Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 20, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.2% from the prior close. Chinese markets were lower, with the Shanghai composite moving down by 0.1% and the Shenzhen index down by 0.1%. U.S. equity futures are signaling a higher opening from the previous close.

Given the large amount of news from the weekend, there were a couple of items that we wanted to mention but, for brevity, waited until today. First, the Bank of International Settlements released its table of early warning indicators for banking system stress.

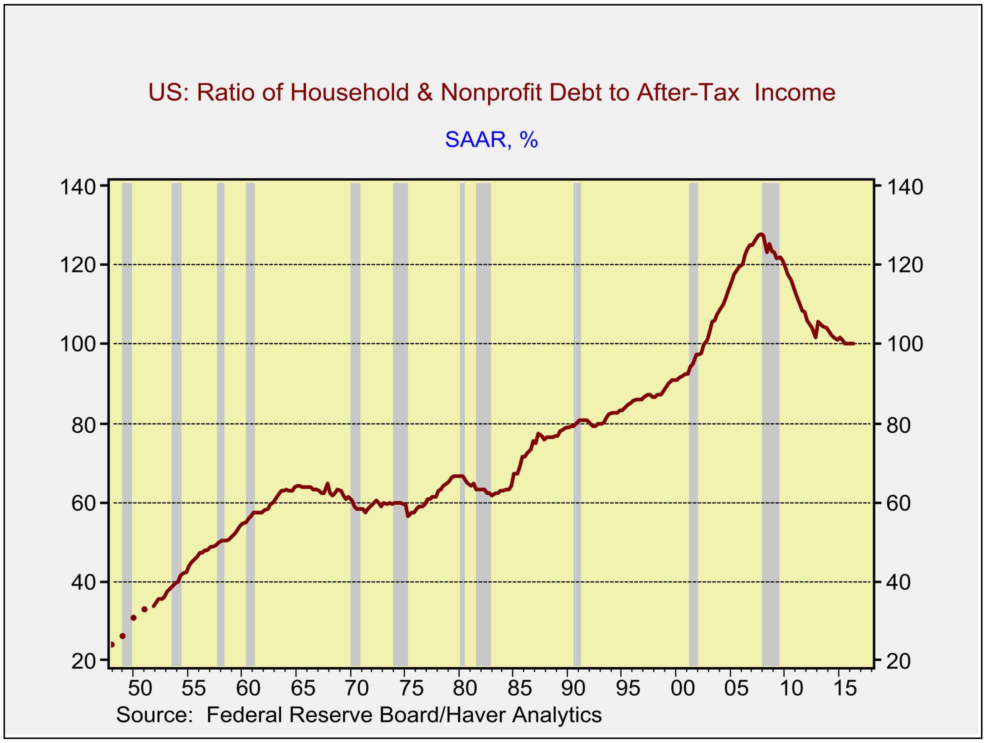
Early warning indicators for stress in domestic banking systems[1] — Table 1

	Credit-to-GDP gap[2]	Property price gap[3]	Debt service ratio (DSR)[4]	DSR if interest rates rise by 250 bp[4, 5]
Asia[6]	12.1	6.0	1.6	3.9
Australia	4.5	3.1	1.4	5.4
Brazil	4.6	–25.6	7.4	9.2
Canada	12.1	5.3	2.8	6.9
Central and eastern Europe[7]	–11.4	8.8	0.1	1.5
China	30.1	–1.9	5.4	8.7
France	–0.6	–11.2	1.0	4.1
Germany	–6.1	13.3	–1.8	0.0
Greece	–13.2	9.4		
India	–2.9		1.8	2.9
Italy	–13.7	–15.4	–0.1	2.0
Japan	4.1	15.6	–2.0	0.8
Korea	3.1	5.7	–0.6	3.0
Mexico	8.8	5.0	0.6	1.3
Netherlands	–20.2	–12.2	0.7	5.4
Nordic countries[8]	–0.8	4.1	1.0	5.0
Portugal	–40.5	12.4	–1.6	1.7
South Africa	–0.2	–9.0	–0.3	1.0
Spain	–47.6	–17.7	–3.2	–0.4
Switzerland	7.2	7.7	0.0	3.2
Turkey	9.6		5.7	7.3
United Kingdom	–27.0	–0.1	–1.7	1.0
United States	–9.9	4.7	–1.7	0.9
Legend	*Credit/GDP gap>10*	*Property gap>10*	*DSR>6*	*DSR>6*
	2≤Credit/GDP gap≤10		*4≤DSR≤6*	*4≤DSR≤6*

(Source: BIS)

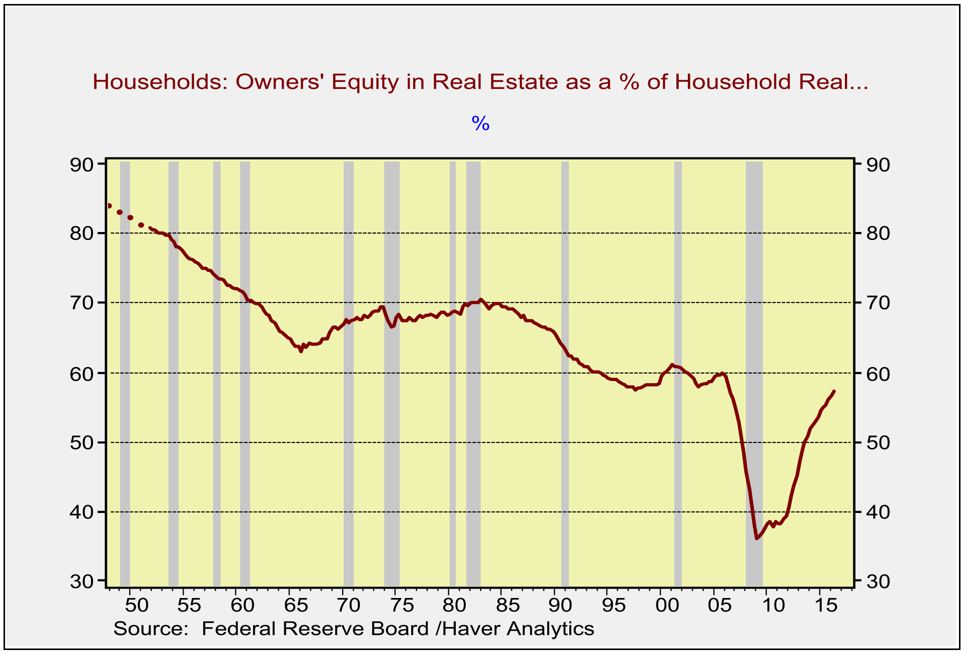
The key data is the credit-to-GDP gap. The BIS measures the ratio against its long-term trend, and any reading over 10% has signaled trouble. China is well above that level and the other columns suggest that the country is rather sensitive to rising rates. The BIS admits that its indicator is "early" and countries can exceed safe levels for a long time before trouble develops. But, this data does show that the Chinese banking system is vulnerable to systemic risk.

Second, the Financial Accounts of the U.S., formerly known as the Flow of Funds data, was released by the Federal Reserve for Q2. Although the report is a treasure trove of information, we would like to point out two charts, in particular.



This ratio peaked at just under 128% in Q4 2007. It has declined to 100.1% but the pace of household deleveraging has clearly slowed. Debt growth remains modest, with household liabilities growing at a modest 2.8%. The slowdown in deleveraging will tend to support economic growth by boosting consumption.

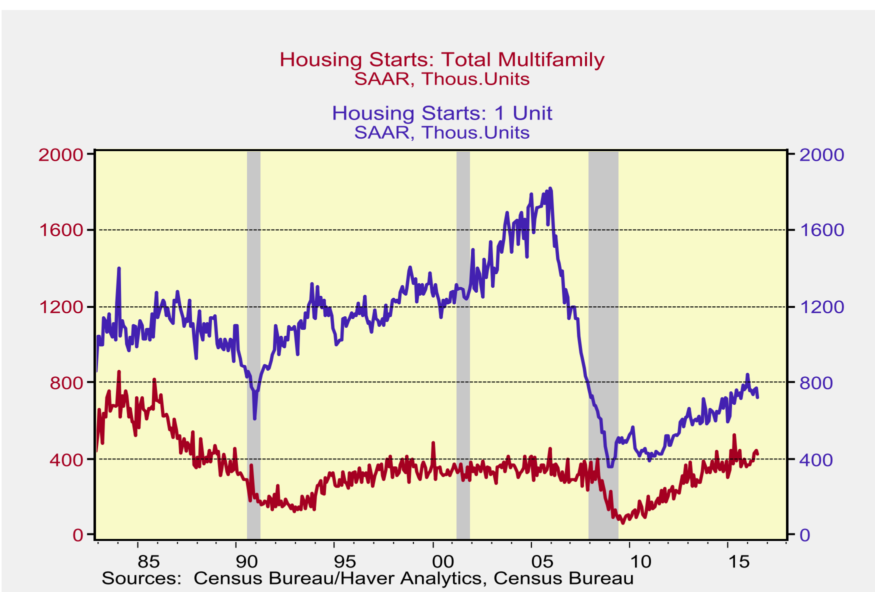
The other chart of note is shown below. It measures homeowners' equity in real estate. In general, we look for a positive wealth effect to boost spending once households have about 60% equity in their homes. The latest shows a reading of 57.1%.



These two charts suggest that current improving consumption will likely continue and maintain positive economic growth.

U.S. Economic Releases

Housing starts disappointed in August, falling 5.8% from the month before compared to the 1.7% decline forecast. Starts were the weakest in the South, falling 14.8% for the month, while the Northeast, Midwest and Western regions all saw gains in housing starts. Weather events were the main cause of slow starts in the South. Permits were also weaker than expected, falling 0.4% compared to the 1.8% increase forecast.



The chart above shows single- and multi-family starts. Single-family starts fell 6.0% in August, while multi-family starts fell 5.4%. However, from their year-ago levels, single-family starts are down 1.2% and multi-family starts are higher by 4.7%. Overall, the decline in starts could be the result of a unique set of circumstances and it would not be surprising for starts to rebound in September.

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

Economic releases		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
9/20-9/21	FOMC meeting	

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								
Australia	House price index	y/y	Q2	4.1%	6.8%	5.1%	**	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	Aug	-1.6%	-2.0%	-1.6%	**	Equity and bond neutral
Switzerland	Trade balance (SNF)	m/m	Aug	3.0 bn	2.8 bn		**	Equity and bond neutral
	Exports	m/m	Aug	-2.1%	5.0%		**	Equity bullish, bond bullish
	Imports	m/m	Aug	-3.5%	8.6%		**	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)	29	28	1	Up
TED spread (bps)	57	58	-1	Down
U.S. Libor/OIS spread (bps)	45	44	1	Up
10-yr T-note (%)	1.69	1.71	-0.02	Narrowing
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	32	33	-1	Down
Currencies	**Direction**			
dollar	up			Up
euro	up			Neutral
yen	down			Down
pound	down			Down
franc	up			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	$45.48	$45.95	-1.02%	Unofficial OPEC meeting
WTI	$42.93	$43.30	-0.85%	
Natural Gas	$2.98	$2.93	1.53%	
Crack Spread	$15.43	$16.00	-3.57%	
12-mo strip crack	$14.10	$14.14	-0.31%	
Ethanol rack	$1.64	$1.64	-0.19%	
Metals				
Gold	$1,314.00	$1,313.19	0.06%	Awaiting the BOJ, Fed decisions
Silver	$19.19	$19.17	0.15%	
Copper contract	$215.70	$215.65	0.02%	
Grains				
Corn contract	$ 339.25	$ 337.25	0.59%	
Wheat contract	$ 407.00	$ 404.00	0.74%	
Soybeans contract	$ 980.00	$ 972.50	0.77%	Domestic harvest delays
Shipping				
Baltic Dry Freight	836	800	36	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.2		
Gasoline (mb)		-1.3		
Distillates (mb)		-0.2		
Refinery run rates (%)		-0.9%		
Natural gas (bcf)		59.2		

Weather

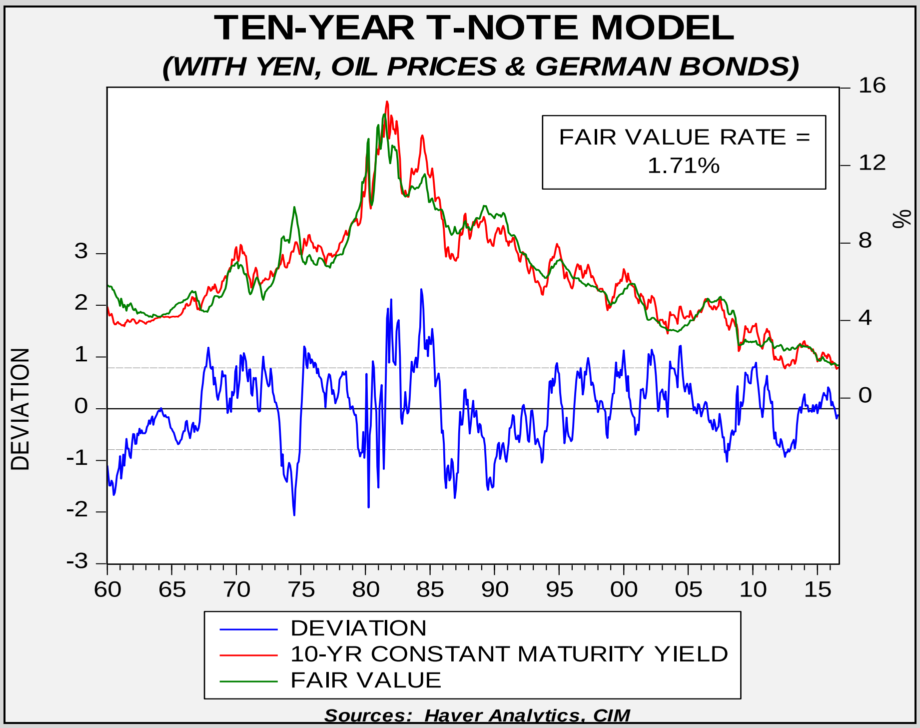
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country, except the Mountain States region. Precipitation is forecast for the middle of the country. Tropical Storm Karl is located in the mid-Atlantic. TS Karl is not expected to enter the Gulf of Mexico and is forecast to slow as it moves northwest. Tropical Depression Thirteen has formed in the eastern Atlantic, but is expected to slow as it moves over cooler waters. 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.

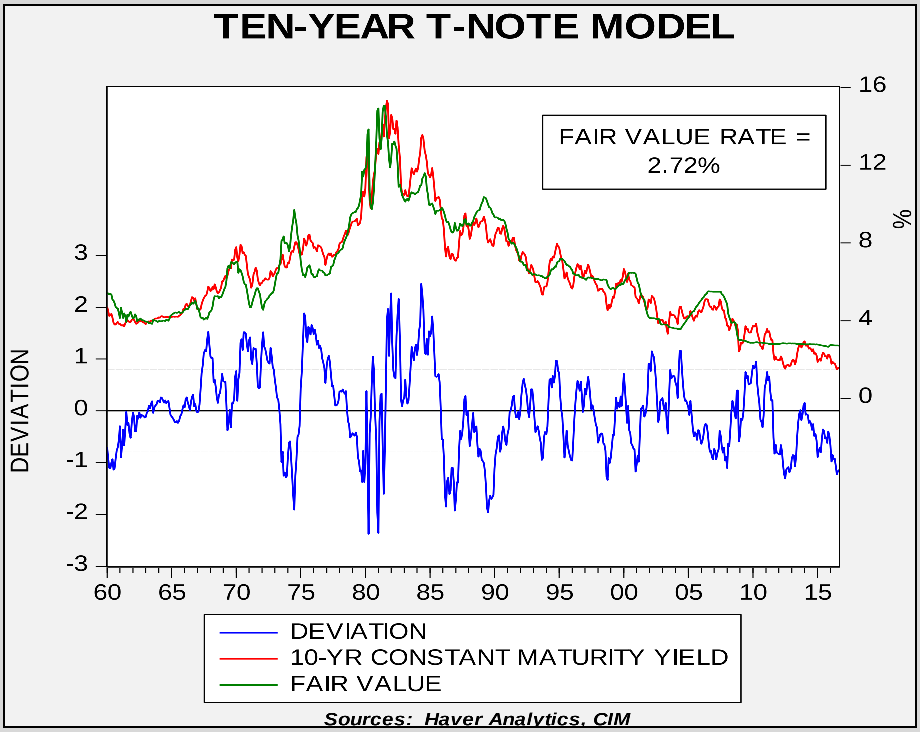
September 16, 2016

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.



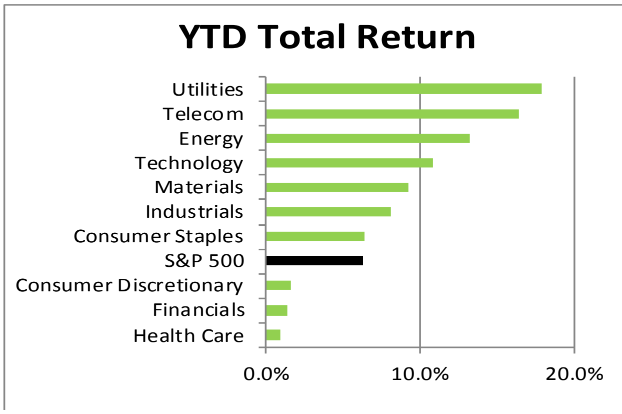
By focusing on domestic factors, the 10-year T-note is deeply undervalued. In fact, a comparison of the models shows that international factors have played a key role in lowering yields over the past two years.

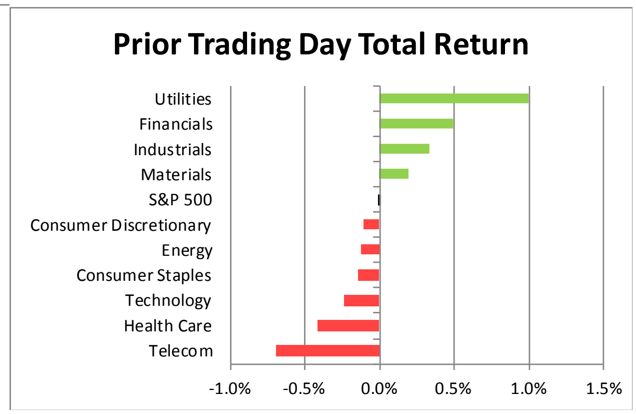
As we assess the prospects for the three international variables, we expect oil prices will likely be rangebound. Over the next year, we look for the average price of oil to hold around $50 per barrel. In the near term, however, seasonal factors will likely weigh on oil prices and support lower T-note 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 9/19/2016 close)

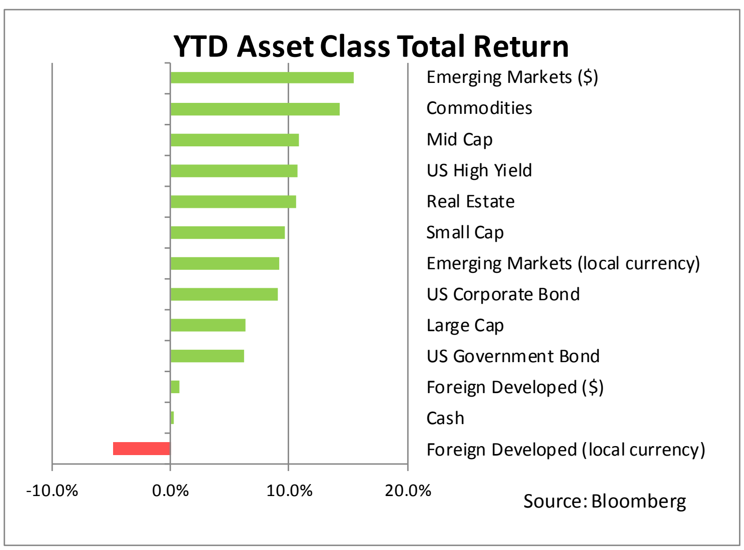




(Source: Bloomberg)

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 9/19/2016 close)

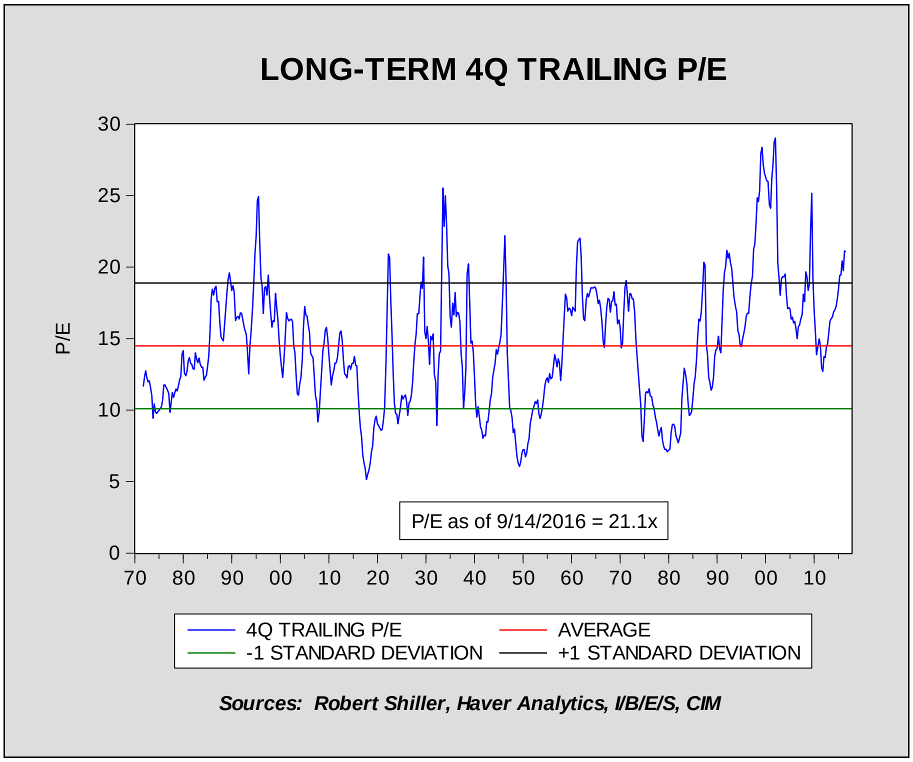


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.