Confluence
INVESTMENT MANAGEMENT

Daily Comment

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

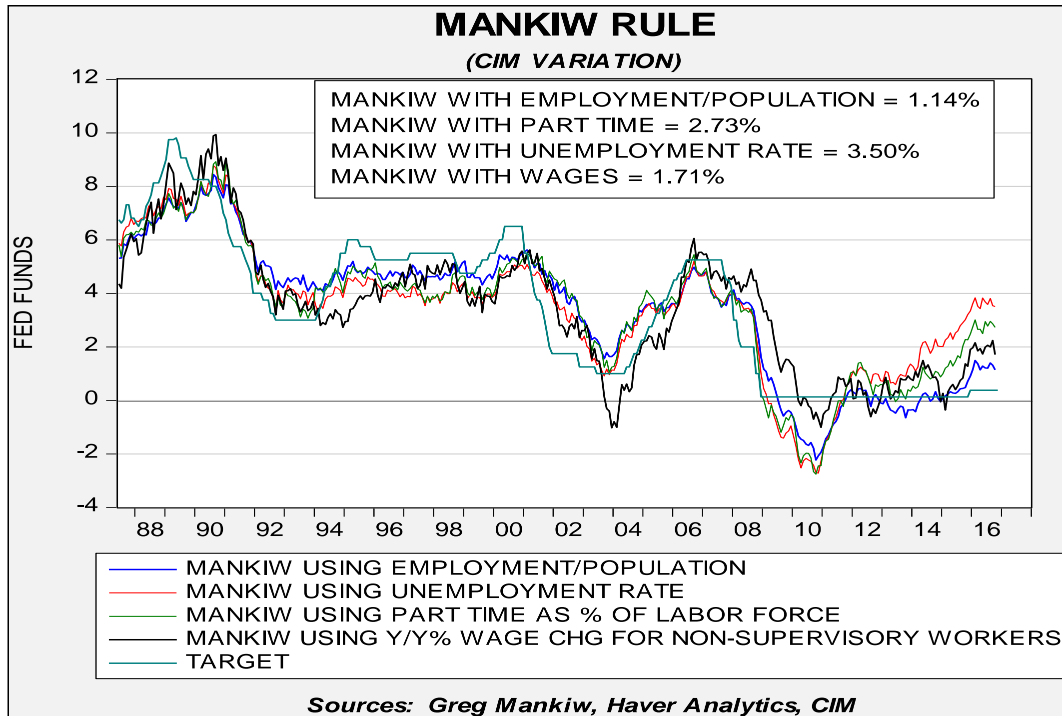
[Posted: November 18, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.2% higher from the prior close. Chinese markets were lower, with the Shanghai composite down 0.5% and the Shenzhen index down 0.3%. U.S. equity futures are signaling a higher opening. With 475 companies having reported, the S&P 500 Q3 earnings stand at $31.25, higher than the $29.23 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 73.0% of the companies reported earnings above forecast, while 20.7% reported earnings below forecast.

It was another quiet night with lots of political speculation and some news. Gen. Michael Flynn was apparently offered National Security Advisor, and Sen. Jeff Session has been offered Attorney General, according to the AP. Meanwhile, in the markets, we are seeing some moderation in recent trends, which looks more like position-squaring in front of the weekend.

Reports from the OPEC meeting are mixed. On the one hand, all the comments from the meetings seemed quite optimistic. However, there is a noticeable lack of substance coming from the meetings. Iran and Iraq both want a deal as long as they can produce as much as they want. Nigeria and Libya want exceptions due to persistent unrest in these countries. Russia wants a deal as well, but has indicated its contribution will be to freeze production levels at current record levels. As is usually the case, OPEC will put together a deal if the Saudis are willing to shoulder most of the burden of market share loss. For the most part, the Kingdom does not want the swing producer role. The unknown here is whether financial conditions have deteriorated enough for the Saudis to accept the market share loss for higher prices, knowing full well that American shale producers, bolstered by a Trump presidency, will likely keep raising production on the back of higher prices. Our expectation is that we get a widely trumpeted agreement with little substance. If so, expect some market disappointment in oil, but probably not a drop much more than $40. However, we are growing more concerned about the dollar's strength, which, thus far, has not weakened oil as much as we would normally expect. To some extent, the dollar rally is putting more pressure on OPEC to make a substantive deal.

With the release of CPI data, we can update our versions of the Mankiw rule model. This model attempts 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 by 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 3.50%. Although this rate is well above fair value, it dropped 5 bps over the past month on the dip in core CPI. Using the employment/population ratio, the neutral rate is 1.13%, down 17 bps. Using involuntary part-time employment, the neutral rate is 2.73%, down 14 bps. And, for the new model using yearly wage growth, the neutral rate is 1.71%. To some extent, the Mankiw models, based off the Phillips Curve, do suggest that the FOMC is behind the curve but the degree of stimulus has actually eased over the past month. Thus, the case for a rate hike has weakened to some extent. However, we don't expect this will change the expectations for a December hike.

U.S. Economic Releases

There was no economic news prior to the release of this publication. The table below lists the Fed speakers and events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Leading Index	m/m	nov	0.1%	0.2%	**
11:00	Kansas City Manf. Activity	m/m	nov		6	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
9:30	Esther George Speaks in Houston	President of the Federal Reserve Bank of Kansas City				
9:35	William Dudley will Speak in New York	President of the Federal Reserve Bank of New York				
21:45	Jerome Powell Speaks in San Francisco	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								
New Zealand	ANZ Consumer Confidence Index	y/y	nov	127.2	122.9		**	Equity and bond neutral
	Retail Sales Ex Inflation	q/q	nov	0.9%	2.3%	0.9%	**	Equity and bond neutral
EUROPE								
Eurozone	Current Accout Balance	y/y	sep	$29.8 bn	$23.6 bn		**	Equity and bond neutral
Germany	PPI	y/y	oct	-0.4%	-1.4%	-0.9%	**	Equity and bond neutral
Italy	Current Accout Balance	y/y	sep	2.81 bn	3.368 bn		**	Equity bearish, bond bullish
Russia	Money Supply Narrow Def	w/w	nov	8.58 tn	8.54 tn		*	Equity and bond neutral
	PPI	y/y	oct	3.1%	4.2%		**	Equity and bond neutral
	Unemployment Rate	y/y	oct	5.4%	5.4%	5.2%	***	Equity and bond neutral
	Real Disposable Income	y/y	oct	-5.9%	-2.8%	-3.7%	**	Equity bearish, bond bullish
	Real Wage	y/y	oct	2.0%	2.8%	2.4%	**	Equity and bond neutral
	Retail Sales	y/y	oct	-4.4%	-3.6%	-3.0%	**	Equity bearish, bond bullish
AMERICAS								
Canada	CPI Core	y/y	oct	1.7%	1.8%	1.8%	***	Equity and bond neutral
	CPI	y/y	oct	1.5%	1.3%	1.5%	***	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)	91	91	0	Neutral
3-mo T-bill yield (bps)	42	42	0	Neutral
TED spread (bps)	49	48	1	Up
U.S. Libor/OIS spread (bps)	57	57	0	Neutral
10-yr T-note (%)	2.28	2.30	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	51	51	0	Neutral
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	up			Down
pound	down			Down
franc	down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Mexico Overnight Rate	5.25%	4.75%	5.25%	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	$46.80	$46.49	0.67%	OPEC Meeting Optimism
WTI	$45.70	$45.42	0.62%	
Natural Gas	$2.76	$2.70	2.00%	
Crack Spread	$12.46	$12.44	0.14%	
12-mo strip crack	$13.77	$13.77	-0.01%	
Ethanol rack	$1.70	$1.70	0.19%	
Metals				
Gold	$1,212.09	$1,216.42	-0.36%	Strengthening Dollar
Silver	$16.66	$16.68	-0.11%	
Copper contract	$249.35	$250.20	-0.34%	
Grains				
Corn contract	$ 352.00	$ 349.75	0.64%	Profit Taking
Wheat contract	$ 419.00	$ 420.00	-0.24%	
Soybeans contract	$ 987.25	$ 989.50	-0.23%	
Shipping				
Baltic Dry Freight	1231	1145	86	
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)	30.00	28.00	2.00	

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.

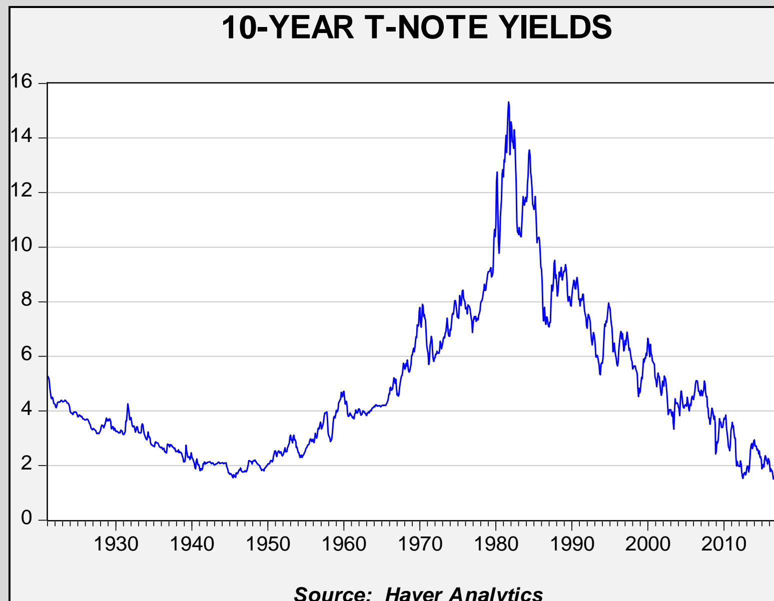
Asset Allocation Weekly Comment

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.

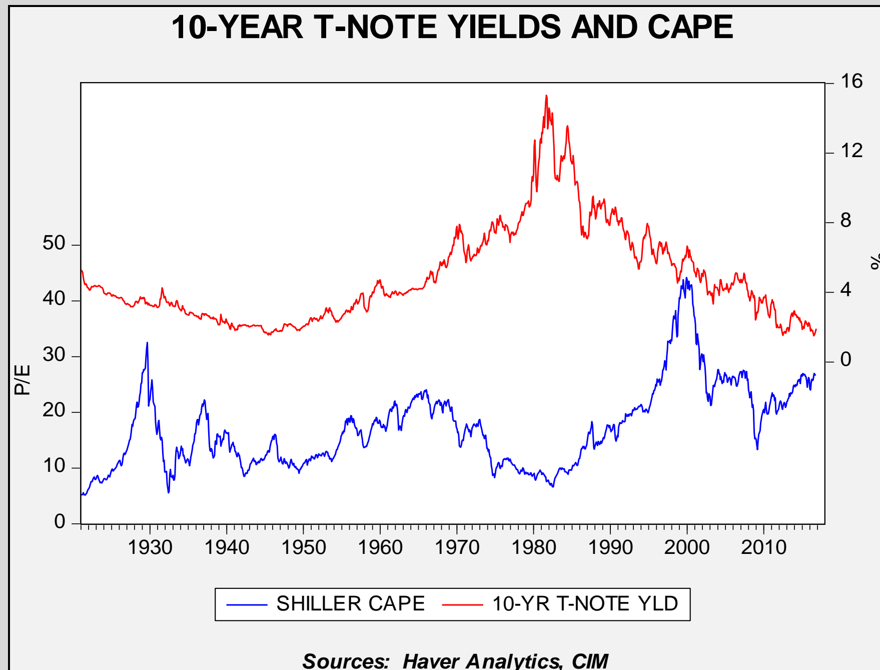
November 18, 2016

Trumponomics looks as if it will be a combination of fiscal stimulus, trade restrictions and deregulation. It looks very likely that environmental regulations will be reversed and there have been promises of financial deregulation as well. The first two will likely reflate the economy. Proposed deregulation may help hold down energy prices but financial services are not a major contributor to inflation (only about 0.24% in CPI) anyway.

With reflation on the horizon, we have seen a rise in the 10-year yield. Even though we would expect a retreat in yield during the next recession, it is likely that the secular bond bull market that began in the early 1980s is coming to a close.

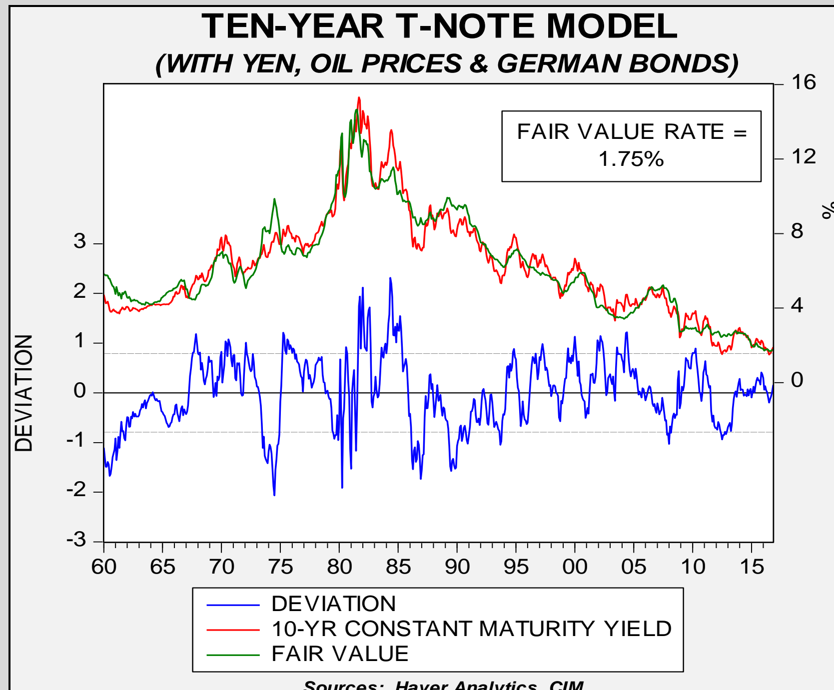


The chart above shows the 10-year T-note yield from 1921. Perhaps the most important issue to remember is that when the last secular bear market began after the lows were made in 1945, the next peak took 36 years. It took eight years before yields doubled. Although the regulatory environment is different, it takes a while for bond yields to reach really high levels. Still, the tailwind for financial assets that this bull market represents is noteworthy.



This chart shows the 10-year T-note yield and the cyclically adjusted price/earnings ratio (CAPE) that was developed by Robert Shiller. The CAPE deflates earnings and stock prices and then averages earnings over a decade, generating a P/E that is designed to capture the underlying trend in real earnings. Note that the P/E rose from 1950 to 1965 even though rates rose. However, as inflation steadily increased, interest rates and the P/E moved in opposite directions. Casual observation suggests that rates above 4% and rising lead to a lower multiple.

How high will interest rates rise? Our broad 10-year T-note model puts the fair value yield at 1.75%.



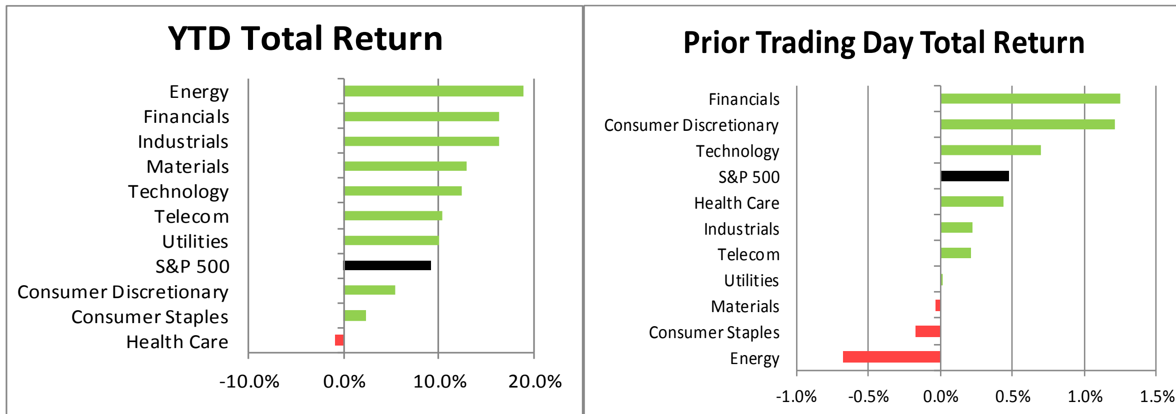
The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The most important variable keeping the fair value low are German bond yields; removing those from the model boosts the fair value yield to 2.42%. In a less globalized world, the impact of foreign rates might be reduced, so there is a concern the model is underestimating the fair value yield. However, as long as capital flows remain open, the impact of lower German yields should be a bullish factor for long-duration Treasuries. In addition, if we assume a 25 bps hike in fed funds next month, the fair value yield would increase to 1.84%.

Overall, a case can be made that the recent spike in long-duration yields is overdone, at least in the short run. On the other hand, as we discussed in the most recent WGR, if the U.S. retreats from the superpower role, inflation expectations will likely rise and weaken the case for holding long-duration instruments. We continue to closely monitor the fixed income markets but it does appear that the long bull market in Treasuries may be coming to an end.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

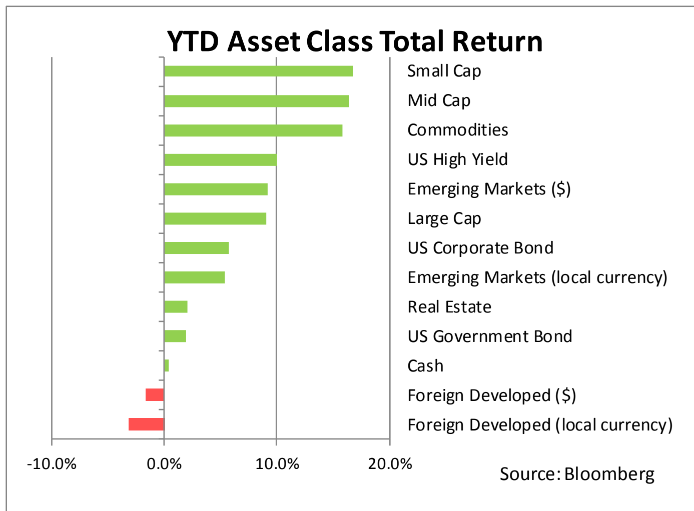
U.S. Equity Markets – (as of 11/17/2016 close)



(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.

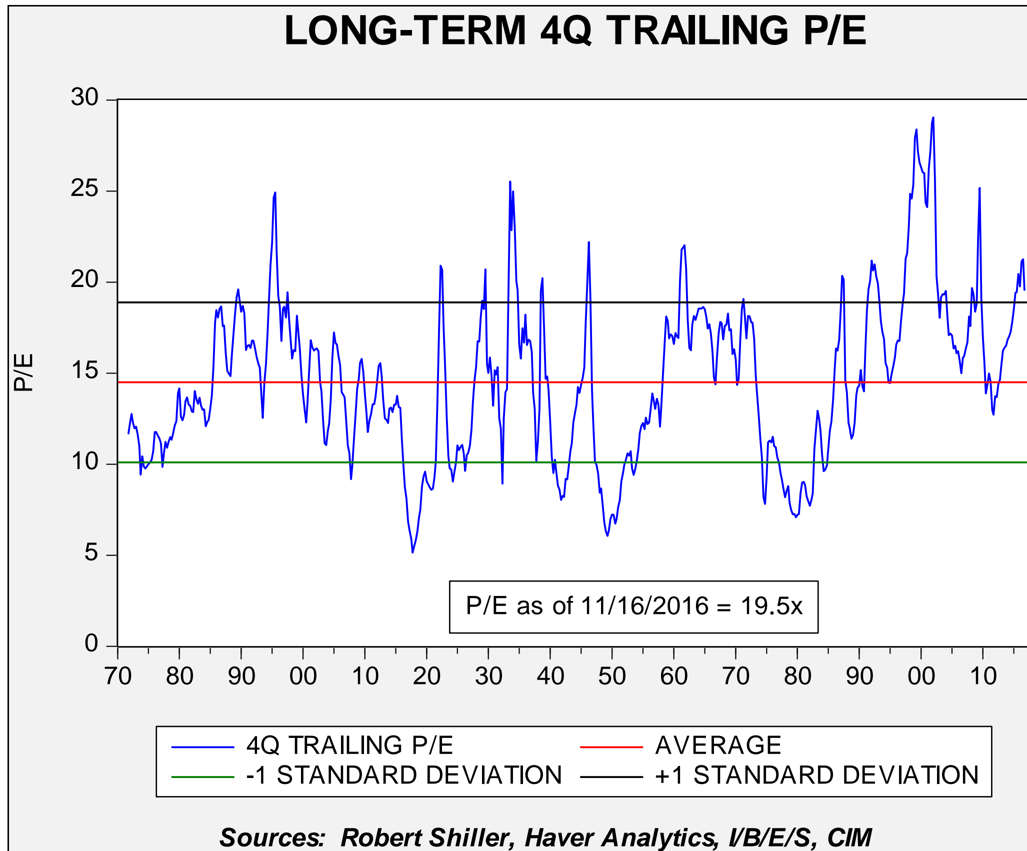
Asset Class Performance – (as of 11/17/2016 close)



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,[1] 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.

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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[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 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.