Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: November 2, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading 0.7% lower from the last close. In Asia, the MSCI Asia Apex 50 closed 1.2% lower from the prior close. Chinese markets were down, with the Shanghai composite down 0.6% and the Shenzhen index also down 0.6%. U.S. equity futures are signaling a lower opening. With 333 companies having reported, the S&P 500 Q3 earnings stand at $30.95, higher than the $29.60 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 72.4% of the companies reported earnings above forecast, while 20.1% reported earnings below forecast.

Risk markets continue to trade lower this morning as anxiety over the election has increased. This morning, a Bloomberg Politics independent poll reported a tight race, with Clinton receiving 39% of the undecided vote over 35% for Trump. When third-party candidates are added, Clinton holds a 3% lead over Trump, receiving 30% of the votes. The Washington Post-ABC News Tracking Poll reported this morning that Clinton supporters' enthusiasm has waned somewhat after the news of the FBI re-opening her e-mail case.[1] Both candidates run nearly even, with 46% of the vote for Trump over 45% for Clinton.

Market volatility has increased leading up to the final week before the elections. The CBOE VIX index, which measures market expectations of near-term volatility, has risen for the past six trading days and is trending higher again this morning. The chart below shows the YTD level of the index. Although volatility has risen, it remains well below the risk market sell-off levels from February and the mid-summer uncertainty.

[1] https://www.washingtonpost.com/news/the-fix/wp/2016/11/01/post-abc-tracking-poll-clinton-falls-behind-trump-in-enthusiasm-but-has-edge-in-early-voting/

(Source: Bloomberg)

Volatility has also increased in Europe but remains well below the volatility levels of the Brexit vote. The chart below shows the VIX index for Europe.

(Source: Bloomberg)

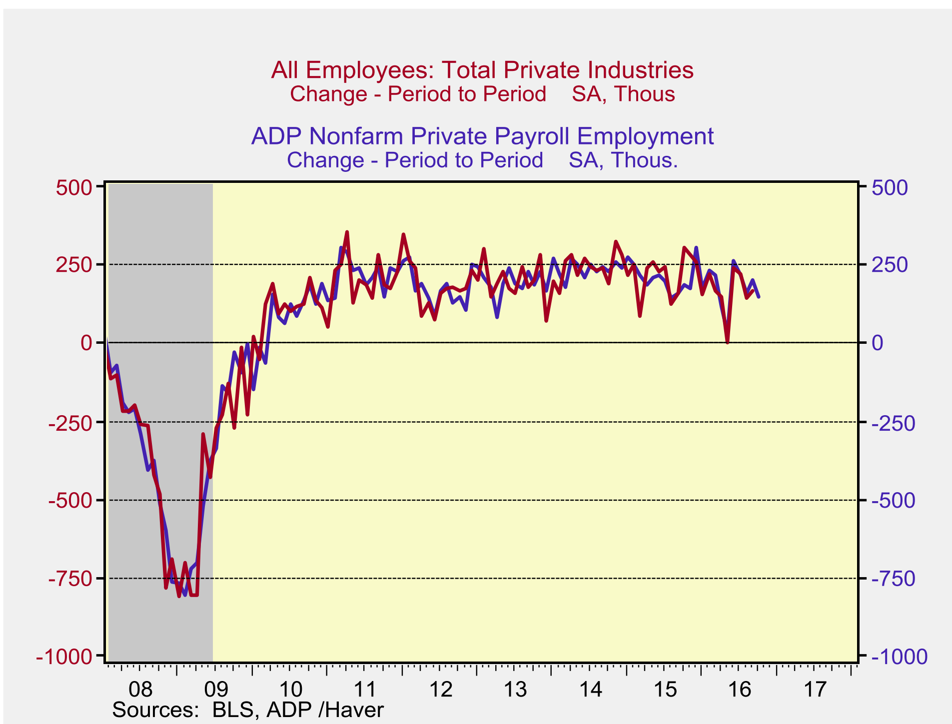
The Mexican peso, which tends to fall when the market perceives Trump gaining over Clinton, has trended lower over the past week. The chart below shows the peso per dollar ratio—a higher reading means a weaker peso. The currency has weakened recently but remains stronger than the September levels.

(Source: Bloomberg)

U.S. Economic Releases

Weekly mortgage applications fell 1.2% last week, up from a -4.1% decline the previous week. Purchase applications fell 0.4%, while refinancing applications fell 1.6%. The 30-year mortgage rate dipped 4 bps to 3.75%.

The September ADP private payroll report showed an increase of 147k, a bit below the forecast rise of 165k. The prior week's employment change report of 154k was revised to 202k.



The chart above shows the ADP data along with the monthly change in the BLS private non-farm payrolls. The ADP data signals a softer number for Friday's report.

The table below lists the economic releases and Fed speakers scheduled for the rest of the day.

Economic Releases							
EDT	Indicator			Expected	Prior	Rating	
9:45	ISM New York	y/y	oct		49.6	**	
Fed speakers or events							
EST	Speaker or event	District or position					
13:00	FOMC Rate Decision						

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								
Japan	Consumer Confidence Index	y/y	sep	42.3	43	42.6	**	Equity and bond neutral
	Monetary Base	y/y	sep	22.1%	22.7%		**	Equity and bond neutral
Australia	Building Approvals	y/y	sep	-6.4%	10.0%	2.1%	**	Equity bearish, bond bullish
New Zealand	Average Hourly Earnings	q/q	3Q	0.3%	1.0%	0.8%	**	Equity and bond neutral
	Unemployment Rate	y/y	3Q	4.9%	5.1%	5.1%	***	Equity bullish, bond bearish
	Employment Change	y/y	3Q	6.1%	4.5%	5.4%	**	Equity bullish, bond bearish
	Participation Rate	q/q	3Q	70.1%	69.7%	69.7%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Manufacturing	y/y	oct	53.5	53.3	53.3	**	Equity and bond neutral
Germany	Unemployment Claims	y/y	oct	6.0%	6.1%	6.1%	**	Equity and bond neutral
	Markit/BME Germany Manufacturing	y/y	oct	55	55.1	55.1	**	Equity and bond neutral
Italy	Markit/ ADACI Italy Manufacturing	y/y	sep	50.9	51	51.4	**	Equity bearish, bond bullish
France	Markit/ ADACI France Manufacturing	y/y	sep	51.8	51.3	51.3	**	Equity bullish, bond bearish
UK	Nationwide House Px	y/y	oct	4.6%	5.3%	4.9%	**	Equity bearish, bond bullish
	Market/ CIPS UK Construction	y/y	oct	52.6	52.3	51.8	**	Equity bullish, bond bearish
Switzerland	UBS Real Estate Bubble Index	y/y	3Q	1.35	1.32		**	Equity and bond neutral
AMERICAS								
Canada	RBC Canadian Manufacturing PMI	y/y	sep	51.1	50.3	51.1	**	Equity and bond neutral
	MLI Leading Indicator	y/y	sep	0.3%	0.1%		**	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)	88	89	-1	Down
3-mo T-bill yield (bps)	35	35	0	Neutral
TED spread (bps)	54	54	0	Neutral
U.S. Libor/OIS spread (bps)	50	50	0	Neutral
10-yr T-note (%)	1.80	1.83	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	45	46	-1	Down
Currencies	**Direction**			
dollar	down			Up
euro	down			Down
yen	down			Down
pound	down			Down
franc	down			Down

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	$47.42	$48.14	-1.50%	Expected increase stocks in the US
WTI	$45.89	$46.67	-1.67%	
Natural Gas	$2.80	$2.90	-3.69%	
Crack Spread	$15.98	$16.12	-0.88%	
12-mo strip crack	$16.11	$16.19	-0.51%	
Ethanol rack	$1.76	$1.76	-0.03%	
Metals				
Gold	$1,297.49	$1,288.20	0.72%	Market uncertainty due to election
Silver	$18.57	$18.36	1.13%	
Copper contract	$221.30	$222.90	-0.72%	
Grains				
Corn contract	$ 349.75	$ 349.00	0.21%	Supply Pressure
Wheat contract	$ 415.25	$ 414.25	0.24%	
Soybeans contract	$ 995.00	$ 993.25	0.18%	
Shipping				
Baltic Dry Freight	838	857	-19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		-1		
Distillates (mb)		-1.8		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		57.00		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country. Precipitation is forecast for the northwestern region of the country.

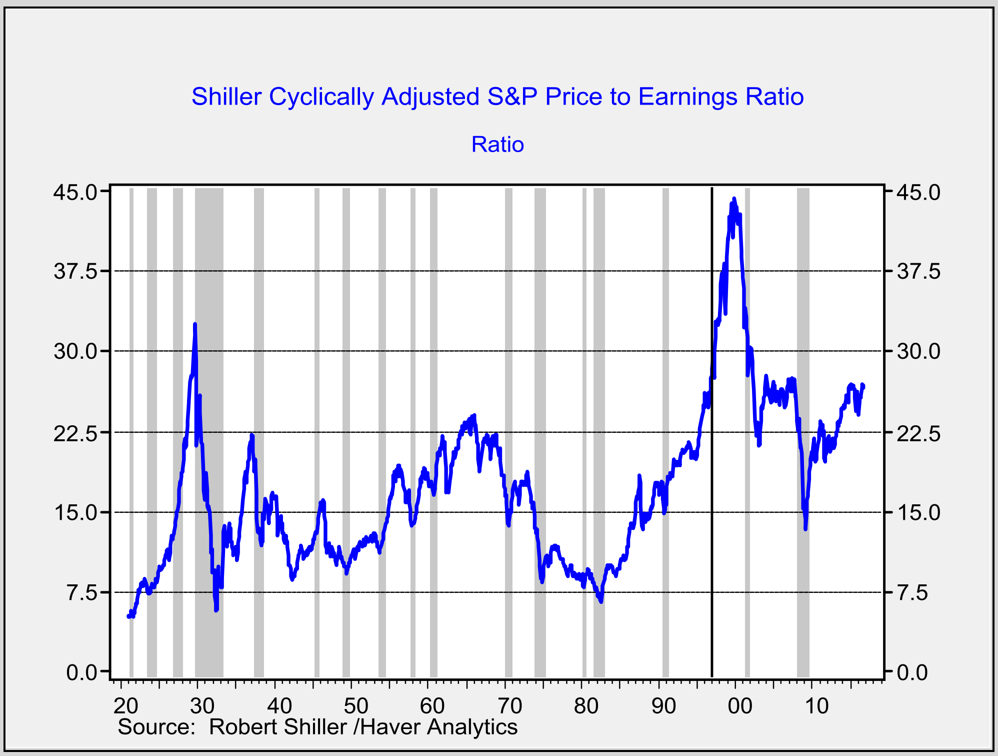
Asset Allocation Weekly Comment

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.

October 28, 2016

My weekend exercise is to take my dogs on long walks. Both dogs seem to enjoy these walks and I use the time to listen to podcasts. I recently listened to a long podcast that interviewed Sebastian Mallaby, a British journalist and senior fellow at the Council on Foreign Relations. He has recently written a biography on Alan Greenspan, titled *The Man Who Knew*. The FT Alphachat podcast[2] was an interview about that book.

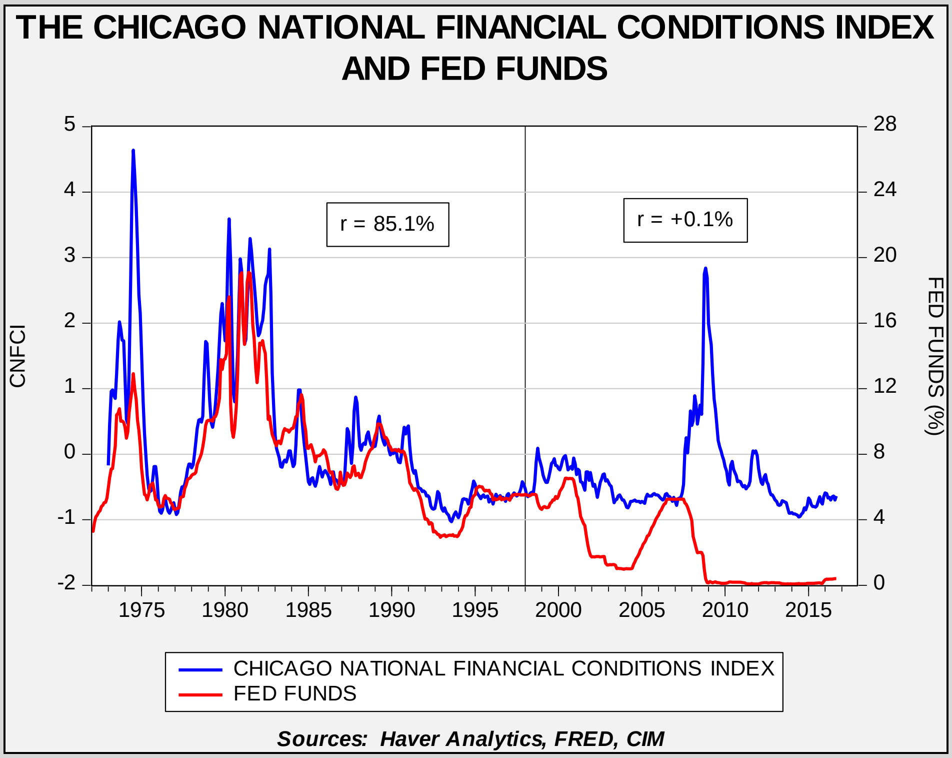
Although I haven't read the book yet (it's on the list), a key takeaway from the podcast was that one of Greenspan's attributes was that he was a savvy political operative. He understood that the Federal Reserve operates in a political environment and that one of the Chair's jobs is to manage the political system to maintain the central bank's independence. Mallaby suggested in the podcast that Greenspan was truly a "maestro" in managing the political situation. However, as I listened, I wondered if managing the political situation meant that monetary policy was being framed to please the politically powerful.



[2] http://ftalphaville.ft.com/2016/10/21/2177678/podcast-our-chat-with-sebastian-mallaby-on-alan-greenspan/

This chart shows the Shiller Cyclically Adjusted Price Earnings ratio (CAPE). We have placed a vertical line at December 1996 when Greenspan gave his famous "irrational exuberance" speech, raising questions about equity market valuations. As the chart shows, the CAPE was approaching levels near the peak of the 1929 stock market bubble that was soon followed with a massive market crash. Although Greenspan didn't suggest that the Fed was about to change monetary policy to curb asset prices, equity markets around the world fell sharply on fears that Greenspan was about to use monetary policy to lower the stock market. Greenspan faced heavy criticism for the speech.[3] Being the consummate political operator, Greenspan's monetary policy seemed to evolve into a form where asset market bubbles cannot be established in advance and the job of the central bank was to use monetary policy to repair the damage wrought to the real economy once the bubble collapses.

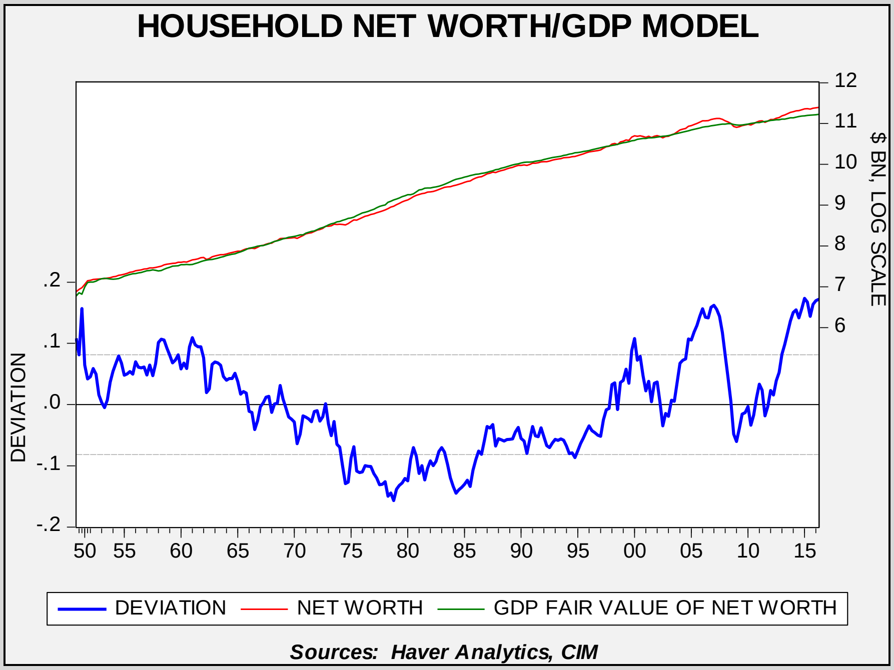
This chart overlays the Chicago FRB National Financial Conditions Index and the fed funds rate. The index measures stress in the financial system. The higher the reading, the greater the stress in the system.



The two series were closely correlated (85.1%) from 1973 through 1997, until the financial conditions index was created in 1998. When fed funds rates rose, financial conditions deteriorated. In some respects, financial conditions acted as a "force multiplier" for policy. But, from 1998 to the present, the two series have become virtually independent. After hearing Mallaby's podcast, we suspect the FOMC may be trying to keep financial conditions calm, which could be construed as a reading under zero on the above chart.

---

[3] http://www.wsj.com/articles/SB95774078783030219



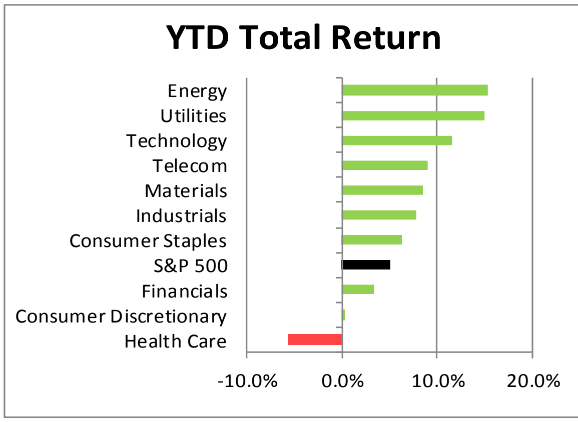
This chart shows a model of household net worth regressed against nominal GDP. Both series have been log-transformed. Net worth was elevated into the early 1960s but steadily declined into the late 1970s. It began to rise in 1995. Note that since 1998, net worth has generally outpaced GDP except during recessions.

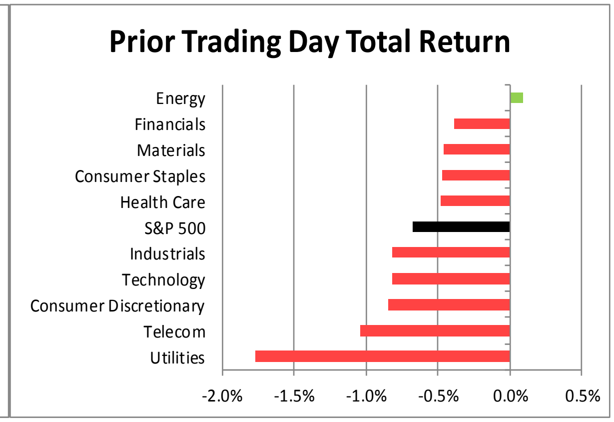
Currently, net worth relative to GDP is elevated. It does appear that these increases in net worth that outpace the overall growth of the economy could be a function of monetary policy. As investors become confident that the Federal Reserve will continue to suppress financial stress, it appears there is a tendency for asset prices to rise to lofty levels. When valuations become unsustainable, often at the turn of the business cycle, it appears that sharp declines in net worth, caused by price declines in real and financial assets, leads to a fall in household net worth.

Mallaby's research of Greenspan suggests he was inclined to allow asset prices to rise while striving to contain price inflation. It is arguable that Greenspan's policies with regard to financial system stress have been adopted by his successors. If so, monetary policy is probably (although perhaps inadvertently) designed to aid asset prices. As the last chart shows, net worth is elevated again at levels that have been difficult to sustain in the past. We still believe that recessions are the primary triggers of market corrections and we closely monitor the economy for such events. The current level of valuation makes this exercise even more critical.

Data Section

U.S. Equity Markets – (as of 11/1/2016 close)

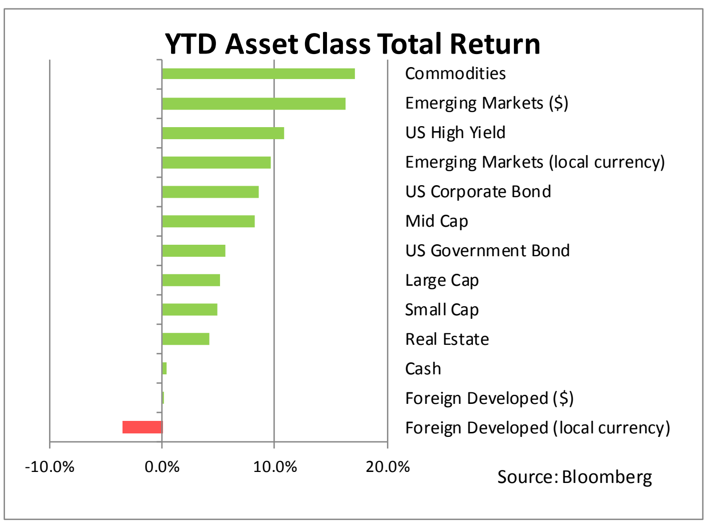




(Source: Bloomberg)

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 11/1/2016 close)

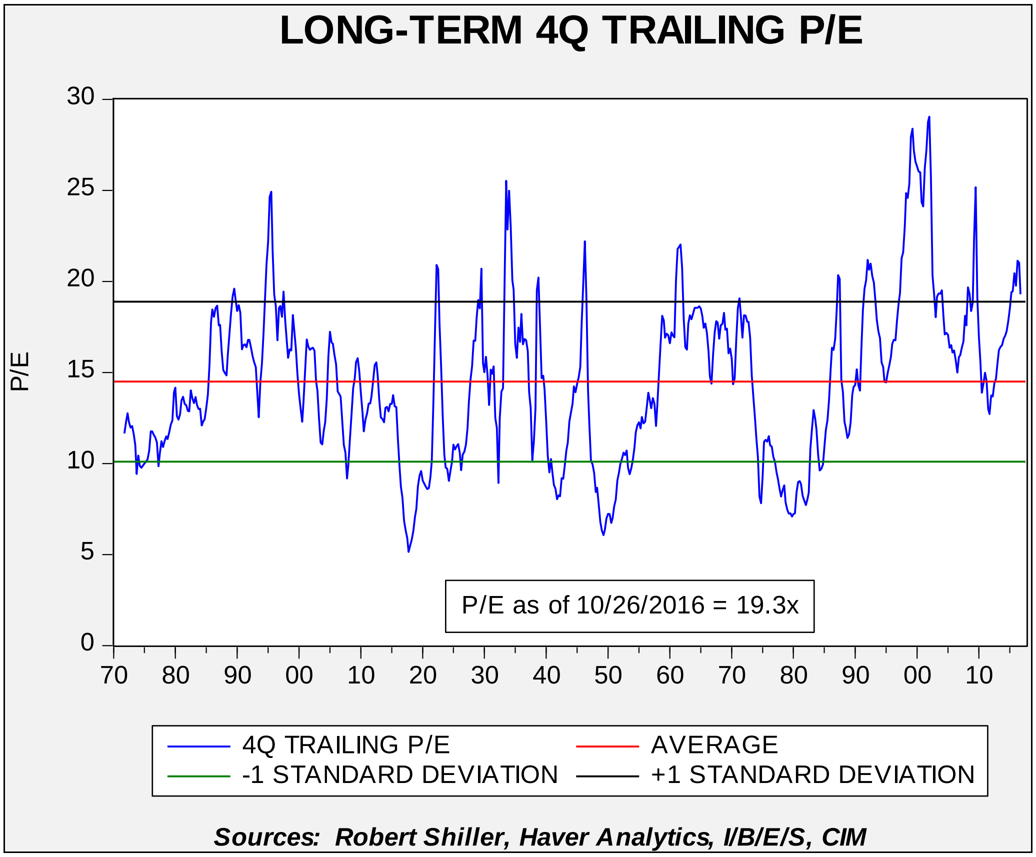


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 27, 2016



Based on our methodology,[4] the current P/E is 19.3x, down 0.1x from last week. Better earnings reports are the cause of the decline in the P/E.

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.

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