Daily Comment

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

[Posted: October 25, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.1% 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 up 0.1% and the Shenzhen index down 0.4%. U.S. equity futures are signaling a flat to higher opening. With 122 companies having reported, the S&P 500 Q3 earnings stand at $30.31, higher than the $29.62 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 77.9% of the companies reported earnings above forecast, while 17.2% reported earnings below forecast.

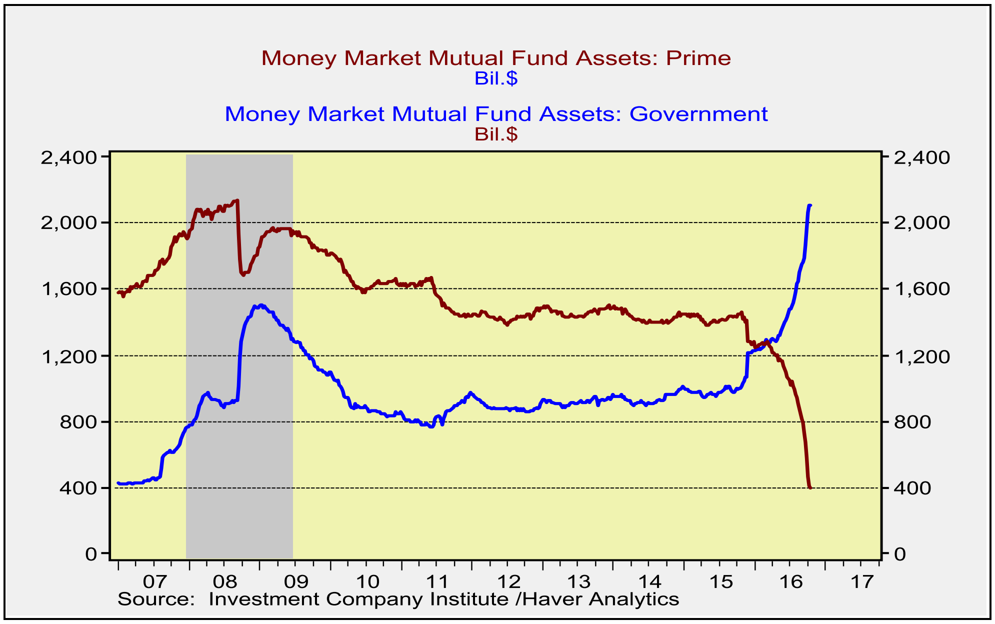
Overnight news flow was unusually low. Earnings are generally coming in favorably as energy companies recover. Equity markets remain relatively firm.

The new money market rules officially went into effect on Oct. 14th and, now that they are in place, the short-term money markets appear to be stabilizing.

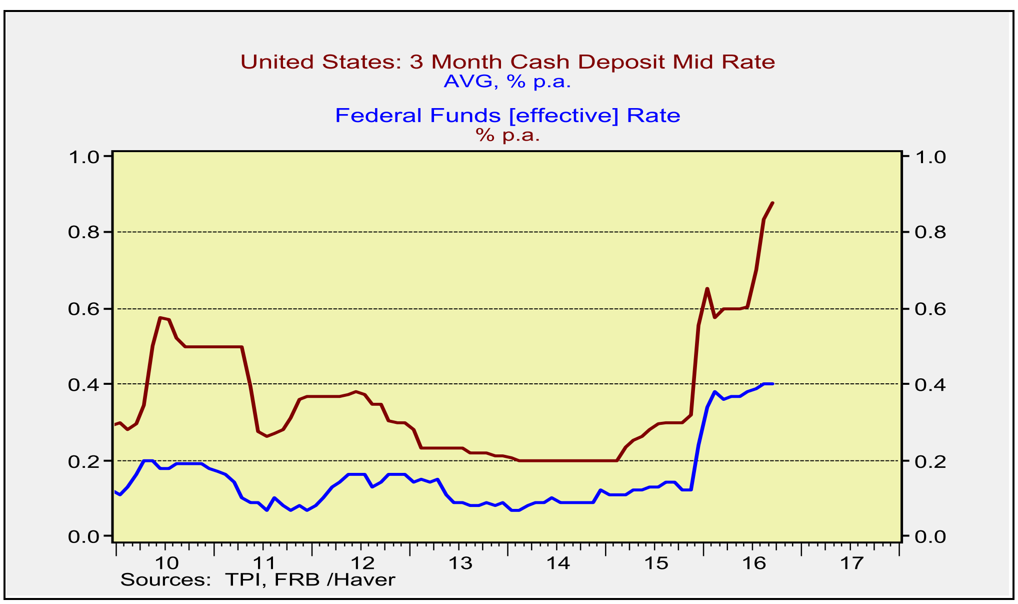
(Source: Bloomberg)

Over the past year, the three-month LIBOR rate has increased by over 50 bps. This is a significant tightening of credit which occurred due to changes in regulation. As we have noted before, there were two notable changes to money market (MMK) rules. First, for institutional prime money market funds, the net asset value (NAV) will no longer be fixed at $1.00 per share (meaning a money market fund could "break the buck"). Second, prime and municipal money market funds can now temporarily halt withdrawals during periods of market turmoil, denying investors access to their cash for up to 10 days.

The new rules have led to a massive shift in money market fund allocation; over the past year, more than $1.0 trillion has exited prime money market funds and shifted to government funds, which do not have a floating NAV or any restrictions on access to cash.



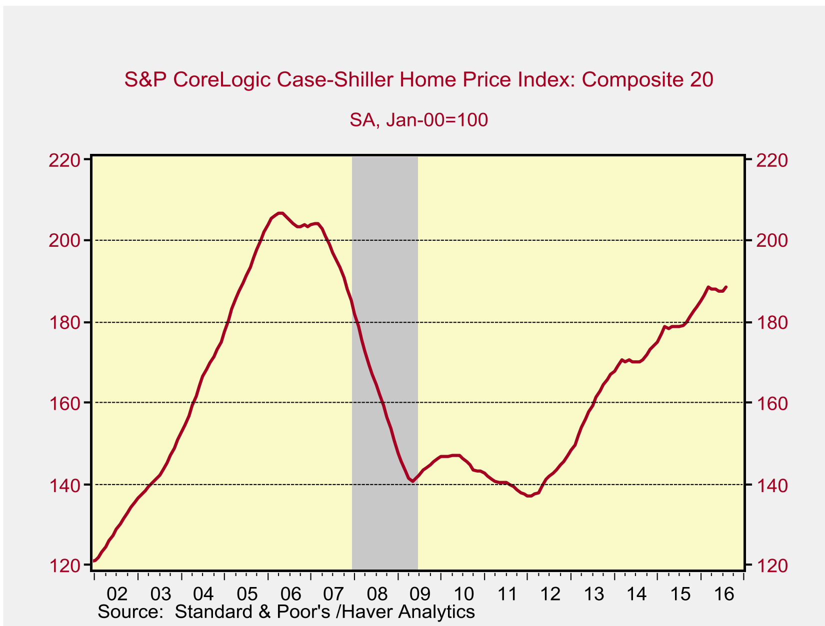
We suspect that the flows away from prime MMK and into government MMK are probably close to ending. What bears watching next will be the impact of projected FOMC tightening in December.



The chart above shows the spread between three-month cash deposit rates and the effective fed funds rate. Currently, the spread is over 47 bps, the widest since the financial crisis. If the FOMC raises rates and this spread is maintained, the market impact will be much stronger than the Fed probably expects. In other words, the rate hike will be larger than it would have been prior to the change in regulation. If, on the other hand, the spread narrows after the Fed raises rates, the market impact from Fed tightening will be less of an issue. This is one of the factors we will be tracking after the next policy tightening. Our expectation is that this spread is a permanent change due to the regulatory adjustments and so borrowing rates have already increased by 30 bps from a year ago.

U.S. Economic Releases

The CoreLogic Case-Shiller 20-city home price index came in higher than expectations in August, rising 0.2% compared to the 0.1% change expected. The prior month was revised to -0.02% from the -0.1% previously reported. Annually, prices rose 5.1%, higher than the forecast of 5.0%.



The chart above shows the house price index level. Prices have been generally trending higher since 2012, but there have been short periods of price moderations. Also, this uptick in HPI indicates that the housing market may be picking up more steam.

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	Consumer Confidence Index	y/y	oct	101.5	104.1	**
10:00	Richmond Fed. Manufact. Index	y/y	aug	-4	-8	*
10:00	IBD/ TIPP Economic Optimism	y/y	sep	47.5	46.7	**
Fed speakers or events						
EST	Speaker or event	District or position				
9:00	Dennis Lockhart Speaks on Community Development	President of the Federal Reserve of Atlanta				

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								
Australia	ANZ Roy Morgan Consumer Confidence	w/w	Oct	113.6	117.8		**	Equity bearish, bond bullish
EUROPE								
Germany	IFO Business Climate	y/y	oct	110.5	109.5	109.6	*	Equity bullish, bond bearish
	IFO Current Assessment	y/y	oct	115	114.7	114.9	**	Equity bullish, bond bearish
	IFO Expectations	y/y	oct	106.1	104.5	104.5	**	Equity bullish, bond bearish
France	Business Survey Overall Demand	y/y	oct	4	12		**	Equity and bond neutral
	Business Confidence	y/y	oct	101	102	102	**	Equity and bond neutral
	Manufacturing Confidence	w/w	oct	102	103	103	**	Equity and bond neutral
	Production Outlook Indicator	y/y	oct	2	7	8	**	Equity and bond neutral
	Own-Company Production Outlook	y/y	oct	9	9	10	**	Equity and bond neutral
Italy	Industrial Sales	m/m	aug	4.1%	2.1%		**	Equity bullish, bond bearish
	Industrial Orders	m/m	aug	16.9%	-10.8%		**	Equity bullish, bond bearish
AMERICAS								
Mexico	Unemployment Rate	y/y	sep	3.9%	3.7%	3.7%	**	Equity and bond neutral
	Bi-Weekly CPI	y/y	oct	3.1%	3.1%	3.1%	**	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	31	2	Up
TED spread (bps)	55	57	-2	Down
U.S. Libor/OIS spread (bps)	50	49	1	Up
10-yr T-note (%)	1.78	1.77	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	45	44	1	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	$51.48	$51.46	0.04%	Doubts about possible output agreement
WTI	$50.66	$50.52	0.28%	
Natural Gas	$2.85	$2.83	0.81%	
Crack Spread	$13.50	$13.56	-0.43%	
12-mo strip crack	$15.05	$15.18	-0.87%	
Ethanol rack	$1.73	$1.73	0.03%	
Metals				
Gold	$1,268.64	$1,264.44	0.33%	
Silver	$17.74	$17.59	0.81%	
Copper contract	$213.45	$209.30	1.98%	
Grains				
Corn contract	$ 349.00	$ 348.25	0.22%	Price taking
Wheat contract	$ 403.25	$ 402.50	0.19%	
Soybeans contract	$ 1,000.25	$ 1,002.25	-0.20%	
Shipping				
Baltic Dry Freight	831	842	-11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.3		
Gasoline (mb)		-1		
Distillates (mb)		-1.5		
Refinery run rates (%)		0.6%		

Weather

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

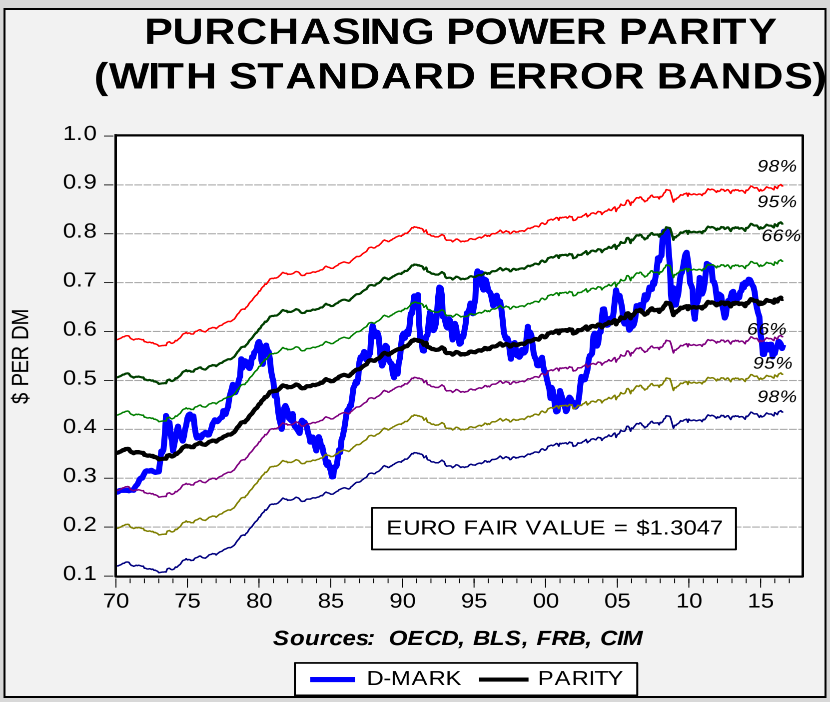
<u>Asset Allocation Weekly Comment</u>

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

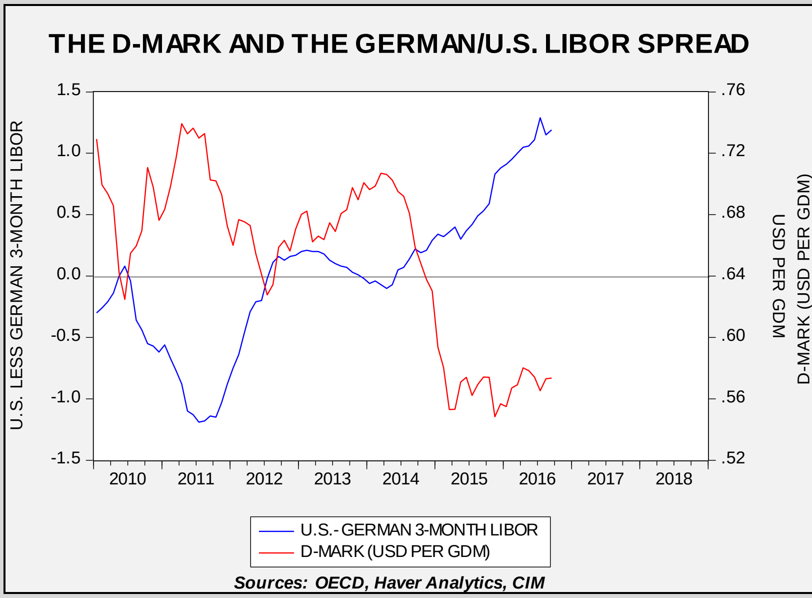
The dollar has been strengthening over the past few weeks; we believe much of this appreciation is due to expectations of tighter monetary policy. Fed funds futures suggest that there is a 60+% chance of a rate hike at the December FOMC meeting. Although the FOMC is divided and there are prominent doves 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.

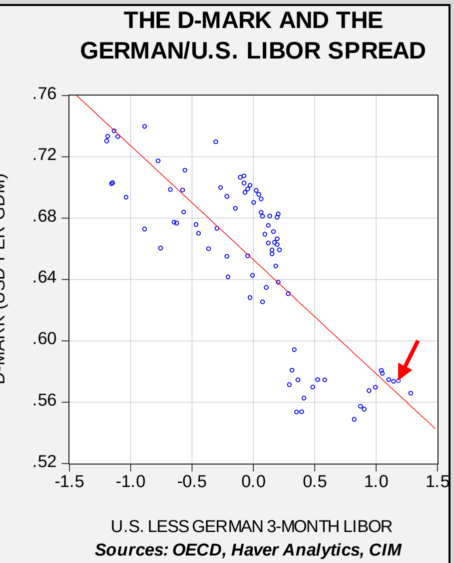
There are at least four different ways to value currencies—relative inflation, relative interest rates, trade performance and relative productivity. As a general rule, if any of the four performed consistently, the other three wouldn't exist. Of the four, relative inflation, so-called "purchasing power 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.





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.

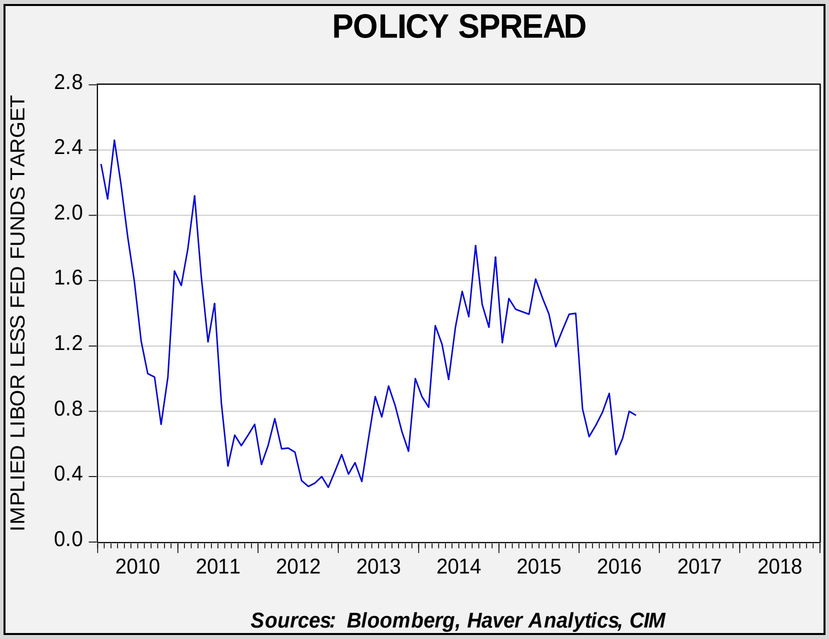
Although interest rate differentials are favoring the U.S., it is interesting to note that the explanatory power of interest rate differentials in the purchasing power parity model is modest at best. In other words, in relation to the past 36 years, the current spread in interest rates should not be having this degree of impact. The current spread is having an expanded impact mostly due to the current level of low rates.[1]

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

[1] 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.

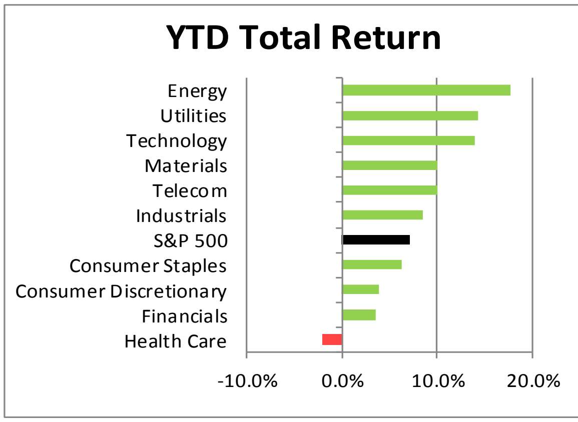


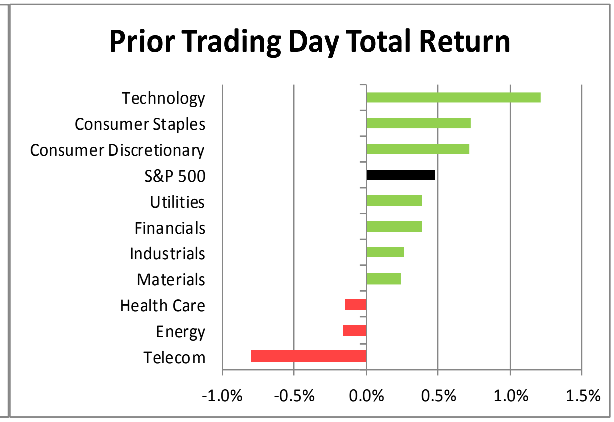
This chart shows the spread between the fed funds target and the two-year deferred Eurodollar futures contract. The latter shows the market's projection for future three-month LIBOR rates. For much of the past two years, Eurodollar futures were projecting a terminal rate for fed funds of 1.50%; that 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 10/24/2016 close)

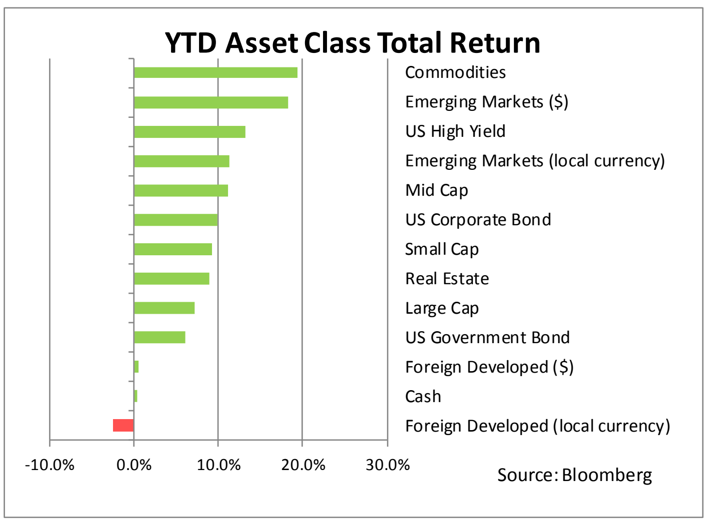




(Source: Bloomberg)

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 10/24/2016 close)

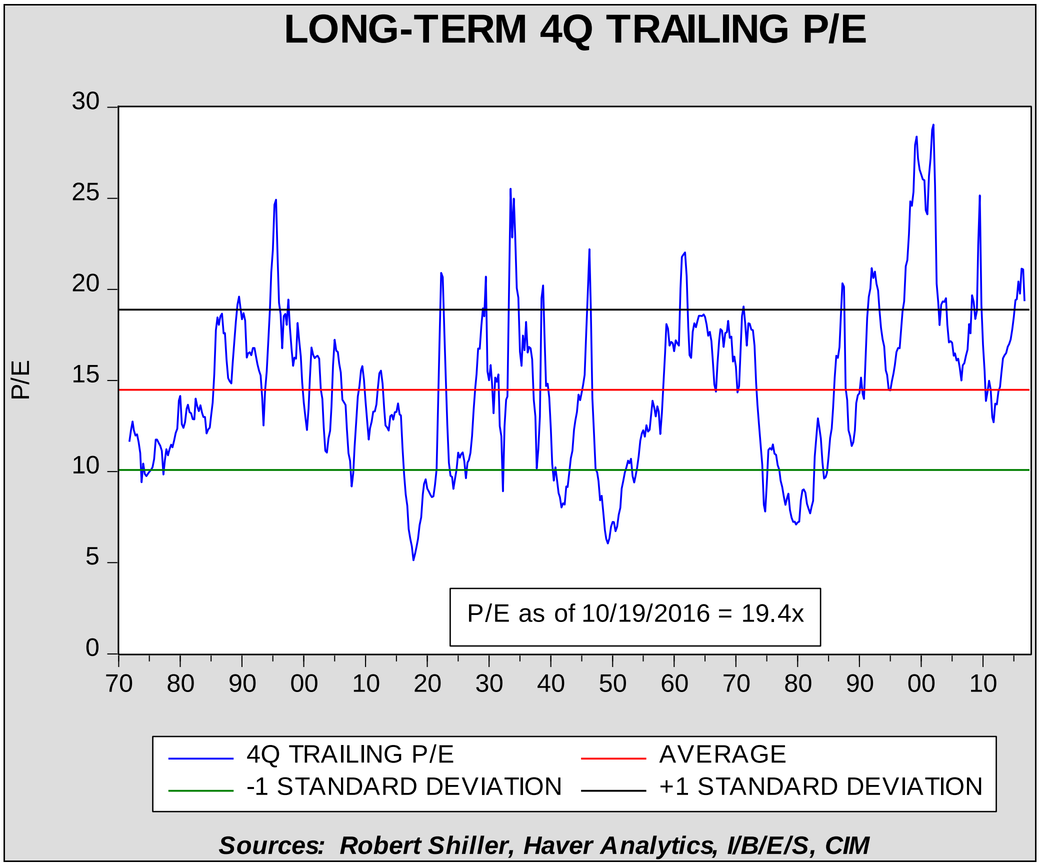


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[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.