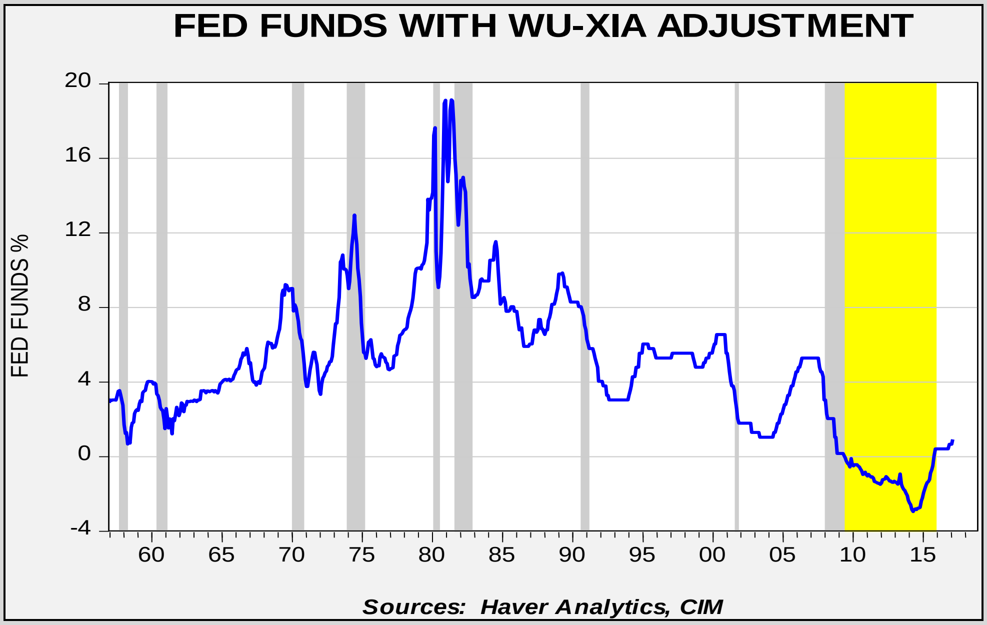
The FOMC dropped rates to near zero by January 2009. Although European central banks (including the ECB) have since taken policy rates below zero, in 2009, the "zero lower bound" was considered to be the lowest rates could fall. Thus, when the Fed wanted to stimulate further, it felt it could not lower 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.



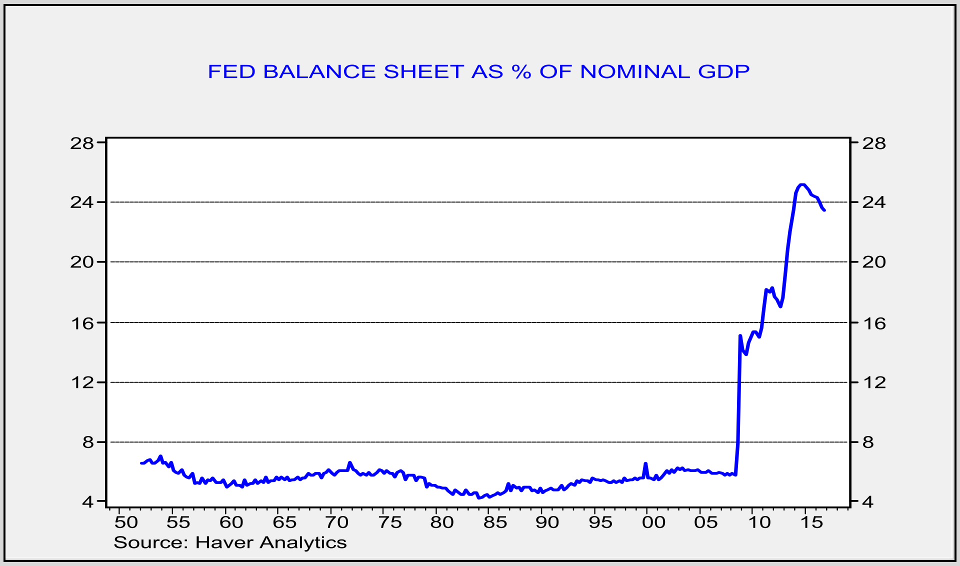
This chart shows the effective fed funds rate from 1957 to 1982, the estimated and actual target from 1982 to 2009, the shadow rate (shaded in yellow on the chart) from 2009 to 2015 and a return to the target rate after 2015. We have then calculated the trough and peak in fed funds tied to the end of 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

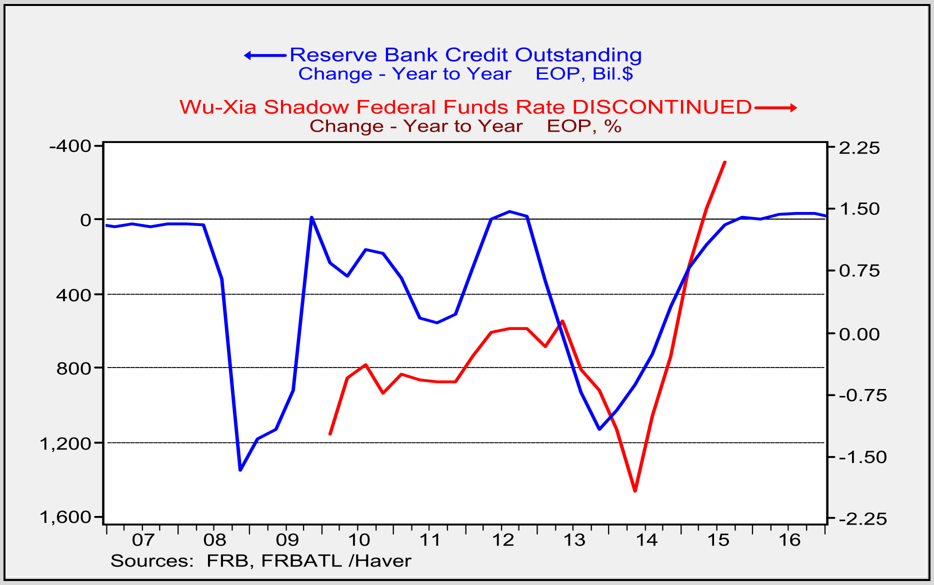
(Source: Haver Analytics, CIM)

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.



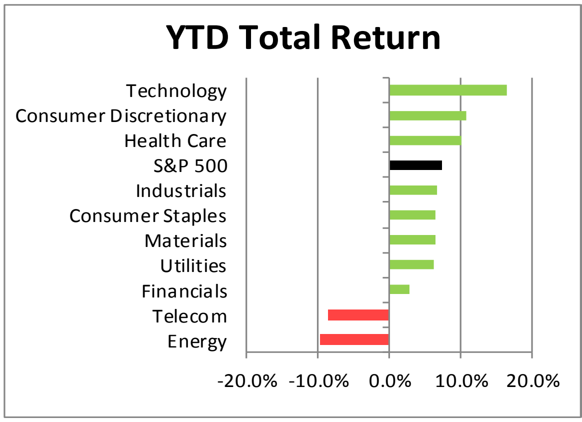
Comments from Fed officials clearly signal that policymakers believe the level is the key indicator of stimulus; last week's report, which compared equity markets to the level of the balance sheet, would support that contention. However, as the above chart suggests, a case can be made that the change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

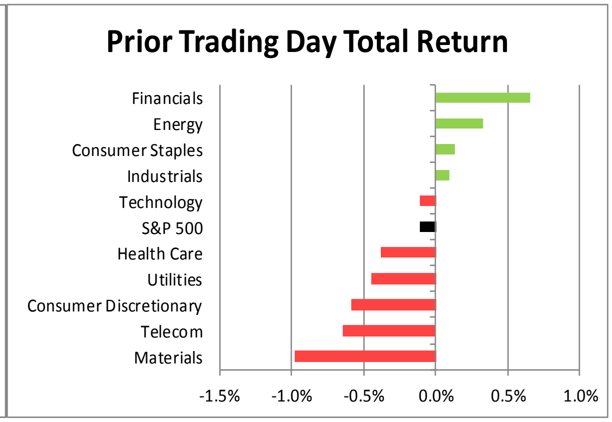
By 2018, it is quite possible the FOMC will have raised rates by another 50 bps and will have started the process of reducing the balance sheet. The latter policy could tighten monetary policy by an unknown amount. And, as we noted above, excluding the early Volcker years, two rate hikes may be getting 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 5/3/2017 close)

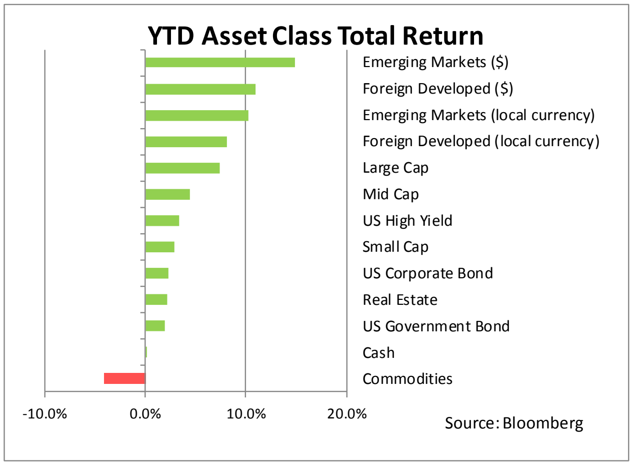




(Source: Bloomberg)

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 5/3/2017 close)

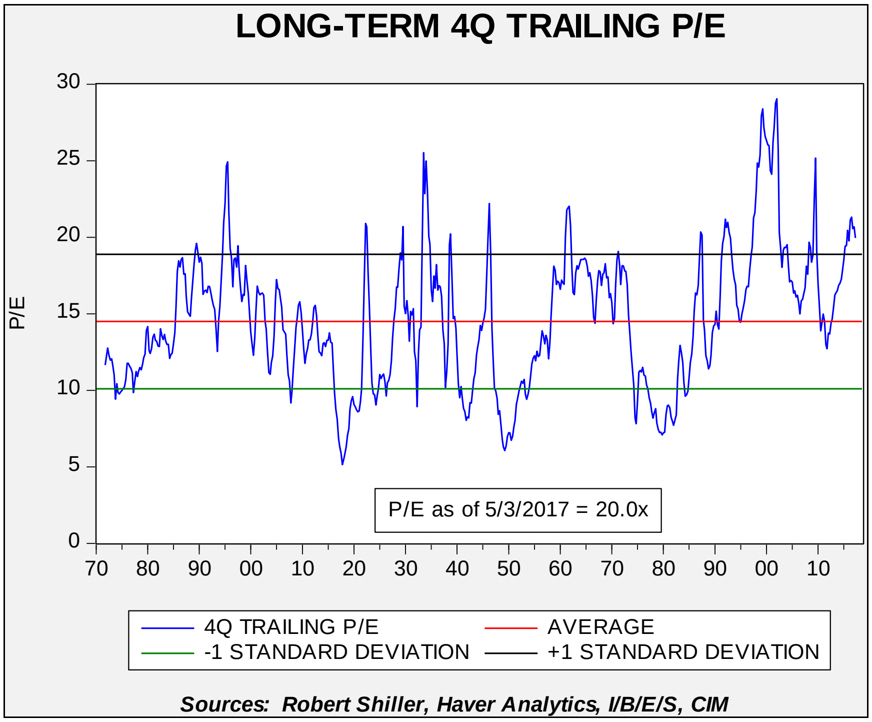


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 4, 2017



Based on our methodology,[1] the current P/E is 20.0x, up 0.1x from last week. The rise in the multiple has mostly come from the recent rise in equity prices.

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[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 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.