Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady, Kaisa Stucke, and Thomas Wash

[Posted: January 26, 2017—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.9% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.7%. U.S. equity futures are signaling a higher open. With 105 companies having reported, the S&P 500 Q4 earnings stand at $31.21, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 71.4% of the companies reported earnings above forecast, while 16.2% reported earnings below forecast.

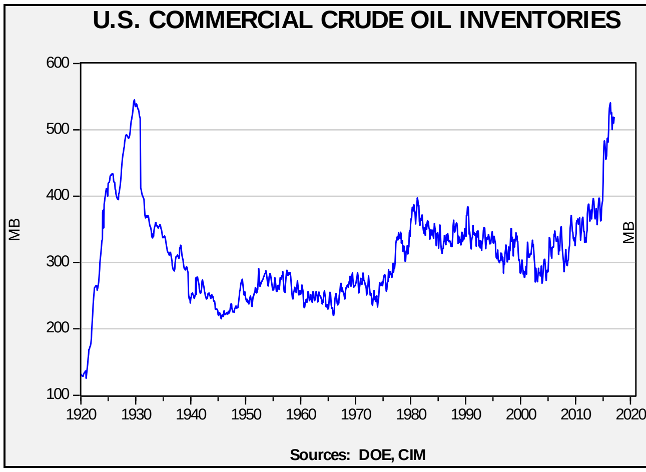
Global equities are holding this week's gains on renewed optimism that tax changes and infrastructure spending will lift the economy and earnings. We note that the GOP House leadership is pressing the idea that tax changes should be mostly revenue-neutral and there is a renewed push for border adjustments in the Ryan bill. As a reminder, the border adjustment would tax imports but not exports. There is also some marketing going on, with proponents suggesting the border tax is a "fee" to avoid the stigma of a tax. According to some sources, Trump is uncomfortable with the border adjustment; he is said to believe it's too complicated and it limits his freedom to unilaterally support friends and harm enemies. However, these sources also claim that advisor Steve Bannon likes the border adjustment idea. It appears to us that without the border adjustment, corporate tax cuts will reduce revenue to the Treasury significantly and will lead to a higher marginal rate. It should also be noted that Congressional Republicans are not strongly behind infrastructure spending but the president is pressing the case for public investment. It remains to be seen how Trump will handle this if Congressional Republicans refuse to yield. Will the president team up with Democrats and threaten GOP unity to get infrastructure spending? We will be watching but we do expect that some infrastructure spending will be forthcoming; the right-wing populists are counting on it. That infrastructure spending will likely include the border wall that the president is proposing.

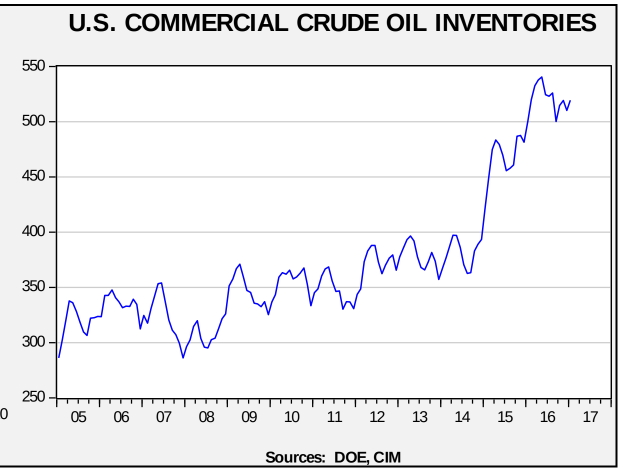
In Europe, we are monitoring a couple of political developments. First, the Social Democratic Party of Germany (SPD) has a new leader, Martin Schulz, and he is apparently looking to run against Chancellor Merkel. The CSU/CDU conservative parties, led by Merkel, are currently governing with the SPD. It doesn't appear to us that one could create a government by excluding either the mainstream conservatives or socialists, but the composition of power could change. In other words, if the SPD does well in the November polling, the CSU/CDU/SPD coalition could remain but the SPD might win more positions of influence in the government. Currently, Schulz's popularity rivals Merkel's. If the SPD gains more power, it may be more willing to expand fiscally and reduce pressure on the southern tier nations by boosting imports.

We are also watching reports that French authorities have opened an investigation of embezzlement against François Fillon, the current leading presidential candidate representing the establishment-right in France. According to reports, authorities are investigating whether Fillon's spouse was paid €500k of public money for a "no-show" job over an eight-year period. There were two jobs, one as Fillon's parliamentary assistant and one as assistant to Marc Jouland, who took Fillon's seat when he became a government minister in 2002. It should be noted that hiring family members is not illegal in France (about 10-15% of members of Parliament practice nepotism), but it would be against the law if Penelope hadn't actually done anything. Fillon has been running as a right-wing candidate in the Reagan/Thatcher mode, which is unusual for France. He is calling for sharp cuts in government spending and a reduction in government jobs; he has also been supportive of ending Russian sanctions. French presidential elections can go two rounds if no candidate wins a majority. In the second round, only the top two candidates participate. There are currently three candidates, Fillon, Marine Le Pen of the National Front and Emmanuel Macron, running as an independent (although a Socialist, he is offering free market positions, almost a center-right platform). The Socialists are still deciding on a candidate. There has been some speculation that if the current polls are accurate and there is a runoff between Fillon and Le Pen, leftist voters may lean toward the National Front which could bring a populist who wants to leave the Eurozone. If the charges against Fillon stick, it might reduce Le Pen's chances, although we tend to think it will simply upend the election and make it harder to predict. Anything that boosts Le Pen will likely be taken as bearish for the EUR.

We monitor a number of issues in our analysis, in part, to turn "black swans" (issues that are completely unexpected, called "unknown/unknowns") into "grey swans" ("known/unknowns"). Infectious disease is one of those factors. The *NYT* is reporting that the WHO is monitoring a bird influenza circulating in China that seems to have a rather high mortality rate. The strain, called H7N9, has been present every winter in China since 2013; more than 1,000 cases have been reported over the past four years with a 39% mortality rate. So far this year, 225 cases have been confirmed and China is about to embark on the New Year's migration, where millions of Chinese migrate home for the weeklong holiday. Vacation travel can increase the likelihood of transmission as travelers mix in close quarters. This strain has mostly affected those directly involved in poultry farming and processing (it is a bird-flu), but there are two suspected cases of human-to-human transmission; if the virus can be directly transmitted, it could indicate it has mutated into a more dangerous influenza. Influenza pandemics have the potential to slow global growth as illness and precautions against contracting the disease affect spending and travel. At this point, this strain remains contained but it does bear monitoring.

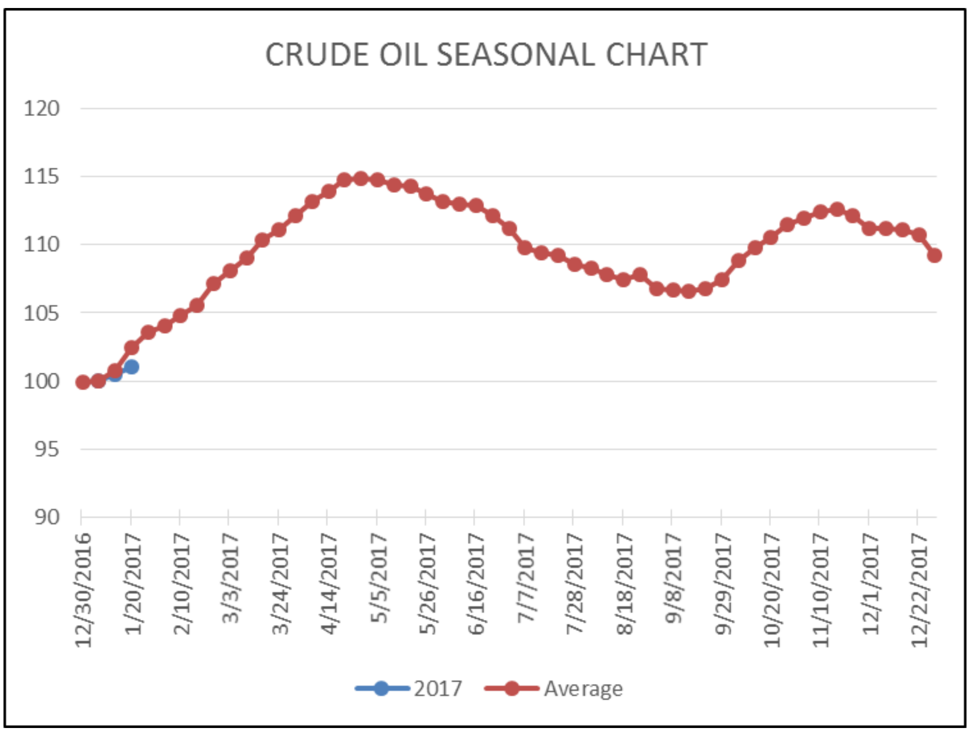
U.S. crude oil inventories rose 2.8 mb compared to market expectations of a 2.5 mb build.



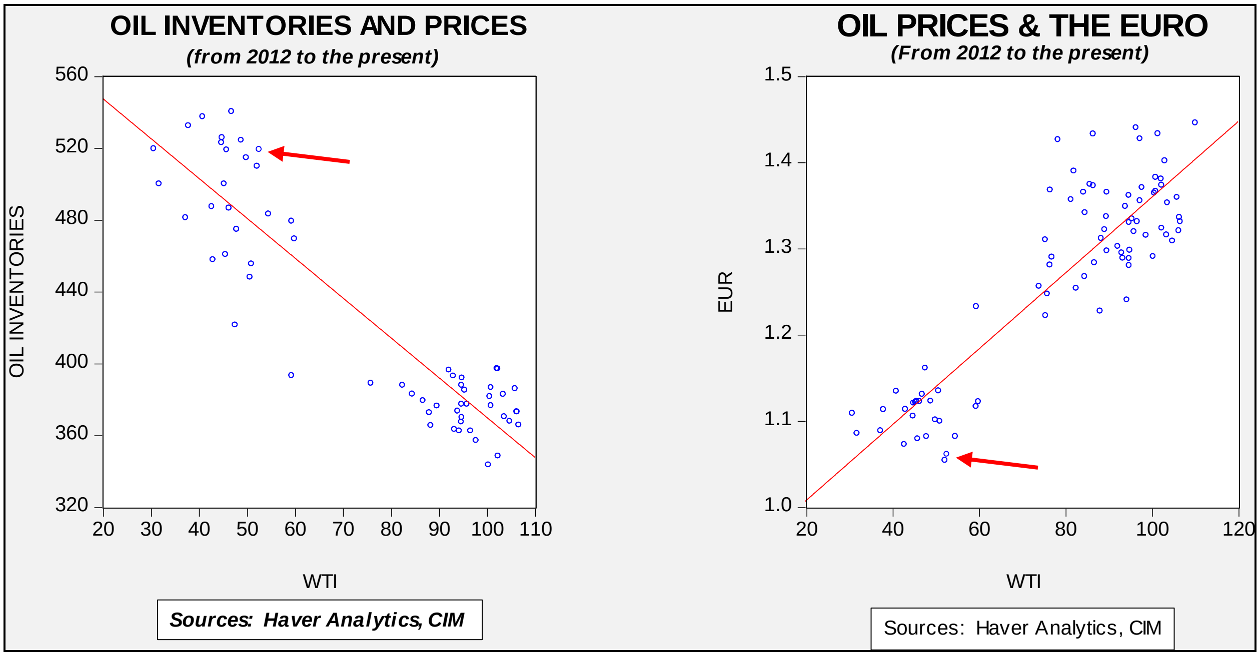


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, inventories remain elevated.

Comparing the seasonal pattern to the current inventory accumulation is supportive. Although it is early, oil inventories are rising slower than average. To justify current prices, inventories will need to decline this year. As the chart shows, that process should begin in earnest in Q2.



(Source: DOE, CIM)

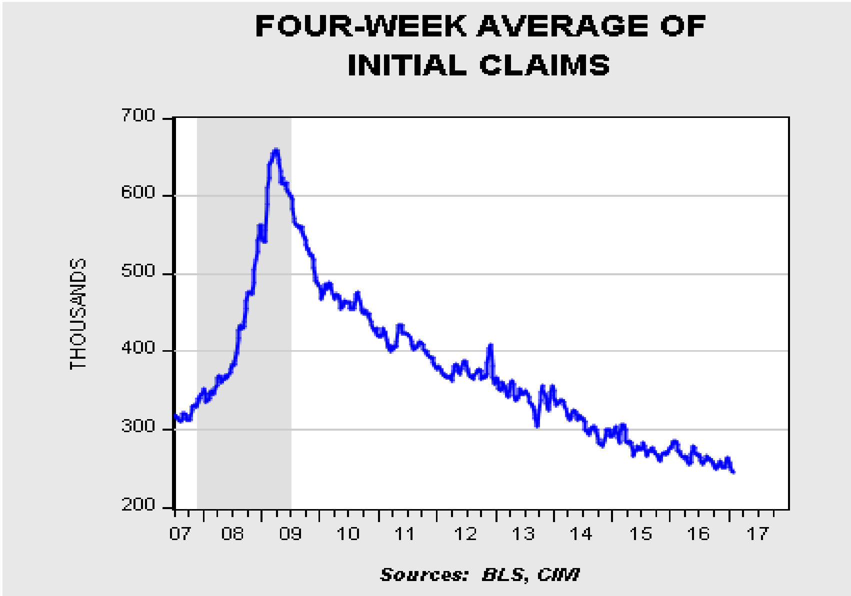


Based on inventories alone, oil prices are overvalued with the fair value price of $39.96. Meanwhile, the EUR/WTI model generates a fair value of $37.71. Together (which is a more sound methodology), fair value is $36.63, meaning that current prices are well above fair value.[1] OPEC has managed to lift prices but maintaining these levels will be a challenge given the dollar's strength and the continued elevated levels of inventories.

U.S. Economic Releases

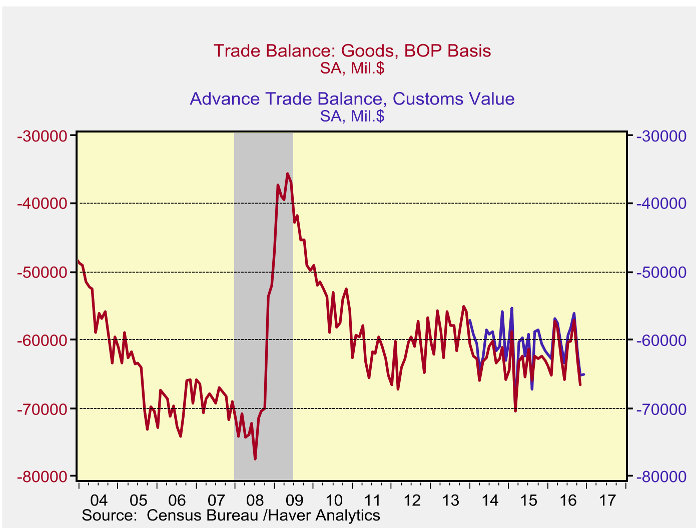
Initial jobless claims came in above expectations at 259k compared to the forecast of 247k. The prior week's report was revised upward from 234k to 237k. This is the 98th consecutive week that initial jobless claims have come in below 300k, the longest streak since 1970. The data suggests that the labor market is still pretty strong.

[1] The forecast that uses both independent variables is lower than the two separate models because the €/$ exchange rate and oil inventories are highly inversely correlated at -89%. In theory, it appears that some investors may be using oil inventories as a way to protect against dollar weakness.



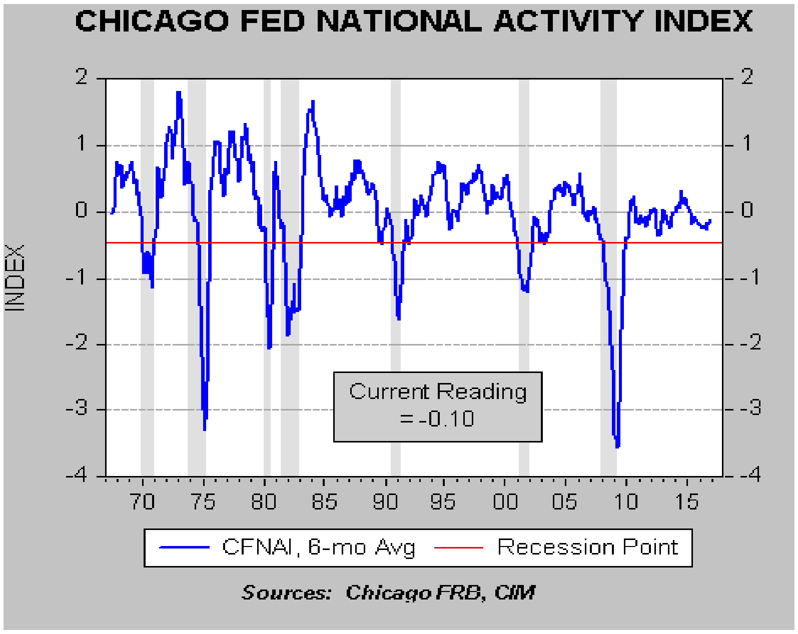
The chart above shows the four-week moving average for initial jobless claims. The four-week moving average fell 1k from 246.5k to 245.5k.

The advanced goods trade balance came in narrower than expected at a deficit of 65.0 bn compared to the forecast deficit of 65.3 bn.



The chart above shows the level of the trade balance for goods and the advanced trade balance. Over the past three years, the trade deficit has been volatile but has generally moved sideways.

The Chicago Fed National Activity Index came in above estimates at 0.14 compared to the forecast of -0.05.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The current reading is -0.10, an increase from the last report of -0.12, suggesting that economic activity is still sluggish but not at recession levels.

Wholesale inventories came in above expectations at 1.0% compared to the forecast 0.1%. Retail inventories were flat from the prior month. The prior report was revised downward from a rise of 1.0% to a rise of 0.8%.

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

Economic Releases						
9:45	Markit US Services PMI	m/m	jan	54.4	53.9	**
9:45	Markit US Composite PMI	m/m	jan		54.1	**
9:45	Bloomberg Consumer Comfort	m/m	jan		45.2	**
10:00	New Home Sales	m/m	dec	5.2%	-0.7%	**
10:00	Leading Index	m/m	dec	0.5%	0.0%	**
10:00	Kansas City Manfacturing Activity	m/m	jan	8	11	**
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	Industrial Profits	y/y	dec	2.3%	14.5%		**	Equity and bond neutral
	Swift Global Payments	y/y	dec	1.7%	2.0%		*	Equity and bond neutral
Japan	Japan Buying Foreign Bonds	y/y	jan	-539.0 bn	332.1 bn		**	Equity and bond neutral
	Japan Buying Foreign Stocks	y/y	dec	-19.1 bn	49.8 bn		**	Equity and bond neutral
	Foreign Buying Japan Bonds	y/y	dec	-168.5 bn	517.0 bn		**	Equity and bond neutral
	Foreign Buying Japan Stocks	y/y	jan	-376.1 bn	246.5 bn		**	Equity and bond neutral
	PPI Services	y/y	dec	0.4%	0.3%	0.3%	**	Equity and bond neutral
New Zealand	CPI	y/y	dec	1.3%	0.4%	1.2%	***	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	m/m	feb	10.2	9.9	10.0	**	Equity and bond neutral
Italy	Retail Sales	m/m	jan	0.8%	-0.2%	0.3%	**	Equity bullish, bond bearish
U.K.	BBA Loans for House Purchase	m/m	jan	43228	40659	41000	**	Equity bullish, bond bearish
	GDP	y/y	4q	2.2%	2.2%	2.1%	**	Equity and bond neutral
	Index of Services	m/m	nov	0.3%	0.3%	0.3%	**	Equity and bond neutral
	CBI Retailing Reported Sales	m/m	jan	26	35	27	**	Equity and bond neutral
Switzerland	Trade Balance	m/m	dec	2.72 bn	3.64 bn		**	Equity and bond neutral
	Exports Real	m/m	dec	9.9%	-0.4%		**	Equity and bond neutral
	Imports Real	m/m	dec	-0.8%	-4.2%		**	Equity and bond neutral
Russia	Unemployment Rate	y/y	dec	5.3%	5.4%	5.5%	**	Equity and bond neutral
	Real Disposable Income	y/y	dec	-6.1%	-5.6%	-5.1%	**	Equity bearish, bond bullish
	Real Wages	y/y	dec	2.4%	1.7%	1.5%	**	Equity and bond neutral
	Retail Sales Real	y/y	dec	-5.9%	-4.1%	-3.7%	**	Equity bearish, bond bullish
	PPI	y/y	dec	7.4%	4.3%	7.0%	**	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	m/m	nov	11.2%	9.3%	7.9%	**	Equity and bond neutral
Brazil	Outstanding Loans	m/m	dec	0.1%	0.3%		**	Equity and bond neutral
	Personal Loan Default Rate	m/m	dec	6.0%	6.1%		**	Equity and bond neutral
	Total Outstanding Loans	m/m	dec	3107	3104		**	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)	103	104	-1	Up
3-mo T-bill yield (bps)	49	49	0	Neutral
TED spread (bps)	55	55	0	Neutral
U.S. Libor/OIS spread (bps)	69	69	0	Neutral
10-yr T-note (%)	2.54	2.51	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	35	35	0	Neutral
Currencies	Direction			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	down			Down
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	$55.35	$55.08	0.49%	Short Covering
WTI	$52.88	$52.75	0.25%	
Natural Gas	$3.43	$3.33	2.79%	
Crack Spread	$13.26	$13.53	-1.94%	
12-mo strip crack	$15.23	$15.32	-0.61%	
Ethanol rack	$1.56	$1.56	-0.36%	
Metals				
Gold	$1,190.13	$1,200.69	-0.88%	Stronger Dollar
Silver	$16.85	$17.00	-0.90%	
Copper contract	$270.15	$271.00	-0.31%	
Grains				
Corn contract	$ 364.00	$ 366.25	-0.61%	
Wheat contract	$ 423.00	$ 424.50	-0.35%	
Soybeans contract	$ 1,051.00	$ 1,055.25	-0.40%	
Shipping				
Baltic Dry Freight	862	886	-24	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.8	2.3	0.6	
Gasoline (mb)	6.8	1.3	5.5	
Distillates (mb)	0.1	-0.3	0.3	
Refinery run rates (%)	-2.4%	-0.70%	-1.7%	
Natural gas (bcf)		-127		

Weather

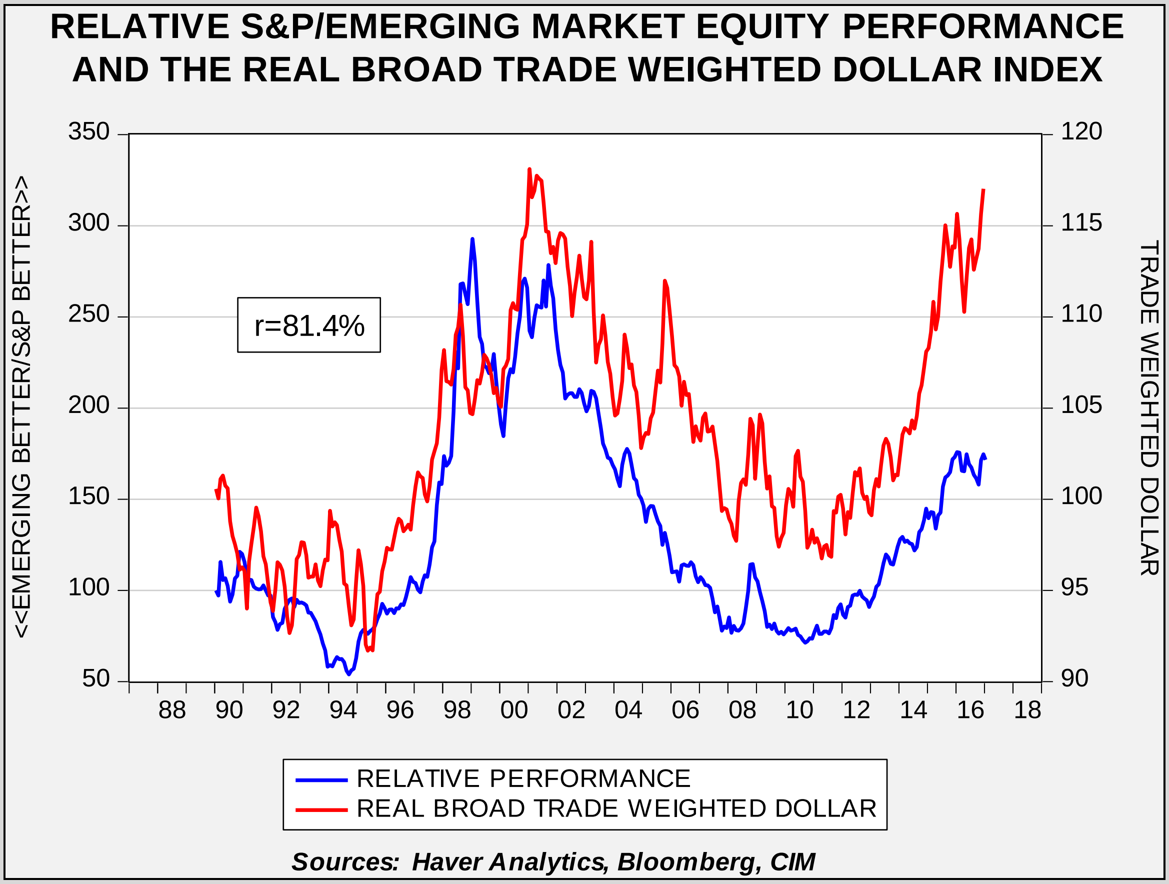
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, and cooler temps for the western region. Precipitation is not expected for the northwestern region.

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 20, 2017

After a short foray into emerging markets, we exited that position in our latest allocation. Prior to the Trump victory, we had expected the dollar to weaken which would have supported emerging markets. However, the dollar's resurgence is a bearish factor for emerging markets, leading the Asset Allocation Committee to look elsewhere for return.

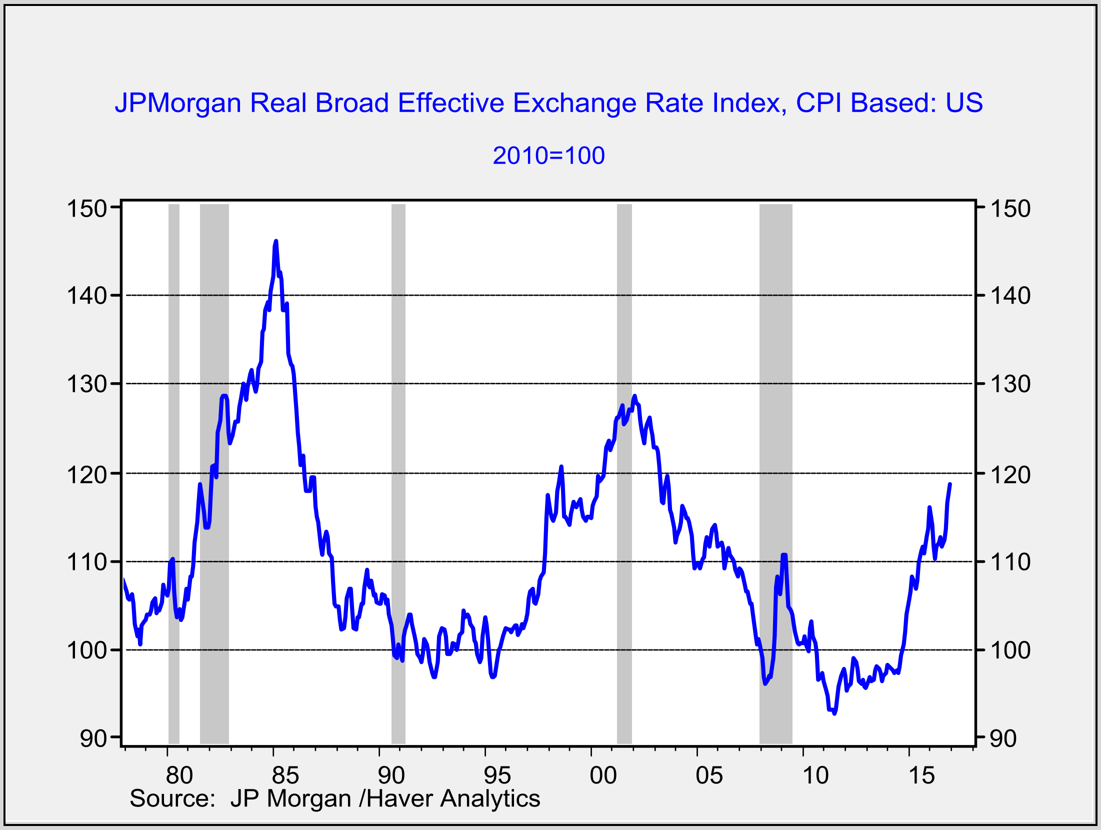


The blue line on this chart looks at the relative performance of emerging markets to the S&P 500. When the line is rising, the S&P is outperforming emerging markets. The red line is the JPM real dollar index. The two series are positively correlated at 81.4%, meaning that a stronger dollar tends to support the S&P relative to emerging markets.

Although the dollar is richly valued based on most currency valuation models, we believe that two factors will tend to support continued strength.

1. The Federal Reserve is set to accelerate its rate hikes this year, while other major central banks are looking to maintain stimulus. Although the stronger dollar may slow the pace of tightening, comments from the FOMC suggest a wide variation of opinions on the impact of the dollar on the economy. Thus, until it is abundantly clear that the exchange rate is hurting the economy and lowering inflation, we suspect the Fed will move rates higher.
2. Fiscal and trade policy are being designed to reduce imports. President-elect Trump is publically shaming firms for investing outside the U.S. and threatening trade restrictions against countries like China. Speaker Ryan's corporate tax reform includes a "border adjustment" that would effectively tax imports and not tax exports. When the reserve currency nation restricts trade, it reduces the supply available to world markets. Since there is no clear substitute for the dollar for reserve purposes, meaning the slope of the demand curve should remain static, a drop in supply should lead to a stronger dollar.

Eventually, the dollar will rise to a level that will fully offset the impact of relatively tighter monetary policy and changes in fiscal and trade policy. Although an exact level is difficult to determine, we would expect the JPM dollar index to rise to levels of past bull markets.



To reach levels seen in the 1995-2001 bull market, the dollar index should rise about another 10%. We doubt we will reach the highs of the Volcker dollar bull market (which would entail another 20% increase from current levels), but we would not be surprised to see a level between the two bull phases. Such a rise will pressure emerging market equities.

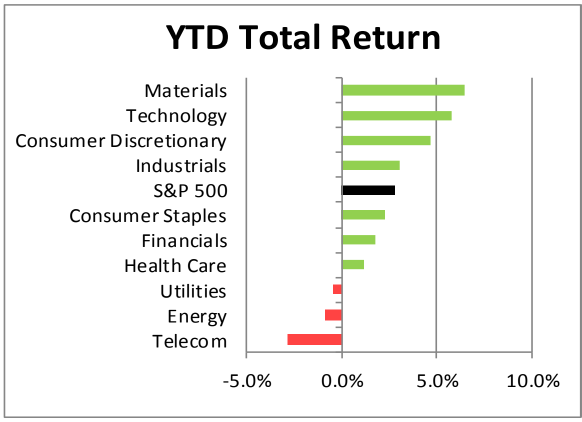
Finally, it is worth noting that the 1982 Mexican Debt Default and the 1997-99 Asian Economic Crisis occurred during rising dollar markets. Dollar strength tends to weigh on commodity prices, which often are produced by emerging market nations. In addition, emerging market nations and companies often borrow in dollars at lower interest rates relative to domestic rates. A rising dollar raises debt service costs and increases the odds of default.

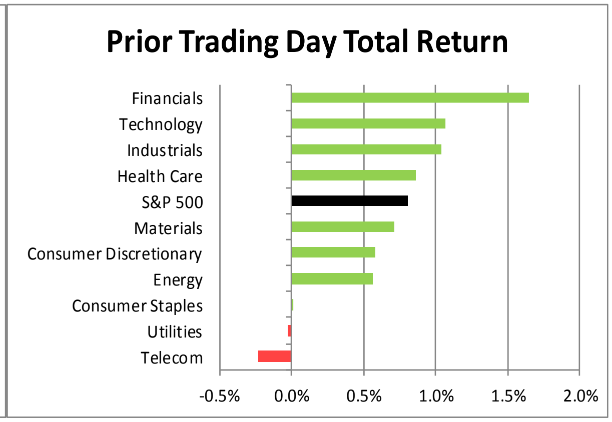
Thus, for the time being, we intend to forego a position in emerging markets. However, once the dollar bull market is exhausted, emerging market equities could become attractive.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 1/25/2017 close)

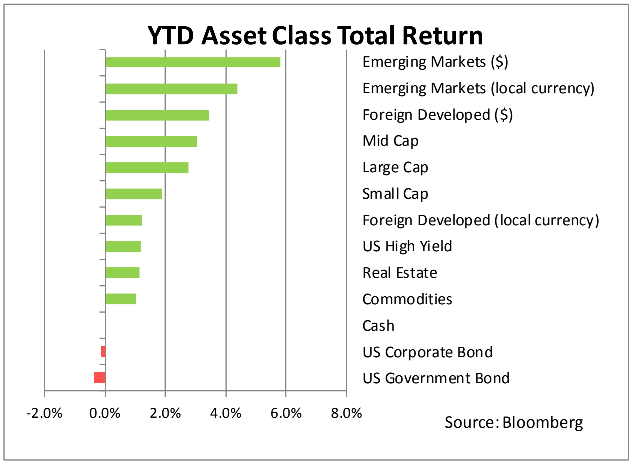




(Source: Bloomberg)

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 1/25/2017 close)

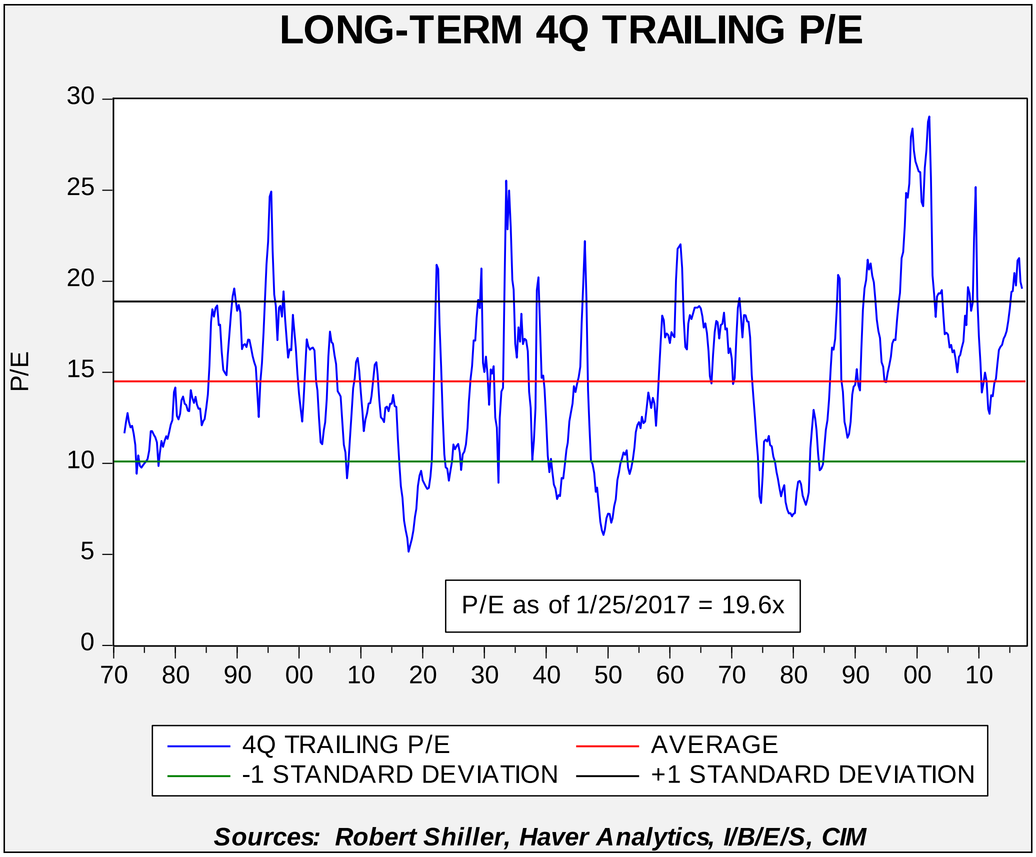


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2017



Based on our methodology,[2] the current P/E is 19.6x, unchanged from our last report. Rising equity values were offset by improving earnings.

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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[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 (Q2 and Q3) and two estimates (Q4, 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.