By Bill O'Grady, Kaisa Stucke, and Thomas Wash

**[Posted: April 26, 2017—9:30 AM EDT]** Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were up, with the Shanghai composite up 0.2% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a lower open. With 152 companies having reported, the S&P 500 Q1 earnings stand at $29.96, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 75.7% of the companies reported earnings above forecast, while 17.8% reported earnings below forecast.

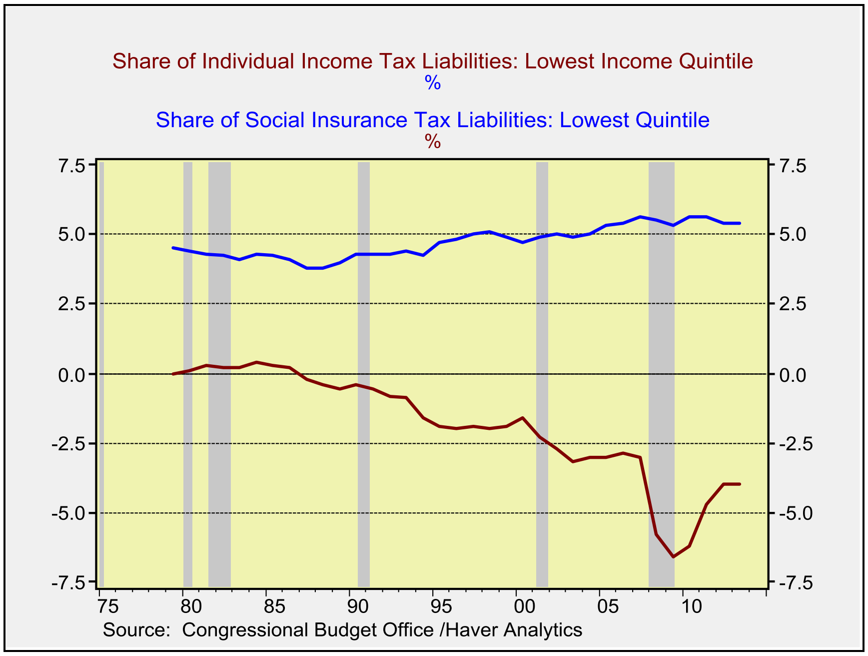
At 1:30 EDT, the White House is scheduled to release its tax proposal. There is quite a bit of speculation about what we will get from this announcement. Current "leaks" suggest a 15% tax rate for corporate taxes, including owner-operated firms, and a reduced rate for repatriation. There is also talk about changing the code for individual taxes too, including a larger tax credit for child care and a higher standard deduction. However, beyond the announcement effects, probably little comes from this. Democrats won't support it and it isn't even likely that it would get enough GOP votes in the House due to the proposal's lack of revenue offsets. There will be talk of dynamic scoring to raise revenue but that will be a stretch. Even using the tactic of reconciliation, which would eliminate the filibuster, is probably not possible because of the lack of revenue offsets.

There is great speculation that this is simply the opening salvo in a bargaining position. We tend to agree with this stance. So, if this is the opening position, what would need to happen in order to get a deal done? First, it appears that a revenue raiser would be necessary. The border adjustment tax (BAT) appears dead but it wouldn't shock me to see it resurrected. The BAT is controversial. Retailers hate it; exporters cheer it. But it would raise revenue. However, it would also likely send the dollar higher. The BAT won't gain any support from the Democrats. Although it's a long shot, James Baker's proposal of a carbon tax[1] coupled with a major cut in tax rates might gain support from the Democrats, but it would not be popular with non-establishment Republicans. Of course, one could get the necessary offsets by cutting spending. However, Congress is so divided that the only way to cut spending would be to use a sequester mechanism of across-the-board cuts. Given the White House's goal of boosting defense and leaving entitlements untouched, cuts will be difficult.

The takeaways from this opening proposal are the following:

[1] https://www.nytimes.com/2017/02/07/science/a-conservative-climate-solution-republican-group-calls-for-carbon-tax.html

1. The White House isn't concerned about expanding the deficit. Congress is concerned but the popularity of tax cuts may change the mood of the legislature into finding ways to live with the loss of revenue;
2. It's hard to see what the White House can do to get Democrats on board, although adjusting Social Security taxes might be an area of discussion.




This chart shows the share of tax liabilities paid by the lowest 20% of households. Due to the earned income tax credit and other exemptions, the bottom 20% receive money from the income tax system, so tax cuts to this group are not meaningful. On the other hand, this quintile pays 5.4% of the Social Insurance tax. So, raising the cap on Social Security earnings might be an offset.

Any talk of cutting corporate taxes is bullish for equities and the dollar and bearish for Treasuries. However, talk without a reasonable path to policy changes won't have much of a lasting effect. In other words, at some point a deal must be struck and market disappointment will rise without it. For now, we will be watching this afternoon's announcement with everyone else to see what is proposed.

**U.S. Economic Releases**

MBA mortgage applications rose 2.7% from the prior week. Purchases fell 1.0%, while refinancing rose 7.2% from the prior week. The average 30-year fixed rate fell by 2 bps from 4.22% to 4.20%.

There are no economic releases or Fed events scheduled for the rest of the day.

## 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** | All Industry Activity Index | m/m | feb | 0.7% | 0.1% | 0.6% | ** | Equity and bond neutral |
| | Small Business Confidence | m/m | apr | 48.6 | 50.5 | 49.4 | ** | Equity and bond neutral |
| | Machine Tool Orders | m/m | mar | 22.8% | 22.6% | | ** | Equity and bond neutral |
| **Australia** | ANZ Roy Morgan Weekly Consumption | m/m | apr | 111.2 | 112.6 | | ** | Equity and bond neutral |
| | Skilled Vacancies | m/m | mar | -0.6% | 0.1% | | ** | Equity and bond neutral |
| | CPI | y/y | mar | 2.1% | 1.5% | 2.6% | *** | Equity and bond neutral |
| **New Zealand** | Net Migrations | y/y | mar | 6100 | 6000 | | ** | Equity and bond neutral |
| | Credit Card Spending | y/y | mar | 7.1% | 5.3% | | ** | Equity and bond neutral |
| **EUROPE** | | | | | | | | |
| **France** | Consumer Confidence | y/y | apr | 100 | 100 | 100 | ** | Equity and bond neutral |
| **Switzerland** | UBS Consumption Indicator | m/m | mar | 1.5 | 1.5 | | ** | Equity and bond neutral |
| | Credit Suisse Survey Expectations | m/m | apr | 22.2 | 29.6 | | ** | Equity and bond neutral |
| **AMERICAS** | | | | | | | | |
| **Canada** | Retail Sales | m/m | jan | -0.6% | 2.2% | 0.0% | ** | Equity and bond neutral |
| | Retail Sales ex Auto | y/y | feb | -0.1% | 1.7% | -0.3% | ** | Equity and bond neutral |
| **Brazil** | FGV Consumer Confidence | y/y | apr | 82.2 | 85.3 | | ** | Equity and bond neutral |
| | Current Account Balance | y/y | mar | 1.397 bn | -0.935 | 0.450 bn | ** | Equity bullish, bond bearish |
| | Foreign Direct Investment | y/y | jun | 7.109 bn | 5.306 bn | 7.000 bn | ** | Equity bullish, bond bearish |

## 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)** | 117 | 116 | 1 | Up |
| **3-mo T-bill yield (bps)** | 81 | 80 | 1 | Neutral |
| **TED spread (bps)** | 36 | 35 | 1 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 99 | 98 | 1 | Up |
| **10-yr T-note (%)** | 2.32 | 2.33 | -0.01 | 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 | down | | | 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 | $51.80 | $52.10 | -0.58% | Long liquidation |
| WTI | $49.27 | $49.56 | -0.59% | |
| Natural Gas | $3.09 | $3.04 | 1.41% | |
| Crack Spread | $17.25 | $17.67 | -2.37% | |
| 12-mo strip crack | $14.65 | $14.86 | -1.43% | |
| Ethanol rack | $1.75 | $1.75 | -0.04% | |
| **Metals** | | | | |
| Gold | $1,265.50 | $1,264.13 | 0.11% | |
| Silver | $17.60 | $17.61 | -0.02% | |
| Copper contract | $259.05 | $259.10 | -0.02% | |
| **Grains** | | | | |
| Corn contract | $ 372.75 | $ 371.75 | 0.27% | |
| Wheat contract | $ 428.50 | $ 427.00 | 0.35% | |
| Soybeans contract | $ 963.75 | $ 965.00 | -0.13% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1154 | 1170 | -16 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -1.9 | | |
| Gasoline (mb) | | 0.8 | | |
| Distillates (mb) | | -1.3 | | |
| Refinery run rates (%) | | -0.45% | | |
| Natural gas (bcf) | | 74.0 | | |

## Weather

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

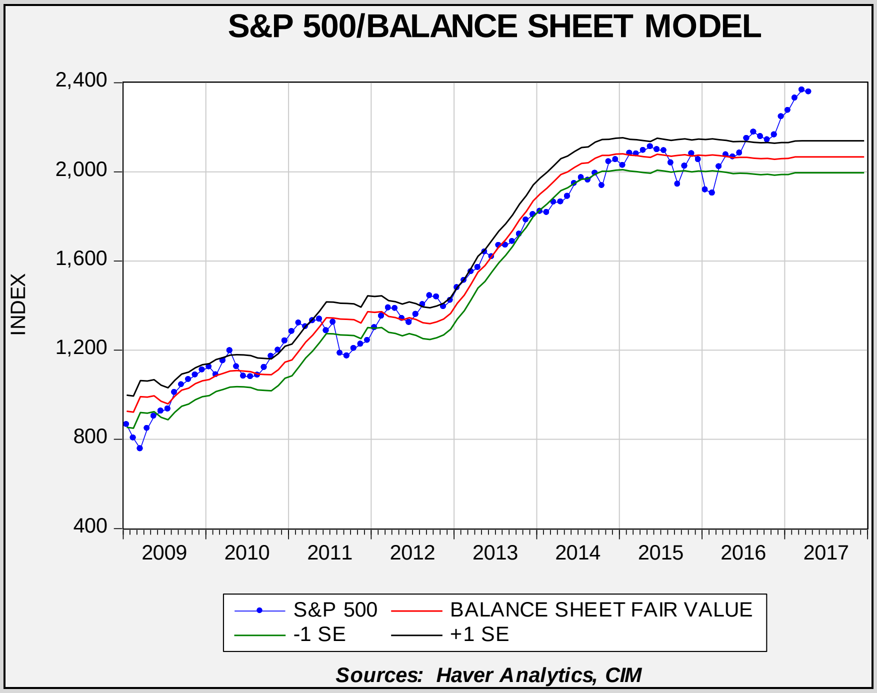
## Asset Allocation Weekly Comment

*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.*

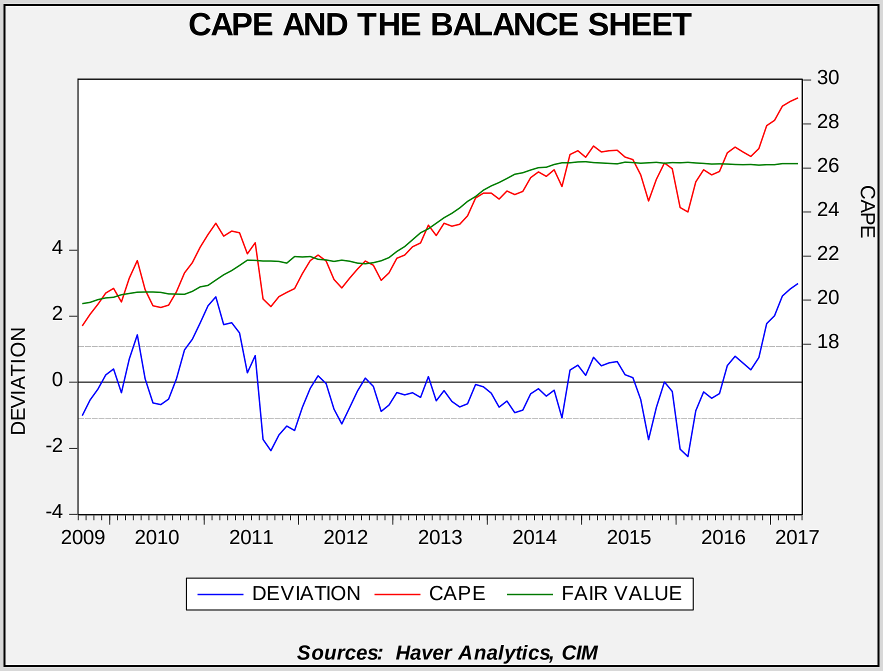
April 21, 2017

Last week, we discussed the impact of reducing the size of the Federal Reserve's balance sheet on the economy. This week we will discuss the effects of QE on financial markets.

The relationship between the balance sheet and equities seems rather straightforward; expanding the balance sheet appears to be clearly supportive for equities.



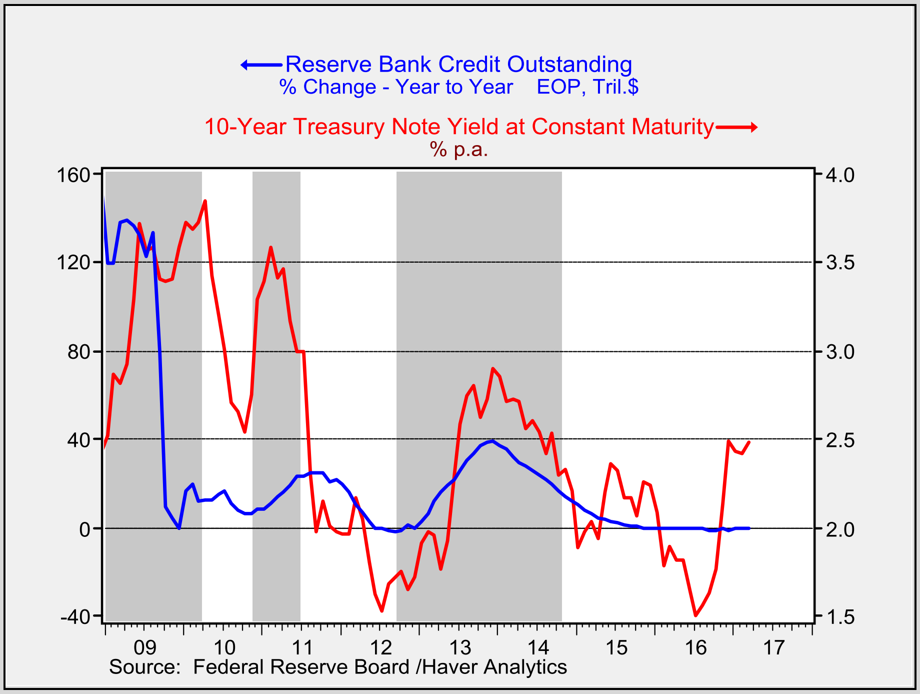

This chart shows the S&P 500 Index regressed against the Fed's balance sheet. From 2009 until last year, this equity index closely tracked the level of the balance sheet. Equities have lifted above the forecast level of the balance sheet recently. If the relationship holds, equities are vulnerable to a large decline. On the other hand, there is no evidence to suggest that bank reserves somehow found their way into the equity market. Comparing the Shiller P/E (CAPE) suggests that the effect of QE was probably psychological; after fed funds reached the zero bound, QE signaled to investors that policy was still easy.




This chart regresses the CAPE against the Fed's balance sheet; the CAPE's behavior is similar to that of the overall equity market. After the election, the market has mostly risen on multiple expansion, rising well above the model's fair value.

It should be noted that low interest rates could have a similar effect. However, the fact that equities and the P/E seemed to track the balance sheet does suggest that QE had an impact on market psychology.

The impact on bonds is rather interesting.



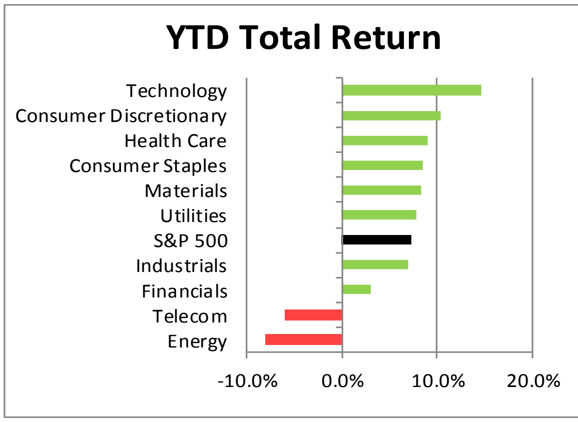

The gray bars show periods when QE was implemented. Especially after QE 1, periods of QE tended to coincide with rising rates. When QE was ending (shown by the decline in the yearly growth rate of the balance sheet), rates tended to decline. Despite the FOMC bond buying, rates rose mostly on fears of inflation. Once QE ended, those fears eased and bond yields declined. The most recent rise is likely due to expectations of fiscal stimulus that will boost growth and potentially raise inflation.

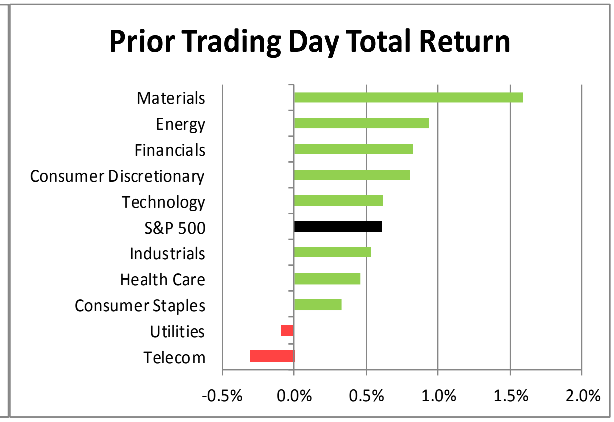
If the Fed's expanding balance sheet was a supportive psychological factor for bonds and stocks, will the contraction have the opposite impact? Simply put, we don't know. If the economy and earnings are improving, the drop in the balance sheet probably won't matter. Unfortunately, if the economy disappoints, cutting the balance sheet could have a bearish impact on these assets.

Next week we will examine the impact of the Fed's balance sheet on monetary policy.

## Data Section

**U.S. Equity Markets** – (as of 4/25/2017 close)

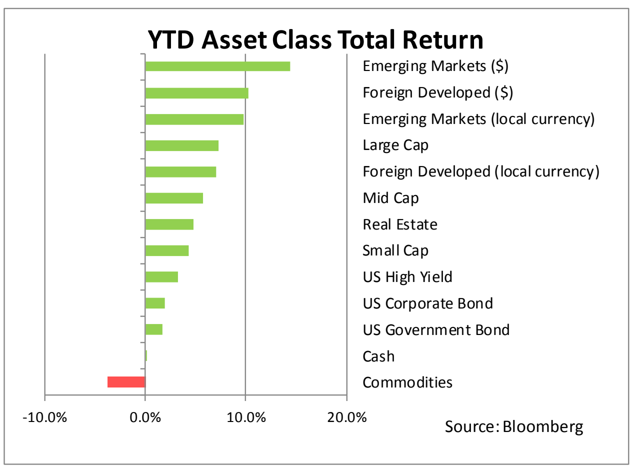



(Source: Bloomberg)

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 4/25/2017 close)

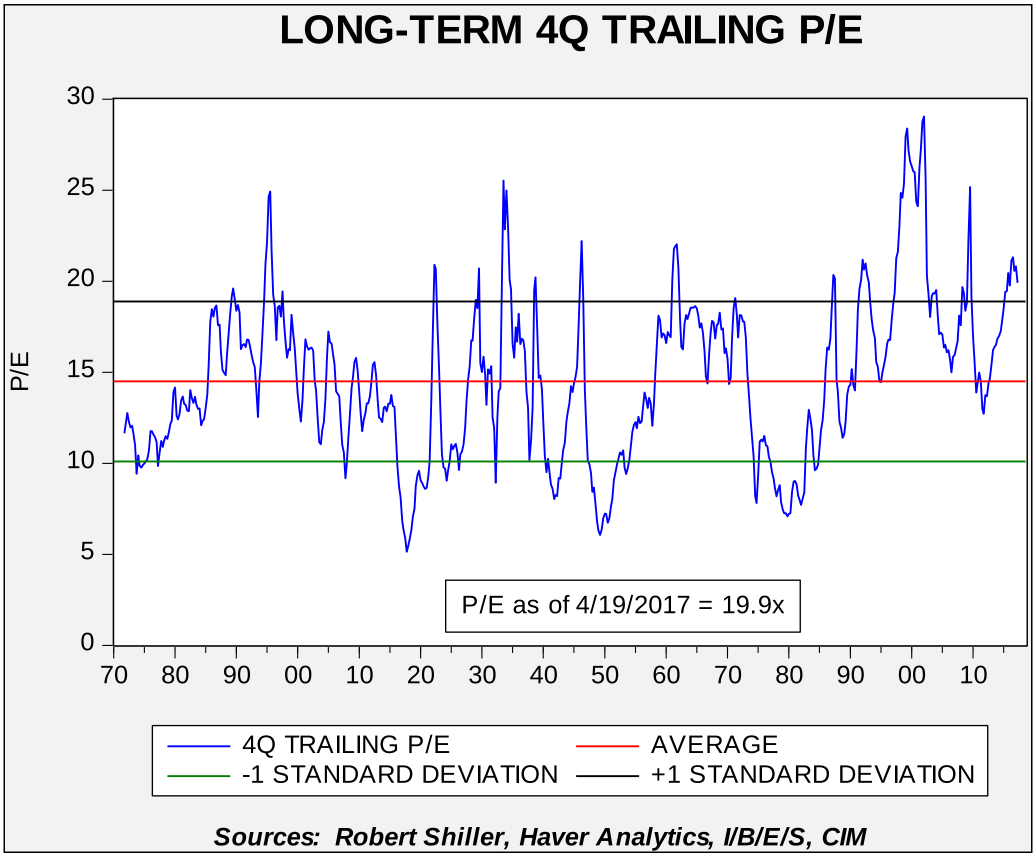



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2017




Based on our methodology,[2] the current P/E is 19.9x, unchanged from last week.

*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.*

[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 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.