Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: November 21, 2016—9:30 AM EST] Global equity markets are up this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.2% higher from the prior close. Chinese markets were higher, with the Shanghai composite up 0.8% and the Shenzhen index up 0.4%. U.S. equity futures are signaling a higher opening. With 476 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, 73.1% of the companies reported earnings above forecast, while 20.6% reported earnings below forecast.

The weekend's news flow seemed to be all about the president-elect. Perhaps the most interesting was an interview in the *Hollywood Reporter*[1] with Steve Bannon, the incoming president's chief strategist. Bannon outlined his policies and it dovetails with our read on him and the incoming administration. Bannon describes himself as an "economic nationalist." He views himself and the incoming administration as similar to Andrew Jackson, a position with which we would agree. His goal is to support the working class who have mostly been on the negative side of globalization and deregulation. In particular, he appears to want to create a coalition similar to Roosevelt's. This coalition was a combination of center-left establishment and right-wing populists. Bannon's appears to be comprised of center-right establishment and right-wing populists. However, we have serious doubts that the center-right can accept the goals of the right-wing populists. We have noted Ralph Nader's book, *Unstoppable*, which called for a political coalition of populists on the left and right. Although still a long shot, the likelihood of such an outcome is probably higher than it's been for a while. We continue to closely monitor comments from Sen. Sanders with regard to the president-elect's policies.

A *WSJ* article[2] today highlights the uneasy relationship between the center-right and the right-wing populists. Here is a good quote:

> One group, which appeared ascendant in the closing weeks of the campaign, largely rejects mainstream economic thinking on trade and believes eliminating trade deficits should be an overarching goal of U.S. policy. That camp views sticks—tariffs on U.S. trading partners and taxes on companies that move jobs abroad—as critical tools to reverse a 15-year slide in incomes for middle-class Americans.

[1] http://www.hollywoodreporter.com/news/steve-bannon-trump-tower-interview-trumps-strategist-plots-new-political-movement-948747
[2] http://www.wsj.com/articles/inside-donald-trumps-economic-team-two-very-different-views-1479643204

> The opposing camp is closer to the traditional GOP center of gravity on taxes and regulation and includes many policy veterans staffing the transition team and advising Vice President-elect Mike Pence.
>
> Those advisers have long championed supply-side economics and reject the hard-line position on trade that one side's gain must come at the other's expense. By offering more carrots—slashing red tape and taxes to make the U.S. the top destination for businesses—they say stronger growth would obviate any need for trade protectionism.

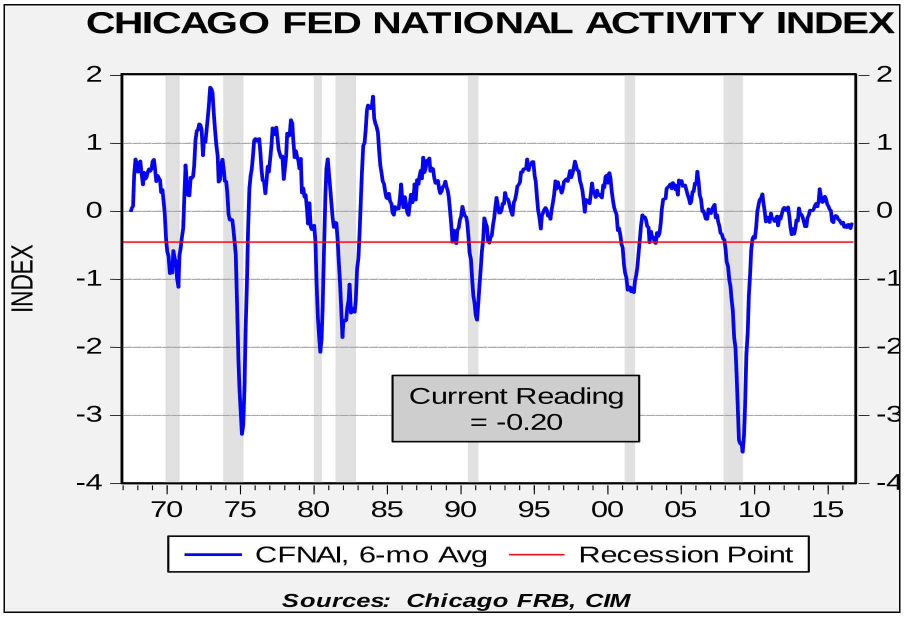
If the latter group wins, we will probably get a fairly standard issue plan of deregulation, tax cuts and pressure on the FOMC to raise rates. Trade protectionism will be token, if at all. If this side wins, we would expect Trump to be popular on Wall Street but probably a one-term president. If the first group wins out, the economy will be much different; trade barriers will rise, reregulation will occur and tax cuts will be modest at best. This outcome would be unpopular for Wall Street but wildly popular in the "flyover zone." At this point, it's unclear who will win. But, for the most part, this is one of the key issues.

In foreign news, Chancellor Merkel has made it official. She will run for another term. At this juncture, she will likely win in next autumn's elections. On the other hand, if there has been any trend it's that betting on the establishment has been a poor wager. It also appears that the Italian referendum is in trouble. The *FT* notes that Chairman Xi was actively wooing Pacific nations in light of the Trump win, the end of the "pivot" to Asia and the end of TPP.

Finally, oil prices are higher again this morning in anticipation of an OPEC deal. This lift is flying in the face of a stronger dollar and the massive inventory overhang. We expect a deal of sorts to be made. We also suspect it will be far short of what is necessary to boost prices and will disappoint the markets. If we are right, prices will trend toward $50 per barrel into Nov. 30th and pull back in the wake of the meeting. Overall, however, oil prices are mostly in a $40 to $50 trading range; we expect that to hold.

U.S. Economic Releases

The October Chicago Federal Reserve National Activity Index was -0.08, slightly below the forecast of no change. The prior month was revised lower to -0.23 from the -0.14 previously reported. The index indicates that the economy is still growing below its long-term trend. When the index reading is below zero, economic growth is slower than its trend. However, we are still above the recession point, which is indicated in red in the chart below.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The average remained steady at -0.20 from the month before.

There are no further domestic releases or economic events scheduled for today.

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	Trade Balance	y/y	oct	496.2 bn	493.3 bn	610.0 bn	**	Equity bearish, bond bullish
	Exports	y/y	oct	-10.3%	-6.9%	-8.5%	**	Equity bearish, bond bullish
	Imports	y/y	oct	-16.5%	-16.3%	-16.1%	**	Equity and bond neutral
	All Industry Activity Index	y/y	sep	0.2%	0.2%	0.0%	**	Equity and bond neutral
	Supermarket Sales	m/m	oct	0.6%	-3.2%		**	Equity and bond neutral
	Convenience Store Sales	y/y	oct	0.2%	0.0%		**	Equity and bond neutral
New Zealand	Credit Card Spending	y/y	oct	10.2%	8.2%		**	Equity and bond neutral
EUROPE								
Switzerland	Money Supply M3	y/y	oct	2.9%	3.0%		**	Equity and bond neutral
	Total Sight Deposits	y/y	nov	524.7 bn	519.9 bn		**	Equity and bond neutral
	Domestic Sight Deposits	w/w	nov	458.4 bn	449.8 bn		**	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)	92	91	1	Up
3-mo T-bill yield (bps)	43	43	0	Neutral
TED spread (bps)	49	48	1	Up
U.S. Libor/OIS spread (bps)	57	57	0	Neutral
10-yr T-note (%)	2.32	2.36	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	52	51	1	Up
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	up			Down
pound	up			Down
franc	up			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	$47.87	$46.86	2.16%	OPEC Meeting Optimism/ Weakening Dollar
WTI	$46.63	$45.69	2.06%	
Natural Gas	$2.92	$2.84	2.74%	
Crack Spread	$12.56	$12.21	2.81%	
12-mo strip crack	$13.94	$13.63	2.27%	
Ethanol rack	$1.72	$1.72	0.00%	
Metals				
Gold	$1,215.72	$1,207.89	0.65%	Commodity Prices Rising
Silver	$16.70	$16.57	0.82%	
Copper contract	$253.45	$247.80	2.28%	
Grains				
Corn contract	$ 353.50	$ 353.50	0.00%	
Wheat contract	$ 426.25	$ 425.25	0.24%	
Soybeans contract	$ 1,002.75	$ 993.75	0.91%	
Shipping				
Baltic Dry Freight	1257	1231	26	

Weather

The 6-10 and 8-14 day forecasts show cooler temperatures for the western region and mild weather for the rest of the country. Precipitation is also expected for most of the country. There is a tropical depression developing in the Caribbean Sea, which is out of season, but it does not appear likely to enter the GOM.

Asset Allocation Weekly Comment

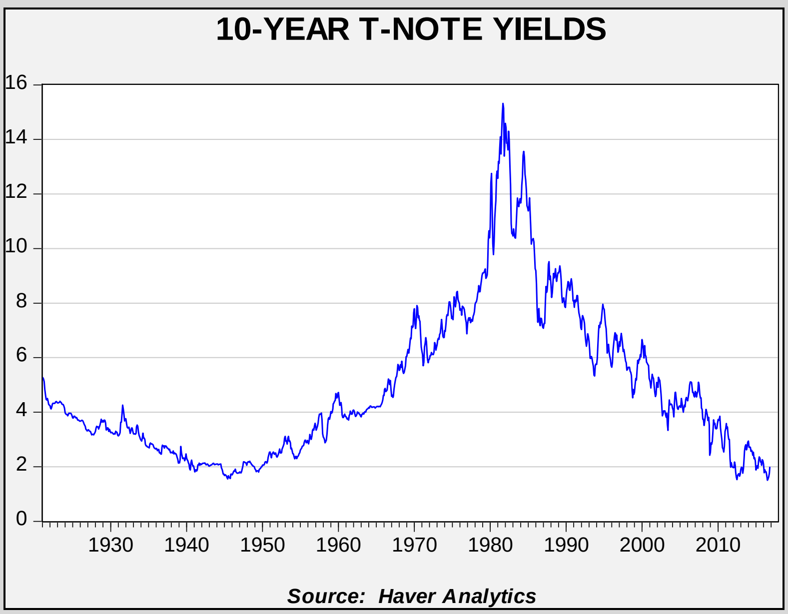
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

Due to the Thanksgiving holiday we will not be publishing a new Asset Allocation Weekly Comment this week. We will resume on Friday, December 2.

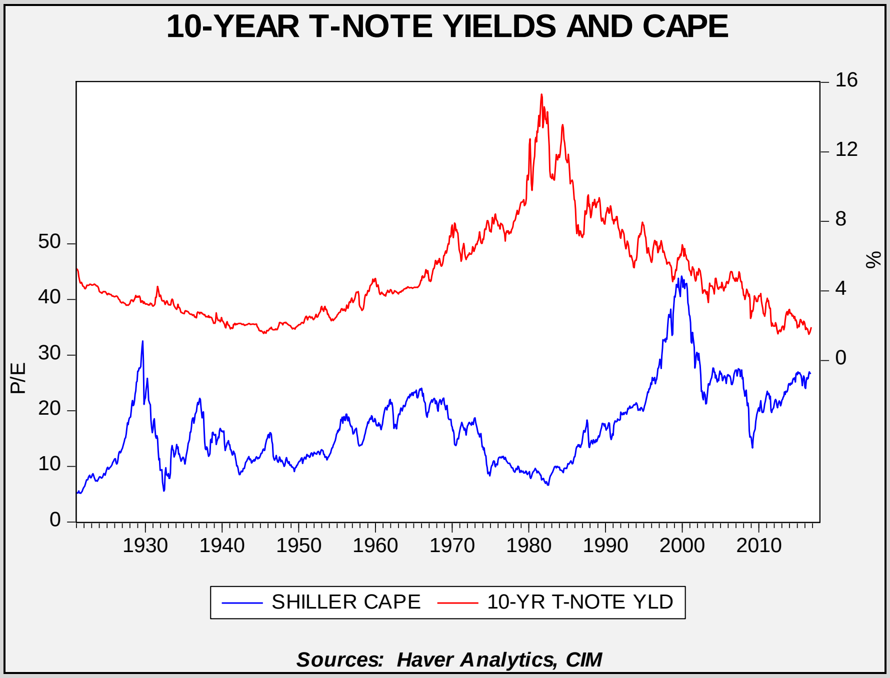
November 18, 2016

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.

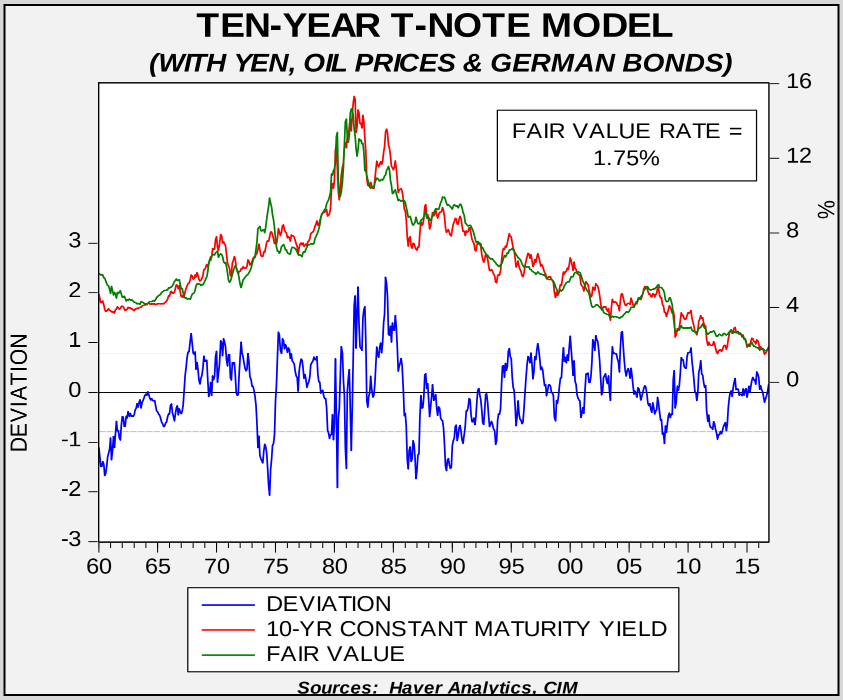


The chart above shows the 10-year T-note yield from 1921. Perhaps the most important issue to remember is that when the last secular bear market began after the lows were made in 1945, the next peak took 36 years. It took eight years before yields doubled. Although the regulatory environment is different, 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%.

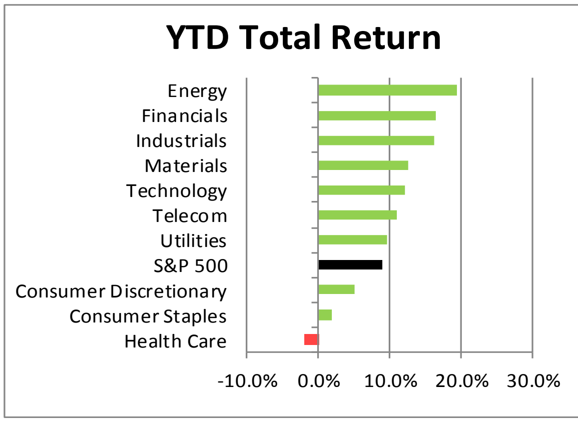


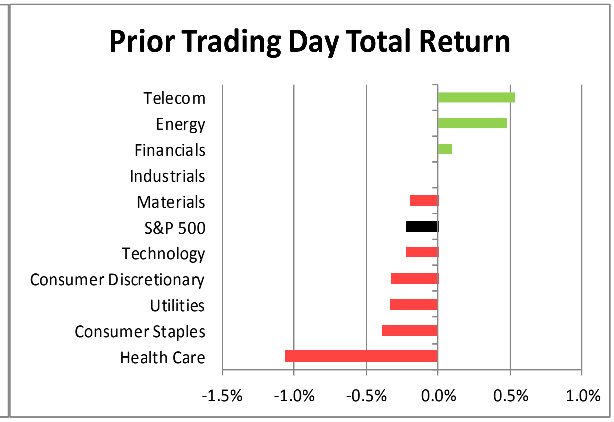
The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The most important variable keeping the fair value low are German bond yields; removing those from the model boosts the fair value yield to 2.42%. 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.

Data Section

U.S. Equity Markets – (as of 11/18/2016 close)

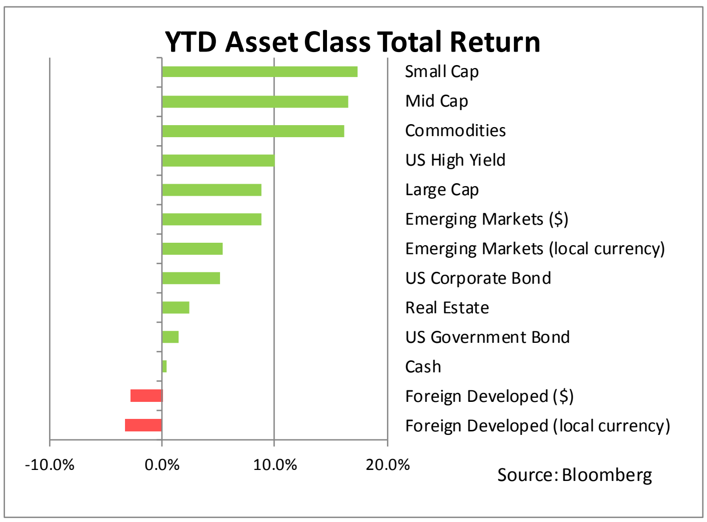




(Source: Bloomberg)

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 11/18/2016 close)



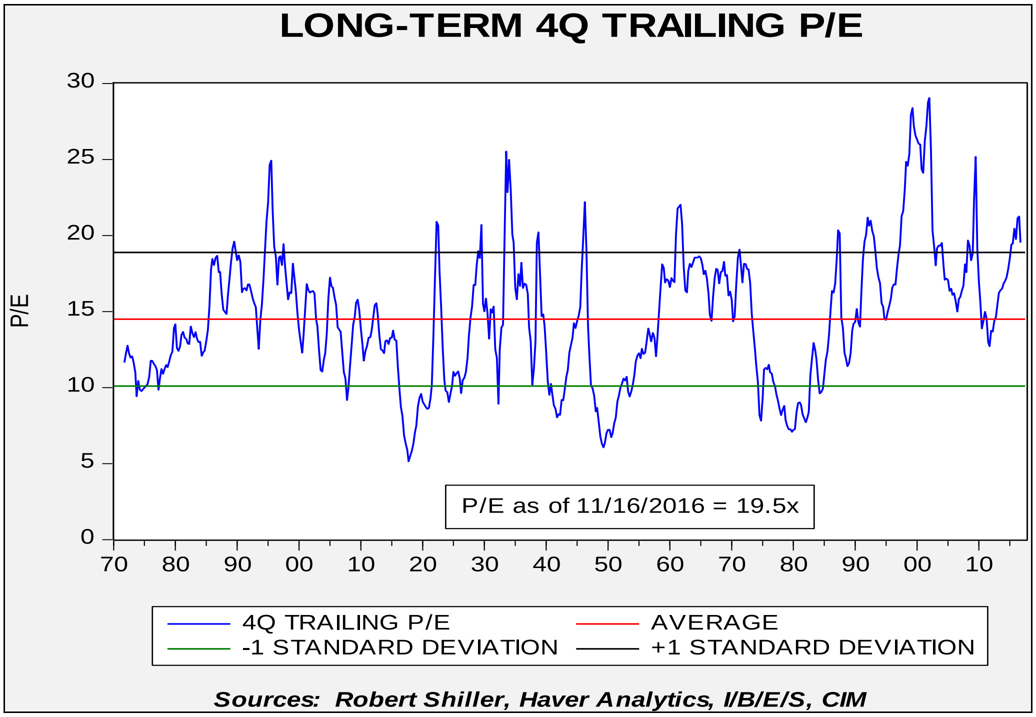
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

Due to the Thanksgiving holiday we will not be updating the P/E chart this week. We will resume on Thursday, December 1.

November 17, 2016



Based on our methodology,[3] 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.

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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 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.