Daily Comment

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

[Posted: February 6, 2017—9:30 AM EST] 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 down 1.0% from the prior close. Chinese markets were up, with the Shanghai composite moving higher by 0.5% and the Shenzhen index higher by 0.9%. U.S. equity futures are signaling a lower open. With 274 companies having reported, the S&P 500 Q4 earnings stand at $31.55, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 66.4% of the companies reported earnings above forecast, while 20.8% reported earnings below forecast.

It was a mostly quiet weekend, at least quiet based on the standards of the new administration. Super Bowl weekend has become something of a national holiday in the U.S. and last night's game was one for the ages. So, even with injunctions and tweets, most of the focus was on the game and the caloric treats that accompany.[1]

Still, there were some articles of interest. One of the key political battles we have been watching is what we have framed as the "Ryan v. Bannon" match. Ryan represents the traditional GOP positions favoring low tax rates, balanced budgets (which, by arithmetic, require cuts in government spending), free trade, globalization and deregulation. Bannon represents the right-wing populists who favor deglobalization, including immigration and trade restrictions, along with defense and infrastructure spending, with little to no regard for deficits.

This battle will have numerous iterations, one of which surrounds corporate tax reform. The Ryan wing wants to cut the highest marginal rate and allow for all investment to be deducted from taxable revenue (ending depreciation) and expand the base of the tax by ending the deduction on interest payments. However, the key revenue offset comes from a "border adjustment," which would tax imports but leave export revenue untaxed.

This border adjustment is complicated and fraught with uncertainty. If it works as planned, the obvious lift in import prices would be offset by a stronger dollar. Over time, the adjustment would give an incentive for firms (foreign and domestic) to source investment and production in the U.S., which would boost U.S. employment but also likely lead to retaliation from foreign nations. The Tax Policy Center estimates that by 2026 the net effect of corporate tax reform will reduce tax revenue by $890.7 bn; if the border adjustment isn't included, this number rises to $2.07 trillion.[2] For establishment members of the GOP, the rise in deficits is unacceptable.

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[1] At the O'Grady household, it was flatiron steak tacos with red mole sauce; white chocolate cake for dessert.
[2] http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000923-An-%20Analysis-of-the-House-GOP-Tax-Plan.pdf

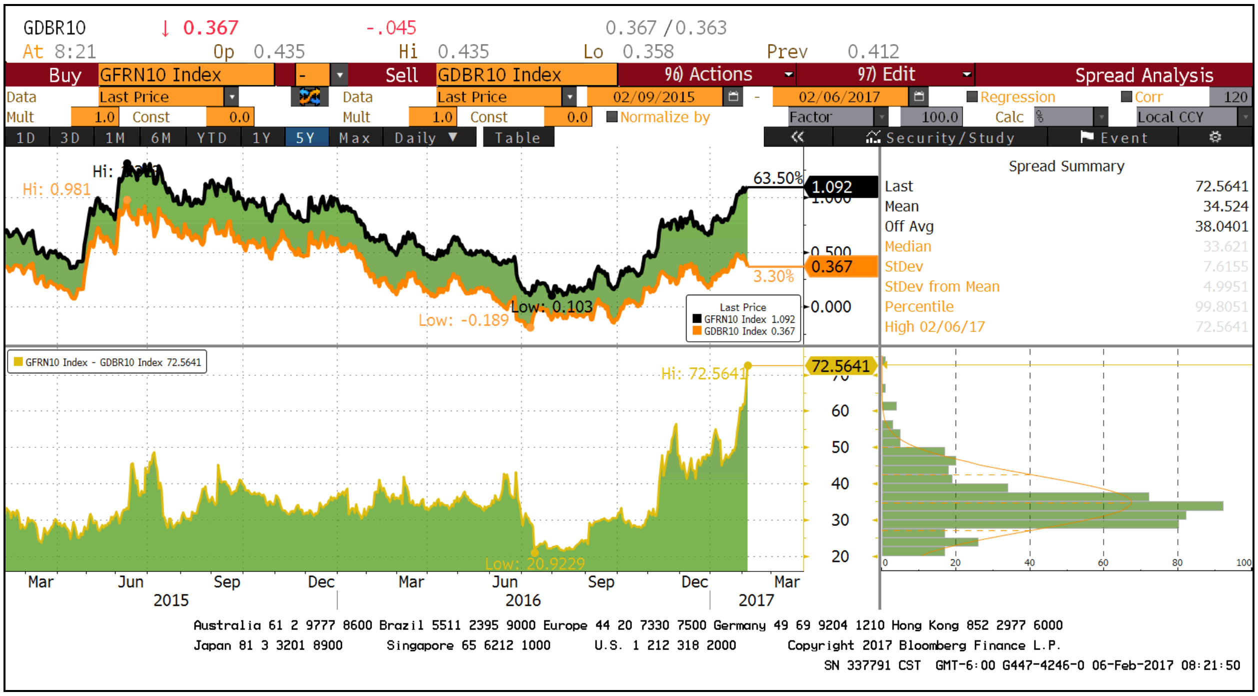
However, President Trump has already indicated he is less concerned about the deficit, suggesting that defense spending alone should rise regardless of tax revenue. He has also vacillated about the border adjustment; on the one hand, if it brings investment into the U.S., it would be favorable. On the other, it does reduce his flexibility to unilaterally impose trade barriers on nations he feels aren't fairly trading with the U.S. We note Reuters is reporting that Kevin Brady, the head of the House Ways and Means Committee, is suggesting he is willing to make adjustments to the program. Once this horse trading starts, the whole purpose of the tax reform, which is to lower the rate and broaden the base, becomes a mere tax cut, which would lower the rate as exceptions are made to the border adjustment.

Our base expectation is that President Trump will need to placate both the GOP establishment and the populists to succeed. This involves doing two things, finding common ground between the factions and figuring out the priorities of each side. Thus, a trade of immigration reform for corporate tax reform that is less revenue-negative might work. How Trump manages these competing interests will, to some extent, define his administration. One thing we do expect, however, is that deficits will likely rise. We still expect both defense and infrastructure spending to increase over the next four years.

Other interesting news…Germany's Finance Minister Wolfgang Schäuble indicated that the EUR is too weak for the German economy and blamed the ECB for this weakness. As we have noted recently, we would tend to agree with this assessment. However, Schäuble's complaints are a bit disingenuous. It's true that Germany doesn't control forex policy; that mandate does reside with the ECB. However, Germany's saving and investment policies lead to large trade surpluses and low inflation, which would lead to a stronger currency if the D-mark still existed. One way Germany could address the overly weak EUR would be to boost its fiscal spending and raise inflation, addressing the currency distortion.

PM May of the U.K. may be facing a revolt within her own party as a group of Tory MPs broke rank and criticized her strategy before parliamentary votes for Brexit. It is still unlikely that Parliament will reverse Brexit but, without solid support from her party, her bill to exit the EU might become larded with amendments and could lead to a hard Brexit without any trade deal.

Marine Le Pen has launched her campaign for president. According to reports, she is following the Trump model, suggesting the nation is under attack from the EU and foreign influences that aim to undermine the French system and its economy. Current polls suggest she will reach the runoff stage (the French electoral system requires a majority; if one does not emerge in the first round, a second round is held between the top two vote winners from the first round). Due to scandal and disarray, the conservatives are falling in the polls and thus a populist win in France is a growing possibility. The chart below shows the German and French 10-year sovereigns. Note the spread is widening as French yields rise relative to Germany on worries about a populist president in France.



(Source: Bloomberg)

U.S. Economic Releases

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
16:30	Patrick Harker Speaks on New Jersey on Economic Outlook	President of the Federal Reserve Bank of Philadelphia

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	Caixin China PMI Composite	y/y	jan	52.2	53.5		**	Equity bearish, bond bullish
	Caixin China PMI Services	y/y	jan	53.1	53.4		**	Equity and bond neutral
Japan	Labor Cash Earnings	y/y	jan	0.1%	0.2%	0.4%	**	Equity and bond neutral
	Real Cash Earnings	y/y	jan	-0.4%	-0.2%		**	Equity and bond neutral
Australia	Melbourne Institute Inflation	y/y	jan	2.1%	1.8%		**	Equity and bond neutral
	Retail Sales Ex Inflation	q/q	jan	0.9%	-0.1%	0.9%	**	Equity and bond neutral
	ANZ Job Advertisements	m/m	jan	4.0%	-1.9%		**	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	y/y	feb	17.4	18.2	16.8	**	Equity and bond neutral
Germany	Factory Orders WDA	y/y	dec	8.1%	3.0%	4.2%	**	Equity and bond neutral
	Markit Germany Construction PMI	y/y	jan	52.0	54.9		**	Equity and bond neutral
	Markit Germany Retail PMI	y/y	jan	50.3	52.0		**	Equity and bond neutral
France	Markit France Retail PMI	y/y	jan	53.1	50.4		**	Equity and bond neutral
Italy	Markit Italy Retail PMI	y/y	jan	45.6	47.9		**	Equity bearish, bond bullish
U.K.	New Car Registrations	y/y	jan	2.9%	-1.1%		**	Equity and bond neutral
Switzerland	Total Sight Deposits	y/y	jan	535.2 bn	532.8 bn		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	jan	463.0 bn	466.7 bn		**	Equity and bond neutral
Russia	CPI	y/y	jan	5.0%	5.4%	5.1%	***	Equity and bond neutral
	CPI core	y/y	jan	5.5%	6.0%	5.6%	***	Equity and bond neutral
AMERICAS								
Brazil	Vehicle Production Anfavea	m/m	jan	174064	200887		**	Equity and bond neutral
	Vehicle Sales Anfavea	m/m	jan	147219	204329		**	Equity and bond neutral
	Vehicle Exports Anfavea	m/m	jan	37189	62941		**	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	103	0	Up
3-mo T-bill yield (bps)	49	49	0	Neutral
TED spread (bps)	54	54	0	Neutral
U.S. Libor/OIS spread (bps)	68	68	0	Neutral
10-yr T-note (%)	2.45	2.47	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	28	28	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	$56.84	$56.81	0.05%	Short Covering
WTI	$53.95	$53.83	0.22%	
Natural Gas	$3.06	$3.06	-0.16%	
Crack Spread	$13.31	$12.99	2.52%	
12-mo strip crack	$15.38	$15.21	1.13%	
Ethanol rack	$1.58	$1.58	0.11%	
Metals				
Gold	$1,226.33	$1,220.30	0.49%	Inflation expectations
Silver	$17.61	$17.51	0.56%	
Copper contract	$263.00	$261.60	0.54%	
Grains				
Corn contract	$ 366.75	$ 365.25	0.41%	
Wheat contract	$ 430.75	$ 430.25	0.12%	
Soybeans contract	$ 1,037.25	$ 1,027.00	1.00%	
Shipping				
Baltic Dry Freight	752	770	-18	

Weather

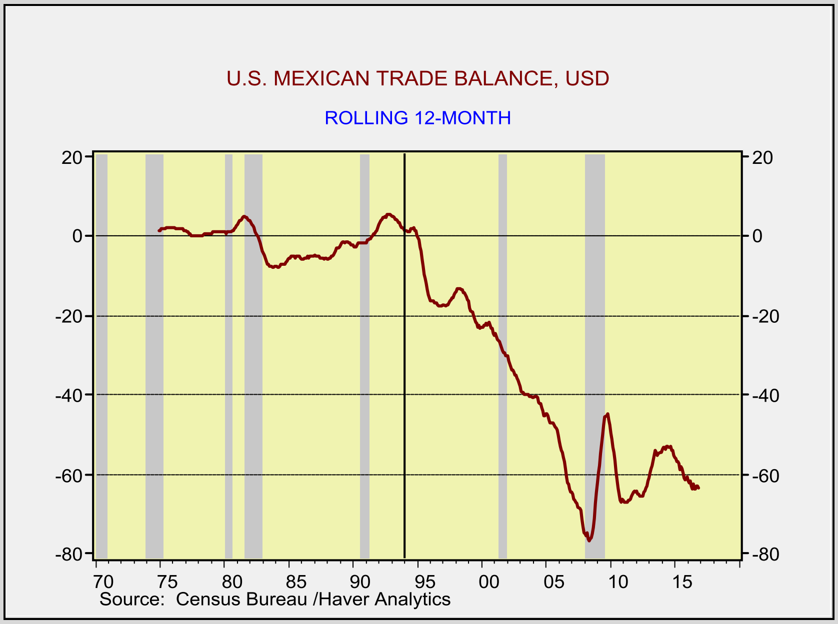
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is not expected for most of the country.

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.

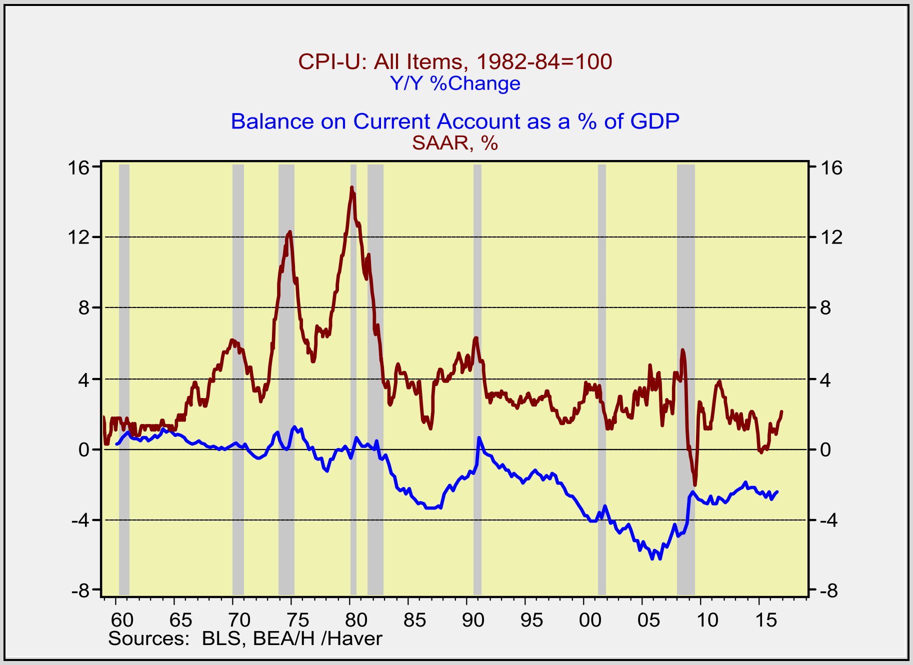
February 3, 2017

Although our current allocation models exclude emerging markets, we still monitor various emerging market nations for potential opportunities. A country that has been in the news recently is Mexico. President Trump has been targeting Mexico and the North American Free Trade Agreement (NAFTA) for Mexico's persistent trade surpluses with the U.S.



This chart shows the rolling 12-month trade account with Mexico; the vertical line on the chart shows the month when NAFTA was enacted. As the chart clearly shows, the trade deficit with Mexico has widened significantly, although it is interesting to note that it hasn't worsened since the last recession.

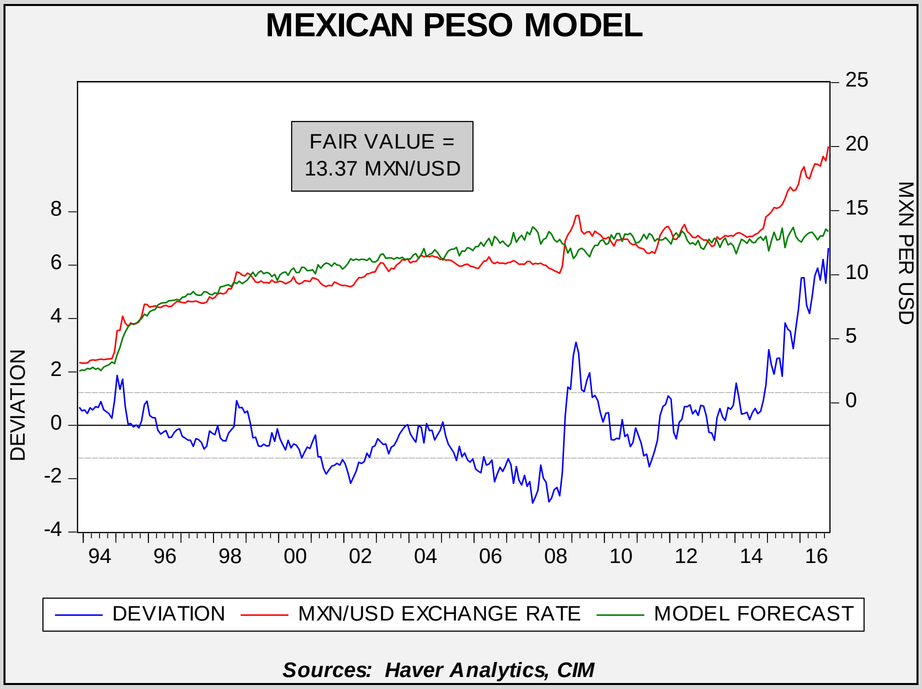
Trade deficits act as a drag on GDP; the tradeoff is microeconomic. Imports tend to improve the competitiveness of an economy.



Until the 1980s, the U.S. tended to run modest current account surpluses.[3] Note that inflation steadily declined after 1980. From 1960 to 1980, inflation averaged 5.1%. From 1980 to the present, it has averaged 3.3%, and since 1990, 2.1%. Competition from foreign trade forces domestic firms to be more competitive and cost efficient. At the same time, since the U.S. provides the reserve currency, there is an incentive for other nations to implement policies designed to run trade surpluses with the U.S. in order to acquire dollars. These policies tend to suppress domestic consumption and expand investment, with the global effect of boosting growth through trade.

The peso/dollar exchange rate has a strong impact on the performance of investments into Mexico. Currently, our model of the exchange rate suggests the peso is deeply undervalued.

[3] The current account is the merchandise trade account plus private and public transfers and remittances.



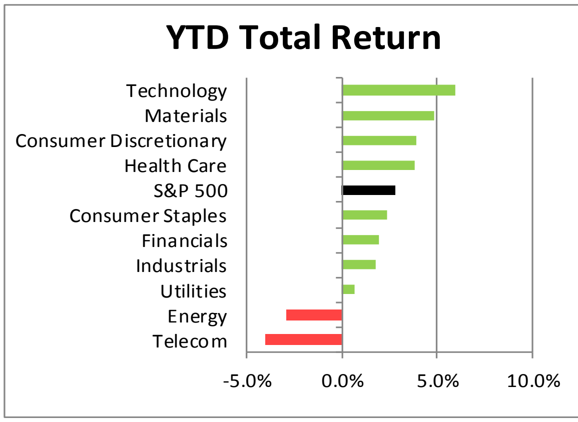
This model uses relative inflation and the trade account as independent variables. It suggests the peso is 33% undervalued relative to the dollar. Note that this undervaluation began in mid-2014 as the dollar began to rise across most currencies due to expectations of U.S. monetary policy tightening. The peso weakened further due to the election of Donald Trump, who promised to build a wall across the southern border of the U.S.

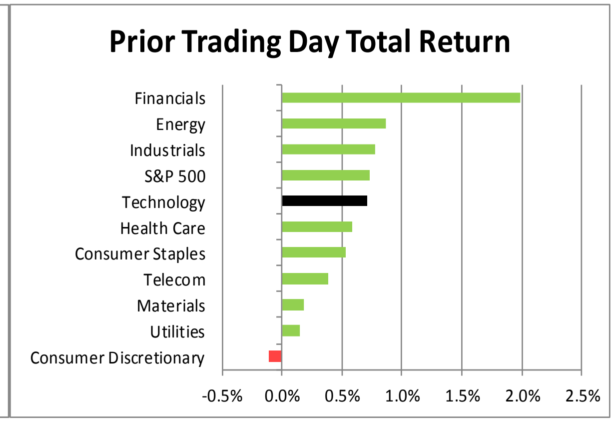
The weak peso has had an effect on Mexican equity values; in peso terms, the MSCI Mexico Index is up 10.1% since mid-2014, an annual gain of 3.8%. In U.S. dollar terms, it is down 28.1%, or -12.0% annualized.

Although the peso is quite competitive with the U.S. at current levels, the degree of political risk is so elevated at present that we are not ready to allocate to Mexican equity markets. However, at some point, the currency should stabilize and offer an opportunity for our asset allocation accounts. Until then, we continue to closely monitor this market.

<u>Data Section</u>

U.S. Equity Markets – (as of 2/3/2017 close)

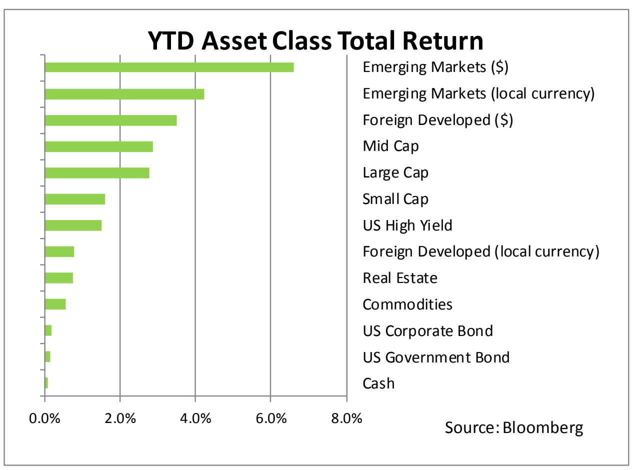




(Source: Bloomberg)

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 2/3/2017 close)

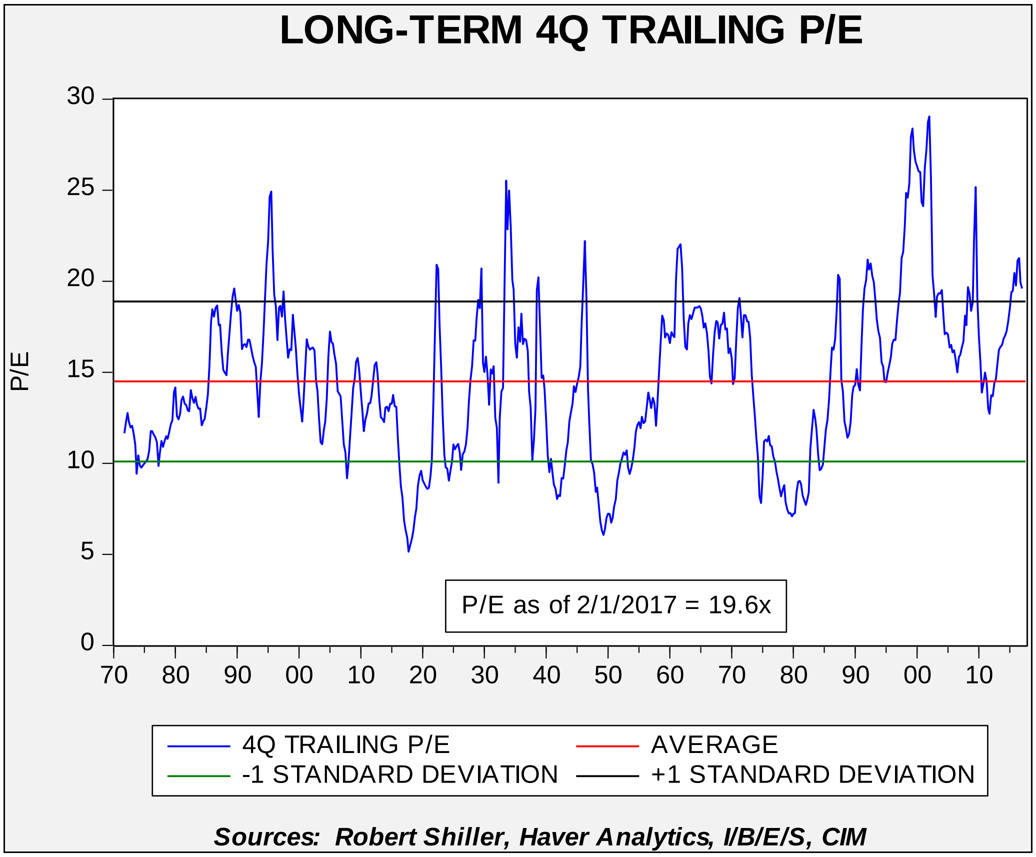


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2017



Based on our methodology,[4] the current P/E is 19.6x, unchanged from our last report.

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.