Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

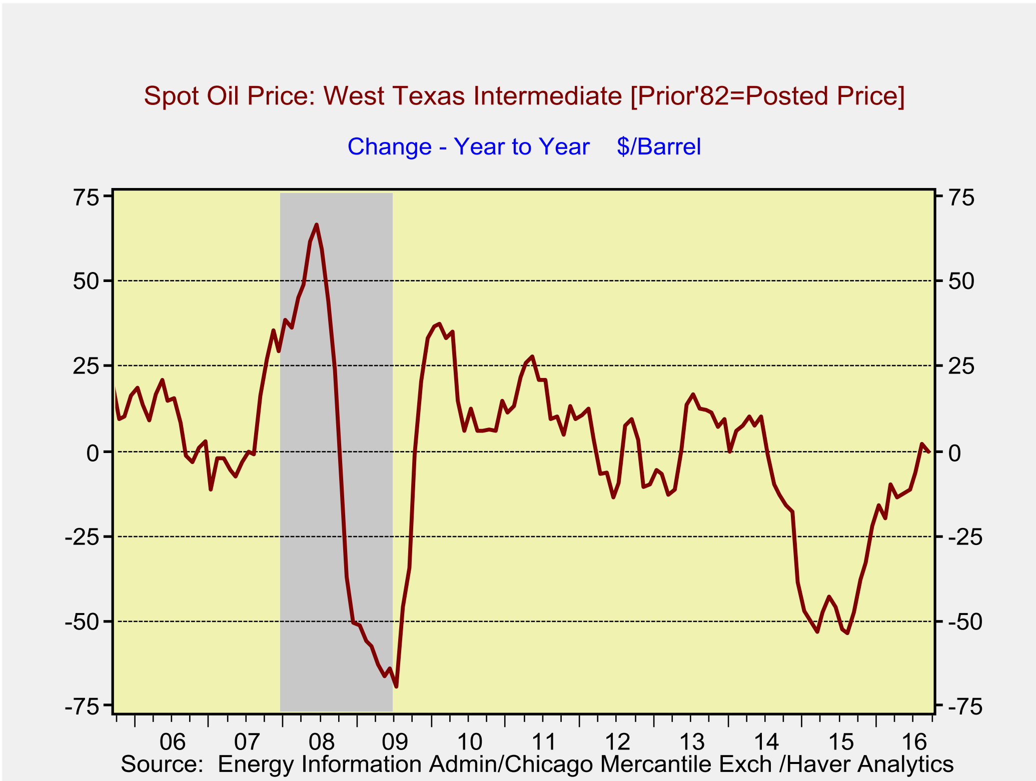
[Posted: October 5, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.09% from the prior close. Chinese markets were also higher, with the Shanghai composite moving up 0.2% and the Shenzhen index higher by 0.5%. U.S. equity futures are signaling a higher opening.

It was a rather quiet night. The VP debate came and went; polls suggest that Pence was better received but we doubt the interaction will change the election chances of either presidential candidate. There are some interesting trends starting to develop that are worth mentioning:

Long-term yields are starting to rise. The uptick in oil and expectations of a reduction in central bank accommodation are starting to have an adverse effect on long-duration bonds. The FOMC seems poised to raise rates in December. The BOJ has decided to set the yield on 10-year JGBs at 0%, which means tapering might occur. Bloomberg reported yesterday that the ECB was considering tapering its QE, which sent long-duration Treasury yields even higher. This morning, Reuters is reporting that the ECB isn't considering such a move, although the formal QE program is set to expire in March. There have been reports that ECB President Draghi is considering an extension of the program but perhaps at lower levels.

In general, there appears to be a shift in sentiment that suggests policymakers are going to move toward fiscal policy and away from monetary stimulus. We believe this is probably justified, although it is remarkably easy to discuss fiscal policy in the abstract, but hard to implement. Fiscal policy generally comes in two varieties, government investment and income enhancement. The former is likely to have the most positive impact if administered correctly. After all, the private sector continues to avoid investment and thus it makes sense for the public sector to fill any resulting gaps. The problem is that the hardest action any society takes is investment because it requires some forecasting of the future. There are monuments to poor investment everywhere; the shells of manufacturing plants that are no longer used are examples of private sector malinvestment, as are the "bridges to nowhere" on the public side. Developing public investment that will actually foster efficient future growth is quite difficult. Thus, the potential is high for building roads that don't effectively move vehicles or dams no one wants. The second variety of fiscal policy is income enhancement in the form of transfer payments, tax cuts, investment incentives, etc. Giving households money during deleveraging likely turns out to be nothing more than a private to public sector debt swap. In other words, if the government gives money to households that are deleveraging, they could simply use the cash to reduce their debt, improving household balance sheets but doing little for immediate growth. As far as investment incentives go, if a project isn't viable in the current interest rate environment then it probably won't ever be feasible. Still, the shift to fiscal policy, even if it disappoints, is probably bearish for long-duration debt.

We will have more to say on the oil situation in tomorrow's comment when we recap the DOE data, but the OPEC plan to reduce supply has, at a minimum, put a floor under oil prices. We expect oil to remain in a trading range but even keeping prices steady will tend to reduce the deflationary impact of weak oil prices.



This chart shows the yearly difference in WTI. Note that prices are now equal to last September, meaning that, on a yearly basis, oil is no longer acting as a damper for inflation. It is important to remember that oil fell below $30 per barrel in February, so even if prices hold steady through Q1, it will raise the inflationary impact of energy prices.

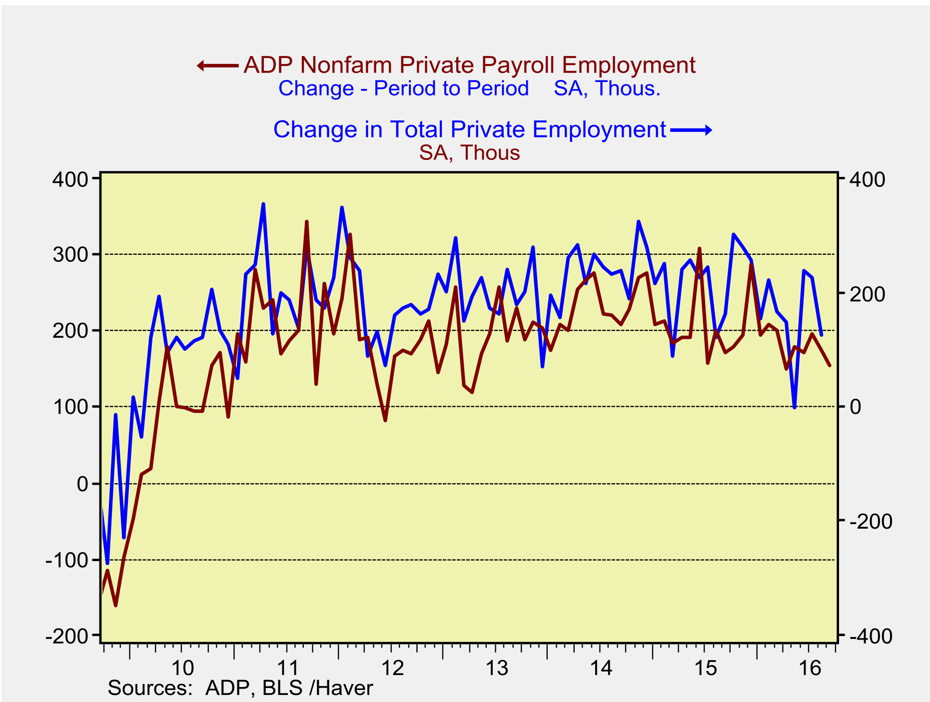
Is Xi the new Mao? The *NYT* is reporting that Chairman Xi is delaying the designation of his successor, perhaps laying the groundwork for staying beyond his two five-year terms. If so, this would change the tradition of power transfers that were put in place by Deng. Deng created a system in which the next leader is anointed during the second term of the current chairman. This allowed for a smooth transfer of power as the new leader put his leadership team together. If Xi doesn't select his successor, this process of the next leader creating his power base won't take place, allowing Xi more influence for the term that begins in 2022. In fact, it very well could lead to Xi remaining in place, which would upset the transition process. This change will likely raise internal tensions within the PRC leadership. It is important to remember that Deng created this system to prevent another Mao from emerging. If Xi does change this practice, it raises the potential for a new cult of personality and for internal party unrest.

Is Deutsche Bank becoming a nationalist issue? We have noted the problems at Deutsche Bank (DB, $13.33, +0.35). A Bloomberg article suggests that a narrative is evolving in Germany that suggests the problems at Deutsche Bank are really due to an attack on German values by foreigners. The DOJ fine is being portrayed as retaliation for back taxes being levied against U.S. firms by the EU, and others are suggesting that the bank is the standard bearer for German firms and an attack on the bank is an attack on German business practices. With elections due next year, this is a popular stance to take, especially with populist parties gaining ground. At the same time, it would not be much of a stretch to see U.S. politicians taking up the cause of the DOJ against Deutsche Bank. Unfortunately, political posturing will reduce policymakers' ability to act if a crisis does develop. Simply put, a global financial crisis will need international cooperation, not nationalism. Although the problems at Deutsche Bank appear manageable, they could become a problem if the political class decides to "take a stand."

U.S. Economic Releases

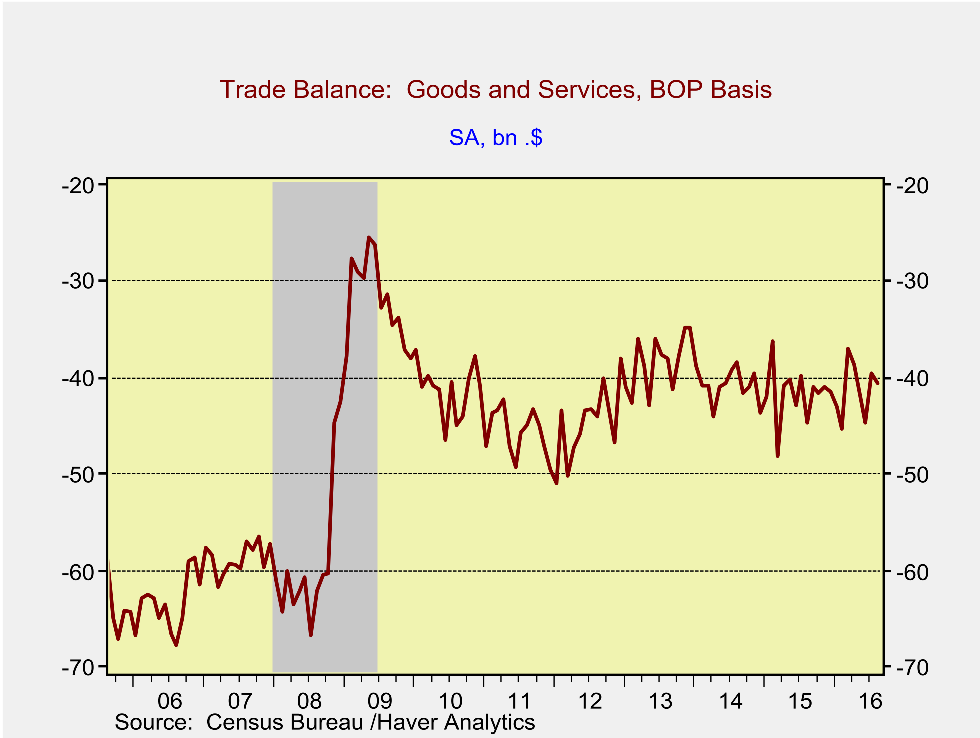
Weekly mortgage applications rose 2.9% last week, up from a -0.7% decline in the previous week. Purchase applications fell 0.1%, while refinancing applications rose 4.7%. The 30-year mortgage rate dipped 4 bps to 3.62%.

The September ADP private payroll report showed an increase of 154k, a bit below the forecast rise of 165k.



This chart shows the ADP data along with the monthly change in the BLS private non-farm payrolls. The ADP data signals a softer number for Friday's report.

The August trade deficit was a bit wider than forecast, at $40.7 bn compared to expectations of a $39.2 bn deficit.



For the most part, the trade deficit has been in a range since 2012. Exports rose 0.8% from July, while imports rose 1.2%.

There are no other releases scheduled before we go to print. The table below indicates the economic releases and Fed speakers scheduled for the rest of the day.

Economic releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Composite PMI	Y/Y	SEP		52	**
10:00	Durable Goods Order	y/y	sep	0.0%	0.0%	**
10:00	ISM Non-Manufacturing	y/y	sep	53	51.4	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
9:30	Kashkari Gives Opening Remarks at Development Conference	President of the Federal Reserve Bank of Minneapolis				
17:00	Lacker to Speak at Marshall University	President of the Federal Reserve Bank of Richmond				

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								
India	Nikkei India PMI Composite	y/y	sep	52.4	54.6		**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	aug	0.6%	2.9%	1.5%	**	Equity and bond neutral
	Markit Eurozone Composite	y/y	sep	52.6	52.6	52.6	**	Equity and bond neutral
France	Markit France Composite PMI	y/y	sep	52.7	53.3	53.3	**	Equity and bond neutral
Germany	Markit Germany Composite PMI	y/y	sep	52.8	52.7	52.7	**	Equity and bond neutral
Italy	Markit Italy Composite PMI	y/y	sep	51.1	51.9	51.5	**	Equity and bond neutral
UK	Official Reserves Changes	y/y	sep	$722 m	-$463 m		**	Equity and bond neutral
	Markit UK Composite PMI	y/y	sep	53.9	53.6	52.3	**	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)	86	85	1	Up
3-mo T-bill yield (bps)	33	32	1	Up
TED spread (bps)	53	54	-1	Down
U.S. Libor/OIS spread (bps)	45	45	0	Neutral
10-yr T-note (%)	1.69	1.69	0	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	46	48	-2	Down
Currencies	**Direction**			
dollar	down			up
euro	up			Neutral
yen	down			Down
pound	down			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	$51.85	$50.87	1.93%	Speculation about stock piles
WTI	$49.59	$48.69	1.85%	
Natural Gas	$2.93	$2.96	-1.21%	
Crack Spread	$15.06	$15.06	-0.03%	
12-mo strip crack	$15.29	$15.24	0.33%	
Ethanol rack	$1.68	$1.67	0.19%	
Metals				
Gold	$1,273.54	$1,268.44	0.40%	
Silver	$17.87	$17.80	0.38%	
Copper contract	$217.80	$216.70	0.51%	
Grains				
Corn contract	$ 346.25	$ 348.25	-0.57%	
Wheat contract	$ 394.50	$ 395.50	-0.25%	
Soybeans contract	$ 965.50	$ 963.50	0.21%	Profit taking
Shipping				
Baltic Dry Freight	860	864	-4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		0.5		
Distillates (mb)		-1.5		
Refinery run rates (%)		-1.0%		
Natural gas (bcf)		65.0		

Weather

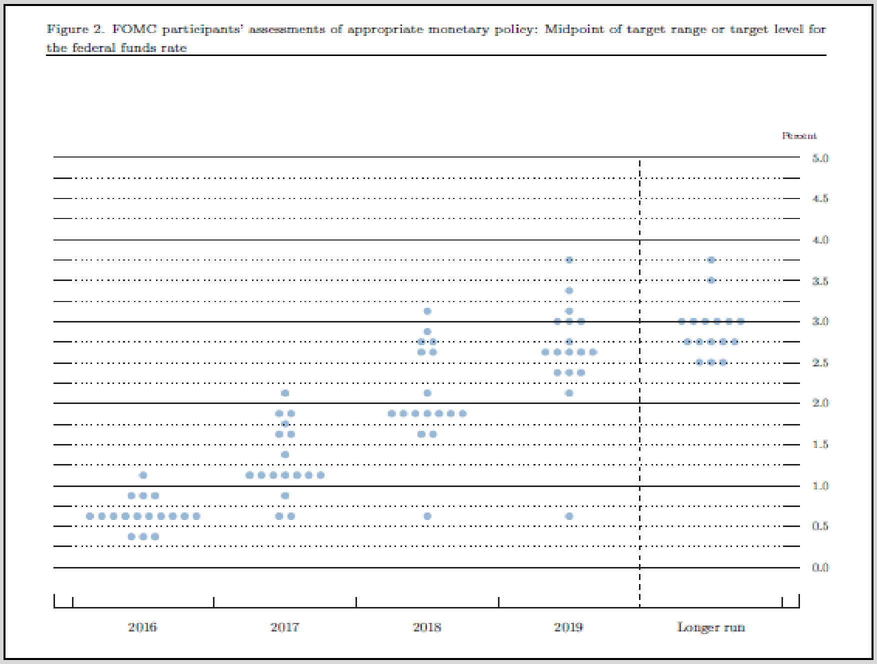
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country. Precipitation is forecast for the northwestern region of the country. Hurricane Matthew is a massive storm, currently a Category 4, and is expected to reach the Atlantic coast of Florida by Friday. Tropical Storm Nicole is also located in the Atlantic but is not 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.

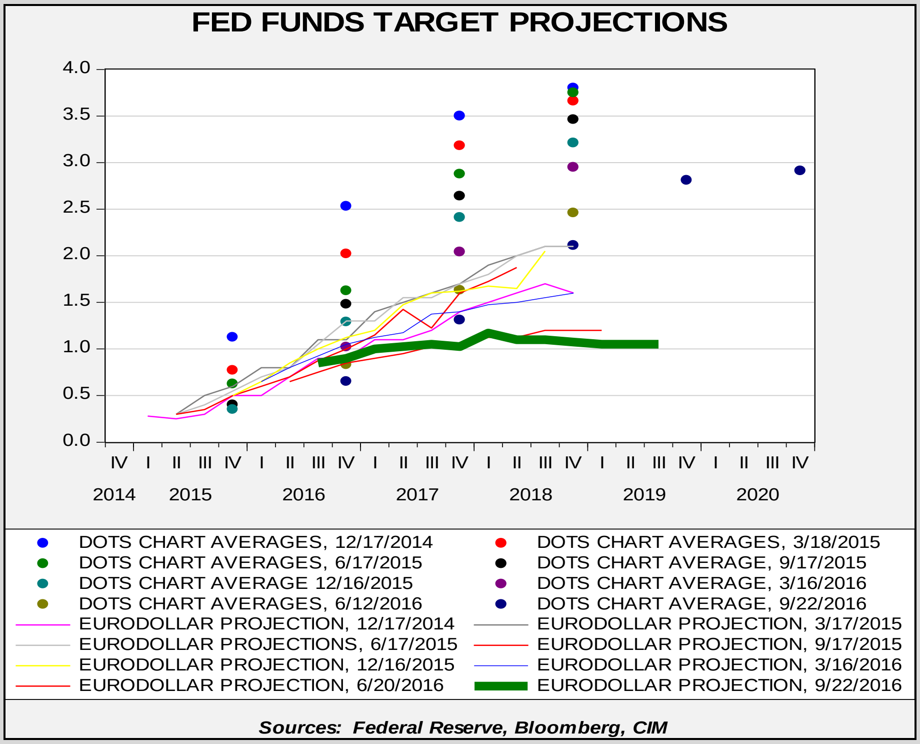
September 30, 2016

Last week, the FOMC left rates unchanged, as expected. The statement was rather hawkish but the accompanying information, such as the "dots" chart, was mostly dovish.



(Source: Federal Reserve)

Note that three of the 17 members of the committee want to stand pat for the rest of the year and two want to raise rates only once next year.

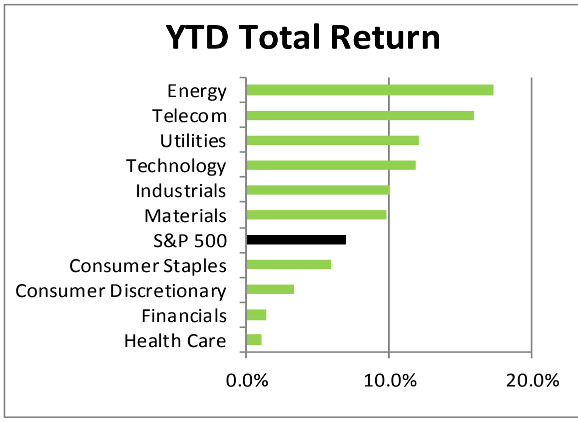


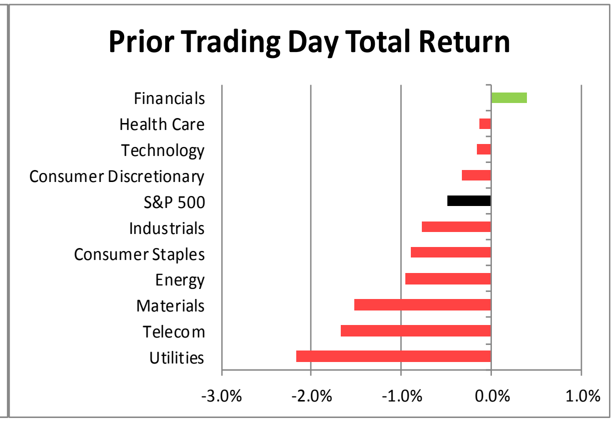
This chart shows the average projected rate from the dots chart along with the projected fed funds rate from the Eurodollar futures market. A couple interesting trends are emerging. As we have seen for some time, the FOMC is steadily lowering its terminal rate, the policy rate where tightening ends. They still hold out hope for a normalization in the long run, around 3%, but this expectation has been in the dots for some time. It never actually seems to occur. For this year, expectations are modest; on average, in fact, there is a chance that no hike will occur, even though the Eurodollar futures have one discounted. However, the Eurodollar futures are also looking for a terminal fed funds rate of around 1.25% at its peak. Simply put, the financial markets expect that the conditions that have led to low rates will continue well into 2019.

What would lead to rate normalization, which appears to be a rise to 3% for fed funds? The most obvious catalyst would be a rise in inflation. As long as the world remains awash in excess capacity, inflation will remain low (assuming trade remains open). That's why the presidential elections are important. We expect Donald Trump to restrict trade, whereas Hillary Clinton will, for the most part, try to maintain the current trade structure. For now, we expect that rates will rise, but expect a terminal rate of 1.25% for fed funds.

Data Section

U.S. Equity Markets – (as of 10/4/2016 close)

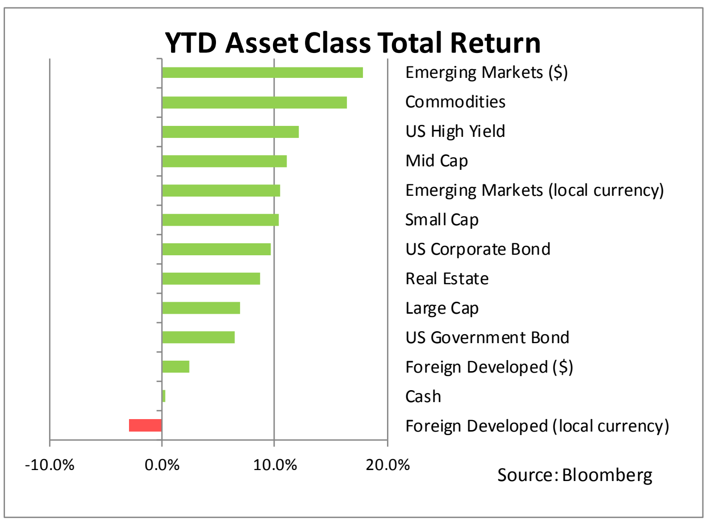




(Source: Bloomberg)

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 10/4/2016 close)

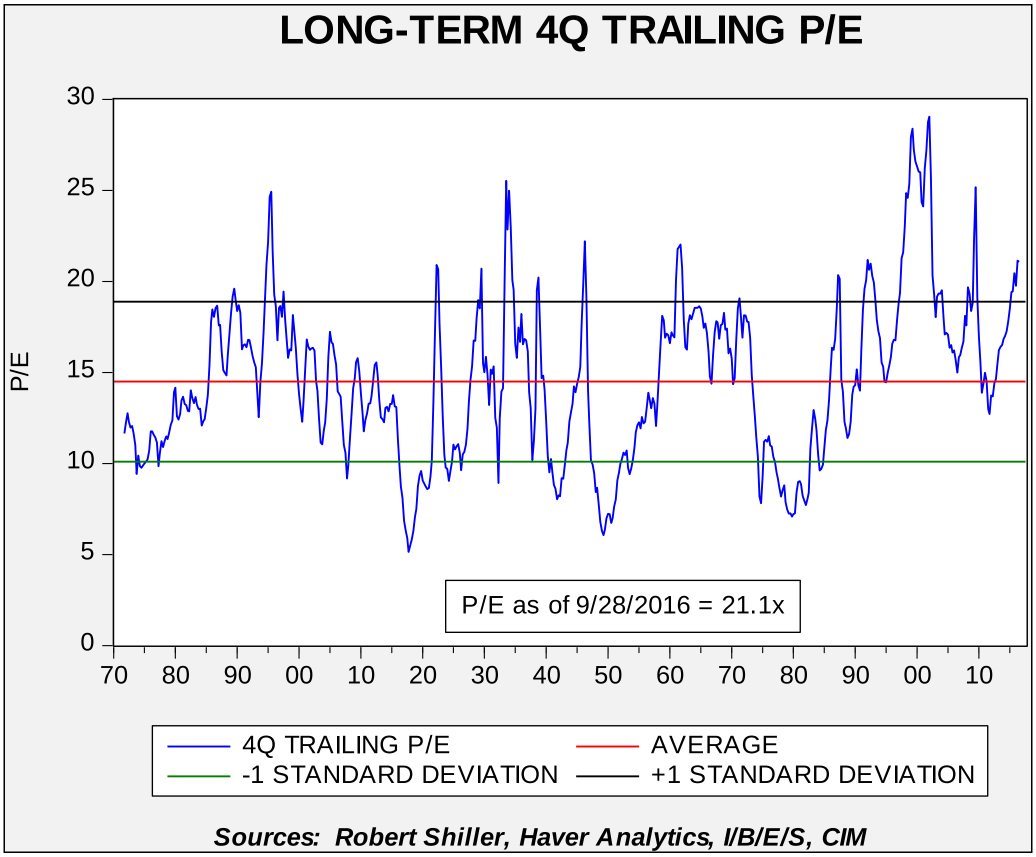


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 29, 2016



Based on our methodology,[1] the current P/E is 21.1x, unchanged from last week.

This report was prepared by Bill O'Grady and Kaisa Stucke of 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 two actual (Q4 and Q1) and two estimate (Q2 and Q3). 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.