Daily Comment

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and Thomas Wash

[Posted: April 17, 2017—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is closed for Easter. In Asia, the MSCI Asia Apex 50 closed down 0.3% from the prior close. Chinese markets were down, with the Shanghai composite down 0.7% and the Shenzhen index down 1.4%. U.S. equity index futures are signaling a lower open. With 29 companies having reported, the S&P 500 Q1 earnings stand at $29.65, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 75.9% of the companies reported earnings above forecast, while 13.8% reported earnings below forecast.

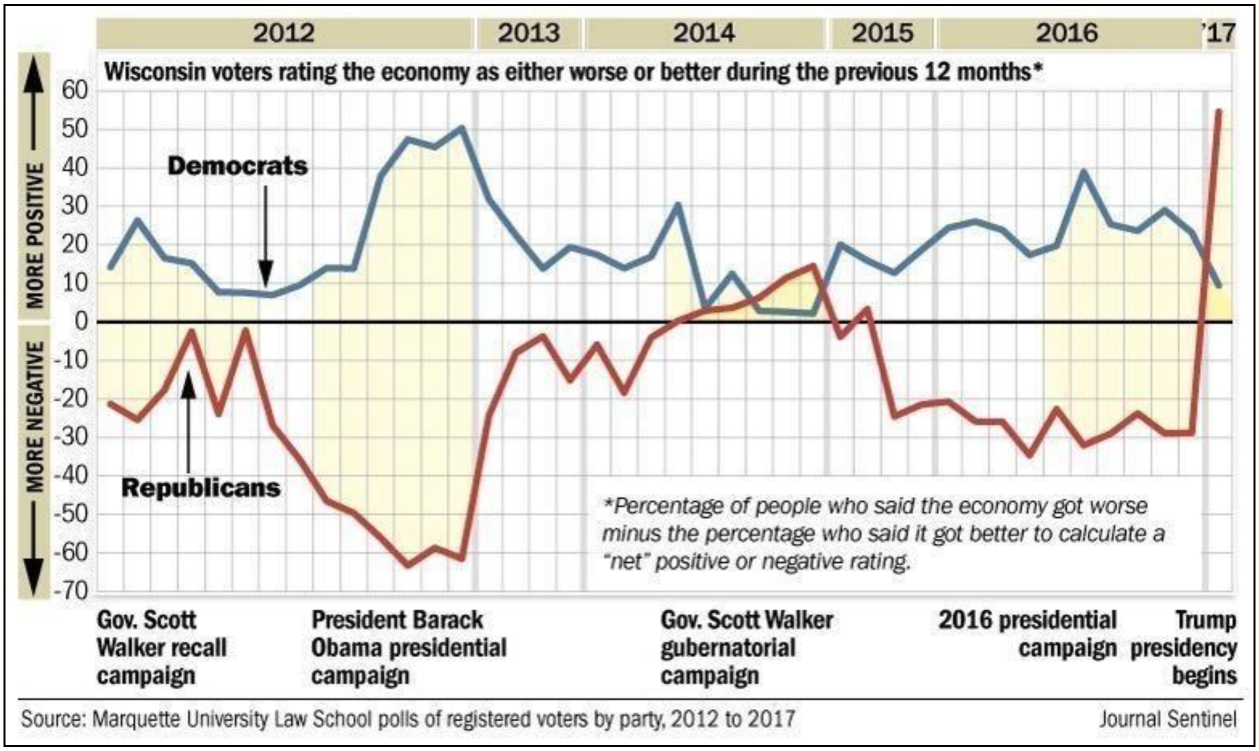
Erdogan narrowly wins: In Turkey, it appears that voters have approved major changes to the political system by a 51% to 49% margin. There were reports of widespread voter irregularity and the opposition has announced it will formally protest the vote. The new laws will dramatically boost the power of the presidency, changing it from a mostly ceremonial, non-partisan post to an executive presidency with wide powers. The parliament will see its powers reduced, requiring supermajorities to open investigations on any of the president's deputies or ministers. The president will effectively be able to govern by decree and can dissolve the parliament at will. He will also be able to appoint deputies, ministers and some judges without legislative oversight.

The new powers won't go into effect until the next president is elected; elections are not scheduled until November 2019. Although a spokesman for Erdogan said that he isn't planning snap elections to take advantage of these new powers, it seems unlikely that he will wait that long. The president can serve two consecutive five-year terms but can sit for a third if elections are called before the second term ends.

We will be watching for two signals. First, will the opposition's voter fraud charges have any impact, and second, assuming the first matter fails, will the opposition accept the results without political and social unrest? On the first point, we doubt the charges will stick. There were numerous media reports suggesting uncertified ballots were counted. This could be a form of ballot box stuffing, but we doubt Erdogan will take these charges seriously. On the second point, given how close the vote was, we would expect some degree of tensions. We doubt these issues will have too much effect on financial markets. European powers have indicated some unease over the results, but the threat of a refugee flood will likely quell these concerns.

North Korea: It was the 105th birthday of the founder of the DPRK, Kim Il-sung. Such occasions usually bring some sort of tests to show North Korea's prowess. Although it does appear the country is preparing a nuclear test, it opted for a missile launch which apparently exploded on takeoff. While incompetence should never be discounted, there was some speculation in the analyst community that U.S. cyber efforts may have played a role. VP Pence is in South Korea and reiterated the line about the "end of strategic patience." We also note Bloomberg[1] is reporting that President Trump is considering a "sudden strike" on North Korea, although the preferred policy is for China to undermine the Kim Jong-un regime. With steady escalation, Robert Litwak of the Woodrow Wilson International Center for Scholars describes the situation as "the Cuban missile crisis in slow motion."[2] Although the financial markets have not done much with the North Korean situation (the JPY would likely be weaker if a war was imminent because Japan would almost certainly be a target), the odds of escalation are probably higher than before. North Korea is getting closer to a deliverable nuclear weapon and no amount of sanctions appear able to deter that steady progress. At some point, the U.S. will either need to attack North Korea to slow or stop its progress, negotiate a slowdown or live with a nuclear Kim regime. The second option is preferred but also the least likely.

We have recently noted the growing political polarization of the country. This chart shows that it even affects views on the economy.



(Source: http://www.jsonline.com/story/news/blogs/wisconsin-voter/2017/04/15/donald-trumps-election-flips-both-parties-views-economy/100502848/)

This chart measures perceptions of the economy by voters in Wisconsin based on political party. Note that during the 2012 elections, Republicans were far more despondent about the economy

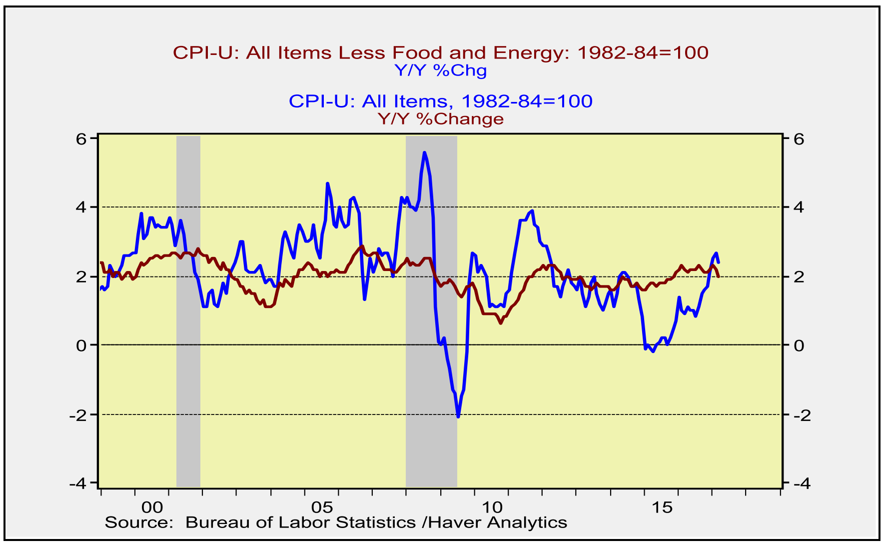
[1] https://www.bloomberg.com/news/articles/2017-04-16/mcmaster-rules-nothing-out-as-trump-team-mulls-north-korea-moves

[2] https://www.nytimes.com/2017/04/16/us/politics/north-korea-missile-crisis-slow-motion.html?rref=collection%2Ftimestopic%2FCuban%20Missile%20Crisis%20(1962)&action=click&contentCollection=timestopics&region=stream&module=stream_unit&version=latest&contentPlacement=1&pgtype=collection

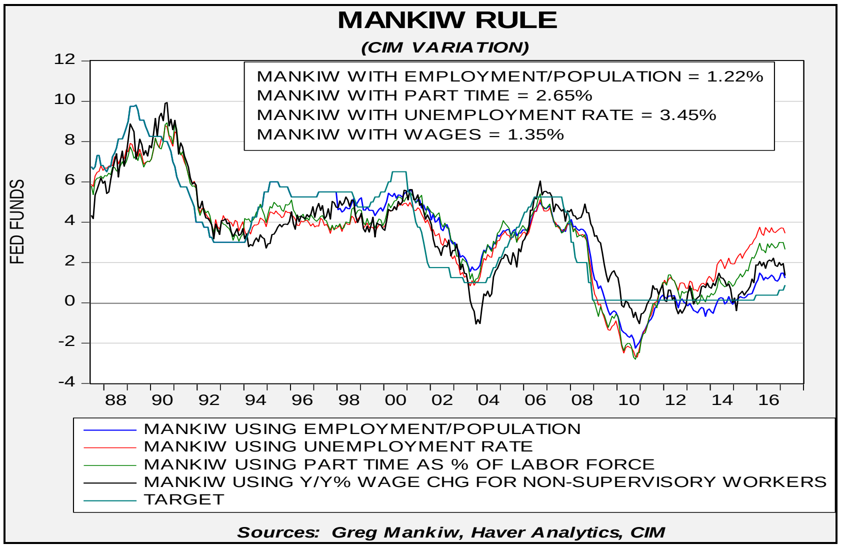
than Democrats. The recent flip is notable and has probably affected some of the well documented improvement in the survey data. What is also interesting about the data is that Democrats seldom become overly bearish on the economy, whereas GOP voters seem to have rather violent mood shifts in their outlook. We do want to note that this is only one state but it does reflect national data, although the shifts are less pronounced. If GOP voter hopes become dashed due to the lack of progress on taxes and other fiscal measures, we could see a reversal in the survey data.

President Trump has indicated that he is likely to select Randy Quarles to the FOMC for the top regulator post. The Dodd-Frank bill created a role on the FOMC for a governor dedicated to regulation. This post was never officially filled, but the recently retired David Tarullo had informally filled the position. Quarles is considered a moderate and was a Treasury undersecretary in the Bush administration.

On Good Friday, the BLS released the consumer price index for March. The data came in surprisingly soft. On a yearly basis, the core rate fell 20 bps to 2.0% while the overall rate dipped 30 bps to 2.4%.



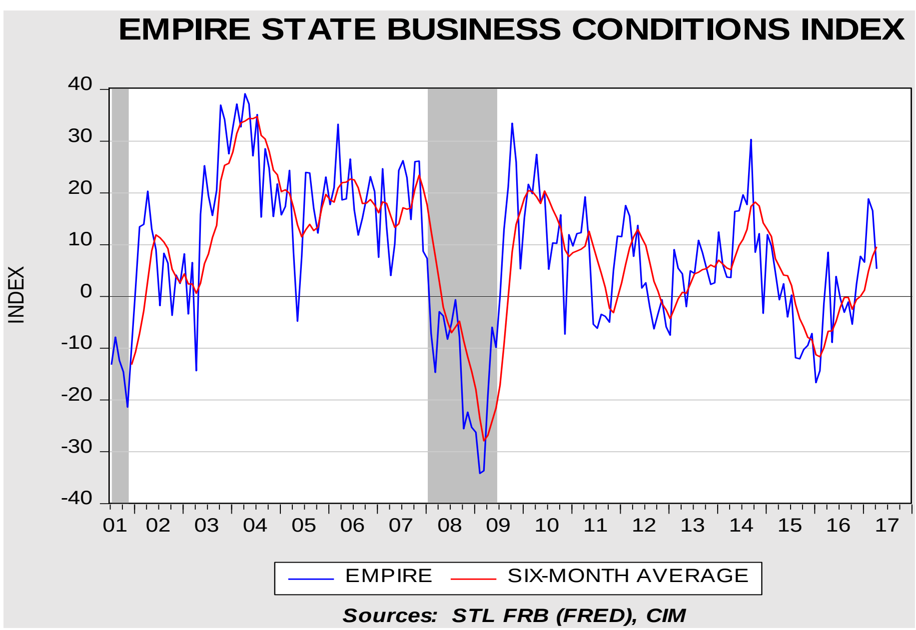
Lower inflation did affect the Mankiw Rule model results. The Mankiw Rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate by core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.



Using the unemployment rate, the neutral rate is now 3.45%. Using the employment/population ratio, the neutral rate is 1.22%. Using involuntary part-time employment, the neutral rate is 2.65%. Using wage growth for non-supervisory workers, the neutral rate is 1.35%. Outside of the unemployment rate, the labor market data was soft. Coupled with weaker than expected inflation data, two of the variations have us approaching policy neutrality. Weak wage growth and a stagnant employment/population ratio would suggest the FOMC is roughly one hike away from achieving a balanced policy. This may be what the dollar and Treasury markets are concluding.

U.S. Economic Releases

Empire manufacturing came in below expectations at 5.2 compared to the forecast of 15.0.



The chart above shows the six-month moving average of the Empire State Business Conditions Index. This moving average indicates that the manufacturing sector has begun to pick up steam.

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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
10:00	NAHB Housing Market Index	m/m	apr	70.0	71.0	**
16:00	Total Net TIC Flows	m/m	feb		$110.4 bn	**
16:00	Net Long-Term TIC Flows	m/m	feb		$6.3 bn	**
Fed speakers or events						
No speakers or events scheduled						

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								
China	M2	y/y	mar	10.6%	11.1%	11.1%	**	Equity and bond neutral
	M1	y/y	mar	18.8%	21.4%	19.3%	**	Equity and bond neutral
	M0	y/y	mar	6.1%	3.3%	3.0%	**	Equity and bond neutral
	New Yuan Loans	m/m	mar	1020 bn	1170 bn	1200 bn	**	Equity and bond neutral
	Aggregate Financing	y/y	mar	2120 bn	1150 bn	1500 bn	**	Equity and bond neutral
	Retail Sales	y/y	mar	10.9%	10.9%	9.7%	**	Equity and bond neutral
	Fixed Assets	y/y	mar	9.2%	9.5%	8.8%	**	Equity bullish, bond bearish
	Industrial Production	y/y	mar	7.6%	6.0%	6.3%	***	Equity bullish, bond bearish
	GDP	y/y	mar	6.9%	6.8%	6.8%	***	Equity bullish, bond bearish
Japan	Industrial Production	y/y	feb	4.7%	4.8%		***	Equity and bond neutral
	Capacity Utilization	y/y	feb	3.2%	0.1%		**	Equity and bond neutral
India	Wholesale Price	y/y	mar	5.7%	6.6%	6.0%	**	Equity and bond neutral
EUROPE								
Italy	General Government Debt	y/y	feb	2.2401t	2.2504t		**	Equity and bond neutral
Russia	Money Supply Narrow Def	y/y	apr	8.80 tn	8.70 tn		**	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	y/y	feb	-0.7%	-0.8%	-2.4%	**	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)	79	79	0	Neutral
TED spread (bps)	37	37	0	Neutral
U.S. Libor/OIS spread (bps)	94	95	-1	Up
10-yr T-note (%)	2.21	2.24	-0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	31	31	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Down
pound	up			Down
franc	up			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	$55.41	$55.89	-0.86%	Long Liquidation
WTI	$52.71	$53.18	-0.88%	
Natural Gas	$3.20	$3.23	-0.84%	
Crack Spread	$18.37	$18.74	-1.95%	
12-mo strip crack	$15.34	$15.70	-2.33%	
Ethanol rack	$1.77	$1.78	-0.03%	
Metals				
Gold	$1,289.08	$1,285.69	0.26%	Weaker Dollar
Silver	$18.58	$18.54	0.17%	
Copper contract	$258.90	$257.05	0.72%	
Grains				
Corn contract	$ 376.50	$ 378.00	-0.40%	
Wheat contract	$ 442.50	$ 442.75	-0.06%	
Soybeans contract	$ 967.00	$ 966.25	0.08%	
Shipping				
Baltic Dry Freight	1296	1282	14	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.2	-1.8	-0.4	
Gasoline (mb)	-3.0	-1.5	-1.5	
Distillates (mb)	-2.2	-1.0	-1.2	
Refinery run rates (%)	0.20%	0.50%	-0.30%	
Natural gas (bcf)	10.0	9.0	1.0	

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 eastern region. Precipitation is expected for most of the country.

<u>Asset Allocation Weekly Comment</u>

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 13, 2017

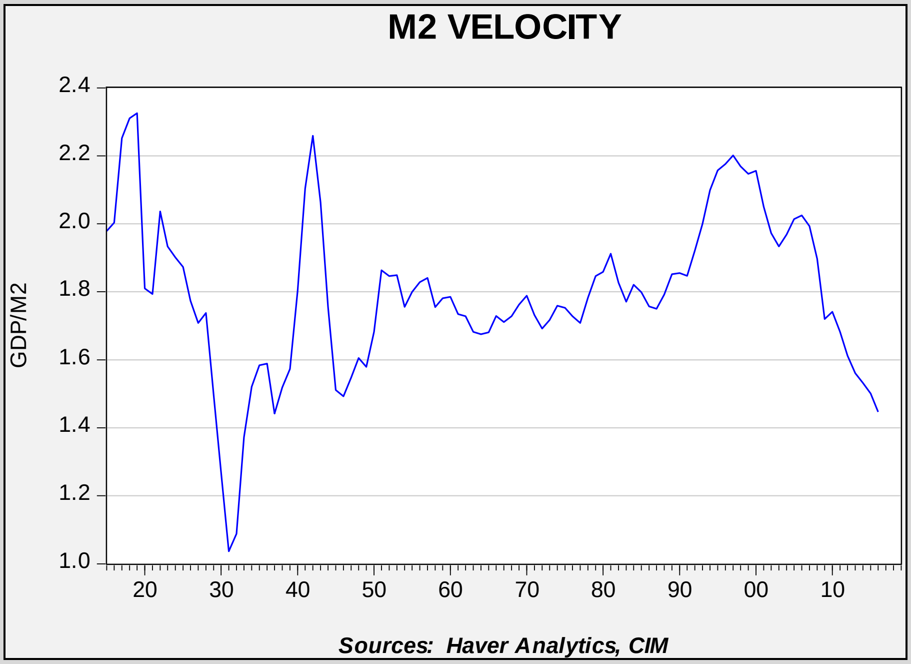
The most recent Federal Reserve minutes indicated that the U.S. central bank is preparing to reverse its experiment with quantitative easing (QE) by reducing the size of its balance sheet. Although the eventual desire to reduce the size of the balance sheet is no real surprise, the timing was unclear. It now appears that the FOMC will begin reducing the balance sheet by year's end. Over the next three weeks, we will look at the potential ramifications of reducing the Federal Reserve's balance sheet. This week we will examine the impact of QE on the economy. Next week, we will focus on the financial markets.

QE was a controversial policy; as policymakers explained it, there seemed to be two elements to the decision to expand the central bank's balance sheet. First, it wanted to boost the level of reserves and lower short-term interest rates to spur bank lending. Second, it wanted to lift the price level of financial assets to increase economic activity through the wealth effect. There were always a number of risks imbedded in the policy. First, if banks aggressively lent the money, the money supply would rise and lead to inflation. Second, the opposite effect could also occur; banks could simply sit on the excess reserves and hamper the stimulative effect of lending. Third, the wealth effect could exacerbate wealth inequality. Upper income households tend to hold more of their wealth in financial assets whereas lower income households usually hold the bulk of their assets in real estate and cash. By lowering bond yields and lifting price/earnings multiples, higher income families benefit. If home prices don't rise, or if lenders prevent cash-out refinancing, the policy's wealth impact would widen wealth gaps. Fourth, the support for financial asset markets could lead to valuation extremes and create fragile market conditions.

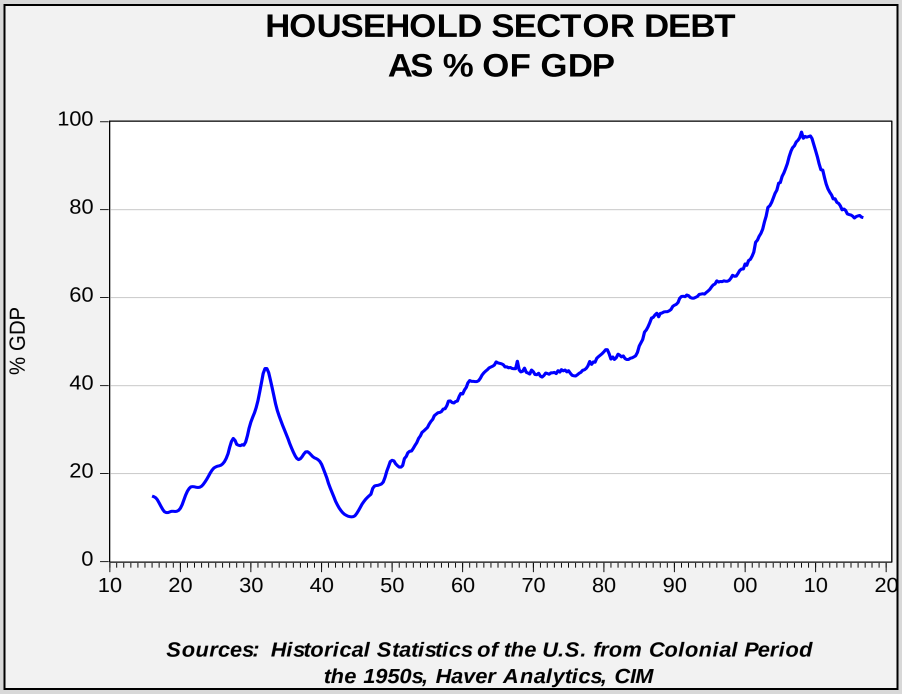
In practice, the effect from QE was rather mixed. We suspect that a whole generation of economists will write dissertations on the impact of QE. However, at this particular moment, we don't have the benefit of this analysis. Instead, we will have to focus on what effect the balance sheet reduction will have on the economy and financial markets. Over the past three decades, bear markets in equities are closely tied to economic recessions; in fact, the last major market decline absent of a recession was the 1987 crash. History also tells us that modern recessions occur for two reasons, a monetary policy mistake (policy is too tight) or a geopolitical event. Reducing the Fed's balance sheet, given the degree of uncertainty surrounding the impact of QE, raises the odds of a policy error.

The impact of QE on the economy: QE appears to have done little for the economy. Economic growth has been stagnant and it isn't obvious that low rates alone would not have yielded a similar outcome.

The fear among some analysts when QE was implemented was that it would spur inflation. This was based on Fisher's monetary identity, which is that money supply times velocity is equal to the price level times available supply, or MV=PQ. If Q, which represents the productive capacity of the economy, is fixed, and V is thought to be dependent upon the institutional arrangements for the circulation of money, and thus mostly fixed as well, raising M will only lead to higher P. If there is slack in the economy, Q could rise with steady prices, leading to higher real output. However, at full employment, inflation is the only result. In fact, what happened is that the reserves sat harmlessly on bank balance sheets, while the real economy grew slowly and velocity plunged. The chart below shows annual velocity of money (GDP/M2, or using the identity, V=PQ/M). Note that during the Great Depression, velocity plunged then as well. Economists during this period soured on monetary policy and mostly focused on fiscal policy. That shift of fiscal policy didn't occur during the 2008 Financial Crisis.



It is unclear why expanding the money supply failed to boost lending. However, deleveraging was common to both periods of low velocity.

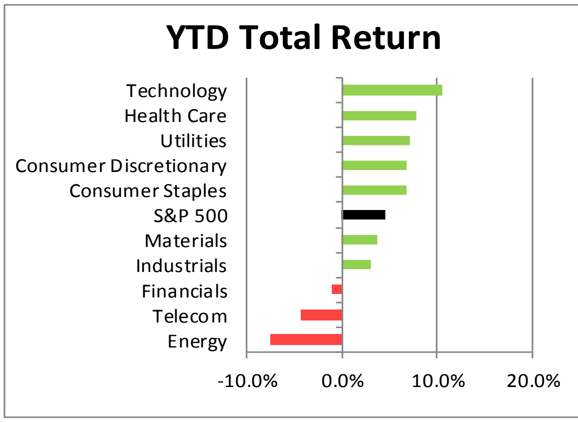


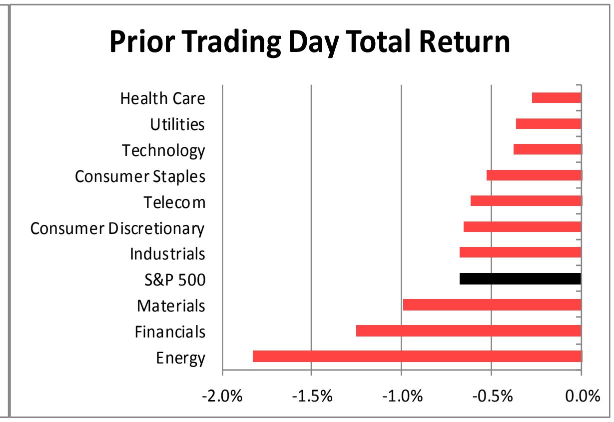
This chart shows household debt as a percentage of GDP. The plunge in the early 1930s coincides with a steady decline in household debt; the same is true now.[3] If there is a drop in demand for loans, injecting reserves into the banking system won't have much impact on the real economy. Conversely, shrinking the balance sheet should do nothing more than reduce the level of excess reserves on commercial bank balance sheets.

[3] It is interesting to note that velocity did rise in the early 1930s during the Great Depression. This was due to a horrific policy error where the Federal Reserve tightened policy into the teeth of the downturn, triggering a deeper drop in growth.

Data Section

U.S. Equity Markets – (as of 4/13/2017 close)

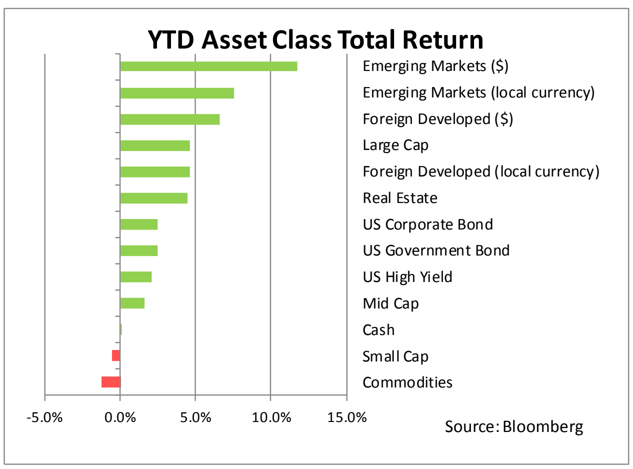




(Source: Bloomberg)

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 4/13/2017 close)

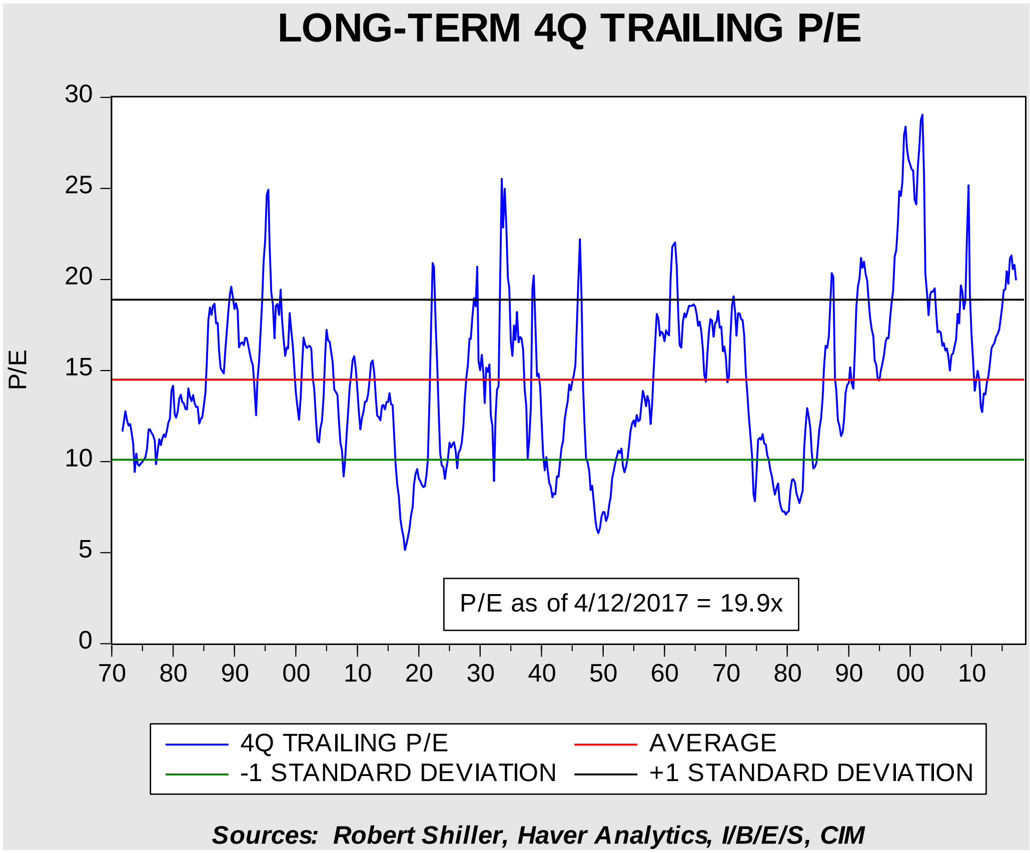


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 2017



Based on our methodology,[4] the current P/E is 19.9x, down 0.1x from last week. Falling equity prices led to the modest decline in the multiple.

This report was prepared by 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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[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.