Daily Comment

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

[Posted: February 21, 2017—9:30 AM EST] Global equity markets are flat to higher this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed unchanged from the prior close. Chinese markets were up, with the Shanghai composite up 0.4% and the Shenzhen index also up 1.0%. U.S. equity futures are signaling a higher open. With 410 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, 66.6% of the companies reported earnings above forecast, while 21.5% reported earnings below forecast.

Even with a three-day holiday weekend to work with, there isn't a ton of news this morning. The president did appoint a new National Security Director and the pick is being well received. European and Asian PMI data (see below) generally came in above the expansion line of 50 and above forecast. Equities remain higher; the dollar is up, gold and Treasuries are lower and oil prices are stronger.

Although Greece was facing a deadline yesterday, the Eurozone blinked and agreed to extend talks for an adjustment in bailout payments. In return for lowering payments from Greece, the Eurozone wants legislation to enforce structural economic reforms. The good news here is that the Eurozone has decided not to foster a crisis in a politically uncertain year. However, this agreement is really more of "delay and pray" by creditors. The simple truth is that Greece isn't able or willing to pay; creditors must either negotiate the workout or consider other forms of collateral capture (in the 19th century, invasion might have been an option).

French polls show that National Front Leader Le Pen is gaining momentum. Polls continue to show she will win the first round and lose the second but, given how poorly the polling industry performed in the U.K. and U.S., we still think that a Le Pen win in May isn't out of the question. On this news, French bond yields rose relative to Germany.

Bill Gates made headlines over the weekend with a provocative interview in *Quartz*[1] in which he recommended that firms that automate should pay a tax for the jobs they eliminate. Although such proposals aren't new, this coming from one of the "godfathers" of the tech revolution is news and suggests that Silicon Valley may be realizing that the unfettered introduction of new technology into the economy may have negative effects that need to be addressed. Essentially, a "robot tax" is a tax on capital. It would be quite difficult to create a tax that would have a positive effect on fiscal revenue and at the same time not severely undermine investment. Still, it isn't hard to see that this tax would make automation more expensive and may lead some firms

[1] https://qz.com/911968/bill-gates-the-robot-that-takes-your-job-should-pay-taxes/?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam

to simply add people. We will be watching this idea to see if it gains any traction. Although the stories aren't directly related, the *NYT*[2] has a long read on how technology is reducing the number of workers needed in oil exploration and drilling. The reduction of jobs in this area due to the expansion of technology could be thwarted if a tax is implemented on the jobs lost through automation.

Finally, we have been watching China's capital flight for a while now.[3] Due to a combination of declining investment opportunities, General Secretary Xi's campaign against corruption, environmental degradation and the desire for political freedom, wealthy Chinese citizens have been steadily moving money out of China. Much of it has found its way into U.S. and European real estate, although we are seeing investment broaden. Capital flight has caused a steady decline in foreign reserves and prompted the government to tighten restrictions on foreign investment. Reuters is reporting that Chinese conglomerate Dalian Wanda's purchase of Dick Clark Productions is on hold because the firm can't get permission to move $1.0 bn out of the country to consummate the deal. This would be the largest transaction so far that has failed due to Chinese investment restrictions and may dampen other investment areas in the West, mostly real estate.

U.S. Economic Releases

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	feb	55.3	55.0	**
9:45	Markit US Services PMI	m/m	feb	55.8	55.6	**
9:45	Markit US Composite PMI	m/m	feb		55.8	**
Fed speakers or events						
13:00	Patrick Harker Speaks on Economic Outlook	President of the Federal Reserve Bank of Philadelphia				
13:00	John Williams speaks to students in Boise, Idaho	President of the Federal Reserve Bank of San Francisco				

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.

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[2] https://www.nytimes.com/2017/02/19/business/energy-environment/oil-jobs-technology.html?emc=edit_ee_20170220&nl=todaysheadlines-europe&nlid=5677267

[3] See WGR, 7/16/2012, The Mystery of Chinese Capital Flight.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Trade Balance	y/y	jan	-10869 bn	641.4 bn	-625.8	**	Equity bearish, bond bullish
	Exports	y/y	jan	1.3%	5.4%	5.0%	**	Equity bearish, bond bullish
	Imports	y/y	jan	8.6%	-2.6%	4.8%	**	Equity bearish, bond bullish
	Nikkei Japan PMI Mfg	y/y	jan	53.5	52.7		**	Equity and bond neutral
	All Industry Activity Index	y/y	jan	-0.3%	0.3%	-0.2%	**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	jan	113.7	116.4		**	Equity and bond neutral
New Zealand	PPI Input	y/y	jan	1.0%	1.5%		**	Equity and bond neutral
	PPI Output	m/m	jan	1.5%	1.0%		**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	y/y	dec	-6.2	-4.9	-4.9	**	Equity bearish, bond bullish
	Markit Eurozone Manufacturing	y/y	jan	55.5	55.2	55.0	**	Equity and bond neutral
	Markit Eurozone Services	y/y	jan	55.6	53.7	53.7	**	Equity and bond neutral
	Markit Eurozone Composite	y/y	jan	56.0	54.4	54.3	**	Equity and bond neutral
Germany	PPI	y/y	jan	2.4%	2.0%	1.0%	**	Equity and bond neutral
	Markit/BME Germany Manufacturing	y/y	jan	57.0	56.4	56.0	**	Equity bullish, bond bearish
	Markit Germany Services	y/y	jan	54.4	53.4	53.6	**	Equity and bond neutral
	Markit/BME Germany Composite	y/y	jan	56.1	54.8	54.8	**	Equity bullish, bond bearish
France	CPI	y/y	jan	1.3%	1.4%	1.4%	**	Equity and bond neutral
	Markit France Manufacturing PMI	y/y	feb	52.3	53.6	53.5	**	Equity and bond neutral
	Markit France Services PMI	y/y	feb	56.7	54.1	53.9	**	Equity bullish, bond bearish
	Markit France Composite PMI	y/y	feb	56.2	54.1	53.8	**	Equity bullish, bond bearish
Switzerland	Trade Balance	m/m	jan	4.73 bn	2.72 bn		**	Equity bullish, bond bearish
	Exports	m/m	jan	-4.0%	9.9%		**	Equity and bond neutral
	Imports	m/m	jan	-5.3%	-0.8%		**	Equity and bond neutral
Russia	Industrial Production	y/y	jan	2.3%	0.2%	3.0%	***	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)	105	106	-1	Up
3-mo T-bill yield (bps)	51	51	0	Neutral
TED spread (bps)	55	55	0	Neutral
U.S. Libor/OIS spread (bps)	72	71	1	Neutral
10-yr T-note (%)	2.45	2.42	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	26	26	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			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	$57.00	$56.18	1.46%	Higher than expected compliance with output cuts
WTI	$54.25	$53.40	1.59%	
Natural Gas	$2.74	$2.83	-3.35%	
Crack Spread	$11.53	$11.57	-0.31%	
12-mo strip crack	$15.03	$14.99	0.21%	
Ethanol rack	$1.61	$1.61	0.02%	
Metals				
Gold	$1,230.77	$1,238.47	-0.62%	Stronger dollar
Silver	$17.94	$18.05	-0.65%	
Copper contract	$275.65	$272.00	1.34%	
Grains				
Corn contract	$ 376.50	$ 375.50	0.27%	
Wheat contract	$ 453.75	$ 455.50	-0.38%	
Soybeans contract	$ 1,048.00	$ 1,043.25	0.46%	
Shipping				
Baltic Dry Freight	757	741	16	

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.

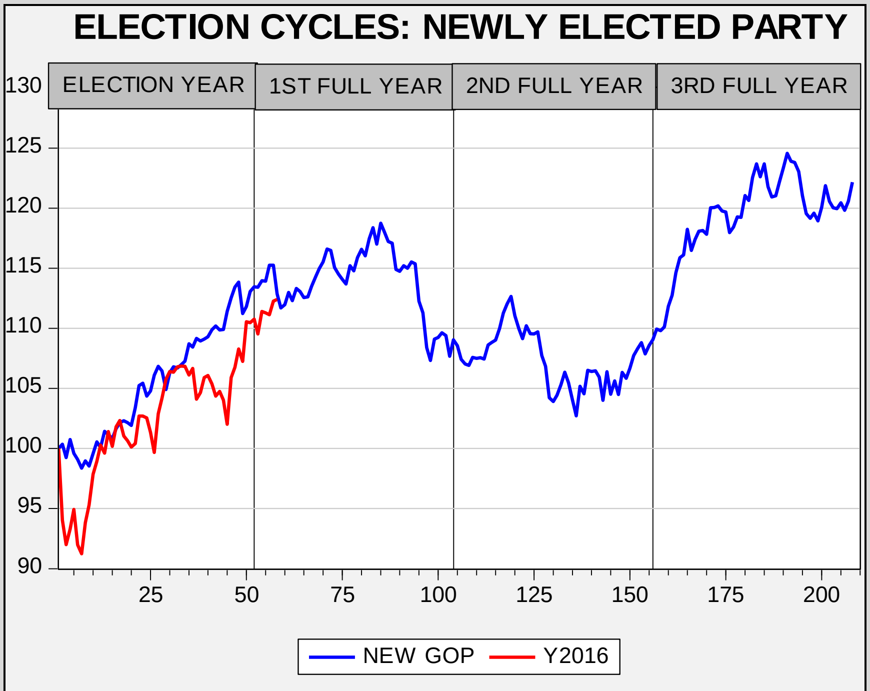
President Trump has two primary constituencies, the right-wing populists (RWP) and the right-wing establishment (RWE). The primary goal of the RWP is to create a surfeit of high paying, moderately skilled jobs. History suggests that these jobs are often created in the manufacturing sector, so policies 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.



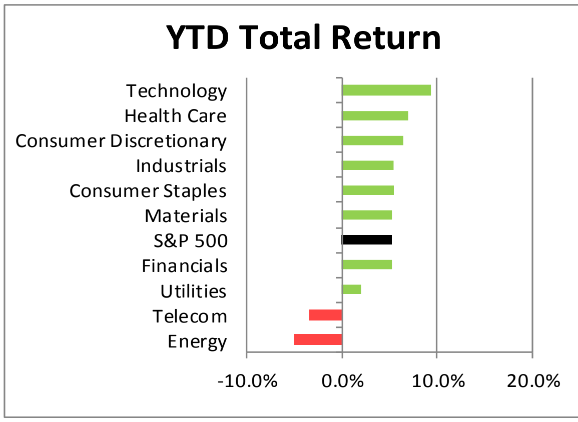
Sources: Bloomberg, CIM

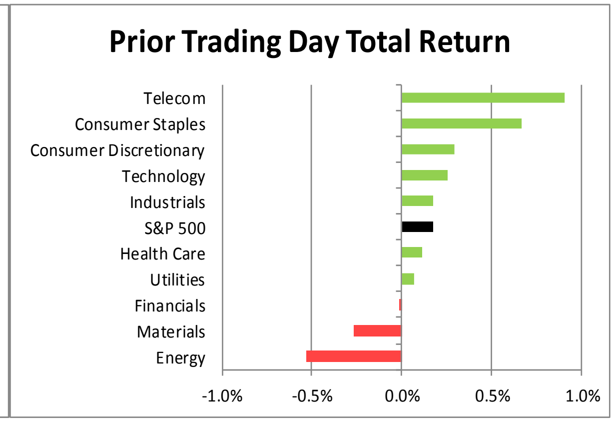
The blue line on this chart takes the average weekly performance of the S&P 500 Index rebased to the first Friday close in the election year of a new Republican president until the next presidential election year. The data begins in 1928. Note that performance for last year and this year mostly follows 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 2/17/2017 close)

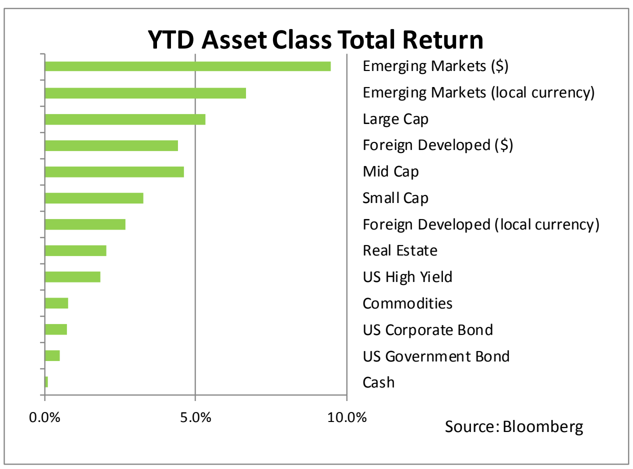




(Source: Bloomberg)

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 2/17/2017 close)

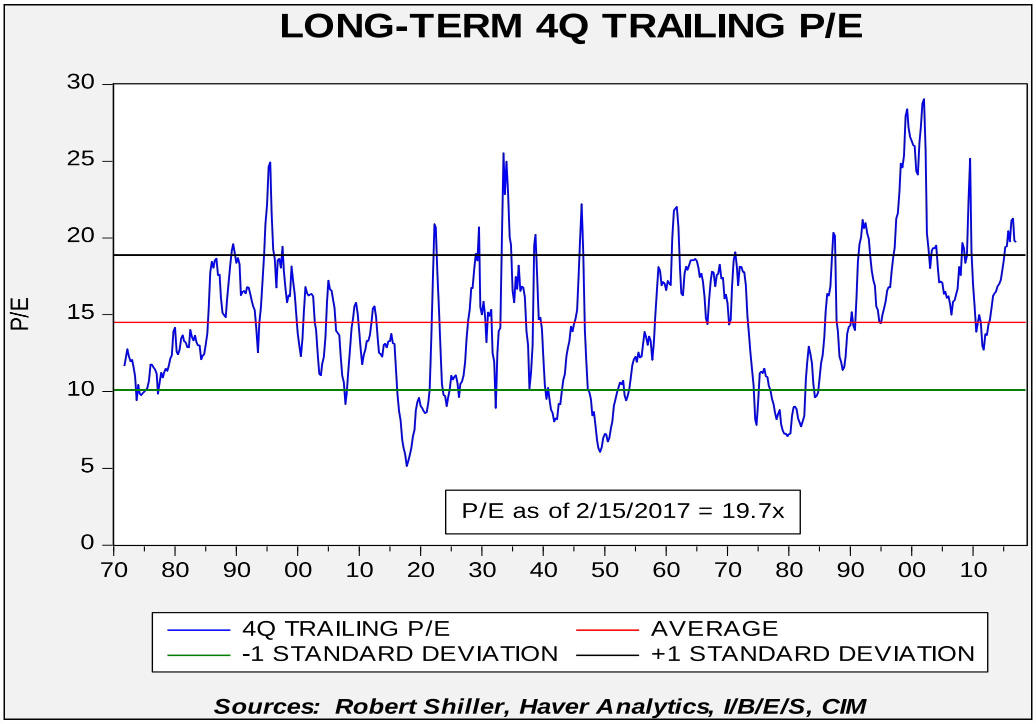


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[4] 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.

[4] 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.