Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: May 5, 2017—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.7% from the prior close. Chinese markets were down, with the Shanghai composite down 0.8% and the Shenzhen index down 1.2%. U.S. equity index futures are signaling a higher open. With 408 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, 73.8% of the companies reported earnings above forecast, while 20.6% reported earnings below forecast.

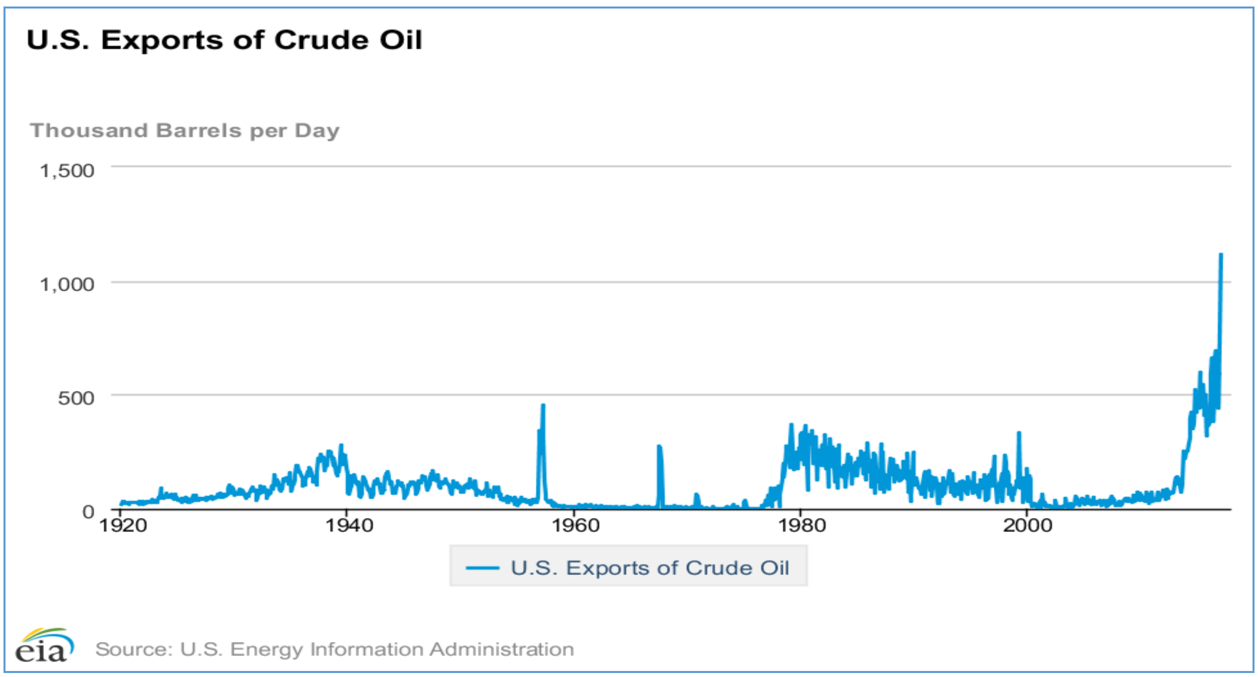
It's employment day! We cover the data in detail below. The report was mostly strong, although wage growth continues to disappoint.

On Sunday, the French go to the polls for a runoff election between Emmanuel Macron and Marine Le Pen. The latest polls show Macron leading 62% to 38%. Although we don't want to call the election prematurely, a Le Pen win would be an historic outlier. As we noted last week, the current spread is roughly where Truman/Dewey stood about five weeks before the election. However, at the time of the election, the spread had narrowed to about 5%. Truman's win was still a stunner but the polls were going his way into the election. Le Pen has not seen any surge in support; in fact, she peaked around 41% last week and has now fallen to 38%. Overall, she commands about 40% of the electorate and probably won't improve beyond that. Thus, we expect Macron to be the next president of France.

We do note that the French president isn't all that powerful; a good way of thinking about the French system of government is that it is a combination of the American presidential system and the European parliamentary system. The president does have great authority in foreign policy but domestic policy power really resides with the prime minister who is approved by the legislature. Normally, the president is the leader of a major party that also controls the legislature. Thus, the PM is usually seen as an agent of the president. However, on occasion, the president will represent a different party than the PM, a condition called "co-habitation." Such governments tend to be unstable. The president can dissolve the Assembly and trigger new elections, but this avenue probably isn't available to Macron if he gets stuck with a legislature he doesn't like since he has no party. Parliamentary elections will be held next month and Macron will have a PM thrust upon him, most likely from the center-right, as he has no real party apparatus. This condition probably means that Macron will be a weak leader and current policies in France will remain in place…and since those policies aren't all that popular, the likelihood of a continued populist backlash is high.

Yesterday, the House did narrowly pass the AHCA bill. Although this is being celebrated with great relish by the House leadership and the president, the Senate has already made it abundantly clear that nothing on this is going to happen quickly. First, Senate leaders are indicating that they will write their own version of the bill and not use the House version as a starting point. That surely means reconciliation will be almost impossible. Second, McConnell has indicated he will wait for the CBO to score the bill. The House moved before the bill was scored, most likely because it feared the CBO would indicate a sharp rise in the uninsured. Although there are some political analysts suggesting that the House may be in play after this vote, it still seems like a long shot. Using the Cook Political Report[1] analysis, the categories of "Likely" Republican and "Lean" Republican bring in 234 seats, a 16-seat majority. Cook did shift 14 seats from Likely to Lean for Republicans after the report,[2] and three into the "Toss-Up" category, suggesting the vote does increase the risk of a turnover in the House. However, at this juncture, it's still a long shot for the Democrats to take control. If the Senate bogs down the process, the potential negative impact of the vote is probably lessened. Still, for the financial markets, the fact that something was accomplished may boost hopes that tax reform, or at least cuts, could be possible.

Oil prices have come under pressure, dipping under $45 per barrel for WTI on a few occasions overnight. We view $45 as psychological support, so some consolidation at this level is possible. As we have been noting for weeks (including yesterday), oil prices have been quite rich relative to oil inventories and the dollar. Some degree of correction was likely. On the other hand, the Saudis remain committed to propping up prices so they should be willing to cede market share to other producers, including the U.S.



This chart shows U.S. crude oil exports. Although the U.S. banned oil exports in 1975, an exception for Canada was made to facilitate smooth refinery operations. Note the spike in exports seen since the ban on exports was lifted in January 2016. Rising U.S. oil production and

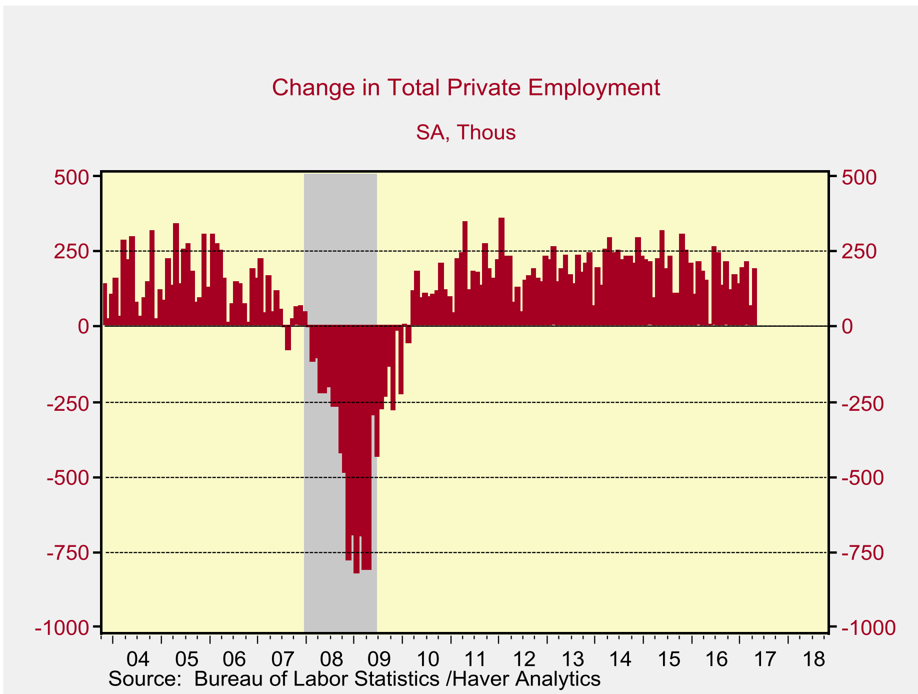
[1] http://cookpolitical.com/house/charts/race-ratings

[2] http://cookpolitical.com/story/10342

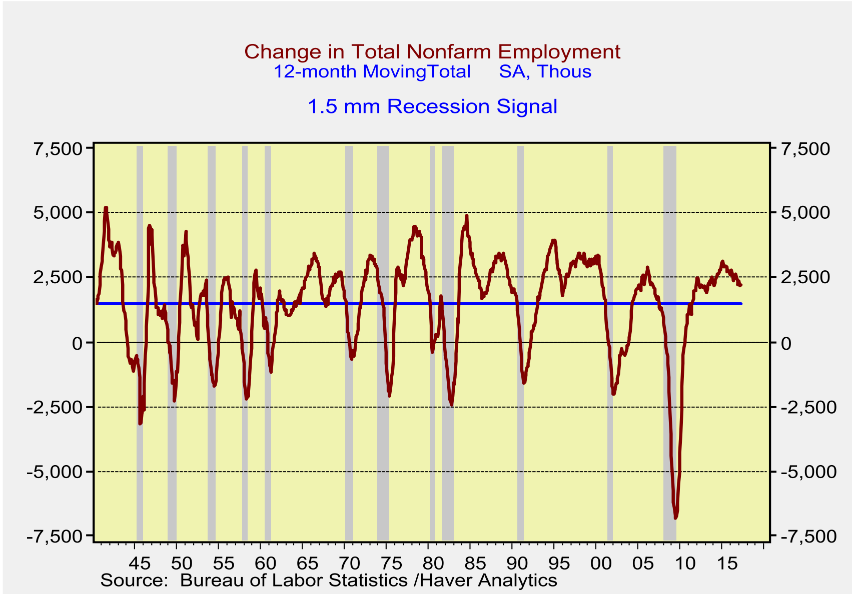
exports pits American producers against OPEC + Russia. It will be interesting to see how long the cartel will tolerate the loss of market share from U.S. production.

U.S. Economic Releases

The change in nonfarm payrolls came in above expectations at 211k compared to the forecast of 190k. The prior month's report was revised downward from 98k to 79k. The change in private payrolls came in above expectations at 194k compared to the forecast of 190k. The prior month's report was revised downward from 89k to 77k. The change in manufacturing payrolls came in below expectations at 6k compared to the forecast of 10k. The prior month's report was revised upward from 11k to 13k.

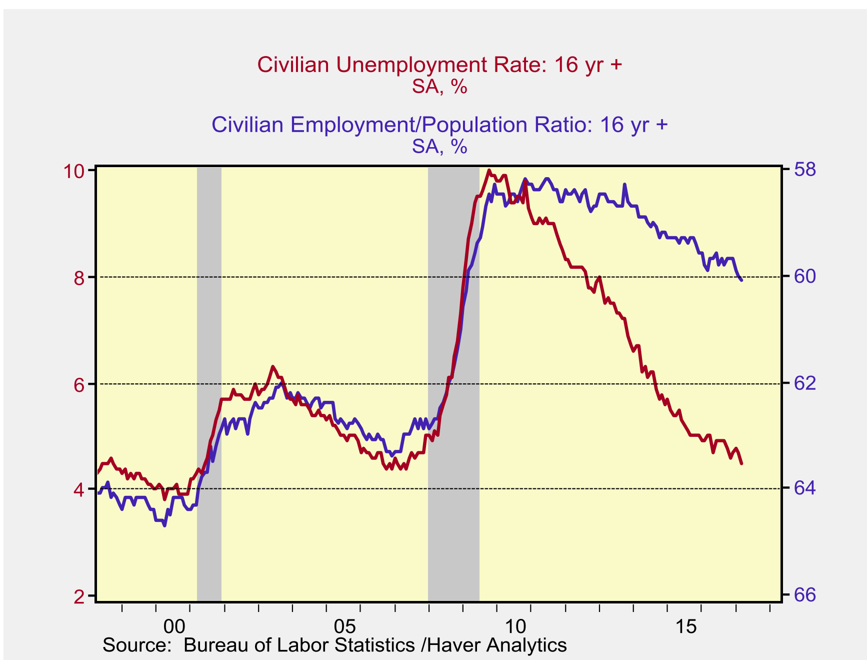


The chart above shows the change in total private employment. This chart suggests we are still in an economic expansion.

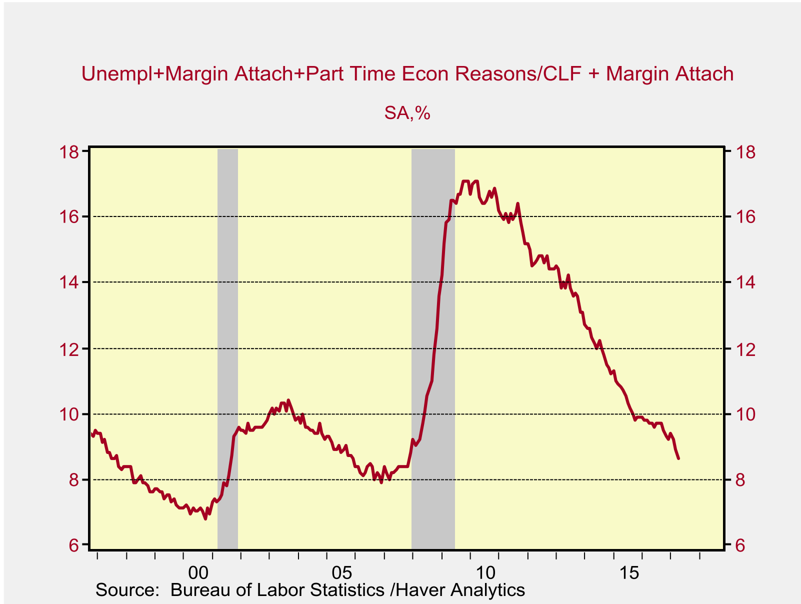


The chart above shows the 12-month moving average of the total change in nonfarm payrolls; a dip under 1.5 mm signals recession.

The unemployment rate came in below forecast at 4.4% compared to the forecast of 4.6%. The labor force participation rate and the underemployment (U-6) rate came in at 62.9% and 8.6%, respectively.

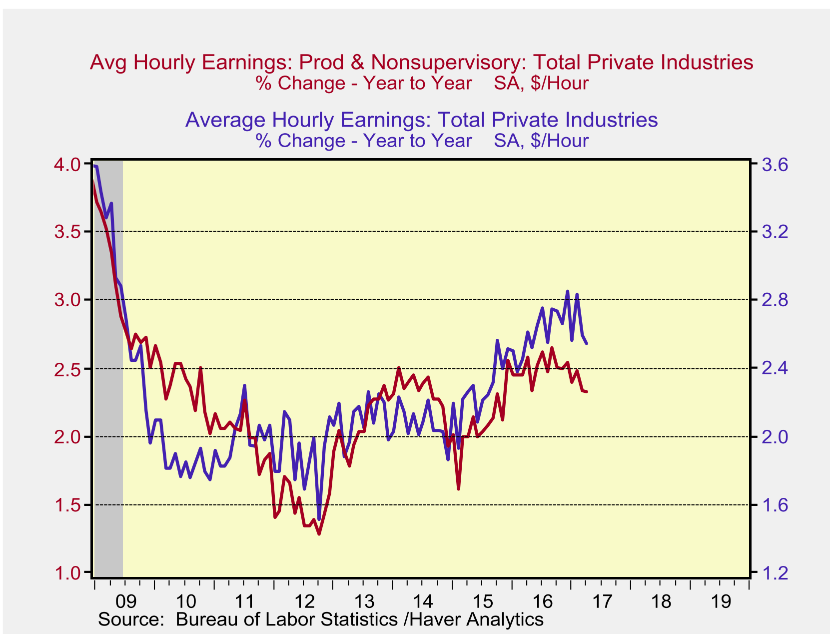


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables suggests that there is still slack within the labor market.



The chart above shows the underemployment rate, also referred to as the U-6 rate. The Fed is currently using this figure to gauge slack in the labor market. The decline in the U-6 rate suggests the labor market is strengthening.

Average hourly earnings came in line with forecasts at a rise of 0.3% from the prior month. Average weekly hours came in line at 34.4.



This chart shows the yearly growth in hourly earnings for all workers and non-supervisory workers. The widening of these two variables suggests that wages are still not rising for most workers. Non-supervisory workers represent about 80% of the labor force.

Overall, the employment data is supportive for the economy, while the wage data continues to disappoint. Financial markets are mostly taking the data as supportive. If the FOMC wants to raise rates in June, this data will aid that goal.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consumer Credit	m/m	mar	$14.000 bn	$15.206 bn	**
Fed speakers or events						
No speakers or events scheduled						
EST	**Speaker or event**	**District or position**				
11:30	Stanley Fischer speaks in New York	Vice Chairman of Board of Governors of Federal Reserve				
12:45	John Williams speaks in Santa Cruz	President of the Federal Reserve Bank of San Francisco				
13:30	Eric Rosengren to address NY Assoc for Business Economics	President of the Federal Reserve Bank of Boston				
13:30	Janet Yellen Speaks at University of Michigan	Chairman of Board of Governors of Federal Reserve				

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								
Australia	AiG Perf of Construction	m/m	apr	51.9	51.2		**	Equity and bond neutral
New Zealand	2Yr Inflation Expectation	m/m	apr	2.2%	1.9%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Retail	y/y	apr	52.7	49.5		**	Equity bullish, bond bearish
Germany	Markit Germany Construction	y/y	apr	54.6	56.4		**	Equity and bond neutral
	Markit Germany Retail	y/y	apr	56.2	52.5		**	Equity bullish, bond bearish
France	Markit France Retail PMI	y/y	apr	51.8	49.4		**	Equity bullish, bond bearish
Italy	Markit Italy Retail	y/y	apr	48.3	45.1		**	Equity and bond neutral
Switzerland	UBS Real Estate Bubble Index	y/y	apr	1.39	1.35		**	Equity and bond neutral
	Foreign Currency Reserves	y/y	apr	695.9 bn	683.7 bn	690.5 bn	**	Equity and bond neutral
Russia	Money Supply Narrow Def	y/y	apr	8.94 tn	8.96 tn		**	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	apr	3.2k	19.4k	10.0k	**	Equity bearish, bond bullish
	Unemployment Rate	y/y	apr	6.5%	6.7%	6.7%	**	Equity and bond neutral
	Full Times Employment Change	m/m	apr	-31.2	18.4		**	Equity and bond neutral
	Part Time Employment Change	y/y	apr	34.3	1.0		**	Equity bearish, bond bullish
	Participation Rate	y/y	apr	65.6	65.9%		**	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)	117	117	0	Up
3-mo T-bill yield (bps)	86	86	0	Neutral
TED spread (bps)	31	31	0	Neutral
U.S. Libor/OIS spread (bps)	102	101	1	Up
10-yr T-note (%)	2.36	2.35	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	30	30	0	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Down
pound	up			Down
franc	down			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	$48.41	$48.38	0.06%	Short Covering
WTI	$45.43	$45.52	-0.20%	
Natural Gas	$3.21	$3.19	0.78%	
Crack Spread	$16.03	$15.73	1.96%	
12-mo strip crack	$13.56	$13.26	2.31%	
Ethanol rack	$1.67	$1.69	-0.97%	
Metals				
Gold	$1,232.71	$1,228.16	0.37%	
Silver	$16.36	$16.33	0.22%	
Copper contract	$251.75	$251.15	0.24%	
Grains				
Corn contract	$ 368.75	$ 366.50	0.61%	
Wheat contract	$ 440.00	$ 437.75	0.51%	
Soybeans contract	$ 974.25	$ 974.25	0.00%	
Shipping				
Baltic Dry Freight	1004	1034	-30	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.9	-3.3	2.3	
Gasoline (mb)	0.2	1.0	-0.8	
Distillates (mb)	2.0	1.5	0.5	
Refinery run rates (%)	-0.30%	-0.10%	-0.2%	
Natural gas (bcf)	62.0	60.0	2.0	

Weather

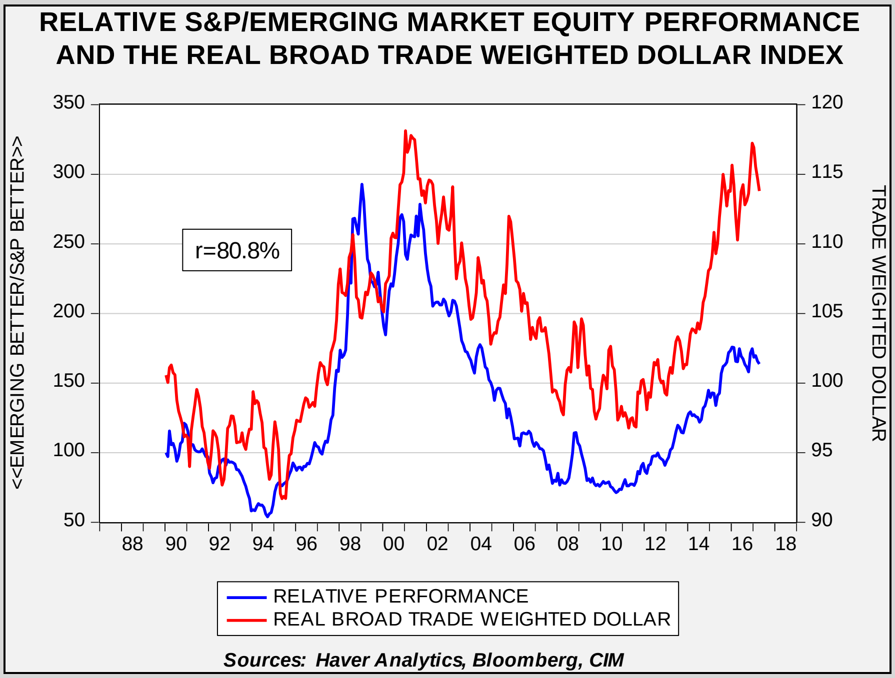
The 6-10 and 8-14 day forecasts show cooler to normal temperatures for most of the country, with warmer temps expected for the mountain region. Precipitation is expected for most of the country.

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.

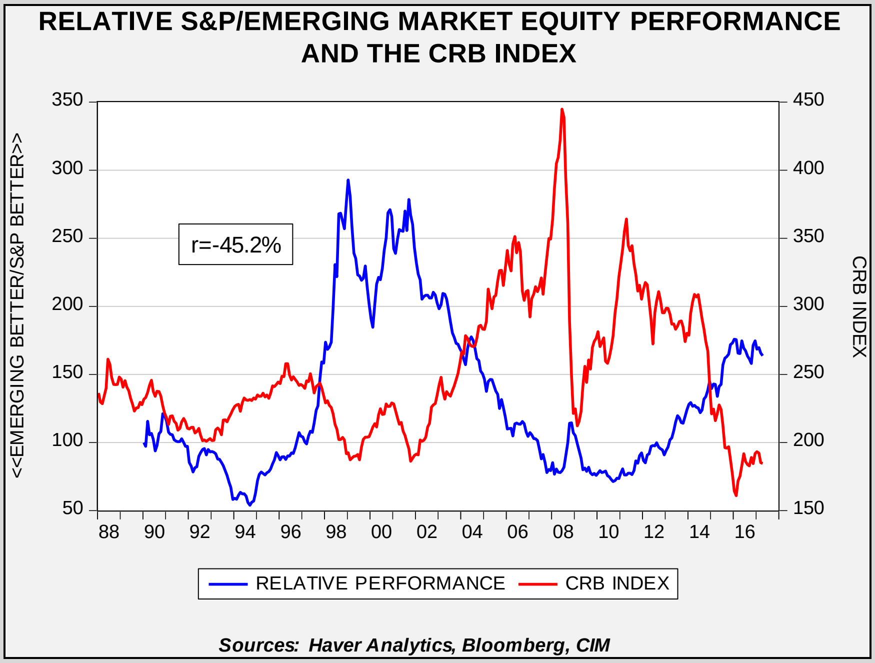
May 5, 2017

In our most recent quarterly asset allocation meetings, our analysis determined that emerging markets would not be added to the portfolios. Since this asset class has been this year's best performer, some explanation is in order. One of the primary reasons we have refrained from adding emerging markets is the dollar's strength.

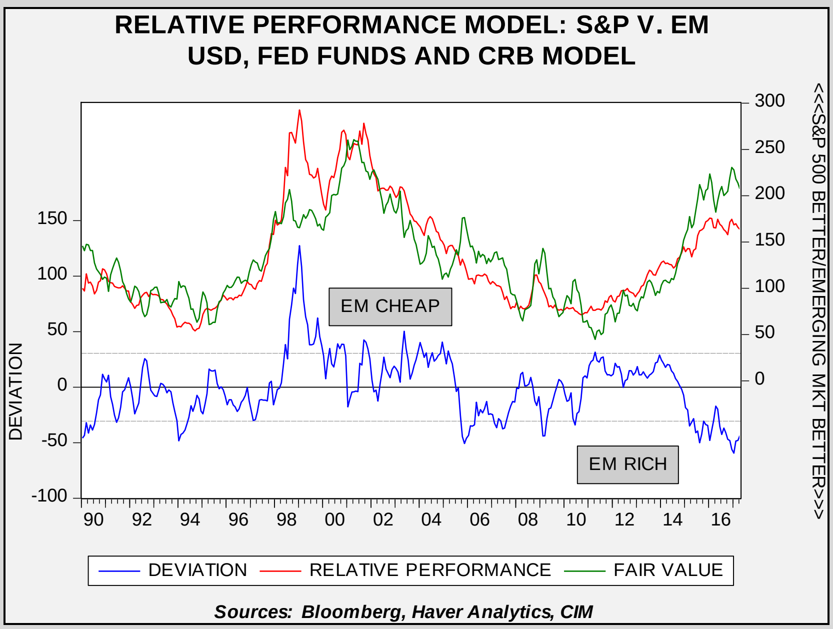


The blue line on this chart looks at the relative performance of emerging markets to the S&P 500. When the line is rising, the S&P is outperforming emerging markets. The red line is the JPM real dollar index. The two series are positively correlated at 80.8%, meaning that a stronger dollar tends to reflect the S&P 500 outperforming the emerging markets. This correlation has weakened modestly recently, but is still quite elevated.

The second reason we have been reluctant to add emerging markets is because the relative outperformance is occurring with weaker commodity prices.



Although the correlation isn't as strong as with the dollar, rising commodity prices tends to coincide with stronger relative emerging market performance. Although commodities are off their lows, they remain depressed. Thus, the current level of commodity prices seems to support weaker relative emerging market equities.

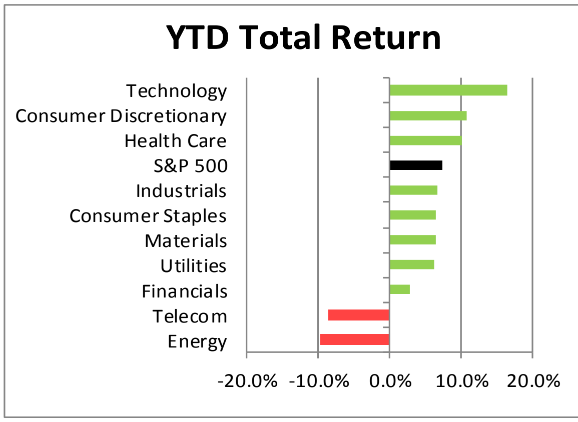


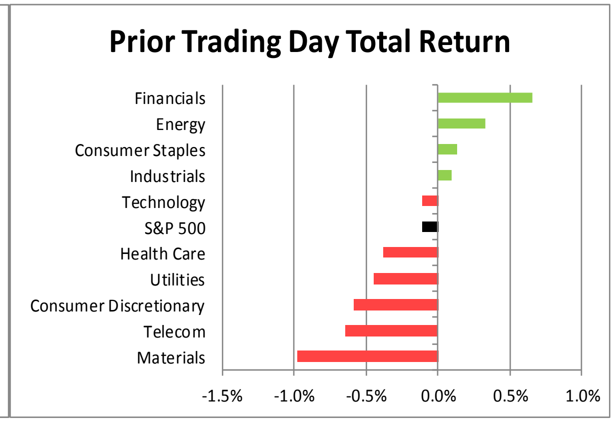
This chart shows a model of the emerging market/S&P 500 relative performance regressed against the JPM dollar index, the CRB index and fed funds (advanced six months). Currently, the model is suggesting that emerging market equities are overvalued relative to the S&P against these three independent variables.

Despite this overvaluation, it is possible that the strong relative performance of emerging markets is anticipating a recovery in commodities, a slowing of monetary policy tightening or a weaker dollar. The dollar lifted on expectations of tighter policy and if the FOMC does not raise rates as much as expected or if foreign central banks reverse their current easy policy stances, then the dollar could weaken. However, this model suggests that emerging market equities have already discounted that outcome. Thus, we are concerned that emerging market equities may be ahead of the fundamentals. If this is true, the current strong performance of emerging markets could stall even with dollar weakness, rising commodities or a stall in Fed tightening. And, if the dollar rises, commodities fall further or the FOMC raises rates according to the "dots plot," emerging markets could be quite vulnerable. For now, we believe the risks exceed the potential return from these levels.

Data Section

U.S. Equity Markets – (as of 5/4/2017 close)

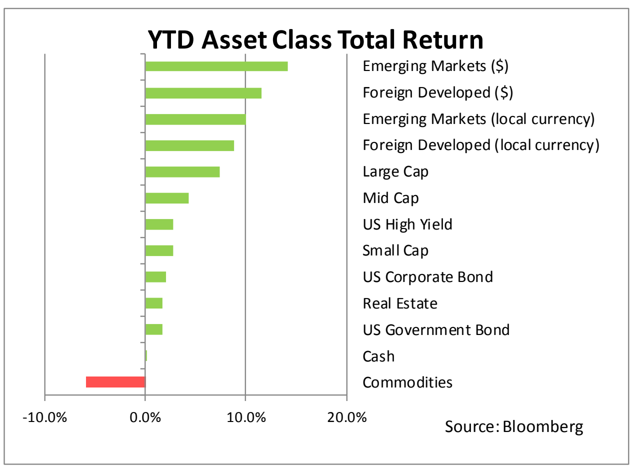




(Source: Bloomberg)

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 5/4/2017 close)

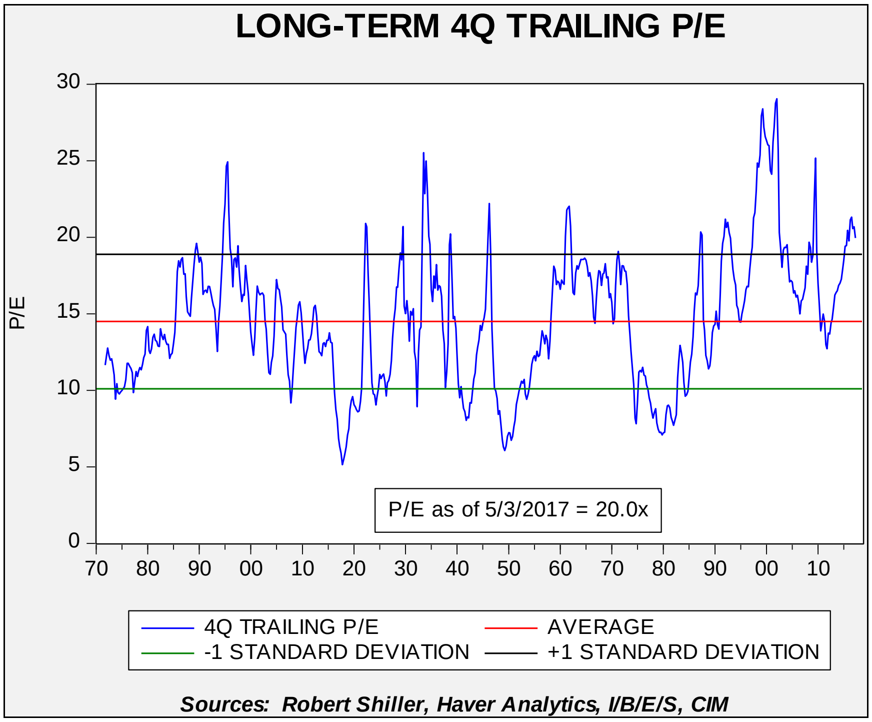


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 4, 2017



Based on our methodology,[3] the current P/E is 20.0x, up 0.1x from last week. The rise in the multiple has mostly come from the recent rise in equity prices.

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 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.