Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: October 7, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.3% from the prior close. Chinese markets are closed for the Golden Week holiday. U.S. equity futures are signaling a lower opening.

Happy employment day Friday! We cover all the information below, but the quick overview is that the data was fairly close to expectations. Non-farm payrolls rose 156k, a bit weaker than the 175k forecast. Revisions subtracted 7k from the current number. The unemployment rate ticked higher, to 5.0% from 4.9%, and was higher than expected. However, this was a "good" rise in the unemployment rate because it came from a 444k rise in the labor force along with a 354k rise in employment as measured by the household survey. Simply put, more Americans returned to the labor force, most likely because economic conditions have improved enough to encourage a return to work. Wages grew by 2.6%, in line with estimates.

Overall, the data is such that one could make a good argument for holding monetary policy steady. In fact, it's almost a "goldilocks" report. The payroll number was strong enough to show no danger of recession but weak enough to reduce the threat of overheating. The worry is that low unemployment will eventually push wages higher and cause inflation. The great unknown is whether the low level of employment participation represents people who are permanently out of the labor force or more of a "reserve army of the unemployed." If the former is true, the Fed should move rates higher now. If the latter is true, there is still slack in the economy and moving rates too quickly will snuff out the expansion just when it is encouraging labor market participation. Given the divisions on the FOMC, we expect a modest "one and done" tightening in December.

But, before we jump into the employment report, we have to take some time to discuss one of the more bizarre events overnight when the British pound plunged.

(Source: Bloomberg)

Around 6:00 EDT last evening, the GBP suddenly plunged over 6%. It should be noted that this is the Bloomberg composite quote, which calculates the median quote—there were banks quoting cable as low as $1.13. The currency did recover but remains down a bit more than 2%.

What happened? What is a bit unsettling about this news is that we really don't know. It's yet another "flash crash" that isn't supposed to happen to "grown up" currencies. Situations like this tend to have multiple causes. Trading algorithms can trigger orders without human intervention and can cascade. We have seen this in the U.S. T-bond futures when open outcry and electronic traded simultaneously. Most of the time, the differences between the two markets were minimal. But, during fast markets, the electronic always had a wider range because human traders will tend to hold off executing stop orders if the market is disorderly in an attempt to get their customers a better price. The pits are now closed and most orders are handled electronically, so if your stop gets hit, you get the next price even if it isn't a "real" trade. This is, to some extent, the cost of efficiency. We don't have to pay all those traders anymore because most of the time, they weren't necessary.[1]

Post-2008 regulations have reduced market liquidity as banks can no longer trade their own book. Although this may make the banking part of the financial system better, it may have simply shifted the risk to other parts of the market.

This isn't to say that it's all just "sound and fury, signifying nothing." A hard Brexit looks increasingly likely. PM May is making it clear that she will fulfill the voter mandate to pull the U.K. out of the EU regardless of the economic costs. French President Hollande signaled that he wants a hardline as well, essentially wanting to punish Britain for leaving the EU to ensure that

[1] It's a bit like saying there is no point to paying firefighters because most of the time we don't have fires…

other nations in the bloc understand the high cost of exit. Still, this news doesn't warrant the kind of market action we saw overnight.

And, it's having a real impact. The 5-year inflation swap, a common measure to indicate future inflation expectations, skyrocketed overnight.

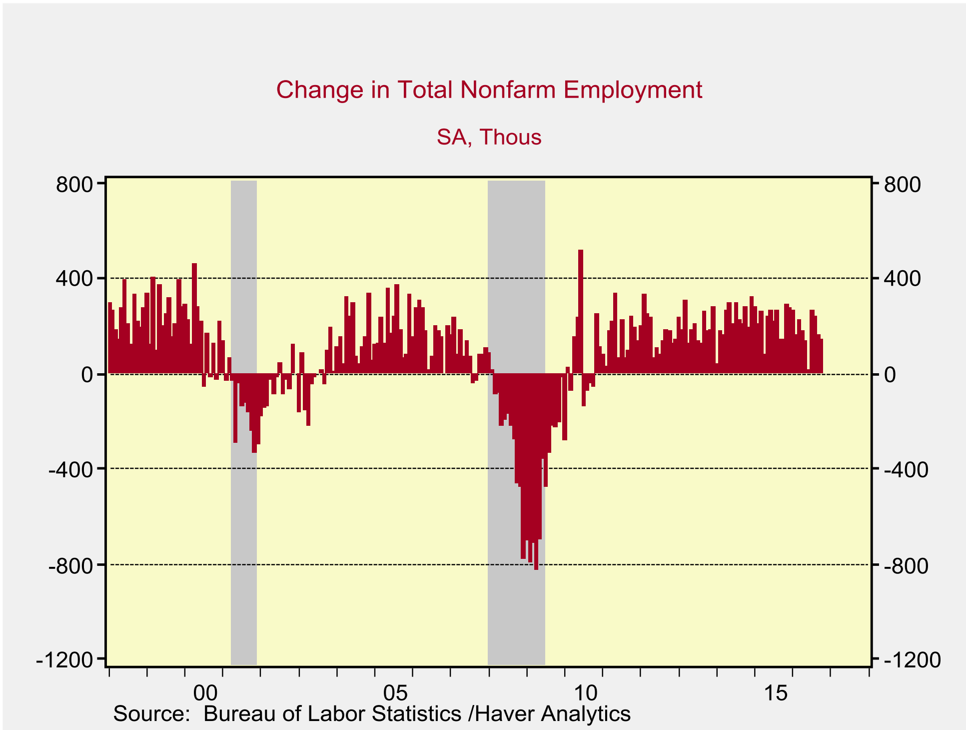
(Source: Bloomberg)

This is a measure of market inflation expectations. If inflation expectations rise, it will put the BOE in a position where it may not be able to cut rates. On the other hand, the weaker pound is doing the easing for the BOE. Another worry is that there isn't a whole lot the BOE can do to affect the GBP. The country only has £27 bn in foreign reserves, only about three months of the current account deficit, meaning that if a currency crisis develops, the only way the BOE can unilaterally arrest the decline is with a large increase in overnight interest rates. The British could ask for G-7 help to jointly intervene to support the pound, but given that three of the seven are EU nations, support might be hard to garner. In last resort, the British could petition the IMF for help, putting them in the same category as Greece.

Finally, China's September foreign exchange reserves came in at $3.166 trillion, a bit lighter than the $3.18 trillion expected.   Thus, the rough estimate of capital outflows is about $50 bn, which is higher than the estimates of $37 bn in August but lower than the levels we saw earlier this year.

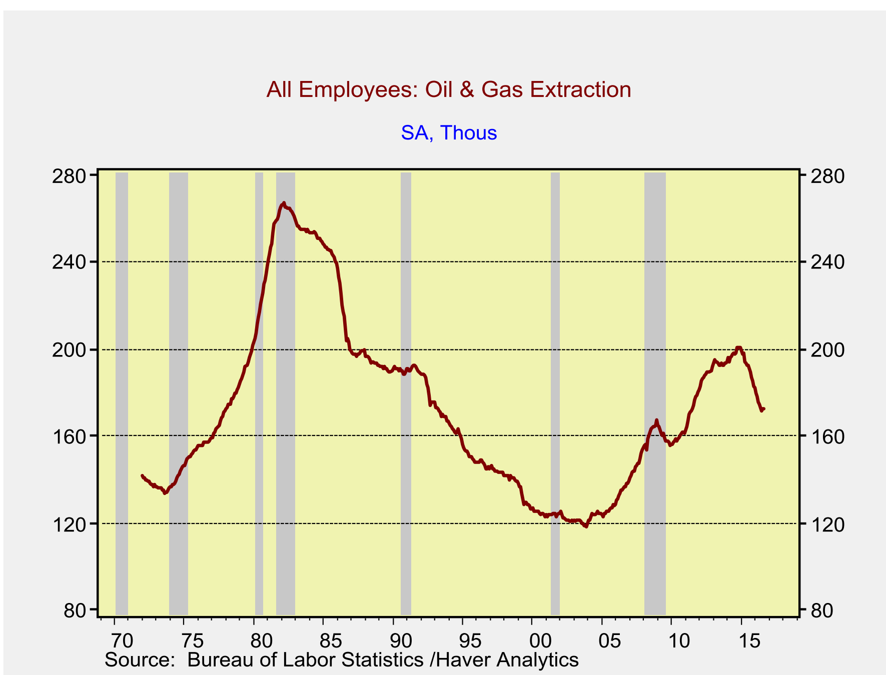
U.S. Economic Releases

The payroll data came in a bit weaker than expected, at 156k compared to a 172k forecast.

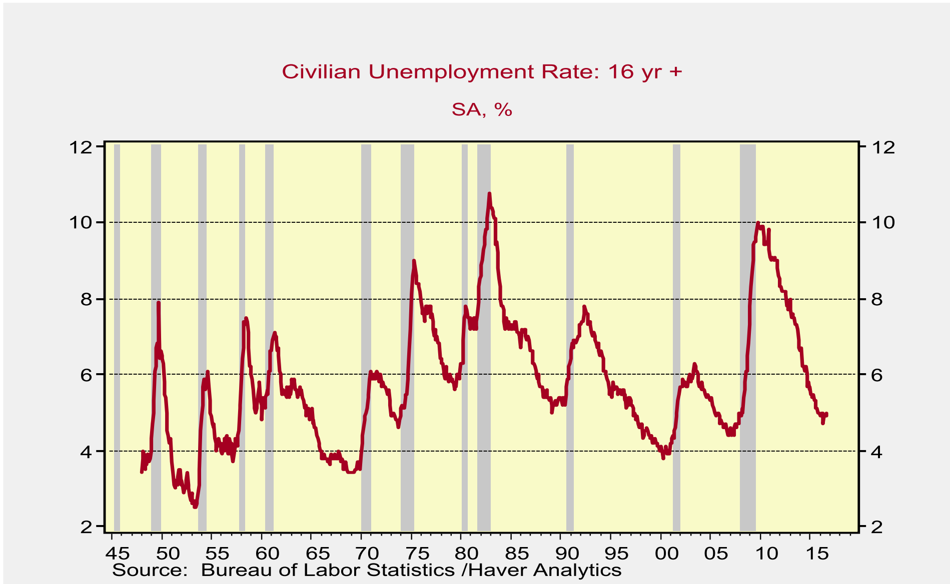


Private employment rose 167k, with goods producing up 10k and services up 157k. Government jobs fell 11k.

As a side note, oil and gas extraction jobs have stabilized at 172.6k which is about 0.12% of total non-farm payrolls. The slowdown in job losses in oil and gas extraction suggests that the rise in rig counts is having a positive impact.

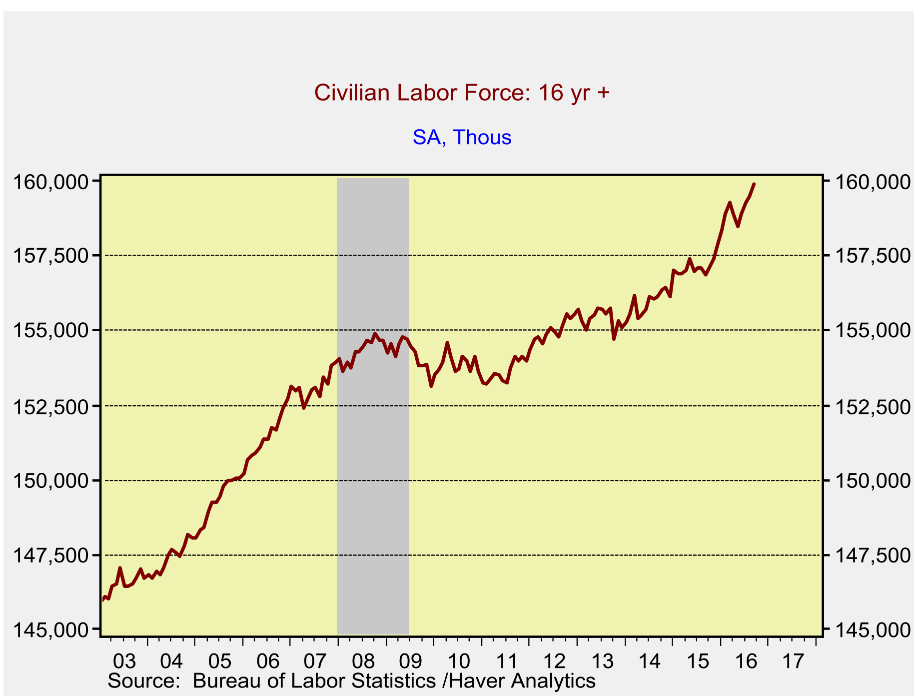


The unemployment rate rose to 5.0%, up 0.1%.

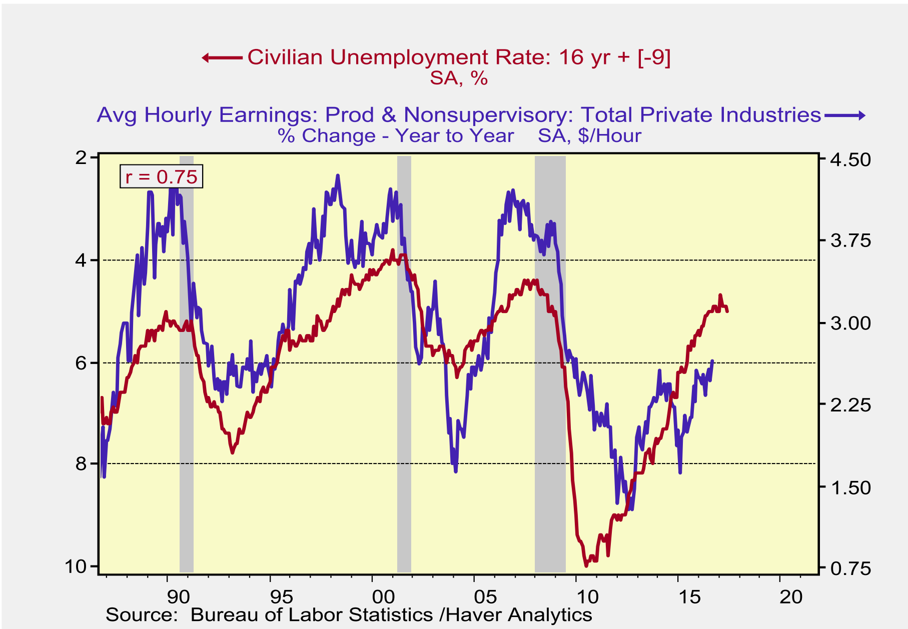


The labor gap narrowed a bit as rising unemployment occurred with improving labor participation. The participation rate (employment divided by the labor force, which includes working and seeking employment) improved to 62.9% from 62.8%. Further improvement in the participation ratio would suggest that there is still slack in the labor markets, reducing the threat of overheating and inflation.

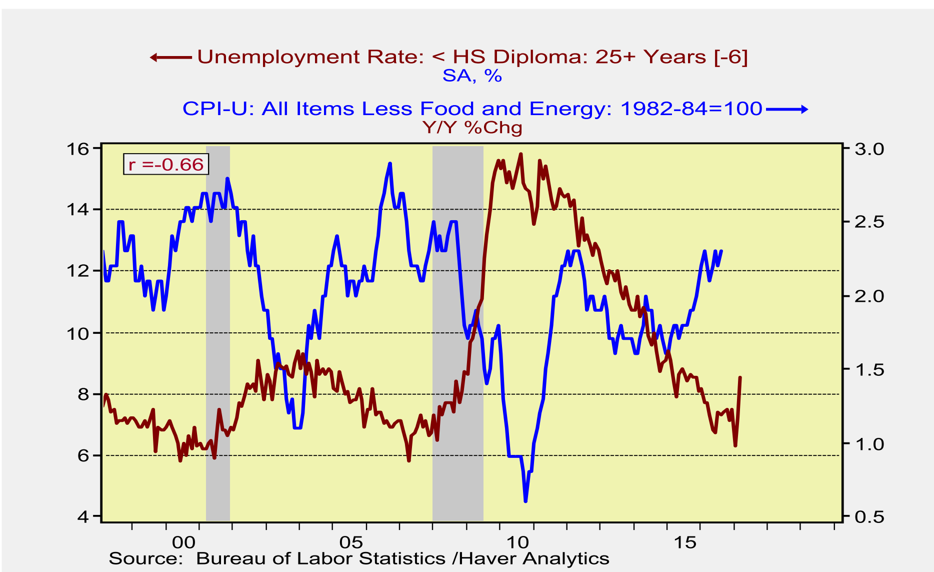
The labor force continues to increase, up over 3 mm over the past year.



Wages rose 2.6% from last year, on expectations. The chart below looks at wage growth and the unemployment rate. Generally speaking, the latter leads wages by about three quarters. In past cycles, an unemployment rate at this level coincided with wage growth in excess of 3.75%. This chart tends to confirm that there is still slack in the labor markets and it doesn't make sense to be overly concerned with inflation at this juncture.



Here's another way of looking at this issue—core inflation has been correlated with the unemployment rate for Americans without a high school diploma. This month, the unemployment rate for this group jumped to 8.5% from 7.2%.



Finally, involuntary part-time work data showed a modest improvement, at 3.686% of the labor force compared to 3.796% in the prior month.

It remains elevated compared to earlier cycles and suggests, again, slack in the labor markets.

The table below shows the economic data and policy speeches for the rest of the day.

Economic releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale Inventories	m/m	aug	-0.1%	-0.1%	**
10:00	Wholesale Trade Sales	m/m	aug	0.1%	-0.4%	**
15:00	Consumer Credit	y/y	aug	$16.5 bn	$17.713 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:30	Stanley Fischer Speaks in New York	Vice Chair of the Federal Reserve Board of Governors				
12:45	Esther George Speaks in Washington	President of the Federal Reserve Bank of Kansas City				
16:00	Lael Brainard Speaks in Washington	Member of the Federal Reserve 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
Japan	Leading Index	y/y	aug	101.2	100	101.6	**	Equity and bond neutral
	Coincident Index	y/y	aug	112	112.1	111.8	***	Equity and bond neutral
EUROPE								
France	Trade Balance	y/y	aug	-4.25 bn	-4.5 bn	-3.85 bn	**	Equity and bond neutral
	Budget Balance	y/y	aug	-96 bn	-80.8 bn		**	Equity bullish, bond bearish
	Current Account Balance	y/y	aug	-2.1 bn	-2.6 bn		**	Equity bullish, bond bearish
	Industrial Production	y/y	aug	0.5%	0.1%	-1.3%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	aug	0.7%	0.4%	-1.4%	**	Equity bullish, bond bearish
Germany	Introductial Production	y/y	aug	2.5%	-1.5%	1.0%	***	Equity bullish, bond bearish
UK	Industrial Production	y/y	aug	0.7%	2.1%	1.3%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	aug	0.5%	0.8%	0.8%	**	Equity bearish, bond bullish
	Trade Balance	y/y	aug	-4.7 bn	-4.5 bn	-4 bn	**	Equity and bond neutral
Switzerland	Foreign Currency Reserves	y/y	sep	628 bn	626.6 bn	630 bn	**	Equity and bond neutral
Russia	Money Supply Narrow Def	w/w	sep	8.56 tn	8.67 tn		**	Equity and bond neutral
AMERICAS								
Canada	Unemployment Rate	m/m	sep	7.0%	7.0%	7.0%	***	Equity and bond neutral
Brazil	CPI IPCA	y/y	aug	8.5%	9.0%	8.6%	**	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)	87	86	1	Up
3-mo T-bill yield (bps)	32	32	0	Neutral
TED spread (bps)	55	55	0	Neutral
U.S. Libor/OIS spread (bps)	46	46	0	Neutral
10-yr T-note (%)	1.74	1.74	0	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	42	43	-1	Down
Currencies	**Direction**			
dollar	up			Up
euro	up			Down
yen	up			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	$52.36	$52.51	-0.29%	Russia may not be willing to agree to cuts
WTI	$50.37	$50.44	-0.14%	
Natural Gas	$3.09	$3.05	1.31%	
Crack Spread	$13.51	$13.84	-2.37%	
12-mo strip crack	$14.71	$14.94	-1.53%	
Ethanol rack	$1.67	$1.67	-0.11%	
Metals				
Gold	$1,254.99	$1,254.38	0.05%	Uncertainty in Foreign Markets
Silver	$17.43	$17.32	0.62%	
Copper contract	$215.85	$215.55	0.14%	
Grains				
Corn contract	$ 340.75	$ 340.50	0.07%	Profit taking
Wheat contract	$ 396.25	$ 395.75	0.13%	
Soybeans contract	$ 959.50	$ 958.50	0.10%	
Shipping				
Baltic Dry Freight	915	869	46	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.0	1.5	-4.5	
Gasoline (mb)	0.2	0.5	-0.3	
Distillates (mb)	-2.4	-1.5	-0.9	
Refinery run rates (%)	-1.8%	-1.0%	0.0	
Natural gas (bcf)	80.0	65.0	15.0	

Weather

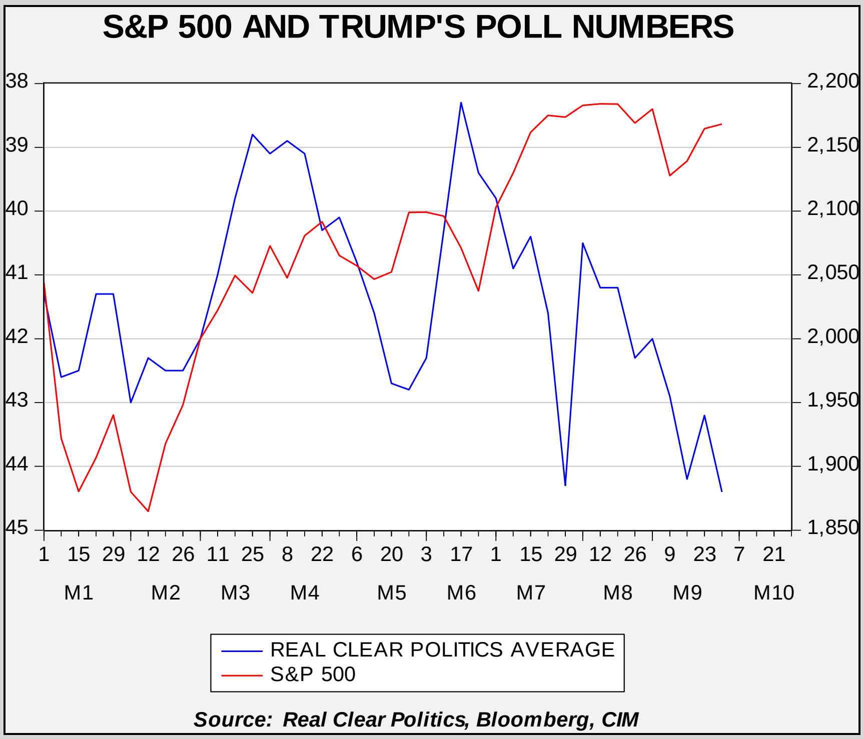
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country. Precipitation is forecast for the northwestern region of the country. Hurricane Matthew is a massive storm, currently a Category 3, and is expected to reach the Atlantic coast of Florida today. It is likely to cause damage along the Florida coast. 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.

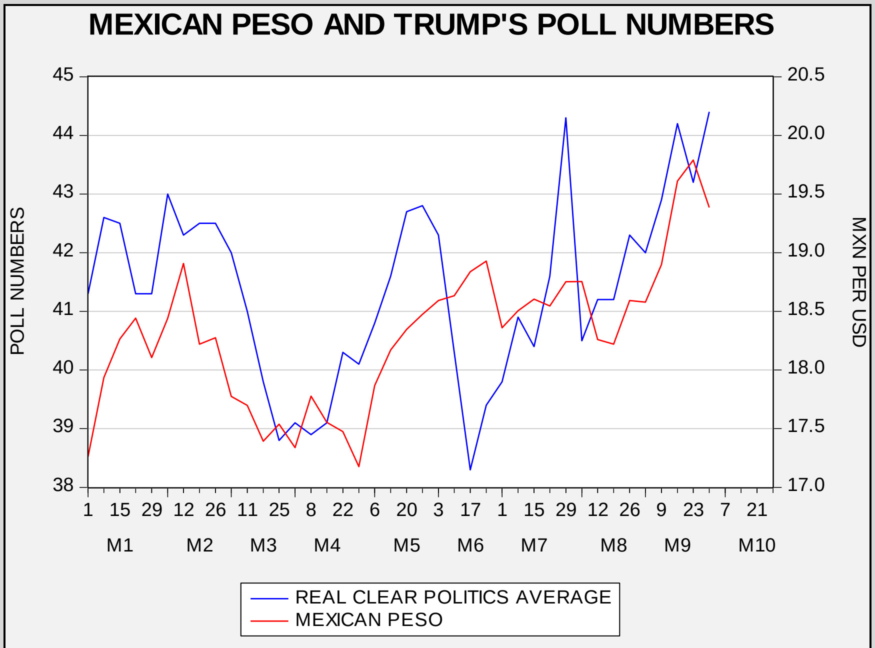
October 7, 2016

With the elections about a month away, we are fielding an increasing number of questions about the market impact of the result. Although some market commentators are raising concerns about a Trump victory, so far, market data doesn't seem to suggest a high level of correlation.



This chart shows Donald Trump's average poll numbers on a weekly basis (using an inverted scale) along with the S&P 500 index on the same basis since the beginning of the year. The weakness seen in the equity markets in Q1 did coincide with reasonably strong numbers for Trump, but most of that equity weakness probably had to do with monetary policy. Note that as Trump's poll numbers have improved, equities have also improved. This could mean that (a) financial markets are not all that concerned about a Trump victory, (b) financial markets simply believe that odds favor a Clinton win, or (c) the outcome of the election isn't material, because the outcome of most elections are not material to the markets. The correlation of the two series is a modest -1%, suggesting that the two are virtually uncorrelated.

Similar results are seen when comparing Trump's poll numbers against the performance of gold and the 10-year Treasury yield. So far, the most significant relationship is the Mexican peso.



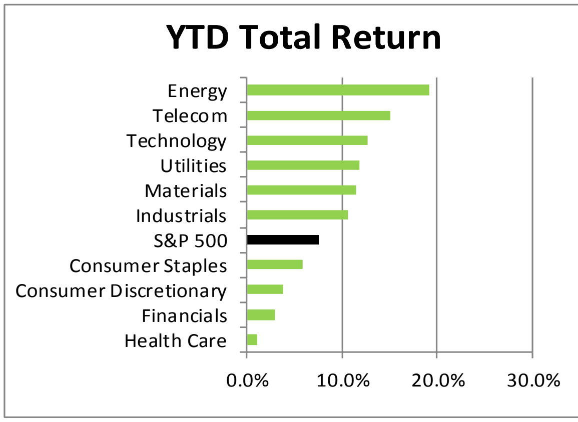
Source: Real Clear Politics, Bloomberg, CIM

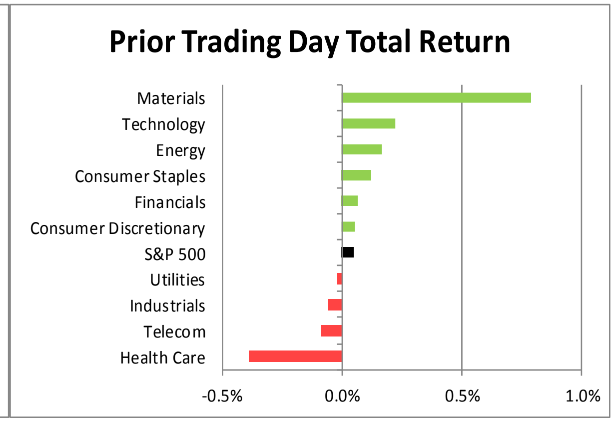
The MXN/USD exchange rate is pesos per dollar, meaning the higher the reading on the above chart, the weaker the peso. As Trump's poll numbers have improved, the Mexican currency has weakened (the correlation is 54%). This relationship makes sense. Trump has promised to "build a wall" on the Mexican border and has called for a rewriting of the North American Free Trade Agreement (NAFTA). A Trump win could be very disruptive to the Mexican economy and thus the peso has been very sensitive to the path of the election thus far.

We believe a Trump victory would be a bearish surprise to the financial markets. Although he has promised many things, we suspect his priorities will start with immigration and then move to trade which is second on the list. He has offered a large infrastructure spending package as well. Although his tax policy has excited traditional supply-side Republicans, we doubt the tax policy is a high priority for Mr. Trump. His policies would be potentially inflationary which could be bearish for both equities and debt. Of course, proposing policy and getting measures through Congress are two different issues. We have doubts he will be able to execute much of his platform. But, the uncertainty alone could increase market turbulence. Thus, as the election approaches we would expect increasing market volatility until the outcome is determined.

Data Section

U.S. Equity Markets – (as of 10/6/2016 close)

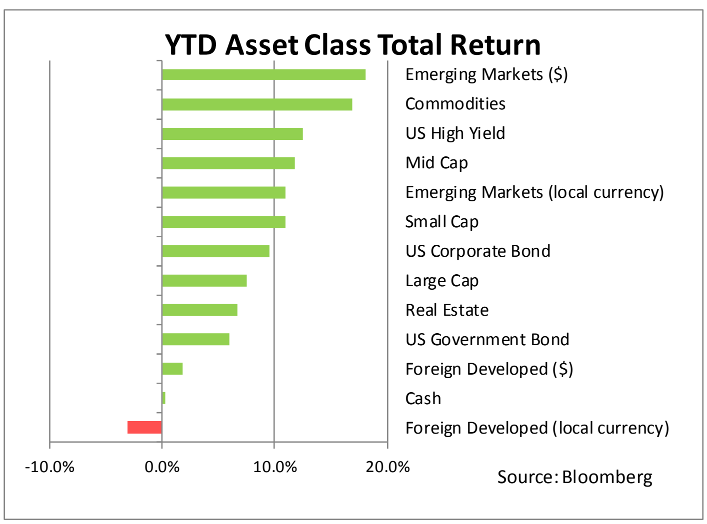




(Source: Bloomberg)

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 10/6/2016 close)

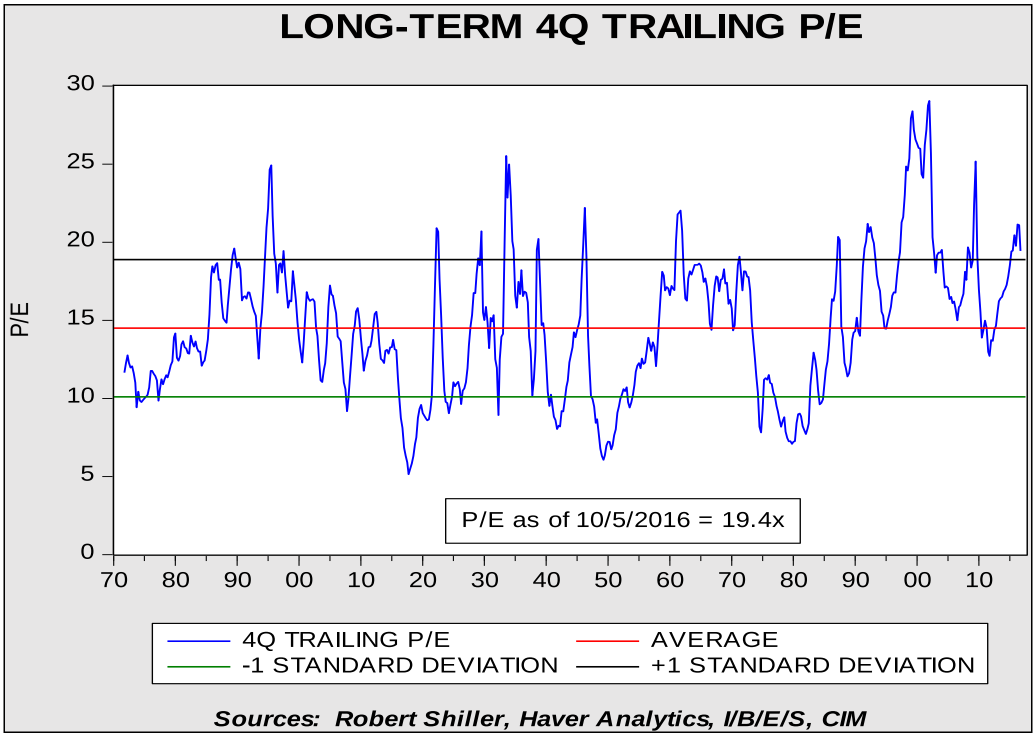


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 6, 2016



Based on our methodology,[2] the current P/E is 19.4, down 21.1x from last week. With Q4 upon us, we are now using earnings estimates for Q3 and Q4, which are elevated and reduce the P/E. We would expect the P/E to rise in the coming weeks, in part due to the current spread between Thomson/Reuters earnings data compared to S&P earnings data.

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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[2] 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 (Q1 and Q2) and two estimates (Q3 and 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.