Daily Comment

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

[Posted: March 23, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index relatively unchanged. U.S. equity futures are signaling a higher open.

Yesterday, there was a terrorist attack near Parliament in the U.K. Five people were killed (including the terrorist) and around 40 injured. Although reports suggest the attacker, who hasn't been named yet, acted alone, eight others have been arrested. This attack followed the pattern where the terrorist uses a vehicle to attack pedestrians in a busy area and then uses a weapon in an attempt to escape or expand the attack. This mode was recently used in France and Germany. We suspect this method is being used because security in Europe has been tightened. For example, it may be more difficult to gather materials commonly used in bomb making because they are being tracked more closely. However, cars and trucks are ubiquitous and it's hard to see how security forces can stop their use. It is noteworthy that many important public venues have been hardened; for instance, the number of barriers around Washington would tend to thwart vehicle attacks. But, hardening all areas would be almost impossible.

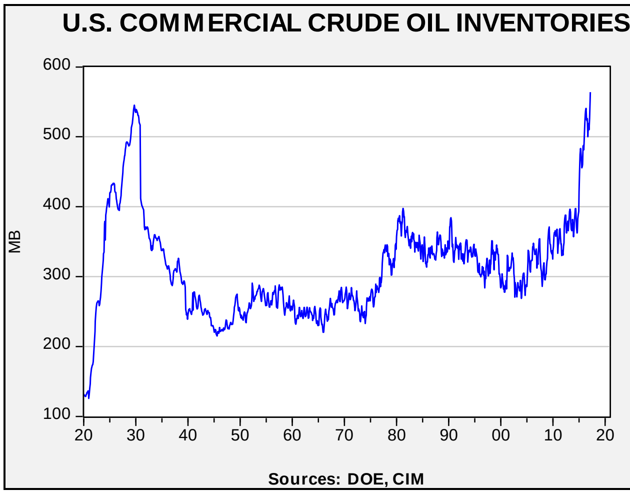
PM May did say the unnamed attacker had been known to MI-5, Britain's internal security service (roughly equivalent to the FBI). However, being known and being stopped are clearly two different things. So far, all indications suggest this attacker was inspired, but probably not directed, by foreign jihadists.

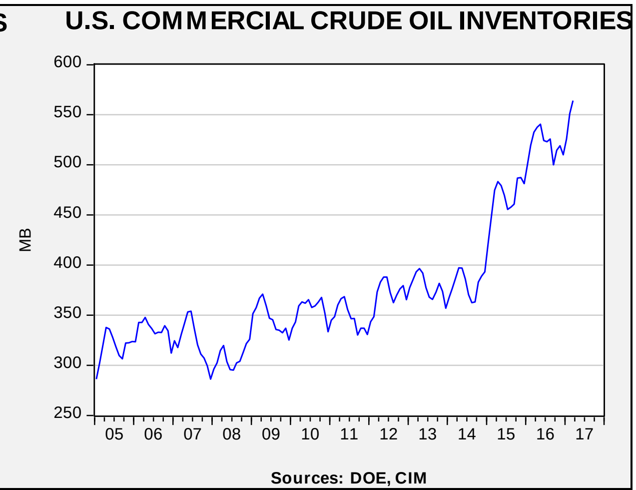
What we found interesting about the attack was the market reaction, which was quite mild. Financial markets tend to follow a pattern where the first time an event occurs, it's a huge deal, while each successive event becomes less significant. Although one could argue that the scale wasn't all that big in this attack (relative to 9/11, for example), the act was still designed to terrorize. That part probably worked. But, financial markets are viewing these events in the proper context—they are something that one hopes shouldn't happen but the single event doesn't threaten the stability of the Western world.

There are reports that the American Health Care Act (AHCA) has been changed enough for the majority of the Freedom Caucus to vote for the bill. According to reports, senior members of this caucus will meet with the president at 11:00 EDT today. We believe that these changes make it almost certain to have no hope of getting through the Senate. If the bill fails in the House, we will likely see a knee-jerk decline in equities on fears that this loss will scotch tax reform. We tend to disagree with this assessment; instead, the president and Congress can simply move on to taxes. Health care is a quagmire; it would have made more sense to focus on tax reform first. We realize that there were hopes that some of the savings from health care reform could have been used to fund tax cuts, but that was always a long shot. If Ryan and

Trump pivot to taxes after the AHCA passes the House but dies in the Senate, or simply dies, the drop in equities will probably be more of a welcome correction.[1]

U.S. crude oil inventories rose 5.0 mb compared to market expectations of a 3.0 mb build.

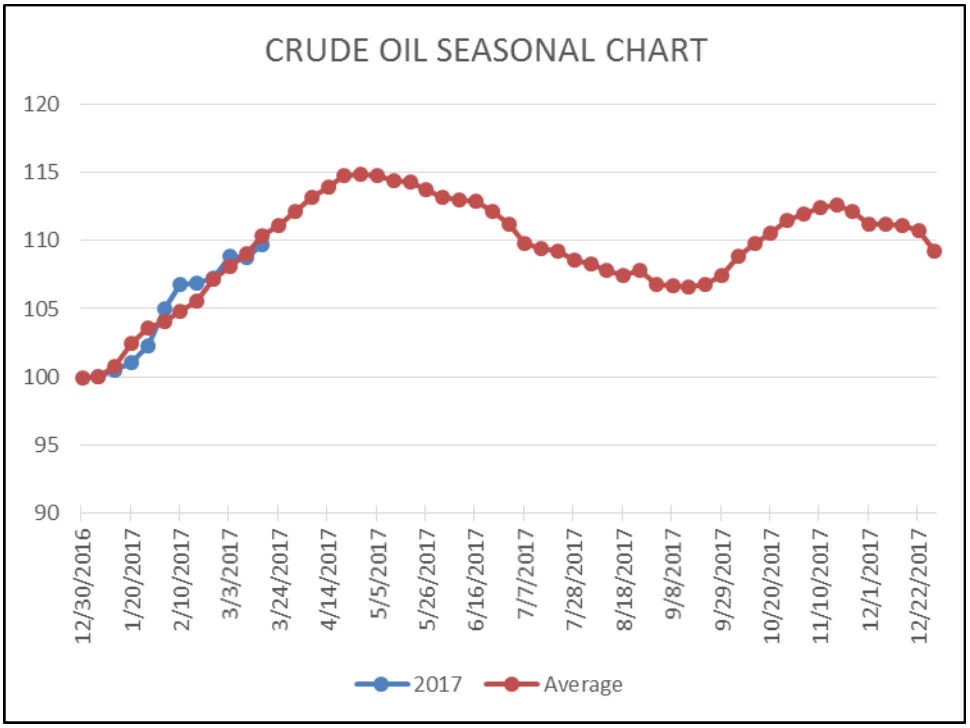




This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain elevated.

As the seasonal chart below shows, inventories usually increase into April before rising refinery operations for the summer driving season lower stockpiles. We did see refinery activity rise this week, which is a welcome sign. This week's rise puts us just below normal. We saw a sharp rebound in crude oil imports that boosted inventories, reversing last week's import weakness. So far, the numbers continue to indicate that we have about another month of inventory accumulation before oil inventories start their seasonal decline.

[1] Or, to use the parlance of a former colleague, a "pause to refresh."

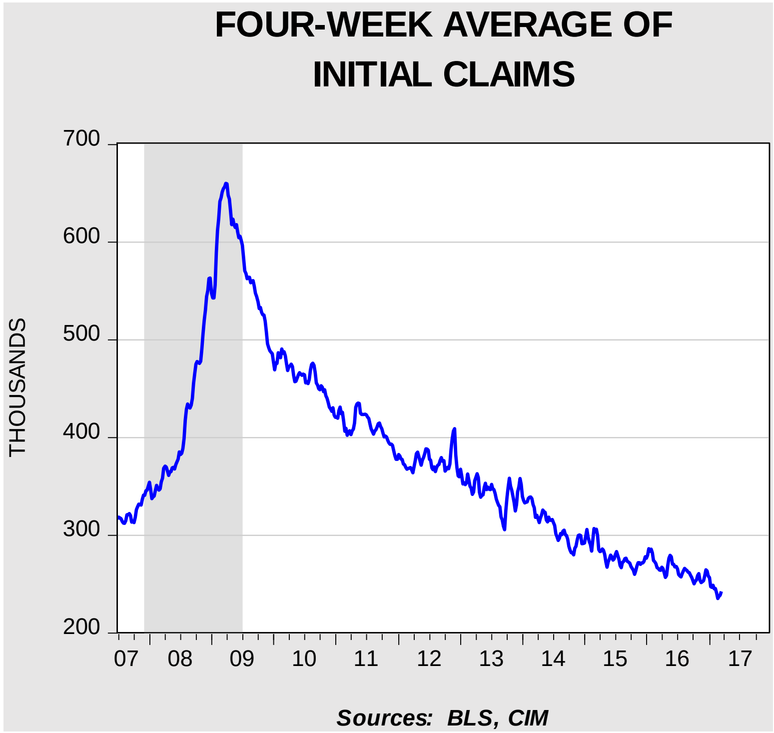


(Source: DOE, CIM)

Based on inventories alone, oil prices are overvalued with the fair value price of $27.59. Meanwhile, the EUR/WTI model generates a fair value of $39.81. Together (which is a more sound methodology), fair value is $34.96, meaning that current prices are well above fair value. The data does show that the bullish case for oil mostly rests on a weaker dollar. If the dollar continues to soften, oil may be able to overcome the inventory overhang which should be approaching its seasonal peak.

U.S. Economic Releases

Initial jobless claims came in above expectations at 258k compared to the forecast of 240k. This report marks the 106th week of jobless claims below 300k, the longest stretch since 1970.



The chart above shows the four-week moving average of jobless claims. The four-week moving average rose 4.0k to 241.75k.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	mar		51.0	**
10:00	New Home Sales	m/m	feb	564k	555k	**
10:00	New Home Sales	m/m	feb	1.6%	3.7%	**
11:00	Kansas City Fed. Manufacturing Activity	m/m	mar	14	14	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
12:30	Neel Kashkari speaks on US Education Outcomes in DC	President of the Federal Reserve Bank of Minneapolis				
19:00	Robert Kaplan Speaks on Economy in Chicago	President of the Federal Reserve Bank of Dallas				

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								
India	BoP Current Account Balance	m/m	4q	-$7.90b	-$3.40b	-$12.0b	**	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	y/y	apr	9.8	10.0	10.0	**	Equity and bond neutral
France	Business Confidence	y/y	jan	104	104	104	**	Equity and bond neutral
	Manufacturing Confidence	y/y	mar	104	107	107	**	Equity and bond neutral
	Production Outlook Indicator	y/y	jan	3	5	7	**	Equity and bond neutral
	Own-Company Production Outlook	y/y	feb	12	20	17	**	Equity and bond neutral
U.K.	Retail Sales Ex Auto Fuel	y/y	feb	4.1%	2.6%	3.2%	**	Equity bullish, bond bearish
	Retail Sales Inc Auto Fuel	y/y	feb	3.7%	1.5%	2.6%	**	Equity bullish, bond bearish
	CBI Retailing Reported Sales	m/m	mar	9	9	4	**	Equity bullish, bond bearish
	CBI Total Dist. Reported Sales	m/m	mar	32	25	20	**	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)	116	116	0	Up
3-mo T-bill yield (bps)	75	75	0	Neutral
TED spread (bps)	41	40	1	Neutral
U.S. Libor/OIS spread (bps)	92	92	0	Up
10-yr T-note (%)	2.41	2.41	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	27	27	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	up			Down
pound	up			Down
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	1.750%	1.750%	1.750%	On forecast

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	$50.85	$50.64	0.41%	Short Covering
WTI	$48.26	$48.04	0.46%	
Natural Gas	$3.04	$3.01	0.83%	
Crack Spread	$17.88	$18.17	-1.57%	
12-mo strip crack	$14.47	$14.61	-0.96%	
Ethanol rack	$1.62	$1.62	0.38%	
Metals				
Gold	$1,248.33	$1,248.84	-0.04%	Strong Dollar
Silver	$17.62	$17.54	0.45%	
Copper contract	$263.95	$263.05	0.34%	
Grains				
Corn contract	$ 357.50	$ 358.75	-0.35%	
Wheat contract	$ 422.50	$ 422.25	0.06%	
Soybeans contract	$ 995.50	$ 999.75	-0.43%	
Shipping				
Baltic Dry Freight	1190	1200	-10	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.0	3.0	2.0	
Gasoline (mb)	-2.8	-2.4	-0.4	
Distillates (mb)	-1.9	-1.0	-0.9	
Refinery run rates (%)	2.30%	0.20%	2.10%	
Natural gas (bcf)		-148		

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.

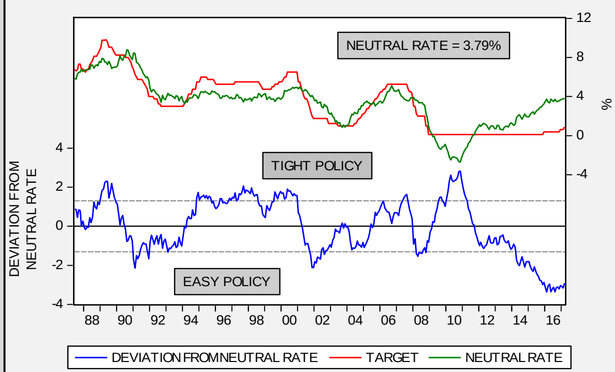
March 17, 2017

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.

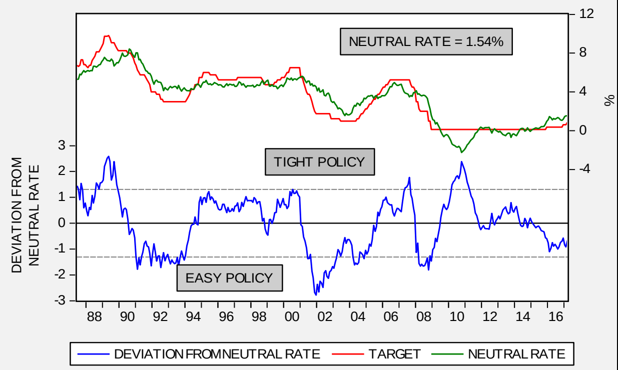
When we create each model, a deviation from the neutral rate is generated and this deviation is compared to the distribution of deviations. In general, one standard error should capture 66% of the deviation from forecast, assuming normally distributed deviations. When the deviation is inside of one standard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

MANKIW USING THE U-3 UNEMPLOYMENT RATE



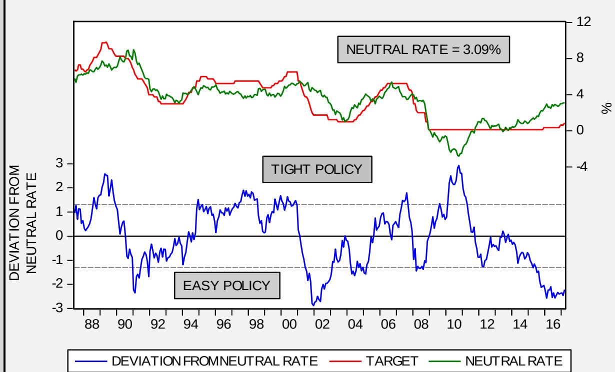
Sources: Haver Analytics, CIM

MANKIW USING THE EMPLOYMENT/ POPULATION RATIO



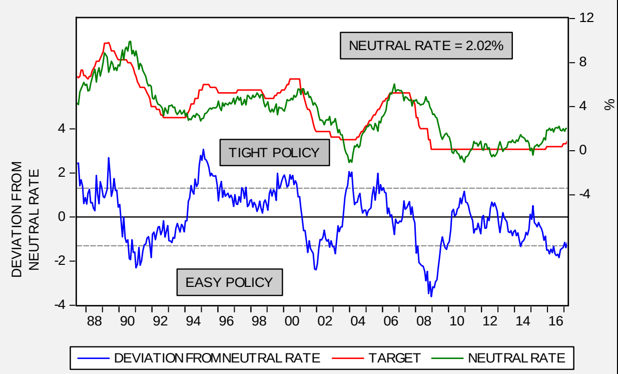
Sources: Haver Analytics, CIM

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.

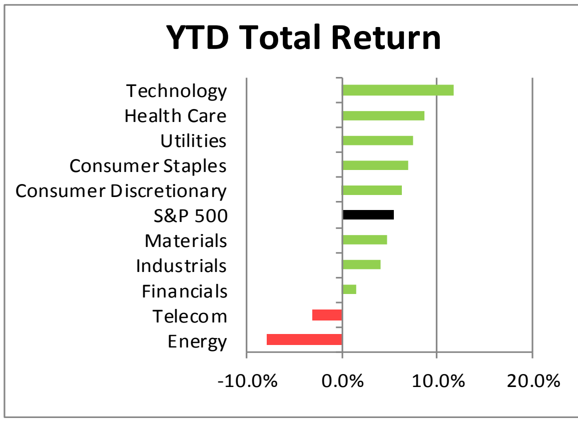
Overall, this means the FOMC, while raising rates, still has a mostly dovish bent. By choosing the most dovish variation of the Mankiw Rule, we are likely closer to the end of this rate cycle, assuming that core CPI remains mostly steady and the employment/population ratio doesn't

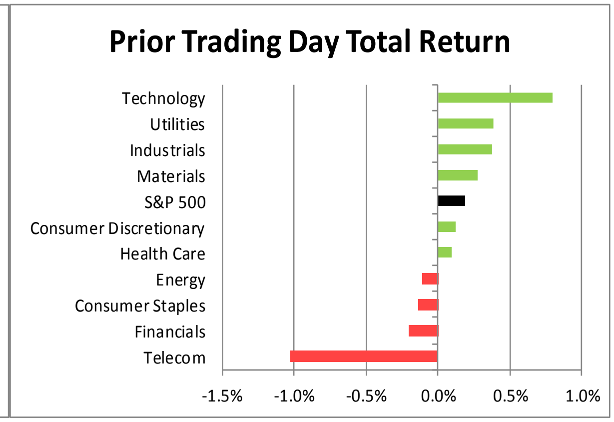
[2] See Asset Allocation Weekly, 2/10/2017.

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.

Data Section

U.S. Equity Markets – (as of 3/22/2017 close)

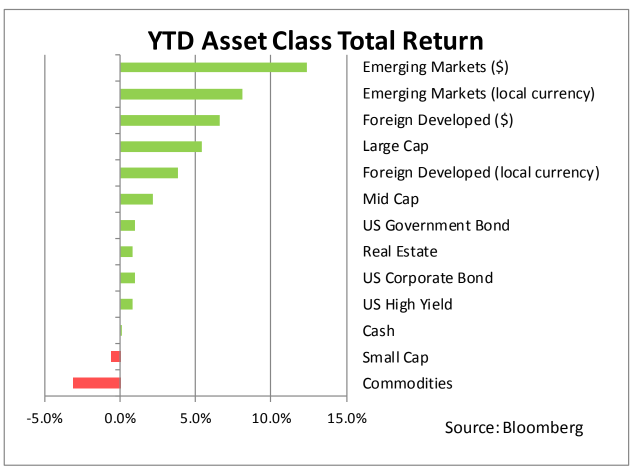




(Source: Bloomberg)

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 3/22/2017 close)

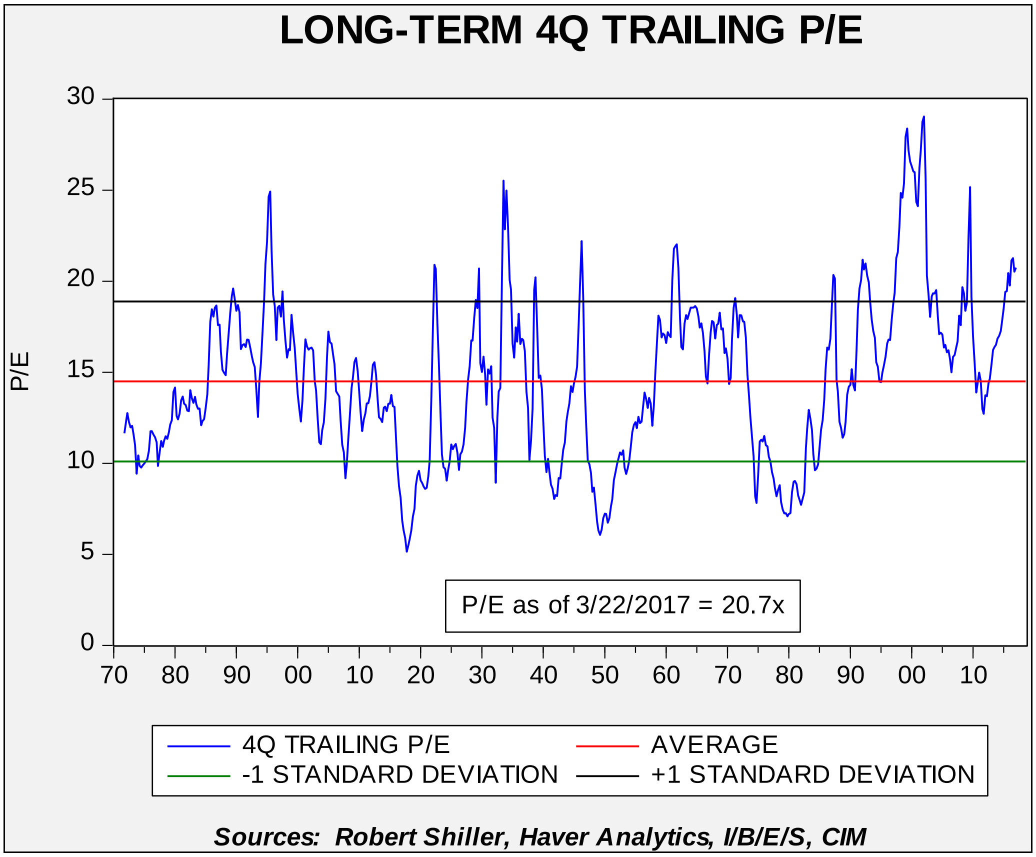


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 23, 2017



Based on our methodology,[3] the current P/E is 20.7x, unchanged from last week.

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 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.