Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: February 1, 2017—9:30 AM EST] Global equity markets are up this morning. The EuroStoxx 50 is up 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets are closed today for New Year. U.S. equity futures are signaling a lower open. With 196 companies having reported, the S&P 500 Q4 earnings stand at $31.26, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 64.3% of the companies reported earnings above forecast, while 21.4% reported earnings below forecast.

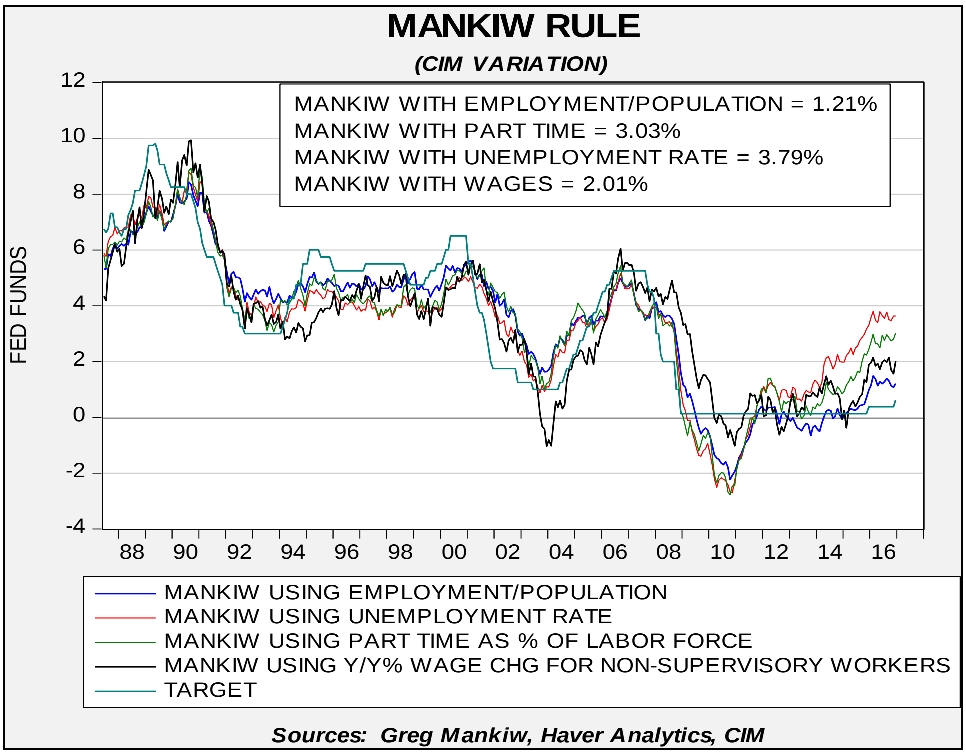
Happy Fed Day! The FOMC completes its first meeting of the year with a new slate of voters.

The Federal Open Market Committee			
Governors		Voter	Stance
	Janet Yellen, Chairman	X	****
	Stanley Fischer, Vice-Chairman	X	***
	Lael Brainard	X	*****
	Jerome Powell	X	***
	Daniel Tarullo	X	****
	Vacant		
	Vacant		
Presidents			
	William Dudley, New York	X	****
	Charles Evans, Chicago	X	*****
	James Bullard, St. Louis		*****
	Esther George, Kansas City		*
	Jeffery Lacker, Richmond		*
	Dennis Lockhart, Atlanta		***
	John Williams, San Francisco		***
	Loretta Mester, Cleveland		**
	Eric Rosengren, Boston		*****
	Patrick Harker, Philadelphia	X	*
	Robert Kaplan, Dallas	X	*
	Kashkari, Minneapolis	X	***
		10	Avg Voter = 3.5
			Avg Member = 3.1

(Sources: FRB, CIM)

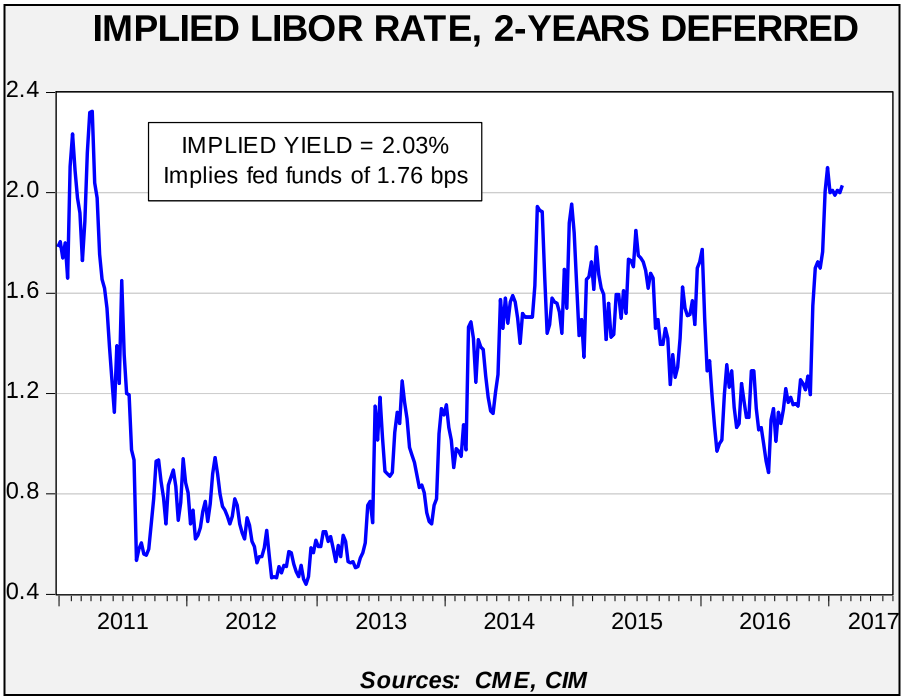
This shows the 2017 voters on the FOMC. The red 'X' represents permanent voters. The 2016 regional bank presidents who won't vote this year are St. Louis FRB President Bullard, Kansas City FRB President George, Cleveland FRB President Mester and Boston FRB President Rosengren. Bullard and Rosengren were very dovish, while George and Mester were hawkish. This year's average is about the same as last year as the dovish Chicago FRB President Evans and moderate Minneapolis FRB President Kashkari join two hawks, Philadelphia FRB President Harker and Dallas FRB President Kaplan.

As a reminder, the Mankiw rule would suggest the Fed needs to raise rates. The Mankiw rule model attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.



Using the unemployment rate, the neutral rate is now 3.79%. Using the employment/population ratio, the neutral rate is 1.21%. Using involuntary part-time employment, the neutral rate is 3.03%. Using wage growth for non-supervisory workers, the neutral rate is 2.01%. We know that the FOMC tends to support Phillips Curve models of the economy, which suggests there is a relationship between wage growth, inflation and unemployment. What we don't know is which of these four models holds the most sway. However, we suspect the wage growth variation might be the most supported; if so, the Fed does need to start moving rates higher.

The implied LIBOR rate from the two-year deferred Eurodollar futures is projecting a 1.76% rate into the future.



The election of President Trump led the markets to reverse policy expectations and rapidly build in rate hikes. For most of last year, this indicator was suggesting that slow economic growth and continued low inflation would lead the Fed to raise rates very slowly; in fact, last July, this indicator was signaling a fed funds of 60 bps two years from now. The interest rate markets expect the new president to boost economic growth and inflation, leading the U.S. central bank to raise rates significantly compared to last summer.

Despite the Fed's statutory independence, it is under the sway of political influence. The administration, as we have recently noted, has been arguing that the dollar is too strong. One of the key components of dollar strength is the divergence in monetary policy between the U.S. and the other major nations' central banks. If Trump can badger Yellen into not raising rates as rapidly or as far as the market expects, the dollar will likely weaken. The risk is that financial markets will begin to build in inflation expectations, which will bring higher rates on long duration assets (which are more sensitive to inflation and less to monetary policy) and could lead to P/E contraction in equities.

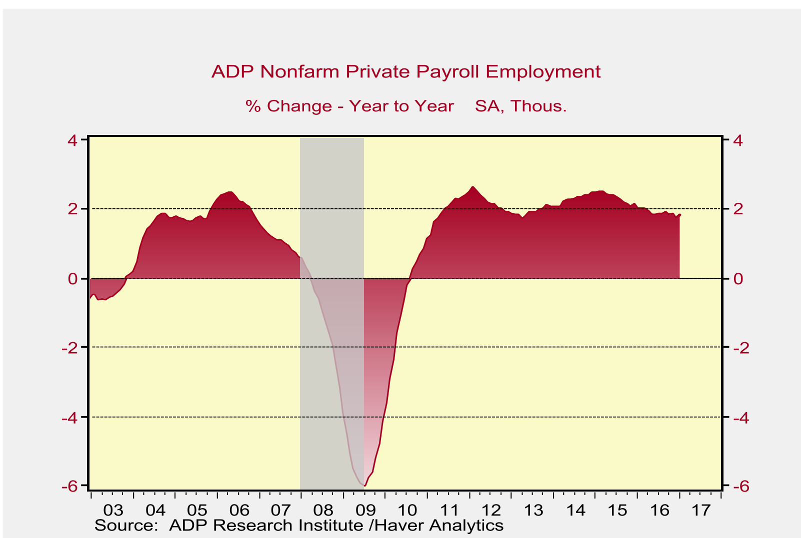
What will Yellen do? Will she cave into what we see as growing pressure on the Fed to be dovish? Or will she press the Fed's independence and move rates higher as the interest rate markets suggest she will? Her history suggests she leans dovish; however, she has publically indicated she opposes fiscal expansion at this stage of the business cycle. It is too early to tell, but one of the stories shaping up for 2017 may be Trump versus Yellen. We might get our first clue today. Although fed funds futures only expect about a 15% chance of a rate hike, we will be closely watching the statement because a hawkish tone could be an indicator that the FOMC is prepared to deal with opposition from the White House on monetary policy. At present, fed funds futures are not expecting a hike this year until May; the odds for March are near 35%. The Fed could tee up a hike for March with a hawkish statement.

We are watching a couple of geopolitical items. First, there has been a notable increase in fighting in eastern Ukraine. We suspect that Putin is testing the West to see if it will react to further encroachment. We don't expect the Trump administration to push back against Russia; any resistance will need to come from Europe. Although western European nations probably won't do much, we do note that Poland has a mutual defense pact with Ukraine and if Poland were to send material support and then get attacked by Russia, it could trigger an Article 5 "collective defense" declaration. Second, the Greek economic and financial crisis is brewing yet again. Greece and its creditors are in negotiations over bailout support. Athens has balked at creditor conditions for the next round of disbursements and the creditor nations, many facing elections this year, are loath to give into Greek demands for relief. PM Tsipras is trying to hold onto a fractious coalition that only holds a five-seat majority. If the government fails, it would mean another European election this year and add to political uncertainty in the EU.

U.S. Economic Releases

Mortgage applications fell by 3.2% from the prior week. Purchases and refinancing are down 5.6% and 1.4%, respectively. The 30-year fixed rate mortgage increased by 4 bps from 4.35% to 4.39%.

The ADP employment change came in above expectations at 246k compared to the forecast of 168k. The prior report was revised downward from 153k to 151k. An increase in employment supports the idea that the labor markets remain strong. The chart below shows the annual change of the ADP private payroll.



The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
9:45	Markit US Manufacturing	m/m	jan	55.0	54.6	**
10:00	ISM Prices Paid	m/m	jan	112.8	113.7	**
10:00	ISM New Orders	m/m	jan		126.1	**
10:00	ISM emplotment	m/m	jan		105.5	**
10:00	Construction Spending	m/m	dec	0.2%	0.9%	**
14:00	FOMC Rate Decision (Upper Bound)		1-Feb	0.75%	0.75%	***
14:00	FOMC Rate Decision (Lower Bound)		1-Feb	0.50%	0.50%	***
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								
China	Non-manufacturing PMI	y/y	jan	54.6	54.5		**	Equity and bond neutral
	Manufacturing PMI	y/y	jan	51.3	51.4	51.2	**	Equity and bond neutral
Japan	Nikkei Japan PMI	y/y	jan	52.7	52.8		**	Equity and bond neutral
	Vehicle Production	y/y	jan	8.6%	10.8%		**	Equity and bond neutral
India	GDP annual estimate	y/y	2016	7.9%	7.2%		***	Equity bullish, bond bearish
	Nikkei India PMI	y/y	jan	50.4	49.6		**	Equity bullish, bond bearish
Australia	AiG Performance of Mfg	y/y	jan	51.4	55.4		**	Equity bearish, bond bullish
	Corelogic House Px	m/m	jan	0.7%	1.4%		**	Equity bearish, bond bullish
	Commodity Index	y/y	4q	120.9	116.8		**	Equity bullish, bond bearish
New Zealand	QV House Prices	m/m	jan	13.5%	12.5%		**	Equity and bond neutral
	Unemployment Rate	m/m	4q	5.2%	4.9%	4.8%	**	Equity and bond neutral
	Employment Change	m/m	4q	5.8%	6.1%	6.1%	**	Equity and bond neutral
	Participation Rate	y/y	4q	70.5%	70.1%	70.2%	**	Equity and bond neutral
	Average Hourly Earnings	q/q	4q	-0.3%	0.3%	0.6%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Markit Eurozone Manufacuring	y/y	jan	55.2	55.1	55.1	**	Equity and bond neutral
Germany	Germany Manufacturing	y/y	4q	56.4	56.5	56.5	**	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing	y/y	dec	53.0	53.3	53.2	***	Equity and bond neutral
France	Markit France Manufacturing	y/y	jan	53.6	53.4	53.4	**	Equity and bond neutral
U.K.	Nationawide House	m/m	jan	0.2%	0.0%	0.8%	**	Equity bearish, bond bullish
	Markit/CIPS PMI Manufacturing	m/m	jan	55.9	56.1	55.1	***	Equity and bond neutral
Switzerland	PMI Manufacturing	y/y	jan	54.6	56.0	55.9	***	Equity bearish, bond bullish
Russia	Markit Russia PMI	y/y	jan	54.7	53.7	53.1	**	Equity and bond neutral
	CPI Weekly	y/y	jan	0.6%	0.5%		***	Equity and bond neutral
	Annual GDP	y/y	jan	-0.2%	-3.7%	-0.5%	***	Equity and bond neutral
AMERICAS								
Mexico	GDP	y/y	4q	2.2%	2.2%	2.0%	***	Equity and bond neutral
	Net Outstanding Loans	m/m	dec	3.625 tn	3.613 bn		**	Equity and bond neutral
Canada	GDP	y/y	nov	1.6%	1.5%	1.4%	**	Equity and bond neutral
	Industrial Product Price	m/m	dec	0.4%	0.3%	0.5%	**	Equity and bond neutral
Brazil	Industrial Production	m/m	dec	-0.1%	-1.1%	0.6%	**	Equity bearish, bond bullish
	Markit Brazil PMI	m/m	dec	44.0	45.2		**	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)	103	104	-1	Up
3-mo T-bill yield (bps)	51	51	0	Neutral
TED spread (bps)	53	53	0	Neutral
U.S. Libor/OIS spread (bps)	69	69	0	Neutral
10-yr T-note (%)	2.47	2.45	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	29	29	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Neutral
yen	down			Down
pound	down			Down
franc	flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Upper Bound)		0.75%	0.75%	On forecast
FOMC Rate Decision (Lower Bound)		0.50%	0.50%	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	$56.02	$55.58	0.79%	Short Covering
WTI	$53.17	$52.81	0.68%	
Natural Gas	$3.19	$3.12	2.31%	
Crack Spread	$13.84	$13.42	3.11%	
12-mo strip crack	$15.44	$15.24	1.28%	
Ethanol rack	$1.57	$1.57	-0.01%	
Metals				
Gold	$1,211.10	$1,210.72	0.03%	Inflation Expectations
Silver	$17.60	$17.56	0.23%	
Copper contract	$271.15	$272.75	-0.59%	
Grains				
Corn contract	$ 358.50	$ 359.75	-0.35%	
Wheat contract	$ 417.75	$ 420.75	-0.71%	
Soybeans contract	$ 1,018.75	$ 1,024.50	-0.56%	
Shipping				
Baltic Dry Freight	800	816	-16	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		1.5		
Distillates (mb)		-0.5		
Refinery run rates (%)		-0.10%		
Natural gas (bcf)		-77.0		

Weather

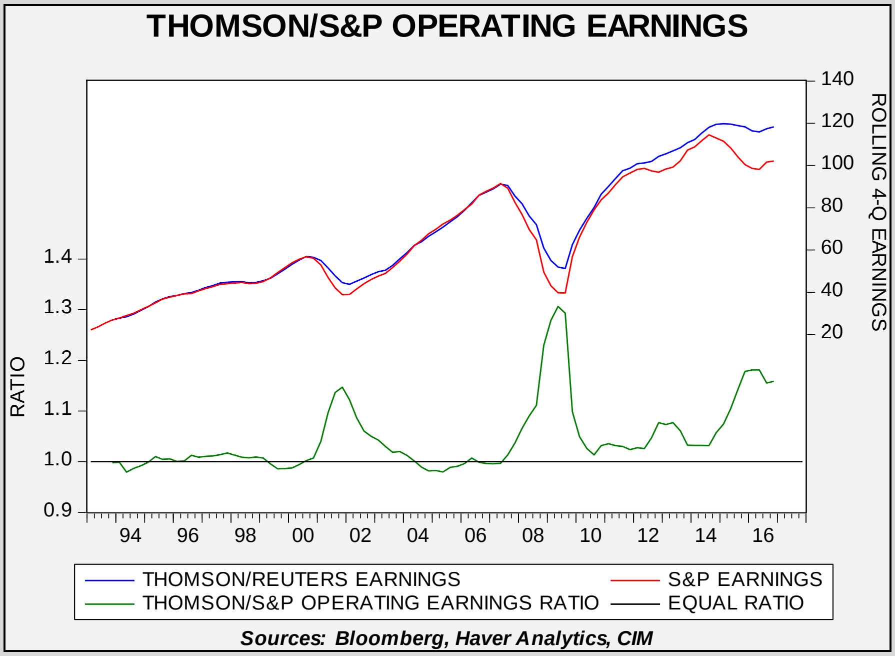
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country except the southwestern region.

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.

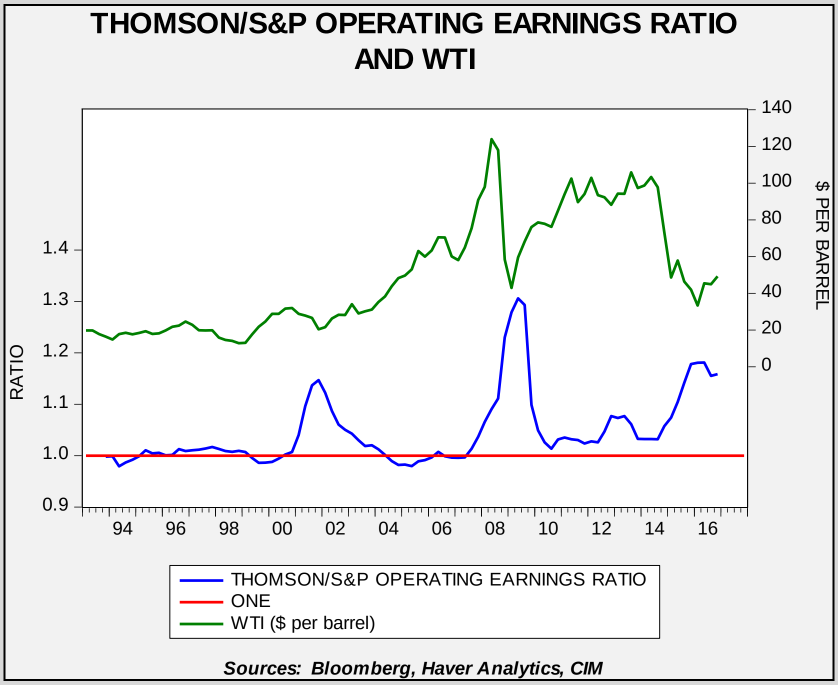
January 27, 2017

The consensus estimate for Q4 2016 S&P 500 operating earnings growth is 3.2%, which translates into a forecast of $118.35 per share for the S&P 500, using Thomson/Reuters data. Using a similar growth rate, the Standard and Poor's calculation of operating earnings generates annual earnings of $102.16. Simply put, these two sources currently have a rather wide divergence.



This chart shows the two series from 1994, with the lower line showing their ratio. The official explanation for the divergence is that S&P earnings are closer to Generally Accepted Accounting Principles (GAAP), which usually don't include "unusual items." The Thomson/Reuters earnings data excludes more of these non-recurring costs, resulting in higher operating earnings.

What concerns us about the current divergence is that two of the past divergences occurred during recessions. Thus, it is possible that the recent event is signaling that a downturn could be coming. However, we have also noted that another factor may help explain the widening—oil prices.



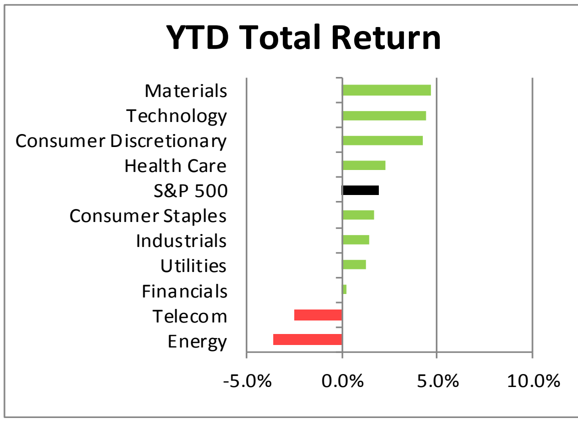
This chart overlays the ratio of the two earnings series with oil prices. Note that the three major divergences coincide with significant declines in oil prices. It is not unusual for recessions to bring lower oil prices; however, oil prices can fall for other reasons, as we have seen since 2014. This means that with the recovery in oil prices, we could very well see a narrowing of the ratio between the two series.

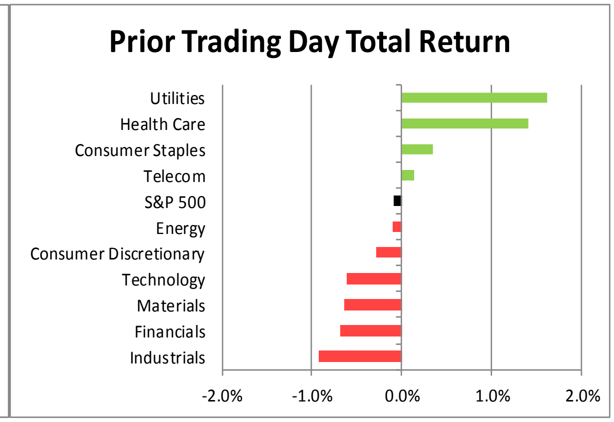
To the extent that the markets usually focus on the Thomson/Reuters data, a narrowing of the ratio won't matter too much. The growth in earnings as reported by S&P could be quite robust next year whereas the growth already estimated by I/B/E/S[1] of about 10.6%, while impressive, won't be as strong as S&P if the ratio approaches one. That would entail a greater than 29% rise in what S&P reports. Still, convergence of the two series does give us more confidence in the veracity of the earnings data.

[1] A part of Thomson/Reuters.

Data Section

U.S. Equity Markets – (as of 1/31/2017 close)

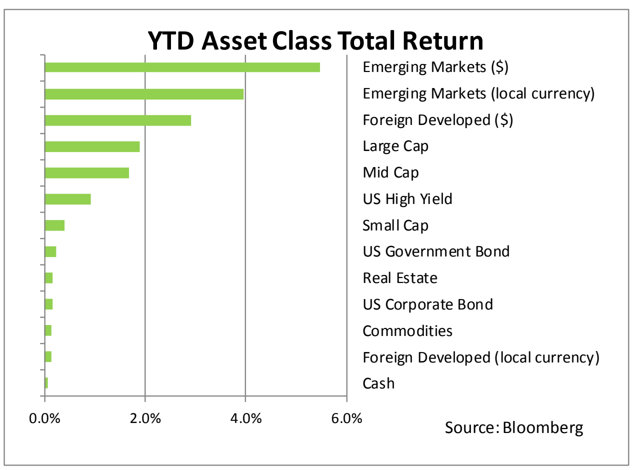




(Source: Bloomberg)

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 1/31/2017 close)

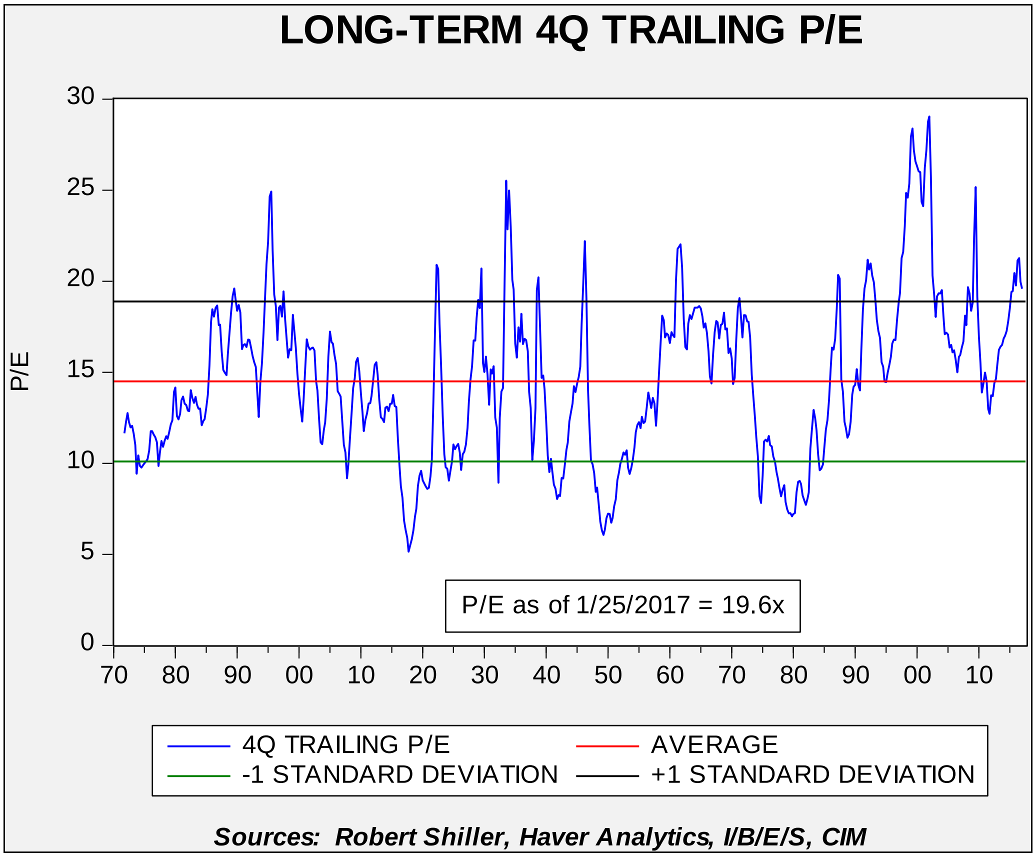


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 26, 2017



Based on our methodology,[2] the current P/E is 19.6x, unchanged from our last report. Rising equity values were offset by improving earnings.

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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[2] 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.