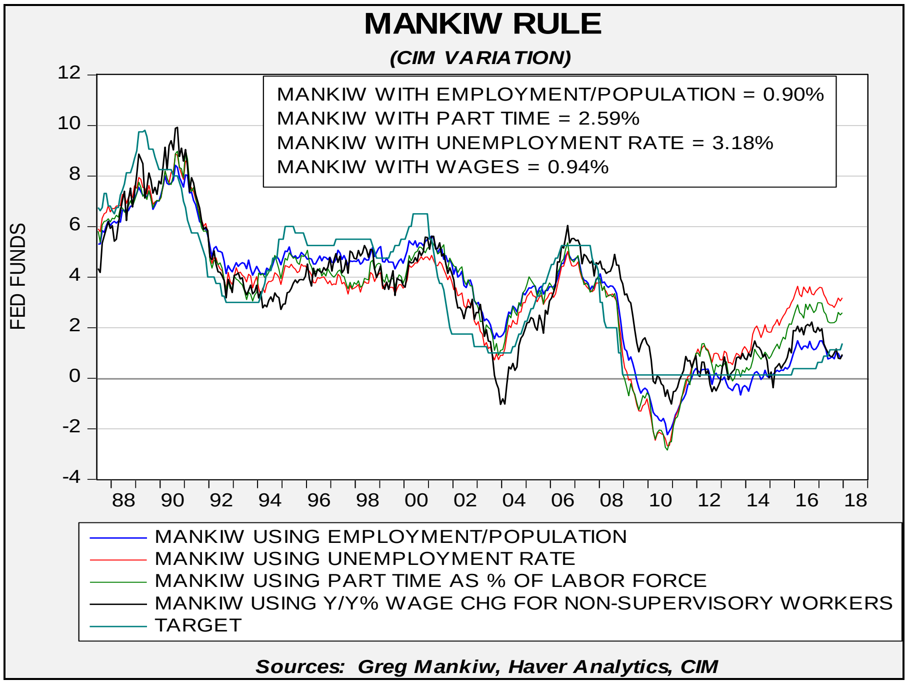
[Posted: January 17, 2018—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is relatively unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed relatively unchanged from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a higher open. With 31 companies having reported, the S&P 500 Q4 earnings stand at $34.85, slightly 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, 77.4% of the companies reported earnings above forecast, while 12.9% reported earnings below forecast.

Financial markets were mostly quiet overnight. Yesterday turned out to be a rare down day for equities but futures are signaling a higher opening this morning. Treasury yields are modestly higher. Here is what we are watching this morning:

A continuing resolution: Congressional leaders are likely to simply extend the government's spending power for about a month and not resolve any of the underlying issues. This means we won't see an imminent government shutdown but will revisit the issue next month. Yesterday, a special election in Wisconsin, in a heavily GOP district, went to a Democrat. This was for the state Senate, so it doesn't affect the U.S. Congress, but it does suggest the chances for a swing in November are rising. Patty Schachtner, a rather centrist Democrat (her bio notes that she is a former member of the Wisconsin Bear Hunter's Association), defeated a well-funded and solid assemblyman, Adam Jarchow. Recent Democrat victories are further hardening the stance of the national party with the idea that their party's chances are improving for November and thus the incentive is waning to negotiate with Congressional Republicans and the president. As a result, we will likely see increased gridlock in Washington for 2018. In the short run, this is probably bullish for equities; gridlock means the status quo remains in place and the status quo is favorable for stocks. Longer term, political turmoil may become a bigger issue.

Fed policy: With the release of the CPI data we can update the Mankiw models. The Mankiw rule models attempt 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.

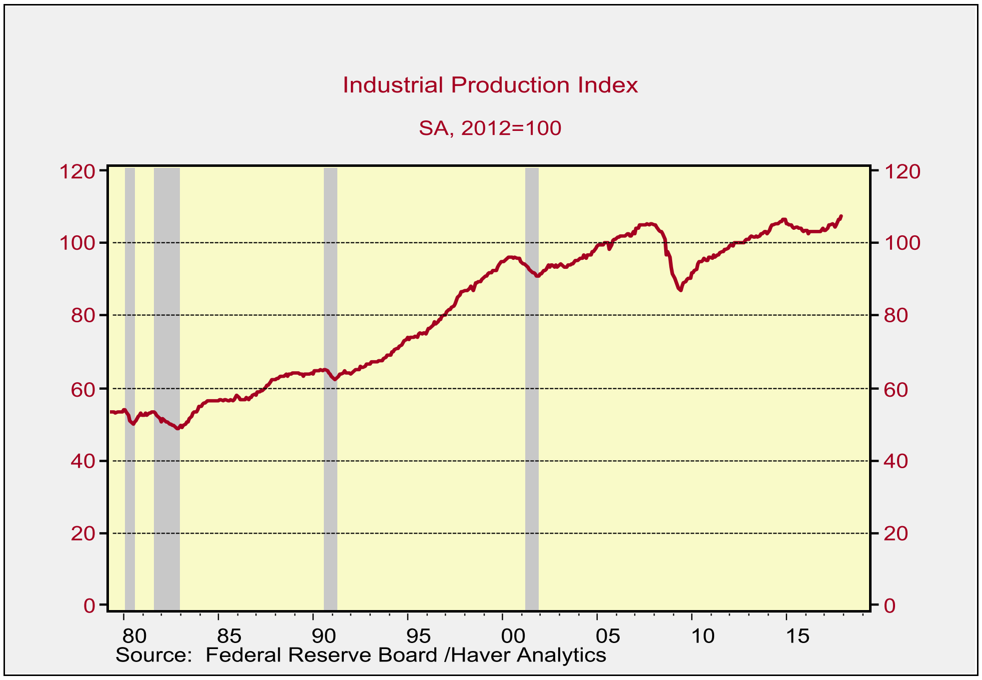


Using the unemployment rate, the neutral rate is now 3.18%. Using the employment/population ratio, the neutral rate is 0.94%. Using involuntary part-time employment, the neutral rate is 2.59%. Using wage growth for non-supervisory workers, the neutral rate is 0.94%. The modest uptick in core CPI has lifted the various neutral estimates higher but, as we have seen for several months, two of the measures of slack suggest the FOMC has achieved rate neutrality, while two suggest the FOMC is well behind the curve. We expect the FOMC to mostly split the difference and end up between 2.25% to 2.50% for the target at the end of this year. However, if the two variations that are signaling lower rates turn out to be the accurate measures of slack, this degree of tightening will lead to an increased risk of recession.

U.S. Economic Releases

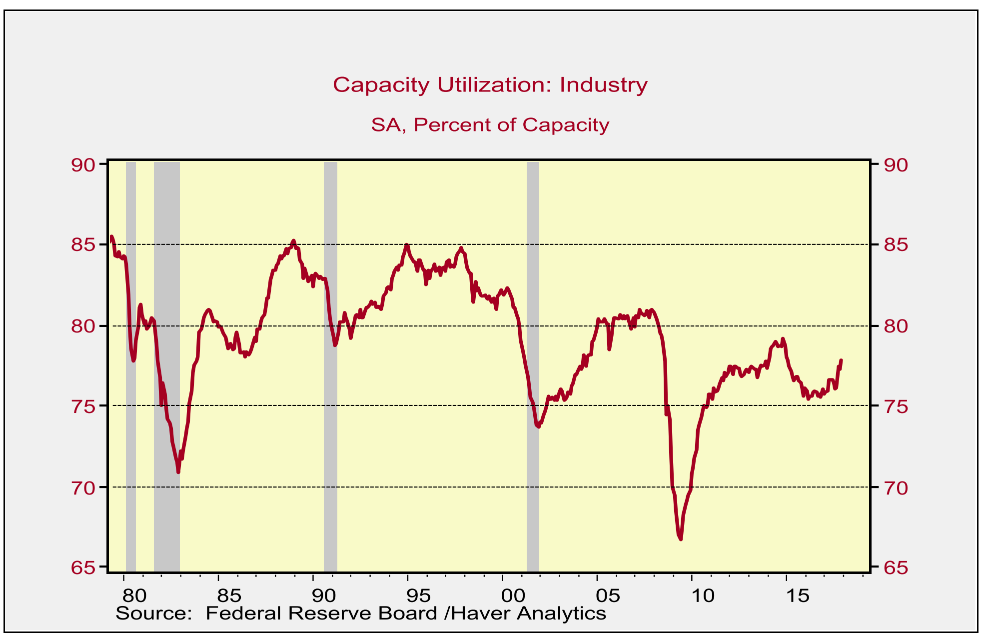
Weekly mortgage applications rose 4.1% from the prior week, with purchases up 2.7% and refinancing up 4.4%. The average rate on a 30-year fixed mortgage rose by 10 bps from 4.23% to 4.33%.

December industrial production rose 0.9% compared to forecasts of a 0.5% rise. The prior month's report was revised downward from 0.2% to -0.1%.



The current reading is a new all-time high for this index.

Capacity utilization came in above expectations at 77.9% compared to a forecast of 77.4%, but the prior month was revised upward from 77.1% to 77.2%.



The chart above shows the level of capacity utilization.

Although the industrial production and capacity utilization numbers are impressive, there is one caveat—much of the rise is coming from the utility sector. Since November, utility output rose

5.7%, while manufacturing rose a modest 0.1% and mining rose 1.6%. Cold weather forces utilities to raise output but this lift dissipates as the weather warms. There are seasonal adjustments in the numbers that reduce some of the weather factors but these assume normal temperatures. Unusual weather patterns cannot be fully accounted for by the seasonal adjustments. Since January has also experienced cold weather, we look for a similar issue with next month's report, with a reversal in the coming months.

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	NAHB Housing Market Index	m/m	dec	72	74	**
16:00	Total Net TIC Flows	m/m	nov		$151.2 bn	**
16:00	Net Long-Term TIC Flows	m/m	nov		$23.2 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
14:00	US Federal Reserve Releases Beige Book	Members of the Board of Governors				
15:00	Charles Evans Speaks on Economy and Monetary Policy	President of the Federal Reserve Bank of Chicago				
16:30	Loretta Mester speaks to Community Banking Conference	President of the Federal Reserve Bank of Cleveland				

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	Core Machine Orders	y/y	nov	4.1%	2.3%	-1.0%	**	Equity bullish, bond bearish
Australia	Westpac Consumer Confidence	y/y	jan	1.8%	3.6%		**	Equity and bond neutral
	Home Loans	y/y	nov	2.1%	-0.6%	0.0%	**	Equity bullish, bond bearish
	Invesment Lending	y/y	nov	1.5%	1.6%		**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	dec	-2.2%	-0.9%		**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registration	y/y	dec	-4.9%	5.9%		**	Equity and bond neutral
	Construction Output	y/y	nov	2.0%	2.1%	2.0%	**	Equity and bond neutral
	CPI	y/y	dec	1.4%	1.4%	1.4%	***	Equity and bond neutral
Switzerland	Real Estate Index Family Homes	y/y	4q	468.8	464.5		*	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)	173	172	1	Up
3-mo T-bill yield (bps)	141	140	1	Neutral
TED spread (bps)	32	32	0	Neutral
U.S. Libor/OIS spread (bps)	149	148	1	Up
10-yr T-note (%)	2.56	2.54	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	27	24	3	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	flat			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision		1.000%	1.250%	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	$68.81	$69.15	-0.49%	OPEC Speculation
WTI	$63.49	$63.73	-0.38%	
Natural Gas	$3.17	$3.13	1.41%	
Crack Spread	$16.60	$16.63	-0.18%	
12-mo strip crack	$19.43	$19.55	-0.62%	
Ethanol rack	$1.43	$1.43	-0.10%	
Metals				
Gold	$1,335.46	$1,338.41	-0.22%	
Silver	$17.17	$17.19	-0.11%	
Copper contract	$320.55	$321.95	-0.43%	
Grains				
Corn contract	$ 348.75	$ 348.25	0.14%	
Wheat contract	$ 416.75	$ 416.50	0.06%	
Soybeans contract	$ 966.50	$ 968.00	-0.15%	
Shipping				
Baltic Dry Freight	1221	1264	-43	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.9		
Gasoline (mb)		3.5		
Distillates (mb)		2.3		
Refinery run rates (%)		-0.50%		

Weather

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

Asset Allocation Weekly Comment

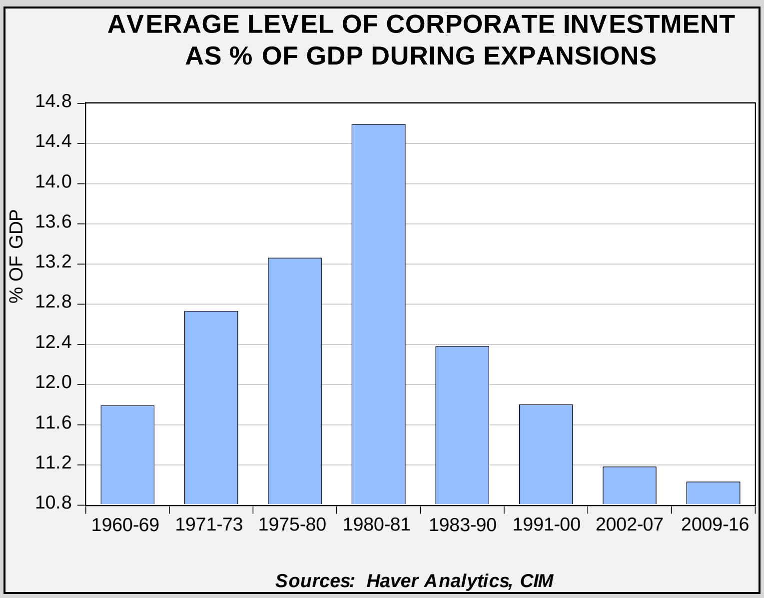
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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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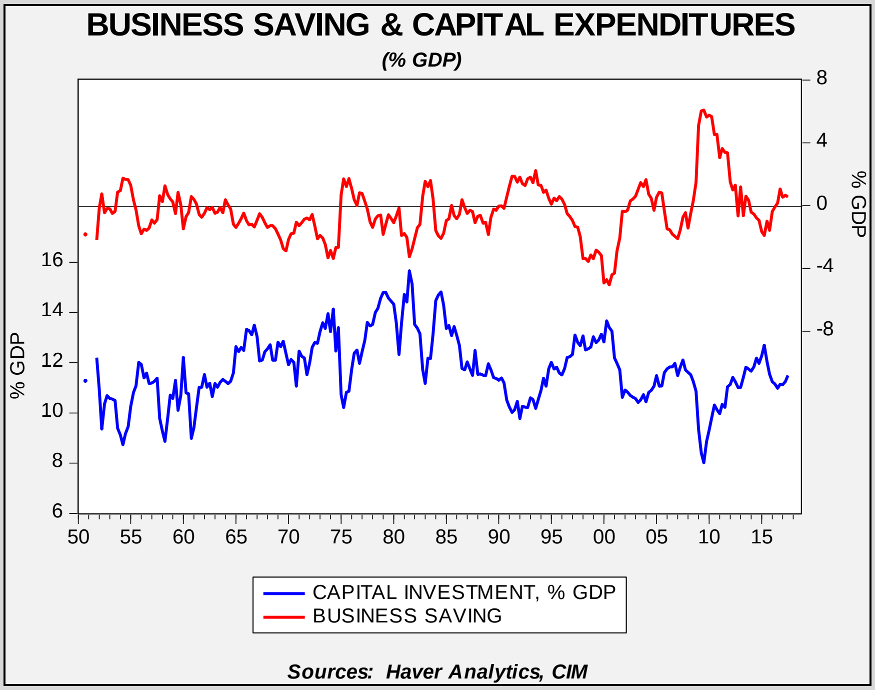
[1] See 2018 Outlook and 2018 Outlook: Addendum

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

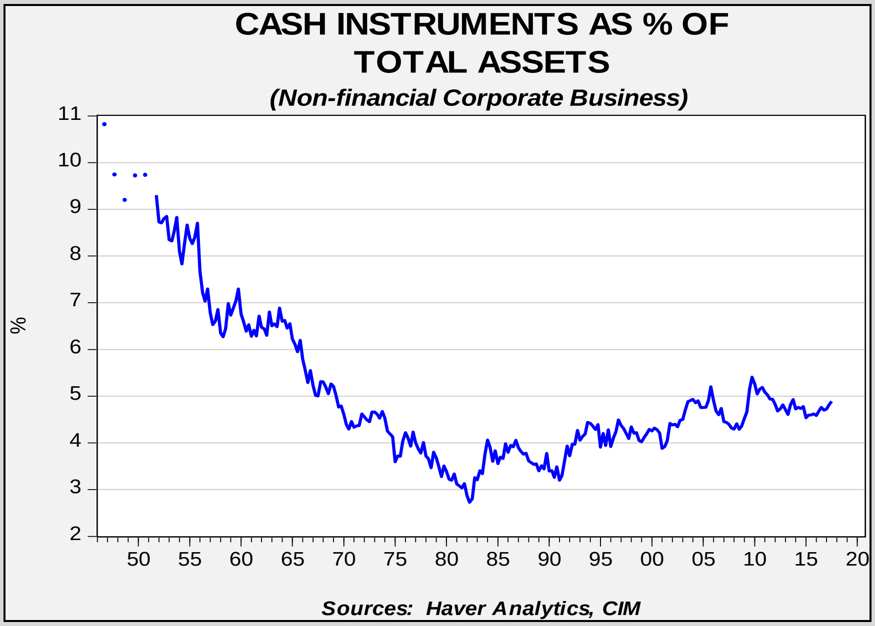
[3] See WGR, 12/18/17, The 2018 Geopolitical Outlook

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.



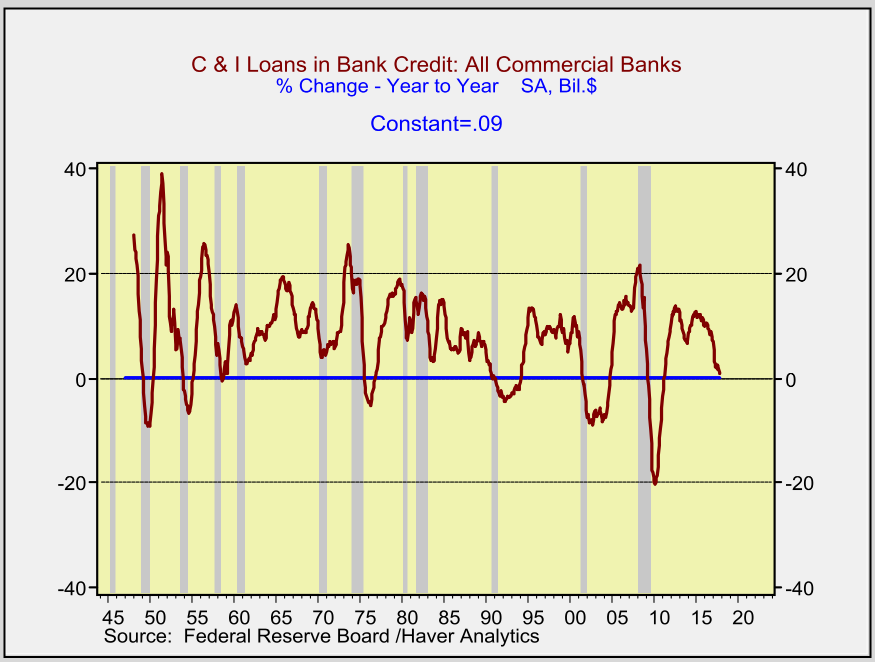
This chart shows capital investment and the level of business saving. Ample capital investment can occur without business saving; in fact, it is not uncommon for business dissaving to occur during periods of expanding capital expenditures. The recent rise in business saving coincides with falling levels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



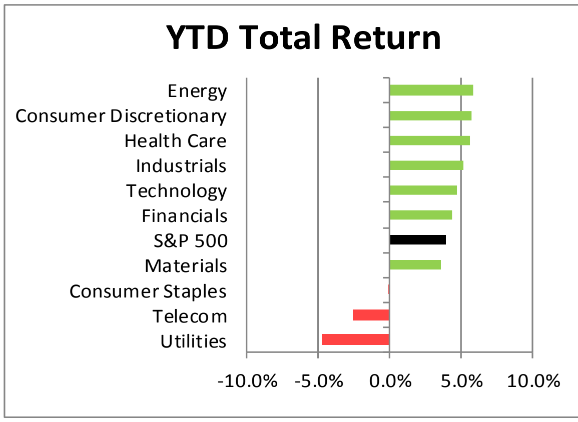
The current yearly growth of C&I loans is +0.09%; in the past, this level is usually observed either when the economy is in recession or shortly after one has ended. In no period during the postwar experience has C&I loan growth been this weak without being associated with a recession. The reason that 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.

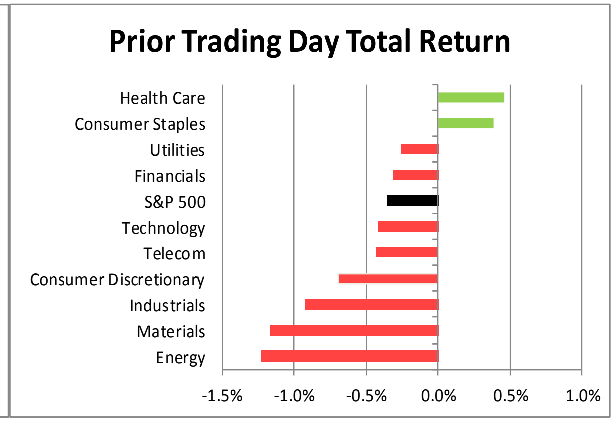
As a result, the corporate sector, which has ample liquidity and isn't borrowing, is about to get even more liquidity pushed its way. The key issue is most likely a lack of aggregate demand. In other words, the economy isn't growing fast enough to trigger an expansion of the capital base. Thus, unless 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 1/16/2018 close)

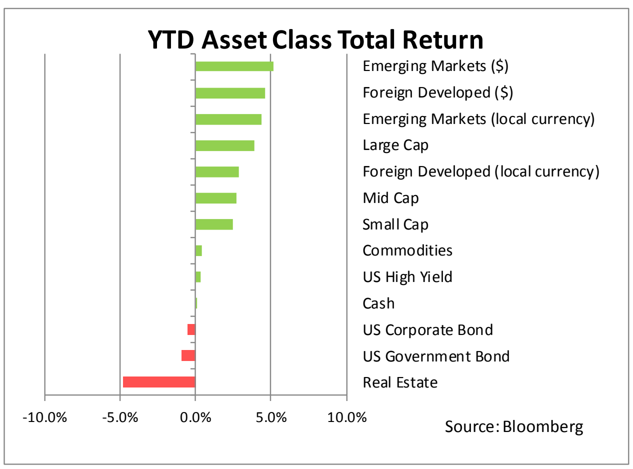




(Source: Bloomberg)

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 1/16/2018 close)

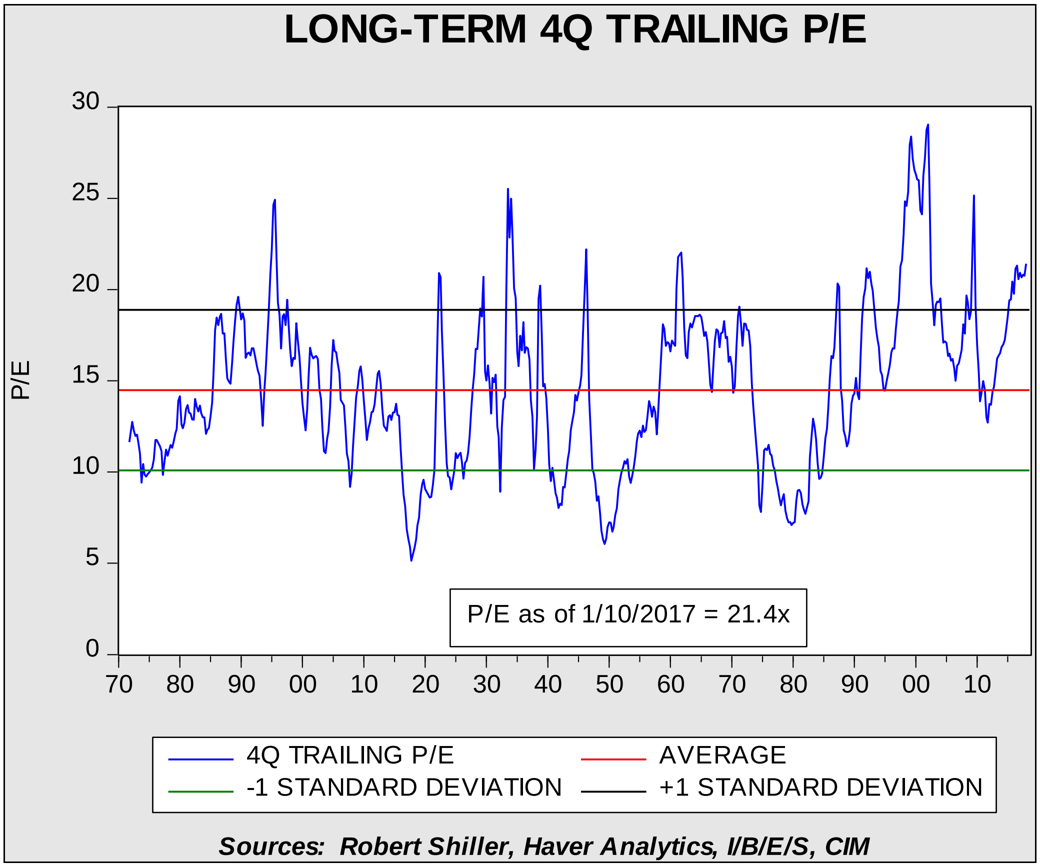


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.