Daily Comment

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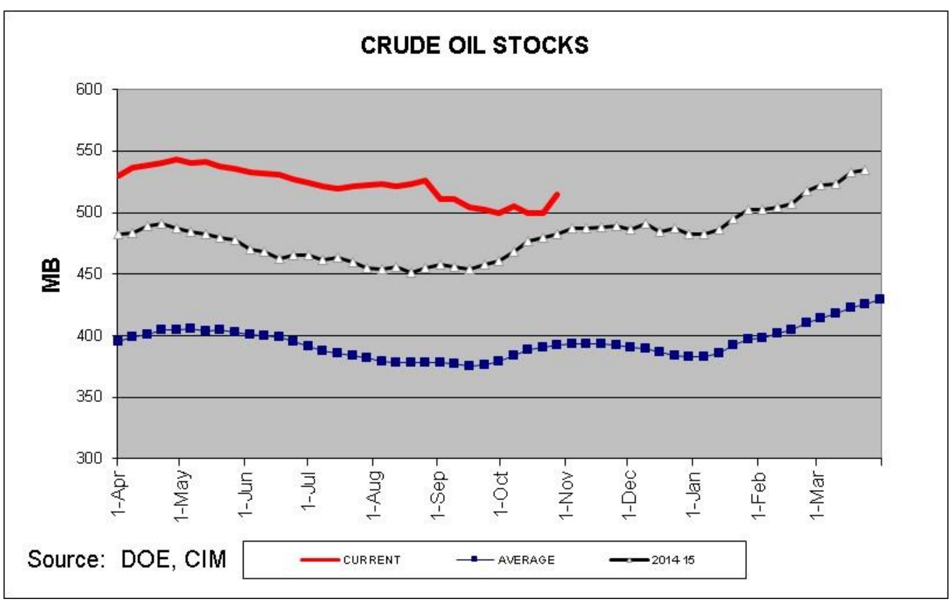
and Thomas Wash

[Posted: November 4, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading 0.9% lower from the last close. In Asia, the MSCI Asia Apex 50 closed 0.2% lower from the prior close. Chinese markets were down, with the Shanghai composite down 0.1% and the Shenzhen index down 0.2%. U.S. equity futures are signaling a lower opening. With 387 companies having reported, the S&P 500 Q3 earnings stand at $31.15, higher than the $29.60 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 73.3% of the companies reported earnings above forecast, while 20.1% reported earnings below forecast.

Given this morning's hefty economic releases, we will keep our opening comments short. Equity markets are trading sideways to higher following this morning's release of the October employment report (see below). Some of the highlights from the report include an improving unemployment rate and better than expected wage growth. Although October payroll gains were weaker than expected, September numbers were revised strongly higher, with the two-month net change surprising to the upside. Additionally, the U-6 unemployment rate, the broadest measure of unemployment, fell to its lowest level since April 2008 as did the median duration of unemployment. The dollar is trading higher this morning as the data likely supports a December Fed hike. Market expectations are calling for an 80% likelihood of a hike at the next meeting.

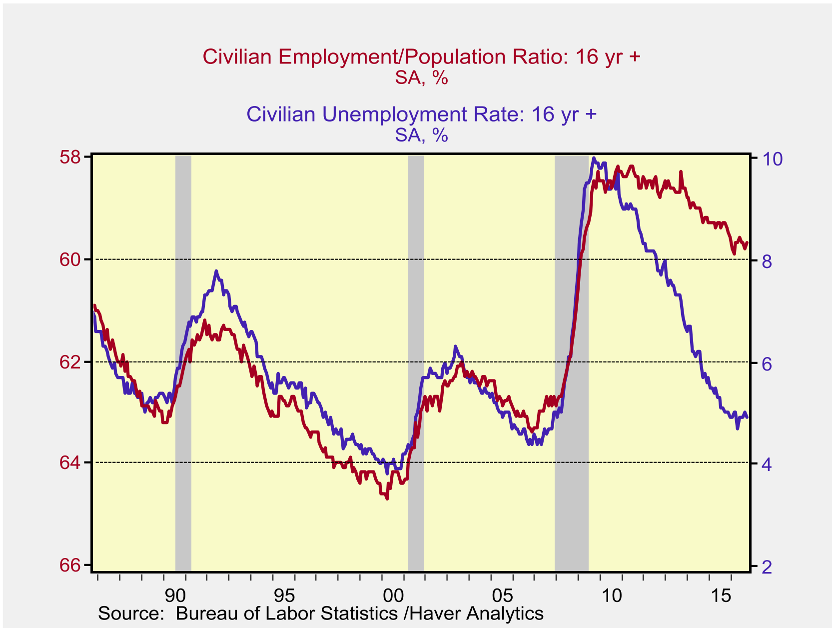
This week's domestic oil inventories rose 14.4 mb, well above market expectations of a 1.6 mb build. The chart below shows the current level of crude inventories, the prior year's levels and the five-year average. We are currently higher than the prior year and well above the average.



The inventory increase was caused by a jump in crude imports, which rose 2.2 mb, and a decline in refinery utilization, which fell 0.4% to 85.2%.

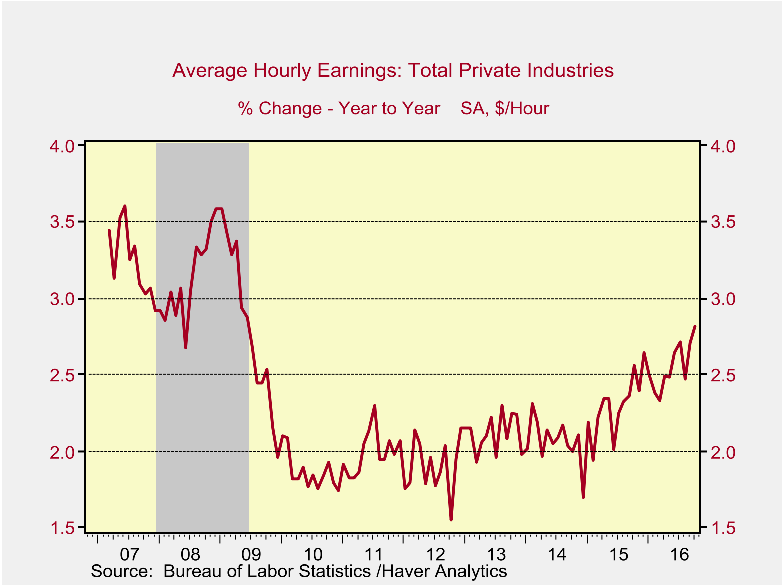
U.S. Economic Releases

The October employment report was generally positive. The unemployment rate fell to 4.9% from 5.0%, on forecast. The unemployment rate fell as the labor force shrank, while employment also fell modestly.



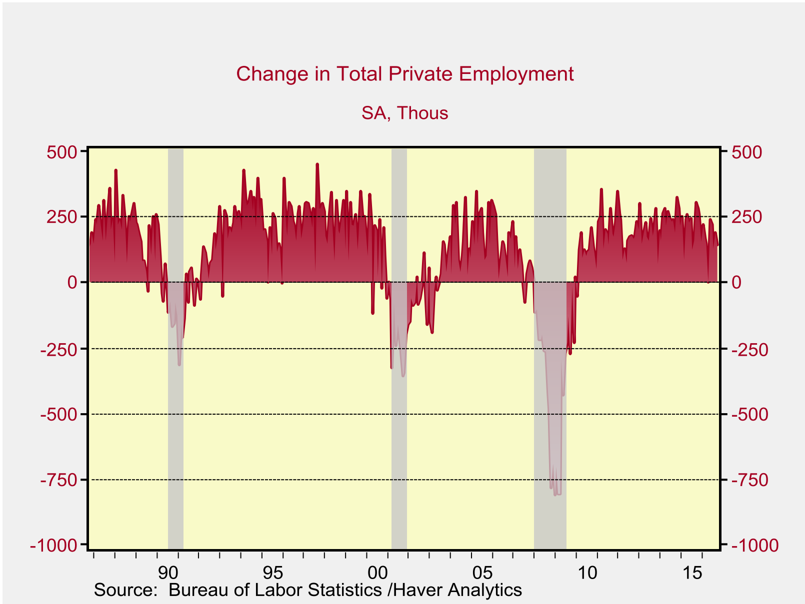
The chart above shows the unemployment rate and the employment/population ratio. The employment/population ratio fell to 59.7% from 59.8% the month before. The gap between the two measures remains wide, which were historically highly correlated.

Average hourly earnings were the biggest surprise from the employment numbers. Hourly earnings came in at 2.8%, above the forecast of 2.6%. This was the fastest rise in hourly earnings since 2009.



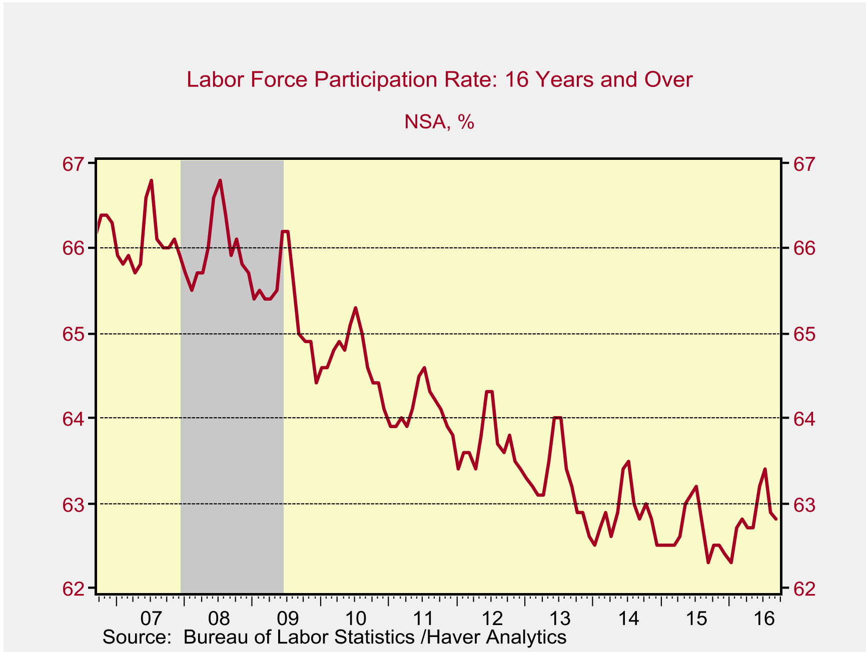
The chart above shows the yearly change of hourly earnings. Wages have been trending upward over the past few years. This data could signal a rate rise by the Federal Reserve in December.

Total nonfarm employment payrolls came in at 161k, below the forecast of 171k. The prior month's report was revised upward from 156k to 191k, suggesting a strengthening labor market.



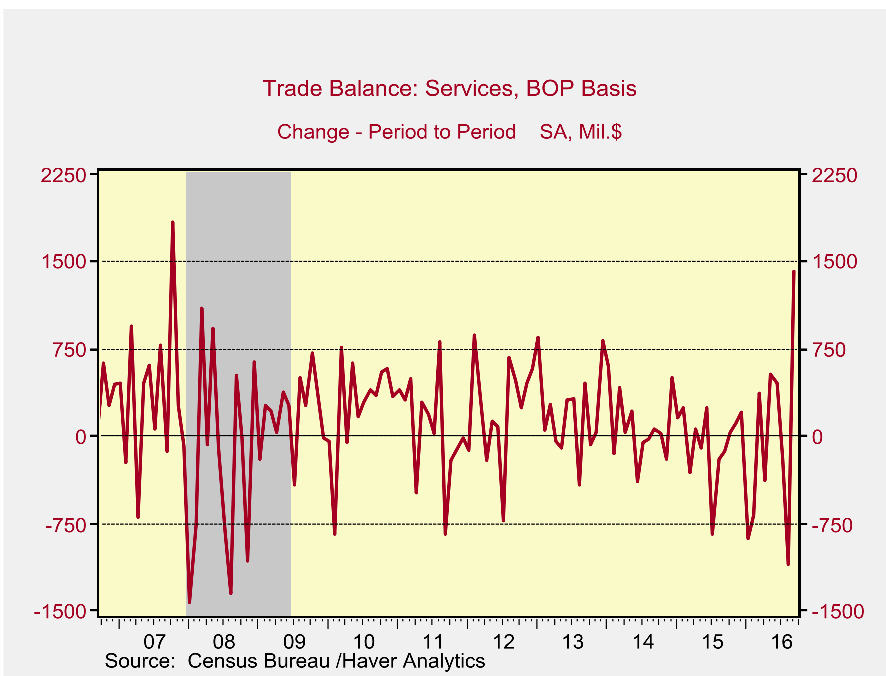
The chart above shows total change in total private employment from year to year. Despite the fact that manufacturing payrolls declined, the service sector was able to expand by 142k.

The labor force participation rate came in at 62.8% from 62.9%, slightly below the forecast of 62.9%.



The chart above shows the labor force participation rate. The downward trend can be attributed to many people leaving the labor force as a result of an aging population.

The trade balance came in at -$36.4 billion, above the forecast of -$38.0 billion.



The chart above shows the change in the trade balance. This month's data shows the largest yearly increase in the balance of payment since October 2007.

There are no other releases for the rest of the day.

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	BoP Current Accounts Balance	y/y	3Q	$71.2 bn	64.1 bn		**	Equity bullish, bond bearish
Japan	Japan Buying Foreign Bonds	y/y	sep	891.9 bn	773.6 bn		**	Equity and bond neutral
	Foreign Buying Japan Bonds	y/y	sep	-267.8 bn	-752.5 bn		**	Equity and bond neutral
	Foreign Buying Japan Stocks	y/y	oct	207.1 bn	-5.6 bn		**	Equity and bond neutral
	Japan Buying Foreign Stocks	y/y	oct	108.9 bn	-85.3 bn		**	Equity and bond neutral
	Nikkei Japan PMI Services	w/w	oct	50.5	48.2		**	Equity bullish, bond bearish
	Nikke Japan PMI Composite	q/q	3Q	51.3	48.9		**	Equity bullish, bond bearish
Australia	Retail Sales	m/m	sep	0.6%	0.4%	0.4%	**	Equity bullish, bond bearish
	Retail Sales Ex Inflation	q/q	3Q	-0.1%	0.4%	0.2%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Markit Eurozone Services	y/y	oct	52.8	53.5	53.5	**	Equity and bond neutral
	Markit Eurozone Composite	y/y	oct	53.3	53.7	53.7	**	Equity and bond neutral
	PPI	y/y	sep	-1.5%	-2.1%	-1.7%	**	Equity bullish, bond bearish
Germany	Markit Germany Services	y/y	oct	54.2	54.1	54.1	**	Equity and bond neutral
	Markit Germany Composite	y/y	oct	55.1	55.1	55.1	**	Equity and bond neutral
Italy	Markit Italy Services	m/m	oct	51	50.7	51.5	**	Equity and bond neutral
	Markit Italy Composite	m/m	oct	51.1	51.1	51.5	**	Equity and bond neutral
France	Markit France Services	y/y	oct	51.4	52.1	52.1	**	Equity and bond neutral
	Markit France Composite	y/y	oct	51.6	52.2	52.2	**	Equity and bond neutral
UK	New Car Registration	y/y	oct	1.4%	1.6%		*	Equity and bond neutral
AMERICAS								
Brazil	Markit Brazil PMI Composite	y/y	oct	44.9	46.1		**	Equity bearish, bond bullish
	Markit Brazil PMI Services	y/y	oct	43.9	45.3		**	Equity bearish, bond bullish

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)	88	88	0	Neutral
3-mo T-bill yield (bps)	36	36	0	Neutral
TED spread (bps)	52	52	0	Neutral
U.S. Libor/OIS spread (bps)	50	50	0	Neutral
10-yr T-note (%)	1.80	1.81	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	46	45	1	Up
Currencies	**Direction**			
dollar	down			Up
euro	down			Down
yen	down			Down
pound	up			Down
franc	up			Up

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	$46.26	$46.35	-0.19%	Supply disruption in Nigeria/ Weaker dollar
WTI	$44.76	$44.66	0.22%	
Natural Gas	$2.75	$2.77	-0.58%	
Crack Spread	$15.05	$15.64	-3.77%	
12-mo strip crack	$15.80	$16.25	-2.79%	
Ethanol rack	$1.73	$1.73	-0.21%	
Metals				
Gold	$1,300.13	$1,302.70	-0.20%	Strenthening Sterling due to court decision
Silver	$18.31	$18.36	-0.28%	
Copper contract	$225.05	$224.90	0.07%	
Grains				
Corn contract	$ 346.50	$ 348.00	-0.43%	Supply Pressure
Wheat contract	$ 411.75	$ 412.00	-0.06%	
Soybeans contract	$ 985.50	$ 989.50	-0.40%	
Shipping				
Baltic Dry Freight	849	834	15	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	14.4	1.5	12.9	
Gasoline (mb)	-2.2	-1	-1.2	
Distillates (mb)	-1.8	-1.8	0.0	
Refinery run rates (%)	-0.4%	0.5%	0.0	
Natural gas (bcf)	54.00	57.00	-3.0	

Weather

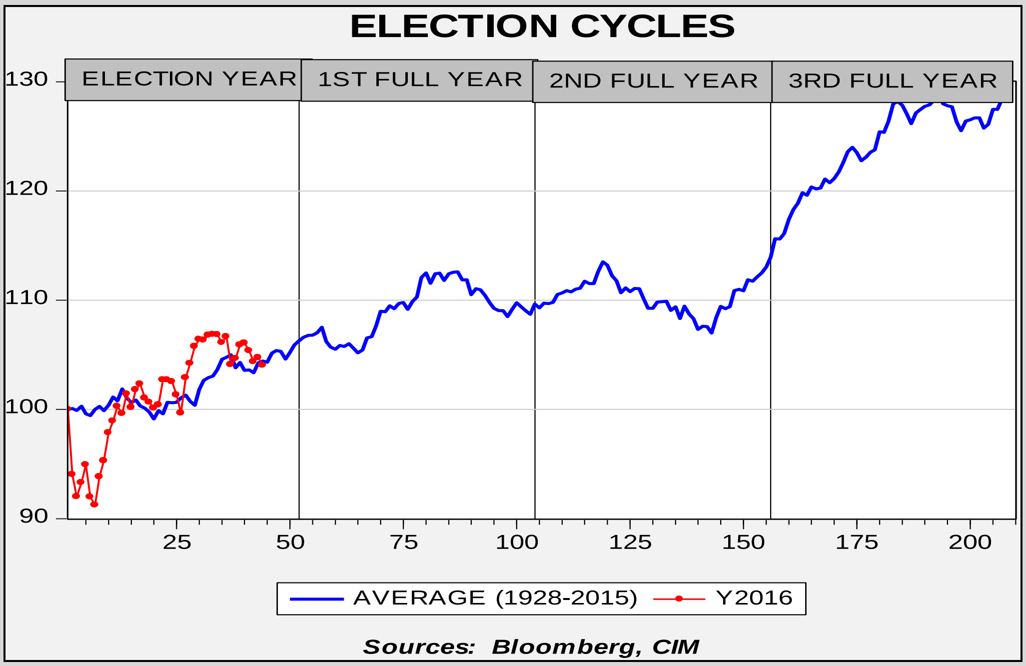
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country. Precipitation is forecast for the northwestern region of the country.

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.

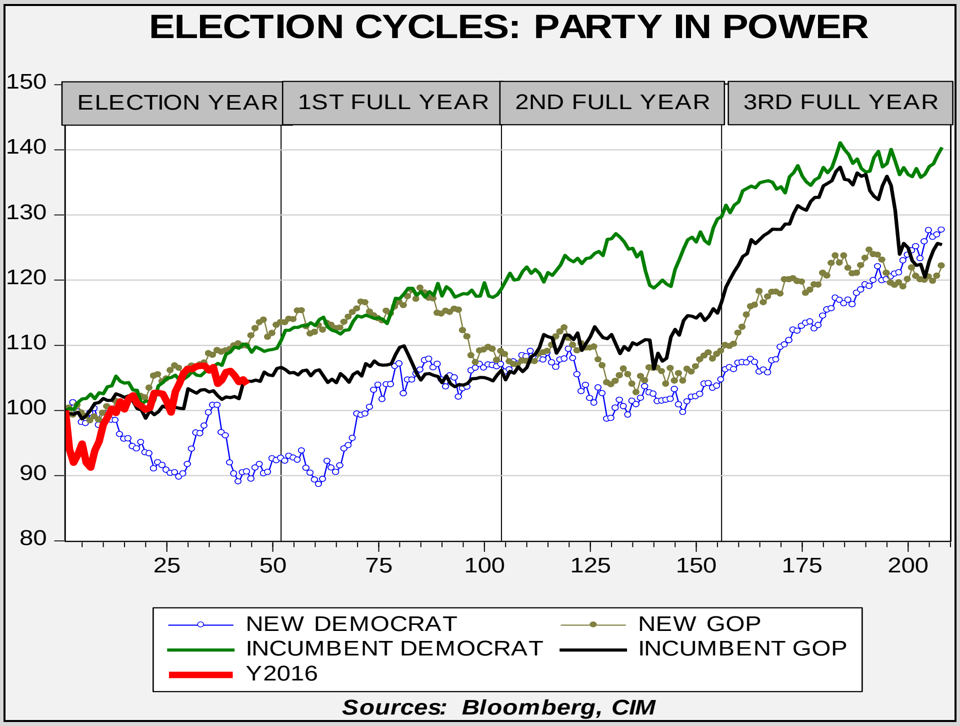
November 4, 2016

With the elections coming next week, it seems like a good time to look at how markets have historically performed during election cycles. We will compare the current election cycle against previous cycles.



The blue line in the chart above shows the indexed market return for the period 1928-2015. To create this average cycle, we use the weekly returns of the S&P 500 Index starting with the first week of the election year through the end of the fourth year of the presidential term. The weekly dataset begins in 1928. The average gain in the first year of the cycle is about 6%. By Q3 of the second year of the cycle, the average return of the S&P 500 is approximately 13%. Equity markets move sideways to lower into late Q3 of the third year and then, on average, stage a strong rally into the last year before the election cycle begins anew. The rally that begins in year three is a fairly well documented phenomena; politicians want to be re-elected and thus create policies that boost growth and, on average, lift equity prices as well. We have added the S&P 500 performance for the current cycle, indexed to the first Friday close of 2016 (red line). Although the market has been volatile, its performance has been close to average since the dip in Q1.

To further analyze the data, we break the historical data into four categories: incumbent Democrat president, incumbent Republican president, new Democrat president and new Republican president. We define incumbent as a consistent party in power. For example, this means we had a Democratic incumbent from 1936 through 1951, which encompassed both Roosevelt and Truman. Similarly, we had an incumbent GOP from 1984 through 1991 which included Reagan's second term and Bush's only term.



As the chart shows, markets have had the best outcome when an incumbent Democrat wins. A new Republican president tends to track an incumbent Democrat until the year after the election, then underperforms. A new Democrat has historically been the worst outcome for the market (excluding the late 4th year rally). The current cycle is mostly following the incumbent Democrat/new Republican averages, suggesting that the equity market isn't offering significant insights thus far. However, it does imply that, regardless of the outcome on Tuesday, we will likely see a recovery into the New Year in that we will either have a new GOP president or an incumbent Democrat president.

Although most analysts are assuming a Clinton win based on polling, this analysis does suggest some equity market trepidation as we are currently underperforming both of the most probable outcomes.[1] This underperformance could reflect the volatile nature of this election season or expectations of monetary policy tightening in December. However, given the usual electoral pattern, we would not be surprised to see a stronger equity market into at least the first half of next year.

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.

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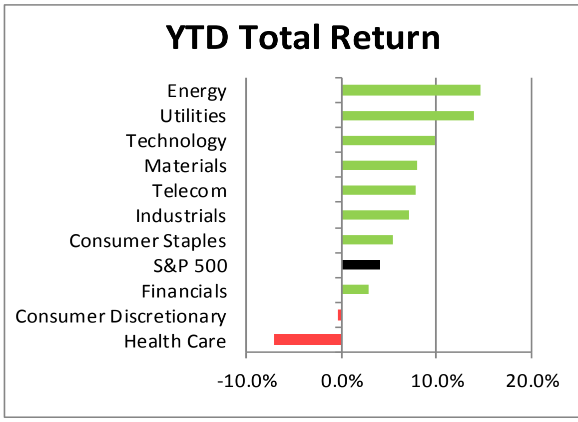
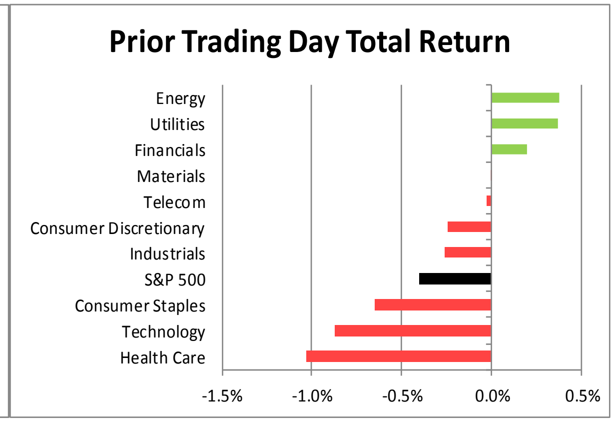
[1] It is possible a third party could win, but highly improbable. The most likely outcome is either an incumbent Democrat or a new Republican.

Data Section

U.S. Equity Markets – (as of 11/3/2016 close)

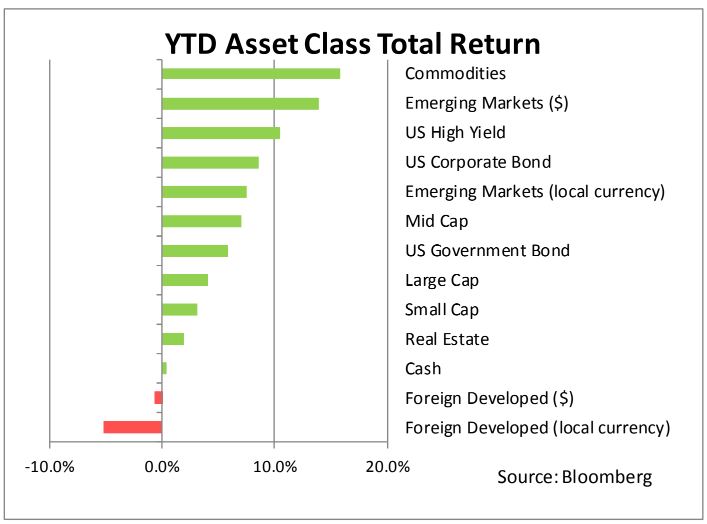




(Source: Bloomberg)

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. The sectors are ranked by total return, with green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 11/3/2016 close)

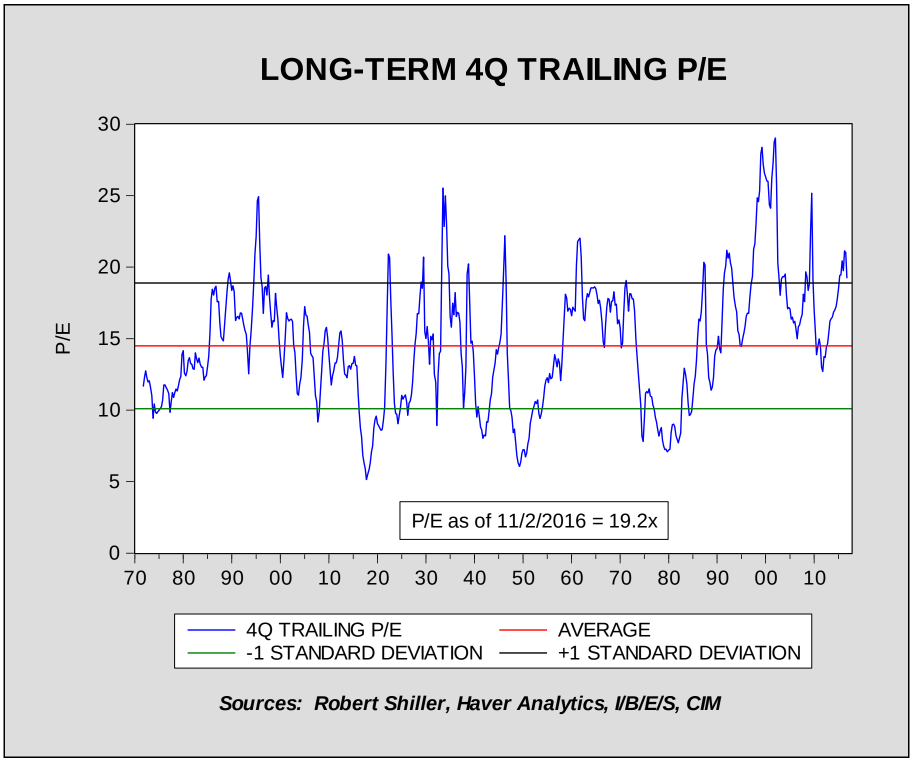


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Dow Jones-UBS Commodity Index).

P/E Update

November 3, 2016



Based on our methodology,[2] the current P/E is 19.2x, down 0.1x from last week. Slightly lower equity levels are the cause of the decline in the P/E.

This report was prepared by Bill O'Grady and Kaisa Stucke of 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 and last 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 (Q1 and Q2) and two estimates (Q3 and Q4). 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.