[Posted: February 7, 2018—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets were down, with the Shanghai composite down 1.8% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a lower open. With 275 companies having reported, the S&P 500 Q4 earnings stand at $35.78, higher than the $34.84 forecast for the quarter. The forecast reflects a 10.7% increase from Q4 2016 earnings and a 4.2% increase from Q3 2017. Thus far this quarter, 76.7% of the companies reported earnings above forecast, while 14.5% reported earnings below forecast.

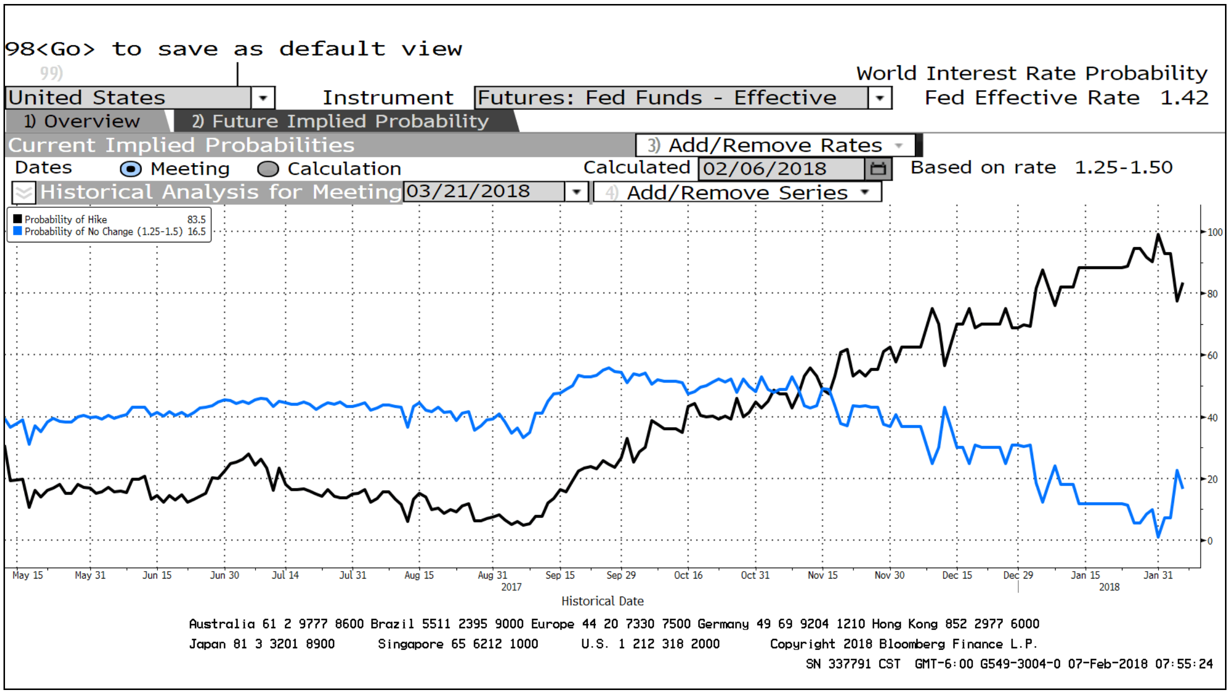
Looking for something to read? In our travels we are often asked about books we recommend. As a result, we have created The Reading List. The list is a group of books, separated by category, that we believe are interesting and insightful. Each book on the list has an associated review to help you decide if you want to read it. We will be adding to the list over time. Books marked with a "" are ones we consider classics and come highly recommended.*

Equity markets are attempting to stabilize this morning. As noted above, Asia was mostly lower while Europe is in the green. Here is what we are looking at this morning:

Is this it? By our calculation, the current decline from the recent high (basis the S&P 500) was just under 10%, but would round up to that level, which is generally considered a full correction. Despite the sudden drop after months of calm, investors have been relatively sanguine. We do note the Ned Davis Crowd Sentiment Poll fell from around 75 to just under 67. Usually, this index would need to decline to around 61 to signal that excessive optimism has "washed out." We note some of the major wirehouses have given "all clear" signals and are suggesting we should move higher from here. We don't necessarily disagree, but would note that in our personal experience equity corrections don't usually end without a greater degree of fear. It is possible that some of the usual panic has been transferred to other markets, perhaps cryptocurrencies or the volatility products, but we would not be surprised to see at least a retest of recent lows before a recovery develops. In other words, this probably isn't a "V" bottom in equities.

At the same time, there is no strong evidence of recession, which is the usual trigger for a major bear market. Recent market action is rather normal behavior; in recent years, persistently supportive monetary policy has dampened market volatility and thus made corrections less common. As monetary policy normalizes, choppy equity markets are a likely outcome.

No change in policy expectations: Fed funds futures are still indicating about an 83% chance of tightening at the March 21st FOMC meeting.



(Source: Bloomberg)

This chart shows the probability of a rate hike for the March meeting. At the end of January, the fed funds futures indicated near certainty of a rate hike. Recent equity market action did add a degree of doubt but odds still strongly favor a rate hike.

The budget process: The House has passed a stopgap measure while Senate leaders are indicating they are nearing a two-year budget deal that would not only address the upcoming spending limit issue but also address the debt ceiling that is looming next month. The keys to the emerging Senate deal are (a) immigration is to be dealt with outside the budget process, and (b) spending will rise to bring enough members on board for passage. The Senate version will not be popular with the Freedom Caucus in the House, which means passage will rely mostly on Democrats and enough moderate Republicans to vote for the measure. We may see another shutdown later this week, but would not expect much market impact.

Merkel has a deal: Chancellor Merkel will give the SPD the finance and foreign ministries in a new grand coalition government, which was apparently enough to get the SDP leadership to agree to form a government. Although the SDP rank and file still need to vote on the measure, getting these two key ministries should be enough to sway most members. Merkel's CDU/CSU party is not pleased, according to reports. The general expectation was that the SDP would get one of these two ministries, but not both. Assuming the SDP approves the deal (and they would be making a huge mistake if they didn't), Germany's stance on the EU could soften dramatically, which could mean a more French vision is in the offing. A more French vision would include more fiscal unity and relaxed rules of fiscal spending by individual states. Although a new government is likely, it may not last very long; most Germans are fearful of providing a "credit card" to the rest of Europe and the SDP's version of the EU won't be popular with the CDU/CSU or the AfD.

U.S. Economic Releases

Mortgage applications rose by 0.7% from the prior week. Purchases and refinancing fell by 3.4% and 0.9%, respectively. The average 30-year fixed rate rose 9 bps from 4.41% to 4.50%.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consumer Credit	m/m	dec	$20.000 bn	$27.951 bn	**
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	Foreign Reserves	m/m	jan	$3.162 bn	$3139.9 bn	$3170.0 bn	**	Equity bullish, bond bearish
Japan	Official Reserve Assets	m/m	dec	$1268.5 bn	$1264.3 bn		**	Equity and bond neutral
	Labor Cash Earnings	y/y	dec	0.7%	0.9%	0.5%	**	Equity and bond neutral
	Real Cash Earnings	y/y	dec	-0.5%	0.1%		**	Equity and bond neutral
	Leading Index CI	m/m	dec	107.9	108.3	108.1	**	Equity and bond neutral
	Coincident Index	m/m	dec	120.7	117.9	120.5	**	Equity bullish, bond bearish
Australia	AiG Performance of Construction Index	m/m	jan	54.3	52.8		**	Equity and bond neutral
New Zealand	Unemployment Rate	m/m	4q	4.5%	4.6%	4.7%	***	Equity bullish, bond bearish
EUROPE								
Germany	Industrial Production	m/m	dec	-0.6%	3.4%	-0.7%	***	Equity and bond neutral
France	Trade Balance	m/m	dec	-3.468 bn	-5.692 bn	-4.854 bn	**	Equity bullish, bond bearish
	Current Account	m/m	dec	0.9 bn	-3.3 bn		**	Equity and bond neutral
Italy	Retail Sales	m/m	dec	-0.1%	1.4%	1.0%	**	Equity and bond neutral
Switzerland	UBS Real Estate Bubble Index	m/m	4q	1.32	1.38		**	Equity and bond neutral
	Foreign Currency Reserve	y/y	jan	731.4 bn	743.9 bn		**	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence Index	m/m	jan	84.2	88.6	88.5	***	Equity bearish, bond bullish
	Gross Fixed Investment	m/m	nov	-4.5%	-2.6%	-2.9%	**	Equity bearish, bond bullish
Canada	International Merchandise Trade	m/m	jan	3.19 bn	-2.54 bn	-2.32 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)	179	179	0	Up
3-mo T-bill yield (bps)	149	149	0	Neutral
TED spread (bps)	30	30	0	Neutral
U.S. Libor/OIS spread (bps)	153	153	0	Up
10-yr T-note (%)	2.78	2.80	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	28	30	-2	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Repurchase Rate	6.000%	6.000%	6.000%	On forecast
RBI Reverse Repo Rate	5.750%	5.750%	5.750%	On forecast
RBI Cash Reserve Ratio	4.000%	4.000%	4.000%	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	$66.82	$66.86	-0.06%	
WTI	$63.19	$63.39	-0.32%	
Natural Gas	$2.77	$2.76	0.29%	
Crack Spread	$15.35	$14.95	2.69%	
12-mo strip crack	$18.43	$18.25	0.99%	
Ethanol rack	$1.50	$1.50	-0.11%	
Metals				
Gold	$1,327.64	$1,324.16	0.26%	
Silver	$16.68	$16.64	0.23%	
Copper contract	$317.30	$318.90	-0.50%	
Grains				
Corn contract	$ 364.25	$ 363.50	0.21%	
Wheat contract	$ 451.50	$ 446.25	1.18%	
Soybeans contract	$ 986.00	$ 986.25	-0.03%	
Shipping				
Baltic Dry Freight	1095	1082	13	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		1.0		
Distillates (mb)		-1.5		
Refinery run rates (%)		-0.40%		
Natural gas (bcf)		-111.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer temperatures for the western region, with cooler to normal temperatures for the rest 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 2, 2018

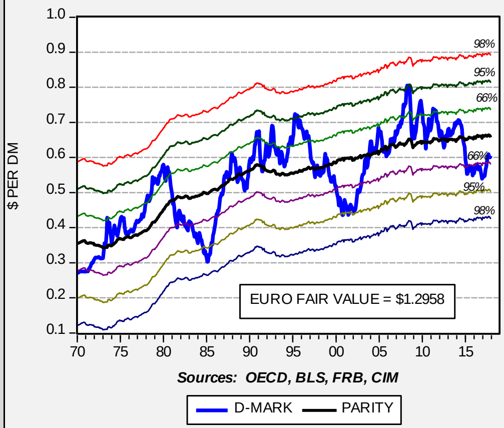
The World Economic Forum in Davos was held recently and various comments were made about the dollar during the meetings. Treasury Secretary Mnuchin seemed to imply that the administration was talking the dollar lower, a violation of unwritten protocols that make it acceptable to have a weaker currency in support of growth but improper to use depreciation to give a nation an advantage on trade. Later, President Trump seemed to contradict his treasury secretary, suggesting the dollar should strengthen. This led the financial media to deploy a parade of currency analysts to try to explain the dollar's behavior. The cacophony of comments did little to explain market action.

Our position on exchange rates is that there is no single valuation method that works consistently. In our over 30 years of monitoring and analyzing exchange rates, we have found they are usually characterized by regimes. During some periods, trade balances drive exchange rates. In other periods, interest rate differentials are the key factor. Relative growth rates or productivity have also been relevant. But, in the long run, the oldest valuation method, purchasing power parity, remains useful for investors.

Purchasing power parity assumes that exchange rates bring equilibrium to relative prices. In other words, if price levels in one nation are higher compared to another nation, the country with higher price levels will experience currency depreciation until price levels equalize. In practice, the ratio of price levels isn't perfect—not all goods in a price index are tradeable, inflation indices between countries are not identical and no markets are frictionless, so adjustments can take time. But, what we find in practice is that when the exchange rate deviates widely from the ratio of inflation rates (or, purchasing power parity), the exchange rate usually adjusts.

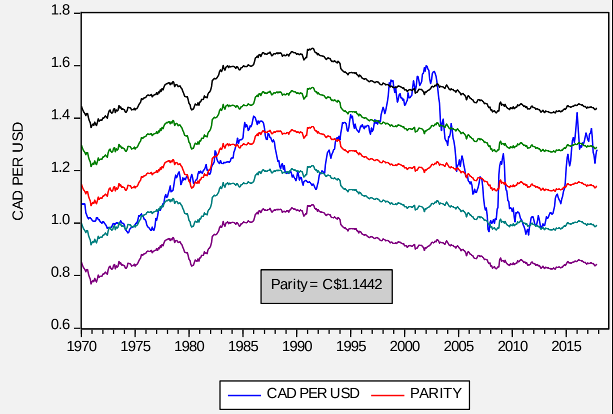
These are exactly the conditions we have seen recently.

EURO PPP MODEL



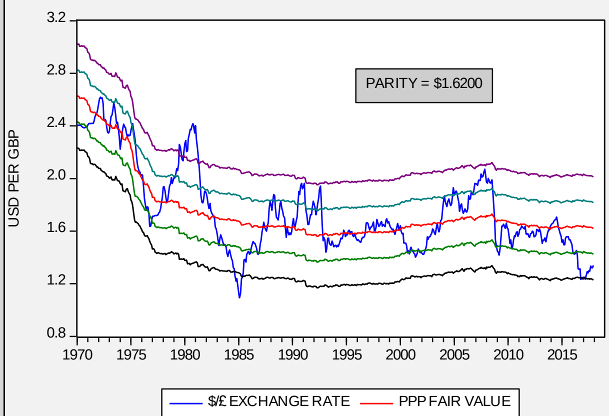
Sources: OECD, BLS, FRB, CIM

CANADIAN PPP MODEL



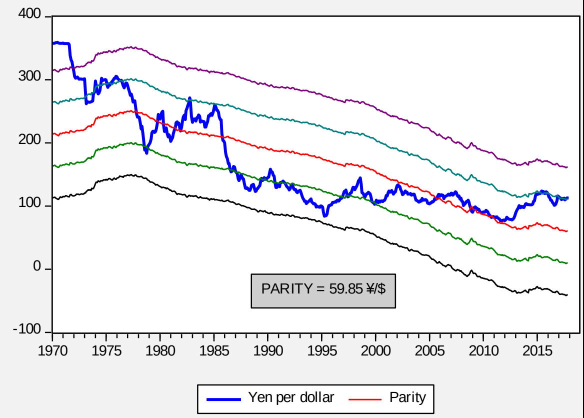
Sources: Haver Analytics, CIM

GBP PPP MODEL



Sources: Haver Analytics, CIM

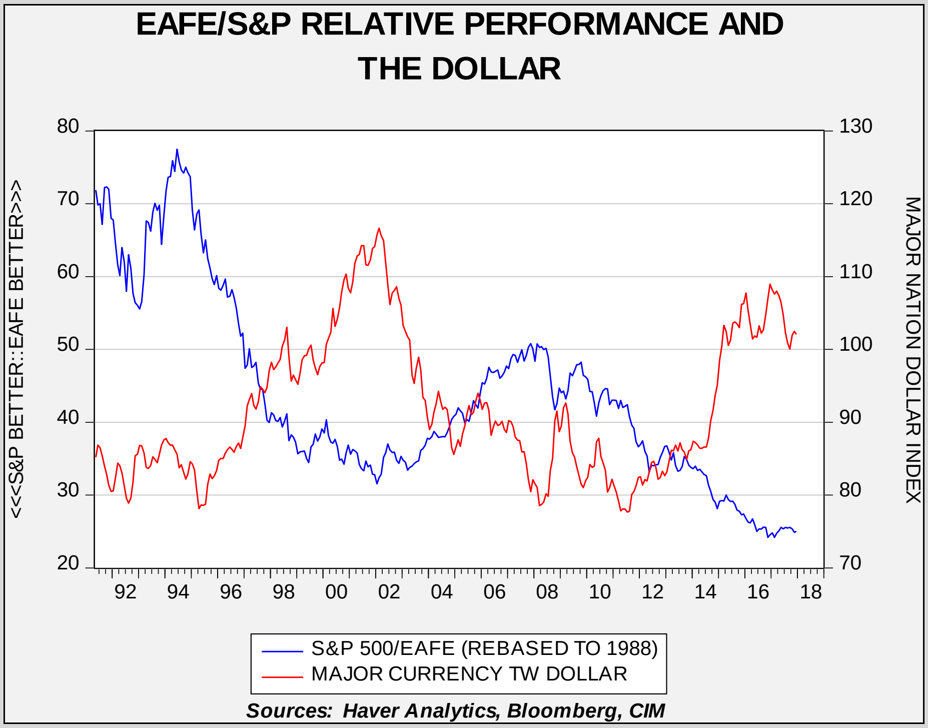
YEN PPP MODEL



Sources: Haver Analytics, CIM

This chart shows our calculation of purchasing power parity for the euro (based off the D-mark at euro parity and German inflation), the Canadian dollar, the British pound and the Japanese yen. In all cases, the dollar is highly overvalued. What we find missing in most comments about the dollar that we see in the financial media is that the dollar is weakening in response to overvaluation. All these charts show that key market signals come at extremes. As exchange rates approach the standard error lines, they become vulnerable to reversals. And, when reversals occur, it is not uncommon for the exchange rate to move to an opposite extreme. This likely means that the dollar will continue to weaken for an extended period.

In response, our asset allocation has added foreign equities.

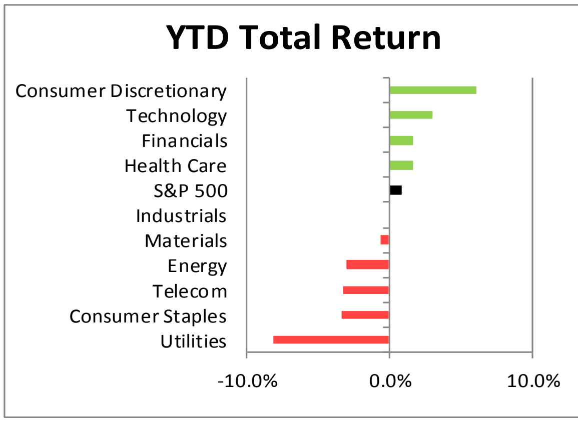


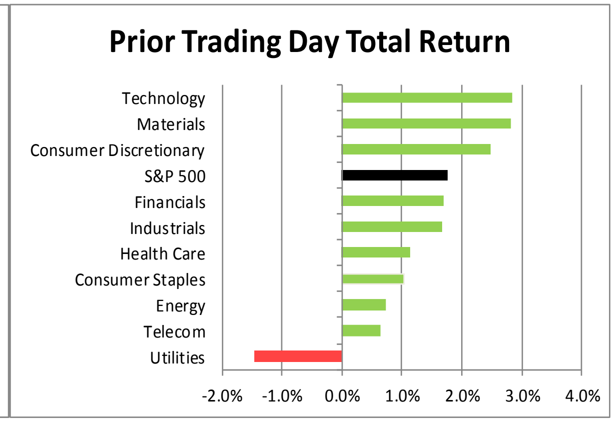
This chart shows the S&P and EAFE equity indices, denominated in dollars. We have rebased the two to 1988 and calculated a ratio of the indices. We have also added the Federal Reserve's major current index. When the dollar is strengthening, U.S. stocks tend to outperform. When the dollar is elevated and reverses, it is usually favorable to foreign equities relative to U.S. equities.

In general, both indices tend to be closely correlated. As a result, shifting to overseas stocks doesn't mean that domestic equities are expected to decline. Instead, it suggests that the tailwind of a weaker dollar boosts the relative value of foreign stocks to a U.S. investor. That is the rationale for our current allocation.

Data Section

U.S. Equity Markets – (as of 2/6/2018 close)

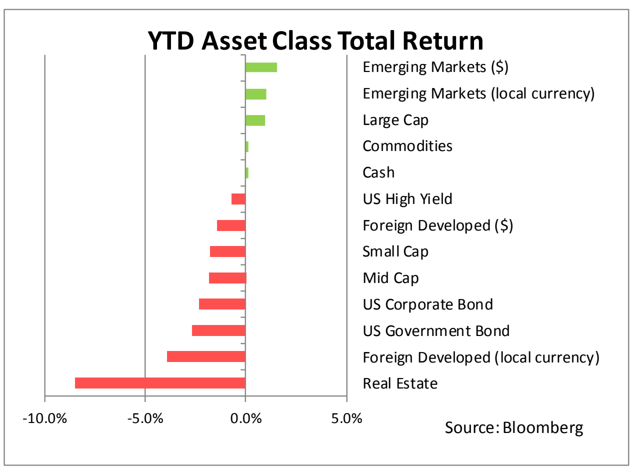




(Source: Bloomberg)

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 2/6/2018 close)

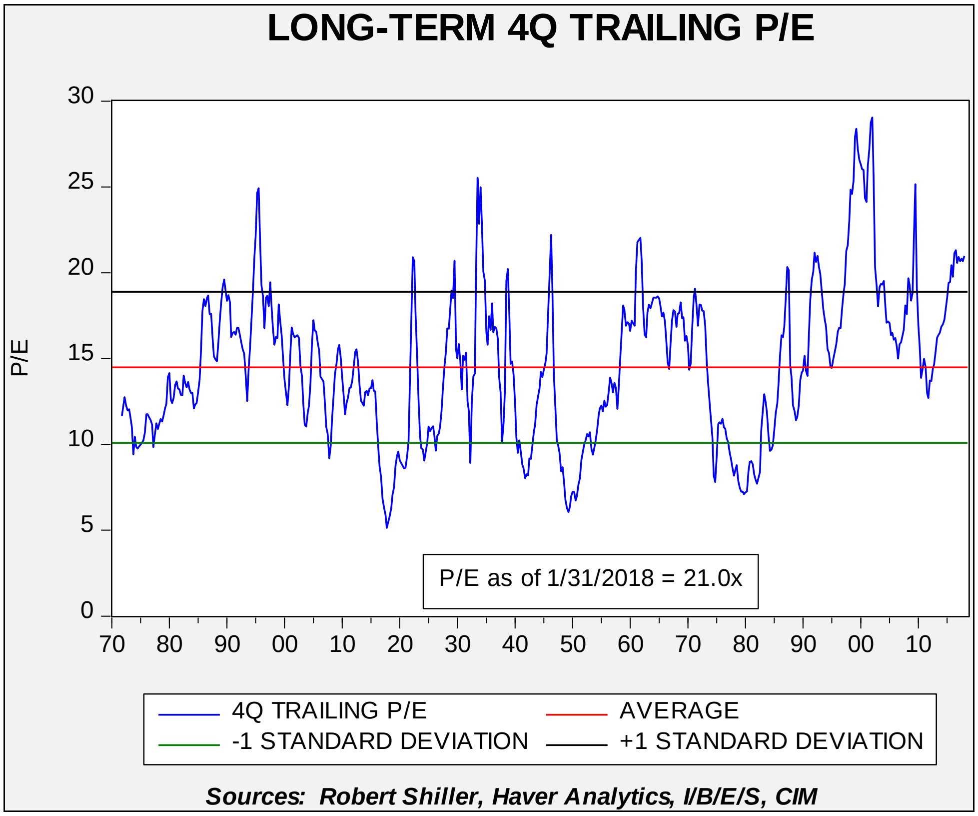


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 1, 2018



Based on our methodology,[1] the current P/E is 21.0x, unchanged from last week.

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 quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q2 and Q3) and two estimates (Q4 and 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.