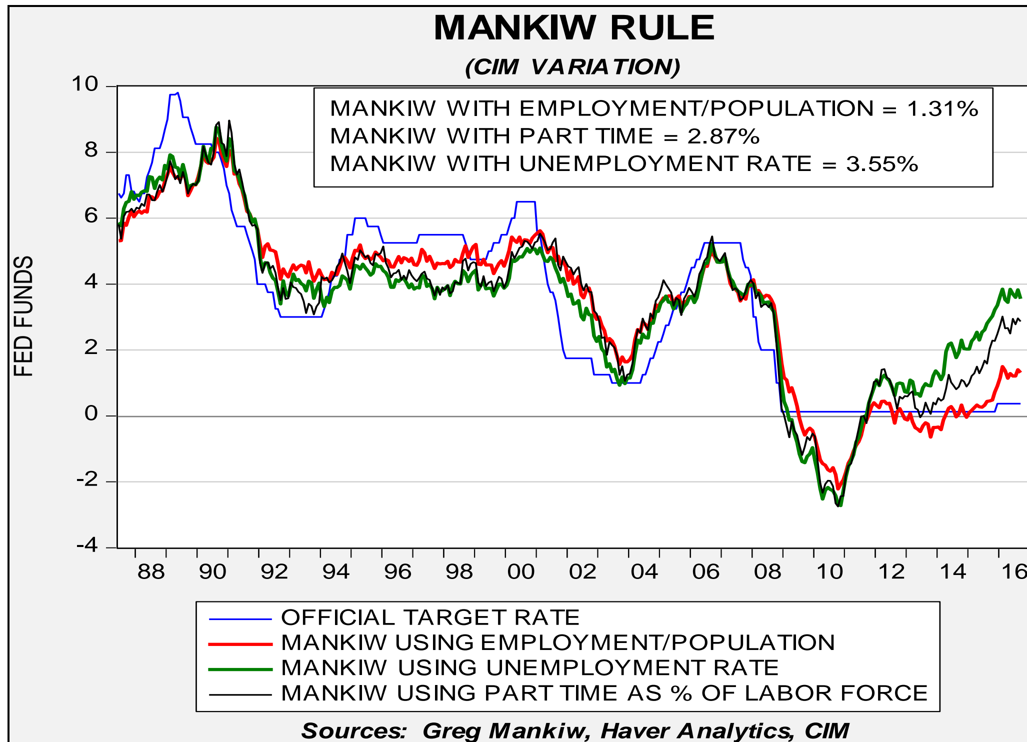
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: October 18, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 1.3% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 1.4% from the prior close. Chinese markets were higher, with the Shanghai composite moving up by 1.4% and the Shenzhen index also moving up by 1.4%. U.S. equity futures are signaling a higher opening. With 41 companies having reported, the S&P 500 Q3 earnings stand at $30.02, higher than the $29.71 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 in the consensus estimates. Thus far this quarter, 80.5% of the companies reported earnings above forecast, while 17.1% reported earnings below forecast.

Equity markets are enjoying a strong morning as financial markets prepare for a modest credit tightening in December. Chair Yellen's recent comments about allowing the economy to run hot were somewhat offset by Vice Chair Fischer yesterday when he cautioned against letting the economy and inflation move too far above target. Overall, our take is that we will get a hike in December and maybe one move next year. If our outlook is correct, it would be supportive for U.S. equities as it would probably lead to a weakening dollar. That probably isn't the path in the short run, but should emerge later in 2017.

With the release of CPI data, we can update our versions of the Mankiw rule model. This model attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate by core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem, Mankiw used the unemployment rate as a proxy for economic slack. We have created three versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio and a third using involuntary part-time workers as a percentage of the total labor force.



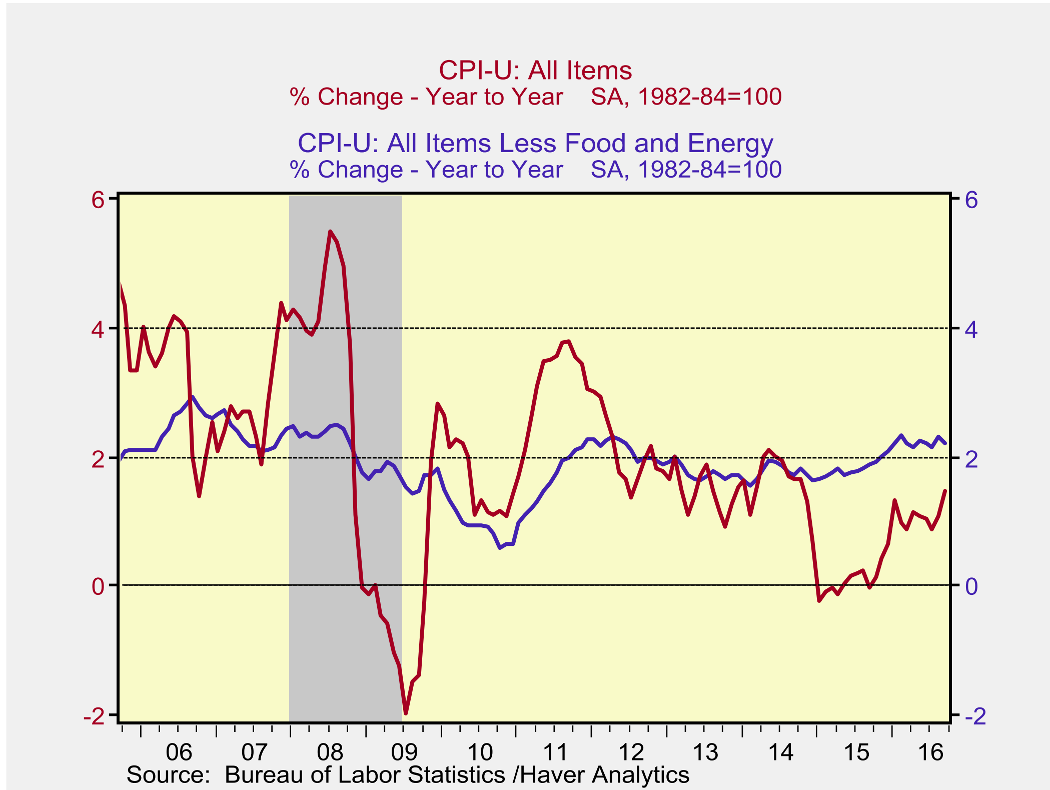
Using the unemployment rate, the neutral rate is now 3.55%. Although this rate is well above fair value, it has dropped 27 bps over the past month as unemployment rises and the core CPI dips. Using the employment/population ratio, the neutral rate is 1.31%, down 10 bps. Finally, using involuntary part-time employment, the neutral rate is 2.87%, down 9 bps. To some extent, the Mankiw models, based off the Phillips Curve, do suggest the FOMC is behind the curve but the degree of stimulus has actually eased over the past month. Thus, the case for a rate hike has somewhat weakened, to an extent. However, we don't expect this will change expectations for a December hike.

Saudi Arabia is pricing its bond issuance this morning. Although a successful bond issuance is neutral for oil prices, a case could be made that the kingdom is selling bonds to offset the loss of revenue that would come from cutting output, assuming prices don't rise. Of course, if the demand curve is more elastic than expected, we could see the revenue loss reduced. We do note that, historically, commodity demand curves are price inelastic in the short run, meaning that a price cut leads to a loss of revenue.

As noted below, China's borrowing is increasing at a rather fast clip. There is a lot of commentary emerging on China's debt growth and its sustainability. We have deep reservations about China's ability to grow at 6% without expanding debt to dangerous levels. Perhaps the one saving grace for China is that the government can more easily assign potential losses because it's a dictatorship. Debt growth of this magnitude is bullish for global growth in the short run, but not in the long run.

U.S. Economic Releases

CPI came in on forecast for September, rising 0.3% from the month before. This is the highest price increase in five months. Core inflation came in lower than forecast, rising 0.1% compared to the 0.2% increase expected. The highest price increases were seen in energy and transportation, while apparel, education and recreation consumer prices fell by the most.



The chart above shows the annual change in headline consumer inflation and core inflation. Headline inflation rose 1.5% annually, on forecast. Core prices rose 2.2% annually, less than the 2.3% increase expected.

August real average weekly earnings rose 0.8% annually compared to the 0.4% increase seen the week before.

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

Economic releases						
EDT	Indicator			Expected	Prior	Rating
10:00	NAHB Housing Market Index	y/y	oct	63	65	*
16:00	Total Net TIC Flows	y/y	aug		140.6 bn	*
16:00	Net Long-Term TIC Flows	y/y	aug		103.9 bn	*
Fed speakers or events						
EST	Speaker or event	District or position				
12:15	Amias Gerety on Financial System Panics	Acting Assistant of the US Department of the Treasury				

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								
China	New Yuan Loans	y/y	Oct	1.22 tn	948.7 bn	1 tn	**	Equity bullish, bond bearish
	Aggregate Financing CNY	y/y	Sep	1.72 tn	1.47 tn	1.39tn	**	Equity bullish, bond bearish
	Money Supply M0	y/y	Sep	6.6%	7.4%	7.3%	**	Equity and bond neutral
	Money Supply M1	y/y	Sep	24.7%	25.3%	24.5%	**	Equity and bond neutral
	Money Supply M2	y/y	sep	11.5%	11.4%	11.6%	**	Equity and bond neutral
Australia	New Motor Vehicle Sales	y/y	sep	0.8%	2.9%		**	Equity bearish, bond bullish
	ANZ Roy Morgan Weekly Construction	y/y	aug	117.8	117.5		**	Equity and bond neutral
New Zealand	CPI	y/y	sep	0.2%	0.1%	0.4%	***	Equity and bond neutral
	Non Resident Bond Holdings	y/y	sep	65.0%	66.7%		*	Equity and bond neutral
EUROPE								
UK	House Price Index	y/y	sep	8.4%	7.8%	8.3%	**	Equity and bond neutral
	CPI	y/y	sep	1.0%	0.9%	0.6%	***	Equity bullish, bond bearish
	Retail Price Index	y/y	sep	264.9	264.7	264.4	**	Equity bullish, bond bearish
	RPI	y/y	sep	2.0%	2.0%	1.8%	**	Equity bullish, bond bearish
	PPI Input NSA	y/y	sep	7.2%	7.4%	7.6%	**	Equity bullish, bond bearish
	PPI Output Core NSA	y/y	sep	1.2%	1.1%	0.8%	**	Equity bullish, bond bearish
AMERICAS								
Canada	Manufacturing Sales	m/m	aug	0.9%	0.2%	0.1%	**	Equity bullish, bond bearish
Brazil	Retail Sales	y/y	aug	-5.5%	-5.0%	-5.3%	**	Equity bearish, bond bullish
	Retail Sales Broad	y/y	aug	-7.7%	-6.0%	-10.2%	**	Equity bearish, bond bullish

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)	88	88	0	Neutral
3-mo T-bill yield (bps)	32	32	0	Neutral
TED spread (bps)	56	56	0	Neutral
U.S. Libor/OIS spread (bps)	47	47	0	Neutral
10-yr T-note (%)	1.77	1.77	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	44	46	-2	Down
Currencies	**Direction**			
dollar	down			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	$51.75	$51.52	0.45%	Putin pledge to commit to OPEC Agreement
WTI	$50.20	$49.94	0.52%	
Natural Gas	$3.29	$3.24	1.51%	
Crack Spread	$13.53	$13.63	-0.77%	
12-mo strip crack	$15.32	$15.37	-0.29%	
Ethanol rack	$1.71	$1.71	0.07%	
Metals				
Gold	$1,260.69	$1,255.85	0.39%	
Silver	$17.60	$17.47	0.78%	
Copper contract	$211.00	$210.70	0.14%	
Grains				
Corn contract	$ 353.00	$ 354.00	-0.28%	
Wheat contract	$ 419.25	$ 423.75	-1.06%	
Soybeans contract	$ 976.00	$ 978.25	-0.23%	
Shipping				
Baltic Dry Freight	894	892	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.7		
Gasoline (mb)		-1.25		
Distillates (mb)		-1.5		
Refinery run rates (%)		-0.3%		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country and cooler temps in the northeastern region of the country. Precipitation is forecast for most of the country. Tropical Storm Nicole has dissipated and moved away from the coast.

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 14, 2016

Given continued sluggish economic growth and fears that monetary policy has reached the point where it can no longer stimulate growth, a renewed attention has been brought to discretionary fiscal policy. In the 1970s, discretionary fiscal policy fell out of favor due to a number of shortcomings:

1. Public investment, if needed, should not be timed to offset recessions. In other words, if the Navy needs an aircraft carrier, one should be built without waiting for a recession. Thus, public investment should be based on need, not designed as a countercyclical policy.
2. Discretionary policy must pass through the legislative process. This tends to slow the outcome to the point that the recession may have passed by the time Congress allocates spending.
3. Fiscal spending, especially fixed asset spending, can "crowd out" private spending. In functioning investment markets, investment spending should be generated by cutting interest rates rather than by directing public investment by government fiat. In addition, private investment is forced to pass through the test of profitability, reducing the likelihood of malinvestment.

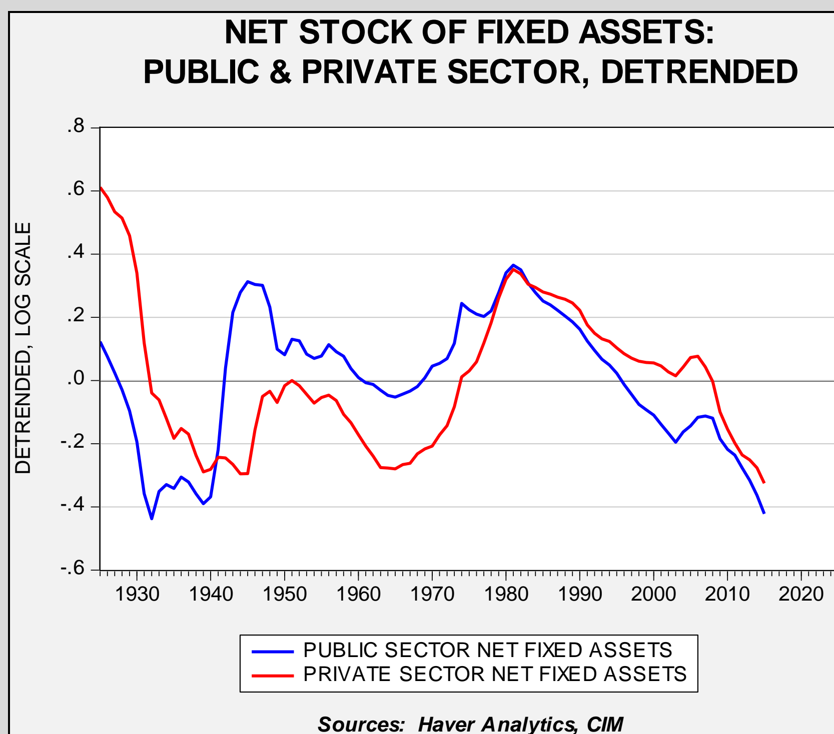
From the late 1970s, economists generally concluded that discretionary fiscal spending was unnecessary and that countercyclical monetary policy was sufficient to guide the economy through recessions. Although there were occasional extraordinary fiscal measures taken during some downturns, such as tax rebates and extended unemployment insurance payments, for the most part, monetary policy was the measure of choice in terms of countercyclical policy.

However, the developed world now finds itself in a situation where monetary policy may have reached its point of diminishing returns. The Bank of Japan (BOJ), the Swiss National Bank and the European Central Bank (ECB) have tried to implement negative interest rates. In these cases, it appears that the damage to the banking system is offsetting any gains from lower rates. Balance sheet expansions (QE) have been deployed by the aforementioned central banks and the Federal Reserve. In general, balance sheet expansion has become less effective; a common complaint is that asset values have been extended in many markets without generating much economic growth. Central banks are also struggling to find assets to purchase. The BOJ has been buying equity ETFs and the ECB has added corporate bonds to its balance sheet, causing further financial market distortions.

This isn't to say that the central banks have exhausted all their options, but the ones that remain cannot be implemented without help. For example, central banks could implement quantitative easing by purchasing foreign bonds; this would likely lead to currency depreciation that would boost exports. However, such "beggar thy neighbor" policies would likely bring retaliation and

further reduce global trade. The other option is "helicopter money," which is the direct central bank financing of government spending. Although this policy would be effective, it does require the participation of fiscal authorities. In addition, central bank independence would almost certainly be compromised.

So, if fiscal policy is expanded, would we face the problems outlined above? Generally speaking, the biggest risk would be point #2 above. Getting spending plans through a divided Congress would be difficult. In addition, avoiding malinvestment, regardless of whether it's public or private, is always hard. But in the current partisan environment, coming up with public investment that would foster future growth will be problematic. However, there is evidence to suggest that public spending has been neglected for some time and that private investment is currently weak, reducing the problem of "crowding out"; in other words, concerns about points #1 and #3 are reduced.



This chart shows the net stock of fixed assets for both the public and private sectors. We have log transformed the data and de-trended both series. In general, a reading over zero indicates the net stock of fixed assets is above its long-term trend and vice versa. Note that public sector assets were above trend from 1940 into the mid-1990s. This was mostly due to elevated Cold War defense spending. During this period, private sector fixed asset levels tended to remain under trend, although a surge that began in the mid-1960s did eventually lead to a rise above trend. Note that the surge of both public and private spending on fixed assets in the 1970s probably led to crowding out and higher inflation.

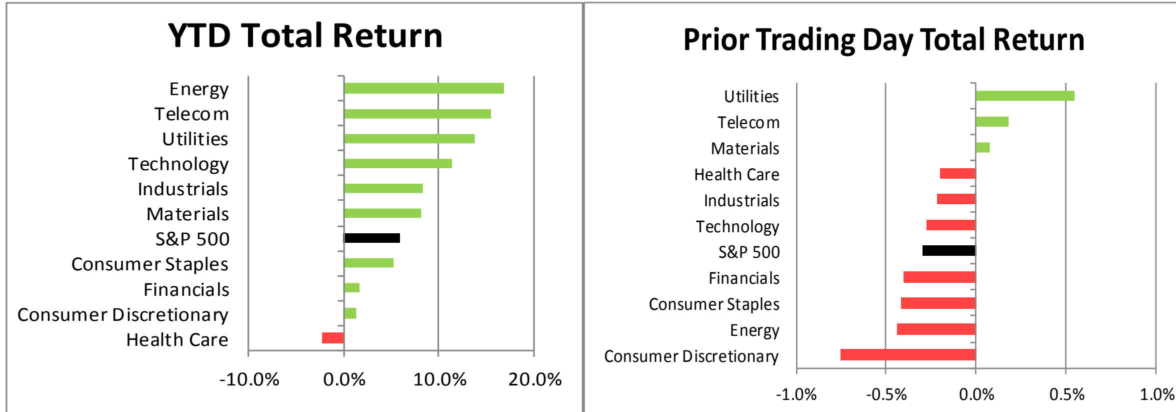
Current conditions suggest that both private and public sector investment are well below trend. In general, private sector investment tends to have a greater impact on future growth and would

thus be preferred. However, given an environment of weak asset formation from both sectors, the economy would likely benefit from increased investment in either sector. Thus, promises of increased spending on infrastructure and defense would likely have a positive effect on the economy and be positive for equity markets.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

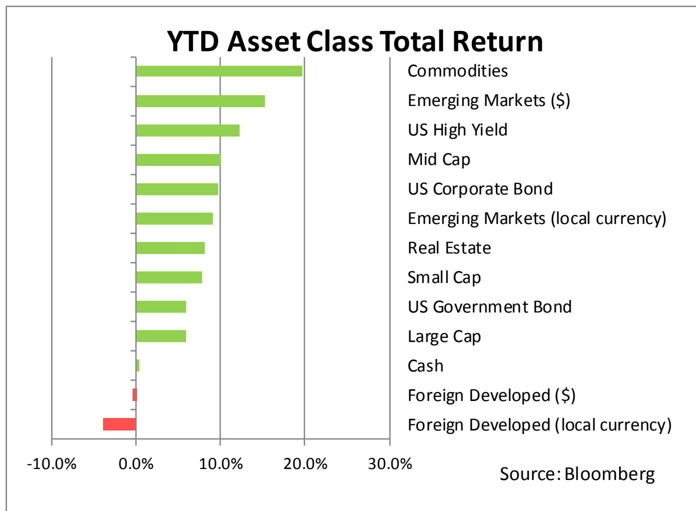
U.S. Equity Markets – (as of 10/17/2016 close)



(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 10/17/2016 close)

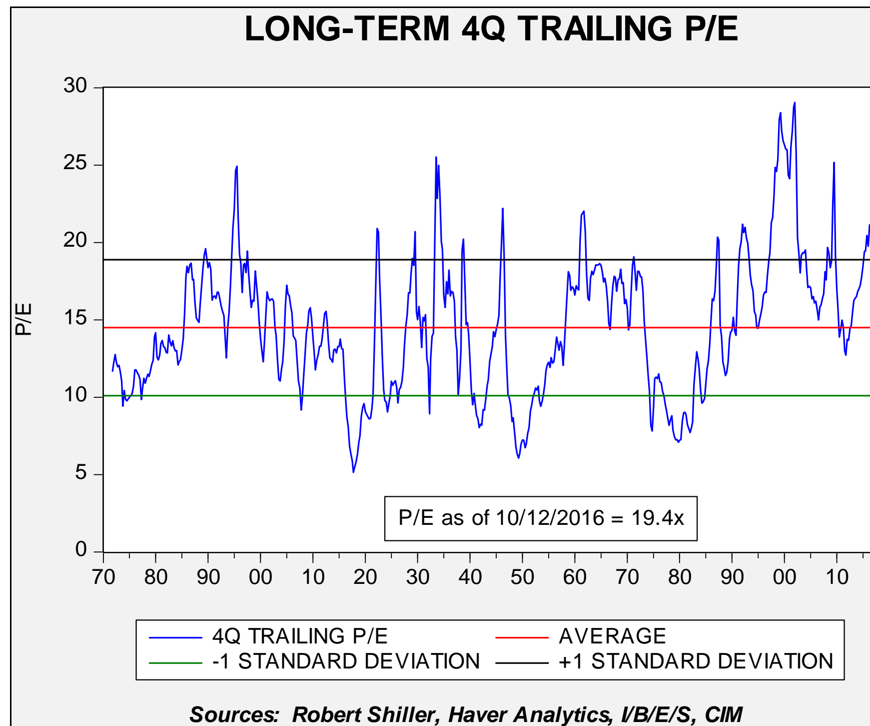


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 2016



Based on our methodology,[1] the current P/E is 19.4x, 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.

[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 (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.