Daily Comment

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[Posted: January 30, 2017—9:30 AM EST] Global equity markets are down this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1% from the prior close. Chinese markets are closed today for New Year. U.S. equity futures are signaling a lower open. With 170 companies having reported, the S&P 500 Q4 earnings stand at $31.20, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 65.9% of the companies reported earnings above forecast, while 19.4% reported earnings below forecast.

One of the key themes we have been monitoring since Trump's election has been the uneasy alliance between the populists and the GOP establishment. We personalized this interaction as Speaker Ryan versus Chief Strategist Bannon. The policies that would be supported from the Ryan camp are primarily personal and corporate tax reform, which would mostly be in the form of lower marginal rates. This group would also want to maintain globalization (including open immigration) and deregulation, with a focus on relaxing financial regulations and environmental rules. This group is cool to the call for infrastructure spending. The Ryan group is where the fiscal budget hawks reside. The latter group, represented by Bannon, are economic nationalists who want to curtail globalization by restricting immigration and reducing the trade deficit through trade barriers, if necessary. This group wants to see fiscal expansion via defense and infrastructure spending. They are less concerned about tax cuts but are also less worried about deficits.

Although equity markets retreated in the early hours after the election, that pullback was short-lived. After a surprisingly conciliatory acceptance speech, equities turned and have been rallying ever since. It appears to us that this rally is predicated on the idea that the Ryan cohort will generally prevail, meaning we would mostly see an establishment GOP program of tax cuts and deregulation.

The key unknown is which group will eventually prevail. It would make sense for Trump to swing between these two groups; in fact, if he completely favors one over the other, it may either lead to him being a one-term president or undermine his ability to work with Congress. In reality, we expect him to give "bones" to each side over the next four years. However, we do have to say that Bannon has won the last few days. The executive order to ban Muslim immigrants, refugees and, for a time, U.S. green card holders from a handful of Islamic nations comes purely out of the Bannon agenda. Although reports are somewhat conflicting, it does appear that this policy change caught much of the government by surprise. According to reports, Bannon and his inner circle were behind the executive order.

The other important decision was to appoint Bannon as a permanent member of the National Security Council while indicating that the director of National Intelligence and the chair of the

Joint Chiefs of Staff will no longer be permanent members of the council. For background, this council was created by President Truman to offer the president advice and assistance with national security and foreign policy issues. The statutory attendees are the president, vice president, secretary of state, secretary of defense and secretary of energy. These members are required, by statute, to attend. Before President Trump's recent decision, the chair of the Joint Chiefs of Staff and the director of National Intelligence were also required by statute to attend; that is no longer the case. The director of National Drug Control Policy is also a statutory member. All other members, now including the chair of the Joint Chiefs of Staff and the director of National Intelligence, are invited to meetings that pertain to their responsibilities.

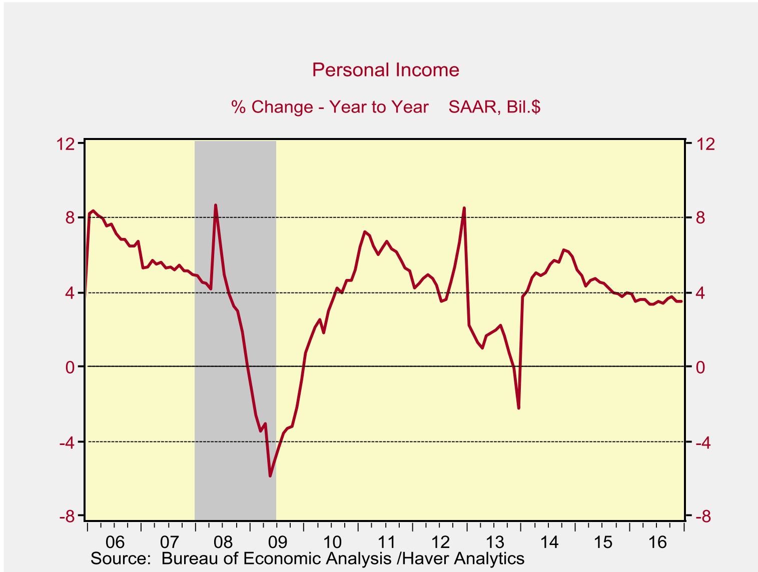
We suspect that the chair of the Joint Chiefs of Staff and the director of National Intelligence will end up attending most meetings. Thus, the downgrade of their positions may be more form over substance. However, appointing Bannon as a permanent member elevates someone whose position has traditionally been more of a political advisor rather than security advisor. It's a bit like putting Karl Rove on the council. It is a clear indication of Bannon's influence on the administration.

We are watching the impact on financial markets. If Bannon's influence grows, we would expect Trump's policies to lean more toward the populists and less toward the establishment. That would be bearish for long duration debt and likely also bearish for equities as we would look for multiples contraction over time. Simply put, populist policies are inflationary and negative for financial markets. The major "known/unknown" is how the FOMC will react. Central bank independence is granted by the political system and thus can be taken away by that same system. A Bannon-influenced Fed will have more in common with the Burns/Miller era than the Volcker/Greenspan era.

At the same time, it is important to remember that President Trump needs Congress to get major things accomplished. Thus, some sort of accommodation to the GOP establishment is probably necessary. We are closely watching the U.S. political situation as well. Trump may very well represent a major rejiggering of party affiliation. It seems hard to imagine that labor may find its home in the GOP while the Democrats become the party of business, but such shifts have occurred before. The Democratic Party was the party of Jim Crow before the 1964 Civil Rights Act and the GOP was the party of trade protection before WWII. Thus, we are paying close attention to party affiliation changes.

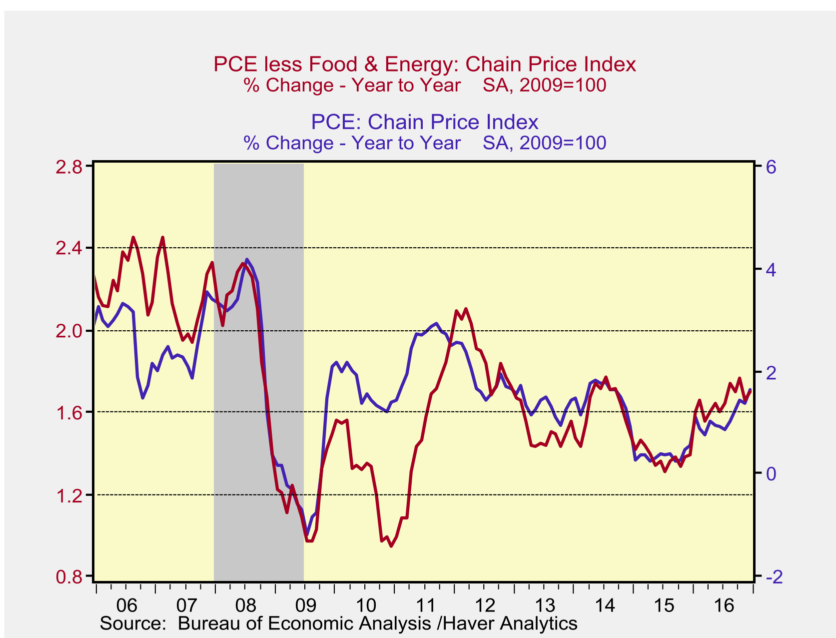
U.S. Economic Releases

Personal income came in slightly below expectations at 0.3% compared to the forecast of 0.4%. The prior report was revised upward from unchanged to a rise of 0.1%.



The chart above shows the year-over-year change of personal income. Personal income has remained relatively flat over the past two years. We expect personal incomes to rise as employers increase wages in order to fill positions as the country continues to operate at full employment.

The PCE deflator came in slightly below expectations at 1.6% compared to the forecast of 1.7%. The PCE core was in line with expectations at 1.7%. A rising PCE suggests that rate hikes by the Fed could be imminent as the PCE is the Fed's preferred tool to determine the level of inflation.



The chart above shows the relationship of the year-over-year change between PCE and core PCE. This chart illustrates that the recent rise in inflation may not be solely attributed to a rise in oil prices. As the Fed weighs its decision on whether to raise rates, it may run into tensions with the Trump administration. President Trump has expressed his preference for a weaker dollar, suggesting he would prefer rates to remain low.

Personal spending was in line with expectations at 0.5%. Real spending also aligned with expectations at 0.3%. The prior report was revised upward from a rise of 0.1% to 0.2%. This report marks the highest growth in consumer spending in three months. An increase in personal spending suggests consumers are feeling more optimistic about the economy.

The chart above shows the year-over-year change in personal spending (outlays). Personal spending has been rising slightly over the past year.

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

Economic Releases						
10:00	Pending Homes Sales	m/m	dec	1.1%	-2.5%	**
10:00	Pending Homes Sales	m/m	jan		1.4%	**
10:00	Dallas Fed Manufacturing Outlook	m/m	jan	15.0	15.5	**
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	Retail Trade	y/y	dec	0.6%	1.7%	1.7%	**	Equity bearish, bond bullish
	Retail Sales	y/y	dec	-1.7%	0.2%	-0.5%	**	Equity bearish, bond bullish
	Dept. Store, Supermarket Sales	y/y	dec	-1.3%	-0.3%	-1.0%	**	Equity bearish, bond bullish
New Zealand	Trade Balance	y/y	dec	-41 mn	-705 mn	-98 mn	**	Equity bullish, bond bearish
	Exports	y/y	dec	4.38 bn	3.86 bn	4.23 bn	**	Equity and bond neutral
	Imports	y/y	dec	4.42 bn	4.56 bn	4.34 bn	**	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	y/y	dec	108.2	107.8	107.8	**	Equity and bond neutral
	Business Climate Indicator	y/y	dec	0.77	0.79	0.80	**	Equity and bond neutral
	Industrial Confidence	y/y	jan	0.8	0.1	0.2	**	Equity bullish, bond bearish
	Services Confidence	m/m	jan	13.5	12.9	12.7	**	Equity bullish, bond bearish
Germany	CPI	y/y	jan	1.9%	1.7%	2.0%	***	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	dec	101.7	102.2	102.9	**	Equity and bond neutral
	Total Sight Deposits	m/m	dec	532.8 bn	532.3 bn		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	jan	466.7 bn	464.3 bn		*	Equity and bond neutral
AMERICAS								
Brazil	FGV Inflation IGPM	y/y	jan	6.7%	7.2%	6.7%	***	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	104	0	Up
3-mo T-bill yield (bps)	50	50	0	Neutral
TED spread (bps)	54	54	0	Neutral
U.S. Libor/OIS spread (bps)	69	69	0	Neutral
10-yr T-note (%)	2.48	2.49	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	37	37	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	up			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	$55.47	$55.52	-0.09%	Long liquidation
WTI	$53.26	$53.17	0.17%	
Natural Gas	$3.28	$3.36	-2.26%	
Crack Spread	$12.94	$13.16	-1.69%	
12-mo strip crack	$15.00	$15.08	-0.54%	
Ethanol rack	$1.57	$1.56	0.13%	
Metals				
Gold	$1,190.66	$1,191.20	-0.05%	Stronger Dollar
Silver	$17.12	$17.14	-0.13%	
Copper contract	$267.65	$268.95	-0.48%	
Grains				
Corn contract	$ 359.25	$ 362.50	-0.90%	
Wheat contract	$ 417.00	$ 420.50	-0.83%	
Soybeans contract	$ 1,035.50	$ 1,049.25	-1.31%	
Shipping				
Baltic Dry Freight	827	840	-13	

Weather

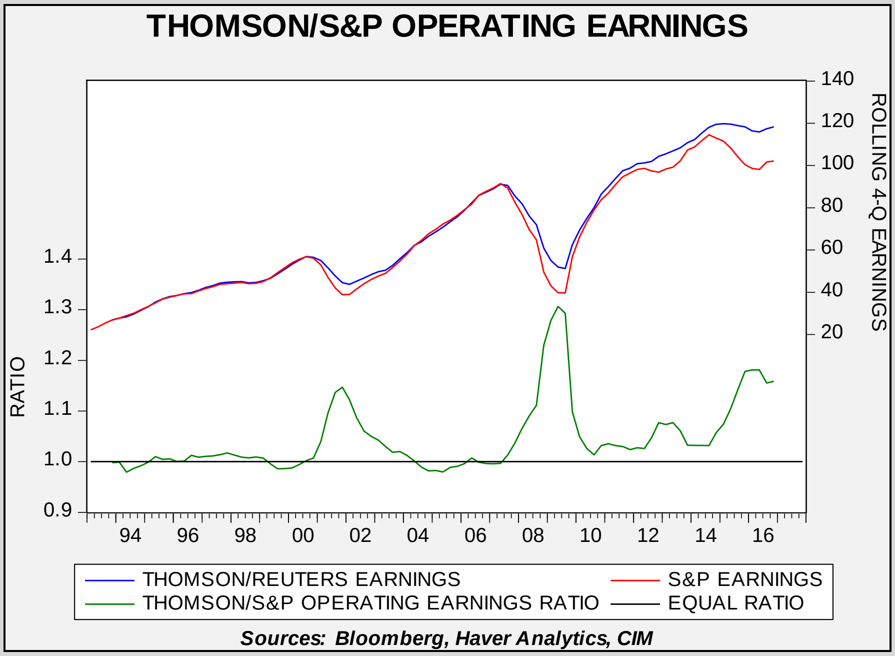
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country except the southwestern region.

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.

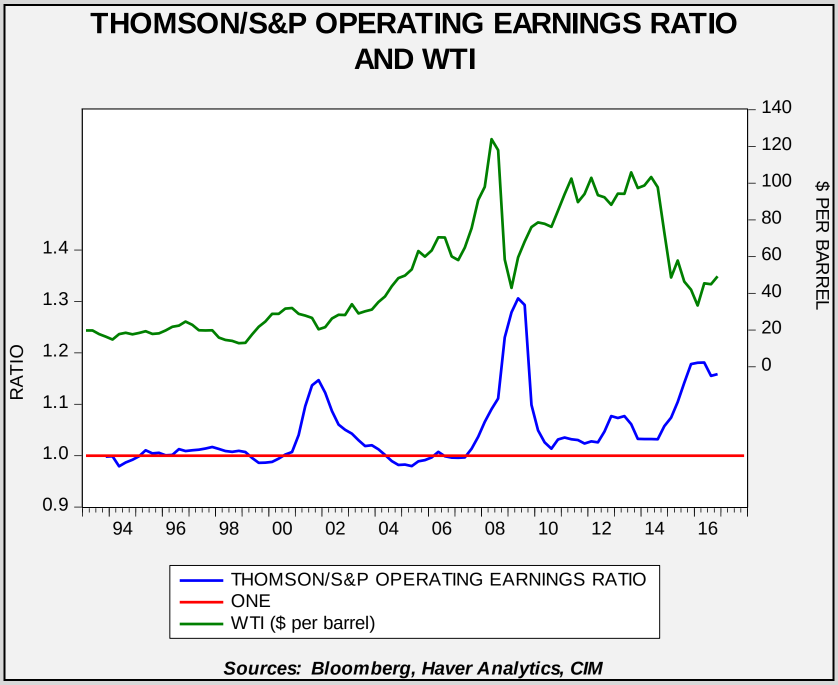
January 27, 2017

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.



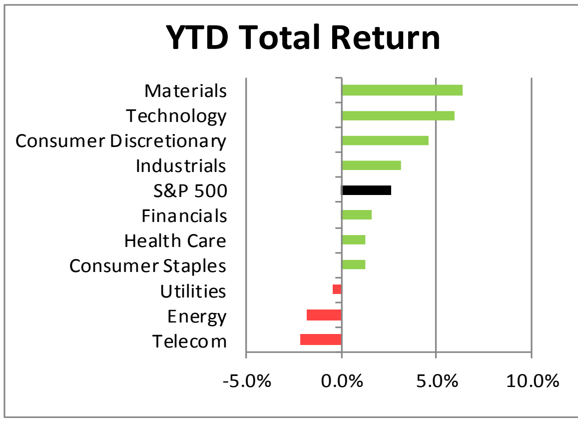
This chart overlays the ratio of the two earnings series with oil prices. Note that the three major divergences coincide with significant declines in oil prices. It is not unusual for recessions to bring lower oil prices; however, oil prices can fall for other reasons, as we have seen since 2014. This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

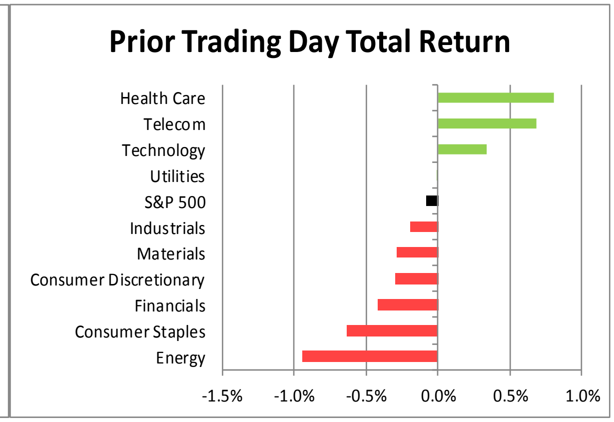
To the extent that the markets usually focus on the Thomson/Reuters data, a narrowing of the ratio won't matter too much. The growth in earnings as reported by S&P could be quite robust next year whereas the growth already estimated by I/B/E/S[1] of about 10.6%, while impressive, won't be as strong as 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.

[1] A part of Thomson/Reuters.

Data Section

U.S. Equity Markets – (as of 1/27/2017 close)

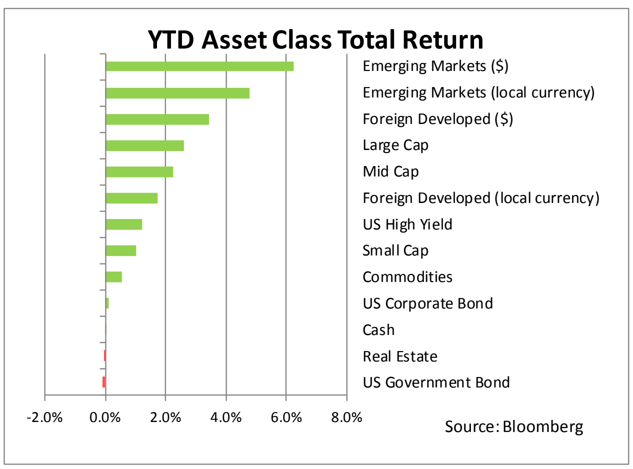




(Source: Bloomberg)

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 1/27/2017 close)

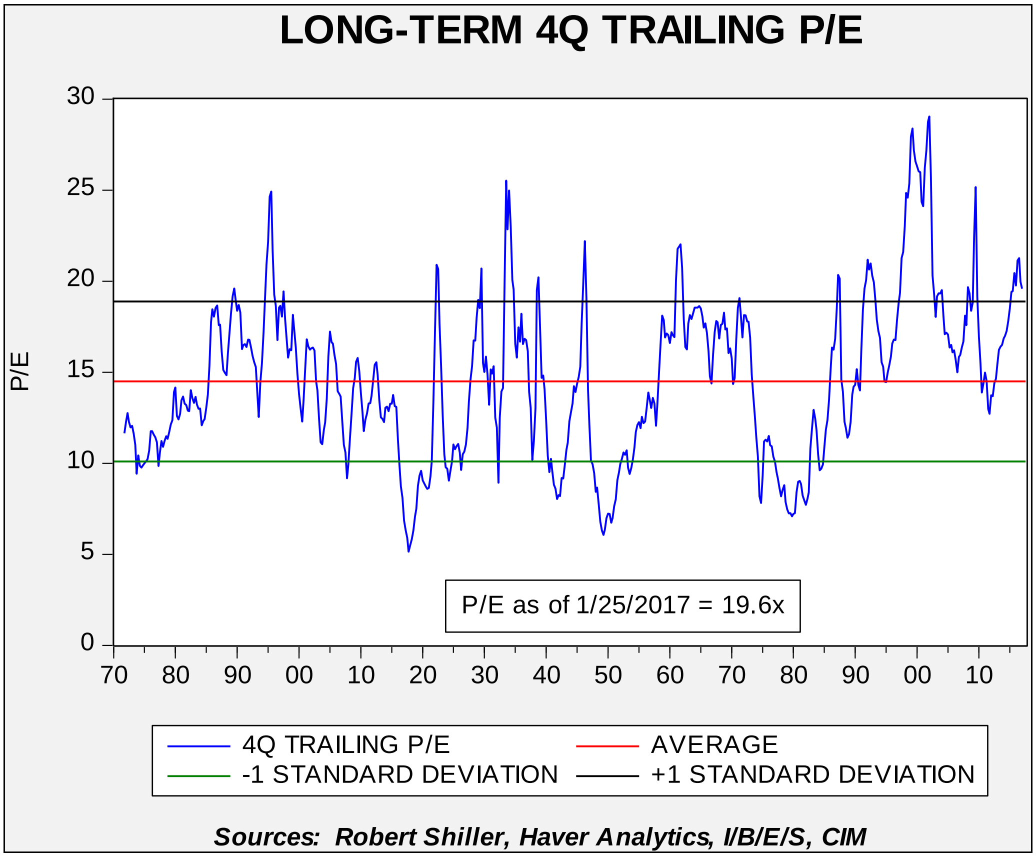


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.