By Bill O'Grady and Thomas Wash

[Posted: January 5, 2018—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were generally higher, with the Shanghai composite up 0.2% and the Shenzhen index relatively unchanged. U.S. equity index futures are signaling a higher open.

Happy employment day! We show all the details below but the quick analysis is that the report was a bit soft; payrolls came in below forecast and wage growth remains tepid. The report was dollar bearish, Treasury bullish and neutral for equities. Here is what we are watching today:

Korean talks: North and South Korea appear headed for talks as Pyongyang is trying to drive a wedge between South Korea and the U.S. The South Korean leadership likely welcomes the talks as they are fearful the U.S. will trigger a conflict in which they would suffer most of the damage,[1] but we doubt negotiations will go anywhere because South Korea can't deliver what North Korea wants. In other words, North Korea wants sanctions lifted and the elimination of the threat of regime change. Only the U.S. can give Pyongyang those outcomes. And, the U.S. has no interest in giving North Korea those goals without the latter giving up its nuclear threat. However, talks will give North Korea some space to further develop its nuclear weapons; after all, the U.S. and South Korea have delayed military exercises without Kim giving up anything.

The Wolff book: We are not going to go into any of the sensational revelations from the Wolff book but there are two takeaways that we see as important. First, Steve Bannon is becoming increasingly isolated. His funding source has abandoned him and the media firm he is associated with, Breitbart, may be forced to cut ties with him or cease to exist. This is significant because Bannon was the real standard bearer of right-wing populism in the White House. It's important to remember that Bannon's trial balloon for tax policy was a 44% marginal tax rate on incomes above $5.0 mm.[2] His "defrocking" will increase the power of the right-wing establishment surrounding the president and steer that path of policy in a more traditional GOP direction. Trade policy remains the item we are watching most closely and the president is inclined to put restrictions in place. But, losing Bannon may hurt that effort. Second, our primary concern is the impact on financial markets. If the Wolff book causes tumult and undermines the presidency, the most likely negative impact will be on the dollar. After all, the tax bill is now law and will continue to support equities. Thus, concern about political stability will likely shift to the exchange rate market.

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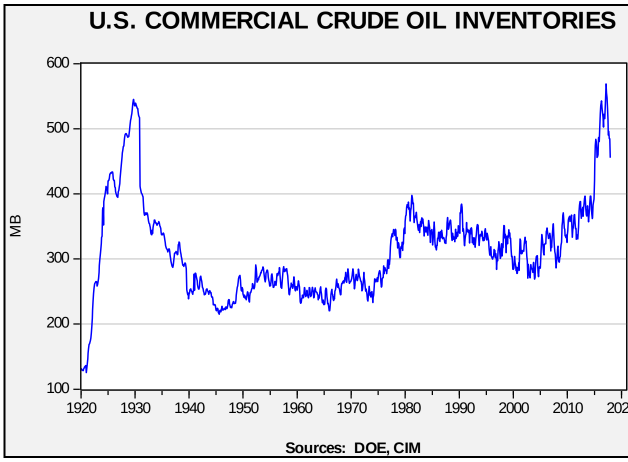
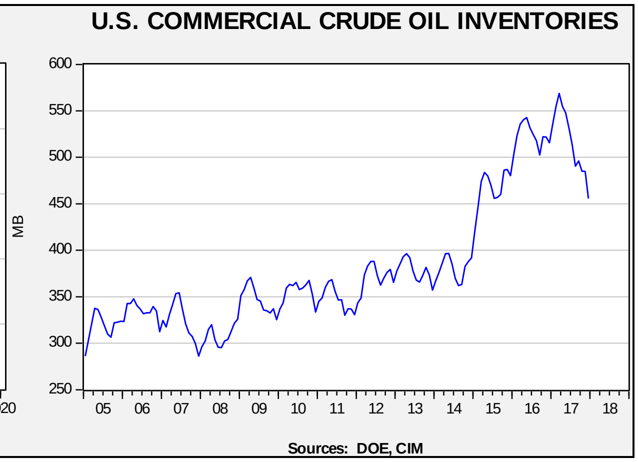
[1] https://www.theatlantic.com/international/archive/2017/08/lindsey-graham-north-korea/535578/

[2] http://fortune.com/2017/07/31/steve-bannon-tax-cuts-paul-ryan/

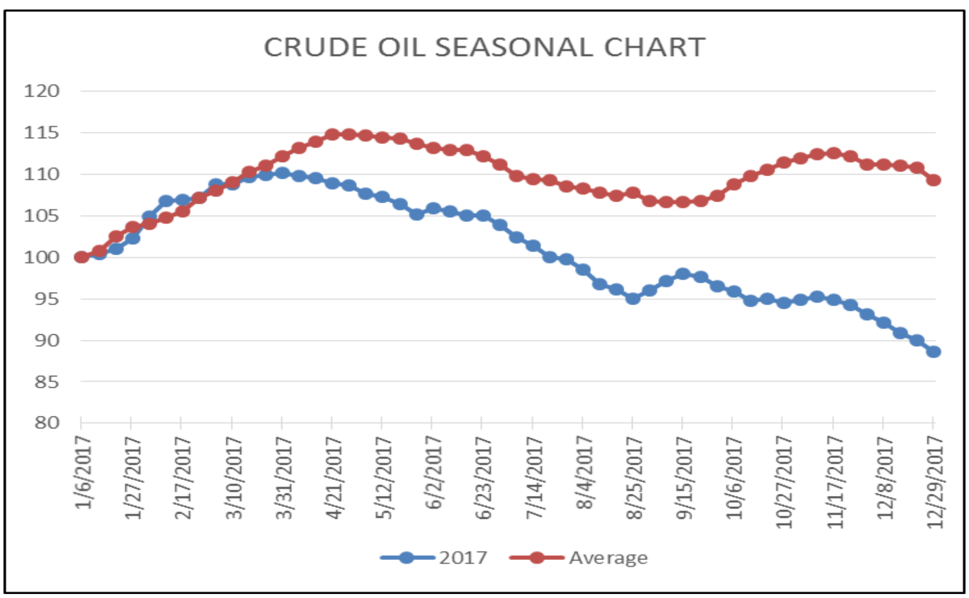
Energy recap: U.S. crude oil inventories fell 7.4 mb compared to market expectations of a 5.0 mb draw.



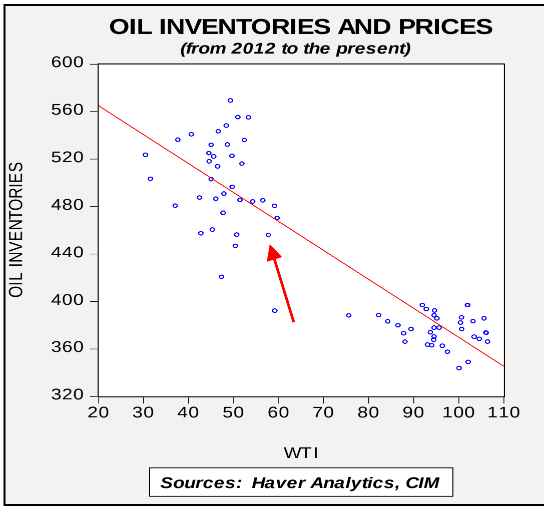


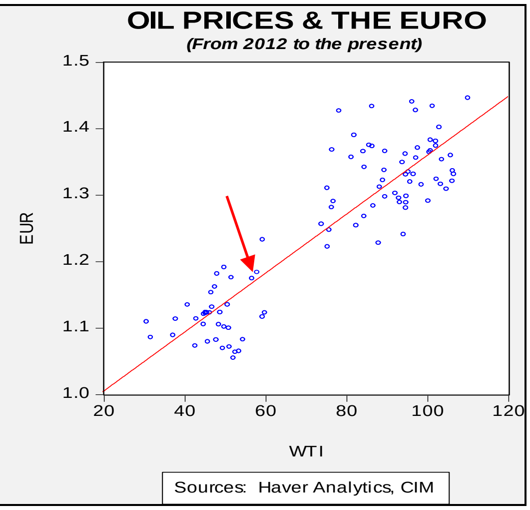
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but stockpiles have declined significantly this year, by 114 mb. This decline doesn't take into account the withdrawal from the SPR, which added an additional 31 mb to supply. Taking the SPR into account, inventories fell a whopping 145 mb.

As the seasonal chart below shows, inventories fell this week. We are now at the end of the late Q4 seasonal draw. Next week, stockpiles will begin their largest seasonal build that lasts from January into early April. This seasonal factor will become a major test for oil prices; if oil prices can hold their current levels as stockpiles rise it will be bullish for the commodity (assuming, of course, that they do rise because if they don't oil prices could rise significantly).



(Source: DOE, CIM)

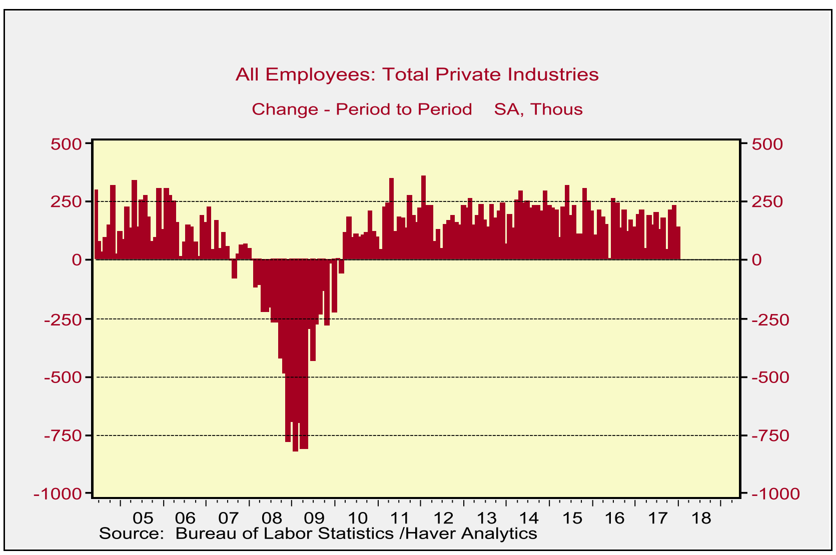




Based on inventories alone, oil prices are undervalued with the fair value price of $62.27. Meanwhile, the EUR/WTI model generates a fair value of $64.46. Together (which is a more sound methodology), fair value is $66.17, meaning that current prices, although elevated, are below fair value. Overall, oil prices are within normal ranges of current fundamentals but we are generally bullish toward crude oil at this time.

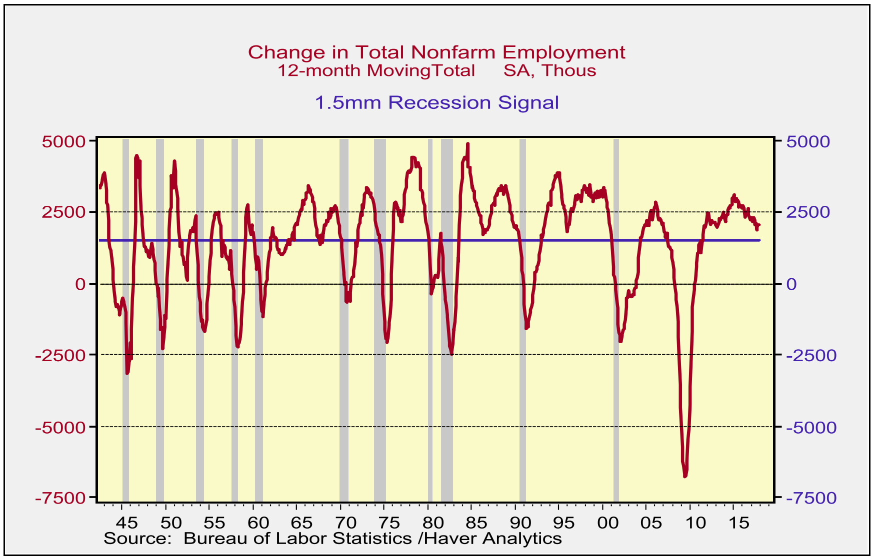
U.S. Economic Releases

The change in non-farm payrolls for December came in below expectations at 148k compared to the forecast of 195k; the net revisions from the prior two reports were -9k. The change in private payrolls came in below expectations at 146k compared to the forecast of 193k. The prior report was revised upward from 221k to 239k. The change in manufacturing payrolls came in above expectations at 25k compared to the forecast of 18k.

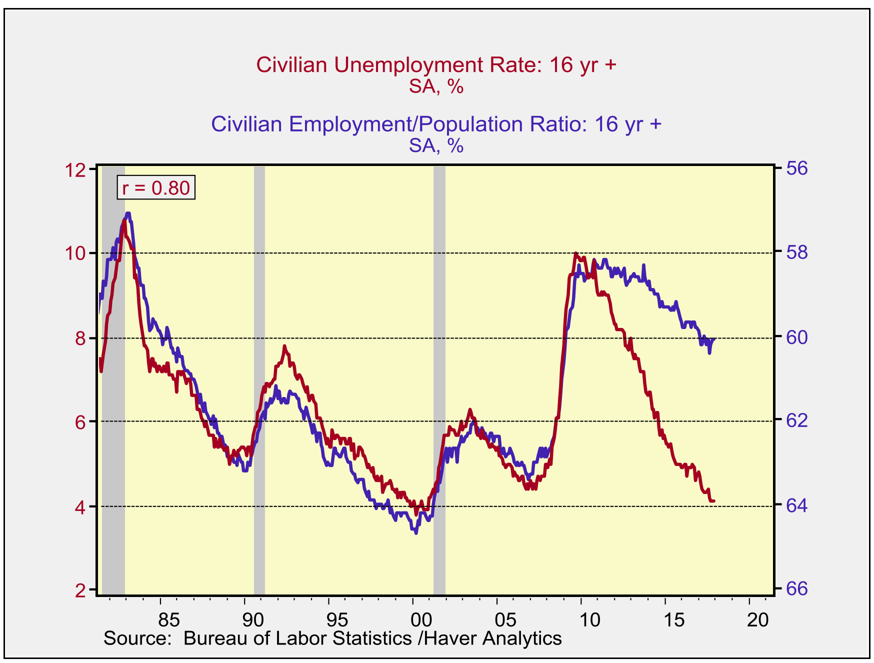


The chart above shows the change in total private employment. This chart suggests the economic expansion continues.

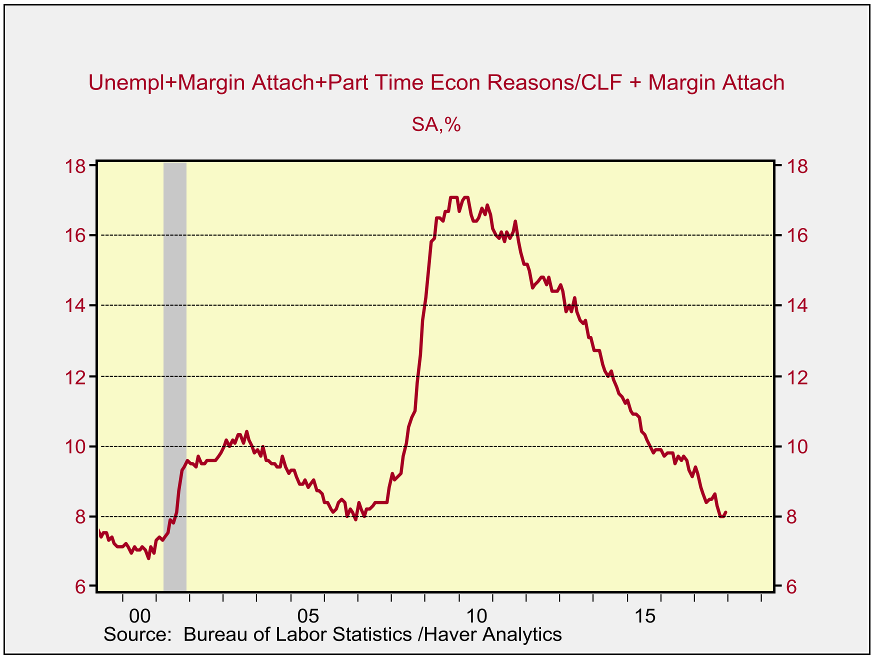
The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in line with expectations at 4.1%. The labor force participation rate was 62.7%, steady from the previous month, while the U-6 unemployment rate rose to 8.1%.

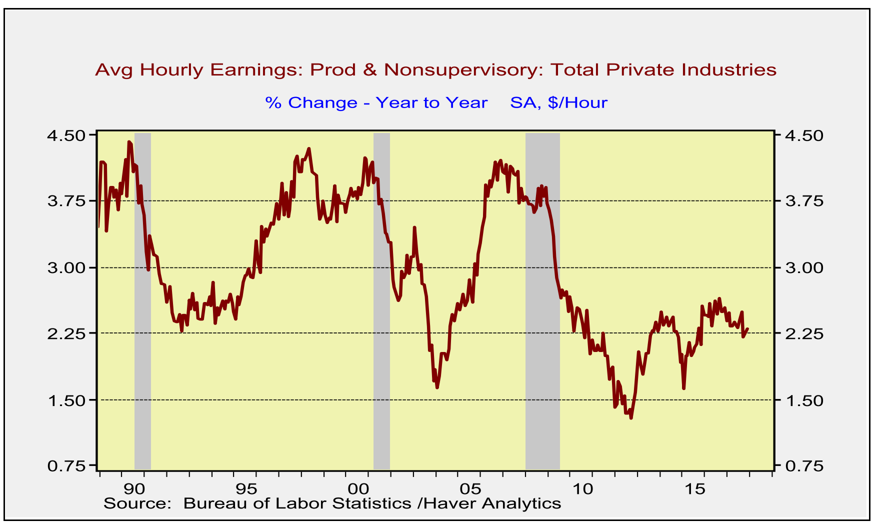


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.



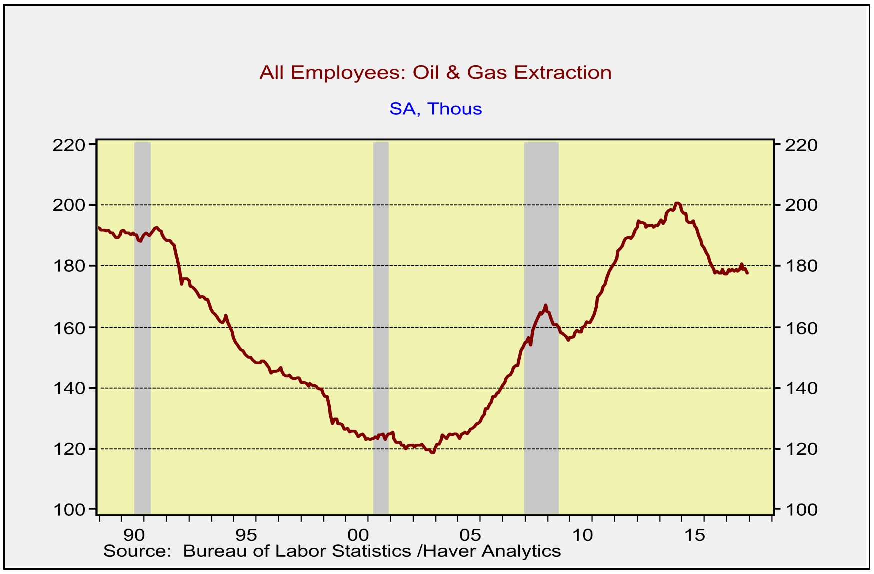
The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.

Average hourly earnings came in line with expectations, rising 0.3% from the prior month.



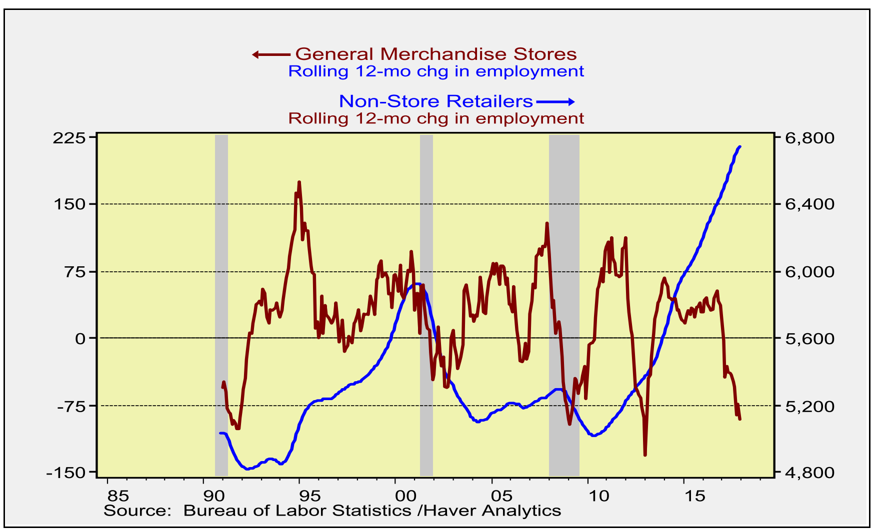
The chart above shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and non-supervisory employees rose 2.3%, in line with November. Wage growth remains subdued even with a historically low unemployment rate.

Here are a couple other charts of interest. First, despite rising oil prices, hiring in oil and gas extraction remains soft.



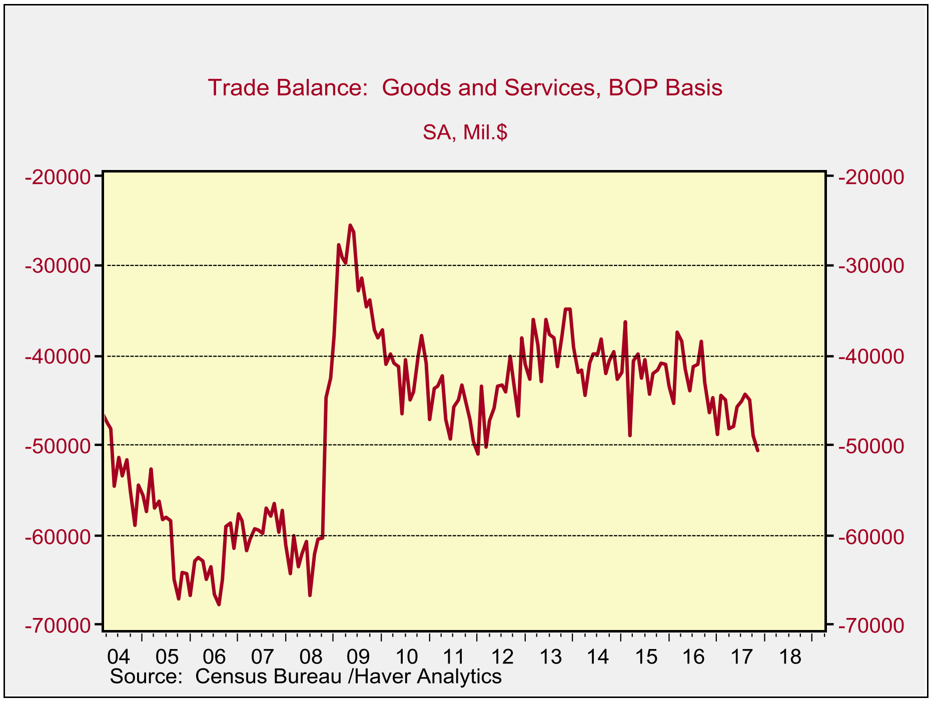
It's difficult to determine why we aren't seeing stronger employment growth. Some of this may be due to increased automation as we are seeing rising production without rising employment. It is still surprising to us to see rising production without hiring. Not only that, but in 2015, employment in this sector was 20k higher.

Second, retailers continue to shed jobs. Although the pace of hiring in non-store retailers (internet) is booming, it is being dwarfed by the job losses.



Non-store retailers have added 6.8k in new jobs over the past year, while general merchandise stores have shed over 90k jobs.

The trade deficit came in wider than expected at $50.5 bn compared to the forecast of $49.9 bn. The prior report's deficit was revised upward from $48.7 bn to $48.8 bn.



The chart above shows the level of the trade balance for goods and services. Over the past six years, the trade deficit has been volatile but has generally moved sideways. As the fiscal deficit widens, we expect the trade deficit to widen as well.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	ISM Non-Manufacturing Composite	m/m	dec	57.6	57.4	**
10:00	Factory Orders	m/m	nov	1.1%	-0.1%	**
10:00	Factory Orders ex Trans	m/m	nov		0.8%	**
10:00	Durable Goods Orders	m/m	nov		1.3%	**
10:00	Durable Goods Orders ex Transportation	m/m	nov		-0.1%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	nov		-0.1%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	nov		0.3%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:15	Patrick Harker Speaks on Inclusive Economic Growth	President of the Federal Reserve Bank of Philadelphia				
12:30	Loretta Mester speaks to Community Banking Conference	President of the Federal Reserve Bank of Cleveland				

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	Monetary Base	m/m	dec	11.2%	13.2%		*	Equity and bond neutral
	Nikkei Japan PMI Services	y/y	dec	51.1	51.2		**	Equity and bond neutral
	Nikkei Japan PMI Composite	y/y	dec	52.2	52.2		**	Equity and bond neutral
	Vehicle Sales	y/y	dec	-1.0%	-5.4%		*	Equity and bond neutral
India	GDP Annual Estimate	y/y	2018	6.5%	7.1%		***	Equity and bond neutral
Australia	Trade Balance	m/m	nov	A$628 mn	A$105 mn	A$550 mn	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Retail PMI	m/m	dec	53.0	52.4		**	Equity bullish, bond bearish
	PPI	y/y	nov	2.8%	2.5%	2.5%	**	Equity bullish, bond bearish
	CPI core	y/y	dec	0.9%	0.9%	1.0%	***	Equity and bond neutral
	CPI Estimate	y/y	dec	1.4%	1.5%	1.4%	***	Equity and bond neutral
Italy	CPI EU Harmonized	m/m	dec	0.3%	-0.2%	0.3%	***	Equity and bond neutral
	Deficit to GDP YTD	q/q	3q	2.3%	2.4%		**	Equity and bond neutral
	Markit Italy Retail PMI	m/m	dec	49.5	49.2		**	Equity bearish, bond bullish
France	Markit France Retail PMI	m/m	dec	53.0	52.2		**	Equity and bond neutral
Germany	Markit Germany Retail PMI	m/m	dec	55.1	54.6		**	Equity and bond neutral
	Markit Germany Construction PMI	m/m	dec	53.7	53.1		**	Equity and bond neutral
	Retail Sales	y/y	dec	4.4%	-1.4%	2.3%	**	Equity bullish, bond bearish
U.K.	Unit Labor Costs	y/y	3q	1.3%	1.6%		**	Equity and bond neutral
AMERICAS								
Canada	Industrial Product Price	m/m	nov	1.4%	1.0%	1.0%	**	Equity and bond neutral
	Raw Materials Price Index	m/m	nov	5.5%	3.8%		*	Equity and bond neutral
Brazil	Industrial Production	m/m	dec	4.7%	5.3%	3.9%	***	Equity bullish, bond bearish

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	170	0	Up
3-mo T-bill yield (bps)	137	137	0	Neutral
TED spread (bps)	32	33	-1	Neutral
U.S. Libor/OIS spread (bps)	145	144	1	Up
10-yr T-note (%)	2.45	2.45	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	22	20	2	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	flat			Neutral
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	$67.98	$67.84	0.21%	
WTI	$61.90	$61.63	0.44%	
Natural Gas	$2.87	$3.01	-4.45%	
Crack Spread	$17.66	$17.93	-1.48%	
12-mo strip crack	$20.20	$20.43	-1.17%	
Ethanol rack	$1.42	$1.43	-0.17%	
Metals				
Gold	$1,323.33	$1,313.21	0.77%	
Silver	$17.23	$17.14	0.57%	
Copper contract	$326.10	$325.75	0.11%	
Grains				
Corn contract	$ 351.00	$ 353.00	-0.57%	
Wheat contract	$ 434.00	$ 436.00	-0.46%	
Soybeans contract	$ 967.75	$ 968.75	-0.10%	
Shipping				
Baltic Dry Freight	1262	1230	32	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-7.4	-5.0	-2.4	
Gasoline (mb)	4.8	2.0	2.8	
Distillates (mb)	8.9	0.5	8.4	
Refinery run rates (%)	1.00%	-0.25%	1.3%	
Natural gas (bcf)	-206.0	-200.0	-6.0	

Weather

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

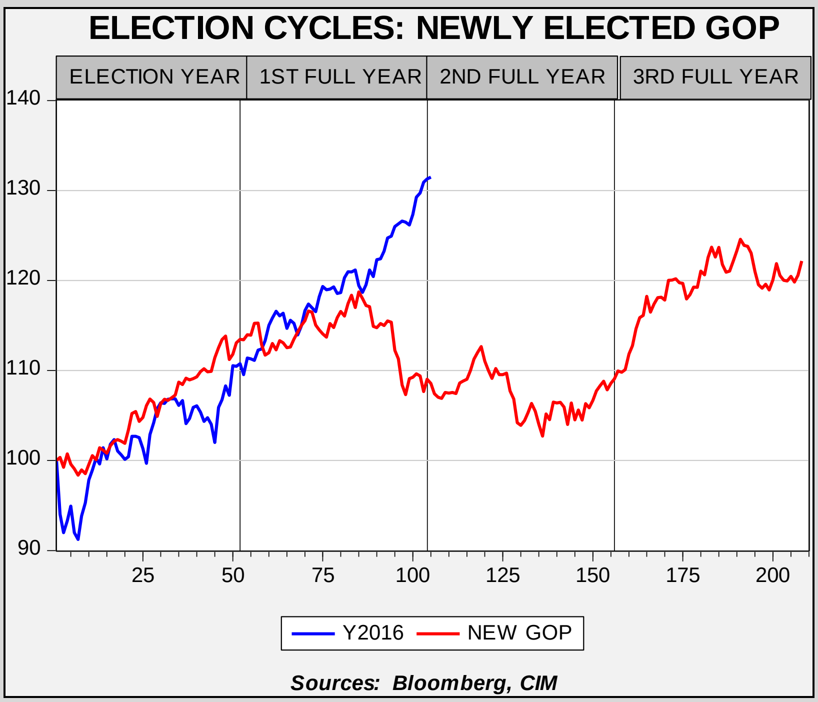
Asset Allocation Weekly Comment

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.

January 5, 2018

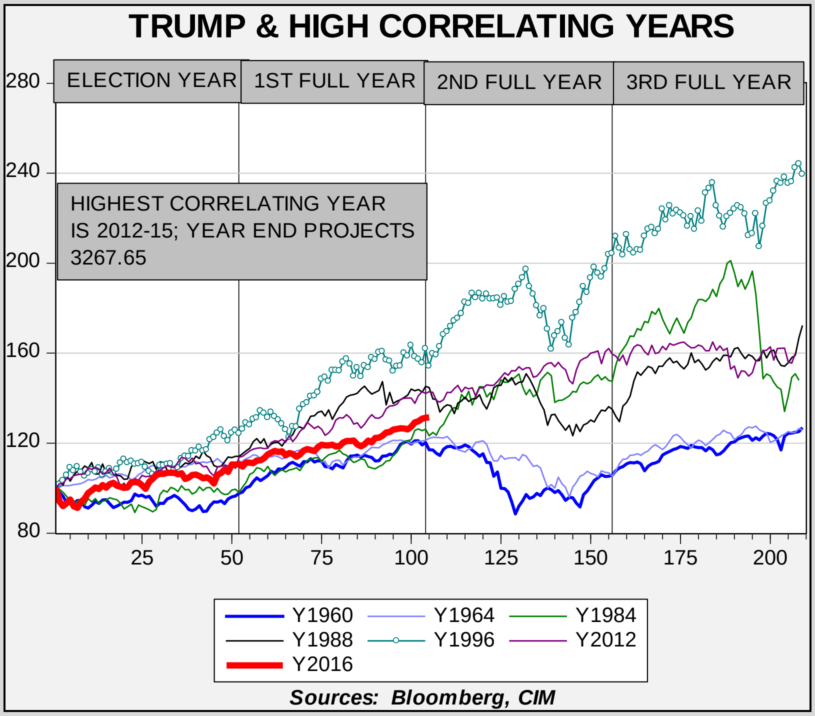
Equity markets had a very strong 2017, with the S&P 500 up over 20% for the year. Earnings rose more than expected, the economy continued to expand and investor sentiment was buoyant, all of which contributed to rising equities. The tax bill, signed in late December, will give equities a lift going into 2018. In this report, we will examine equity market behavior as part of the presidential cycle.

To perform this exercise, we look at weekly closes for the S&P 500 starting in 1928. We rebased the index for every four-year election cycle, so the first year is the actual election year (with elections held in November) along with the next three years of the term. Using this database, we can sort by incoming party, incumbent party, high correlating terms, etc. Earlier this year, we published this graph.



The red line on the chart shows the average S&P 500 performance for a new GOP president; the blue line shows the performance during the Trump administration. From the beginning of 2016 into Q3 2017, the two lines closely followed each other. However, they have diverged rather dramatically since then. We suspect that the anticipation of tax reform has led to the sharp rise in equities.

The real question is how will equities perform in 2018? The tax reductions built into the tax bill will likely have a significant impact on corporate earnings; we will have more to say about that in subsequent reports. However, another way to look at equities is by comparing the performance of the current Trump term to other four-year cycles.



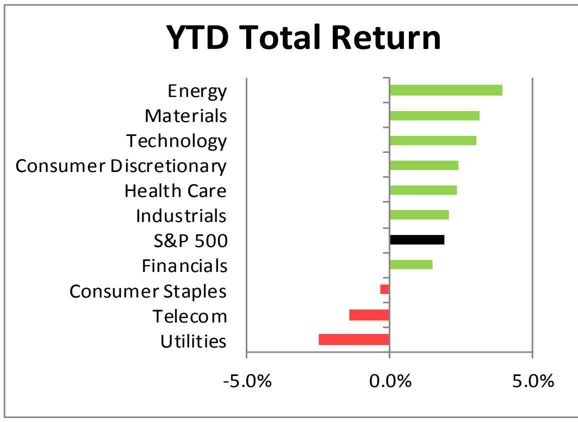
There are six other periods that correlate at 90% or above. Three of the six show weakness in the second full year of the administration, 1960-63, 1964-67 and 1988-91. In the first instance, the Cuban Missile Crisis likely led to the pullback. The escalation of the Vietnam War and rising inflation (the highest rise in the CPI in nine years) weighed on equities in 1966. The First Gulf War and the 1990-91 recession were behind weaker equities in the 1988 cycle. The other three had mostly rising equity values in the second full year of the political cycle.

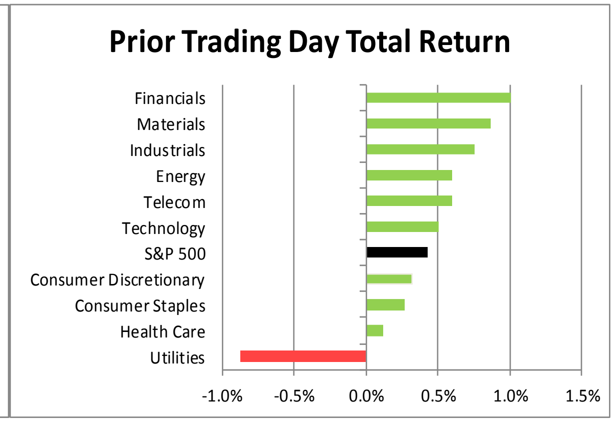
Interestingly enough, the highest correlating cycle is 2012-15, the second Obama term. Although the current index is running a bit behind compared to that year, the index pattern is most similar. If we continue to track that cycle and narrow the gap, the S&P 500 would end up at 3267.65 at the end of 2018.

How is this exercise useful? This analysis looks at high correlation periods and projects what may occur assuming that no major exogenous events occur. Obviously, a war or recession would lead to different outcomes. But, if the U.S. avoids an economic downturn or a major political or geopolitical event, equity markets could have another strong year.

Data Section

U.S. Equity Markets – (as of 1/4/2018 close)

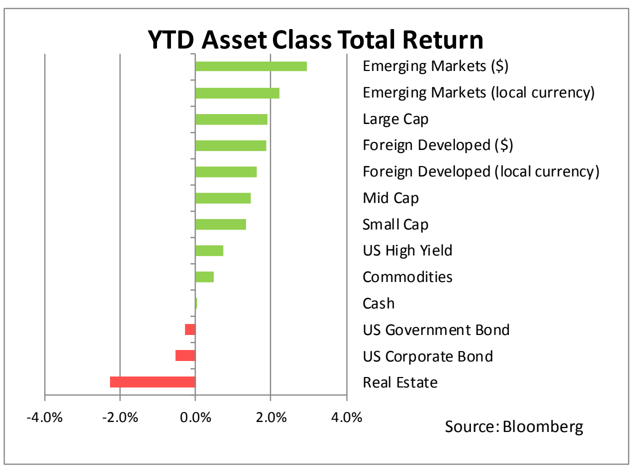




(Source: Bloomberg)

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 1/4/2018 close)

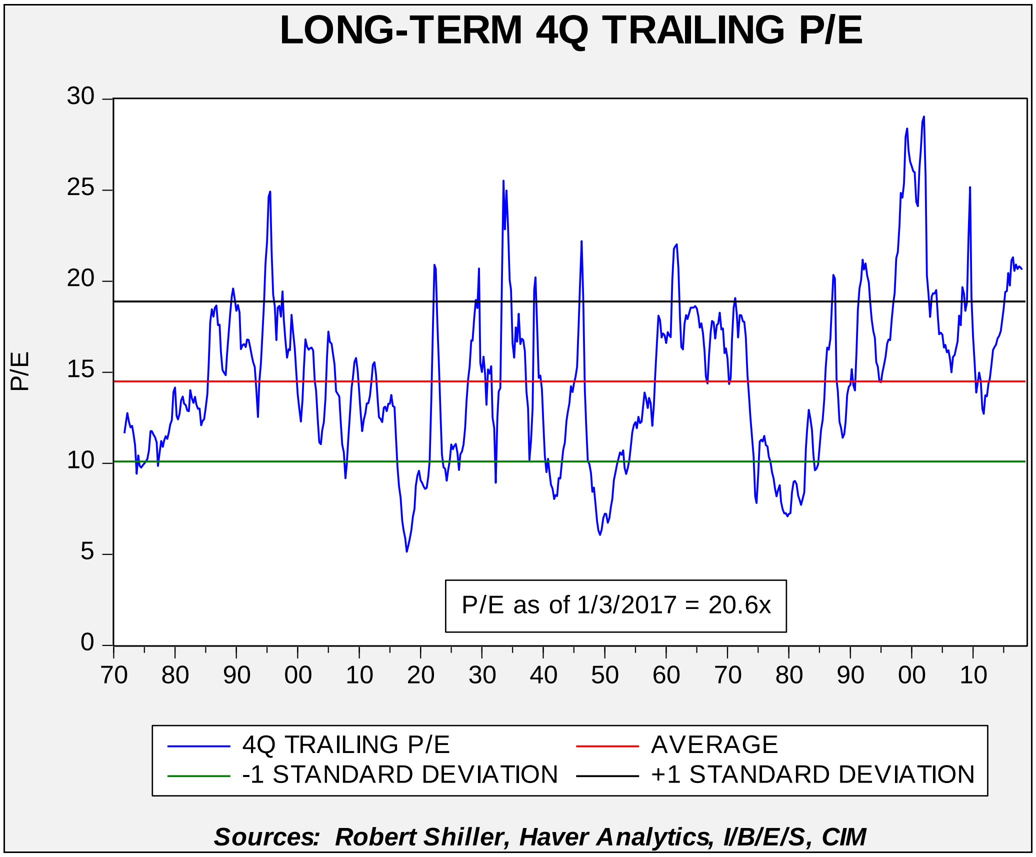


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

[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 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.