Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 19, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.1% from the prior close. Chinese markets were also higher, with the Shanghai composite moving higher by 0.8% and the Shenzhen index up by 1.1%. U.S. equity futures are signaling a higher opening from the previous close.

It was a very busy weekend for news. Let's take a look:

Terrorist attacks: There were a couple of bomb explosions over the weekend along with a number of unexploded devices found in the Greater New York area. The story is evolving but security officials have named two suspects and are seeking three others for questioning. Although police and FBI have stepped up their investigation, so far, the public and markets are taking this event in stride. There is no evidence of problems in the financial markets. Separately, a terrorist attacked and wounded nine people in a stabbing incident in a Minneapolis shopping mall. This assailant was killed by an off-duty police officer. IS did claim responsibility for the Minneapolis attack but has not made mention of the New York bombings. We will have a WGR on terrorism out later today.

Central banks: The BOJ and Fed meet this week. Perhaps the most important is the BOJ meeting as this bank is starting to grapple with the problem of the exhaustion of monetary policy. Rumors continue to fly about what the BOJ will do. In our opinion, the key is getting the JPY to weaken. The most effective policy, QE with foreign bonds, probably won't be implemented; we expect more QE. This may not satisfy the financial markets but it is also likely that this outcome has been mostly discounted. Meanwhile, the FOMC probably will not move this week but will likely signal a change by December. The *WSJ* has a profile of Boston FRB President Rosengren who has moved into the hawkish camp due to worries about overvalued financial assets. Although there is a case to be made for raising rates for this reason, it is hard for any Fed chair to go to Congress and explain that they raised rates because the stock market was too strong.

European elections: There were two elections over the weekend. In what was no surprise, the United Russia Party, which is Putin's affiliation, won Duma elections in a landslide. The government had scripted the election, putting a virtual freeze on opposition media and thus making it nearly impossible for any opposition to campaign. United Russia won 76% of the Duma, or 343 seats, up from 238 in the 2011 elections. However, turnout was only 48% compared to 60% in 2011, suggesting that Russians are expressing their opposition by simply not voting. In Germany, the CDU, Chancellor Merkel's party, lost ground in Berlin local elections, its second straight defeat in a local election. The populist AfD won 11.5% of the vote, which will give it proportional representation in the local government. The CDU won 18% of the vote, down from 23% in the last election.

OPEC meeting: OPEC meets informally next week and, according to the cartel's secretary general, if a consensus is reached at this meeting then an emergency formal meeting could be held. According to Venezuelan officials, the group is "close" to an agreement. We do not expect any move to cut production; at best, OPEC may freeze output at current levels. However, Iran won't agree to such a move and Saudi output is near record highs. Thus, a freeze won't do much to relieve the overhang. Simply put, we look for more supportive talk but little supportive action.

An EU military: Saturday's *NYT* reported that EU leaders are considering a consolidated military force, something that would have been impossible before Brexit. The U.K. would not allow its soldiers to come under EU control but, now that the British are leaving, European leaders are considering a joint military force with its command in Brussels. According to the article, the French are solidly behind the idea. France has always tried to use the EU to leverage its influence. Eastern European leaders were less enthusiastic about the plan for a couple of reasons. First, they fear that the force won't be strong enough to deter Russia but an EU army might tempt the U.S. to pull back from NATO. Second, the French have never been keen on adding additional members in Eastern Europe and they worry a French-led EU military might be willing to offer them up to Russia in return for other favors. Under a President Trump, the EU may have no other choice than to remilitarize, so preparing for that possibility is probably prudent. However, given the EU's inability to act in concert on most matters, it does seem like a long shot that they could coalesce around a plan to defend themselves. In addition, the EU has long acted as a "free rider" to U.S. military power and it would be a shock for EU governments to actually take up their own defense.

The deplorable state of the U.K. military: The front page, below-the-fold article in the weekend *FT* was a telling of the woefully inadequate state of the British military. According to the report, the U.K. has no plan to defend itself from a conventional attack, meaning a Russian attack might succeed. It appears the defense plan is to call Washington. The article also noted that Navy and RAF planes deploy without adequate munitions due to their growing dependence on the U.S. Additionally, manpower has become depleted as it lacks adequate depth and the government has spent too much money on a few items of expensive military equipment.

The devolution of the British Labour Party: Next weekend, the British Labour Party will hold its annual conference and is expected to re-elect Jeremy Corbyn as leader. Corbyn is an unrepentant leftist who is taking the Labour Party back to its platforms of four decades ago. Although the political class abhors Corbyn, the rank and file Labour Party members seem to like him a lot. If the process continues as expected, the Tories would be fools not to call a snap election. The Conservatives may not have a definable opposition if they do. On the other hand, the fact that Corbyn can hold his current position after years in the political wilderness speaks volumes about changes in the Western electorate.

Good lives without good jobs: One of the more intriguing editorials in the Sunday *NYT* was about how to create good lives without good jobs. It discussed an ever growing safety net designed to boost household income for those earning low wages. This trend has been in place and growing for a while; we believe we are still in the early stages of this development. Globalization, deregulation and the rapid introduction of technology are creating conditions that offer an ever narrowing road to the middle class. For the bottom 50% of income brackets (and maybe up to the bottom 80%), jobs don't pay well and have become increasingly uncertain. At the same time, without enough income for the majority of households, spending will be restrained as will economic growth. Social unrest will certainly rise. This isn't a new problem; we have been tracking this trend since the late 1970s. However, the growth of household debt covered up this development and allowed this trend to continue. The financial crisis ended this response to weakening income growth. The article discusses how a patchwork of government programs, including disability, earned income tax credit, unemployment insurance, subsidies for health care, etc., have given households some support. Essentially, society has two choices. The first is a broader safety net that will provide some semblance of income for a workforce that is dealing with employment that is increasingly temporary and marginal, or a return to the 1950-60s model of essentially make-work programs where jobs were protected by regulation. The former model will mean higher taxes, low inflation and the continued expansion of technological and global progress. The second will lead to higher inflation, slower introduction of new technology, more regulation and less trade, but more people working. We suspect we will end up with something that takes a bit from both, but the preponderance will be from the first model.

U.S. Economic Releases

There are no releases scheduled before we go to print. 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	NAHB housing market index	m/m	Sep	60.0	60.0	**

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	Property prices- increases	m/m	Aug	64 out of 70 cities followed	51 out of 70 cities followed		**	Equity bullish, bond bearish
	Property prices- unchanged	m/m	Aug	2 out of 70 cities followed	3 out of 70 cities followed		**	Equity bullish, bond bearish
	Property prices- declines	m/m	Aug	4 out of 70 cities followed	16 out of 70 cities followed		**	Equity bullish, bond bearish
EUROPE								
Eurozone	Current account balance	m/m	Jul	€21.0 bn	€29.5 bn		**	Equity and bond neutral
Italy	Current account balance	m/m	Jul	€9.4 bn	€7.2 bn		**	Equity and bond neutral
U.K.	House prices	y/y	Sep	4.0%	4.1%		**	Equity and bond neutral
AMERICAS								
Brazil	Economic activity	y/y	Jul	-5.2%	-2.9%	-4.5%	**	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)	86	86	0	Neutral
3-mo T-bill yield (bps)	28	28	0	Neutral
TED spread (bps)	58	58	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	33	0	Neutral
Currencies	**Direction**			
dollar	down			Up
euro	up			Neutral
yen	up			Down
pound	up			Down
franc	down			Neutral

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	$46.36	$45.77	1.29%	Possible supply disruption
WTI	$43.62	$43.03	1.37%	
Natural Gas	$2.91	$2.95	-1.19%	
Crack Spread	$16.79	$17.57	-4.41%	
12-mo strip crack	$14.41	$14.69	-1.88%	
Ethanol rack	$1.64	$1.64	0.00%	
Metals				
Gold	$1,313.10	$1,310.35	0.21%	Lower dollar
Silver	$19.21	$18.79	2.24%	
Copper contract	$215.60	$216.00	-0.19%	Demand concerns
Grains				
Corn contract	$ 338.50	$ 337.00	0.45%	
Wheat contract	$ 406.50	$ 403.25	0.81%	
Soybeans contract	$ 976.75	$ 966.00	1.11%	
Shipping				
Baltic Dry Freight	800	764	36	

Weather

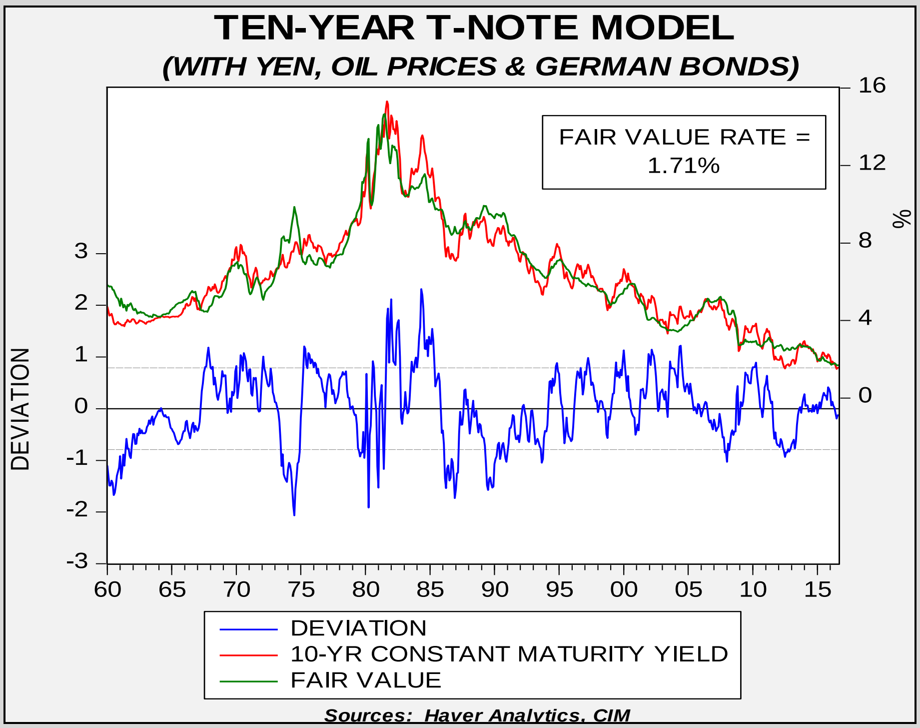
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country, except the Mountain States region. Precipitation is forecast for the eastern two-thirds of the country. Tropical Storm Karl is located in the mid-Atlantic. TS Karl is not expected to enter the Gulf of Mexico, but is forecast to slow as it moves northwest. Another low pressure area has formed off the coast of Africa. This development has a high 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.

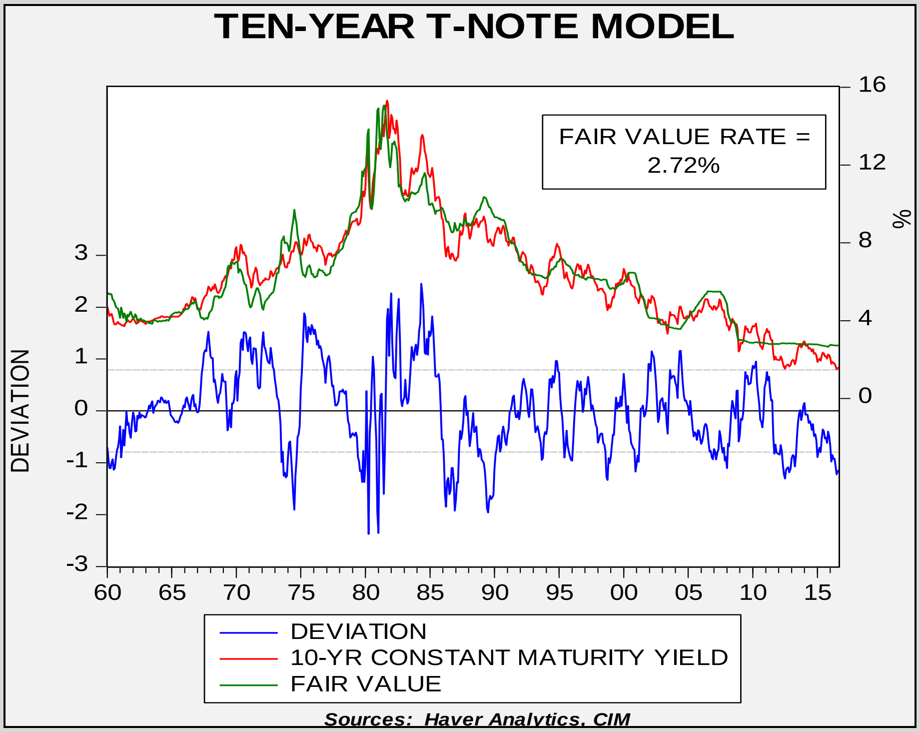
September 16, 2016

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.



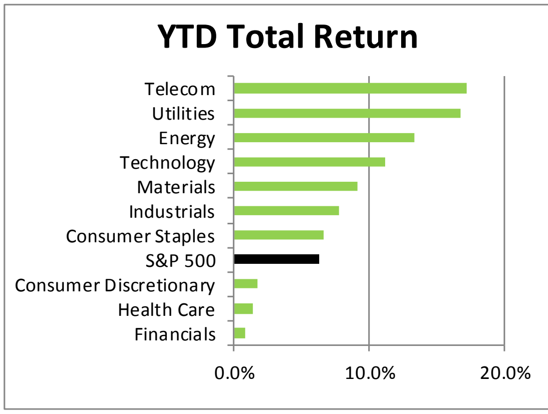
By focusing on domestic factors, the 10-year T-note is deeply undervalued. In fact, a comparison of the models shows that international factors have played a key role in lowering yields over the past two years.

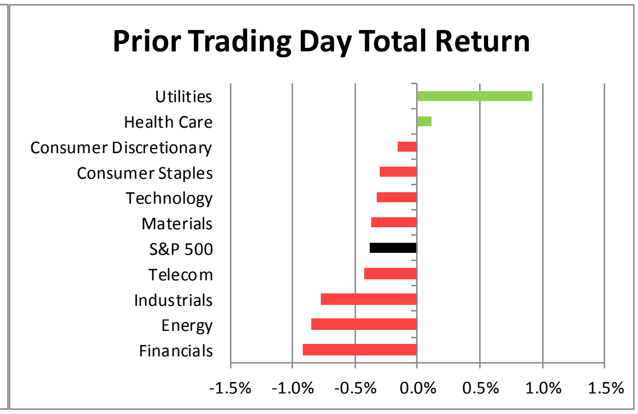
As we assess the prospects for the three international variables, we expect oil prices will likely be rangebound. Over the next year, we look for the average price of oil to hold around $50 per barrel. In the near term, however, seasonal factors will likely weigh on oil prices and support lower T-note 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 9/16/2016 close)

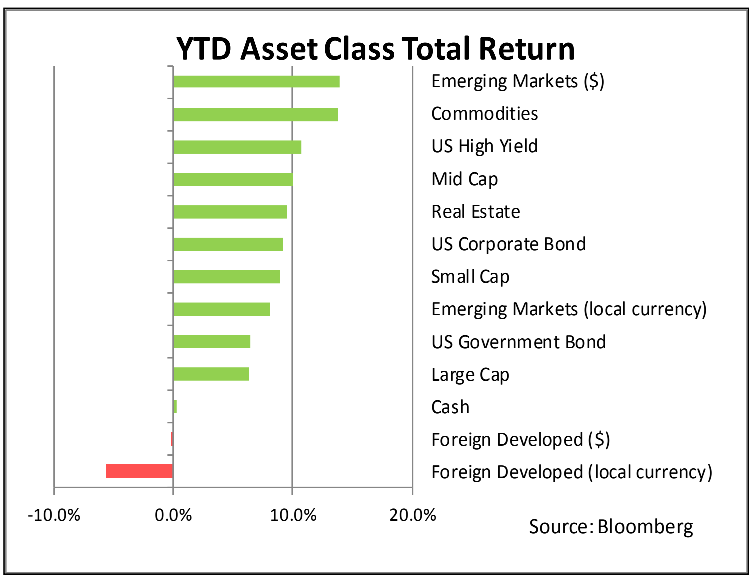




(Source: Bloomberg)

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 9/16/2016 close)

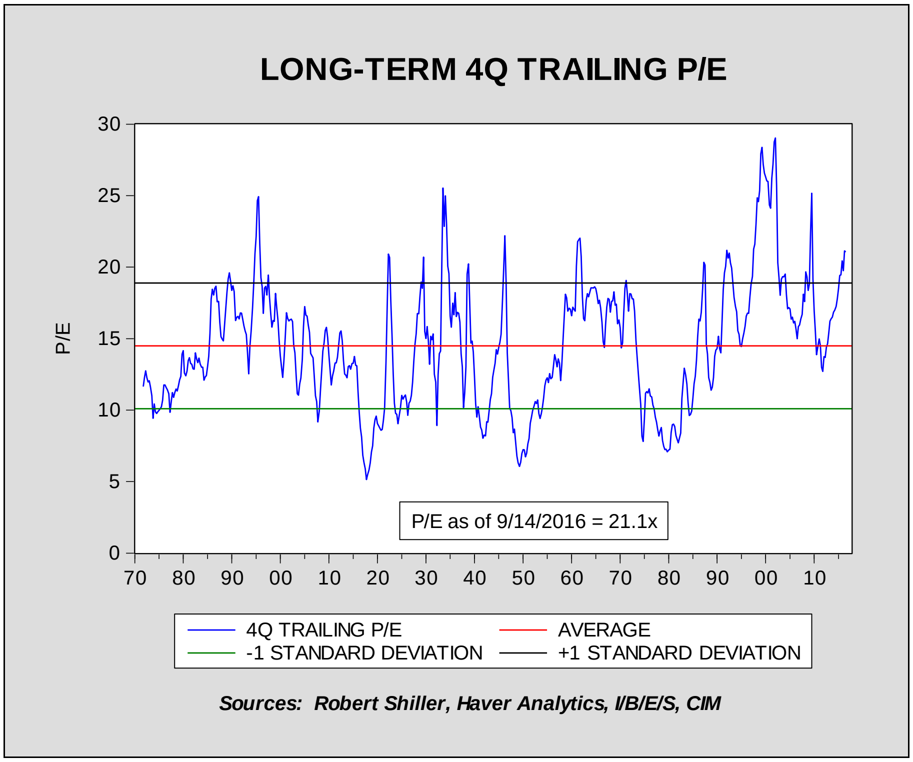


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

---

[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.