[Posted: October 24, 2016—9:30 AM EDT] Global equity markets are up this morning. The EuroStoxx 50 is trading lower by 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.8% from the prior close. Chinese markets were higher, with the Shanghai composite moving up 1.2% and the Shenzhen index down 0.9%. U.S. equity futures are signaling a higher opening. With 116 companies having reported, the S&P 500 Q3 earnings stand at $30.29, higher than the $29.61 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 78.4% of the companies reported earnings above forecast, while 16.4% reported earnings below forecast.

Good ISM data from Europe (see below) lifted global equity markets. Mergers are another factor affecting financial markets, with the biggest being Time Warner (89.48, +6.84) and ATT (37.49, -1.15). This one is getting lots of political attention. Donald Trump has already indicated that his administration would kill the deal. Sen. Clinton's campaign issued a statement calling for caution and scrutiny. And, Sen. Sanders has come out saying "no way" would he approve the merger. The persistent theme of populism v. establishment appears to be playing out in this merger.

On the election front, it is becoming a foregone conclusion that Donald Trump will lose in historical fashion. We remain unconvinced. Although we still expect Sen. Clinton to win, we suspect the vote will be much closer than current polls suggest. However, we also warn that focusing solely on the presidential race runs the danger of missing major cultural, social and political shifts. The country is dividing along populist and establishment lines. Further evidence of this split comes from reports suggesting that House Majority Leader Ryan (R-WI) is facing a leadership challenge from the Freedom Caucus, the populist GOP House faction. According to Forbes,[1] it is doubtful that the Freedom Caucus can muster enough votes to actually oust Ryan. However, Ryan was never all that keen on the job anyway and has presidential ambitions. Ryan, like his predecessor, will probably be forced to cobble together a voting bloc of establishment Democrats and Republicans to pass any legislation, and such moves will make him unpopular. If the Freedom Caucus makes conditions difficult enough for Ryan, he may just resign, throwing the House into disorder during the lame duck session.

A couple of interesting trends appear to be developing in China. First, the weekend *NYT* reported that the anti-corruption campaign is evolving into a loyalty policing campaign instead. The CPC Central committee begins meetings today and part of Chairman Xi's agenda is tighter control and management of the party. Displays of loyalty are now being demanded. Another

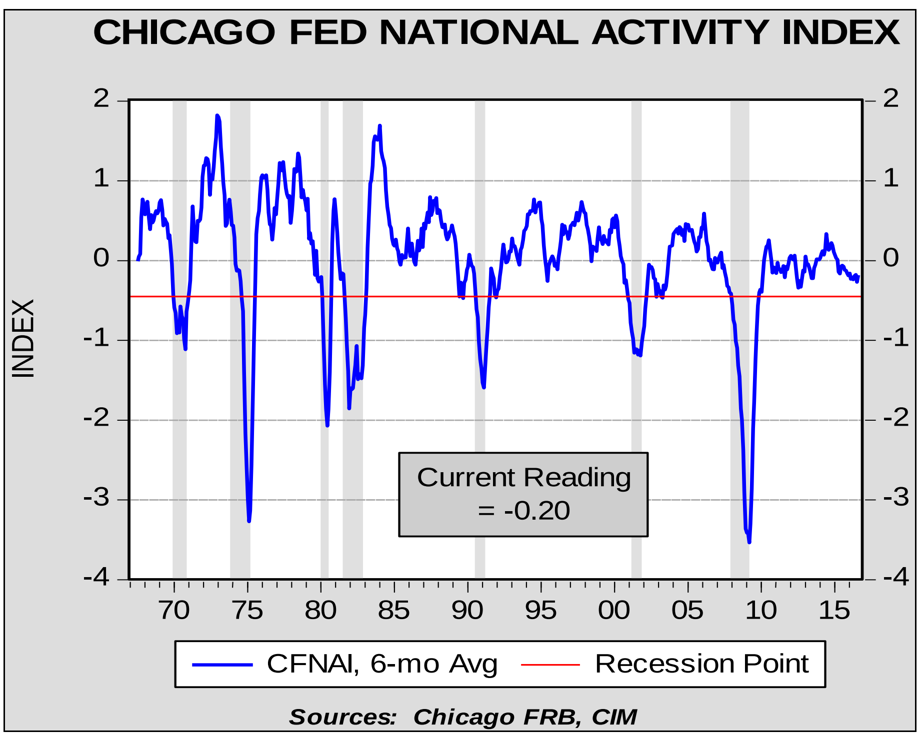
[1] http://www.forbes.com/sites/stancollender/2016/10/23/paul-ryan-could-be-ousted-in-3-weeks-throw-the-lame-duck-into-chaos/#6b6022c77bba

element that appears to be emerging is that Xi is pressing for an end to mandatory retirement rules, which would allow his most trusted advisor, Wang Qishan, who runs the anti-corruption office, to remain in power. Second, there are hints that Xi is also pressing for a third term as leader of China, breaking the tradition established by Deng. The post-Mao rulers did not want to create another dynastic leadership structure and thus implemented an informal two-term limit. Xi has not indicated who will succeed him, something that would be required over the next year if he does not intend to run for a third term. Loyalty oaths would likely support the process of grabbing a third term.

Finally, Iraq is indicating that it will not participate in OPEC output cuts, citing the fact that it is engaged in a war with IS and needs all the revenue it can muster to defeat this foe. With Iran refusing to participate as well, and Russian compliance doubtful, Saudi Arabia is facing the unpleasant prospect of returning to the role of swing producer which will effectively force it to lose market share. If OPEC is unable to negotiate a deal, oil prices are vulnerable to a break into the $40 to $45 per barrel range.

U.S. Economic Releases

The September Chicago Federal Reserve National Activity Index was -0.14, slightly below the forecast of -0.13. The prior month was revised lower to -0.72 from the -0.55 previously reported. The index indicates that the economy is still growing below its long-term trend. When the index reading is below zero, economic growth is slower than its trend. However, we are still above the recession point, which is indicated in red in the chart below.



The chart above shows the six-month moving average of the Chicago Fed National Activity Index. The average improved modestly to -0.20 from -0.28 the month before.

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

Economic releases							
EDT	Indicator			Expected	Prior	Rating
10:00	Markit US Manufacturing PMI	y/y	oct	51.5	51.5	**
Fed speakers or events						
EST	Speaker or event	District or position				
9:00	William Dudley speaks at U.S. Treasury	President of the Federal Reserve of New York				
9:05	James Bullard Speaks on Economy, Monetary Policy	President of the Federal Reserve of St. Louis				
13:30	Jerome Powell Speaks at New York Fed	Member of the Board of Governors				
14:00	Charles Evans Speaks in Chicago	President of the Federal Reserve Bank of Chicago				

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
Japan	Leading Index CI	y/y	Sep	100.9	101.2		**	Equity and bond neutral
	Coincident Index	y/y	oct	100.9	101.2		**	Equity and bond neutral
	Trade Balance	y/y	3Q	498.3 bn	-18.7 bn	366.1 bn	**	Equity bullish, bond bearish
	Exports	y/y	sep	-6.9%	-9.6%	-10.8%	**	Equity bullish, bond bearish
	Imports	y/y	sep	-16.3%	-17.3%	-17.0%	**	Equity and bond neutral
	Nikkei Japan PMI Mfg	y/y	sep	51.7	50.4		**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Composite PMI	y/y	oct	53.7	52.6	52.8	**	Equity bullish, bond bearish
	Markit Eurozone Services PMI	y/y	sep	53.5	52.2	52.4	**	Equity bullish, bond bearish
	Markit Eurozone Manufacturing PMI	y/y	aug	53.4	52.6	52.7	**	Equity bullish, bond bearish
Germany	Markit Germany Manufacturing PMI	y/y	aug	55.1	54.3	54.4	**	Equity bullish, bond bearish
	Markit Germany Composite PMI	y/y	sep	53.3	52.8	53.3	**	Equity and bond neutral
	Markit Germany Services PMI	w/w	oct	54.1	50.9	51.5	**	Equity bullish, bond bearish
France	Markit France Manufacturing PMI	y/y	sep	51.3	49.7	50	**	Equity bullish, bond bearish
	Markit France Composite PMI	y/y	sep	52.2	52.7	52.8	**	Equity and bond neutral
	Markit France Services PMI	w/w	oct	52.1	53.3	53	**	Equity and bond neutral
UK	CBI Selling Prices	y/y	sep	8	5		**	Equity bullish, bond bearish
	CBI Trends Total Orders	y/y	sep	-17	-5	-5	**	Equity bullish, bond bearish
	CBI Business Optimism	y/y	sep	-8	-47		**	Equity bullish, bond bearish
Switzerland	Total Sight Deposits	y/y	oct	518.5 bn	518.2 bn		*	Equity and bond neutral
	Domestic Sight Deposits	y/y	oct	451.3 bn	451.3 bn		*	Equity and bond neutral
AMERICAS								
Canada	Wholesale Trade Sales	y/y	aug	0.8%	0.3%	0.6%	**	Equity bullish, bond bearish

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)	32	32	0	Neutral
TED spread (bps)	56	56	0	Neutral
U.S. Libor/OIS spread (bps)	49	49	0	Neutral
10-yr T-note (%)	1.74	1.74	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	43	43	0	Neutral
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	down			Down
pound	up			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	$51.33	$51.78	-0.87%	Doubts about possible output agreement
WTI	$50.20	$50.85	-1.28%	
Natural Gas	$2.99	$2.99	-0.23%	
Crack Spread	$14.01	$13.79	1.62%	
12-mo strip crack	$15.41	$15.36	0.32%	
Ethanol rack	$1.73	$1.73	0.00%	
Metals				
Gold	$1,264.97	$1,266.46	-0.12%	Strong dollar
Silver	$17.62	$17.55	0.42%	
Copper contract	$208.65	$208.85	-0.10%	
Grains				
Corn contract	$ 351.75	$ 352.50	-0.21%	
Wheat contract	$ 413.50	$ 414.50	-0.24%	
Soybeans contract	$ 1,004.75	$ 992.25	1.26%	
Shipping				
Baltic Dry Freight	842	849	-7	

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 the Midwest and the western region.

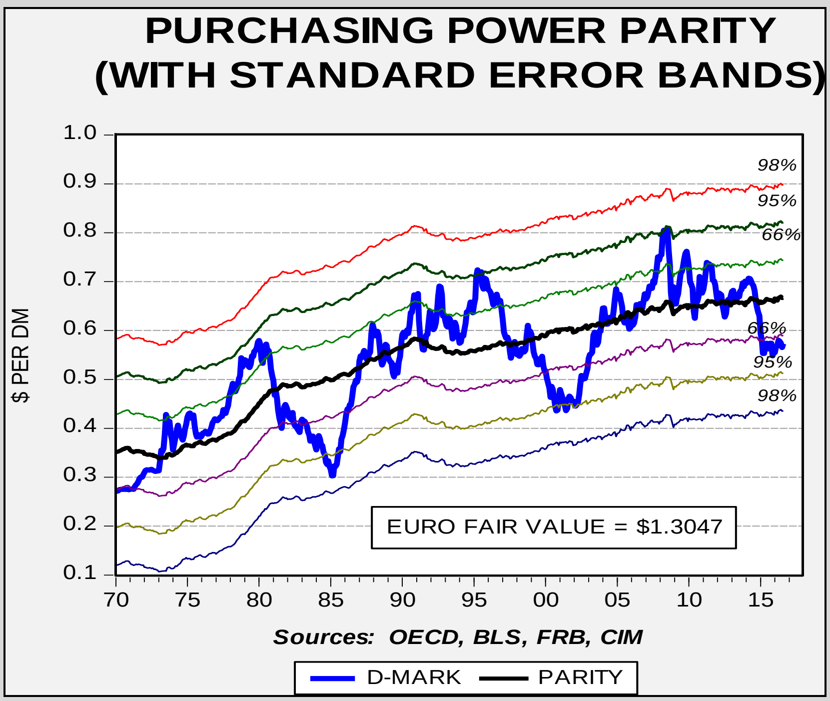
Asset Allocation Weekly Comment

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 21, 2016

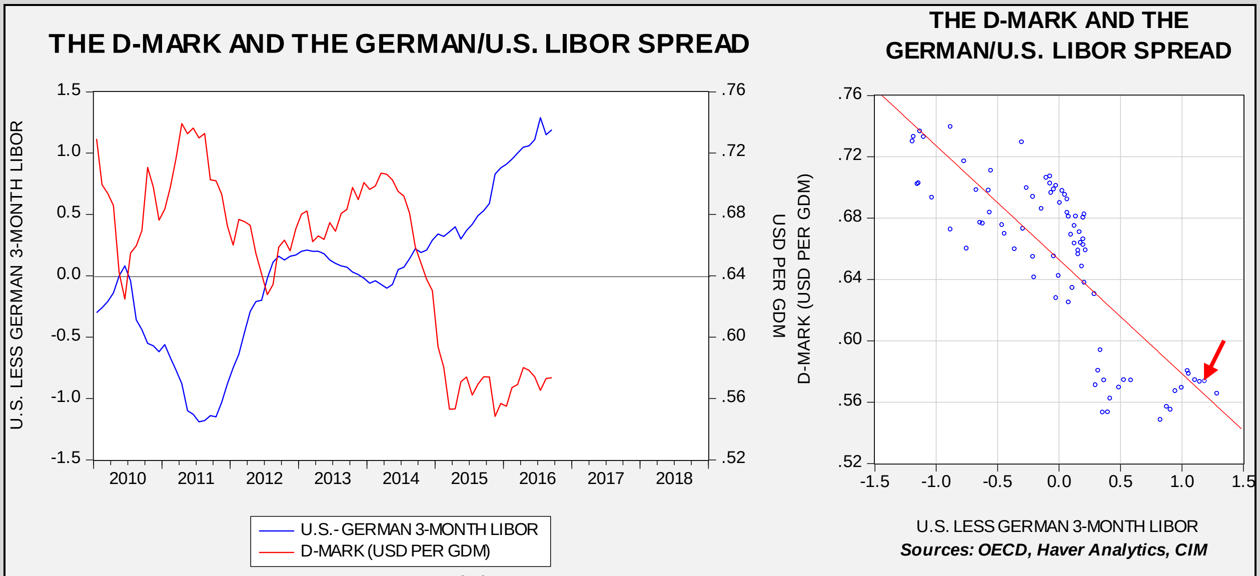
The dollar has been strengthening over the past few weeks; we believe much of this appreciation is due to expectations of tighter monetary policy. Fed funds futures suggest that there is a 60+% chance of a rate hike at the December FOMC meeting. Although the FOMC is divided and there are prominent doves that oppose any tightening, the consensus on the committee seems to be leaning toward a 25 bps increase. However, we also suspect that the next hike (following December) will be delayed for several months. In other words, to placate the doves on the FOMC, Chair Yellen will need to promise a very slow path; to satisfy the hawks, she will need to raise rates in December.

There are at least four different ways to value currencies—relative inflation, relative interest rates, trade performance and relative productivity. As a general rule, if any of the four performed consistently, the other three wouldn't exist. Of the four, relative inflation, so-called "purchasing power parity," is the oldest. Although most of the time it doesn't give strong signals, it does tend to indicate when a currency pair is at an extreme.



This chart shows the purchasing power parity relationship between the dollar and the D-mark. We use the legacy German currency and calculate its currency value based on its conversion rate at the time the euro was introduced. We do this for two reasons; first, we have a consistent inflation history with Germany, and second, Germany is the dominant economy in the Eurozone, meaning the comparison with Germany is likely representative for the leading nations in the Eurozone. In our opinion, parity models are only useful at extremes. When the relationship becomes more than one standard error from parity, it tends to signal a problem with valuation. Currently, the dollar is overvalued by more than one standard error. There have only been two other periods when the dollar was stronger based on this measure. And, we note that this degree of overvaluation has been in place since January 2015, indicating it has been overvalued for a rather long time.

It appears that this deviation from fair value is due to divergent monetary policy. The spread between German and U.S. three-month LIBOR rates has widened in favor of the U.S.



Sources: OECD, Haver Analytics, CIM

Sources: OECD, Haver Analytics, CIM

These charts show the same data in two forms, a simple line graph and a scatter plot. In 2014, as the markets began to discount future FOMC tightening, the LIBOR rate began to rise modestly. At the same time, German rates fell sharply as the ECB tried to address deflation and weak economic growth; in fact, German three-month LIBOR remains in negative territory.

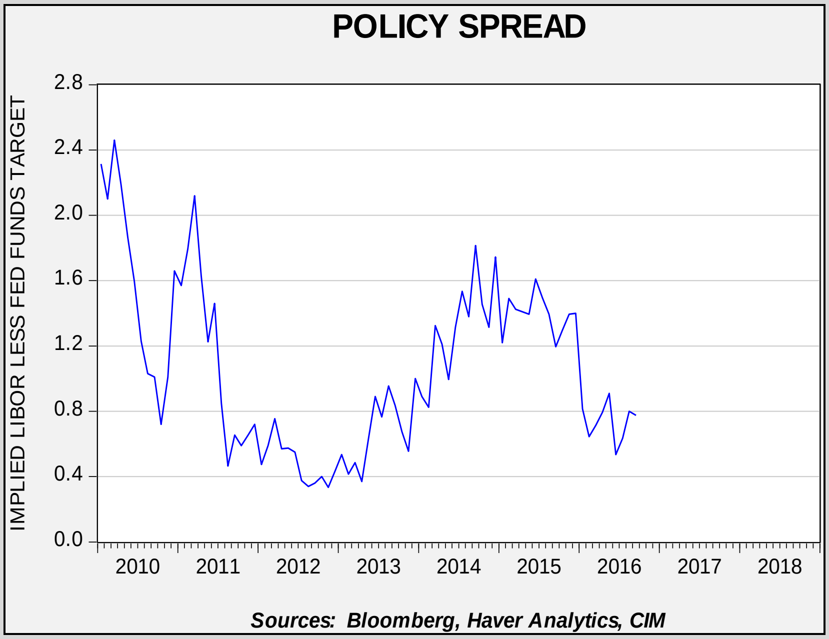
Although interest rate differentials are favoring the U.S., it is interesting to note that the explanatory power of interest rate differentials in the purchasing power parity model is modest at best. In other words, in relation to the past 36 years, the current spread in interest rates should not be having this degree of impact. The current spread is having an expanded impact mostly due to the current level of low rates.[2]

Complicating matters is that the U.S. three-month LIBOR rate has been rising due to changes in U.S. money market regulation. There has been a sustained exodus of liquidity out of institutional prime money market funds and this has led to higher three-month LIBOR rates. We doubt this

[2] Since 1970, the average spread between the U.S. and Germany is 69 bps, suggesting the current spread of 119 bps is rather wide. However the standard deviation is 235 bps, meaning the current spread is within the normal range.

level of LIBOR will be sustained over time, and so the U.S. side of the interest rate spread should ease. In addition, German LIBOR rates have been negative for the past few months. We doubt the ECB will maintain negative rates much longer and instead use QE for monetary stimulus. Thus, we would expect the spread to narrow in the coming weeks.

In addition, there has been a marked change in market expectations toward FOMC monetary policy.

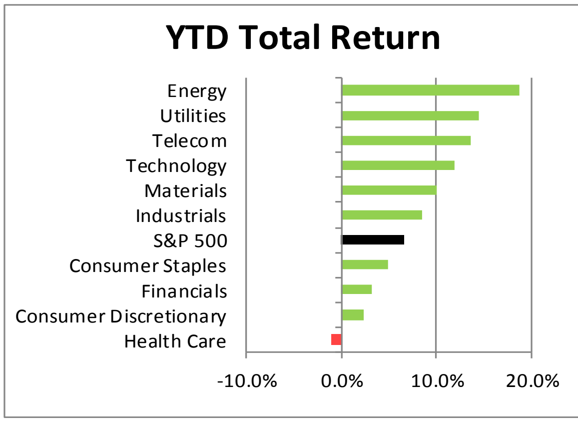


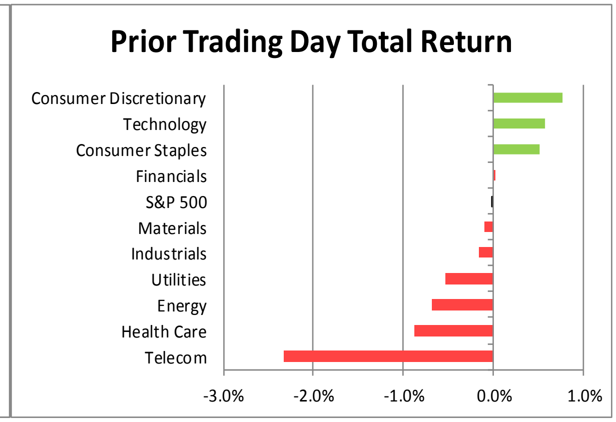
This chart shows the spread between the fed funds target and the two-year deferred Eurodollar futures contract. The latter shows the market's projection for future three-month LIBOR rates. For much of the past two years, Eurodollar futures were projecting a terminal rate for fed funds of 1.50%; that has now declined to around 75 bps. Simply put, the financial markets expect perhaps one or two more rate hikes over the next two years. If this is all we get, we would expect the rate differentials between Germany and the U.S. to steadily contract.

It is worth noting that the current strength of the dollar appears based on the policy spread in 2014-15. If so, once the market adjusts to a lower terminal fed funds target, we would expect some dollar weakness to develop. In the second half of next year, a USD/EUR of 1.25 (a USD/DMK of 0.6410) would be likely. A weaker dollar would be supportive for equities and commodities and bearish for debt and foreign equity markets, although this weakness would be partially offset by stronger foreign currencies. In addition, emerging equities usually strengthen relative to developed markets when the dollar weakens. Thus, in our asset allocation models, we have been slowly adding commodities and emerging equities to portfolios. If the dollar weakens in 2017, we would likely build on these initial positions.

Data Section

U.S. Equity Markets – (as of 10/21/2016 close)

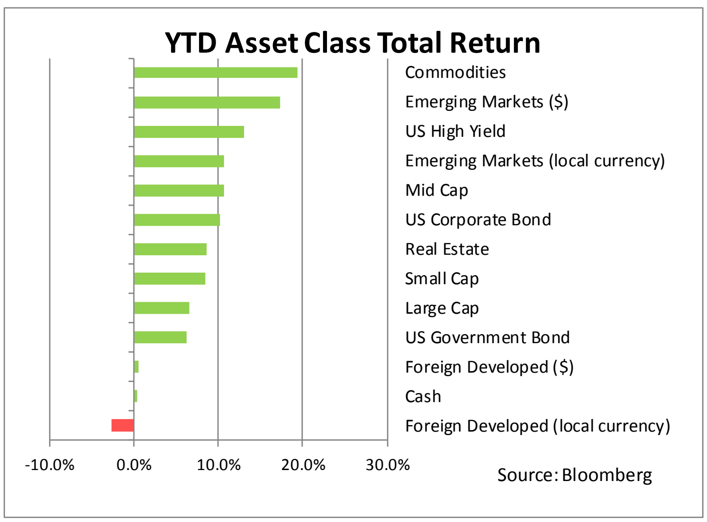




(Source: Bloomberg)

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 10/21/2016 close)

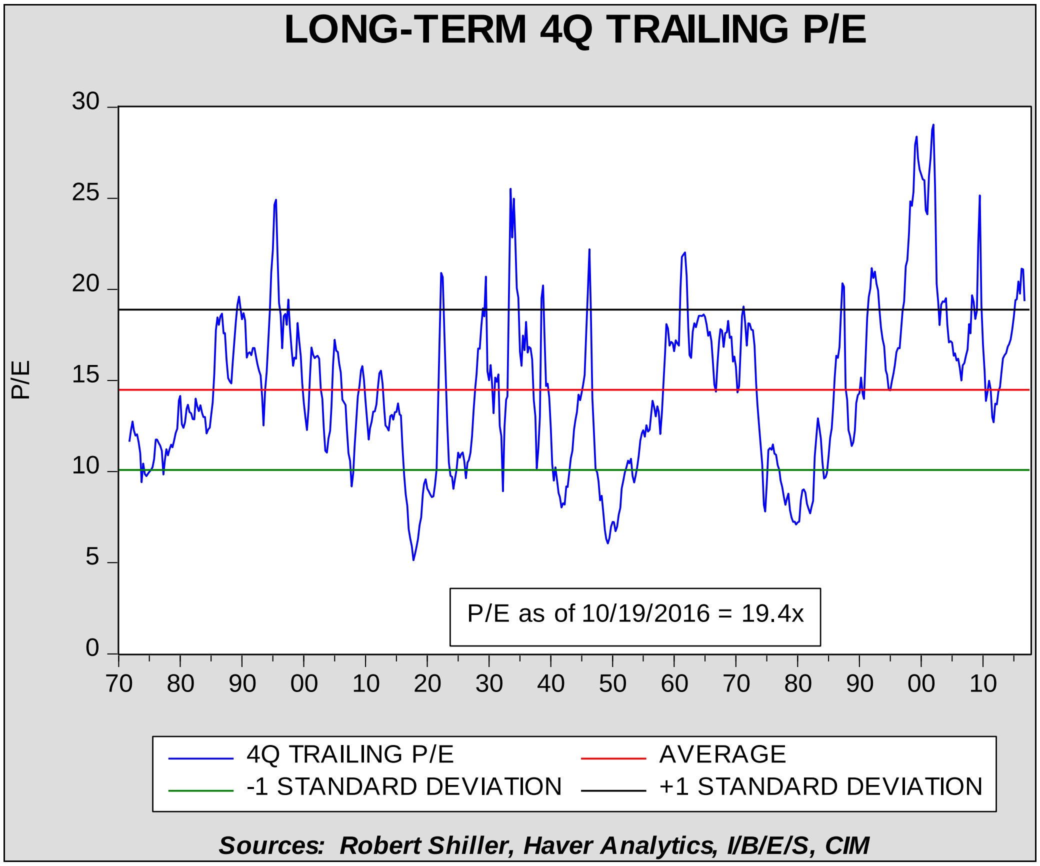


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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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[3] 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.