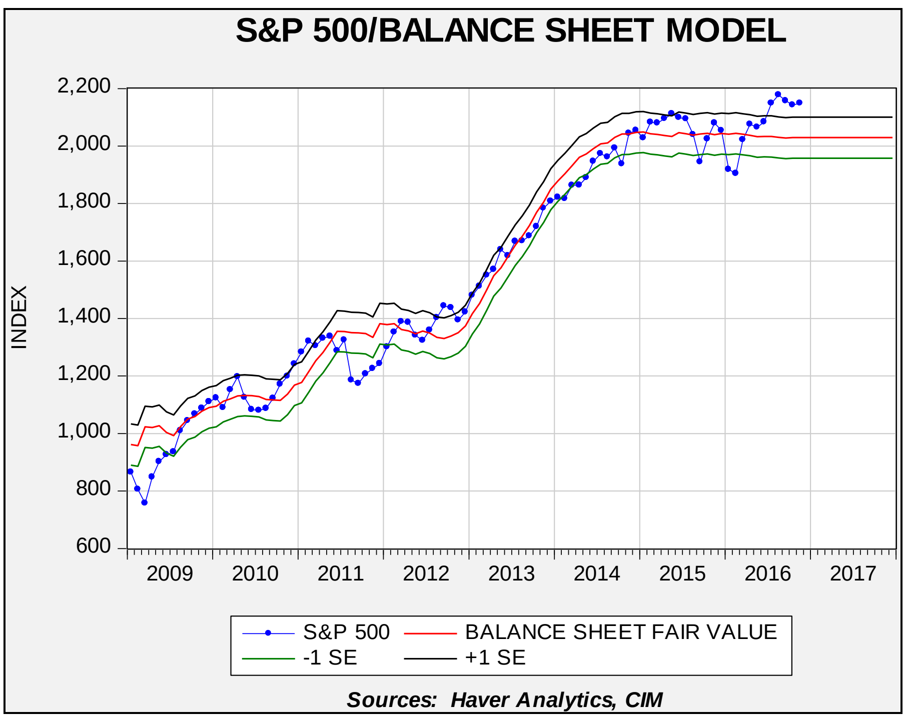
Daily Comment

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

[Posted: November 22, 2016—9:30 AM EST] Global equity markets are up this morning. The EuroStoxx 50 is up 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed 1.6% higher from the prior close. Chinese markets were higher, with the Shanghai composite up 0.9% and the Shenzhen index also up 0.9%. U.S. equity futures are signaling a higher opening. With 477 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, 72.9% of the companies reported earnings above forecast, while 20.8% reported earnings below forecast.

Equities continue to move higher in the post-election environment. This rise is coming in the face of virtual certainty that the FOMC will raise rates next month. We may be starting to see a shift in market sentiment away from the focus on monetary policy toward economic growth.



This chart shows a model of the S&P 500 using the Fed's balance sheet as the independent variable. Since 2009, the relationship has been quite close; the mostly sideways market seen since 2014 is consistent with tapering. However, since the middle of the year, we have seen equities persistently exceed the upper band of the model. Either equities are overvalued (fair value based on this model is 2029) or the relationship is starting to break down. We are leaning toward the latter. Both presidential candidates were calling for fiscal expansion with Trump's admittedly vague promises expected to be larger than Clinton's. If we are shifting toward economic growth and away from policy, it means the FOMC may be able to raise rates and have less impact on equities than the past few years would have suggested. On the other hand, equities may become more sensitive to economic growth and if there are delays in fiscal expansion or we fail to see growth pick up, equities could be vulnerable to weakness. In the near term, however, hopes are high that Trump and a GOP Congress will be able to move on policy changes.

We do note that President-elect Trump gave a statement yesterday in which he indicated the U.S. would formally remove itself from the TPP group. Japanese PM Abe indicated that TPP is "meaningless" without the U.S. We would agree.

Meanwhile, optimism surrounding OPEC remains elevated. Nigeria was the most recent cartel nation to comment on the proximity of a deal. However, in the past hour, oil prices have begun to slide. We have probably reached a price point that OPEC must now deliver. If they fail to negotiate a credible deal, oil prices will be vulnerable to a sharp decline. Given the EUR/WTI relationship since 2012, a 1.06 €/$ exchange rate translates into a WTI price of $35.80.

U.S. Economic Releases

There were no domestic releases prior to the release of this publication. The table below lists the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Richmond Fed. Manufacturing Index	m/m	oct	0	-4	**
10:00	Existing Home Sales	m/m	oct	5.44m	5.47m	**

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	Nationwide Dept Sales	y/y	oct	-3.9%	5.0%		**	Equity bearish, bond bullish
	Tokyo Dept Sales	y/y	oct	-4.4%	-3.4%		**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	y/y	sep	115.5	118.2		**	Equity and bond neutral
EUROPE								
UK	Public Finance	y/y	oct	-3.4 bn	13.3 bn		**	Equity bearish, bond bullish
	Central Government	y/y	oct	- 4.0 bn	22.5 bn		**	Equity bearish, bond bullish
	Public Sector Net Borrowing	y/y	oct	4.3 bn	10.0 bn	6.0 bn	**	Equity and bond neutral
	PSNB ex Banking Groups	y/y	oct	4.8 bn	10.6 bn	6.0 bn	**	Equity and bond neutral
	CBI Trends Total Orders	y/y	nov	-3	-17	-8	**	Equity and bond neutral
	CBI Trends Selling Prices	y/y	nov	19	-8		**	Equity bullish, bond bearish
Switzerland	Trade Balance	y/y	oct	2.68 bn	4.37 bn	3.88 bn	**	Equity and bond neutral
	Exports Real	y/y	oct	-4.7%	4.3%		**	Equity bearish, bond bullish
	Import Real	y/y	oct	2.8%	-3.3%		**	Equity bearish, bond bullish
AMERICAS								
Canada	Retail Sales	m/m	sep	0.6%	-0.1%	0.6%	**	Equity and bond neutral
	Retail Sales ex Auto	m/m	sep	0.0%	0.0%	0.5%	**	Equity and bond neutral
Brazil	Current Accout Balance	y/y	oct	-3.339 bn	-.465	-3.1 bn	**	Equity and bond neutral
	Foreign Direct Investment	y/y	oct	8.4 bn	5.233 bn	6.5 bn	**	Equity bullish, bond bearish

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)	46	47	-1	Down
TED spread (bps)	46	44	2	Up
U.S. Libor/OIS spread (bps)	59	57	2	Up
10-yr T-note (%)	2.29	2.32	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	55	53	2	Up
Currencies	**Direction**			
dollar	up			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	$48.74	$48.90	-0.33%	Strengthening Dollar
WTI	$47.92	$48.24	-0.66%	
Natural Gas	$2.92	$2.95	-1.02%	
Crack Spread	$13.09	$12.49	4.80%	
12-mo strip crack	$14.44	$14.08	2.56%	
Ethanol rack	$1.74	$1.73	0.75%	
Metals				
Gold	$1,216.10	$1,214.23	0.15%	Commodity Prices Rising
Silver	$16.81	$16.59	1.29%	
Copper contract	$255.85	$252.75	1.23%	
Grains				
Corn contract	$ 355.25	$ 357.75	-0.70%	
Wheat contract	$ 424.75	$ 427.00	-0.53%	
Soybeans contract	$ 1,019.75	$ 1,020.25	-0.05%	
Shipping				
Baltic Dry Freight	1240	1257	-17	

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. Tropical Storm Otto is developing in the Caribbean Sea, which is out of season, but it does not appear likely to enter the GOM. By Friday, Otto is forecast to reach the Pacific Coast of Costa Rica and cross into the Pacific over the weekend.

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.

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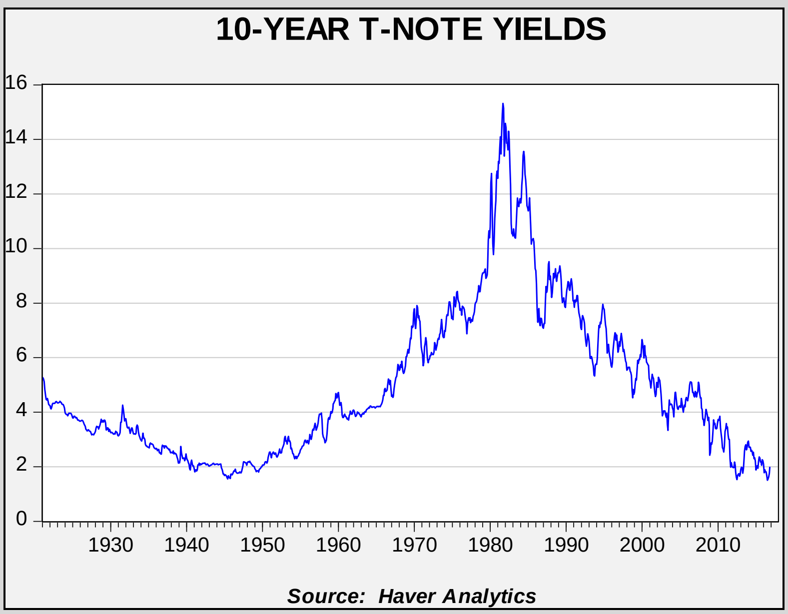
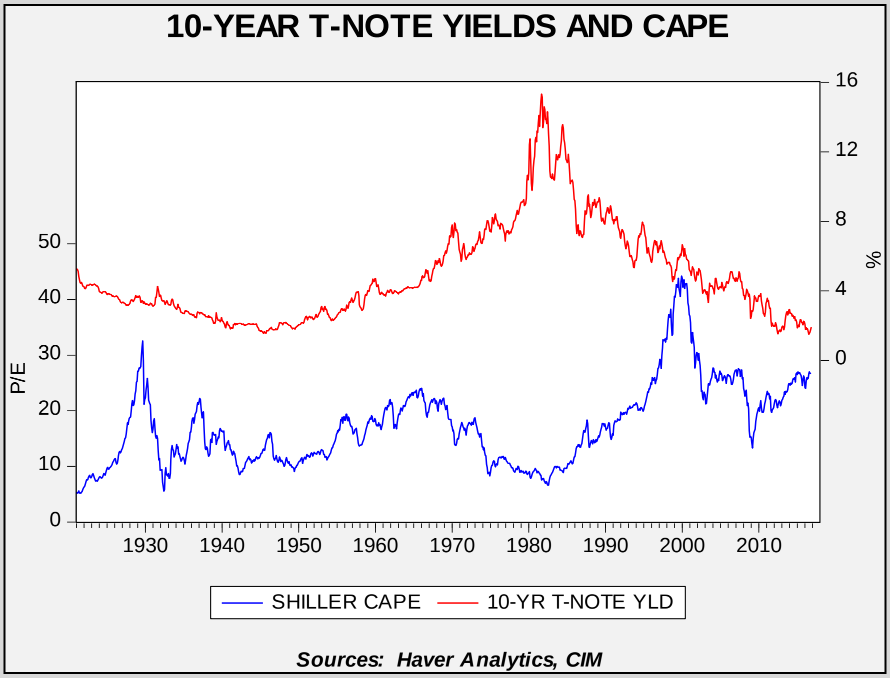
Trumponomics looks as if it will be a combination of fiscal stimulus, trade restrictions and deregulation. It looks very likely that environmental regulations will be reversed and there have been promises of financial deregulation as well. The first two will likely reflate the economy. Proposed deregulation 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.

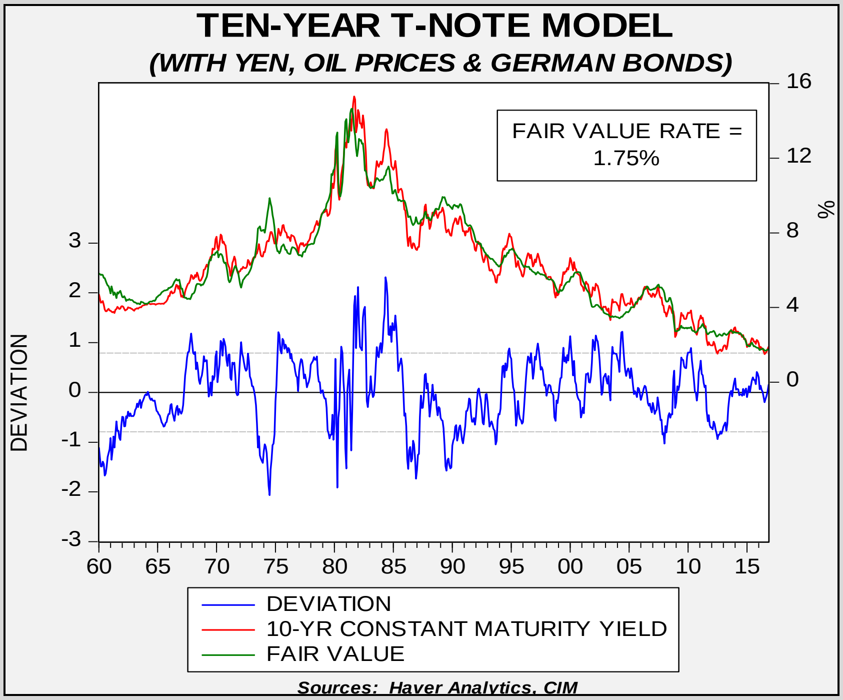


The chart above shows the 10-year T-note yield from 1921. Perhaps the most important issue to remember is that when the last secular bear market began after the lows were made in 1945, the next peak took 36 years. It took eight years before yields doubled. Although the regulatory environment is different,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

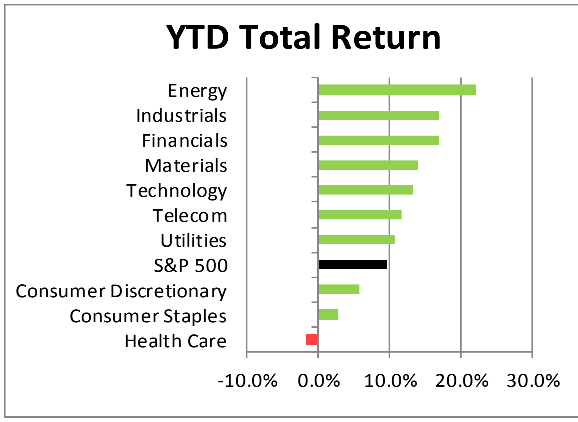


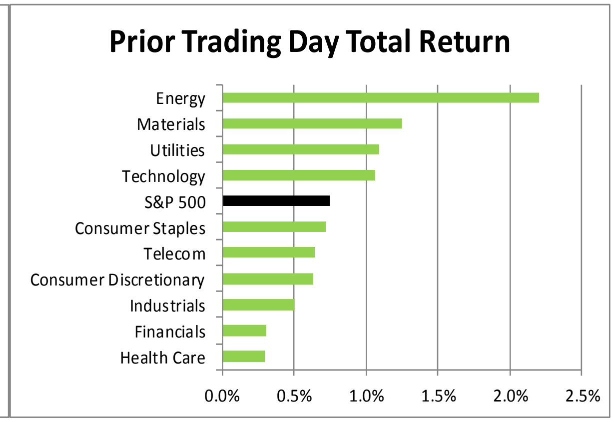
The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The most important variable keeping the fair value low are German bond yields; removing those from the model boosts the fair value yield to 2.42%. 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 11/21/2016 close)

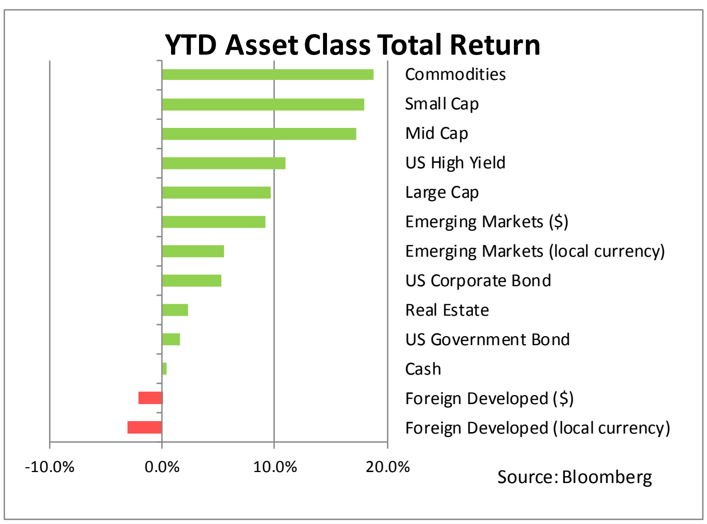




(Source: Bloomberg)

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 11/21/2016 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.

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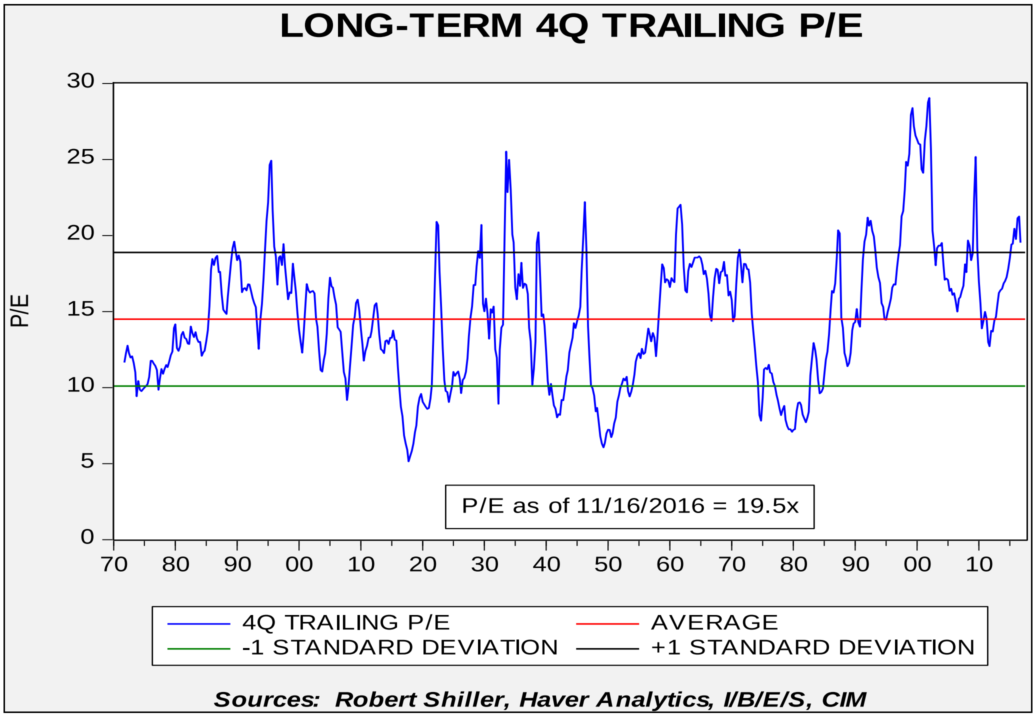

Based on our methodology,[1] the current P/E is 19.5x, up 0.4x from last week. The rise in the P/E is due to the fact that we now have enough data that S&P has projected its earnings report for Q3. Although earnings are up strongly, the divergence we have noted in the past continues between Thomson-Reuters and S&P.

[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.