Confluence Investment Management

Daily Comment

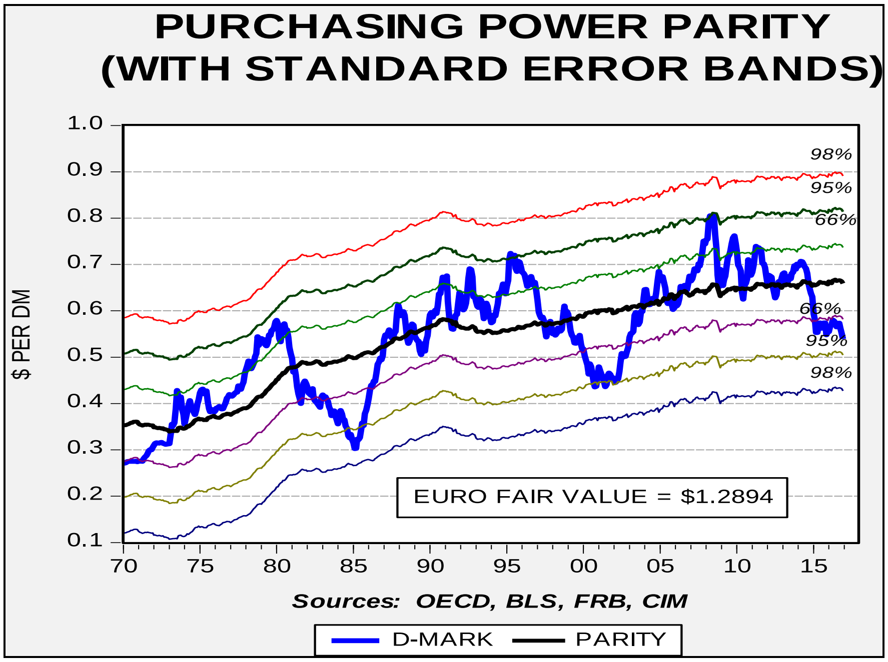
By Bill O'Grady, Kaisa Stucke, and Thomas Wash

[Posted: January 31, 2017—9:30 AM EST] Global equity markets are down this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets are closed today for New Year. U.S. equity futures are signaling a lower open. With 175 companies having reported, the S&P 500 Q4 earnings stand at $31.19, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 65.1% of the companies reported earnings above forecast, while 19.4% reported earnings below forecast.

There was a lot of political news overnight but it didn't have much impact on financial markets. However, this morning, Peter Navarro, the director of the newly formed National Trade Council, told the *FT* that Germany is using a "grossly undervalued" exchange rate to "exploit" the U.S. and its EU trading partners. The EUR rose on the news, indicated by the red arrow on the chart below.

(Source: Bloomberg)

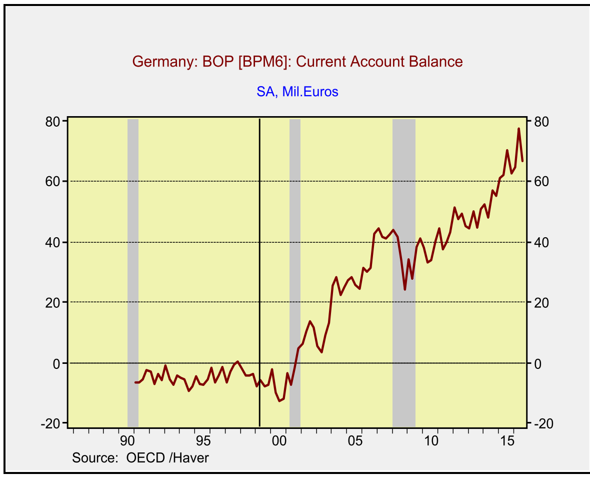
In terms of his analysis of the euro, we tend to agree with him. Here is our parity model of the euro, using German and U.S. consumer inflation.

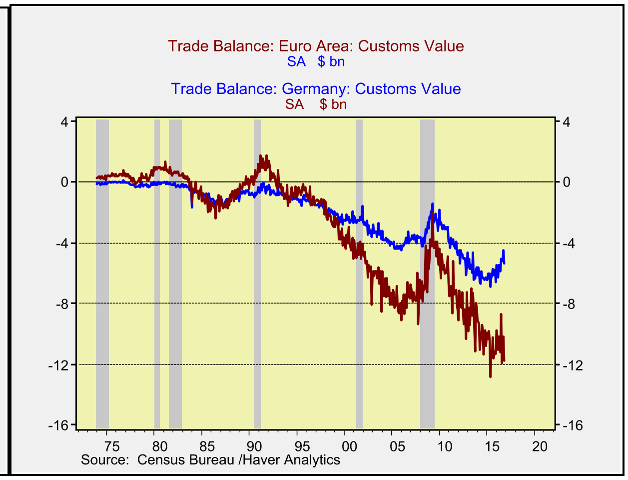


Purchasing power parity uses relative inflation to value exchange rates. The theory is that in a freely floating environment, the exchange rate should move to equalize prices between nations. So, if cars in Canada are cheaper than in the U.S., Americans would buy Canadian cars but the demand for Canadian dollars would rise as a result and the exchange rate would appreciate to eventually equalize the exchange rate-adjusted prices between the two countries. Simply put, the lower price levels are in a nation, the stronger its exchange rate. In reality, it's only a guide to exchange rate valuation. For example, not all goods in a consumer price index are tradeable, so relative inflation rates are not perfect proxies for exchange rate valuation. Trade isn't frictionless, so deviation in the price of goods can persist even if tradeable. And, financial factors, such as interest rates, may overwhelm inflation. However, at extremes, the measure has some value.

The model suggests the D-mark is trading almost two standard errors from the forecast, or around 18% undervalued relative to the dollar. There have only been two other periods when the dollar has been this strong relative to the D-mark, in the mid-1980s and at the turn of the century. Eventually, the exchange rate reversed.

Navarro's claim that Germany manipulates its currency also has merit (although technically it's Europe's currency, in reality, Germany effectively controls it because of its economic dominance over the Eurozone). Germany has traditionally suppressed consumption and boosted saving, macroeconomic policies designed to bring trade surpluses. Until the introduction of the euro, Germany was typically prevented from expanding its trade surplus due to D-mark appreciation. However, now that it uses the euro, its European trading partners can't use depreciation to remain competitive. Since the euro was introduced, Germany's current account (trade surplus plus official and private remittances) has ballooned.





These charts show Germany's current account (the vertical line shows the introduction of the euro) and the Eurozone and German trade accounts with the U.S. Clearly, Germany and the Eurozone run persistent trade surpluses with the U.S. and the German current account has swelled since the introduction of the euro.[1]

Here are the complications in Navarro's comments. First, the Treasury has the mandate for currency policy. If multiple voices start commenting on exchange rates, it will make it tricky to determine what the administration's currency policy actually is. Second, the U.S. runs trade deficits because this is how the system is designed. As long as we are the reserve currency, other nations in the world have an incentive to adopt the same policies as Germany (and many do, including China, South Korea, Japan, etc.). The U.S. does benefit from being the reserve currency; we receive goods from the world and give dollars back that are held as savings. In fact, if these reserves are not immediately spent, those dollars are recycled back into the U.S. financial system in the form of investment, often in Treasuries. This means that foreigners give us stuff and also help fund our deficit in return for dollars; *The Economist* describes this condition as writing checks that nobody cashes. The downside? If one competes in an industry facing import competition, there is a fair chance one will not be working at some point. It's hard to compete in a globalized world.

It appears the administration is figuring out that its goals of reducing the trade deficit and boosting jobs in the U.S. could be thwarted by a strong dollar. In fact, the controversial border adjustment in the GOP House corporate tax reform bill won't be inflationary if only the dollar appreciates. So, the administration is finding itself at cross-purposes. On the one hand, it wants to create more jobs in the U.S. and is targeting import reduction as a policy to achieve that goal. However, as long as the dollar is the primary reserve currency, other nations will take steps (e.g., currency depreciation) to maintain import flows into the U.S. In fact, the more barriers we erect, the more aggressive foreign nations will become because the dollar is still the best currency to use for global trade.

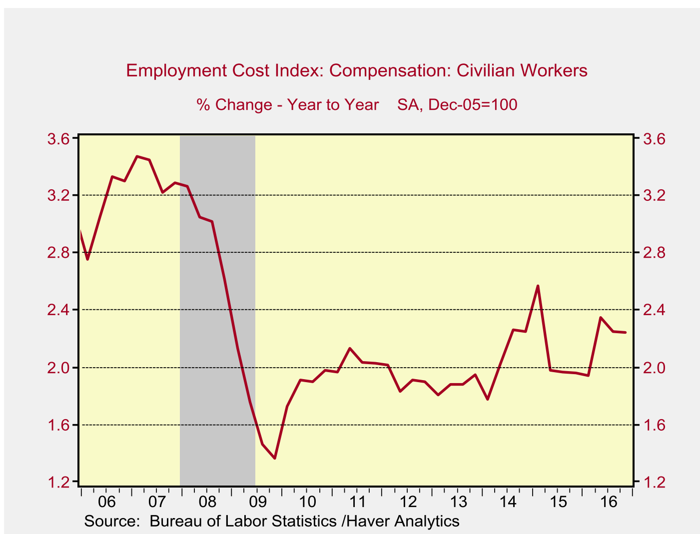
[1] For a deeper look at this issue, see this week's WGR.

Perhaps the most important person in this whole debate is Chair Yellen. If the Fed turns more hawkish on fears of inflation and fiscal expansion, the dollar will tend to appreciate. As we continue to say, we will be watching very closely to see how the president reacts to Fed tightening. If the Fed faces a strongly negative reaction from the administration, the dollar may not rally much from here. Of course, the lack of monetary tightening, a weaker dollar and trade impediments are a recipe for inflation and higher interest rates, especially on long-duration assets.

So, the FOMC meets tomorrow. Current expectations for a rate hike are only at 13%; in fact, they don't exceed 50% until June (all based on fed funds futures). This suggests the markets are not expecting an overly hawkish statement. Stay tuned…

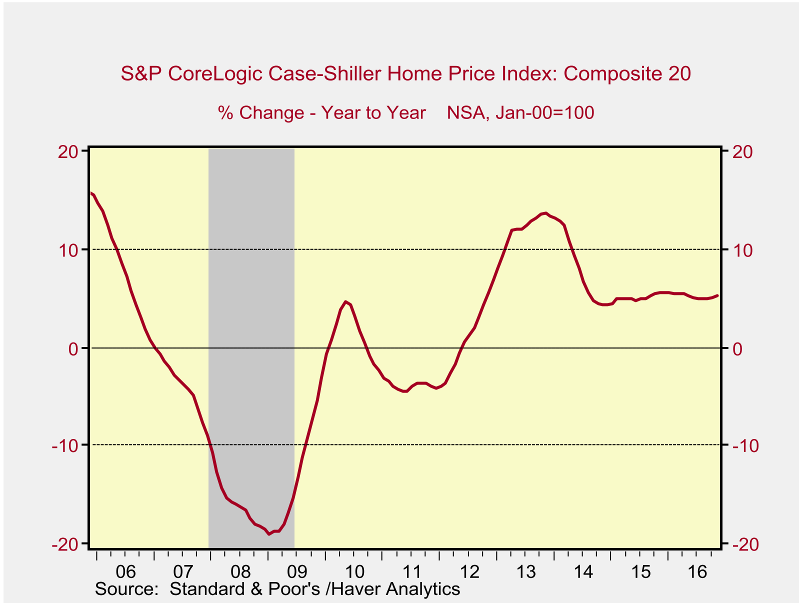
U.S. Economic Releases

The employment cost index came in below expectations at 0.5% compared to the forecast of 0.6%. The lower than expected ECI suggests that businesses may still be reluctant to spend more on labor, despite their optimism following the election of Donald Trump. Or, it may mean that there is more slack in the labor market than the unemployment rate would suggest.



The chart above shows the year-over-year change of the employment cost index.

The S&P CoreLogic Case-Schiller 20-City Home Price Index for November came in above expectations at 0.88% compared to the forecast of 0.65% from the prior month. The S&P CoreLogic Case-Schiller U.S. HPI increased by 5.27% from the prior year.



The chart above shows the year-over-year change of the home price index. Over the past two years, the HPI has remained steady at about 5% yearly. We expect there to be an uptick in this trend as income picks up and inflation rises.

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

Economic Releases						
9:45	Chicago Purchasing Manager	m/m	jan	55.0	54.6	**
10:00	Conference Board Consumer Confidence	m/m	jan	112.8	113.7	**
10:00	Conference Board Presentation Situation	m/m	jan		126.1	**
10:00	Conference Board Expectations	m/m	jan		105.5	**
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	Jobless Rate	y/y	dec	3.1%	3.1%	3.1%	**	Equity and bond neutral
	Job-to-Applicant Ratio	y/y	dec	1.43	1.41	1.42	**	Equity and bond neutral
	Overall Household Spending	y/y	dec	-0.3%	-1.5%	-0.9%	**	Equity and bond neutral
	Industrial Production	y/y	dec	3.0%	3.0%	4.6%	**	Equity bearish, bond bullish
	Vehicle Production	y/y	dec	4.2%	6.6%		**	Equity and bond neutral
	Housing Starts	y/y	dec	4.2%	6.6%		**	Equity and bond neutral
	Construction Orders	y/y	dec	7.1%	-6.6%		**	Equity and bond neutral
	Small Bussiness Confidence	y/y	dec	48.3	48.8		***	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Construcion	m/m	jan	118.1	117.0		**	Equity and bond neutral
	HIA House Affordability Index	y/y	4q	77.7	81.8		**	Equity and bond neutral
	NAB Business Confidence	m/m	dec	11	5		**	Equity and bond neutral
	Private Sector Credit	m/m	dec	5.6%	5.4%	5.4%	**	Equity and bond neutral
New Zealand	Net Migration	m/m	dec	6010	6220		**	Equity and bond neutral
	Money Supply	y/y	dec	6.4%	5.9%		**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	y/y	dec	9.6%	9.8%	9.8%	***	Equity and bond neutral
	GDP	y/y	4q	1.8%	1.7%	1.7%	***	Equity and bond neutral
	CPI Estimate	y/y	jan	1.8%	1.1%	1.5%	***	Equity bullish, bond bearish
	CPI Core	m/m	jan	0.9%	0.9%	0.9%	***	Equity and bond neutral
Germany	Retail Sales	y/y	dec	-1.1%	3.2%	0.5%	**	Equity and bond neutral
	Unemployment Change	m/m	jan	-26k	-17k	-5k	**	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	jan	5.9%	6.0%	6.0%	***	Equity and bond neutral
Italy	Unemployment Rate	y/y	dec	12.0%	11.9%	11.8%	***	Equity and bond neutral
	PPI	y/y	dec	0.9%	-0.3%		**	Equity and bond neutral
France	GDP	y/y	4q	1.1%	1.0%	1.1%	***	Equity and bond neutral
	PPI	y/y	dec	1.7%	-0.2%		**	Equity and bond neutral
	CPI	y/y	jan	1.4%	1.1%	0.6%	***	Equity bullish, bond bearish
	Consumer Spending	y/y	dec	1.5%	3.3%	2.1%	**	Equity bearish, bond bullish
U.K.	Net Consumer Credit	m/m	dec	1.0 bn	1.9 bn	1.7 bn	*	Equity bearish, bond bullish
	Net Lending Sec. on Dwellings	m/m	dec	3.8 bn	3.2 bn	3.2 bn	*	Equity and bond neutral
	Mortgage Approvals	m/m	dec	67.9k	67.5k	69.2k	*	Equity and bond neutral
	Money Supply M4	m/m	dec	-0.5%	0.4%			Equity and bond neutral
AMERICAS								
Brazil	National Unemployment Rate	m/m	dec	12.0%	11.9%	11.9%	***	Equity and bond neutral
	PPI Manufacturing	m/m	dec	0.8%	-0.1%		**	Equity and bond neutral
	Primary Budget Balance	m/m	dec	-70.7 bn	-39.1 bn	-72.8 bn	**	Equity and bond neutral
	Net Debt % GDP	m/m	dec	45.9%	43.8%	45.8%	**	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)	51	51	0	Neutral
TED spread (bps)	53	53	0	Neutral
U.S. Libor/OIS spread (bps)	69	69	0	Neutral
10-yr T-note (%)	2.47	2.49	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	33	33	0	Neutral
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Down
pound	up			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Short-Term Policy Rate	-0.10%	-0.10%	-0.10%	On forecast
BOJ Long-Term Policy Rate	0.00%	0.00%	0.00%	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	$55.33	$55.23	0.18%	Short Covering
WTI	$52.52	$52.63	-0.21%	
Natural Gas	$3.16	$3.23	-2.13%	
Crack Spread	$13.56	$13.04	4.03%	
12-mo strip crack	$15.25	$15.03	1.47%	
Ethanol rack	$1.57	$1.56	0.08%	
Metals				
Gold	$1,206.63	$1,195.70	0.91%	Weaker Dollar, Inflation Expectations
Silver	$17.41	$17.12	1.69%	
Copper contract	$269.65	$265.50	1.56%	
Grains				
Corn contract	$ 358.50	$ 357.75	0.21%	
Wheat contract	$ 414.75	$ 414.00	0.18%	
Soybeans contract	$ 1,025.75	$ 1,022.75	0.29%	
Shipping				
Baltic Dry Freight	816	827	-11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		1.5		
Distillates (mb)		-0.5		
Refinery run rates (%)		-0.10%		

Weather

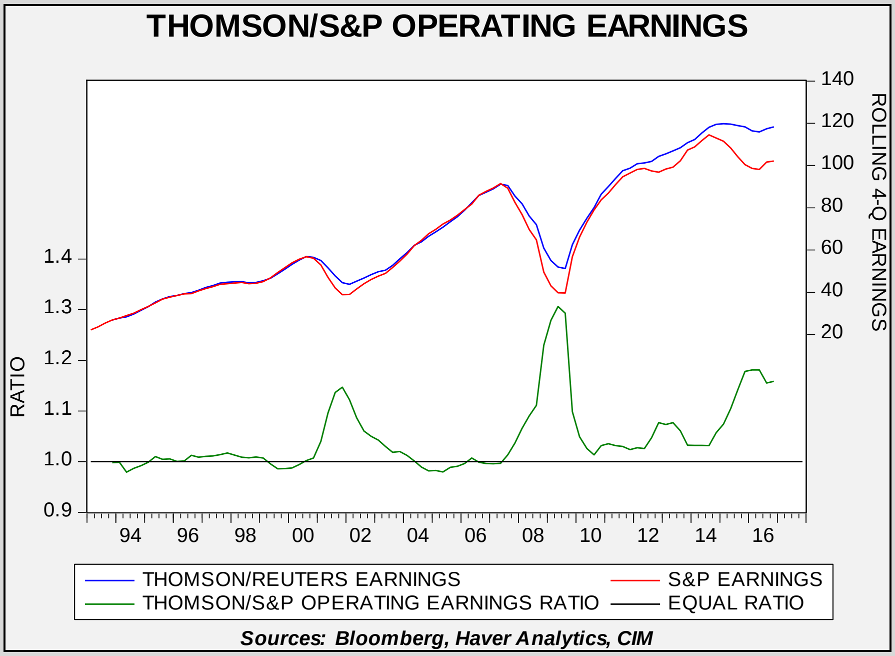
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country except the southwestern region.

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.

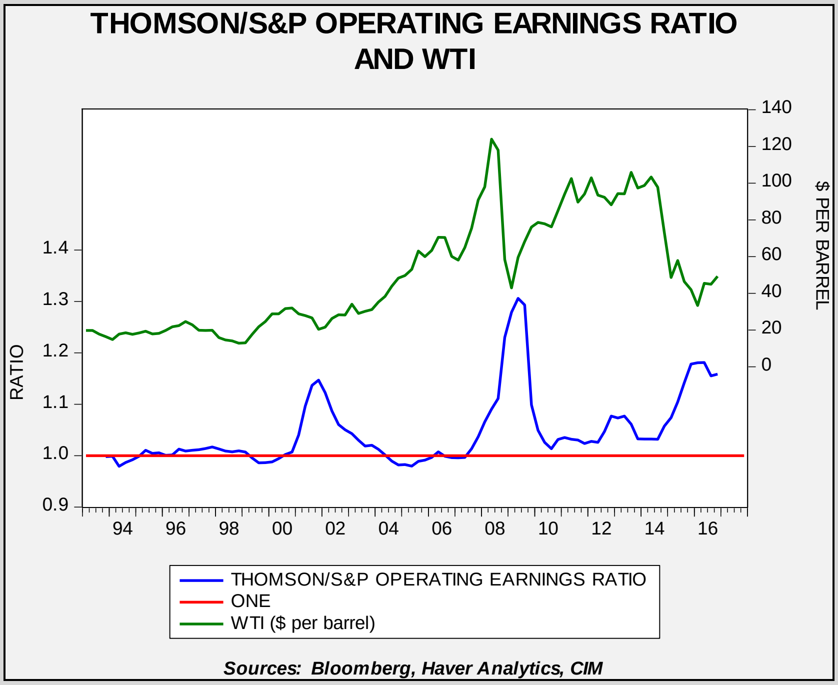
January 27, 2017

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.

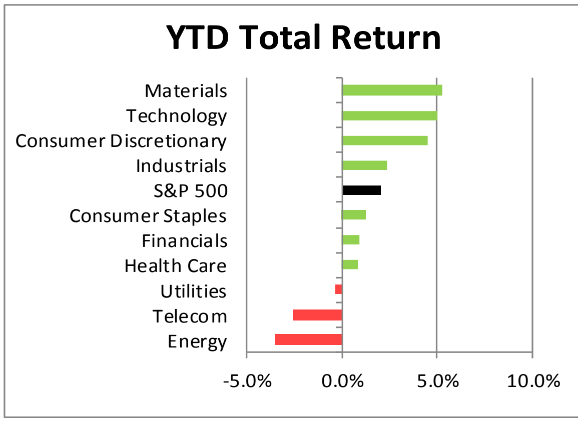
To the extent that the markets usually focus on the Thomson/Reuters data, a narrowing of the ratio won't matter too much. The growth in earnings as reported by S&P could be quite robust next year whereas the growth already estimated by I/B/E/S[2] of about 10.6%, while impressive, won't be as strong as 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.

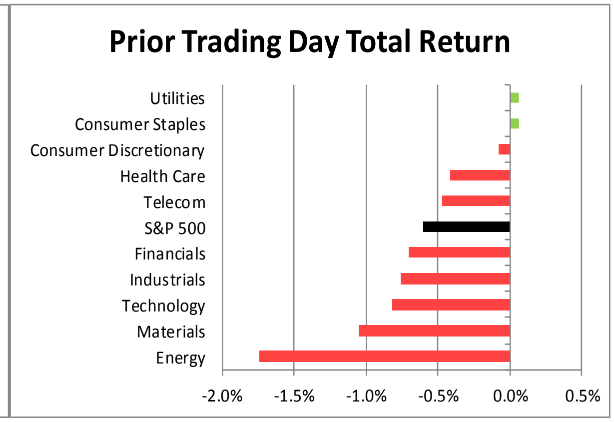
Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors 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.

[2] A part of Thomson/Reuters.

Data Section

U.S. Equity Markets – (as of 1/30/2017 close)

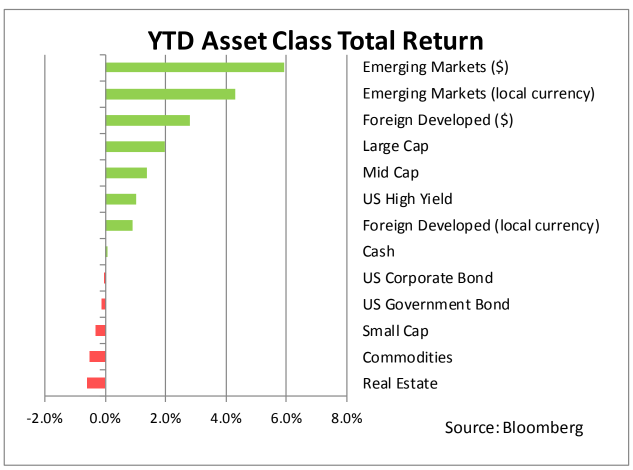




(Source: Bloomberg)

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 1/30/2017 close)

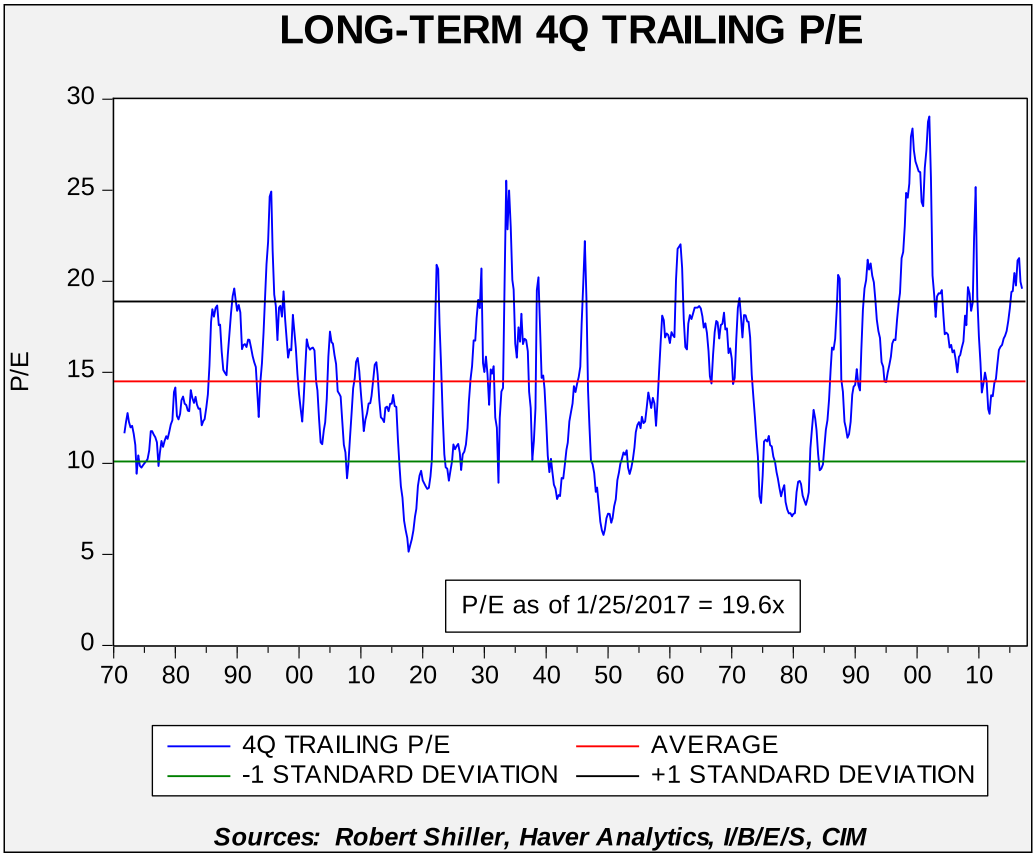


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

---

[3] 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.