Confluence Investment Management

Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: January 8, 2018—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 0.2%. U.S. equity index futures are signaling a lower open.

Happy Monday! We may be on a path to the first down day of the year for equities, although it is obviously early. Here is what we are noting this morning:

Abandoning the Palestinians: We have always believed that the Palestinian cause was more for show than reality among the Arab governments. In other words, it was expected that Arab leaders would support the cause of the Palestinians against Israel. In reality, however, none of the Arab states were willing to do a whole lot to push for an actual two-state solution. In fact, not having a separate Palestinian state worked in their favor because the messy realities of governing become a problem once a state is born. A report in the weekend *NYT*[1] discussed how an Egyptian intelligence officer placed phone calls to influential talk show hosts asking them to publically denounce the U.S. move of its embassy to Jerusalem but persuade their viewers to accept it. Essentially, the article indicates that the building of a Sunni bloc to oppose the rising Shiite bloc, led by Iran, requires the Sunnis to have good relations with Israel. It was noted that King Salman denounced the move but has "quietly signaled…tacit approval for the Israeli claim to Jerusalem." This shows that support for the Palestinians in opposition to Israel is a luxury the Arab states can't afford in light of the Iranian threat.

German coalition talks: Chancellor Merkel and SDP leaders are meeting to try to build a new grand coalition. There are numerous sticking points. Two big ones are over the EU and immigration. The SDP is the party of a "United States of Europe," which is becoming increasingly unpopular in Europe; in fact, this stance has probably been one of the key factors in the overall demise of the center-left across Europe. The SDP supports French President Macron's call for a unified Eurozone budget and an EU finance minister. German conservatives blanch at this goal because they fear the rest of Europe will try to expand fiscally at the expense of German taxpayers (which is probably true). In addition, the SDP wants open immigration, another policy that appears out of step with the direction of policy across Europe. Talks are expected to continue until Thursday; at that point, either the SDP and CDU/CSU will begin formal negotiations on forming a government (deciding which party gets what ministries) or end discussions. If talks end, then Merkel must either (a) form a minority government, which she opposes, or (b) call snap elections. Both the SDP and CDU/CSU are uncomfortable with another round of elections, fearing their unpopularity will lead to even greater political fracture. At the

[1] https://www.nytimes.com/2018/01/06/world/middleeast/egypt-jerusalem-talk-shows.html?emc=edit_mbe_20180108&nl=morning-briefing-europe&nlid=5677267&src=twr&te=1

same time, Merkel has mostly ruled out a minority government, fearing it would be unworkable. No such arrangement has occurred in the postwar period.

May reshuffle: PM May announced she will reshuffle her cabinet, which has been rocked by recent resignations. Most of the changes will likely be to non-core ministries and we expect the PM to name younger ministers to these roles. It is possible, but not likely, that May will shift or fire some of her rivals, e.g., Boris Johnson. We would not expect it, but it might happen. If it does, it would suggest May feels emboldened.

Cohn pushes back: With SALT deductions limited in the tax bill, high tax states are considering other ways to maintain revenue and deductibility. One idea being floated is to shift the income tax to a payroll tax paid by employers, which remain deductible. Another is to establish a donation fund that citizens can contribute to in lieu of taxes. Cohn suggested the administration would fight such moves as it would reduce Federal tax revenue.

2018 policy: Trump administration officials met over the weekend to begin the process of policy priorities in the new year. Usually, these are outlined in the State of the Union address. There is growing concern that the president will push for trade restrictions; this is where the GOP establishment will try to thwart the president's agenda. An increase in trade restrictions will almost certainly raise inflation and interest rates and put the current equity bull market at risk.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consumer Credit	m/m	nov	$18.000 bn	$20.519 bn	**

Fed speakers or events		
EST	**Speaker or event**	**District or position**
13:35	John Williams speaks in Las Vegas on Monetary Policy	President of the Federal Reserve Bank of San Francisco
16:00	Eric Rosengren to speak on U.S. Economy in Boston	President of the Federal Reserve Bank of Boston

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	Foreign Reserves	m/m	dec	$3.140 tn	$3.119 tm	$3.127 tn	*	Equity and bond neutral
Australia	AiG Performance of Construction Index	y/y	dec	52.8	57.5		**	Equity and bond neutral
	Foreign Reserves	y/y	dec	A$85.4 bn	A$85.8 bn		**	Equity and bond neutral
EUROPE								
Eurozone	Factory Orders	m/m	dec	-0.4%	0.5%	0.0%	**	Equity bearish, bond bullish
	Sentix Investor Confidence	y/y	dec	32.9	31.1	31.3	**	Equity and bond neutral
	Consumer Confidence	y/y	dec	0.5	0.5	0.5	***	Equity and bond neutral
	Retail Sales	y/y	dec	2.8%	0.4%	2.4%	**	Equity bullish, bond bearish
	Economic Confidence	m/m	dec	116.0	114.6	114.8	**	Equity bullish, bond bearish
	Business climate indicator	q/q	dec	1.66	1.49	1.50	**	Equity bullish, bond bearish
	Industrial Confidence	m/m	dec	9.1	8.2	8.4	**	Equity bullish, bond bearish
	Services Confidence	m/m	dec	18.4	16.3	16.5	**	Equity bullish, bond bearish
U.K.	Halifax House Prices	m/m	dec	-0.6%	0.5%	0.2%	*	Equity bearish, bond bullish
Switzerland	CPI	y/y	dec	0.8%	0.8%	0.8%	***	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)	170	170	0	Up
3-mo T-bill yield (bps)	137	138	-1	Neutral
TED spread (bps)	33	33	0	Neutral
U.S. Libor/OIS spread (bps)	145	146	-1	Up
10-yr T-note (%)	2.46	2.48	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	23	22	1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	down			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	$67.84	$67.62	0.33%	
WTI	$61.75	$61.44	0.50%	
Natural Gas	$2.85	$2.80	2.00%	
Crack Spread	$17.14	$17.35	-1.21%	
12-mo strip crack	$19.86	$19.94	-0.43%	
Ethanol rack	$1.42	$1.42	-0.22%	
Metals				
Gold	$1,320.06	$1,319.59	0.04%	
Silver	$17.18	$17.22	-0.25%	
Copper contract	$322.75	$322.95	-0.06%	
Grains				
Corn contract	$ 351.00	$ 351.25	-0.07%	
Wheat contract	$ 427.25	$ 430.75	-0.81%	
Soybeans contract	$ 969.25	$ 970.75	-0.15%	
Shipping				
Baltic Dry Freight	1371	1341	30	

Weather

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

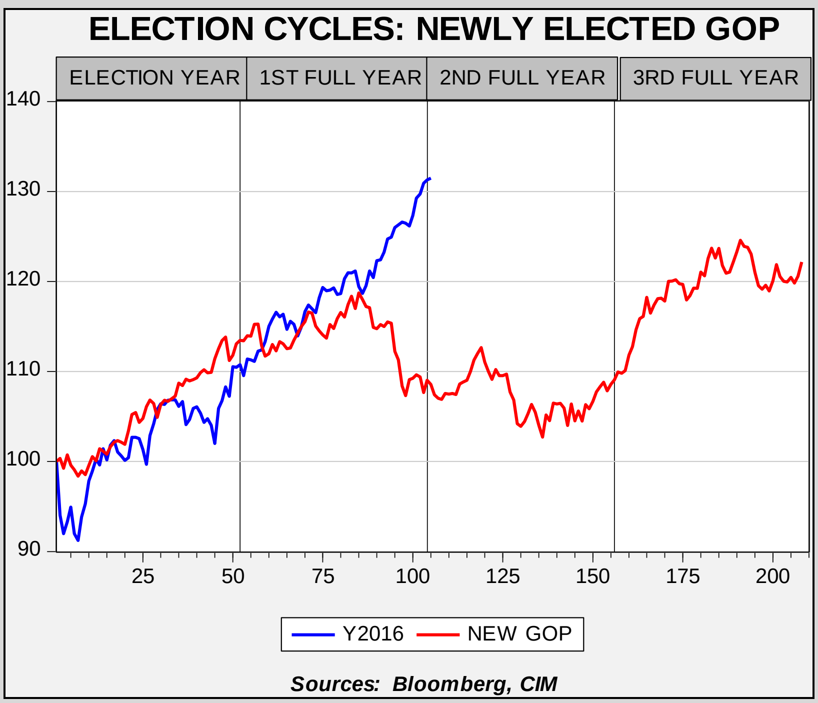
Asset Allocation Weekly Comment

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 5, 2018

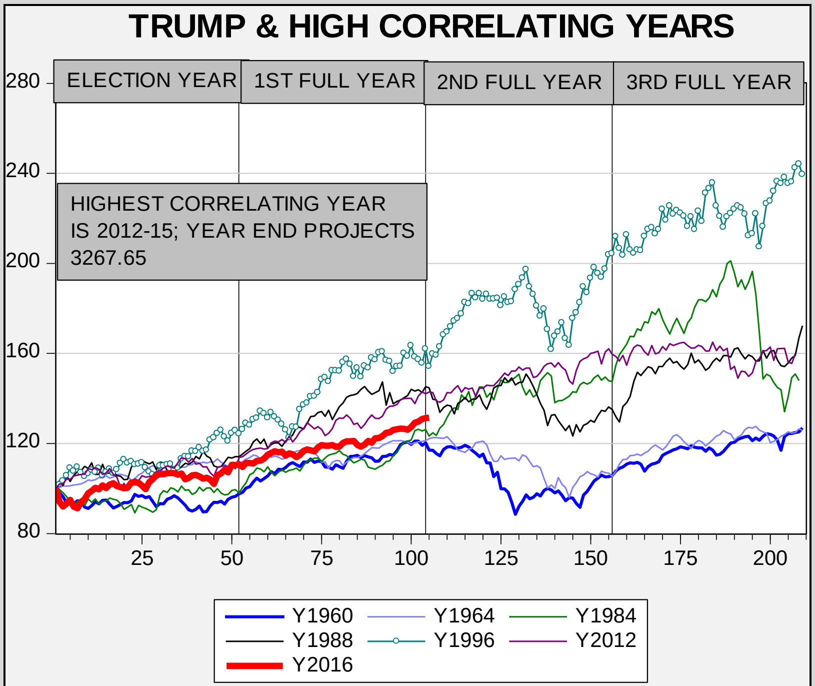
Equity markets had a very strong 2017, with the S&P 500 up over 20% for the year. Earnings rose more than expected, the economy continued to expand and investor sentiment was buoyant, all of which contributed to rising equities. The tax bill, signed in late December, will give equities a lift going into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



Sources: Bloomberg, CIM

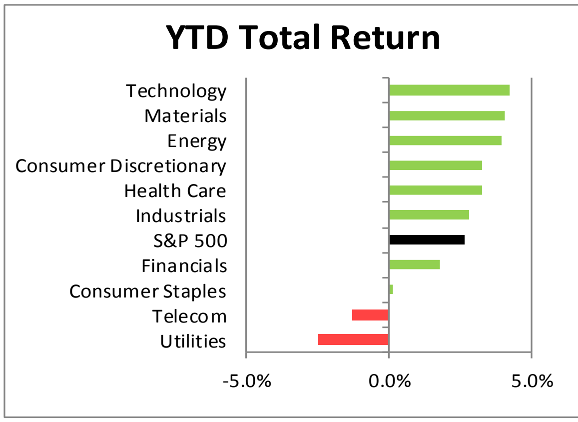
There are six other periods that correlate at 90% or above. Three of the six show weakness in the second full year of the administration, 1960-63, 1964-67 and 1988-91. In the first instance, the Cuban Missile Crisis likely led to the pullback. The escalation of the Vietnam War and rising inflation (the 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.

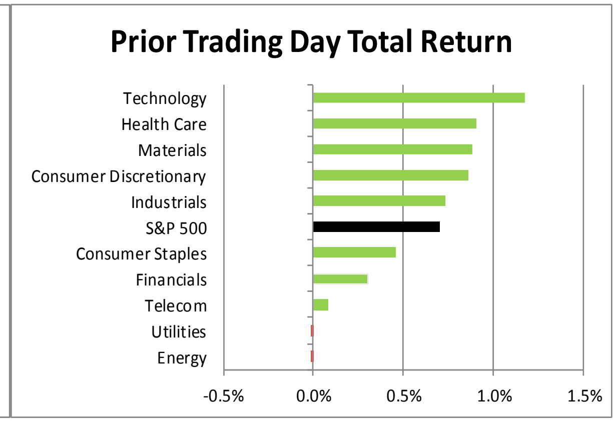
Interestingly enough, the highest correlating cycle is 2012-15, the second Obama term. Although the current index is running a bit behind compared to that year, the index pattern is most similar. If we continue to track that cycle and narrow the gap, the S&P 500 would end up at 3267.65 at the end of 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 1/5/2018 close)

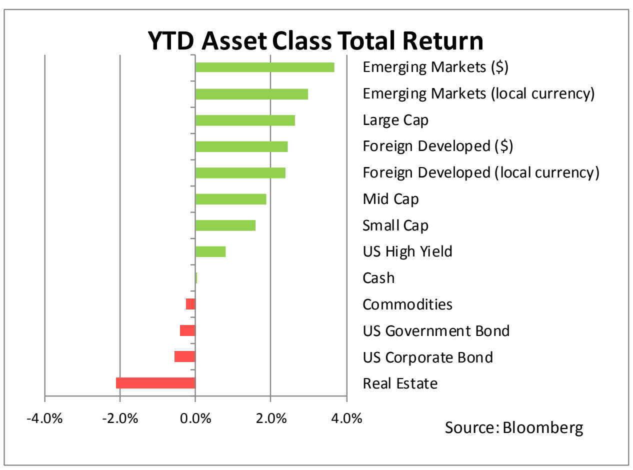




(Source: Bloomberg)

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 1/5/2018 close)

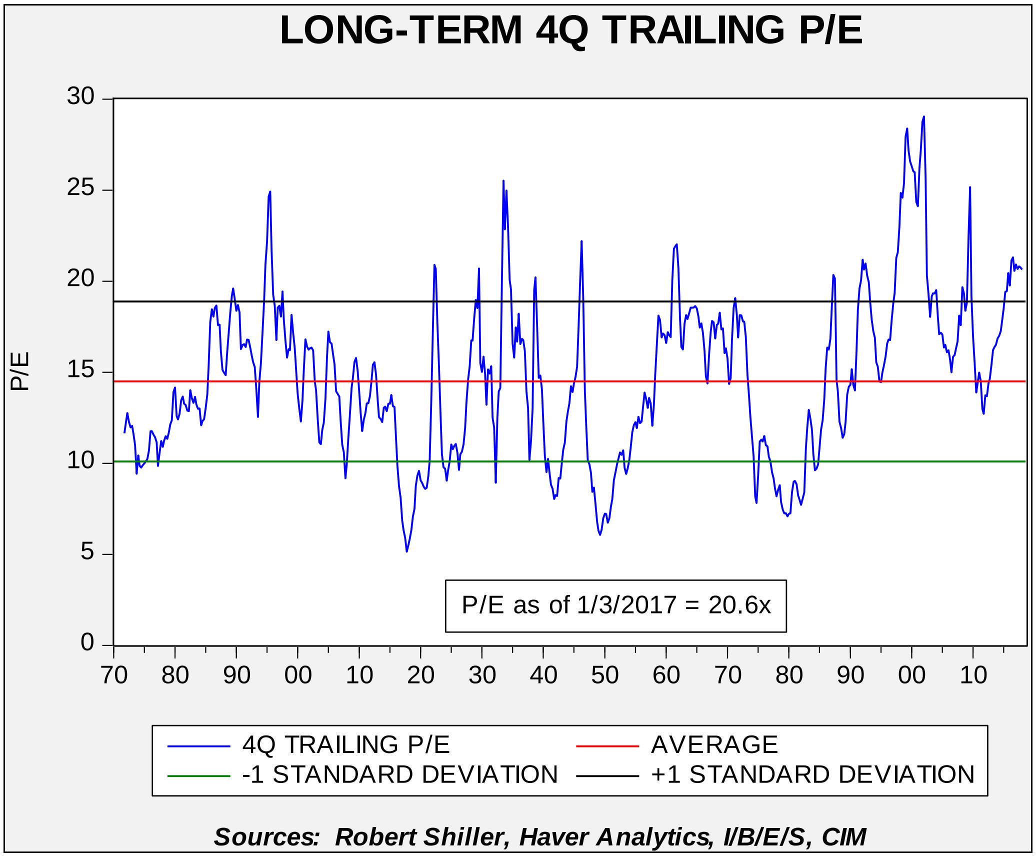


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

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[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 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.