Daily Comment

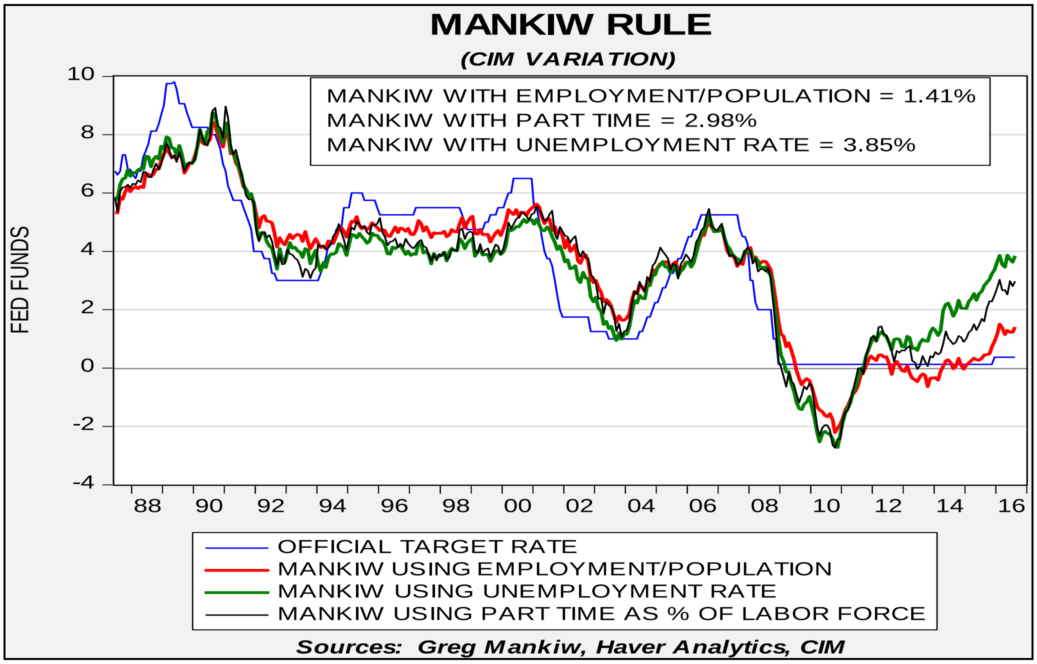
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 16, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.1% from the prior close. Chinese markets were closed today. U.S. equity futures are signaling a lower opening from the previous close.

There isn't a ton of news in the financial markets this morning. The most discussed is the DOJ decision to levy a $14 bn fine against Deutsche Bank AG (DB, $14.76). In European trading, shares were off over 8% overnight. The bank was anticipating a fine but the size far exceeded expectations. Other banks in Europe will likely also face fines, so how much Deutsche Bank actually pays is broadly important. In addition, Deutsche Bank has other woes, so this fine came at an inopportune time. This event raises fears that the Eurozone banking system may be suspect; the problems plaguing Italian banks have been known for a while, for example. There is a solution—European banks will likely have to raise capital and consider international mergers. So far, this outcome hasn't been embraced.

EU leaders are holding informal meetings in Bratislava today to discuss Brexit. In a speech today, Chancellor Merkel said that the EU is at a "critical point." We would tend to agree. Brexit exposed real differences within the EU. Southern Europe wants more financial support and an easing of debt and deficit rules. Northern Europe, being the creditor, disagrees. Central and Eastern Europe are seeing rising nationalism and oppose Brussel's rules on immigration, refugees and other issues. At the same time, the northern European nations are dealing with a rise of nationalist parties themselves. How the EU manages Brexit is part of this debate; some nations want to pressure Britain with harsh conditions on the hope that the British will change their minds. After all, several referendums on EU treaties have failed in other nations only to be eventually ratified. The danger of going this route is that Britain's position will harden even further, disrupting trade and investment flows. On the other hand, going too easy on the U.K. may prompt others to follow suit and leave the EU. It is these conditions that prompted Merkel's aforementioned comment.

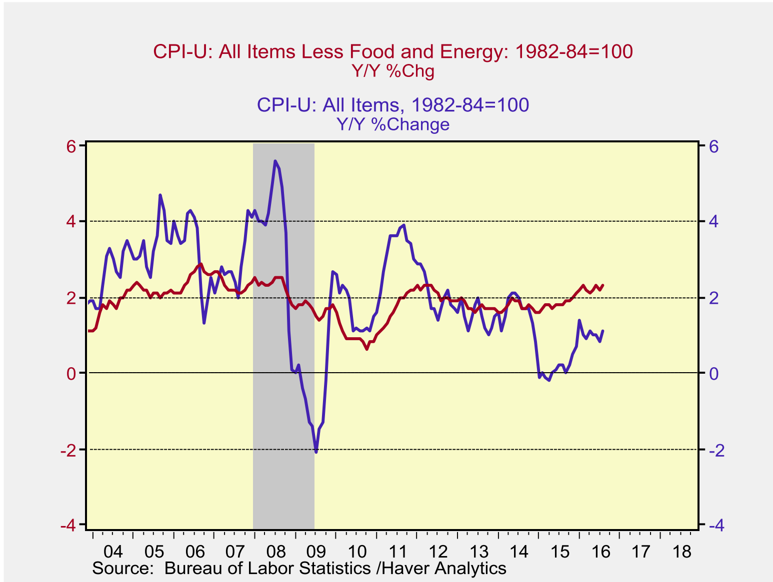
With the release of CPI data, we can update our versions of the Mankiw rule model. This model attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate by 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 3.85%, suggesting the FOMC is well behind the curve. Using the employment/population ratio, the neutral rate is 1.41%, indicating that, even using the most dovish variation, the FOMC needs a rate hike of at least 100 bps to achieve neutral policy. Finally, using involuntary part-time employment, the neutral rate is 2.98%. Although we don't expect the FOMC to raise rates next week, the pressure to raise rates is intensifying. Of course, there is an ongoing debate as to the wisdom of the Taylor/Mankiw Rule framework. Although there are clearly doubts about the model (the current wide deviation is clear evidence that the FOMC is deviating from these models), there is no obvious replacement. Thus, we believe policymakers view the current deviation from the Taylor/Mankiw Rule models as temporary and policy rates will rise sharply at some future point.

U.S. Economic Releases

CPI came in above forecast for August, rising 0.2% compared to the 0.1% increase expected. Core inflation also came in higher than forecast, rising 0.3% compared to the 0.2% increase expected. Price increases were broad-based, while price declines were seen in transportation, recreation and commodities.



The chart above shows the annual change in headline consumer inflation and core inflation. The headline inflation rose 1.1% annually, more than the 1.0% increase expected. Core prices rose 2.3% annually, also more than the 2.2% increase expected. The pick-up in consumer inflation could lead to a rising PCE, which the Fed uses as one of its favorite inflation gauges. A rise in PCE could mean an increase in the likelihood of a rate hike. Equities fell initially following the release but have rebounded since then.

August real average weekly earnings rose 0.4% annually compared to the 1.2% increase seen the week before.

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

Economic releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	University of Michigan sentiment	m/m	Sep	90.6	89.8	**
12:00	Household change in net worth	q/q	Q2		$837 bn	**
4:00	Total net TIC flow	m/m	Jul		-$202.8 bn	**
4:00	Net long-term TIC flow	m/m	Jul		-$3.6 bn	**

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
EUROPE								
France	Wages	q/q	Q2	0.3%	0.3%	0.3%	**	Equity and bond neutral
Italy	Trade balance	m/m	Jul	€7.8 bn	€4.7 bn		**	Equity bullish, bond bullish
Russia	PPI	y/y	Aug	3.1%	4.5%	4.5%	**	Equity bullish, bond bullish
AMERICAS								
Canada	Manufacturing sales	m/m	Jul	0.1%	0.8%	1.0%	**	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)	85	85	0	Neutral
3-mo T-bill yield (bps)	29	28	1	Up
TED spread (bps)	57	57	0	Neutral
U.S. Libor/OIS spread (bps)	44	44	0	Neutral
10-yr T-note (%)	1.69	1.69	0.00	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	33	29	4	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Neutral
yen	up			Down
pound	down			Down
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Russia key rate	10.00%	10.50%	10.00%	On forecast

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	$45.80	$46.59	-1.70%	Ample global inventories
WTI	$43.13	$43.91	-1.78%	
Natural Gas	$2.87	$2.93	-2.02%	
Crack Spread	$16.95	$15.96	6.16%	
12-mo strip crack	$14.51	$14.28	1.60%	
Ethanol rack	$1.64	$1.64	-0.12%	
Metals				
Gold	$1,310.41	$1,314.75	-0.33%	Higher dollar
Silver	$18.87	$18.98	-0.62%	
Copper contract	$215.20	$215.95	-0.35%	Demand concerns
Grains				
Corn contract	$ 328.25	$ 330.00	-0.53%	Ample supplies
Wheat contract	$ 397.50	$ 399.50	-0.50%	
Soybeans contract	$ 946.50	$ 950.50	-0.42%	
Shipping				
Baltic Dry Freight	764	756	8	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.6	2.8	3.4	
Gasoline (mb)	0.6	-0.6	-1.2	
Distillates (mb)	4.6	1.3	-3.3	
Refinery run rates (%)	-0.8%	-0.4%	0.4%	
Natural gas (bcf)	62.0	58.9	-3.1	

Weather

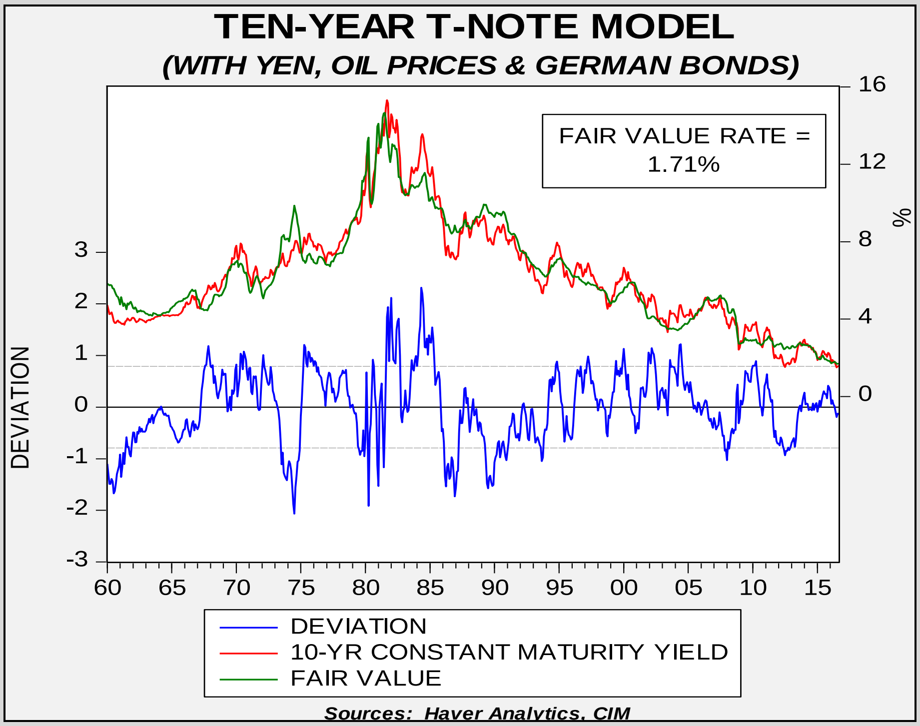
The 6-10 and 8-14 day forecasts are calling for warmer conditions for all of the country, except for the upper Midwest and the Northwest. Precipitation is forecast for the middle of the country. Tropical Storm Julia moved back over the Atlantic and will cause rain and thunderstorms for the coastal Carolinas. Tropical Storm Ian is located in the north Atlantic and is expected to slow as it moves further north. Tropical Storm Karl continues moving west. TS Karl is not currently expected to enter the Gulf of Mexico. A small low pressure area has formed in the Gulf of Mexico. This development has a low chance of becoming a cyclone over the next two days. We note that the average peak in tropical storm development is September 10, so we should see fewer storms as the weeks pass.

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.

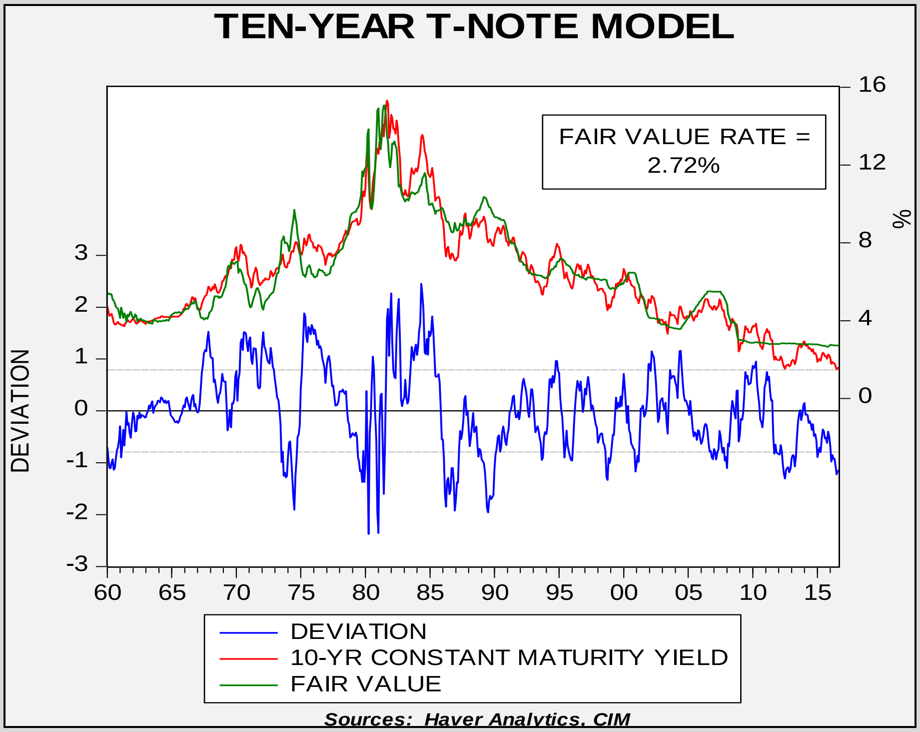
September 16, 2016

Since the beginning of September, 10-year T-note yields have risen from a low of 1.52% to a high of 1.75%. This backup in yields is as issue we are monitoring carefully because we have favored long-duration assets for some time. We analyze long-dated interest rates by starting with a fair value assessment of the 10-year T-note yield.



This is our full T-note model. It uses the effective fed funds rate, the 15-year average of inflation (a proxy for inflation expectations), the yen/dollar exchange rate, oil prices and the yield on German bonds. The current fair value rate is 1.71%, suggesting that the long end is a bit overvalued at current yields. A hike of 25 bps in the effective fed funds rate would raise the fair value yield to 1.88%, assuming no change in the other variables. Thus, the recent rise in yields is due, in part, to concerns about the potential for tightening monetary policy.

Deeper examination shows that foreign factors are keeping yields low. Eliminating the yen/dollar exchange rate, oil prices (which are set globally) and German bond yields creates a model using only domestic factors. Namely, using just inflation expectations and fed funds boosts the fair value by 100 bps.



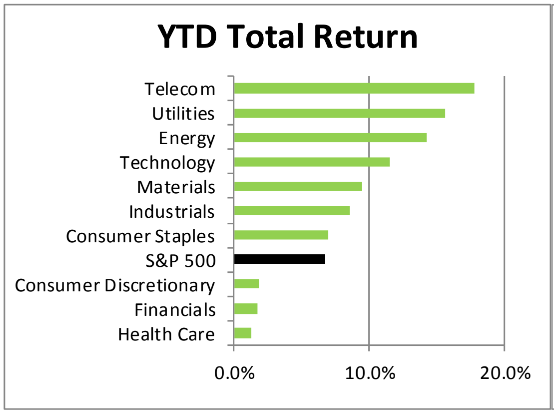
By focusing on domestic factors, the 10-year T-note is deeply undervalued. In fact, a comparison of the models shows that international factors have played a key role in lowering yields over the past two years.

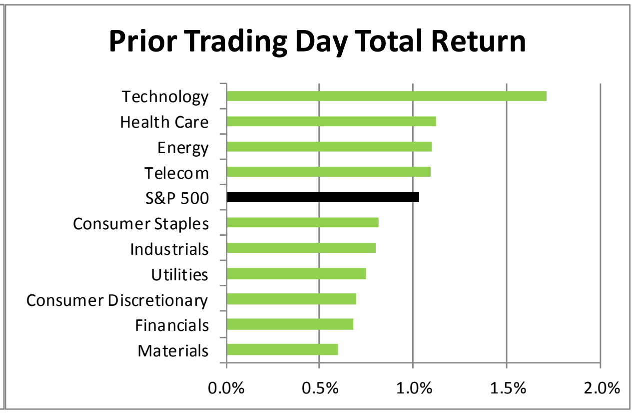
As we assess the prospects for the three international variables, we expect oil prices will likely be rangebound. Over the next year, we look for the average price of oil to hold around $50 per barrel. In the near term, however, seasonal factors will likely weigh on oil prices and support lower T-note yields. Barring helicopter money in Japan, the JPY will likely drift higher against the dollar which will also bring lower T-note yields. The key factor will probably be German yields. German yields ticked higher after the ECB refused to adjust policy last week. But, worries about the upcoming Italian referendum, expected to be held as early as October, and the rising likelihood that the ECB will eventually boost stimulus should lower German bond yields. Thus, for now, we believe the case for long-duration fixed income remains in place.

Longer term, we continue to closely monitor the expansion of populism. Populist policies will tend to eventually lift inflation and will most likely end the long decline in interest rates. For now, the establishment continues to hold sway but we would expect that somewhere in the next four to eight years, or perhaps sooner, inflation will return and we will need to position portfolios for such an environment.

Data Section

U.S. Equity Markets – (as of 9/15/2016 close)

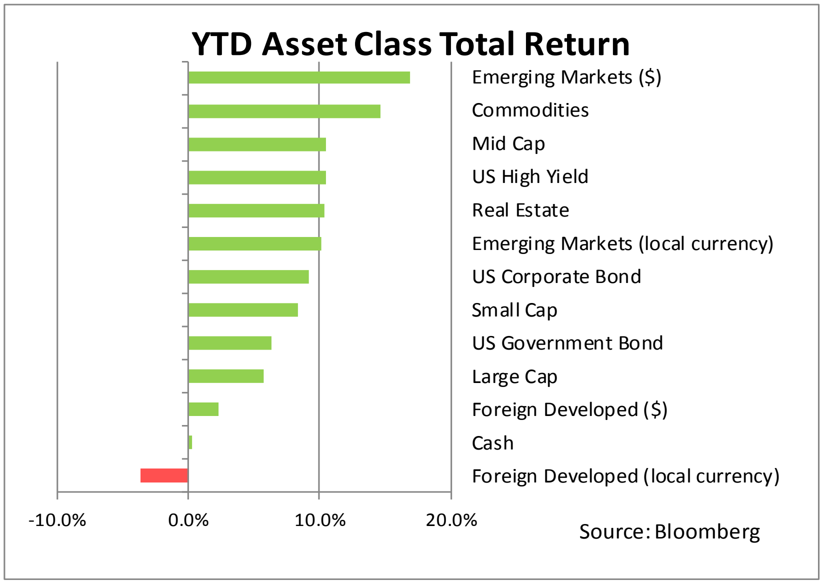




(Source: Bloomberg)

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 9/15/2016 close)

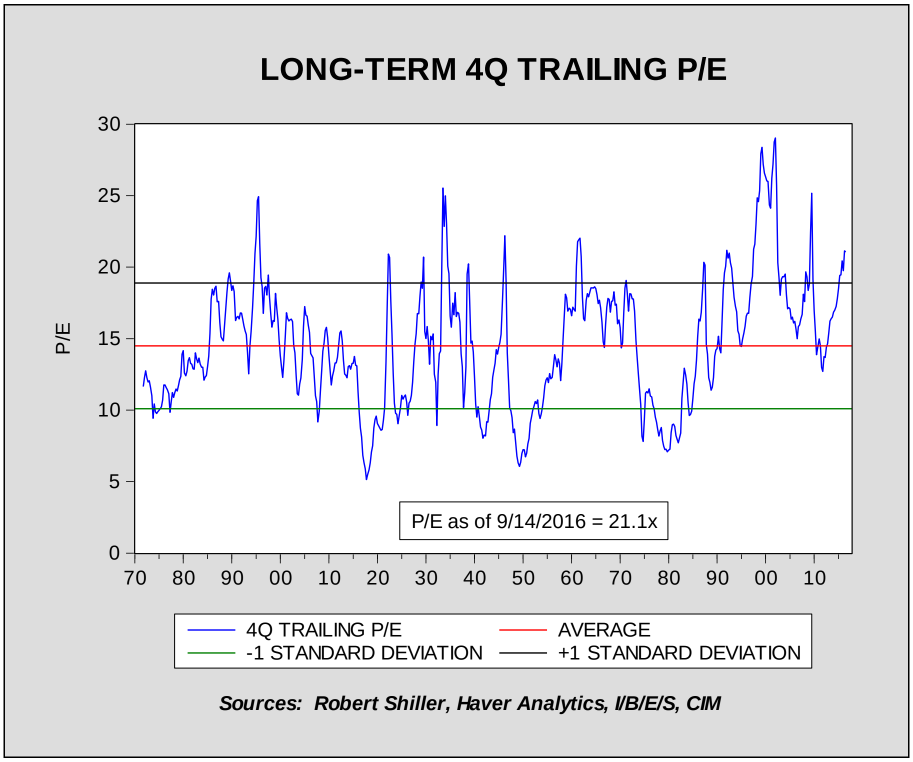


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2016



Based on our methodology,[1] the current P/E is 21.1x, up 0.6x from last week. As we adjust from Thomson-Reuters to S&P data for earnings, the latter number is lower, which is leading to the higher 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.

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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.