Confluence INVESTMENT MANAGEMENT

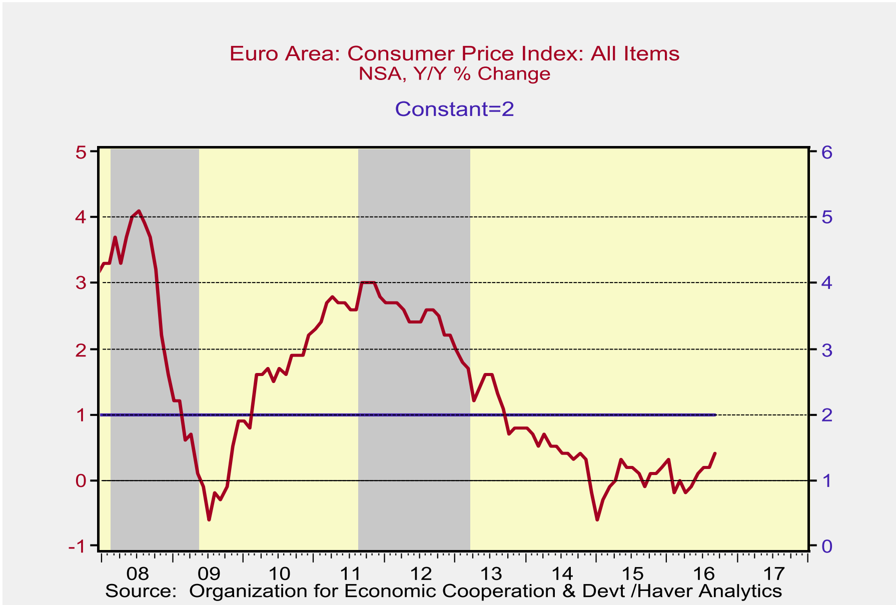
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: October 20, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite moving sideways and the Shenzhen index moving up by 0.1%. U.S. equity futures are signaling a higher opening. With 81 companies having reported, the S&P 500 Q3 earnings stand at $30.13, higher than the $29.63 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 in the consensus estimates. Thus far this quarter, 79.0% of the companies reported earnings above forecast, while 17.3% reported earnings below forecast.

ECB President Mario Draghi is giving his press conference as we write this. The ECB maintained its benchmark lending rate at zero, the deposit rate at -0.4% and the asset purchases at €80 bn a month. Draghi said that the central bank expects interest rates to remain at presently low rates or lower. He was asked if the committee would consider lowering rates in December, which Draghi deemed to be possible if the data calls for it, especially the strength of the economy and inflation. Updated economic projections are also due for the ECB's December meeting, thus providing more color on the effect of the current interest rate and stimulus policies.

The current ECB QE program is slated to end in March 2017, and what's interesting is that Draghi indicated that there was no discussion during this week's meetings of continuing or extending the stimulus program. At the same time, Draghi said that he would not expect an abrupt end to the QE program, but that a tapering is more likely when the Governing Council decides to withdraw stimulus. The stimulus package will be maintained until there is "a sustained adjustment in the path of inflation" consistent with the ECB's inflation aim. Inflation has remained mild in the Eurozone, having remained below the central bank's target rate of 2.0% since 2013. The chart below shows the annual change in the headline CPI and the ECB's target rate. Although CPI has picked up modestly recently, it still remains below the target rate.



The bank expects inflation to move close to the target rate by early 2019. Given the lack of inflationary pressures and the ECB's own inflation expectations, we would expect the QE program to remain in place until at least 2019.

Markets were expecting these outcomes; despite an initial drop in European equities, risk markets have bounced back. The chart below shows the intraday chart of the euro, which spiked initially when the press conference started but has moved lower since.

(Source: Bloomberg)

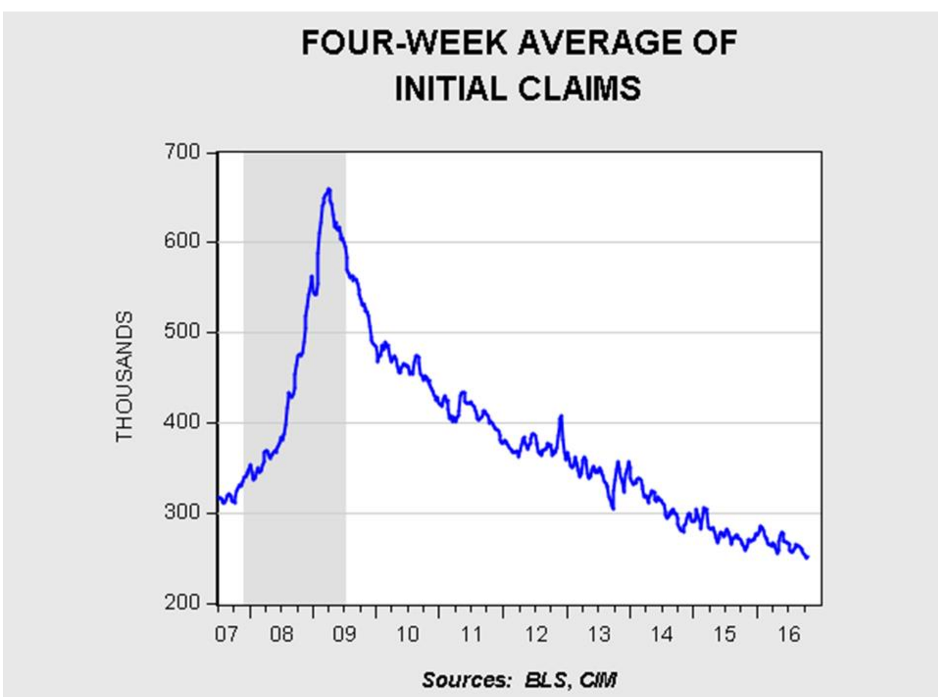
Additionally, the chart below shows the EuroStoxx 50, which fell after comments from Draghi that the future of the stimulus package was not even discussed, but equities have rebounded since.

(Source: Bloomberg)

Regarding the U.S. presidential race, the third and final debate was held last night. The debate focused on immigration, the Supreme Court and the Second Amendment. It is unclear whether either candidate was able to persuade the undecided voters.

U.S. Economic Releases

Initial claims rose 13k to 260k, more than the 250k level forecast. Claims still remain near four-decade lows.



The chart above shows the four-week moving average of initial jobless claims. The average rose 2k to 252k.

The October Philadelphia Fed Business Outlook came in at 9.7, higher than the 5.0 level forecast, but weakening from the 12.8 level seen last week.

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

EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg US National Economy Expectations	y/y	oct		41.5	*
9:45	Bloomberg Consumer Comfort	y/y	oct		42.1	*
10:00	Existing Home Sales	y/y	sep	5.31 m	5.33 m	**
10:00	Leading Index	y/y	sep	0.2%	-0.2%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
8:30	William Dudley Gives Remarks at Bank Culture Conference	President of the Federal Reserve Bank of New York				

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	Nationwide Dept Sales	y/y	sep	-5.0%	-6.0%		**	Equity bearish, bond bullish
	Japan Buying Foreign Bonds	w/w	oct	317.7 bn	-737.7 bn		**	Equity bullish, bond bearish
	Foreign Buying Japan Bonds	w/w	oct	365.4 bn	289.6 bn		**	Equity bullish, bond bearish
	Japan Buying Foreign Stocks	w/w	oct	145.4 bn	87.1 bn		**	Equity bullish, bond bearish
	Foreign Buying Japan Stocks	w/w	oct	72 bn	430.3 bn		**	Equity bullish, bond bearish
	Machine Tool Orders	y/y	Sep	-6.3%	-6.3%		*	Equity and bond neutral
Australia	NAB Business Confidence	y/y	3Q	5	2		*	Equity bullish, bond bearish
	Employment Change	y/y	sep	-9.8k	-3.9k	15k	**	Equity and bond neutral
	Unemployment Rate	y/y	sep	5.6%	5.6%	5.7%	***	Equity and bond neutral
	Participation Rate	y/y	sep	64.5%	64.7%	64.8%	**	Equity and bond neutral
EUROPE								
Eurozone	Current Account	y/y	sep	23.6 bn	31.5 bn		**	Equity bearish, bond bullish
	ECB Main Refinancing Rate	y/y	sep	0.0%	0.0%	0.0%	**	Equity and bond neutral
Italy	Current Account	y/y	aug	3.368 bn	9.418 bn		**	Equity bearish, bond bullish
Switzerland	Trade Balance	y/y	sep	4.37 bn	3.02 bn		**	Equity bullish, bond bearish
	Exports Real	y/y	sep	4.3%	-2.1%		**	Equity bullish, bond bearish
	Imports Real	y/y	sep	-3.3%	-3.5%		**	Equity and bond neutral
Germany	PPI	y/y	sep	-1.4%	-1.2%	-1.6%	**	Equity and bond neutral
UK	Retail Sales	y/y	sep	4.1%	4.7%	6.2%	**	Equity bearish, bond bullish
AMERICAS								
Brazil	Economic Activity	y/y	aug	-2.7%	-5.2%	-2.9%	**	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)	88	88	0	Neutral
3-mo T-bill yield (bps)	33	33	0	Neutral
TED spread (bps)	56	55	1	Up
U.S. Libor/OIS spread (bps)	48	47	1	Up
10-yr T-note (%)	1.75	1.74	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	40	38	2	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	down			Down
pound	down			Down
franc	up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada	0.50%	0.50%	0.50%	On forecast
Brazil Selic Rate	14.00%	14.25%	14.00%	On forecast
ECB marginal lending facility	0.25%	0.25%	0.25%	On forecast
ECB asset purchase target	€80 bn	€80 bn	€80 bn	On forecast

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	$51.84	$52.67	-1.58%	Profit taking due to a stronger dollar
WTI	$50.85	$51.60	-1.45%	
Natural Gas	$3.18	$3.17	0.35%	
Crack Spread	$12.92	$13.01	-0.71%	
12-mo strip crack	$14.96	$15.16	-1.34%	
Ethanol rack	$1.72	$1.72	0.25%	
Metals				
Gold	$1,271.65	$1,269.23	0.19%	
Silver	$17.68	$17.68	-0.03%	
Copper contract	$209.65	$210.35	-0.33%	
Grains				
Corn contract	$ 358.00	$ 357.50	0.14%	Profit taking
Wheat contract	$ 420.50	$ 420.25	0.06%	
Soybeans contract	$ 984.25	$ 981.50	0.28%	
Shipping				
Baltic Dry Freight	872	890	-18	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.2	1.7		
Gasoline (mb)	2.5	-1.25		
Distillates (mb)	-1.2	-1.5		
Refinery run rates (%)	-0.5%	-0.3%		
Natural gas (bcf)		73.00		

Weather

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

October 14, 2016

Given continued sluggish economic growth and fears that monetary policy has reached the point where it can no longer stimulate growth, a renewed attention has been brought to discretionary fiscal policy. In the 1970s, discretionary fiscal policy fell out of favor due to a number of shortcomings:

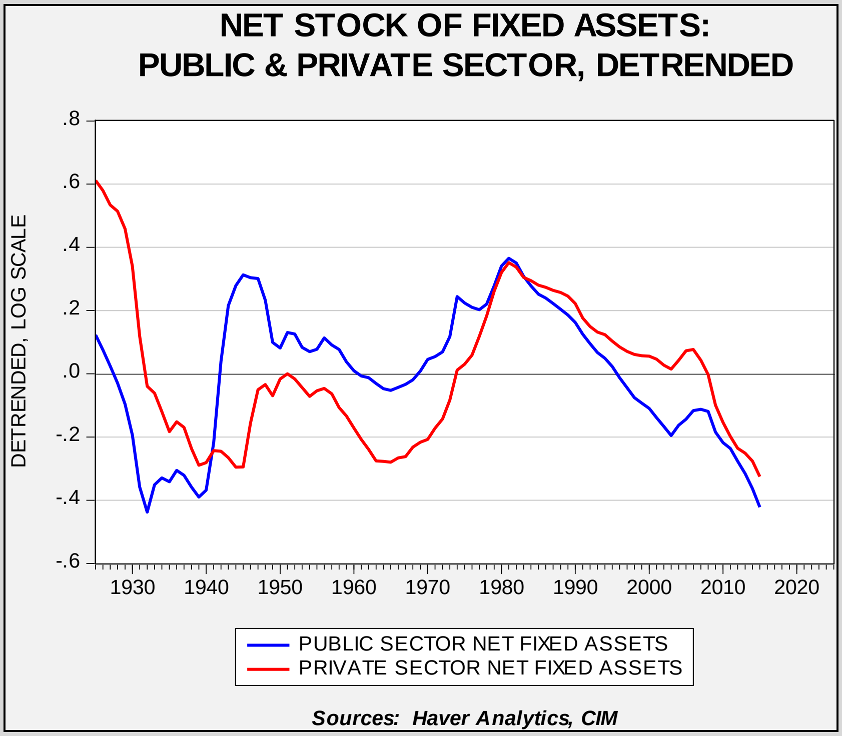
1. Public investment, if needed, should not be timed to offset recessions. In other words, if the Navy needs an aircraft carrier, one should be built without waiting for a recession. Thus, public investment should be based on need, not designed as a countercyclical policy.
2. Discretionary policy must pass through the legislative process. This tends to slow the outcome to the point that the recession may have passed by the time Congress allocates spending.
3. Fiscal spending, especially fixed asset spending, can "crowd out" private spending. In functioning investment markets, investment spending should be generated by cutting interest rates rather than by directing public investment by government fiat. In addition, private investment is forced to pass through the test of profitability, reducing the likelihood of malinvestment.

From the late 1970s, economists generally concluded that discretionary fiscal spending was unnecessary and that countercyclical monetary policy was sufficient to guide the economy through recessions. Although there were occasional extraordinary fiscal measures taken during some downturns, such as tax rebates and extended unemployment insurance payments, for the most part, monetary policy was the measure of choice in terms of countercyclical policy.

However, the developed world now finds itself in a situation where monetary policy may have reached its point of diminishing returns. The Bank of Japan (BOJ), the Swiss National Bank and the European Central Bank (ECB) have tried to implement negative interest rates. In these cases, it appears that the damage to the banking system is offsetting any gains from lower rates. Balance sheet expansions (QE) have been deployed by the aforementioned central banks and the Federal Reserve. In general, balance sheet expansion has become less effective; a common complaint is that asset values have been extended in many markets without generating much economic growth. Central banks are also struggling to find assets to purchase. The BOJ has been buying equity ETFs and the ECB has added corporate bonds to its balance sheet, causing further financial market distortions.

This isn't to say that the central banks have exhausted all their options, but the ones that remain cannot be implemented without help. For example, central banks could implement quantitative easing by purchasing foreign bonds; this would likely lead to currency depreciation that would boost exports. However, such "beggar thy neighbor" policies would likely bring retaliation and further reduce global trade. The other option is "helicopter money," which is the direct central bank financing of government spending. Although this policy would be effective, it does require the participation of fiscal authorities. In addition, central bank independence would almost certainly be compromised.

So, if fiscal policy is expanded, would we face the problems outlined above? Generally speaking, the biggest risk would be point #2 above. Getting spending plans through a divided Congress would be difficult. In addition, avoiding malinvestment, regardless of whether it's public or private, is always hard. But in the current partisan environment, coming up with public investment that would foster future growth will be problematic. However, there is evidence to suggest that public spending has been neglected for some time and that private investment is currently weak, reducing the problem of "crowding out"; in other words, concerns about points #1 and #3 are reduced.



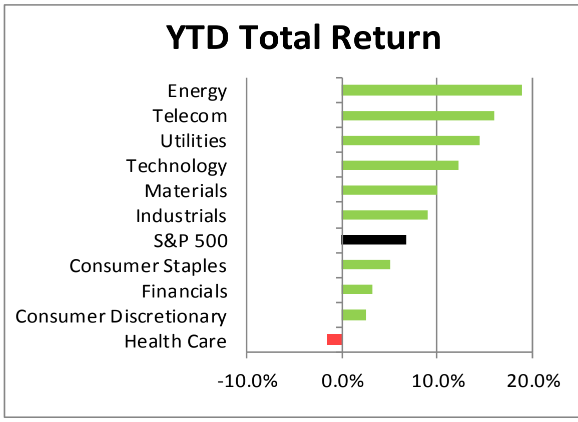
This chart shows the net stock of fixed assets for both the public and private sectors. We have log transformed the data and de-trended both series. In general, a reading over zero indicates the net stock of fixed assets is above its long-term trend and vice versa. Note that public sector assets were above trend from 1940 into the mid-1990s. This was mostly due to elevated Cold War defense spending. During this period, private sector fixed asset levels tended to remain under trend, although a surge that began in the mid-1960s did eventually lead to a rise above trend. Note that the surge of both public and private spending on fixed assets in the 1970s probably led to crowding out and higher inflation.

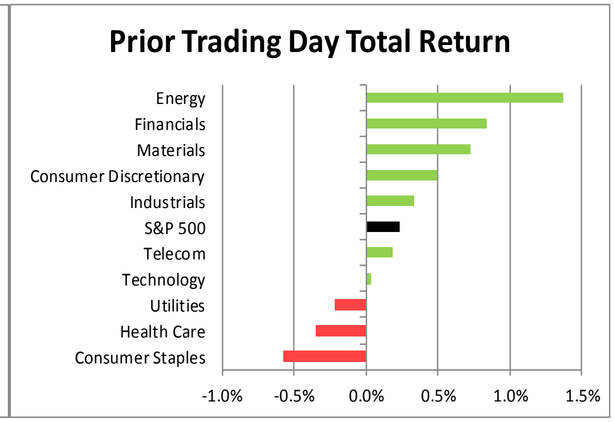
Current conditions suggest that both private and public sector investment are well below trend. In general, private sector investment tends to have a greater impact on future growth and would thus be preferred. However, given an environment of weak asset formation from both sectors, the economy would likely benefit from increased investment in either sector. Thus, promises of increased spending on infrastructure and defense would likely have a positive effect on the economy and be positive for equity markets.

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.

Data Section

U.S. Equity Markets – (as of 10/19/2016 close)

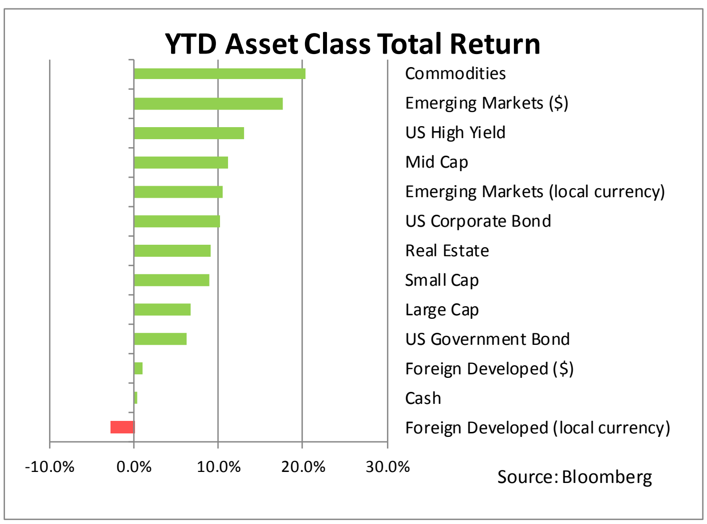




(Source: Bloomberg)

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 10/19/2016 close)

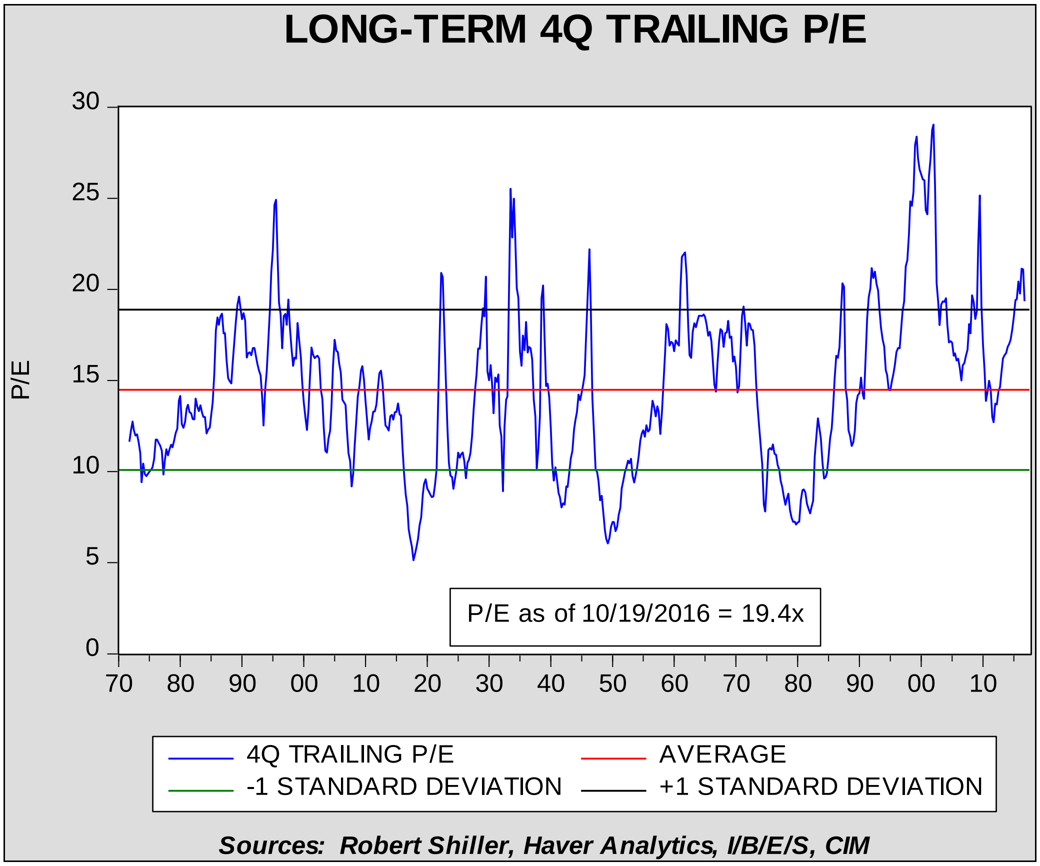


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 20, 2016



Based on our methodology,[1] the current P/E is 19.4x, unchanged from last week.

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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[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 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.