Daily Comment

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and Thomas Wash

[Posted: March 7, 2017—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were up, with the Shanghai composite up 0.3% and the Shenzhen index up 0.3%. U.S. equity futures are signaling a lower open. With 489 companies having reported, the S&P 500 Q4 earnings stand at $31.48, higher than the $30.77 forecast for the quarter. The forecast reflects a 3.2% increase from Q4 2015 earnings. Thus far this quarter, 65.4% of the companies reported earnings above forecast, while 23.1% reported earnings below forecast.

In Washington, the wheels of policy continue to move forward. The GOP has offered its first swing at replacing the Affordable Care Act (ACA). It keeps many of the more popular measures, such as pre-existing condition coverage and child coverage up to age 26. It does jettison the individual coverage mandate, replacing it with a 30% penalty to renew coverage if allowed to lapse. All the taxes surrounding the ACA would be repealed. Two popular proposals, including a national market for insurance (allowing policies to be sold across state lines) and malpractice reform, failed to make it into the bill because these measures would require a filibuster-proof majority in the Senate. This new version would be part of budget reconciliation, which only requires a majority in the Senate.

We place low odds that this proposal will pass in its present form. We expect the Democrats to oppose the measure since it reverses the bill the party passed under President Obama (the ACA). But there isn't all that much unity in the GOP for the bill either. This new version is strikingly similar to the ACA and that won't be lost on most observers. Still, some movement on health care will allow Congress to move forward on a budget and tax policy.

China's forex reserves rose modestly in February to $3.005 trillion, up from $2.998 trillion, a $6.92 billion rise. This is the first rise in reserves in eight months. China has tightened rules on foreign investment, which has thwarted a number of overseas mergers and acquisitions. The rise in reserves could be signaling that these measures have had some effect, although we note that the Chinese New Year also fell mostly in February, which may have distorted the measure. Still, the rise in reserves does give the Xi regime some breathing room and may ease pressure on the government to add additional measures to restrict outflows.

The Reserve Bank of Australia left rates unchanged, as expected. The AUD rose modestly on the news. The ECB meets on Thursday; although no change in policy is expected, the markets will pay close attention to forward guidance. The Eurozone economy is showing signs of improvement and inflation has lifted, although the latter has mostly been a function of rising oil prices. If the ECB's guidance remains unchanged, we could see the EUR weaken.

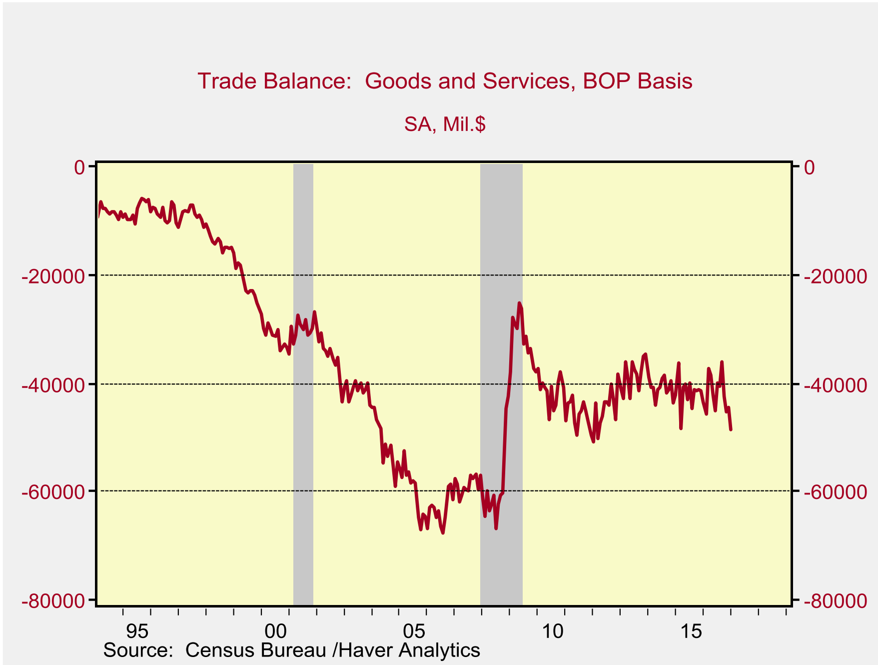
Peter Navarro, President Trump's head of the National Trade Council, again called out Germany for its massive trade surplus and accused the country of using the Eurozone as a cover for policies that triggered the growing surplus. Although Navarro's economic nationalism lies outside mainstream economic thought, we agree with his analysis of Germany's policy mix. Germany has effectively colonized the Eurozone through its saving and investment policies, creating conditions where other nations in the group, especially in the southern tier of Europe, cannot compete with German productivity. Without the ability to depreciate their currencies, these states must either depress their labor costs through unemployment to improve competitiveness or rely on Germany to expand its economy to raise wages in Germany and improve the southern tier's competitiveness. Germany is forcing the former condition on the southern tier, which has been negative for their economies. However, this inter-Eurozone condition has tended to weaken the euro, making it more competitive with the rest of the world.

What does seem to be lacking from Navarro's analysis is a recognition of the dollar's reserve status. As the supplier of the reserve currency, the U.S. must run trade deficits because a surplus would effectively reduce the global money supply, cutting global economic growth. If the Trump administration makes good on its promises to reduce the trade deficit, there will be fewer dollars available for the global economy and, very likely, a slowdown in the global economy. We note today that the OECD is warning that the upswing in financial markets and surveys, by itself, won't necessarily guarantee a stronger global economy. The OECD is currently forecasting global GDP growth of 3.3% for 2017 and 3.6% for next year. This is roughly average for the past decade. The G-20 meets next week in Germany. We will be watching to see how the Trump administration handles its first major international meeting.

Finally, in an update to this week's WGR, North Korea has banned Malaysians in the country from leaving in response to the ouster of the North Korean ambassador from Malaysia. This makes Malaysians in North Korea virtual hostages of the regime.

U.S. Economic Releases

The trade deficit was in line with expectations at $48.5 bn. This is the widest deficit since March 2012. The increase in the trade deficit may be the result of an increase in imports due to a stronger dollar. If trade continues to hinder GDP growth within the U.S., we expect President Trump to push harder for renegotiations of trade agreements. It is worth noting that President Trump has been relatively quiet about the border adjustment tax, despite initially dismissing it as being too complicated.



The chart above shows the trade balance of goods and services. The trade balance has been somewhat volatile but has generally moved sideways.

The table below shows the domestic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
15:00	Consumer Credit	m/m	jan	$17.250b	$14.160b	**
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								
China	Foreign Reserves	y/y	jan	$3.0051 tn	$2.9982 tn	$2.9690 tn	**	Equity and bond neutral
Japan	Official Reserve Assets	y/y	feb	$1.2323 tn	$1.2316 tn		**	Equity and bond neutral
Australia	AiG Perf of Construction Index	y/y	feb	53.1	47.7		**	Equity bullish, bond bearish
	ANZ Roy Morgan Weekly Consumption	m/m	mar	113.9	119.1		**	Equity and bond neutral
	Foreign Reserves	y/y	feb	A$66.8 bn	A$68.6 bn		**	Equity and bond neutral
EUROPE								
Eurozone	GDP	y/y	4q	1.7%	1.7%	1.7%	**	Equity and bond neutral
	Household Consumption	y/y	4q	0.4%	0.3%	0.5%	**	Equity and bond neutral
	Government Expenditure	y/y	4q	0.4%	0.5%	0.4%	**	Equity and bond neutral
	Gross Fix Capital	m/m	4q	0.6%	0.2%	0.6%	**	Equity and bond neutral
Germany	Factory Orders	m/m	jan	-0.8%	8.1%	4.3%	**	Equity bearish, bond bullish
France	Budget Balance YTD	y/y	jan	-5.4 bn	-69.0 bn		**	Equity and bond neutral
Italy	PPI	y/y	feb	2.8%	0.9%		**	Equity and bond neutral
U.K.	Halifax House Prices	m/m	feb	0.1%	-0.9%	0.4%	**	Equity and bond neutral
Switzerland	Foreign Reserves	m/m	feb	668.2 bn	643.7 bn		**	Equity and bond neutral
Russia	Official Reserve Assets	y/y	feb	397.3 bn	390.6 bn	395.5 bn	**	Equity and bond neutral
	CPI	y/y	feb	4.6%	5.0%	4.6%	**	Equity and bond neutral
AMERICAS								
Brazil	GDP	y/y	4q	-2.5%	-2.9%	-2.4%	**	Equity and bond neutral
	PPI Manufacturing	m/m	feb	-0.03%	0.80%		**	Equity and bond neutral
Canada	International Merchandise Trade	m/m	feb	0.81 bn	0.92bn	0.75bn	**	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)	110	110	0	Up
3-mo T-bill yield (bps)	71	71	0	Neutral
TED spread (bps)	40	39	1	Neutral
U.S. Libor/OIS spread (bps)	87	86	1	Neutral
10-yr T-note (%)	2.50	2.50	0.00	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	25	25	0	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	down			Down
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate	1.50%	1.50%	1.50%	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	$56.17	$56.01	0.29%	Short Covering
WTI	$53.37	$53.20	0.32%	
Natural Gas	$2.84	$2.90	-2.00%	
Crack Spread	$16.62	$16.09	3.33%	
12-mo strip crack	$14.01	$13.62	2.86%	
Ethanol rack	$1.58	$1.58	-0.09%	
Metals				
Gold	$1,223.10	$1,225.29	-0.18%	Stronger Dollar, Fed Expectations
Silver	$17.70	$17.78	-0.46%	
Copper contract	$263.65	$265.20	-0.58%	
Grains				
Corn contract	$ 377.25	$ 378.50	-0.33%	
Wheat contract	$ 457.50	$ 458.50	-0.22%	
Soybeans contract	$ 1,035.00	$ 1,037.25	-0.22%	
Shipping				
Baltic Dry Freight	979	939	40	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.4		
Gasoline (mb)		-2.0		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.50%		

Weather

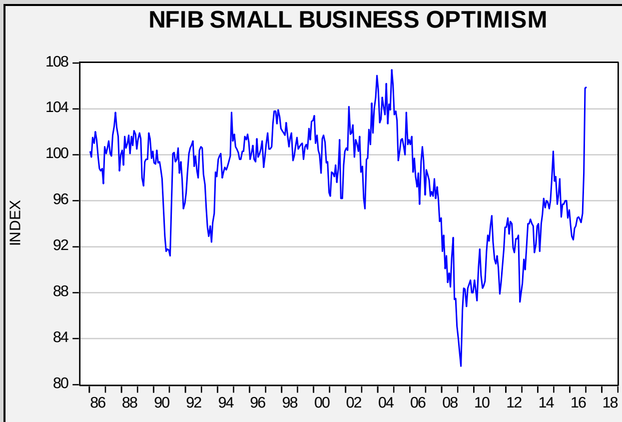
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, while the northern region is expected to have cooler temps. Precipitation is expected for most of the country, excluding the southwestern region.

Asset Allocation Weekly Comment

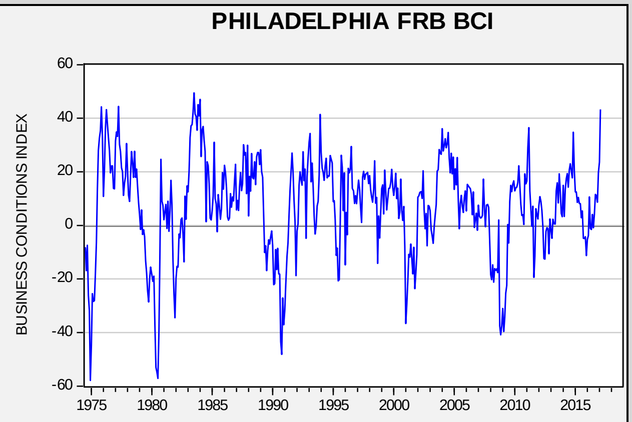
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

March 3, 2017

Since the election of President Trump, a number of sentiment indicators have risen strongly. There is concern that the improving sentiment isn't warranted. In this week's report, our research supports the conclusion that improving sentiment is better described as a reflection of the overall state of the economy. In other words, our analysis suggests that the improvement in sentiment is actually more in line with the economy and the earlier pessimism was probably excessive.

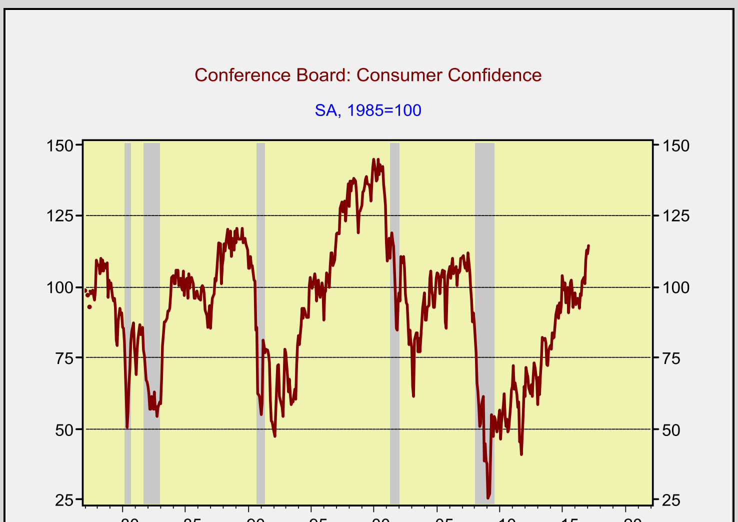


Sources: Bloomberg, CIM



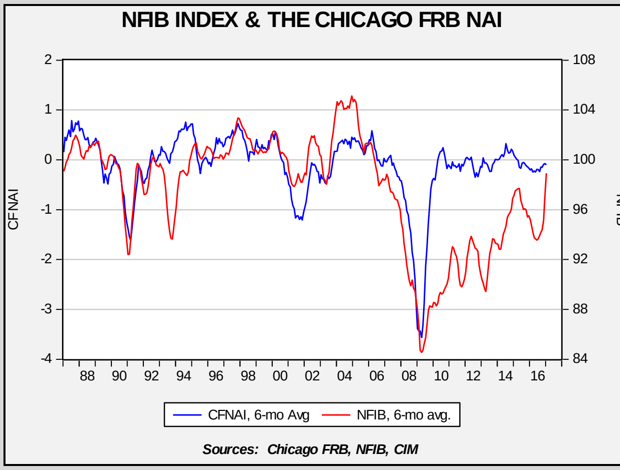
Sources: Philadelphia FRB, CIM

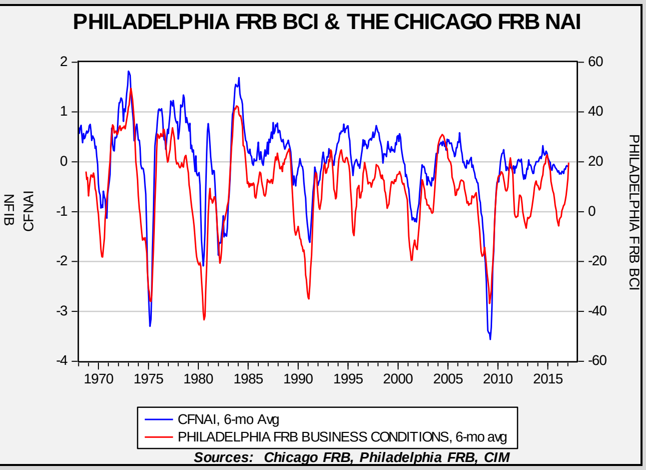
The chart on the left shows the National Federation of Independent Business (NFIB) Optimism Index and the one on the right is the Philadelphia FRB Business Conditions Index (BCI). Both have jumped since the November elections. Consumer confidence has improved as well.



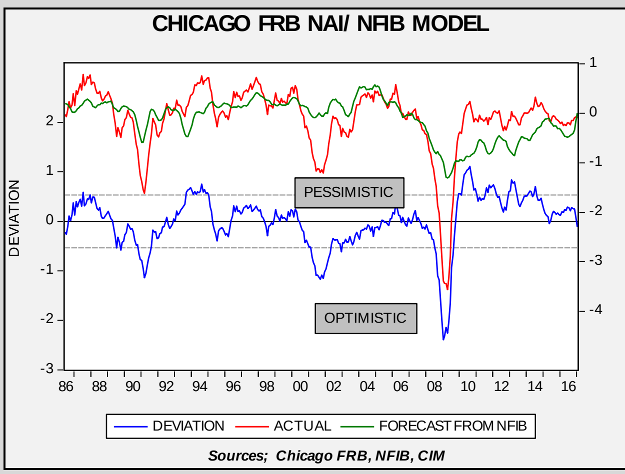
Source: The Conference Board /Haver Analytics

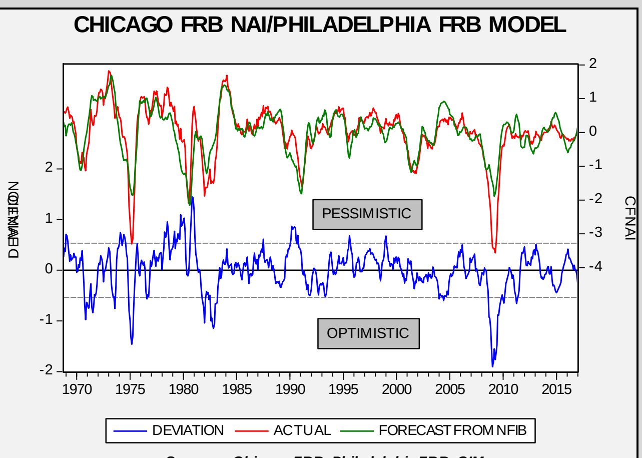
To compare how the business sentiment indicators have reacted to the actual data, we compared the aforementioned NFIB and BCI indices to the Chicago FRB's National Activity Index (CFNAI). The latter index is a broad-based measure of the economy that captures both business and household activity. To reduce the volatility in all these measures, we have smoothed them with a six-month moving average.





Note that in both cases, the sentiment indicators and the CFNAI have tended to track each other. Interestingly enough, post-2008, small business sentiment has dramatically lagged the overall performance of the economy. It would appear that concerns about the Affordable Care Act and other regulations dampened small business sentiment.

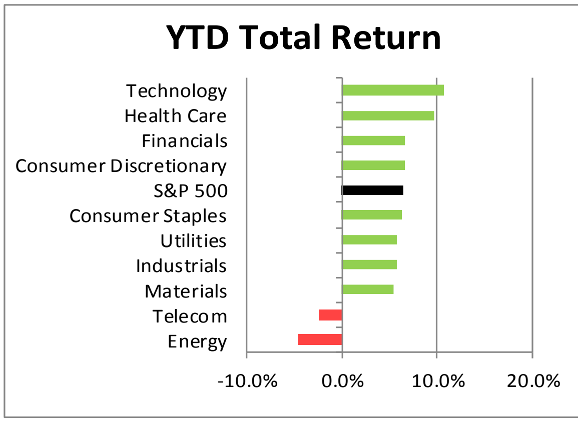


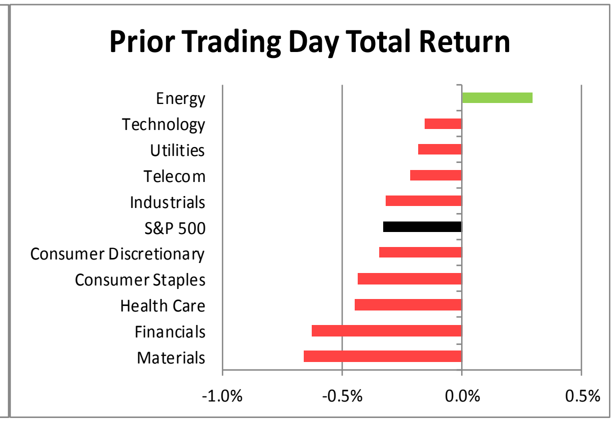


These two charts show the results of regressions where the CFNAI is the dependent variable and either the NFIB or the BCI is the independent variable. When the model suggests that sentiment is too pessimistic relative to the economy, the deviation line is above zero. The recent jump in the NFIB (on a smoothed basis) suggests that small business sentiment is just now reflecting the overall economy. That could mean that if sentiment remains elevated either the model will turn optimistic or, perhaps, the economy will improve. The Philadelphia FRB BCI has just turned modestly optimistic but remains in the normal range of deviation values. Thus, the improvement in sentiment is notable but appears to be more of a reversion to the actual performance of the economy. Interestingly enough, both models indicate that the impact of sentiment on the economy is coincident, meaning sentiment doesn't necessarily lead to better economic performance. At the same time, the models also suggest that the improvement in sentiment doesn't signal conditions of excessive optimism, either. This means that the rise in sentiment isn't necessarily creating conditions of disappointment which might adversely affect equity markets.

Data Section

U.S. Equity Markets – (as of 3/6/2017 close)

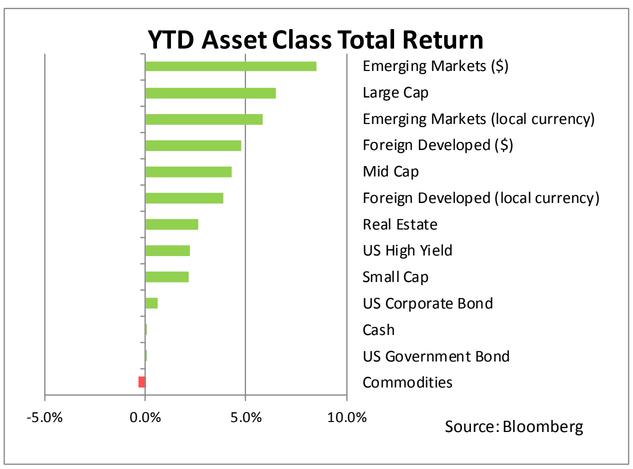




(Source: Bloomberg)

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 3/6/2017 close)

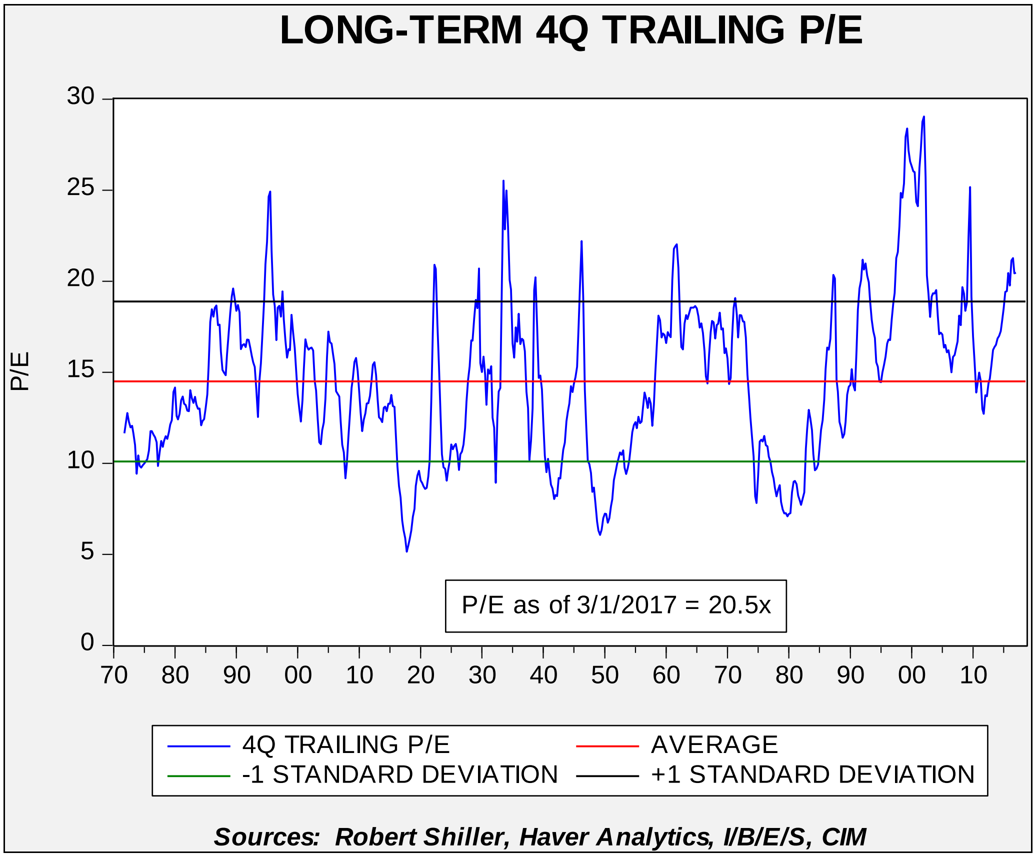


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2017



Based on our methodology,[1] the current P/E is 20.5x, up 0.7 from last week. As previously discussed in the commentary above, we have moved Q4 from Thomson/Reuters to Standard & Poor's, which has a lower calculation from operating earnings. This drop in earnings coupled with a rising market have led to the rise in the P/E multiple.

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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.