Daily Comment

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

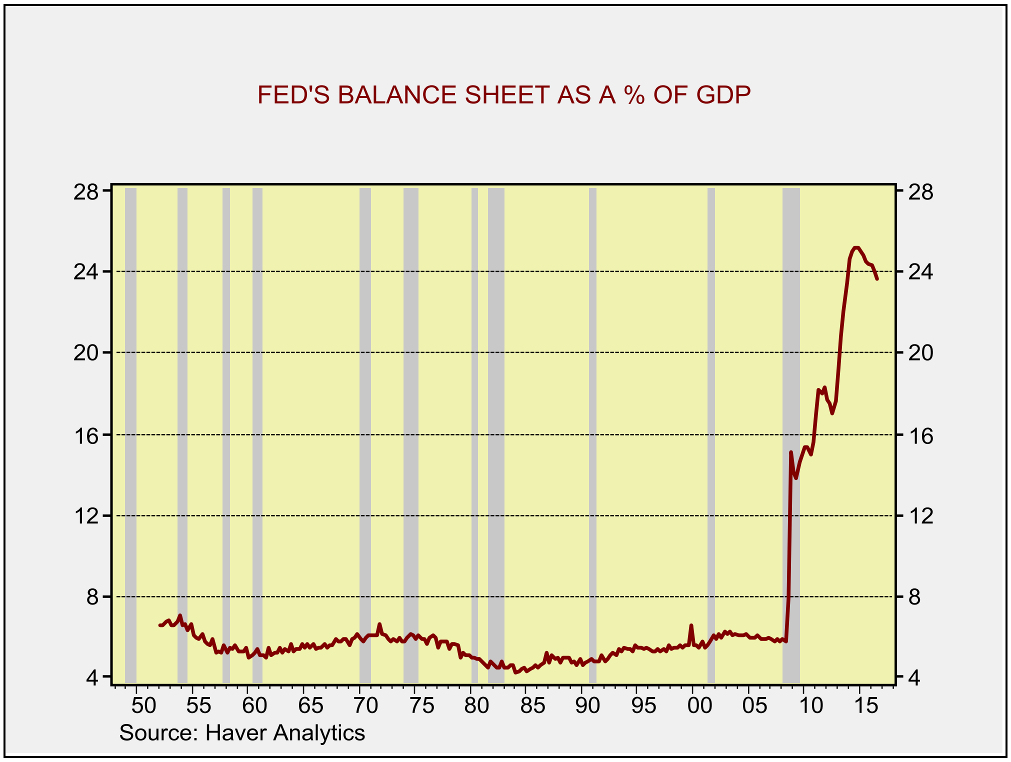
[Posted: December 19, 2016—9:30 AM EST] Global equity markets are down this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.8% lower from the prior close. Chinese markets were down, with the Shanghai composite down 0.2% and the Shenzhen index down 0.4%. U.S. equity futures are signaling a modestly higher open.

Markets are quiet as we head into the last two weeks of the year, although there is an old faithful tendency for the "Santa Claus Rally," which usually runs the last five days of the old year and the first two days of the New Year. Still, we expect volumes to thin and trading to slow as we head into the holiday week.

Late last week, China captured a U.S. research drone operating in what appeared to be international waters. Although there were concerns that this event would escalate, according to reports, the Chinese have agreed to return the drone after the U.S. filed an official protest. We view this as China's way of retaliating against President-elect Trump taking a call from Taiwan's president. If so, this was a low risk way of getting America's attention. By taking a drone, there were no human lives at risk and giving the vessel back keeps the situation from escalating. At the same time, we expect China to signal that it will respond to all hostile U.S. actions, a warning to the incoming administration that it will not merely acquiesce to actions it deems unfriendly.

President-elect Trump selected Congressman Mick Mulvaney (R-SC) as head of the Office of Management and Budget (OMB) over the weekend. Mulvaney is a staunch fiscal conservative, a supporter of entitlement reform, which is the opposite of what Mr. Trump's campaign promised. We have been framing the Trump presidency as Speaker Ryan v. Advisor Bannon. For the most part, the picks so far have favored Ryan, suggesting the GOP establishment is mostly co-opting the incoming president. That doesn't mean the populist cause is lost but he hasn't selected cabinet and department heads that support Trump's platform. Although financial markets will tend to support these establishment figures, we still believe the wave of history is in favor of the populists. If Trump fails to satisfy this group, he may return to being a private citizen in 2020.

Finally, there are a couple of Fed items worth noting. Chair Yellen is giving a commencement speech today. We would not expect any policy news to emerge from her comments. St. Louis FRB President Bullard, thought to be the low dots on the dots chart, indicated that the Fed should begin the process of shrinking the balance sheet. This is not a dovish act and would be taken as further policy tightening. It is worth noting that the Fed's balance sheet is already falling relative to the size of the economy.



After peaking at 25.2% of GDP, the balance sheet is now at 23.6% of GDP. If the Fed merely stops reinvesting expiring debt, the balance sheet will steadily shrink; for example, about $44 bn of Treasury holdings alone mature in 90 days or less. We expect the Fed, once it decides to reduce the balance sheet, will shrink it by allowing it to unwind through maturation, not by active sales. If this is the case, the balance sheet would become more weighted in mortgages, which have a longer term maturity profile.

U.S. Economic Releases

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Services PMI	m/m	dec	55.2	54.6	**
9:45	Markit US Composite PMI	m/m	dec		54.9	**

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	Trade Balance	m/m	oct	152.5 bn	496.2 bn	227.4 bn	**	Equity bullish, bond bearish
	Exports	m/m	nov	-0.4%	-10.3%	-2.3%	**	Equity bullish, bond bearish
	Imports	m/m	oct	-8.8%	-16.5%	-12.1%	**	Equity bullish, bond bearish
New Zealand	Westpac Consumer Confidence	m/m	4q	113.1	108.0		**	Equity bullish, bond bearish
	Perfomance Services Index	m/m	nov	57.9	56.3		**	Equity and bond neutral
	Building Permits	m/m	oct	2.6%	0.2%		**	Equity and bond neutral
	ANZ Activity Outlook	m/m	dec	39.6	37.6		**	Equity and bond neutral
	ANZ Business Confidence	m/m	dec	21.7	20.5		**	Equity and bond neutral
EUROPE								
Eurozone	Construction Output	y/y	nov	2.2%	1.8%		**	Equity and bond neutral
	Labor Costs	y/y	oct	1.5%	1.0%		**	Equity and bond neutral
Germany	IFO Business Climate	q/q	dec	111.0	110.4	110.6	**	Equity and bond neutral
	IFO Current Assessment	m/m	dec	116.6	115.6	115.9	**	Equity and bond neutral
	IFO Expectations	y/y	dec	105.6	105.5	105.6	**	Equity and bond neutral
Russia	Unemployment Rate	y/y	nov	5.4%	5.4%	5.5%	***	Equity and bond neutral
	Real Disposable Income	y/y	nov	-5.6%	-5.9%	-5.0%	**	Equity bearish, bond bullish
	Real Wages	y/y	nov	1.7%	2.0%	2.1%	**	Equity bearish, bond bullish
	Retail Sales	y/y	nov	-4.1%	-4.4%	-3.4%	**	Equity bearish, bond bullish
Switzerland	Total Sight Deposits	y/y	dec	527.9 bn	527.4 bn		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	dec	457.3 bn	454.8 bn		**	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)	100	99	1	Up
3-mo T-bill yield (bps)	49	49	0	Neutral
TED spread (bps)	51	51	0	Neutral
U.S. Libor/OIS spread (bps)	65	65	0	Neutral
10-yr T-note (%)	2.56	2.59	0	Neutral
Euribor/OIS spread (bps)	-31	-32	1	Up
EUR/USD 3-mo swap (bps)	57	54	3	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	up			Down
pound	down			Down
franc	down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Rate		-0.10%	-0.10%	On forecast

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	$55.20	$55.21	-0.02%	
WTI	$51.90	$51.90	0.00%	
Natural Gas	$3.35	$3.42	-1.79%	
Crack Spread	$15.14	$15.11	0.19%	
12-mo strip crack	$16.47	$16.43	0.28%	
Ethanol rack	$1.89	$1.89	0.00%	
Metals				
Gold	$1,138.52	$1,134.88	0.32%	Markets are down
Silver	$16.03	$16.10	-0.41%	
Copper contract	$252.35	$256.45	-1.60%	
Grains				
Corn contract	$ 355.00	$ 356.25	-0.35%	
Wheat contract	$ 411.00	$ 409.25	0.43%	
Soybeans contract	$ 1,029.75	$ 1,036.75	-0.68%	
Shipping				
Baltic Dry Freight	946	966	-20	

Weather

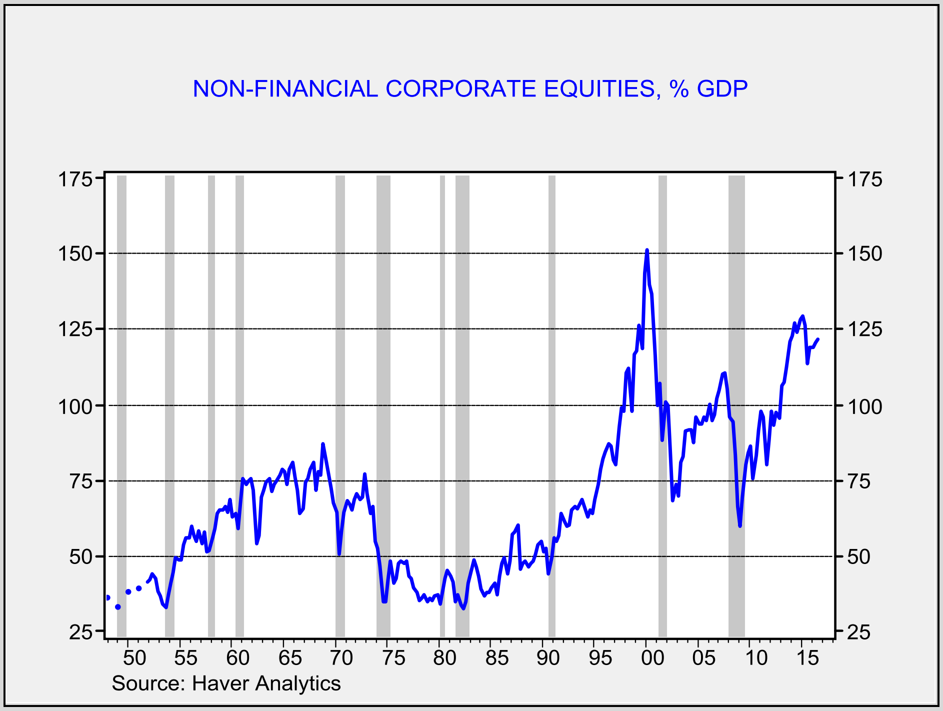
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the eastern region of the country, while the western region is expected to see cooler temps. Precipitation is also expected for most of the country.

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.

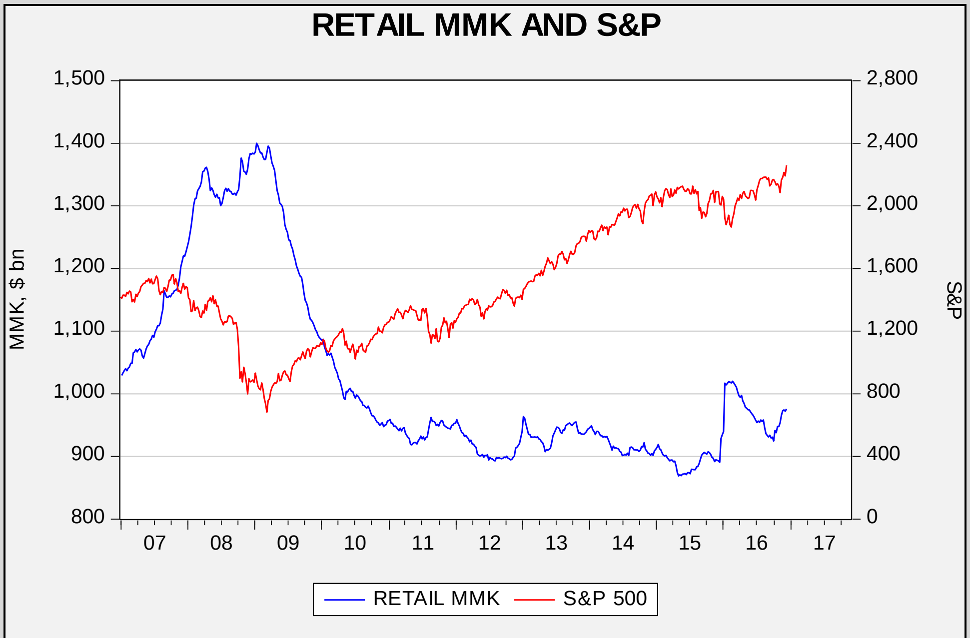
December 16, 2016

Equity markets are expensive by numerous measures and have become even more extended in the wake of the "Trump Rally." As noted in our weekly P/E update (found in the last section of the Daily Comment), our four-quarter measure of the P/E is elevated. Another well-known derivation of the "Buffet Indicator" has also reached lofty levels.



This ratio divides the market value of equities outstanding from the Federal Reserve's Financial Accounts of the U.S. by GDP. Although the ratio is off its recent highs, it is still at the upper end of its historical range.

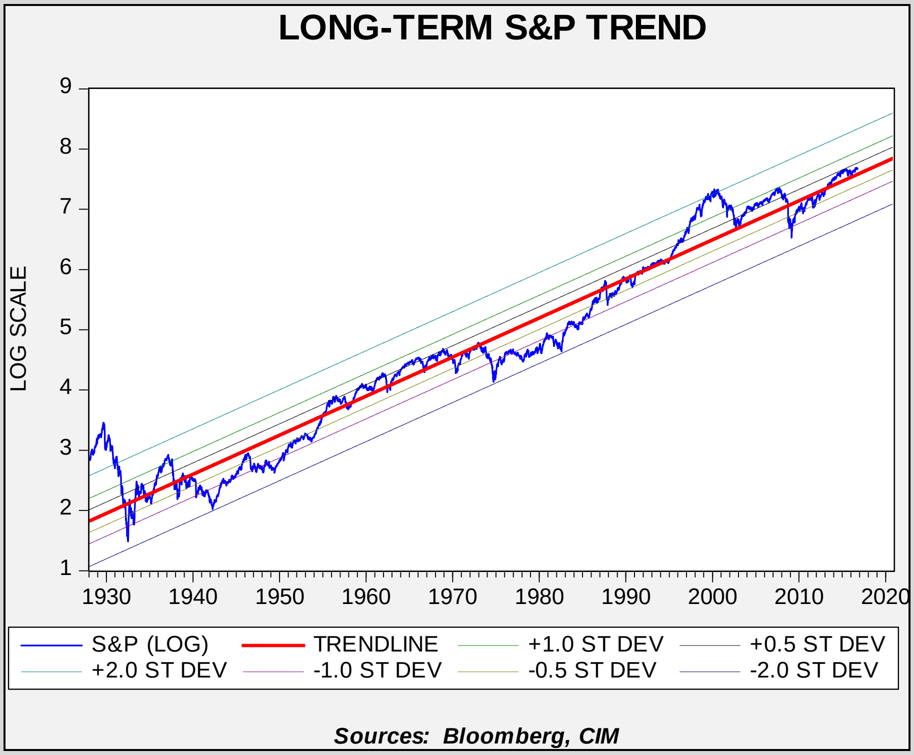
At the same time, the optimism isn't unfounded. Proposals for corporate tax reform could bring repatriation of the more than $2.0 trillion of corporate cash parked overseas. Tax cuts would boost after-tax earnings. The "E" part of the P/E could rise, making the market less expensive. Another factor to note is that investor cash levels remain elevated.



Sources: Haver Analytics, CIM

This chart shows the level of retail money market funds relative to the S&P 500. Since 2011, equities have tended to trend higher when money market fund levels exceed $920 bn. Once money market holdings fall below that level, equities have tended to stall. It appears that investors were building cash in front of the election but, so far, retail investors are not aggressively entering the equity markets. The weekly mutual fund flows suggest that investors are selling out of bonds which probably accounts for the recent rise in money market funds; to date, there isn't any evidence in the same data that equity mutual fund buying is increasing. This data would suggest that there is ample fuel for further gains in equities.

So, if equities are rich but could work higher, how high is high?



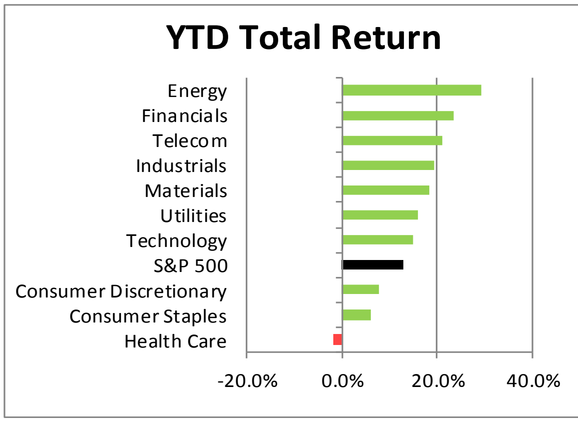
On this chart, we log-transform the weekly close of the S&P 500 starting in 1928. The red line is the long-term trend. We have regressed the trend line against the weekly close and have calculated the standard deviation at the ½ level, one deviation and two deviations from trend. Only twice in the past 88 years has the index exceeded two standard deviations to the upside and it has only touched that level on the downside three times. We are currently below ½ deviation on the upside, suggesting that, on a long-term trend basis, equities are not all that extended.

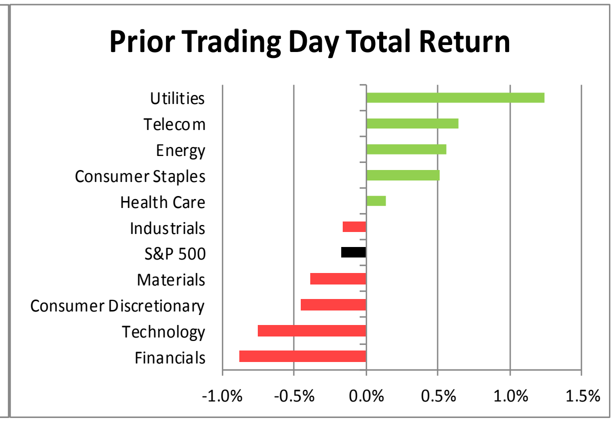
If we reach +½ standard deviation by mid-2017, the S&P 500 would reach 2480.70; the year-end reading would be 2562.22 by the same measure. By comparison, reading the +one standard deviation line would put the index at 2995.80 by June 2017, and 3094.24 by year's end. We are not anticipating a rise to +one standard deviation next year but a rise to the +½ level isn't out of the question.

We still don't know what the specific policies will be of the incoming Trump administration. Tax policy is complicated and there is always the potential for mistakes. The current euphoria surrounding other policies will probably fade over time. And, although the above analysis suggests that equity markets are sporting high valuations, cash levels are high and current equity levels, while above trend, haven't reached levels of concern. Thus, for the time being, the path of least resistance for equities is probably higher.

Data Section

U.S. Equity Markets – (as of 12/16/2016 close)

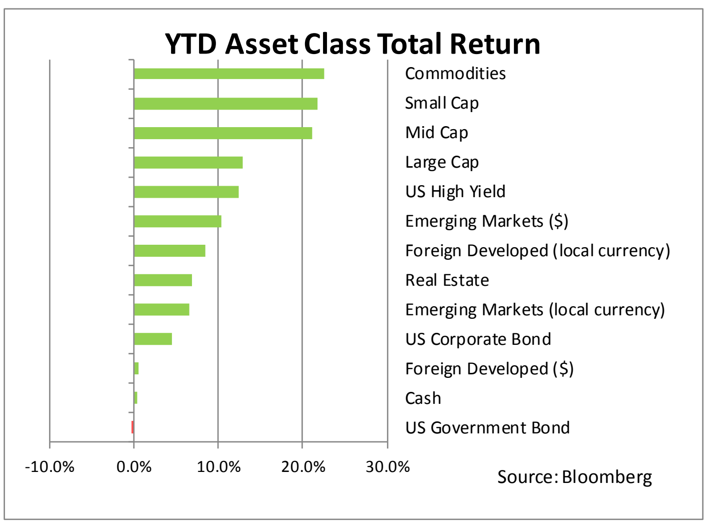




(Source: Bloomberg)

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 12/16/2016 close)

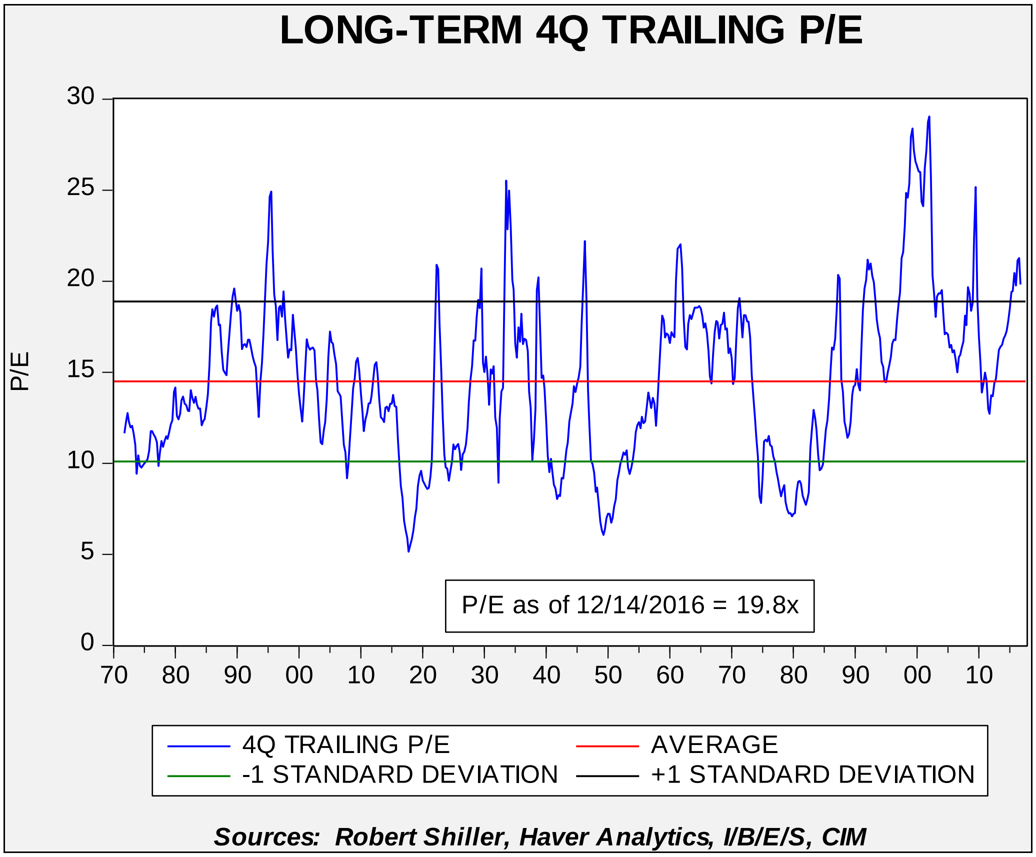


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2016



Based on our methodology,[1] the current P/E is 19.8x, up 0.1x from last week. Rising equity values led to the rise in the P/E.

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.

[1] 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.