Daily Comment

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

[Posted: December 20, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.2% lower from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 0.1%. U.S. equity futures are signaling a higher open.

There wasn't much on the economic front overnight. The BOJ, as expected, left policy unchanged. There had been some rumblings about the Japanese central bank allowing bond yields to rise in line with rates in the U.S. To recount, the BOJ has fixed its 10-year JGB yield at zero and will adjust its balance sheet to maintain that price. This policy was changed earlier this year away from a set level of buying. We see little reason for the BOJ to change policy now; in fact, it now becomes more powerful as U.S. rates rise because it supports a weaker JPY. And, that is what we saw in the aftermath of the meeting.

In the press conference, BOJ Governor Kuroda made it clear that policy will remain in place. He indicated that inflation still remains too low and the current JPY weakness is mostly due "to a strong dollar, not a weak yen." If the BOJ maintains its current policy, we would expect the JPY to continue to weaken.

There were two geopolitical events yesterday. First, a truck struck pedestrians in a crowded market in Berlin in an apparent terrorist attack. According to reports, the man arrested was a 23-year-old Pakistani refugee who entered Germany at the end of last year. This attack will increase pressure on Chancellor Merkel who has come under heavy criticism for her open refugee policy. The chancellor is a consummate politician; given the growing wave of populism, we would expect her to shift her stance away from refugee support to maintain power. However, if she does make this change, Europe will become closed to Middle Eastern refugees and problems in the latter region will worsen.

The other event was the assassination of Russia's ambassador to Turkey who was killed by one of his security guards, a Turkish policeman. Peter Zeihan, a geopolitical analyst we follow, made an interesting observation about Russia's elite. In the U.S., there is a surprisingly wide road to influence. A university education, the right internship, a stint in the military, powerful friends, state and local government, a place in the bureaucracy, business success and connections, etc. can be paths to positions of power. In Russia, there is really only one path to national leadership, which runs through the intelligence agencies. The FSU and GRU are the only real roads to positions of influence. Thus, in the U.S., approximately 2.0 mm people have some degree of influence. More importantly, they become a pool of talent that people in power can tap. That number in Russia, according to Zeihan, may be around 200. Thus, losing a figure like Ambassador Andrei Karlov may be quite a blow. He was multi-lingual and savvy. Before going to Turkey he represented Russia in North Korea. Thus, Karlov was no mere functionary but a rare talent. It is important to note that Karlov managed the 2015 incident when Turkey downed a Russia warplane. Karlov was apparently instrumental in helping Erdogan deescalate the situation and maintain Russian/Turkish relations. If anything, they have improved since the event.

Who Putin puts in Turkey will be important. As IS collapses, Turkey, Iran, the Kurds and Syria will be trying to grab territory and influence in the region. If Russia can't replace Karlov with someone of equal stature, the potential increases for larger conflicts.

U.S. Economic Releases

There are no domestic releases for 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								
China	Swift Global Payments	m/m	nov	2.0%	1.7%		**	Equity and bond neutral
Japan	Nationwide Department Sales	y/y	nov	-2.4%	-3.9%		**	Equity and bond neutral
	Tokyo Departments Sales	y/y	nov	-1.4%	-4.4%		**	Equity and bond neutral
New Zealand	Food Prices	m/m	nov	-0.1%	-0.8%		**	Equity and bond neutral
EUROPE								
Eurozone	Current Account	y/y	oct	32.8 bn	29.8 bn		**	Equity bullish, bond bearish
Germany	PPI	y/y	nov	0.1%	-0.4%	-0.2%	**	Equity bullish, bond bearish
Italy	Current Account	m/m	uct	6.086 bn	2.810 bn		**	Equity bullish, bond bearish
UK	CBI Retailing Reported Sales	m/m	dec	35	26	20	**	Equity bullish, bond bearish
	CBI Total Dist. Reported Sales	m/m	dec	42	34		**	Equity and bond neutral
Switzerland	Trade Balance	y/y	nov	3.64 bn	2.68 bn	3.56 bn	**	Equity bullish, bond bearish
	Exports Real	y/y	nov	-0.4%	-4.7%		**	Equity bullish, bond bearish
	Imports Real	y/y	nov	-4.2%	2.8%		**	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)	100	99	1	Up
3-mo T-bill yield (bps)	50	50	0	Neutral
TED spread (bps)	50	50	0	Neutral
U.S. Libor/OIS spread (bps)	65	65	0	Neutral
10-yr T-note (%)	2.57	2.54	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	59	59	0	Neutral
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	down			Down
franc	down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Rate	-0.10%	-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	$55.45	$54.92	0.97%	Belief that output agreement will hold
WTI	$52.35	$52.12	0.44%	
Natural Gas	$3.35	$3.39	-1.24%	
Crack Spread	$15.23	$15.04	1.28%	
12-mo strip crack	$16.56	$16.49	0.41%	
Ethanol rack	$1.90	$1.89	0.11%	
Metals				
Gold	$1,129.38	$1,138.21	-0.78%	Stronger dollar
Silver	$15.74	$15.97	-1.45%	
Copper contract	$249.80	$249.95	-0.06%	
Grains				
Corn contract	$ 352.25	$ 353.25	-0.28%	
Wheat contract	$ 404.00	$ 405.00	-0.25%	
Soybeans contract	$ 1,011.75	$ 1,021.50	-0.95%	
Shipping				
Baltic Dry Freight	927	946	-19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		1.3		
Distillates (mb)		-1.8		
Refinery run rates (%)		0.3%		

Weather

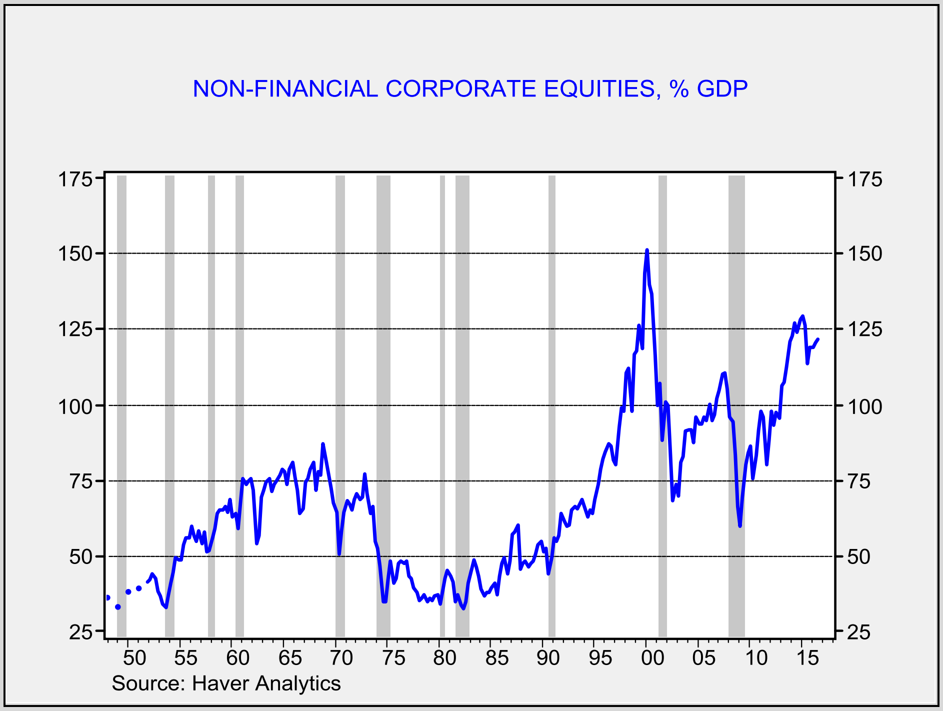
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the eastern region of the country, while the western region is expected to see cooler temps. Precipitation is also expected for most of the country.

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.

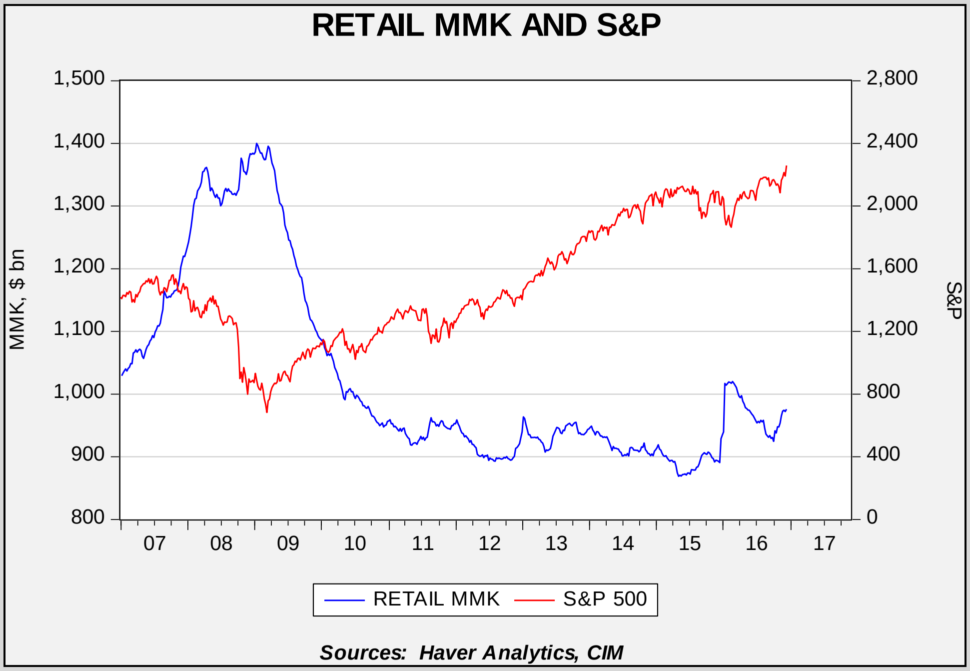
December 16, 2016

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.



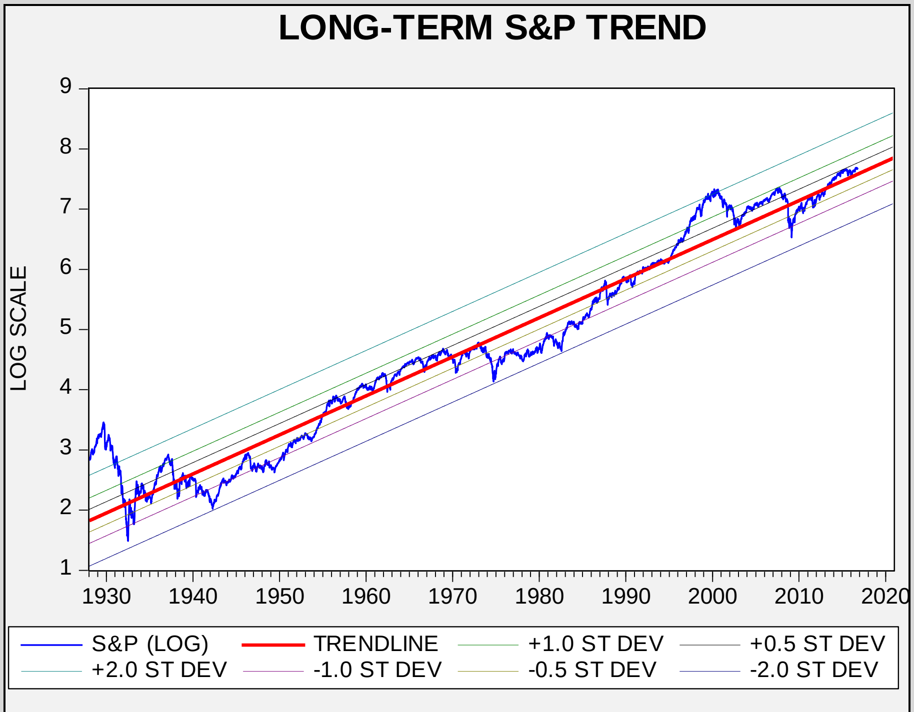
This ratio divides the market value of equities outstanding from the Federal Reserve's Financial Accounts of the U.S. by GDP. Although the ratio is off its recent highs, it is still at the upper end of its historical range.

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.



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?



Sources: Bloomberg, CIM

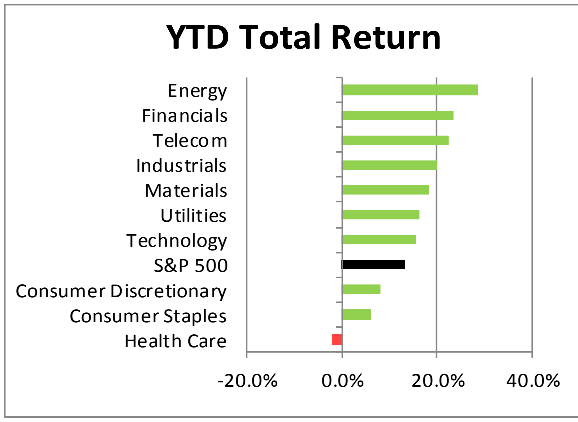
On this chart, we log-transform the weekly close of the S&P 500 starting in 1928. The red line is the long-term trend. We have regressed the trend line against the weekly close and have calculated the standard deviation at the ½ level, one deviation and two deviations from trend. Only twice in the past 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.

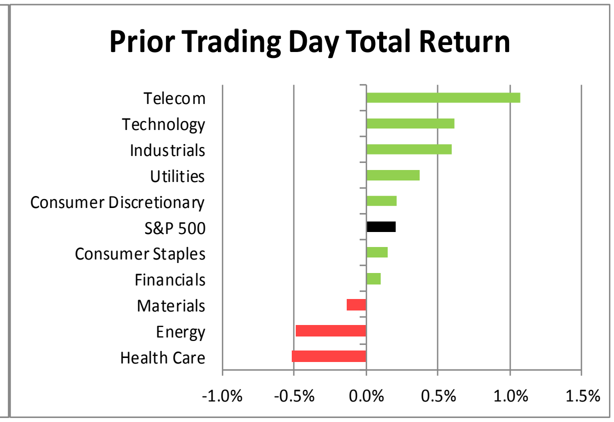
If we reach +½ standard deviation by mid-2017, the S&P 500 would reach 2480.70; the year-end reading would be 2562.22 by the same measure. By comparison, reading the +one standard deviation line would put the index at 2995.80 by June 2017, and 3094.24 by year's end. We are not anticipating a rise to +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 12/19/2016 close)

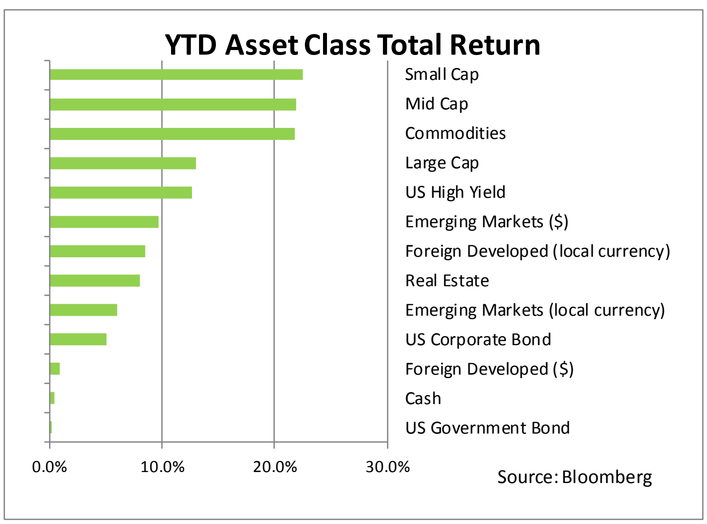




(Source: Bloomberg)

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 12/19/2016 close)

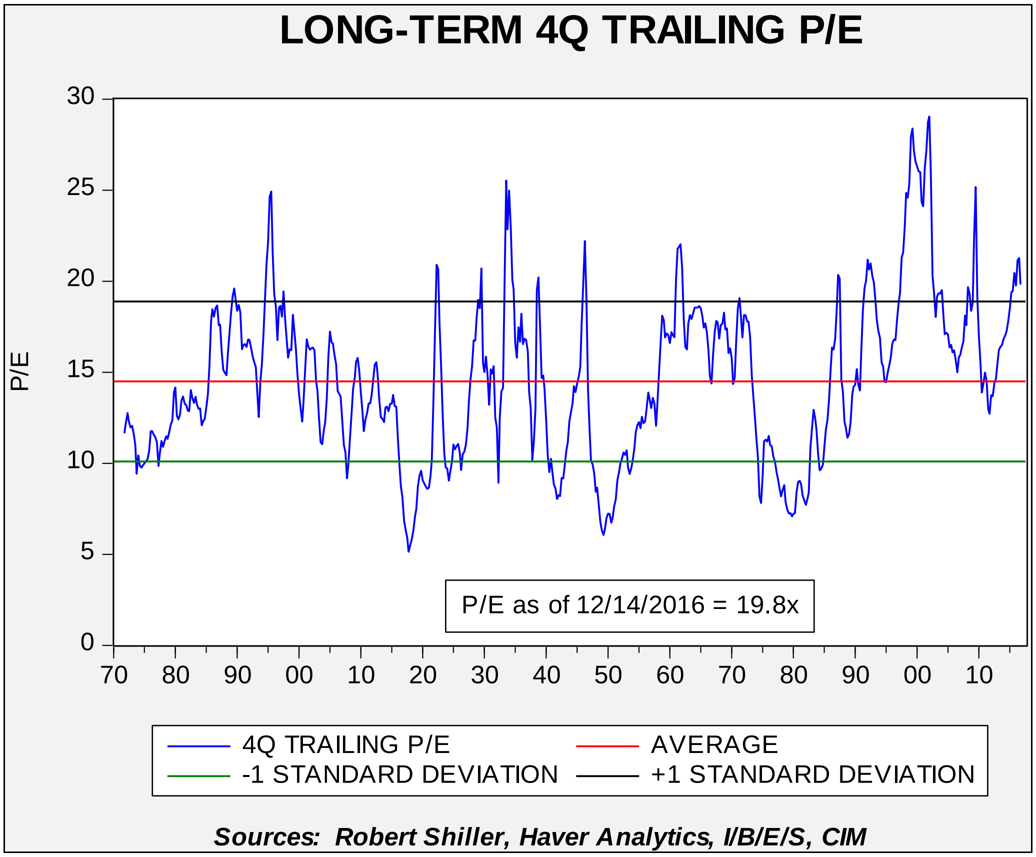


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.