Daily Comment

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

[Posted: October 31, 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 sideways from the prior close. Chinese markets were down, with the Shanghai composite down 0.1% and the Shenzhen index down 0.1%. U.S. equity futures are signaling a higher opening. With 291 companies having reported, the S&P 500 Q3 earnings stand at $30.91, higher than the $29.60 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 74.9% of the companies reported earnings above forecast, while 18.2% reported earnings below forecast.

Happy Halloween!

There was lots of news over the weekend. Let's dig in:

The return of the emails. On Friday, FBI Director Comey announced the agency had come across a massive number of emails related to the private server issue that somehow ended up on a computer in the household of Anthony Weiner and Huma Abedin. The latter is a long-time close aide to Sen. Clinton. It is unclear what, if anything, is in these emails. In fact, it's not obvious how these emails ended up on a laptop reportedly controlled by Weiner. The emails were discovered because the FBI was investigating a different issue with Weiner. Whatever the reason, this issue has resurrected itself just about a week before the election. Here is our take:

1. **There is no way the FBI can get through all these emails before the vote.** According to reports, some 650k emails were gathered and, with a mere eight days before the vote, it is physically impossible to vet them all. Thus, the odds of a blockbuster revelation before the election are low.
2. **It probably doesn't swing the presidential election, but it might affect the down ballot vote.** It's hard to imagine there are any more truly undecided voters between Trump and Clinton. Both offer stark differences in policy direction and thus, by now, most voters have probably made up their minds, regardless of what they tell pollsters. However, the news might encourage voters to opt for the familiar in terms of Senate and Congress, which would favor the GOP.
3. **Comey was stuck.** Earlier this year, when FBI Director Comey opted not to recommend an indictment against Sen. Clinton, Democrats lauded his position and Republicans wanted him to resign. On Friday and through the weekend, the same support and criticism was expressed, but the party names had been switched. Comey's problem was that in the face of this huge amount of potentially new information, if he had kept quiet and something was revealed to trigger an indictment, he would have been accused of throwing the election to the Democrats. Some Democrats claim that all of the new

information is actually old information, which cannot be ascertained in advance; at the same time, it is probable that much of what has emerged isn't new.

4. **It didn't help Comey that AG Lynch has been compromised by her ill-advised contact with the Clintons.** She really could not offer any guidance. If she suggested the FBI should wait, it would be unclear whether she was taking that position because she didn't believe the new emails were material or if she was offering allegiance to the Clintons. About all that Lynch could do to remain above reproach would be exactly what Comey did, and she would have made herself the target of what Comey is now suffering.
5. **The email uncertainty will plague a President Clinton should she win the election.** As we have discussed before, new presidents have a limited amount of political capital that has a "sell date" of about 18 months after the inauguration. A President-Elect Clinton would already have less than a normal new president because she ran a campaign similar to that of a sitting vice president, who wins by vowing to maintain the policies of the predecessor. The email issue would further require a President Clinton to spend precious political capital to defend herself from charges that could stem from this investigation.
6. **A President Clinton, wounded by the ongoing investigation, may be forced to tack to the Sanders-Warren wing of the party.** The Sanders-Warren wing could offer Clinton unwavering support in return for getting their preferred candidates in key cabinet positions. Depending on how dire the investigation becomes, she may seek shelter in this wing of the party. If so, regulations could take a much harder turn to the left on both the financial system and the environment.

So, our take is that the emails will take the focus off of the Trump campaign and will cause the polls to tighten (which it appears has already occurred). However, we have been holding a rather jaundiced eye toward the polls anyway on fears that preference falsification is rampant in this election. Our probabilities haven't changed—we see a 10% chance of a Clinton landslide, a 50% chance of a narrow Clinton win and a 40% chance of a narrow Trump win.

Will Carney leave? The weekend British press reported that BOE Governor Carney is preparing to resign. The *FT*'s lead story this morning scotched these reports, which appear to have emerged from the right-wing press in Britain. Carney supported the Remain campaign and Brexit supporters have been furious with him. At the same time, Carney has been a steady hand during this period of tumult and it would be quite bearish for the GBP if he were to exit early. If he stays his entire term, he will be in office into 2018.

OPEC fail? OPEC held informal meetings over the weekend to hash out production adjustments before the major meeting on Nov. 30. The meetings did not go well. Iran and Iraq insisted that they should not be forced to cut output. Iran says it is still recovering from sanctions and Iraq says it's fighting a war against IS and needs the revenue. It seems that if cuts are going to come, the Saudis will be the primary source, forcing the kingdom back to the "swing producer" role it has rejected since the mid-1980s. Since Saudi Arabia has priced its bond issue, we would be surprised to see the kingdom shoulder most of the burden of output cuts. Non-OPEC producers rejected the idea of cuts if OPEC isn't able to negotiate a deal. Although hope still exists that the cartel can engineer a cut by the end of November, it looks increasingly unlikely. If no deal emerges, a retreat to the $40 to $45 range for oil prices is likely.

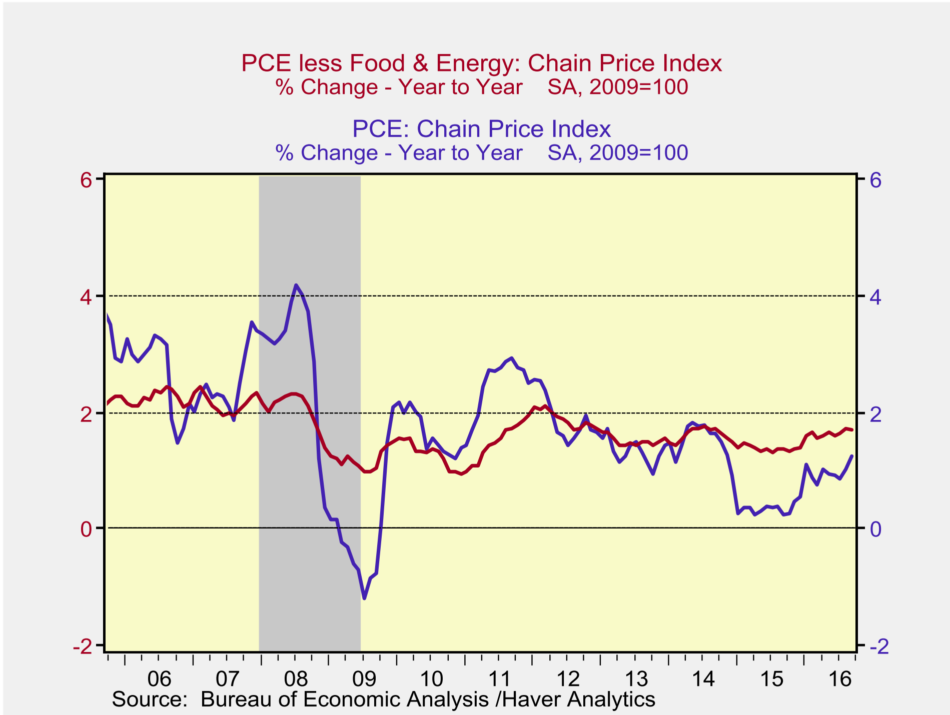
Charges dropped against Gordhan. Earlier this month, South Africa's finance minister, Pravin Gordhan, was due to face charges on corruption, which appeared to be politically motivated. This morning, we learned these charges will be dropped. The South African rand rallied.

(Source: Bloomberg)

This chart shows XAR per USD on an inverted scale. Note how the currency rallied today.

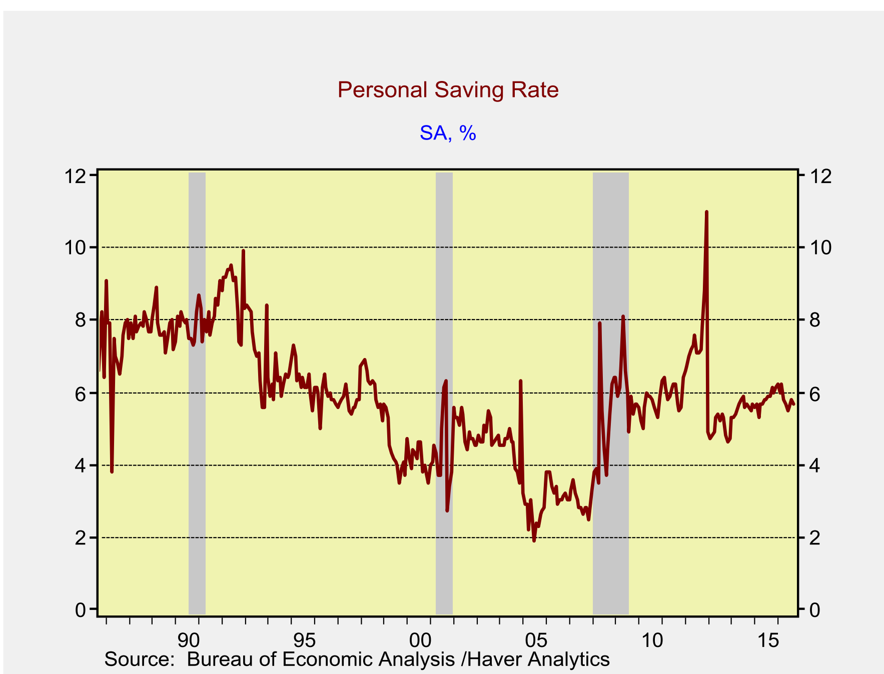
U.S. Economic Releases

Today, personal income and spending numbers were released by the Department of Commerce. Personal income rose by 0.3%, lower than the 0.4% forecast. Personal spending rose by 0.5%, higher than the 0.4% forecast.



The chart above shows that the rise of personal consumption is being weighed down by food and energy prices. The core PCE also suggests that the economy is moving closer to the Federal Reserve's 2% target. In fact, the PCE is the Fed's preferred inflation measure compared to CPI.

The rise in spending led to weaker saving, in spite of softer income growth. The savings rate fell modestly to 5.7% of after-tax income.



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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Chicago Purchasing Manager	y/y	oct	54	54.2	**
10:00	Dallas Fed Manf. Activity	y/y	oct	1.8	-3.7	**

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	Industrial Production	y/y	sep	0.9%	4.5%	1.9%	***	Equity bearish, bond bullish
	Retail Trade	y/y	sep	-1.9%	-2.1%	-1.8%	**	Equity bearish, bond bullish
	Dept. Store, Supermarket Sales	y/y	sep	-3.2%	-3.6%	-2.7%	**	Equity bearish, bond bullish
	Vehicle Production	y/y	sep	1.4%	8.8%		*	Equity bearish, bond bullish
India	Eight Infrastructure	y/y	sep	5.0%	3.2%		**	Equity bullish, bond bearish
Australia	Melbouurn Institute Inflation	y/y	oct	1.5%	1.3%		**	Equity and bond neutral
	Private Sector Credit	y/y	sep	5.5%	5.8%	5.5%	**	Equity and bond neutral
New Zealand	Building Permits	m/m	sep	0.2%	-1.0%		**	Equity bullish, bond bearish
	ANZ Business Confidence	y/y	oct	24.5	27.9		**	Equity and bond neutral
	ANZ Activity Outlook	y/y	oct	38.4	42.4		**	Equity and bond neutral
	Money Supply M3	y/y	sep	4.8%	5.3%		**	Equity and bond neutral
EUROPE								
Eurozone	GDP	y/y	sep	1.6%	1.6%	1.6%	***	Equity and bond neutral
	CPI Estimate	y/y	oct	0.5%	0.4%	0.5%	***	Equity and bond neutral
Germany	Retail Sales	y/y	oct	0.4%	3.7%	1.5%	**	Equity bearish, bond bullish
Italy	CPI NIC	y/y	oct	-0.1%	0.1%	0.1%	**	Equity bearish, bond bullish
	PPI	y/y	sep	-0.8%	1.1%		***	Equity bearish, bond bullish
Switzerland	Total Sight Deposits	y/y	sep	518.5	518.5 bn		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	sep	451.9	451.3 bn		**	Equity and bond neutral
UK	Net Consumer Credit	y/y	oct	1.4 bn	1.6 bn	1.5 bn	***	Equity and bond neutral
	Net Lending Sec. on Dwelling	y/y	sep	3.2 bn	2.9 bn	3 bn	**	Equity bearish, bond bullish
	Mortgage Approvals	y/y	sep	62.9 k	60.1k	61.5k	**	Equity bullish, bond bearish
	M4 Money Supply	y/y	oct	6.2%	5.4%		**	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)	89	89	0	Neutral
3-mo T-bill yield (bps)	28	28	0	Neutral
TED spread (bps)	61	61	0	Neutral
U.S. Libor/OIS spread (bps)	50	50	0	Neutral
10-yr T-note (%)	1.84	1.85	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	49	46	3	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	$49.34	$49.71	-0.74%	Skepticism about possible output agreement
WTI	$48.41	$48.70	-0.60%	
Natural Gas	$3.13	$3.11	0.68%	
Crack Spread	$13.97	$13.84	0.88%	
12-mo strip crack	$15.59	$15.60	-0.04%	
Ethanol rack	$1.75	$1.75	0.00%	
Metals				
Gold	$1,273.21	$1,275.47	-0.18%	
Silver	$17.80	$17.76	0.25%	
Copper contract	$219.30	$219.35	-0.02%	
Grains				
Corn contract	$ 353.25	$ 355.00	-0.49%	
Wheat contract	$ 410.00	$ 408.50	0.37%	
Soybeans contract	$ 1,011.00	$ 1,012.00	-0.10%	
Shipping				
Baltic Dry Freight	834	798	36	

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.

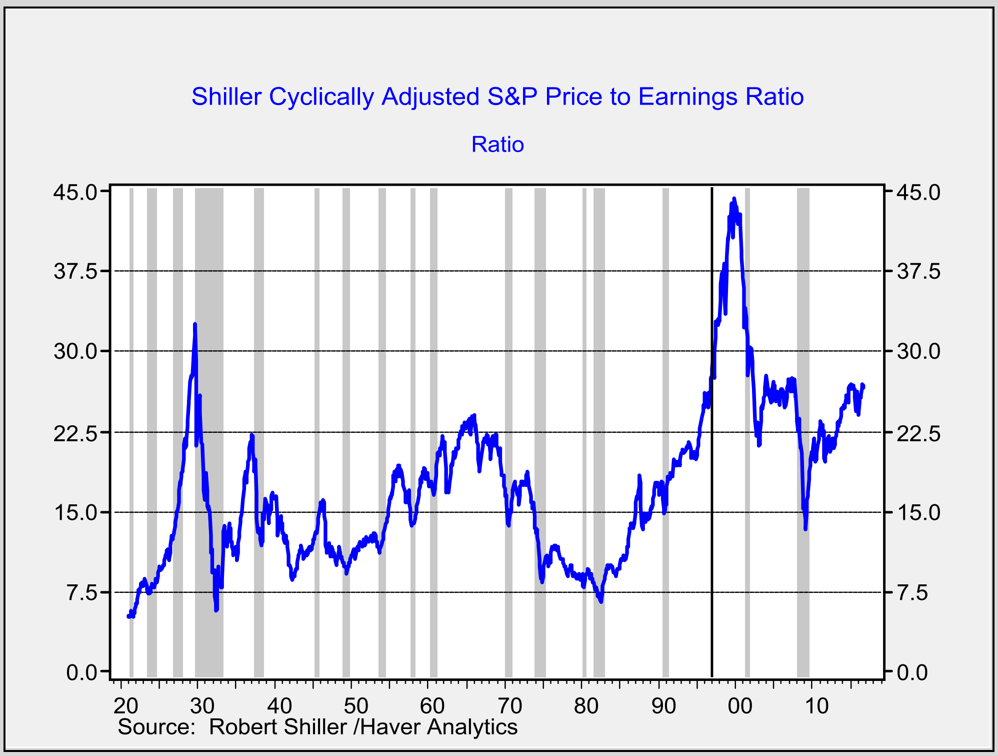
Asset Allocation Weekly Comment

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 28, 2016

My weekend exercise is to take my dogs on long walks. Both dogs seem to enjoy these walks and I use the time to listen to podcasts. I recently listened to a long podcast that interviewed Sebastian Mallaby, a British journalist and senior fellow at the Council on Foreign Relations. He has recently written a biography on Alan Greenspan, titled *The Man Who Knew*. The FT Alphachat podcast[1] was an interview about that book.

Although I haven't read the book yet (it's on the list), a key takeaway from the podcast was that one of Greenspan's attributes was that he was a savvy political operative. He understood that the Federal Reserve operates in a political environment and that one of the Chair's jobs is to manage the political system to maintain the central bank's independence. Mallaby suggested in the podcast that Greenspan was truly a "maestro" in managing the political situation. However, as I listened, I wondered if managing the political situation meant that monetary policy was being framed to please the politically powerful.

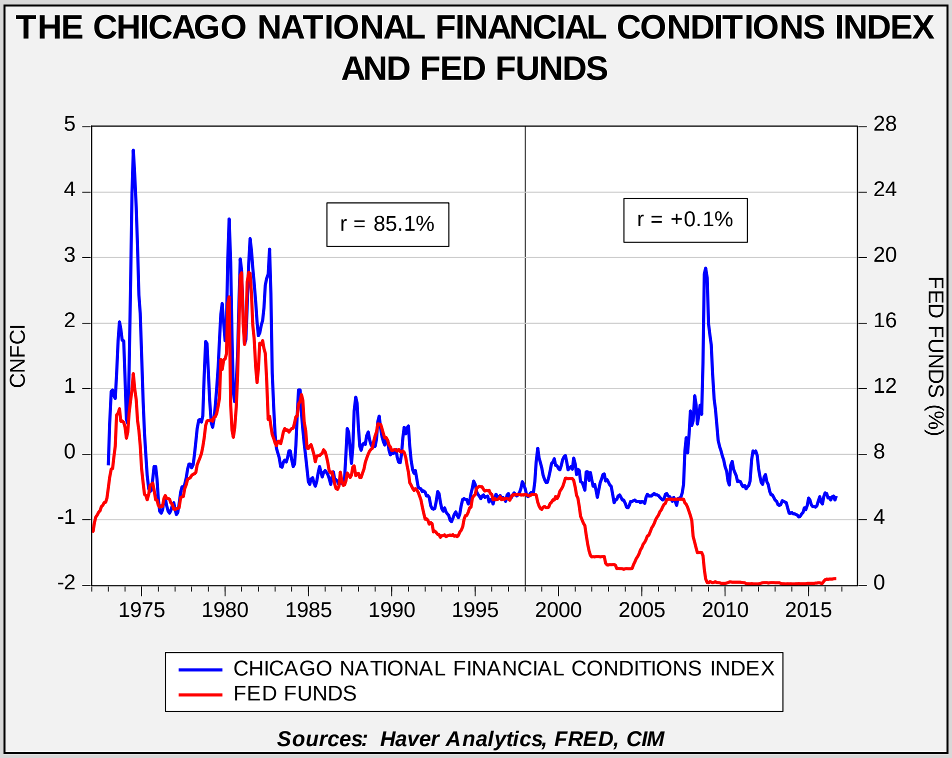


---

[1] http://ftalphaville.ft.com/2016/10/21/2177678/podcast-our-chat-with-sebastian-mallaby-on-alan-greenspan/

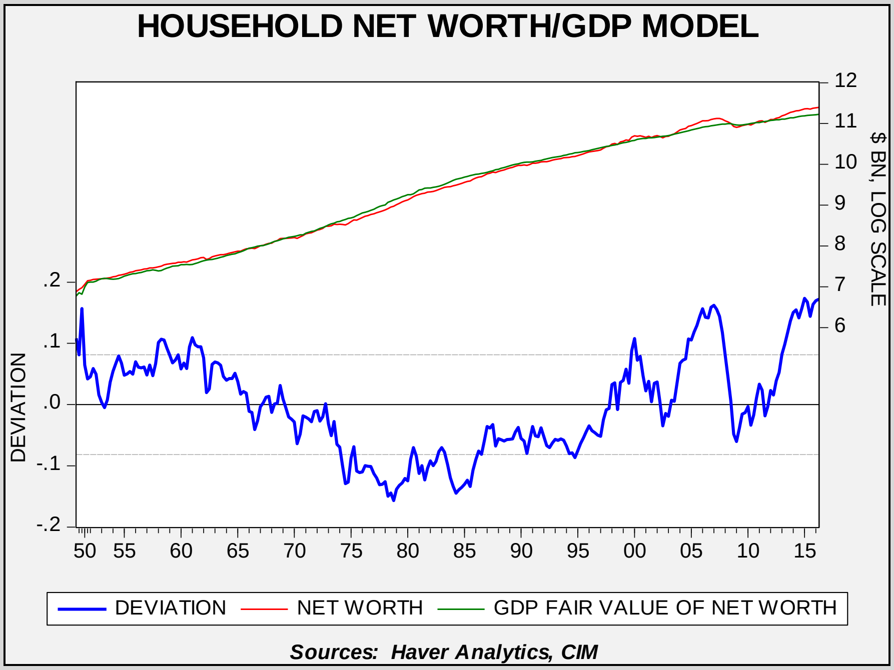
This chart shows the Shiller Cyclically Adjusted Price Earnings ratio (CAPE). We have placed a vertical line at December 1996 when Greenspan gave his famous "irrational exuberance" speech, raising questions about equity market valuations. As the chart shows, the CAPE was approaching levels near the peak of the 1929 stock market bubble that was soon followed with a massive market crash. Although Greenspan didn't suggest that the Fed was about to change monetary policy to curb asset prices, equity markets around the world fell sharply on fears that Greenspan was about to use monetary policy to lower the stock market. Greenspan faced heavy criticism for the speech.[2] Being the consummate political operator, Greenspan's monetary policy seemed to evolve into a form where asset market bubbles cannot be established in advance and the job of the central bank was to use monetary policy to repair the damage wrought to the real economy once the bubble collapses.

This chart overlays the Chicago FRB National Financial Conditions Index and the fed funds rate. The index measures stress in the financial system. The higher the reading, the greater the stress in the system.



The two series were closely correlated (85.1%) from 1973 through 1997, until the financial conditions index was created in 1998. When fed funds rates rose, financial conditions deteriorated. In some respects, financial conditions acted as a "force multiplier" for policy. But, from 1998 to the present, the two series have become virtually independent. After hearing Mallaby's podcast, we suspect the FOMC may be trying to keep financial conditions calm, which could be construed as a reading under zero on the above chart.

[2] http://www.wsj.com/articles/SB957740787830302 19



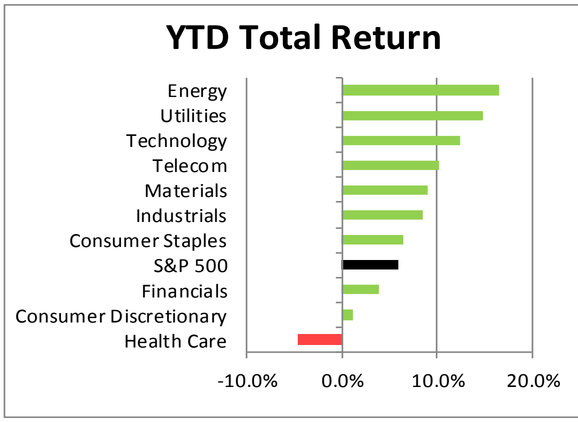
This chart shows a model of household net worth regressed against nominal GDP. Both series have been log-transformed. Net worth was elevated into the early 1960s but steadily declined into the late 1970s. It began to rise in 1995. Note that since 1998, net worth has generally outpaced GDP except during recessions.

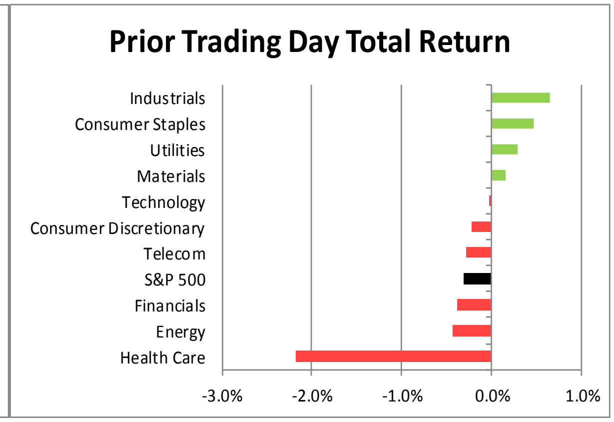
Currently, net worth relative to GDP is elevated. It does appear that these increases in net worth that outpace the overall growth of the economy could be a function of monetary policy. As investors become confident that the Federal Reserve will continue to suppress financial stress, it appears there is a tendency for asset prices to rise to lofty levels. When valuations become unsustainable, often at the turn of the business cycle, it appears that sharp declines in net worth, caused by price declines in real and financial assets, leads to a fall in household net worth.

Mallaby's research of Greenspan suggests he was inclined to allow asset prices to rise while striving to contain price inflation. It is arguable that Greenspan's policies with regard to financial system stress have been adopted by his successors. If so, monetary policy is probably (although perhaps inadvertently) designed to aid asset prices. As the last chart shows, net worth is elevated again at levels that have been difficult to sustain in the past. We still believe that recessions are the primary triggers of market corrections and we closely monitor the economy for such events. The current level of valuation makes this exercise even more critical.

Data Section

U.S. Equity Markets – (as of 10/28/2016 close)

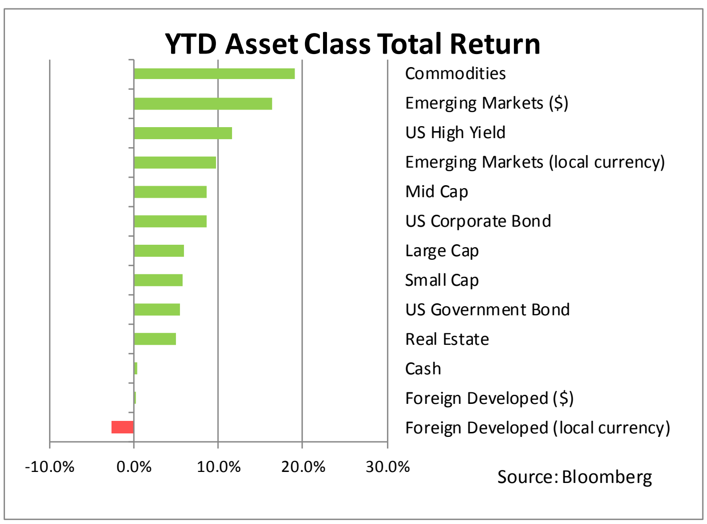




(Source: Bloomberg)

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 10/28/2016 close)

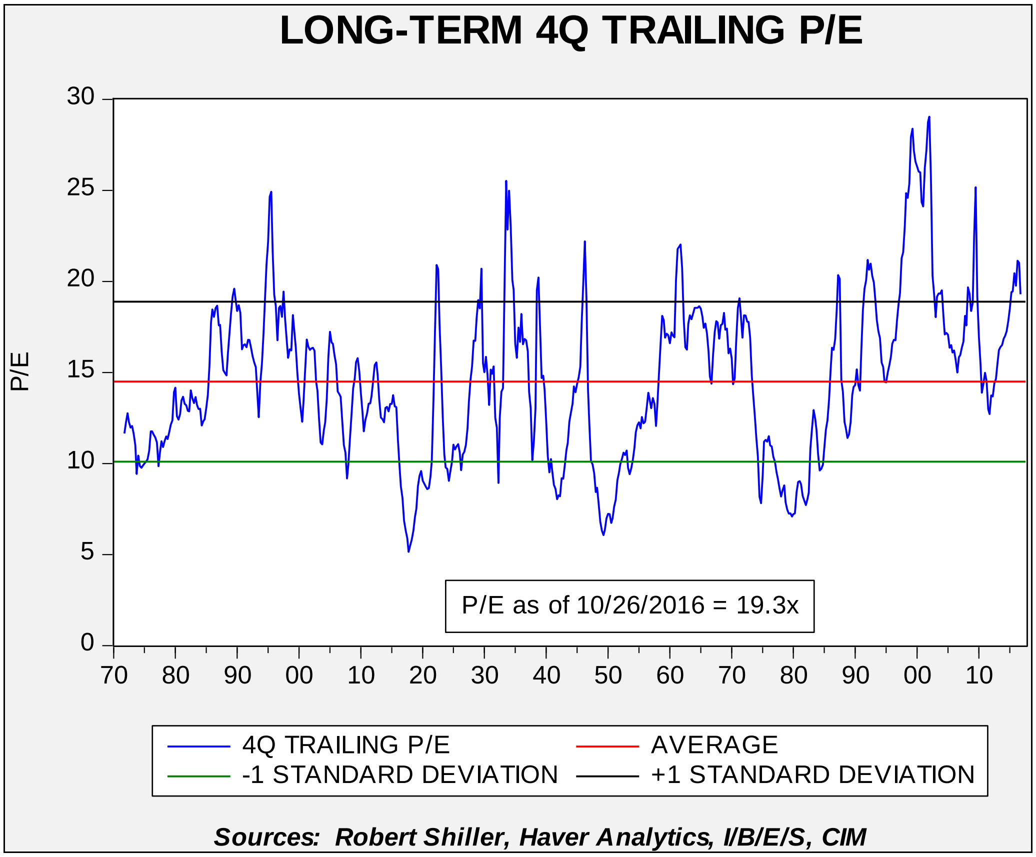


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 27, 2016



Based on our methodology,[3] the current P/E is 19.3x, down 0.1x from last week. Better earnings reports are the cause of the decline in the P/E.

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.

---

[3] 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.