Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: March 21, 2017—9:30 AM EDT] Global equity markets are up this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.8% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.4%. U.S. equity futures are signaling a higher open.

As noted below, we have a full slate of Fed officials talking today. We expect these speakers to generally confirm the Fed's policy stance for at least two more hikes this year, with the potential for a third. The most interesting member, Minneapolis FRB President Kashkari, has already made the media rounds; he had a dovish dissent to the move, arguing that there is no evidence of accelerating inflation or rising expectations. Thus, in his analysis, there was no reason to move rates. We would not expect such talk today.

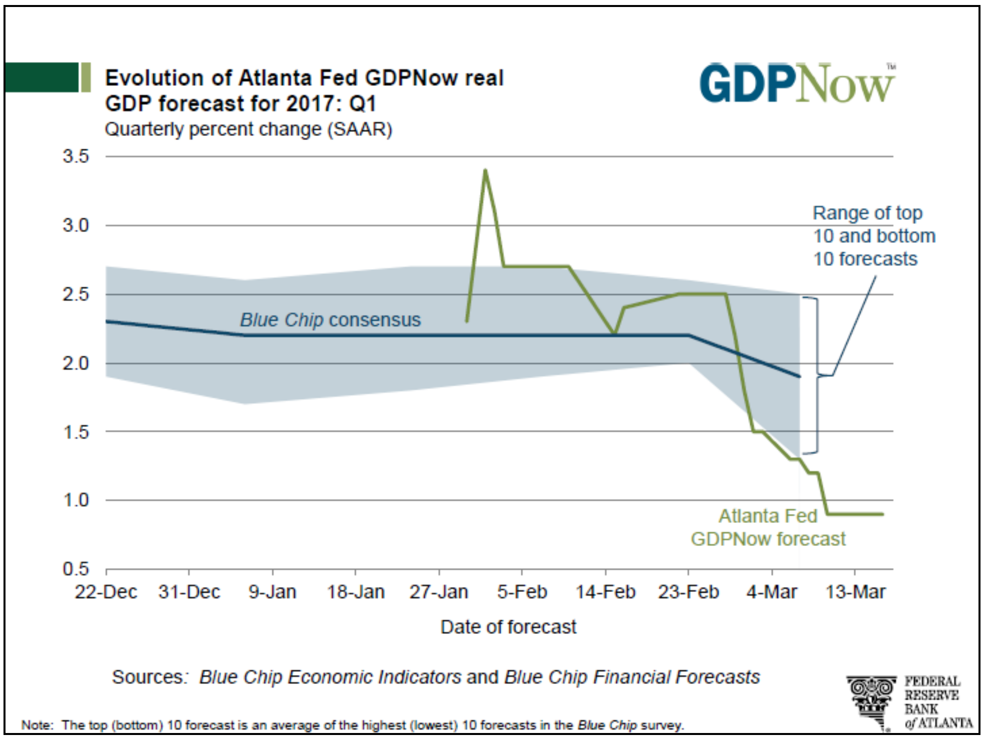
The FBI director testified yesterday that there was no evidence of wiretaps on Trump party headquarters and did suggest that there was a broad investigation of Russian interference in the U.S. election. We doubt this investigation will rise to the level of Watergate; however, it will act as a distraction to the administration. Our position is that presidential political capital is at its peak on inauguration day and, like time decay on an option, is eroded until nearly fully diminished 18 months after the oath of office. Despite this obvious pattern, presidents often squander their limited and perishable political capital on superfluous policy battles. Health care is burning a lot of the president's capital as are all the investigations which divert attention.

The financial markets have been focused on deregulation and tax cuts, sending equities and the dollar higher and bond prices lower. However, we are starting to see the dollar roll over despite Fed tightening, in part because there is growing skepticism that the administration will be able to get tax reform in place. Tax reform is one of the factors that has raised market sentiment and if the administration becomes bogged down in health care reform and defense against investigations, there simply won't be enough bandwidth to get much of anything else accomplished. This is an issue we are watching closely.

There was a French presidential debate yesterday. Media reports suggest that the current presidential favorite, Emmanuel Macron, managed to avoid any major mistakes. Although Macron is currently second in the polls to Marine Le Pen (Le Pen is at 27%, Macron at 23%), the polls all signal a Macron victory in the second runoff election. Macron is relatively inexperienced and there were fears among Le Pen opponents that he would make a mistake at the debates and boost Le Pen's chances for the presidency. According to reports, Macron, though not spectacular, did avoid losing. The EUR's rally this morning is partly due to his better performance.

SOS Tillerson announced he will skip the NATO meetings next month to be with the president when General Secretary Xi visits the U.S. His office also announced he will visit Russia later in April. This sends the signal that the administration is focusing on the big nations and paying less attention to the smaller allies in Europe. There is some fear that the U.S. is also indicating a greater affinity for authoritarian governments and paying less attention to democracies. The charge of playing to enemies and ignoring allies was leveled at the previous administration as well.[1] It should be remembered that one of the goals of creating the EU was to give Europe a platform on the world stage. Henry Kissinger famously destroyed this idea with his comment, "Who do I call if I want to speak to Europe?" Europe still hasn't solved this problem. Simply put, the trend of U.S. administrations paying less attention to Europe has been underway for some time.

Finally, despite strong sentiment indicators, the Atlanta FRB GDPNow forecast is currently at an anemic +0.9%.



In the contribution data, consumption has declined 108 bps from the initial forecast and inventories have reduced the growth projection by 39 bps.

[1] https://www.theatlantic.com/international/archive/2016/12/obama-israel-kerry-allies/511796/

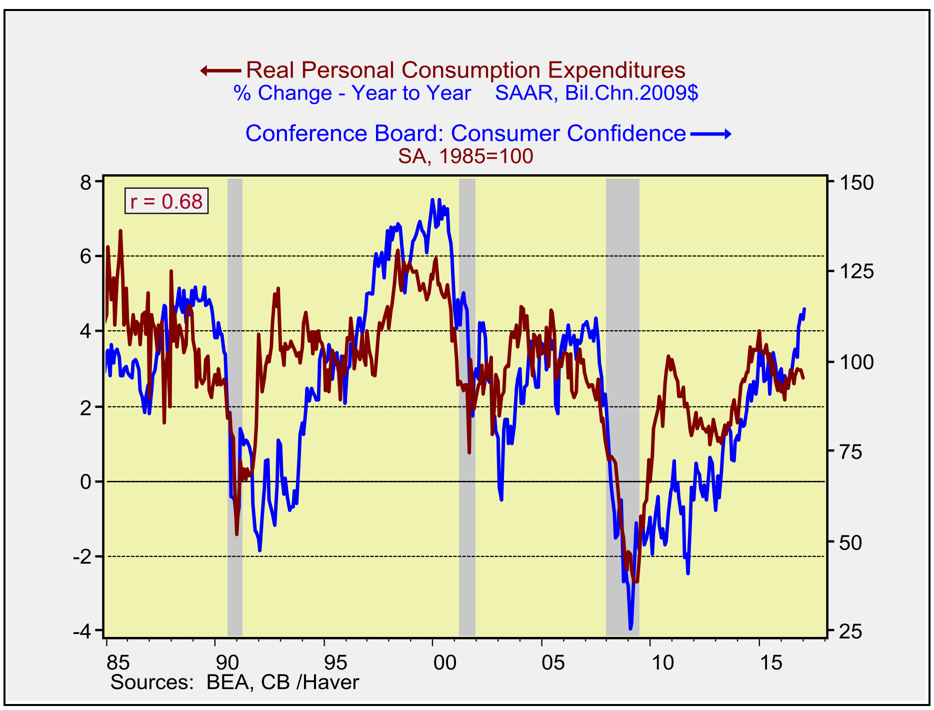
Atlanta Fed GDPNow forecasts for 2017: Q1, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
30-Jan	Initial nowcast	2.3	2.08	0.39	0.23	0.02	0.11	0.25	-0.30	-0.44
22-Feb	Exisiting-home sales	2.5	1.92	0.37	0.24	0.10	0.43	0.14	-0.30	-0.39
24-Feb	New-home sales/costs	2.5	1.92	0.37	0.24	0.11	0.40	0.14	-0.30	-0.39
27-Feb	Advance durable manufacturing	2.5	1.92	0.39	0.24	0.11	0.40	0.14	-0.30	-0.41
	GDP/Adv. Econ. Indicators (Feb 28), Personal income/PCE, ISM Manuf.,									
1-Mar	Construction spending	1.8	1.44	0.50	0.21	0.18	0.54	-0.10	-0.47	-0.52
2-Mar	Light vehicle sales	1.5	1.26	0.40	0.21	0.18	0.54	-0.10	-0.47	-0.50
3-Mar	ISM Nonmanufacturing Index	1.5	1.25	0.40	0.21	0.18	0.53	-0.10	-0.46	-0.50
6-Mar	M3 Manufacturing report	1.3	1.25	0.41	0.21	0.18	0.53	-0.10	-0.46	-0.72
7-Mar	International trade	1.3	1.25	0.46	0.21	0.18	0.53	-0.10	-0.50	-0.72
8-Mar	Wholesale trade	1.2	1.25	0.46	0.21	0.18	0.53	-0.10	-0.50	-0.79
9-Mar	Import/export prices	1.2	1.25	0.46	0.21	0.18	0.53	-0.10	-0.52	-0.78
10-Mar	Employment, Treasury statement	0.9	1.09	0.41	0.22	0.17	0.47	-0.05	-0.49	-0.88
14-Mar	Producer Price Index	0.9	1.09	0.40	0.22	0.17	0.48	-0.05	-0.49	-0.89
15-Mar	Retail trade, CPI	0.9	1.00	0.40	0.22	0.17	0.53	-0.05	-0.49	-0.87
16-Mar	Housing starts	0.9	1.00	0.40	0.22	0.17	0.52	-0.05	-0.49	-0.87
Maximum forecast of real GDP growth										
1-Feb	ISM Manufact., Construct. spending	3.4	2.62	0.62	0.24	0.13	0.29	0.23	-0.35	-0.40
Minimum forecast of real GDP growth										
16-Mar	Housing starts	0.9	1.00	0.40	0.22	0.17	0.52	-0.05	-0.49	-0.87

Note: CIPI is "change in private inventories." All numbers are percentage point contributions to GDP growth (SAAR). Table does not necessarily include all forecasts for the quarter; see tab "ContribHistory" in online excel file for entire history.

FEDERAL RESERVE BANK of ATLANTA

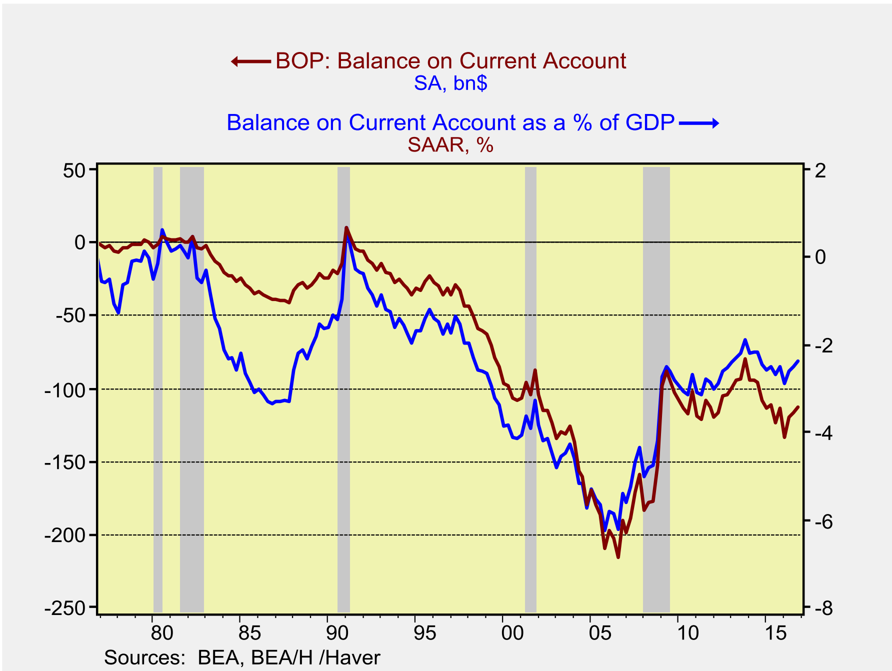
We are looking at a soft Q1 number. Consumer confidence data suggests that consumption should improve in the coming months, although the relationship is not always consistent.



This chart shows real consumption expenditures with the Conference Board's Consumer Confidence report. In general, they do move together, although a case could be made that consumption led confidence in the early 1990s and in 2011. In addition, consumption softened in front of the last two recessions despite elevated confidence. The divergence between rising confidence and sluggish spending is something we monitor. So far, this isn't a major problem; however, it could develop into one if this situation persists.

U.S. Economic Releases

The current account deficit came in narrower than expected at $112.4 bn compared to the forecast of $129.0 bn. The prior report was revised wider from a deficit of $113.0 bn to $116.0 bn.



The chart above shows the relationship between the balance on current account and the balance on current account as a percentage of GDP. Although the trade deficit widened, it was offset by a rise in net income flows. American investors earned more income on their overseas assets than foreigners did on their U.S. holdings.

The table below shows the Fed speakers scheduled for the rest of the day.

Economic Releases		
	No economic releases today	
Fed speakers or events		
EST	**Speaker or event**	**District or position**
12:00	Esther George Speaks in Houston	President of the Federal Reserve Bank of Kansas City
20:00	Loretta Mester speaks to New York	President of the Federal Reserve Bank of Cleveland
21:45	Eric Rosengren to address NY Assoc for Business Economics	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								
Japan	Convenience Store Sales	y/y	feb	-1.7%	0.1%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumer	y/y	mar	112.0	113.1		**	Equity and bond neutral
	House Price Index	y/y	4q	7.7%	6.3%	3.5%	**	Equity bullish, bond bearish
New Zealand	Net Immigration	m/m	feb	6000	6460		**	Equity and bond neutral
	Credit Card	y/y	feb	5.3%	7.1%		**	Equity and bond neutral
EUROPE								
U.K.	CPI	y/y	feb	2.3%	1.8%	2.1%	***	Equity bullish, bond bearish
	CPI core	y/y	feb	2.0%	1.6%	1.7%	***	Equity bullish, bond bearish
	RPI	y/y	feb	3.2%	2.6%	2.9%	**	Equity bullish, bond bearish
	RPI Ex Mort Int Payments	y/y	feb	3.5%	2.9%	3.1%	**	Equity bullish, bond bearish
	PPI Input NSA	y/y	jan	19.1%	20.5%	20.1%	**	Equity and bond neutral
	PPI Output NSA	y/y	feb	3.7%	3.5%	3.7%	**	Equity and bond neutral
	PPI Output Core NSA	y/y	feb	2.4%	2.4%	2.5%	**	Equity and bond neutral
	House Price Index	y/y	jan	6.2%	7.2%	6.4%	**	Equity and bond neutral
	Public Finances	m/m	feb	12.9b	-26.5b		**	Equity and bond neutral
	Central Government	m/m	feb	-3.6b	-27.8b		**	Equity and bond neutral
	PSNB ex Banking Groups	m/m	feb	1.1b	-9.8b	2.8b	**	Equity and bond neutral
	CBI Trends Total Orders	m/m	mar	8	8	5	**	Equity and bond neutral
	CBI Trends Selling Orders	m/m	mar	29	32	32	**	Equity and bond neutral
Switzerland	Trade Balance	m/m	feb	3.11b	4.73b		**	Equity and bond neutral
	Exports Real	m/m	feb	-2.2%	-4.0%		**	Equity and bond neutral
	Imports Real	m/m	feb	2.9%	-5.3%		**	Equity and bond neutral
AMERICAS								
Brazil	Trade Balance Weekly	m/m	feb	$1.437b	$1.725b		**	Equity and bond neutral
Canada	Retail Sales	m/m	jan	2.2%	-0.5%	1.5%	**	Equity bullish, bond bearish
	Retail Sales ex Auto	m/m	jan	1.7%	-0.3%	1.3%	**	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)	115	115	0	Up
3-mo T-bill yield (bps)	74	74	0	Neutral
TED spread (bps)	41	41	0	Neutral
U.S. Libor/OIS spread (bps)	91	91	0	Up
10-yr T-note (%)	2.49	2.46	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	29	29	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			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	$52.09	$51.62	0.91%	Short Covering
WTI	$48.58	$48.22	0.75%	
Natural Gas	$3.07	$3.04	1.02%	
Crack Spread	$18.46	$18.09	2.04%	
12-mo strip crack	$14.76	$14.50	1.77%	
Ethanol rack	$1.61	$1.61	0.13%	
Metals				
Gold	$1,232.90	$1,234.24	-0.11%	
Silver	$17.42	$17.43	-0.09%	
Copper contract	$264.30	$266.70	-0.90%	
Grains				
Corn contract	$ 362.25	$ 363.50	-0.34%	
Wheat contract	$ 428.25	$ 430.25	-0.46%	
Soybeans contract	$ 998.50	$ 999.50	-0.10%	
Shipping				
Baltic Dry Freight	1205	1196	9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-2.4		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.20%		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the northwestern region. 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.

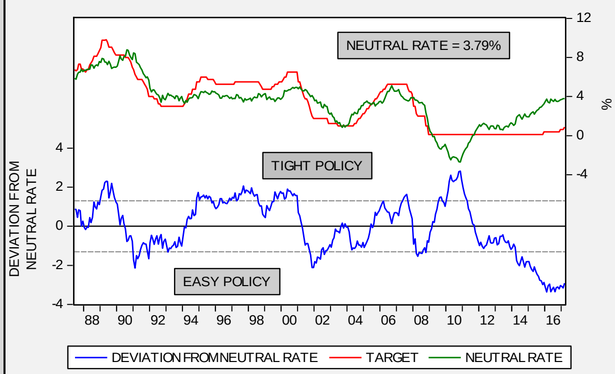
March 17, 2017

The FOMC has moved on rates; as expected, the Fed lifted its target fed funds rate to a range between 75 bps and 100 bps. The projections are for a 1.50% rate by the end of 2017 and a 2.25% rate by the end of 2018.

In this week's report, we want to examine the current neutral policy rates that are generated by our variations of the Mankiw Rule. The Mankiw Rule attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. The Mankiw Rule is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.

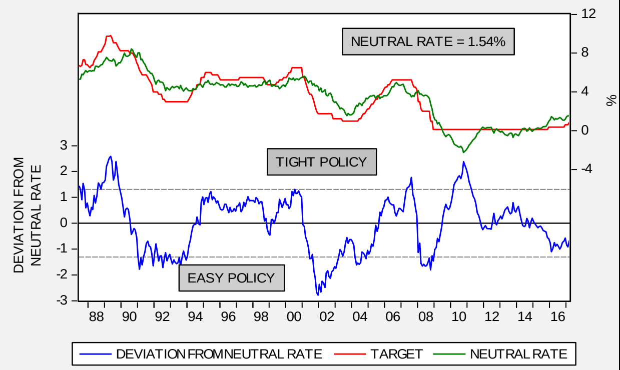
When we create each model, a deviation from the neutral rate is generated and this deviation is compared to the distribution of deviations. In general, one standard error should capture 66% of the deviation from forecast, assuming normally distributed deviations. When the deviation is inside of one standard error, it is generally within the acceptable range.

MANKIW USING THE U-3 UNEMPLOYMENT RATE



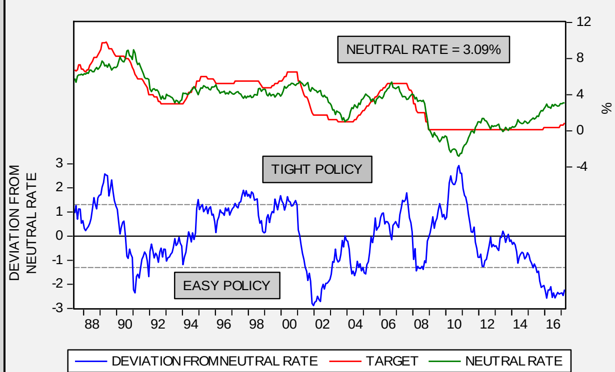
Sources: Haver Analytics, CIM

MANKIW USING THE EMPLOYMENT/ POPULATION RATIO



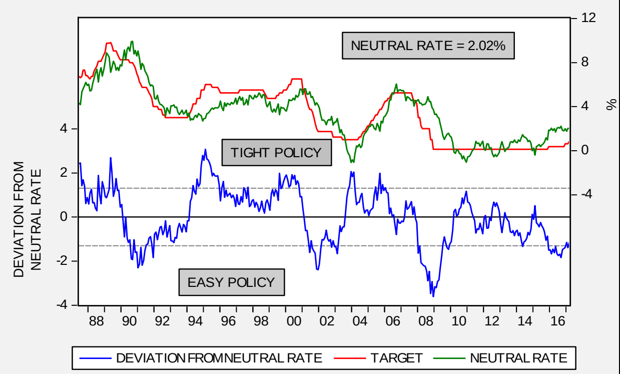
Sources: Haver Analytics, CIM

MANKIW USING INVOLUNTARY PART-TIME EMPLOYMENT AS % OF THE LABOR FORCE



Sources: Haver Analytics, CIM

MANKIW USING THE Y/Y% WAGE GROWTH FOR NON-SUPERVISORY WORKERS



Sources: Haver Analytics, CIM

The charts above show our four variations of the Mankiw Rule. We have published the neutral rates for each model on each chart. Two of the variations, using the unemployment rate and involuntary part-time employment, are well outside the lower standard error line, suggesting easy policy. However, the variations using the employment/population ratio and wage growth for non-supervisory workers is at or within one standard error, which indicates that policy is closer to neutral.

So, what does the FOMC think is the appropriate variation? Given their forecast of a 1.50% rate by year's end, we would argue that they are probably leaning toward the most dovish variation, the one using the employment/population ratio. As we argued earlier,[2] the employment/population ratio has been a better guide to wage growth than the unemployment rate. If this is correct, the longer term expectation for a policy rate of 2.25% is based on expectations that core CPI will rise or there will be continued improvement in the employment/population ratio. If neither occur, we could be at the terminal rate by year's end.

Overall, this means the FOMC, while raising rates, still has a mostly dovish bent. By choosing the most dovish variation of the Mankiw Rule, we are likely closer to the end of this rate cycle, assuming that core CPI remains mostly steady and the employment/population ratio doesn't

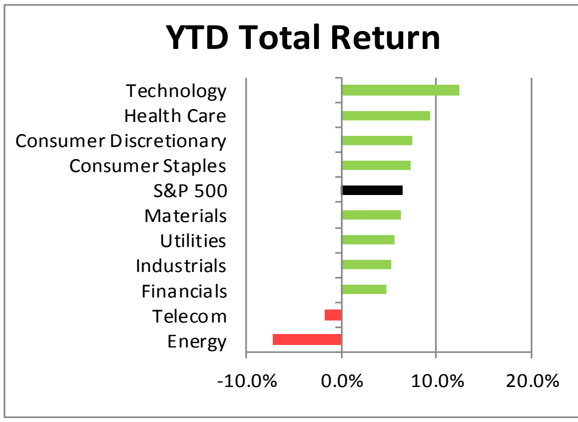
[2] See Asset Allocation Weekly, 2/10/2017.

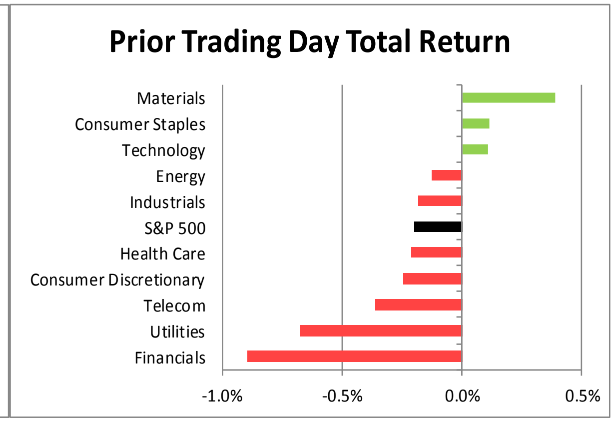
unexpectedly rise. Such a stance is bullish for equities; however, it may be bearish for the dollar which may bring some adjustments to our current asset allocation mix.

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.

Data Section

U.S. Equity Markets – (as of 3/20/2017 close)

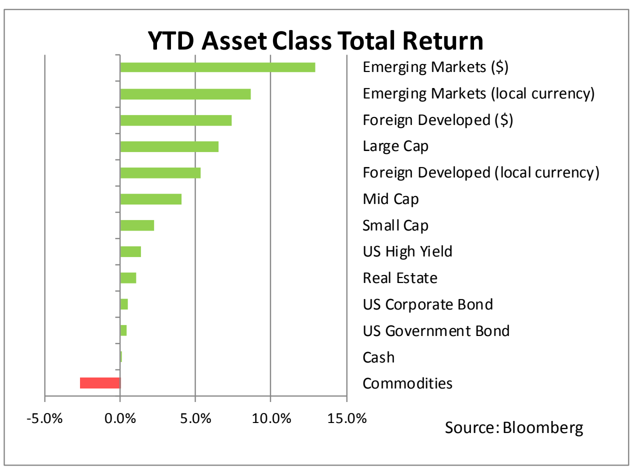




(Source: Bloomberg)

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 3/20/2017 close)

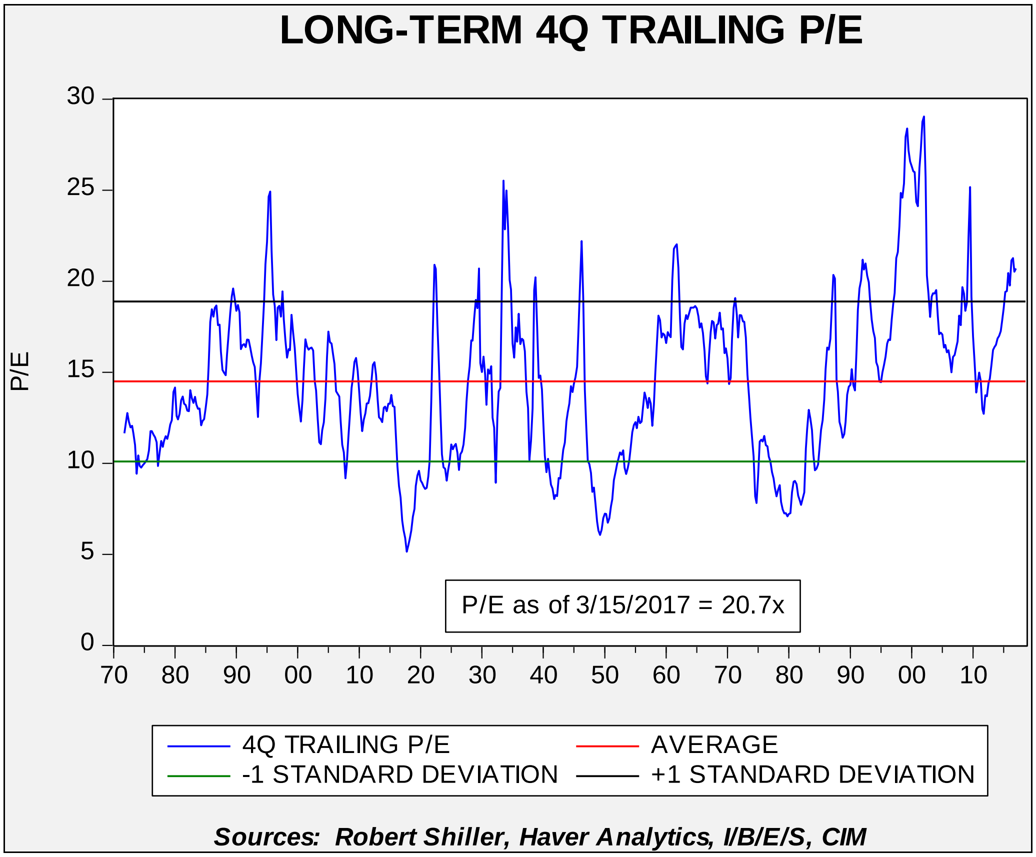


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2017



Based on our methodology,[3] the current P/E is 20.7x, up 0.2x from last week. Falling Q1 earnings coupled with market strength led to the rise in the multiple.

[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 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.