Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: November 14, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed 1.4% lower from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index also up 0.3%. U.S. equity futures are currently moving sideways. With 455 companies having reported, the S&P 500 Q3 earnings stand at $31.21, higher than the $29.23 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 72.7% of the companies reported earnings above forecast, while 21.1% reported earnings below forecast.

The Trump market effect continues this morning; equities are flat to higher, but the most consistent market action has been in interest rates and the dollar, which continue to march higher. Like everyone else, we are trying to determine the impact of Trump's policies for the economy and markets. At present, the focus seems to be on who is in key positions on his team. Some establishment members are being paired off with populist insurgents and it isn't clear if we are going to get a standard issue GOP agenda (tax cuts, deregulation) or a populist program (protectionism, deglobalization and reregulation). The inside track seems to be for the standard issue program, because the Washington establishment knows how the system works and can get policies executed. The populists don't have that knowledge. However, the Sunday papers make it abundantly clear that if Trump doesn't execute at least some high profile populist goals, such as immigration control and trade impediments, then Trump shouldn't bother with a second term and 2020 could bring us a left-wing populist. This is going to be a "stay tuned" situation.

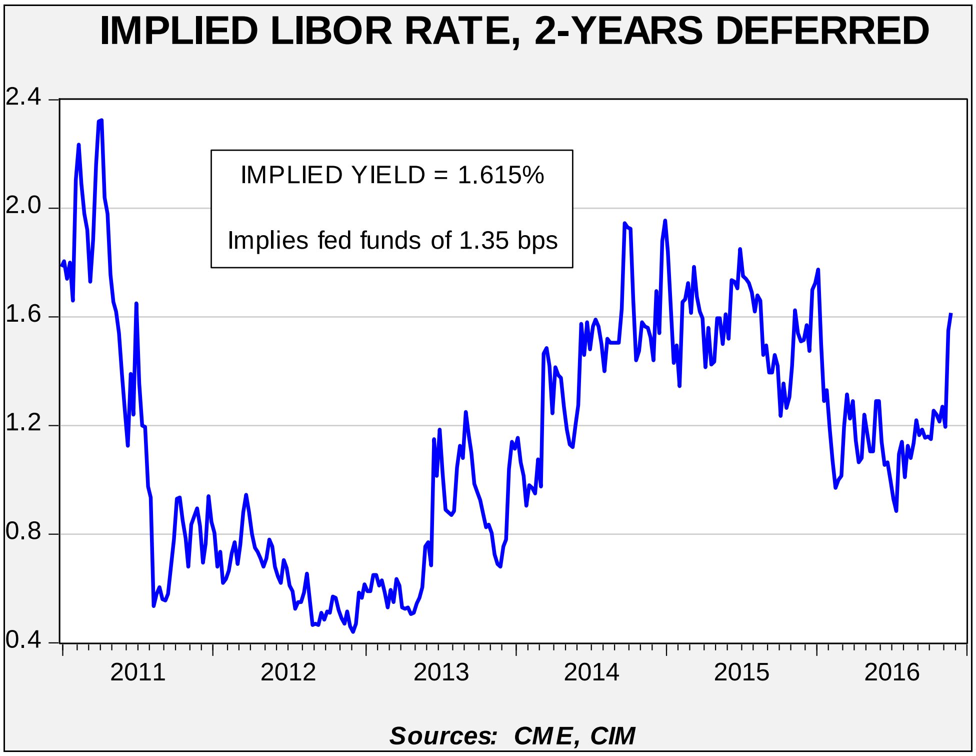
The Trump global effect also continues. Francis Fukuyama had a good op-ed in the weekend *FT* in which he examines the rise of economic nationalism in the West. Here is a salient quote from his piece:

> *The world today is brimming with economic nationalism. Traditionally, an open trade and investment regime has depended on the hegemonic power of the U.S. to remain afloat. If the U.S. begins acting unilaterally [ed. "America First"] to change the terms of the contract, there are many powerful players around the world who would be happy to retaliate, and set off a downward economic spiral reminiscent of the 1930s.*

In the Sunday *NYT* Review section, Ruchir Sharma of Morgan Stanley had a solid analysis of the dangers of deglobalization. Essentially, world growth slows, inflation rises and the dangers of war increase. We are seeing emerging markets weaken in the face of Trump's election.

The issue of monetary policy is less visible but equally important. The Sunday *NYT* had a report on GOP desires to reduce the power of the central bank. There is growing speculation that Janet

Yellen could be replaced with John Taylor. If he were to implement his Taylor rule for optimal interest rates, Haver Analytics calculates the fair value rate for fed funds at 1.78%. Appointing Taylor would lead to a more mechanistic Fed and higher rates. Wolfgang Münchau of the *FT* is suggesting that the consensus surrounding central bank independence is weakening. This makes sense; in an era of reflation, it is consistent to force the central bank to accommodate fiscal spending (of course, we doubt John Taylor would join such a Federal Reserve—this is an example of the traditional vs. populist GOP). In the meantime, expectations of policy tightening have increased.



The chart above shows the implied three-month LIBOR rate, two years deferred. Note the recent spike in the implied rate. This puts the fed funds target at 135 bps two years from now, up about 35 bps from prior to the election. Essentially, the election of Trump is acting as a policy tightening.

Finally, we do want to note that there are growing calls from left- and right-wing populists in Italy to reject the December 4th referendum on government restructuring in Italy. If the vote fails, PM Renzi will likely resign and the potential will rise for further financial problems in Europe.

U.S. Economic Releases

There were no economic releases prior to this publication. The table below lists the Fed speakers and events scheduled for the rest of the day.

Fed speakers or events		
EST	Speaker or event	District or position
13:20	Robert Kaplan Speaks in Wichita Falls	President of the Federal Reserve Bank of Kansas City
17:00	Jeffrey Lacker Speaks in Chestertown, MD	President of the Federal Reserve Bank of Richmond
18:30	John Williams Speaks in San Francisco on Panel	President of the Federal Reserve Bank of San Francisco

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	Industrial Production	y/y	oct	6.1%	6.1%	6.2%	***	Equity and bond neutral
	Retail Sales	y/y	oct	10.0%	6.0%	6.1%	**	Equity bullish, bond bearish
	Fixed Assets	y/y	oct	8.3%	8.2%	8.2%	**	Equity and bond neutral
Japan	GDP	q/q	3q	0.5%	0.2%	0.2%	***	Equity bullish, bond bearish
	GDP Private Consumption	q/q	3q	0.1%	0.2%	0.0%	**	Equity and bond neutral
	GDP Business Spending	q/q	3q	0.0%	-0.1%	0.2%	**	Equity and bond neutral
	Industrial Production	y/y	sep	1.5%	0.0%		***	Equity and bond neutral
	Capacity Utilization	m/m	sep	-2.0%	2.6%		**	Equity and bond neutral
Australia	Credit Card Purchases	y/y	sep	$25.3 bn	$26.8 bn		*	Equity and bond neutral
	Credit Card Balances	y/y	sep	51.4 bn	$51.3 bn		*	Equity and bond neutral
New Zealand	Reinz House Sales	y/y	oct	-14.2%	-9.5%		**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production	y/y	sep	1.2%	1.6%	0.9%	***	Equity bullish, bond bearish
Italy	CPI EU Harmonized	y/y	oct	-0.1%	-0.1%	-0.1%	***	Equity and bond neutral
Switzerland	Producer and Import Prices	y/y	oct	-0.2%	-0.1%	-0.1%	**	Equity and bond neutral
	Total Deposits	m/m	nov	519.9 bn	518.6 bn		*	Equity and bond neutral
	Domestic Sights	m/m	nov	449.8 bn	451.8 bn		*	Equity and bond neutral
Russia	GDP	y/y	3q	-0.4%	-0.6%	-0.5%	***	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	sep	-1.3%	0.3%	-0.9%	***	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)	91	90	1	Up
3-mo T-bill yield (bps)	48	46	2	Up
TED spread (bps)	43	44	-1	Down
U.S. Libor/OIS spread (bps)	54	53	1	Up
10-yr T-note (%)	2.25	2.15	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	43	40	3	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	down			Down
franc	down			Down

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	$44.31	$44.75	-0.98%	Stronger Dollar, Pessimism about output caps
WTI	$42.83	$43.41	-1.34%	
Natural Gas	$2.67	$2.62	1.91%	
Crack Spread	$12.89	$12.76	1.07%	
12-mo strip crack	$14.21	$14.11	0.68%	
Ethanol rack	$1.72	$1.72	0.00%	
Metals				
Gold	$1,221.15	$1,227.64	-0.53%	
Silver	$17.19	$17.37	-1.02%	
Copper contract	$254.40	$250.90	1.39%	
Grains				
Corn contract	$ 346.00	$ 349.00	-0.86%	Higher than expected yields
Wheat contract	$ 397.50	$ 403.00	-1.36%	
Soybeans contract	$ 976.50	$ 986.00	-0.96%	
Shipping				
Baltic Dry Freight	1045	974	71	

Weather

The 6-10 and 8-14 day forecasts continue to call for mild weather, undermining natural gas demand. Precipitation is also expected for the western and Midwestern regions.

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.

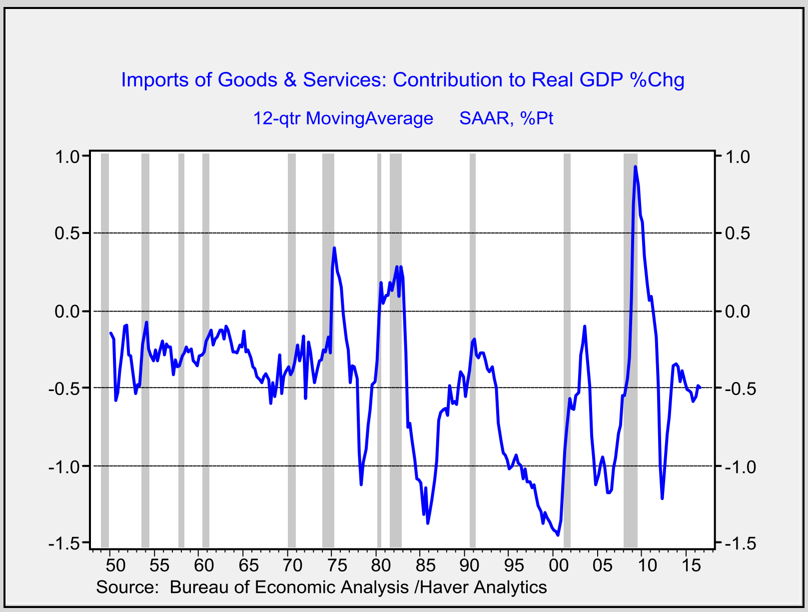
November 11, 2016

The Trump victory has significant ramifications for the economy and markets. The president-elect's platform is somewhat ambiguous, which isn't all that unusual; candidates want to build in some degree of flexibility that a detailed platform can reduce. Despite this lack of clarity, there are elements that are emerging that offer a guide to the policy changes the new administration will likely implement.

We believe the key to Trump is his campaign slogan, "America First." Trump made it abundantly clear that he intends to conduct policy from the standpoint of whether it is best for America. Although the term "America First" harkens back to an earlier movement,[1] Trump's version appears broader, including both domestic and foreign policy.

So, what does an America First policy mean for the domestic economy? Trump has promised both fiscal stimulation and trade restrictions. The combination of these two policies contradicts the accepted economic orthodoxy since Reagan-Thatcher, which adopted globalization. However, combining the two supercharges the domestic impact. Why? Because under conditions of globalization, some fiscal stimulus is lost to imports.

Globalization and deregulation began in earnest in 1978. This chart shows the contribution to GDP from imports on a three-year average basis.



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[1] The earlier America First movement, led by Charles Lindbergh just before Pearl Harbor, was designed to keep the U.S. out of a European war.

The pattern of imports clearly changes in the late 1970s, becoming a persistently larger drag on growth but also more volatile. On average, from 1950 through 1977, imports reduced GDP by 31 bps. From 1978 to the present, the average loss to imports nearly doubled, to 61 bps. Trade restrictions will tend to add to real GDP; if Trump can reduce imports to the pre-1978 years, it would consistently add about 30 bps to GDP. If fiscal stimulus adds 60 bps (the average that government spending alone added in Reagan's first term), real GDP could rise nearly 1% per year. This analysis does not include any rise in consumption that might coincide with changes in the income tax code or investment from reforms in corporate taxes.

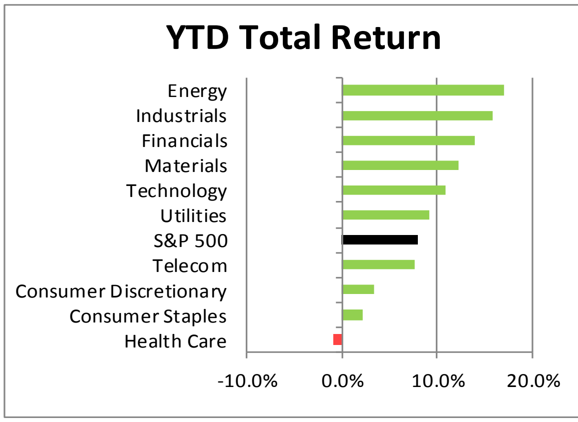
Simply put, the combination of fiscal stimulus and import restrictions could lead to a sizeable boost to growth. The downside to the policy is that it would certainly be inflationary. One of the key elements to containing inflation over the past nearly four decades has been through globalization. Trade impediments shift the aggregate supply curve toward the origin, meaning that price levels are higher at the same level of output. But, in an economy that is struggling to boost price levels, the impact of higher inflation will be benign, at least for a while.

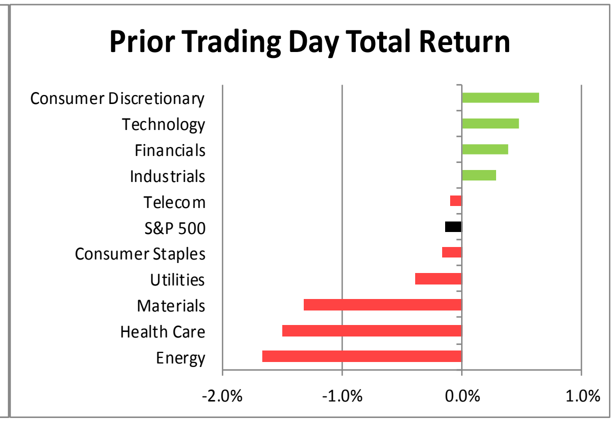
Higher inflation will raise interest rates. We expect monetary policy to remain accommodative in the face of rising inflation due to political pressure on the Federal Reserve. The dollar will likely rally because trade restrictions reduce the global supply of the U.S. currency, driving up the price. The deflationary impact of a stronger dollar will be reduced because of fewer imports, although the imports that do arrive will be cheaper.

We will continue to monitor the progress of policy in the coming months. But, in terms of asset allocation, our committee has started to address these changes and will be reacting in due course.

Data Section

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

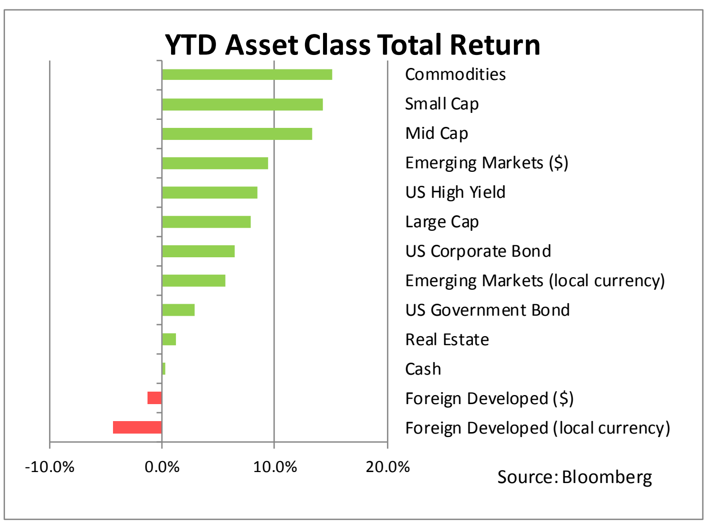




(Source: Bloomberg)

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 11/11/2016 close)

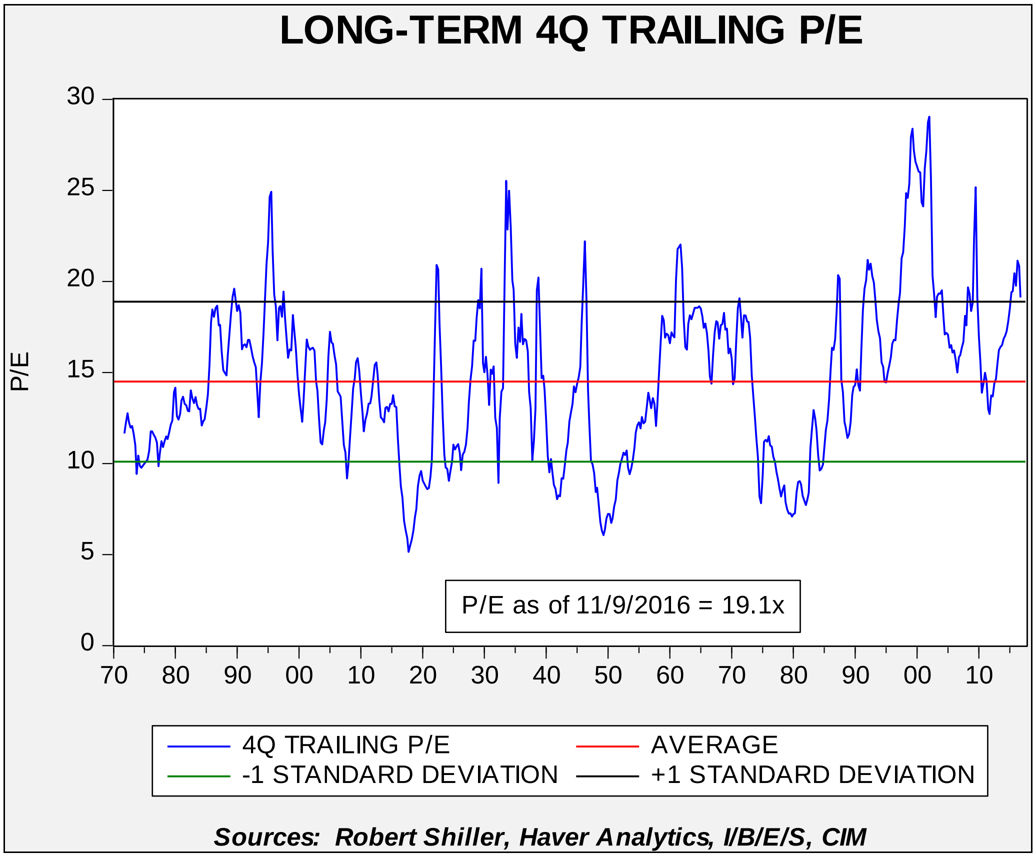


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 10, 2016



Based on our methodology,[2] the current P/E is 19.1x, down 0.1x from last week. Improved earnings 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.

[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.