Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

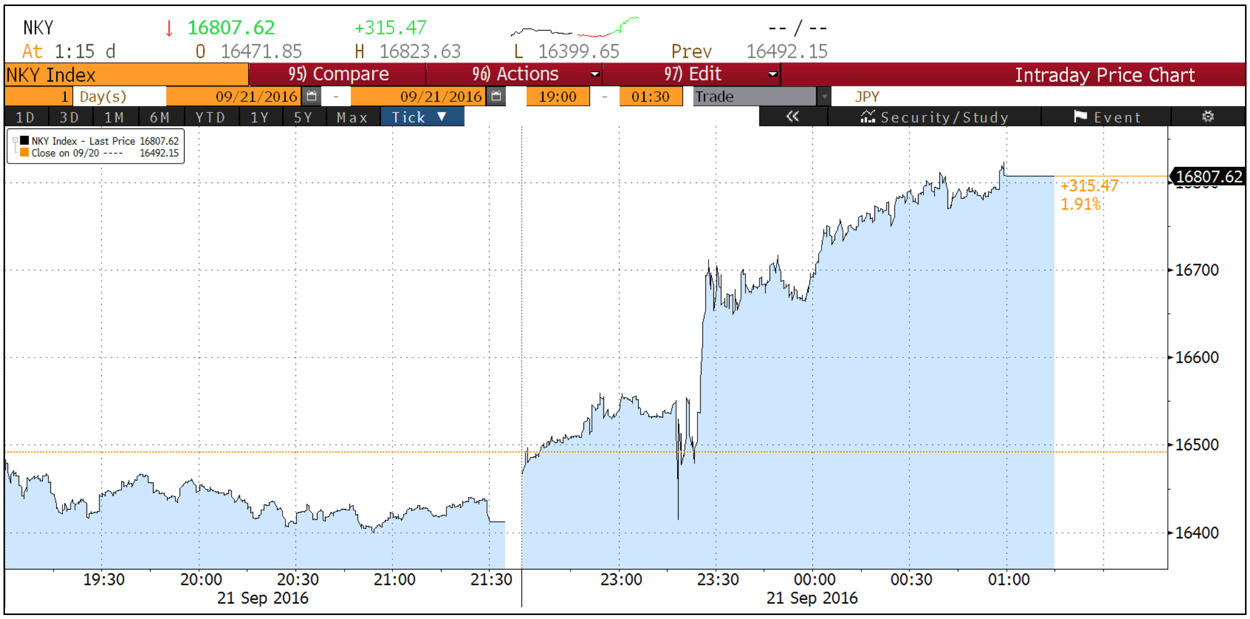
[Posted: September 21, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.7% from the prior close. Chinese markets were higher, with the Shanghai composite moving up 0.1% and the Shenzhen index higher by 0.3%. U.S. equity futures are signaling a higher opening from the previous close.

Equity markets are generally higher following the BOJ release. The BOJ did not do anything too radical—no helicopter money or foreign bond purchases. But, there were some changes. The focus of policy will shift to the yield curve as the 10-year JGB will be pegged at zero; the rate had been negative. This move appears designed to steepen the yield curve. Asset purchases will continue but will depend on rates as opposed to a specific target amount for QE. Thus, in theory, QE could exceed the ¥80 bn per month but could also fall from that level, introducing tapering, depending on the rate path of the long end of the curve. There will probably be no changes in purchases in the short run, but we would look for a modest decline in purchases over time. Finally, there was some degree of forward guidance as the bank promised to exceed its 2% inflation target. This move isn't really significant as it has been missing its 2% inflation target for over a year.

Although global equity markets seem to like the BOJ's moves, we think a key insight can be derived from the forex market. The JPY initially weakened but has subsequently rallied.

(Source: Bloomberg)

If BOJ policy had been seen as stimulative, the JPY would have continued to weaken. We suspect that, eventually, markets will conclude the BOJ is running out of policy tools and deflation will remain in place indefinitely. It would not be unusual for markets to take 24-48 hours to digest the ramifications of the central bank's moves. Investors' attention is now turned to the Fed and market reaction to the BOJ decision could change following the FOMC release. Nevertheless, today's market reaction to the BOJ was not negative. The chart below shows the overnight move in the Nikkei index, which rose following the BOJ release.



(Source: Bloomberg)

The consensus is that the FOMC will stand pat, with market expectations calling for a 22% likelihood of a rate increase. We recently read a provocative analysis from Ben Hunt, the chief risk officer at Salient Partners. In his report, "Epsilon Theory," he makes the case that the Fed's culture is much like a large research university. If this is true, the Fed's decision making isn't about keeping the markets calm or supporting the banking system. Instead, it's all about reputation. A college professor usually isn't in it for the money (although most are not opposed to getting a bit of cash along the way); the goal is to be perceived as smart. Hunt's argument is that if a decision is between hurting the market but sustaining the Fed's reputation or supporting the market but making the Fed look incompetent, then the former will win. Thus, the idea that the Fed follows the market is nothing more than a coincidence, a spurious correlation.

The Fed's reputation has been taking a beating recently. Negative interest rates are feared by the public and seen as a potential mistake. Low interest rates are quite unpopular with the retiring baby boom generation. What does the Fed need to do, at least according to Hunt? Raise rates and declare victory. Does the economy need a rate hike? Probably not. However, if negative rates are not a possibility, then the Fed has little room to act when the next recession hits. Lifting rates to give itself room to cut doesn't make a lot of sense—policy should be in response to current circumstances. But, from a reputational perspective, having room to cut will give the illusion that the central bank can act, even if the rate hike itself potentially contributed to the recession.

In addition, if the Fed is really nothing more than a high-powered university economics department, then the goal also seems to be about creating a consensus among the really smart people. There does appear to be a growing consensus about a rate hike. Declaring victory by saying the FOMC has met its institutional goals (full employment and low inflation), raising rates today and signaling that it will be a long time before the next move would likely be a good outcome. Although financial markets would not react well initially, the signal of no more moves this year would be welcomed. Financial markets would likely rebound and the dollar would probably remain mostly steady. By declaring victory, the Fed would then put the onus of the next recession on fiscal policy.

An alternative scenario is no hike today but certain hike in December. In fact, market expectations call for a 60% likelihood of a December increase. No hike in September with a hike in December would tend to damper equities and boost the dollar. A better outcome would probably be "a hike today and go away," stating the terminal rate is in place for the foreseeable future. Of course, the worst outcome would be a hike today that the market doesn't expect with no declaration of victory.

The bottom line: although odds still favor a December rate increase, the odds of a move today are probably higher than the market thinks. We will find out at 2:00 pm EDT when the Fed releases its policy decision, economic projections and dots chart, followed by a press conference.

U.S. Economic Releases

Mortgage applications fell 7.3% for the most recent reporting week, with purchases down 6.8% and refinancing down 7.6%. Purchases have taken back the gains made over the past month, but purchases are still up 3.3% annually. The 30-year mortgage rate rose 3 bps to 3.70%, pressuring refinancing activity lower.

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**
2:00	FOMC fed funds decision released	

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								
India	Current Account Balance	y/y	Q2	-$.3 bn	-$.3 bn	$2.7 bn	**	Equity bearish, bond bullish
EUROPE								
Switzerland	Money Supply M3	y/y	Aug	2.8%	2.7%		**	Equity and bond neutral
UK	Public Sector Net Borrowing	m/m	Aug	$10.1 bn	-$1.0 bn	$10.3 bn	*	Equity and bond neutral
	Public Finance	y/y	Aug	$.7 bn	-$2.1 bn		*	Equity and bond neutral
Russia	CPI	y/y	Sep	4.0%	3.9%		***	Equity and bond neutral
AMERICAS								
Mexico	Aggregate Supply and Demand	y/y	Q2	2.1%	2.5%	2.4%	**	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	29	0	Neutral
TED spread (bps)	58	57	1	Up
U.S. Libor/OIS spread (bps)	46	45	1	Up
10-yr T-note (%)	1.68	1.69	-0.01	Narrowing
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	35	33	2	Up
Currencies	**Direction**			
dollar	down			Up
euro	down			Down
yen	up			Down
pound	up			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ key rate	-0.10%	-0.10%	-0.10%	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	$46.77	$45.88	1.94%	Awaiting Fed decisions, moving higher with equity markets
WTI	$44.97	$44.05	2.09%	
Natural Gas	$3.06	$3.05	0.30%	
Crack Spread	$13.25	$12.90	2.76%	
12-mo strip crack	$13.79	$13.57	1.66%	
Ethanol rack	$1.63	$1.64	-0.15%	
Metals				
Gold	$1,324.36	$1,314.84	0.72%	Awaiting Fed decisions
Silver	$19.61	$19.25	1.86%	
Copper contract	$215.55	$216.50	-0.44%	Demand concerns
Grains				
Corn contract	$ 338.50	$ 340.50	-0.59%	Profit taking
Wheat contract	$ 403.25	$ 406.00	-0.68%	
Soybeans contract	$ 985.25	$ 989.75	-0.45%	
Shipping				
Baltic Dry Freight	865	836	29	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.4		
Gasoline (mb)		-1.3		
Distillates (mb)		0.0		
Refinery run rates (%)		-0.7%		
Natural gas (bcf)		57.4		

Weather

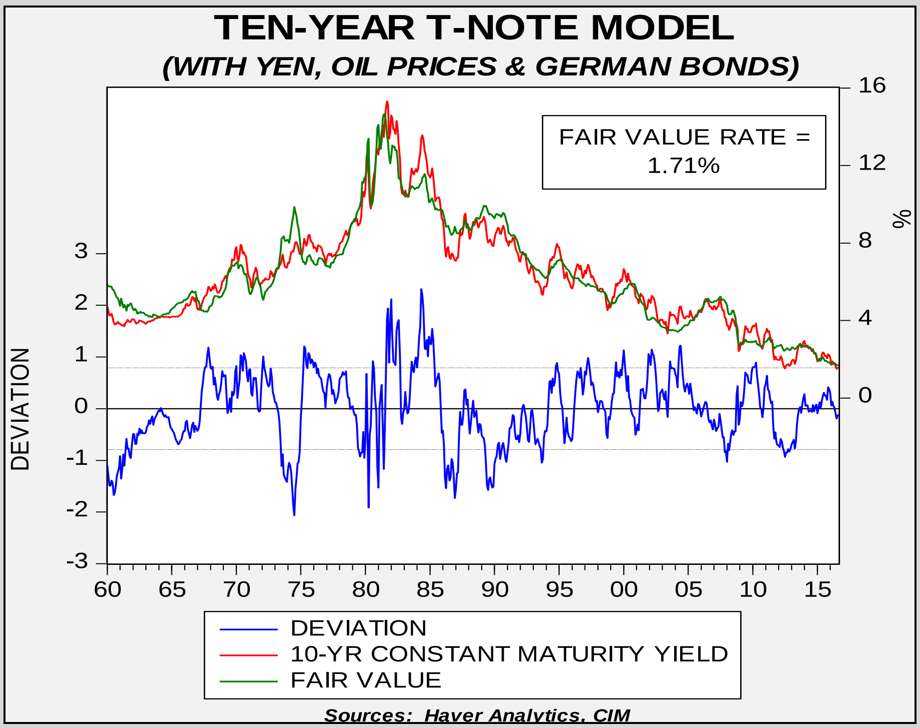
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country, except parts of the western region. Precipitation is forecast for the middle of the country. Tropical Depression Karl has slowed and is expected to dissipate as it moves north over cooler waters. Tropical Storm Lisa strengthened overnight in its current location in the mid-Atlantic, but is expected to calm as it turns north. 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.

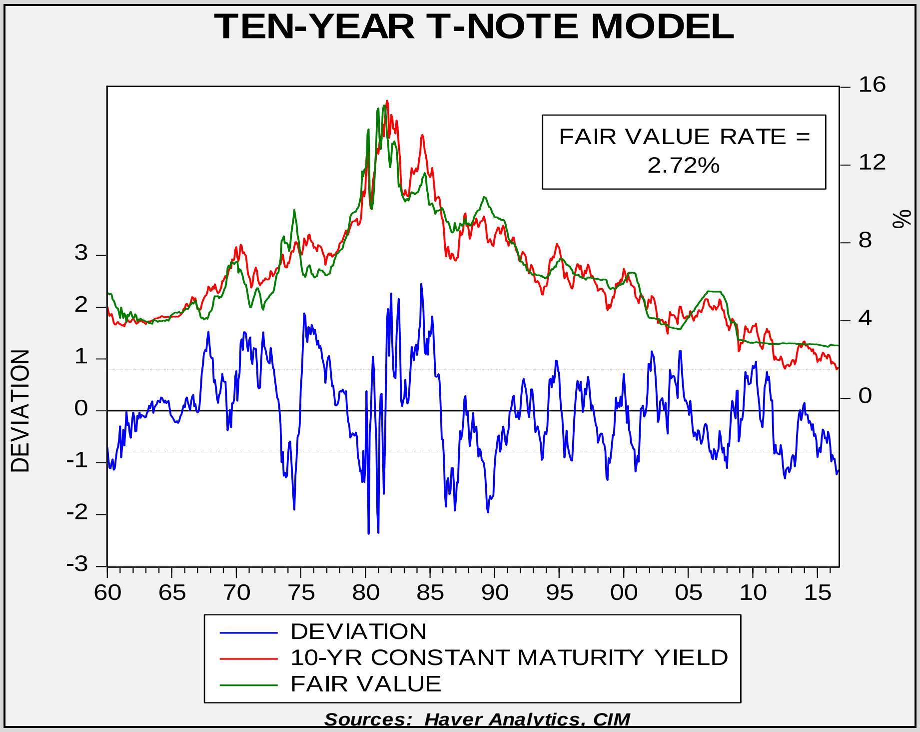
September 16, 2016

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.



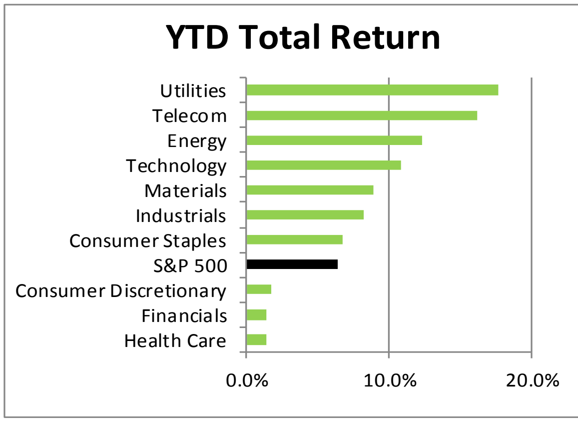
By focusing on domestic factors, the 10-year T-note is deeply overvalued. In fact, a comparison of the models shows that international factors have played a key role in lowering yields over the past two years.

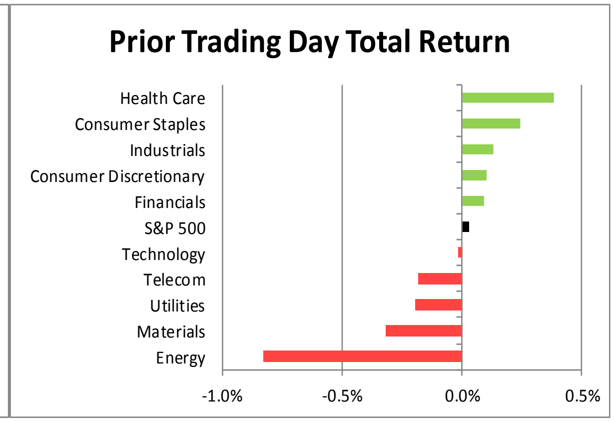
As we assess the prospects for the three international variables, we expect oil prices will likely be rangebound. Over the next year, we look for the average price of oil to hold around $50 per barrel. In the near term, however, seasonal factors will likely weigh on oil prices and support lower T-note 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 9/20/2016 close)

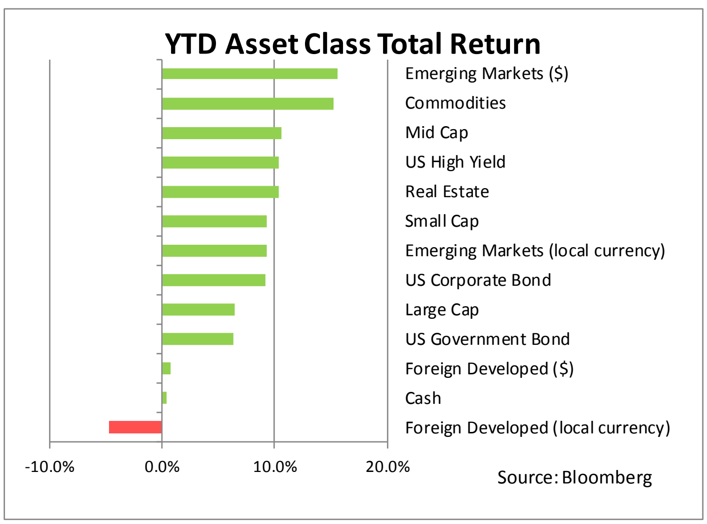




(Source: Bloomberg)

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 9/20/2016 close)

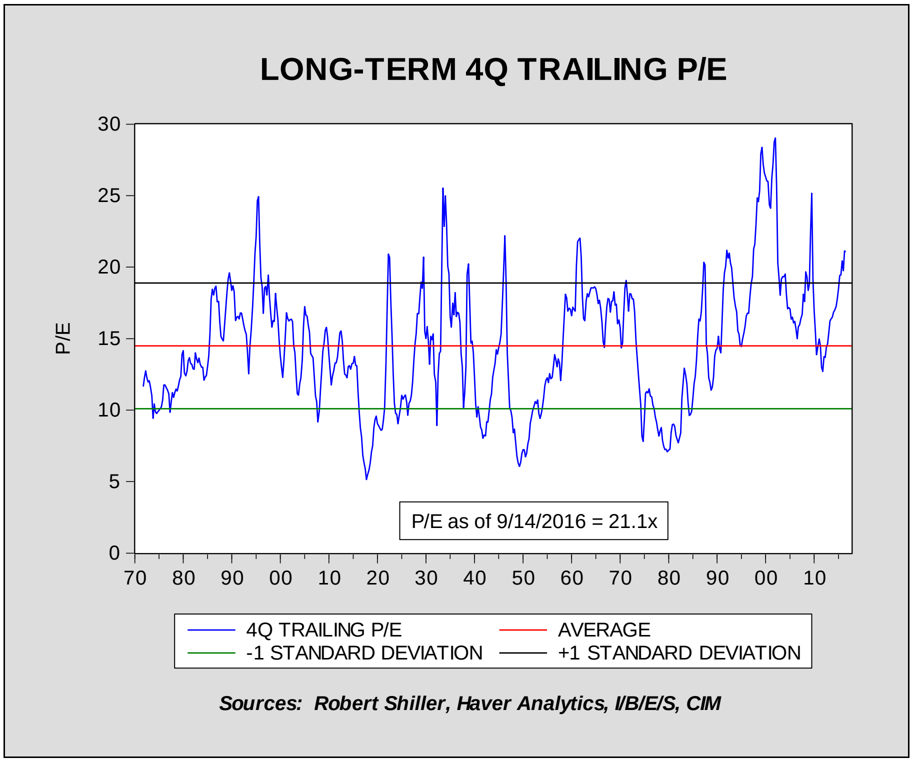


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.