Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: May 22, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.1% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 1.4%. U.S. equity index futures are signaling a higher open. With 473 companies having reported, the S&P 500 Q1 earnings stand at $30.80, 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 20.3% reported earnings below forecast.

The news over the weekend was fairly quiet, although there were several things we noted:

The first leg of the president's trip went rather well: President Trump offered support to authoritarians in Egypt and the Gulf State which was well received. Iran was isolated as the problem state in the region, a shift from the Obama administration. Military and other sizeable investments were announced. And, the president delivered a speech on Islam that was well crafted and delivered. There was a significant break in policy from the previous administration. First, the arms sales were three times larger than what was done over two terms of the previous president. Second, the partial thaw with Iran that President Obama had started is over. So, all in all, the first part of the trip was a success.

The second leg could be a bit more challenging: Israeli leaders are not pleased with President Trump's decision to share intelligence with Russian diplomats. The massive arms deal with Saudi Arabia will also raise concerns. Although Israel and the Gulf States share a common enemy, Iran, the Israelis rightly fear that arming the Arab states may present a problem for them at some point. Finally, the administration's apparent decision to at least slow the move of the U.S. embassy from Tel Aviv to Jerusalem is a disappointment to parts of PM Netanyahu's conservative coalition.

Grants to loans: The Trump administration's budget proposal will end some of the foreign military grants, converting them to loans. The State Department believes this would affect about $1.0 bn in aid to various nations. Although this proposal is consistent with the platform Trump campaigned on, it may lead some of these nations to cancel the purchase and seek equipment from other nations. It will also make them less amenable to "strings attached" to the use of the equipment if they are buying it rather than receiving it as a gift. This is an old conundrum—if you rely on allies to do your bidding in foreign policy, they may not be easy to control.

U.K. polls are tightening: A week ago, the Tories were holding a 20% point lead over Labour; that lead has narrowed to 9% in the latest polls. The most recent gaffe was a proposed tax on the elderly which would require them to pay most of their support costs until they reach a net worth of £100k. Dubbed the "Alzheimer tax," it was slammed in the press; PM May has retreated on the policy only to now face criticism that "the lady is for turning" in comparison to Lady Thatcher, who was not for turning. We still expect the Conservatives to win but the mandate to manage Brexit will be compromised if the victory is narrow.

Rouhani wins: Hassan Rouhani won a second term in convincing fashion, taking 57% of the electorate. Although we doubt he will be able to make major changes to liberalize Iran, his win does act as a bulwark against more hardline policies. However, Rouhani may have to move in the hardline direction if the Sunni coalition is able to contain Iran's regional ambitions, as noted above.

Pedro Sanchez returns: Eight months ago, Spanish Socialists ousted Sanchez when he refused to compromise on the vote to allow PM Rajoy to form a minority government. Sanchez's return to leadership likely means the previously center-left Socialists will lean left to retake votes from the radical Podemos Party. The polarization of the Spanish electorate is reflected, to greater or lesser extent, across Europe.

Another North Korea missile test: The Hermit Kingdom launched another ballistic missile into the Sea of Japan, flying around 300 miles. Although this was a shorter test than what we have seen previously, the cycle of tests is accelerating which means the country is probably moving up the missile-learning curve faster.

An OPEC deal? Saudi oil officials suggest they have gotten agreements from other cartel members, although there is some trepidation over extending it past six months. There are two factors at play; first, the longer this agreement is in place, the harder it will be to maintain output cuts. If Saudi Arabia wants to keep the price propped up, it will need to continue to make the largest production cuts. Second, the ECB and the Fed may play a bigger role in oil prices; a weaker dollar would be bullish for oil and likely overshadow anything the cartel does in terms of output restrictions.

Thinking about narratives: Earlier this year, Robert Shiller wrote a paper[1] suggesting that data and theory can only carry analysis so far. In addition, it's useful to understand what people were thinking, in other words, the "narrative" they were using to explain phenomena around them. Since Shiller is an economist, he examines such narratives with reference to markets and economics. In the Sunday *NYT*,[2] he notes that mere economic data about housing really didn't do a good job in forecasting the housing bubble. In his report, he notes that pervasive reports about "flipping," where real estate investors would buy a home, make cosmetic improvements and sell the property quickly to make scads of money, became part of the "narrative" about the strong housing market. The early success of flipping led more investors to get into the market and use increasing leverage to further magnify the gains. Of course, when home prices stopped rising, the leverage became a serious problem. Shiller's op-ed is related to a similar one in the review section of the same paper reporting that psychologists are beginning to conclude that one of the factors that separates human mental activity from animals is that we project into the

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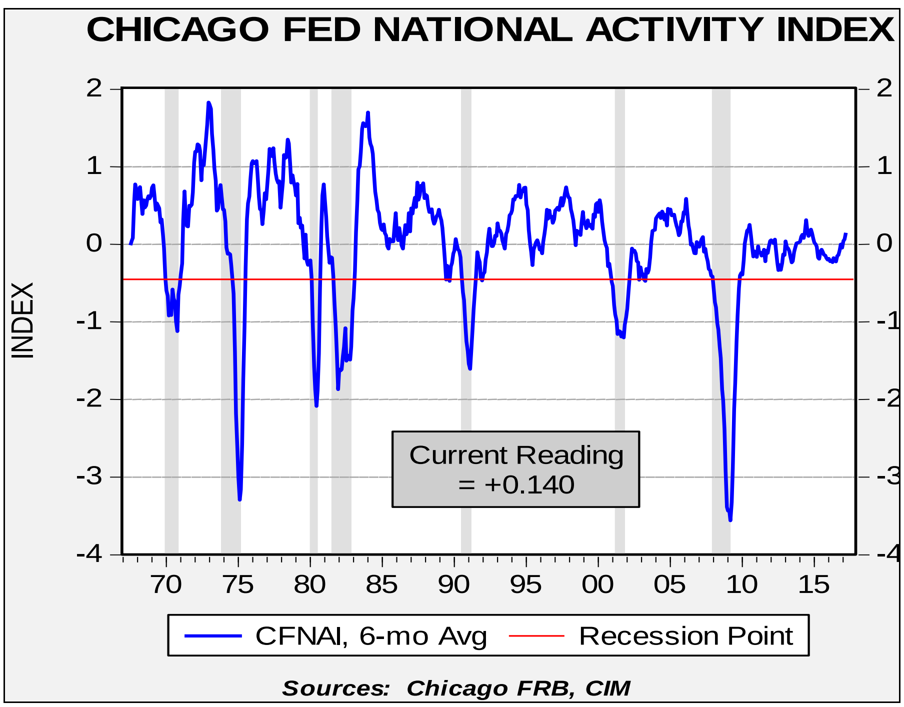
[1] http://cowles.yale.edu/sites/default/files/files/pub/d20/d2069.pdf
[2] https://www.nytimes.com/2017/05/18/upshot/how-tales-of-flippers-led-to-a-housing-bubble.html?ref=business

future. In fact, it's almost impossible for us to be "in the moment."[3] The article suggests that the primary function of memory is to project into the future. We have seen this in the narrative people have about markets; when we go through something painful, like the burst of the tech bubble, we are on guard for that event continually, almost guaranteeing it won't happen the same way again. This practice, sadly, makes us vulnerable to other "unexpected" outcomes.

Thoughts about trade: This week's "Odd Lots"[4] podcast interviewed Dave Donaldson, the recent winner of the John Bates Clark medal for the best economist under the age of 40. He conducted a massive study of the Indian railway system under British rule to measure how trade within India changed with better infrastructure. He discovered that once trading expands, specialization develops. This is true of both international and intranational trade. Although this specialization makes the economy more efficient, the improvement from trade is much less welcome to those who used to supply a local market and are then eliminated by a distant competitor.

U.S. Economic Releases

The Chicago Fed National Activity Index came in above expectations at 0.49 compared to the forecast of 0.10.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The current reading is 0.14, an improvement over the last report of 0.068.

[3] https://www.nytimes.com/2017/05/19/opinion/sunday/why-the-future-is-always-on-your-mind.html?src=me
[4] https://itunes.apple.com/us/podcast/odd-lots/id1056200096?mt=2&i=1000385614557

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
10:00	Patrick Harker Speaks on Economy in Philadelphia	President of the Federal Reserve Bank of Philadelphia
19:30	Lael Brainard Speaks on Role of Inclusion in Economy	Member of the Board of Governors
20:10	Charles Evans Speaks in Shanghai	President of the Federal Reserve Bank of Chicago

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	Trade Balance	y/y	apr	481.7 bn	614.7 bn	520.7 bn	**	Equity and bond neutral
	Exports	y/y	apr	7.5%	12.0%	8.0%	**	Equity bearish, bond bullish
	Imports	m/m	apr	15.1%	15.8%	14.8%	**	Equity bearish, bond bullish
	Convenience Store Sales	m/m	apr	0.3%	0.0%		**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	may	-3.3	-3.6	-3.0	**	Equity bearish, bond bullish
UK	Rightmove House Prices	y/y	may	3.0%	2.2%	2.0%	**	Equity and bond neutral
Switzerland	Money Supply M3	y/y	apr	3.0%	2.8%		**	Equity and bond neutral
	Total Sight Deposits	m/m	may	575.5 bn	575.0 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	may	487.5 bn	484.5 bn		**	Equity and bond neutral
Russia	PPI	y/y	apr	7.6%	11.3%	9.1%	**	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)	119	117	2	Up
3-mo T-bill yield (bps)	90	89	1	Neutral
TED spread (bps)	29	28	1	Neutral
U.S. Libor/OIS spread (bps)	105	105	0	Up
10-yr T-note (%)	2.25	2.24	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	down			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	$54.04	$53.61	0.80%	Optimism that OPEC will extend production cuts
WTI	$50.78	$50.33	0.89%	
Natural Gas	$3.31	$3.26	1.78%	
Crack Spread	$18.11	$18.09	0.08%	
12-mo strip crack	$15.23	$15.23	-0.02%	
Ethanol rack	$1.62	$1.61	0.32%	
Metals				
Gold	$1,257.05	$1,255.93	0.09%	Market Uncertainty
Silver	$17.00	$16.87	0.80%	
Copper contract	$258.60	$258.15	0.17%	
Grains				
Corn contract	$ 373.75	$ 372.50	0.34%	
Wheat contract	$ 438.00	$ 435.25	0.63%	
Soybeans contract	$ 956.75	$ 953.00	0.39%	
Shipping				
Baltic Dry Freight	956	957	-1	

Weather

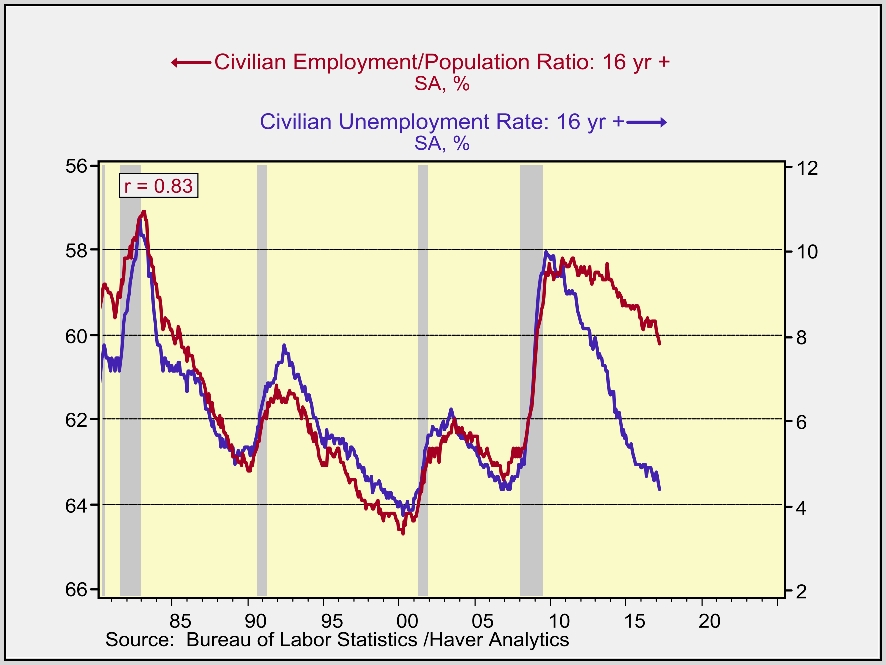
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected for the central region. Precipitation is expected for most of the country.

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.

May 19, 2017

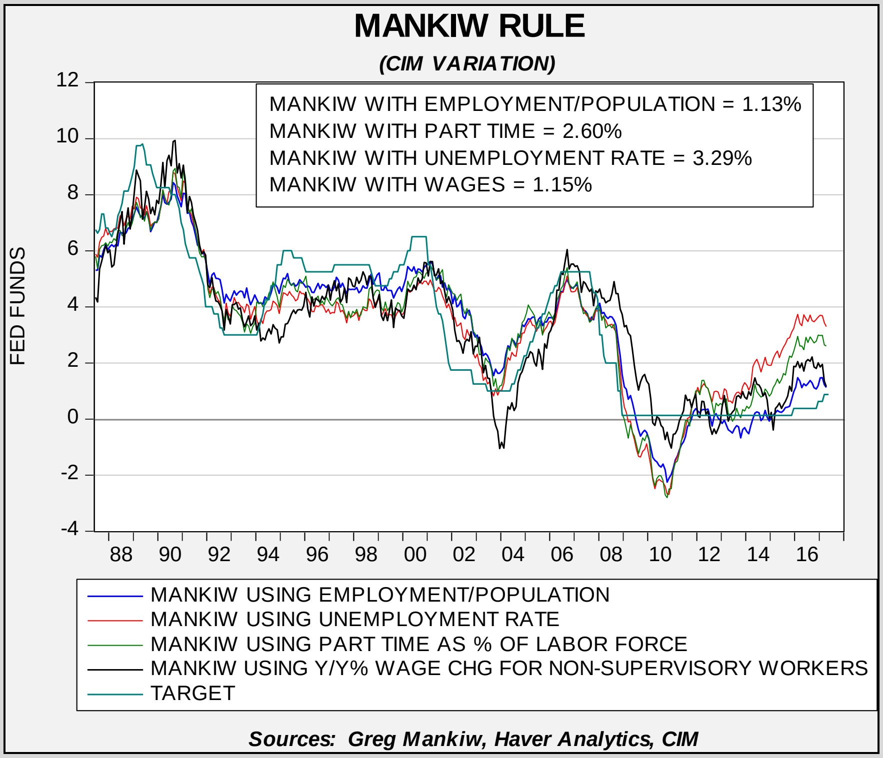
One of the significant "known/unknowns" is the true condition of the labor market. The below chart highlights the issue.



The blue line is the unemployment rate, while the red line is the employment/population ratio (scale inverted). From 1980 until 2010, these two series closely tracked each other. During the period since the last recession, the two have clearly diverged. The current unemployment rate is 4.4%; if the relationship from 1980 to 2010 had held constant, the unemployment rate would be approximately 7.5%.

For policymakers, the problem is determining which measure of the labor market best characterizes the degree of slack in the economy. If the employment/population ratio is correct, then ample slack exists and policymakers should keep policy accommodative. If the unemployment rate is the better measure, then labor markets are tight and the FOMC needs to be raising rates.

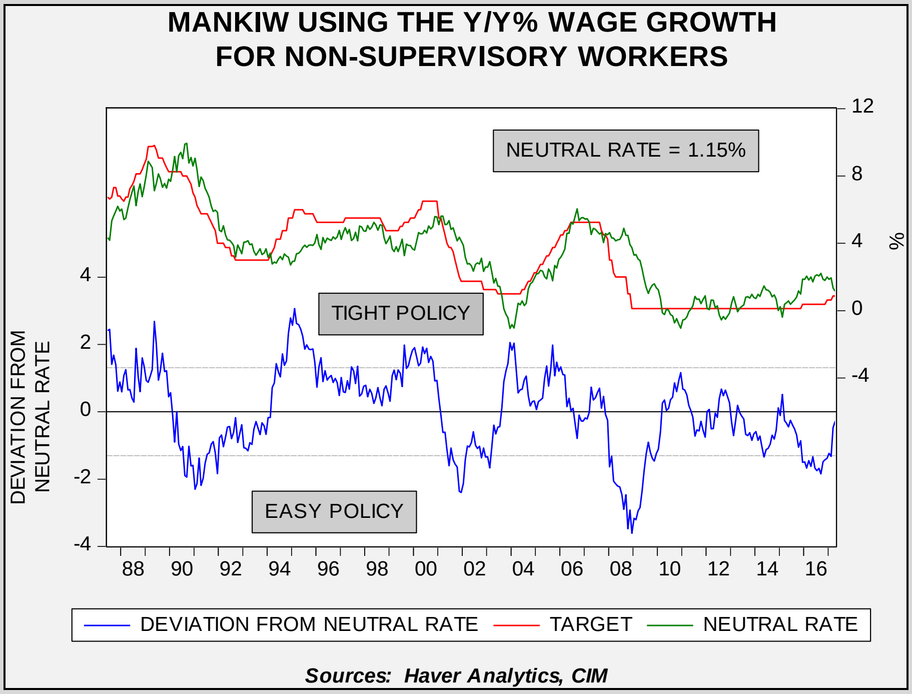
To determine the degree of accommodation, we use four variations of the Mankiw Rule. The Mankiw Rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral 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.



Sources: Greg Mankiw, Haver Analytics, CIM

Using the unemployment rate, the neutral rate is now 3.29%. Using the employment/population ratio, the neutral rate is 1.13%. Using involuntary part-time employment, the neutral rate is 2.60%. Using wage growth for non-supervisory workers, the neutral rate is 1.15%. Note that for two of the variations, wage growth and the employment/population ratio, the FOMC is already near the neutral rate. The fact that policymakers appear driven to lift rates further suggests they believe that some other measure is a proper measure of slack.

Since the Great Financial Crisis, it has been unclear which measure of employment accurately characterizes the labor market. Because the Fed had been conducting very easy monetary policy, the debate was mostly academic; that isn't the case anymore. If the most accurate measure is actually the employment/population ratio or wage growth, but the Fed thinks either the unemployment rate or involuntary part-time employment is the correct indicator of slack, then policymakers could run the risk of overtightening and potentially risking a recession.



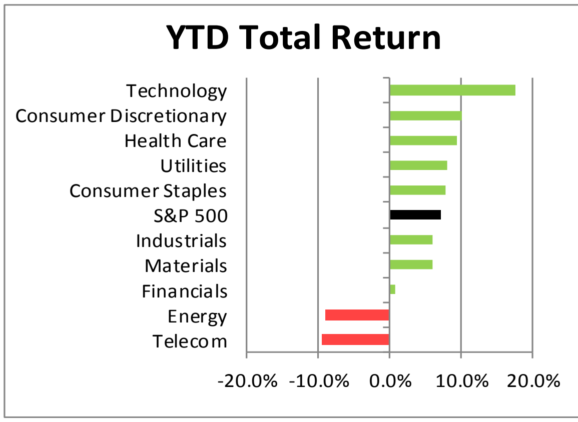
This chart shows the issue; this is the Mankiw model variation using wage growth. The lower line on the chart shows the deviation from the neutral rate as projected by the model. When the rate is below zero, policy is leaning toward accommodative. Note the parallel lines on the lower part of the chart; these lines measure a standard error on either side of the neutral rate. When the deviation is within the parallel lines, it suggests policy is mostly neutral. Thus, based on wage growth, we are close enough to neutral policy that the Fed could stand pat until either wage growth accelerates or core CPI rises.

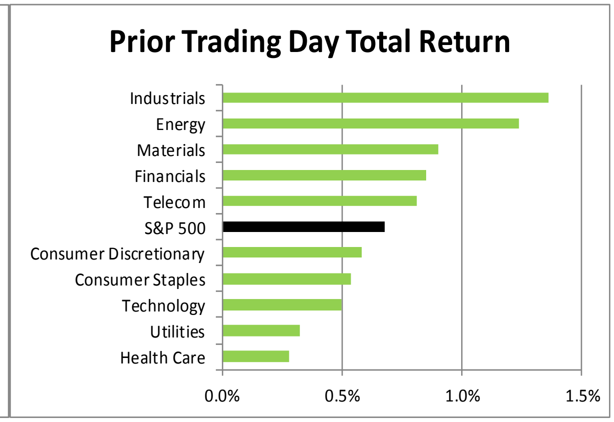
Thus, the coming months will be key. If this model is the most accurate measure of slack then the Fed needs, at most, one more hike. Policy would be tight at a fed funds target of 2.40%, so there is some margin for error. Based on the dots chart, we would be at this level by the end of next year. Simply put, we could be approaching a period where monetary policy shifts to a headwind.

The path of monetary policy has been a key element in the asset allocation committee's analysis of the economy and markets. We are moving into a more critical phase where the potential for a policy error is rising. By year's end, we could have a fed funds rate that would be modestly higher than neutral using at least two of the four variations of the Mankiw Rule model. That would increase the potential for a recession which we would expect to have a negative impact on equity markets. Thus, this is an issue we will be closely monitoring into the second half of 2017.

Data Section

U.S. Equity Markets – (as of 5/19/2017 close)

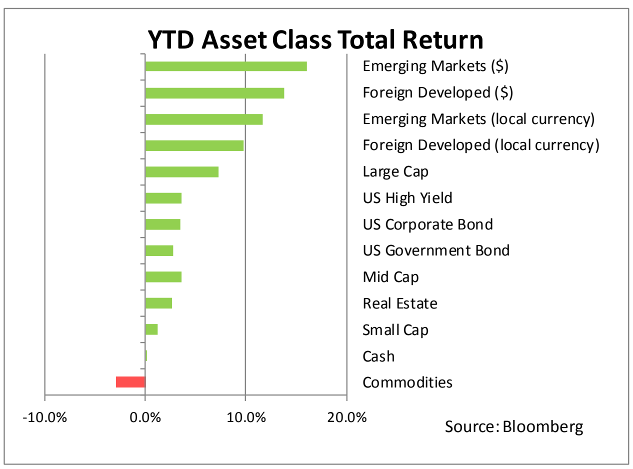




(Source: Bloomberg)

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 5/19/2017 close)

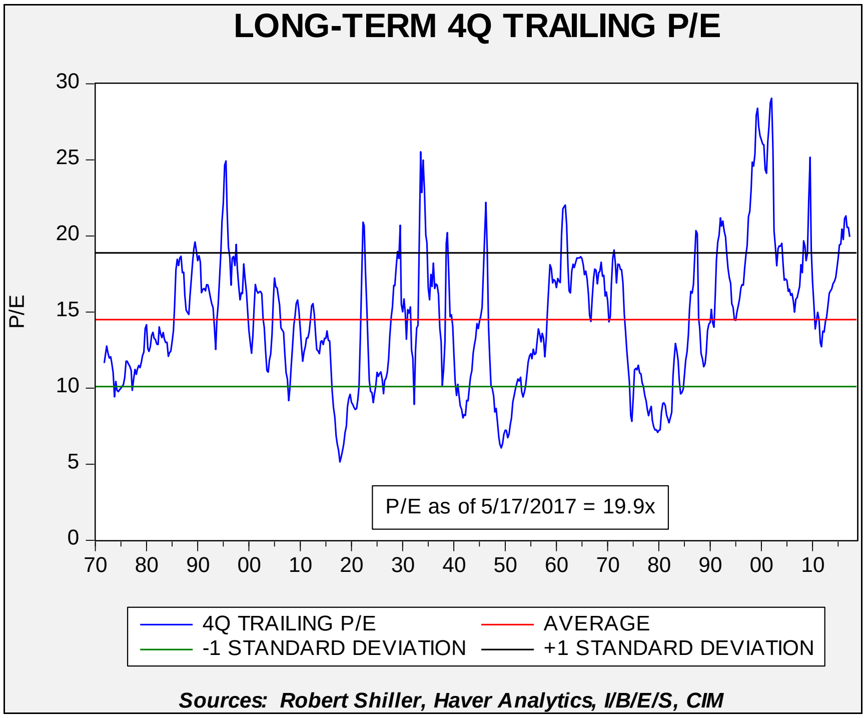


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2017



Based on our methodology,[5] the current P/E is 19.9x, 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.

[5] 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.