Daily Comment

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

[Posted: March 24, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.6% and the Shenzhen index up 0.4%. U.S. equity futures are signaling a higher open.

The focus of attention remains on the AHCA, which is due for a vote this afternoon. The president has already pivoted on this issue; he has warned that if the vote fails, the GOP is stuck with the ACA for good and he is moving on to tax reform. It is becoming increasingly apparent that moving on health care so soon in his term was a mistake. We suspect the White House was expecting a quick win and didn't fully comprehend the splits that exist within the House GOP. The Freedom Caucus wants nothing less than full ACA repeal with really no replacement other than interstate insurance. We note that a few states do allow interstate sales. Georgia, Maine, Kentucky, Rhode Island and Wyoming passed laws allowing out of state insurers to sell in their states; to date, none have taken up the offer. It's hard to crack a local monopoly. Meanwhile, more moderate Republicans are facing a backlash against losing some of the more popular parts of the ACA, like no lifetime caps and the pre-existing conditions clause.

Twitter is abuzz with talks of backroom deals to bring House members on board. In the end, it may pass, although if forced to bet we would fade the trade. However, even if it passes the House, it won't pass the Senate in its current form. So, once the Senate gets the bill, it will make changes that the Freedom Caucus won't accept. It should also be remembered that when Americans say they want health care reform, it's different than when economists talk about it. The latter want to bring some semblance of a market to health care, with insurance only covering catastrophic health events and all other care coming out of pocket. To lower costs, there is talk of price transparency (imagine websites that list prices and customer feedback on medical procedures, much like what we have with cars, restaurants and credit cards) and maybe loosening the regulations on health care to boost the number of providers. When the public says health care reform, it mostly means the ability to consume all the health care desired at little to no cost. Given these parameters, reform that health care economists craft will be disliked by the public; thus, a politician who puts his name on such reform will inevitably face some degree of disappointment.

The White House has correctly assessed this situation and is calling for a vote; if the AHCA goes down, the president will move on to tax reform and hang the loss on Speaker Ryan. If this is the outcome, we expect the damage to equities will be slight and the financial markets will turn their attention to tax changes. It should be noted that the reason for working on health care first was to create revenue to allow for tax cuts to be partly funded by health care reform. The president seems unconcerned about the deficit and so we are setting up for another tussle between the White House and deficit hawks.

However, there is a sleeper to watch; on March 16th, the Treasury reached the debt ceiling borrowing limit. For the time being, the Treasury has work-arounds that should keep the government running until autumn. But, at some point, Congress will need to vote to raise the debt ceiling. Fiscal hawks in the GOP will be loath to support more borrowing and will want Trump's tax and spending policies to be offset by reductions elsewhere. Given the tensions witnessed within the GOP on the AHCA, the debt ceiling could be another point of contention.

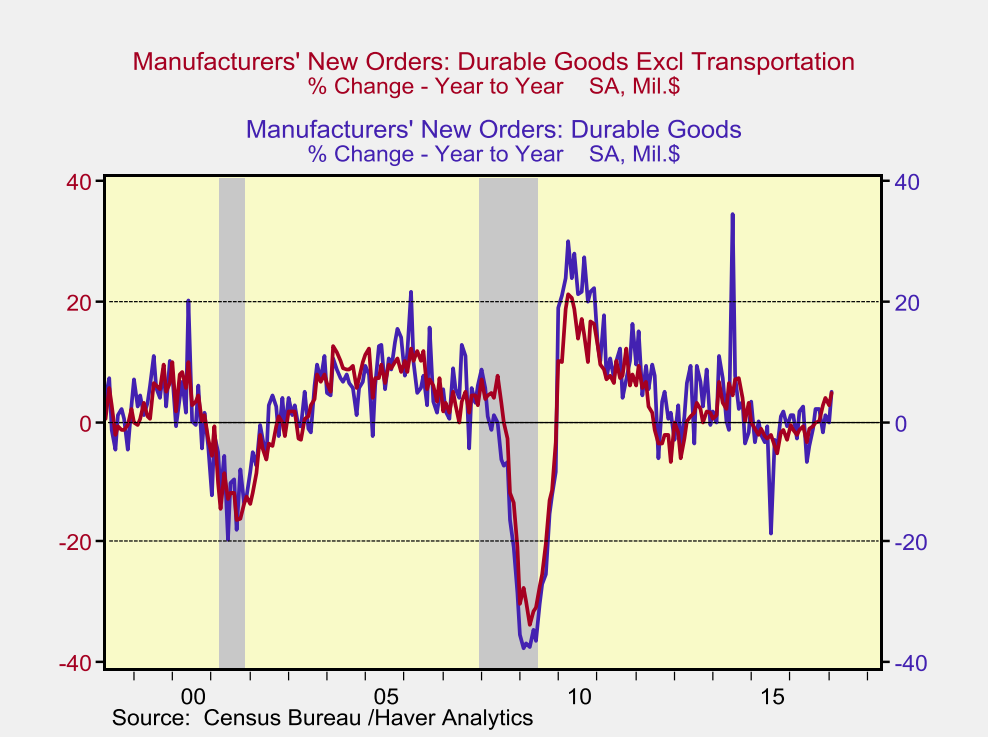
Senate Minority Leader Schumer (D-NY) is indicating his party will filibuster Judge Gorsuch and essentially force the leadership to either find a new candidate or invoke the so-called "nuclear option," which would allow Supreme Court candidates to be voted on by a simple majority, ending the filibuster on judge approvals. Going nuclear would be a further step toward turning the Senate from a moderating influence into simply a second House. Although this outcome won't necessarily affect financial markets immediately, as we move toward reducing the Senate's traditional role, the more volatile policy will become. In a sense, we could see wholesale shifts in policy every time we have unified government (when a single party controls Congress and the White House). It would make elections even more critical and create market conditions where the fate of companies and industries rests on who controls the government.

Finally, AFL-CIO President Richard Trumka is rooting for the populists in the White House. Although unions traditionally support Democrats, Trump won the largest share of the union vote since Reagan, mostly due to his stance on trade. In a *WSJ* article,[1] Trumka is worried that the Wall Street wing will moderate the president's anti-trade stance. The juxtaposition is a bit jarring, but an interesting read.

U.S. Economic Releases

February durable goods orders came in above expectations at 1.7% compared to the forecast of 1.4%. The prior month's gains were revised upward from 2.0% to 2.3%. Durable goods excluding transportation came in below expectations at 0.4% compared 0.6%. The prior month's report was revised upward from unchanged to a gain of 0.2%. Capital goods orders nondefense excluding airplanes came in below expectations at -0.1% compared to the forecast of 0.5%. The prior month's loss of 0.1% was revised upward to a gain of 0.1%. Capital goods shipments nondefense excluding airplanes came in above expectations at 1.0% compared to the forecast of 0.2%. The prior month's loss of 0.4% was revised upward to a loss of 0.3%.

[1] https://www.wsj.com/articles/trumps-trade-vows-succumbing-to-moderate-advisers-trumka-says-1490283529 (paywall)



The chart above shows the annual change in headline durable goods orders including and excluding transportation. There seems to be relatively little movement with durable goods on an annual basis. Annually, new orders rose by 2.7%, shipments rose by 5.1%, unfilled orders fell by 1.4% and inventories fell by 0.1%.

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	Markit US Manufacturing PMI	m/m	mar	54.8	54.2	**
10:00	Markit US Services PMI	m/m	mar	54.0	53.8	**
10:00	Markit US Composte PMI	m/m	mar		54.1	**
Fed speakers or events						
EST	Speaker or event	District or position				
10:00	John Williams speaks in Santa Cruz	President of the Federal Reserve Bank of San Francisco				
13:00	William Dudley will Speak on Bank Culture in New York	President of the Federal Reserve Bank of New York				

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	Japan Buying Foreign Bonds	m/m	mar	149.4b	-0.7039b		**	Equity and bond neutral
	Japan Buying Foreign Stocks	m/m	mar	-465.7b	-0.3605b		**	Equity and bond neutral
	Foreign Buying Japan Bonds	m/m	mar	-586.8b	-0.0473b		**	Equity and bond neutral
	Foreign Buying Japan Stocks	m/m	mar	-580.4b	-0.7227b		**	Equity and bond neutral
	Nikkei Japan PMI Mfg	m/m	mar	52.6	53.3		**	Equity and bond neutral
	Leading Index CI	m/m	jan	104.9	105.5		**	Equity and bond neutral
	Coincident Index	m/m	jan	115.1	114.9		**	Equity and bond neutral
India	Current Account Balance	q/q	4q	-7.90b	-3.40b	-12.00b	**	Equity and bond neutral
New Zealand	Trade Balance NZD	y/y	feb	-0.018m	-0.285b	-0.180b	**	Equity and bond neutral
	Exports NZD	y/y	feb	4.01b	3.91b	4.20b	**	Equity and bond neutral
	Imports NZD	y/y	feb	4.02b	4.19b	3.99b	**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	y/y	mar	56.2	55.4	55.3	**	Equity bullish, bond bearish
	Markit Eurozone Services	y/y	mar	56.5	55.5	55.3	**	Equity bullish, bond bearish
	Markit Eurozone Composite	y/y	mar	56.7	56.0	55.8	**	Equity bullish, bond bearish
Germany	Markit/BME Germany Manufacturing	y/y	jan	58.3	56.8	56.5	**	Equity bullish, bond bearish
	Markit Germany Services	y/y	feb	55.6	54.4	54.5	**	Equity bullish, bond bearish
	Markiy/BME Germany Composite	y/y	feb	57.0	56.1	56.0	**	Equity bullish, bond bearish
France	GDP	y/y	feb	1.1%	1.2%	1.2%	***	Equity and bond neutral
	Markit France Manufacturing PMI	m/m	mar	53.4	52.2	52.4	**	Equity and bond neutral
	Markit France Services PMI	m/m	mar	58.5	56.4	56.1	**	Equity bullish, bond bearish
	Markit France Composite PMI	m/m	mar	57.6	55.9	55.8	**	Equity bullish, bond bearish
UK	BBA Loans for Homes Purchase	m/m	mar	42613	44657	44900	**	Equity and bond neutral
Russia	Money Supply Narrow Def	m/m	mar	8.93t	8.86t		**	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	feb	2.0%	2.1%	2.1%	***	Equity and bond neutral
	CPI Core	m/m	feb	1.3%	1.3%		***	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)	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)	91	92	-1	Up
10-yr T-note (%)	2.43	2.42	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	28	28	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			Down
pound	down			Down
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Russia Key Rate	9.750%	10.000%	10.000%	Below 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	$50.77	$50.56	0.42%	Short Covering
WTI	$47.95	$47.70	0.52%	
Natural Gas	$3.04	$3.05	-0.23%	
Crack Spread	$18.10	$18.09	0.03%	
12-mo strip crack	$14.64	$14.61	0.16%	
Ethanol rack	$1.63	$1.63	-0.07%	
Metals				
Gold	$1,245.09	$1,245.20	-0.01%	
Silver	$17.62	$17.59	0.20%	
Copper contract	$263.80	$264.45	-0.25%	
Grains				
Corn contract	$ 356.25	$ 356.75	-0.14%	
Wheat contract	$ 423.00	$ 421.00	0.48%	
Soybeans contract	$ 985.00	$ 991.00	-0.61%	
Shipping				
Baltic Dry Freight	1196	1190	6	
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)	-150.0	-148	-2.0	

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.

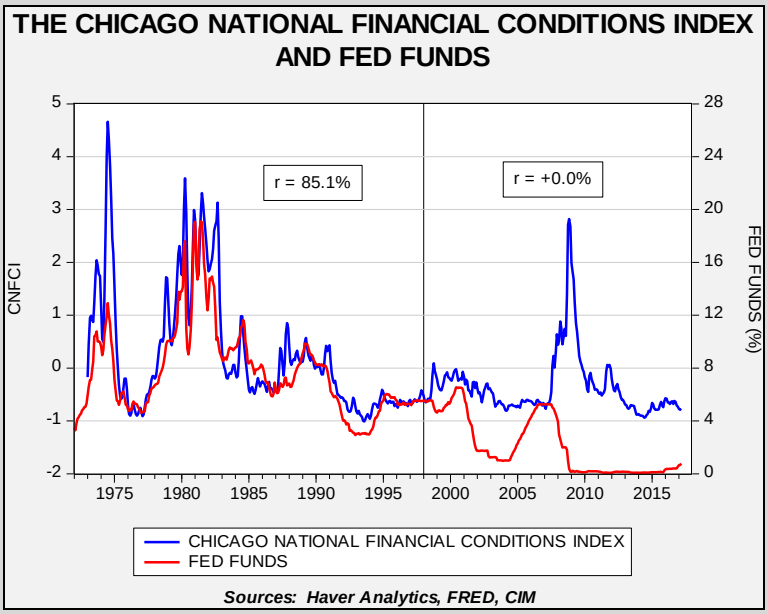
Asset Allocation Weekly Comment

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 24, 2017

In a recent Bloomberg Surveillance podcast,[2] Sebastian Mallaby made an interesting observation about the recent Fed tightening. He noted how the asset markets mostly ignored or cheered the move. Mallaby suggested that this isn't necessarily a good outcome, meaning that central bank tightening should not be welcomed by the financial markets. When it is, it can make the markets complacent; this is one of the main tenets of Hyman Minsky's research.

This chart clearly shows how financial markets have changed.



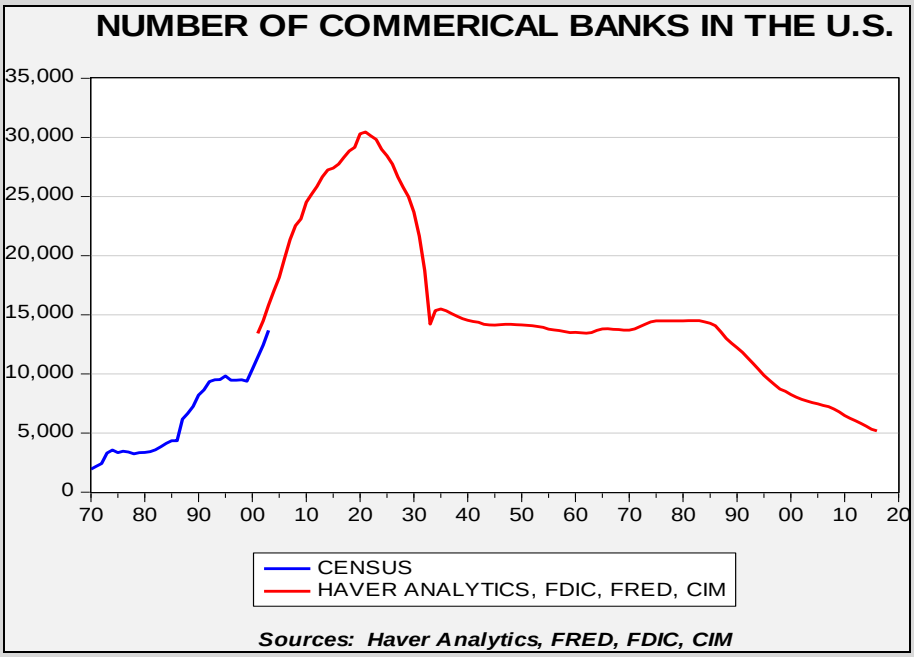
The blue line on the chart shows the Chicago FRB Financial Conditions Index. It measures the level of stress in the financial system. It is constructed of 105 variables, including the level of interest rates, credit spreads, equity and debt market volatility, delinquencies, borrower and lender surveys, debt and equity issuance, debt levels, equity levels and various commodity prices (including gold). A rising line indicates increasing financial stress. The red line is the effective fed funds rate. Until 1998, the two series were positively and closely correlated. When the Fed raised rates, financial stress rose; when the Fed lowered rates, stress declined.

We believe one factor that changed this relationship is policy transparency. Starting in the late 1980s, the Fed became increasingly transparent. Before 1988, for example, the FOMC would meet but issue no statement about what it had decided to do. Investors and the financial system had to guess if policy had been changed. Starting in 1988, the central bank began publishing its

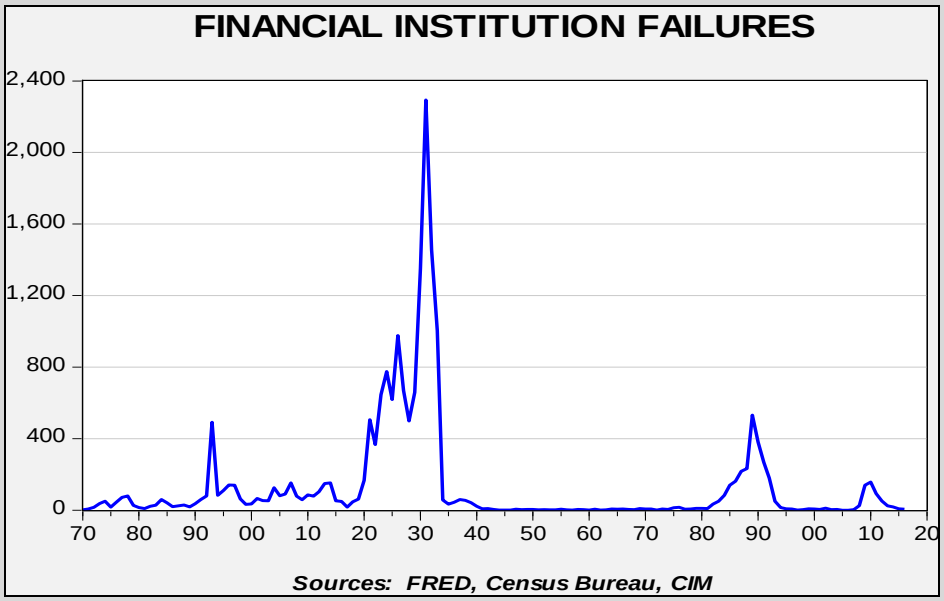
[2] https://www.bloomberg.com/news/audio/2017-03-16/trump-s-budget-is-borderline-incompetent-furman-says

target rate. In the 1990s, it began issuing a statement when rates changed; eventually, a statement followed all meetings. As the FOMC has become more transparent, the correlation between stress and the level of fed funds has changed. Essentially, the markets now know with a high degree of certainty when rate changes are likely. This is especially true of tightening. The FOMC appears to avoid making rate hikes that surprise the market.

Central bank policy goals are another factor that may have changed the stress/fed funds relationship. Although Congress has specifically tasked the Fed with managing full employment and low inflation, all central banks exist to act as lenders of last resort. Central banks provide liquidity during panics to prevent widespread financial firm failures during crises. For most of the post-Depression period, the financial system was heavily regulated; investment banking and commercial banking were separated by Glass-Steagall, and the Bank Holding Company Act restrained bank operations across state lines. This led to a high number of small commercial banks.



This chart shows the number of commercial banks in the U.S. There is a break in the series around 1905; we have put together a time series from a variety of sources. There was a sharp consolidation of banks during the 1920s into the early years of the Depression. Banking regulation kept the number mostly stable. Financial institution failures show how the financial system stabilized from the mid-1930s into the early 1980s.



Financial firm failures began to rise during WWI and spiked during the Great Depression. The regulatory environment focused on stability until the 1980s, when deregulation began. The goal of deregulation was to improve the efficiency of the banking system. Although it did improve efficiency, it also made it more fragile. The rise in failures in the 1980s was due to the S&L Crisis, while the recent rise was due to the Great Financial Crisis.

From the mid-1930s into the early 1980s, the Federal Reserve did not have to concern itself with financial stability. In a world of widely distributed, heavily regulated commercial and investment banks, the odds of failure were low and the impact from any particular failure was insignificant. Thus, monetary policy could be conducted simply to manage the goals of controlled inflation and full employment. However, in the current deregulated environment, the Fed now has to be concerned with financial system stability. This is why we believe the central bank has opted to become more transparent. The problem is, that by adopting this policy, the central bank has lost control over financial stress. The data indicates that when the FOMC raises rates, financial stress tends to remain stable…until some sort of crisis occurs. And, perversely, easing policy seems to have little effect on reducing stress.

Instead, what seems to happen is that monetary policy, by being transparent and designed not to increase financial stress, leads to overconfident investors who tend to build asset prices to unsustainable levels. This leads to eventual asset price corrections and easier monetary policy. Following Hyman Minsky's theory, low financial stress becomes the catalyst for rising asset prices that eventually become problematic; unfortunately, the usual response of easing monetary policy does little to reduce financial stress.

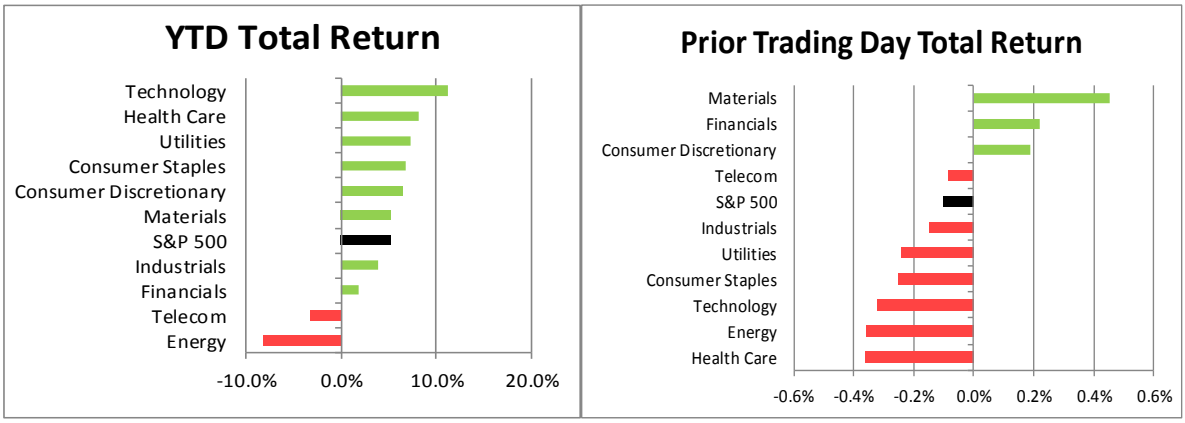
What does this mean for investors? Sadly, it means that monetary policy seems designed to maintain low levels of financial stress and tends to lift asset prices to the point of unsustainability, which then leads to painful corrections. This isn't the only factor involved; this same monetary policy tends to foster long economic expansions which also support asset prices. Although each investor's goals and risk tolerance is different, this analysis suggests that risks are

higher than they first appear and balanced portfolios are one of the better longer term responses to this condition.

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

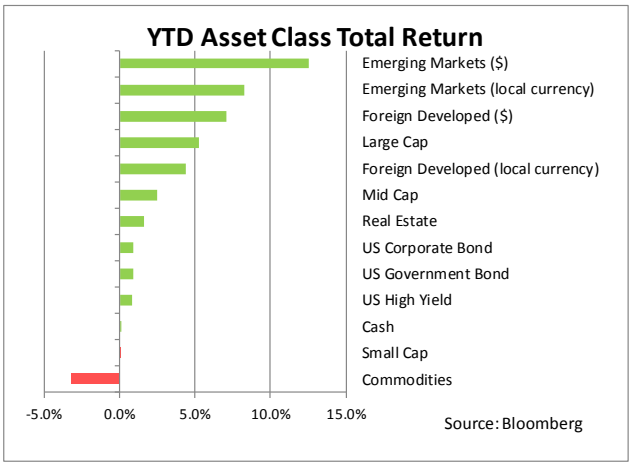
U.S. Equity Markets – (as of 3/23/2017 close)



(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 3/23/2017 close)

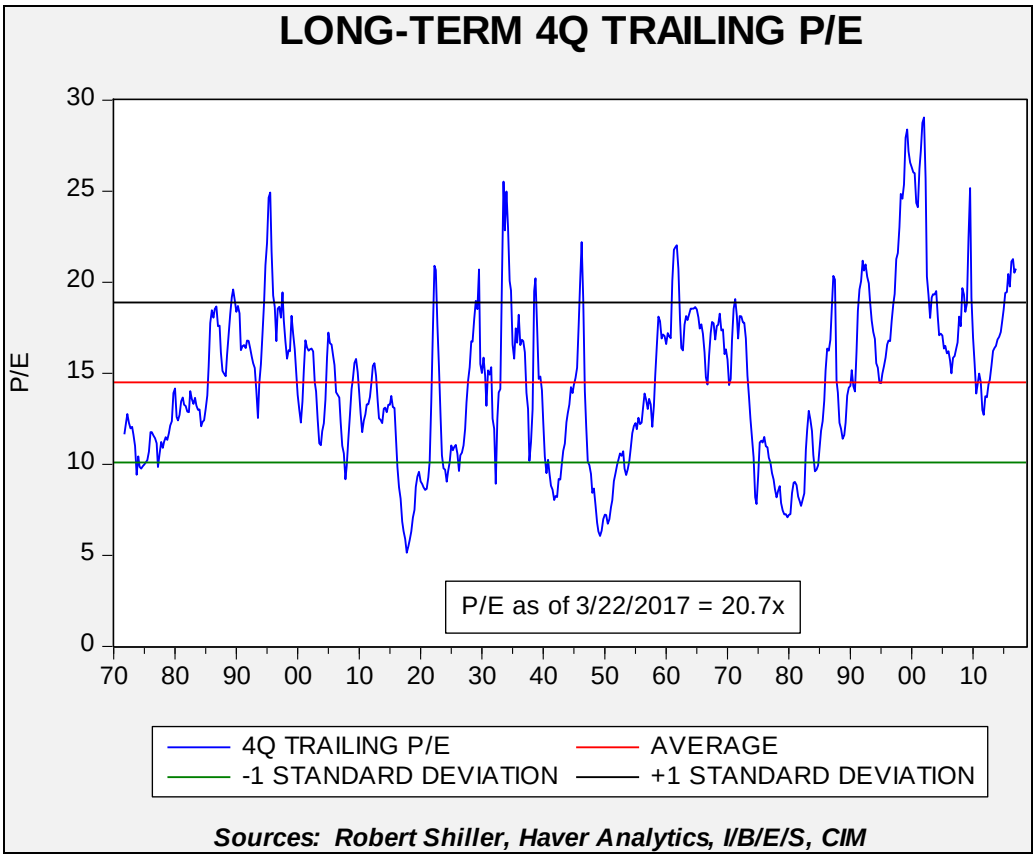


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.