Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: January 26, 2018—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.7% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.3% and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a higher open. With 88 companies having reported, the S&P 500 Q4 earnings stand at $35.07, 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, 79.5% of the companies reported earnings above forecast, while 11.4% reported earnings below forecast.

Happy Friday! President Trump just ended his speech in Davos and GDP came in soft. Here is what we are watching this morning:

Trump's speech in Davos: The speech can best be described as "selling America" as a place to invest. As we discussed yesterday, if protectionist threats encourage foreign firms to invest in the U.S. to avoid trade impediments, it's supportive for the U.S. economy. We would expect some increase in inflation from sourcing production in the U.S. instead of overseas but it would probably not be excessive. The postwar U.S. "contract" with the world was to be the global importer of last resort and the supplier of the reserve currency. These policies have led to the development of the "rust belt" and harmed lower skilled labor. President Trump is trying to adjust that policy by forcing foreign firms to build in the U.S. to gain access to the American consumer. It isn't known what effect that will have on the rest of the world. Our expectation is that it won't be as favorable.

The administration and the dollar: Comments from Treasury Secretary Mnuchin sent the dollar lower on Wednesday. Yesterday, President Trump appeared to contradict his Treasury secretary by calling for a strong dollar. Mnuchin protested that he has made similar comments before and nothing has happened (which is true).[1] So, did we see a change in policy, as we speculated earlier in the week? Who knows? If the administration wants a narrower trade deficit, jawboning the dollar lower is one way to support this outcome. After Trump's comments yesterday, the dollar rallied but it has resumed its downtrend this morning. Our position is that the dollar is overvalued on a longer term basis and is simply correcting from that valuation issue, but the confusion on policy is clearly boosting currency market volatility.

[1] It is actually rather surprising this sort of thing hasn't happened sooner. New cabinet members, especially those without government experience at a high level, are accustomed to speaking frankly without much ramification. Once a person becomes a cabinet member, their comments suddenly take on much more importance. Usually, in the first year of the first term of a new president, so-called "gaffes" of truth are common but they become less common over time as the new cabinet members learn that what they say makes things (like markets) move.

The TPP: President Trump indicated yesterday that he might be willing to revisit TPP if it was a "better deal." We suspect much of this is pandering to the globalists and Davos. Negotiating a multilateral trade deal is difficult, and then to suggest that the U.S. could renegotiate the current agreement is very unlikely. The media is reading much into this; we would not.

NAFTA: Negotiations continue on the agreement but there appears to be some movement on developing a new deal. According to reports, Canadian negotiators offered some new frameworks on trade and U.S. negotiators were moderately positive. Maintaining NAFTA would be supportive not only to U.S. financial markets but would likely boost Mexican and Canadian equity markets as well.

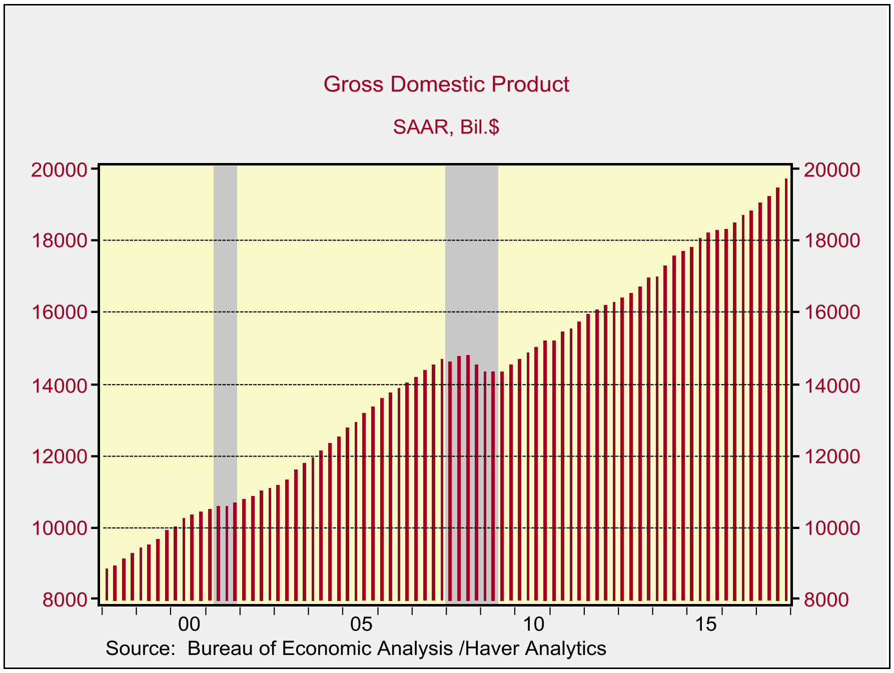
Mueller: The *NYT* reported that the president was prepared to fire Special Council Mueller in June but his White House counsel opposed the action and threatened to resign if he moved to do so. To some extent, this isn't a major surprise. On the other hand, we find it interesting that this news is emerging now. We suspect members of the White House legal team are trying to shape the narrative regarding how it makes them look personally. As always, we mostly focus on how such events affect markets. Clearly, it isn't bearish for equities and it hasn't been bullish for Treasuries, either. But, this turmoil may be affecting the dollar and is probably supportive for gold.

Saudi Arabia: The *FT*[2] is reporting that the November corruption arrests are going to allow the crown to take direct control of the Middle East Broadcasting Center, the largest in the region. While ostensibly this is a corruption crackdown, there is an element of asset grab by the king and the crown prince. As we noted earlier this month, the Ritz-Carlton (MAR, 145.50) in Riyadh has reopened but the report suggests that some princes and other dignitaries are still detained in the facility, as the leader of the broadcasting firm, Waleed bin Ibrahim al-Ibrahim, was calling from the hotel. So far, there has been little negative repercussions for the crown prince's crackdown; instead, he is gaining support from ordinary Saudis who are unhappy with the privileges the royal family princes have enjoyed and, at the same time, the crown appears to be gathering important assets in return for releasing those arrested.

U.S. Economic Releases

The first reading of Q4 GDP came in below expectations at 2.6% compared to the forecast of 3.0%. Personal consumption came in above expectations at 3.8% compared to the forecast of 3.7%. Core PCE came in line with expectations, rising 1.9% from the prior quarter. The GDP price index came in above expectations, rising 2.4% from the prior quarter compared to the forecast of 2.3%.

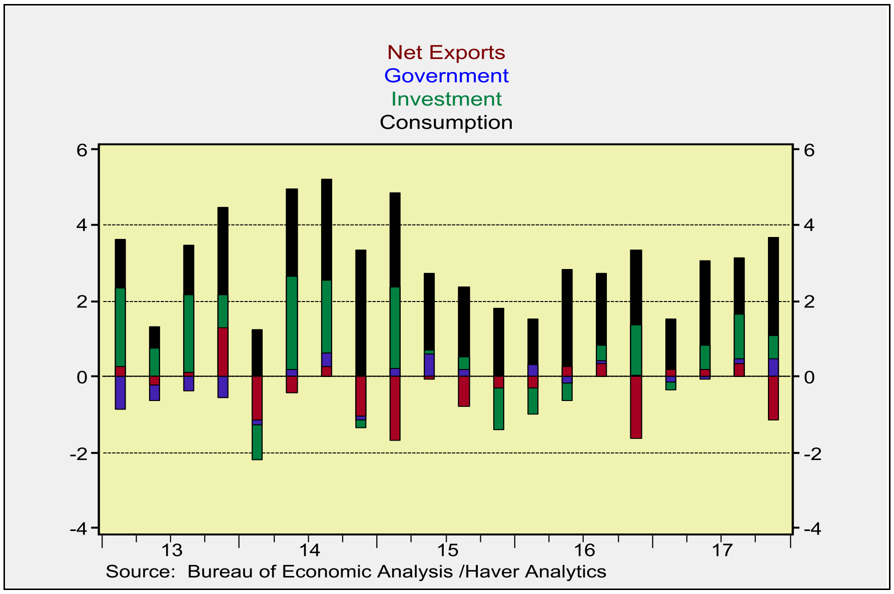
[2] https://www.ft.com/content/a50075d2-0069-11e8-9650-9c0ad2d7c5b5?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56



Assuming the GDP number for Q4 does not change, the economy grew 2.3% in 2017. GDP got off to a slow start last year, growing at an annualized pace of 1.5% in Q1, following a slowdown in consumer spending and business investment. GDP gained momentum for the remaining three quarters as consumer confidence and business outlook rose, which led to three consecutive quarters of annualized GDP that exceeded 2.5%.

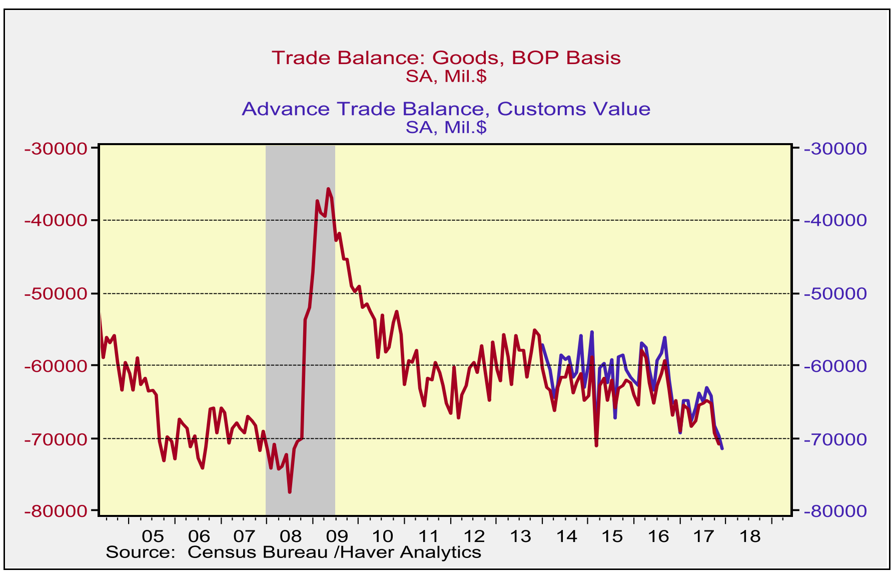
	Q4 2017 Prelim Reading	Q3 2017 Final Reading	Difference
GDP	2.6%	3.2%	-0.6%
Consumption	2.6%	1.5%	1.1%
Investment	0.6%	1.2%	-0.6%
Inventories	-0.7%	0.8%	-1.5%
Net Exports	-1.1%	0.4%	-1.5%
Government	0.5%	0.1%	0.4%

The table above shows the contributions to GDP. The rise in consumption was offset by a rise in imports and a decline in business inventories. An increase in imports could signal a possible increase in inflation.



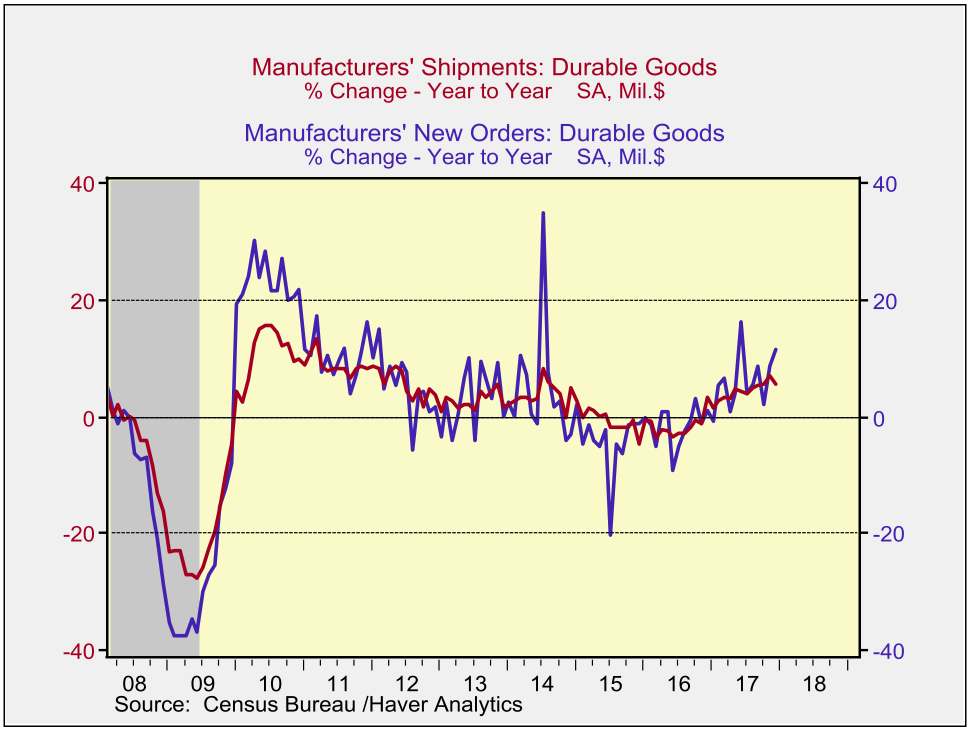
This chart shows the contributions graphically. Net exports were a major negative for GDP in Q4.

The advance goods trade deficit came in wider than expected at $71.6 bn compared to the forecast of $68.9 bn. The prior report's deficit was revised upward from $69.7 bn to $70.0 bn. Wholesale inventories came in below expectations at 0.2% compared to the forecast gain of 0.4%. Retail inventories rose 0.2% from the prior month.



The chart above shows the trade balance of goods and the advance trade balance.

December durable goods came in above expectations, rising 2.9% from the prior month compared to the forecast gain of 0.8%. The prior report's gain was revised upward from 1.3% to 1.7%. Durables ex-transportation came in line with expectations, rising 0.6% from the prior month. The prior report's loss of 0.1% was revised to a gain of 0.3%. Capital goods orders non-defense ex-air came in below expectations, falling 0.3% from the prior month compared to the forecast gain of 0.6%. The prior month's loss of 0.2% was revised to a gain of 0.2%. Capital goods shipments non-defense ex-air came in above expectations at 0.6% from the prior month compared to the forecast rise of 0.4%. The prior report's loss of 0.1% was revised to a gain of 0.4%.



The chart above shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 11.5%, shipments rose by 5.8%, unfilled orders rose by 1.9% and inventories rose by 3.9%

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomber Consumer Comfort	m/m	jan		53.8	**
10:00	New Home Sales	m/m	dec	675k	733k	**
10:00	New Home Sales	m/m	dec	-7.9%	17.5%	**
10:00	Leading Indec	m/m	dec	0.5%	0.4%	**
11:00	Kansas City Fed Manf. Activity	m/m	jan	14	14	**
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	Swift Global Payments CNY	m/m	dec	1.5%	1.8%		*	Equity and bond neutral
	Industrial Profits	y/y	dec	10.8%	14.9%		**	Equity and bond neutral
Japan	National CPI	m/m	dec	1.0%	0.6%	1.1%	***	Equity and bond neutral
	National CPI ex Fresh Food, Energy	m/m	dec	0.3%	0.3%	0.4%	***	Equity and bond neutral
EUROPE								
France	Consumer Confidence	m/m	jan	104	105	106	***	Equity and bond neutral
	Business Survey Overall	m/m	jan	20	18		**	Equity and bond neutral
	Business Confidence	m/m	jan	110	112	112	**	Equity and bond neutral
	Manufacturing Confidence	m/m	jan	113	112	112	**	Equity and bond neutral
	Production outlook indicator	y/y	jan	34	30	31	**	Equity bullish, bond bearish
	Own-Company Production	y/y	jan	16	15	16	**	Equity and bond neutral
Eurozone	M3 Money Supply	m/m	dec	4.6%	4.9%	4.9%	**	Equity and bond neutral
U.K.	Index of Services	m/m	nov	0.4%	0.2%	0.2%	**	Equity bullish, bond bearish
	GDP	y/y	4q	1.5%	1.7%	1.4%	***	Equity bullish, bond bearish
Russia	Unemployment	y/y	dec	5.1%	5.1%	5.1%	***	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	nov	-1.5%	-0.1%	-0.9%	**	Equity bearish, bond bullish
Canada	Retail Sales Ex Auto	m/m	nov	1.6%	0.8%	0.9%	**	Equity bullish, bond bearish
Brazil	Federal Debt Total	m/m	dec	3559 bn	3493 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)	175	175	0	Up
3-mo T-bill yield (bps)	140	140	0	Neutral
TED spread (bps)	36	35	1	Neutral
U.S. Libor/OIS spread (bps)	152	152	0	Up
10-yr T-note (%)	2.64	2.62	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	27	27	0	Down
Currencies	**Direction**			
dollar	down			Down
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	$70.43	$70.42	0.01%	
WTI	$65.59	$65.51	0.12%	
Natural Gas	$3.50	$3.45	1.48%	
Crack Spread	$17.33	$17.49	-0.88%	
12-mo strip crack	$19.42	$19.54	-0.57%	
Ethanol rack	$1.43	$1.43	0.18%	
Metals				
Gold	$1,351.63	$1,348.26	0.25%	
Silver	$17.41	$17.30	0.65%	
Copper contract	$321.40	$321.65	-0.08%	
Grains				
Corn contract	$ 356.00	$ 355.25	0.21%	
Wheat contract	$ 437.25	$ 434.50	0.63%	
Soybeans contract	$ 992.25	$ 992.25	0.00%	
Shipping				
Baltic Dry Freight	1217	1200	17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.1	-2.3	1.2	
Gasoline (mb)	3.1	2.1	1.0	
Distillates (mb)	0.6	-1.3	1.9	
Refinery run rates (%)	-2.10%	-1.00%	-1.10%	
Natural gas (bcf)	-288.0	-268.0	-20.0	

Weather

The 6-10 and 8-14 day forecasts call for warmer temperatures on both coasts, with cooler to normal temperatures for the rest of the country. 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.

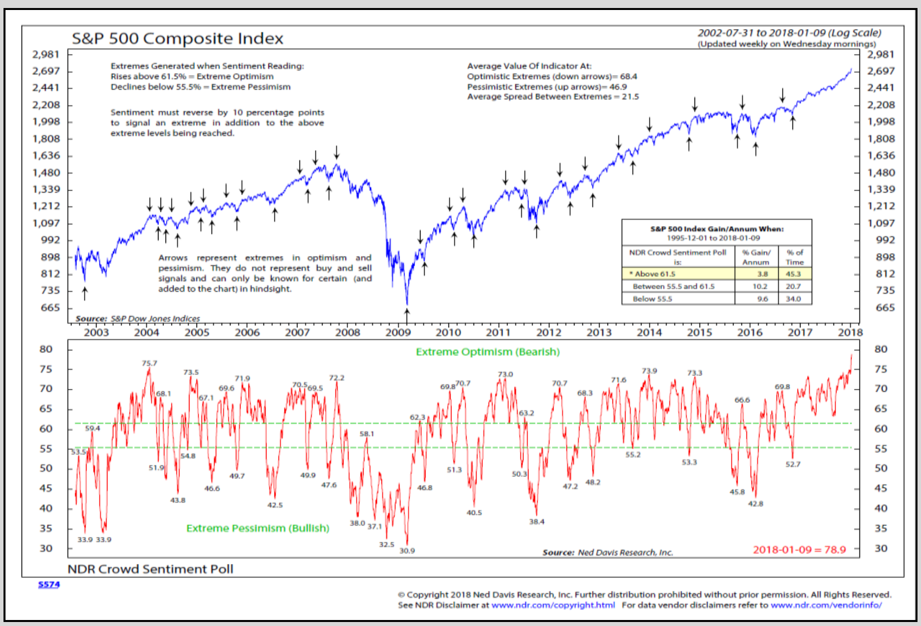
January 26, 2018

Equity markets have been steadily rising, with the major indices making a series of new all-time highs. The recent impetus to equities has been the tax law. As we detailed in our recent addendum to our 2018 Outlook,[3] the tax bill will shift about 1.3% of GDP to after-tax corporate profits. This development led us to raise our forecast for the S&P 500 to 3056.12 for 2018. At the same time, we realize bear markets do happen. So, what do we think as the market keeps trending higher?

In our 2018 Outlook[4] we detailed our views on the economy and how the economy affects equity markets. In summary, since 1987, each bear market in equities has coincided with economic recession. There is no evidence at present that a recession is looming in the near future; however, we do pay very close attention to the two major causes, geopolitical events and monetary policy mistakes, and will try to warn readers if we see anything looming.

This report, instead, is going to focus on short-term market factors. The steady rise in equities fosters both fear and greed. Here are some of the factors we are watching:

First, investor sentiment is elevated. The American Association of Individual Investor Sentiment Index is elevated; in fact, the ratio of bulls/bears is 5.25, wider than before the 1987 crash. Another sentiment indicator we monitor, from Ned Davis, tells a similar story.

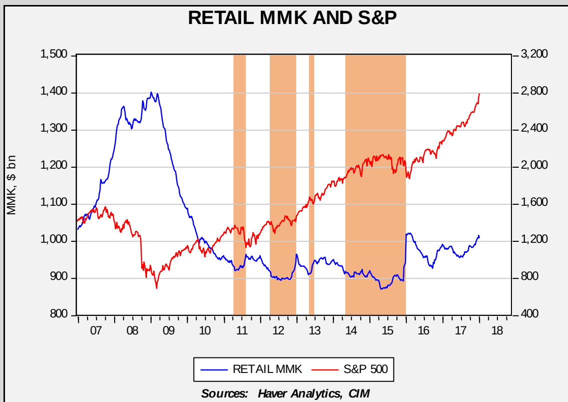


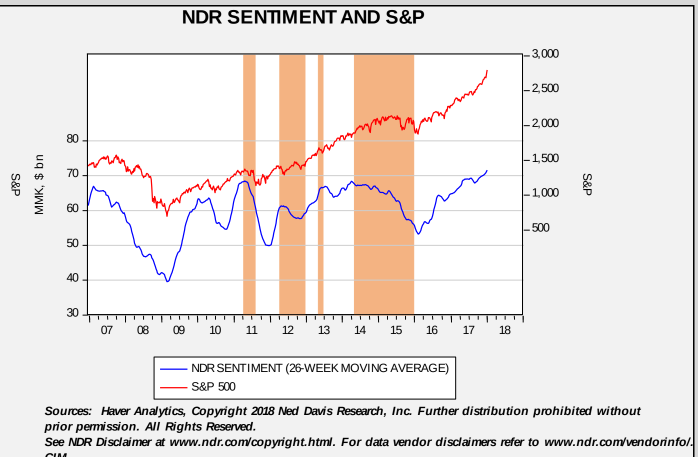
[3] See 2018 Outlook: Addendum, 1/4/18.
[4] See 2018 Outlook, 11/30/17.

The theory behind these sentiment indicators is "contrarianism." Contrarianism is based on the idea that what the crowd believes is probably either (a) wrong, or (b) already discounted by the market. In other words, once investors become extremely bullish, not only does the price probably contain that sentiment, but high sentiment means there probably isn't more upside left. Another variation of this theory can be seen in famous magazine covers, like *The Economist* predicting $5 crude oil in the late 1990s very close to the bottom around $10 per barrel.

Still, it is evident from the above chart that sentiment alone isn't reliable. After all, Ned Davis uses a reading above 61.5 as an indicator of elevated sentiment; based on this figure, sentiment has been elevated since last November's election with no significant declines in equity prices.

Second, another factor we monitor is the level of money market funds held by retail households. Since the recovery began in 2009, equity markets have tended to do well as long as money market funds exceed $920 bn. But, if money market funds fall below this level, equity markets seem to stall, most likely due to the lack of liquidity. The combination of liquidity and sentiment appears to offer better insights into market behavior than just sentiment alone.





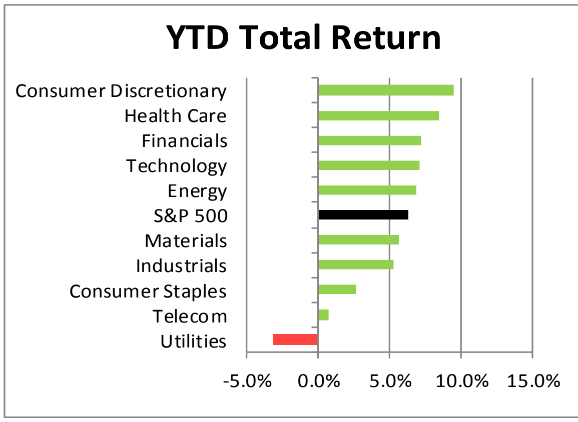
The chart on the left shows household money market funds. We have placed orange shading on periods when money market funds fell below $920 bn. Note how equity markets tended to stall once liquidity became tight. On the right, we use the same shading (indicating a low level of available liquidity) and the 26-week moving average of the NDR Sentiment Indicator. This shows that high levels of sentiment with ample cash levels tend to support high equity prices, whereas a reading over 60 on the sentiment index and low cash levels tend to lead to a flat to weaker market.

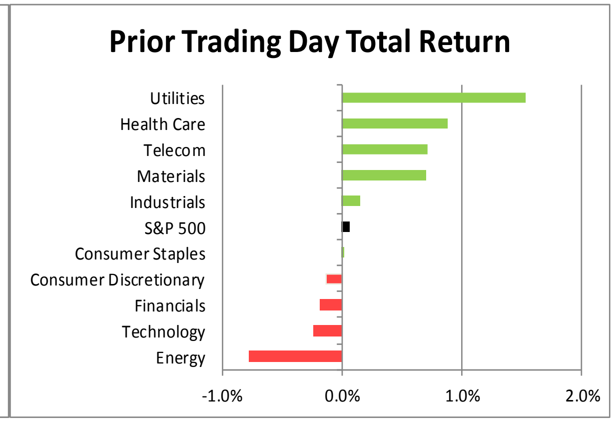
What is salient about the current situation is the combination of elevated sentiment and ample liquidity. Although it is possible that short-term interest rates have risen to a level where investors find them attractive, we rather doubt that's the case. Over the past few years, elevated levels of cash usually indicate the potential for increased allocation to equities. High money market balances, coupled with elevated levels of investor sentiment, probably signal higher equity values.

That being said, concern about the elevated level of equities is not without merit. There is no doubt we are in the "late innings" of this bull market. After all, the current expansion will soon be the second longest on record. Although expansions don't die of old age, rising geopolitical tensions and expectations of tighter monetary policy do suggest this bull market may be measured in quarters, not years. At the same time, the combination of strong sentiment and high liquidity suggests that further upside is likely and it is probably premature for investors to become overly defensive.

Data Section

U.S. Equity Markets – (as of 1/25/2018 close)

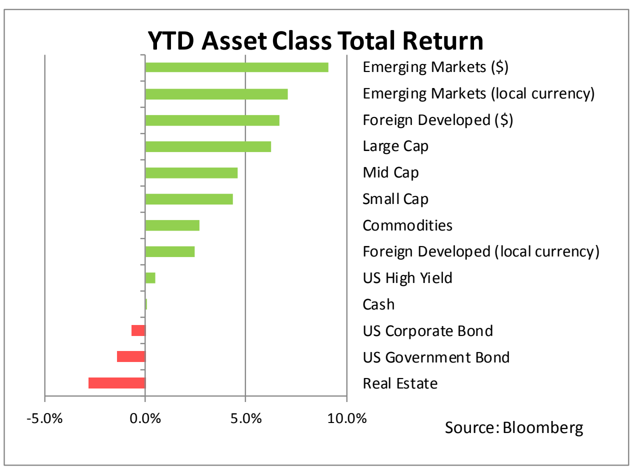




(Source: Bloomberg)

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 1/25/2018 close)

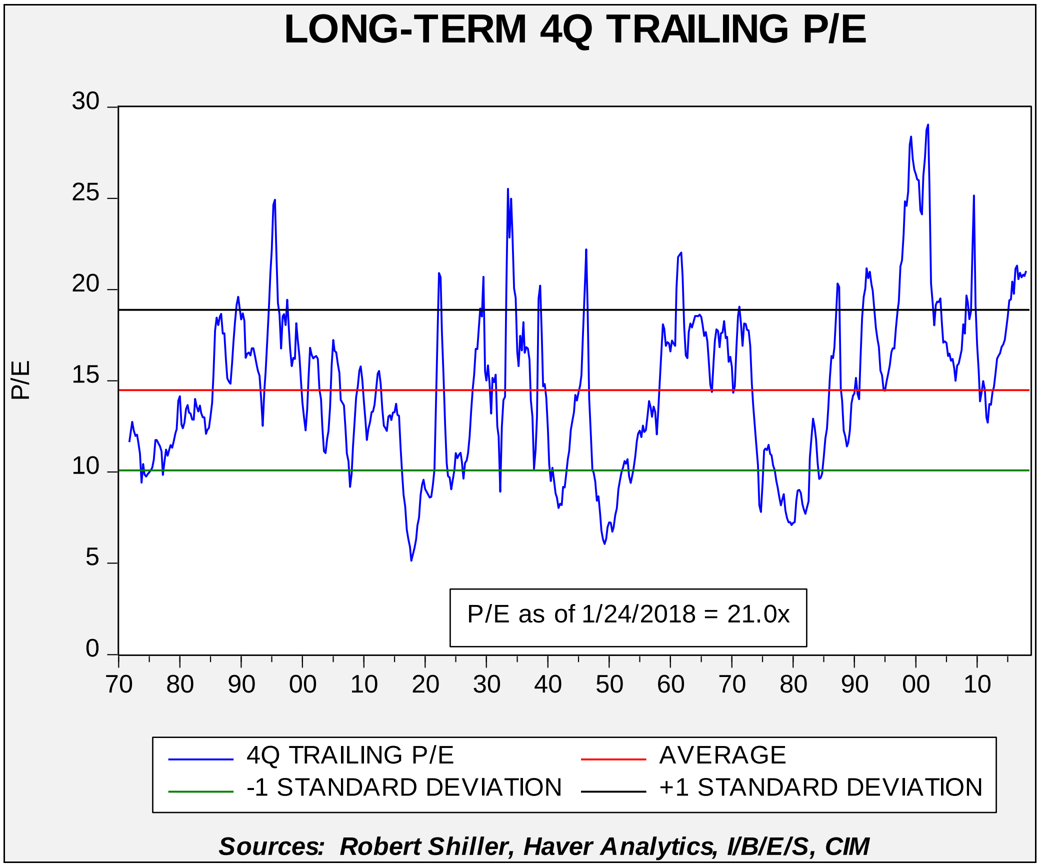


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2018



Based on our methodology,[5] the current P/E is 21.0x, up 0.1x from the last report. The rise in the S&P index led to the modest rise in the P/E multiple.

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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[5] 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.