Daily Comment

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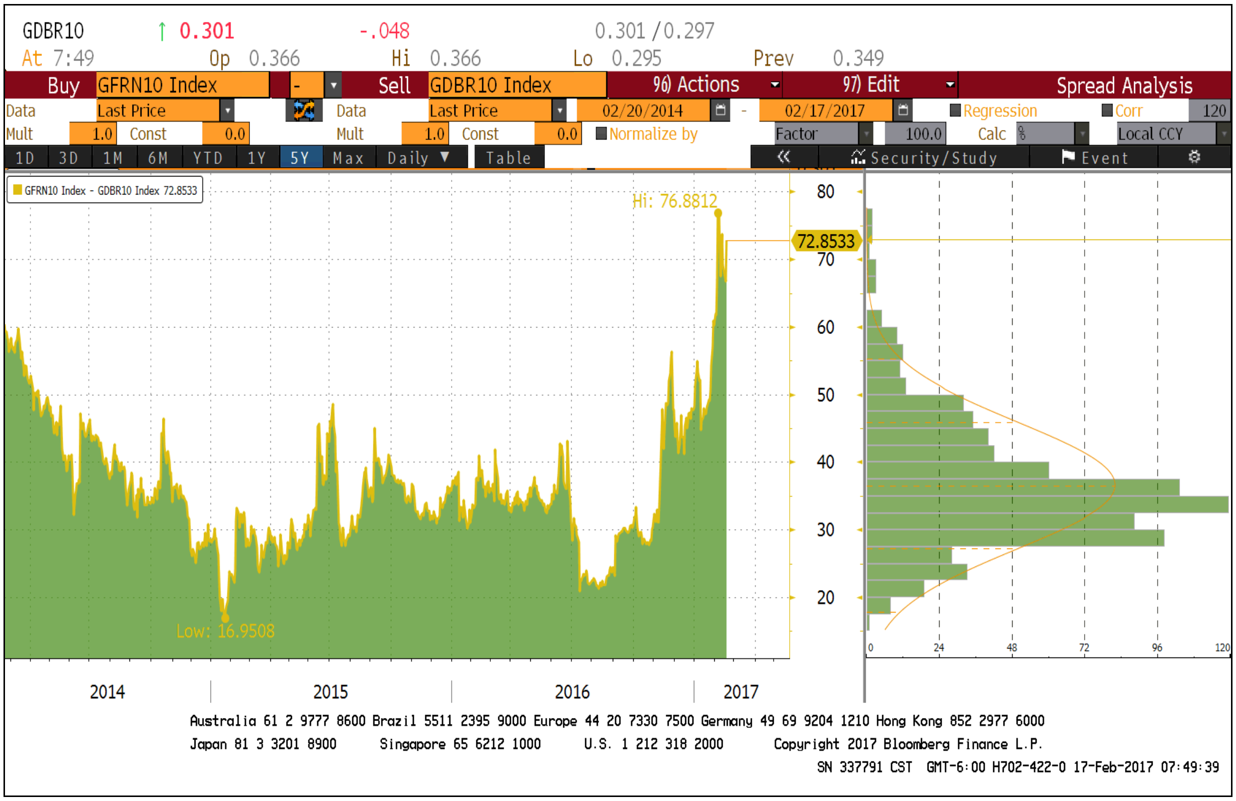
[Posted: February 17, 2017—9:30 AM EST] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.9% and the Shenzhen index also down 0.7%. U.S. equity futures are signaling a lower open. With 402 companies having reported, the S&P 500 Q4 earnings stand at $31.40, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 66.7% of the companies reported earnings above forecast, while 21.6% reported earnings below forecast.

Equity markets are lower this morning. We suspect two issues are weighing on sentiment. First, the two left-wing candidates in France, Socialist Benoit Hamon and hard-left Jean-Luc Melenchon, are holding talks that may lead one of these candidates to drop out of the race. Hamon is the candidate from the established Socialist party, while Melenchon used to be a member of that center-left group but found it too centrist and started his own party. Polls show that neither would make it into the second round runoff, most likely against National Front Leader Le Pen. Latest polls show Le Pen winning 26% of the vote and winning the first round. Emmanuel Macron, the leader of the breakaway party *En Marche!*, is getting 19.5% of the vote, while Republican Party François Fillon is third with 18.5%. Fillon has been hit by a corruption investigation alleging he paid family members to work for him but they did no actual work. Most polls suggest that Le Pen will lose against either Fillon or Macron in the second round.

However, it should be noted that, combined, Melenchon and Hamon are polling at 25%; if either drops out and can sway those supporters to stay with the remaining candidate, Le Pen will be running against a leftist candidate. Given the deep unpopularity of the Socialists, if Hamon is the remaining candidate, Le Pen may very well win. Melenchon may fare better against Le Pen but he is calling for a 100% marginal tax rate on incomes in excess of €360k. That may prove to be unpopular enough to give Le Pen the presidency.

The chart below shows the spread between German and French 10-year sovereigns. The average spread runs around 35 bps (with French rates usually exceeding German rates). The spread has nearly doubled as elections loom. The first round will be held on April 23; if no candidate attains a majority in the first round (and none have since the 5th Republic was formed in 1958), a second round is held between the two top performers. That round would be held on May 7. The polls show that Le Pen's support peaks at 35% to 40% against either Fillon or Macron. However, no polls have been run against the leftist candidates so the markets are justifiably concerned about a Le Pen win if the leftists join forces. Although negotiations do raise this possibility, we suspect that Melenchon and Hamon won't be able to reach an agreement. They have sharp differences and it's difficult to see either stepping down. If they do come to a deal, the risks of a Le Pen win in the second round probably rise.



(Source: Bloomberg)

The other issue weighing on sentiment is that it looks like the Ryan corporate tax reform is failing to gain traction; the sticking point is the border adjustment tax, which is proving to be quite unpopular. Without this provision, it doesn't appear that the tax change would be revenue-neutral unless the cut is inconsequential. We suspect the White House would be more than happy to see deficits but much of the Congressional GOP won't agree with deficit increases. Much of the equity and dollar rally has rested on corporate tax cuts; if these can't get passed, it will be bearish for both equities and the dollar.

U.S. Economic Releases

There were no economics releases prior to the publication of this report. The table below shows the domestic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Leading Index	m/m	jan	0.5%	0.5%	**
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								
New Zealand	BusinessNZ Manufacturing PMI	m/m	jan	51.6	54.5		**	Equity and bond neutral
	Retail Sales	q/q	4q	0.8%	0.9%	1.0%	**	Equity and bond neutral
EUROPE								
Eurozone	Current Account	y/y	dec	47.0 bn	40.5 bn		**	Equity bullish, bond bearish
	Construction Output	y/y	dec	3.2%	0.0%		**	Equity and bond neutral
Italy	Current Account Balance	y/y	dec	5.535 bn	4.64 bn		**	Equity bullish, bond bearish
U.K.	Retail Sales	y/y	jan	1.5%	4.3%	3.4%	**	Equity bearish, bond bullish
	Core Retail Sales	y/y	dec	2.6%	4.9%	3.9%	**	Equity bearish, bond bullish
Russia	PPI	y/y	jan	12.1%	7.4%	9.1%	**	Equity and bond neutral
AMERICAS								
Brazil	Current Account Balance	m/m	jan	-$5.085 bn	-$5.881 bn	-$5.400 bn	**	Equity and bond neutral
	Foreign Direct Investment	m/m	jan	$11.528 bn	15.409 bn	9.4 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)	104	104	0	Up
3-mo T-bill yield (bps)	51	51	0	Neutral
TED spread (bps)	54	52	2	Neutral
U.S. Libor/OIS spread (bps)	72	72	0	Neutral
10-yr T-note (%)	2.42	2.45	-0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	25	25	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	up			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	$55.36	$55.65	-0.52%	Long Liquidation
WTI	$53.13	$53.36	-0.43%	
Natural Gas	$2.86	$2.85	0.07%	
Crack Spread	$11.47	$12.14	-5.52%	
12-mo strip crack	$14.77	$15.18	-2.66%	
Ethanol rack	$1.62	$1.62	-0.07%	
Metals				
Gold	$1,242.24	$1,239.04	0.26%	Uncertainty in equity markets
Silver	$18.03	$18.10	-0.37%	
Copper contract	$271.20	$273.55	-0.86%	
Grains				
Corn contract	$ 378.00	$ 381.00	-0.79%	
Wheat contract	$ 457.00	$ 461.25	-0.92%	
Soybeans contract	$ 1,047.00	$ 1,054.75	-0.73%	
Shipping				
Baltic Dry Freight	710	688	22	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	9.5	3.5	6.0	
Gasoline (mb)	2.8	0.6	2.3	
Distillates (mb)	0.7	0.8	-0.1	
Refinery run rates (%)	-2.30%	0.00%	-2.3%	
Natural gas (bcf)	-114.0	-128.0	14.0	

Weather

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

February 17, 2017

A regular question we are asked by financial advisors and clients is, what is the impact of the Trump presidency on financial markets? The simple response is that we don't know for sure, but a pattern is starting to emerge. And that pattern has to do with the perceptions of Trump's two main constituencies.

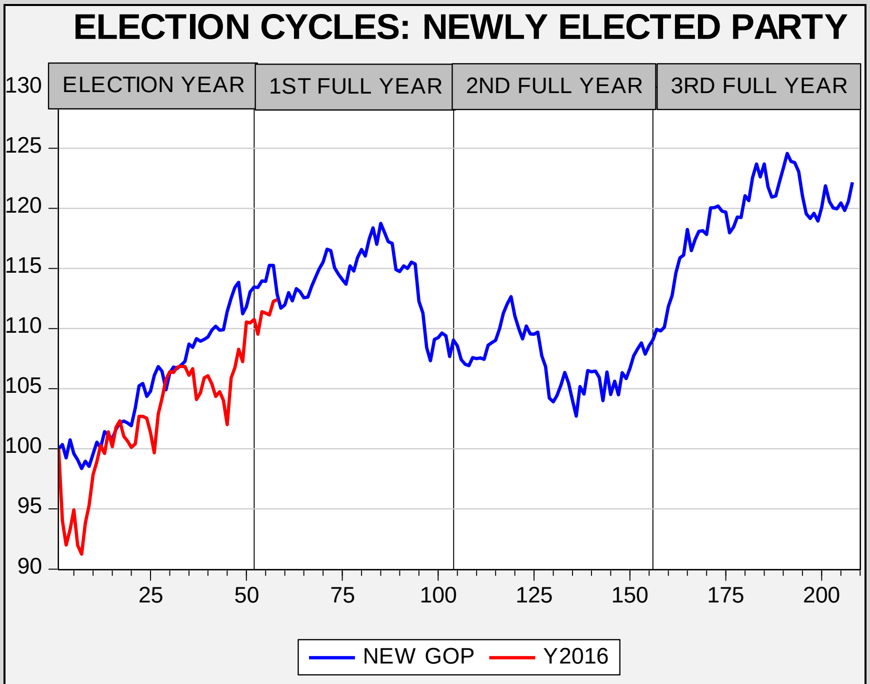
President Trump has two primary constituencies, the right-wing populists (RWP) and the right-wing establishment (RWE). The primary goal of the RWP is to create a surfeit of high paying, moderately skilled jobs. History suggests that these jobs are often created in the manufacturing sector, so policies are being promoted that protect and expand these positions. In general, policies favoring trade protection, immigration restrictions, infrastructure spending and the support of incoming foreign direct investment are being discussed. In addition, protection for entitlements, especially the universal ones (those that are not granted due to means testing or favor a specific group) such as Social Security, Medicare and Disability, are favored. There is little concern for fiscal deficits. The RWE, on the other hand, prefer tax cuts, deregulation, entitlement reform and lax immigration policies. Infrastructure spending is opposed and concern about fiscal deficits is high.

The problem the president faces is that there isn't much overlap between the policy preferences of these two groups. That isn't to say there isn't any overlap. The House GOP is trying to build support for its corporate tax reform by including a border adjustment tax that would leave revenue from exports untaxed while taxing the revenue derived from imports. The border adjustment tax, in theory, would be attractive to the RWP due to its impact on trade. At the same time, it would lift revenue and partially pay for corporate tax cuts. But, for the most part, policies that the RWE want will not be backed by the RWP and vice versa.

So far, equities and the dollar have risen when policies championed by the RWE appear to be advancing. Gold, commodities and Treasuries perform better when the president seems to be supporting the RWP policies. Lately, most of the policy direction seems to be favoring the RWE. This is because more members of the cabinet being approved are coming from the GOP establishment. It is unlikely this pattern will continue indefinitely; we would expect Trump to vacillate between the two groups in order to stay in power.

However, at some point, the financial markets will determine where the president's priorities lie. If it turns out he is truly a populist, inflation expectations will rise, which will likely be bearish for equities and fixed income markets. If the Federal Reserve remains independent, under these conditions, the dollar will rally while commodity prices will suffer. On the other hand, if the U.S. central bank's independence is compromised, commodity prices will rise and the dollar will fall. If Trump turns out to be an establishment figure at heart, equities will perform well, interest rates will rise modestly and the Federal Reserve will remain independent. We would not expect a runaway bull market in any asset class.

Is it possible to know when the financial markets make this determination? In reality, it behooves the president to maintain enough strategic ambiguity to keep both sides on board. But, history does offer some guidance. So far, the S&P 500 Index is tracking the path usually seen with new GOP presidents.



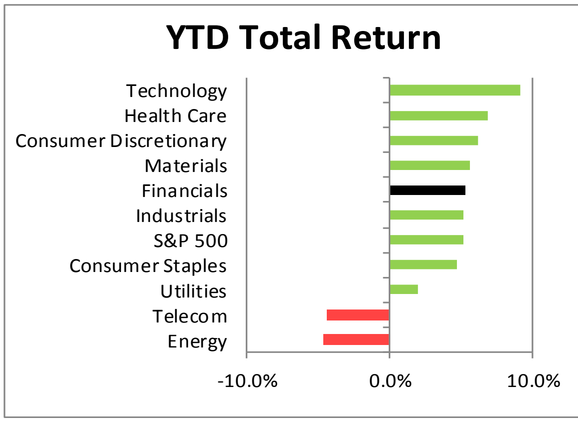
Sources: Bloomberg, CIM

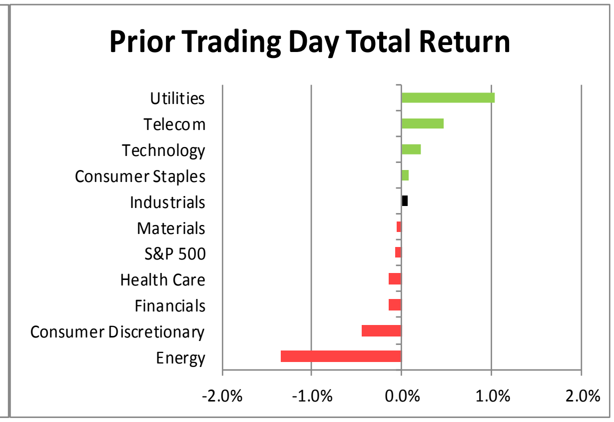
The blue line on this chart takes the average weekly performance of the S&P 500 Index rebased to the first Friday close in the election year of a new Republican president until the next presidential election year. The data begins in 1928. Note that performance for last year and this year mostly follows the historical average pattern. If this situation continues, the S&P 500 Index will reach the 2375-2400 level by late Q3.

The drop seen in the average at the end of the first full year could represent disappointment in the ability of a Republican president to actually deliver the policy changes promised during the election. In other words, a degree of realism develops which leads to a correction in equities. Again, this analysis is simply an average and, if anything, the current president is clearly unique. However, if the financial markets conclude that Trump is mostly a populist, it would not be surprising to see equities pull back. Thus, for now, we remain confident that equity markets will continue to trend higher. This position could be tested later this year.

Data Section

U.S. Equity Markets – (as of 2/16/2017 close)

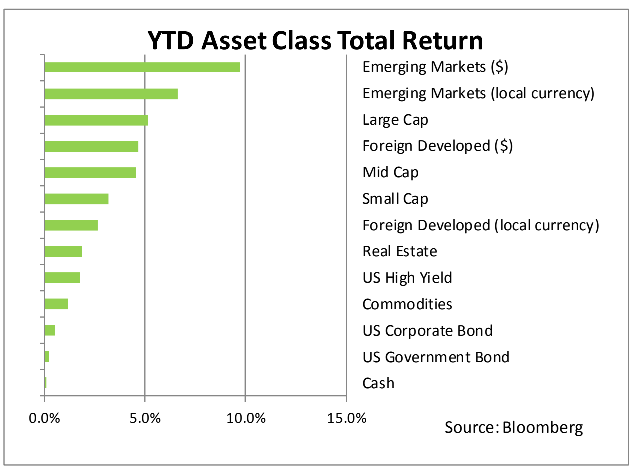




(Source: Bloomberg)

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 2/16/2017 close)

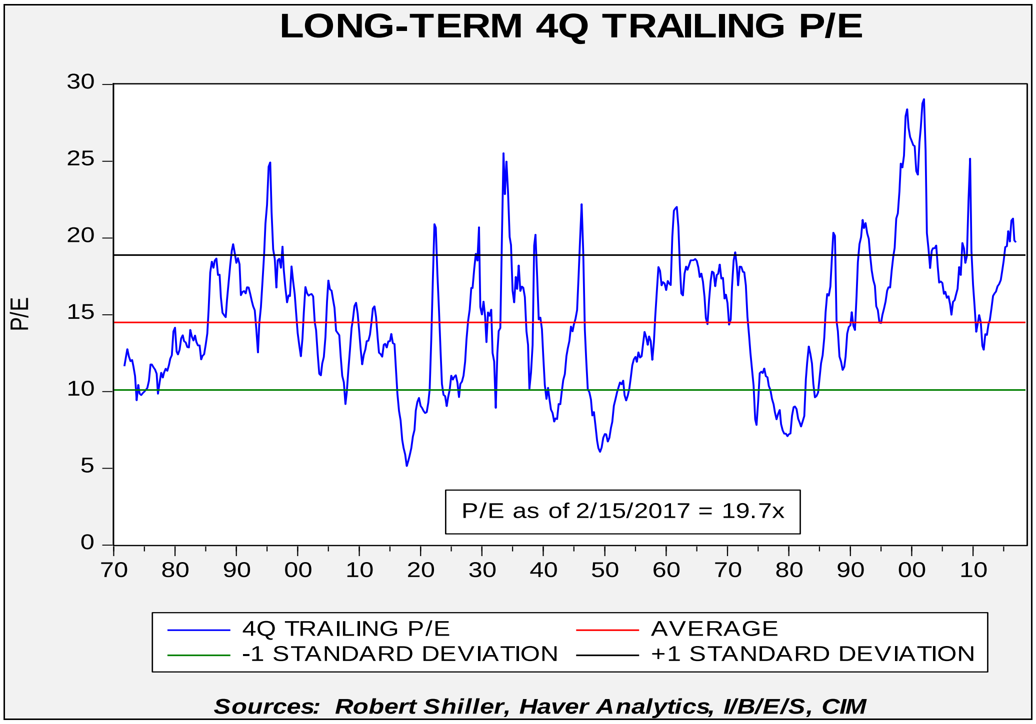


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 16, 2017



Based on our methodology,[1] the current P/E is 19.7x, unchanged from last week. Rising Q4 earnings offset the rise in equity prices, keeping the multiple steady.

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 (Q2 and Q3) and two estimates (Q4, Q1). 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.