Confluence Investment Management

Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: October 24, 2017—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index down 0.1%. U.S. equity index futures are signaling a higher open. With 96 companies having reported, the S&P 500 Q3 earnings stand at $32.25, lower than the $32.46 forecast for the quarter. The forecast reflects a 3.7% increase from Q3 2016 earnings. Thus far this quarter, 77.1% of the companies reported earnings above forecast, while 13.5% reported earnings below forecast.

Here is a recap of what we are watching this morning:

Xi elevated: Although the news is rather obscure to Western eyes, "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era" was added to the Chinese constitution today. Such thoughts, such as Jiang Zemin's "Three Represents" or Deng's "Theory on Socialism with Chinese Characteristics," are also part of the constitution. For the first time since Mao, such theories have been added to the constitution for a sitting general secretary. Essentially, this elevates Xi to the same level as Mao in terms of leadership status. Deng Xiaoping wanted to ensure that China would never have to deal with a cult of personality like Mao had created and thus built a consensus leadership structure that elevated the Standing Committee of the Politburo to the leadership of the Communist Party of China (CPC) and the general secretary was *primus inter pares* (first among equals). This pronouncement about Xi suggests that the Deng era is now over. As we noted yesterday, Xi's speech jettisoned Deng's concept of a quiet rise of China; instead, Xi is now signaling that China intends to act as a major power on the world stage. How this actually plays out will be something to watch. History isn't encouraging.[1] We will get the Standing Committee announcement around 11:45 EDT. However, with this announcement, it doesn't really matter who is on the committee. We don't expect a successor to be established and our operating assumption is that Xi will remain general secretary until late next decade, although he will legally be required to give up the president title.

EU labor rule change: Currently, within the EU, a worker from a poorer part of the union can take a job in a richer part but accept less pay than the prevailing wage in the richer nation. These are known as "posted jobs." Posted jobs give "imported" labor an advantage in the richer parts of Europe. The issue has divided the EU. Not surprisingly, the richer nations, led by France, want to cap the time a posted worker can accept lower pay to 18 months. Transportation would not be part of the agreement. Needless to say, the EU's periphery nations aren't happy about the proposed changes, while the core of the EU (Germany, Netherlands, France) support them. Meanwhile, Hungary's PM Viktor Orban praised Central Europe as a "migrant-free zone."

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[1] https://www.amazon.com/Destined-War-America-Escape-Thucydidess-ebook/dp/B01IAS9FZY

Merkel and the U.K.: We noted last week that Chancellor Merkel seemed to turn dovish on Brexit. Germany apparently has discovered that it runs a large trade surplus with the U.K.; some €50.4 bn last year, or about 1.6% of Germany's GDP. This is the largest bilateral surplus with any other nation, even exceeding the U.S. Merkel seemingly wants to avoid a sudden shock of disrupting trade flows. In addition, because of the CDU/CSU's lackluster showing in the last elections, Merkel will be forced to engage in fiscal spending or tax cuts to gain coalition partners. Thus, Germany will be less able to spend on EU goals and thus can't easily fill a gap if the U.K. decides to stop paying its EU contributions. Consequently, Merkel has decided that if the U.K. will pay a fair share of its EU obligations then she will give May some slack in trade negotiations. As a side note, coalition-building fiscal spending will tend to turn the ECB hawkish sooner than it otherwise would have and thus is EUR bullish.

Differences in vision: Over the past week, we have seen two ex-presidents offer thinly veiled criticisms of the current president. The criticism was fairly wide-ranging but included the foreign policy of this president, which can be both interventionist and isolationist at the same time. As we have discussed before, the Trump policy model is Jacksonian.[2] Jacksonians shun the global policing role of a superpower. They only go to war when honor is besmirched or when an existential threat to the homeland develops. Yesterday, at the Hudson Institute, Gen. David Petraeus and Steve Bannon offered dueling visions of American foreign policy. At heart, however, is a key difference of opinion on policy—Petraeus is defending the traditional superpower role while Bannon is wanting to jettison those burdens. We suspect Bannon's position is becoming increasingly dominant.[3]

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	oct	53.4	53.1	**
9:45	Markit US Services PMI	m/m	oct	55.2	55.3	**
9:45	Markit US Composite PMI	m/m	oct		54.8	**
10:00	Richmond Fed Manufacturing Index	m/m	oct	17	19	**
Fed speakers or events						
No speakers or events scheduled						

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

[2] http://www.confluenceinvestment.com/weekly-geopolitical-report-april-4-2016/ and http://www.confluenceinvestment.com/weekly-geopolitical-report-president-trump-preliminary-analysis-november-14-2016/
[3] https://s2.washingtonpost.com/camp-rw/?e=Ym9ncmFkeUBjb25mbHVlbmNlaW0uY29t&s=59ef2311fe1ff6159ed3f073

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	Supermarket Sales	y/y	sep	-0.3%	-0.5%		**	Equity and bond neutral
	Nikkei Japan PMI Mfg	m/m	sep	52.5	52.9		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	sep	113.3	112.4		**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	oct	-1.0	-1.2	-1.1	***	Equity bearish, bond bullish
	Markit Eurozone Manufacturing PMI	m/m	oct	58.6	58.1	57.8	**	Equity bullish, bond bearish
	Markit Eurozone Services PMI	m/m	oct	54.9	55.8	55.6	**	Equity and bond neutral
	Markit Eurozone Composite PMI	m/m	oct	55.9	56.7	56.5	**	Equity and bond neutral
Germany	Markit Germany Manufacturing PMI	m/m	oct	60.5	60.6	60.0	**	Equity and bond neutral
	Markit Germany Services PMI	m/m	oct	55.2	55.6	55.5	**	Equity and bond neutral
	Markit Germany Composite PMI	m/m	oct	56.9	57.5	57.7	**	Equity and bond neutral
France	Markit France Manufacturing PMI	m/m	oct	56.7	56.1	56.0	**	Equity bullish, bond bearish
	Markit France Services PMI	m/m	oct	57.4	57.0	56.9	**	Equity bullish, bond bearish
	Markit France Composite PMI	m/m	oct	57.5	57.1	57.0	**	Equity bullish, bond bearish
	Business Survey Overall Demand	m/m	oct	18	16		**	Equity and bond neutral
	Business Confidence	m/m	oct	109	109	109	**	Equity and bond neutral
	Manufacturing Production	m/m	oct	111	110	110	**	Equity and bond neutral
	Production Outlook Indicator	m/m	oct	31	23	23	**	Equity bullish, bond bearish
	Own-Company Production	m/m	oct	17	18	16	**	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	oct	57.7	57.9		**	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)	136	136	0	Up
3-mo T-bill yield (bps)	108	108	0	Neutral
TED spread (bps)	29	29	0	Neutral
U.S. Libor/OIS spread (bps)	125	125	0	Up
10-yr T-note (%)	2.40	2.37	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	42	42	0	Up
Currencies	Direction			
dollar	down			Down
euro	up			Up
yen	down			Neutral
pound	down			Neutral
franc	down			Neutral

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	$57.80	$57.37	0.75%	OPEC Speculations
WTI	$52.30	$51.90	0.77%	
Natural Gas	$2.98	$2.99	-0.43%	
Crack Spread	$19.01	$19.05	-0.18%	
12-mo strip crack	$20.16	$20.11	0.26%	
Ethanol rack	$1.55	$1.54	0.33%	
Metals				
Gold	$1,278.41	$1,282.27	-0.30%	
Silver	$17.04	$17.09	-0.26%	
Copper contract	$322.35	$318.80	1.11%	
Grains				
Corn contract	$ 350.25	$ 351.25	-0.28%	
Wheat contract	$ 435.25	$ 436.75	-0.34%	
Soybeans contract	$ 988.75	$ 991.00	-0.23%	
Shipping				
Baltic Dry Freight	1586	1578	8	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-0.5		
Refinery run rates (%)		1.45%		

Weather

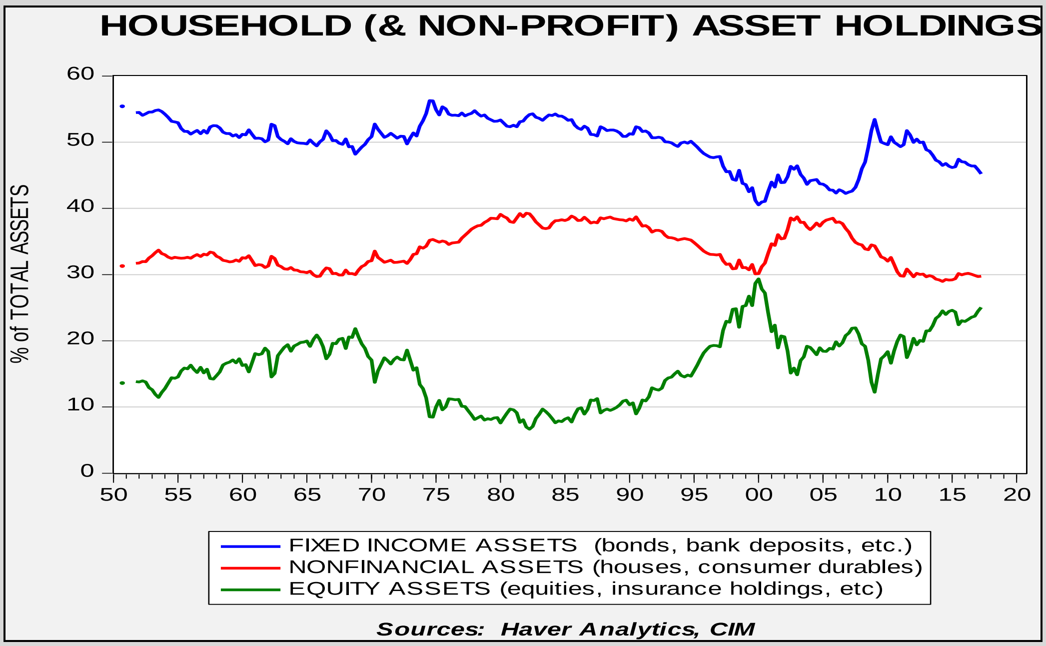
The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmer to normal temps expected for the western region. There are no tropical cyclones or disturbances approaching the Gulf of Mexico at this time.

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.

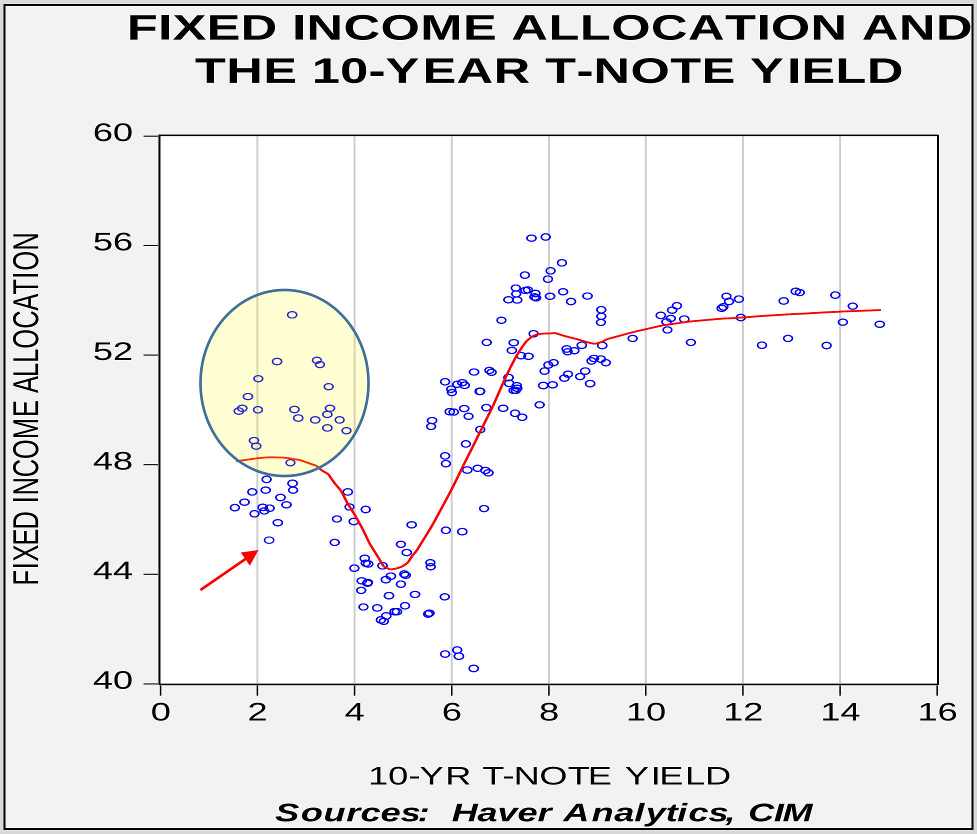
October 20, 2017

The Financial Accounts of the United States (formerly known as the Flow of Funds Report) is published by the Federal Reserve and provides data on the level of financial assets and liabilities by sector. Using this data, we can approximate the average asset allocation of American households over different periods. This accounting of assets is broad; for example, the equity portion includes equities held in defined benefit plans and insurance policies. In addition, the Federal Reserve includes non-profits in its data. In our view, non-profits are not material to the overall calculations.



The data goes back to the 1950s. On average, 50% of household assets are held in some sort of fixed income, while equity assets average 16% and non-financial assets average 34%. A casual observation of the data suggests that allocations to fixed income and non-financial assets (likely housing) are favored during periods of high levels of inflation and elevated nominal interest rates. On the other hand, equity allocations are higher during periods of low inflation and low nominal interest rates. The allocation to non-financial assets rose sharply after 2000 as part of the housing bubble. After the Great Financial Crisis, non-financial asset holdings declined; initially, fixed income rose and equities fell, but since 2010, that trend has steadily reversed as equities have taken a large share of assets.

Some of the gains in the various asset classes have come from price appreciation and other parts from reallocation of assets. It isn't completely obvious how much is coming from which part, although in future reports we will examine this issue more fully. However, the chart does suggest that equities have benefited from being "the only game in town." Historically low interest rates and the aftermath of the housing crisis have undermined allocations to fixed income and housing. Historical patterns suggest that allocations to fixed income don't increase until 10-year Treasury rates exceed 6%.

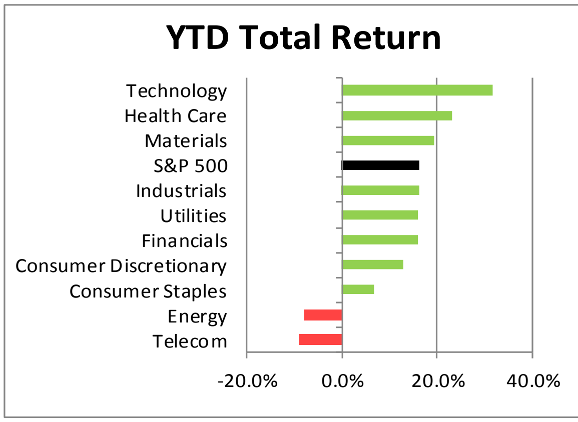


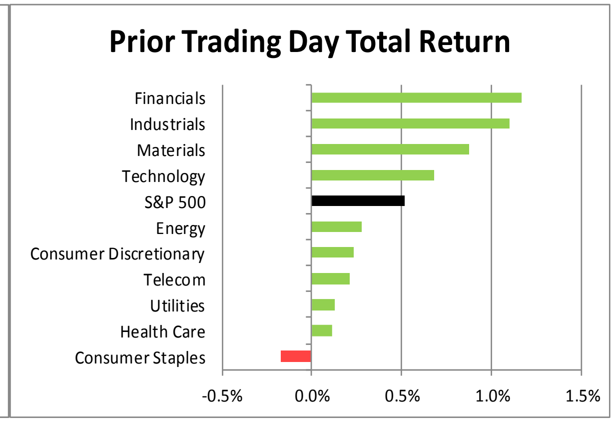
This chart shows a scatterplot of the percentage of total assets held in fixed income and the 10-year T-note yield. We have plotted a nearest neighbor fit study to the data. We have seen high fixed income levels along with low rates (shown in the circle), but these mostly occurred during the Great Financial Crisis. Although the current level of fixed income is low (shown by the arrow), a consistent rise above 50% generally has been seen with interest rates in excess of 6%. Thus, history suggests that it would take a more significant rise in interest rates to trigger a flight to fixed income.

Of course, recessions or geopolitical events could trigger a move out of equities. At 25%, the current allocation to equities is elevated. This level is similar to where it was in Q3 1999 and not far from the peak of 27% in Q1 2000. At the same time, the liquidity does need another place to go. After the 2000 tech crash, the primary beneficiary was housing. We don't expect that pattern to repeat itself. Thus, without an event to scare households out of equities or a sizeable rise in interest rates, equities should maintain their favored status for the time being.

Data Section

U.S. Equity Markets – (as of 10/23/2017 close)

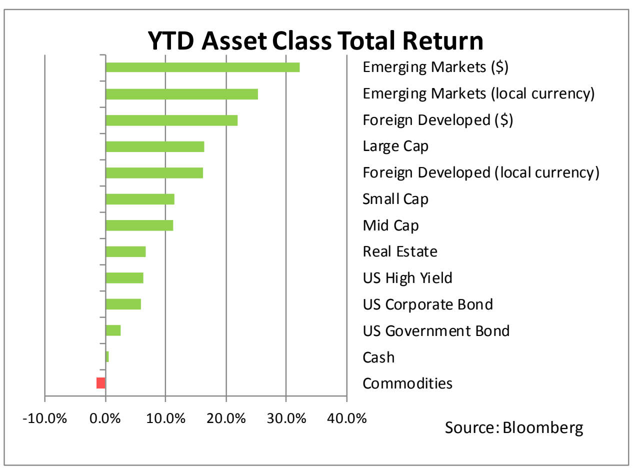




(Source: Bloomberg)

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. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 10/23/2017 close)

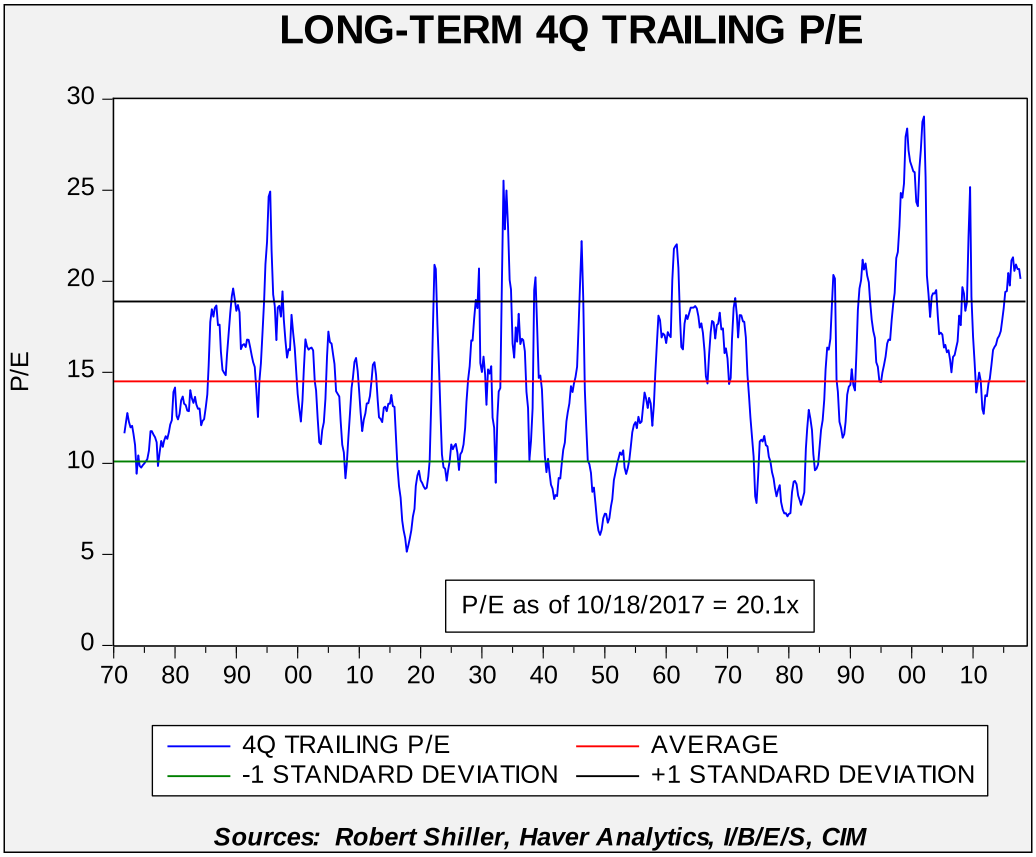


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Bloomberg total return Commodity Index).

P/E Update

October 19, 2017



Based on our methodology,[4] the current P/E is 20.1x, unchanged from last week.

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.

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[4] 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 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 quarters (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.