Daily Comment

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

[Posted: January 27, 2017—9:30 AM EST] Global equity markets are down this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets are closed today for New Year. U.S. equity futures are signaling a flat to higher open. With 160 companies having reported, the S&P 500 Q4 earnings stand at $31.29, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 68.1% of the companies reported earnings above forecast, while 18.8% reported earnings below forecast.

It was a quiet night overall; the big news is Q4 GDP, which we will cover below. Here are a few items we are watching:

The Italian Constitutional Court finally clarified the 2015 election reform law, known as the "Italicum." It ruled against a runoff system (similar to France's) but did retain the proposal to offer "bonus seats" to parties winning over 40% of the vote. The goal is to eliminate the influence of smaller parties and make Italian governments less fragile.[1] This change probably won't lead to that outcome as it is highly unlikely that any single party will gather 40% of the vote. Thus, coalition governments will remain the norm. Italy isn't scheduled to hold elections until early next year but now that this Italicum has been clarified, the odds will increase that the current government may be dissolved early and we could see another major European election this year.

PM May is meeting with President Trump today. There are reports that the president may offer May a bilateral free trade deal as a "reward" for Brexit. Making such an offer, especially with TTIP virtually dead, may encourage other nations that are considering leaving the Eurozone (Italy, France) to look to bilateral deals with the U.S. European unity is coming under strain and how this meeting goes today may lead to even more concerns in the EU.

Greece refused to extradite Turkish military officers who participated in last July's coup. Eight officers fled Turkey as the coup failed, seeking refuge in Greece. Greek courts ruled that the alleged coup conspirators may face overly harsh punishment if they are returned and thus did not allow the government to extradite the soldiers. Needless to say, this decision will infuriate Turkey and worsen already poisoned relations between the countries. The legal decision is being hailed as a victory for "European values," which will undermine EU relations with Turkey as well. Will this prompt Turkey to open its borders and allow refugees to return to Europe in retaliation? This is an issue we will be monitoring.

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[1] Not the word from the movie *A Christmas Story* which is usually associated with an Italian word describing a leg lamp.

In our travels to the coasts we have noted a common comment that foreign money is boosting real estate values in local markets (not an issue here in St. Louis, BTW). Similar reports are often heard from cosmopolitan cities such as London, Sydney and Melbourne. Bloomberg is reporting that real estate agents in many cities are saying that there has been a sudden drop in interest, and transactions are not being consummated due to China's tightening of capital controls. One of the rules the Chinese State Administration of Foreign Exchange (SAFE) enacted late last year was a clause that forced anyone who was using their legal quota of moving $50k offshore to promise not to use the funds for offshore property investments. Violating the promise would lead to a three-year ban on foreign currency and a money laundering investigation. This change has apparently cooled the ardor for shifting assets out of the country. As a general rule, regulation can't completely halt capital flight but it can raise the cost of moving money out of the country. Recent regulations appear to have succeeded for now, although we would expect new tactics to emerge over time which will allow Chinese citizens to invest overseas.

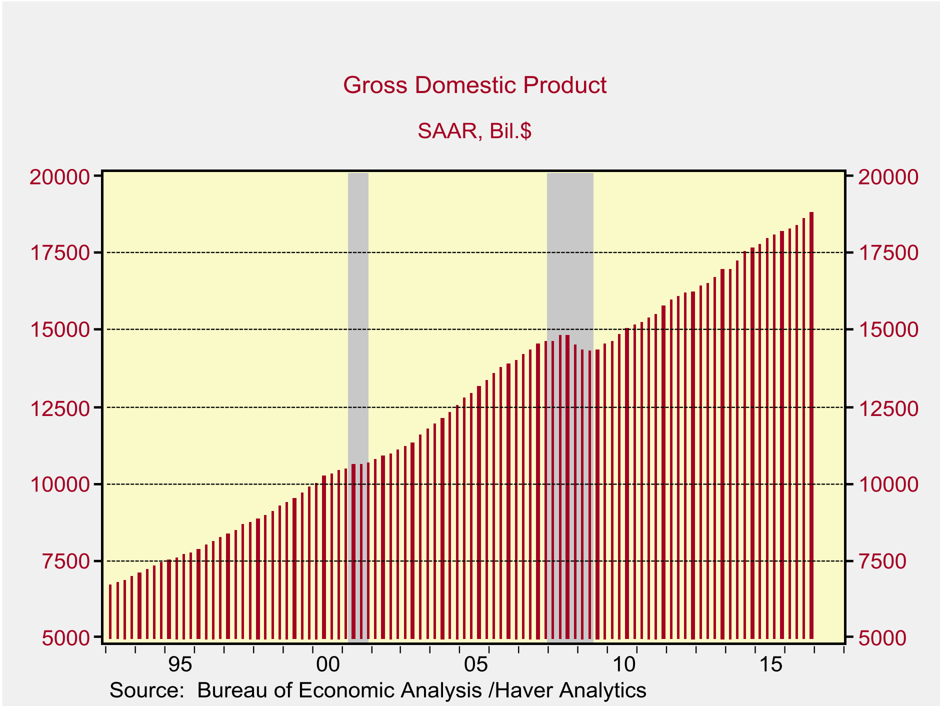
Finally, we note that Amazon (AMZN, $839.15) has been granted a patent for a robot that would pack shipping boxes, something that is currently being done by humans. It's not that humans are inefficient; CNN[2] reports that Amazon warehouse workers spend only about a minute fulfilling each order, which includes 15 seconds packing the box with bubble wrap and tape. Automating the process suggests that the company simply wants to reduce the amount of labor involved. It is fairly clear that the current administration wants to boost jobs in the U.S., especially the routine jobs that have traditionally been held by the middle class. Trump and his government appear convinced that foreign trade is the primary reason these jobs have disappeared. However, economists mostly believe that automation has probably played a larger role and so, if the goal is to increase routine jobs with good pay, regulations against automation may eventually be required.[3]

U.S. Economic Releases

The preliminary Q4 GDP showed an increase of 1.9%, below the forecast of 2.2%. Despite tepid GDP growth throughout the last eight years, this period appears to be one of the longest expansions in history. Market expectations anticipate that the expansion will continue and may pick up during the Trump administration as many believe that the increase in infrastructure spending and tax cuts will likely stimulate the economy.

[2] http://money.cnn.com/2016/10/06/technology/amazon-warehouse-robots/

[3] https://www.nytimes.com/2017/01/25/business/dealbook/how-efficiency-is-wiping-out-the-middle-class.html

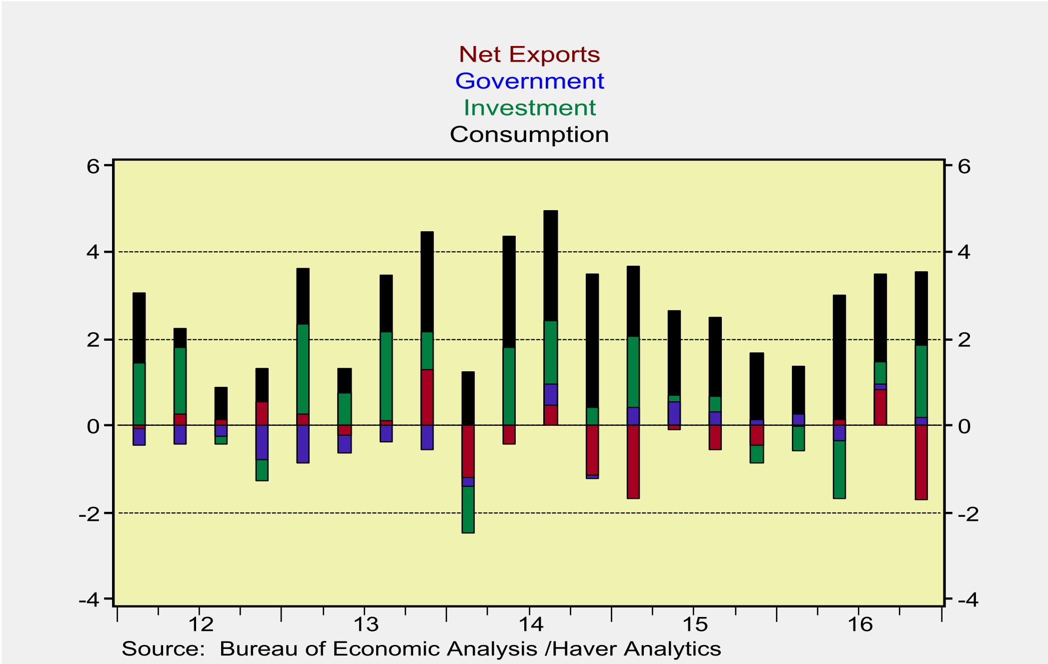


The chart above shows that the economy is still expanding.

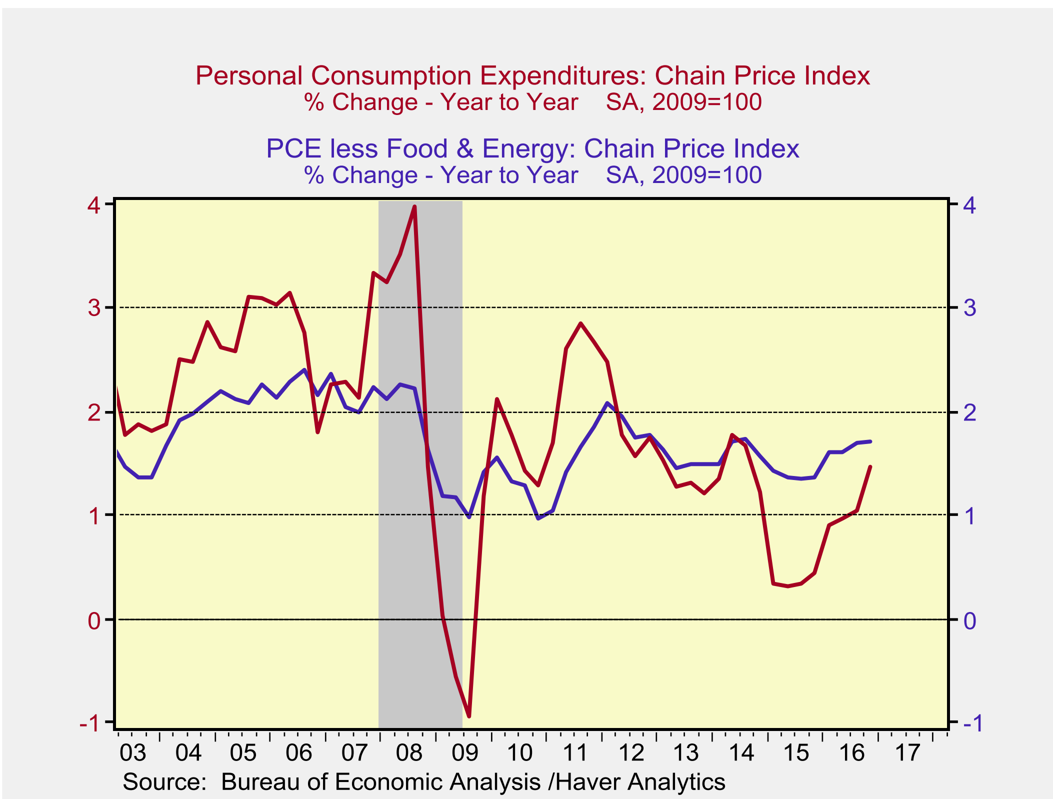
	Q4 2016 final prelim	Q3 2016 final revision	Difference
GDP	1.9%	3.5%	-1.6%
Consumption	1.7%	2.0%	-0.3%
Investment	1.7%	0.5%	1.2%
Inventories	1.0%	0.5%	0.5%
Net Exports	-1.7%	0.9%	-2.6%
Government	0.2%	0.1%	0.1%

The table above shows the revised contribution to GDP. The less than forecast rise in GDP is largely attributed to lower than expected consumption and sharply negative net exports in the quarter.

Here's another look at the contribution from the components of GDP. As the chart shows, net exports were a serious drag on Q4 GDP.

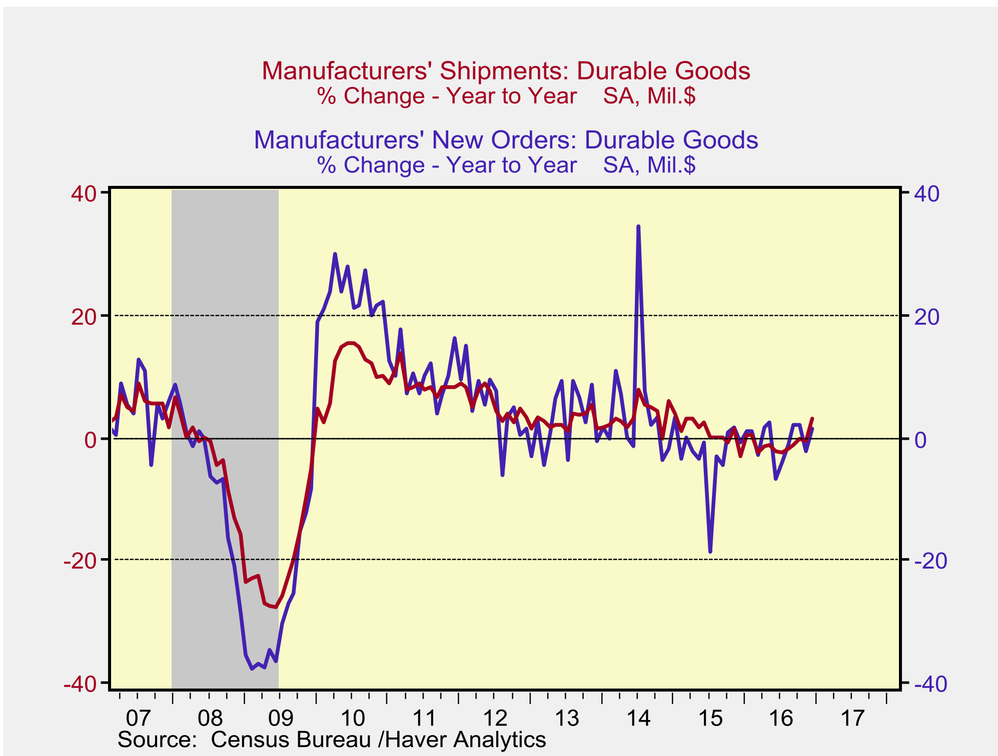


Personal consumption showed an increase of 2.5%, on forecast. Core PCE came in at 1.3%, in line with forecasts. Due to the Fed's use of PCE as a barometer for inflation, we expect the Fed to raise interest rates further if this upward trend in inflation continues.



The chart above shows the relationship between personal consumption and core personal consumption price deflators. The increase in the PCE could be slightly attributed to the rise in oil prices. The core PCE is one of the primary tools used by the Fed to gauge inflation. If President Trump is successful in implementing tariffs on goods, we expect the Fed to raise rates in order to slow the inflation that will likely result.

December durable goods fell 4.6% from the prior month, below the forecast rise of 2.5%. The prior month's losses were revised downward to 3.8% from the 3.5% previously reported. Durable orders excluding transportation rose 0.5%, in line with forecasts. The prior month's gains were revised upward from 0.6% to 1.0%. Non-defense capital goods orders excluding airplane orders, a proxy for planned business investment, rose 0.8%, better than the 0.2% increase forecast. The prior month's gain of 0.9% was revised upward to 1.5%. At the same time, shipments of the same non-defense capital goods ex-air increased 1.0%, higher than the 0.5% increase forecast. The prior month's report of a 0.2% increase was revised upward to 0.6%.



The chart above shows the annual change in headline durable goods orders including and excluding transportation. Despite the recent uptick, there seems to be relatively little movement within durable goods on an annual basis. Annually, new orders rose by 3.1%, shipments rose 1.6%, unfilled orders dropped 1.4% and inventories fell 0.95%.

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

Economic Releases						
9:45	University of Michigan Sentiment	m/m	jan	98.1	98.1	**
9:45	University of Michigan Current Conditions	m/m	jan	112.0	112.5	**
9:45	University of Michigan Expectations	m/m	jan		88.9	**
10:00	University of Michigan 1 yr Inflation	m/m	jan		2.6%	**
10:00	University of Michigan 5-10 yr Inflation	m/m	jan		2.5%	**
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								
Japan	National CPI	y/y	dec	0.3%	0.5%	0.2%	***	Equity and bond neutral
	Tokyo CPI	y/y	dec	0.1%	0.0%	0.0%	**	Equity and bond neutral
Australia	PPI	y/y	4q	0.7%	0.5%		**	Equity and bond neutral
	Export Price Index	y/y	4q	12.4%	3.5%	12.1%	**	Equity and bond neutral
	Import Price Index	y/y	4q	0.2%	-1.0%	0.4%	**	Equity and bond neutral
EUROPE								
Eurozone	M3 Money Supply	y/y	dec	5.0%	4.8%	4.9%	**	Equity and bond neutral
Germany	Import Price Index	y/y	dec	3.5%	0.3%	2.7%	**	Equity and bond neutral
France	Consumer Confidence	y/y	jan	100	99	100	**	Equity and bond neutral
Italy	Economic Sentiment	m/m	jan	102.5	100.3		**	Equity and bond neutral
	Manufacturing Confidence	m/m	jan	104.8	103.5	103.3	**	Equity and bond neutral
	Consumer Confidence	m/m	dec	108.8	111.1	110.0	**	Equity and bond neutral
	Hourly Wages	m/m	dec	0.4%	0.4%		**	Equity and bond neutral
Russia	Money Supply Narrow Def	y/y	jan	8.83 t	8.83 t		*	Equity and bond neutral
AMERICAS								
Brazil	FGV Construction Costs	m/m	jan	0.3%	0.4%	0.3%	*	Equity and bond neutral
	Tax Collections	m/m	dec	127.607 bn	102.245 bn	125.000 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)	104	103	1	Up
3-mo T-bill yield (bps)	49	49	0	Neutral
TED spread (bps)	55	54	1	Neutral
U.S. Libor/OIS spread (bps)	70	70	0	Neutral
10-yr T-note (%)	2.52	2.51	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	38	38	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	down			Down
franc	down			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	$55.67	$56.24	-1.01%	Long liquidation
WTI	$53.42	$53.78	-0.67%	
Natural Gas	$3.27	$3.38	-3.31%	
Crack Spread	$13.34	$13.37	-0.21%	
12-mo strip crack	$15.27	$15.28	-0.10%	
Ethanol rack	$1.56	$1.56	0.12%	
Metals				
Gold	$1,183.53	$1,188.50	-0.42%	Stronger Dollar
Silver	$16.73	$16.81	-0.47%	
Copper contract	$267.90	$267.30	0.22%	
Grains				
Corn contract	$ 363.00	$ 363.75	-0.21%	
Wheat contract	$ 426.00	$ 427.00	-0.23%	
Soybeans contract	$ 1,047.25	$ 1,049.50	-0.21%	
Shipping				
Baltic Dry Freight	840	862	-22	
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)	-119.0	-127	8.0	

Weather

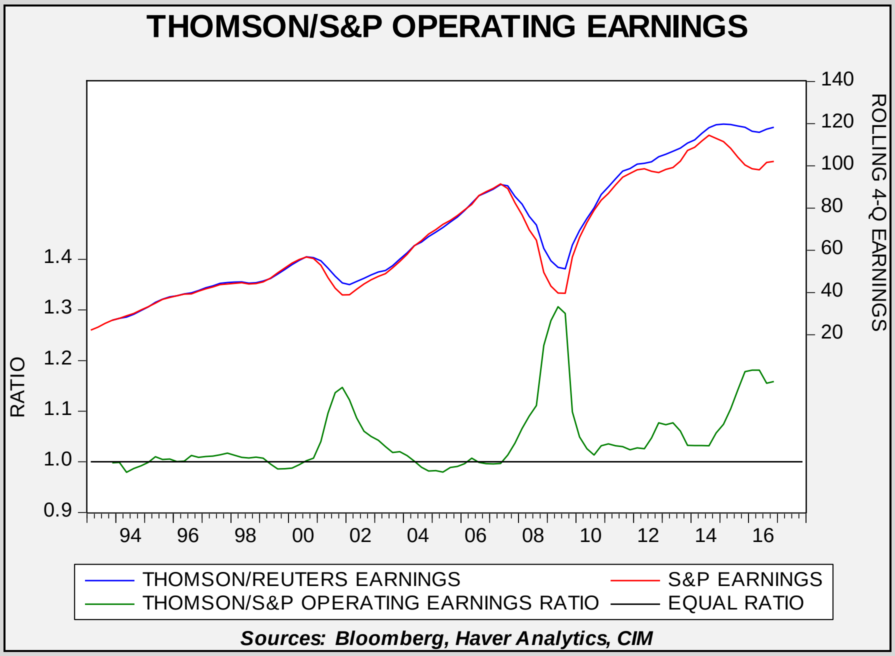
The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, and warmer temps for the southern region. Precipitation is expected for most of the country.

<u>Asset Allocation Weekly Comment</u>

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.

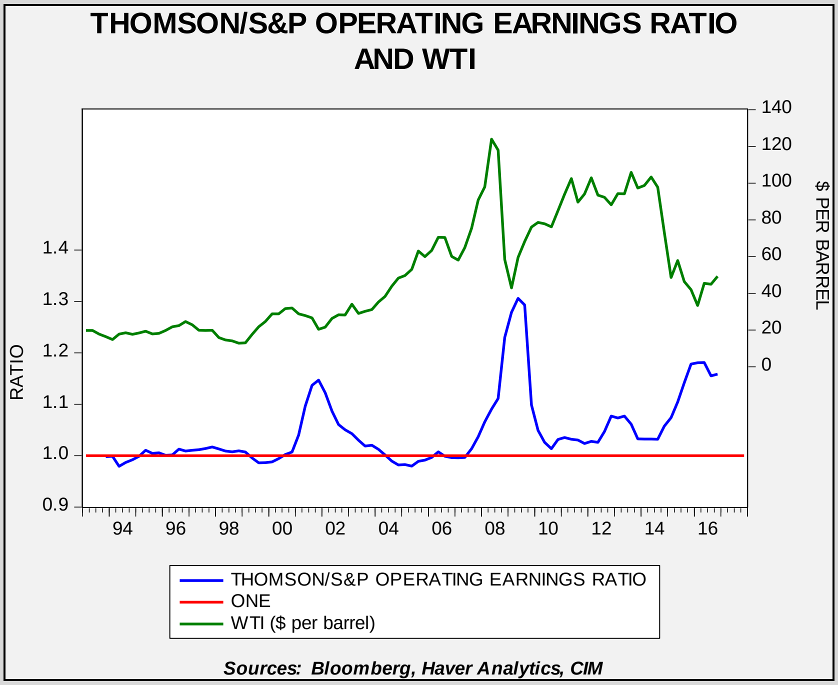
January 27, 2017

The consensus estimate for Q4 2016 S&P 500 operating earnings growth is 3.2%, which translates into a forecast of $118.35 per share for the S&P 500, using Thomson/Reuters data. Using a similar growth rate, the Standard and Poor's calculation of operating earnings generates annual earnings of $102.16. Simply put, these two sources currently have a rather wide divergence.



This chart shows the two series from 1994, with the lower line showing their ratio. The official explanation for the divergence is that S&P earnings are closer to Generally Accepted Accounting Principles (GAAP), which usually don't include "unusual items." The Thomson/Reuters earnings data excludes more of these non-recurring costs, resulting in higher operating earnings.

What concerns us about the current divergence is that two of the past divergences occurred during recessions. Thus, it is possible that the recent event is signaling that a downturn could be coming. However, we have also noted that another factor may help explain the widening—oil prices.



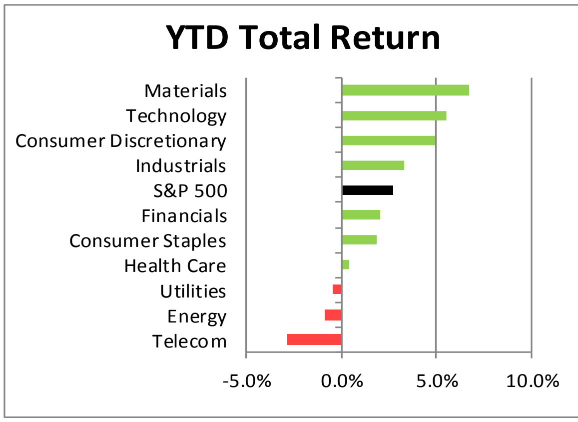
This chart overlays the ratio of the two earnings series with oil prices. Note that the three major divergences coincide with significant declines in oil prices. It is not unusual for recessions to bring lower oil prices; however, oil prices can fall for other reasons, as we have seen since 2014. This means that with the recovery in oil prices, we could very well see a narrowing of the ratio between the two series.

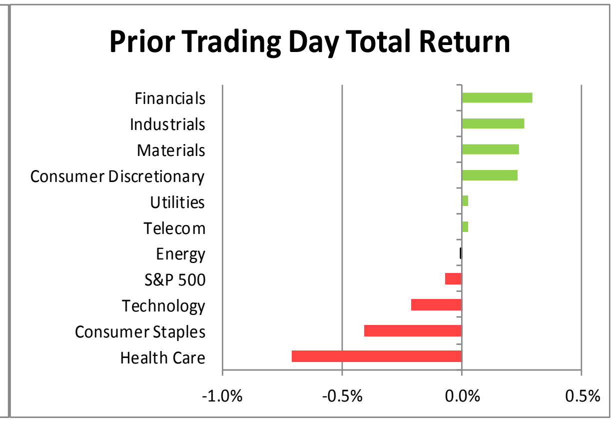
To the extent that the markets usually focus on the Thomson/Reuters data, a narrowing of the ratio won't matter too much. The growth in earnings as reported by S&P could be quite robust next year whereas the growth already estimated by I/B/E/S[4] of about 10.6%, while impressive, won't be as strong as S&P if the ratio approaches one. That would entail a greater than 29% rise in what S&P reports. Still, convergence of the two series does give us more confidence in the veracity of the earnings data.

[4] A part of Thomson/Reuters.

Data Section

U.S. Equity Markets – (as of 1/26/2017 close)

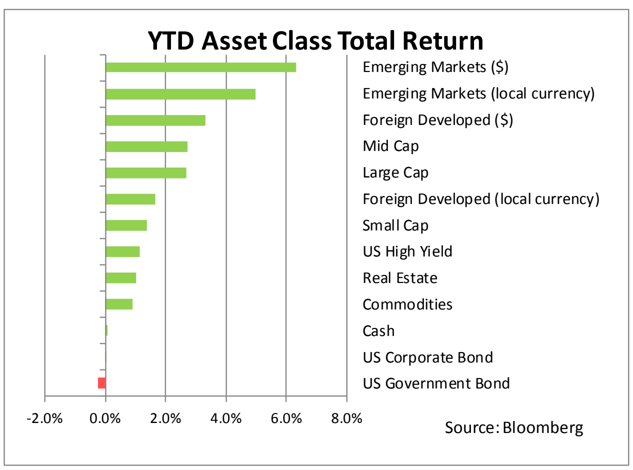




(Source: Bloomberg)

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 1/26/2017 close)

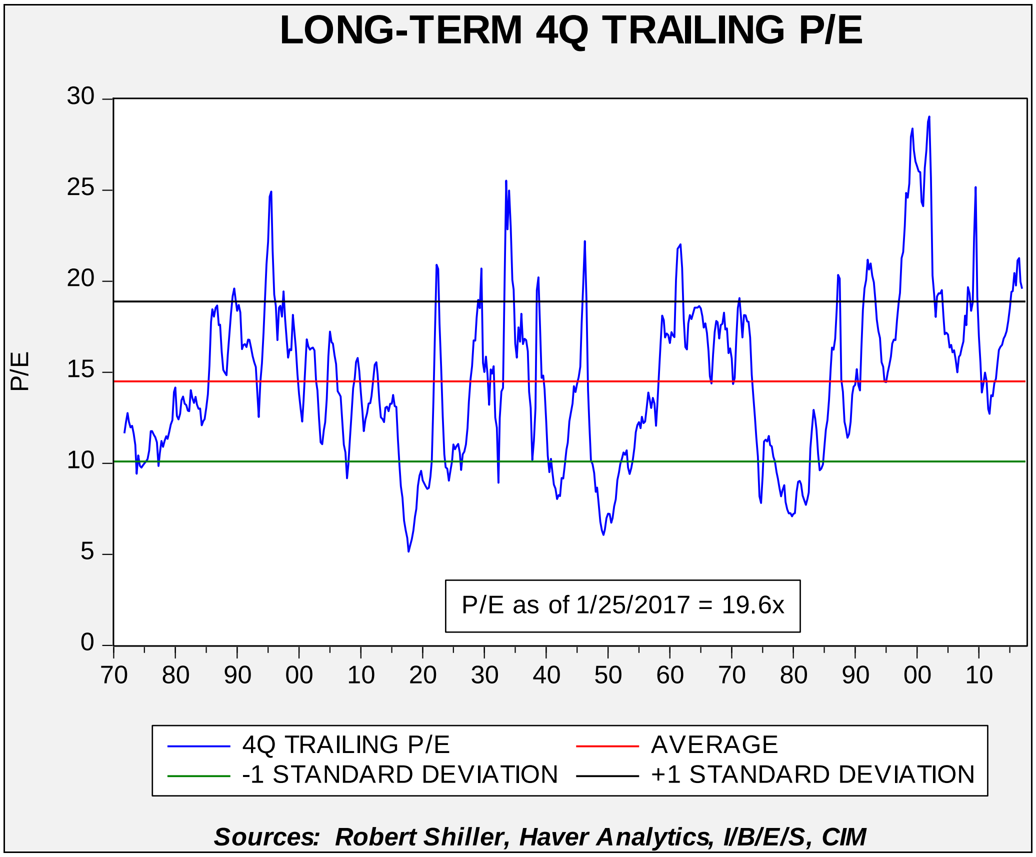


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[5] 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.

[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 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.