Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: December 13, 2016—9:30 AM EST] Global equity markets are up this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.3% higher from the prior close. Chinese markets were up, with the Shanghai composite up 0.1% and the Shenzhen index up 0.3%. U.S. equity futures are signaling a higher open.

The FOMC begins its meeting today. Tomorrow we expect to see a 25 bps rate hike and little, if any, change to the structure of the dots plot. These expectations are based on the idea that, like all of us, the FOMC doesn't know exactly what changes will be made to fiscal and monetary policy, and so moving policy expectations based on what policymakers think might happen is fraught with risk. Thus, we look for mostly a status quo event tomorrow.

We have been avoiding commentary on President-elect Trump's selections for his administration. This is because the individual selections are not as important as the pattern and we needed to see more appointments to get a feel for how this new government is going to be structured. This morning, Exxon (XOM, 90.98) CEO Rex Tillerson was named as the incoming president's selection for Secretary of State, with former Texas Governor Rick Perry for Energy Secretary. Here are a few thoughts on what we have seen so far.

Oil and natural gas production will be favored: The new Secretary of Energy was the governor of a major oil-producing state, and the head of the Environmental Protection Agency is the attorney general of Oklahoma, another major oil-producing state. Now, the Secretary of State is coming from the oil industry. Oil drilling and exploration looks to be favored in the Trump government.

Lots of brass: Military figures are prominent in the Trump administration. As noted in yesterday's 2017 Geopolitical Outlook, the plethora of generals probably indicates a return to the Powell Doctrine, which, in a nutshell, means fewer military adventures and if conflicts do occur they will be well defined and delivered with overwhelming force. Simply put, we strongly disagree with some commentators who argue that the presence of military figures means more wars. These appointees know firsthand the human costs of warfare and won't take it lightly.

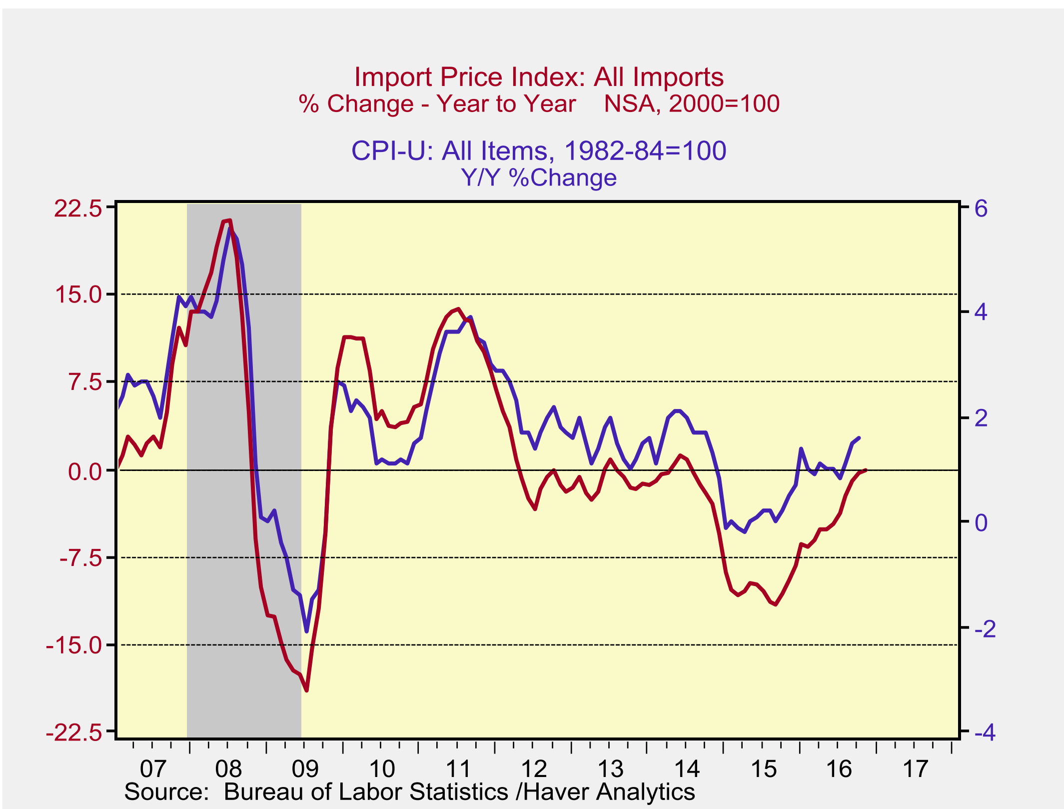
The populists, so far, are behind: We have been characterizing the internal conflict for the heart and soul of Donald Trump as a war between Speaker Ryan and Senior Counselor Bannon. So far, Steve Bannon holds the only senior position going to someone outside the political and economic establishment. However, that doesn't mean the populists are finished. We believe that to be successful Trump will need to address issues that both constituents want. Part of the financial market's positive sentiment seems to be coming from the idea that populist policies, such as restrictions on trade and immigration, won't be significant. It's probably too soon to take that position but, given the imbalance of selections, it isn't unreasonable to believe the populists have lost. That may be true but, again, it's likely too soon to determine.

We look for a quiet trade today in front of the FOMC meeting; the statement will be released at 1:00 EST tomorrow with a press conference soon after.

U.S. Economic Releases

Today, the NFIB Small Business Optimism came in at 98.4, above the forecast of 96.7. The growing optimism is due to more employers anticipating job creation and expecting more sales. The election of Donald Trump has had a positive effect on the outlook of small business owners as they expect regulatory relief and lower taxes.

The import price index fell 0.1% from the prior year, below the forecast of no change. The prior report was revised downward from a drop of 0.2% to a drop of 0.3%. The drop in import prices is likely due to the stronger dollar, although we do note that import prices are less deflationary even with dollar strength. Rising oil prices are partly to blame for a slower decline in import prices.



The chart above shows the year-over-year relationship between import prices and consumer prices. Rising import prices suggest that inflation could be on the horizon and would support the Federal Reserve's case to raise interest rates during this week's FOMC meeting.

There are no other economic releases today.

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	Manpower Survey	y/y	1q	4.0%	5.0%		**	Equity and bond neutral
	Industrial Production	y/y	nov	6.0%	6.1%	6.1%	**	Equity and bond neutral
	Retail Sales	m/m	nov	10.8%	10.2%	10.0%	**	Equity bullish, bond bearish
	Fixed Assets Ex Rural	y/y	nov	8.3%	8.3%	8.3%	**	Equity and bond neutral
Japan	Manpower Survey	y/y	1q	23.0	23.0		**	Equity and bond neutral
India	Manpower Survey	y/y	1q	21.0%	31.0%		**	Equity and bond neutral
Australia	Manpower Survey	y/y	1q	8.0%	12.0%		**	Equity and bond neutral
	ANZ Roy Morgan Weekly Consumption	m/m	dec	113.4	118.6		**	Equity bearish, bond bullish
	NAB Business Confidence	m/m	nov	5	6		**	Equity and bond neutral
	NAB Business Condtions	m/m	nov	5	4		**	Equity and bond neutral
	Housing Price Index	q/q	3q	3.5%	4.1%	4.6%	**	Equity bearish, bond bullish
New Zealand	Manpower Survey	q/q	1q	15.0%	15.0%		**	Equity and bond neutral
	Manufacturing Activity Volume	q/q	3q	2.1%	2.8%			Equity and bond neutral
EUROPE								
Eurozone	Employment	y/y	3q	1.2%	1.4%		***	Equity and bond neutral
Germany	Wholesale Price Index	y/y	nov	0.8%	0.5%		**	Equity bullish, bond bearish
	CPI	y/y	nov	0.8%	0.8%	0.8%	***	Equity and bond neutral
	Zew Survey Current Situation	y/y	dec	63.5	58.8	59.0	**	Equity and bond neutral
	Zew Survey Expectations	y/y	dec	13.8	13.8	14.0	**	Equity and bond neutral
Italy	Industrial Production	y/y	oct	-1.8%	1.9%		***	Equity bearish, bond bullish
UK	CPI	y/y	nov	1.2%	0.9%	1.1%	***	Equity and bond neutral
	Retail Price Index	y/y	nov	2.2%	2.0%	2.1%	**	Equity and bond neutral
	PPI Input	y/y	nov	12.9%	12.2%	13.5%	*	Equity bearish, bond bullish
	PPI Output	y/y	nov	2.3%	2.1%	2.5%	*	Equity and bond neutral
	House Price Index	y/y	nov	6.9%	7.7%	7.3%	**	Equity bearish, bond bullish
Russia	GDP	y/y	3q	-0.4%	-0.4%	-0.4%	**	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	oct	-8.2%	-5.9%	-8.5%	***	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)	96	95	1	Up
3-mo T-bill yield (bps)	52	52	0	Neutral
TED spread (bps)	44	44	0	Neutral
U.S. Libor/OIS spread (bps)	65	65	0	Neutral
10-yr T-note (%)	2.45	2.47	0	Neutral
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	57	55	2	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	up			Up
franc	up			Down

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	$56.31	$55.69	1.11%	Saudi Arabia may lower output more than expected
WTI	$53.32	$52.83	0.93%	
Natural Gas	$3.51	$3.51	0.00%	
Crack Spread	$14.14	$13.78	2.63%	
12-mo strip crack	$15.54	$15.52	0.13%	
Ethanol rack	$1.91	$1.88	1.72%	
Metals				
Gold	$1,159.44	$1,162.22	-0.24%	Stronger Dollar
Silver	$17.06	$17.08	-0.08%	
Copper contract	$262.45	$261.90	0.21%	
Grains				
Corn contract	$ 360.00	$ 360.50	-0.14%	
Wheat contract	$ 416.00	$ 417.25	-0.30%	
Soybeans contract	$ 1,032.75	$ 1,031.00	0.17%	
Shipping				
Baltic Dry Freight	1069	1090	-21	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		2.0		
Distillates (mb)		1.0		
Refinery run rates (%)		0.5%		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, while the southeast region is expected to see warmer temps. Precipitation is also expected for parts of the country north of the southwestern region.

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.

December 9, 2016

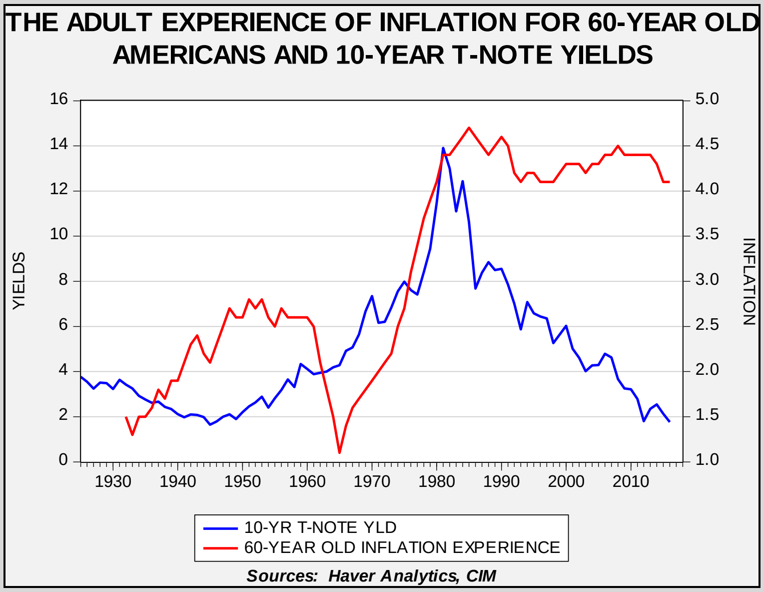
The rapid rise in longer duration Treasury yields since the presidential election has been surprising. As of December 8, the 10-year T-note yield was approximately 2.40%. Although President-elect Trump's policies will probably be inflationary, it is still unclear how much of his arguably vague plans will get passed. It is possible the FOMC will become more hawkish and we have seen some increase in rate hike expectations.[1] Still, our 10-year T-note model is putting the fair value yield at 1.85%. Assuming fed funds at 1.25% still only raises the 10-year rate to 2.20%. Taking oil to $60 and assuming the 1.25% fed funds only raises the fair value yield to 2.27%. Only when assuming steady oil, fed funds at 1.25% and German bunds at 1.25% (up from the current 33 bps) does the yield even reach 2.40%. The current spike in yields can be best justified by assuming a significant jump in inflation expectations.

In our yield model we use the 15-year average of CPI as a proxy for inflation expectations. This assumption comes from the work of Milton Friedman, who postulated that inflation expectations are derived over a long-term time frame. We realize our calculation is a proxy but have refrained from using more market-based expectations because of their lack of predictability. If one assumes that nominal rates are the sum of the expectations of real rates plus inflation forecasts, inflation forecasts are very important to predicting nominal interest rates.

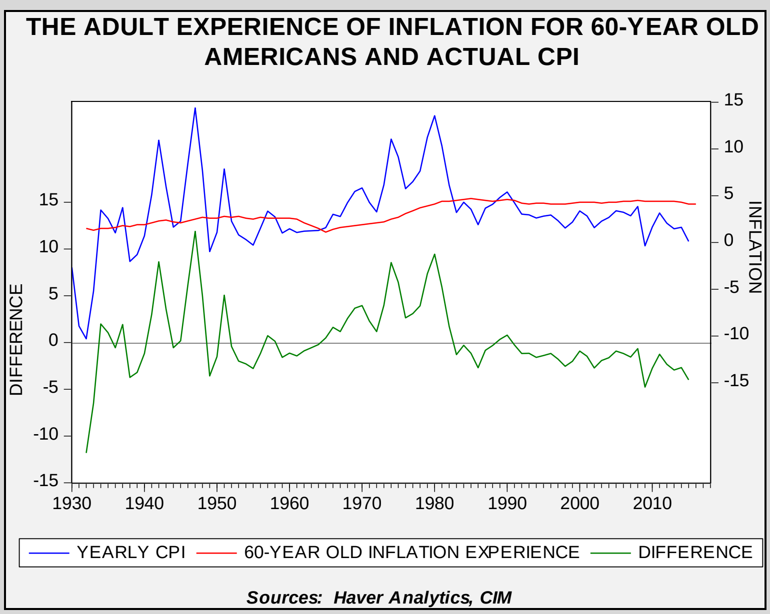
If the lifetime experience of inflation is important, then what is the most important age? We estimate that 60 is a reasonable age; the average age of the Senate is 61 years, the current FOMC average is 62 and the average age of an S&P 500 CEO is 57.[2] Simply put, it's around the age of 60 that people come into power in politics and business. We believe that their personal experiences color the expectations of any investor and so using 60 as an influential age makes sense.

[1] For example, the two-year deferred Eurodollar futures, which measure three-month LIBOR two years into the future, have jumped nearly 50 bps since the election.

[2] http://fortune.com/2015/12/13/oldest-ceos-fortune-500/



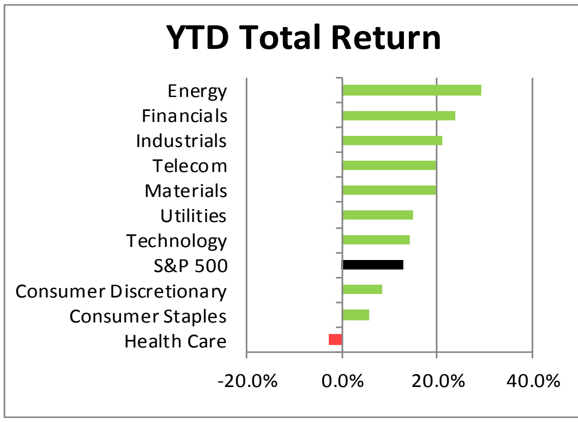
This chart shows the adult experience of inflation for a person turning 60 from 1932 to the present. To reflect the adult experience, we use the average annual change in CPI from ages 16 to 60. Note that inflation experience rose into the late 1940s and stabilized into 1960, when it fell sharply. This was the generation that entered adulthood during the Great Depression. It is interesting to note that as rates began to rise in the mid-1960s, the inflation experience steadily rose as well. Essentially, the rise in rates coincided with the rise in inflation experience. However, after peaking in 1981, bond yields began a steady drop into the current year despite the relatively high level of inflation experience. On the other hand, T-note yields exceeded the inflation experience of 60-year-olds in absolute terms until 2002.

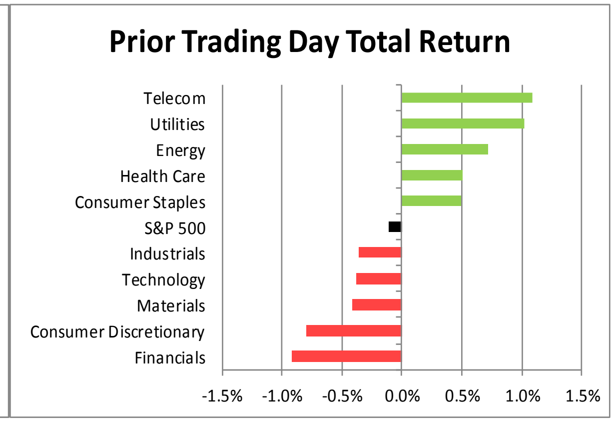


This chart shows the actual inflation rate compared to an average 60-year-old's adult experience of inflation. In general, bull markets in bonds tend to occur when the actual inflation rate is persistently below the average rate. Bear markets happen when the opposite condition is in place. Currently, the actual inflation rate is still well below the average rate, suggesting that the bull market in bonds should have more time to run. However, our worry is that the average 60-year-old is unusually sensitive to inflation fears and thus may overreact to the incoming president's policies. In other words, inflation expectations may become unanchored rather quickly, forcing the Federal Reserve to turn unexpectedly hawkish. Thus, we are taking a more cautious stance on fixed income into 2017, expecting higher yields and greater duration risk. At the same time, we will be closely monitoring the economy in light of less accommodative monetary policy. Most recessions occur because the Fed tightens too much. We don't expect that to become a problem until late next year or early 2018 if the Fed continues to raise rates. So, for the upcoming year, we expect a weak fixed income environment.

Data Section

U.S. Equity Markets – (as of 12/12/2016 close)

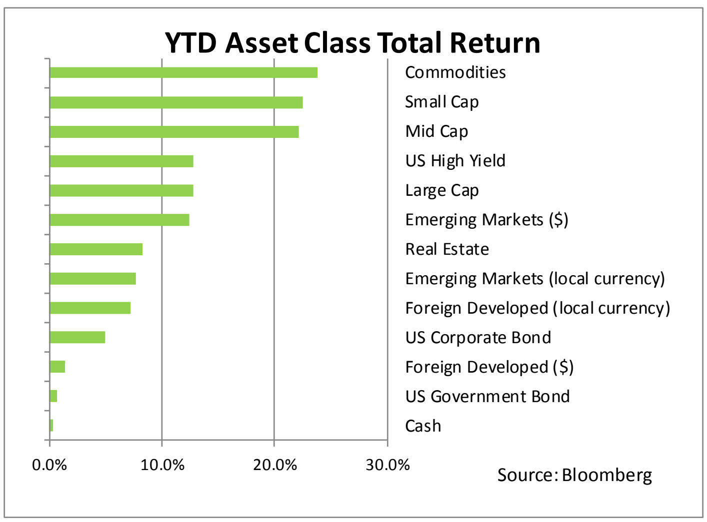




(Source: Bloomberg)

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 12/12/2016 close)

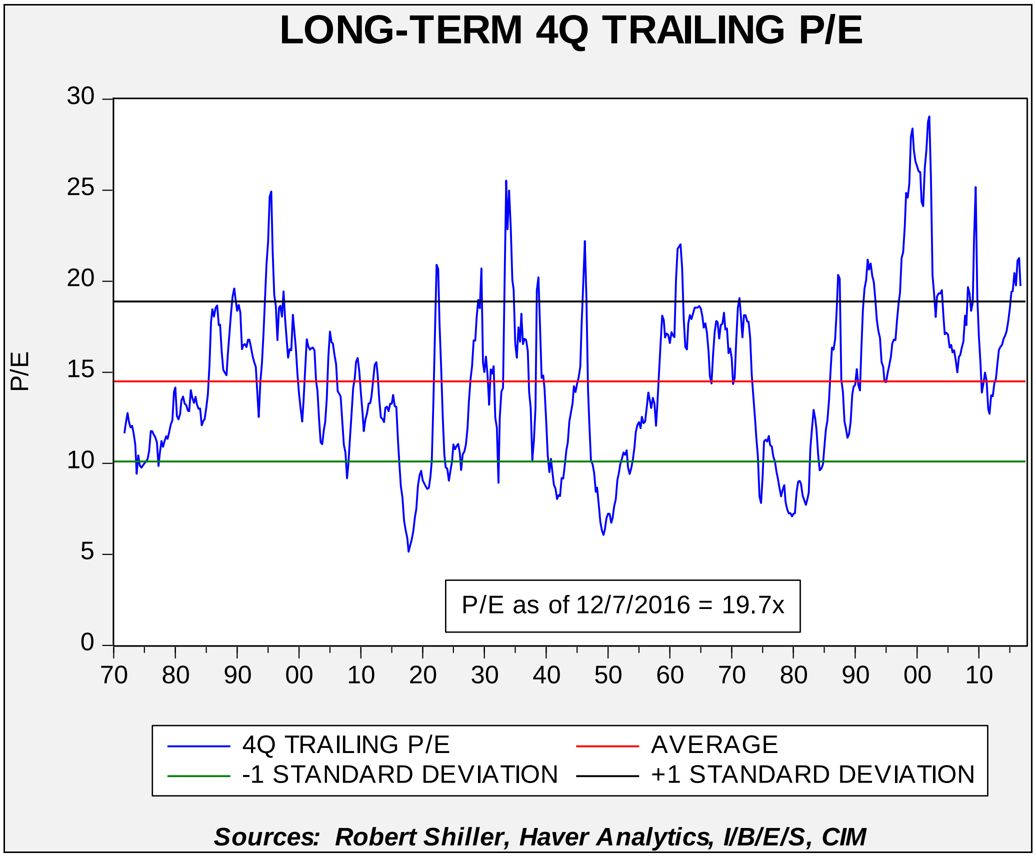


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 8, 2016



Based on our methodology,[3] the current P/E is 19.7x, steady from our last report.

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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[3] 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 the actual (Q1,Q2 and Q3) and one estimate (Q4). 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.