Daily Comment

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and Thomas Wash

[Posted: April 10, 2017—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 1.0%. U.S. equity futures are signaling a higher open.

Global markets are generally quiet this morning as investors try to discern how to handle President Trump's new muscular exercise of foreign policy. After reading and reflecting over the weekend, we offer our take on the missile strike against Syria. First, this is a president that eschews consistency; although a number of analysts are trying to figure out if these attacks signal a "Trump Doctrine," we suspect not. Instead, it shows that personal issues matter. It appears that the president was truly moved by video of the aftereffects of the sarin attack and reacted based on that feeling. This sort of behavior is consistent with a Jacksonian view of the world. Trump seemed to view the Assad gassing as a matter of honor and reacted accordingly. Second, the military appointees are clearly influencing policy. The strikes were designed to warn, not escalate. Military leaders try to avoid "mission creep," where a military intervention keeps expanding as civilian leaders try to accomplish ever larger goals. The military prefers discrete events and this missile strike is a classic example.

We do note that the U.S. is sending a carrier group toward North Korea. We doubt this is little more than a signaling exercise but that doesn't mean it won't be effective. The U.S. doesn't want war with North Korea but no president wants the Hermit Kingdom to acquire a nuke on their watch. Thus, sending a signal to the Kim regime that there could be costs to its current policy is prudent.

The Trump/Xi meetings ended with little drama. China did offer some modest concessions on finance and beef, and they set a plan to discuss trade over the next 100 days that may create conditions for a bilateral trade agreement. In the meantime, China will likely adjust higher its allowed percentage of foreign ownership of financial firms and lift the ban on U.S. beef imports. It also promised to buy more agricultural products. China will want to avoid a trade war until the October CPC meetings. After that, we will get a better look at China's real trade policy.

The French polls have tightened, with the center-right Fillon and the hard-left Melenchon gaining ground. There is a high number of undecided voters going into the first round of elections later this month and the surge of these two candidates show how divided the French electorate has become. This election still holds the potential to upset Europe. We also note that Greece and the EU have reached an agreement on its bailout program. Now we will see if the Greek legislature will actually pass further unpopular reforms or bring down the government.

After the election, we argued that the fate of the Trump presidency rested on the poles of "Bannon v. Ryan." That is morphing into "Bannon v. Kushner" but the battle is the same. The former represents the new isolationism, an attempt to return to a less globalized world. The latter in both cases represent a world that is globalized and deregulated. This is going to be a long war because even if the personalities are vanquished, the sides of the debate remain. At present, Bannon is losing power; the establishment is steadily marginalizing him. For investors, this is a good outcome because it means that inflation remains under control and margins should continue to be robust. However, the forces of populism remain and even if the right-wing version gets quashed by the right-wing establishment, the left-wing version remains in the background.

In Sunday's *NYT*,[1] Louis Hyman, a professor of economic history at Cornell, published an op-ed arguing that Main Street is mostly dead because it's inefficient and so its return is not a likely outcome. Although he makes some good points, we believe he is being a bit naïve. Since the late 1970s, policymakers have bought into a "cult of efficiency" that Marx obliquely discussed. Marx's assertion was that, at some point, capitalism becomes so efficient and income inequality so profound that there isn't enough consumption to absorb all the productive capacity the efficient capitalists create. Marx thought that scenario would create a crisis for capitalism that would result in its collapse. So far, that hasn't been the case. Nevertheless, that doesn't mean that changes haven't occurred. Both the Roosevelts took steps to retard the efficiency of capitalism through regulation. Hyman noted that we used to have "fair trade" laws that set minimum prices; a retailer could not put a price below a certain level meaning that the chain and the small independent business didn't compete on price.[2]

Some of us represent capital, most labor, but all of us are consumers. The economic model that Hyman says can't return was actually good for capital and labor but bad for consumers. The high inflation of the late 1960s and 1970s was a result of this model. As consumers, we cheer foreign trade because it keeps prices low, but foreign trade is mixed for capital and labor. We are less sure that Hyman is right; a return to a model that is less friendly for consumers is ultimately the goal of populism based on the idea that globalization and deregulation have been worse for labor. Although we could argue the case, that is the perception and thus a return to an earlier model cannot be so easily dismissed.

U.S. Economic Releases

There were no new economic releases prior to this publication. The table below shows the economic releases and Fed speakers scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Labor Market Conditions Index	m/m	mar		1.3	**
Fed speakers or events						
16:00	Janet Yellen Speaks at University of Michigan	Chairman of Board of Governors of Federal Reserve				

[1] https://www.nytimes.com/2017/04/08/opinion/sunday/the-myth-of-main-street.html (paywall)
[2] This is one of the reasons Sears (SHLD, 11.34) developed in-house brands like Kenmore and Craftsman; because these weren't national brands, it allowed Sears the ability to undercut the national branded competition.

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								
Japan	BoP Current Account Balance	m/m	feb	2.8136t	0.0655t	2.5129t	**	Equity bullish, bond bearish
	Trade Balance BoP Basis	m/m	feb	1.0768t	-0.853.4b	0.9817t	**	Equity bullish, bond bearish
	Bankruptcies	y/y	mar	5.4%	-4.8%		**	Equity and bond neutral
	Eco Watchers Survey Current	m/m	mar	47.4	48.6	49.8	**	Equity and bond neutral
	Eco Watchers Survey Outlook	y/y	mar	48.1	50.6	50.7	**	Equity bearish, bond bullish
Australia	Home Loans	y/y	feb	-0.5%	0.5%	0.0%	**	Equity bearish, bond bullish
	Investment Lending	y/y	feb	-5.9%	4.2%		**	Equity and bond neutral
	Own-Occupier Loan Value	y/y	feb	-0.5%	-0.2%		*	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	apr	23.9	20.7	21.0	**	Equity bullish, bond bearish
France	Bank of France Business Sentiment	m/m	mar	103	104	104	**	Equity and bond neutral
Italy	Industrial Production	m/m	feb	1.9%	-0.5%	2.4%	***	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	feb	564.1b	561.7b		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	feb	476.2b	475.1b		**	Equity and bond neutral
Russia	Light Vehicle Car Sales	y/y	mar	9.0%	-4.0%		*	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	mar	253.7k	210.2k	215.5k	**	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)	116	116	0	Up
3-mo T-bill yield (bps)	80	80	0	Neutral
TED spread (bps)	36	35	1	Neutral
U.S. Libor/OIS spread (bps)	95	95	0	Up
10-yr T-note (%)	2.38	2.38	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	26	26	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	up			Down
franc	down			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	$55.76	$55.24	0.94%	Short Covering
WTI	$52.67	$52.24	0.82%	
Natural Gas	$3.27	$3.26	0.18%	
Crack Spread	$19.38	$19.45	-0.39%	
12-mo strip crack	$15.72	$15.75	-0.17%	
Ethanol rack	$1.73	$1.73	0.21%	
Metals				
Gold	$1,250.36	$1,254.53	-0.33%	Stronger Dollar
Silver	$17.90	$18.03	-0.71%	
Copper contract	$261.60	$264.70	-1.17%	
Grains				
Corn contract	$ 359.75	$ 359.50	0.07%	
Wheat contract	$ 423.25	$ 424.00	-0.18%	
Soybeans contract	$ 945.75	$ 942.00	0.40%	
Shipping				
Baltic Dry Freight	1223	1215	8	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the western region. Precipitation is expected for most of the country.

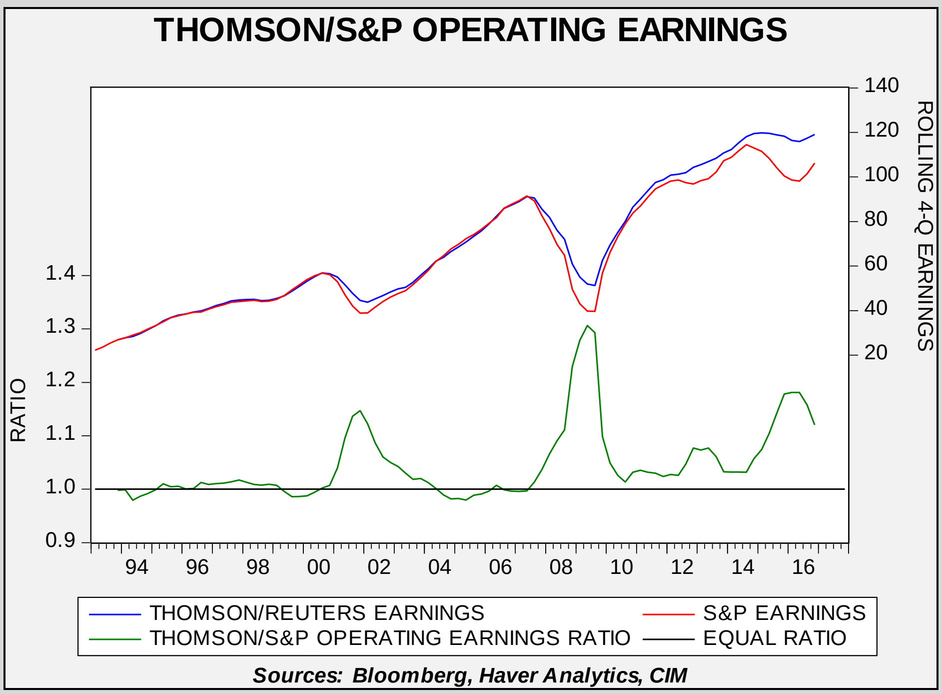
Asset Allocation Weekly Comment

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.

April 7, 2017

In our 2017 Outlook, our earnings forecast for the S&P 500 was $119.45 per share, up from $106.25 in 2016.[3] Based on new data and other trends, we are raising this forecast to $126.44 for this year. There are three reasons for the change.

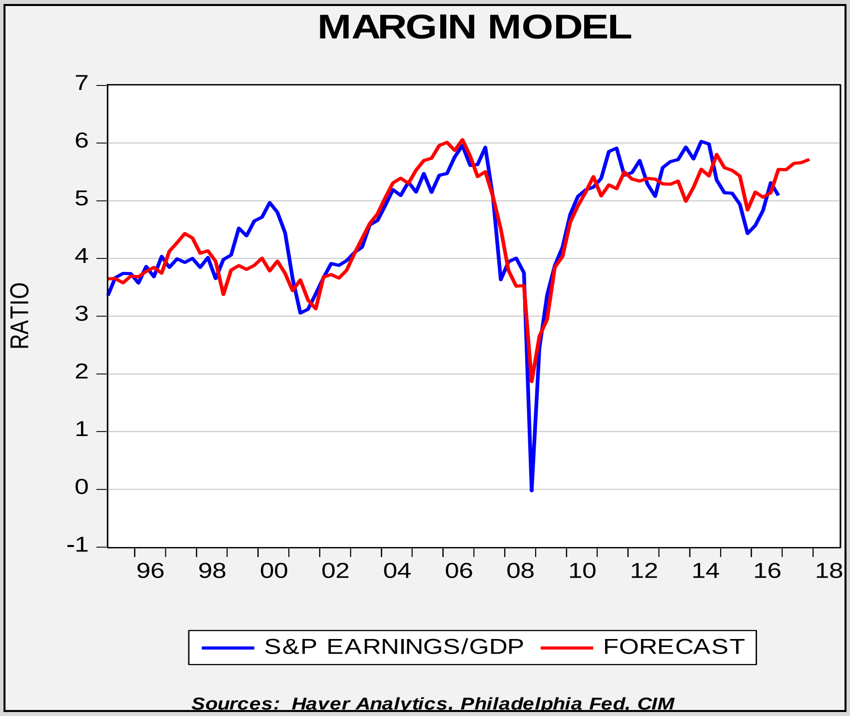
The spread between Thomson-Reuters and S&P operating earnings is narrowing. This is an issue we have discussed in the past. There are two primary sources of information for earnings, Standard and Poor's and Thomson-Reuters. Most of the time, the two sources are consistent. However, since the Great Financial Crisis, the latter has tended to report higher operating earnings for the S&P 500 than the former. Explanations for this divergence vary. It does appear that Thompson-Reuters takes a more "relaxed" view on what costs are excluded compared to Standard and Poor's. Here is the data through Q4 2016:



In 2001 and 2008, the spread between the two series coincided with recessions. Since the Great Recession, we have had two periods where the spread has widened; both are tied to declines in oil prices. As oil prices recover, the current spread should narrow.

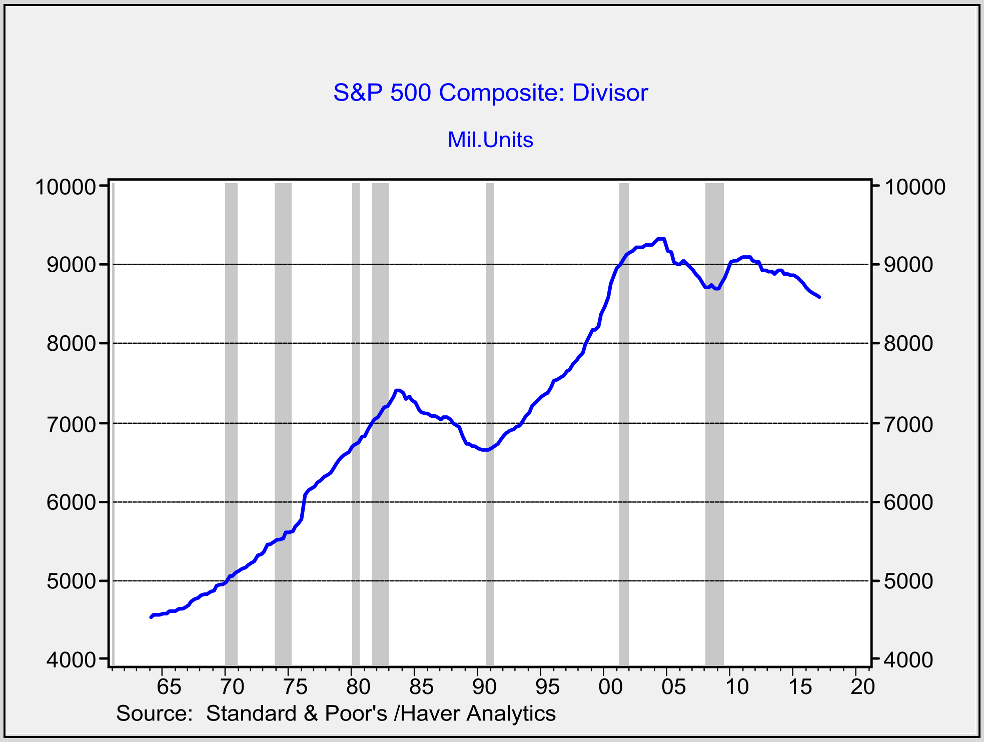
[3] This is basis S&P operating earnings. The other major provider, Thomson-Reuters, has the higher numbers that are usually reported in the media.

Margins are showing some improvement. We compare total S&P 500 earnings to GDP. Our model for this percentage is indicating that margins will improve this year.



The blue line on the chart shows the actual percentage of S&P 500 total operating earnings to nominal GDP. For most of this century, this percentage has been ranging between 5% and 6%. The drop in oil prices led to some margin compression. We also expect improving productivity and a modest widening of the trade deficit to boost margins, shown above as the red line, which is the model forecast.

Finally, the per-share data will be supported by a steadily declining divisor. The below chart shows the S&P 500 divisor; it's a scaling factor for the index.

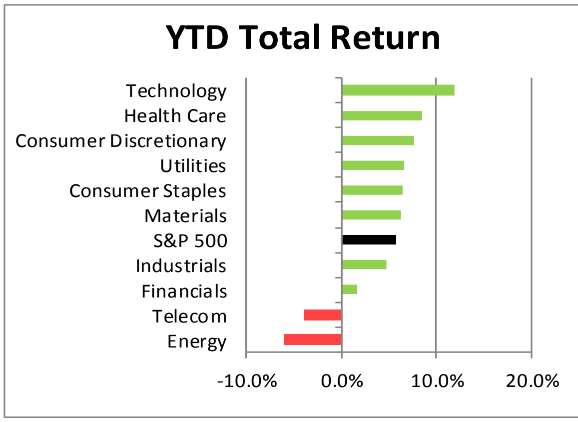


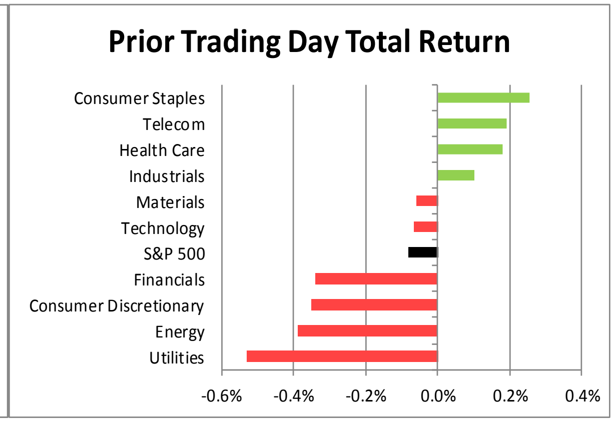
To calculate the index, one takes the overall market capitalization and divides it by the divisor. The divisor adjusts to changes in the composition of the index, as well as new issuance, share repurchases and mergers. The rise in share buybacks has led to a steady drop in the divisor; we are now at levels last seen in early 2000. As the divisor declines, the per-share value rises.

Despite this increase in earnings, we have not boosted our S&P 500 target forecast of 2400 for the year. We view the P/E as elevated at this point and so we expect the rise in earnings to mostly result in a weaker multiple. At the same time, this change will make equity markets less expensive and thus less vulnerable to disappointment. If the rise in business and consumer sentiment supports the multiple, we will make appropriate adjustments to our forecast.

Data Section

U.S. Equity Markets – (as of 4/7/2017 close)

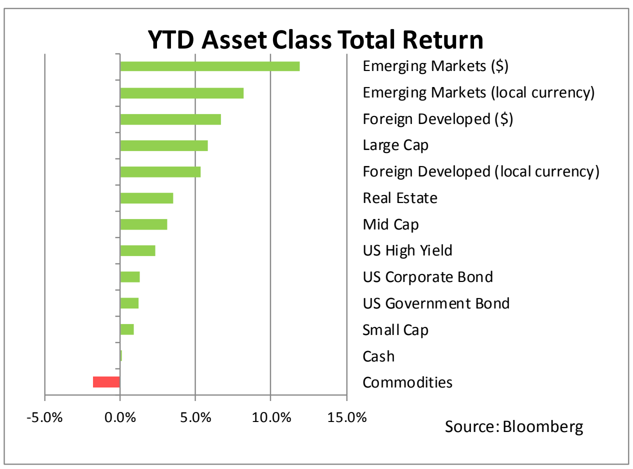




(Source: Bloomberg)

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. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 4/7/2017 close)

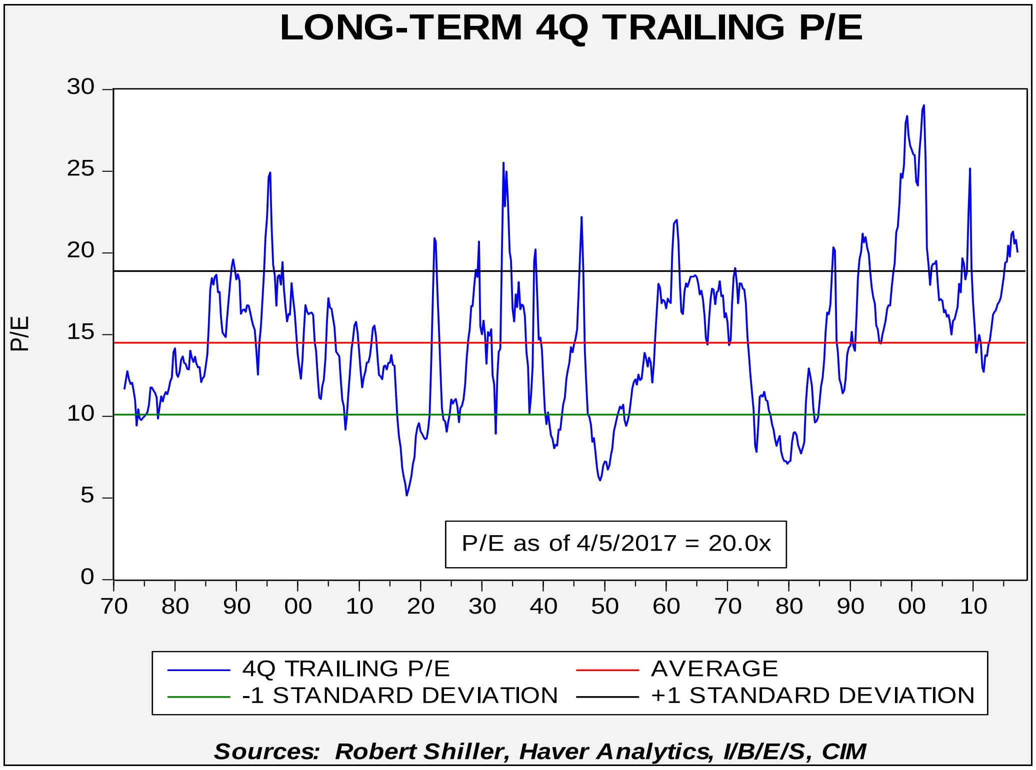


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Bloomberg total return Commodity Index).

P/E Update

April 6, 2017



Based on our methodology,[4] the current P/E is 20.0x, down 0.8x from last week. We are now into Q2 which means we added expectations for the current quarter to our calculation. Those earnings estimates led to the decline in the multiple.

[4] 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 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 quarters (Q3 and Q4) and two estimates (Q1 and Q2). 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.