

[Posted: February 2, 2016—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading lower by 1.8% from the last close. In Asia, the MSCI Asia Apex 50 was down 1.2% from the prior close. Chinese equities were actually higher, with the Shanghai composite up 2.3% and the Shenzhen index up 3.4%. U.S. equity futures are signaling a lower opening from the previous close. With 42.8% of the S&P 500 companies having reported, the Q4 adjusted earnings stand at \$29.45, higher than the \$28.95 forecast. Of the 214 companies that have reported, 76.2% beat expectations while 15.0% fell short.

The Iowa caucuses are over and the results were something of a surprise. Donald Trump, who had been leading in the polls, apparently couldn't get enough supporters to actually engage in the political process. Sen. Rubio had a better than expected night but Sen. Cruz was the big winner. On the Democratic Party side, Sen. Clinton narrowly won against Sen. Sanders in a closer than expected race.

History shows that it's a mistake to read too much from the Iowa results. In recent years, especially on the GOP side, the state has not selected viable candidates. For example, in the last two caucuses, the state selected Gov. Huckabee and Sen. Santorum, neither of whom came close to the eventual nomination. However, we do have a few observations to make as attention shifts to New Hampshire.

First, on the GOP side, anti-establishment candidates took well over 50% of the vote. Cruz won the traditional way—by deploying a good ground operation and spending a lot of time campaigning. Trump did remarkably well given the unorthodox nature of his campaign. There is talk that the establishment can coalesce around Sen. Rubio but that won't happen until after New Hampshire, if it happens at all. Three establishment candidates, Sen. Kasich, Gov. Bush and Gov. Christie, have all targeted the state as their "line in the sand." If they can't win and decide to call off their campaigns, we should see the field narrow after February 9. At this point, the real winner in Iowa was populism.

Second, the same can be said on the Democratic Party side. Sen. Clinton's narrow win, despite solid support from the Democratic Party apparatus and her deep experience in national politics, suggests she is a vulnerable candidate. That doesn't mean she won't win, but if a quirky candidate like Sen. Sanders can hold his own against her, imagine what a real threat (e.g., Sen. Warren) would do to her chances.

Yesterday, Vice Chairman Stanley Fischer gave a speech to the Council on Foreign Relations in New York. Fischer is the consummate central banker; he taught Ben Bernanke and Mario Draghi, and was the former head of Israel's central bank. Having him as Vice Chair is probably

both beneficial and intimidating for Chairman Yellen. It was safe to assume that Fischer would not tip anything obvious in his prepared remarks or Q&A session. This is what we gleaned:

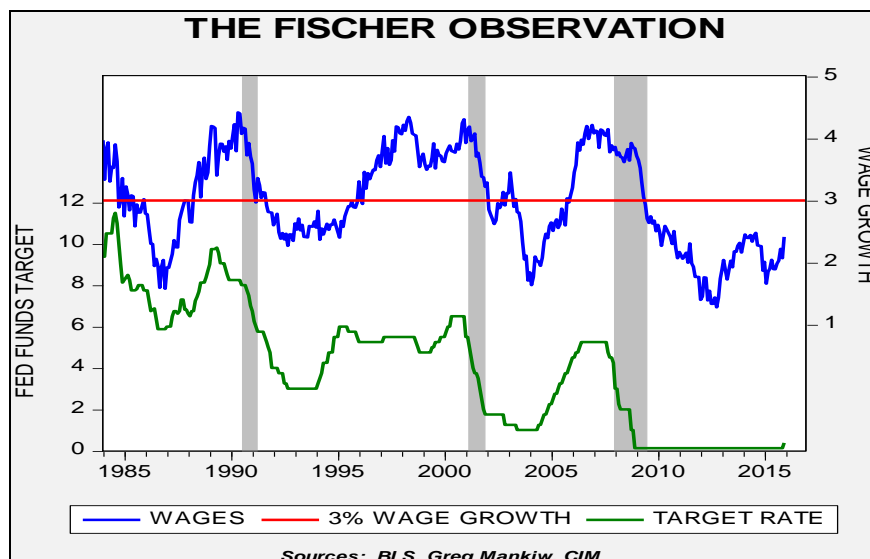
The FOMC is truly data-dependent at this point. Fischer went out of his way to indicate that the FOMC is carefully watching world events and the domestic economy. Thus, the decision to move on rates or stand pat is really a meeting-to-meeting situation. He did reiterate the point that Yellen makes often, which is that once oil prices stabilize, inflation rates will likely move higher and hit the Fed's target.

The FOMC does not conduct policy with a terminal rate in mind. We are not completely convinced that this is the case for all members, but it does appear to be Fischer's position. He has opposed forward guidance and we would not be shocked to see the dots chart disappear if he were Chairman. Given Fischer's gravitas, we doubt others would try to argue for rate adjustments based on some calendar-based timetable.

The Fed does watch the financial markets but is keenly aware that they do not always send proper signals. This goes back to Paul Samuelson's famous quip that the "stock market has predicted nine of the past five recessions."

Fischer is as befuddled by the tight relationship between equities and oil prices as we are. The argument for a direct correlation between oil and equity values is that the former is giving us signals about the state of the global economy. Fischer, like us, sees the current oil weakness as a function of excess supply rather than weak demand. This doesn't mean that we are near a break in the current relationship (today's action clearly shows oil and equities remain positively correlated), but it does show that others are seeing the market's position on this correlation as mistaken.

Fischer did mention the controversy over the Phillip's Curve, noting that it makes intuitive sense but the linkages are far from impressive. *He also may have let something slip...he noted that a 3% level of wage growth would be "good."*



On the above chart, we show annual wage growth for private sector non-supervisory workers, the fed funds target and a line at 3%. Fischer’s comments don’t yield a hard and fast rule, but we may be able to discern a few observations by looking at the three recessions since known targets have been introduced. First, the FOMC may start tightening before wages reach 3%, but that probably only means the Fed believes it is being too accommodative and that real tightening commences when wage growth exceeds 3%. Second, Greenspan showed his “radical” side by keeping fed funds mostly steady despite strong wage growth in the late 1990s. He was convinced that strong productivity would keep inflation under control (see below). Third, it would appear that the FOMC views wage growth in excess of 4% as a problem and tends to keep rates elevated until wage growth falls below that level. However, once wage growth starts falling from these elevated levels, the damage has been done and a recession is almost impossible to avoid.

This all tells us that the FOMC believes it is tightening from overly accommodative levels and it sees policy as slowly removing that stimulus. However, it seems that the Fed will be cautious about tightening until wage growth exceeds 3%. If that fails to happen, the Fed will probably remain in slow tightening mode. We will continue to monitor these events to see if the 3% wage growth line is a good indicator of policy intentions.

In the final analysis, we view Fischer’s comments as generally dovish. He didn’t signal new easing but he clearly showed that the Fed doesn’t have a terminal rate in mind and that it is as puzzled about current economic conditions as anyone. Perhaps the Fed won’t move to aggressively tighten until it sees clear evidence that wage growth is at or exceeding 3%.

U.S. Economic Releases

There are no releases scheduled before we go to print. The table below shows the releases scheduled for the rest of the day.

Economic releases						
EST	Indicator			Expected	Prior	Rating
9:45	ISM New York	m/m	Jan		62.0	*
10:00	IBD/TIPP Economic Optimism	m/m	Feb	47.6	47.3	**
10:00	Wards total vehicle sales	m/m	Jan	17.3 mn	17.2 mn	**
10:00	Wards domestic vehicle sales	m/m	Jan	13.7 mn	13.5 mn	**
Fed Speakers and Events						
EST	Speaker or event	District or position				
1:00	George	Kansas City				

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, with red indicating a concerning development, yellow indicating an emerging trend that we are following closely for possible complications and green indicating neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
EUROPE								
Eurozone	Unemployment rate	y/y	Dec	10.4%	10.5%	10.5%	***	Equity bullish, bond bearish
	PPI	m/m	Dec	-3.0%	-3.2%	-2.8%	**	Equity bearish, bond bullish
Italy	Unemployment rate	m/m	Dec	11.4%	11.4%	11.2%	***	Equity bearish, bond bullish
Switzerland	Retail sales	y/y	Dec	-1.6%	-1.7%		**	Equity bearish, bond bullish
AMERICAS								
Brazil	Industrial production	y/y	Dec	-11.9%	-12.4%	-10.6%	***	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)	61	62	-1	Down
3-mo T-bill yield (bps)	34	34	0	Neutral
TED spread (bps)	27	28	-1	Down
U.S. Libor/OIS spread (bps)	40	40	0	Neutral
10-yr T-note (%)	1.91	1.95	-0.04	Narrowing
Euribor/OIS spread (bps)	-16	-16	0	Neutral
EUR/USD 3-mo swap (bps)	22	21	1	Up
Currencies	Direction			
dollar	down			Rising
euro	up			Falling
yen	up			Falling
franc	up			Falling
Central Bank Action	Current	Prior	Expected	
Australia key rate	2.00%	2.00%	2.00%	On forecast
India repo rate	6.75%	6.75%	6.75%	On forecast
India reverse repo rate	5.75%	5.75%	5.75%	On forecast
India cash reserve ratio	4.00%	4.00%	4.00%	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	Cause/ Trend
Energy markets				
Brent	\$ 32.59	\$ 34.24	-4.82%	Chinese growth slowing, while OPEC production rises
WTI	\$ 30.38	\$ 31.62	-3.92%	
Natural gas	\$ 2.04	\$ 2.15	-5.25%	
Crack spread	\$ 11.95	\$ 13.22	-9.61%	
12-mo strip crack	\$ 11.30	\$ 12.12	-6.81%	
Ethanol rack	\$ 1.54	\$ 1.54	0.06%	
Metals				
Gold	\$ 1,126.24	\$ 1,128.41	-0.19%	Falling investment demand
Silver	\$ 14.28	\$ 14.35	-0.52%	
Copper contract	\$ 205.35	\$ 205.55	-0.10%	Chinese manufacturing slows
Grains				
Corn contract	\$ 370.25	\$ 371.25	-0.27%	
Wheat contract	\$ 474.75	\$ 475.25	-0.11%	Ample inventories
Soybeans contract	\$ 881.75	\$ 880.75	0.11%	
Shipping				
Baltic Dry Freight	314	317	-3	
DOE inventory report expectations of weekly change				
	Actual	Expected	Difference	
Crude (mb)		3.7		
Gasoline (mb)		2.1		
Distillates (mb)		-1.2		
Refinery run rates (%)		-0.8%		
Natural gas (bcf)		-171.0		

Weather

The 6-10 and 8-14 day forecasts indicate cooler than normal weather for the eastern two-thirds of the country. Precipitation is forecast for the East Coast.

Weekly Asset Allocation Commentary

Confluence Investment Management offers various asset allocation products which are managed using “top down,” or macro, analysis. This year, we have started reporting asset allocation thoughts on a weekly basis, updating the section every Friday.

January 29, 2016

Last week, we examined the second of our “known/unknowns” discussed in our [2016 Outlook](#), which was that the slowing world economy could potentially drag the U.S. into recession. As promised, this week we will analyze the first “known/unknown,” the idea that the Federal Reserve could make a policy mistake and trigger a recession.

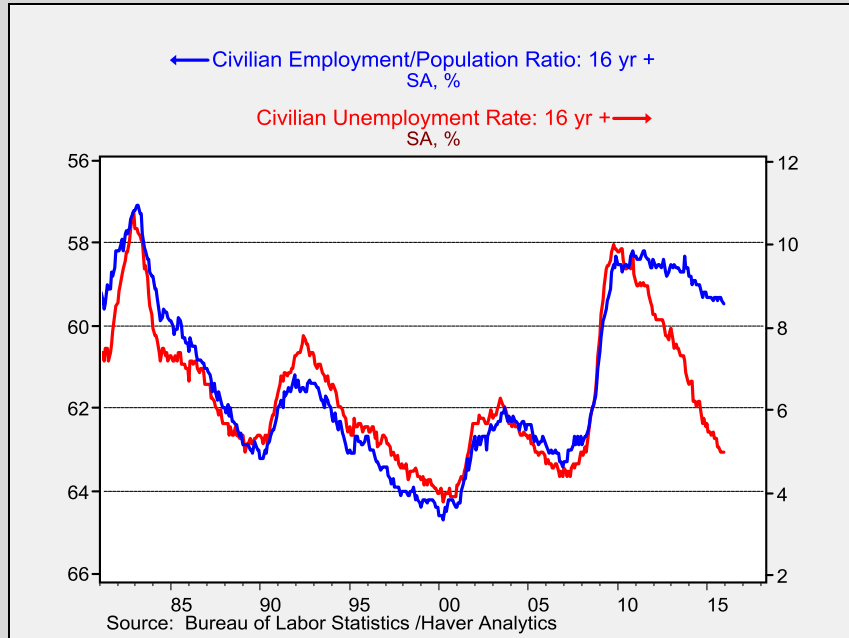
One of the key narratives of monetary policy is the concept of the Phillips Curve. This hypothesis states that there is an inverse relationship between wage growth and unemployment. Essentially, as labor markets tighten, one would expect the price of labor (wages) to rise in response to scarcity. This concept is generally uncontroversial. What is controversial is that economists have tended to link wage growth, unemployment and inflation together. If the basic elements of the Phillips Curve are correct, it can be argued that falling unemployment leads to rising inflation. Of course, other factors might lead to higher wages without resulting in inflation, such as higher wages due to rising productivity; a second would be an expansion of the labor force where formerly discouraged workers rejoin the labor market due to improving conditions. It should be noted that the Phillips Curve isn’t universally accepted. In a globalized world, a labor force that is subject to global competition may not have the ability to demand higher wages. In other words, the supply curve for labor could be nearly perfectly elastic, which would mean that rising demand for labor brings out not just new entrants into the domestic labor market, but it increases imports, meaning that the demand for labor can rise without triggering a jump in wages.

The behavior of the FOMC suggests that one pillar of their policy is the Phillips Curve. Some economists have attempted to create rules for policymakers, arguing that these rules would help policymakers achieve a balance between inflation and full employment. Assuming there is some sort of relationship between labor markets and inflation (the basis of the Phillips Curve), one should be able to create a rule that tells policymakers what the policy interest rate should be. The Taylor Rule is one such attempt at building a policy “algorithm.” The Taylor Rule assumes that there is a relationship between the level of economic slack and the desired inflation rate. Thus, the Taylor Rule takes economic slack (GDP less potential GDP) and the current inflation rate less the target rate to project a neutral policy rate.¹

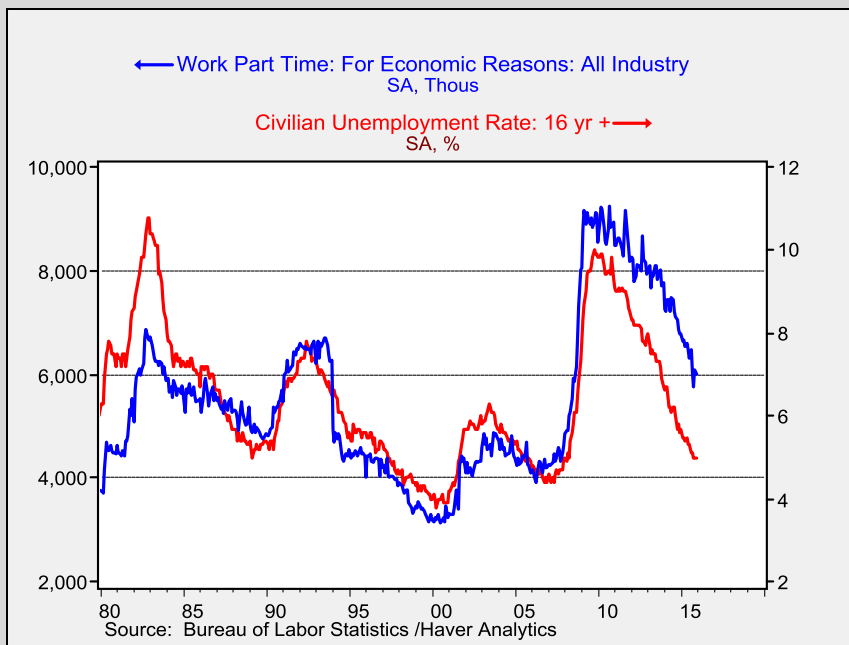
The problem with the Taylor Rule is that potential GDP isn’t directly observable. Several economic groups try to establish what the economy’s potential GDP is, but all such numbers are estimates. In response, Greg Mankiw, an economist at Harvard, reconstructed the Taylor Rule substituting the unemployment rate for the measure of economic slack. We have taken Mankiw’s work and created two additional variations of the original model. We did this because

¹ A neutral policy rate is an interest rate that is neither stimulative nor accommodative.

we have seen some rather unusual divergences in the labor markets which suggest that the low unemployment rate may not be indicative of a tight labor market. We focus on two other measures of labor market slack, the employment/population ratio and the level of involuntary part-time employment.

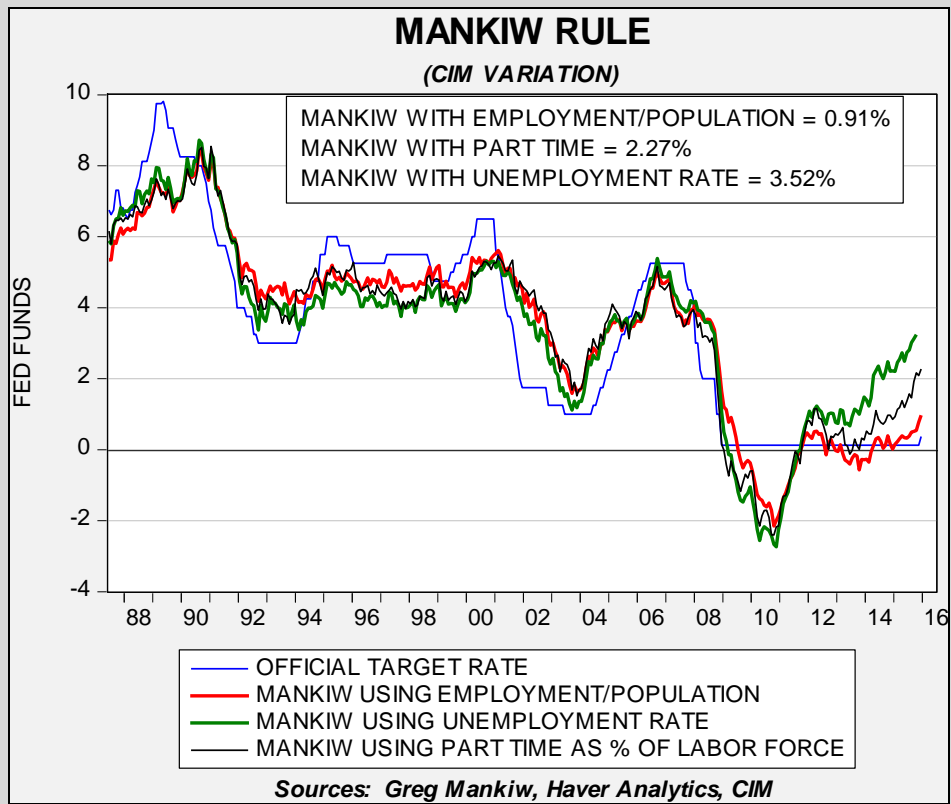


This chart shows the spread between the employment/population ratio and the unemployment rate. From 1980 until 2011, the two series closely tracked each other but have diverged sharply over the past five years. The spread represents about 7.5 mm jobs; if the earlier relationship had held, the current employment/population ratio would result in a 7.7% unemployment rate.



A similar condition exists with involuntary part-time employment and the unemployment rate. Again, using the relationship since 1980, the current level of involuntary unemployment would generate an unemployment rate of 6.8%.

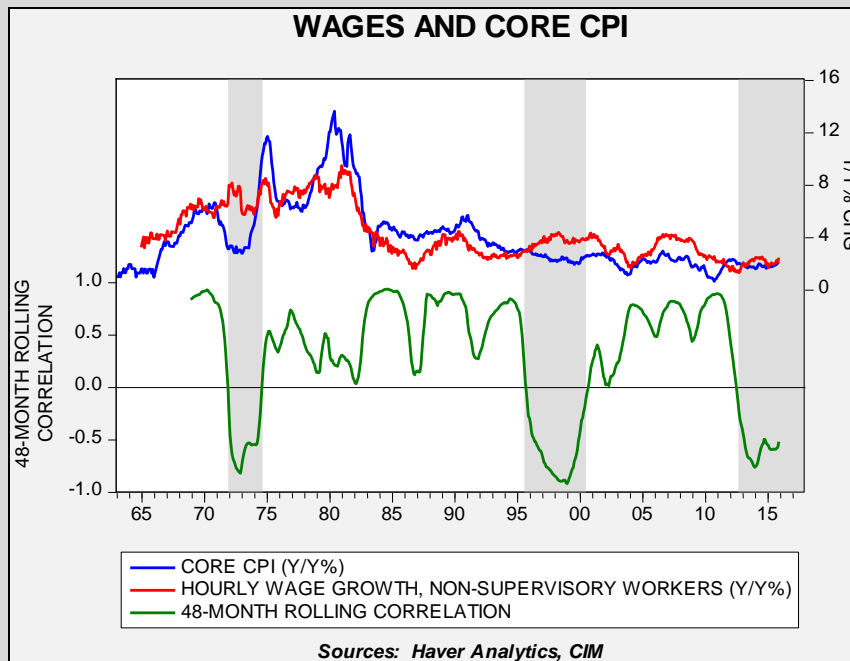
In order to generate a projected neutral policy rate, using the Mankiw Rule, we created three models. All use core CPI, and then three separate models are generated using the unemployment rate, the employment/population ratio and involuntary part-time employment. The following chart shows the results.



The model using the unemployment rate puts the neutral policy rate at 3.52%, suggesting the FOMC is in danger of generating inflation and needs to raise rates aggressively. The model using involuntary part-time employment suggests a neutral policy rate of 2.27%, while the one based on the employment/ population ratio suggests a 0.91% neutral policy rate.

Although some of the more hawkish members of the FOMC would probably lean toward the outcome using the unemployment rate, the more moderate members would likely center on the middle rate, the rate using involuntary part-time employment. The most recent “dots” chart shows an average policy rate of 2.41% at the end of 2017. Thus, a gradual increase toward the part-time model estimate makes sense. Even the most dovish model outcome, using the employment/population ratio, still suggests at least two increases in the policy rate to achieve a neutral rate.

However, what if the Phillips Curve doesn't hold? What should the policy rate be under these conditions? First, there is evidence that the Phillips Curve isn't working in the current environment.



This chart shows core CPI and hourly wage growth on the upper part of the graph, with the rolling 48-month correlation on the bottom part of the graph. As the lower line shows, most of the time the relationship between the two series is positive. However, we have highlighted three periods where the two series are inversely correlated. The first occurred in the early 1970s and was probably tied to the Nixon price freeze, which lowered the growth rate of inflation but didn't stop wages from rising. Inflation roared back after the freeze was lifted, returning the positive relationship back to inflation and wages. The second occurred in the second half of the 1990s, when the FOMC decided that rising productivity would offset wage pressures. It turns out that the assessment was correct; inflation never became a serious problem, although the relationship normalized as productivity waned in the last decade.

We are currently in another period where core CPI and wage growth are inversely correlated. However, it would be difficult to blame the divergence on productivity, which has been sluggish. We suspect that excess global capacity is holding down wages. It is also possible that the lingering effects of high unemployment earlier in the decade are acting to depress wage demands. In any event, in a period where wages and core CPI are not directly correlated, policymakers should be very cautious in raising rates. If globalization is keeping wage growth contained, raising interest rates to fight "phantom inflation" increases the odds of a policy mistake.

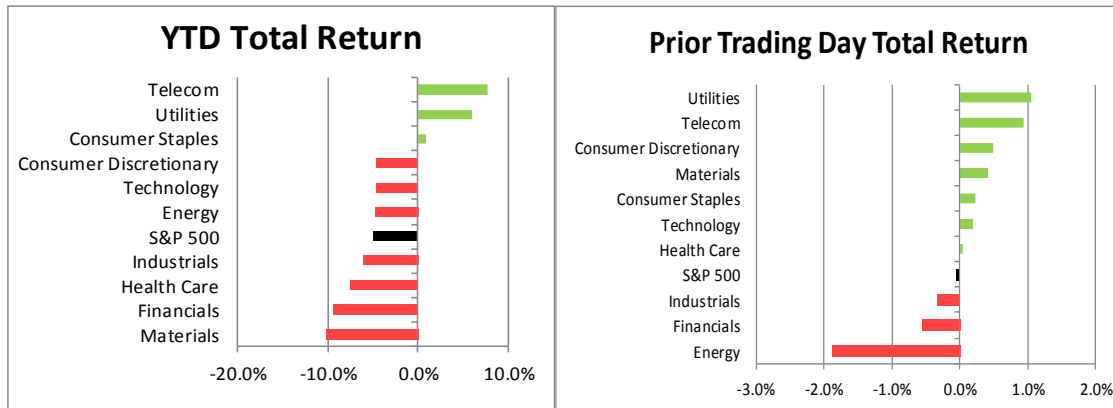
Our fear is that the FOMC members are hesitant to stop thinking in terms of the Phillips Curve because, without this construct, they are intellectually adrift. Therefore, rather than live with the ambiguity that the aforementioned distortions in the labor markets and weak wage growth are

signals that the Phillips Curve relationship may not be working, they appear willing to risk a policy error by raising rates when they probably shouldn't. Most likely, given the high degree of uncertainty, the prudent path would be to move rates up very slowly. Thus, the chances of the FOMC making a policy mistake are elevated at this point, but we are not yet at a level where policymakers have already moved too far. Given the current state of the economy, we expect two rate increases at most this year and would not be surprised to see the FOMC move only once in 2016. However, if our assessment is too sanguine, the odds increase for a recession and a more serious drop in equities.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

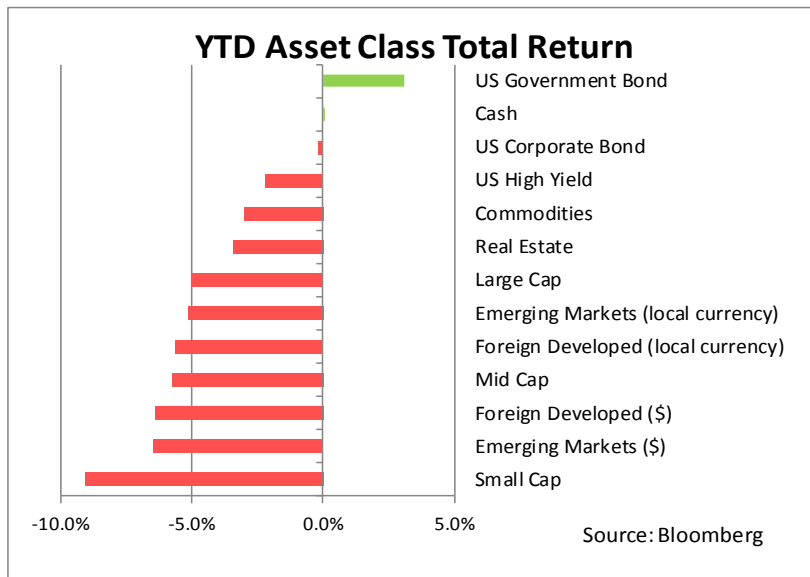
U.S. Equity Markets – (as of 2/1/2016 close)



(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 2/1/2016 close)



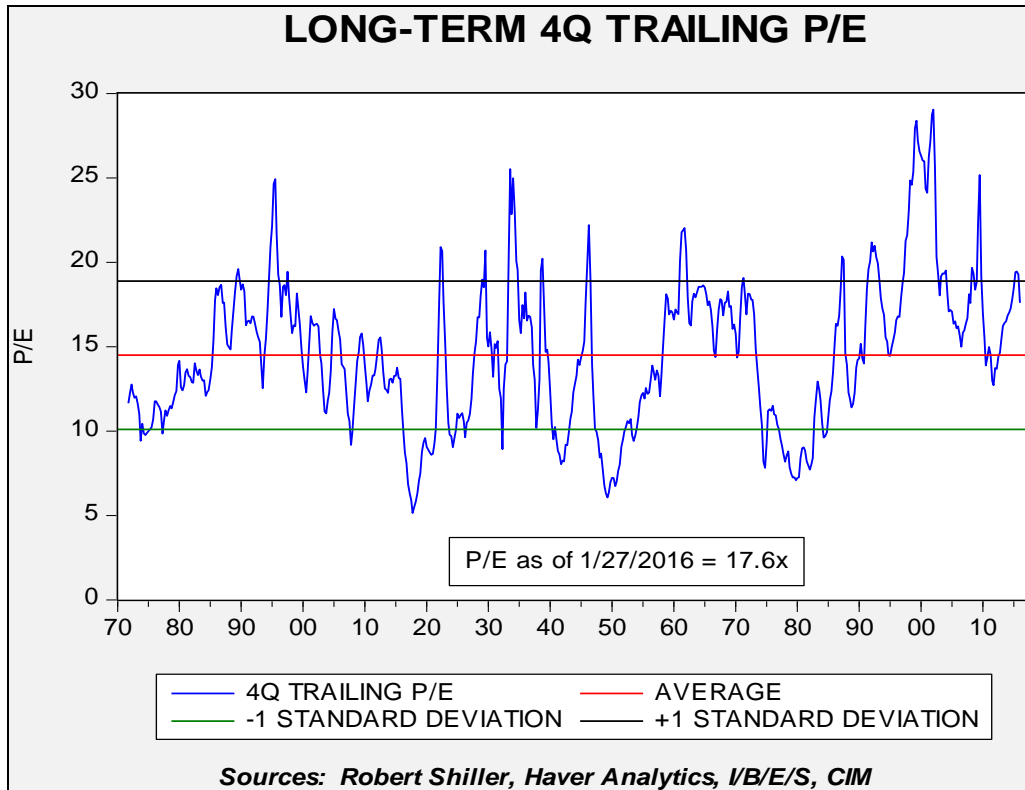
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 28, 2016



Based on our methodology,² the current P/E is 17.6x, down 0.1x from last week. Falling equity prices and stable earnings led to the drop 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.

² 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 (Q2 and Q3) and two estimates (Q4 and Q1). 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.