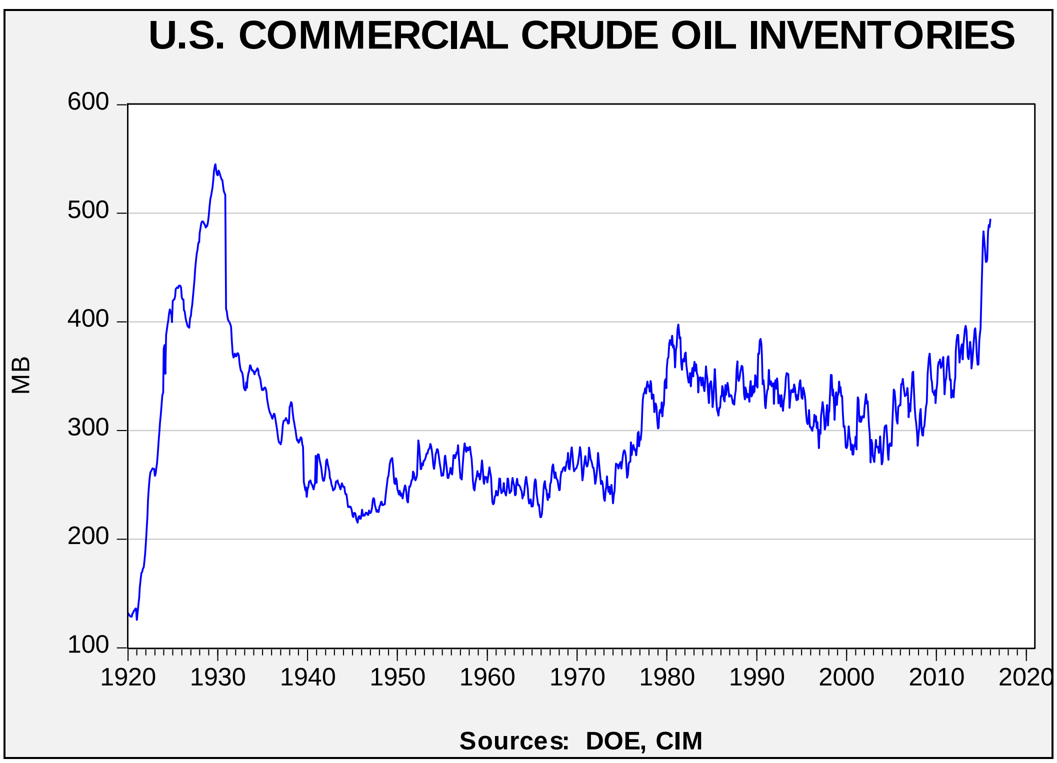
# Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

**[Posted: January 28, 2016—9:30 AM EST]** Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 1.8% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.2% from the prior close. Chinese equities were lower, with the Shanghai composite down 2.9% and the Shenzhen index down 4.2%. U.S. equity futures are signaling a sideways opening from the previous close. With 26.6% of the S&P 500 companies having reported, the Q4 adjusted earnings stand at $29.45, higher than the $28.95 forecast. Of the 133 companies that have reported, 76.7% beat expectations while 15.0% fell short.

**BREAKING NEWS: BLOOMBERG IS REPORTING THAT OPEC AND "OTHER PRODUCERS" WILL MEET NEXT MONTH. SO FAR, THERE HAS BEEN NO CONFIRMATION FROM SAUDI ARABIA. OIL PRICES ARE UP SHARPLY ON THE NEWS. FURTHER COMMENTS BELOW.**

Oil rallied yesterday despite a huge increase in both crude oil and gasoline stockpiles.




Current inventories are rising toward what the DOE refers to as "working storage," which is a little over 500 mb. There is probably another 100 mb of "shell capacity," which consists of less than ideal storage facilities, e.g., pipelines, topping off tanks, etc. So, why did crude rally yesterday in spite of this inventory rise? First, inventories at Cushing, OK, the delivery point for the CME crude oil futures, fell 0.8 mb, easing some immediate worries about "hitting the storage wall." Total Cushing stocks are at 63.4 mb, or 89.3% of working capacity. The drop is welcome but could easily reverse next week.

Most likely, the rally in oil was driven by a rumble of stories suggesting that a deal among producers may be in the works (note breaking news above). This is bullish news on its face. However, some degree of caution is warranted. Earlier this morning, Reuters reported that Russian officials are embarking on a plan to talk to Saudi Arabia and other OPEC producers about output cuts. The head of Russia's oil pipeline system, Nikolai Tokarev, was quoted as saying such talks should be considered. In further comments, Tokarev indicated that the talks should focus on Saudi Arabia. These comments come as Bloomberg reports that Russia's January production is set to surpass the previous post-Soviet record, with output expected to reach 10.89 mbpd. It should be noted that Reuters is also reporting that unnamed oil officials are calling the idea of production cuts "impossible," most likely because shutting down wells might permanently reduce productive capacity. The *NYT* is carrying a story today indicating that the Saudis are not considering production cuts anytime soon. Their fear is that cutting output will merely give up market share. It is important to remember that it isn't just oil share that matters. Saudi Arabia is aligned against Russia, Iran and, increasingly, Iraq. The latter two are now Shiite powers in the region and Russia is successfully supporting Bashar Assad in Syria, a leader the Saudis want to oust. Even worse, Russian planes are bombing Sunni insurgent groups that the Saudis support.

This doesn't mean a deal can't be reached. In fact, the script is actually rather simple. Iran and Russia agree to put Assad into exile and allow Syria to break into autonomous zones with weak federal control. In return, Iran, Iraq, Russia and the Gulf States agree to reduce oil output and allow prices to lift. Could this happen? It isn't too farfetched. Is such a deal on the horizon? There is no evidence of any deals; in fact, peace talks concerning Syria have been postponed.

Overall, we view these headlines about cutting output as desperate attempts by oil producers to jawbone the market higher. Such behavior does work sometimes, especially when markets are oversold and speculative short interest is high. However, if overused, it soon becomes ignored and it cannot overcome fundamentals. At present, production exceeds demand and, as the above chart shows, there is a historic inventory overhang in place. ***Still, the breaking news noted at the top of this report is clearly bullish and will lift oil prices further, but the Saudis must confirm they will participate in talks for follow-through to occur.***

In the wake of the FOMC statement, equities fell yesterday, suggesting that traders were disappointed in policymakers. We viewed the statement as leaning dovish. It's true it didn't completely rule out a March hike but the statement acknowledged the weakening economy and noted a rather risky global environment. In fact, in December, the statement indicated that risks between inflation and growth were mostly balanced. This newest statement noted that global developments called this assessment into question. That isn't to say the FOMC is now changing their balance of risk toward recession, but it does indicate that the members are not as sure about the economy as they were in December.

It's hard to see how things could improve dramatically by March. If anything, we will be getting most of the data for Q4 2015, which is looking really soft at this point. There was surprisingly little concern about the impact of lower oil prices. It appears that the committee continues to believe that the oil price declines will be transitory. Since the FOMC uses core inflation, which excludes food and energy from calculating inflation, they may have a bias, but we doubt oil prices will make a strong recovery barring a conflict that disrupts oil supplies from the Middle East.

It appears to us that the equity markets were expecting some strong statements, something akin to "no more hikes this year" and "QE4 is being considered." That wasn't going to happen. In fact, we view the fact that the decision was unanimous as a very positive sign. The fact that the dollar didn't rally is a clear indication that the statement was not hawkish.

If we are correct in our assessment, the FOMC will probably pass on a hike in March, although holding steady will likely trigger one hawkish dissent. If they don't move in March, the earliest the next hike will come is likely June, which would put us on a pace of three hikes maximum this year. Although such a pace will weigh on equities, if the economy is improving fast enough to support 75 bps of rate hikes then conditions will have improved significantly.

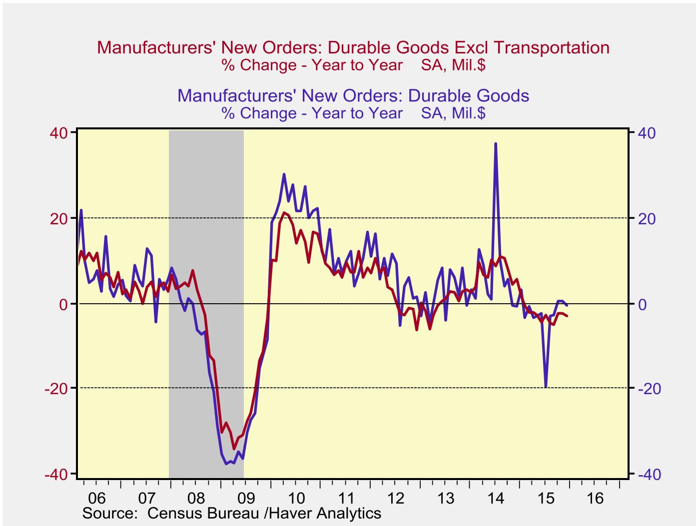
Finally, a short note on the upcoming GOP debates…Trump's decision to not participate is fascinating. Risky, but fascinating. The move could backfire on Trump. He will be portrayed as a coward. However, the decision has broader ramifications. First, the battle lines are being drawn between the candidate and Fox News. The latter, the voice of the right, risks losing credibility among the populist right by unveiling the fact that the network's leadership is part of the political establishment. Second, it is quite possible that viewership will decline. If it becomes clear that the draw is the Donald, he will become even more aggressive in dictating terms for future debates. Third, Sen. Cruz's situation just became ugly. He will now be the front runner at the upcoming debate and the target of those who participate as Trump won't be around to divert attention. Thus, Cruz will bear the brunt of attacks, enduring the costs of being the front-running candidate without actually being the poll leader. That's why he is calling for a "man to man" debate just between the two. Trump will wisely decline. Fourth, we expect Trump to "twitter-bomb" the debate. Although he will be participating in a charity event, Trump will almost certainly use social media to comment on the progress of the debate.[1] Thus, he could very well hammer the candidates and they won't even be aware they are being attacked.

**U.S. Economic Releases**

December durable goods orders came in much weaker than forecast, falling 5.1% compared to the 0.7% decline forecast. Orders excluding transportation fell 1.2%, also weaker than the 0.1% decline forecast. Defense orders, a volatile segment due to the "lumpiness" of orders, fell 34.4% following a 45.8% increase in orders. Transportation was also weak on the back of strong declines in non-defense aircraft orders. Non-defense capital goods orders, excluding aircraft orders, were particularly weak, falling 4.3% compared to the 0.2% decline forecast. Orders

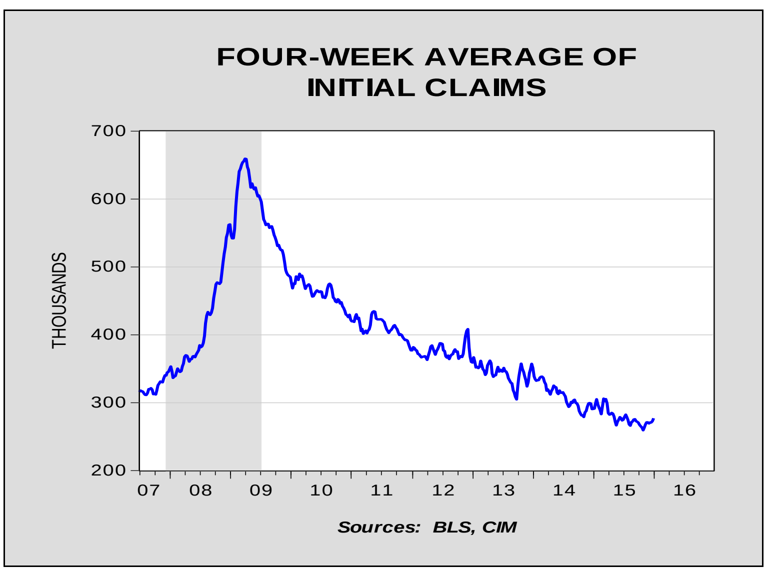
[1] It should be noted that *Saturday Night Live* ran a skit that resembled this situation when Trump was the guest host.

declines were broad-based, with only electrical equipment and primary metals orders seeing positive order growth.




The chart above shows the annual change in the overall orders and orders excluding transportation. Both remain mildly negative. Orders are not clearly signaling recession but are indicating a very weak economy. This is further evidence the FOMC should probably keep rates steady.

Initial claims fell 16k to 278k, better than the 281k forecast. The volatility seen in claims over the past few weeks is likely due to post-holiday workforce adjustments.




The chart above shows the four-week average of claims, a more stable measure of firings. The average fell 2k to 283k.

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

| Economic releases | | | | | | |
|---|---|---|---|---|---|---|
| EST | Indicator | | | Expected | Prior | Rating |
| 10:00 | Pending home sales | m/m | Dec | 0.9% | -0.9% | * |
| 10:00 | Kansas City Fed manufacturing activity | m/m | Jan | -10.0 | -9.0 | * |

### 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, 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 |
|---|---|---|---|---|---|---|---|---|
| ASIA-PACIFIC | | | | | | | | |
| Japan | Retail sales | m/m | Dec | -0.2% | -2.5% | 1.0% | ** | Equity bearish, bond bullish |
| EUROPE | | | | | | | | |
| Eurozone | Consumer confidence | m/m | Jan | -6.3 | -6.3 | -6.3 | ** | Equity and bond neutral |
| | Economic confidence | m/m | Jan | 105.0 | 106.7 | 106.4 | * | Equity bearish, bond bullish |
| | Business climate indicator | m/m | Jan | 0.3 | 0.4 | 0.4 | * | Equity bearish, bond bullish |
| | Industrial confidence | m/m | Jan | -3.2 | -2.0 | -2.5 | * | Equity bearish, bond bullish |
| | Services confidence | m/m | Jan | 11.6 | 12.8 | 12.9 | * | Equity bearish, bond bullish |
| Germany | CPI | y/y | Jan | 0.5% | 0.3% | 0.4% | *** | Equity bullish, bond bearish |
| U.K. | GDP | y/y | Q4 | 1.9% | 2.1% | 1.9% | *** | 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)** | 62 | 62 | 0 | Neutral |
| **3-mo T-bill yield (bps)** | 30 | 31 | -1 | Down |
| **TED spread (bps)** | 32 | 31 | 1 | Up |
| **U.S. Libor/OIS spread (bps)** | 39 | 39 | 0 | Neutral |
| **10-yr T-note (%)** | 1.98 | 2.00 | -0.02 | Narrowing |
| **Euribor/OIS spread (bps)** | -16 | -16 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 22 | 22 | 0 | Neutral |
| **Currencies** | **Direction** | | | |
| dollar | down | | | Rising |
| euro | up | | | Falling |
| yen | down | | | Falling |
| franc | up | | | Falling |

## 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 | $ 33.65 | $ 33.10 | 1.66% | |
| WTI | $ 32.76 | $ 32.30 | 1.42% | |
| Natural gas | $ 2.11 | $ 2.16 | -2.13% | |
| Crack spread | $ 13.01 | $ 12.09 | 7.56% | |
| 12-mo strip crack | $ 12.34 | $ 11.75 | 5.01% | |
| Ethanol rack | $ 1.52 | $ 1.52 | 0.19% | |
| **Metals** | | | | |
| Gold | $ 1,120.89 | $ 1,124.97 | -0.36% | Yesterday's rally may have been overdone |
| Silver | $ 14.40 | $ 14.48 | -0.56% | |
| Copper contract | $ 205.05 | $ 206.40 | -0.65% | Global demand to remain weak |
| **Grains** | | | | |
| Corn contract | $ 368.00 | $ 369.25 | -0.34% | Improving South African crop |
| Wheat contract | $ 475.00 | $ 476.50 | -0.31% | |
| Soybeans contract | $ 881.00 | $ 883.00 | -0.23% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 337 | 345 | -8 | |
| **DOE inventory report expectations of weekly change** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | 8.4 | 4.3 | | |
| Gasoline (mb) | 3.5 | 0.7 | | |
| Distillates (mb) | -4.1 | -1.9 | | |
| Refinery run rates (%) | -3.2% | -0.8% | | |
| Natural gas (bcf) | | -210.0 | | |

## Weather

The 6-10 day forecast indicates warmer than normal weather for the coasts and precipitation for the northern half of the country.  The 8-14 day forecast indicates colder than normal weather 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 22, 2016

As we noted last week, equities have suffered through a very difficult beginning in 2016 and it's not showing signs of improvement. In our 2016 Outlook, we didn't anticipate such a soft start; however, we did note four "known/unknowns" that might thwart our expectations for modest equity gains this year. It does appear that two of our caveats are behind the weak start for equities. This week, we will discuss the second caveat, that a weakening world economy could potentially pull the U.S. economy into recession.

In the aforementioned report, we discuss that for most of the post-WWII period the U.S. economy was large enough relative to the rest of the world that foreign influences rarely triggered a U.S. recession. In general, only oil events, such as the 1973 Oil Embargo or the 1990 Gulf War, were international events that coincided with U.S. recessions. On the other hand, there is ample evidence in the historical record of U.S. downturns causing havoc in the global economy. For example, the 1980-82 recession was primarily caused by Federal Reserve policy; the increase in U.S. interest rates triggered the Latin American Debt crisis of the 1980s and led to mostly a "lost decade" for that region. In fact, the Mexican Peso Crisis of 1994 was partly caused by tighter U.S. monetary policy. Although policy tightening did not cause a U.S. recession, it was a major crisis for Mexico.

The relative size of the U.S. economy has fallen over the years. At the end of WWII, the U.S. economy represented almost 36% of global GDP; it is now down to 15%. By some measures, the Chinese economy is now larger than the American economy. Therefore, it makes sense that problems in China might have a larger than normal impact on the U.S. China's need to restructure from an industrial and exporting economy to one focused on domestic demand has been well documented. Making that shift is fraught with risk. We believe that concerns about China's economy have been one of the primary factors behind the equity market's woes.

Determining the true conditions of China's economy is difficult. Data collection and analysis are still rudimentary and there are legitimate concerns about government interference in the reporting of economic data. Thus, analysts constantly search for information that is less prone to manipulation and frequent enough to offer timely insights into the Chinese economy. Monitoring the relationship between the onshore and offshore exchange rates of the yuan (CNY) has offered important information about the economy and investor sentiment.

Because the CNY doesn't float freely, a rather convoluted market for the Chinese currency has evolved. It has three components. On the one side is the CNY, the internal exchange rate for China, which is completely controlled by China's monetary authorities. On the opposite end of the spectrum are non-deliverable forward CNY markets that are used by offshore investors to either hedge or take positions in CNY. This is more of a swap market and is completely unfettered. In between those two is the Hong Kong deliverable market, called the CNH. The CNH, in theory, should move with the CNY. The Bank of China's (BoC)[2] Hong Kong arm manages the spread by buying or selling against the spread to keep it in line. So, if the CNH trades at a premium to the CNY, the BoC delivers more CNY to the Hong Kong market (and presumably trades these for USD and EUR); if the CNH trades at a discount, CNY is moved from Hong Kong to the mainland (and sells USD and EUR either from exporters or out of reserves to buy the CNY). ***China created this situation so that no private arbitrage can exist***. Essentially, the government, through the BoC, captures the arbitrage instead of speculators.

As long as the CNY and CNH move together, this exchange rate arrangement isn't a problem. However, when the CNY and CNH rates diverge, especially when the CNH rate is weaker than the CNY rate, Chinese authorities have three policy choices, which require accepting the appropriate consequences:

1. They can allow the CNY to depreciate to the CNH level. This process eliminates the potential arbitrage between the two rates but raises the possibility that the government is losing control over the exchange rate. A weaker CNY can also raise international pressures (lambasting China is a staple of American presidential candidate debates) and boost export competitiveness, which may trigger retaliatory exchange rate responses from other emerging market nations. It also might raise fears of further currency weakness and boost capital flight.
2. It can spend foreign reserves to buy CNH and sell dollars, bringing the rates back together. Although China's reserves are large, they are not infinite and, as we show below, have been falling steadily for 18 months. In addition, if the reason for currency weakness is capital flight, propping up the currency becomes a form of subsidy for Chinese citizens trying to move their money out of the country.
3. It can raise short-term interest rates dramatically, which will make shorting the currency expensive. Of course, higher short-term interest rates will also tend to weaken economic growth and this tactic usually can't be maintained indefinitely.

We believe that divergences in the CNY/CNH relationship, especially when the latter weakens compared to the former, tend to signal that China's policymakers are failing to maintain order in financial markets.

---

[2] A large commercial bank in China; not to be confused with the People's Bank of China (PBOC), which is the country's central bank.

(Source: Bloomberg)

This chart shows the CNY/USD[3] and CNH/USD exchange rates on the upper graph, and the spread between the CNY/CNH on the lower graph. The upper graph shows how many of either form of yuan is required to buy one USD, so a higher reading indicates a weaker yuan. On the lower graph, when red appears, it means the CNY is stronger than the CNH. The spread in 2011 was likely tied to the downgrade of U.S. sovereign debt which was caused by a budget standoff. The prospect of falling U.S. Treasury prices was a potential crisis for China given the composition of its foreign reserves. However, the rapid resolution of that crisis led the two rates to converge and mostly trade together until last year.

Last August, the PBOC shocked the market by modestly devaluing the CNY. Fears that there would be more to come led the CNH to depreciate much more than the CNY. A combination of statements and intervention in the foreign exchange markets eventually brought the two rates back together. The Xi administration was anxiously awaiting the IMF's decision on whether to include the CNY in the Special Drawing Rights (SDR) basket, which would confirm that China is now an economy on par with the other members of the SDR (Japan, Britain, the Eurozone and the U.S.). The IMF announced last November that the CNY would be added to the SDR in October 2016. After the announcement, the CNY and CNH began to weaken. However, as the above spread chart shows, the latter weakened much faster than the former.

Why is this exchange rate spread important? The financial markets seem to be using China's ability to control this spread as a proxy for policy effectiveness.

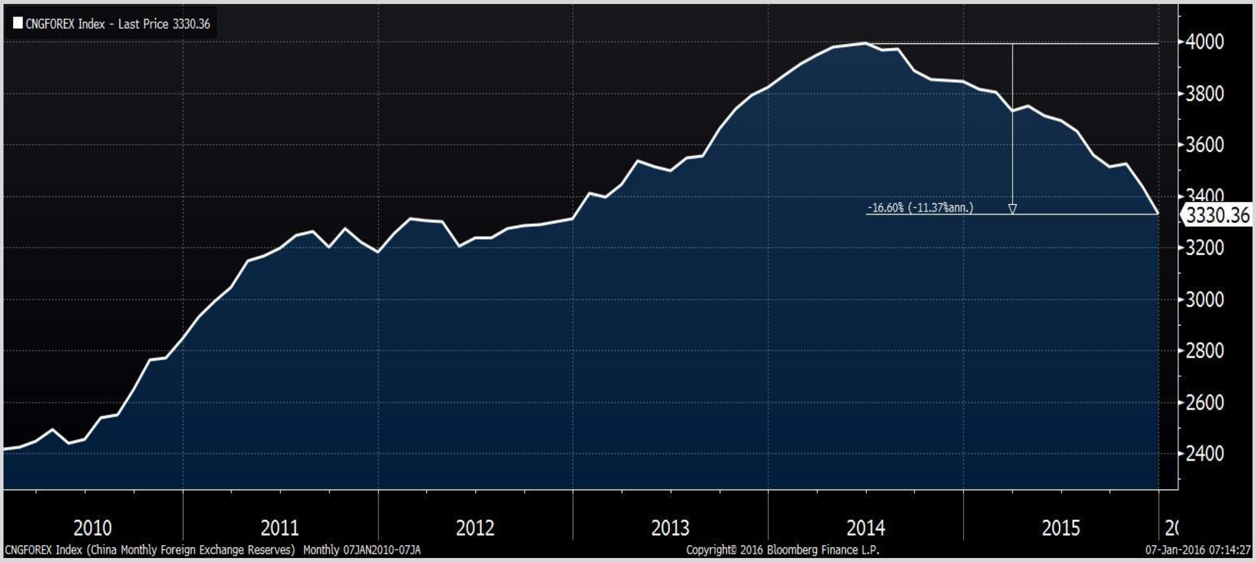
[3] USD=U.S. dollar


(Source: Bloomberg)

This charts shows the S&P 500 along with the CNY/CNH exchange rate. The widening of the spread (shown in white) tends to track the U.S. equity market, signaling both the August/September pullback in equities and the most recent weakness. The fact that the spread has narrowed is good news; note that it took a few weeks of maintaining a narrow spread last year before equities recovered.

Perhaps the bigger issue is what causes these two rates to diverge in a bearish fashion? We believe capital flight is the most likely cause. This is an issue we have been monitoring for some time.[4] Capital flight is when domestic investors begin moving their assets out of the country at an aggressive pace. There are numerous reasons why investors may move funds out of the country; it may be simple diversification. China has had a closed capital account for years and as controls become increasingly "leaky" the goal may be to reduce risk by investing overseas. However, as often seen in emerging markets, rising investment outflows often portend problems. Usually, capital flight comes from the best-connected and most politically astute members of a society. When they sense societal, economic and political shifts that may not be in their favor, they have an incentive to move their financial assets (and, in some cases, their families) to perceived safer venues.

[4] See WGR, 7/16/2012, The Mystery of Chinese Capital Flight.



(Source: Bloomberg)

This chart shows China's foreign reserves, which peaked at nearly $4.0 trillion in mid-2014 and have fallen over 16% from their highs. The declines are accelerating. It is worth noting that China is still running a trade surplus. For reserves to decline, the capital outflows must be greater than the trade surplus and foreign investor inflows. Although China isn't in any danger of running out of reserves in the near future, the pace of outflows does suggest a significant decline in Chinese investor confidence. That confidence is probably not being helped by Chairman Xi's ever widening purges and arrests of critics.

Since China is the second largest economy in the world, a financial crisis there could adversely affect the U.S. economy. At the same time, it might not. The U.S. is clearly a target of Chinese capital flight,[5] which benefits the U.S. economy. If Chairman Xi faces a major financial breakdown, it isn't clear how he would respond, although an increase in purges or an attempt to change the "conversation" with a military adventure cannot be ruled out. This is why we believe that uncertainty about China's policy direction and effectiveness is pressuring U.S. equities.

Next week, we will examine how another one of our known/unknowns, a Federal Reserve policy error, may be undermining U.S. investor confidence.

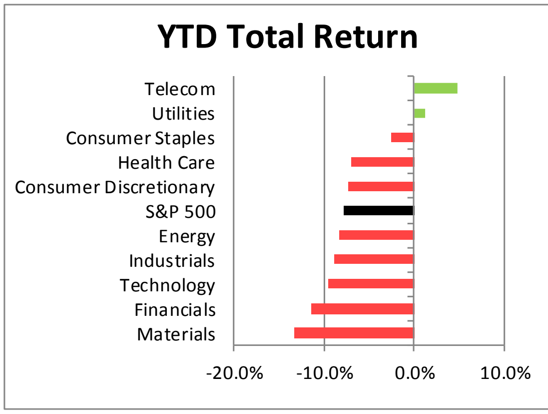


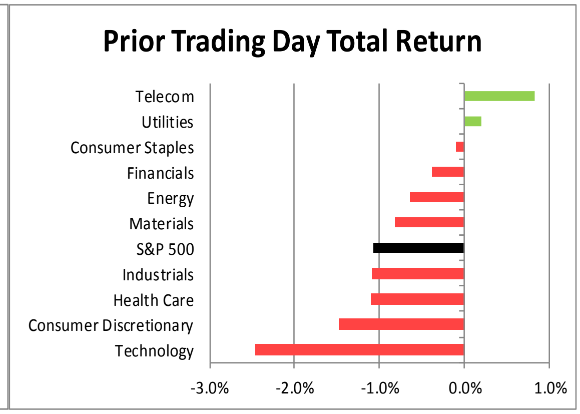
---

[5] As any real estate agent on the West Coast can attest to.

## Data Section

**U.S. Equity Markets** – (as of 1/27/2016 close)

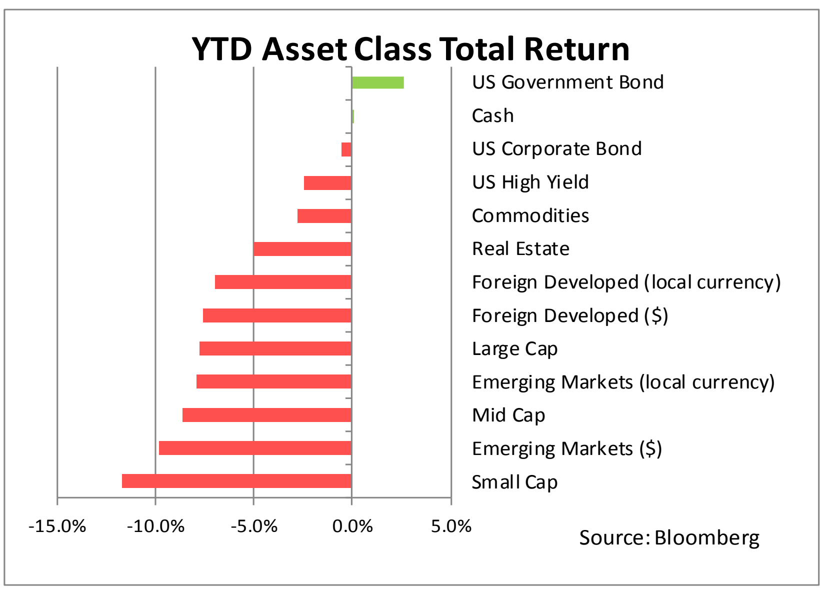



(Source: Bloomberg)

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 1/27/2016 close)

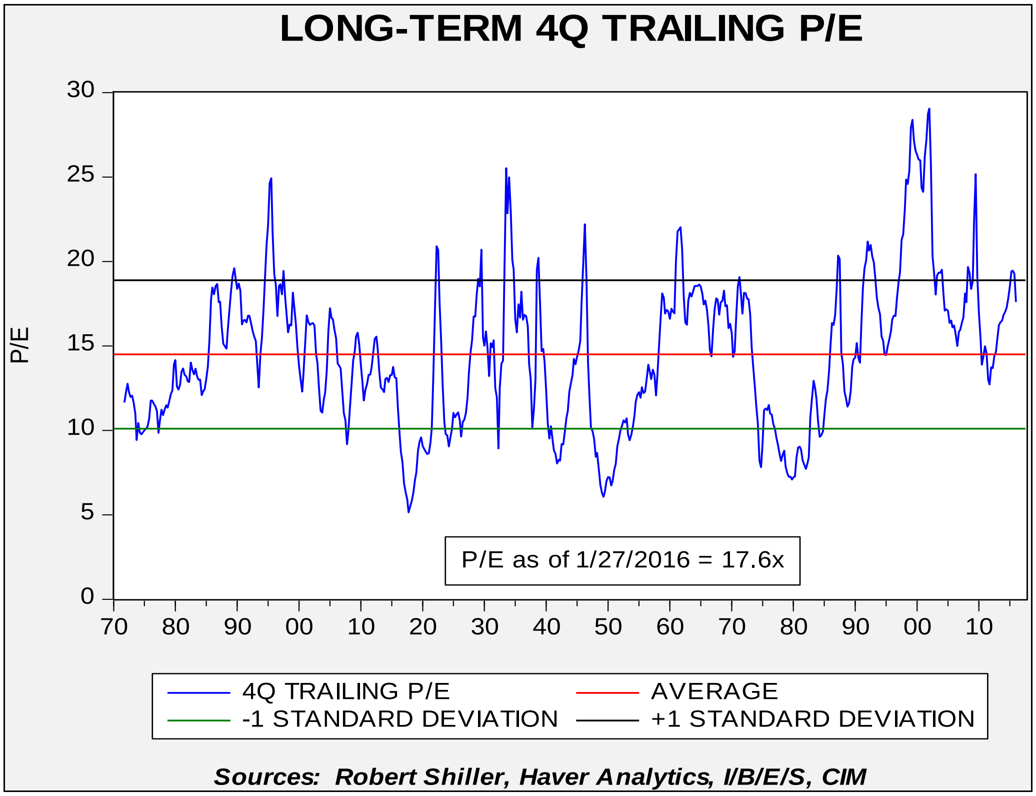



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[6] 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.*

---

[6] 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.