Confluence Investment Management

Daily Comment

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

[Posted: May 16, 2017—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.1% 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 0.7% and the Shenzhen index up 2.1%. U.S. equity index futures are signaling a higher open. With 455 companies having reported, the S&P 500 Q1 earnings stand at $30.71, higher than the $29.24 forecast for the quarter. The forecast reflects a 9.1% increase from Q1 2016 earnings. Thus far this quarter, 73.2% of the companies reported earnings above forecast, while 20.4% reported earnings below forecast.

Another controversy…the *Washington Post*[1] reported late yesterday that President Trump revealed highly classified information to the Russian foreign minister and ambassador. Although not illegal (the president essentially can determine the distribution and classification of information), the decision to share the intelligence is potentially reckless. The sources of the information appear to be from deeply imbedded moles within ISIS and from a Middle East source. The decision to share the information will likely put these resources at risk; the *WP* story indicates that the president revealed the city controlled by ISIS that generated the information. U.S. intelligence agencies did not reveal this information with close allies so the action is troublesome. Although the official stance of the administration is that nothing was revealed, it is notable that Tom Bossert, the assistant to the president on homeland security and counterterrorism, soon placed calls to the CIA and NSA to warn them of the breech. If nothing was revealed, it seems odd that Bossert would have notified the two primary U.S. intelligence agencies of what occurred.

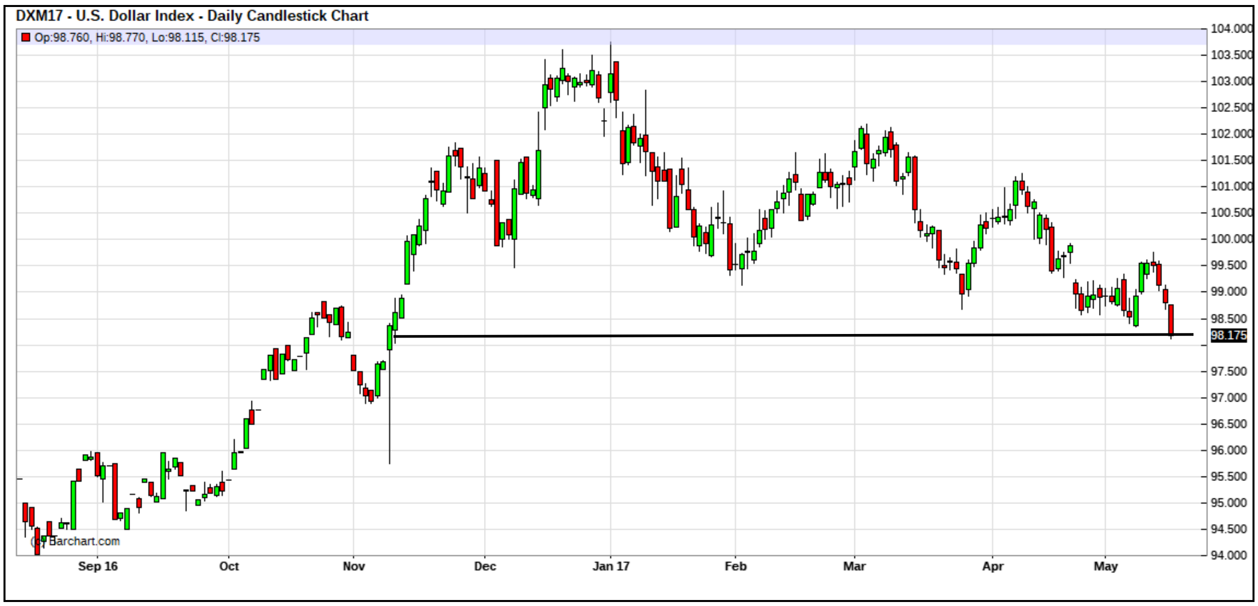
There are two issues that concern us about this report. First, if this turns out to be a serious mishandling of critical information, other nations will stop sharing intelligence with the U.S.[2] In fact, it is highly possible that U.S. intelligence agencies will be less open to sharing intelligence with the White House, fearing the security of the information. Second, it's important to remember that while there is a lot of information the government "classifies," there is some information that is much more important than others. In general, the "sources and methods" is often more important than the information itself. This may be one of those cases. The information seems to relate to the laptop ban on some international flights; it appears quite likely that some terrorist group has figured out how to put a bomb on a laptop that is difficult to detect. The fact that laptops haven't been banned on U.S. flights suggests that either (a) TSA's methods

[1] https://www.washingtonpost.com/world/national-security/trump-revealed-highly-classified-information-to-russian-foreign-minister-and-ambassador/2017/05/15/530c172a-3960-11e7-9e48-c4f199710b69_story.html?utm_term=.f059dc318ad3

[2] Concerns over sharing intelligence have been rising since Trump was elected. http://www.haaretz.com/israel-news/1.764711

can screen these bombs, or (b) (the more likely scenario) the laptop bomb is so sophisticated that they can't be mass produced and thus the terrorist group wants to create a greater sense of terror than attacking an international flight would probably bring. If the president's actions inadvertently reveal a path to sources and methods, it would seem reckless.

Here is where this action may start to affect financial markets. Political events tend to be "tail" risks. In other words, they are the sort of things that are difficult to predict, and if predicted, are difficult to determine their market effects. At a minimum, a White House that seems unable to avoid constant controversy will eventually undermine market confidence. Financial markets have put a good deal of faith into this president; the sharp rally in equities and the dollar strength we have seen since his election are a testament to the hopes that this administration would cut taxes, boost infrastructure spending and lift growth. Instead, we are seeing precious political capital squandered in unnecessary errors that distract policymakers from moving on the agenda the markets expected. Perhaps the "canary in the cage" is the dollar.



(Source: Barchart)

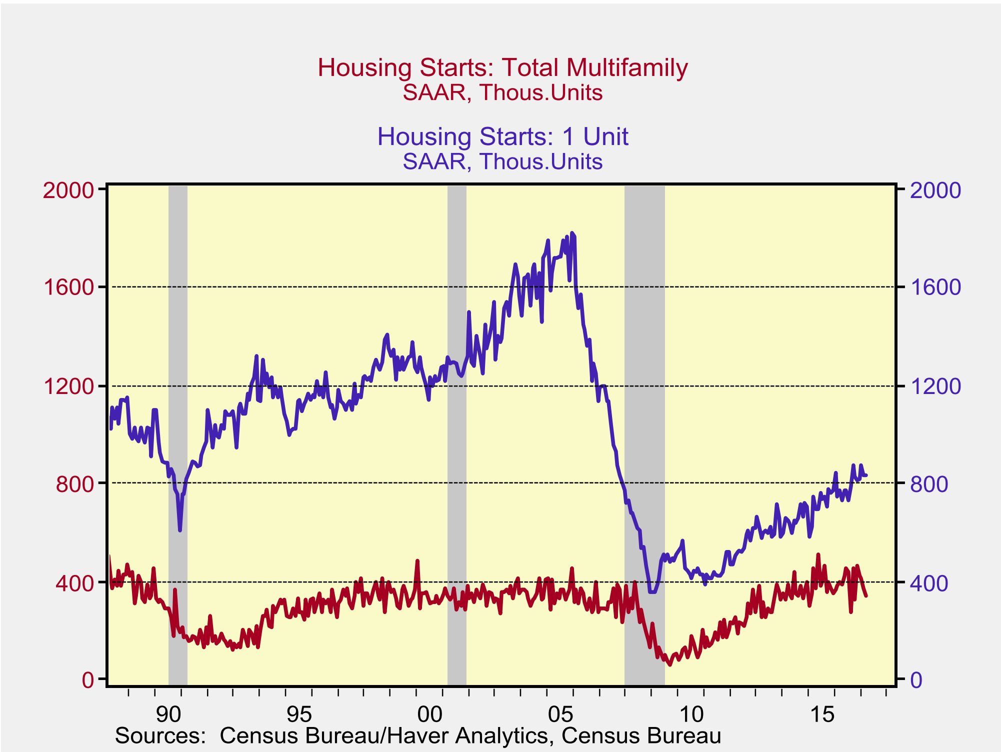
The line on the chart shows the dollar index over the past nine months. We have placed a horizontal line from the election to now. The dollar has essentially given up all of the post-election gains even though the FOMC appears on a path to at least two, if not three, more rate hikes this year. If other markets begin to conclude that the administration isn't going to get anything accomplished, we may see similar moves in other markets as well.

This doesn't mean the White House can't recover. However, the current path is raising the chances that this administration will be unable to formulate policy which will be disappointing to investors. At the same time, the economy is holding up, earnings are solid and rates remain manageable. There is nothing that signals an immediate problem for equities. Unfortunately, the political situation is becoming more of a headwind when investors were anticipating a tailwind. That could become problematic as the year continues.

In other news, the recent ransomware attacks appear to be tied to North Korean hackers. Although the clues are not conclusive, a number of cybersecurity officials suggest that there is evidence pointing to North Korea. Apparently, the WannaCry virus used tools that North Korean hackers used against other targets in the recent past. At the same time, it should be noted that although this code isn't commonly used, it could have been copied by a criminal organization or another state with hopes of pinning it on the Hermit Kingdom as cover. Still, if the North Koreans were involved, it will tend to make it easier to put sanctions on them with wider support.

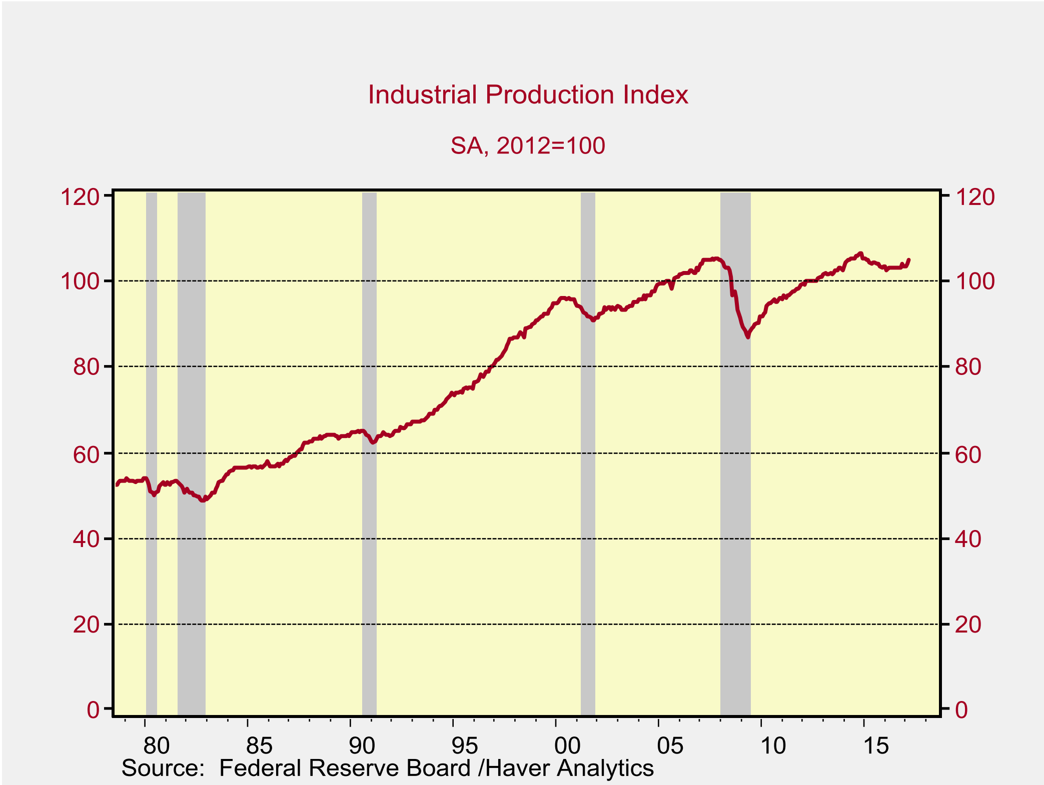
U.S. Economic Releases

Housing starts came in below expectations at -2.6%, compared to a forecast of a 3.7% increase from the prior month. The prior report was revised upward from -6.8% to -6.6%. Building permits came in below expectations at -2.5%, compared to a forecast of 0.2%. The prior report was revised downward from 3.6% to 3.4%.



The chart above shows single- and multi-family starts. Single-family starts are up 8.9% from last year and multi-family starts are down 15.1% over the same time period.

Industrial production came in above expectations at 1.0%, compared to a forecast of 0.4%. Capacity utilization came in above expectations at 76.7%, compared to a forecast of 76.3%. Manufacturing production came in above expectations at 1.0%, compared to a forecast of 0.4%.



The chart above shows the industrial production index over the past 30 years. Recently, industrial production has been stagnant, which could suggest that manufacturers are experiencing reduced exporting power as a result of the stronger dollar.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	MBA Mortgage Foreclosures	m/m	1q		1.5%	**
10:00	Mortgage Delinquencies	m/m	1q		4.8%	**
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								
Japan	Tertiary Industry Index	m/m	mar	-0.2%	0.2%	0.1%	**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	y/y	may	109.4	112.3		**	Equity and bond neutral
	New Motor Vehicle Sales	y/y	apr	0.1%	-3.0%		**	Equity and bond neutral
EUROPE								
Europe	EU27 New Car Registration	y/y	apr	-6.6%	11.2%		*	Equity and bond neutral
	Trade Balance	y/y	mar	23.1 bn	19.2 bn	18.7 bn	**	Equity bullish, bond bearish
	GDP	y/y	1q	1.7%	1.7%	1.7%	***	Equity and bond neutral
Germany	ZEW Survey Current Situation	m/m	may	83.9	80.1	82.0	**	Equity and bond neutral
	ZEW Survey Expectations	m/m	may	20.6	19.5	22.0	**	Equity bearish, bond bullish
France	CPI	y/y	apr	1.2%	1.2%	1.2%	***	Equity and bond neutral
Italy	GDP	y/y	apr	0.8%	1.0%	0.8%	***	Equity and bond neutral
UK	CPI	y/y	apr	2.7%	2.3%	2.6%	***	Equity and bond neutral
	RPI	y/y	apr	3.5%	3.1%	3.4%	**	Equity and bond neutral
	PPI Input	y/y	apr	16.6%	17.9%	17.0%	**	Equity and bond neutral
	PPI Output	y/y	apr	2.8%	2.5%	2.5%	**	Equity bullish, bond bearish
	HPI	y/y	mar	4.1%	5.8%	5.3%	**	Equity bearish, bond bullish
AMERICAS								
Canada	Existing Home Sales	y/y	apr	-1.7%	1.1%		**	Equity and bond neutral
	Bloomberg Nanos Confidence	m/m	may	58.1	59.0		**	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)	118	118	0	Up
3-mo T-bill yield (bps)	88	88	0	Neutral
TED spread (bps)	30	30	0	Neutral
U.S. Libor/OIS spread (bps)	104	103	1	Up
10-yr T-note (%)	2.35	2.34	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	31	31	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Down
yen	up			Down
pound	down			Neutral
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	$52.07	$51.82	0.48%	Russia and Saudi Arabia agree to extend output cut
WTI	$49.11	$48.85	0.53%	
Natural Gas	$3.36	$3.35	0.30%	
Crack Spread	$17.17	$16.96	1.23%	
12-mo strip crack	$14.26	$14.14	0.83%	
Ethanol rack	$1.68	$1.68	-0.27%	
Metals				
Gold	$1,234.81	$1,230.82	0.32%	Weaker dollar
Silver	$16.72	$16.63	0.54%	
Copper contract	$253.30	$253.90	-0.24%	
Grains				
Corn contract	$ 365.75	$ 367.75	-0.54%	
Wheat contract	$ 421.50	$ 423.25	-0.41%	
Soybeans contract	$ 965.25	$ 965.25	0.00%	
Shipping				
Baltic Dry Freight	994	1014	-20	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.8		
Gasoline (mb)		-1.0		
Distillates (mb)		-1.3		
Refinery run rates (%)		0.50%		

Weather

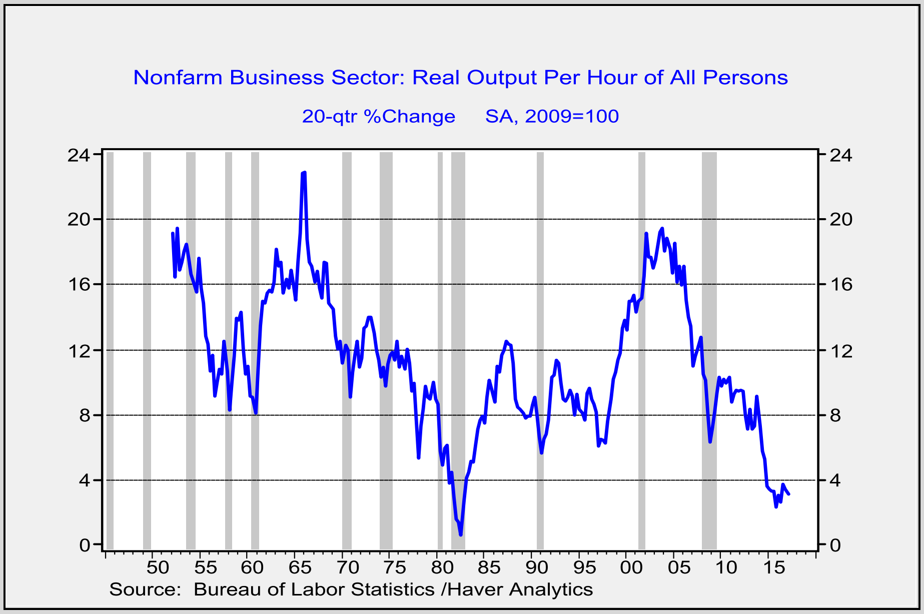
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the Midwest. Precipitation is expected for most of the country.

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.

May 12, 2017

Slow economic growth has plagued the West. Although the concern has been acute since the Great Financial Crisis (GFC), worries about slowing growth predated that event. Perhaps the most important factor contributing to sluggish growth has been tepid productivity growth.



This chart shows the five-year change in productivity; we use this longer term rate of change to more clearly show the trend in productivity growth. As the chart indicates, productivity growth is remarkably weak; in fact, in the postwar era, only the weakness seen in the depths of the 1981-82 recession recorded lower productivity growth by this measure.

Economic theory holds that production comes from the combination of land, labor, capital and entrepreneurship. Most models focus on capital and labor. The Cobb-Douglas production function[3] is a canonical expression of how economists think about forecasting output. Production is the combination of capital and labor, scaled by productivity. If productivity is constant, growth comes by adding capital (investment in plant and equipment, etc.) and workers (or, specifically, hours worked). If an economy increases its productivity, more output is gained for each additional unit of labor and capital. That's why falling productivity is such a problem; it

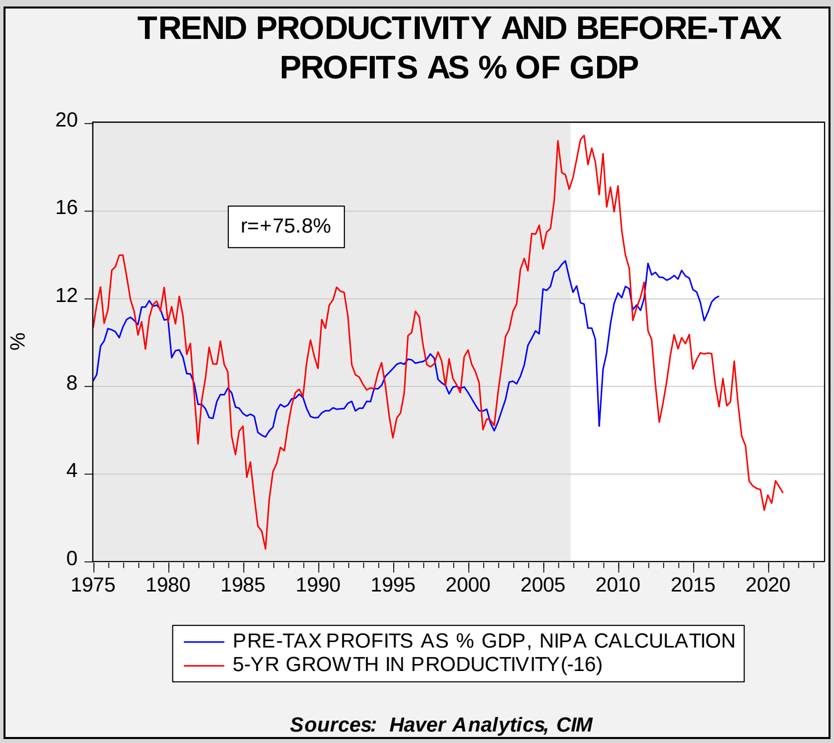
[3] **P(L, K) = bLαKβ, where**: • P = total production (the monetary value of all goods produced in a year) • L = labor input (the total number of person-hours worked in a year) • K = capital input (the monetary worth of all machinery, equipment and buildings) • b = total factor productivity • α and β are the output elasticities of labor and capital, respectively. These values are constants determined by available technology.

means that additional labor and capital resources must be deployed just to keep production steady.

Productivity is something of the holy grail of economics. Theories of what boosts productivity abound; deregulation and competition are thought to increase it, supporting entrepreneurship with low taxes could be a factor, education and immigration could support increases and, of course, technological progress is a necessary ingredient. However, no economist has yet been able to definitively say what causes productivity to universally rise under all conditions.

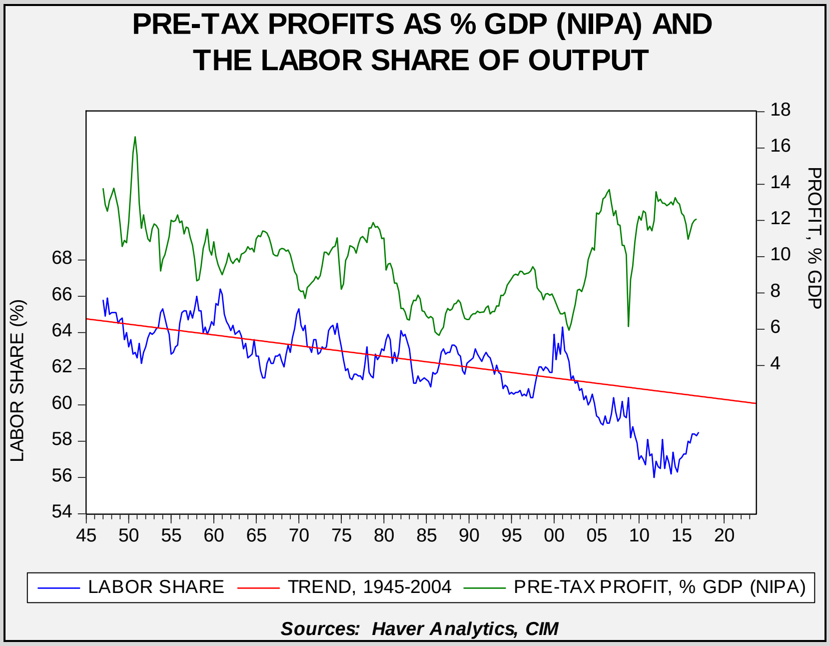
However, we can say that an economy with weak productivity growth will struggle. Capital and labor essentially divide total output and low productivity makes that division difficult. On the other hand, rising productivity can allow both capital and labor to enjoy a rising absolute share of output. Social peace is much easier to achieve with rising productivity. It is probably no accident that the rise of populism in the West has coincided with weak productivity growth.

From the mid-1970s into the GFC, the relationship between corporate profits and the five-year growth rate of productivity was fairly consistent.



This chart shows pre-tax corporate profits, on a national income product accounts basis, as a percentage of GDP along with the five-year growth rate of productivity. From the mid-1970s into 2007, the two series were highly correlated at 75.8%, with trend productivity leading profits by four years. Since 2007, the two are inversely correlated at the 53.3% level. Clearly, profits have remained elevated despite weak trend productivity, which begs the question—how did profits hold up in the face of falling productivity?

What has occurred is that relative labor compensation has fallen.



The upper line on this chart shows pre-tax profits as a percentage of GDP. The lower line shows labor's share of output along with a time trend calculated from 1947 to 2004. From 1947 through 2004, the share held fairly steady; although there was a clear downtrend, the slope was fairly benign. Clearly after 2004 the share fell well below trend, and the labor share plummeted after the GFC. It has recovered some of its losses since 2015 but the data is still well below trend. A falling share to labor has allowed firms to overcome weak productivity trends and retain high margins.

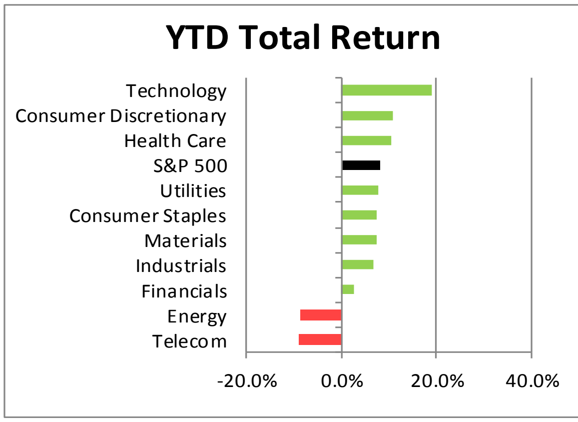
Why has labor's share of output declined? The media discusses a litany of reasons…technology and globalization have given firms market power over labor and allowed companies to keep wages contained despite tightening labor markets. Although this condition has been a boon for profit margins, it has been difficult for workers and we suspect the rise of populism is a direct result of wage pressures.

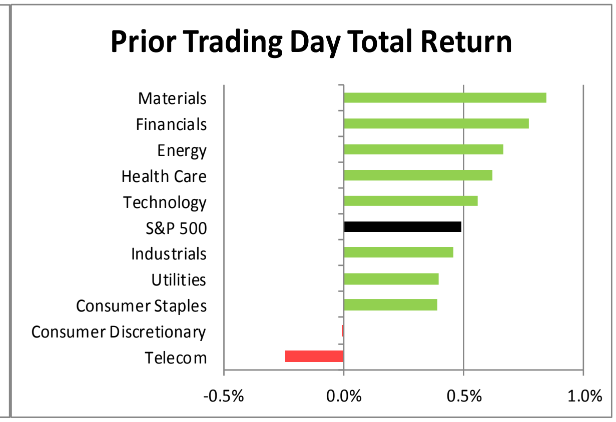
As the first chart shows, because of the lagged effect of trend productivity, the effects of weak productivity will become acute starting around mid-2018. Without a decline in the labor share of output, profit margins will come under growing pressure. Using a simple regression of trend productivity and labor share, to maintain pre-tax profits of 12% would require the labor share to fall to 55% by the end of 2018. If the labor share remains constant, profit margins will decline to 9.6% of GDP. This level is still historically high but, given market expectations of continued strong profit margins, even this decline will be problematic.

The Trump administration continues to straddle the line between a traditional GOP stance that favors business and capital and a populist variant that calls for trade protection and immigration restrictions. If President Trump decides to favor his working class supporters, which would likely boost the labor share, profit margins would come under even more pressure. This is a factor we will be monitoring closely as the year progresses.

Data Section

U.S. Equity Markets – (as of 5/15/2017 close)

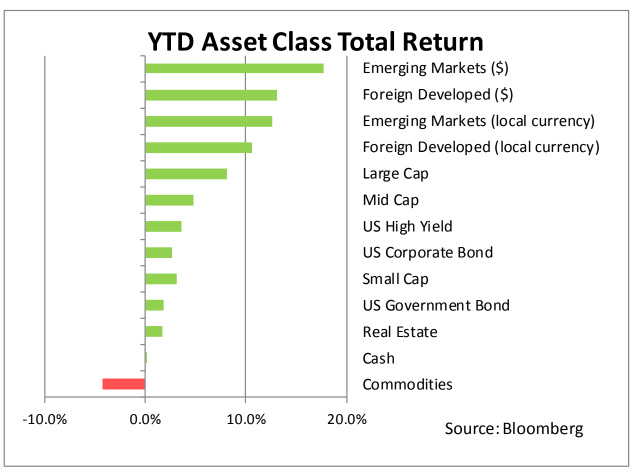




(Source: Bloomberg)

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 5/15/2017 close)

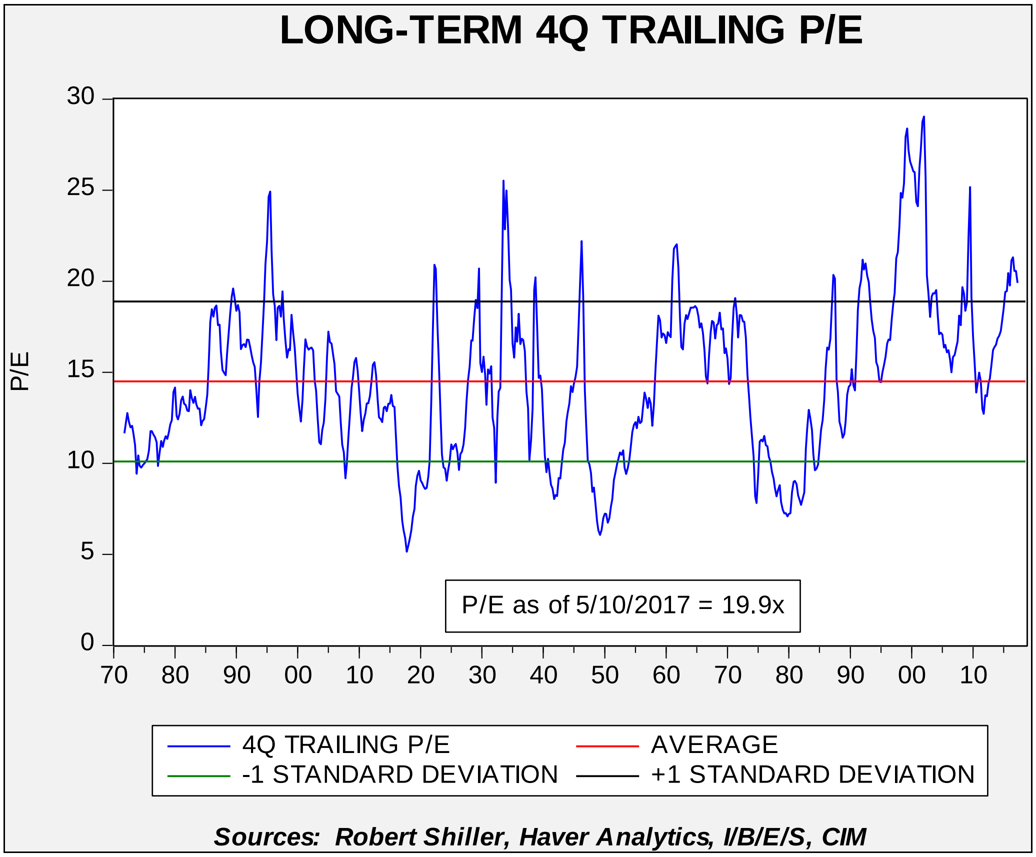


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 11, 2017



Based on our methodology,[4] the current P/E is 19.9x, down 0.1x from last week. The decline in the multiple has mostly come from the continued rise in operating earnings.

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[4] 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 two actual quarters (Q3 and Q4) and two estimates (Q1 and Q2). 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.