Confluence INVESTMENT MANAGEMENT

Daily Comment

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

[Posted: November 25, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed 0.4% higher from the prior close. Chinese markets were higher, with the Shanghai composite up 0.6% and the Shenzhen index also up 0.4%. U.S. equity futures are signaling a higher opening. With 489 companies having reported, the S&P 500 Q3 earnings stand at $31.28, higher than the $29.23 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 72.5% of the companies reported earnings above forecast, while 20.7% reported earnings below forecast.

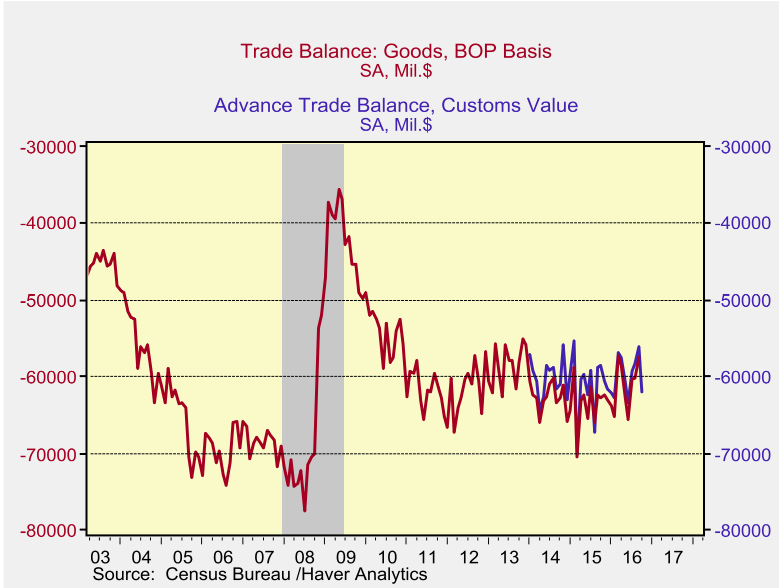
Uncertainty continues to plague the European Union as a result of growing populist movements. Today, Turkish President Recep Tayyip Erdogan threatened to allow refugees to enter Europe after the European Parliament voted to stop talks regarding Turkey's admission into the EU. Turkey has received a lot of criticism from the EU for its brutal crackdown following the failed coup earlier this year. If Erdogan were to carry out this threat it would strengthen populist movements throughout the EU. Populist leaders such as France's National Front Leader Marine Le Pen, who plans to immediately withdraw France's membership from the EU if elected, have exploited peoples' frustrations with slow economic growth and growing immigration. If populism were to take hold throughout Europe it could lead to the end of the European Union.

The stock market rally is continuing to rise to new highs. President-elect Trump's proposals to increase infrastructure spending and tax cuts along with business deregulation have been met with optimism about possible economic growth. A lot of this growth in optimism can be attributed to beliefs that he is more flexible than most people gave him credit for during the election. He has recently softened his stance on climate change, Obamacare and immigration.

There is still uncertainty within the oil markets as Russia has only committed to an output freeze and Iran is looking for an exemption. As a result of this uncertainty, Saudi Arabia has pulled out of "non-OPEC" meetings. Even though it is widely perceived that an agreement will be reached before November 30, there is growing pessimism within the market.

U.S. Economic Releases

The October advance goods trade deficit came in wider than forecast, coming in at $62.0 bn compared to the forecast deficit of $59.0 bn. The previous month's deficit was revised wider to $56.5 bn from $56.1 bn. The trade deficit has widened for the first time in four months. Exports fell 2.7% for the month, while imports rose 1.1%.



The chart above shows the level of the trade balance. Over the past three years, the trade deficit has been volatile but has generally moved sideways.

Wholesale inventories came in below forecast at -0.4% compared to the +0.2% estimated. The prior month's report was revised downward from 0.1% to -0.1%. The fall in inventories came from a 0.9% decline in nondurable goods.

The table below lists the economic releases for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Services PMI	m/m	nov	54.8	54.8	**
9:45	Markit US Composite PMI	m/m	nov		54.9	**

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	National CPI	m/m	oct	0.1%	-0.5%	0.0%	***	Equity and bond neutral
	Tokyo CPI	m/m	oct	0.5%	0.0%	0.1%	***	Equity and bond neutral
	PPI Services	y/y	oct	0.5%	0.3%	0.3%	**	Equity and bond neutral
New Zealand	Trade Balance	y/y	oct	-.846 bn	-1.436 bn	-.971 bn	**	Equity bullish, bond bearish
	Exports	y/y	oct	3.90 bn	3.47 bn	3.76 bn	**	Equity bullish, bond bearish
	Imports	y/y	oct	4.74 bn	4.90 bn	4.66 bn	*	Equity and bond neutral
EUROPE								
Germany	Private Consumption	y/y		0.4%	0.2%	0.3%	**	Equity and bond neutral
	Exports	y/y		-0.4%	1.2%	-0.3%	**	Equity and bond neutral
	Imports	y/y		0.2%	-0.1%	-0.3%	**	Equity and bond neutral
	GDP	y/y		1.5%	1.5%	1.5%	***	Equity and bond neutral
France	Manufacturing Confidence	y/y		103	102	102	**	Equity and bond neutral
	Consumer Confidence	y/y		98	98	98	**	Equity and bond neutral
Italy	Retail Sales	y/y		-1.4%	-0.1%	0.2%	**	Equity bearish, bond bullish
	Hourly Wage	y/y		0.6%	0.6%		**	Equity and bond neutral
UK	GDP	y/y		2.3%	2.3%	2.3%	***	Equity and bond neutral
	Exports	y/y		0.7%	-1.0%	1.0%	**	Equity and bond neutral
	Imports	y/y		-1.5%	1.3%	-0.1%	**	Equity and bond neutral
Switzerland	Industrial Output	y/y		0.4%	-1.2%			Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	nov	8.1%	8.9%	8.1%	***	Equity and bond neutral
	Bi-Weekly CPI	y/y	nov	3.3%	3.0%	3.2%	**	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)	93	92	1	Up
3-mo T-bill yield (bps)	49	49	0	Neutral
TED spread (bps)	44	44	0	Neutral
U.S. Libor/OIS spread (bps)	60	60	0	Neutral
10-yr T-note (%)	2.36	2.35	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	56	57	-1	Down
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	up			Down
pound	down			Down
franc	up			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	$48.31	$49.00	-1.41%	Resistance from Russia and Iran in OPEC talks
WTI	$47.63	$47.96	-0.69%	
Natural Gas	$3.03	$3.03	0.17%	
Crack Spread	$13.38	$13.75	-2.67%	
12-mo strip crack	$14.89	$15.15	-1.70%	
Ethanol rack	$1.76	$1.76	0.00%	
Metals				
Gold	$1,189.53	$1,181.67	0.67%	Slightly weaker dollar
Silver	$16.46	$16.29	1.04%	
Copper contract	$267.35	$261.75	2.14%	
Grains				
Corn contract	$ 359.25	$ 359.00	0.07%	
Wheat contract	$ 423.75	$ 427.25	-0.82%	
Soybeans contract	$ 1,034.25	$ 1,030.00	0.41%	
Shipping				
Baltic Dry Freight	1201	1224	-23	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.3	2.5	-3.8	
Gasoline (mb)	2.3	1.0	1.3	
Distillates (mb)	0.3	-1.0	1.3	
Refinery run rates (%)	1.7%	0.5%	1.2%	
Natural gas (bcf)	-2.0	6.0	-8.00	

Weather

The 6-10 and 8-14 day forecasts show cooler temperatures for the western region and mild weather for the rest of the country. Precipitation is also expected for most of the country. Tropical Storm Otto has moved toward the Pacific but it does not appear likely to enter the GOM.

Asset Allocation Weekly Comment

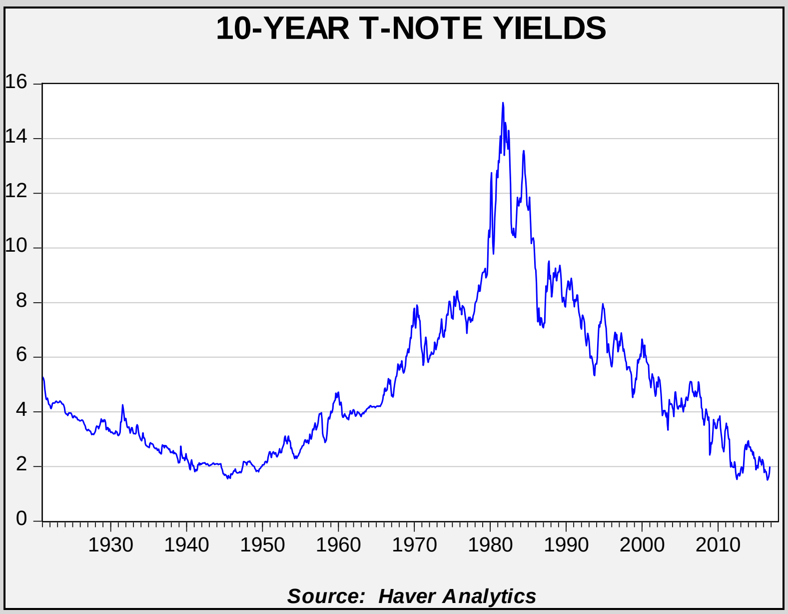
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

Due to the Thanksgiving holiday we will not be publishing a new Asset Allocation Weekly Comment this week. We will resume on Friday, December 2.

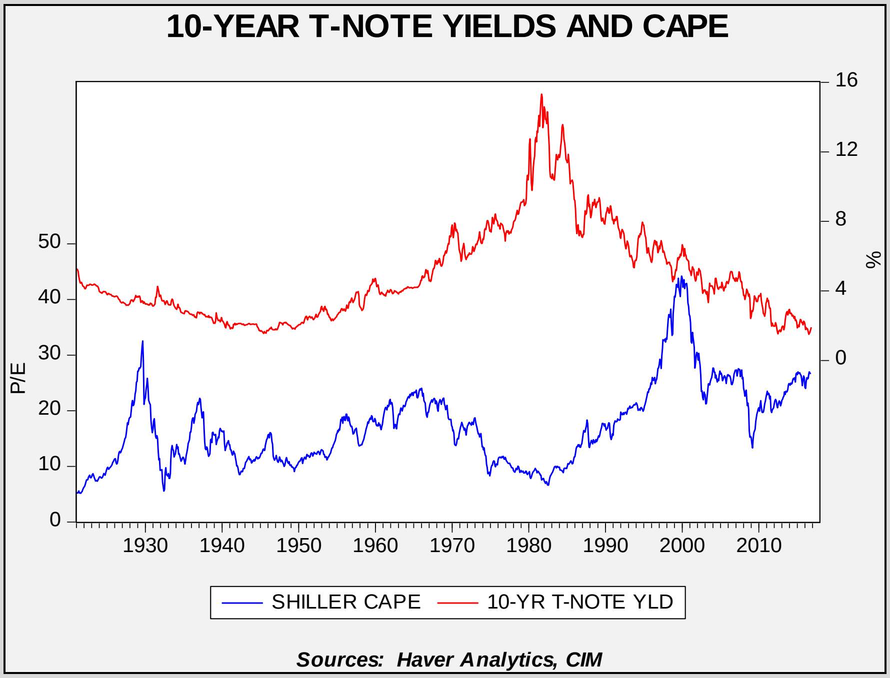
November 18, 2016

Trumponomics looks as if it will be a combination of fiscal stimulus, trade restrictions and deregulation. It looks very likely that environmental regulations will be reversed and there have been promises of financial deregulation as well. The first two will likely reflate the economy. Proposed deregulation may help hold down energy prices but financial services are not a major contributor to inflation (only about 0.24% in CPI) anyway.

With reflation on the horizon, we have seen a rise in the 10-year yield. Even though we would expect a retreat in yield during the next recession, it is likely that the secular bond bull market that began in the early 1980s is coming to a close.

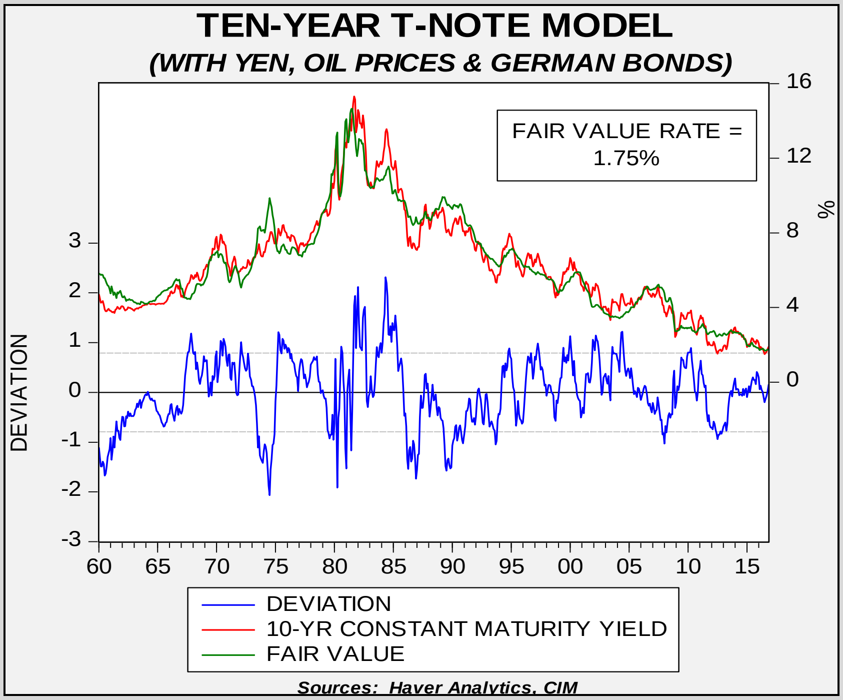


The chart above shows the 10-year T-note yield from 1921. Perhaps the most important issue to remember is that when the last secular bear market began after the lows were made in 1945, the next peak took 36 years. It took eight years before yields doubled. Although the regulatory environment is different, it takes a while for bond yields to reach really high levels. Still, the tailwind for financial assets that this bull market represents is noteworthy.



This chart shows the 10-year T-note yield and the cyclically adjusted price/earnings ratio (CAPE) that was developed by Robert Shiller. The CAPE deflates earnings and stock prices and then averages earnings over a decade, generating a P/E that is designed to capture the underlying trend in real earnings. Note that the P/E rose from 1950 to 1965 even though rates rose. However, as inflation steadily increased, interest rates and the P/E moved in opposite directions. Casual observation suggests that rates above 4% and rising lead to a lower multiple.

How high will interest rates rise? Our broad 10-year T-note model puts the fair value yield at 1.75%.

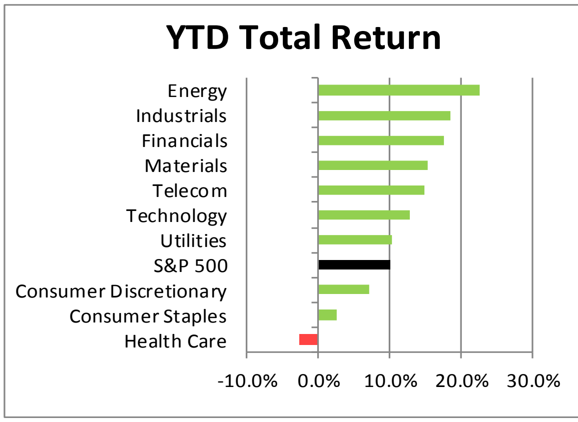


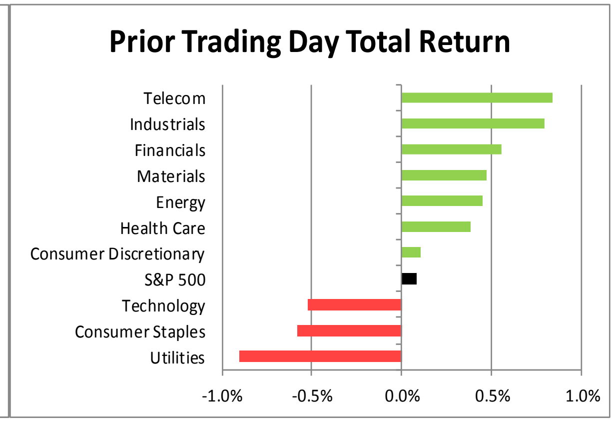
The model uses fed funds, the 15-year moving average of CPI (an inflation expectations proxy), the yen/dollar exchange rate, oil prices and German bond yields. The most important variable keeping the fair value low are German bond yields; removing those from the model boosts the fair value yield to 2.42%. In a less globalized world, the impact of foreign rates might be reduced, so there is a concern the model is underestimating the fair value yield. However, as long as capital flows remain open, the impact of lower German yields should be a bullish factor for long-duration Treasuries. In addition, if we assume a 25 bps hike in fed funds next month, the fair value yield would increase to 1.84%.

Overall, a case can be made that the recent spike in long-duration yields is overdone, at least in the short run. On the other hand, as we discussed in the most recent WGR, if the U.S. retreats from the superpower role, inflation expectations will likely rise and weaken the case for holding long-duration instruments. We continue to closely monitor the fixed income markets but it does appear that the long bull market in Treasuries may be coming to an end.

Data Section

U.S. Equity Markets – (as of 11/23/2016 close)

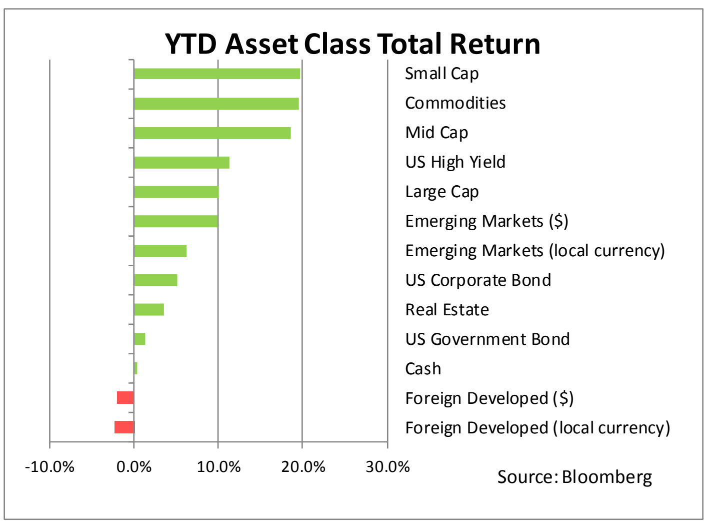




(Source: Bloomberg)

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 11/23/2016 close)



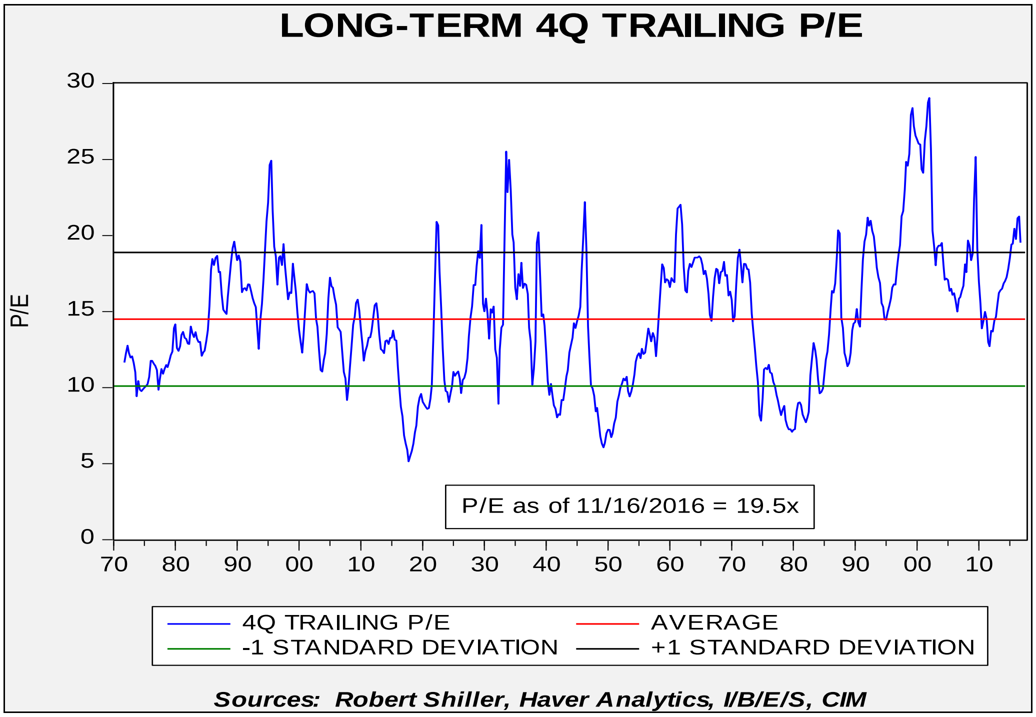
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

Due to the Thanksgiving holiday we will not be updating the P/E chart this week. We will resume on Thursday, December 1.

November 17, 2016



Based on our methodology,[1] the current P/E is 19.5x, up 0.4x from last week. The rise in the P/E is due to the fact that we now have enough data that S&P has projected its earnings report for Q3. Although earnings are up strongly, the divergence we have noted in the past continues between Thomson-Reuters and S&P.

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[1] 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 the actual (Q1,Q2 and Q3) and one estimate (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.