By Bill O'Grady and Thomas Wash

[Posted: January 12, 2018—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.2% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a higher open. With 22 companies having reported, the S&P 500 Q4 earnings stand at $34.92, 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, 72.7% of the companies reported earnings above forecast, while 13.6% reported earnings below forecast.

Coalition deal in Germany: This morning, Chancellor Merkel announced that an agreement has been reached to form a conservative coalition with the Social Democrats (SPD). This agreement will likely pave the way for Merkel to finally form a new government after months of negotiations following the results of the September election. Recently, there has been speculation that Merkel may step down from her role as chancellor due to her inability to form a government; this agreement has quelled those fears. The euro appreciated immediately after the news broke. Although an agreement has been reached, it still needs to be finalized by members of the SPD during its party conference on January 21.

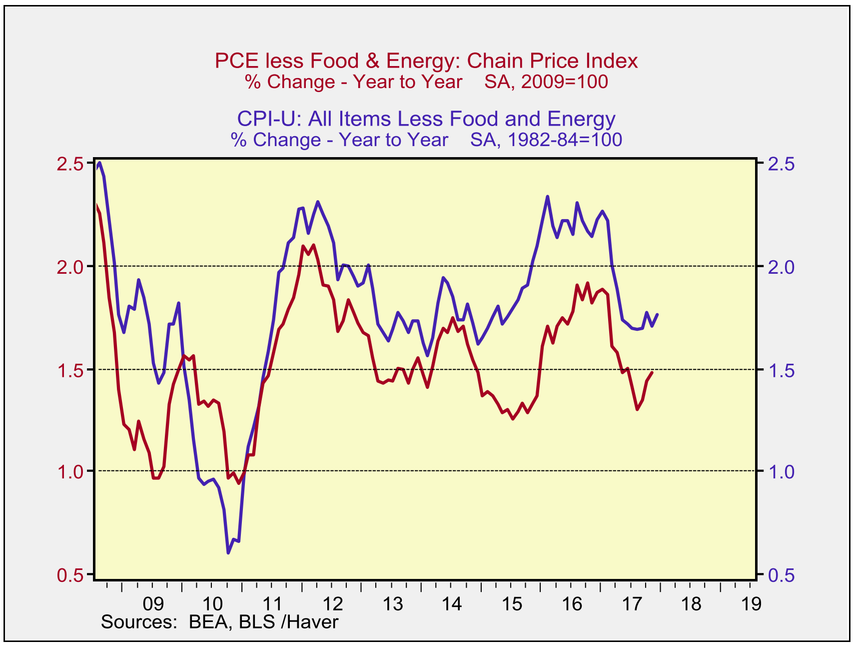
Pakistan intelligence: Yesterday, Pakistan announced it would withhold key ground intelligence from the United States in response to the State Department's decision to withhold security aid. The U.S. has accused Pakistan of harboring Afghan Taliban and has demanded that Pakistan do more to assist in the fight against terrorism if it would like to receive additional aid. The lack of intelligence is likely to hamper U.S. war efforts in Afghanistan; however, the U.S. will still be able to gather intelligence from air surveillance and intercepted communications. Pakistan's retaliation is likely to escalate tensions and could push it to strengthen its relationship with China. The waning relationship with Pakistan could be further evidence that the U.S. is pivoting its foreign policy toward improving relations with India, which it sees as a counterweight to China's influence throughout Asia. During a press conference in Norway, President Trump singled out India, in addition to Russia and China, as a country with which he would like to build a working relationship. Furthermore, Pakistan and India have always had a tense relationship since Pakistan split from India in 1947.

DACA deal: Yesterday, a bipartisan deal to protect those who were brought into the U.S. as children illegally, also known as dreamers, was rejected by the president. Clauses that caught the president's ire involved maintaining the diversity lottery in developing countries, which the president has openly opposed in the past. After hearing about its inclusion in the bill the president gave a somewhat salacious response questioning the logic behind diversity lotteries. Those comments have been widely reported elsewhere, so we will not repeat them here, but instead we will focus on how it may impact his legislative agenda going forward. The president's remarks could make it harder to reach a deal on immigration in the future, which has held back budget talks. In addition, Democrats will likely use President Trump's harsh rhetoric as fodder for their base in the run-up to the mid-term elections.

Nuclear deal lives another day: President Trump is expected to extend sanctions relief to Iran on the condition that the U.S. and its allies come up with a better nuclear deal. The president has never been a fan of the agreement, labelling it the "worst deal ever." There was some speculation that the president would pull out of the deal due to the Iranian government's response to recent protests in the region. We will continue to monitor this situation.

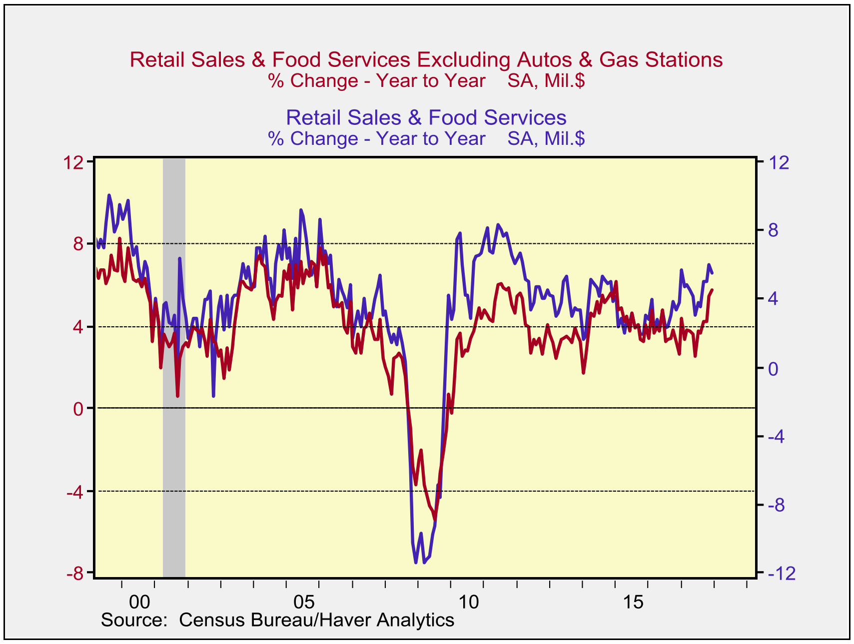
U.S. Economic Releases

CPI came in line with expectations, rising 0.1% from the prior month. Core CPI came in above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%.



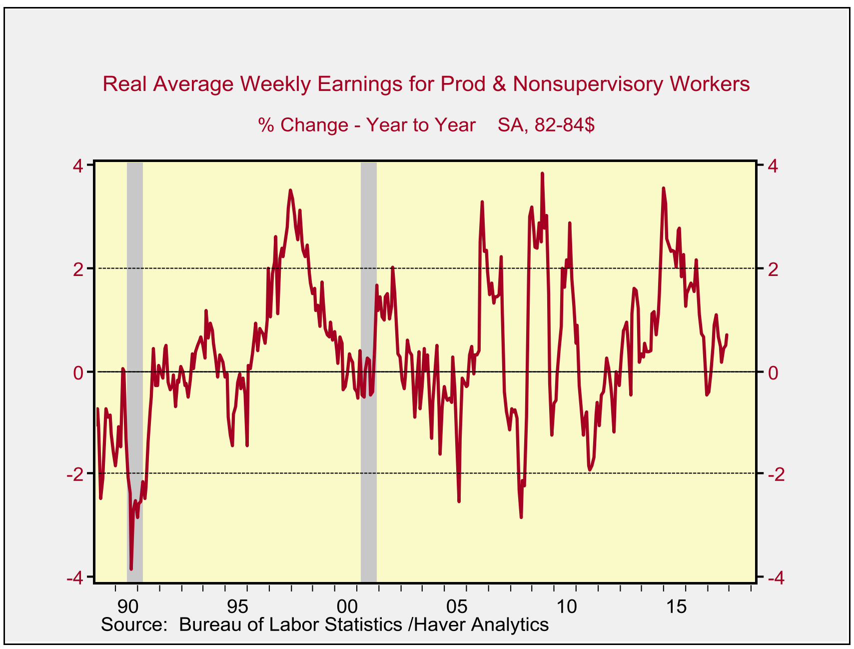
The chart above shows the year-over-year change in core CPI and core PCE. Core CPI rose 1.8% from the prior year. It is worth noting that although CPI is the most commonly used inflation gauge, the Fed's preferred measure is the PCE.

Retail sales advance came in below expectations, rising 0.4% from the prior month compared to the forecast gain of 0.5%; the prior month's gain was revised upward from 0.8% to 0.9%. Retail sales ex-auto came in above expectations, rising 0.4% from the prior month compared to the forecast gain of 0.3%; the prior month's gain was revised upward from 1.0% to 1.3%. Retail sales ex-auto and gas were in line with expectations, rising 0.4% from the prior month. The retails sales control group came in below expectations, rising 0.3% from the prior month compared to the forecast of 0.4%. The prior month's gain was revised upward from 0.8% to 1.4%.



The chart above shows the year-over-year change in retail sales and core retail sales.

Real average weekly earnings rose by 0.7% from the prior year; real average hourly earnings also rose by 0.4% from the prior year.



The chart above shows the year-over-year change in real average weekly earnings for production and non-supervisory workers, which rose 0.7% from the prior year.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Business Inventories	m/m	nov	-0.1%	0.4%	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:00	Patrick Harker Speaks on Economic Outlook	President of the Federal Reserve Bank of Philadelphia				
16:15	Eric Rosengren gives keynot address at US San Diego	President of the Federal Reserve Bank of Boston				

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								
Japan	BoP Current Account Balance	y/y	nov	¥1347.3 bn	¥2176.4 bn	¥1836.1 bn	**	Equity bearish, bond bullish
	Japan buying foreign bonds	y/y	jan	¥173.0 bn			*	Equity and bond neutral
	Japan buying foreign stocks	y/y	jan	¥217.1 bn			*	Equity and bond neutral
	Foreign buying Japan bonds	y/y	jan	¥128.3 bn			*	Equity and bond neutral
	Foreign buying Japan stocks	y/y	jan	¥597.9 bn			*	Equity and bond neutral
India	CPI	y/y	dec	5.2%	4.9%	5.1%	***	Equity and bond neutral
	Industrial Production	y/y	nov	8.4%	2.2%	4.4%	***	Equity bullish, bond bearish
Australia	Credit Card Purchases	m/m	dec	A$27.9 bn	A$27.5 bn		*	Equity and bond neutral
	Credit Card Balances	q/q	dec	A$52.2 bn	A$51.2 bn		*	Equity and bond neutral
New Zealand	Building Permits	m/m	nov	10.8%	-9.6%		**	Equity and bond neutral
EUROPE								
France	CPI	y/y	dec	1.2%	1.2%	1.2%	***	Equity and bond neutral
Italy	Industrial Production	y/y	nov	2.2%	3.1%	3.3%	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Consumer Confidence	m/m	dec	88.6	89.3	89.0	***	Equity bearish, bond bullish
	Industrial Production	y/y	nov	-1.5%	-1.1%	-1.0%	***	Equity bearish, bond bullish
	Manufacturing Production	m/m	nov	2.4%	2.7%	2.6%	***	Equity and bond neutral
Canada	New Housing Price Index	m/m	nov	3.4%	3.5%		**	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)	140	141	-1	Neutral
TED spread (bps)	31	30	1	Neutral
U.S. Libor/OIS spread (bps)	147	147	0	Up
10-yr T-note (%)	2.55	2.54	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	24	26	-2	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	$68.98	$69.26	-0.40%	Long Liquidation
WTI	$63.33	$63.80	-0.74%	
Natural Gas	$3.12	$3.08	1.13%	
Crack Spread	$16.94	$16.71	1.35%	
12-mo strip crack	$19.64	$19.58	0.30%	
Ethanol rack	$1.42	$1.42	0.38%	
Metals				
Gold	$1,332.00	$1,322.44	0.72%	Weaker Dollar
Silver	$17.13	$16.99	0.86%	
Copper contract	$322.40	$323.30	-0.28%	
Grains				
Corn contract	$ 349.50	$ 348.75	0.22%	
Wheat contract	$ 434.00	$ 433.25	0.17%	
Soybeans contract	$ 950.50	$ 950.00	0.05%	
Shipping				
Baltic Dry Freight	1303	1366	-63	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.9	-3.8	-1.2	
Gasoline (mb)	4.1	3.3	0.9	
Distillates (mb)	4.3	2.3	2.0	
Refinery run rates (%)	-1.40%	-0.50%	-0.9%	
Natural gas (bcf)	-359.0	-325.0	-34.0	

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

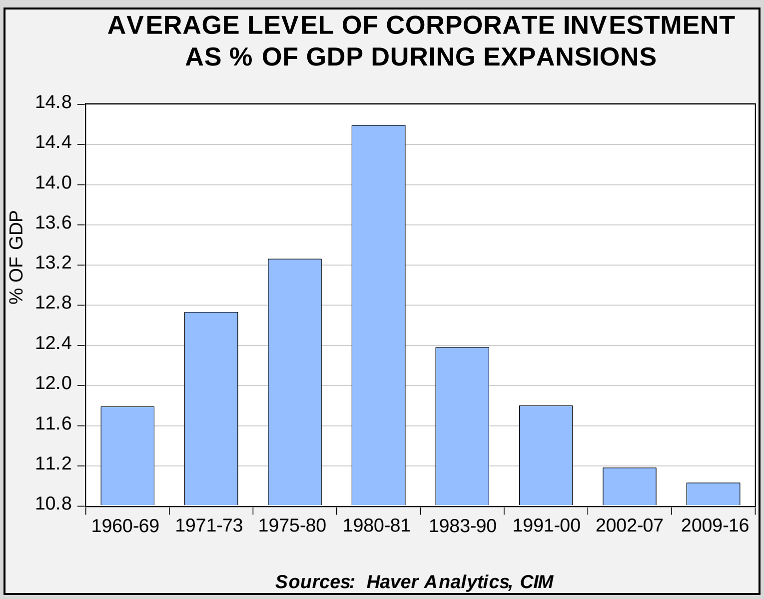
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

January 12, 2018

Last week, we issued an addendum to our 2018 Outlook[1] to take into account the recent tax law changes. Our top-down analysis suggests there will be a significant increase in corporate earnings which will translate into higher S&P 500 earnings. Our original forecast was for $129.82[2] for 2018; we have increased our earnings forecast in light of the tax bill to $144.84. We are assuming a 21.1x P/E multiple for 2018, meaning our forecast for the S&P 500 has increased from 2739.20 to 3056.12.

Whenever we make a forecast, as part of the process, we look for factors that could lead us to be wrong. In the original 2018 Outlook, we focused on a number of factors, including an unexpected recession, excessive monetary policy tightening, etc. In our 2018 Geopolitical Outlook,[3] we added other events that could adversely affect this forecast. In this report, we will focus on another factor that could lead to forecast variance.

One of the goals of the tax bill is to boost investment. The focus on investment does make sense; since the early 1980s, investment levels relative to GDP have been falling with each expansion.



This chart shows the average level of corporate investment relative to GDP for each expansion since the 1960s. As noted, the level of corporate investment has been falling with each

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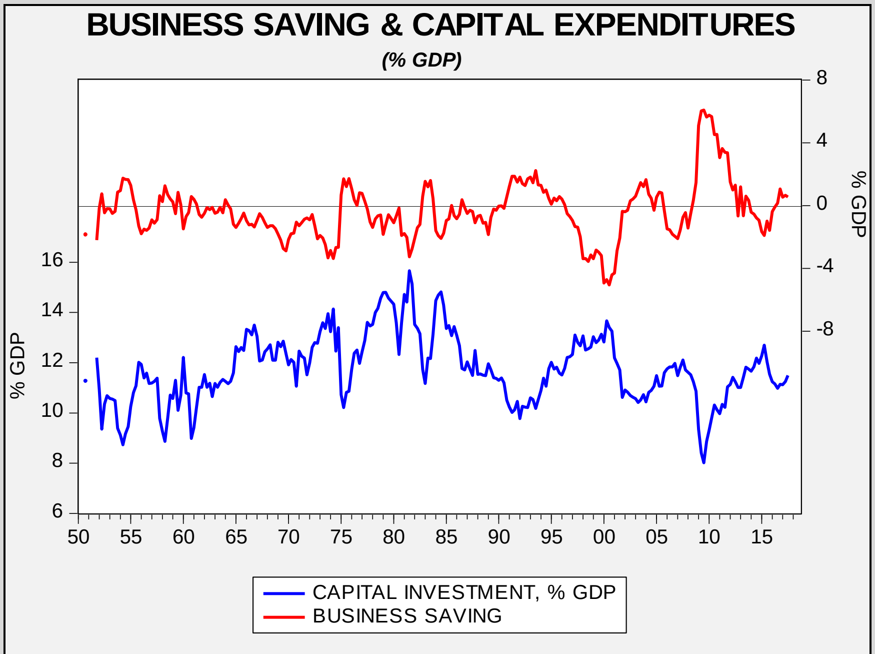
[1] See 2018 Outlook and 2018 Outlook: Addendum

[2] Using Standard & Poor's operating earnings rather than the more commonly quoted Thomson/Reuters operating earnings, which averages approximately 8% higher.

[3] See WGR, 12/18/17, The 2018 Geopolitical Outlook

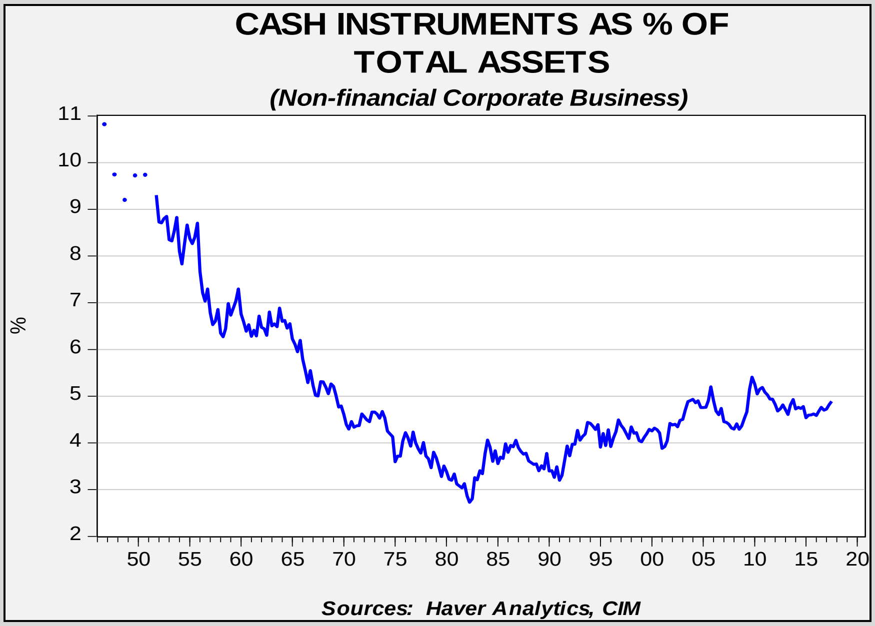
expansion. It isn't obvious why this is occurring—a number of factors are probably involved, including more corporate investment offshore due to globalization, improved efficiency of investment due to technology and less investment due to industry concentration (fewer firms making the same things don't duplicate productive capacity). The problem is that these are structural factors and we doubt mere changes to the tax bill will foster a significant boost in investment.



Sources: Haver Analytics, CIM

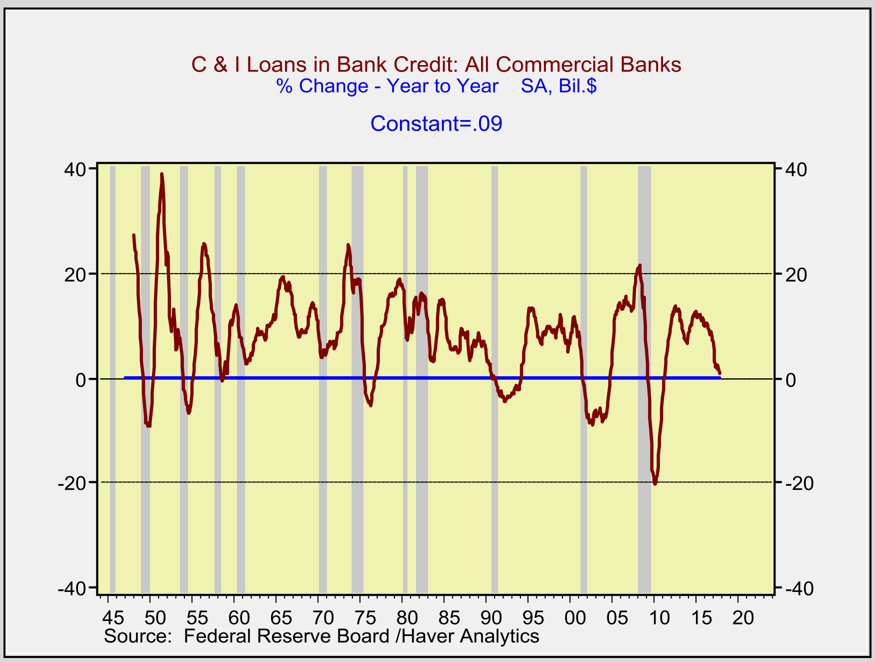
This chart shows capital investment and the level of business saving. Ample capital investment can occur without business saving; in fact, it is not uncommon for business dissaving to occur during periods of expanding capital expenditures. The recent rise in business saving coincides with falling levels of capital expenditures.

Cutting corporate tax rates could lift investment if there was a lack of available liquidity because cutting tax rates should lift the level of cash available for investment. However, there is little evidence to suggest a liquidity shortage. First, as seen above, flows into business saving have been rising. Second, cash and near-cash holdings of non-financial corporations is relatively high and well above the trough level seen since 1980.



Current liquid assets relative to total assets are 4.9%, which appears ample for self-funding investment.

Third, and perhaps even more telling, is that commercial and industrial (C&I) loan growth is at a level associated with recession.



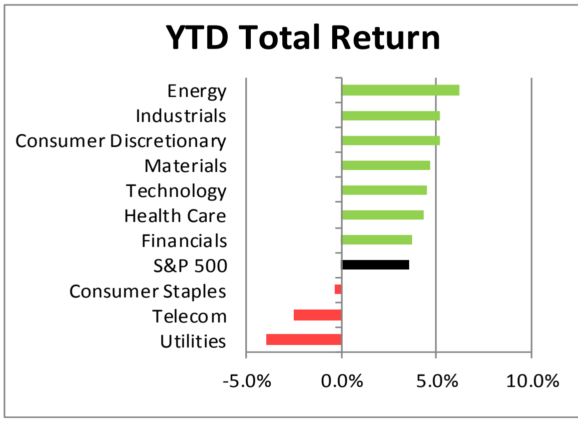
The current yearly growth of C&I loans is +0.09%; in the past, this level is usually observed either when the economy is in recession or shortly after one has ended. In no period during the postwar experience has C&I loan growth been this weak without being associated with a recession. The reason that slowing C&I loan growth affects the economy is that when commercial banks begin cutting back on loans, it usually lowers investment; at the same time, commercial banks tend to be cautious and don't begin restricting lending until it is abundantly clear that the economy is weakening, thus making this indicator mostly a lagging one. Lending surveys from the Federal Reserve do not suggest senior loan officers are tightening credit. Thus, we conclude that the drop in lending is probably a function of falling demand for the loans—simply put, businesses don't need the liquidity and aren't borrowing for the current level of economic activity.

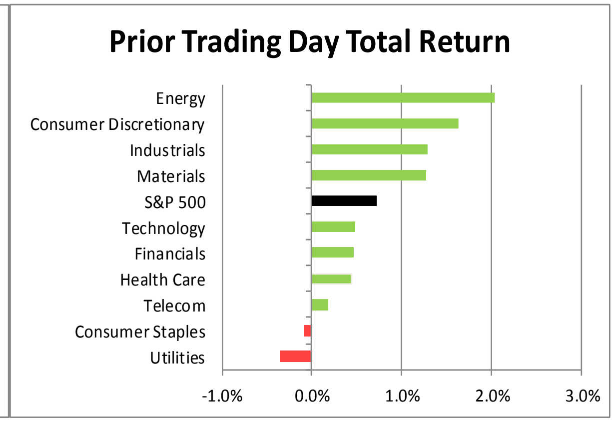
As a result, the corporate sector, which has ample liquidity and isn't borrowing, is about to get even more liquidity pushed its way. The key issue is most likely a lack of aggregate demand. In other words, the economy isn't growing fast enough to trigger an expansion of the capital base. Thus, unless other parts of the tax law encourage economic growth, the economic impact from the tax cuts will likely be rather small.

However, the financial impact could be significant. Expanding corporate liquidity will likely encourage higher dividends, share buybacks and merger activity. Given the expected boost in earnings from the tax cuts, the expansion of corporate liquidity and the anticipated response from corporations to reward shareholders should support the continued elevated multiple and perhaps even lift investor sentiment further.

Data Section

U.S. Equity Markets – (as of 1/11/2018 close)

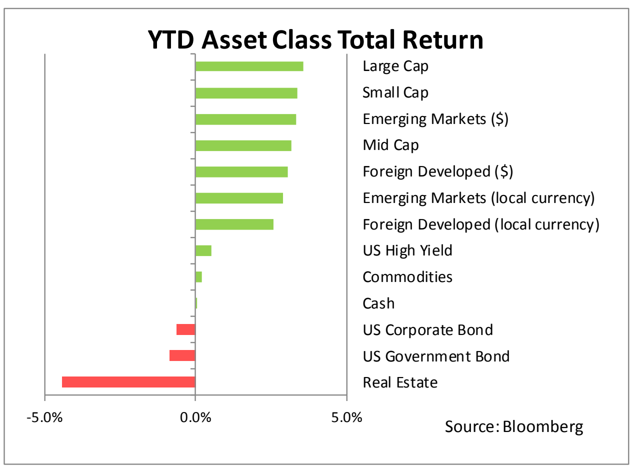




(Source: Bloomberg)

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 1/11/2018 close)

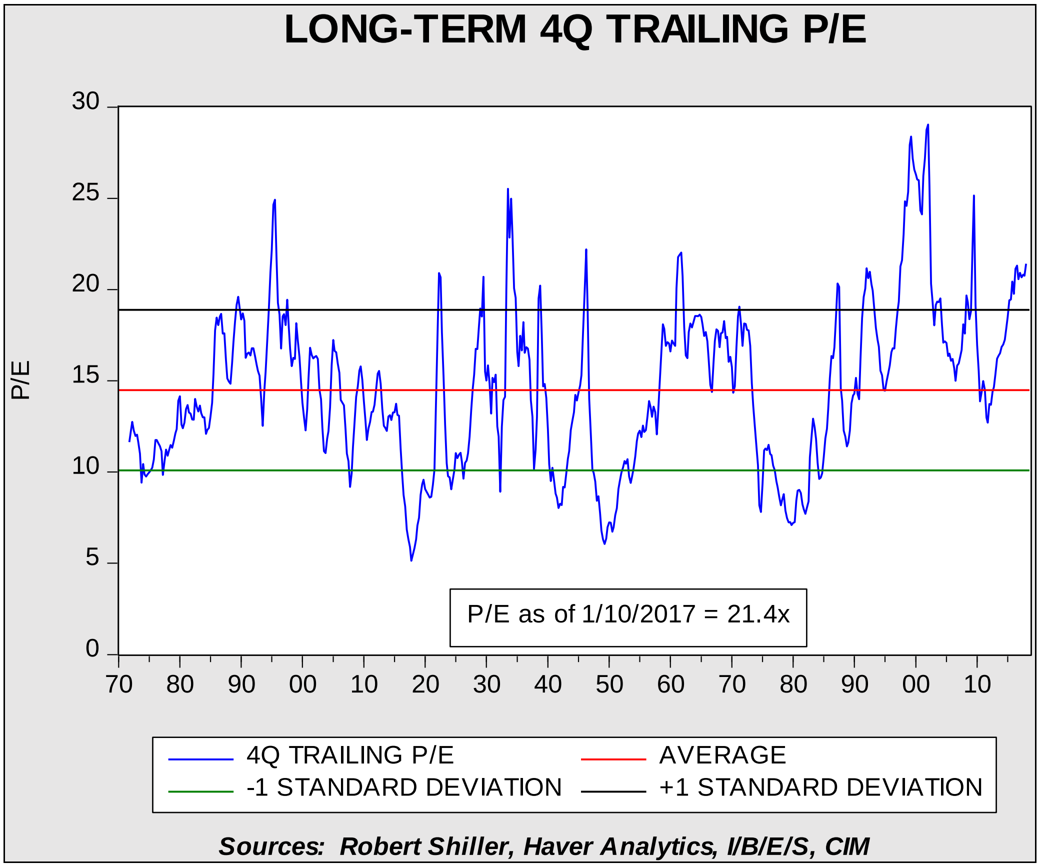


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 11, 2018



Based on our methodology,[4] the current P/E is 21.4x, up 0.8x from the last report. A rising S&P and falling earnings led to a sharp rise in the P/E this week.

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[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 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.