By Bill O'Grady and Thomas Wash

[Posted: January 10, 2018—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.7% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a lower open.

The problem with bonds: Bond yields jumped yesterday with the 10-year T-note yield breaching 2.55%, breaking 2.50% for the first time since March. There appear to be two catalysts behind the jump. First, the BOJ reduced its purchases of bonds; it should be remembered that the Japanese central bank is adjusting its balance sheet to maintain a zero yield on JGBs. If the demand from the private market rises for this bond, the central bank will buy less. Thus, this adjustment probably doesn't mean all that much. If private demand falls in the future, BOJ buying will increase. The second issue is more material. Yesterday, we noted the growing Fed chorus calling for different policy constructs. Currently, the FOMC uses the Phillip's Curve as its primary economic construct, which postulates there is an inverse relationship between the unemployment rate and inflation. Thus, policymakers focus on the unemployment rate and the Fed tends to lean toward rate hikes as it declines. The problem the Fed has faced is that inflation has failed to decline despite the slide in the unemployment rate. A number of FOMC members are now suggesting that the Fed consider other constructs, including targeting nominal GDP or the price level instead of the rate of change. If such a shift is made, the mostly likely outcome would be that the Powell Fed will be tolerant of higher inflation rates. A key reason for low long-duration Treasury yields is low inflation expectations. These low expectations are partly due to beliefs that the FOMC will not tolerate higher price levels. If that has changed, the yield curve will certainly steepen. It remains to be seen whether this paradigm shift occurs. The Fed doesn't make these shifts all that often. When Paul Volcker moved from targeting fed funds to bank reserves on Oct. 6, 1979, it was referred to as the "Saturday night massacre." Later, in the 1980s, the Fed returned to interest rate targeting after seeing inflation decline. Although a number of FOMC members are calling for consideration of a new paradigm, an actual change is less likely. If we hear statements in the near future from Powell or others indicating the policy construct hasn't changed, we will be watching to see if long-duration rates decline.

Vice Chair comments: According to reports, President Trump is close to naming a vice chair nominee. Richard Clarida is no longer said to be considered, with Larry Lindsey and Mohammad el-Erian as the remaining candidates. The latter name is better known and would receive a warmer reception from the media, but Lindsey is more hawkish and could be being pushed by Cohn/Mnuchin.

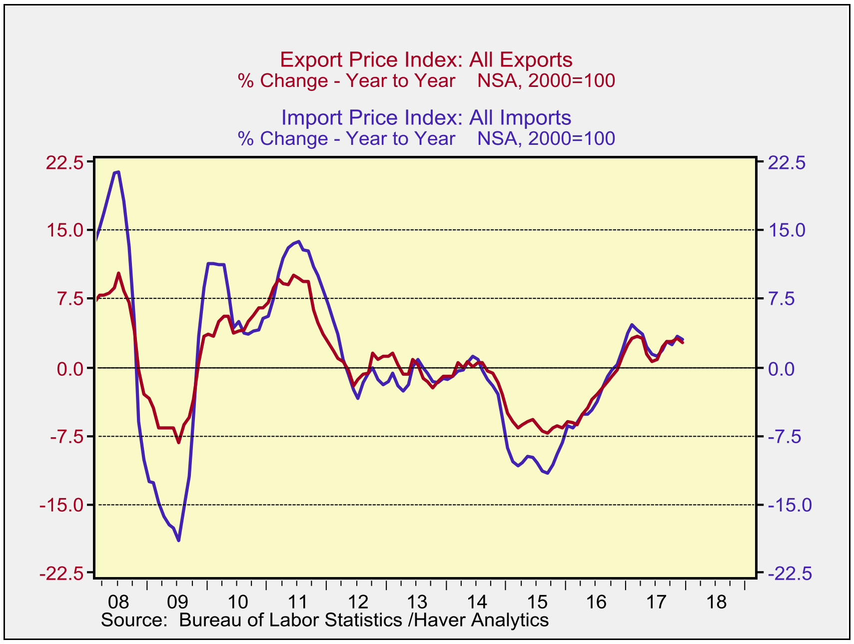
Korea talks: Yesterday, North and South Korea held formal talks. As expected, South Korea received some assurances that North Korea would not disrupt the Winter Olympics. As we mentioned yesterday, North Korea also agreed to send a delegation to participate in the Winter Olympics next month in Pyeongchang, South Korea. However, South Korea, at the urging of Japan and the U.S., brought up the nuclear issue with North Korean negotiators. The latter suggested this was a breach of protocol. Essentially, North Korea isn't going to negotiate away its nuclear deterrent and there isn't much the South can do about that fact.

Return of the earmarks: Yesterday, President Trump suggested bringing back earmarks in order to break up the gridlock in Washington. Earmarks allow reluctant statesmen to receive extra funding for special projects in exchange for their support on legislation. The practice is widely unpopular among constituents as it is commonly associated with mismanagement of public funds, such as Alaska's "Bridge to Nowhere." Banning earmarks was a part of the Republican platform that helped take back Congress in 2010; as a result, they immediately balked at the idea of restoring them. Although the president has received a lot of flak for the idea, if the Republicans lose their majority in the mid-terms, we would expect him to broach the topic again.

U.S. Economic Releases

Weekly mortgage applications rose 8.3% from the prior week, with purchases up 5.0% and refinancing up 11.4%. The average rate on a 30-year fixed mortgage rose by 1 bp from 4.22% to 4.23%.

The import price index came in below expectations, rising 0.1% from the prior month compared to the forecast gain of 0.4%. The prior month's gain was revised down from 0.7% to a loss of 1.6%. The import price index excluding petroleum came in below expectations, falling 0.2% from the prior month compared to the forecast rise of 0.1%. The prior month's gain was revised upward from 0.1% to 0.2%. The export price index came in below expectations, falling 0.1% from the prior month compared to the forecast rise of 0.3%.



The chart above shows the year-over-year change in the import price index and export price index. The import price and export price indexes rose 3.0% and 2.6%, respectively. This report is somewhat uneventful and therefore unlikely to have an impact on the Fed's decision-making.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Wholesale Inventories	m/m	nov	0.7%	0.7%	**
15:00	Wholesale Trade Sales	m/m	nov	0.6%	0.7%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:15	Robert Kaplan speaks in Dallas	President of the Federal Reserve Bank of Dallas				

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	PPI	y/y	dec	4.9%	5.8%	4.8%	**	Equity and bond neutral
	CPI	y/y	dec	1.8%	1.7%	1.9%	***	Equity and bond neutral
Australia	Job Vacancies	y/y	nov	2.7%	6.0%		**	Equity and bond neutral
EUROPE								
France	Industrial Production	m/m	nov	-0.5%	1.9%	-0.5%	***	Equity and bond neutral
	Manufacturing Production	m/m	nov	-1.0%	2.7%	-1.4%	**	Equity and bond neutral
U.K.	Industrial Production	m/m	nov	0.4%	0.0%	0.4%	***	Equity and bond neutral
	Manufacturing Production	m/m	nov	0.4%	0.1%	0.3%	**	Equity and bond neutral
	Trade Balance	m/m	nov	-£2803	-£1405	£1500	**	Equity bearish, bond bullish
AMERICAS								
Canada	Housing Starts	m/m	dec	217.0k	252.2k	212.0k	***	Equity and bond neutral
Mexico	CPI	y/y	dec	6.8%	6.6%	6.8%	***	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)	171	170	1	Up
3-mo T-bill yield (bps)	142	140	2	Neutral
TED spread (bps)	29	30	-1	Neutral
U.S. Libor/OIS spread (bps)	146	146	0	Up
10-yr T-note (%)	2.58	2.55	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	24	24	0	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Neutral
pound	up			Neutral
franc	up			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	$69.20	$68.82	0.55%	Bullish API
WTI	$63.48	$62.96	0.83%	
Natural Gas	$2.95	$2.92	0.99%	
Crack Spread	$17.28	$17.38	-0.59%	
12-mo strip crack	$19.86	$20.02	-0.80%	
Ethanol rack	$1.42	$1.42	0.23%	
Metals				
Gold	$1,323.51	$1,312.85	0.81%	Weaker Dollar
Silver	$17.14	$16.97	0.98%	
Copper contract	$326.05	$321.60	1.38%	
Grains				
Corn contract	$ 349.75	$ 349.00	0.21%	
Wheat contract	$ 433.25	$ 432.25	0.23%	
Soybeans contract	$ 960.75	$ 963.75	-0.31%	
Shipping				
Baltic Dry Freight	1395	1385	10	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.8		
Gasoline (mb)		3.3		
Distillates (mb)		2.3		
Refinery run rates (%)		-0.50%		
Natural gas (bcf)		-325.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer temperatures in the western region, while the rest of the country will see cooler to normal temperatures. Precipitation is expected for the northwestern region.

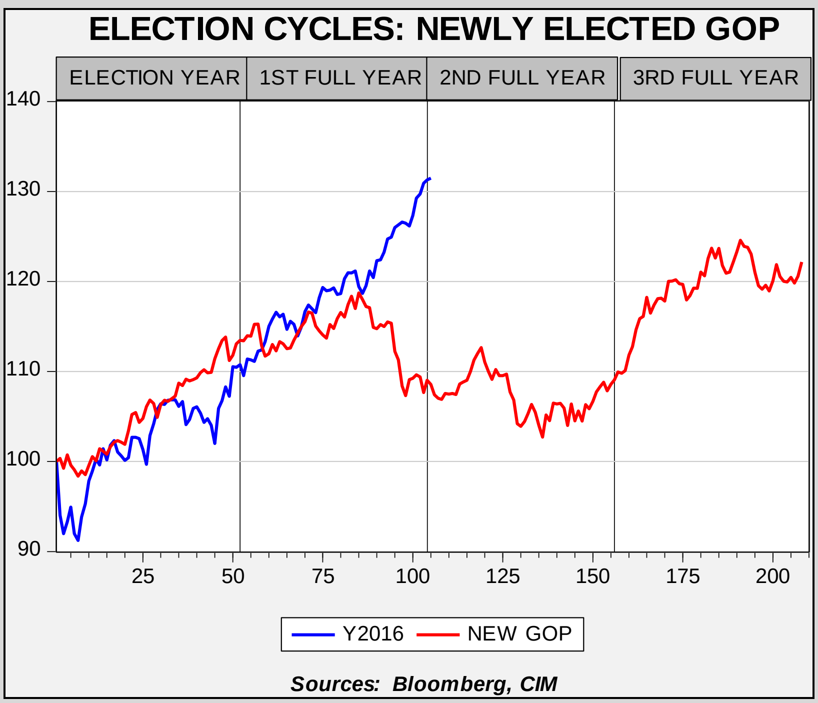
Asset Allocation Weekly Comment

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 5, 2018

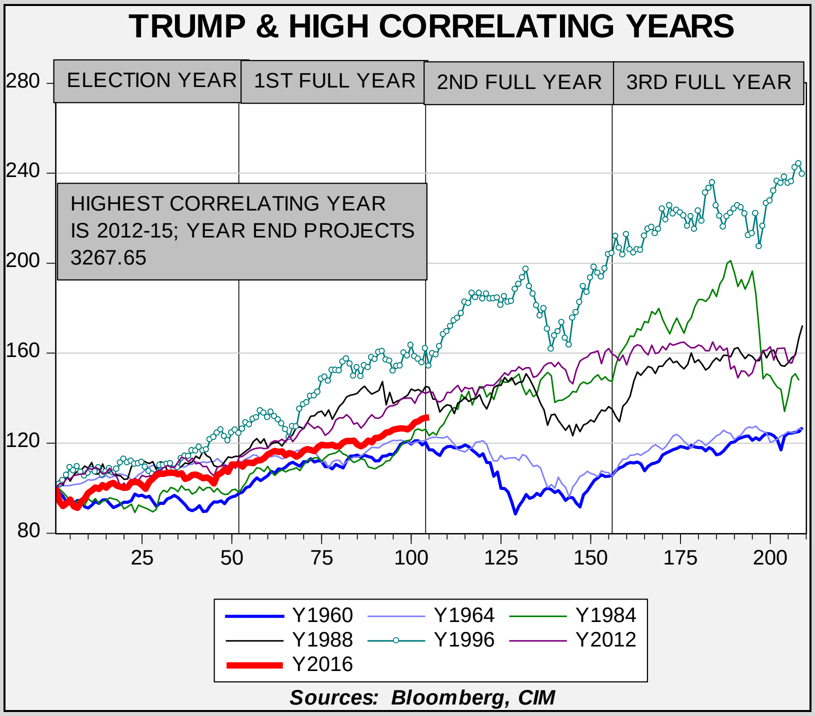
Equity markets had a very strong 2017, with the S&P 500 up over 20% for the year. Earnings rose more than expected, the economy continued to expand and investor sentiment was buoyant, all of which contributed to rising equities. The tax bill, signed in late December, will give equities a lift going into 2018. In this report, we will examine equity market behavior as part of the presidential cycle.

To perform this exercise, we look at weekly closes for the S&P 500 starting in 1928. We rebased the index for every four-year election cycle, so the first year is the actual election year (with elections held in November) along with the next three years of the term. Using this database, we can sort by incoming party, incumbent party, high correlating terms, etc. Earlier this year, we published this graph.



The red line on the chart shows the average S&P 500 performance for a new GOP president; the blue line shows the performance during the Trump administration. From the beginning of 2016 into Q3 2017, the two lines closely followed each other. However, they have diverged rather dramatically since then. We suspect that the anticipation of tax reform has led to the sharp rise in equities.

The real question is how will equities perform in 2018? The tax reductions built into the tax bill will likely have a significant impact on corporate earnings; we will have more to say about that in subsequent reports. However, another way to look at equities is by comparing the performance of the current Trump term to other four-year cycles.



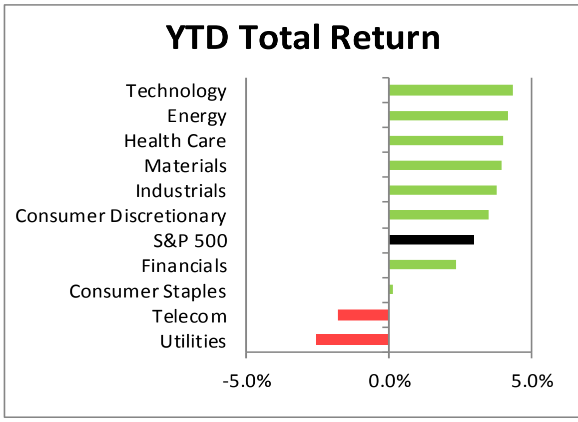
There are six other periods that correlate at 90% or above. Three of the six show weakness in the second full year of the administration, 1960-63, 1964-67 and 1988-91. In the first instance, the Cuban Missile Crisis likely led to the pullback. The escalation of the Vietnam War and rising inflation (the highest rise in the CPI in nine years) weighed on equities in 1966. The First Gulf War and the 1990-91 recession were behind weaker equities in the 1988 cycle. The other three had mostly rising equity values in the second full year of the political cycle.

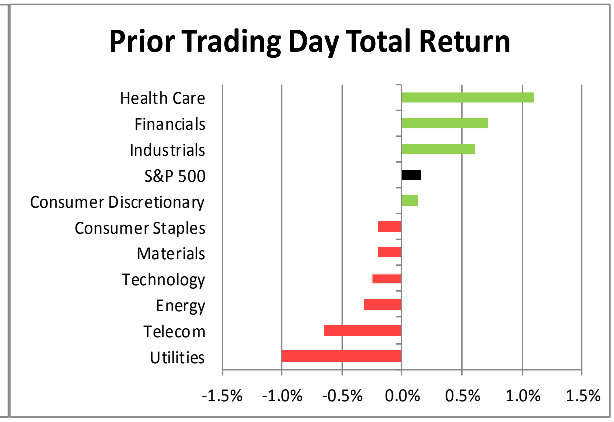
Interestingly enough, the highest correlating cycle is 2012-15, the second Obama term. Although the current index is running a bit behind compared to that year, the index pattern is most similar. If we continue to track that cycle and narrow the gap, the S&P 500 would end up at 3267.65 at the end of 2018.

How is this exercise useful? This analysis looks at high correlation periods and projects what may occur assuming that no major exogenous events occur. Obviously, a war or recession would lead to different outcomes. But, if the U.S. avoids an economic downturn or a major political or geopolitical event, equity markets could have another strong year.

Data Section

U.S. Equity Markets – (as of 1/9/2018 close)

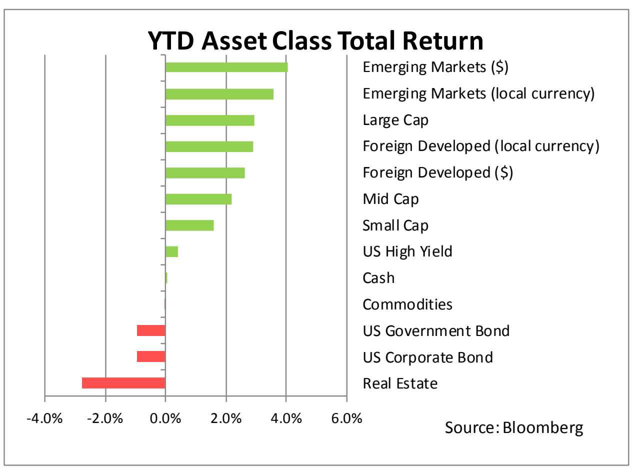




(Source: Bloomberg)

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 1/9/2018 close)

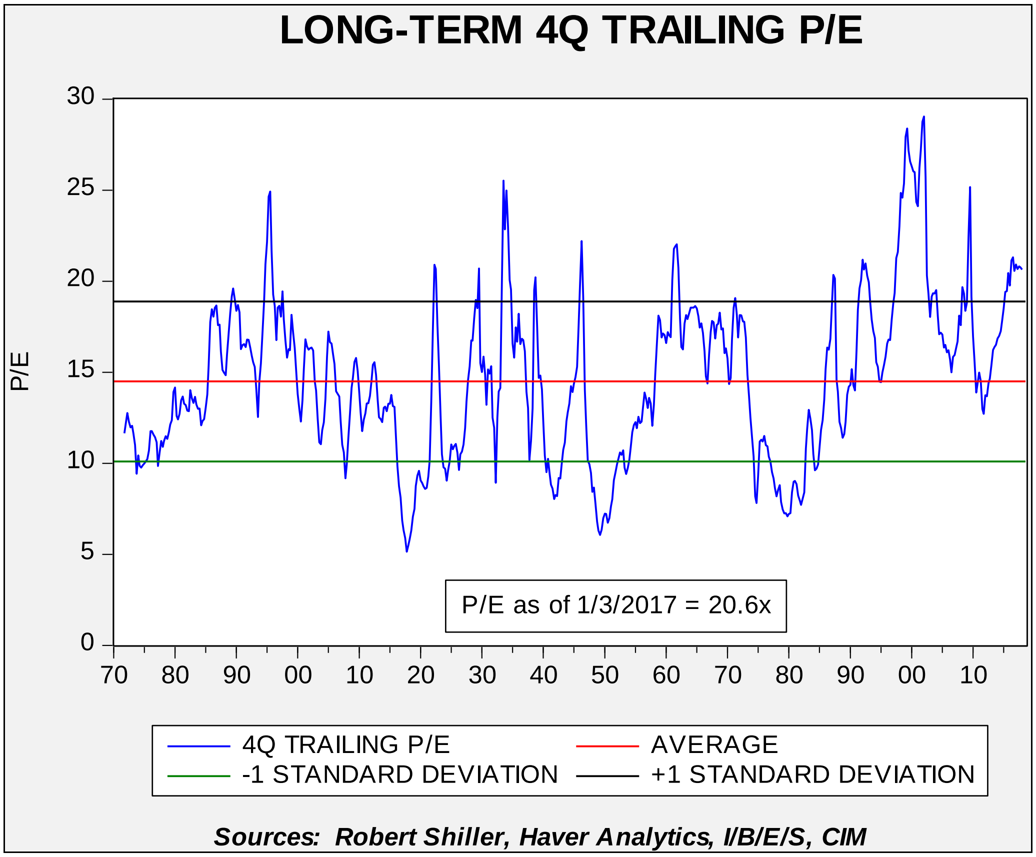


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 4, 2018



Based on our methodology,[1] the current P/E is 20.6x, unchanged from the 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.

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[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.