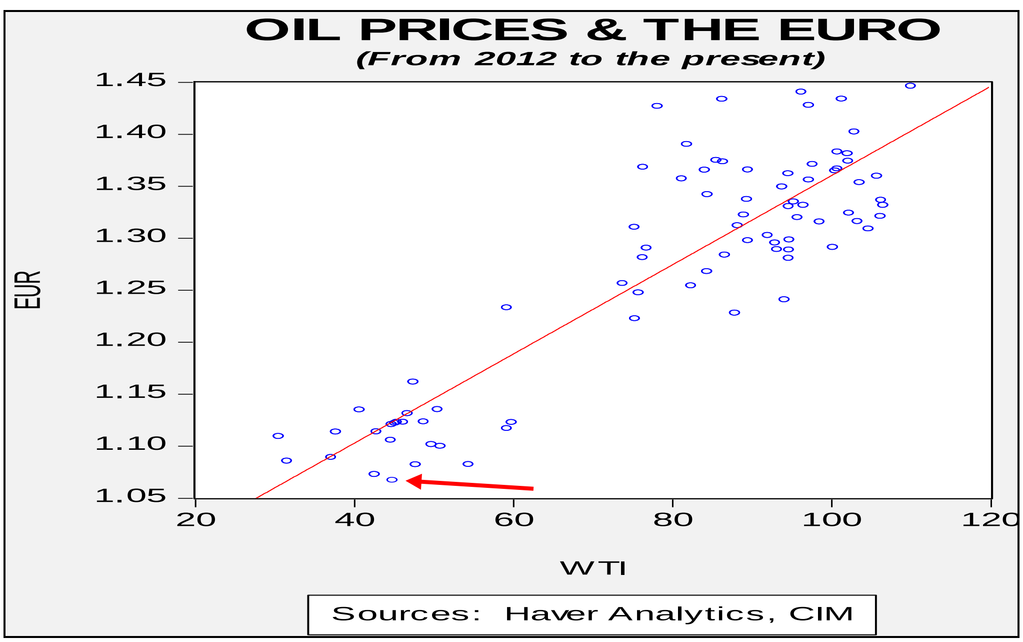
Daily Comment

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

[Posted: November 29, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.3% lower from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index down 0.8%. U.S. equity futures are signaling a sideways to lower open. With 489 companies having reported, the S&P 500 Q3 earnings stand at $31.29, higher than the $29.23 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 72.5% of the companies reported earnings above forecast, while 20.7% reported earnings below forecast.

On the eve of the OPEC meeting, the cartel is struggling to come to an agreement, with Iraq and Iran still insisting on a production freeze above their current levels of output. Russia has decided not to send a delegate. If a deal of substance is going to be made, it will require unilateral cuts from Saudi Arabia. Because oil demand is price inelastic in the short run (which means that a 1% rise in price will lead to a <1% fall in demand), revenue would rise to all producers; however, for Saudi Arabia, any rise in revenue would be less than its rivals. It also runs the risk that non-OPEC producers, mainly U.S. shale producers, will lift output and fill any reductions OPEC makes. Although the odds of a substantial deal are low, we would not be shocked by some sort of face-saving agreement in which non-specific cuts are promised. Unfortunately for the cartel, a deal lacking substance will probably fail to lift the market because the stronger dollar is working against higher oil prices.

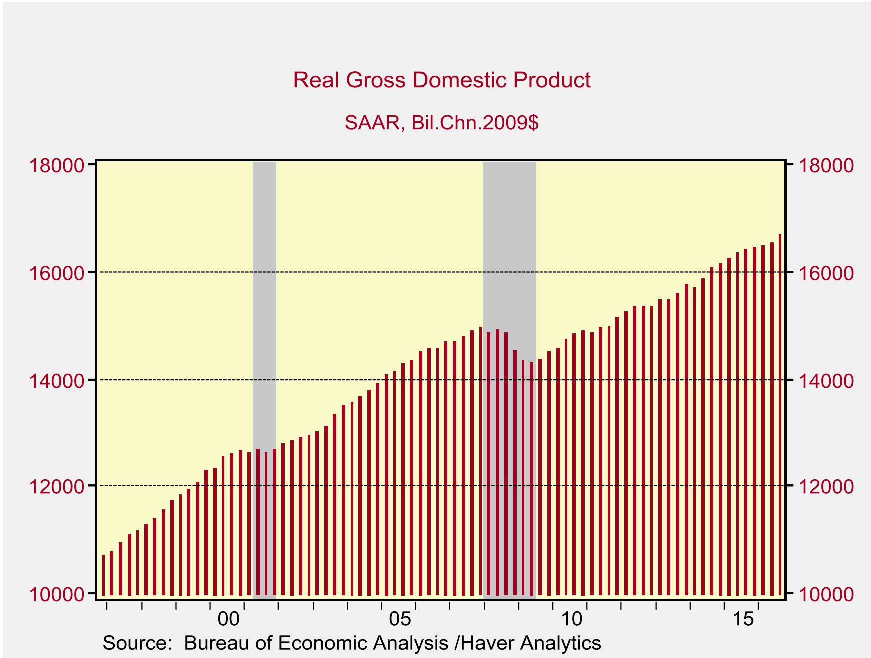


Current oil prices are more consistent with a EUR/USD exchange rate closer to $1.100. For the most part, oil prices have ignored the impact of Trump's election. It seems rather obvious that OPEC hopes have allowed oil prices to levitate in the face of a stronger dollar. But, a disappointing OPEC outcome runs the risk that oil will fall to around $37 per barrel.

It appears that Park Geun-hye, the president of South Korea, is preparing to resign from office. Her administration has been rocked by a scandal where a Rasputin-like figure appears to have used her relationship with the president for personal gain. It is unclear whether the legislature will accept her resignation or press for impeachment. Resignation would probably not be immediate, whereas impeachment would remove her from office more quickly. Park has been facing massive protest rallies against her government as the scandal worsens. What is concerning about this outcome is that as the South Korean government is distracted with internal strife, the geopolitical situation in the Far East is becoming increasingly unstable. The president-elect has officially killed TPP, raising the impression that the next government is ending the "pivot" to Asia, and, as we noted in our recent WGR series, the Philippines has moved toward China. It isn't out of the question that the mercurial leader of North Korea, Kim Jong-un, could view this as an opportunity to "make some noise," which could be anything from nuclear blackmail to military action against the South. We don't think Kim will necessarily do anything rash, but the odds have increased. It behooves the South Korean leadership to act quickly to address the presidential question because the longer the turmoil lasts, the greater the odds are that North Korea takes the opportunity to create problems.

U.S. Economic Releases

Today, revised annualized GDP for Q3 showed an increase of 3.2%, slightly above the forecast of 3.0%. The prior report showed an increase of 2.9% real GDP growth. The revision shows that GDP is stronger than previously thought. Despite tepid GDP growth throughout the last eight years, this period appears to be one of the longest expansions in history. Market expectations anticipate the expansion to continue into the Trump administration as many believe that the increase in infrastructure spending and tax cuts will likely stimulate the economy.

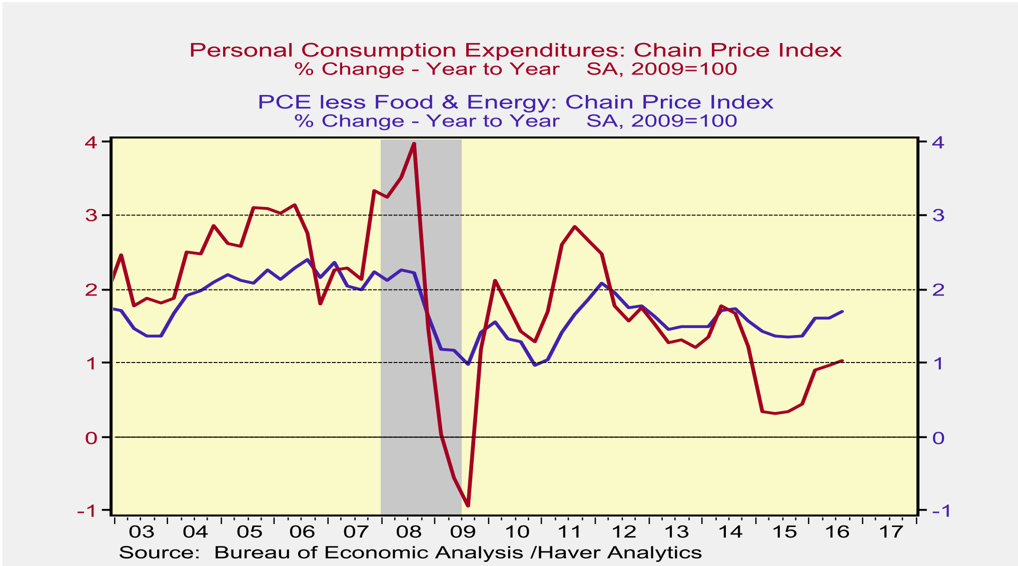


The chart above shows that the economy is still expanding.

	Q2	Q3: 2nd Rev	Q3: Prelim	Q3 Chg
GDP	1.40	3.20	2.90	0.30
Consumption	2.88	1.89	1.47	0.42
Investment	-1.34	0.34	0.52	-0.18
Inventory	-1.16	0.49	0.61	-0.12
Net Exports	0.18	0.87	0.83	0.04
Government	-0.30	0.05	0.09	-0.04

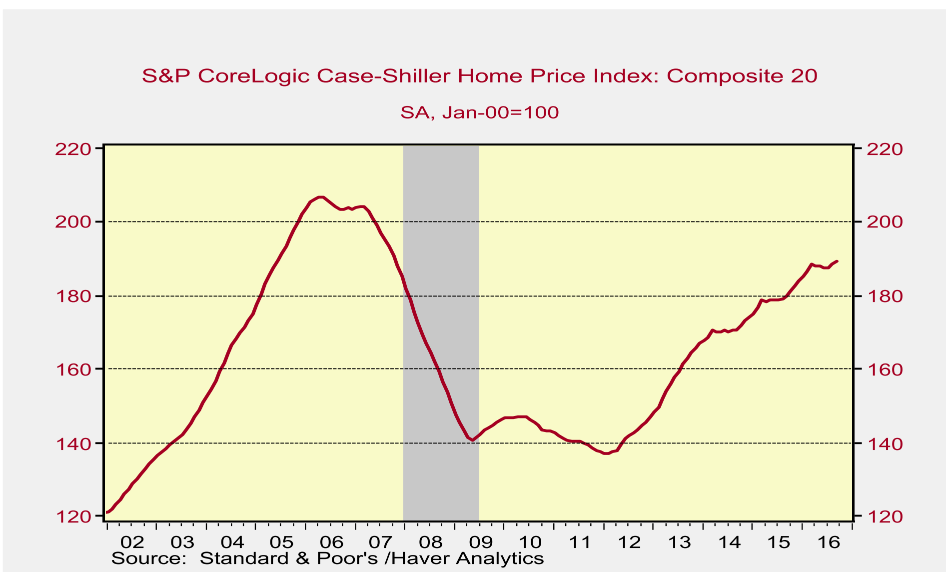
The table above shows the revised contribution to GDP. The increase in GDP is largely attributed to higher than expected consumption in the third quarter.

Personal consumption showed an increase of 2.8%, above the forecast of 2.3%. Core PCE came in at 1.7%, in line with forecasts. Due to the Fed's use of PCE as a barometer for inflation, this report confirms market sentiment that a rate hike will likely happen in December.



The chart above shows the relationship between personal consumption and core personal consumption price deflators. The broader based personal consumption expenditures index has been held down due to falling oil prices, while the core PCE has been increasing steadily toward the Federal Reserve's target of 2% inflation.

The S&P CoreLogic Case-Shiller U.S. National Home Price Index showed an overall increase of 0.83% from the prior month, while the 20-City index showed an increase 0.37%, slightly below the forecast of 0.40%. The prior month's reports were both revised upward, coming in at 0.62% and 0.30%, respectively.



The chart above shows the S&P CoreLogic Case-Schiller Housing Price Index of 20 cities. Housing prices are steadily improving as the housing market responds to recent increases in household wages.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Consumer Confidence Index	m/m	nov	101.5	98.6	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:40	Jerome Powell Speaks on Puerto Rico Economy	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	Jobless Rate	m/m	oct	3.0%	3.0%	3.0%	***	Equity and bond neutral
	Job-to-applicant ratio	m/m	oct	1.40	1.38	1.39	**	Equity and bond neutral
	Overall Household Spending	y/y	oct	-0.4%	-2.1%	-1.0%	**	Equity bullish, bond bearish
	Retail Trade	y/y	oct	-0.1%	-1.9%	-1.6%	**	Equity bullish, bond bearish
	Retail Sales	m/m	oct	2.5%	0.0%	1.1%	**	Equity bullish, bond bearish
	Department Store, Supermarket Sales	y/y	oct	-1.0%	-3.2%	-0.9%	**	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	y/y	nov	106.5	106.3	106.8	**	Equity and bond neutral
	Business Climate Indicator	y/y	nov	0.42	0.55	0.60	**	Equity and bond neutral
	Industrial Confidence	y/y	nov	-1.1%	-0.6	-0.5	**	Equity bearish, bond bullish
	Services Confidence	y/y	nov	12.1	12.0	12.5	**	Equity and bond neutral
Germany	Import Price Index	y/y	oct	-0.6%	-1.8%	-0.8%	**	Equity and bond neutral
	CPI	y/y	nov	0.8%	0.8%	0.8%	***	Equity and bond neutral
France	GDP	y/y	3q	1.1%	1.1%	1.1%	***	Equity and bond neutral
	Consumer Spending	y/y	oct	1.5%	0.7%	1.0%	**	Equity and bond neutral
UK	Net Consumer Credit	y/y	oct	1.6 bn	1.4 bn	1.5 bn	**	Equity and bond neutral
	Net Lending Sec. Dwellings	y/y	oct	3.3 bn	3.2 bn	3.2 bn	**	Equity and bond neutral
	Mortgage Approvals	y/y	oct	67.5 k	62.9 k	65.0 k	**	Equity and bond neutral
AMERICAS								
Canada	Current Accout Balance	q/q	3q	-18.3%	-$19.86 bn	$16.50 bn	**	Equity and bond neutral
Mexico	Unemployment Rate	y/y	oct	3.6%	3.9%	3.9%	***	Equity bullish, bond bearish
Brazil	Net Dent % GDP	y/y	oct	44.2%	44.1%	44.2%	**	Equity and bond neutral
	Inflation	y/y	nov	7.1%	8.8%	7.2%	***	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)	94	94	0	Neutral
3-mo T-bill yield (bps)	48	47	1	Up
TED spread (bps)	46	46	0	Neutral
U.S. Libor/OIS spread (bps)	60	60	0	Neutral
10-yr T-note (%)	2.33	2.31	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	63	61	2	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	up			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	$46.88	$48.24	-2.82%	Saudi Arabia's reluctance to the OPEC Agreement
WTI	$45.72	$47.08	-2.89%	
Natural Gas	$3.30	$3.32	-0.75%	
Crack Spread	$13.92	$13.93	-0.04%	
12-mo strip crack	$15.12	$15.22	-0.65%	
Ethanol rack	$1.76	$1.76	0.00%	
Metals				
Gold	$1,183.77	$1,194.00	-0.86%	Stronger Dollar
Silver	$16.47	$16.61	-0.84%	
Copper contract	$262.95	$267.05	-1.54%	
Grains				
Corn contract	$ 356.00	$ 358.25	-0.63%	
Wheat contract	$ 413.50	$ 416.50	-0.72%	
Soybeans contract	$ 1,047.50	$ 1,056.00	-0.80%	
Shipping				
Baltic Dry Freight	1184	1181	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.2		
Gasoline (mb)		1.2		
Distillates (mb)		1.6		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		-53.0		

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.

Asset Allocation Weekly Comment

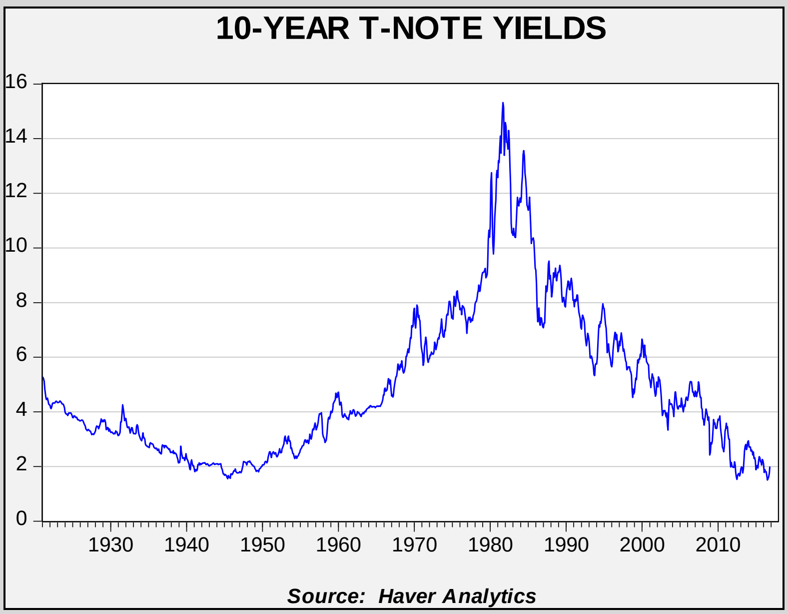
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

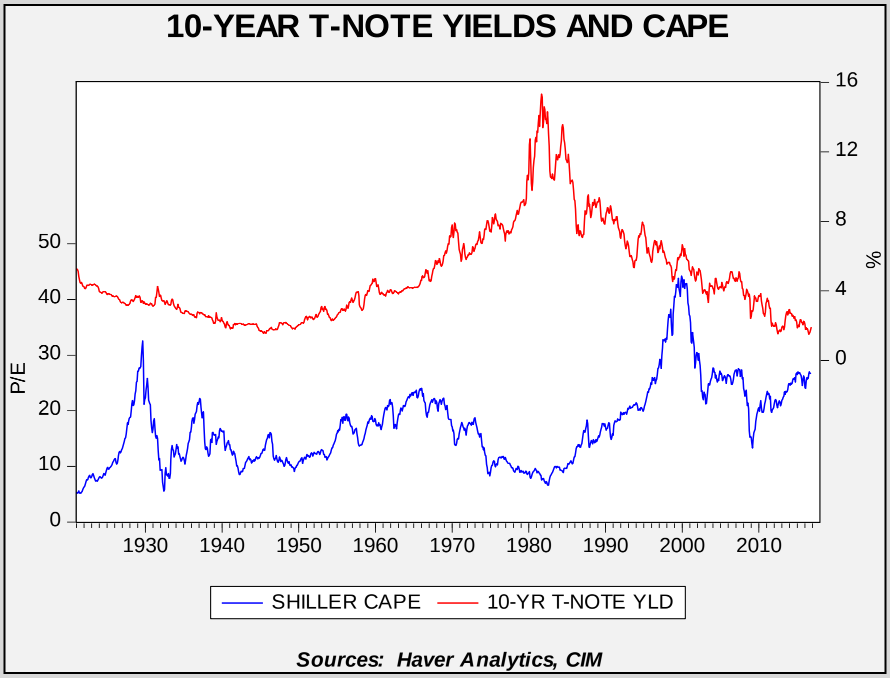
November 18, 2016

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.

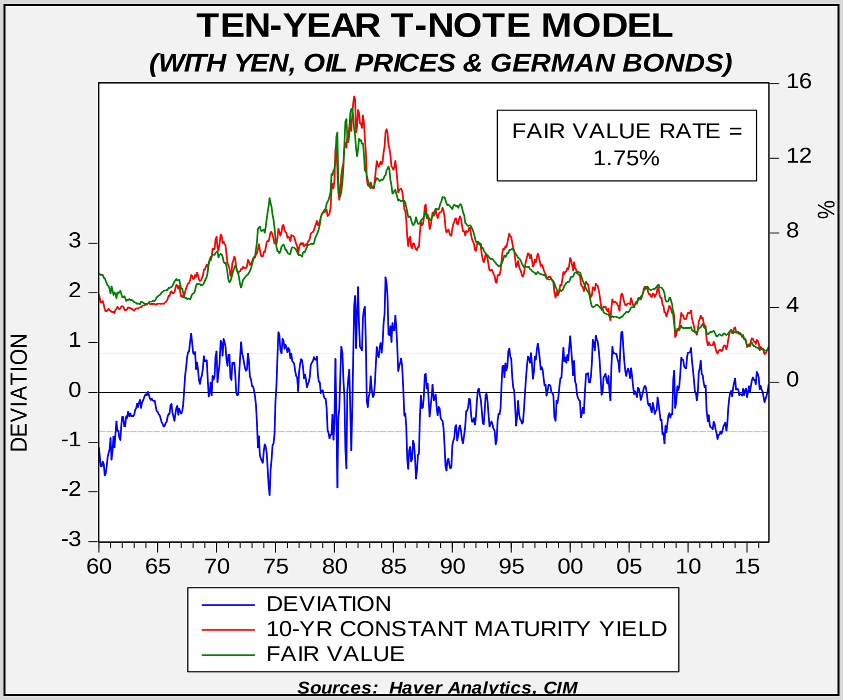


The chart above shows the 10-year T-note yield from 1921. Perhaps the most important issue to remember is that when the last secular bear market began after the lows were made in 1945, the next peak took 36 years. It took eight years before yields doubled. Although the regulatory environment is different,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

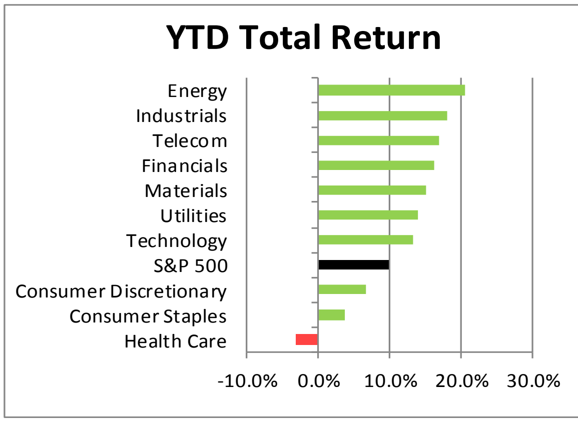


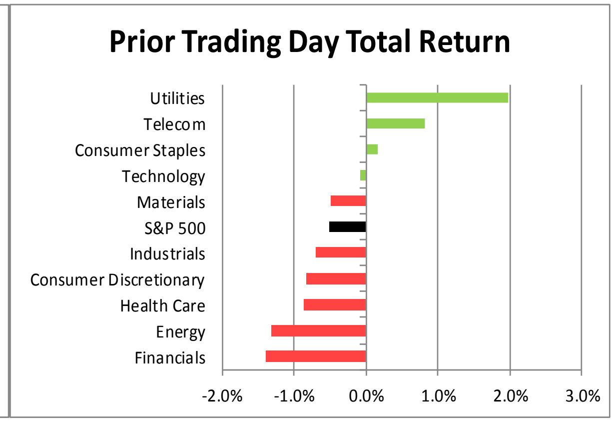
The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The most important variable keeping the fair value low are German bond yields; removing those from the model boosts the fair value yield to 2.42%. 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 11/28/2016 close)

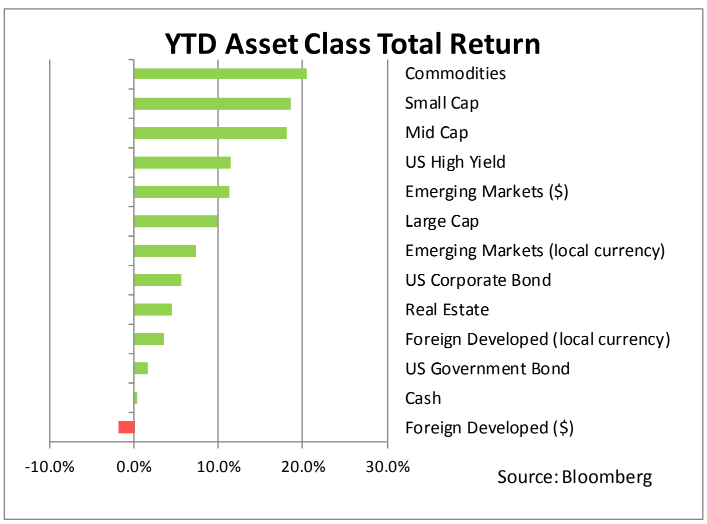




(Source: Bloomberg)

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 11/28/2016 close)



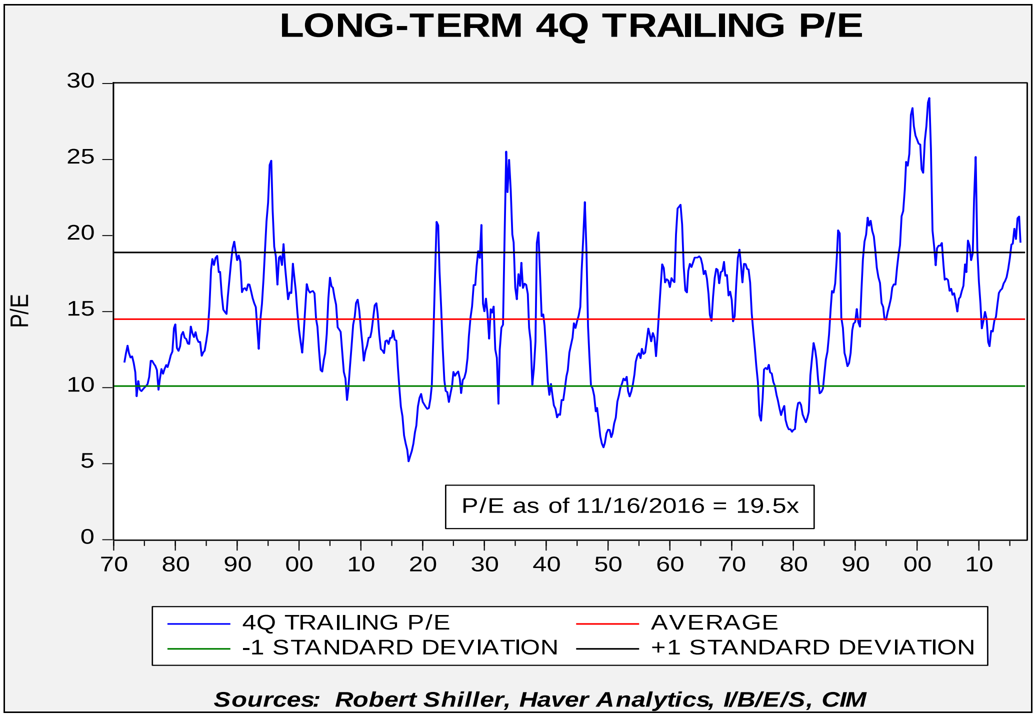
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[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.