Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 8, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.4% from the prior close. Chinese markets were also higher, with the Shanghai composite moving up by 0.1% and the Shenzhen index higher by 0.3%. U.S. equity futures are signaling a sideways opening from the previous close.

This morning's big news is the ECB's decision to leave policy unchanged. The EUR rallied, Treasuries dipped and Eurozone yields rose as well. We are well into Draghi's press conference at the time of this writing and it is evident that the ECB did nothing at this meeting. Draghi did indicate that the ECB is ready to act and has the capacity to do so if necessary, but did not believe it was necessary at this meeting. We suspect, and think this is the market's take as well, that Draghi could not convince the rest of the committee to take steps to add new accommodation. With QE set to end in March 2017 (although the ECB has indicated it could extend the program), there are worries that ECB stimulus may be coming to a close. Equity markets have turned lower in Europe and U.S. equity futures have also moved modestly lower.

One of the lesser followed indicators we monitor is the National Credit Managers Index. The index measures the health of corporate credit—everything from the demand for borrowing to the recoveries on bad debt. The group noted that sales fell 6.3 points, from 60.0 to 53.7, consistent with the weak data seen in the PMI data.

(Sources: Bloomberg, NACM, CIM)

This chart shows the composite index. It should be read like the PMI data; 50 is the expansion/contraction line. The current reading is the lowest since 2009 and it has been falling since Q2. Note that in 2008, the index hovered around 50 only to plunge under 50 as the financial crisis emerged. Although the data does not have a long history, the trend we are seeing is a worry.

We haven't commented on the tax situation between the EU, Ireland and Apple (AAPL, 108.36), although we are gathering information on the issue. However, we do note that Sen. Elizabeth Warren (D-MA) has an editorial in today's *NYT* in which she is critical of the tech giant and of corporate tax policy, in general. Economists tend to believe that corporate taxes are a bad idea—the incidence of the tax tends to fall on households anyway through higher product prices. Clearly, the more competitive the industry, the less those firms can pass the tax on to their products. But, for unique products and concentrated industries, the tax incidence tends to fall on households. However, that knowledge doesn't stop Warren from calling for higher taxes on corporations. That she would take that position isn't really news. What is interesting to us is the target of her wrath, Apple. Her party has received significant support from the tech sector and most of the commentary we have seen from Washington has been critical of the EU. This is the second time we have noted that Warren has attacked the tech sector, suggesting that the Sanders/Warren wing of the party holds significantly different positions from the current leadership of the Democratic Party.

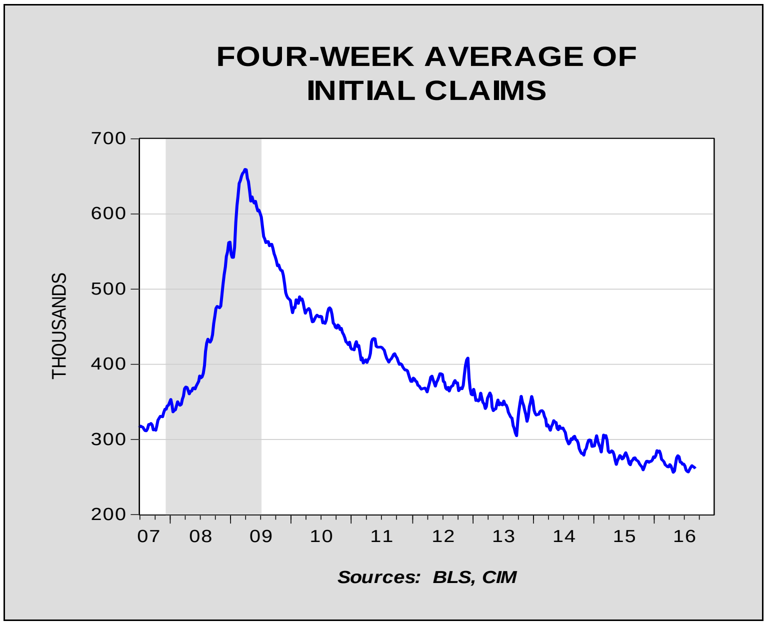
Although Portugal has fallen from the headlines, today's *FT* notes that structural adjustments have not been addressed in the 30 months since the last crisis. There are growing worries that a second bailout may be necessary. The current Socialist government holds a minority and remains in office only due to the tacit support of hard-left parties. If the current government falls, and creditors become nervous, a credit crisis originating in Portugal is possible. If it coincides with the upcoming Italian referendum next month, the potential for another Eurozone crisis will rise.

We want to update comments we made earlier this week regarding Venezuela. We noted earlier that Citibank (C, 47.48) had resigned as pay agent for PDVSA bonds. We speculated that if no other bank took the role, it might increase the likelihood of default. Our report that Citibank has resigned from its role is true. However, according to the terms of the agreement, Citibank can resign but cannot stop performing the role until another pay agent is appointed. Thus, PDVSA will have a pay agent for the foreseeable future and it will be Citibank, because it is highly unlikely that anyone else will want the job.

Russian President Putin withdrew support for a batch of new security laws, called the "Spring Package." The new rules are very strict, essentially ending free speech, severely restricting foreign NGOs and curtailing social media. With parliamentary elections on September 18th and presidential elections in March 2018, Putin is caught between worries about unrest stemming from a weak economy, prompting the new security rules, and growing unpopularity due to the security measures themselves.

U.S. Economic Releases

Initial jobless claims came in better than expected, falling 4k to 259k compared to the 265k forecast. Claims have remained below 300k since March 2015.



The chart above shows the four-week average of claims, which have continued to trend near four-decade lows. The average fell 2k to 261k.

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

Economic releases						
EDT	Indicator			Expected	Prior	Rating
3:00	Consumer credit	m/m	Jul	$16.0 bn	$12.3 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
ASIA-PACIFIC								
Australia	Trade balance (AUD)	m/m	Jul	$63.0 bn	$66.0 bn		**	Equity and bond neutral
China	Trade balance	m/m	Aug	$52.1 bn	$52.3 bn	$58.9 bn	**	Equity and bond neutral
	Exports	y/y	Aug	-2.8%	-4.4%	-4.0%	**	Equity and bond neutral
	Imports	y/y	Aug	1.5%	-12.5%	-5.4%	**	Equity and bond neutral
Japan	GDP	y/y	Q2	0.7%	0.2%	0.2%	***	Equity bullish, bond bearish
	Trade balance	m/m	Jul	¥613.9 bn	¥763.6 bn	¥571.2 bn	**	Equity and bond neutral
	Eco watchers survey current	m/m	Jul	45.6	45.1	45.5	**	Equity bullish, bond bullish
	Eco watchers survey outlook	m/m	Jul	47.4	47.1	46.4	**	Equity bullish, bond bullish
EUROPE								
France	Business sentiment (Bank of France)	m/m	Aug	98.0	98.0	98.0	**	Equity and bond neutral
Russia	Light vehicle sales	y/y	Aug	18.0%	17.0%	16.0%	**	Equity and bond neutral
AMERICAS								
Canada	Capacity utilization rate	m/m	Q2	80.0%	81.4%	79.6%	**	Equity bullish, bond bullish
Brazil	CPI	y/y	Aug	11.3%	11.2%	11.1%	***	Equity bearish, bond bullish
Mexico	CPI	y/y	Aug	2.7%	2.7%	2.8%	***	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)	84	83	1	Up
3-mo T-bill yield (bps)	33	33	0	Neutral
TED spread (bps)	51	50	1	Up
U.S. Libor/OIS spread (bps)	45	43	2	Up
10-yr T-note (%)	1.58	1.54	0.04	Widening
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	30	32	-2	Down
Currencies	**Direction**			
dollar	down			Up
euro	up			Neutral
yen	up			Down
pound	down			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB main refinancing rate	0.00%	0.00%	0.00%	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	$48.71	$47.98	1.52%	API data shows domestic inventories falling
WTI	$46.31	$45.50	1.78%	
Natural Gas	$2.72	$2.68	1.64%	
Crack Spread	$12.54	$12.17	3.03%	
12-mo strip crack	$13.26	$13.05	1.59%	
Ethanol rack	$1.60	$1.60	-0.01%	
Metals				
Gold	$1,346.54	$1,345.18	0.10%	Lower dollar
Silver	$19.88	$19.80	0.42%	
Copper contract	$209.40	$209.75	-0.17%	Chinese copper imports decline
Grains				
Corn contract	$ 334.75	$ 333.25	0.45%	
Wheat contract	$ 403.00	$ 402.75	0.06%	
Soybeans contract	$ 980.75	$ 975.50	0.54%	Increasing demand
Shipping				
Baltic Dry Freight	773	745	28	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.6		
Gasoline (mb)		-0.7		
Distillates (mb)		1.2		
Refinery run rates (%)		-0.3%		
Natural gas (bcf)		43.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for the eastern half of the country and the West Coast. Precipitation is forecast for the middle of the country. A small low pressure area has formed in the southwest Atlantic. This development has a low chance of becoming a cyclone over the next two days. Another small low pressure area has formed in the mid-Atlantic and also has a low chance of becoming a cyclone.

Asset Allocation Weekly Comment

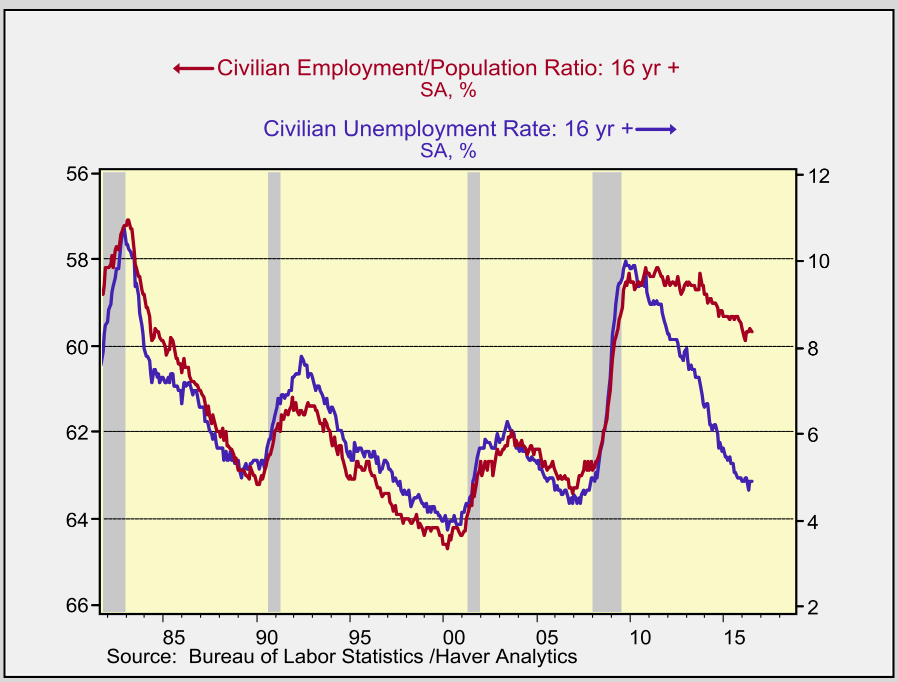
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

September 2, 2016

At the recent Kansas City FRB's gathering at Jackson Hole, the tone from policymakers turned surprisingly hawkish. Vice Chair Stanley Fischer was quoted as saying that two rates hikes are possible this year and the upcoming FOMC meeting in September could generate a rate hike if the payroll numbers are on trend. Until those comments, the financial markets were mostly leaning toward no change in rates until 2017.

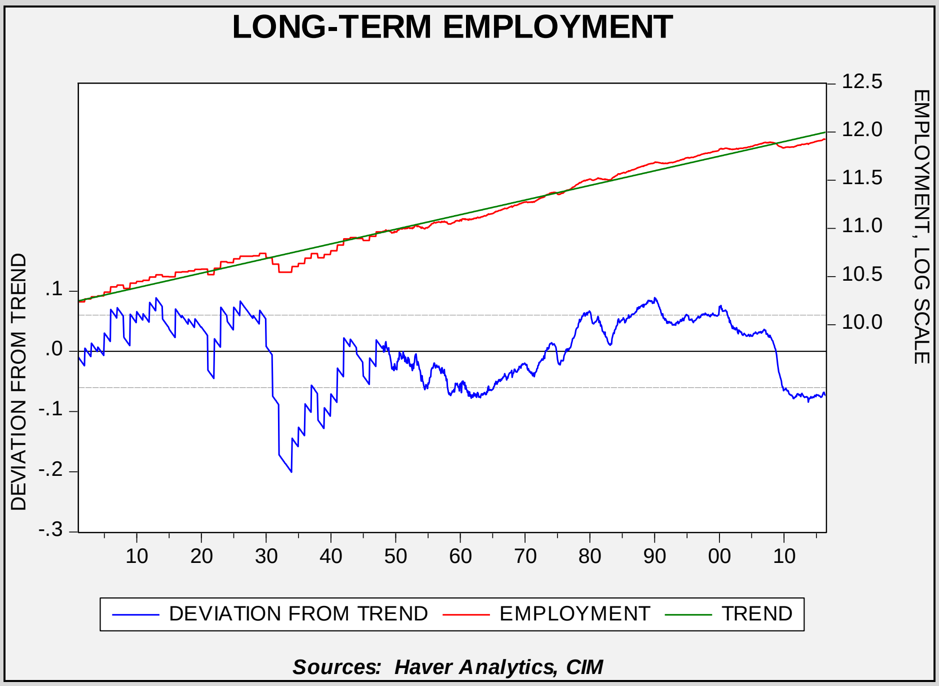
The best argument for rate increases is that the labor market is tightening. The theoretical construct for policymakers is the Philips Curve, which postulates that tight labor markets boost wages and eventually inflation. There have been periods in U.S. history when the Phillips Curve was a useful tool for policy. Over time, it has become increasingly controversial as institutional changes, such as the decline of labor unions, deregulation and globalization, have changed the slope of the Phillips Curve. Despite these changes, policymakers continue to use the Phillips Curve (best seen in the Taylor and Mankiw models, which attempt to set rates based on inflation and the level of slack in the economy) for lack of other alternatives.

The issue of slack is important, because the presence of available productive capacity would mean the FOMC would not need to tighten policy as much compared to a situation where capacity is constrained. One of the great unknowns about the economy is whether the unemployment rate or the employment/population ratio better reflects the labor market.



This chart shows the two series, with the employment/population ratio on an inverted scale. From 1980 into 2010, the two series closely tracked each other. However, since the recession, the two have diverged. The unemployment rate would suggest a labor market without much slack. The employment/population ratio would indicate that there is ample slack in the economy; if the relationship had held, the unemployment rate would be closer to 8%. If the divergence is structural, due to baby boom retirements along with geographic and skills misalignment, then the issue is probably not going to change suddenly and slack will continue to diminish. If, on the other hand, discouraged workers can be lured from the ranks of the unemployed with modestly higher wages, then sizeable slack exists. At 8% unemployment, the Fed should be easing.

Here is another way to look at the data.



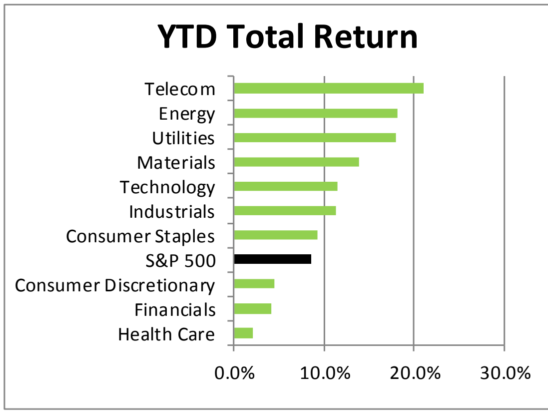
This chart shows a time trend of total employment. The data is annual from 1900 to 1947 and monthly thereafter. We have regressed a time trend through the data. Note that employment growth was above trend into the Great Depression and didn't consistently return to trend until the mid-1970s. Employment remained above trend into the 2008 Financial Crisis but has been depressed since.

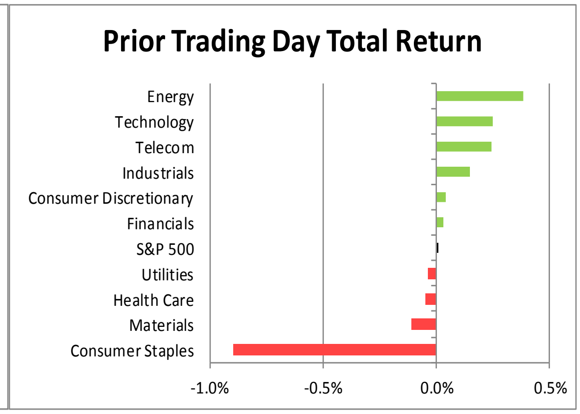
It is quite possible that after a traumatic event, like the 1930s or the 2008 crisis, the labor market takes a long time to normalize. Note that social norms capped employment during the 1950s and 1960s. There were legal and social restrictions by race and gender that likely prevented a recovery above trend. Racial and gender equality laws, coupled with social changes, led to steady employment growth from the early 1960s; by the late 1970s, employment had risen well above trend.

We suspect the current situation has more in common with the Great Depression than the early 1960s, but that doesn't mean it's a duplicate situation. The demographics are different—the baby boomers are retiring. But, we do suspect that there is a pool of workers that could be tapped if the economy grows quickly enough. Thus, the FOMC probably has much more time than it thinks to raise rates. Despite this opinion, the Fed will likely move at least once, if not twice, before year's end even if a strong case can be made for remaining steady. The key variable we will be watching is the dollar—if the Fed raises rates and the dollar appreciates strongly, look for the FOMC to back away from moving rates higher. On the other hand, if the dollar does not react, there are probably more hikes to come.

Data Section

U.S. Equity Markets – (as of 9/7/2016 close)

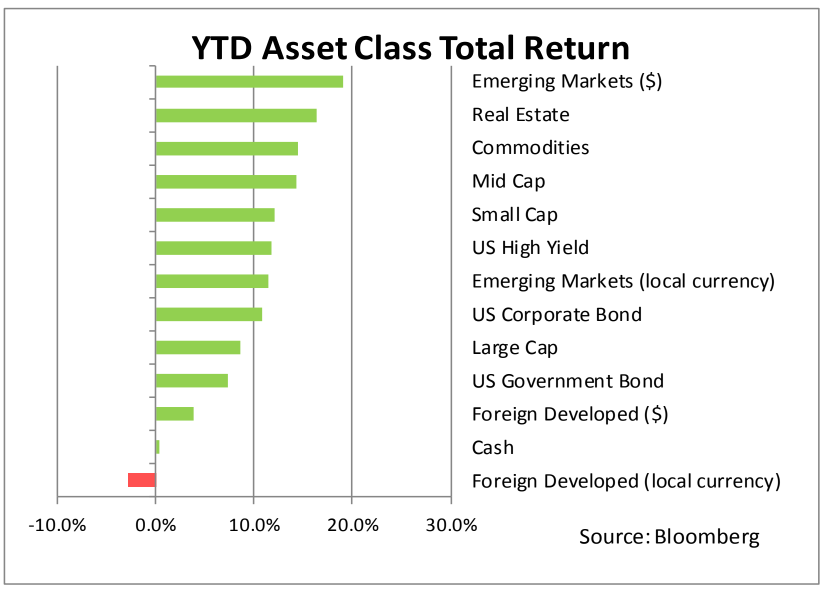




(Source: Bloomberg)

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 9/7/2016 close)

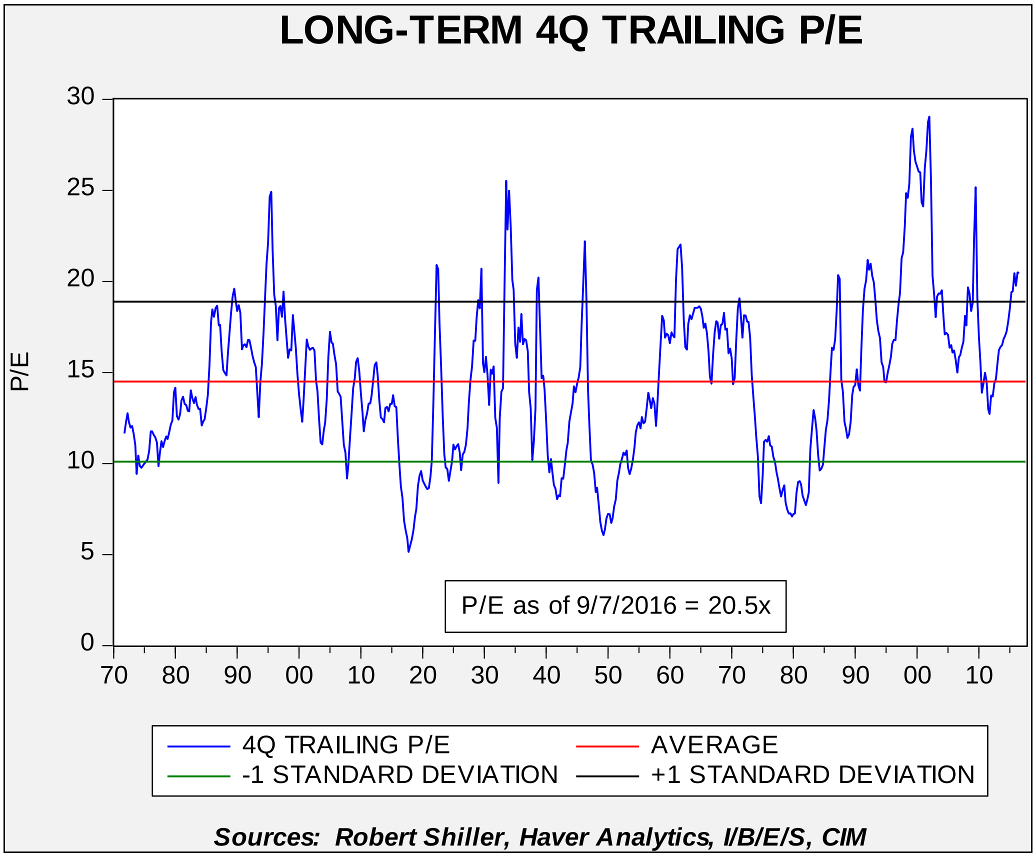


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 8, 2016



Based on our methodology,[1] the current P/E is 20.5x, down 0.5x from last week. A rise in Q2 S&P earnings led to the improvement 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.

---

[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.