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and Thomas Wash

[Posted: January 03, 2017—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were up, with the Shanghai composite up 1.0% and the Shenzhen index up 0.9%. U.S. equity futures are signaling a higher open.

Happy New Year! We're back…

After some profit-taking into year's end, the first trading day of the year is starting off with a return to mid-December trends—long-term interest rates are rising, the dollar is up and U.S. equities are up as well. The dollar's strength is pushing gold prices lower but oil continues to trade stronger despite the rising greenback. News that Kuwait and Oman have made production cuts in line with the OPEC agreement is supporting higher oil prices.

President-elect Trump has appointed Robert Lighthizer to the post of U.S. Trade Representative. Like Trump's pick of Peter Navarro, Lighthizer leans toward trade restrictions, especially against China, and is friendly toward tariffs and quotas.

One of the aspects of Trump's trade policy that has, in our opinion, been underestimated by financial markets is the lack of understanding of the reserve currency role. The dollar, as the global reserve currency, is used for trade transactions that do not involve the U.S. The BIS estimates that about 80% of trade-related letters of credit are denominated in U.S. dollars.[1] The most effective way for foreign nations to acquire dollars is by trading with the U.S. In fact, the world needs to run trade surpluses with the U.S. so that there are ample dollars available for global trade. This situation creates a problem; eventually, either domestic support for trade falters in the reserve currency nation due to job losses or foreigners lose faith that the reserve currency nation will maintain the value of the currency. This problem was first identified by an economist named Robert Triffin (thus it has been described as the "Triffin dilemma").

What the incoming administration doesn't seem to recognize is that if the U.S. takes steps to restrict trade it will reduce the supply of dollars on global markets. Falling supply without a commensurate reduction in demand will lead to a stronger dollar. And, fears among foreign nations that the U.S. is going to restrict trade will actually boost demand, enhancing the effect. Couple this policy with proposed changes in corporate tax law that would create border adjustments to tax imports and not exports and the dollar will rise further (not to mention the potential impact of a repatriation holiday). In the face of tighter imports, the FOMC may be inclined to lift rates sooner and by more than the markets expect. Although we always have concerns about "one-way trades," a stronger dollar looks inevitable.

[1] http://www.bis.org/publ/cgfs50.pdf, especially page 13.

Overall, then, what does a stronger dollar bring? It's bearish for commodities; gold is especially vulnerable. As noted above, oil is trading counter to the stronger dollar on expectations of OPEC supply cuts but, in general, dollar strength is negative for commodities. Dollar strength is a profoundly bearish factor for emerging market equity and debt; dollar strength has been behind emerging market economic problems since currency floating began. For developed markets, it's something of a wash. The weaker foreign currencies act as a form of policy stimulus, which is bullish for equities in local terms, but the unknown for a U.S.-based investor is whether the dollar strength will offset the equity market rally. In the U.S., small and mid-caps tend to benefit on a relative basis to large caps because the latter have more foreign exposure and thus earnings for large caps are at greater risk.

U.S. Economic Releases

There were no domestic releases prior to this publication. The table below lists the economic 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	dec	54.2	54.2	**
10:00	ISM Manufacturing	m/m	dec	53.8	53.2	**
10:00	ISM Prices Paid	m/m	dec	55.5	54.5	**
10:00	ISM New Orders	m/m	dec		53.0	**
10:00	ISM Employment	m/m	dec		52.3	**
10:00	Construction Spending	m/m	nov	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								
China	Caixin China PMI Manufacturing	m/m	dec	51.9	50.9	50.9	**	Equity bullish, bond bearish
India	Eight Infrastructure Industries	m/m	nov	4.9%	6.6%		**	Equity bearish, bond bullish
Australia	AiG Perf of Mfg Index	m/m	nov	55.4	54.2		**	Equity bullish, bond bearish
	Corelogic House Px	m/m	dec	1.4%	0.2%		**	Equity and bond neutral
	Commodity Index	y/y	dec	45.5%	32.1%		**	Equity and bond neutral
EUROPE								
Germany	Unemployment Rate	y/y	nov	6.0%	6.0%	6.0%	***	Equity and bond neutral
	CPI	y/y	nov	1.7%	0.8%	1.4%	***	Equity bullish, bond bearish
France	CPI	m/m	dec	0.6%	0.5%	0.8%	***	Equity and bond neutral
U.K.	Markit UK PMI Manufacturing	m/m	Nov	56.1	53.4	53.3	**	Equity bullish, bond bearish
Switzerland	PMI Manufacturing	m/m	dec	56.0	56.6	56.0	**	Equity and bond neutral
	Total Sight Deposits	m/m	dec	529.0 bn	528.4 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	dec	466.3 bn	463.6 bn		*	Equity and bond neutral
AMERICAS								
Mexico	Markit Mexico PMI Manufacturing	m/m	dec	50.2	51.1		**	Equity bearish, bond bullish
Brazil	Markit Brazil PMI Manufacturing	y/y	dec	45.2	46.2		**	Equity bearish, bond bullish
	Imports Total	y/y	dec	$11.525 bn	$11.463 bn	$12.091 bn	**	Equity and bond neutral
	Exports Total	y/y	dec	$15.941	$16.22 bn	$16 bn	**	Equity and bond neutral
	Trade Balance Monthly	y/y	dec	$4.415 bn	$4.758 bn	$3.75 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)	100	100	0	Neutral
3-mo T-bill yield (bps)	49	49	0	Neutral
TED spread (bps)	51	51	0	Neutral
U.S. Libor/OIS spread (bps)	67	67	0	Neutral
10-yr T-note (%)	2.50	2.45	0.05	Down
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	49	49	0	Neutral
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	flat			Down
franc	down			Down

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	$58.05	$56.82	2.16%	Projected Output Cuts
WTI	$54.91	$53.72	2.22%	
Natural Gas	$3.47	$3.72	-6.79%	
Crack Spread	$17.36	$17.02	1.99%	
12-mo strip crack	$17.39	$17.22	1.03%	
Ethanol rack	$1.82	$1.82	0.00%	
Metals				
Gold	$1,148.31	$1,147.50	0.07%	
Silver	$15.97	$15.93	0.27%	
Copper contract	$253.45	$250.55	1.16%	
Grains				
Corn contract	$ 352.50	$ 352.00	0.14%	
Wheat contract	$ 408.00	$ 408.00	0.00%	
Soybeans contract	$ 1,000.75	$ 1,004.00	-0.32%	
Shipping				
Baltic Dry Freight	961	928	33	

Weather

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

Asset Allocation Weekly Comment

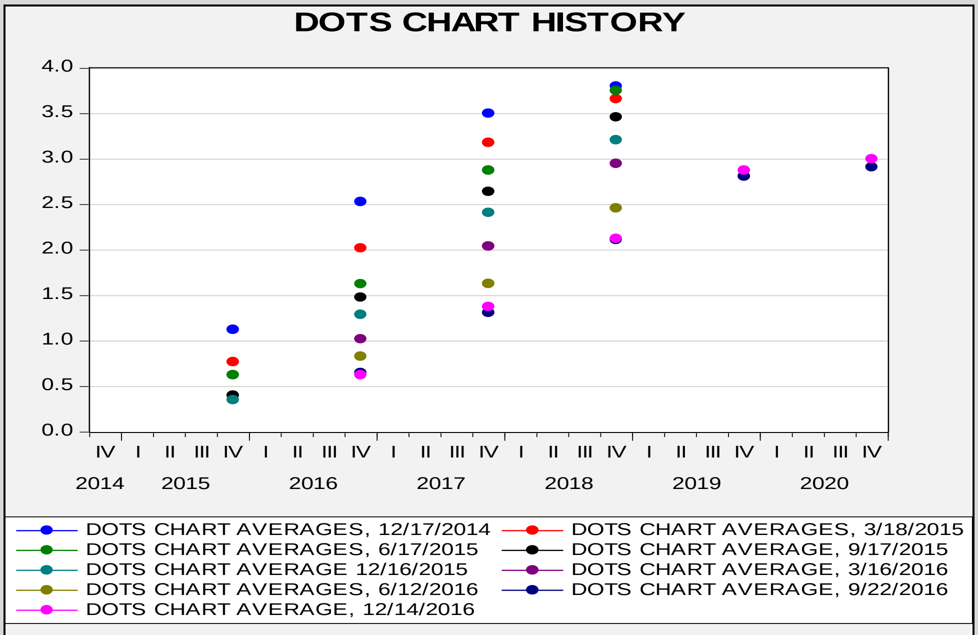
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

Due to the holiday season, the next edition of this report will be published on January 6, 2017.

December 23, 2016

The Fed gave us a modest hawkish surprise last week, calling for three rate hikes in 2017 rather than two. The news has boosted Treasury yields and lifted the dollar. Equities mostly absorbed the news without incident.

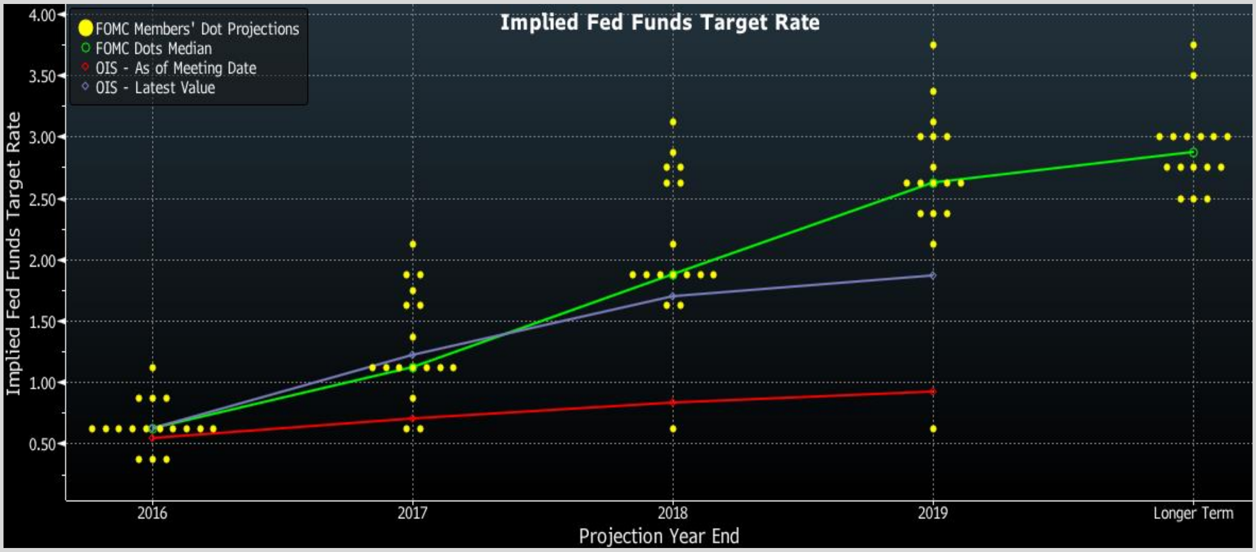
Here is a chart of the FOMC's average dots over the past two years.



Sources: Federal Reserve, CIM

The fuchsia dots represent the most recent meeting. The dots have stopped their steady progression toward lower levels. For better or worse, the path of policy expectations from the dots suggests that the FOMC is becoming comfortable with this path of hikes.

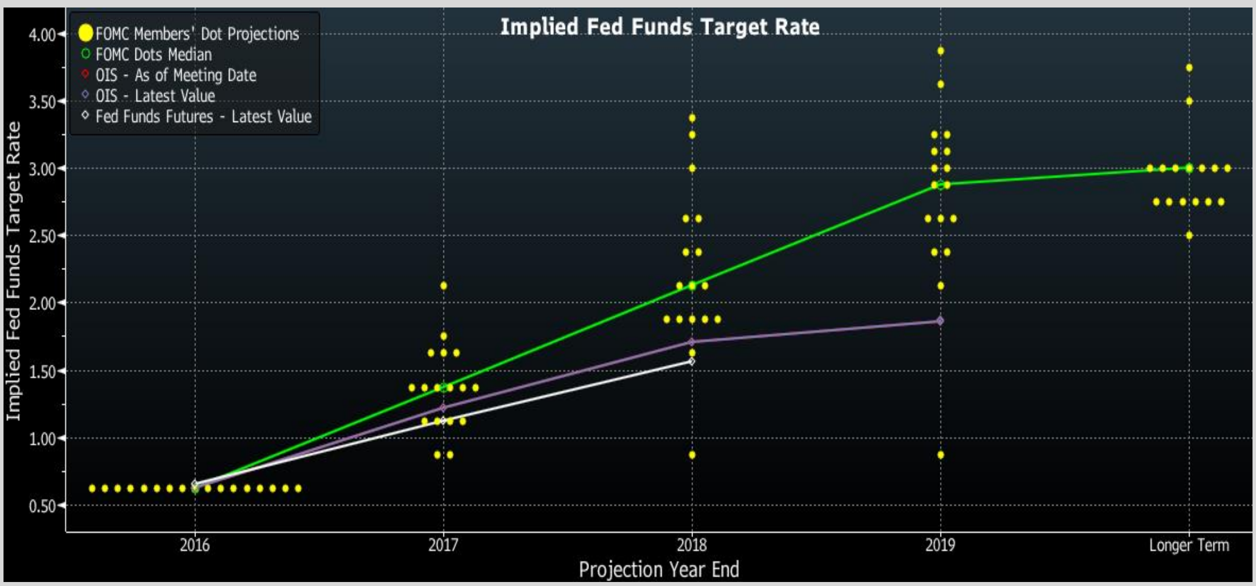
Here is the dots plot from September.



(Source: Bloomberg)

Note the purple line, which is the LIBOR-OIS curve from the meeting day. It has jumped from where it was on the meeting date in September, shown by the red line. For the past few years, the FOMC dots have tended to decline toward the market. The rise in the LIBOR-OIS curve suggests that process is reversing.

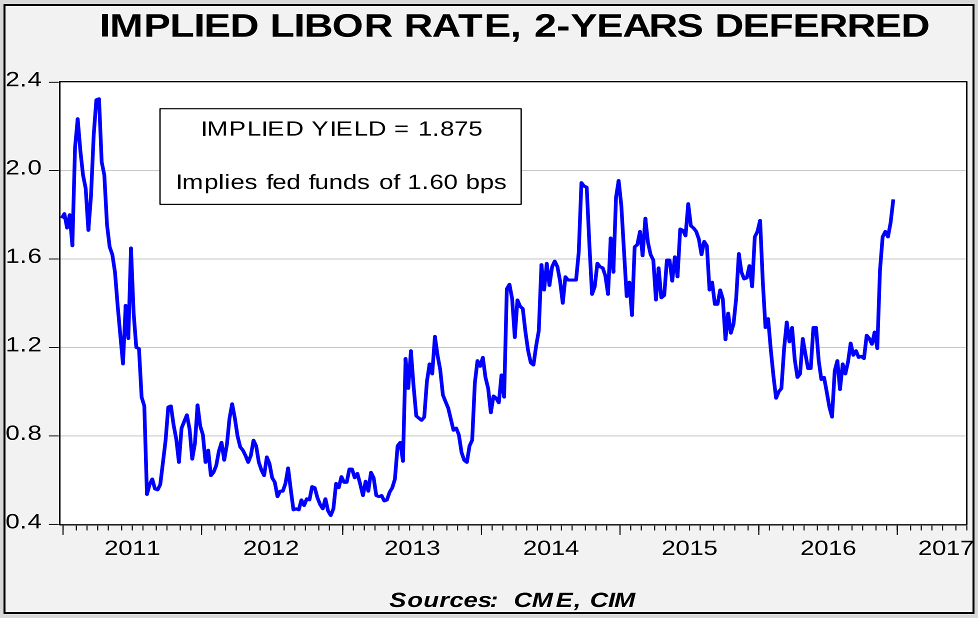
This is the new dots plot, released at the December meeting.



(Source: Bloomberg)

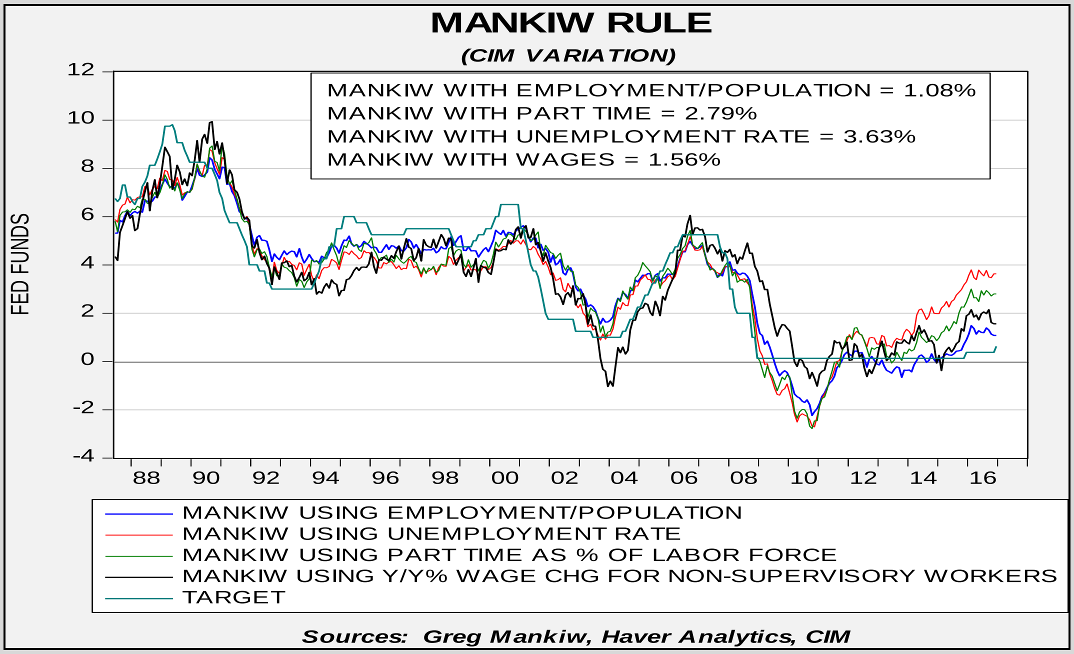
For 2017, the median forecast is currently 1.375%, up from 1.125% in September. For 2018, the median is up to 2.125% from 1.875%. Two participants see no change next year but one of those is probably St. Louis FRB President Bullard, who has decided not to participate in the dots procedure. Although market expectations continue to lag, we did see the LIBOR-OIS rate rise to 1.25% from 0.875% in September.

This can be seen in the deferred Eurodollar futures.



The jump in yields since Trump's election has been striking. We are approaching the highest level of implied rates since the "taper tantrum." This rise triggered the onset of the dollar rally in mid-2014 and we note that the dollar has been rising since the election.

To get some sense of where policy is in relation to the neutral rate, we use the Mankiw rule model, incorporating the recent rate changes by the FOMC. This 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.

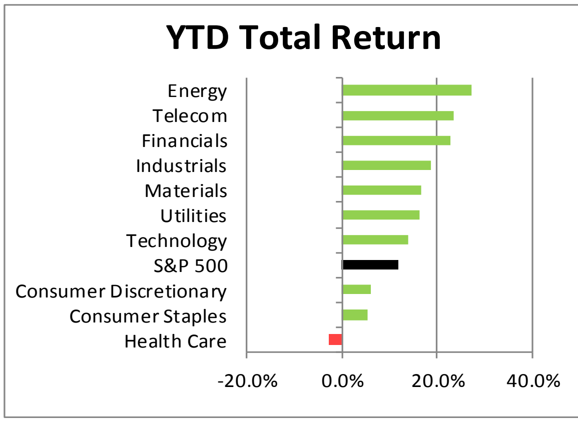


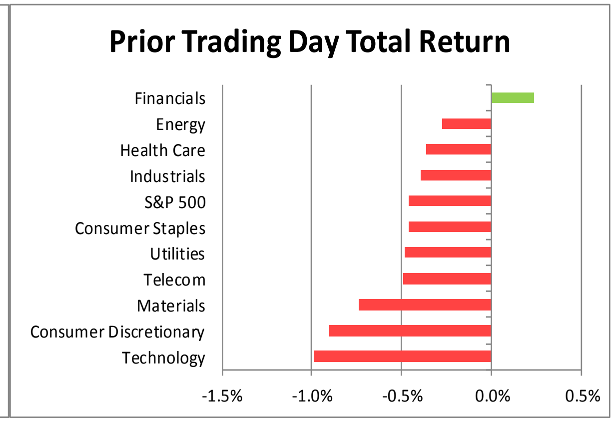
Using the unemployment rate, the neutral rate is now 3.63%. Using the employment/population ratio, the neutral rate is 1.08%. Using involuntary part-time employment, the neutral rate is 2.79%. And finally, the wage growth model puts the neutral rate at 1.56%.

It is still uncertain which of these variants best reflects slack (or lack thereof) in the economy. Although we tend to think that wage growth or the employment/population ratio is the best measure of slack, the key is which one policymakers view as the most consistent with measuring slack. At this point, we don't know, although we think the hawks are probably relying on the unemployment rate variant while the chair and most of the doves probably believe the involuntary part-time employment variant is the best measure. The involuntary part-time employment variant is most consistent with six rate hikes over the next 24 months. That path would bring the policy rate near neutral; however, if they are wrong and, for example, the employment/population ratio is actually correct, then policy will be overly restrictive (assuming that ratio doesn't improve dramatically). Thus, the FOMC is moving rates higher in a slow fashion to allow them time to adjust if it turns out there is more slack (reflected by the lower neutral rate variants) than some data would suggest. Of course, by going slow, assuming the higher neutral rate variants are correct, the Fed could keep policy overly accommodative longer than it should. However, as long as the economy remains globalized and deregulated enough to allow for the nearly unfettered introduction of new technology, being late isn't all that risky. That assumption would change if the incoming President Trump puts up trade barriers. Thus, the path of monetary policy could be a risk factor in the upcoming year.

Data Section

U.S. Equity Markets – (as of 12/30/2016 close)

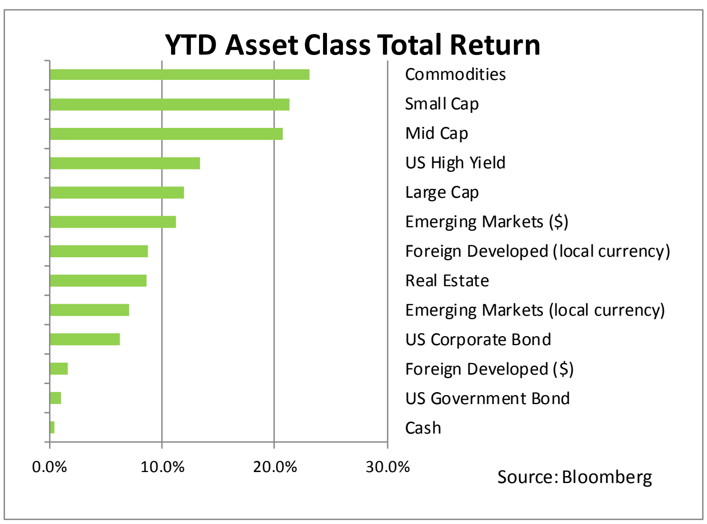




(Source: Bloomberg)

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. The sectors are ranked by total return, with green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 12/30/2016 close)

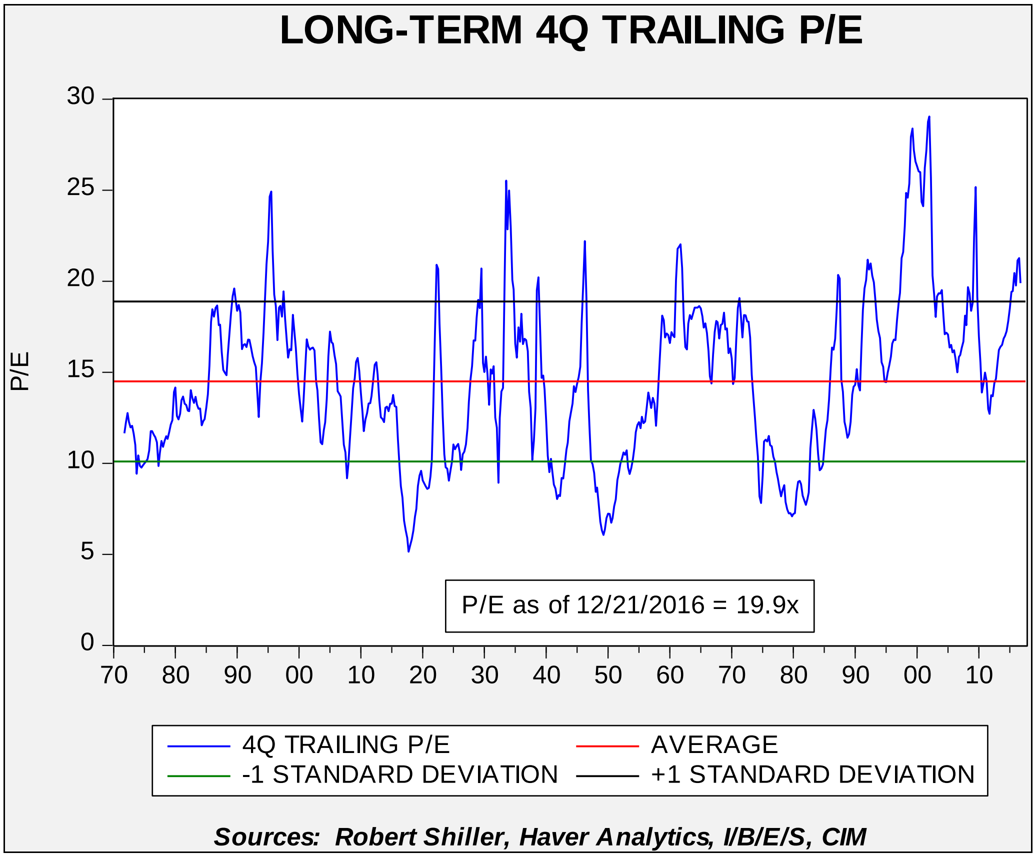


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Dow Jones-UBS Commodity Index).

P/E Update

December 22, 2016



Based on our methodology,[2] the current P/E is 19.9x, up 0.1x from last week. Rising equity values led to the rise in the P/E.

[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 (Q1,Q2 and Q3) and one estimate (Q4). 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.