Daily Comment

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and Thomas Wash

[Posted: March 13, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.8% and the Shenzhen index up 0.8%. U.S. equity futures are signaling a lower open.

BREAKING NEWS: The Atlanta FRB announced that Raphael Bostic has been named as the new president, replacing the retiring Dennis Lockhart. Bostic will take over the bank on June 5. He was a housing official in the Obama administration and his academic work is mostly on the housing market. He is currently a professor at USC. He also spent time as an economist at the Federal Reserve in Washington. He did his undergraduate studies at Harvard and has a Ph.D. from Stanford. The Atlanta FRB will be a voting member of the FOMC in 2018.

There is a lot of impending news this week. Here is what's on tap:

The FOMC: The Fed meets Tuesday and Wednesday and is virtually certain to raise rates by 25 bps to a range of 75 bps to 100 bps. With that outcome well telegraphed, the focus will move to the progression of future rates. Therefore, the dots chart will take on unusually high significance when it's released on Wednesday. It is quite possible that the text of the release will read much more hawkish than the press conference; Yellen is more dovish than the committee and if the projection is three more hikes this year, and maybe three to four next year (all 25 bps), she will probably try to suggest that such an outcome isn't necessarily her position. If we get a negative financial market reaction (higher interest rates, weaker equities), we will be watching to see if the Fed is subjected to Twitter criticism from the Oval Office.

President Trump and Chancellor Merkel meet: The two leaders meet on Tuesday as the latter comes to the U.S. for a visit with the new president. The Trump administration has been highly critical of the German government's positions on immigration and trade. The *NYT* reports that Merkel is bringing executives from several large German firms that have operations in the U.S. to show how German companies are major American employers. Merkel has a generally good record of handling strongmen; she parries President Putin well and managed Italian President Berlusconi when he led Italy.

Dutch elections: Elections will be held in the Netherlands. Geert Wilders will likely win the most seats but won't be able to form a government. Building a government without the most popular party will tend to undermine its mandate. We will be watching to see if the polls underestimate the popularity of populists as we saw in the U.K. and U.S. elections. An interesting side note developed over the weekend when the Dutch government banned a Turkish diplomat from visiting the country to rally support for an upcoming referendum on the Turkish constitution that would give the president (currently Recep Erdogan) sweeping powers.

President Erdogan called the Dutch "Nazis" for not allowing his representative to rally support. Dutch officials were concerned about unrest just before their elections as civil disorder would likely lift support for Wilders, which is something the current government wants to avoid. Both Erdogan and Wilders are trying to use the incident to boost their respective electoral chances.

The BOE and BOJ meet: These two central banks hold meetings on Thursday. The BOE is facing increasing pressure to raise rates as the U.K. economy outperforms. The BOJ has been toying with allowing a modest rise in the 10-year JGB, which is pegged to zero by the Japanese central bank. We don't expect much movement from either bank.

Article 50: U.K. PM May is working to dispense with two amendments from the House of Lords, one that would unilaterally guarantee the rights of EU citizens working in the U.K. and the other granting a meaningful vote on the final agreement. If she can garner enough support for a "clean" bill in the House of Commons, Article 50 could be activated as soon as tomorrow. That would begin the 24-month process for the U.K. to exit the EU.

G-20 Summit: The G-20 will hold a leaders' summit in July in Hamburg. On Friday, foreign ministers will meet in Bonn as a pre-meeting. Although the leaders' meeting will gain more press, actual work is done at the pre-meetings so the leaders can mostly sign off on things. Russia is expected to use the forum to expand its influence. The weekend media had several "where's Rex" reports, suggesting U.S. Secretary of State Tillerson has been mostly sidelined. If that is the case (and we have doubts), the U.S. could find itself at a disadvantage at the July gathering.

In other news, there are reports that Chairman Xi may visit Mar-a-Lago next month on April 6 and 7. According to reports, there are no golf outings planned. The U.S. wants China to rein in North Korea; China wants to keep trade open. This could be a very important meeting for the global economy and for stability in the Far East. The weekend *FT* reported a "civil war" in the administration between the economic nationalists (Bannon and Navarro) and the establishment (Cohn and Mnuchin). The president seems to support internal strife among his staff but all indications still signal that the nationalists are dominant. Finally, the CBO is expected to score the new GOP replacement for the ACA. Given the high number of critical comments about the office, it looks likely that it won't get a favorable score (which means that it will either increase the deficit or the number of uninsured Americans). The level of opposition in the Senate to the Ryan replacement is very high and thus we may see an ACA repeal but there is no obvious replacement.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Labor Market Conditions Index	m/m	feb	2.5		**
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	PPI	m/m	feb	1.0%	0.5%	1.0%	**	Equity and bond neutral
	Machine Orders	m/m	jan	-8.2%	6.7%	-3.7%	**	Equity bearish, bond bullish
	Tertiary Industry Index	m/m	jan	0.0%	-0.4%	0.1%	**	Equity and bond neutral
Australia	Credit Card Balances	m/m	feb	A$51.5b	A$52.8b		**	Equity and bond neutral
	Credit Card Purchases	m/m	feb	A$24.6b	A$27.7b		**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	feb	-14.2%	-14.7%		**	Equity and bond neutral
	Food Prices	m/m	feb	0.2%	2.8%		**	Equity and bond neutral
EUROPE								
Italy	Industrial Production	y/y	jan	-0.5%	6.6%	3.2%	**	Equity bearish, bond bullish
Switzerland	Total Sight Deposits	y/y	mar	555.4b	553.4b		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	mar	467.4b	471.5b		**	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)	112	112	0	Up
3-mo T-bill yield (bps)	73	73	0	Neutral
TED spread (bps)	39	39	0	Neutral
U.S. Libor/OIS spread (bps)	89	89	0	Up
10-yr T-note (%)	2.57	2.58	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	20	20	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Down
pound	up			Down
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	$51.14	$51.37	-0.45%	Long liquidation
WTI	$48.19	$48.49	-0.62%	
Natural Gas	$3.07	$3.01	1.96%	
Crack Spread	$17.19	$17.36	-1.00%	
12-mo strip crack	$14.15	$14.21	-0.42%	
Ethanol rack	$1.58	$1.58	0.41%	
Metals				
Gold	$1,207.11	$1,204.64	0.21%	Weaker dollar
Silver	$17.07	$17.04	0.16%	
Copper contract	$263.05	$259.50	1.37%	
Grains				
Corn contract	$ 362.50	$ 364.25	-0.48%	
Wheat contract	$ 437.50	$ 440.50	-0.68%	
Soybeans contract	$ 1,006.25	$ 1,006.50	-0.02%	
Shipping				
Baltic Dry Freight	1086	1064	22	

Weather

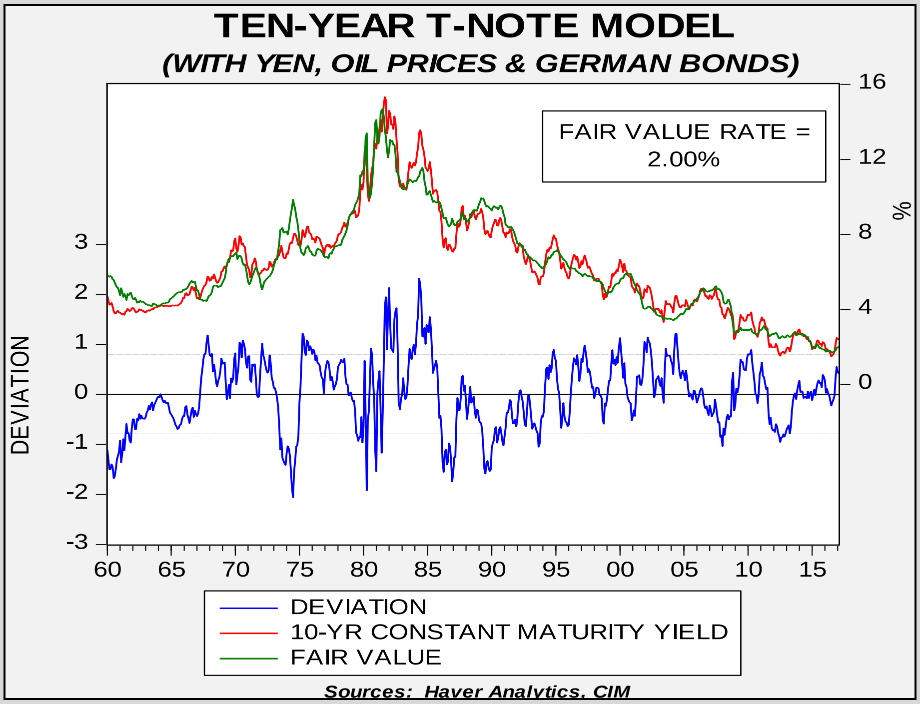
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

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.

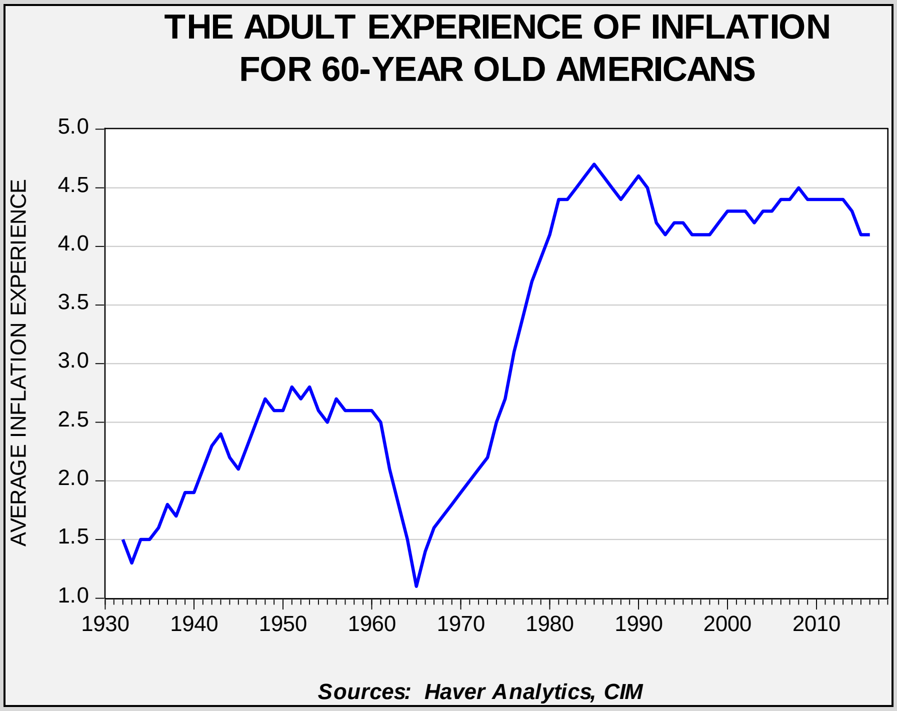
March 10, 2017

As the FOMC prepares to raise interest rates, it's a good time to update our views on long-term interest rates. The chart below shows our current estimate of fair value for the 10-year Treasury.



The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The current yield is about 42 bps above fair value; we move above one standard error of fair value at a 10-year yield of 2.70%. Assuming the other variables remain steady, the current yield on the 10-year T-note has discounted fed funds of 1.80%, suggesting that a series of rate hikes is already in the market.

The factor that could lead to a bigger bear market in long-duration fixed income would be a change in inflation expectations. Our inflation proxy estimates inflation expectations of 2.1%, which is roughly in line with the implied 10-year inflation rate from the TIPS spread. Our worry about inflation expectations is that older investors could ratchet higher if the new administration's policies raise inflation concerns.

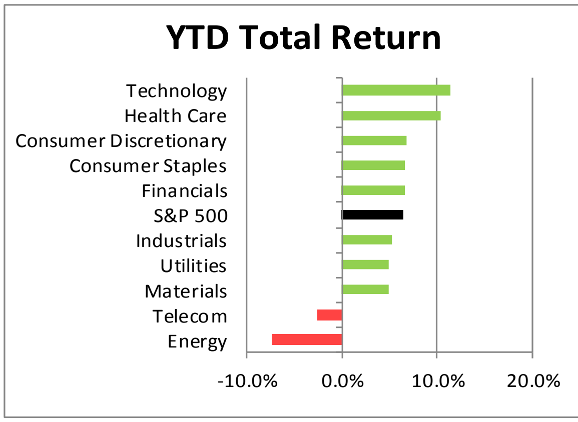


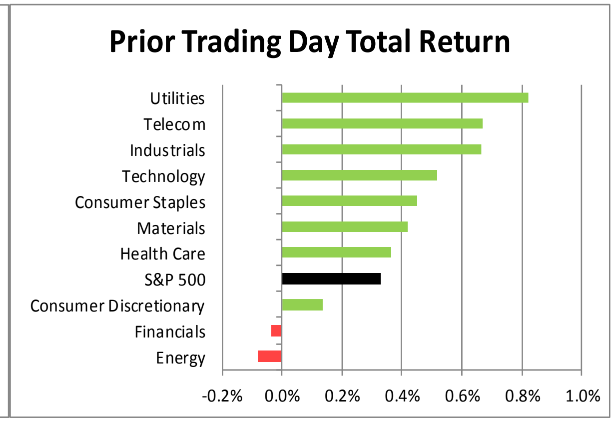
This chart shows the average adult (ages 16 to 60) experience of inflation for 60-year-olds. It's currently 4.2%. It should be noted that younger Americans have, on average, experienced lower levels of inflation; the inflation experience of the current 50-year-old cohort is only 2.8%. We expect older investors to favor fixed income to preserve capital and replace wages in retirement. We also assume that fixed income investors are sensitive to inflation and base their inflation expectations on long-run inflation experiences. Thus, if new government policies on trade and infrastructure spending raise fears of inflation, older Americans may be more prone to "inflation panic" and demand higher rates. Over the next 18 months, that is probably the greatest risk to long-duration fixed income.

For now, we remain cautious on long rates and have tended to favor credit risk over duration risk in fixed income. However, if inflation expectations remain anchored (and tighter monetary policy should assist in this effort), then long-duration fixed income assets could become more attractive as the Fed's tightening cycle continues.

Data Section

U.S. Equity Markets – (as of 3/10/2017 close)

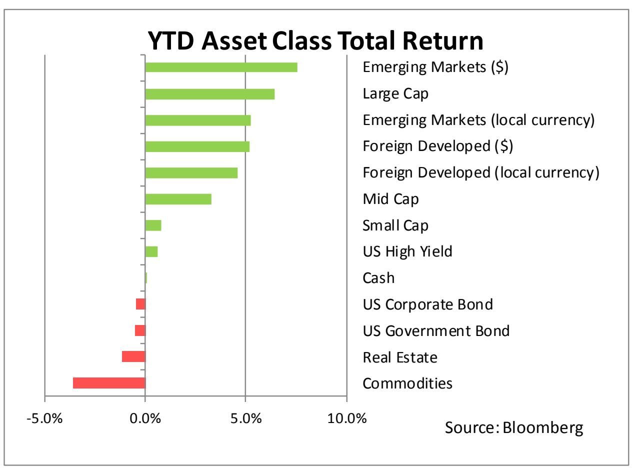




(Source: Bloomberg)

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 3/10/2017 close)

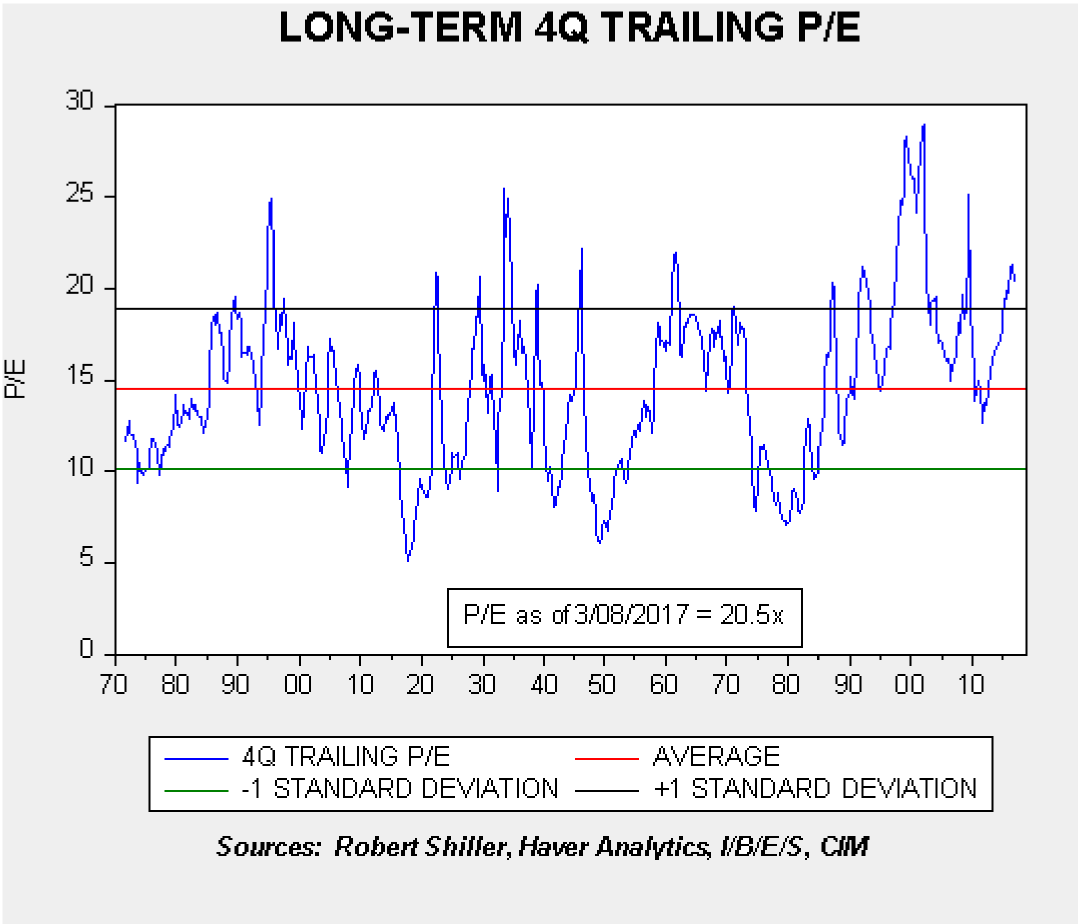


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 9, 2017



Based on our methodology,[1] the current P/E is 20.5x, relatively unchanged from last week. Falling Q1 earnings were balanced by a rising S&P 500.

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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[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 the actual (Q2, Q3 and Q4) and one estimate (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.