Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: December 7, 2015—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 1.7% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.4% from the prior close. Chinese equities are actually higher, with the Shanghai composite up 0.3% and the Shenzhen index up 1.3%. U.S. equity futures are signaling a sideways opening from the previous close.

Before we launch into our comment, we want to note that today is the 74th anniversary of the surprise attack by Imperial Japan on the U.S. Naval base at Pearl Harbor. The attack marked the beginning of direct U.S. involvement in WWII and led to America's acceptance of its new role as global hegemon. The U.S. has been forever changed by the experience; in fact, many of our current political divisions are a direct reflection of the disconnect between the view that America is a small government republic and its global role as superpower, which are inconsistent with one another. These major milestones remind us of the brave U.S. soldiers that fought tyranny and, at the same time, reveal to us how difficult the superpower role is for a democracy and a republic.

There was lots of news over the weekend.

Political News: President Obama, in a rare move, gave a prime time address last night. It was only the third of his two administrations and was in response to the shootings in San Bernardino. The president's poll numbers on this issue show widespread disapproval; a new CNN/ORC poll shows the disapproval of his handling of IS at 64%/33% and his handling of terrorism at 60%/34%. The president correctly noted that Western intelligence has gotten proficient in preventing the mass-killing terrorist events like 9/11 and so terrorists are now left with small-scale "lone wolf" attacks. The good news is that the numbers of casualties are far lower, but the bad news is that these attacks are almost impossible to stop, even with draconian measures to curb civil liberties. It appears that the president's goal was to assure the American people that his policies are the right ones and they are effective. Although we won't know for sure until we get new poll numbers in a week or so, the general tone seen in the media suggests the president's plan failed. Americans want to be assured that the government is "doing something." Calling for further gun control is a *non sequitur*; the guns used were purchased legally in a state with relatively strict laws. In fact, the attacks in France occurred even though that nation has very strict gun control laws. Such attacks have even occurred in Russia, not a state known for respecting civil liberties. In one sense, the president is correct; "doing something" may not really help much and may be harmful. After all, "doing something" has led to the TSA; we don't feel particularly safe by the nationalization of passenger screening, but in the moments after 9/11, we "did something." Politically, the president's stance will tend to support his opposition, probably the most populist among them.

In Venezuela, the opposition won a smashing victory, gaining at least 99 seats compared to 46 for the Chavistas. About 22 seats are still undecided; if the opposition gains two more seats, it will have a three-fifths majority and will be able to force through significant measures. This turn of events will increase tensions in the country, although we would not expect any loss of oil production in the near term.

In France, Le Pen's National Front made record gains in regional elections, winning 29% of the vote on a national level and finishing first in six of 13 regions. The center-right won 26.7%, suggesting that the Socialists are in serious trouble. A second round will be held on December 13th. The better the National Front runs, the more nationalistic France will become.

The Middle East: Turkey has deployed troops toward Mosul, which is partially controlled by IS and by the Kurds. The Iraqi government vehemently protested the decision to move troops into Iraqi territory, but this shows that both Iraq and Syria are becoming fictional states as major swaths of the country are no longer under the control of their respective governments.

In this week's WGR, which will be posted later today, we examine IS's new tactics toward using terrorism against the "far enemy." We also delve into the primary reason why IS survives, which is that no outside power has the goal of removing IS from power as its first priority. In part, this is due to the power vacuum that will be created, and also due to worries that whatever group or nation they support will be harmed by the crushing of IS.

Russia: The weekend *NYT* reported that Putin is facing a rare uprising from truck drivers in Russia who are upset by new tolls that are measured by GPS and collected by miles driven. The truckers are threatening to shut down traffic unless the tolls are removed. As the Russian economy falters, Putin will struggle to maintain order. If he loses the working class, his regime is in major trouble.

Europe: U.K. PM Cameron set off a minor firestorm over the weekend due to his call for the EU to allow nations to permanently stay out of the Eurozone. At the Maastricht Treaty, all members of the EU were eventually required to join the Eurozone; Denmark and the U.K. were granted a "temporary" exemption that looks to be mostly permanent. If the EU cannot get all of Europe within the Eurozone, the single currency will face pressure as nations within it might decide they would be better off outside the Eurozone. Cameron's position is a major threat to the concept of European unity.

U.S. Economic Releases

There are no releases scheduled before we go to print, but for the rest of the day, at 10:00 EST, the November Labor Market Conditions index will be released, with a forecast level of 1.6, unchanged from the month before. At 3:00, the October consumer credit report will be published, with a level of $19.0 bn, down from $28.9 bn the month before. At 12:30, St. Louis FRB President Bullard will give a speech about monetary policy.

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, with red indicating a concerning development, yellow indicating an emerging trend that we are following closely for possible complications and green indicating neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Foreign reserves	m/m	Nov	$3,438 bn	$3,525.5 bn	$3,492.5 bn	**	Equity and bond neutral
Japan	LEI	m/m	Oct	102.9	101.6	102.9	**	Equity and bond neutral
	Coincident indicator	m/m	Oct	114.3	112.3	114.1	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Sentix investor confidence	m/m	Dec	15.7	15.1	17.0	**	Equity bearish, bond bullish
Germany	Industrial production	m/m	Oct	0.2%	-1.1%	0.8%	***	Equity bearish, bond bullish

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)	46	45	1	Up
3-mo T-bill yield (bps)	21	21	0	Neutral
TED spread (bps)	25	24	1	Up
U.S. Libor/OIS spread (bps)	32	31	1	Up
10-yr T-note (%)	2.28	2.27	0.01	Widening
Euribor/OIS spread (bps)	-11	-12	1	Up
EUR/USD 3-mo swap (bps)	35	35	0	Neutral
Currencies	**Direction**			
dollar	up			Rising
euro	down			Falling
yen	down			Falling
franc	down			Falling

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	Cause/ Trend
Energy markets				
Brent	$ 42.49	$ 43.00	-1.19%	OPEC effectively abandons production quota
WTI	$ 39.21	$ 39.97	-1.90%	
Natural gas	$ 2.13	$ 2.19	-2.56%	
Crack spread	$ 14.47	$ 14.39	0.59%	
12-mo strip crack	$ 15.45	$ 15.56	-0.73%	
Ethanol rack	$ 1.64	$ 1.64	-0.05%	
Metals				
Gold	$ 1,062.92	$ 1,062.11	0.08%	Awaiting Fed meeting
Silver	$ 14.18	$ 14.11	0.48%	
Copper contract	$ 207.00	$ 206.10	0.44%	
Grains				
Corn contract	$ 377.00	$ 377.00	0.00%	
Wheat contract	$ 481.00	$ 478.75	0.47%	
Soybeans contract	$ 894.75	$ 897.50	-0.31%	
Shipping				
Baltic Dry Freight	574	590	-16	

Weather

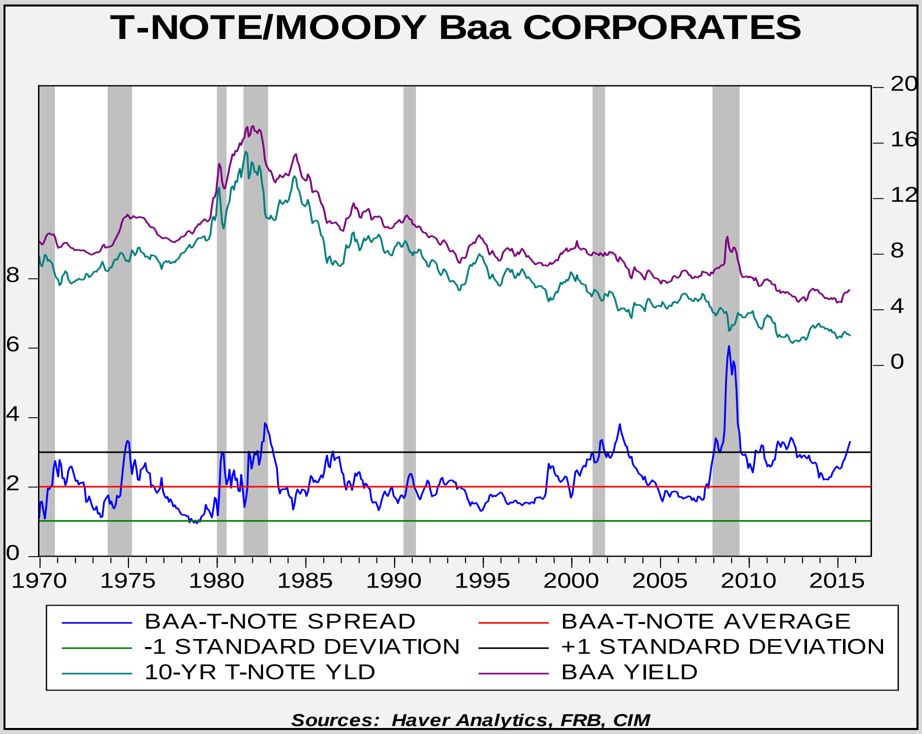
The 6-10 and 8-14 day forecasts call for warmer than normal temps for the eastern two-thirds of the country. Precipitation is forecast for most of the country.

Weekly Asset Allocation Commentary

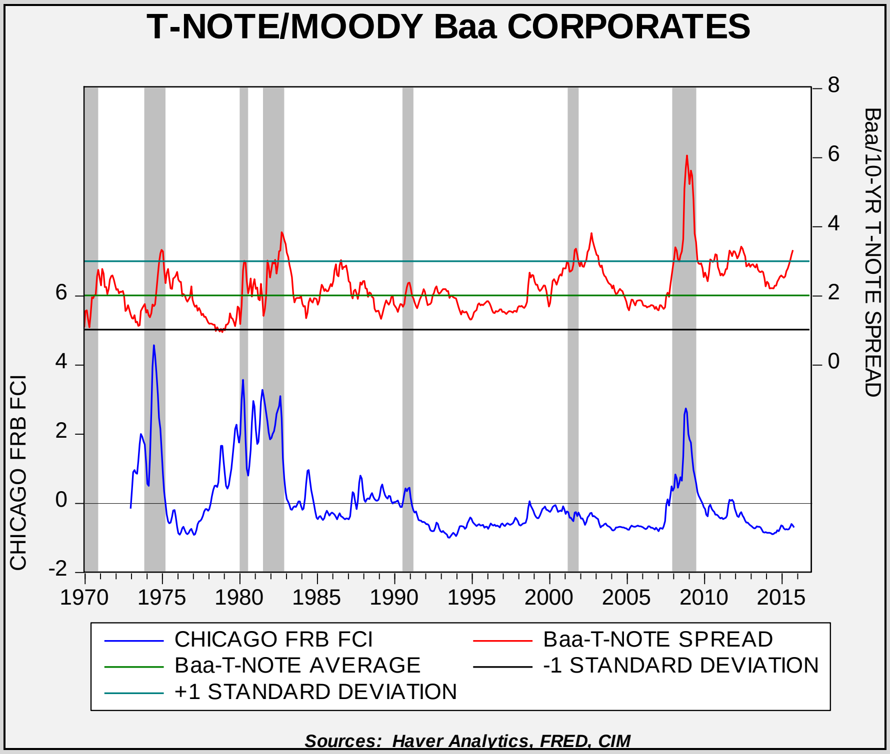
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. This year, we have started reporting asset allocation thoughts on a weekly basis, updating the section every Friday.

December 4, 2015

In our fixed income allocations we have favored corporate bonds over Treasuries. This position is partly based on the relative yield advantage corporates offer and on the belief that continued accommodative monetary policy will keep credit risk low. However, over the past 18 months, credit spreads have steadily widened.



This chart shows the yield on 10-year T-notes and Moody's Baa corporates. The spread between the two yields is shown on the bottom of the chart, with average and standard deviation lines calculated from 1921. Currently, spreads are above one standard deviation. The key question is whether current spreads are a buying opportunity or a warning of worsening credit problems?

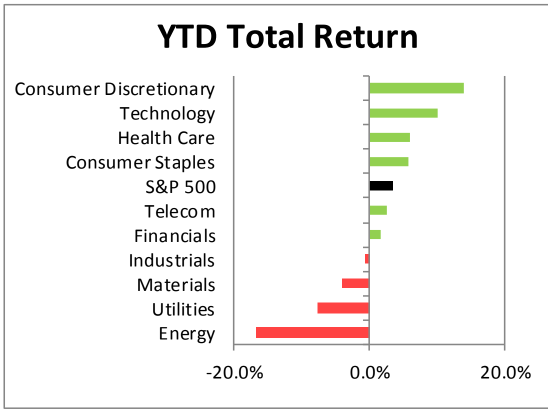


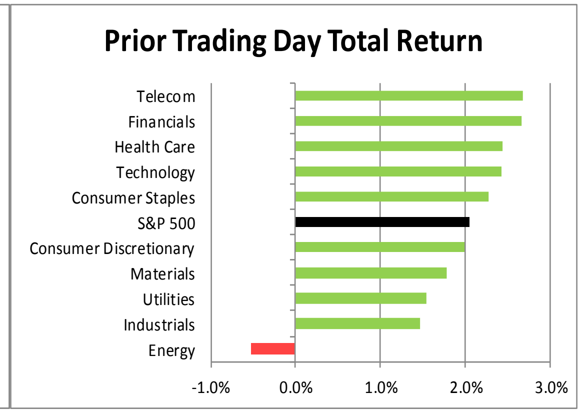
One way to address this question is to compare spread levels to financial stress. The top half of this chart shows the spread from the first chart, while the lower half is the Chicago Federal Reserve's Financial Conditions Index (FCI), a measure of financial stress. Since stress indices usually contain credit spreads as one of their components, it isn't surprising the two series tend to be related. However, the FCI also includes various financial market volatility indices and the level of rates as well. As the upper series suggests, the current spread level is rather unusual and, outside of the 2008 Financial Crisis, should offer investors a better yield without much risk of further spread widening. In fact, in 1983 and 2001, the combination of a wide spread and low financial stress led to narrowing spreads in the subsequent months.

Although there isn't a long-term relationship, currently, the widening of credit spreads appears to be closely tied to the decline in oil prices, which began in the summer of 2014. Fears about credit problems emanating from the oil industry are the likely culprit. Although we are concerned about weakening oil prices in the first half of next year, as we noted last week, Saudi Arabia may be easing its position on expanding its market share, meaning that OPEC may take steps to stabilize oil prices in the coming months. If so, credit spreads will likely narrow next year. In any case, we believe that current spreads offer investors an attractive opportunity, and current conditions would not warrant further widening.

Data Section

U.S. Equity Markets – (as of 12/4/2015 close)

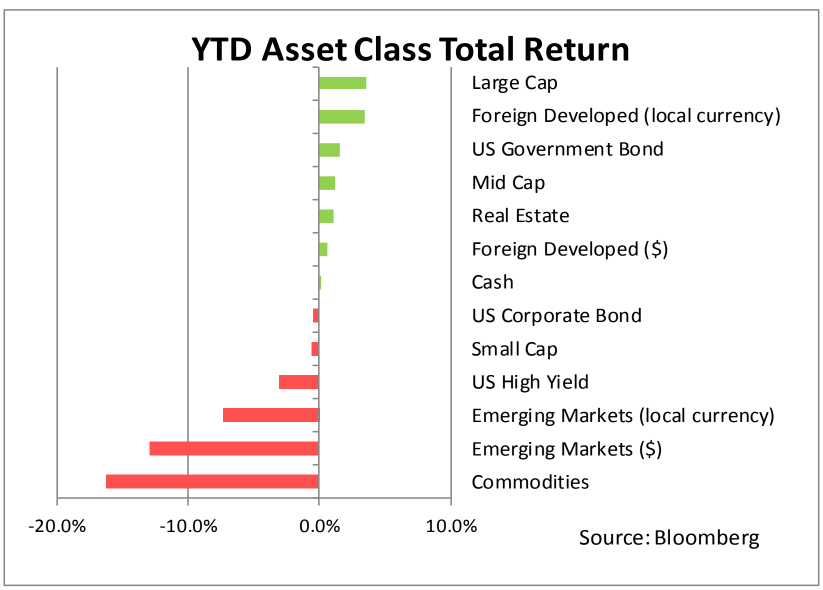




(Source: Bloomberg)

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 12/4/2015 close)

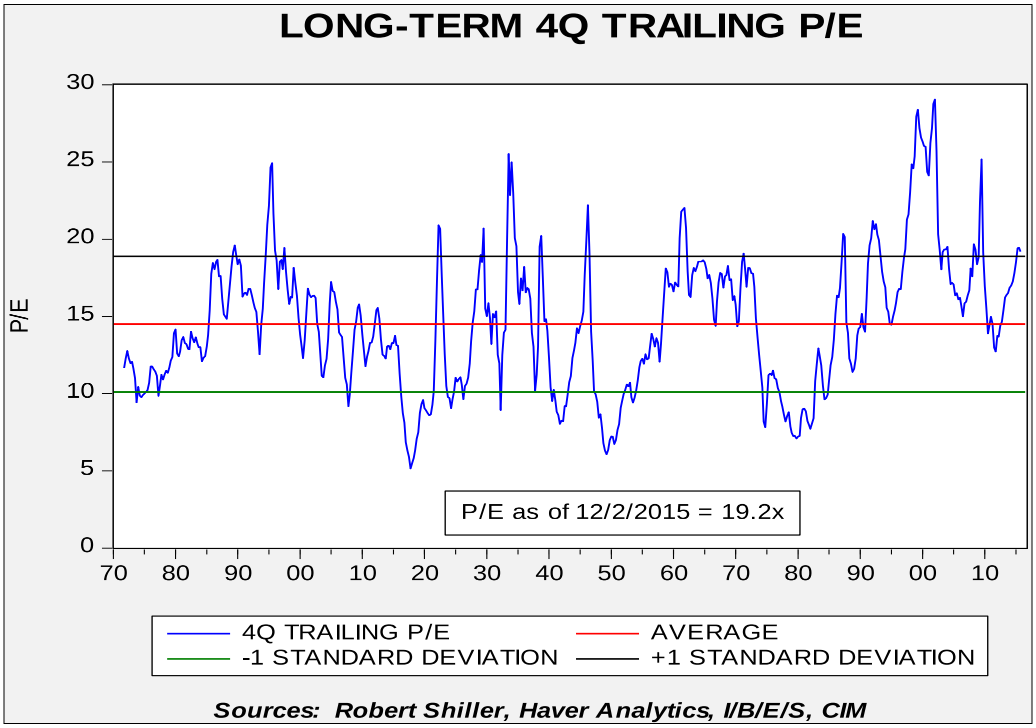


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 3, 2015



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.

Based on our methodology, the current P/E is 19.2x, steady from last week. The multiple remains elevated, which is a concern, but not so high as to suggest a turn is imminent.

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.