Confluence INVESTMENT MANAGEMENT

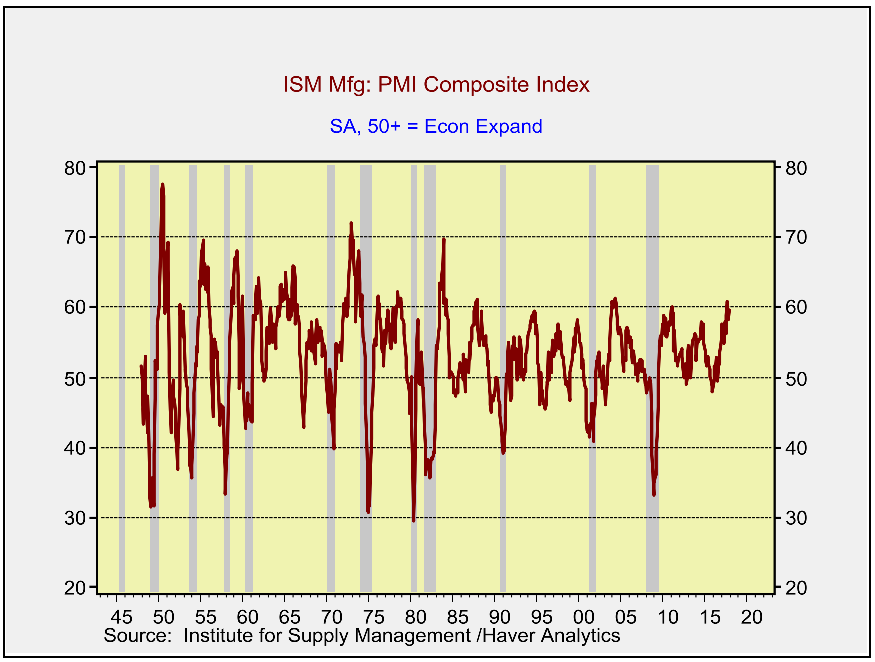
Daily Comment

By Bill O'Grady and Thomas Wash

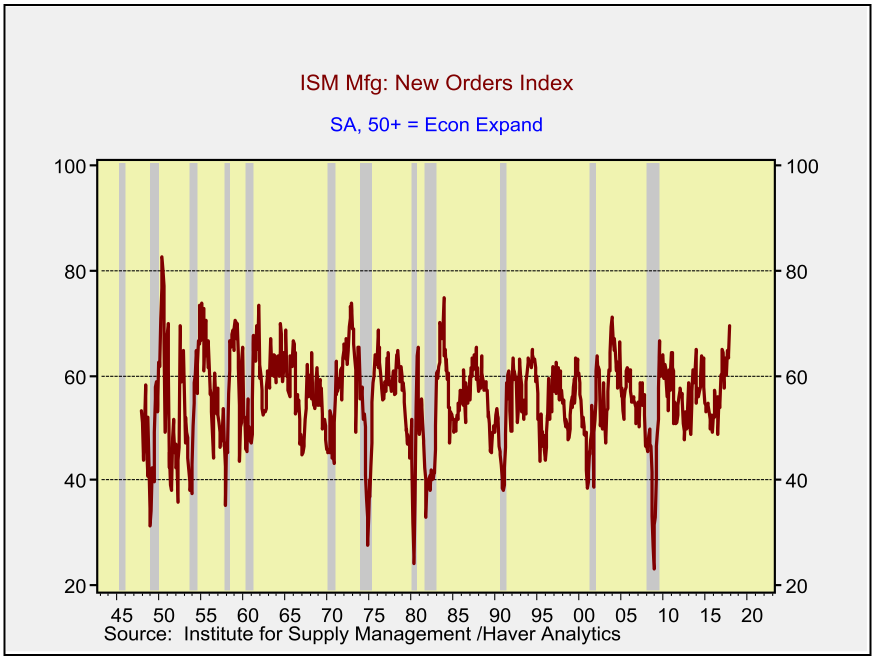
[Posted: January 4, 2018—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 1.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a higher open.

It's a rather quiet morning. Here is what we are following:

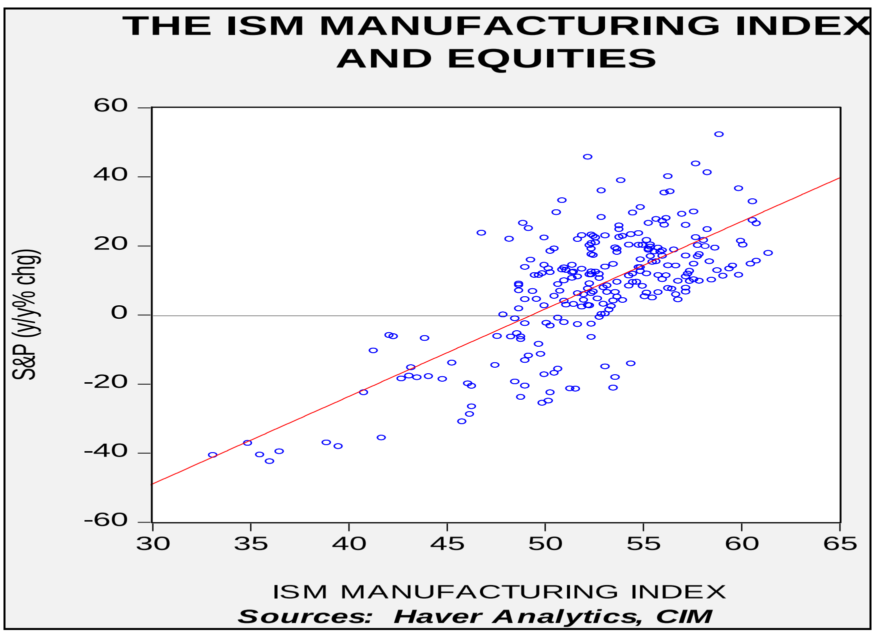
Economic momentum is rising: The ISM manufacturing index continued to hold near the 60 mark, which is an unusually high level.



The ISM manufacturing index exceeds 59.0 only 17% of the time. Equally impressive is the new orders index.



The current reading of 63.5 is the highest since 2004 and only happens about 16% of the time. The ISM indices are sentiment indicators; purchasing managers indicate if conditions are "better, the same, or worse" for various subsectors, such as orders, supplier performance, etc. In general, there is a positive relationship between the ISM manufacturing index and equity performance.



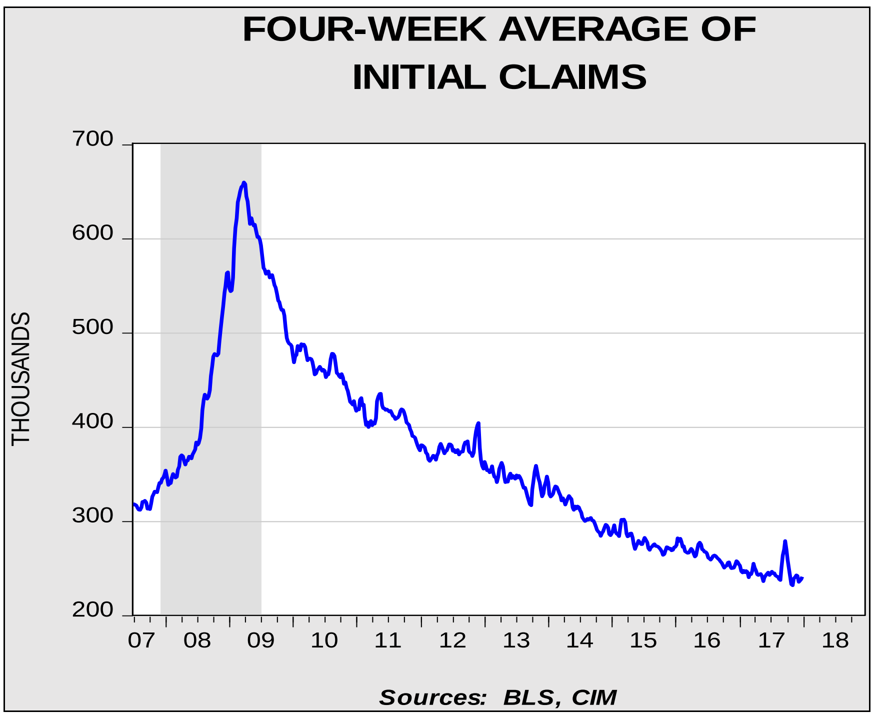
This chart shows a scatterplot of the ISM manufacturing index and the yearly change in the S&P 500. The regression line shows that readings of 60 for the ISM index are consistent with yearly growth of 20% for the S&P 500. Thus, the strength we are seeing in equities is consistent with economic activity.

Iran: Although protests continue in Iran, the intensity appears to be waning, as we expected. Poor citizens don't have the financial resources for weeks of protests. We will be watching to see how the government responds to the recent unrest. This issue is the topic of next week's Weekly Geopolitical Report.

Winter storm: The Northeast is getting slammed by a winter storm that will reduce travel and boost energy demand in the short run. So far, natural gas prices have not jumped significantly because supply capacity remains high. There have been local price spikes but this is mostly due to the lack of pipeline capacity; adding pipeline capacity is usually unpopular but this is the cost of not overcoming NIMBY complaints. We may see some impact on market liquidity but it will probably be much less of a factor than in the past due to continued trading automation.

U.S. Economic Releases

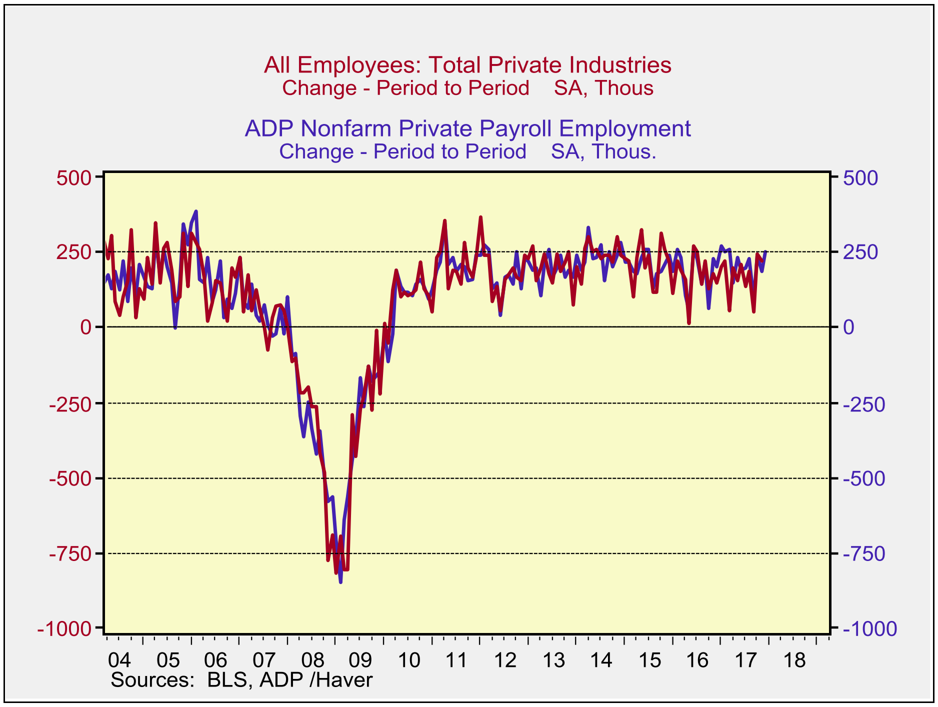
Initial jobless claims came in above expectations at 250k compared to the forecast of 240k. The prior report was revised upward from 245k to 247k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose from 237.75 to 240.5.

The December Challenger job cuts report fell by 3.6% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

ADP employment change came in above expectations at 250k compared to the forecast of 190k. The prior month's report was revised downward from 195k to 185k.



The chart above shows the change in ADP employment and private payrolls. A high ADP employment change number signals a strong BLS non-farm payroll report for Friday.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit Services PMI	m/m	dec	52.5	52.4	***
9:45	Markit Composite PMI	m/m	dec		53.0	**
9:45	Bloomberg Consumer Comfort	m/m	dec		52.4	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
13:30	James Bullard Speaks in Philadelphia	President of the Federal Reserve Bank of St. Louis				

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	Caixin China PMI Composite	m/m	dec	53.0	51.6		**	Equity and bond neutral
	Caixin China PMI Services	m/m	dec	53.9	51.9	51.8	**	Equity and bond neutral
Japan	Nikkei Japan PMI Mfg	m/m	dec	54.0	54.2		**	Equity and bond neutral
India	Nikkei India PMI Services	m/m	dec	50.9	48.5		**	Equity and bond neutral
	Nikkei India PMI Composite	m/m	dec	53.0	50.3		**	Equity and bond neutral
Australia	CBI Australia PMI Services	m/m	dec	55.1	54.0		**	Equity and bond neutral
	CBI Australia PMI Composite	m/m	dec	55.5	54.3		**	Equity and bond neutral
	AiG Performance of Services Index	m/m	dec	52.0	51.7		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Services PMI	m/m	dec	56.6	56.5	56.5	**	Equity and bond neutral
	Markit Eurozone Composite PMI	m/m	dec	58.1	58.0	58.0	**	Equity and bond neutral
Germany	Makit Germany Services	m/m	dec	55.8	55.8	55.8	**	Equity and bond neutral
	Markit/ BME Germany Composite	m/m	dec	58.9	58.7	58.7	**	Equity and bond neutral
France	Markit France Services PMI	m/m	dec	59.1	59.4	59.4	**	Equity and bond neutral
	Markit France Composite PMI	m/m	dec	55.8	55.8	55.8	**	Equity and bond neutral
Italy	Markit Italy Services PMI	m/m	dec	55.4	54.7	54.7	**	Equity bullish, bond bearish
	Markit Italy Composite PMI	m/m	dec	56.5	56.0	56.0	**	Equity bullish, bond bearish
U.K.	Markit UK Services PMI	m/m	dec	54.2	53.8	54.0	**	Equity and bond neutral
	Markit UK Composite PMI	m/m	dec	54.9	54.9	55.0	**	Equity and bond neutral
	Nationwide House Px	m/m	dec	0.6%	0.1%	0.1%	**	Equity bullish, bond bearish
	Net Consumer Credit	m/m	jan	1.4 bn	1.5 bn	1.5 bn	*	Equity and bond neutral
Switzerland	PMI Manufacturing	m/m	feb	65.2	65.1	64.5	**	Equity bullish, bond bearish
AMERICAS								
Mexico	PPI manufacturing	m/m	nov	1.6%	1.5%		**	Equity and bond neutral
	Markit Brazil PMI Services	m/m	dec	47.4	46.9		**	Equity bearish, bond bullish
	Markit Brazil PMI Composite	m/m	dec	48.8	48.9		**	Equity bearish, bond bullish

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)	170	169	1	Up
3-mo T-bill yield (bps)	137	137	0	Neutral
TED spread (bps)	33	32	1	Neutral
U.S. Libor/OIS spread (bps)	145	144	1	Up
10-yr T-note (%)	2.47	2.45	0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	22	20	2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	down			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	$67.83	$67.84	-0.01%	
WTI	$61.81	$61.63	0.29%	
Natural Gas	$2.99	$3.01	-0.53%	
Crack Spread	$17.63	$17.93	-1.67%	
12-mo strip crack	$20.26	$20.43	-0.86%	
Ethanol rack	$1.43	$1.43	-0.15%	
Metals				
Gold	$1,311.98	$1,313.21	-0.09%	
Silver	$17.12	$17.14	-0.11%	
Copper contract	$328.65	$325.75	0.89%	
Grains				
Corn contract	$ 352.50	$ 353.00	-0.14%	
Wheat contract	$ 434.25	$ 436.00	-0.40%	
Soybeans contract	$ 966.00	$ 968.75	-0.28%	
Shipping				
Baltic Dry Freight	1262	1230	32	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-5.0		
Gasoline (mb)		2.0		
Distillates (mb)		0.5		
Refinery run rates (%)		-0.25%		
Natural gas (bcf)		-200.0		

Weather

The 6-10 and 8-14 day forecasts suggest that the western region will have warmer temperatures, while the rest of the country will see cooler to normal temperatures. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

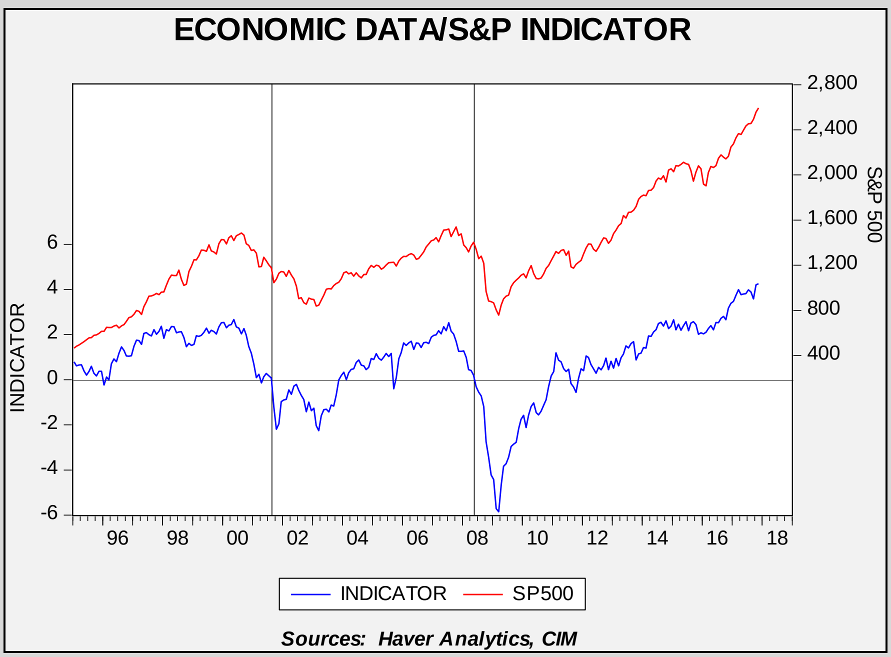
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

December 22, 2017

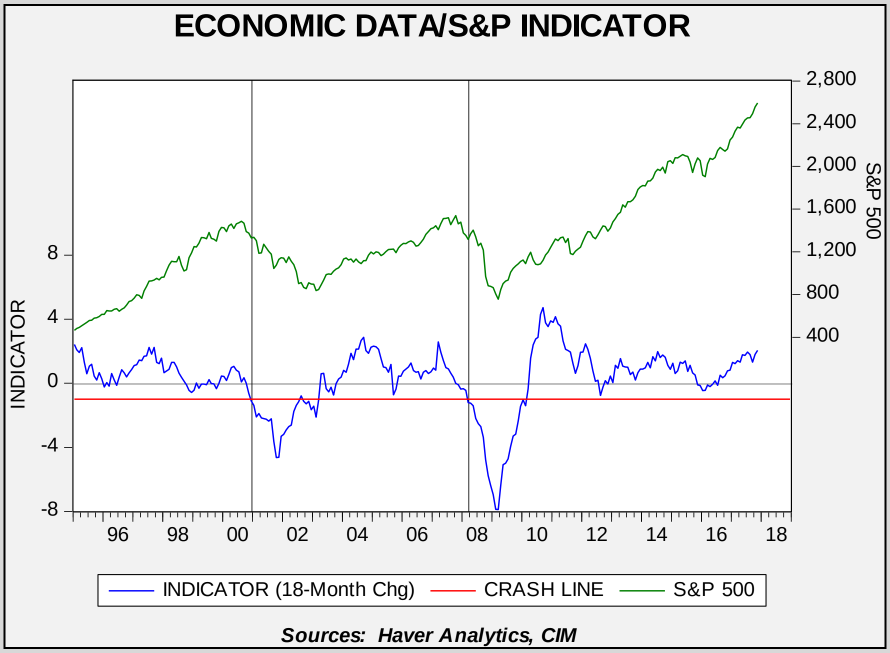
(N.B. This will be the last Asset Allocation Weekly for 2017. We thank our readers and wish them a Merry Christmas and Happy New Year. The next report will be published on January 5, 2018.)

As equity markets continue to trend higher, there are always worries about how long the bull market can last. In general, bull markets over the past three decades have tended to end with recessions, triggered either by a policy mistake or a geopolitical event. Unfortunately, the latter are binary events and difficult to predict. We do pay close attention to such events in our Weekly Geopolitical Reports.

Due to its importance to financial asset performance, we also closely monitor the economy. One of our more simple indicators is constructed with commodity prices, initial claims and consumer confidence. We standardize the data and combine it into a single indicator. The thesis behind this indicator is that these three components should offer clear signals on the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery.



This chart shows the results of the indicator and the S&P 500 since 1995. We have placed vertical lines when the indicator falls below zero. Although it works fairly well as a signal that equities are turning lower, it is a bit slow.

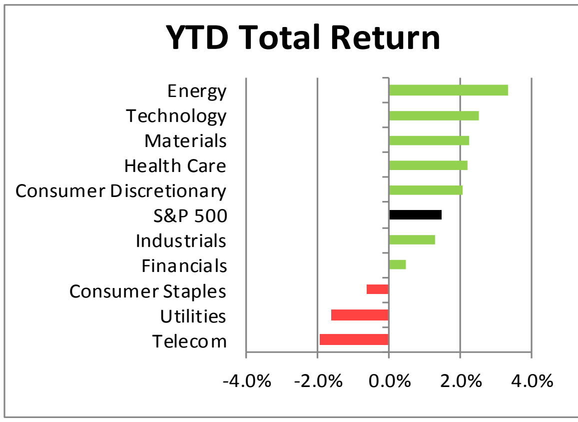


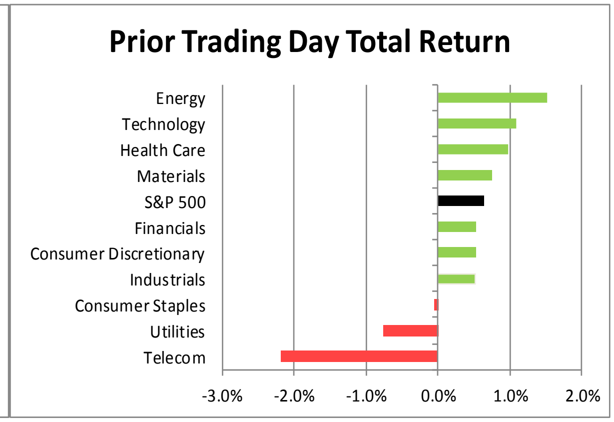
To make a more sensitive indicator, we took the 18-month change and put the signal at -1.0. This triggers a more useful sell signal and also eliminates the false positives that setting it at zero would generate. However, we do pay close attention when the 18-month change falls under zero.

What does the indicator say now? Clearly, if we are going to have a pullback, it won't be from the economy. The economy is healthy and will be supportive for equity markets. That doesn't mean that valuation doesn't matter, but it does suggest that the economy shouldn't cause a bear market in the near term.

Data Section

U.S. Equity Markets – (as of 1/3/2018 close)

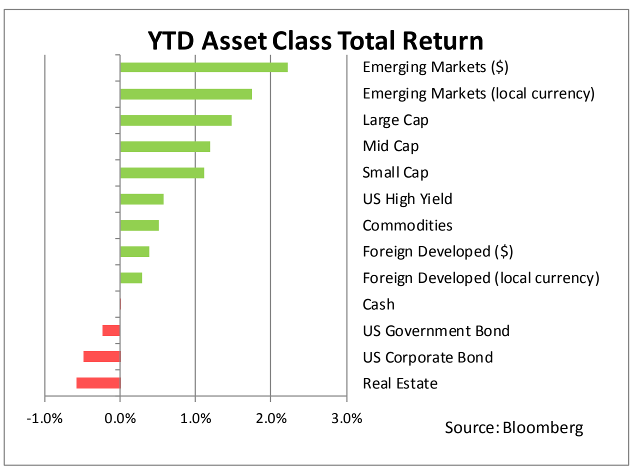




(Source: Bloomberg)

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 1/3/2018 close)

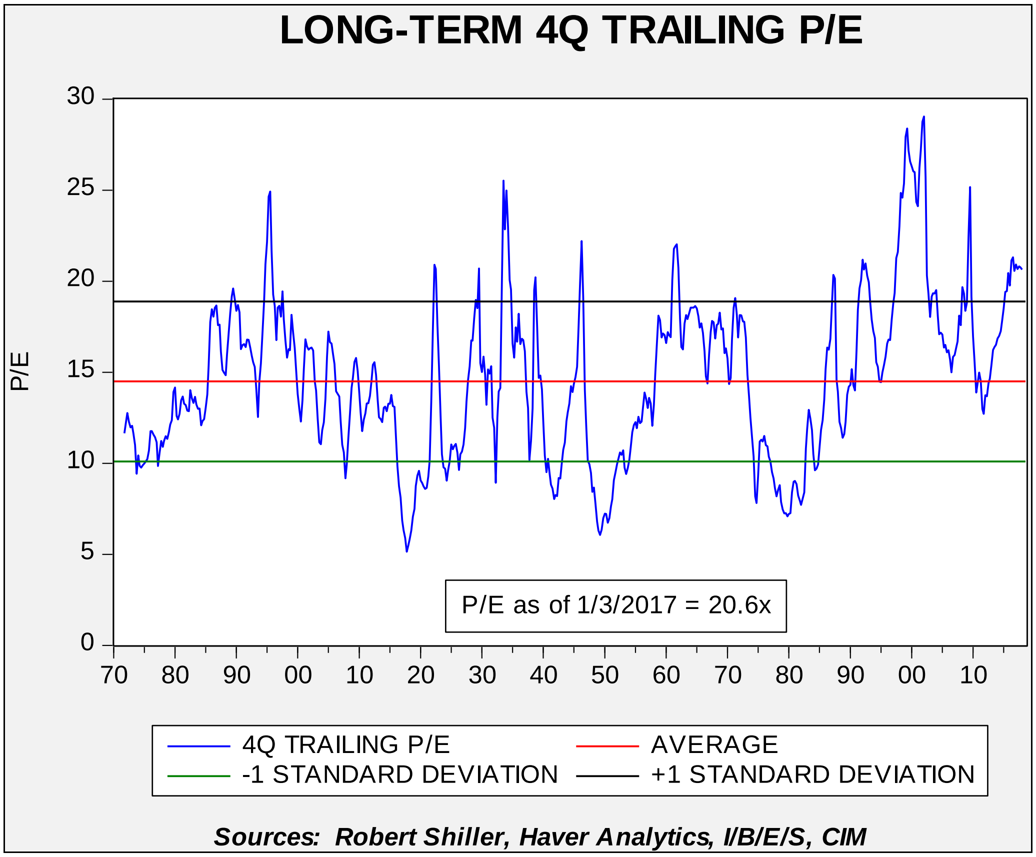


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 4, 2018



Based on our methodology,[1] the current P/E is 20.6x, unchanged from the last report.

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.

[1] 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.