Daily Comment

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

[Posted: November 16, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.1% higher from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.1% and the Shenzhen index moving sideways. U.S. equity futures are signaling a lower opening. With 460 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, 72.8% of the companies reported earnings above forecast, while 21.1% reported earnings below forecast.

After a day of profit taking, the previous trends have returned; the dollar is up as are Treasury yields. Gold prices are lower. Oil prices are giving back some of their large gains from yesterday as the API data showed a larger than expected build in stockpiles. The official DOE data is out at 10:30 EST.

The media remains focused on President-elect Trump's transition. We are watching this too but with some degree of restraint because, at this juncture, it's a bit like what's going on in baseball. In the latter, this is "hot stove" season, where trades are made and free agents are soon to follow. Baseball writers are floating all sorts of trade packages and tracking down rumors of deals. Although it's great sport, it will be a bit of time before actual transactions occur. The same is true for the new administration. Names are being floated about; a great deal of electronic ink is being deployed in commentary. But, the "decider," Trump, has been rather quiet about his choices. Until people are actually named to positions, we are not going to comment about his choices and the impact on policy.

It appears we are seeing a battle within the transition team between the populists and the establishment. The latter does seem to be trying to sway the new president into a traditional center-right package of tax cuts and hard money. For example, David Malpass, an economic consultant with supply side leanings to the Trump campaign, is on the tape this morning calling for the Fed to create a plan to shrink its balance sheet. We suspect this would lift long-term interest rates; how much rates would rise depends on a number of factors but, barring a recession, it is difficult to see how this would lower rates. Similar talk has emerged about appointing hawks to the two open Fed governor positions. The establishment wants the new administration to focus on tax cuts and deregulation. Fiscal spending, trade restrictions and immigration curtailment would be, at best, back burner concerns for the establishment and probably not enacted. The populists could probably live without hard money and tax cuts but really want to see infrastructure spending, immigration control and trade impediments. Our read is that if the establishment wins, Trump will likely face a primary challenge by a populist in 2020, and the Democrats won't make the same 2016 mistake and will run a candidate from the Warren/Sanders wing of the party.

Meanwhile, we are seeing the dollar strengthen. What is occurring in China is especially notable.

(Source: Bloomberg)

This chart shows the CNY/USD exchange rate (inverted scale). The Chinese yuan is making new lows this morning. Such weakness will likely trigger Trump's campaign promise to declare China a "currency manipulator."

We are also seeing rising rates abroad.

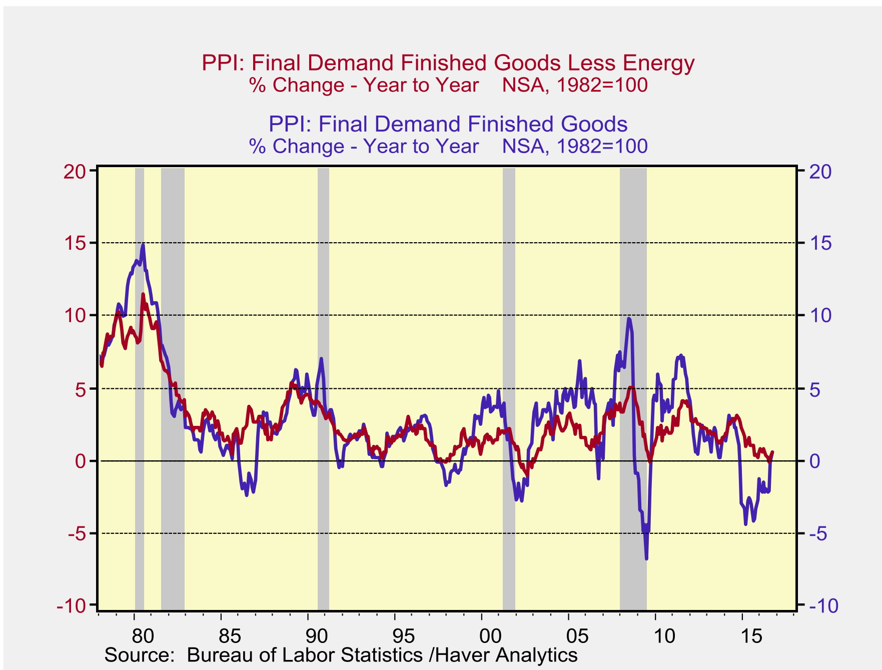
(Source: Bloomberg)

This chart shows the yield on the 10-year German sovereign. After falling into negative territory for the first three-quarters of the year, we are seeing a sharp rise in rates. In our standard bond model, a 100 bps change in this yield adds 23 bps to the U.S. 10-year T-note.

U.S. Economic Releases

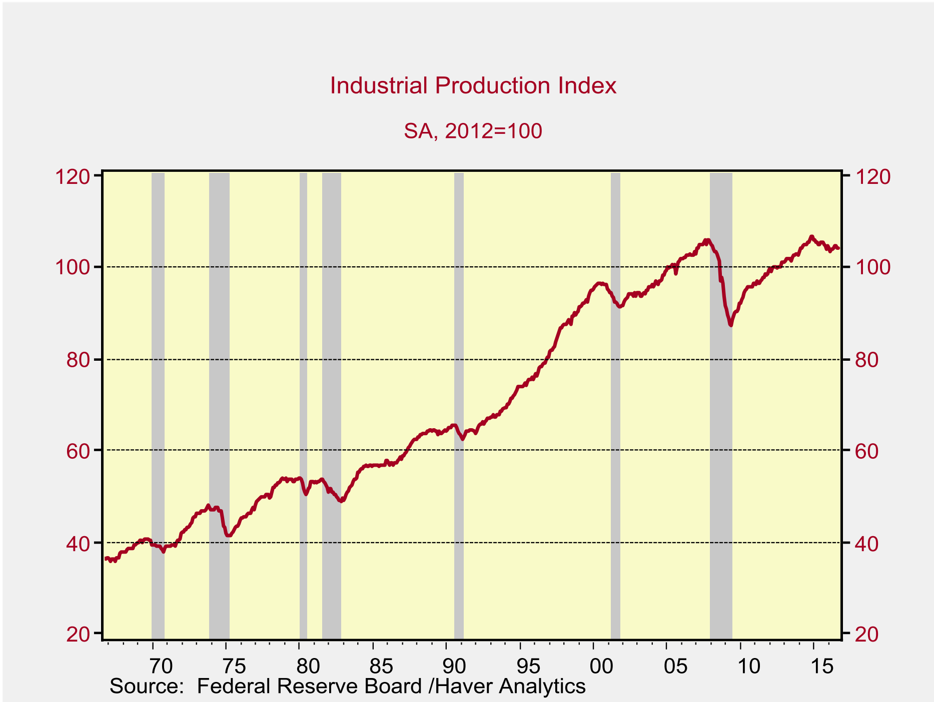
Today, MBA mortgage applications came in at -9.2%, a decrease from the prior week at -1.2%. Applications for purchases fell 6.2% and applications for refinancing plunged 10.9%. The 30-year mortgage rate jumped to 3.95%, up 18 bps. The spike in yields is the likely reason for the drop in applications.

PPI final demand remained unchanged from last month, falling below estimates of a 0.3% increase. PPI excluding food and energy fell by 0.2%, also below estimates of a 0.2% increase.

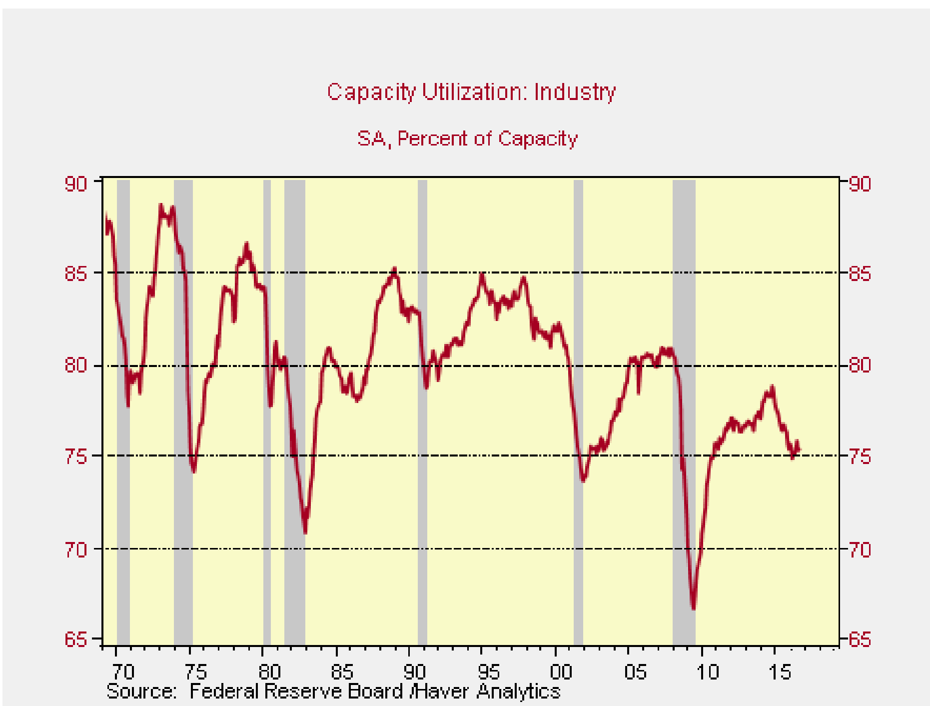


The chart above shows the annual change in PPI of finished goods and finished goods without food and energy. The annual changes were 0.6% and 0.5%, respectively. This graph shows that inflation is still relatively low but could be picking up.

Industrial production was unchanged for October, below the forecast of 0.2%. The prior month's change was revised downward to -0.2% from 0.1%.



Capacity utilization came in weaker than expected at 75.3% compared to the 75.5% forecast, and also lower than September levels of 75.4%.



The chart above shows growth capacity utilization over the past 30 years. Recently, capacity utilization has been weak due to lower than expected economic activity.

The table below lists the Fed speakers and events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Housing Market Index	m/m	nov	63	63	**
16:00	Total Net TIC Flows	m/m	nov		$73.8 bn	**
16:00	Net Long- Term TIC Flows	m/m	nov		$48.3 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
17:30	Patrick Harker Speaks on Purpose of the Fed	President of the Federal Reserve Bank of Philadelphia				

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	Housing Loans	y/y	3q	2.7%	2.4%		**	Equity bullish, bond bearish
Australia	Westpac Leading Index	m/m	oct	0.1%	0.1%		**	Equity and bond neutral
	Wage Price Index	y/y	3q	1.9%	2.1%	2.0%	**	Equity and bond neutral
	New Motor Vehicles Sales	y/y	oct	1.2%	0.8%		**	Equity and bond neutral
New Zealand	Non Resident Bond Holdings	y/y	oct	63.9%	65.0%		**	Equity and bond neutral
EUROPE								
UK	Claimant Count Rate	y/y	oct	2.3%	2.3%	2.3%	**	Equity and bond neutral
	Jobless Claims Change	y/y	oct	9.8k	0.7k	2k	**	Equity bearish, bond bullish
	Average Weekly Earnings	y/y	sep	2.3%	2.3%	2.3%	**	Equity and bond neutral
	Employment Change	y/y	sep	49k	106k	91k	**	Equity bearish, bond bullish
Switzerland	Credit Suisse ZEW Survey Expectations	y/y	nov	8.9	5.2		**	Equity bullish, bond bearish
Russia	CPI Weekly	y/y	nov	4.8%	4.7%		**	Equity and bond neutral
	Industry Production	y/y	oct	-0.2%	-0.8%	-0.4%	**	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)	91	91	0	Neutral
3-mo T-bill yield (bps)	48	48	0	Neutral
TED spread (bps)	44	43	1	Up
U.S. Libor/OIS spread (bps)	56	55	1	Up
10-yr T-note (%)	2.27	2.22	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	51	48	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	$46.49	$46.95	-0.98%	Pessimism about possible OPEC Agreement
WTI	$45.26	$45.81	-1.20%	
Natural Gas	$2.69	$2.71	-0.66%	
Crack Spread	$12.13	$11.79	2.89%	
12-mo strip crack	$13.84	$13.61	1.69%	
Ethanol rack	$1.70	$1.71	-0.41%	
Metals				
Gold	$1,225.61	$1,228.73	-0.25%	
Silver	$17.00	$17.08	-0.43%	
Copper contract	$248.05	$250.50	-0.98%	
Grains				
Corn contract	$ 350.25	$ 349.25	0.29%	Price Taking
Wheat contract	$ 419.25	$ 418.75	0.12%	
Soybeans contract	$ 994.00	$ 989.50	0.45%	
Shipping				
Baltic Dry Freight	1084	1065	19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.0		
Gasoline (mb)		-1.6		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.5%		

Weather

The 6-10 and 8-14 day forecasts continue to call for mild weather for most of the country and cooler weather for the eastern region. 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.

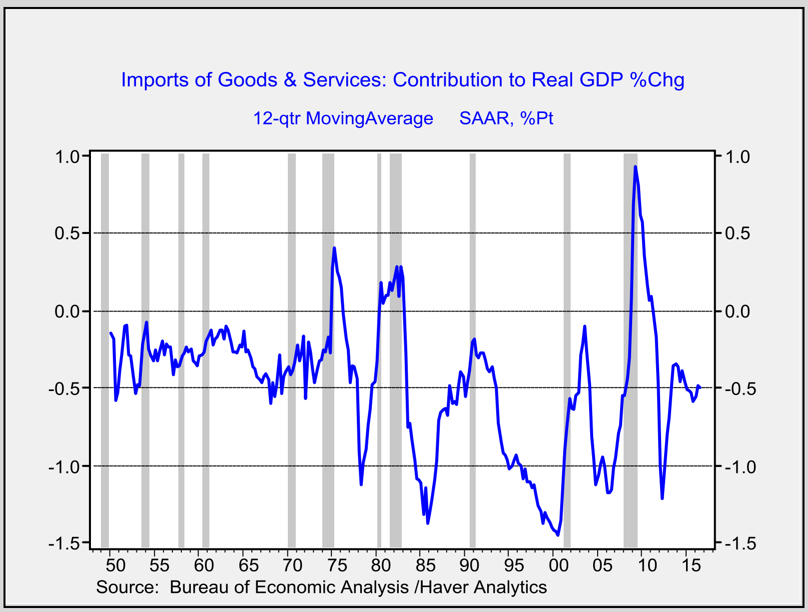
November 11, 2016

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.



[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.

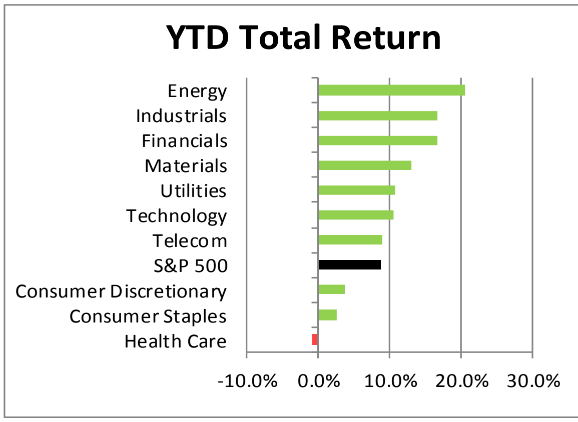
Simply put, the combination of fiscal stimulus and import restrictions could lead to a sizeable boost to growth. The downside to the policy is that it would certainly be inflationary. One of the key elements to containing inflation over the past nearly four decades has been through globalization. Trade 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.

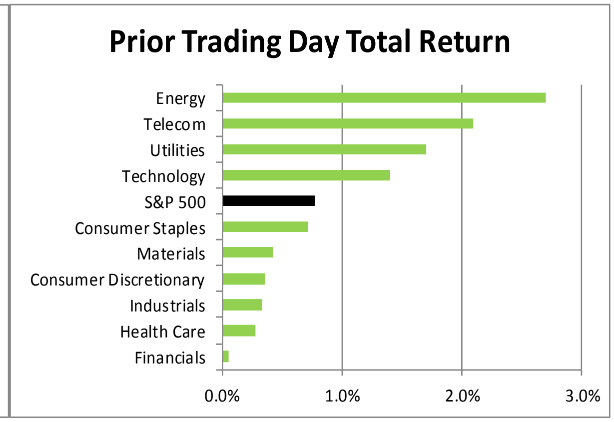
Higher inflation will raise interest rates. We expect monetary policy to remain accommodative in the face of rising inflation due to political pressure on the Federal Reserve. The dollar will likely rally because trade restrictions reduce the global supply of the U.S. currency, driving up the price. 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 11/15/2016 close)

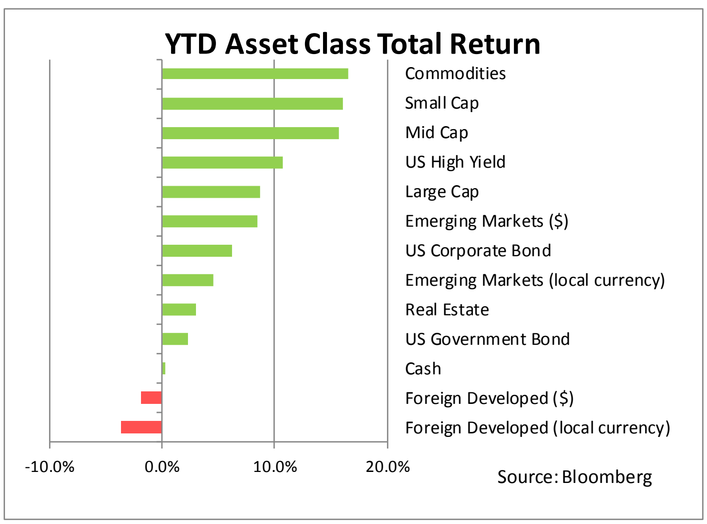




(Source: Bloomberg)

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 11/15/2016 close)

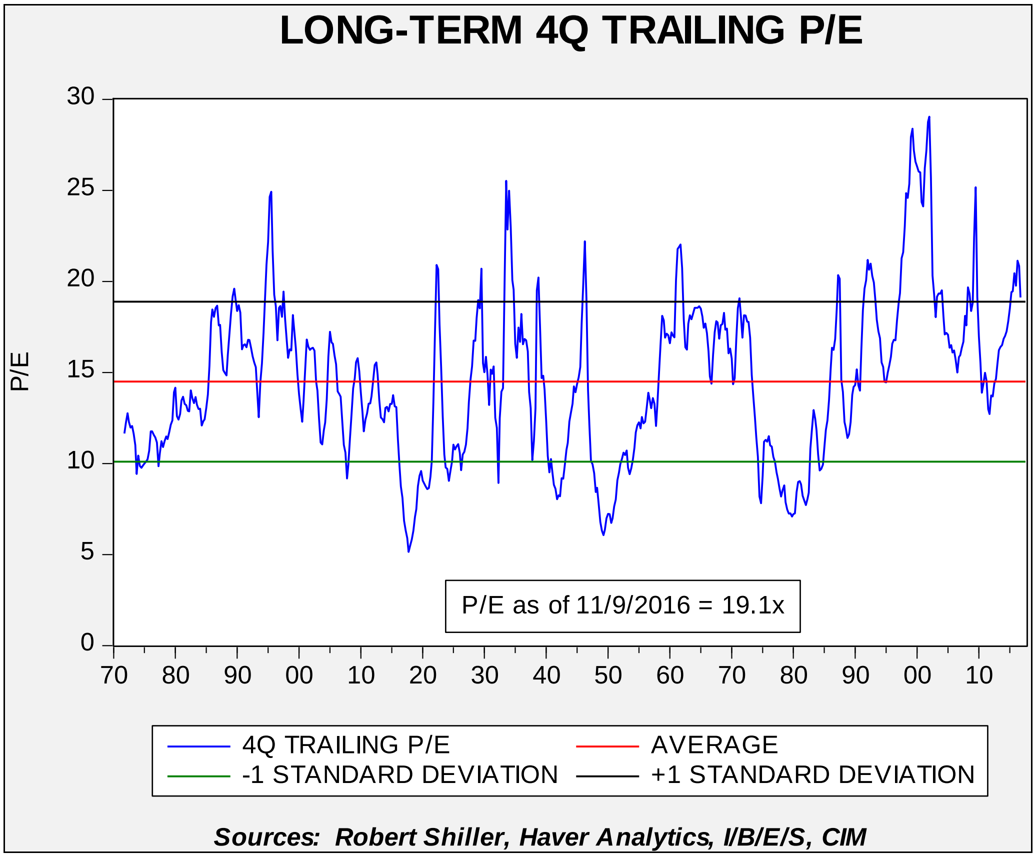


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 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.