Daily Comment

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

[Posted: November 17, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.1% higher from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index down 0.4%. U.S. equity futures are signaling a higher opening. With 465 companies having reported, the S&P 500 Q3 earnings stand at $31.23, higher than the $29.23 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 72.8% of the companies reported earnings above forecast, while 21.1% reported earnings below forecast.

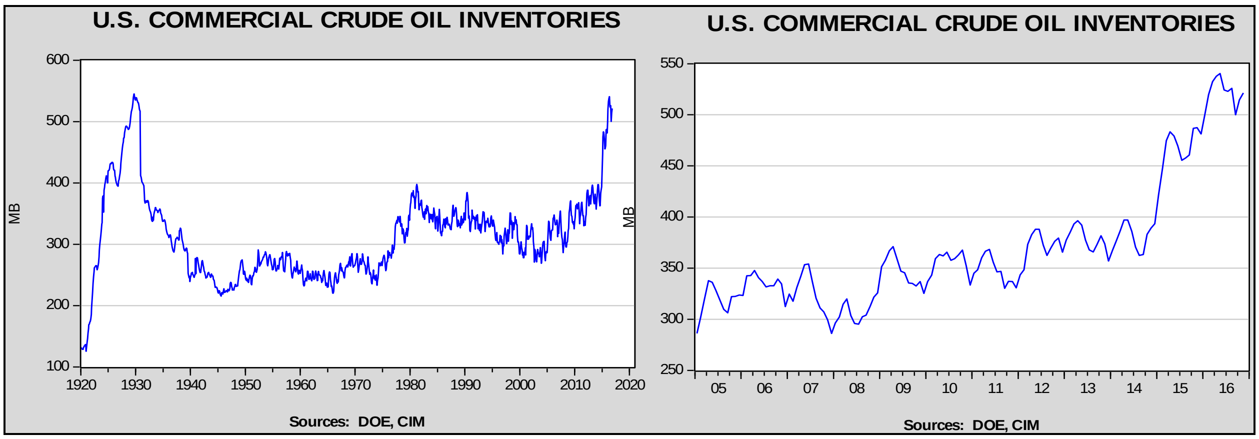
In terms of market and economic news, it was a fairly quiet night. Chair Yellen gave testimony before the Joint Economic Committee of Congress. The prepared remarks were, for the most part, unremarkable. There was no mention of the new president which, for Yellen, is probably prudent. Until policies are actually enacted, there is no point in joining the speculation.

Meanwhile, speculation abounds about Trump's cabinet and what will actually occur with stimulus and such. The *WSJ* suggests that Trump may be leaning toward an infrastructure bank, which would probably have less impact than direct spending. However, it is worth remembering that Trump appears to be a more "shoot from the hip" sort of manager. He probably hasn't completely made up his mind. What appears to be going on now is an attempt by the populists among his advisors and friends to make major changes that were popular with the working class voters (trade impediments, immigration reform, major infrastructure spending), whereas the establishment center-right is trying to focus Trump's precious political capital on tax reform and deregulation. We suspect Trump will continue to allow the two sides to fight each other before making a decision on where he leans. Thus, the current lack of clarity will likely be with us for another week or so.

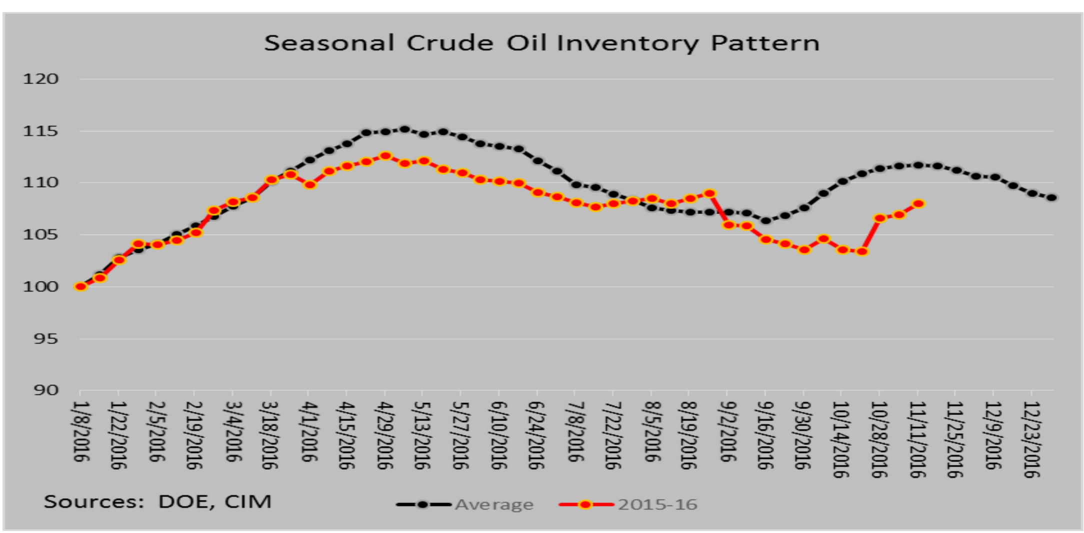
The BOJ proved its mettle overnight; last month, the bank indicated it was changing its policy. Instead of targeting a steady expansion of its balance sheet, it indicated instead that it would simply target the 10-year JGB at 0% and buy all the bonds necessary if yields rise above that level. It worked like it was designed today; as the 10-year approached zero, the BOJ indicated it was in the market. Yields promptly eased. This program probably makes more sense and would become quite powerful if coupled with fiscal spending.

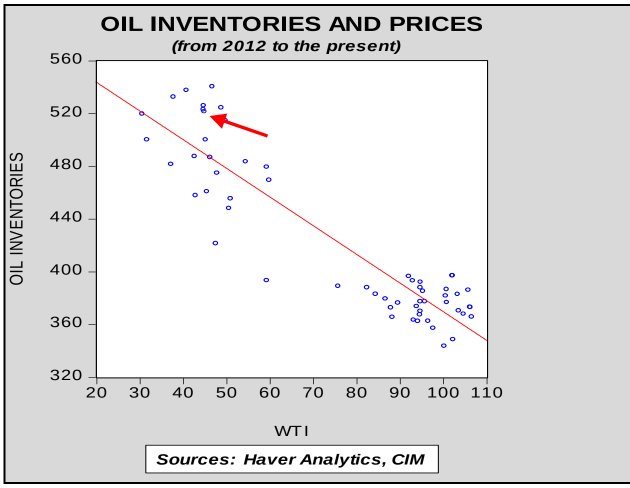
A cautionary tale is emerging from Europe. Since the end of WWII, the U.S. has effectively demilitarized Europe. After being the source of two world wars, the U.S. decided that the only way to ensure the continent wouldn't do so again was to take over its security. European militaries have, to a greater or lesser extent, atrophied over the years. The further removed we are in time from this decision, the more current leaders have forgotten why this policy was implemented in the first place. All that is seen now are the costs; the benefits of not fighting a land war in Europe (or, God forbid, a nuclear one) are mostly forgotten. President-elect Trump has indicated he considers NATO questionable and thinks Europe should be responsible for its own defense. Roderich Kiesewetter, a foreign policy spokesman for Merkel's conservative coalition, suggested today that Europe may need its own nuclear deterrent if the U.S. is no longer willing to protect it through NATO. If Europe remilitarizes, it would reduce some of America's military burdens, but the cost would be that we may not be able to control European defense policy. Although it seems inconceivable that Europe could behave in a belligerent manner, given the Cold War history, the first half of the 20th century offers a stark lesson as to what Europe is capable of.

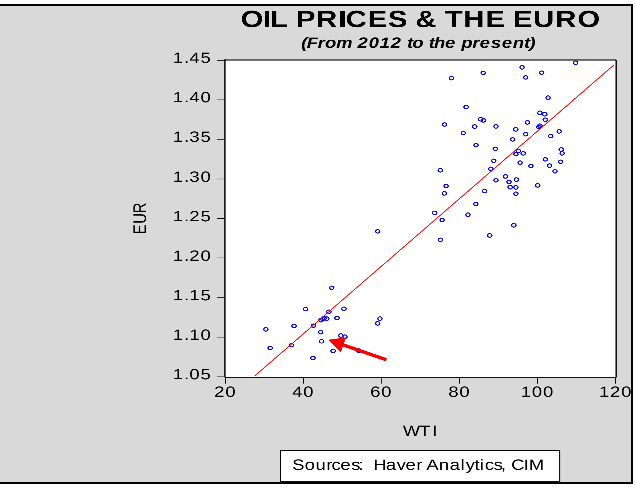
U.S. crude oil inventories rose 5.3 mb compared to market expectations for a 1.0 mb build.



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 below shows, seasonally, we should see inventories tend to stabilize into the end of November and decline into year's end. This week's rise worked against that seasonal pattern and suggests we are seeing importers catch up from this summer's tropical storm disruptions.



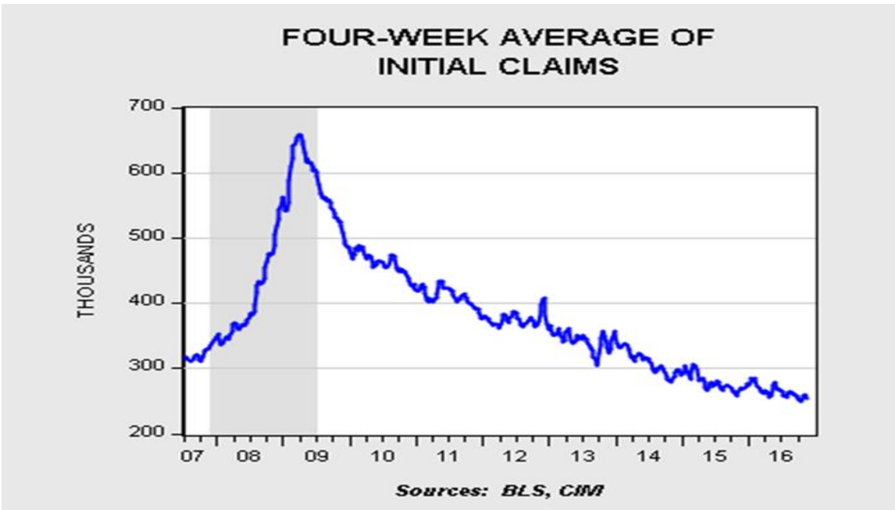




Based on inventories alone, oil prices are overvalued with the fair value price of $37.97. Meanwhile, the EUR/WTI model generates a fair value of $43.10. Together (which is a more sound methodology), fair value is $39.53, meaning that current prices are above fair value. The divergence from fair value is due to hopes of an OPEC deal that would boost prices. Saudi Arabian officials indicated today they are hopeful a deal will be done, which lifted prices this morning. However, the current strengthening dollar and rising inventories make it clear that OPEC really needs to make credible cuts at the Nov. 30th meeting. If it fails, oil prices could fall into the high $30s.

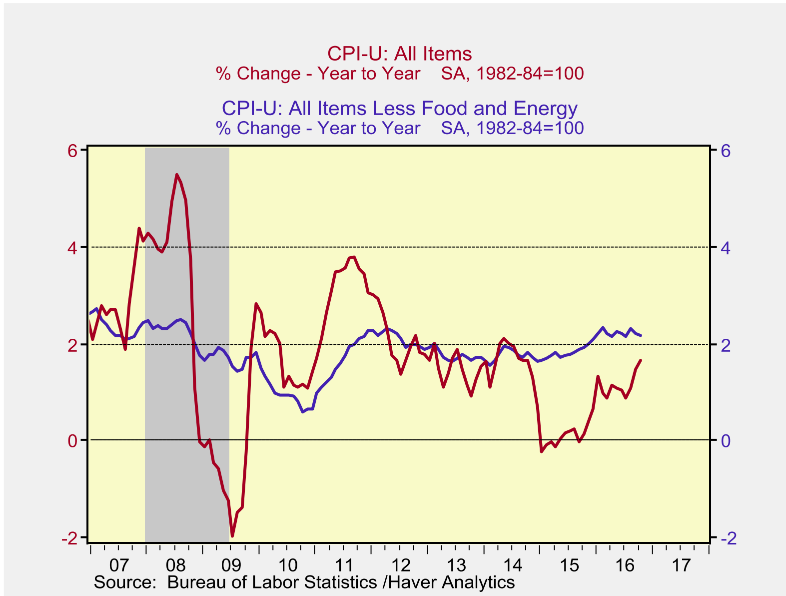
U.S. Economic Releases

Today, initial job claims came in at 235k, well below the 257k forecast. This is the lowest jobless claims since 1973. Continuing claims came in at 1.977m, below the forecast of 2.03m. This data support the claim that the labor market is strengthening.



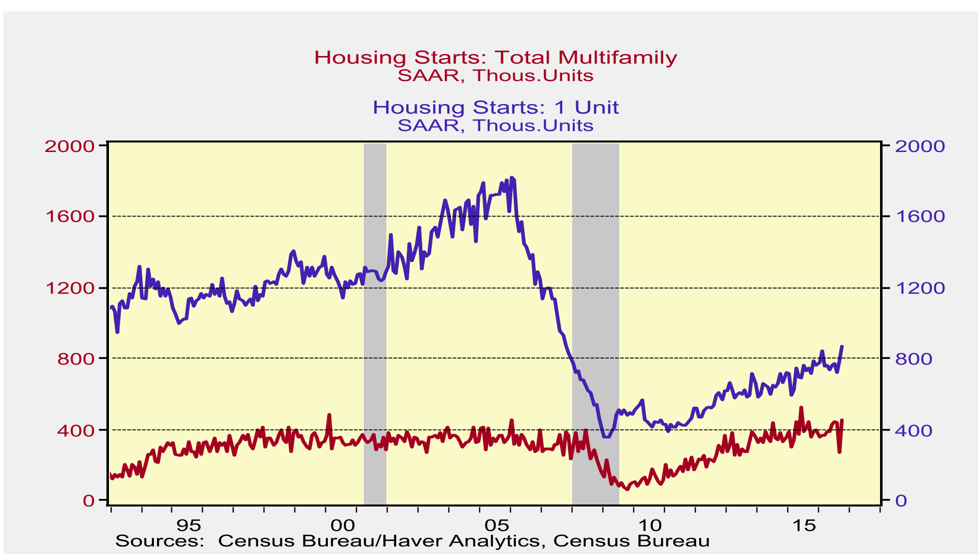
The chart above shows the four-week moving average of initial claims. The four-week moving average fell from 260.0 to 253.5. Initial jobless claims seem to be following a downward trend.

CPI came in on forecast for September, rising 0.4% from the month before. This is the highest price increase in five months. Core inflation came in lower than forecast, rising 0.1% compared to the 0.2% increase expected.



The chart above shows the annual change in headline consumer inflation and core inflation. Headline inflation rose 1.6% annually, on forecast. Core prices rose 2.1% annually, slightly less than the 2.2% increase expected.

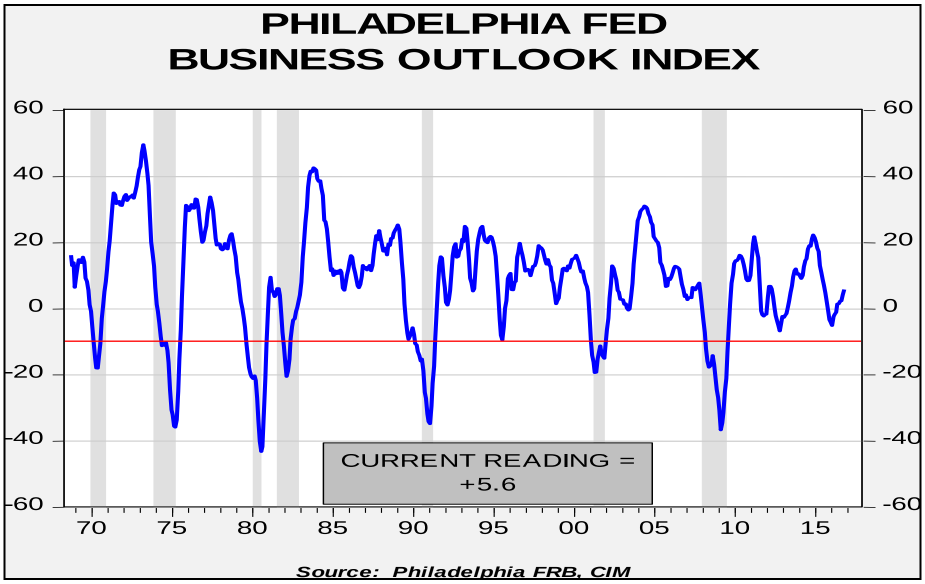
Housing starts rose by 25.5%, far above the October forecast of a 10.4% increase. The rise is the result of a spike in multi-family home construction. In addition, building permits rose 0.3%, above the forecast drop of 2.7%. There were 1.229 million permits issued, higher than the 1.193 million permits forecast for September.



The chart above shows single- and multi-family starts. Single-family starts are up 21.1% and multi-family starts are up 26.5%. The unusual spike in housing starts can be attributed to the relatively mild October weather.

Real weekly wage earnings came in at 0.9%. The prior week's report was revised upward from 0.8% to 0.9%.

The Philadelphia FRB Business Conditions Index came in at 7.6, a bit weaker than the 7.8 reading forecast.



We smooth this report with a six-month moving average. The index is showing improvement, rising to +5.6 from last month's number of +2.2. Although we are concerned about any number below zero, a reading under -10 is necessary to confirm a recession is underway.
The table below lists the Fed speakers and events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Economic Expectations	m/m	nov		45.0	**
9:45	Bloomberg Consumer Comfortable	m/m	nov		45.1	**
Fed speakers or events						
EST	Speaker or event	District or position				
19:45	William Dudley will Speak in New York	President of the Federal Reserve Bank of New York				
18:30	Lael Brainard Speaks in New York	Member of the Board of Governors				

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	Japan Buying Foreign Bonds	m/m	nov	466.2 bn	604.9 bn		**	Equity and bond neutral
	Foreign Buying Japan Bonds	m/m	nov	421.9 bn	-6.2 bn		**	Equity and bond neutral
	Japan Buying Foreign Stocks	m/m	nov	338.6 bn	183.3 bn		**	Equity and bond neutral
	Foreign Buying Japan Stocks	m/m	nov	545.8 bn	-106.4 bn		**	Equity and bond neutral
Australia	Employment Change	y/y	oct	9.8k	-9.8k	16.0k	**	Equity and bond neutral
	Unemployment Rate	y/y	oct	5.6%	5.6%	5.7%	***	Equity and bond neutral
	Participation Rate	y/y	oct	64.4%	64.6%	64.5%	**	Equity and bond neutral
New Zealand	ANZ Job Advertisements	y/y	oct	0.6%	0.3%		**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registrations	y/y	oct	0.0%	7.2%		*	Equity and bond neutral
	CPI	y/y	oct	0.5%	0.4%	0.5%	***	Equity and bond neutral
Italy	Trade Balance	y/y	sep	3.67 bn	2.519 bn		**	Equity bullish, bond bearish
France	ILO Unemployment Rate	y/y	3q	10.0%	9.9%	9.9%	***	Equity and bond neutral
UK	Retail Sales	y/y	oct	7.4%	4.1%	5.3%	**	Equity bullish, bond bearish
	Retail Sales ex Auto Fuel	y/y	oct	7.6%	4.0%	5.4%	**	Equity bullish, bond bearish
Russia	Gold and Forex Reserve	y/y	nov	393.1 bn	395.7 bn		*	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	y/y	sep	-3.7%	-2.7%	-3.7%	**	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)	91	91	0	Neutral
3-mo T-bill yield (bps)	45	45	0	Neutral
TED spread (bps)	46	46	0	Neutral
U.S. Libor/OIS spread (bps)	56	56	0	Neutral
10-yr T-note (%)	2.22	2.22	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	50	48	2	Up
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	down			Down
pound	up			Down
franc	up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA FX Transactions Government	-$450 mn	-$699 mn		On forecast
RBA FX Transactions Market	$439 mn	$673 mn		On forecast
RBA FX Transactions Other	$26 mn	$ 37 mn		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	$47.44	$46.63	1.74%	Weakening Dollar
WTI	$46.32	$45.57	1.65%	
Natural Gas	$2.75	$2.76	-0.58%	
Crack Spread	$11.77	$11.46	2.78%	
12-mo strip crack	$13.53	$13.34	1.46%	
Ethanol rack	$1.70	$1.70	-0.06%	
Metals				
Gold	$1,227.12	$1,224.99	0.17%	
Silver	$16.98	$16.98	-0.01%	
Copper contract	$247.55	$247.90	-0.14%	
Grains				
Corn contract	$ 347.50	$ 346.50	0.29%	Profit Taking
Wheat contract	$ 417.50	$ 414.25	0.78%	
Soybeans contract	$ 988.50	$ 985.75	0.28%	
Shipping				
Baltic Dry Freight	1145	1084	61	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.3	1.0	4.3	
Gasoline (mb)	0.7	-1.6	2.3	
Distillates (mb)	0.3	-2.0	2.3	
Refinery run rates (%)	2.1%	0.5%	1.7%	
Natural gas (bcf)		28.00		

Weather

The 6-10 and 8-14 day forecasts continue to call for mild weather for most of the country and cooler weather for the eastern region. Precipitation is also expected for most of the country. NOAA issued its monthly forecast for December and the three-month forecast for December through February. For December, the western two-thirds of the nation and New England through New York are expected to experience warmer than normal temps. Normal temperatures are expected for the northern central states and the Ohio Valley. For the rest of winter, only the northern tier states are forecast to be colder than normal. This forecast is somewhat bearish for heating products.

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.

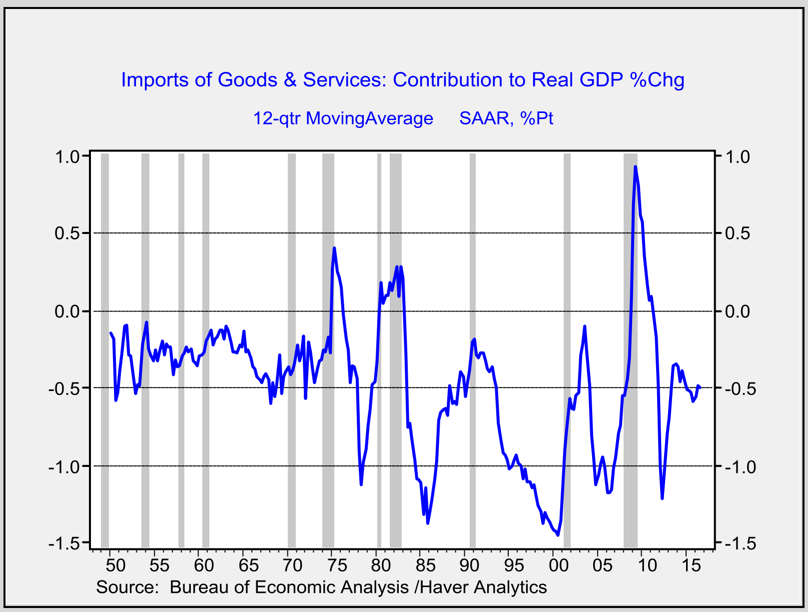
November 11, 2016

The Trump victory has significant ramifications for the economy and markets. The president-elect's platform is somewhat ambiguous, which isn't all that unusual; candidates want to build in some degree of flexibility that a detailed platform can reduce. Despite this lack of clarity, there are elements that are emerging that offer a guide to the policy changes the new administration will likely implement.

We believe the key to Trump is his campaign slogan, "America First." Trump made it abundantly clear that he intends to conduct policy from the standpoint of whether it is best for America. Although the term "America First" harkens back to an earlier movement,[1] Trump's version appears broader, including both domestic and foreign policy.

So, what does an America First policy mean for the domestic economy? Trump has promised both fiscal stimulation and trade restrictions. The combination of these two policies contradicts the accepted economic orthodoxy since Reagan-Thatcher, which adopted globalization. However, combining the two supercharges the domestic impact. Why? Because under conditions of globalization, some fiscal stimulus is lost to imports.

Globalization and deregulation began in earnest in 1978. This chart shows the contribution to GDP from imports on a three-year average basis.



[1] The earlier America First movement, led by Charles Lindbergh just before Pearl Harbor, was designed to keep the U.S. out of a European war.

The pattern of imports clearly changes in the late 1970s, becoming a persistently larger drag on growth but also more volatile. On average, from 1950 through 1977, imports reduced GDP by 31 bps. From 1978 to the present, the average loss to imports nearly doubled, to 61 bps. Trade restrictions will tend to add to real GDP; if Trump can reduce imports to the pre-1978 years, it would consistently add about 30 bps to GDP. If fiscal stimulus adds 60 bps (the average that government spending alone added in Reagan's first term), real GDP could rise nearly 1% per year. This analysis does not include any rise in consumption that might coincide with changes in the income tax code or investment from reforms in corporate taxes.

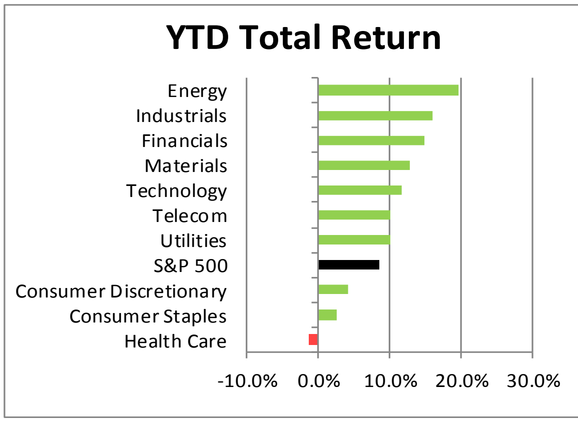
Simply put, the combination of fiscal stimulus and import restrictions could lead to a sizeable boost to growth. The downside to the policy is that it would certainly be inflationary. One of the key elements to containing inflation over the past nearly four decades has been through globalization. Trade impediments shift the aggregate supply curve toward the origin, meaning that price levels are higher at the same level of output. But, in an economy that is struggling to boost price levels, the impact of higher inflation will be benign, at least for a while.

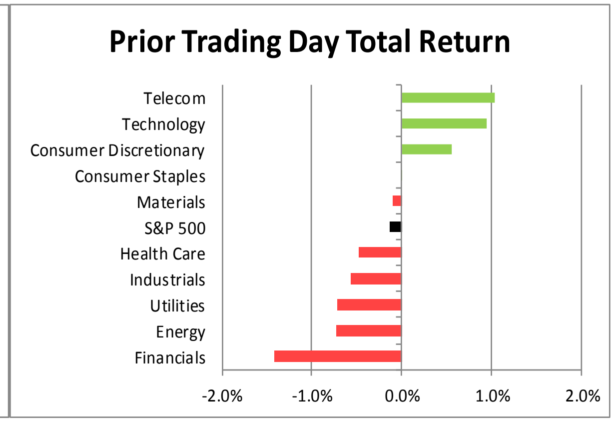
Higher inflation will raise interest rates. We expect monetary policy to remain accommodative in the face of rising inflation due to political pressure on the Federal Reserve. The dollar will likely rally because trade restrictions reduce the global supply of the U.S. currency, driving up the price. The deflationary impact of a stronger dollar will be reduced because of fewer imports, although the imports that do arrive will be cheaper.

We will continue to monitor the progress of policy in the coming months. But, in terms of asset allocation, our committee has started to address these changes and will be reacting in due course.

Data Section

U.S. Equity Markets – (as of 11/16/2016 close)

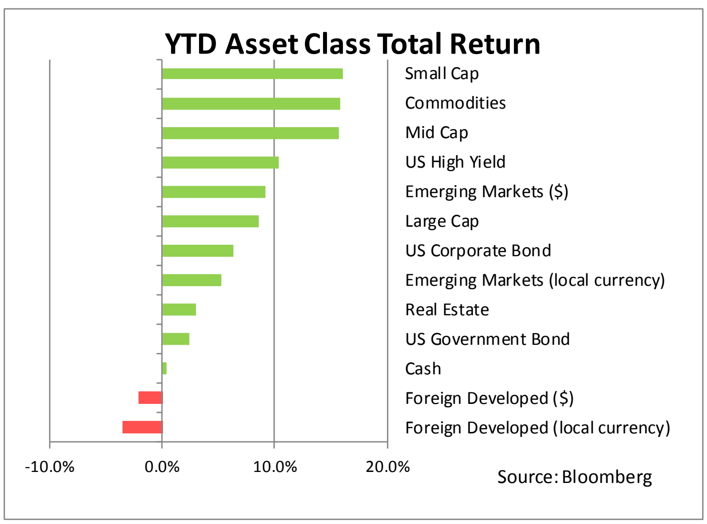




(Source: Bloomberg)

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.

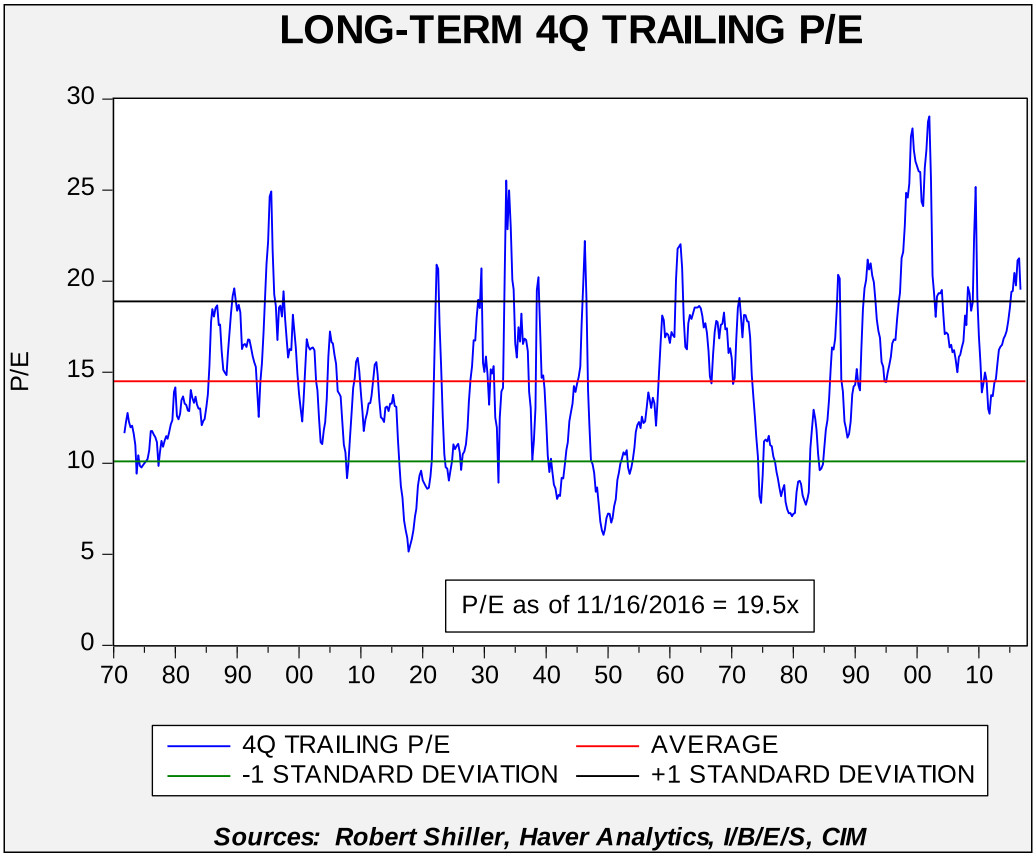
Asset Class Performance – (as of 11/16/2016 close)



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
November 17, 2016



Based on our methodology,[2] the current P/E is 19.5x, up 0.4x from last week. The rise in the P/E is due to the fact that we now have enough data that S&P has projected its earnings report for Q3. Although earnings are up strongly, the divergence we have noted in the past continues between Thomson-Reuters and S&P.

[2] 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 the actual (Q1,Q2 and Q3) and one estimate (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.