Confluence Investment Management

Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: December 20, 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 0.5% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.3% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a higher open.

(Note to readers: The Daily Comment will go on hiatus after Friday; commentary will resume on January 2, 2018.)

Markets are showing more of the same—U.S. equities are rising and bond yields are also rising. Here is what we are watching this morning:

Tax bill update: It's essentially a done deal. The House will need to vote again on the tax bill due to procedural issues in the Senate that required a vote late last night. The vote was strictly by party line, 51-48. We expect a similar outcome in the House. The president will have the bill no later than tomorrow; although there is some talk he might sit on it for a few days, we suspect he will sign it immediately.

Some thoughts on the tax bill: First, this bill got finished at record speed. Kudos to the GOP congressional leadership. Whether one likes the outcome or not, the fact that it was done so quickly is remarkable, especially given the disarray evident this fall. Second, don't expect durability. In the hyper-partisan political environment in Washington now, both parties are looking for retribution when they get power. Look how hard the GOP worked to unwind the ACA. Universal healthcare is a totem for the Democrat Party. And, even though a full "repeal and replace" failed, the GOP has undermined the ACA with various measures, including removing the insurance mandate as part of this tax legislation. ***One should fully expect the Democrats to try to unwind this tax bill if they gain political power in 2018 and 2020.*** Why? Because tax cuts are a totem for the GOP.

Compare the current tax reform bill to the last one. The 1986 Tax Reform Act only had 12 Democrat senators vote against it in its final form. It passed 74-23; 11 Republicans opposed the measure. Three decades ago, party discipline was clearly not as strong as it is today. To get that degree of bipartisanship, legislators from both sides had to work in concert to craft the bill. When bills have that degree of bipartisanship, they tend to remain unchallenged by future administrations.

This is a key point. We are rapidly reaching a status where households and businesses can only rely on the current regulatory and legislative environment to endure as long as the party in power remains in place. Once the government shifts, one should expect a wholesale reversal to occur. This fact will make it increasingly difficult to invest and plan. The current tax bill's support is completely partisan, which means a new environment will develop if and when the opposition gains power.

The other issue to remember is that this tax bill has all sorts of surprises embedded in it, due in part to the haste in which it was fashioned. The sunset provisions, which "everybody" knows will be extended, won't be if the Democrats are in power. An interesting sidelight is a provision that will eliminate the ability of cryptocurrency holders to transfer their holdings into another similar instrument and defer taxes. Before this legislation, cryptocurrencies were treated as property, allowing tax deferral for like-kind exchanges. In the media, there is lots of talk about how other, lesser known cryptocurrencies are jumping in value relative to bitcoin. This buying may be tied to the tax legislation.

We will have more to say on the tax bill next year. But, for now, it will boost corporate earnings, anywhere from 5% to 10%, and is clearly bullish for equities. That fact will support stocks into Q1.

The EU rules on Uber: The EU's top court says Uber is a transportation company, not a platform company, and thus is subject to EU regulation on livery companies. This is a huge blow to the company, which was mostly built on regulatory avoidance. If this ruling becomes precedent, other platform firms may find themselves subject to similar laws in their markets.

The shutdown: Although the GOP leadership in Congress is celebrating its tax win, the looming spending bill has to be passed by Friday or the government will run out of spending authority. We expect a shutdown will be avoided but we will likely only get a short-term extension. This issue will probably return by mid-January.

Catalan vote tomorrow: Catalonia will hold regional elections tomorrow. Current polling shows that separatists and unionists are in a dead heat, with nearly 20% of the electorate undecided. The most likely outcome is an indecisive election and weeks of jockeying before a regional government is formed. However, if the separatists win decisively, a constitutional crisis could develop in Spain.

China blinks (again): The *WSJ*[1] is reporting that the Xi regime is dialing back its deleveraging program to support economic growth. This has been a consistent pattern from the CPC; although the need to deleverage is obvious, the restructuring necessary will lead to a slower growth economy, something the leadership fears. That is good news in the short run because China is an important component to global growth. However, the debt level is clearly unsustainable and the safest way to address it is to slow growth and shift resources to the household sector.

Cryptocurrency woes: Two cryptocurrency exchanges had issues yesterday—one in South Korea was forced into bankruptcy after a cyberattack and another in the U.S. is investigating the potential of insider trading.[2] These issues highlight the security problems of the new currencies.

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[1] https://www.wsj.com/articles/china-seeking-growth-softens-focus-on-cutting-debt-1513700557

[2] https://www.ft.com/content/aa9fdd64-e536-11e7-97e2-916d4fbac0da?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

U.S. Economic Releases

Weekly mortgage applications fell 4.9% last week, with purchases down 5.5% and refinancing off 3.2%. The average rate on a 30-year fixed mortgage was 4.16%, down from 4.20% last week.

This table shows the schedule for the rest of the day.

Economic Releases				Expected	Prior	Rating
EDT	Indicator			Expected	Prior	Rating
10:00	Existing Home Sales			5.53m	5.48n	***
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								
Australia	Westpack LEI	m/m	nov	0.1%	0.1%		*	Equity and bond neutral
EUROPE								
Eurozone	Current Account	m/m	oct	€ 30.8 bn	€39.2 bn		*	Equity and bond neutral
	Labor Costs	y/y	Q3	1.6%	1.8%		*	Equity and bond neutral
Germany	PPI	y/y	nov	2.5%	2.7%	2.6%	**	Equity and bond neutral
Italy	Current Account	m/m	oct	€ 6.6 bn	€4.3 bn		*	Equity bullihs, bond neutral
UK	CBI retail reported sales	m/m	dec	24.0	30.0		*	Equity and bond neutral
AMERICAS								
Canada	wholesale sales	m/m	oct	1.5%	-1.2%	0.5%	**	Equity bullish 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)	163	161	2	Up
3-mo T-bill yield (bps)	135	134	1	Neutral
TED spread (bps)	28	27	1	Neutral
U.S. Libor/OIS spread (bps)	140	141	-1	Up
10-yr T-note (%)	2.47	2.47	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	52	60	-8	Down
Currencies	**Direction**			
dollar	steady			Neutral
euro	steady			Up
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Japan	-0.100%	-0.100%	-0.100%	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	$63.88	$63.80	0.13%	
WTI	$57.79	$57.56	0.40%	Bullish API's
Natural Gas	$2.74	$2.69	1.78%	Colder weather
Crack Spread	$17.59	$17.52	0.41%	
12-mo strip crack	$19.90	$19.86	0.18%	
Ethanol rack	$1.40	$1.40	-0.14%	
Metals				
Gold	$1,265.29	$1,261.70	0.28%	Bitcoin exchange failure
Silver	$16.21	$16.13	0.48%	
Copper contract	$317.15	$315.15	0.63%	
Grains				
Corn contract	$ 348.00	$ 347.50	0.14%	
Wheat contract	$ 418.25	$ 419.50	-0.30%	
Soybeans contract	$ 969.25	$ 966.75	0.26%	
Shipping				
Baltic Dry Freight	1547	1588	-41	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.1	3.1	
Gasoline (mb)		2.3	-2.3	
Distillates (mb)		0.3	-0.3	
Refinery run rates (%)		-0.30%	0.3%	
Natural gas (bcf)		-164.0	164	

Weather

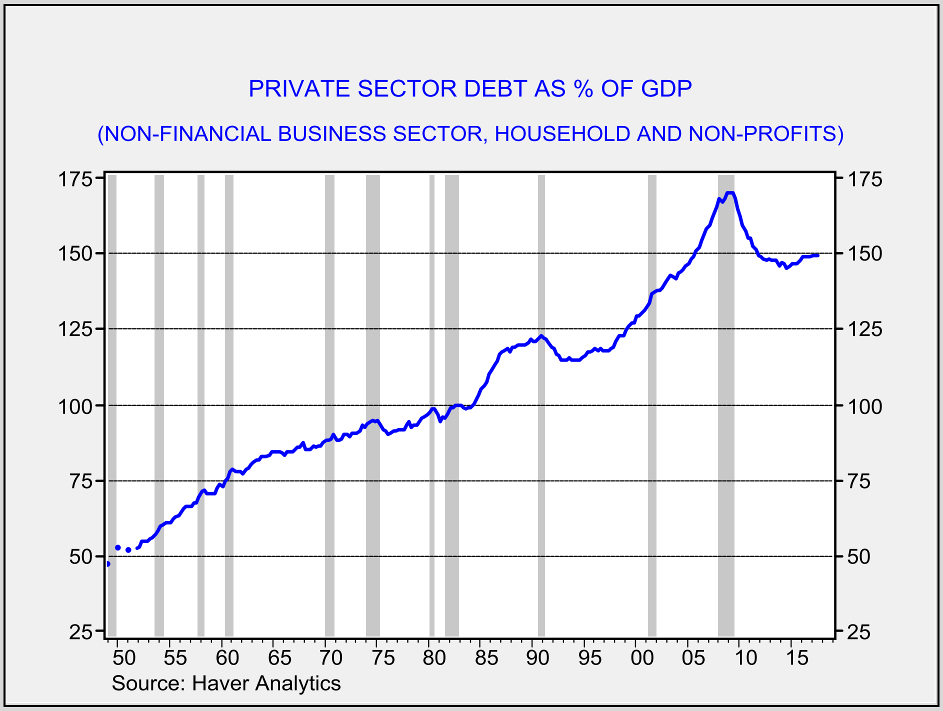
The 6-10 and 8-14 day forecasts are calling for a deep cold snap that should last into New Year's.

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.

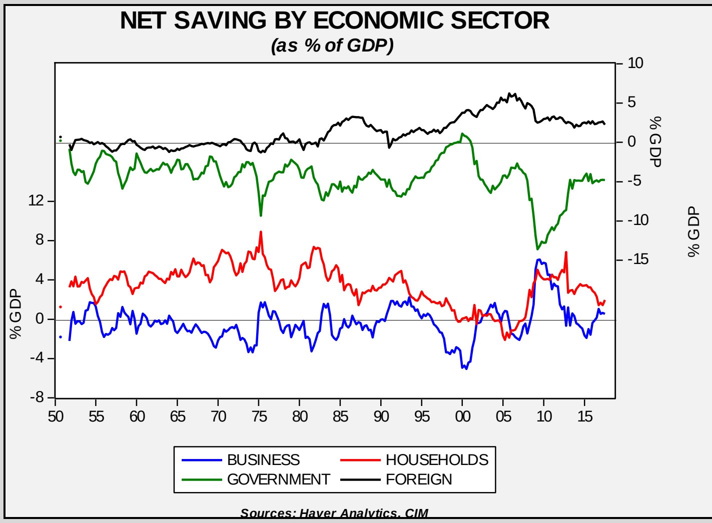
December 15, 2017

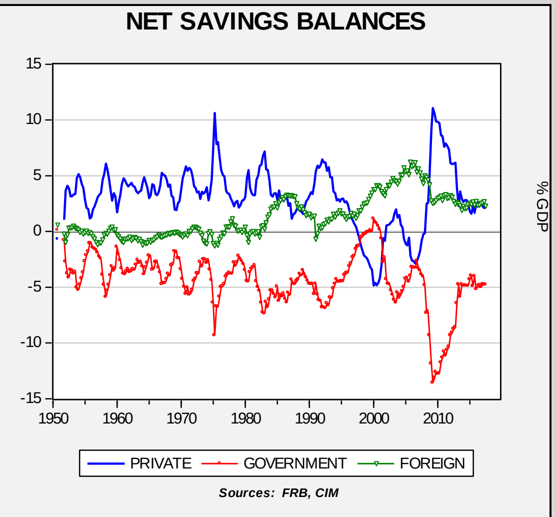
Last week, the Federal Reserve released its Financial Accounts of the United States, formerly called the Flow of Funds report. It is a broad set of data that covers many aspects of the economy. Here we present some key charts from the report.



This chart shows key private sector debt as a percentage of GDP. We exclude the financial sector to avoid double counting. We consider private sector debt more important to the economy for two reasons. First, business sector investment is funded with debt and household sentiment is also tied to debt. Leverage will boost growth, while deleveraging weighs on growth. The other important factor is that private sector debt has different capacity constraints than public sector debt. Private sector debt has to be serviced from income or revenue; the private sector cannot print its own money to service its debt. The public sector can not only print money to service its debt, but it can use coercion to force compliance. That is why government debt is a profoundly different risk to the economy; a large deficit is mostly an inflation risk, not a default risk. When the private sector deleverages, it must either write down the debt (harming creditors) or create increased saving (harming debtors). The current expansion is long in duration but growth has lagged previous growth periods in part because of deleveraging. The above data suggests that the private sector has mostly stopped reducing debt relative to the economy but isn't releveraging, which would tend to increase growth.

The other chart we closely watch is net saving by sector.

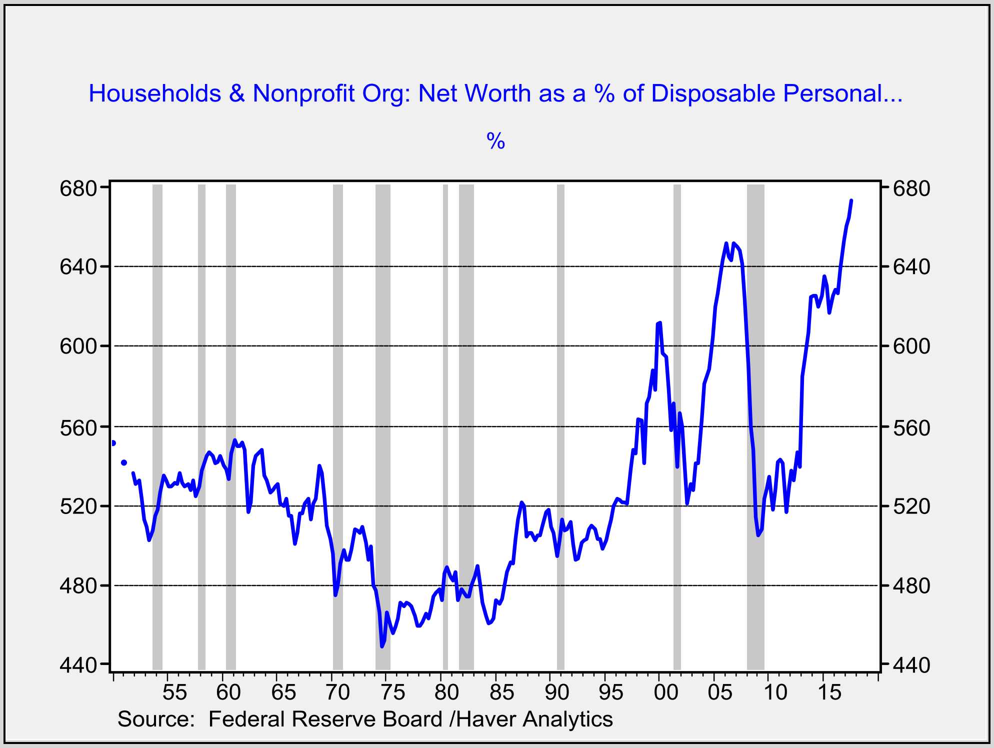




The chart on the left shows net saving by the four sectors of the economy—business, households (which represent the domestic private sector), government and the foreign sector. They have been scaled to GDP. Business saving is revenue less investment. Household saving is income less consumption. The government sector is the fiscal balance and foreign saving is the inverse of the current account. For macroeconomic accounting, the four act like a balance sheet—the net sum always equals zero. For the past few quarters, saving by sector has been mostly steady. The combination of domestic private sector saving and foreign saving has been balancing the government's deficit. That is best observed on the chart on the right side.

One of the less discussed ramifications of the current tax bill is that it is expected to raise the government's deficit; in other words, government dissaving must rise. This must be offset by either rising domestic private sector saving or foreign saving (in other words, a rising trade deficit). One of the other policy goals of the Trump administration is to lower the trade deficit but the tax bill may actually foster a wider deficit. At the same time, if the administration meets that goal, domestic private sector inflation must rise. If it is to come from the business sector, investment must fall without a significant rise in business revenue. Of course, rising business investment is a key goal of the tax bill. The other way saving could rise is from higher household saving, but that would likely come from lower consumption which would weaken growth. That's why getting a revenue-neutral tax bill was so important. If the tax bill were revenue-neutral and simply improved efficiency through tax reform, investment could rise and perhaps be funded without a drop in business saving due to higher revenue.

Finally, net worth of households has reached a new record high.

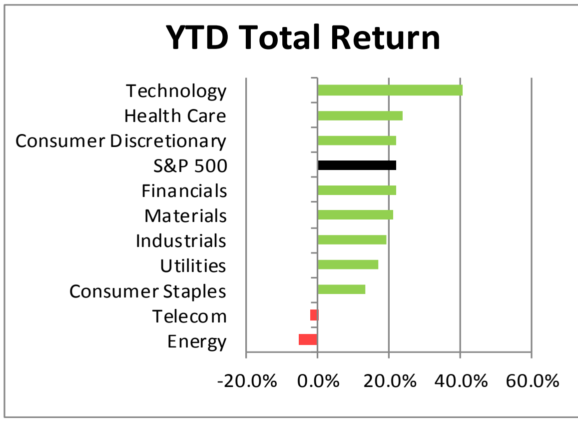


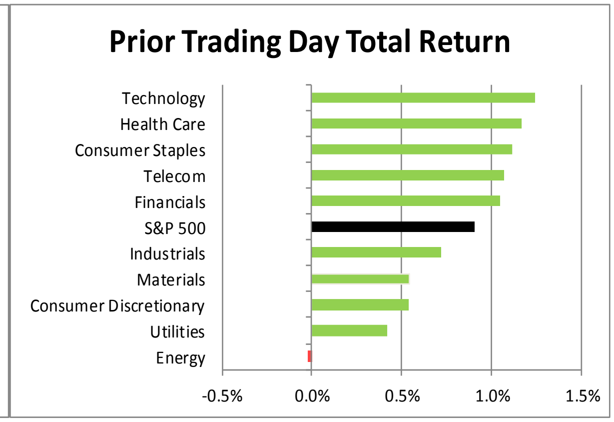
Household net worth is now 673.0% of after-tax income, a new record. The current level reflects rising equity markets and improved housing prices. The chart does indicate that this number tends to fall rather abruptly during recessions. As we noted in our 2018 Outlook, we do not expect a recession next year so this ratio probably has further to rise.

Overall, the Financial Accounts of the United States paints a picture of stability and slow healing. Saving and debt are stabilizing and net worth is rising. We will be watching how the tax bill affect this stability in the coming months.

Data Section

U.S. Equity Markets – (as of 12/19/2017 close)

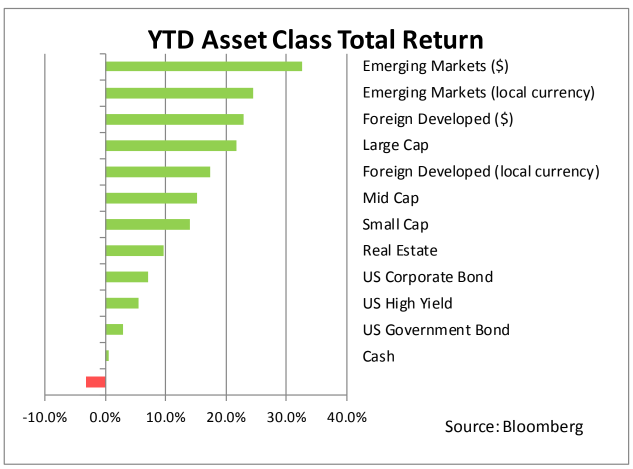




(Source: Bloomberg)

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 12/19/2017 close)

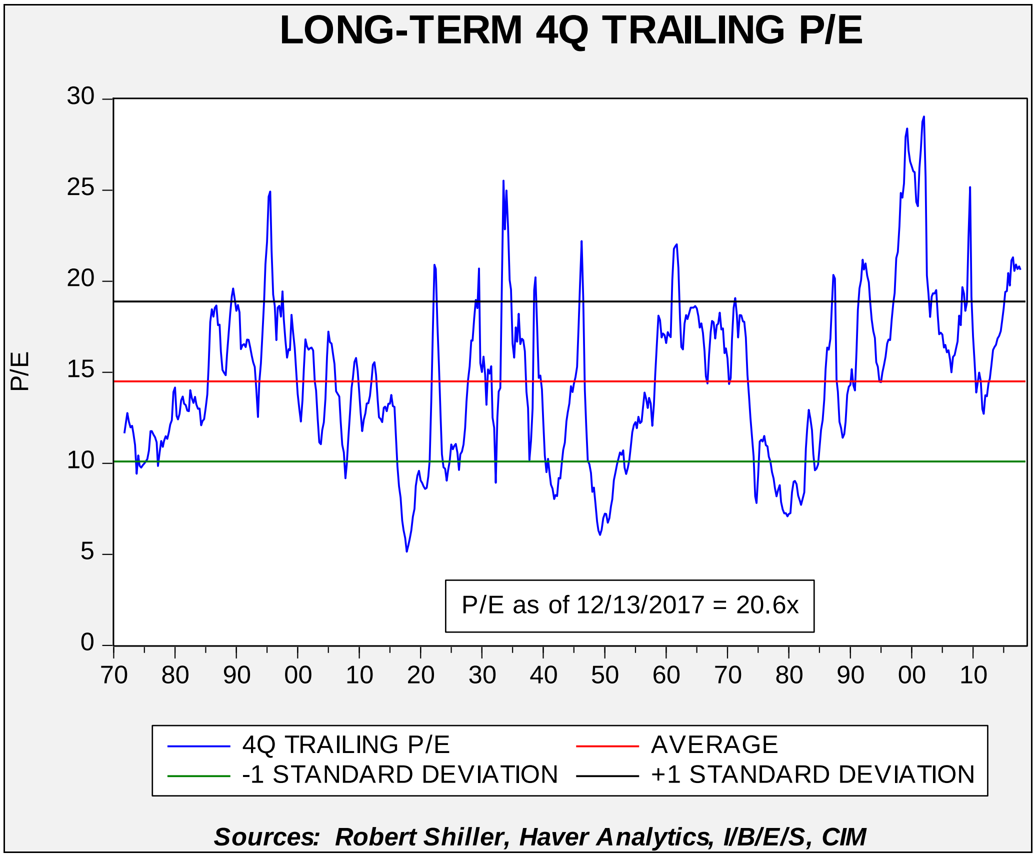


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 14, 2017



Based on our methodology,[3] the current P/E is 20.6x, up 0.1x from last week. The rise in the ratio is mostly due to the rise in the index.

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 quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes three actual quarters (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.