Daily Comment

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

[Posted: March 27, 2017—9:30 AM EDT] Global equity markets are generally down this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed relatively unchanged from the prior close. Chinese markets were down, with the Shanghai composite down 0.1% and the Shenzhen index down 0.4%. U.S. equity futures are signaling a lower open.

Global equity markets are in retreat this morning as bond yields fall and the dollar declines. What we are seeing is the reversal of the "Trump trade" that came out of the election. The Trump trade was to buy equities (especially financials), sell bonds and buy the dollar. Thus, concerns about the future path of policy are leading to a retreat on these positions.

As it become obvious on Friday that the AHCA was not going to pass, Speaker Ryan decided not to hold a vote on the bill. We did see some weakness in equities; overall, the decline looked to be well contained. However, over the weekend, sentiment deteriorated and concerns rose that the whole Trump agenda may be imperiled. This is how that current analysis stands:

The GOP faces major divisions that Trump will struggle to manage. As we have documented over the past two years, populists on both the left and right wings have become increasingly unhappy with how the center-left and center-right establishment have been managing the country. The insurgent campaigns of Sen. Sanders and the victory of Donald Trump revealed those divisions, and the AHCA revealed the divisions within the GOP. We found it notable how the president initially blamed the Democrats after the AHCA failed but shifted his focus to the right wing of the GOP later in the weekend, including the Club for Growth, Heritage, etc. It's worth remembering that Trump is a populist; the GOP establishment and much of the hard right are not.

Those divisions exist for tax reform as well. The Freedom Caucus usually want policy to be revenue neutral and tend to be deficit hawks. We note that Rep. Mark Meadows (R-NC) did suggest over the weekend that tax cuts don't have to be "fully offset," suggesting there may be some room to maneuver. However, it's unclear how much room exists. A simple cut in rates may get through Congress on just GOP votes but only in the reconciliation process, meaning the cuts will sunset in 10 years. Such cuts won't have as much effect because businesses won't know if the reductions will stand and thus will be reluctant to make long-term investments based on them. Expansive tax reform may be more difficult than the health care bill, so it could mean a very simple tax cut and little else. And, the border adjustment tax is probably dead as well.

Trump is reaching out to Democrats. If that was the plan, he should have led with infrastructure. That would have created goodwill in a policy area where Democrats are inclined to help. Trump could have used that goodwill to gain support for other policies. Trump is facing a similar problem that Speaker Boehner faced; some legislation may require isolating the Freedom Caucus and joining with moderate Democrats to pass things. Unfortunately, in the current partisan political environment, those moderates may be terrified to vote for anything GOP-led for fear of being hit with a primary challenge from the left. Thus, by leading with the AHCA and trying to bring down what the Democrats see as one of their major achievements, it will be difficult to get any bipartisan cooperation.

The AHCA's failure will make tax reform harder in other ways. Speaker Ryan wanted to lead with health care because the AHCA would have would have eliminated the taxes that the ACA levied. By reducing the amount of revenue coming into the government from the ACA, the baseline would have been reduced, making the impact of tax cuts appear less onerous. In addition, the spending cuts shown by the CBO would have freed up revenue for tax reductions. Thus, the scope of tax reform may be reduced.

The debt ceiling may become a crisis. The continuing resolution funding the government expires on April 28. We have been expecting it to be extended, with the real "crunch" coming in autumn. However, the failure of the AHCA suddenly complicates this issue. The Freedom Caucus will likely insist that any new resolution end funding for Planned Parenthood. There is no way the Senate will vote for such a resolution even if the House goes along with the Freedom Caucus on this issue. The other way this moves forward is the "Boehner option" of pulling Democrats into a coalition to fund the government. However, they will have their own demands and will undermine the speaker. The president will be unsympathetic; his argument will be that the Freedom Caucus had the chance to defund Planned Parenthood with the AHCA and their failure to pass that bill means that Planned Parenthood will continue to receive money from the government.

The big picture is that political coalitions are shifting. A two-party system is really one of enforced coalitions. In other words, political parties tend to have groups within them that are not necessarily compatible but grudgingly work together for political purposes. Every so often, however, these coalitions can't hold and new ones are formed. For example, we noted last week that the head of the AFL-CIO was worried that the anti-trade group within the Trump administration is losing influence. It's a bit shocking when "anti-trade" and "GOP" are united; however, it should be noted that the GOP was the party of tariffs before WWII. We are not sure how various groups will realign in the coming years but we feel confident that it will occur. Investors should be careful in that the GOP may evolve into the party of the working class and the enemy of capital. It's worth remembering that Andrew Jackson was a Democrat; Trump recently laid a wreath at his tomb.

In other news, there were widespread protests in Russia over the weekend and Russian security forces arrested Alexei Navalny, an opposition figure. The protests rose over reports that PM Medvedev took over $1.0 bn in bribes but also seemed to reflect opposition to Putin's reign. The protests occurred despite official bans. Unlike earlier protests, they occurred across the country, along the Black Sea coast and as far east as Vladivostok. Putin is usually able to quash these uprisings but the fact that this one came out of nowhere will likely rattle the Kremlin.

OPEC is talking about extending its production cuts and Saudi Arabia is clearly wanting to boost prices by cutting its own output. The Kingdom noted its output cuts are nearly double what it had promised. However, non-OPEC cuts have been disappointing as Russia has mostly failed to reduce output. Anyone surprised by Russia's lack of compliance has no sense of history; Russia is notorious for not meeting such promises. Saudi Arabia should have known these promises were unlikely to be fulfilled, which has likely led it to reduce output beyond its quota cuts. We believe the Saudis are engaging in "window dressing" in front of its Saudi Aramco IPO next year and thus will take aggressive steps to keep prices supported. However, there are limits to how much the kingdom can cut output and maintain revenue in a falling price environment.

So, where does all this lead us? After the election, all the groups supporting President Trump were projecting their best outcomes on his presidency. Reality is starting to set in. It's fair to say he won't get everything done; no president ever does. However, worries on even the most basic legislation (like tax reform) are bearish for equities. How bearish? We note that the economy is still doing ok and there appears to be ample cash on the sidelines. Thus, the worst case scenario is probably a pullback toward the 2200 area for the S&P 500. We will have more on this tomorrow.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:30	Dallas Fed. Manf. Activity	m/m	mar	22.0	24.5	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
13:15	Charles Evans Speaks on Economy and Policy in Madrid	President of the Federal Reserve Bank of Chicago				
18:30	Robert Kaplan Speaks in College Station, Texas	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								
Japan	PPI Services	y/y	feb	0.8%	0.5%	0.5%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	M3 Money Supply	y/y	mar	4.7%	4.9%	4.9%	**	Equity and bond neutral
Germany	IFO Business Climate	y/y	mar	112.3	111.0	111.1	**	Equity bullish, bond bearish
	IFO Expectations	y/y	mar	105.7	104.0	104.3	**	Equity bullish, bond bearish
	IFO Current Assessment	y/y	mar	119.3	118.4	118.3	**	Equity bullish, bond bearish
Switzerland	Total Sightd Deposits	y/y	mar	560.1b	557.2b		**	Equity and bond neutral
	Domestic Sight Deposits	y/y	mar	476.3b	470.9b		**	Equity and bond neutral
AMERICAS								
Brazil	FGV Consumer Confidence	m/m	mar	85.3	81.8		**	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	116	-1	Up
3-mo T-bill yield (bps)	75	75	0	Neutral
TED spread (bps)	40	40	0	Neutral
U.S. Libor/OIS spread (bps)	92	92	0	Up
10-yr T-note (%)	2.41	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	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	$50.52	$50.80	-0.55%	Long Liquidation
WTI	$47.56	$47.97	-0.85%	
Natural Gas	$3.11	$3.08	0.98%	
Crack Spread	$18.56	$18.32	1.35%	
12-mo strip crack	$14.84	$14.72	0.86%	
Ethanol rack	$1.64	$1.63	0.32%	
Metals				
Gold	$1,257.80	$1,243.57	1.14%	Weaker Dollar
Silver	$17.94	$17.76	1.02%	
Copper contract	$258.30	$263.10	-1.82%	
Grains				
Corn contract	$ 356.75	$ 356.25	0.14%	
Wheat contract	$ 422.75	$ 424.75	-0.47%	
Soybeans contract	$ 972.75	$ 975.75	-0.31%	
Shipping				
Baltic Dry Freight	1240	1196	44	

Weather

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

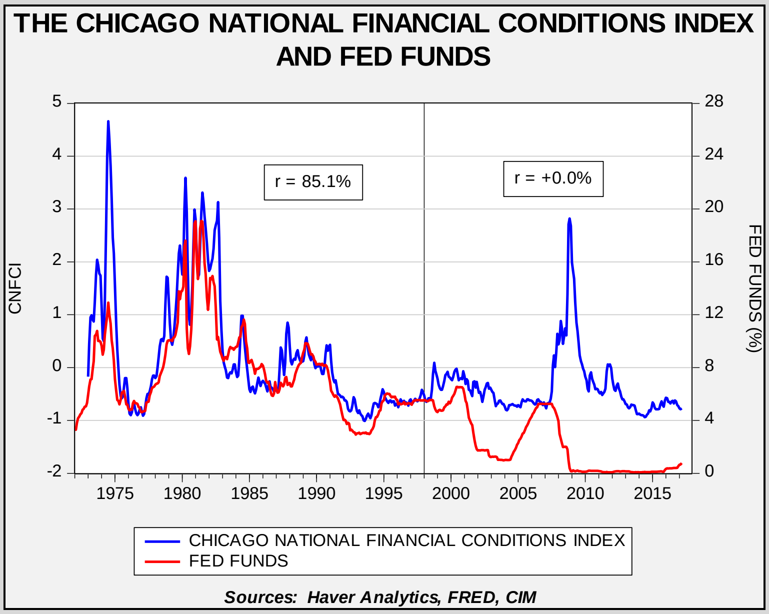
Asset Allocation Weekly Comment

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,[1] 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.



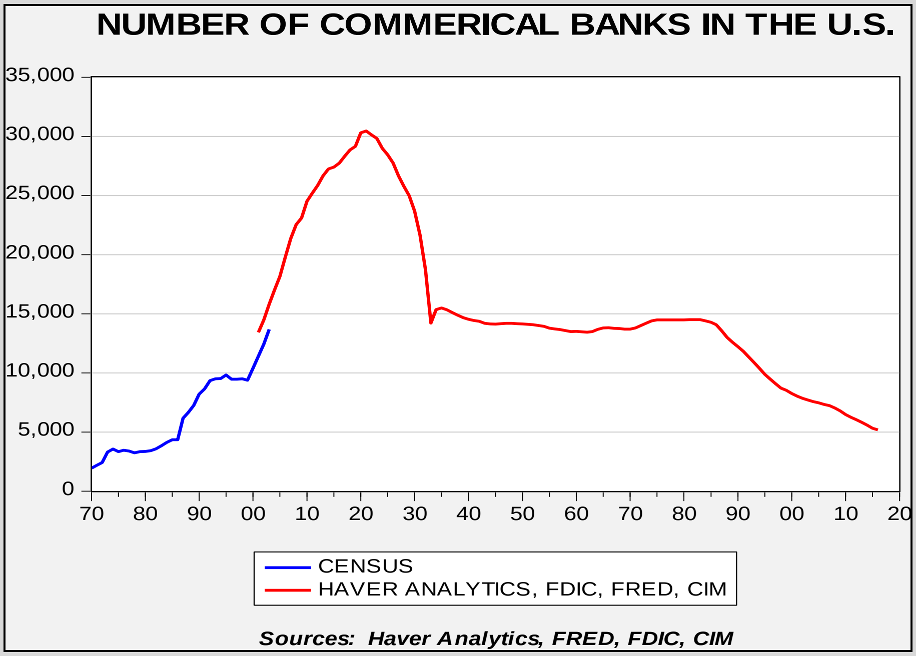
The blue line on the chart shows the Chicago FRB Financial Conditions Index. It measures the level of stress in the financial system. It is constructed of 105 variables, including the level of interest rates, credit spreads, equity and debt market volatility, delinquencies, borrower and lender surveys, 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

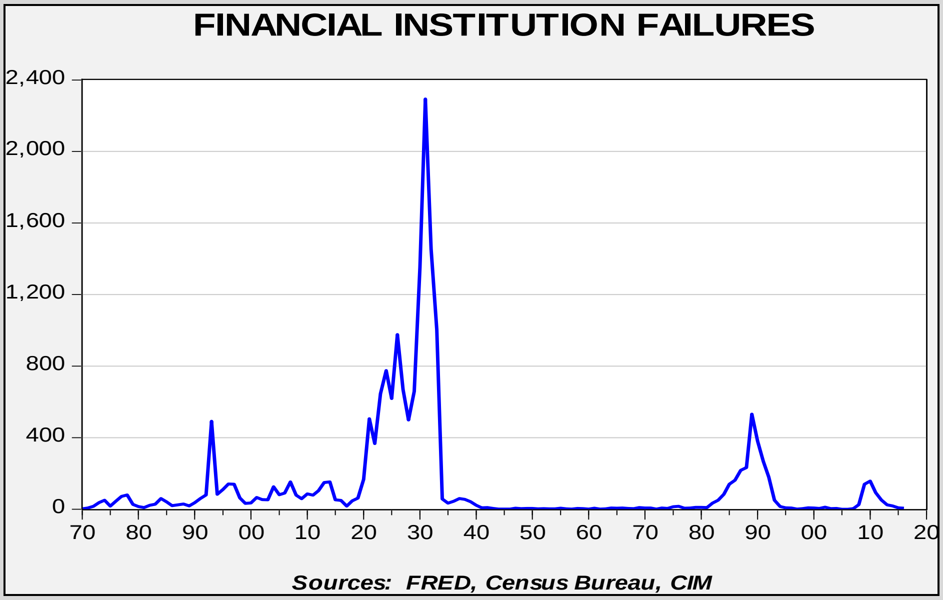
[1] https://www.bloomberg.com/news/audio/2017-03-16/trump-s-budget-is-borderline-incompetent-furman-says

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.

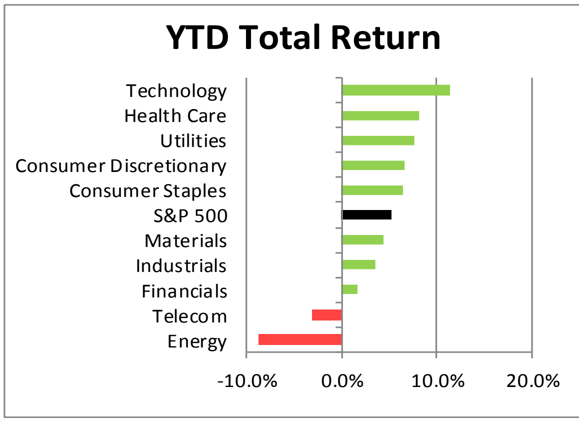
Instead, what seems to happen is that monetary policy, by being transparent and designed not to increase financial stress, leads to overconfident investors who tend to build asset prices to unsustainable levels. This leads to eventual asset price corrections and easier monetary policy. Following Hyman 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.

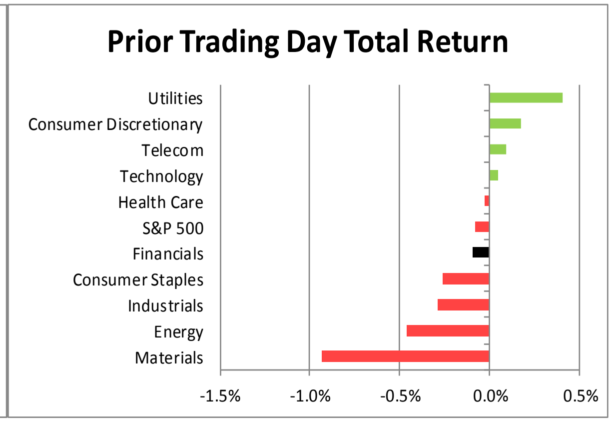
What does this mean for investors? Sadly, it means that monetary policy seems designed to maintain low levels of financial stress and tends to lift asset prices to the point of unsustainability, which then leads to painful corrections. This isn't the only factor involved; this same monetary policy tends 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 3/24/2017 close)

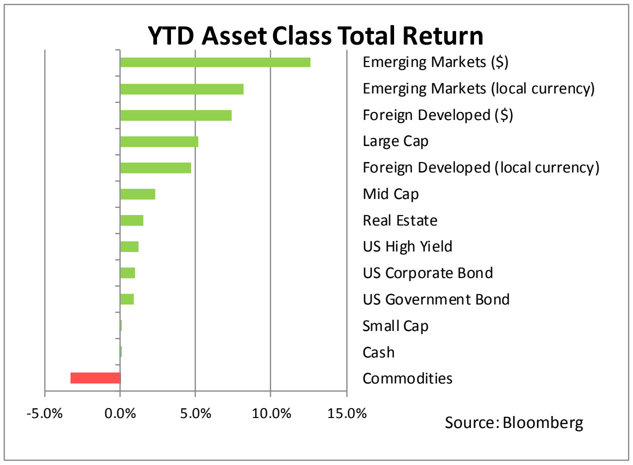




(Source: Bloomberg)

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 3/24/2017 close)

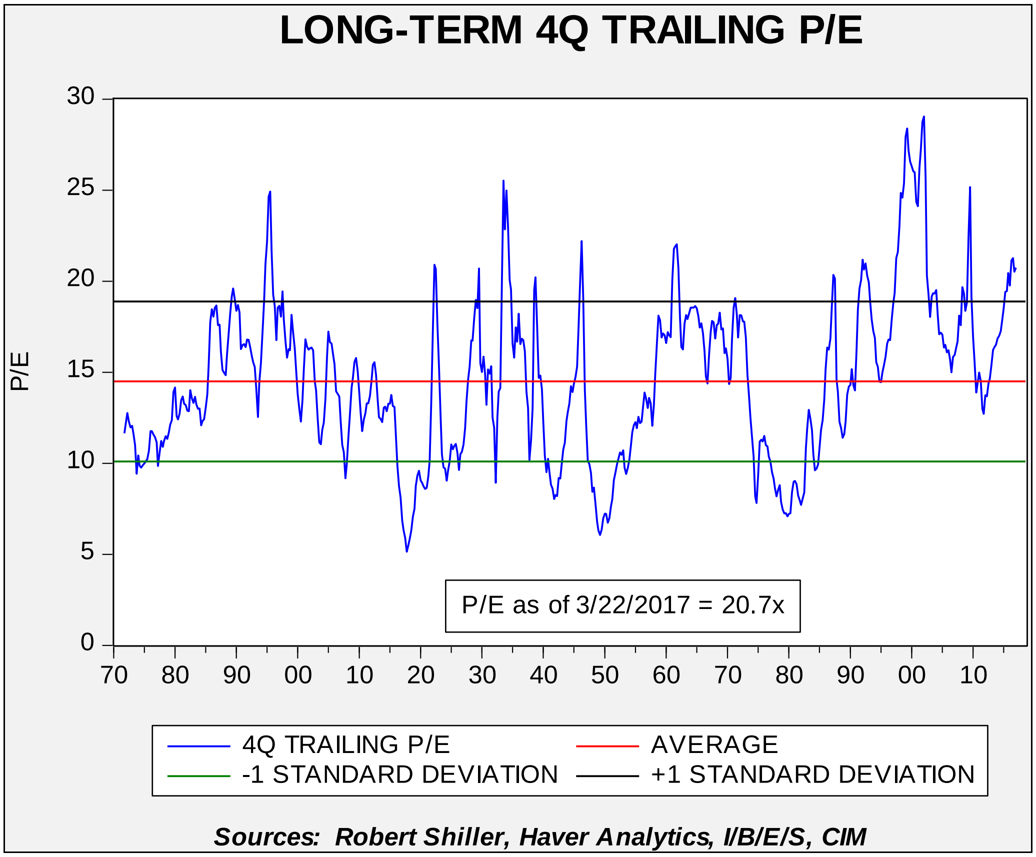


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

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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 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.